

**Fiscal Policy
Choices in
Budget
2008-09**

Research Report No.76

FOREWORD

Over the last few years SPDC's reports have been highlighting the problems of widening macro-economic imbalances, rising rate of inflation and growing income disparities in Pakistan. This year the problems have come to a head particularly due to the policy in action during 2007, external shocks of rising oil and food prices and the more recent emergence of some political instability.

The budget for 2008-09, therefore, comes at a time of growing economic difficulties although there are high expectations of relief for the people from the newly elected democratic government. There are numerous challenges and the policy makers face difficult choices in the area of fiscal policy.

Historically, SPDC has presented reports after the announcement of budgets. This year we have also prepared a pre-budget report. The objective is to present a civil society perspective on the policy choices involved in the preparation of the budget.

We hope that this report will be of some assistance not only to the government but would also help in stimulating debate on key public policy issues of today.



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ACRONYMS

| | |
|-------|---|
| APCC | Annual Plan Coordination Committee |
| CBO | Community Based Organization |
| CPI | Consumer Price Index |
| EOBI | Employees Old Age Benefits Institutions |
| FATA | Federally Administrative Tribal Area |
| FBR | Federal Board of Revenue |
| FDI | Foreign Direct Investment |
| FSP | Food Support Program |
| GDP | Gross Domestic Product |
| GES | Graduate Employment Scheme |
| GST | General Sales Tax |
| HIES | Household Income and Expenditure Survey |
| HOBC | High Octane Blending Components |
| HSD | High Speed Diesel |
| IPP | Institute of Public Policy |
| LDO | Light Diesel Oil |
| MIS | Management Information Systems |
| NEC | National Economic Council |
| NEGS | National Employment Guarantee Scheme |
| OGRA | Oil and Gas Regulatory Authority |
| OMC | Oil Marketing Companies |
| PBM | Pakistan Bait-ul-Maal |
| POL | Petroleum Oil and Lubricant |
| PSDP | Public Sector Development Program |
| R & D | Research and Development |
| SBP | State Bank of Pakistan |
| SPDC | Social Policy and Development Centre |
| USC | Utility Stores Corporation |
| WAPDA | Water and Power Development Authority |

INTRODUCTION

Budget season is here again. But this year's budget is unique because of a number of factors. First, there are high expectations from the democratic government which has acquired the reigns of government after a gap of eight years. Second, it comes at a time when the economy is in the midst of an unprecedented level of stress following a period of apparent buoyancy. After the bonanza following 9/11, the economy revived achieving not only high growth and macroeconomic stability but also some poverty reduction. However, the growth was neither inclusive nor sustainable. Till last year there was little realization or acceptance of how vulnerable the foundations of that so called 'buoyancy' was and how gradually the economy was heading towards difficult times. The unraveling started last year. By the time the new government took power, the economy had already been through power and attack crises and the price hike had assumed alarming proportions.

How grave is the current macroeconomic situation? Pakistan is facing serious economic challenges in terms of high inflation and unsustainable fiscal and current account deficits. The revised estimate of fiscal deficit is 9.5 percent of GDP as revealed by the Ministry of Finance in April 2008. This unsustainable fiscal deficit is putting pressure on monetary policy, resulting in higher growth in monetary aggregates. This monetary expansion together with higher international oil and food prices has already translated into high double-digit inflation. Moreover, the projected estimate of current account deficit for 2007-08 has crossed 8 percent of GDP, soaking up foreign savings and resulting in depletion of foreign exchange reserves and increase in foreign debt. These deficits and the alarming level of inflation have affected the pace of economic growth. There are signs that GDP growth would be below 6 percent in 2007-08, below the current year's target and the growth rate last year.

This challenging economic situation leads independent economists as well as policy makers to ask the fundamental question: "what are the fiscal policy options that can help control the slide in the economic fundamentals? How can the poor and the vulnerable be protected from the burden of economic adjustment?" This pre-budget report gives SPDC's perspective in this regard and attempts to present feasible options available to the budget makers in Islamabad to improve the macroeconomic situation and insulate the poor from the burden of adjustment.

The report has five sections. Section 1 discusses current macro economic trends. Section 2 presents the macroeconomic scenario for 2008-09. Section 3 presents the contours of tax policy for improved resource mobilization and redistribution. Section 4 discusses the policy choices with regard to oil pricing. Finally, Section 5 discusses social protection in Pakistan and evaluates various social safety net options available to the government in Pakistan at a time when relief to the poor must have topmost priority.

SECTION I

MACROECONOMIC TRENDS IN RECENT YEARS

An important question which arises is whether the current state of economy is a result of recent external shocks or whether the economy was moving in this direction and corrective policy measures were not taken timely to reverse the deterioration in trends or at least limit them? It appears that our present economic predicament is a result of a combination of factors, both of a short and long term nature. Furthermore, the factors are both domestic and exogenous in character. We discuss these below.

Growth

The GDP growth rate peaked in 2004-05 at 9 percent. Since then there has been a gradual decline in the growth rate, most pronounced in the manufacturing sector. Also, there has been considerable volatility in agricultural growth and the average growth rate is down in the current decade to 2.5 percent as compared to over 4 percent in the 90s. Much of the buoyancy has been concentrated in the services sector.

| | GDP | Agriculture | Manufacturing |
|---------|------------|--------------------|----------------------|
| 2000-01 | 2.0 | -2.2 | 9.3 |
| 2001-02 | 3.1 | 0.1 | 4.5 |
| 2002-03 | 4.7 | 4.1 | 6.9 |
| 2003-04 | 7.5 | 2.4 | 14.0 |
| 2004-05 | 9.0 | 6.5 | 15.5 |
| 2005-06 | 6.6 | 1.6 | 10.0 |
| 2006-07 | 7.0 | 5.0 | 8.4 |

Source: PES.

Inflation

Inflation has been threatening the economy since 2004-05 as shown in Table 1.2. Cumulative inflation from 2004-05 to 2006-07 has been 27 percent in the overall CPI and 33 percent in food prices. As per the recent press conference of the Governor of the State Bank, food inflation at present is 25 percent on a year-to-year basis.

| | CPI | Food Prices |
|-----------|------------|--------------------|
| 1999-2000 | 3.6 | 3.8 |
| 2000-01 | 4.4 | 3.6 |
| 2001-02 | 2.5 | 2.5 |
| 2002-03 | 3.1 | 2.8 |
| 2003-04 | 4.6 | 6.0 |
| 2004-05 | 9.3 | 12.5 |
| 2005-06 | 7.9 | 6.9 |
| 2006-07 | 7.8 | 10.3 |

Source: PES

What has caused this spiraling inflation of almost an unprecedented level in recent history? Since 2002-03, the monetary policy stance has been expansionary. There was lack of sterilization of foreign exchange flows which came into the country after 9/11. The initial impact was, of course, growth in output in 2003-04 and 2004-05, which peaked at 9 percent. Thereafter, monetary expansion has increasingly spilled over into higher inflation, due to limits of capacity. The initial boom was basically a release of 'repressed growth'. The precipitous fall in interest rates sparked off an explosion in private sector credit and raised aggregate demand in the economy. Expansionary monetary policy also helped in creating 'fiscal space' due to the sharp fall in interest payments.

Overall, it appears that inflation was initially monetary in character. Monetary policy remained 'too easy for too long'. Come 2007-08, structural dimensions added to inflation due to "external shocks" of raising oil and food prices. However, the impact had not been felt directly till recently because of limited pass through into domestic prices. An indirect effect has come via the sharp jump in the subsidy bill that has raised the fiscal deficit which has been financed largely by borrowings from the

Central Bank. It is clear that the expansionary fiscal policy is now putting pressure on monetary policy. Consequently, inflation has reached double-digit level and is acquiring a ‘spiraling tendency’ as domestic prices (for example, energy) are being adjusted upwards.

Fiscal Deficit

The economic managers did a good job of fiscal stabilization up to 2003-04 as shown in Table 1.3. This was due, first, to severe containment in development expenditure and fall in interest payments following the rescheduling of debt. There was over a 3 percent of GDP drop in public expenditure. However, there was no improvement on the revenue side.

Deficit started increasing after 2003-04 as public expenditure was built up once again with rising PSDP and higher non-interest current expenditure. By 2006-07, public expenditure had exceeded the 1999-2000 level by 0.5 percent of the GDP. Deficit approached the 4.5 percent level. We witnessed an emergence of revenue and primary deficits. The former implied that the government had started to borrow to run its day-to-day operations.

| | As % of GDP |
|-----------|-------------|
| 1999-2000 | 4.6 |
| 2000-01 | 4.3 |
| 2001-02 | 5.6 |
| 2002-03 | 3.8 |
| 2003-04 | 2.3 |
| 2004-05 | 3.3 |
| 2005-06 | 4.3 |
| 2006-07 | 4.3 |

Source: PES

It is not clear if there was full accounting of expenditures in earlier years. In 2006-07, interest payments went up sharply by 1 percent of GDP due particularly to the maturity of Defense Saving Certificates (DSCs). Also, it is not clear if defence expenditures (due to operations in the North), export subsidy payments, jump in pre-election development spending by provincial governments, etc. were fully accounted for. It is not surprising that the so-called “unidentified” expenditure reached a peak of 1.4 per cent of the GDP in 2006-07. If such expenditure did take place then the ‘true’ fiscal deficit had already approached 6 per cent of the GDP in 2006-07.

Perhaps the biggest disappointment of fast growth was that this was not translated into an increase in the tax-to-GDP ratio, which remained stagnant around 10-11 percent. This stagnation can be attributed to a number of factors, including, decline in tax rates, plethora of concessions and exemptions given and inability of the taxation authority to expand the tax base. Detailed discussion of these factors is presented in Section 3.

The large deterioration in the fiscal deficit position in 2007-08 is attributable both to domestic factors and external shocks. The former includes costs of military operations in Swat and unbudgeted export subsidy. External shocks include the impact of higher oil prices in the form of deferred claims of Oil Marketing Companies (OMCs), wheat import subsidy and higher power subsidy to WAPDA (due largely to rise in costs of fuel).

An additional complication in 2007-08 is the reliance by the government on financing the large incremental deficit, of 5 ½ per cent of GDP, primarily through borrowings from the Central Bank. This has led to monetization of the deficit. Presumably, this was done to keep a lid on interest rates and to prevent a large-scale crowding-out of the private sector, thereby jeopardizing the process of growth. In effect, the policy choice has been in favor of higher inflation to support growth in the face of shocks.

But such a policy could prove counterproductive because the negative real rate of interest in the economy could discourage saving and increase the investment-saving gap, leading to corresponding rise in the current account deficit, which is what has happened.

Balance of Payments

Pakistan experienced a strong balance of payments position in earlier years of the new millennium. After 9/11, the jump in private transfers led to current account surpluses from 2001-02 to 2003-04. Thereafter, there has been a steady deterioration as shown in Table 1.4.

| Years | Current Account Balance (% of GDP) |
|---------|------------------------------------|
| 1999-00 | -1.6 |
| 2000-01 | -2.7 |
| 2001-02 | 3.9 |
| 2002-03 | 4.9 |
| 2003-04 | 1.8 |
| 2004-05 | -1.4 |
| 2005-06 | -3.9 |
| 2006-07 | -4.9 |

Source: State Bank of Pakistan, Annual Report
IMF Article 4 Consultation's Press Releases

Strong growth in aggregate demand, liberalization of imports due to falling tariffs, falling interest rates and emergence of consumer financing increased demand for imported consumer durables while private investment (mostly with imported machinery) also rose because of the fall in financing costs. Therefore, unprecedented growth was experienced in imports. As shown in Table 1.5, non-oil, non-food imports increased by over 38 per cent and 31 percent in 2004-05 and 2005-06 respectively. The marginal propensity to import jumped up three times in relation to the 90s. Clearly much of the increase in this period was due to the jump in 'non-essential' imports.

| Years | Import Growth (%) |
|---------|-------------------|
| 2002-03 | 20.1 |
| 2003-04 | 21.2 |
| 2004-05 | 38.3 |
| 2005-06 | 31.7 |
| 2006-07 | 8.0 |

*excluding oil and food imports

This was sustained by fairly rapid growth in exports upto 2005-06. Thereafter exports began to falter. Favorable developments in the capital account starting with debt rescheduling and larger aid inflows improved the reserve position. Reserves peaked at 6.5 months of imports of goods and services in 2002-03 and fell to about 3.5 months by 2005-06. Recovery to 4.5 months in 2006-07 was due to exceptionally large foreign direct investment flows.

The balance of payments started becoming unsustainable because of high level of imports, loss of momentum in exports, reliance of financing on volatile capital inflows like portfolio investment. Come 2007-08, the rise in oil prices and food imports along with continued growth in non-oil, non-food imports has led to a large deterioration in the current account. Simultaneously, foreign direct investment inflows are beginning to dry up. A speculative element has probably entered into import demand because of falling reserves and depreciating exchange rate, which has already fallen by about 14 per cent.

MACROECONOMIC SITUATION IN 2007-08

The macroeconomic targets for the year 2007-08 were set at the time when perceptions about the economy continued to be optimistic, at least in government quarters. As shown in Table 1.6, the expectations were that Pakistan will enjoy a

GDP growth of 7 percent, with a relatively low level of inflation and sustainable level of fiscal deficit. As a result, an optimistic target of 7.2 percent was set for GDP growth based on sector-wise growth targets of 4.8 percent for agriculture, 9.9 percent for manufacturing and 7.1 percent for services. However, due to a combination of factors including large exogenous shocks, wrong or absence of policy response and a neglect of emerging structural problems in three key sectors—energy, agriculture and exports, the nine month official statistics lead to the conclusion that the targets will be missed by wide margins. The revised estimates for GDP growth is 5.8 percent (a decline of 1.2 percentage points in relation to target) with: 1.8 percent in agriculture, 5.0 percent in manufacturing and 7.1 percent in services sector.

In contrast, the revised estimates for inflation, fiscal deficit and current account deficit have greatly exceeded the targets set for 2007-08 of 6.5 percent, 4 percent and 5.9 percent respectively. At present, the rate of inflation is close to 11 percent, while the fiscal deficit may exceed 9.5 percent of GDP and the current account deficit could reach 8 percent of the GDP.

GDP Growth

Our estimates show that even the revised estimates for GDP and sectoral growths are difficult to achieve. For instance, nine month statistics showed a growth of 4.8 percent in the manufacturing sector. Given the high level of power load shedding and limits to capacity utilization it is expected that the growth rate for the year will not exceed 5 percent. Similarly, in the presence of low wheat and cotton crops, the growth rate of agriculture is likely to fall below 2 percent. The service sectors continue to show a degree of resilience with a combined growth rate of 6 percent.

Inflation

As mentioned earlier, the high single digit inflation in the last three years and the soaring inflation this year have built-in inflationary expectations. Consequent behavioral changes along with soaring prices of energy and food and rupee depreciation have introduced spiraling inflation as reflected in the monthly inflationary trend. We believe that the monthly trend is likely to continue in the remaining two months of current fiscal year. As such the year will close with an inflation of 11 percent rather than the target of 6.5 percent for 2007-08.

Fiscal Magnitudes

Pakistan's key fiscal magnitudes based on nine month performance shows considerable deviations from the budget estimates for 2007-08. While tax collection by Federal Board of Revenue (FBR) is expected to be lower by Rs 35 billion, the expenditure side shows significant variation. The revised estimates for three major heads of current expenditure, namely interest payments, defense and subsidies are

| | Targets for 2007-08 | Government's Revised Estimates | SPDC Estimates |
|------------------------------------|------------------------------------|---|---------------------------|
| | | | (%) |
| GDP Growth Rate | 7.2 | 5.8 | 5.3 |
| Agriculture | 4.8 | 1.8 | 1.8 |
| Manufacturing | 9.9 | 5.0 | 5.0 |
| Services | 7.1 | 7.1 | 6.0 |
| Inflation | 6.5 | 11.0 | 11.0 |
| Fiscal Deficit | 4.0 | 9.5 | 7.5 |
| Current Account Deficit | 5.9 | 9.2 | 7.5 |

Rs 450 billion higher than budgeted. Due to higher international fuel prices and food prices revised expenditure on subsidies has increased from Rs 114 billion to Rs 365 billion (more than tripled). Similarly, interest payments on external and domestic debt have increased from Rs 375 billion to Rs 499 billion (an increase of 33 percent). Likewise, defense expenditure has gone up from Rs 275 billion to Rs 350 billion (an increase of 27 percent). Other current expenditure has also increased from Rs 230 billion to Rs 276 billion (an increase of 20 percent).

The SPDC estimates for current expenditure deviate from revised expenditure on two heads: subsidies and other current expenditures. SPDC estimates show that expenditure on subsidy would be Rs 315 billion instead of Rs 365 billion because fuel prices have been increased and WAPDA tariffs have been raised by 9 percent. Similarly, the Ministry of Finance has already taken some corrective measures to check expenditure growth, such as reversion of unutilized amounts in various divisions. According to our estimates these measures could save up to Rs 50 billion (see Table 1.7).

| | Budget Estimates | Revised Estimates | SPDC Estimates | Variation in Budget and SPDC Estimates |
|-------------------------------------|------------------|-------------------|----------------|--|
| Total Federal Revenues (Net) | 902.2 | 890.0 | 890.0 | 12.2 |
| Tax Revenues | 1030.5 | 995.5 | 995.5 | 35.0 |
| CBR Revenues | 1025.0 | 990 | 990 | 35 |
| Other | 5.5 | 5.5 | 5.5 | 0.0 |
| Non-Tax Revenues | 337.7 | 346.9 | 346.9 | -9.2 |
| Provincial Share | 466.0 | 452.4 | 452.4 | 13.6 |
| Total Expenditures | 1,352.8 | 1,874.8 | 1,684.9 | -332.1 |
| Current Expenditures | 993.5 | 1515.5 | 1415.6 | -422.1 |
| Interest | 374.6 | 499.4 | 499.4 | -124.8 |
| Defense | 275.0 | 350.0 | 350.0 | -75.0 |
| Subsidies | 113.9 | 365.0 | 315.0 | -201.1 |
| Supplementary Grants | 0.0 | 25.0 | 25.0 | -25.0 |
| Others | 230.0 | 276.1 | 226.2 | 3.8 |
| Development Expenditures | 359.3 | 359.3 | 269.3 | 90.0 |
| Federal Fiscal Deficit | 450.6 | 984.8 | 794.9 | -344.3 |
| Provincial Surplus | 51.7 | 28.2 | 28.2 | 23.5 |
| Overall Fiscal Deficit | 398.9 | 956.6 | 766.7 | -367.8 |
| As % of GDP | 4.0 | 9.5 | 7.5 | -3.5 |

Historically, cutback in development expenditure has been a popular policy response to fiscal crunch in Pakistan. Continuing with the tradition, it seems likely that development activities will be curtailed. Given this, we project a cutback of Rs 90 billion in development expenditure in 2007-08. Based on these calculations, we project that the fiscal year will end with an overall fiscal deficit of Rs 767 billion, which is 7.5 percent of GDP rather the revised estimates of Rs 957 billion, or 9.5 percent of GDP as of April 2008.

Balance of Payments Position

Balance of payments has become a major source of concern in the present macroeconomic situation. Persistent deterioration in the current account balance over the last three years has brought the economy to the brink of a financial crisis. As shown in Table 1.8, current account deficit is expected to approach \$13.5 billion at the end of fiscal year 2007-08, with an increase of \$6.6 billion as compared to 2006-07. As a percentage of GDP, it will increase by 2.6 points from 4.9 percent in 2006-07 to 7.5 percent in 2007-08, which is clearly unsustainable.

The major source of current account deficit is the ballooning trade deficit, which has shown a massive increase of 57 percent over the last fiscal year. The increase in the deficit reflects a surge of over 29 percent in imports while exports have increased by about 15 percent in the same period. One of the main reasons for higher values of imports is increasing international prices of crude oil and food items particularly of wheat and palm oil. Moreover, import of raw cotton and fertilizers have also

increased significantly. In the case of Pakistan, a rise in merchandise imports also brings forth an increased demand for shipping and insurance services, which are also largely imported. Hence, the external deficit on services has also widened from \$4.2 billion in 2006-07 to \$6.7 billion in 2007-08. On the other hand, private transfers have increased by \$1.4 billion.

On the financing side, as shown in Table 1.8, FDI and Portfolio investment together may decline from \$8.4 billion to \$3.5 billion. Moreover, increase in the foreign aid component is expected to remain under \$800 million. This situation has left no option but to finance the deficit through depletion of foreign exchange reserves, which would face a depletion of \$5.8 billion. Moreover, as a result of worsening of external account, Pak Rupee has been unable to hold its grounds against US Dollar. Since the beginning of current fiscal year, about 14 percent depreciation has already occurred till May 21, 2008, although there has been a modest recovery in recent days.

