POLICY BRIEF

Federal Budget 2024-25: An Overview of Strategies and Priorities

Social Policy and Development Centre
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THE POLICY CONTEXT

The federal budget for fiscal year 2024-25 has been presented against the backdrop of a moderately improved macroeconomic environment compared to the previous fiscal year and a colossal fiscal challenge ahead. According to the Pakistan Economic Survey, the real GDP growth for 2023-24 is estimated to be 2.38%, driven by the agricultural sector (6.25%), while modest growth in industry (1.21%) and services (1.21%) tempers overall performance. Moreover, there are some positive signs of economic stabilization, such as a declining trend of inflation rates in April and May 2024. Also, the State Bank of Pakistan (SBP) recently reduced the policy rate by 150 basis points, bringing it down from 22% to 20.5%, though it still remains relatively high. Furthermore, there has been a notable improvement in per capita income, which rose from US$1,551 in the previous year to US$1,680 presently.

Despite these positive indicators, key concerns remain to be addressed. The investment-to-GDP ratio, already low as per global standards, has further declined from 14.1% to 13.1%, and large-scale manufacturing has not shown significant growth. These trends likely stem from the SBP's demand management policies, which include maintaining high interest rates. Additionally, high government borrowing from private banks to finance the deficit crowds out private investment.

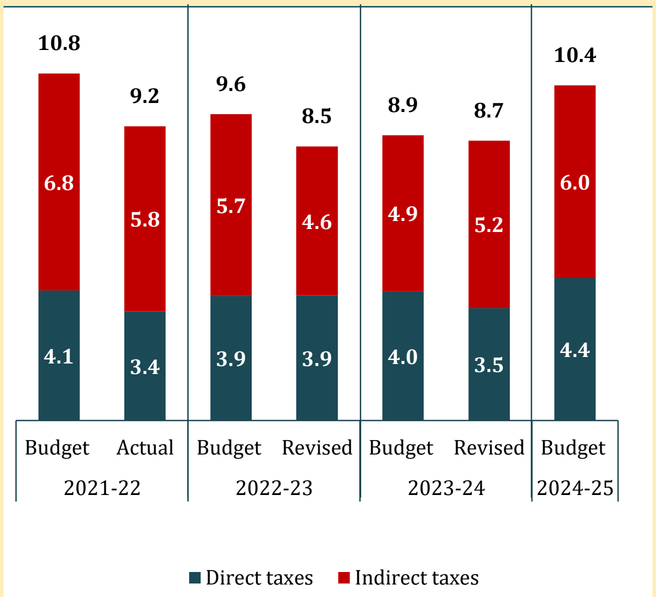
AN OVER-AMBITIOUS AND REGRESSIVE RESOURCE MOBILIZATION STRATEGY

The Federal Board of Revenue (FBR) is projected to fall short of its revenue target by Rs 163 billion in 2023-24, as the revised estimates show a collection of Rs 9.25 trillion against the target of Rs 9.42 trillion.

Looking ahead to 2024-25, the government has set an overambitious revenue target of Rs 12.97 trillion, with a 40% increase over 2023-24, achieving which would be an uphill task. The government's strategy hinges on a substantial increase in direct taxes, aiming for a rise from Rs 3.7 trillion to Rs 5.5 trillion. Interestingly, all the categories of direct taxes are projected to grow exactly at the same level (48.1%) despite the fact that no visible changes in the worker welfare fund and workers' profit participation fund are proposed. This is a reflection of an arbitrariness in revenue projections. Indirect taxes are also expected to grow by 34.8%, largely driven by an anticipated increase in sales tax revenues from Rs 3.6 trillion to Rs 4.9 trillion (a 36.4% rise).

The overall targeted growth in tax revenues (40.2%) far exceeds the projected growth in nominal GDP (17.1%), resulting in a sharp increase in the projected tax-to-GDP ratio (10.4%). However, this is not the first time the government has set such a high target. For instance, in 2021-22, the government targeted a tax-to-GDP ratio of 10.8%, but the actual collection was 9.2% (see Figure 1).

Figure 1: Tax-to-GDP Ratio (%)



Source: Estimates based on Federal Budget in Brief 2024-25.

Similarly, in 2022-23, the collection was 8.5% of GDP against the target of 9.6%. Therefore, it is important to examine what the government plans to do differently to achieve this high target and reach a double-digit tax-to-GDP ratio.

