

PRE-BUDGET ANALYSIS

FY 2019-20: The Mind Boggling Budget Math

SYED FARAN RIZVI

FY 2019-20:

The mind boggling budget math

SYED FARAN RIZVI

Islamabad Policy Institute, Pakistan

- ❖ The announcement of **Rs5.55tn tax revenue target** is disconcerting at the very least. Even under a nominal GDP growth rate assumption, marginal revenues would land between Rs400-500bn, leaving us with a **monstrous shortfall** of ~Rs1tn in *additional* revenues. The FY20 revenue target has undoubtedly led us to an uncharted territory. **It is unsettling therefore that the incumbent Finance Minister breezed past the tax target in its official announcement.**
- ❖ Under the current circumstances, it is fair to assume that **the government will have to leave no stone unturned in its quest to achieve the set target.** Given that indirect taxes have empirically been the quickest route to higher revenues, **GST seems to top the hit-list:** a 1% increase (we pray for no more) can be expected in the upcoming budget. The corporate sector is expected to feel the burn too as the **29% tax rate may be continued.** Additionally, **re-imposition of the Super Tax** (in principle at least) on non-financial corporations must not be ruled out while an **increase in turnover taxes** remains a strong possibility. Achieving the humungous target will be difficult; that much is certain as the economy limps into FY20. The newly appointed Chairman of the FBR is hopeful of fruitful results as he plans to document the grey economy. While even the mention of such novel ideas is refreshing, deteriorating economic conditions remain an unfortunate drawback. Nevertheless, **time will be the best judge: the next three odd months should be critical to give us a glimpse of their eventual outcome.**

While rebranding the clichéd amnesty schemes under the banner of the ‘Asset Declaration Ordinance’ may seem like a good start going into the next fiscal year, **we feel that the ‘stick’ in the Carrot and Stick approach (something that had set this scheme apart from its predecessors) remains elusive.** Furthermore, Chairman FBR has made two broad claims: (1) it is being used as an economy-documenting tool as opposed to a revenue-generating one (something we don’t quite agree with) and (2) it has been launched in conjunction with the Benami Act. Regardless, we are running out of time. In the words of the great poet Faiz Ahmed Faiz, “Hum Dekhain Gay” (we will see).

- ❖ Now, as the government gears up to collect record revenues under an IMF program, **we long to see the changes that will be brought about in customs duties/import tariffs.** This is because in the not-so-distant past, policies to open up the economy practically destroyed our trade balance leaving us with an unsustainable import-led economy. If we are to make up for our past mistakes, it is essential to realise that the country is in dire need of **import curtailment on an urgent basis.** Otherwise, the stabilization goals for FY20 will remain a dream.

- ❖ Moreover, we would like to share the following excerpt from our note on the finance minister's press conference which highlights some additional points worthy of attention:
 - *The massive revenue target has created some tremors among existing tax payers; however, the government has clarified that it has **no intention of overburdening this segment**. This is another point that leaves us agape, yearning for some clarity on how exactly then would the government achieve the alarmingly high target.*
 - *The icing on the cake is that the government is still planning to increase federal **PSDP expenditures** to Rs925bn (from this year's Rs550-600bn) in addition to increasing funds for the **social safety net** (such as increasing electricity subsidy by Rs50bn to Rs216bn and almost doubling cash transfers for e.g. under Ehsaas program to Rs180bn). In this regard, a major challenge for the govt. will be quarterly IMF reviews, where **if the targets are not met, it will become very difficult to continue with these social relief packages**. Besides, PSDP has historically been the first item to face the axe in times of austerity.*
 - *As far as **defence expenditure** goes, in the earlier part of the press conference the Finance minister mentioned possible need for austerity measures from both civil & military institutions. However, he later on emphasized that safeguarding national sovereignty remains a top priority, given our difficult neighbourhood.*
- ❖ In a way, the upcoming budget can be viewed as the **antithesis to the previously announced 'mini-budgets'** since most of the incentives announced in the latter will almost certainly be done away with in the upcoming budget. In addition, another major development is **abolishing the zero-rating status** for the five major export sectors (most visibly textiles).
- ❖ News flows suggest **resumption of income taxes on salaries below Rs1.2mn per annum**. This will be in addition to **restoration of taxes on mobile phone cards** as per the Supreme Court's decision. Interestingly, the verdict on mobile phone cards was announced right after the appointment of the new finance minister. That said, these taxes would lead to further demand compression as they will directly affect disposable incomes. **This is notably coming at a time when inflation seems to be barging headfirst into double digit territory.**
- ❖ We would like to highlight that one item in the IMF press release which stood out is the **primary deficit** target of 0.6% of GDP. In the midst of all the expected stringent conditions, it appears the IMF has allowed some breathing room. Considering that our debt repayments make a significant portion of our total expenditures, the IMF has so far opted to set a primary deficit target instead of mentioning the traditional fiscal deficit

