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NEW RELEASE

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**India's fiscal—between a rock and a hard place.** The government needs to raise revenue receipts on a structural basis to account for credible fiscal consolidation. The cyclical turn in tax revenues may not be enough as growth may be relatively weak over the next few years. Given the need to increase the share of capital expenditure, and curtailment of revenue expenditure being difficult, the government has limited space for much fiscal consolidation. We estimate that even with optimistic assumptions GFD/GDP may take more than the expected 2-3 years to glide down to 3%.

#### 80% of government expenditure is either 'fixed' or 'necessary'

Our analysis of the government's expenditure indicates that ~80% of it is either 'fixed' or 'necessary'. We define 'fixed' as expenditure on defense, interest payments, pension and wages and 'necessary' as expenditure on education, health, loans and grants to states and UTs and rural development (see Exhibit 1). We consider food subsidy a fixed expenditure and fertilizer subsidy a necessary expenditure. Out of the remaining ~20% of total expenditure, we believe most of it needs to be reworked and some, discontinued.

#### Capital expenditure growth must reach 25% CAGR over next five years

Capital expenditure is only 12.5% of total expenditure. This compares to an average of 20% over FY2002-05—during the investment cycle pick-up over FY2003-07. The present focus has been mainly on capital outlay in defense (42% of total capital expenditure). Roads and railways form only 15% of total capital expenditure. Even as social-scheme expenditure is unlikely to decline substantially, capital expenditure share needs to move up, specifically in sectors like roads, railways and ports. Assuming 10% annual growth in revenue expenditure (the rationale is detailed later), we note capital expenditure must rise by 25% CAGR over the next five years to reach ~20% of total expenditure.

#### Fiscal consolidation will take time; revenue-led consolidation needed

We analyze two scenarios with the following common assumptions—(1) 10% contraction each year for 20% of revenue expenditure and 15% growth each year in the remaining 80% (rationale explained later) and (2) introduction of GST in FY2017 and consequent tax revenue growth of 20% each year. Scenario 1: Only fiscal consolidation and no significant increase in share of capital expenditure; GFD/GDP is likely to be 3% by FY2018. However, it is unlikely that any sustainable growth trajectory would evolve as the expenditure quality continues to be poor. Scenario 2: Increase in share of capital expenditure and aim for fiscal consolidation; GFD/GDP glides down to 3% by FY2019-20. The consolidation choice remains between short-term (without improving expenditure mix) and long-term (with improving expenditure mix) targets. In case there is no structural increase in tax/GDP ratio (through GST or otherwise), it is unlikely that GFD/GDP can reach 3% even by FY2020.

#### Asset sales, natural resources auctions and asset monetization

Tax collections will need to finance capital expenditure, but part of this should be funded by asset sales (divestment and resources auctions). We estimate the government can garner ₹4.0 tn (US\$65 bn) if it reduces its holdings in PSUs to 51%. However, realistically, the government can garner only ~₹1.3 tn assuming (1) reduction of stake in PSUs to 75% (₹560 bn) and (2) sale of minority holdings in Hindustan Zinc and SUUTI (₹780 bn). The government needs to prioritize natural resources auction policies and monetize fixed assets of PSUs (land banks and buildings of defense, ports and railways) to fund capital expenditure.

#### QUICK NUMBERS

- 80% of government expenditure is either 'fixed' or 'necessary'
- Capital expenditure needs to grow at 23% 5 year CAGR by FY2020 to reach 20% share in total expenditure
- GFD/GDP to reach 3% by FY2019/FY2020

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### Which are the 'fixed' and 'necessary' expenditures?

Exhibit 1 highlights our classification of government expenditure. We define fixed expenditure as the portion of expenditure that is either directed by law or is essential for national security and the efficient functioning of the country. The typical components of a fixed nature would be defense, salaries, pensions, interest payments, police, railways, roads and transport and food subsidy. We estimate expenditure of a fixed nature accounts for ~60% (or ₹11.0 tn) of total expenditure.