The tax strategy outlined in the Federal Budget in Brief emphasizes the government's commitment to ambitious revenue targets for 2024-25. This aligns with ongoing reforms at the FBR, including comprehensive digitization efforts and the integration of AI to automate processes. A new compliance risk management system is also being introduced to ensure adherence to tax laws. While the integration of AI and digitalization promises to enhance tax compliance and broaden the tax base inclusively, their effective implementation remains critical, ensuring no exclusions of elites or high-profile individuals.

In contrast, the Finance Bill portrays an entirely different strategy of relying primarily on tax rate enhancement and pursuing a more regressive taxation. The proposed revisions include higher tax rates for both salaried and non-salaried taxpayers. Non-salaried individuals face tax rates ranging from 15% to 45%, with an unchanged exemption limit of Rs 0.6 million (annual income). The tax rates for the salaried class range from 5% to 35%, maintaining the same exemption limit.

The exemption limit can be better understood in its historical context. In 2018-19, the government set an exemption limit of Rs 1.2 million for income tax. This limit was revised downward in 2019-20 to Rs 0.6 million and has remained unchanged since then. However, subsequent high inflation and substantial depreciation of the Pakistani rupee against leading currencies have significantly eroded the purchasing power of the rupee. Our estimates show that in real terms, Rs 0.6 million in 2019-20 is equivalent to Rs 0.31 million in 2023-24, with further erosion expected next year. Additionally, in 2019-20, the minimum wage was Rs 17,500, and the budget for 2024-25 has increased it to Rs 37,000. Despite these developments, keeping the exemption limit unchanged is highly regressive.

The government has also enhanced the tax rates for both salaried and non-salaried individuals. For the salaried class, each income bracket has seen an increase of 2.5%, except for the highest rate, which remains at 35%. Consequently, the rates have shifted from 2.5% to 5%, 12.5% to 15%, and so on. Furthermore, except for the first slab, the upper and lower limits of the income brackets have been reduced. For instance, the second slab now starts at Rs 2.2 million instead of Rs 2.4 million, and the topmost slab starts at Rs 4.1 million instead of Rs 6.0 million. This restructuring will substantially increase the tax burden on the salaried individuals. The proposed changes in tax rates are estimated to result in an annual incremental tax of up to Rs 270,000 per individual.

The salaried class is perhaps the only group that consistently pays its due share of taxes. The withholding tax regime ensures that their income is transparent, as employers deduct taxes before disbursing salaries. The proposal in the current budget to raise tax rates while keeping the tax exemption limit the same and changing the slab cut-offs is highly regressive, as it disproportionately affects lower-income individuals.

Moreover, the very high tax rates for the non-salaried class are likely to encourage under-reporting of income and the misclassification of income as agricultural income, which falls outside the FBR's purview. A comparison of tax liabilities across different income groups, relative to previous years, indicates an estimated annual incremental tax of up to Rs 2.225 million per individual.

Apart from these changes, the FBR is aggressively targeting non-filers and late filers with substantially higher rates. While this approach may help document the economy and increase the number of filers, it is unlikely to result in a significant increase in tax revenues, as many existing filers have zero tax returns.

In addition to major revisions in income tax, the government has also changed the rate of capital gains tax on both stocks and real estate, along with other adjustments. While these revisions will enhance tax collection, they are unlikely to achieve the desired level of revenue because of likely under-reporting in real estate value and a fall in transactions at stock. These changes are expected to negatively affect real GDP growth, which will likely shrink the tax base. Therefore, while there may be a positive rate effect, the overall impact will be moderated by a negative base effect.

Dynamism in Federal Non-tax Revenues

The revised estimates for federal non-tax revenues in 2023-24 indicate a collection of Rs 2.95 trillion, which is almost equal to the target of Rs 2.96 trillion, with some adjustments in different heads. This achievement is primarily due to a substantial increase in petroleum development levy revenues, which amounted to Rs 960 billion against the target of Rs 869 billion. In contrast, SBP profits (Rs 0.97 trillion) fell lower than the target of Rs 1.1 trillion despite a massive growth in domestic debt servicing. This shortfall indicates that T-bills sold to the private sector by SBP were more than the targeted at the time of the budget.

The outlook for 2024-25 indicates a massive growth of 64% in non-tax revenues. This growth is largely driven by the targeted SBP profits, which are expected to reach Rs 2.5 trillion. Essentially, the government aims to borrow a substantial amount of money from the SBP, paying interest to the SBP instead of commercial banks, which in turn results in SBP profits. While this approach may help reduce the crowding-out effect of government borrowing, it could also lead to a rebound in inflation.

