INSTITUTE FOR POLICY REFORMS

IPR FACT SHEET

June 2020

Need for empathy: Comments on Budget FY 21

About IPR

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Budget making was not easy this year. On the one hand, there are especial health and welfare costs that have arisen suddenly. On the other, the recession has made revenue collection sluggish and GoP must still keep in mind the EFF framework agreed with the IMF. In the event, the budget has focused almost entirely on EFF targets.

This year too, the budget speech gave GoP credit for moving forward on all fronts from climate change to 21st century knowledge, SDGs, and regional balance. As is expected from a stabilization focused budget, in actual fact it is mostly a routine nod to these areas. The budget gave no strategy or meaningful initiative. Some efforts has been made to meet the health challenge, though it does not seem nearly enough. What we needed were bold steps to help those affected by the virus or to keep businesses alive. What we saw was business as usual. This is exactly what the economy did not need.

Given the hoopla that surrounds budget season each year, the delivery of the budget speech lacked conviction or spirit. Perhaps Minister Azhar was too involved with ignoring his protesting colleagues. Perhaps there was not much to be spirited about.

In any event, the budget speech could not avoid the feeling of gloom brought by the pandemic, as Pakistan was well on its upward march in the world COVID 19 ranking. Already, the people were feeling the effect of a recession with massive job losses. This budget did not offer any balm for their wound.

Their worst fears were confirmed by the Pakistan Economic Survey issued a day earlier. Not only Pakistan had missed all growth targets, actual growth was mostly negative. But the National Accounts are based on nine months data. That means that negative growth was not because of COVID 19. The pandemic’s

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effect will show in the last quarter of FY 20. This was an economy already going south. On two counts, it is cause for special concern. Each year's budget speech paints a promising picture of stability and revival. And at the end of that year the outcome is vastly different. Compare Economic Survey's results with last year's budget speech. Second, economic slowdown in FY 20 was because of GoP policies, not the virus, had hit the economy hard. The virus made it worse.

Last year, we had warned that the economic framework was not realistic and may even have lacked consistency. This year too we wish to raise the same red flag. The target fiscal deficit is 7% of GDP at Rs. 3,195 Billion. This large gap exists despite the proposed major increase in total federal revenue, to Rs. 6,573 Billion a growth of 19% over FY 20 revised estimate, FBR taxes will grow to Rs. 4,963 Billion from its (third) revised estimate of Rs. 3,908 Billion. The fiscal deficit includes an estimated provincial surplus of Rs. 242 Billion. Any slippage in revenue collection or a smaller provincial surplus, both very likely prospects, would further increase the size of the deficit. With an estimated debt servicing of Rs. 2,946 Billion, the Primary deficit will be 0.5%, within IMF target. Budgeted expenditure is expected to fall FY 21. Estimate for Current expenditure is 17% below last year. We may discover that this estimate is too ambitious and current expenditure will be higher.

With Revised Estimates 2019-20 as base, the new budget proposes total federal tax revenue to grow by 30% and FBR tax revenue by 27%. In an environment of uncertainty where the full effect of the virus could take months to unfold, it is hard to share GoP's enthusiasm, especially as the Annual Plan estimates a sluggish GDP growth of 2.1%. Not sure where the extra tax Rupees will come from. Last year too, the budget provided for a growth of 33% in FBR taxes. They did so with a tight monetary policy, an FBR smelling blood, and low Rupee value. So far, GoP has had to revise its estimate downwards by 30%.

In FY 21, the pandemic's effect is sure to last until the end of this year. In such circumstances, it is unlikely that revenue would grow by 27%. Much of the revenue increase comes from indirect taxes. They depend on transactions and economic activity. Both will be slow to recover in the coming months.

We hope that the premise on which the budget's its revenue targets rest are valid. If not, we fear that the budgetary framework will not hold, with deleterious effect on the economy. Last year IPR had warned that we would see frequent revision during the fiscal year or an even larger deficit. Both happened. The budget is a document to enable government to work for the people of Pakistan. It must be realistic.

Let us take a look at last year's outcomes and then this year' estimates.

