# PAKISTAN ECONOMIC UPDATE

## (JULY 2004 - JUNE 2005)

**ASIAN DEVELOPMENT BANK**

**SEPTEMBER 2005**

Pakistan Resident Mission
Asian Development Bank

ASIAN DEVELOPMENT BANK
September 2005
Pakistan Resident Mission
OPF Building, Shahrah-e-Jamhuriyat
G-5/2, Islamabad, P.O. Box 1863
Islamabad, Pakistan.

Tel : (92-51) 2825011-16
Fax: (92-51) 2823324
(92-51) 2274718
E-mail: adbprm@adb.org

# FOREWORD

The Asian Development Bank is a long-standing development partner of Pakistan, having provided a total of $14.3 billion to the country in development assistance from 1968 to 2004. Of this amount, $709 million were provided in 2004. The Bank will provide another $797 million in 2005. The projected assistance for the period 2006-2008 amounts to $3.6 billion. The major development sectors in which ADB has invested include energy, agriculture and rural development, finance and trade, transport and communications, social sectors, and governance. Under its Country Strategy and Program for Pakistan for 2002-2006, reduction of poverty is the central objective, which will be operationalized through promoting sustainable pro-poor growth, inclusive social development, and good governance, with governance being the key area of focus.

Together with this lending portfolio, the Pakistan Resident Mission (PRM) is actively engaged in Economic and Sector Work to develop an understanding of important economic policy and sector concerns, particularly with regard to poverty and governance issues. To bring this work to a wider audience, PRM published, in July 2002, a country poverty assessment titled “Poverty in Pakistan: Issues, Causes, and Institutional Responses”, after extensive consultations and dialogue with the key development partners. PRM has also started a working paper series on topical issues, and the first paper titled “Escaping the Debt Trap: an Assessment of Pakistan's External Debt Sustainability” was published in December 2002. In addition, PRM published Pakistan: Sector Assessment Review in October 2003, which provides an overview of ADB's operations in various sectors in Pakistan. A paper titled “Industrial Competitiveness: The Challenge for Pakistan” was published in October 2004, based on a seminar organized by PRM in collaboration with the ADB Institute (Japan). The most recent working paper titled “Agricultural Growth and Rural Poverty” was published in March 2005.

In 2002, PRM initiated a series to provide regular updates on the state of the national economy. The first Pakistan Economic Update was published in April 2002. The present report provides an analysis of economic trends in Pakistan in fiscal year (FY) 2005, and presents an outlook of the economy for FY2006. The report also reviews poverty related public expenditure in the first three quarters of FY2005. In addition, the report has a special section on the Federal Budget for FY2006 and poverty analysis based on social indicators data collected in a recent household survey using the Core Welfare Indicators Questionnaire. We hope that the contents of this report will be of use to all stakeholders including the Government, civil society, donors, academia, media, and others. 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

# Contents

## TABLES



## FIGURES



## BOX

# PAKISTAN ECONOMIC UPDATE

## (JULY 2004 - JUNE 2005)

*Pakistan's economic performance improved further in FY2005 and the economy achieved the highest growth in the last two decades. However, because of shortages of essential food items, high oil prices, and strong domestic demand, inflation increased sharply and external balance worsened. The fiscal deficit also increased. Sound macroeconomic fundamentals, increasing private investment, and expending development expenditure will sustain high economic growth in FY2006. The medium-term prospects for the economy also look good.*

Pakistan's economic performance improved further in FY2005 and the economy achieved the highest growth in the last two decades. Economic growth during the year was broad-based, with agriculture, industry, and services sectors recording robust growth. Rising aggregate demand, accommodative monetary policy, and favorable weather conditions, all contributed to rapid economic expansion. However, because of shortages of essential food items, high oil prices, and strong domestic demand, inflation increased sharply and external balance worsened. The fiscal deficit also increased. Poverty related public expenditure showed a substantial increase during the first three quarters of the year, reflecting the Government's continuing commitment to poverty reduction. This report analyses macroeconomic developments in FY2005, along with outlook for FY2006, in section I and reviews poverty related public expenditures in the first three quarters of FY2005 in section II. The report also analyses the Federal Budget for FY2006 and reviews trends in poverty, based on social indicators data collected in a recent household survey using the Core Welfare Indicators Questionnaire approach, in section III.

## I. MACROECONOMIC DEVELOPMENTS

High economic growth seen in FY2004 strengthened further in FY2005. The two most important crops, namely wheat and cotton, achieved record high output and the rice crop was also larger than the preceding year. Growth of the industrial sector was somewhat less than last year, but still in double digits, mainly because of a rapid growth of the large-scale manufacturing. Exports recorded a double-digit growth, albeit much lower than import growth, resulting in more than three-fold increase in the trade deficit and the current account balance turning into a deficit for the first time in four years. Inflation accelerated sharply and posed a serious challenge for policy makers.

### Domestic Sector

**Growth:** The economy's overall performance improved further in FY2005, with the real GDP growth for the year estimated at 8.4 percent the highest in the last two decades (see table 1). For the second consecutive year, economic growth was led by the industrial sector, which expanded by 10.2 percent. The agriculture sector grew by 7.5 percent and the services sector by 7.9 percent, reflecting a broad-based economic growth.

Mainly because of a record growth of 45.5 percent in cotton production to 14.6 million bales, agriculture achieved the highest growth in the last one decade. Cotton accounted for half

**Table 1: Sectoral Growth and Inflation**

| | FY2003 | FY2004 | FY2005 |
|---|---|---|---|
| | % Growth Rates | | |
| GDP | 4.8 | 6.4 | 8.4 |
| Agriculture | 4.1 | 2.2 | 7.5 |
| Industry | 4.7 | 12.0 | 10.2 |
| *Of Which:* | | | |
| Large-scale Manufacturing | 7.2 | 18.2 | 15.4 |
| Services | 5.2 | 6.0 | 7.9 |
| GNP | 7.6 | 5.3 | 8.1 |
| Per-capita Income | 5.5 | 3.3 | 6.0 |
| Inflation | 3.1 | 4.6 | 9.3 |
| | % Contribution to GDP Growth | | |
| Agriculture | 1.0 | 0.5 | 1.7 |
| Industry | 1.1 | 2.7 | 2.5 |
| *Of Which:* | | | |
| Large-scale Manufacturing | 0.8 | 2.0 | 1.8 |
| Services | 2.7 | 3.2 | 4.2 |

Source: Pakistan Economic Survey 2004-05. Government of Pakistan.

*The large-scale manufacturing sector grew by 15.4 percent in FY2005.*

of the growth in agriculture. Of the other three main crops, output of wheat increased by 8.3 percent and that of rice by 2.9 percent. Only the sugarcane crop was 15.2 percent smaller than last year. The sharp increase in the output of cotton was underpinned by rise in both the area sown under the crop and per acre yield, with the area increasing by 7.8 percent and yield by 35.0 percent. While high cotton prices in FY2004 prompted farmers to sow larger area under the crop in FY2005, favorable weather conditions and use of better quality pesticides led to record increase in its yield. Increasing availability of credit at low interest rates also helped agriculture. Livestock, which accounts for 46.7 percent of value-added in the agriculture sector, recorded only a modest growth of 3.1 percent.

Robust growth of the industrial sector in FY2005 was mainly due to rapid expansion of the large-scale manufacturing (LSM), which grew by 15.4 percent on the back of an 18.2 percent growth in FY2004. Rapid expansion in LSM was supported by strong domestic demand fuelled by record growth in private sector credit, higher incomes of farmers, and increase in remittances. Production data for large-scale manufacturing shows that the quantum index of manufacturing increased by 15.6 percent on the back of an 18.2 percent growth in FY2004 (see table 2). The increase in LSM production was broad-based, with particularly large increases recorded in the production of export products (cotton yarn and cloth), consumer durables (cars, motorcycles, air-conditioners, and refrigerators), construction materials (cement and paints and varnishes), and investment goods for agriculture (tractors, diesel engines, and wheat threshers).

Of the two other sub-sectors of the industrial sector, construction picked up and grew by 6.2 percent in FY2005 in contrast with a decline of 6.9 percent in FY2004. Large increase in public sector development program and pick up in residential construc-

### Table 2: Growth in Production of Selected Large-scale Manufacturing Items

| Items | Weights | % Growth FY2004 | % Growth FY2005 |
|---|---|---|---|
| **Textiles** | **24.5** | **6.5** | **24.7** |
| *Of Which:* | | | |
| Cotton Yarn | 13.1 | 0.7 | 18.2 |
| Cotton Cloth | 7.5 | 17.4 | 28.9 |
| Cotton Ginned | 3.4 | -1.6 | 45.3 |
| **Food, Beverages, Tobacco** | **14.4** | **13.5** | **-2.0** |
| *Of Which:* | | | |
| Sugar | 4.2 | 9.1 | -23.1 |
| Vegetable Ghee | 4.2 | 15.2 | 3.2 |
| Cooking Oil | 1.3 | 32.7 | 15.1 |
| Cigarettes | 3.1 | 12.2 | 10.3 |
| **Petroleum Products** | **5.2** | **4.4** | **9.4** |
| **Pharmaceuticals** | **5.0** | **14.0** | **4.0** |
| **Chemicals** | **4.8** | **24.5** | **3.4** |
| **Automobiles** | **4.0** | **50.7** | **32.6** |
| *Of Which:* | | | |
| Jeeps and Cars | 2.5 | 58.2 | 28.3 |
| **Fertilizers** | **3.4** | **65.5** | **25.7** |
| Phosphatic Fertilizer | 1.9 | 151.7 | 37.8 |
| Nitrogenous Fertilizer | 1.5 | 1.6 | 3.6 |
| **Metal Industries** | **3.5** | **2.4** | **-5.0** |
| *Of Which:* | | | |
| Pig Iron | 1.6 | 3.5 | -3.6 |
| Coke | 1.4 | 1.3 | -1.6 |
| **Non-metallic Mineral Products** | **4.2** | **18.5** | **16.8** |
| *Of Which:* | | | |
| Cement | 4.1 | 18.6 | 16.9 |
| **Electronics** | **2.5** | **58.1** | **44.8** |
| **Leather Products** | **2.3** | **31.5** | **-5.6** |
| **Paper and Board** | **0.6** | **7.6** | **3.7** |
| **Engineering Goods** | **0.5** | **16.1** | **21.6** |
| **Overall Growth** | | **18.2** | **15.6** |

Sources: State Bank of Pakistan (SBP) Website. www.sbp.org.pk

*The services sector recorded the highest growth in the last two decades.*

tion supported by increased availability of housing loans at a low interest rate boosted the construction industry. However, value-added in generation and distribution of electricity and gas increased by only 2.1 percent compared with 21.1 percent last year. Slowdown in the sector was mainly because of decline in hydel generation due to shortage of water. Data available for the first three quarters of the year shows that hydel generation, which is the higher value-added component of electricity generation, was 14.6 percent lower than last year, while thermal generation increased by 23.6 percent. Growth of gas output also dropped to a more sustainable rate of 13.7 percent from 21.2 percent last year.

The services sector, which contributes 52.4 percent to GDP, recorded the highest growth in the last two decades because of rapid expansion in the financial sector, wholesale and retail trade, and telecom services. Strengthened by reforms and privatization in the past several years, financial sector expanded by 21.8 percent. Sharp increase in imports, robust double-digit growth in exports, and rapid expansion of commodity producing sectors resulted in a 12.0 percent growth in wholesale and retail trade. Telecom services continued to expand at a rapid pace, with mobile telephone connections increasing by 150 percent to 12.5 million.

On the demand side, growth was led by private consumption, which, fuelled by a sharp increase in consumer credit, higher incomes of farmers, and wealth effect of booming asset prices, increased by 16.8 percent in real terms. The external sector, on the other hand, had a contractionary impact on growth, as increase in imports exceeded that in exports by a wide margin. Analysis of other components of aggregate demand is not very useful because of the poor quality of data (see box).

The Pakistan's economic growth has accelerated in the last three years, with the real GDP growth increasing from 3.1 percent in FY2002 to 4.8 percent in FY2003, to 6.4 percent in FY2004, and further to 8.4 percent in FY2005. On the supply side, industrial and services sectors consistently achieved high growth rates in each of the three years, with the former sector recording double-digit growth in the last two years, mainly because of very rapid expansion in large scale manufacturing. In the services sector, communications, particularly telecom services, financial sector, and wholesale and retail trade expanded rapidly. Very rapid expansion was seen in mobile telephone connections, which doubled in each of the last three years and have increased to 12.5 million in June 2005 from 1.2 million in June 2002. In two out of the three years, the agriculture sector also

### Poor Quality of National Accounts Data

The data on national income accounts, particularly various components of aggregate demand, is generally of poor quality. Numbers on various components of aggregate demand are not consistent with fiscal, trade, and private sector credit data. For instance, with 41.9 percent increase in public sector development expenditure shown in the budget, it is very difficult to explain as to how fixed capital formation in the public sector, according to national income accounts, decreased by 0.4 percent in nominal terms and by 14.1 percent in real terms. In addition, although small revisions in previous year's national accounts data at the time of releasing the data for the outgoing year are understandable, drastic changes made every year in these data undermine their credibility. For instance, according to the Pakistan Economic Survey 2003-04, public sector fixed investment at constant prices increased by 40.8 percent in FY2004 and private sector investment increased by 7.9 percent. In the Economic Survey 2004-05 released in June 2005, growth in public sector investment in FY2004 has been revised downward to 21.1 percent and private investment is shown as having declined by 11.0 percent.

