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Sifting facts from fiction: Comments on Pakistan Economic Survey FY 19

About IPR

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This fiscal year too the economy missed most of the targets set at the beginning of the year. Although COVID 19 may have had something to do with it, the economy was already in slowdown before the pandemic struck. Data given in later paragraphs will validate this fact. Despite the best face put on the economy's performance, the Pakistan Economic Survey brings home to us once again a fact that is now known widely. That is, the macro framework and budget estimates shared by GoP at the start of the fiscal year have little basis in fact. This has gone on for decades.

For years, the economy has been bound in a vicious circle of weak fundamentals, weak growth, leading further to weak fundamentals. Added to this was some unwise economic policy making during the year, and continued issues of the political economy. The longer Pakistan postpones economic reforms and does not enforce political oversight on economic decision making, the worse would be the effect on the economy.

This Institute has said so for years. Without revisiting our paradigm for policy making, Pakistan should not expect an improved economy. No amount of spin or bluster can fix that. There are three areas that hinder economic progress:

- No political oversight of economic policy. Two clear examples are the harmful level of high markup followed for over a year with no economic logic. And the sharp decline in Rupee value which did nothing for exports but impaired imports.
- Continued transfer of resources to sectors that earn surplus profits because of guarantees and concessions.
- Inability to fix tax policy and tax administration.

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In the case of tax collection, even before the pandemic, there was no 'real' increase in FBR revenue. Government revenues grew because of SBP profits (Jul-Mar Rs. 635 B) from high markup and PTA profits (Rs. 113 B). With economic slowdown, decline in growth of tax revenue was expected. Yet, contrary to how widely it was advertised, there was no reform of tax administration. In fact, GoP's reform efforts brought transactions to a halt without any gain in collection. This harmed the economy even more which had been affected already by high interest rates and Rupee depreciation. Another initiative announced with some fanfare was a tax amnesty scheme. The results were dismal.

With a sluggish economy, government missed its revenue target by a wide margin. The scale of missed target is such that it cannot be explained by the effect of COVID 19 alone. The ambitious FBR revenue level agreed with IMF was based on tax reforms. That house of cards fell with the first sign of challenge. GoP gave in the moment traders made a strike call. The fall in demand had already affected indirect taxes. Customs duty fell by 9%, though sales tax and excise grew by 18 and 20% each.

Below is a recap of the economy's performance during FY 20. How the economy performed should not be a surprise. Sustained economic growth will come with reorienting spending priorities, ensuring economic inclusion, and by investing in and empowering the people of Pakistan. Disregard of this fundamental truth about nation building is what keeps the economy sub-optimal and dependent on others for survival.

At the centre of the economy's travails were several negative developments, that were entirely because of flawed policies. These include sharp decline in Rupee value and a tight monetary policy, with high markup. Together, they reduced demand. They also increased input cost for businesses, which were hit throughout the year with high tariffs on power and gas. In fact, all administrative prices increased. This way businesses suffered both from the demand and supply sides. That such policy making defies logic does not reduce the pain that it caused. Coronavirus came to the rescue of poor policy, for which there was no other excuse.

The combined effect of sharp devaluation, high interest, restriction on transactions and increase in indirect tax rates, with rapid increase in administrative prices took their toll on the economy. It was as though policy making was in free fall.

Economic Performance FY 20

Below is GDP growth rates against targets approved by the NEC in Annual Plan 2019-20. Against a target of 4% for the current fiscal, the expected GDP growth is minus 0.4% (IMF expects GDP to fall by 1.5%). Table below:

	Target FY 20 %	**Actual FY 20 %**
GDP growth	*4.0*	*-0.38*
Industry	***2.3***	***-2.64***
Manufacturing	2.5	-5.56
LSM	1.3	-7.78
Mining	2.0	-8.82
Electricity and Gas Generation and Distribution	1.5	17.70
Construction	1.5	8.06
Agriculture	***3.5***	***2.67***
Crops:	--	2.98
Important crops	3.5	2.90
Other crops	3.1	4.57
Ginned Cotton	2.5	-4.61
Livestock	3.7	2.58
Forestry	2.0	2.29
Fishery	4.0	0.60
Commodity producing (Industry + Agriculture)	*2.9*	*-0.05*
Services	***4.8***	***-0.59***
Wholesale * Retail	3.9	-3.42
Transport & Communication	3.5	-7.13
Finance & Insurance	6.5	0.79
Housing Services (OD)	4.0	4.02
General Government Services	5.7	3.92
Other Private Services	7.1	5.39
Source: Targets Annual Plan 2019-20, Actual PES/National Accounts FY 20		

Within the GDP all sectors performed below target. Manufacturing was especially hit as demand fell and input cost rose. LSM fell throughout the year. Agriculture has suffered from continued weak policy and underinvestment. That it grew at all is a surprise. Decline of the productive sector, meant less demand for services. Even with double digit markup, finance and insurance grew by less than 1%.

With such economic conditions, it was no surprise that taxes took a hit. Against an initial unrealistic estimate of Rs. 5,555 Billion (since revised down twice and the target is now Rs. 4,8 Trillion), FBR tax revenue will be about Rs. 4,300 Billion, even if government does not pass the benefit of low oil prices to consumers. This is a massive gap of about Rs. 400 to Rs. 500 Billion in resource generation. If we take away the inflation effect, there os no rise in tax collection. Expanding the tax base entails political cost. Thus far, it is at best work in progress. As in the past, government took the easy route of raising indirect taxes. These taxes are driven by demand and transactions. With soft demand and a hold on big ticket transactions, indirect taxes also did not grow sufficiently.

Revenue Collection

Rs. Billion

	Target FY 20	Revenue FY 20 July March	Revenue FY 19 July March	% Growth
Total Revenue Fed and provincial		4,689.9	3,583.7	13
Tax Revenue	5,822	3,594.3	3,162.1	13.6
Federal Revenue	6,717	4,306.9	3,243.3	33
FBR Tax Revenue	5,555	3,273.1	2,874.4	14
Direct Taxes	2,082	1,146.1	997.4	15
Indirect Taxes	3,473	1,898.2	1,707.1	11
• Customs		474.1	507.2	--9
• Sales tax		1,242.3	1,048.5	18
• Fed Excise		181.8	151.4	20
Other Taxes	267.6	228.8	242.2	-5
Non-Tax Revenue	894.5	1,033.9	368.9	180

Source: Budget from Budget in Brief FY 20, Revenue actuals from respective Fiscal Operations

Fiscal deficit:

In the budget speech of June 2019, the fiscal deficit was set at 7.1% of GDP. The July-March actual is about 4% which grew to 5.3% up to July-April. Government estimates that it will climb above 9% by year end. This will happen because of the extra expenditure from COVID 19 and further fall in revenue.

In any case, government's main target now is the primary and not the fiscal deficit. As GoP mainly spends money on debt servicing, the primary deficit is easy to control. Fiscal deficit minus debt servicing, is primary deficit. As IMF's focus is the primary deficit, MoF's main interest too is in managing the primary balance.

Balance of Payment:

This year's one achievement is a substantial reduction in the current account balance by 71%. Ten-month actual current account deficit is USD 3.3 Billion against last year's USD 11.4 Billion for the same period. The current account deficit for FY 20 is estimated to stay well within this year's target of USD 8.3 Billion, against USD 13.4 last fiscal. Trade deficit for July-April FY 20 fell by 29.5%. For the same period remittances grew by 5.5% and net FDI was USD 2,281 up 120%. Net Forex Exchange Reserves with the SBP stood at USD 10.1 B on 5 June 2020.