FY 20 Outcomes: Missed targets

As we reported in the review of the Pakistan Economic Survey, government missed most targets for FY 20. In most cases, growth was negative. FY 20 GDP growth is estimated to fall by 0.4% against the target of 4%, with the productive sector, agriculture, and industry, contributing minus 0.05%. While COVID is the reason we hear of, the anemic GDP performance of many years is because of loss of the economy's productive capacity. Since 2000, combined share of agriculture and industry to GDP has fallen by over 8 percentage points. Share of service sector has grown.

Pakistan's service sector is not efficient or competitive to replace the commodity producing sector. Exports of services as a percent of GDP have fallen in the last ten years. So, the growth rates in the last 20 years are mostly from one time spending, not from investing in capacity.

This trend should disturb anyone thinking strategically about the future of our economy and its ability to compete in world markets. As stated in this Institute's comments on the Economic Survey, this has happened despite very large flows of foreign aid to Pakistan in the past. We have been unable to use the assistance to build productive capacity and boost our exports. Even now, there is total focus on fiscal issues by policy makers and none on increasing production. We have pursued such chimerical goals for decades without realizing that macro stability can only come from growth and exports.

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 with job creation. According to the Economic Survey, this year an estimated 18 million jobs were lost to the crisis. Though government job data is usually amorphous, even if job losses is smaller than 18 million, it would add to youth vulnerability and alienation.

Another cause for concern is consistent fall in the savings rate. This fiscal, national savings grew to 13.9% of GDP from 10.8% in FY 19. However, domestic savings are still very low at 6.8%. Overall, revival is too small to make a difference, especially as workers' remittances may fall and with it overall savings. Perhaps the increase was because of high returns on savings. Those returns on savings have fallen already. Low savings constrain investment and keeps the economy in low growth. This also increases our dependence on foreign capital. Savings rate of growth economies are usually 30% or more of GDP. We have some catching up to do.

IPR has always advocated for a more strategic approach to economic policy. The budget works on a one-year time frame. Its main task is to estimate revenue and expenditure. It is useful if it is part of a strategic plan. That is a thought that eludes our policy makers.

It is critical that the budget's revenue and expenditure must form part of 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.

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 FY 21: Too much reliance on hope

Total FY 21 budget outlay of Rs. 7,295 Billion is 11% less than the revised budget estimate for FY 20. Gross revenue receipts are estimated at Rs. 6,573 Billion, an increase of 19% over FY 20 Revised Estimates. FBR taxes will grow to Rs. 4,963 Billion an increase of 27 % over the FY 19 Revised Estimates. Estimate of net receipts, after transfer to provinces, is Rs 3,699 Billion. The ambitious goal of raising total revenue will be a challenge in the face of an economy in recession.

Budget Framework	**In Billion Rs**
	FY 21
Gross Fed Revenue	6,573
Net Revenue Receipts	3,699
Total Expenditure	7,136
▪ *Current Expenditure*	6,345
▪ *PSDP*	650
▪ *Net lending*	72
▪ *Other development*	70
Federal Deficit	3,437
Provincial surplus	242
Overall deficit % GDP	3,195 7%
Primary deficit % GDP	486 0.5%

The estimate for total federal expenditure is Rs. 7,136 Billion, of which current expenditure is Rs. 6,345 Billion. Current expenditure is 89% of total spending. Federal PSDP is estimated to be Rs. 650 Billion 9 % of total expenditure. Budgeted fiscal deficit is Rs. 3,195 Billion or 7% of GDP. Primary deficit is estimated at 0.5% of GDP.

Estimates show that GoP will spend 41 % of total expenditure and 80% of net revenue receipts on debt servicing while it will spend 9% on development. Debt servicing was 42.5% of total expenditure in Revised Estimates for FY 20 and 87% of net revenue receipts.

Receipts:

- At 2.1% estimated GDP growth rate, FBR must pull a rabbit out of the hat to achieve the desired 27% growth in revenue. All credit to their spirit and determination. Direct taxes is targeted to grow by 26 % and indirect taxes by 27 % from FY 20's revised estimate. Estimate for these taxes are Rs. 2,043 Billion and Rs. 2,920 Billion, respectively.
- The target for tax/GDP ratio is estimated at 12 and FBR tax at 11 %
- The budget estimates that non-tax revenue will fall by 14.5 %, mostly from reduction in SBP and PTA profit.
- The budget also estimates provincial surplus of Rs. 242 Billion.

