INDIA'S BUDGET SETS FINANCIAL TRAJECTORY FOR NEXT FISCAL YEAR

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Over the last few weeks, while we were inundated by news related to the changing of the guard in Washington, D.C., another interesting development was happening some 7,500 miles away from D.C. in New Delhi, India. The Modi government released its annual budget on February 1, chalking out its financial road map for the next fiscal year.

Below, I present a brief look at India's financial path over the next year, its economic implications in the long run, the state of corporate India, and why we think investors should not miss out on the potential growth that India has to offer.

Quick Summary: Fiscal Expansion and Tax Cuts

Riding on an improved tax collection base because of the recent demonetization exercise in November, the government did not disappoint, in our view. There is a significant focus in the government's budget to increase infrastructure spending through higher capital spending on roads, railways, metro projects and ports. It also includes tax relief for individuals and small and medium enterprises (SMEs). Continuing its agenda to curb the parallel untaxed economy, the government also announced steps to further plug loopholes that allow tax evasion. And, finally, it will offer incentives toward the digitization of the overall economy and financial transactions.

Overall, the government seems to have maintained a fine balance of keeping up with investors looking for economic prudence as well as the general public looking for relief on taxes. The budget seems to be positive for most sectors and seems to be focused on supporting infrastructure and consumption.

Key Broad Directions and Economic Benefits[1]

- Significant boost to fiscal spending, especially in rural areas

- 25% increase in planned government socioeconomic schemes aimed at rural areas.

- Lower income tax rates

- Income taxes on the lowest income tier (up to 500,000 rupees or $7,350 per year) cut from 10% to 5%.

  - On the other hand, the government also imposed a 10% surcharge on taxes on individuals with annual income between 5 million and 10 million rupees (about $75,000–$150,000 per year). This increases the tax rate of this group to around 34%, up from around 31%.

- Lower tax rates for smaller companies

  - SMEs saw their corporate tax rate cut by 5%.

- Boost to spending on infrastructure

  - 25% year-over-year growth in allocation to capital expenditures.

  - 20% of the total budget deployed only for infrastructure-stimulating projects, such as railways, roadways, airports, power, etc.

  - Budgetary allocation for highways has been hiked by 13%, while that for railways increased by 8%

- Push for digital economy

  - Multiple steps to incentivize cashless payments and keep up the momentum post-demonetization.

  - Various government apps (BHIM, Aadhaar Payment , etc.) to facilitate cashless transaction of social welfare schemes.

- Increased transparency of political funding

  - Limiting individual cash donation to 2,000 rupees from 20,000 rupees without any declaration.

Economically speaking, spending by the government on various social welfare schemes in rural areas and income tax reductions will boost consumption, in our view. This is good for consumer companies that could benefit primarily from increased spending by individuals who now have more money in their pockets. It's important to note that in India, consumption accounts for around 60% of headline GDP.2 In other words, by attempting to boost consumption, the government could accelerate the overall economic engine at a faster pace.

Corporate Tax Cuts

There are around 700,000 SMEs in India, and they employ over 40% of India's workforce while contributing 40% of India's exports and 45% of its manufacturing output.[3] Reduction by 5% in taxes for SMEs could have a cascading effect, as these enterprises invest to grow, employ more, and therefore increase economic activity.

Infrastructure

Up to 90% of foreign investment is now allowed directly, without government approvals for any project. As the government pushes to spend more on infrastructure, it will also create tailwind opportunities for private investors to invest in this sector.

Finally, despite increased spending in the above segments, the government emphasized its plan for fiscal consolidation, with the fiscal deficit declining from 3.5% of GDP in the previous year to 3.2% for the next fiscal year.[4] This is largely due to the increased tax base after demonetization, which helped the government spend more next year without falling behind on its fiscal targets.

Outlook for Investors

So far, almost 70% of companies in the MSCI India Index have reported earnings for the previous quarter, with overall profits up 1% year-over-year. Within the reported universe, 60% (24 out of 40) reported earnings either in line with or better than estimates. Broad consensus expects MSCI India's third-quarter earnings per share to rise about 8% year-over-year.[5] This is despite a temporary growth scare that the demonetization policy created.

Thus, what we see right now in India is the following: Policy makers are not shy about taking bold steps for long-term growth. A central bank that successfully fought inflation now supports growth through lenient monetary policy. We have a global macro environment that is not disruptive of growth in India. Financial planning is accelerating consumption, infrastructure and digitization. And, finally, corporate earnings seem to be turning around.

We believe that investors interested in emerging markets have the potential for long-term growth by allocating to Indian markets, which are at the right junction of recovery and growth.

[1]Source : Government of India, as of 2/1/17.

[2]Source: World Bank, as of 12/31/16.

[3]Sources: Economic Times, World Bank, as of 12/31/16.

[4]Source: Government of India, as of 2/1/17.

[5]Sources: Goldman Sachs, Bloomberg, as of 1/31/17.

Important Risks Related to this Article

Investments focused in India increase the impact of events and developments associated with the region, which can adversely affect performance.

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DEFINITIONS

Earnings per share : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

Inflation : Characterized by rising price levels.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.