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Budget 2015-16: More of the Same

About IPR

Institute for Policy Reforms is an independent and non-partisan think tank established under Section 42 of the Companies Ordinance. IPR places premium on practical solutions. Its mission is to work for stability and prosperity of Pakistan and for global peace and security. IPR operations are supported by guarantees from the corporate sector.

The Finance Minister presented yesterday the mid-year (third) budget of the PML-N Government. By now a pattern has been established. The focus continues to be on fiscal consolidation under the aegis of the on-going IMF Program. Reduction in the fiscal deficit remains the prime objective. This is to be achieved by a combination of wishful thinking, involving over-optimistic projections, and through the adoption of some creative accounting techniques. There is also an element of subterfuge, with some of the more oppressive taxation and other measures not being explicitly highlighted. In addition, the Finance Minister has highlighted the accolades that the Government is receiving for its economic performance (see Box 1).

This IPR Fact Sheet will focus first on the budgetary outcome of 2014-15 and the strategy adopted for achieving the fiscal deficit target of 4.9 per cent of the GDP. This is followed by a discussion of the key budgetary numbers in the Budget of 2015-16. Thereafter, the impact of the taxation proposals on the people, will be derived. Finally, an analysis is undertaken of the Federal PSDP for 2015-16, especially from the viewpoint of prospects for enhanced power generation and extent of incorporation of CPEC infrastructure projects.

BUDGETARY OUTCOME

The Finance Minister has indicated that the fiscal deficit target for 2014-15 of 4.9 per cent of the GDP will be met. This is despite a short fall in FBR revenues of Rs 205 billion and a larger outlay on the PSDP than the originally budgeted magnitude of Rs 525 billion. Further, the Provinces are likely to fall well short of generating the required cash surplus of Rs 289 billion? How then is the fiscal deficit target being achieved? The answer is given below.

First, non-tax revenues are expected to be higher by as much as Rs 226 billion. SBP profits are way above the budgeted magnitude of Rs 270 billion, at Rs 399 billion. The large difference is primarily attributable to the receipts of almost Rs 100 billion from the sale of shares of UBL. In effect, privatization receipts have been shown `above the line` as revenue. According to the Privatization Ordinance of 2002, these receipts are expected to be a financing item `below the line` and used 90 per cent for the reduction of the public debt. In effect, an important accounting

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convention has been violated to raise the level of revenues and reduce the resource gap. It is interesting that the Explanatory Memorandum of Federal Receipts shows SBP profits at Rs 296 billion.

Second, defence receipts are up by Rs 64 billion above the projected level of Rs 140 billion. These are primarily receipts from the Coalition Support Fund (CSF) of the USA. At Rs 204 billion these are at an all-time high record level. Will they continue at a high level following the US withdrawal from Afghanistan?

Third, falling interest rates have led to a saving of Rs 55 billion in the mark-up payments on domestic debt. Fourth, following the passage of the GIDC bill by the Parliament recently, all arrears have accrued to the Federal Consolidated Fund (FCF) and the target revenue of Rs 145 billion has apparently been achieved. However, there is the fundamental question as to whether GIDC revenues should go into the FCF, as they are earmarked for specific purposes like financing the infrastructure development of Iran-Pakistan Pipeline, TAPI Pipeline, LNG or other ancillary projects. Also, there is a ruling by the Supreme Court that GIDC is not a tax. However, the Ministry of Finance has adopted the practice of showing GIDC in tax revenues, presumably to show a higher tax-to-GDP ratio.

All in all, somewhat questionable accounting practices have been adopted to achieve the IMF-mandated fiscal deficit target of 4.9 per cent of the GDP.

Box 1
International Perceptions / Rankings of Pakistan

The Finance Minister has highlighted the accolades that Pakistan is receiving on the Government's economic performance and potential for growth. This includes recognition by JETRO, OICCI, Goldman Sachs, Moody's, Standard and Poors, Nielsons and Bloomberg News.

There is need for a reality check by looking at some of Pakistan's international rankings as follows:

- Pakistan had a ranking of 107 in the Ease of Doing Business Index of the World Bank/IFC in 2013. In 2014 the ranking fell to 127.
- Pakistan has a ranking of 146 in the Human Development Index of UNDP. This compares with a ranking of 135 of India and 142 of Bangladesh.
- The Global Competitiveness Index of the World Economic Forum ranks Pakistan at 129, as compared to 71 for India and 109 for Bangladesh.
- Pakistan is tanked below India in the Food Security Index of the Economics Intelligence Unit (EIU) of the London Economist.
- Pakistan is in the `high alert` zone of the Fragile States Index of the Institute of Peace, Washington.

THE KEY BUDGETARY MAGNITUDES OF 2015-16

As the process of fiscal consolidation continues, the Government has committed to a further reduction in the consolidated fiscal deficit by 0.6 per cent of the GDP to 4.3 per cent of the GDP. How will this be achieved in the presence of a jump in the size of PSDP of 42 per cent and fall in non-tax revenues of 14 per cent?

