FEDERAL BUDGET INSIGHTS

2021

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BUDGET 2021

June 15, 2020

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PTI government has presented its second budget on June 12, 2020 (in reality a third one as it came into power in August 2018) in a situation when the economy has suffered one of its major shocks from ongoing covid19 with its first ever negative GDP growth and record high fiscal deficit. While government has been emphasizing on reviving the economy and putting it back on growth trajectory again after the sudden stop economic lockdown due to covid19 in recent months, it is finding itself unable to do anything meaningful about either controlling the spread of virus or reviving the economy. One major hope is that Covid cases are on decline in the developed world and they have largely lifted their lockdowns, which has raised hopes that the situation will be brought under control over the next few months in other countries such as Pakistan where Covid cases have surged in recent days. While Prime Minister Imran Khan has been advocating 'we will have to live with this virus now and we can't afford lockdowns', there are serious apprehensions about the country's ability to tackle the situation for longer duration and handle the economic shock associated with this.

BUDGET 2021-SNAPSHOT

REVENUES (bn)	2020 (budgeted)	2020 estimated	2021 budgeted	Change (Rs)	change (%)	Comments/explanation
Direct taxes	2,082	1,623	2,043	420	25.9%	Directly linked to profitability of the corporate sector. Slow growth in profits and no increase in salaries means less likelihood of higher direct taxes. Not achievable
Indirect taxes						
Sales tax	2,108	1,427	1,919	492	34.5%	This number is directly linked to start of normal economic activities say post covid days or based on V shaped sharp economic rebound. Not achievable
Custom duty	1,000	546	640	94	17.2%	Regulatory duties reduced in the budget, govt hoping to pick up in demand by manufacturers. Achievable
FED	365	312	361	49	15.7%	cigarettes, soda/energy beverages. Achievable
Total FBR	5,555	3,908	4,963	1,055	27.0%	Total FBR revenues may not increase 4.5 trillion. Growth of 15% likely.
Other taxes	267	300	501	201	66.7%	Has budgeted for petroleum levy of 450bn compared to 260bn last year. Hoping for lower international oil prices and not passing on price decline to consumers.
Non-tax revenues	894	1,296	1,109	(187)	-14.4%	Highly dependent on SBP profits. It includes 620bn SBP profit in FY21, compared to 785bn in 2020.
Gross Revenues	6,717	5,504	6,573	1,068	19.4%	Total gross revenues may not increase 6 trillion. Growth of 9% likely.
Provincial share	3,255	2,402	2,874	472	19.6%	Provinces got much lower share in current year due to sharp reduction in tax collection. Next year allocation has been increased 20%.
Net revenue receipts	3,462	3,102	3,699	597	19.2%	

BUDGET 2021-SNAPSHOT

EXPENDITURES (bn)

(Billion)	2020 (budgeted)	2020 estimated	2021 budgeted	Change	change (%)	Comments/explanation
Servicing of foreign debt	360	335	315	(20)	-6.0%	
foreign loans repayment	1,095	1,245		(1,245)	-100.0%	Repayment of foreign loans will now be adjusted against gross external resources and not shown in current expenditures.
Servicing of domestic debt	2,532	2,374	2,631	257	10.8%	Indicates no decline in Policy rate.
Debt servicing (total)	3,987	3,955	2,946	(1,009)	-25.5%	this decline is due to no repayment of foreign loans.
Defence expenditures	1,152	1,227	1,289	62	5.0%	
civil govt, pension, subsidies etc	1,620	1,584	1,482	(102)	-6.4%	
Public order (police)	153	153	170	17	10.9%	
Economic affairs	84	106	72	(35)	-32.5%	
Education	77	81	83	2	2.6%	
Social protection	191	245	231	(14)	-5.7%	
Total current expenditures	7,292	7,618	6,345	(1,273)	-16.7%	no significant deviation (reduction/increase) is expected in current expenditures.

Deficit	(3,830)	(4,516)	(2,645)	1,870	-41.4%	This shows budget deficit will be around 10% in FY 2020 and around 6% in FY21. Budget statement said this year deficit will be 9.1% and next year it will be 7.1%.
Net capital receipts	832	967	1,463	496	51.3%	These are non-bank borrowings such as issue of PIBs, sukuks, TB, NSS, prize bonds etc. They are projecting to increase this by almost 50%.
Net external receipts	3,032	2,273	810	(1,463)	-64.4%	They have changed the treatement of foreign debt repayment. It has been adjusted against gross revenue receipts . Previously it was shown in current expenditures. Total gross external receipts are projected at Rs 2.2tr, out of this 1.4tr will be paid back.
Bank borrowings	339	1,724	917	(807)	-46.8%	Govt. ended up borrowing much higher than its initial projections given the steep shortfall in tax collections. Next year it aims to reduce this borrowing. We think it is highly unlikely given the possibility of shortfall in tax collections.

