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Centered on tax Reforms and fiscal discipline!!

SUMMARY

The budget for FY12 has been focused mainly on tax reforms and to meet other conditions imposed by IMF. Containing fiscal deficit to 4% of GDP and lower fiscal expenditures were some of the key goals of FY12 budget. Total budget outlay is estimated at PKR 2.767 trn for FY12 higher by 12.3% with total revenue collection target of PkR 2.732trn (Tax revenue 1.952trn and PkR 0.637 trn through non tax revenue) and a fiscal deficit target of PkR 850 bn (4% of GDP). The tax revenue is targeted at PkR 1.952 trn, 17% higher YoY which we feel is an optimistic target to achieve. The annual development expenditure – Public Sector Development Programme (PSDP) has been kept at a restricted level of PkR 730 bn. Pakistan will cut its subsidies to PkR 166.5 bn for FY12, compared with PkR 395.8 bn in the FY11. Govt. has projected GDP growth at 4.2 %, and inflation below 12% for FY12. In order to achieve the targeted inflation, the sales tax has been rationalized by lowering the tax rate by 1% to 16% from 17% while bringing several other areas under tax net. These targets though conservative, would be challenging to achieve considering the political instability, deteriorating law & order situation, ongoing circular debt issue and electricity crises. These factors would hinder the operational efficiency of almost all the sectors of the economy.

Contrary to the expectations, the capital gains tax (CGT) on securities at the rate of 10% for holding period less than six months and at 8% for gains booked up to one year has remained intact for FY12 in the budget. Though, the budget has not put forth any tough decision which would have burdened the masses but it lacks road-map to resolve the many outstanding issues faced by economy like circular debt and energy crisis that has hampered day-to-day business of energy business of the country.

KEY GOALS OF FY11 BUDGET

Protection of Recovery

GDP growth is lacking the desired momentum and the budget has been centered to ease off some pressures which have contributed to the subdued economic performance. The lower sales taxes, removal of regulatory duties and investment friendly policies have been the theme of the budget in order to provide some relief to the ailing economy. This has been done as there remain concerns to stabilize the economy and divert it towards prosperity. While attracting foreign investment, curtailing government expenses at the same time that have been resulting in crowding out of private investment.

Curtailment of Inflation

Limiting inflation in single digit has remained a key focus of the policy makers, though measures did not yield the desired results. This time inflation has been projected to be contained to 12% which seems achievable after the sales tax has been lowered and the consequence of high base effect of recent high inflation. In order to curtail inflation central bank increases interest rates but curtailment of inflation does not come in isolation but at the expense of economic growth. Higher governmental expenses leads to borrowing either from international sources or from within the country. Higher borrowing from internal sources leads to higher interest rates leading to higher cost of borrowing thus adversely affecting the margins. We expect some relief on this front in FY12. There exists a concern that when the repayment of IMF loan is made which is due in February 2012, it would exert pressure on the exchange rate which in turn would heat up inflation as Pakistan is a net importer. However, higher remittances are expected to mitigate some of this effect.

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Salient features of the budget

Salient features of budget proposals for FY12 are as follows:

- Reduction in the rate of Sales Tax from 17% to 16%. Removal of selected exemptions and zero-ratings under GST.
- Removal of Regulatory duty, particularly on edible items. 392 regulatory duties out of 397 are proposed to be abolished, limiting these to luxury vehicles, cigarettes, arms and ammunitions, betel nuts and sanitary ware / tiles. All special excise duties are proposed to be abolished.
- Further, federal excise duty on aerated beverages is also being phased out. It is being reduced to 6% from 12% this year and would be completely abolished next year.
- Tax rate for commercial importers on value addition rises to 3 % from 2 %.
- In order to encourage enhanced equity financing, and to provide relief to new corporate industrial undertakings established on or after 1st July 2011, with 100% equity financing, a tax credit equal to 100% of tax payable is proposed. The existing companies may also take benefit under this arrangement if investment in BMR is financed through their 100% equity.
- For encouraging companies' enlistment on stock exchange, the existing tax credit equal to 5% is proposed to be enhanced to 15%.
- The rate of tax deductible on Cash Withdrawals from Banks is proposed to be reduced to 0.2% from existing 0.3%, for bringing in improvement in the liquidity position of eligible taxpayers.
- In order to harmonize the existing tax credits available to individuals for investment in shares and for premium paid to Insurance Company, the maximum cumulative limit for both the investments is fixed @ 15% of the taxable income, with maximum upper limit for investment upto PkR 500,000.
- Tax relief is proposed to be provided to withdrawals exceeding PkR 500,000/- from a Voluntary Pension Fund.
- In order to discourage the practice of arbitrage by banks for receiving 'dividends' from Asset Management Companies, the rate of tax on such return is proposed to be enhanced from 10% to 20%.
- After imposition of capital gain tax on Modaraba certificates and instruments of redeemable capital traded at stock exchange through Finance Act 2010, the 0.01% CVT on such instruments is proposed to be withdrawn in order to encourage their trade.
- There will be an increase of 15 % in salaries of government employees. The basic exemption limit on income tax of individuals is proposed to be enhanced from PkR 300,000/- to PkR350,000/-. However individual taxpayers whose normal income is between PkR 300,000/- to PkR 350,000/- shall be required to file return of income and statement, for the purposes of documentation.
- Reduction of duty to 5% on pharmaceutical raw materials. Concession for butyl acetate industry through concession on import of its raw materials (Sabutol)
- For encouraging investments made by non-residents in Government Securities, the withholding tax on profit on debt deductible @ 10% is proposed to be a final tax. This measure will relieve the non-residents from the statutory requirement of filing of return of income.
- Revision in the upward limit of duty slabs to enhance the burden of Federal Excise Duty on locally produced Cigarettes. The Federal Excise Duty leviable on filter rods for cigarettes has been rationalize from PkR1/- per filter rod to 20% ad val. The Federal Excise Duty on un-manufactured tobacco is being enhanced from PkR 5/- per kg to PkR 10/- per kg.
- Federal excise duty levied on services provided by property developers or promoters to reduce the level of taxation which will in turn reduce the quantum of taxation on housing sector already subject to levy of Capital Value Tax
- The value addition tax levied on commercial importers is being enhanced from 2% to 3%, which is levied and collected at import stage.
- Limit for adjustment of minimum tax on turnover is being increased from 3 years to 5 years.

