Budget Strategy Paper
FY 2020-21

FINANCE DEPARTMENT
GOVERNMENT OF KHYBER PAKHTUNKHWA

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1. Preface

Budget Strategy Paper (BSP) is a statement of Government's policy goals and strategic priorities for the upcoming budget in relation to the fiscal outlook. The BSP sets out the indicative budget ceilings to the administrative departments and is a useful tool for prioritising spending plans based on policy priorities. The BSP also assists the legislature to gauge the performance of the Government as well as to suggest improvements in the financial management. The fiscal projections are based on the socioeconomic outlook of the province; fiscal forecasts of the federal government, provincial revenue expectations and expenditure priorities, financing options and debt management. The BSP has been presented to the Cabinet for its approval on June 04, 2020.

2. Socioeconomic Outlook of Khyber Pakhtunkhwa

2.1 Economic Landscape

The province of Khyber Pakhtunkhwa (KP) is the smallest province in Pakistan in terms of area, even including Newly Merged Areas (NMAs), but the third most populous one according to the latest census 2017. With 35.5 million people in an area of 101,741 sq.km, KP's population density is 340 persons/sq.km. A large segment of the population (approx. 84%) resides in rural areas and 64% of the population represents the youth bulge, i.e. those below the age of 24 years[1].

The province contributes on average 11.5% to 13% to the national GDP, where in 2018-19 a major share was in services sector (58.9%) followed by industrial (22.8%) and agriculture (18.3%) sectors. KP's economy has grown by 5.8% on average in the last four years (3.7% in 2018-19), with agriculture, industry and services sectors growing on average by 2.4%, 4.9% and 7.4% respectively. Agriculture is the main source of livelihood for much of the rural populace. The employed labour is around 7.5 million of which 33% are in agriculture, 15.1% are in wholesale and retail trade, 13.7% are in construction, and 8.4% are in transportation and storage sectors. The province has an unemployment rate of 7.16% which is higher from the national average of 5.8% and is also highest among the provinces[2].

The economy of KP enjoys a comparative advantage in a few selected goods and sectors such as fruits and vegetables, tourism, mines and minerals etc. However, due to structural constraints the potential is not fully tapped. KP is also rich in natural resources like gemstones, gold, oil and gas deposits; however, only 30% of the province's total area has been explored so far. KP is also endowed with abundant water and a large capacity to produce electricity from its natural resources (water and gas). Yet these resources are vastly underpriced compared to their demand and remain underutilized[3].

The province has been faceing formidable challenges in the form of a high population growth rate, rising unemployment rate and poverty. There is high percentage of people living in multidimensional poverty (settled areas 49%, NMAs 73%) in KP with the highest level of poverty incidence in NMAs.

2.2 Social Development Outcomes

The status of socioeconomic development in KP has improved in recent years, however, social outcomes are still far from perfect. The Human Development Index (HDI) score for KP is 0.628, which is higher than

1 Khyber Pakhtunkhwa Multiple Indicator Cluster Survey (MICS), 2016-17
2Labor Force Survey, 2017-18, Table 6 to 6.4
3 ibid

the national value at 0.56 and lower only than Punjab at 0.7324 However, NMAs score the lowest out of all regions at only 0.216. Nearly half of the population in the province and 73% of the population in merged areas is facing multidimensional poverty in terms of education, health and living standards[5].

Health outcomes are below par for settled areas and NMAs. The maternal mortality ratio (MMR) in NMAs is 395 per 100,000 live births, and the rest of the province is 206 per 100,000 live births. Similarly, the immunization rate for children aged 12-23 months is 33.9% in NMAs and 40% in the rest of KP.

Education outcomes are equally dismal. Literacy rate in NMAs is only 33.3% and the rest of KP is 53%[6], while Net Enrolment Rate at primary level in NMAs is 52.1% and the rest of KP is 59%%. Similar gaps exist at middle and high school levels.

Table 1: Human Development Index Indicators

	Pakistan	Punjab	Sindh	KP	Balochistan
Health					
Infant mortality rate per 1000 live births, 2017-18	62	73	60	53	66
Under five mortality rate per 1,000 live births, 2017-18	74	85	77	64	78
Water & Sanitation (percentage)					
Access to tap water resources 2014-15	27	18	41	35	33
Access to sanitation facilities (toilet with Flush) (2014-15)	73	79	67	76	31
Education (percentage)					
Overall Literacy Rate, 10 yrs & above (2017-18)	62.3	64.7	62.2	55.3	55.5
Net Enrollment Rate at primary level (6-10 years) % 2014-15	67	70	61	71	56
Population aged 10 and above ever attended school (2014-15) (%)	62	65	61	55	44
Rate of completion of Primary level or Higher 2014-15 (%)	52	54	53	44	35
Poverty (per thousand)					
Multidimensional Poverty Head Count	38.8	31.4	43.1	49.2*	71.2

Sources: Demographic and health survey 2017-18, Economic Survey 2018-19, PSLM 2014-15, MPI Pakistan; * (FATA 73.7%)

The Government of Pakistan has committed to the goals and targets enshrined in Sustainable Development Goals. Several of these goals are being localized and adopted into development planning by Planning and Development Department.

