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Faulty budgeting

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The Fed-eral Ministry of Finance (MoF) has set a new record in the last year of the PML-N government. This relates to the extent of deviation of the actual budget deficit from the estimate of the deficit given to the National Assembly at the time of presentation of the Budget for the next fiscal year.

The biggest deviation was observed last year. The estimate of the fiscal deficit for 2017-18 was 4.1% of the GDP. The information on fiscal operations released recently by the MoF is that the actual deficit is 6.6% of the GDP, based on information from the AGPR, provincial AGs, SBP and Economic Affairs Division. Therefore, the deviation is as much as 2.5% of the GDP or Rs 780 billion.

Earlier, during the tenure of the IMF programme, the MoF performed exceptionally well. The maximum annual deviation was only 0.4% of the GDP from 2013-14 to 2015-16. In fact, in the first year, 2013-14, the deficit was budgeted at 6.3% of the GDP and turned out to be significantly lower at 5.5% of the GDP.

The tendency towards large deviations became visible in the first year, 2016-17, after the end of the IMF Programme, when it approached 2% of the GDP.

What explains the much higher deficit than targeted in 2017-18? The shortfall in net federal revenue receipts accounts for 57% of the deviation of Rs 780 billion. The remainder, 43%, is due to the lack of generation of cash surplus by the provincial governments.

Interestingly, total Federal expenditure was almost exactly on target as per the original budget estimates, with a deviation of only 1%. However, this hides the large extent of deviation in different components of expenditure. Current expenditure was higher by Rs 337 billion over the budget estimates, especially on debt servicing and defense expenditure. Consequently, development expenditure, especially on the Public Sector Development Program, had to be cut back massively by an equivalent amount. If this has not been done, the consolidated fiscal deficit in 2017-18 would have exceeded 7.5% of the GDP.

There are two possible explanations as to why deviations of the actual deficit from the originally targeted level have become so much larger in the last two years. First, unlike the period when IMF program performance criteria on the size of the quarterly deficit were present, there has been no such pressure on the MOF after 2015-16. Consequently, the fiscal effort has slackened on the revenue side and there has been lesser adherence to the budgetary limits on expenditure, especially on the current expenditure side. It is a sad testament to the quality of the budgetary process that the deficit had to be contained by a 34% cut in development spending in 2017-18. This is the expenditure mostly like to generate jobs, both directly and indirectly, and also help the economy in achieving a higher rate of growth. Estimates are that a cut of Rs 1 billion in the size of the PSDP leads to a loss of over 90,000 jobs.

Second, there may also be a growing tendency on the part of the MOF to overstate revenues and understate expenditures at the start of the year. The objective may to convince the Parliament that the Government is engaged in prudent fiscal behavior and thereby avoid an in-depth examination of the details of the budget. This precludes an objective and careful technical examination of the various budget documents.

Based on the experience of the last two years, is there a danger of faulty budgeting also for the on-going fiscal year, 2018-19? The answer unfortunately is a yes. The evidence presented below will indicate the extent to which revenues have probably been overstated and expenditure, especially on the current side, understated. The resulting estimate of the projected deficit for 2018-19 by the MOF is 4.9% of the GDP. This represents a big downward adjustment of 1.7% of the GDP from the actual level in 2017-18.

Total federal revenues are expected to show a handsome growth rate of over 20% in 2018-19 as compared to the growth rate of less than 12% last year. FBR tax revenues are projected to increase by 15%. This, of course, does not factor in the revenue loss of over Rs 90 billion due to the extreme income tax concessions announced in the Budget for 2018-19. Also, the base figure of revenues is inflated by the Rs 100 billion once-and-for-all revenues from the amnesty scheme. Therefore, a more realistic estimate of FBR revenues in 2018-19 is Rs 4228 billion. This implies that getting to the projected figure of Rs 4435 billion will require additional taxation proposals of over Rs 200 billion.

The most glaring overstatement is in other taxes, which are expected to yield more than twice the revenues in one year. Petroleum levy yielded Rs 179 billion in the previous year. It is expected to generate Rs 300 billion this year, a jump of 68%. At a time when the international oil price is high and possible rising, there is no space available to raise the flat rate levy, especially on HSD oil. Another over ambitious target is in the case of the Gas Infrastructure Development Cess, which yielded Rs 15 billion in 2017-18 and is now expected to generate Rs 100 billion this year. These projections appear to be almost wishful thinking by the MOF. Overall, Federal revenues in 2018-19 appear to have been overstated by over Rs 400 billion.

Turning to the expenditure side it is necessary to build in the cost of the increase in salaries, allowances and pensions announced in the budget of Rs 70 billion in 2018-19. This may, of course, be understated. The Provincial Governments have followed with similar increases in emoluments in their respective budgets. This will cost almost Rs 180 billion to the four Provincial Governments combined and contribute to a big reduction in the potential cash surplus to be generated by these governments as contribution to the reduction of the consolidated fiscal deficit.

The two major heads where Federal current expenditure is likely to be understated for 2018-19 are the cost of domestic debt servicing and defense services. The growth rate for the former is projected at only 5%, when interest rates are on the rise and the public debt has increased faster last year. Defense services had a budget allocation of Rs 920 billion in 2017-18. The actual spending was Rs 1030 billion, showing a relatively high growth rate of 16%.

The budget estimate for 2018-19 is Rs 1100 billion, only 7% higher. If the Armed Forces voluntarily join the national austerity effort launched by the new Government then this would be a great contribution. However, it is likely that total Federal current expenditure will exceed the budget estimates for 2018-19 by almost Rs 200 billion.

Turning to the development side, the Federal PSDP has been increased from last year's level by Rs 140 billion. This is a relatively modest increase and a cut of more than Rs 100 billion may not be feasible. In addition, there is likely to be pressure on the Government to engage in more lending operations to reduce the circular debt and improve the liquidity of the power sector.

Based on the above, it appears that the Federal Budget deficit has been understated in the estimates for 2018-19 by as much as Rs 600 billion. This includes the overstatement of revenues by Rs 400 billion and understatement of current expenditure by Rs 200 billion. In addition, given the rise in the emoluments of government employees and shortfall in transfers, the Provincial Governments are unlikely to generate any part of the targeted cash surplus of Rs 285 billion, like last year.

Overall, at this stage, it appears that the MOF has underestimated the consolidated fiscal deficit in 2018-19 by as much as Rs 885 billion. Based on the projected GDP, the deficit is likely to reach 7.2% of the GDP, as compared to the much lower target deficit of 4.9% of the GDP for 2018-19.

There is a pressure this year to strongly restrict the size of the fiscal deficit. Otherwise, the rise in aggregate demand will exert further pressure on the level of imports and worsen the current account deficit. Estimates are that Rs 100 billion higher fiscal deficit increases imports by $ 400 million.

The government may consider presenting a revised and more realistic budget soon for 2018-19, valid for the last three quarters of the year. The target deficit will need to be kept unchanged at 4.9% of the GDP. However, the revised budget will need to contain new taxation proposals to generate additional revenue of Rs 400 billion.

There will have to be also an overall expenditure cut of Rs 200 billion, through the austerity drive and reduction in the size of the Federal PSDP. The Provincial Governments will also need to be motivated to exercise strong economy in their current and development expenditures and mobilize more resources.

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