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BUDGET STRATEGY PAPER FOR 2015-16

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BUDGET STRATEGY PAPER

This Budget Strategy Paper prepared by IPR for 2015-16 focuses first on the extent of stabilization achieved by the economy. It then recommends that the time has come to switch from the stabilization mode to revival of the economy. Fiscal and other measures required to raise the GDP growth rate to 5.5% in 2015-16 are identified below.

1. PROCESS OF STABILIZATION

The Government of PML (N) has been actively engaged in the process of stabilizing the economy following assumption of power. This has been aggressively pursued under the aegis of an IMF program from the Extended Fund Facility.

As part of the stabilization program for public finances the Government has taken the following actions:

(i) Additional taxation in the form of a one percentage point increase in the standard GST rate; increase in the minimum tax on companies from 0.5% to 1%; introduction of new withholding/advance taxes and enhancement in rates of such existing taxes; levy of a 1% duty on all non-dutiable (exempt) imports; withdrawal of a number of SROs in import duties and GST; enhancement in the excise duty on cigarettes . Provinces meanwhile have focused on developing the sales tax on services.

The consequence has been that the tax-to-GDP ratio has increased by 0.5% of the GDP in 2013-14, to reach 10.4%. It is projected that there will be further increase in the ratio by 0.5% in 2014-15. However, this seems unlikely given the current performance of FBR revenues.

On the expenditure side, a big increase in power tariffs early in the Program has helped contain the large tariff differential subsidy. In addition, the combined PSDP of the Federal and Provincial Governments was cut by 25% in 2013-14, in order to meet the deficit target of 5.5%. This represents a 2.5% point reduction in the deficit in comparison to 2012-13. It is likely to remain at the same level in 2014-15.

(ii) The balance of payments position has shown substantial improvement and there has been an exponential increase in foreign exchange reserves. From $6 billion at the end of June 2013, they have doubled now to $12 billion.

This has largely been facilitated by large external borrowings under the umbrella of the IMF Program. Eurobonds of $2 billion were floated last year and $1 billion was generated through Ijara-Sukuk bonds this year. In addition, a gift of $1.5 billion was received from a friendly country in 2013-14. The net credit from the IMF has approached $1.5 billion by end-March this year. Further, the Government has engaged in the sale of shares of profitable companies like HBL, UBL and PPL to generate over $1 billion from foreign investors.

The current account of the balance of payments has been transformed from a deficit to a surplus in the last two months. This is the result of the sharp fall in oil prices and continued buoyancy in home remittances. It is projected that the current account deficit will fall to an exceptionally low level of 0.8% of GDP in 2014-15.

(iii) The inflation rate has also shown a very steep decline, from about 8 %, on a year-to-year basis, in September 2014 it has fallen to only 2.5% in March 2015. The annual average rate of inflation in 2014-15 is expected to be less than 5%, the lowest rate in the last eleven years.

Therefore, there are clear signals that the economy has stabilized due to favorable external developments and internal policy actions.

Unfortunately, the cutbacks in development spending and additional taxation have had a negative impact on the growth rate of the economy. Growth rate is likely to be about 3.6 to 3.8% in the revised estimates of the GDP for 2013-14. During the current year, the large-scale manufacturing sector is witnessing a slow down, with the growth rate of 2% only in the first eight months. Also the IMF has asked for a large national PSDP cut of almost Rs 300 billion. Major crops like cotton and wheat have performed better. However, it is unlikely that the GDP growth rate will exceed 4% this year, as compared to the target of 5.1%.

Clearly, while stabilization has been largely achieved this has come at the cost of sacrificing growth. The time has come to switch from the stabilization mode to a process of revival of the economy. As such, the budget strategy has to be radically different in 2015-16. Pakistan must now attempt to get out of the ‘low growth trap’.

2. MACROECONOMIC FRAMEWORK

We first present the macroeconomic framework for 2015-16 from which the budget strategy can be derived. The IPR framework is compared with the IMF framework, which continues to target for further stabilization and projects a low fiscal deficit of 3.9% of the GDP in 2015-16.

The Annual Plan for 2015-16 must target for a growth rate of about 5.5%. This will require a number of stimuli to be provided to the economy. On the fiscal front this may include the following:

(i) The 2015-16 budget ought to be a 'tax free' budget. No tax rates should be enhanced unlike the last two years. FBR should focus on broadening the tax base (details are given later) and on improvements in tax administration.

