Budget FY22 Preview - Providing impetus for growth

NEXT CAPITAL

Strategy

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Key Points

- Announcement of Federal Budget 2021-22 is expected on June 11, 2021 and we expect the key focus of the budget would be to maintain and expedite the growth momentum that has emerged from FY21.
- Pakistan is already negotiating with IMF for maximum possible fiscal space to maintain its growth-centric policies with higher expenditure on development side and provision of subsidies.
- Ensuring and implementing sustainable growth will require relaxation / abolishment of unconducive tariff lines (CDs, ACDs and FEDs) spreading over various industries including construction, steel, textiles etc.
- Social safety and welfare schemes are also expected to remain in focus amidst COVID-19 and inflationary pressures with Ehsaas program likely to stay in limelight along with proposals regarding upward revision in minimum wage rate and continued government assistance in the ongoing fight against the pandemic.
- FBR tax collection target is expected to clock in at PKR5.8tn (original target set by IMF was PKR6tn), which is still ambitious and would be relying on incremental revenue generated through improvements in FBR efficiencies, rationalization of GST, increased taxation of higher income groups and documentation of informal sector.
- For FY22, the government is expected to earmark PKR900bn for Federal PSDP, an increase of 38% YoY over budgeted figure of FY21.
- Overall outlay of the budget is expected at PKR8tn with an estimated fiscal deficit of 5.5%-6%.
- We believe that overall Federal Budget would have neutral to positive implications for Pakistan's capital markets.

Growth to be the main focus of the upcoming Federal budget FY22

With the announcement of Federal Budget for FY22 expected on June 11, 2021, we present our preview of expected budgetary measures and their impacts on the general market and various sectors. After achieving a provisional real GDP growth of 3.9% for FY21, overshooting all expectations ranging between 1% and 3%, the National Economic Council (NEC) has approved a target for real GDP growth of 4.8% for FY22.

Component-wise growth targets for Agriculture, Industrial and Services sectors are 3.5%, 6.5% and 4.7%, respectively compared to provisional estimates of 2.8%, 3.6% and 4.4%, during FY21. Contrary to previous expectations of a revenue focused budget with curtailment of deficit and rationalization of subsidies, the recent news flows post-appointment of Mr. Shaukat Tarin as Finance Minister, suggest that key focus of the budget for FY22 would now be to maintain and expedite the growth momentum that has emerged from FY21.

Besides growth, social safety and welfare is also expected to remain in focus amidst the COVID-19 pandemic and inflationary pressures. We do not anticipate any new tax or any major increase in rates of existing taxes. However, we do not rule out possibilities of adjustments of tax burdens on higher income groups and rationalization of General Sales Tax (GST). Overall outlay of the budget is expected at PKR8tn with an expected fiscal deficit of 5.5%-6% of GDP for FY22 compared to an estimated deficit of 6% of GDP during FY21.

Balancing growth and fiscal consolidation within the IMF EFF program

The Government is undergoing discussions with IMF to maintain its growth centric policies, as against the international body advocating prudent policies and measures for fiscal consolidation. Pakistan is already negotiating for maximum possible fiscal space to develop a growth focused budget with higher expenditure on development side and provision of subsidies while imposing no new taxes and even reducing/abolishing some of the existing taxes and duties to promote economic activities in the country and curb inflation. Power sector reforms and hike in electricity tariff is the key focus of the IMF. Curtailment of circular debt requires increasing electricity tariffs, which is a difficult decision indeed considering the inflationary outcomes. The new Finance Minister has clearly stated that masses will not be burdened by additional tariffs and consequently, Pakistan is expected to submit an alternate plan that does not involve hikes, at least not immediately.

On the other hand, revised FBR tax collection target for FY21 (PKR4.7tn) is expected to be met. For FY22 however, collection target (PKR6tn with Pakistan stressing for PKR5.7tn) appears unachievable, possibly leading to increase in debt burden. We believe IMF has been very lenient with targets amidst the COVID-19 pandemic and foresee successful negotiations between the local authorities and the IMF at least for this year.