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 2020-21
Federal Revenue

Billion Rs.

	Revised Estimates 2019-20	Budget Estimates 2020-2021	Change %
FBR Taxes	*3,908*	*4,963*	*27*
Direct	*1,623*	*2,043*	*26*
Indirect	*2,285*	*2,920*	*27*
Other Taxes	300	501	67
Non-Tax Revenue	1,296	1,109	-15
Gross receipts	5,504	6,573	19
Net Receipts	3,102	3,699	19
FBR Tax to GDP ratio	9.4%	12%	

It is hard to see where this growth in taxes will come from, in a low economic growth environment. Government may be putting too much faith in some of the reform efforts that were mentioned in the budget speech. In order to stay within the deficit target, it may increase revenue from petroleum levy, though that depends also if oil prices stay low. Also, as subsidies budget has fallen, it may decide to park more circular debt off budget. Also, it could hold back releases to provinces, and it will cut the welfare or PSDP spending. These are the usual MoF tools for staying within the fiscal framework.

Normally, revenue measures justifiably attract considerable interest, as they affect business bottom line. This year, there is no especial incentive for businesses.

Expenditure:

- Current expenditure is budgeted to decrease by a substantial 17 % from this fiscal's revised estimate. The main difference is because in FY 21 the budget does not provide for loan repayment.
- Debt servicing will grow by 9 % from Revised Estimates 2019-20, 41 % of total expenditure. Defense will grow a modest 5% above FY 20's revised estimate. Subsidies and other grants will decline. Government has targeted to increase civil government expenditure by 6.5%.
- Government has not shared a strategy to reform PSEs, which still need significant subsidies to survive, provided by the budget. This year, subsidy estimate is 40% below last year. This is well below needs, especially as none of the PSEs have been reformed or privatized. DISCOs are especially resistant to change. Government may be banking on improving their revenue collection. For now, that is work in progress and expenditure on subsidies to PSEs is bound to increase. From an economic efficiency point of view, it is jarring to see large sums paid as subsidy, while the people are being asked to pay more taxes.
- Earlier claims about improved power sector sustainability seems to have fallen by the wayside. Line losses are still high. Difference in energy production and consumption data show a gap of 15.5. Together with subsidy for below 300 units consumers, and leakage in bill collection, the provided allocation for power subsidy 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. 1,900 Billion in circular debt, which is liability that must be paid at some point.

Federal Expenditure					Billion Rs and %
	FY 21	FY 20	+/- %	% of total Fed Exp BE FY 21	% of FY 21 GDP
Gross federal Exp % of net receipts	7,136			100	15.6
Federal current % of net receipts	6,345 171	7,618 245	-17	89	14
Debt servicing % of net receipts	*2,945* *80%*	*2,709* *87%*	*9*	*41*	*6.5*
Defence	*1,289* *35*	*1,227* *40*	*5*	*17*	*3*
Subsidies, grants, and pensions	*1,583* *43*	*1,990* *64*	*-20*	*22*	*3.5*
Balance for rest of civil government	475 13	445 14	7	7	1
Federal PSDP % of net receipts	650 17.5	701 22.5	-7	9	1.4

Macro Framework guiding the budget:

The economy's targeted growth rate is 2.1% and the current account deficit estimate is 1.6 % or USD 4,447 Million. This estimate is about 14.5% higher than FY 20's projected balance. The growth seems realistic. We see the following pressures on the current account.

- Export orders have fallen. IMF has recorded reduced container traffic at ports, signaling cancellation of order by overseas buyers. As it is, exports had been stagnant for five years and the massive devaluation had resulted in a modest increase of 4% in July-April FY 20 export. There is no sign of its revival as manufacturing sector is in a slump.
- Workers remittance of over USD 20 Billion may fall if some of them lose jobs and return. It seems that the fall would be temporary. GoP has not done much to accelerate the shift of remittances from informal to banking channels.
- FDI has revived in FY 20 to reach USD 2,281. With GDP growth at moderate or low levels, FDI cannot be expected to grow by much. For a number of reasons that have to do with the economy's competitiveness, Pakistan has never attracted FDI in large amounts. IMF arrangement will restore confidence in the economy. Yet, government's

estimate of USD 3 Billion FDI is realistic. Even this may not happen in a world beset by liquidity problems.

