ANALYTICAL BRIEF

A Reflection on the State of Economy and Federal Budget 2017-18

Social Policy and Development Centre **June 2017**

This analytical brief has been prepared by SPDC in the light of Economic Survey 2016-17 and the Federal Budget 2017-18. This brief analysis will be followed by a detailed research report.

GROWTH AND INVESTMENT

The rate of GDP growth has gradually been increasing over the last three years albeit at a slower pace. Finally, the growth rate for 2016-17 is estimated to be over 5 percent, first time after 2006-07. However, the government has missed a number of important macroeconomic targets including sectoral and overall GDP growth, investment and exports. The current trajectory of growth is unlikely to be sustainable unless these challenges are addressed.

The growth rate of GDP (5.3 percent) does not appear to be broad-based with 67 percent of the contribution coming from the services sector only while industry and agriculture sectors contributed 20 percent and 13 percent respectively. Distribution of growth within the various sectors is also skewed. For instance, two major components of the services sector, wholesale & retail trade and transport & communication grew at 6.8 and 3.9 percent respectively.

The growth in agriculture sector has traditionally been dependent on the crops with fiscal year 2016-17 being no exception. The crop sector in Pakistan is vulnerable to exogenous factors such as weather conditions. Global index for volatility of agricultural production 2016 indicates that Pakistan lags behind other regional countries like India, Bangladesh, Sri Lanka and Indonesia. On the other hand, livestock sector (which is less volatile) does not get the due attention of policy makers in Pakistan. It is important to note that livestock has the largest share (58 percent) in agriculture sector as compared to crops (37 percent). Average growth in livestock has been 3.4 percent during the last five years. In order to attain a higher and sustainable growth in agricultural sector, livestock needs to be given due priority.

Growth in industrial sector (5 percent) has been respectable though it declined from 5.8 percent in 2015-16. Within the industrial sector, large scale manufacturing sector grew at 4.9 percent. Higher growth has mainly been observed in industries like iron & steel, electronics, foods & beverages and non-metallic mineral products. However, the major area of concern is textile sector which contributes about 25 percent of the industrial value-added and provides employment to about 40 percent of the industrial labour force. As per the Quantum Index of Manufacturing, growth in textile sector production remained below one percent during July-March 2016-17. The deteriorating situation of textile sector has serious implications for the labour force and employment.

The level of total investment remained at 15.8 percent of GDP in 2016-17 against the target of 17.7 percent. Particularly, continuous decline in private investment (as percentage of GDP) over the last three years is alarming. It is interesting to note that industrial growth of 5 percent has been achieved with a relatively low level of private investment which declined from 10.2 percent of GDP in 2015-16 to 9.9 percent in 2016-17

THE FISCAL PERFORMANCE

The federal budget documents for 2017-18 present a familiar picture of fiscal performance during 2016-17, which is characterised by revenue shortfalls, current expenditure overruns, development expenditure cuts and more than projected fiscal deficit despite the hefty provincial surplus (as estimated by the federal government).

The revised estimates of federal gross revenue receipts reflect a shortfall of over Rs178 billion for 2016-17 (Rs4.74 trillion against Rs4.92 trillion). In contrast, the current expenditure shows an overspending of Rs60 billion. If grants to provinces and others were not slashed by Rs59 billion, the overrun would have crossed Rs100 billion mark.

Contrary to current expenditures, the development expenditures are estimated to be slashed by more than Rs114 billion. All these statistics lead to a federal fiscal deficit of Rs1.64 trillion or 5.1 percent of GDP. A massive provincial surplus of Rs290 billion brings this fiscal deficit down to Rs1.35 trillion or 4.2 percent of GDP, still showing a slippage of 0.4 percentage point compared to its target. Given the revised estimates for development expenditure of Rs936 billion, the fiscal deficit indicates that government borrowed more than Rs400 billion to finance its current expenditures.

The fiscal outlook for 2017-18 also follows the same trend except for having some influence of the election-year politics on development expenditure. The size of federal Public Sector Development Program (PSDP) has been increased by over 40 percent which includes both block allocations for Prime Minister's programmes and higher allocations for National Highway Authority (NHA). On the other hand, current expenditures are budgeted to be reduced by 3.6 percent due to an anticipated decline of over Rs200 billion in foreign repayments. These projections lead to an increase of around Rs130 billion in the budget deficit while it remains more or less constant as a percentage of GDP.