As exports have fallen and increase in remittances is so far quite modest, the correction in current account balance is mainly because of fall in imports. Fall in imports affects exports, investment, and GDP growth. While fall in Rupee value has not helped exports, it may have hurt it because of anti-export bias. PIDE relates fall in import with significant drop in exports and in GDP growth. It estimates that a 20% fall in import could depress GDP by 4.6%. For July-April FY 20, imports fell by more than 16%. YoY, it fell by 32%. Import of almost all commodities fell. Exports will grow with increase in competitiveness and production of higher value goods. It does not respond to Rs. Value alone. Even in Pakistan's mainstay export of textiles, quantity growth has come from drop in unit value.

The Balance of Payment was hit also because of flight of portfolio funds. As we have said before, the policy to attract debt with high interest was unwise. The money left quickly. FDI has been slow to revive, though the economy received FDI of USD 2,281 Million during July-April FY 20. It is an increase of 120% over last year. FY 19's full year FDI was USD 1,362 Million.

FY 20 exports is estimated to be USD 21.5 Billion against a target of USD 26 Billion for the year. Likewise, FDI is estimated to reach USD 1,650 Million against a target of USD 4,145 Million. Both these indicators leave a massive gap in the sustainability of the BoP.

Balance of Payment Major Indicators				
	FY 19	**July-April FY19**	**July-April FY20**	**Change +/-**
	Million USD			***%***
Current Account Balance	-13,434	-11,449	-3,343	-17%
Trade Deficit FOB (incl. Services)	-32,582	-27,242	-19,058	-30%
Workers' Remittance	21,838.6	17,801.0	18,781.6	6%
FDI	1,362	1,006	2,281	116%

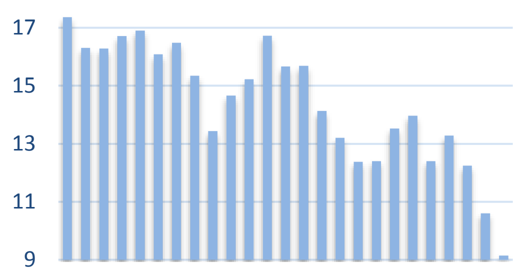
Trade Flows July-April FY 20 Million USD			
	July-April FY 20	**July-April FY 19**	**% +/-**
Exports	18,408	19,160	-3.9%
Imports	38,021	45,393	-16.2%
Trade Deficit	-19,613	-26,233	-25.2%

Trade and Services Flows July-April FY 20 Million USD			
	July-April FY 20	**July-April FY 19**	**% +/-**
Exports	23,076	24,212	-5%
Imports	45,306	54,375	-17
Trade Deficit	22,230	30,163	-26

Low savings and investment: Low savings and Investment affect growth. Along with low technology content in our production base, this is the most enduring predicament of our economy. As per the Economic Survey, investment was 15.4 % of GDP against a target of 15.8 % of GDP. In the last two years, total investment was 15.6% and 17.3%. Until ten years ago, Pakistan's historical Investment/GDP ratio was 20%. With an Incremental Capital Output Ratio of 4 or more, 20% investment is needed to generate 5% GDP growth.

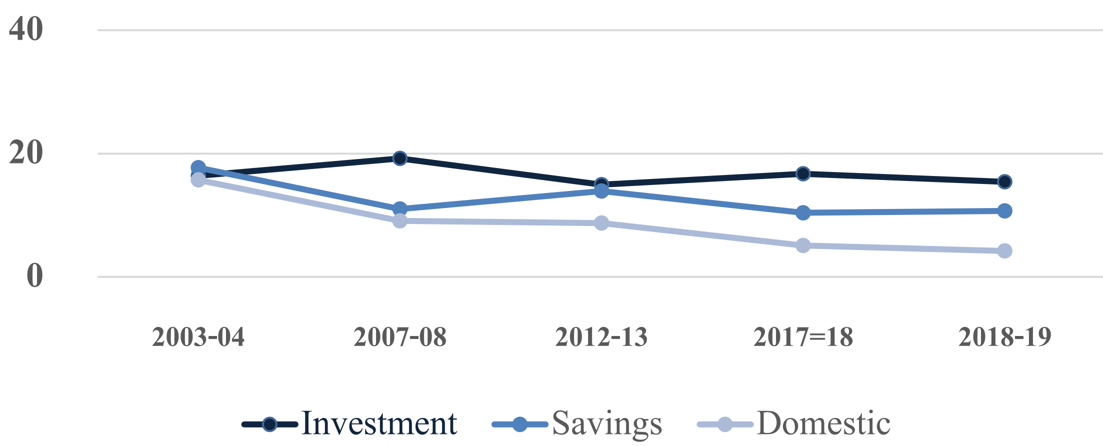
National savings is 13.9% of GDP in the current fiscal against a low target of 12.8%. Domestic savings (i.e. national savings minus remittances) was a paltry 6.9% of GDP. Over the years, domestic savings have progressively fallen. This is grave cause for concern and yet not a GoP priority. There is a direct relationship between savings, investment, manufacturing, and export. Fall in savings lead to a fall in all other indicators. These are key indicators for the growth and health of the economy. See Charts below:

Exports/GDP 1992-2017



Manufacturing/GDP 1990-2015

Falling Savings and Investment as % GDP



Inflation: CPI for July-May FY 20 grew by 11.3% Vs 7.2% for July May 19. . YoY growth in May 2020 was 9.1%. See Table below:

Inflation: July-May FY 20 and YoY May 20 %				
	Average July-May		YoY May 2020	
	FY 20	FY 19	May 2020	May 2019
CPI	11.32	7.19	9.07	9.11
SPI	16.92	4.65	14.81	10.81
WPI	11.70	11.90	5.20	13.99

Inflation was in check until 2018, based on an artificial Rupee value. The combination of correction of exchange rate, perhaps more than what was needed, brought import driven inflation. This was aggravated by continuous increase in administered prices of utilities and essentials. Even in the present recession, inflation is high. CPI grew by over 11% while sensitive price has grown by 17%, YoY for May 2020 the increase was 15%. The drop in wholesale prices signal that CPI and SPI may follow soon.

Fiscal Operations:

Overall, despite GoP's claims the economic fundamentals have been weak, a trend that continued and has worsened now. GoP's focus on current account balance and primary balance may not work out. This has slowed down the economy and with it government revenue. Total debt servicing has increased, as new loans service old ones. Last fiscal year, federal government's net revenue is less than its debt servicing cost. In FY 19, GoP paid Rs. 2,091 Billion in mark-up. During that period, its net revenue was Rs, 2,037 Billion, or Rs. 54 Billion less. Net revenue is gross receipts of the federal government minus transfer to provinces. This means any expenditure on running the government and development came from loans. In the current fiscal, the situation was better, but only modestly. This is questionable public finance management. So far, this year is better with a marging of Rs. 495 Billion.

Similarly, for the current account. GoP's external financing needs are on the rise and without growth in exports it must rely on more debt to balance its external account. It is not clear what strategy GoP is pursuing. Because what it is doing now will not succeed. Its estimates for medium term macro framework seem too optimistic. IMF is kind to accept them.

GDP growth has declined, public debt including external debt has increased, inflation has climbed, and forex reserves are precarious. Public debt has not grown simply because of change in Rupee value. Between June 2018 and March 2020, GoP has borrowed USD 11.03 Billion in external public debt alone. Its commercial finance stock and its short term debt have increased. The fundamentals cannot improve with stability alone. The economy must grow.

In the last two decades there were two occasions when Pakistan had large fiscal space to build its production base and revive the economy for sustained GDP and export growth. On both occasions, we missed the opportunity. The first was after 9/11, when Pakistan received massive aid and foreign funds from the US and other bilateral and multilateral donors. Along with rescheduling of USD 28 Billion of Paris Club debt for fifteen years, estimates of the total space available to Pakistan was about USD 60 Billion. The second was during 2015-2018 when along with IMF's Extended Fund Facility, Pakistan received massive Chinese assistance for CPEC. Both times Pakistan did nothing to build competitiveness and exports. On the second occasion we at least built infrastructure, albeit on a lavish scale. During 2001-2007, when most flows were either grant or Coalition Support Fund and concessional multilateral funds, we did not even do that. The energy shortage and the circular debt are products of that decade. Over many governments, we have repeated the same mistakes. That is why the macro-economic indices forever stay weak.

