Issue Briefs

Islamabad Policy Institute

Supporting Dialogue for Peace & Development

CRISIS BUDGETING DURING COVID-19 PANDEMIC

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Pre-Budget Analysis

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Islamabad Policy Institute, Pakistan

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Syed Hussain Haider

The latest update is that COVID-19 is now firmly entrenched within every nook and cranny of the developing world. Pakistan is now ranking consistently among the top countries (in terms of new cases). Another important trend of late has become easing lockdowns compared to the previous global emphasis on 'flattening the curve' and this easing is irrespective of whether the curve is flattening or steepening, putting developing countries such as Pakistan at extreme risk. Yes, Pakistan cannot afford the luxury of a complete lockdown, but easing is only feasible under stricter controls with effective communication and harmony among the center and provinces.

Recent GDP growth estimates for FY20 suggest a 7.5-12% contraction in the economy in 4Q alone, which gives an inkling as to how FY21 might pan out. The base case should be flattish or slightly negative GDP growth in FY21. Corporate earnings during Mar-20 show a QoQ/YoY decline in most sectors and this is without the COVID-19 impact! With the FY21 Federal Budget around the corner, the focus should undoubtedly be growth, employment generation and reducing income inequality. To do this, it is vital to provide liquidity for emergency needs in the economy, promote investment and develop a savings culture.

A casual onlooker might think, based on recent evidence, that there is a mutually exclusive set of causal factors for both financial markets and the real economy as both appear to be heading in separate directions. The reason of course is that markets are forward looking and appear to be betting on an early recovery from COVID-19, coupled with expectations of a 'sympathetic' budget. With the market trading at FY21F P/E and P/B of 6.2x and 1.03x respectively (Bloomberg estimates), it is quite clear to everyone that valuations are immensely attractive from a longer term perspective. The challenge remains the near term COVID-19 infected outlook, which remains hazy at best.

Pakistan's reaction and response to the Coronavirus was not too dissimilar to that of most countries as it followed conventional wisdom. The differences, if any, arose on the basis of the available means and resources at the government's disposal compared to developed countries, for instance. A lockdown was imposed along with fiscal and monetary stimuli disbursed. Yet, perhaps one area that could have been managed a bit better was the flow of official communication and the political friction during this period. Then, once the process of easing the lockdown began, it would maybe have been prudent to do so with the aid of various 'law enforcement agencies' to control the more rogue elements. Perhaps one factor that might have been overlooked is that while other countries have also eased lockdowns, they have done so after firmly flattening their respective curves. Delegating responsibility and hoping the people exercise restraint is not exactly the wisest measure, particularly in a developing country.

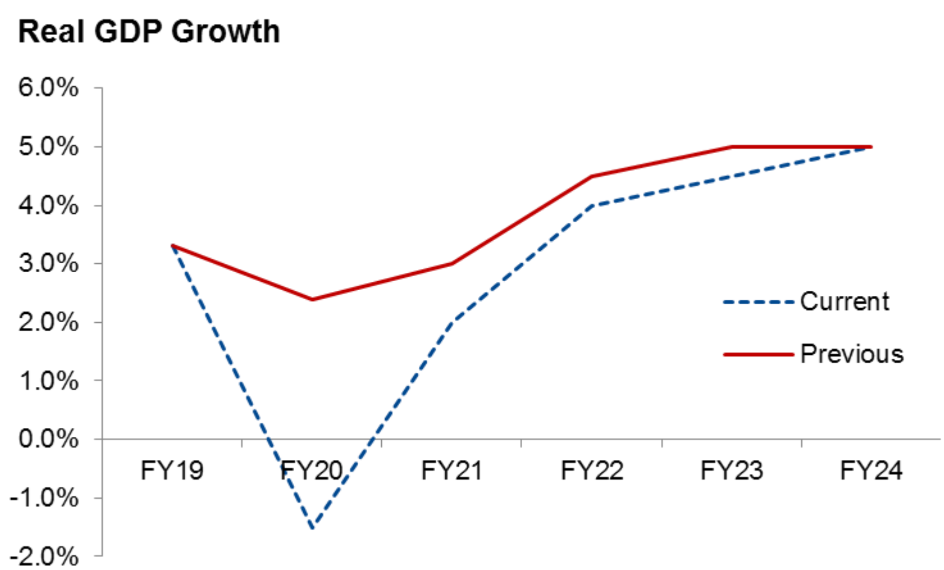
In any case, most governments have faced rancid criticism for coming late to the party, so to speak. Yet our case is unique, considering we share borders with China and Iran, two of the earliest recipients of the disease. Prudent and timely control measures at the borders would have been a much easier exercise than controlling a pandemic that has permeated on a local scale.

