Budget Preview: Spending growth likely to remain subdued in FY26

Expect fiscal deficit target at 4.5% of GDP in FY26

- **The Government of India (GoI) will present its Budget 2025-26 on Saturday, 1st Feb'25. The first full-year Budget of the new government comes against the backdrop of slower domestic economic growth, a weakening currency, and a highly uncertain global geopolitical situation (especially the Trump-led US administration). Not surprisingly then, the expectations are running high. In this note, we present our five key expectations from the Union Budget 2025-26 and also discuss the fiscal math.**

Five key expectations from the Union Budget 2025-26:

1. **Make interest-free capex loans to states conditional: One of the most worrying trends in public finances for the past 2-3 years has been the increasing number of welfare schemes. The Union Government announced the PM-KISAN scheme in the interim Budget 2019, which was followed up with free food grains to about 813.5m citizens in Dec'22 for one year and was extended to five years in Nov'23. Notwithstanding the prospering India, several states have announced unconditional monthly stipends to various groups (women, students, unemployed, etc.) without any economic criteria or statistical reasoning, which is a bit confusing. If states have the resources to announce cash transfers or other welfare schemes, then the need for interest-free loans for capex to states by the central government must be reviewed. It would be useful to link such capex loans with some conditions, such as a) the achievement of capex by each state vs. its budget estimate, and b) the ratio of welfare schemes/cash transfer/current expenditure to capital expenditure of each state. The higher the former and the lower the latter, the more the state deserves capex support from the central government. Such conditions would help bring some fiscal discipline.**
2. **Lower/simplify indirect taxes and change dividend income tax policy: There is no doubt that personal income tax rates are high, but the burden of indirect taxes is more widespread and concerning. Based on the central government's gross taxes data, direct taxes (personal and corporate income taxes) account for ~57% of total taxes now, the highest share in 15 years. Nevertheless, if we include states' taxes, the indirect taxes still account for ~60% of all tax receipts in the country, the same as it was a decade ago *(Exhibit 1)*. We recommend that: a) double taxation on dividend income be abolished by either making it tax deductible for companies or by reverting to the old system of including it only in the corporate income taxes, and b) the government needs to articulate its intention of making GST simpler by reducing tax slabs and interventions and lowering the burden of indirect taxes.**
3. **Focus on boosting household income, not consumption: It is widely believed that urban consumption growth has slowed down, while the rural economy has improved in FY25. There is, thus, a lot of expectation from the government to boost consumption. This, we believe, is unwarranted. The government needs to focus on improving household income growth rather than consumption. Apart from simplifying and lowering indirect taxes, any support to the construction sector (the second-highest employer industry in India) would be highly effective. Further, while the formalization of the economy is beneficial, it is not advisable to completely overlook the huge informal sector (e.g., MSMEs). Therefore, any non-inflationary support to the micro and small enterprises would be welcome.**
4. **Remain on the path of fiscal consolidation and focus on capex: It is very likely now that the government will miss its FY25 capex target by about INR1t. Further, the first batch of supplementary demands for grants for FY25 included proposals involving a net cash outgo of INR441b. Total spending, thus, is anticipated to be lower than the targets this year, even though total receipts could meet the budget estimates (slightly better tax receipts, offset by lower non-debt capital receipts). Therefore, the central government will probably overachieve its fiscal deficit target this year. We recommend that the government continue on the path of consolidation and target a deficit of 4.5% of GDP next year, with a clear preference for capex. We expect 10-15% growth in capex in FY26, following +/-5% change this year (FY25). At the same time, if the government chooses to target the debt-to-GDP ratio from the subsequent years, it needs to clearly outline its target range (or point target) over a longer period.**

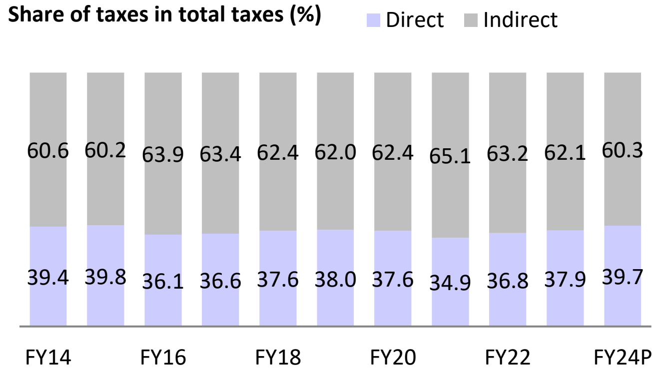
Nikhil Gupta – Research Analyst (Nikhil.Gupta@MotilalOswal.com)
Tanisha Ladha– Research Analyst (Tanisha.ladha@motilaloswal.com)