In conclusion, we expect that the fiscal year 2007-08 will close with unsustainable levels of the twin deficits and high inflation. Clearly, budget 2008-09, which is the fiscal policy statement for the forthcoming year will have to focus on reducing the deficits and bringing the economy on the path of stability. In a precipitate set of actions. State Bank of Pakistan has moved to stabilize the economy. This represents a reversal of the growth-oriented monetary policy over the last five years. Is this a

| | 2006-07 | 2007-08 | | |
|--------------------------------|-------------|--------------|-------------|--------------|
| | | July-April | May-June | Total |
| Current Account Balance | -6.9 | -11.6 | -1.9 | -13.5 |
| Trade Balance | -9.7 | -12.7 | -2.5 | -15.2 |
| Exports | 17.3 | 16.2 | 3.5 | 19.7 |
| Imports | 27.0 | 28.9 | 6.0 | 34.9 |
| Services (Net) | -4.2 | -5.6 | -1.1 | -6.7 |
| Income Net | -3.6 | -3.1 | -0.7 | -3.8 |
| Current Transfers | 10.6 | 9.8 | 2.2 | 12.0 |
| Financing | | | | |
| Foreign Aid | 2.2 | | | 3.0 |
| FDI and Portfolio | 8.4 | | | 3.5 |
| Change in Reserves | 3.7 | | | 5.8 |
| Others | 0.2 | | | 1.2 |

Source: SBP

case of 'too much, too late'? In fact, evidence of the 'over-heating' of the economy had become visible since 2004-05 and SBP ought to have gradually changed the monetary policy stance to curb inflation and contain aggregate demand. But the money supply continued to expand rapidly by as much as 19 percent in 2006-07. Now with inflation acquiring a runaway character and imports rising rapidly with a precipitous fall in reserves and exchange rates, SBP has opted to raise interest rates sharply in the economy. Whether this will contain aggregate demand hinges crucially on the nature of fiscal policy to be announced in the federal budget of 2008-09. If the fiscal deficit is brought down sharply by about 2 per cent of GDP and less reliance placed on borrowing from the Central Bank then monetary and fiscal policies could reinforce each other not only in restoring confidence but also to containing inflation. But it is clear that temporarily at least the process of adjustment will imply some loss of growth.

SECTION II

THE MACROECONOMIC SCENARIO FOR 2008-09

The previous section has highlighted that the current fiscal year is likely to close with burgeoning deficits in the budget and in the current account of the balance of payments along with galloping inflation. The real economy is also witnessing a slowdown in the rate of growth, especially in the agricultural and manufacturing sectors, and poverty is on the rise again in face of high and rapidly increasing food prices.

Sustainability of the growth process requires, no doubt, the attachment of high priority to containment of the 'twin' deficits and to achievement of moderation in the rate of inflation. This has to be accomplished at the minimum cost in the short run to the rate of economic growth.

The objective of this chapter is to project magnitudes of macroeconomic indicators like growth, inflation, public finances and balance of payments which we consider achievable in 2008-09 on the basis of implementation of a relatively strong package of policies. An attempt must be made to ensure that the measures proposed have a minimal impact on the living conditions of the poor. Demonstration of a strong commitment on the part of the government to stabilizing the economy will calm markets and help in restoring confidence.

Growth Projections for 2008-09

Table 2.1 below gives the government projections of growth in 2008-09 as presented for approval initially to the Annual Plan Coordination Committee (APCC) and subsequently by the National Economic Council (NEC). SPDC projections are also given in the table. These are based on the economic performance in 2007-08 and the challenges being faced by the economy.

| | Government* | SPDC | Variation |
|---------------|--------------------|-----------------|--------------------|
| GDP | 6.5 | 5 – -5.5 | -1.0 – -1.5 |
| Agriculture | 4.0 | 4.0 | 0.0 |
| Manufacturing | 8.5 | 5.0 – 6.0 | -2.0 – -3.0 |
| Services | 6.7 | 5.5 – 6.0 | -0.7 – -1.2 |

*yet to be approved by NEC

The government projections are very optimistic and essentially ignore the difficulties being experienced by the economy. In the present context of trends both in the global and in the domestic economy it is difficult to visualize in the short run a recovery in the growth rate of the economy from 5.8 percent in 2007-08 to 6.5 percent in 2008-09.

In fact, given the need to stabilize the economy, emphasis will have to be placed on management of aggregate demand through contractionary fiscal and monetary policies. As such, subject to skillful management of the economy with the appropriate mix of policy instruments, an outcome in terms of the growth rate of 5 to 5 ½ percent may be considered as a good performance of the economy in 2008-09. Factors which will influence the level of aggregate demand in the economy are the level of interest rates and tax rates, the size of the public sector development program and

so on. Ideally, the containment in aggregate demand will be reflected more in consumption than on investment, especially by the private sector.

Turning to sectoral growth rates, there was a sharp decline in the performance of the agricultural sector in 2007-08, with a growth rate of less than 2 percent. This was probably due to a fall in the production of wheat and cotton. During 2008-09 agricultural prices are likely to remain high because of high international commodity prices. A supply response could be forthcoming, especially if government intervenes in terms of easier and cheaper availability of inputs. Therefore, we concur with the government's projection of a 4 percent growth in the agricultural sector in 2008-09. This is based on growth rates of 4.5 percent in major crops, 4 percent in livestock and 2.5 percent in minor crops.

The manufacturing sector has shown a considerable loss of dynamism in 2007-08. The growth rate has plummeted from 8.4 percent in 2006-07 to 5 percent in 2007-08. Factors responsible for this are, first, the limits to capacity being approached in a number of industries, second, the stagnation in exports of textiles and clothing and, third, the high incidence of power outages which has adversely affected production. The anticipated near-doubling of the growth rate of the manufacturing sector during 2008-09 is optimistic. High energy prices and rising interest rates will raise costs of production. Also, industries producing luxury consumer durables, like automobiles, face the prospects of higher taxes. As opposed to this, the depreciating rupee could provide a fillip to export-oriented industries although the introduction of margin requirements on raw material imports could stretch the liquidity of industrial enterprises.

The services sector has the largest share in GDP and has been the main contributor to growth in recent years, including 2007-08. The initial government projection is that this sector will grow by 6.7 percent in 2008-09. Relatively high growth rates are anticipated in sectors like banking and insurance at 12 percent, 8 percent in social, community and personal services and 6.5 percent in wholesale and retail trade. We project a somewhat slower growth rate for the following reasons:

- (i) The interim monetary policy measures announced recently by SBP, especially the introduction of a minimum return of 5 percent on savings deposits, could adversely affect profitability of commercial banks and reduce the growth in value added.
- (ii) Measures like the introduction of margin requirements and depreciation of the rupee are likely to reduce the volume of imports and the level of wholesale and retail trade in imported goods.
- (iii) A possible extension of the sales tax/excise duty net to services in the federal budget of 2008-09 could restrict growth in value added from social, community and personal services.
- (iv) In an effort to contain the size of the fiscal deficit the government is likely to limit the growth in current expenditure, both civilian and military. This will dampen the growth of value added in public administration and defence.

Inflation in 2008-09

The official projection of the rate of inflation (in the consumer price index) for 2008-09 is 8 percent, while this year's outcome according to SBP is close to 11 percent. This projection also appears to be optimistic in light of the following factors:

- (i) Inflation has acquired a galloping character and during the last two months of March and April 2008 the monthly rate of inflation has crossed 3 percent. Inflationary expectations have become embedded in the behavior of economic agents and imparted a strong dynamic to inflation in the country.
- (ii) There is a strong monetary 'overhang', due especially to the high rate of government borrowing from the Central Bank, which has substantially added to the stock of reserve money.
- (iii) There has been incomplete adjustment yet to the rising oil prices internationally and if the government opts to raise domestic POL prices accordingly in 2008-09, to reduce the large oil subsidy bill (see Section IV), then this could impact significantly on the overall price level.
- (iv) The rupee has depreciated rapidly in recent months by over 10 percent and, as highlighted by the Governor of SBP, this will imply more imported inflation in coming months.

Altogether, arresting inflation is going to be a huge challenge in 2008-09. Somehow, the tendency for inflation to acquire a runaway character has to be controlled. This will depend clearly on the strength and nature of the adjustment process. In our view, real success will have been achieved if inflation can be contained to 10 percent in 2008-09. Targeting for a single-digit rate of inflation may become possible only after 2008-09. If, however, the government proceeds to adopt almost draconian measures to bring down the inflation rate to, say, 8 percent then this could seriously impair the process of growth and employment in the economy.

FISCAL ADJUSTMENT

The announcement by the Finance Minister on 9th April 2008 that the fiscal deficit could reach a high of 9½ percent of the GDP in 2007-08 exceeded all expectations. It is due apparently to underreporting of some expenditures, like interest payments, by the previous government and unanticipated higher expenditures, like the deferred claims of oil marketing companies due to higher oil prices and inadequate policy response to these shocks. A breakup of the expenditure overrun (if no actions are taken before the end of the fiscal year) of Rs 522 billion (over 5 percent of the GDP) and revenue shortfall is given in Table 2.2. About 54 percent is due to factors of domestic origin like higher interest payments on domestic debt, cost of military operations in Swat, R & D allowance for textiles, etc. The remainder of 46 percent is the consequence of external shocks leading to higher subsidies on oil, power and wheat import. Therefore, contrary to perceptions, the substantial deviation from budgetary targets is due more to domestic than to international factors.

There are a number of consequences of the explosion in the size of the fiscal deficit. First, as highlighted earlier, the incremental deficit has been largely financed by borrowings from the Central Bank which have approached Rs 550 billion (5 ½ percent of the GDP). This high rate of monetization of the deficit implies continuation of strong inflationary pressures, as highlighted earlier. Second, the large public sector deficit is spilling over into a higher current account deficit. Removal of the imbalance in the external balance of payments, therefore, depends also on the containment of the fiscal deficit. Third, the large deficit implies that there will be a big

revenue deficit and the public debt-to-GDP ratio will start rising once again, leading to a violation of the provisions in the Fiscal Responsibility and Debt Limitation Act.

| | Provision in Budget | Actual July – February | Projection | Variation from Budget Provision | |
|-------------------------------|------------------------|---------------------------|------------|------------------------------------|---------------|
| DOMESTIC | | | | 303.5 | 54.4% |
| • Domestic Interest Payments | 318.2 | 265.3 | 443.0 | 124.8 | |
| • Military operations in Swat | - | 38.5 | 75.0 | 75.0 | |
| • Export Subsidy | - | 19.4 | 43.0 | 43.0 | |
| • Supplementary Grants | - | 12.0 | 25.0 | 25.0 | |
| • Revenue Shortfall (Net) | 902.2 | 535.9 | 890.0 | -12.2 | |
| • Provincial Surplus | 51.7 | 10.9 | 28.2 | -23.5 | |
| INTERNATIONAL | | | | 254.1 | 45.5% |
| • Oil Differential Claims | 15.0 | 15.0 | 153.6 | 138.5 | |
| • WAPDA Subsidy | 52.8 | 34.5 | 123.5 | 70.7 | |
| • Wheat Import Subsidy | - | - | 44.9 | 44.9 | |
| | | | | 557.6 | 100.0% |

The financial scenario for 2008-09 is developed by us is based on the following considerations:

- (a) Getting back to the path of debt sustainability by limiting the size of the fiscal deficit and preventing the debt-to-GDP ratio from rising in 2008-09.
- (b) Exploring limits to non-bank borrowing and external assistance and keeping borrowing from the SBP within 'safe' limits of deficit financing from the inflation point of view.
- (c) Avoiding too drastic a reduction in expenditure, especially on development, and too big a hike in tax rates which could fundamentally impair the process of growth.

Recent statements made by government indicate that strong efforts are underway to limit the fiscal deficit in 2007-08, although not much time is available for making adjustments. There are some indications that the budget deficit will be brought down to 6½ percent of the GDP by the end of the fiscal year, representing a sizeable reduction of almost 3 percent of the GDP from the level projected in early April. We believe that this is perhaps too optimistic and instead base our projections for 2008-09 on a fiscal deficit outcome of 7½ percent of the GDP in 2007-08 as indicated in the previous section. There is the danger that in an effort to bring down the deficit to 6½ percent of the GDP some expenditure liabilities may be transferred to 2008-09.

Given the three above-mentioned considerations, our calculations reveal that the budget deficit in 2008-09 can be upto 5½ percent of the GDP, representing a downward adjustment of 2 percent of the GDP from the likely level this year. This size of deficit keeps the public debt-to-GDP ratio, more or less, constant in 2008-09. Also, it is small enough to obviate the need for large-scale borrowing from the Central Bank. Further, it provides enough space for keeping the PSDP at a

reasonably high level and is based on a feasible level of resource mobilization without fundamentally affecting the growth process.

Table 2.3 gives SPDC projections of the key public finance magnitudes for 2007-08 and 2008-09. Total current expenditure is essentially derived as a residual in order to ensure attainment of the fiscal deficit target.

The assumptions underlying the fiscal projections for 2008-09 are as follows:

Tax revenues: the tax-to-GDP ratio is projected to increase by 0.7 percent of

GDP to 10.4 percent of the GDP in 2008-09. This will require a relatively high level of fiscal effort in the form of taxation proposals aggregating to Rs 80 billion. Specific proposals for mobilizing additional revenues of this magnitude are highlighted in Section III.

Non-tax revenues: assumed to remain unchanged as a percentage of the GDP.

Development expenditure: fixed at 2 ½ percent of the GDP for the federal PSDP, at about the same level as in 2007-08.

Current expenditure: given the above assumptions and the target level of fiscal deficit of 5 ½ percent of the GDP, the implied level of current expenditure is Rs 1500 billion, representing an increase of 6 percent over the likely level in 2007-08.

The big question is whether the growth of current expenditure can be restricted to 6 percent in 2008-09. A number of factors will put pressure for higher outlays as follows:

- (i) Interest payments are likely to increase faster because of the debt build-up in 2007-08 due to the large deficit and short-term interest rates (on treasury bills) will be higher as monetary policy becomes tighter. Also, the depreciation of the rupee will add to external debt servicing.
- (ii) The oil subsidy bill will be under pressure as international prices of oil continue to rise (in excess of \$ 130 per barrel currently), as highlighted in Section. The magnitude of this bill will depend upon the extent to which domestic prices of POL products are raised in line with the international prices.
- (iii) The power subsidy to WAPDA could rise in lieu of higher fuel costs unless appropriate adjustments are made in tariffs.

| | 2007-08 | 2008-09 | Growth Rate (%) |
|------------------------------------|---------------|---------------|-----------------|
| Total Federal Revenue (Net) | 890.0 | 1080.0 | 21.3 |
| • Tax Revenue | 995.5 | 1250.0 | 25.6 |
| • Non-Tax Revenue | 346.9 | 400.0 | 15.3 |
| • Less Provincial Share | -452.4 | -570.0 | 26.0 |
| Total Federal Expenditure | 1684.9 | 1800.0 | 6.8 |
| • Current Expenditure | 1415.6 | 1500.0 | 6.0 |
| • Development Expenditure | 269.3 | 300.0 | 11.1 |
| Federal Fiscal Deficit | 794.9 | 720.0 | -9.4 |
| • Provincial Surplus | 28.2 | 50.0 | 77.3 |
| Overall Fiscal Deficit | 766.7 | 670.0 | -12.6 |
| • As % of GDP | 7.5 | 5.5 | |

- (iv) Given a larger volume of imports of wheat (upto 2.5 million tons), the wheat subsidy could be larger than in 2007-08.

Therefore, success in attainment of the fiscal deficit target of 5½ percent of the GDP will hinge crucially on containing the overall subsidy bill in 2008-09.

Our simulations reveal that the growth of current expenditure can be restricted to 6 percent in 2008-09 with the following actions:

- (i) POL prices are adjusted upwards in 2008-09 to eliminate at least half the level of subsidy, as recommended in Section IV.
- (ii) The defence budget is brought down by Rs 50 billion from the likely level of Rs 350 billion in 2007-08 following a peace settlement and cessation of military operations in Swat / FATA.
- (iii) Power tariffs are raised by about 15 percent during 2008-09
- (iv) Non-salary expenditure of all government departments is kept constant in nominal terms at the 2007-08 level.

Of course, if the government is able to eliminate a larger component of the subsidies through enhancements in administered prices then more fiscal space will become available for higher PSDP and / or higher outlays on social safety nets.

The above analysis indicates that the process of fiscal adjustment involving deficit reduction to 5 ½ percent of the GDP in 2008-09 is achievable. It will involve intensive, but feasible, efforts at mobilizing resources and containing expenditure in ways that hurt growth the least and do not impact adversely on the poor.

How should the fiscal deficit be financed in 2008-09? The government will have to limit its recourse to Central Bank borrowing given the high buildup already. As such, this should be limited to a maximum of 1 percent of GDP. Another 1 percent of the GDP could be mobilized, largely through sale of PIBs, from the commercial banking sector without leading to major 'crowding-out' of the private sector. As in the past, external resources of about 2 percent of the GDP could be mobilized. The remainder, upto 1 ½ percent of the GDP, would need to be generated from the National Savings Schemes. This would require an enhancement of about 3 percentage points in the returns on the various certificates.

Overall, it appears that a pattern of financing of deficit (of upto 5½ percent of the GDP) can be evolved which has minimal inflationary impact and does not lead to a major displacement of the private sector. As highlighted earlier, containment of the fiscal deficit could also help greatly in reducing the gap in the balance of payments, projections of which are given next.

BALANCE OF PAYMENTS ADJUSTMENT

Curtailment of the current account deficit in the balance of payments has assumed prime importance in view of the large decline in foreign exchange reserves of more than \$ 5 billion in 2007-08 and the rapid depreciation in the value of the rupee during the last few months. In fact, at \$11.5 billion the reserves already represent an import cover of goods and services of less than three months. A significant decline in coming months could usher in a full-blown financial crisis.

However, government projections for 2008-09 appear to be largely oblivious of the extremely fragile position of the balance of payments. The current account deficit next year is projected at \$ 12.5 billion, only marginally lower than the estimated deficit of \$ 13.5 billion this year. The latter was financed by a drawdown of reserves as mentioned above. If this process of depletion of reserves continues because of a lack of adjustment in the balance of payments then in the next few months reserves could fall below the psychological threshold level of \$ 10 billion, leading to greater nervousness in the markets and putting further pressure on the rupee.

Therefore, if stabilisation is to be achieved then the target must be to keep foreign exchange reserves throughout 2008-09 at a relatively high level. If, as promised by the Finance Minister, aid inflows of \$ 3 billion are expected during the month of June 2008 then these must all be used to build up the level of reserves. As such, efforts must be made to keep reserves at the relatively safe level of \$ 14 billion or more throughout 2008-09, thereby restoring confidence in markets and facilitating the inflow of FDI.

The crucial element in the process of adjustment is, therefore, the size of the current account deficit which can be financed without any reserve depletion. During 2007-08, we estimate that the inflow of FDI and external assistance were able to finance a deficit of upto \$ 8.5 billion. Allowing for some growth in the size of the economy, a deficit of upto \$ 9.5 billion in 2008-09 can be financed without cutting into foreign exchange reserves. Therefore, the target for the current account deficit in 2008-09 has to be fixed at \$ 9.5 billion or about 5 percent of the GDP, as compared to the target of 6.5 percent initially set by the government.

What are the implications of a process of balance of payments adjustment which targets for a reduction in the current account deficit from about 8 percent of the GDP in 2007-08 to 5 percent of the GDP in 2008-09? Clearly, this a sharp adjustment and has to be achieved without disrupting the growth process in the economy. It hinges on success in raising exports, maintaining the growth momentum in home remittances and containing the increase in imports. We have derived the level of imports which is consistent with the attainment of a 5 percent current account deficit in 2008-09 in Table 2.4.

| | (\$ Billion) | | | | |
|-------------------------|--------------|---------|-------------|-------------|-------------|
| | July – April | | July – June | | July – June |
| | 2006-07 | 2007-08 | 2006-07 | 2007-08 (P) | 2008-09 (P) |
| Current Account Balance | -6.6 | -11.6 | -6.9 | -13.5 | -9.5 |
| Trade Balance | -8.3 | -12.7 | -9.7 | -15.2 | -10.5 |
| • Exports | 14.0 | 16.2 | 17.3 | 19.7 | 22.7 |
| • Imports | 22.3 | 28.9 | 27.0 | 34.9 | 34.2 |
| Services (Net) | -3.9 | -5.6 | -4.2 | -6.7 | -8.0 |
| Income (Net) | -2.9 | -3.1 | -3.6 | -3.8 | -4.0 |
| Current Transfers | 8.4 | 9.8 | 10.6 | 12.0 | 14.0 |

The calculations reveal that imports will have to kept at, more or less, the *same level* as 2008-09. This is sharp contrast to government projections of an increase in

imports of 12 percent next year. There are a number of factors which will operate on the level of import demand in the economy. Factors which could exert an upward pressure are, first, continued rise in the oil import bill due to higher prices, especially if domestic prices are not adjusted fully to contain demand and, second, a higher level of food imports, especially of wheat. These factors could add up to \$ 3 billion to the import bill.

As opposed to this, there are a number of factors which could restrict the growth in imports, including, first, the management of aggregate demand via contractionary fiscal and monetary policies which could depress import demand in the economy, second, depreciation in the value of the rupee of 14 percent already in 2008-09, third, the introduction of 35 percent margin requirements on imports (except oil and food), and, fourth, the prospect of introduction of regulatory duties on non-essential imports, especially luxury goods in the forthcoming Budget.

Overall, if oil and wheat imports are higher by \$ 3 billion in 2008-09 then, if total imports are to remain constant, all other imports combined will have to fall by \$ 3 billion. The implied extent of containment of such imports is about 13 percent. Depreciation of the rupee, introduction of margin requirements and possible imposition of regulatory duties alongwith more aggressive overall demand management may prove to be adequate to bring about this containment otherwise additional measures may be necessary. Efforts should be made to curtail more the import of consumer goods rather than raw materials and capital goods, if necessary, through variation in margin requirements and level of regulatory duties.

