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Quid Pro Quo

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ECONOMIC REPORT

SHARING THE BURDEN

The expansionary fiscal policy of GOP has been criticized due to the resulting fiscal deficit, on the rise since FY04. In our opinion, a major weakness lies in the present structure of government expenditure rather than the consequential fiscal deficit.

Federal expenditure has outpaced Federal revenue growth for years and due to limitations emanating from the prevailing global economic environment, there is a need to turn inward and increase government revenues. Pakistan has one of the lowest Tax-to-GDP ratios in the region, improving this vital statistic is essential in order to pull the economy out of its conundrum and put it on a solid growth path.

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INTRODUCTION

Taxes are broadly defined as a *financial levy* imparted by the government on individuals and legal entities. There are two basic types of taxes, namely direct and indirect taxes.

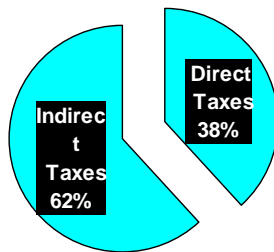
Direct taxes in Pakistan comprise mainly of income and other taxes such as; Capital Value Tax, Worker Welfare Fund and Worker Participatory Fund. Direct taxes contributed 38.6% to total receipts during FY08. Net collection for last FY under this head was PKR 387.5 bn against a target of PKR 385 bn. The major contributor herein is income tax, which constitutes roughly 94% of total direct receipts (approximately PKR 364 bn).

Indirect taxes in Pakistan are mainly contributed to by the General Sales Tax (GST). During FY08 the gross and net collection of GST stood at PKR 405.1 bn and PKR 376.9 bn respectively, this translates into approximately 37.6% of total tax receipts (the highest after income tax). Others include Customs and Federal Excise Duty (FED). Customs contributes around 15% of total taxes, while FED contributes 9.2%.

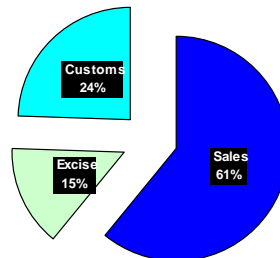
During FY08 indirect taxes accounted for 62% of total tax receipts. In our opinion these types of taxes are regressive in nature, as they are applied uniformly to all income brackets, therefore individuals with income of PKR 10,000 or PKR 100,000 pay the same amount of tax, e.g. GST. Even though the nominal amount will be same, the percentage of tax-to-income for the smaller income individual will be much higher.

In this sense indirect taxes reflect, more than anything else, inefficiency of the tax machinery, since it does not share the tax burden equally; hence violating the re-distribution purpose of taxes.

Composition of Total Taxes in FY08



Composition of Indirect Taxes in FY08



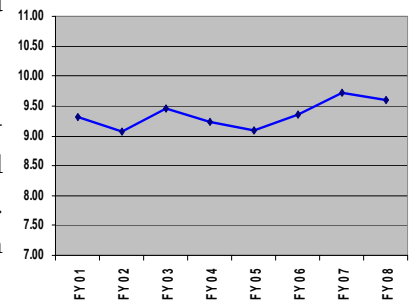
INTRODUCTION ... Continued

Taxes are one of the main sources of income for any government. Therefore, having an established and expansive tax collection network is essential for meeting development targets and long-term growth. Tax-to-GDP ratio of Pakistan has hovered between 9-10% for some time now. This ratio is low compared to developed countries as shown below.

Pakistan's low tax to GDP ratio essentially means the government's ability to finance its expenditures in important areas such as defense, infrastructure, social welfare and public services like transportation and water management is hindered. Hence, in order to fill gaps the GOP is often left with no other choice but to attain financing from the SBP, i.e. monetization of fiscal deficit.