ECONOMIC TARGETS/OUTLOOK

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GDP Growth to remain subdued in FY21

For the year ending June 2020, government is saying GDP will shrink by 0.4% in current fiscal year. Agriculture sector recorded growth of 2.67%, while manufacturing and services declined by 2.64% and 0.59% respectively in FY20.

For next year, government is targeting GDP growth of 2.1% with inflation target at 6.5%. At this stage, we are not sure exactly what the growth number will be for current fiscal year. Only last week, government statistics department revised downward its GDP growth number for the previous year 2019 to 1.9% from 3.1%. This very slow growth assumption is perhaps on the basis of uncertainty over ongoing covid19 situation, which appears to be extending its duration in the first quarter of next fiscal year (July-September).

In budget 2021, government has tried to provide some necessary relief to various industries by reducing withholding tax, reduction/abolishment of custom duties, abolishment of advance tax, reduction in sales tax, reduction in federal excise duty (it was increased on cigarettes and energy drinks). Pharmaceuticals, cement, packaging, steel, engineering, FMCGs and textiles will have overall positive impact coz of these duties reduction.

However, key challenge facing the manufacturers is slowing economic growth amid Covid pandemic. The sudden stop of economic activities for almost three months have proved to be devastating for many businesses especially the small and medium enterprises, where many will struggle to go back into their businesses. Large manufacturers on the other hand, which have been provided with necessary financial support from the banking system, will have relatively less difficulties in starting their operations as long as they can sell their products.

One other thing which has damaged agriculture side of the economy is locust attack on crops during past few months and its intensity and spread has increased in many areas of Punjab, Sindh and Baluchistan in past few weeks. Untimely rains in April also impacted wheat crop and production has come lower than the earlier estimates. So 4Q of FY20 saw damage to almost all segments of the economy including agriculture which was also hit by these unpredictable events.

Unrealistic higher tax collection target for FY21

This is second year in a row that government has come out with unrealistic and unachievable targets/projections for tax collections. Tax collections of FBR by June 2020 is projected to be around Rs 3.9 trillion, which they have budgeted to increase to Rs4.9tr by June 2021, growth of 27%. The start of corona pandemic in March 2020 and the resultant lockdown has led to Rs1tr shortfall in tax collections in past four months. The virus situation has taken a very bad turn since start of June and daily reported infection cases has jumped over 6000 per day and deaths exceeding 100 per day and government officials now saying peak period could come later in July or August and therefore we could see major increase in corona cases in the country over the next few months. It seems certain now that virus situation will stretch into the first quarter of next fiscal year. Despite no lock down since mid of May many businesses and services sectors are operating at lower levels or partially operative, it seems quite unlikely that tax collections will show improvement in 1Q and most likely to remain at low level. Provided Covid situation comes under control by the end of 1Q, we can expect significant pickup in economic activities in subsequent quarters thus enabling FBR to see growth in tax collections. Given this outlook, we project FBR tax collections could increase maximum 15% up to Rs 4.5tr, with total gross revenue collections (including other taxes and non-tax revenues) to grow maximum 9% to around 6tr against government target of Rs 6.5tr.

Fiscal deficit will remain elevated

Fiscal deficit is estimated to be around 9.1% this fiscal year ending June 2020 and government aims to reduce this deficit to 7.1% next year. On the basis of reported fiscal position in budget documents, it appears that fiscal deficit could be as high as 10% above the estimate presented in budget. For next year, it seems government has made changes in the accounting of foreign debt repayments, which has been removed from current expenditures and placed under the head of external receipts where it is shown as reduction from gross external receipts. Had this been made part of current expenditures, fiscal deficit would have remained around Rs4 trillion in next year compared to more or less similar deficit in FY20. We are waiting for further clarity on this, however, there is little possibility of any improvement in fiscal deficit next year given the very tight fiscal position of the government in the form of extra spending on covid19 and reduced prospects of major increase in tax collections.

