INSTITUTE FOR POLICY REFORMS

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Comments on Budget FY 20

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.

Gloom surrounded the presentation of the budget 2019-20. A day earlier the Economic Survey had presented a dismal picture of the economy. The market also had reacted. Rupee lost further value and the stock exchange dipped and then recovered. That it was presented amid loud protests and jeers within the assembly was a reminder that IMF or not, economic policy is part of the political process.

The more substantial concern with the budget is its framework and consistency between its parts. The target fiscal deficit is a high Rs. 3,137 Billion, or 7.1% of GDP. This large gap exists despite the proposed major increase in federal revenue and an estimated provincial surplus of Rs. 423 Billion. Any slippage in revenue collection or a smaller provincial surplus would further increase the size of the deficit. With an estimated debt servicing of Rs. 2,891 Billion, the Primary Balance will be below 0.6%.

Government's stated goal for the budget is to increase gross federal revenue. With Revised Estimates 2018-19 as base, the new budget proposes total federal tax revenue to grow by 32.5% and FBR tax revenue to grow by over 33%. This magnitude of increase in revenue is unprecedented. The paradox is that it must necessarily depend on higher economic activity to generate the revenue, which a tight monetary policy and high taxes may dampen.

The budget has been made in the framework of an IMF arrangement. Its revenue generation targets are based on a premise that we hope is valid. If not, we fear that the budgetary framework will not hold, with deleterious effect on the economy. We could then see frequent revision during the fiscal year or an even larger deficit. In fairness, in the buildup to the budget, the government had cautioned about the difficulties faced by the economy and the hard choices. But first the numbers.

Outcomes of 2018-19: The usual story of missed targets

As is widely known, government missed most targets for FY 19. The economy grew by 3.29% against the target of 6.2%, with the productive sector, agriculture and industry, contributing a meager 1.13%. The anemic economic performance is because of loss of the economy's productive capacity.

The share of productive sector in GDP has consistently fallen for many years. In FY 19, this share is 38.8%. This is compared to 43% in 2010 and 46.4% in 2,000.

This trend was okay, had the service sector developed to replace the commodity producing sector. There has been no major value addition in the service sector. Export of services too is on a weak base. This trend should disturb anyone thinking strategically about the future of our economy and its ability to compete in the region. As stated in this Institute's comments on the Economic Survey, this has happened despite very large flows of foreign aid to Pakistan. We have been unable to use the assistance to build productive capacity and boost our exports.

Fiscal deficit was high in FY 19. July-March deficit was 5% compared to the already high 4.3% of GDP in the previous fiscal year. For the full year, it is expected to approximate 7% of GDP. The current account deficit improved, though there were no export gains during the year. All of the improvement was from reduction in imports. Despite radical fall in value of the rupee, exports did not grow.

Each year an estimated two million young people enter the job market. While data on new jobs is scarce, clearly the moderate growth rates of recent years have not helped. This budget has made efforts to incentivize job creation through tax measures.

Another cause for concern is consistent fall in the savings rate. National savings was 10.7% of GDP in FY 19. In fiscal 18 it was 11.5% and in fiscal 17 it was 12%. Low savings constrains investment and keeps the economy at low growth. This also increases our dependence on foreign capital.

It is important to take note that this year's economic targets were set by a government that was close to completing its five-year term. Whether the present government owned the targets or considered them realistic has never been clear.

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IPR has always advocated for a more strategic approach to economic policy. The budget works in a one-year framework. Its main task is to estimate revenue and expenditure. The revenue measures justifiably attract considerable interest. However, it is important to note that their goal is to meet revenue needs. They do not flow from any strategic plan, even if the rationalization is framed in strategic language.

It is critical that the budget's revenue and expenditure must take cue from an overall strategy. This budget and the many before it, do not show any such intent. It is not surprising that our economy has drifted with no idea about its long-term goals. One could say that the Five-Year Plans are its guide. But the budget does not even pay lip service to the plans. And a plan is as good as the funds placed to execute them.

Thus, we see productive sectors in long term decline. Savings and investment similarly adrift. And no one doing much to make the economy competitive or to create export capabilities. Such exclusive focus on one year cycles is counterproductive for the economy. Year in and year out we see how irrelevant economic management has become to the country's long term economic and national goals. Bluster is no substitute for economic policy.

Budget Framework 2018-19: The numbers may not add up

Total FY 20 budget outlay of Rs. 8,238 Billion is 38.9% more than the revised budget estimate for FY 19 of Rs. 6,419 Billion. The budget estimates gross revenue receipts of Rs. 6,716.6 Billion, an increase of 33% over FY 19 Revised Estimates. FBR taxes will grow to Rs. 5,555 Billion an increase of 33.8% over the FY 19 Revised Estimates, but a whopping and perhaps unrealistic increase of over 40% from the expected actuals. Estimate of net receipts, after transfer to provinces, is Rs 3,462 Billion. The ambitious goal of raising total revenue will be a challenge in the face of a slow economy.

