

PAKISTAN
ECONOMIC UPDATE
(JULY 2002 - JUNE 2003)

ASIAN DEVELOPMENT BANK

AUGUST 2003

Pakistan Resident Mission
Asian Development Bank

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August 2003

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FOREWORD

The Asian Development Bank is a long-standing development partner of Pakistan, having provided a total of US\$12.7 billion to the country in development assistance from December 1968 to December 2002. Of this amount, US\$1.1 billion were provided in 2002. In 2003 the level of assistance is expected to be about US\$900 million, and the projected assistance for the period 2004-2006 about US\$2.7 billion. Historically, the major development sectors in which ADB has invested have included agriculture and rural development, energy, social sectors, finance and trade, and transport and communications. Under its Country Strategy and Program for Pakistan for 2002-2006, reduction of poverty is the central objective, which is operationalized through promoting sustainable pro-poor growth, inclusive social development, and good governance, with governance being the key area of focus.

Together with this extensive lending portfolio, the Pakistan Resident Mission (PRM) is actively engaged in Economic and Sector Work to develop an understanding of important economic policy and sector concerns, particularly with regard to poverty and governance issues. To bring this work to a wider audience, PRM published, in July 2002, a country poverty assessment titled "Poverty in Pakistan: Issues, Causes, and Institutional Responses", after extensive consultations and dialogue with the key development partners. PRM has also started a working paper series on topical issues, and the first one titled "Escaping the Debt Trap: an Assessment of Pakistan's External Debt Sustainability" was published in December 2002.

In 2002, PRM initiated a quarterly series to provide a regular update on the state of the national economy. The first Pakistan Economic Update was published in April 2002. The present report, which is the fifth in this series, provides an analysis of economic trends in Pakistan in fiscal year (FY) 2003. The report also reviews the progress in the area of poverty reduction, particularly with regard to public expenditure, and analyses the FY2004 federal budget. In addition, the report presents outlook of the economy for FY2004 and for the medium term based on current trends. We hope that the contents of this report will be of use to all stakeholders including the Government, civil society, donors, academia, media, and others. We look forward to receiving comments on the report, and also suggestions for improvement of future reports in this series.

M.ALI SHAH
Country Director, Pakistan

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Improvements in macroeconomic fundamentals, as well as recovery in the real sector of the economy, were further consolidated in FY2003. The economy grew at a pace not seen in the preceding six years, the fiscal deficit and inflation declined, and the current account surplus and foreign exchange reserves rose to all time high levels. Foundation has been laid for the economy to move to a higher growth path in the medium-term.

Key macroeconomic fundamentals at the beginning of FY2003¹ were better than at any time in the past one decade, because of macroeconomic stabilization and economic and governance reforms pursued by the Government in the preceding three years and some post-11 September 2001 developments. The real sector of the economy had also started showing signs of recovery in the second half of FY2002. These gains were further

consolidated in FY2003, when the economy grew at a pace not seen in the preceding six years; the current account surplus increased; foreign exchange reserves touched new heights; the overall fiscal deficit declined further; the annual inflation rate remained low; and interest rates fell sharply. The export growth was also the highest in the last 14 years, while the import growth had been exceeded only once during this period.

I. MACROECONOMIC DEVELOPMENTS

Domestic Sector

Growth: The economy's overall growth performance showed a sharp improvement in FY2003. The real GDP growth rate is officially estimated at 5.1 percent compared with 3.4 percent in FY2002 (see table 1). However, there is some skepticism about the growth rate estimate, as growth rates were consistently overestimated in each of the preceding three years (see box 1). GNP grew by 8.4 percent due to a sharp increase in net factor income from abroad,² and per-capita income increased by 6.1 percent. The improvement in GDP growth performance was broad-based, with agriculture, manufacturing, and services, all recording higher growth than FY2002.

1. Fiscal year (FY) starts on 1 July and ends on 30 June.

2. The growth in net factor income from abroad resulted from almost doubling of the inflow of workers' remittances.

Table 1: Sectoral Growth & Inflation

	FY01	FY02	FY03
% Growth Rate			
GNP	2.3	5.3	8.4
Per Capita Income	0.0	3.1	6.1
GDP	2.2	3.4	5.1
Agriculture	-2.7	-0.1	4.2
Industry	2.5	5.4	5.4
Of which:			
Large-Scale Manufacturing	9.5	4.9	8.7
Services	4.7	4.1	5.3
CPI - Based Inflation*	4.4	3.5	3.0
% Contribution to GDP Growth			
Agriculture (23.9%)	-32.1	-0.5	19.5
Industry (25.6%)	27.7	40.0	27.3
Of which:			
Large-Scale Manufacturing (12.7%)	49.8	18.1	21.6
Services (50.6%)	104.3	60.5	53.2

* Based on comparison of the 12-month average of CPI.

Note: Numbers in parentheses give respective weights of sectors in GDP.

Box 1: Overestimation of GDP Growth Rates

In the past three years, the Government had overestimated the annual GDP growth rate in the provisional estimates of national income accounts. These estimates were consistently revised downward in the following year (see table).

Table: Growth Rate Estimates

	FY2000	FY2001	FY2002	FY2003
GDP (fc)				
Provisional Estimate	4.5	2.6	3.6	5.1
First Revision	3.9	2.5	3.4	
Second Revision	3.9	2.2		

Agriculture, which had recorded negative growth in the preceding two years, registered a significant positive growth in FY2003. However, its contribution to overall growth, at 19 percent, was less than

its share in GDP. The recovery of the agriculture sector was mainly due to revival of growth in major crops, which constitute two fifths of the value-added in the agriculture sector. Value-added in major

crops increased by 5.8 percent in contrast with a decline of 1.8 percent last year. Except cotton, all other major crops recorded robust growth, with rice output increasing by 15.4 percent, sugarcane by 8.3 percent, wheat by 5.5 percent, and gram by 60.8 percent. The yield of all major crops improved, with the exception of sugarcane. The growth in the livestock sub-sector, which contributes 39 percent of the value-added in agriculture, declined to 2.9 percent from 3.7 percent last year. The major factor responsible for revival of growth in the crop sector was the greater availability of water during the crop year 2003 compared with crop year 2002. Availability of water from the canal system, the main source of irrigation in Pakistan, was 15 percent and 36 percent higher for the summer and winter crops, respectively, compared with the preceding year. Farmers also increased the use of certified seeds and fertilizers, which was facilitated by: (1) higher farm incomes resulting from higher cotton prices, and (2) greater availability of credit at lower interest rates.

The industry sector (including mining, manufacturing, construction, and electricity and gas distribution sub-sectors) maintained a robust growth of 5.4 percent in FY2003 for the second consecutive year. This was mainly due to a sharp acceleration in the growth of the large-scale manufacturing (LSM) sub-sector, which constitutes about half of the industrial sector. Mining and quarrying also registered a growth of 9.5 percent, the highest in the last decade. Higher growth in the above sectors was partly offset by an unexplainable decline in growth of value-added in construction and

contraction of value-added in electricity and gas distribution.³

The growth in LSM picked up in FY2003 and it contributed more than one fifth of the GDP growth. The quantum index of manufacturing available for the July 2002 May 2003 period shows that the LSM production increased by 7.2 percent compared with 5.2 percent in the corresponding period last year. Growth in LSM production was led by sugar, automobiles, electronics, and cement, which together accounted for two-fifths of the growth in LSM.⁴ Both demand and supply factors helped boost LSM production in FY2003. Automobiles and electronics benefited from increase in domestic demand fuelled by growing availability of consumer finance at low interest rates, increase in remittances, and higher prices and output of major crops. Production of cars and jeeps increased by 53.3 percent, motorcycles by 30.3 percent, tractors by 13.4 percent, television sets by 69.7 percent, and refrigerators by 18.9 percent. Higher remittances also pushed up real estate prices and demand for cement and other construction related products. Production of cement increased by 16.2 percent and steel products by 11.5 percent.

The impact of higher exports is not reflected in official data on textile production, as it does not fully cover production of cloth in the informal sector, readymade garments, knitwear, and towels, which account for the bulk of textile exports. The official data on textile production, which covers only the mill sector of the textile industry, showed a

Except cotton, all other major crops recorded robust growth.

Growth in LSM production was led by sugar, automobiles, electronics, and cement.

-
3. The growth of value-added in construction declined to 3.4 percent in FY2003 from 4.3 percent in FY 2002. The slowdown took place despite the high growth in output of cement and steel products, two of the main inputs used in construction. Similarly, value added in the electricity and gas distribution sector should have increased as greater availability of water boosted generation of hydel electricity by 14.3 percent. Thermal generation of electricity also increased by 2.9 percent, and gas supply increased by 4.9 percent.
 4. Excluding sugar and automobiles production, the LSM production increased by 4.9 percent.

Despite recovery in domestic economic activity in FY2003, investment failed to pick up.

growth of 4.1 percent in the first eleven months of FY2003 compared with 4.9 percent in the corresponding period of last year. Sugar industry benefited from the larger sugarcane crop and was able to increase its production by 13.6 percent in the first eleven months of FY2003. However, as Pakistan does not enjoy comparative advantage in sugar production, its growth is not sustainable (see box 2).

The services sector (comprising of transport, storage and communication, trade, finance, ownership of dwellings, public administration and defense, and other services) grew by 5.3 percent in FY2003 compared with 4.1 percent in FY2002. Improvement in the growth performance of the sector was mainly due to a sharp increase of 7.3 percent in value-added in wholesale and retail trade. This was the highest increase in value-added in trade in the last ten years and reflected the large increases in exports and imports as well as recovery in domestic economic activity. For the same reasons transport, storage and communication also picked up during the year. Public administration and defense, too, registered a high growth (5.2 percent) due to the full-year impact of increase in salaries of government servants and higher expenditure on defense for the second consecutive year.

The stagnation of investment despite historically low interest rates is partly explained by the existence of excess capacity in the industrial sector.

Investment and Savings: Despite recovery in domestic economic activity in FY2003, investment failed to pick up. As most industries had excess capacity, they were able to accommodate higher demand by increasing capacity utilization rather than adding new capacity. As a percentage of GDP, gross domestic investment increased from 14.7 percent to 15.5 percent, but the entire increase was due to an increase in inventories, reflecting accumulation of stocks of wheat and sugar. Gross fixed investment remained stagnant at 13.1 percent of GDP, which is an all time low level. It was 3.5 percentage points below the average for the 1990s. A marginal improvement in fixed capital formation in the private sector was offset by an equal decline in public investment. The stagnation of investment despite historically low interest rates is partly explained by the existence of excess capacity in the industrial sector. Investors may also have adopted a wait-and-see attitude in an environment of political uncertainty generated by confrontation between the Government and the Opposition over the status of the Legal Framework Order. However, once excess capacity is exhausted, fixed capital formation will pick up, if economic recovery is sustained.

