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ECONOMIC UPDATE

PAKISTAN

October 2006

Asian Development Bank

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(JULY 2005 - JUNE 2006)

ASIAN DEVELOPMENT BANK

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Pakistan Resident Mission
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FOREWORD

The first Pakistan Economic Update was published in April 2002 and has since then been appearing regularly. The present report provides an analysis of economic trends in Pakistan during the fiscal year 2005/06, and presents an outlook of the economy for 2006/07. The report reviews poverty related public expenditure during the three quarters of 2005/06. The report also provides a brief analysis of the federal budget 2006/07.

The Asian Development Bank (ADB) is a long-standing development partner of Pakistan, having provided a total of \$15.03 billion to the country in development assistance from 1968 to 2005. Major development sectors in which ADB has provided assistance include energy, agriculture and rural development, finance and trade, transport and communications, social sectors, and governance. Under its Country Strategy and Program for Pakistan, reduction of poverty is the central objective, which has been operationalized through promoting sustainable pro-poor growth, inclusive social development, and good governance.

In addition to this assistance portfolio, the Pakistan Resident Mission (PRM) is actively engaged in economic and sector analysis to develop a better understanding of important economic and social policy issues. To share our work with a wider audience, PRM initiated a working paper series and background papers on various subjects. Recently published papers include a working paper on “Targeting Efficiency of Poverty Reduction Programs in Pakistan”, and three background papers on “The Poverty-Health Relationship in Pakistan”, “Gender and Poverty in Pakistan”, and “The Impact of Global Cotton Markets on Rural Poverty in Pakistan”. These papers will also serve as useful inputs for a Pakistan Poverty Assessment Update that PRM is currently in the process of preparing.

We look forward to receiving comments on the report, and also suggestions for improvement of future reports in this series.

Peter L. Fedon
Country Director, Pakistan

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PAKISTAN ECONOMIC UPDATE (JULY 2005 - JUNE 2006)

The economy slowed down, but still maintained a robust growth of 6.6 percent in 2005/06, despite a devastating earthquake in October 2005 and high oil prices. However, trade and current account deficits soared and inflation remained high. Fiscal deficit also increased. Based on substantial increase in investment last year and a further increase in investment forecast for the current year, the economy is expected to maintain strong growth in 2006/07. The medium-term outlook for the economy is positive and the growth target of 7-8 percent looks feasible.

I. MACROECONOMIC DEVELOPMENTS

The economy maintained a strong growth in 2005/06, albeit lower than a year earlier. Commodity-producing sectors slowed down, with agriculture, manufacturing, and construction witnessing lower growth. The services sector, on the other hand, improved its performance. Due to continued strong growth in consumer demand, private consumption expenditure increased sharply and led economic growth on the demand side. Inflation slowed down, but was still high, mainly because of higher oil prices. The State Bank of Pakistan (SBP) continued to pursue tight monetary policy, and for the first time in last five years, monetary expansion was less than growth in nominal GDP. Unplanned spending related to the 8 October 2005 earthquake resulted in increase in the fiscal deficit. The import growth exceeded the export growth by a wide margin, leading to a sharp increase in the trade and current account deficits.

This report analyses macroeconomic developments in 2005/06, along with the outlook for 2006/07, in section I and reviews poverty related public expenditure in the first three quarters of the 2005/06 in section II. The report analyses the federal budget for 2006/07 in section III.

Domestic Sector

Growth: The economy demonstrated resilience and maintained a robust growth of 6.6 percent in 2005/06, despite a devastating earthquake in October 2005 and high oil prices. Although high, the growth in the year was the lowest in the last three years. The slower growth was mainly due to a decline in the growth of commodity-producing sectors, particularly agriculture (see table 1). The growth of the value-added in commodity-producing sectors declined to less than half of that witnessed in 2004/05, as agriculture, large-scale manufacturing, and construction, all

witnessed a slow down. In contrast, the services sector picked up further steam and recorded the highest growth in the last two decades.

The growth of the agriculture sector declined to 2.5 percent in 2005/06 from 6.7 percent a year earlier, because of lower value-added in the crop sub-sector, despite an improvement in the availability of water, agricultural credit, and the use of fertilizers. The output of two of the four major crops recorded significant declines. Unfavorable weather conditions resulted in a 12.9 percent smaller cotton output compared with its record level in 2004/05. Similarly, continued price disputes between farmers and sugar mills were responsible for lower output of sugarcane for the second consecutive year. Wheat remained more or less at the same level as in the preceding year. Among major crops, only rice recorded increase. The livestock sub-sector, which accounts for 45.9 percent of value-added in agriculture, picked up and expanded by 8.0 percent compared with 2.3 percent in the preceding year.

The growth of the large-scale manufacturing (LSM) sector declined to 9.0 percent in 2005/06 from 15.6 percent in 2004/05, due to emerging capacity constraints and the high base effect. Smaller cotton and sugarcane crops, which provide raw materials for the textile and sugar industries, also affected the LSM sector adversely.

Table 1: Sectoral Growth and Inflation

	2003/04	2004/05	2005/06
	% Growth Rates		
GDP (fc)	7.5	8.6	6.6
Commodity Producing Sectors	9.2	9.2	4.3
Of which:			
Agriculture	2.3	6.7	2.5
Industry	16.3	11.4	5.9
Of which:			
Large Scale Manufacturing	18.1	15.6	9.0
Services	5.9	8.0	8.8
GNP (mp)	6.3	7.8	6.0
Per-Capita Income	4.2	5.8	4.1
Inflation	4.6	9.3	8.0
	% Contribution to GDP Growth		
Agriculture	0.6	1.5	0.6
Industry	3.8	2.9	1.5
Of which:			
Large Scale Manufacturing	1.9	1.8	1.1
Services	3.1	4.1	4.5

Sources: (1) Pakistan Economic Survey 2005-2006

(2) Federal Bureau of Statistics (FBS) Website: www.statpak.gov.pk

Growth in the textile industry decelerated to 4.3 percent in 2005/06 from 24.7 percent in 2004/05.

Growth in the textile industry decelerated sharply to 4.3 percent in 2005/06 from 24.7 percent in 2004/05, and sugar production continued to decline for the second consecutive year (see table 2). Phosphatic fertilizers, iron and steel, caustic soda, cement, buses, and tires and tubes also witnessed significant slowdown. However, assembly of cars and jeeps continued to grow strongly, albeit at a lower rate than in the preceding two years. The continued robust growth in the assembly of cars and jeeps, despite the import of a large number of fully assembled personal vehicles last year, reflects strong domestic demand fuelled by expanded availability of lease finance and bank loans. The number of trucks assembled in the country also increased sharply by 41.0 percent, which indicates growing freight transport. The small-scale manufacturing picked up and expanded by 9.3 percent, up from the preceding year's 7.5 percent.

Construction activity has picked up in the last two years. The value-added in construction grew by 9.2 percent in 2005/06 on the back of

an 18.6 percent expansion in the preceding year. Substantial increases in the Public Sector Development Program, a quantum jump in the availability of institutional credit for house building, and foreign direct investment in the sector, all boosted construction activity. With continued expansion of construction activity, demand for cement exceeded its domestic production, resulting in a sharp increase in price. To check this price increase, since April 2006, the Government has allowed duty-free import of cement from India along with freight subsidy. Electricity and gas distribution, another important component of the industrial sector, contracted and its value-added declined to a level lower than that achieved two years earlier, when Ghazi Barotha hydel power generation project came on line.

