

Animal Spirits Economy

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FY10 *Bougette* (That's French for budget)

- The FY10 fiscal budget is due to be announced on Saturday, June 13, 2009
- A tax revenue target of PKR1,406bn has been set for FY10, an increase of 25% over estimated FY09 tax collection
- Total expenditure or outlay has been estimated at PKR2,900bn, bringing the target deficit to PKR735bn or 5.0% of GDP
- PSDP spending has been approved to the tune of PKR621bn, with 49% spending on infrastructure, 46% on social sectors and 5% on productive sectors

The government is due to announce the FY10 budget this Saturday, June 13, 2009 and in contrast to previous years, speculation over budget allocations have inundated media reports and gripped capital markets in a way not seen before. Given that the country is in the midst of an economic slowdown and seems to be at yet another crossroads, the fiscal stance in FY10 will be instrumental in determining the extent and sustainability of economic growth.

Overview: **Pro Poor?**

According to the Ministry of Finance (MoF) and Federal Board of Revenue (FBR), the tax collection target for FY10 will be PKR1,406bn, an increase of almost 25% over this year's projected collection of PKR1,130bn. Whether this target is attainable or even reasonable in an economy which has been ravaged by record high commodity prices, galloping inflation and a heavy interest rate environment remains to be seen. Perhaps the biggest danger from setting ambitious tax revenue targets is the eventual mismatch with government expenditure and consequent expansion of the fiscal deficit to unsustainable levels. We have already seen what happens when a cash-strapped government with no options is forced to finance its deficit through central bank borrowing. Budgetary borrowing from the SBP touched almost PKR700bn in FY08 and exacerbated supply side inflationary pressures to a peak of 25.3% in Aug08.

Fortunately this year the country seems to have the support of the international community and has been extended USD14bn in aid, grants and loans over the next two years. Moreover the IMF seems to be much more cognizant of allowing extra fiscal space to adopt a counter cyclical policy in order to stimulate growth and ease the burden on an impoverished population. While the usual conditions of eliminating subsidies on electricity, gas and petroleum have been imposed (power tariff is set to increase by 17%) the government has also been allowed to run a fiscal deficit of 5.0% of GDP for FY10. This target was initially revised upwards from 3.3% to 4.6% and now has been extended by another 0.4% to 5.0% or approximately PKR735bn. However the government will not be able to borrow money to finance this additional deficit, which is why the materialization of the funds pledged in the Friends of Democratic Pakistan conference, become crucially important. The proposed deficit of PKR735bn will be financed through PKR200bn from National Savings Schemes, PKR300bn from domestic sources and PKR250bn through external financing.

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The basic purpose of allowing a larger deficit is to encourage government spending on health, education and infrastructure so necessary for economic recovery. A public sector development programme of PKR621bn has been approved by the National Economic Council. Of this, 49.0% will be spent on infrastructure, 46.0% on the social sector and 5.0% on the productive sector. Total expenditure for FY10 has been estimated at PKR2.9trn, which is an increase of almost 42% over the initial outlay of PKR2.04trn in FY09. Major expenditures are expected to come in the form of debt servicing, which is projected at PKR750bn, while a 15.5% increase in defence spending to PKR342bn has also been proposed.

FY10 Fiscal Budget Overview

Fiscal Operations	FY10BE (PKR bn)
Total Revenue	2,165
Tax Revenue	1,406
Non-Tax	759
Total Expenditure	2,900
Current Expenditure	2,279
Of which : Interest	750
Defence	342
Development Expenditure	621
Budget Deficit	-735