Federal taxes: missed target

Federal Budget 2017-18 indicates that the target of FBR revenues for 2016-17 is likely to be missed by Rs100 billion. It further reflects a compromise on equity and progressivity by a heavy reliance on indirect taxes. Revised estimates for 2016-17 show a collection of Rs2,142 billion under indirect taxes against the target of Rs2,063 billion – an increase of about Rs80 billion. Sales tax contributed the bulk of these revenues (67 percent) followed by customs (23 percent) and federal excise duty (10 percent). While major revenue spinners of sales tax were not mentioned in budget documents, it is more likely that POL products and imported consumer durables played an instrumental role in sales tax revenues.

In contrast, there is a shortfall of over Rs179 billion in direct taxes. The growth in direct taxes remained merely 4 percent in 2016-17. The shortfall is hard to understand in the light of government's claim of a higher real growth in GDP of 5.3 percent and almost 10 percent growth in nominal GDP. There is clearly a mismatch between economic growth and direct taxes. Economic theory indicates that during the high growth period direct taxes grow faster than the economy as people move into higher tax brackets. However, direct taxes in Pakistan are not truly "direct" in nature containing many indirect taxes in the form of withholding and advance taxes. Thus, they fail to perform an automatic stabiliser to moderate the economy in both high and low growth periods.

For 2017-18, the federal government has projected a high growth of 16 percent in direct taxes while indirect taxes are targeted to increase by 13 percent. Given the performance of the previous year, 16 percent growth in direct taxes appears to be a daunting task. The only hope for achieving this target is highest ever allocations for PSDP, which may have a positive impact on direct taxes collection.

Non-tax revenues: a lacklustre performance

The federal non-tax revenues showed a lacklustre performance in 2016-17. The data of fiscal accounts for July-March 2016-17 shows that federal non-tax revenues were Rs392 billion, which is a significant decline from Rs436 billion during the same months in 2015-16. The fall was due to reduction in the inflow from Coalition Support Fund (CSF) and lower profits of SBP because of decline in markup rates.

Surprisingly, the revised estimates for the whole year show a negligible decline of Rs0.7 billion in non-tax revenues in 2016-17 compared to 2015-16. Given the situation in the first nine months, non-tax revenues for 2016-17 appear to be over-estimated in the budget documents. Since non-tax revenues are not shared with the provincial governments, the impact of any shortfall is fully borne by the federal government.

For the fiscal year 2017-18, federal government is expecting an increase of more than Rs60 billion in defence revenues (largely CSF) and Rs32 billion increase in SBP profits. Given the geopolitical situation and declining/stable interest rate, both of these targets do not appear to be plausible.

Current expenditure over-runs
The revised estimates of current expenditures for 2016-17 show an increase of over Rs60 billion as compared to the budget estimates. Debt servicing, subsidies, economic services, and public order & safety affairs are the major contributors to the increase.

The budget estimates of current expenditures for 2017-18 show a decline of 3.6 percent due to an anticipated reduction of over Rs200 billion in foreign repayments. The federal government is also planning to reduce more than Rs30 billion in subsidies and around Rs24 billion in economic services.

Debt servicing
Despite, various claims on reduction in debt servicing, revised estimates of 2016-17 show that more than 70 percent of net revenue receipts (gross revenues excluding transfers to provinces) are consumed by debt servicing alone. 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.

For 2017-18, a reduction of more than Rs218 billion in debt servicing expenditure is estimated. Despite this anticipated decline, debt servicing obligations are more than half of the net revenue receipts. The previous trend shows that federal government generally underestimates the debt servicing obligations.

Defence expenditure indicates puzzling pattern
The expenditure on defence affairs and service has grown by 8.5 percent in 2016-17 as compared to the previous year. This growth seems reasonable but it is quite puzzling to observe a decline of 11.5 percent in employees-related expenditures – falling from Rs324 billion in 2015-16 to Rs287 in 2016-17.

Development expenditures
The revised estimates of federal development expenditure for 2016-17 reflect a reduction of Rs114 billion as compared to the budgeted allocation. However, for 2017-18, development expenditure shows a hefty growth of 43 percent including a 40 percent increase in PSDP. The bulk of PSDP (32 percent) is allocated to NHA with a growth of more than 52 percent over the previous year. In absolute terms, development allocations for NHA reached Rs320 billion. Despite an 11 percent cut in PSDP during 2016-17, NHA received about 12 percent increase compared to its budgeted allocation.

