Chapter 4

Fiscal and Monetary Developments

With a view to laying a solid base for sustainable economic growth, higher investment and improved levels of productivity, wide-ranging fiscal reforms and stabilization measures were introduced in the last seven years. On the revenue side, comprehensive tax and tariff reforms are backed by improved tax administration. The driving philosophy behind the reforms relates to reducing the tax rates and broadening the tax base by netting the hitherto untaxed or under-taxed sectors. At the same time it aims at shifting the incidence from imports and investment to consumption and income. The reduction in tax rates is intended to stimulate production and investment on the one hand, and promote voluntary tax compliance on the other. On the expenditure side, tight expenditure policies were pursued. The rationalization of current expenditure has substantially reduced the wasteful expenditure and resulted in creating the fiscal space which finally helped to increase the size of development allocations for social and pro-poor sectors.

The government successfully contained the growth of wasteful expenditure. Various economy measures and strict discipline and control enforced on non-development expenditure resulted in rationalization of public expenditure. Both the revenue as well as expenditure measures led to lower fiscal deficit thus lending stability to the economy. The above measures resulted in lowering the overall fiscal deficit from 5.4 percent of GDP in 1999-00 to 4.2 per cent in 2006-07.

Fiscal Policy

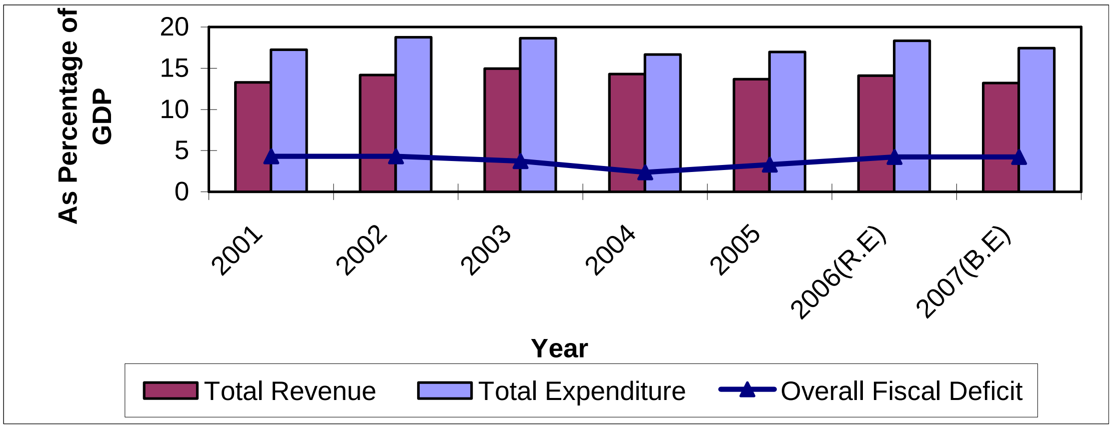
The Medium Term Development Framework (MTDF) (2005-10) envisages an integrated approach to development. The MTDF proposes an appropriate mix of policy measures in the area of revenue collection and taxation. Budgetary policy in coordination with monetary and exchange rate policies have been implemented for improving quality of life and living standards. The policy stance in the area of revenue collection and reform in taxation system led to generation of sufficient funds for enhancing the share of social, economic and community services and poverty reduction programs. The MTDF in the last two years has achieved most of its objectives.

The fiscal accounts of the government considerably improved in recent years. Revenues are buoyant, expenditures are rationalized. Revenue deficit is eliminated and public debt and fiscal deficit are at sustainable level. A milestone has been established by setting the unprecedented level of Public Sector Development Program (PSDP) of Rs 435 billion (4.9 percent of GDP) in 2006-07 from Rs 89.8 billion (2.2 percent of GDP) in 2000-01. Higher development expenditures were made in social and physical infrastructure sectors.

The trends in total government expenditure, total government revenue and overall fiscal deficit as percentage of GDP show a continuous decline. The overall deficit at 8.8 percent in 1990-91 came down to 4.2 percent of the GDP in 2006-07. This decline in fiscal deficit is due to faster increase in total revenue (34 percent per annum) as compared to relatively slow increase in total expenditure (29 percent per annum). Details are given in Figure 4.1.

