PRIME Policy Note: Federal Budget 2020-21

18th June, 2020

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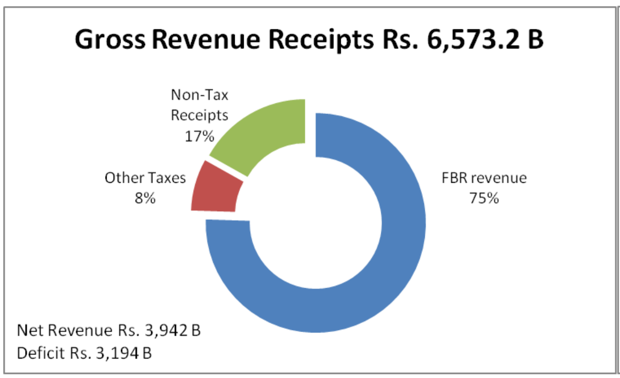

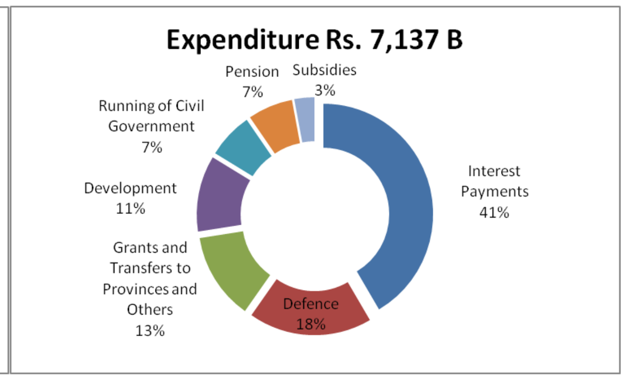

1. **Federal budget speech 2020-21 notes that the expected recession due to Covid-19 calls for an expansionary fiscal policy.** An expansionary fiscal policy aims for greater public spending, which drives up aggregate demand, generating employment opportunities and economic activity. Having mentioned the need for an expansionary fiscal policy without exposure to unsustainable deficit financing, the federal minister presenting the budget speech went on to present a budget with a stated total federal expenditure of Rs. 7,137 B[1] as against the revised budget estimates of Rs. 8345.3 billion incurred in FY 2020. As for sustainable debt financing, this year's budget entails further debt assumption, as the primary balance is still in the negative.

2. **The government holds the opinion that by limiting public expenditures, it will reduce pressure on aggregate demand thereby reducing inflationary pressures on the economy.** This line of thinking became a part of the policy landscape after Pakistan negotiated its re-entry into an IMF program in 2019. However, both policies do not go hand in hand. Pakistan had a double digit rate of inflation when discount rate was at 13.25%, in January this year. Over the next five months, to drive up economic growth, it has been lowered by 525 basis points to 8%.

