A pro-growth and inflation prone budget

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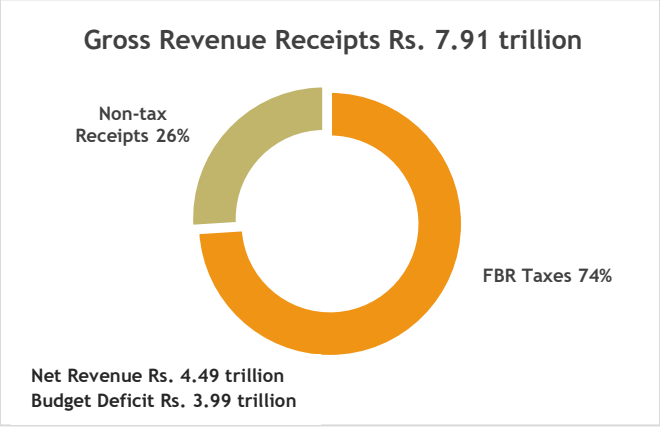
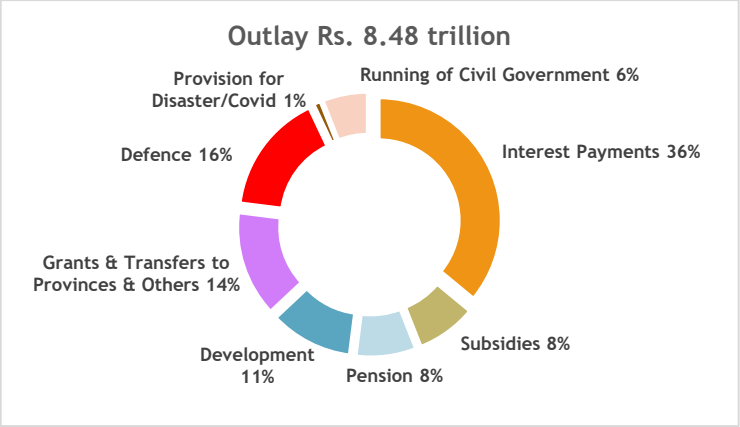
Key Messages

- The federal budget strategy for FY22 is pro-growth and spending-led.
- Customs and Federal Excise Duties have been reduced to facilitate the industry and exports.
- The new budget entails reduction in existing taxes with no new direct tax on salaried class.
- Gains from higher growth rate can be wasted in the case of increased food inflation.
- If international oil price does not come down, a possible hike in petroleum levy is likely to result in cost-push domestic inflation.
- The budget FY22 entails increase in power subsidies but not food subsidies.
- Fiscal prudence in the case of Public Sector Enterprises (PSEs) and commitment to privatization is appreciable.





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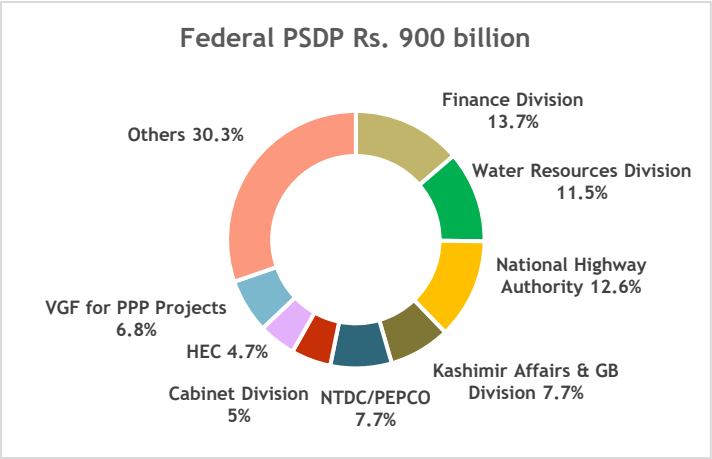
PRIME, since 2013, has been advocating for reduction of tax rate, lowering import tariffs, debt reduction, and reducing wasteful expenditures. It has also led an exclusive campaign encouraging Pakistan's accession to Information Technology Agreement implying zero customs duty on IT and telecom products. It is acknowledged that the federal government has taken important measures in reducing at least some indirect tax rates, tariff elimination on a wide range of industrial raw materials and committing to improved recoveries from state-owned enterprises as well as higher targets from privatization proceeds. We welcome this budget on all these fronts and at the same time caution against food inflation due to higher taxation on some crucial kitchen items.