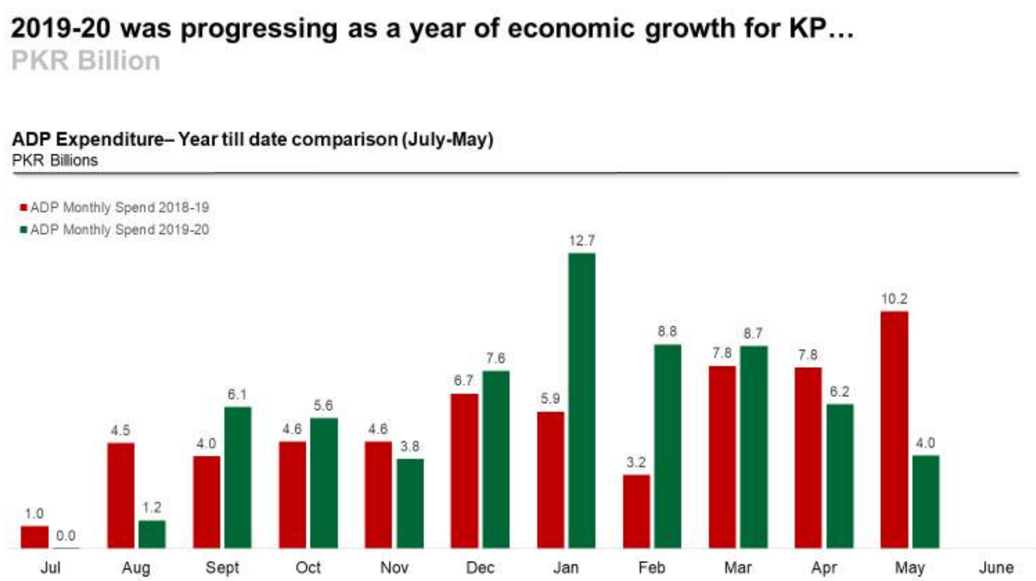
3. Budget Performance for FY 2019-20

The budget performance for the year 2019-20 in terms of revenue collections, development spend and economic growth was progressing as a year of economic growth for KP. This unprecedented provincial

[4] Pakistan National Human Development Report 2017, UNDP, (p.155)
5 Multidimensional poverty in Pakistan, UNDP 2015, (Table 3.3, p.15)
6 KPESED Figures

economic growth is based on bold agenda of financial reforms introduced by the government like rolling forecasting – integrated cash flow model, actual receipts and expenditure based budgeting, integrated budget call circular, securing monthly NHP releases, KPRA performance based incentive system, ADP rationalization exercise andformulation of ADP policy and pension reforms. Year -on Year (upto April 2020) comparison shows 12% increase in FBR collection, 73% increase in KPRA revenue from PKR 8.1 billion to PKR 14 billion . Similarly, the non-tax revenue increased from PKR 9.1 billion in 2018-19 to PKR 9.6 billion in 2019-20 same period. The development budget of Newly Merged Areas (NMAs) increased immensely after its merger with the KP province from PKR 25 billion and PKR 48 billion. See below figure for details:

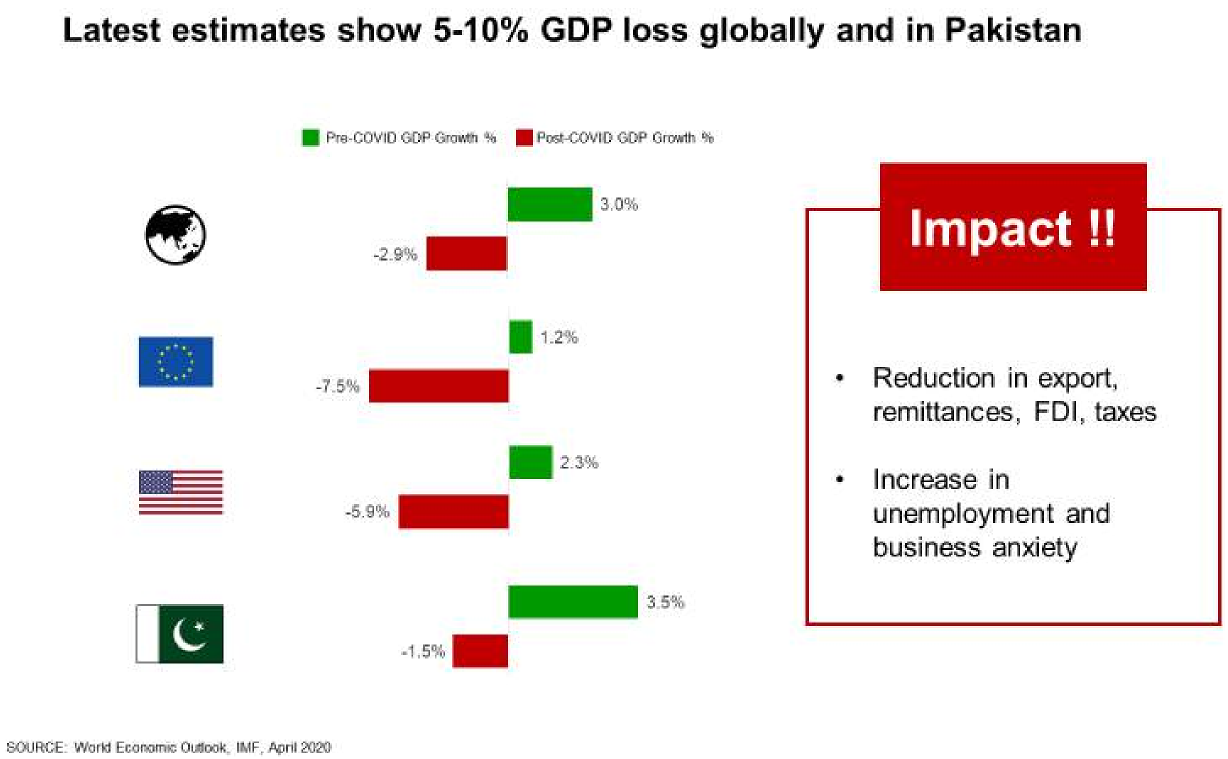
In terms of Annual Development Programs (ADP), higher expenditure and releases are witnessed this year in comparison to last financial year till March FY2020. After the COVID-19 pandemic, the Government receipts reduced resulting in reduction in releases and expenditure on ADP schemes. See below figure for details:



