INSTITUTE FOR POLICY REFORMS

IPR FACT SHEET

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Review of Budget 2017-18

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.

Budget 2017-18 was presented in the shadow of protests by farmers. The protests should not have been a surprise. They show the disconnect between economic policy making and realities of the productive sectors. This was in stark contrast to the Finance Minister’s budget speech, which was a mix of claims of economic success and promises of further growth. Government would have done well to take a pause to think about the reasons for the farmers’ discontent. Industry and agriculture need fundamental reforms to grow. The government responds with ad hoc measures.

A day earlier the Finance Ministry released the Economic Survey 2017-18, which showed several weaknesses in the economy. Considering these, government’s claims of economic success sounded particularly jarring.

The Minister said that “sustained and inclusive economic growth” was anchored in successful completion of structural reforms. He did not list the specific reforms. In IPR’s view, Government has not touched the structure of the economy or its political economy. By favouring indirect taxes over direct taxes, we continue with regressive taxation. Continued increase in public debt means that the whole nation pays for the profligacy of the few. The federal PSDP prefers to invest in highways over all other expenditure.

Despite some encouraging incentives, budget 2017-18 does not do enough to address the real issues of the economy that would revive growth. IPR does not find a strong economic strategy driving budget 2017-18. There is need to build productivity of agriculture and industry to revive the economy and place it on a path of sustained growth. While government has announced a series of measures for these sectors, IPR prefers an approach that does not rely on fiscal incentives alone. These sectors need long term commitment to build competitiveness.

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Outcomes 2016-17: Missed Targets

Government missed all targets for fiscal 2015-16. The economy grew by 5.28% against the target of 5.7%, but contribution of the productive sector, agriculture and industry, was 1.74% and their share in the GDP fell. Exports declined again. Each year an estimated two million people enter the job market. Job growth is well below the number needed.

On the other hand, fiscal deficit was high and the current account deficit is twice the estimated amount. Savings fell from the year before. National savings was 14.3% of GDP in 2015-16, it declined to 13.1% in 2016-17. Domestic savings fell from 8.2% to 7,5% of GDP. Investment was 15.8% of GDP in 2016-17 against a target of 17.7%. Indicators for health and education showed no improvement, with literacy rate actually slipping. Public debt has reached 62.3% of GDP. GoP could not meet its last year's promise to observe provisions of the fiscal responsibility law. External debt is 23.4% of GDP.

These numbers are hardly the base to build a growth edifice.

Budget Framework 2017-18: The numbers don't add up

For fiscal 2017-18, government forecasts a growth rate of 6%. Fiscal deficit is targeted at 4.1% of GDP. GoP moved to a growth strategy from stability. An enhanced fiscal deficit will allow space to the economy for infrastructure and other services.

Let's look at the receipts first:

- FBR achieved the target of 20% increase in revenue in 2015-16 and another 13% in 2016-17. However, it will need to increase collection by a further 14% in 2017-18 to collect Rs. 4,013 Billion. This increase will depend on whether growth in the tax base takes place.
- The budget provides an increase of 4.3% in other taxes and 7.4% in non-tax revenue. For other tax income to grow, it, of course, assumes that energy price will increase somewhat.
- It also assumes that coalition support fund remittance will continue.
- The budget also estimates a provincial surplus of Rs, 347 Billion. Each year, surplus from provinces have fallen short of budgetary provision by a large margin. In an election year, it is ambitious to expect it to increase.

Current expenditure is budgeted to increase by 2.3% from this year. Given that inflation is to be 6%, this means a decline in real terms and the budget may need revision:

- Government has given many fiscal incentives in the shape of tax relief and subsidy to agriculture and textile industry. Yet, total subsidy amount provided in the budget is below the actuals for 2016-17 by 18%.
- Over two thirds of this amount is for the power sector. As fuel price is on a slight increase, it seems that government plans tariff increase or further postponement of payment of the tariff differential subsidy.
- Provision for mark up on domestic and foreign debt is the same as in 2016-17. Expenditure will increase in this head.
- Civil government and defence employees have been allowed 10% and 20% increase in emoluments respectively. Provision for emoluments to civil employees are below the actuals for 2016-17. Although provision for defence services has increased by about 10%, security often places additional demands. Limiting increase in current expenditure in 2016-17 to 2.3% over 2016-17 will be a challenge. Next year too debt-servicing expenditure will increase.