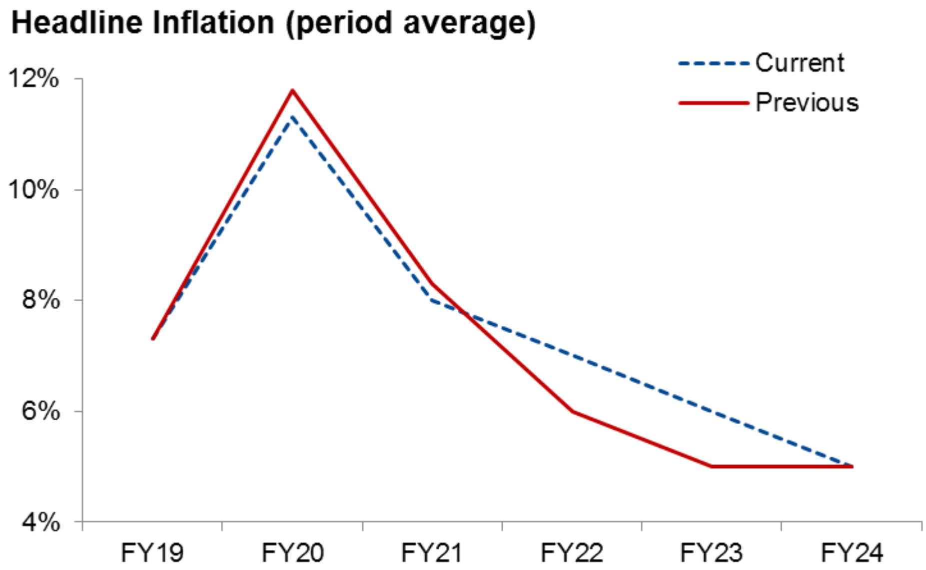
Economy: The good, the bad and the future

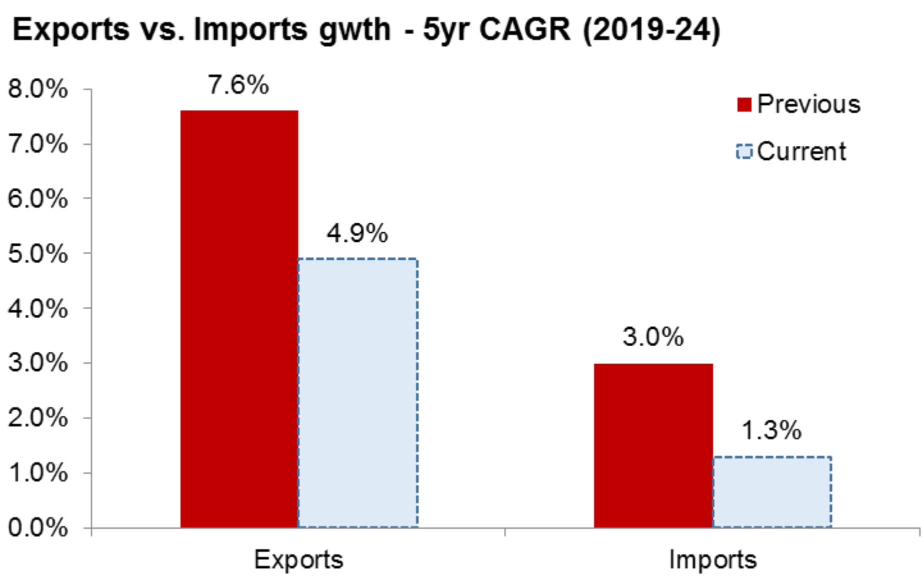
Looking at the provincial estimate of 0.38% GDP contraction in FY20, this would imply a 7.5% contraction in 4Q alone! And this 4Q decline worsens to -12% if one considers IMF's -1.5% forecast for FY20. And these numbers have not been plucked out of thin air. There has been an overall decline across multiple fronts. Large-scale manufacturing (LSM) plunged by 23% YoY in March alone (down 5.4% YoY in 9MFY20). Local cement dispatches declined by 38% in May, whereas automobiles registered zero sales in April. On the external side, exports and imports dropped by 33% and 24% in April, respectively. In FY21 owing to a low base effect and provided that COVID-19 is contained, we could see 2% GDP growth (which would be the best case scenario). If this is not to be, growth will most likely be flattish or might even end up slightly negative (which should be the base case).