4. COVID-19 Impact and Government Strategy

4.1 Adverse Impact of COVID-19 on Economy

The world has been competing with the pervasive COVID-19 amid the wide and severe uncertainty and intensity of the shock. The IMF has recently projected a sharp contraction of 2.9% in global output in 2020[7] due to 'Great Lockdown' that is much worse than the financial crises of 2008-09. However, subject to fading out of pandemic in the second half of 2020, the global economy is projected to grow by 5.9% in 2021 with considerable uncertainty about the strength of the rebound. The IMF has also cautioned about the considerable uncertainty around the forecast, the pandemic itself and its macroeconomic fallout and subsequent stresses in financial and commodity markets. See below figure for details:



Under the Extended Fund Facility (EFF) second staff review in February 2020, the IMF has acknowledged the considerable progress made by Pakistan on reforms and sound economic policies during the last few months.[8] However, in the wake of the pandemic, the IMF has recently downgraded the growth prospects for the national economy into negative growth territory. Against the growth rate of 3.5% in 2019, IMF has forecasted contraction in national output up to 1.5% during 2020 with an unemployment rate of 4.5% to 5.1%. The World Bank[9] has also forecasted a dire economic outlook for South Asia, with Pakistan's growth expectations for 2020 to be between -2.2% and -1.3%. Similarly, the State Bank of Pakistan (SBP) has also forecasted a contraction of 1.5% in 2019-20 owing to exceptionally high uncertainty regarding the timeline and severity of the COVID-19. The national output is expected to rebound with around 2% growth in 2020-21[10]. Inflation is expected to be on the lower side of previously announced 11-12% range during the

[7] IMF Outlook April 2020
[8] https://www.imf.org/en/News/Articles/2020/02/14/pr2051-pakistan-statement-at-the-conclusion-of-the-imf-mission
[9] South Asia Economic Outlook Focus, the World Bank Group Spring 2020
[10] SBP 2nd Quarterly Report 2019-20

ongoing fiscal year and is expected to fall to 7-9% range during 2020-21 with some upside risks to inflation due to supply disruptions or food prices shock, however, these are unlikely to generate strong second-round effects due to weakness of the economy. The falling global prices, including already plummeted energy prices and low import demand would help in containing exchange rate depreciation pass through to the general price levels.

The pandemic induced supply disruption has been accompanied by the shock to the aggregate demand thus negatively affecting different sectors of the provincial economy at varying scale. The issue of immediate concern, however, is the effect on the employment situation resulting in major layoffs, especially of those that fall in the vulnerable employment group. The expected layoff, particularly in highly vulnerable groups including daily wage workers, paid workers by piece rate, street vendors etc., with stringent and expanded lockdowns, is expected to be around 2.8 million.[11] With the expanded disruption in economic activities (6 to 12 months). The sectoral analysis shows the agriculture sector, which employs 32.6% of the total provincial labour force, is largely unaffected. The manufacturing sector engages 12.03% of the labor force and will witness a slowdown in general due to the lockdown. Construction, which employs 13.7% of the labour force, is the worst-hit sector of the economy. The wholesale sector engages 15.1% of the labor force, the majority of which are daily wagers, is also negatively affected in terms of layoffs and slow down. The transport sector is expected to be affected mildly as freight and commodities shall be kept running, however, the ban on interprovincial transportation may cause losses in the sector. Another worst-hit sector will be tourism which employs about 1.6% of the labour force in the province. Since most of the labour force engaged by the tourism sector is of daily wagers therefore the sector is going to be affected by the layoffs.

4.2 Revenue Shortfall Affected Expenditure Plan

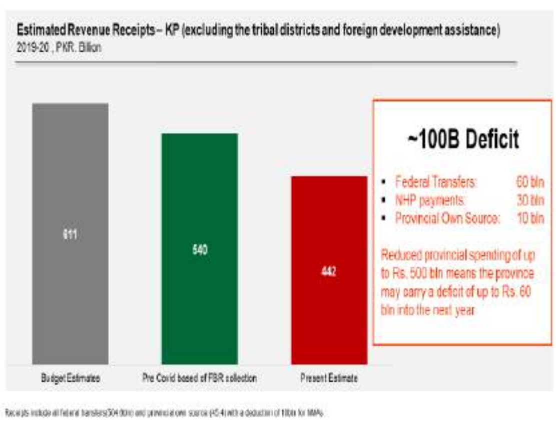
The immediate and anticipated contraction in the real economy will also translate into the decline in government revenues. The shortfall in federal transfer to provinces will further be substantiated by the decrease in the provincial own sourced revenue as well high emergency spend would further squeeze the fiscal space for public investment in the provinces