5. <u>The government should accept its limitations in incentivizing corporate investments:</u> **Finally, the government needs to recognize its limitations in pushing private corporate investments higher. During the past five years (FY20-FY24E), government capex has recorded a CAGR of 16%, household investments have risen by 12%, and corporate investments have experienced a CAGR of only 6%. Excluding CPSEs (whose capex declined), private corporate capex grew 8% during the past five years. This is despite a steep reduction in the corporate income tax rate in Sep'19. Although it may be appealing to attribute the lack of increased spending to companies, we must acknowledge that their spending decisions are primarily driven by project viability and available profitable opportunities. The government needs to accept that the rising prominence of equity markets, globalization, and independent management have diminished the policymakers' ability to influence corporate investments. It is worth analyzing if India's corporate investments can rise from the current levels without compromising sustainability, rather than announcing further incentives to push corporate investments.**

Budget 2025-26 in numbers:

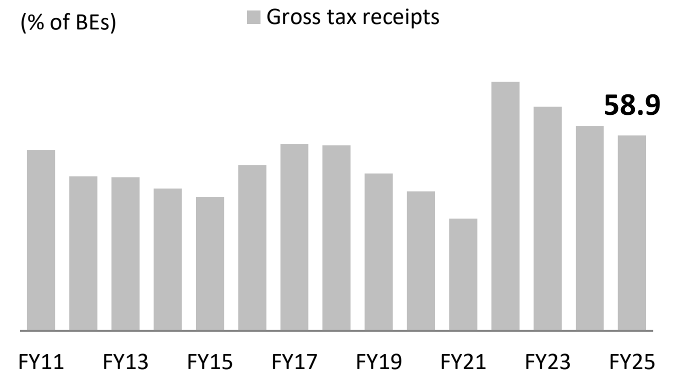
- **The Center's fiscal deficit stood at INR8.5t or 52.5% of budget estimates (BEs) in the first eight months of FY25 (Apr-Nov'24), compared to 50.7% of BEs in the corresponding period last year. One of the reasons for the higher fiscal deficit in FY25TYD is that the Center has devolved two advance installments of taxes to state governments (INR699b in Jun'24 and INR891b in Oct'24). The GoI released an additional amount of INR839b in early Jan'25 as well. Therefore, the GoI had devolved almost two-thirds of the budgeted tax devolution to states as of Nov'24, compared to 53%/58% in the corresponding periods in FY23/FY24 (which increased to 86% as of Jan'25 vs. 70%/73% in the previous two years).**
- **Although the GoI has devolved more taxes to states, gross tax collections have also amounted to 59% of BEs as of Nov'24, lower than 61% in the corresponding period last year *(Exhibit 2)*. It means gross taxes have increased 10.7% YoY during Apr-Nov'24, similar to the budgeted growth of 10.8% in FY25. Although GST receipts have posted slower growth in recent months, total indirect taxes have been 64.2% of BEs as of Nov'24 (better than 62.5% last year), and direct taxes have been only 54.9% (vs. 59.3% in FY24). Going forward, we expect the GoI to meet its indirect tax collection target and overachieve its personal income tax target but likely fall short in terms of corporate tax receipts. Overall, we expect the GoI to overachieve its tax target in FY25.**
- **At the same time, total expenditure was at a two-decade low of 56.9% of BEs as of Nov'24, compared to 58.9% in FY24. This was largely led by a decline of 12% YoY in capital spending, due to which it was at a 15-year low of 46.2% of BEs as of Nov'24 (vs. 8.5% in FY24). Revenue spending, on the other hand, was 60.1% of BEs as of Nov'24, better than 59% achieved in the corresponding period last year *(Exhibit 3)*.**
- **We hope that the contraction in capex is only temporary and will pick up in the remaining months of FY25. Assuming 40% YoY growth during Dec'24-Mar'25, total capital spending will still fall short by about INR1t this year, standing at around INR10t compared to the BE of INR11.1t *(Exhibit 4)*. Including the first batch of supplementary grants, revenue spending could be higher than BEs by INR440b, which means that the aggregate fiscal deficit could be around INR15.5t or INR600b lower than the BEs in FY25. Considering nominal GDP growth of 9.2% (vs. the NSO's estimate of 9.7%), it would mean a deficit of 4.8% of GDP, lower than the 4.9% budgeted in FY25.**
- **For FY26, we expect a 10.6% growth in gross taxes, which would convert into an 8.3% growth in total receipts as the RBI dividend will likely be significantly lower than it was last year. If so, assuming 10.8% nominal GDP growth in FY26, total spending could grow 7.1% YoY next year, the same as in FY25 *(Exhibit 5)*. Nevertheless, we believe that capital spending will grow by 10-15% next year, which means a growth of 5.5-6% in revenue spending.**
- **All in all, with the Center's total spending expected to come down to a six-year low of 14.3% of GDP from 14.8% of GDP in FY25 *(Exhibit 6)*, the fiscal drag on economic growth will continue. We do not expect any serious improvement in private spending and fear further slowdown. Accordingly, we keep our real GDP forecast at 6.3% in FY26, similar to 5.8% in FY25.**
- **Detailed fiscal math for FY25E (based on provisional data up to Nov'24) and FY26BE (forecast) is provided in *Exhibit 7*.**

