SECTOR IN-DEPTH

4 February 2025

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Government Policy – India

Budget signals slowing fiscal consolidation as focus shifts to reinforcing growth

Summary

On 1 February, India's (Baa3 stable) government announced the budget for the fiscal year ending March 2026 (fiscal 2025-26). Planned cuts to personal income tax rates will bolster middle-class spending power and consumption, which is credit positive for many corporates and the financial sector. However, the resulting foregone revenue will slow the pace of the country's fiscal consolidation even as total spending declines as a share of GDP. The proportion of spending allocated to debt servicing continues to increase.

» **Fiscal consolidation slows as budget relies on tax measures to support economic growth.** The latest budget signals a slowing pace of fiscal consolidation, as the government seeks to provide firmer support for economic growth amid a dampened macroeconomic backdrop compared to recent years. Still, we expect the government is within reach of its near-term deficit target of 4.5% by fiscal 2025-26.

» **Policy support underpins outlook for consumption, provides some buffers to external shocks.** The increase in exemption limits for income tax will boost disposable income, particularly for urban middle-class households. Along with easing inflation, higher growth in real income will bolster consumption growth, facilitating a credit-positive recovery for many consumer-facing sectors.

» **Budget promotes private and state investments in infrastructure and energy transition.** Infrastructure development continues to be a key focus. The government aims to accelerate growth and invigorate private sector investments in the economy, including in the infrastructure sector. To meet energy-transition and net-zero objectives, the government aims to have 100 GW of nuclear power capacity by 2047, with private sector participation. The capital outlay for highways and railways remains high.

» **Domestic manufacturing and infrastructure spending are credit positive for nonfinancial companies.** Rising disposable incomes will boost spending by India's large and young population. Growing consumption will benefit makers of two-wheelers, passenger vehicles and white goods, and ride-hailing service providers. Initiatives aimed at agriculture and rural infrastructure will bolster consumer demand from rural India. Infrastructure development will support demand for building materials, cement and steel.

» **Enhanced support for agriculture and small businesses is credit positive for the financial sector.** Retail credit has been the mainstay for overall credit expansion in the last few years. Personal income tax cuts will increase individuals' disposable income and improve the debt-servicing capacity of this segment. Broadening credit access for farmers and small businesses will improve debt affordability. Meanwhile, an increase in the foreign direct investment limit will boost the insurance sector's growth prospects.

Fiscal consolidation slows as budget relies on tax measures to support economic growth

India's latest budget signals a slowing pace of fiscal consolidation, as the union government seeks to provide firmer support for economic growth amid a dampened macroeconomic backdrop compared to recent years. In the budget for the fiscal year ending March 2026 (fiscal 2025-26), the government is targeting a central government deficit of 4.4% of GDP. This is 0.4 percentage point lower than the revised estimate of 4.8% for fiscal 2024-25 and represents half the pace of the 0.8 percentage-point narrowing recorded in each of the past two fiscal years. Nevertheless, the budget puts the government within reach of its near-term deficit target of 4.5% by fiscal 2025-26, which has guided fiscal policy since 2021.

Announced tax measures account for the bulk of the government's support for the economy. In particular, the government has effectively eliminated direct tax liabilities for workers earning less than INR1.2 million (about $13,860) per year to catalyze household consumption. The previous threshold was INR700,000 (about $8,100). Although the government has estimated consequent foregone revenue at around INR1 trillion (0.3% of GDP), it has continued to project a 14.4% rise in income taxes, contributing to an 11.0% rise in total tax receipts that is more rapid than the assumed 10% rise in nominal GDP. As a result, the materialization of downside risks to income tax collection, which the government has budgeted to account for about one-third of gross tax revenue, would belie the government's view of revenue buoyancy that hinges on improved compliance and the return of robust economic growth.

