# Public Finance

## *Introduction to Public Finance:*

Before we begin with the public finance, we would like to point out the major functions of a modern government:

(a) Improving economic efficiency

(b) Making the distribution of income less unequal

(c) Stabilising the economy through macro-economic policies

(d) Representing the country internationally

It is duty of the government to bring economic and social justice in the country. And this can only be done by properly utilising the funds raised through taxes and other sources of public finance.

The famous ***American Economist J.M. Keynes*** has revolutionised and changed the meaning of public finance. According to Keynes, public finance should be used as an instrument for achievement of certain economic and social objectives. Before Keynes, the concept of public finance was to raise sufficient revenues for meeting public expenditure. In other words, before Keynes, public finance was concerned with the raising of financial resources for the State. But Keynes made a fundamental change in the nature and scope of public finance. Keynes and his followers emphasised that public finance is to help in the achievement of certain social and economic objectives and finance some essential economic activities.

Keynes underlines the fact that the taxation and public expenditure policy of the State vitally affects the level of income and employment in the country. Keynes showed that during depression, how a government could reduce the depression from the economy by increasing its public expenditure and raise the level of employment. When the government increases its investment expenditure on public works, then the level of income and employment in the country increases more than the ratio of increase in initial investment. This is Keynes' Income Multiplier.

Generally, the level of full employment in the economy is impossible. This is so because whenever there is lack of effective demand, the production remains unsold which ultimately leads the entrepreneur to loss. Thus investor will reduce the level of investment resulting more unemployment and a situation of depression in the economy. In depression, the purpose of budgetary policy is to provide investment opportunities and increase employment level in the economy. The government should increase public expenditure during depression more than the public revenue. The deficit can be covered by deficit financing, i.e., by creating money. The result of deficit financing is that the purchasing power with the people increases and aggregate demand for goods and services increases.  Owing to increase in aggregate demand and the operation of multiplier, the depression will tend to disappear and the economy will move towards full employment.

On the contrary, whenever, there is a higher effective demand and when the money supply is increased, there will be a generation of inflation in the economy.  In such a situation, the purpose of fiscal policy to reduce money supply in the economy so as to reduce the inflationary pressure and so people can save more and consume less. When there is inflation in the economy and the prices are soaring higher and higher, the government should levy heavy taxes and in this way withdraw purchasing power from the people and should also reduce its own expenditure.  The demand having been reduced in this way, prices would tend to come down.  It is clear that to fight inflation, the government should frame a 'surplus budget'.  A surplus budget means that the government should collect more money from the public by imposing more taxes but keep its expenditure less than the revenue raised.  The result will be that less purchasing power will be left with the people and the aggregate demand for goods will be reduced.  Consequently, the prices will have a tendency to fall.

The above situation is mostly existed in economically advanced and rich countries.  The less developed countries, like Pakistan, Bangladesh, India, China, Myanmar, etc. are caught up in the vicious circle of poverty and their main problem is to break this circle and move towards economic development so that poverty is removed and the living standard of the people is raised.  The objectives of public finance in less developed countries are to give a fill up to capital formation, encourage industrialisation, encourage productive investment, and foster economic growth.  Thus the objectives of public finance in less developed countries are different from those in the developed countries. Whereas in developed countries, the function of public finance is to accelerate economic growth so that the widespread unemployment and poverty prevailing in the country are removed.



## *Causes of Market Failure / Reasons of Government's Intervention in Market Economy:*

The market economic system operates under Price Mechanism.  Consumers show their will or desire to buy a commodity at a given price in order to maximise their utility.  On the other hand, the producers are aimed at maximising their profit for what they produce.  In market economy, there is no justification for state intervention but there are some reasons that necessitate the government's intervention in the economy as discussed below:

**(a) To avoid Monopoly:** Monopoly is a situation in which one seller rules over the whole industry.  The buyers are compelled to purchase commodity at the price fixed by the monopolist.  Therefore, the government interferes for the benefits of the consumers. The government interferes in pricing of the commodity, and/or encourages new firms to enter into the market/industry.

**(b) To maintain Price Mechanism:** There may be possibilities of prevailing an unjustified price mechanism even in the presence of perfect competition in the market. The government can monitor the prices fixed by the market and protect the consumers from the burden of unjustified prices.

**(c) To meet Externalities:** Externalities represents those activities that affect others for better or worse, without those others paying or being compensated for the activity. Externalities exist when private costs or benefits do not equal social costs or benefits. There are two major species, i.e., external economy and external diseconomy. In such situation, government intervene the market with its different policies.

**(d) Increasing Social Welfare and Benefits:** Another strong reason of government's intervention in the market economy is the social welfare and benefit. It is one of the duties of an elected government to work for the common welfare of the nation; to provide social goods and services, like hospitals, education facilities, parks, museums, water and sewerage, electricity, old age benefits, scholarships, etc; and the protect the people from the evils of a laissez faire economy.

**(e) To meet Modern Macro-Economic Issues:** It is the duty of the government to ensure that the country is in a right direction of economic development. Government must ensure controlled inflation, greater employment opportunities, rapid technological advancement, adequate capital formation, and higher economic growth rate.

## *Governmental Activities / Actions taken by the Government:*

Intervention of government in the economy takes a number of forms. The government may undertake the conduct of production, or may influence private economic activity by subsidies or taxes, or they may exercise direct control over behaviour on the private sector. Finally, governments may transfer purchasing power from some persons to others. The government activities can be broadly classified into four groups:

**(a) Allocative Activities:** These activities alter the overall mix of gross national product. The allocative activities arise out of the failure of the market mechanism to adjust the outputs of various goods in accordance with the preferences of society. The ultimate goal of the government is to maximise per capita income.

**(b) Efficiency in Resource Utilisation:** Maximum efficiency in the use of resources requires the attainment of three conditions:

(i) Attainment of least cost combinations

(ii) Operation of the firms at the lowest long-run average cost

(iii) Provision of maximum incentive for developing and introducing new techniques.

While the private sector is presumed to be less deficient, on the whole, in attaining optimal efficiency than in attaining optimal allocation of resources, nevertheless in several situations governments may be more effective.

**(c) Stabilisation and Growth Activities:** are those activities reducing economic instability and unemployment and increasing the potential and actual rates of economic growth.

**(d) Distributional Activities:** are those activities altering the pattern of distribution of real income.

## *Approaches of Government Actions:*

Following are the approaches or tools of government action plan against the malfunctions of market economy:

**(a) Governmental Conduct of Production:** The public goods such as defence, law enforcement, etc are supplied by the government, since their inherent character they cannot be produced and sold on a profit-making basis by private enterprise.

Government may also undertake education. In order to adapt the nature and quality of education to meet community goals, governments produce the services directly, although allowing private enterprise to provide them as well for persons who prefer the private product.

Government conduct of production may also be undertaken for efficiency reasons - to avoid collection costs, to obtain advantages of longer-term investments, or to attain economies of scale.

**(b) The Subsidy Approach:** An alternative to governmental production is subsidisation of private producers to induce them to increase output or to undertake investments that they would not otherwise make. Thus private schools could be subsidised to provide additional education at prices less than those equal to marginal cost. Subsidies might also be used to increase investment to lessen unemployment or to lower output when carried beyond the optimal figure.

**(c) The Control Approach:** For some purposes, direct control of private sector activity, with no governmental production except the limited amount involved in administration of the regulatory rules, is a satisfactory solution. Activity that gives rise to significant external costs, such as pollution, may be subjected to controls, such as requirements for adequate waste disposal. Monopoly may be broken up by antitrust laws or monopoly firms may be subjected to detailed regulation of rates and services. This form of regulation creates a continuous clash of interest between government and the firms.

**(d) Aggregate Spending:** Prevention of unemployment and attainment of the potential rate of economic growth or prevention of inflation may require fiscal and monetary policies that influence aggregate demand in the economy. To eliminate unemployment the government may raise the level of public spending and the scope of its activities beyond the levels as warranted, or may reduce taxes below the optimal levels.

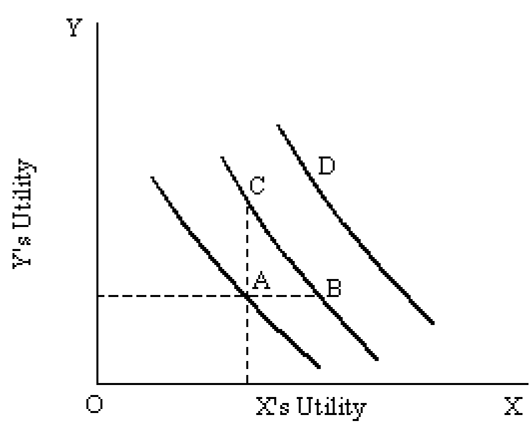
**(e) Transfer Payments:** Transfer payments are made by the government for bringing down the inequality in income distribution more closely in line with the desired one. Transfer payments may be 'specific' or 'non-specific', for example, scholarships in universities are specific, and provision of education and parks free of charge is non-specific. Non-specific transfer payments or general transfer payments are made on the basis of the income status of the recipients in conjunction with various criteria of needs. For example, old age benefits, aid for dependent children, direct relief, or negative income tax.

## *Pareto Optimality / New Welfare Economics:*

The New Welfare Economics represents a break with the utilitarian tradition in Economics. The new welfare economists claim to arrive at optimum conditions of production and exchange without adding the utilities of different persons or comparing the satisfactions of different individuals. The new welfare economics is claimed to be objective and scientific and not ethical. It is said that welfare economics furnishes an analysis of the causes governing the measure of welfare or an increase or decrease thereof. Italian born Vilferdo Pareto is said to be the pioneer of new welfare economics, although there have been introduced some subsequent refinements since then.

The ***Italian Economist Vilferdo Pareto*** has laid down the conditions for maximising social welfare or for achieving a social optimum. A Paretian optimum refers to a situation in which it is impossible to make any one better off without making some one worse off. For judging such a situation, Pareto has enunciated a very simple and straightforward criterion thus: "Any change which harms no one and which makes some people better off (in their own estimation) must be considered to be an improvement."

In the following diagram, an example of a community is taken, in which there are only two persons X and Y:



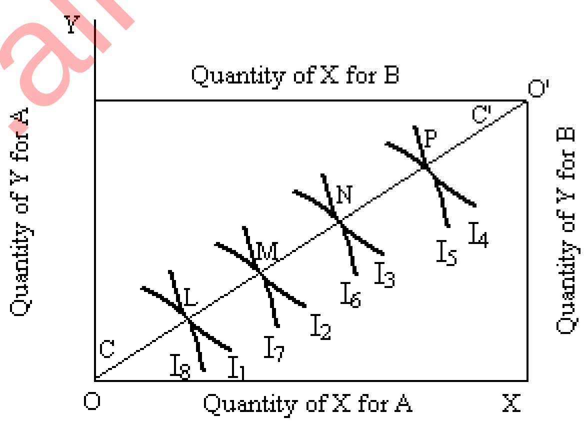
The utility of X is represented along horizontal axis and that of Y along the vertical axis. The Pareto criterion states that if we start off from a situation which is represented by a point like A, then a policy change by the Government is an improvement if it results in a move to any point like B or C which lies to the right of A or above. At B, X is better off than at A with Y as well off as before, whereas the move to C benefits Y without harming X and the move to D, benefits both the persons.

## *Conditions of Paretian Optimum:*

The conditions of Paretian optimum are given below:

**(a) Optimum Allocation of Products:** Allocation of products to be optimal must be such as to make it impossible for any pair of individuals to exchange any quantity of any pair of consumer goods resulting in increase in one's satisfaction without decreasing that of another. That is, if any alternative allocation can increase some one's satisfaction without decreasing another's, it is not optimal. To put in terms of indifference curve technique, the marginal rate of substitution (MRS) between any two good must be same for any pair of owners of the same two goods. We know that MRS is the rate at which units one good can be exchanged for the units of another without lowering the level of satisfaction.

This can be explained with the help of an *Edgeworth Box diagram*. The Edgeworth diagram for consumption shows the indifference curve preference maps of the two individuals and their derived levels of satisfaction from the various combinations of goods. The indifference curve preference maps of both A and B have been combined and shown with the help of an Edgeworth Box in the following figure:




The indifference curve preference map of A starts from origin O, whereas the indifference curve preference map of B starts from origin O'. $I_1$ to $I_8$ represents the indifference curves of individuals A and B. $I_1$, $I_2$, $I_3$ and $I_4$ represent the indifference curves of individual A, and $I_5$, $I_6$, $I_7$ and $I_8$ represent the indifference curves of individual B. The slope of an indifference curve, as we know, at any point is the marginal rate of substitution between commodities X and Y ($MRS_{xy}$). The point would be optimal where the $MRS_{xy}$ of both individuals are same. If the $MRS_{xy}$ is not the same, then with the help of exchange, it is possible to increase the level of satisfaction of one without diminishing that of the other. Now if we joint the points L, M, N, P where the different sets of indifference curves of individuals A and B are tangent to each other, we get a curve known as *'Contract Curve'*, i.e., cc'. The points L, M, N and P lie on the contract curve cc'. At each of these points, the $MRS_{xy}$ for A and B is the same. Therefore, each point along a contract curve cc' represents a point of Pareto-optimality. In other words, any redistribution of the goods X and Y between A and B will yield a lower level of satisfaction.

**(b) Optimum Degree of Specialisation:** It refers to the condition that the marginal rate of transformation (MRT) between any two goods must be the same for any pair of firms producing both of them. The MRT between two goods is the amount of one good which would have to be sacrificed to produce one unit of another good. This only means the ratio of marginal opportunity cost of the two goods. Obviously, if MRT is not the same for any pair of producers, it would be possible to increase the combined output of the two goods or increase the output of one without decreasing that of another. This will mean that the present degree of specialisation is not the optimum.

**(c) Optimum Factor Utilisation:** This represents optimum relationship between the factor and the product. The utilisation of a factor will be optimal if the marginal rate of transformation (MRT) between any factor and any product is the same for any two firms using the factor and producing the product. If MRT is not the same, it will be a departure from the optimum.

**(d) Optimum Allocation of Factors:** All factors of production must be so allocated among the various uses that the marginal production in each use is that same. If it is not the same, it will pay to shift some units of a factor from one use to another. In terms of new economics, the marginal rate of technical substitution (MRTS) between any pair of factors must be the same for any two firms using both to produce the same product. Only then, the allocation will be optimal. If it is not, it will be possible to increase the total product by shifting a factor from one firm to another.

**(e) Optimum Direction of Production:** Another condition for maximising welfare is that the marginal rate of substitution between any pair of products for any person consuming both must be the same as the marginal rate of transformation for the community between them. In terms of utility analysis, it means:

(i) That the ratios of marginal utilities of the two goods must be the same for all consumers, i.e.,

$$\frac{\textbf{MU of A}}{\textbf{Price of A}} = \frac{\textbf{MU of B}}{\textbf{Price of B}} \quad \textbf{and so on.}$$

This will represent maximum satisfaction of the consumer.

(ii) The ratio of their marginal costs must be the same for all producers producing them, i.e.,

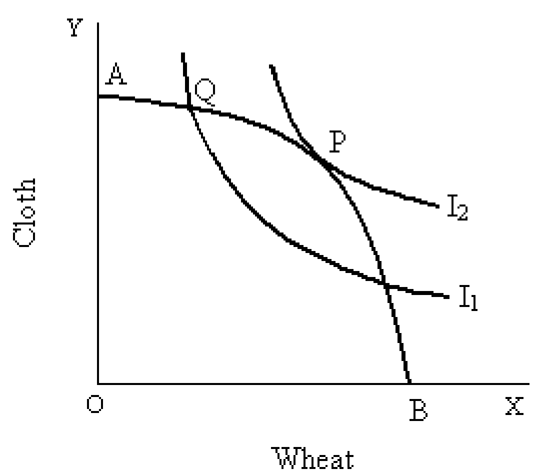
$$\frac{\text{MC of A}}{\text{Price of A}} = \frac{\text{MC of B}}{\text{Price of B}} \quad \textbf{and so on.}$$

(iii) These ratios must be equal.

This condition relates to the maximum efficiency of the economic system. The goods must be produced in such combinations that they not only conform to consumers' preferences but are also produced at the minimum average cost. If it is technically possible to substitute one good for another and make one better off without making another worse off, the production is not optimal.

Let us take a community producing two goods. The quantity of each good it produces will depend on its factor endowments and on its existing technical knowledge. By factor endowments we mean the amounts of factors of production the community possesses. Let us assume that the community can produce either 100 bushels of wheat or 100 yards of cloth when all its factors are fully and most efficiently employed in the production of either wheat or cloth respectively. The various combinations of wheat and cloth that it can produce are shown by the 'production possibility curve' or the 'transformation curve'. If the community chooses to produce wheat only, it can produce 100 bushels. If it would also like to produce cloth, it must forgo the production of some of its wheat. The amount of wheat, which the community foregoes in order to have an extra unit of cloth, is known as the 'opportunity cost' of wheat in terms of cloth.

In the following diagram, the community's production possibility curve drawn on the assumption of increasing opportunity cost. The meaning of increasing opportunity cost is that the amount of extra wheat the community produces by decreasing production of cloth with given factors is steadily increasing.



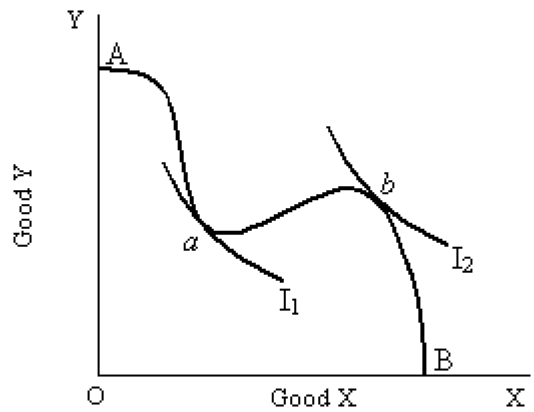
Let us superimpose the indifference curve preference map, i.e., $I_1$ and $I_2$ of an individual A on AB production possibility curve. Now the Pareto-Optimal point would be where the slope of production possibility curve AB and of the indifference curve (A) is the same or tangent. In this diagram, point P is the optimal point, as the slope of the indifference curve $I_2$ and PB on curve AB is the same. The point Q is not the point of optimum.

**(f) Optimum Allocation of a Factor-Unit's Time:** The owner of a factor unit has the option of using the factor to render him a direct service or hiring it out to others for aiding in production. Hence, the problem for the owner of a factor is to allocate the time of factor rendering direct services or working for a money reward in an optimal manner.

**(g) Inter-Temporal Allocation of Assets:** Every individual firm has to bring about an optimal allocation of factor inputs and product output over time. A firm may produce a given output stream with various time patterns of factor inputs and conversely, it may have various time patterns of outputs with a given input stream of factor services. It refers to the allocation of products or factors that may relate to different moments of time. In this case, the allocation will bring maximum welfare when the marginal rate of substitution between any pair of moments is the same for every pair of individuals or firms.

The above-discussed conditions are also known as *'First-Order Conditions'*. From the above first-order conditions, the Pareto-Optimality can be attained. But the fulfilment of these first-order conditions may not be enough to lead to welfare optimality. To achieve an optimum welfare position, it is very necessary that the *'Second-Order Conditions'* along with the first order conditions should also be satisfied to achieve the maximum welfare. These second order conditions are no other than the stability conditions for equilibrium position. The fulfilment of second order conditions means that all the indifference curves and the production possibility curves should have the right curvature in the neighbourhood of any position where marginal conditions are satisfied. In the neighbourhood of maximum welfare, all indifference curves must be convex to the origin and all transformation curves must be concave to it.

In the following figure, AB is the production possibility curve of the community, $I_1$ and $I_2$ are the indifference curves of an individual. The point *b* is a point of optimum welfare as the indifference curve $I_2$, is a tangent to the production possibility curve AB. At point *a*, the indifference curve $I_1$ is also a tangent to the production possibility curve AB but it is not a point of optimum welfare, as by moving from *a* to *b*, the community reaches on a higher indifference curve $I_2$.




## *Relation between Pareto Optima and Perfect Competition:*

**(a) Equality of Marginal Rate of Substitution:** Under conditions of perfect competition, the consumer in order to maximise satisfaction makes the marginal rate of substitution between any two goods equal to the ratio of their prices. At equilibrium, the MRS between two goods is equal to the ratio of their prices for any consumer. Therefore, the first condition of optimum allocation of goods of Pareto-optimality is satisfied under perfect competition.

**(b) Equality of Marginal Rate of Transformation b/w Two Factors:** Under conditions of perfect competition, in order to have minimum cost combination of the factors to produce a given output tries to equate the marginal rate of transformation (MRT) between two factors to the ratio of their prices. At equilibrium, this condition of equating MRT between two factors to the ratio of their prices is satisfied. Hence, the condition about the optimum allocation of factors is also satisfied.

**(c) Equality of Marginal Rate of Transformation b/w Two Commodities:** The producer under perfect competition, in order to maximise the profits, tries to equate the marginal rate of transformation (MRT) between two commodities to the ratio of their prices. At equilibrium, this condition of equating MRT between two commodities to the ratio of their prices is satisfied. Hence, the condition about the optimum utilisation of a factor is satisfied.

**(d) Equality of Marginal Product of Each Factor:** The producer in order to maximise his profits tries to equate the marginal product of each factor to its price and, at equilibrium, this condition is satisfied. Therefore, the condition of optimum factor-product relationship is satisfied.

**(e) Equality of MRS to MRT b/w Two Commodities:** Under perfect competition, at equilibrium, the marginal rate of substitution (MRS) between the two commodities is equal to the marginal rate of transformation (MRT) between the two commodities and both are equal to the ratio of their prices. Therefore, the condition about the optimum direction of production is also satisfied.

**(f) Equality of MRS & MRT:** Under perfect competition, a factor will be utilised to the point where the marginal rate of substitution (MRS) between employment of the factor and its leisure equals the rate of payment made to it. Similarly, with a view to maximising his profit, a producer equates the MRT between the factor and its product. Since the price of the product is the same for all the producers and rate of payment is the same for all the factor units, the condition of optimum allocation of a factor unit's time is also satisfied.

**(g) Equality of Marginal Productivity of Asset:** An owner of an asset makes the MRS between present income and future income equal to his rate of time preference. In the same way, a borrower of the asset equates the cost of borrowing with the MRS between the present asset and future asset. Since under perfect competition, the rate of payment for all similar assets is the same, as also the cost to the borrowers, it is equal to the marginal productivity of the asset. In this way, the condition of inter-temporal optimum allocation of assets is also fulfilled under perfect competition.

From the above it is clear that under perfect competition all the marginal conditions of Paretian-optimum are satisfied.

## *Obstacles to Welfare Maximisation:*

If maximum welfare is to be attained, optimum allocation of factors of production is essential. This allocation must be in keeping with the consumer's preferences. For this purpose, there must prevail perfect competition. But, in the real world, there is no perfect competition, instead there is imperfect competition. This constitutes a big obstacle in the way of the attainment of maximum welfare. We shall see how different forms of imperfect competition stand in the way of welfare maximisation:

**(a) Monopoly:** By pursuing restrictive price and output policies, the monopolists exploit the consumers' weakness by charging exorbitant prices and by restricting output. They reduce the national income. In all these ways, they reduce social welfare, especially because they cause misallocation of productive resources.

Under monopoly, the monopolist faces a downward sloping demand curve (instead of horizontal straight line as under perfect competition). Hence, the marginal revenue is less than average revenue / price. In order to maximise profit, the producer will equate marginal cost and marginal revenue. His marginal cost is less than the price or price is kept higher than the marginal costs. Thus, the monopolist does not operate at the optimum output level. This means higher prices for the consumers and lower remuneration for the factors of production. By creating a divergence between factor price and the value of its marginal product, a monopoly distorts factor allocation. Too little resources are used in monopolised industries, which is not in conformity with consumer's preferences.

**(b) Monopsony:** It is a buyer's monopoly. Firstly, take the case of monopsony in factor market, where a firm is compelled to pay higher prices for factors in use. Hence, the marginal cost of the factor will exceed its price per unit. For profit maximisation, the factor will tend to be used up to a point where its marginal cost is equal to its marginal revenue product. But as said above, marginal cost exceeds price. Hence, the price paid to the factor is less than marginal product. Thus, the factor is not being paid its worth, which shows a faulty allocation of factors which in turn militates against welfare maximisation.

Take the case of monopsony in product market. In this case, the marginal cost of the product will be higher than the price paid by the monopsonist. The quantity purchased will be smaller and the price paid lower than under competition. This represents misallocation of resources in the economy.

**(c) Monopolistic Competition:** In this case, there are too many firms in the industry operating at less than optimum scales of output having excess capacity which is socially wasteful. Product differentiation compels waste. Hence there is a reduction in social welfare.

**(d) Oligopoly:** In pure oligopoly (without product differentiation), there is a misallocation of resources and hence a reduction of social welfare. In this case, a dominant firm determines the price and output policy. In order to maximise profit, the firm equates marginal cost with the marginal revenue. But the price will exceed marginal cost and distort resource allocation.

## *Market Structure and Social Welfare:*

In the Paretian sense, if a policy change makes at least one individual better off without making any one worse off it is said to maximise social welfare. Let us see how this social optimum can be attained under different market structures:

**(a) Social Welfare under Perfect Competition:** To achieve maximum social welfare under perfect competition, the allocation of resources needs to be efficient. For allocation of resources to be efficient, it is necessary that the MRS between any two commodities for a consumer is equal to the MRT between these two commodities is equal from producer's point of view. This would lead to:

- The equality of the ratio of marginal utilities and the ratio of commodity prices for the consumers, which would result in maximum satisfaction; and
- The equality of the ratio of marginal costs and the ratio of commodity prices for the producers, which would result in maximum profit.

This situation is possible only in perfectly competitive market.

The conditions of perfect competition also bring about the equality between the private marginal product and social marginal product. The basic condition for maximum welfare is that social marginal utility be equal to social marginal cost:

**Maximum Social Welfare = Social Marginal Utility = Social Marginal Cost**

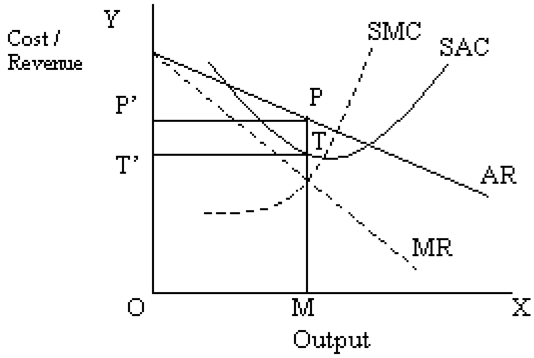
The equality between private marginal utility and social marginal utility will depend upon the distribution of money income in the community. The distribution must be such as would equalise its marginal utilities for all the consumers. The marginal cost of producing any alternative commodity would be the same as for the one that is being produced. This will lead to equality between private marginal cost with private marginal utility and hence the social marginal utility and social marginal cost. This is how conditions of perfect competition result in the attainment of maximum social welfare.

**<u>(b) Monopoly:</u>** The conditions of efficient allocation of resources do not exist in a condition of monopoly, therefore, the maximum social welfare cannot be attained under monopoly. The monopoly equilibrium is based on the equality of marginal revenue and marginal cost. Under conditions of monopoly, price is greater than marginal revenue of output and also the marginal cost. The inequality of price and marginal cost represents the violation of basic condition of efficient allocation of resources and hence maximisation of social welfare. Following things are happened under monopoly:

- Under monopoly, the entrepreneur neither achieves optimum levels of production nor does he like to achieve it.
- A productive factor is not paid according to its marginal productivity because, simply under monopoly, the price exceeds the marginal cost of a commodity.
- Since productive factors do not get paid according to their marginal productivity under monopoly, they are not attracted to this form of business enterprise / industry to the fullest extent; whereas in the interest of maximum social welfare, it is necessary that the factors must be employed where their marginal productivities are at their highest points.

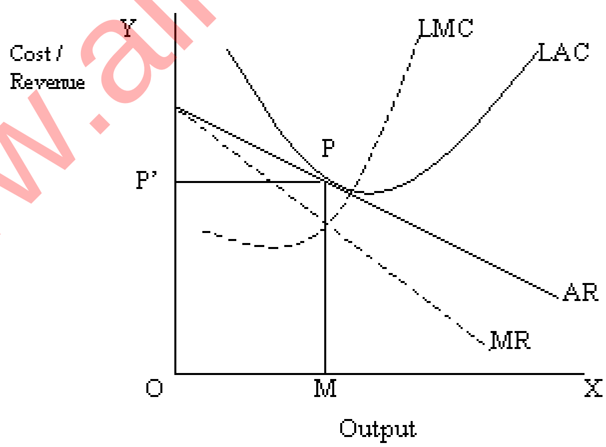
It is thus clear that monopoly form of business is not consistent with the maximum social welfare. Whatever the form of monopoly, whether in the commodity market or in the factor market (monopsony), it works as a hindrance to the achievement of maximum social benefits.

**<u>(c) Monopolistic Competition:</u>** Under monopolistic competition, efficient allocation of resources is not as possible as compared to perfect competition. Under monopolistic competition, in the short run, the demand curve is not tangential to the average cost curve at its lowest or optimum point. On the other hand, the demand curve is tangential to the average cost curve at a point higher than the optimum scale point. It is shown in the following diagram:




**Short Run Equilibrium under Monopolistic Competition**

Since the levels of output are not optimum, the allocation of productive resources under monopolistic competition cannot be termed as efficient as in the case of perfect competition. If social welfare is to be maximised there must be fullest use of installed capacity. However, in the long run, the total efficiency achieved can be summed up to the level of maximum social welfare. Because in the long run, the long run average revenue curve or the demand curve is tangent to the long run average cost curve at its lowest point or the optimum point. Which is because of greater divisibility of the factors of production in the long run. In the long run, the indivisible factors of production can be used more economically because, in the long run, they are, in fact, to extent, divisible. In the long run, the cost curves depend on 'returns to scale'. In the long run, the amount of capital can be altered and the management can be arranged differently. If all the factors of production can be used in varying proportions, it means that the scale of operations of the firm can be changed. Consider the following diagram:




**Long Run Equilibrium under Monopolistic Competition**

In the above diagram the industry is said to be producing at its technically optimum output level, i.e., OM. Output is optimum in the sense that average cost is at a minimum.

In short, under monopolistic competition, the maximum social welfare can be sufficiently attained, but not as much as compared to the perfect competition. So far as there is product differentiation, monopolistic competition offers greater product variety as compared to perfect competition. Under perfect competition, the products are homogenous, where the distinctive characteristic of monopolistic competition is product differentiation on bases of design, style, quality, income, age, sex, etc. Each product variety represents different taste and temperament of consumers, and gives better satisfaction to different classes of consumers.

**(d) Oligopoly:** Under oligopoly, there is misallocation of resources. Under oligopoly, few producers/sellers often form a cartel to have a tight grip on the market and a super-normal profit. Consumers and labourers are the worse victims of this form of market structure. The sellers may almost destroy the social interest and may work for their own interests. There are various global examples of oligopoly including OPEC (Organisation of Petroleum Exporting Countries). That is why oligopoly is not considered as the best companion of the governments around the world to achieve social welfare. Misallocation of resources is due to the fact that the market leader determines the price of the commodity for the entire industry. This price is calculated to yield maximum profit, i.e., where firm's marginal cost is equal to marginal revenue. Since price is higher than marginal cost, it results in misallocation of productive resources.

**Study Notes** Go to...

# Public Finance

***The Principle of Maximum Social Advantage:***
According to Dalton, the best system of public finance is that which secures the maximum social advantage from the operations which it conducts.

Attainment of maximum social advantage requires that:

**(a)** Both public expenditure and taxation should be carried out upto certain limits and no more,

**(b)** Public expenditure should be utilised among the various uses in an optimal manner

**(c)** The different sources of taxation should be so tapped that the aggregate sacrifice entailed is the minimum

**(a) Limits of Public Expenditure and Taxation:** Pigou has stated that expenditure should be pushed in all directions up to the point at which satisfaction obtained from the last shilling expended is equal to the satisfaction lost in respect of the shilling called up on government service. In Pigou's statement there is a balancing of utility of expenditure with the disutility of a tax. This is the same principle by acting on which a consumer maximises his satisfaction and a producer maximises his profit. A consumer's satisfaction is maximised when the marginal utility of the last unit of a commodity purchased is equal to its price. In the same manner, a producer maximises his profit when he has equalised the output of the marginal unit of a factor of production with the payment he has made for it, i.e., when marginal productivity is equal to price.

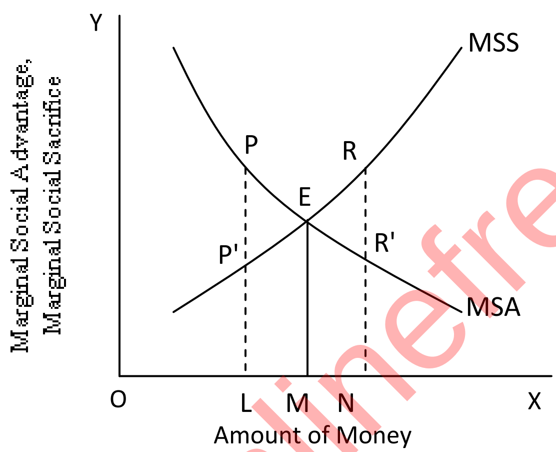
In case of public finance, the government should try to maximise the benefit to the community as a whole from its public finance. The community's welfare is maximised when marginal social utility of an item of expenditure has been equated to the marginal social disutility of the tax imposed for the purpose. Obviously, expenditure confers a benefit and the tax entails a sacrifice and the two must be balanced against one another.

**(b) Public Expenditure: Maximum Social Welfare:** Achieving maximum social advantage also involves the use of the principle of equi-marginal utility. The government should act on the principle of equi-marginal utility in order to maximise social advantage from the alternative modes of expenditure.

Public expenditure has to be incurred on numerous items. No government can just heedlessly go on spending its revenues. It knows of the various demands on public revenue. A wise government should exercise all possible discrimination between the various uses in which public revenue can be put. It should arrange a list of priorities, just as a prudent consumer does.

**(c) Distribution of Tax Burden: Minimum Social Sacrifice:** The tax burden should be such distributed in the community so that the sacrifice entailed is the minimum (or the advantage is maximum). A wise government should see that this suffering or sacrifice is not unnecessarily increased. The sacrifice entailed by the various taxes should be compared and optimum combination of taxes should be found out.

For instance, it is felt that raising of the income tax and corporation taxes further will result either in increasing the sacrifice entailed or in the discouragement of productive enterprise, it will be better not to put extra burden on the income tax payers.




In the above diagram MSS represents marginal social sacrifice, and MSA represents marginal social advantage. As more and more funds are collected from the people by way of taxation, MSS increases. The MSS curve rises upwards from left to right, and MSA slopes downward from left to right. The net social welfare will be maximum where the MSS from taxation is equal to MSA from public expenditure.

***Role of Public Finance in a Developing Economy:***

In a developing economy, the State must play a very active role in promoting economic development and public finance is the instrument that the State uses in this regard. This instrument has to be used to break the vicious circle of poverty and to accelerate economic growth. Hence, there is a great importance of public finance in under-developed countries desirous of rapid economic development.

There are various reasons why the State must play an important role in a developing economy:

**(a) As an instrument of Capital Formation:** Capital formation is of strategic importance in the matter of rapid economic development and the under-developed economies suffer from capital deficiency. People in less developed countries are extremely poor and they can hardly make two ends meet, not to speak of making saving and investment. It is, therefore, necessary to achieve a higher ratio of savings to national income, which is the government's responsibility to see how savings can be generated and capital formation promoted. This can be best done through fiscal measures. There is another problem that in under-developed nations the increased incomes arising from whatever little economic development is made are spent under the demonstration effect in imitating the higher standards prevailing in the developed nations.

**(b) As an instrument for Regulating Consumption and Production:** There are other methods also, besides public finance or fiscal policy, by which capital formation can be promoted, e.g., taking the various means of production under government control. This system had been adopted by many nations like Russia (Former USSR), China, Czech Republic (former Czechoslovakia), Yugoslavia, Mongolia, Cuba and North Korea. But the system proved to be a failure when addressing public needs. By the end of 1980s, the socialist countries of Eastern Europe including Russia were ruins, with long lines for bread and other necessities in the stores, low and declining living standards, outdated technologies, and deteriorating environmental conditions.

**(c) Matching Physical Development:** In any plan of economic development, a physical plan must be matched by a financial plan. The balance has to be achieved both in real terms and in financial terms. Money incomes are generated in the process of production and supplies are utilised in response to money demands. It is important, therefore, to operate upon and modify money income flows so as to maintain a balance between the supply of consumer goods and the purchasing power available for being spent on them, between savings and investment and between receipts and payments abroad.