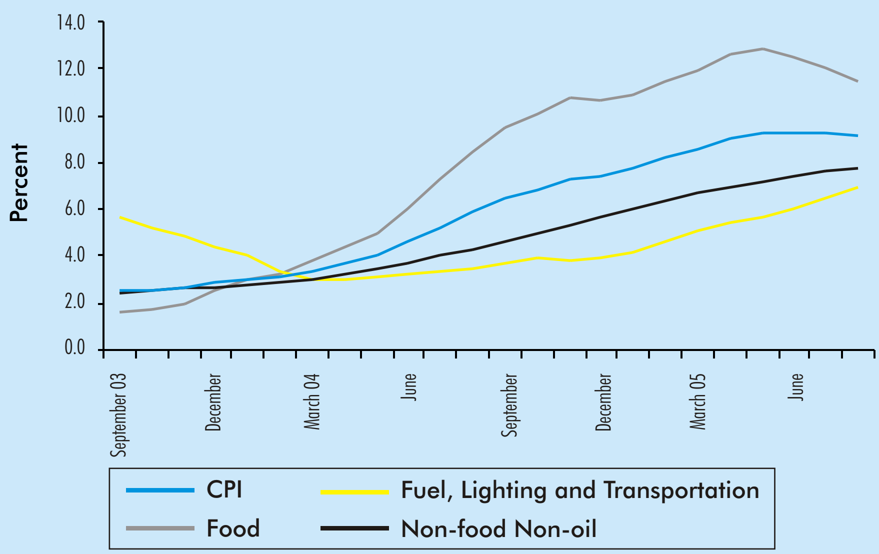
recorded robust growth. In terms of the structure of the economy, the large-scale manufacturing gained in importance over the last five years, with its share in GDP increasing from 9.6 percent in FY2000 to 12.7 percent in FY2005. The share of agriculture, on the other hand, declined from 26.2 percent to 23.1 percent.

**Prices:** Inflation accelerated sharply in FY2005, with the annual inflation based on the Consumer Price Index (CPI) increasing to 9.3 percent from 4.6 percent in FY2004 (see figure 1). Increase in inflation was led by food prices, house rents, and transportation charges. The last item reflected a sharp increase in domestic oil prices in the second half of the year, after the Government temporarily discontinued its policy of insulating domestic consumers from increase in the international price of oil. Growth in food prices increased from 6.0 percent to 12.5 percent, house rent from 4.5 percent to 11.3 percent, and transportation costs from 3.4 percent to 8.4 percent. Core inflation, defined as non-food non-oil inflation, increased from 3.7 percent to 7.4 percent. The Wholesale Price Index (WPI) inflation in FY2005 was lower than in FY2004 because of a sharp decline in the price of cotton, which has a large weight in raw materials. Stable prices of manufactures, particularly cotton textiles, electronics, and consumer goods competing with imports from China, which flooded the domestic market during FY2005, also contributed to smaller increase in WPI-based inflation during the year. The WPI for raw materials declined by 18.3 percent in contrast with an increase of 17.0 percent in FY2004 and that for manufactures increased by only 1.1 percent compared with a 7.9 percent increase last year. However, there were sharp increases in prices of food, fuel and lighting, and building materials. The price data for the last five months shows that inflation may have started subsiding. The quarterly CPI-based inflation, which had peaked at 10.4 percent in April 2005, declined to 8.7 percent in August.

*Inflation increased to 9.3 percent from 4.6 percent in FY2004.*

Both supply and demand factors contributed to mounting inflationary pressures during FY2005. On the supply side, lean wheat harvests in the preceding 3-4 years and mishandling of wheat import operations during the year created shortages of the staple food item in various parts of the country. The Government's decision to end the freeze

**Figure 1: Annual Inflation**



*SBP avoided aggressive tightening of monetary policy until April 2005.*

on domestic prices of petroleum products in mid-December 2004 pushed up all other prices, particularly transportation costs. Lower production of sugar and damage caused by rains to minor crops, like potatoes and onions, also reinforced the rise in food prices. Record growth in private sector credit, particularly consumer credit, in the last two years pushed up demand and put pressure on prices, which is reflected in a sharp increase in core inflation.

Inflation had been low and declining during the two years preceding FY2004. In those two years, comfortable availability of essential food items, unutilized capacity in the LSM sector, overall stagnant economy, declining interest rates, appreciating Rupee, and global price stability, all helped keep inflation below 4.0 percent, despite expansionary monetary policy. While monetary growth continued to exceed growth of nominal GDP by a wide margin in FY2004, the factors responsible for price stability in the preceding two years started changing. With the economy picking up in FY2004, excess capacity in the LSM sector disappeared. Subsidized exports and lean harvests of wheat in the preceding two years had already depleted stocks of wheat, a situation that was further aggravated by mishandling of wheat imports. In FY2004 oil prices started rising and their rise accelerated further in FY2005. These changes reinforced the inflationary impact of excessive monetary growth in FY2004, which had been muted by favorable supply-side factors in the preceding two years. As a result, inflation started rising in FY2004 and continued rising through FY2005. The CPI-based inflation increased from 3.1 percent in FY2003 to 4.6 in FY2004 and further to 9.3 percent in FY2005. With large monetary overhang from the past four years and rising oil prices, monetary policy will have to be tightened aggressively to bring about a significant decrease in inflation. As tightening of monetary policy has been delayed considerably, the Government now faces a difficult trade-off between protecting growth and fighting inflation.

*Monetary growth was only marginally lower than increase in nominal GDP.*

**Monetary Management:** Despite rising inflation, the State Bank of Pakistan (SBP) avoided aggressive tightening of monetary policy until the first week of April 2005, as it sought to keep interest rates from rising too rapidly. SBP was of the view that inflation was primarily driven by supply-side factors and to control it the Government needed to mainly adopt administrative measures to boost supply. However, as inflation, particularly core inflation, continued to rise, SBP aggressively tightened monetary policy in the beginning of the fourth quarter of the year, and increased discount rate from 7.5 percent to 9.0 percent, effective 11th April 2005. SBP also began accepting more than pre-announced amounts in the auctions of treasury bills (TBs) and let short-term interest rates rise. Interest rate on 6-month TBs, which had risen by 343 basis points to 5.51 percent in the first three quarters of the year, increased further by 243 basis points to 7.9 percent in the last quarter. The rate at which SBP provides refinancing to banks under the Export Finance Scheme was also raised in a number of steps from 2.0 percent in July 2004 to 6.5 percent in June 2005. The weighted average interest rate charged by banks on new loans disbursed during the year increased from 5.1 percent in June 2004 to 8.4 percent in June 2005.

Money supply growth of 17.0 percent in FY2005, which was only marginally lower than growth of nominal GDP, also shows that SBP did not aggressively tighten monetary policy during the year (see table 3). Monetary growth was mainly due to increase in net domestic assets of the banking system, which accounted for 90.1 percent of monetary expansion. The major source of increase in net domestic assets was the accelerated flow of credit to the private sector, which increased by Rs 390.3 billion compared with Rs 291.6 billion last year. Net borrowing by the Government sector for financing the budget increased to Rs 76.3 billion from Rs 59.0 billion in FY2004. In order to prevent a rapid increase in interest rates, SBP met the entire bank borrowing requirement of the

**Table 3: Monetary Growth (Billion Rs)**

| | Monetary Impact during | |
|---|---|---|
| | **FY2004** | **FY2005** |
| Monetray Assets | 357.6 | 422.1 |
| % Growth in Monetray Assets | 17.2 | 17.0 |
| % Growth in Reserve Money | 23.7 | 16.6 |
| Net Foreign Assets of the Banking System | 44.5 | 41.7 |
| Net Domestic Assets of the Banking System | 313.1 | 380.5 |
| Net Borrowing by Government Sector | 53.0 | 100.1 |
| *Of Which:* | | |
| Budgetary Support | 59.0 | 76.3 |
| 1. Central Bank | 122.5 | 154.5 |
| 2. Scheduled Banks | -63.4 | -78.2 |
| Commodity Operations | -8.6 | 21.8 |
| Net Borrowing by Non Government Sector | 282.4 | 366.4 |
| *Of Which:* | | |
| Borrowing by the Private Sector | 291.6 | 390.3 |
| Other Items (net) | -22.3 | -86.1 |

Source: SBP website. www.sbp.org.pk

Government and even shifted some of its outstanding debt from commercial banks to its own portfolio, resulting in a 16.6 percent expansion in reserve money.

**Stock Market:** After declining in the first quarter, share prices increased in the subsequent two quarters (see figure 2). Particularly sharp increase was seen in the first two and half months of the calendar year 2005, when the KSE index rose by 65.7 percent to 10,303 on 15 March. Higher corporate earnings, privatization of state-owned enterprises through the stock market,

**Figure 2: Stock Market Performance**

*The focus of fiscal policy shifted from stabilization to growth.*

announcement of privatization plans of some major public sector enterprises, and large injection of foreign portfolio investment[1] were the main factors behind the sharp increase in share prices. Speculative buying and the hype generated by statements of stockbrokers and government officials also reinforced the bullish trends in the market, pushing equity prices to an unsustainable level. The subsequent profit taking sales turned into a rout and the KSE-100 index declined by as much as 37.2 percent to 6,467 on 27 May, before rising again to 7,450 on 30 June. In addition to unsustainably high prices, uncertainty caused by the transition from carry-over-transactions to margin financing also contributed to the steep fall of share prices after 15 March 2005.

**Fiscal Policy:** The Government pursued an expansionary fiscal policy in FY2005 and let the fiscal deficit increase to 3.3 percent of GDP from 2.3 percent in FY2004 (see table 4).[2] The primary balance also turned into a small deficit of Rs 6.8 billion from a surplus of Rs 66.8 billion seen in the preceding year. There was a shift from focus on fiscal stabilization of the preceding three years to promoting growth. Development expenditure was increased by 41.9 percent, raising its share in GDP from 2.9 to 3.5 percent. Current expenditure also increased by 21.2 percent. The poverty related public expenditure available for the first three quarters of the year shows a robust increase of 23.2 percent. The FY2006 budget continues the expansionary fiscal policy and envisages a further increase in the fiscal deficit to 3.8 percent of GDP.

*Development expenditure increased by 41.9 percent.*

The primary fiscal balance, which is an indicator of future developments in the debt position of the economy, turned into deficit in FY2005 after recording surpluses in the preceding six years. This means that the Government had to borrow to meet a part of its interest payment liability, albeit a small part. With GDP growth exceeding the average interest rate on public debt and the primary deficit being quite small, Pakistan is still on the trajectory of declining debt burden, as measured by debt-to-GDP ratio. However, if the primary deficit continues to increase, the declining trend could be reversed.

Consolidated expenditure of federal and provincial governments increased sharply by 20.9 percent in FY2005, with current expenditure increasing by 21.2 percent and development expenditure by 41.9 percent. Current expenditure of both federal and provincial governments recorded substantial increases. The large increase in current expenditure of the Federal Government was due to sharp increases in transfer payments and defense expenditure (also see section on Federal Budget).

Both federal and provincial governments sharply increased their development expenditure in FY2005, with federal expenditure increasing by 32.2 percent and provincial expenditure by 58.7 percent. The provincial development expenditure also exceeded budgetary allocation for the year by as much as 71.3 percent. However, the Federal Government could utilize only 91.3 percent of the allocation made in the budget. There was a better management of development expenditure by both federal and provincial governments and crowding of expenditure in the last quarter decreased from 46 percent to 38 percent in the case of the Federal Government and from 48 percent to 41 percent in the case of provincial governments. To the extent that crowding of expenditure in the last quarter results in poor quality of expenditure, this means an improvement in the effectiveness of expenditure.

The increase in consolidated revenue of federal and provincial governments in FY2005, at 13.3 percent, lagged behind the

1. Foreign portfolio investment during FY2005 was $151 million in contrast with disinvestment of $28 million in FY2004.
2. For FY2005, a large amount of Rs. 78.5 billion has been shown as negative unidentified expenditure, for which no explanation has been given. Even if a part of this turns out to be actual expenditure, the fiscal deficit will rise above 3.3 percent of GDP.