The estimate for total federal expenditure is Rs. 8,238 Billion, of which current expenditure is Rs. 7,288 Billion, 88.5%. Federal PSDP is estimated to be Rs 701 Billion 8.5% of total expenditure. The balance is other development and loans. Budgeted fiscal deficit of Rs, 3,137 Billion or 7.1% of GDP is the highest in recent years.

Receipts:

- Regardless of what happened with tax revenue in FY 19, in four years before that there has been unprecedented growth in FBR receipts. So, at 4% GDP growth rate, FBR must pull a rabbit out of the hat to achieve the desired growth in revenue. All credit to their spirit and determination. Direct taxes will grow by 24.5% and indirect taxes by 39.4% from FY 19's revised estimate to reach their target of Rs. 2,081 Billion and Rs. 3,473 Billion, respectively. In FY 19, tax expenditure was Rs. 942 Billion. In this budget many of the exemptions and concessions have been removed. FBR would also have to address the issue of evasion and broadening the tax base.

- Contrary to some claims made before the budget, the share of direct tax to total revenue will not improve. In fact, it is targeted to decline from 39% of total FBR taxes in FY 19's Revised Estimates to 37% in FY 20.
- The target for tax/GDP ratio is 12.6%
- The budget estimates that non-tax revenue will grow by 40%, mostly from SBP profit, which is realistic as it should rise with the large fiscal deficit.
- The budget estimates receipt of Rs.423 Billion provincial surplus.

The ambitious revenue target would take some doing. Coupled with the high estimate for provincial surplus, we hope that the fiscal deficit does not go higher than 7.1% of GDP.

BE 2019-2020

Federal Revenue

Billion Rs.

	Revised Estimates 2018-19	Budget Estimates 2019-2020	Change %
FBR Taxes	4,150	5,555	33.8
Direct	*1,659*	*2,082*	*25.4*
Indirect	*2,491*	*3,473*	*39.4*
Other Taxes	244	267	9.5
Non-Tax Revenue	638	894	40.1
Gross receipts	5,032	6,716	33.4

Expenditure:

- Current expenditure is budgeted to increase by a massive 30.3% from this fiscal's revised estimate. Without loan repayment, it is estimated to grow by over 33%.
- Debt servicing will jump by 45% from Revised Estimates 2018-19, about 40% of current expenditure. Defense will stay at or just above FY 19's revised estimate. Subsidies and other grants will grow. Government has targeted to reduce civil government expenditure by 6.5%.
- Government has not shared a strategy to reform PSEs, which need hundreds of billion in subsidies. Yet, total subsidy amount of Rs. 271 Billion provided in the budget appears to be below needs, of which Rs. 191 Billion is for the power sector. Subsidies to PSEs is bound to increase. We believe it is underestimated. PSE subsidy is a waste of resources. It is jarring to see it, while the people are being asked to pay more taxes.
- There has been some effort to improve power sector sustainability. Government has begun to counter line losses and less recovery of bills. Yet difference in energy production and consumption data show still show an 18% gap. This has been the level of line losses for many years, Together with subsidy for below 300 units consumers. It seems that the provided allocation for power subsidy of Rs. 191 Billion will not be enough.

The sum of these under provisions and the ambitious tax increase targets 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 about Rs. 1,200 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.

Macro Framework guiding the budget:

The economy's targeted growth rate is 4% and the current account deficit is -3% or USD 8.3 Billion (in his speech, the MOS said USD 6.5 Billion). The USD 8.3 Billion estimate is about 38% below FY 19 revised estimate of USD 13.3 Billion. While the growth rate seems realistic, the current account deficit target is ambitious. We see the following pressures on the current account.

- Exports have been stagnant for five years and there is no sign of its revival as manufacturing sector is in a slump. Additional taxes and withdrawal of exemptions, though necessary may further dampen manufacturing.
- Workers remittance of over USD 20 Billion is expected to be at past levels. Government could take especial efforts to encouraging their transfers through formal channels and by exporting more workers.
- FDI declined considerably in FY 19. CPEC will see modest growth, if any. With GDP growth at moderate level, FDI cannot be expected to increase by much. IMF arrangement will restore confidence in the economy. Yet, government's estimate of USD 4.34 Billion FDI, a 2.5 times increase from FY 19, seems high.

- The correction in current account deficit is also dependent on imports being stagnant. In some ways, that may act as a dampener on growth. Exports is estimated to grow by about 13% and imports are estimated to stay at current year's level.
- In Rupee terms, external debt is 35% of GDP. Dependence on external savings means higher debt servicing needs. All this will put pressure on the Balance of Payment.

Because of the above, it will be hard to keep the current account deficit at 3% of GDP.

