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The Illusion of Sync

Reflections on Budget 2025–26: A fiscal framework pedaling with imbalance

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At its core, the Federal Budget 2025–26 comes across as a routine, business-as-usual exercise. While references have been made to structural reforms, it remains to be seen whether these will materialize meaningfully or simply serve to project a sense of forward movement.

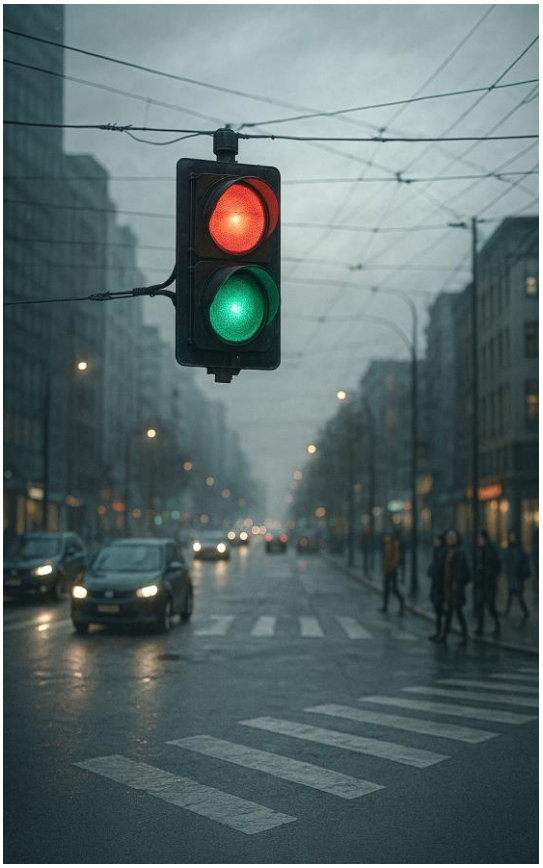
As with previous years, the numbers have been aligned to present a well-balanced fiscal outlook, particularly when viewed through a conventional accounting lens. That said, some figures appear overstated, most notably the projected SBP profits of Rs 2.4 trillion under non-tax revenues, which seem difficult to justify given the sharp reversal in interest rates. This estimate appears overstretched by at least Rs 500 billion, if not more. Furthermore, as in previous years, certain sections of the Finance Bill leave room for improvement in clarity to aid broader understanding.

As an investor reviewing this year's budget, one key element to note is that there has been no change in the tax treatment of dividends and capital gains for Mutual Funds, and the same tax regime continues as in the previous year.

For institutional and corporate investors, the implications of this change depend on individual corporate tax profiles and structures. In some cases, this capital gain tax withholding could be offset if capital gains are adjusted. Additionally, if dividends are not the sole component of income, and the flat 25% is accepted as final tax, it may offer a simplified route for managing tax obligations.

From an individual investor's perspective, the increase in the tax rate on interest income from bank deposits, from 15% to 20%, has enhanced the relative attractiveness of fixed-income mutual funds. Moreover, the clarity that the 25% withholding tax on mutual fund investments is treated as full and final further strengthens the appeal. Mutual funds thus offer a compliant, professionally managed, and operationally efficient investment avenue, free from the administrative complexities associated with direct investments.

In summary, while the new tax regime has nuanced implications, mutual funds remain an efficient and hassle-free solution, particularly for investors seeking diversified exposure and simplified compliance.



However, several proposed changes warrant attention for those planning long-term financial security through mutual funds and pensions, where the key ones are:

The exemption allowing 50% tax-free withdrawal from Voluntary Pension Schemes (VPS) at retirement has been proposed for withdrawal, which could make retirement payouts more heavily taxed than before.

Transfers from Provident Funds to VPS, previously exempt, are now proposed to be treated as taxable events, reducing flexibility in consolidating retirement savings into structured vehicles.

While these proposals introduce new tax considerations, it's important to note that the asset management industry is actively working with tax consultants and policy experts to engage with authorities. There is strong advocacy underway to reinstate the earlier exemptions, especially for VPS withdrawals and provident fund transfers, which have long been pillars of structured retirement planning in Pakistan. Based on these efforts, we remain optimistic that greater clarity will emerge and key provisions may be revisited during the final stages of the Finance Bill process.