(ii) The combined PSDP of the Federal and Provincial Governments should be given a quantum jump from 3.2% to 4.5% of the projected GDP in 2015-16. This will represent an increase in absolute terms of about Rs 500 billion. Earlier research has demonstrated that the short-run 'fiscal multiplier' is close to two. A rupees one billion increase in development spending leads to an increase in GDP of almost rupees two billion. Beyond this impact, larger investment in infrastructure expands the productive capacity and takes the economy to a higher growth trajectory. There is also the phenomenon that public investment 'crowds in' private investment, especially if the bottleneck of energy is removed.

On top of all the above reasons for a big increase in the PSDP in 2015-16, there is need for 'fiscal space' to make rupee resources available for implementation of projects agreed with the Chinese Government. The total outlay is $ 46 billion and it is essential that about Rs 200 to Rs 250 billion be allocated for CPEC projects in 2014-15 in the Federal PSDP.

(iii) The current account deficit is expected to widen by over $ 3 billion in 2015-16. This is largely due to larger imports of machinery for power projects being executed with the Chinese assistance. However, this is not expected to increase the balance of payments deficit. There will be a corresponding inflow of FDI or higher borrowing from China. Further, a net inflow is expected of IMF credit of almost $ 2 billion in 2015-16.

(iv) Current expenditure of the Federal and Provincial Governments is projected at 19.2% of the GDP both in the IMF and IPR Macroeconomic Frameworks. Efforts will be needed to reduce the tariff differential subsidy by diversion of more gas to the power sector.

MACROECONOMIC FRAMEWORK (BY IMF AND BY IPR)

	Unit	2013-14	2014-15		2015-16	
		Actual	Projected		Projected	
			IMF	IPR	IMF	IPR
GDP Growth Rate	%	4.1	4.3	4.0	4.7	5.5
Rate of Inflation (period average)	%	8.6	6.0	4.8	5.3	6.0
Gross National Saving	% of GDP	12.8	13.8	13.5	14.9	14.2
Gross Capital Formation	% of GDP	14.0	15.0	14.3	16.0	16.0
Balance of Payments						
Current Account Balance	$ billion	-3.1	-3.3	-2.1	-3.3	-5.4
Net Capital Flows**	$ billion	7.0	8.1	6.5	6.0	9.0
of which : FDI	$ billion	1.7	1.6	1	2.6	4.0
Gross Official Reserves	$ billion	9.1	15.4	14	20.2	18.0
Public Finances						
Revenue and Grants	% of GDP	15.1	14.8	14.1	15.3	14.5
of which: Tax Revenues	% of GDP	10.4	11.1	10.5	11.9	10.5
Expenditure***	% of GDP	19.8	19.4	19.6	19.2	19.2
of which: Current Exp	% of GDP	16.2	16.2	16.4	15.7	16.0
Development (incl. lending) Exp	% of GDP	3.8	3.2	3.2	3.5	4.5
Fiscal Balance (incl. grants)	% of GDP	-4.7	-4.6	-5.5	-3.9	-6.5

Projected after Sixth Review (December 2014)

**Difference between Overall Balance and the Current Account Balance

***Including Statistical Descrepancy

Source: IMF, Sixth Review Report

It is crucial that the IMF be brought on board with the change in the budget strategy for 2015-16. Already, following the Sixth Review, the Fund has been praising Pakistan for achieving a considerable degree of stabilization. Therefore, it should be willing now to support the Government's efforts at revival of the economy and taking the GDP growth rate above 5% for the first time in seven years. Given committed Chinese financing, a big increase in the PSDP is fiscally sustainable.

3. TAX REFORMS

We have indicated earlier that there should be no enhancement in tax rates in 2015-16. Instead, the emphasis should be on broadening the tax base and improving tax administration.

As a strong signal to the private sector, the reduction in corporate income tax rate should be accelerated. Earlier, the policy was to reduce the tax rate by one percentage point annually from 35% to 30%. Currently, the rate is 33%. It may be brought down to 30% in one go in 2015-16. A corresponding reduction in tax rate for individual tax payers may also be announced.

With regard to broadening the direct tax base, there is need to focus on companies also along with the number of individuals filing returns. According to the latest Tax Directory, 24186 companies have filed returns. This is only 40% of the number of companies registered with the SECP. Therefore, a drive should be launched to induce corporate entities to file returns or face heavy penalties.