The services sector led the growth in 2005/06, as financial services, telecoms, and wholesale and retail trade continued to expand rapidly. The value-added in finance and insurance increased by 23.0 percent. Expanding at an annual average rate of 20.6 percent in the last three years, finance and

Table 2: : Growth in Production of Selected Large Scale Manufacturing Items

Items	Weights	% Growth		
		2003/04	2004/05	2005/06
Textiles	24.5	6.5	24.7	4.3
Of which:				
Cotton Yarn	13.1	0.7	18.2	11.6
Cotton Cloth	7.5	17.4	28.9	0.6
Cotton Ginned	3.4	-1.6	45.3	-12.3
Food, Beverages, and Tobacco	14.4	13.5	-2.0	5.3
Of which:				
Sugar	4.2	9.1	-23.1	-5.0
Vegetable Ghee	4.2	15.2	3.2	9.4
Cooking Oil	1.3	32.7	15.1	13.4
Cigarettes	3.1	12.2	10.3	5.0
Petroleum Products	5.2	4.4	9.4	2.2
Pharmaceuticals	5.0	14.0	4.0	12.9
Chemicals	4.8	24.5	3.4	11.2
Automobiles	4.0	50.7	32.6	25.8
Of which:				
Jeeps and Cars	2.5	58.2	28.3	27.1
Fertilizers	3.4	65.5	25.7	5.1
Phosphatic Fertilizer	1.9	151.7	37.8	5.5
Nitrogenous Fertilizer	1.5	1.6	3.6	4.2
Metal Industries	3.5	2.4	-5.0	-13.5
Of which:				
Pig Iron	1.6	3.5	-3.6	-30.7
Coke	1.4	1.3	-1.6	-76.8
Non-metallic Mineral Products	4.2	18.5	16.8	12.7
Of which:				
Cement	4.1	18.6	16.9	13.0
Electronics	2.5	58.1	44.8	36.5
Leather Products	2.3	31.5	-5.6	5.8
Paper and Board	0.6	7.6	3.7	13.2
Engineering Goods	0.5	16.1	21.6	31.2
Overall Growth		18.2	15.6	10.7

Source: State Bank of Pakistan Website: www.sbp.org.pk

insurance has emerged as one of the most vibrant sectors. In telecoms, phenomenal expansion has been witnessed in mobile telephone services. The number of mobile telephone connections increased to 34.5 million at end-June 2006 from 12.0 million at end-June 2005. The continued double-digit

growth in exports and imports helped the wholesale and retail trade and boosted freight transport.

On the demand side, for the second consecutive year, the real GDP growth was led by private consumption expenditure, which

Gross fixed investment increased from 16.5 percent of GDP to 18.4 percent.

increased by 8.1 percent in 2005/06. This reflects continued strong growth in consumer demand financed by rising incomes, robust expansion of consumer credit, and higher remittances. A particularly sharp increase was witnessed in the demand for consumer durables, such as cars and air-conditioners and other electric appliances. Gross fixed investment in current prices increased by 30.7 percent and its share in GDP increased from 16.5 percent to 18.4 percent. Gross fixed investment at constant prices of 1999/00 increased by 10.3 percent and its share in GDP rose from 13.9 percent to 14.4 percent. At this level, it is still significantly lower than the 16.4 percent reached in 2000/01. With the deficit in the current account of the balance of payments increasing sharply, the contribution of net export of goods and non-factor services to GDP growth became negative (1.0 percent).

Inflation declined to 8.0 percent in 2005/06 from 9.3 percent in 2004/05.

National savings declined marginally from 16.5 percent of GDP in 2004/05 to 16.4 percent in 2005/06. National savings have declined continuously for the last three years, and that has led to an increase in the gap between gross domestic investment (including change in stocks) and savings. Only about four-fifths of gross domestic investment was financed through national savings in 2005/06. After a short period of high savings (from 2001/02 to 2003/04), when Pakistan experienced surpluses in the current account of the balance

of payments, the investment-saving relationship seems to be returning to the long-term pattern of large saving-investment gap witnessed in the last three decades (see box).

Prices: Inflation, based on the Consumer Price Index (CPI), declined to 8.0 percent in 2005/06 from 9.3 percent in 2004/05, as food inflation declined to almost half of its level a year earlier (see figure 1).¹ The Government's policy of liberal import of essential food items, announced in the budget for 2005/06, paid off by augmenting domestic food supplies. Inflation in the house rent, another major driver of inflation in the preceding year, also declined. As these two categories have a 63.8 percent weight in CPI, this had a significant dampening effect on inflation. However, this was in part offset by a sharp increase in the cost of fuel, lighting, lubricants and transport (FLLT) due to the higher oil price. The core inflation based on non-food non-oil (NFNO) prices, which is amenable to demand management policies, showed a downward trend in the last seven months of the year. Inflation measured by the Wholesale Price Index (WPI) was higher in 2005/06 than a year earlier, but flattened out in the last two months of the year. The higher WPI-based inflation reflects higher prices of fuel and lighting, raw materials (mainly raw cotton), and manufactures, which together have a weight of 53.1 percent in the WPI.

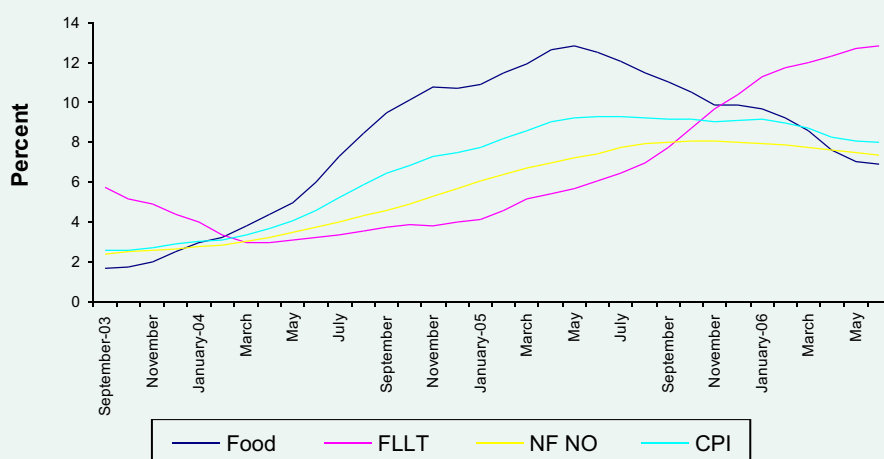
Box: Low Investment and Savings and Large Investment-Savings Gap

Historically, low investment and low savings, as well as large investment-saving gap, have characterized the Pakistan economy. During the three decades ending in 1999/00, gross domestic investment, including accumulation of stocks, averaged at 18.0 percent of GDP and savings almost five percentage points lower, with the gap financed by external resources. Developing countries normally experience investment-saving gap, but for most developing countries the gap is not as large as in Pakistan. The period from 2001/02 to 2003/04 was rather exceptional in the country's economic history with respect to savings, as net factor income from abroad, which is the same thing as savings of Pakistani nationals out of their earnings abroad, increased sharply, primarily because of a spike in remittances. The result was a quantum jump in national savings, which exceeded gross domestic investment by 1.3-3.9 percentage points in those three years.

Remittances stabilized around \$4.0 billion after 2002/03, and the share of net factor income from abroad in GDP declined. Domestic savings also declined continuously after 2002/03, partly due to the Government's policy of pursuing demand-driven growth. With both components of national savings declining, national savings dropped sharply to 16.4 percent of GDP in 2005/06 from their peak level of 20.8 percent in 2002/03. If the declining trend in savings continues, the country will be back to the historical pattern of saving and investment, resulting in an increase in external debt.

¹ The price data for the first two months of 2006/07 shows that the annualized CPI-based inflation in August 2006 was 7.8 percent.