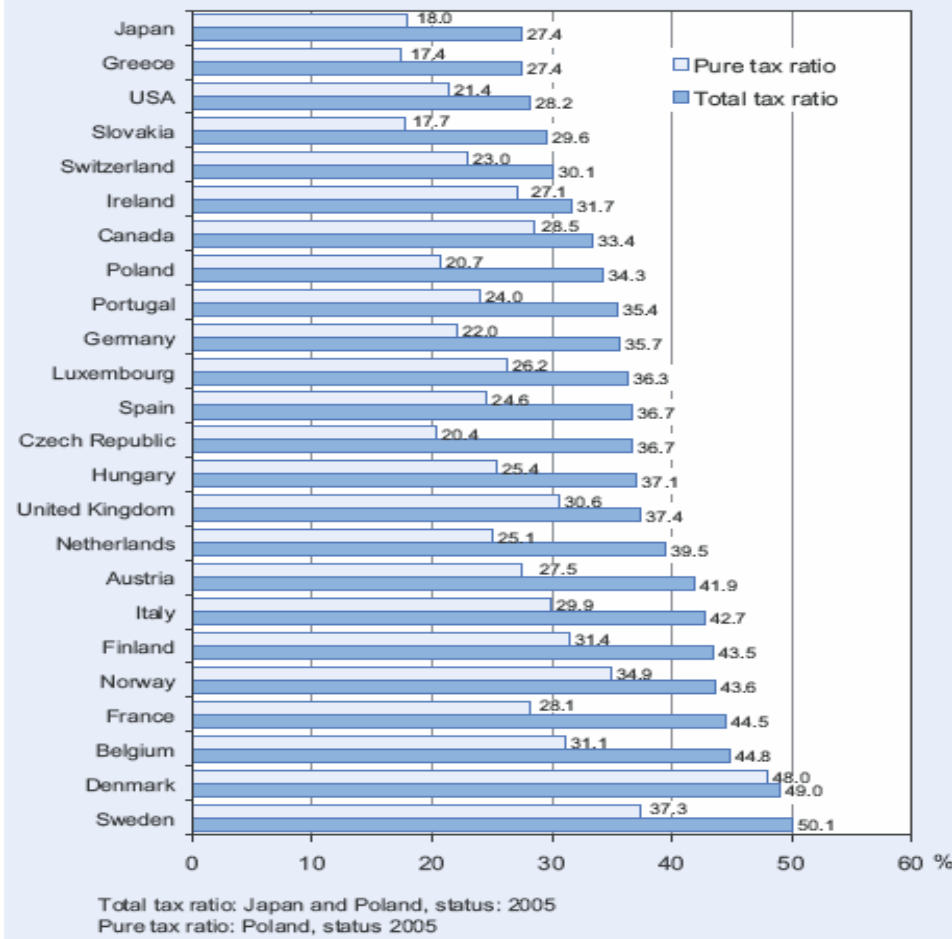
The solution is simple, increase the Tax-to-GDP ratio, but its implementation is far more complex.

Tax-to-GDP ratio (%) FY01-FY08



Source: SBP

INTERNATIONAL COMPARISON OF TOTAL TAX RATIOS as % of GDP



Source: OECD Revenue Statistics 1965-2006

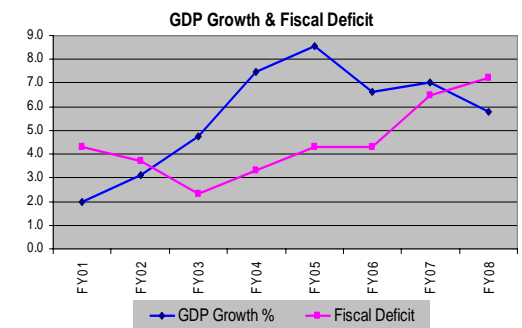
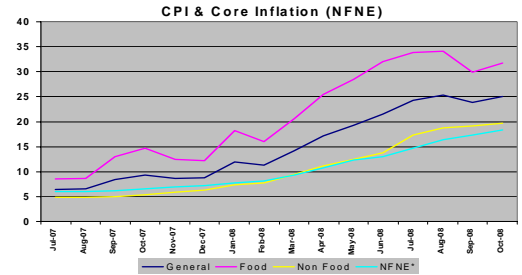
THE STORY SO FAR

In order to insulate local consumers from high international commodity prices, the government provided sizeable subsidies, which ballooned fiscal deficit to 7.2% in FY08 compared to 6.5% in FY07. This was accompanied by a falling GDP (5.78% in FY08 compared to 7.02% in FY07), and slow growth in government revenue vis-à-vis government spending.

