ASG Analysis: India’s 2021 Union Budget

February 9, 2021

Key Takeaways

- India’s first post-Covid-19 budget was presented on February 1. It outlines measures to accelerate recovery, aiming to steer the economy toward a higher growth trajectory and out of its current slide. Expectedly, the budget prioritizes growth over fiscal consolidation.

- India is in the middle of a pandemic-induced recession. GDP is expected to decline by 7.7 percent in 2020-21, a stark contrast to the 4.2 percent growth India achieved in 2019-20. Additionally, India’s fiscal deficit is expected to reach 9.5 percent of GDP in the current financial year.

- At a time when private consumption and investments are declining, the budget steps up spending by the government – prioritizing investments for infrastructure development – and takes measures to strengthen the financial sector and boost domestic manufacturing.

Areas of Reform

There are six key reform areas proposed in the budget:

1. **Managing the macroeconomic situation through structural reforms:** Despite the ballooning fiscal deficit, the government has prioritized growth and laid down a plan for fiscal consolidation in the coming years.
2. **Continuing financial sector reforms:** India’s financial sector has long faced serious challenges – huge non-performing assets (NPAs) among public sector banks being one of the biggest. This year’s budget continues to address NPAs and includes new measures to strengthen the financial sector.
3. **Attracting foreign investment:** The budget contains reforms to help ensure that India remains attractive to foreign investors – a major goal of the government.
4. **Increased public spending on key sectors:** Key sectors will see an increase in public spending to manage the socioeconomic impact of the pandemic.
5. **Enhancing ‘‘Ease of Doing Business”:** In line with its long-stated vision, the government continues to introduce reforms that ease compliance for doing business.
6. **Pushing “self-reliance” to promote domestic industries:** The budget incentivizes domestic manufacturing, given its multiplier effect and impact on employment and the services sector.

Managing the macroeconomic situation through structural reforms

In order to sustain an economy slowed down by the pandemic, the government increased spending throughout 2020. This has resulted in a much higher fiscal deficit than anticipated.

- While the government pegged the fiscal deficit at 3.5 percent for FY 21 in the last budget, India saw its fiscal deficit hit 9.5 percent. The government's intentions in the new budget are clear: it wants to prioritize growth despite this ballooning fiscal deficit.
- The Covid-19 crisis also led to a reset of the medium-term fiscal road map. The government wants to continue fiscal consolidation and now aims to reach a fiscal deficit of 4.5 percent of GDP by 2025-2026. The government will amend a key parliamentary act to reflect this change.
- Instead of increasing the tax burden on corporations and individuals, the government has opted to meet its revenue shortfall through increased borrowing and a large disinvestment exercise. The government has set an ambitious FY 22 disinvestment revenue target of Rs 1.75 lakh crore (~ $23.9 billion).
- Following a decision to reduce the number of public sector enterprises, the government identified four strategic sectors where it will maintain a "bare minimum" presence – atomic energy, space, and defense; transport and telecommunications; power, petroleum, coal, and other minerals; and banking, insurance, and financial services.
- Two public sector banks and one general insurance company will be privatized in 2021-22. This will provide additional revenue to the government. The Initial Public Offering of the Life Insurance Corporation of India (LIC, a government-owned insurance and investment corporation) will also be taken up this financial year.
- Structural reforms to finance public spending include the creation of a Development Financial Institution (DFI) for infrastructure financing and the monetization of operating public infrastructure assets for new infrastructure construction. A "National Monetization Pipeline" of potential brownfield infrastructure assets will be launched. While highway and transmission assets have been offered for monetization in the first phase, oil and gas pipelines, airports in tier II and III cities, railway infrastructure assets, warehousing assets, and sports stadiums will also be included in the pipeline.
- To encourage private sector participation in the ports and shipping sector, major ports will move from managing their operational services themselves to a model where a private partner will take on management responsibilities. Seven public-private partnership (PPP) projects will be offered by the major ports in 2021-22.

Through these reforms, the government expects to achieve nominal GDP growth of 14.4 percent and real GDP growth of 11 percent in 2021-22. However, as a trade-off to growth, Finance Minister Nirmala Sitharaman stated that the fiscal deficit is expected to rise to 7.5 percent of GDP—which is twice the target initially set for 2021.

Continuing financial sector reforms

While the government has recapitalized public sector banks several times to address the non-performing asset (NPA) crisis, the following additional measures have been proposed to effectively deal with any rise in NPAs in the wake of the pandemic:

- Setting up an Asset Reconstruction Company and an Asset Management Company for stressed assets to take over bad loans.

- Equity infusion of Rs 20,000 crore ($2.7 billion) for public sector banks.

These measures are expected to strengthen the state-owned banks and hasten the process of balance sheet clean-up. Unsurprisingly, India's financial markets and industry leaders have responded positively to the budget.