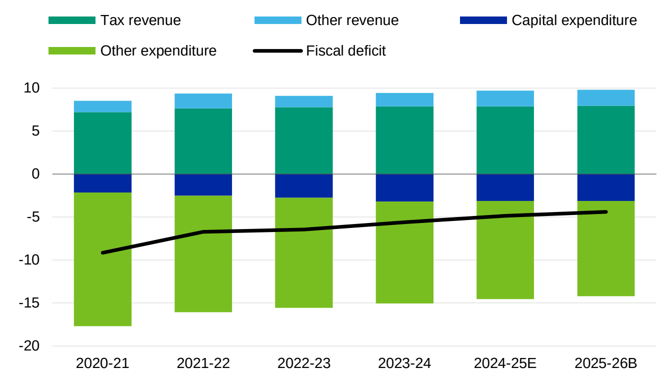
Lower-than-expected revenue would further pressure debt affordability, which we measure as interest payments as a share of revenue. But the risk to the fiscal deficit would be mitigated by some level of underspending, especially on capital expenditure. The government estimates that it will spend less than 92% of the budgeted allocation for capital expenditure in fiscal 2024-25, lower than the execution rate of around 95% in the previous year. Although some of the underspending has been attributed to the general elections held in the middle of last year, it remains unclear whether other administrative or capacity constraints have been addressed. At the same time, the complete execution of the fiscal 2025-26 budget would represent a 10.1% rise in capital expenditure compared with the revised estimate for fiscal 2024-25, even as the budgeted allocation was virtually unchanged relative to the original budget for fiscal 2024-25.

The continued narrowing of the fiscal deficit has been sustained on the back of a fall in spending. Total budgeted expenditure[1] will decline to 14.2% of GDP in fiscal 2025-26, from a revised estimate of 14.6% in the current fiscal year and 17.7% amid the pandemic in fiscal 2020-21 (see Exhibit 1). The improvement to the quality of spending from the government's emphasis on infrastructure development has been offset by the persistence of higher debt-servicing costs (see Exhibit 2). Compared to fiscal 2020-21, the budget for fiscal 2025-26 projects capital expenditure[2] to rise to 22.1% of total central government spending from 12.1%, while the share of interest payments would increase to a high of 25.2% from 19.4%. At the same time, the reliance on expenditure consolidation in the absence of more material gains in revenue generation constrains the government's ability to sustain the large gains in infrastructure development from recent years; the original budget allocations for capital expenditure rose by an average of 31.3% in the four years between fiscal 2020-21 and fiscal 2023-24, before slowing to 11.0% for fiscal 2024-25 and 0.9% in the latest budget.

Exhibit 1

Expenditure consolidation is the main driver of a narrowing fiscal deficit

Central government fiscal accounts, % of GDP

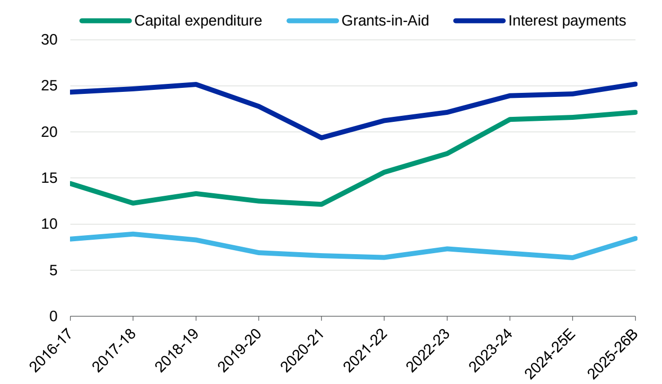


Sources: Government of India Budget 2025-26 and Moody's Ratings

Exhibit 2

Improvement in quality of spending from rising proportion of capex is offset by a concurrent increase in debt servicing

Percent of central government total expenditure



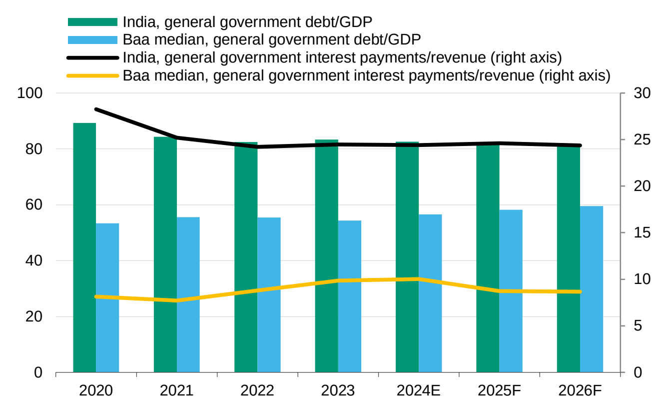
Sources: Government of India Budget 2025-26 and Moody's Ratings