(further details will unfold once the program is unveiled). **While this may sound less severe for now, it is merely a reflection of the gravity of our debt obligations.**

- ❖ **The long debated topic of applying a uniform Capital Gains Tax (CGT) on different asset classes (real estate and equity) may finally be settled.** However, not in a way we had expected: instead of decreasing the CGT applicable to equity stocks to match that of real estate, the CGT on real estate may be increased to match that of equity stocks. For all other aspects we expect status quo to prevail. In reality, the major positives from the market's perspective have already taken place, i.e. ahead of the budget, namely the **market support fund** and the **softening of rules pertaining to buyback of shares** by listed companies. Hence, one logically should not expect any major relief measures for equity markets.

Expected budget measures on sectors

- **Cement:** As mentioned earlier, the ambitious PSDP budget set for FY20 may well be revised down in due course. In this scenario, the demand for cement will undoubtedly be dented. Even though GST is a pass-through item, any increases could make industry players uncomfortable at the very least. Additionally, manufacturers who had booked tax reversals on account of reduction in future tax liabilities could face a one-off hit if the corporate tax rate stays at 29%. Moreover, increase in turnover taxes would not bode well for the players. We believe that the possibility of a reversal in the custom duty reduction on import of coal cannot be discarded. There is also the chance of an increase in FED in the range of Rs0.50 to Rs1.00 per kg. It is expected that GIDC may be replaced by FED.
- **Steel:** Currently, GST on steel scrap is fixed in absolute terms at Rs5600/ton under the special sales tax treatment. However, change towards a fixed percentage rate in this regard could negatively affect long steel producers. Other than this, effects of PSDP, Corporate tax and turnover taxes would be the same as those mentioned in the Cement sector.
- **Autos:** News flows suggest that the 10% FED on 1,700cc+ cars might be removed in the upcoming budget since it has adversely affected volumes of 2 local OEMs. Although recent news pertaining to the budget has generally been accurate so far, we opine that the FED removal would go against the government's current agenda of increasing tax revenues. If anything, the FED might be reduced, but not eliminated altogether, in our view. In the same vein, it is unlikely that the SRO to curb used car imports would be lifted in the coming budget. Similarly, we do not expect any relief for tractor assemblers in terms of reduced GST.

- **Textiles:** To say news related to the textile sector has not been too bright would be an understatement. Recently, there has been news of removal of zero-rating status for textiles, which would undoubtedly be negative for the sector. There are ominous signs that subsequent governments are almost out of patience with the sector for their inability to boost exports despite disproportionate incentives. Expect no further relaxation for the sector in terms of import duties on cotton, whereas there is a possibility that GST on local sales might be increased to tilt the scales in favour of exports. On the plus side, there is optimism that the sales tax refunds issue might be resolved (or alleviated at least) in the coming days.
- **OMCs:** The sector may have to face some difficult times ahead. Currently the government has the choice of adjusting GST to absorb the impact of higher oil prices. However, if the GST rate is fixed, the government be stripped of this option and will be left with no choice but to pass on the price increases, undoubtedly denting the demand for POL products. Furthermore, it goes without saying that any increase in turnover tax would be negative for industry players.
- **Power:** As Sukuk tranches can only offer short term relief to players in the power sector, the IMF has opted for its signature remedy of increasing prices of utilities. This step would not only bring liquidity into the power sector, it could be a major development in addressing the circular debt menace.
- **Banks:** We expect no major changes in Banks except increase in tax on investments in government instruments. This would negatively affect earnings of banks. However, one key event in the IMF backdrop would the Treasury Single Account (TSA): while its implementation could constrict liquidity, we will have to wait for further developments on the issue.
- Some additional sectors that could feel the brunt of GST or FED hikes include **Consumers, Chemicals, Fertilizer, Sugar and Tobacco**. Fertilizers in particular enjoy significantly lower GST (~2%) on Urea and DAP which, if brought at par with that of the other sectors, could result in significant price hikes. Additionally the impact of replacing GIDC with FED currently remains a question mark and we will have to await further details on the matter.
- Other sectors for which we believe the new tax regime could be a non-event (for now) include the **Oil & Gas upstream (E&Ps and Refineries) and Pharmaceuticals**. However, given the FY20 tax target, novel ideas such as carbon emissions tax may be introduced (the Prime Minister has already ‘given his blessings’ for the same to be implemented in Punjab, as per news sources).