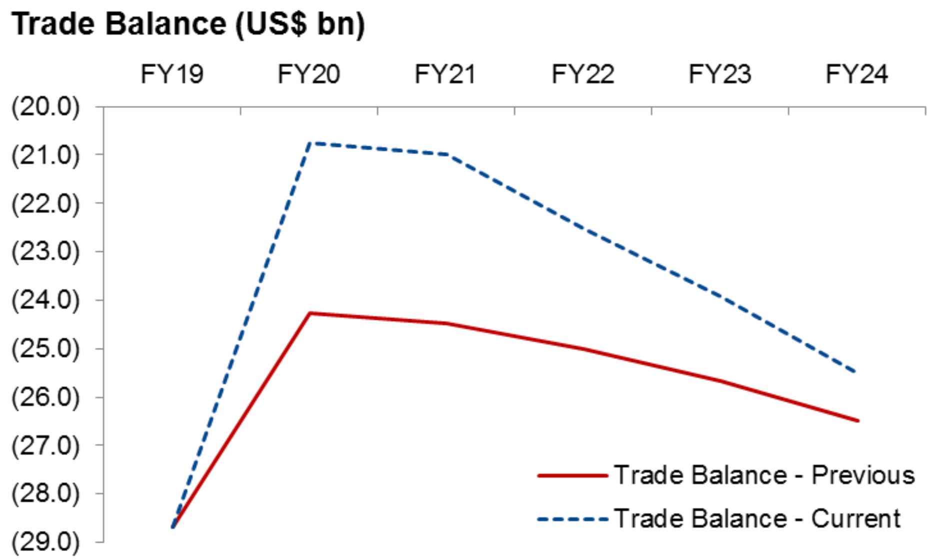
As far as the monetary vs. fiscal debate is concerned, efforts need to be ramped up on the fiscal side, which can, we believe, be more effective in stimulating growth. Besides, there has been significant monetary easing already and not much room is left in our view (100bps max). That said, if the pandemic situation worsens, God forbid, then further rate cuts cannot be ruled out and inflation will not remain a causal factor. In that case, a worst case scenario could entail a more than 2.5-3.0% contraction in GDP in FY21. However, this would be followed by a sharp recovery (over 5%) in FY22 owing to low base effect and, assuming the world is able to successfully produce a vaccine for the Coronavirus.

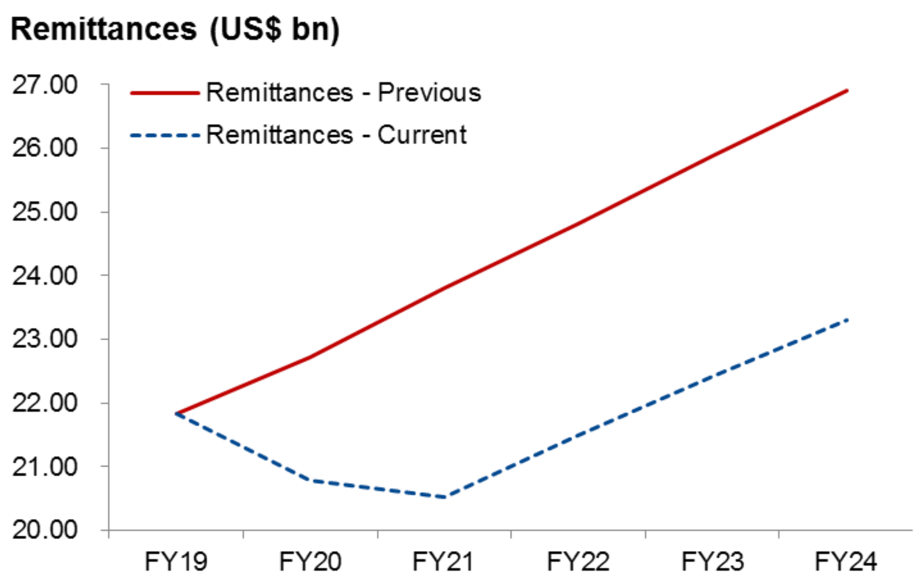
IMF Forecasts (Pre and Post COVID-19)



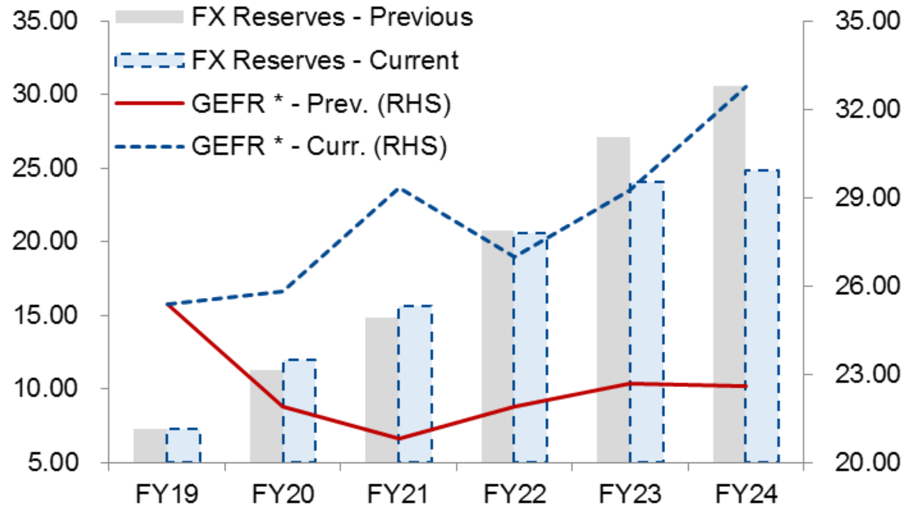

Headline Inflation (period average)
Current
Previous
12%
10%
8%
6%
4%
FY19
FY20
FY21
FY22
FY23
FY24


