INSTITUTE FOR POLICY REFORMS

IPR FACT SHEET

April 2018

Comments on Federal Budget FY 19

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.

IPR does not take sides in the discussion about whether a government must present the next fiscal budget one month before the end of its term. Yet, what is important is that the budget does not do away with professionalism to become part an election campaign. In fact, compared to the spin and the embellishments of the past, we see a budget with a bit more realistic numbers mixed with more than a dash of electioneering.

That does not mean that all the claims about improved indicators are true. The economy suffers from many vulnerabilities, especially an external sector that is far more at risk than where it was five years ago. That the budget speech was announced amid protests by opposition parties shows that it is hard to separate a professional exercise from politics. It also showed that for the government consultation or consensus was not a preference. Despite claims that the budget is a strategic breakthrough in economic policy, measures in the budget are as tepid as their halting delivery by the freshly minted Finance Minister.

In the last five years, the world economic environment could not have been better. World economy revived after the 2008 financial crisis. Energy prices fell sharply in 2014 and interest rates were low worldwide, while international trade grew. During this period, China completely restructured economic relations with Pakistan, committing large investment capital for infrastructure development. From 2014, Pakistan's security situation has improved. All this meant a fillip for the economy. We cannot say for sure that the government made much use of these positive developments.

The government pats itself on the back for revival of GDP growth rates. In the face of the above cited, it would have been a surprise to not see economic growth in the country. However, it will take a lot more reforms and difficult policy choices to place Pakistan on the path of sustained long-term growth. Two recent developments hold promise, though we do not know yet if they will succeed. There is marginal hope that the tax amnesty scheme may redirect the economy towards documentation. Its success is anything but guaranteed, because there is no known plan for its implementation. There are also legal issues involved with promulgation of the tax amnesty ordinance.

Successful implementation of the National Water Policy can have enormous impact on the economy. This Institute has time and again recommended major policy and infrastructure interventions in the water sector. It is encouraging to see the first step in that direction. Overall, to build dynamism in the economy, policy makers must do a lot more to build competitiveness and productivity.

Despite some encouraging incentives, budget 2018-19 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 the budget that would build productivity of agriculture and industry. While government has announced a series of measures for these sectors, they still seem ad hoc. IPR prefers an approach that does not rely on fiscal incentives alone. These sectors need long term commitment to build competitiveness

Outcomes of 2017-18: The usual story of missed targets

Government missed most targets set for FY 18. The economy grew by 5.79% against the target of 6%, with the productive sector, agriculture and industry, contributing 4.84%. Its share in the GDP fell from 40.1% to 39.7%. In FY 08, the share of productive sector in GDP was 44%.

Fiscal deficit was high and the current account deficit is more than twice the estimated amount. Savings fell from the year before. National savings was 12% in FY 17. It fell to 11.5% of GDP in 2017-18. It is estimated to grow to 13% in FY 19. Domestic savings fell from 8.2% in 2015-16 to 7.5% in 2016-17, and to 6.5% of GDP in the current fiscal. Investment was 16.4% of GDP this fiscal against a target of 17.2%. The gap between savings and investment was Rs. 1,733 Billion or 5% of GDP.

Public debt increased to 70% of GDP. GoP could not meet its last year's promise to limit it to 60% of GDP, a ceiling placed by law. External debt grew to 23.7% of GDP. Much of the increase resulted from high interest commercial loans. These numbers are hardly the base on which to build a growth edifice

With fiscal incentives and change in rupee value, exports recovered. A major overlooked matter that concerns the country's prosperity is growth in jobs. The budget does not even pay lip service to this matter. Each year an estimated two million people enter the job market. Job growth is well below the number needed. In fact, government did not even count how many jobs the economy added.

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Budget Framework 2018-17: The numbers may just about add up

The budget numbers are still unrealistic, though not to the extent of recent years. For fiscal 2017-18, government forecasts a growth rate of 6.2%. Fiscal deficit is targeted at 4.9% of GDP. GoP has clearly made a policy transition from stability to growth. This would change if the vulnerable external sector makes Pakistan knock on the doors of the IMF again. An enhanced fiscal deficit will allow space to the economy for infrastructure and other services. This is validated also by the recently approved five year plan that aims for an inflation rate averaging 7% per annum.

