PAKISTAN'S BUDGET FOR 2005-2006
LINKS WITH STRATEGIC FRAMEWORK

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Let me first begin by commending the Institute of Bankers for organizing this forum once again for the banking community so that they get a first shot of what the budget implies for them, as well as, for the country as a whole. I would not like to repeat what has been said by the two previous speakers but let me say that we should understand the process because there is some confusion about the way the budget is formulated.

The budgetary proposals are formulated by the Ministry of Finance and the Central Board of Revenue (CBR) and they are presented to the Cabinet. Because there is a time shortage between the approval of the Cabinet and the presentation to the Assembly, the proposals in their original form are displayed in the budget documents which are available to the public. The Cabinet has the prerogative of turning down some of the proposals from the Ministry and the CBR and this is exactly what has happened. So there is no confusion. All the proposals were debated for the whole day and some of them were rejected by the Cabinet. Once the Cabinet approves the proposals and the Finance Bill, they are submitted to the Legislature. They will then be debated within the Standing Committees of both the houses i.e. the National Assembly as well as the Senate, and there may be some proposals which may be rejected or which may be modified by these Committees. Those proposals which are finally okayed by the Standing Committees will go to the full floor debate and approval.. It's only at the end of this whole process that you will get the clear picture

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of what the approved budget will look like. I think we should be quite aware that it's no longer the previous situation where an Ordinance was promulgated and the budget was accepted. It's a much longer process now which is absolutely essential, if we have to get the views of both the executive as well as the legislature incorporated in the budget. Similarly, there are rules which will be made under the Finance Bill when the Finance Bill is approved and some of the procedures will be clarified under those rules.

As far as the proposals directly affecting the banking industry are concerned, the corporate tax rate has actually come down from 58% to 38% this year and next year the government is committed to bring it to 35% which is the average corporate tax rate. So the main beneficiary of the tax rate reduction is actually the banking sector which is now almost at par with all public companies. Even the private banks who are not listed are eligible for the same tax rate. Now this should increase your incentives and your profitability. So I think as far as the banking community is concerned this is a very positive move. During the last five years the government has stuck to the timetable of reducing the tax rate gradually and bringing it at par with other public companies. The proposal of excise duty on commissions, leasing business of the banks has been withdrawn.

Now, what I would like to do is to discuss how this budget fits in into the strategic economic framework. The budget is not just the estimates of income and expenditure but it is trying to achieve certain objectives. To remind ourselves, there were four objectives of the economic strategy which we are following since 1999-2000. The first is that we want to reduce the poverty from the current level of 33% to 15% by 2015. The second objective is to have growth rates anywhere between 6 to 8 percent. So when people talk about sustaining growth, nobody is suggesting that in the coming fiscal year we will again have 8.4% growth rate. That is not possible because this year there were very many favorable exogenous positive factors. But if we reach anywhere between 6 to 8 percent annually, I think we are on the right track. The variation across the mean always happens because it is difficult to predict how the weather is going to behave, what the international demand conditions are going to be, etc. This 6 to 8 percent range is very much consistent with the poverty reduction targets.

The third objective is to continue the structural reforms which have been initiated for the last five years and to extend them to the second generation reforms. And what are the second generation reforms? Those are institutional reforms which are very difficult to implement but the lack of these reforms is one of the reasons as to why the benefits of growth are not accruing to the poor segments or to the less well-to-do population. There are leakages taking place through our existing institutional framework and our institutions are incapable of plugging them. So we have to come up with the second generation reforms to strengthen the institutional capacity to deliver the basic services to the poor.

The fourth objective which is also related to the structural reforms is to continue on good economic governance. We see that the corruption at the top has been eliminated but the corruption is still rampant at the middle and the lower levels and we have to come up with the solutions which will minimize the corruption. I will now explore each of these four objectives and show the linkages between the budgetary proposals and each of these objectives.

Now what is the poverty reduction strategy? There are four elements of the poverty reduction strategy. First, growth is necessary but not a sufficient condition for poverty reduction. We may have rapid growth but the growth may just benefit the well-to-do populations but not the middle class and the lower income groups. That kind of growth will not lead to the poverty reduction. So it is the pattern of growth and the quality of growth which are equally important along with the growth rate. That is why we need the second element i.e. poverty targeted interventions. What are the poverty targeted interventions? This year we are going to have a new Khushhal Pakistan Fund. Every single community will decide whether they will give priority for electrification of their village or for drinking water supply or for farm-to-market road or they want to have gas connections. There will be four choices given to each of the village so that they can use the funds which would be allocated from this Fund. Khushhal Pakistan Program is being strengthened and has been given higher allocation. The third element is social safety nets – the Zakat, the baitul maal and the most important the micro credit program which is being channeled through the Poverty Alleviation Fund and also through the microfinance institutions. So far, we have reached only half a million people but we want to reach about a million families who do not have any collateral to offer to the banks for obtaining loans. They can get upto 25,000 rupees as loans from the Microfinance Institutions without any collateral. And the record during the last three years is excellent as the recovery rate in microfinance has been between 95 to 96%. The fourth element is, of course, investment in education and health which have been given a big boost in this year's budget – an increase of 50 percent for education and 72 percent for health.