But there is no doubt that one of the biggest challenges in 2008-09 will be to contain the growth in imports in order to fundamentally enhance the sustainability of the balance of payments position of Pakistan. It needs to be emphasized, however, that over the medium run the emphasis will have to be at diversifying the export base and achieving a faster growth in exports, beyond the 15 percent targeted for 2008-09.

How will the projected current account deficit of \$ 9.5 billion in 2008-09 be financed? As highlighted earlier, if any drawdown of reserves is to be avoided in order to improve market perceptions then it will have to be largely financed by foreign direct investment and aid inflows. Net aid inflow of upto 2 percent of the GDP of just under \$ 4 billion is feasible especially if the democratic process continues successfully and the government demonstrates a strong commitment to the process of adjustment through far-reaching reforms, especially in the area of fiscal policy. The remaining needs of financing of about \$ 5.5 billion could be mobilized through foreign direct investment (including privatization proceeds), especially if a degree of market confidence is restored through maintaining foreign exchange reserves at about \$ 14 billion, preventing volatility in the foreign exchange and stock markets and perhaps, most importantly, achieving stability in the functioning of the political process in the country.

SECTION III

TAXATION POLICIES

Among the many challenges coming to the forefront in the last few years is also the growing perception of increasing inequality among different segments of population. The general feeling is that growth in the earlier part of the decade has benefited few, and the masses have been silent spectators witnessing others prosper. Though hard core estimates on distribution of income are not available after 2004-05, perception of inequality is almost as harmful as actual inequality as it leads to a feeling of being disenfranchised and causes unrest in the people. Therefore, budget of 2008-09 has to address the sense of growing inequality in the country while focusing on the macroeconomic objectives. A concerted effort has to be made to remove both inter-personal and inter-regional inequalities. Though the latter can best be addressed by the National Finance Commission which decides on inter-governmental revenue sharing transfers between the federation and the federating units, the former is more directly under the fiscal policy ambit.

The key fiscal policy tool for redistribution is taxation. According to taxation theory, it has three goals: to transfer resources from the private to the public sector; to distribute the cost of government fairly by income classes (vertical equity) and among people in approximately the same economic circumstances (horizontal equity); and to promote economic growth, stability and efficiency. The uneven distribution of tax burden across sector has led to serious concerns regarding the equity of tax structure in Pakistan. Has taxation in Pakistan contributed to redistribution? Kemal [2006] quantifies the incidence of the overall tax system of Pakistan. He finds that from being progressive in 1987-88, the incidence had become regressive by 1999-2000. The decline in corporate income tax rates and tariff rationalization have benefited the well off, while with the broadening of the sales tax base, the tax burden on the poor has increased.

Developments since 1999-2000 may have contributed to even greater regressivity of the tax system? These include the following:

- Abolition of the wealth tax in 2000 and continued reduction in personal and corporate income tax rates, as highlighted above, especially on private companies and on the banking sector, at a time of sharply rising corporate profitability.
- Further reduction in import tariffs, especially on luxury consumer goods, like automobiles, and withdrawal of excise duties on domestically produced consumer durables.
- Reduction of revenues from the petroleum development surcharge and its virtual elimination in 2007-08. The surcharge has historically taxed motor spirit at a differentially higher rate, with the burden falling more on the upper income groups.
- The extension of GST to fertilizer which has impacted relatively more on small farmers.

A positive development, however, is the rise recently in the share of direct taxes in total tax revenues.

Another key concern related to taxation in Pakistan is the lack of buoyancy in federal and provincial tax revenues. In fact one of the disappointments in the four previous years when there was continuously high economic growth was that the tax-to-GDP ratio did not rise correspondingly. It has remained stagnant at 10 to 11 percent of the GDP. Is this because the tax base of different taxes has somehow been concentrated in the slower growing parts of the economy, possibly because of conscious policy direction, or that the opening of fiscal space in the economy (especially due to the decline in the debt servicing burden) has led to a slackening of fiscal effort both in terms of tax policy (erosion in tax base due to increased exemptions and concessions) and tax administration (increased evasion)?

This section attempts to answer these questions and suggests a strategy to make the incidence of taxes progressive and tax revenues more buoyant.

TREND IN REVENUES

Important structural changes are visible in tax revenues during the last decade or so as shown in Table 3.1. The share of direct taxes has increased significantly from about 32 percent in 1999-2000 to 39 percent in 2006-07. In fact, the share jumped by almost 8 per cent in one-year in 2006-07. The rise in the share of direct taxes can largely be attributed to the introduction of withholding/presumptive tax regime in the early 90s and in 2006-07 to improved voluntary compliance. More than half of the direct tax revenues are presently generated as withholding/presumptive taxes. Within indirect taxes, there have been significant changes in the importance of different taxes. The contribution of excise duties has declined sharply while that of sales tax has risen, as the latter substitutes the former. Import duties have virtually stagnated due to the decline in tariff rates which were brought down from a maximum level of 35 percent to 25 percent in an effort to liberalize trade.

| Year | Tax Revenues Rs Billion | Direct Taxes | | Excise Duties | | Imports Duties | | Sales Tax | |
|---------|-------------------------------|---------------|--------------|---------------|--------------|----------------|--------------|---------------|--------------|
| | | Rs Billion | Share (%) | Rs Million | Share (%) | Rs Million | Share (%) | Rs Million | Share (%) |
| 1999-00 | 347 | 113 | 32.5 | 56 | 16.1 | 62 | 17.8 | 117 | 33.6 |
| 2000-01 | 392 | 125 | 31.8 | 49 | 12.5 | 65 | 16.6 | 154 | 39.1 |
| 2001-02 | 404 | 143 | 35.3 | 47 | 11.7 | 48 | 11.8 | 167 | 41.2 |
| 2002-03 | 461 | 152 | 33.0 | 45 | 9.7 | 69 | 14.9 | 195 | 42.4 |
| 2003-04 | 521 | 165 | 31.7 | 46 | 8.7 | 91 | 17.5 | 219 | 42.1 |
| 2004-05 | 590 | 183 | 31.1 | 53 | 9.0 | 115 | 19.5 | 239 | 40.4 |
| 2005-06 | 713 | 225 | 31.5 | 55 | 7.7 | 138 | 19.4 | 295 | 41.3 |
| 2006-07 | 847 | 334 | 39.4 | 72 | 8.5 | 132 | 15.6 | 309 | 36.5 |

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2006-07.

Table 3.2 gives the overall and individual tax-to-GDP ratios of federal taxes collected by Federal Board of Revenue (FBR), which constitute over 90 percent of the tax revenues in the country. The table clearly reveals the lack of elasticity of some FBR taxes. The tax-to-GDP ratio of income tax and sales tax has risen, that of customs duty has remained constant while that of excise duty has fallen. Clearly there is need to understand these changes, which we attempt in the next section by decomposing the tax-to-GDP ratio into its two key components- tax-to base and base-to GDP ratios.

TABLE 3.2
TAX-TO-GDP RATIO, 1999-00 TO 2006-07

| Year | Direct Taxes | Excise Duties | Customs Duties | Sales Tax | Total Indirect Taxes | Total Taxes |
|----------|--------------|---------------|----------------|-----------|----------------------|-------------|
| 1999-00 | 3.0 | 1.5 | 1.6 | 3.1 | 6.1 | 9.1 |
| 2000-01 | 3.0 | 1.2 | 1.5 | 3.6 | 6.4 | 9.3 |
| 2001-02 | 3.2 | 1.1 | 1.1 | 3.7 | 5.9 | 9.1 |
| 2002-03 | 3.1 | 0.9 | 1.4 | 4.0 | 6.3 | 9.4 |
| 2003-04 | 2.9 | 0.8 | 1.6 | 3.9 | 6.3 | 9.2 |
| 2004-05 | 2.8 | 0.8 | 1.8 | 3.7 | 6.3 | 9.1 |
| 2005-06 | 3.0 | 0.7 | 1.8 | 3.9 | 6.4 | 9.4 |
| 2006-07B | 3.8 | 0.8 | 1.5 | 3.6 | 5.9 | 9.7 |

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2006-07.

Direct Taxes

Using non-agricultural GDP as the tax base, we have decomposed the buoyancy of direct taxes into its components, as shown in Table 3.3. The rise in the tax-to-GDP ratio is a combined consequence of both a rise in tax-to-tax base and base-to-GDP ratios. The former is also referred to as the effective tax rate. The tax base effect appears to be large, as indicated by the 7 percentage point increase in the tax base-to-GDP ratio. A high growth momentum was witnessed during the period, 1999-00 to 2005-06, when this ratio rose rapidly. Thereafter there was a clear slow down. In contrast, the effective tax rate showed a decline of 0.4 percent during 1999-2000 to 2005-06. Beyond this, the effective rate has shown a sharp increase of 1.1 percent.

What explains the decline in the effective rate of direct taxes in the first half of the decade? The answer can be found in the movement of statutory rates, which have tended to decline. The marginal rates of personal income tax and the corporate tax rates have generally been brought down over the period. For instance, corporate tax rates on banking companies declined from over 50 percent to 35 percent. Similarly, corporate tax rates on private companies declined by 10 percentage points and personal income tax rate for highest slab declined from 35 percent to 20 percent. Clearly these modifications disproportionately benefited the upper income groups.

TABLE 3.3
BOUYANCY OF DIRECT TAXES
TAX-TO-GDP, TAX-TO-TAX BASE AND
TAX BASE-TO-GDP RATIOS
1999-2000 TO 2006-07

| Years | Tax-to-GDP Ratio | Tax Base-to-GDP Ratio | Tax-to-Tax Base Ratio |
|----------|------------------|-----------------------|-----------------------|
| 1999-00 | 3.0 | 69.0 | 4.3 |
| 2000-01 | 3.0 | 70.7 | 4.2 |
| 2001-02 | 3.2 | 71.4 | 4.5 |
| 2002-03 | 3.1 | 71.3 | 4.4 |
| 2003-04 | 2.9 | 72.4 | 4.0 |
| 2004-05 | 2.8 | 74.0 | 3.8 |
| 2005-06 | 3.0 | 75.7 | 3.9 |
| 2006-07B | 3.8 | 76.0 | 5.0 |

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2006-07.

Excise Duty

The tax base of excise duty consists primarily of value added in large scale manufacturing. Major revenue contributors include petroleum products, cigarettes, sugar, cement, etc. During the early 90s, the tax net of excise duty was extended to cover services like banking, telephones, electricity and professional services. As such, the tax base for excise duty has been extended to include value added in finance and insurance, and transport and communications.

The tax base for excise duties is large and fast growing as indicated by almost an 8 percentage point improvement in the tax base-to-GDP ratio as shown in Table 3.4. The slow growth in revenues is largely explained by the declining effective tax rate. This is essentially a reflection of, first, incomplete adjustment of the tax rates to inflation, as the duty continues to be levied at specific rates on certain items and, second, the gradual replacement of excise duties by sales tax.

Customs Duty

The tax base for customs duty is the value of dutiable imports, that is, total value of imports minus the value of exempt items like food, fertilizer and pharmaceuticals. Table 3.5 shows that the tax base-to-GDP ratio varies year-to-year depending, in particular, on fluctuations in international prices. But 2004-05 onwards, the base-to-GDP ratio appears to be noticeably higher. This is a reflection of the increase in POL prices and more importantly a higher demand for imports of consumer durables like automobiles and capital goods due to the prevailing boom in the economy and greater buoyancy in the manufacturing sector.

TABLE 3.4
BOUYANCY OF EXCISE DUTY
TAX-TO-GDP, TAX-TO-TAX BASE AND
TAX BASE-TO-GDP RATIOS
1999-2000 TO 2006-07

| Years | Tax-to-GDP Ratio | Tax Base-to-GDP Ratio | Effective Tax Rate |
|----------|------------------|-----------------------|--------------------|
| 1999-00 | 1.5 | 22.8 | 6.4 |
| 2000-01 | 1.2 | 24.7 | 4.7 |
| 2001-02 | 1.1 | 24.9 | 4.3 |
| 2002-03 | 0.9 | 25.4 | 3.6 |
| 2003-04 | 0.8 | 25.9 | 3.1 |
| 2004-05 | 0.8 | 27.9 | 2.9 |
| 2005-06 | 0.7 | 30.3 | 2.4 |
| 2006-07B | 0.8 | 30.7 | 2.7 |

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2006-07.

TABLE 3.5
BOUYANCY OF CUSTOMS DUTY
TAX-TO-GDP, TAX-TO-TAX BASE AND
TAX BASE-TO-GDP RATIOS
1999-2000 TO 2006-07

| Years | Tax-to-GDP Ratio | Tax Base-to-GDP Ratio | Effective Tax Rate |
|----------|------------------|-----------------------|--------------------|
| 1999-00 | 1.6 | 8.4 | 19.1 |
| 2000-01 | 1.5 | 8.7 | 17.8 |
| 2001-02 | 1.1 | 9.0 | 12.0 |
| 2002-03 | 1.4 | 9.5 | 14.8 |
| 2003-04 | 1.6 | 11.3 | 14.3 |
| 2004-05 | 1.8 | 15.8 | 11.2 |
| 2005-06 | 1.8 | 15.1 | 12.1 |
| 2006-07B | 1.5 | 14.5 | 10.5 |

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2006-07.

The effective tax rate of customs duty has fallen sharply during the current decade. The tax-to-tax base ratio in 2006-07 was almost half of the level in 1999-2000. This is primarily a consequence of the substantial cascading down of import tariffs in an effort to liberalize trade in the country. Maximum tariff rates have been brought down from 35 percent to the current level of 25 per cent. Compared internationally, these tariffs are on the lower side. The question that arises is whether Pakistan 'did too much, too quickly' in the context of tariff reduction?

Sales Tax

Sales tax is levied at two stages in Pakistan- at the stage of import and domestic production respectively. During the decade of the 90s, it acquired the characteristics of a value added tax. Therefore, the tax base for the tax is the value of dutiable imports plus revenue from import duty plus value added in large-scale manufacturing. In recent years, there has been a major broad basing of the tax, which has increasingly substituted for customs duty, excise duty and the petroleum development surcharge. The size of the tax base has, therefore, been accordingly extended.

The sharp rise in the tax base is captured by the rapidly increasing tax base-to-GDP ratio (See Table 3.6). Magnitude of the tax base-to-GDP ratio shows a sharp increase, of roughly ten percentage points during 2000-07, primarily due to rapid growth in taxable imports and expansion of the tax base. Effective tax rates, on the other hand, exhibits a somewhat declining trend in the last few years. Reasons for this need to be explored.

In conclusion, the overall constancy or minimal increase in the tax to GDP ratio during the current decade is essentially because the gains due to the expanding tax bases were almost neutralized by the decline in effective tax rates (see Table 3.7). The relative expansion has raised the tax-base-to-GDP ratio by 2.8 percent, but the decline in effective rates implied a fall in the tax-to-base ratio of 2.2 percent. This analysis has clear implications for the resource mobilization strategy for the forthcoming budget.

Essentially, the losses in effective tax rates have to be regained through more effective exploitation of the tax bases. This takes us to another key area requiring reform in tax policy in Pakistan, exemptions and concessions allowed under existing tax laws, which erode the tax base.

TABLE 3.6
BOUYANCY OF SALES TAX
TAX-TO-GDP, TAX-TO-TAX BASE AND
TAX BASE-TO-GDP RATIOS
1999-2000 TO 2006-07

| (%) | | | |
|----------|------------------|-----------------------|--------------------|
| Years | Tax-to-GDP Ratio | Tax Base-to-GDP Ratio | Effective Tax Rate |
| 1999-00 | 3.1 | 26.3 | 11.6 |
| 2000-01 | 3.6 | 27.8 | 13.1 |
| 2001-02 | 3.7 | 26.5 | 14.1 |
| 2002-03 | 4.0 | 27.0 | 14.8 |
| 2003-04 | 3.9 | 30.6 | 12.7 |
| 2004-05 | 3.7 | 36.7 | 10.0 |
| 2005-06 | 3.9 | 37.8 | 10.3 |
| 2006-07B | 3.6 | 36.0 | 9.9 |

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2006-07.

TABLE 3.7
DECOMPOSITION OF THE CHANGES
IN TAX-TO-GDP RATIO

| (% of GDP) | | | |
|---------------------------|----------------------------|-------------|-------------|
| Tax | Change in Tax-to-GDP Ratio | Base Effect | Rate Effect |
| 1999-00 to 2006-07 | | | |
| Direct Taxes | 0.9 | 0.3 | 0.6 |
| Excise Duty | -0.6 | 0.3 | -0.9 |
| Customs Duty | -0.1 | 0.9 | -1.0 |
| Sales Tax | 0.5 | 1.3 | -0.8 |
| Total Taxes | 0.7 | 2.8 | -2.2 |

Source: Estimates Based on Taxes Data from SBP website and GDP data from Economic Survey 2006-07.

TAX EXPENDITURES

Tax expenditures quantify the revenues foregone due to exemptions and concessions allowed under tax laws. Tax expenditures are usually justified on the grounds that they promote certain social or economic goals. They include special tax relief (through deductions, credits, exemptions, etc.) to encourage certain types of behavior by taxpayers or support taxpayers in certain circumstances. Of course, some such concessions find their basis not only in economic rationale but are allowed under pressure from strong local lobbies and vested interest groups. The most dramatic example of this is the continued exemption of capital gains from income taxation especially at a time when massive unearned incomes were accruing in the economy to the relatively well-off, due to the exceptional buoyancy of the stock market and property values. The Pakistan Economic Survey [2006-07] has admitted that the exemption alone of capital gains on stocks from income taxation cost the economy annually about Rs 112 billion, almost 1½ percent of the GDP. Other tax expenditures aggregate to Rs 186 billion as shown in table 3.8. These include import duty exemptions on import of sugar, machinery and other items, income tax holiday to independent power producers and sales tax exemption on items like pharmaceuticals and tractors etc. Notice the sharp increase in the cost of these exemptions to the economy.

| Type of Tax | 2000-01 | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 | 2006-07 |
|--------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Income Tax | 11.20 | 10.20 | 6.80 | 6.15 | 4.60 | 4.65 | 123.07 |
| Sales Tax | 13.20 | 8.60 | 10.39 | 9.25 | 7.85 | 8.65 | 12.00 |
| Customs Duties | 6.20 | 5.42 | 4.71 | 4.40 | 12.38 | 8.21 | 50.52 |
| Central Excise | 0.50 | 0.50 | 0.01 | 0.00 | 0.02 | 0.40 | 0.50 |
| TOTAL | 31.10 | 24.72 | 21.91 | 19.80 | 24.85 | 21.91 | 186.09 |

Source: Pakistan Economic Survey

The list of exemptions can be extended to include accelerated depreciation allowances, lack of coverage of sales tax on wholesale and retail trade, effective exemption of a large number of services from GST, effective zero-rating of domestic sales of export-oriented sectors, etc. If all these concessions and erosions of the tax base are accounted for then the aggregate tax expenditure in the federal tax system could reach a whopping Rs 300 billion or so. This is equivalent to almost 3½ percent of the economy and about one thirds of revenues actually collected.

The Federal Board of Revenue has made some moves for improving the quality of tax administration like facilitating the process of self-assessment, simplification of processes, establishment of large tax payer units, computerization, etc. But, perhaps due to lack of political will, there has been limited effort to extend the tax net to hard-to-tax sectors like domestic trade, small-scale manufacturing and services, especially those provided in the informal sector, private companies and incomes of the self-employed. The share of withholding/presumptive taxes has remained high at almost 57 percent of direct tax revenue. The share of voluntary payments is still low at 39 percent.

Overall, a lax tax policy coupled with a reluctance to make tax administration more effective has implied that the tax-to-GDP ratio has remained stagnant or improved only marginally in the economy during a period of rapid economic growth. Given the emerging resource constraints it is important now to remove the slack in the tax system especially by taxing the incomes or consumption of sectors and households with greater ability-to-pay. This takes us to the subject of potential proposals for resource mobilization which budget makers in Islamabad must be actively evaluating at this point of time.

TAXATION PROPOSALS

Tax proposals for the federal budget 2008-09, will have to be designed not only to mobilize more revenues for the public exchequer, but also to generate them in a way that the burden of taxes is not on the lower income groups. We present below some such progressive tax proposals.

In income taxation, given the high level of inflation during the fiscal year 2007-08, a strong case exists for lowering the tax burden on lower income groups. It is suggested that that tax exemption limit should be enhanced from Rs 150,000 to Rs 200,000 for salaried and from Rs 100,000 to Rs 150,000 for non-salaried tax payers. Simultaneously, incidence of the tax has to be enhanced to make the structure more progressive for high incomes above Rs 100,000 per month.

Currently, more than half of income tax revenues are collected under the withholding/ presumptive tax regime, which strictly speaking, acquires an indirect tax character. We suggest that effort needs to be made to gradually withdraw the presumptive taxes and replace them by income tax collection based on self assessment and tax audit. We suggest taxation of real estate which has historically been a "tax haven" for speculators who have diverted capital from productive activities. There is a strong case for the introduction of capital Gains Tax on real estate by the provincial governments, which could yield Rs 10 billion.

One other progressive proposal which can have favorable impact on the twin deficit is imposition of regulatory duty on non essential imports. We suggest imposition of a regulatory duty, say 10 percent, on luxury good imports. This proposal will not only mobilize extra revenues of upto Rs 30 billion, to partially finance the relief package for the poor, discussed in the subsequent section, it will also bring down the growing level of luxury imports in the country.