**Table 4: Consolidated Federal and Provincial Fiscal Position (Billion Rs)**

| | FY2004 | FY2005 (Revised Estimates) | percent Change |
|---|---|---|---|
| Total Revenue | 794.1 | 900.0 | 13.3 |
| Federal Revenue | 743.9 | 833.5 | 12.0 |
| *Of Which:* | | | |
| CBR Taxes | 521.9 | 588.4 | 12.7 |
| Surcharges | 61.4 | 26.8 | -56.4 |
| Non-tax Revenue | 160.6 | 218.3 | 35.9 |
| Provincial Revenue | 50.2 | 57.0 | 13.5 |
| Total Expenditure | 923.6 | 1,117.0 | 20.9 |
| Booked Expenditure | 959.4 | 1,195.6 | 24.6 |
| Current Expenditure | 778.4 | 943.1 | 21.2 |
| Federal | 560.0 | 688.6 | 23.0 |
| *Of Which:* | | | |
| Interest | 196.3 | 210.2 | 7.1 |
| Of Which: | | | |
| Domestic | 154.8 | 170.5 | 10.1 |
| Foreign | 41.4 | 39.7 | -4.1 |
| Defense | 180.4 | 211.7 | 17.4 |
| Transfer Payments | 65.0 | 118.5 | 82.3 |
| Provincial | 218.4 | 254.5 | 16.5 |
| Development Expenditure and Net Lending | 181.0 | 252.5 | 39.5 |
| Development Expenditure | 160.5 | 227.7 | 41.9 |
| Federal | 102.3 | 135.2 | 32.2 |
| Provincial | 58.3 | 92.5 | 58.7 |
| Net Lending | 20.4 | 24.8 | 21.6 |
| Unidentified Expenditure | -35.8 | -78.5 | 119.3 |
| Budget Deficit | -129.5 | -217.0 | 67.6 |
| As percent of GDP | 2.3 | 3.3 | |

Sources: 1. Ministry of Finance Website. http://finance1.finance.gov.pk
2. Budget 2005-06 Documents.

increase in expenditure. As a percentage of GDP, revenue declined from 14.4 to 13.7. In the first half of the year the Government pursued the policy of insulating domestic consumers from increase in international prices of oil, which resulted in a sharp decline in receipts from petroleum development surcharge. Tax collection by the Central Board of Revenue (CBR) also increased at a slow pace and fell short of the growth in nominal GDP by a wide margin. The slow growth in tax revenues was somewhat made up by a sharp increase of 35.9 percent in non-tax revenues of the Federal Government. Non-tax receipts of provincial governments increased by only 1.8 percent.

Despite a shift to expansionary fiscal policy, fiscal deficit remains low, especially when compared with average deficit of 6.9 percent of GDP during the 1990s. Fiscal stabilization efforts in the past five years have

*Imports increased by 32.3 percent and exports by 17.0 percent in FY2005.*

resulted in a significant improvement in fiscal balance, with fiscal deficit declining from 5.4 percent of GDP in FY2000 to 3.3 percent in FY2005.

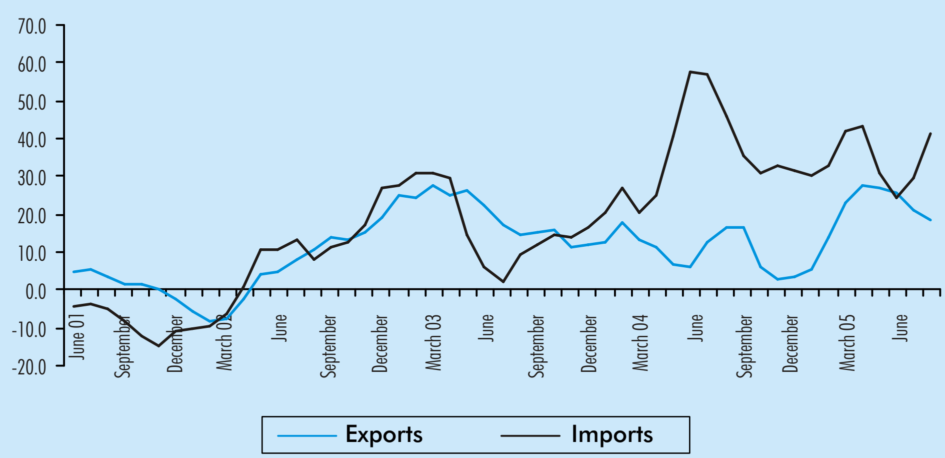
In addition to fiscal stabilization, there was a substantial restructuring of expenditure and tax system in the past five years. As a result, the share of interest payments and defense in total expenditure has been reduced significantly, creating fiscal space for increasing expenditure on physical infrastructure, social sectors, and operations and maintenance. The share of total expenditure going to interest payments and defense declined from 55.8 percent in FY2000 to 37.8 percent in FY2005. The share of development expenditure increased from 13.5 percent to 20.4 percent over the same period. Similarly, the share of poverty-related expenditure, both current and development, increased from 19.1 percent in FY2002 to 28.0 percent in FY2004.

Tax reforms implemented in the past several years included, among other things, expansion of the coverage of income tax and general sales tax, lowering of import tariffs, and phasing out excise duty and confining it to a few items. The purpose of these reforms was to raise adequate revenues to finance essential expenditures and to minimize the disincentive effects of taxes on economic activity. Through tax surveys and documentation exercises 588,923 income taxpayers have been added to the tax base since FY2001. The maximum rate of import duty has been reduced to 25 percent, the average tariff rate has been lowered to 14.9 percent, and the number of tariff slabs reduced to 4. However, tax reforms have failed to enhance the ability of the taxation system to raise revenues, with tax buoyancy remaining as low as 0.91 in the last five years and the tax-to-GDP ratio declining from11.5 percent in FY2003 to 9.9 percent in FY2005.

## External Sector

**Merchandise Trade:** Due to strong domestic demand and a sharp increase in oil prices, imports increased sharply by 32.3 percent to $20.6 billion in FY2005, putting pressure on balance of payments. Exports also increased at a rate of 17.0 percent to $14.4 billion. Most of the increase in exports took place in the second half of the year, when export growth accelerated to 23.0 percent from 10.5 percent recorded in the first half (see figure 3). Import growth on the other hand was lower in the second half of the year. Growth of both exports and imports for the full year was higher than targets set in the Trade Policy for FY2005.

**Figure 3: Quarterly Growth of Exports and Imports (% Change over Corresponding Quarter of Previous Year)**



Discontinuation of the quota regime in January 2005 significantly affected textile and clothing exports during FY2005. Anticipating lower prices under the quota free regime, foreign importers of Pakistan textiles and clothing withheld orders in the first half the year, which resulted in decline of 5.8 percent in the volume of these exports and 2.5 percent in their value (see table 5). There were sharp declines in quantum exports of art silk and synthetic textiles, bedwear, readymade garments, and cotton yarn. The trend was reversed after the discontinuation of the quota regime, with the volume of textile and clothing exports increasing by 19.9 percent in the second half of the year. As a result, value of these exports increased by 14.9 percent, despite lower prices due to intense competition among textile exporting countries.[3] Readymade garments, towels, bedwear, cotton yarn, and cotton cloth recorded high double-digit increases in their volume ranging from 18.1 percent to 59.9 percent. Large increases in their volume under the quota free regime, indicate that these products are competitive in the international market, and that there is a potential for rapid growth in their exports in future. The export volume of art silk and synthetic textiles and knitwear recorded significant declines in the second half of the year.

For full FY2005, non-textile exports recorded much higher growth of 37.5 percent compared with textile export growth of only 6.6 percent, which indicates a move toward product diversification of exports (see table 6). As a result, concentration of exports in textiles declined from 65.3 percent to 59.5 percent. From the point of view of diversification, large increases of 66.6 percent in non-classified items (mostly consisting of non-traditional exports) and 25.1 percent in non-textile manufactures are particularly encouraging. Export of primary commodities also increased by 31.6 percent, mainly because of a sharp increase in export of non-basmati rice, which more than doubled to $442 million. Among non-textile manufactures, large increases were recorded in petroleum products, chemical and pharmaceutical products, leather gloves, and engineering goods.

*Concentration of exports in textiles declined from 65.3 percent to 59.5 percent.*

**Table 5: Trends in Textile and Clothing Exports in FY2005**

| | First Half | | | Second Half | | |
|---|---|---|---|---|---|---|
| **Commodities** | **% Change in Price** | **% Change in Quantity** | **% Change in Value** | **% Change in Price** | **% Change in Quantitiy** | **% Change in Value** |
| **Textile and Clothing** | **2.5** | **-5.8** | **-2.5** | **-4.2** | **19.9** | **14.9** |
| *Of Which:* | | | | | | |
| Cotton Yarn | 2.5 | -15.5 | -13.4 | -15.3 | 24.1 | 5.0 |
| Cotton Cloth | 5.4 | -3.0 | 2.2 | 8.5 | 18.1 | 28.1 |
| Knitwear | 9.6 | 28.9 | 41.3 | -5.6 | -10.9 | -15.9 |
| Bedwear | -5.5 | -18.5 | -23.0 | -4.0 | 29.2 | 24.0 |
| Readymade Garments | -2.8 | -18.0 | -20.3 | -10.9 | 59.9 | 42.5 |
| Towels | -2.6 | 23.4 | 20.2 | -9.6 | 41.2 | 27.6 |
| Art Silk and Synthetic Textiles | -1.5 | -44.7 | -45.5 | 3.4 | -24.2 | -21.7 |

Source: Federal Bureau of Statistics (FBS) website. www.statpak.gov.pk

3. Lower price of cotton was another factor responsible for decline in prices of textiles.

**Table 6: Growth in Exports (Million US$)**

| Commodities | FY2004 | FY2005 | % Change |
|---|---|---|---|
| **Primary Commodities** | **1,011** | **1,331** | **31.6** |
| Rice | 634 | 933 | 47.1 |
| a) Basmati | 422 | 491 | 16.4 |
| b) Others | 213 | 442 | 107.9 |
| Raw Cotton | 48 | 111 | 133.5 |
| Fish & Fish Preparations | 153 | 129 | -15.6 |
| Fruits | 103 | 90 | -12.3 |
| **Textile Manufactures** | **8,039** | **8,569** | **6.6** |
| *Of Which:* | | | |
| Cotton Yarn | 1,127 | 1,088 | -3.4 |
| Cotton Cloth | 1,711 | 1,994 | 16.5 |
| Knitwear | 1,459 | 1,626 | 11.5 |
| Bedwear | 1,383 | 1,408 | 1.8 |
| Towels | 404 | 502 | 24.4 |
| Readymade Garments | 993 | 1,109 | 11.6 |
| Art Silk & Synthetic Textiles | 471 | 301 | -36.1 |
| **Other Manufactures** | **2,228** | **2,786** | **25.1** |
| Carpets, Rugs & Mats | 231 | 283 | 22.2 |
| Petroleum Products | 267 | 413 | 54.9 |
| Sports Goods | 325 | 315 | -3.0 |
| Leather Tanned | 252 | 296 | 17.7 |
| Leather Manufactures | 414 | 491 | 18.5 |
| *Of Which:* | | | |
| Leather Garments | 324 | 306 | -5.3 |
| Leather Gloves | 71 | 152 | 115.2 |
| Surgical Goods & Medical Instruments | 133 | 172 | 29.9 |
| Chemicals and Pharm. Products | 263 | 382 | 45.2 |
| Engineering Goods | 100 | 160 | 60.0 |
| **Non-classified Items** | **1,035** | **1,725** | **66.6** |
| **Total** | **12,313** | **14,410** | **17.0** |

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

In FY2005, exports to three largest countries in the South Asia region, namely India, Bangladesh, and Sri Lanka, and the two western neighbors Iran and Afghanistan increased by 76.4 percent (see table 7). Exports to India more than doubled to $190 million and those to Sri-Lanka increased by 64.4 percent to $143 million. Exports to Afghanistan increased by 81.6 percent to $732 million. Although exports to these five countries represented only 6.5 percent of the country's total export receipts in FY2004, they accounted for 30.3 percent of the increase in export receipts in FY2005. This provides an indicator of the impact expansion in intra-regional trade could have on the Pakistan economy in the next few years.