The other measure which has been announced in this budget is to raise the minimum wage from Rs 2,500 to Rs 3,000. The private sector institutions would also be obligated that they will have to pay at least Rs 3,000 instead of Rs.2,500/- to a worker. Although it is not in my view adequate but at least it is better than what they are getting at present.

We are struggling this year with high inflation. A trader, a transporter, or a farmer can adjust the prices of the goods he is producing or selling and 90% of the population in Pakistan is in either agriculture or in SMEs or they are self-employed. They are not in the formal employment sector – private or public. So the majority among this 90% segment of the population can adjust their prices as the inflation rises. But the worst sufferers of inflation are the government servants, the fixed income group in the private sector and the people who are out of the labor force like pensioners, the widows. For the salaried class in the public sector the budget has given 22 to 30 percent rise and similarly there is rise in pensions too. I hope that this would become the benchmark for the private sector salaries also because the government is always the leader as far as salary and pension increase is concerned. The private sector has its own compulsions and they will be guided by other considerations also. But at least there is this benchmarking of the salary increases. If these increases occur at the expense of the corporate profits then there is not much of a difficulty because the corporate earnings of the listed companies in Pakistan for the last two years have averaged more than 43%. So if they are able to cut the earnings down from 43% to 35% or 36%, I don't think this will be a major disincentive to the corporate sector. So, this is the way this particular ingredient of poverty reduction strategy will work.

Now, we come to the second part which is growth and macro-economic stability. This is the fifth year, and I would say 15th year, of Pakistan's economic history where private sector has been given more and more responsibilities and roles for stimulating the growth impulses. The government is receding in the background, laying down the policies and the enabling environment but the responsibilities for production, distribution and trade are being given more and more to the private sector.

And that is the right way of doing it. This process was started in 1991 and this has continued but for the five years the policies have become more perceptible and more effective producing some tangible results. No new public enterprise has been established in any commodity-producing sector. As a matter of fact, even in infrastructure there is an active program for privatization. But we still have a long way to go.

I don't need to remind you about the reforms in the banking sector but the banking sector is a very potent influence on the private sector. In the last two years, the banks have provided 12 billion dollars of credit to the private sector for expanding their businesses, for increasing the capacity and that is what has led to higher growth rate. Because the fiscal deficit had to be contained the only lever which was available was the monetary policy and the credit expansion. And that lever was used quite effectively.

Four years ago we had a growth rate of 1.8 per cent that means we had a negative growth rate in per capita terms. Unemployment rate was rising. The question was then raised. What is all this macroeconomic stability good for? What do we do with this low inflation of 3% because the people do not have any purchasing power? It was argued in a Research Report produced by an independent body that inflation was low because there was no demand for goods and services as people didn't have purchasing power. A lot of them didn't have any incomes. So, we decided to step up the accelerator on the monetary policy and this has shown up in form of higher growth rates and higher average incomes. Naturally there will be disequilibrium in the supply and demand in the short term which has not been helped very much by the international oil prices or the supply shortages of the food last year and therefore inflation has picked up.

These are the trade-offs which any economy has to make. Do you provide two million new jobs by accelerating growth so that some families who do not even have a single earning member are able to generate some incomes and tolerate some inflation temporarily or do you continue with policies that achieve very low inflation but a large number of households having no incomes as the household heads or members have no jobs? These are the tough choices which have to be made all the time. So in the period 1999-2002 we had low growth and low inflation but a lot of unemployed. Now we are in a situation where for the last three years, we have had 5%, 6.4% and 8.4% growth and inflation has gone up from 4%, 4.6% and this year it will end up between 9 to 10 percent. But more than two million new jobs have been added in the economy in the last two years. Inflation is the cost of accelerating the monetary policy and I don't feel ashamed to admit that this was done deliberately because the economy was stuck in a low level equilibrium for a very long period. The social costs of low investment and low growth were becoming intolerable. There is nothing wrong in trying to kick-start economy by using the only lever which was available. Why was the fiscal policy lever not available? Because we already had debt GDP ratio of 100% at that time. This has been brought down today to less than 65% and the debt servicing ratio is down from 66% of revenues to 25%. Had we used the fiscal policy to stimulate the economy the debt ratios would have risen sharply instead of declining. This meant that our next generation would have been completely strangled again by the international financial institutions. Every Pakistani desires economic sovereignty and that can be achieved only when the debt ratios are on a downward trajectory. This strategy of reducing debt and debt servicing has been successful in providing a fiscal space whereby public sector development expenditure has increased from 100 billion rupees three years ago to 272 billion rupees this year. And most of this amount is going to build infrastructure and finance social sectors and unless the country has adequate infrastructure and robust social sectors, it will not be possible to sustain high growth rates. It is only through high growth rates that employment can be generated and in the absence of rising employment it becomes hard to reduce poverty. Thus the transmission mechanism is growth to higher incomes to higher employment, and finally reduced poverty. That is the part of this growth strategy.