Figure 1: Annual Inflation



Monetary Management: In view of high inflation, SBP had started tightening monetary policy in 2004/05, by raising the 6-month treasury bill (TB) rate from 3.0 percent in June 2004 to 8.0 percent in June 2005 and the discount rate from 7.5 percent to 9.0 percent in April 2005. SBP continued to pursue a tight monetary policy in 2005/06, but instead of further raising the discount rate and pushing up the 6-month TB rate, it focused on

draining excess liquidity from the inter-bank market through open market operations, pushing up the inter-bank overnight rate from 3.7 percent to 7.9 percent.

The tighter liquidity conditions slowed down the expansion of private sector credit from 34.4 percent in 2004/05 to 23.5 percent in 2005/06 (see table 3). The deceleration of growth in private sector credit was particularly

Table 3: Monetary Growth (Billion Rs.)

	Monetary Impact During	
	2004/05	2005/06
Monetary Assets	479.8	446.1
% Growth in Monetary Assets	19.3	15.0
Net Foreign Assets of the Banking System	53.7	50.1
Net Domestic Assets of the Banking System	426.0	396.0
Net Borrowing by Government Sector	95.8	90.8
Of which:		
Budgetary Support	71.8	70.9
1. Central Bank	155.6	135.1
2. Scheduled Banks	-83.8	-64.1
Commodity Operations	22.0	19.9
Net Borrowing by Non Government Sector	418.7	408.4
Of which:		
Borrowing by the Private Sector	437.8	401.8
Other Items (Net)	-88.4	-103.1

Source: State Bank of Pakistan Website: www.sbp.org.pk

For the first time in the last five years, monetary growth was less than growth in nominal GDP.

sharp in the second half of the year, when it dropped to only 5.2 percent from 9.2 percent a year earlier. Adjusted for WPI-based inflation, the real growth in private sector credit in the second half of the year was a negative 4.1 percent. The Government's borrowing for financing the fiscal deficit was slightly lower than in the preceding year, despite a larger deficit, as four-fifths of the fiscal deficit was financed through external resources, privatization proceeds, and non-bank borrowing. For the first time in the last five years, the overall monetary expansion, at 15.0 percent, was less than growth in nominal GDP.

Fiscal Policy: The Government continued to pursue an expansionary fiscal policy in 2005/06, when total public expenditure increased by 25.5 percent (see table 4). Particularly sharp increases were recorded in expenditure on poverty reduction (see section on "Poverty Reduction") and infrastructure improvement. Unplanned spending related to the 8 October earthquake also contributed to the increase in expenditure. At the same time, revenues recorded a robust growth of 19.6 percent. Since this was still lower than the growth of expenditure, the overall fiscal deficit increased to 4.2 percent of

Table 4: Consolidated Federal and Provincial Fiscal Position

	2004/05	2005/06	% Change
	(Billion Rs)		
Total Revenue	900.1	1,076.6	19.6
Federal Revenue	843.1	992.1	-15.1
Tax Revenue	598.0	716.2	
CBR Taxes	588.4	702.9	19.5
Non-CBR Taxes	9.6	13.3	
Of which:			
Surcharges	26.8	50.8	89.4
Non-tax Revenue	218.3	225.2	3.2
Provincial Revenue	57.0	84.5	48.2
Total Expenditure	1,117.1	1,401.8	25.5
Booked Expenditure	1,195.6	1,488.1	24.5
Current Expenditure	943.1	1,121.0	18.9
Federal Current Expenditure	688.6	788.3	14.5
Of which:			
Interest	210.2	237.1	12.8
Domestic	170.5	195.0	14.4
Foreign	39.7	42.1	6.1
Defense	211.7	242.0	14.3
Provincial Current Expenditure	254.5	332.7	30.7
Development Expenditure and			
Net Lending	252.5	367.1	45.4
Development Expenditure	227.7	365.0	60.3
Federal	135.3	224.0	65.6
Provincial	92.5	141.0	52.5
Net Lending	24.8	2.1	
(Pro-poor Expenditure (1))	192.5	258.5	34.3
Unidentified Expenditure	-78.5	-86.3	9.9
Budget deficit	-217.0	-325.2	49.9
As % of GDP	3.3	4.2	

(1) For the first three quarters of 2004/05 and 2005/06.

Source: Ministry of Finance Website: www.finance.gov.pk

GDP, against a target of 3.8 percent. Excluding the earthquake related expenditure, the fiscal deficit was 3.4 percent of GDP.

Development expenditure increased by 60.3 percent in 2005/06. The Government has used the fiscal space created through fiscal consolidation to increase development expenditure in the last three years, by a very substantial 42.2 percent per annum. As a percentage of GDP, development expenditure increased from 2.7 in 2002/03 to 4.8 in 2005/06.

Despite increase of the fiscal deficit in the last two years, total public debt, as a percentage of GDP, continued to decline. This was because: (1) the increasing use of privatization proceeds for financing the deficit contained the growth in debt; and (2) the GDP growth during the period was quite robust. However, the increasing role of non-sustainable receipts, such as privatization proceeds, receipts from the US for logistic support for the war in Afghanistan, and external grants (together amounting to 2.7 percent of GDP in 2005/06) in the budget raises issues of sustainability.

External Sector

Merchandise Trade: Boosted by strong domestic demand, imports continued to grow

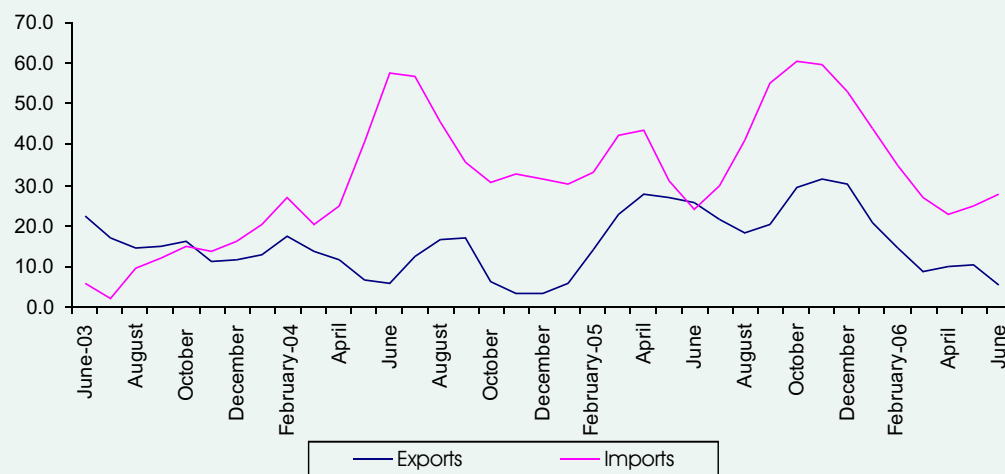
at a rapid rate (38.8 percent) for the fourth consecutive year in 2005/06. Exports also continued to increase at a double-digit rate, but their growth at 14.4 percent was much lower than that of imports.² Total exports fell short of the official target for the year, while imports exceeded the target by a wide margin. The growth of both exports and imports decelerated in the second half of the year (see figure 2).

Textiles and clothing (T&C) led the growth of exports in 2005/06 (see table 5). Increasing by 16.8 percent, T&C exports accounted for 68.4 percent of the growth in total exports. Particularly sharp increases were witnessed in the export of bedwear (38.3 percent), cotton yarn (34.8 percent), and readymade garments (21.3 percent). An increase in the unit value, possibly due to a shift to higher value clothes, explains the bulk of the increase in the export of readymade garments, while the growth of yarn exports was entirely due to increase in the volume. In the case of bedwear exports, increases in the price and volume more or less equally contributed to the growth. On the other hand, the export of art silk and synthetic textiles and made up articles declined during the year. The share of items at the lower end of value-added (cotton yarn and cloth) in total T&C exports increased to 36.1 percent from 34.6 percent in 2004/05. The growth of all major T&C exports, except

Development expenditure increased by 60.3 percent in 2005/06.