The upward trend in foreign direct investment (FDI), which started after lifting

Box 2: Non-competitive Sugar Production

Sugar industry is the second largest industry after textiles. It is based on domestically produced sugarcane in which Pakistan does not enjoy comparative advantage, except in a few districts of southern Sindh. As a result, the unit cost of sugar produced in the country is higher than in the international market and the industry thrives only under tariff protection and export subsidies. Higher prices have encouraged over-production of sugar, resulting in accumulation of stocks (over one million tons), which are difficult to dispose of, except through subsidized exports. (The FY2004 budget has allocated Rs 500 million for subsidizing sugar exports. Actual outlay could be much larger.) As sugarcane is a water-intensive crop, its excessive production results in misallocation of this scarce resource as well as of land, both of which could be better utilized for increasing the production of cotton and rice, in which Pakistan enjoys comparative advantage. In addition, consumers are made to pay higher prices. Thus keeping sugar price high behind the tariff wall benefits the sugar mill owners, sugarcane growers, and to some extent the labor employed in the industry, and hurts the rest of the population including the poor.

of economic sanctions by G-7 countries in FY2002, continued in FY2003. Inclusive of privatization proceeds for the United Bank Limited, FDI increased by 64.6 percent to US\$798 million in FY2003. After excluding privatization proceeds, there was a 13.3 percent increase in the inflow of FDI. About three-fourths of FDI was in financial sector, oil and gas exploration, chemicals, and transport and communication. In terms of sources, U.K., U.S.A., and U.A.E. accounted for 69 percent. In the case of portfolio investment, there was a net inflow of US\$22.1 million in contrast with a net outflow of US\$10.1 million last year.

Gross national saving (GNS) increased from 17.0 percent of GDP in FY2002 to 19.2 percent in FY2003, entirely due to a sharp increase in net factor income from abroad, which signifies savings by overseas Pakistanis. Net factor income from abroad constituted almost one-fourth of GNS compared with only 5.3 percent in the preceding year. Gross domestic savings, however, declined to 14.7 percent of GDP, compared with 16.1 percent in FY2002. Lower interest rates, increase in purchases of consumer durables financed through greater availability of consumer credit, and a sharp increase in prices of real estate and corporate shares may have boosted consumption and lowered domestic savings.

Prices: Inflation remained low during FY2003. The annual rate of inflation based on a comparison of 12-month moving average of the Consumer Price Index (CPI) decreased to 3.1 percent from 3.5 percent in FY2002, despite increase in petroleum prices. A number of factors contributed to the low CPI-based inflation. One, comfortable supply position of essential food commodities, like wheat and sugar, resulted in stable food prices, which carry the largest weight (40.3 percent) in CPI. Two, because of excess capacity in most industries, increased demand could be accommodated without exerting upward

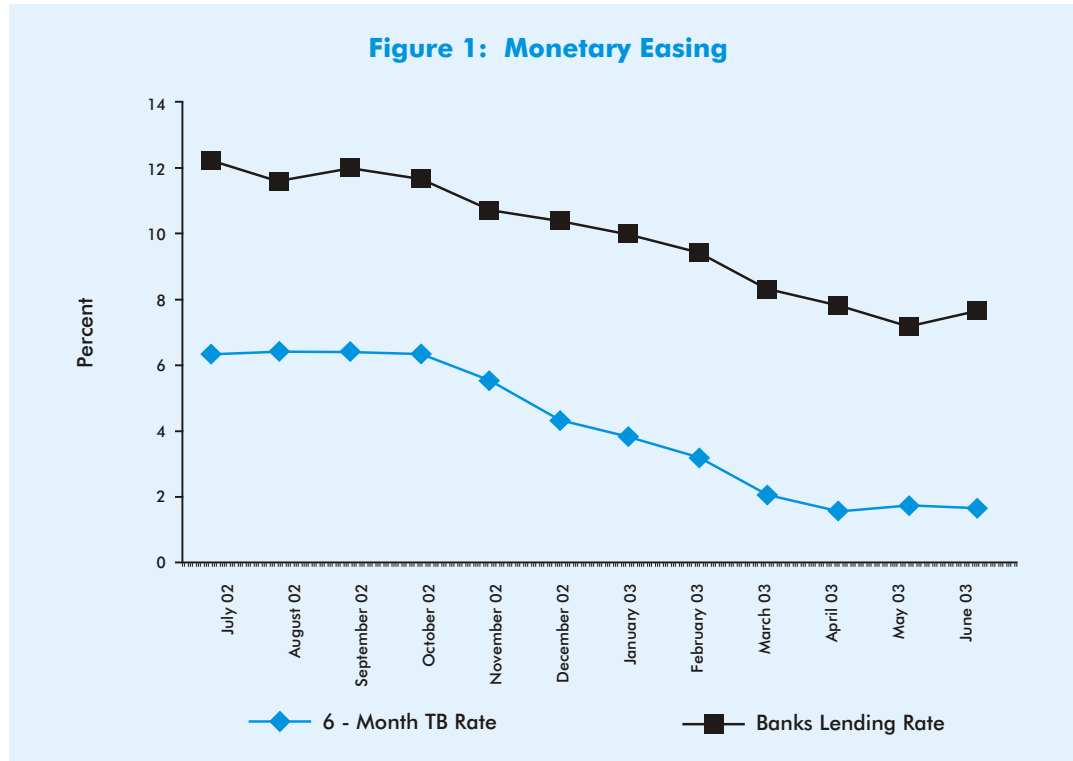
pressure on prices. Three, except for petroleum, world prices remained subdued during the year. Four, appreciation of the Pak Rupee exerted downward pressure on prices of imports and exportables. However, the Wholesale Price Index (WPI) showed a substantial increase due to a sharp rise in prices of cotton, vegetable ghee and cooking oil, and cotton yarn. The WPI-based inflation increased from 2.3 percent in FY2002 to 5.9 percent in FY2003.

Monetary Management: In an environment of stable prices, the State Bank of Pakistan (SBP) continued to pursue an easy monetary stance in FY2003 to stimulate investment and growth. Besides, SBP did not need to pursue a tight money policy to support the Rupee. On the contrary, SBP constantly intervened in the inter-bank market to prevent large exchange rate appreciation, and in the process injected liquidity in the market. The SBP lowered its discount rate by 150 basis points to 7.5 percent in November 2002. The rate of interest on 6-month treasury bills, which serves as a benchmark for all other interest rates, and the yield on long-term government paper, i.e. 10-year Pakistan Investment Bonds, maintained a steep downward trend throughout the year (see figure 1). The average lending rate charged by banks on their advances declined by 554 basis points to 7.6 percent in FY2003, and the spread between lending and deposit rates declined from 8.4 percent to 5.7 percent. While low interest rates on bank advances encouraged greater use of bank credit (see p. 6) by the private sector to meet its increased working capital requirements, extremely low rates of return on bank deposits, which have become negative in real terms, may have discouraged savings (see p. 5).

Despite SBP's policy of partial "sterilization" of the liquidity generated by its purchases of foreign exchange in the inter-bank market (see box 3), broad money

The CPI-based annual rate of inflation decreased to 3.1 percent from 3.5 percent in FY2002, despite increase in petroleum prices.

In an environment of stable prices, the State Bank of Pakistan continued to pursue an easy monetary stance to stimulate investment and growth.



Net borrowing by private sector increased to Rs 153.6 billion compared with Rs 37.7 billion in the preceding year.

supply increased by Rs 309.3 billion, or 17.6 percent during FY2003, compared with an increase of 14.8 percent in FY2002. Monetary expansion in FY2003 was higher than the revised target of 16.0 percent for the year. Increase in money supply was triggered exclusively by a large expansion of Rs 310.5 billion in net foreign assets of the banking system. Net domestic credit remained more or less unchanged. The Government retired Rs 44.0 billion of its borrowing from banking system for budgetary support, as funds available from other sources exceeded its deficit financing

requirements (see p. 8). The Government also managed to retire Rs 25.0 billion of its borrowings on account of commodity operations. Other items (net), too, had a contractionary impact of Rs 69.0 billion. However, private sector credit picked up and net borrowing by private sector, including export finance, was Rs 153.6 billion compared with a net borrowing of Rs 37.7 billion in the preceding year. The sharp increase in private sector credit was driven by the improved economic activity and an unprecedented decline in interest rates.

Box 3: SBP's Sterilization Operations

SBP injected substantial liquidity in the banking system through its purchases of foreign exchange in the inter-bank market in FY2003. It sterilized a part of this additional liquidity by offloading treasury bills and other government securities held in its portfolio through auctions. This way, SBP was able to limit the growth in reserve money, which serves as a base for further monetary expansion through money multiplier effect. However, because of continuous appreciation of the Rupee during the year, SBP incurred losses in its sterilization operations, which reduced its overall profits (see p. 10).

Stock Market: There was a boom in the stock market in FY2003, when share prices almost doubled. The KSE-100 index increased by 92.2 percent from 1,770 in June 2002 to 3,402 in June 2003, which was the highest level ever reached (see figure 2). Trading in the market also increased sharply and turnover of shares in the Karachi Stock Exchange increased to 52 billion shares, from 29 billion shares in FY2002. Market capitalization of shares listed on the Karachi Stock Exchange also increased from Rs 408 billion to Rs 746 billion.

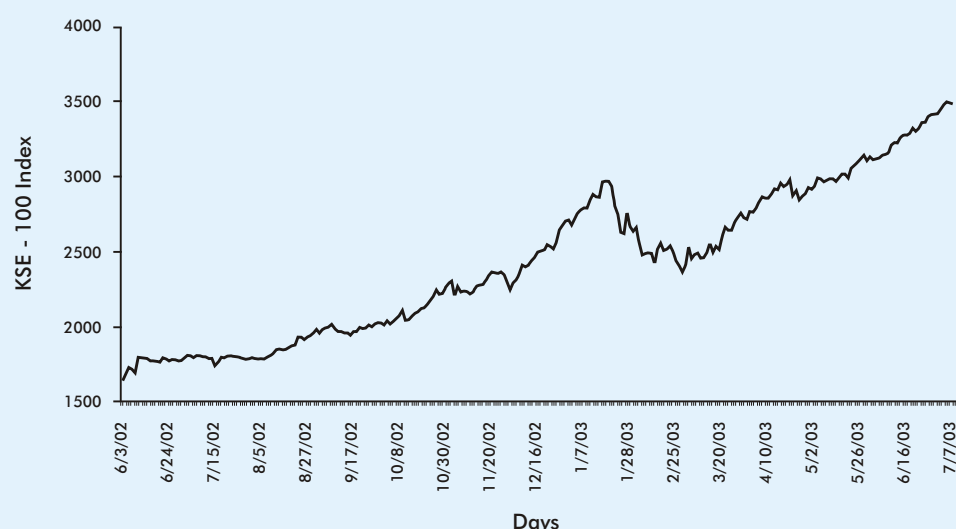
Continued increase in remittances, appreciation of the Rupee, low interest rates, and lack of investment opportunities in real sectors raised the demand for equities. In addition, the low interest rates also improved corporate earnings by reducing the financial cost of businesses. The share of financial charges in cost of production declined to as low as 3 percent.

The Indian Government's decision to withdraw troops from the border with Pakistan in October 2002 also gave boost to the market sentiment. There was also some speculative buying of shares to earn quick profits, as is evidenced from very steep rise in interest rate (up to 50 percent) on short-term financing of share purchases in January 2003.

Fiscal Policy:⁵ The Government pursued a tight fiscal policy during FY2003, resulting in a significant decline in the overall fiscal deficit to 2.1 percent of GDP in the first three quarters of the year, compared with 3.2 percent in the corresponding period of FY2002 (see table 2). Increase in expenditure was contained at 6.8 percent, while revenues were increased by 15.7 percent. The decrease in the fiscal deficit and consequent decrease in Government's borrowing requirements have allowed SBP to lower

A boom in the stock market in FY2003, resulted in almost a 100 percent increase in share prices.