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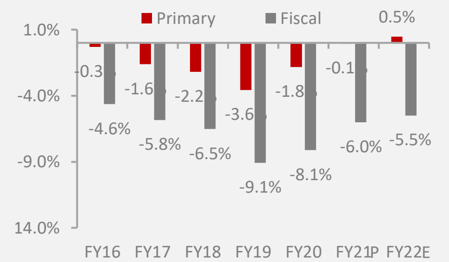
Key Data	
KSE100 Index	48,148
KSE-All Share Value (PKRmn)	23,902
KSE-All Share Value (USDmn)	153.4
KSE-All Share Volume (Shmn)	104.1
Market Capitalization (PKRtn)	8.4
Market Capitalization (USDbn)	53.7
1Year High	48,303
1 Year Low	33,439

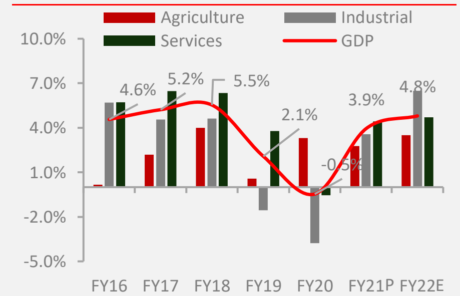
Source: PSX, Next Research

Deficits %age of GDP



Source: MoF, PBS, Next Research

Component-wise GDP Growth



Source: MoF, PBS, Next Research

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Key fiscal measures expected in FY22 budget

Pro-growth initiatives and relief measures

Subsidies would once again play an important role in stimulating growth: Supporting our rural-based economy is absolutely vital and the Government has not ignored it either by proposing a PKR110bn agricultural package (spread over 3 years) focused towards increasing crop yields, elevating farmer economics and applying a brake on inflationary outruns. Moving towards the other end of the spectrum, the Government took a bold step of postponing increase in electricity tariffs and continuation of subsidies for sustaining the growth momentum (at the expense of a burgeoning circular debt).

Abolishing unconducive tariffs and reducing turnover taxation: Ensuring and implementing sustainable growth will require relaxation in taxes and duties while improving corporate cash flows. Many proposals have been put forth in this regard, where the Government has reportedly approved reduction in a total of almost 600 tariff lines spreading over various industries including construction, steel, textiles etc. Furthermore, there has been a sustained pressure by steel manufacturers to reduce turnover tax on their dealers in advertently opening up a new revenue stream for the Government as turnover taxation discourages dealers from entering into the tax net.

Social safety and upliftment: The government has faced severe backlash for its inability to curb inflationary pressures on its masses and we expect certain proposals to be included in the budget to address these concerns and provide relief going forward. We believe Ehsaas program will stay in limelight along with proposals regarding increment in salaries of government employees and a possible upward revision in minimum wage rate.

Fight with pandemic; not over yet: With vaccination programs rolling out throughout the country, we believe Government assistance and special provisions in the budget are absolutely imperative and will be given its due importance. Reportedly Pakistan has imported COVID-19 vaccines amounting to over USD250mn during the ongoing year.

Revenue enhancement measures

FBR target of PKR5.8tn is still ambitious: The Government requested IMF to set target for FBR tax collection at PKR5.8tn for FY22 (original target by the IMF is PKR6tn) compared to PKR4.6-4.7tn estimated collection during FY21 (9MFY21 FBR tax collection stood at PKR3.4tn, 11.5%YoY higher). Even if the request is accepted by the IMF, the target appears ambitious implying YoY growth in excess of ~23% (increase of over PKR1.1tn) where the nominal GDP is expected to register a growth of 12-13% during FY22. The Government estimates PKR600bn incremental tax collection following nominal GDP growth. It estimates another incremental amount of PKR200-300bn through improvements in efficiencies of the FBR, and estimates another PKR100-150bn through the already implemented Income Tax Amendments. Further, taxes may be raised by rationalization of GST, increasing taxes on unnecessary items, increasing rates of taxes on groups and individuals that fall in higher income brackets, removing tax exemptions, and increasing the documentation of the economy bringing informal sectors in the tax net.