**(d) Influencing Rates of Saving and Investment:** Public Finance can exercise an important influence in increasing the rate of saving and investment. For example, the tax system can be so devised as to discourage the consumption of less essential goods and thereby release resources for being employed in more productive channels. Further, the tax system can be used to increase public saving which in turn can be used to finance an increase in public investment.

***Divisions of Public Finance:***

Public Finance can be studied under the following divisions:

(a) Public Expenditure,
(b) Public Revenue,
(c) Public Debt, and
(d) Budgeting.

# Budget Policy

***Introduction:***
According to ***Paul A. Samuelson***, a budget shows, for a given year, the planned expenditures of government programmes and the expected revenues from tax systems. The budget typically contains a list of specific programmes (i.e. education, welfare, defence, etc.), as well as tax sources (i.e., individual income tax, social-insurance taxes, etc.).

According to ***John F. Due***, a budget may be defined as a financial plan that serves as the basis for expenditure decision-making and for subsequent control.

A *'budget surplus'* occurs when all taxes and other revenues exceed government expenditures for a year. A *'budget deficit'* is incurred when expenditures exceed taxes. When revenues and expenditures are equal during a given period, the government has a 'balanced budget'.

When the government incurs a budget deficit, it must borrow from the public to pay its bills. To borrow, the government issues bonds, which are IOUs that promise to pay money at some time in the future. The government debt (sometimes called the public debt) consists of the total or accumulated borrowings by the government from various sources including public, banks, businesses, foreigners, and other non-federal entities.

***Functions of Budget Policy:***
According to ***Musgraves***, the major functions of the Public Finance or the governmental programmes can be grouped into three major classes, relating to allocation of resources, to efficiency in the use of resources and attaining economic stability and growth, and redistribution of income. These are discussed as follows:

**(a) Allocative Function:** The allocative function or activity arises out of the failure of the market mechanism to adjust the outputs of various goods in accordance with the preferences of society with the goal of maximising per capita real income. Allocative function refers to the process by which total resource use is divided between private and social goods and by which the mix of social goods is chosen. This is done by the budgetary policy. The budget policy ensures the optimum allocation of resources which will result on production and determination of public and private goods on optimum quantity or level. Also it will cause to remove the evils or shortcomings of price mechanism. As in price mechanism, the motive of profit maximisation is so strong that public and social welfare is altogether ignored, and the production of social goods and services, i.e., libraries, parks, schools, hospitals, etc., are avoided. Because in production of such goods and services the entrepreneur earns limited profit. Therefore, in these circumstances the government intervention becomes very necessary.

But to determine an optimum quantity of public goods is to some extent a difficult task because no one wants to pay the price for public goods rather they wants to be as a 'free rider'. But this problem is solved through decision of taxes or expenditures. Such decision may be centralised or non-centralised.

Thus the problem of optimum allocation of resources for the production of social goods is resolved through budget policy.

**(b) Distributive Function:** The budgetary policy also affects the distribution of income in the community. The tax and expenditure measures are adopted to modify the existing distribution with a view to reducing economic inequalities. In this way optimal income distribution is brought about.

Through budgetary policy, the resource distribution and the optimum distribution of income and wealth can be ensured. Through government measures such steps can be taken whereby the resources can be diverted to the poor and depressed segments of the society. To remove inequalities, government mostly levies heavy taxes on rich people's income and provides subsidies on the goods of basic needs, i.e., food, housing, education, health, etc.

**(c) Stabilisation Function:** The budgetary policy can also be used to maintain a high level of employment, a reasonable degree of price level stability, an appropriate rate of economic growth and stability in the balance of payments.

In the stabilisation function of budget policy, we see the performance of the economy. In this function we trace the measures that how can the objectives of full employment be obtained. This function also ensures that inflation or deflation is controlled, and the GDP growth rate is higher or at least stable.

***Importance of Budget:***

**(a) Assessment of Economic Conditions:** Budget provides us the economic conditions of the concerned country, for example, if economy is growing, it means that all the sectors of the economy are growing. If the production of the economy is increases the incomes of the people will also increase. Thus when government assess the economic position of the economy and increase the expenditures, they will have multiplier effects pushing the level of income and employment.

**(b) Financial Resources' Information:** From budget, we come to know the financial position of the country, as it tells us about the total revenues, total expenditures, surplus or deficit. Moreover, it also tells us about how much revenue from direct and indirect taxes, from fees and surcharges to be earned. It also tells us about the extent of development expenditure to be spent on public sector development.

**(c) Assessment of Budget Conditions:** Through budget, the government can also assess the surplus or deficit in monetary terms to be attained next year. If the budget is deficit, the government will have to decide how these deficits could be met. Moreover, it could be observed from budget whether the provinces will be able to meet their expenditures or they will have to depend upon federal government.

**(d) Expenditures' Distribution:** What will be the proportion of expenditures on different sectors of the economy, this will be assessed through government budget. Moreover, the relative importance of different sector of the economy can also be judged from budget.

**(e) Assessment of Income and Wealth Distribution:** The budget gives us knowledge regarding income distribution in the country. Thus government can mobilise the resources through different policies and tools, i.e., taxes, expenditures, rebates, subsidies, etc., to the needy sectors and sections of the society through budget. Thus inequalities can be removed, when the assessment is easy regarding the incomes and wealth distribution in the economy.

**(f) Indication of Economic Policies and Strategies:** Budget also provides us knowledge regarding economic policies and strategies of the government. As from budget estimates, we can see whether the government is spending more on developmental purposes or on non-developmental purposes, whether the tax policy is encouraging or discouraging the entrepreneurs, etc. Similarly, it also assess whether the government preferences regarding expenditures are confined to one area or various sectors of the economy.

**(g) Indication of Foreign Trade Sector:** From the budget, we can see the direction of foreign trade of the economy, whether the government is providing facilities and rebates to exporters or import substitution strategy is being followed. The budget tells us whether the foreign loans are being used and what will be their repercussions on the economy.

**(h) Importance for Consumers:** Budget is a great matter of concern for the consumers, because the incidence of tax imposed by the government is on final consumers. Government generally imposes direct taxes (i.e., income tax, and corporate tax) on individual and corporate incomes; and avoids indirect taxes (i.e., sales tax) on consumer goods as it directly affects the consumers' purchasing power.

**(i) Importance for the Producers:** In under-developed countries, the entrepreneurs and the producers largely depend on the fiscal announcements in the budget policy. Government's tax cuts can boost the investment level in the economy; and encourage the private sector to come forward and invest in order to improve the employment level and the productivity level in the economy. Tax exemptions, rebates, tax holidays, and reduced import duties on industrial goods can achieve the employers' confidence in the economy and provide them the opportunity to achieve cheaper raw material and lower cost of production.

**(j) Importance for the Employees:** The working class of the society has also a keen interest in the government's announcements regarding increase in salaries of government employees and the overall increase in wage rates and pensions. The employees wait for the budget in anticipation of an increase in wages, salaries, and pensions with the fall in taxes.

***Operation of Budgetary Process:***

A budget is designed to improve adjustment of government activities in terms of the preferences of society by facilitating the comparison of conflicting programs and methods in the attainment of the goals as defined by preferences and to facilitate attainment of greater efficiency in the use of governmental resources. This, especially for the federal government, is an extremely complex one, particularly in establishing priorities for competing goals, for example, priorities for defence and the elimination of poverty. The task is extremely complex, even with the aid of the most modern systems analysis and computers.

As a consequence of these complexities, the operation of budgetary process has inevitably developed many shortcuts in order to be workable, which take several forms:

**(a) Specialisation:** The various agencies play a key role in determination of actual expenditure levels; each is concerned only with its own specialised work, with which its officials are familiar. The budgetary authority examines the requests. Furthermore, the government considers the direct needs of the particular activity as well as other activities.

**(b) Fragmentation:** the overall budget is fragmented into small pieces for most of the work, both at the level of preparation and at the committee level.

**(c) Incremental Nature of Action:** Existing programmes are not reviewed in detail each year. No one considers each year the questions of antitrust regulations, restructuring of postal department, etc. The presumption is that existing activities will continue unless there is strong evidence that their existence should be reconsidered.

***Programme Budget / Traditional Budget vs. Programme Budget:***

A primary function of the budget system is to facilitate evaluation of proposals and to compare the relative merits of various requests. Unfortunately, the traditional presentation of budget lacks the fulfilment of this task. Following are the disadvantages of a traditional budget:

**(i)** The usual budget is organised on the basis of agencies, without any related work coordination among them.

**(ii)** The budgets are organised in such a fashion as to stress inputs, without reference to outputs. The relationships between inputs and accomplishments are not established.

**(iii)** The typical budget is on a strictly one-year basis, without regard to future prospects or commitments arising out of the proposals included in this year's budget.

The programme budget is the replacement of the traditional budget, in which emphasis is given on performance. The local governments and to some extent the federal governments have also been introducing program features into their budgets. Following are the features of a programme budget:

**(i)** The ***programme approach stresses the end product***, such as eliminating poverty, increasing employment, increasing agricultural production yield, or aggressive approach regarding the achievement of the community goals, rather than the inputs of various types of materials and manpower.

**(ii)** The ***programme budgeting stresses the relationship between various outputs or programmes and the inputs necessary to produce them***, facilitating the use of techniques to analyse alternative programmes that will attain the goals and various alternative means of implementing them.

**(iii)** The ***programme approach seeks to be all-inclusive***, recognising all contributions that the activity makes and all costs incurred, regardless of the organisational structure.

**(iv)** It ***provides a more useful basis for evaluation*** of agency requests by department, and the Federal Government by concentrating on end products instead of inputs and by providing better information on costs and all benefits.

***Planning-Programming-Budgeting Systems (PPBS):***

The Planning-Programming-Budgeting Systems (PPBS) seek to integrate long-range planning of governmental activities and programming of specific activities with annual budgeting, making use of the programme-budget structure and of various quantitative techniques in the evaluation of proposals. Systems analysis and cost-benefit techniques are employed, with quantification of costs and benefits to aid in the selection of the best alternatives. This approach seeks to aid in defining the goals and in choosing among the goals, in specifying alternative programmes to attain the goals, in choosing the best alternatives, and, subsequently, in measuring performance. Planning is extended forward for several years, rather than focusing attention on the current year. Programming involves the statement of the relationship of inputs and outputs, under various alternatives, to accomplish the desired objectives.

The Planning-Programming-Budgeting Systems (PPBS) are extensively used in all federal units especially in defence.

***Cost-Benefit Analysis:***

Governments presumably consider both the benefits and the costs of programmes. But this consideration has often been haphazard, with little serious effort to quantify benefits or to include all costs and benefits. Governments' decision making is sometimes dominated by the 'absolute needs' approach, i.e., certain expenditure is imperative and must be undertaken regardless of cost. Sometimes it is dominated by the 'money first' approach, i.e., only a certain amount of revenue is available for the purpose and expenditures are therefore confined to this amount.

In recent decades, to some extent concurrently with the development of programme budgeting and PPBS activities, systematic analysis of benefits and costs has increased in importance. The first major applications were in the field of water resources (i.e., building up canals, dams, etc.), characterised by long-term investments and strong pressure groups.

*'Cost-benefit analysis'* can be defined as a systematic examination of the benefits and costs of a particular governmental programme, setting out the factors that should enter into the evaluation of the desirability of the programme and frequently analysing several alternatives for the attainment of the objective. Cost-benefit analysis is designed to ascertain the optimal alternative for the attainment of the desired goals, and to rank other alternatives.

**Elements in a Cost-Benefit Study:** Cost-benefit studies are typically undertaken within a particular governmental department as a preliminary to budget preparations, or as a continuing program to ascertain optimal expenditure patterns and budget recommendations. A cost-benefit study involves several major steps:

**(i) Statement of Objectives:** Obviously, the goals of the particular programmes must be defined. The goal may be very specific, such as that of an irrigation project, with the immediate objective of bringing 2,000 acres under cultivation by providing adequate water. The goal may be long term, such as to increase the country's potential food supply, may be much less well defined, especially in a situation of crop surpluses. Other projects have multiple goals; dams may have flood control, irrigation, navigation, electric generation and recreational objectives. The more sharply the goal can be defined, the greater the contribution that cost-benefit analysis can make to decision-making.

**(ii) Statement of Alternatives:** With many types of activities, there are various alternative ways of attaining the goals: different locations for irrigation facilities, different timing for parts of the project, different methods of construction. Cost-benefit analysis seeks to ascertain relative benefits and costs of the major alternatives.

**(iii) Analysis of Benefits:** With objectives defined and alternatives established, analysis proceeds to a consideration of the benefits. With many activities, this analysis involves determination of the physical units of 'output' from the activity and valuation of these units. Only those benefits should be included that alter the physical conditions of production or consumption for common persons or businesses; and those benefits should not be included in the benefits that reflect changes in prices and incomes arising out of the use of activities.

**(iv) Analysis of Costs:** Analysis of costs involves the same type of problem as that of benefits, although costs are more easily calculable. The direct costs included both capital costs and operating costs over the years. Indirect costs include those created for other governmental agencies, and overall costs to society not directly borne by the government. These are in a sense negative benefits. Without cost-benefit analysis indirect costs are often not taken into consideration. Air pollution provides an excellent example.

**(v) Interest Rate:** With many governmental programmes, especially those of types that lend themselves to cost-benefit analysis such as water and transport development, the benefits will be obtained over a period of years. Likewise some of the costs will be incurred at the time the programme is undertaken while others will be incurred in subsequent years. But a rupee of benefits now is worth more than a rupee of benefits 10 years from now because of the interest phenomenon. In order to evaluate a particular project and to compare alternatives, therefore, an interest factor must be used to determine the present value of future benefits and costs; in other words the stream of consumption benefits and the stream of costs must be discounted back to the present for a comparison to be made.

**(vi) The Criteria for Judgement:** With estimates of benefits and costs discounted back to present value, the final question in cost-benefit analysis is the selection and use of criteria for evaluation. The basic comparison is between two streams: those of benefits and those of costs, both discounted back to the present. The alternative that provides the maximum excess of benefits over costs may be regarded as the optimal one, and any particular project that is the best for attainment of the goals and has discounted present value of benefits equal to the discounted present value of costs is warranted.

***Essentials of A Good Budget / Balanced Budget:***

Budget policy or fiscal policy has three major objectives:

- To insure that the actual rate of growth of the economy coincides with the potential rate of growth through maintenance of full employment;
- To attain a reasonably stable general price level; and
- To increase potential rate of growth if possible without interfering with attainment of other objectives of society.

Budget policy making depends on the economic conditions of the country. The level of expenditure on public works depends on the level of employment in the economy. If the country is facing financial depression, the country needs a boost in investment, which can be achieved through more development expenditure. In any circumstances, there are three standards of a good budget, i.e., optimal allocation of resources, distribution of resources, and stabilisation of the economy.

A good budget is one in which the assurance of optimal allocation of resources and factor should be maximum so that an optimum quantity of public good is obtained. In addition, a good budget should be in accordance with the conditions of demand and supply. Besides these considerations a good budget should possess the position of stability in the economy, i.e., the existence of inflation and deflation in the economy should be minimised if not removed.

**Budget - Balanced or Unbalanced:**> There are two ways of balancing a budget, i.e., to cut the spending to match taxes or raising taxes to match spending:

**(a) *Cuts in government spending*** can be done in two ways:

(i) Either by reduction of purchases, or
(ii) By reduction of personnel.

Both options result in unemployment. Reduced purchasing would force government suppliers to lay off people. Lay-off of government workers likewise increases unemployment, obviously. More unemployment means fewer incomes to tax and more demands for government services such as unemployment compensation, food, medical aid, etc. Cutting welfare spending likewise reduces sales for food, medical service, rent, etc.

**(b) *Raising taxes*** is politically unpopular. However, the economic effects of raising taxes may be less evident. Increased taxation, particularly federal taxes, takes money from local communities. Government economists may argue that the government spends the money back into the economy so there is not a net loss in the general economy. At least two things mitigate against economists' theories. One is that money spent to maintain the huge federal establishment of the country does not circulate back to local communities. Another is that the theory contains no time factor for how long it takes for the money to return, and how much money inputted will be returned back. Sending taxes to the Federal Government and expecting them back is like giving oneself a blood transfusion from the right arm to the left and spilling half of it on the floor.

Balancing the budget by either methods, or any combination, would result in hardship on the people.

This is the most complicated and controversial issue of public finance. Every government faces heavy criticism from social and political organisations regarding the public spending and taxation. In a period of inflationary pressures, fiscal policy seeks to lessen total spending, but its task is complicated by the wage-rate problem; the reduction in total spending must be accomplished in such a way as to minimise the additional pressure placed upon wages and thus upon prices from the cost side.

According to Professor Jack Winner, it is a wrong concept that government should present a balanced budget every year without considering overall circumstances of the economy. When the country is under heavy debt burden, it is quite often that the government paid off her debts by collecting more taxes. In such a situation, a surplus budget is desirable, but collecting taxes in excess of expenditures to reduce the debt is highly deflationary.

Rational fiscal policy calls for deficits when an expansionary stimulus is desirable, surpluses and debt reduction only when fiscal constraints are called for in a full employment and inflationary situation. From the above discussion, it would be evident that more employment, more public welfare and a balanced budget have no mutual relationship and cannot be attained at a time.

# Fiscal Policy in Pakistan

## Government Receipts

The Government receipts consist of the following four sources:

1. **Revenue Receipts (Net of Provincial Shares):** In Pakistan, the heavy dependence is upon revenue receipts, about 65-70% of the revenue is estimated to be drawn from revenue receipts. It includes tax revenue, non-tax revenue, and surcharges.

   **(a) Tax Revenue:** In taxes we have direct taxes such as income tax, and wealth tax. Indirect taxes such as central excise, sales tax, and custom duty. Direct tax comprises about 70% of Pakistan's total tax revenue.

   **(b) Non-Tax Revenue:** It includes income from government property and enterprises and receipts from Civil Administration and other functions.

   **(c) Surcharges:** Surcharges on natural gas and petroleum fall under this category.

2. **Capital Receipts:** Capital receipts include external borrowing and internal non-bank borrowings consisting of unfunded debt, public debt, treasury and deposit receipts besides the revenue account surplus and the surplus generated by public sector, etc.

3. **External Resources:** External resources are loans and grants which come from various sources. These sources include consortium, non-consortium and Islamic sources of aid:

   **(a) Consortium:** Consortium provides aid at both bilateral and multilateral levels:

   (i) Sources of **consortium bilateral aid** are Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Norway, Sweden, United Kingdom and United States.

   (ii) **Consortium multilateral aid** comes from Asian Development Bank (ADB), International Bank for Reconstruction and Development (IBRD), Int. Development Association (IDA), Int. Finance Corporation (IFC), and Int. Fund for Agricultural Development (IFAD).

   **(b) Non-Consortium:** Non-consortium sources of loans and grants mostly provide bilateral aid. These include Australia, China, Czech Republic, Denmark, Finland, Rumania, Switzerland, Russia and Yugoslavia.

(c) **Islamic Aid:** Bilateral aid from Islamic countries come from Saudi Arabia, Kuwait, Qatar, United Arab Emirates, Turkey, Lebanon, Libya and Iran. While multilateral Islamic sources of aid are OPEC Fund, and IDB.

Loans and grants received by Pakistan can be classified into 'project' and 'non-project aid'. Non-project aid can be further decomposed into food, non-food, BOP and Relief aid.

4. **Self-Financing by Autonomous Bodies:** This is actually the surplus left after meeting all the expenses of these bodies. This surplus is available to government for revenue and development expenditures.

## Government Expenditure

Government expenditure is classified into current expenditure and development expenditure:

1. **Current Expenditure:** It comprises mainly debt servicing, defence, general administration, social services, law and order, subsidies, community services, economic services, grants to Azad Jammu and Kashmir, Railway and others.
2. **Development Expenditure:** Public Sector Development Program (PSDP) is another name given to Government's development expenditure. The priority areas are transport and communication, power and water. These three sectors combined cover about 50% of total allocation of PSDP.

The share of current expenditure is always remain substantial, it constituted around 70-80% of total Government expenditure. Non-development expenditure is generally regarded as being excessive and therefore subjected to persistent public criticism. With sharp increase in population, constant threat from the enemies and increasing cost of corruption, non-development expenditure is subjected to a rising trend which could only be controlled by rapid economic development. On the other hand, negligence of non-development expenditure may result into ill-equipped and under-staffed hospitals, dispensaries and educational institutes, and arrears in maintenance of roads, dams, bridges, electricity and forests. Non-development expenditure should be economically managed in order to ensure the economic development of Pakistan.

There are six major heads of current expenditure of Federal Government of Pakistan:

1. Defence,
2. Debt servicing,
3. Subsidies and grants,
4. General administrative,
5. Social services, and

6. Others.

## Tax Structure of Pakistan

1. The narrow base enigma has been a base in Pakistan's tax structure from the beginning.
2. In 1987 when population of the country was more than a hundred million, the total number of taxpayer was just over a million.
3. The main base taxes imposed are direct and indirect taxes.
    a. Direct tax of the Federal Government comprises of income tax, wealth tax and corporate tax
    b. Indirect tax, on the other hand, consists of custom duty, excise duty, sales tax, import duty and all others.
4. Indirect tax contributes the predominant share to the total tax collection. Direct taxes have persistently dropped their share in total tax revenue.
5. Indirect tax, on the other hand, contributes more than 70% of the total tax revenue. Indirect tax is regressive. It may cause the inflation to rise and its incidence is fall on poor class of the economy.

## Deficit Financing in Pakistan

Following are the sources of deficit financing in Pakistan:

1. Printing new currency notes
2. Public borrowings
3. Foreign loans, aid and grants
4. Using previous balances, and
5. Borrowings from banks including from the central bank.

Dr. Mahboobul Haq defines deficit financing in the following words:

(i) Net borrowings by the government from the banking system which includes the State Bank of Pakistan (SBP) and commercial banks but excludes non-banking institutions and individuals, and

(ii) Net borrowings by the Government from the SBP only.

But the public debt does not only constitute the above sources, it also includes money lent to Government out of the balances of the banks which would have been held if the Government had not borrowed them.

Deficit financing is a sound and necessary instrument of the Government finance and its role, its desirability and limitations of its use in mobilising revenue, must be properly analysed in the context of its broad implications on the economy and compared to the adequacy of other techniques of resource mobilisation.

It was planned in Third Five-Year Plan that there will be no deficit financing during the said plan but the government had to revise the plan. In the Fourth Five-Year Plan there were annual plans and major upsets in the economy. In the Fifth and Sixth Five-Year Plans, though there were very large amounts of foreign remittances but there was not remarkable reduction in deficit financing.

A well-managed deficit financing could be a key to greater economic achievements especially for a less developed country. A wise finance minister has to keep an eye on all the factors of the economic development and spent the public fund in the manner that is most beneficial to the nation.

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# Incidence of Taxation

Taxes are not always borne by the people who pay them in the first instance. They are often shifted to other people. Tax incidence means the final placing of a tax. Incidence is on the person who ultimately bears the money burden of tax. According to the modern theory, incidence means the changes brought about in income distribution by changes in the budgetary policy.

***Impact and Incidence:*** The impact of a tax is on the person who pays it in the first instance and the incidence is on the one who finally bears it. Therefore, the incidence is on the final consumers.

***Incidence and Effects:*** The effect of a tax refers incidental results of the tax. There are several consequences of imposition of tax, for example, decreased demand.

***Money Burden and the Real Burden:*** The money burden of a tax is represented by the total amount of money received by the treasury. For example, the consumer has to spend Rs. 50 more on sugar monthly, it is the money burden that he has to bear. But if he has to reduce his consumption of sugar it means there is a reduction in economic welfare. This inconvenience, pinching, sacrifice or in short the loss of economic welfare is the real burden of tax.

## *Theories of Tax Shifting and Incidence*

1. **Earlier Theories:** The earlier theories may be classified into:

   **(a) Concentration or Surplus theory:** According to concentration theory, each tax tends to concentrate on a particular class of people who happen to enjoy surplus from their products.

   **(b) Diversion or Diffusion theory:** The diffusion theory states that the tax eventually got diffused in the entire society. That is, the final placing of tax is not one but multiple. The process of diffusion took place through shifting or through process of exchange.

2. **Modern Theory:** According to modern theory, the concentration and diffusion theories are partially true. Actually there are both concentration and diffusion of taxes according to the conditions present. The modern theory seeks to analyse the conditions which bring about concentration or diffusion.

## *Factors determining Tax Incidence*

**(a) Elasticity:** While considering incidence we consider both elasticity of demand and elasticity of supply. If the demand for the commodity taxed is elastic, the tax will tend to be shifted to the producer but in case of inelastic demand, it will be largely borne by the consumer.

In case of elastic supply, the burden will tend to be on the purchaser and in the case of inelastic supply on the producer.

**(b) <u>Price:</u>** Since shifting of the tax burden can only take place through a change in price, price is a very important factor. If the tax leaves the price unchanged, the tax does not shift.

**(c) <u>Time:</u>** In short run, the producer cannot make any adjustment in plant and equipment. If, therefore, demand falls on account of price rise resulting from the tax, he may not be able to reduce supply and may have to bear the tax to some extent. In the long run, however, full adjustment can be made and tax shifted to the consumer.

**(d) <u>Cost:</u>** Tax raises the price; rise in price reduces demand and reduced demand results in the reduction of output. A change in the scale of production affects cost and the effect will vary according as the industry is decreasing, increasing or constant costs industry. For instance, if the industry is subject to decreasing cost, a reduction in the scale of production will raise the cost and hence price, shifting the burden of the tax to the consumer.

**(e) <u>Nature of tax:</u>** The incidence of taxation will definitely depend on the nature of tax. For example, an indirect tax's burden is fall on the consumer.

**(f) <u>Market form:</u>** Another factor determining the incidence of taxation is the market form. Under perfect competition, no single producer or single purchaser can affect the price; hence shifting of tax in either direction is out of the question. But under monopoly, a producer is in a position to influence price and hence shift the tax.

## ***<u>Distinction between Direct and Indirect Taxes</u>***

A direct tax is not intended to be shifted, whereas an indirect tax is so intended.

Taxes on commodities are generally called indirect taxes as they completely or partially shifted consumers. But it should be remembered that all the commodity taxes are not indirect taxes. A tax is said to be indirect if its burden is shifted finally to the consumer.

Direct tax is the tax in which the commodity is taxed by the government, yet its price remains unaffected or changed. In this case the tax is not shifted to consumer and the tax will be called direct tax. If the tax is shifted, the tax is indirect, otherwise indirect.

## ***<u>Merits and Demerits of Direct and Indirect Taxes</u>***

### ***<u>Merits of Direct Tax:</u>***

1. **Equitable**, i.e., the principle of progression is applied
2. **Economical**, i.e., the cost of collection is small
3. **Certain**, i.e., the direct tax can be calculated with a fair degree of precision
4. **High degree of elasticity**, i.e., the direct tax can be raised much easily
5. **Civic consciousness**, direct tax creates civic consciousness among tax-payers

6. **Reduction of inequalities**, i.e., the objective of direct tax is to reduce economic inequalities by taxing higher income earners at progressive tax rates.

***Demerits of Direct Tax:***

1. **Inconvenient:** for the tax payer to pay and file the income tax return
2. **Unpopular tax system**
3. **Tax evasion is common**
4. **Unarbitrary tax rates**

***Merits of Indirect Tax:***

1. **Convenient:** for the tax payer to pay and it requires no filing of returns
2. **No tax evasion**
3. **Unified tax rate**
4. **Beneficial social effects** (in case of harmful drugs and intoxicants)
5. **Capital formation**
6. **Re-allocation of resources**
7. **Wide coverage**

***Demerits of Indirect Tax:***

1. **Uncertain**
2. **Regressive**
3. **No civic consciousness**
4. **Inflationary**
5. **Loss of economic welfare**

## ***Incidence of Some Taxes***

***Taxes on Personal Income:***

1. Income tax, super tax and excess profit tax are all direct taxes and generally cannot be shifted.

2. However, the business is in a strong position and can shift a part of his tax burden to his customers. But this situation is rarely present and the income tax payer must bear the burden of tax.

3. If the income tax is extremely heavy, it may discourage saving and investment. However, it will mainly depend on whether the tax falls on average income or marginal income, the effects would be adverse. If the increase in tax is fall on marginal income, it will mean a positive discouragement to the earning of that income.

***Corporate Tax:***

1. Corporate tax discourages investment, level of national income and employment.

2. A corporation tax, by reducing the earnings of the existing firms, discourages the entry of new firms into the industry which may result in a monopoly or a semi-monopoly for the existing firms with all the attendant evils.

3. A part of corporate tax may be shifted to the buyers through a price rise.

***<u>Tax on Profits:</u>***

1. Some economists are not of the view that the tax on profit should be shifted to buyers. It should be borne by the seller who pays it.

2. The second view does not subscribe with the above approach. It is argued that normal profit is a part of the cost and when the entrepreneur is able to influence the price, the tax is generally shifted to the consumer.

3. However, the tax on profit in the form of a licence duty will be borne by the producer.

***<u>Wealth Tax:</u>***

1. Wealth tax is imposed on value of a person's stock of wealth

2. By enabling the government not to raise the income tax rates too high, the wealth tax encourages investment in modern industries

3. Another obvious effect of wealth tax is the reduction of economic inequalities by reducing the size of inherited wealth

***<u>Property Tax:</u>***

1. The wealth tax is imposed on the net worth of the individual. Whereas, the property tax is levied on the gross amount of assets' value

2. There is no shifting of tax and the incidence is on the person on whom the tax is levied. However, the tax on productive property may be shifted to consumers.

***<u>Land Taxation:</u>***

1. The value of land depends on two sets of factors:

   (a) Natural factors like the fertility of the soil, the situation of the land, some other natural conditions, and

(b) Investment of capital in drainage schemes, anti-erosion measures, irrigation facilities and other measures necessary to increase and sustain productivity

2. The tax on the first set is a tax on economic rent and has a tendency to fall on the owners

3. But when the owner can vary his investment when the tax increases, he can shift the tax burden to the consumer.

***Tax on Buildings:***

1. If the tax is imposed on the owner, he will try to raise the house rent and thus shift the tax to the occupier or tenant. But he cannot do this during the currency of the lease.

2. A heavy tax will check building activity and the remuneration of the builder and of other people engaged in the trade may fall

3. The tax may fall partly on the owner, partly on the builder and partly on the occupier

***Death Duty:***

1. Death duty may take two forms, i.e., Estate Duty and Succession Duty

2. The Estate Duty is levied on the total value of the estate (i.e., movable and immovable property) left by the deceased irrespective of the relationship of the successor

3. The succession duty varies with the relationship of the beneficiary to the deceased. It takes into consideration individual share of the successor and not the total value as in the estate duty.

***Tax on Monopoly:***

1. The monopoly tax may be:

   (a) Independent of the output of the monopolised product, or

   (b) It may vary with the output, i.e., increase or decrease with the output

2. When the tax is independent of the quantity produced, it may either be lump sum tax on the monopolist or a percentage of the monopoly net revenue (profits). In both cases it will be borne by the monopolist and he cannot shift the same to the consumer, because the monopolist is already on a price with maximum beyond which his profit will decline

3. In the second case, the price of the commodity or incidence of taxation will depend on the elasticities of supply and demand, and the influence of laws of returns.

4. Taxing of the commodity, therefore raises the price which will tend to reduce the demand

5. If, however, the demand is inelastic, it cannot be appreciably reduced and the tax will be borne by the consumer.

6. If the demand is elastic, the consumers may buy less when the tax has raised the price. Instead of facing a decline in demand the monopolist may reduce the price and decide to bear the tax himself.

***<u>Commodity Tax:</u>***

1. Taxes on commodities may take several forms:

   (a) Tax on manufacture or production of a commodity called excise duties,

   (b) Tax on sale of a particular commodity known as sales tax, and

   (c) Import or export of commodities known as custom duties.

2. The commodity tax is tended to be shifted to the consumer and from consumer to the producer

3. Tax on production tends to raise the prise and will therefore be normally borne by the consumer

4. But the consumption tax is likely to check consumption and tends to be shifted backward to the producer.

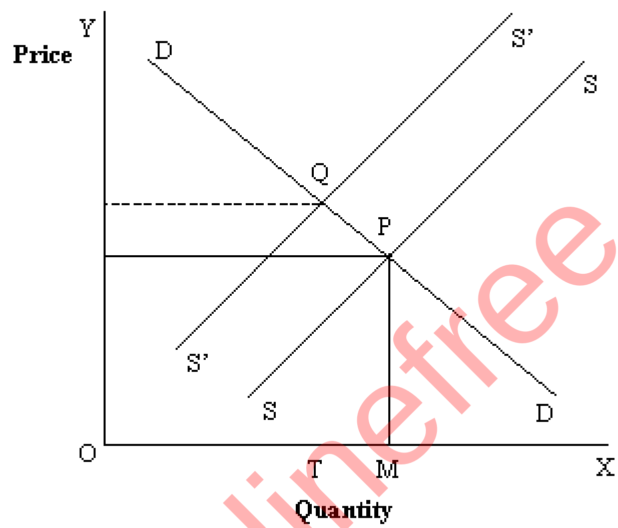
5. Therefore, the tax on commodity will be partly borne by the producer and partly borne by the consumer

6. The portions of commodity tax to be borne by the producer and consumer depends on the degree of elasticity of demand and supply:

| Elasticity | Incidence |
|---|---|
| Elastic demand | More tax burden on the supplier / producer |
| Inelastic demand | More tax burden on the buyer / consumer |
| Elastic supply | More tax burden on the buyer / consumer |
| Inelastic supply | More tax burden on the supplier / producer |

7. As a rule, the consumer bears a smaller part of the tax when the demand is more elastic than the supply

8. This may happen that the price may not rise at all. This is because the consumers have been able to discover an untaxed supply of the commodity or substitute. In this case, the tax burden will fall on the producer.




9. DD and SS intersect at point P and MP is the price determined. Now suppose a sales tax per unit is levied. As a result the supply curve of the commodity will rise upward equal to the tax per unit. The new supply curve will be S'S'. The distance between the two supply curves represents the tax per unit of the commodity. S'S' cuts the demand curve DD at Q and, therefore, now TQ is the price determined which is higher than the old price PM by RQ. Hence RQ is the burden of tax borne by the consumer even though the tax per unit is LQ. Therefore, RL (LQ – QR) is the burden of the tax borne by the seller or he has RL price less than before (PM being the first price).

10. Therefore the commodity tax is distributed between the buyers and sellers according to the ratio of elasticities of demand and supply:

$$\frac{RL}{RQ} = \frac{\text{Burden of the tax on the seller (producer)}}{\text{Burden of the tax on the buyer (consumer)}}$$

$$Ed = \frac{\text{Proportionate decrease in quantity demanded}}{\text{Proportionate increase in price}}$$

$$= \frac{MT}{OM} \div \frac{RQ}{MP}$$

$$= \frac{MT}{OM} \times \frac{MP}{RQ} \text{ ---------------------------------- } (i)$$

*Es* = <u>*Proportionate decrease in quantity supplied*</u>
*Proportionate decrease in price*

$$= \frac{MT}{OM} \div \frac{RL}{MP}$$

$$= \frac{MT}{OM} \times \frac{MP}{RL} \text{ ------------------------------------- } (ii)$$

= <u>*Elasticity of Demand (Ed)*</u>
*Elasticity of Supply (Es)*

$$= \frac{(i)}{(ii)}$$

$$= \frac{\frac{MT}{OM} \times \frac{MP}{RQ}}{\frac{MT}{OM} \times \frac{MP}{RL}}$$

$$= \frac{RL}{RQ}$$

11. In the above equation, RL is the burden of the tax on the seller and RQ is the burden of tax on the buyers. Hence:

<u>*RL*</u> = <u>*Burden of tax on the seller*</u>
*RQ* = *Burden of tax on the buyer*

= <u>*Elasticity of demand (Ed)*</u>
*Elasticity of supply (Es)*

***<u>Sales Tax:</u>***

1. The sales tax is levied on the turnover, profits or no profits. It covers a wide variety of commodities.

2. The sales tax may make heavy inroads into profits which may lead to retrenchment in the staff and management, restrict enterprise and employment and hamper utilisation of resources.

3. Thus, its incidence may fall upon employees, management and landlords.

***Import Duties and Export Duties:***

1. Import Duties are generally borne by the home consumer

2. If the demand for the imported product is elastic and the supply is inelastic and the foreign producer has no alternative market, then in such a case the burden of tax may be shifted to foreign seller. This situation is rarely present.

3. Export duty is borne by the exporter. The price in the world market is fixed and no individual exporter is in a position to influence the world price.

4. There are certain exceptional situations in which the purchaser may bear the burden of export duty. For example, the supplier or the producer has the monopoly of the supply of a commodity.

