INSTITUTE FOR POLICY REFORMS

IPR FACT SHEET

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# Comments on Pakistan Economic Survey 2017-18 issued by the Government[1]

### 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.

What is unusual about the economy this year is that its real sector has performed well, while the fundamentals are very weak. Continued weak fundamentals will reduce growth rate and damage the real sector. Also, it will soon affect citizen welfare. The longer Pakistan postpones reforms to arrest the negatives, the worse would be its effect.

Positive indicators include GDP growth, moderate inflation, and high consumer demand. Weak fundamentals include high budget deficit, a soaring current account deficit, unmanageable indebtedness (borrowing to pay off old debt), and depleting forex reserves as foreign exchange needs for imports and debt-servicing are much above earnings.

Improved FBR performance has helped limit the budget deficit. Since 2015, Government revenue has increased by double digits each year. During this period, GoP set ambitious revenue targets while also, conversely, offering tax incentives, exemptions, and lower corporate rates.

This year the Economic Survey has been published about a month earlier than usual and National Accounts were issued almost three months before year end. There is considerable margin of error in the assumptions made in both documents. Economic Survey this year bases its estimates for the fiscal year on mostly six months actuals, unlike the past when it was based on nine months July-March actuals.

This was the first complete year that the economy functioned without IMF's watchful eyes. (The EFF ended in September 2016).

In most years, review of the economy is a story of missed targets. This year is no different. It is surprising that this happens each year, though policy makers do not draw a lesson. Sustained economic growth will come with reorienting spending priorities, ensuring economic inclusion, and by investing in and empowering the people of Pakistan.

[1] As in the past, official references to the fiscal year vary. MoF refers to it as fiscal year 2017-18, while SBP prefers the simpler FY 18.

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## Performance of the economy

The Pakistan Economic Survey 2017-18 sets out how the economy has done this fiscal. This year too the economy missed many targets.

Below is performance against targets approved by the NEC in Annual Plan 2017-18:

- GDP grew at 5.79% against a target of 6.0%. Manufacturing fell short, growing by 6.24% against a target of 7.3%, (LSM grew by 6.13 % against a target of 6.3%).
- Agriculture production was above target. It grew by 3.81% against a target of 3.5%. Services grew by 6.43% against a target of 6%.
- Fiscal deficit for July-December is 2.3% against a fiscal year target of 4.1%. While the Economic Survey estimates annual fiscal deficit variously at 4.5% and 5%, it is expected to be above 5%. The government will have to severely control expenditure to keep it within 5% of GDP.
- Government's total revenue is expected to fall short by Rs.  Billion. FBR taxes will be about Rs.  Billion short. Target for total federal tax revenue was Rs.  Billion with Rs.  Billion for FBR taxes
- **Balance of Payment**
    - Current account deficit reached USD 12,090 Million by March 2018, year on year increase of 50%. It is expected to approach USD  16 Billion by year end. Compared to Government's target of 2.6% of GDP the deficit was more than 5% by March 2018. Current account deficit level is alarming for the size of the economy.
    - Nine months exports grew by 13% to USD 17 Billion. Exports are expected to be USD 23 Billion for FY 18, against a target of USD 23.1 Billion.
    - Imports is expected to touch USD 60 Billion against a target of USD 48.8 Billion. Nine months imports were USD 44.3 Billion, 15.6% above last year.
    - Workers' remittance will equal its target of USD 20.2 Billion. Remittance amounts have seen no change in two years.
    - FDI will be USD 3 Billion against the target of USD 4.55 Billion
- Low savings and Investment affect growth:
    - Investment was 17.4 % of GDP against a target of 17.7 % of GDP. Until ten years ago, Pakistan's historical Investment/GDP ratio was 20%. With an ICOR[2] of 4 or more, 20% investment is needed to generate 5% GDP growth.

[2] ICOR or Incremental Capital Output Ratio. Incremental unit of capital needed to generate one unit of output. Usually, developing economies have higher ICOR than industrial economies as the latter are more productive and efficient. However, ICOR is an inadequate measure as it does not adequately measure factors such as branding or deigning.

- National savings may have declined to 12% of GDP against a target of 16.2%. Domestic savings (i.e. national savings minus remittances) was 6.5% of GDP. Both fell from last year. The gap of Rs. 1,733 Billion or 5% of GDP between national savings and investment is the economy's dependence on external savings.

July-March 2017-18 inflation (CPI) was 3.78 % YoY against a target of 6%. Last year, CPI was 4%. SPI and WPI increased by 0.96% and 2.7% respectively, well below last year's levels[3]. The economy has so far absorbed the adjustment in the value of the Rupee.