Other tax proposals which also focus on 'taxing the undertaxed' are summarized below:

- (i) *A Broad-based Sales Tax on Services:* Many services cater primarily to the demand of upper income groups and to corporate entities. Their revenue contribution is very limited. Introduction of a broad-based sales tax could follow the lines of development of the service tax in India. The number of taxed services is 80 and the number of tax assesseees has approached one million in India. The yield has crossed one percent of the GDP, with a tax rate of 12 percent. It is estimated that introduction of such taxes in Pakistan would lead to additional revenue of Rs 25 billion initially.

(ii) *Higher Tax on Private Companies:* Rate of corporate tax on private companies may be enhanced which could result in additional revenue of Rs 10 billion.

(iii) *Higher Property Tax:* The property tax is levied by provincial governments. Currently the assessed-to-market rental values are very low and could be enhanced significantly.

Altogether, the above menu of proposals could yield additional revenues of between Rs 70 to 85 billion. They have been identified from the viewpoint of balancing the sectoral incidence of taxes and collecting more from those with the greater ability-to-pay. They will help in reducing perceptions of inequality among the people.

SECTION IV

OIL PRICING POLICIES

One of the most difficult policy choices in the Budget of 2008-09 is determination of the appropriate level of prices of petroleum products in response to the sharp jump in international oil prices, which have virtually doubled over the last one year. The lack of adjustment of domestic POL prices last year to this development led to a large increase in the oil subsidy which is reflected in the budget as deferred claims of OMCs. According to the Finance Minister's statement of the 9th of April, this liability has increased to Rs 153.6 billion in 2007-08 as compared to the original provision of only Rs 15 billion. Therefore, in the absence of a clear policy on linking domestic POL prices to international prices, the implied oil subsidy has emerged as one of the principal reasons why the fiscal deficit in 2007-08 has risen so sharply in relation to the original target set at the beginning of the financial year.

The issue of domestic POL prices not only has significant fiscal policy implications but could also impact on the overall price level in the economy, on the level of competitiveness of Pakistani industry and on the level of energy demand in the economy which would determine the size of the oil import bill that has made a major contribution to the deterioration in the balance of payments position of the country. Therefore, the setting of domestic POL prices is confronted with serious policy tradeoffs which have to be carefully considered by the government.

The objective of this section is to identify first the extent of price adjustment that has been made since March 1 2008, after a period, since January 2007, when prices remained unchanged despite underlying increase in international prices. The apparent explanation for this is the reluctance to raise prices prior to general elections. We derive on an annualized basis the extent to which the oil subsidy has been reduced effectively in 2008-09 due to the recent price increases.

The next part of the analysis relates to the estimation of the present level of subsidy (as of 31st May 2008) on individual POL products and the extent of taxation, principally the general sales tax. This enables derivation of the projected net subsidy bill in 2008-09 on the basis of currently prevailing prices.

The Prime Minister has apparently indicated in his meeting with the Vice President of the World Bank on May 27 2008¹ that the government has decided to eliminate the subsidy on POL products in a phased manner in 2008-09, in order especially to relieve the pressure on the budget. This is a major policy decision. We derive the extent to which prices will have to be raised in order to achieve this goal of subsidy elimination. Finally, some of the broader implications of the POL price enhancements are indicated.

¹ *Dawn* headlines of May 28 2008. There has been a subsequent retraction on May 29.

Recent Increases in POL Prices

The Oil and Gas Regulatory Authority (OGRA) makes recommendations to the government on the level of POL prices (except high speed diesel oil) on a fortnightly basis. After a gap of over one year the first price increase was announced on the 1st of March 2008 at the fag end of the tenure of the caretaker government, followed by another increase on the 16th of March. Thereafter, following the induction of the new government, two more price increases have been announced on the 18th of April and 1st of May respectively.

Table 4.1 gives the resulting cumulative price increase since 1st of March. It is Rs 15.11 per litre in the case of motor spirit/petrol, Rs 12.40 in high speed diesel oil (HSD), Rs 12.02 in light diesel oil (LDO) and Rs 6.21 in kerosene oil. These are fairly substantial increases, over 30 percent on average. Therefore, a significant effort has been made recently to respond to the rising international prices, although the process is incomplete.

| | (Rs per litre) | | | | |
|--------------------------------|----------------|---------------|---------------------|-------------|-------------|
| | HOBC | Petrol | Kerosene Oil | HSD | LDO |
| 17 th February 2008 | 64.88 | 53.70 | 35.23 | 37.73 | 32.57 |
| 1 st March 2008 | 69.88 | 58.70 | 38.73 | 41.23 | 36.07 |
| 16 th March 2008 | 74.77 | 62.81 | 41.44 | 44.13 | 38.59 |
| 18 th April 2008 | 77.77 | 65.81 | 41.44 | 47.13 | 41.59 |
| 1 st May 2008 | 80.77 | 68.81 | 41.44 | 50.13 | 44.59 |
| Cumulative % Increase | 24.5 | 28.1 | 17.6 | 32.9 | 36.9 |

Source: OGRA

The reduction in subsidy on an annualized basis in 2008-09 is quite sizeable at over Rs 151 billion. The biggest saving is in the case of high speed diesel oil of almost Rs 118 billion, due largely to the much greater volume of consumption of this product. The next big reduction in subsidy is in the case of motor spirit of Rs 29 billion. Credit must be given to both the caretaker and the newly elected governments for having announced the relatively large price increases which imply significant savings for the forthcoming budget. During the last quarter of fiscal year 2007-08 these increases should reduce the claims of OMCs by Rs 38 billion.

However, there has been a visible jump in the monthly rate of inflation during the months of March and April 2008. The Consumer Price Index has risen by over 3 percent each month as compared to the average monthly rate of inflation of 1.1 percent in the previous six months. Part of this jump in the rate of inflation is due to the direct and indirect effects of higher POL prices.

Oil Subsidy in 2008-09

The present pricing structure of POL products is highlighted in Table 4.2. The international fob price is based on prices prevailing internationally between May 14 and May 31 2008, while the import parity price has been worked out at the exchange rate of Rs 66.36 per dollar. Given the outlook of rising oil prices and the depreciation beyond the assumed value already of the rupee, it is likely that the import parity prices for 2008-09 are somewhat understated.

| | International FOB price* (\$ per barrel) | Import Parity Price (Rs/Litre) | Inland Freight + OMC Margin + Dealers Margin | Tax GST + PDS | Price (with no subsidy) | Current Price | Subsidy |
|---------------------|--|--------------------------------------|--|------------------|-------------------------------|------------------|---------|
| | | | | | | | |
| HSD | 144.35 | 68.81 | 5.01 | 6.54 | 80.36 | 60.13 | 30.23 |
| Motor Spirit/Petrol | 118.40 | 51.63 | 7.40 | 9.78 | 68.81 | 68.81 | 0.00 |
| Kerosene Oil | 144.67 | 62.63 | 5.54 | 5.41 | 73.58 | 41.44 | 32.14 |
| Light Diesel Oil | 135.37 | 58.17 | 4.46 | 5.82 | 68.45 | 44.59 | 23.86 |
| HOBC | 121.10 | 52.76 | 12.78 | 15.23 | 80.77 | 80.77 | 0.00 |

*OGRA calculations for May 15 – May 31 2008 and exchange rate of Rs 66.3646 per \$.

According to Table 4.2, government collects GST at 15 percent on all petroleum products. In addition, there is a small petroleum development levy on motor spirit and HOBC. Given the price buildup it appears that high speed diesel oil, light diesel oil and kerosene oil continue to receive large subsidies of Rs 30.23, Rs 23.86 and Rs 32.14 per litre respectively. Motor spirit and HOBC receive no subsidy.

The estimated subsidy bill for 2008-09 in gross terms (after covering taxes) is derived in Table 4.3. It adds up to the massive amount of Rs 300 billion, just under 3 percent of the GDP. The bulk is on high speed diesel oil of over Rs 287 billion. Therefore, any policy of elimination of subsidy in 2008-09 will essentially involve raising the price of HSD. It is likely that government will continue the policy of subsidization of kerosene oil, consumed primarily by the lower income groups, and light diesel oil, which is largely used in running tubewells for agricultural purposes.

| | Subsidy (per litre) | Annual Consumption (million litres) | Subsidy Bill (million Rs) | Tax Revenue (million Rs) |
|----------------------|------------------------|--|------------------------------|-----------------------------|
| HSD | 30.23 | 9502.9 | 287272 | 62148 |
| Motor Spirit | 0 | 1952.3 | | 19093 |
| Kerosene Oil | 32.14 | 286.7 | 9214 | 1551 |
| Light Diesel Oil | 23.86 | 156.0 | 3722 | 907 |
| HOBC | 0 | 17.4 | | 265 |
| TOTAL | | | 300208 | 83964 |
| Net Subsidy = | | | 216244 | |

The projected revenue generation (at current prices), primarily from the general sales tax, is about Rs 84 billion in 2008-09. Therefore, the estimated subsidy bill in net terms on petroleum products in 2008-09 is approximately Rs 216 billion, almost 2 percent of the GDP. However, as indicated above, if oil prices continue rising (already approaching \$ 130 per barrel of crude oil) and if the rupee continues to depreciate then the net subsidy bill could be even higher.

Subsidy Elimination

We now work out the implications of subsidy elimination (at current prices). Prior to doing this exercise, we discuss the issue of elimination of taxes on POL products, specifically the GST. It has been suggested that in the presence of subsidies there is no logic in the retention of taxes. This is apparently a rational argument. But there are two problems. First, there is no subsidy on motor spirit (and HOBC), an item largely consumed by upper income groups, and removal of GST on these products would represent an unnecessary loss of revenue of over Rs 19 billion and reduce the element of progressivity in the tax system. Second, the GST forms an important part of the federal divisible pool of revenues which is shared with the provinces. Withdrawal of GST from petroleum products would lead to a loss of transfers of as much as Rs 35 billion to the provinces. This is unlikely to be acceptable to the provincial governments, especially at a time when efforts are being made to strengthen the federation. On top of this, the elimination of GST on petroleum products can reduce the already low tax-to-GDP ratio by 0.8 percent of the GDP.

Based on the assumption that GST will continue to be levied, we derive below the required price increase to eliminate the subsidy.

| PRICE INCREASE FOR ELIMINATION OF SUBSIDY | | | | (Rs / iitre) |
|---|---------------|-----------------------|-------------------|--------------|
| | Current Price | Price with no subsidy | Absolute increase | % increase |
| HSD | 50.13 | 84.88 | 34.75 | 69.3 |
| Kerosene Oil | 41.44 | 78.38 | 36.94 | 89.1 |
| Light Diesel Oil | 44.59 | 72.01 | 27.42 | 61.5 |

The results are striking. In the case of HSD, the product which accounts for bulk of the subsidy bill, the price would have to be increased by about Rs 34.75 per litre, equivalent to a 69 percent increase on the present price. As mentioned earlier, prices of kerosene oil and light diesel oil are unlikely to be changed significantly, implying a continuing subsidy of about Rs 13 billion.

The basic question is what are the implications of a big increase in the price of HSD? In order to soften the adjustment we have done a simulation of price increases of an equal magnitude in HSD and motor spirit (and HOBC) such that the required price in the former is reduced by generation of more revenues (in the form of petroleum development levy) from the former. Results of the simulation are that an increase of Rs 20 per litre is necessary in the price of HSD, motor spirit and HOBC for elimination of the overall net subsidy on petroleum products. The next section traces the likely broader implications on the economy of these price increases.

Impact of Price Increases

The enhancement especially in the price of high speed diesel oil has wide ranging impact on prices throughout the economy because of the associated increase in the costs of goods transportation or in production costs. There is also a direct impact on households in the form of higher transport fares both for inter-city and intra-city passenger transportation by road or by rail.

SPDC has undertaken earlier in 2000 a study on *Economic Modeling of Inter-fuel pricing* which estimates via an input-output matrix the impact of change in HSD price on prices in various sectors of the economy.

If the oil subsidy is to be eliminated then we have suggested that the price of HSD needs to be raised by 20 Rs per litre from the present level, implying a cumulative increase of 86 percent over the price prevailing prior to March 1 2008. We use the SPDC model to identify which sectors are likely to be impacted most by this price increase and by how much. Results are given below in Table 4.4.

| Sector | % Price Increase | Sector | % Price Increase |
|-------------------------------------|------------------|-----------------------------------|------------------|
| Road Transport | 11 | Fisheries | 4 |
| Rail Transport | 11 | Chemicals | 2 |
| Cement | 8 | Mining | 3 |
| Water works and supply; electricity | 5 | Construction and land improvement | 3 |
| Basic metal products | 4 | Cotton cloth | 2 |

Therefore, the price impacts are sizeable, ranging from 11 percent in the case of rail and road transport to 2 percent in the case of industry producing cotton cloth.

The overall impact on households, both direct and indirect, is derived below in Table 4.5.

| Households | Rural | Urban |
|---------------------------|------------|------------|
| 1 st Quartile* | 2.4 | 2.4 |
| 2 nd Quartile | 2.1 | 2.3 |
| 3 rd Quartile | 1.9 | 2.1 |
| 4 th Quartile | 1.3 | 1.5 |
| Total | 1.6 | 1.9 |

* by level of income

Therefore, the effective loss in real income of households due to the rise in HSD price approaches 2 percent in urban areas and is somewhat less in rural areas, due primarily to less demand for transportation. More importantly, the impact is *regressive*, at almost 2.5 percent for the poorest households. In fact, the price increase could wipe out over one year's gain in real income for the poor due to GDP growth.

Turning now to the demand side effects, the SPDC study has derived the price elasticities of demand as follows:

High speed diesel oil : -0.121
Motor spirit : -0.223

This implies that a 86 percent increase in the HSD price could translate into a 10 percent reduction in demand. This could lead to a contraction in oil import by about \$ 850 million. The simultaneous increase in price of motor spirit of 65 percent could yield further savings in the import bill of \$ 200 million. Therefore, the combined reduction in the cost of oil imports is in excess of \$ 1 billion.

Policy Recommendations

The above analysis has demonstrated that elimination of the oil subsidy in 2008-09 would involve primarily an increase in the price of HSD by almost 35 Rs per litre. This is not only a massive increase which would cause dislocation in the transport

sector and jeopardize the process of growth but also the inflationary impact is sizeable, with a relatively higher burden falling on the poor.

Therefore, we recommend the following:

- (i) The elimination of the oil subsidy should be phased over a period of *two* years and be implemented in small steps periodically
- (ii) Equal absolute increase in price per litre of Rs 10 be resorted to in 2008-09 of HSD, motor spirit and HOBC.

A staggered process of adjustment will reduce the probability of severe protests from people at large.

Elimination of the subsidy by half in 2008-09 will mean that the net subsidy on petroleum products will remain at about Rs 108 billion. Efforts will have to be made in the forthcoming budget to cover this through expenditure-switching from other heads and overall higher resource mobilization.

SECTION V

RELIEF FOR THE POOR

Social Protection Programs in Pakistan

The growing macroeconomic stress, particularly the rising inflation and slow down in the growth momentum is bound to have a proportionately higher impact on the vulnerable segments of society. In fact, recent research on poverty consequences of the current economic situation undertaken by IPP (2008) shows that whatever gains in poverty reduction were achieved in the earlier part of the decade have largely been washed out. "The evidence shows that after a decline in poverty during the period, 2000-01 to 2005-06, the poverty levels have increased to neutralize the earlier gains, as food inflation accelerated and GDP growth declined. For the Musharraf period as a whole (1999-2008), the percentage of population below the poverty line increased from 30 percent in 1998-99 to almost one-thirds currently, with an additional 12 million people being pushed into poverty during this period. The central policy lesson of the economic performance of the Musharraf regime is that poverty levels increased in spite of high GDP growth in later years because of the fact that growth was heavily tilted in favor of the rich and high food inflation was not controlled. The analysis highlights the importance of controlling food inflation and at the same time bringing about the institutional changes necessary for pro-poor growth".

As the process of adjustment continues, vulnerable groups are likely to be further burdened. Therefore along with achieving stabilization, the budget for 2008-09 will also have to focus on a package of relief for the poor. There is need to ensure that the aggregate demand management of the economy and the withdrawal of subsidies does not lead to a sharp rise in poverty. Strong social safety nets will have to be put in place to ensure that there is adjustment with a human face. In particular, food security of the poor will have to be protected to avoid a big fall in nutrition levels. This can best be achieved by a combination of various types of social safety nets so that different categories of vulnerable groups are adequately targeted. Currently, Pakistan is spending only about 0.1 percent of GDP on various safety net programs. There clearly is a strong case for increasing this proportion manifold.

To be effective, social safety nets must be designed on the basis of an understanding of the extent and nature of poverty. They must respond to the needs of those groups most likely to be affected by the process of structural adjustment. There are generally at least three types of programs. The first is long-term financial assistance to those who are unable, more or less, permanently, to provide for themselves through work, the chronically poor. This group includes handicapped and disabled people, orphans, widows, etc. The second type of program is designed for those who are able to work but whose incomes are low and irregular. The goal here is to smooth income and consumption in slack seasons.

Of great importance in the present context of Pakistan is the third type of programs. These are for people normally capable of earning adequate incomes but who are temporarily unable to earn an adequate living because of shocks or downturn in the economy such as, in Pakistan. Such programs provide short-term assistance (such

as unemployment benefits), promote employment through public works programs and offer micro-credit for income generation.

Transfers to people living in poverty can be in the forms of cash transfers or in-kind transfers like food subsidy. What are the principal forms of social safety nets in Pakistan? In Pakistan, the principal form of cash transfer to the poor is through the publicly administered Zakat system (along with private charitable contributions). Cash transfers have acquired importance following the introduction of the food subsidy scheme through the Bait-ul-Maal. A traditional social safety net has been the generalized wheat subsidy, a primary source of expenditure for both federal and provincial governments.

In the area of social security, the federal government operates an employees' old age benefits insurance scheme through a semi-autonomous institution, the Employees' Old Age Benefits Institution (EOBI). It is a compulsory federal social insurance scheme for private sector workers mostly in the organised sector. In addition, the government is currently in the process of implementing livelihood schemes announced by the newly-elected Prime Minister in his maiden speech to the nation. We will discuss these later.

We next turn to an analysis of the various forms of social safety nets operating in Pakistan. Such an analysis becomes important as the country seriously needs a significant expansion in financial resources allocated for this purpose. We start by first laying down the criteria for evaluating different types of safety nets and then see how each safety net fares on the criteria.

Criteria for Evaluation of Social Safety Nets

SPDC (2000) developed a number of criteria to evaluate the effectiveness of various safety nets for the poor. These include:

- *Targeting efficiency*: the extent to which program expenditure actually reaches the poor rather than the relatively well-off segments of the population. The programs which promote self targeting by the poor are ranked higher under these criteria. For instance, a low wage rate in public works program has potential to attract unemployed workers only and not to divert workers from other jobs. Similarly, provision of subsidy for a low quality of food grain or rice, has the potential to exclude relatively better off sections of the population and attract only relatively low income households.
- *Extent of program coverage*: the proportion of poor households which receive benefits from the program.
- *Degree of ease of access*: the level of transaction costs incurred by eligible households in accessing the program, as indicated by the simplicity and transparency of procedures, documentation requirements and level of discretion with program officials in the disbursement of intended benefits. Programs with ease of access score high on this criterion.
- *Percentage of program expenditure dedicated to benefits*: the extent to which a program's budget is spent on beneficiaries rather than on administrative costs. Programs with low administration costs get higher ranking in this.

- *Income equivalence of transfer*: the extent to which the transfer is equivalent to a cash transfer and does not distort consumption choices of the beneficiaries. For example, an open – ended price subsidy on a good or service may lead to over-consumption and waste;
- *Absence of negative incentive effects*: potential to distort economic incentives. Anti-poverty interventions can change behavior. For instance, an unemployment allowance may reduce motivation for job search. In contrast, school voucher schemes and school food programs can provide incentives to raise school enrolment and reduce dropout rates;
- *Extent of self financing*: Programs which raise funding through well-defined and earmarked sources are likely to be more sustainable fiscally. A program is considered more secure if it is supported by higher income households rather than general budgetary sources which are vulnerable to inflation and cut-backs when the fiscal position worsens, as inherited by the newly elected coalition government since March 2008;
- *Degree of independence from private transfers*: the extent to which transfers displace private sector contributions. For instance, compulsory deduction of Zakat may lead to, more or less, matching reduction in voluntary charitable contributions;
- *Degree of impact on development*: programs have potential to contribute for development either directly or indirectly. A public works program, for example, could lead to the creation of improved irrigation or farm-to-market roads and thereby contribute to higher agricultural productivity. Similarly, a school voucher scheme may lead to improve participation and human development.

We evaluate the different social safety nets on these criteria.

