

Research Report No.88
July 2014

**An Evaluation of the
Federal Budget
2014-15**



SOCIAL POLICY AND DEVELOPMENT CENTRE

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the Federal Budget
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FOREWORD

In keeping with tradition, Social Policy and Development Centre (SPDC) is pleased to present and share its research report State of the Economy. The report is based on the Pakistan Economic Survey 2013-14, and the federal budget for fiscal year 2014-15.

The report is based on an in-depth and objective analysis of the macroeconomic and fiscal situation and policies. It brings forward the issues related to economic growth, a number of fiscal challenges being confronted, and the development priorities of the government. It reviews the economic performance of fiscal year 2013-14 and particularly analyses the feasibility of budgetary and macroeconomic targets for 2014-15.

We hope that all stakeholders including policy makers, parliamentarians, academicians, development practitioners, researchers, civil society activists, donors and the business community will benefit from this report.

Prof. Dr. Khalida Ghaus
Managing Director

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ACRONYMS

ADP	Annual Development Programme
BoP	Balance of Payments
CDWP	Central Development Working Party
CPEC	China-Pakistan Economic Corridor
CSF	Coalition Support Fund
ECNEC	Executive Committee of National Economic Council
EU	European Union
FBR	Federal Board of Revenue
FY	Fiscal Year
GDP	Gross Domestic Product
GDS	Gas Development Surcharge
GIDC	Gas Infrastructure Development Cess
GOP	Government of Pakistan
GSP	Generalised Scheme of Preferences
IDA	International Development Association
IMF	International Monetary Fund
LPG	Liquefied Petroleum Gas
MTBS	Medium-Term Budgetary Statement
NEC	National Economic Council
NFC	National Finance Commission
PBS	Pakistan Bureau of Statistics
PES	Pakistan Economic Survey
PML(N)	Pakistan Muslim League (Nawaz)
PSDP	Public Sector Development Programme
SBP	State Bank of Pakistan
SRO	Statutory Regulatory Order
TIE	Tax Investment and Exports
WAPDA	Water and Power Development Authority

The year, 2013-14, is the first year of the newly-elected Government of PML-N. With a strong mandate and a reputation for being business-friendly, it was expected that the process of transformation of the economy would start vigorously, with stabilization followed quickly by economic revival.

Given this expectation, the Government set its economic targets for 2013-14. As highlighted recently¹ by the Planning Minister

‘Tax revenues, investment and exports (what he calls TIE) have to go up as the current levels were not sustainable. The results against these goals will determine how quickly the Government can achieve its overall economic goals’.

The release of the Pakistan Economy Survey enables analysis of the extent to which the above three key targets for 2013-14 have been met. These targets are contained in the Budget for 2013-14, approved by the Parliament, and in the Annual Plan for the year, approved by the National Economic Council, chaired by the Prime Minister.

TAX REVENUES

Federal tax revenues are projected to increase in 2013-14 by 26.3 percent and rise from 9.0 percent to 10.2 percent of the GDP in the Medium-Term Budgetary Statement. From July to March, the growth rate achieved is 16.4 percent. Unless there is a sharp recovery in the last quarter, the annual tax revenue target is likely to be missed by as much as Rs 200 billion. It will be surprising if the tax-to-GDP ratio rises by more than 0.2 percent of the GDP, as compared to the target increase of 1.2 percent of GDP.

INVESTMENT

The Annual Plan for 2013-14 has set a target for fixed investment as percentage of GDP of 13.5 percent as compared to 13 percent last year. The initial impetus to investment is expected to be provided by the public sector with a growth rate of 32 percent, followed by the private sector with an increase of 17 percent.

According to the Pakistan Economic Survey, the outcome is likely to be disappointing. Rather than show rapid growth, private investment is projected to actually fall in 2013-14 by 1.6 percent. Public investment remains constrained, with an increase of only 0.5 percent. Overall, the target for fixed investment is likely to be missed by over Rs 250 billion, equivalent to 1 percent of the GDP.

¹ *The Express Tribune*, May 31, 2014

EXPORTS

Exports are projected to increase by 5.1 percent in the Annual Plan of 2013-14. This is a modest target and ought to have been revised upwards following the granting of GSP plus status by the EU in January 2014. But due to the persistence of a high level of power outages and a growing gas shortage, even the modest target for export growth is not likely to be attained.

According to the SBP, the growth rate of exports from July to April is only 2.4 percent. Textile exports have performed moderately well with a growth rate of 6.7 percent, exports of other manufactures have actually declined by 3.5 percent.

Beyond the three key targets, other targets have also been missed. The GDP growth target for 2013-14 is 4.4 percent. While the government's claim is that a growth rate of 4.1 percent will be achieved, the actual outcome is likely to be closer to 3.5 percent². Similarly, the target for the rate of inflation is 8 percent. It is likely to be closer to 8.5 percent.

Fortunately, one important target is likely to be achieved. This relates to the level of official foreign exchange reserves of \$ 9.4 billion by the end of June 2014. Although this has largely been achieved by external borrowings, it will provide a degree of stability to the economy.

² See Section 2: Overstating GDP Growth.

2 OVERSTATING GDP GRWOTH

Following the third review of the IMF in March 2014, the agreed growth rate projection of the GDP was 3.3 percent for 2013-14. However, the Pakistan Economic Survey has raised the growth rate to 4.1 percent.

We have examined the GDP estimates for 2013-14 on the basis of the methodology developed by the Pakistan Bureau of Statistics for rebasing the national income accounts from 1999-2000 to 2005-06. The GDP estimates are arrived at by deriving the value added of each sector at constant prices of 2005-06.

The PES states that the GDP growth rate has crossed 4 percent after a gap of six years. This is not factually correct. A growth rate of 4.4 percent was achieved in 2011-12. This has now been reduced to 3.8 percent two years later. If this growth rate was to be changed it should have been done in 2012-13. Therefore, the PBS has manipulated the data to show the highest GDP growth rate in the last six years in 2013-14.

There are reasons to believe that the growth rate has been significantly overstated in 2013-14, especially in the case of the following sectors: large-scale manufacturing, construction, wholesale and retail trade, finance and insurance.

The growth rate of large-scale manufacturing of 5.3 percent is for the eight months period, July – February. In March, the growth rate is a negative 2.7 percent. Consequently, the nine-month growth rate for July – March has fallen to 4.3 percent. The normal practice is to base the provisional figures in the GDP on the basis of the nine monthly growth rate.

As such, the growth rate of large-scale manufacturing has been overstated by 1 percent. This also has consequential effect on the growth rate of the wholesale and retail trade sector. This reduces the GDP growth rate by 0.2 percentage points.

Similarly, the growth rate of the construction sector of 11.3 percent appears too high, given that the consumption of the key input, cement, has increased by 4.2 percent. This reduces the GDP growth rate by another 0.2 percentage points.

88 percent of the value added banking and insurance sector is generated by commercial banks. Banks have shown a decline in profitability in real terms of over 15 percent. Therefore, the growth rate of this sector is unlikely to be 5.2 percent in 2013-14. It is probably negative. This reduces the GDP growth rate by another 0.2 percentage points at the minimum.

Overall, we estimate that the growth rate of GDP in 2013-14 is close to 3.5 percent, and not 4.1 percent. This means that the GDP growth rate in 2013-14 is the lowest in the last four years.

Another indicator of the overstatement of GDP growth is the phenomenal increase of household final consumption expenditure by almost 6 percent in 2013-14. This is substantially higher than the growth rate last year of only 2.5 percent.

The explanation for the high growth rate is that household final consumption expenditure is estimated as a residual. If the GDP obtained from the production side is overstated while investment, exports and imports are properly estimated then the residual also tends to be overstated.

It is hardly likely that consumption standards of the people have gone up by as much as 6 percent in 2013-14. If anything, sharply rising food prices have probably restrained consumption of basic food items, like atta, vegetables and pulses.

The Finance Minister has assured in this press conference on the PES that the PBS is available to explain GDP estimates. We welcome an opportunity to interact with the PBS. This will also enable a discussion on the methodology that has been developed for estimation of the GDP on a quarterly basis.

Also, the Minister has indicated that the Government is willing to involve diverse stakeholders in overseeing the PBS. Ideally, the PBS should be made an autonomous agency. This will greatly enhance the credibility of the statistics that it produces.

