INSTITUTE FOR POLICY REFORMS

IPR ANALYSIS

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Discovering the Real Budget 2014-15

IPR's analysis of the federal budget 2014-15 shows high risks for imbalance and limited opportunity for economic growth. The risks are in the shape of inability to meet revenue targets, high inflation from increase in fiscal deficit, declining credit worthiness from high debts, and government's inability to invest in priority projects or in human development and too many resources diverted to highways. The budget also likely entails increase in power tariff and other levies with little to show for improved service to the people. Despite the rhetoric, the budget shows little consideration for the ultimate purpose of public finances which is to improve the living standard and quality of life of the people of Pakistan.

Tuesday's budget speech was an object lesson in spin. Analysts at IPR have spent hours parsing out the elaborate claims in the speech and deciphering what was left unsaid. A study of the released documents shows the real budget beneath. And what we find is some cause for concern. At its best, the budget is a combination of promise and government's usual inclination to rely on improbable hope. More realistically, the numbers do not add up. The budget estimates are meant to satisfy donor expectations, especially the IMF. It will be a challenge for government to meet the targets set in the budget. Here is what IPR found:

ABOUT IPR

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- Government is right to claim some success in stabilizing the economy.
- The budget does address some irritants for businesses (this is the promise of the budget) though it avoids making necessary reforms in the working of the government to reduce costs of doing business and improve revenue collection.
- IPR has concerns about the estimates for fiscal 2014-15. Numbers in the budget document do not square up with the story in the Finance Minister's speech. IPR finds that the budget documents do not support the following :
  - government's estimates of growth in tax collection,
  - increase in tax to GDP ratio and contribution of direct taxes,
  - control over inflation,
  - GDP growth rate, and
  - Decline in fiscal deficit.

This is the budget beneath and it is one that carries significant risks for the economy. What was left unsaid in the Finance Minister's speech is, at least, as important as the speech itself.

Let's first look at the positives.

Successes of the Government

The Finance Minister listed a number of successes for his government. IPR endorses some of these achievements.

- The government claims that the economy grew at an encouraging 4.1% during fiscal 2013-14. However, IPR estimate is that the GDP growth rate of3.5%.
- Inflation was down to 8.6% annually, which though high is well below double digit.
- Tax collection has increased at a somewhat rapid rate of over 16% for 2013-14 and the usually incurable fiscal deficit seems somewhat tamed at 5.8% of GDP, compared to the out of control 8% for the previous fiscal year. Similarly, net forex reserves are at

at a more sustainable $8.5 billion USD than the fragile level a year ago.

- The Finance Minister also referred to the market's endorsement of government's economic policy with the KSE Stock Price Index at about 28000. He cited successful auction of licenses for 3G and 4G mobile telephony and the high levels of programme lending secured from international donors.

But there are other areas where more progress is required.

- Agriculture growth rate declined from 2.9% in 2012-13 to 2.1% in 2013-14 (Table 1.3 Pakistan Economic Survey).
- Private investment (gross fixed capital formation in the private sector) has declined by 1.6% in fiscal 2013-14 notwithstanding government's claim of major increase in private credit (Table 1.8A Pakistan Economic Survey).
- Increase in foreign reserves and the accompanying appreciation in the value of the Pakistan Rupee come at the expense of potentially unserviceable foreign debt and unanswered questions about the purpose of voluntary grants extended by a 'friendly' government.
- Government may feel satisfied at the 16% growth rate for tax collection, but it falls well below government's target growth rate of 27%.
- Despite the rhetoric about tax reforms, there is little change in the tax to GDP ratio and especially in the abysmally low contribution of direct taxes to total revenue.
- And while programme lending provides much needed relief to a foreign exchange starved economy it does little to generate the cash flows needed to service that debt (as these are not linked to projects). In fact, such budgetary support allows governments an easy exit without forcing upon it the disciplines of economic management.
- Low growth in exports, accentuated lately by an appreciating Rupee, means that current account deficit remains high.
- Fiscal deficit currently at a manageable 5.8% may increase to 6.8% if government pays off the circular debt and not postpone it to the new fiscal year.
- If this happens, inflation will likely rear its head again.

Incentives for Exports and Investment

The new budget does well to incentivize exports and private investment:

- Reduction in mark-up by two percentage points each for working capital financing (the export refinance scheme) and the long term financing facility will give a fillip to exports.

- Performance based duty drawbacks for textile exporters too is a positive as is a two year extension in tax exemption for import of textile machinery.
- Government proposes to set up an EXIM Bank for export growth though its efficacy will depend on how well it operates. So far, not much is known about its structure or source of funding.

These incentives will offset the loss to our exports that could result from appreciation in the value of the rupee. Clearly, government's misplaced faith in talking up the rupee has been counter-productive and necessitated the incentives above. While IPR supports such incentives for the private sector, it hopes that they will stand the test of scrutiny by IMF or the WTO.

