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ANALYSIS

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CHOOSING BETWEEN IMF AND VOTES: COMMENTS ON FEDERAL BUDGET FY 24

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Choosing between IMF and votes: Comments on federal budget FY 24

This is a budget made in the midst of many pulls and strains. The planners eye was understandably on the elections. The first tightrope to walk was to balance between easing the pain of the people while keeping expenditure in check. The economy must not sink further into an irredeemable swamp.

Clearly, the government has opted to ease the pain of the people, yet keep an eye on what the IMF may minimally accept.

It is not certain though that the budget deficit of 6.54 % of GDP is acceptable to IMF. There is a primary surplus of 0.4%. If the main focus is the primary balance, these numbers would fill the bill. If not, there will be revision of some numbers before long.

The deficit of 6.54% of GDP is perhaps an unprecedented number as a target. Because it is not uncommon for the fiscal year to end up with a deficit higher than target. Markup liability is budgeted at Rs. 7.3 trillion, 8.5% of GDP, about 40% more than FY 23's expected Rs. 5.2 trillion. At more than 50% of total federal outlay, this is clearly becoming an unmanageable expense. Unrestrained borrowing is no longer feasible. Markup will be 106% of federal net receipts. All other expense, defence, PSDP, subsidy and salaries will be met from borrowing.

During the fiscal year, it is possible that we see at least domestic restructuring of debt. According to a finance ministry adviser, each percentage point reduction in bank interest rate is a saving of Rs. 400 billion in mark up expense.

Government has announced removal of all restrictions on imports in FY 24. Perhaps they are confident of foreign inflows following an IMF agreement. Rupee might stabilize in value giving impetus to imports. Not many experts are convinced that continued foreign debt too is sustainable.

Given the key role that external account plays in economic stability, it would be prudent for government to share with the nation the amount of increased borrowing, their sources and how it plans to meet debt servicing obligations. Debt servicing estimates for the next three years are in the middle 20 billion dollars, not counting the new debt. GOP must provide its well informed estimates for the coming three years and the source of funding the debt servicing. Only then investors will have confidence in our economy. Overall, IMF estimates our total financing needs of $ 37 billion yearly. Better numbers will be available after the 9th review.

In this scenario, the budget offers salary/pension increases, business incentives, duty exemption on raw material and some machinery imports and reduction on a number of other items. It also enhances direct transfers through the BISP and USC as well as offers incentives for exporters. The FM informed that this is a 'responsible budget', though we could likely see a correction in some areas within the fiscal year.

Government is right to claim some success in stabilizing the external account, though it must now aim to put this on a sustainable footing through export growth rather than through emergent action of restricting imports.

IPR will follow the metrics below to give an opinion on the budget, i.e., whether it would:

a. Satisfy the IMF sufficiently to restore the programme, or to begin talks for a new programme.
   The fiscal deficit number is high, but the primary balance is an acceptable number. If markup expense exceeds estimate, it would not affect the primary balance. The main risk is of achieving 28-30% higher revenue from this year's actual revenue. With an estimated 21 % inflation and GDP growth of 3.5%, FBR would need to increase revenue by an additional 4.5 to 5%. In FY 23, FBR's increase in collection of 19% was well below the CPI of 29%. Slow down in the economy reduced indirect taxes. Clearly, there is a risk of falling short of the revenue target by about 5%, or by Rs. 460 billion. That difference could be filled by Rs. 650 billion provincial surplus, though each year actual surplus fall short of estimate. GoP's estimate for the deficit of Rs. 6,923 billion may increase further, even if expenditure remain within target or the PSDP picks up the slack.
   The Annual Plan pegs the current account deficit at about 1.8% of GDP with a deficit of $ 6,012 million. With incentives to increase remittances, including an amnesty for up to $ 100,000 remittance, total inflow stated in the budget speech is expected to be $ 33 billion. The annual plan estimate is $ 30.5 billion. Exports are expected to be $ 30 billion. Imports of goods and services will be an estimated $ 68 billion.
   Overall, treading with care, IMF may agree to the budgetary and the balance of payment framework.

b. Are the expenditure and revenue numbers achievable? Or would we see them revised later?
   As stated above, revenue estimates are perhaps optimistic and the provincial surplus is unlikely to occur. If the estimates for expenditure on administration, pensions, and defence include the announced increase in compensation their numbers are realistic. The sad reality is that revenue shortfall or higher expenditure will be met by reducing the PSDP.

