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ASG Analysis: Will India's Union Budget Jumpstart Growth?

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Key Takeaways

- India's finance minister presented the first budget of the Modi government's second term on February 1.
- Given that India is experiencing an economic slowdown and is struggling to manage a fiscal deficit of 3.5 percent, analysts had expected the government to announce a series of dramatic measures to stimulate consumption, jumpstart growth, support exports, and attract investments. However, the government chose to take a more measured approach that it hopes will lead to economic growth in the long term.
- Major announcements included: a simplified tax regime, a stronger commitment to harness the power of technology, both in terms of digital governance and people empowerment, the government's desire to promote low or no-emission energy options, initiatives to attract and retain more foreign direct investment, accelerate infrastructure development, promote domestic manufacturing and entrepreneurship, and support farmer incomes.
- Increased tariffs on specific agricultural imports, automotive vehicles, electronics and medical devices are likely to have a negative impact on global investor sentiment.

Overview

India's Union Minister of Finance, Nirmala Sitharaman, presented the annual budget to Parliament on February 1, 2020. The announcement comes at a time when the Indian economy is showing signs of an economic slowdown with falling domestic consumption, a deceleration in manufacturing, lower government revenues, and declining rates of export growth.

Despite this background, the government chose to announce a measured plan to stimulate growth through structural reforms and a series of strategic initiatives intended to create long term wealth. The budget also underscored the government's long-standing commitment to double the income of farmers by 2022. To this end, the government announced a 16-point action plan to boost agricultural exports, build efficient value chains for perishable commodities, and encourage states to carry out agri-marketing reforms.

This ASG Analysis summarizes the key reforms introduced in the Budget.

Simplified Tax Regime

- **New personal income tax slabs and lower rates:** In an effort to put more money into the hands of consumers, taxpayers can choose to file under the new system, provided they forgo the deductions they have under the existing tax rates.

- **Tax amnesty scheme**: To reduce litigation related to direct taxes, taxpayers will have to pay only the amount of disputed taxes with the interest and penalty waived, if payment is made by March 31, 2020.

- **Removal of criminal action in tax disputes:** The Companies Act was amended to remove criminal action in case of tax disputes. In addition, the Finance Minister has promised to build a tax charter in the statutes to curb harassment for compliant taxpayers.

- **Tax parity between corporates and cooperatives**: This measure reduces tax rates for cooperative societies to create parity with tax rates for private enterprises.

- **Tax Deducted at Source (TDS) for e-commerce:** In a move that is likely to hurt e-commerce operators, the government has mandated that they deduct tax at source on all payments or credits to e-commerce participants on the platform.

Incentives for Foreign Investment

- **Tax exemptions for Sovereign Funds:** There will be 100 percent tax exemption on the interest, dividend, and capital gains income on investments made in infrastructure and priority sectors before March 31, 2024 by the Sovereign Wealth Fund of foreign governments, with a minimum lock-in period of 3 years. This is likely to attract more investments, particularly from the Middle East, in infrastructure and priority sector projects.

- **Removal of DDT:** The Dividend Distribution Tax (DDT) that companies pay on shareholder dividends (at the rate of 15 percent plus applicable surcharge and cess) will be removed. The DDT particularly burdened foreign investors, due to non-availability of credit in their home country.

- **Investment promotion cell:** An investment promotion cell to provide "end to end" facilitation and support, including pre-investment advisory and help with clearances at the Center and State levels, will be created. Investors seeking to establish manufacturing facilities in India are likely to be the biggest beneficiaries.

- **Attracting investments in FPIs and securities market:** The limit for Foreign Portfolio Investors (FPI) in corporate bonds, currently at 9 percent of outstanding stock, will be increased to 15 percent. Additionally, certain specified categories of government securities will be opened fully for non-resident investors, apart from being available to domestic investors as well.

- **Improvements in economic accounting:** The creation of a National Official Statistics Policy aims to help restore confidence in India's macroeconomic data, a key pre-requisite for foreign investors interested in investing in India.

- **Offering stocks of leading PSUs under disinvestment:** The government will sell a portion of its holding in Life Insurance Corporation of India (LIC) through an Initial Public Offer. The government also plans to sell the balance of its holding in IDBI Bank. These steps will provide significant opportunities for private investors to invest in India's banking and insurance sectors.