External receipts

Against the budgeted Rs 3trillion target ($18bn) borrowings for FY20, government borrowed Rs 2.2trillion (around $14bn). For next year, government has budgeted for gross external borrowings of Rs 2.178trillion (around $13bn on current exchange rate). From next fiscal year, government has changed the recording of foreign debt repayments in its accounts. This has been moved from current expenditures to direct adjustments in the net external receipts. This change has resulted in reducing the quantum of current expenditures by approximately Rs 1.4trillion in FY21 as this debt repayment will now be adjusted against new receipts (new loans) during the year. After this change, net external receipts in FY21 is now being shown as Rs 810 bn compared to last year's Rs 2,273bn bn, with net repayments of Rs 1.4trillion. The question is why this change was made as it appears to be only an accounting entry, but what this change has done is that it is showing reduced fiscal deficit position as removing foreign debt repayments from current expenditures has brought down the total expenditures and hence lower reported fiscal deficit on papers.

IMPACT ON EQUITY MARKET

For stock market, number of listed sectors and their companies will see some benefit in the form of marginal reduction in custom duties, reduction in regulatory duties, reduction in FED, abolishment of advance tax, reduction in sales tax. ***Sectors which will see direct benefit are pharma, cement, packaging, steel, engineering, FMCGs and textiles***. In the case of cement sector, reduction in FED from Rs 2/kg to 1.75/kg will reduce 20kg bag price of cement by Rs 5 only. Key thing for cement is resumption in demand which has taken severe hit in past three months. Despite lifting ban them in April construction activities largely remained subdued or suspended in ongoing covid situation. In next fiscal year, allocation of Rs 30bn for Naya Pakistan Housing Scheme and Rs 69bn for dams/water projects could create additional demand provided these things get executed timely. Similarly for steel industry, new demand will originate from the above mentioned allocation in budget, this industry will also witness improved demand after the start of work on ML1 railway (Rs 24bn allocation).

Brokers of stock exchange have expressed their unhappiness on budget as government failed to provide any incentive or relief to investors such as lowering the capital gains tax on investments, making appropriate changes in short term gains and gains on long term investments and gave no real incentive/tax advantage for being listed on stock exchange.

While in budget speech the minister did emphasize that it is time to provide fiscal stimulus to the economy, one wonders how government could provide any fiscal stimulus when it is already running a fiscal deficit near 10%. There is simply no room to go for extra spending and create additional demand and enable the industries to revive their productions.

Major stimulus for local industries and especially exporters will be control over covid spread in the country and opening up of developed countries' import markets. Local demand is directly linked to covid situation inside the country while exporters are looking forward to opening up of their export markets. Sectors such as pharma, food, FMCGs, fertilizers and packaging have largely remained unaffected due to lockdown and have performed well during the pandemic. These sectors are expected to continue performing relatively better in prevailing economic situation.

IMPACT ON FIXED INCOME MARKET

SBP had to act and respond by slashing the policy rate by 525bps to 8% in past three months when the economic activities were brought to a halt in March 2020 after covid19 pandemic hit Pakistan and the world. Four months into corona virus situation, the economy has taken a hit in the form of almost Rs1trillion reduction in tax revenues (as economic activities reduced sharply in past four months) and the government has to provide Rs1trillion in relief in the form of social spending and businesses support.

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For FY21, government has forecasted additional borrowings (net capital receipts) of Rs 1,463 billion against FY20 net capital receipts of Rs 967bn (budgeted was Rs 832bn). This money will be raised from Ijara sukuk
is shown in Ijara sukuk and TBills for FY2021, while it plans to borrow almost same amount through the issue of PIBs. At the same time, government projects 50% reduction in money raised from NSS and continuous redemption in prize bonds.

Net capital receipts (bn)					
	Budgeted FY20	Estimated FY20	Budgeted FY21	Change Rs	Change %
PIBs	200	410	400	-10	-2%
Ijara sukuk	9	229	450	221	97%
T-Bills	300	155	400	245	158%
Prize bonds	71	-182	-85	97	-53%
NSS	276	427	223	-204	-48%
Gross	856	1039	1388	349	34%
others	-24	-72	75	147	-204%
Net capital receipts	832	967	1,463	496	51%

Given the high borrowing needs of the government and this planned supply of fixed income instruments in the market, we expect that yields will move up in coming fiscal year. Most likely the yield curve which has started to flatten in recent months after being inverted during previous few months will now move upward slopping. There is little space on the downside as far as policy rate is concerned as inflation is unlikely to move down into lower single digit, therefore we project that policy rate is likely stay at 8% over the next several months in next fiscal year. Even if inflation moves up (government projection is 6.5% for the year) we don't expect SBP will do any intervention by increasing the policy rate either. Key risk to this forecast (no change in policy rate) is abnormal increase in international oil prices and rupee depreciation as these two factors will have direct bearing on inflation.