Building upon its intention to anchor fiscal policy to a decline in debt to GDP as announced in last year's budget, the government articulated a medium-term fiscal consolidation path that puts the central government debt burden at around 50% of GDP by fiscal 2030-31 from an estimated 57.1% in fiscal 2024-25 and 57.4% in the year before that. While adherence to the downward trajectory in debt would support a view of enhanced policy credibility, the projected improvements may not be sufficiently material to change our broader assessment that India's fiscal strength will remain weaker than most of its Baa-rated peers. Over the next two years, we continue to expect India's general government deficit, which combines the fiscal position of the central and state governments, to remain among the widest when compared to Baa-rated emerging market peers, rendering India's debt burden higher and debt affordability weaker (see Exhibit 3). Moreover, India's fiscal metrics would remain weaker than pre-pandemic levels (see Exhibit 4).

Exhibit 3

India's fiscal metrics remain much weaker than those of similarly rated peers

General government metrics, %

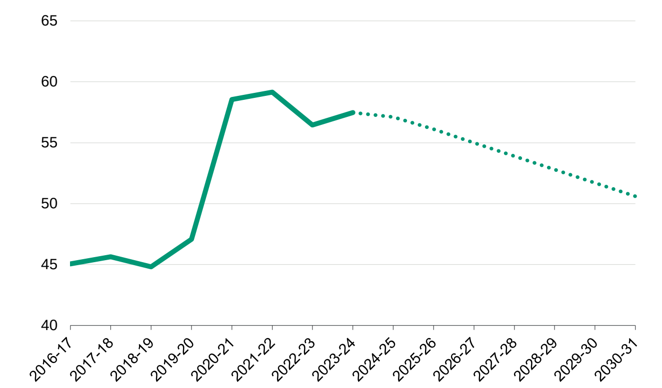


Fiscal years start in April for India.
Source: Moody's Ratings

Exhibit 4

Government simulations show that public debt is likely to remain higher than pre-pandemic levels over the medium term

Central government debt, % of GDP



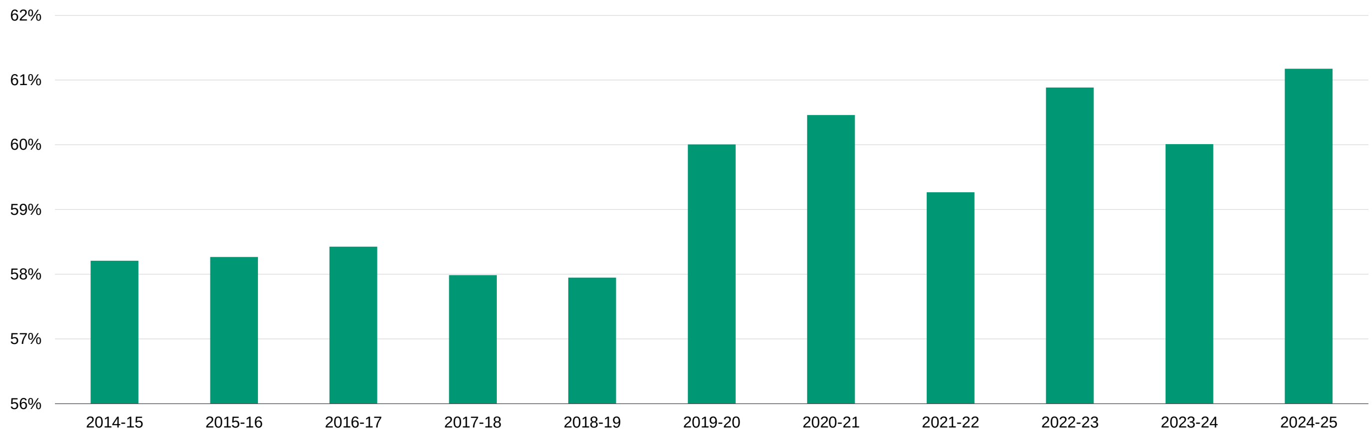
Moderate case for fiscal consolidation assuming 10% nominal GDP growth.
Sources: FRBM Statement February 2025, Haver Analytics and Moody's Ratings

Policy support underpins outlook for consumption, provides some buffers to external shocks

The budget will support a recovery in growth to 6.6% in fiscal 2025-26 from the government's first advanced estimate of 6.4% for fiscal 2024-25. In the first half of the current fiscal year, real GDP growth fell to 6.0% from 8.2% recorded in the year-ago comparable period.