- Exemption of sales tax on cement/concrete blocks and bricks has been withdrawn to extend similar treatment in line with other inputs used in the construction industry
- The sales tax leviable on sugar at import and local supply stage has been withdrawn and federal excise duty @ 8% is being levied on aforesaid stages.

Economic Overview of the outgoing year - FY11

The fiscal year 2011 has seen gradual signs of recovery in the economy as macroeconomic indicators have turned positive and are showing sustenance, though not very impressive. The government has missed major macro economic targets set for the outgoing fiscal year with GDP growth recorded at 2.4% in FY11 against the target of 4.5% which was 3.8% last year and fiscal deficit stood at 5.1% against actual target of 4%, according to Pakistan Economic Survey for 2010-11.

The major causes of the slackness in performance can be attributed to the devastating floods in 2010, deteriorating security situation and increase in oil prices in the international market. Floods caused severe damage to the infrastructure and crops while displacing over 20 mn people which led to economic slowdown. The economy witnessed a decline in investment from 15.4% of the GDP in FY10 to 13.4% in FY11, mainly due to high interest rate and deteriorated law & order situation in the country. The average CPI inflation from July-May 2010-11 was reported at 14% with 10% core inflation.

Agriculture Sector: The growth in the agriculture is estimated at 1.2% on the back of 3.7% growth in the livestock sector. Major Crops constituting 31.1% of agricultural value added registered negative growth of 4.0% compared to a negative growth of 2.4% last year and a target of 3.7%. Minor crops registered a growth rate of 4.8% compared to the target of 3.0% and negative growth of 7.8% last year.

Manufacturing Sector: Output in the manufacturing sector witnessed expansion of 3% in 2010-11 as compared to expansion of 5.5% last year on the back of strong performance from small and medium manufacturing sector Large-scale manufacturing grew by 0.98 % as against 4.9 % of last year.

Services Sector: The services sector grew by 4.1% against the target of 4.7% and actual outcome of 2.9 %. Within services sector wholesale and retail trade sector grew at 3.9 % as compared to 4.6 % last year and the target for the year of 5.1 %. Finance and insurance sector recorded negative growth of 6.3 % in 2010-11 as against contraction of 11.3 % last year. Public administration and defense posted a stellar growth of 13.2% as compared to 2.5% in last year. Social services sector grew by 7.1% which is slightly higher than the target of 5.0% but lower than last year's actual growth of 7.8%.

Per Capita Income: Pakistan's per capita real income has risen by 0.7% in 2010-11 as against 2.9% last year. Per capita income in dollar term rose from USD1,073 last year to USD1,254 in 2010-11, thereby showing considerable increase of 16.9 %. Real private consumption rose by 7.0 % as against 4.0 % attained last year.

Investment: The total investment has declined from 22.5 % of GDP in 2006-07 to 13.4 % of GDP in 2010-11. Fixed investment has decreased to 11.8 % of GDP from 13.4 % last year.

National And Domestic Savings: The national savings rate has decreased to 13.8% of GDP in 2010-11 as against 15.4% of GDP last year. Domestic savings also declined substantially from 16.3 % of GDP in 2005-06 to 9.5 % of GDP in 2010-11.

IMPACT OF BUDGET ON DIFFERENT SECTORS

CAPITAL MARKET: Neutral

Contrary to the market expectations, the capital gain tax on securities has not be withdrawn and it has remained intact as per the previous schedule. However, the main focus has remained to provide incentives on getting listed on the exchanges for which the existing tax credit equal to 5% is proposed to be enhanced to 15%. Therefore, the budget would have a neutral impact on the stock market if not negative. However, some selective sectors which have been provided benefit like cement sector would generate a positive rally in the market.