Non-tax revenue to remain in focus: Petroleum Levy (PL), an important component of the non-tax revenues is likely to remain slow as the Government is practicing the policy of not completely passing on the impacts of higher international petroleum products' prices to end-consumers by taking a hit on PL.

Expenditures

Expected 38% hike in PSDP allocation: Against budgeted PKR650bn Federal PSDP for FY21, the Government is expected to spend to the tune of PKR550-600bn resulting in a high utilization when compared to previous years. For FY22, the Government is expected to earmark PKR900bn for Federal PSDP, which is an increase of 38% over the budgeted amount for FY21. The amount includes PKR244bn for Transport & Communications, PKR118bn for Energy, PKR91bn for Water Resources, PKR113bn for social Sector, PKR100bn for Regional Equalization, and PKR31bn for Science & Technology & IT Sector.

While we believe that the overall Federal budget would have neutral to positive implications for Pakistan's capital markets, some budgetary expectations and their impacts on key sectors along with the probability of implementation are discussed below:

Expected key budgetary measures for capital market and their impacts

Measure	Probability	Effect	Comment
CGT rate charged on disposal of listed securities should be made in par with other regional exchanges and CGT rates applied on sale of immovable property	Medium	Positive	The current 15% tax rate on capital gains on disposal of securities is relatively higher compared to CGT charged on immovable property, which ranges from 2.5% to 10%. In addition, there is no benefit of holding period, which is offered on sale of immovable property. It has been proposed to charge 10% tax rate on holding period of up to twelve months while removing charges for period exceeding twelve months.
Tax incentives available for investments in new shares and collective investment schemes (CIS) should be extended to ETFs	Medium	Positive	Offering tax credit in line with other asset classes would attract investments in ETF. At present the unit holder is unable to avail tax credit as per section 62 of the Ordinance. It has been proposed that ETFs should be incorporated under the definition of shares for tax credit. In addition, for the purpose of tax calculation holding period should be considered to have commenced from the date of purchase from the stock market for investors other than the Authorized Participant.
Rationalize tax rates for listed companies	Medium	Positive	It has been proposed that a tax credit equal to 20% of the tax payable shall be allowed for the tax year in which the company is listed.
Enhance tax credit for listed SMEs	Low	Positive	SMEs contribute significantly to economy and have large number of people employed. To attract small companies to get listed PSX has launched an SME board. However, to encourage their enlistment it has been suggested to give tax credit of 50% of tax payable for a period of 3 to 4 years of listing and reducing it to 20% thereon.
Promoting REITs structure and documenting real estate sector	Medium	Positive	At present the rate of tax on dividend from REIT schemes is higher at 25%. It is proposed to bring this in line with 15 % charged on mutual funds. In addition, advance tax on property transfers to/from a REIT scheme should be exempted along with removal of sunset clauses (June 2023) for developmental REIT scheme and Rental REIT schemes. More so CGT exemption should be provided to all categories of REITs (commercial and mixed-use). Application of these measures will attract more investments and help document real-estate sector via disclosures of actual prices and income earned.
Levelling Tax for Corporates	Low	Positive	There is inconsistency in tax charged such that corporate businesses pay 44% total tax whereas unincorporated businesses are taxed in various slabs from 0% to 35%. More so, corporate profits are taxed twice: 29% on income and 15% on dividend distribution. It is therefore proposed to reduce corporate tax rates (or increase and add clarity in tax laws for Limited Liability Partnerships) so as to promote corporatization and generate more tax revenue.
Disparity in FBR & SECP rules relating to Sharia Compliance	Medium	Positive	The requirement stated in Income Tax Ordinance (2001) compared to those mentioned in SECP Regulations for availing tax benefit (2% if company becomes Sharia compliant) are more stringent and not feasible to implement. Hence, it is proposed that income tax laws be modified and made practical in order to encourage the development of Islamic capital markets.