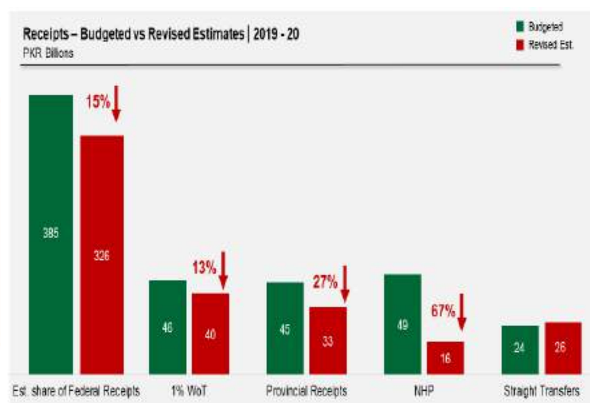
Regular Receipts of the province include Federal Receipts, Provincial Own Source Revenue, and Other Receipts (Hydel Profit and NHP Arrears). A major part of the federal transfers is revenue assignment (shares) from the divisible pool taxes, which comprise of tax on income, sales tax on goods, central excise, custom duties, wealth tax, and capital value tax. These taxes are collected by the Federal Government and are distributed between Federal Government and Provincial Governments (vertical distribution), and among the provinces (horizontal distribution) as per formula determined by the National Finance Commission as per Article 160 of the Constitution of Islamic Republic of Pakistan. Straight transfers are the net proceeds of the Federal duty of excise on natural gas, development surcharge on gas and the royalties on natural gas/oil. Under the Article 161 of Islamic Republic of Pakistan, these duties and royalties are not part of the Federal Consolidated Fund, hence these are rights of the province where well-head of natural gas/oil is situated. These are provincial receipts, which are collected by the Federal Government and transferred to provinces, after deduction of 2% collection charges. KP also receives one

[11] Source: Coping Strategy to mitigate the adverse impact of COVID-19, April 2020, the Planning and Development Department KP

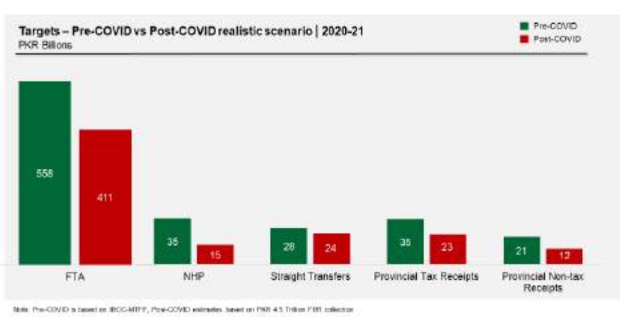
percent of net proceeds of the divisible pool taxes in lieu for War on Terror. Foreign Project Assistance is another important source of financing for the province.

The government of KP is highly reliant on federal transfers from the divisible pool of resources to meet much of the provincial public expenditure. KP's Own Source Revenue (OSR) constituted only 7% of the total resource envelop as compared to 27% and 22% in Sindh and in Punjab, respectively. Consequently, this low size of OSR does not provide enough cushion to cover any shortfall from federal transfers, which have historically remained unpredictable in terms of volume. COVID challenging backdrop, the KP government may face significant decline approximatly 30% revenue shortfall in FY 2019-20 and FY 2020-21 both comparing the pre-COVID estimates i.e from PKR 611 billion for the FY 2019-20 to revised estimate of PKR 442 billion. Provincial receipts estimates reduced by 27% and Net Hydel Profits (NHP) from the Federal Government reduced by 67%. The anticipated squeezing of resource envelope would challenge the government for more efficient resource mobilization and allocation for service delivery for health emergency and social protection. See below figgure for details;