c. Would the incentives and direct transfers compensate the people against the additional burden of more indirect and direct taxes?
   There are not too many new taxes, though the Finance Bill/Customs Act changes do provide for 'rationalization' of revenue. For example, indirect tax on branded cooking oil and some electric fans will increase. Branded leather goods will also increase in price. There are many more instances.
   Incentives for agriculture, including for small farmers, especial measures for SMEs (including tax breaks and credit), schemes for the youth and women, and increase in direct transfers will help the poor. If the incentives actually reach the small farmers and SMEs, they will increase their income generating capacity. It would also boost economic activity.

d. Would the budget measures add to inflation?
   MoF estimates inflation at 21% for fiscal year 2023-24, which is below the CPI for this year, though high by any standards. But coming on top of the current runaway prices, it will burden the people especially the common people. Budget numbers are not clear about the additional petroleum levy, as some of the publications are still under preparation and have not been shared by government. But an increase of over Rs. 1.3 trillion in non-tax income would include increase in petroleum levy. That will burden everyone, slow down the economy, and add to inflation.

e. Would the tax burden be felt by all or just the common person paying indirect taxes? The budget doesn't deal with some major areas of exemptions and concessions. In FY 23, tax expenditure or exemptions totaled Rs. 2,239.6 billion[1]. They included Rs. 423.9 billion income tax, Rs. 1,294 sales tax and Rs. 521.7 billion in customs duty. These are exemptions given by exercise of discretion. A number of beneficiaries are NGOs. This is not just for the rich. While increasing taxes on the common people, the budget did not mention about reducing these exemptions. Even a 30 to 50% reduction would bring in considerable revenue.

   Nor does it touch upon increasing direct collection from the agriculture sector and the untaxed services sectors (traders and transporters). especially traders who successfully resist enforcement. The budget has made no effort to take on special interests.

f. What do tax measures and incentives do for private investment?
   Each year we receive assurances about stimulating savings and investment, but by year end actuals fall short. This year GoP estimates saving and investment to increase marginally. The measures announced for SMEs, agriculture, and the IT sector should increase investment.

g. Do budget measures attempt to control the high expenditure on subsidy and grants?
   In fact, budget provision for subsidy has increased to Rs. 1,074 billion. There is no resolve to reduce Disco revenue losses. No government has adequately addressed the matter, resulting in regular power tariff increases for all.

Some other areas need attention about which nothing was said. Economies do not revive without high rates of spending on education, health and infrastructure that firms need to enhance their productivity. We need improvement in amount and quality of these services. There is token emphasis on these items in the budget.

Businesses need key infrastructure in utility supplies, logistics support, land to base their operations. There is nothing beyond general references in this regard.

The private sector also needs quality economic services such as custom facilitation, standards and quality controls, and seamless dealing with FBR and other government offices. There are far too many glitches in this regard.

This Institute advocates deep engagement of top political leaders in economic decision making. Few things affect citizen well being more than progress of the economy. A big part of the leaders' vote bank chooses them for the voters' perception of the leaders' economic preferences.

In its essence, government decisions on allocations, interest or exchange rates and taxes affect everyone through jobs, prices and economic services such as health, education, security and other services. The top leaders must be fully engaged in decisions that have a bearing on such outcomes. We also believe that parliamentary oversight is needed especially for incurring debt. We could have escaped the present abject situation had we borrowed less and invested more. Our economic situation today is a failure of twenty years of flawed and amateurish economic decision making.

[1] Pakistan Economic Survey 2022-23

Budget's presentation in parliament and its approval of the Finance Bill is insufficient oversight bordering on tokenism. Participatory government is about voicing the aspirations of the people. There is no more important way to do so than in matters of public money that are paid for by the people through their taxes. Two days of focus on the economy via presentation of the economic survey and the Budget session is an affront to the idea of oversight by parliament.

The budget speech highlighted the positives while the budget documents show government's actual plans. The seeds of the current high inflation, placed at the door of Rupee devaluation, were sown also in the last budget announced in 2022. That budget provided for sharp increases in petroleum levy. It also withdrew other subsidies. One consequence of subsidy withdrawal is constant increase in tariff rates as GoP has not reduced DISCO inefficiencies that cause revenue losses of about 25 to 27% for the system. Most experts warned then that the impact of such measures would be inflationary. This is not to lessen the effect of the fall in Rupee value. Government's attempt to keep the interbank dollar exchange rate at under Rs. 230 also undermined confidence in its policies.

We look at the broad numbers to see what is in store for the people in the coming fiscal.

