Fiscal Stimulus for an ailing economy

The government today provided a major fiscal boost to the economy by cutting the corporate tax rate to 25% Markets cheered this announcement and the INR gained by 0.5%. However, this announcement also brought forth worries over an already stressed fiscal situation. The 10-year bond yield rose by 20bps and was trading at 6.8% at the time of writing.

We estimate that, in the absence of any significant expenditure cuts, the fiscal deficit could rise to 4.1% of GDP in 2019-20. This implies a borrowing overrun of close to Rs. 1.5 lakh crore with total borrowings likely to rise to Rs. 8.55 lakh crore (from Rs. 7.04 lakh crore budgeted) in 2019-20. The 10-year bond yield is expected to trade within a 6.7%-6.9% range in the near term. We are keeping our USD/INR call unchanged at 71-73 in the near term and 69.50-70.50 over the next 3-6 months. While higher equity and FDI flows (driven by today's announcement) are likely to be positive for the currency, concerns over the fiscal situation and risks related to oil could put a floor to the USD/INR pair.

Effective Corporate tax rate lowered

The effective tax rate has been reduced from 35% to 25.2%, which includes all surcharges and is applicable on companies that aren't availing any incentives. If calculated without the charges, the tax rate cut works out to 22% from 30% earlier. Furthermore, domestic firms incorporated on or after October 1, 2019 that want to make fresh investment in manufacturing will have an option to pay income tax at 15%. The new tax structure is effective from April 1, 2019.

Booster shot for growth

The recent tax move is likely to provide a boost to the economy. We are revising our GDP growth forecast to 6.5% from 6.3% for 2019-20. The corporate tax cut is likely to not only attract greater foreign investments but could also support some revival in the capex cycle (driven by greater corporate savings). Our analysis show that a 10% reduction in corporate tax rate can result in 0.20-0.50 bps increase in GDP growth (based on the tax multiplier for India, RBI Working Paper, 2013).

Moreover, weak consumption has been a major drag on growth and this could see some uptick in the second half as well. Greater transmission of interest rate cuts, accommodative monetary policy, and a normal monsoon are likely to support demand. Overall, we expect the second half of this fiscal to look better with GDP growth likely to be between 6.5%-7% in H2 2019-20.

Impact on the fiscal math

While the growth impact of the corporate tax rate cut is positive, it's not good news for the already stressed fiscal situation.

The fiscal deficit could rise to 4.1% of GDP in 2019-20 (assuming there are no significant expenditure cuts) versus a budgeted estimate of 3.3% of GDP. This implies a borrowing overrun of close to Rs. 1.5 lakh crore with total borrowings likely to rise to Rs. 8.55 lakh crore (from Rs. 7.04 lakh crore budgeted) in 2019-20.

- Pressures: Lower corporate tax cut collections, revenue shortfall on account of lower GST collections and additional outlay for recent measures announced for the real estate and export sector could put pressure on the fiscal deficit.

    - Lower corporate tax collections: The cut in corporate tax announced today amounts to Rs. 1.45 lakh crore in lower tax collections for the fiscal year. Overall, direct tax collections have grown by a

mere 6.5% so far as against a budget target of 18% for the fiscal year. In this, corporate tax collections have averaged at Rs. 22,100 crores between Apr-Jul 19 in comparison to a required monthly run-rate of Rs. 63,800 crores.

o Lower GST collections: The targeted growth rate for FY20 in GST collections is budgeted at 10% while so far this fiscal the growth has been close to 6.4%. After touching 1.13 lakh crore in April, GST collections have fallen off to INR 98,000 crore in August 2019. If this trend continues, collection shortfall could be close to INR 40,000 core. Then, there are also concerns that revenue collected through the compensation cess may not be enough to compensate states this year.

· Cushions: That said, the higher surplus transfer by the RBI this year (additional cushion of 0.3% of GDP, Rs. 58,000 crore), and an improvement in growth numbers (increasing tax collections) could alleviate some of the pressure.

- Expenditure compression? There is a possibility that with higher disinvestments, revenue expenditure roll-overs, and some expenditure cuts the government could buy some fiscal space. For instance, the government has on average rolled over 30% of its food subsidy bill to FCI over the last three fiscals. A similar roll-over this year could add close to 0.3% of GDP in fiscal space. So in the event of an expenditure compression or higher disinvestment proceeds, the fiscal deficit could come in between 3.7%-3.9% of GDP for 2019-20.

Bond View

In response to expectations of higher borrowing by the government this fiscal, the 10-year bond yield rose by 20bps today (trading at 6.802% at the time of writing). We expect the 10-year yield to trade in the range of 6.7%-6.9% in the near term. Higher borrowing pressures and risks related to a spike in oil prices are likely to somewhat offset the impact of a rate cut by the RBI in October. Moreover, we now expect a smaller cut by the central bank given that a fiscal stimulus is likely to take some pressure off the RBI to support growth. We expect a 15-25bps cut by the RBI in October. That said, there could be some support for yields as well. Given the increase in expected borrowings, the likelihood of a sovereign bond issuance has increased. An announcement on this front, could somewhat temper the pressure on yields.

FX View

The impact of the corporate tax cut on flows is likely to be positive, leading to a possible pop in equity and FDI flows to India. However, we think that concerns over the fiscal deficit are likely to contain the upside in the USD/INR pair. Moreover, risks related to oil prices continue to linger on, putting a floor to the pair for now. The USD/INR pair was trading at 71.06 today from yesterday’s close to 71.37.

We are keeping our FX call unchanged at 71-73 in the short run, and 69.50-70.50 for the next 3 months.

Thanks & Regards

Treasury Research Desk