Savings-Led Strategy at a Crossroads

From an investor's perspective, these developments come at a critical juncture, just as many governments and employers are transitioning toward defined-contribution retirement models like VPS. Applying punitive tax treatment to such frameworks sends mixed signals and risks discouraging the very behavior that fosters long-term financial resilience. That said, the conversation is not over. We are hopeful that a more enabling structure will ultimately prevail.

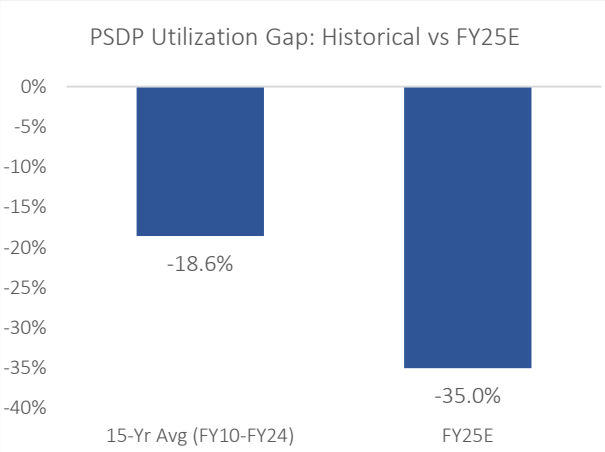
In parallel, a revival of tax credits for mutual fund investments should be seriously considered to reinvigorate savings participation, especially now, as local capital markets are increasingly expected to fund the fiscal gap. Building a sustainable domestic savings base is not just beneficial for individual investors but vital for the economy's long-term financing needs.

Likewise, alternative investment classes like REITs, Private Equity, and Venture Capital were again overlooked in this year's budget. Investors had anticipated policy signals – particularly the extension of the capital gains tax exemption under Clause 99A for REITs – to reinforce the government's support for formal real estate and diversified investment channels. Although this did not materialize, we believe that continued dialogue can help bring these critical sectors into future policy frameworks, unlocking broader opportunities for investors and promoting economic growth.

Stretched Targets, Strained Taxpayers

Turning to the broader fiscal framework, the tax revenue target set in the budget appears significantly ambitious. The recent uptick in tax collection was primarily driven by extraordinary factors – record-high inflation, the imposition of a 10% super tax, a windfall tax on banks, and substantial tax hikes on salaried individuals and companies. Setting a similar growth expectation for the upcoming fiscal year, despite a still-fragile economic recovery, appears inconsistent.

Breakdown of Tax Revenue Growth	5-Year Avg.	FY26B
Inflation (a)	15.7%	7.5%
GDP Growth rate (b)	3.4%	4.2%
Tax Revenue growth:		
Organic Growth (c = a + b)	19.0%	11.7%
Overall Growth (d)	24.4%	18.7%
Growth from new tax measures (e = d - c)	5.3%	7.0%



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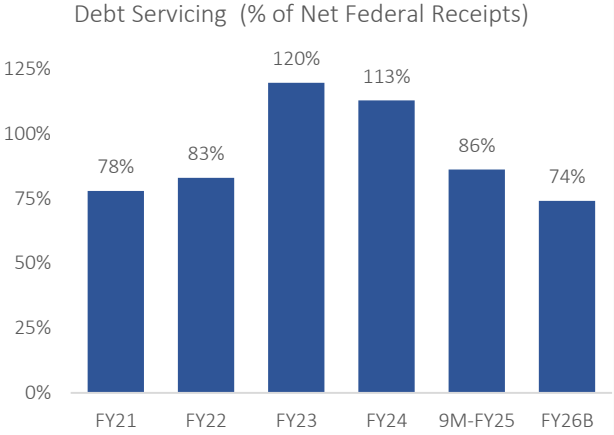

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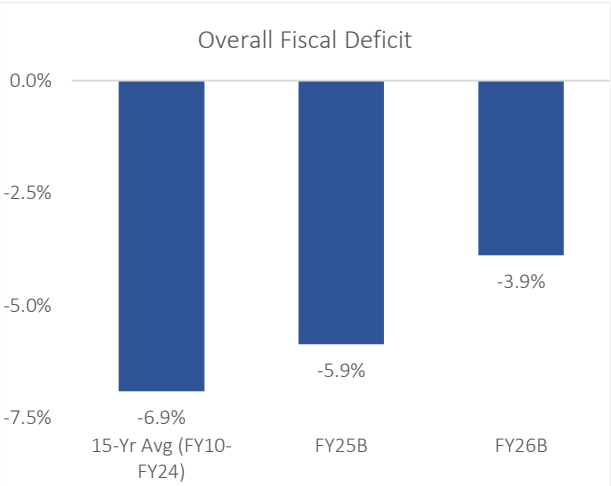