## ***Effects of Taxation on Production, Consumption and Distribution***

***Effects on Production:***

1. Production is affected by taxes in two ways:

   (a) By affecting the ability to work, save and invest

   (b) By affecting the desire to work, save and invest

2. A tax on necessaries of life, will obviously affect the workers' productivity and hence reduce production. A heavy tax on income tends to reduce the ability to save and invest on part of individuals. A decrease in investment is bound to affect adversely the level of output in the country

3. Normally taxation induces people to work harder, earn more, save more and invest more to increase their income and enjoy the same income after tax

4. Some taxes has no adverse effects, for e.g., import duties, tax on monopolists, etc.

5. High marginal rates of income tax are likely to affect adversely the tax payers' desire to work, save and invest

6. The reaction varies from individual to individual. It depends on the individual's elasticity of demand for income. When it is fairly elastic, the tax will lessen his desire to work and save

7. Entrepreneurs may avoid the production of goods which are taxed. There is likely to be a diversion of resources from some sectors of economy to others

***Effects on Income Distribution:***

1. The effects of taxes on income distribution depends on the type of taxes and rates of taxes

2. Taxation of goods of mass consumption is regressive and redistributes incomes in favour of rich.

3. But if such commodities are exempted and luxuries are taxed, and the taxation is made progressive, then the income will be redistributed in favour of poor.

***Effects on Consumption:***

1. By imposing tax on a consumable good which is injurious to health, its consumption can be checked.

2. Similarly the tax on luxury goods can decrease their consumption and resources diverted to the production of mass consumption

## ***Merit Goods:***

The concept of merit goods is introduced as a result of public and private goods. The term 'Merit Goods' is defined as those goods representing the aggregate values, circumstances, culture, environment and social behaviour of the society. Then it becomes the duty of the government to provide these goods.

Merit goods may be public or private, but the provision of merit goods may lead to distort the choices of individuals. But as these goods represent the preferences of so many people, hence, they are called as 'merit goods'.

In case of merit goods, efforts have been made to establish a relationship between public and private goods, which are generally opposite to each other. The government has to management in such a manner that the individual choices of the society may not be affected.

It is being observed that the merit goods are being introduced at governmental level in the countries like Iran and Saudi Arabia. As in these countries adulterer is given death sentence. While in Western countries, the merit goods are being brought forward with the help of legislation, referendum, budget policy, media and educational development. Here the prostitution is being discarded because of the spread of AIDS.

Thus merit goods motivate the people to defend their own interests as well as their countries also.

## ***Externalities:***

Externalities are those activities that affect others for better or worse; without those others paying or being compensated for the activity. Externalities exist when private costs or benefits do not equal social costs or benefits. The two major species are *'external economies'* and *'external diseconomies'*:

***External Economies:*** External economies are those economies which accrue to each member firm as a result of expansion of the industry as a whole. Expansion of an industry may lead to the availability of new and cheaper raw materials, tools and machinery, and to the discovery and diffusion of a superior technical knowledge. Moreover, with the expansion of an industry, certain specialised firms may come into existence which work up its waste products. The industry can sell them at a good price. The entry of new firms enlarging the size of an industry may enable all firms to produce at lower cost. There is every possibility of external economies to be reaped when a young industry grows in a new territory.

There are various types of external economies that are broadly classified into three categories discussed as below:

**(a) Economies of Concentration:** These economies relate to advantages arising from the availability of skilled workers, the provision of better transport and credit facilities, stimulation of improvements, benefits from subsidiaries, and so on. Scattered firms cannot enjoy such economies. These are the advantages of a localised industry. Such economies are of special importance in the countries like India and Pakistan which has not yet been fully industrialised.

**(b) Economies of Information:** These economies refer to the benefits which all firms engaged in an industry derive from the publication of trade technical journals and from central research institutions. In a localised industry, research and experiments are centralised. Each individual firm need not incur expenditure on research. It can draw such benefits from common pool.

**(c) Economies of Disintegration:** When an industry grows, it becomes possible to split up some of the processes which are taken over by specialised firms. For example, a number of cotton mills located in a particular locality may have the benefit of a separate calendaring plant.

***External Diseconomies:*** When an industry expands, the firms enjoy external economies. But too much expansion will result in greater external diseconomies than external economies. As a consequence, the cost of production goes up instead of falling.

It is common experience that, when an industry in an industrial centre expands, there is a keener competition among the firms for the factors of production and the raw materials. As a consequence, the prices of raw materials and of the factors production go up. All firms have now to pay higher wages, higher rents and higher rates interest besides higher prices for the raw materials. Suitable labour ceases to be available; and capital also becomes scarce. The result is that, with the expansion of an industry the costs of production go up instead of falling. Too much expansion of industries may cause other social costs, like pollution, use of very cheap (even harmful) materials in food / medical products, etc.

The main point is that the additional factors of production, the employment of which becomes now necessary, are less efficient and they are obtained at a higher cost. It is in this manner that diseconomies result as an industry expands.

***Policies to Correct Externalities:***

What weapons the government can use to combat inefficiencies arising from externalities? The governments today combat externalities using either direct controls or financial incentives to induce firms to decrease harmful externalities or to increase beneficial activities. The government steps to restrain pollution and other harmful activities arising from external diseconomies are:

**1. Government Programmes:**

***(a) Direct Controls,*** i.e., through social regulations or direct regulatory controls, usually enforced by the Federal Department of Environmental Protection.

***(b) Market Solution,*** i.e., through economic incentives instead of direct regulatory controls. One of the approaches may be to charge 'emission fees' which would require the firms to pay a tax on their pollution equal to the amount of external damage. This in effect internalised the externality by making the firm face the social costs of its activities.

**2. Private Approaches**:

***(a) Negotiation and the Coase Theorem:*** A startling analysis by Chicago's Ronald Coase suggested that voluntary negotiations among the affected parties would in some circumstances lead to the efficient outcome. Coase's analysis does point to certain cases where private bargains may help alleviate externalities - namely, where property rights are well defined and where there are only a few affected parties who can get together and negotiate an efficient solution.

***(b) Liability Rules:*** A second approach relies on the legal framework of liability laws or the tort system rather than direct government regulations. Here, the generator of externalities is legally liable for any damages caused to other parties. Thus, if you are injured by a negligent driver, you can sue for damages. Or, if, through negligence, a company causes illness to its workers, the workers can sue the company for compensation.

# *Public Finance and Private Finance:*

***Similarities:***

**(a)** Both have to balance their incomes and expenditure;
**(b)** Both try to maximise the benefit with the minimum use of resources;
**(c)** Both have to borrow to bridge gap between their current revenue and current expenditure; and
**(d)** Both can increase their income by increasing their investment expenditure.

***Differences:***

**(a) Adjustment of Income and Expenditure:** For an individual, there is a general note: "Cut your coat according to your cloth". But a government first settles the dimension of the coat and then proceeds to arrange for the cloth required. In other words, the individuals have to adjust their expenses according to their income. Whereas, the public enterprises adjust their incomes according to their expenses, which is, however, not always true.

On the whole, we can say that there is a real difference in approach towards the finance of an individual and that of a government. The government first calls for an estimate of expenditure from the various departments, settles the total expenditure, and than levies the taxes accordingly.

**(b) Budgeting:** For the public authorities, the unit of time for the budget is one year. But the individual attaches no special sanctity to the period. He need not balance his budget by a particular date or during a given period.

**(c) Internal Borrowing:** In their resources, a government and an individual differ. When hard-pressed, a government can borrow both at home and abroad, i.e., it can raise either an internal loan or an external loan or both. But the only way open to an individual is external loan. There can be no internal loan for an individual.

**(d) Deficit Financing:** There is another source of income open to a government, i.e., deficit financing. A government can obtain more money by printing more currency notes. An individual cannot print his / her own currency note to be acceptable in the market.

**(e) Different Objectives:** An individual tries to maximise his satisfaction or profit from the consumption or production from a given amount of resources. Whereas the theme objective of a government to maximise the social welfare. The government spends money in order to attain the level of maximum social benefit. Further, the governments seek to achieve full employment, an equitable distribution of income and rapid economic growth or economic stability through their fiscal operations. But these objectives have no counter-parts in individual finances.

**(f) Deliberate and Changes in Finance:** For an individual, big and deliberate changes either in income or in expenditure are not so easy. But governments are in better position to make big and fundamental changes in the scheme of public income and public expenditure for future prospects.

**(g) Provision for the Future:** In the matter of providing for the future, a government is much more liberal and far-sighted. Governments spend large amounts of money on schemes of afforestation, public works or social security schemes, and developmental projects which will ensure in future, faster and stable economic growth, more social welfare, more employment opportunities, etc. The individual, on the other hand, may be anxious to reap quick returns. Human life is so uncertain that some individuals discount the future at a very heavy rate.

**(h) Surplus Budgeting:** A prudent individual must spend less than he earns. He must have a surplus budget. But for a state, it depends on the economic situation in the country. Deficit budgeting during times of a depression may stimulate effective demand. On the other hand, during periods of inflation, the emphasis is on surplus budgeting so as to reduce the level of effective demand.

**(i) Individual Finance is Concealed:** An individual, for security reason, may conceal his income or wealth. Whereas a government annually publishes its budgetary policy revealing national income, expenditure, resources in use, etc. This shows the strength of an economy and the capability of nation as a whole.

**(j) Coercive Authority:** The private individual lacks the coercive authority which a government has. A government has simply to pass a law and compel the citizens to pay a tax or subscribe to a compulsory loan (i.e., a compulsory deposit), but an individual cannot do raise his income in this way.

# Public Debt

Public debt refers to borrowing by a government from within the country or from abroad, from private individuals or association of individuals or from banking and NBFIs.

## Classification of Public Debt

**(a) <u>Internal and External:</u>** When a state finds that it is not possible to obtain further money by taxation, it resorts to borrowing from citizens and financial institutions within the country. This is 'internal borrowing'. The state may accumulate funds by raising short-term loans or long-term loans or by both. If the state is passing through a very critical period, then it can borrow all the money which the nation saves. In that case trade and industry will suffer a lot because no money is left to finance them. In the normal period, however, the state can borrow only surplus funds which are left with the businessmen after meeting all the needs of the business.

External loan is that which is raised from international money markets, foreign governments, and from international agencies like International Monetary Fund. When a state is in need of money, it tries to get as much loan as it can from other states. The foreign governments do not advance loans without a limit. They minutely study the budgetary position of the borrowing country, the tax-bearing capacity of the nation, the per-capita income of the people and the purpose for which the loan is desired. If the position of the budget is sound and the taxable capacity of the nation is high, then a foreign government may advance sizable loan to the borrowing country.

**(b) <u>Productive and Unproductive:</u>** The debt that is expected to create assets which will yield income sufficient to pay the principal amount and the interest on it, is known as 'productive debt'. In other words, they are expected pay their way; they are self-liquidating. J.L. Hanson has referred such a debt as 'reproductive debt'.

On the other hand, unproductive debt is the debt that is raised for financing unproductive assets or heavy unproductive expenditures. Such a debt is a deadweight debt. Debt invested on wars or prevention of war is a deadweight debt.

**(c) <u>Short-term and Long-term:</u>** The loans that are repayable within a period of one year, they are termed as 'short-term loans' and if they are taken for more than one year, they are referred to as 'long-term loans'. Following are the reasons for raising short-term loans:

1. If, at any time, the expenditure of the government exceeds the revenue, then she takes recourse to short-term borrowing.

2. If, at any time, the rate of interest in the market is very high and the government is in need of large fund to finance her various projects, then it raises loan for a

short-period of time only and waits till the prevailing high rate of interest comes down.

3. The commercial banks find a very safe and profitable opportunity to invest their surplus funds in the government short-term loans.

If the government is in need of large funds and the short-term loans are not enough, then she takes recourse to long-term borrowing. Long-term loans entail following advantages:

1. Long-term loan provides an opportunity to the state in undertaking large projects like construction of canals, hydroelectric projects, buildings, highways, etc. As these loans are not to be repaid at a short notice, so the government safely spends them on productive projects.

2. Long-term loans are also unavoidable for strengthening country's defence.

3. Long-term loans provide good opportunity for commercial banks and insurance companies to invest their surplus funds. As the rate of interest on long-term loans is higher than on the short-term loans.

4. Long-term loans can be repaid by the government by the time which is favourable or convenient to her. She can also convert these loans at a lower rate of interest later on.

5. If at any time, the rate of interest is low, the government can contract a long-term loan and with the amount thus raised some public work programmes at lower cost.

## Causes of Increase in Public Debt

1. War or war-preparedness, including nuclear programmes
2. To cover the budget deficits on current account
3. To undertake public welfare schemes
4. Urge for economic growth
5. Inefficiencies of public organisations and corruption

## Purposes of Public Debt

1. Bringing gap between revenue and expenditure through temporary loans from central bank. In Pakistan, the Government issues what are called 'Treasury Bills' which are repayable within one year.
2. To reduce depression in the economy and financing public works programme.
3. To curb inflation by withdrawing the purchasing power from the public.

4. Financing economic development esp. in under-developed countries.
5. Financing the public sector for expanding and strengthening the public enterprises.
6. War, arms and ammunition financing.

## Methods of Debt Redemption

1. **Utilisation of surplus revenue:** This is an old method and badly out of tune with the modern conditions. Budget surplus is not a common phenomenon. Even when there is a surplus, it cannot be used for making any substantial reduction in the public debt.

2. **Purchase of government bonds:** The government may buy her own stocks in the market, thus wiping off its obligation to that extent. This may be done by the application of surplus revenues or by borrowing at low rates, if the conditions are favourable.

3. **Terminable annuities:** When it is intended completely to wipe off a permanent debt, it may be arranged to pay the creditors a certain fixed amount for a number of years. These annual payments are called 'annuities'. It will appear that, during the time these annuities are being paid, there will be much greater strain on the government finances than when only interest has to be paid.

4. **Conversion of high-interest-rated loans to low-interest-rated loans:** A government may have borrowed when the rate of interest was high. Now, if the rate of interest falls, it can convert a high-rated loan into a low-rated one.

5. **Sinking fund:** This is the most important method. A fund is created for the repayment of every loan by setting aside a certain amount every year out of the current revenue. The sum to be set aside is so calculated that over a certain period, the total sum accumulated, together with the interest thereon, is enough to pay off the loan.

## Burden of Public Debt

If the debt is taken for productive purposes, for e.g., for irrigation, transportation, railway, roads, information technology, human skill development, etc., it will not mean any burden. Infact, they will confer a benefit. But if the debt is unproductive it will impose both money burden and real burden on the economy.

**(a) Burden of internal debt:** Internal debt involves a series of transfers of wealth within the country, i.e., from lender to government and then later on at the time of redemption from government to lender. Money is thus transferred from one section of the community to other sections. In this case the money burden on the economy is zero.

But there may be real burden on the community. In order to repay the interest and the principal amount of the debt, the government has to levy taxes. What the taxpayers pay the lenders receive. The lenders are generally rich people and tax burden is fall on poor especially in the case of indirect taxes. The net result may be that the wealth is transferred from poor to rich. This is the loss of economic welfare.

**(b) Burden of external debt:** External debt also involves a series of transfer of wealth from the foreign lender to the borrowing country, and when it is repaid the transfer is in the opposite direction. As the borrowing country paid interest to the foreign lenders, a direct money burden is fall on the whole community.

The community is also suffered from real burden of external debts. Government has to cover the amount of interest to be paid to the foreign lender by heavily taxing the income of the community. As a result the production, consumption and distribution of income is badly affected. Moreover, the foreign lender has direct involvement in the economic activities of the country.

## Role of Public Borrowing in a Developing Economy

1. Taxation should cover at least current expenditure on normal government services and borrowing should resort to finance government expenditure which results in creation of capital assets.
2. Public borrowing for financing productive investment generates additional productive capacity in the economy
3. It is used as an instrument to mobilise resources which would otherwise hoarded in real estate or jewellery
4. It provides the people opportunities to hold their wealth in the form of safe and stable income-yielding assets, i.e., government bonds
5. The management of public debt is used as a method to influence the structure of interest rates.
6. Public has become a powerful tool of developmental monetary policy
7. There are two ways in which the governments of under-developed countries raise resources through public loans:
   a. Market borrowing, i.e., sales to the public of government bonds (long-term) and treasury bills (short-term) in the capital market
   b. Non-market borrowing, i.e., issue to the public of debt which is not negotiable and is not exchange in the capital market, for e.g., National Saving Certificates
8. There are two forms of loans, i.e., voluntary and forced loans. Forced loans or compulsory borrowing is a compromise between taxation and borrowing. Like a tax it is a compulsory contribution to the government but like a loan, it is to be repaid with interest.

## Difficulties of Public Borrowings in UDCs

1. In UDCs there are no or very small organised capital and money markets. The resources are too inadequate to fulfil the capital needs of the economy.
2. Resources are hoarded in non-productive sections of the economy, for e.g., real estate jewellery.
3. The savings in rural areas cannot be mobilised effectively because rural incomes do not move through monetary channels
4. The response to government securities is also poor because of rising prices.

Effects of Public Debt on Production, Consumption, Distribution and Level of Income and Employment

1. **Effects on Production:** Public debts are raised to finance productive enterprises of various kinds, e.g., steel works, cement, multipurpose projects, construction of ships, railway lines and highways, heavy electrical and engineering works, mining, oil refining, etc.
2. **Effects on Consumption:** When people subscribe to government loans, they generally have to curtail consumption. Since investment of funds raised by borrowing raises the level of employment and as a result raises the level of consumption.
3. **Effects on Distribution:** Public loans transfer money from rich to government. The fiscal operations of the government are to benefit the poor primarily. The incomes of the poor increase directly through increased employment or it benefits them in directly through the enlargement of social services.
4. **Effects on the Level of Income and Employment:** In modern times, public borrowing is resorted to in order to raise funds for financing agriculture, industry, mining, transportation, communication, etc. It increases employment opportunities, the level of income and standard of living.

## Hicks' Classification of Public Debts

1. **Deadweight Debt:** Deadweight debt is one which is not covered by any real assets. In the words of Hicks: "Deadweight is that which is incurred in consequences of expenditures which in no way increase the productive power of the community, yielding neither money revenue nor a future flow or utilities." The loan raised during war period is a deadweight debt because for such debts no real assets exist to balance them.
2. **Passive Debt:** Sometimes government raises loans for spending on such projects which neither yield money income nor help in raising the productivity of the country. They simply provide enjoyments to the citizens such as public parks, museums, public buildings, etc.
3. **Active Debt:** Active debt is one which is spent on those projects that directly help in yielding money income and increasing the productive power of the community.

## Hanson's Classification of Public Debt

J.L. Hanson has classified public debt into four main classes:

1. **Reproductive Debt:** When a debt has assets to balance it, it is called reproductive debt. For instance, if a state borrows money for spending it on the construction of canals, railways, factories, etc, it is then able to repay the loan from these self-liquidating projects.
2. **Deadweight Debt:** A debt which is not covered by any real assets is called deadweight debt. Debt invested on wars or prevention of war is a deadweight debt.
3. **Funded Debt:** Funded debts are long-term debts. The government continues paying the annual interest on such loans but makes no promise to pay the principal sum to the lender on any specified date. The examples of funded debts are long-term government stocks, war loans and console.
4. **Floating or Unfunded Debt:** Floating or unfunded debt comprises of short-term loans. It is payable to the lender with interest on or before a fixed date.

# Economic Survey 2004-05

## *Growth and Investment:*

Real GDP grew by 8.4 % in 2004-05 as against 6.4% last year and surpassed the target of 6.6% by a wide margin. This is because of a steller performance in large-scale manufacturing (15.4%), agriculture (7.5%) and services sector (7.9%).

Agriculture grew by 7.5% in 2004-05, which is higher than actual growth of 2.2% last year and a target of 4.0 percent.

The overall manufacturing, accounting for 18.3% of GDP repeated stellar performance by registering a growth of 12.5% in 2004-05 as against 14.1% last year and surpassing its target by 2.3%. Accordingly, its share in GDP also increased by 0.7% over last year.

The construction sector is provisionally estimated to grow by 6.2% in 2004-05 as against a decline of 6.9% last year.

The services sector has registered an impressive growth of 7.9% in 2004-05 as against an equally robust growth of 6.0% last year and against the target of 6.2% for this year.

The wholesale & retail trade, finance & insurance sub-sectors grew by 12.0 and 21.8% respectively against 8.1% and 4.5%.

The commodity producing sectors (agriculture and industry) and service sector contributed equally to the real GDP growth of 8.4%. The commodity-producing sector contributed 50% or 4.2% to this year's growth while the remaining 50% or 4.2% contribution came from services sector. Within the CPS, agriculture contributed 1.74% or 20.7% to overall growth while industry contributed 2.46% or 29.3%.

The per capita income in dollar has grown at an average rate of 13.5% per annum during the last three years rising from $579 in 2002-03 to $657 in 2003-04 and further to $736 in 2004-05. The major factor responsible for the sharp rise in per capita income include acceleration in real GDP growth, stable or even appreciation in exchange rate and four fold increase in the inflows of workers' remittances.

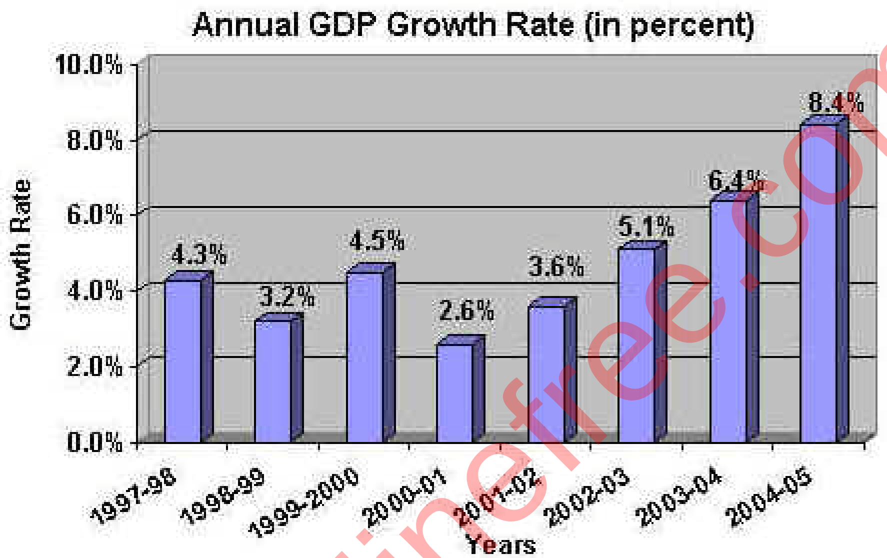
Total investment provisionally estimated at 16.9%, slightly lower than last year 17.3%. Fixed investment as percentage of GDP is estimated at 15.3% as against 15.6% last year. Public Sector investment declined from 4.8% to 4.4%. Private sector investment rose marginally to 10.9%.



### Annual GDP Growth Rate in Percent (1997-2005)

| Year | GDP Growth Rate (%) |
|---|---|
| 1997-98 | 3.5 |
| 1998-99 | 4.2 |

| | |
|---|---|
| 1999-2000 | 3.9 |
| 2000-01 | 2.2 |
| 2001-02 | 3.4 |
| 2002-03 | 5.1 |
| 2003-04 | 6.4 |
| 2004-05 | 8.4 |




***Agriculture:***

Agriculture accounts for nearly 23% of Pakistan's national income (GDP) and employs 42% of its workforce. Most importantly, 67.5% of country's population living in rural areas are directly or indirectly dependent on agriculture for their livelihood. Government of Pakistan attaches high priority to raising agricultural productivity with a view to promoting faster agricultural growth and hence, raising farmers income.

During the last three years (2002-05), Pakistani witnessed a modest recovery in agriculture growth after a two-year unprecedented draught.

14.6 million bales of cotton produced and 21.1 million tons of wheat produced during the year, as against the production of 10.05 million bales and 19.5 million tones last year.

Rice production increased from 4.848 million tons last year to 4.991 million tons in 2004-05.

Sugarcane production decreased from 53.419 million tons in 2003-04 to 45.316 million tons in 2004-05, showing a decrease of 15.2%.

As regards the minor crops, the production of chillies and onions increased by 34.7% and 25.4% respectively during 2004-05.

The production of potato also decreased by 2.7%.

Lesser production over last year is due to shortfall in urea. Excessive rain also damaged some minor crops.

Major crops registered stellar growth of 17.3% as against 1.8% last year. Minor crops grew by 3.1% as against 2.6% last year.

The performance of livestock, fisheries and forest grew by 2.3%, 2.1% and 0.4% respectively.

***Manufacturing, mining and investment policies:***

The overall manufacturing, accounting for 18.3% of GDP, registered an impressive growth of 12.5% against the target of 10.2% and last year's achievement of 14.1%. Overall manufacturing is growing at a much faster pace than agriculture and services and if this pace is sustained its share in GDP is likely rise even further in the medium-term.

The main contributors to this impressive growth of 15.4% in July to March 2004-05 over last year are:

- textile and apparel group (24.5%),
- chemicals (14.4%),
- petroleum (11.8%),
- tyres and tubes (10.1%),
- non-metallic mineral products (15.1%),
- engineering goods (11.3%),
- electrical items (54.9%),
- and automobile (30.1%).

The major items that registered positive growth are:

- cotton yarn (18.2%),
- cotton cloth (28.5%),
- phosphatic fertiliser (59.7%),
- cooking oil (27.8%),
- cement (15.3%),
- cigarettes (10.5%),
- jeeps and cars (26.1%),
- tractors (24.5%),

- LCVs (62.3%),
- motor cycles/scooters (47.6%),
- paper and paper board (4.3%),
- TV sets (5.7%),
- motor tyres (18.9%),
- refrigerators (19.8%) and
- caustic soda (11.1%).

The individual items exhibiting negative growth include: sugar (21%), vegetable ghee (1.9%), bicycles (14.8%) and billets (20.5%).

The output of the mining and quarrying sector grew by 5% this year as against the rise of 3.8% last year. The principal minerals which have shown positive growth are:

- baryte (16.6%),
- limestone (19.3%),
- natural gas (19.3),
- rock salt (2.88%),
- sulphur (11.5%) and
- chromites (183.3%).

While negative growth was exhibited by dolomite (22.2%), gypsum (52.9%), and magnetite (12.5%).

Foreign direct investment has witnessed an increase of 17.2% in the first ten months (July to April, 2004-05), whereas, net foreign private investment stood at US $ 1027 million against US $ 629.1 million last year, thereby, showing increase of $ 397.9 million. The increase in foreign private investment is because of the inflow of portfolio investment of $ 135.5 million as compared to inflow of $ 131.3 million in the comparable period last year.

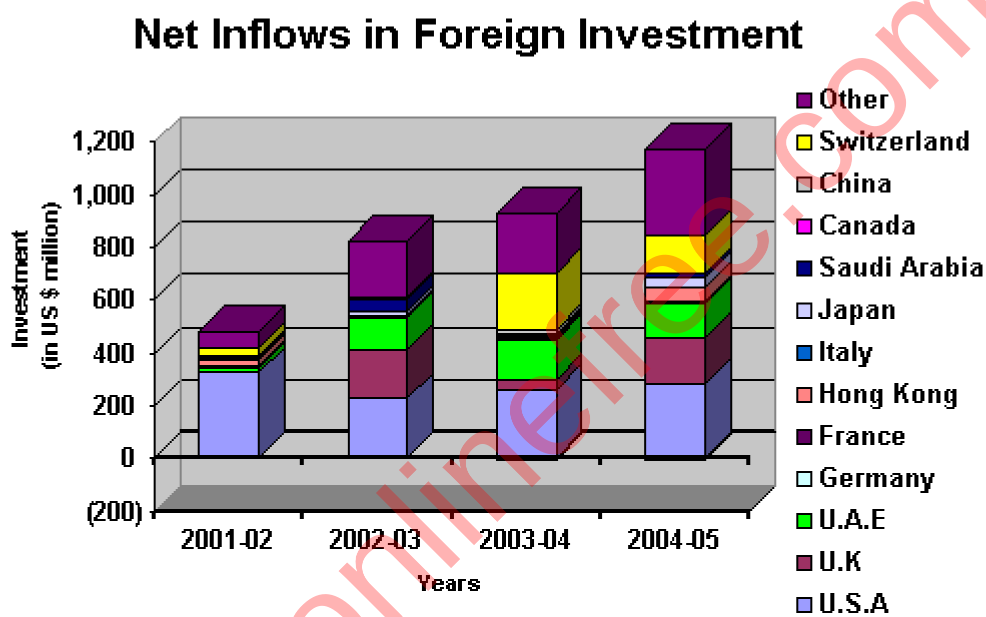


## Net Inflow of Foreign Investments

| Countries | 2001-02 | 2002-03 | 2003-04 | 2004-05 (upto May) |
|---|---|---|---|---|
| U.S.A | 324.7 | 226.6 | 259.8 | 285.6 |
| U.K | -2.1 | 184.8 | 41.9 | 173.3 |
| U.A.E | 17.3 | 120.4 | 146.5 | 125.9 |
| Germany | 11.2 | 3.8 | 4 | 12.8 |
| France | -6.6 | 2.6 | -5.6 | -3 |
| Hong Kong | 23.4 | 5.2 | 5 | 48.6 |
| Italy | 0.1 | 0.4 | 0 | 0.3 |
| Japan | 6.6 | 14.1 | 11.6 | 38 |

| | | | | |
|---|---|---|---|---|
| Saudi Arabia | 1.4 | 43.6 | 5.3 | 15.1 |
| Canada | 6.2 | 0.5 | 0.5 | 4.5 |
| China | 0.3 | 3 | 14.3 | 0.4 |
| Switzerland | 30.6 | 5.7 | 211.3 | 140.3 |
| Other | 61.5 | 209.4 | 227.1 | 329 |
| Total | 474.6 | 820.1 | 921.7 | 1,170.8 |

*Source: State Bank of Pakistan – www.sbp.org.pk*






The privatisation programme maintained its pace during 2004-05 and succeeded in privatising some high-ticket items. By the end of April 2005, Pakistan had completed or approved 146 transactions at gross proceeds of Rs. 148.3 billion. Of this an amount of Rs. 13.5 billion was received during the period July to April 2004-05 from the sale off the Government's shareholding in PIA, KESC, KAPCO, Gharibwal Cement, and Falleti's Hotel. In June 2005, the Government also privatised PTCL by selling 26% of its holdings to a foreign company from Dubai, Etisalaat. Government also sold its major shareholdings in Habib Bank Limited to Aga Khan group of investors in the current FY. The major shareholdings in United Bank Limited were already sold to a foreign investor from UAE, and some of the shareholdings were also publicly offered during the current FY.

## ***Poverty:***

The Government of Pakistan adopted a strategy for poverty reduction in 2001, focusing on five areas which include:

**(i)** accelerating economic growth and maintaining macroeconomic stability,

**(ii)** investing in human capital,

**(iii)** augmenting targeted interventions,

**(iv)** expanding social safety nets, and

**(v)** improving governance.

During this period, the economic growth has accelerated and the country had achieved macro-economic stability. Sound macroeconomic policies and implementation of structural reforms in almost all sectors of the economy have transformed Pakistan into a stable and resurgent economy in recent years. Agriculture, SMEs, and housing & construction have been prioritised in accordance with their potential to provide employment to the poor segments of the society. SMEs are an important conduit for labour absorption and thereby reducing unemployment and poverty.

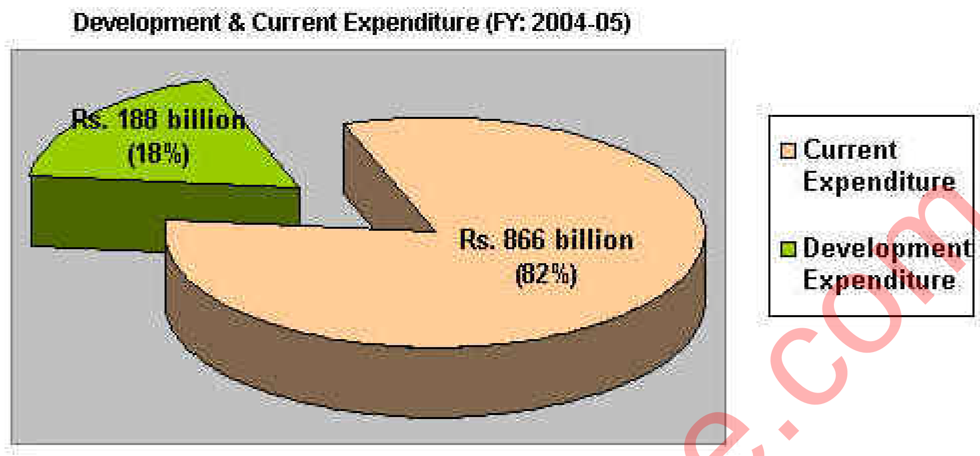
Poverty and social sector related expenditures under the PRSP have increased over 120% in the last four years, from Rs. 114 billion in 1999-2000 to Rs. 254 billion in 2003-4 to Rs. 278 billion in 2004-05.

***Fiscal Development:***

As a result of pursuance of prudent fiscal policy, Pakistan has succeeded in reducing fiscal deficit down from an average of 7% of the GDP in the 1990s to 2.3% last year and at around 3% in the current fiscal year. The associated public debt burden also declined sharply from over 100% of GDP to less than 60% in the current fiscal year. The revenue deficit has been narrowed from 3% of GDP in the late 1990s to 0.2% and the primary balance has remained in surplus for the last many years.

Tax collection by CBR has picked up, the overall budget deficit as percentage of GDP has declined the revenue deficit has been narrowed, and the primary surplus has increased. During the last six years, tax collection has increased by 70%. CBR has collected Rs. 451.1 billion as net revenue receipts during July-April 2004-05, exceeding the target by around Rs. 7 billion. When compared with last year's collection of the corresponding period, this collection indicates a healthy growth of 13.6%, whereas the gross collection has increased by 14.5%.

Total expenditure is estimated Rs. 1050.4 billion in 2004-05, which is 9.9% higher than last year. Of this current expenditure is estimated at Rs. 866 billion (82.4% of total expenditure) while development expenditure is amounted to Rs. 188 billion (17.6% of total expenditure). The current expenditure which was 14% of GDP last year has declined to 13.2% in the current year. However, there as no change in development expenditure as percent of GDP which remain stagnant at 2.9% of GDP in 2003-04 and 2004-05. The share of interest payments in total expenditure declined from 32.7% in 2000-01 to 20.2% in 2004-05 while that in current expenditure, dropped from 36.3% in 2000-01 to 25.3% in 2003-04 and further to 24.6% in 2004-05. In line with reduction in debt burden, the interest payments burden dropped from 3.5% last year to 3.3% of GDP in 2004-05.




Defence expenditure in 2004-05, amounting to Rs. 194 billion is 7.5% higher than last year. However, as percentage of GDP, it has dropped from 3.3% last year to 3% this year. As percentage of total outlay, defence spending has declined marginally from 18.8% to 18.5% this year. Similarly, as percentage of current expenditure it has declined from 23.3% to 22.4% in the same period.

The public debt to GDP ratio which stood at almost 85% in end June 2000, declined substantially to 59.4% in end March 2005. In absolute terms, public debt grew by 3.8% during the first nine months (July to March) of the current FY. It is important to note that the growth in public debt has slowed considerably in recent years because of the prudent debt management. Public debt was 317% of total revenue in end June 1980, increased to 505% by the end of 80s and further to 627% by the end of 90s. The public debt burden in relation to total revenue has declined substantially to 457% as of end March 2005.

As percent of GDP, domestic debt is expected to decline sharply from 36.4% to 30.8%, a decline of almost 6% in domestic debt burden. During the last 5 years (2000-05), the real cost of domestic borrowing averaged 4.1%, mainly on account of relatively low inflation. Accordingly the real cost of borrowing for public debt averaged 2.9% during the last five years (2000-05). The combined effect of growth in revenue and debt resulted in a sharp decline (6.4% per annum) in the country's debt burden.

## ***Money and Credit:***

The financial services sector in Pakistan has been going through a major reform process for the last several years. The State Bank of Pakistan has also strengthened its regulatory capacity. It is now more proactive in aligning its regulatory profile in a rapidly changing domestic and global financial environment. As a result of such reforms, the Pakistani banks are strengthened to compete with foreign banks both in the domestic market and internationally. Financial sector reforms has brought marked improvement in the financial health of the commercial banks in terms of capital adequacy, profitability and asset quality and also greater attention to risk management.

The broad money (M2) showed a growth of 13.1% (Rs. 325.6 billion) during July-March 2004-05 compared with the full year revised target of 14.5% (Rs. 360 billion) and the actual growth of 12.3% (Rs. 254.8 billion) in the corresponding period of last year.

Budgetary borrowings of the government amounted to Rs. 5.8 billion during July-March 2004-05 against the annual target of Rs. 60 billion and the actual borrowings of Rs. 53.6 billion in the same period last year.