First, as usual, an ambitious target has been set for FBR revenues at Rs 3104 billion. This implies a growth rate of at least 19 per cent over the level of Rs 2605 billion (in which there may be some short fall). The growth rates achieved, despite heavy doses of taxation proposals, in FBR revenues are 16 per cent and 13 per cent respectively in 2013-14 and 2014-15. As per past practice, many taxation proposals (discussed later) yielding Rs 253 billion are proposed. However, the possibility exists of a significant shortfall in FBR revenues once again.

Second, for the first time in Pakistan's history, the 2015-16 Budget actually targets for a decline in current expenditure (of Rs 20 billion). In 2014-15, the growth rate is likely to be at least 10 per cent. This unprecedented drop in current expenditure is to be achieved, first, by no increase in costs of debt servicing. This is presumably based on the big fall recently in interest rates. But there is a `lock in` effect of the large stock of outstanding permanent and unfunded debt at higher rates of interest. Almost, 62 per cent of domestic public debt is of medium or long term tenure. In addition the public debt will increase by almost 9 per cent by the end of 2014-15. Therefore, there could be still some increase in costs of debt servicing in 2015-16.

Third, subsidies are to be slashed, primarily to the power sector, by Rs 105 billion in 2015-16. In 2014-15, these subsides aggregated to Rs 243 billion, almost Rs 40 billion above the budgeted amount. The implication is that there will be a 15 per cent to 20 per cent increase in electricity tariffs, sooner or later. How will this be justified in the presence of lower fuel costs?

Fourth, the fiscal deficit target of 2015-16 is based on the generation of a large cash surplus by the Provinces combined of Rs 297 billion (almost 1 per cent of the GDP). This is highly unlikely given that during the 9th NFC deliberations, the Provincial Governments will have a strong incentive to establish higher expenditure benchmarks.

Overall, the Budget of 2015-16 is based on fragile and unrealistic assumptions. Like 2014-15, there may be a need for a series of minibudgets to meet the quarterly quantitative performance criteria of the IMF.

TAXATION PROPOSALS IN 2015-16 BUDGET

As mentioned earlier, the 2015-16 Budget envisages substantial additional taxation with a yield of Rs 253 billion (equivalent to 0.8 per cent of the GDP). Fortunately, almost 56 per cent of the yield is expected from direct taxes.

The most positive aspect of the budget is the effort to increase the incidence of taxation on unearned capital income and capital gains. This includes the change in rate and taxable holding period for securities, higher rate of taxation of dividends and effectively a surcharge for rehabilitation of temporarily displaced persons (TDPs) on the income of large tax payers. In the presence of large profits, steps to increase the incidence of direct taxation on commercial banks are also a step in the right direction.

However, some of the more radical proposals by the Tax Reforms Commission (TRC) have not been adopted. These include the withdrawal of the special tax privileges of VIPs, measures to tax foreign income of residents and inclusion of mechanisms for checking transfer pricing. Further, the holding period for the capital gains tax on properties should have also been extended, as done in the case of securities.

The government is placing great emphasis on higher advance/withholding taxes on non-filers to induce them to file returns. The difference in tax rates has been further increased in the 2015-16 Budget. But, beyond a point, this may become counterproductive and increase the incentive to engage in cash transactions. For example, the enhancement of the tax rate on bank transactions may lead to a fall in bank deposits.

A major step in the area of import duties is the withdrawal of the concessions embodied in various SROs. However, it has not been made clear in the Budget Speech, which SROs will cease to be operative. There is rationalization simultaneously of the tariff regime involving a reduction in the maximum tariff (from 25 per cent to 20 per cent) and decrease in the number of slabs. However, there was need for imposition of minimum import prices on items which are especially vulnerable to under-invoicing.

A very retrogressive step is the enhancement of import duty from 1 per cent to 2 per cent on items which were historically exempt from import duty. Consequently, basic food items which are imported like pulses, vegetables, medicines, books and stationery, etc., will become more expensive. Also, major imports like fertilizer, crude oil and POL products have been included in the ambit of the minimum import duty regime. This will lead to a jump in the consumer price index.

In the realm of GST some minor changes are proposed like the enhancement of further tax for supplies to unregistered persons, increase in the sales tax on mobile phones, etc. The rate of excise duty is being enhanced on aerated waters and cigarettes. It is reassuring that the Finance Minister has made a commitment to clear all outstanding sales tax refunds by the 31st of August 2015.

IMPACT ON THE PEOPLE

We turn now on an overall impact of the budget on the people. It is clear that the Budget does not contain any significant relief. The pressure to raise revenues and cut back on expenditure to achieve the fiscal deficit target agreed with the IMF has pre-empted the granting of any significant relief.