We classify necessary expenditure as that which is essential for the socio-economic welfare and efficient functioning of the state machinery. We classify loans and grants to state, fertilizer subsidy, rural development schemes (aimed at social welfare like mid-day meals, rural housing and rural roads), health and family welfare, financial services (bank recapitalization), power, etc. We do not include NREGA in this classification. However, this classification is subjective and the estimate of this expenditure will vary. According to our estimates, expenditure of a necessary nature accounts for ~19% (or ₹3.3 tn) of total expenditure.

Other expenditure is where we believe most of the expenditure is discretionary or has components that need to be reworked (for example NREGA, fuel subsidies). This forms ~21% (or ₹3.8 tn) of total expenditure and the government will have leeway to reduce expenditure on this front.

Exhibit 1: 'Fixed' and 'necessary' expenditure forms ~80% of total expenditure  
 Classification of expenditure, March fiscal year-ends (Rs bn)

	FY2014RE	FY2015BE	Share in total expenditure (FY2015BE, %)
<b>Total expenditure</b>	<b>15,904</b>	<b>17,949</b>	
<b>Fixed expenditure</b>	<b>9,582</b>	<b>10,881</b>	<b>60.6</b>
<b>Non-plan expenditure</b>	<b>8,970</b>	<b>10,180</b>	<b>56.7</b>
<b>Capital</b>	<b>827</b>	<b>989</b>	<b>5.5</b>
Defence (capital outlay)	789	946	5.3
Police	21	24	0.1
Road	18	19	0.1
<b>Revenue</b>	<b>8,143</b>	<b>9,191</b>	<b>51.2</b>
Interest payments	3,801	4,270	23.8
Civilian wages	1,101	1,184	6.6
Food subsidy	920	1,150	6.4
Pensions	741	820	4.6
Defence wages	628	685	3.8
Loans and grants (states, UTs and foreign govts)	521	619	3.4
Police	431	464	2.6
<b>Plan expenditure</b>	<b>612</b>	<b>701</b>	<b>3.9</b>
<b>Capital</b>	<b>464</b>	<b>526</b>	<b>2.9</b>
Railways	270	301	1.7
Road	148	158	0.9
Police	46	67	0.4
<b>Revenue</b>	<b>148</b>	<b>175</b>	<b>1.0</b>
Road transport and highways	103	131	0.7
MOSPI (MPLAD scheme, etc)	45	45	0.2
<b>Necessary expenditure</b>	<b>3,085</b>	<b>3,274</b>	<b>18.2</b>
<b>Non-plan</b>	<b>780</b>	<b>822</b>	<b>4.6</b>
<b>Revenue</b>	<b>780</b>	<b>822</b>	<b>4.6</b>
Fertilizer subsidy	680	730	4.1
Other subsidies	101	93	0.5
<b>Plan</b>	<b>2,305</b>	<b>2,451</b>	<b>13.7</b>
<b>Capital</b>	<b>308</b>	<b>292</b>	<b>1.6</b>
Financial Services	169	135	0.7
Economic affairs (incl. centralized provisions)	125	136	0.8
Power	15	21	0.1
<b>Revenue</b>	<b>1,996</b>	<b>2,160</b>	<b>12.0</b>
Economic affairs (incl. centralized provisions)	864	686	3.8
School education and literacy	472	516	2.9
Rural development (IAY, PMGSY, etc)	263	466	2.6
Health and family welfare	216	284	1.6
Women and child development	182	208	1.2
<b>Other expenditures</b>	<b>3,237</b>	<b>3,794</b>	<b>21.1</b>
<b>Non-plan</b>	<b>855</b>	<b>634</b>	<b>3.5</b>
<b>Revenue</b>	<b>855</b>	<b>634</b>	<b>3.5</b>
Fuel subsidy	855	634	3.5
<b>Plan</b>	<b>1,090</b>	<b>1,547</b>	<b>8.6</b>
<b>Capital</b>	<b>127</b>	<b>210</b>	<b>1.2</b>
Civil Aviation	61	65	0.4
Space	25	37	0.2
Atomic Energy	24	41	0.2
Telecommunication	4	37	0.2
External Affairs	15	30	0.2
<b>Revenue</b>	<b>962</b>	<b>1,336</b>	<b>7.4</b>
Rural development (NREGA)	330	334	1.9
Agriculture and cooperation	189	223	1.2
Higher education	147	168	0.9
Drinking water and sanitation	120	153	0.8
Water resources	6	130	0.7
Urban development	5	79	0.4
Power	35	76	0.4
Panchayati Raj	35	70	0.4
Social Justice and empowerment	56	57	0.3
Textiles	39	48	0.3

