Budget 2019-20: A Tsunami of Inflation

Pakistan is currently under the affect of a tsunami of inflation triggered by Budget FY20, with its epicenter found with the IMF. It is hurting everyone, from the effluent businessman to the poorest consumer, wave after wave showing no signs of reprieve. The tsunami has been caused by the govt., under IMF guidelines, allowing virtual free float of the exchange rate, incessantly raising old taxes and imposing new ones, increased burden of documentation on the economy and giving energy regulators (NEPRA, OGRA) and gas distribution companies a virtual free hand to raise prices in order to keep their respective account books favorably balanced.

The business and industrial community (comprising of industrialists, small and medium enterprises, cottage industries, traders and service providers) is the engine of the economy, and the engine has now been clogged with bad grease in the form of inflation i.e. cost push inflation. In cost push inflation, products become expensive not because domestic demand is rising but due to increase in the cost of factors of production. Macroeconomic instability leading to persistent deterioration in the fundamental metrics have given way to policies such as devaluation of the PKR, tight monetary policy, lifting of subsidies from utilities and incessant brutal indirect taxation which have critically increased cost of production. Accompanied with lower demand (both from higher prices and higher interest rates), inflation is leading the economy towards stagflation.

Widespread dissatisfaction in Naya Pakistan

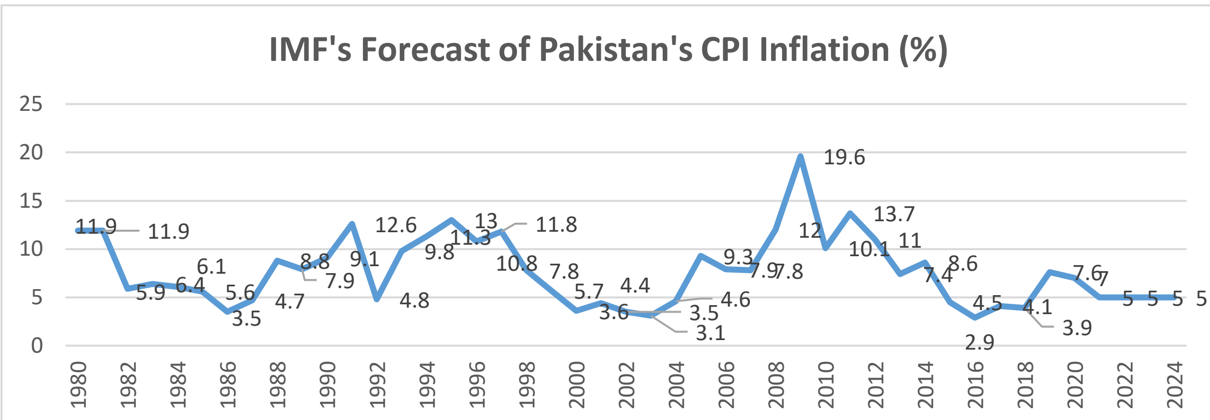
About a year ago, incumbent PM Imran Khan swept to power with a promise to make a corruption free prosperous "New Pakistan", having equal opportunities for all. But today, there is widespread dissatisfaction among all cadres of society owing to rising prices. In the past one year, value of the Pakistani rupee has dropped up to 30%, prices of both imported and domestic commodities have sky-rocketed and inflation has soared by 7%, with expectations of further price hikes in the aftermath of budget FY20. Imran Khan promised a welfare state, but a derailed economy has forced him on the back foot leaving most of his promises unfulfilled.

An IMF loan Invariable comes with painful conditions

To revive the country's economy, the govt. borrowed money from countries such as Saudi Arabia, UAE and China; yet the amount received was insufficient and Pakistan was left with no other option than to approach the International Monetary Fund (IMF). However, the IMF's structural development conditions for the loan aid worsened the situation and have led to a rise in prices of essential services. An IMF loan invariably comes with conditions requiring painful reforms including reducing higher interest rates, monetary tightening, currency depreciation, higher taxation and more documentation; all of these , fiscal and trade deficits, fixing or selling off loss-making govt. companies and leaving the exchange rates free of the central bank’s intervention, even if rupee devaluates.