The macroeconomic framework estimates slight growth in investment to GDP ratio to 15.8%. It estimates savings to increase to 12.8% from FY 19's 10.8%.

For FY 20, the government has increased PSDP envelope to Rs.701 Billion from FY 19's revised estimate of Rs 500 Billion. Given the expected fiscal challenges, the axe will certainly fall on the PSDP in the second half of the year.

Tax Proposals

Following are the estimates for growth in FY 20 taxes:

- Total federal tax revenue: Rs. 5,822 B, +32.5%
- FBR taxes Rs. 5,555, 33.8%
- Direct tax: Rs. 2,082 B, 26%
- Indirect: Rs. 3,473 B, 39%
- Other taxes Rs. 267 B, 10%
- Tax to GDP ratio: 12.6%

Despite substantial withdrawal of exemptions, it is hard to see where this growth in taxes will come from, in a moderate economic growth environment. Government may be putting too much faith in the Asset Declaration/Tax Amnesty Scheme and FBR's ability to enhance tax base.

Its success also depends on how much cost GoP places on tax evasion and, especially, on non-filing of returns.

Incentives for revival of manufacturing and agriculture and new tax measures:

Coupled with higher taxes, the finance bill 2019-2020 offers a number of incentives to stimulate business. Government's expectation for greater economic activity and possibly investment lies at the core of its policy to increase revenue and correct the current account deficit.

The budget contains a number of incentives for the productive sectors. To counter the 4.4% fall in major crops production in FY 19, GoP has offered to reduce input cost for agriculture. GoP has also offered incentives for revival of selected industries. They include reduced customs duty, sales tax, and federal excise. Preferred industry that attract these incentives are printing, textiles, wood and paperboard, mobile phones, pharmaceuticals, and hospitals.

Sales tax reductions have been offered to petroleum products, mobile phones, restaurants and bakeries, and concentrated milk. Sales Tax has been reduced also for jewelry manufacturing.

However, revenue enhancing measures far exceed the incentives.

There is no strategy to promote value added sectors. These sectors need long term support with technology diffusion and access to capital. Government must look 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.

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 firm move in that direction. The budget does not refer to SEZs under CPEC. SEZs 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 about 8% of GDP

Impact of the Budget on Growth and Living Standards:

The budget announced a vast number of measures to address the social deficit and to alleviate poverty. This is perhaps the most clearly considered and encouraging part of the announcements. We hope that there will be enough funds to meet the budget's promise for the poor.

Other measures will hurt the poor. Although the poor have been protected from tariff adjustment in utilities and would likely benefit from the increase in cash and other support, overall increase in prices will affect their welfare. They are hurting already from low and moderate GDP growth rates.

PSDP

Development Budget: PSDP

From an ambitious Rs. one Trillion in FY 18, PSDP was reduced in FY 18, and has declined further to 701 Billion in FY 2020. This is a paltry 1.7% of GDP down from over 3% in FY 17. Including provincial allocations, national PSDP is about 4% of GDP. Given the many ways in which the budget may miss its revenue and expenditure targets, it is unlikely that this reduced envelope would be spent in full.

Reduced size of PSDP calls for even more judicious use of funds to meet the severe shortage of physical and soft infrastructure and human resource deficit in the country. Reduced development envelope requires that government exercise more care in project selection. Yet we see the PSDP spread over more than a thousand projects.

It is encouraging to see higher allocation for the water sector. Allocation for Dasu and Diamer Bhasha has increased. Partly, the secular decline in agriculture production is because of water availability. In addition to storage, GoP must also consider an aggressive programme for water conservation. Water sector's Rs. 85 Billion is allocated to 107 projects. The budget would have been more effective if GoP had selected fewer projects and completed them early.

In the power sector, most of the allocation is from NTDC/PEPCO's own resources. With major growth in generation, it is necessary to prioritize transmission projects.

A major concern about the PSDP is the large component of discretionary special schemes. These total Rs. 220 Billion or 30% of the development budget. The Rs. 220 Billion includes grants for Finance Division, which are block allocation for regions as well block allocations for Kashmir and Gilgit Baltistan Division. Other heads are relief and rehabilitation of IDPs, security enhancement, PM's Youth Initiative, a green initiative, and more.

IPR feels that though they are necessary, they are not strictly developmental. 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. 480 billion rather than Rs. 701 Billion.

An encouraging sign is increase in allocations in health and food security areas. On the other hand, PSDP has reduced allocations in some important sectors. Allocation to HEC has declined, whereas it is an important area to build economic competitiveness. Similarly, a major cut in budget for the Railways is a blow to providing logistics support to businesses and movement of people. It suggests that CPEC's very important ML 1 project has been shelved.

The Pakistan economy has been in low to moderate growth for several years. Despite the hype, a growth of 5.8% would not be considered high and it lasted one year only. 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. The budget's ad hoc nature is understandable as there is no major government programme for economic reforms that it is a part of.