Figure 4.1: Trends in Government Expenditure, Revenues and Fiscal Deficit

(% of GDP)

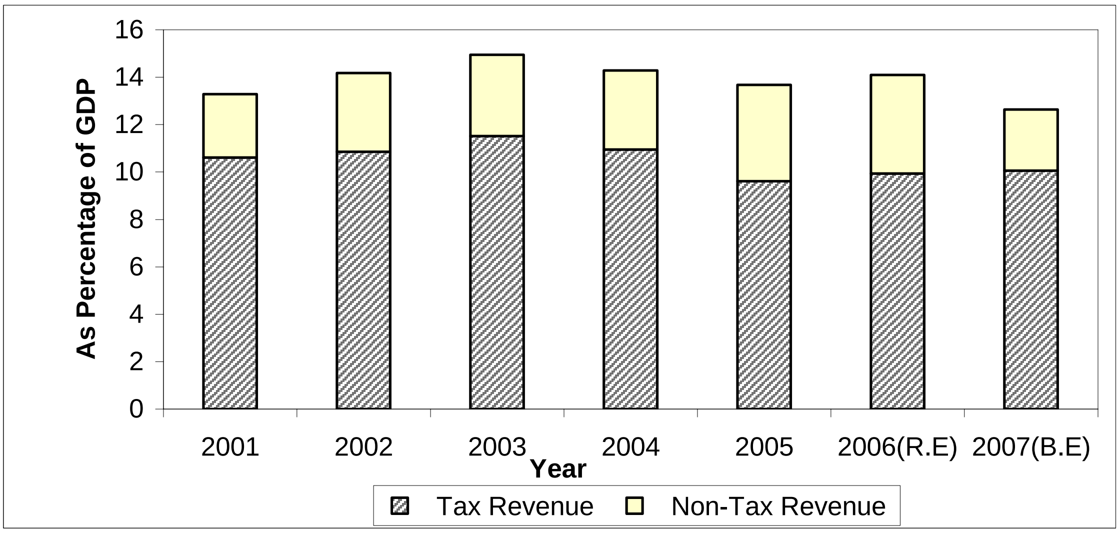


Source: Statistical Supplement Pakistan Economic Survey 2005-06

The trends in government revenue collection i.e. total revenue; tax revenue and non-tax revenue are reflected in Figure 4.2. An analysis of the trends suggests that total revenue, tax revenue and non-tax revenue since 2000-01 are respectively hovering around 13-14, 9.5-10.5 and 3-4 percent of the GDP. Non-tax revenue however, dipped to 3.1 percent of GDP in 2006-07.

Figure 4.2: Trends in Revenue Collection

(% of GDP)

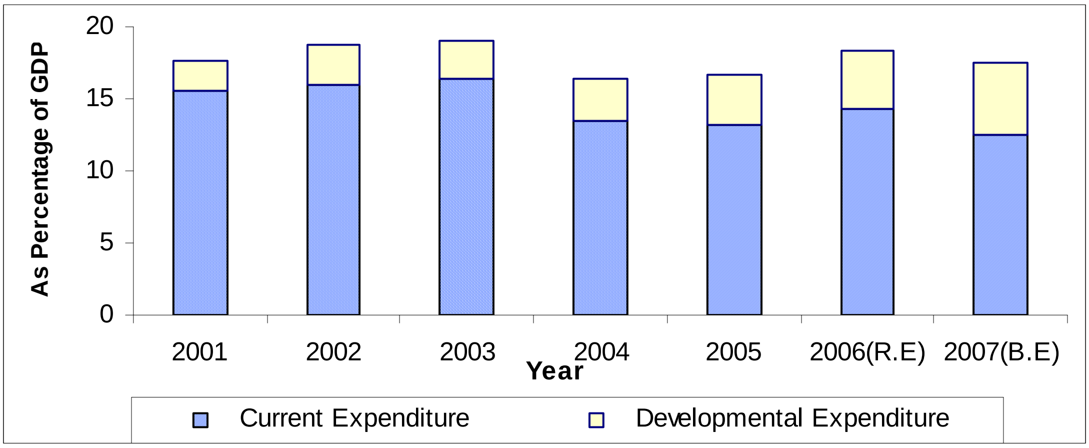


Source: Statistical Supplement Pakistan Economic Survey 2005-06

The total expenditure on an average remained around 18 percent of GDP during 2000-07, current expenditure decreased and that of development outlay as a percentage of GDP increased during this period. Development expenditure after falling from 2.5 percent in 1999-2000 to 2.2 percent of GDP in 2001-02 increased gradually to 4.9 percent in 2006.07 (Figure 4.3).