Inflation has affected everybody

In order to curb inflation, and to ease demand pressures, the State Bank of Pakistan (SBP) has been continuously tightening the monetary policy and further tightening is expected in the current year, while to curb demand of imported products, multiple barriers (both tariff and non-tariff) are being aggressively applied. These measures have affected businesses; almost everyone, from small to big, employees, trade unions, daily wage earners, teachers, agriculturalists, industrialists, industrial workers – seems to be agitating against the IMF's prescriptions of high taxes and increases in oil, gas and electrify prices, giving rise to unprecedented inflation in the country. It is common knowledge that whenever an economy grows, businesses expand and more jobs are created. People get promotions, salary increments and start spending money on food, clothing, recreation, automobiles and even houses. And all of this reverses, when it shrinks. This is exactly what the govt. is doing; it is purposefully slowing down the economy, thereby giving rise to unemployment and wage reduction, and hence lesser propensity to spend.



Almost all sectors are feeling the heat

Profitability of multiple sectors is already on the decline with a number of auto makers already resorting to multiple production stoppages during the week, with indications of massive layoffs in the near term. Layoffs in other sectors, notably from senior positions has also begun. This will create a dangerous downward cycle as people who are laid off will be left with no income, albeit temporarily, to create demand that is already lackluster to begin with. They might be compelled to work for less pay which is quite cruel considering that the purchasing power of their current income has already fast depleted.

Higher inflation and a tighter job market will slow down economic growth. On the other hand, higher taxes and lower spending will squeeze all expansion plans of businesses, although it will help govt. reduce budget deficit. Higher budget deficit has also reduced governmental capacity to spend on development projects like transport, energy and water infrastructure, education and health.

Inflationary effect of Budget FY20 on traders, Small Medium Enterprises and Industrialists

- Turnover tax of loss making firms was increased in the budget. This places a burden on firms already incurring losses. This regressive tax will push loss making companies towards closing their businesses. Giants such as Pak Suzuki Motors has reported half yearly loss of PKR 1.5Bn while Honda has reported 41% reduction in profits. When these large behemoths are struggling, how can small enterprises not?
- Furthermore businessmen need working capital from the Banks which has also become expensive increasing the cost of filling export orders.
- Key factors of productions such as electricity, gas and petrol are increasing at a frightening pace.

- Tax on essential business services including transportation has been enhanced by 2% to 4% which will push the cost of doing business manifolds. On top of that the govt. played at the hands of the transporters and increased Axle load restrictions which means that now two trucks will carry the load that previously carrying. Transportation head charges will be doubled.
- Increase in fuel prices will increase the cost of doing business as transporters will pass it down to the consumer. Rail transport has also become costly with hike in petroleum prices.
- 5 Rated Zero sectors will now be subject to tax. This will ruin the export oriented industries, cause flight of capital, mass unemployment and foreign exchange losses and worsen cost push inflation. In one annual budget never have so many industries been taxed.
- Tax rates have been increased on inputs and production on large-scale industries like textiles, leather manufactures, aerated water, vegetable ghee, cooking oil, cigarettes, sugar, cement, iron and steel, engineering goods, CNG and fertilizer.
- Furthermore the small-scale manufacturing sector also has been brought more into the tax net. Thus, increasing the cost of production and tightening breathing space for informal businesses.

