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The forthcoming budget

The Federal and Provincial Budgets for 2020-21 are expected to be announced in the month of June, starting with the presentation of the Federal Budget on the 5th of June. These budgets come at a time when the economy has been badly hit by the COVID-19 and public finances are in a state of disarray. Revenues have fallen sharply and expenditures have increased, in particular, due to the relief packages.

Prior to COVID-19, the overall fiscal operations had shown significant progress. The first three quarters of 2019-20 witnessed a sizeable reduction in the consolidated budget deficit to 3.6 percent of the GDP from 5 percent of the GDP in the corresponding period of 2018-19. In fact, a primary surplus of 0.4 percent of the GDP was actually generated. The performance criteria on the fiscal front in the IMF Program were mostly met.

The impact of COVID-19 is visible from March onwards. FBR revenues which had been showing a steady growth rate of 17 percent fell by 10 percent in March and even more by almost 17 percent in April. Simultaneously, big relief packages are being implemented with additional cost on the budget of almost Rs 500 billion. Conservative projections for the fiscal deficit in the last quarter are that the deficit in the quarter could approach the unprecedented level of over 6 percent of the GDP. Consequently, the budget deficit for the full year could rise to the record level of 9.8 percent of the GDP, as compared to the target for the year of 7.3 percent of the GDP.

Therefore, the budgets for 2020-21 are being framed in the backdrop a growing financial crisis. As such, the fundamental question is what should be the posture of the budget? Should it be contractionary or expansionary in nature?

The answer is that if the COVID-19 stops spreading in the next two to three weeks and if the economy starts recovering on the back of a very limited lockdown then perhaps the budgetary posture could be more aggressive in nature. However, the likelihood of the pandemic abating is low and there is the probability that the Federal Budget may be presented on the 5th of June in an environment of peak numbers of people being hit by the virus and the economy floundering sharply. Therefore, as identified already by the Adviser on Finance the forthcoming budget will have to be a 'Corona budget'. As such, the budget should contain wide-ranging relief and incentive measures to keep the economy going and gradually reviving.

Interestingly, the IMF staff members seem to be living in a world of their own. The recent budget projections for 2020-21 onwards have been made by them as part of the report for giving access to the IMF Rapid Financing Facility. The projections imply an extremely contractionary fiscal policy. Tax revenues, including these by FBR, are targeted to increase by 31 percent in an environment where their own expectation is that the economy will grow by not more than 2 percent. The increase in non-debt servicing current expenditure is actually expected to fall by 3 percent. Consequently, the budget deficit is expected to come down sharply from close to 9.8 percent of the GDP this year to 6.6 percent of the GDP next year, a degree of reduction which has never been achieved before.

Fortunately, there are two 'silver linings' in the cloud which will greatly facilitate the budget-making process, as follows:

(i) The State Bank of Pakistan has rapidly brought down the policy rate from 13.25 percent to 8 percent. If this can be carried down further to 7 percent by the beginning of the next fiscal year, this will bring down the projected debt servicing liability to about Rs 1915 billion as compared to Rs 2865 billion projected by the IMF for 2020-21. This implies a large saving of Rs 950 billion.

(ii) The precipitate fall in international oil prices has enabled the Government not only to reduce domestic prices sharply but also to virtually double the rate of petroleum levy on motor spirit and HSD oil. If the price does not rise beyond $40 per barrel in 2020-21 then additional revenues of almost Rs 150 billion could be generated.

Combined together, these two positive developments create fiscal space of Rs 1100 billion. This is equivalent to 2.5 percent of the projected GDP in 2020-21.

The normal growth, without any additional taxation, in FBR will hinge on the GDP growth rate, the rate of inflation and the trend in imports. In particular, the change in industrial production will play a critical role. Already, the Quantum Index of Manufacturing has fallen by an unprecedented 23 percent in March. This fall is likely to persist for some time. Simultaneously, imports have declined by 21 percent in April. However, following the big drop this year, imports are likely to stabilize more in 2020-21.

The GDP growth is likely to be near zero or even marginally negative in 2020-21, unlike the IMF's projection. Also, due to low commodity prices (especially of oil) and low level of aggregate demand, the rate of inflation is unlikely to exceed 7 percent.

