Faysal Asset Management

BUDGET FY18 PROLOGUE

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ECONOMIC STATISTICS FOR OUTGOING FY 2016-17

The economic survey to be unveiled by Finance Minister today (Thursday) will highlight the GDP growth rate at 5.28%, increasing the size of the economy at $304 billion and per capita income at $1,629 during the outgoing financial year.

The main features of the comprehensive reforms agenda undertaken by the present government have resulted in macro-economic stability and a 10-year high growth rate of 5.28%.

On the Economic Survey, Pakistan will explain that the government envisaged the real GDP growth of 5.7% based upon sectoral growth projections for agriculture, industry and services sectors at 3.5%, 7.7% and 5.7% , respectively.

The macroeconomic indicators showed signs of a marked improvement on the back of agriculture performance, revival of private sector activities, acceleration in large scale manufacturing and expansion in construction sector in 2016-17. The GDP registered a growth of 5.3%, though it narrowly missed the target, but it is the highest growth rate during the last nine years.

Agriculture was targeted to grow by 3.5% on the basis of expected contributions of important crops (2.5%), other crops (3.2%), cotton ginned (2.5%), livestock (4.0%), fishing (3.0%) and forestry (3.0%). Agriculture met its target of 3.5%. Major crops grew by 4.1% while other crops registered a growth of 0.2%. Livestock, fisheries and forestry achieved growth of 3.4%, 1.2% and 14.5% respectively.

The overall target of wheat crop was achieved despite lower production from barani areas. Cotton production showed growth of 7.6%, though falling short of its target. Rice crop registered a growth of 0.7% in its production, whereby the area under rice cultivation decreased by 0.6% over the last year. Sugarcane crop remained satisfactory and registered a growth of 7.6%. Therefore, the overall growth in agriculture increased by 3.5% in 2016-17.

Industrial sector registered a growth of 5% during 2016-17 as against the target of 7.7%. This growth is driven by construction and manufacturing sector. Manufacturing grew by 5.3% in 2016-17. The overall output of large scale manufacturing industries (LSM) increased by 4.9%. Mining and quarrying sector posted a growth of 1.3% against target of 7.4% for 2016-17. Small and household manufacturing met its target of 8.2%.

Value addition in electricity, gas and water supply grew by 3.4% against the targeted growth of 12.5%. Construction sector showed growth of 9.1% against the target of 13.2%.

Services sector registered a growth of 6% against its target of 5.7% with positive contribution by its constituent subsectors. Specifically, wholesale and retail trade, transport, auctioning, hoteling and restaurants have been the major contributors of growth in services in 2016-17.

Wholesale and retail trade managed to grow by 6.8% and surpassed its target of 5.5%. The subsector, transport, storage and communication, (dominated by transportation services) managed to grow by 3.9%, against its target of 5.1%. In transportation, the contributors to its positive growth were railways, communication and road and storage.

Finance and insurance grew by 10.8% surpassing its target of 7.2%. This was achieved mainly due to better performance of scheduled banks and activities auxiliary to financial services and insurance activities. With positive growth in real estate, construction and residential societies, housing services registered the targeted growth of 4%, maintaining the same pace over four consecutive years since 2013-14.

General government services grew by 6.9% against the target of 7.0%. Most of the government expenditures were on security and defence services. In development expenditures, construction of roads and highways, power generation and social sector expenditures remained on government priorities. Other private services grew positively at 6.3% against its target of 6.7% for 2016-17.

During 2016-17, fixed investment as a percentage of GDP increased from 14% in 2015-16 to 14.2% in 2016-17. Public investment as percent of GDP increased from 3.8% to 4.3%, whereas private investment as percent of GDP declined from 10.2% to 9.9%. National savings were at 13.1% of GDP in 2016-17, falling short of the target of 16.2% of GDP.

Overall fiscal deficit was curtailed, from 8.2% of GDP in 2012-13 to 4.6 % in 2015-16 and was targeted at 3.8% during 2016-17. The consolidated total revenue during July-March 2016-17 stood at PKR 3145.5 billion which is 6.2% higher than the total revenue of PKR 2,961.9 billion collected during the same period of last year.