Acceleration in imports in FY2005 was broad-based, with oil imports increasing by 20.4 percent, food imports by 28.7 percent, and non-food non-oil imports by 35.9 percent

**Table 7: Exports to Regional Countries (Million US$)**

| Country | FY2004 | FY2005 | % Change |
|---|---|---|---|
| **Total Export Receipts** | **12,015** | **13,993** | **16.5** |
| *Of Which:* | | | |
| India | 84 | 190 | 126.2 |
| Sri Lanka | 87 | 143 | 64.4 |
| Bangladesh | 156 | 204 | 30.8 |
| Afghanistan | 403 | 732 | 81.6 |
| Iran | 55 | 116 | 110.9 |
| **Total for Five Countries** | **785** | **1,385** | **76.4** |

Source: SBP Website. www.sbp.org.pk

(see table 8). Increase in non-food non-oil imports accounted for more than four-fifths of increase in total imports. In this category, there were large increases in imports of raw materials and machinery, reflecting sustained high economic growth and strong demand for investment goods. Availability of consumer loans at low interest rates, higher farm incomes, increased inflow of remittances, and wealth effect of booming asset prices also pushed up imports of consumer durables.

Import of textile machinery, which is the single largest item in the machinery group, increased sharply by 50.8 percent to $902 million in FY2005, reflecting a further pick up in investment in textile industry. Textile industry is undergoing modernization to face the challenges of the post-quota regime ushered in January 2005. Construction and mining and agricultural machinery also increased by 38.6 percent and 50.0 percent, respectively. Import of other miscellaneous machinery more than doubled to $2.6 billion, indicating a broad-based pick up in investment. Among raw materials, there were large increases in imports of iron and steel, plastic materials, and synthetic fiber, which were required for continuing expansion of the industrial sector.

Among consumer durables, import of motor vehicles increased by 48.9 percent in FY2005 on the back of 26.2 percent and 51.7 percent increases in the preceding two years. Other consumer durables, which can be identified in the summary data released by the Federal Bureau of Statistics, are electric appliances. Their import increased by 30.3 percent during the year.

*Import of textile machinery increased sharply by 50.8 percent in FY2005.*

In the face of an increase of 35-40 percent in the international price of crude oil, it is very difficult to explain how the unit value of crude oil imports into Pakistan increased by only 6.8 percent and that of petroleum products by only 11.1 percent. Because of this anomaly in the data, it is not possible to analyze the increase in oil import bill, which seems rather modest considering increases of 10.8 percent and 10.7 percent in quantum imports of crude oil and petroleum products, respectively.

In the last three years, external trade has expanded very rapidly, with both exports and imports recording double-digit growth in each of the three years as the Government liberalized the trade regime. Cumulatively, exports increased by 57.7 percent, and imports doubled over this period. The trade-to-GDP ratio increased by 4.6 percentage points to 31.8 percent, reflecting increasing integration with the global economy.

*The current account balance turned into a deficit after three years.*

**Current Account:** The balance of payments position weakened in FY2005, as the current account balance turned into a deficit after having been in surplus in the

**Table 8: Growth in Imports (Million US$)**

| | FY2004 | FY2005 | % Change |
|---|---|---|---|
| **Food Group** | **1,033** | **1,330** | **28.7** |
| *Of Which:* | | | |
| Wheat Unmilled | 24 | 79 | 233.2 |
| Tea | 193 | 231 | 19.7 |
| Edible Oil | 659 | 706 | 7.1 |
| Sugar | 3 | 77 | 2,267.6 |
| Pulses | 75 | 114 | 51.7 |
| **Machinery Group** | **3,309** | **4,510** | **36.3** |
| Power Generating Machinery | 278 | 379 | 36.4 |
| Office Machines | 209 | 254 | 21.2 |
| Textile Machinery | 598 | 902 | 50.8 |
| Construction & Mining Machinery | 101 | 140 | 38.6 |
| Aircrafts, Ships and Boats | 790 | 154 | -80.5 |
| Agricultural Machinery | 38 | 57 | 50.0 |
| Other Machinery | 1,295 | 2,625 | 102.7 |
| **Petroleum Group** | **3,167** | **3,813** | **20.4** |
| Petroleum Products | 1,401 | 1,723 | 23.0 |
| Petroleum Crude | 1,765 | 2,090 | 18.4 |
| **Consumer Durables** | 911 | 1,308 | 43.6 |
| Electrical Machinery & Appliances | 258 | 336 | 30.3 |
| Roadmotor Vehicles | 653 | 972 | 48.9 |
| **Raw Materials** | **2,084** | **3,034** | **45.6** |
| *Of Which:* | | | |
| Synthetic Fiber | 106 | 138 | 29.6 |
| Synthetic & Artificial Silk Yarn | 118 | 125 | 6.1 |
| Fertilizers | 285 | 384 | 35.0 |
| Insecticides | 124 | 136 | 9.3 |
| Plastic Materials | 549 | 774 | 40.9 |
| Iron and Steel | 606 | 1,102 | 81.8 |
| **Others** | **5,087** | **6,628** | **30.3** |
| **Total** | **15,592** | **20,623** | **32.3** |
| **Non-oil Non-food Imports** | **11,392** | **15,480** | **35.9** |

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

preceding three years. The current account, excluding official transfers, showed a deficit of \$1.8 billion in contrast with a surplus of \$1.3 billion in FY2004 (see table 9). The sharp deterioration in the current account was mainly due to substantial increases in the trade deficit and the deficit on the services account. There was a more than three-fold increase in trade deficit to \$4.5 billion, as imports increased by 38.1 percent, compared to only 16.0 percent increase in exports. Large increase in trade-related freight charges and payments for other business services (mainly reflecting the impact of integration of foreign currency transactions channeled through foreign exchange companies (FECs) in the

**Table 9: Balance of Payments (Million US$)**

| | FY2004 | FY2005 | % Change |
|---|---|---|---|
| **Trade Balance** | **-1,279** | **-4,523** | **253.6** |
| Exports | 12,459 | 14,450 | 16.0 |
| Imports | -13,738 | -18973 | 38.1 |
| **Services (net)** | **-1,316** | **-3,317** | **152.1** |
| **Income (net)** | **-2,207** | **-2,392** | **8.4** |
| *Of Which:* | | | |
| Interest | -936 | -1,057 | 12.9 |
| **Current Transfers (net)** | **6,713** | **8,706** | **29.7** |
| *Of Which:* | | | |
| Workers Remittances | 3,871 | 4,168 | 7.7 |
| Resident FCAs | 367 | 561 | 52.9 |
| Saudi Oil Facility | 302 | 0 | |
| **Current Account (net)** | **1,811** | **-1,526** | |
| **Current Account (net) excl. Official Transfers** | **1,300** | **-1,774** | |
| **Capital Account (net)** | **82** | **658** | **702.4** |
| *Of Which:* | | | |
| Debt Forgiveness | 0 | 495 | |
| **Financial Account (net)** | **-1,334** | **575** | |
| *Of Which:* | | | |
| Foreign Direct Investment | 951 | 1,525 | 60.4 |
| Portfolio Investment (Liabilities) | 311 | 609 | 95.8 |
| Equities | -28 | 151 | |
| Debt Securities | 339 | 458 | 35.1 |
| Disbursement of Foreign Assistance | 978 | 2,156 | 120.4 |
| Amortization | -2,744 | -1,550 | -43.5 |
| Errors & Omissions | 222 | -133 | |
| Official Reserves | 10,564 | 9,792 | -7.3 |

Source: SBP Website. www.sbp.org.pk

formal system of payments)[4] resulted in a 152.1 percent increase in deficit in the services account to $3.3 billion. On the positive side, a 7.7 percent increase in remittances to $4.2 billion, a substantial increase in inflows of foreign exchange through FECs, and higher inflows into foreign currency accounts resulted in a 29.7 percent increase in the surplus in current transfers to $8.7 billion. This helped to finance a part of the deficits on trade, services, and income accounts.

## Capital and Financial Account:

The capital account improved sharply in FY2005, showing a surplus of $658 million compared with only $82 million in FY2004 -- mainly due to debt forgiveness of $495 million by the USA. The financial account showed even larger improvement, turning into a

4. Outflows through FECs have no impact on overall current account balance as they are offset by the proceeds of FECs shown as other private transfers.

*As a percentage of GDP, external debt and liabilities decreased from 36.7 to 32.5.*

surplus of $575 million from a deficit of $1.3 billion in FY2004. The sharp improvement in the financial account was due to broad-based increases in foreign direct investment, portfolio investment in both equities and debt securities, and disbursement of foreign assistance, as well as decline in amortization. Foreign direct investment, including privatization proceeds, increased by 60.4 percent to $1.5 billion. Disbursement under long-term program assistance more than doubled to $2.2 billion, while short-term lending by the Islamic Development Bank rose from $8 million to $271 million. Because of $600 million raised through Islamic bonds in January 2005, there was an inflow of $458 million on account of debt securities compared with $339 million last year. Amortization, at $1.6 billion, was 43.5 percent lower than last year. Prepayment of expensive loans had increased amortization last year.

The emergence of deficit in the current account balance in FY2005 after large surpluses in the preceding three years is not a matter of concern for three reasons. One, the deficit is relatively small at 1.6 percent of GDP (compared with average deficit of 4.5 percent of GDP seen during the 1990s), and can be easily financed through foreign direct investment, including privatization proceeds, and soft loans from multilateral institutions. Two, the major factor underlying the deficit was a sharp increase in the import of machinery, intermediate goods, and raw materials, triggered by rapid expansion of the economy. Higher investment, requiring a large increase in import of machinery, will eventually lead to higher production and additional exports, thus correcting a part of external imbalance. Three, developing economies like Pakistan need foreign savings to finance a part of their investment, which exceeds their own savings. This inevitably results in deficit in the current account of balance of payments. Large surpluses recorded in three years preceding FY2005 were not a normal phenomenon. They resulted from stagnant economy and some developments after the 11 September 2001 terrorist attacks in New York and Washington.

*The economy is projected to grow by 6.5 percent in FY2006.*

**Foreign Exchange Reserves:** Due to reappearance of the current account deficit, foreign exchange reserves held by SBP declined by $0.8 billion to $9.8 billion in FY2005. At this level, reserves are sufficient to finance 6.2 months of merchandise imports. The Rupee depreciated by 3.5 percent to Rs 60.03/US$ in the first four months of the year, but strengthened somewhat after SBP intervened in the inter-bank market in support of the Rupee and also started providing foreign exchange for payments for oil imports, effective 1 November 2004. For full FY2005, the Rupee depreciated by 2.9 percent from Rs 57.92/US$ to Rs 59.67/US$.

Pakistan's external debt and liabilities increased by 1.4 percent to $35.8 billion in FY2005. The bulk of the increase was in multilateral debt, which normally has low interest rate and long maturity period. Private non-guaranteed debt and foreign exchange liabilities, including Special US Dollar Bonds, Foreign Currency Bonds, and the central bank deposits, showed significant declines. As a percentage of GDP, external debt and liabilities decreased from 36.7 to 32.5.

## Economic Outlook

With sound macroeconomic fundamentals, enhanced private investment, and the sharp increase in the public sector development program, the economy is projected to grow by 6.5 percent in FY2006 (see table 10). After peaking in FY2005, inflation is expected to decline somewhat during the year. The balance of payments is likely to come under further pressure as high economic growth and high oil prices push up imports.

After growing at very high rates in the last two years, the manufacturing sector is expected to settle down to a more sustainable, but still robust, growth of about 11.0 percent in FY2006. Substantial production capacity built in the last two years will come on line during the year. Exemption of major export industries from GST and withdrawal of import duty on raw materials and other supplies in the FY2006 budget will also boost production.

### Table 10: Economic Outlook

| Item | FY2005 | FY2006 | FY2007 |
|---|---|---|---|
| | | % Growth | |
| GDP Growth | 8.4 | 6.5 | 7.3 |
| Agriculture | 7.5 | 3.0 | 5.0 |
| Large-scale Manufacturing | 15.4 | 11.0 | 13.2 |
| Other Sectors | 7.4 | 6.9 | 6.9 |
| Inflation (CPI) | 9.3 | 8.5 | 7.6 |
| Merchandise Exports | 16.0 | 15.0 | 13.0 |
| Merchandise Imports | 38.1 | 18.0 | 15.0 |
| | | % of GDP | |
| Budgetary Deficit | -3.3 | -3.8 | -3.7 |
| Trade Balance | -4.1 | -4.7 | -5.0 |
| Current Account (including Official Transfers) | -1.4 | -2.8 | -2.9 |

Sources: 1. Medium Term Development Framework 2005-10. Government of Pakistan.
2. Staff Estimates.

Agricultural growth is likely to decline in FY2006, mainly because of the high base effect. It will also be difficult to sustain the last year's all time high output of cotton because of heavier monsoon rains and greater moisture that increase crop vulnerability to pests. However, greater availability of water will benefit water-intensive crops like rice and sugarcane, as well as help winter crops, such as wheat. Lowering of import duty on tractors and fiscal incentives for the livestock sector, announced in the FY2006 budget, will encourage investment in agriculture. Considering these factors, growth of agriculture is projected at about 3.0 percent in FY2006.