Figure 2: Stock Market Performance June 2002 - June 2003



5. In this section we discuss the fiscal stance of the Government and its impact on the economy. The numbers used in the section are for consolidated expenditures and revenues of the Federal and Provincial Governments in the first three quarters of FY2003, which have been posted by the Ministry of Finance, Government of Pakistan on its web page. The analysis of the Federal Budget FY2004 is presented in Section III.

Decrease in Government's borrowing requirements allowed the State Bank of Pakistan to lower interest rates, and provided space for private sector credit expansion.

interest rates, besides providing space for private sector credit to expand.

The budget deficit was financed through external sources, domestic non-bank sources mainly comprising of national saving schemes (NSS), and privatization proceeds (see table 3). As financing available through these sources exceeded the total deficit financing requirements of the Government, it had to retire a substantial amount of its borrowing from the banking system (see p. 6). The availability of funds through the above sources is determined independently of the Government's deficit

financing requirements. Depositors decide the amount they want to offer through NSS, which are available on tap. With rates of return on NSS being significantly higher than on other government paper of comparable maturity, the Government's borrowing through NSS has crowded out its borrowing from the banking system. As a result, the Government has not been able to reap full benefits of the decline in interest rates.

The Government was able to contain the increase in expenditure because of lower interest payments, 15 percent less in the first

**Table 2: Consolidated Federal and Provincial Fiscal Position
(Million Rs)**

	July - March		Change %
	FY2002 (Revised Estimates)	FY2003 (Prel. Estimates)	
Total Revenue	436,406	505,009	15.7
Of Which:			
Federal Revenue	408,034	471,392	15.5
Taxes	266,847	311,396	16.7
Surcharges	40,627	48,653	19.8
Non-Tax Revenue	100,560	111,343	10.7
Total Expenditure	553,522	591,395	6.8
Current Expenditure	466,131	528,835	13.5
Federal	353,632	367,893	4.0
Of Which:			
Interest	175,194	148,760	-15.1
Domestic	137,080	121,871	-11.1
Foreign	38,114	26,889	-29.5
Defense	94,520	115,768	22.5
Running of Civil Administration	54,625	65,010	19.0
Subsidies	14,432	23,541	63.1
Provincial	112,499	160,942	43.1
Development Expenditure and Net Lending	96,528	86,756	-10.1
Development Expenditure	91,508	82,416	-9.9
Federal	70,477	48,955	-30.5
Provincial	21,031	33,461	59.1
Unidentified Expenditure	-9,137	-24,195	164.8
Budget Deficit	-117,116	-86,386	-26.2
As % of GDP	-3.2	-2.1	

Source: Ministry of Finance Website.

**Table 3: Financing of Overall Fiscal Deficit
(Million Rs)**

	July - June		July - March	
	FY2001	FY2002	FY2002	FY2003
Overall Fiscal Deficit Financing	180,400	242,766*	117,116	86,336
External Borrowing (Net)	118,800 (65.9)	106,564 (43.9)	55,735 (47.6)	64,171 (74.3)
Domestic Non-Bank Borrowing (Net)	93,900 (52.1)	115,395 (47.5)	66,604 (56.9)	66,200 (76.7)
Domestic Bank Borrowing (Net)	-32,300 (-17.9)	12,455 (5.1)	-5,223 (-4.5)	-52,513 (-60.8)
Privatization Proceeds	—	8,352 (3.4)	—	8,529 (9.9)

Numbers in parentheses show the percentage share of each source of financing the deficit.

* Unadjusted fiscal deficit including one-time expenditures.

three quarters of FY2003 compared with the same period of FY2002. The decline in interest payments on foreign debt was much larger than on domestic debt. The policy of substituting high-cost short-term foreign loans with low-cost long-term loans over last 2-3 years and re-profiling of bilateral foreign debt negotiated in December 2001, have enabled the Government to reduce the cost of servicing external debt by 29.5 percent. Because of its failure to limit borrowings through high-cost NSS instruments, the Government did not reap the full benefit of lower interest rates in the domestic market (see preceding para). Interest payments on domestic debt declined by only 11.1 percent.

Lower interest payments created the much-needed fiscal space to increase poverty reducing and development expenditures, but it was used to increase expenditure on defense, running of general administration, and subsidies. Defense expenditure increased by 22.5 percent in the first three quarters of FY2003 compared with the corresponding period of FY2002, because of deployment of forces on borders with India during the first half of the year.

Expenditure on running of federal civil administration increased by 19.0 percent, reflecting an upward revision of the remuneration package of Government employees, effective since December 2001. Expenditure on federal subsidies, at Rs 23.5 billion, in the first three quarters of FY2003 was 63.1 percent higher compared with the corresponding period of last year. The increase in subsidies was mainly because of losses of the Water and Power Development Authority (WAPDA) and Karachi Electric Supply Company (KESC) as well as adjustment for GST on electricity consumed by households and compensation for lower-than-normal electricity tariffs charged on supplies to Azad Jammu and Kashmir and tubewells in Balochistan.

Development expenditure in the first three quarters of FY2003 was 9.9 percent lower than in the same period of FY2002. The decline was entirely in federal development expenditure, which was 30.5 percent lower than last year, despite a much higher allocation made in the budget. In each of the preceding four years, total development expenditure of the federal and provincial governments fell short of budget

Fiscal space resulting from lower interest payments was used to increase expenditure on defense, running of general administration, and subsidies.

Even if no new projects are started, it will take 8 years to complete ongoing projects given the present level of Federal Government's development expenditure.

allocations by wide margins, reflecting poor implementation capacity of the Government. Lower development expenditure by the Government partly explains decline in fixed investment in the public sector in FY2003 (see p. 4).

Besides persistent failure of the Government to utilize budgeted allocations for development due to poor implementation capacity, individual projects included in the development program take unduly long time to complete, as limited resources are spread thinly over a very large number of projects. This is particularly true of the Federal Government, which has not cleaned up its project portfolio like provincial governments. At present, there are 958 projects in the Federal development program, with a "throw-forward" cost of Rs 928 billion. That is even if no new projects are started, it will take 8 years to complete the ongoing projects given the present level of Federal Government's development expenditure, and assuming that there are no cost overruns. Under these circumstances, very few projects are completed and become operational to benefit the society in any one year, badly undermining the effectiveness of whatever development expenditure is incurred.

Exports grew by 20.8 percent and imports by 17.9 percent, exceeding the targets set at the beginning of the year by a wide margin.

Increase in revenues in the first three quarters of FY2003 was broad-based, with federal tax revenues increasing by 16.7 percent to Rs 331.4 billion, surcharges by 19.8 percent to Rs 48.7 billion, and non-tax revenues by 10.7 percent to Rs 111.3 billion, compared with the first three quarters of FY2002. The increase in tax revenues resulted from recovery in domestic economic activity and sharp increase in imports as well as reforms of tax administration. As percentage of GDP, total

revenues in the first three quarters of the year were 12.4 percent of GDP and tax revenues, including surcharges, 9.4 percent compared with 11.8 percent and 8.8 percent, respectively, in the same period of last year. The increase in non-tax revenues was mainly due to receipts from the United States for logistic support for operations in Afghanistan and payment of dividend by the Pakistan Telecommunication Corporation Limited (PTCL) for the year ending on 30 June 2002. Excluding receipts for logistic support from USA (Rs 39.6 billion in July-March 2003 and Rs 8.1 billion in July-March 2002), non-tax receipts of the Federal Government witnessed a fall of 22.5 percent, primarily because receipts from the SBP were less than one third of the level of last year, as a result of the losses incurred on account of SBP's sterilization operations (see box 3).

External Sector

Balance of Trade: Exports grew by 20.8 percent to \$11.0 billion and imports by 17.9 percent to \$12.2 billion, exceeding the targets set at the beginning of the year by a wide margin. There was some slowdown in the growth of imports in the last two months of FY2003, while export growth kept accelerating throughout the year (see figure 3). The trade deficit in FY2003, at \$1,154 million, was the 4.2 percent lower than in the corresponding period of FY2002.

Increases in both quantities and prices (in US Dollars) contributed to higher value of exports during FY2003 (see table 4). Price increases contributed slightly more than half of the total growth in value of exports for which quantity and price data is available.⁶ More than four fifths of such exports in value terms recorded increases in prices; for about half of them price increases

6. Exports for which quantity and price data is available accounted for 79.9 percent of total exports in FY2003.

Figure 3: Growth of Exports & Imports Based on 12 Months Moving Average

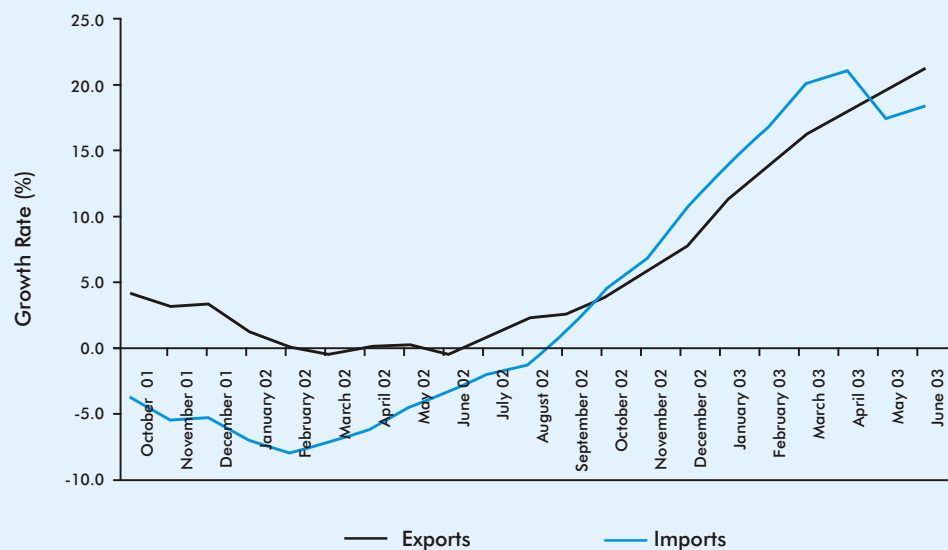


Table 4: Changes in Price and Quantities of Major Exports in FY2003

Commodities	% Change in Price	% Change in Quantity
Primary Commodities		
<i>Of Which:</i>		
Basmati Rice	7.6	29.2
Other Rice	5.6	-6.8
Fish and Fish Preparations	-1.7	9.6
Wheat	2.2	77.1
Textile Manufactures		
<i>Of Which:</i>		
Cotton Yarn	3.6	-3.4
Cotton Cloth	12.1	5.0
Knitwear	-5.0	41.0
Bedwear	8.1	33.1
Readymade Garments	40.4	-10.9
Art Silk and Synthetic Textiles	16.9	17.2
Other Manufactures		
Carpets	4.5	-20.0
Petroleum Products	33.7	21.8
Tanned Leather	9.7	-16.5
Plastic Materials	6.5	250.1

Growth in exports was broad-based, with textiles growing by 24.2 percent, primary commodities by 22.7 percent, and other unclassified items by 27.5 percent.

were in double digits. Widespread increases in prices of Pakistani exports in an environment of global weakness is somewhat puzzling, but may be explained by appreciation of the Pak Rupee, move to higher value items in textiles, particularly garments, and possibly due to a change from under- to over-invoicing of exports to bring back funds transferred abroad in earlier years.