Let's look at the receipts first:

- There has been unprecedented growth in FBR receipts in the past three years. They grew by 20% in 2015-16 and by another 13% in 2016-17. This fiscal, FBR revenue are estimated to grow by another 18% to reach an estimated Rs. 3,935 Billion. However, FBR will need to increase collection by a further 12.7% in FY 19 to achieve the target of Rs. 4,435. Given the many exemptions and incentives in the Finance Bill FY 19, the increase will depend on success in broadening the tax base.
- The fiscal framework estimates tax to GDP to grow from about 12.5% at present to 13.8% in FY 19.
- The economy needs a restructuring of tax policy not merely tweaking at the edges. So far, FBR's improved performance comes from efficiency gains. We need progressive taxation.
- The budget provides an increase of 114% in other taxes and negative 9% in non-tax revenue. For other tax income to grow, there must be an assumption that energy price will increase for petroleum and GIDC to grow. Else GoP plans to increase their rates.
- The budget also estimates a provincial surplus of Rs, 285 Billion in FY 19. Each year, surplus from provinces have fallen well short of budget. In 2016-17, there was a provincial deficit of Rs. 163 Billion. That may happen in FY 18 too. It is an artifice to expect a surplus of Rs. 285 Billion next fiscal.

Expenditure:

- Current expenditure is budgeted to increase by 8% from this fiscal's revised estimate. Actual FY 18 expense are estimated to grow by 23% from fiscal 2016-17. Increase in debt means rising markup payments and with growth in defence allocation, increase in pay and pension and BISP, inflation of 5 to 6%, the government would be hard pressed to limit its increase to 8%.
- Government has not shared a strategy to reform PSEs, which need hundreds of billion in subsidies. Yet, total subsidy amount of Rs. 175 Billion provided in the budget is below needs. Closure of Pakistan Steel Mills and continued losses in PIA are avoidable.
- There has been no effort in the last five years to improve power sector sustainability. Low energy prices provided an opportune moment to do so. Line losses and less recovery of bills are at the levels they were five years ago. Each new unit of power generated needs subsidy. Circular debt is expected to grow. This is seen also from the variance in GoP's

data for power generation and consumption. Power generation and distribution have grown by double digit, as also claimed by the Finance Minister in the budget speech, yet consumption has increased by 1% only. There can be no improvement in reliability of power supply without improvement in DISCO performance.

- Provision for mark up on domestic and foreign debt is higher by 6% over revised estimates of FY 18. This is an underestimation in view of growth in central government debt as well as in greater reliance on high cost commercial finance. Expenditure will increase in this head.
- Civil government and defence employees and pensioners have been allowed 10% increase in emoluments. Increase of 2.3% in budget for pension and of 11.5% for civil pay and allowances seem inadequate (the latter involves regular increment in pay also).
- Provision for defence services has increased by 10% to reach Rs. 1.1 Trillion.
- Thus limiting increase in current expenditure in 2018-19 to 8% over 2017-18 Revised Estimate will be a challenge.

All these will stress the fiscal framework and make it that much more difficult to achieve the deficit target. Any discussion on fiscal deficit is incomplete without mention of over Rs. 900 Billion in circular debt, which is liability that must be paid at some point.

To stay within the fiscal framework government would likely cut development expenditure. Last year, while commenting on current fiscal year's budget, this Institute had forecast higher fiscal deficit, higher current account deficit, and cut in GoP's ambitious development envelope of Rs. 1 Trillion. It is sad to see that all these have come to pass. IPR does not claim especial expertise or knowledge of the future. But even a cursory look at the fiscal framework called for such prognostication. This approach to budget making is non-serious and compromises a professional exercise.

This year the government has a more realistic PSDP envelope of Rs.800 Billion, though without totally forsaking artifice, in his budget speech, the Finance Minister claimed a PSDP of Rs. 1,030 Billion. Rs. 230 Billion is self financing by corporations, an amount that has always been considered off-budget.

The fiscal framework also plans to reduce Net Public Debt from the present 70% of GDP to 63.2% of GDP. The budget documents do not suggest how this will happen, especially as budget deficit this year would likely be 5.5% and it would be 5% next year.

Of special concern is the weakness in external sector. Exports have recovered, but only in a favourable environment of weakening Rupee and incentives for exporters. It is hard to see how exports will grow without significant growth

Workers remittance of USD 20 Billion is at the level of two years ago. FDI has grown modestly and is well below government's estimates. Imports have continued to rise. Until a few months ago, government could explain that the increase was because of growth inducing machinery imports. However, machinery imports have declined. Increase in imports is because of LNG and scrap iron and steel. Perhaps government should not have allowed Pakistan Steel to shut down.

