NBP Fullerton Asset Management Ltd.
A Subsidiary of National Bank of Pakistan

Dr. Amjad Waheed, CFA
Chief Executive Officer

Budget FY14 – Implications on the Economy and Capital Markets

Revenues: Federal Budget FY14 is a traditional budget, and is not geared to address the key structural issues facing the economy. Rather than broadening the tax net, which is the need of the hour, the budget heavily burdens the existing tax payers by increasing indirect taxes (GST rate from 16% to 17%), and higher tax rates on the salaried class. Tax collection target of Rs 2.6 trillion for FY 14 (see Table 1), entailing 22.3%YoY growth, looks ambitious considering (i) the slow economic growth rate of the country at present; (ii) limited new taxation measures in the budget; and (iii) the likely downward revision in FY13 tax collection. Provincial governments have also not made any serious efforts to increase tax collection. We feel that the actual Federal and provincial tax collection will fall short of the target in FY 14.

Table 1: Tax revenues

	FY13E	FY14T	% change	% GDP*
Federal	2,125	2,598	22.3%	10.0%
Provincial	173	230	32.8%	0.9%

* FY14 GDP
Source: Federal and provincial budget documents

Tax collection remains extremely low because major sectors of the economy - Agriculture and Services -remain undocumented and under-taxed. Presently, tax collection from the aforesaid sectors is disproportionate to their contribution towards the economy (GDP), while the industrials sector remains heavily taxed (see Table 2). Agriculture contributes 21 percent to GDP, but pays just one percent in taxes. Services Sector contributes 58 percent to the GDP, while it pays only 26 percent in taxes. Within this sector, services such as banking and insurance pay most of the taxes while transport, wholesale and retail sectors contribute very little. The last NFC awards have further aggravated country's fiscal weaknesses by transferring significant funds to the provinces without associated shift in responsibilities, and lack of progress on RGST which is meant to substantially enhance revenues.

Expenditures: On the expenditure side, defense, debt servicing and subsidies are expected to devour almost all of the projected tax revenues, leaving very little for important services like health and education. We think that there is an urgent need to rationalize defense spending, control the exorbitant government borrowing, and arrest continuous bleeding of Public Sector Enterprises (PSEs) so that funds could be made available for health, education, infrastructure and other vital social services.

Table 2: Sectoral share in GDP and taxes

Sector	Contribution to GDP (%)	Contribution to Tax (%)
Agriculture	21	1
Industry	21	63
Services	58	26

Source: Pakistan Economic Survey

Table 3: Selected expenditures-Budget 2014

Expenditure Head	Amount (PKRbn)	% of tax revenues
Defense*	760	29.3%
Debt servicing	1,154	44.4%
Subsidies and grants**	526	20.3%
Education	318	11.2%
Health	121	4.3%

* includes military pensions, ** includes subsidies to loss-making PSEs
Source: Federal Budget, education and health includes Provincial Budgets

Implications on Capital Markets & Economy:

In addition to the increase in General Sales Tax rate, the government is expected to gradually increase the electricity rates by about 60% during the Fiscal Year. CNG prices are also expected to rise by about 80% within the next few months. On the insistence of IMF, the government is also expected to devalue the rupee by about 5% over the next six months. All of these measures are expected to result in a significant rise in inflation in FY 14, which is again expected to touch double digits during the Fiscal Year. As a result, the State Bank of Pakistan could raise the discount rate possibly before December, 2013. On a positive note, the government is expected to succeed in gradually reducing power shortages to the industry, and the economic growth rate is likely to improve to 4% in FY 2014. The privatization process is anticipated to be revived over the next few months, and the privatization proceeds will help the government fund the overall deficit for FY 2014. The stock market is expected to respond negatively to rising inflation and interest rates. However, investors investing on a one- year or longer investment horizon may still earn double digit returns from the stock market as corporate earnings respond positively to reduction in load shedding, privatization, and improvement in economic growth.