## Weak fundamentals:

Review of the Economic Survey shows that the underlying economic framework that underpins growth is weak and vulnerable. Lets delve deeper into see some of the indicators:

- GDP growth rate
- Revenue, expenditure and budget deficit
- Public debt
- Current Account Deficit
- Forex reserves
- Inflation

How growth will play out in the short-term? Following factors will dampen growth rate:

- The weak fundamentals may have begun to affect growth already. Machinery imports, an indicator of buoyant investment fell by 3% in FY 18 over FY 17. Power generation equipment fell by 19% and construction machinery by 29%.

- Flow of bank loans to private businesses grew by 9% during July-March 2017-18 compared to the same period last year. However, of the total bank loans just 10% was used for fixed investment.

- An alarming increase in current account deficit will affect import volumes impacting for investment and economic activity. Correction in value of Rupee also may be affecting imports already.

- High consumer demand has fueled recent growth. However, this may be transitory as the days of relaxed monetary policy may be ending. The value of the Rupee has declined by 11% and energy prices may revive soon (Saudi Arabia wants to see it back to USD 100 bbl). Though inflation has held off for now, these factors will put pressure on CPI, on interest rates, and consumer demand.

- PSDP spending has slowed to curtail the fiscal deficit. This too is growth dampening. Nine months into the fiscal year, by 31 March 2018, PSDP releases were 60% of total. PSDP spending for FY 18 would likely be 20% (Rs. 200 Billion) short of budget.

[3] CPI Consumer Price Index, SPI Sensitive Price Index, and WPI wholesale price index

- The present government will leave over Rs. 900 Billion in circular debt, which will become worse if energy prices go up again. Government has had four years of low energy prices, but did very little to review power policy framework and improve governance. Resultantly, power sector loses over 25% of its gross revenues.
- Public debt including external debt is growing rapidly. Debt servicing takes up an increasing share in government expenditure.

There is no example of sustained growth of an economy with such weak fundamentals. Next fiscal, the economy's growth rate is bound to decline. Growth needs a stable macro-economic framework. Without major reforms and governance improvement, the economy will continue to grow at moderate rates. There is no talk yet in policy circles on structural reforms. GoP must put in place structures to reduce cost of doing business. Economic policies reflect political choice.

This Institute has time and again proposed a way forward with deep structural reforms, which could transform the economy.

## Accuracy of GDP growth rates and other indicators:

For several years, IPR has questioned the method of estimating growth rates in the national accounts. Some PBS's assumptions increase GDP growth estimates. Industry includes LSM, small scale manufacturing, others, mining, energy and power, and construction. Each year, GOP approximates estimates for small scale and other industries. Their growth rates have not changed for years. Rates of 8.2% for small scale manufacturing and 3.5% for slaughtering, 4% for housing and 6% for private services have no support in data. These are part of national accounts whose accuracy is hard to ensure. IPR recommends a review of accounting methods. It appears that the much-celebrated reorganization of government statistics organization has not achieved any result. Without such a review, decision makers and the public will lose faith in government data. The credibility of government data must never be questioned.

## Fiscal Operations and budget deficit

### Fiscal operations: Government Revenue

Improved revenue collection by FBR has limited the extent of budget deficit. Government has performed well in this area. After 20% increase in FBR revenue in FY 16, the budget set revenue growth target of another 16% and 19% respectively for FY 17 and FY 18. During this period, GoP has offered concessions and exemptions. Also, GDP has grown by about 5% each year and inflation by another 4%. Considering these factors, growth in revenue beyond 9% is entirely efficiency gains. Tax to GDP ratio also has grown from 9.5% in 2013 to 12.5% in 2017. However, tax structure must change to become more progressive and income elastic. The share of direct taxes must increase in a major way.

The Table below compares actual revenue growth with targets. The target for tax revenue increase for FY 18 was 18.7%. Actual growth was --. FBR tax grew by --, direct tax collection

by – while indirect grew by %. That the actuals are uniformly short of target, reflects less on FBR's performance and more on ambitious budgeting to show low fiscal deficit at the start of the year. To expect a growth in tax revenue of more than 9% (GDP growth % plus CPI) is unrealistic unless GoP makes policy changes.

