BUDGET FY16

IMPACT ON MICROFINANCE PROVIDERS

June 2015

Key Highlights:

- The Budget for FY16 projects a total outlay of PKR 4,451bln, up 5% from revised estimates of outgoing fiscal year.
- The Budget focuses on fiscal consolidation and creating an enabling environment to provide impetus for growth.
- The fiscal deficit improved (FY15: -5%, FY14: -5.8%). The government aims to reduce it to 4.3% in FY16 through improvement in tax collection (Additional Tax Revenue: ~PKR 240bln) and rationalization of subsidies (Subsidy Reduction: ~PKR 105bln).
- Infrastructure development, especially energy and highways remain government's priority.
- Policy rate (SBP Discount: 7%) is at 42 years low. The low interest environment will reduce cost of funding for MFPs.
- Focus on documenting the economy. Cost for non-filers set to rise on multiple fronts especially on banking transactions.
- Government strengthening its social net for the poor by allocating additional funds for BISP, Insurance schemes and direct loans.
- Other salient areas of the budget included:
  - ✓ GDP grew at 4.2% in FY15 and is projected to grow at 5.5% for FY16 and 7% by FY17.
  - ✓ Debt to GDP ratio to be brought down to less than 60% in 3 years (FY15: 63%) and Investment to GDP ratio to increase to 20% in medium term.
  - ✓ Inflation remained at 4.6% during FY 15 and government intends to keep it in single digit in the medium term.
  - ✓ National PSDP allocation of PKR 1,514bln (+27% YoY) with Federal component of PKR 700bln (+29% YoY).
  - ✓ Credit Guarantee and insurance schemes for agriculture sector.
  - ✓ One time levy of 4% for all banking companies and 3% for others having income greater than PKR 500mln.

Impact on Microfinance

The following budgetary measures are considered for having Positive, Neutral or Negative impact on Microfinance Service Providers (MFPs):

Positives:

- **Proposal:** Government allocating PKR 1.0bln for Credit Guarantee Scheme (CGS) for small & marginalized farmers, PKR 500mln for Crop Loan Insurance Scheme for farmers holding up to 25acres of land, and PKR 100mln for Livestock Insurance.
  Impact: These insurance and guarantee schemes will reduce cost of financing for borrowers and also protect microfinance providers against potential losses.

- **Proposal:** Health Insurance Scheme (HIS) shall be provided to persons meeting poverty score for hospitalization. An amount of PKR 9.0bln is allocated for this purpose.
  Impact: The coverage of health under this scheme protects microfinance lenders against possible losses and expenses due to health problems of the clients.

- **Proposal:** Interest free Loans for Solar Tube Wells for first 30,000 farmers against deposit of PKR 100,000/- for farmers having up to 12.5 acres of land. Exemption from sales tax and custom duty at import stage for certain items of Solar Panels.
  Impact: This will act as a supplement enabling small growers to utilize loans from MFPs in crop cultivation and other inputs hence reducing the risk. MFPs providing alternate energy solutions can offer their products at lower prices.

- **Proposal:** Relief to small taxpayers; Salaried taxpayers earning taxable income from PKR 400,000 to PKR 500,000 are proposed to be taxed at 2% *(FY15: 5%)* and non-salaried taxpayers earning income taxable income from PKR 400,000 to PKR 500,000 are proposed to be taxed at 7% *(FY15: 10%)*.

Impact: Employees & borrowers of MFPs earning up to PKR 500,000 will have more income with reduced tax rate. This will also benefit disposable income of MFB employees.

Neutrals:

- **Proposal:** Allocations for Benazir Income Support Program (BISP) to increase by 11% (FY16: PKR 102bln; FY15: PKR 92bln). BISP outreach to expand to 5.3mln families from existing ~5.0mln families.
  Impact: These funds are not routed through MFPs. Although this may be viewed as an increase in competition, BISP is a disposable income meant for basic necessities. Hence, it is not likely to impact MFPs and may reduce the risk of micro loans being used for consumptive purposes.