The FBR's tax collection was recorded at PKR 2,260.5 billion during July-March 2016-17 as compared to PKR 2,103 billion during the corresponding period last year, registering a growth of 7.5%. Direct taxes and indirect taxes registered growth of 12.4% and 4.5%, respectively. Customs duties and federal excise duty recorded growth of 14.5% and 10.6% respectively. Sales tax registered a growth of 0.4%. Current and development expenditures grew by 5.8% and 14.9%, respectively.

The policy rate stood at 40 years lowest at 5.75% as State Bank of Pakistan is pursuing easy monetary policy since second quarter of 2014-15. Money supply (M2) grew by 7% (PKR 903.9 billion) during July 2016 to April 2017 compared to its expansion by 6% (PKR 683.8 billion) during the corresponding period of last year. Private sector credit gained momentum and availed credit not only for working capital but also for fixed investment. Credit to private sector expanded by PKR 513.5 billion as against the expansion of PKR 336.5 billion last year, showing an increase of 53%.

Consumer Price Index (CPI) for 2016-17 targeted at 6% was contained at 4.1% for July-April 2016-17 as against 2.8% in July-April 2015-16. Average SPI was contained in July-April 2016-17 i.e. 1.7% as against 1.8% last year. Average WPI however registered at 4 percent as against 1.3% in July-April 2015-16 which is a good sign of generating economic activity.

The current account deficit for July-March 2016-17 stood at $6.1 billion as against a deficit of $2.3 billion in July-March 2015-16. Trade deficit during the first nine months of this fiscal year stood at $17.8 billion with exports of $16.1 billion and imports of $33.9 billion. Exports declined by 1.4% whereas imports increased by 14.2%. The decline in exports resulted from global slump in oil and commodities prices. Workers' remittances amounted to $15.6 billion in first ten months of FY17, compared to $16 billion during same period last year i.e. a decline of 2.8%.

DISSECTING PROPAGATED ECONOMIC TURNAROUND

Now for the million dollar question:

Is a 5.28% growth in GDP in any given fiscal year something to rejoice about? There can be a number of ways to answer this question. Yes, it becomes something to rejoice for the national economic managers when it is the highest figure recorded in 9 consecutive fiscal years. It also indicates a continuous upward trajectory during the past four years of the tenure of the incumbent government.

But another way to answer the question is to see if the figure recorded is meeting the target set for this very number? No is the answer in this case. What no one can deny is that that the growth figure is falling short of the target it was expected to meet by the end of the fiscal year 2016-17, i.e., 5.7%. Yet another manner to make sense of it is to have a kind of regional comparison. We remain considerably short of what India next door is posting for last several years, around 7% per annum. Some other regional nations are also doing better than us.

But the overall GDP number is just one indicator, and usually not-so-correctly depicting the actual health of the economy. The tax-to-GDP ratio, the reliance on borrowed resources, worrisome performance of the export sector and resultantly widening trade deficit, the fiscal deficit and more importantly the overall current account deficit all are stark reminders of the fact that we are quite far from a point where we can actually have a sigh of relief – much less think of saying that all is well on the economic front. On some of these accounts, the government has failed miserably. And those managing the national economy have a fair idea of that.

So what kind of a budget can one expect at federal level in such a setting, particularly so when it is going to be the last full-year budgetary exercise before the next general elections become due (constitutionally, however, this very PML-N government may get another chance to present, what would be its sixth in a row, budget next year.)

Budget making, presentation and approval in Pakistan have by and large been customary exercises, rather rituals, over the years. Analyst finds little reasons to be optimistic that the coming budget, to be announced by the finance minister on Friday, May 26, on the eve of Ramzan, would in a way be a departure from this ongoing ‘tradition’ of the past.

What we can see clearly is the unfolding of an exercise aimed primarily at balancing the account books, with little out-of-the-box thinking or any bold initiatives. We can hardly expect any real move towards self-reliance and a shying away from the tendency to thrive on borrowed money, and thus borrowed time, unfortunately so.

Yes, popular the budget 2017-18 is surely going to be. And that is an important political need of the PML-N government before it goes in the electioneering mood. Do expect the doll-outs – including those to favourite industries such as textile, cement, steel, construction and allied industries etc. Concessions on taxation with regard to the import of machinery for several industries is on the cards. Salaries of the government employees are going to be raised by around 10%, and pensions would also see a notable upward revision.