Pakistan *Bait-ul-Maal* (PBM)

Pakistan *Bait-ul-Maal* (PBM) was established in 1992 under the provision of the Pakistan *Bait-ul-Maal Act*, 1991. It is administered by an autonomous board of management consisting of chairman, five non-official members (appointed by the federal government) and three official members. Financial assistance under the heads of different programs is provided through provincial and district

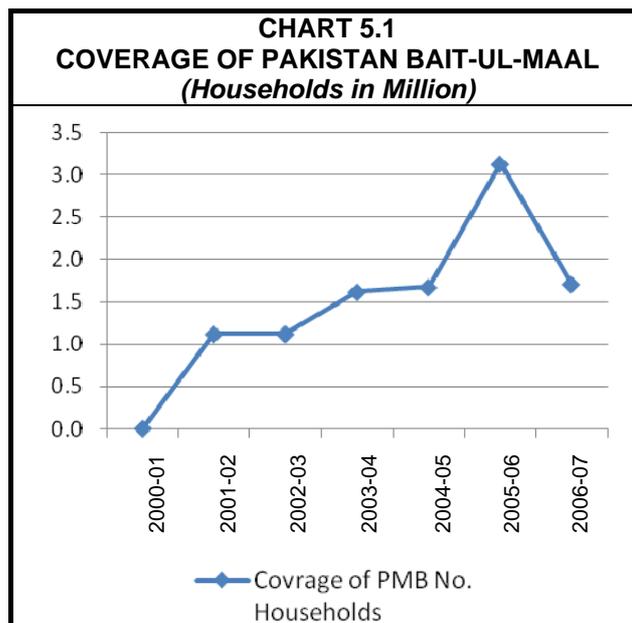
branches. These branches operate independently from Zakat structure and social welfare offices. It has more rural presence than the urban areas.

PBM has developed a management information system (MIS) to record basic information on program beneficiaries – which makes targeting more effective and monitoring of progress easier. Its overall administrative costs are 4 percent of total resources.

| Year | Rs. (billion) | GDP % |
|---------|------------------|-------|
| 2001-02 | 2.23 | 0.05 |
| 2002-03 | 2.24 | 0.05 |
| 2003-04 | 3.16 | 0.06 |
| 2004-05 | 3.27 | 0.05 |
| 2005-06 | 3.80 | 0.05 |
| 2006-07 | 4.28 | 0.05 |

Source: Poverty Reduction Strategy Paper (PRSP), various annual reports.

The PBM is financed through budgetary allocations in the form of non-lapsable grants. Occasionally, it also receives small grants from the Central Zakat Fund, provincial and local governments. Its disbursement during last few years is shown in Table 5.1. Though PBM disbursements have increased in absolute terms over the years, it appears to be, more or less, fixed in relation to the GDP. This means that benefits of high growth in the economy are not passed down to the poor sections of the society in the form of larger bait-ul-maal transfers. Also, in periods when poverty is on the rise, adequacy of the program may become an increasing issue.



BOX 5.1
PROFILE OF BAAT-UL-MAAL PROGRAMS

Disbursement and coverage of different programs under PMB is given in the Table below. Food Subsidy Program (FSP) has remained a core of Pakistan Bait ul Maal. Food subsidy has been in operation in Pakistan since 1992 under different names: Food Stamp Scheme and *Atta Subsidy Scheme*. FSP started with an annual Budget of Rs. 2.5 billion. It is administered and monitored by Food Support Program Steering Committees at Federal, Provincial and district levels. The programme includes a transfer of Rs. 2400 per household biannually.

| | Pakistan Bait-ul-Maal Expenditures | | | | | | | |
|---|------------------------------------|---------------|------------------|---------------|------------------|---------------|------------------|---------------|
| | 2003-04 | | 2004-05 | | 2005-06 | | 2006-07 | |
| | No. Hholds | Rs. (Million) | No. Hholds | Rs. (Million) | No. Hholds | Rs. (Million) | No. Hholds | Rs. (Million) |
| Food Support Program(FSP) | 1,124,570 | 2,804 | 1,113,601 | 2,703 | 1,460,000 | 3,081 | 1,460,000 | 3,548 |
| Individual Financial Assistance(IFA) | 21,230 | 222 | 30,043 | 348 | 27,229 | 450 | 20,202 | 382 |
| National Centre for Rehabilitation of Child Labor | 9,060 | 80 | 11,040 | 112 | 13,440 | 139 | 15,006 | 204 |
| Vocational Training Centre | 2,286 | 10 | 9,212 | 24 | 13,156 | 71 | 193,981 | 51 |
| Institutional Rehabilitation (Grant to NGO's) | 456,965 | 43 | 506,680 | 83 | 1,615,938 | 97 | 17,516 | 94 |
| TOTAL | 1,614,111 | 3,159 | 1,670,576 | 3,270 | 3,129,763 | 3,838 | 1,706,705 | 4,279 |

Individual Financial Assistance (IFA) is the other major scheme in PBM. There are four type of assistance under *IFA*: subsistence; treatment for chronic diseases; education and rehabilitation.

Overall coverage of the PMB is shown in Chart-5.1. After the big jump in 2005-06, to over 3 million households, there was a decline in the subsequent year to only 1.7 million households. So, not only is the level of coverage low, it is also decreasing. The main reason for this low coverage is primarily lack of financial resources. A profile of PBM is presented in Box 5.1.

PBM performs well on a number of criteria as shown in table 5.3. It is the only scheme which provides targeted food subsidy to the poor. World Bank (2007) reports that 85 percent of PBM beneficiaries were poor. The other strong point of the program is the low, 4 per cent, cost of administration.

The coverage of PBM is low, particularly keeping in view the magnitude of poverty and increasing risk of food insecurity in the country. Another shortcoming of the program is its financial dependence on government's budgetary allocations –which are unreliable particularly at the time of economic downturn.

Based on the above criteria, PBM food support program gets 'high' score on four criteria relating to targeting efficiency, percentage of program expenditure dedicated to benefits, income equivalence of transfers, and degree of independence from private transfers. It performs poorly on two criteria, extent of self-financing, and the degree of impact of the program on the development. The four criteria on which PBM scores a 'medium' include extent of program coverage, degree of ease of access, adequacy of support and absence of negative incentives effects.

| Criteria | FSP (PBM) | Food subsidy (USC) | SUMMARY OF SCORES | | | |
|--|--------------|--------------------------|-------------------|----------|----------|-----------|
| | | | High | Medium | Low | Total |
| Targeting Efficiency | H | L | 2 | 0 | 1 | 3 |
| Extent of Program Coverage | M | L | 0 | 2 | 1 | 3 |
| Degree of Ease of Access | M | H | 1 | 2 | 0 | 3 |
| Share of Program Expenditure of Benefits | H | L | 2 | 0 | 1 | 3 |
| Adequacy of support | H | L | 2 | 0 | 1 | 3 |
| Income Equivalence of Transfers | H | M | 2 | 1 | 0 | 3 |
| Absence of Negative Incentives Effects | M | H | 2 | 1 | 0 | 3 |
| Extent of Self Financing | L | L | 0 | 1 | 2 | 3 |
| Degree of Freedom from Private Transfers | H | H | 2 | 1 | 0 | 3 |
| Degree of Impact on Development | H | L | 1 | 0 | 2 | 3 |
| SUMMARY OF SCORES | 31 | 20 | 14 | 8 | 8 | 30 |
| High | 6 | 3 | 14 | | | |
| Medium | 3 | 1 | 8 | | | |
| Low | 1 | 6 | 8 | | | |
| Total | 10 | 10 | 30 | | | |

H = High (4); M = Medium (2); L = Low (1)

Food Support Program (FSP)

In the light of increased food insecurity in the country, there is an urgent need to upgrade PBM's food support program as a separate entity. Indeed, it appears to have a high potential to be considered to cover additional number of poor households because of three reasons. One, there is a high risk of food insecurity to around 4-5 million vulnerable households; two, institutional structure of FSP to deliver food support, already exists and is working quite effectively; three, and most importantly, it may also cover all the recipients of Zakat, automatically; and finally, unit cost of the program to deliver the benefits, would be very low, compared with starting any new program. It may also be very important to mention here that presently, administrative cost for FSP is only 2 percent. The FSP is also the only program in social safety nets which has computerized list of beneficiaries and potential beneficiaries. An expansion of food support program of PBM appears viable.

Targeting efficiency of FSP in PBM already is high. Nevertheless, to further improve it, FSP's committee for selecting beneficiaries can be further expanded to include persons from local community based organizations (CBO) and the local school teacher as well. In addition, a third party validation is also recommended as mandatory to minimize any risks of leakages in the funds disbursement.

Adequacy of support for FSP needs to be enhanced. Presently, FSP provides Rs 200 per households as food support. Based on the estimation of monthly expenditures on food items by the lowest income quintile in HIES, 2005-06, the support amount is recommend at Rs 1000 per month per household². On the basis of this, if program covers 4 million households, as recommended, the total annual cost of the program would be Rs 4 billion. Also, to further improve its accessibility, the frequency of payment, can be enhanced to monthly.

Based on the existing performance of FSP, it performs well on a number of criteria. It scores a 'high' for targeting efficiency, on the basis of its existing performance in PBM. As the recommended amount, Rs 1000, would be sufficient for income support for the lowest income quintile. FSP's administration cost is only 2 percent of all the benefits. As such it scores high on adequacy of support and share of Program expenditure of benefit.

If the coverage of FSP is expanded to 4 million households, through scaling up of PBM, with income supplement of Rs 1000 per month per household then the annual fiscal cost of the program is Rs 4 billion.

Food Subsidy

The food subsidy program is government's relief program through the Utility Store Corporation of Pakistan (USC). The USC stores provide various food items including wheat flour on government control rate to all consumers irrespective of income level. Its targeting, therefore, is a serious issue.

USC stores exist largely in major urban centers in the country and do not have much of a presence in vast majority of rural areas of the country, where a high number of poor households reside. Its coverage, therefore, is quite limited. Total price relief provided through this program, including wheat flour, was Rs. 3.6 billion for the last ten years. Annually, this amount was below Rs. 500 million.

Overall rating of USC is mixed as shown in table 5.2. It scores a 'low' on six criteria including targeting efficiency, low coverage, and high share of program expenditure of benefits. It scores 'high' in three criteria, degree of ease of access, absence of negative incentive effects, and degree of freedom from private transfers. Therefore, this program is not recommended for upscaling. The preferred choice is the FSP of PBM.

We next analyze two key livelihood programs currently under government's consideration

² HIES: 2005-6, lowest income quintile spends Rs. 3282 on food items. This is estimated at about Rs 3,500 per month in 2006-07. Therefore, to cover the inflation of 15 percent in 2007-08 and the likely inflation in 2008-09, an income supplement of Rs 1,000 per month is recommended.

ENSURING LIVELIHOODS FOR THE POOR

The newly elected Prime Minister announced relief package as part of his 100 day program for the poor on March 30, 2008. This includes two schemes: national employment guarantee scheme (NEGS) for poor and, graduate employment scheme (GES) for graduates in the country. Both the schemes have potential to ensure livelihoods for the poor. Furthermore, the GES can contribute to improvement in educational outcomes and basic health care in the country. We describe and evaluate the potential of these programs on the basis of the evaluating criteria enunciated earlier.

National Employment Guarantee Scheme for Poor (NEGS)

The NEGS is an important employment generation initiative proposed by the present coalition government. The main objective of this scheme is to provide income support to poorest households through guaranteed employment during slack periods of upto 100 days in the year. Main target group of this scheme is unskilled labor in poorest regions of the country. It therefore can contribute to a reduction in regional disparities. The salient features, targeting criteria, and fiscal cost of the schemes are described below.

Salient features

- Strengthening the livelihood of poor households
- Provision of maximum one hundred days of guaranteed wage employment for one adult member of every poor household in a fiscal year who are prepared to do unskilled manual labor at the specified wage rate
- Wages may be paid in cash, in kind, or both, provided that at least one-fourth of the wages shall be paid in cash only
- Employment is to be provided within a radius of five kilometers of the village where the applicant resides at the time of applying.
- To improve women participation and providing income support to them, roughly one-third of the stipulated work force is for women.
- A minimum wage rate payable is Rs. 150.

The main responsibility of identification, execution, and supervision of projects is of local level *institutions*.

Selection Criteria and Potential Coverage

Potentially the magnitude of the eligible households for NEGS is substantial; it is therefore prudent to start the scheme on a pilot basis targeting initially only one or two backward districts in each province in the country. Launch of a comprehensive scheme runs the danger of being rendered difficult to administer and financially too unbearable at times of high fiscal imbalances. After initial pilots and learning from experience, the scheme can be expanded to all the backward areas in the country.

The initial allocation for the pilot stage could be Rs 4 billion, Rs one billion for each province.

Potential Effectiveness of the Scheme

The potential effectiveness of the scheme to ensure livelihoods for unskilled labor appears very high as the main target group of the scheme are households in

backward districts with low educational skills. The strong point of the scheme is that it not only provides livelihood to those who need it the most but also in those areas where it is needed the most. So, by design its coverage and targeting efficiency is high.

The income support offered by the scheme appears appropriate to provide at least minimum food security to needy families. Effectiveness of the scheme will depend upon the wage rate offered and on institutions utilized for the implementation of the scheme. Ideally, existing local government institutions should be used to identify and execute potential schemes to generate employment, which can additionally contribute to local development also.

Based on the above, NEGS, scores a 'high' on four of the evaluating criteria targeting efficiency, adequacy of support, income equivalence of transfers, and degree of freedom from private transfers. The four criteria it scores a 'medium' on include degree of ease of access; share of program expenditure of benefits; adequacy of support; degree of freedom from private transfers, as shown in Table 5.3.

| Criteria | National Employment Guarantee Scheme | Graduate Employment Scheme | SUMMARY OF SCORES | | | |
|--|---|----------------------------------|-------------------|----------|----------|-----------|
| | | | High | Medium | Low | Total |
| Targeting Efficiency | H | H | 2 | 0 | 0 | 2 |
| Extent of Program Coverage | H | M | 1 | 1 | 0 | 2 |
| Degree of Ease of Access | M | M | 0 | 2 | 0 | 2 |
| Share of Program Expenditure of Benefits | M | M | 0 | 2 | 0 | 2 |
| Adequacy of support | M | H | 1 | 1 | 0 | 2 |
| Income Equivalence of Transfers | H | H | 2 | 0 | 0 | 2 |
| Absence of Negative Incentives Effects | L | L | 0 | 0 | 2 | 2 |
| Extent of Self Financing | L | L | 0 | 0 | 2 | 2 |
| Degree of Freedom from Private Transfers | M | H | 1 | 1 | 0 | 2 |
| Degree of Impact on Development | H | M | 1 | 1 | 0 | 2 |
| SUMMARY OF SCORES | 26 | 26 | 8 | 8 | 4 | 20 |
| High | 4 | 4 | 8 | | | |
| Medium | 4 | 4 | 8 | | | |
| Low | 2 | 2 | 4 | | | |
| Total | 10 | 10 | 20 | | | |

H = High (4); M = Medium (2); L = Low (1)

Graduate Employment Scheme/Literacy and Health Corp Scheme

Graduate Employment Scheme (GES) is for unemployed graduate youth in the country. The scheme proposes to offer employment in two key social sectors- education and health. These are sectors in which the country lags behind as compared to other developing countries. It is, therefore, a commendable initiative which addresses four key inter-related challenges confronting Pakistan- poverty, educated unemployment, low level of education and health. This scheme is similar to the National Internship Program introduced last year in March 2007. The scheme, however, offered internship opportunity to graduates in all public departments.

Main objectives of the GES, its key features, selection criteria, fiscal costs and its evaluation are discussed below.

Main Objectives

- Generating employment opportunities for young graduates in the country
- Improving capacity building and knowledge base of graduates for better professional careers
- Improving quality and services of education and health sectors in the economy through employment of educated and motivated youth in the country
- Engaging youth in productive activities and preventing them from engaging in illegal activities.

Salient Features

- The new appointees are to work in provincial and district education and health departments, close to their local residence.
- The appointment of the candidate may be considered on broader educational qualification of the graduate and the matching requirement of education and health departments in the district/province.
- The first priority of job would be in the local district of the applicant
- Female graduates would be preferred to male candidates to increase female participation in health and education.
- The duration of the employment is one year, initially. Subject to evaluation of performance, employment may be extended for another year.
- The newly appointed graduates would be entitled to a monthly stipend of Rs. 10,000, all inclusive, during the course of employment.

The selection criteria for the candidates include:

- Fresh graduates and post graduates who have completed minimum 16 years of education from Higher Education Commission (HEC) recognized educational institutions in all field of studies in the country upto the age of 40 years.

Potential Coverage

To assess potential coverage of the scheme we need to know the number of unemployed graduates. Overall there are three million unemployed in the country, yielding an unemployment rate of 6.2 per cent. This rate is higher in urban (8 per cent) than rural (5.4per cent) areas of the country.

However, for our purpose, the relevant information is the number of graduates who are unemployed. Table 5.4 shows the rate of unemployment among graduates on the whole and those who are below 40 years age. Overall, the scheme has to cover 166,000 people, 105,000 of which reside in urban areas. A number of interesting insights emerge from the Table. First, the unemployment rate among graduates is 6.27

| | All Graduates (000) | Below 40 Years (000) | All Graduates (%) | Below 40 Years (%) |
|--------------------|---------------------|----------------------|-------------------|--------------------|
| Pakistan | 195 | 166 | 6.27 | 5.25 |
| Rural | 68 | 61 | 3.72 | 3.32 |
| Urban | 127 | 105 | 9.97 | 8.24 |
| Punjab | 86 | 75 | 4.72 | 4.12 |
| Rural | 32 | 29 | 3.04 | 2.77 |
| Urban | 55 | 46 | 6.93 | 5.87 |
| Sindh | 73 | 59 | 14.26 | 11.65 |
| Rural | 15 | 14 | 8.16 | 7.66 |
| Urban | 58 | 46 | 17.58 | 13.83 |
| NWFP | 30 | 25 | 4.34 | 3.64 |
| Rural | 20 | 17 | 3.51 | 2.86 |
| Urban | 10 | 9 | 8.29 | 7.4 |
| Balochistan | 6 | 6 | 8.06 | 7.97 |
| Rural | 2 | 2 | 4.51 | 4.52 |
| Urban | 4 | 4 | 14.14 | 13.16 |

Source: Pakistan Labor Force Survey: 2005-06

percent, in line with the overall unemployment rate in the country. However, this rate is higher in urban areas at 10 per cent, than in rural areas, at 4 per cent. As expected graduate unemployment is largely an urban phenomenon. Second, at provincial level, the rate of graduate unemployment is highest in Sindh (14.3 per cent), with an urban unemployment rate of over 17 per cent, nearly double the national level. Similarly, graduate rural unemployment rate, of 8.2 per cent, in Sindh is over two times higher than the national level. Clearly increase in economic activity in the province is not enough to absorb the output of the graduate institutions. This provincial break-up is important in terms of the regional targeting of the scheme.

The total cost of the scheme for youth at full scale implementation is Rs 8 billion. It is suggested that initially an allocation of Rs 4 billion be made for the scheme.

Potential Effectiveness

As mentioned earlier, this scheme has a number of potential advantages. First, generation of employment. Second, the choice of sectors is optimal as both education and health have a wide network in all the districts in the country. Third, employment is offered at local level, implying low transaction costs and costs of transportation and housing.

Fourth, with increasing population, demand for social services is on the rise and so is the demand for qualified manpower for these sectors. Fifth, engaging youth in productive activities diverts them from extreme and violent activities and engages them in development of the country.

The other strong point of the scheme is its potential impact on the degree of development. As the identified areas for the scheme, education and health, are the two key areas for the human development, it is expected that the scheme will not only generate employment but will also contribute to improvement in educational and health facilities for masses. Overall, scheme scores 'high' on five criteria: targeting efficiency, extent of coverage, income equivalence of transfers, freedom from private transfers, and degree of impact on development.

A main shortcoming of the scheme is the incentive signals. It might deter young graduates to search for other employment possibilities. Similarly, the dependence of the scheme on budgetary allocations raises potential issues of financial unsustainability. Accordingly, the scheme scores 'low' on these two criteria.

In conclusion, both the proposed schemes to provide livelihoods rank high on our evaluating criteria. As such both should be implemented by the government, following successful piloting.

Our analysis in the last sections has identified the potential routes the government can take to provide relief to the needy in the forth coming budget. It is important to emphasize that, given the characteristics of the people which need to be cushioned from the adjustment burden, a combination of cash transfers and livelihood schemes have to be implemented concurrently. Of course the magnitude of financial allocations earmarked for the purpose in the budget 2008-09, will be the ultimate testimony of government's commitment and seriousness to the cause of the poor. On the basis of the estimated fiscal costs above we recommend that a total allocation of Rs 56 billion be made in the budget for providing relief to the poor in 2008-09.

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TEHNICAL ANNEXURE 1

SCOPE FOR SEIGNORAGE

To the extent that the fiscal deficit can be financed through money creation or seignorage, for example, new debt, either domestic or external, which generates interest obligations, will not be incurred. However, financing through excessive money creation can lead to a runaway inflation, which places a limit, both politically and economically, on the extent to which this approach can be adopted. The objective of this section is to determine the scope for seignorage in Pakistan that does lead to high rates of inflation.

The major issue of policy is the extent to which governments can resort to seignorage for financing of budget deficits. This corresponds to the imposition of an inflation tax. In this respect it does not add to the debt servicing burden. However, there are limits to the extent to which this financing mechanism can be used.

The Inflation Tax

Printing of money to finance budget deficit, referred to as monetization of the budget deficit, is an alternative to explicit taxation. Governments can obtain significant amounts of resources by simply printing money which corresponds to an inflation tax (closely defined). The amount of revenue that can be obtained from seignorage is determined by a number of factors. These include the demand for base or high powered money in the economy, the real rate of growth of the economy, and the elasticity of the demand for real balances with respect to inflation and income.