- **Proposal:** Additional WHT on cash withdrawal of 0.6%, and interest and dividend income increased to 17.5 for non-filers.
  Impact: This provision will impact commercial banks and Microfinance banks(MFB) alike, as it relates to all depositors who do not file their tax returns. Hence, there will not be any competitive disadvantage. However, this may have a direct impact on MFPs that '*do not file'* their tax returns.

Negatives:

- **Proposal:** Tax rate for all kinds of banking income from all sources is charged at 35%.
  Impact: This will result in additional tax on income from other sources and will impact profitability of MFB that have investment portfolios or alternate income sources.

- **Proposal:** Minimum wage rate enhanced from PKR 12,000 to PKR 13,000.
  Impact: All employees of MFPs earning below PKR 13,000 will now be paid more impacting the institutions' bottom-line. On the other side, borrower's disposable income will go up, in turn, enhancing their ability to repay loans.

- **Proposal:** Adjustable advance income tax deduction at the rate of 0.6% of the amount of transaction on all banking instruments will be made for Non-filers.
  Impact: Those MFPs (mainly MFBs) that are involved in deposit taking will be impacted from this change since majority of the depositors in Pakistan are non-filers. It will impact branchless banking transactions as well. The government is considering a threshold of PKR 50,000 for this. If approved, it will lessen the impact on customers of MFPs, since they deal mainly in small amounts. MFBs will have to integrate this information into database although this will have the same impact on commercial banks.

- **Proposal:** Capital Gains Tax (CGT) on sale of equity and debt securities has been increased to 15% (previous 12.5%) for holding period less than 12 months, 12.5% (previous 10%) for more than 12 but less than 24 months and 7.5% (previous 0%) for more than 24 months.
  Impact: MFPs that have an investment portfolio will have to pay additional tax on capital gains on sale of securities, in turn, impacting their profitability.

- **Proposal:** Allocation for PM Youth Loan Program increased by 185% (FY16: PKR 20bln. FY15: PKR 7bln) and interest rate reduced to 6% from 8% on these loans.
  Impact: These funds are not routed through MFPs and will be in direct competition.

- **Proposal:** Budgeted allocation of funds to Pakistan Poverty Alleviation Fund (PPAF) reduced by 46% (FY16: PKR 4.3bln; FY15: PKR 7.9bln).
  Impact: This will reduce the funding available to MFPs from PPAF which may result in higher competition amongst MFPs. Also, MFPs will have to explore other funding avenues to compensate for this reduction.

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- Improving economic indicators

1.1 GDP Growth (FY15): Pakistan's Economy is broadly divided into three major sectors: Service, Agriculture, and Industry, contributing 59%, 21%, and 20% to the GDP respectively. Assisted by favorable dip in oil prices, brisk growth in service sector and implementation of International Monetary Fund (IMF) reform program, Pakistan Economy has recuperated steadily. The GDP growth reached 4.2% in FY15 (FY14: 4.1%) despite several challenges. The service sector growth (5%) dominantly contributed towards the GDP. Growth in industry was positive but lower than last year as energy constraints persist. The contribution of agricultural sector remained stagnant.

	FY15	FY14	FY13	FY12	FY11
Real GDP Growth (%)	4.2	4.1	3.7	3.8	3.6
Inflation (%)	4.8	8.7	7.4	11.0	13.7
Per Capita Income ($)	1,512	1,386	1,339	1,321	1,274

1.1.1 The GDP growth – highest in the last seven years – is commendable but growth target of 5.1% in FY15 was unattained as key economic sectors fell short of their targeted growth. The government had optimistically set the target anticipating increased production from important agriculture crops, curbing energy shortages, capitalization on GSP status, and better investment prospects. The Agriculture sector was affected by floods in Punjab and later wheat productivity was lower (FY15: 25mln Tones; FY14: 26mln Tones) due to rains and prolonged winter. The Industry missed its target by a wide margin as energy shortage took its toll on few sectors (textile and fertilizer) in Large Scale Manufacturing (LSM). Further, five sub-sectors (wood product, engineering product, paper and board, food beverage, and tobacco) in LSM recorded negative growth. The service sector was slightly held back in achieving its target as moderate growth in agriculture and LSM impacted whole sale and retail trade growth.