3 THE PERFORMANCE OF EXTERNAL SECTOR

The year 2013-14 witnessed a stress on external sector primarily on account of draining out of foreign exchange reserves initially and government's eagerness to keep the exchange rate at below Rupee 100 per US\$.

The performance of external sector of a country can be gauged by its Balance of Payments (BoP) Account that documents its economic transactions with the rest of the world. It is comprised of three separate accounts: the current account, the capital account and financial account. This article evaluates the performance of the external sector of Pakistan by analyzing each of the three accounts of the BoP.

	2011-12	2012-13	Growth (%)	July-April		Growth (%)
				2012-13	2013-14	
Trade Balance	-15,765	-15,431	-2.1	-12,892	-13,259	2.8
Exports (f.o.b)	24,696	24,795	0.4	20,544	21,038	2.4
Imports (f.o.b)	40,461	40,226	-0.6	33,436	34,297	2.6
Services Balance	-3,192	-1,472	-53.9	-931	-2,171	133.2
Receipts	5,035	6,733	33.7	5,860	4,189	-28.5
Payments	8,227	8,205	-0.3	6,791	6,360	-6.3
Income Balance	-3,245	-3,685	13.6	-2,958	-3,156	6.7
income credit	826	488	-40.9	395	438	10.9
income debit	4,071	4,173	2.5	3,353	3,594	7.2
Current Transfers (net)	17,544	18,092	3.1	15,207	16,424	8.0
(Workers' Remittances)	13,186	13,922	5.6	11,570	12,895	11.5
Current Account Balance	-4,658	-2,496	-46.4	-1,574	-2,162	37.4
Trade Balance as % of GDP	9.5	8.8			5.7	
Current Account Balance as % of GDP	2.1	1.1		0.9	1.1	

Source: Pakistan Economic Survey (2013-14)

Table 1 presents the current account that records transactions related to goods, services, income, and current transfers. It indicates that during July 2013 and April 2014, exports (f.o.b.) stood at \$21 billion and imports (f.o.b.) at \$34.3 billion resulting in a trade deficit of \$13.2 billion, up by 2.8 percent compared to same period a year ago. However, comparison of 2012-13 over 2011-12 depicts a decline of 2 percent in trade deficit. The services deficit widened to \$2.2 billion during July 2013 to April 2014 from \$0.9 billion over the same period a year ago, registering a big increase of 133 percent. According to Economic survey 2013-14, this growth in services account deficit was due to lower receipts under coalition support fund during this period.

At the same time, the deficit in the income account has worsened primarily because of increase in income payable abroad. On the other hand, net current transfers increased by 8 percent of which workers' remittances constitute a major part (78 percent) increased by over 11 percent. In spite of this, current account was in deficit of \$2.2 billion in the first ten months of FY14 compared to \$1.6 billion in the corresponding period of FY13 (an increase of 37 percent). As a percentage of GDP, it is 1.1 percent which is slightly up compared to the same period a year ago.

Table 2				
Capital and Financial Account				
(\$ Million)				
	FY12	FY13	July-April	
			FY13	FY14
Trade Balance	-15,765	-15,431	-12,892	-13,259
Services Balance	-3,192	-1,472	-931	-2,171
Income Balance	-3,245	-3,685	-2,958	-3,156
Deficit (Goods & Services)	-22,202	-20,588	-16,781	-18,586
Financing of Deficit				
Transfer Payments (net)	17,544	18,092	15,207	16,424
Capital and Financial Account				
Capital Transfers	183	264	244	1,755
Foreign Direct Investment	744	1,258	670	654
Portfolio Investment	-144	26	298	2,244
Other assets/grants	680	-735	-1,652	345
Errors and Omissions (net)	-80	-309	-76	-898
Overall Balance or Change in reserves	-3,275	-1,992	-2,090	1,938

Source: Pakistan Economic Survey (2013-14)

Table 2 gives the capital and financial accounts that record assets pertaining to international monetary flows, foreign direct or portfolio investments and hence illustrate the financing of external deficit. It shows that the combined deficit of trade, services and income accounts constitute \$18.6 billion in the first ten months of FY14 compared to \$16.8 billion in the same months of FY13 (increased by 11 percent). As mentioned above that the transfer payments reached to \$16.4 billion but helped financing 88 percent of the deficit as opposed to 91 percent previously. Consequently, other modes of financing have increased that include capital inflows and portfolio investment. The former are long-term loans, amounting to \$1.8 billion, from friendly countries and disbursements from multilateral and bilateral international financial institutions and the latter is floating of sovereign bond amounting \$2.2 billion. These two sources not only have financed the deficit but also have created a surplus of \$1.9 billion in balance of payments accounts. At the same they add to the foreign exchange reserves held with the State Bank of Pakistan that declined to an extent to pay only for one month import bill during November 2013 to February 2014 (Chart 1).

It needs to be mentioned that in the absence of grant amounting \$1.5 billion from a friendly country (Saudi Arabia) and sovereign bonds, the balance of payments might have suffered a deficit of \$1.8 billion.

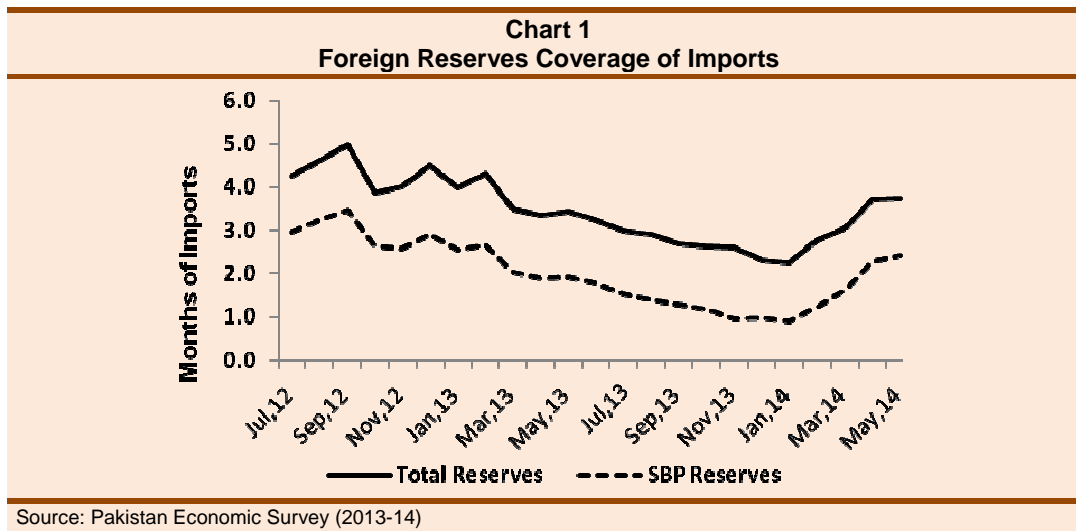


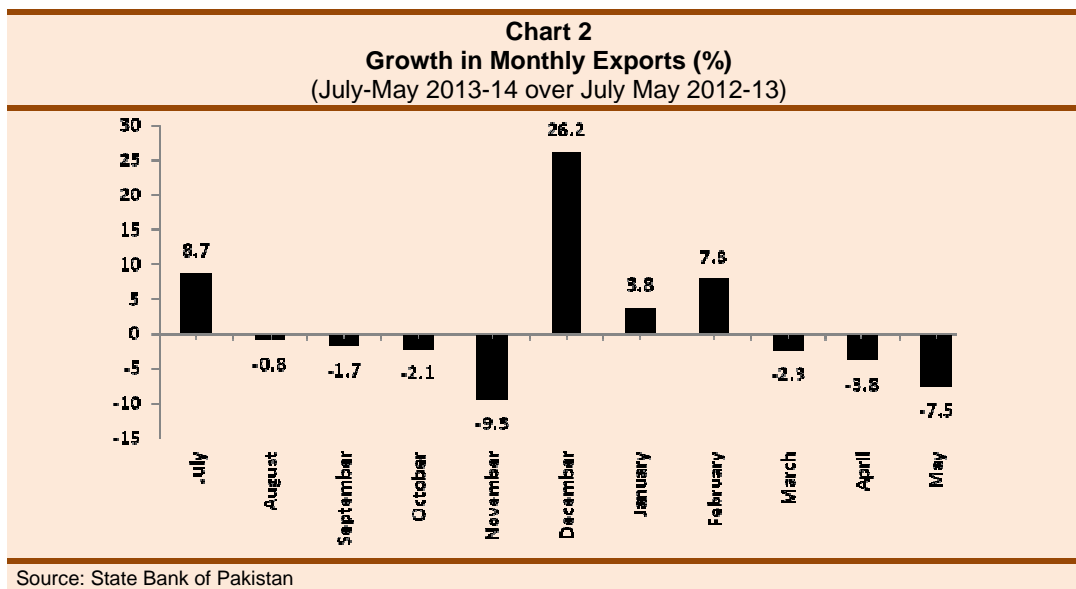
Table 3 presents the behaviour of exports that stood at \$21 billion during July 2013 and April 2014. Comparison of the first ten months of FY2014 indicates a growth of 4.2 percent in exports. It is higher compared to the growth of 3.2 percent recorded in 2012-13 relative to 2011-12. Textile sector that constitutes more than 50 percent of total exports showed improvement with a growth of 6.5 percent during first ten months of 2013-14 over the same months of 2012-13 compared to 5.8 percent during 2011-12 over 2012-13.