More importantly, we expect a sizeable increase in total allocation as well as the monthly individual allowances being given under the so-called Benazir Income Support Program (BISP). This single initiative, being continuously run by two successive governments for the past about a decade, in itself has become a very ‘creative’ way of ensuring millions of votes of the poor and desperate.

Its actual socio-economic impacts may be debated; but the sad reality that millions of families have somehow been made ATM-card-carrying beggars – depending upon monthly meagre amounts instead of any comprehensive and sustainable drive to make them self-sufficient, respectable members of the society – is quite pinching.

At the macro-level, it is going to be another CPEC-focused budget. Infrastructure spending is all set to get a booster, a major one perhaps. It is being signalled that the allocation for energy sector projects may be deceased, but that may be due mainly to the fact that some of the ongoing projects are expected to come online in months ahead. An around 10% increase in the defence budget seems inevitable in the prevailing regional security situation and particularly considering that India has raised its budget just a couple of months ago.

The need of the hour is a bold budget, with across-the-board moves to ensure that every person who has a taxable income, from any source, pays what is due. That is the only way ahead to gradually get rid of the massive and unbearable burden of external and domestic debts that have accumulated dangerously high levels. CPEC indeed is a game changer in many ways but our economic managers need to understand, and then plan accordingly, that Pakistani economy is much larger than CPEC alone. The potential and prospects of such an economy call for a broad-based approach, not the one in the shape of a presently titled one, in favour of CPEC projects. Equally important is to integrate the CPEC projects and plans into overall economic planning – considering the long-term needs of the country's economy. This is by no means to say that CPEC in any way is a less important set of projects and plans, but the point here is to highlight that every sector needs a proportionate attention and allocations.

In the nutshell, the budget-time around this time calls for something that actually strengthens the economic fundamentals of the economy and social fabric of the society. The time for cosmetic measures, what we usually see in the annual federal budget, is over for long.

UPCOMING BUDGET FY 2017-2018

Salient features of the budget recommendations for fiscal year 2017-18. The major points of the upcoming budget — to be presented on Friday — are as follows:

1. Total outlay: PKR 4.778 trillion

2. Development budget: PKR 1,001 billion

3. Defence budget: PKR 940 billion

4. Recommendation to allocate PKR 1,401 billion for interest payments on loans

5. Recommendation to increase FBR's tax collection target by 15%

6. Two recommendations to increase government employees' salaries

a. Proposal to merge old ad hoc salary after 10 % increase in salaries

b. Proposal to increase running salaries by 10% after merging old ad hoc

7. Proposal to allocate PKR 230 billion for subsidies and grants

8. Proposal to allocate PKR 123 billion for Benazir Income Support Programme

9. Proposal to allocate PKR 90 billion for rehabilitation of homeless people and security arrangements

10. Proposal for GDP growth in upcoming fiscal year: 6%

11. Estimated inflation [CPI]: 6%

12. 4.1% fiscal deficit

13. PKR 272 billion for development schemes for parliamentarians

14. Current account deficit targeted at 2.6% of GDP

Break-up Of The Federal Government's Development Budget

- Higher Federal PSDP in FY18 at PKR 1,001 billion versus a budgeted PKR 800 billion in FY17, up 25%YoY (total PSDP, including provincial, at around PKR 2,113 billion versus PKR 1,675 billion for FY17,up 26%YoY), along with allocation towards CPEC/power.
- PKR 30bn allocated to Prime Minister's SD,
- PKR 40bn for special development projects,
- PKR 12.5bn for the energy for all programmes,
- PKR 12.5bn for the clean water for all projects.
- Similarly, PKR 5bn for completion of development projects under the China-Pakistan Economic Corridor (CPEC),
- PKR 90bn for IDPs (internally displaced persons) and security,
- While PKR 4.34bn for the Aviation Division.
- It is also learnt that PKR 5bn has been allocated for the Cabinet Division,
- PKR 810.5million for the Climate Change Division,
- PKR 1.2bn for trade industry,
- PKR 13.66bn for the Communications Division,
- PKR 5.305bn for the Defence Division, and
- PKR 4.46bn for the Defence Production Division,
- Whereas PKR 270mln for the Establishment Division.
- PKR 2.96bn for the education division,
- PKR 18.93bn for the finance ministry,
- Of which PKR 200m will be allocated towards development projects,
- PKR 11bn for the Ministry of Housing and Works and
- PKR 300m for the Ministry of Human Resources.