Specifically, the relationship between seignorage and the demand for real balances is as follows:

$$\frac{\Delta M}{P} = \frac{(\tau + g) M}{P}$$

where;

$$\begin{aligned} \frac{\Delta M}{P} &= \text{inflation tax} \\ \tau &= \text{domestic rate of inflation} \\ g &= \text{real GDP growth rate} \\ M &= \text{base or high powered money} \\ P &= \text{domestic price level} \\ \frac{M}{P} &= \text{real base money} \end{aligned}$$

If the demand for real balances is inelastic with respect to the inflation, the

government can potentially mobilise large amounts of resources through money creation. But the demand for high powered money declines as the inflation rate rises. This implies that there are two opposing forces in above equation. Higher inflation rate reduces the demand for real money balances. As such government revenues from seignorage reaches a maximum and declines thereafter because high inflation actually contracts the revenue base, that is, demand for real base money.

Sustainable Level of Seignorage for Pakistan

To what extent can debt crisis be avoided and a large budget deficit be financed through seignorage or inflation tax? In order to estimate the relationship between seignorage and inflation, there is need to first estimate the base money in Pakistan. We have focused on currency in circulation, the major component of base money. The remainder which consists primarily of reserves of commercial banks held with the SBP can be regulated by policy. For the period, 1972-73 to 2006-07, demand for currency has been estimated for Pakistan.

Order of Integration

As a prior step, Dicky-Fuller generalized least square (DF-GLS) is employed to examine the order of integration of variables in the concerned model. This is a newly developed and most reliable test for small sample data. The results show that for all series – log of currency in circulation (LCC), log of real GDP (LRGDP) and inflation (DGDPI/GDPI) – there is a unit root in the level but not in the first difference (see Table-1). This indicates that all variables are stationary at first order of integration or I (1).

| Variables | At Level | | At 1 st Difference | |
|------------|-------------------|-----|-------------------------------|-----|
| | DF-GLS Statistics | Lag | DF-GLS Statistics | Lag |
| LCC | -2.0219 | 2 | -4.2923* | 0 |
| LRGDP | -1.3709 | 1 | -3.9950* | 0 |
| DGDPI/GDPI | -1.6386 | 2 | -3.4091** | 2 |

Note: *(**) represent the 1% (5%) level of significance

Co-integration Tests

The Johansen-Juselius (1990) cointegration technique is used to estimate the money demand function. The function includes three I (1) variables: log of currency in circulation (LCC), log of real GDP (LRGDP) and inflation (DGDPI/GDPI). The results reported in Table-2 show that for Likelihood Ratio, the null hypotheses $R = 0$ can be rejected in favor of its alternative $R = 1$. This indicates that there exist at least one co-integrating vector and confirms that there prevails a long run association among the concerned variables in the model.

| Hypotheses | Likelihood ratio | 5 % critical value | Inst-values | Maximum Eigen values | 5 % critical value | Inst-values |
|------------|------------------|--------------------|-------------|----------------------|--------------------|-------------|
| $R = 0$ | 51.83964 | 35.19275 | 0.0004 | 33.95988 | 22.29962 | 0.0008 |
| $R \leq 1$ | 17.87975 | 20.26184 | 0.1030 | 13.76771 | 15.89210 | 0.1048 |
| $R \leq 2$ | 4.112044 | 9.164546 | 0.3957 | 4.112044 | 9.164546 | 0.3957 |

Table 2 also shows that for Maximum Eigen values there exists at least one co-integrating vector, which further confirms the existence of long run connection among variables in case of small developing country like Pakistan.

The results of ML estimates of long-run money demand function where the estimates are normalised to represent the demand function for money are given below.

$$\text{LCC} = -27.844 + 3.041 \text{LRGDP} - 3.476 \text{DGDPI/GDPI}$$

(1.77555) (0.12390) (1.70834)

Normalized cointegrating coefficients (standard error in parentheses)

The Dynamics of the Model and Seignorage Revenue

The error correction model (ECM) is also relevant here. Agents respond to changes in their equilibrium holding of real balances only gradually. Seignorage revenue obtaining from monetary base can be decomposed into two parts. The first part of the revenue is generated from real balances in the new equilibrium and the second part is the flow of the revenue generated through the period, while agents are out of equilibrium [see, for example, Adam and et al., (1996)].

The following error correction model is specified and estimated.

| DLCC(-1) | DLRGDP | DGDPI1 | CR1(-1) | C |
|---------------------------|----------|-----------------|----------|----------|
| 0.774571 | 1.352647 | -0.96813 | -1.2933 | -0.06003 |
| 0.244627 | 0.510515 | 0.369607 | 0.269404 | 0.026643 |
| Adjusted R-squared | | 0.475138 | | |

The crucial parameter of the ECM is the speed of adjustment coefficient. The high value of this coefficient, -1.29, implies that any deviation from equilibrium persists for a relatively short period of time. This has important implications for seignorage revenue. Following a shock (e. g. an increase in inflation), agents adjust their real balances quickly toward new equilibrium and so agents hold excess money for very short time. Hence, in this case, the government cannot generate considerable seignorage revenue through the adjustment period.

TECHNICAL ANNEXURE 2

RETURNS ON NATIONAL SAVING SCHEMES

The domestic non-bank borrowing is largely comprised of National Saving Schemes (NSS). As mentioned earlier, in the late 1990s, the financing of a significant part of fiscal imbalance had been done by relying to a great extent on generating borrowings from non-bank sources i.e. the NSS. It competes with the commercial banking sector and other financial institutions to attract both personal and institutional investors. For this, the government kept relatively high rate of profit on the NSS during the late 1990s. In the 2000s, the government of Pakistan in an effort to reduce the reliance on NSS and to rationalize the structure of domestic debt, discouraged investment in these schemes by slashing down the rates of profit on different saving instruments to a considerably low level. As a result, the share of NSS in the financing of fiscal imbalance declined significantly (see Table 1).

| | Annual Rate of Return on NSS | | Share of NSS in Deficit Financing |
|---------|------------------------------|------|---|
| | Nominal | Real | |
| 1995-96 | 15.8 | 7.9 | 35.1 |
| 1996-97 | 15.8 | 7.9 | 43.9 |
| 1997-98 | 15.8 | 7.9 | 54.4 |
| 1998-99 | 15.8 | 7.9 | 78.0 |
| 1999-00 | 15.8 | 7.9 | 44.3 |
| 2000-01 | 12.6 | 8.2 | 26.0 |
| 2001-02 | 12.3 | 8.8 | 44.6 |
| 2002-03 | 8.8 | 5.7 | 75.2 |
| 2003-04 | 7.2 | 2.6 | 1.4 |
| 2004-05 | 7.3 | -2.0 | -20.5 |
| 2005-06 | 8.7 | 0.8 | -1.8 |
| 2006-07 | 9.7 | 1.7 | 17.7 |

In order to attract domestic investment through these saving schemes, the interest rate structure on key debt instruments is required to be somewhat realistic i.e. efficient, neutral and consistent with the their characteristics.

This section attempts to determine the rates of profit that will have to be offered on the key saving schemes to attract private saving into these schemes. For this it is imperative to observe what determines the investment in government saving schemes by addressing the issues like: does investment in a particular instrument depend on the rate of profit on that instrument? Does the rate of profit on other instruments also matters? What is the elasticity of investment in particular instrument with respect to private savings in the economy?

In the light of these considerations, the following model has been developed to study the determinants of investments in key saving instruments in Pakistan.

$$\frac{SS}{Y} = f\left(\frac{SV}{Y}, r - i, \theta\right)$$

Where;

- SS = level of investment into saving schemes
 SV = total private domestic saving
 Y = Gross domestic product (GDP)
 r = nominal rate of profit on saving schemes
 i = rate of inflation
 θ = rate of return on term deposits

The above model explains that investment in saving instruments as a percent of GDP is expected to be a function of total private domestic saving as a percent of GDP, real rate of profit ($r - i$) on saving schemes and the rate of return on other investments like the term deposits. The higher the level of private domestic saving the higher would be the investment in saving schemes; increase in the real rate of return offered on the saving schemes increases the investment in saving schemes. Moreover, in a competitive market, the level of investment in saving schemes tends to be affected negatively by the rate of return offered on other competitive instrument.

The above model has been estimated by using the annual data for the period 1972-73 to 2006-07. The estimated results are presented below.

$$\begin{array}{rcccc}
 \text{SS/Y} = & 0.019553 & + & 0.599 \text{ SV/Y} & + & 0.011225 (r - & - & 0.008703 \\
 & (0.67) & & (3.85) & & i) & & \theta \\
 & & & & & (1.72) & & (-1.38) \quad \dots\dots\dots(1) \\
 R^2 = & 0.80 & & & & & & \\
 DW = & & & 1.42 & & & &
 \end{array}$$

The sign of each estimated coefficient is according to a priori expectations. The estimated coefficient of private saving as a percentage of GDP is positive and statistically significant at 1 percent level of significance. It implies that an increase of 1 percent in private savings to GDP ratio will translate into 0.6 percent in investment into saving schemes to GDP ratio. The estimated coefficient of real rate of profit ($r - i$) on saving schemes is positive and statistically significant at 10 percent level of significance. This indicates that increase in real rate of return on saving schemes by 1 percentage points increases the level of investment in to saving schemes by 0.1 percent of GDP. The negative sign of the coefficient of term deposit implies that investment in to saving schemes declines with increase in rae of return on other complete instruments.

Since the coefficient of rate of return on time deposit is statistically insignificant, we re-estimated the model by omitting this variable and obtained the following results.

$$\begin{array}{rcccc}
 \text{SS/Y} = & 0.0532 & + & 0.5759 \text{ SV/Y} & + & 0.00219 (r - \\
 & (2.52) & & (3.56) & & i) \\
 R^2 = & 0.79 & & & & (1.97) \quad \dots\dots\dots (2) \\
 DW = & & & 1.37 & &
 \end{array}$$

Table 2 gives the nominal actual and suggested gross rates of returns on key instruments of NSS. In order to increase the scope of financing through national saving schemes, we suggest a 3 percent increase in all saving instruments. This will reduce the pressure on greater reliance on money printing, which will help to arrest inflationary pressures.

| TABLE 2 | | |
|---|--|---|
| ACTUAL AND SUGGESTED RATE OF RETURN ON NSS | | |
| <i>(In percent)</i> | | |
| Saving Schemes (Maturity) | Actual Nominal Rate of Return | Suggested Nominal Rate of Return |
| Defense Saving Certificates (10 Years) | 10.03 | 13.03 |
| Special Savings Certificates, Reg. (3 Years) | 9.34 | 12.34 |
| Regular Income Certificates (5 Years) | 9.24 | 12.24 |
| Mahana Amdani Accounts (7 Years) | 10.41 | 13.41 |
| Pensioners' Benefit Accounts (10 Years) | 11.52 | 14.52 |
| Bahbood Saving Certificates (10 Years) | 11.52 | 14.52 |
| Saving Accounts (Running Accounts) | 6.00 | 9.00 |
| Prize Bonds (Running Accounts) | 6.50 | 9.50 |

TECHNICAL ANNEXURE 3

DETERMINANTS OF CHANGE IN TAX-TO-GDP RATIO

In order to understand the causes of low tax-to-GDP ratio, it is important to decompose the impact of different factors in “base” and “rate” effect on the changes observed in the tax-to-GDP ratio for individual taxes and for FBR as a whole. The methodology for attributing any change in the tax-to-GDP ratio to the ‘base’ and ‘rate’ effects respectively is described below.

We designate the following:

| | | |
|---|---|--------------------|
| T | = | actual tax revenue |
| t | = | effective tax rate |
| B | = | tax base |
| Y | = | GDP |

That is, $T = tB$

Subscripts 0 and 1 designate the base and terminal years respectively.

The change in the tax-to-GDP ratio is given by

$$\frac{T_1}{Y_1} - \frac{T_0}{Y_0} = \frac{t_1 B_1}{Y_1} - \frac{t_0 B_0}{Y_0}$$

$$\frac{T_1}{Y_1} - \frac{T_0}{Y_0} = \frac{t_1 B_1}{Y_1} - \frac{t_1 B_0}{Y_0} + \frac{t_1 B_0}{Y_0} - \frac{t_0 B_0}{Y_0}$$

That is,

$$\frac{T_1}{Y_1} - \frac{T_0}{Y_0} = t_1 \left[\frac{B_1}{Y_1} - \frac{B_0}{Y_0} \right] + \frac{B_0}{Y_0} [t_1 - t_0] \quad \dots \dots \dots [1]$$

➤ base effect ÷ + ➤ rate effect ÷

Equation (1) gives the expressions for the base and rate effects respectively. The former essentially identifies to what extent the change in tax-to-GDP ratio is due to change in the ratio of the tax base to GDP. That is, if the tax base of a tax is stagnant/buoyant in relation to the GDP then the ‘base’ effect will be negative/positive, implying, other things being equal, a fall/rise in the tax-to-GDP ratio.

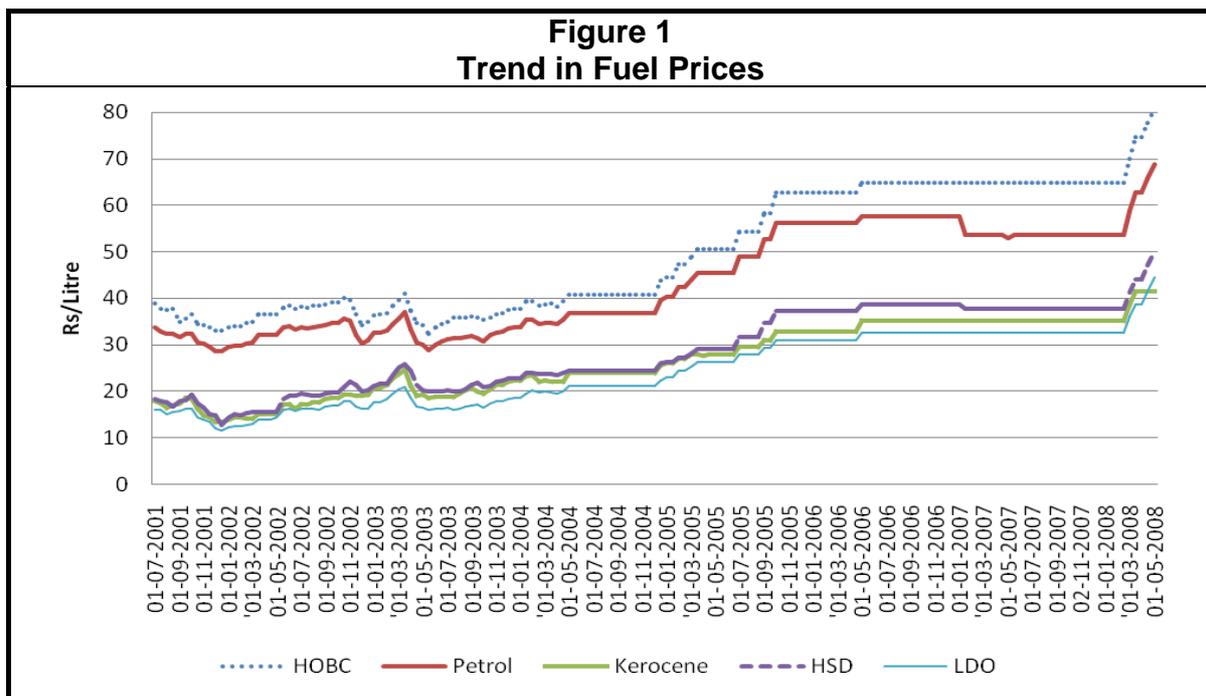
The ‘rate’ effect is meant to primarily capture the change in the ‘effective’ tax rate on the tax base. Effective rates can change either if statutory tax rates are altered or if, given unchanged statutory rates, there is a change in the efficiency of tax collection. For example, if statutory rates fall, as happened in the case of import duty during the 90s, then the ‘rate’ effect will be negative.

TECHNICAL ANNEXURE 4

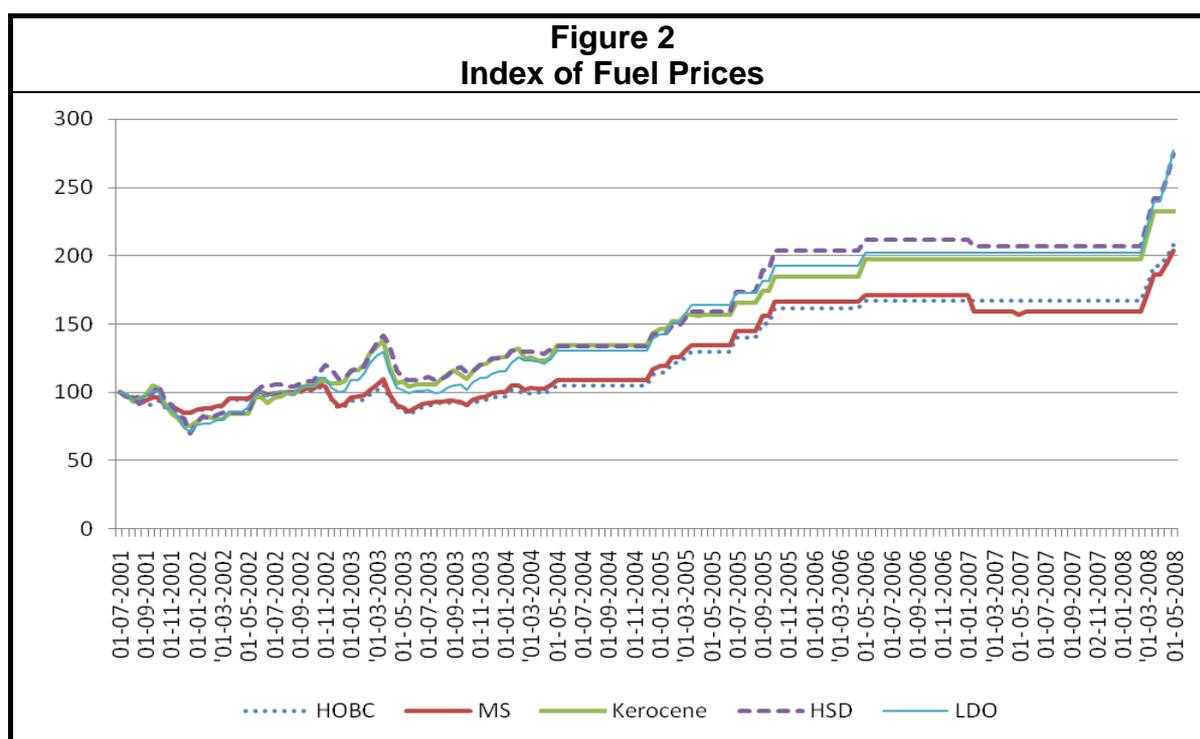
ANALYSIS OF STRUCTURE AND TREND IN FUEL PRICES

I INTRODUCTION

Rising energy prices is a great concern for the common man and one of the key challenges faced by economy of Pakistan. The trend in energy prices showed ever high prices of petrol (Premium Motor Gasoline), High Speed Diesel (HSD) and related fuels. Figure 1 shows the trend in fortnightly retail prices of petrol, HSD, High Octane Blending Component (HOBC), kerosene and Light Diesel Oil (LDO) for the period July 01, 2001 to May 01, 2008. It is apparent that during this period the price of a liter of petrol rose from Rs. 33.8 to Rs. 68.81 (a rise of Rs. 35) in Pakistan. Similarly, price of HSD increased from Rs. 18.26 to Rs. 50.13 (an increase of 2.7 times) percent. Figure 1 also highlights two periods in which fuel prices rose sharply: firstly from December 2004 to September 2005 and secondly the since February 2008. Other than these two periods there are ups and downs during 2002 and 2003, and a period of relative price stability during the most part of 2006 and 2007.



Interesting findings emerged from the trend in index of retail prices of five major fuels for the same period. The similar trends appear in fuel price index as indicative by fuel prices in Figure 1. However, in contrast to general perception index of HSD, LDO and kerosene shows relatively higher growth followed by petrol and HOBC. This finding is important from distributive impact of fuel prices. HSD is largely used in vehicles of public road transportation, which is used by poor population. Any increase in its price ultimately affects the cost of travelling for the poor. In contrast, petrol is generally used by relatively well-offs segment of population for personal road transportations.



II PRICE STRUCTURE OF PETROLEUM PRODUCTS

Prices of petroleum products are clearly influenced by three key factors: international purchasing parity prices or ex-refinery prices, distribution costs (inland freight margin, Oil Marketing Companies (OMCs) distribution margin and dealer's commission), and net taxation (tax minus subsidies). The nature and influence of these factors varies with the type of fuel due to cost structure of raw materials, demand and supply of fuels and policy of government related to that type of fuel. Details related to price structure of five major petroleum products namely HOBC, petrol, kerosene HSD, and Light Diesel Oil (LDO) are provided in following sub-sections. Each sub-section contains three sets of statistics presented in graphical forms related to actual prices, percentage share each cost components and index values of each cost component since July 2001.