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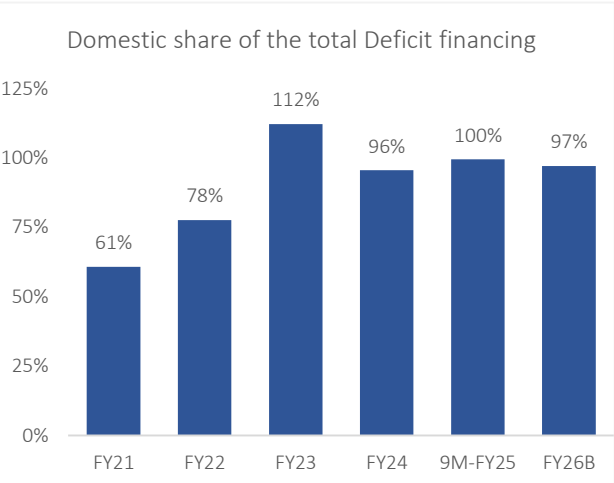

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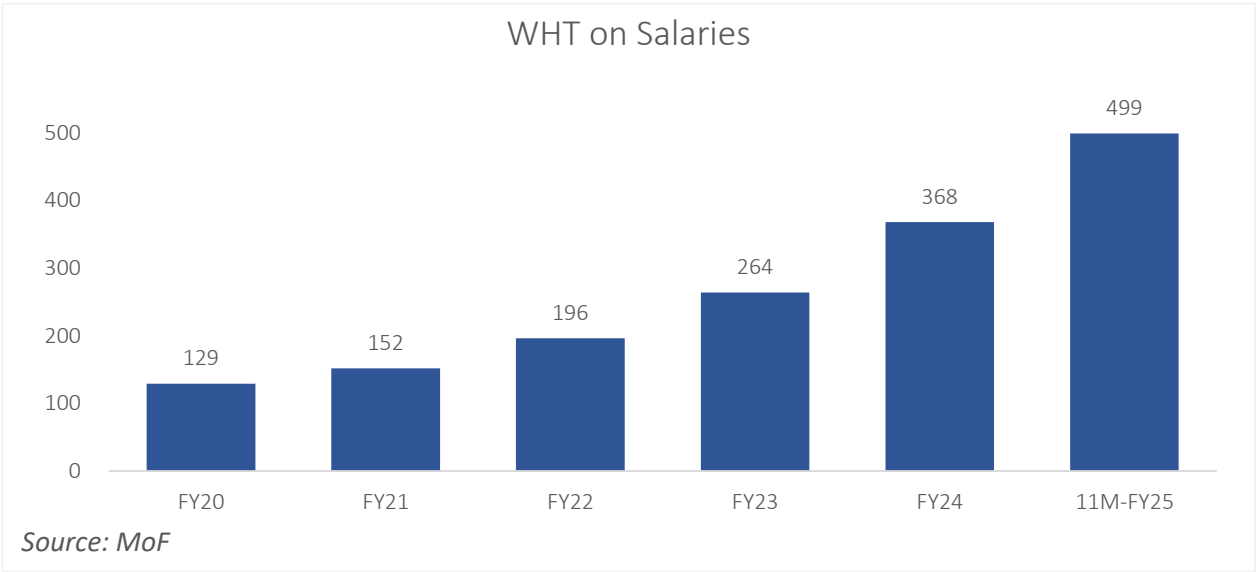
Similarly, while the appeal of mutual funds and VPS as structured savings vehicles seems to have been undermined, policy support appears to be shifting back toward real estate, highlighting yet another contradiction in the overall policy direction. This divergence could prove detrimental for small investors and the broader public.