Economic Sectors Growth Rate

	Target (FY15)	Achieved (FY15)	Target (FY16)
GDP	5.1%	4.2%	5.5%
Agriculture	3.3%	2.9%	3.9%
Industry	6.8%	3.6%	6.4%
Services	5.2%	5.0%	5.7%

Source: Economic Survey (2014-15)

1.2 Economy at a Glance: Pakistan's macroeconomic indicators improved in FY15 despite significant socio-economic challenges. The outgoing year saw assortment of positives to take hope from and few challenges to be addressed.

- ***Fiscal Deficit:*** Despite improvement to 9.7% in FY15 from 9% in FY14, Pakistan still has one of the lowest Tax to GDP ratio in the region. The government increased its revenue by successful issuance of Sukuk, privatization proceeds and external inflows. The government was able to curtail its fiscal deficit which is expected to be contained at 5% of GDP for FY15, lower than previous period (FY14: 5.8%). The deficit is targeted to be brought down to 4.3% through increase in tax revenue collection and prudent management of expenditure in FY16.

- ***Debt to GDP ratio:*** Pakistan's Debt to GDP ratio slightly increased to 63% in FY15 (FY14: 62%). The proportion of domestic debt in overall debt increased to 70%. The external debt reduced by PKR 72bln to PKR 5,004bln. The government intends to bring debt to GDP ratio to below 60% in next 3 years.

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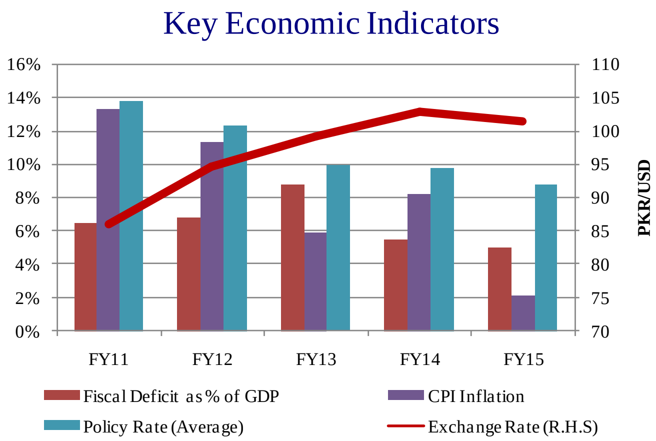
- ***Debt to GDP ratio:*** Pakistan's Debt to GDP ratio slightly increased to 63% in FY15 (FY14: 62%). The proportion of domestic debt in overall debt increased to 70%. The external debt reduced by PKR 72bln to PKR 5,004bln. The government intends to bring debt to GDP ratio to below 60% in next 3 years.

- ***Exchange Rate:*** Subsequent to inflow of USD1.5bln from CSF, mobilization of sukuk, growth in remittances and lower oil prices, the external account posted surplus of USD 2.1bln at end-Apr15. The strengthening foreign reserve helped in stabilizing the rupee-dollar parity. The rupee appreciated by ~ 1.4% in FY 15 to 101.5 per US dollar.



- ***Inflation Rate:*** The purchasing power was provided respite as CPI inflation hit its lowest point in last seven year, plunging down to 4.6% (FY 15). This is mainly attributable to dip in oil prices by around 40% during the same time period. The government aims to keep inflation in single digits in the medium term.

- ***Policy Rate:*** The overall macroeconomic stabilization provided an opportunity to cut down the policy rate by 300bps in FY15 to reinvigorate the economy. As lending and funding rates are linked with policy rate, low interest rate environment will reduce cost of funding for MFPs.

1.2.1 The above highlighted achievements should be viewed in the backdrop of several challenges that Pakistan's economy faces. Energy shortage and lack of infrastructure continues to impede growth. Law and order and war against terrorism weigh heavily on the economy. Nonetheless, year ended with certain positive news from international financial bodies. The improvement in external account has made Pakistan eligible for International Bank for Reconstruction and Development (IBRD) lending as its foreign reserves climbed to USD 17.8bln at end-Apr15. Moody's has raised Pakistan's rating to **'B3'** from **'Caa1'** while S&P has assigned a positive outlook, likely to result in an upgrade. The capital market performed well and coupled with economic improvements, MSCI is considering upgrading KSE into emerging market index. These steps will improve Pakistan's risk perception internationally.