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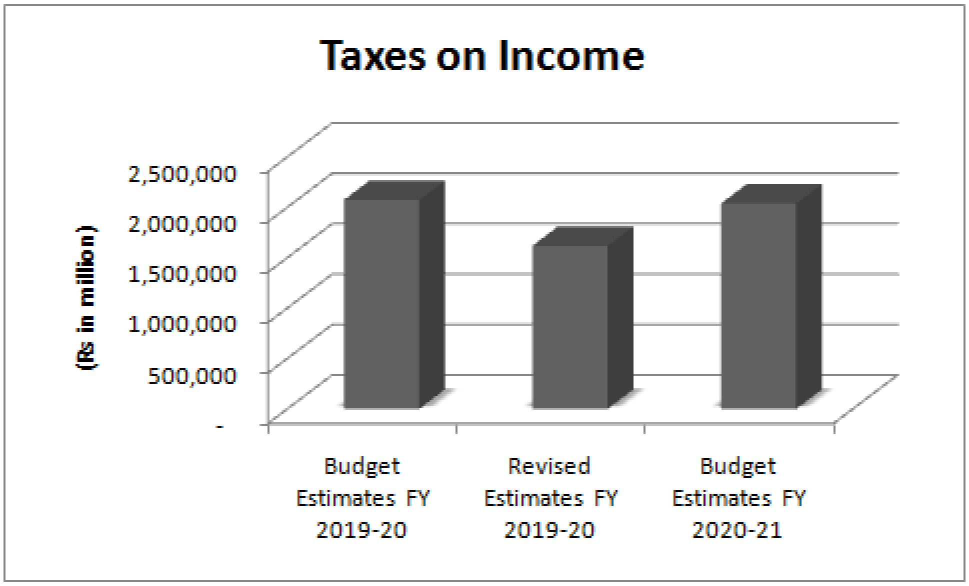
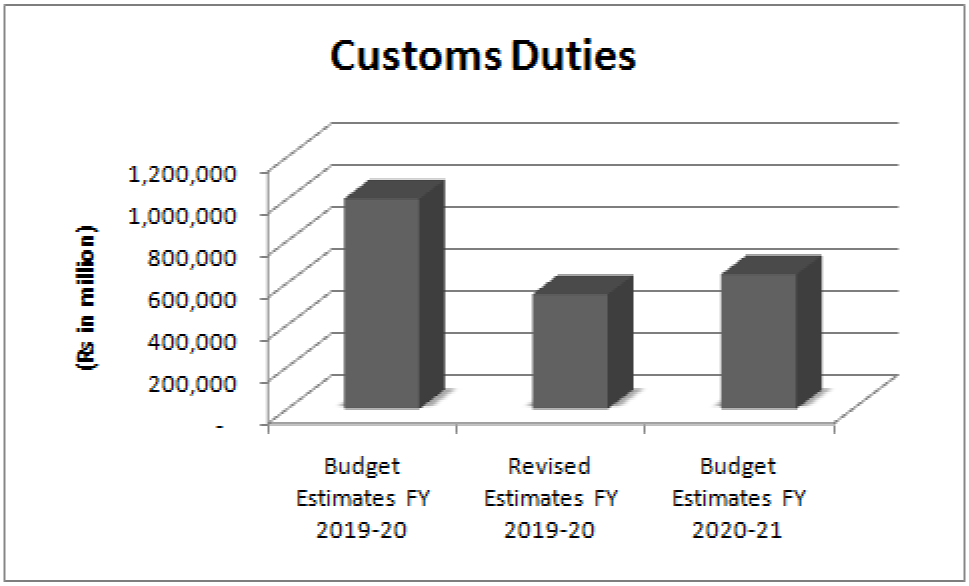
[1] Hammad Azhar, Federal Minister for Industries and Production, Page 11, Federal Budget Speech 2020-21, http://www.finance.gov.pk/budget/budget_speech_english_2020_21.pdf

The government seems confused on which of the two outcomes does it aim to achieve – lowering inflation or driving up economic activity. The massive 1302% surge in allocation for housing and community development illustrates the policy conundrum.



3. **The government is terming the non-increase in income tax rates as a relief in itself.** The budget estimates Rs. 2036.8 billion as collection through taxes on income. This estimate is an increase of about 25.9% over revised estimates of FY 2019-20. It is not easy to fathom how the government plans to increase its income tax collection by almost 26 percent, when the economy has been forecasted to contract by 1.5% in real value terms. This past fiscal year, the income tax collection by FBR faced a shortfall of 21.9%, as measured by the difference between budget and revised estimates for FY 2019-20. This 21.9% shortfall from the original target has been attributed to Covid-19, by the government. This fiscal year, Pakistan has faced restrained economic activity in the last quarter. Since Covid-19 is here to stay for the time being, it should come as no surprise if the country faces another three months of constrained economic activity. So if in the next fiscal year too, one quarter is to see constrained economic activity, and the tax rate remains the same, the budgeted increase of 25.9% in income tax collection should be eyed with caution. Perhaps the government should readjust this target in light of its own estimates of job losses, as contained in the latest Economic Survey of Pakistan.



4. **Customs Duties have been lowered to provide some much needed relief for raw materials importers.** The budget proposes to introduce amendments in the Customs Act, 1969 to eliminate customs duties on imports of raw materials. These raw materials belonging to the chemicals, rubber, fertilizers, leather and textiles sectors constitute about 20% of total exports volume. Regulatory Duties are also being proposed to be reduced on items such as cloth, sanitary ware, electrodes, padlocks and quilts, to discourage the act of these items being smuggled back into the country from Afghanistan. While the purpose of the Regulatory Duties was to curb imports, the government has realized reducing them will result in increase in customs revenue. Another proposal is to eliminate all duties and taxes on imports of diagnostic kits for Covid-19. Proposed amendments to the Customs Act also include the introduction of minimum applicable punishments in the Act so that customs officials' powers to set free those offenders who are involved in smuggling, are curtailed.