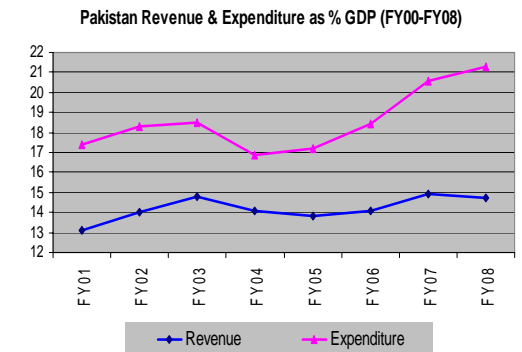
Fiscal deficits are scorned upon by economists especially the IMF (who deem them unsustainable in the long run). However, Pakistan successfully managed running fiscal deficits while registering strong growth at the same time. A major reason for this was the massive financial inflows that came into the country and helped plug the current account gap.

These flows were primarily motivated by prevalent opportunities rather than the fiscal deficit. As a result, foreign institutional investors were making a beeline for investment into developing countries like Pakistan, which saw foreign direct investment (FDI) and portfolio investment increase (Graph on next page). Hence, the economic fears generated by fiscal deficits did not really lead to a constriction in economic activity, as assumed by conventional economics.

Therefore, economic theories that define fiscal deficits as inherently bad carry little weight in the real world. In fact, in order to assess the negative impacts of fiscal deficit it is best to examine specifics regarding the kind of expenditure the government incurs. If the deficit results from wasteful expenditure which have a low ROI (e.g. constructing a new President House versus a school or road), then it is best to resort to tax hikes and/or cuts in government purchases to balance the budget.



Source: SBP

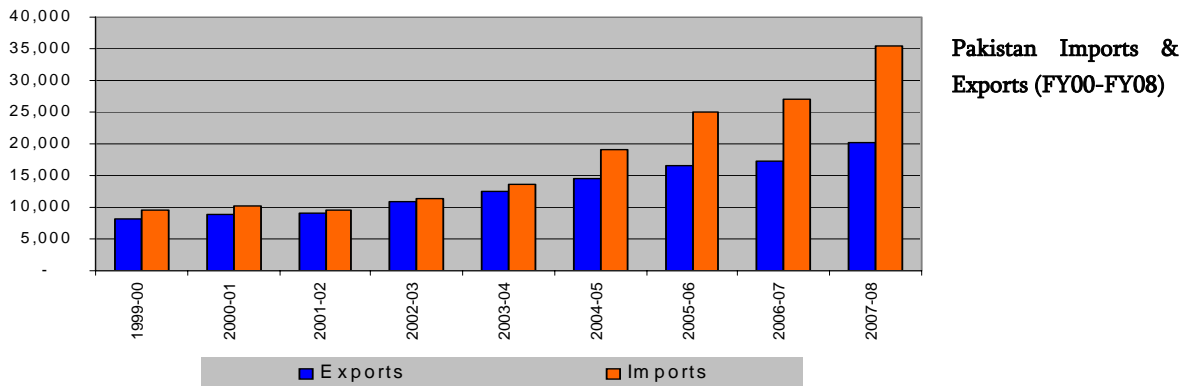
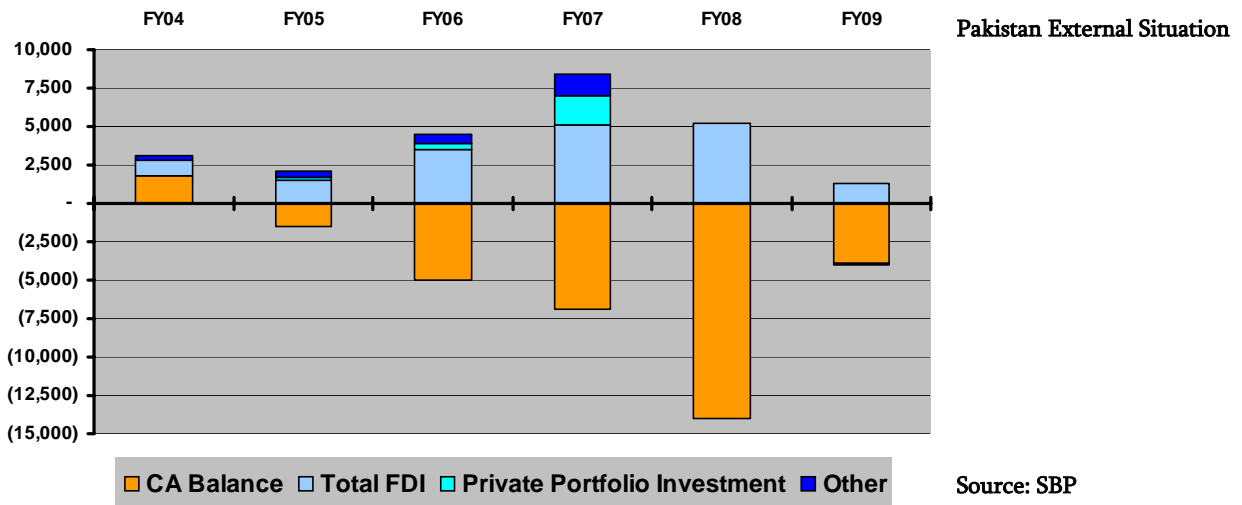