1.3 FY16 – Prospective Assessment: Pakistan Economy with highlighted achievements appears to be moving into the right direction. Macro policies, which previously focused on stabilization, should now shift to support growth. The government is upbeat in its projections for the upcoming fiscal year. It has projected real GDP to grow by 5.5% in FY16 and reaching growth level of 7% by FY18. Considering the performance in recent years and prevailing structural issues it appears to be challenging. The government is making concerted effort to overcome these impediments. A key development in this perspective will be USD 42bln China-Pakistan Economic Corridor (CPEC) project. The extent of success of this project will be critical for future economic growth. Another positive is the success of Zarb-e-Azb operation and improving law and order situation, which will stimulate investment in the country.

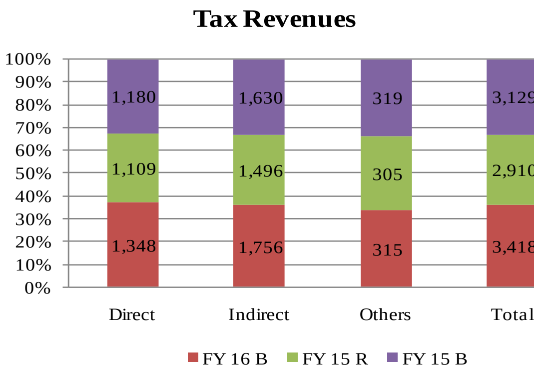
2. BUDGET FY16 - HIGHLIGHTS

- Focus on stabilization and growth
- Repercussions for non-filers
- Reduction in power subsidy

2.1 Budget Strategy: The budget for FY16 projects a total outlay of PKR 4,451bln. The budget focuses on fiscal consolidation and creatig an enabling environment to invigorate growth. The government intends to reduce its fiscal deficit. The revenue collection is being enhanced through additional tax revenue of ~ PKR 240bln. While on the expenditure side the government will rationalize subsidies by ~ PKR 105bln. The drive to document the economy by imposing additional taxes on non-filers continues in this budget. The cost for non-filers will increase on several fronts. On the development spending has increased as energy and infrastructure (highways, railways, communication etc.) remain high on priority list. The government is strengthening its social net by offering various insurance, guarantee and loan schemes for the under priviliged segment of the society. The allocation for these initiatives has increased and the government will directly offer these social services to masses. However, evolving a fair mechanism for outreach and distribution mechanism is critical to achieve meaningful results.

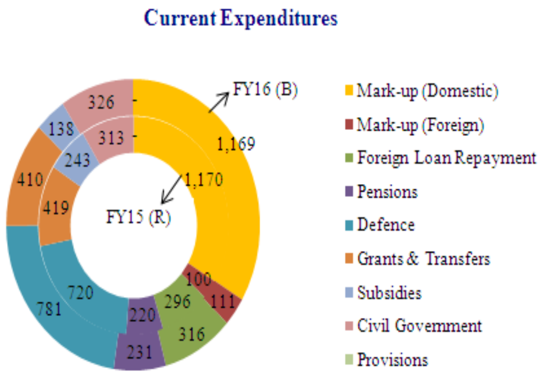
	Budget Snapshot-FY16			PKR bln
	Inflows	**FY 16 (B)**	**FY 15 (R)**	**FY 15 (B)**
i	Gross Revenue	4,313	3,952	3,945
ii	Provincial Share	(1,849)	(1,574)	(1,720)
1	Net Revenue Receipts (i+ii)	2,463	2,378	2,225
2	Net Capital Receipts	606	603	691
3	Estimated Provincial Surplus	297	142	289
4	External Receipts	752	693	671
5	Privatization Proceeds	50	18	198
6	Bank Borrowings	283	402	228
	Total Inflows	**4,451**	**4,235**	**4,302**
	Outflows			
i	Current	3,482	3,481	3,463
ii	Development	969	754	838
	of which Federal PSDP	700	542	525
7	**Overall Expenditure (i+ii)**	**4,451**	**4,235**	**4,302**
	(B): Budgeted , (R):Revised			