Non performing loans (NPLs) of commercial banks, specialised banks, and DFIs have declined during the first nine month of 2004-05 from Rs. 220 billion in June 2004 to Rs. 203.7 billion in March 2005, a reduction of 7.4%. The process of privatisation continued as fast track with the privatisation of HBL in 2004. Shares of NBP were also offloaded through local stock exchanges. As a result of privatisation and restructuring, more than 80% of the banking assets are now owned and managed by the private sector. The government is also in the process of restructuring of IDBP, ZTBL and SME bank for their ultimate privatisation.

Khushhali Bank's efforts over the past four years have been to develop an efficient distribution system capable of handling large volume of business across diverse operating environments while at the same time, developing an insight into the market. Today, Khushhali Bank has a network of 130 service outlets across 64 districts of the country, has processed nearly 400,000 loans valuing about Rs. 4 billion and with a predominantly rural portfolio.

Bank credit to SMEs sector continued to expand considerably as its share in total private sector credit rose from 7.9% (Rs. 5.2 billion) during July-September 2004 to 18.1% (Rs. 59.9 billion) during July-February 2004-05.

***Capital Market:***

As a result of successful implementation of the successive reform measures the capital market in Pakistan has been growing by leaps and bounds and has emerged as one of the important pillars of the economy. Under the new privatisation strategy, the government is selling off its shares of state controlled enterprises by listing them on the bourses as well with a view to broadening and deepening the capital markets. During July-March 2004-05 the KSE 100 shares index rose from 5,279 points to 7,770 points, an increase of 47.2%. During this period the AMC rose from Rs. 1,357.5 billion to Rs. 2,114.8 billion, thus showing a growth of 55.8%. The Karachi Stock Market remained as one of the five best performing markets around the world with rate of returns in dollar term of 100%.

Total turnover of shares on the KSE was 71.7 billion in the first nine months of 2004-05 as compared to 65.2 billion in the same period last year. In the early part of 2005, the Karachi Stock Exchange witnessed an accelerated rise with KSE 100 index rising by 65% in a period of just 2 1/2 months to a record level of 10,303 on 15th March, 2005. The stock market turned bearish since March 16, 2005 and the KSE 100 index dropped to as low as 6,939 as on April 12, 2005 from its peak of 10,303 on 15th March, 2005 showing a decline of 32.7%. Notwithstanding this sharp fall there were no broker defaults in the stock market and also market was not closed or suspended, as had been the case in some previous market falls.

Although market faced extreme volatility in the month of March 2005 however, for the period beginning January to March 2005 the KSE performed better than the other regional markets. The KSE 100 index increased by 24% from 1st January 2005 till 28th March 2005 as compared to the other regional markets. The Sensex-Mumbai Index during the same period declined by 2%, and the Hong Kong Han Seng Index declined by 4%. The Thailand SET and the all Singapore SES Index during the same period increased by 3% and 5% respectively.

The SECP in consultation with the stock exchanges has introduced significant capital market reforms in the fields of risk management, governance, transparency and investor protection. The reform measures provided include the following:

**(a)** measures for strengthening risk management at the exchanges,

**(b)** amendments in the listing regulations of the exchanges relating to rotation of auditors,

**(c)** prohibition on use of group account by central depository system participants,

**(d)** internet trading guidelines, 2005, and

**(e)** demutualisation of stock exchanges.

***Inflation:***

For the first 10 months of the current fiscal year, inflation as measured by the Consumer Price Index (CPI), averaged 9.3%, compared to 3.9% for the corresponding period last year.

While food price inflation was recorded at 12.8% compared to 4.9% for the same period last year, non-food inflation increased to 6.9% versus 3.3% in the comparable period of last year.

Core inflation, also indicated a rising trend 7.4% for the first 10 months of 2004-05.

The largest contributions to the acceleration in CPI have come from:

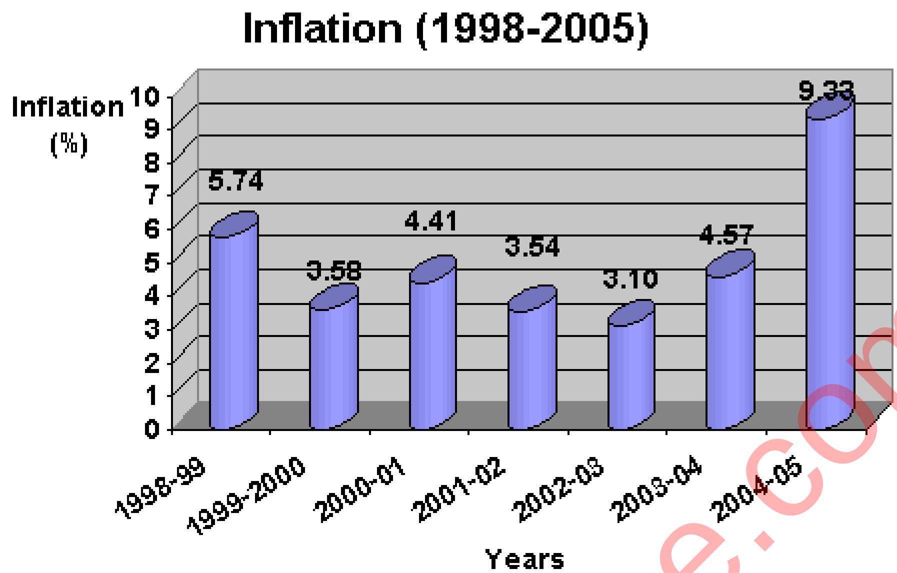
- Food (weight: 40%),
- House Rent (23%),
- Fuel & Lighting (7.3%) and
- Transport & Communication (7.3%).

Contributing factors to the rise in inflationary pressure in the economy points to the fact that a phenomenal increase in aggregate demand in the economy, on the one hand, was compounded by supply shocks of principal commodities, on the other.

The government responded in a multi-pronged manner to the rise in the price-level. First a high level committee was constituted to monitor the price situation on daily basis by keeping a close watch on the supply and demand conditions. The government also did not pass on the entire increase in the international price of oil to general consumers. To ease off the demand pressures generated by the rising level of economic activity, the State Bank of Pakistan began to tighten monetary policy rather aggressively. Like in Federal Government where price situation is reviewed weekly, the provincial governments have been asked to the same in their respective capitals and take necessary measures, if required, to stabilise prices of essential commodities. The easing of demand pressure through monetary policy and improving the supply situation of food items either through raising their production or through imports are likely to downward pressure on general price level in coming months.

**Ratio of CPI Inflation (1998-2005)**

| Year | Inflation (%) |
|---|---|
| 1998-99 | 5.74 |
| 1999-2000 | 3.58 |
| 2000-01 | 4.41 |
| 2001-02 | 3.54 |
| 2002-03 | 3.10 |
| 2003-04 | 4.57 |
| 2004-05 *(for 11 months)* | 9.33 |




***Trade and Payments:***

The strengthening of domestic demand triggering a pickup in investment spending after a multi-year lull, has fuelled Pakistani import growth. Higher global oil prices further added to a massive surge in imports which more than offset the improved outcome from exports and accordingly were the key drivers of the widening trade gap.

Exports were up by 14.6% during the first 9 months of the FY 2004-05, rising to $ 10,206.6 million from $ 8,905.2 million in the same period last year. One-half of the net increase in exports amounting to $ 650.7 million has come from the non-traditional export items.

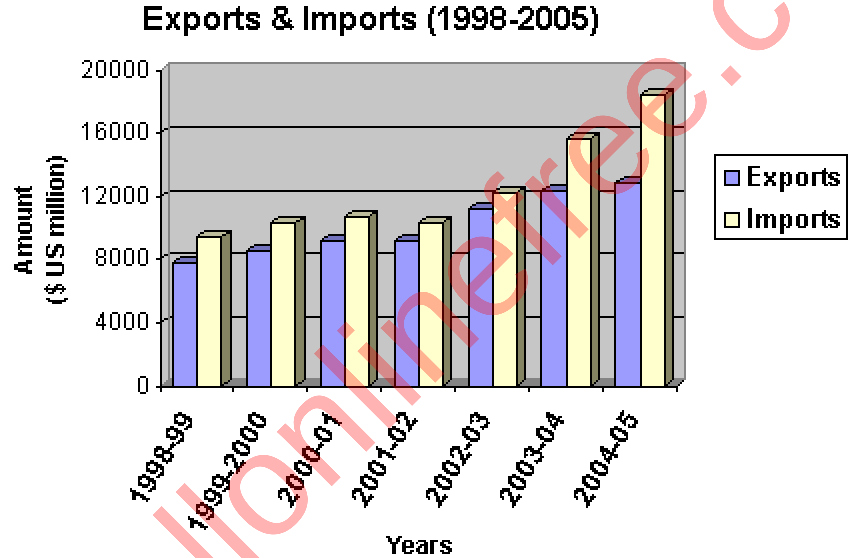
Imports during this period were up by 37.8%, rising from $ 10,497.4 million to $ 14,468.6 million. The extra-ordinary increase in import owes mainly to strengthening domestic demand and higher prices of crude oil and petroleum products. The surge in domestic demand fuelled an exceptional 41.5% increase in non-food non-oil imports (in particular machinery, chemicals and metal groups, consisting of one-half of total imports). The unprecedented rise in oil prices pushed the oil import bill up 30.9% to $ 2,760.5 million, caused a relatively larger increase in overall imports than exports.

As a result trade deficit has widened to $ 4,262 million as against $ 1,592.3 million in the same period last year.

Pakistan's current account balance has slipped into red in 2004-05 after posting surpluses for three consecutive years. The current account deficit, excluding official transfers stood at $ 1,358 million during July-March 2004-05 as against a surplus of $ 1,505 million in the same period last year. The deterioration in the current account was driven by substantially wider trade deficit owing to higher oil import bill and hefty gains in non-oil imports resulting from strong domestic demand.

## Exports and Imports (1998-2005)

| Year | Exports (US $ Million) | Imports (US $ Million) |
|---|---|---|
| 1998-99 | 7,779.3 | 9,431.7 |
| 1999-2000 | 8,568.6 | 10,309.4 |
| 2000-01 | 9,201.6 | 10,728.9 |
| 2001-02 | 9,134.6 | 10,339.5 |
| 2002-03 | 11,160.2 | 12,220.3 |
| 2003-04 | 12,313.3 | 15,591.8 |
| 2004-05 (11 months) | 12,879.3 | 18,390.8 |






### ***External Debt and Liabilities:***

Following a credible strategy of debt reduction, Pakistan has succeeded in reducing the rising trend in external debt and foreign exchange liabilities which has declined by $1.24 billion, down from $ 37.86 billion in 1999-2000 to $ 36.62 billion by end March 2005. However, the external debt and liabilities during July-March 2004-05 amounted to $ 36.62 billion are showing an increase of 3.9% over the last year. The rise in absolute amount of the stock of debt ($1,365 million) during this period is the result of valuation effect and the net inflow effect.

As percentage of GDP, external debt and liabilities stood at 51.7% in end June 2000, declined to 36.7% in end June 2004 and further to 33.1% in end March 2004-05. It may be pointed out that Pakistan's external debt and liabilities were 22 times of its foreign exchange reserves in 1998-99 but declined sharply to 2.8 times in six years.

During 2000-05, the real growth of external debt burden witnessed massive decline (13.1% per annum) on account of almost 14.7% real growth in foreign exchange earnings, decline in real cost of borrowing (-0.2%) and marginal (1.6%) rise in real growth of external debt.

These developments helped Pakistan to enter into the capital market by issuing Eurobond as well as Islamic bond (Sukuk) worth $ 500 million and $ 600 million, respectively.

***Education:***

Government of Pakistan has adopted this sector as one of the pillars for poverty reduction and benefit of masses. Existing National Education Policy 1998-2010 was formulated keeping in view the prevailing problems in the society. The government has initiated major administrative reforms such as Devolution of Power and Education Sector Reforms. Moreover, Millennium Development goals (MDGs) and Education For All (EFAs) are the international policy concerns announced in 2000, which need to be properly reflected in our policy. As such, the Ministry of Education has taken in hand an exercise to review the National Education Policy (1998-2010) for its updating to bring it in line the current needs of the country.

Overall literacy rate of 52%, according to Government, has increased by about 2% compared to that of Labour Force Survey (LFS), 2001-02.

Major progress has been made in the first two years of the Higher Education Commission, with the establishment and execution of transparent system for award of indigenous and foreign Ph.D. Scholarships with the aim of enhancing local research activities and developing future faculty member. Over eleven hundred indigenous Ph.D. Scholarships have been awarded. Furthermore, increased opportunities have been provided for Ph.D. scholars, selected via rigorous testing and screening process, to pursue their studies in industrially advanced nations such as China, France, Germany, UK, USA and Austria. In-service teachers were supported through various teacher training programmes training. More than 200 faculty member benefited from these programmes.

Federal Government has decided to encourage the private sector to play its due role in the promotion and development of educational opportunities especially in the rural areas. This policy has resulted in the establishment of an estimated 30,000 private educational institutions at all levels with an enrolment of approximately 3 million students. Enrolment in private primary schools is now in the order of 42% of total enrolment in 2004. During 2004, at the middle school level, the private sector had a share of 37% of total enrolment. At the secondary and higher secondary level in the same year, the private sector share was 30% and 64% respectively of the total enrolment.

***Health and Nutrition:***

The public health sector is a priority area of Government activities. Under the commitment to achieve the goals of 'Health for all' the agenda of Millennium Development Goals for health and human development is being implemented and a broad based strategy under the poverty reduction strategy paper (PRSP) to attend the imbalances in health sector has been prepared. The existing network of medical services consists of 916 hospitals, 4582 dispensaries, 5301 basic health units (BHUs), 552 rural health centres (RHCs), 906 maternity and child health centres (MCHs) and 289 TB centres (TBCs). In the calendar year 2004, there was one doctor 1359 persons, one dentist for 25107 persons, one nurse for 3175 persons and one hospital bed for 1540 persons. The total outlay on health sector is budgeted at Rs. 38 billion which has increased by 15.8% over last year and as percent of GDP, it is 0.57%. The new health facilities added to the overall health services include construction of 45 new facilities, upgrading of 40 existing facilities, and addition of 3500 new doctors, 1700 nurses and 17000 lady health workers. to reduce the incidence of diseases and promote the health status of people, various health programmes like Family Planning and Child Immunisation Programme, AIDS Prevention, Cancer Treatment, Drug Abuse, TB and Malaria Control Programmes had been carried out during the current year.

## ***Population, Labour Force and Employment:***

During the last 50 years, Pakistan's population has increased from 33 million to 152.53 million in 2004-05. Although the current population growth rate slowed to 1.9% per annum, overall population has increased by 2.76 million people as compared to last year.

Total labour force has increased from 41.38 million in 2001 to 45.76 million in 2004. Of this 99.25 million of work force is in the rural areas and 51.22 million as in the urban area.

Agricultural sector has absorbed 17.97 million of the total employed labour force.

About 3.52 million people were estimated to be unemployed in fiscal year 2004-05 as compared to 3.72 million last year.

## ***Transport & Communications:***

Pakistan's achievement in building high and low types of roads have been quite credible. As on March 2005, the total length of roads in the country was 259,758 kilometres, including 162,879 kilometres of high type (63%) and 96,879 kilometres of low type roads (37%). During 2004-05, the length of high type roads has increased by 2.7%. The construction work on Islamabad-Peshawar Motorway (M1) is in progress.

During the first nine months of the current FY, Pakistan Railway carried 61.3 million passengers and 4.9 million tons of freight. Its gross earnings stood at Rs. 13.2 billion, against Rs. 10.6 billion last year, which was higher by 25%.

PIA carried 3.83 million passengers during the first nine months of the current FY as against 3.69 million passengers in the same period last year. Both passenger capacity and traffic volume increased by 14.5% and 9.1%, respectively. Its fleet consists of 49 aircrafts of various types. There are presently three airlines, i.e., PIA, Shaheen Airlines and Aero Asia, operating in the country two of them are providing both domestic and international services.

Karachi Port has handled 21.8 million tons of cargo during the first nine months of the current FY, compared to 20.5 million tons of cargo during the same period last year, showing an increase of 6.6%.

The Port Qasim has handled 16 million tones of cargo during the first nine months of the current FY, as against 11.2 million tones of cargo handled during the same period last year, showing an increase of 43%.

The Gwadar Port is being built with Chinese assistance and its first phase has almost completed.

In 1999-2000, there were only 0.3 million cellular mobile subscribers in Pakistan which jumped to 2.4 million by 2002-03 as a result of introduction of CPP regime and addition of another mobile operator (i.e., Ufone). Mobile subscription continued to rise at an unprecedented pace, reaching 5 million by 2003-04. Major turnaround was witnessed when the mobile companies started giving free mobile connections and bearing the cost of government levies themselves. In a short period of 10 months in the outgoing fiscal year, more than 5 million new subscribers have been added to the list, reaching over 10.5 million by end April 2005. In other words more than 100% increase in subscribers in just 10 months was unprecedented. Accordingly, the teledensity with respect to cellular mobile has jumped from 0.2% in 1999-2000 to 7% in 2004-05. When comparing to India, where there are around 40 million mobile users with teledensity of just 3.5%, Pakistan has done remarkably best.

For promotion of information technology, 1900 cities/towns/villages have been provided internet facility, upto March 2005. Total telephone lines installed by March 2005 were 5.5 million as against 4.4 million up to June 2004 last year.

This year two mobile companies were issued licenses and allowed to enter into the market, i.e., Telenor and Warid Telecom. An existing AMPS mobile company Paktel introduced its GSM services and start giving mobile connections absolutely free. Moreover, a Wireless Local Loop (WLL) company GO CDMA offered its services and provide the consumers wireless phones with lots of features like voice messaging, SMS, Prepaid facility, call conference, CLI, etc. for the first time in Pakistan's short telecom history.

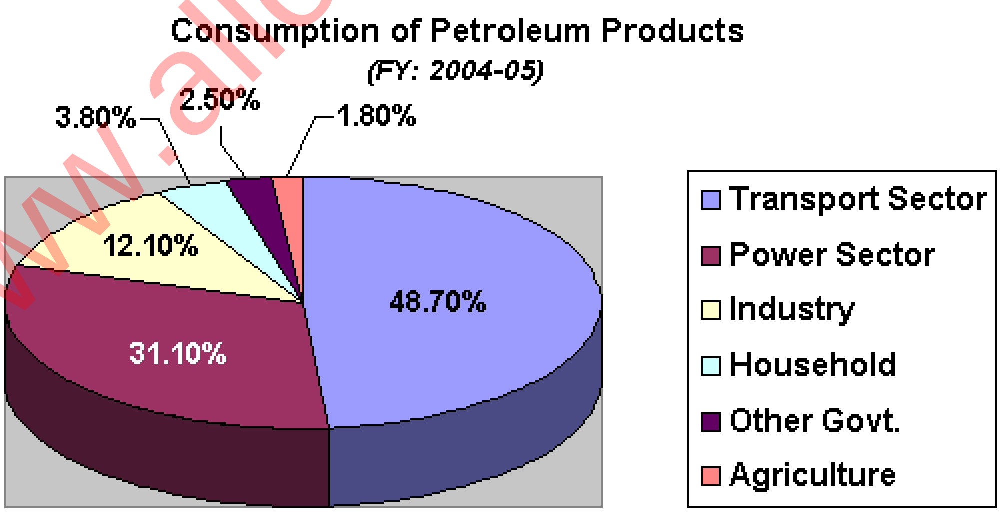
On 18th June 2005, 26% of Government holdings in PTCL shares were sold to a Dubai company, namely, Etisalaat at $ 1.96 per share, even after a mass agitations of PTCL trade union activists and other workers, which result into an agreement between the Government and PTCL trade union activists.

## Energy:

The consumption of energy is one of the critical indicators of the level of development of any country. Developed countries use more energy per unit of economic output and far more energy per capita than developing countries. At present, over a billion people in the industrialised countries use some 60% of the world's commercial energy supply, while 5 billion people living in the developing countries consume the remaining.

During July-March 2004-05, the production of crude oil per day has increased by 66,508 barrels, from 62,122 barrels per day during the same period last year, showing an increase of 7.1%. The over all production of crude oil has increased to 18.1 million barrels during July-March 2004-05, from 17.1 million barrels during the comparable period last year, showing an increase of 5.8%. On average the consumption of petroleum products of different sectors during the last 14 years (1990-2004) are:

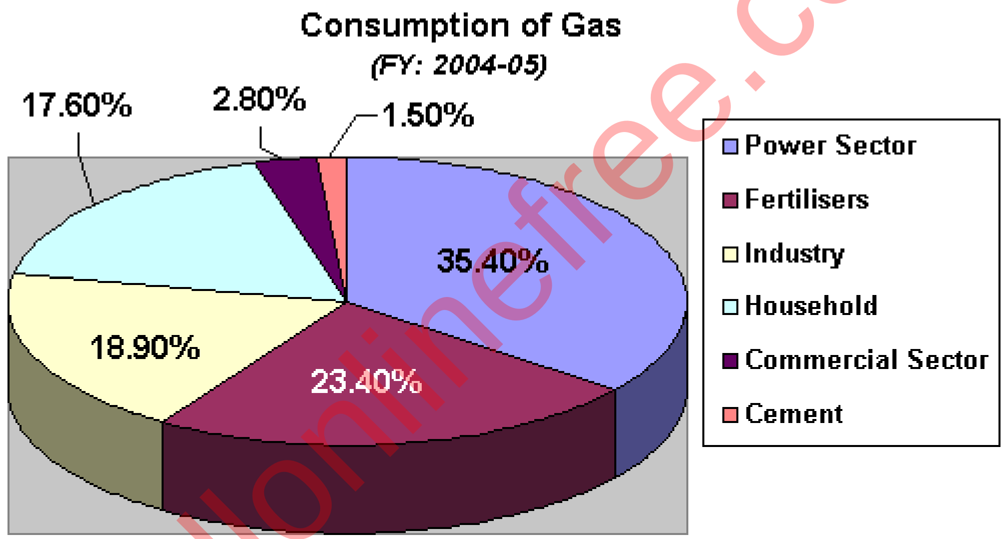
- transport sector (48.7%)
- power sector (31.1%),
- industry (12.1%),
- household (3.8%),
- other government (2.5%), and
- agriculture (1.8%)




The production of natural gas per day has stood at 3,681 million cubic feet during the first nine months of the current FY, as compared to 3,210 million cubic feet in the same period last year, showing an increase of 14.7%. Production of gas has increased to 1,003,198 million cubic feet during the first nine months of current FY, as compared to

882,684 million cubic feet during the same period last year, showing an increase of 13.6%. On average different sectors of the economy consumes gas during the last 14 years from 1990 to 2004 are:

- power sector (35.4%),
- fertilisers (23.4%),
- industrial sector (18.9%),
- household sector (17.6%),
- commercial sector (2.8%), and
- cement (1.5%)




The installed capacity of electricity (hydel and thermal) has increased by 0.7% during the first nine months of the current FY and stood at 19,389 MW. Total installed capacity of WAPDA stood at 11,298 MW during July-March 2004-05 of which hydel generation was 6,463 MW (57.2%) and thermal was 4,835 MW (42.8%). During first three quarters of current fiscal year 61,759 GW electricity has been generated as against 56,145 GW were produced in the same period last year, showing an increase of 10%. The number of villages electrified has increased to 87,698 during July-March 2004-05, from 78,820 in 2003-04, showing an increase of 11.3%.

Presently, some 700 CNG stations are operating in the country while 200 are under construction. By March 2005 about 700,000 vehicles were converted to CNG as compared to 450,000 vehicles during the same period last year, showing an increase of about 56%. With these developments Pakistan has become the leading country in Asia and the third largest user of CNG in the world after Argentina and Brazil.

***Environment and Housing:***

**(a) Environment:**

In Pakistan, the environmental situation has risen due to a number of factors including high population growth rate, lack of public awareness and education, mismanagement of water and other natural resources as well as unplanned urban and industrial expansion.

Draft of *'National Environmental Policy 2005'* which has been approved by the Prime Minister in principle and is being circulated to larger stakeholders for comments. Once approved, it would be country's first ever 'environmental policy'. This policy would compliment the objectives of NEAP-SP and will address the sectoral issues like:

**(i)** water management and conservations

**(ii)** energy efficiency and renewable

**(iii)** agriculture and livestock

**(iv)** forestry and plantation

**(v)** biodiversity and protected areas

**(vi)** climate change, air quality and noise, and

**(vii)** pollution and waste management.

In addition, the proposed policy aims to address other cross-sectoral issues such as:

**(i)** Population and environment

**(ii)** gender and environment

**(iii)** health and environment

**(iv)** trade and environment

**(v)** poverty and environment

**(vi)** environment and local government

The key factors contributing to air pollution in Pakistan are:

**(i)** rapidly growing energy demand, and

**(ii)** a fast growing transport sector.

In the cities widespread use of low-quality fuel, combined with a dramatic expansion in the number of vehicles on roads, has led to significant air pollution problems. Rickshaws have grown by more than 59%, while motorcycles and scooters have almost doubled over the past ten years. This data does not include locally assembled diesel engine turned 'auto carts' used in rural areas. Motorcycles and Rickshaws due to their two-stroke engines, are the most inefficient in burning fuel and contribute most to emissions.

Pakistan is the largest user of CNG in Asia and presently, some 700 CNG stations are operating in the country while 200 are under construction. By March 2005, about 700,000 vehicles were converted to CNG as compared to 450,000 vehicles during same period last year, showing an increase of 56%. After the successful CNG programme for petrol replacement, the government is now embarking upon a programme to replace the more polluting diesel fuel in the road transport sector.

Per capita water availability in Pakistan has been decreasing at an alarming rate. In 1951, per capita availability was 5,300 cubic meters, which has now decreased to 1,105 cubic meters just touch water scarcity level of 1,000 cubic meters. The existing water resources are under threat due to rapid degradation, soil erosion, deforestation and untreated discharge of municipal and industrial wastes to rivers and other water bodies.

Plans are underway to extend the coverage of clean drinking water from 63% to 70% in 2005-06 and sanitation from 40% to 55% in the same period. It is targeted to provide 93% of population with access to clean drinking water by 2015 and 90% of the population with access to sanitation.

It is estimated that about 38% of Pakistan's irrigated land is water logged, 14% is saline. In the urban areas, less than 60% of solid waste is collected. No city in Pakistan has proper waste collection and disposal system for municipal or hazarders wastes. our industries use about 525 types of chemicals and dyes/colours in different processing industries. Their processing generates wastes causing contamination of soil and pose potential risk to public health and damage the fertility of cropland.

The National Conservation Strategy (NCS) has represented a National Environment Action Plan (NEAP). The main objectives of NEAP are to safeguard public health, promote sustainable livelihood and enhance quality of life for the people of Pakistan.

**<u>(b) Housing Sector:</u>**

Realising the potentials of housing and construction as productive sector of the economy, the present Government has declared housing and construction as a priority industry and also formulated a pragmatic and workable National Housing Policy with a view to:

**(i)** accelerate housing activity and contribute towards employment generation and economic development,

**(ii)** facilitate provision of housing inputs including land, finance, building materials, institutional and legal framework,

**(iii)** analyse the culture of poverty and the forces generating ever-increasing slums and katchi abadis including political, public, socio-economic, bureaucratic and environmental forces,

**(iv)** promote ways and means for housing development by enhancing affordability, saving capacity, human tendencies and potential,

**(v)** provide safeguards against malpractices, bureaucratic inefficiencies, institutional weaknesses and mafia assaults, and

**(vi)** particularly for the low income groups.

**Tables & Graphs:**



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# Economic Survey 2005-06

## HIGHLIGHTS

- Overall performance of the economy: ***Strong.***
- Three or four years of strong economic growth have positioned Pakistan among ***the fastest (growing) economies in the Asian region***.
- ***Real GDP Growth Rate*** during the first 10 months of the fiscal year 2005-06 is 6.6%.
- ***Per Capita Income*** in dollar terms registered an increase of 14.1% over the last year, rising from $742 to $847.
- ***Foreign Direct Investment (FDI)*** increased by over 238%, attracting $3.1 billion against $891.5 million during the same period last year.
- The country's ***Foreign Exchange Reserves*** swelled to over $13 billion or equivalent to over 6-month coverage of imports.
- The ***Gross Fixed Capital Formation (GFCF)*** or domestic fixed investment grew by 30.7% against a rise of 28.6% last year. ***Private sector investment*** grew by 31.6% against 29.1% last year.
- ***National Savings*** as percentage of GDP stood at 16.4% this year, as against last year's 16.5% growth. Domestic savings stood at 14.4% of GDP this year, as against 14.5% last year.
- ***Foreign Remittances*** - Against the full year target of $4 billion, workers' remittances totalled $3.63 billion during the first 10 months of the current fiscal year against $3.4 billion in the same period last year. It is likely that workers remittances may touch $4.4 billion in 2005-06.
- ***Inflation*** has declined to 8% this year as compared to 9.3% last year.
- The ***Public Debt to GDP ratio*** declined by almost 30% to 54% in 2005-06 against 85% in 1999-2000, while as a percentage of GDP, it declined from 61.4% to 54.7%, recording a 6.7% decline in a single year. The overall stock of public debt, however, increased from $35.8 billion last year to $36.557 billion, excluding earthquake-related loans, which have not yet started coming in.
- Boost in ***Service Sector*** – the services sector increased by 8.8%, much higher than the 6.8 % target, which is because of the phenomenal boost in banking and insurance sector. The banking and insurance sector grew by a mammoth 23% against a target of 6.7%. The transport and communication sector grew by 7.1% against a target of 5.8 % and last year's growth of 3.5 %. Similarly, the wholesale and retail trade rose by 10 % against a budgeted target of 9.3 % but lower than last year's growth of 12 %.
- The overall ***Commodity-Producing Sector*** shows a depressing situation with 4.3% growth during the current fiscal year as compare to 9.2% in the previous fiscal year. However, the construction industry and small scale and household industry show satisfactory growth, which were supported by the consumer finance.

- The performance of ***Agricultural Sector*** was very disappointing. The sector, with about 23% share in the GDP, grew by a nominal 2.5% against a target of 4.8% for the current year and against 6.7% growth achieved last year.
- The ***Overall Fiscal Deficit*** is 4.2% during the outgoing financial year as against the target of 3.8% of the GDP.
- Exports in 9 months of the current fiscal year rose by 18.6% to $12 billion while imports grew by 43.2% to $20.7 billion, leaving a ***Trade Deficit*** of $8.6 billion.
- ***The Current Account Deficit***, excluding official transfers, stood at $4.7 billion in first nine months of the year against just $1.18 billion last year, showing an increase of 300%.

## SUMMARY

Pakistan's economy continues to maintain solid pace of expansion since the fiscal year 2002-03 recovery in the economy has been strong, rapid and sustained. During the fiscal year 2005-06, Pakistan's economic fundamentals have gained further strength. The most important achievements of this year include:

### GROWTH AND INVESTMENT:

Pakistan's economy maintains a solid pace of expansion during the fiscal year 2005-06 despite facing headwinds from rising energy prices at $70-75 per barrel and the widespread damage caused by the earthquake of October 8, 2005.

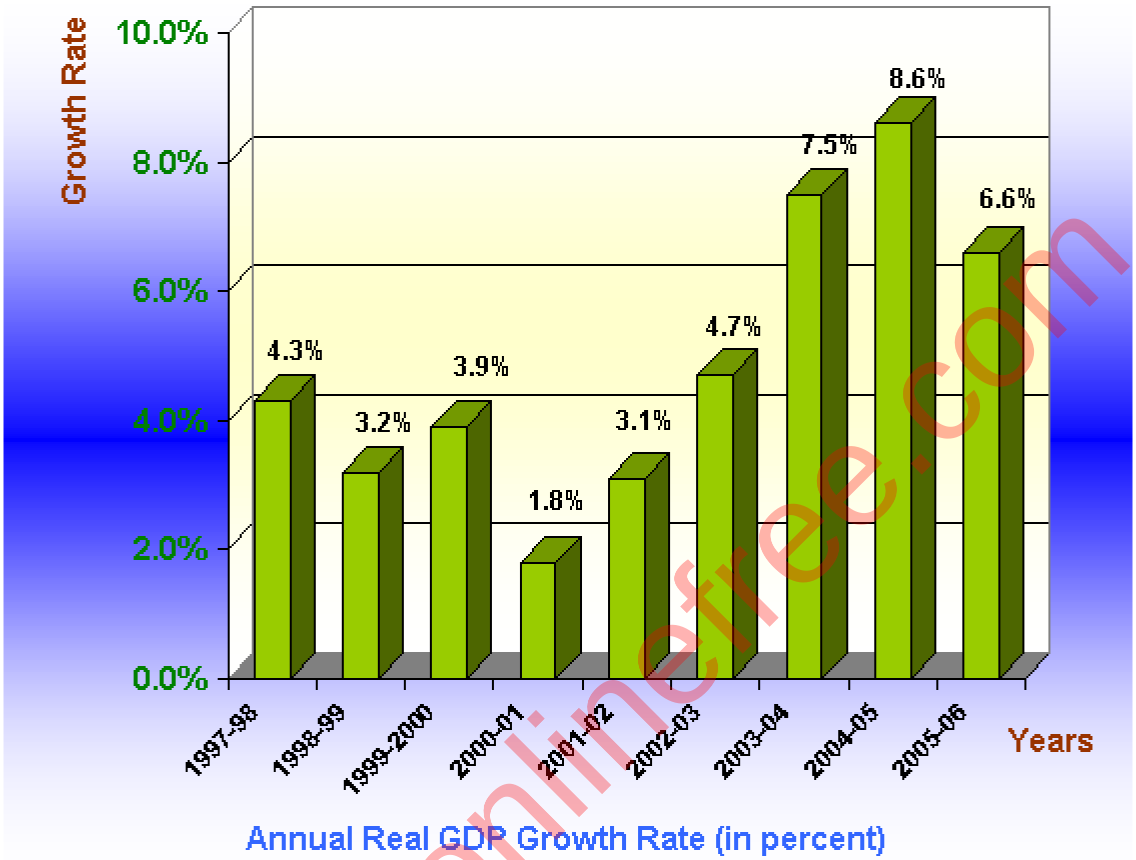
The growth momentum that Pakistan sustained for the last four years is underpinned by dynamism in industry, agriculture and services, and the emergence of a new investment cycle supported by strong credit growth.

***Real GDP*** grew by 6.6 % in 2005-06 as against 8.6 % last year and fell short of the target (7.0 %). With economic growth at 6.6 % in 2005-06, Pakistan's economy has grown at an average rate of almost 7.0 % per annum during the last four years and over 7.5 % in the last three years, thus enabling it to join the exclusive club of the fastest growing economies of the Asian region.

**Annual GDP Growth Rate in % (1997-2006)**

| Year | GDP Growth Rate (%) |
|---|---|
| 1997-98 | 3.5 |
| 1998-99 | 4.2 |
| 1999-2000 | 3.9 |
| 2000-01 | 1.8 |
| 2001-02 | 3.1 |
| 2002-03 | 4.7 |
| 2003-04 | 7.5 |
| 2004-05 | 8.6 |
| 2005-06 *(for 10* | 6.6 |

| *months)* | |
|---|---|






***Growth of value addition in Commodity Producing Sector (CPS)*** slowed to 4.3 % in 2005-06 as against 9.2 % last year. Both the important components of the commodity producing sector namely, agriculture and manufacturing performed less than their targets. Within the CPS, agriculture and manufacturing grew by 2.5 % and 8.6 %, respectively.

***Agriculture*** and particularly its crop sector could not perform up to the expectation especially major crops registered a 3.6 % contraction in growth. Livestock, a major component of agriculture, exhibited strong showing and pulled the overall growth in agriculture to 2.5 % as against the target of 4.2 %.

***Overall manufacturing***, accounting for 18.2 % of GDP, registered the growth of 8.6 % against the target of 12.0 % and last year's phenomenal achievement of 12.6 %.

***Large-scale manufacturing*** grew by 9.0 % as against 15.6 % of last year and 14.5 % target for the year, exhibiting signs of moderation on account of higher capacity utilisation on the one hand and strong base effect along with several other factors on the other hand. ***Small-scale manufacturing*** grew at estimated 9.3 % in 2005-06.

***The Construction sector*** continued its strong showing, partly helped by activity in private housing market, spending on physical infrastructure, and reconstruction activities in earthquake affected areas. The construction sector is estimated to grow by 9.2 % in 2005-06 as against extraordinary growth of 18.6 % last year.

***The services sector*** impressively grew by 8.8 % in 2005-06 as against 8.0 % of last year. Growth in the services sector in 2005-06 was primarily attributable to strong growth in the finance and insurance sector, better performance of wholesale and retail trade, as well as transport and the communications sector. Finance and insurance sector spearheaded the growth in the services sector and registered stellar growth of 23.0 % during the current fiscal year 2005-06, which is slightly lower than 29.7 % of last year.