In the services sector, the rapid growth of telecom services is likely to be sustained in FY2006. Private telecom service providers have made substantial investment last year, which will facilitate further expansion of their services. Also, the introduction of wireless local loop services will open up rural areas to telecom services. The banking sector is also expected to register robust growth.

Tightening of monetary policy since April 2005 and opening up of imports of essential food items will dampen inflationary pressures in FY2006. However, expansionary fiscal policy, continued high oil prices, and the large monetary overhang may make it difficult to reduce inflation significantly. Hence inflation is projected to decline only marginally to 8.5 percent in FY2006.[5]

With high GDP growth, imports maintaining a double-digit increase, and ongoing improvements in tax administration, tax revenues are projected to grow by 17 percent in FY2006. Debt servicing will remain on target because of significantly improved debt management. Increase in defense expenditure is also projected to be limited. However, large increases projected in development expenditure, and in salaries and pensions of government servants, will contribute to a higher fiscal deficit in FY2006, although it will remain below 4.0 percent of GDP.

*The agriculture growth is projected at about 3.0 percent in FY2006.*

Imports are projected to grow at a double-digit rate of about 18 percent in FY2006

5. CPI increased by 8.7 percent in the first two months of FY2006 compared with the same period of FY2005.

*High oil prices can have a negative impact on the Pakistan economy.*

because of continuing high GDP growth rate, high oil prices, and planned import of wheat and other essential food items.[6] Exports are expected to benefit from liberal incentives for export industries announced in the FY2006 budget, the textile industry's restructuring and modernization over the past several years, and the ending of textile quotas since January 2005. However, because of the expected slow down of the global economy, export growth will decelerate to about 15 percent and the trade deficit will widen further to about $5.8 billion.[7] The deficit on the services account is also expected to increase due to higher expenditure on shipping and lower receipts from the US for logistic support for the war in Afghanistan. As a result, the current account deficit will increase to about $3.5 billion, or 2.8 percent of GDP, though its financing is not expected to present a problem because of anticipated substantially larger privatization related FDI in FY2006.

With sound macroeconomic fundamentals, government's pro-growth policies, pick up in private investment, and increase in development expenditure, medium-term prospects for the Pakistan economy look good. Improved relations with India and possible increase in bilateral trade will also boost growth in the medium term. Reduction of external security concerns in the region is also likely to promote foreign investment. It is projected that the high economic growth will be sustained, inflation will be brought down, the fiscal deficit will be kept below 4.0 percent of GDP, and the current account deficit will be contained at 2.5-3.0 percent of GDP.

High oil prices can have a negative impact on the Pakistan economy, necessitating revisions in a number of projections given above. If oil prices continue to remain at the current record high level, or rise further, projections for imports, fiscal deficit, and inflation may have to be revised upward. High oil prices could also adversely affect the global economy, resulting in lower growth of Pakistan's exports.

6. Imports increased by 44.3 percent in the first two months of FY2006. However, it is too short a period to serve as a basis for the full-year projection of imports.
7. Exports increased by 13.0 percent in the first two months of FY2006.

## II. POVERTY REDUCTION

**Poverty Reducing Public Expenditures:** Over the last three years, the Government has consistently increased pro-poor public expenditure under its poverty reduction strategy initially spelled out in the Interim Poverty Reduction Strategy Paper (PRSP) released in February 2001 and later in the Full PRSP. PRSP has identified 17 sectors, expenditure on which has the greatest positive impact on poverty.[8] Public expenditure on these sectors increased from 3.8 percent of GDP in FY2002 to 4.7 percent in FY2004.

PRSP expenditures continued to increase rapidly in the first three quarters of FY2005. At Rs 192.5 billion, they represented a 23.2 percent increase over the same period of FY2004 (see table 11). As a percentage of GDP, PRSP expenditures increased from 2.8 to 2.9.[9] Their share in total public expenditure increased from 24.9 percent to 25.1 percent.

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, except safety nets, recorded increases in the first three quarters of FY2005, with the sharpest increase being in expenditure on access to market and community services (73.9 percent), followed by development of rural areas (59.5 percent), and governance (24.7 percent). Expenditure on human development increased by only11.5 percent. There was a decline of 18.1 percent in expenditure on social safety nets.

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 may be considered core areas. Total expenditure in these sectors, at Rs 112.0 billion, represented an increase of 12.3 percent compared with the first three quarters of FY2004, which was much lower than the overall increase in PRSP expenditure.

*The Government has consistently increased pro-poor public expenditure over the last three years.*

Expenditure on education, which accounts for 42.6 percent of the total pro-poor expenditure, increased by 11.9 percent to Rs 74.4 billion in the first three quarters of FY2005. As a percentage of GDP, it declined from 1.2 to 1.1. Except general universities and secondary schools, expenditure on other levels/types of education increased only modestly or declined. Current expenditure on general university education increased sharply by 48.9 percent, and expenditure on secondary education increased by 18.4 percent, while expenditure on primary education increased by only 11.0 percent. Expenditure on professional universities declined to less than half of its last year's level.

Expenditure on health increased by 12.9 percent to Rs 19.3 billion. The sharpest increase of 20.2 percent was recorded in expenditure on preventive health care measures, which accounted for more than one-fifth of the increase in total expenditure on health. The increase in expenditure on preventive health measures was mainly due to more than five-fold increase in development expenditure by the Government of Balochistan and a 30.2 percent increase in current expenditure by the Federal Government. The latter was mainly on lady heath workers, who provide basic and preventive health care facilities in rural areas.

*PRSP expenditure increased by 23.2 percent in the first three quarters of FY2005.*

8. 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, administration of justice, and law and order.
9. In computing these percentages, GDP for full year has been used as denominator and poverty related public expenditure for only three quarters of the year as numerator.

### Table 11: PRSP Expenditures (Billion Rs)

| | | | | July - March | |
|---|---|---|---|---|---|
| | **FY2002** | **FY2003** | **FY2004** | **FY2004** | **FY2005** |
| | | | Access to Market and Community Services | | |
| Roads | 6.3 | 13.1 | 22.7 | 8.5 | 16.6 |
| Water Supply & Sanitation | 4.6 | 3.4 | 5.8 | 3.0 | 3.4 |
| **Sub-Total** | **10.9** | **16.6** | **28.5** | **11.5** | **20.0** |
| | | | Human Development | | |
| Education | 66.3 | 78.4 | 97.7 | 66.5 | 74.4 |
| Health | 19.2 | 22.4 | 27.0 | 17.1 | 19.3 |
| Population Planning | 1.3 | 3.1 | 4.7 | 2.7 | 2.5 |
| **Sub-Total** | **86.8** | **103.9** | **129.4** | **86.3** | **96.2** |
| | | | Development of Rural Areas | | |
| Irrigation | 10.1 | 15.5 | 22.5 | 12.1 | 21.3 |
| Land Reclamation | 1.8 | 1.7 | 2.0 | 1.3 | 1.7 |
| Rural Development | 12.3 | 16.9 | 18.6 | 8.1 | 9.2 |
| Village Electrification | - | - | - | - | 2.1 |
| **Sub-Total** | **24.2** | **34.2** | **43.1** | **21.5** | **34.3** |
| | | | Social Safety Nets | | |
| Social Security & Welfare | 3.7 | 1.3 | 4.1 | 2.3 | 3.2 |
| Natural Calamities/Disasters | 0.2 | 0.4 | 0.5 | 0.4 | 0.4 |
| Food Subsidies | 5.5 | 10.9 | 8.5 | 4.3 | 1.2 |
| Food Support Program | 2.0 | 2.0 | 2.8 | 2.0 | 2.7 |
| Low Cost Housing | - | - | - | 0.4 | 0.2 |
| Tawana Pakistan | 0.8 | 0.8 | - | - | - |
| **Sub-Total** | **12.2** | **15.4** | **16.0** | **9.4** | **7.7** |
| | | | Governance | | |
| Administration of Justice | 2.0 | 2.2 | 2.4 | 1.7 | 2.1 |
| Law and Order | 31.0 | 36.3 | 39.4 | 25.8 | 32.2 |
| **Sub-Total** | **33.0** | **38.5** | **41.8** | **27.5** | **34.3** |
| **Grand Total** | **167.1** | **208.5** | **258.8** | **156.2** | **192.5** |
| **GDP (Current MP)** | **4,401.7** | **4,822.8** | **5,532.7** | **5,532.7** | **6,547.6** |
| **Total PRSP Expenditure as % of GDP** | **3.8** | **4.3** | **4.7** | **2.8** | **2.9** |
| **Total PRSP Expenditure as % of Total Public Expenditure** | **19.1** | **23.2** | **28.0** | **24.9** | **25.1** |

Source: PRSP Quarterly Progress Reports. PRSP Secretariat, Finance Division, Government of Pakistan.

Expenditure on general hospitals and clinics, which accounts for 73.1 percent of total expenditure on health, increased by only 10.6 percent. The shift in emphasis from tertiary and curative health facilities to preventive health facilities seen in the first three quarters of FY2005 is a positive development from the point of view of poverty reduction.

Among other categories of pro-poor budgetary expenditure, the Federal Government spent Rs 2.1 billion on rural electrification in the first three quarters of FY2005. No expenditure on this head was reported in FY2004. Rural electrification plays an important role in boosting economy of rural areas where the bulk of the poor live. In the area of governance, expenditure on law and order increased by 24.8 percent to Rs 32.2 billion and that on administration of justice by 23.5 percent to Rs 2.1 billion.

In addition to pro-poor budgetary expenditure, the Government provides safety nets for the poor through transfers from the *Zakat* (an Islamic welfare fund) and Employees Old Age Benefits Institution (EOBI), as well as microcredit disbursed by Khushali Bank (KB) and the Pakistan Poverty Alleviation Fund (PPAF) through its partner non-government organizations. In the first three quarters of FY2005, microcredit disbursed by the PPAF, and KB rose by 69.1 percent to Rs 3.5 billion. Number of their beneficiaries increased by 45.7 percent to 274 thousand. However, disbursement of Zakat declined by 41.3 percent to Rs 2.2 billion and the number of its beneficiaries declined by 12.4 percent to 890 thousand.

*Disbursement of microcredit increased by 69.1 percent to Rs 3.5 billion.*

# III. SPECIAL TOPICS

## A. Federal Budget FY2006

### Introduction

*Slower growth in tax revenues in FY2005 was offset by larger-than-budgeted growth in non-tax revenues.*

As the first budget after the end of the textile quota regime in January 2005, the federal budget for FY2006 focuses on encouraging exports by introducing tax-free regime for major exports, particularly textiles. The budget also continued with the expansionary fiscal stance, initiated last year after focusing on macroeconomic stabilization from FY2000 to FY2004.

The FY2006 budget attempts to promote growth by significantly increasing development spending and by lowering the cost of doing business, particularly in the export sector, through reduction in tariffs and other taxes. The budget also provides for a 16.5 percent increase in poverty-related public expenditure, which reflects the Government's continued commitment to poverty reduction. In addition, the budget has increased the allocation for Khushal Pakistan Program (KPP), under which small development schemes are implemented in rural and low-income urban areas to provide essential infrastructure and generate employment. At a micro level, the budget has attempted to reduce supply-side pressures by waiving import duty on some essential food items.

### Fiscal Outcome FY2005

*Non-tax receipts increased by 30.0 percent.*

**Revenues:** The Federal Government's gross revenue receipts in FY2005 were 8.9 percent higher than the budget estimate for the year (see table 12). Tax revenues were lower than the budget estimate because of lower-than-budgeted collection from petroleum development surcharge. Taxes collected by the CBR exceeded the budget estimate. However, compared with FY2004, they increased by much less than the growth in the nominal GDP, partly reflecting the low buoyancy of the tax system and partly due to liberal tax exemptions announced in last year's budget. Slower growth in tax revenues was offset by larger-than-budgeted growth in non-tax revenues.

CBR tax receipts, which constitute the bulk of government revenues, increased by only 12.7 percent to Rs 588.4 billion, compared with Rs 521.9 billion in FY2004. Receipts from customs showed the highest growth of 28.9 percent and their share in total CBR revenues increased to 19.9 percent from 17.4 percent in FY2004. The general sales tax (GST) increased by only 6.7 percent. Although GST continues to be the largest contributor to tax revenues, its share in total CBR tax receipts has declined in the last two years. Direct taxes also showed only a modest increase of 7.5 percent. Receipts from petroleum development surcharge were only 23.8 percent of receipts from this source last year.