Domestic demand has remained steady, accounting for 61.2% of GDP, the highest level for fiscal first-half periods over the past 10 years (see Exhibit 5). However, the recovery in demand is uneven between rural and urban areas. Rural demand saw a more visible rebound backed by record kharif production (crops harvested during the monsoon season) and favorable agricultural conditions. On the other hand, urban demand for autos and fast-moving consumer goods (FMCG) has moderated. According to the Federation of Automobile Dealers Associations, the growth of passenger vehicle sales has slowed to 4.2% year-over-year in April to November 2024 compared with 9.2% in the corresponding period of the previous year. FMCG sales in urban areas, per NielsenIQ, have also recorded a moderation in growth.

Exhibit 5
Private final consumption expenditure reached its highest H1 level in fiscal 2024-25
Percent of GDP in market prices



Only H1 data for each fiscal year is taken for comparison.
Sources: Central Statistics Office and Haver Analytics

The announced tax measures, particularly the increase in exemption limits for income tax, is set to boost disposable income, particularly for urban middle-class households. Along with easing inflation, higher growth in real income will bolster consumption growth, helping to facilitate a credit-positive recovery for many consumer-facing sectors such as autos and FMCG.

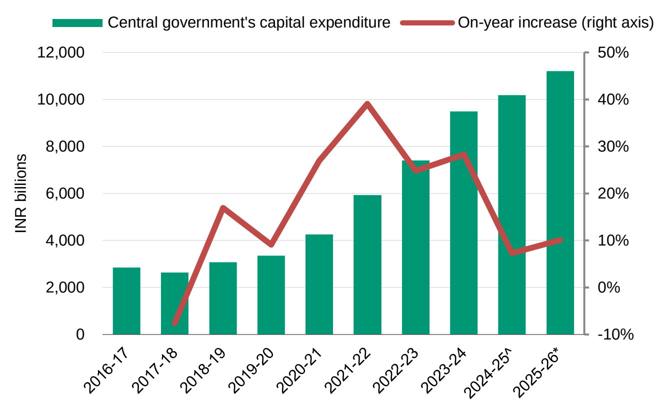
The new policy announcements related to the export sector will better prepare the economy to face external challenges in anticipation of the Trump administration's rollout of more tariffs globally. The policies encompass initiatives to facilitate easy access to export credit and support to micro, small and medium enterprises (MSMEs) to tackle non-tariff measures in overseas markets, the creation of a digital public infrastructure for trade documentation and financing solutions, and various measures to support the integration with global supply chains.

In addition, the budget called for a national framework to promote global capacity centers, which typically provide a range of services such as research and development, IT services, business process outsourcing, engineering services, and other higher value-added services to global clients. Service exports including global capacity centers more than doubled from $155 billion in fiscal year 2013-14 to $341 billion in fiscal year 2023-24 and now account for about 45% of total exports.

Budget promotes private and state investments in infrastructure and energy transition

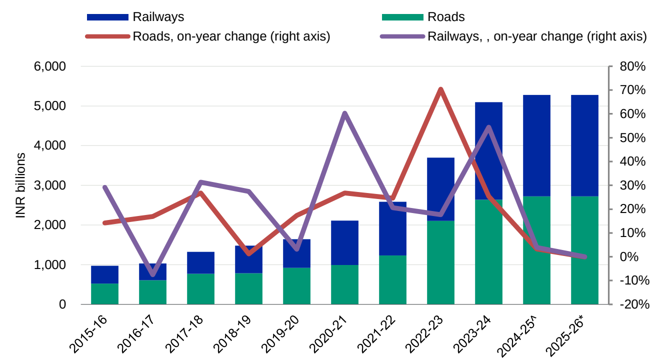
Infrastructure development remains one of the key focus areas in the fiscal 2025-26 budget. The total allocation for capital expenditure (INR11.2 trillion) is up 10.1% from revised estimates of fiscal 2024-25 (see Exhibit 6). However, as shown in Exhibit 7, the budget outlay for highways and railways is flat (on a high base), compared with the revised estimates for the previous fiscal year. The budget allocations for highways and railways have increased by 1.9x-2.2x over the last five years. The government would be launching an asset monetization plan for 2025-30, which will help raise capital of INR10 trillion for the development of new infrastructure projects. This will pave the way for more private sector participation in the operation and maintenance of infrastructure assets in the country.