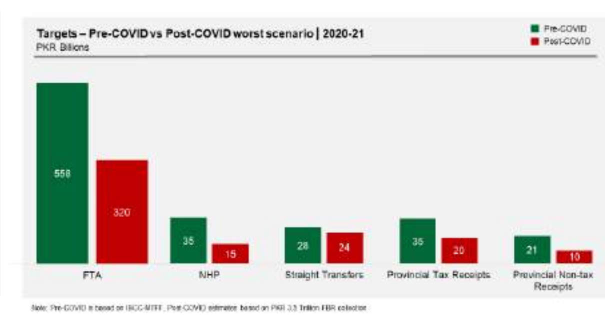




Pressure on Federal and Provincial revenue sources

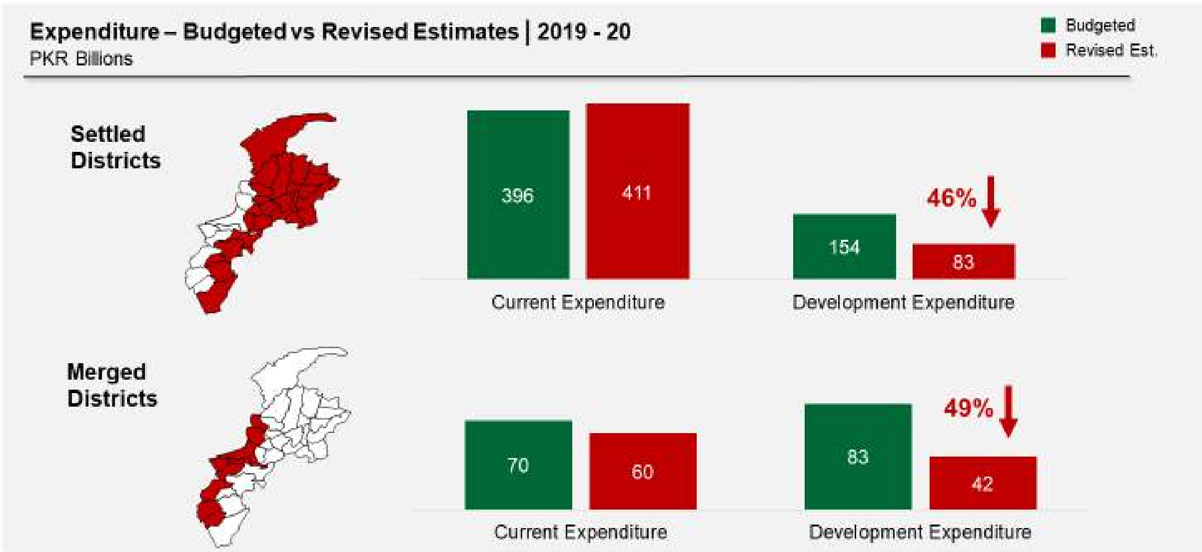


Some estimate show that if virus hits significantly FBR collection will decrease by Rs. 1 trillion



Current expenditure in KP increased, mainly due to increase in the pension expenditure and the COVID-19 pandemic. For settled districts, the revised current expenditure increased from PKR 396 billion to PKR 411 billion, while the development expenditure was reduced from PKR 154 billion to PKR 83 billion, implying a decrease of 46%. For the NMAs, the Government restricted the budget and reduced current expenditure by PKR 10 billion and development expenditure by PKR 41 billion. See below figure for details:

Resulting in low expenditure on planned development



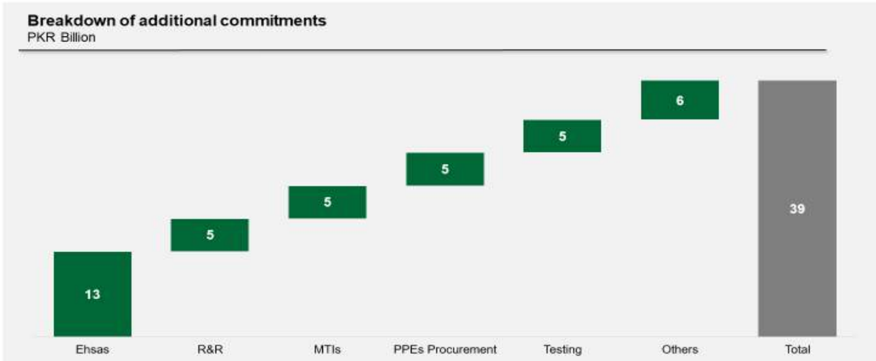
4.3 Emergency Spend on COVID-19

To reduce the impact of COVID-19 on the economy, the Federal Government came up with a relief and economic stimulus package of PKR.1.2 trillion including PKR.144 billion for 'Ehsas Emergency Cash Program'[12]. The package aims to provide relief to all vulnerable groups and sectors. On the other side, SBP has slashed down the policy rate to 9% and provided various incentives to the economic sector for sustenance during the crisis.

The government of KP has made sufficient additional allocation for emergency expenditure especially for investment in the health sector for the provision of all necessary infrastructure and equipment to combat the COVID-19. At the face of constrained resources, public investment is required to ensure a sufficient level of physical and human resource, PPEs, technical inputs for public sector labs to enhance testing etc. See below figgure for details:

[12] Economic updates April 2020 Ministry of Finance Islamabad.

The Covid challenge itself increases the cost of government while revenues are challenged. However, these costs must be budgeted

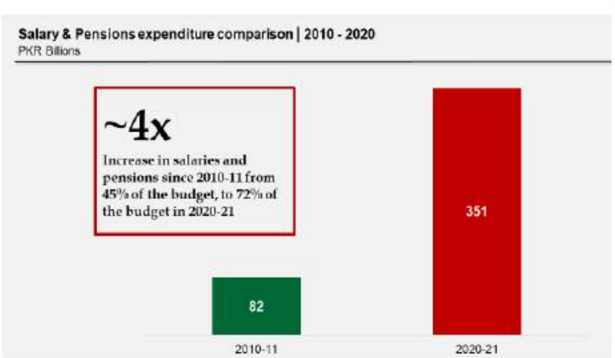


With the pervasive slowing down of economy and loss of livelihoods, the government has to allocate resource for social safety nets and livelihood support programs. So far, the bulk of support has been received from the federal government, however, the provincial governments are also commited to supplement the process through provincial Ehsaas Programs. At the same time, with a high incidence of multidimensional poverty, low ranking HDI indicators and pervasive loss of anticipated livelihoods, in particular of daily wagers in the informal sector and SMEs, the government has to make sure to make a reasonable level of allocation in the next budget to ensure liquidity in the market and to offset the adverse effects of COVID-19 on the vulnerable segments of the population.