Exports vs. Imports gwth - 5yr CAGR (2019-24)
Previous
Current
8.0%
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
7.6%
4.9%
3.0%
1.3%
Exports
Imports

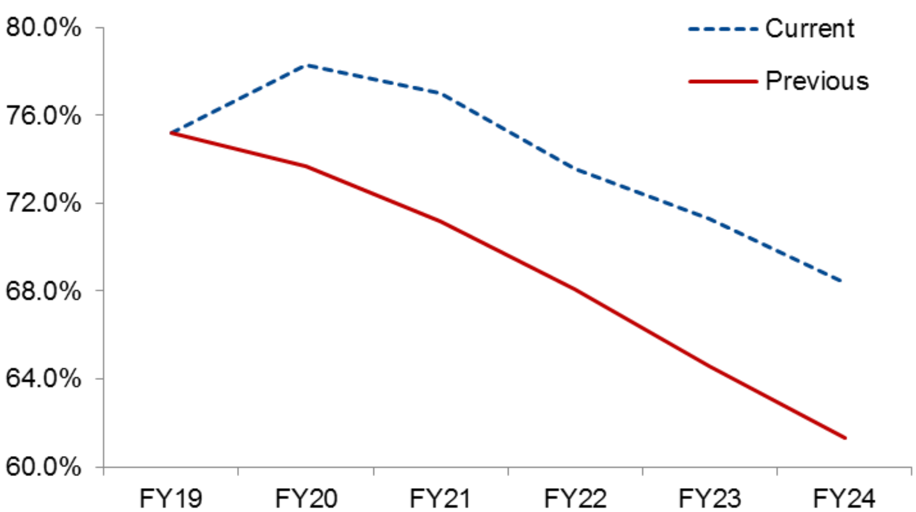

Trade Balance (US$ bn)
FY19
FY20
FY21
FY22
FY23
FY24
(20.0)
(21.0)
(22.0)
(23.0)
(24.0)
(25.0)
(26.0)
(27.0)
(28.0)
(29.0)
Trade Balance - Previous
Trade Balance - Current

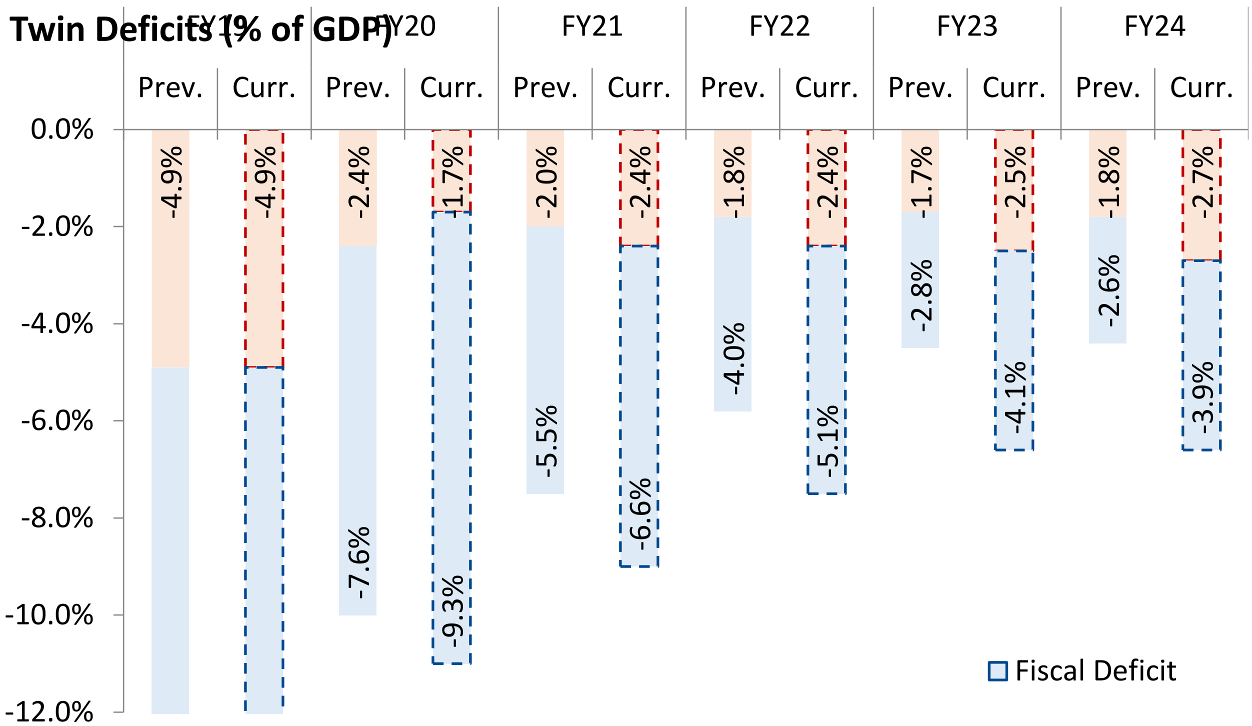

Remittances (US$ bn)
27.00
26.00
25.00
24.00
23.00
22.00
21.00
20.00
Remittances - Previous
Remittances - Current
FY19
FY20
FY21
FY22
FY23
FY24