Other manufactures whose exports depicted an increase of 5.6 percent in 2011-12 over 2012-13 indicate a decline of 9 percent in the first ten months of 2012-13 compared to the same period a year earlier. However, export of petroleum products indicates a manifold increase in the first ten months of 2013-14 over the same months of 2012-13 primarily because of Petroleum top Neptha (a by-product of petroleum refinery). Growth in export of food group remained less than one percent as almost all the major items in this group registered a negative growth except rice, fish and fish preparation, and fruits that showed improved performance.

Chart 2 gives the comparison of monthly data of exports for the first eleven months of 2012-13 and 2013-14. It shows a decline in export in each month except for the months of July, December, January and February. This indicates that the entire increase in 2013-14 (July-May) is largely a result of increase in exports during December when exports increased by 26 percent that occurred on account of export of rice.

Imports amounted to \$37 billion during July 2013 and April 2014 registering an increase of only 1.2 percent over the same period a year ago, as shown in Table 4. This indicates that government has succeeded in curtailing the import bill. An increase of 7 percent is recorded in imports of machinery group (led by textiles and construction) constituting 19 percent of total imports, 5.6 percent in agriculture and

chemical group (led by fertilizer, insecticides and plastic material) constituting 15 percent of total imports, and 2.4 percent in textile group constituting 6 percent of total imports machinery imports. Imports of petroleum group constituting 33 percent of total imports declined by 1.3 percent, primarily on account of a decline of 4 percent in petroleum products. A decline of nearly 6 percent is also observed in the imports of food group that constitute 9 percent of total imports.



Current account deficit arises when a nation saves less than it spends, and then meeting the difference with inflows of foreign capital. Despite slower growth in imports, the foreign reserves kept on declining during September 2013 to February 2014. This was due to the reason that exports grew at a modest pace and services receipts depicted an immense decline. It is to mention that if the exports of Petroleum top Neptha amounting \$600 million are excluded, the growth in total exports reduced to just 1.3 percent, which is a token improvement in our traditional export items. This raises serious concerns as exports seemed witnessing a growth in the range of 10 to 20 percent during the decade of 2000s. The government though managed to keep the exchange rate at Rs100 per US \$ by bringing in foreign exchange but this seems that the appreciation in the value of rupee has eroded the competitiveness and affected the export growth negatively. The present bleak performance put pressure on efforts to increase exports. Pakistan though has acquired a GSP Plus status in European Markets which does not seem to have had any positive impact on exports yet.

Financing of deficit through borrowing from abroad, remittances and other transfer payments can only pave the way for a short term solution. There is a risk of uncertainty in inflow of these sources. The absence of such inflows results in a large loss of international reserves and requires a big correction in the current account deficit either by import compression through a sharp slowdown in economic growth or a sudden and large depreciation of exchange rate.

Table 3
Major Exports

(\$ Million)

Commodities	2011-12		2012-13		Growth (%)	July-April				
	Value	% Share	Value	% Share		2012-13		2013-14		Growth (%)
						Value	% Share	Value	% Share	
Food Group	4,250	18.0	4,762	19.5	12.1	3,918	19.5	3,946	18.8	0.7
Rice	2,062		1,922		-6.8	1,590		1,850		16.4
Fish & Fish Preparation	320		318		-0.7	256		292		14.2
Fruits	358		392		9.5	341		399		17.1
Vegetables	180		247		37.0	214		187		-12.4
Tobacco	29		25		-13.4	20		19		-5.5
Wheat	127		54		-57.8	53		7		-86.8
Spices	52		68		31.6	55		45		-19.0
Oil seeds and nuts	30		36		19.6	28		77		174.2
Sugar	28		530		1789.9	393		248		-36.8
Other food items	1,063		1,170		10.0	969		822		-15.2
Textile Group	12,336	52.2	13,048	53.3	5.8	10,740	53.3	11,438	54.5	6.5
Raw cotton	462		154		-66.7	138		196		41.8
Cotton Yarn	1,810		2253		24.5	1,861		1,708		-8.2
Cotton Cloth	2,442		2690		10.1	2,224		2,347		5.5
Knitwear	1,983		2043		3.0	1,664		1,842		10.7
Bedwear	1,742		1785		2.5	1,468		1,767		20.4
Towels	686		770		12.1	645		624		-3.2
Readymade Garments	1,616		1800		11.4	1,471		1,581		7.5
Synthetic Textile	546		406		-25.7	324		319		388.0
Others	1,049		1,148		9.4	945		1,052		-66.2
Petroleum Group	903	3.8	28	0.1	-96.9	6	0.0	601	2.9	9598.6
Other Manufactures	4,503	19.1	4,754	19.4	5.6	3,937	19.5	3,584	17.1	-9.0
Carpets, Rugs & Mats	121		122		1.4	97		106		10.0
Sports Goods	338		334		-1.1	269		286		6.6
Leather Tanned	446		500		12.1	390		438		12.3
Leather Manufactures	523		569		8.9	463		519		12.1
Surgical Goods & Instruments	304		304		-0.1	253		282		11.5
Chemicals & Pharmaceuticals	1,075		874		-18.7	636		963		51.3
Engineering Goods	277		290		4.9	218		255		17.1
Gems & Jewelry	920		1,182		28.4	1,143		319		-72.1
Cement	499		577		15.8	469		415		-11.5
Others	1,633	6.9	1,869	7.6	14.5	1,542	7.7	1,429	6.8	-7.3
Total	23,624	100	24,460	100	3.5	20,143	100	20,997	100	4.2

Source: Pakistan Economic Survey (2013-14)

**Table 4
Major Imports**

(\$ Million)

Commodities	2011-12		2012-13		Growth (%)	July-April				
	Value	% Share	Value	% Share		2012-13		2013-14		Growth (%)
						Value	% Share	Value	% Share	
Food Group	5,035	11	4,188	9	-16.8	3,632	10	3,423	9	-5.8
Milk/cream & infants food	161		137		-14.9	112		132		17.8
Tea	351		368		5.0	323		248		-23.3
Spices	101		67		-33.4	57		71		24.6
Soya bean Oil	51		74		44.8	59		79		35.2
Palm Oil	2,375		1,963		-17.3	1,700		1,529		-10.1
Pulses	434		327		-24.7	283		240		-15.3
Others	1,562		1,251		-19.9	1,098		1,124		2.4
Machinery Group	7,865	18	8,142	18	3.5	6,558	18	7,010	19	6.9
Power Generating	1,040		959		-7.8	818		850		3.9
Textile	444		388		-12.6	307		490		59.7
Construction & Mining	148		162		9.5	122		210		71.5
Electrical & apparatus	812		844		3.8	681		916		34.5
Telecom	1,268		1,494		17.8	1,285		1,027		-20.0
Road Motor Vehicles	1,656		1,450		-12.5	1,192		1,018		-14.6
Others	2,496		2,845		14.0	2,153		2,499		16.1
Petroleum Group	15,253	34	14,973	33	-1.8	12,362	34	12,206	33	-1.3
Petroleum Products	10,292		9,529		-7.4	7,767		7,467		-3.9
Petroleum Crude	4,960		5,444		9.8	4,596		4,739		3.1
Textile Group	2,398	5	2,612	6	8.9	2,192	6	2,245	6	2.4
Agriculture/Chemical Group	7,143	16	6,416	14	-10.2	5,196	14	5,488	15	5.6
Fertilizer	1,244		659		-47.1	499		584		17.2
Insecticides	137		88		-36.3	64		96		50.4
Plastic Material	1,529		1,425		-6.8	1,151		1,353		17.5
Medicinal Products	697		833		19.5	667		675		1.2
Other	3,536		3,412		-3.5	2,816		2,780		-1.3
Metal Group	2,824	6	3,337	7	18.2	2,672	7	2,448	7	-8.4
Iron & Steel	1,396		1,611		15.4	1,285		1,107		-13.8
other	1,428		1,726		20.8	1,387		1,341		-3.3
Others	4,394	10	5,282	12	20.2	4,052	11	4,286	12	5.8
Total	44,912	100	44,950	100	0.1	36,665	100	37,105	100	1.2