Source: PSX Proposals, NEXT Research

Expected key budgetary measures and their impacts

	Measure	Probability	Effect	Comment
Banks	Reduction in corporate tax rate from 35% to 29%	Low	Positive	PBA has proposed to reduce corporate tax rate on banks from 35% to 29%, in-line with other corporate sector companies. If this proposal is accepted, it would have a positive earnings impact of 9% on banks' earnings.
	Discontinue Super Tax at 4%	Low	Positive	PBA has also proposed not to extend super tax that is charged now only on banks at 4%. We find it unlikely given the revenue shortfall and the government's fight against COVID-19. If implemented, it should increase earnings of banks by around 4%.
	Reduction in WHT on banking transactions of over PKR50,000	Low	Neutral	We do not see it happening however, if implemented, it would have a neutral impact on banks.
Oil & Gas E&P	Reduce tax rate to bring it in-line with other sectors	Low	Positive	Tax rate on E&P companies is over 40% with adjustments for certain allowances. Reducing it to bring it in-line with other corporates will increase the profitability of these companies. However, we do not see this proposal, materializing.
Cements	Incentivizing BMR through enhanced tax credits	Medium	Positive	Currently the tax credits incentives for BMR are set at 5% (although this was slashed down from 10% in previous budget). Upward revision of this tax credit will provide companies an additional incentive to participate in the upcoming expansion cycle.
	Reinstating exemption from income tax on Greenfield investments	Low	Positive	It has been recommended by Pakistan Business Council (PBC) to restore exemption from income tax on Greenfield investments for a period of 5 years. This would be extremely beneficial from a profitability perspective.
	Bringing turnover tax to 0.5% (on a gradual basis)	Low	Neutral	A proposal is put forth, which recommends gradual reduction of 20bps from existing turnover tax of 1.5% for a period of 5 years (ultimately bringing it down to 0.5%). Since we expect strong earnings profile for the sector, this development would serve as a 'safety net' in the short-medium term.
	Rationalization of custom duties and tariffs	Low	Positive	Abolishing / rationalizing custom duties on imports of construction-related machinery and goods would add impetus to cement demand growth.
	Removal of 5% duty on coal	Low	Positive	Any reduction in taxes / duties surrounding coal will be a huge cost-saving for manufacturers, although we don't expect the government to abolish this duty because of limited fiscal space.
	Gradual reduction in FED	Low	Positive	Presently, PKR1,500/ton is charged as FED on cement and a stepwise reduction in FED would surely elevate gross margins across the board, however, risk of the full benefit not being passed on to consumers, this proposal is unlikely to be materialized.
Fertilizer	Agriculture Package	High	Positive	The government is planning to introduce a reform package of PKR110bn, which will be implemented during a period of three years. The package will enhance crop production and improve farmers income by increasing lending to PKR2.7tn (80%). More so, PKR40bn will be allocated in the form of subsidy (PKR1,000/bag) on nitrogenous and phosphoric fertilizers. Besides this, government is also looking to gradually enhance agriculture credit from PKR1.5tn to PKR2.7tn to support farmer economics.
	Input-Output Tax disparity	Low	Positive	The input output tax mismatch has been an ongoing issue for long and has impacted cash flows of fertilizer manufacturers leading to build up of refundable. At present fertilizer players have to collect 2% GST on sales of all fertilizer products, The input tax is charged at 5% on feed and 17% on fuel gas consumption for urea production while 5% on phosphoric acid for DAP along with custom duty of 5%. This results in mismatch of over PKR30/bag on urea and PKR110-150/bag for DAP leading to refund claims by the manufactures. Any rationalization in this regard would impact cash flows of the manufacturers positively.
	Normal tax regime	Low	Positive	Restoring to normal tax regime will be beneficial for fertilizer importers (improve trading margins) who are taxed under minimum tax regime.
	Increase in sales tax rate to 10% from 2%	Medium	Neutral	The government is mulling to increase sales tax from 2% to 10%, which can raise prices of fertilizers products (e.g. urea and DAP by over PKR170/bag and PKR500/bag, respectively). Although its beneficial for manufacturers in easing down input and output tax disparity but we think increase in prices would have ripple effect on food prices.