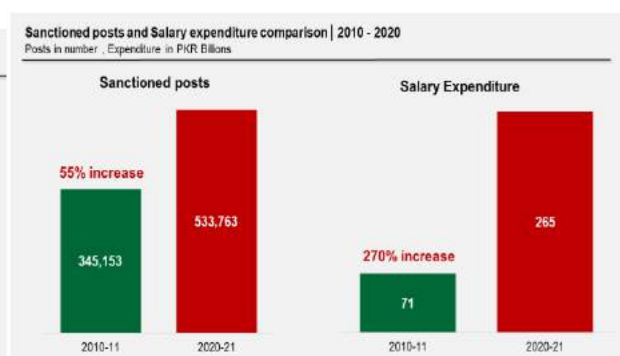
5. Financial Impact of Increase in Government Size and Scale

In case of size, scale and productivity of government associated fixed costs, Government expenditures on the salaries and the pension is increasing. There is 4 times increase in salaries and pensions since 2010-11 from 45% of the budget to 72% of the budget in 2020-21. The size of the government has increased by 2 times since the 18th amendment. The major reason for such an increase was 55% rise in sanctioned posts and an increase in salary expenditure from PKR 71 billion in 2010-11 to PKR 265 billion in 2020-21. See below figure for details:

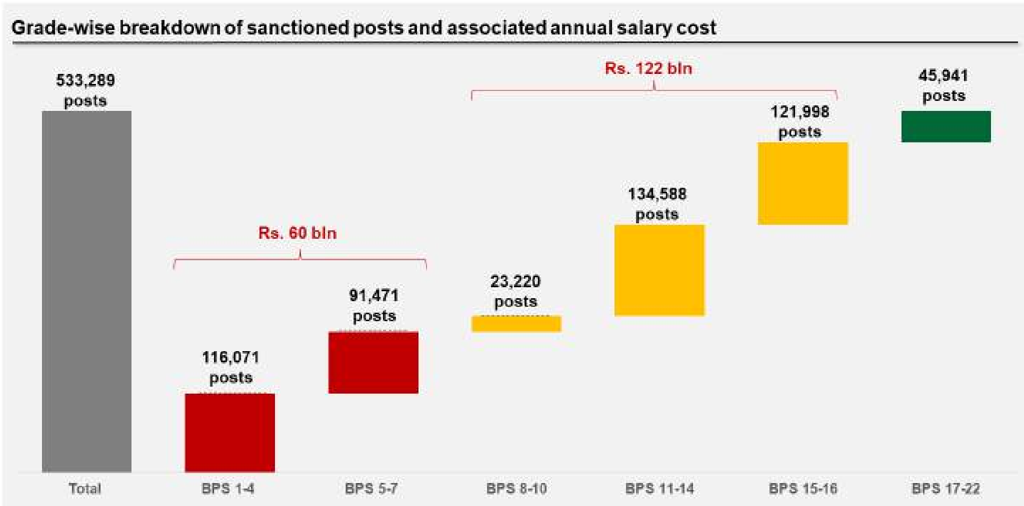
Increased size and scale of govt results in massive drain of resources



Size of government has moved by 2 times since the 18th amendment

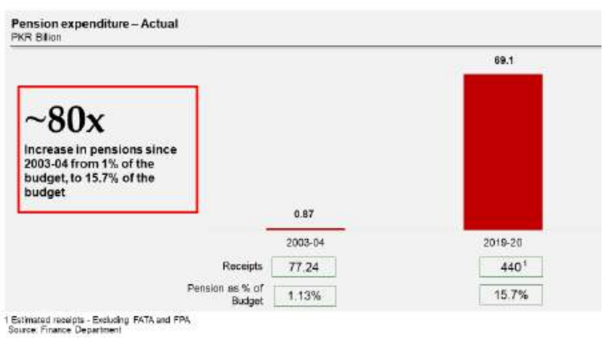


Structure of government: lots of support and ministerial staff



The pension expenditure increased from 1% to 15.7% of the budget during the last 15 years. This signifies that the Government spending on pension increased each year. The estimates entail that if the same trend continue, pension will rise to PKR 127 Billion by 2023 and PKR 507 Billion by 2030. The Government in this case have to reform policies and make structural amendments to address such massive increase in pensions.

Similarly, pension expenditure have gone from 1% to more than 15% of the budget in last 15 years…



With this trend continuing pensions will rise to PKR 127 Bn by 2023 and 507 Bn by 2030

6. Budget Strategy FY 2020-21

The Finance Department is revising and reconsidering every cost, reducing unnecessary allocation and only prioritizing the services in sectors such as health, education, police and relief and rehabilitation. As part of the budget strategy, the Government is keen to reform its policies to avoid unnecessary costs, maximize development spending to revive economy, fostering employment opportunities and reforming tax to enhance compliance and increase tax base. In case of current expenditure, it intends to reform pension policies to improve salary budgeting and increase sustainability. Similarly, it is also streaming new hiring policies and making arrangements to reduce allocation of non-essential departments. Under the development expenditure component, essential services are mainly being considered and focus is given to labour intensive schemes in order to generate employment opportunities and protect those who lost their jobs in the ongoing pandemic. In addition to this, the government relied heavily on foreign and domestic borrowing, whereas it is planning to for utilize provincial funds such as pension funds and GP funds. The Government as part of the budget strategy, is taking austerity measures, which include no allocation for training and entertainment purposes, reducing allocations for non-essential services.