Increase in exports in FY2003 was

broad-based, with textile manufactures growing by 24.2 percent to \$7,174.3 million, primary commodities by 22.7 percent to \$992.6 million, and other unclassified items by 27.5 percent to \$945.9 million (see table 5). Export of non-textile manufactures, mainly comprising leather and leather manufactures, sports goods, and carpets, also rose by 4.5 percent to \$1,994.6 million. Besides better access to the European Union and US markets and improved competitiveness of the domestic

**Table 5: Structure of Exports
(Million US\$)**

Commodities	FY2002	FY2003	% Change
Primary Commodities	808.7	992.6	22.7
Of Which:			
Rice	448.2	546.1	21.8
a) Basmati Rice	258.0	358.8	39.1
b) Other Rice	190.3	187.4	-1.5
Fish and Fish Preparations	125.6	135.3	7.7
Wheat	71.4	129.1	80.9
Textile Manufactures	5,778.3	7,174.3	24.2
Of Which:			
Cotton Yarn	929.7	930.1	0.5
Cotton Cloth	1,130.8	1,331.0	17.7
Knitwear	845.9	1,136.2	34.3
Bedwear	918.6	1,320.8	43.8
Towels	267.7	373.6	39.5
Readymade Garments	875.0	1,094.5	25.1
Art Silk and Synthetic Textiles	410.0	561.7	37.0
Other Manufactures	1,909.2	1,994.6	4.5
Of Which:			
Carpets, Rugs & Mats	249.6	208.6	-16.4
Petroleum Products	115.8	188.7	62.9
Sports Goods	304.5	315.7	3.7
Leather & Leather Manufactures	623.1	581.1	-6.7
Surgical Goods & Medical Instruments	145.0	138.6	-4.4
Chemicals & Pharm. Products	152.8	255.1	67.0
Of Which:			
Plastic Materials	27.4	102.0	272.8
Others	741.7	945.9	27.5
Total	9,134.6	11,030.5	20.8

textile industry, availability of export finance at lower interest rates,⁷ and accelerated pace of sales tax refunds by CBR also helped boost exports.

Growth in exports in FY2003 was led by textiles, which contributed almost three-fourths of the total increase in exports. Their share in total exports increased from 63.0 percent to 65.0 percent. Like most other exports, textile exports also benefited from both rising volume and higher unit prices in FY2003. However, unlike non-textile exports, increases in volume were predominant and contributed more than half of the growth in value of textile exports. With the exception of readymade garments and cotton yarn, all other textile exports recorded increases in volume ranging from 5.0 percent in the case of cotton cloth to 41.4 percent for knitwear. There was a clear shift away from low value-added items like cotton yarn, whose share in textile exports declined to 13.0 percent compared with 16.1 percent in FY2002. On the other hand, the share of five higher value-added items, bedwear, knitwear, towels, readymade garments, and synthetic textiles, increased from 43.9 to 53.3 percent. Also, within some categories, like readymade garments, the sharp increase in unit value indicates a shift to higher value-added items.

Substitution of low-priced irri rice with high priced basmati rice in rice exports, which started last year because of a similar shift in domestic production of the commodity, progressed further in FY2003. The share of basmati rice increased to 65.7 percent from 57.2 percent in the preceding year. As a result, the unit value of rice increased by 16.2 percent and total earning

from its export registered an increase of 21.8 percent to \$546.1 million. Another noticeable development about primary exports is the emergence of wheat as the third largest export earner after rice and fish. Its export fetched \$129.1 million in FY2003 compared with \$71.4 million in the preceding year. This, however, has a downside to it. As the domestic price of wheat was higher than its international price, its export was heavily subsidized.

Growth in imports was led by machinery, which contributed more than one third of total increase in imports in FY2003 (see table 6). Among machinery, particularly large increases were recorded in textile machinery (29.0 percent), power generating machinery (28.9 percent), electrical machinery and apparatus (65.2 percent), and agricultural machinery (115.6 percent). Increasing imports of textile machinery in the last three years have helped in the modernization of the textile industry, which enabled the industry to increase exports. Sharp increase in power generating machinery was due to industrial units installing their own power generators to improve the reliability of power supply, as well as import of machinery for Ghazi Barotha Hydel Electricity Project. Similarly, the increase in imports of electrical machinery and apparatus was attributable to increase in production /assembly of electronic goods.

Due to rising world prices, imports of petroleum crude and petroleum products in value terms increased by 7.5 percent and 11.0 percent in FY2003. However, the volume of their imports decreased by 4.9 percent and 8.5 percent, respectively, because of the continued switch from petrol

With the exception of readymade garments and cotton yarn, all other textile exports recorded increases in volume.

Particularly large increases were recorded in the import of textile machinery, power generating machinery, electrical machinery and apparatus, and agricultural machinery.

7. Effective from 1 April, the SBP reduced its export refinance rate to 2.5 percent from 3.5 percent, the fifth such cut during the year. As a result, commercial banks were able to lower their rate of interest on loans under the Export Finance Scheme to 4.0 percent, down from 8.0 percent at the beginning of FY2003.

**Table 6: Structure of Imports
(Million US\$)**

Commodities	FY2002	FY2003	% Change
Food Group	823.2	970.0	17.8
Of Which:			
Tea	156.6	172.5	10.2
Edible Oil	393.0	580.4	47.7
Of Which:			
Palm Oil	380.4	532.7	40.0
Pulses	135.9	115.0	-15.4
Machinery Group	2,207.5	2,839.1	28.6
Of Which:			
Power Generating Machinery	203.8	262.8	28.9
Office Machines Incl. Data Proc. Equip.	224.3	208.8	-6.9
Textile Machinery	406.9	524.8	29.0
Construction & Mining Machinery	118.6	98.0	-17.4
Electrical Machinery & Apparatus	128.0	211.6	65.2
Roadmotor Vehicles	330.0	492.4	49.2
Petroleum Group	2,807.0	3,060.9	9.0
Petroleum Products	1,576.2	1,694.4	7.5
Petroleum Crude	1,230.8	1,366.5	11.0
Textile Group	187.5	222.9	18.9
Of Which:			
Synthetic Fibre	74.4	93.0	25.1
Synthetic & Artificial Silk Yarn	82.4	92.0	11.7
Agricultural & Other Chemicals Group	1,869.4	2,166.2	15.9
Of Which:			
Manufactured Fertilizers	176.2	239.7	36.0
Plastic Materials	352.7	423.0	19.9
Medicinal Products	228.1	218.0	-4.4
Metal Group	433.9	503.1	16.0
Of Which:			
Iron & Steel	336.1	399.9	19.0
Miscellaneous Group	285.4	304.5	6.7
Of Which:			
Rubber Tyres & Tubes	66.6	78.0	17.2
Others	1,725.7	2,118.3	22.7
Total	10,339.5	12,185.0	17.8

Non-food, non-oil imports increased by 21.5 percent in FY2003

to the use of compressed natural gas in the transport sector and from furnace oil to coal by the cement industry. There was also some shift in the composition of power generation away from thermal generation, and the share of hydel generation increased from 26.9 percent to 29.4 percent.

Non-food, non-oil imports increased by 21.5 percent in FY2003. Besides machinery, raw materials and intermediate goods recorded substantial increases, reflecting recovery in the economy. Import of knocked down kits of motor vehicles increased by 49.2 percent to support

expansion in automobile assembly. Among raw materials, synthetic fiber, plastic materials, and iron and steel recorded substantial increases. Notably, there is virtually no import of textile manufactures into Pakistan, although smuggled cloth and readymade garments are freely available in every large city. There is a need to remove barriers to the import of textile manufactures to expose the local textile industry to competition and thus encourage it to further improve quality and lower cost of production.

Current Account: The current account of the balance of payments showed a substantial improvement in FY2003, with

the surplus, excluding official transfers, increasing by 144.6 percent to \$3,273 million, compared with FY2002 (see table 7). This improvement in the current account resulted from lower interest payments and higher workers' remittances. Additional receipts for logistic support for operations in Afghanistan also helped. Two out of the three components of the current account showed improvement, as discussed below.

The trade deficit increased marginally to \$398 million in FY2003 compared with \$294 million in FY2002.⁸

There was a reduction of \$694 million in deficit in the services account, mainly

There was a surplus of over \$3.2 billion on the current account of the balance of payments, excluding official transfers.

**Table 7: Balance of Payments
(Million US\$)**

	FY2001	FY2002	% Change	FY2003	% Change
Trade Balance	-1,269	-294	-76.8	-398	35.3
Services (Net)	-3,211	-2,617	-18.5	-1,923	-26.5
Current Transfers	4,737	5,744	21.3	7,577	31.9
Of Which:					
Workers' Remittances	1,087	2,390	119.9	4,237	77.3
Official Transfers	839	1,495	78.2	1,983	32.6
Purchases from Kerb Market	2,157	1,376	-36.2	0.0	—
Current Account Balance	257	2,833	1,002.3	5,256	85.5
Current Account Balance (Excl. Official Transfers)	-582	1,338	—	3,273	144.6
Capital Account (Net)	-644	-1,107	71.9	-653	-41.0
Change in Reserves (-Inc/+Dec)	-1,000	-2,792	179.2	-4,744	69.9
Errors & Omissions	626	928	48.2	187	-79.8
Exceptional Financing	692	138	-80.1	-46	—
Official Reserves (End Period)	1,688	4,337	156.9	9,529	119.7
(In Weeks of Merchandise Imports)	8.6	24.0	179.1	43.9	82.9

Source: State Bank of Pakistan Website.

8. The trade balance numbers quoted here are derived from export receipts and import payments based on foreign exchange transactions and, because of leads and lags, differ from trade numbers based on the physical movement of goods across borders discussed earlier. The trade deficit based on physical movement of goods declined by 4.2 percent to \$1,154 million in FY2003 compared with \$1,205 million in FY2002.

Sharp increase in foreign direct investment reflects partly the enhanced investor confidence following the buildup of foreign exchange reserves.

because of receipts from the USA for logistic support provided for operations in Afghanistan, lower interest payments, and larger net receipts for transportation other than shipping. The policy pursued by the SBP in the last three and half years to pay back high-cost foreign exchange liabilities like FE45 foreign currency deposits and Special US Dollar Bonds is paying off in the form of lower interest payments.⁹

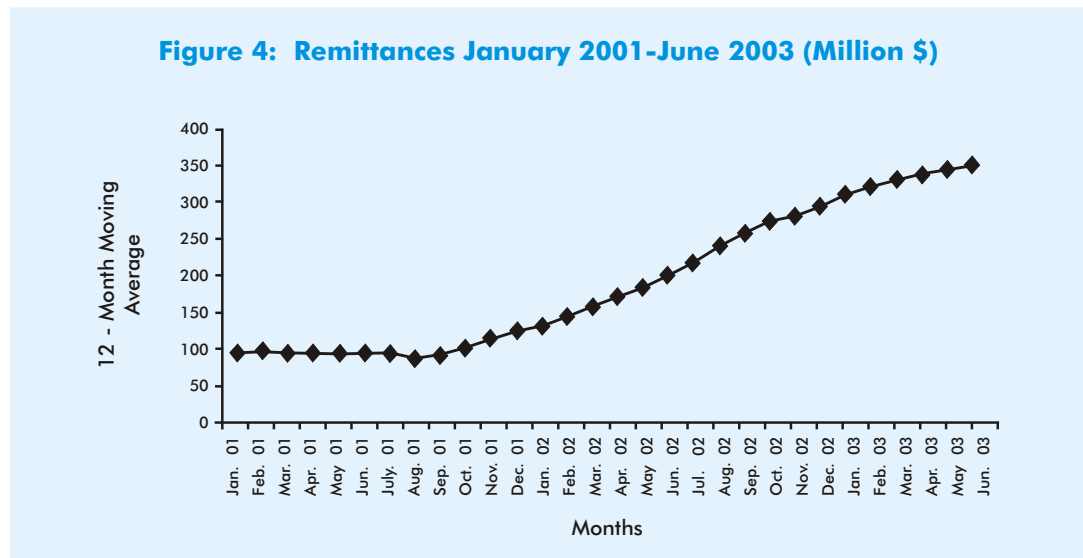
Net current transfers to Pakistan in FY2003 increased by 31.9 percent to \$7,577 million compared with \$5,744 million in FY2002, mainly due to a 77.3 percent increase in remittances to \$4,237 million (see figure 4). The increase in net current transfers took place despite discontinuation of outright purchases by SBP of foreign exchange in the kerb market, which amounted to \$1,376 million last year.