5. **Proceeds from privatization have been estimated at Rs. 100, 000 million but contingency remains high.** Estimates under this head in Budget 2019-20 were set out at Rs. 150, 000 million. From July - March 2019-20, Pakistan's fiscal operations have not registered any inflows under this category, at all. Strange still, the revised budget estimates for 2019-20 have maintained the privatization proceeds at Rs. 150, 000 million. The government still has till the end of June to make good on its revised estimates for the year. If this amount fails to materialize, then the skepticism over the Rs. 100, 000 million in privatization proceeds should not come as unwarranted. The government is planning on privatizing Pakistan Steel Mills but it will soon come to realize that it is easier said than done. The opposition in the parliament is vehemently opposed to it, and the risk of judicial intervention cannot be discounted. Even if the plan goes ahead, it certainly would not result in sales proceeds within the fiscal year. It is also pertinent to mention here, there is not a single instance of usage of the word 'privatization', in PTI Election Manifesto 2018. The party promised instead to transfer ownership of SOEs under a wealth fund modeled on the lines of 'Khazanah', Malaysia. Pakistan did emulate the model, establishing its own 'Sarmaya Pakistan'. So far, operational ownership of any SOE has not been transferred to the holding company.

6. **Budget allocation for Defence Affairs and Services went up by 5%, while allocation for Social Protection has been cut down by 5.8%, as compared to revised budget estimates 2019-20.** This comes at a time when the Economic Survey of Pakistan, released a day before the federal budget, states that Pakistan's HDI ranking declined to 152, from the earlier 150, as reported in the UNDP Human Development Index Report, 2019. The survey further states in its 'Covid-29 Advent and Impact Assessment', an estimated 56.6% of Pakistan's population is socio-economically vulnerable due to Covid-19 crisis. Among the most vulnerable, the expected loss of employment (across both the agriculture and non-agriculture sectors) is estimated to be between 12.5 million to 15.5 million in case of moderate slow-down of economic activity/partial lockdown, and between 18.7 million and 19.1 million in case of severe restrictions to economic activity/full lockdown. It is expected that wholesale and retail trade will lose maximum workers followed by manufacturing, construction and transport. One thing the Economic Survey of Pakistan misses out on is that actual unemployment would likely be greater than these estimates due to homecoming of Pakistan's overseas workforce, now unemployed due to Covid-19 related economic recession.

7. **The federal budget document starts off on the wrong foot by assuming a GDP growth rate of 2.1% during the upcoming fiscal year.** Since the primary assumption is not grounded in reality, all the subsequent outputs such as budget estimates for direct and indirect tax revenue are bound to come undone. If indeed the projected GDP growth figure is to be taken any seriously, the authorities need to explain why the budget estimates 2020-21for customs duty collection show sharp decline of 36%, over the budget estimates 2019-20. In an import-dependent economy such as Pakistan, exports are reliant upon imports of raw materials, on which customs duty is applicable. Furthermore, as GDP growth results in income growth, national spending on consumption of imports goes up, which should also drive up custom duty collection. Therefore, a GDP growth rate of 2.1% does not sit together well with a decline of 36% in customs duty proceeds. To sum up, to dress up public accounts for the IMF, the federal government had presented over-ambitious revenue targets in budget 2019-20, and that (coupled with effect of Covid-10) has resulted in a magnanimous revenue shortfall towards the end of the fiscal year. In the upcoming fiscal year, let alone a 2.1% growth in real terms, just holding its ground against economic contraction will be quite a challenging task for the government.

8. Since 2013, PRIME has been advocating for flat taxation, lowering import tariffs to facilitate the country's integration into Global Value Chains, and for supporting the IT sector to enable ICT exports. While the government has proposed to lower customs duties, the measures taken are not nearly enough, and there is a lot more room for trade liberalization. The government has not taken any steps towards reducing the state footprint in the economy. The recent inquiry commissions' reports on sugar and wheat illustrate the dire need for the state to let pricing of commodities be determined by the market for optimum resource allocation through the forces of supply and demand. Subsidizing the industry to benefit cartels at the cost of tax payers is downright unacceptable.