Source: Pakistan Economic Survey (2013-14)

4 GROWTH OF EXTERNAL DEBT

The external debt of the Government of Pakistan³ stood at \$ 47.3 billion on the 30th of June 2013. This was equivalent to 20.3 percent of the GDP (see Table 5). This constituted about 88 percent of the total external public debt.

The Budget of 2013-14 was based on a gross inflow of \$4.5 billion consisting of project loans of \$1.5 billion; program loans of \$1.1 billion and other inflows of \$1.9 billion (including Eurobonds of 0.5 billion). With debt repayment of \$3.5 billion, the net inflow is expected to be close to close to \$1 billion.

The Revised Estimates reveal that external borrowing in 2013-14 is likely to be substantially largely. Gross inflow is expected at \$6.6 billion, 47 percent higher than originally anticipated. The big increase is in programme loans of 126 percent, following the entry into an IMF program. Also, the receipt from flotation of Eurobonds is \$2 billion, four times larger than budgeted.

External debt repayment in 2013-14 is estimated at \$2.6 billion, one billion dollars less than projected. Consequently, the net inflow of external borrowing is \$4 billion in 2013-14, 300 percent more than budgeted. Therefore, the Government has resorted to massive external borrowing in an effort to build up the level of foreign exchange reserves.

	Revised Estimate 2012-13	Budget Estimate 2013-14	Revised Estimate 2013-14	Budget Estimate 2014-15
GROSS INFLOW	2.2	4.5	6.6	6.2
Project Loans	1.9	1.5	1.6	1.7
Program Loans	0.1	1.1	2.4	2.0
Other Inflows	0.2	1.9	2.	2.5
DEBT REPAYMENT	1.9	3.6	2.6	3.3
NET INFLOW	0.3	0.9	4.0	2.9
EXTERNAL DEBT (at end of year)	47.3	48.2	51.3	54.2

The consequence is that the external debt of the Government will stand at \$51.3 billion by the end of June 2014. This implies that the Government external debt-to-GDP will start rising once again and reach 20.8 percent.

³ Excluding debt of the SBP, like the loans from the IMF, and by private sector entities. Includes PSEs debt.

One indicator of external debt sustainability is the ratio of external debt to exports of goods and non-factor services. In the context of the external debt of the GOP, this was 150 percent in 2012-13 and is expected to increase significantly to 169 percent in 2014-15.

The recently announced Budget for 2014-15 envisages some reduction in gross inflow of external borrowing to \$6.2 billion, from \$6.6 billion in 2013-14. The reduction is primarily in program loans. Debt repayment is expected to be significantly higher at \$3.3 billion, implying a net inflow of \$2.9 billion. If external borrowings are restricted to the budgeted level then the Government External Debt to GDP ratio will stand at 20.9 percent at 30th June 2015, more or less, at the same level as at the end of 2013-14.

The Government has proceeded to mobilize large amounts of external borrowing. This has been considered essential to finance the big hump of investments in mega projects like dams, power plants and highways⁴ over the next five to seven years.

The Chinese Government has agreed to lend \$32 billion over the next five to seven years. The recently finalized World Bank Country Assistance Strategy involves IDA credits of \$12 billion over a five year period. The Government is also likely to float more Euro and Ijara Sukuk bonds in the international capital market.

Given the high level of potential borrowing, the Government external debt could reach \$100 billion by 2020-21. This could raise the debt-to-GDP ratio to almost 29 percent of the GDP.

It is extremely important that the Government focuses on external debt sustainability. External borrowings should only be invested in projects which enhance the debt repayment capacity. Otherwise, there is the danger that the country may find itself in a 'debt crisis' once again.

⁴ See Section 9: The Federal PSDP

5 A FRAGILE BUDGET

The 2014-15 budget is cleverly designed to achieve further stabilization while beginning the process of economic revival. The former goal will be realized if the consolidated fiscal deficit falls to 4.9 percent of the GDP from 5.8 percent in 2013-14. The latter goal of revival will be facilitated by the incentives provided to exports and investment, by the big jump in the PSDP and by less reliance on domestic borrowings, so as to avoid 'crowding out' the private sector.

But the basic question is whether the key targets embodied in the Budget will be realized or not? The degree to which a budget is fragile depends upon the robustness of its projections of revenues and expenditure.

We first take up the projection of FBR revenues at Rs 2810 billion for 2014-15. This is based on normal growth of Rs 285 billion from the level likely to be attained in 2013-14 of Rs 2275 billion and on a set of taxation proposals with the expected yield of almost Rs 250 billion.

The problem is, first, that the normal growth will be lower next year. The appreciation of the rupee implies that the rupee value of imports will rise only modestly next year, thereby affecting the growth of almost 40 percent of FBR revenues.

Second, the taxation proposals may not yield as much as projected for the following reasons:

- (i) The sales tax SROs that have been withdrawn include many raw materials and intermediate goods. Revenues that accrue from these items at the import stage could be largely input tax invoiced away at the stage of domestic manufacturing.
- (ii) Part of the increase in revenue from advance or withholding taxes may be reflected in lower tax payments with returns.
- (iii) Some of the new impositions of taxes will fall on very elastic tax bases like cigarettes (due to evasion) and bonus shares (companies will instead pay higher dividends or build reserves). Consequently, the additional revenue yield will be small.

Overall, we project that FBR revenues will reach Rs 2640 billion. The shortfall could be as large as Rs 170 billion, due to the above mentioned reasons.

Turning to non-tax revenues, two sources are uncertain. The first is defense receipts of Rs 140 billion, consisting primarily of reimbursements from the Coalition Support Fund (CSF). These flows may decrease following a significant US withdrawal from Afghanistan.

Second, SBP profits may not reach the high level of Rs 270 billion. These will be reduced by the cost of export incentives provided in the Budget of cheaper export finance and the long term financing facility.

On the expenditure side interest payments have been projected at Rs 1325 billion, with growth of 11.6 percent over the estimate for 2013-14. This appears to be on the low side for the following reasons:

- (i) Since 2010-11, the annual growth rate in costs of debt servicing has been high, approaching 19 percent.
- (ii) The composition of domestic debt in 2013-14 has shifted towards relatively high cost PIBs away from treasury bills.
- (iii) The interest cost on the Eurobonds alone will be about Rs 16 billion.
- (iv) Interest costs were underestimated in the budget of 2013-14 by Rs 40 billion.

We expect that the interest payments in 2014-15 will be at least Rs 50 billion higher than budgeted.

The Budget makes no provision for the retirement of outstanding circular debt in the power sector of almost Rs 300 billion. This will become essential if power outages are not to reach a crisis level.

On the top of all this, the Provincial Governments are expected to generate a cash surplus of Rs 183 billion this year, rising by over Rs 100 billion to Rs 289 billion in 2014-15. If these Governments are to come close to implementing their combined ADP of Rs 650 billion in 2014-15, as approved by the National Economic Council (NEC), then they do not have the fiscal space to generate such a large cash surplus. At the maximum a cash surplus of about Rs.100 billion can be generated.

Overall, the Budget of 2014-15 appears to be very fragile. In the worst case scenario, the consolidated fiscal deficit could be higher by over 2.5 percent of the GDP (over Rs 700 billion) in relation to the deficit target of 4.9 percent of the GDP.

