

INDIA MARKET ANALYSIS

Union Budget 2005-06

Highlights

➤ Taxation:

- Various measures were announced by the government on both direct & indirect taxation fronts that will go a long way in boosting confidence in the capital markets & economy.
- The new tax slabs for Individuals are:

Old Rates		Budget 2005- 06	
Income	Rate	Income	Rate
Under 50,000	Nil	Under Rs 1 lac	Nil
50,000 – 60,000	10%	1 Lac- 1.5 Lacs	10%
60,000 – 1,50,000	20%	1.5 Lacs – 2.5 Lacs	20%
Over 1.5 Lacs	30%	Over Rs 2.5 Lacs	30%

- Level at which the surcharge of 10% will apply is raised to Rs 10 lacs taxable income.
- Section 88 is eliminated and Section 80L would be omitted. A new section called 80CCE to be introduced under which every taxpayer would be allowed a consolidated limit of Rs 1 lac for savings, which would be deducted from the income before tax.
- **A fringe benefits tax** of 30% will be imposed on the employer on perquisites enjoyed collectively by employees
- **Interest in NRE accounts** and foreign currency deposits will continue to enjoy income-tax exemption
- **Corporate tax rate** (for domestic companies) has been reduced from 35% to 30%. The surcharge is now 10% (2.5% earlier). Thus the peak corporate tax rate is down from 36.6% to 33.7%. This 300 bps reduction in peak rate will be helpful for corporate earnings especially for those in higher effective tax bracket.
- The **peak customs duty** for non-agricultural products has been reduced from 20% to 15%.
- **Service tax** has been maintained at 10% and more services have been brought under the service tax net.
- **Derivative trades** would no longer be considered speculative transactions. This would make such trades them eligible for much lower tax (STCG : 10%) from current tax rate of 30%
- **The securities transaction tax (STT)** rate has been changed as follows:

Transaction	Current STT (%)	Proposed STT (%)
Delivery Based Purchase of Equities by Buyers	0.075	0.10
Delivery Based Purchase of Equities by Seller	0.075	0.10
Non Delivery Based Transaction by Seller	0.015	0.02
Derivatives Transaction (F&O)	0.010	0.0133
Sale of Units by Mutual Funds	0.15	0.20

Source: Budget Document

- **GDP** growth for 2004-05 is estimated at 6.9% with the manufacturing sector expected to grow at 8.9%.
- The biggest achievement of FY06 Union Budget is that it has avoided any significant giveaways and managed to keep status quo on fiscal deficit. **FY06 fiscal deficit** is targeted at **4.3% of GDP** (4.5% in FY05). Unlike last year, this is based on more realistic assumptions on revenue growth (21%) and NIL privatization receipts. Focus on infrastructure spending is retained, through a new scheme to fund infrastructure using all-time high forex reserves and higher cess on auto fuels to fund highway projects. Cut in oil subsidies is a positive sign.
- To its credit, the Budget avoids any significant populist negatives, despite intense pressure from allies (esp Left parties). Lowering of personal and corporate income taxes is also a positive
- **Infrastructure spending: New initiative using forex reserves, higher cess on auto fuels for highway spending:** The Budget proposes to make a start towards using part of the all-time high forex reserves (currently at US\$131bn) towards funding infrastructure projects. Forex reserves will be used via an SPV with borrowing limit of Rs100bn (US\$2.3bn) for FY06. If the scheme proves successful in kick-starting some key infrastructure projects, the initial limits can be easily raised much higher. In addition, the cess on gasoline and diesel to fund highways has been increased from Rs1.5/litre to Rs2/litre.

Equities Market

- UPA government's 2nd Budget got a favorable 2.2% response from the market, which Citigroup believes was more of a relief rally, on government avoiding populist pitfalls.
- Through restructuring of personal income tax slabs and change in tax deductions, the Budget reduces overall tax burden on individuals - this could prove to be positive for disposable incomes in salaried middle classes and consumption demand.
- Marginal hike in the STT rate is not expected to have any significant impact on market sentiment as the participants were expecting the same. More significant move is the proposal for derivative trades not to be considered speculative transactions (currently attracting tax at 30%). Classification of derivative trades as normal stock market transaction will make them eligible for a much lower tax (short-term capital gains tax is 10%)- a move that will be much welcome by market participants.
- Reduction in corporate taxation rate is expected to positively impact the bottomline of domestic companies esp companies in the higher effective tax bracket. Standalone for this change, earnings benefit from lower marginal tax rate should be around 3-4% (Citigroup Smith Barney estimates).
- Going ahead, Citigroup expects two key themes driving the India story in coming years:
 - Investment cycle turn-up,
 - Urban consumption.