FERTILIZER: Neutral

The government has allocated PkR 12 bn subsidy to the Trading Corporation of Pakistan (TCP) for import of urea fertilizers while subsidies on manufacturing of phosphatic & potashic fertilizers and imports of phosphatic & potashic fertilizers have been removed. The amount of subsidy for FFBL has also been reduced to PkR 162 mn from PkR 185 mn hence, FFBL being a price taker would incur greater cost of inputs and would result in less profitability.

The budget did not cover the fertilizer sector regarding ensured gas supply however; the reduction of sales tax by 1% would be favorable for fertilizers.

Keeping in view the inelastic demand of fertilizers, urea imports would increase due to gas curtailment in the country thus, we expect urea prices to further increase. However, fertilizer imports might fall if Engro's new fertilizer plant begins its production which would improve the supply situation in the country. FFC and ENGRO having pricing power will pass on the additional cost to the end users. Therefore these companies in the fertilizer sector will maintain their profitability intact.

POWER SECTOR: Neutral

Considering the dire need of power development project the government has allocated PkR115.248 bn for ongoing and new schemes in power sector in PSDP for the year fiscal year 2011-12. Out of the total PkR71.070 bn has been proposed for ongoing projects, PkR1.225 bn for new schemes while PkR42.953 bn for hydel projects in the upcoming financial year.

PkR18.0 bn have been allocated for Diamer Basha dam land acquisition and PkR2.5 bn for construction of Diamer Basha dam project. An amount of PkR10.81 bn has been allocated to Neelum Jhelum; PkR3.241 bn for Dubir Khawar, PkR2.144 bn for Allai Khawar, PkR1.789 bn for Golan Gol, PkR1.124 bn for Jinnah and PkR0.65 bn for Bunji Hydro power projects in the PSDP.

Moreover, an amount of PkR14.577 bn has been specified for 747 MW Guddu power project, PkR13.850 bn for 525 MW Combined Cycle power plant at Chicho Ki Malian, PkR3.845 bn for 425 MW Combined Cycle Nandipur power plant and PkR1.65 bn for power system transmission enhancement project-II. PkR 1.8 bn have been allocated for import for 100 MW power from Iran and PkR400 million for interconnection for dispersal of power from Barrage Mounted Kerkey Rental Power plant phase-1. All these measures would have a positive impact on the economy in general would not have a direct impact on the listed companies of the power sector.

OIL MARKETING COMPANIES: Neutral

The petroleum levy was kept at the previous levels, thus there would be neutral impact on the OMC sector.

TELECOMMUNICATION: Positive

With the sales tax rationalized to 16% the telecom sector is expected to be a higher beneficiary as there was higher tax rate of 21% on telecom industry. Therefore, it is positive for the telecom sector.

REFINERY SECTOR:Neutral to Positive

No measure except the lowering of sales tax by 1% directly holds any impact on the refinery sector. However, the deemed duty has been kept intact which can be considered as positive for the refinery sector. Therefore we maintain a neutral to positive stance on the sector.

ENERGY AND EXPLORATION SECTOR:Neutral

The FY12 budget has been a non-event for the oil and gas exploration companies except for the concession in machinery and equipment to benefit oil exploration companies which would have a neutral impact on this sector.

CEMENT SECTOR: Positive

FED on cement shall be phased out in 3 years. A reduction of PkR 200/MT is proposed in the first year and equal reduction of the balance of PkR 500/MT in the next two budgets. This would have a positive impact on the Cement sector.

BANKS – Neutral

The rate of tax deductible on Cash Withdrawals from Banks is proposed to be reduced to 0.2% from existing 0.3%. However, the expected increase in corporate tax has not been announced in the budget which bodes well for the banking sector. Dividends from AMCs to be taxed at 20%, to be risen by 10% for the banks to avoid arbitrage . This is going to have a marginal negative effect on 'Non-Interest' Income of banks. This measure is also going to discourage banks from investing in mutual funds.

Moreover, banks have also been allowed to 'carry over' bad debts for 5 years on advances to consumers and SME's. 100% tax credit has been allowed on investment in industrial undertaking and BMR with 100% equity. i.e. without taking any debt. This would encourage investors to invest without taking advances from banks, however its effect will not be significant for banks.

AUTOMOBILE – Neutral

The impact would be neutral as no significant measures directly pertaining to automobile sector have been announced.

TEXTILE – Positive

A portion of PSDP has been allocated for the development of the textile sector. The government has allocated PkR 150.016 mn for the five ongoing projects of Textile Industry Division in PSDP 2011-12. Pak-Korean Garments Technology Training Institute, Karachi is entitled to get PkR 30 mn including foreign funds of PkR 20 mn for the scheme. PkR 48.834 mn has been allocated for Providing and Laying of Dedicated 48 inch Diameter mild Steel Water Pipeline for Textile city Karachi, PkR 28.682 mn for Faisalabad Garments City Project, PkR 25 mn for Extension in Export Development Plan Implementation Unit and PkR 17.5 mn were fixed for Lahore Garment City Company. These measures are expected to benefit the textile sector.

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