- Correction in current account deficit is mostly because of drop in imports. This in turn will further reduce exports. a dampener on growth.
- In Dollar terms, external debt is 40 % of GDP. Dependence on external savings means higher debt servicing needs. All this will put pressure on the Balance of Payment. IMF estimates external financial needs of USD 29.5 Billion for FY 21.

The macroeconomic framework estimates slight growth in investment to GDP ratio to 15.5% from present year's 15.4%. It estimates savings at 13.8% of GDP about the same as FY 20's 13.9%.

For FY 21, the government has decreased federal PSDP envelope to Rs.650 Billion from Rs. 701 Billion in FY 20. Given the expected fiscal challenges, the axe will certainly fall even more on the PSDP in the second half of the year.

Increase in welfare to those affected by COVID 19 and incentives for businesses

In the build up to budget day, there was expectation of support for health workers, direct transfers to those who have lost jobs or businesses and incentives to businesses to limit job losses and prevent bankruptcies. There was also some discussion about a revival plan for industry and agriculture. Surprisingly, the budget brought no relief nor created incentives for businesses. This is unwise policy making, as job losses and bankruptcies will dampen demand and could lead to unrest.

Government announced some modest concessions for a very narrow group of businesses. Those incentives cannot lead to a revival.

Regarding, health workers and the vulnerable, the modest increase offered in the budget will bring little to no benefit. In adopting this course, government may be taking a health and economic risk.

There are individual customs duty and sales tax correction. Let us hope they bring buoyancy to the economy, though one may have to be a hardened optimist to believe so.

The budget will not do anything to improve peoples' lives.

Development Budget:

PSDP has seen cuts in the last two years. This is the norm for our economy when under an IMF programme. From an ambitious Rs. one Trillion in FY 18, federal PSDP declined to 701 Billion in FY 2020, and is budgeted to be Rs. 650 Billion in FY 21. This is a paltry 1.4% of GDP. Its recent peak was over 3% in FY 17. Including provincial allocations, national PSDP is about 2.6% of GDP, down from 4% of GDP last year. Given the many ways in which the budget may miss its revenue and expenditure targets, it is likely that this reduced envelope may not be spent in full.

The PSDP's main thrust is infrastructure, which is 56% of total budget. Infrastructure investment must result in reliable and improved service quality for businesses. This does not usually happen. Moreover, too many projects in the PSDP, some with modest returns, spread the limited funds thin. Consequently, economic return to the country is delayed.

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.

Though allocation for the water sector has dropped by 5%, it is still at a good level of Rs. 81.6 Billion. Allocation for Diamer Bhasha is substantial, though its size does not suggest that an EPC contract is imminent. Partly, the decline in agriculture production is because of water availability. In addition to storage, GoP must also consider an aggressive programme for water conservation and on-farm water management. The latter would give higher returns on investment than storage. Water sector's Rs. 81.5 Billion is allocated to 83 projects. We prefer to see more funds for selected fewer projects for their early completion.

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.

It is good to see government correct the hitherto large component of discretionary special schemes. Their size has come down. This fiscal it amounts Rs. 139 Billion or 21% of PSDP, still substantial. This includes funds for Finance Division which are block allocation for specific regions and for AJK and Gilgit Baltistan Division. It is good to see Rs. 70 Billion allocated for COVID response. However, it is time that Special schemes and allocation for regions are brought within the PSDP project selection and approval discipline.

Health sees a modest increase in allocations of 9% compared to FY 20. This is surprising given that we are in the midst of a pandemic. Some increase in health has occurred on the revenue side. Allocation for HEC has remained the same. It is encouraging to see growth in budget for the Railways, though Rs. 40 billion is below its needs. GoP must provide effective logistics support to businesses and movement of people. There are news reports that CPEC's very important ML 1 project may see the light of day.

The Pakistan economy has been in low or negative growth for two years. Even before, growth rates were moderate. 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.