Textile and clothing led the growth of exports.

Figure 2: Quarterly Growth of Exports and Imports (% Change Over Corresponding Quarter of Previous Year)



² Imports grew by 17.9 percent and exports by 6.9 percent in the first two months of 2006/2007.

Table 5: Growth in Exports (Million US\$)

Commodities	2004/05	2005/06	% Change
Primary Commodities	1,340	1,559	16.3
Rice	933	1,112	19.3
a) Basmati	439	507	15.5
b) Others	493	605	22.7
Raw cotton	110	67	-38.7
Fruits	91	117	28.4
Textile Manufactures	8,445	9,867	16.8
Cotton yarn	1,057	1,424	34.8
Cotton cloth	1,863	2,139	14.8
Knitwear	1,635	1,731	5.8
Bed wear	1,450	2,005	38.4
Towels	521	600	15.2
Readymade garments	1,088	1,320	21.3
Art silk & synthetic textile	300	200	-33.4
Madeup articles	466	410	-11.9
Other Manufactures	2,999	3,413	13.8
Carpets,rugs & mats	278	251	-9.5
Petroleum products	462	771	66.8
Sports goods	307	348	13.4
Leather tanned	304	281	-7.4
Leather manufactures	527	697	32.3
a) Leather garments	329	489	48.6
b) Leather gloves	164	144	-12.2
Surgical goods & medical instruments	183	160	-12.5
Chemicals & Pharma. Products	453	438	-3.3
Engineering goods	182	209	14.6
Non-classified items	1,607	1,630	1.5
Total	14,391	16,469	14.4

Source: Federal Bureau of Statistics Website: www.statpak.gov.pk

knitwear, declined sharply in the second half of 2005/06.

Among non-textile manufactures, export of petroleum products increased sharply by 66.8 percent in 2005/06 on the back of 54.9 percent growth a year earlier. In addition to a sharp increase in the price, the increase in quantity also contributed significantly to the growth of export of petroleum products. The export of leather garments and footballs recorded substantial increases, as did non-classified machinery. In the primary exports category, rice exports maintained a robust growth, albeit much lower than witnessed in

the preceding year, and crossed the \$1 billion mark. This has been made possible through diversification of the market for rice exports during the last two years. Carpets, leather gloves, and surgical instruments among manufactures, and raw cotton among primary exports, declined during the year.

Petroleum and petroleum products led Pakistan's import growth and accounted for one third of the total increase in the import bill in 2005/06 (see table 6). Import of petroleum and petroleum products increased by 66.6 percent to \$6.7 billion mainly due to a 58.6 percent increase in the unit value of crude oil

Petroleum accounted for one third of the total increase in the import bill.

Table 6: Growth in Imports (Million US\$)

Commodities	2004/05	2005/06	% Change
Food Group	1,409	1,932	37.1
Of which:			
Wheat Unmilled	93	133	42.8
Tea	223	220	-1.1
Edible Oil	758	721	-4.8
Sugar	88	524	496.2
Pulses	123	168	36.7
Machinery Group	4,494	5,845	30.1
Power Generating Machinery	393	483	22.9
Office Machines	274	284	3.8
Textile Machinery	929	772	-16.9
Construction & Mining Machinery	141	186	32.3
Air crafts, Ships & boats	169	435	157.3
Agriculture Machinery	74	135	82.7
Other Machinery	2,516	3,551	41.2
Petroleum Group	4,000	6,663	66.6
Petroleum Products	1,851	2,869	55.0
Petroleum crude	2,149	3,794	76.6
Consumer Durables	1,424	2,105	47.8
Electrical Machinery & appliances	356	491	38.2
Roadmotor Vehicles	1,069	1,613	50.9
Raw Materials	2,739	3,923	43.2
Synthetic Fiber	147	255	73.7
Synthetic & artificial Silk Yarn	130	236	81.3
Fertilizers	417	643	54.1
Insecticides	140	115	-18.0
Plastic Materials	793	996	25.6
Iron and Steel	1,112	1,679	50.9
Others	6,533	8,113	24.2
Total	20,598	28,581	38.8
Non Food Non Oil Imports	15,190	19,986	31.6

Source: FBS Website: www.statpak.gov.pk

and 46.4 percent increase in that of petroleum products. These increases in prices were much sharper than the actual increase in the international oil price (about 35 percent) during the year. This is because the country buys crude oil and petroleum products from countries in the Middle East under contracts and effects of changes in the international oil price, therefore, show up with a time lag, but more sharply. For example in 2004/05, the unit

value of the crude oil import to Pakistan increased by only 6.8 percent and that of petroleum products by 11.1 percent in the face of a 35-40 percent increase in the international price of crude oil.

Non-oil imports also recorded substantial increases. Significant increases were seen in imports of machinery, raw materials, and consumer durables, reflecting continued

The current account deficit increased more than three times to \$5.7 billion in 2005/06.

strong domestic demand. Food imports, too, increased sharply, as the Government liberalized the import of sugar, wheat, and pulses to meet domestic shortages of these items.

Balance of Payments: The balance of payments position deteriorated in 2005/06, with the current account deficit, excluding official transfers, increasing more than three times to \$5.7 billion (see table 7). As a percentage of GDP, it rose from 1.6 to 4.4, the highest level in the last nine years. With imports increasing more than twice as fast as

exports, the trade deficit swelled by 87.0 percent to \$8.4 billion. This was augmented by a sharp increase in the deficit on the services account, because of large increases in payments for shipping and other business services associated with higher imports. The deficit on the income account also increased. The deficits in the trade, services, and income accounts were partly offset by higher surplus in current transfers, with remittances rising to a historic high level of \$4.6 billion.

The deterioration in the current account in 2005/06 was more than offset by a sharp

Table 7: Balance of Payments (Million US\$)

	2004/05	2005/06	% Change
Trade Balance	-4,514	-8,442	87.0
Exports	14,482	16,506	14.0
Imports	18,996	24,948	31.3
Services (net)	-3,293	-4,402	33.7
Income (net)	-2,386	-2,676	12.2
Of which:			
Interest	1,037	1,233	18.9
Current Transfers (net)	8,659	10,516	21.4
Of which:			
Workers Remittances	4,168	4,600	10.4
FCA Residents	521	312	-40.1
Current Account	-1,534	-5,004	226.2
Current Account (Excl. Official Transfers)	-1,784	-5,683	218.6
Capital Account (net)	685	191	-72.1
Of which:			
Debt Forgiveness	495	0	
Financial Account (net)	446	5,897	
Of which:			
Foreign Direct investment	1,525	3,521	130.9
Portfolio Investment (Liabilities)	609	964	58.3
Equities	151	351	132.5
Debt Securities	458	613	33.8
Disbursement of Foreign Assistance	2,163	2,230	3.1
Amortization	1,558	1,446	-7.2
Errors & Omissions	-7	244	
Overall Balance	-410	1,328	
Official Reserves	9,805	10,760	9.7

Source: State Bank of Pakistan Website: www.sbp.org.pk

improvement in the financial account, which recorded a large surplus of \$5.9 billion compared with only \$446 million in 2004/05. This was made possible as a result of a jump in foreign direct investment (FDI), which more than doubled to \$3.5 billion, including \$1.5 billion in the form of privatization proceeds. Even after excluding privatization proceeds, FDI was up by 70.5 percent. A well received \$800 million Eurobond issue by the Government also helped improve the financial account, as did draw down of reserves by commercial banks in contrast to a substantial build up a year earlier. The capital account, however, deteriorated with no debt forgiveness during the year compared with the \$495 million debt forgiveness by the United States in 2004/05. Nevertheless, the sharp improvement in the financial account resulted in an overall surplus of \$1.3 billion in the balance of payments.

