A Difficult Budget Context

The Federal Budget for 2022-23 was presented on June 10, and by the time this article is published, it will have been approved by Parliament. The Finance Bill has undergone several important revisions since its presentation to align it with IMF conditionality.

The budget comes in extremely difficult and challenging conditions. The macro-economic context, to which the budget must respond, is the most challenging Pakistan has faced in decades. Large fiscal slippages have accelerated public debt accumulation over the past few years. Interest payments now consume 40 percent of gross federal revenue and a whopping 71 percent of net federal revenue (i.e. after transfers to provinces).

The effects of overly accommodative policy settings have been amplified by the global super cycle in commodities since the start of 2021, to produce an unsustainable external current account deficit. Sharply higher external debt repayments, and lower financing, have meant that the overall financing gap on the external account has been met by drawing down foreign exchange reserves held by the central bank. The sharp decline in the country's international liquidity has led to uncertainty in markets and evaporation of confidence in the Rupee triggering a vicious inflationary spiral.

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Why is Pakistan facing this dire economic situation? Given the polarised political environment, current commentary on the macroeconomic situation facing the country is sharply divided and very rarely balanced. Hence, it is important to place the economic and fiscal situation in the proper context.

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A large part of the fiscal and monetary accommodation since 2020 was in response to a once-in-a-lifetime pandemic. The previous government opened the spending taps to protect jobs, incomes, and businesses from the effects of the Covid-19 pandemic, in line with measures taken by governments around the world.

Spending on social safety nets via the Ehsaas program and other initiatives was ramped up. The central bank introduced a host of low-cost loan and financing schemes while easing monetary policy. In total, the government spent around 3 to 4 percent of GDP under its efforts to combat the effects of Covid, with the result that the economic contraction Pakistan experienced during 2020 was amongst the lowest in the world, with a sharp bounce back in growth in 2021.

The problem occurred not with the fiscal and monetary measures per se, but with their persistence. The fiscal and monetary stimulus had a spillover effect on imports, which destabilized the country's external account due to a narrow export base.

In a similar vein, the previous government's subsidy on petrol and electricity effective March 1 has been made the villain of the piece by the current government and many commentators. While the untargeted nature of the subsidy and uncertain financing were indeed problematic, the subsidy lasted less than one and a half months with total budgetary spending amounting to an estimated 0.06 percent of GDP. On its own, it can hardly explain the mayhem in the economy unleashed since April.

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A far more potent factor has been the sharp, sustained spike in global commodity prices and the sluggish and confused policy response.

Given the macro-economic context, the priorities before the budget makers were clear: achieving significant fiscal consolidation, while finding ways to expand social safety nets and continue to provide relief to not just the poor but the lower middle-class segment as well. More specifically, the fiscal adjustment should be achieved through a combination of revenue mobilization and expenditure rationalization.

Under these circumstances, a key objective before policymakers is to ensure that the "burden of adjustment" falls on the affluent to the largest extent possible, and is commensurate with ability-to-pay. Given these priorities, how did the announced federal budget perform?

The thrust of the federal budget's revenue measures appears cantered on:

- Progressivity in taxation measures
- Withdrawing exemptions from the corporate sector
- Claw-backs via super tax/tax on windfall profits
- Bringing property owners into the tax net via deemed rental income
- An attempt to tax non-Tier 1 retailers
- Relief to salaried segment

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However, the budget appears to be weak/falls short in its measures to increase the tax net and document the informal sector. In addition, there is "pork-barrelling" in expenditure allocations at a time when the entire burden of global commodity prices is being passed on to consumers. Special perks for the military, the bureaucracy, and the judiciary, large allocations for coalition partners, and "special" unexplained allocations for segments like film and drama reflect policy capture and weak prioritization.

An important parameter in the current context against which the budget needs to be evaluated is the extent of fiscal consolidation - and its composition. The government aims to reduce the overall budget deficit by an overly-ambitious 2.2 percent of GDP. While this target is dictated by the revised parameters agreed upon with the Fund in March, the targeted reduction is based on both revenue over-estimation as well as expenditure under-estimation.

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The revenue over-estimation is based not on the unrealistic growth rate assumed, which will be compensated by inflation being much higher than targeted, but on the underlying tax elasticity estimate. Under conditions of high inflation and severe demand management economy-wide, FBR is unlikely to extract an increase in tax revenue commensurate with the increase in nominal GDP. More significantly, the under-estimation in interest payments on account of the grossly unrealistic assumption regarding inflation makes the fiscal deficit target look unachievable. Any hope of coming close has been wrecked by the evaporation of the assumed provincial surplus of Rs 800 billion. In sum, the overall fiscal deficit is likely to be around 2 percent of GDP over the budget target in the best of circumstances.

This likely outturn, in addition to reversals in agreed areas of reform such as personal income tax, has made navigating the budget past the IMF difficult in its original form. Hence, an effort has been made to rework the federal budget over the past two weeks to align it with IMF expectations. In its reported revised form, budgetary measures include a greater revenue effort with total new tax measures amounting to an unprecedented 2 percent of GDP.

With the revisions in the budget, a deal with the IMF to revive Pakistan's stalled EFF program is expected by around mid-July.

About the Author: *The author has been a member of several government economic advisory councils in the past. He was the Principal economic adviser at the Ministry of Finance between 2009 and 2010 and was a member of the Planning Commission's Panel of Economists. He currently heads Macro Economic Insights, an advisory firm based in Islamabad.*