Figure 4.3: Trends in Government Expenditure

(% of GDP)



Source: Statistical Supplement Pakistan Economic Survey 2005-06

In the last seven years, the pro-poor expenditure has increased rapidly from Rs 180 billion (4 percent of GDP) in 2000-01 to Rs 464 billion (6 percent of GDP) in 2005-06. The public expenditure on social sectors has also risen from Rs 103 billion in 2001-02 to Rs 228 billion in 2005-06 reflecting an increase of 22 percent per annum. As a result, poverty has declined significantly from 34 percent in 2001 to 24 percent in 2005. Unemployment rate has declined from historically high level of 8.3 percent in 2001-02 to 6.2 percent in 2005-06 and social sector indicators have improved in recent years.

Fiscal Developments 2006-07

The consolidated budget for 2006-07 aimed at maintaining the fiscal deficit at 4.2 percent of the GDP. The government revenues have been estimated to rise by 7.0 percent from Rs 1087 billion to Rs 1163.0 billion in 2006-07. The resource mobilization through taxes is estimated to rise from Rs 441.6 billion in 2000-01 to Rs 885.7 billion in 2006-07

The government expenditure in 2006-07 is estimated to increase by 114.0 percent over the expenditure incurred in 2000-01 from Rs 717.9 billion to Rs 1536.6 billion. The expenditure on Public Sector Development Program (PSDP) financed from the budget is estimated to increase by 384.0 percent from Rs 89.8 billion in 2000-01 to Rs 435.0 billion in 2006-07.

About 54 percent of the estimated fiscal deficit of Rs 373.5 billion for FY 2006-07 will be financed by domestic borrowing. Of the internal financing of Rs 201.7 billion, the bank borrowing is estimated at Rs 140 billion and the non-bank borrowing including privatization will be Rs 61.7 billion. The external borrowing (net) is estimated at Rs 171.7 billion.

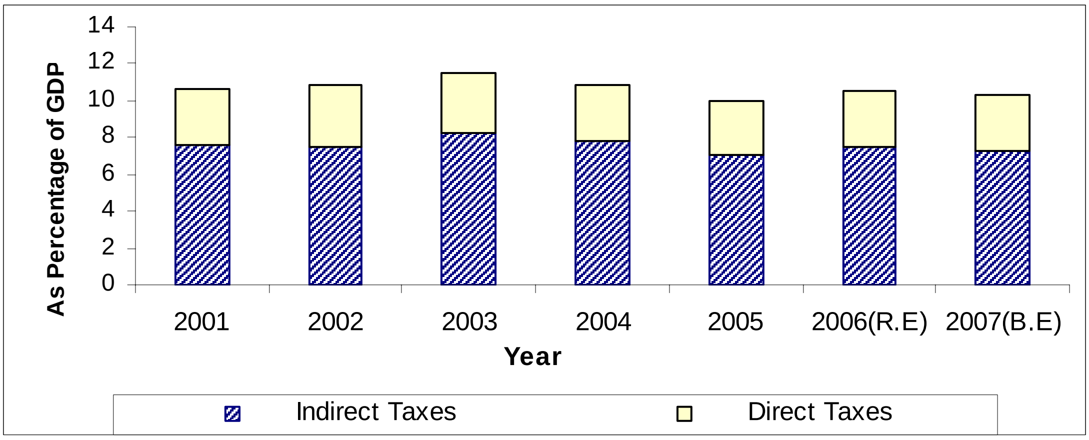
The implementation of the 2006-07 Budget indicates that the target of government revenue and expenditure would be met. The tax collection by CBR is expected to be higher than the target, fixed at Rs 835.0 billion for the year.