Source: Media reports, BMA Research

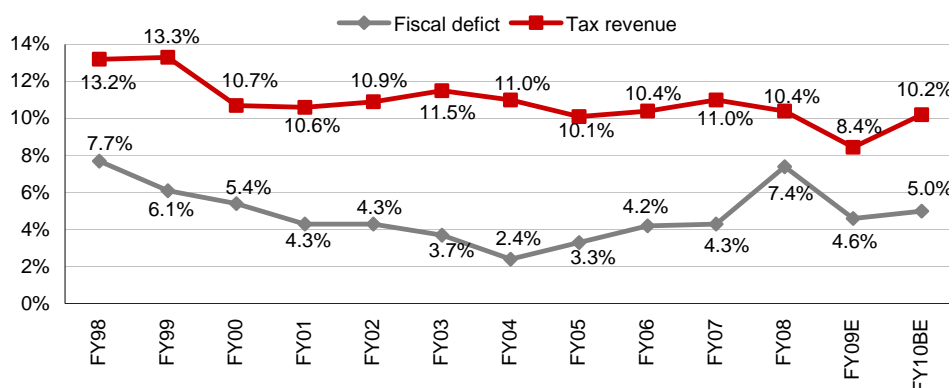
With a target deficit of PKR735bn, the government will have to earn approximately PKR760 bn in non tax revenue. Non tax revenue for 9MFY09 is PKR452.2bn and is projected at nearly PKR650bn for the full year. The two major contributors to non tax revenue in 9MFY09 have been SBP profits (PKR135.3bn) which are transferred to the government and the development levy (PKR85.2 bn) currently being charged on petroleum and gas. With international oil prices breaching the USD70 mark, the PDL collected by the government will be neutralized to zero. Add the recent judicial objection to PDL and it is easy to surmise that the government will be reluctant to continue with this unpopular form of taxation. In its place a carbon tax has been proposed, this tariff would be at a fixed rate of between PKR5.0–6.0/litre and would earn the government approximately PKR90bn in FY10. There has also been a proposal to classify the funds collected through PDL part as part of the revenue budget and thus become eligible for distribution amongst the provinces. Currently the PDL is collected by the Ministry of Petroleum and goes directly into the Federal government's account. Dividing part of the revenue amongst the provinces may be the best way to garner support for this levy.

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Taxes: Widen the net

As stated above, a tax collection target of PKR1,406bn will take considerable effort to achieve. Pakistan's tax to GDP ratio compares unfavourably with the region average of 15%+ and has been on a continuous downtrend from its peak of 14.4% in FY96. In fact projections for FY09 put the tax to GDP ratio at a dismal 8.44% and it is difficult to see how this can be increased meaningfully over the next couple of years.

Fiscal deficit and tax revenue as % of GDP FY98 - FY10BE



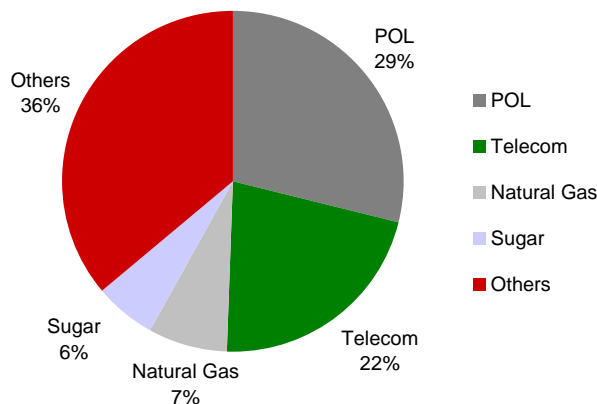
Source: Ministry of Finance, BMA Research

Encouragingly, official statements have leaned towards expanding the tax net rather than increasing taxes on sectors which already contribute an unreasonably high percentage of the total collection. It is estimated that only 1.5mn out of almost 180mn people pay taxes in Pakistan. For example the manufacturing/industrial sector which constitutes 25% of GDP contributes almost 60% total tax revenue, on the other hand the agriculture sector which makes up 20% of GDP contributes barely 1%, while the services sector with a 55% weight in GDP remains largely undocumented and hence untaxed. It is thus heartening to note that the government has pledged to bring (in order of priority) the real estate, services, capital markets and agriculture sectors under the tax net.

Speculation over a 1% increase in the general sales tax to 17% has been put to rest by emphatic statements from the Advisor on Finance to the Prime Minister, who has claimed that there will be no increase in the GST this year. Moreover with large scale manufacturing contracting by over 7% in FY09, no new taxes for industry are being pushed by the government either. However there are expectations that a gross asset tax may be implemented in this budget. This measure had previously been taken in FY91 but was abolished after only one year. With over 53,000 corporate companies registered with the SECP, a gross asset tax has the potential to generate around PKR40–50bn in revenue. The tax slabs for such a tax based on previous implementation could be as follows; assets below PKR50mn would not be taxed, between PKR50–100mn would pay PKR750K, between PKR100–250mn would pay PKR1.5mn and above 250mn would pay PKR2.5mn.

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Sector break up of Sales tax on domestic activity FY08



Source: Ministry of Finance

Import Tariffs: Counterproductive?