Expected Relief Amid Upcoming Elections Focused Measures

- 1% reduction in corporate tax rate to 30% in-line with the 5-year strategy of bringing down the corporate tax rate from 35% in FY13 to 30% in FY18.
- Likely extension in deadlines for availing tax relief and credit for equity investments.
- Increase in subsidies for the power and agriculture sector.
- Taxi, tractor, small business, housing and other direct subsidy schemes.
- Higher allocation for social sector welfare such as Benazir Income Support Program.
- The government is considering continuing the zero-rating regime for export oriented sectors i.e. textile, leathers, sports, carpet and surgical goods sectors. While further export oriented sectors might also be added to the list.
- Duties and taxes are expected to be brought down on raw materials of export oriented sectors.
- Increase in exemption threshold from PKR400k to PKR500k for salaried class.
- Amnesty scheme for regularizing income.
- Tax incentives for new listings.
- Measures to improve tax administration and collections procedures to encourage filing of taxes.

Key Taxation Measures

- The finance ministry seeks to increase the revenue collection by over rupees four trillion in the next fiscal year. The ministry intends on imposing taxes on non-filers. The ministry’s vision, therefore, entails an increase in tax rates for individuals and companies that do not file returns.
- As per the proposal, FBR will treat returns submitted by non-filers as final and will only pay a certain amount back if returns are filed afterwards.
- The ministry had sought to draw a distinction between filers and non-filers in order to expand the tax base by providing tax rate incentives to the latter. However, the policy has so far seen little accomplishment and the tax base still remains narrow.
- The new policy proposal would increase the revenue collected by FBR from indirect taxation. The department’s reliance on indirect revenue receipts would exceed 90%. The proposal renders convenience for the department as it aims not to increase the tax base.
- The Ministry of Finance has expressed reservations that the new policy will only add to the burdens of existing taxpayers, said sources.

- On the contrary, FBR has stated that the new policy is instrumental to achieving an extra PKR 500 billion in tax receipts for the upcoming financial year. Further, the department has expressed reservations for “too many” rejections of its proposals by the ministry.

- It is reported that the tax on dividend income of non-filers would rise from 20% to 25% in the new financial year. On the other hand, Tax rates would rise from 12.5% to 15% on dividend income for filers, adding PKR 5 bn in revenues.

- Another proposal seeks to increase the tax on profit from debt, securities and bonds by non-filers. The existing rate for non-filers is 17.5% while that of filers is 10%.

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- The FBR has also proposed a reduction in withholding tax on commercial importers from 5.5% to 4%. However, it has suggested an increase to 2% in the tax on imports made by the industries. The rate difference is being proposed to stop the misuse of the facility.

- It has been proposed to increase the 1% minimum tax rate applicable on turnover of all businesses (sole proprietors, AOP’s and companies) with turnover in excess of PKR 10 million annually.

- This tax is applied to businesses even if it is in losses.

- Last year the government had kept this rate stagnant at 1% but reduced the threshold turnover level from PKR 50 million to PKR 10 million, thereby including many more smaller businesses into the ambit of this regime.

- Continuation of Super Tax with a possibility of expanding its net to high net worth individuals and raising rate for banks by 1ppt (i.e. 5%).

- Tax measures to make import of luxury items more expensive which include enhancing the scope of Regulatory Duties to such items.

- Increasing tax rates for non-filers on dividend income, banking transactions, cash withdrawals & purchasing of assets.

Capital Market’s Few Key Demands

- Rationalization of tax on bonus shares,

- Tax credit on the enlistment on the stock exchange,

- Capital gains tax (CGT) on the disposal of securities,
- Unrealized gains on the sale of immovable property to real estate investment trust (REIT) schemes,
- Investment in REIT to be treated as investment in a stock fund,
- Rationalization of the taxation regime for brokers and
- Applicability of minimum tax on services rendered by the PSX.