During July-April 2006-07, the CBR collected Rs 646.9 billion as against Rs 547.0 billion during corresponding period of 2005-06 up by 18.3 percent. It constitutes 77.5

percent of the full year target of Rs 835.0 billion. The increase in CBR taxes mainly comes from the direct taxes. The collection under this head amounted to Rs 249.3 billion during July-April, 2006-07 against Rs 167.6 billion collected during July-April, 2005-06 showing an increase of 48.8 percent. Under indirect taxes an amount of Rs 397.6 billion has been collected during July-April 2006-07 against Rs 379.4 billion collected during the same period in 2005-06, showing an increase of 4.8 percent. Within the indirect taxes, the main increase is in federal excise (17.8 percent) followed by sales tax (6.2 percent). The ratio of direct to indirect taxes which was 44 percent in July-April 2005-06 has increased to 62 percent in July-April 2006-07. This implies that the tax structure is moving towards better and progressive direction. Trends in tax collection since FY01 are reflected in Figure 4.4, while details of CBR revenue collection are given in Table 4.1 below.

Fig: 4.4: Trends in Tax Collection

(% of GDP)



Source: Statistical Supplement Pakistan Economic Survey 2005-06

Table 4.1: FEDERAL TAX COLLECTION BY CBR (July – April, 2006-07)

(Rs billion)

Heads	2005-06	2006-07 (Targets)	Collection July – April			Collections as % of full year target
			2006-07	2005-06	% Change	
Direct Taxes	**224.6**	**264.7**	**249.3**	**167.6**	**48.8**	**94.2**
Indirect Taxes	**487.9**	**570.3**	**397.6**	**379.4**	**4.8**	**69.7**
Sales Tax	294.6	343.8	242.7	228.5	6.2	70.6
Federal Excise	55.0	69.0	53.5	45.4	17.8	77.5
Customs	138.3	157.5	101.4	105.5	-3.9	64.4
Total:	**712.5**	**835.0**	**646.9**	**547.0**	**18.3**	**77.5**

Source: Revenue Division/CBR

Box 4.1 Tax Administration Reform Program (TARP)

To build a modern tax system and an effective tax administration in Central Board of Revenue (CBR) that facilitates and improves voluntary tax compliance and to increase tax revenues by improving the effectiveness, responsiveness and efficiency of the tax administration through institutional and procedural reforms.

Therefore the initiatives under the Tax Administration Reform Program (TARP) include, inter alia, the implication of universal self-assessment, creation of a functional organization, building of a taxpayer service function, use of modern work layout for conducting tax administration, creation of database for management reporting, audit selection, statistical analysis, and automation in CBR and its field formations. The following actions have been completed by CBR so far.

- One Large Taxpayers Unit (LTU), was set up in Karachi on 1st July, 2002. Another LTU was also established in June, 2005. All the federal domestic taxes administered by the CBR are being dealt under one roof in LTUs. This is a giant step towards facilitation of the taxpayers. Similarly, to address the issues of medium and small income taxpayers, an MTU at Lahore was established. Acknowledging the success of the MTU Lahore, five more MTUs at Rawalpindi, during 2005 and 2006. As indicated earlier, these six MTUs Regional Tax Offices (RTOs) to be established during 2006 and 2007. The nine additional RTOs will be located at Hyderabad, Sukkur, Multan, Lahore. Gujranwala, Sialkot, Islamabad, Sahiwal and Abbottabad.

- Electronic Compliance Mechanisms filing of statements of withholding taxes has been routed through electronic media at LTU, Karachi.

- A Custom Administration Reform Project (CARE) to modernize customs clearances. In this regard, a pilot project was launched in April, 2005 by the Prime Minister of Pakistan. The program shall be rolled out at 11 Model Customs Collectorate during FY06-07 and FY07-08 including four regional hubs.

- Sales Tax Automated Refund Repository (STARR) software has been developed which has streamlined the process of issuance of sales tax refunds. The system has been upgraded and now refunds claims are processed through Risk-based Refund Analysis System (RRAS).

With the introduction of a modern tax system backed by state-of-the-art information management system, it is expected that the objectives of raising direct tax collection and improvement in tax/GDP ratio would be achieved.