Price Structure of HOBC

Figure 3 shows the fortnightly trend in a litre of HOBC's three price components namely: ex-refinery prices, distribution costs and total taxes (sum of excise duty, petroleum development levy and sales tax). It is apparent that during July 2001 and May 2008 the ex-refinery price of a liter of HOBC in Pakistan rose significantly from Rs. 14.88 to Rs. 49.62 (a rise of Rs. 34.74), followed by distribution costs, which increase from Rs. 4.94 to Rs. 10.39 (an increase of Rs. 5.45) during the same period. However, during the same period, amount of total taxes on a liter of HOBC rose slightly from Rs. 19.05 to Rs. 20.76 (a rise of Rs. 1.71 or 9 percent) in Pakistan. Altogether, these factors pushed a litre price of HOBC from Rs. 38.87 to Rs. 80.77.

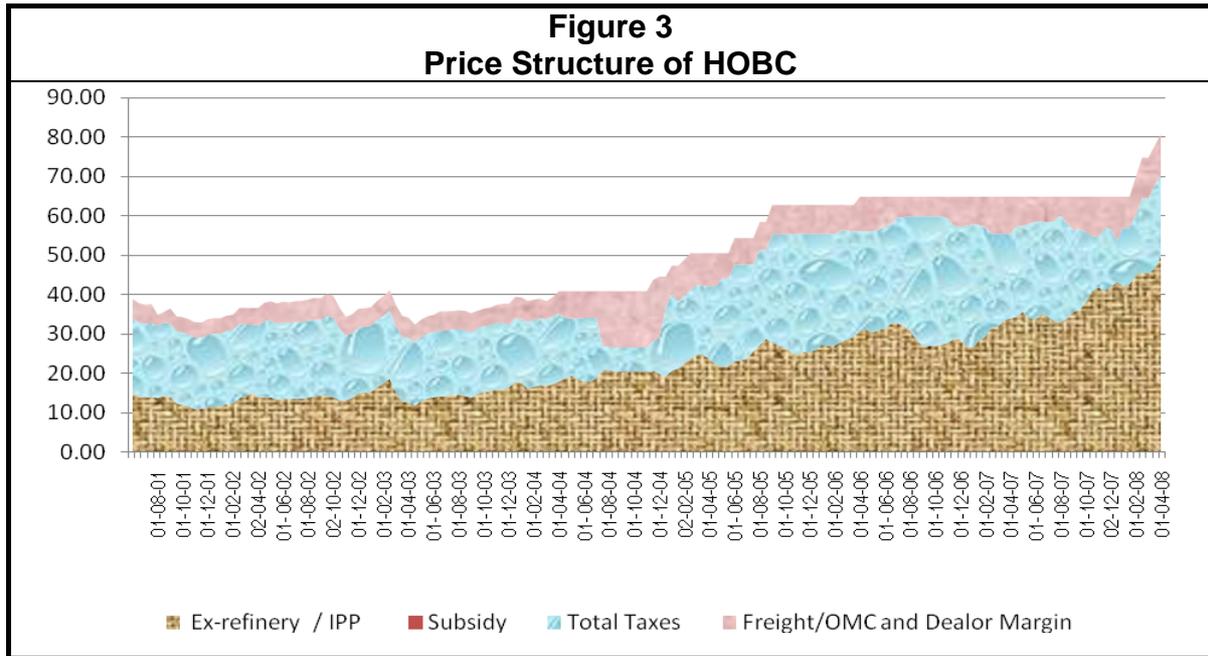


Figure 4 presents structure of a litre of HOBC final price by quarterly percentage share of each price component during July 2001 to May 2008. Three time increase in ex-refinery price pushed its share pushed up from almost 40 to 60 percent, resulted a rise of 20 percent in HOBC price. Moreover, doubling in distribution costs did not affect its share, which remained constant around 12 percent due to doubling of final prices of HOBC. However, the nine percent increase in taxes resulted in decline of its share from almost 50 percent in 2001 to 25 percent of final price of HOBC in 2008.

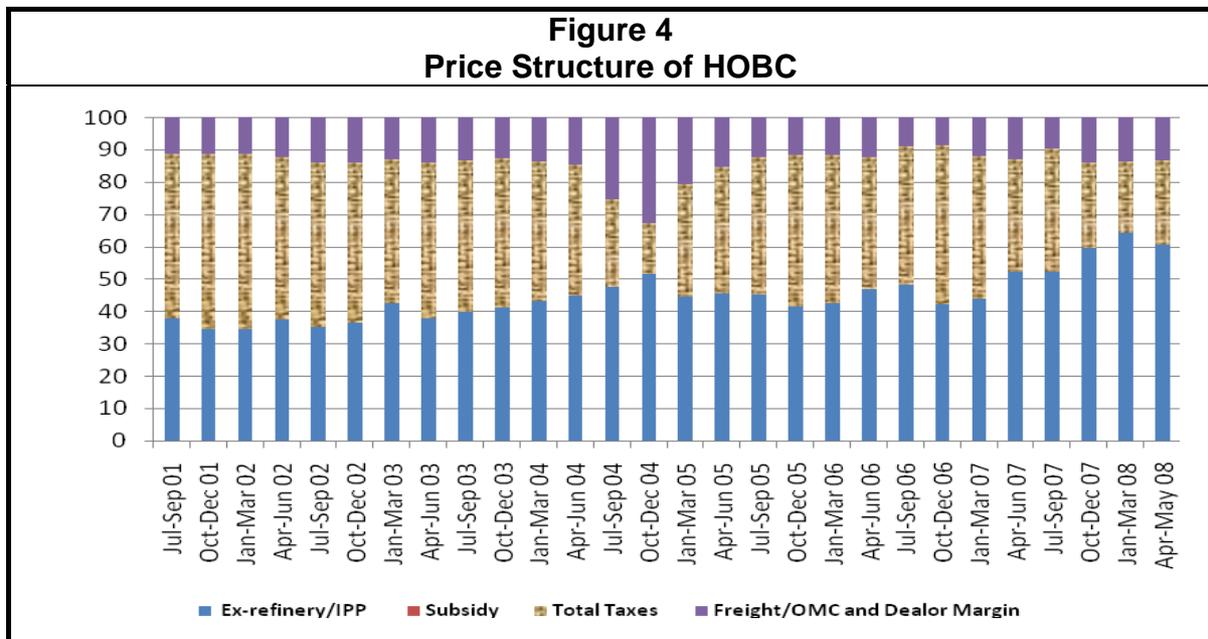
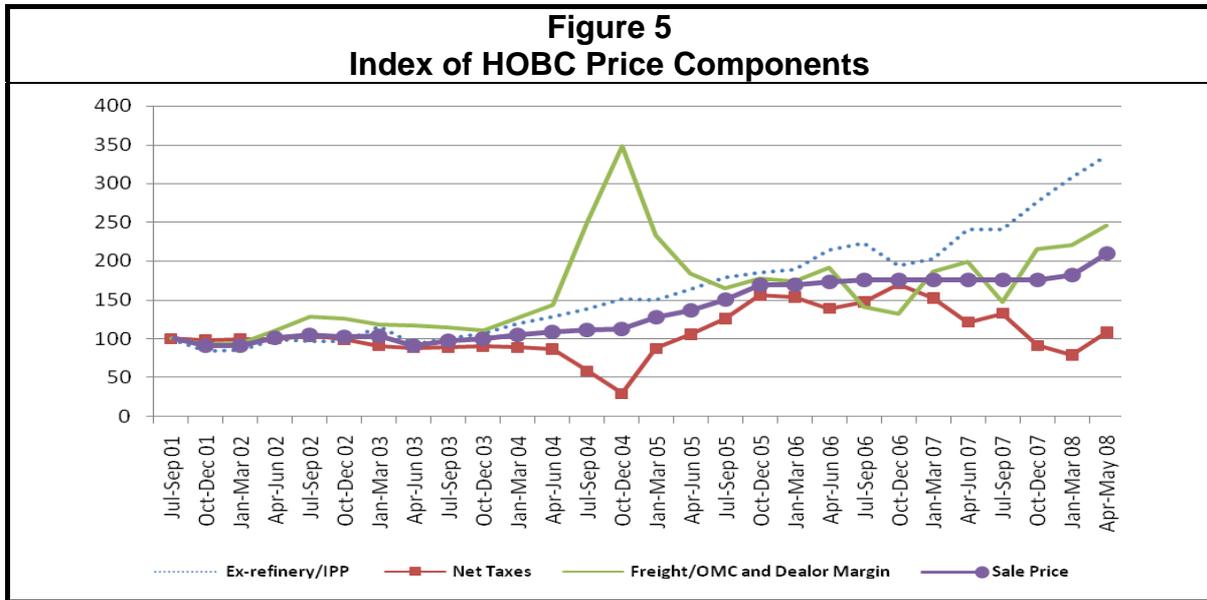


Figure 5 shows trend in index of HOBC final prices along with its three price components during July 2001 to May 2008. The trend clearly shows that the extra ordinary increase in ex-refinery price index from 100 to 335, and rise in distribution costs from 100 to 246 are key factors behind the increase in HOBC price index,

which rose from 100 to 210. Moreover, despite this extra ordinary increase in ex-refinery prices, government of Pakistan taking slightly higher per litre taxes as in 2001.



Price Structure of Petrol (Premium Motor Gasoline)

Figure 6 shows the fortnightly trend in a litre of HOBC’s three price components namely: ex-refinery prices, distribution costs and total taxes during July 2001 to May 2008. Similar to HOBC, It is apparent that ex-refinery price of a liter of Petrol rose from Rs. 14.57 to Rs. 48.55 (a rise of Rs 35), followed by distribution costs, which increase from Rs. 2.54 to Rs. 7.05 (a rise of Rs. 4.51). In contrast, between July 2001 and May 2008 the amount of total taxes on a liter of Petrol decline slightly from Rs. 16.69 to Rs. 13.21 – a drop of Rs. 3.48 or 21 percent. Altogether, these factors pushed a litre price of petrol from Rs. 33.80 to Rs. 68.81 (more than doubled) in Pakistan.

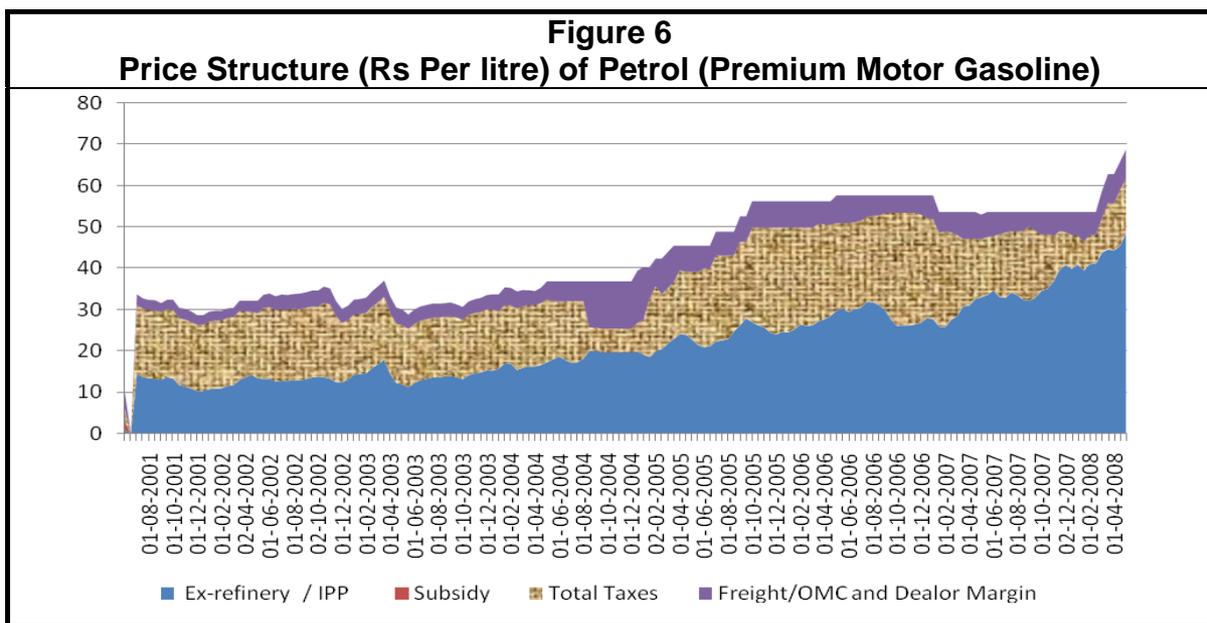


Figure 7 presents structure of a litre of petrol final price by quarterly percentage share of its price component during July 2001 to May 2008. The extra ordinary rise in ex-refinery price pushed its share pushed up from slightly above 40 percent to 70 percent, resulted a rise of 30 percent in petrol price. Moreover, doubling in distribution costs also raise its share from seven and half percent to ten percent. In contrast, share of total taxes decline from almost 50 percent to 20 in a liter of petrol.

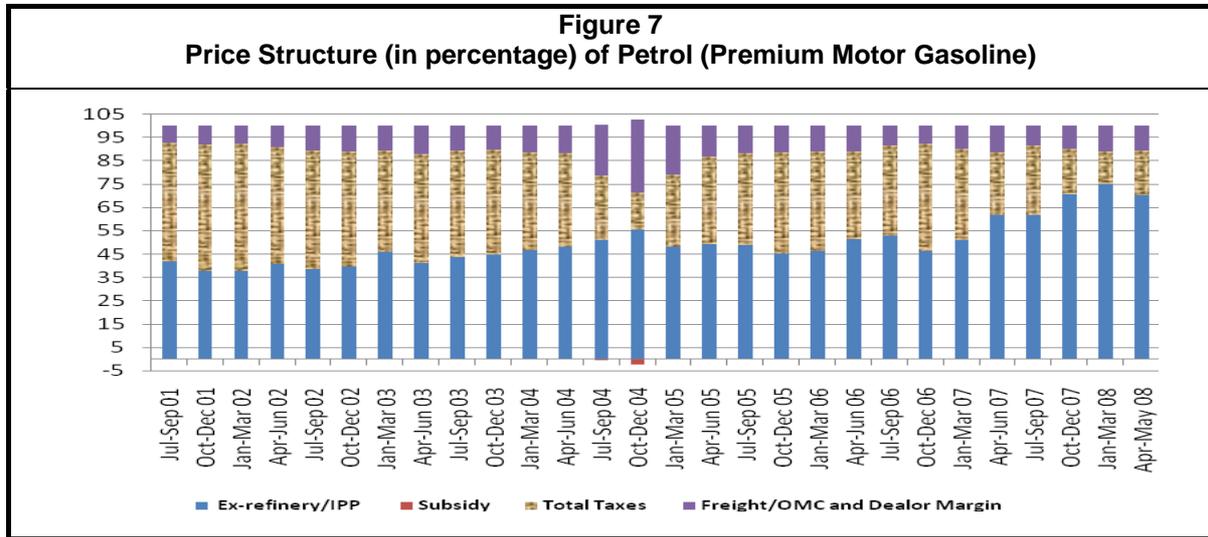
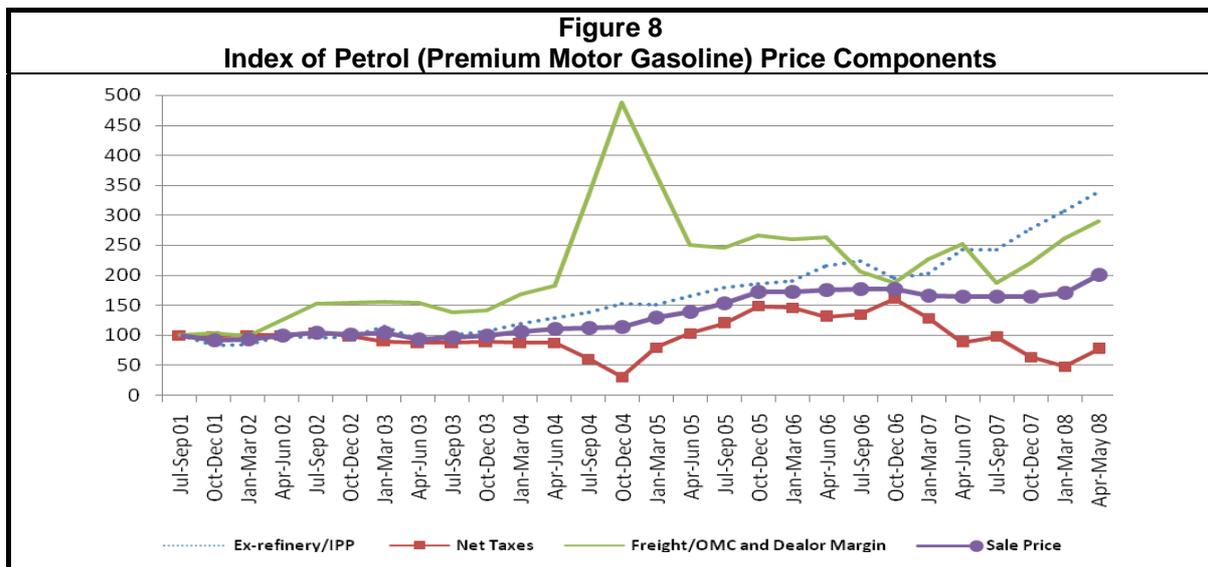


Figure 8 presents trend in index of petrol sale price along with its three price components during July 2001 to May 2008. The trend clearly shows that the extra ordinary increase in ex-refinery price index from 100 to 338, and rise in distribution costs from 100 to 291 are key factors behind the increase in petrol price index, which rose from 100 to 202. However, due to these sharp increases, government of Pakistan is taking slightly lower per litre net taxes as in 2001.



Price Structure of Kerosene

Figure 9 presents the fortnightly trend in four components of kerosene prices namely: ex-refinery prices, distribution costs, total taxes (excise duty, petroleum development levy and sales tax) and subsidies between July 2001 and May 2008.

The ex-refinery price of a liter of kerosene rose much sharper than other fuels increased from Rs. 12.57 to Rs. 58.36 (a rise of Rs. 45.79). Similarly, during the same period distribution costs increased even faster than ex-refinery prices from Rs. 0.80 to Rs. 4.43 (Rs 3.63). Similarly, per litre taxes on kerosene slightly increase from Rs. 4.48 to Rs. 5.41 (a rise of Rs. 0.93 or 21 percent). However, since 2004, government of Pakistan started subsidy on kerosene and the per litre subsidy on kerosene reach to Rs. 26.76 in May 2008.

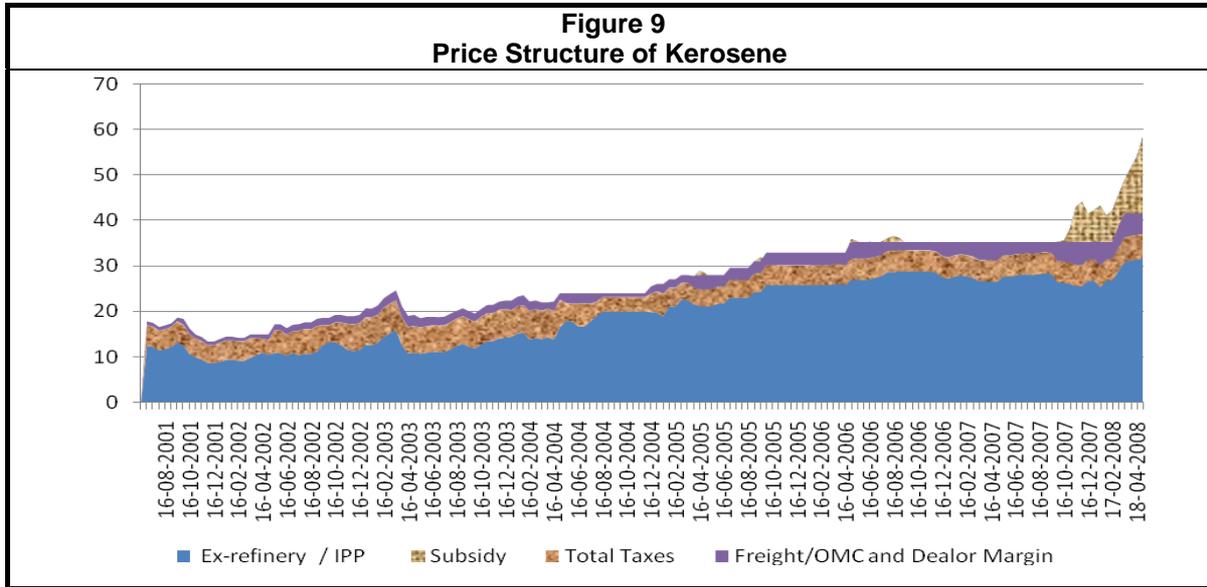


Figure 10 presents share of ex-refinery price, distribution costs, taxes and subsidies as a percentage of final prices of a litre of kerosene during July 2001 and May 2008. More than 100 percent share of ex-refinery price in recent time indicates that consumers are getting kerosene less than its ex-refinery price or cost. This is just a reflection of higher government subsidies, which made it cheaper than ex-refinery price. Presently, size of subsidies reaches as high as 60 percent of its final price. In contrast, distribution costs rose from 4.48 percent to 10.69 percent of sale price of kerosene.