All this will stress the fiscal framework and make it that much more difficult to achieve the deficit target.

Any discussion on fiscal deficit must bear in mind a liability of about Rs. 700 Billion in the shape of circular debt that remains unpaid. Rs.400 Billion of this amount has arisen since 2013. This amount has to be paid.

To stay within the fiscal framework government would likely cut development expenditure. It is understood that the ministries had proposed a development envelope of Rs. 875 Billion, which suddenly got a boost to Rs.1 Trillion in the last meeting. A cut would affect much needed improvement to infrastructure. It may also affect execution of CPEC projects.

In a positive move, the Finance Minister announced GoP's plan to observe provisions of the fiscal responsibility law and to strengthen its provisions. It had promised to do so last year as well, but in March 2017, total debt and liabilities were 62.3%, i.e. beyond the law's limit.

Of special concern is the weakness in external sector. It is affected in many ways. Exports have been in decline. Workers remittance has reduced and at best stabilized. FDI has grown modestly and well below government's estimates. Imports have continued to rise with sizeable increase in machinery imports. Dependence on external savings means higher debt servicing needs. All this has put severe pressure on the Balance of Payment. It is likely that the 2017-18 current account deficit will exceed the estimated USD 8.9 Billion.

Government so far has no response. In a recent statement the Finance Minister expressed his reluctance to go back to the IMF. Evidently, he feels that Chinese assistance will fill the gap. GoP must make public the arrangement. Else, we assume this must be paid back. Most known Chinese assistance is at 3 to 6 months LIBOR plus a premium of 2.8% to 3.5%. Their tenure is three years. These are commercial terms and they put further pressure on the Balance of Payment.

Tax proposals

The budget provides for an increase in FBR tax collection by Rs. 492 Billion. In all, it provides for an increase of 572 Billion in tax and non-tax revenue. This will stretch the collection system.

Over 48% of the additional tax revenue is to come from indirect tax, in the shape of GST, FED and Custom Duty. FED has been increased to 5% on cement and withholding tax on tobacco production has increased. About 38% increase will come from direct taxes. For example, dividend income will now be taxed at 15% compared to 12.5%.

In IPR's view, it is also important to raise the cost of tax evasion and, especially, non-filing of returns. While government has addressed this issue through higher withholding tax on non-registered persons, the best course is for this tax to be collected through annual assessments. IPR welcomes the proposal for continuation of zero rating of five major export products. It also welcomes duty concessions for the health and poultry sectors. Government aims for a tax to GDP ratio of over 12%[1].

Incentives for revival of agriculture and industry

The budget contains a number of incentives for the productive sectors. GoP's efforts to revive agriculture centre on reduction in input cost and other fiscal incentives. Revival of industry is based on fiscal incentives, facility for subsidized credit for manufacturers and exporters (LTTF and ERF), and setting up an information technology park. Some past incentives that are to lapse have been extended. While these are positive steps, some observations are necessary.

There is no word about evaluation of whether or not such incentives stimulated growth in the past. This is important to ensure that the incentives work and have the desired effect. These sectors need long term support with technology diffusion and access to capital. Fiscal incentives work for the duration they are available. They do not always promote efficiency or competitiveness and at times create dependency. Government has not looked at these sectors holistically. While reduction in input cost will help, agriculture suffers from neglect of water resources and management. The proposals also do not address the real issue of improving seeds and restricting virus. This year's PSDP has increased allocation

[1] Based on revenue from tax estimates in the budget and 2017-18 GDP estimate in the Annual Plan.

for the water sector to Rs. 36 Billion. This is still Rs. 10 Billion less than the allocation of 2014-15. Water must receive higher priority.

Several measures for farmers are encouraging. These include holding or reducing fertilizer prices and concessional agriculture financing.

Concessions given to the textile sector are welcome and may help exports. Most concessions are extended from last year. In the last two months, there are signs of mild recovery of export. Continuation of attractive rates for LTTF and export refinance scheme will help also.

