ANALYTICAL BRIEF

A Reflection on the State of Economy and Federal Budget 2018-19

Social Policy and Development Centre May 2018

Macroeconomic and fiscal indicators present a mixed picture of Pakistan's economy. In terms of official estimates of the GDP's growth rate, the economy has been showing an upward trend since 2012-13, which has reached to 5.8 percent in 2017-18. At the same time, the economy is confronted with some serious challenges on fronts of balance of payment, debt and fiscal deficit. These vulnerabilities need to be remediated to make the existing trajectory of growth sustainable.

The federal budget 2018-19 has been presented in the backdrop of a complex political situation. This budget is unique as it has been prepared by an outgoing government, mainly for an interim and the next elected government. Consequently, proper implementation of the budget is contingent upon the ownership of future governments. This analytical brief has been prepared by SPDC in the light of the Economic Survey 2017-18 and the federal budget 2018-19.

GROWTH AND INVESTMENT

The GDP growth in 2017-18 has been driven by the services sector which grew by 6.4 percent, while the growth in industry and agriculture is reported to be 5.8 and 3.8 percent, respectively. The contribution of the services sector in GDP growth was 67 percent, followed by the industry (20 percent) and agriculture (13 percent).

Growth in agriculture sector has traditionally been dependent on crops. However, on a positive note the livestock sector has also shown an improvement in 2017-18, with a growth of 3.8 percent as compared to 3.0 percent in 2016-17. Since livestock has the largest share (58 percent) in the agriculture sector as compared to crops (37 percent), it is crucial to give greater attention to its development for achieving a sustainable growth in agricultural sector.

Within the industrial sector, the growth in manufacturing sector is recorded to be 6.2 percent. Major contributors in the large-scale manufacturing sector are iron & steel products, automobiles, electronics and petroleum products. While there has been low (or negative) growth in some industries (food, beverages & tobacco, chemicals and fertilizers), the major area of concern remains the textile sector which contributes more than 20 percent of the industrial value-added and provides employment to about 40 percent of the industrial labour force. The growth in textile sector production remained below 0.47 percent in 2017-18 (July-February) as compared to 0.59 percent in 2016-17. Also, despite the government's claim of giving high priority to the power sector, growth in electricity generation/distribution and gas distribution remained below two percent.

There appears to be an element of disconnectedness in some areas regarding inter and intra sectoral linkages, which requires a detailed analysis. Some initial observations are presented as follows:

- Growth in the industrial sector is 5.8 percent, while the industrial consumption of electricity actually declined by 3 percent (from 15.7 thousand Gwh to 15.3 thousand Gwh).
- Within agriculture crops, sugarcane production increased by 7.8 percent, whereas the production of sugar declined by 7.7 percent.
- Cigarette production grew by 77.5 percent, whereas tobacco production and tobacco export have shown no growth.
- Petroleum production shows a growth of more than 10 percent, while fuel being a major input in the transport sector, indicated a growth of only 3.6 percent.
- Growth in crop sector is recorded at 3.8 percent, the fertilizer offtake decreased by 3.4 per cent – it was 3.7 million N/T in 2017-18 compared to 3.8 million N/T in 2016-17.

- Credit to farmers for cropping was also reduced by 3 percent – from Rs193 billion in 2016-17 to Rs187 billion in 2017-18.

The level of total investment remained at 16.4 percent of GDP in 2017-18 against the target of 17.2 percent. However, it did show some improvement as opposed to the previous level of 16.1 percent. Increase in the level of total investment is due to public investment, which increased from 4.5 percent to 5.0 percent of the GDP. On the other hand, private investment which is the largest component of total investment in the country, declined from 10.0 percent to 9.8 percent despite low interest rates, huge infrastructure development programs (China-Pakistan Economic Corridor) and a relatively improved energy situation.

External Sector

External imbalance continues to remain a major challenge for the economic managers of the country. According to the State Bank of Pakistan, total foreign reserves on 20th April 2018 were more than $17 billion. Out of which $10.9 billion (63.7 percent) are the net reserves with State Bank of Pakistan (SBP) and almost $6.2 billion (36.8 per cent) are with commercial banks. A negative growth of 20 percent in the foreign reserves was observed in fiscal year 2017-18.

Exports showed a growth of 12 percent in the first nine months of 2017-18, while imports increased by 17 percent. Pakistan's trade deficit is more than $22 billion in 2017-18, which is 20 percent higher than the previous year.

The top 5 importing items and their growth is as follows: transport equipment (50 percent), petroleum products (30 percent), edible oil (25 percent), chemicals (21 percent) and machinery (minus 2 percent). This clearly indicates that the rise in imports is not due to higher imports of machinery, as claimed by the government.