Attracting foreign investment

The government is targeting reform-led growth that ensures that India remains an attractive place for foreign investment. It aims to lower barriers for foreign investment through the following steps:

- The government has increased the FDI limit in the insurance sector from 49 percent to 74 percent in response to a long-standing demand by foreign investors. It had previously been hesitant given the sector's sensitivity and criticality.
    - Accordingly, this reform comes with safeguards: a majority of directors on the board and key management persons would have to be resident Indians, with at least 50 percent of directors being "independent directors." A specified percentage of profits would need to be retained as general reserve.
    - The increase in the FDI limit in insurance is an important step not just for the rapid expansion of the insurance sector but also as a significant indicator of the government's intent to reform. However, the implementation of insurance reforms requires tedious legislative approval and operationalization.
- To attract sovereign and pension fund investments for infrastructure, the new budget has also relaxed the last budget's prohibition of private funding, commercial activities, and direct investment in infrastructure.
- The government has reiterated its commitment to building a global financial hub in India by offering tax incentives for relocating foreign funds and by allowing tax exemptions to the investment divisions of foreign banks located in India.
- The government has extended the eligibility period to claim capital gains tax exemptions for investments made in startups by one more year to March 31, 2022. This will benefit startups and investors alike.

Increasing public spending in key sectors

The government has budgeted for a 26 percent increase in capital expenditure to trigger a growth cycle, generate employment, and boost incomes. Several key sectors will see an increase in public spending to manage the socioeconomic impact of the pandemic.

- The government has increased the budget outlay for health by 137 percent relative to the previous year. The government has allocated approximately $4.79 billion for Covid-19 vaccines for financial year 2021-22.
- The budget has increased the investment in health infrastructure to $8.79 billion, mainly to increase capacity of primary, secondary, and tertiary care health systems; to strengthen existing national health institutions and create new institutions; and to help detect and cure new and emerging diseases over the next six years.
- The budget also contains allocations for nutritional outcomes, universal urban water supply, and affordable housing.

In addition to the large public spending push, the government has announced that social security benefits will be extended to gig and platform workers and that minimum wages will apply to all categories of workers.

Enhancing "Ease of Doing Business"

"Ease of Doing Business" (EoDB) has been a priority for the Modi government since 2014. Key reforms in this budget include:

- A proposal to omit criminalization provisions from the Limited Liability Partnership (LLP) Act of 2008. Since LLPs are long-term investment vehicles and a preferred investment choice for many investors, this initiative is intended to promote participation of LLPs in India's growth.
- To provide certainty on equalization levy, the budget has clarified that transactions taxable under income tax are not liable for equalization levy. It has also provided clarifications regarding applicability of equalization levy on the physical and offline supply of goods and services.
- Startups have been offered a tax holiday for their first ten years of operation. The budget has extended the eligibility period to claim tax holiday for startups by one more year, moving the deadline to March 31, 2022.
- For timely and quick resolutions and to help reduce litigation costs, the government will strengthen the National Company Law Tribunal (NCLT) framework, implement the e-courts system, and introduce alternate methods of debt resolution and a special framework for micro, small, and medium enterprises (MSMEs).
- By increasing the turnover threshold to qualify as a "small company," the government has eased compliance requirements for more than 2 lakh companies.

Pushing for self-reliance to promote domestic industry

To spark the multiplier effect of domestic manufacturing, the budget proposes measures to kick-start key sectors like textiles and automobiles and to promote local value addition. The budget has acknowledged that for the manufacturing sector to grow in double digits on a sustained basis, Indian manufacturing companies need to become an integral part of global supply chains and possess core competence and cutting-edge technology. To achieve this, Production-Linked Incentive (PLI) schemes to create manufacturing global champions for an *AtmaNirbhar Bharat* ("self-reliant India") have already been announced for 13 sectors. New measures announced in this budget include:

- To enable the Indian textile industry to become globally competitive, attract large investments, and boost employment generation, a scheme of Mega Investment Textiles Parks (MITRA) will be launched in addition to the PLI scheme. Seven textile parks will be established in the country in the next three years.
- The budget has proposed several new economic corridors to further augment road infrastructure development. To deploy more public bus transport services in Indian cities, a new scheme will be launched which will facilitate deployment of innovative PPP models to enable private sector players to finance, acquire, operate, and maintain over 20,000 buses. Further, a voluntary vehicle scrapping policy will be introduced to phase out old and unfit vehicles. Besides encouraging fuel-efficient and environmentally friendly vehicles, this will create demand for the automobile industry.

- The budget focuses on boosting domestic production in several sectors by hiking customs duties on finished goods and bringing down costs of imported raw materials. The government has reduced duties on raw materials and inputs used by domestic manufacturers across eight industries, including petrochemicals, textiles, metals, and aviation. To create a level playing field for MSMEs and domestic manufacturers, duties on finished goods have been raised in sectors like electronics, chemicals, gems and jewelry, capital goods, and auto parts.
- As part of the revised customs duty structure the government will review more than 400 exemptions.
- There is also an attempt to rationalize procedures and enhance ease of compliance. In this regard, the government has proposed certain changes in provisions relating to anti-dumping and countervailing levies and seeks to prescribe timelines for completion of customs investigations.

While the budget has garnered a positive response from domestic industries, some experts have argued that not enough emphasis is placed on sectors such as education and defense. India is currently in a military standoff with China on its northern and northeastern frontier and defense experts have opined that the government needs to increase its defense budget substantially due to the threats it faces. In addition, the allocations for education has seen a 6 percent reduction despite the exigencies posed by the pandemic.

About ASG

Albright Stonebridge Group (ASG) is the premier global strategy and commercial diplomacy firm. We help clients understand and successfully navigate the intersection of public, private, and social sectors in international markets. ASG's worldwide team has served clients in more than 120 countries.

ASG's South Asia practice has extensive experience helping clients navigate markets across South Asia. For questions or to arrange a follow-up conversation please contact Sukanti Ghosh.