Source: Union Budget documents, Kotak Economic Research estimates

### GFD/GDP may take some time to fall to comfortable levels

Over FY2002-05, a precursor to the investment cycle boom period of FY2003-07, capital expenditure as a proportion of total expenditure averaged ~20%. Currently, the ratio is ~12.5%. We analyze the fiscal consolidation path with an objective to increasing the capital expenditure share in total expenditure over the next 4-5 years to ~20%. This increase, we believe, will help to kick start the investment cycle and offer sustainable growth.

We work on two scenarios with two common assumptions in both—(1) introduction of GST in FY2017 increases tax revenue growth to 20% each year on a sustained basis (based on our estimate of 70 bps increases in central tax/GDP ratio post-GST) and (2) two buckets of revenue expenditure growth—10% contraction for 20% of revenue expenditure and 15% growth for the remaining 80%. The bucket of 20% revenue expenditure is part of the 'others' expenditure category, which we discussed in the earlier section. This assumption implies that the government will aim to contract wasteful expenditure steadily over the next few years.

The assumption of GST in both the scenarios is crucial to the analysis. In case India fails to implement GST it will be very difficult to be on the path of fiscal consolidation and achievement of the target of 3% of GFD/GDP will have to be shifted further out. In fact, if tax/GDP ratio continues to be 10-11%, the target GFD/GDP of 3% would not be achievable even by FY2020 if share of capital expenditure is also increased steadily.

- **Scenario 1.** The government focuses on only fiscal adjustment and maintains capital expenditure at about current levels. Given our earlier assumptions of tax revenue growth and revenue expenditure growth, we expect the GFD/GDP to reach 3% by FY2018. However, even though revenue expenditure is being reduced, it is not increasing capital expenditure much. This will have negative implications for growth, which in the long-run is not optimal.

#### Exhibit 2: GFD/GDP can reach 3% by FY2018

Estimates of various components of fiscal, March fiscal year-ends, 2014-20E (Rs bn)

	2014	2015E	2016E	2017E	2018E	2019E	2020E
Gross tax revenue	11,388	13,060	14,889	17,866	21,440	25,728	30,873
Growth (%)	9.9	14.7	14.0	20.0	20.0	20.0	20.0
Net tax revenue	8,160	9,364	10,675	12,810	15,372	18,447	22,136
Non-tax revenue	1,992	2,125	2,338	2,571	2,828	3,111	3,422
Recovery of loans	125	105	120	120	120	120	120
Divestment	276	634	600	600	600	600	600
Total expenditure	15,635	18,041	20,035	22,182	24,472	27,000	29,791
Expenditure growth (%)	10.9	15.4	11.1	10.7	10.3	10.3	10.3
Revenue expenditure	13,756	15,762	17,338	19,072	20,979	23,077	25,385
<b>Revenue expenditure growth (%)</b>	<b>10.6</b>	<b>14.6</b>	<b>10.0</b>	<b>10.0</b>	<b>10.0</b>	<b>10.0</b>	<b>10.0</b>
Capital expenditure	1,879	2,279	2,697	3,110	3,493	3,923	4,407
<b>Capital expenditure growth (%)</b>	<b>12.6</b>	<b>21.3</b>	<b>18.3</b>	<b>15.3</b>	<b>12.3</b>	<b>12.3</b>	<b>12.3</b>
<b>Capital expenditure/Total expenditure (%)</b>	<b>12.0</b>	<b>12.6</b>	<b>13.5</b>	<b>14.0</b>	<b>14.3</b>	<b>14.5</b>	<b>14.8</b>
<b>Capital expenditure growth (5yr CAGR, %)</b>	<b>15.8</b>	<b>15.1</b>	<b>11.5</b>	<b>14.4</b>	<b>15.9</b>	<b>15.9</b>	<b>14.1</b>
Fiscal deficit	5,081	5,813	6,302	6,080	5,551	4,722	3,513
Nominal GDP	113,551	127,858	145,506	164,422	185,797	209,950	237,244
<b>GFD/GDP (%)</b>	<b>4.5</b>	<b>4.5</b>	<b>4.3</b>	<b>3.7</b>	<b>3.0</b>	<b>2.2</b>	<b>1.5</b>