2.2 Receipts: The Federal Government envisages generating gross revenue of PKR 4,313bln through tax and non-tax avenues. The provincial share based from this amount totals PKR 1,849bln. The balance amount will be funded through a mix of external receipts, bank borrowings and surplus generated by provinces. All of these inflows, with exception of bank borrowings, are projected to increase YoY from FY15. As a policy matter, this is a positive development as over-reliance on domestic banks in the past led to a *'crowding out'* effect on private sector credit, in turn, hampering economic growth.

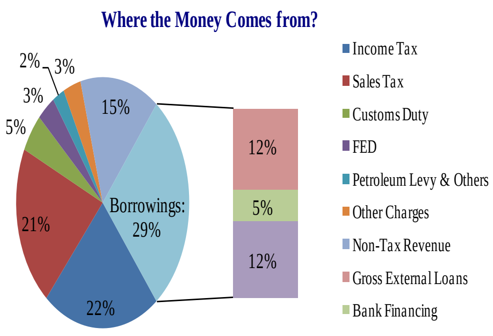


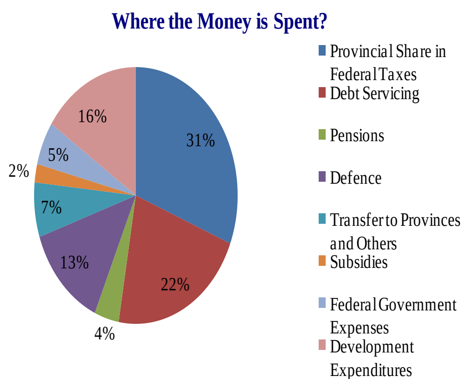
2.3 Tax Collection: The government has not made any drastic changes to the tax net and has focused on increasing collection from existing avenues rather than bringing new segments in tax net. Certain measures have been undertaken to charge higher tax from non-filers in multiple areas. The reliance on Indirect taxes (51%) as major tax generation sources still remains high. This mechanism might increase goods prices in Pakistan.

2.4 Expenditures: The budget for FY16 projects total expenditures at PKR 4,451bln, up 5% from revised estimates of outgoing fiscal year. The budgetary outlay constitutes 78% of current and 22% developmental expenditures. A major shift in expenditure was cut in power subsidies by 47%, which kept current expenditure in check. On the socio-economic development side, allocation to overall PSDP (FY15: 1,514bln, FY14: 1,188bln) has risen by over 27% against the revised estimates of FY15. Although actual utilization of this amount remains to be seen. As in the past, government has resorted to under utilization of PSDP, in order to compensate for soaring current expenditures and lower revenue collection.



Budgetary Allocation FY16





3. IMPACT ON MICROFINANCE

- Increased focus on agriculture
- Certain government initiative in direct competition with MFPs
- Increased tax burden on banking sector

3.1 The budget FY16 has several implications for the microfinance sector. Some of these provisions have a direct impact, while others are likely to create opportunities or present threats indirectly. The following discussion highlights all such areas and their repercussion – positive, negative or neutral – for microfinance sector in Pakistan

3.2 POSITIVE:

3.2.1 Policy rate (SBP Discount: 7%) is at 42 years low: Stabilization of Pakistani rupee against US dollar and reduction in inflation rate have provided the room for government to cut down the discount rate by 300bps in FY15 to 7%. It is expected to stimulate private sector lending.

→ **Impact:** The reduction in policy rate will have two-prong effect on the sector. The cost of funds for MFPs (especially MFBs) will go down in line with low interest rate environment. However, MFPs lending rate to borrowers is not expected to come down in similar proportion. This will improve sector spreads. The low interest rates are expected to prevail in near future.