Source: CBR Year Book 2005-06

Monetary and Credit Policy

The major objectives of monetary and credit policies are to keep monetary expansion commensurate with the expansion of real economic activity, contain inflationary pressure to a reasonable level and to cater to the credit needs of the priority sectors. To achieve these objectives, financial sector reforms by the Government aim to correct the distortions implicit in the administered structure of rates of return on various financial instruments, to ensure availability of adequate credit to the private sector, to facilitate the productive sectors, to enhance competition and efficiency in the financial system and to strengthen the supervisory role of the State Bank of Pakistan. Since 1999-00 a number of prudential measures improved the efficiency of the financial institutions, enhanced the recovery of defaulted loans and restructured public sector banks in terms of organizational strength and branch network.

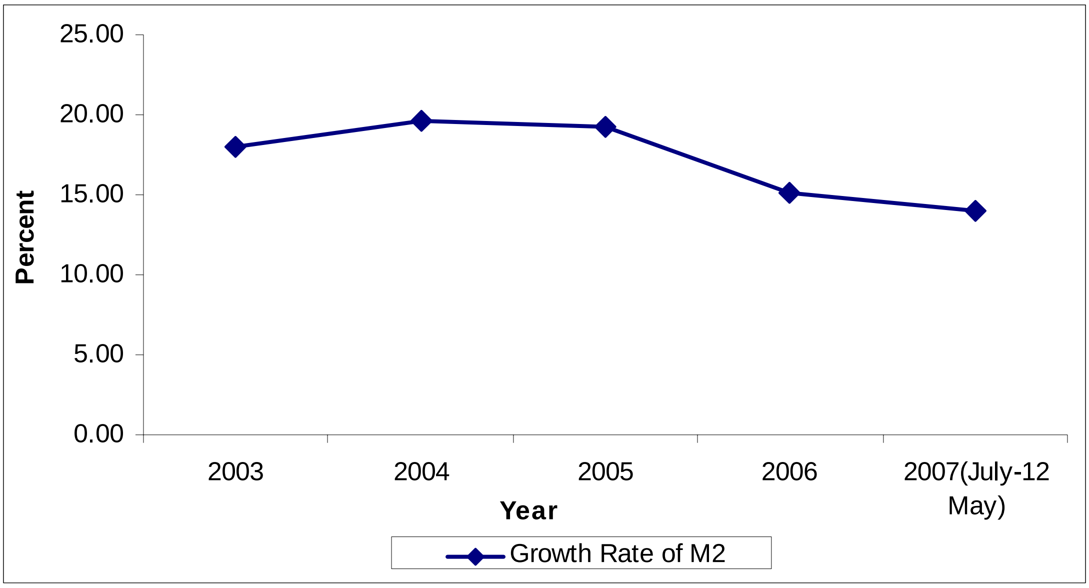
Review of Credit Plan 2006-07

The Credit Plan for the fiscal year 2006-07 envisaged growth in money supply (M2) at 13.5 percent (Rs 459.9 billion), which was based on the assumption of a GDP growth target of 7.0 percent and inflation rate target of 6.5 percent for the year. The net domestic assets were estimated to grow by Rs 450 billion or 13.2 percent. The credit to government sector for budgetary support was targeted at Rs 120 billion and credit to private sector at Rs 390 billion. The net foreign assets of the banking system were envisaged to exert an expansionary effect to the tune of Rs 9.8 billion.

The monetary expansion during July 1, 2006 to May 12, 2007 stood at Rs 477.9 billion (13.99 percent) as against the full year target of 13.5 percent and an expansion of 12.1 percent during the corresponding period for 2005-06. Although, the overall money supply growth is higher than the corresponding period of the 2005-06, it is, however, showing significant declining trend since 2005 due to tight monetary policy. (Fig 4.5).

Fig: 4.5 Growth Rate of Money Supply

(Percent)



The government borrowing for budgetary support has already crossed the full year limit by 77 percent. This expansion (Rs 212 billion) is 188.6 percent higher than the expansion taking place in the corresponding period of 2005-06. Demand for the private sector credit during the first ten months shrunk by 22.5 percent to Rs 263.4 billion as against Rs 339.9 billion during the corresponding period last year. The expansion in credit to private sector is 67.5 percent of the annual target. The net foreign assets expanded to the tune of Rs 88.2 billion as against Rs 43.8 billion during the corresponding period last year. This is due to rising foreign investment inflows and a record level of remittances ($ 4.45 billion) from Pakistanis abroad during July 06-April 07. Details of Credit Plan for 2006-07 and its implementation during 1st July 2006 to 12th May 2007 are given in Table 4.2 below.