Infrastructure Development Initiatives

In December 2019, the Government announced infrastructure projects worth $1.4 trillion under the National Infrastructure Pipeline.

- **Logistics and supply chain:** To continue efforts to improve efficiencies and create a unified market across Indian states following the introduction of GST, a National Logistics Policy will be finalized soon. The Ministry of Commerce circulated a draft policy. To improve warehousing infrastructure (particularly for agri-products), the budget proposes the following initiatives:
    - Mapping and geo-tagging of all agri-logistics facilities in the country.
    - Establishing warehouses through viability gap funding in Public Private Partnerships (PPPs).
    - Improving holding capacity and reducing logistics costs for farmers through a backward linkage village storage scheme run by the Self-Help Groups (SHGs).
    - Providing refrigerated coaches in express and freight trains for perishables (e.g., milk, meat and fish) through PPP arrangements.

- **Aviation:** UDAAN – a scheme to connect India's tier-2 and tier-3 cities through airports – will be expanded to include 100 new airports that will be developed by 2024. A special program has been proposed to connect remote areas of the country.

- **Railways:** To increase private sector participation in railways, four station re-development projects and operation of 150 passenger trains will take place through PPPs. Indian Railways will add solar power capacity alongside the rail tracks.

- **Road transport:** Over 15,000 km of new highway will be developed. This includes an expressway between Delhi and Mumbai and expressways between other key metro cities. The government will also monetize highway bundles (over 6000 km) before 2024.

- **Energy:** The gas grid will be expanded from 16,200 km to 27,000 km. To further boost natural gas consumption, the government will introduce efforts to facilitate transparent price discovery and ease transactions. In the electricity sector, the concessional corporate tax rate of 15 percent introduced earlier for new manufacturing companies has now been extended to cover electricity generation. In the renewable energy sector, the government has set a target of providing solar pumps to 2 million farmers.

Focus on 'Make in India'

- **Protections for Indian manufacturers:** The government has increased import duties on certain products and reduced import duties on raw materials for several of these same products. These changes are likely to impact toy manufacturers, foreign single brand retailers, medical device manufacturers, and electric vehicle and smartphone parts manufacturers.

- Taxes on imports of items including kitchenware, fans, and small electrical appliances will be doubled to 20 percent, while the levy on furniture including seats, lamps, and mattresses will be raised to 25 percent from 20 percent. Taxes on imported toys will be tripled to 60 percent. The government also announced a tax of 5 percent on imported medical devices to fund health infrastructure.
- Customs duty rates have been revised on electric vehicles and parts of mobiles to promote Make in India under the Phased Manufacturing Plans (PMPs).
- The government plans to review the Rules of Origin requirements to restrain imports under existing Free Trade Agreements (FTAs).

- **Dedicated policies for priority sectors:** The government will create schemes to encourage manufacturing of mobile phones, electronic equipment, semi-conductor packaging, and medical devices. Additionally, the Government has announced a National Technical Textile Mission to reduce import dependence on technical textiles.

Entrepreneurship Initiatives:

- **Reforms for startups:** To encourage early stage startups, the government has announced the creation of a $2.8 billion seed fund. The turnover limit up to which startups can receive 100 percent deduction on their profits for computing tax liability for three consecutive assessment years has been enhanced to $14 million, up from $3.5 million. This can now be done within 10 years, up from the earlier limit of 7 years. The Budget also proposed easing taxation on startup employees by deferring tax payment on their Employee Stock Option Plan (ESOP) by five years or until they leave the company or sell their shares. Exemption from taxes on ESOPs will encourage companies to introduce ESOPs, in turn allowing them to attract top talent while keeping employee costs in check.

- **Encouraging MSMEs:** The budget proposed an initiative to provide subordinate debt to MSME entrepreneurs to ease the working capital crunch in the MSME sector. Additionally, the government will launch an app-based invoice financing loans product. To reduce the compliance burden on small retailers, traders, and MSME sector, the government has revised the auditing threshold from $140,000 to $700,000. MSMEs below the threshold will not be mandated to get their books audited provided they transact less than 5 percent in cash.

- **Promoting exports:** The budget introduced the NIRVIK scheme to provide higher insurance coverage, reduction in premium for small exports, and simplified procedures for claiming settlements. Specific sectors, such as pharmaceuticals and auto components, will receive $140 million to enhance technology, R&D, and business strategies.

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