1. **The Federal budget strategy for FY22 is pro-growth and spending-led.** The total size of the budget is Rs. 8.5 trillion which is almost 19 percent higher than outgoing year's budgeted expenditure of Rs. 7.1 trillion. The increased spending is expected to boost economic activity through total development expenditure of Rs. 964 billion, which is up 22 percent from previous year's budget. The GDP growth target for FY22 has been set at 4.8 percent which is viable given the estimated growth rate of 3.94 for the outgoing fiscal year. Since primary balance posted a surplus of Rs. 159 billion during 10MFY21, debt assumption is expected to remain low during FY22. Further, the government borrowing from banks is projected to decrease from Rs. 889 billion to Rs. 681 billion in FY22. Similarly, the borrowing from non-bank sources is also projected to decrease from Rs. 1,395 billion to Rs. 1,241 billion.

2. **Customs and Federal Excise Duties have been reduced to facilitate the industry and exports.** The government has introduced tariff exemption on almost 600 industrial products and customs duty has also been reduced from 11 percent to 3 percent on import of raw materials. This step was much needed to make imports cheaper in the light of local currency depreciation. Federal Excise Duty on 850cc cars has also been done away with which will make locally manufactured cars cheaper for the middle and low-income groups. According to an estimate by Pakwheels[2], a price reduction of anywhere between Rs. 64,000 to Rs. 110,000 can be expected due to the withdrawal of FED and cuts in GST on cars 880cc and less. These measures will augment on-going demand in the automobile, manufacturing and industrial sector in the upcoming fiscal year.

[2] Celebrations – Car Prices Going Down in Pakistan. Pakwheels. Retrieved: https://www.pakwheels.com/blog/these-are-new-expected-prices-of-alto-bravo-pearl/

3. **Big-ticket items will consume 70 percent of PSDP**. The Public Sector Development Programme (PSDP) allocation is expected to grow by 40%, and approximately 70 percent would be consumed by eight entities namely Finance Division[3], Water Resources Division, National Highway Authority, PEPCO, Kashmir Affairs & Gilgit-Baltistan Division, Cabinet Division, HEC and VGF. This implies a relatively smaller amount for important sectors like special economic zones, national food security division etc.



4. **The new budget proposes reduction in existing indirect taxes with no new direct tax on salaried class or on businesses.** In order to facilitate the private sector, the government has brought down various tax rates to provide relief to the taxpayers and businesses reeling from Covid-19. Some of the tax-related relief measures include:
   - GST being reduced from 17% to 12.5%, applicable only if retailers install Point of Sale (POS) system
   - CGT on stocks down from 15% to 12.5%
   - Turnover tax being reduced from 1.5% to 1.25%
   - Withholding taxes (WHT) on mobile phones to be reduced from 12% to 10% at first and then to 8%
   - Sales tax on electric vehicles reduced from 17% to 1%
   - Reduction in tax liability by 25% for women entrepreneurs
   - WHT on telecommunication services will also be reduced from 12.5% to 3%

   Other areas where WHT is abolished include banking transactions, air travel, stock exchange, CNG, petroleum products, international debit credit card transactions, and extraction of minerals.

"The good news is that the government has accepted our proposals to reduce income tax burdens on SMEs.

Government has also done away with 12 withholding taxes including on cash withdrawal from banks which will ease transactions and bring back cash into the formal system.

The Government has not reduced sales tax as per our proposal but it has bought down sales tax for retailers implementing POS system which will hopefully help in showcasing that lowering sales tax will encourage more retailers to be a part of the system.

We need to shift to low-rate, broad-based taxation that is simple, fair and predictable with strong enforcement mechanism.

Dr. Ikramul Haq
Author of 'Towards Flat, Low-rate, Broad and Predictable Taxes'

[3] Finance Division's development expenditures for FY22 include construction of office building of Competition Commission of Pakistan, capacity building of the Finance Division, financial inclusion and infrastructure project, construction of federal audit complex, modernization and upgradation of Pakistan Mint, and implementation and mainstreaming of audit management information system.

For the SMEs the reduced rates are subject to the following:

- If turnover does not exceed Rs 100 million 7.5% of net income
- If turnover exceeds Rs 100 million but does not exceed 250 million 15% of net income
- In case if the SME opts for a turnover tax basis the tax rate shall be 0.25% or 0.5% of turnover for turnover up to Rs 100 and 250 million respectively

The tax-relief measures for the SMEs should be considered a step in the right direction but these alone are not sufficient to encourage the businesses to become taxpayers. Moreover, according to Mr. Ehtisham Ahmad, a senior economist and having rich experience of restructuring tax systems of various countries, "it may also create incentives for larger firms to masquerade as SMEs, or hide value chains by transacting with untraceable SMEs. Much depends on how the General Sales Tax or Value Added Tax (GST/VAT) is applied. The Mexicans solved the problem by effectively dropping the VAT registration threshold to zero, bringing in complete value chains without the possibility of manipulation by the SMEs or the larger firms using the SMEs (important in textiles for example)".

