

The Indian Budget 2015: the long election campaign

11 March 2015

Summary

At its heart, the February Indian budget was a calculation that a renewed pace of growth buys the Modi government time to get its political house in order to deliver further structural reforms. It was a political budget sustaining government welfare support while aiming to channel it more effectively. Insofar as it was a budget for investors, it focused on infrastructure investment and measures to improve ease of doing business, without ultimately dealing with some of the knottier structural challenges, like land reform. It was a budget that reflected the political realities of the Modi government: high and binding voter expectations and a government whose power to govern is weaker than an historic election win would suggest.

Narendra Modi's election landslide in May 2014 swept the BJP into the first majority government in India in thirty years. His government came to power with the promise of unlocking the economic growth potential of the country for all levels of society. It was a promise that captured the votes of a vastly diverse electorate. His first full budget, delivered at the end of February, reflected the two key features of that historic win.

The first is the voters that delivered it. In May, the BJP secured its victory by broadening its support from its traditional base. Their supporters included many of the 150m first-time voters, with particularly strong support among 18-22 year olds. A vote for the BJP was aspirational: taken as a whole, with 70% of the Indian population under thirty, these were voters low on patience

and high on expectation. Modi won heavily across both rural and urban areas and 45 out of 87 seats with the highest concentration of Muslim voters. While the margin of his victory in 2014 gave him a huge mandate, the breadth of this constituency is proving both a strength and a challenge for Modi's reform agenda.

The second is the fact that the size of this win at the national level masked a governing challenge for Modi. Many of the structural reforms the Indian economy need - such as to tax and labour - require a dual approach at the centre and state levels. While he won 282 out of 542 parliamentary seats in the lower house of the Indian parliament, the BJP controls only eight out of 29 states and is far from a majority in the upper house. This was highlighted in the December session of parliament, where

his legislative agenda in critical areas from land acquisition, to mining and insurance, was derailed by a collection of opposition and state parties. Modi resorted at the time to procedural tools to nudge each measure forward, but each will still require conversion into laws in this parliamentary session.

Elections since October 2014

State	Date	Winner
Maharashtra	October 2014	BJP
Haryana	October 2014	BJP
Jharkhand	December 2014	BJP
Jammu and Kashmir	December 2014	J&K Peoples Democratic Party
Delhi	February 2015	AAP

Looking ahead

State	Date*	Lok Sabha Seats	Rajya Sabha Seats
Bihar	November 2015	40	16
Puducherry	January 2016	1	1
Assam	April 2016	14	7
Tamil Nadu	May 2016	39	18
West Bengal	May 2016	42	16
Kerala	May 2016	20	9
Goa	March 2017	2	1
Punjab	March 2017	13	7
Uttar Pradesh	May 2017	80	31
Uttarakhand	July 2017	5	3
Manipur	October 2017	2	1

*exact dates will be announced closer to the elections

This continued weakness in the upper house and at the state level meant that campaigning politics did not end for Modi with the May 2014 national election. Since then, he has been focused on gaining ground at each state election. The budget reflected this. After winning state elections in the autumn in Haryana and Maharashtra this momentum was knocked in February, when the BJP suffered its first electoral defeat in Delhi, losing to the Aam Aadmi (“Common Man”) Party. While the AAP is a local Delhi phenomenon, the cause of the ‘common man’ had echoes across the country and for the BJP and Modi appeared to challenge political ground they had claimed for themselves. Regaining momentum in the next state elections - particularly states with large allocations of parliamentary

seats, notably the poorer states of Bihar this year and West Bengal in early 2016 - will be a key focus in the coming months. This budget was in part a prospectus for those states.

A pre-election post-election budget

Some consequences of this political positioning run through the budget. The most obvious is perhaps the choice of a slower fiscal squeeze. Helped in part by a recent change to the measurement of GDP by the Indian Ministry of Statistics, which bumped up overall growth rates, Finance Minister Arun Jaitley settled on a slower pace of fiscal consolidation, targeting a deficit of 3.9% of GDP in 2015-16 from 4.1% now, on a trajectory to 3% in 2017-18. The external environment is helping to ease the fiscal position. The fall in oil prices has halved the subsidy on fuel and contributed to a healthier - if not healthy - external balance of payments and a strengthening and less volatile rupee. It has also contributed to a sharp fall in inflation with the benchmark consumer price index, falling to 5.1 percent in January, well below the 8 percent target. This economic environment is starkly different the one encountered by the Congress-led UPA government the BJP so clearly defeated in 2014.

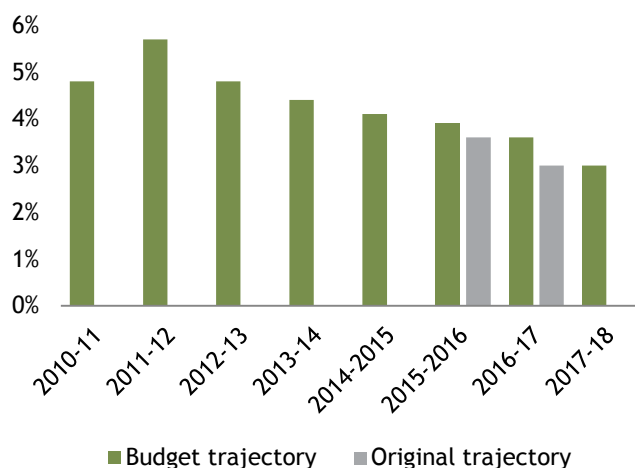


Fig 1: Central government deficit (% of GDP)
Source: Indian Ministry of Finance, IMF (CPI)

Nevertheless, Jaitley is calculating on an 8% rate of growth in 2015 to make his numbers add up and to allow him to do relatively little to cut politically sensitive spending. The government’s subsidies bill is largely unchanged, aside from the fall in fuel spending, which is a function of falling oil prices. Jaitley’s approach to other subsidies - principally food and fertilisers - was focused on reducing the leakages, not levels. He wants to target subsidies better so they benefit the poorest, while reducing

waste and steadily withdrawing support from the more affluent as growth returns.