Key Principles

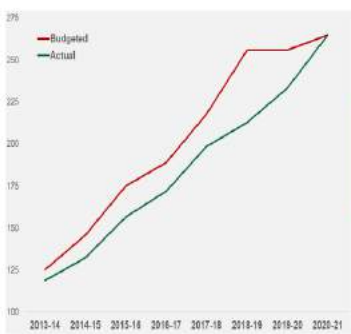
Revenue	Current Expenditure	Development Expenditure	Debt / Savings
• No increase in taxes • Elimination of redundant taxes • Integration of duplicate taxes • Broadening the tax base • Revenue collection will be used to fund the costs of emergency	• Improve salary budgeting to reflect actuals • Pension reform – For increased sustainability • Streamlined hiring policies • No allocation for training, entertainment etc. • Reduced allocation in case of non-essential departments for TA/DA, POL, electricity and purchase/repair of assets	• Essential services schemes to be given priority • Focus on labor intensive schemes to generate employment • Increase development spending for accelerated economic recovery	• Domestic borrowing under provincial / federal guarantee • Foreign borrowing • Utilize provincial funds (HDF, pension fund, GPI fund)

Austerity Measures	▪ No allocation for trainings, entertainment, etc. ▪ Reduced allocations to non-essential services ▪ Recruitment and purchase of assets only for essential services ▪ No general increase in Salary and Pension, unless the federal govt decides
Social Protection Plan	▪ PKR 13 billion allocated to Cash Transfers (Ehsas Program) ▪ Employment Warranty schemes will be focused
Health Care Plan	▪ Additional focus on health, while focusing on existing infrastructure ▪ Special focus on COVID costs
Economic Stabilization Plan	▪ Tax Incentives ▪ Potential Deferment of Loan Re-payments and Interest waivers (BoK) ▪ Incentivization plan for tourism, construction, transport, mines, ICT, hospitality and other vulnerable sectors

6.1 Budget Forecasts FY 2020-21 – Setteled Areas

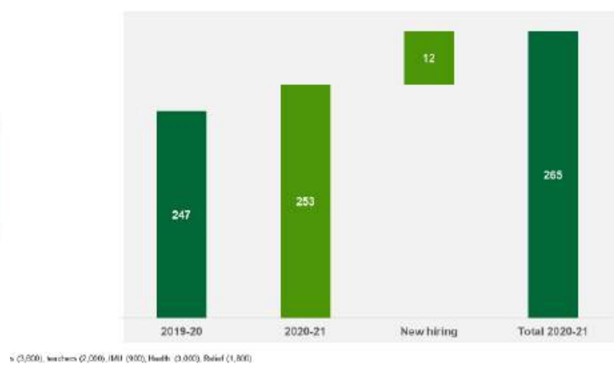
Head	Budget Estimates 2019-20	Actuals 2019-20	Budget Estimates 2020-21
Total Expenditure	**693**	**580**	**708**
Current Revenue Expenditure	**457**	**444**	**515**
Salary (Provincial)	256	247	265
O&M and Contingency	99	83	98
Pension	70	68	86
Subsidy	3	3	3
Investment & Committed Contribution	9	4	0
Debt Servicing	20	24	24
Covid		15	39
Development Expenditure	**236**	**136**	**193**
ADP (Provincial)	108	83	100
ADP (Districts)	46	2	43
Development Grants (PSDP Federal)		3	
Foreign Project Assistance	82	48	50

This will be the first year for salary bill to be budgeted on real basis



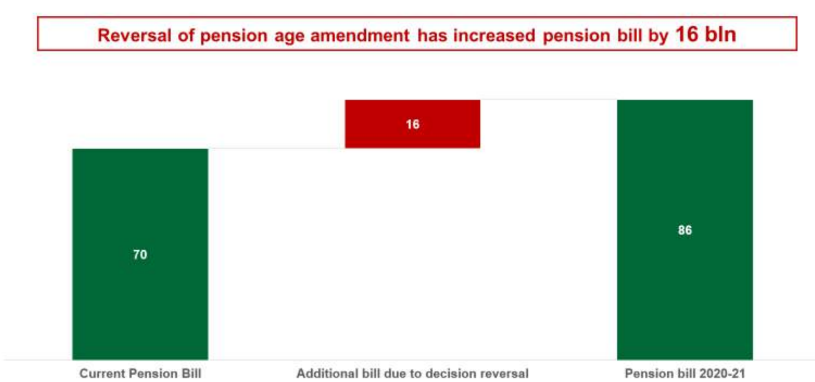
2020 – KP will be the first govt across sub-continent to budget salaries in real terms

An additional Rs. 12 bln has been set aside for necessary new recruits in the pipeline, which will now be a norm
PKR Billions

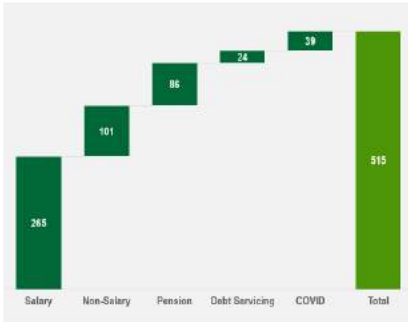


There is a projected increase of 23% on account of enhancement in pension and addition of new pensioners to the system. The government expenditure on pensions is anticipated to be on the higher side i.e. PKR 86 billion for FY 2020-21 as compared with PKR70 billion for the ongoing fiscal year.