The substantial overall surplus in the balance of payments raised foreign exchange reserves held by SBP to \$10.8 billion at end-June 2006, which are sufficient to finance 4.5 months of imports. Partly due to a comfortable reserve position and partly due to SBP interventions in the market, the nominal exchange rate stayed in a narrow range throughout the fiscal year, closing at 60.18/US\$ at end-June 2006.

External debt increased further to \$35.7 billion from \$34.0 billion at the end of 2004/05 because of the increase in multilateral debt and private non-guaranteed debt, as well as the Euro Bond issued in January 2006. However, as a percentage of GDP, external debt continued to decline for the fifth consecutive year and stood at 27.7, sharply down from 49.5 in 2000/01.

The higher current account deficit in the balance of payments was easily financed in 2005/06, with more than two-thirds financed through non-debt creating inflows such as FDI and investment in equities. However, the current account deficit would have been larger without non-recurring receipts of \$1.1 billion from the US for logistic support for the war in Afghanistan. Also, inflows from privatization and foreign investment in equities played a

significant role in financing the current account deficit. This heavy reliance on these non-recurring and volatile inflows raises the issue of sustainability and points to the need to strengthen the underlying fundamentals of the balance of payments.

Economic Outlook

The outlook for 2006/07 presented below is based on the assumption that the economic policies pursued in the last six years will be further strengthened, and that macroeconomic fundamentals will improve after coming under strain in the last two years. The outlook also presupposes that SBP will continue to pursue a tight monetary policy to reduce inflation. On the external front, it is assumed that the global economy will maintain healthy growth and that oil prices will stabilize.

The real GDP growth in 2006/07 is projected at 7.0 percent (see table 8). The main commodity producing sectors are expected to pick up and the services sector is likely to maintain its robust growth. The projected high growth is underpinned by a substantial increase in investment last year and a further increase in investment forecast for the current year. Expected stabilization of oil prices in the year will also help growth. Substantial public sector investment in irrigation in the last several years and a sharp increase in import of agricultural machinery last year is expected to boost agriculture output, as will the duty free import of tractors, enhanced subsidy on fertilizers, and the new package of incentives for the livestock sub-sector, all announced in the 2006/07 budget. Heavier than normal rains in the monsoon season are expected to help the water-intensive rice and sugarcane crops. Greater moisture in the soil will also improve the prospects of the wheat crop. However, the cotton crop could be adversely affected by greater moisture, which makes the crop more vulnerable to pest attacks. On balance, the agriculture sector is projected to grow by 4.5 percent in 2006/07.

The industry sector is expected to expand by 9.0 percent. The large-scale manufacturing, which accounts for almost half of the value-added in the industry sector, is expected to

Foreign direct investment more than doubled to \$3.5 billion.

The GDP growth in 2006/07 is projected at 7.0 percent.

Table 8: Outlook

Item	2004/05	2005/06	2006/07
	Growth (%)		
GDP Growth	8.6	6.6	7.0
Agriculture	6.7	2.5	4.5
Industry	11.4	5.9	9.0
Of which: Large-scale Manufacturing	15.6	9.0	11.0
Services	8.0	8.8	7.1
Inflation (CPI)	9.3	8.0	6.5
Merchandise Exports	16.2	14.0	13.0
Merchandise Imports	38.3	31.3	15.0
	(In percent of GDP)		
Budgetary Deficit	-3.3	-4.2	-5.0
Trade Balance	-4.1	-6.6	-7.0
Current Account	-1.6	-4.4	-5.9

Source: Annual Plan 2006/07 and Staff Estimates

grow by 11.0 percent, supported by new investments in textiles, cement and fertilizer industries, and a number of incentives provided in the 2006/07 budget. The projected higher sugarcane crop will boost the sugar industry. The two other important sub-sectors included in the industry sector, construction and electricity and gas, are also projected to show robust growth. The significantly enlarged size of the public sector development program, reconstruction of areas affected by last year's earthquake, and greater supply of cement due to its duty-free import from India permitted since April 2006, will all boost construction in 2006/07. Hydel generation of electricity, which has a relatively larger value-added component than thermal electricity, will get a boost from greater availability of water in the two main water reservoirs. Finally, substantial foreign investment in the past few years will boost the oil and gas sector.

In the services sector, the large foreign investment in telecoms in recent years, along with the privatization of the Pakistan Telecommunication Company Limited, will

help the sector sustain robust growth in 2006/07. Strengthened by reforms and privatization, the financial sector is expected to maintain strong growth. Ongoing mergers and consolidation of banks will further strengthen the financial sector. The services sector, as a whole is projected to grow by over 7 percent in 2006/07, which, while less than last year, is more likely to be sustainable in the medium and long run.

Inflation is expected to decline in 2006/07, as monetary policy is further tightened,³ the supply of food is augmented by the projected high growth in agriculture, and the oil price stabilizes. The lower monetary growth in 2005/06 relative to the growth of nominal GDP will also have a lagged dampening effect on inflation. Inflation in 2006/07 is expected to decline to 6.5 percent.

With the projected high GDP growth, extension of the tax net to real estate transactions, and increase in tax rates on some financial services, tax receipts are expected to maintain a robust double-digit growth in

Inflation in 2006/07 is expected to decline to 6.5 percent.

³ The Monetary Policy Statement (MPS) for July-December 2006, released by SBP in July 2006, stated that the balance of risks had "tilted towards managing domestic and external imbalances effectively and curbing inflation". MPS raised discount rate by 50 basis points to 9.5 percent, reserve requirement ratio by 200 basis points to 7.0 percent, and statutory liquidity ratio by 300 basis points to 18.0 percent.

2006/07. Non-tax receipts are expected to exceed the budget estimate, as the estimate of receipts from the USA for logistic support for the war in Afghanistan appears conservative. Current expenditure is also expected to exceed the budget estimate, mainly because of expected overrun in the interest payment on domestic debt. The budgeted decline in interest payments on domestic debt (see section on “Federal Budget”), is not likely to be achieved, considering the increased domestic debt stock at the beginning of the year, the higher planned borrowing from the banking system for financing the budget, and the expected further increase in interest rates. On balance, the fiscal deficit is likely to increase to 5.0 percent of GDP in 2006/07.

Import growth is likely to decelerate in 2006/07, because of expected stabilization of oil prices and lower demand for consumer durables because of higher interest rates. However, the projected high economic growth and substantial increase forecast in investment will sustain high growth of imports, which is expected to remain at about 15.0 percent. The continued robust growth in global trade, the China-specific safeguards imposed by the USA and European Union (EU) on import of textiles and clothing, and the lower anti-dumping duty on bed linen imports from Pakistan by EU will all boost exports, which are likely to increase by 13.0 percent in 2006/07. The current account deficit is projected to increase to \$8.5 billion, or 5.9 percent of GDP.

With pro-growth government policies, continuous increase in the public sector development program, and the projected increase in total investment, the medium-term outlook for the economy is positive and the growth target of 7-8 percent looks feasible. Substantial investment in the T&C industry over the past several years will strengthen growth in manufacturing. Increasing trade with countries in the region, including the People's Republic of China (PRC) will also help the economy. The boom in banking and telecoms is likely to continue, as policy environment for both these sectors is favorable. Foreign investments in the oil and gas sector in recent years will also start paying off. Finally, significantly strengthened through reforms and privatization, the banking system is well positioned to support economic growth by channeling savings to productive uses.