Based on these projections, the normal growth in FBR revenues can be derived as ranging from 7 percent in the sales tax to 10 percent in the income tax, with growth in the two smaller taxes, customs duty and excise duty, within this range. Overall, in the absence of taxation proposals, FBR revenues are unlikely to increase by not more than Rs 350 billion. Heavy additional taxation will need to be avoided if the economy is not to slump further. At best, progressive additional taxation of Rs 200 billion is possible.

Non-tax revenues will see a peak of Rs 1350 billion in 2019-20, with SBP profits contributing almost half to this record level of revenues. However, with the large fall in interest rates, SBP profits in 2020-21 could come down sharply by over Rs 250 billion. Simultaneously, profits of public sector corporate entities like OGDC and PPL are down and the flow of dividends to the government will be lower. Overall, non-tax revenues could be lower in 2020-21 by almost Rs 300 billion.

Therefore, taking the above factors into account, the net change in 'fiscal space' for budget making is given below. It is close Rs 1400 billion, equivalent to 3 percent of the projected GDP in 2020-21.

	'Fiscal Space' in 2020-21 (Rs in Billion)
Reduction in cost of debt servicing	950
Higher rate of Petroleum Levy	150
FBR Revenues Increase:	
Normal growth	350
Additional taxation	200
Decline in non-tax revenues	-250
Net Fiscal Space	1400

A balanced approach would be to use half the fiscal space for deficit reduction and the remaining half for increasing public expenditure in critical areas like providing relief to the poor and unemployed and giving special tax incentives for reviving vital sectors. This strategy will imply a budget deficit at the Federal level of 8.1 percent of the GDP in 2020-21, which will be a major step forward compared to the last two years. The remainder of the fiscal space of Rs 700 billion could be used as follows:

(i) Increase in the budgetary allocation for grants and subsidies of Rs 300 billion, to sustain and expand, if necessary, the coverage of the relief packages.

(ii) Increase in the size of the Federal PSDP by Rs 100 billion to provide a small fiscal stimulus to the economy and raise the GDP growth by 0.5 percentage point.

(iii) Increase of Rs 150 billion in other budget heads including defense services. This will provide for growth in these expenditures of almost 8 percent.

(iv) Tax breaks of up to Rs 150 billion in sectors like exports, agriculture, domestic value-added industries and imported food items.

Based on the analysis above, the key projected budgetary magnitudes in 2019-20 and 2020-21 are presented in the Table below. The tax-to-GDP ratio remains low at 9.2 percent of the GDP in 2019-20. It could rise modestly to 9.9 percent of the GDP in 2020-21. However, overall revenue receipts are likely to remain unchanged at just above 13 percent of the GDP. Due to the big fall in the expenditure on debt servicing current expenditure may decline from 16.2 percent to 15.1 percent of the GDP. Overall, the Federal budget deficit could fall from 9.3 percent to 8.1 percent of the GDP.

BUDGET PROJECTIONS – (% of GDP)

	2019-20	2020-21
Tax Revenues	10.1	11.0
• FBR Taxes	9.2	9.9
• Other Taxes	0.9	1.1
Non-Tax Revenues	3.1	2.3
Gross Revenue Receipts	13.2	13.3
Transfers	5.9	6.3
Net Revenue Receipts	7.3	7.0
Total Expenditure	16.6	15.1
Current Expenditure	15.1	13.5

• Debt Servicing	6.2	4.2
• Pensions	1.1	1.1
• Grants and Subsidies	3.6	4.0
• Defence	3.0	3.0
• Others	1.2	1.2
Development Expenditure	1.5	1.6
FEDERAL BUDGET DEFICIT	-9.3	-8.1
PROVINCIAL DEFICIT	-0.5	0.0
CONSOLIDATED BUDGET DEFICIT	-9.8	8.1

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There is need to recognize that Provincial finances have also come under stress perhaps for the first time since the 7th NFC Award. Transfers are likely to be as much as Rs 900 billion below budget estimates for 2019-20 with the biggest drop in the fourth quarter. As such, the Provinces could face a cash deficit of 0.5 percent of the GDP by the end of 2019-20. Conscious efforts will then have to be made by the Provinces to balance their respective budgets in 2020-21.

The above analysis highlights the kind of estimates that will have made by the MOF to come up with a Federal Budget for 2020-21 which is not only feasible but also recognizes the difficulties imposed on the economy and the people of Pakistan during the pandemic and in the post-COVID-19 world. We wish the MOF success in presenting a well-crafted budget at this difficult time.

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