Total federal budget outlay for FY 23 is Rs. 14,460 billion, Rs. 3,370 billion or 30 % more than FY 23's outlay. Of this, current expenditure is budgeted at Rs. 13,320 billion, or 92% of total.

Federal revenue and FBR taxes are estimated to grow by 40 % and 28 % respectively. Current expenditure will go up by 26% and total federal expenditure by 30 %. With inflation rate targeted at 21 %, this means expenditure would see a substantial increase in real terms.

For FY 23, budget estimate for interest payments have increased to Rs. 5.2 trillion, or by 64 percent from FY 22 revised estimate. This amount is 52 % of total federal outlay and a shocking 6% of GDP. FY 23 expenditure on interest is 107 % of net federal revenue of Rs. 4,904 billion. FY 24's numbers are similar.

These numbers need to be imprinted on the nation's consciousness. This is what years of borrowing has done to federal public finances. Every time the government demands more tax from the people, tax payers must know that all of the extra burden will go to pay interest to creditors, including foreign creditors. This Institute hopes that the Finance Minister too would be conscious of this fact. And find ways to gradually exit from the debt burden.

Budget framework:

Budget framework In Billion Rs	
	FY 24
Gross Fed Revenue	12,163
Federal taxes ➢ *Direct taxes* ➢ *Indirect taxes*	9,200
Non-Tax revenue	2,963
Net Revenue Receipts	6,887
Total Expenditure	14,460
➢ *Current Expenditure*	13,320
• *Interest payment* • *Subsidy* • *Grant* • *Defence* • *Pension* • *Civil administration*	*7,303* *1,074* *1,464* *1,804* *761* *714*
➢ PSDP	1,150
Federal Deficit	7,573
Provincial surplus	650
Privatization proceeds	--
Overall deficit % GDP	-6,923 -6.54
Primary deficit % GDP	380 0.4
Federal tax to GDP ratio	8.7%

As we see every fiscal year, the estimate of Rs. 650 billion for provincial surplus is an unrealistic amount. There is no evidence to suggest that this would indeed happen. This means that the budget deficit could be higher than target. Cuts in PSDP would likely pick up the deficit.

The budget speech lauds the government for the steep rise in PSDP allocation. To be fair, PML N governments have in the past boosted PSDP spending. But with the budget deficit already pegged at a high 6.54 %, it is unlikely that the federal government will actually utilize the allocation. For example, until 5 June 2023 for FY 23, actual spent amount was 35% below the year's allocation.

There was no mention of privatizing or restructuring loss making PSEs. Last year the budget reduced allocation for grants. Yet, no privatization happened.

Savings are possible on the expenditure side, if government is willing to take difficult decisions. Sectors that enjoy surplus rent through generous incentives remain untouched. This is opposed to government's oft stated resolve to make the rich pay. These sectors slow the economy because of high user cost or having tax payers pay for the deficit. Such incentives also divert investment from the more productive manufacturing sector. Concessions made available to such industries do not yield returns to the economy consistent with their cost to the tax payers or users.

High levels of incentives for an indefinite period to IPPs and the auto assembly industry defies all principles of good economic management. The estimated level of protection enjoyed by auto manufacturers is 60%. Some of the beneficiaries have received these benefits for 25 years or more. These are well established large scale businesses who should have stood on their own by now. To allow transfer of resources from general consumers and tax payers to big business is an absurd distortion. This budget again gives incentives for the construction and real estate sector, another disincentive for manufacturing.

The lack of policies to boost manufacturing is perhaps a sign that government views the coming year as a period of regaining stability, while offering relief to the poor and middle classes. This is an understandable approach. But what is hard to understand is the continuous burden on the same classes through petroleum levy and increase in indirect taxes, while the rich and those who treat indirect taxes as a pass through item are let off without sharing the burden.

There is no announced measure for FBR to mine the widely available data to broaden the tax base. FBR must link together data from withholding taxes, imports, bank deposits, utility bills, property records, and excise and sales tax returns of individuals and businesses. It will be a gradual process, but government must begin doing so immediately. Otherwise the oft stated goal of broadening the tax base would remain as distant as it has for many years. If not, tax evasion would likely go on.

It is encouraging to see information technology as a strategic area of focus. As stated in another context above, blanket incentives for any sector does very little to build efficiency and competitiveness for export. Firms earning surplus profits become untouchable lobbies. In fact Pakistan's experience has proven this time and again. Last year's government's decision to impose a modest Rs. 10,000 per year in full settlement of their tax liability was withdrawn at the first hint of resistance.