Any slippages will clearly jeopardize the process of stabilization coupled with a degree of revival. In particular, a larger deficit will necessitate cuts in the PSDP and resort to higher domestic borrowing, leading not only to more inflation but also 'crowding out' the private sector. The Government needs to build in contingency plans in the event of slippages, but hopefully not in the form of 'mini budgets'.

Table 6	
Summary of Key Deviations in Budgetary Magnitudes	
<i>(Rs in Billion)</i>	
REVENUES	330
<ul style="list-style-type: none"> • Shortfall in FBR Revenues • Shortfall in dividends received • Shortfall in SBP Profits • Shortfall in CSF Receipts 	170 20 70 70
CURRENT EXPENDITURE	40
<ul style="list-style-type: none"> • Higher debt servicing costs 	40
DEVELOPMENT EXPENDITURE	300
<ul style="list-style-type: none"> • Retirement of Circular debt of power sector 	300
PROVINCIAL CASH SURPLUSES	160
TOTAL INCREASE IN FISCAL DEFICIT	830
<ul style="list-style-type: none"> • % of GDP 	2.9
<ul style="list-style-type: none"> • Projected Fiscal Deficit(% of GDP) <i>(in the worst case scenario)</i> 	7.8

6 UNPLEASANT BUDGETARY ARITHMETIC

Fiscal stabilization is the key feature emerged from the statistics presented in the federal budget documents 2014-15. According to the budget documents, revised estimates for 2013-14 indicate that budget deficit was much lower compared to what was envisaged at the time of budget making. At the time of budget making, authorities estimated the budget deficit of 6.3 percent of GDP, while as per revised estimates overall budget deficit would likely to be 5.8 percent of GDP in 2013-14. Even in absolute terms, it declined from Rs1.65 trillion to Rs1.45 trillion as per official estimates. Pakistan's authorities believe that this positive deviation is the result of their austerity efforts; they claim that their policies acted as a stimulus to economy and helped to achieve much needed fiscal stabilization. This article analyses whether this deviation is an outcome of sound macroeconomic policies or flawed computation made during the budget making exercise.

Conceptually, budget deficit is simply a difference between total revenues and total expenditure. The former includes both tax and non-tax revenues and the latter includes both current and development expenditures. In reality, the computation of the budget deficit is slightly more complicated due to allocations made to repayment of foreign debt, different tiers of governments and lending to autonomous bodies.

Table 7 highlights that the net revenue receipts – sum of both tax and non-tax revenues after excluding the provincial share in revenues – surpasses the budget estimates for 2013-14 by 13.9 percent as per revised estimates. Given the sluggish economic activities and ongoing security challenges and threats, apparently, this increase is commendable. However, scrutiny of various components of net revenue receipts indicates that it is not due to taxation efforts of federal government. In fact, once again federal government has failed to achieve its tax target for 2013-14 even after including Rs88 billion from Gas Infrastructure Development Cess (GIDC). The increase in net revenue receipts is derived by tremendous growth in non-tax revenues. Foreign grants of more than Rs204 billion (including grant from a friendly country) is the largest contributor in this growth. Other two major contributors are SBP profits and other profits. While, former is revised upward to Rs260 billion against the budget estimate of Rs200 billion, the latter shows Rs67.6 billion as revised estimate from zero budget estimate.

On expenditure side, net current expenditure, after excluding repayment of foreign debt, reveals an increase of more than 4 percent compared to budget estimates set for the 2013-14. An analysis of the trend in current expenditures and detailed screening of federal budget documents highlight that this may further augment if government tries to retire circular debt similar to last year.

In contrast to current expenditure, federal PSDP shows a decline of 21 percent compared to budget estimates. However, development expenditures outside PSDP show phenomenal growth.

Heads		2013-14		2014-15
		BE	RE	BE
	Net Revenue Receipts	1,917.7	2,183.8	2,225.4
Plus	Net Lending to Provinces and others	27.3	-50.4	32.1
Minus	Current Expenditures	3,196.1	3,198.6	3,463.2
Plus	Repayment of Foreign Loans	366.8	263.6	333.2
Minus	Federal Development Expenditures	789.4	858.7	838.5
Federal Budget Surplus(+)/Deficit (-) A		-1,673.7	-1,660.3	-1,711.0
Provincial Budget Surplus/Deficit				
	Punjab	-30.0	34.7	0.0
	Sindh	-16.6	-10.3	-3.0
	Khyber Pakhtunkhwa	14.9	13.4	11.7
	Balochistan	8.5	13.8	-1.8
Provincial Budget Surplus(+)/Deficit (-) B		-23.2	51.6	7.0
OVERALL Budget Surplus(+)/Deficit (-) (A+B)		-1,696.9	-1,608.7	-1,704.0
GDP (MP)		26,001	25,402	29,078
BUDGET DEFICIT (as %age of GDP)		-6.5	-6.3	-5.9

Source: Author's Estimates based on Federal Budget in Brief 2014-15, Annual Budget Statement (Province-Wise) 2014-15
Note: BE implies Budget Estimates and RE implies Revised Estimates

Despite the reservations expressed above and assuming the statistics presented in the federal budget documents are correct, what would be the federal and overall budget deficit (aggregate of federal and provincial budget deficit/surplus)?

The computation of the federal budget deficit simply requires subtraction of total expenditures (sum of net current expenditures and federal development expenditures) from total revenues (sum of net revenue receipts and net lending to others). The result shows a budget deficit of Rs1.7 trillion and Rs1.6 trillion as per budget and revised estimates of 2013-14 respectively. However, neither of them is less than 6 percent of GDP. For 2014-15, it is Rs1.7 trillion, which is roughly 5.9 percent of the GDP.

In order to lower the overall budget deficit, the federal budget documents show provincial surpluses of Rs183 billion in 2013-14 and Rs289 billion in 2014-15. As a

result, overall budget deficit in 2013 -14 declines to Rs1.48 trillion from Rs1.67 trillion, which is exactly 5.8 percent of the projected GDP.

To check the consistency of provincial surplus, province-wise and aggregate budget surpluses/deficits are computed by using provincial budget documents.

Surprisingly, the result indicates that Sindh has a deficit of more than 10 billion instead of surplus. Among the other provinces, Punjab has a surplus of Rs35 billion, Khyber Pakhtunkhwa of Rs13 billion and Baluchistan has budget surplus of roughly Rs14 billion. The sum of these budgetary balances resulted in a net surplus of Rs51.6 billion instead of a surplus of Rs183 billion for 2013-14. The situation for 2014-15 depicts a gloomy picture since the aggregate projected provincial budget surplus is only Rs7 billion rather a surplus of Rs289 billion.

Aggregation of provincial and federal budget deficits and surpluses gives a relatively higher overall budget deficit of Rs1.6 trillion in 2013-14 and Rs1.7 trillion in 2014-15, which is 6.3 and 5.9 percent of the projected GDP. After taking into account the monetary impact of overestimation in revenues and underestimation in current expenditures of the federal government, this overall budget deficit is likely to reach 7 percent of GDP in 2013-14 and cross 6 percent of GDP in 2014-15.

Based on these estimates, it can be inferred that the large deviation in budgeted and revised estimates of budget deficit pertains to systematic errors, which may have been made intentionally to show a lower deficit within the prescribed limits of IMF.

If such budgeting practices continue then it would further erode the credibility of the government among people, donor agencies and in the eyes of IMF. Moreover, it creates uncertainties in federal and provincial fiscal planning, which is a potential harbinger of negative implications for development.

7 TAX EXPENDITURE

Tax expenditure is an oxymoron which is a measure of the revenue foregone due to tax exemptions and concessions that go beyond the normal preferential treatment given in most tax regimes, like no taxation of basic food items. Tax expenditures are either embodied in the tax laws or promulgated through SROs in Pakistan. They have the same impact on the budget deficit as higher expenditure, thus the name 'tax expenditure'.

The total value of tax expenditure in the Federal Tax system has been given in Annexure-II of the Pakistan Economic Survey for 2013-14. These aggregate to Rs 477 billion, equivalent to 1.9 percent of the GDP and as much as 21 percent of the tax revenues likely to be collected by FBR during the year.

