

October 05, 2009

Pakistan Market**Fiscal consolidation and IMF****MORNING BRIEFING**

KSE100 Index: Closing 9455.15 ↑ (+153.97)

IMF has prescribed a tax revenue collection target of Rs1.38trn for the full FY10, up 19.2%YoY. The macroeconomic fundamentals, future of capital markets and policy outlook are increasingly hinging with the fate of overall tax collection. In fact, course of IMF disbursements are linked with government commitment of increasing tax to GDP through introduction of VAT law in the parliament and formation of Inland Tax Revenue departments, where all taxation departments will work under one roof. The question remains whether the tax targets prescribed by IMF are realistic.

Tax targets vs reality

IMF has set quarterly tax collection targets of Rs286bn, Rs346bn (up 20%QoQ), Rs321bn, and Rs426bn (up 32%QoQ), respectively, in FY10. Interestingly, the share of direct tax collection has been set at 40% in total tax revenues, compared to 38.1% collected during FY09. We believe the formation of Inland Revenue department will help increase the tax compliance and in turn overall direct tax collection share. Through looking at the quarterly targets the obvious question comes to mind is: 'are higher QoQ targets are ambitious to achieve?' However, historical data depicts that on average tax collection surged up by 10% QoQ in 2nd quarter and 30-35% QoQ in the 4th quarter in each respective year. This suggests a higher QoQ target is not the central issue. We believe the central issue is narrow based tax avenues, which results into massive deviation from the targets.

(Rs mn)	FY10 Target	FY09	FY08
1st quarter	286,000	262,091	205,136
2nd quarter	346,000	291,743	229,940
Change (%)	21%	11%	12%
3rd quarter	321,000	261,276	244,853
4th quarter	426,000	341,892	328,163
Change (%)	33%	31%	34%
Total	1,379,000	1,157,002	1,008,092

Pakistan tax avenues in brief

Sales tax accounts for 39% of the total tax proceeds, followed by direct taxes (38%), customs (12%) and Federal Excise (10%).

Direct taxes: Within direct taxes, majority of the revenues are generated through deduction at source (WHT) followed by Voluntary payments. Unfortunately, voluntary payments compliance is a mere 34%, which depicts a massive room of improvement in the tax collection. Moreover, a mere 2.2mn Income tax returns and certificates were filled during FY09, compared to population size of 180mn. WHT is dominated by deduction at source from contract payments, imports, salaries, exports, utility bills, dividends and cash withdrawal from bank.

Indirect taxes: 63% of indirect taxes are being contributed by sales tax. But unfortunately, this source is vulnerable and heavily relies on petroleum and telecom services. Within domestic sales, tax petroleum and telecom services contributes over 63% and 10 commodities contributes roughly 89% of total domestic sales tax collection. Likewise petroleum shares a majority of the sales tax collection on import stage and contributes 37% of it, followed by edible oil (7.9%), plastics (7.5%) etc.

Outlook

As highlighted above, Pakistan's low tax compliance and narrow based indirect tax collection has put the country's fiscal accounts at a greater risk. Any shock to oil price, imports, employment and government spending could deviate tax revenues from target. With the installation of Rental Power Plants (RPPs), Pakistan oil consumption is likely to surge by 20% in FY10, additionally inline with IMF guidelines Pakistan electricity tariff is likely to surge by another 30% in ongoing fiscal year. This will help government to meet the tax targets. However, given the inefficient tax structure in the country, we believe higher tax incidence will continue to dampen Pakistan's growth outlook. Higher corporate tax (35%) and

Sales tax (16%) is not only encouraging tax evasion but also dampening investment prospects. This should lead to economic slowdown, in our view.

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Also in focus**Cumulative cotton arrivals up by 30%YoY**

According to the latest numbers released by Pakistan Cotton Ginners Association (PCGA), cumulative cotton arrivals stood at 3.1mn bales as of Oct 1, 2009, translating into a growth of 30%YoY. However, due to pest and virus attacks in the lower Punjab belt we expect the growth to decline significantly. The PCGA is also expecting a shortfall of the cotton crop in the FY10 to about 12mn bales as against the target of 13.4mn bales set by the government earlier. This shortcoming can cause a hike in cotton prices which already are hovering around Rs3600 per maund.

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