| Government Revenue: Comparison of Target with Actuals<br>Billion Rs. | | | | | |
|---|---|---|---|---|---|
| | **Actual 2016-17** | **Budget 2017-18** | **Growth C/B %** | **Actual July-December 2017-18** | **Growth July-December 2017-18/ 16-17 %** |
| **A** | **B** | **C** | **D** | **E** | **F** |
| Total Revenue | 4,549.0 | 4,915.6 | 8.0 | 2,150.8 | 18.4 |
| Tax Revenue | 3,647.5 | 4,330.4 | 18.7 | 1,850.4 | 15.9 |
| FBR Tax | 3,361.0 | 4,013.0 | 19.4 | 1,730.0 | 17.9 |
| Direct Tax | 1,343.1 | 1,594.9 | 18.7 | 673.8 | 14.9 |
| Indirect Tax | 2,017.8 | 2,418.1 | 19.8 | 1,056.3 | 19.9 |
| Other Tax | 286.4 | 317.41 | 10.8 | 120.4 | -6.1 |
| Non-Tax | 901.5 | 979.8 | 8.7 | 300.3 | 36.2 |

Setting unrealistic targets weakens the budgeting process, an important policy tool. IPR estimates that government revenue will fall short by Rs. 500 to 600 Billion, of which FBR collection will be shy by Rs. 300 Billion.

| Estimated revenue shortfall 2017-18<br>Billion Rs. | | | |
|---|---|---|---|
| | **Target** | **Estimated Actual** | **Shortfall** |
| **Total Federal Revenue** | **4,915.6** | **4,400.0** | **515.0** |
| **FBR Revenue** | **4,013.0** | **3,700.0** | **313.0** |

## Fiscal operations: Government expenditure

Federal government July-December total and current expenditure grew by 14.4% and 12.3% respectively. The final numbers will depend mostly on a. how much debt servicing is due in the last quarter (by all estimates it will grow substantially), b. if security needs increase, and c. how much PSDP is cut and its releases slowed.

Higher interest expense this year is indicative of the debt trap in which the economy finds itself. Development expenditure increased by a healthy margin during July- December though it is likely to reduce in the second half of the year. Macro constraints once again have fallen on federal development expenditure, which will be shy by about Rs. 200 billion or 20%.

## How much of the expenditure is growth stimulating?

Government has limited control on the bulk of expenditure. Very little goes to improve welfare of the people or to stimulate growth. In FY 17, spending on defence and interests was 51% of total budget, current and development. On the other hand, PSDP spending was 16.8%. It is understood that actual defence spending is far more as the booked amount does not include payment for pensions, military operations, and procurement.

**Federal Government Expenditure Analysis**

**Billion Rs.**

| | **Actual FY 17** | **Actual FY 18** | **Increase %** | **Share in total %** | |
|---|---|---|---|---|---|
| | | | | **FY 17** | **FY 18*** |
| **Current Expenditure** | **2455.8** | **2,757.9** | **12.3** | **87** | **86** |
| Interest payment<br>• Domestic<br>• Foreign | 1,094.4<br>1,009.8<br>84.6 | 1,273.8 | 16.4 | 38.9 | 39.8 |
| Defense | 535.6 | 626.2 | 16.9 | 19.1 | 19.6 |
| Public order and safety | 81.9 | 94.7 | 15.6 | 2.9 | 2.9 |
| Others | 743.1 | 763.2 | 2.7 | 26.4 | 23.8 |
| **Development Expenditure** | **354.7** | **442.3** | | **12.6** | **13.8** |
| PSDP | 327.2 | 367.7 | 12.3 | 11.6 | 11.5 |
| Others mainly BISP | 57.2 | 60.8 | 6.3 | 2.0 | 1.9 |
| **Total Expenditure** | **2,810.5** | **3,200.2** | | | |
| ***July-Dec 2017-18** | | | | | |

Available data for July-December FY 18 shows 58% of total expenditure (current and development) was spent on interest payment and defense. Their share may reduce after data for the full year is available. Expenditure on defence is much needed because of Pakistan's especial security needs, and without which economic activity suffers. However, it does not contribute directly to economic growth. What goes to defence must come out of expenditure on development or on other for the people. The two expenditures of interest payment and defence are growing the fastest and their share in total expenditure is increasing. So far, just 13% of spending in FY 18 was on development. In times of fiscal constraints, development is the first head to be cut.

Subsidy for PSEs are a particular concern. Despite claims to contrary, government has done very little, if at all, to restructure and turn around PSEs or to privatize them. Accumulated PSEs losses are estimated to be between Rs. 1.2 to 1.4 Trillion.

## Fiscal Operations: Budget deficit

Target fiscal deficit was 4.1% of GDP for 2017-18. It is certain that end of year deficit will be more than the target and more than Economic Survey's estimate of 4.5%. IPR estimates it to be about --%. The higher than estimated fiscal deficit is because of ambitious revenue and provincial surplus targets. As we see in the two above Tables, federal revenue is expected to be shy of the budget. In addition, the budget FY 18 had estimated provincial surplus of Rs. 347 Billion for 2017-18. This is unrealistic especially in an election year. This surplus amount was kept in the budget despite last year's provincial deficit of Rs. 163 Billion. This shows budget making removed from reality.