Given that the country had immense difficulties dealing with an USD15.3bn trade deficit in FY08 (FY09E: USD12.0bn), one of the first measures taken in the wake of the crisis was to impose duties ranging between 15% - 35% on the import of 397 luxury items. The purpose being to discourage imports, rationalize the trade deficit and earn some additional revenue for a government. For this reason one of the main ways the government seeks to increase revenue in the short term is to impose additional duties on all imports. In theory an across the board increase of 1% in import duties could earn the government an additional PKR25bn, however according to the Ministry of Commerce the decision to impose duties on luxury items resulted in a net loss to the government. The reason being that such duties were not applicable to goods imported under the Afghan Transit Trade agreement and encouraged the import and subsequent smuggling of such items from Afghanistan to Pakistan. This phenomenon can be witnessed in the exponential increase of 53% in imports under the ATTA to USD775.0mn in just a year. Moreover an increase in import duties does not bode well for exports, as Pakistani missions seeking greater market access abroad are simply reminded of their own high tariffs on various consumer items and sent back empty handed.

Equities: Spare the rod, spoil the child

The taxes most widely expected to be implemented are the capital gains tax on real estate transactions and general services tax on services. The CGT on real estate would be imposed after excluding initial buying cost, transfer documentation cost, provincial fees and the impact of inflation. The 4.5% proposed tax on services is estimated to generate PKR30bn in revenue and would be uniformly imposed and collected by provincial governments.

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Equity markets will be spared any additional taxation in this year, though the exemption on CGT is no longer expected to be extended beyond the end of FY10. No increase in the corporate level of taxation currently at 35.0% is expected, nor are any changes in dividend or turnover taxes being proposed.

On the flip side it is expected that the federal excise duty on local cement dispatches will be slashed by 15% to PKR765 per ton. Also it has been reported that the Ministry of Finance has agreed in principle to abolish the 5% federal excise duty on local automobile sales. This exemption is a bail out measure for the auto industry which has been in a crisis like state over the past year with dispatches declining by 46%.

The cross subsidy enjoyed by the fertilizer sector as well as domestic consumers has recently come under fire. The government currently projects the cross subsidy to be PKR35.3bn with PKR11.1bn for fertilizer and PKR23.0bn for domestic consumers. The cost of this subsidy is currently being borne by the commercial, industrial, CNG and power sectors and has served only to compound their pre-existing inefficiencies and make their products uncompetitive in international markets. With the Ministry of Petroleum asking for the elimination of this cross subsidy, it is very likely that a step may be taken to redress the current imbalance between the different sectors. However given that agriculture has been awarded top priority in this budget it would seem that a separate subsidy would be allocated for fertilizers as well as domestic consumers.

Long term strategy: **Change the mindset**

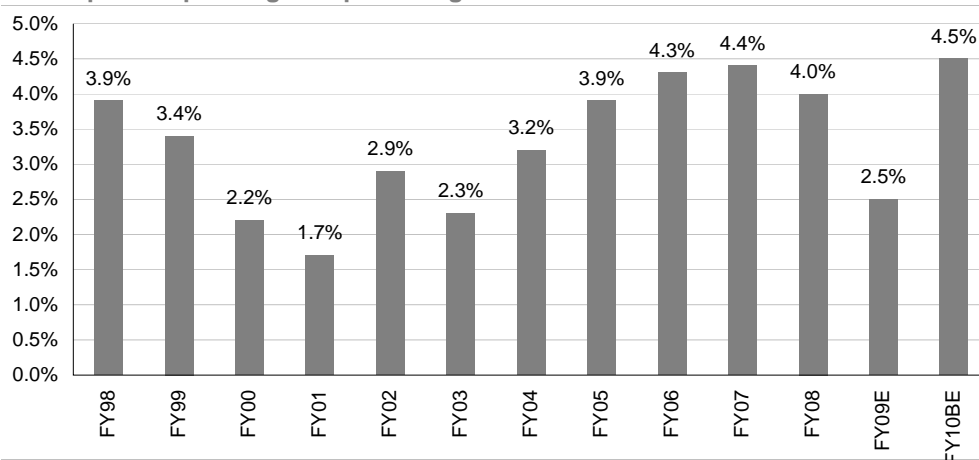
Many proposals for increasing the tax net have been floated and it is imperative for Pakistan to increase the tax to GDP ratio to around 15% if economic growth is to be sustained and not suffer from the boom and bust cycle that has been witnessed four times in the last two decades. The first measure should be to eliminate the incentives for tax evasion. Periodic tax amnesty schemes which allow undocumented income and wealth to be “whitened” have encouraged evaders to continue operating outside the documented economy. Strict penalization of such offenders rather than the implicit promise of amnesty will be instrumental in shifting the mindset of taxpayers. Secondly the correct implementation of a tax credit policy will encourage documentation. By allowing tax credit against expenses incurred on education and health there will be a basic incentive for users to demand receipt and documented evidence of the transaction. Thirdly, reducing the tax differential of 15% between small and corporate companies will encourage corporatisation and expansion, which should increase revenue for the government. In essence the long term tax policy should focus on expanding the tax base by limiting and rationalizing the exemption provisions and taking in to consideration the constantly evolving sector composition of GDP.