The key to increasing growth is further stimulating investment and this was the spending priority for Jaitley, who announced a 25% uplift in infrastructure investment this year, with spending on roads to double, an increase in railway spending by a third, and a plan for five huge 4,000 megawatt power plants. He also announced plans to create a new national infrastructure investment fund, suggesting public-private partnerships will be a cornerstone of the government's investment approach. To encourage more formal savings - which can potentially be channelled into infrastructure - he announced plans for a universal social security system, with basic health insurance and pensions, while incentivising private savings in formal financial products. What was not addressed as ambitiously as many expected was the public banks, which will be critical to the delivery of infrastructure investment. While these received new capital in the budget, the injection fell well below the level analysts estimates will be required to address the levels of non-performing loans on the books, and to strengthen their positions sufficiently to stimulate credit growth.

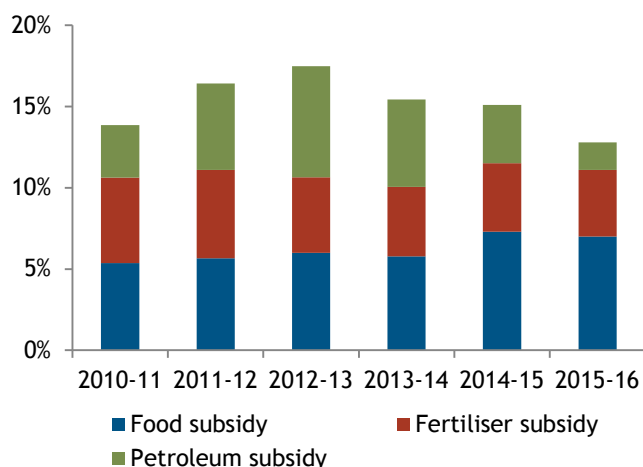


Fig 2: Subsidy items as share of total central government expenditure
 Source: Indian Ministry of Finance, IMF (CPI)

On the revenue side, Jaitley focused principally on tax rationalisation, and overwhelmingly on the wealthy and the scope for tackling black money. There were proposals to go after wealth held offshore and punitive measures for those individuals and companies involved, while increasing a levy on the superrich to replace an easy-to-avoid wealth tax. Combined, the measures sought to underline the BJP's credentials as a party for all, not just

the well-off, to claim back some of the political ground lost in Delhi to Aam Aadmi (Common Many) Party. He also announced a reduction in corporation tax, from 30% to 25% over four years, starting next year, coupled with the removal of a web of tax exemptions which make the effective rate around 23% at present. If executed well, this may not change the sums a huge deal, but will simplify the convoluted Indian tax environment and make it easier for businesses. For now, however, Jaitley stayed away from addressing the sensitive question of India's exceptionally narrow (and shallow) tax base.

Political space

Modi and Jaitley's calculation is that eighteen months of reinvigorated growth will buy them time and win them further support for their governing agenda. Much of this calculation rests on achieving healthy growth targets and the ability of the system to start to deliver. This explains why the first nine months of their government have been focused on winning state elections and reforming the tools of government, principally through cutting red tape and moving to removed bureaucratic hurdles.

A key test of this ability - and one which would materially benefit business - remains the introduction of a Goods and Services Tax (GST), essential for creating a single Indian market. Jaitley's budget reaffirmed the commitment to introduce GST by April 2016. This would be a major achievement and transformative for domestic and foreign investment.

Negotiations with the states on GST however have been, and will continue to be, sensitive. This in part explains why there were measures in the budget focused on channelling more funds to the states, including a greater share of tax revenues and the proceeds of natural resources. At the same time, measures of support for farmers and other poorer constituents were maintained or increased - key in poorer states like Bihar. In the BJP's political strategy, these are not merely political give-aways. Boosting and sustaining growth levels - especially in the poorer states - will be vital to protect the political space the BJP needs to push through more difficult reforms in the future.

Other such structural reforms have been postponed. It is less than clear, for example, that the government will be able to secure land acquisition reforms in this parliamentary session, given their sensitivity in rural constituencies. Given the existing laws have in effect halted land

purchases across the country, such reforms will be essential if investment in infrastructure, natural resources, power, and manufacturing is to rise. The government may be able to pass laws to partially open up the insurance sector to foreign investment in this parliament - and it will be an important signal of their ability to deliver legislation if they do - but the more contentious issues may have to wait until they have secured greater representation at a state level.

Modi and Jaitley have encouraged high expectations both internally and externally and this budget was a further step in meeting them. But the budget serves as reminder of the Modi's administration's structural limitations as well as its ambitions. Modi's broad political base is a liability as well as an obvious asset and his weakness at the state level and the

challenge of pushing legislation and reform through the Indian system remain his essential problem. Modi is calculating that he has the capacity to be a two-term Prime Minister: one term to deliver the legislative and political platform for far-reaching change; one to implement transformative policies. This is an incremental strategy by necessity and design, and one in which domestic political calculation has primacy. External observers will have little choice but to be patient.

For an in-depth analysis of the political and economic prospects for India under the new government, read [Global Counsel's India Outlook](#) published in November last year.

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