Whatever the deficit amount, it is understated as there is a large unpaid liability of over Rs. 900 Billion of circular debt. Total liabilities stand at Rs. 922 Billion. Of this, government's direct payable is Rs. 472 Billion and the rest Rs. 450 Billion are bonds of the Power Holding Private Ltd.

## Public Debt

Weak fundamentals find their denouement in unsustainable debt levels. As noted already, Pakistan is effectively in a debt trap. Both external and domestic debt have increased. In six months, during July-December FY 18, total central government debt grew by Rs. 2.1 Trillion or 6% of GDP, reaching Rs. 22.9 Trillion or 66.5% of GDP. This is a major breach of the target government had set for itself as well as of the fiscal responsibility act.

External debt and liabilities also grew rapidly. In six months, up to December 2017, the economy's external debt and liabilities grew by USD 5.9 Billion or 2.5% of GDP. Total external debt reached an unprecedented 89 Billion by December 2017. Public debt increased by USD 4.4 Billion. Central government debt grew by USD 4.2 Billion and private sector debt grew by USD 730 Million.

In FY 17, external capital financed 29% of the budget deficit. During FY 18 (until December 2017), this figure is 48% for external finance. A more disturbing trend is that high interest commercial loans increasingly finance external borrowings. In FY 17, borrowings of Eurobond, Sukuk, and from commercial banks was 48% of total external disbursed loans. This figure grew to 64% in July-December FY 18. In FY 13, this figure was zero.

Looking at stock of external debt numbers, proportion of commercial debt (Eurobond/Sukuk/Commercial loans) was 2.3% of central government external debt in FY 13. Its proportion grew to 17% on 30 June 2017 and to 21% on 31 December 2017. Of the USD 4.4 Billion increase in public debt, since June 2017, over USD 3 Billion is in commercial foreign debt, Eurobond, Sukuks, and commercial loans. These are prohibitive cost debt. The incremental reliance on commercial debt is alarming and imprudent.

Resultantly, there has been a run on the country's Forex reserves.

| **Central Government Debt Profile Trend** **Billion Rs.** | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | **30 June 2013** | | | **30 June 2017** | | | **2018** | | |
| | **D** | **Ext** | **Tot** | **D** | **Ext** | **Tot** | **D** | **Ext** | **Tot** |
| Federal Government | **9,522** | **4,797** | **14,318** | **14,849** | **5,919** | **20,768** | 15,948 | 6,958 | 22,906 |
| % of GDP | 42.5 | 21.4 | 63.9 | 46.6 | 20.5 | 67.1 | 46.3 | 20.2 | 66.5 |

## External debt and liabilities

| **Pakistan External Debt Profile** **Billion USD** | | | | | | |
|---|---|---|---|---|---|---|
| | **2000-01** | **2006-07** | **2012-13** | **2016-17** | **2018 31 Dec 2017** | **Increase in six months** |
| **Public** | 29.7 | 36.7 | 50.0 | 66.1 | 70.5 | 4.4 |
| **Total Debt and liabilities** | 37.2 | 40.5 | 60.9 | 83.0 | 88.9 | 5.9 |
| **% of GDP** | 52.1 | 28.3 | 26.1 | 27.3 | 28.5 | 2.5 |
| **% of FEE** | 278 | 122.6 | 121.0 | 163.5 | 170.4 | 39 |

| Repayment of Principal and Interest<br>Million USD | | | | |
|---|---|---|---|---|
| | **30.6.2001** | **30.6.2007** | **30.6.2013** | **30.6.2017** |
| Payments of Principal and Interest | 1,668 | 2,977 | 5,978 | 8,157 |
| % Export | 18.7 | 16.7 | 24.0 | 39.7 |

## Gross Forex Reserves

Forex Reserves declined:

June 2017 17,550 Million USD, 4.3 months import

December 2017 15,764 Million USD, 3.6 months import

March 2018 13,300 Million USD, 3 months import

Gross foreign exchange stood at USD 13,300 Million on 31 March 2018 compared to 17,844 Million on 31 March 2017, and USD 17,550 Million on 30 June 2017. March 2018 balance is USD 4,544 Million less than March 2017. During this period external indebtedness grew by USD 11,168 Million. The sum of lower foreign exchange and higher indebtedness equals USD 15,712 Million. This is the foreign exchange amount that the economy needed above what was available in foreign exchange earnings. This is so despite recent adjustment in exchange rates, growth in exports, and lower machinery imports.