Inflationary effect of Budget FY20 on the consumer

- Tax exemption threshold on salaried class has been reduced to 0.6Mn from 1.2Mn. Purchasing power of the salaried class is eroding as the dollar continues to scale new heights. To further make things worse for the salaried class even those with lower salaries will now be subject to income tax.
- Due to this back breaking inflation many parents will now decide to take out their children out of school and make them to work as underage laborers be it in brick kilns, agricultural fields and factories in order to increase their family's income. Inflation will essentially ruin another generation of the poor and drive them away from education and towards poverty.
- With rise in inflation more people will move towards a life of crime leading to an increase in snatching, robberies, kidnapping and possible resurgence in extortion.
- Enhancing sales tax on essential items such as sugar and edible oil will make family home staples expensive and eat into the pockets of even the poorest of people. The price of Roti has gone up by almost 50%. Previously it was selling at PKR 10 but now it is selling at PKR 15.
- Increase in CNG price in Region 1 by 15.54% to 74.04/kg. CNG is the go to fuel and the increase will lead to hike in bus fares and higher amounts of salary being spent on travelling for those owning cars.
- Sindh govt., in its provincial budget, announced increase in taxes on online cab aggregators such as Uber and Careem, further increasing the cost of transport for the middle and lower middle class segments of society.
- Sindh govt. has also increased the tax on internet services which will decrease the pace of growth of the digital economy.
- As opposed to the PM's vision for low cost housing, by doing away with the special tax procedures on steel sector, application of PKR 13/unit of electricity to FED rate of 17% will lead to the raw material essential to building a house becoming even more expensive. Similarly FED on cement has been increased to 2/kg from 1.5/kg.
- FED has been enhanced on fruit juices from 0 to 5% and to 13% on beverages from 11.5%. The two items have become a consumer staple within their own right and the increased price will hit the common man.

- Clothing which is a human necessity will now be subject to 17% sales tax. Previously the duty was 0% as govt. finishes up on 5 zero rated sectors. Also on the local supplies of finished articles of textile and leather sales tax has been increased from 6 % to 15%. The lower middle class and the poor who previously used to buy just one or two pieces of clothes particularly for Eid will now find it even harder to buy them even.
- Rise in CNG prices has led to bus transporters to jack up their prices leading to the transportation expense of the poor to increase.
- Healthcare will become more expensive similarly as on local sales of surgical items now a sales tax of 17% will be charged. With illnesses on the rise due to a multitude of reasons such as pollution and poor quality of food, this step will inflate the hospital bills to new heights.
- Local sports goods will also become more expensive with the withdrawal of zero-rated exemptions. Sports goods will now have a 17% tax included which will make it expensive for the masses to get involved in healthy activities and instead fall prey to bad elements of society. This also goes against the vision of PM Imran Khan to create a healthy and sporty nation.
- From tea to desserts, everything that uses sugar will be more expensive as price of sugar will increase by PKR 3.5 per Kg following an increase in sales tax. Similarly, processed food like meat, chicken, fish and cooked and semi-cooked meals will have a 17% sales tax imposed on them. The govt. believes these items are usually consumed by people who are financially well off.
- Those who like to have a cold drink with their meal will have to pay a bit more as the duty on carbonated drinks has increased from 11.25% to 13%. The purpose is to discourage the consumption of sugary drinks. They are also imposing a 5% duty on non-aerated drinks like syrups and squash juices. And only if you were thinking that you would not be affected because you do not have a sweet tooth, you would be wrong because other foods like fried items will also see a rise in tax. The govt. is abolishing the PKR 1 per kg tax on ghee and cooking oil, but increasing the federal excise duty (FED) on these items to 17%.
- Cement was chargeable to federal excise duty @ 1.5 per kg which has now been increased to PKR 2 per kg. This would increase the 50kg cement bag rate by PKR 25.
- Similarly, buying cars will also cost more since the FED on all automobiles of 1000cc and above will increase. You will be charged an FED of 2.5%, 5% and 7.5% on vehicles with engine capacities in the range of 1001 and 2000 cc, and 2001 cc and above respectively. Even driving your car on gas will cost more.

Inflationary Impact of Govt.'s Measures before Federal Budget 2019-20

- **Electricity:** Prices revised in May 2019 in which cost of electricity increased by 30.94% for commercial users (till 5kw) and by up to 23% for industrial consumer.
- **Petroleum:** Price of petrol was PKR 91.96 on 12th Jun'18, which has been increased to PKR 117.83 (up by 28%) as of 1st Aug'19.
- **Interest Rate:** Interest Rate has seen a drastic change as it was 7.5% in Jul'18, but now it has reached to 13.25% increasing by 575 bps. It will increase the cost of borrowing and working capital financing by manifolds.
- **Freight Trains:** Rate of Freight Trains from Karachi to other destinations before Jun'19 was in between PKR 500-576, now rates have been increased to PKR 600-640 an increase in the range of 20% - 11.30%.