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Public Sector Development Program: **A new dawn**

The National Economic Council has approved a PSDP of PKR621bn for FY10, with PKR421bn as the federal component and PKR200bn for the provinces. For FY09 PKR550bn had been allocated to development expenditure, out of which PKR216bn has been spent until 9MFY09. Historical data indicates that actual PSDP expenditure is on average 60% of the total allocation. Development spending in Pakistan has traditionally been on the lower side with debt servicing and defence taking up the lion share of the government's resources. This year additional fiscal space has been provided to the government so that it can deploy a counter cyclical policy and stimulate economic growth through development spending on the social sector and infrastructure.

Development spending as a percentage of GDP FY98–FY10BE



Source: Ministry of Finance, BMA Research

Agriculture: **Takes the top spot**

Out of the PKR421bn in federal development spending, PKR209bn would go to infrastructure, while PKR190bn would be earmarked for the social sector and PKR22bn for the productive sector. In an effort to strengthen the safety net for the nation's poor, the Benazir Income Support Program will be allocated PKR70bn, while an additional PKR4bn will be spent on the Benazir Green Tractor Scheme. In a further boost to agriculture, the government will spend PKR27bn on developing and expanding grain storage facilities. This expense was perhaps allocated keeping in mind the difficulties the government has faced in meeting its procurement targets in the face of a bumper wheat crop totalling 24.0mn tons this year. An additional PKR3.5bn will also be pledged to enhancing the public – private partnership in dairy farming. Keeping in mind the importance of agriculture, the government has decided to allocate PKR60bn to the water sector. These funds will be used to finance 32 small and medium sized dams (8 in each province) in FY10. Moreover PKR12bn will be allocated to the Mangla dam project which would allow the storing of an additional 2.88mn acre feet of water during the next monsoon season.

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Social sector: **More needed**

In an effort to develop the quality of the labour force the government plans to ramp up spending on health and education. With 3.5mn people expected to be added to the labour force over the next 5 years and 54% of the population under the age of 19, social sector spending should rightly be a top priority if unemployment levels are to be contained to manageable levels. Allocation for health has been increased by 82% to PKR26bn, with the major funding going to the expanded programme on immunization (PKR6bn), mother and child care (PKR3bn) and primary health care (PKR7bn). In addition PKR32bn will be spent on education and training, with the focus being on imparting tangible skill sets to at least one member of pre-identified impoverished families.

One of the major obstacles to sustained economic growth and development has been the power deficit, which is estimated to be in the range of 3,000MW. To address this problem PKR139bn have been allocated to the energy sector with electricity generation and conservation projects being the top priority. In addition PKR190bn will be spent on developing the nuclear plants C3 and C4 which are expected to provide 600MW of electricity by 2016.

Proposed Public Sector Development Spending for FY10

PSDP	PKR (bn)
Water	60
Energy	139
Education	32
Health	26
Grain storage	27
Dairy Farming	3.5
Transport	70
Railways	12
Total PSDP	621

Source: Media reports, BMA Research

The first to go: **Threats to PSDP spending remain**

While the government seems to have gotten a firm handle on which sectors need immediate attention, PSDP spending has always been vulnerable to budget cuts. Whenever fiscal expenditures threaten to derail macroeconomic stability, PSDP spending is the first to go. Not only does this lead to a deceleration of direct tax growth as WHT receipts from cancelled development contracts decline but economic growth is directly compromised. To this end it is essential that the majority of the USD14bn pledged by the international community actually materializes over the next two years. Without external sources to prop up PSDP and finance 30% of the deficit, the government may be forced to either borrow from the SBP which would sour relations with the IMF and lead to delays/cancellations in future tranches, or jack up NSS and government paper auction rates to procure the funds from domestic sources. The first option would result in inflationary pressures and burgeoning external deficits, while the latter would exacerbate private sector crowding out and prolong the oppressively high interest rate environment. In short none of those two is really an option if Pakistan wants to return to a high rate of growth and avoid the social and security repercussions of a deep recession.