Textile	Restoration of Zero-Rating Status or reduction in sales tax rate from 17% to 5%	Low	Positive	This will be beneficial for the sector to overcome liquidity issues and meet working capital requirements. However, chances are highly unlikely for its enactment as FBR is not in favour for this proposal and has already devised a mechanism for faster sales tax refund transfer.
	Extension in abolishment of custom and regulatory duty on import of cotton yarn	High	Neutral	The government abolished 5% custom duty on import of cotton yarn for the period till 30 June, 2021. Cotton shortage in the country remains an issue which has affected exports of value-added textile products. Continuation of this measure will not only improve margins but also ensure timely availability of Pakistan textile products in international markets benefiting our exports.
	Extension in regionally competitive energy tariff (RCET) regime	High	Neutral	Provision of cheap electricity at 9 cents/unit and gas at 6.5/MMBtu (PKR50bn subsidy) may likely continue as has been stressed by the Finance Minister. This will ensure reduced cost of production for the textile units.
	Exemption from WHT	Low	Positive	The withholding tax is charged at various levels such as commercial knitting and dyeing items and import of raw material. Removal of the tax will be beneficial for exporters in bringing down their refunds.
	Export Finance Scheme (EFS) and Long-Term Financing Facility (LTFF) schemes	Medium	Positive	It is proposed that an amount of PKR200bn be allocated to ensure short-term credit availability and long-term finance facility to exporters.
	Reduction in Corporate Income Tax rate to 25% and Turnover Tax to 0.5%	Low	Positive	This will improve sector earnings going forward especially for loss making textile units.
Automobile Assembler	Remove Federal Excise Duty (FED)	Medium	Positive	Removal of FED (2.5% - 7.5%) on locally manufactured cars will reduce car prices and improve sales especially of high-end vehicles. We think government may consider removing FED on vehicles having engine capacity up to 800cc.
	Reduce Turnover Tax from 1.5% to 0.5%	Low	Positive	Reduction in turnover tax will be beneficial for loss making OEMs operating on weak margins. This will also be positive for foreign players who have recently started their operations and are in the beginning of their sales cycle. In addition, the proposed benefit should also be passed to auto parts dealers, retailers and distributors who are unregistered and are taxed at 1.5% of their turnover.
	Removal of Additional Custom and Regulatory Duties	High	Positive	Removal of additional custom duty (7%) and regulatory duties will bring down costs for the manufacturers and in turn will reduce prices. Chances are highly likely for this proposal to get enacted as government is aiming to reduce car prices especially in low engine capacity (800cc). To note, FBR has already exempted ACD and VAT on import of electric vehicles (3W and 2W).
	Import of five year old used cars	Medium	Negative	Enhancing age limit of imported used cars from 3 years to 5 years may hurt local manufactures as customers would switch their buying preference (as 5 years old used cars will be relatively cheaper). However, we think chances are slim for this proposal to get implemented as this would push up imports and put pressure on foreign exchange.
	Incentives for Localization	Medium	Positive	The government may look forward to provide incentives to local manufactures for increasing localization. Such measures may become part of the upcoming auto policy which we think will be focused on encouraging hybrid vehicle manufacturing in the country. Such a measure would be very positive auto parts manufacturers.
Engineering	Removal of 5% RD on import of scrap	Low	Positive	Long steel manufacturers are subjected to 5% regulatory duty on the import of scrap and 2% Additional Custom Duty. Removal of these will help increase gross margins and could also potentially lead to a decline in retail prices but with the entire construction sector booming, we don't expect the government to remove these duties and.
	Reduction in turnover tax for steel dealers	Low	Positive	It's important to reiterate that dealers usually operate with single-digit margins and turnover tax at 1.5% proves detrimental to their profitability which subsequently discourages them from registering themselves into tax brackets. This development would not only improve business environment of the dealers but it will also provide an additional avenue of revenue collection along with streamlining the supply chain process of the industry.
	Removal of CD and ACD on Flat Steel raw materials	Low	Positive	Karachi Iron and Steel Merchants Association has recommended reduction of CD and ACD on HRC and CRC and Sheets pertaining to HS Codes 7225, 7208, 7209 and 7210.