This Institute urges GoP to offer IT incentives intelligently to boost competitiveness, linking them with clearly stated performance benchmarks agreed before approving the incentives. These performance indicators could be amount earned in export or based on new technology the firm will use. Tax incentives must not be automatic but granted each year on achieving past year's agreed performance benchmarks. The review must not take more than a couple of days by a joint team of experts from the IT ministry and industry.

Also, GoP must immediately commit to improving education and training in the IT sector to boost supply of talented people for the software industry. That would be the industry's main competitive advantage as software houses must rapidly learn to transit to AI. In offering incentives, GoP must also distinguish between start-ups and established companies.

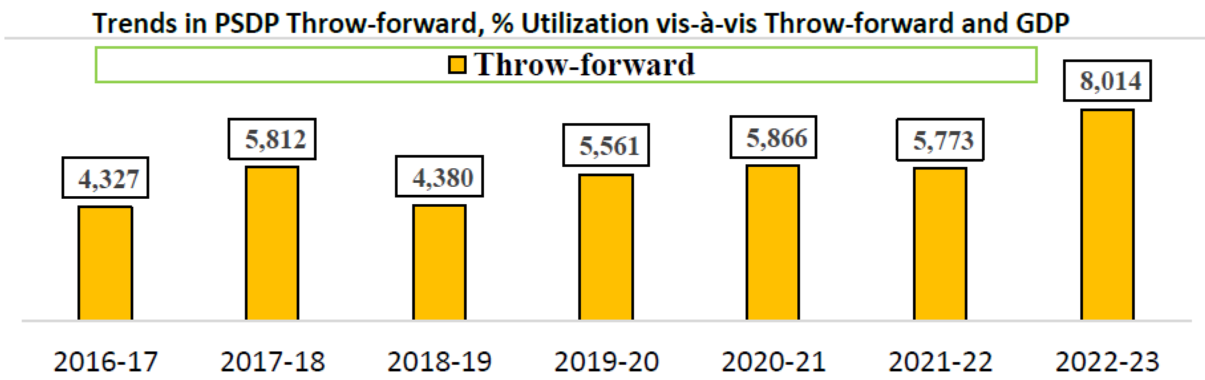
Development budget: PSDP

There is no concerted strategy in PSDP allocations to focus on any sector. The strategy such as there is, comes in many forms. There are allocation guidelines for individual projects. They are 13 in number and replete with generalizations such as 'core national projects' that beg definition or 'PPP/BOT projects' about whose existence we do not have any knowledge. In addition, there are key initiatives of the PM. They are mostly for the youth, for health and education and many other areas. Also, economic growth will materialize through 5Es and 4RFs[2]. PSDP strategy comes in these different and nebulous forms.

These are good goals to have, but how these ideas operationalize into projects is to be seen. Also, it is unclear if they would lead to economic and export growth.

Nor would any strategy work. Each fiscal, soon as financial crunch occurs, PSDP is the first item on the cutting block. Last year's Rs. 727 billion PSDP was corrected to Rs. 714 billion. Of which, just Rs. 466 billion has been utilized, so far. The utilized amount is 0.55% of GDP. This year too, a correction would likely occur.

Also, the limited funding is spread over 1,210 projects with a combined throw forward of over 8 trillion Rupees, see figure below[3]. Reportedly, 54% of total allocation of Rs. 1,150 billion or Rs. 621 billion would go to ongoing projects. At this rate the projects in the PSDP would take about 13 years to complete, not accounting for cost overrun. The Planning Commission is right to prioritize allocations to projects that are nearing completion. Yet, they must reduce the number of projects and fund those projects that support the economy's core goals.



It is good to see that allocation for the water sector is up 10% to about Rs.100 billion. That amount, however, has 172 projects to fund. The throw-forward in the water sector is Rs. 1,415 billion. So, again the average completion period of the projects is 13 years. The water sector must focus on the key objectives of efficient use of water, increase in supply volumes, and to meet the threat of climate change. Funding a few key projects that would yield results quickly is preferable for economic impact than spreading too thin.

In a positive development, HEC receives a 33.5% increase in PSDP allocation from fiscal 2022-23. Allocation for the Railways has increased by 27% to Rs. 33 billion.