There have also been widespread complaints about the percent GST system. It is handicapped with a number of serious problems as follows:

(i) Rising Input-Output Ratio (2% points in 2013-14), referred to as the 'Flying Invoice' Problem

(ii) Problem of large pending refunds of Rs 118 billion

(iii) Problem of Cross-Government Tax invoicing

(iv) Sharp Regressivity of the Tax Structure

(v) Complicated System of reporting and filing of returns

(vi) High Standard Tax Rate at 17%

(vii) 'Documentation Chain' available but not used because of very limited audit

(viii) Withdrawal of import Sales Tax SROs does not add much to revenue, due to input tax invoicing at the domestic production stage.

Further, the growth rate of GST has fallen to only 6% in the first nine months of 2014-15.

Therefore, there is need to explore the possibility of switching to a Single-Stage Sales Tax, possibly at the stage of consumption. It is hoped that the Tax Reforms Commission will come up with important recommendations in this area.

The next area for broad-basing is the withdrawal of SROs in import duty and GST. The first step has already been undertaken in the budget of 2014-15. The next step should be in the forthcoming budget. Simultaneously, the number of tariff slabs should also be brought down to four.

Finally, there are strong allegations by the private sector of under invoicing of imports, especially from China. There is a strong case for introducing minimum import prices of products which are vulnerable to under invoicing. There are provisions within the WTO rules for undertaking this step

4. SUPPORTING MEASURES

Monetary Policy

A number of other steps for revival of the economy can also be taken in 2015-16. In the presence of a low rate of inflation, the monetary policy can also be more expansionary in character. The policy rate of the SBP can be brought down from 8% to 7% and export concessionary finance made available at 5%. Borrowings from SBP may be positive and up to the limits of 'seignorage' (increase in demand for money). This has been estimated at about 1% of the GDP. Further, government borrowing from commercial banks should be limited to 2.5% of the GDP, so as to enable a doubling of credit to the private sector.

The Budget of 2015-16 may also consider giving special fiscal incentives to banks for lending to SMEs, microfinance, agriculture and housing.

Trade Policy

There is strong evidence that the Rupee is significantly overvalued. According to the SBP, the index of the real effective exchange rate, with the base year of 2010, today stands at almost 118. This is at a time when countries are engaged in competitive devaluations in a world economy where trade is expanding slowly. For example, during the last three months the Indian rupee has depreciated with respect to the dollar by 4%; the Turkish Lira by 16%; the Indonesian rupee by 4%; the Philippine Peso by 36%, and so on. At the same time, the Pakistani rupee has depreciated by only 1 percent.

Pakistan has not been able to take full advantage of the GSP+ status with EU due to the overvalued exchange rate. Exports to China have declined by 20% in the first eight months of 2014-15. In particular, exports of cotton yarn have fallen by 23%.

Turning to imports, the fall in price of oil has, no doubt, restricted the import bill. But many industries, which are import substituting in nature, are suffering because of a big increase in cheaper imports. For example, the quantity of imports of synthetic fibre has gone up by 43%; iron and steel by 21%; paper and paper board by 25% and food items by 61%.

Overall, there is a strong case for adjusting downwards the value of the rupee by about 10%, sooner than later. This will provide the much needed fillip to exporters and contain imports. This will also lead to higher tax revenues.

5. CONCLUSIONS

The last two years have witnessed efforts for stabilization of the economy under the aegis of an IMF program. Following the Sixth Review, the Fund has certified that much stabilization has been achieved. Therefore, the IMF should be convinced that the time has come for switching gear from stabilization to revival of the economy so as to achieve a GDP growth rate above 5% in 2015-16.

The appropriate revival strategy will involve , first, a 'tax free' federal budget in 2015-16 with the focus on broad-basing the various taxes rather than raising tax rates. Second, there should be a quantum jump in the size of the national PSDP, not only to create a large 'fiscal multiplier' but also to enable the inclusion of CPEC projects with access to large Chinese finance. Third, make the monetary policy more expansionary and remove largely the overvaluation of the rupee, to increase competitiveness and restrict imports.

The people have waited for the last seven years for a return to buoyancy of the economy. During this period, unemployment and poverty have increased. The time has come for revival of the economy. Fortunately, the environment, both external an internal, has become more conducive for taking the economy to a higher growth trajectory.

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