Instead, some measures, which have been proposed but not highlighted, will add to the cost-of-living burden of the people. The first relates to the reduction of subsidies to the power sector. As highlighted earlier, this will involve a significant increase in tariffs, not only to implement the reduction in subsidy but also to compensate for the elimination of various surcharges following a judgment by the Lahore High Court. Further, the imposition of a duty (statutory rate of 5 per cent plus regulatory duty of 7 per cent) on furnace oil will imply a higher fuel adjustment charge. The imposition of a 2 per cent duty on POL products will be reflected in a higher price of these products.

Overall, there is not much on the side of tax relief to the people. However, the Government's continued commitment to the Benazir Income Support Program is welcome, although the allocation for this program in 2014-15 was underutilised by 6 per cent. In addition, the health insurance scheme and the PM's youth program will be received well by the people.

Beyond the social protection program, a number of incentives have been announced for promoting investment and special packages for labor-intensive sectors like textiles, agriculture and construction. However, two measures which would have had a significant positive impact have not been announced. The first is the withdrawal of the GST on agricultural inputs like fertilizer at a time when agricultural prices are low. The second is the removal of the excise duty on cement, a key input in the construction industry.

We complete the appraisal of the Budget for 2015-16 by focusing on the federal PSDP for the next year.

THE FEDERAL PSDP

Federal government's public investment budget of Rs 700 billion is about 2.3 per cent of the country's GDP of Rs 30.7 trillion. Including provincial ADPs, Pakistan's total public investment will barely reach 5 per cent of GDP. The federal PSDP is only 16 per cent of the total federal budget of Rs 4.3 trillion. This is nowhere close to the economy's need. For a number of reasons, low public investment is reason for concern. The country's economy, which has seen modest growth for seven years running, needs a strong stimulus. In addition, Pakistan suffers from serious infrastructure and social deficits, retarding economic activity and causing hardship to the people.

The federal PSDP of Rs 700 billion too is an overstatement. Some expenditure lines, in fact, belong to the current and not development budget. Provision of Rs 100 billion for resettlement of IDPs is for an important cause, but is not investment. Similarly, provision of Rs 20 billion for the PM's Youth Programme in current budget should be shown in other development expenditure. The PSDP document does not show projects against these provisions indicating that they may not have gone through the rigorous process, which entitles inclusion into the development budget. Effectively, the PSDP is no higher than Rs 580 billion.

The modalities for investment seem obtuse. The modest scale of the PSDP contrasts with the enormous size of the federal government's public investment program. Projects in the federal PSDP number 1020 in all. Of these, about 140 are financed off budget by PEPCO and NTDC, leaving some 880 projects. Of the Rs 700 billion PSDP, special programmes such as for TDPs, youth, and some others have an allocation of Rs 175 billion. Of the remaining Rs 525 billion, nineteen projects (17 CPEC and 2 LNG power) are allocated about Rs 120 billion. The PSDP is left with Rs 400 billion for about 850 projects having a throw forward of over Rs 3 trillion. On an average, these projects would take about eight years to complete, if there were no cost increases from delays. Most water- sector projects will take eight to twelve years to complete at present costs. Because of renewed focus on roads, NHA's throw forward alone is Rs 1.2 trillion.

Compared to the revised PSDP of Rs 542 billion for 2014-15, next year's budget shows an increase of 29 per cent. Yet, twenty-two of forty ministries have less allocation next year than this year. Cuts have been placed in some critical areas. The combined allocations for higher education and federal education and training have declined by Rs 5.7 billion or over 20 per cent. The allocation for HEC mostly meets stipends for students studying abroad. Many HEC projects which have a total throw forward of Rs 146 billion would stop. Allocation for health stands reduced by over Rs 7 billion or by 25 per cent. Pakistan Atomic Energy Commission receives a cut of 51 per cent (this could well be because its C3 and C4 projects may be nearing completion). Water is the biggest cause for concern. Federal allocation for the Water Sector has been reduced by 35 per cent from Rs 46 billion to Rs 30 billion. As a water stressed country and with high dependence on agriculture, this is alarming.

On the surface, it is good to see an increase of Rs 40 billion or 259 per cent in rupee allocation for federally funded power projects. However, IPR questions the selection of projects. Of the Rs 56 billion allocation, Rs 44.5 billion is for two 1200 MW each LNG power plants. LNG is an expensive fuel source. We would have preferred this increase to target hydropower generation. In fact, other than LNG power plants, federal allocation for the power sector has declined substantially. This is astonishing when the country faces extreme power shortage. On the other hand, allocations to roads and highways have increased by a large 46 per cent from Rs 109 billion in 2014-15 to Rs 160 billion in 2015-16.

In conclusion, the Federal Budget of 2015-16 has remained constrained by the need for further consolidation of public finances by further reduction in the fiscal deficit, as agreed with the IMF. The hope that there would be a mid-term correction by the PML (N) Government of shifting from stabilization to revival of the economy and providing significant relief to the people has not been fulfilled.