PERFORMANCE OF THE EXPORT SECTOR

The performance of exports has been quite disappointing despite the fact that government launched Strategic Trade Policy Framework (STPF) 2015-18 in March 2016 with the aim to boost the export sector. One of the major targets of this policy framework was to enhance the annual exports to $35 billion by 2017-18. However, Pakistan's exports that stood at $17.9 billion in 2014-15 declined to $15.6 billion in 2015-16 and further to $15.1 billion in 2016-17.

It has been argued by the government that the decline in exports has occurred as a result of Brexit due to which British Pound witnessed a sharp fall in its value with reference to other currencies. Hence Pakistani exports to UK became expensive. It is important to note that only 8 percent of Pakistan's total exports are destined to UK.

Analysis of major export items indicates that exports have actually declined in terms of quantity as well. These include rice (15 percent), fruits (26 percent), vegetables (24 percent), meat & meat preparations (30 percent), leather tanned (6 percent), leather manufactures (8 percent), cotton yarn (15 percent), towels (2 percent), and cement (20 percent).

The government also expected that STPF implementation would enable Pakistani firms to produce and export more sophisticated and diversified range of products. There are only four categories of commodities that constituted about 76 percent of Pakistan's total exports during Jul-Mar 2014-15 including textile and clothing (61 percent), rice (7.7 percent), leather and products (4 percent) and, fruits and vegetables (3 percent). Concentration of these items has remained unchanged during the same period in both 2015-16 and 2016-17. This suggests that STPF could not succeed in bringing diversification in exports.

SOCIAL DEVELOPMENT

Poverty
The Economic Survey 2016-17 does not contain a specific chapter on poverty. However, the Finance Minster gave reference to the poverty estimates that were provided in the Economic Survey 2015-16. According to these estimates, which are based on a new methodology, incidence of poverty declined from 67 percent in 2002 to 29.5 percent in 2014. On the contrary, according to SPDC's latest

estimates, based on the Household Income and Expenditure Survey 2015-16, the incidence of poverty is 38 percent[1].

Education

The Economic Survey 2016-17 presents a bleak and alarming picture of the state of education. Based on the data of Pakistan Social and Living Standards Measurement Survey, it shows that net primary enrolment rate[2] in Pakistan has declined from 57 percent 2013-14 to 54 percent in 2015-16. Since education is a provincial subject, the provincial governments need to pay utmost attention to the effective delivery of educational services.

Gender and federal budget

For more than a decade now, gender responsive budgeting has intermittently been on the policy agenda at federal and provincial level. Last year, the federal government added a chapter named "Gender Budget Statement" (GBS) in Federal Budget in Brief 2016-17 to show its commitment towards gender responsive budgeting. This was the first time GBS found a place in a key budget document. However, current year's federal budget documents did not contain anything in the name GBS.

[1] Poverty and Vulnerability Estimates: Pakistan, 2016-2017, SPC Research Report 99. Available at http//spdc.org.pk/Data/Publication/PDF/RR-99.pdf

[2] Children of age 5-9 years enrolled in schools (grade 1 to 5) as a percentage of total population of children aged 5-9.

Social Policy and Development Centre (SPDC) is a policy research think. Since its establishment in 1995 as a private non-profit company, SPDC has made significant intellectual contribution in placing issues of pro-poor growth and social development on Pakistan's policy-making agenda. With a focus on issues related to poverty and inequality, governance, social service delivery, gender, and pro-poor macro-economic policy, it contributes to the national goal of social development through research, policy advice, and advocacy. Being an independent and non-partisan research organization, the centre collaborates and cooperates with organizations working on issues relevant to its mandate both at home and abroad. It determines its own agenda and has successfully maintained its independence and balance between responsive and proactive social sector research.

Social Policy and Development Centre
C-99, KDA Scheme 1, off Karsaz Road
Karachi
Tel: (92-21) 111-113-113
Email: spdc@spdc.org.pk
www.spdc.orgpk

Islamabad Office:
209, 2nd Floor, Emirates Towers
F-7 Markaz, Islamabad
Tel: (92-51) 2099146