***Value added in the wholesale and retail trade sector*** has increased by 9.9 % over the previous year, compared to 11.1 % growth last year. ***The transport, storage and communications sector*** has an impressive growth of 7.1 % compared to 3.5 % growth last year.

Major contribution towards growth has come from the services sector. The commodity producing sectors (agriculture and industry) has contributed 1/3$^{rd}$ of the GDP growth and the services sector contributed the remaining 2/3$^{rd}$ to the real GDP growth of 6.6%.

The CPS contributed 31.7 % or 2.1 percentage point to this year's growth while the remaining 68 % or 4.5 percentage points contribution came from services sector.

Within the CPS, agriculture contributed 0.55 percentage points or 8.4 % to overall growth while industry contributed 1.54 percentage points or 23.3 %. Within services sector wholesale and retail trade has contributed 27.9 % or 1.84 percentage points to GDP growth.

***Pakistan's per capita real GDP*** has risen at a faster pace during the last three years (5.6 % per annum on average in rupee terms) leading to a rise in average income of the people. Such increases in real per capita income have led to a sharp increase in consumer spending during the last three years. Per capita income defined as Gross National Product at market price in dollar term divided by the country's population, grew by an average rate of 13.9 % per annum during the last four years - rising from $579 in 2002-03 to $847 in 2005-06. Per capita income in dollar term registered a phenomenal increase of 14.1 % over last year - rising from $742 to $847.

## INVESTMENT:

During the fiscal year 2005-06, gross fixed capital formation or domestic fixed investment sharply grew by 30.7 % as against the rise of 28.6 % last year. Private sector investment grew by 31.6 % this year as against a growth of 29.1 % last year.

Major growth in investment by private sector is witnessed in agriculture (15.3 %), manufacturing (14.4 %), mining and quarrying (45.5 %), construction (9.5 %), transport and communication (20.2 %), and wholesale and retail trade (424.5 %). Public sector investment on the other hand registered massive growth of 46.7 % as against a hefty 32.9 % increase last year.

The growth in domestic investment was largely a public sector phenomenon last year but this year, it was mainly public-private sector partnership driven. Total investment increased from 18.1 % of GDP last year to 20.0 % of GDP in 2005-06.

Fixed investment as percentage of GDP is estimated at 18.4 % as against 16.5 % last year. Both public sector investment and private sector investment as percentage of GDP have increased to 4.8 % and 13.6 % respectively, up from 4.4 % and 12.1 % last year.

## SAVINGS:

National savings as percentage of GDP stood at 16.4 % in 2005-06 fractionally lower than last year's level of 16.5 %. Domestic savings stood at 14.4 % of GDP in 2005-06 slightly lower than 14.5 % of GDP last year.

## AGRICULTURE:

Agriculture is the mainstay of Pakistan's economy. Nearly 22 % of total output (GDP) and 44.8 % of total employment is generated in agriculture. It also contributes substantially to Pakistan's exports. Agriculture also contributes to growth as a supplier of raw materials to industry as well as market for industrial products.

The performance of agriculture during the fiscal year 2005-06 has been weak. Against the target of 4.2 % and last year's achievement of 6.7 %, overall agriculture grew by 2.5 % in 2005-06, due to a relatively poor performance of major crops and forestry, and weaker one of minor crops and fishery. At the same time, Livestock has been the sole saving grace.

Major corps, accounting for 35.2 % of value added in agriculture, registered a decline of 3.6 % as production of two of the four major crops, namely cotton and sugarcane has been significantly less than last year for a variety of reasons including, excessive rains at the time of sowing, high temperature at the flowering stage, late harvesting of wheat crop, a strong base effect (cotton) and lastly the incidence of frost, damaging sugarcane crop in the month of January, 2006.

The production of third major crop, namely wheat, remained more or less at last year's level at 21.7 million tons thereby registering a meager growth of 0.4 %. The production of rice - the fourth major crop - has been the sole major crop which registered an impressive growth of 10.4 %, but failed to turn the negative growth in major crops to a positive one.

Minor crops, accounting for 12.3 % of agricultural value added, barely managed to register a positive growth of 1.6 % in 2005-06 as against a growth of 3.0 % last year.

The performance of livestock, the single largest sector accounting for almost one - half of agricultural value added, has been impressive as this sector grew by 8.0 % on the back of substantial increase in the population of species, milk etc. The performance of fisheries has been poor as it grew by 1.9 % only in 2005-06. Forestry has been registering negative growth for three consecutive years - registering a negative growth of 9.7 % in 2005-06 as against a negative growth of 30.4 %.

Pakistan's agriculture has been suffering, on and off, from a severe shortage of irrigation water in recent years. As against the normal surface water availability at canal heads of 103.5 million-acre feet (MAF), the overall (both for Kharif and Rabi) water availability has been less in the range of 5.9 % (2003-04) to 29.4 % (2001-02). Relatively speaking, the Rabi season faced more shortage of water than Kharif during these periods.

Amongst major crops, cotton production is estimated at 12.417 million bales for 2005-06 lower by 13 % over the last year's production of 14.265 million bales. Wheat production is estimated at 21.7 million tons in 2005-06, as against 21.612 million tons last year, showing an increase of 0.4 %. Rice production has increased by 10.4 % in 2005-06 from 5.025 million tons last year to 5.547 million tons in 2005-06. Sugarcane production, however, decreased from 47.244 million tons in 2004-05 to 44.312 million tons in 2005-06, showing a decrease of 6.2 %.

As regards the minor crops, the production of chillies and onions increased by 34.8 and 29.0 % respectively during 2005-06. The production of all the pulses, namely *masoor, mung* and *mash* are down by 13.5, 12.6 and 9.8 %, respectively during 2005-06.

The production of potato also decreased by 17.9 % on account of frost, which affected the potato crop. Agriculture credit disbursement of Rs 91.161 billion during July-March, 2005-06 is higher by 23.5 %, as compared to Rs 73.811 billion over the corresponding period last year. The fertiliser off-take stood at 2982 thousand nutrient tons in July-March 2005-06 or higher by 6.1 %, as compared to 2811 thousand nutrient tons for the corresponding period last year.

## MANUFACTURING, MINING AND INVESTMENT:

The overall manufacturing sector continued to maintain its growth momentum with more vigour during the current fiscal year. Overall manufacturing recorded an impressive and broad based growth of 8.6 %, against a target of 12.0 % and last year's growth of 12.6 %. Large-scale manufacturing registered an impressive growth of 9.0 % in the current fiscal year 2005-06 against a target of 14.5 % and last year's achievement of 15.6 %.

The main contributors to this impressive growth of 9.0 % in July-March 2005-06 over last year are the automobile group (29.76 %), engineering goods group (6.46 %), non-metallic mineral products (9.49 %), leather products (10.91 %), chemicals (9.08 %), pharmaceuticals (14.83 %) and electricals (11.78 %).

The items that registered positive growth were cotton cloth (0.07 %) and cotton yarn (11.16 %) in the textile group; cooking oil (17.6 %) in the food, beverages and tobacco groups; nitrogenous fertiliser (4.46 %), in the chemical group, cement (9.75 %) in the non-metallic mineral products group and Jeeps & Car (29.9 %), LCV's (29.3 %) and motorcycles/scooters (15.04 %) in the automobile group. The individual items exhibiting negative growth include; sugar (2.40 %), coke (77.39 %), power looms (24.67 %) and billets (47.95 %).

The output of the mining and quarrying sector grew by 3.8 % this year as against the rise of 9.6 % last year. The principal minerals which have shown positive growth are: baryte (11.4 %), limestone (9.9 %), natural gas (4.5 %), rock salt (13.2 %), sulphur (5.4 %) and gypsum (12.6 %). While negative growth was exhibited by chromite (6.7 %) and magnetite (10.7 %).

Foreign direct investment has witnessed an increase of 238.7 % in the first ten months (July-April, 2005-06), whereas, net foreign private investment stood at US $3376 million against US $1027 million last year, thereby, showing increase of $2349 million, i.e., an increase of 229%. The increase in foreign private investment is because of the inflow of portfolio investment of $355.8 million as compared to inflow of $135.5 million in the comparable period last year.

The privatisation program maintained its pace during 2005-06 and succeeded in privatising some high-ticket items despite an inhospitable global environment. By end April 2006, Pakistan had completed or approved 160 transactions at gross proceeds of Rs 985 billion. This includes 57 transactions for Rs 337.908 billion completed during October 1999 to April 2006.

## POVERTY AND INCOME DISTRIBUTION:

In Pakistan, the Poverty Reduction Strategy was launched by the government in 2001 in response to the rising trend in poverty during 1990s. Preliminary findings of Pakistan Social and Living Standards Measurement Survey (PSLM 2004-05) on poverty status were released at the end of February 2006, which indicates that the poverty level in Pakistan has been reduced during the last four years.

A strong growth (7.5 % on average) for three years in a row, with per capita income growing at an average rate of 5.6 %; a large inflow of remittances (over $4.0 billion per annum) in recent years, a huge expenditure on poverty-related and social sector program, and many other interventions have made a significant dent to poverty in Pakistan.

As per HIES survey 2004-05, the percentage of the population living below the poverty line is provisionally estimated at 25.4 % in 2005 - down from 32.1 % in 2001.

The social sector and poverty related expenditures grew at an average rate of more than 20 % per annum during 2001-05.

Within the various categories of pro-poor expenditure, human development comes out to be the priority item of the Government with expenditures under this head constituting, on average, more than 50 % of all PRSP related expenditures.

## FISCAL DEVELOPMENT:

Pakistan has gained further strength on fiscal side. Revenues are buoyant, expenditure is rationalised, fiscal deficit is at sustainable level and revenue deficit has almost been eliminated. Resultantly, Public debt is fast moving towards a sustainable level. Much progress has been made towards fiscal consolidation.

As a result of prudent fiscal management over the last 5 years, the burden of interest payment in domestic budget has declined sharply, thereby, releasing resources for development and social sector program.

During the five years from 2000-01 to 2005-06, ***tax collection*** by the CBR increased by 81.0 %. The Central Board of Revenue (CBR) was targeted to collect Rs 690 billion but it is most likely to collect Rs 710 billion - Rs 20 billion more than the target and 20.6 % more than last year.

The ***total expenditure*** remains more or less stable in a narrow band of 17 to 18.8 % of GDP during the last six years.

Substantial decline in ***interest payments*** from as high as 7.5 % of GDP in 1998-99 to 3.1 % of GDP in 2005-06, has provided fiscal space to reorient expenditure in favour of development expenditure. Resultantly the share of current expenditure in total expenditure declined from 89 % of total expenditure in 1998-99 to 78 % in 2005-06. In addition, the share of development expenditure doubled from 11 % to 22 % in the same period.

During the last six years the ***development expenditure*** improved from 2.2 % of GDP in 2000-01 to 4.2 % of GDP in 2005-06. Second largest component of the current expenditure, namely, ***defence spending*** remained stagnant at around 3.1 % to 3.3 % of GDP during the last six years. Government is achieving the goal of fiscal stabilisation without compromising spending on the social sector. Non-defence-non-interest expenditure has improved from 7.8 % of GDP in 1999-2000 to 11.8 % of GDP in 2005-06.

During the last six years the real growth in current expenditure hovered around 3 % per annum and pace of growth has slowed down. Total expenditure grew by 3.4 % in the first three years (2000-03) but accelerated to 5.6 % during the last three years (2003-06). The main contribution is coming from development expenditure which grew by 7.4

% per annum in first three years (2000-03) and by 23.8 % in recent three years (2003-06).

Total ***consolidated revenues*** are targeted at Rs 1095.6 billion in 2005-06 compared to Rs 900.0 billion in 2004-05, an increase of 21.7 %. This was primarily due to a rise of 22.2 % in tax revenue on the back of increases in both federal and provincial tax revenues, which grew by 19.8 % and 50.1 %, respectively. Non-tax revenue increased by 19.3 % in 2005-06 but remained stagnant at 3.8 % of GDP.

In 2005-06, Pakistan is likely to face an ***overall fiscal deficit*** of Rs 261.6 billion or 3.4 % of GDP excluding earthquake effect and if we include earthquake related spending worth Rs 65.8 billion, the size of the deficit stood at Rs 327.3 billion or 4.2 % of GDP. This revenue-expenditure gap was financed through external and domestic sources.

Out of the gap of Rs 327.3 billion, financing from external sources is expected at Rs 118.4 billion. The remaining gap of Rs 208.9 billion is likely to be financed from domestic sources. Within domestic sources, financing from non-bank sources amounted to Rs 22.4 billion while Rs 96.7 billion would be contributed by the Banking sources, and Rs 90.0 billion is to be financed through privatisation proceeds.

The ***revenue deficit*** (the difference between total revenue and total current expenditure), a measure of government dis-saving, was at a deficit of 0.7 % of GDP in 2004-05 compared to a deficit of 2.2 % in 2000-01. It has further progressed towards almost elimination at 0.03 % of GDP in 2005-06.

The ***public debt- to-GDP ratio***, which stood at almost 85 % in end June 2000, declined substantially to 61.4 % by the end of June 2005, i.e. 23.6 % decline in country's debt burden in 5 years. By end March 2006, public debt further declined to 54.7 % of the projected GDP for the year.

Following the debt reduction strategy in which raising revenue was one of the key elements, the ***public debt burden in relation to total revenue*** has declined substantially from 562.5 % in 1999-2000 to 448.9 % by end-June 2005 and further to 384.9 % by end-March 2006 to the projected revenue for the year. During the last six years, the ***debt servicing liabilities*** have declined sharply from 65.4 % of revenue in 1999-2000 to 27.8 % of revenue and from 53.5 % to 27.8 % of current expenditure in 2005-06.

The ***ratios of domestic debt to GDP*** and ***to tax revenue*** both decreased during 2005-06. The stock of domestic debt as % of GDP declined from 35.7 % in 2003-04 to 32.8 % in 2004-05 and further to 29.4 % by end March 2006.

***Interest payments as a percentage of total revenue*** have been reduced to one-half (41 % to 20 %) over the last six years. Similarly, ***share in total expenditure*** declined from 30 % to 16 % during the same period. Most importantly, ***as percentage of GDP***, interest payments declined from 6 % to 2.6 % in the last six years.

## MONEY & CREDIT:

The easy and accommodative ***monetary policy*** stance that had been pursued during the last few years by the SBP underwent considerable changes during the FY05, switching from a broadly accommodative to aggressive tightening in the second half of the last fiscal year, since April 2005.

The same tight monetary policy stance continued during the current fiscal year despite declines in both core and overall inflation. Notwithstanding the tight monetary policy stance the SBP continued to strike a balance between promoting growth and controlling inflation on the one hand and maintaining a stable exchange rate environment on the other. Tight monetary policy stance is likely to continue until inflationary pressures are significantly eased off.

The State Bank of Pakistan has taken a number of steps in various areas to further enhance the effectiveness of the banking industry in Pakistan. To further revamp the financial sector in line with the global financial system, the State Bank of Pakistan has set out a road map for the implementation of *Basel-II*. It is the new regulatory capital adequacy regime, which offers a series of approaches ranging from simple to more complex methodologies for capital allocation against credit and operational risk.

The ***credit plan for 2005-06*** set the target for monetary expansion at Rs 380 billion or 12.8 % higher than last year (FY05) on the basis of a growth target of 7.0 % and inflation target of 8 %. The money supply during July-April 22, 2006 of the current fiscal year expanded by Rs 294.9 billion or 9.94 % as against an expansion of Rs 332.4 billion or 13.37 % in the same period last year.

The ***net credit to the Government*** for budgetary purposes was Rs 43.3 billion compared to the annual credit plan target of Rs 98 billion and Rs 15.0 billion borrowed in the corresponding period of last year. However, credit to the private sector has exceeded the credit plan target and stood at Rs 345.1 billion as against Rs 330 billion envisaged for the year in the credit plan.

Despite the tight monetary policy stance of the SBP, ***credit to the private sector*** was broad-based which grew by 20.2 % (Rs 345.1 billion) during July-April 22, 2006 compared with the growth of 28.0 % or Rs 357.4 billion during the same period of last year. Credit to the private sector continued to exhibit strong demand, reflecting the confidence of the private sector on the continuously improving macroeconomic fundamentals of the country.

***Credit to manufacturing sector*** – the manufacturing sector continued to be the largest recipient of bank credit, amounting to Rs 130.0 billion during July- March 2005-06, -- 17.1 % more than the comparable period of last year and accounting for almost 47.9 % of the credit to private sector businesses.

***Credit disbursement to the agriculture sector*** also remained consistent with the previous year trend. Scheduled banks and DFIs advances to SME sector witnessed a growth of Rs 40.6 billion during July-February FY06 compared with an expansion of Rs 59.9 billion in the same period of last year.

The growth in ***consumer loans*** remained robust, and their scale expanded by 27 % to Rs 67.2 billion. The consumer loans were acquired to finance a range of products including automobiles, personal loans, credit cards and house building.

The ***scheduled banks*** have opened 304 offices during the period from 01-04-2005 to 31-03-2006. During July-March 2005-06, there was an increase of Rs 303.9 billion (17.3 %) in the net advances of the scheduled banks. Their deposits increased by Rs 272.9 billion (11.5 %) and their total investments increased by Rs 77.1 billion during the first nine months of the current fiscal year. In 2005, the banking sector produced impressive results. The year has been unprecedented in terms of profits.

Pakistan continues to be at the forefront of the ***Micro-Finance Sector Development Program (MSDP).*** Within the overall MSDP framework, Khushhali Bank (KB) is the lead micro-finance institution in Pakistan. The Bank now serves nearly 250,000 clients, with a cumulative disbursement of over Rs 6.0 billion in 75 districts of Pakistan with high poverty incidence. 60 % of KB's clients are in the rural areas, roughly one-third being women.

## CAPITAL MARKET:

During the fiscal year 2005-06, the stock market continued to maintain its strong performance and achieved new heights by creating many new records. The KSE-100 Index crossed the barrier of 12000 mark for the first time in the history of capital market and touched an all time high on April 13, 2006.

The KSE-100 index made further inroad and reached 12274 points on April 17, 2006 showing a growth of 64.7 % over June 2005. Between December 2005 and April 2006 alone, the KSE share index increased by 25 %. Similarly, the total market capitalisation also increased to Rs 3419.4 billion on April 17, 2006 (US $57.0 billion) from Rs 2013.2 billion ($33.7 billion) showing a growth of 70 % over June 2005. At current levels, KSE's market capitalisation is equivalent to about 44.3 % of estimated GDP of FY06.

## INFLATION:

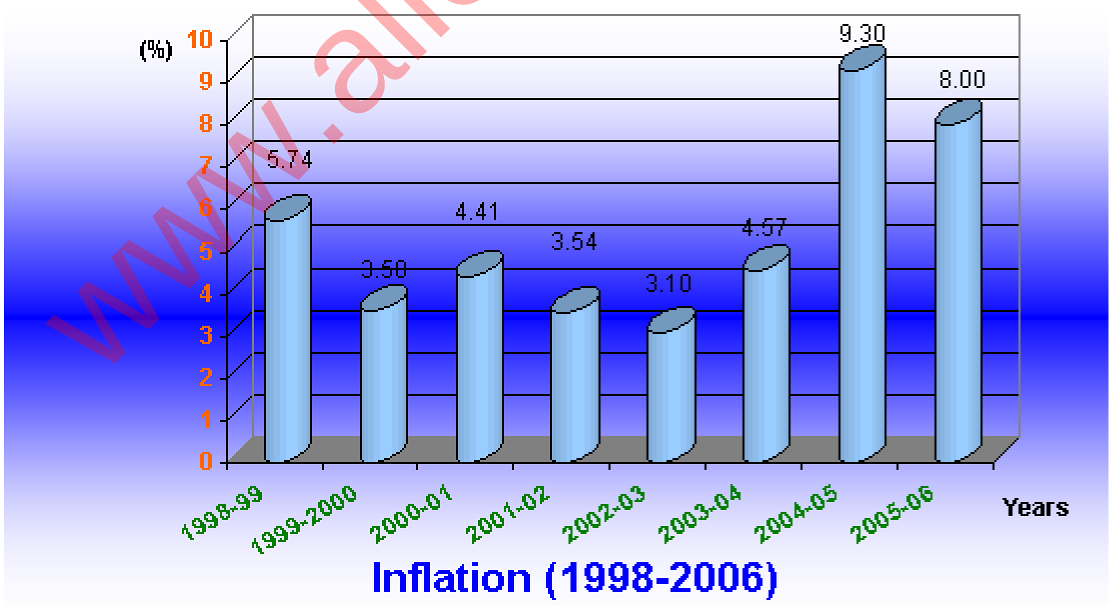
For the first ten months of the current fiscal year (July - April) 2005-06, the inflation as measured by the Consumer Price Index (CPI), declined to 8.0 % from 9.3 % in the same period last year. Food price inflation averaged at 7.0 % compared to12.8 % for the same period last year. Non-food inflation (i.e., house rent, energy and transport components) increased to 8.8 % versus 6.9 % in the comparable period of last year.

Factor contributing to the build-up in inflationary pressures is the increase in aggregate demand in the economy, which is compounded by supply shortages of principal commodities.

Cognisant of the impact of inflation on the economy and its disproportionate effect on the poor and fixed income groups of society, the government has responded in a multi-pronged manner to the rise in the price level. A strategy of regular monitoring of domestic stocks of key commodities and their prices was adopted, by which the government was able to respond in a timely manner to shortages by importing substantial quantities of wheat, sugar, pulses and other essential commodities.

**Ratio of CPI Inflation (1998-2006)**

| Year | Inflation (%) |
|---|---|
| 1998-99 | 5.74 |
| 1999-2000 | 3.58 |
| 2000-01 | 4.41 |
| 2001-02 | 3.54 |
| 2002-03 | 3.10 |
| 2003-04 | 4.57 |
| 2004-05 | 9.30 |
| 2005-06 *(for 10 months)* | 8.00 |






## TRADE AND PAYMENTS:

***Export*** during the first nine months (July-March), of the current fiscal year, are up by 18.6 % - rising from $10183 million to $12073 million in the same period last year. Thus, Pakistan is gradually moving towards higher value added in exports of textile manufacturers. The shares of value added exports have also increased. Pakistan doubled its exports in seven years and has increased its trade-to-GDP ratio from close to 26 % in 1999-2000 to an estimated 34 % in 2005-06.

The exports of *primary commodities* were up by 22 %; prominent among those are exports of:

- rice (33.6 %),
- fish and fish preparation (30.2 %), and
- fruits (20.6 %).

Exports of *textile manufactures* grew by 19.2 %; prominent among those are exports of:

- bedwear (58.4 %),
- readymade garments (31 %),
- cotton yarn (29.4 %),
- cotton cloth (16.5 %), and
- towels (12 %).

Exports of *other manufactures* also registered a high double-digit growth of 19.2 %. Within this category, exports of following come under this category:

- petroleum products (80.8 %), and
- leather manufactures (44 %).

In recent years, Pakistan has also entered in the exports of *engineering goods*. Though relatively small in numbers, exports of engineering goods were up by 10.3 %.

The overall exports posted an increase of $1890.2 million, in absolute term in the first nine months, of the current fiscal year over the same period of last year. Of this increase, 61.4 % or $1160.5 million has come alone from textile manufactures followed by other manufactures (20.9 % or $395.7 million), primary commodities (11.1 % or $209.6 million) and other exports (6.5 % or $124.5 million). In other words, over 82 % incremental exports in the first nine months (July-March) of the current fiscal year owe to textile and other manufactures and the remaining 18 % to primary and non-traditional exports.

The seven countries, namely USA, Germany, Japan, UK, Hong Kong, Dubai and Saudi Arabia account for 50 % of its exports. The United States is the single largest export market for Pakistan, accounting for 27 % of its exports followed by the United Kingdom, Dubai, Germany and Hong Kong. Japan as Pakistan's export destination is fast loosing its significance less than one percent of its exports entering Japan. Pakistan needs to diversify its exports not only in terms of commodities but also in terms of markets.

Heavy concentration of exports in few commodities and few markets could cause serious export instability.

***Imports***, on the other hand, have risen by 43.2 % or $6247 million in absolute terms during the first nine months of the current FY 05-06, i.e., rising from $14446 million to $20693 million.  This higher import bill is due to unprecedented rise in oil prices, and the continued strength of non-oil imports.

Imports of *petroleum group* have played a key role in taking Pakistan's import to a new height.  Emerging as the largest single item in the country's import bill, the petroleum group import amounted to $4615.8 million, during the first nine months (July-March), of the current fiscal year, as against $2806.6 million in the same period last year.

The trade deficit increased to $8620 million, in comparison to $4263.4 million in the same period last year.

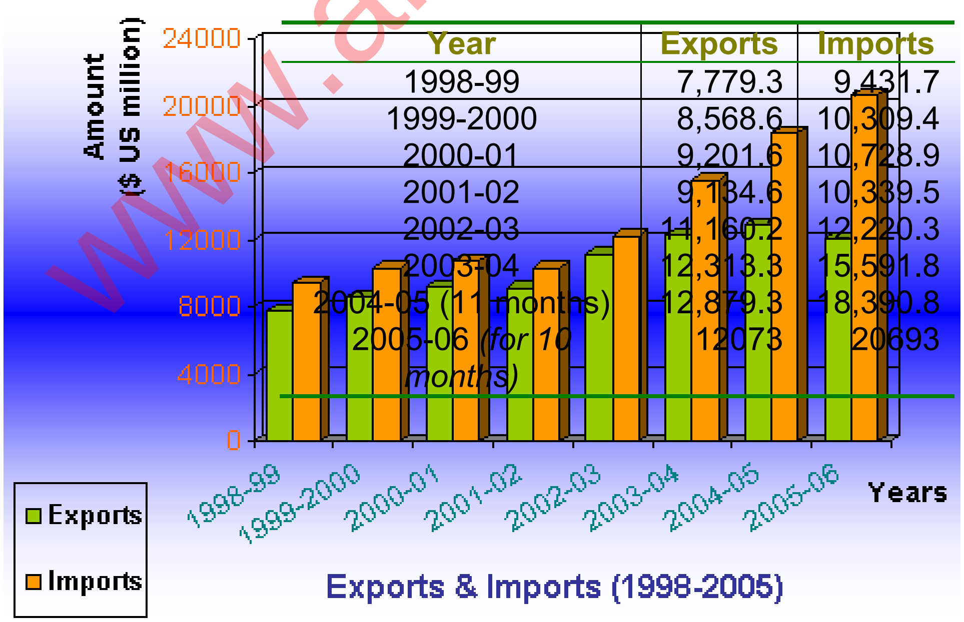
Like exports, Pakistan's imports are also highly concentrated in few items namely, machinery, petroleum & petroleum products, chemicals, transport equipments, edible oil, iron & steel, fertiliser and tea. These eight categories of imports accounted for 72.5 % of total imports during 2005-06. Among these categories machinery, petroleum & petroleum products and chemicals accounted for 53.4 % of total imports.

Pakistan's imports are highly concentrated in few countries. Over 40 % of them continue to originate from just seven countries namely, the USA, Japan, Kuwait, Saudi Arabia, Germany, the UK and Malaysia. Saudi Arabia is emerging as major suppliers to Pakistan followed by the USA and Japan.

**Exports and Imports (1998-2006)**

***(All figures in US $ Million)***

| Year | Exports | Imports |
|---|---|---|
| 1998-99 | 7,779.3 | 9,431.7 |
| 1999-2000 | 8,568.6 | 10,309.4 |
| 2000-01 | 9,201.6 | 10,728.9 |
| 2001-02 | 9,134.6 | 10,339.5 |
| 2002-03 | 11,160.2 | 12,220.3 |
| 2003-04 | 12,313.3 | 15,591.8 |
| 2004-05 (11 months) | 12,879.3 | 18,390.8 |
| 2005-06 *(for 10 months)* | 12073 | 20693 |



## CURRENT ACCOUNT BALANCE:

The current account deficit, excluding official transfers, stood at $4696 million in the first nine months (July-March) of the current fiscal year as $1181 million in the same period last year. As percentage of projected GDP for the year the current account deficit stood at 3.7 % as against 1.1 % in the same period last year. This heavy current account deficit is brought about by high crude prices, hefty rise non-oil imports, higher freight charges by international shipping lines, and the growth in personal travel.

## WORKERS' REMITTANCES:

Workers' remittances, the second largest source of foreign exchange inflow after exports, continue to maintain its rising trend. Workers' remittances totalled $3.63 billion during the first ten months (July - April) of the current fiscal year, as against $3.45 billion in the same period last year, depicting an increase of 5.2 %. The United States continues to be the single largest source of cash workers' remittances accounting for 27.4 % or $995 million, followed by Saudi Arabia ($585 million or 16.1 %), UAE ($556 million or 15.3 %), UK ($346 million or 9.5 %) and other GCC countries ($426 million or 13.2 %). Given the trend so far, it is likely that workers remittances may touch $4.4 billion in 2005-06. Remittances have so far proved remarkably resilient and have hovered around $4.0 billion since 2002-03.

## FOREIGN DIRECT INVESTMENT:

FDI in the first ten months (July-April) of the current fiscal year has reached $3.02 billion - the highest ever in the country's history, as against $0.89 billion in the same period last year, thus registering an increase of 238.7 %. By the end of the current fiscal year, FDI is expected to reach $3.5 billion or 2.7 % of GDP.

Almost 75.0 % of FDI has come from six countries, namely, the UAE, US, Saudi Arabia, Switzerland, UK and Netherlands:

- UAE – 42.5 % ($1284.6 million),
- US – 13.9 % ($419.1 million),
- Saudi Arabia – 9.06 % ($273.7 million),
- Switzerland – 5.34 % ($161.5 million),
- UK – 5.0 % ($151.4 million), and
- Netherlands – 2.9 % ($87.1 million).

The telecom sector has been the single largest recipient of FDI with $1 billion followed by the energy sector:

- telecom sector, ($1000.0 million),
- energy sector ($304 million),
- financial services ($265.5 million),
- trade ($81.9 million),

- construction ($54.4 million),
- food ($52.7 million),
- personal services ($45.2 million), and
- cement ($33.6 million).

## FOREIGN EXCHANGE RESERVES:

Pakistan's total liquid foreign exchange reserves stood at $13.0 billion at the end of April, 2006. Of which, reserves held by the State Bank of Pakistan amounted to $10.6 billion and by banks stood at $2.4 billion.

During this period, Pakistan has added $407.0 million in its foreign exchange reserves. Many factors contributed towards this comfortable position of reserves. The most prominent among those are: private transfers that include remittances, higher export proceeds, floatation of bonds, higher FDI flows and privatisation proceeds. With this build up in reserves, Pakistan is in a position to meet any abnormal external shock.

## PRIVATISATION:

Foreign investors are not only entering into the greenfield projects but are also actively participating in Pakistan's privatisation program. This is also the reflection of the confidence of the global investors on the transparent privatisation program that has been followed in the past several years.

Since January 1991 and until April 18, 2006, Pakistan has completed 160 transactions with gross proceeds of Rs 395.2 billion. Of which, 57 transactions worth Rs 338 billion were completed during October 1999 to April 2006. During the first ten months (July - April) of the current fiscal year, 11 transactions worth Rs 217.9 billion have been completed.

The major milestones achieved under the privatisation program for the year include the strategic sale of the entities like KESC, Pak-Arab Fertilisers, PTCL, PSM, Pak-American Fertiliser, Mustehkam Cement, Javedan Cement and CTI. The upfront payment of $1.4 billion by Etisalat and transfer of management control of PTCL has been one of the major achievements of privatisation program for the year. However, in June 2006, the Supreme Court, on the petition of the employees, declared the privatisation of PSM as an illegal transaction.

The major privatisation initiatives which are under process and are likely to be complete soon include: PSO, PPL, OGDCL, FESCO, GENCO-1 Jamshoro, NIT and other industrial units.

## EXTERNAL DEBT AND LIABILITIES:

Pakistan's ***total stock of external debt and foreign exchange liabilities*** grew at an average rate of 7.4 % per annum during 1990-99 - rising from $20.5 billion in 1990 to

$38.9 billion by end June 1999 but declined slightly to $37.9 billion in 1999-2000. It exhibited a declining trend thereafter. Pakistan's external debt and liabilities have declined by $3.1 billion - down from $38.9 billion in 1998-99 to $35.834 billion by 2004-05. However, external debt and liabilities increased to $36.557 billion by end-March 2006, thus showing a rise of $0.723 billion in the first nine months of the current fiscal year. The rise is mainly on account of issuance of Sovereign bonds worth $800 million in March 2006.

External debt and foreign exchange liabilities, instead of growing at the pace of the 1990s, were in fact reduced from U.S. $38.9 billion in 1998-99 to $36.5 billion by end-March 2006 - a reduction of $2.4 billion in seven years.

Most importantly, the ***burden of the debt*** has declined substantially during the same period. For example, the external debt and liabilities as a percentage of foreign exchange earnings which stood at 335.4 % in 1998-99, declined to 127.6 % by end-March 2006.

The external debt and liabilities stood at 64.1 % of GDP in end-June 1999, declined to 28.3 % in end-March 2006. The annual debt servicing payments made during the period 1999-2000 to 2003-04 averaged just above $5 billion per annum. This amount has drastically come down to around $3 billion in 2004-05. An amount of $2.4 billion has been paid during July-March 2005-06 and the amount rolled over declined from $4.1 billion in 1999-2000 to $1.1 billion in July-March 2005-06.

On March 23, 2006, Pakistan successfully issued US $500 million new ***10-year Eurobond*** and US $300 million new ***30-year Bonds*** in the international debt capital markets lead managed by J. P Morgan, Citi group and Deutsche Bank. This transaction, which represented the first international 144A bond issued by Pakistan since 1999, raised significant interest amongst international Institutional investors.

By issuing 10 and 30 year tranches, Pakistan completed its primary objective of establishing a full Pakistani International yield curve in record time. With over 170 accounts participating, books closed with total orders exceeding US $2bn. The issue was over 2.5 times oversubscribed.

## GOVERNMENT'S REFORM AGENDA:

Government’s reform agenda include:

- strengthening institutions, including judiciary, police, civil service and pension,
- restructuring the institutions, including Central Directorate of National Savings (CDNS), transforming the existing Monopoly Control Authority into a Competition Authority Organisation, and introduction and adoption of e-Government Strategy,
- improving the competitiveness of our industry,

- building a robust financial system in an environment of global financial restructuring,
- strengthening of tax administration, including the restructuring of CBR,
- promoting transparency in economic policy-making,
- reform in capital market, and
- strengthening the country's physical and human infrastructure.

## EDUCATION:

Currently, in Pakistan, the literacy rate is 53 % which is much below the targets set to be achieved in 2005 (60 % ESR and 58 % in PRSP) and far away from reaching the Millennium Development Goals (MDGs) target of 80 % literacy till 2015.

Looking at the gender disaggregated data for overall literacy, 65 % of males and 40 % of females were literate in the year 2004-05. District disaggregated data for adult literacy show that, in Punjab Rawalpindi with 75 % is ranked at the top and Lohdran with 34 % at the bottom. Karachi with 78 % literacy is ranked at the top while Jacobabad with 43 % is ranked at the bottom in Sindh. In NWFP, Abbotabad (65 %) is at the top and Kohistan (25 %) at the bottom. Finally, in Balochistan Quetta (65 %) at the top and Jhal Magsi (20 %) and Qilla Saifullah (20 %) are at the bottom.

The key impediments to the progress in reaching a higher level of literacy in Pakistan are the low enrolment rates and poor quality of education provided by the public sector. In case of enrolments, Net Enrolment Rate (NER) has seen a considerable increase of 10 percentage points from 42 % in 2001-02 to 52 % in 2004-05. The MDG targets to reach 100 % NER till 2015. This requires almost 50 % increase in enrolment in next 10 years, which is a huge challenge for the policy makers.

Another factor that contributes to lower literacy rates is the high dropout rate at all levels. Major reasons behind dropout include poor quality of infrastructure, teacher's absenteeism, quality of education and the value of returns attached to sending children to schools. There exist wide gender gaps especially in the rural areas in enrolments at all levels.

In the past year, 2187 new primary schools were established, 1221 in the public sector and 881 in the private sector. This increase has occurred in both rural and urban areas. Enrolment at the primary level increased from 19.92 million in 2001-02 to 21.33 million in 2004-05, 4.28 million to 4.55 million at the middle level and 1.79 million to 1.88 million at the secondary level during 2001-02 to 2004-05. During the past four years 249 additional technical and vocational institutions were established.

There is a significant increase of 35 universities during the period 2001-02 to 2004-05 including 13 new public and 22 new private universities. Government of Pakistan is currently spending 2.1 % of its GDP on education sector which is very low as compared to other countries in the region. The share of education sector has not seen much change in the past several years, in fact it has stagnated to about 2 % from 2003-2005.