FX Reserves & External Funding Gap (US$ bn)



Net Govt. Debt (incl. IMF) - % of GDP





		2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
		3.3%	**-1.5%**	**2.0%**	**4.0%**	**4.5%**	**5.0%**	**5.0%**
GDP	**(%)**	3.3%	2.4%	3.0%	4.5%	5.0%	5.0%	5.0%
		0.0%	*-3.9%*	*-1.0%*	*-0.5%*	*-0.5%*	*0.0%*	*0.0%*
		7.3%	**11.3%**	**8.0%**	**7.0%**	**6.0%**	**5.0%**	**5.0%**
Inflation	**(%)**	7.3%	11.8%	8.3%	6.0%	5.0%	5.0%	NA
		0.0%	*-0.5%*	*-0.3%*	*1.0%*	*1.0%*	*0.0%*	*NA*
		24.2	**23.7**	**24.8**	**26.5**	**28.4**	**30.9**	**33.9**
Exports	**(US$bn)**	24.2	25.7	27.8	29.9	32.3	35.0	NA
		0.0%	*-7.5%*	*-10.6%*	*-11.2%*	*-12.3%*	*-11.7%*	*NA*
		52.9	**44.5**	**45.8**	**49.0**	**52.3**	**56.4**	**61.4**
Imports	**(US$bn)**	52.9	49.9	52.3	54.9	58.0	61.5	NA
		0.0%	*-10.9%*	*-12.3%*	*-10.6%*	*-9.9%*	*-8.3%*	*NA*
		(28.7)	**(20.7)**	**(21.0)**	**(22.5)**	**(23.9)**	**(25.5)**	**(27.5)**
Trade Balance (Goods)	**(US$bn)**	(28.7)	(24.3)	(24.5)	(25.0)	(25.7)	(26.5)	NA
		0.0%	*-14.5%*	*-14.3%*	*-9.9%*	*-6.9%*	*-3.7%*	*NA*
		(13.8)	**(4.5)**	**(6.6)**	**(7.4)**	**(8.4)**	**(9.8)**	**(10.5)**
Current Account Balance	**(US$bn)**	(13.8)	(6.6)	(5.9)	(5.9)	(6.0)	(6.8)	NA
		0.0%	*-32.0%*	*10.7%*	*26.1%*	*39.3%*	*44.6%*	*NA*

		2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
FBR Revenues	(Rs bn)	**3,829.0**	**3,908.0**	**5,101.0**	**6,100.0**	**6,956.0**	**7,723.0**	**8,513.0**
		3,829.0	5,238.0	6,799.0	8,075.0	9,207.0	10,153.0	NA
		0.0%	*-25.4%*	*-25.0%*	*-24.5%*	*-24.4%*	*-23.9%*	*NA*
PSDP	(Rs bn)	**1,008.0**	**949.0**	**1,280.0**	**1,533.0**	**1,721.0**	**1,970.0**	**2,168.0**
		1,008.0	1,481.0	1,776.0	2,110.0	2,331.0	2,570.0	NA
		0.0%	*-35.9%*	*-27.9%*	*-27.3%*	*-26.2%*	*-23.3%*	*NA*
Fiscal Balance	(Rs bn)	**(3,445.0)**	**(3,916.0)**	**(3,061.0)**	**(2,676.0)**	**(2,392.0)**	**(2,527.0)**	**(2,536.0)**
		(3,445.0)	(3,389.0)	(2,781.0)	(2,264.0)	(1,764.0)	(1,772.0)	NA
		0.0%	*15.6%*	*10.1%*	*18.2%*	*35.6%*	*42.6%*	*NA*
Primary Balance	(Rs bn)	**(1,353.0)**	**(1,210.0)**	**(196.0)**	**350.0**	**838.0**	**928.0**	**1,035.0**
		(1,353.0)	(264.0)	463.0	1,064.0	1,614.0	1,790.0	NA
		0.0%	*358.3%*	*-142.3%*	*-67.1%*	*-48.1%*	*-48.2%*	*NA*
Govt. Domestic Debt	(Rs bn)	**20,732.0**	**22,577.0**	**23,994.0**	**25,122.0**	**26,238.0**	**28,207.0**	**29,927.0**
		20,729.0	22,049.0	23,732.0	25,037.0	26,062.0	27,638.0	NA
		0.0%	*2.4%*	*1.1%*	*0.3%*	*0.7%*	*2.1%*	*NA*
Govt. External Debt (incl. IMF)	(Rs bn)	**11,448.0**	**13,225.0**	**14,869.0**	**16,446.0**	**18,194.0**	**18,583.0**	**18,514.0**
		11,448.0	13,605.0	14,969.0	16,151.0	16,966.0	17,230.0	NA
		0.0%	*-2.8%*	*-0.7%*	*1.8%*	*7.2%*	*7.9%*	*NA*
Net Govt. Debt (incl. IMF)	(Rs bn)	**28,980.0**	**32,819.0**	**35,881.0**	**38,585.0**	**41,449.0**	**43,808.0**	**45,459.0**
		28,977.0	32,672.0	35,718.0	38,206.0	40,045.0	41,886.0	NA
		0.0%	*0.4%*	*0.5%*	*1.0%*	*3.5%*	*4.6%*	*NA*