The breakup of the total tax expenditure is as follows: Rs 97 billion in income tax; Rs 249 billion in the sales tax and Rs 131 billion in customs duty. According, only about 20 percent of the tax expenditure is in the income tax. This indicates that the rich and powerful are not the major beneficiaries of tax exemptions and concessions in Pakistan. The remaining 80 percent in indirect taxes tends to convey the impression that the tax benefits accrue primarily to the poorer sections of society.

But it is our contention that the tax expenditure estimates are seriously flawed. They understate direct tax expenditure by exclusion or understatement of a number of tax breaks to both corporate and personal income tax payers. Simultaneously, the indirect tax expenditure is overstated.

For example, the revenue loss, in a booming stock market, due to under taxation or under recovery of capital gains is in excess of Rs 40 billion, while the PES quantifies this as only Rs 5 billion.

Under Section 37 of the ITO capital gains on property are also taxable, if the sale occurs within two years. In India and in other countries long-term capital gains, reduced by inflation, are also subject to taxation. The absence of this provision in Pakistan implies a revenue loss annually of over Rs 25 billion. Other tax benefits to personal tax payers not mentioned in PES include investment allowance, exemptions of income from some saving schemes and bonds, tax credit on provident fund contribution etc.

For corporate tax payers, there are also a number of tax benefits which have not been included in the PES estimates. The first is accelerated depreciation allowance, with a revenue loss of Rs 30 billion; lower presumptive taxes on exporters of goods

and services costing over Rs 35 billion; tax deduction on provisioning for bad debt by banks costing Rs 25 billion; specific sectoral and regional tax holidays, so on.

The total tax expenditure in income tax is Rs 250 billion, which is more than 150 percent higher than that reported in the PES. If tax expenditures in provincial direct taxes like the agricultural income tax and the urban immovable property tax are also included, then the total tax expenditure in direct taxes rises to Rs 315 billion, equivalent to 36 percent of the revenues actually collected.

Turning to indirect taxes, the tax expenditure in sales tax is substantially overstated. PES mostly reports losses under SROs 727(1), 525(1), 549(1), 575(1), 55(1), promulgated between 2006 and 2011. Most of the items covered by these SROs are raw materials, intermediate goods, sub-components, components, plant and machinery. This implies less input tax invoicing at the stage of value added taxation of domestic output. Consequently, almost 60 percent of the tax expenditure is recovered. As such, the revenue loss due to SROs in sales tax is not Rs 249 billion, as reported in the PES, but much less at Rs 105 billion. Tax expenditure in the provincial sales tax on services is estimated at Rs 80 billion.

Similarly, the PES includes the tax expenditure due to reduction in import tariffs in preferential or free trade agreements of Pakistan. These cannot be withdrawn and are legitimately a part of such agreements. The withdrawal of these tax expenditures implies that the revenue loss due to SROs in imports is about Rs 100 billion.

Overall, we estimate the total expenditure in both Federal and Provincial taxes combined at close to Rs 600 billion. This is equivalent to 2.3 percent of the GDP and almost 25 percent of the tax revenues likely to be generated in 2013-14. As opposed to the estimates in the PES, the major share of tax expenditure is in direct taxes of almost 53 percent.

The budget of 2014-15 makes hardly any attempt to eliminate or reduce the above mentioned tax breaks for the big corporate and rich individual taxpayers. Instead, the capital gains tax rate on securities has been reduced from 17.5 percent to 12.5 percent. Also, the corporate tax rate for multinational companies investing in Pakistan has been reduced from 33 percent to 20 percent. This tax break alone will cost over Rs 30 billion annually over the last few years.

In conclusion, the quantification of tax expenditure by PES grossly understates the exemptions and concessions in direct taxes to the richer segments of society. In fact, the major share of tax expenditure is in direct taxes both at the federal and provincial levels. If the tax-to-GDP is to be raised and the tax system made more equitable then many of the direct tax expenditures will have to be phased out.

8 THE TALE OF TAX-TO-GDP GROWTH

The budgetary outcome in 2013-14 shows the only positive fiscal development-increase in tax-to-GDP ratio. This is the first time that tax revenues cross Rs2.5 trillion (at least in budget documents). While, FBR is the major contributor in tax revenues, contribution of taxes other than FBR has also reached to almost 10 percent of federal tax revenues. The growth in tax revenue other than FBR is an outcome of inclusion of Gas Infrastructure Development Cess (GIDC) and Gas Development Surcharge (GDS) in tax revenues. Previously both GIDC and GDS were part of non-tax revenues. Given that GDS, GIDC and Petroleum Development Levy have been gradually transferred from non-tax revenues to the tax revenues, Petroleum levy on LPG still being part of the non-tax revenues is enigmatic. In order to avoid impact of definitional changes on tax-to GDP ratio, the analysis in this section focuses only on FBR taxes.

Table 8 gives the overall and specific tax-to-GDP ratios of federal taxes collected by the Federal Board of Revenue (FBR), which constitute over 90 percent of the tax revenues in the country. The table clearly reveals the lack of elasticity in FBR taxes during 2005-06 to 2013-14. On average, the tax-to-GDP ratios of income tax and sales tax have been hovering around 3.5 percent while that of excise and customs duties have fallen. A marginal increase of 0.3 percentage points in the tax-to-GDP ratio in 2013-14 came after a sharp decline of 0.7 percentage points in 2012-13. Hence, there is a need to understand these changes. The rest of analysis throws light on these changes by decomposing the tax-to-GDP ratio into its two key components -- tax-to-base and base-to GDP ratios.

Year	Direct Taxes	Excise Duties	Customs Duties	Sales Tax	Total Indirect Taxes	Total Taxes
2005-06	2.7	0.7	1.7	3.6	5.9	8.7
2006-07	3.6	0.8	1.4	3.3	5.6	9.2
2007-08	3.6	0.9	1.4	3.5	5.8	9.5
2008-09	3.3	0.9	1.1	3.4	5.4	8.8
2009-10	3.6	0.8	1.1	3.5	5.4	8.9
2010-11	3.3	0.8	1.0	3.5	5.2	8.5
2011-12	3.7	0.6	1.1	4.0	5.7	9.4
2012-13	3.3	0.5	1.1	3.7	5.3	8.7
2013-14R	3.5	0.5	0.9	4.0	5.4	9.0

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2013-14.
R=Revised Estimates

DIRECT TAXES

Using non-agricultural GDP as the tax base, we have decomposed the buoyancy of direct taxes into its components, as shown in Table 9. The initial rise in the tax-to-GDP ratio is a combined consequence of both a rise in tax-to-tax base and effective tax rate. The decline in tax-to-GDP ratio of direct taxes in 2012-13 is a combined consequence of both a decline in effective tax rate and base-to GDP ratios. However, in 2013-14 direct tax to GDP ratio marginally increased by 0.2 percentage points of GDP as per revised estimates. Therefore, it can be gauged from the table that increase in effective tax rate dominates the decrease in tax base to GDP ratio which has finally resulted in an overall increase in tax-GPD ratio.

Years	Tax-to- GDP Ratio	Tax Base-to-GDP Ratio	Effective Tax Rate
2005-06	2.7	72.3	3.8
2006-07	3.6	72.7	5.0
2007-08	3.6	74.8	4.9
2008-09	3.3	72.3	4.6
2009-10	3.6	72.6	4.9
2010-11	3.3	71.4	4.6
2011-12	3.7	72.9	5.1
2012-13	3.3	71.9	4.6
2013-14 (R)	3.5	71.0	4.9

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2013-14.
(R) = Revised Estimates

What explains the increase in the effective rate of direct taxes in 2013-14? The answer is fairly apparent in the movement of statutory rates. In 2013-14, income tax rates for both salaried and non-salaried were revised. Moreover, new withholding taxes were introduced (minimum tax on builders and developers, and withholding tax on cable operators and other electronic media and the like) and tax rates of few existing withholding taxes including withholding tax on cash withdrawals were revised upwards.

EXCISE DUTY

The tax base of excise duty consists primarily of value added in large-scale manufacturing. Major revenue contributors include petroleum products, cigarettes, sugar, cement, etc. In the early nineties, the tax net of excise duty was extended to cover services like banking, telephones, electricity and professional services. Consequently, the tax base for excise duty has been extended to include value added in finance and insurance, and transport and communications.