Pakistan Stock Exchange (PSX) has sought a withdrawal of withholding income tax on bonus shares issued by listed companies from the Federal Board of Revenue, demanded the exemption on the ground that the listed companies are documented and there are problems in adjustment of paid withholding tax.

Currently, listed companies are required to withhold 5% tax on the bonus shares issued to the shareholders. The stock exchange also asked for an extension in the period for tax credit in case of a new listing. Presently, tax credit is allowed to a new listing for two years, which is very short period. The PSX demanded an extension in the period to five years.

Currently, there is a 7.5% capital gains tax on shares sold after two years. The stock exchange asked this period to be restricted to five years. After five years, there should not be any tax on the shares disposal, it was proposed.

The PSX also proposed that income tax on rental real estate investment trust should be exempted. Further, the earnings of the stock exchange should be treated as stock rather than money market fund for the taxation purpose.

Stock brokers also urged the FBR to withdraw the minimum tax regime and they be allowed adjustment against expenditures. Currently, they fall under the services sector and bear eight percent minimum tax, much higher considering their return on commission.

The stock brokers also demanded the settlement of stuck refunds on account of tax paid under the transfer of membership rights of a stock exchange.

Sector-wise Impact

	Proposals/Demands	Impact	Comment
	CAPITAL MARKETS		
1	20% corporate rate for SME's that list on PSX	Positive	**If approved this would allow small and growing companies to raise capital from the exchange, improve corporate governance while also contributing to the breadth of PSX.**
2	Increase in tax credit from 2 years to 5 years for new listings	Positive	**If approved this would encourage new listing & increase market coverage.**
3	Imposition of WHT on face value of bonus shares	Positive	**If approved this would lead to increased bonus issues and higher activity at the bourse.**
	Abolition of CVT and reduction in advance tax	Positive	**As per a proposal, PSX has proposed complete withdrawal of CVT (Capital value tax) and rate of advance tax on sale and purchase of shares to be reduced from 0.02% to 0.01%. If**

			approved it would improve the trading activity of the market.
4	1% reduction in corporate tax rate	Positive	**This is expected to be likely approved and marginally improve earnings profile of the companies.**
5	Changes in Capital Gains Tax	Neutral	**The government is considering increasing the holding period for CGT applicability from 4 to 5 years. However, PSX in its budget proposals has proposed 10% rate on gains on holdings of up to 6 months and 8% on holdings of up to 12 months while gains on holdings of over 12 months should be exempted from CGT. We do not see either of these considerations to be approved in the budget.**
6	Continuation of Super Tax	Neutral	**Super tax is likely to extend for third year as well which would reduce corporate profitability.**

Proposals/Demands		Impact	Comment
BANKS			
1	Extension of Super Tax and increasing it by 1ppt to 5%	Negative	**In case Super Tax rate from 4% earlier is raised to 5% for banks, It would have a negative earnings impact of additional 1%-2%.**
2	Raising minimum threshold of WHT on banking transaction to 100k and above (previously 50k)	Neutral	**This would likely result in increased banking transactions which would also boost deposits slightly.**
3	Withdrawal of 7th schedule amendments	Negative	**Though it could have significant impact, we believe it is less likely to be implemented.**

Proposals/Demands		Impact	Comment
TEXTILE			
1	Duty/tax free import of cotton and other synthetic fibers & Lycra used as raw material	Positive	**Decrease in RM cost would be a major catalyst for the value added sector**
2	Zero rating for all inputs including coal, HFO & spare parts	Positive	**This would reduce costs and improve cash flows of the sector.**
3	Payments of all pending refunds	Positive	**Delayed disbursement of refunds is a major liquidity constraint for the sector. Alleviation of the same could improve operational capacity & improve profitability.**
4	Removal of GIDC & Surcharges on electricity & removal of RLNG.	Positive	**APTMA has demanded reduction in electricity rates to PKR7/kWh, exemption from additional surcharges, and withdrawal of GIDC. This demand is unlikely to be met given GIDC is a major contributor to non-FBR revenues of the GoP.**
E&PS			
1	Normal corporate tax rate of 30% relative to 40%	Positive	**This could be a major positive but is unlikely to go through given GoPs revenue shortfall.**
2	Amendment in definition of depletion allowance	Positive	**Allowance for depletion to be calculated at 15% of revenues before royalty deduction, could increase profit after tax of E&P companies.**