	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
Current Account Balance	**-4.9%**	**-1.7%**	**-2.4%**	**-2.4%**	**-2.5%**	**-2.7%**	**-2.7%**
	-4.9%	-2.4%	-2.0%	-1.8%	-1.7%	-1.8%	NA
	0.0%	*0.7%*	*-0.4%*	*-0.6%*	*-0.8%*	*-0.9%*	*NA*
Fiscal Balance	**-8.9%**	**-9.3%**	**-6.6%**	**-5.1%**	**-4.1%**	**-3.9%**	**-3.6%**
	-8.9%	-7.6%	-5.5%	-4.0%	-2.8%	-2.6%	NA
	0.0%	*-1.7%*	*-1.1%*	*-1.1%*	*-1.3%*	*-1.3%*	*NA*
Primary Balance	**-3.5%**	**-2.9%**	**-0.4%**	**0.7%**	**1.4%**	**1.4%**	**1.5%**
	-3.5%	-0.6%	0.9%	1.9%	2.6%	2.6%	NA
	0.0%	*-2.3%*	*-1.3%*	*-1.2%*	*-1.2%*	*-1.2%*	*NA*
Govt. Domestic Debt	**53.8%**	**53.8%**	**51.5%**	**47.9%**	**45.1%**	**44.1%**	**42.5%**
	53.8%	49.8%	47.3%	44.6%	42.0%	40.4%	NA
	0.0%	*4.0%*	*4.2%*	*3.3%*	*3.1%*	*3.7%*	*NA*
Govt. External Debt (incl. IMF)	**29.7%**	**31.5%**	**31.9%**	**31.4%**	**31.3%**	**29.0%**	**26.3%**
	29.7%	30.7%	29.8%	28.8%	27.4%	25.2%	NA
	0.0%	*0.8%*	*2.1%*	*2.6%*	*3.9%*	*3.8%*	*NA*
Net Govt. Debt (incl. IMF)	**75.2%**	**78.3%**	**77.0%**	**73.6%**	**71.3%**	**68.4%**	**64.5%**
	75.2%	73.7%	71.2%	68.1%	64.6%	61.3%	NA
	0.0%	*4.6%*	*5.8%*	*5.5%*	*6.7%*	*7.1%*	*NA*

An Empathetic Budget

One has to sympathize that this has to be unquestionably the toughest time possible to be formulating a budget, and lest we forget, setting revenue targets. A recently released IMF Staff Report, indicating expected growth of 30.5% in FBR revenues for FY21 (~Rs5.1tn) has been the talk of the town. Most informed people realize that IMF was following procedures, and achieving this growth, particularly in the given circumstances is next to impossible. One might recall that revenues were in the spotlight at this same time last year. Perhaps this year, the time has come to address the other side of the coin i.e. expenditures. There is a need for the authorities to pinpoint all those areas and niches where there is space to implement cost cutting measures.

Perhaps if one were to define a ‘Corona budget’, the appropriate answer would be that the underlying theme is growth and employment generation. Being cognizant of the risks at present, the following three pillars of growth that should be prioritized in the budget are: 1) Liquidity (first and foremost to meet bare necessities), (2) Promoting investments (job creation), and (3) savings (to create a saving culture to better deal with such catastrophes in the future). Finally, it goes without saying that tax reforms, revenue generation and documentation of the economy should remain cornerstones of the budgeting philosophy. These are much more critical in our view than the more widely discussed (in recent times) 18th Amendment and NFC award.

FY21 Budget Recommendations

During these difficult times, a relief in indirect taxation could go a long way in benefitting the masses. The resultant loss in revenue may be partly offset by a renewed focus on direct taxes such as Imposition of a wealth tax on high net worth individuals and corporations. For this purpose, connecting NADRA and FBR databases would not only increase documentation but would also assist in seamless revenue collections.

In addition, an alternative minimum tax (AMT) can be considered, similar to what is being employed in the US to minimize tax avoidance/tax evasion. The AMT adds back certain deductible items back into gross income to calculate taxable income.

Rationalization of sales tax should be considered with blanket application across the board. Moreover, to encourage documentation, there should be a refund facility for end consumers of say, 2% or 3%, provided the necessary invoices and proof of ST payment is shown. In that case, buyers will demand the necessary invoice to avail the refund.

It is high time to pause and reflect on how to revamp the existing tax base. Those areas which have a significant part in the economy but a disproportionately lower contribution to the national exchequer can no longer be absolved. In this regard, perhaps a hard look at land and agricultural reforms is of utmost importance.