The tax base for excise duties is not very large and has been declined by more than 4.4 percentage points since 2008-09 as shown in Table 10. However, the sluggish growth in revenues, particularly in 2012-13 and 2013-14, is mainly explained by the declining effective tax rate compared to 2011-12. Firstly, this is essentially a

reflection of incomplete adjustment of the tax rates to inflation, as the duty continues to be levied at specific rates on certain items; secondly, this is also a result of gradual replacement of excise duties by sales tax and transfer to sales tax on services to provinces after the 7th NFC Award. In essence, the marginal increase in effective tax rate is an outcome of increase in statutory rate of excise duty on cigarettes in 2013-14.

Years	Tax-to- GDP Ratio	Tax Base-to-GDP Ratio	Effective Tax Rate
2005-06	0.7	26.1	2.6
2006-07	0.8	26.7	2.9
2007-08	0.9	26.6	3.3
2008-09	0.9	27.3	3.2
2009-10	0.8	26.6	3.1
2010-11	0.8	25.2	3.0
2011-12	0.6	24.1	2.5
2012-13	0.5	23.7	2.3
2013-14 (R)	0.5	22.9	2.4

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2013-14.
(R) = Revised Estimates

CUSTOMS DUTY

The tax base for customs duty is the value of dutiable imports which is the total value of imports minus the value of exempt items like food, fertilizer and pharmaceuticals. Table 11 highlights that since 2011-12 the tax base to GDP ratio is hovering around 11 percent; however the decline from 14 percent to 11 percent during 2005-2006 to 2011-12 is noteworthy. The relatively higher tax to GDP ratio particularly till 2008-09 reflects the increase in POL prices and more importantly the higher demand for imports of consumer durables like automobiles and capital goods. This was the result of boom in the economy and greater buoyancy in the manufacturing sector during that period.

Years	Tax-to- GDP Ratio	Tax Base-to-GDP Ratio	Effective Tax Rate
2005-06	1.7	14.0	12.1
2006-07	1.4	13.7	10.5
2007-08	1.4	14.3	9.9
2008-09	1.1	12.7	8.9
2009-10	1.1	11.8	9.2
2010-11	1.0	11.6	8.7
2011-12	1.1	11.0	9.8
2012-13	1.1	11.2	9.5
2013-14 (R)	0.9	11.0	8.6

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2013-14.
(R) = Revised Estimates

Despite, marginal increase in the tax-base-to-GDP ratio in 2012-13, there is no increase in the tax-to GDP ratio in customs duty. It is due to decline in the effective tax rate of customs duty from 9.8 percent in 2011-12 to 9.5 percent in 2012-13. However, in 2014-15 both base and rate effects are negative. Consequently, tax-to-GDP ratio of custom duty declined by 0.2 percentage points of GDP. While, base effect has contributed marginally it is the decrease in effective tax rate which paints the real picture of this decline in tax-GDP ratio. The decline in effective tax rate is primarily a consequence of the cascading down of import tariffs in an effort to liberalise trade in the country.

SALES TAX

Sales tax is levied at two stages in Pakistan -- import and domestic production. During nineties, it acquired the characteristics of a value added tax. Therefore, the tax base for the tax is the value of dutiable imports plus revenue from import duty plus value added in large-scale manufacturing. In recent years, there has been a major broad basing of the tax, which has increasingly substituted for customs duty, excise duty and the petroleum development surcharge. The size of the tax base has, therefore, been accordingly extended.

Table 12 shows that the tax base-to-GDP ratio varies from year to year. Similar to fluctuations in customs duty, this variation is mainly caused by volatility in international prices. Since 2011-12, tax-base-to GDP ratio has been consistently declining to 31 percent in 2013-14. Consequently, in 2013-14 base effect is negative. On the other hand rate effect is positive in 2013-14. The significant positive rate effect of 1 percentage point increase in the statutory rate from 16% to 17% caused the 0.3 percentage points increase in the tax-to-GDP ratio.

Years	Tax-to- GDP Ratio	Tax Base-to-GDP Ratio	Effective Tax Rate
2005-06	3.6	32.9	10.9
2006-07	3.3	32.3	10.4
2007-08	3.5	36.7	9.7
2008-09	3.4	31.3	10.9
2009-10	3.5	31.0	11.2
2010-11	3.5	32.3	10.7
2011-12	4.0	32.9	12.2
2012-13	3.7	31.7	11.8
2013-14 (R)	4.0	31.0	12.8

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2013-14.
(R) = Revised Estimates

Table 13 presents the result of decomposition for three periods: (1) 2005-06 to 2012-13, (2) 2013-14 and (3) 2005-06 to 2013-14. It indicates that during 2005-06 to 2012-13, there was a decrease in the tax-to-GDP ratio of 0.03 percentage points. Although, there is a negative base effect of 0.46 percentage points, the rate effect

shows an improvement of 0.43 percentage point in the tax-to GDP ratio. Similarly, in 2013-14 base effect is negative and rate effect is positive due to increase in statutory rates in 2013-4. Precisely, this analysis clearly indicates that resource mobilization strategy of present government hinges on increase in tax rate and not in broadening the tax base.

Table 13			
Decomposition of the Changes in Tax-To-GDP Ratio			
<i>(% of GDP)</i>			
Tax	Tax-to-GDP Ratio	Base Effect	Rate Effect
2005-06 to 2012-13			
Direct Taxes	0.57	-0.03	0.59
Excise Duty	-0.14	-0.07	-0.06
Customs Duty	-0.62	-0.26	-0.36
Sales Tax	0.16	-0.09	0.25
Total Taxes	-0.03	-0.46	0.43
2013-14			
Direct Taxes	0.20	-0.04	0.25
Excise Duty	0.01	-0.02	0.02
Customs Duty	-0.12	-0.01	-0.10
Sales Tax	0.21	-0.08	0.29
Total Taxes	0.30	-0.16	0.46
2005-06 to 2013-14			
Direct Taxes	0.77	-0.07	0.84
Excise Duty	-0.13	-0.09	-0.04
Customs Duty	-0.74	-0.28	-0.46
Sales Tax	0.37	-0.18	0.54
Total Taxes	0.27	-0.61	0.89

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2013-14.

9 THE FEDERAL PSDP

As 2013-14 comes to an end, the Federal Public Sector Development Program (PSDP) releases stand at near Rs 400 billion, lower than the figure shown in the budgeted documents of Rs 425 billion. Over the year, the PSDP has been cut by almost 25%. The axe has fallen on the PSDP, as in the presence of a large revenue shortfall, the Government had no other option in trying to achieve the fiscal deficit target imposed by the IMF.

Now, the target for the Federal PSDP in 2014-15 has been set at Rs 525 billion, even below the target originally of 2013-14 of Rs 540 billion. But, meanwhile, there has been a veritable explosion in the number and cost of projects added to the portfolio of projects to be financed through the PSDP.

The throw forward (remaining cost) of on-going projects stands at Rs 4218 billion as of 1st of July 2014. The cost of new projects is Rs 3540 billion. Therefore, the Federal portfolio of projects has been expanded in one year by a massive 84 percent, and the total cost now is Rs 7758 billion. Given a PSDP of Rs 660 billion (including self-financing by Corporations) this means that it will take almost twelve years on average to fully execute a project!

Which are the key sectors where new projects have been added? Clearly, the biggest expansion is in the WAPDA (hydel) sector of Rs 1595 billion, due to the inclusion of the Bunji Hydro Power Project. This project has the potential of generating 7100MW of electricity.

The next major inclusion is of projects in the China-Pakistan Economic Corridor (CPEC) of Rs 746 billion. This includes primarily of the cost of the Karachi-Lahore motorway. The remaining Rs 1199 billion consists of projects to be executed by the 35 other Divisions of the Federal Government. Already, new projects have pre-empted 31 percent of PSDP funds. This diversion may delay the completion of on-going projects.

The Planning Commission has accepted passively the substantial spreading thin of development resources. The size of the portfolio of Rs 7758 billion is much too large in relation to the available resources of Rs 660 billion only, which may even be cut during the year, if past experience is any guide.