3.2.2 Credit Guarantee Scheme for Small and Marginalized Farmers made operational: The government, through the State Bank of Pakistan, will provide guarantee to commercial, specialized, and Microfinance Banks for up to 50% loss sharing. The scheme will cover farmers having up to 5 acres irrigated or 10 acres non-irrigated land holdings. It will benefit 300,000 farmer households/families with a loan size up to PKR 100,000. The government has allocated **PKR 1bln** for this scheme in FY16.

→ **Impact:** Loss coverage of 50% is likely to encourage lending under this scheme, augmenting growth prospects. The microfinance sector is expected to reap benefits from this opportunity as the loan size falls under limits allowed to microfinance lenders. Since the microfinance sector is already working with small and marginalized farmers, they stand in good position to capitalize on this opportunity.

3.2.3 Livestock Insurance Scheme made operational: Small farmers with up to 10 cattle will be eligible for this scheme. The insurance will cover livestock insurance in case of calamity and disease. The scheme will benefit 100,000 Livestock farmer households/families. An allocation of **PKR 100mln** has been made in the current budget for the scheme.

→ **Impact:** Pakistan is a major livestock and milk producer. But livestock is exposed to risk of loss through illness, injury or death. This scheme provides small livestock farmers a coverage to mitigate such losses, and in turn, protects microfinance lenders. This is an opportunity for microfinance lenders to penetrate further into this domain as it remains largely insulated from commercial banks due to its small size.

3.2.4 Health Insurance Scheme (HIS): Insurance shall be provided to persons meeting poverty score for hospitalization. In the initial phase the scheme is covering 23 districts. The coverage will be gradually increased to 60% of poorest segments of population over the next three years. The eligibility criteria will be on the base of poverty score methodology that is used for the BISP. An amount of **PKR 9bln** is allocated for this purpose.

→ **Impact:** The access to better medical care facilities is becoming costlier in Pakistan. The introduction of health insurance schemes will reduce medical cost for under privileged population in case of illness or disease. It will provide cushion against potential use of loan proceeds to cover medical expenses.

3.2.5 Interest free Loans for Solar Tube Wells: Facilitating small growers in reducing heavy expenditure incurred on diesel/electricity tube wells, the government has decided to provide interest free loans for setting up new solar tube wells or replacing the existing tube wells. It is proposed to provide mark-up free loans for 30,000 tube wells in the next 3 years, against a deposit of PKR 100, 000. All farmers, with landholdings up to 12.5 Acres, will be eligible to apply for this loan. In case the number of applications in any one-year is more than 10,000, the beneficiaries will be selected through transparent balloting.

→ **Impact:** Utilization of Solar energy is expected to increase considering the cost benefits. This will act as a supplement enabling small growers to utilize loans from MFPs in crop cultivation and other inputs hence reducing the risk. Capitalizing on this opportunity MFPs providing alternate energy solutions can offer their products at lower prices.

3.2.6 Relief to small tax payers: Salaried or non-salaried taxpayers earning taxable income from PKR 400,000 to PKR 500,000 are proposed to be taxed at 2% (FY15: 5%) and non-salaried taxpayers earning income taxable income from PKR 400,000 to PKR

LAW REFERENCING

Previous Section Reference: Income Tax Ordinance, 2001	Change	New Reference Number: Income Tax Ordinance, 2001
231A	**Amendment:** Rate of WHT on cash withdrawals increased from 0.5% to 0.6% for non-filers and kept constant at 0.3% for filers for transactions exceeding PKR. 50,000	**Division VI**
Division II	**Insertion:** All banking transactions including dividends and income from capital gains to be taxed at 35% in addition to a one time super tax of 4%	**Division II A; 4B**
37A	**Amendment:** CGT on securities held for less than a year, between 1 and 2 years and more than 2 years to be charged at 15%, 12.5% and 7.5% respectively	**same**
37 A	**Amendment:** GGT deductible by Mutual Funds and REIT schemes for filers will be 10% for stock funds and 25% for others while 25% for non filers	**same**
231 AA	**Amendment:** Adjustable advance income tax deductable at the rate of 0.3% and 0.6% for filers and non filers respectively, for transactions exceeding PKR. 50,000	**236P**
100 C	**Amendments:** Insertion of word “The income of” before Non-profit and “and incomes” after “Persons”	**same**