Source: Bloomberg

THE STORY SO FAR ... Continued

Most importantly the government must spend the borrowed money in a constructive manner, in order to secure recurring financial and/or social benefits. In the case of emerging economies where economic output is substantially behind optimal output, it is best to direct fiscal expenditure for tapping underutilized resources of the economy. In other words, Pakistan's fiscal deficit is in itself not bad as long as the expenditure is concentrated on development, infrastructure and utilizing idle resources, which will generate higher incomes and subsequently higher savings and tax revenues in the long run.

However, Pakistan's present current account balance is not a result of prudent developmental expenditure, but rather a result of aggregate demand continually outpacing aggregate supply, to a point that in FY08 imports swelled to almost double of exports (See graph given below).



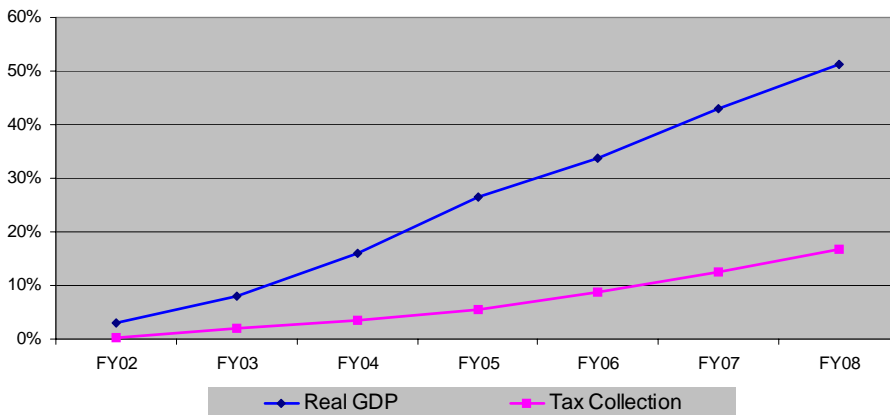


WHAT NEXT?

Government expenditures are traditionally sticky because significant portions are committed, e.g. defense, debt/interest payments and general public service, therefore it is difficult to compress them in the short run. The only plausible cuts may occur in PSDP (Public Sector Development Program), education, housing and removal of subsidies.

Therefore, a revenue led approach needs to be implemented in the long run, so that the government has a bigger pool of funds at its disposal in the future. This has been echoed by advisor on finance to PM Mr. Shaukat Tarin, who proposed to increase Tax-to-GDP ratio to 15% in the five years, compared to 9.6% last FY.

% increase in Real GDP & Tax Collection (Base FY01)



Source: SBP

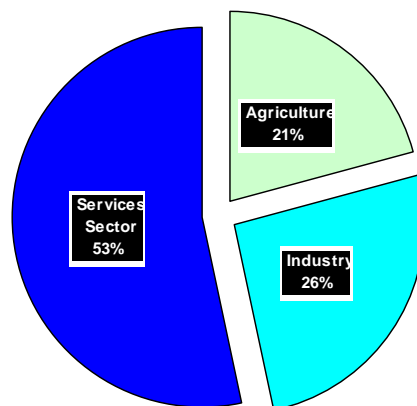
Pakistan's tax collection performance has been dismal. From FY01 to FY08 total tax collection has lagged behind GDP growth (See above). This is because there are several sectors whose tax contribution compared to GDP contribution remains a grey area, e.g. manufacturing, construction, textile, hotels/restaurants, commission agents, wholesale businesses, retail sector and transport.