The budget's commitment to growth of private investment, however, is not unqualified. Textiles apart, tariff rates have increased on import of machinery used by the export sector. Among others, these include marble cutting machinery, rice parboiling plants, horticulture, cool chain, and agricultural machinery. While previous governments encouraged export of services, the new budget taxes machinery imports used for call centres and hotels and tourism. Non-tradable services too have been affected. The new budget taxes import of hospital equipment including operating tables, angiography and other cardiac machinery, and dental equipment. Similarly, effluent plants for treating industrial waste and desalinization plants have been subjected to Customs duty.

Budget Estimates 2014-15

IPR is concerned that the numbers for Budget 2014-15 do not add up. The basis of the budget is fragile at best. Inability to achieve targets will result in high fiscal deficit, high inflation, decline in GDP growth, and friction in relations with IMF.

Within the present policy framework and structure of the economy, government cannot conceivably meet the tax revenue target of 2810 billion rupees or remain within its expenditure estimates. This is not only because government has underperformed historically, (actual FBR tax collection for 2013-14 is over 200 billion rupees below the original collection estimate).

Below are three cases where the numbers do not add up.

- Gas Infrastructure Development Cess (Table 9, Budget in Brief): IPR estimates that collection of the Cess has been overstated by 56 billion rupees. Government estimates total collection of 145 billion rupees in fiscal 2014-15. The present rate of the levy does not justify this level of collection. This revenue target satisfies IMF's requirement for contribution of 0.4% of GDP on this account. Government will either fall well short of its promise or increase the rate of the levy. IPR fears a combination of both.

- `Reduction in Subsidy by 120 billion rupees (Table 15, Budget in Brief): Subsidy to the power sector mainly contributes to this line item. A reduction in subsidy of such magnitude requires an increase of 15 to 20% in power tariff. It is curious that the Finance Minister's speech missed this important detail. It is likely also, that, in keeping with the past, expenditure on this account will breach the estimated amount putting to question government's claim of controlling the fiscal deficit. IPR's past research has proven that continued tariff increase has become counter-productive (because they add to higher T&D losses and under-recovery of bills) and has affected international competitiveness of our businesses.

- Estimated Provincial Surplus (Table 7, Budget in Brief): Government estimates that provinces will not spend all of their revenue and will generate a surplus of 289 billion rupees. IPR finds such optimism misplaced. After an initial warm-up time, most provincial governments are ready with ambitious plans for development. At least two provincial governments do not belong to the same political party as the federal government and may not easily give in to persuasion. This item is a cosmetic put in to balance the books and is especially optimistic because, in the first place, total resources transferable to provincial governments from the federation would likely be below estimates.

- There is more to come. Incentives to private sector entail a cost. IPR estimates that this to be 100 billion rupees. The combined effect of concessional financing for exports (LTFF and Export Refinance) is 75 billion rupees. Duty drawback will cost about 5 billion rupees and reduction in corporate tax rate, 20 billion rupees. Government's additional tax proposals would likely generate an equivalent amount of a maximum of 150 billion rupees.

- Despite government's professed objective of increase in contribution of direct taxes, the Finance Bill does not propose any major measures for its enhancement. Last year, finding resistance among some key constituents, government gave up quickly its objective to broaden the tax base. This year, the government did not even consider it worth a mention. Proposals for additional tax are based mostly on expansion in the withholding tax regime, increase in customs duty such as those listed earlier.

The number of SROs withdrawn is not indicated.

- Nor does government's objective to raise the low tax to GDP ratio find support in the proposals. Pakistan has one of the lowest ratios in the world, which successive governments have been unable to correct. The budget resorts to subterfuge to hide this fact. It evasively includes non-tax revenues under the euphemism of 'other taxes' (Table 8, Budget in Brief). These now include gas infrastructure development cess and gas development surcharge of almost Rs 200 billion.. Such collections are meant for a specific purpose and cannot be included in general revenues of the government (though governments have often breached the principle). Their designation as taxes shows a lack of intent to spend the amount for the purpose approved by parliament. This artifice also bails out a department that has traditionally under-performed and needs correction. Improved tax administration should be a key government objective.

Overall, IPR finds a major gap in projected resources for fiscal 2014-15 as follows:

Total tax revenues 2014-15	2810 billion rupees
Total tax receipts 2013-14	2275 (IPR estimates 2250)
Additional resources needed	**535 billion**
Normal growth	**200 billion**
New tax measures:	150 billion
Minus incentives to private sector	-100 billion
Expected shortfall	285 billion or almost 1% of the GDP

This shortfall will be financed from further external borrowing (Eurobonds, project financing, and programme loans). IPR has serious concerns about further indebtedness of the Pakistan economy. It makes debt servicing unsustainable (already it claims 33% of total budget), reduces credit worthiness while increasing donor dependence. This allows government to postpone difficult decisions about tax policy and development prioritization.

Beneath the hype and self-congratulatory budget speech of the government, exists a real budget with high risks for imbalance and limited opportunity for economic growth. The risks are in the shape of high inflation from increase in fiscal deficit, declining credit worthiness from high debt, and government's inability to invest in priority projects of power and water or in human development and too many resources diverted to highways. The budget also likely entails increase in power tariff and other levies with little to show for improved service to the people. Despite the rhetoric, the budget shows little consideration for the ultimate purpose of public finances which is to improve the living standard and quality of life of the people of Pakistan.