INSTITUTE FOR POLICY REFORMS

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FACT SHEET

TESTING CREDULITY: COMMENTS ON THE BUDGET FY 2021-2022

June 2021

Testing Credulity: Comments on the Budget FY 2021-2022

Budget making is always a challenge, though more so under an IMF programme whose details may still be under negotiation. That is not the only complexity that budget makers faced. Perhaps because there is a new finance minister or because the 2023 elections loom, there is now an urgency to revive the economy and to ease some of the pain that citizens have been caused for about three years.

Some of the proposed measures are very welcome. Belatedly, government rightly plans to move ahead purposefully with massive vaccinations and enhanced social safety net under its Ehsaas programme. It has also offered subsidy and interest free loans to the poor, small famers and small enterprises. And then there are large concessions to revitalize industry and agriculture. Also, government aims to restore the development budget increasing it a by a high 40%.

All this needs spending and growth in revenue, which must grow by 22% to 24% of FY 21's actuals. Where will this money come from?

Also, despite GoP's freshly acquired pro-poor stance, there are several anti-poor and middle class measures in the budget, which this report lists in subsequent paras.

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. It has also congratulated itself for the 4% growth in GDP, a growth rate about which it had no idea until a few weeks ago.

So, the budget was announced in that celebratory mood, which accounts for its expansive targets and huge promises. There was no mention about where the burden of 24% revenue growth would fall. The people have been left to scour the fine print. Having in its views stabilized the economy, government rightly wants to move the economy towards growth. In doing so, it targets a GDP growth rate of 4.8% with a fiscal deficit of 6.3%. All the stars must align for the economy to achieve these targets.

In reality, the budget gave no long-term strategy, unless hope and optimism count as one. Yet, that is how it should be. Despite the hoopla that surrounds it, the budget is an annual document that estimates that year's income and expenditure. It is effective as part of a long-term growth and development strategy. Successive governments have not prepared such a strategy. Perhaps that is why bravado becomes a substitute for serious policy-making. The five-year plans of the Planning Commission cannot be considered a growth and development strategy. They have become a routine exercise. The budget speech did not even make a token reference to the five-year plan.

Despite the buzz of 4% growth, delivery of the budget speech lacked conviction or spirit. Perhaps Minister Tarin was too involved with ignoring his protesting colleagues. Perhaps there was not much to be spirited about, as GoP may not be able to keep many of the promises it has made.

In any case, the general public hardly takes notice of the budget announcement as past hope has been tempered by cynicism. For them, reality lies in the marketplace. Just a short while before the budget was presented, gates of the secretariat were locked as workers were on strike, reflecting the chasm between the perceptions inside the secretariat and outside. In any event, the budget speech could not avoid the feeling of a much hyped event out of touch with reality. It was clear that the balm on offer were words whose soothing effect could stay on paper.

And now the numbers behind the haze of bluster. With respect to the economic framework presented in the budget, this Institute wishes to raise a red flag. The fiscal deficit target may not hold. The target fiscal deficit is 6.3% of GDP at Rs. 3,990 Billion, net Rs. 3,168 Billion after a provincial surplus of Rs. 570 Billion (which the provinces may or may not yield) and privatization proceeds.

This large gap exists despite the proposed major increase in total federal revenue, to Rs. 7,909 Billion a growth of 22-24% over FY 21 actual revenues. FBR taxes will grow to Rs. 5,829 Billion, up 17.4% from last year's budget and 24% from estimated actuals. The estimates include increase of 25% in indirect taxes (31% growth in GST) and 6.8% in direct taxes.

To realize the 25% increase in indirect taxes, consumption and investment demand, on which indirect taxes depend, must grow. In FY 21, demand grew because of high, though fortuitous, growth in remittances, Ehsaas payments, and major concessional credit to the private sector. It is moot if workers' remittances will continue at the pace that it did in FY 21. Any slippage in revenue collection or a smaller provincial surplus, both not unlikely prospects, would further increase the size of the deficit.

With an estimated debt servicing of Rs. 3,060 Billion, the primary deficit is expected to be within IMF target. FY 22's budgeted total expenditure will increase by 19%. Estimate for current expenditure is 18.5 % above last year and development 38% more. Despite the generous increase, we may find that the demands for subsidy, concessions, and development may exceed provisions, if those promises are met.

We hope that the premise on which the FY 22 budget's revenue estimates 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 could see a larger than projected deficit. That 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's estimates.

FY 21 Outcomes: Mixed results with a promising growth rate

As we reported in the review of the Pakistan Economic Survey, government missed a few targets for FY 21, while others held up. GDP growth exceeded expectation as did the current account balance.

The moderate though, under present circumstances, encouraging growth rate of 4% was supported by buoyancy in the commodity producing sector, agriculture and manufacturing.

Yet, it is too early to celebrate, as much depends on the source of growth. Sustained growth, GoP's declared goal, results from capital accumulation and structural transformation. FY 21's growth rode on the back of demand for consumption. There is no sign yet of a breakthrough in increasing 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. FY 21's growth in agriculture and manufacturing was not enough to reverse the trend. Share of services grew again in FY 21 to 61.68% of GDP.