To improve institutional governance, particularly in these times of fiscal pressure, rightsizing is of paramount importance in various institutions, including reducing the size of the government and elimination of overlapping functions of various arms and ministries. Similarly, loss making PSEs will have to be privatized on an emergency basis.

For SMEs struggling to afford rental payments in the pandemic, the government can assist by providing a tax credit to land/building owners for a minimum 25% concession in rent, where the tax credit would be equivalent to the amount of the concession.

Making salary deductions and employer contribution towards provident funds optional for the next three months should address some liquidity concerns of individuals while giving employers some breathing space.

Provide support to micro finance institutions to effectively and efficiently penetrate the local market. Provide incentives to encourage further investment in the field of micro finance banking. This will enhance the scope of cheap financing and provide access to liquidity to SMEs and individuals outside of the documented economy.

The turnover tax for companies may be cut in half at least for industries that have not been profitable in recent years and the time period to avail tax credit should be increased from 5 to 7 years.

Minimum pay-out ratio (dividend distribution) which was reduced to 20% in the last Budget should be completely waived to allow needed cash flows to companies.

Special incentives should be provided to reinvigorate the economy by encouraging capital investment.

For companies to embrace technology and innovation that helps them become export competitive. 20% tax credit (on all sources financing) and waiver of duties on import of Plant and Machinery would be helpful.

In the interest of export diversification, sectors other than textiles should also be given a fair chance at supporting the economy. Imports of machinery should be given waivers in customs duty and WHT.

Minor taxes that hinder ease of doing business should be eliminated.

Public Private Partnership should be a viable option for PSDP projects as it would cushion the fiscal deficit impact. The PSDP budget should be at least equal to last year, if not higher.

There should be minimum disparity in the KYC/ documentation/ taxation regime for various investment avenues and asset classes. A case in point is equities vs. real estate.

Focus on Capital market reforms in consultation with relevant stakeholders to provide incentives and attract investors in line with global best practices. Such as removal of or reduction in Capital Gains Tax (CGT).

Create a Tax Free Savings Account (TFSA) which would be registered with the relevant regulatory bodies, with a maximum ceiling per annum. The aim is to try and develop a saving culture among the masses. If an individual saves a certain portion of income every year in the TFSA (or for instance invest the same in the stock market), no taxes should be applicable on that income.

A one-time incentive needs to be provided to encourage technology transfer and dramatically increase localization in the country. For e.g., every time demand for automobiles increases this will pose an adverse impact on the external account. Higher localization is the only win-win solution for the sector and the overall economy.

To rationalize the taxes on passenger cars, the FED on smaller/cheaper cars should be reduced or removed; whereas the FED on luxury cars should be maintained or increased. Similarly, to protect the external account and enhance revenues, the FED on imported CBUs should be increased.

Electric Vehicle (EV) manufacturing needs to be prioritized with adequate incentives to the private sector to invest in charging stations across the country.

The preferred transport option given the nature of our economy should be public transport (this will also lead to lower traffic congestion in major cities and lower fuel imports). Car ownership needs to be significantly more expensive in relative terms than public transport. But for that, urban transport infrastructure needs to be highly reliable and efficient.

Incentives should be provided to manufacture electric and hybrid buses, particularly for congested cities.

Cargo transportation via rail is more economical than trucks. Special measures need to be taken to revitalize the rail transportation infrastructure. Same applies to passenger transportation via rail.

To increase the effectiveness of the government's commendable construction package, the following measures are recommended:

The FED on Cement should be reduced to half from the existing levels as current pricing is not feasible for manufacturers. A reduction in FED will help reduce construction costs and make housing more affordable, also generating higher revenues for the government.

Steel scrap is assessed significantly higher than its actual value for taxation purposes, leading to an uncompetitive local industry. Valuations should be determined keeping an eye on reliable indices such as the London Metal Exchange.

The existing 4% Super Tax should be withdrawn from the banking sector, aligning it with other sectors, as it only contributes Rs10-12bn per annum to the country's annual tax collection. The 4% Super Tax for banks is in addition to the higher corporate tax (35%) it has been paying.

Steps should be initiated to bring down the all-time high currency in circulation and encourage deposits, where one of them could be removal of WHT on banking transactions.

Tax anomalies need to be removed, such as the prevalence of gap in input/output tax in some industries such as IPPs and tractor manufacturing, where input taxes are higher than output taxes, leading to accumulation of tax refunds and cause a liquidity burden on the relevant industries.

Tax laws need to be reassessed with input from relevant industry players to assess any unforeseen irregularities. One example is the case where a company acquiring a loss making entity (as a subsidiary) to avail tax benefits cannot receive the said benefit until a period of 5 years has passed after which the company should remain unprofitable for the benefits to be redeemable, which is seldom the case.

As is no secret, smuggling needs to be minimized as it leads to massive tax revenue losses. One clear example is the case of tobacco products. One suggestion is the deployment of covert task forces at retail points and subsequent application of punitive measures to discourage sale of smuggled products.