Source: CEIC, Union Budget documents, Kotak Economic Research estimates

- **Scenario 2.** The government focuses on fiscal consolidation and increases share of capital expenditure. Given our assumptions, GFD/GDP in this scenario can glide down to 3% only by FY2019-20. However, this scenario would ensure that there is significant chance of growth potential increasing and India benefiting from sustainable growth. On the other hand, the fiscal consolidation path may not be as sharp as expected. The government should aim at the second scenario if long-term growth is more important.

Exhibit 3: GFD/GDP can reach 3% by FY2019-20

Estimates of various components of fiscal, March fiscal year-ends, 2014-20E (Rs bn)

	2014	2015E	2016E	2017E	2018E	2019E	2020E
Gross tax revenue	11,388	13,060	14,889	17,866	21,440	25,728	30,873
Growth (%)	9.9	14.7	14.0	20.0	20.0	20.0	20.0
Net tax revenue	8,160	9,364	10,675	12,810	15,372	18,447	22,136
Non-tax revenue	1,992	2,125	2,338	2,571	2,828	3,111	3,422
Recovery of loans	125	105	120	120	120	120	120
Divestment	276	634	600	600	600	600	600
Total expenditure	15,635	18,041	20,132	22,531	25,306	28,542	32,356
Expenditure growth (%)	10.9	15.4	11.6	11.9	12.3	12.8	13.4
Revenue expenditure	13,756	15,762	17,338	19,072	20,979	23,077	25,385
<b>Revenue expenditure growth (%)</b>	<b>10.6</b>	<b>14.6</b>	<b>10.0</b>	<b>10.0</b>	<b>10.0</b>	<b>10.0</b>	<b>10.0</b>
Capital expenditure	1,879	2,279	2,794	3,459	4,326	5,465	6,972
<b>Capital expenditure growth (%)</b>	<b>12.6</b>	<b>21.3</b>	<b>22.6</b>	<b>23.8</b>	<b>25.1</b>	<b>26.3</b>	<b>27.6</b>
<b>Capital expenditure/Total expenditure (%)</b>	<b>12.0</b>	<b>12.6</b>	<b>13.9</b>	<b>15.4</b>	<b>17.1</b>	<b>19.1</b>	<b>21.5</b>
<b>Capital expenditure growth (5yr CAGR, %)</b>	<b>15.8</b>	<b>15.1</b>	<b>12.3</b>	<b>16.9</b>	<b>21.0</b>	<b>23.8</b>	<b>25.1</b>
Fiscal deficit	5,081	5,813	6,399	6,430	6,385	6,264	6,078
Nominal GDP	113,551	127,858	145,506	164,422	185,797	209,950	237,244
<b>GFD/GDP (%)</b>	<b>4.5</b>	<b>4.5</b>	<b>4.4</b>	<b>3.9</b>	<b>3.4</b>	<b>3.0</b>	<b>2.6</b>

Source: CEIC, Union Budget documents, Kotak Economic Research estimates

We note that cumulative capital expenditure of ~₹20 tn until FY2020 is required if the share of capital expenditure is indeed increased to ~20%. We believe most of the expenditure on asset creation should be funded through asset sales such that most of the tax revenue growth can be used to fund socio-economic welfare projects. This would also ensure equitable distribution of value creation in the economy.

We estimate the government can garner ~₹3.7 tn (US\$65 bn) if it reduces its holdings in PSUs to 51% (see Exhibit 4). However, realistically, the government can garner only ~₹1.3 tn assuming (1) reduction of stake in PSUs to 75% (₹560 bn) and (2) sale of minority holdings in Hindustan Zinc and SUUTI (₹780 bn) (see Exhibits 5 and 6). This implies the government needs to prioritize natural resources auction policies and monetize fixed assets of PSUs (land banks and buildings of defense, ports, railways and others) to fund higher capital expenditure.