Exhibit 6
Central government's outlay on capital expenditure



^ revised estimates, * budget estimates
Sources: Government of India Budget 2025-26 and Moody's Ratings

Exhibit 7
Public spending on highways and railways



^ revised estimates, * budget estimates
Sources: Government of India Budget 2025-26 and Moody's Ratings

To encourage state governments to increase capital spending, the central government has continued with special assistance in the form of 50-year interest-free loans of INR1.5 trillion. The central government will also incentivize state governments to carry out electricity distribution reforms and to augment intrastate transmission capacity by allowing additional borrowings of 0.5% of gross state domestic production, contingent on the reforms. In addition, INR180 billion has been allocated in the budget for the reform-linked distribution scheme and for grid strengthening, a 15% increase over revised estimates of fiscal 2024-25.

To help meet energy-transition targets and net-zero objectives, India aims to have at least 100 gigawatts (GW) of nuclear power generation capacity by 2047. This will require a 12x increase in nuclear power capacity (as of 31 December 2024, nuclear power capacity was 8.2 GW) over the next 22 years. To promote private sector participation in nuclear energy, the central government will look to amend key legislation including the Atomic Energy Act and Civil Liability for Nuclear Damage Act. The budget also announced the National Manufacturing Mission to promote an ecosystem for manufacturing solar PV cells, wind turbines, grid scale batteries and electrolysers.

Domestic manufacturing and infrastructure spending are credit positive for nonfinancial companies

The expected increase in disposable incomes will provide a significant boost to retail spending by India's large and young population, which typically has a high propensity to spend. Growing consumption will particularly benefit manufacturers of two-wheelers, passenger vehicles and white goods, as well as ride-hailing service providers. Additionally, various initiatives aimed at agriculture and rural infrastructure development will bolster consumer demand from rural India, especially for two-wheelers and entry-level cars. India's passenger vehicle industry, the world's third-largest by unit sales in 2024, will maintain growth of around 4% in fiscal 2025-26 after experiencing sluggish sales over the last 12 months.

India's electric vehicle (EV) adoption remains nascent compared to its regional and global counterparts, with EV penetration at a modest 2.5% for passenger vehicles, significantly short of the government's target of 30% by 2030. The exemption on import duties announced in the budget for critical raw materials in EV battery manufacturing, such as cobalt, lithium, lead, zinc, and ion battery scrap, will help develop an EV manufacturing ecosystem over time. Domestic manufacturing of lithium-ion batteries and other components will reduce manufacturing costs and help increase EV adoption.

However, Indian zinc and lead miners will have to lower product prices, in line with the industry practice for import parity pricing. The setting up of a state mining index will boost industry transparency, enabling better pricing discipline, a credit positive for miners. Meanwhile, the government's policy for the recovery of critical minerals from tailings, the byproducts or leftover materials from mining activities, will reduce wastage and address inherent environmental concerns for miners. However, their capital spending on tailings management may increase.

The government's focus on infrastructure development, including roads, railways, airports, ports and helipads, will sustain demand for building materials such as cement and steel. Volumes for these two sectors will likely grow by 5% and 6%, respectively, during fiscal 2025-26. Longer-term prospects for these sectors will be further fueled by the government's objective to develop the country's top 50 tourist destinations.

Streamlined e-visa facilities and selected visa fee waivers should boost international passenger traffic, while higher disposable incomes will likely prompt a spike in domestic travel. Increased travel will benefit hospitality companies. Meanwhile, the government's renewed focus on spiritual and medical tourism, as well as development of tourist destinations will serve as longer-term demand catalysts for the hospitality sector.

The budget did not include any grants – which had been expected by market analysts – to oil marketing companies (OMCs) to compensate them for selling liquefied petroleum gas (LPG) at below-market prices over the past 10 months. The LPG losses have been a key driver of the OMCs' weak earnings in the first nine months of the current fiscal year, leading to significant weakening in their credit metrics.

Enhanced support for agriculture and small businesses is credit positive for the financial sector

Retail credit has been the mainstay for overall credit expansion in India in the last few years. Personal income tax cuts will increase disposable income of individuals, improving debt servicing capacity of the household borrowers.