Another important source of foreign reserves is worker remittances. In 2017-18, worker remittances showed a growth rate of only 3.6 percent. The net foreign direct investment (FDI) during July-March 2017-18 was only $2 billion, with a growth of 4.4 percent.

Public Debt

The level of public debt in Pakistan has shown an increasing trend over the past few years and has now mounted to an unsustainable level – nearly 72 percent of the GDP[i]. Regarding fiscal deficit and debt management, the Fiscal Responsibility and Debt Limitation (FRDL) Act is in place since 2005. The Act has, from time to time, been amended to add new roles over targets. It was last amended on 1st July 2017. As per the revised limit, federal government will ensure that by June 30, 2019 the total public debt-to-GDP ratio does not exceed 60 percent. At present, bringing public debt to 60 percent of the GDP appears to be a daunting task. In order to show a lower level of debt liability, the government has introduced a new concept of 'net debt' which is simply the total public gross debt excluding government deposits. This definition is inconsistent with general accounting practices since the outstanding debt has debt servicing obligations and deposits kept for other purposes are not likely to be available for retiring debt. Therefore, the use of this definition for declaring the level of public debt is misleading.

FISCAL PERFORMANCE

Given that this is the last budget of the present government before the forthcoming election, it offers various relief measures and different resource mobilization strategies. Consequently, a higher federal revenue deficit – net federal revenues minus current expenditure, excluding repayment of foreign loans – of more than one trillion rupees is projected. This implies that one-fourth of the current expenditures and entire development budget is to be financed through external and domestic debt. Given that external resources are largely tapped or dried-up, the current budgetary policy relies heavily on domestic debt and largely on bank borrowing within domestic borrowing.

Apart from fiscal outlook, the federal budget documents for 2018-19 portray a picture of fiscal performance during 2017-18 that is similar to previous years. This is characterized by revenue shortfalls, current expenditure overruns, heavy cuts in development expenditures and the PSDP focusing on fewer sectors, with National High Authorities (NHA) having a lion share. All these factors have resulted in more than the projected fiscal deficit, despite the hefty provincial surplus (as estimated by the federal government).

Performance of federal taxes: missed target

The federal budget 2018-19 indicates that despite various claims about achievements of Federal Board of Revenue (FBR), the target of FBR revenues for 2017-18 is likely to be missed by Rs78 billion. This is surprising given that imports are on the rise and estimated growth in real GDP is nearly

6 percent. While revised estimates of revenues from customs are more than the budgeted amount, revenues from sales tax have not increased accordingly. It further reflects a compromise on equity and progressivity by heavy reliance on indirect taxes. Revised estimates for 2017-18 show a collection of Rs2,372 billion under indirect taxes against the target of Rs2,418 billion – a decline of about Rs46 billion.

Similar to indirect taxes, there is a shortfall of over Rs31 billion in direct taxes. The shortfall is hard to understand in light of the government's claim of a higher real growth in GDP. There is clearly a mismatch between economic growth and direct taxes. Economic theory indicates that during high growth periods, direct taxes grow faster than the economy as people move into higher tax brackets. That is why direct taxes are referred to as automatic stabilizers. However, direct taxes in Pakistan are not truly "direct" in nature, since they contain many indirect taxes in the form of withholding and advance taxes. Thus, they fail to perform as automatic stabilisers to moderate the economy in both high and low growth periods.

Outlook of federal taxes: a new tax strategy

For 2018-19, the federal government has announced an income tax strategy different than the previous ones in a significant way. There is a shift from over-reliance on withholding taxes for resource mobilizations through direct taxes to broad-basing while reducing tax rates, enhancing tax exemption to an unprecedented level and reduction in corporate tax rates (not only in the coming year but also in forthcoming five years). As per the budget documents, income tax exemption limits have been enhanced to Rs1.2 million, which is at present Rs0.4 million per year; the maximum income tax rate is proposed to decline from 30 percent to 15 percent and a one percentage point decline is proposed for the corporate tax rate each year. Despite these relief measures, revenues from income tax are projected to grow by 11 percent. The linchpin of this anticipated increase is broadening of the tax net by bringing more tax payers into the system. These measures are commendable and can achieve the desired results if properly implemented. However, given the present scenario of the FBR's performance, these measures appear to be very ambitious.

Indirect taxes are targeted to increase by more than 13 percent. Given the performance of the previous year, this growth appears to be a daunting task. Another strange move is the reliance on petroleum development levy by increasing the per litre rate to Rs30. Given that international petroleum prices are already bottomed out and the rupee is depreciating, this increase will directly translate into an increase in fuel prices.