Exhibit 4: Government can raise ~Rs3.7 tn if it reduces its holdings to 51%  
List of PSUs with more than 51% of government holding (sorted on stake sale)

Company	Market Cap.		Govt holding	Stake sale	
	(Rs bn)	(US\$ bn)	(%)	(%)	(Rs bn)
Coal India	2,360	39	89.7	38.7	912
Oil & Natural Gas Corp.	3,811	64	68.9	17.9	684
NTPC	1,149	19	75.0	24.0	275
NMDC	716	12	80.0	29.0	208
Indian Oil Corp.	949	16	68.6	17.6	167
SAIL	334	6	80.0	29.0	97
NHPC	249	4	86.0	35.0	87
Bharat Heavy Electricals	536	9	63.1	12.1	65
Neyveli Lignite Corp.	152	3	90.0	39.0	59
Oil India	384	6	67.6	16.6	64
Power Grid Corp.	712	12	57.9	6.9	49
National Aluminium Co.	167	3	81.1	30.1	50
Bharat Electronics	164	3	75.0	24.0	39
Hindustan Copper	85	1	90.0	39.0	33
SJVN	99	2	90.0	39.0	39
MMTC	76	1	90.0	39.0	30
GAIL (India)	578	10	56.1	5.1	30
Container Corporation	252	4	61.8	10.8	27
Engineers India	81	1	69.4	18.4	15
NBCC	62	1	90.0	39.0	24
BPCL	489	8	54.9	3.9	19
MOIL	53	1	80.0	29.0	15
HMT	32	1	90.0	39.0	12
Rashtriya Chemicals & Fertilizers	31	1	80.0	29.0	9
National Fertilizer	17	0	90.0	39.0	7
Fertilizers & Chemicals Travancore	11	0	90.0	39.0	4
State Trading Corporation of India	13	0	90.0	39.0	5
ITDC	13	0	87.0	36.0	5
Shipping Corporation of India	31	1	63.8	12.8	4
ITI	9	0	90.0	39.0	3
Dredging Corporation of India	13	0	78.6	27.6	4
Andrew Yule & Co.	10	0	90.0	39.0	4
MTNL	20	0	56.3	5.3	1
BEML	26	0	54.0	3.0	1
Scooters India	1	0	93.7	42.7	0
Punjab Communications	1	0	71.2	20.2	0
Hindustan Organic Chemicals	1	0	58.8	7.8	0
Mysore Paper Mills	1	0	64.7	13.7	0
Bharat Immunological & Biological Corp.	2	0	59.3	8.3	0
<b>Banks/Finance</b>					
State Bank of India	1,904	32	58.6	7.6	145
Power Finance Corp.	343	6	72.8	21.8	75
Rural Electrification Corp.	265	4	65.6	14.6	39
IDBI Bank	124	2	76.5	25.5	32
Central Bank of India	91	2	88.6	37.6	34
Canara Bank	186	3	69.0	18.0	34
Bank of India	179	3	66.7	15.7	28
Punjab National Bank	345	6	58.9	7.9	27
UCO Bank	87	1	77.2	26.2	23
Indian Bank	67	1	81.5	30.5	21
Indian Overseas Bank	77	1	73.8	22.8	18
Bank of Baroda	389	6	56.3	5.3	20
Syndicate Bank	75	1	67.4	16.4	12
Bank of Maharashtra	47	1	85.2	34.2	16
Union Bank of India	128	2	60.1	9.1	12
Vijaya Bank	39	1	74.1	23.1	9
State Bank of Mysore	25	0	90.0	39.0	10
United Bank of India	33	1	88.0	37.0	12
Corporation Bank	54	1	63.3	12.3	7
Oriental Bank of Commerce	82	1	59.1	8.1	7
Punjab & Sind Bank	16	0	81.4	30.4	5
Allahabad Bank	64	1	58.9	7.9	5
Andhra Bank	43	1	60.1	9.1	4
Dena Bank	33	1	58.0	7.0	2
IFCI	57	1	55.5	4.5	3
Jammu and Kashmir Bank	75	1	53.2	2.2	2
Balmer Lawrie Investment	6	0	59.7	8.7	1
<b>Total</b>					<b>3,647</b>

Source: Capitaline, Kotak Institutional Equities

**Exhibit 5: Government can raise ~Rs560 bn if it reduces its holding to 75%**  
List of PSUs with more than 75% of government holdings (sorted on stake sale)