Non-tax revenues in FY2005 exceeded the budget estimate for the year by 71.6 percent, mainly because of receipts from the USA for logistic support for war in Afghanistan, and significant increases in dividends received from public sector enterprises (PSEs), like Pakistan Telecommunication Company Limited and Oil and Gas Development Corporation. In addition, receipts from fees for licenses issued by the Pakistan Telecommunication Authority (PTA) for various telephone services also contributed significantly to increase in non-tax revenues last year. Compared with actuals for FY2004, non-tax receipts showed an increase of 30.0 percent. While increase in dividends from PSEs is a positive development, license fees of PTA and receipts from USA for logistic support are not sustainable sources of revenues.

**Expenditures:** Total expenditure of the Federal Government in FY2005 was 9.3 percent higher than the budget estimate for the

**Table 12: Federal Revenue Receipts ( Billion Rs)**

| | FY2004 | FY2005 | | FY2006 |
|---|---|---|---|---|
| | | Budget Estimates | Revised Estimates | Budget Estimates |
| Gross Revenue Receipts | 770.1 | 796.3 | 867.6 | 927.4 |
| Tax Revenue (Gross) | 583.3 | 654.8 | 624.8 | 732.6 |
| CBR Tax Revenue | 521.9 | 580.0 | 588.4 | 690.0 |
| Direct Taxes | 164.5 | 181.9 | 176.9 | 215.4 |
| Sales Tax | 220.6 | 249.2 | 235.5 | 294.0 |
| Customs Duties | 90.9 | 103.2 | 117.2 | 121.2 |
| Excise Duties | 45.8 | 45.7 | 58.7 | 59.4 |
| Federal Taxes Other Than CBR | 61.4 | 74.8 | 36.4 | 42.6 |
| *Of Which:* | | | | |
| Surcharges | 61.4 | 65.3 | 26.8 | 32.6 |
| Petroleum | 44.6 | 47.5 | 10.6 | 15.9 |
| Gas | 16.8 | 15.0 | 16.2 | 16.6 |
| Non Tax Revenue | 186.8 | 141.5 | 242.8 | 194.8 |
| *Of Which:* | | | | |
| Interest Receipts (Provinces) | 26.1 | 26.0 | 24.6 | 22.6 |
| Interest Receipts (Others) | 39.3 | 28.1 | 33.8 | 28.5 |
| Dividend | 36.1 | 34.8 | 56.8 | 53.0 |
| Defense Services | 42.9 | 11.8 | 52.5 | 12.1 |
| Less Transfers to Provinces | 200.6 | 239.2 | 257.4 | 284.3 |
| Net Revenue Receipts | 569.5 | 557.1 | 610.2 | 643.1 |

Sources: 1. FY2006 Budget Documents.
2. Website of Ministry of Ministry of Finance: http//finance1.finance.gov.pk

year and 23.2 percent higher than the actuals for FY2004 (see table 13). As a percentage of GDP also, expenditure increased to 13.3 from 12.8 in FY2004. Current expenditure increased by 21.8 percent to Rs 719 billion, and was also 10.7 percent higher than the budget estimate for the year. Among major expenditures, defense expenditure exceeded the amount provided in the budget by a wide margin. One of the reasons for overrun in defense expenditure was the military operation against militants in tribal areas during the year. After showing modest increases in the preceding several years, defence expenditure also recorded a sharp increase of 17.3 percent compared with FY2004. However, as percentage of GDP, defence expenditure declined marginally from 3.3 to 3.2 percent, because of high GDP growth. Interest payments on domestic debt was more or less the same as provided in the budget, but 10.1 percent higher than in FY2004 due to rise in interest rates in domestic market. Expenditure on transfer payments increased by 82.3 percent to Rs 119 billion, mainly because of a sharp increase in expenditure on contingent liabilities. Interest payment on foreign debt, however, was lower than both the actuals for FY2004 and budget allocation for FY2005, a possible dividend from the Government policy of pre-paying expensive foreign debt. Federal development expenditure increased by 32.2 percent to Rs 135 billion.

*Defense expenditure exceeded the budget estimate by a wide margin.*

## FY2006 Budget

The FY2006 budget is the second budget in a row to focus on growth rather than fiscal

**Table 13: Federal Expenditures (Billion Rs)**

| | FY2004 | FY2005 | | FY2006 |
|---|---|---|---|---|
| | | Budget Estimates | Revised Estimates | Budget Estimates |
| Total Expenditure | 707.8 | 797.7 | 872.3 | 965.2 |
| Current Expenditure | 590.6 | 649.7 | 719.2 | 761.2 |
| Interest Payments | 196.3 | 214.2 | 210.2 | 236.0 |
| Domestic | 154.8 | 170.2 | 170.5 | 190.2 |
| Foreign | 41.4 | 44.0 | 39.7 | 45.8 |
| Non-Interest Expenditure | 394.3 | 435.5 | 509 | 525.2 |
| *Of Which:* | | | | |
| Defense | 180.4 | 193.9 | 211.7 | 223.5 |
| Transfer Payments | 65.0 | 65.4 | 118.5 | 79.8 |
| Development Expenditure and Net Lending | 117.2 | 148.0 | 153.1 | 204.0 |
| *Of Which:* | | | | |
| Development Expenditure | 102.3 | 148.0 | 135.3 | 204.0 |

Sources: 1. FY2006 Budget Documents.
2. Ministry of Finance Website. www.finance1.finance.gov.pk

stabilization. It envisages a large increase in development expenditure, elimination of tariffs on raw materials used in the manufacture of machinery, tax-free regime for major exports, and reduction in corporate and personal income taxes. The budget also contains measures to boost agriculture by lowering import duties on agricultural machinery and eliminating tariffs on import of raw materials used in poultry feed and on machinery used in meat processing and cotton ginning. The revenues, expenditures, and tax proposals included in the FY2006 Federal Budget are discussed in the following paragraphs.

*The projected increase in tax revenues will have to come mainly from economic growth.*

**Revenues:** The budget envisages CBR tax revenues to increase by 17.3 percent, to Rs 690 billion (see table 12). The estimated increase in tax revenues is about 2 percentage points higher than the projected growth in the nominal GDP for the year. Considering very liberal reductions in rates of income tax, import duties, and GST on export-oriented industries, the increase in tax revenues will have to come mainly from economic growth and as a pay-off to reforms of tax administration carried out in the past few years. However, it may be difficult to realize given that in the past buoyancy of tax revenues has been less than one at time of high GDP growth.[10]

Receipts from surcharges on petroleum and gas are projected to increase by 21.6 percent to Rs 33 billion. Petroleum development surcharge is projected to increase by 50.0 percent mainly because of very low base last year. However, the projected receipts from petroleum surcharge are much lower than seen in the years preceding FY2005, as international oil prices are expected to remain high and it will be difficult for the government to raise domestic prices due to political considerations.

Non-tax revenues for FY2006 are budgeted at Rs 195 billion, significantly lower than Rs 243 billion in the outgoing year. This is mainly due to a 76.9 percent decrease

10. CBR Tax receipts increased by 22.6 percent in the first two months of FY2006, which indicates that tax collection so far has been above the target.

projected in receipts from defense services, most of which come from payments by the United States for logistic support for war in Afghanistan. As in the past, the Government has been conservative in its projections of receipts from this source, assuming that the US war in Afghanistan and their use of Pakistan aviation and other facilities will taper off. So far each year, these receipts have exceeded budget estimates by a wide margin.

**Expenditures:** Total expenditure of the Federal Government in FY2006 has been budgeted at Rs 965 billion, which is 10.6 percent larger than FY2005 (see table 13). Interest payments are projected to increase by 12.3 percent to Rs 236 billion and defence expenditure by only 5.6 percent to Rs 223 billion. With inflation forecast at 8.5 percent, the defence expenditure will decline in real terms. Also, as a percentage of GDP, defence expenditure will decline to 3.0 from 3.2 in FY2005. However, the budget estimate of defence expenditure seems rather low. Subsidies are budgeted to increase sharply by 40.7 percent to Rs 72 billion. The bulk of the increase in subsidies is to go to inefficient, high-cost electricity distribution companies for equalizing electricity tariffs across the country. There is also an almost four-fold increase in allocation for subsidy on wheat.

Development expenditure by the Federal Government is budgeted to increase by 37.8 percent to Rs 204 billion in FY2006, compared with budget estimate for FY2005 (see table 14). The Federal Government's development program for FY2006 envisages large

*Federal development expenditure is projected to increase by 37.8 percent to Rs 204 billion.*

**Table 14: Development Expenditure (Billion Rs)**

| | Budget Estimates | |
|---|---|---|
| **Classification** | **FY2005** | **FY2006** |
| **Federal Programme** | 148 | 204 |
| **Federal Ministries/Divisions** | 96.6 | 136.4 |
| *Of Which:* | | |
| Higher Education Commission | 9.1 | 11.7 |
| Health Division | 6.0 | 9.4 |
| Population Welfare Division | 2.6 | 4.4 |
| Interior Division | 4.9 | 6.6 |
| Law Justice and Human Rights Division | 2.4 | 4.8 |
| Water & Power Division | 20.8 | 35.6 |
| Railways Division | 9.3 | 9.8 |
| **Corporations** | 31.3 | 36.1 |
| WAPDA (Power ) | 13.7 | 15.6 |
| WAPDA-Village Electrification | 0.5 | 0.5 |
| National Highway Authority | 17.1 | 20.1 |
| **Special Programmes** | 8.8 | 17.8 |
| Khushal Pakistan Programme-I | 5.3 | 4.4 |
| Khushal Pakistan Programme-II | 2.5 | 7.5 |
| Khushal Paksitan Fund | 0.0 | 5.0 |
| Provision for Less Developed Areas | 0.0 | 0.9 |
| DERA | 1.0 | 0.0 |
| **Prvincial Programme** | 54.0 | 68.0 |
| **Total PSDP** | 202.0 | 272.0 |

Source: FY2006 Budget Documents.

*Major export industries have been zero-rated for the purpose of the general sales tax.*

increases in expenditure on higher education, population planning, health (mainly lady health workers), law, justice and human rights, law and order, water resource development, and KPP. For instance, allocation for law, justice, and human rights has been almost doubled to Rs 4.8 billion, for health it has been raised by 56.7 percent to Rs 9.4 billion, for water resources development by 71.2 percent to Rs 35.6 billion, and for KPP by 52.6 percent to Rs 11.9 billion.

**Fiscal Measures:** The FY2006 budget has a number of fiscal measures to boost exports and encourage overall economic growth. Prepared in an environment of rising inflation, the budget includes reductions or exemptions from tariffs and other taxes on a number of essential items to boost supply and reduce prices. There are also a number of tax measures to provide relief to common people. We discuss important fiscal measures below.

Major export industries, like textiles, garments, carpets, surgical instruments, sports goods, and leather have been zero-rated for the purpose of GST. The local sales of these industries, however, will be subject to a 3 percent tax (one percent income tax plus two percent GST), if their annual local sale exceeds Rs five million. Import duty on import of all raw materials and other supplies meant for these industries has been abolished. Although the 15 percent import duty on PTA has been retained (because of an existing sovereign guarantee to a foreign investor), all imports and purchases of locally manufactured PTA will be entitled to refund equal to import duty. These are very positive measures, and in the wake of the end of the quota regime in January 2005 they are expected to provide a significant boost to exports, particularly textiles, which account for about two-thirds of country's total exports.

*The Government continued to reduce corporate tax rates for banks and private companies.*

Custom duty on machinery and equipment for industry is currently at 5 percent; the budget has proposed to lower duty of their parts also to the same level. The budget has announced elimination of GST on supply and import of raw materials and parts used in the manufacture of plant and machinery. To encourage electronics industry, the Government has reduced custom duty on raw materials and components used in the manufacture of home appliances like air conditioners, TV sets, washing machines, refrigerators, and computer monitors. To encourage further expansion of telecommunication services, the budget announced the reduction of activation charges for mobile telephone connections from Rs 1,000 to Rs 500.

To boost agriculture and sustain high growth in the sector, the Government has announced a reduction in import duty on tractors from 20 to 15 percent. In addition, import of 2500 tractors will be allowed without duty, and a couple of hundred bulldozers will be imported duty free for leveling land to improve utilization of water in NWFP and Balochistan. Also, import duty on some raw materials, especially vitamins used in the poultry feed, and on machinery and parts used by meat processing and cotton ginning industries have been eliminated.

To facilitate the growth of small and medium enterprises, the budget has abolished GST on services rendered by laundries, drycleaners, and marriage halls. SMEs that transform themselves into companies will be subject to a lower corporate tax rate of 20 percent.

As part of the program, initiated in FY2002, to gradually reduce corporate tax rates to a uniform rate of 35 percent for all types of companies by FY2007, the Government announced further reduction of 2 percentage points in tax rate for private companies other than banks and 3 percentage points for banking companies. The new tax rates are 35 percent for public companies, 37 percent for private companies, and 38 percent for banks. These rates have been brought down to their present level from 38 percent, 48 percent, and 58 percent in FY2001.

