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ANALYSIS

CHOOSING BETWEEN IMF AND THE PEOPLE: COMMENTS ON THE FEDERAL BUDGET FY 25

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Choosing between IMF and the people: Comments on the federal budget FY 25

It seems that for an economy faced with massive strains, the budget makers made their choices simple. They kept their eyes entirely on the goal of concluding another IMF programme.

More debt would keep the economy afloat for a while and allow it to continue its prodigal ways. The cure may turn out to be worse than the malady. Our over one score visits to the IMF is evidence.

Few nuclear armed nations have a preference for such high foreign debt levels without an exit plan. We borrow without investing. Servicing the debt depends on more debt.

Pakistan's economic break down is a failure of politics. It is the inability of our leaders to imagine a progressive and self-respecting society. Weak policy making are the cause of the chronic economic troubles. But government expects the people of Pakistan to pay for its missteps, as a good part of the increase in tax revenue would come from indirect taxes and from existing tax payers paying more.

These comments do not apply to just one government. This has been Pakistan's approach to economic policy for many decades. The malaise is the cumulative result of continued disregard for businesses, people, jobs, GDP growth and exports.

Also, IPR does not oppose an IMF programme. Our concern is with it lacking an accompanying strategy for growth within the agreed framework. We are also concerned at the implementation of the programme.

The purpose of IMF programmes is to meet balance of payments emergencies arising from sudden events: wars, a pandemic or an energy crisis. Economies use the opportunity to rebuild and reform. We borrow and plan for the next programme.

Today this strategy is especially risky because of Pakistan's young population. What was to be a demographic dividend for the economy could well become a social challenge. Recent events showing a volatile youth or a desperation for exit from the country are instructive. There is loss of hope among the young people.

GoP makes some cautious effort to ease the pain of the people, reaching for those measures that IMF also accepts. 27% increase in BISP is one measure. This is shown as government's concern for the poor. The people of Pakistan, however, wish to see fewer poor people not more. Revealingly, neither the Economic Survey nor the budget speech makes mention of how many Pakistanis live below the poverty line. The speech does mention increase in poverty levels.

The budget speech mostly highlighted the positives while the budget documents show government's actual plans.

As IPR mentions in its review of the Economic Survey, GoP can rightfully claim success in achieving economic stability. Falling rate of inflation, low current account deficit and export revival. Overall, the stability comes at a high cost for the people of Pakistan. There is low economic activity and lack of jobs with high prices and high taxes.

The budgetary framework

While the budget deficit of 6.9 % of GDP is high, the primary surplus of 1 % would be acceptable to IMF. If, as expected, the main focus is the primary balance, these numbers would be good enough. If not, there will be revision of some estimates before long, during the course of negotiations with IMF. This is especially so, as it is not uncommon for the fiscal year to end up with a deficit higher than the target.

The budget announced increase in salary and pension of present and past government employees and some business incentives in the IT sector and a in a few other areas. It has announced a major increase in the PSDP. If growth in taxes fall short of estimates, we may see a correction in some areas within the fiscal year. PSDP would most likely suffer a cut.

On the expenditure side, the markup liability is budgeted at Rs. 9,775 billion, 8.4 % of the targeted GDP of Rs. 116,351. Estimated markup payment is 34 % more than FY 24's expected Rs. 7.3 trillion. At more than 52% of total federal outlay, this is clearly becoming an unmanageable expense. Unrestrained borrowing is no longer feasible. Markup will be 107% of federal net receipts. All other expense, defence, PSDP, subsidy and salaries will be met from borrowing.

High interest rates, despite the 150 basis points cut, is a major source of the budget deficit and slow economic growth. It appears that SBP and GoP expect more rate cuts during FY 25. Otherwise, the growth in interest expense could have been higher.

Both domestic and foreign debt are a major source of vulnerability for the economy. Foreign debt and liabilities have grown to over $ 130 billion, or 43% of the GDP. Debt servicing of foreign debt, including principal repayment, will be about $ 25 billion next fiscal year. This is 62% of exports of goods and services and 34 % of foreign earnings. The amount would be touching 6% of GDP with nothing to show in new assets to boost production. That is a major strain on the economy. It does not seem that more foreign debt is sustainable. Yet, that seems to be the major thrust of the government. Though IMF has called for a fall in Rupee value, it is unlikely that the Rupee would fall any further.

Given the key role that external account plays in economic stability, it would be prudent for government to share how it would meet debt servicing obligations. Only then investors will have confidence in our economy. Overall, in the second review IMF estimates that our gross financing need is $ 25 billion yearly for the next five years.

The following are important considerations:

a. Would GoP satisfy the IMF sufficiently to conclude a new programme?

The fiscal deficit number is high, but the primary balance is in surplus and would be acceptable. Even if markup expense exceeds estimate, it would not affect the primary balance. The main risk is whether FBR achieves 38 % higher revenue than this year's actual.

Inflation is an estimated 12 % inflation and target GDP growth is 3.6%, FBR would need to increase revenue by an additional 20 % to reach the budget target. Stringent tax measures announced in the budget, especially on personal income tax with marginal tax rates of 45% would increase collection. Salaried class would still pay a marginal tax of 35% but adjustment in slabs has increased their tax liability.

Removing exemptions given to exporters and modest amounts of tax on retailers and wholesalers would help in reaching the target. Real estate also attract a higher capital gains rate. Tax on farm assets are also a possibility. Increase in all components of indirect tax, i.e. GST, customs and federal excise would burden consumers, but would help meet tax targets.