Table: 4.2 Credit Plan and its Implementation

(Rs Billion)

	Credit Plan 2006-07	Implementation	
		1st July 06 to 12-May-2007 P	1st July 05 to 13-May-06
1. Government Sector (a+b+c)	**130.1**	**185.5**	**63.9**
a) Net Budgetary borrowing	120.1	212.0	73.5
b) Commodity Operations	10.0	-26.4	-8.9
c) Others	-	-0.1	-0.7
II. Non-Government Sector (a+b+c)	**395.0**	**274.0**	**344.0**
a) Credit to Private Sector	390.0	263.4	339.9
b) Credit to PSEs including Autonomous Bodies	5.0	10.2	5.4
c) Other Financial institutions (SBP credit to NBFIs)	-	0.4	-1.3
III. Other Items (Net)	**-75.0**	**-69.8**	**-93.5**
IV. Net Domestic Credit Expansion	**450.1**	**389.7**	**314.4**
V. Net Foreign Assets	**9.8**	**88.2**	**43.8**
VI. Monetary Expansion	**459.9**	**477.9**	**358.2**
(% Change)	**(13.46%)**	**(13.99%)**	**(12.08%)**

P: Provisional
Source: State Bank of Pakistan

The banking spread (average lending rate minus average deposit rate) increased from 7.15 in July 2006 to 7.5 percent in December 2006. Although it declined to 6.63 percent in Mach 2007 but it is still very high and has negative implication for domestic savings.

Inflation

The rate of inflation (CPI) for the year 2006-07 was targeted at 6.5 percent this target is to be achieved by adequate supply of essential commodity items and tight monetary policy to ensure price stability. Based on July – April 2006-07 data, the annualized rate of inflation is 7.9 percent as against 8.0 percent during the corresponding period last year. It is estimated that the rate of inflation for year 2006-07 at around 7.7 percent will exceed the target.

Box 4.2
Salient Features of SBP Monetary Policy Statement
January-June 2007

- Monetary policy measures adopted in July 2006 augmented the earlier tightening stance adopted by the State Bank of Pakistan and reduced year on year core inflation (Non-Food Non-Energy – NFNE) to 5.5 percent by December 2006 from 7.4 percent a year earlier. However, the headline inflation remained stubbornly high at 8.9 percent by December 2006.

- Although non-food inflation declined to 6.2 percent, acceleration in food inflation to double-digit levels offset the downward trend in headline inflation.

- The impact of monetary tightening is visible from an upward movement in Monetary Conditions Index (MCI) during H1-FY07.

- In line with its dual objective of balancing growth and price stability, monetary policy has also supported economic growth by ensuring effective liquidity management and by providing adequate and timely concessional credit to priority sectors. Specifically, the liberal access of concessional Long-term Financing for Export Oriented Projects (LTFEOP) offered by SBP and reduced rates on Export Finance Scheme (EFS) were helpful in keeping the textile industry's growth prospects intact.

- While keeping the average weekly cash reserve requirement the same as before (3 percent for time and 7 percent for demand liabilities), SBP is increasing daily minimum requirements to 2 percent and 6 percent for the time and demand liabilities (from earlier levels of 1 percent and 4 percent) respectively.

- The key challenges facing the Pakistan economy remain the same as were at the beginning of FY07. In particular, (a) while inflation is likely to ease further, it may remain above the 6.5 percent target for FY07 unless some additional administrative measures are taken to reduce food inflation; (b) international commodity prices may exert pressure on domestic inflation; (c) reserve money growth is increasing, because support to the textile sector which is backed by SBP refinancing; (d) expansionary fiscal stance coupled with occasional upsurges in borrowings from SBP and the uncertainty created by financing mix of the deficit is posing difficulties for the conduct of monetary policy; and (e) burgeoning external imbalances continue to pose a challenge.

- SBP will continue to pursue its existing tight monetary policy during the remaining half of FY07. It will, however, remain vigilant of the developments in the economy and take corrective actions, if warranted.