[2] 5Es are Exports, Equity, Empowerment, Environment and Energy Framework and 4RFs are Resilience, Recovery, Rehabilitation and Reconstruction.
[3] Annual Plan 2023-24, Page 37

PSDP has adopted a separate head for projects in provinces and special areas (GB, AJK and merged districts). An allocation of Rs. 168 billion will fund almost a 100 projects. They are small projects that normally provinces should fund. It is obvious that as a convenient catch all their allocation has ballooned. Allocation is 15% of total PSDP budget and it comes at the cost of essential spending on water or power transmission lines.

A sum of Rs. 90 billion or about 8% of PSDP is for SDGs allocated to the Cabinet Division. News reports reveal that these are funds for MNAs. To allocate them under SDGs is a misnomer. Such subterfuge, if true, reduce trust in the budget making process.

- Rather than aim for higher PSDP allocations for the same portfolio of projects, GoP must totally revamp the PSDP to make it effective again. GoP must especially end periodic gifts to parliamentarians in the garb of 'development fund', for which GoP has allocated Rs. 90 billion this year. This is not good use of resources. Public investment is key for economic development if done under a strategy serving long-term development goals. Our federal PSDP has now been trivialized and reduced to act as a tool of patronage. It has lost its developmental effectiveness.

- GoP must develop new project selection metrics in consultation with private sector, especially exporters. It must reduce number of projects for early project completion and focus on following broad goals for the future:
  - Projects that increase private sector productivity and competitiveness
  - Projects that support exports
  - Projects for very selective import substitution

- Focus on water, logistics, power transmission, tech skills development, R&D

Macro Framework guiding the budget and the balance of payment:

The economy's targeted growth rate is 3.5 % and the current account deficit is estimated to be 1.8 % of GDP or $ 6 billion. The budget is expansive. Yet, achieving the target growth rate is possible with both public and private economic activity. Incentives for private sector growth should help, but without enough information, it is not possible to know if it is enough. Also, given the very low level of growth in FY 23, it is easier to achieve the modest growth target from a low base. It will be a fiscal year of many economic and political uncertainties. Elections and their outcomes will guide economic policy. Whether government successfully enters into an arrangement with IMF is the other imponderable.

The export target of $ 30 billion should be achievable based on present goods exported. There are no new export products in which Pakistan competes as well as it does in textiles. Government's announcements about the IT sector should boost its potential, though realization may come in a year or two. We could see modest growth in pharmaceutical export.

- Estimate of workers' remittance of about $ 33 billion ($ 30.5 billion in the Annual Plan) is realistic, a growth of about 8 % from FY 23's expected actuals. The fall in workers' remittance was caused by keeping interbank rate below Rs. 230/USD 1. Whether or not overseas Pakistanis move back to the banking channel would depend on narrowing the spread between market and the interbank rates. It depends also on the ability of banks to promote themselves as a more convenient option. At a time of high commodity prices, the economies of the Gulf countries, from where most remittances originate, are doing well.

- GoP's estimate for FDI in FY 23 is a negligible 205 million. The FY 24 target is pitched at Rs. 2,773 million or 13.5 times more than FY 23 estimated inflow. It seems too optimistic and dependent on realization of IMF programme. Also, it will depend on domestic economic condition. Inflation and GDP growth levels would play their part. The outlook for both is uncertain. It will take a few months to change our image that has been affected by the combination of political, security concerns and a distressed economy. IMF agreement may change perceptions and business confidence. 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 has risen to about 37% of GDP. Public external debt is over 28%/GDP. Dependence on external savings that would flow in only with IMF agreement also means higher debt servicing needs. No estimates on these were shared by the government. Government may have to ease import restrictions, which might add pressure on the Balance of Payment. IMF estimates external financial needs of about $ 37 billion in each of the coming five fiscal years, based on import and debt servicing needs.

  The macroeconomic framework estimates a slight increase in total investment to GDP ratio to 13.6% in FY 23 to 15.1 % in FY 24. Fixed investment is targeted to go up to 11.9 % to 13.4 % in FY 24. Private fixed investment, a key indicator, is targeted to go up from 8.8% to 10.2% of GDP. The Annual Plan estimates savings to stay at a low 13.4 % of GDP.

  Though the targets are an improvement from FY 23 estimates, these are very low targets for any hope of economic revival. Our savings and investment levels are the lowest in South Asia. Economies don't grow without investment. On top of that, growth and sustained economic stability depend on the quality of investment. Present incentives for construction, power and auto assembling divert investment from the more productive manufacturing for exports sector. Public investment too needs revamping with reorienting of PSDP as explained in foregoing paras.

4- Shami Road, Lahore Cantt, Pakistan
UAN:111-123-586
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