Of course, the current account deficit after three years of being surplus has become negative this year. There are very few developing countries which have been able to make strides without running current account deficits. What does current account deficit mean? Current account deficit means that the domestic savings of a country are not sufficient to finance the required level of domestic investments. If we do not have enough resources for investment, that means the growth rate is going to be lower. So countries opt for foreign savings to supplement the domestic savings so that they can have higher investment ratios and higher investment will, in turn, lead to higher growth. What does current account surplus mean? Current account surplus means that the Central Bank of Pakistan is transferring the surplus savings of Pakistan to finance the current account deficit of the United States. Is that what we would like to see? No. Is the current account deficit manageable? Yes. The current account deficit is likely to be around 1.3 per cent of GDP. Foreign direct investment which does not create any new debt can provide 1.0 percent of GDP and 500 million of new borrowing either though sukook or through Eurobond can take care of the rest. This borrowing is not a cause for concern because the debt ratios are declining and we can easily afford and absorb this level of external financing. So this current account deficit is manageable without any serious difficulty.

Why is the current account rising? The current account is rising because oil prices have doubled and the imports of the machinery and the raw materials for capital goods have increased at the rate of 41%. What does that mean? That means that these investment goods will translate into higher production and the higher production will lead to higher growth. Some of that production will translate itself into higher exports. With higher exports, the imbalance between imports and exports is going to decline over time. So it is an investment which is going to produce returns in three years or so. After a long time we are seeing an upsurge in the imports of machinery and goods and industrial raw material and these higher imports along with high oil prices are responsible for large trade deficit and a modest current account deficit.

What is this budget providing for that purpose? During the last five years I have gone through the length and breadth of the country and the exporters had one simple request: "Please get rid of this oppressive sales tax refund regime. We have to run around the sales tax officers, we have to put our own money which we borrow from the banks in order to pay the sales tax which is zero rated on exports and then we have to get this money back after six months, one year and we have to pay commission to the sales tax officials. What kind of business we would be doing"? This year, with a stroke of a pen this major obstacle to expansion of exports has been removed. Resolution of tariff on the PTA will also give a filip to man-made fibers, which are expanding all over the world, were not expanding in Pakistan because of the protection given to ICI in 1998. That irritant has also been removed. With this, the smuggling of the polyester cloth, which is ruining the domestic industry will also decline. We would soon see a big boost in the export of textiles, carpets, surgical goods, sports goods and leather goods. Then another area for the growth and macroeconmic stability is the fiscal deficit. Every single year there has been a reduction in fiscal deficit. CBR revenues have doubled from Rs. 300 billion to Rs. 590 billion in the last five years although Tax-GDP ratio is still low. There is some skepticism expressed about the CBR tax target for this year. Why is Rs. 690 billion such as unbelievable target? The economics of this is very simple. The increase of 100 billion rupees over 590 billion which is the actual collection for this fiscal year translates into a 16% nominal increase. If the real GDP is going to rise by 7% and inflation is going to be 8% we have a nominal GDP growth of 15% already. And if the elasticity of the tax to GDP which has been historically 1.2 in Pakistan, 16% is not such a big hurdle for the CBR to cross. They are simply keeping up with the growth in the nominal GDP. That is the reason why 690 billion is not such an optimistic or ambitious target. I personally believe that this target should have been much higher and expect that with the kind of reforms which are going on in the CBR with a very competent and a dedicated Chairman of the CBR, we can have much higher tax collections than the target. Therefore, the tax GDP ratio will be higher than what is envisaged.