Crux of the matter

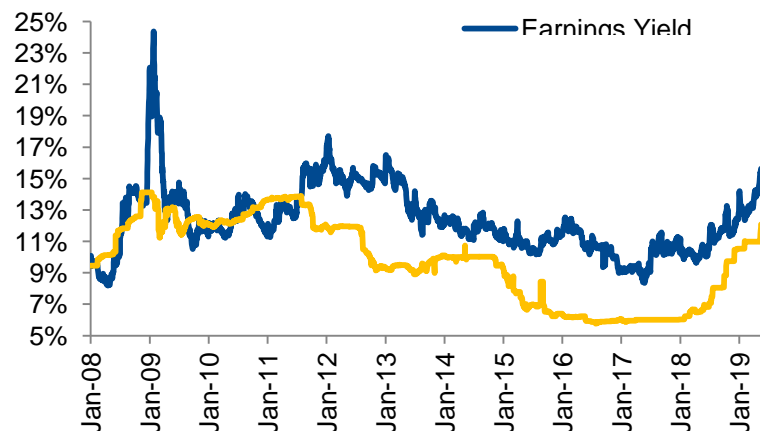
- ❑ The recent downward spiral of the KSE-100 began as the IMF deal was signed. It is fairly logical to assume that the same will determine the fate of the equity markets henceforth.
- ❑ The external account will continue to dictate monetary and fiscal policies with dark clouds still hovering over the PKR outlook.
- ❑ The most obvious aspect of the FY20 budget is the bizarre tax revenue target which has surprisingly not received its merited attention. It goes without saying that the government will leave no stone unturned in achieving this target under an IMF program.
- ❑ A major challenge will be periodic IMF reviews where if the targets are not met, it will become very difficult to continue with social relief packages. Besides, PSDP has historically been the first to face the axe in times of austerity.

As rising inflation and falling disposable incomes deplete purchasing power, coming out of the quicksand may not be so easy for the stock market

Market performance and developments on the IMF



The narrowing gap makes a



Reality under an IMF flag

If we look back, it was during April-2019 when the market acquired a squeamish tone, staying jittery for the majority of the month. **Coincidentally, this was about the same time when IMF news flows began to gather steam**, culminating in the mid-April IMF/World Bank Spring Meetings in Washington D.C. (which eerily happened to be the last high level meeting of the

previous finance minister). This led to the news that an IMF mission would be visiting Pakistan for further talks on yet another fund program by the end of April. These meetings commenced from April 29 (lasted for over a week) and it was at this very same time that the market gave up all pretence and virtually began to nosedive. In contrast, one strong narrative doing rounds had been of IMF as the messiah for the plight of the equity market. And experts following this school of thought would most likely have been the ones expecting a sharp turnaround in market performance following the IMF visit. **Yet, as is now in plain sight, the situation has been almost the opposite.** And quite possibly, this would have come as a big shock to some. In fact, this reaction in itself would be surprising, considering that in recent months (specifically the latter half of CY18) **the equity market has treated IMF news with a good degree of trepidation.** We share here an excerpt of a response that we put forward within our CY19 Strategy Report on this very same topic.

“...The equity market has been unable to take a clear stance relating to IMF news flows. At the same time, ‘experts’ have steadfastly overhyped the significance of an IMF package. Truth be told, so far the equity market has either reacted negatively (Sep 27th to Oct 4th) or cautiously at the very least (Nov 7th to 20th) to any news break in favour of an IMF program.”

Walking in circles – right back where we started

One often hears fables of **decent returns in tandem with IMF programs.** Even if the market was to provide handsome returns it should not be taken as a major achievement, considering the bloodbath of preceding months. One need not go too far back in history (Dec-18/Jan-19) where some were expecting that markets had bottomed out, interest rates peaked and the Rupee sufficiently devaluated. Yet the market stayed bearish and macro indicators worsened. Now, **we are back in the same situation with vibes of a feel good factor.**

Specifically, while the market has picked up in recent days (courtesy of the market support fund), peaked out interest rates (post the latest 150bps hike) and a stable currency (following recent devaluation) are being advocated in some corners. Is this a repeat telecast or will the market truly recover is what remains to be seen.

External account: the mother of all evils

One ponders what has happened to the equity market in recent years as one piece of bad news has followed the other (Panama leaks, worsening twin deficits, IMF, Pulwama attacks, etc.). Frustratingly, it seems that the wave of misfortune will not subside at least in the short term. In our view, **the most critical issue that needs to be resolved is the external account – there are still dark clouds over the rupee outlook.** Resolution of this issue will be of paramount

importance; otherwise a deteriorating external account could further bear down heavily on the performance of fiscal and monetary policies.