Increase healthcare expenditure and provide duty exemptions for the procurement of plant and machinery for the manufacture of pharmaceutical APIs. This will decrease our reliance on neighboring countries and improve FX flows.

Last but the not least, discussions within the business grapevine suggest gross misdeclaration and under-invoicing at the import stage and the same has often been highlighted in print and visual media. Perhaps there is a need to reform Pakistan Customs and encourage hiring of university graduates as officers. Another suggestion would be to revamp the CSS curriculum to make it more appealing to the youth which often shuns it in favour of the private sector.

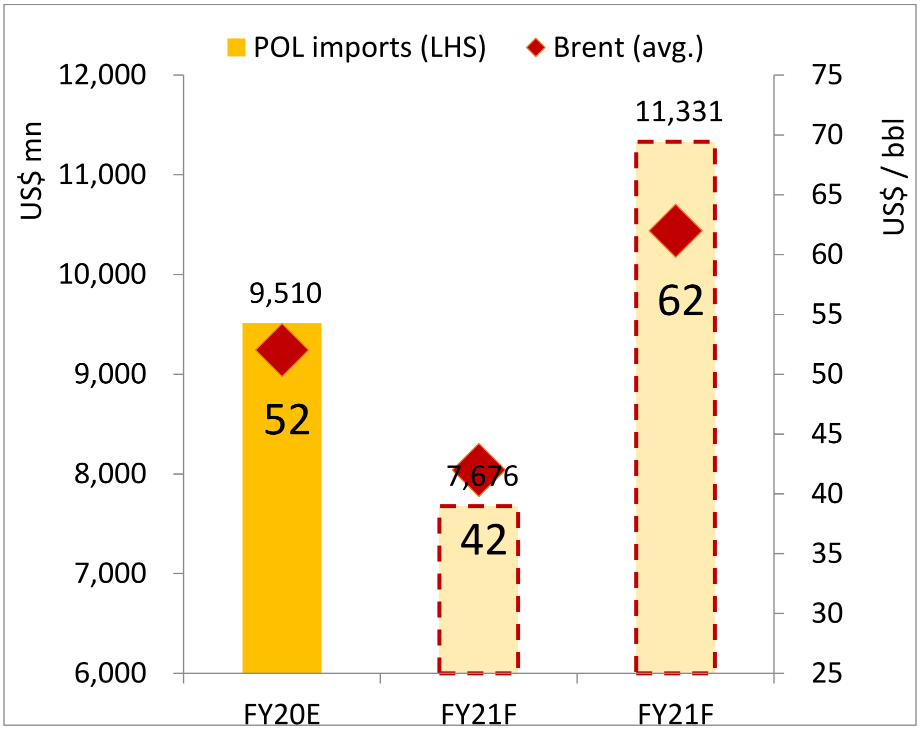
Exchange Rate (PKR): Embrace the volatility

After a few months of blissful stability, the exchange rate outlook has yet again been in the spotlight in recent weeks. SBP's FX reserves have plummeted by US$1.7bn WoW (14%) in the latest reading alone, whereas the declining trend is now four weeks long. In fact during this period we have also received US$1.4bn from IMF under emergency funding. The official narrative is that there is sufficient funding available to maintain rupee stability. The last time some pressure was witnessed on the rupee, some were even predicting Rs200/US$ but the rupee actually ended up appreciating. At the same time, intra-day volatility and medium term gyrations will be part and parcel of the exchange rate, as with any other floating currency or commodity or security. However, we concur with SBP's views and reiterate that the overall exchange rate outlook remains stable. If the situation does deteriorate further, as far as the Current Account is concerned, declines in exports and remittances are most likely going to be largely offset by a decline in imports. The main indicator to keep in the radar is the financial account. It is crucial that net inflows in the financial account sustain and by the looks of it, it appears that this will indeed be the case.

Oil price sensitivity to POL import bill

Assuming the current oil price (US$42.5/bbl) will prevail through FY21, the estimated savings for the year would amount to US$1.75bn (0.6% of GDP). *

For this impact to be extended to 1% of GDP, oil prices will have to average at US$37.5/bbl during FY21, assuming no change in quantity imported.



Rising debt inevitable amid COVID-19

The oft-discussed debt levels of Pakistan have been consistently on an increasing trend, currently at over 80% of GDP compared to below 60% a decade ago. In recent times, at the lower end of our typical boom-bust cycle, it was inevitable that debt levels would surge yet again. Looking forward, it is interesting that the IMF expects debt levels to decline and that would be nothing short of brilliant for the economy. Realistically speaking, debt levels, at least in the next few years are set to continue to march north considering yet another year of a high fiscal deficit in FY21 (and maybe even FY22). While that is important, what matters most is that we spend wisely and doggedly focus on an overall policy that fosters economic growth and seeks to broaden our tax base. There really are no shortcuts available here. The true path of progress is one where we are able to repay our debt and that is one entailing a long term approach. This would mean expanding tax revenues and exports, unwavering focus on import substitution and broadening the scope of documentation.

@Courtesy: JS Global Research