Dependence on external savings means higher debt servicing needs. All this has put severe pressure on the Balance of Payment. This year's current account deficit will be almost twice the amount of USD 8.9 Billion estimated by government. For FY 19, government estimates a current account deficit of USD 13.3 Billion or 4% of GDP (GoP's budget strategy paper forecasts the deficit at 4.2%). The macroeconomic framework estimates an increase in investment to GDP ratio. It also forecasts correction in public debt ratio and build up of foreign exchange. With these targets it will be hard to keep the current account deficit to 4%. GoP has done so by estimating an extremely conservative 4.8% growth in imports. That is sure to be breached. Once again the Annual Plan is removed from reality.

Government so far has no response on how it will manage the external account. If IMF is an option, perhaps government has been waiting to publicise it after the election. If they wish to rely on Chinese assistance, GoP must make public the arrangement. 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

Following are the estimates for growth in FY 19 taxes:

- Total federal tax revenue: 17.8%
- FBR taxes 12.7%
- Direct tax: 11.0%
- Indirect: 13.7%
- Other taxes 113.0%
- Tax to GDP ratio: 13.8%

With substantial relief in direct and indirect taxes, it is hard to see where this growth will come from other than government's faith in the success of the tax amnesty scheme. The amnesty scheme is a risk. If it does not deliver as hoped, total tax revenue will decrease.

Its success also depends on how much cost GoP places on tax evasion and, especially, on non-filing of returns. IPR welcomes the proposal for continuation of zero rating of five major export products. It also welcomes other duty concessions.

Incentives for revival of manufacturing and agriculture:

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). 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, quality support of extension services, and research. The proposals also do not address the real issue of improving seeds and restricting virus.

This year's PSDP has increased allocation for water by 125%. This is encouraging, though most of the increase is because of Rs. 23 Billion allocation for Diamer Bhasha dam. Several measures for farmers are encouraging. These include holding or reducing fertilizer prices and concessional agriculture financing.

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 7.6% 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. The focus on export growth is misplaced to an extent. If exports are to grow without continuous incentives, the economy needs revival in manufacturing and increase in value added production. Exports cannot grow without growth in industry.

Impact of the Budget on Growth and Living Standards:

As stated before, the budget does not set a strategic direction. Immediately, it will have no significant effect on the people. It offers relief in tax of between Rs. 150 Billion and 300 Billion. It is not significant and affects the relatively prosperous segment of the populace. The budget has minimal relief for exit from poverty. It is good to see continued commitment and enhancement of the Benazir Income Support Programme. 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 and the block allocation seen until FY18 has all but disappeared with an allocation of Rs 5 Billion in the new PSDP. Even in the past, SDGs provision were used as 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 has reduced allocation for National Health Services compared to original allocation for FY 18.

Development Budget: PSDP

From an ambitious Rs. one Trillion in FY 18, PSDP has been brought down to Rs. 800 Billion. This is a paltry 2.4% of GDP with provincial allocation national PSDP is 5% of GDP. It is hoped that this reduced envelope would be spent in full.

How does GoP plan to raise GDP growth rate while reducing investment. Reduced size of PSDP calls even more for judicious use of funds to meet the severe shortage of physical and soft infrastructure and human resource deficit in the country.

Despite reduction, 25% of the PSDP is budgeted for roads and highways. The economic benefit of highway projects is unproven. On the other hand, government's allocation for the power sector has declined. It has fallen from Rs. 75 Billion in 2016-17 to Rs. 60 Billion in 2017-18, and Rs. 36 Billion in 2018-19. Of this, only Rs. 4 Billion or less is from the PSDP. The rest is off budget self financing by NTDC/PEPCO. The governance weakness in DISCOs leaves very little space for investment in power infrastructure.

The other concern is a massive component of discretionary special schemes. These total Rs. 232.5 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 this is nothing but politicization of development funds. 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. 568 billion rather than Rs. 800 Billion.

One encouraging signs in the PSDP are increase in funds for HEC of Rs. 46.6 Billion. Allocation for Railways has decreased to Rs. 40 Billion from (original) Rs. 43 Billion. Also, power sector should have received higher funding. Total number of projects have increased from 1148 to 1284. 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 13.4% of the total federal budget of Rs. 5,932 Billion, down from 20% of original budget.

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 is not a major strategic departure from the past, though it includes several incentives. The budget's ad hoc nature is understandable as there is no major government programme for economic reforms that it is a part of.