The growing current account deficit, continuing high inflation, and the emerging power shortage are potential risks to the country's medium-term economic prospects. Any deterioration in the law and order situation could also adversely affect medium-term growth. The end of China specific safeguards imposed by the USA and EU against T&C imports in 2008 may further weaken Pakistan's textile export prospects. A possible further increase in the oil price, in case of sanctions against Iran for example, could also hurt Pakistan's economic prospects.

The fiscal deficit is likely to increase further in 2006/07.

II. POVERTY REDUCTION

Poverty Reducing Public Expenditure: Over the last three years, the Government has consistently increased pro-poor public expenditure under its poverty reduction strategy spelled out in the Poverty Reduction Strategy Paper (PRSP) issued in December 2003. PRSP has identified 17 sectors, expenditure on which is assumed to have the greatest positive impact on poverty.⁴ Public expenditure on these sectors increased from 3.8 percent of GDP in 2001/02 to 4.8 percent in 2004/05.

PRSP expenditure continued to increase rapidly in the first three quarters of 2005/06, when it increased by 34.3 percent over the same period of 2004/05 (see table 9). As a percentage of GDP, PRSP expenditure increased from 2.9 to 3.4 in the first three quarters of 2005/06. The share of poverty related expenditure in total public expenditure also increased from 25.1 percent to 27.6 percent during this period.

Pro-poor expenditure has been grouped under the following heads: improving access of the poor to market and community services; fostering human development; accelerating development of rural areas; improving governance; and providing safety nets. Expenditures under all these heads recorded significant increases in the first three quarters of 2005/06, with the sharpest increase being in expenditure on social safety nets, which more than doubled. Expenditure on development of rural areas also witnessed a strong increase. Of all categories of pro-poor expenditure, governance witnessed the lowest, but still robust double-digit increase.

Of the 17 sectors identified for pro-poor expenditure, education, health, population planning, social security and social welfare, water supply and sanitation (WSS), and rural development, including village electrification,

may be considered core areas. Almost three-fifths of the total poverty related expenditure is incurred in these sectors. The total expenditure in these core areas, at Rs. 143 billion, represented an increase of 25.7 percent compared with the first three quarters of 2004/05, which was lower than the overall increase in PRSP expenditure.

Expenditure on education, which accounts for 37.4 percent of the total pro-poor expenditure, increased by 30.1 percent to Rs. 96.8 billion in the first three quarters of 2005/06. As a percentage of GDP, it increased from 1.1 to 1.3. More than one-third (37.2 percent) of the increase in expenditure on education was due to sharp increases in development expenditure on secondary and higher education (college and university education). Development expenditure on general college and university education increased sharply to Rs. 8.9 billion from Rs. 558 million in the corresponding period of the preceding year, reflecting the high priority given to higher education by the Government.

Expenditure on health increased by 19.2 percent to Rs. 23 billion. Expenditure on hospitals and preventive health measures, which together account for the bulk (87.3 percent) of the expenditure on health, recorded increases of 17.4 percent and 22.4 percent, respectively. Mother and child health expenditure more than tripled to Rs. 155 million. The shift in emphasis from curative to preventive health care facilities is a positive development. Both current and development expenditure on rural water supply and sanitation, which play a significant role in improving the health of the population, also recorded a sharp increase in the first three quarters of 2005/06.

Among other categories of pro-poor budgetary expenditure, unplanned relief and rehabilitation operations in areas affected by the 8 October 2005 earthquake resulted in a

Pro-poor public expenditure continued to increase rapidly in the first three quarters of 2005/06.

Expenditure on education increased by 30.1 percent.

⁴ These sectors are: education, health, population planning, water supply and sanitation, social security, food subsidies, food support program, Tawana Pakistan, natural calamities, roads, irrigation, land reclamation, rural development, village electrification, low-cost housing, justice administration, and law and order.

Table 9: PRSP Expenditure (Billion Rs.)

	July-March		
	2004/05	2005/06	% Change
Access to Market and Community Services			
Roads	16.6	20.6	24.1
Water Supply & Sanitation	3.4	5.3	55.9
Sub-Total	20.0	25.9	29.5
Human Development			
Education	74.4	96.8	30.1
Health	19.3	23.0	19.2
Population Planning	2.5	5.0	100.0
Sub-Total	96.2	124.8	29.7
Development of Rural Areas			
Irrigation	21.3	36.1	69.5
Land Reclamation	1.7	1.7	
Rural Development	9.2	10.0	8.7
Village Electrification	2.1	1.0	-52.4
Sub-Total	34.3	48.8	42.3
Social Safety Nets			
Social Security & Welfare	3.2	2.3	-28.1
Natural Calamities/Disasters	0.4	12.1	
Food Subsidies	1.2	1.3	8.3
Food Support Program	2.7	2.1	-22.2
Low Cost Housing	0.2	0.2	
Tawana Pakistan	0.0	0.0	
Sub-Total	7.7	18.0	133.8
Governance			
Courts and Justice	2.1	2.3	9.5
Law and Order	32.2	38.7	20.2
Sub-Total	34.3	41.0	19.5
Grand Total	192.5	258.5	34.3
GDP (Current MP)	6,581.1	7,713.1	
Total PRSP expenditure as % of GDP	2.9	3.4	
Total PRSP expenditure as % of total public expenditure	25.1	27.6	

Source: PRSP Quarterly Progress Reports. PRSP Secretariat, Finance Division, GOP

sharp increase in expenditure on natural calamities (included in safety nets) to Rs. 12.1 billion in the first three quarters of 2005/06 from Rs. 408 million in the same period of 2004/05. Expenditure on irrigation and roads and highways continued to increase at a rapid pace. However, expenditure on rural

electrification declined to less than half of the amount spent in the corresponding period of 2004/05.

In addition to pro-poor budgetary expenditure, the Government provides safety nets for the poor through transfers from the

Zakat Fund (an Islamic welfare fund) and Employees Old Age Benefits Institution (EOBI), as well as microcredit disbursed by the Pakistan Poverty Alleviation Fund (PPAF), Khushali Bank (KB), and Zarai Taraqqiati Bank Limited (ZTBL). Disbursement of microcredit, which had more than doubled in the preceding two years, slowed down significantly, increasing by only 4.7 percent in the first three quarters of 2005/06. Microcredit

disbursed through partner organizations of PPAF, which accounts for 70.1 percent of total microcredit, declined by 6.6 percent. Disbursement by KB, however, increased by 31.5 percent. The number of female recipients of microcredit increased by 35.1 percent, while that of male recipients declined by 9.6 percent. Female recipients, at 50,244, constituted 38.4 percent of the total beneficiaries of the various microcredit programs.

III. FEDERAL BUDGET 2006/07

The federal budget 2006/07 reflects the continuation of an expansionary fiscal policy for the third consecutive year, envisaging a continuing substantial increase in development expenditure. The budget also contains a number of populous measures, such as higher subsidies on food, fertilizers, fuel, and electricity, and relief for individual income taxpayers, salaried persons, pensioners, and senior citizens. A number of fiscal incentives have been provided for agriculture, livestock, and a number of export industries to encourage production and exports. Some services, not taxed previously, have been brought in the tax net and tax rates on some services have been increased.

Fiscal Outcome 2005/06

Expenditure: The total expenditure of the Federal Government in 2005/06 was 11.3 percent higher than the budget estimate for the year and 22.8 percent higher than the revised estimate for 2004/05 (see table 10).⁵ As a percentage of GDP also, expenditure increased from 13.3 in 2004/05 to 13.9 in 2005/06. Both the current and development expenditures overshot the budget estimates for the year and also showed substantial increases over the revised estimates for the preceding year. Development expenditure increased sharply (47.8 percent) for the third consecutive year.