	Proposals/Demands	Impact	Comment
		OMCs	
1	Subsidy and Circular Debt	Neutral	**We expect the GoP to ramp up power generation before the election year through upcoming RLNG based power plants & inefficient GENCOs in the absence of proportionate increase in subsidy. This might result in further escalation in net power sector receivables which we estimate at 323bn (~USD3bn) as of 3QFY17 in our sample space of 19 listed companies. With T&D losses (~18% in FY16) & collection losses (collection at 94.6% in FY16) cumulatively resulting in loss of ~23% units generated, expansion in generation in the absence of improvement in efficiencies and timely payment would aggravate circular debt further. Within this backdrop, PSO remains most vulnerable, carrying the highest quantum of receivables on its books which as off Mar-17 stood at PKR215bn.**
		POWER	
1	1% Reduction in Corporate Tax rate	Neutral	**Power companies with the exception of KAPCO are exempt from taxation. 1% reduction in taxation would increase KAPCO's FY18 earnings by PKR0.1/sh for KAPCO.**
2	Circular Debt	Neutral	**Power companies are vulnerable to increasing circular debt with KAPCO & HUBC relatively insulated due to fuel supply guarantees, where they fund receivables with payables to oil supplier i.e. PSO.**
3	New listings	Neutral	**No Privatization of state owned entities is expected in the run up to elections in FY18, while IPO of GEPCO may take place.**

	Proposals/Demands	Impact	Comment
		CEMENTS	
1	Increase in Total PSDP allocation to PKR 2.1tn	Positive	**Allocation for hydropower projects like Diamer Basha, Suki Kinari etc. along-with major infrastructure projects under CPEC will lead to upbeat domestic cement demand.**
2	Low cost housing scheme of 50,000units	Positive	**The project has the potential to add up to 0.6-0.7mtpa or 2% of domestic demand.**
		STEEL	
1	Increase in Regulatory Duty by 5ppt	Positive	**FBR has proposed to uniformly increase Regulatory Duty by 5ppt on all items subject to RD. In this backdrop, we estimate that increase in Regulatory Duty would raise imported scrap prices by ~PKR1,600/ton and lower ASTL's FY18/FY19 EPS by PKR1.22/2.00 to PKR5.92/10.13 (assuming cost is not passed on to the consumers). However, similar increase in duty on imported re-bars is estimated to increase the discount with local rebar prices by PKR2,400/ton to 12,400/ton. Hence we believe increase in RD on imported raw material would be easily passed on the consumers by local re-bar producers. Assuming both the increases; ASTL's FY18/FY9 EPS is expected to go up by PKR0.43/PKR0.64 to PKR7.57/12.76.**

Proposals/Demands	Impact	Comment

PHARMACEUTICALS			
1	Zero rating status demanded instead of tax exemption	Positive	**Zero rating would result in refunds for inputs of pharmaceutical sector resulting in reduced costs.**
2	Expansion in the list of inputs getting Low custom duty of 5%	Positive	**The implication of a rationalized duty would be improvement in margins of Pharma companies.**
BEVERAGES			
1	Reduction in FED to 9% from 11.5%	Positive	**Reduction in FED could increase the volumes for beverage companies.**
TOBACCO			
1	Cigarette Manufacturers have demanded penalties on illicit Cigarettes	Neutral	**Smuggled cigarettes form ~40% of the market share, where a further increase in taxation on the same to curb illegal imports cannot be ruled out.**

Proposals/Demands		Impact	Comment
AUTOS			
1	Orange Cab Scheme	Positive	**PSMC would be the main beneficiary taking cues from last Cab scheme, where Bolan & Ravi variants of the company were part of the scheme.**
FERTILIZER			
1	Elimination of GST	Positive	**Fertilizer companies have demanded replacement of subsidy on urea with elimination of Sales tax, which would result in improvement in cash flows for the companies given disbursement of subsidy is usually delayed.**
DAIRY			
1	10% Sales tax on Tea Whiteners	Negative	**FBR has proposed 10% sales tax on tea whiteners. If approved it could hurt demand for tea whiteners. EFOODs stands to lose the most with Tarang, its flagship tea whitener brand, has significant contribution to bottom line.**