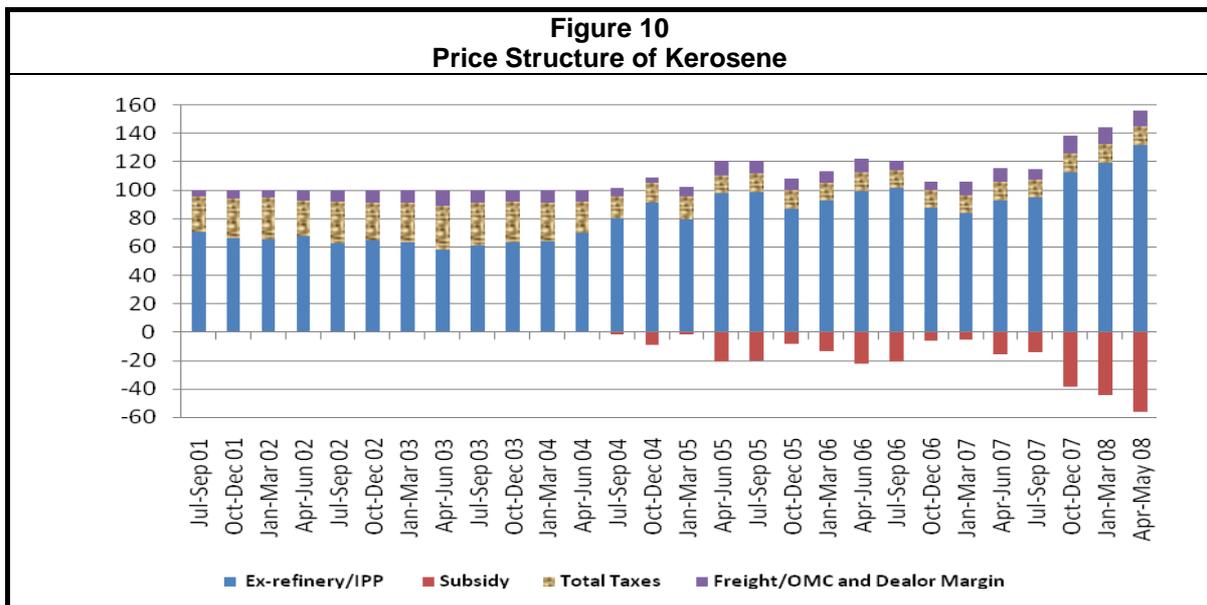
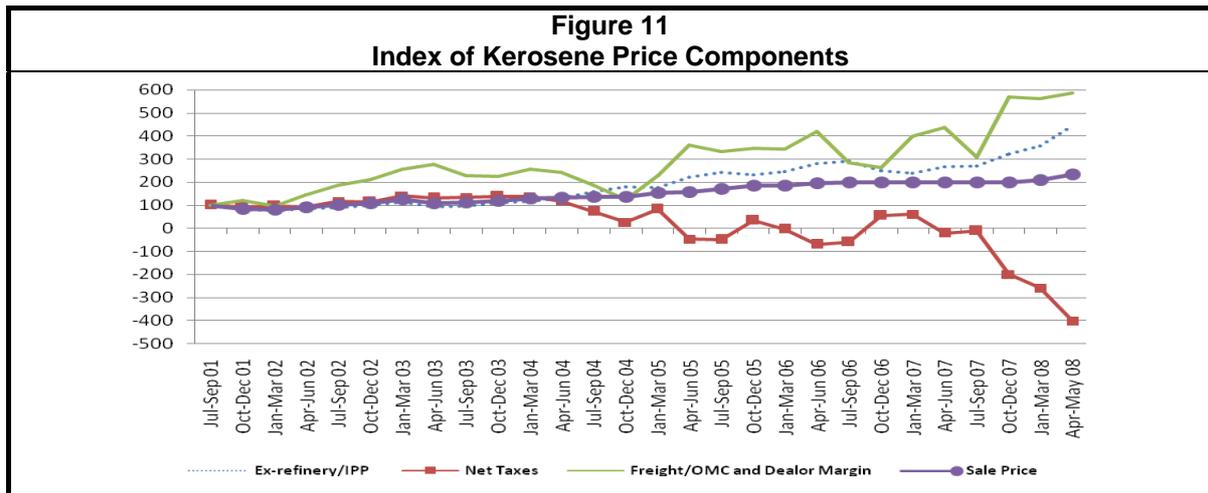


Figure 11 presents trend in index of kerosene sale price along with its three price components namely ex-refinery price, distribution costs, and net taxes (total taxes minus subsidies) during July 2001 to May 2008. The trend clearly shows that the extra ordinary increase in ex-refinery price index from 100 to 445, and rise in distribution costs from 100 to 586 are key factors behind the increase in kerosene price index, which rose from 100 to 237. In contrast to HOBC and petrol, per litre taxes on kerosene decline massively and amount of per litre subsidies increased from taxes, resulted in negative values of net taxes index, which reach to -402 in May 2008.



Price Structure of HSD

Figure 12 presents the fortnightly trend in four components of HSD prices namely: ex-refinery prices, distribution costs, total taxes (excise duty, petroleum development levy and sales tax) and subsidies between July 2001 and June 2007. The ex-refinery price of a liter of HSD rose from Rs. 12.22 to Rs. 34.25 (a rise of Rs. 22.03). Similarly, during the same period distribution costs increased from Rs. 1.85 to Rs. 3.77 (an increase of Rs. 1.92). Moreover, the size of per litre taxes of HSD slightly increases from Rs. 4.19 to Rs. 4.92 (a rise of Rs. 0.73 or 17 percent). However, since 2001, Government of Pakistan off and on subsidized HSD. The per litre amount of subsidy on HSD touch its peak in August 2006 and reach to Rs. 6.22.

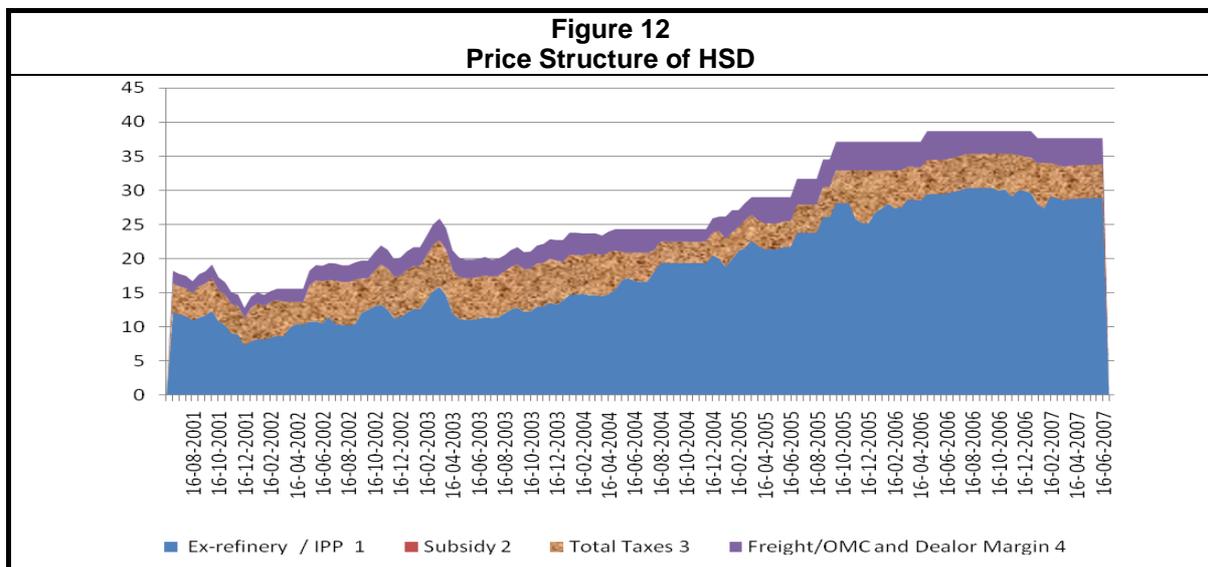


Figure 13 presents share of ex-refinery price, distribution costs, total taxes and subsidies as a percentage of final prices of a litre of HSD during July 2001 to June 2007. Due to sharp increase in ex-refinery prices its share reached to 90 percent in June 2007. During the same period, the share of distribution costs was almost 10 percent, which reflects that consumers were paying the sum of ex-refinery prices and distribution costs. The size of per litre taxes on HSD declined from 23 percent in July 2001 to 13 percent of sale price in June 2007, resulted a decline of ten percentage points. However, this collection was nullified by the equal share of subsidies during the same period.

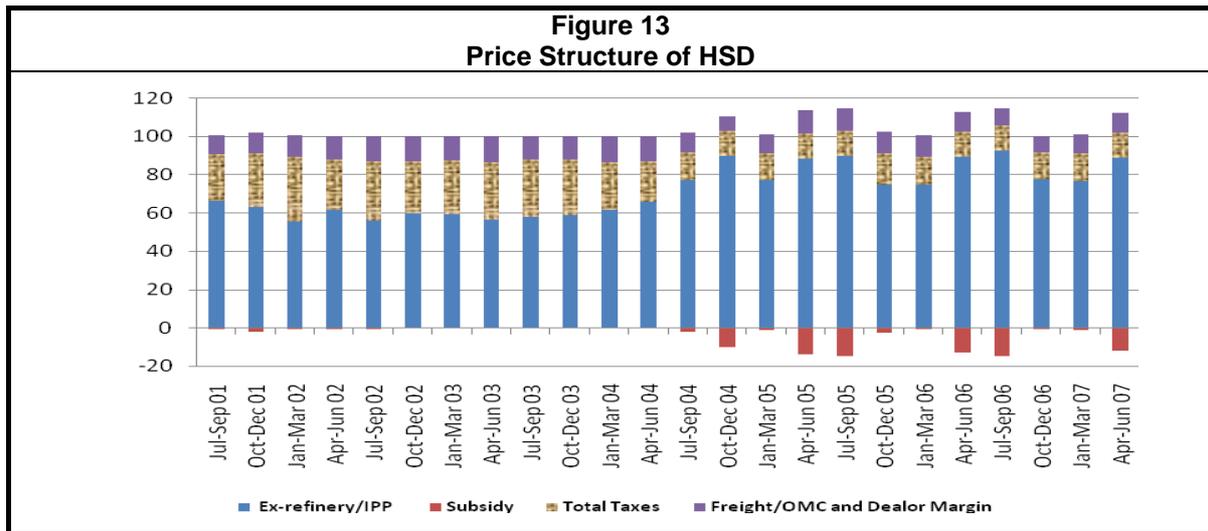
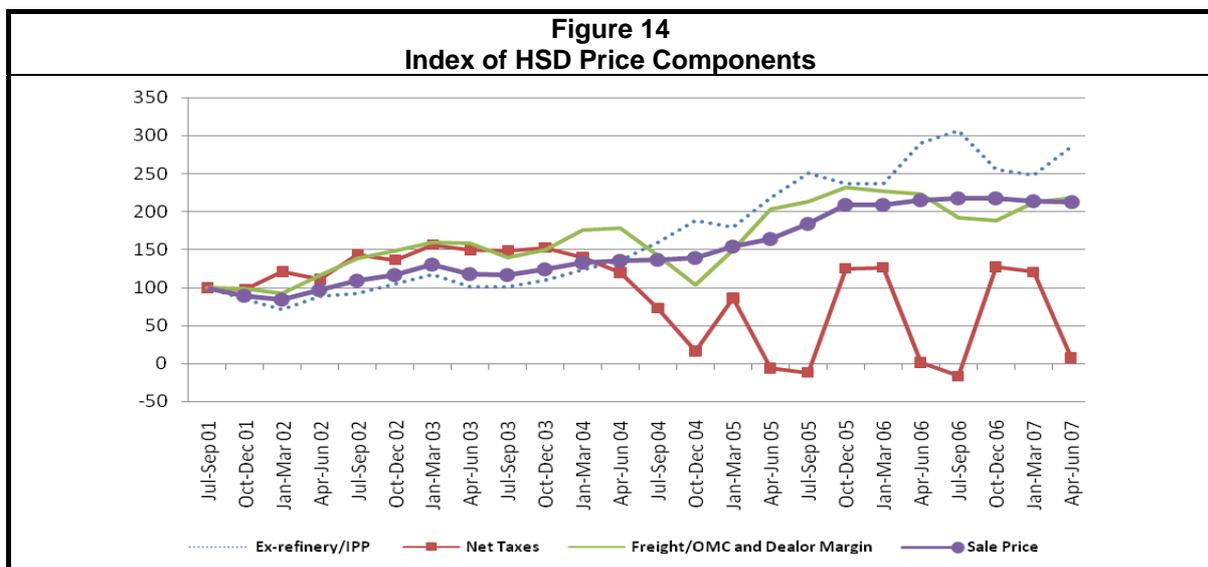


Figure 14 presents trend in index of HSD sale price along with its three price components namely ex-refinery price, distribution costs, and net taxes (total taxes minus subsidies) during July 2001 to June 2007. The trend clearly shows that the sharp increase in ex-refinery price index from 100 to 285, and rise in distribution costs index from 100 to 219 are key factors behind the increase in HSD price index, which rose from 100 to 213. On the one hand, per litre taxes on HSD declined and per litre subsidies almost touched total taxes, as a result net tax indexed touched zero in June 2007.



Price Structure of LDO

Figure 15 shows the fortnightly trend in four components of LDO prices namely: ex-refinery prices, distribution costs, total taxes (excise duty, petroleum development levy and sales tax) and subsidies between July 2001 and May 2008. It is apparent that the ex-refinery price of a liter of LDO rose from Rs. 11.69 to Rs. 54.36 (a rise of Rs. 42.67). Similarly, during the same period distribution costs increased from Rs. 1.46 to Rs. 4.11 – an increase of Rs. 2.65). Similarly, between July 2001 and May 2008 the amount of total taxes on a liter of LDO increased from Rs. 2.97 to Rs. 5.82 (a rise of Rs. 2.85). However, since 2004, government of Pakistan started subsidy on LDO and the per litre amount of subsidy touch its peak in May 2008 and reach to Rs. 19.70.

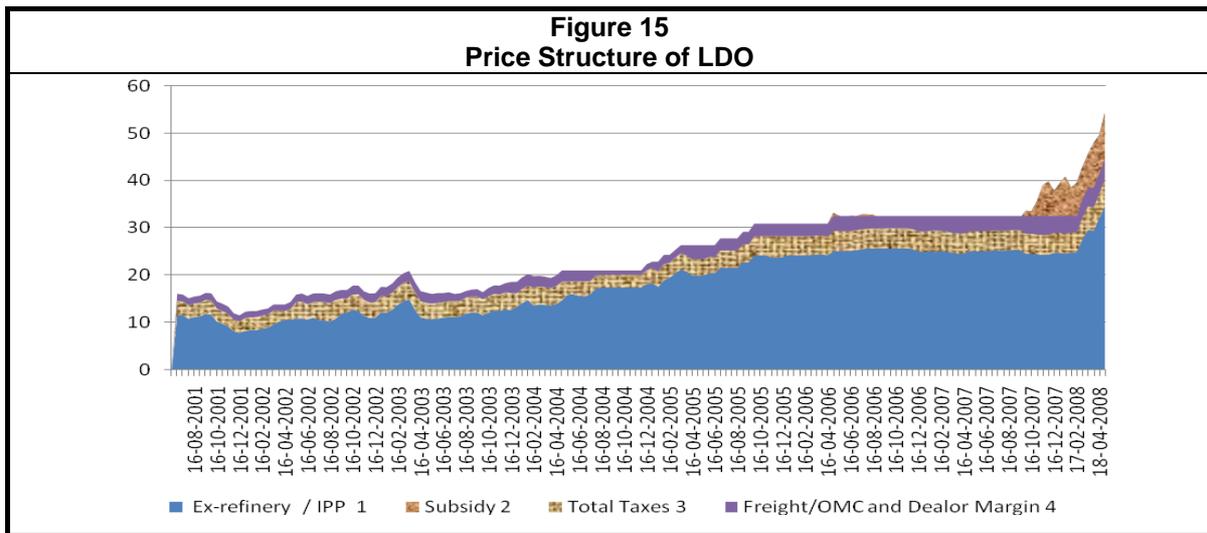


Figure 16 share of ex-refinery price, distribution costs, total taxes and subsidies as a percentage of final prices of a litre of LDO during July 2001 to May 2008. Similar to kerosene, It is apparent ex-refinery price in a liter of LDO rose from seventy-two percent to over hundred percent of final sale price of per litre LDO, and indicates growing share of subsidies, which increased from zero percent to forty four percent. In contrast, share of total taxes decline from 18.4 percent to 13 percent of sales price of a liter of LDO. However, the distribution costs are almost constant at 9 percent.

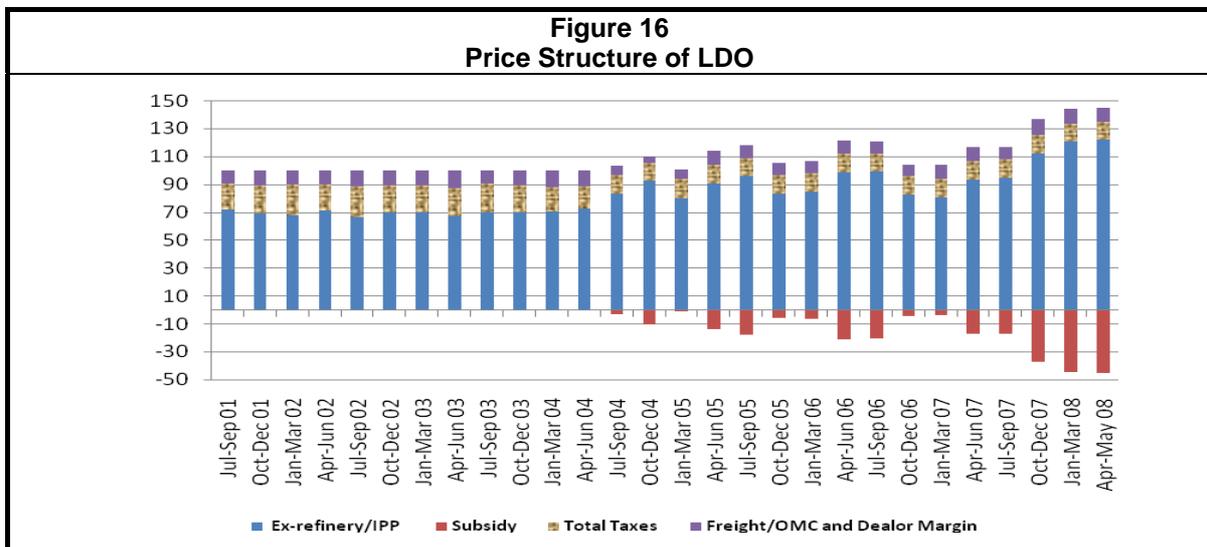
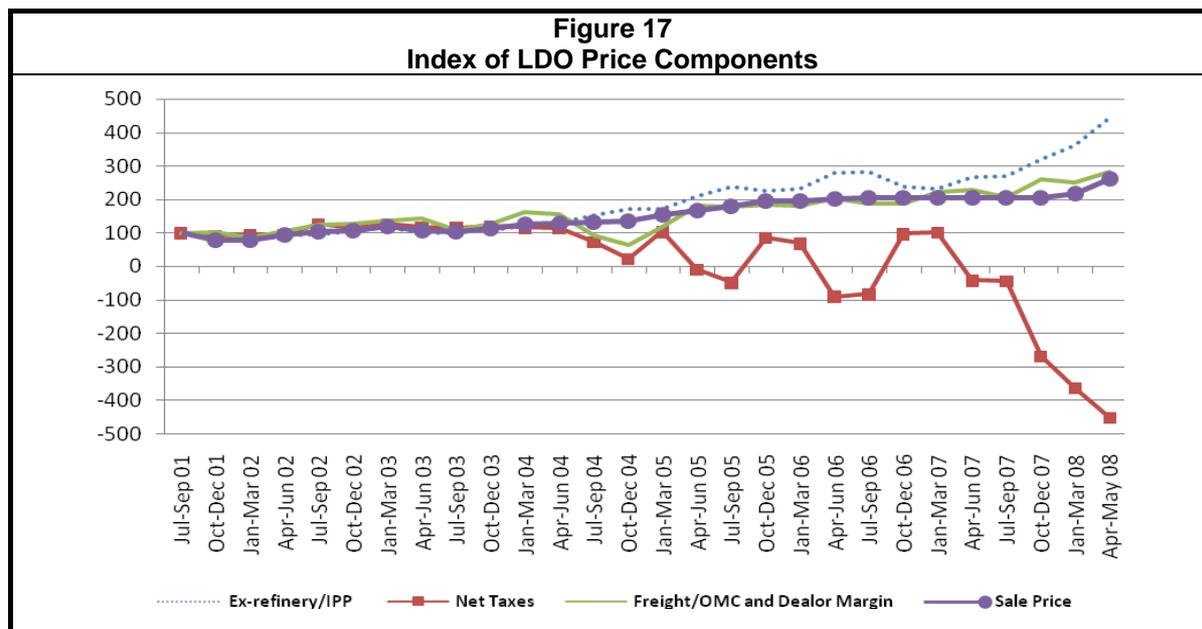


Figure 17 presents trend in index of LDO sale price along with its three price components namely ex-refinery price, distribution costs, and net taxes (total taxes minus subsidies) during July 2001 to May 2008. The trend clearly shows that the sharp increase in ex-refinery price index from 100 to 444, and rise in distribution costs index from 100 to 219 are key factors behind the increase in HSD price index, which rose from 100 to 282. On the one hand, per litre taxes on HSD declined and per litre subsidies crossed total taxes, as a result net tax indexed touched turn out negative and reach to -451 in May 2008.





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