Exchange rate woes to continue

In the context of the external account, we have yet to obtain sufficient clarity on the things that matter most, namely solutions to the **financing gap, or the size of the gap itself** in the first place. Constrained by these information limitations, we believe that the US\$6bn IMF package is insufficient even as a short-term fix for the external account. At the same time, there has been no light shed on any potential debt rescheduling to date even with IMF. For example, if the country is to receive US\$2bn in FY20 from IMF, news flows suggest that ~US\$0.75bn will be eaten up by debt repayments leaving us with ~US\$1.25bn per year. Similarly, emerging news also give **we assume that the rupee has stabilized, it would imply that all the external funding requirements are being** the impression that this IMF program is actually worth US\$3bn rather than US\$6bn taking into account repayments to IMF. Simply stated, looking from an exchange rate context, **if satisfied by an equal amount of inflows, whereas right now we are teetering at the very edge**. Timing of FX inflows becomes ever so important in such situations. For instance, over ~US\$1bn is expected in Jun-19 as per news flows and since we have not heard of any balance of payments support from any major funding sources, it will become inevitable that the debt repayments will be met via FX reserves. It goes without saying what this outcome will mean to the fate of the local currency.

In this context, we share an excerpt from our recent commentary on the twin deficits release

“In 10MFY19, CAD has averaged over US\$1bn per month, which in our view is still unacceptably high, despite being 27% YoY lower. For one, it would be unwise to compare this year’s external account performance with FY18’s unsustainably high number. Needless to say, we do not buy into this narrative of exceptional performance on the external account as quite simply more needs to be done on this front. In our view, significant improvement in external account would result only if CAD is restricted within US\$5bn per annum. As we had indicated earlier, one eye needs to be kept on the financial account, which has become more relevant now than perhaps at any other time in recent memory.”

Deficits, charts and the wait...

Ironically, our annual strategy report for CY19 was titled ‘deficits, charts and the wait,’ which in itself carried negative connotations in our view. The **wait** is seemingly over (IMF staff level agreement clearly signalling that we have opted for IMF). **Charts** have further worsened (after the infamous bearish crossover formed as the market fell below the 38k level) whereas **deficits** remain a serious challenge (controlling which will define the rest of 2019 or maybe even the entire FY20). We would like to share an excerpt from the start of our strategy report here.

*“2019 could be the bitter pill we have to swallow given our excesses in the previous few years. Time is of the essence since we need emergency funding to counter risks that have arisen from unsustainable import-led growth of the past. **For 2019, nothing else matters other than how the economic scenario unfolds. Make no mistake that we are economically worse off now than during the previous two IMF entry points (2008 and 2013) and our external funding plague will continue to infect our monetary and fiscal policies in 2019.** Due to the crisis-like situation at present, the government’s explanation that the issues stand ‘resolved’ is clearly not being digested by equity and fixed income markets. Quite possibly, even the IMF team would have been left perplexed by the government’s ambitious rhetoric. **What more can be said when even the charts tell the same story? Technically, the market should find support at these levels. If not, it would not be a pretty sight.**”*

Another excerpt suggesting **safe entry levels (which basically fell victim to the bearish crossover)** is as follows:

*“In our view, **equity valuations have still not fully absorbed the severity of the economic slowdown**; the impact may reflect in the upcoming quarterly earnings’ announcements. This leads us to believe that **a tipping point lurks round the corner, independent of the funding gap scenario.** Therefore, we recommend a strategy of building equity exposures on those dips (**below 38,500 levels**) to fully exploit the rare opportunity.”*

Attractive valuations?

Although a general theme at the start of the year revolved around attractive valuations, we had specifically mentioned that this was not entirely true as the **gap between the earnings yield and bond yield had significantly narrowed**, reducing the attractiveness of equities over fixed income instruments. Moreover, valuations did not seem too bright due to the fact that the P/E multiple was hovering close to its historic average.

As far as earnings’ growth is concerned, barring banks, news flows ahead of the upcoming budget should be sufficient in silencing any optimism in our view. Besides, earnings visibility remains extremely clouded.

For **interest rates**, we would prefer not to buy the inverted yield curve notion in haste. The unfolding scenario on inflation, particularly after the budget, will probably determine the fate of interest rates in the near future. Moreover, headwinds over the rupee outlook will also continue to influence monetary policy decisions. The previous finance minister recently disclosed in a recorded public discussion that the **IMF initially wanted interest rates hiked up to 21%, given 19% YoY initial expectations for inflation!** Only time will tell if we will reach such a calamitous situation. On the bright side, oil prices have begun to correct, and we pray that this trend of softer oil prices continues unabated!