Exhibit 1: Share of direct and indirect taxes in India's total tax receipts (% of total)



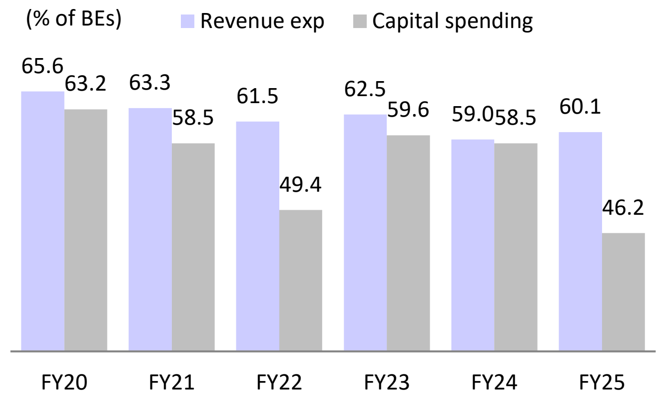
Center + states data FY24P is provisional data

Exhibit 2: Gross tax receipts are at a four-year low during Apr-Nov'24 (FY25YTD)



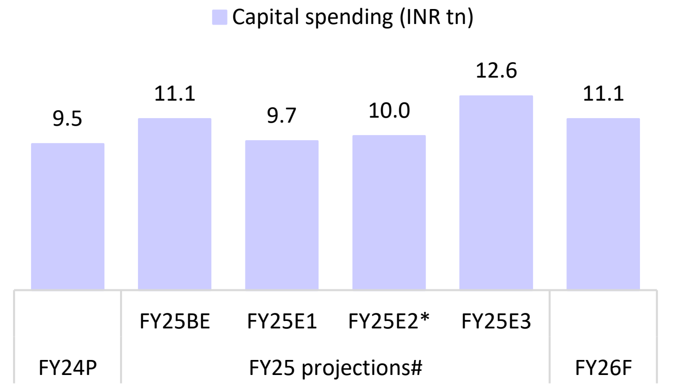
Apr-Nov period for all years

Exhibit 3: Total spending is lower due to weak capex in FY25YTD



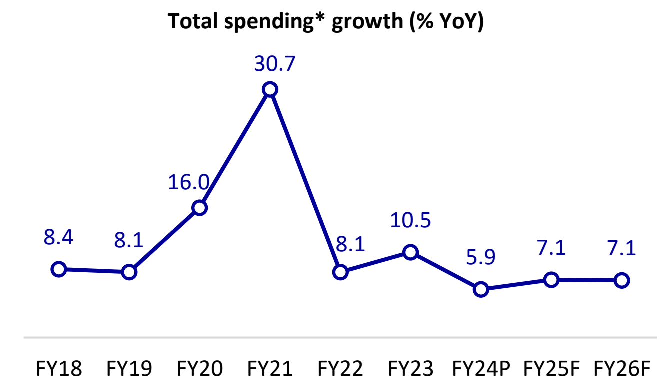
Apr-Nov period for all years

Exhibit 4: Capital spending could fall short by about INR1t this year



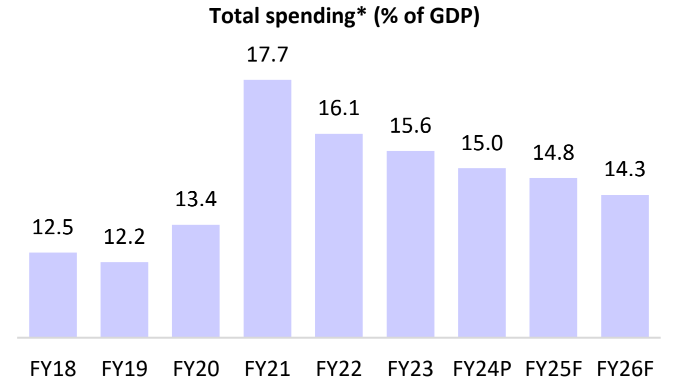
#E1/E2/E3 = 25%/34%/45% YoY growth in Dec'24-Mar'25
*Base case

Exhibit 5: Total spending growth could remain subdued at ~7% YoY next year



Revenue + Capital spending

Exhibit 6: Total spending is expected to fall to six-year low of 14.3% of GDP in FY26



FY25 based on data up to Nov'24

Exhibit 7: What could the fiscal math look like?