In view of persistent shortages and rising prices of meat and other edibles, the budget announced reduction in import duties on such items. Similarly, import duties on 55 plastic products, whose prices have risen in the wake of a sharp rise in petroleum prices, have been reduced. Items of daily use like soap and detergents, which are presently subject to both GST and excise duty, have been exempted from excise.

To provide relief to salaried persons, income tax rates applicable to them have been lowered, with the minimum rate reduced from 7.5 percent to 3.5 percent and the maximum rate from 35 percent to 30 percent. The salaries of government servants have also been increased by 23-29 percent.

The minimum wage for unskilled workers was last fixed at Rs 2,500 per month in October 2001; it has been raised to Rs 3,000, effective from 1st January 2005. Similarly, old age pension for workers of industrial, commercial, and other organization has been raised from Rs 700 to Rs 1,000.

**Tax Reforms:** To simplify excise duty laws and procedures, the Government has replaced the Central Excise Act of 1944 with the new Federal Excise Act 2005. To promote automation of tax collection procedures and also facilitate taxpayers, the Government has allowed them to file various tax returns and statements electronically. Large taxpayer and medium taxpayer units will be set up in major cities for the facility of taxpayers.

### Assessment

The FY2006 budget is a business-friendly and export-oriented budget. By lowering the cost of doing business through reduction in tariffs and other taxes, it will make domestic production more competitive and boost exports. That, together with the large increase in development spending, will encourage investment and help sustain a high rate of economic growth.

The budget almost entirely relies on economic growth to achieve the targeted increase in tax revenues in FY2006, which may not be very realistic, given low buoyancy of the tax system observed in the last several years. Lowering of income tax rates for both individuals and corporate entities and abolition or reduction in import tariffs on number of items will also make it difficult to achieve the tax collection target. The generally held expectation that the real estate transactions will be brought in the tax has not been fulfilled. Also, no significant effort has been made to broaden the tax net through documentation of the economy.

*The FY2006 budget is a business-friendly and export-oriented budget.*

Inflation has emerged as a major challenge for macroeconomic stability. It is proposed to increase the fiscal deficit for the second consecutive year. The cumulative increase in fiscal deficit in FY2005 and FY2006 will be 1.5 percentage points of GDP. Continued slackness in fiscal policy in a high inflation environment can have serious ramifications for future macroeconomic stability.

## B. Poverty Analysis

The main data source for poverty analysis in Pakistan has been the Household Integrated Economic Survey (HIES), and the last survey in this series was carried out in 2001-02.[11] A new data series, named as the Pakistan Social and Living Standard Measurement (PSLM) survey, was launched in 2004, containing the HIES-type consumption module, necessary and sufficient for poverty estimation. Results of the PSLM would be available late this year. It then would be possible to determine the poverty trends between the 2001-02 and 2004-05 period. However, under the new PSLM series, an independent household survey representative at the district level, and based on the Core Welfare Indicators Questionnaire (CWIQ) approach, was also launched in 2004

*Continued slackness in fiscal policy can have serious ramifications for future macroeconomic stability.*

11. The last two rounds of the HIES, 1998-99 and 2001-02, were combined with the Pakistan Integrated Household Survey (PIHS).

and completed in early 2005, with a large sample of 49,376 rural and 27,144 urban households. This CWIQ-PSLM survey, which has not included the HIES-type consumption module, has particularly been designed to collect data for the purpose of monitoring progress in social indicators. Its results have recently become available, and show a significant improvement in social indicators over the last three years (FBS, 2005[12]). This section analyses changes in various indicators pertaining to education, health, and sources of drinking water by comparing two datasets, Pakistan Integrated Household Survey 2001-02 and CWIQ-PSLM 2004-05. Results of the 2003-04 Labour Force Survey have also been discussed briefly in this section to examine the recent trends in unemployment.

## Education

**Primary-level Enrolment:** Gross Enrolment Rate (GER) and Net Enrolment Rate (NER) are the two commonly used measures for assessing the progress in primary-level schooling.[13] The overall increase in primary school GER is impressive, from 72 percent in 2001-02 to 86 percent in 2004-05 (Table 15). A decline in gender gap has also been witnessed; from 22 percent in

**Table 15: Enrolment Rates at Primary Level (Excluding Katchi Class) by Gender, Province and Rural-urban Areas**

| Region and Province | Gross Enrolment Rate | | | | | | Net Enrolment Rate | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2001-02 PIHS | | | 2004-05 PSLM | | | 2001-02 PIHS | | | 2004-05 PSLM | | |
| | Male | Female | Both | Male | Female | Both | Male | Female | Both | Male | Female | Both |
| **Urban Areas** | **94** | **87** | **91** | **107** | **100** | **104** | **57** | **54** | **56** | **66** | **63** | **64** |
| Punjab | 95 | 93 | 94 | 111 | 108 | 110 | 57 | 58 | 57 | 69 | 68 | 68 |
| Sindh | 91 | 78 | 84 | 103 | 94 | 99 | 56 | 50 | 53 | 64 | 59 | 61 |
| NWFP | 100 | 86 | 93 | 100 | 84 | 92 | 59 | 51 | 55 | 58 | 52 | 56 |
| Balochistan | 98 | 75 | 88 | 101 | 86 | 94 | 55 | 41 | 49 | 59 | 53 | 56 |
| **Rural Areas** | **80** | **52** | **66** | **89** | **68** | **79** | **43** | **33** | **38** | **53** | **42** | **48** |
| Punjab | 80 | 61 | 70 | 96 | 82 | 89 | 44 | 38 | 41 | 57 | 50 | 54 |
| Sindh | 69 | 37 | 53 | 70 | 44 | 58 | 41 | 25 | 33 | 45 | 29 | 38 |
| NWFP | 96 | 52 | 74 | 92 | 62 | 78 | 47 | 31 | 39 | 52 | 37 | 45 |
| Balochistan | 73 | 38 | 57 | 79 | 41 | 61 | 36 | 21 | 29 | 41 | 24 | 33 |
| **Overall** | **83** | **61** | **72** | **94** | **77** | **86** | **46** | **38** | **42** | **56** | **48** | **52** |
| Punjab | 84 | 69 | 76 | 100 | 89 | 95 | 47 | 43 | 45 | 60 | 55 | 58 |
| Sindh | 76 | 51 | 63 | 84 | 65 | 75 | 46 | 34 | 40 | 53 | 42 | 48 |
| NWFP | 97 | 56 | 77 | 93 | 65 | 80 | 48 | 33 | 41 | 53 | 40 | 47 |
| Balochistan | 77 | 44 | 62 | 83 | 49 | 67 | 39 | 24 | 32 | 44 | 29 | 37 |

Note: GER = number of children attending primary level (classes (1-5) divided by number of children aged 5-9 years multiplied by 100. NER = number of children aged 5-9 years attending primary level (classes (1-5) divided by number of children aged 5-9 years multiplied by 100. Enrolment in *katchi* is excluded for GER as well asNER.

12. See www.statpak.gov.pk
13. GER = number of children attending 1-5 classes (primary) divided by number of children aged 5-9 years $\times$ 100. NER = number of children aged 5-9 years attending 1-5 classes (primary) divided by number of children aged 5-9 years $\times$ 100. Enrolment in katchi is excluded for GER as well as NER.

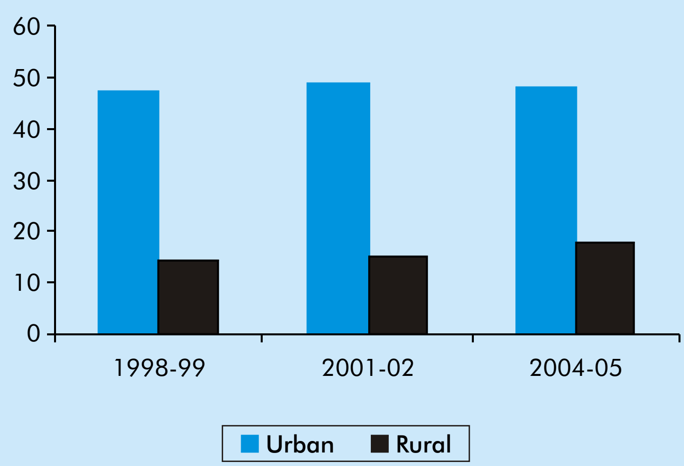
2001-02 to 17 percent in 2004-05. This decline was due to relatively grater increase in female GER (16 percent) than in male GER (11 percent) between the 2001/02 and 2004/05 period. In urban areas, female GER is impressive in all provinces, ranging from 84 percent in NWFP to 108 percent in Punjab. In rural areas, Punjab has made a marked progress, particularly in female GER, which increased from 61 percent in 2001-02 to 82 percent in 2004-05. However, the progress in GER in rural areas of Balochistan, Sindh and NWFP has been rather slow. In rural Sindh, for example, male GER could increase only marginally from 69 percent in 2001-02 to 70 percent in 2004-05 while the corresponding increase in female GER was about 7 percent. Even with this modest increase, female GER in Sindh remained low, only 44 percent in 2004-05. In rural Balochistan, it could increase only marginally from 38 percent in 2001-2 to 41 percent in 2004-05. The progress in female GER was also modest in rural NWFP.

Strong improvement in NER at the primary level (age 5-9) has also been witnessed; it increased by 10 percentage points from 42 percent in 2001-02 to 52 percent in 2004-05. The performance of Punjab, particularly in female NER in rural areas has been impressive, increasing from 38 percent in 2001-02 to 50 percent in 2004-05. The increase in male as well as female NER in the other three provinces has been slow. The better performance of Punjab in NER compared to other provinces has increased the regional disparities. For example, the NER gap between Punjab and Balochistan increased from 13 percent in 2001-02 to 21 percent in 2004-05. This gap of Punjab with Sindh doubled, from only 5 percent in 2001-02 to 10 percent in 2004-05.

The share of private school enrolment in the total primary-level enrolment increased marginally from 26 percent in 2001-02 to 28 percent in 2004-05. However, there are considerable regional (rural/urban) as well as provincial variations in this share. In urban areas, approximately half of the total primary enrolment is in private schools, but it has marginally declined from 49 percent in 2001-02 to 48 percent in 2004-05 (see figure 4). In rural areas, however, private school enrolment as percentage of total primary enrolment increased from 15 percent in 2001-02 to 18 percent in 2004-05. Province-level data show that private schools' share in primary enrolment varies from only 14 percent in urban

*Female GER in rural Punjab increased from 61 percent in 2001-02 to 82 percent in 2004-05.*

**Figure 4: Primary-level Enrolment in Private Schools as Percentage of Total Primary Enrolment 1998/99-2004/05**




Source: PSLM 2004-05.

*Adult literacy rate rose from 45 percent to 53 percent.*

Balochistan to 54 percent in urban Punjab. Only a small proportion of school-going children are enrolled in private schools in rural areas of Sindh and Balochistan, 4 percent and 3 percent, respectively. While in rural areas of Punjab and NWFP relatively greater percentage of children, 23 percent and 17 percent, respectively, are enrolled in private schools. Nevertheless, in rural areas as a whole, where majority of the poor live, public schools remain the main source for primary education.

**Secondary-level Enrolment:** The GER for the middle level has increased from 41 percent in 2001-02 to 46 percent in 2004-05. The increase was same for both male and female. There is a large gap between urban and rural areas in the middle-level GER, 64 percent and 38 percent respectively. Net enrolment rates at the middle level are much lower than GER. This is due to the large number of over age children that are enrolled in these classes. The middle-level NER increased only from 16 percent in 2001-02 to 18 percent in 2004-05. At the matric level, GER stands at 44 percent and NER at 11 percent, with a wider gender gap.

**Adult Literacy:** Adult (10 years and older) literacy rate increased from 45 percent in 2001-02 to 53 percent in 2004-05, according to CWIQ-PSLM (see table 16). Male literacy increased from 58 percent in 2001-02 to 65 percent in 2004-05 while the corresponding increase in female literacy was from 32 percent to 40 percent. Female literacy rates vary from only 13 percent in Balochistan to 35 percent in Punjab. In fact, there wasn't much progress in reducing literacy gaps either between rural and urban areas or between the genders in Balochistan and Sindh.