## HEALTH:

The existing vast network of health care facilities consist of 946 hospitals, 4554 dispensaries, 5290 basic health units/sub health centres (BHUs/SHCs), 552 rural health centres (RHCs), 907 maternal and child health centres (MCHs) and 289 TB centres (TBCs).

Available human resource for the fiscal year 2005-06 turn out to be 118160 doctors, 6761 dentists and 33427 nurses which makes the ratio of population per doctor as 1310, population per dentist 25297 and population per nurse as 4636. The new health facilities added to overall health services include construction of 56 new facilities (42 BHU and 14 RHCs), upgrading of 59 existing facilities (18 RHCs and 41 BHUs) and addition of 3500 new doctors, 1900 nurses, and 15000 lady health workers.

The total outlay on health sector is budgeted at Rs 40 billion which shows an increase of 5.3 % over the last year and turns out to be 0.51 % of GDP. To reduce incidence of disease and to alleviate their suffering and pain so as to improve the health status of people, various health programmes like Lady health worker program, Malaria, Tuberculosis, HIV/AIDS control program, the expanded program on immunisation, National Maternal and child Health Program, Prime Minister Program for prevention and Control of Hepatitis in Pakistan, Drug Abuse, Cancer Treatment program remained operative during fiscal year 2005-06.

## POPULATION, LABOUR FORCE & EMPLOYMENT:

Pakistan being a developing country also faces the problem of over population. During the past 25 years, cultivable land has increased by 27 % compared to 98 % increase in population, resulting in reduced individual land holdings in Pakistan. Due to a high birth rate urban population will double in the next 20 years causing more and more forests to be cut to make way for humanity.

Even now each year, deforestation occurs at the rate of 2.5 %. In addition, since only 60 % of our population has sewerage facility, the remaining 40 % churn out wastes damaging the environment and causing a lot of diseases. Rising levels of income on the one hand and easy availability of loan facility/financing on the other has lead to an increase in motorization in the country and almost 70 % of our on-the-road vehicles have outlived their life span and emit unburnt monoxide gases.

In Pakistan, labour force participation is estimated on the basis of the Crude Activity Rate (CAR) and the Refined Activity Rate (RAR). The CAR is the percentage of the labour force in the total population while RAR is the percentage of the labour force in the population of persons 10 years of age and above.

The figures both for CAR (32.8 %) and RAR (46.9 %) for the first half of 2005-06 fare higher than LFS 2003-04 (30.4 % and 43.7 %). This phenomenon is more obvious for rural areas and women. Augmentation of the rates for the set of economic activities carried out within the house precincts also depicts the same scenario (42.8 vs. 38.5 %).

Agriculture still accounts for the largest source of employed work force. The share of agriculture in employment has increased from 43 % in 2003-04 to almost 45 % by mid of 2005-06. Sector wise break up of employed labour force shows that female labour force participation is on the rise for most sectors especially agriculture, fishery and telecom sectors.

## TRANSPORT AND COMMUNICATIONS:

A strong, efficient and affordable infrastructure is a critical element of a good investment climate and therefore, is a pre-condition to sustain the growth momentum. Transport and Communications both are important elements of infrastructure services and are essential in maintaining economic growth and competitiveness. In fact, the transport and communication sector in Pakistan account for about 11 % of GDP, 16 % of fixed investment, 6 % of employment and about 15 % of the Public Sector Development Programme.

Road transport is a backbone of Pakistan's transport system, accounting for 90 % of national passenger traffic and 96 % of freight movement. Over the past ten years, road traffic - both passenger and freight - has grown much faster than the country's economic growth. The 9,518 km long National Highway and Motorway network contributes about 3.7 % of the total road network and carries 90 % of Pakistan's total traffic.

The total length of roads in Pakistan was 258,340 Km, including 165,762 Km of high type (64 %) and 92,578 Km of low type roads (36 %) by the end of March 2006. During the outgoing fiscal year, the length of high type roads has increased by 1.8 % over the last year but the length of low type roads has declined by 2.9 %.

The construction work on Islamabad-Peshawar Motorway (M-1) however, is still in progress.

Furthermore, the Pakistan Railways have carried 61.3 million passengers and 4.3 million tons freight, with its gross earnings stood at Rs 12.5 billion during July-March 2005-06.

In comparison, PIA carried 3.972 million passengers during July-February 2005-06 as against 3.571 million in the same period last year, showing an increase of 11.2 %. Both passenger capacity and traffic volume also increased by 2.4 % and 8.7 %, respectively. In addition, its fleet consists of 41 aircrafts of various types. In addition, there are three private airlines, operating in the country and provide both domestic and international services.

Karachi Port has also handled 24,572 thousand tons of cargo during July-March, 2005-06, compared to 21,845 thousand tons during the same period last year, showing an increase of 12.5 %. Port Qasim has handled 16.8 million ton of cargo during July-March 2005-06 compared to16 million cargo handled during the corresponding period last year, registering a growth of 5 %. The Gwadar Port is also being built with Chinese assistance and its first phase has almost been completed.

In 1999-2000, there were only 0.3 million cellular mobile subscribers in Pakistan which jumped to 2.4 million by 2002-03 as a result of introduction of CPP regime and addition of another mobile operator (Ufone). Mobile subscribers continued to rise at an unprecedented pace, reaching 12.8 million by 2004-05. A major turnaround was witnessed when the mobile companies started giving free mobile connections and bearing the cost of government levies themselves. In a short period of 9 months in the outgoing fiscal year, more than 16 million new subscribers have been added to the list, reaching over 29.6 million by end April 2006. In other words, a more than 131 % increase in subscribers in just 9 months was unprecedented. Accordingly, the total teledensity (Fixed + Cellular + WLL) has jumped form 3.7 % in 2001-02 to 23.1 % by end March 2005-06.

For promotion of Information Technology, 2339 cities/towns/villages have been provided Internet facility, by March 2006. Total fixed telephone lines installed by March 2006 were 5.2 million as against 5.1 million up to June 2005 last year.

**ENERGY:**

The overall production of crude oil has decreased to 17.9 million barrels during July-March 2005-06 from 18.1 million barrels during the corresponding period last year, showing a decline of 1.1 %. On an average, the transport sector consumes 49.7 % of the petroleum products, followed by power sector (32.3 %), industry (11.8 %), household (2.5 %), other government (2.3 %), and agriculture (1.4 %) during last 10 years i.e. 1995-96 to 2004-05.

The overall production of gas has increased to 1,048,190 million cubic feet during July-March 2005-06 as compared to 1,003,189 million cubic feet daily in the same period last year, showing an increase of 4.5 %. On average, the power sector consumes 36.6 % of gas, followed by fertiliser (22.5 %), industrial sector (18.8 %), household (18.4 %), commercial sector (2.8 %) and cement (1.3 %) during last 10 years i.e. 1995-96 to 2004-05.

Total installed capacity of electricity (WAPDA, KESC, KANUPP AND IPPs) stood at 19,439 MW during July-March 2005-06, compared to 19,389 MW during July-March 2004-05. Total installed capacity of WAPDA stood at 11,363 MW during July-March 2005-06 of which, hydel accounts for 56.9 % or 6,463 MW, thermal accounts for 43.1 % or 4,900 MW. During the first three quarters of current fiscal year, 63,978 GWh electricity has been generated as against 61,758 GWh were produced in the same period last year. The number of villages electrified increased to 99,595 by March 2006 from 90,467 up to 2004-05, showing an increase of 10 %.

Presently, some 930 CNG stations are operating in the country, while 200 are under construction. By March 2006 about one million vehicles were converted to CNG as compared to 700,000 vehicles during the same period last year, showing an increase of 43%. With these developments Pakistan has become the leading country in Asia and the third largest user of CNG in the world after Argentina and Brazil.

## ENVIRONMENT AND HOUSING:

Several policies, plans, programs and projects have been initiated for environmental protection and conservation in the sectoral areas of water and air pollution control, land use, forest management, energy efficiency, biodiversity conservation, and waste management, etc. One of the major achievements during 2005-06 was the formulation of the ***"National Environmental Policy 2005"*** which addresses the sectoral issues such as:

(a) water management and conservations,

(b) energy efficiency and renewable,

(c) agriculture and livestock,

(d) forestry and plantation,

(e) biodiversity and protected areas,

(f) climate change, air quality and noise, and

(g) pollution and waste management.

***Housing*** is one of the basic human requirements, as every family needs a roof. Providing shelter to every family has become a major issue as a result of rapid urbanisation and higher population growth.

According to the housing census 1998, the housing backlog, which stood at 4.30 million, has been currently projected at 6.19 million. It is estimated that to address the backlog and to meet the housing shortfall in the next 20 years the overall housing production has to be increased to 500,000 housing units annually.

The present housing stock is also rapidly aging and estimates suggest that more than 50% stock is over 50 years old. It is also estimated that 50 % of the urban population now live in slums and squatter settlements. Meeting the backlog in housing, besides replacement of out-lived housing units is beyond the financial resources of the Government.

The Government of Pakistan is, therefore, encouraging the participation of local as well as foreign investors, developers, private sector companies and financial sector to build more and more housing projects and to provide housing finance to meet the demands of vast segment of the society. Having realised the importance of the housing sector in the overall economic development of the country, the government, as an immediate measure, declared Housing and Construction as a priority industry and simultaneously formulated a pragmatic and workable National Housing Policy. This is aimed at revitalising the housing sector, providing therein various incentives for the construction industry and the private sector builders/developers.

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# Economic Survey 2006 – 07

## HIGHLIGHTS:

- Overall performance: ***strong***;
- ***Real GDP growth rate:*** 7%. Whereas the World Economy expanded by 5.4% in 2006. The Euro Zone shown a growth of 2.6% in 2006. While advanced economies grew by 3.1% and developing economies show an astonishing figure of 7.9%. China grew by 10.7%, India grew by 9.2%, Vietnam grew by 7.4% and CIS grew by 7.7% including Russia's growth rate of 6.7%. ASEAN (Indonesia, Thailand, Malaysia and Philippines) grew by 5% – 5.5%. Saudi Arabia and Kuwait grew by 6.3% and 6.2% respectively;
- ***Per capita income*** in current dollar term was up by 11% to $925;
- ***Agricultural growth rate***: 5%;
- ***Large-scale manufacturing growth rate***: 8.8%;
- ***Services sector growth rate***: 8%;
- ***Real per capita GDP*** grew by 5.2%;
- Aggressive tight ***monetary policy*** by SBP;
- ***Rate of inflation*** averaged 7.9% in the first ten months of the fiscal year;
- ***Public debt*** declined from 56.9% to 53.4% of GDP, and external debt and liabilities declined from 29.4% to 27.1%;
- Highest ever ***workers' remittances*** at around $5.5 billion;
- Highest ever ***foreign investment*** at around $6.5 billion, emerging as the single largest source of external finance after exports;
- ***Stable exchange rate***;
- Successful launch of a new $750 million 10-year 144 A sovereign bond in international debt capital market;
- Major health indicators improved.

## SUMMARY:

Pakistan's economy continues to maintain solid pace of expansion since the fiscal year 2002-03 recovery in the economy has been strong, rapid and sustained. During the fiscal year 2006-07, Pakistan's economic fundamentals have gained further strength. The most important achievements of this year include:

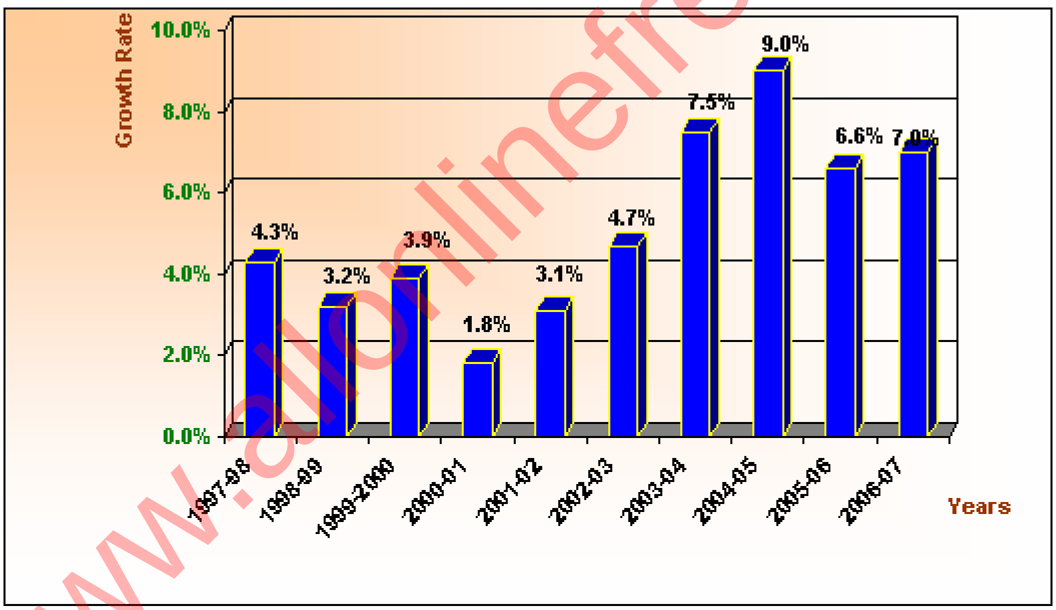
## GROWTH AND INVESTMENT:

Pakistan's economy continues to maintain its strong growth momentum for the fifth year in a row in the fiscal year 2006-07. With economic growth at 7% in the current fiscal year, Pakistan's economy has grown at an average rate of almost 7% p.a. during the last five years. This brisk pace of expansion on sustained basis has enabled Pakistan to position itself as one of the fastest growing economies of the Asian region.

The ***real GDP*** grew strongly at 7% in 2006-07 as against the revised estimates of 6.6% for the last year and 7% budgeted growth rate for the year.

**Annual GDP Growth Rate in % (1997-2007)**

| Year | GDP Growth Rate (%) |
|---|---|
| 1997-98 | 3.5 |
| 1998-99 | 4.2 |
| 1999-2000 | 3.9 |
| 2000-01 | 1.8 |
| 2001-02 | 3.1 |
| 2002-03 | 4.7 |
| 2003-04 | 7.5 |
| 2004-05 (revised) | 9.0 |
| 2005-06 (revised) | 6.6 |
| 2006-07 (10 months) | 7.0 |




Growth of ***value addition in Commodity Producing Sector (CPS)*** is estimated to increase by 6% in 2006-07 as against 3.4% in 2005-06. Within the CPS, agriculture and manufacturing grew by 5% and 8.4%, respectively. ***Large-scale manufacturing (LSM)*** registered a growth of 8.8% in 2006-07 as against the target of 12.5% and last year's achievement of 10.7%. As a result of structural transformation, the share of agriculture in GDP has declined by 3.2% points in the last 6 years alone and the share of the manufacturing sector has increased by 3.1% points in the same period.

Major crops witnessed an impressive growth of 7.6% as against a negative growth of 4.1% last year. Livestock, a major component of agriculture, exhibited signs of moderation from its buoyant growth of 7.5% last year to 4.3% in 2006-07.

The ***services sector*** grew by 8.5% in 2004-05, by 9.6% in 2005-06 and by 8% in 2006-07. Finance and insurance sector spearheaded the growth in the services sector and registered stellar growth of 18.2% during the current fiscal year. Value added in the wholesale and retail trade sector increased by 7.1% in 2006-07 compared to 8.6% growth in 2005-06.

Value added in the transport, storage and communications sector grew by 5.7% as compared to 6.9% growth in the previous fiscal year. Public administration and defence posted a growth of 7% while ownership of dwellings grew by 3.5% and social services sector improved the growth performance to 8.5% from 6.3% last year.

Pakistan's per capita real GDP has shown fast pace growth in the last years averaging at 5.5%. Whereas, the per capita income in dollar term has grown at an average rate of 13% p.a. during the last 5 years, rising from \$586 in 2002-03 to \$925 in 2006-07. The main factors responsible for the sharp rise in per capita income include acceleration in real GDP growth, stable exchange rate and four fold increase in the inflows of workers' remittances.

The ***investment*** has reached record level of 23% of GDP. This is the highest investment rate ever in recent economic history. This year's economic growth is largely investment-driven but ably supported which provides source of optimism that a growth of 6-8% in the next 5 years is quite achievable. National savings are financing a large part of this investment boom. The national savings rate is now at 18% of GDP.

***Fixed investment*** has increased to 21.4% of GDP from 20.1% last year. Total investment has increased to 23% from last year's 16.9% of GDP. ***Private sector investment*** grew by 20.4% this year as against 37.5% increase in last year in nominal terms. Public sector investment has also increased by 25.7% during the current fiscal year in nominal terms. Major nominal growth in private sector investment is witnessed in manufacturing (27%), mining & quarrying (93.6%), construction (10.7%), transport and communication (20.8%), and wholesale and retail trade (25.4%). The overall foreign investment during the fist ten months of the current fiscal year has touched \$6 billion – highest ever in the country's history. The overall foreign investment grew by 47.7%.

Almost 78% of ***FDI*** has come from five countries, namely, the UAE, US, China, UK and Netherlands. Total FDI has reached \$4160.2 million as against \$3038.2 million of last year, showing an increase of 36.9%. The major sectors of FDI are financial business (20.9%), energy (14.1%), and food, beverages and tobacco (11.8%).

## AGRICULTURE:

Agriculture is still the largest sector of Pakistan. It accounts for 20.9% of GDP and directly employs 43.4% of the total workforce. This year, the agriculture growth has shown a mixed trend. Pakistan's agriculture has faced two droughts in the last seven years, i.e., in 2000-01 and 2001-02. Hence agriculture registered negative growth in these two years. With positive growth during 2002-03, 2003-04 and 2004-05, the performance of agriculture remained weak during the year 2005-06, because its crops sector particularly major crops could not perform up to the expectations. Growth in the agriculture sector registered a sharp recovery in 2006-07 and grew by 5% as against the preceding year's growth of 1.6%. Major crops posted strong recovery from negative 4.1% last year to positive 7.6% mainly due to higher production of wheat and sugarcane.

***Wheat*** production of 23.5 million tons is highest ever in the country's history, registered an increase of 10.5% over last year. ***Sugarcane*** production likewise improved by 22.6% over last year to 54.8 million tons, both being record high production. ***Cotton*** production at 13 million bales remained mostly unchanged in comparison to 13.02 million bales of last year. ***Rice*** production at 5.4 million tons was marginally less than 5.5 million tons produced last year. Despite the lower yield, higher demand abroad for Pakistan Basmati Rice and high international prices are expected to surpass the last year's export earning from Basmati Rice.

***Minor crops*** registered a weak growth of 1.1% while it was 0.4% last year. However, amongst the minor crops, production of potato increased by 67.2%, mung and masoor pulses improved by 21.5% and 17.9% respectively. ***Livestock*** registered a strong growth of 4.3% over the last year's impressive growth of 7.5% due to increase in the livestock and poultry products. ***Fishery*** performed positively at 4.2% as against 20.5% of last year. Forestry has shown a negative growth of 3.8% as against the negative growth of 43.7% last year.

## MANUFACTURING AND MINING:

The overall manufacturing sector continued on its strong positive trend during the current fiscal year. Overall manufacturing recorded an impressive and broad based growth of 8.45%, as against last year's growth of 9.9%. LSM, accounting for 69.5% of overall manufacturing registered an impressive growth of 8.75% in the current fiscal year as against the last year's 10.68%.

The main contributors of this impressive 8.75% during the first ten months of current fiscal year (2006-07) are cotton cloth (7%) and cotton yarn (11.9%) in textile group; cooking oil (6.8%), sugar (19.6%) and cigarette (4.14%) in the food, beverages and tobacco group; cement (21.11); jeeps and cars (3%), LCVs (17.04%), motorcycles (12.3%) and tractors (11.4%) in the automobile group. Nitrogenous and phosphatic fertilizers shown negative growths of 0.08% and 3.1% respectively. Similarly, petroleum products and galenicals also shown negative growths of 5.59% and 24.49% respectively.

The Government is fully committed to make the mineral sector as one of the most profitable sector in Pakistan. During the current fiscal year, the ***mining and quarrying sector*** has registered a growth rate of 5.6% as against 4.58% of last year, which was mainly due to positive growths in magnetite, dolomite, limestone and chromites.

## POVERTY AND INCOME DISTRIBUTION:

With Government's dynamic economic policies, the ***poverty*** has reduced from 1/3$^{rd}$ to 1/4$^{th}$, which is quite phenomenal, but still, with 23.9% of poverty level, Pakistan is facing its horrendous social, political and economic effects. Government of Pakistan is still trying her best. Since fiscal year 2002, the economy has created 10.62 million jobs, thereby reducing the open unemployment rate to 6.2% by fiscal year 2005-06. Foreign inflows in the form of remittances also have salutary impact on poverty. Development expenditure as a ratio of GDP, increase in human capital base, and openness of the economy are some of the other important factors that reduce the absolute poverty levels in Pakistan. On the debit side, food inflation increases poverty levels. The economy has witnessed a gradual increase in all the former set of determinants, while food inflation remained benign till 2004-05.

## FISCAL DEVELOPMENT:

Pakistan has succeeded in reducing ***fiscal deficit*** from an average of 7% of GDP in the 1990s to an average of 3.5% during the last seven years. The associated public debt accumulation also declined sharply from over 100% of GDP to 53% this year. Pakistan's hard earned macroeconomic stability is therefore, underpinned by fiscal discipline.

The underlying fiscal deficit is targeted at 3.7% of GDP (excluding earthquake spending) for the current fiscal year 2006-07 which is slightly higher than the deficit level of the previous year (3.4% of GDP).

***Total revenues*** are budgeted at Rs. 1163.1 billion in 2006-07 compared to Rs. 1087 billion in 2005-06, showing an increase of 7%. This was primarily due to a rise of 15.5% in tax revenue on the back of increase in federal tax revenues are projected to rise by 17.5%. Provincial tax revenue is projected to decline by 12.6%. Non-tax revenue is targeted to decline by 13.3% by moving to Rs. 277.3 billion in 2006-07 as against Rs. 320 billion last year.

During the last seven years, ***tax collection by CBR*** has increased by 112.8%. During the current fiscal year, CBR has exceeded the revenue target of Rs. 645.2 billion fixed for the first 10 months of current fiscal year by Rs. 11.3 billion. The net collection stood at Rs. 656.5 billion as against Rs. 547 billion of last year, thereby showing an increase of 20%. The direct taxes contributed most of the increase they have surpassed the target by Rs. 52.4 billion and recorded massive growth of 50.9%.

The ***share of direct taxes in total taxes*** has increased from 18% to over 38.5% in first 10 months of the current fiscal year 2006-07. Whereas, the share of indirect taxes in total taxes has declined from 82% to 61.5 during the same period, which will give a relief to final consumers. The share of sales tax increased at a tremendous pace from 14.4% to 41% of total taxes and from 17.6% to 60.3% of indirect taxes during the same period. The collection from custom duty account for 18.6% of total tax collection and 32.3% of indirect taxes in the current fiscal year.

***Total expenditure***, during the first 9 months of the current fiscal year, is estimated at Rs. 1168.5 billion. Current expenditure is estimated at Rs. 925.3 billion for the first 9 months of the current fiscal year. The higher increase in current expenditures during the last two years is mainly on account of earthquake-related spending amounting to 0.5% to 0.8% of GDP. Interest payments are estimated at Rs. 241.2 billion as against the target of Rs. 239.5 for the first 9 months of current fiscal year.

***Development expenditure*** is estimated at Rs. 241.8 billion for the first 9 months of the current fiscal year as against the target of Rs. 435 billion and revised estimate of Rs. 313.7 billion in 2005-06. This expenditure may likely to pick-up in the last quarter of the year. The size of PSDP was budgeted at Rs. 270 billion and provincial PSDP was estimated at Rs. 115 billion; totalling Rs. 385 billion. An amount of Rs. 50 billion was budgeted for earthquake related spending; therefore, the total size of the PSDP was budgeted at Rs. 435 billion. However, an operational shortfall of Rs. 20 billion in PSDP was anticipated in 2006-07. During the last seven years, the developed expenditure improved from 2.2% of GDP in 2000-01 to 4.9% of GDP in 2006-07.

The ***overall fiscal deficit*** is targeted at Rs. 373 billion or 4.2% of GDP for 2006-07. The Government is well placed to meet this target as fiscal deficit during the first nine months remained at 3.1% of GDP or 73% of the yearly target. On the basis of the developments on revenue and expenditure front, the overall fiscal deficit during the first 9 months of the current fiscal year stood at Rs. 272.8 billion or 3.1% of GDP. Earthquake accounted for sizeable amount of fiscal deficit and underlying fiscal deficit excluding earthquake expenditure is targeted at 3.7% of GDP for 2006-07. Revenue balance (revenue minus current expenditure) – a measure of government's savings or dis-savings was targeted to be in surplus to the extent of 0.6% of GDP. During the fist 9 months of the current fiscal year, the revenue balance has remained in deficit to the extent of Rs. 29.6 billion or 0.3% of GDP. The primary balance (total revenue minus non-interest total expenditure) remained in surplus for the last 7 years. However, primary balance turned negative for the first time in 2005-06.

The ***public debt-to-GDP ratio***, which stood at almost 85% on June 30, 2000, declined substantially to 56.9% by the end of June 2006, and by the end of March 2007, it further declined to 53.4%. Public debt was 562.5% of revenue by the end of 1990s. With effective debt reduction strategy, the public debt burden in relation to total revenue has declined substantially to 401% by end of June 2006 and further to 400% by end of March 2007.

By end of June 2006, ***total domestic debt*** stood at Rs. 2312 billion which was 30% of GDP. The outstanding stock of domestic debt rose by Rs. 211.8 billion and domestic debt stock stood at Rs. 2523 billion by the end of March 2007 which is 28.4%,

## MONEY AND CREDIT:

There has been a remarkable improvement in Pakistan's financial sector as it initiated a broad-based program of reforms in the early 1990s. The pace of reforms, however, has increased manifold since 2000. As a result of successful reforms in the financial sector the M2/GDP ratio, which is an indicator of financial deepening and development has been showing rising trend since 1990-91. M2/GDP ratio has increased from 39.3% in 1990-91 to 45% in 2005-06. Credit to private sector / GDP ratio is also rising from 21.7% in 1990-91 to 27.4% in 2005-06.

During the current fiscal year, the SBP took several additional policy measures in different phases as part of monetary policy tightening. In the first phase, the SBP raised the ***Statutory Liquidity Ratio (SLR)*** from 15% to 18% and ***Cash Reserve Ratio (CRR)*** from commercial banks from 5 to 7%.

The ***money supply*** during the period July 1 to May 12, 2007 expanded by Rs. 477.9 billion or 14% as against an expansion of Rs. 358.2 billion or 12.1% in the same period last year.

Consistent with its objective of shaving off domestic demand with a view to reducing inflation, the SBP not only raised reserve requirements for banks w.e.f. July 22, 2006, but also increased the discount rate 50 bps to 9.5% from 9%. In addition, SBP continued its frequent open market operations to drain excess liquidity from the inter-bank market. SBP also raised the cut-off yield on 6-months and 12-months treasury bills which had increased gradually by 41 and 29 basis points to 8.9% and 9.07% respectively during July – April FY 07. Interest rates of 3.5 and 10 years maturities of ***Pakistan Investment Bonds (PIBs)*** exhibit an increase in the range of the 14 basis points to 33 basis points during the FY 07 over the last year. The weighted average lending rate has increased by 240 basis points in a period of 21 months from June 2005 to March 2007 from 8.2% in June 2005 to 10.6% in March 2007.

## CAPITAL MARKETS:

Pakistan's capital and stock markets have witnessed impressive growth over the last several years on account of market friendly and investment friendly policies pursued by the government. The ***KSE-100 index*** has increased from 1521 points in June 2000 to 12370 points in April 2007, i.e., an increase of 713%. Similarly aggregate market capitalisation has increased from Rs. 392 billion ($7.6 billion) in June 2000 to Rs. 3604 billion ($53 billion) or an increase of 819%. ***Aggregate market capitalisation*** also increased by 35% from Rs. 2801 billion in June 2006 to Rs. 3781 billion in May 2007. Portfolio investment has increased from a negative $140 million in 2000-01 to positive $1819 during July-April 2006-07.

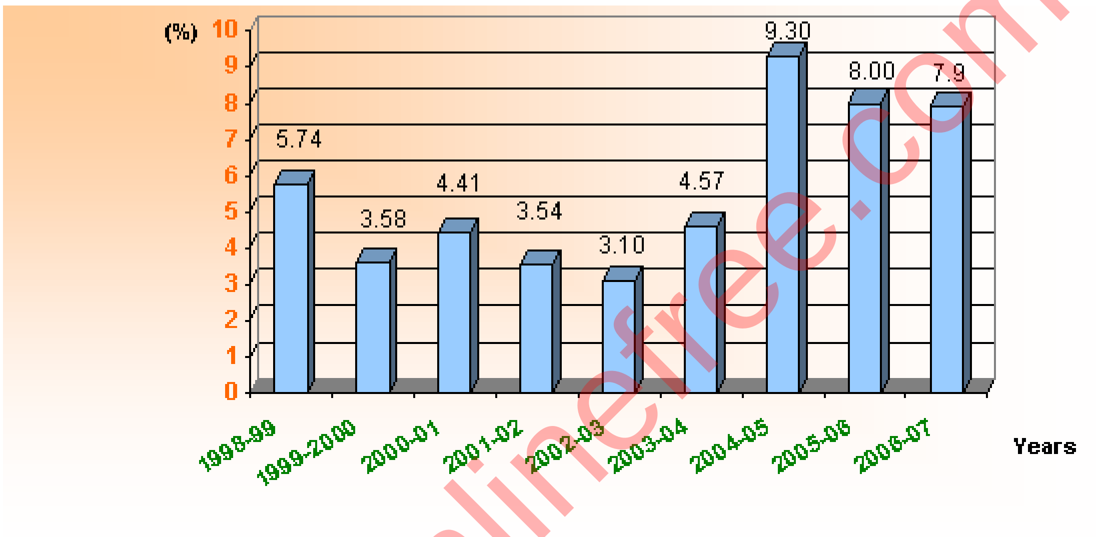
## INFLATION:

During the first 10 months of the current fiscal year, the average inflation rate as measured by the change in consumer price index (CPI) stood at 7.9% compared with 8% last year. ***Food inflation*** during this period increased to 10.2% from 6.9% in the same period last year whereas the ***non-food inflation*** is estimated at 6.2% against 8.8% in the same period of last year. The core inflation which represents the rate of increase in cost of goods and services excluding food and energy prices also subdued from 7.7% to 6%. The major contributors to the high pick up in food inflation and there by overall CPI inflation include the rise in prices of vegetable ghee, various kinds of pulses, rice, poultry, meat, milk, fresh vegetables and fruits on account of imbalance in demand and supply of these commodities. Besides, the soaring global price of key importable food items such as edible oil, milk powder, tea, medicine and food related components have boosted domestic inflation. A number of measure were initiated by the Government to contain price hike in the country including easing of imports for commodities facing supply shortage, reforms geared towards increase in agricultural output and improvement in marketing mechanism.

**Ratio of CPI Inflation (1998-2007)**

| Year | Inflation (%) |
|---|---|
| 1998-99 | 5.74 |

| | |
|---|---|
| 1999-2000 | 3.58 |
| 2000-01 | 4.41 |
| 2001-02 | 3.54 |
| 2002-03 | 3.10 |
| 2003-04 | 4.57 |
| 2004-05 | 9.30 |
| 2005-06 *(for 10 months)* | 8.00 |
| 2006-07 *(for 10 months)* | 7.90 |






## TRADE AND PAYMENTS:

During the last several years, ***exports*** are growing at an average rate of almost 16% p.a. Despite improvements in the international trading environment, Pakistan's export growth witnessed abrupt and sharp deceleration to less than 4% in the first 10 months of the current fiscal year.

Exports were targeted at $18.6 billion or 12.9% growth rate. But exports during the first 10 months of the current fiscal year are up by only 3.4% - rising from $13457 million to $13909 million in the same period last years.

After growing at an average rate of 29% p.a. during 2003-06, Pakistan's ***import*** growth slowed to a moderate level in the current fiscal year. Pakistan's imports grew by 8.9% or $2047 million in the first 10 months of the current fiscal year.

Pakistan's ***balance of payments*** shows a record increase in capital flows that has substantially offset a gradual widening of the current account deficit. Pakistan's current account deficit further widened to $6.2 (4.3% of GDP) in the first 9 months) of the current fiscal year from $4.6 billion (3.6% of GDP) in the same period last year. A sticking feature of this year's current account deficit is that it has widened even tough the import growth has slowed to 10.2% but the performance of exports has been lack luster at best, resulting in widening of trade deficit. Deficit in services account also widened and as such even a robust growth of 7.8% in private transfers could not narrow the current account deficit.

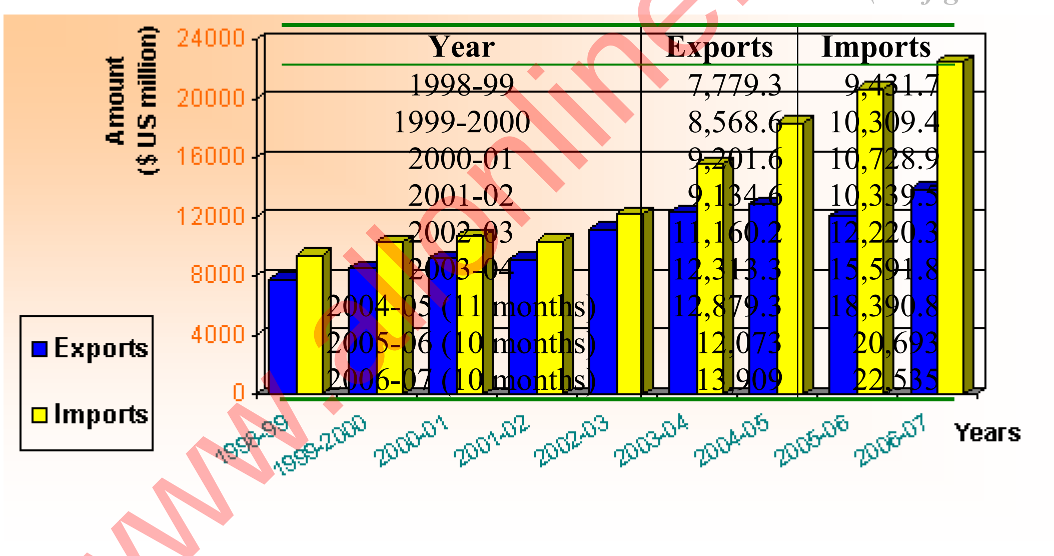
The ***current account deficit*** for the year is likely to be around 5% of GDP as against 4.4% last year. The strong inflows in capital account will more than offset the current account deficit and add to the stock of foreign exchange reserves. The flow under long-term capital (net) has surged to $5.7 billion in first nine months of the current fiscal year as against $3.1 billion in the same period last year, showing an increase of 82%.

***Exchange rate*** remained more or less stable during the current fiscal year. However, rupee depreciated only marginally (0.7%) from Rs. 60.2138 per dollar as at end of June 2006 to Rs. 60.6684 as of end of April 2007. In the open market, rupee traded at Rs. 60.655 to a dollar, that is, at a discount of 0.02% as at end of April 2007.

Pakistan's total liquid ***foreign exchange reserves*** stood at $13738 million at the end of April 2007, considerably higher than the end of June 2006 level of $13137 million.

**Exports and Imports (1998-2007)**

***(All figures in US $ Million)***




| Year | Exports | Imports |
|---|---|---|
| 1998-99 | 7,779.3 | 9,431.7 |
| 1999-2000 | 8,568.6 | 10,309.4 |
| 2000-01 | 9,201.6 | 10,728.9 |
| 2001-02 | 9,134.6 | 10,339.5 |
| 2002-03 | 11,160.2 | 12,220.3 |
| 2003-04 | 12,313.3 | 15,591.8 |
| 2004-05 (11 months) | 12,879.3 | 18,390.8 |
| 2005-06 (10 months) | 12,073 | 20,693 |
| 2006-07 (10 months) | 13,909 | 22,535 |



## EXTERNAL DEBT AND LIABILITIES (EDL):

Due to a credible debt reduction strategy and successive high growth rates, Pakistan has reduced its public debt burden from 100.3% of GDP in the end of FY99 to 53.4% of GDP by the end of March 2007. The external debt component of public debt (excluding private non-guaranteed) debt and liabilities) has decreased from 40.8 at end of FY02 to 24.6 at end of March FY07.

***External debts and liabilities (EDL)*** at the end of March 2007 were $38.86 billion. This is an increase of $1.6 billion in total with 4.3% increase. There is much criticism about increase in EDL. The debt burden of a country is measured in proportion to GDP and not in totality. As stated earlier, public debt was 100.3% of GDP in the end of FY99 and now, with Government's effective debt reduction and management policy, it is 53.4% of GDP. Government has also ensured the growth in EDL lesser than the growth in GDP. In brief, Pakistan has succeeded to decrease the debt burden in proportion to GDP.