Partly, we find explanation by comparing the amount paid to service external debt (interest and principal). In FY 2007, this amount was less than USD 3 Billion. It grew to almost USD 6 Billion in FY 13, and USD 8.2 Billion in FY 17.

## Balance of Payments

Current Account Deficit for July-March 2017-18 has worsened compared to last year. Comparative positions for July-March of selected fiscal years are given below:

FY 18 has the worst external account indicators in ten years. March 2018 current account deficit is 5% of GDP, 54% of exports of goods and services, 33% of foreign exchange earnings inclusive of workers' remittances. The current account deficit in March 2018 is 50% higher than for the same period last year. Despite heavy borrowings, gross foreign exchange reserves are at 3.3 months of fob imports.

| Comparative Current Account Balance<br>July-March FY | | | | | |
|---|---|---|---|---|---|
| | **2017-08** | **2012-13** | **2015-16** | **2016-17** | **2017-18** |
| Current Account Deficit Million USD | 6,168 | 1,255 | 3,367 | 7,990 | 12,029 |
| %GDP | 5.3 | 0.7 | 1.5 | 3.5 | 5 |
| % Export (Goods + Services) | 40.0 | 5.3 | 16.7 | 38.9 | 54.4 |
| % FEE Exports + Remittances | 32 | 0.7 | 1.5 | 9.6 | 32.7 |
| Forex Reserves in Months Import | 5.5 | 2.75 | 5.7 | 4.3 | 3.0 |

July-March 2017-18, CAD was USD 12,029 Million. This amount was USD 7,990 last year and 3,367 at the end of March 2016. There was good news for exports, which increased by 12% in July-March FY 18 over the same period FY 17. Pakistan's merchandise exports had been in decline for three years. The reversal is probably the result of GoP's fiscal incentives and adjustment in exchange rates.

Pakistan has not adapted to the changes in world economy. Its exports are constrained by issues of competitiveness and productivity and have not adapted to evolving market demands. This is a major concern with which GoP has not yet come to terms.

For July-March fiscal 2017, exports were 7.6% of GDP compared to 7.1% the previous year. Historically this ratio has been over 10%. It was 13.5% in 2002-03 and 10.3% in 2012-13. These are indicators of a serious secular decline. We have yet to see a policy response.

FDI is the other concern. It grew by a healthy 15.65 % for July-February 2017-18 over the same period last year. Total FDI of USD 1,941 Million is still very low. GoP's FDI target for FY 18 was USD 4,183 Million. FDI for fiscal 2018 will barely touch USD 3 billion. This is way below what the economy needs to grow. Pakistan must do something special to attract investment.

Since 2014-15, GoP has made substantial borrowing from commercial sources at a cost. Most of this debt is to pay back earlier loans.

## Under-performance of energy sector

Despite improvements energy shortage constrains power supply, which has hampered industry and commerce. A bigger concern is that the government has done very little, if at all, to improve policy and governance. That is the only way to attract investment and ensure reliable power supply at a reasonable cost. We would have expected government to take benefit from low energy prices and place the power sector on a sustained path. Overall, power production improved this fiscal year. According to the Pakistan Economic Survey power consumption grew by a minimal 1% during July February 2017-18 compared to the same period last year. Total consumption was 61,485 GWh in July-February 2017-18 compared to 60,813 GWh last fiscal. However, this growth is understated by the large line losses. Power generation increased by an estimated 10% during the period. During this period circular debt increased to reach a total of Rs. 922 Billion by March 2018.

## Social sector indicators

It was thought that social sector indicators would improve with greater autonomy and fiscal resources with the provinces. There is no, or at best, marginal improvements in social sector indicators. Human development is not just a moral issue or one of fairness. It is economic issue as it stimulates growth. There can be no long-term economic growth without it. The sector suffers from low public-sector allocation. Low top-level priority also suggests low monitoring. So, what funds the sector gets is often poorly spent. Pakistan ranks 147$^{th}$ among 188 countries in the Human Development Index. It is well below other economies of equivalent level economic development. Claims of economic progress by successive governments seem insignificant when placed in the perspective of such serious social deficit.

## Inflation

Prices have picked up from last year, though will stay within the target rate of 6% inflation. CPI is --% this year, up to April 2017, compared to --% for the same period last year. WPI grew at --% compared to % last year. Core inflation non-food non-energy has grown at --%. For the next year, it is necessary to keep an eye on inflation. Currency in circulation grew -- times in first half 2017-18. The value of the Rupee has declined by 11% and energy prices may revive (Saudi Arabia wants to see it back to USD 100 bbl).