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

This trend would disturb anyone thinking strategically about the future of our economy and its ability to compete in world markets. It was good to see the budget speech reflect signs of moving towards raising investment for sustained growth. We must have far more details to know if that shift is indeed afoot. Otherwise, fiscal incentives on offer may improve investment in the short-term, but a current account crisis may force government to reverse the incentives.

As stated in the past by this Institute, Pakistan received very large flows of foreign aid in 2002-2007 and 2015-17. Yet, we have been unable to use the assistance to build productive capacity to boost our exports. It will take a fundamental rethink to re-orient this approach.

And despite hints of a re-think, there is still too much focus on fiscal issues by policy makers and not enough on increasing production. We have pursued such chimerical goals for decades without realizing that macro stability can only come from growth and exports.

For example, in this year's budget speech, statements of good intention were not accompanied by supportive policy or spending interventions. The high ambition shown for increase in IT exports were accompanied by an increase on GST on data usage. Does the left hand even know what the right hand is doing. And as an indication of how much thought goes into such decisions, it was reversed within hours, as

Pakistanis on social media went up in arms. Again, this happened with no explanation about the reversal's effect on the fiscal deficit and which unfortunate sector would bear the brunt of GoP's unthinking glare to make up for the loss in revenue. Reportedly, this was to yield Rs. 100 Billion.

Each year an estimated two million young people enter the job market. While data on new jobs is scarce, latest figures available are for 2017-18, show unemployment growing in the last ten years. The economy must grow by about 7% to meet the job deficit, a target that it last achieved in 2004. The government's plans to move towards 6-7% growth are welcome, though they may need more than just good fortune to get there.

Another cause for concern is consistent fall in the savings rate. In FY 21, national savings grew to 15.3% of GDP from 13.6% in FY 20. However, domestic savings are still very low at 5.8%. Higher than inflation return on savings are needed to motivate savers. Also, saving suffers from too many barriers to its productive use. And there are too many unbanked people. 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.

Budgetary Framework FY 22

Total FY 22 budget outlay of Rs. 8,487 Billion is 19 % more than the budget estimate for FY 21. Gross revenue receipts are estimated at Rs. 7,909 Billion, an increase of 20 % over FY 21 estimates. FBR taxes will grow to Rs. 5,829 Billion an increase of 17.4% % over FY 21 estimates and about 24% above FY 21 estimated actuals. Estimate of net receipts, after transfer to provinces, is Rs 4,497 Billion. The ambitious goal of raising total revenue will be a challenge, though government has announced some thoughtful enforcement measures.

Of the total federal expenditure of Rs. 8,487 Billion, current expenditure is Rs. 7,523 Billion. Current expenditure, 89% of total spending. Federal PSDP is pegged at Rs 900 Billion, 10.6 % of total expenditure. Budgeted fiscal deficit is Rs. 3, 990, 3,168 Billion after deducting provincial surplus and privatization proceeds, or 6.3% of GDP. Primary deficit will be within IMF target of -0.6% of GDP.

Estimates show that GoP will spend 36 % of total expenditure and 70 % of net revenue receipts on debt servicing while it will spend 10.6 % on development. In case cuts are needed, we know that debt servicing has to take preference over PSDP. In a positive development, debt servicing's share in total expenditure and revenue receipts has reduced in the last three years.

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			In Billion Rs
	FY 21	FY 22	% +/-
Gross Fed Revenue	6,573	7,909	20
Net Revenue Receipts	3,699	4,497	21.5
Total Expenditure	7,136	8,487	19
• **Current Expenditure**	6,345	7,523	18.5
• **PSDP**	650	900	38.5
• **Net lending**	72	64	--
• **Other development**	70	--	--
Federal Deficit	3,437	3,990	16
Provincial surplus	242	570	135
Privatization proceeds	--	252	--
Overall deficit	3,195 -7%	3,168 -6.3%	-1
% GDP	486 -0.5%	108 -0.2	78

Receipts:

- At 4.8 % estimated GDP growth rate, FBR would have to pull a rabbit out of the hat to achieve the desired 24 % growth in revenue from FY 21 actuals. Direct taxes is targeted to grow by 6.8 % (required growth rate from FY 21 actuals will be higher) and indirect taxes by 25 % from FY 21's estimate. Estimate for these taxes are Rs. 2,171 Billion and Rs. 3,647 Billion, respectively.
- The target for FBR tax/GDP ratio is estimated at 11.5%
- Non-tax revenue is budgeted to grow by 29 %, from increases in many heads, especially petroleum levy by 35%.
- The budget also estimates provincial surplus of Rs. 570 Billion and privatization proceeds of Rs. 252 Billion.

High tax target coupled with the high estimate for provincial surplus, raises the fear that the fiscal deficit would be higher than 6.3 % of GDP.

BE 2021-22
Federal Revenue

Billion Rs.