While under an IMF arrangement, we exercise discipline to stay in the programme. Even then more often than not the programmes do not go beyond the first couple of tranche. Space provided by IMF should be used to institute deep structural reform. During the programme, we test IMF's patience. Once the programme is over, we go back to our ways. In the past, we should have contained spending, chosen infrastructure development carefully to boost exports, and invested in our technical capacity. Reforms of revenue and spending policy (public finance) would have corrected major inequities. That was needed to build competitiveness.

We neither stabilized nor built competitiveness. There could not have been a worse use of IMF space and other assistance such as US aid and CPEC finance. Since then, tight monetary policy and adjustments in Rupee value and in utility tariffs have spurred inflation and have dampened investment plans.

Inevitably, growth has fallen and will remain so for a couple of years. The discipline being imposed by IMF was much needed. The test lies in what the government does once the arrangement ends and whether it has the foresight and the willingness to correct the economy's structural flaws. We have to move from a crony and elite economy to an efficient dispensation. The future of the economy rests on that decision.

GoP has been unable to reduce revenue leakage in the power sector. If successfully done, this will mitigate the circular debt to an extent. With considerable tariff increase in power and gas sectors, GoP hopes to recover fully their cost and restore financial order to the sector. However, this has not happened. Meanwhile, circular debt continues to grow.

PSDP spending received a large cut in the last two years. The Rupee PSDP budget for FY 18 was Rs. 838 Billion. For FY 19, the revised Rupee PSDP budget is Rs. 530 Billion and it was Rs. 572 Billion for FY 20 (total 701 B). Actual expenditure booked up to March 20 was Rs. 417 Billion. Cuts in PSDP also depress growth.

Summarized Fiscal Operations

in Billions PKR

	July-March FY 20	July-March FY 19	% +/-	July-June FY 19	% Share in total expenditure
Total	**4,422**	**3,655**	**21%**	**5,699**	**100**
Current	**3,946**	**3,202**	**23%**	**4,804**	**85.12**
Defence	802	775	3.5%	1,147	18.1
Debt servicing	1,880	1,459	29%	2,091	42.5
Pensions, grants, subsidies	1,011	731	38%	1,182	22.8
Sub-Total of above 3	3,693	2,965	27%	4,420	83.4
Balance for civil government	253	237	-27%	384	5.7 (37.78 % of current)
PSDP	**476**	**408**	**16%**	**795**	**10.8**
Fiscal Deficit	-3.80%	-5.00%		8.90%	

Public Debt:

Public debt including external debt grew rapidly, as in the past years. Resultantly, debt servicing has taken an increasing share in expenditure.

With FBR taxes barely growing, in real terms, fiscal deficit has been hard to control, though it has improved from last year. July-March FY 20 fiscal deficit was 3.8% of GDP, compared to 5% same period last year. Total expenditure increased by 15.8% (current by 17%). Yet, what has saved the public finance is high SBP and PTA profits. July March growth of 14% in FBR taxes, is barely equal to inflation. Indirect taxes grew by 11%.

As in past years, government this year too has not addressed the issue of PSE losses. Each year, this is a major drain on GoP resources. While taxpayers are rightly being asked to fulfill their responsibilities as citizens and pay the taxes due, government has yet to show strong urgency in creating expenditure efficiencies. Unrestrained PSE losses is money that could go to development, security, or to improve service provision to the people. Plans for strong action have been have afoot, but so far, there is nothing on ground. 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 routinely estimated to be between Rs. 1.2 to 1.4 Trillion. This includes revenue loss by DISCO, which government must control but has been unable to do so. Government does not clearly disclose PSE losses.