Federal non-tax revenues: lacklustre performance

Federal non-tax revenues continue to depict a lacklustre performance by missing the target for 2017-18 by more than 13 percent. While revenue from property and enterprise showed a growth of more than 10 percent, collection in other non-tax revenue heads (cumulatively) has declined by more than 20 percent. The fall is due to a sharp reduction in the inflow from the Coalition Support Fund – Rs16 billion were received against the estimated amount of Rs141 billion. The SBP profit is the only head that shows the same amount under both budgeted and revised estimates. Another good performer is extraordinary receipts which is more than Rs135 billion. However, it is not clear as to what comprises these extra ordinary receipts and from where they are generated.

The ninth month figures of non-tax estimates have not been available at the time of finalization of this brief, it is hard to judge whether actual collection will be in line with revised estimates or slippage will further be enhanced. The outlook for 2018-19 is even bleaker as the federal government is expecting a further decline of more than Rs70 billion, largely due to a decline in extraordinary receipts.

Current expenditures: over-runs

The revised estimates of current expenditures for 2017-18 indicate an increase of over Rs530 billion as compared to the budget estimates. All main heads of current expenditures have contributed to this massive deviation, except social services (education, health and the like). For instance, revised estimates of general public services are 16 percent more than the budget estimates – within general public services, civil and military pensions are 34 percent more than the budget estimates, while debt servicing is 18.5 percent higher. Due to all these deviations, federal current expenditures have reached 12.5 percent of the GDP, which is more than 160 percent of the federal net revenue receipts.

It was expected that the federal government will take strict measures to halt this growing trend. However, the outlook for 2018-19 presents an opposite picture. The budget estimates of current expenditures for 2018-19 show a growth of more than 11 percent. There is a 12 percent increase in the salary bill of the civil government alone. This is due to various measures announced by the federal government, including increase in allowances for its employees.

Debt servicing: a serious challenge

A massive deviation of more than Rs300 billion in debt servicing expenditures indicates an underestimation at the time of budget announcement last year. The increase in foreign repayment and markup can be justified due to the depreciation of the rupee against leading currencies; however, a large increase of more than Rs100 billion in domestic interest payment is surprising. As per revised estimates of 2017-18 debt servicing alone is likely to consume more than 73 percent of net revenue receipts (gross revenues excluding transfers to provinces). This implies that most of the current and development expenditures of federal government are financed through borrowing, which further enhances the debt servicing obligations of the country in future.

For 2018-19, an increase of more than Rs267 billion in debt servicing expenditure is estimated that keeps the debt servicing to net revenue receipt ratio intact at around 73 percent. Previous trends show that the federal government generally underestimates the debt servicing obligations. If this trend continues, debt servicing obligations will be more damaging than presented in budget documents.

Defence expenditure indicates a puzzling pattern

The expenditure on defence affairs and services has grown by more than 18 percent in 2017-18 as compared to the previous year. This growth seems to be on the higher side and is probably due to ongoing operations. However, it is quite puzzling to observe that every year the government underestimates expenditure on defence administration almost by one-third, which is also reflected in the deviation in the budget and revised estimates of 2016-17 and 2017-18. Defence expenditure for the next fiscal year (2018-19) shows a growth of more than 10 percent.

Development expenditures: lacking credibility

The Public Sector Development Program (PSDP) of 2017-18 was announced with a big bang, by showing a hefty increase of 40 percent over the previous year. The size of the federal PSDP was budgeted to be Rs1,001 billion in 2017-18 as compared to Rs715 billion in 2016-17. It was claimed in the budget speech that by keeping current expenditure under tight control, the government will be able to create substantial space for development. However, the revised estimates for 2017-18 provided in the Budget in Brief (2018-19) indicate a mammoth slashing of the PSDP by Rs251 billion. The size of the PSDP has been reduced substantially (by 25 percent) to curtail the budget deficit. As usual, the axe has fallen on the social sectors. For instance, development allocations for national health services have been reduced from Rs48.7 billion to Rs28 billion. Similarly, the budgeted allocation of Rs12.5 billion for clean drinking water is non-existent in the revised budget.

A number of anomalies are evident when data about PSDP allocations provided in the Budget in Brief (prepared by the Finance Division) is compared to the summary of the PSDP Releases (as on April 27, 2018), released by the Planning Commission, Ministry of Planning Development & Reform. For example, the budget document indicates a revised allocation of Rs21.7 billion (for whole fiscal year of 2017-18) for the SDGs and Community Development Program against budgeted amount of Rs30 billion. On the other hand, according to the summary of the Planning Commission[ii], an amount of Rs30 billion has already been released under this scheme. Similarly, the summary suggests that Rs28.3 billion and Rs11.7 billion have been released for the Special Federal Development Programme and Energy for All against Rs40 billion and Rs12.5 billion, respectively. Whereas, revised estimates as per the budget document are zero for both schemes. This creates serious doubts about the accuracy of budgetary figures and coordination among the two top federal ministries.

