Institute for Policy Reforms

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Economic policies - More of the same: IPR Review

Government must shift its focus from stabilization to economic growth. This was stated at a discussion on the federal and provincial budgets held at Karachi today by the Institute for Policy Reforms. Former Commerce Minister, Humayun Akhtar Khanand well-known economist and former Finance Minister, Dr. Hafiz Pasha shared their findings. Dr. Pasha also discussed the on-going NFC negotiations. The event was held with the cooperation of KCCI and Pakistan Readymade Garments Manufacturers Association.

Dr. Pasha discussed the ongoing negotiations in the current round of the National Finance Commission. He said that, contrary perhaps to perceptions, there are a number of burning issues that need to be resolved by the 9th NFC. These include the completion of the transfer of functions under the 18th Amendment and the implication thereof on the provincial share from the Divisible Pool ,formula-based financing of newly elected local governments , borrowing powers of provincial governments, especially for commercially viable projects in the power sector, incorporation of incentives for higher fiscal effort and improved delivery of services, ,establishment of expenditure benchmarks and removal of encroachment by the federal government on provincial tax bases.

Reviewing the state of the economy, HumayunKhan stated that performance during fiscal 2014-15 was mixedat best. He said that it was important to see whether government's policies and performance address major challenges faced by the economy. The economyhas had seven years of low growth. Severe infrastructure and social deficit also restrict economic activity. The tax burden fell unevenly on the people. Indirect levies and increase in liability of those who already pay taxes may skew even more burden of taxation. He said that policy makers have focused entirely on fiscal consolidation within the ongoing IMF program. There were some positives. Inflation rate and current account deficit declined mostly because of steep fall in oil prices. In other areas, however, the economy performed poorly.

Large-scale manufacturing grew at an estimated 2.5 % while agriculture showed modest growth with decline in wheat, maize, and sugarcane production. Cotton production increased and the service sector performed well.

The country's two major concern of security and continued load sheddingimpedes economic activity. Coupled with steep fall in private credit, these factors caused private investment to fall to 9.7% of GDP, perhaps the lowest level ever. Public investment is likely to be 3.4 % of GDP and overall investment/ GDP ratio is a paltry 14.7 %. The economy seems to be stuck in a low growth trap. Its inability to create new jobs was especially worrying.

Once again, FBR tax revenues will miss the reduced target of Rs 2,691 Billion for 2014-15. For the first ten months, revenue grew by 12.7% only compared to the budgeted growth rate of 24%. This is despite indiscriminate increase in indirect taxes during the year. Shortfall in revenues may lead to the inevitable cutback in PSDP releases. As of 22 May 2015, governmenthad released less than 60 % ofthe budgeted amount.

The power sector continues to underperform. It seems to be a question of management rather than generation (which has been government's entire focus so far). In 2014-15, there was modest increase in generation capacity, but actual power supply still fell by 2.3%. Government has been unable to address the enduring issues of sustainability of the sector.

Humayun said that worsening social sector indicators was especially alarming. This is perhaps for the first time in Pakistan's history. Literacy rate has fallen by 2 percentage point's form 60 to 58 percent. Immunization fell by 6 points from 82 to 76 %, and percentage of household with improved water fell by 4 points from 30% to 26 %. Net primary enrollment rate remains the same. Apparently with increased role for provinces this sector has suffered greatly.

The Federal budget 2015-16 stuck to a predictable template. With reduced fiscal deficit its prime objective,there seems no possibility of a jump in GDP growth rate.

The budget seems to have been prepared on unrealistic assumptions. The budget sets a fiscal deficit target of 4.3% of GDP. On the other hand, it has allowed growth of 29% in PSDP and a fall of 14% in non-tax revenues. This is overly optimistic. FBR revenues of 3.1 trillion are ambitious and require a growth rate never achieved before.The budget projects 10% reduction in current expenditure. Here too the underlying assumption of saving in debt servicing cost may not occur because of the 'lock in effect' of outstanding debt. Reduction in subsidies and provincial surplus are fragile assumptions. Government has done nothing to reduce line losses in DISCOs and provinces are likely to increase expenditure to establish high benchmarks for the ninth NFC. Already, NEPRA has announced a big increase in power tariffs in line with the decline in subsidy. Along with the rise in oil prices the escalation in power tariffs will lead once again to an upsurge in the rate of inflation.

The budget estimates additional yield of 253 billion in tax revenuefrom the multitude of taxation proposals. IPR welcomes tax on unearned capital income and gains though it would have liked to see a move to withdrawVIP tax privileges, tax on foreign income of residents, and a mechanism for checking transfer pricing. Increase in import duty of basic food items is a regressive step. Similarly application of minimum import duty on key imports such as fertilizer, oil and POL products will increase CPI.

Federal PSDP, which is 16% ofthe announced budget, is too low to address serious infrastructure and socialdeficits. Releases each year are well below budget, which further reduces its size. While the annual budget is small, number of projects and the amount needed to complete them is stupendous. On an average, the projects will take eight years to complete. Allocations have been reduced in some areas including higher education (18%), water and irrigation projects 35 %, and health by 25% . 80 % of power projects allocation is for LNG power plants. Rupee allocation for hydro projects has actually declined. Almost Rs 200 Billion has been allocated for highways.

Discussing the provincial budgets, Dr Hafiz Pasha said the combined development outlay by the provincial governments now exceeds the federal PSDP. Therefore, the issue of proper development priorities of provincial governments is very important. There is a need not only to focus on physical infrastructure, especially power and irrigation, but also on provision of basic services like preventive health, safe drinking water and higher quality primary education.

He also highlighted the reluctance of provincial governments to tap large and progressive sources of revenue like the agricultural income tax and the urban immoveable property tax.

However, he recognized the strong effort of the governments of Sindh and Punjab in developing the sales tax on services. Given the potential of provincial taxes he said that the target must be to raise the share of provincial taxes in the total national tax revenues from 7% currently to 15 % in the next five years.