Still, there is a risk of falling short of the revenue target and the provinces not able to throw up a surplus. GoP's estimate for the deficit of Rs. 8,028 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 % of GDP with a deficit amount of $ 3,707 million. The budget has announced incentives to increase remittances, including support for transfer charges. Workers' remittances is expected to be $ 30.2 billion. Exports of goods and services are expected to be over $ 40 billion. Imports of goods and services will be an estimated $ 68 billion.

The budget vows to expand the tax base to enhance the tax-to-GDP ratio. It also targets to document the economy, a promise expressed by every government. It also aims for progressive taxation regime to ensure that those with the ability to pay do so. There is a high increase in transaction taxes for non-filers.

These are the stated goals of the revenue policy. It is clearly work in progress.

Overall, treading with care, IMF may agree to the budgetary and the balance of payments 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 always an uncertainty. 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 too many new taxes, not all clearly enunciated in the speech. For example, GST on branded textile and leather goods will increase prices at a time when the economy needs growth domestic demand.

Incentives for agriculture, including for small farmers and 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. So far, most past announcements for SMEs have fallen short of their promise.

Overall, there are not enough incentives to compensate the burden of higher taxes and administered prices

d. Would the budget measures add to inflation?

MoF estimates inflation at 12 % for fiscal year 25. That number seems low, at present interest rates. SBP is likely to cut its discount rate, though whether it does so to a low enough level to bring average inflation down to 12% is uncertain. Dawn quotes an expert that 12% CPI growth is possible at 16% discount rate.

Increase in indirect taxes and petroleum levy would add to prices.

Yet, even this seemingly moderate rate of 12% is high as it comes on top of high price increase in the last two years. Double digit inflation is sure to burden the people further.

Even hours after the budget speech, budget numbers are not fully clear, as some of the publications are still not made public. The large estimate of Rs. 3,487 for non-tax revenue would largely ride on the back of higher petroleum levy. This is especially so as SBP profits would fall this year. Increase in fuel prices will burden everyone, slow down the economy, and add to inflation.

It is increasingly clear that higher fuel prices reduce demand. So, how much increase would bring the necessary revenues. Last year, petroleum levy of Rs. 869 billion was estimated to be 40% of total non-tax revenue.

Similarly, each increase in power tariff has led to growth in ‘circular debt’. DISCO revenue have not improved. In itself, the logic of higher tariffs have become circular, as they lead to lower demand. That increases the need for more tariff differential subsidy.

e. Would the tax burden be felt by all or just the common person paying indirect taxes?

In essence, the budget widens the tax base and increases taxes on those who can pay.

The budget removes some major exemptions and concessions. In FY 24, tax expenditure was Rs. 3,879 billion. Some export businesses that benefit from zero rating and other benefits would contribute.

Retailers and wholesalers would pay tax now. Also, high income individual tax payers and salaried class would pay higher taxes. Though a marginal tax rate of 45% on individuals is a disincentive to documentation. Higher capital gains on real estate sector would also be a tax on the upper income.

The major increase in tax rates differential on non-filers may encourage them into the tax net.

GoP has done a good job with increasing direct taxes FY 24 and that trend would continue in FY 25. So, while the common citizen would be burdened, so would the higher income groups.

One important concern is growth in the informal economy, as more people try to avoid the high tax rates.

In this respect, our next question becomes important.

f. What do tax measures and incentives do for private investment?

The FM has pledged "primary importance to the private sector in our economy", though present circumstances preclude any major initiative. GoP plans to increase investment, economic output, and exports. Those good intentions do not have the support of substantial action.

As the economic survey shows, in the last 4 years, private investment has hovered at about 10% of GDP. In FY 24, it would likely be under 9% of GDP. Private investment is already very low and about half of what a growth economy needs to have.

Interest rate cuts could boost investment, though higher tax rates in many areas would dampen demand for investment. Overall, interest rate cuts would reduce government borrowing and make credit available for the private sector.

Each year we receive assurances about stimulating savings and investment, but by year end actuals fall short. In FY 25, GoP estimates saving and investment to increase marginally over FY 24. The measures announced for SMEs and the IT sector should increase investment.

If CPEC second phase with its focus on SEZs become a reality, we might see improvement in private investment and growth in the medium term.

g. Do budget measures attempt to control the high expenditure on subsidy and grants?

In fact, budget provision for subsidy has increased to Rs. 1,363 billion. There is stated resolve to reduce Disco revenue loss. Yet, it seems more an expression of good intentions. No government has adequately addressed the complex matter of the power policy. Regular power tariff increases have not helped.

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. The economic survey shows government's apathy to the social sector. The minister announced an allocation of Rs. 200 billion, but that is business as usual.

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 availability 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. The FM mentioned some investment to digitalize FBR dealings, though even if successful, it would take a few years to show results.

The high PSDP allocation is welcome. But two things mar its prospects. First, PSDP would most likely see reduction. Second, the PSDP portfolio needs a thorough overhaul. Its spread over many areas show a lack of strategy. All infrastructure projects and some social sector projects must have private sector input. GoP must build assets that the private sector needs to increase its productivity and competitiveness. Infrastructure must not be an outcome of the whims and fancies of individuals.

A disturbing trend is to increase the share for elected parliamentarians to spend for the uplift of their constituency. This spending is more often a waste. Even when used well, it is not part of any development strategy. This is of special concern for tax payers. In essence their taxes are used as campaign financing for the parliamentarians.

Yet, 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 turn, the leaders seem to have outsourced economic decision making to technocrats and bureaucrats.

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 foreign debt. We could have escaped the present abject situation had we borrowed less and invested more. Our economic situation today is a failure of decades of flawed and amateurish economic decision making.

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.

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