Source: State Bank of Pakistan

Food & beverages (10.2 percent), fuel and lighting (9.7 percent), Medicare (9.1 percent), house rent (7.4 percent), education (7.2 percent), house hold furniture and equipment (6.8 percent), apparel, textile and footwear (4.8 percent), cleaning, laundry & personal appearance (4.2 percent) and transport and communication (3.1 percent) contributed to the increase in CPI.

The price changes measure by various indices is summarized in Table 4.3.

Table 4.3: Changes in Price Indices (2000-01=100)

(% Change)

Indices	July-April	
	2005-06	2006-07
Consumer Price Index (CPI-374 items)	8.0	7.9
Food Inflation	7.0	10.2
Non-food Inflation	8.8	6.2
Wholesales Price Index (WPI-106 items)	10.3	6.9
Sensitive Price Indicator (SPI-53 items)	6.6	11.1

Source: Federal Bureau of Statistics

During July-April 2006-2007 food inflation witnessed an increase of 10.2 percent as compared to food inflation of 7.0 percent in the corresponding period 2005-06. The higher food inflation is mainly due to upward shift in the prices of essential items like vegetables, edible oil, pulses, poultry, fresh milk and fresh fruits.

The non-food inflation rate in July-April 2006-07 is 6.2 percent as against 8.8 percent in the corresponding period last year. The non-food inflation in July-April 2006-07 exhibits slow increase in its sub-groups of Transport & Communication (3.2 percent) and house rent (7.4 percent) relative to the corresponding period last year.

Figure 4.6 explains the trends in Consumer Price Index (CPI), food & non-food inflation over the years.

Fig 4.6: Trends in CPI Inflation, Food & Non-Food Group

(Percent)

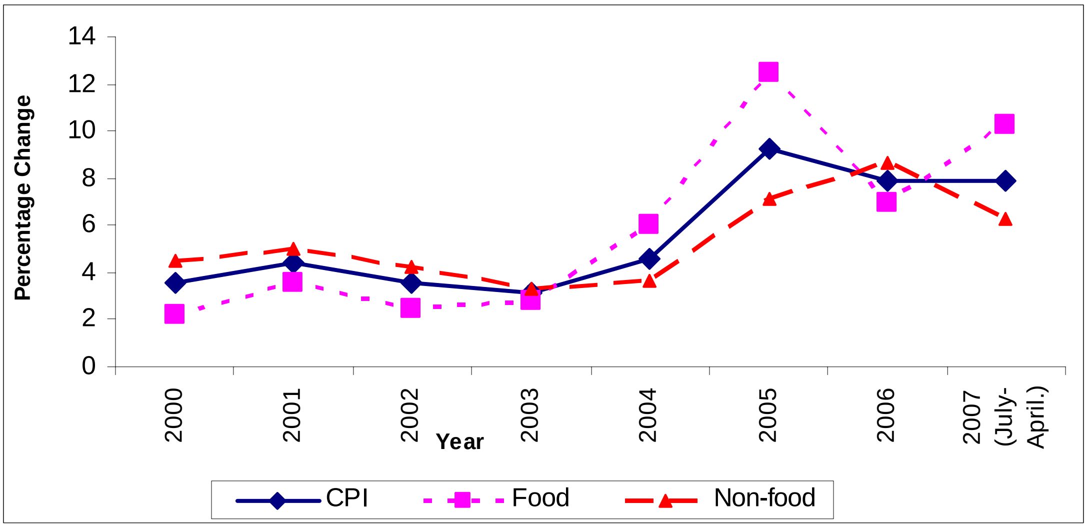
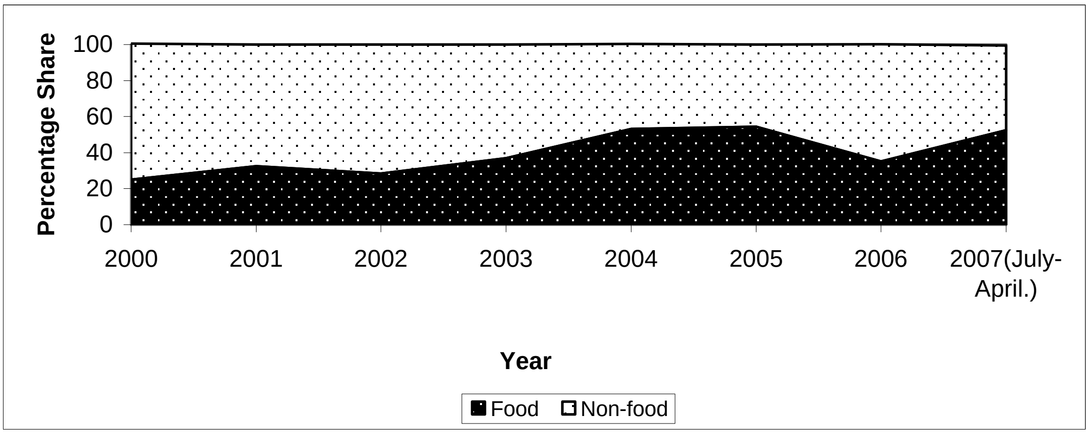