The EDL declined from 50.9% of GDP at end of FY02 to 26.3% of GDP by end of March 2007. Similarly, the EDL were 236.8% of foreign exchange earnings, declined to 119.7% in the same period. The EDL were embarrassingly 5.8 times of foreign exchange reserves at the end of FY02 but effectively declined to 2.8 times by end of March 2007. Interest payments on external debt were 7.8% of current account receipts but declined to 3.2% during the same period.

Continuing the credible debt policy, Pakistan successfully issued a $750 million 10 year note at a fixed rate of 6.875% on May 24, 2007 lead managed by Deutsche Bank, Citi Group and HSBC. This was the largest 10-year deal to date, beating the previous deal of $500 million. The transaction was announced and priced within 72 hours, an impressive feat and testament to investor confidence in Pakistan's economy.

## EDUCATION:

In recent years, the ***literacy rate*** in Pakistan has, somehow, improved. The overall literacy rate was 45% in 2001 which has increased to 54% in 2005-06. The literacy rate for non-poor went up from 51% in 2001 to 59% in 2005, whereas for poor it improved from 30% to 40% in the same period. Male literacy rate (10 years & above) increased from 58% in 2001 to 65% in 2005-06, whereas for female it improved from 32% to 42% during the same period.

The Government has taken several strong initiatives to improve and overhaul the existing system o education. It has taken prudent step towards streamlining the education sector at the national level. Education sector reform Action Plan 2001-2005 is one of the examples of this multi-pronged strategy which envisage in it the devolution of responsibility of the delivery of the education to local governments along with improving the overall literacy, enrolment and access to education. Also, National Education Policy 1998-2010 is currently under review to include to participation of all the stakeholders and ensuring ownership of the policy by federating units and other stakeholders.

The current situation of education (including the education of privately owned institutions, Government-owned institutions and madrasas) and its quality are still horrifying. Pakistan still needs revolutionary and radical education policies.

## HEALTH AND NUTRITION:

A healthy nation is very essential for the development of a country. Supply of cheap medicine, best conditions of hospitals, higher supply of doctors and nurses, hygienic food, clean water, hygienic working environment, clean streets and roads, and health awareness in the people are some of the essentials of health and nutrition requirements of Pakistan. And these requirements are recognised by the Government and fully committed to their fulfilment.

For the fiscal year 2006-07, there are 122,798 doctors, 7,388 dentists and 57,646 nurses which make the ratio of population per doctor as 1,254, population per dentist as 20,839 and population per nurse as 2,671. The new health facilities added to overall health services include construction of 87 new facilities, upgrading of 65 existing facilities and addition of 5,000 new doctors, 2,300 new nurses and 14,000 lady-health workers. To reduce incidence of disease and to alleviate people's suffering and pain so as to improve their health status, various health programmes remained operative during the current fiscal year. These include the national programs for the prevention and control of Tuberculosis, malaria, HIV/AIDS, hepatitis, blindness and program on maternal, neonatal and child health, etc.

## POPULATION, LABOUR FORCE AND EMPLOYMENT:

At the time of independence is 1947, 32.5 million people lived in West Pakistan, and by 2006-07, the ***population*** is estimated to have reached 156.77 million. Thus in roughly three generations, Pakistan's population has increased by 124.27 million or has grown at an average rate of 2.6% p.a. Pakistan's population has a high proportion of young people with high motivation to work. Therefore, Pakistan's high population represents a large potential market for production and consumption of goods and services. With broad consumer-based economy, Pakistan has bigger opportunities to attract investment (esp. foreign investment).

In Pakistan, the ***labour force participation rate*** is measured on the basis of Crude Activity Rate (CAR) and Refined Activity Rate (RAR). The CAR is the percentage of the labour force in the total population while RAR is the percentage of the labour force in the population of persons 10 years of age and above. The labour market in Pakistan demonstrates a lower Labour Force Participation Rate (LFPR). It has been in the range of 28.6% to 32.3% over a decade, even the RAR is low and hovered at 43% over a decade. It is nevertheless important to point out that both these ratios are increasing in recent years. This is mainly attributed to increasing economic activities that are fairly diversified and thus are not only generating employment opportunities but also motivating others to join workforce. The CAR has stayed roughly constant since 1980, but has started to rise in the last few years; from 29.6% in 2001-02 to 32.3% in 2005-06. Similarly, the RAR has also started to increase from past trend of 43.3% in 2001-02 to 46% in 2006-07. Participation rates are highest in Punjab and lowest in NWFP. These rising rates point towards an increasing optimism in the labour market.

## TRANSPORT AND COMMUNICATION:

Government has given top priority to ***infrastructure development*** in Pakistan. Major infrastructure projects completed during the last seven years include: Islamabad-Lahore Motorway (M2), Makran Costal Highway, Sibi Bypass, Kohat Tunnel and access roads, Karachi Northern Bypass, Pindi-Battian-Faisalabad Motorway (M3), Lahore-Sahiwal Section, Rahim Yar Khan-TMP Section, Torkham-Jalalabad Road, rehabilitation of Band Road, Lahore and inauguration of Gwadar Port, etc. Major on-going projects include Islamabad-Peshawar Motorway (M1), Gwadar-Turbat-Hoshab (M8), Khuzdar-Shahdadkot Section, Kalat-Quetta-Chaman Section, Sibi-Dhadar Section, Lyari Expressway, D.I. Khan-Mughalkot Section, Islamabad-Murree Dual Carriageway and R.Y. Khan-Bahawalpur Section.

The total length of roads in Pakistan was 259,197 km, including 172,827 km of high type (67%) and 86,370 km of low type roads (33%) by the end of March 2007. During the current fiscal year, the length of high type roads has increased by 3.2% over the last year but the length of low type roads has declined by 5.6%.

***Pakistan Railways*** have carried 66 million passengers and 4.5 million tons freight. Its gross earnings stood at Rs. 14.1 billion during the first nine months of the current fiscal year.

***Pakistan International Airlines (PIA)*** carried 4.2 passengers during the first nine months of 2006-07 as against 4.3 million in the same period last year showing decrease of 2.3%. Its fleet consists of 39 aircrafts of various types.

***Karachi Port Trust (KPT)*** has handled 22,427 thousand tons of cargo during the first nine months of current fiscal year, as compared to 24,572 thousand tons during the same period last year, showing decrease of 8.7%. The Port Qasim has handled 19.7 million ton of cargo during July-March 2006-07 as against 16.8 million ton cargo handled during the same period last year, registered a growth of 17%. The Gwadar Port was inaugurated on March 20, 2007.

In 1999-2000, there were only 0.3 million ***cellular mobile*** subscribers in Pakistan which jumped to 2.4 million by 2002-03 as a result of introduction of cord pay phone (CPP) regime and addition of more mobile operator. Mobile subscribers continued to rise at an unprecedented pace, reaching 34.5 million by 2005-06. In a short period of 9 months in the outgoing fiscal year, more than 24 million new subscribers have been added to the list, reaching over 58.6 million by end of April 2007. In other words, more than 70% increase in subscribers in just 9 months. Accordingly, the total teledensity (Fixed + Cellular + WLL) has jumped from 3.7% in 2001-02 to 40.2% by end of March 2007. For promotion of IT, 2,444 cities/towns/villages have been provided Internet facility up to March 2007.

## ENERGY:

The energy demand in Pakistan has been increased due to rapid growth of economy esp. during the last 4 years. ***Production of crude oil*** per day has increased from 65,385 barrels per day to 66,485. The overall production of crude oil has increased to 18.2 million barrels from 17.9 million barrels showing an increase of 1.7%. On average, transport sector consumes 50.7% of the petroleum products, followed by power sector (32.1%), industry (11.4%), household (2.2%), other government (2.3%) and agriculture (1.3%) during the last 10 years.

The average ***production of natural gas*** per day stood at 3,876 million cubic feet during the first nine months of the current fiscal year, as compared to 3,825 million cubic feet over the same period last year, showing an increase of 1.3%. The overall production of gas has increased to 1,062,124 million cubic feet during July-March 2006-07 as compared to 1,048,190 million cubic feet during the same period last year. On average, power sector consumes 36.4% of gas, followed by fertilizer (21.6%), industrial sector (19.1%), household (17.8%), commercial sector (2.7%) and cement (1.1%) during the last 10 years.

The total installed generation capacity indicates no change. By March 2007, it was 19,440 MW. Total capacity of ***WAPDA*** stood at 11,363 MW during July-March 2006-07 of which, hydel accounts for 56.9%, thermal accounts for 43.1%. During the first three quarters of current fiscal year 71,033 GWh electricity has been produced as against 66,110 GWh in the same period last year showing an increase of 7.4%. The number of villages electrified increased to 113,605 by March 2007 from 103,231 up to 2005-06, showing an increase of 10%.

Presently, some 1,414 ***CNG*** stations are operating in 85 cities and towns. By March 2007, about 1.35 million vehicles were converted to CNG as compared to 1 million vehicles during the same period last year, showing an increase of 35%. On average 29,167 vehicles are being converted to CNG every month. With these developments, Pakistan has become the leading country in Asia and the third largest user of CNG in the world after Argentina and Brazil.

## ENVIRONMENT:

The environmental threats have become the major concern for the leaders of the world. Due to global warming, which is a cause of massive industrial and transport wastages, the earth's stock of ice is melting at a very fast pace. This can create horrifying environmental problems for humans, for e.g., droughts, cyclones, twisters, floods, etc. On other hand, many rivers are drying and such countries are facing the threat of water shortages in near future.

In Pakistan, environmental degradation is intrinsically linked to poverty because of the overwhelming dependence of the poor on natural resources for their livelihoods, whether agriculture, forestry, fishery, hunting, etc. Poverty combined with a burgeoning population and rapid urbanisation, is leading to intense pressures on the environment. Pakistani cities are facing problems of urban congestion, deteriorating air and water quality and waste management while the rural areas are witnessing rapid deforestation, biodiversity and habitat loss, crop failure, desertification and land degradation.

In Pakistan, the Government has initiated the ***National Environment Action Plan (NEAP)*** in 2001 as an umbrella programme to address these environmental concerns in a holistic manner. The UNDP has been supporting the implementation of this initiative through the NEAP Support Programme (NEAP-SP). Some of the key policies and programmes that have stemmed from NEAP are: Air and Water Quality Monitoring, Clean Drinking Water, Pakistan Wetlands Programme, National Sanitation Policy, Sustainable Land Management to Combat Desertification in Pakistan, Environmental Rehabilitation and Poverty Reduction through Participatory Watershed Management in Treble Reservoir and Energy Efficiency and Renewable Energy, etc.

The Government has also committed itself to achieving the ***Millennium Development Goals (MDGs)*** as adopted by the UN member states in the year 2000. The MDG target for land area to be protected for the conservation of wildlife is 12% by the year 2015. Pakistan already has 11.3% of its area under protection for conservation of wildlife. Thus, it is very likely that this target can be met by 2015. Government's MDG target for number of vehicles using CNG (which previously used diesel and petrol) is 920,000, whereas, the current estimate for 2005-06 is 1.4 million vehicles. Therefore, Pakistan has already met its MDG target well in advance.

Currently, only 54% of the population of Pakistan has access to safe sanitation and 66% to safe drinking water, whereas the targets for 2015 are 90% and 93% respectively. Even though there has been an improvement in water supply coverage from 53% in 1990 to 66% in 2005, however, the MDG target of 93% poses a considerable challenge. Pakistan has committed to increasing forest cover to 5.7% by 2011 and to 6% by the year 2015. An increase of 1.2% implies that an additional 1.051 m.ha area has to be brought under forest cover within the next 10 years. This will include all state lands, communal lands, farmlands, private lands, and municipal lands.

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V

# Annual Budget 2005

## Highlights

- Freedom from IMF Loans
- 8.4% GDP Growth Rate
- Pakistan has now become one of the five most impressive economies of Asia, and Second fastest growing economy in Asia
- Overseas Pakistani Remittances: US $ 3.4 bn (during the first 10 months), and reserves in foreign currency account stood at US $ 12.4 bn as on 24th June 2005.
- The main crops set a target of 6.6 per cent and for the agriculture sector as a whole a growth rate of 4.8 per cent. The growth target for manufacturing sector has been set at 11 per cent and for the services sector at 6.8 per cent. After taking into account the targets of the three major sectors we have set a GDP growth target of 7 per cent.
- The budget for the current year was Rs 902.8 billion. After adding an increase of 21.7 per cent the budget for 2005-06 is set at Rs 1,098.5 billion. The deficit for 2004-05 was estimated at 3.2 per cent and for the next financial year the deficit level is set at 3.8 per cent.
- The government has recently got the Fiscal Responsibility Law unanimously passed by the Parliament under which the irresponsible use of borrowed money has been stopped. Under this law every government will have to spend at least 4.5 per cent of the GDP on the development of social sectors.
- The development budget has been increased by 34.7 per cent, which is the highest increase to date.
- Current expenditures will increase by 18 per cent. The main reasons for the increase are the relief that government is giving to the government servants. Additionally, increases are anticipated under the heads of interest charges and subsidy.
- CBR revenue will increase by 17 per cent. Last year revenue through CBR was at Rs 590 billion which will become Rs 690 billion for the next year.
- The resources passed on by the federation to the provinces will increase from Rs 239 billion to Rs 284 billion registering a 19 per cent increase.
- For 2005-06, the National Economic Council has approved a development programme of Rs 306 billion, which is unparalleled in the 58 year history of Pakistan. As a result of this programme a network of development work will be spread all over the country and the destiny of the people will be changed. During 2005-06 completion of 353 projects will be facilitated.
- For the next year the allocation:

    - for water will increase by 66.5 per cent,
    - for health will increase by 68.6 per cent,
    - for education and professional training will increase by 49.5 per cent,
    - for higher education will increase by 28.6 per cent,
    - for IT will increase by 35.6 per cent and
    - for science and technology will increase by 60.8 per cent.

- A sum of Rs 92.2 will be spent on infrastructure so that inadequacies of infrastructure do not become a constraint in faster development.
- Rs 73.1 will be spent on social sector. Rs 38.7 will be spent on IT, science and technology, tourism, environment and law and justice.
- Expenditure on defence will be curtailed to 3.1 % of GNP.

Federal Budget 2005-06

***(Rs. in million)***

| Receipts | % | Rs. | Payments | % | Rs. |
|---|---|---|---|---|---|
| (a) Tax Revenue | | 690000 | **Current (A)** | | **826502** |
| (b) Other Tax Revenue | | 42638 | General Public Service | 46 | 503114 |
| (c) Non-Tax Revenue | | 194762 | Defence Affairs & Services | 20 | 223501 |
| Gross Revenue Receipts | | 927400 | Public Order Safety Affairs | 2 | 18721 |
| Less: Provincial Share | | 284319 | Economic Affairs | 5 | 56449 |
| **I. Net Revenue Receipts** | 58 | **643081** | Environment Protection | 0 | 147 |
| II. Net Capital Receipts | 5 | 50556 | Housing and Community | 0 | 863 |
| III. External Receipts | 19 | 212371 | Health Affairs and Services | 0 | 4128 |
| IV. Self Financing of PSDP by Provinces | 4 | 43801 | Recreational, Culture Services | 0 | 2309 |
| V. Change in Provincial Cash Balance | 3 | 30652 | Education Affairs Services | 2 | 16648 |
| VI. Privatisation Proceeds | 2 | 20000 | Social Protection | 0 | 623 |
| VII. Bank Borrowing | 9 | 98040 | **Development (B)** | **25** | **272000** |
| | | | Provincial Government | | 68000 |
| | | | Federal Government | | 204000 |
| **Total Resources (I to VII)** | **100** | **1098502** | **Total Expenditures (A + B)** | **100** | **1098502** |

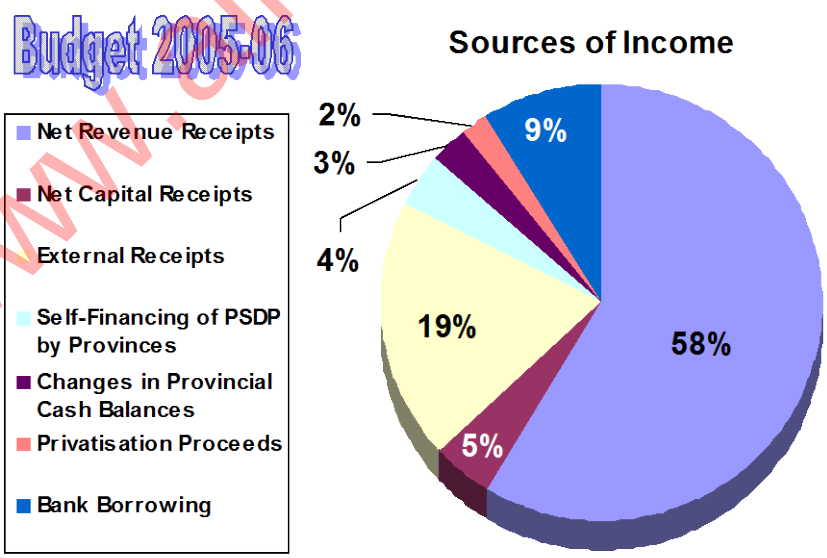


Figure 1 – Sources of Income

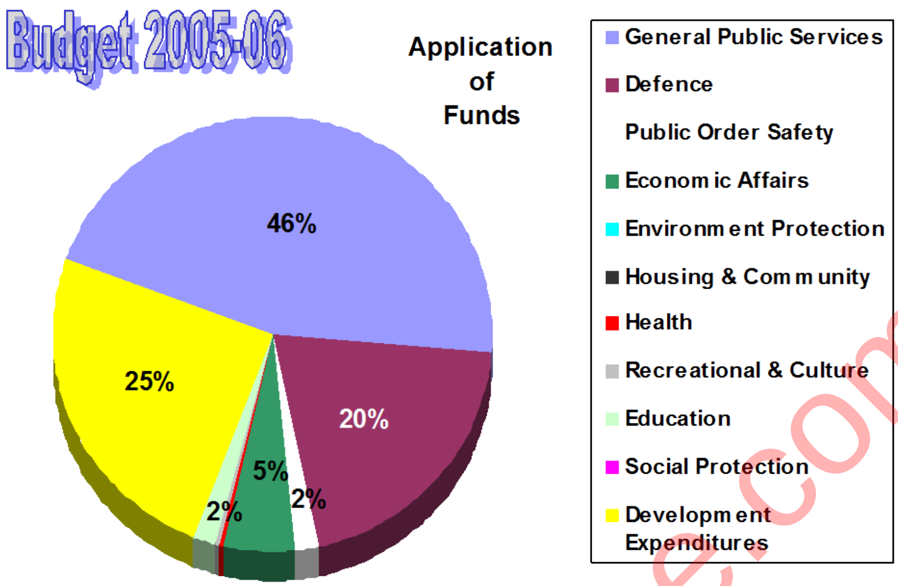


Figure 2 – Application of Funds

## Agriculture

- The allocation for agriculture has been increased from Rs.7 billion to Rs.9.1 billion.
- The main crops set a target of 6.6 per cent and for the agriculture sector as a whole a growth rate of 4.8 per cent.
- Farming community's income increased by Rs. 147 bn.
- In 2004-05 Rs. 100 bn loans were provided to the farming sector.
- Imported 238,000 tons of fertilizer and granted a subsidy of Rs. 3.8 bn. to the farmers in various forms.
- 41,653 farm tractors have been manufactured during the year

**Proposals:**

- Government has raised the minimum prices of wheat and cotton for the betterment of farmers.
- Agricultural related items will be given relief by reducing the duties but the protection available to fisheries, poultry and dairy will be considered.
- 5% duty is proposed to be abolished on Urea.
- Duty on tractors is reduced to 15% from 20%, on cotton ginning machinery to be abolished; so also on the pressing units in this sector.
- Duty also to be abolished on Bulldozers, levellers, graders etc.
- Inputs of the Poultry Industry to be duty free, similarly poultry feed and poultry meat processing machinery to be duty free.
- The Government has already reduced customs duty on phosphates. With increased demand for urea, it is proposed that 5% customs duty on urea also be withdrawn.

## Water & Irrigation, and Power

- For WAPDA resource projects Rs. 21 bn were spent in 2004-05 this has been increased to Rs. 43 bn
- During the current financial year 2004-05, 9300 villages were provided with electricity. Next year another 13000 will be provided electricity. Rs 15.58 billion has been allocated for projects of power sector under the National Development Programme.
- The development funds allocated for water for agriculture have been increased by 64 per cent. During 2004-05 Rs 4 billion were allocated for lining canals and watercourses.
- About 11,000 people would get direct employment and 400,000 jobs would be created through the project of lining of water courses. Next year 10,000 watercourses would be lined.
- Sukkar barrage was reconstructed under the supervision of Army.

**Proposals:**

- The Mangla Dam is being raised, Gomal-Zam, Kurram-Tangi, Mirani and Subzkai dams are being constructed. Kachi, Greater Thal, Rainee and Pat Feeder Extension canals are being constructed.
- During 2005-06 work would start on Neelum Jhelum Hydro Electric Plant. This plant would produce 969 MW of electricity. Through a long-term plan, action is being taken so that by 2010, 700 MW of electricity should be produced through alternate sources.

## Manufacturing Sector

- The growth target for manufacturing sector has been set at 11 per cent
- The private sector has invested $4 billion in textile industry and textile exports are touching the $10 billion mark. Karachi Textile City is being established. Garments cities are being set up both at Lahore and Karachi. The growth in the textile sector can be judged from 18 per cent increase in the production of cotton yarn, 28.45 per cent increase in the production of cotton and 45 per cent increase in the production of ginned cotton.
- During 2004-05, 31,663 tractors, 1,637 trucks and 1,341 buses 87,992 jeeps and cars and 342,678 motorcycles were produced and offered for sale.
- During the last one year the production of air conditioners increased by 462 per cent, deep freezers by 55 per cent, refrigerators by 19.79 per cent, soaps and detergents by 21.86 per cent. This increase reflects increasing purchasing power of an emerging middle class and its financial strength.

**Proposals:**

- To promote investment in production of capital and engineering machinery making industry it is proposed to rationalize their duty structure. For similar reasons, duty on raw material for zinc and chrome coating is proposed to be exempted.
- The plastic sector primarily depends upon the petroleum sector. Prices in the international market of petroleum sector have skyrocketed in the past year. As

plastic goods come into daily use of the common man therefore it is proposed to reduce the customs duty on 55 plastic goods items.

- Raw material used for textile, pharmaceuticals are being exempted from duty or will get substantial relief.
- Raw material, components, and subcomponents to manufacture home appliances like air conditioners, TV, washing machines, refrigerators, computer monitors, circuit breakers, energy saving lamps, composite doors and windows, are being proposed to be given reduction in customs duty.
- Spares and components used for replacement, modernization, and balancing of machinery not produced within the country, will be subject to 5% duty while investment in plant manufacturing sector will enjoy substantial cut in duty.
- In addition, machinery and equipment for setting up, balancing, modernization or replacement of industry are proposed to be kept at 5 per cent duty, and duty on their parts is being brought to the same rate.
- Abolition of sales tax on spares and components for plants and machinery as well as raw materials, spares and components used for manufacture of plants and machinery.
- Similarly lead and chromium raw material will be duty free.
- Artificial silk industry: (all items in the chain) to get duty relief
- Duty paid in respect of export of textile, leather, carpets and sports goods is refunded as duty drawback. This is a problem area and it is proposed to abolish levy of duty altogether.
- Cotton, yarn, clothing are major export items. It is therefore proposed to introduce zero rate for import of all items used in textile industry; so also the carpet, leather, surgical instruments and sports goods industry.
- It is proposed that to increase industrial production the custom duty on basic raw material may be reduced. Hence raw materials for chemical, pharmaceutical, textiles, furniture, confectionary and soap industry are being exempted from duty or is being reduced.
- Abolition of excise duty on soap and detergents.
- Ginning industry has a vital role in the textile chain, therefore, its machinery is proposed to be exempted from customs duty. Similarly duty on presses for ginning industry is also proposed to be withdrawn.

## Services Sector

- The growth target for the services sector at 6.8 per cent.
- The services sector performed an exceedingly satisfactory role in achieving 7.9 per cent growth.
- Service sector accounts for 52% of country's economy. Services occupy centre stage of the economy and their share in the GDP of Pakistan has surpassed that of agriculture and industry. And it is proposed to bring more services within its ambit.

(a) Banking & Finance

- During the year banking and insurance sector have registered growth rate of 21.76%.
- The result is that in the first nine months of the financial year there was record increase of credit to the private sector which stood at Rs. 348 billon out of which Rs. 100 billon were given to the agriculture sector.
- During the last four years, 500,000 families have availed micro-financing. During the next four years the number of those who availed micro-financing will increase to three million. Within one year one million small micro loans will be made available. Khushhali bank will by 2007 make 563,000 micro loans available.
- It is now proposed to build up the service sector of the economy. In this connection, the Excise Legislation is being rationalised, and it is proposed to levy excise duty @ 7.5 per cent on fees and commission charged by banks for services for letters of credit, guarantees, broking and foreign currency dealings; and also levy excise duty @ 7.5 per cent on charges received on account of lease management fee, documentation fee and processing fee at the time of executing lease agreements. However lease money and mark-up will be exempt.

(b) Whole Sale and Retail, and Other Service Sectors

- Within the service sector wholesale and retail trade increased by 12 per cent. This year 270 companies related to export and import, 240 companies offering miscellaneous services and 117 telecom companies got themselves registered. A total of 2,697 companies started operating in the country. Out of these 54 companies belong to 20 different countries.
- The annual retail sale of clothes and garment, carpets, sport goods in excess of Rs. 5 million will be subjected to 3% tax inclusive of 1% income tax. and it will be considered as final tax.
- The retail prices of cigarettes is proposed to be increased by cigarette manufacturers, accordingly threshold of excise duty is proposed to be increased by 7% to 8%.
- Withdrawal of sales tax on laundry, dry cleaners and marriage halls is proposed.
- To support SME sector the Government will establish the Business support fund.
- Tourism & hotel industry will pay only 5% duty on machinery and equipment used by them but aviation sector will pay no duty on the machinery.
- Presently, machinery and equipment used in hotel and tourism industry carries concessionary duty of 5 per cent, while other items used in such industry are not so entitled. It is proposed that 5 per cent customs duty also be allowed to all other items on certification by Ministry of Tourism. Besides, duty on Machinery, equipment and parts used by Aviation Industry is proposed to be exempted.

## Telecommunication

- According to one estimate up to June 2005 $3 billion have been invested in the telecom sector. In telecom sector alone government revenues has increased from Rs. 3.7 bn to Rs. 15.6 bn.
- Number of mobile phone users increased by 125%.

- The mobile connections in the country have exceeded 10 million.

**Proposals:**

- Tax on mobile connection presently at Rs. 2,000/- shall be reduced to Rs. 500/-
- It is proposed to levy 15% Excise duty on the sale of pay phone and pre-paid calling cards instead of on the billed amount of PTCL. The proposed measure would not bring additional burden to consumers and call charges would also remain the same, because the price at which such cards are sold to consumers have an in-built component of excise duty.
- It is proposed to levy 15% Excise Duty on Wireless Local Loop.

## Poverty Alleviation

- Poverty alleviation allocation will go up from Rs. 278 bn to Rs. 324 bn next year.
- Poverty reduction expenditures will increase by 16.5 per cent. Last year Rs 278 billion were allocated, while in the next year Rs 324 billion will be spent on this account.
- Under the Khushal Pakistan Programme next year Rs 7.5 billion will be spent. Under this programme clean drinking water, sanitation, electricity and farm to market metal roads will be provided on which in the initial two phases, local development projects totalling Rs 5 billon are under implementation. A substantial increase has been made in the households that use electricity and gas.
- 50 % tax rebate is available to senior citizens whose income does not exceed Rs. 300,000/-. Now this limit is proposed to be increased to Rs. 400,000/-
- A special programme has been developed for 32 less developed districts of the country which will benefit 22,000,000 citizens.
- The government of Pakistan is contributing Rs 7.74 for every litre of diesel to give relief to the people. Similarly, on every litre of kerosene oil Rs 8.24 is being contributed by the government. The price per litre of kerosene oil instead of Rs 36.24 is Rs 28.
- To maintain the prices of petroleum products at a lower level, the government had to withstand a loss of Rs 52 billion in its revenue. In India, the average price of diesel is Rs 40.12 and of petrol Rs 55.93, which on an average is Rs 10 litre more than the prices in Pakistan.
- In the annual development program National Housing Authority has been allocated Rs. 20 bn.
- For widows and orphans HBFC Loan upto Rs. 100,000/- has been written-off.

## Human Resource Development

- Government is establishing an institution under the name of NTEVTA to provide vocational and technical training to youth. So that they will have better job opportunities in technical side.
- Under Khushhal Pakistan Programme young people will get local jobs.

## Health

- Rs.12.4 bn will be spent on health sector next year.
- The federal government is also initiating a basic health programme for women in all the provinces. The services of lady health workers will be provided in each district.
- People having access to tap water have increased from 25 per cent to 40 per cent.

## Education

- Next year Rs 12.4 billon will be spent by the federation on education.
- During 2004-05 from July to March the federation and the four provinces spent Rs 74.43 billion on education.
- The changes that are taking place can be gauged from the fact that primary school enrolment of children has increased from 71 to 86 per cent.
- During the last four years the rate of literacy has increased from 45 per cent to 53 per cent whereas the literate males have now become 65 per cent.

## Transportation

- Pakistan Railways will be provided Rs. 9.8 bn to complete 12 development projects.
- Pakistan Railways now does not need subsidy. There will be a saving of Rs5 billion in the subsidy allocated for it in the current year.
- Karachi has been connected with Gwadar Port through the *Makran Coastal Highway* and now the entire coastal region of Balochistan is ready for development. Projects are being implemented to connect Gwadar Harbour with Quetta and other cities of the country and onwards with Peoples Republic of China, Afghanistan and Central Asia.
- Work is in progress on *Peshawar-Islamabad* and *Faisalabad-Multan Motorways*. Work on Lowari tunnel will be started and alternate route will be provided to Gilgit through Jalkad Chilas Road. Indus Highway is being made operational between Karachi and Peshawar. Once this highway is completed the distance will be reduced by 400 kilometres. Rs 20 billion have been allocated in the Annual Development Programme for the National Highway Authority so that these important projects are completed well in time.

## Energy

- To provide relief to people of Pakistan government is providing subsidy of Rs. 7.74 per litre of diesel. Likewise on Kerosene oil government is providing subsidy of Rs 8.24 per litre. To maintain oil prices at minimum possible level Government has suffered loss of revenue by Rs. 52 bn. The price per litre of kerosene oil instead of Rs 36.24 is Rs 28.
- During the year Government has provided 250,000 new gas connections to domestic users, whereas gas has been provided to additional 270 towns and villages. 529 kilometres of pipeline were laid to make the gas available.
- Liquefied Petroleum Gas (LPG) is being used in 1.81 million houses and it is expected that next year the households using this gas will increase to 2.1 million.

## Construction

- The construction sector grew at a rate of 6.2 per cent. The construction sector has become the main job provider for the technical and non-technical people. During 2004-05, 134 construction companies registered themselves with SECP.
- Imported Vehicles (including CNG kits & other automobile spare parts)
- For imported cars duty will be paid in three slabs:

    - 50% on cars upto 1500cc,
    - 65% on cars of 1501cc upto 1800cc, and
    - 75% on cars of more than 1800cc.

- The import & supply of CNG buses, Euro II buses will be exempted from sales tax.
- Exemption of duty on CKD Kits for CNG buses and Euro-II buses (CNG Kits for cars are already duty-free).
- CNG Dispensers: Duty reduced to 10%.
- For tyres imported for small trucks, duty will be 20% but 10% on construction vehicles.
- Bicycle is a popular conveyance amongst the population. To reduce its cost, customs duty on all bicycle parts is proposed to be reduced from 35 per cent to 25 per cent.

## Pay & Pension

- Under the pay & pension committee, the government has announced the following relief for the government employees.

    - 15 % increase in pay scale
    - 10 % increase in pensions
    - Total increase of 23 % to 29 %.

- The government will spend Rs25.5 billion on the increase in pay and pension
- The minimum wage has been increased from Rs. 2500/- to Rs. 3000/- similarly the lowest pension limit has been increased from Rs. 700/- to Rs. 1000/-.

## Proposals Relating to Income Tax

- The salaried class needs our special attention. Our present regime is two tiered. The standard tax rates range between 7.5 per cent to 35 per cent. To simplify and rationalize law, it is proposed that tax rates for salaried persons may be reduced to lie between 3.5 per cent to 30 per cent.
- In order to further facilitate salaried taxpayers, it is proposed that if their source of income is only salary, then they need not file income tax return or employer's certificate if their employer has filed mandatory tax deduction statement of his employees.

- Teachers & researchers also need special encouragement. Therefore, the existing tax reduction limit of 50 per cent for them is proposed to be enhanced to 75 per cent.
- It is proposed that perks carrying zero marginal cost to the employers be exempted from tax. This will benefit teachers, hospital employees, hotel employees, employees of transport companies and of educational institutions.
- Limit of contribution towards approved pension fund for claiming tax credit is being enhanced from Rs 200,000 to Rs 500,000.
- Taxpayers are allowed tax credit on donations made by them to non-profit organizations. In order to encourage philanthropy, it is proposed to convert this credit into straight deduction from income for tax purposes in case of donations made to specific welfare institutions.
- The profit on investment up to Rs 150,000 in National Saving Schemes is exempt from withholding tax whereas 10% tax is withheld on investments in TFCs. It is proposed to bring the investors in TFCs at par with them, and to allow similar exemption from withholding tax for investments up to Rs 150,000 in TFCs. In order to provide an incentive for investment in IPOs, the limit of investment for claiming tax credit is proposed to be enhanced from Rs. 100,000 to Rs. 150,000.
- The corporate sector has prime importance in the Country's economy. The Government aims to strengthen and revitalize this sector. It was announced in 2002 that there would be the gradual reduction in corporate tax rates. These rates are therefore proposed to be further reduced for tax year 2006 to the following levels:

    - Banking companies 38%
    - Public Companies 35%
    - Private Companies 37%

- Further more, it is proposed to exempt capital gain of insurance companies.
- To encourage enlistment, a reduction of 1% in tax is proposed for companies enlisted on stock exchange during next year.
- Small and Medium Enterprises (SME) entities is an established vehicle to play a major role in creating employment. It is our proposal that those SMEs that transform into companies, a reduced corporate rate of 20% be applied to them, and no turnover tax be payable by them.
- The maximum value of passenger transport vehicle (not plying for hire) for the purpose of depreciation allowance is Rs 1 million. It is proposed that this maximum limit be removed.
- Currently, withholding tax is deducted @ 3 per cent of the value of the condemned ship imported for the purpose of breaking. This industry was once a thriving sector providing livelihood to thousands of people. With passage of time, ship-breaking activity has come to a standstill. In order to revive this industry, it is proposed that rate of withholding tax be reduced to 1 per cent.
- It is proposed that large trading companies be exempted from Presumptive Taxation so that more of them are attracted to make investment in Pakistan. The tax to GDP ratio needs to be improved. This can only be possible by expanding

the tax net. To further strengthen these initiatives it is proposed that: On cash withdrawals from banks of amounts exceeding Rs 25,000, withholding tax at 0.1 per cent be deducted.

- At present imported cars are subjected to 6 per cent withholding tax. It is proposed that sale of locally manufactured new cars be also subjected to withholding tax at the same rate. However, that tax would be adjustable.
- Sales Tax regime has been rationalized by zero-rating imports and supplies consumed by textile, carpets, leather, surgical and sports goods' export sectors. As a package deal their tax rate is being revised upward by 0.25 per cent.

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**Tables & Graphs**

# Annual Budget 2006-07

The Federal Budget 2006-07 has been presented at the back of a sustained high economic growth. The objectives of the Federal Budget have been:

- To provide relief to the fixed income group as well as to the common man,
- To work for the welfare of the common man,
- To create employment opportunities,
- To promote investment and growth,
- To broaden the tax net,
- To strengthen the country's physical infrastructure, and
- To improve social indicators.

## SALIENT FEATURES OF THE FEDERAL BUDGET 2006-07

In the following text, the 'budgeted year' should be taken as Year 2006-07, and the 'previous year' as the Year 2005-06:

- ***Total outlay*** of the Federal Budget 2006-07 is Rs.1315 billion, which is 19.7% higher than the previous budget.
- ***Current expenditure*** is Rs.880 billion which is 6.4 % higher than the previous budget estimate of Rs.826.5 billion.
- ***Development expenditure*** is Rs.435 billion, which is up by 59.9%. Of which, federal component stood at Rs.320 billion which also include Rs.50 billion for earthquake reconstruction and rehabilitation program. The provincial component is Rs.115 billion.
- The ***share of current expenditure in total budgetary outlay*** is 66.9 % as compared with 74.5 % of previous year (2005-06).
- The ***share of development expenditure in total budgetary outlay*** increased sharply to 33.1% as against 25.5% of previous year budget (2005-06).
- ***Debt servicing*** is estimated at Rs.295.8 billion which is lower by 3.0 % over previous year's revised estimates of Rs.304.8 billion.