Capital Account: The capital account deficit declined to \$653 million in FY2003 compared with \$1,107 million in FY2002, primarily because of a large increase in FDI (64.5 percent). Sharp increase in FDI reflects partly the enhanced investor confidence following the buildup of foreign exchange reserves, and partly privatization proceeds for the sale of UBL and investments in oil and gas sector.¹⁰

Foreign Exchange Reserves: As a result of the large current account surplus and substantial purchases of foreign exchange from the inter-bank market undertaken by the SBP to limit the appreciation of the Rupee, foreign exchange reserves held by the SBP increased to \$9.5 billion by end June 2003, compared with \$4.3 billion as of end June 2002.

External Debt: The SBP continued to pursue the policy of paying off high-cost

Figure 4: Remittances January 2001-June 2003 (Million \$)



9. Pakistan has reduced the stock of its expensive foreign debt and liabilities by \$3.9 billion over the last three and half years.
10. Out of total FDI of \$798 million, receipts on account of privatization amounted to \$300 million FY2003. There were no such receipts in FY2002.

short-term foreign exchange liabilities in order to lower the country's external debt servicing liability. Foreign exchange liabilities, mainly consisting of foreign currency accounts, Special US\$ Bonds, and other foreign currency bonds, which had been reduced from \$5.7 billion in June 2001 to \$3.1 billion by June 2002, were further reduced to \$2.1 billion by end-March 2003. As a result, total external debt and liabilities declined from \$36.5 billion on 30 June 2002 to \$35.6 billion by end-March 2003.

Outlook

In FY2003, Pakistan made further progress in macroeconomic stabilization. The overall fiscal deficit and inflation declined to the lowest levels in last three decades and the current account surplus and

foreign exchange reserves rose to all time high levels. For FY2004 and FY2005, the Pakistan Government has made projections with respect to GDP growth, inflation, budgetary deficit, investment, exports, imports, and current account of the balance of payments (see table 8).

As far as FY2004 is concerned, with sound macroeconomic fundamentals, the economy should be able to realize the growth target of 5.3 percent set by the Government. Good monsoon rains throughout Pakistan have improved the prospects of the rice and sugarcane crops, standing in the fields at present. Heavier snowfall in the mountains during the last winter (than in the last four years) has raised the level of water in the two major water reservoirs for use throughout the year.¹¹

With sound macroeconomic fundamentals, the economy should be able to realize the growth target of 5.3 percent set by the Government for FY2004.

Table 8: Medium-Term Outlook

	Projections*		
	FY2003	FY2004	FY2005
	(Annual Changes in Percent)		
Real GDP	5.1	5.3	5.8
Of Which:			
Agriculture	4.2	4.0	4.3
Large-Scale Manufacturing	8.7	8.8	9.0
Inflation Rate (CPI)	3.1	4.0	4.0
Exports	20.8	6.6	6.5
Imports	17.8	4.9	8.0
	(In Percent of GDP)		
Budgetary Deficit	-4.5	-4.0	-3.7
Investment	15.5	16.5	17.0
Trade Balance	-1.5	-1.2	-1.4
Current Account Balance			
Exc. Official Transfers	4.2	0.7	0.1

* Sources: 1) Federal Budget in Brief 2003 - 2004
2) The Trade Policy 2003 - 2004.

11. Of the two main water reservoirs, Mangla is already full and the level of water in Tarbela, at 1,547 feet, as of 12 August 2003, is only three feet short of the maximum capacity level.

Given adequate food supplies and excess capacity in the manufacturing sector, the inflation rate target of 4 percent looks achievable.

This along with greater moisture in the soil (resulting from monsoon rains) will benefit wheat and other winter crops. Impact of heavy rains on cotton, however, is somewhat uncertain, as greater moisture provides better environment for breeding of pests and viruses, which damage the cotton crop. Nevertheless, the overall outlook for the agriculture sector is good, and the sector is likely to realize the growth target of 4.0 percent.

The large-scale manufacturing is also likely to achieve the growth target of 8.8 percent set by the Government. Both demand (fed by ample liquidity in the economy and higher exports) and supply side factors (low interest rates and excess capacity in major industries) augur well for the growth of the manufacturing sector. Electricity generation will benefit from greater availability of water. A number of fiscal incentives announced in the FY2004 budget and high level of remittances are expected to boost construction activity and related industries.

Given adequate supplies of food items, excess capacity in the manufacturing sector, and good prospects of stable exchange rate, the inflation rate target of 4.0 percent also looks achievable. The budgetary deficit target of 4.0 percent of GDP, however, may be difficult to realize, mainly because of the persistence of large losses by PSEs and resulting need for subsidies. With interest rates expected to remain low in FY2004, the increase in investment to 16.5 percent of GDP projected by the Government is likely to be realized.

The medium-term prospects for the Pakistan economy have improved after substantial improvements in macroeconomic fundamentals.

Growth of both exports and imports is likely to exceed the targets of 6.6 percent and 4.9 percent, respectively, set by the Government. While there is likely to be some deceleration, Pakistan's exports may still grow by about 11-12 percent because of pick up expected in FY2004 in the US, European and Japanese economies. Also, with higher growth projected in the domestic economy, imports may grow by about 10 percent. As a result, the trade deficit is likely to be at around \$800 million, or 1.0 percent of GDP, somewhat lower than the Government projection. Remittances are likely to be sustained more or less at the level achieved in FY2003, as these have mostly resulted from a shift from the hundi system to the banking channels. The surplus in the current account is projected to decline, as external grants and payments received for logistic support for operations in Afghanistan are likely to decrease, but is still likely to be higher than Government's projection.

The medium-term prospects for the Pakistan economy have improved after substantial improvements in macroeconomic fundamentals. Modernization of the textile industry underway for the last 3 - 4 years has started showing results in the form of substantial increase in the industry's output and in export volumes. If the Government continues to pursue sound macroeconomic policies and to implement the planned economic and governance reforms, it would be possible to achieve the growth target of 5.8 percent, set for FY2005 in the medium-term macroeconomic framework.

II. RECENT POVERTY REDUCTION INITIATIVES

Poverty alleviation is the key objective of the Pakistan Government's economic policies. Under its poverty reduction strategy the Government is committed to increasing poverty reducing public expenditure as a percentage of GDP.¹² To assess the impact of poverty reducing public expenditures and policies, the Government monitors a number of intermediate human development indicators related to education, health and population planning. The Government has also recently defined the official poverty line as consumption expenditure required for caloric intake of 2,350 calories per adult equivalent per day, and carries out regular household surveys to estimate the incidence of poverty. In this section, we discuss the trends in poverty, poverty reducing public expenditures, and intermediate human development indicators related to health based on data released since the last Economic Update.

Incidence of Poverty: According to the Government's estimate, the head count ratio of persons living below the newly defined official poverty line increased from 30.6 percent in FY1999 to 32.1 percent in FY2001.¹³ Although the incidence of poverty increased in both rural and urban areas, increase in rural poverty was much more pronounced, due to the persistent drought conditions in the past four years. Low economic growth during the 1999-2001 period was a major factor in the increase in the incidence of poverty.

Poverty Reducing Public Expenditure: The pro-poor expenditure

incurred in the first three quarters of FY2003, at Rs 102.1 billion, showed a sharp increase of 27.6 percent over the corresponding period of FY2002, but fell short of the target of Rs 114.0 billion for the period (see table 9). As a percentage of the annual GDP, the pro-poor expenditure in the nine months increased from 2.2 percent in FY2002 to 2.5 percent in FY2003. The large increase in expenditure in the first three quarters of FY2003 was mainly because of a sharp increase in the first half of the year due to the base effect. During the first half of FY2002, responsibilities for basic service delivery, which constitute the bulk of pro-poor expenditure, were being devolved to local governments. Modalities for fiscal devolution had not been fully completed, and the district governments finalized their budgets only in December 2001. As a result of this transition, poverty reducing budgetary outlays in the first half of FY2002 were 15.0 percent lower than in the same period of FY2001. Thus a better comparison is with the third quarter of FY2002, when poverty reducing expenditures had picked up, and in the third quarter of FY2003 such expenditures show only a small increase of 4.1 percent. Unless pro-poor expenditures pick up significantly in the fourth quarter, they will fall short of the target of Rs 161.5 billion for FY2003.

Of the 12 sectors identified for pro-poor expenditure, we consider education, health, population planning, social security and social welfare, water supply and sanitation (WS&S), and rural development as the key areas. Expenditure in these sectors taken together registered an increase of 28.2 percent in the first nine months of FY2003 compared with the same period of the

The head count ratio of persons living below the official poverty line increased from 30.6 percent in FY1999 to 32.1 percent in FY2001.

Pro-poor expenditures increased by 27.6 percent in the first three quarters of FY2003.

12. Under the I-PRSP, poverty reducing expenditures include: education, health, water supply and sanitation, population planning, land reclamation, rural development, irrigation, roads and bridges, social security and social welfare, relief in natural calamities and disasters, food subsidies, and food support program.

13. Some other studies show a larger increase in poverty during this period.

**Table 9: Pro-poor Budgetary Expenditures
(Rs Million)**

	July - June		Change	July - March		Change
	FY2001	FY2002	%	FY2002	FY2003	%
Roads, Highways & Bridges	8332	6340	-23.9	2982	5043	69.1
Water Supply & Sanitation	4497	4644	3.3	2686	1988	-26.0
Education	56536	66290	17.3	43854	51280	16.9
Health	17508	19211	9.7	10829	13457	24.3
Population Planning	1588	1331	-16.2	909	1798	97.8
Social Security & Social Welfare	1576	3664	132.5	762	797	4.6
Natural Calamities & Other Disasters	912	189	-79.3	109	293	168.8
Irrigation	8154	10133	24.3	5038	8179	62.4
Land Reclamation	1380	1838	33.2	1168	1097	-6.1
Rural Development	11415	12325	8.0	5675	13662	140.7
Food Subsidies	9390	5513	-41.3	3973	3200	-19.5
Food Support Program	1061	2017	90.1	2017	1256	-37.7
Grand Total	122349	133495	9.1	80002	102050	27.6

Sources 1) I-PRSP Fourth Quarter/Full Year Progress Report FY2001-02. Finance Division, GOP
2) I-PRSP Third Quarter Progress Report FY2002-03. Finance Division, GOP

previous year. Of individual sectors, expenditure on rural development and family planning showed substantial increases, while increases in expenditure on education and health were smaller than the increase in total poverty reducing expenditure. Surprisingly, expenditure on WS&S, which is essential to increase the access of population to safe drinking water and reduce their vulnerability to water-related diseases, declined by 26.0 percent. Under devolution the responsibility for WS&S is with the tehsil local governments, and the decline may be because of inadequate implementation capacity at tehsil level, lack of clarity in the relations between district and tehsil governments, as well as between concerned provincial departments and tehsil governments.