The government's interest subvention scheme for around 77 million farmers will improve farmers' debt affordability following the raising of the loan limit to INR500,000 from INR300,000. The government has enhanced the credit guarantee cover for small businesses (MSMEs and startups), allowing banks to undertake cash-flow-based lending with adequate risk protection. The guarantee cover for micro-to-small enterprises will increase from INR50 million to INR100 million, while that for startups will increase from INR100 million to INR200 million. Further, to help MSMEs achieve higher efficiencies of scale, technological upgrades and better access to capital, the investment and turnover limits for the classification of all MSMEs will increase to 2.5x and 2x, respectively.

The National Bank for Financing Infrastructure and Development's partial credit enhancement facility for corporate bonds linked to infrastructure development can help boost investments in infrastructure.

Continued fiscal consolidation will lead to largely stable government borrowings from domestic funding markets and small savings schemes through retail customers in the next fiscal year, keeping domestic interest rates in check. The reduction in fiscal deficit in the last few years has helped government benchmark bond yields to decline since the middle of 2022.

Increase in insurance sector's foreign direct investment limit is credit positive

The increase in the maximum foreign ownership stake to 100% from 74% will likely boost foreign insurers' interest in investing in the growing Indian insurance market, where we expect strong premium growth will boost profitability. Many foreign insurers already present in the country through joint ventures could seek to increase their ownership stakes in their Indian affiliates following this change in regulation. We view foreign investment as credit positive because it increases product innovation. The presence of foreign stakeholders also brings benefits in the areas of capital adequacy, financial flexibility and governance standards.

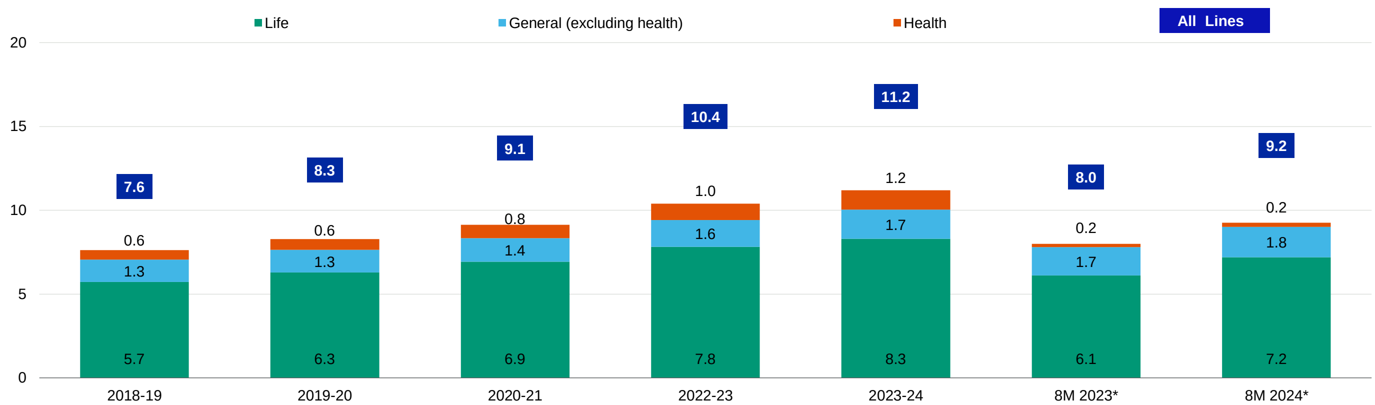
Similar to the wider financial services sector, the reduction in personal income tax will have positive trickle-down effects for the insurance sector. Increased levels of disposable income in the middle-class segment, the insurance sector's largest target market, bodes particularly well for health insurance, given increasing awareness around well-being and protection in the post-COVID era.

These changes will further boost the Indian insurance industry's growth prospects, which are already favorable. Strong economic growth supports average household incomes and increasing demand as a result of consumers' increasing risk awareness and the steady digitalization of the Indian economy, which facilitates the distribution and sale of insurance products. Indian insurers' total premium revenue rose 16% to INR9.2 trillion ($77 billion) in the first eight months of fiscal 2024-25, driven by a 21% increase in health insurance and an 18% increase in new business written in the life sector. This marked an acceleration from fiscal 2023-24, when premiums were up 8% on year to INR11.2 trillion.

Exhibit 8

India's insurance market's rapid premium growth continues

INR trillions



Sources: IRDAI annual reports, General Insurance Council monthly statistics and Moody's Ratings

Endnotes

1 Including "revenue" expenditure, capital spending, debt service payments and other on-budget expenditures.

2 Excluding grants-in-aid for creation of capital assets.

REPORT NUMBER 1436308

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