The overrun in the current expenditure was mainly due to grants-in-aid to the provinces

The federal budget 2006/07 reflects the continuation of an expansionary fiscal policy.

Table 10: Federal Expenditure (Billion Rs.)

	2004/05		2005/06		2006/07	
	Revised Estimates	Budget Estimates	Revised Estimates	Budget Estimates	Revised Estimates	Budget Estimates
Total Expenditure	874.8	965.2	1,073.9	1,143.5	1,073.9	1,143.5
Current Expenditure	730.4	761.2	855.2	823.5	855.2	823.5
Of which:						
Interest Payments	220.5	236.0	241.2	239.5	241.2	239.5
Domestic	180.1	190.2	200.6	190.8	200.6	190.8
Foreign	40.4	45.8	40.6	48.7	40.6	48.7
Defense	216.3	223.5	241.1	250.2	241.1	250.2
General Administration	50.5	67.4	50.5	75.1	50.5	75.1
Subsides	51.4	72.3	64.3	88.9	64.3	88.9
Grants to Provincial Governments	35.3	41.3	63.5	29.3	63.5	29.3
Grants to Others	83.3	38.4	107.7	44.8	107.7	44.8
Development Expenditure	148.0	204.0	218.7	320.0	218.7	320.0
Net Lending	-3.6	0.0	0.0	0.0	0.0	0.0

Source: Budget Documents 2005/06 and 2006/07.

⁵ Revised estimates represent fiscal data for the first three quarters of the year extrapolated for the whole year.

Tax receipts in 2005/06 were higher than the budget target for the year.

and autonomous bodies, which exceeded the budget estimates by 53.8 percent and 180.5 percent respectively. The grants-in-aid were also significantly higher than revised estimates for 2004/05. In addition, subsidies recorded a substantial increase of 25.1 percent over revised estimates for the preceding year, mainly because higher subsidies on food and those given to Karachi Electric Supply Company and WAPDA.⁶ The Interest payment on domestic debt was also higher, reflecting higher interest rates, whereas interest payment on foreign debt remained more or less the same as in the preceding year. Defense expenditure increased over the preceding year, but as a

percentage of GDP, it declined further to 3.1 from 3.3, because of continued strong GDP growth.

Revenue: The Federal Government's gross revenue receipts⁷ in 2005/06 exceeded the budget estimate for the year by a wide margin, mainly because of a large overrun in non-tax revenues (see table 11). Tax receipts were also higher than the budget estimate. Compared with the revised estimate for 2004/05, gross revenue receipts posted a robust growth of 16.8 percent, with tax revenues increasing by 21.1 percent and non-tax revenues by 6.3 percent.

Table 11: Federal Revenues (Billion Rs.)

	2004/05	2005/06		2006/07
	Revised Estimates	Budget Estimates	Revised Estimates	Budget Estimates
Gross Revenue Receipts	875.3	927.4	1,022.7	1,082.8
Tax Revenue (Gross)	626.3	732.6	758.2	859.0
CBR Tax Revenue	590.0	690.0	704.0	828.5
Direct Taxes	182.7	215.4	225.0	261.7
Sales Tax	239.0	294.0	286.5	341.6
Customs Duties	113.9	121.2	136.0	157.1
Excise Duties	54.4	59.4	56.5	68.1
Federal Taxes other than CBR	36.3	42.6	54.2	30.5
Of which:				
Surcharges	26.8	32.5	42.4	18.1
Petroleum	10.6	15.9	20.2	-
Gas	16.2	16.6	22.2	18.1
Non Tax Revenue	249.0	194.8	264.6	223.8
Of which:				
Interest Receipts (Provinces)	24.6	22.6	21.6	22.7
Interest Receipts (Others)	33.8	28.5	23.6	31.6
Dividend	56.8	53.0	63.8	54.8
Defense Services	52.5	12.1	74.8	15.2
Less Transfers to Provinces	245.3	284.3	301.3	378.3
Net Revenue Receipts	630.0	643.1	721.4	704.5

Source: Budget Documents 2004/05 and 2006/07

⁶ The two power companies (WAPDA and KESC) account for 68.6 percent and the oil refineries and oil marketing companies for another 12.8 percent of federal subsidies.

⁷ Before excluding revenue transfers to provinces under the National Finance Commission Award.

CBR tax receipts, which constitute the bulk of government revenues, increased by 19.3 percent to Rs. 704 billion, compared with the revised estimate for 2004/05.⁸ Receipts from direct taxes recorded the highest growth of 23.2 percent and their share in total CBR revenues increased from 31.0 percent to 32.0 percent. The universal self-assessment system introduced in 2004/05 appears to be taking root, as indicated by almost doubling of receipts with tax returns (filed on self-assessment basis) during the first half of the year. The general sales tax (GST) also showed a robust growth of 19.9 percent, but fell short of the budget target for the year. The increase in customs was 19.4 percent, more are less in line with the increase in dutiable imports. Among non-CBR taxes, petroleum development surcharge increased sharply, as the Government increased domestic prices of various petroleum products in September and October 2005 and again in May 2006 in line with increases in international oil prices but did not lower domestic prices when international prices declined in the second and third quarters of the year.

Non-tax revenues in 2005/06 were 35.8 percent higher than the budget estimate for the year, mainly because of receipts from defense services, the bulk of which consists of receipts from the USA for logistic support for the war in Afghanistan. As in the past, the Government had underestimated receipts from this source, with actual receipts being more than six times the budget estimate. There was also an overrun in dividends received from public sector enterprises (PSEs), particularly from those in the oil and gas sector. For instance, dividend receipts from the Oil and Gas Development Corporation overshot the budget estimate by 87.2 percent, as its profits increased because of higher oil prices. Compared with the revised estimate for 2004/05 also, non-tax receipts showed an increase, particularly in receipts from defense services, royalty on oil and gas, and profits from SBP. The profits of the Pakistan Telecommunication Authority and

interest receipts from provinces and autonomous bodies declined. For the last four years, the Federal Government's interest receipts from provinces have been declining continuously, as provinces have substituted low-cost foreign loans for high-cost loans from the Federal Government.

Budget 2006/07

Expenditure: The total expenditure of the Federal Government in 2006/07 is budgeted to increase by only 6.5 percent over the revised estimates for 2005/06, with current expenditure declining by 3.7 percent and development expenditure increasing by 46.3 percent.

The decline in current expenditure is mainly due to a sharp decline envisaged in grants to both provinces and autonomous bodies. Interest payments, one of the two largest heads of current expenditure, are also budgeted to decrease marginally because of lower interest payments on domestic debt. The interest payment on foreign debt, which accounts for only 16.8 percent of total interest payments, is however, to increase by 20.0 percent. Expenditure on defence is budgeted to increase only nominally, and with inflation forecast at 6.5 percent, it is projected to decline in real terms. Also, as a percentage of GDP, defence expenditure is projected to decline to 2.8 from 3.1 in 2005/06. Subsidies are projected to increase sharply by 38.3 percent, mainly because of significantly higher provisions for electricity, fertilizers, and sugar imports (see table 12).

Development expenditure by the Federal Government is budgeted to increase significantly for the fourth consecutive year in 2006/07 (see table 13). Even after excluding the allocation for reconstruction in areas affected by the 8 October 2005 earthquake (Rs. 50 billion), the budgeted size of the federal public sector development program is 32.3 percent larger than 2005/06. As per the

Provinces have substituted low-cost foreign loans for high-cost loans from the Federal Government.

The Federal Government's development expenditure is projected to increase by 46.3 percent in 2006/07.

⁸ Data used in this report is taken from the budget documents. According to the data released by CBR, tax receipts increased by 20.7 percent to Rs 712 billion in 2005/06.

Table 12: Subsidies (Billion Rs.)