Among non-budgetary income transfer programs, disbursement of Zakat, at Rs 3,893 million, in the first three quarters of

FY2003 was 26.0 percent higher compared with the corresponding period of last year. Priority was given to rehabilitating the poor on a permanent basis through one-time rehabilitation grants to help them set up their own small-scale businesses. The total amount disbursed in the first three quarters of the year under this head more than doubled, and its share in total Zakat disbursement increased to 53.4 percent from 32.7 percent in the same period of last year. On the other hand, disbursement of subsistence grants declined by 10.1 percent and its share decreased from 49.5 percent to 35.3 percent.

Disbursement of micro credit through Khushali Bank (KB), Pakistan Poverty Alleviation Fund (PPAF), and Zari Taraqqiati (Agricultural Development) Bank (ZTB), taken together, increased by 261.1 percent to Rs 2,477 million in the first three quarters of FY2003 compared with the

In disbursement of Zakat, priority was given to rehabilitating the poor on a permanent basis through one-time rehabilitation grants.

same period of FY2002. The largest increase was seen in disbursements by PPAF, which increased by 393.6 percent to Rs 1,802 million.

Besides the Zakat Fund and microcredit, the Government finances small public works under the Khushal Pakistan Program, and operates a food support program. Public works provide gainful employment to the poor, besides creating essential infrastructure (farm-to-market roads, water supply schemes, repair of schools, etc.) in rural and low-income urban areas. Under the food support program households with monthly income of Rs 2,000 or less receive Rs 1,000 in two biannual installments. Total number of beneficiaries of all the four programs in the first three quarters decreased from 3.2 million in FY2002 to 2.7 million in FY2003. Assuming that each beneficiary represents one poor family consisting of 6-7 members, about 17.6 million persons, or about 37 percent of those below the poverty line were helped through these government administered social safety net programs.¹⁴

Intermediate Human Development Indicators:¹⁵ There was a marked deterioration in most health indicators in the first three quarters of FY2003 (see table 10).¹⁶ Immunization coverage of children and pregnant mothers declined sharply and so did the percentage of births attended by skilled birth attendants. The percentage of first level health care facilities (FLCFs), not experiencing stock outs of any of five essential supplies (ORS, cotrimoxazole, foalte tablets, chloroquine, and syringes), as

well as those with supplies of contraceptives also declined. On the positive side, the utilization rate of FLCFs, defined as number of cases handled per day, per facility, and the coverage of population by the lady health workers scheme improved. Deterioration in intermediate health indicators, despite large increases in expenditure, reflects poorly on the effectiveness of expenditure and highlights the need for improving governance of the health sector.

III. SPECIAL TOPIC: FEDERAL BUDGET FY2003 - 04

Introduction

The federal budget FY2004, announced on 7 June, is the first budget of the elected Government, which came into power in November 2002. The budget reflects the Government's commitment to continue structural reforms initiated by the Musharraf Government in 2000. This commitment is demonstrated by a further reduction in corporate tax rates for private companies and banks, as announced last year, and further progress in phasing out excise duties and eliminating tax exemptions, particularly in the area of income tax. The budget also envisages a reduction in the overall fiscal deficit from 4.5 percent of GDP in FY2003 to 4.0 percent in FY2004.

The budget is considered as pro-growth; it provides fiscal and non-fiscal

About 37 percent of those living below the poverty line were helped through the government administered social safety net programs.

There was a marked deterioration in most health indicators in the first three quarters of FY2003.

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14. Given some overlap among beneficiaries of various programs, the number given here somewhat overstates the percentage of the poor benefiting from these programs.
 15. The I-PRSP Progress Report for the third quarter of FY2003 posted on the Ministry of Finance website, for some reason, does not give numbers on intermediate human development indicators related to education. Therefore only health indicators are discussed in this paragraph.
 16. Data on intermediate indicators for education for the first three quarters of FY2003 is not given in the IPRS Third Quarter Progress Report FY 2002-03.

Table 10: Intermediate Health Indicators

Indicators	July - March		Change
	FY2002	FY2003	%
Utilization Rate of FLCFs*	33	34	3.0
Proportion of Population Covered by LHWs (Rural only - %)	48	58	20.8
Immunization Coverage of Children & Pregnant Mothers DPT III (%)	80	69	-13.8
Immunization Coverage of Children & Pregnant Mothers TT II (%)	60	48	-20.0
Births Attended by Skilled Birth Attendants (%)	13	11	-15.4
Number of Skilled Female Birth Attendants (Progressive Totals - 000s)	96.4	96.4	0.0
FLCFs not Experiencing Stock-outs of any of Five Key Supplies (%)	37	28	-24.3
FLCFs Meeting Staff Norms (%)	34	30	-11.8
Availability of Contraceptives at FLCFs	96	69	-28.1

FLCFs = First Level Health Care Facilities.

LHWs = Lady Health Workers

* Number of Patients treated per facility per day

incentives for private investment, particularly in housing and construction. Pro-investment measures announced include: tax concessions on mark up paid on housing loans, reduction in taxes on inputs for construction, allowance for initial depreciation on secondhand machinery, and losses incurred during tax holiday made adjustable against profits earned in the post-tax holiday period.

The budget reflects the Government's commitment to reduce poverty under its poverty reduction strategy articulated in the Interim Poverty Reduction Strategy Paper (I-PRSP) issued in November 2001. Poverty reducing expenditure is estimated to have increased by 22 percent to Rs 162 billion, or 4.0 percent of GDP in FY2003 and is projected to increase further to 4.2 percent of GDP in FY2004.

Although the Government has more or less stayed on course in implementing

structural reforms, there is some slowdown in the process. For instance, the general sales tax (GST) has not been extended to the services sector; and some amendments have been made in the Income Tax Ordinance 2001 partially reversing the process of reducing the discretionary powers of the tax officials, which go against the spirit of self-assessment. The budget has also enhanced the ceiling of minimum turnover liable for proper VAT-type GST for small taxpayers and wholesalers, allowing them to opt for turnover tax.

However, the greatest concern is that the losses of the public sector enterprises (PSEs), particularly the two state-owned power utilities, continue to be a massive drain on the Government budget, and greater effort is needed to address this problem. Total impact of implicit and explicit contingent liabilities pertaining to PSEs on the federal budget was Rs 100 billion, or 2.5 percent of GDP, in FY2003,

The losses of the two state-owned power utilities continue to be a massive drain on the Government budget.

and is budgeted at Rs 74 billion, or 1.7 percent of GDP, in FY2004. Of these, subsidies paid by the Federal Government to power utilities in FY2003 were Rs 36.4 billion, and are budgeted at Rs 30.3 billion in FY2004. In addition, the Government has written off a large amount (Rs 57 billion) of its equity in the Karachi Electric Supply Company.

The Government has also revived the controversial Taamir-e-Watan Program under which Members of the National Assembly and the Senate identify small

development schemes to be executed in their respective constituencies.¹⁷ The budget makes an allocation of Rs 3.6 billion for the program in FY2004. The program had been a source of gross misuse of funds in the past.

Fiscal Outcome FY2003

The Government's fiscal position improved significantly in FY2003, with the overall fiscal deficit declining to 4.5 percent of GDP compared with 5.2 percent in FY2002¹⁸ (see table 11). However, there was some slackening of fiscal adjustment

The Fiscal position improved significantly in FY2003, with the overall fiscal deficit declining to 4.5 percent of GDP.

Table 11: Summary of Fiscal Indicators

	Budget Estimates 2002-03	Revised Estimates 2002-03	Budget Estimates 2003-04
	(Billion Rs)		
Gross Revenue Receipts	674.9	703.3	728.3
Provincial Share in Taxes	193.5	192.8	214.8
Net Federal Revenue	481.4	510.5	513.5
Total Expenditure	660.9	706.7	728.5
Of Which:			
Current Expenditure	563.2	627.6	599.2
Interest Payments	244.9	211.8	210.0
Non-interest Expenditure	318.3	415.8	389.2
Federal Budget Deficit	-179.5	-196.2	-207.0
Change in Provincial Cash Balances	17.0	16.6	28.0
Overall Fiscal Deficit	-162.5	-179.6	-179.0
Primary Surplus	82.4	32.2	31.0
	% of GDP		
Federal Budget Deficit	-4.5	-4.9	-4.7
Change in Provincial Cash Balances	0.4	0.4	0.6
Overall Fiscal Deficit	-4.0	-4.5	-4.0
Primary Surplus	2.0	0.8	0.7

17. Provincial Governments have revived similar programs for Members of Provincial Assemblies.

18. Fiscal deficit excluding one-time expenditures of Rs 52 billion on account of equity injection in KESC and issue of CBR bonds to banks. The fiscal deficit including one-time expenditures was 6.6 percent of GDP in FY2002. (Source: IMF's Fifth Review Under the Poverty Reduction and Growth Facility, June 2003)

There was a considerable slackening of fiscal adjustment effort in FY2003, which is evident from a sharp decline in the primary surplus.

effort, which is evident from a sharp decline in primary surplus from 1.3 percent of GDP to 0.8 percent.¹⁹ In other words, the decline in fiscal deficit was less than the reduction in interest payments. The Federal Government's budget deficit declined from 5.4 percent to 4.9 percent. The decline in the federal deficit was, however, less than envisaged in the budget, because of large overruns in expenditure on subsidies and defense, which more than offset the higher-than-budgeted increase in revenue receipts. Increase in revenues was broad-based as all three heads of revenues, namely taxes, surcharges, and non-tax receipts, recorded substantial increases over FY2002. On the expenditure side, large savings in interest payments created a much-needed fiscal space, which could have been used to increase expenditure on poverty reducing and development expenditures.

Growth of CBR tax receipts in FY2003 exceeded the growth in nominal GDP by a wide margin. This was a break from the preceding ten years, when for the most part increase in tax revenues had lagged behind the increase in nominal GDP. Compared with only a 10.7 percent growth in nominal GDP, tax receipts increased by 14.0 percent in FY2003. Sharp increases were recorded in receipts from customs (44.6 percent) and GST (16.9 percent), while receipts from direct taxes showed a smaller increase (6.4 percent) (see table 12). The share of customs in total CBR tax receipts increased from 11.8 percent in FY2002 to 15.0 percent in FY2003, after declining continuously over the preceding 11 years. Substantial increase in imports, particularly those imports which are subject to highest tariff rates, and levy of 6-10 percent import duty on POL products effective from 1 July

Net revenue receipts of the Federal Government increased by 14.1 percent.

2002, account for the bulk of the increase in collection from customs. The increase in GST resulted from an upturn in domestic economic activity, extension of GST to vegetable ghee and cooking oil, and increase in imports, as well as increase in the GST rate on a number of imports, including edible oil, talc, and solvent oil, from 15 percent to 20 percent.

Surcharges on petroleum and gas and non-tax revenues also registered large increases in FY2003. Receipts from surcharges increased by 21.9 percent on the back of an 80 percent increase recorded in FY2002. Non-tax receipts showed an increase of 9.9 percent compared with the preceding year. Defense receipts more than doubled because of larger payments received for logistic support provided for operations in Afghanistan. However, this increase was partly offset by sharply lower profits of the State Bank of Pakistan, reflecting the impact of its sterilization operations during the year.