Various trends that support these two mega trends are- Corporate capex recovery, higher infrastructure investments, sustained strength in outsourcing trends to India, consumer credit growth, rapid overall credit expansion (+25% currently), ample liquidity and growth-supportive interest rates. This Budget has not changed any factors/ the long-term growth drivers for the India story.
- When one considers the fundamentals of the economy and the expected growth by corporate India over the medium term to long term, valuations appear to be reasonable. Continued FII flows and increased allocation from domestic investors (because of attractive tax structure) could act as a positive trigger for the markets. Inflationary trends combined with low interest rate regime might force investors to look for investment avenues, which have the potential to give higher risk-adjusted returns, and this would help the equity markets.

Fixed Income Market

- The budget was a mixed bag for bonds – After the recent hike in EPF rates, there was some concerns about the small savings rate, which have been left unchanged in the budget, which is positive. The fiscal deficit number & the total market borrowings were however higher than market expectations.
- The amendments to the definition of “securities” to provide a legal framework for trading of securitized debt including mortgage-backed debt is positive as this would strengthen the securitization market.
- The pause given to FRBM is slightly worrying, as global rating agencies would be watching these numbers closely. The borrowing of Rs 1028 bn was higher than market expectation of around Rs 910 bn and as a result of which the benchmark 10-year GOI rose to close at 6.55%.
- Markets are expected to remain rangebound and going ahead domestic rate movements would depend on fundamentals such as inflation and liquidity along with factors such as oil & commodity prices and rupee appreciation. Investors with a short to medium term horizon should consider investing into liquid or short term floating rate funds, while investors with a slightly longer-term perspective may look at investing into short maturity funds and long term floating rate funds

Budget Snapshot			
Rs bn	FY05RE	FY06BE	Growth rate
a. Revenue Receipts	3,009	3512	16.7
Tax Revenues	2,258	2735	21.1
Non-Tax	751	777	3.5
b. Non-Debt Cap Receipts	657	120	-81.7
Recoveries of Loans	616	120	-80.5
PSU Divestments	41	0	-100.0
c. Total Receipts (a+b)	3,666	3632	-0.9
d. Revenue Expenditure	3,861	4465	15.7
of Which Interest (1)	1,259	1295	2.9
f. Capital Expenditure	1,197	678	-43.3
h Plan Expenditure on Rev & Cap A/C	1,374	1435	4.4
i. Non-Plan Expenditure on Rev & Cap A/C	3,684	3708	0.7
j. Total Expenditure (d+f +g) =(h+i)	5,058	5143	1.7
j. Fiscal Deficit (j-c)	1,392	1511	8.6
% to GDP	4.5	4.3	
Revenue Deficit (a-d)	852	953	11.9
% to GDP	2.7	2.7	
Primary Deficit (j-1)	133	172	62.4
% to GDP	0.4	0.6	
GDP Assumption (Rs Bils.)	31,086	35,150	13.1

*BE = Budget estimates; RE = Revised estimates.
Source: Budget documents.

This report is provided for general information only and nothing contained in the material constitutes a recommendation for the purchase or sale of any security and/or currency. Although the statements of fact in this report are obtained from sources that Citibank consider reliable, we do not guarantee their accuracy and any such information may be incomplete or condensed. Any person considering an investment should seek independent advice on the suitability or otherwise of the particular investment. Investments are not deposits or other obligations of, guaranteed or insured by Citibank N. A. , Citigroup Inc., or any of their affiliates/subsidiaries, or by any local government or insurance agency, and are subject to investment risk, including the possible loss of the principal amount invested. Investors investing in funds denominated in non-local currency should be aware of the risk of exchange rate fluctuations that may cause a loss of principal. Past performance is not indicative of future performance; prices can go up or down. Mutual Funds are not available to US persons and may not be available in all jurisdictions.