Company	Market Cap.		Govt holding (%)	Stake sale	
	(Rs bn)	(US\$ bn)		(%)	(Rs bn)
Coal India	2,360	39	89.7	14.7	346
NMDC	716	12	80.0	5.0	36
NHPC	249	4	86.0	11.0	27
Neyveli Lignite Corp.	152	3	90.0	15.0	23
SAIL	334	6	80.0	5.0	17
Hindustan Copper	85	1	90.0	15.0	13
SJVN	99	2	90.0	15.0	15
MMTC	76	1	90.0	15.0	11
National Aluminium Co.	167	3	81.1	6.1	10
NBCC	62	1	90.0	15.0	9
HMT	32	1	90.0	15.0	5
National Fertilizer	17	0	90.0	15.0	3
MOIL	53	1	80.0	5.0	3
Fertilizers & Chemicals Travancore	11	0	90.0	15.0	2
State Trading Corporation of India	13	0	90.0	15.0	2
Rashtriya Chemicals & Fertilizers	31	1	80.0	5.0	2
ITDC	13	0	87.0	12.0	2
ITI	9	0	90.0	15.0	1
Andrew Yule & Co.	10	0	90.0	15.0	1
Dredging Corporation of India	13	0	78.6	3.6	0
Scooters India	1	0	93.7	18.7	0
<b>Banks/Finance</b>					
Central Bank of India	91	2	88.6	13.6	12
Indian Bank	67	1	81.5	6.5	4
Bank of Maharashtra	47	1	85.2	10.2	5
State Bank of Mysore	25	0	90.0	15.0	4
United Bank of India	33	1	88.0	13.0	4
IDBI Bank	124	2	76.5	1.5	2
UCO Bank	87	1	77.2	2.2	2
Punjab & Sind Bank	16	0	81.4	6.4	1
<b>Total</b>					<b>561</b>

Source: Capitaline, Kotak Institutional Equities

**Exhibit 6: Government can raise ~Rs700 bn by selling minority stakes in non-government companies**  
Key minority holdings of government in certain companies

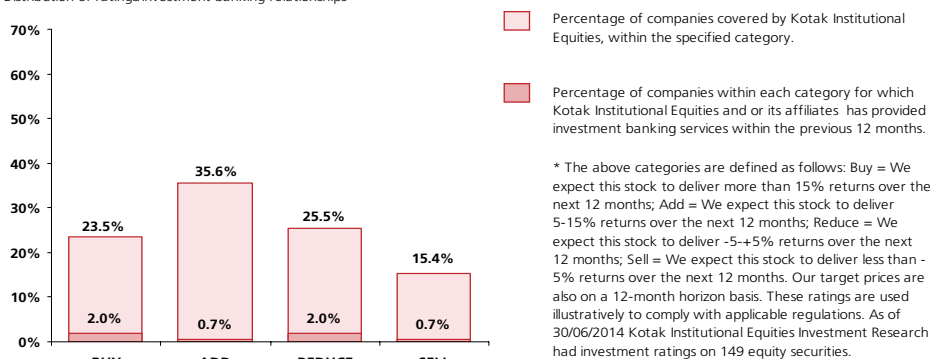
Company	Mcap.	Shares	Govt holding	
	(Rs bn)	(mn)	(%)	(Rs bn)
Axis Bank	978	55	11.7	114
Hindustan Zinc	739	1,248	29.5	218
ITC	2,842	897	11.3	321
Larsen & Toubro	1,469	76	8.2	120
<b>Total</b>				<b>774</b>

Source: Kotak Institutional Equities

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of June 30, 2014

## Ratings and other definitions/identifiers

### Definitions of ratings

**BUY.** We expect this stock to deliver more than 15% returns over the next 12 months.

**ADD.** We expect this stock to deliver 5-15% returns over the next 12 months.

**REDUCE.** We expect this stock to deliver -5-+5% returns over the next 12 months.

**SELL.** We expect this stock to deliver <-5% returns over the next 12 months.

Our target prices are also on a 12-month horizon basis.

### Other definitions

**Coverage view.** The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: **Attractive, Neutral, Cautious.**

### Other ratings/identifiers

**NR = Not Rated.** The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.

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