WHAT NEXT? ... Continued

Furthermore, in FY08 15 commodities contributed 78% of total Customs duties, while 10 commodities generated 81% of all Sales tax proceeds. This means, only 25 commodities generated more than 42% of Pakistan's total tax collection. In addition, according to FBR 2,139,397 tax returns were filed in FY08, even if we assume that all of the filers were tax compliant, they represent only 1.33% of the total population (assuming a population of 160 million). An astonishing 98.66% of the population is not under the tax net. Adding real estate, agriculture sector and stock market (through Capital Gains Tax) to the net will increase tax collections by widening the base, as opposed to increasing burden on existing taxpayers.

However, taxing these sectors has been a contentious issue and hotly debated in the parliament - but in our opinion this is inevitable and quite frankly the sensible thing to do. Agriculture constitutes approximately 21% of our GDP (see below), and hence is too big a slice of the production pie to be ignored for too long. Similarly our contention regarding the CGT is simple, the KSE went from 700 odd points to well above 15,000 over the past decade, during which there was never a *right enough time* to impose CGT. Well if there wasn't one back then, the possibility of one being around the corner is quite stark - so let's just impose CGT and live with it.

Composition of GDP in FY08





THE PATH BEYOND

Pakistan has to become frugal with its expenditures. However, cutting back on Federal expenditure will not suffice this time round, as it is only a short term solution. For a developing country like ours, where infrastructure is underdeveloped and productive capacity underutilized, expenditure by the government on development projects is essential. Slashing the PSDP, education and health budget will only slow future output and GDP growth.

An equal emphasis needs to be put on increasing revenue primarily through broadening the tax base. Since some major contributors to GDP are not yet taxed and less than 2% of the population pays taxes - we have a good sized target market to identify new tax payers.

The solution is to increase sustainable revenue, which can only be achieved by increasing recurring income, and keep spending on development to achieve sustainable growth.





ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct
<u>Inflation</u>														
Headline Inflation	%	9.3	8.7	8.8	11.9	11.3	14.1	17.2	19.3	21.5	24.3	25.3	23.9	25.0
Core inflation	%	6.5	6.9	7.2	7.8	8.1	9.3	10.8	12.3	13.0	14.7	16.4	17.3	18.3
Food inflation	%	14.7	12.5	12.2	18.2	16.0	20.6	25.5	28.5	32.0	33.8	34.1	29.9	31.7
Non-food inflation	%	5.4	5.9	6.3	7.3	7.8	9.4	11.2	12.5	13.8	17.3	18.7	19.2	19.7
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.1	9.1	9.1	9.1	9.4	9.6	9.6	10.0	11.3	12.2	12.4	12.6	12.6
6 month	%	9.1	9.2	9.3	9.3	9.6	9.9	9.9	9.9	11.5	n/a	n/a	n/a	12.7
12 month	%	9.4	9.4	9.5	9.4	9.9	10.1	10.1	10.3	11.7	n/a	n/a	n/a	12.8
<u>External Sector</u>														
Export	Mln US\$	1,593	1,524	1,500	1,634	1,591	1,833	1,862	1,954	1,089	1,921	1,726	1,779	1,926
Import	Mln US\$	2,555	2,864	2,910	3,316	2,909	3,549	3,406	3,241	7,869	3,117	3,153	3,806	3,647
Trade balance	Mln US\$	(962)	(1340)	(1410)	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1,427)	(2,027)	(1721)
<u>Remittances</u>	Mln US\$	580	505	479	557	502	602	590	584	547	627	592	660	466
<u>Forex Reserves</u>	Mln US\$	16,354	15,807	15,589	14,657	14,031	13,232	12,362	11,258	11,285	9,920	9,130	8,322	7,323





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