After meeting debt servicing and subsidies, not much of government spending is left for stimulating growth or for public welfare. During July-March FY 20, PSDP spending was a paltry 11% of total expenditure. Debt servicing and defence had a share of 61% in total expenditure. Add to it grants, subsidy, and pensions and their combined share is 83% of total. The pace of growth of debt servicing is formidable and a cause of concern. From 42.5% this year, next year it may grow close to 50%. We cannot have a prudent fiscal policy without a major reform programme.

Pakistan Total Debt and Liabilities Billion Rs.					
	Jun-07	**Jun-13**	**Jun-19**	**March 2020**	**Growth March 2020/June 19**
Total Debt and Liabilities	**5,024**	**16,228**	**40,223**	**42,820**	**6.46%** **98.2% of GDP** **+2597.2B**
Domestic Debt	**2,597**	**9,833**	**22,126**	**23,875**	**7.91%** **1,749**
Government	*2,597*	*9,521*	*20,732*	*22,478*	*8.42%* *1,746*
PSEs	--	*312*	*1,394*	*1,398*	*0.25%* *4*
External Debt	**2,341**	**5,698**	**15,631**	**16,653**	**23.30%** **2,543**
Government	*2,135*	*4,311*	*11,055*	*11,658*	*5.45%*
IMF	*85*	*435*	*921*	*1,071.30*	*16.32%*
PSEs & Private incl intercompany	*121*	*952*	*3,655*	*3,924*	*7.37%*
Total Debt	**4,935**	**15,531**	**37,757**	**40,529**	**7.34%** **2,772**
Liabilities	**89**	**697**	**2,467**	**2,292**	**-7.08%**
Domestic	--	*470*	*756.4*	*649.3*	*-14%*
External	*89*	*227*	*1,710.1*	*1,643*	*-4%*

High fiscal deficit over many years and an unprecedented over 9% this year (though for understandable reasons), means that government has continued to incur debt. Total debt and liabilities stood at almost Rs. 43 Trillion or over 98% of GDP. Debt and liabilities have grown by Rs. 2.6 Trillion from the debt stock on 30 June 2019, or 6.5%. In June 2018, total debt and liabilities was 29.8 Trillion, so we have added over Rs. 13 Trillion to the total.

Since June 2019, domestic has grown by 8% and external debt by 23.3% (this includes also the effect of a devalued Rupee).

External debt and liabilities alone is now over 42% of GDP. Measured in dollars, external debt has grown in double digits. Public debt has grown from USD 75.5 Billion in June 2018 to USD 86.4 Billion in March 2020. Total debt and liabilities stood at USD 110 Billion end March 2020, compared to USD 95.1 Billion in June 2018, up over 16%.

We have also seen more commercial debt, a growth of 32%. The increase in market-based debt with limited tenure and high cost was a great factor in causing fragility in the economy.

Table 4: Pakistan External Debt and Liabilities

Billion USD

	Jun-07	Jun-13	Jun-19	March 2020	March 2019	Change USD/%
Public Debt + Forex Liabilities	**36.7**	**50.2**	**83.9**	**86.372**	**84.233**	**2.1383** **2.54%**
• *Multilateral and concessional bilateral*	32.5	44.2	62.23	62.88	61.16	1.7204 2.81%
• *Bonds, Sukuks, commercial, PIBs*	2.8	1.6	14.80	14.36	16.19	-1.8321 -11.31%
• *Short-term debt*	0	0	1.26	2.69	1.11	1.58 142.34%
• *IMF*	1.4	4.4	5.65	6.44	5.77	0.67 11.61%
Private debt	**2**	**6.8**	**19.08**	**19.33**	**18.54**	**0.7894** **4.26%**
Total External Debt + Guaranteed Liabilities	**38.7**	**57**	**103.02**	**105.7**	**102.77**	**2.9277** **2.85%**
Forex Liabilities non-guaranteed	**1.5**	**2.8**	**3.33**	**4.25**	**3.2**	**1.05**
Total Ext Debt & Liabilities	**40.2**	**59.8**	**106.35**	**109.95**	**105.97**	**3.9777** **3.75%**