Additionally, the Petroleum Development Levy (PDL) is a major non-tax revenue generator for 2024-25, with a target of Rs 1.3 trillion. The projected growth of more than 33% in PDL revenues is largely based on an upward revision of the per-litre PDL rate on both petrol and diesel. For 2024-25, the upper limit of the per-litre PDL has been increased to Rs 75 for petrol and Rs 80 for diesel. While this revision may help achieve the revenue target, it is likely to have significant inflationary implications. On the other hand, it could also be seen as a positive move since the PDL functions as a form of carbon tax, potentially helping to reduce greenhouse gas emissions.

Federal Own Revenues and Transfers to the Provinces

In fiscal transfers, the provinces receive a larger share of tax revenues, while non-tax revenues are solely owned by the federal government. The revised estimates for 2023-24 indicate that provinces will receive the budgeted amount of Rs 5.4 trillion. The fiscal outlook for 2024-25 for transfers to provinces is also positive, with a targeted amount of Rs 7.4 trillion. This substantial increase is based on the hefty increase in tax revenues budgeted for 2024-25.

In contrast, the federal government's net revenues fell short by Rs 207 billion – Rs 6.77 trillion against the target of Rs 6.98 trillion. This shortfall poses challenges to the federal government's financial objectives and may necessitate a closer examination of non-tax revenue sources, particularly the shortfall in SBP profits. The outlook for net revenue receipts is also positive for 2024-25 as the federal government heavily relies on both tax and non-tax revenues.

THE STATED EXPENDITURE STRATEGY

The *Federal Budget in Brief 2024-25* outlined the expenditure strategy. It stated,

> "*On the expenditure side, non-essential spending has been curtailed under austerity measures, and state-owned enterprises (SOEs) are being revamped for improved management and governance. Looking ahead, this will create the necessary fiscal space for enhanced pro-poor spending, climate change mitigation, and provision of quality public services.*"

In this context, we attempt to examine the federal government's expenditure priorities and explore what austerity measures are delineated in the budget documents.

Austerity Measures Fall Short, Current Spending Set to Rise

Revised estimates of current expenditure for 2023-24 significantly exceeded initial allocation targets. The revised estimates show that spending will surpass Rs 14 trillion – Rs 0.9 trillion above budget estimates. This surge is primarily driven by rising interest payments on domestic and foreign loans. Furthermore, revised estimates reveal that all major spending categories surpassed their allocations in 2023-24, raising concerns about the presence/effectiveness of any austerity measures.

To assess the effectiveness of austerity measures, current expenditure allocations for 2024-25 and revised estimates for 2023-24 are compared. Total current expenditures are projected to reach Rs 17.2 trillion (Figure 2), with a substantial increase of 21% compared to the previous year. Even accounting for the 12% inflation target, this represents a significant real-term rise.

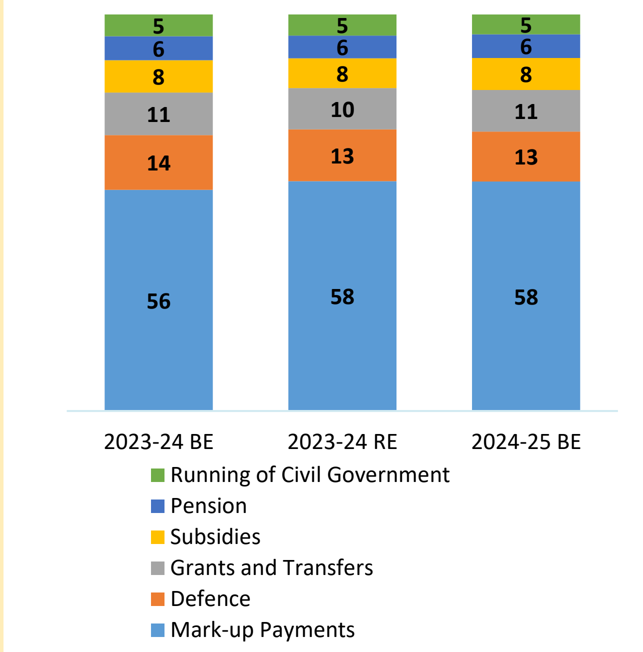
Figure 2: Current Expenditure Priorities (Rs trillion)

	2023-24		2024-25
	Budget	Revised	Budget
Mark-up Payments	7.30	8.25	9.78
Defence	1.80	1.85	2.12
Transfers and Grants	1.41	1.48	1.78
Subsidies	1.06	1.07	1.36
Pensions	0.80	0.82	1.01
Civil Government	0.71	0.75	0.84
Emergency Provisions	0.25	0.00	0.31
Total	**13.34**	**14.23**	**17.20**

Source: Federal Budget in Brief 2024-25.