Figure 4.7 depicts the share of food and non-food groups' inflation in CPI inflation. The share of food inflation is rising with the exception of 2006.

Figure 4.7: Share of Food & Non-Food Group in CPI Inflation

(Percent)



Box 4.3 Comparative Prices in Neighboring Countries

Pakistan prices of essential commodities compares favourably with the prices of neighbouring countries. Pakistan is still relatively cheaper country in the region.

Value in Pak Rs/Kg.

Items	**Islamabad**	**Dhaka**	**New Delhi**	**Colombo**	**Kabul**	**Beijing**
Wheat	12.1	21.4	22.7	35.0	18.8	16.0
Wheat Flour	13.6	23.1	22.7	35.0	20.0	15.6
Rice Basmati Broken	32.8	62.3	31.2	64.0	62.5	-
Masoor Pulse	49.3	62.3	54.0	38.0	62.5	-
Mash Pulse Washed	76.9	62.3	76.7	38.0	100.0	-
Moong Pulse	59.5	62.3	82.4	38.0	75.0	-
Gram Pulse Washed	44.1	53.4	56.8	38.0	62.5	-
Sugar	32.8	33.8	25.6	40.0	35.0	45.0
Beef	133.8	151.3	71.0	166.0	200.0	181.0
Mutton	260.0	200.3	213.0	262.0	275.0	189.0
Farm Chicken	77.0	89.0	127.8	146.0	93.8	114.0
Potato	17.8	13.4	14.2	39.0	31.0	42.0
Onion	24.3	19.6	17.0	24.0	31.0	55.0
Tomato	37.0	14.2	17.0	15.0	31.0	63.0
Red Chilies Powdered	131.9	71.2	184.6	125.0	112.5	165.1

Source: Ministry of Commerce
As on 3rd May 2007.

In order to keep close vigilance, the Economic Coordination Committee of the Cabinet (ECC) regularly reviews the prices of essential items. The provincial governments have been asked to take necessary measure to stabilize the prices. In addition the efforts have been made to improve the supply position of food items either through raising production or through increased imports to put downward pressure on general price level in the coming months.

Annual Plan 2007-08

Fiscal Policy

The main thrust of fiscal policy during the year 2007-08 would be on strengthening the reforms in tax system and tax administration to further broaden the tax base at the federal, provincial and district governments level, improve the tax compliance and minimize tax evasion, The main objective of policy would be to allocate adequate resources for development activities particularly for pro-poor expenditure in conformity with the Fiscal Responsibility and Debt Limitation Act, 2005 to achieve projected economic growth of 7.2 percent and further reduce unemployment and poverty and improve social indicators.

Monetary Policy

The monetary expansion for the year 2007-08 will be in line with the projected GDP growth of 7.2 percent and CPI inflation of 6.5 percent. The State Bank of Pakistan will continue to follow tight monetary policy to curb the inflationary pressures.

Inflation

A lower level of inflation is a key component of stable macroeconomic environment. Determined efforts will continue by the Government to bring it down during the fiscal year 2007-08 and beyond. The target rate of inflation (CPI) during 2007-08 is set at 6.5 percent. Reduction in the rate of inflation will be achieved by tight monetary policy and increased supply of essential items.