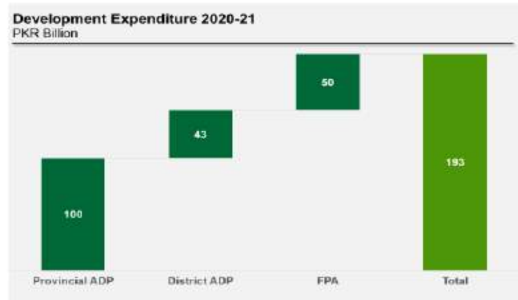
Pension expenditure will increase by min 23% in the upcoming year
PKR Billions



Total Current Expenditure will see a rise of 13% from 2019-20 due to COVID
PKR Billions



Total Development Expenditure



Actual Revenue could be significantly lower given economic uncertainly
PKR Billion

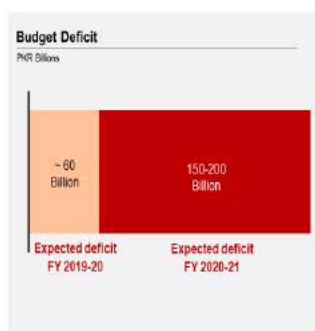
Provincial Settled Districts Receipts Scenarios 2020-21

Receipts Heads	Extreme	Current	Likely	Optimistic
Federal Tax Collection	**3,500**	**4,000**	**4,500**	**5,100**
Federal Divisible Pool	286	326	367	416
1% war on terror	34	39	44	50
Royalty Oil & Gas	24	24	24	24
NHP*	15	15	15	15
Provincial Receipts	30	33	35	47
	389	**437**	**485**	**552**
FPA	**50**	**50**	**50**	**50**
Total Receipts	**439**	**487**	**535**	**602**
DEFICIT	**(269)**	**(221)**	**(173)**	**(106)**

Realistic Scenarios

The deficit can range from 100-250 bln , depending on FBR collection, NHP payments and straight transfers
PKR Billions

The province could face a deficit deficit of ~ Rs 150-250 Billion for FY 2019-20 and 2020-21



Options Available

I. Further cuts in current expenditure
II. Domestic borrowing under provincial / federal guarantee
III. Foreign borrowing
IV. Utilize provincial funds available
V. Cut the ADP

6.2 Budget Forecasts FY 2020-21 - Newly Merged Areas

Expenditure of Newly Merged Areas (NMAs) are maintained separately by the government with two broader classification i.e. Current Expenditure and Development Expenditure of NMAs. Keeping in view the dire needs of NMAs, budget allocations for FY 2020-21 are protected.

Head	Budget Estimates 2019-20	Revised Estimates 2019-20	Budget Estimates 2020-21
Total Expenditure	**151**	**114**	**153**
Current Expenditure	**79**	**74**	**81**
Salary	47	45	51
PKR Billion	32	29	30
Development Expenditure	**72**	**40**	**72**
ADP	24	24	24
AIP	48	16	48

6.3 Combined One Khyber Pakhtunkhwa Budget

Total Budget for FY 2019-20 was PKR 844 both for settled and newly merged areas Revised Budget for FY 2019-20 is PKR 664 billion and Budget Estimate for FY 2020-21 is PKR 861 billion.

Head	Budget Estimates 2019-20	Revised Estimates 2019-20	Budget Estimates 2020-21
Total Expenditure	**844**	**664**	**861**
Settled Areas	**693**	**550**	**708**
Current	457	444	515
Development	236	106	193
NMAs	**151**	**114**	**153**
Current	79	74	81
Development	72	40	72

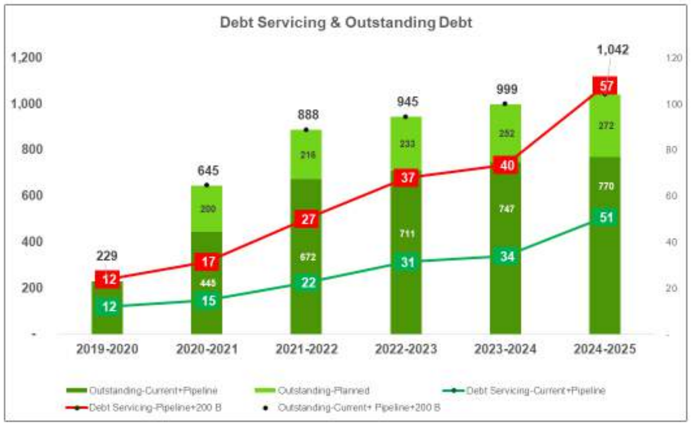
7. Deficit Financing Strategy

Amid the global pandemic, Pakistan's tax collection target was revised down from PKR. 5.5 trillion to PKR 3.8 trillion. As a result, KP's share in the divisible pool shrinks too. Also, the Provincial own resources budgeted target was revised down to PKR 33 billion from PKR 53 billion. In turn, this created pressure on the fiscal side for the FY 2019-20 as well as will have, significant implications on the upcoming budget i.e. FY 2020-21. Going forward, it is expected the budget deficit for FY 2020-21 will be around PKR 150 to PKR 250 billion. In order to full fill the proposed fiscal deficit, KP government intends to tap the envisage deficit from various sources, these are:

1. Borrowing from commercial banks, which offers loans at KIBOR plus a spread;
2. Running finance, that means that a client will be charged only for the number of days the loan is outstanding and not for the complete period. That way the loan finance can be adjusted to the cash outflows of the government to minimize borrowing costs;
3. The government also have surplus funds of employees such as pension fund, GP fund and Hydel fund, currently, the outstanding balance is PKR 130 billion, invested in different government securities and various financial intuitions;
4. The external donors have certain windows for financing budget deficit which could be exercised if no other immediate financing source is available.

Borrowing to finance deficit budget will increase debt servicing in the years to come.

PKR 200 billion borrowing Impact on Debt Servicing for over 5 years



Note: Borrowing is assumed from External Lender under Federal Government Guarantee for the period 25 years including grace period of 5 years. Currently the Average Interest Rates ranging for external loans is 1.5% to 2% per annum but effective mark-up rate becomes 8-9% after adjusting PKR devaluation. During the grace period Only mark-up will be charged.

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