All major spending categories, except for foreign debt markup payments, are set to grow by double digits in 2024-25. Subsidies are leading the charge with a 27.3% increase, followed by allocations for civil and military pensions (23.5%) and domestic interest payments (21.2%). Transfer payments, defence spending, and administrative costs are also slated for significant increases of 19.9%, 14.5%, and 11.4%, respectively. These figures paint a clear picture: the federal government is not implementing meaningful austerity measures in the current budget.

Figure 3: Current Expenditure Priorities (% shares)



Source: Estimates based on Federal Budget in Brief 2024-25.

A comparison of current expenditure distribution across categories between 2024-25 and 2023-24 (both budget and revised estimates) reveals no changes in spending priorities (Figure 3). For Instance, the share of markup payments remains 58% in revised estimates for 2023-24 and budget estimates for 2024-25. Similarly, defence, transfers and grants, subsidies, pensions and running civil governments have the same shares of 13%, 10%, 8%, 6% and 5%, respectively, in both years. This clearly reflects a lack of prioritization in addressing the current fiscal challenges.

Federal Development Expenditure

The total federal Public Sector Development Program (PSDP) was budgeted to be Rs 1.15 trillion in 2023-24. However, revised estimates reveal a worrying trend as the PSPD allocations remained at 0.834 trillion, including Viability Gap Funding (VGF) for Public-Private Partnership (PPP). A decline of 27.5% in development spending suggests a priority away from long-term development goals.

The PSDP outlay for 2024-25 is budgeted to be Rs 1.5 trillion. Interestingly, the budget allocates a substantial increase for water resources development, with spending rising from Rs 100 billion to nearly Rs 260 billion. Additionally, the allocations under the Cabinet Division have increased from Rs 10.9 billion (2023-24 revised estimates) to Rs 75.8 billion in 2024-25. This significant increase suggests a potentially growing role of the Cabinet Division in shaping development priorities.

Meanwhile, allocations for the national highway authority and NTDC/PEPCO remain consistent with previous years at Rs 180 billion and Rs 176 billion, respectively. This suggests a continued and growing focus on highway and power distribution networks.

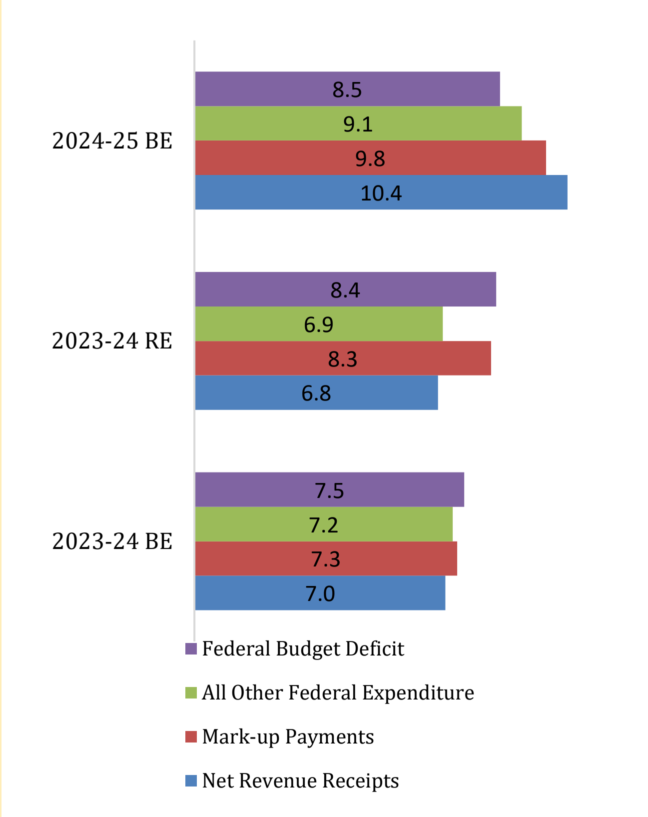
FEDERAL FISCAL DEFICIT: AGGRESSIVE TAXES MAY NOT BE ENOUGH

As mentioned above, the federal government slashed the PSDP by 27.5% in 2023-24. While this decision may have long-term implications for economic growth and development, it did succeed in reducing overall government spending (excluding interest payments). However, this reduction was not enough to meet the federal government's fiscal deficit target. The root cause of the shortfall lies in net revenue receipts (gross revenue minus transfers to provinces) falling significantly short of covering both interest payments (mark-up payments) and all other government expenses. This resulted in a substantial fiscal deficit exceeding both the target and the net revenue collected.