Net revenue receipts of the Federal Government (after adjusting for transfers to provincial governments) increased by 14.1 percent to Rs 510.5 billion, compared with FY2002.

Total expenditure of the Federal Government declined from 18.8 percent of GDP in FY2002 to 17.6 percent in FY2003, mainly because of savings in interest payments, which, according to revised estimates, were Rs 211.8 billion against Rs 250.5 billion in FY2002 and Rs 244.9 billion provided for in the FY2003 budget (see table 13). Interest payments on both domestic and foreign debt were lower than budget estimates, with percentage saving on

19. Primary surplus/deficit is defined as overall fiscal deficit minus interest payments and is generally accepted as a critical measure of fiscal adjustment effort.

Table 12: Revenue Receipts

	Prov. Actuals 2001-02	Budget Estimates 2002-03	Revised Estimates 2002-03	Budget Estimates 2003-04
(Billion Rs)				
Gross Revenue Receipts	619.0	674.9	703.3	728.3
Tax Revenue*	404.2	460.6	460.6	510.0
Direct Taxes	142.6	148.4	151.7	161.1
Indirect Taxes	261.6	312.2	308.9	348.9
Sales Tax	166.6	205.7	194.8	223.1
Customs	47.8	56.5	69.1	78.1
Excise	47.2	50.0	45.0	47.7
Surcharges	54.9	60.5	66.9	61.1
Petroleum	36.0	45.5	45.8	46.1
Gas	18.9	15.0	15.3	15.0
Arrears	0.0	0.0	5.8	0.0
Non Tax Revenue	159.9	153.8	175.8	157.2
Of Which:				
Interest	55.0	59.1	54.0	68.0
SBP Profits	26.0	26.0	6.0	0.0
Defense Receipts	20.9	21.0	56.3	30.7
Dividends	28.6	20.0	27.7	23.8
Provincial Share in Taxes	171.5	193.5	192.8	214.8
Net Federal Revenue	447.5	481.4	510.5	513.5
% of GDP				
Tax Revenue	11.0	11.4	11.5	11.5

* As given in tax collection statement released by the CBR on 31 July 2003.

foreign loans being higher than on domestic loans. Interest payments in FY2003 absorbed 41.5 percent of Federal Government's net revenues (excluding transfers to provinces) compared to 56.0 percent in FY2002.

Federal non-interest current expenditure increased by 25.3 percent from Rs 331.8 billion in FY2002 to Rs 415.8 billion in FY2003. Among these expenditures, there was a large increase in subsidies, which amounted to Rs 49.8

billion in FY2003 compared with Rs 25.5 billion in FY2002. As a percentage of GDP, subsidies increased from 0.7 percent to 1.2 percent. Almost three-fourths of subsidies were due to losses of WAPDA and KESC as well as adjustment for GST²⁰ and compensation for lower-than-normal tariffs charged on supplies to Azad Jammu and Kashmir and tubewells in Balochistan. Subsidy to WAPDA, according to revised estimates for FY2003, amounted to Rs 26.4 billion compared with the budgeted amount of Rs 6.1 billion. Similarly, KESC had to be

Interest payments in FY2003 absorbed 41.5 percent of Federal Government's revenues compared to 56.0 percent in FY2002.

20. On electricity bills up to a certain amount, subsidy is provided to offset the impact of GST to provide relief to low-income users of electricity.

Table 13: Federal Expenditures

	Prov. Actuals 2001-02	Budget Estimates 2002-03	Revised Estimates 2002-03	Budget Estimates 2003-04
(Billion Rs)				
Total Expenditure	680.5	660.9	706.7	728.5
Current Expenditure	582.3	563.2	627.6	599.2
Of Which:				
Interest Payments	250.5	244.9	211.8	210.0
Defense	149.3	146.0	160.1	160.3
Running of Civil Govt.	89.8	92.7	92.6	100.5
Grants	66.7	56.3	55.6	62.0
Subsidies	25.5	20.8	49.8	64.5
Development Expenditure	98.4	90.0	90.0	113.0
Net Lending	-0.2	7.7	-10.9	16.3
Operational Shortfall in PSDP	0.0	0.0	0.0	-8.0
As % of GDP				
Total Expenditure	18.8	16.4	17.6	16.5
Defense	4.1	3.6	4.0	3.6
Subsidies	0.7	0.5	1.2	1.5
Development Expenditure	2.7	2.2	2.2	2.6

paid a subsidy of Rs 10.0 billion against the budgetary provision of Rs 0.9 billion.²¹ Oil refineries were paid a subsidy of Rs 8.5 billion. The Government also paid Rs 2.3 billion to the Pakistan Agricultural Storage and Supplies Corporation and Rs 1.0 billion to the Punjab Government to cover their losses on export of wheat.

The defense expenditure increased by 7.2 percent due to the deployment of armed forces on borders with India for part of the year. However, as a percentage of GDP, defense expenditure remained more or less unchanged at 4.0 percent.

Development expenditure of the Federal Government in FY2003 declined to 2.2 percent of GDP, from 2.7 percent in FY2002. Moreover, the development expenditure of Rs 90.0 billion, as shown in budget documents, may be overestimated. The reconciled accounts available for the first three quarters of the year show that the actual development expenditure in that period was Rs 48.9 billion, i.e., only 54.0 percent of the estimated amount for the whole year, compared to Rs 70.5 billion, or 71.0 percent of the total in the corresponding period of last year.

In the first three quarters of FY2003, development expenditure was only 54 percent of the budget estimate.

21. In addition, the Government wrote off Rs 57 billion of its equity in KESC, which is shown in the budget as unallocable expenditure.

Federal Budget FY2004

Stabilization

The FY2004 budget has been prepared within a medium-term macroeconomic framework for the period FY2003 to FY2006, as well as macroeconomic parameters agreed under the Poverty Reduction and Growth Facility (PRGF) 2002-2004 with the International Monetary Fund in 2001. The medium-term framework envisages:

GDP growth rate to increase to 6.0 percent in FY2006;

Gross investment to GDP ratio to be raised to 18.0 percent;

Overall fiscal deficit to decline to 3.0 percent of GDP;

Current account deficit on balance of payments to be contained at 1.8 percent of GDP;

Foreign exchange reserves to be maintained at a level sufficient to finance a minimum of 28 weeks' imports.

Consistent with the objectives set in the medium-term macroeconomic framework, the FY2004 budget sets the overall fiscal deficit target of 4.0 percent of GDP, compared with the 4.5 percent in FY2003 (see table 11). The reduction in the Federal Government's fiscal deficit is to come from lower interest payments, and the primary surplus is projected to decline from 0.8 percent to 0.7 percent. Also, to meet the overall fiscal target agreed under the PRGF, the burden of fiscal adjustment is mainly on provincial governments, and their surplus is

projected to increase from 0.4 percent of GDP in FY2003 to 0.6 percent in FY2004. The fiscal deficit of the Federal Government, on the other hand, is projected to decline from 4.9 percent of GDP to 4.7 percent.

Net revenues of the Federal Government (i.e., net of transfers to provinces) are budgeted to increase only marginally due to conservative/realistic assumptions regarding growth of tax revenues and declines projected in non-tax revenues and surcharges (see below). As percentage of GDP, net revenues of the Federal Government are budgeted to decline by 1.1 percent, which is to be matched by a 1.3 percent reduction in expenditure,²² to realize a decline of 0.2 percentage points in federal fiscal deficit.

The CBR tax revenues are budgeted to increase by 10.7 percent to Rs 510.0 billion in FY2004 (see table 12). As a percentage of GDP, they are projected to remain unchanged at 11.5 percent. As in the past five years, the main driver of the growth is going to be GST, which is budgeted to contribute more than half of the total increase in tax revenues. Receipts from customs are estimated to increase by 13.0 percent, after a sharp increase of 44.6 percent last year. With expected nominal GDP growth of around 10 percent, the budget target for CBR tax revenue appears achievable.

Non-tax revenues, which now constitute 34 percent of the Federal Government's net revenue receipts, are budgeted to decline mainly because of lower defense receipts, as payments for logistic support for operations in Afghanistan are expected to taper off. Government's dividend receipts from its investment in

The burden of fiscal adjustment will be mainly on provincial governments.

Tax revenues are budgeted to increase by 10.7 percent, i.e. at about the same rate as growth in nominal GDP.

22. Adjusted for the likely operational shortfall of Rs 8 billion in the Federal Government's development expenditure.

As a percentage of GDP, defense expenditure is budgeted to decline to 3.6 percent from 4.0 percent in FY2002.

PSEs, included in non-tax receipts, are also budgeted to decline mainly due to lower transfers from OGDC. In addition, transfers from the profits of SBP have been budgeted as nil compared with Rs 6.0 billion received in FY2003 due to expected continuation of SBP's sterilization operations (see box 3). Surcharges on petroleum and gas are also projected to decline by 8.7 percent mainly because of the base effect. Last year the Government recovered past arrears, which will not be there in the current fiscal year.

The Federal Government's current expenditure is budgeted to decline by 4.5 percent to Rs 599.2 billion in FY2004, mainly because of a large decline in non-classified expenditures and a nominal decrease in interest payments. The non-classified expenditure is budgeted to decline to Rs 1.9 billion from Rs 57.7 billion in FY2003, which represented write-off of Government's equity in KESC. Interest payments are projected to decline as the Government plans to repay prematurely some of the more expensive foreign loans. Also, domestic interest rates are expected to remain low in FY2004. Allocation for defense expenditure has been kept at the last year's level, and as a percentage of GDP, it is budgeted to decline to 3.6 percent from 4.0 percent in FY2003. However, holding defense expenditure at last year's level will be contingent upon expected normalization of relations with India.

Subsidies, which had doubled last year, are budgeted to increase further by 29.5 percent in FY2004.

Subsidies, which had almost doubled last year, are budgeted to increase further by 29.5 percent to Rs 64.5 billion due to a provision of Rs 21.5 billion for offsetting the liabilities of PSEs. At this level, subsidies will amount to 1.5 percent of projected GDP. As in the last two years, the

actual expenditure on subsidies may turn out to be larger than the budgeted amount, with slow progress in improving the operational efficiency of PSEs, particularly the two power companies. Grants, too, are budgeted to increase by 11.5 percent to Rs 62.0 billion, mainly due to the transfer of 2.5 percentage points (i.e., one-sixth) of the 15 percent GST to provincial governments in support of local governments, a block provision of Rs 3.9 billion for transfers to provinces, and a provision of Rs 1.2 billion for Afghanistan's reconstruction.

The 15.0 percent increase in salaries of Federal Government employees, including defense personnel, announced in the Finance Minister's Budget Speech, may not be fully reflected in budgetary allocations for running of civil government and defense. Increase in expenditure due to increase in salaries and pensions is estimated at Rs 11-12 billion, more or less equally shared between civil and military personnel. If the recent improvement in relations with India continues, the increase in the salary bill for the defense personnel may be partly met out of saving in non-salary defense expenditure. In the case of expenditure on running of civil administration, the increase in salaries may lead to an overrun compared to the budgetary provision.