**Table 16: Literacy Rate**

| Region and Province | 2001-02 PIHS | | | 2004-05 PSLM | | |
|---|---|---|---|---|---|---|
| | Male | Female | Both | Male | Female | Both |
| **Urban Areas** | **72** | **56** | **64** | **78** | **62** | **71** |
| Punjab | 71 | 60 | 66 | 78 | 66 | 72 |
| Sindh | 74 | 54 | 64 | 80 | 62 | 72 |
| NWFP | 70 | 41 | 56 | 75 | 47 | 61 |
| Balochistan | 71 | 36 | 54 | 74 | 42 | 60 |
| **Rural Areas** | **51** | **21** | **36** | **58** | **29** | **44** |
| Punjab | 51 | 26 | 38 | 59 | 35 | 47 |
| Sindh | 51 | 14 | 33 | 56 | 18 | 38 |
| NWFP | 55 | 16 | 35 | 61 | 23 | 41 |
| Balochistan | 49 | 11 | 32 | 47 | 13 | 32 |
| **Overall** | **58** | **32** | **45** | **65** | **40** | **53** |
| Punjab | 57 | 36 | 47 | 65 | 44 | 55 |
| Sindh | 60 | 31 | 46 | 68 | 41 | 56 |
| NWFP | 57 | 20 | 38 | 64 | 26 | 45 |
| Balochistan | 53 | 15 | 36 | 52 | 19 | 37 |

Source: PSLM 2004-05.

## Health

The CWIQ-PSLM provides useful information on the self-reported sickness, use of health services, child immunization coverage, use of ORS during the recent diarrhea episode, pre- and post-natal care and drinking water supply and sanitation. Some of these indicators are discussed below.

**Child Immunization:** In the CWIQ-PSLM, data on child immunization was collected using two methods, 'recall' and 'record'. Under the former method, the full immunization[14] has increased from 53 percent in 2001-02 to 77 percent in 2004-05. This increase is particularly impressive in rural areas, from 46 percent in 2001-02 to 72 percent in 2004-05. As expected, the 'record' method[15] shows a relatively lower rate of full immunization, 49 percent in 2004-05 compared to 77 percent under the 'recall' method. However, there has been an improvement in record-based immunization rate, from only 27 percent in 2001-02 to 49 percent in 2004-05. It is also encouraging to see a significant improvement in immunization coverage in all provinces.

*Child immunization increased from 53% in 2001-02 to 77% in 2004-05.*

**Pre- and Post-natal Consul-tation:** According to CWIQ-PSLM, the proportion of married women who had given birth during the three years preceding the survey and had attended at least one pre-natal consultation has increased from 35 percent in 2001-02 to 50 percent in 2004-05 (see table 17). This attendance rate in 2004-05 was much higher in urban areas (66 percent) than in rural areas (40 percent). However, during the last three years the rural areas have witnessed a substantial increase from 26 percent in 2001-02 to 40 percent in 2004-05. It is encouraging to see an increase in the pre-natal attendance rate in rural areas of all provinces. Also the post-natal attendance rate has improved considerably from only 9 percent in 2001-02

**Table 17: Pre-and Post-Natal Consultation (%)**

| Region and Province | 2001-02 PIHS | | | 2004-05 PSLM | | |
|---|---|---|---|---|---|---|
| | Urban | Rural | Overall | Urban | Rural | Overall |
| **Pre-Natal Consultation** | | | | | | |
| Pakistan | 63 | 26 | 35 | 66 | 40 | 50 |
| Punjab | 64 | 31 | 40 | 67 | 47 | 56 |
| Sindh | 68 | 22 | 38 | 74 | 40 | 55 |
| NWFP | 45 | 19 | 22 | 51 | 35 | 39 |
| Balochistan | 45 | 16 | 21 | 57 | 27 | 35 |
| **Post-Natal Consultation** | | | | | | |
| Pakistan | 16 | 6 | 9 | 34 | 16 | 23 |
| Punjab | 15 | 8 | 10 | 32 | 17 | 23 |
| Sindh | 19 | 6 | 10 | 41 | 16 | 27 |
| NWFP | 8 | 4 | 4 | 29 | 17 | 21 |
| Balochistan | 16 | 5 | 7 | 32 | 10 | 16 |

Source: PSLM 2004-05

14. Full immunization of a child includes 8 recommended vaccines BCG, DPT1, DPT2, DPT3, Polio1, Polio2, Polio3 and measles.
15 Under this method, respondents are asked to show the immunization cards to write down the information.

*Percentage of rural households with access to tap water increased from 10 to 23 percent.*

to 23 percent in 2004-05, with relatively higher rates in urban areas. In both rural and urban areas, the three most commonly consulted sources for pre-natal as well as post-natal care are private hospitals/clinics, government hospitals/clinics and Traditional Birth Attendants (TBAs). The last three years have witnessed an increase in the pre-natal consultation through TBAs and Lady Health Workers (LHWs). Data by quintile is not available, but poor women are more likely to utilize the services of TBAs and LHWs.

## Sources of Drinking Water

The CWIQ-PSLM provides information on main sources of drinking water including 'tap water', 'hand pumps' and 'motor pumps', 'dug wells' and 'other sources'. There is a positive shift in rural areas from 'hand pumps' to 'tap water'. In 2001-02, 10 percent of rural households reported the 'tap water' as their main source of drinking water and this percentage increased to 23 in 2004-05, with a decline in the use of hand pumps (see table 18). This shift from 'hand pumps' to 'tap water' has been witnessed in rural areas of three provinces, Punjab, Sindh and Balochistan. In rural as well as urban NWFP the access to 'tap water' is still higher than in other provinces. The use of 'motor pumps' as the source of drinking water has substantially increased in rural Punjab, from 19 percent in 2001-02 to 29 percent in 2004-05. While all these developments regarding the access to drinking water are positive and encouraging, there is a one major concern. A considerable proportion of households in rural Balochistan (69 percent) and NWFP (44 percent) still get the drinking water from dug wells, rivers, ponds etc.

*About half of the households perceived no change in their economic situation.*

## Change in Economic Condition: Household Perception

In the CWIQ-PSLM, a simple qualitative question was asked from the sampled households about their perception regarding change in their economic situation during the year preceding the survey. As the answer to this question is subjective, it cannot be considered as a substitute for poverty estimates based on income or consumption data. However, the perception of people can be a lead indicator for poverty monitoring. Thus the inclusion of a simple qualitative question in the CWIQ-PSLM concerning the change in economic condition is a useful addition. These types of questions can be added in labor force and/or demographic surveys in order to get the feedback (people's perception) more frequently.

According to the 2004-05 CWIQ-PSLM, in both rural and urban areas, half of the households perceived no change in their economic situation during the year preceding the survey (see table 19). However, 27 percent of households in urban areas and 22 percent in rural areas reported an improve-

**Table 18: Main Sources of Drinking Water (Percentage Distribution)**

| Source of Drinking Water | 2001-02 PIHS | | | 2004-05 PSLM | | |
|---|---|---|---|---|---|---|
| | Urban | Rural | Overall | Urban | Rural | Overall |
| Tap Water | 58 | 10 | 25 | 60 | 23 | 39 |
| Hand Pump | 14 | 56 | 44 | 13 | 39 | 27 |
| Motor Pump | 22 | 14 | 17 | 22 | 14 | 18 |
| Dug Well | 2 | 10 | 7 | 2 | 9 | 6 |
| Other | 3 | 10 | 7 | 3 | 16 | 10 |
| Total | 100 | 100 | 100 | 100 | 100 | 100 |

Source: PSLM 2004-05.

**Table19: Perception of Change in Economic Situation (% of Households)**

| Rural/Urban | Much Worse | Worse | Same | Better | Much Better | Don't Know | Total |
|---|---|---|---|---|---|---|---|
| **Urban Areas** | 3.59 | 18.73 | 50.51 | 23.97 | 2.71 | 0.49 | 100 |
| Punjab | 3.06 | 18.24 | 48.37 | 26.75 | 3.08 | 0.49 | 100 |
| Sindh | 4.16 | 18.41 | 52.99 | 21.43 | 2.64 | 0.38 | 100 |
| NWFP | 5.36 | 23.85 | 44.88 | 23.32 | 2.13 | 0.45 | 100 |
| Balochistan | 2.25 | 15.42 | 63.95 | 16.1 | 1.36 | 0.93 | 100 |
| **Rural Areas** | 4.49 | 20.66 | 52.27 | 20.42 | 1.81 | 0.36 | 100 |
| Punjab | 3.54 | 19.33 | 50.78 | 23.63 | 2.47 | 0.26 | 100 |
| Sindh | 6.24 | 22.61 | 58.09 | 11.9 | 0.93 | 0.23 | 100 |
| NWFP | 4.81 | 23.06 | 41.24 | 28.28 | 2.2 | 0.41 | 100 |
| Balochistan | 3.88 | 18.05 | 61.61 | 14.83 | 0.81 | 0.81 | 100 |
| **Overall** | 4.1 | 19.82 | 51.51 | 21.96 | 2.2 | 0.41 | 100 |
| Punjab | 3.31 | 18.81 | 49.62 | 25.13 | 2.76 | 0.37 | 100 |
| Sindh | 5.23 | 20.58 | 55.63 | 16.51 | 1.76 | 0.28 | 100 |
| NWFP | 4.99 | 23.31 | 42.39 | 26.71 | 2.18 | 0.42 | 100 |
| Balochistan | 3.42 | 17.3 | 62.28 | 15.19 | 0.97 | 0.85 | 100 |

Source: PSLM 2004-05.

ment in their economic situation compared to the last year condition. A considerable proportion of rural (25 percent) as well as urban households (22 percent) also reported worsening of their economic situation during the year preceding the survey. Provincial variations are interesting as well. For example, about half of the households in Punjab and 56 percent in Sindh perceived no change in their economic condition. In Balochistan, more than 60 percent of households perceived that their economic condition remained the same while the corresponding ratio in NWFP was only 42 percent. In rural Sindh, more households (29 percent) reported worsening of their economic condition as compared to households reporting improvement (13 percent) in their condition. A similar situation has been observed in rural Balochistan. In rural NWFP, 30 percent of households reported their economic condition as being better than last year, but 28 percent of the sampled households perceived that their condition has worsened over time. A similar pattern has been observed in Punjab. However, based on these simple statistics, it is not possible to relate the change in economic condition with poverty status of the reporting households. Analysis of the people's perception data by quintile would give a better idea about this change.

## Employment

Poverty and employment are strongly related. Overall unemployment rate increased between the 1997-98 and 2001-02 period. The last labor force survey, carried out in 2003-04, has witnessed a modest decline in unemployment, from 8.3 percent in 2001-02 to 7.7 percent in 2003-04 (see table 20). Change in the unemployment rates varies between rural and urban areas. The female unemployment rate declined in rural as well as urban areas while for male a modest decline was observed

*Unemployment declined from 8.3 percent in 2001-02 to 7.7 percent in 2003-04.*

*About 30 percent of the unemployed have 10 or more years of education.*

in only rural areas. In urban areas the male unemployment rate in fact increased from 7.9 percent in 2001-02 to 8.4 percent in 2003-04. Age-specific unemployment rates among males and females for 2001-02 and 2003-04 period show that women's unemployment has consistently been on decline across the constituent age intervals. But, men's unemployment rate increased among 20-44 years old.

The overall unemployed labor force has declined slightly between the 2001/02 and 2003/04 period. It is a welcome news and it would help in poverty reduction. However, at present the total unemployed labor force, 3.48 million, is still more than double of the unemployed labor force in 1990. More than a million unemployed or approximately 30 percent of the total unemployed stock have had 10 or more years of education. A considerable proportion of the educated unemployed are degree holders. Data on unemployment for the 2004-05 period are not available. However, the unemployment trends between the 1999/2000 and 2003/04 period show that growth has not generated sufficient employment opportunities to absorb the increasing labor force in the country.

To sum up, CWIQ-PSLM survey shows a significant improvement in social indicators over the last three years. There was a substantial increase in primary school enrolment and literacy rates. Gender gaps in these two indicators have also narrowed over time. These improvements have largely been observed in Punjab; thus there was a widening of regional differences. Regarding the health sector, the analysis shows that both the child immunization coverage and pre- and post-natal attendance rates have increased in all provinces. Overall use of 'tap' water has increased, however, a considerable proportion of households in rural Balochistan and NWFP still get the drinking water from dug wells, rivers, and ponds. People's perception about change in their economic condition gives a mixed picture. Recent decline in overall unemployment has resulted in reduction in the total stock of unemployed labor force.

**Table 20: Unemployment Rate (%) by Gender and Rural-urban Areas (10 Years and Above)**

| Urban/Rural Areas | 2001-02 | | | 2003-04 | | |
|---|---|---|---|---|---|---|
| | Both | Male | Female | Both | Male | Female |
| Pakistan | 8.3 | 6.7 | 16.5 | 7.7 | 6.6 | 12.8 |
| Urban | 9.8 | 7.9 | 24.2 | 9.7 | 8.4 | 19.8 |
| Rural | 7.6 | 6.1 | 14.1 | 6.7 | 5.7 | 10.9 |

Source: Labor Force Survey 2001-02 and 2003-04.