Turnover taxes have been presented as a simple alternative by the government over years and have been accepted by the business community to some degree. In our view, they are harmful both for businesses and public exchequer. Turnover tax is not sensitive to the level of income- and is applicable even in the case of losses- thus destroying the fundamental concept of income tax.

Notwithstanding the tax-relief measures, 46 percent of the gross revenues for FY22 will be generated through indirect taxes while 27 percent though direct taxes. The indirect taxes are up by 25 percent while direct taxes by only 6.8 percent as against the budget estimates of FY21. Much of this increase in indirect taxes will come from sales tax, which means additional burden on low-income and poor households, thus conflicting the 'pro-poor budget' claims of the government.

5. **Gains from higher growth rate can be wasted in case of increased food inflation.** The government targets to keep inflation at 8.2 percent in FY22 which is significantly higher than the 6.5 percent target for FY21. The inflation has hit double-digits twice in the outgoing fiscal year and has remained above 8 percent during most of FY21. Now that a higher target rate has been set for FY22, a similar pattern may be expected due to the cascading effect of higher economic activity. Inflation may also go northward as a result of imposition of GST on milk and sugar, higher petroleum levy and a turn-over tax on flour mills.
6. **If international oil price does not come down, a possible hike in petroleum levy is likely to result in cost-push domestic inflation**. As per the Finance Minister, the government might have to increase levy on petroleum products from Rs. 5 per litre to Rs. 20 per litre in order to achieve the petroleum levy target of Rs. 610 billion in FY22.[4] However, whether this would be inflationary or not is contingent upon the lifting of US sanctions against Iran and its oil production and resultant lower international oil prices. If this expectation is not realized, then the cost of production will likely increase resulting in cost-push inflation.

[4] Tarin hints at major hike in levy on oil products. Dawn. Retrieved: https://www.dawn.com/news/1629095

7. **The budget FY22 entails increase in power subsidies but not food subsidies.** The government has increased total subsidies by 225 percent for FY22 measuring Rs. 682 billion. Most of this increase is on account of power subsidies worth Rs. 596 billion. This is an attempt to provide relief to the inflation-ridden public by bringing down the electricity tariffs. However, the effectiveness of these subsidies will be based on how efficiently these are targeted. Historically in Pakistan, power subsidies have more often than not been targeted inefficiently. With prevailing food inflation, rise in food subsidies was much needed but denied. The allocated amount for food security only increased by 2.9 percent in FY22 as against FY21, with no additional grants budgeted. This will likely have a negative effect on food security and prices.

8. **Fiscal prudence on the Public Sector Enterprises (PSEs) and higher privatization proceeds in the books.** The recoveries of loans and advances from PSEs and others are set at Rs. 178 billion in FY22, which is up 85.4 percent from the revised estimate of FY21, suggesting commitment to fiscal prudence and a signal of confidence on institutional reforms. Further, the privatization proceeds are projected at Rs. 252 billion, up 152 percent from FY21. This figure seems questionable. From past two years, the Ministry of Finance has not registered any inflows under this category, yet the budget estimates of the outgoing fiscal years (FY20 and FY21) still show Rs. 150 billion and Rs. 100 billion respectively under this category. It would therefore not be surprising if the same occurs in the incoming fiscal year also.

Concluding Remarks

PRIME since 2013, has been advocating for reduction of tax rate, lowering import tariffs and reducing wasteful expenditures. The lowering of customs duties and tariffs on raw material imports as well as announcing of zero duty regime on IT products is certainly a great news. Contrary to the narrative of being a pro-poor budget, ambiguity remains as to how this budget will reduce food inflation in the upcoming fiscal year. Under the federal budget FY22, government has proposed to increase the turnover tax on wheat from 0.25 percent to 1.25 percent, while the sales tax on flour bran is set to enhance from 7 percent to 17 percent[5]. Moreover, Rs. 7 billion would also be collected from sales tax on sugar.[6] Since both are essential commodities, increase in their prices is likely to worsen food inflation. Direct and indirect cash transfers to low-income group is a short-term solution for mitigating the effects of food inflation and other socio-economic issues, which this budget entails. However, a long-term and a more sustainable approach calls for increasing real incomes, employment opportunities, human capital development and sustaining economic growth in order to achieve a definite improvement in socio-economic indicators.

[5] 20kg flour bag may cost Rs90 more after tax revision. *The News*. Retrieved: https://www.thenews.com.pk/amp/849315

[6] Massive taxation relief to boost industrial growth. *Dawn*. Retrieved: https://www.dawn.com/news/1628879/massive-taxation-relief-to-boost-industrial-growth