	FY24P	FY25BE$		As of Nov'24	FY25E*		FY26BE#	
	INRb	INRb	YoY (%)	% of BEs	INRb	YoY (%)	INRb	YoY (%)
Total receipts	27,889	32,072	**15.0**	**59.1**	32,087	**15.1**	34,747	**8.3**
Revenue receipts	27,284	31,292	**14.7**	**59.8**	31,487	**15.4**	33,947	**7.8**
Gross taxes	34,648	38,402	**10.8**	**58.9**	38,629	**11.5**	42,725	**10.6**
Net taxes	23,265	25,835	**11.0**	**55.9**	25,978	**11.7**	28,947	**11.4**
Direct taxes	19,220	22,070	**14.8**	**54.9**	21,880	**13.8**	24,165	**10.4**
Corporation taxes	9,111	10,200	**12.0**	**50.2**	9,748	**7.0**	10,821	**11.0**
Income taxes	10,109	11,870	**17.4**	**59.0**	12,131	**20.0**	13,345	**10.0**
Indirect taxes	15,428	16,332	**5.9**	**64.2**	16,750	**8.6**	18,560	**10.8**
Goods & Services Tax (GST)	9,621	10,619	**10.4**	**63.9**	10,583	**10.0**	11,747	**11.0**
Customs	2,331	2,377	**2.0**	**64.8**	2,517	**8.0**	2,769	**10.0**
Excise Duties	3,053	3,190	**4.5**	**54.9**	3,145	**3.0**	3,491	**11.0**
Less: Devolution to states	11,295	12,472	**10.4**	**65.1**	12,555	**11.2**	13,672	**8.9**
Non-tax revenue receipts	4,019	5,457	**35.8**	**78.3**	5,509	**37.1**	5,000	**-9.2**
Non-debt capital receipts	605	780	**29.0**	**30.7**	600	**-0.8**	800	**33.3**
Divestment	331	500	**51.0**	**18.0**	400	**20.8**	600	**50.0**
Total expenditure	44,425	48,205	**8.5**	**56.9**	47,594	**7.1**	50,950	**7.1**
Primary expenditure^	29,651	32,292	**8.9**	**55.8**	31,680	**6.8**	33,873	**6.9**
Revenue expenditure	34,940	37,094	**6.2**	**60.1**	37,594	**7.6**	39,850	**6.0**
Interest payments	10,639	11,629	**9.3**	**56.6**	11,629	**9.3**	12,792	**10.0**
Subsidies~	4,135	4,284	**3.6**	**65.2**	4,284	**3.6**	4,284	**0.0**
Defense	2,904	2,828	**-2.6**	**68.6**	2,828	**-2.6**	3,111	**10.0**
Pensions	2,168	2,433	**12.2**	**72.1**	2,433	**12.2**	2,676	**10.0**
Other	15,094	15,920	**5.5**	**57.8**	16,420	**8.8**	16,986	**3.5**
Capital spending	9,485	11,111	**17.1**	**46.2**	10,000	**5.4**	11,100	**11.0**
Defense	1,543	1,720	**11.5**	**41.1**	1,720	**11.5**	1,926	**12.0**
Railways	2,426	2,520	**3.9**	**66.8**	2,520	**3.9**	2,722	**8.0**
Roads & Highways	2,639	2,722	**3.2**	**53.9**	2,722	**3.2**	2,940	**8.0**
Others	2,878	4,149	**44.2**	**30.8**	3,038	**5.6**	3,512	**15.6**
Fiscal deficit	16,537	16,133		**52.5**	15,507		16,203	
Fiscal deficit (% of GDP)	**5.6**	**4.9**			**4.8**		**4.5**	
Nominal GDP	2,95,357	3,26,369	**10.5**		3,22,445	**9.2**	3,57,338	**10.8**
Memo:								
Capex@ (Capital outlays)	7,874	9,187	**16.7**	**46.5**	8,200	**4.1**	9,100	**11.0**

$As per the Budget presented in Jul'24 (% YoY over FY24P)
*Our estimates for the full-year based on provisional data available up to Nov'24
~ For major subsidies only
#Our forecast for FY26
^Total expenditure *less* interest and subsidies
@ Excluding loans & advances
Source: Union Budget documents, CGA, CSO, MOFSL

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Correspondence Address: Palm Spring Centre, 2nd Floor, Palm Court Complex, New Link Road, Malad (West), Mumbai- 400 064. Tel No: 022 71881000. Details of Compliance Officer: Neeraj Agarwal, Email Id: na@motilaloswal.com, Contact No.:022-40548085.

Grievance Redressal Cell:

Contact Person	Contact No.	Email ID
Ms. Hemangi Date	022 40548000 / 022 67490600	query@motilaloswal.com
Ms. Kumud Upadhyay	022 40548082	servicehead@motilaloswal.com
Mr. Ajay Menon	022 40548083	am@motilaloswal.com

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