For 2024-25, an increase of 53% in net revenue receipts of the federal government is projected due to massive taxation proposals. However, it appears that this increased revenue will almost be entirely consumed by markup payments. This means the government will still need to borrow money to cover all other expenditures.

On a positive note, the extensive taxation measures, if materialized, are expected to generate a primary surplus (fiscal deficit excluding interest payments) for the first time in recent history. This suggests some progress towards controlling debt, but significant challenges remain.

Figure 4: Key Budgetary Magnitudes (Rs in trillion)



Source: Estimates based on Federal Budget in Brief 2024-25.

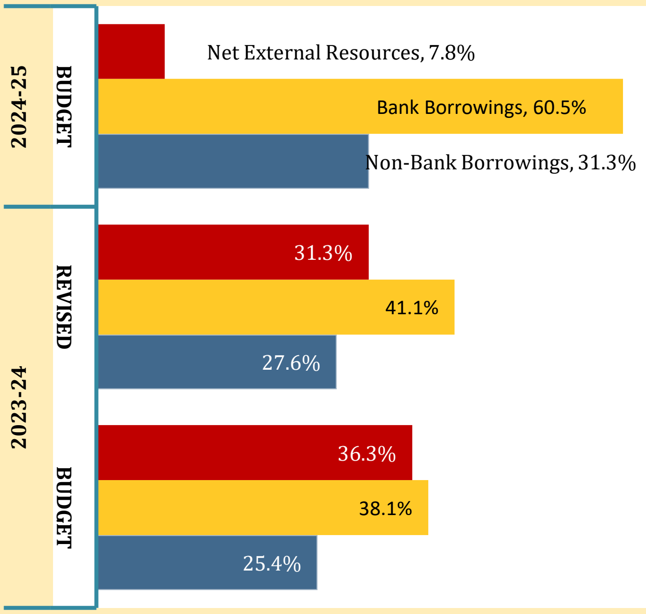
Financing the Fiscal Gap: A Cause for Concern

Figure 5 reveals how the federal government finances its budget shortfalls (fiscal deficits). In the budget 2023-24, the government initially planned to finance the deficit with 25% from non-bank sources, 38% from bank loans, and 36% from external borrowing. However, revisions show a shift, with 28% coming from non-bank sources, 41% from banks, and 31% from external sources. This increased reliance on bank borrowing has macroeconomic consequences. It can "crowd out" private sector investments, meaning banks lend more to the government and less to businesses. This restrained the industrial sector, which grew by 1.2% in 2023-24.

The outlook for 2024-25 paints a worrying picture. With over 60% of the fiscal deficit planned to be financed through bank borrowing, 31% from non-bank sources, and 8% from external sources, a significant decrease in foreign funding is evident.

This heavy reliance on bank borrowings is a double-edged sword. While the government secures funding, it could crowd out private businesses seeking credit, potentially hindering investment – already a concern given the low investment-to-GDP ratio. Additionally, borrowing from the SBP can significantly impact monetary policy. This might lead to excessive money printing, fueling inflation.

Figure 5: Financing of Federal Fiscal Deficit (%)



Source: Estimates based on Federal Budget in Brief 2024-25.

Furthermore, the massive growth in SBP profit under non-tax revenues suggests the government intend to borrow heavily from the SBP, essentially monetizing the deficit. This strategy carries a significant risk of exacerbating inflationary pressures, potentially jeopardizing recent efforts to achieve price stabilization. In essence, the chosen financing approach could backfire, jeopardizing both investment and inflation control.

CONCLUSION

The federal budget 2024-25 prioritizes fiscal sustainability within a relatively stable domestic environment but faces challenges from a less supportive external environment, such as dried-up foreign resources. The emphasis on achieving fiscal sustainability through ambitious tax targets and lack of austerity measures in budgetary allocations raises two key concerns.

First, aggressive tax increases, coupled with high inflation, disproportionately burden lower and middle-income earners compared to wealthier filers who may evade taxes. Targeted tax relief is essential to alleviate this burden. Second, budgetary outlays indicate that inefficient spending persists, with significant real growth in current and development expenditures.

The persistent high federal fiscal deficit and escalating domestic bank borrowing amid a challenging external environment raise significant concerns about the potential crowding out of private investment and fueling inflationary expectations. Urgent measures are required to mitigate these risks and secure a sustainable fiscal outlook for 2024-25.

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