Yet, it is important to look at sectors other than textiles. Manufacture must upgrade in terms of complexity, the extent of knowledge inputs, and degree of processing, to reach higher value addition. Pakistan also must become part of the global supply chain. We have yet to see a move in that direction. This is the time to make these choices when SEZs with the help of China will offer an opportunity to attract investment in new industries.

A greater concern is that our export to GDP ratio is in serial decline. The current ratio is 7% of GDP. It was 10.3 % in fiscal 2013- 14 and remained above 10% throughout the 2000-2010 decade. Regardless, we hope that these incentives will have the desired effect on growth.

Impact of the Budget on Growth and Living Standards

As stated before, the budget makes no big moves or set a strategic direction. Immediately, it will have no significant effect on the people. The budget has minimal relief for exit from poverty. It is good to see continued commitment and enhancement of the Benazir Income Support Programme. Decrease in subsidy or increase in power tariff, if they take place, will affect people in the lower quintiles. Increase in GST, FED, and import tariff on some consumer and industrial items will increase prices and burden on the poor. It will also increase inequality. The budget directs few resources towards reducing the social deficit. Admittedly, this is a subject for the provincial and local governments to address. However, the federal government does not state it as a priority. There was no mention of SDGs as a national narrative. Allocation for it in the PSDP is in the shape of discretionary funds for ad hoc use. Improving provision of basic human needs adds to the total capacity of the economy and stimulates growth. The budget gives targeted subsidies to small farmers. This will be poverty reducing.

Development Budget: PSDP

A 25% increase in federal development budget from the original 2016-17 level of Rs. 800 Billion to Rs 1 Trillion is welcome news. This reorients public spending towards development rather than current expenditure.

However, there are a couple of concerns.

- Increase in the budget to Rs. 1 Trillion was sudden and way beyond what the concerned ministries had proposed. We hope GoP will have the resources to meet this commitment. This amount is still 3.3% of GDP and with provincial allocations would be more than 6% of GDP. It calls for judicious use of funds to meet the severe shortage of physical and soft infrastructure and human resource deficit in the country.
- The PSDP increase focuses overwhelmingly on transport, especially on roads and highways. The allocation for roads almost doubles from last year's Rs. 165 billion to Rs. 320 Billion. On the other hand, government's allocation for the power sector has declined. It has fallen from Rs. 75 Billion to Rs. 60 Billion.
- The other concern is a massive increase in discretionary special schemes. These total Rs. 242.5 Billion or almost a quarter of the development budget. They include PM's SDG programme, Special federal development programme, Energy and Clean Drinking Water for All, a separate special provision for CPEC, PM's Youth initiative and more. IPR feels that some of these politicizes use of development funds. They seem to have been added especially in view of the coming elections. The PSDP does not show specific projects against these provisions indicating that they may not have gone through the rigorous process, which appraises efficacy of expenditure and evaluates past efforts.
- In essence, the federal PSDP is Rs. 758 billion rather than Rs. 1 Trillion.
- Some encouraging signs in the PSDP are increase in funds for HEC from Rs. 21.5 to 35.6 Billion. Health has seen an increase from Rs. 25 Billion to Rs. 48.7 Billion. Railways has increased modestly from Rs. 41 Billion to Rs. 43 Billion. Overall, the PSDP shows several positive developments. However, power sector should have received higher funding.

Total number of projects have increased from 813 last year to the present 1148. The throw forward is seven years. The PSDP would be more effective if it focused on completion of a smaller number of key projects.

The federal PSDP is about 20% of the total federal budget of Rs. 5,104 Billion. Although this has corrected a long-skewed relationship between current and development, we hope there will be no cut in development funds. The Pakistan economy has been in low to moderate growth for several years. The people of Pakistan expect jobs and economic activity to grow. Serious infrastructure gaps and social deficit constrain business development and depress living standards. They are important for providing stimulus to the economy as well as to enhance business competitiveness.

The budget makes no strategic departure from the past, though it includes several incentives for mostly traditional sectors of agriculture and textiles. The budget's ad hoc nature is understandable as there is no major government programme for economic reforms that it is a part of. Its framework is weak and the fiscal deficit will be more than the projected 4.1% of GDP. Similarly, current account deficit seems out of control and would likely be more than the reduced amount of USD 8.9 Billion.

Managing the Balance of Payments will be a big challenge in the coming fiscal.