Total development expenditure of the Federal and Provincial Governments is budgeted to increase to Rs 160.0 billion in FY2004 compared with Rs 131.7 billion in FY2003.²³ After adjusting for the likely shortfall of Rs 8 billion shown in the budget, total development expenditure in FY2004 is budgeted at Rs 152 billion. Even if fully implemented, it will only increase

23. Although revised estimates given in budget documents put the development expenditure in FY2003 at Rs 131.7 billion, the Finance Minister mentioned the figure of Rs 120 billion in his Budget Speech. Actual development spending of Federal and Provincial Governments in the first three quarters of the year, according to reconciled fiscal accounts, was only 61 percent of the amount budgeted for the full year.

development expenditure as a percentage of GDP from 3.3 percent to 3.4 percent. However, considering the institutional constraints, this amount may not be spent. In the past ten years, actual development spending has consistently fallen short of the budgeted amount.

Out of development program (before adjusting for likely shortfall), Federal Government will spend Rs 113.0 billion, which is more than two-thirds of the total. Details of the federal development program available in the budget document reveal that the bulk of the expenditure (54.5 percent) is allocated to infrastructure (see table 14).

The priority is given to roads, water, and power sectors. Although the responsibility for provision of social services is largely with the Provincial Governments, some parts of higher education and health as well as provision of social services in the Federal Capital Territory are with the Federal Government. Allocations for these services, taken together, have been increased by 84.1 percent to Rs 15.1 billion. Allocations for the Education Division and Higher Education Commission has been increased almost three folds to Rs 7.6 billion, reflecting high priority being given to higher education. The Government has also accorded high priority to the development of

The bulk of the development expenditure is allocated to infrastructure, with priority given to roads, water, and power sectors.

Table 14: Federal PSDP: Sectoral Allocations

	Budget Estimates		
	FY2002	FY2003	FY2004
	(Billion Rs)		
Total Federal PSDP	100.0	90.0	113.0
Infrastructure	43.2	47.1	61.6
<i>Of Which:</i>			
Roads	13.3	14.6	18.4
Railways	6.4	6.9	8.1
WAPDA (Power)	13.0	11.5	12.6
Water (Dams/Irrigation/Drainage)	9.0	10.0	14.7
Ports	1.1	4.0	3.1
Ministries & Divisions, excl.			
Infrastructure*	26.7	25.8	35.4
<i>Of Which:</i>			
Education & Higher			
Education Commission	2.5	2.6	7.6
Health	2.5	3.3	4.4
Population Welfare	1.7	2.3	3.1
Access to Justice	0.1	1.1	2.1
Special Programs	24.8	9.4	6.6
<i>Of Which:</i>			
Khushal Pakistan Program (KPP)	7.0	0.0	0.0
Drought Relief Program (DRP)	10.0	6.0	0.5
Taamir-e-Watan	0.0	0.0	3.6
KANA and SAFRON**	5.2	7.7	9.4

* Railways, Water and Power, and Communications, which are included under infrastructure.

** Kashmir, Northern Areas, States and Federal Regions.

Rs 3.6 billion has been allocated for Taamir-e-Watan Program under which each member of National assembly and Senate will identify development schemes of up to Rs 10.0 million.

less developed areas in the past two years, which is reflected in substantial increases in allocations for the Ministry of Kashmir, Northern Areas, States, and Federal Regions (KANA and SAFRON).

The federal development program has allocated Rs 3.6 billion for Taamir-e-Watan Program under which each Members of the National Assembly and the Senate will identify development schemes of up to Rs 10.0 million to be executed in their constituencies. Similar programs were started by the Benazir Bhutto and Nawaz Sharif governments. They were discontinued because of widespread misuse of funds. Besides wastage of funds, this program may interfere with the working of local governments formed under the devolution program.

Structural Reforms

A number of measures have been announced in the budget to improve tax administration, further reduce the corporate tax rates, and encourage investment. Some of these measures are discussed below.

Tax Administration: (i) In addition to the Large Taxpayers' Unit already established in Karachi, a number of Medium Taxpayers' Units are being set up in different cities, where taxpayers will be able to pay all their taxes (corporate income tax, sales tax, excise duty) at one place. (ii) Through introduction of computer aided filing of import documents, the time taken in clearance of goods will be reduced to 48 hours from the current 8-10 days. (iii) At present importers importing raw material for their own consumption have to obtain a certificate to that effect for each consignment to avail of exemption from withholding tax at import stage, now they will be issued the required certificate for one full year. (iv) Instead of multiple audits of sales tax, which are a source of harassment for the taxpayer, there will be only one audit

All income tax returns for incomes earned in FY2003, but assessed in FY2004 will be filed under the self-assessment system.

during a given year. The audit report will be shown to the taxpayer to provide him an opportunity to explain his viewpoint.

Reduction in Corporate Tax Rates:

The corporate tax rates for banks and private limited companies are much higher than for public limited companies, putting some economic activities (finance) and forms of organization at an unwarranted disadvantage vis-à-vis others. To remove these distortions, the Finance Minister in his budget speech last year had announced a plan to progressively reduce tax rate for banks by 3 percentage points per year and for private companies by 2 percentage points over the next five years, starting with FY2003, to bring these rates down to 35 percent by FY2006, the rate applicable to public companies since FY2002. In line with this plan, the tax rates for private companies and banks have been further reduced (see table 15).

Self-assessment System: All income tax returns for income earned in FY2003, but assessed in FY2004 will be filed under the self-assessment system. Under this system, the responsibility for determining the tax liability is placed on the taxpayer and not on the assessing officer, as was the case in the past. According to the original Income Tax Ordinance 2001, all income tax returns were to become assessment orders on the date they were filed, except in 20 percent of cases selected through parametric random method for audit to verify the accuracy of the contents of the return. However, some amendments have now been made in the ordinance, which go against the spirit of self-assessment. For instance, the Income Tax Commissioner has been given the power to determine whether an income tax return is complete or not. The Income Tax Commissioner can issue a notice to the taxpayer within a year after the return is filed informing him of deficiencies and directing the taxpayer to provide the required information necessary to complete

Table 15: Corporate Tax Rates

	Public Companies Other than Banks	Private Companies Other than Banks	Banks
2000-01	38% *	48%	58%
2001-02	35%	45%	50%
2002-03	35%	43%	47%
2003-04	35%	41%	44%
2004-05	35%	39%	41%
2005-06	35%	37%	38%
2006-07	35%	35%	35%

* Including surcharge @ 5%

the return. So only if the taxpayer receives no notice during the year, will he be sure that assessment order has been issued on his return. Some features of the old Income Tax Ordinance have also been brought back which can be used by the Income Tax Commissioner to reject a return if in his/her judgment the cost of investment and the amount of expenditure given in the return are not “reasonable”. These amendments have reversed the process of reducing discretionary powers of tax officials.

Elimination of Exemptions: The Government has been pursuing the policy of lowering tax rates and broadening the tax-base by eliminating exemptions. This year 20 more exemptions from income tax have been withdrawn.

Phasing out Excise Duty: As part of the policy to reduce the number of excisable items, excise duty on paper and paperboard and cables and wires has been abolished.

Pro-Growth Measures

Following measures have been announced in the budget to encourage both domestic and foreign investment to foster growth.

To attract foreign investment, the Government is initiating a process of advance rulings on tax issues relating to such investment. A high level Committee headed by the CBR Chairman and comprising the CBR Member (Income Tax) and Additional Secretary, Law Division will give such rulings.

Investment in second hand machinery has been made eligible for availing initial depreciation allowance.

Losses incurred by industrial units during the tax holiday period have been made adjustable against profits earned in the post tax holiday period.

To enhance the competitiveness of heavy engineering, light engineering, fans, and ceramics industries, the rates of import duty on 112 items, used as raw materials in these industries, have been reduced. Similarly, import of machinery used for branding, processing and storage of rice, vegetables, fruits, meat and dairy products has been exempted from sales tax. This measure is also expected to increase the export of these items.

Some amendments made in Income Tax Ordinance 2001 have reversed the process of reducing the discretionary powers of tax officials.

To encourage investment in the housing and construction sector, following measures were announced.

Number of measures were announced to encourage investment in the housing and construction sector.

Individuals taking loans from banks and non-bank financial institutions for house construction have been allowed to claim tax rebate on maximum of Rs 500,000 paid in interest (compared with Rs 100,000 allowed previously) or 40 percent of income, whichever is less.

The withholding tax of 7.5 percent on annual rental income of Rs 100,000 or more has been replaced with a 5 percent tax on rental income of Rs 200,000 or more.

Excise duty on cement has been reduced from Rs 1,000 per ton to Rs 750, and 10 percent excise duty on cables and wires has been abolished.

The Government will guarantee house-building loans taken by government employees from the House Building Finance Corporation. Repayment of these loans will be made through deduction from salaries of the employees.

Miscellaneous

The ceiling of minimum annual turnover liable for sales tax has been increased from Rs 2.5 million to Rs 5.0 million for small taxpayers and from Rs 5.0 million to Rs 20.0 million for wholesalers. Turnover for these taxpayers will be assessed on the basis of a predetermined set of parameters like location, type of business, number of workers, amount of capital, etc. This measure will allow a large number of taxpayers to opt for turnover tax and get out of the net of the proper VAT-type GST.

The primary surplus is projected decline further in FY2004.

A special Saving Scheme has been introduced for widows similar to one

launched in January 2003 for pensioners. This will allow widows to invest up to Rs 1.0 million in this scheme and earn return of 11 percent per annum, which is higher than rates available on other National Saving Schemes (NSS), which themselves are higher than the market interest rates. The decision will further erode the Government's ability to reap the full benefit of lower interest rates in its borrowing for financing the budget deficit.

Risks and Concerns

There are many positive elements in the FY2004 budget, which have already been discussed above, but there also some concerns which are the focus of this section.

A slackening of fiscal adjustment effort is evidenced by a further decrease in the projected primary surplus. The reliance for the reduction in the fiscal deficit is largely on lower interest payments. However, even with lower interest payments, the overall fiscal deficit target of 4.0 of GDP for FY2004 may be difficult to realize, as current expenditure of both federal and provincial governments is likely to exceed the budget estimates. This is because of the 15 percent increase in salaries (not fully reflected in the budget) and possibility of higher than budgeted losses of the two power companies and other PSEs, as discussed below. Revenues could be higher than budgeted (because of conservative projections made in the budget) and development expenditure lower (because of implementation constraints), but these may not completely offset the above overruns.

The Government has allocated a large amount of Rs 49.8 billion as subsidies for the two state-owned power utilities and other PSEs. Allocations for subsidies for WAPDA and KESC are Rs 8.0 billion less than actuals in FY2003. However, the budget does not contain any measures for

reducing the losses of these enterprises or "hardening" the budget constraint faced by them. Without a determined effort to improve their operational efficiency, recurrent losses of PSEs will continue to be a major drain on the public exchequer and undermine the viability of the federal budget.

The FY2004 budget is generally considered to be a pro-growth budget because of a number of measures announced in the budget to promote investment, particularly in housing, along with increased allocation for development. However, there is also the need to address the institutional weaknesses in housing finance sector, which are a major constraint on increasing demand for housing.

The across the board 15 percent increase in salaries of the Federal Government employees is not performance based. It will result in a further compression in the public sector wage structure and increase its distortion, as lower-level government employees are already paid more than the market wage, while higher-level employees are grossly underpaid.

The one-year extension of the exemption of capital gains from trading in shares is a good measure, but it should be made conditional on a minimum holding period. Without the requirement of a minimum holding period, the exemption will continue to encourage speculative trading rather than investment in the stock market.

Without a determined effort to improve their efficiency, losses of the two state owned power utilities will continue to undermine the viability of the Federal budget.