As the country had to borrow heavily to finance the high fiscal deficits of the 1990s the debt ratio went up to 100% of GDP. This is the sixth year in succession where the fiscal deficits are not only lower but are coming down and we have primary surplus. And when we have primary surplus, the debt ratios are going to decline. Defence expenditure which used to be 40 to 50% of our budget in the past is down to 18.5% - less than 20%. In real terms, there is a decline. It has come down from 3.4% of GDP to 3.1% of GDP. A major increase is recorded in Development expenditure that has jumped by 35 percent from 200 billion to 272 billion. Previously defence was higher than development. Last year for the first time this equation was corrected. Defence was 193 billion and development was 202 billion. This year defence is 223 billion and development is 272 billion. Therefore, to keep the fiscal deficit at 3.8%, it was essential to bring down the recurrent expenditure of the government. And whatever growth is taking place, it is on the development expenditure. There we have concerns about the institutional capacity of Civil Service, Local Governments, other development agencies like the WADPA and other public sector institutions which are responsible for delivering this amount of 272 billion rupees particularly in the social sectors. Their capacity has to be strengthened so that they are able to utilize these expenditures in an effective manner, and its benefits reach the poor.

Ours is a status ridden society. All of us have much better access because we are all well known and connected to those responsible for the delivery of public services. All of us will be given all the attention when we visit the Civil Hospital. But the doctors will not have even 3 minutes to see a poor patient who has traveled all the way from Jacobabad to come to visit the Hospital. The real problem that we are facing today is that our institutions are not able to deliver the services to the people who deserve these services the most. Raising the allocations from 2% of GDP to 4% is not the answer. I have gone to villages where there are beautiful school buildings under lock and key and the teachers are not available to teach. That I think is the issue which we have to tackle under the second generation reforms.

The third area is the structural reforms. Let me take up the tariff reforms first. In this budget duties on thousands of items which were either industrial raw materials or which were prone to smuggling have been reduced. The effective rate of tariff in this country has come down to 10%. The maximum rate today is 25%. And there are lots of items which are no longer in the top 25% slab. Ten years ago we used to have 250 to 300 percent as a maximum tax. What used to happen then? Smuggling was rampant and customs was most lucrative service. That is no longer the case because the tariff reforms have created a situation where it is no longer very remunerative to smuggle. Of course smuggling takes place, but the quantum of smuggling is not as much as it used to be. Let me now turn to the financial sector reforms. The Government can no longer directly influence the allocation of resources through the banking system for its own use or that of public sector enterprises. The banks have done a marvellous job by broad basing the credit to the SMEs, to the consumers, to the agriculture and this should continue in the future. Unlike the past, the banks are no longer exclusively catering to the needs of the Government or the Public Sector Corporations or the big corporate names. When banks provide credit to a large segment of population, the purchasing power of the middle classes of this country expands. And this expanding size of the middle class with higher purchasing power translates into demands for goods and services in the economy and higher growth and employment. This is the linkage between bank borrowing and the growth. People sometimes ask the question "why are the banks giving all this money for consumer financing"? The simple arithmetic is that there were only half a million borrower in this country before 1999. And most of them were corporate or international trade transactions, public sector corporations or high net worth individuals or well connected families. The number of the borrowers has now increased to almost 3 million. If this number expands from 3 million to 6 million, imagine how much additional purchasing power capacity is created in the economy. Farmers use the bank credit to buy fertilizers, seeds, insecticides and use those inputs to improve the productivity of their land. So with the same area we produced 15 million bales of cotton this year as compared to 10 million bales last year. Agriculture credit enabled the small farmers who never had the resources in the past to buy modern inputs and apply them to their land. Because hundreds of thousands of farmers had access to agricultural credit and they used this for purchasing inputs, farm productivity increased. Of course, this year we will not have 45% increase in cotton that was exceptionally high and good weather helped. So good luck was a part of this increase.

The fourth area is good economic governance. There I think we have a lot to do. And, as I said, the second generation reforms, the Civil Service, Judiciary, Police, Education Department, Health Department, all these local governments have to build capacity and they have to be held accountable for results. And unless there is good economic governance in the country, I do not think we will have sustainable growth or poverty reduction. We may have growth but we may not be able to reach our target of poverty reduction.

So, to sum up, the budget should be examined against the strategic economic framework set out in December 1999. We now need to identify what are the existing weaknesses and work to remove those weaknesses. Most of the weaknesses have to do with governance and the institutional decay. But the change there will not happen overnight. The institutional reforms take much longer. You can yourself realize that what you are doing in the banking sector to bring about a new culture, to bring about new people, bring new systems, takes a lot of time. Similarly, to reform the institutions which are responsible for delivering goods and services to the poor and bring about good governance will take a long time. If we are able to follow this strategic framework for the next five years without getting off the track and implement the second generation reforms with full vigour and sincerity, I am quite confident that we will be able to reduce the poverty from 33% to 15%.

Thank you very much.