- ***Defence budget*** is estimated at Rs.250.2 billion or 2.8 % of GDP as against **revised** estimates of Rs.241.1 billion or 3.1 % of GDP of previous year (2005-06).

- ***Expenditure on running civil administration*** at Rs.126.9 billion higher than previous year's estimates of Rs.103.1 billion on account of various relief measures provided by the government.

- ***Transfers to the provinces*** are estimated at Rs 378 billion under net proceeds of the Federal divisible pool against previous year's revised estimates of Rs 331 billion, showing an increase of about 19 % or Rs 47 billion higher.

- For the next year, ***revenues from investments*** are projected at Rs 16 billion against Rs 51 billion for the previous budget, showing a decrease of over 300 %, perhaps because of disinvestment of government shares in public sector entities.

- The estimates for the budgeted year's ***foreign inflows*** has been put at Rs 239 billion which is 12.7 % higher than the previous budget.

- An amount of Rs 504 billion has been earmarked for ***general public service*** which includes interest payments, debt servicing and superannuation allowances. This accounts for about 57.3 % of total current expenditure.

- For the budgeted year 2006-07, it has been projected that the government will earn about Rs. 20 billion from ***privatisation*** proceeds.

- ***Government borrowings*** – The Government is targeting to borrow Rs 140 billion from the banking sector to meet its budgetary deficit during the next fiscal year. Previous year's revised estimates (2005-06) for bank borrowing have now been put at Rs 66.8 billion.

- The government has estimated zero collection on account of ***petroleum development levy*** compared with previous year's revised collection of Rs 20 billion to cap oil prices. However, it would collect Rs 18 billion development surcharge on natural gas. The government will not charge petroleum development levy on diesel.

- The government expects Rs 239.3 billion resources from ***foreign sources*** compared with previous year's revised estimates of Rs 234 billion. This includes Rs 213.4 billion from foreign loans and Rs 26 billion grants. Foreign loans also include Rs 76.4 billion project loans, Rs 76.5 billion programme loans, Rs 30.2 billion foreign currency bonds and others. Foreign grants during previous year amounted to Rs 45 billion, according to budget documents.

- The Government has also allocated Rs 89 billion ***subsidy for WAPDA, KESC, Utility Stores, cement, and other such commodity operations*** against previous year's revised estimates of Rs 64 billion, showing an increase of over 28 %.

- For ***cement*** prices, the government has allocated a subsidy to maintain a lower price in the next year through an amount of Rs 720 million.

## Public Sector Development Programme:

- Out of the ***Federal PSDP*** of Rs.270 billion (excluding earthquake-related spending), 44.3 % (Rs.119.5 billion) will be spent on physical infrastructure and 44.1 % (Rs.119.0 billion) on social sector.

- Within **infrastructure development**, ***water and power***, including village electrification received Rs.70.6 billion or 59.1 %. This allocation is up by 44.4 % from previous year (2005-06).

- Allocation to ***communication*** (including NHA, Ports and Shipping and Railways) is Rs.37.6 billion or 31.5 % of infrastructure development.

- Within **social sector development**, allocation to the ***health and population sectors*** amounted to Rs.15.4 billion – which is up by 21.3 % from previous year (2005- 06).

- Allocation to ***education*** including HEC has been increased to Rs.22.9 billion – up by 52.7%.

- Allocation to the ***Science & Technology*** is up by 95.3 % (Rs.4.4 billion vs. Rs.2.3 billion).

## Revenue:

- The target for next year ***overall revenue collection*** has been estimated at Rs 1.083 trillion, which is 16.8 % higher than the year 2005-06 budget estimate. This would include a tax revenue of Rs 840.9 billion, up by 17.5 % higher than previous year and non-tax revenue at Rs 241.89 billion, up by 6.4 % over previous year's budgeted estimates of Rs 227.3 billion.

- ***Direct tax*** is estimated at Rs.267.0 billion (18.7 % higher than previous year) and ***indirect tax*** is targeted at Rs.568.0 billion (18.6 % higher than previous year).

- The target for ***non-tax revenue*** has been put at Rs 242 billion, compared with previous year's revised estimates of Rs 307 billion, showing a reduction of about 21 %. This also includes Rs 115 billion revenue estimates from properties and public departments, about Rs 4 billion less than previous year.

- ***Tax collection by CBR*** is targeted at Rs.835 billion – up by 18.6 % against revised estimates of previous year (Rs.704 billion).
- ***Fiscal deficit*** as percentage of GDP is targeted at 4.2 % including earthquake related spending, and without earthquake spending it is targeted at 3.7 % of GDP, mainly on account of unprecedented increase in the PSDP.

## Relief to the Common Man:

- In the last five Budgets the salary of the government servants was raised for four times. In the Federal Budget 2006-07, the government will provide ***Dearness Allowance*** at the rate of 15.0 % of the basic salary.

- ***Pensions of the government servants*** have also been raised. Those government servants who retired before May 1, 1977, their pensions are up by 20 %.

- Those who retired after May 1, 1977, their pensions are up by 15 %.

- The ***overtime of Drivers and Dispatch Riders*** are up by 50 %.

- ***Conveyance Allowance of Grade 1-16 government servants*** is up by 50 %.

- ***Pension under the Employees Old Age Benefits Act 1976*** has been increased from Rs.1000 to Rs.1300 per month.

- ***Grant of Workers Welfare Fund for daughter's marriage*** has been increased from Rs.30,000 to Rs.50,000.

- In the event of the ***death of the workers***, the grant to their heirs has been increased from Rs.150,000 to Rs.200,000.

- The ***scholarship for workers' children*** has been increased from Rs.800 to Rs.1000 per month.

- The ***ceiling of workers' share in Institutions Profit*** has been enhanced from Rs.6,000 to Rs.12,000.

- The ***Minimum Wage of Worker*** has been increased by 33.3 %, that is, from Rs.3000 to Rs.4000 per month.

- ***Teachers*** will get additional relief with a slab of Rs.500, Rs.750 and Rs.1000 per month, depending upon their qualification.

- In the event of the ***death of the government servants***:

(a) the widow will receive one time grant ranging between Rs.200,000 to Rs.1.0 million, depending upon the grade of the deceased government servants;

(b) the widow can retain the official accommodation provided to the deceased for up to 3 to 5 years;

(c) once heir will get a contract job for two years in Grade 1-15;

(d) one child will get free education until the age of 18 years;

(e) the widow will receive life-long free medical facility;

(f) 2% quota is now fixed for the heirs of the government servants who die during service in Government Housing Scheme;

(g) the members of the Law Enforcing Agencies who die during their service, their heirs will get a relief package according to the nature of the assignment performed by the deceased.

- The rates of return for the various ***schemes of the National Savings*** have been raised as follows:

| Schemes | Increases in Rate of Return |
|---|---|
| Special Savings Certificates | from 8.6 % to 9.17 %. |
| Regular Income Certificates | from 8.88 % to 9.24 %. |
| Defence Savings Certificates | from 9.46 % to 10.0 %. |
| Pensioners Benefit A/c & Bahbood Savings Certificates | from 11.04 % to 11.52 %. |
| Savings Accounts | from 5.0 % to 6.0 %. |
| Prize Bonds Rate | from 5.1 % to 6.5 %. |

- The ***senior citizens*** of 65 years and above, with annual income up to Rs.400,000, were exempted from taxation. This facility will now be received by citizen of 60 years and above.

- ***Pulses*** of various types will be sold through the Utility Stores Corporation (USC) at less than the market price from June 6, 2006. The prices of gram pulse are fixed at Rs.30/kg; Masoor daal at Rs.31/kg, Moong daal at Rs.53/kg; and Mash daal at Rs.58/kg.

To encourage private sector to import pulses the government will provide subsidy to importers so that pulses are imported and supplied in large quantity in the market.

The government is determined to enhance the supply of pulses in the market and keep their prices stable. Subsidy on imports and sale of daal through utility store will cost Rs.2.5 billion to the government.

- The common man will continue to get ***sugar*** at Rs.27.5/kg from the USC. The government is supplying 33,000 tons sugar to USC every month for sale to common man at a much cheaper rate than the market.

- The government has decided to establish at least one ***Utility Stores*** at Tehsil level.

- The USC will establish ***Mobile Units of the USC*** to cater the needs of the far-flung areas. The USC is also considering setting up Franchise.

- The Government is appointing ***Price Magistrates*** in every District for the implementation of the Price Mechanism Law. The Magistrate will have the power to punish profiteers and hoarders. The relevant Law has been amended.

- A model ***Sabzi Mandi*** (Vegetable Market) will be constructed in Islamabad and the Provincial Chief Ministers will do the same in their respective Provinces. This will improve the supplies of the essential commodities in the market and will help stabilize their prices.

- Rs.55 billion subsidy will be provided from the Budget to keep the price of ***electricity*** at affordable levels in 2006-07. The government has provided Rs.44 billion subsidy in 2005-06 for the same.

- The government will provide facilities of ***Angiography, MRI and Dialysis free*** of cost to the deserving persons in Federal Government Hospitals.

- The government is spending Rs.11 billion to control ***Malaria, TB, HIV/AIDS, Hepatitis and Blindness.***

- Threshold income increased to Rs.200,000 from Rs.100,000 for income tax purpose for ***working women*****;** for non-salaried women, this has been increased from Rs,100,000 to Rs.125,000.

- ***Free textbook*** for students up to class VIII from September 1, 2006. Education up to Metric class is already free.

## Agriculture:

- A Program of Rs.7.8 billion is being introduced to increase the ***incomes of the farmers*** in 13,000 villages. The Program will start from 1000 villages in 2006-07. This will create jobs in rural areas.

- A Public-Private Partnership in ***dairy sector*** development with Rs.3.6 billion has been launched. This Company will set up 1200 Model Dairy Farms and will establish 2950 farms for raising livestock. This project will enhance rural incomes.

  The production of dairy products is now exempt from Sales Tax. The dairy and livestock equipments are exempt from custom duty and sales tax. The custom duty on the packaging material of dairy products has been reduced to 5 %. This will help promote dairy sector in rural area.

- ***Drip irrigation and sprinklers technology*** are being introduced in agriculture with Rs.15.0 billion.

  Rs.7.0 billion is being spent in 2005-06 for lining of 15,000 canals. Rs.6.0 billion will be spent in 2006-07 for the same. As a result, the loss of canal water will be reduced by 25%.

- Rs.5.5 billion will be spent on ***Katchi Canal*** in 2006-07. The government is constructing Katchi Canal with Rs.22 billion in Balochistan. This will bring revolution in agriculture in Balochistan.

- Rs.10 billion is allocated for the initial work on ***big dams*** in 2006-07.

- The government has provided Rs.5.0 billion subsidy on ***fertilizer*** in 2005-06. In 2006- 07, Rs.12.3 billion subsidy will be provided to keep the price of fertilizer at affordable level for the farmers.

- To enhance the agricultural productivity the government is launching ***National Agricultural Research Program*** with Rs.2.5 billion.

- The ***machinery for agriculture, horticulture and Floriculture*** will be exempt from custom duty.

- ***Machinery for promoting fisheries*** will be exempt from custom duty.

- Custom duty is reduced from 60 % to 30 % on ***refrigerated vans.***

- Exemption from custom duty on ***new and used agriculture tractors*** in CBU conditions.

- Special incentive package in the shape of reduced tariff rates for ***poultry industry*** has been proposed.

All these measures will help enhance agricultural activities in the country. This will increase the incomes of the farmers.

## Promoting Investment and Growth:

### *1. Manufacturing:*

- Incentives for promotion of ***exports of leather/ footwear industry, marble and granite, pharmaceutical industry and parboiled rice plants.***

- Incentives for industrial growth and development to ***aluminium processing, boiler manufacturing, chemical industry, CNG dispenser manufacturing, electrical devices for vehicles and electronics, plastic industry, iron and steels industry and engineering industry.***

- Reduction of duty on ***industrial inputs*** like copper raw material, forging and foundry inputs, zinc, lead, refractory cement, chemicals used for tanning leather, earth colours, pharmaceutical chemicals, plastics and sheets, solution for Rubber, etc.

- Exemption of duty on ***material for manufacture of fixed wireless towers for CDMA, CNG equipment for assembly, inputs of leather and leather products, broadcasting equipment, computer hardware and parts.***

- Reduction of duty on ***bicycle parts and components, flat rolled steel products and articles, cutting tools, machine tools, electrical devices, plastic raw materials, petrochemicals, machinery, inorganic and organic chemicals and chemicals used in textile processing.***

- Promotion of ***medical tourism*** through good quality hospitals and care facilities by exempting duty and taxes on import of plant and machinery, medical, surgical, dental or veterinary machinery/ equipment, fixtures, fittings, and furniture, diagnostic kits not manufactured locally.

### *2. Services Sector:*

- In order to attract investment in ***wholesale and retail trade,*** exemption from customs duty in excess of 5 % on import of equipments for establishing the wholesale/ retail chain stores, like, refrigeration system, fork lift trucks, high racks, fittings/ fixtures, etc.

### *3. Automobile Industry:*

- Introduction of tariff based system (TBS), rationalization of duty on multi-axle trucks, rationalization of duty on purpose built taxi, exemption from duty on agriculture tractors in CBU condition.

Import of old/ used cars – Importability in TR, baggage and gift (for age of car) to be restricted to five years.

*4. Transport Sector:*

- For promoting transport system in the country the government is reducing custom duty on buses, trucks and dumpers from 20 % to 10 % in CKD condition and from 60 % to 30 % in CBU condition. Trucks and dumpers of more than five tons are exempt from sales tax.

## Export Promotion:

To increase export, the Government has introduced Export Promotion Package under which leather, shoe, marbles, granite and pharmaceuticals industries have been exempted from customs duty.

## Self-Employment Generation:

- ***Rozegar Scheme*** with Rs.12 billion is launched. Educated persons in the age bracket of 18 – 40 years will get loan for self-employment. This will begin from July 2006. They can establish PCO, mobile utility store; can get franchise for USC; can own transport (taxi etc.). The Government will share the risk associated with loan. The government will pick up half of the mark up and other half will be picked by the person himself.

National Bank of Pakistan will issue the loans. Under this scheme 1.8 million jobs will be created during a span of 5-years.

## Welfare of the People:

i) Rs.4.0 billion is allocated for 6035 ***big filters for clean drinking water*** in villages and Union Councils.

ii) In the next two years, 425 more villages will get ***gas***.

iii) Rs.35 billion has been allocated for ***Khushal Pakistan Program***. This money will be spent on rural roads, village electrification, water supply, gas, education, health, sanitation and levelling of lands for irrigation purpose.

## Pays and Pension:

- For salaried employees income tax exemption base has been increased from Rs. 100,000 to Rs, 150,000.
- Likewise for salaried employees, range of Tax rates has been decreased which was 3.5% - 30% previously, now it has been revised downwards in the range of 0.25% - 20%.
- Rise in salary of ***railway employees.***

## Health Sector:

- The budget has allocated Rs 4.728 billion for health sector.

- Promotion of ***health sector*** through reduction/ exemption of duty on life saving drugs, diagnostic kits and equipments like all medicines for cancer, drugs used for kidney dialysis and kidney transplant, all types of vaccines for hepatitis, interferon and other medicines for hepatitis, all vaccines/anti-sera, cardiac medicine, injection anti-D immunoglobulin, bloods bags CPDA.1, all medicines for HIV, all medicines for thalassemia and eye drops and medicinal ointment.

## Education Sector:

- Allocation to ***education*** including HEC has been increased to Rs.22.9 billion.

- Promotion of ***education sector*** through special incentive package for setting-up of universities and technical training and research institutes on import of machinery, instruments, equipments, spares and parts and other related items, required for setting-up or up-gradation of projects of educational nature recognized by the HEC.

## Others:

### *1. Stock Market*

i) ***Withholding tax on brokerage commission*** on sale and purchase of shares has been increased from 0.005 % to 0.01 %.

ii) ***Withholding tax on trading*** has been increased from 0.005 % to 0.01 %.

iii) ***CVT on the purchase of share*** has been increased from 0.01 % to 0.02 %.

### *2. Real Estate*

- ***CVT @ 2.0 % on the purchase of 500 Sq. Yards*** and above or one kanal and above which ever is less, residential plot in urban areas.

- ***CVT @ 2.0 % on all purchase of commercial property***.

- If there is no determined value then a CVT charge @ of Rs.50/Sq. Yard.

### *3. Cash Withdrawal from Banks:*

Last year 0.1 % Tax was imposed on cash withdrawal of Rs. 25,000 or more from banks. Now, this tax rate is being enhanced to 0.2%

### *4. FOREX Dealing:*

5% excise duty has been imposed on FOREX dealers.

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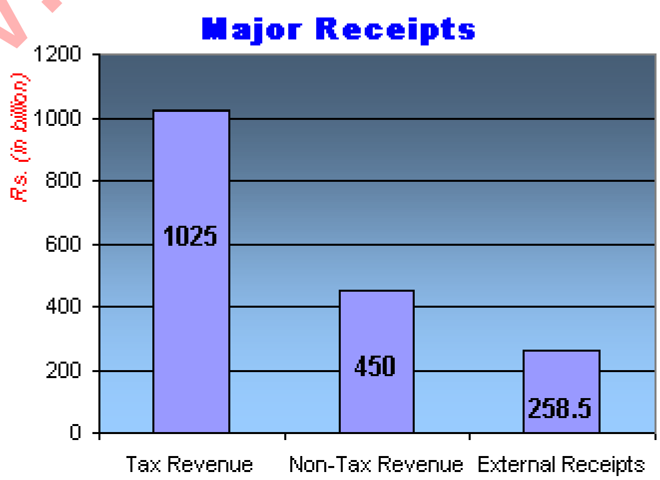
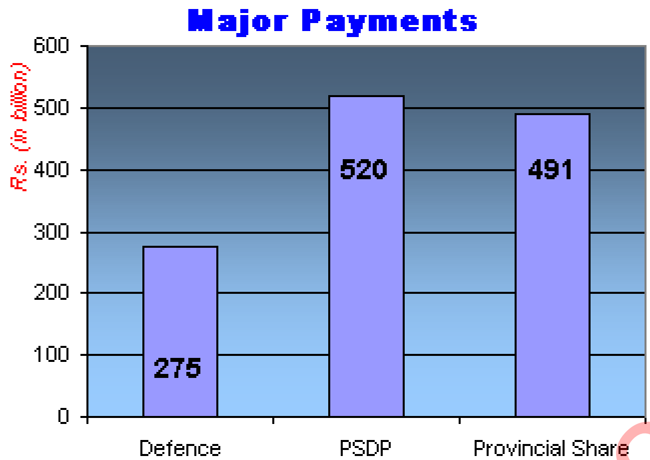
# Annual Budget 2007-08

## Highlights:

- A budget of major relief to public and other populist measures;
- A budget of Rs. 1.874 trillion, envisaging a revenue target of Rs. 1.025 trillion, with defence spending of Rs. 275 billion and a fiscal deficit of Rs. 398 billion;
- 25% increase in PSDP budget;
- A major chunk of subsidies to WAPDA, KESC, textiles, petroleum companies and oil refineries;
- Handsome increases in minimum wages, pensions of government employees, EOBI pensions and salaries of government employees;
- Promotions to 87,500 federal employees;
- Housing scheme for low-paid government employees in Islamabad;
- Multi-billion rupee subsidy package to ensure the availability of essentials such as lintels, daal chana, moong, mash, rice, cooking oil, ghee, tea, sugar, etc. at utility stores at cheaper rates;
- Announcement of construction of several irrigation and water projects;
- Announcement of construction of several highway projects;
- Tax relief to industrial sector;
- Subsidy on electricity charges on agricultural tube-wells;
- Investment in private equity bonds has been tax exempt till 2014 and reduction of capital gain tax on sale of asset share of private companies to private equity and venture capital;
- Introduction of Real Estate Investment Trust (REIT);
- Share of education is 4% of GDP;
- Sellers of property exempted from tax up to 2010;
- Other relieving tax measures in manufacturing, agriculture, horticulture, medical sciences, computers, automobile industry, etc.






## SALIENT FEATURES OF THE FEDERAL BUDGET 2007-08

In the following text, the 'budgeted year' should be taken as Year 2007-08, and the 'previous year' as the Year 2006-07:

- ***Total outlay*** of the Federal Budget 2007-08 is Rs. 1.875 trillion, which is almost 25% higher than the previous budget.

- ***Budget deficit*** is estimated to be Rs. 398 billion to be about 6.5% higher than the previous budget. As ratio of GDP, the budget deficit falls slightly to 4% from 4.2% during the previous year. This would be met through external resources, Rs. 258 billion; bank borrowing, Rs. 131 billion and remaining through national savings.

- ***Overall size of the economy*** (GDP) has been estimated at almost Rs. 10 trillion ($166 billion);

- ***Current expenditure*** for the budgeted year is Rs. 1.353 trillion which is 54% higher than the previous budget estimate of Rs. 880 billion.

- ***Public Sector Development Programme (PSDP)*** is Rs.520 billion against Rs. 415 billion of the previous year, with an increase of 25%.

- The ***share of current expenditure in total budgetary outlay*** is 66 % as compared with 72.4 % in revised estimates for 2006-07.

- ***Defence expenditure*** is Rs. 275 billion against Rs. 250.2 billion of the previous year, showing an increase of almost 10%.

- ***Education sector*** (including higher education) has been allocated Rs. 24.5 billion, which is about 22% higher than the previous year's Rs. 20.1 billion.

- ***Health Sector*** has been allocated Rs. 14.3 billion which is about 29.7% higher than the previous year's Rs. 11 billion.

## Revenue:

- The ***overall revenue collection*** target increased by 22.37% to Rs. 1.025 trillion for the year 2007-08, as compared to Rs. 837.61 billion for 2006-07.
- ***Direct taxes*** projected at Rs. 405 billion for the budgeted year as compared to revised target Rs. 320.61 billion for Rs. 2006-07, indicating an increase of 27.3%
- ***Indirect taxes*** projections increased by 19.9% to Rs. 620 billion for the budgeted year as against the revised target of Rs. 517 billion for previous year.
- The ***income tax*** collection has been revised upwards to Rs. 305 billion. With this upward revision, the Government has projected an increase of 27.2% over the revised target set for previous year.
- The ***customs duty*** collection target was cut by 1.91% to Rs. 154 billion for the fiscal year 2007-08 as against the target of Rs. 157.1 billion for 2006-07. The customs duty collection for previous year has been revised downwards to Rs. 134 billion.
- The collection under the head of ***sales tax*** was increased by 9.97% to Rs. 375 billion for budget year as against Rs. 341.6 billion set for previous year. The sales tax was revised to Rs. 311 billion because of a shortfall.
- The ***federal excise*** collection has been projected at Rs. 91 billion as compared to Rs. 68.1 billion previous year, showing an increase of 33.6%.
- ***Tax administration*** has been made more efficient. More friendly tax reforms are introduced in the CBR. The future strategy is to co-locate all the domestic taxes under one roof, for which Regional Tax Offices (RTO) are being established in the major cities of the country.
- Similarly, the ***international taxes*** are to be handled through the Model Customs Collectorates (MCC) which is being established by adopting best international practices.
- For large taxpayers, three large taxpayers units have been established equipped with modern resources.

## Public Sector Development Programme (PSDP):

- Rs. 520 billion has been earmarked for ***Public Sector Development Programme (PSDP),*** showing an overall increase of 24% over the last year's allocation and a 30% jump in the provincial development programmes' amount.
- 86% of the PSDP allocated to on-going projects, leaving only 14% for new high-priority projects.
- The ***real PSDP*** amount reduces to Rs. 427 billion when foreign loans totalling Rs. 58.6 billion and Rs. 35 billion earmarked for earthquake reconstruction is deducted.
- The ***PSDP/GDP ratio*** is 4.8% for the budgeted year as compared to 4.3% for previous year.
- The ***federal share*** in the PSDP is Rs. 335 billion while the ***provincial governments*** are expected to receive 15 billion.
- ***Public sector corporations*** will invest Rs. 204 billion beside the budget increasing the volume of the overall PSDP to Rs. 724 billion.

- ***Water and power sector*** will receive Rs. 84 billion, power sector Rs. 26 billion, agriculture 15.8 billion, Kashmir affairs and Northern Areas 13.72 billion, petroleum and natural resources Rs. 72.81 billion, communications Rs. 6 billion, ports and shipping Rs. 17.39 billion, interior division Rs. 15 billion, industries and production Rs. 1.42 billion and defence division Rs. 19.1 billion.
- No funds have been allocated for ***Kalabagh Dam***.

## Provinces' Shares:

- The Federal Budget 2007-08 envisages Rs. 491.7 billion net transfers to provinces, including Rs. 403 billion in net proceeds from the federal divisible pool under the interim ***National Finance Commission (NFC) Award.***
- The budgeted year's provincial share out of net proceeds from the ***divisible pool and straight transfers*** has been estimated to total Rs. 465.9 billion, up by 19.5% against previous year's Rs. 390 billion. This does not include project aid and subventions.
- ***Punjab*** would get a total of Rs. 236.3 billion on account of net proceeds, up by 25% when compared to previous year's Rs. 188.9 billion.
- ***Sindh*** would get a total of Rs. 144.15 billion increased by 11.57% as compared to previous year's Rs. 129.2 billion.
- ***NWFP*** would get a total of Rs. 55.9 billion increased by 24.77% as against Rs. 44.8 billion.
- ***Balochistan*** would get a total of Rs. 29.6 billion increased by 5.8% as compared to Rs. 28 billion previous year.
- Similarly, ***special grants and subventions to the provinces*** have been projected at Rs. 31.27 billion as against Rs. 29.25 billion during the fiscal year 2006-07, thus showing an increase of 6.9%.
- ***Project aid to the provinces*** has been projected at Rs. 26 billion increased by 55% as against previous year's Rs. 16.8 billion.
- ***Straight transfers to provinces*** for the budgeted year have been projected at Rs. 62.8 billion as compared to 70.3 billion during the year 2006-07 showing a decline of 11%.
- The provinces will get 1/6$^{th}$ of ***sales tax revenue***, which would subsequently be transferred to district government and cantonment board. Under this head, Punjab will get 50%, Sindh 34.85%, NWFP 9.93% and Balochistan 5.22%.
- The ***remainder of the divisible pool*** would be distributed among the provinces on population basis. Under this head, Punjab will get 57.36%, Sindh 23.71%, NWFP 13.82% and Balochistan 5.11%.
- ***Total transfers to provinces*** during the budgeted year 2007-08 would be Rs. 524.5 billion against Rs. 439.6 billion of the year 2006-07, increased by 19.3%. However, the federal government will deduct Rs. 32.8 billion as interest payments and debt servicing of federal loans, leaving total transfers of Rs. 491.75 billion.

## Relief for Employees and Retired Employees:

- In the Federal Budget 2007-08, the ***minimum wage for unskilled labour*** has been increased to Rs. 4,600 per month from Rs. 4,000 per month, showing an increase of 15%.

But critics argued that it is still impossible for a poor man to survive in a monthly income of Rs. 4,600.

- Increase in the ***salaries of government employees*** by 15%.
- ***Pensioners*** retired before 1997 will get 20% increased pension and pensioners retired after 1997 will get 15% increased pension.
- ***Government employees*** in the grades BPS-5, BPS-7 and BPS-11 are being promoted to BPS-7, BPS-9 and BPS-14 respectively. 87,500 federal employees will be benefited from this measure.
- Government announced a ***housing scheme for low-paid employees*** in Islamabad. 37,000 new houses would be constructed for such employees on ownership basis. In the first phase, construction of 5,000 units would begin immediately and the land would be provided by Capital Development Authority (CDA).
- About 250,000 housing units would be constructed in five years under the ***'low-cost housing scheme'*** to be launched in collaboration with the provincial and district governments, for which the loan from the House Building Finance Corporation (HBFC) would be available.
- Upgradation of ***basic salary of railway employees*** by one step for the remaining 62,482 workers, excluding secretarial staff. The long-standing demand of railway employees regarding upgrading of posts had already been accepted with an increase in their allowances and 12,510 employees had benefited from the increase. In this way, the government has provided relief to 74,992 railway employees and their long awaiting demand has been met.
- ***EOBI pension*** has been increased by 15% and the minimum pension has been increased from Rs. 1,300 per month to Rs. 1,500 per month.
- Earlier, if a husband and wife both contributed to old-age benefit, the surviving one did not get the pension of the deceased spouse. Now the surviving partner shall get the pension of the deceased spouse.
- All the workers, regardless of their wage level, will be entitled to compensation on account of disability caused during the course or as a result of performance of duty. Earlier, the ***Workmen Compensation Act, 1923*** did not allowed the compensation for workers receiving more than Rs. 6,000 per month.
- The ***Workers Welfare Fund Ordinance, 1971***, is being amended to allow industrial workers to get medical, education, housing and death grant from the fund for units having an annual income in excess of Rs. 500,000. The Ordinance has been amended to increase the limit of death grant from Rs. 200,000 to Rs. 300,000.

## Technology (including Defence):

- The ***defence budget*** for the year 2007-08 has been increased to Rs. 275 billion from Rs. 250.2 billion of the year 2006-07, showing an increase of 10%.
- Separate allocations may be made for the ***purchase of JF-17 Thunder aircraft*** from China and ***F-16 multi-role fighter jets*** from US.
- An amount of Rs. 1.789 billion has been earmarked for 32 ongoing projects, including 10 of the ***Space and Upper Atmosphere Research Commission (SUPARCO).***
- There are 36 new projects. An amount of Rs. 500,000 has been allocated for reconstruction of an observatory in Balakot.

- Rs. 1.8 billion for ***Pakistan Communication Satellite System (PakSat IR).***
- Rs. 7.171 million for ***metrological training facilities*** for neighbouring countries.
- Rs. 13.719 million for ***capacity building of the meteorological department***.
- Rs. 9.935 million for establishment of the ***aeronautical met office at Sialkot International Airport.***
- Rs. 103.71 million for the ***remote sensing data transmission facility.***
- Rs. 37.392 million for the ***satellite bus development facility (Phase I).***
- Rs. 26.161 million for development of ***satellite dynamic system test facility.***
- Rs. 41 million for establishment of the ***atmospheric data receiving and processing centre.***
- Rs. 245.79 million for the ***PakSat project (Phase I extended).***
- 31.5 million for upgradation of the ***precision machine shop.***
- Among the ongoing projects Rs. 7.175 million has been allocated for ***networking in the offices of the defence ministry.***
- Rs. 17.587 million for ***National Centre for Drought and Early Warning System.***
- Rs. 750 million for construction of ***Gwadar International Airport.***
- Rs. 100 million for development of a ***satellite environmental validation and testing facility*** in Lahore.

## Health:

- Rs. 14.3 billion has been earmarked for ***health sector*** development in the year 2007-08, showing an increase of 29.7% over the last year's Rs. 11 billion.
- Rs. 12.68 billion will be met from ***domestic resources*** and Rs. 1.52 billion through ***foreign assistance.***
- ***President's Initiative for Urban Clinics*** envisages 815 medical clinics at the union council level in cities like Karachi, Rawalpindi, Lahore, Islamabad, Peshawar and Quetta. A doctor, lady health worker and a dispenser would work at each clinic. Staff would be recruited from local union councils to generate 4,917 jobs.
- There are total 100 different ongoing and new projects under health sector.
- Significant among the new projects is construction of a medical tower at ***Jinnah Postgraduate Medical College (JPMC)*** in Karachi at a cost of Rs. 400 million, which will be met by the Government through its own resources. The total cost of the project is Rs. 3.3 billion.
- Rs. 200 million has been allocated for construction of a medical tower at the ***Pakistan Institute of Medical Sciences (PIMS)***, Islamabad. The total cost of the project is Rs. 2.2 billion.
- Establishment of a ***burns centre*** in Faisalabad at a cost of Rs. 240 million is also included. An amount of Rs. 140 million has been earmarked for upgrading the paediatric cardiac unit at the National Institute for Handicapped in Rawalpindi, from a total of Rs. 321 million allocated for the project.
- Government is also planning to construct two ***trauma centres*** in Lahore and Rawalpindi.
- Rs. 60 million has been earmarked for providing 64 Slice Helical CT Scan angiography equipment at the ***Karachi Institute of Heart Diseases.***
- A ***cancer hospital*** in Lahore will also be constructed for which Rs. 46.340 million has been reserved. A sum of Rs. 50 million has been fixed for strengthening the National

Control Authority for Biology, Islamabad, and its independent laboratory. The project's total cost is Rs. 231 million.

- Rs. 4.89 billion has been allocated for ***National Programme for Family Planning and Primary Healthcare***, of which Rs. 4.5 billion will be Government's own contribution and Rs. 360 million foreign loan.
- Rs. 360 million has been earmarked for ***Enhanced HIV/AIDS Control Programme.***

## Agriculture:

- In Pakistan, two big companies are working in the private sector producing ***dairy products.*** Under Prime Minister Special Cell livestock produce and allied services will be spread to 1,963 union councils all over the country benefiting 3 million poor farmers. As a result of these measures, 12 million litres additional milk will be produced and 200,000 tons additional meat will be produced.
- As a result of this Government policy, a multinational company, i.e., Nestle, has set up the ***largest milk processing plant in Asia*** in Pakistan. Similarly, other companies are also bringing investment from within as well as outside the country.
- With the use of better ***seeds*** agriculture production can potentially improve by 20% to 30%. The government has allocated Rs. 336 million for production of better seeds. 15 new seed testing laboratories will be set up. For better production of cotton, BT Cotton seeds and Bio-Safety arrangements will be introduced.
- The ***general lifestyle of poor farmers*** living in rural areas has been improved during the last 5 – 6 years. They are now spending their incomes on their children's education; renovation of houses; set up of tube-wells; purchase of tractors, harvesters, cycles, motorcycles, mobile / WLL telephone sets, TV, DVD/VCD player, furniture, etc.

## Mega Projects:

- The long awaited ***Bhasha-Diamir Dam's*** designing is going to complete in 2008. Rs. 500 million has been reserved for this project.
- The work on upraising of ***Mangla Dam*** started by WAPDA is close to completion. As a result, 2.09 million acres feet additional water will be available for storage and 644 MW electricity will be generated. By construction of these dams, 2.6 million acres land will be irrigated. Underdeveloped areas will be transformed into prosperous pieces of land.
- The work is also started on expansion of ***Kara Kurram Highway.***
- The work on expansion of ***Hasanabad-Mansehra Section*** will be started in the next few months.
- The ***N-5 Highway*** will be linked with the National Trade Corridor. Rs. 29 billion has been allocated for this purpose. The total length of this highway is 1,585 km, which will be constructed at a cost of Rs. 147 billion.

## Real Estate Investment Trust (REIT):

Through REIT a new form of investment tool is being introduced for investment in capital markets which will enable small investors to reap profits from investments in real estate, which, so far, was open only to large investors. In order to increase the use of REIT their use has been given tax concession. For example, the profit of REIT, will be exempted from taxation up to 90%., upon distribution. The most important tax concession for REIT is that under this scheme sellers of property will be exempted from tax up to 2010.

## Amendment in Companies Ordinance, 1984:

For the benefits of shareholders, the shareholder who has 12.5% shares of any company call for an election of new Board of Directors in the next AGM. In order to provide protection to minority shareholders, any person or persons with 20% or more shares of any company, can request SECP for special audit.

## Industrial Sector:

- A ***Special Economic Zone (SEZ)*** near Lahore is being set up for Chinese products, with Chinese assistance. Chinese companies would exclusively invest there. Apart from that, companies intending to set up SEZs would be given various tax breaks and different incentives. These measures would boost up our industry.
- Appropriate laws are being framed for setting up of SEZs.
- Some time ago R&D facility was provided to ***textile sector***. Now the DTRE system is being revamped whereby the import of PSF will be allowed through DTRE. R&D facility will also be available to fibre manufacturers @ 3.5%, which will be availed through SBP.
- The facility of debt/swap to ***spinning sector*** is granted. Similarly, for exporter the existing withholding tax rate of 0.75% to 1% is being rationalised and 1% of withholding tax is being proposed. The textile exporters will also be beneficiaries.
- Customs duty on more than 400 tariff lines of raw materials and machinery used in textile industry has been reduced.
- Exemption of raw material and components for local production of ***CNG*** processors, the non-conventional energy sources equipment from sales tax and customs duty.
- Duty reduced to 0 on sports ***football bladder raw materials***.
- Duty reduced to 5%-10% from 10%-20% on components on ***electrical transformers.***