Total federal development expenditures are budgeted to be Rs1,152 billion for 2018-19, showing a growth of 8.4 percent over the previous year. Out of this, the size of PSDP has been kept at Rs800 billion, which is 6.7 percent higher than the revised PSDP of 2017-18. The focus of PSDP remains on infrastructure development including transport and communication, power and water. Allocations made for the water sector have been significantly increased – Rs37.7 billion to Rs79 billion. Regarding allocations to social sectors, an important development is the decline in expenditure on health and population welfare – the allocations were reduced from budget estimates of Rs48.7 billion to revised estimates of Rs28 billion in 2017-18, which now have been budgeted at Rs25billion. This is perhaps due to the declining role of the federal government in financing vertical programs in the health sector, including National Program for Family Planning &

Primary Health Care and Population Welfare Program for Provinces. This is a move in a right direction since health is a provincial subject that requires provincial ownership. Thus, provincial governments need to pay the utmost attention to the effective delivery of health and other social services.

Federal fiscal deficit: out of control

Revised estimates of federal fiscal deficit show a slippage of more than Rs350 billion or 1.2 percent of the GDP compared to budget estimates. This is due to a shortfall of over Rs300 billion in gross revenue receipts for 2017-18 (almost Rs5.0 trillion against Rs5.3 trillion targets). The shortfall is partly borne by provincial governments (more than Rs68 billion) and largely by the federal government (around Rs250 billion). In contrast, the current expenditure shows an overspending of Rs500 billion if repayment of foreign debt is included. However, for the computation of fiscal deficit repayment is excluded from the current expenditures. Consequently, the net impact of the overrun of current spending is around Rs400 billion. These estimates resulted in a massive revenue deficit of more than Rs1.1 trillion. If development expenditures were not slashed by more than Rs270 billion, the federal budget deficit would have reached Rs2.5 trillion. Despite the reduction in PSDP, the federal budget deficit crossed Rs2.1 trillion and reached to 6.3 percent of the GDP.

A massive provincial surplus of around Rs274 billion brings this fiscal deficit down to Rs1.9 trillion or 5.5 percent of GDP, still showing a slippage of 1.4 percentage point compared to the target. This huge federal fiscal deficit indicates that the government borrowed more than Rs300 billion from external sources and more than Rs600 billion from domestic non-banking to finance the budget deficit. Rest of the deficit was financed through bank borrowings.

The fiscal outlook for 2018-19 also follows the same trend and more or less a similar quantum of fiscal deficit. Given that the federal government has a tendency of underestimating current expenditure and overestimating revenues, the projected deficit has a strong possibility of slippage.

Implications of bank borrowing

Higher reliance on bank borrowings has serious implications for monetary policies and is likely to contribute to the crowding out of private investments. The share of the government sector in total credit disbursed by the banking sector is almost 60 percent. Government has increased its borrowing from SBP. From June 2017 to May 2018, credit to government by SBP increased by 92 per cent and credit from commercial banks showed a negative growth of 22 percent.[iii] While the SBP continued with an easy monetary policy, expansionary fiscal policy and over-reliance on bank borrowing resulted in enhancement of the policy rate by 25 basis points causing it to reach 6 percent in January 2018. It also affected credit to private sector that grew by merely 8.4 percent.

POVERTY

The Economic Survey 2017-18 provides poverty estimates based on a new methodology. It shows that the percentage of people living below poverty line has declined from 50.4 percent in 2005-06 to 24.3 percent in 2015-16. SPDC's research report entitled Poverty and Vulnerability Estimates 2016[iv] provided a detailed critique on the new methodology. It states that "the choice of reference group casts doubts over the whole exercise of poverty estimation and it seems that the methodology is adjusted to obtain a required poverty number by trial and errors." Using a consistent methodology, SPDC's estimates based on the Household Integrated Economic Survey 2015-16, reveal that the incidence of poverty was 38 percent in 2015-16.

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[i] As per State Bank of Pakistan (SBP), total debt was 7.17 percent of GDP at the end of quarter 2 of fiscal year 2017-18. Source: SBP, http://www.sbp.org.pk/ecodata/Profile.pdf

[ii] Available at http://pc.gov.pk/uploads/archives/Details_of_Rleases_2017-18(27-04-2018).pdf

[iii] Summary of credit/loans classified by borrowers, SBP, http://www.sbp.org.pk/ecodata/CreditLoans.pdf

[iv] Poverty and Vulnerability Estimates 2016, Social Policy and Development Centre (SPDC). Available at http://spdc.org.pk/Data/Publication/PDF/RR-99.pdf

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