Foods	Restoration of zero-rated sales tax status for dairy products	Low	Positive	ICMA in its budget proposals has staked a case for the reinstating of zero-rated sales tax status for dairy sector. Taxation of milk and cream concentrated i.e., full cream milk powder should be taxed in line with liquid milk counterparts. This will ensure the delta between packaged milk products and loose milk will decrease, subsequently increasing demand of packaged products.
	Abolishing duties on import of dairy cattle	Medium	Positive	Import of animals carries a 2% duty and ACD of 1%. It's proposed to remove these duties which would help increase purchasing power of farmers.
	FED on fruit juices to be abolished	Low	Positive	Currently fruit juices are levied with a 5% FED. This abolishment would help increase gross margins for companies and could potentially provide a trigger for sales.
	50% FED on beverage concentrates to be substantially reduced	Medium	Positive	Beverage concentrates are charged 50% FED while beverages are levied with 11.5% FED. Recommendations to reduce both of these excessively high duties by 50% is given.
OMCs	Reduction in turnover tax can boost profitability (but in the medium-long term)	Low	Positive	According to PBC recommendations, turnover tax is proposed to be reduced gradually by 0.2% every year until it reaches 0.5%. However, OMCs will not reap benefits (at least not in the short term) as this sector is subjected to turnover tax of 0.75%. Nonetheless, with oil prices constantly fluctuating and inventory losses always a concern, materialization of this development will especially bode well for SHEL and HASCOL who have suffered the brunt of this taxation the most in the recent past.
Power	Subsidy allocation for sector	High	Negative	The MoF has alluded to provide PKR330bn, which are estimated to be only 60% of total estimated requirements. Just as a matter of perspective, these unpaid subsidies have contributed towards the accumulation of circular debt. Moreover, it was previously understood that subsidies would not be given to 5 export-oriented sectors under the existing mechanism and they would be linked to actual export receipts. However, the Finance Minister has decided that existing mechanism would continue for at least this fiscal year.
	Electricity tariff would not be increased	High	Negative	It has been clearly indicated by the Finance Minister that public would not be burdened with an increase in electricity tariffs in the upcoming budget, although there is still an air of inevitability regarding its implementation. Accumulation of circular debt would continue to take place if these tariffs are not passed-on.
Technology and Communication	Reduction in taxes on IT products	Medium	Positive	Taxes on computer hardware and equipment's are high and as per industry sources accumulate to 36%. Reduction in taxes will not only provide relief to sellers but also in reducing under invoicing and help bringing under tax net. Similarly, sales tax on IT services imposed on infrastructure equipment should also be reduced.
	Tax exemptions	Low	Positive	It has been proposed that various tax exemptions granted to zero rated sectors should be extended to the sector for next five years in order to boost exports. If made effective this will encourage local and international IT companies to make investments.
	Development of IT parks	Medium	Positive	Incentives should be provided for the development of free Technology Parks (proper IT facilities and supporting equipment) in Special Technology Zones which will facilitate development of start-ups.
	E- Commerce business	Medium	Positive	Other proposals are also being put forward in ecommerce domain to promote this business for e.g. development of electronic payment gateway system; IT Security and Audit system of banks for secure payments.
Pharma	Exemption of GST on purchase of items	Low	Positive	Pharma companies import API from other countries owing to lack of excess production capacity. GST rate charged on some of the excipient, packaging material and services procured is made part of the product cost. It is proposed to grant exemption on different stages in order to reduce cost of production.

Source: News Media, ICMA, PBC, NEXT Research

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