
No Pain, No Gain

Mushtaq Khan, June 12, 2019

Unlike the opposition parliamentarians who tried to drown out the budget speech, let's give the FY20 Federal Budget a fair hearing. FY19 has not ended yet, but analysts project the fiscal deficit at 7.4% and the current account deficit at 4.0 % of GDP. The average twin deficit for the past three years (FY17 to FY19) is a dangerous 11.3% of GDP.

This imbalance is clearly unsustainable, so a populist budget would have been irresponsible. Hence, the FY20 budget is a source of some comfort.

But this doesn't change the fact that this is a hard budget, which will squeeze the average Pakistani from both sides: rising inflation (projected at 13%) and slowing growth that creates job insecurity (real growth is projected at 2.4% in FY20). Purchasing power will fall sharply and the most vulnerable will be salaried people in the low & middle income classes.

Increasing taxes during an economic recession is hardly ideal. It does, however, reveal the dire situation that this government is grappling with. Clearly, the FY20 budget is strongly influenced by the forthcoming IMF program, but we think the Pakistani team was able to get its way with the IMF (this could explain the prolonged negotiations). Specifically, while debt servicing is projected to increase by a massive 78% in FY20 (which makes sense with the sharp increase in interest rates and the depreciating Rupee), the government has *increased* allocations for defence spending, pensions, PSDP, BISP and subsidies.

Excluding possible cash balances held by provincial governments at the end of the fiscal year, the federal government has stated that the fiscal deficit in FY20 could be as much as Rs 3.6 trln, or 8.2% of GDP. This means debt consolidation has been delayed till FY21 (and beyond), and the government is willing to accept the cost of stabilization (higher interest rates and a weaker currency) without downgrading its discretionary spending plans.

This preference is also reflected in its external sector projections. The government has set a current account target of \$ 6.5 bln for FY20, which is half the anticipated external gap this year. In our May 2019 presentation, we expected the external deficit to be smaller at \$ 4 bln, arguing that the underfunded IMF/IFI programs would not provide much money to finance a larger gap.

Again, by allowing for a larger external deficit, the government is seeking a middle-of-the-road approach. This means more external borrowing, which implies that Pakistan's dollar debt will continue to grow. The issue is: where does Pakistan expect to secure this additional funding from? This is where the wishful thinking begins.

To finance the Rs 3.6 trln fiscal deficit, the government expects Rs 1.8 trln from external sources (foreign borrowing) and Rs 1.3 trln from domestic sources (but not from SBP). Assuming the PKR/\$ averages 175/\$ during FY20, this boils down to *net* borrowing of about \$ 10 bln in FY20 *alone*. To put this into context, the total financing available from the IFIs for the next three years, is only \$ 9 bln. So again, where will the government secure this additional hard currency from, especially after Pakistan has been forced to reschedule most of the loans it got from friendly countries?

Before discussing the revenue side of the budget, let us flag some positives. FBR has increased the number of income tax slabs, which is an interesting way of revealing that there are some super-rich Pakistanis who live and work in the country. FBR has also reduced the tax exemption limit from Rs 1.2 mln per annum to Rs 600,000. While this will squeeze the middle class (which will struggle with rising household expenditures), it shows that the tax authorities are serious about expanding the tax base, and also to keep tax rates progressive. Furthermore, FBR has increased the withholding tax on interest incomes, which is a nice way to *retain* a fraction of the massive increase in debt servicing in FY20. Finally, real estate transactions above a certain volume will now have to use banking channels. This means barring the use of currency notes for large transactions should stop the hoarding of Rupees, which in turn will benefit the banking system.

The revenue target.

FBR expects to collect Rs 5.55 trln in revenues during FY20, which is a 33.7% increase over the revised target in FY19. For this to materialize during an economic slowdown, is truly a stretch. While a large share of this increase will come from new revenue measures (Rs 516 bln, of which Rs 200 bln each will come from *new* sales tax and *new* income taxes), the total revenue target is nothing short of fantastic.

While imposing a 17% sales tax on almost all household items will surely spark inflation, we are equally concerned about whether FBR has the capacity – and incentive – to follow through. For example, there is a policy that says any shop with a covered area above 1,000 square feet, must have a POS that is integrated with FBR's computerized system. The logistics of implementing this policy change are quite daunting.

The issue is: can we expect this from an institution that the PM had once suggested should be shut down and replaced by an entirely new agency?

Tentative conclusion

This budget is wishful but not delusional. It delays debt consolidation as the government seeks to protect some of its spending plans. The focus is rightly on revenue generation, and this burden is to be spread across the board – some taxes are progressive (e.g. income tax) and some are regressive (e.g. sales tax). The growth and inflation targets for FY20 are credible, but without analyzing the IMF program details, little can be said about the Rupee, interest rates and the country's debt dynamics.

While the budget is realistic and hits the right tone, delaying the debt management could unravel the government's plan. More specifically, the external sector projections are not convincing, especially the quantum of foreign loans the government expects in FY20. If these loans are not forthcoming, the external deficit would have to be smaller than the \$ 6.5 bln target, as the net international reserve (NIR) targets on SBP, are likely to be binding. This means further PKR adjustments and higher interest rates, which will surely make the fiscal deficit target (and financing) much more difficult.

Despite the gloom that the budget has created, we see a silver-lining. The budget's revenue target is too ambitious, and could stall the forthcoming IMF program. However, as we have discussed in our last paper (*The Parable of Pakistan & the IMF (Part 2)*, 3 June 2019), a stalled program could pave the way for a more decisive endgame, which will force Pakistan's policymakers to do the right thing.

To be fair, one should consider the possibility that this government could *actually* meet the revenue target. This would entail unbiased enforcement, strict monitoring, diligent follow up, an uncharacteristic level of professionalism in FBR, and the use of database (and banking details) that cannot be contested. These challenges are as daunting as the revenue target, but when a country comes to the stage that

Pakistan is in, there are two options: (1) it muddles through as it has in the past, fails, and eventually implodes; or (2) it comes out with an ambitious plan and tries its level best to implement.

The second option does not guarantee success, but it does show that the leadership tried. If the government is sincere in its intentions, but is still unable to take on the vested interests that are bankrupting the country, the next generation of Pakistan's leadership will know what to do.