- **Gas Prices**: The govt. in Sep'18 had increased natural gas prices by up to 143% to recover PKR 94Bn. Now again Petroleum Division has increased gas prices by up to 200% for domestic consumers with effect from July 1, 2019.
- **Axle Load:** The govt. decided to implement the Axle Load limit on National Highways and Motorways (NHM) as provided in National Highway Safety Ordinance-2000, from June 1 which has been deferred for the time being. This would also increase the cost of doing business as transporters would be enticed to make more trips which would nearly double the cost of transportation.

Radical solutions needed to fix inflation

The common man will continue to suffer on account of increase in the prices of basic commodities. The govt., instead of blaming the situation on economic fundamentals flaws stoked about by the past governments, should focus on at least fixing some of the structural issues responsible for this disastrous inflation. Food supply chains in Pakistan are highly flawed. Procurement and supply of all food items are highly unregulated. There are huge margins for middlemen without any documentation and taxation. These middlemen need to be regulated and their margins brought under control so that at least the consumers can get some relief in these items. The perfect solution lies in elimination of middlemen and replacement of such persons by a documented sector having preservation capabilities and improved logistics.

The greatest counter to cost push inflation that Pakistan suffers from is facilitating businesses to increase the supply of goods and services. However, interest rates have been raised so high, businesses focus on short term projects and returns and also choose to trade in foreign currencies. Enhancing manufacturing by creating a more investment-friendly environment, broadening its tax base, and encouraging innovation and modernization in export-led industries are just some of the most urgent measures the govt. needs to take. If businesses are not given incentives to produce more goods how can inflation possibly come down?

Heavy reliance on imported petroleum products is one of the chief causes of inflation. As a heavily oil-reliant importer, and with no real foreign exchange or fiscal buffers to limit pass-through to domestic prices, a major part of Pakistani inflation is simply determined by global oil price movements. The govt. needs to try to find cheaper innovative methods to lower the oil import bill. Current policy of shifting towards LNG is certainly a step in the right direction. However the energy mix needs to become much cheaper in order to bring the cost of production down.

One of the biggest reasons for inflation was the govt.'s heavy reliance on borrowing from the SBP. As it delayed going to IMF, it was left with no choice but to borrow from the central bank. To keep this under check govt. needs to enhance tax collection not from the already strained formal sector but the vast undocumented informal sector.

India was also suffering from double digital inflation on the back drop of the global financial crises in 2008 but they have a better price control and governance mechanism there. So as soon as energy and global food commodity prices plummeted, the prices also were also reigned. Unfortunately in Pakistan, once the prices of goods go up they never come down. As food is an overwhelming component of Consumer Price Index, Pakistani can temporarily ban the exports of food items to increase the domestic supply and reduce the prices.

Govt. can help offer a wage subsidy to try to decrease the cost of production. For example, after the 2008 financial crisis, Singapore helped firms pay 12% of the wages of a worker up to the first $ 2,500. This can reduce the cost of production in the economy substantially as labor cost accounts for the largest proportion of the total cost of production in the economy.

Pakistani govt. also needs to decrease the cost of production in the economy by increasing labor productivity in the economy through increasing the skills and knowledge of labor. A greater focus needs to put on the skills of the 4th industrial revolution. Also SBP needs to try to become more active in the exchange rate market and try to bring the price of the USD down so that the cost of imported raw materials comes down which will help reduce the cost of production.

In sum, inflation is a multi-source problem. It has been high, but manageable, in Pakistan. But because it affects the poor disproportionately, the govt. must continue to take structural measures to keep it low, and to compensate the poor via lifeline tariffs and cash transfers for any temporary surges. The next two years are difficult and if the govt. is able to fix the largest economic problem, taxing the rich (read tax dodgers), the economy will bounce back strongly. If not, we may need another bailout from the IMF at the end of this govt.'s tenure.