What is unacceptable is that the Planning Commission has included over 90 percent of new projects for financing that currently have 'unapproved status'. This is a serious violation of the procedure for appraisal and approval of projects. A project has to have a PC-1, indicating the cost-benefit analysis and the returns from the

project. It has then to be subjected to CDWP/ECNEC approval, depending on the size. Are these new projects likely to be given ex post approval subsequently in a ritualistic manner?

Further, it is not clear how the financing for the large portfolio of projects will be organized. The contribution of foreign assistance is Rs 102 billion, equivalent to 19 percent of the PSDP outlay in 2014-15.

Presumably, the understanding is that the large amount of \$ 32 billion will be forthcoming in the next five to seven years from the Chinese Government (primarily through the China EXIM Bank). This will include financing for projects in the CPEC, Chashma nuclear power projects and large number of coal-based power plants. All these projects have been included in the PSDP without the formal process of 'financial close' being completed.

On top of all this, there appears to be a complete disconnect between the Ministries of Planning and Development and Finance. The three year Medium-Term Budgetary Statement (MTBS) of the latter provides hardly any 'fiscal space' for increased funding of the larger portfolio of projects in the PSDP in 2015-16 and 2016-17. There is little increase in development expenditure as a percentage of the GDP. Instead, the fiscal deficit is proposed to be brought down sharply to 4 percent of the GDP.

Given that the country is entering a capital-intensive stage of development, with large investments in dams, nuclear and coal-based energy projects and highways, the Federal PSDP will have to be raised from the projected level of 1.8 percent of the GDP to over 3 percent of the GDP. This will take the fiscal deficit in 2015-16 and 2016-17 to well above 4 percent of the GDP.

Overall, the PSDP of 2014-15 reveals a hurried and ad hoc inclusion of a number of large new projects. This has been done without adequate project preparation, approval and financing arrangements. The ministry of Planning and Development must prioritize and insist on the due process of appraisal and approval. Also, it must resist big cuts in releases for the PSDP during a financial year. Further, it must ensure that the implementation capacity is generally expanded for the peak in development spending that is likely to come in the next few years.

10 MACROECONOMIC TARGETS FOR 2014-15

The Government has presented ambitious macroeconomic targets for 2014-15 in its Annual Plan⁵. For the first time in seven years, the GDP growth rate is expected to rise above 5 percent, while there will be a minor drop in the rate of inflation.

We discuss below the prospects for key macroeconomic variables. The official projections are given in Table 14.

GROWTH

There were no major visible signs of growth revival in 2013-14. With a properly estimated GDP growth rate of 3.5 percent, the economy continued to be in grips of stagflation. The main drivers of growth showed negative trends, as follows:

- (i) The agriculture sector recorded a low growth rate of 2.1 percent, due particularly to the failure of the cotton crop and minor crops.
- (ii) The investment-to-GDP ratio declined, due especially to a fall in real capital formation by the private sector of almost 2 percent.
- (iii) Exports of goods and services have decreased by 4.5 percent in the first ten months of 2013-14.

	2013-14	2014-15 (Target)
Real GDP Growth (%)	4.1 (3.5)*	5.1
Inflation (%)	8.5	8.0
Fiscal Balance (% of GDP)	5.8	4.9 (7.0-73)*
Current Account Balance ** (\$ billion)	-2.8	-3.3
Gross Official Reserves** (\$ billion)	9.3	12.7

*According to SPDC estimates, given in Section 2: Overstating GDP Growth.
 **According to IMF projections.
 Source: Ministry of Finance, Budget-in-Brief.
 IMF, Staff Report.

The only sector which has showed a positive trend is large-scale manufacturing with a growth of just over 4 percent in the first nine months of 2013-14. But even in this sector, the last two months, February and March, saw negative growth.

⁵ As of the 16th of June 2014, the Annual Plan has not been released by the Planning Commission.

What are the prospects for 2014-15? At this time, it seems unlikely that the growth rate target of above 5 percent can be attained, for the following reasons:

- (i) The terrorist attack at Karachi airport has been followed by the launching of the large-scale military operation in Northern Waziristan. This is bound to raise concern about reprisal terrorist attacks and scare away both domestic and foreign investors, till such time as relative peace is restored.
- (ii) The power loadshedding situation is unlikely to improve substantially in 2014-15. The new projects for electricity generation that have been undertaken will take time to reach completion. Further, the situation with regard to availability of natural gas is deteriorating and the price of gas to industry and power has been enhanced significantly by imposition of higher Gas Infrastructure Development Cess.
- (iii) Export incentives have been provided in the Federal Budget. These include a reduction in the mark-up rate of export finance and in the long-term financing facility. But the overvalued exchange rate (which has appreciated in real terms by 12 percent since March 2014) will continue to discourage exports. Further, the world economy and trade are showing only very limited signs of recovery and there is greater competition among countries for export markets.

Overall, given the above constraining factors, the economy will do relatively well if it can achieve a growth rate above 4 percent in 2014-15.

RATE OF INFLATION

The prospects for a reduction in the rate of inflation appear brighter at this point. First, a stable currency should limit the extent of imported inflation. Second, the rate of expansion in money supply due to government borrowing could be restricted if privatization receipts reach almost Rs 200 billion in 2014-15.

However, there are some factors which could impact adversely on the price level. The first is the escalation in power tariffs of 15 to 20 percent during the earlier part of 2014-15 and the increase that has already taken place in gas prices. Second, the withdrawal of some concessionary SROs in the Budget on import duty and sales tax may raise prices in some industries. Third, a recent development is the spike in oil prices due to the situation in Ukraine and the insurgency in Iraq. Already, the price of oil has increased by over 10 percent and it may rise further in coming weeks.

FISCAL DEFICIT

In a previous Chapter we have already highlighted how fragile the 2014-15 Budget is, both on the revenue and expenditure sides. In the worst case scenario, the deficit could exceed 7 percent of the GDP as compared to the target of 4.9 percent of the

GDP, especially if provisions have to be made for retirement of circular debt of over Rs 300 billion and the Provinces fail to generate large cash surpluses.

CURRENT ACCOUNT DEFICIT

We have already highlighted the absence of growth in exports, despite the availability of GSP plus status from the EU. If the jump in oil prices persists, then the import bill could be significantly larger. For every \$10 increase in the price of oil per barrel, the import bill of POL products and crude oil rises by almost \$1.5 billion. Therefore, the current account in the balance of payments is vulnerable. It could rise from just over 1 percent in 2013-14 to almost 2 percent of the GDP in 2014-15.

On the financial account of the balance of payments the outcome will hinge on the quantum of inflows from foreign investors in the privatization process. If the target of \$ 2billion is achieved, then this will make a significant contribution to improving the BOP position.

The net inflow of foreign assistance is projected at \$2.9 billion in 2014-15, including \$500 billion from another flotation of Eurobonds. The likelihood of this inflow remains high if Pakistan continues to be on track in the IMF program and the multilateral agencies maintain program support funding. Also, the net inflow from the EFF facility of the IMF will be larger in 2014-15.

Given the above, an increase of foreign exchange reserves of \$3 billion or so seems likely. If these reserves rise beyond \$12 billion they will place Pakistan in a relatively safe position with import cover approaching three months.

All in all, our projections are of a mixed nature. The GDP growth rate will be close to 4 percent; inflation should fall to below 8 percent and the fiscal deficit may approach a relatively high level of 7 percent of the GDP. Depending on no further spike in oil prices, the BOP position will remain manageable and reserves could rise significantly.

The Social Policy and Development Centre (SPDC)

Established in 1995, SPDC is a civil society sector research organisation that serves as a focal point for policy-relevant research on social sector development. Using a multidisciplinary approach, SPDC assists both public and private sector institutions including non-governmental organisations (NGOs) to plan, design, finance, execute and manage social sector programmes in a cost-effective manner. The results of its research are made available to policy makers, interested groups and general public to promote informed discussion and action on vital social sector issues.

SPDC being an independent and non-partisan organisation cooperates and collaborates with organisations/institutions working on issues of common concerns (both) within Pakistan and abroad. Being an autonomous and independent organisation, the centre identifies its own research agenda and parameters remaining within the mandate and objectives identified. The main areas identified for research by SPDC are: poverty, inequality, governance, provincial finances, social sector policies, gender issues and macroeconomic policy issues. Having established its credibility, SPDC is considered as one of the outstanding research policy institutions of Pakistan focusing on public policy analyses and social sector development.



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