	Budget Estimates 2020-2021	Budget Estimates 2021-2022	Change %
FBR Taxes	4,963	5,829	17.4
Direct	2,043	2,182	6.8
Indirect	2,920	3,647	25
Non-Tax Revenue	1,610	2,080	29
Gross receipts	6,573	7,909	20
Net Receipts	3,699	4,497	21.5
FBR Tax to GDP ratio	12%	11.5	

There are several areas of concern within the revenue estimates:

- Target for growth in direct taxes is just 6.8%, while indirect tax is budgeted to grow by 25%. Sales tax alone will grow by 31%. Indirect tax is a penalty on the poor.
- Low estimated growth of 6.8% for direct taxes over last year's actuals is contrary to the budget speech's otherwise pro-poor stance. If we take government's GDP growth forecast of 4.8% and inflation of about 8%, even without any additional effort, direct taxes should grow by 12.5%, but the targeted growth rate is 6.8%. While government vowed to go after evasion, the numbers suggest otherwise. It reinforces the impression that the government is protecting the rich.
- Petroleum levy will grow by 35%. This is also anti-poor.
- There is an 800% increase in Gas Infrastructure Development Cess. It will grow from Rs. 15 Billion to Rs. 130 Billion

Expenditure:

- Current expenditure is budgeted to grow by 18.5 % from FY 21's estimates.
- Debt servicing will grow by 3.8 % from FY estimates, 36 % of total expenditure. This may be an underestimate. Defense will grow a modest 6% above FY 21's revised estimate. Subsidies will triple and other grants will grow by 29%, civil government expenditure will stay the same. There is a separate head for pay and pension which perhaps accommodates the 10% increase in compensation.
- Government has also shared a strategy to reform PSEs, though until that is put in place, PSEs will need large amounts in subsidy to survive. So far, none of the PSEs have been reformed or privatized, but there are plans to do so. The finance minister's plans to restructure IPPs' guarantees is welcome, as its correction will reduce the huge burden that taxpayers and consumers of power have to meet. DISCOs performance still seems resistant to change. So far, there is no improvement in their revenue collection. So, it appears that expenditure on subsidies to PSEs will stay high. From both an equity and economic efficiency points of view, it is jarring to see large sums paid as subsidy, while the people are being asked to pay more taxes.

With so many concessions and subsidies along with an ambitious tax increase target, the fiscal framework will be under stress. Any discussion on fiscal deficit is incomplete without mention of over Rs. 2,600 Billion in circular debt, which is liability that must be paid at some point.

Macro Framework guiding the budget:

The economy's targeted growth rate is 4.8 % and the current account deficit estimate is – 0.7 % or USD 2,276 Million. Both estimates seem realistic. We see the following pressures on the current account.

- Growth in exports is mainly in the textile and apparel sectors. While orders from importing countries will grow as economic activity revives in industrial economies, it is unclear how much latent capacity exists in Pakistan to benefit from new orders. There are no new export products in which Pakistan competes and competition in textiles exports is severe. We hope the economy succeeds in reviving the manufacturing sector to build exports.

- Workers remittance of over USD 31 Billion seems realistic. Recent increase in workers' remittance may have been caused by higher savings because of Covid affected lockdowns. It is to be seen if revival of economic activity takes place in the Gulf, and how that affects remittances.

- FDI fell by 28% in FY 21. With GDP growth reviving and with SEZs in operation, FDI should revive. For a number of reasons that have to do with the economy's competitiveness, Pakistan has never attracted FDI in large amounts, especially not in export oriented industries.

- In Dollar terms, external debt is 45 % 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 113 Billion in the coming five fiscal years.

The macroeconomic framework estimates a modest growth in investment to GDP ratio to 16% from FY 21's 15.2 %. It estimates savings to stay at the present 15.3 %.

Development Budget: PSDP

PSDP which has been cut in the last two fiscal years, is set to grow by a high margin of 38%. 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, less in actual spending. It will be Rs 900 Billion in FY 22 about 1.7% of GDP. Combined federal and provincial PSDP will grow from 3.8% to 4.4 of GDP. Given the many ways in which the budget may miss its revenue and expenditure targets, it is likely that this envelope may not be spent in full.

Also, growth in PSDP budget is not enough. What is important is the quality of the PSDP portfolio. Its test is whether PSDP spending boosts future growth or just FY 22's growth from one time spending. That depends on selection of projects and how quickly they are completed.

Other concerns remain. First, that there would likely be PSDP budget cuts. Second, the quality of PSDP portfolio should be such that it boosts growth. In the past too, PSDP budget has touched a Trillion Rupees without much impetus to exports. PSDP portfolio must provide the soft and hard infrastructure that firms need to enhance investment and productivity. Also, we fear that PPP in infrastructure is an idea that sounds good on paper, just as IPPs sounded a solution to our power supply problems in the 1990s. However, PPP may be another IPPs in the making, as elite capture is common in Pakistan. It is good to see GoP’s focus on water sector, health and vaccinations, and HEC.

Much hope is placed on increase in IT exports. Yet, one does not see corresponding investment in training to produce the high number of qualified experts and technicians needed to boost the IT sector. Nor do we see investment in hardware and connectivity to increase IT access. Fiscal incentives, even when provided, are needed, but may not be enough.

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