Classification	2004/05		2005/06	2006/07
	Revised Estimates	Budget Estimates	Revised Estimates	Budget Estimates
Power Subsidies	29.5	52.1	44.2	55.9
WAPDA	22.0	24.0	25.2	20.9
Of which:				
WAPDA on Account of GST	0.0	16.2	17.1	17.9
WAPDA on Account of Tubewells in Balochistan	2.5	2.6	2.9	3.0
WAPDA Adhoc	2.6	2.8	2.9	0.0
KESC	7.5	7.1	19.0	13.9
Of which:				
KESC on Account of GST	2.2	2.4	2.7	2.8
KESC for Cash Shortfall	6.5	0.0	6.6	0.0
KESC on Account of Tariff Discount	0.0	5.0	9.1	10.8
Inter Disco Tariff Differential	0.0	21.0	0.0	21.0
Oil Marketing Companies and Oil Refineries	11.9	6.0	8.2	10.0
Food Subsidies	1.3	4.5	4.8	7.9
Of which:				
Import of Wheat	0.6	3.3	3.3	2.0
Import of Sugar	0.0	0.6	0.6	5.2
Miscellaneous subsidies	8.7	9.7	7.1	15.1
Of which:				
Import of Fertilizer	4.0	5.0	5.0	12.3
FFC Jordan	1.0	1.0	1.0	1.0
Total	51.4	72.3	64.3	88.9

Source: Federal Budget in Brief 2006-2007, Government of Pakistan, Finance Division, Islamabad.

priorities of the Government, sharp increases have been made in allocations for the water and power sector, higher education, rural development, and development of low income urban areas. The allocation for the Water and Power Division has been increased by 34.3 percent and for the Water and Power Development Authority by 43.6 percent.

The total allocation for the two Khushhal Pakistan programs and the Khushhal Pakistan Fund, which aim at providing gainful employment, besides creating essential infrastructure (farm-to-market roads, water supply schemes, repair of schools, etc.) in rural and low income urban areas, has been more than doubled.

Table 13: Development Expenditure (Billion Rs.)

	Budget	Estimates	% Change
	2005/06	2006/07	
Federal Program	204.0	320.0	56.9
Federal Ministries	136.3	170.7	25.2
Of which:			
Higher Education Commission	11.7	16.3	39.3
Health Division	9.4	11.0	17.0
Population Welfare	4.4	4.4	
Interior Division	6.6	8.0	21.2
Law, Justice & Human Rights Division	4.8	4.1	-14.6
Water & Power Division	35.6	47.8	34.3
Railways Division	9.8	10.9	11.2
Corporations	36.1	48.0	33.0
WAPDA (Power)	15.6	22.4	43.6
WAPDA (Village Electrification)	0.5	0.5	
National Highway Authority	20.0	25.0	25.0
Special Programs	17.9	84.4	371.5
Khushal Pakistan Program - I	4.4	4.4	
Khushal Pakistan Program - II	7.5	20.0	166.7
Khushal Pakistan Fund	5.0	10.0	100.0
Provision for Less Developed Areas	1.0	0.0	-100.0
ERRA	0.0	50.0	
Special Areas	13.7	16.9	23.4
Provincial Program	68.0	115.0	69.1
Total Development Expenditure	272.0	435.0	59.9

Source: Federal Budget in Brief 2006-2007, Government of Pakistan, Finance Division, Islamabad.

Revenue: The federal budget envisages only a modest 5.9 percent growth in gross revenues in 2006/07. With a very sharp increase (25.6 percent) in transfers to provinces under the new National Finance Commission (NFC) Award, net revenue receipts of the Federal Government are projected to decline in 2006/07. Main factors responsible for the modest increase in gross revenues, despite a robust growth in the CBR tax revenues, include the under-budgeting of receipts from the USA for the logistic support for the war in Afghanistan and nil receipts budgeted for the petroleum development levy. Growth of revenues to be collected by CBR is expected to maintain a robust growth of 17.7 percent in 2006/07, with double-digit increases

in all tax heads. The general sales tax is projected to increase by 19.2 percent and direct taxes by 16.3 percent on the back of continued strong economic growth and reforms in tax administration implemented in the past few years. Bringing some previously untaxed services into the tax net will also help increase tax receipts in 2006/07.

Non-tax revenues are budgeted to decline by 15.4 percent in 2006/07. Receipts from defense services, the bulk of which comes from payments by the United States for logistic support for the war in Afghanistan, are projected to decline to one-fifth of the revised estimate of these receipts in 2005/06. As in the past, the Government has been conservative in

Revenue transfers to provinces are expected to increase by 25.6 percent under the new NFC award.

its projection of receipts from this source. So far, each year, these receipts have exceeded budget estimates by a wide margin. Dividends received from PSEs have also been projected to decline significantly. Transfers from SBP, on the other hand, are projected to almost double.

New Fiscal Measures: The budget contains a number of measures to provide incentives to agriculture, industry, and services to promote economic growth. Measures have also been announced to provide relief to taxpayers, pensioners, and senior citizens. In addition, the budget has announced an employment program for educated unemployed people. Some services, which were not taxed before, have been brought in the tax net, and for some other already taxed services, the tax rate has been increased.

The budget has provided a number of incentives for the **agriculture** sector. These include withdrawal of customs duty on the import of tractors, equipment for livestock and dairy, and machinery for horticulture. The budget has announced the establishment of a Livestock and Dairy Development Board and a Pakistan Dairy Development Company in collaboration with the private sector. These institutions will set up 1,200 model dairy farms and 2,950 livestock breeding farms throughout the country. The government has also provided a subsidy of Rs. 12.3 billion for the fertilizer industry to ensure lower prices for farmers. Last year, the level of this subsidy was only Rs. 5.0 billion.

A number of incentives have been provided for the **industry** to promote exports of leather/footwear and marble and granite. The deletion program for car assemblers has been replaced with a tariff-based system under which the assemblers will have the choice to either import auto parts at a specified duty or use locally manufactured parts.

To promote **public transport**, the Government has reduced the customs duty

from 20 to 10 percent on buses, trucks, and dumpers imported in completely knocked down condition and from 60 to 30 percent on those imported in completely built condition.

An attempt has been made to **broaden the tax base** by bringing into the tax net some previously untaxed sectors. The real estate has been brought in the tax net by levying a capital value tax (CVT) of 2 percent on all real estate transactions and a withholding tax of 5 percent on rental income. An excise duty of 5 percent has been imposed on non-fund services provided by the financial sector and on commission and brokerage of foreign exchange dealers. The tax rate on cash withdrawal of over Rs. 25,000 has been increased from 0.1 percent to 0.2 percent. The withholding tax on share transactions at stock exchanges has also been increased from 0.005 percent to 0.01 percent.

The budget contains a number of **relief measures**. These include: an increase in the exemption limit for personal income tax from Rs. 100,000 to Rs. 150,000 (Rs. 200,000 for salaried women); reduction in lower and upper income tax rates from 3.5 to 0.25 percent and from 30 to 20 percent, respectively; a dearness allowance of 15 percent for all government employees; a 15-20 percent increase in pensions of retired government servants; and an increase in the minimum wage from Rs. 3,000 per month to Rs. 4,000. For the purpose of exemption from income tax and other benefits, the age for senior citizens has been lowered from 65 to 60 years.

The budget has also announced the launching of a self-employment scheme for citizens of age 18-40, who will be provided loans by the National Bank of Pakistan for setting up their own businesses. The Government will subsidize these loans by paying half of the interest cost and the full cost of insuring the assets acquired for setting up the business.

The federal budget announced a number of relief measures for taxpayers, pensioners, and senior citizens.

A 2 percent CVT has been levied on real estate transactions.

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