Moreover, while modest relief measures have been proposed for salaried individuals, such as reduced tax rates for income brackets up to Rs 3.2 million and a 1% reduction in surcharge, these are offset by regressive steps like increasing the sales tax on small cars (up to 850cc) from 12.5% to 18%, which will disproportionately affect middle-income earners. Collectively, these moves reinforce the perception that revenue generation continues to rely heavily on the most accessible segments of the tax base.



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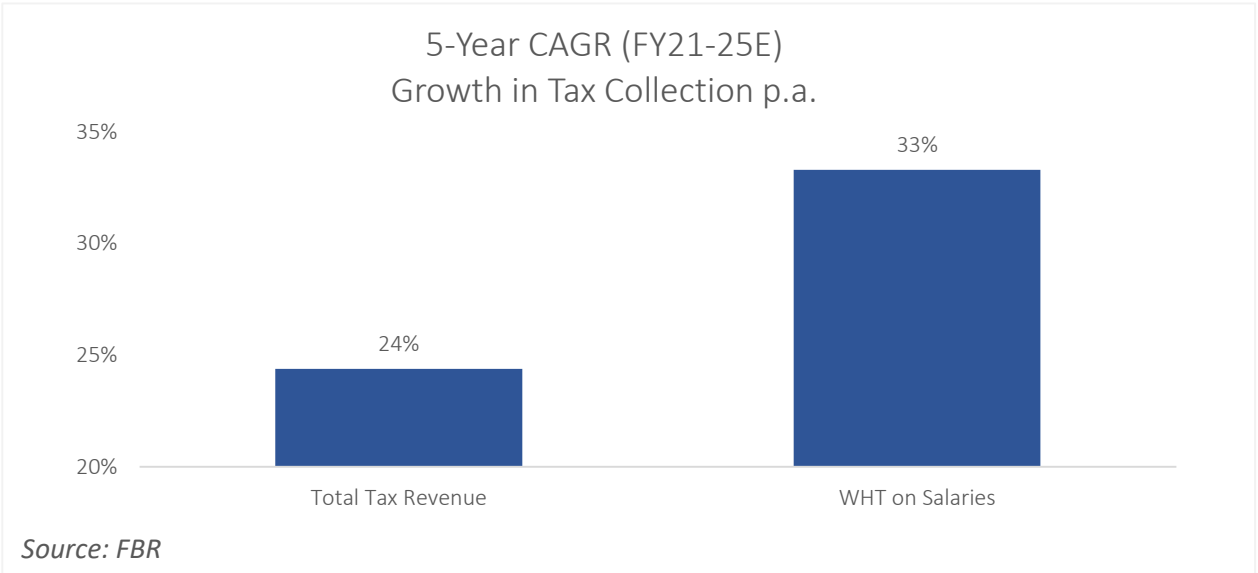

Source: FBR

Formalization: The Real Test Begins

Continuing the conversation, one can't help but reflect on the broader concern that terms like "fiscal consolidation," "structural reforms," and "macroeconomic stabilization" – often central to the budgeting narrative – tend to disproportionately apply to those already within the tax net. Encouragingly, however, this year's proposals signal a noticeable shift from carrot to stick in dealing with the undocumented economy. Notably, the budget introduces firm restrictions on non-filers: they will be entirely barred from purchasing vehicles or immovable property, and prohibited from investing in securities or mutual funds, marking a stronger push towards formalization.

Complementing these restrictions is a broader push to formalize economic activity and digitize financial flows. The budget introduces several measures aimed at reducing informality, including disallowing business expenses on purchases made from unregistered vendors and discouraging large cash transactions by denying expense deductions unless payments are routed through digital channels. Significant asset purchases – such as property valued above Rs 5 million or other assets exceeding Rs 1 million – must now be made through banking channels to qualify for depreciation or cost allowance. Banks are also required to flag suspicious account activity that appears misaligned with declared income.

On the digital front, the budget proposes a framework to bring Pakistan-based e-commerce and online vendors into the formal net. This includes taxation on domestic online deliveries, mandatory tax registration for online sellers, penalties for platforms hosting unregistered vendors, and the application of sales tax on automated digital services such as streaming or software subscriptions. Moreover, enhanced integration with FBR systems – such as real-time POS and e-invoice reporting for Tier-1 retailers, alongside cargo tracking through a digital freight tracking mechanism, underscores the government's intent to tighten compliance and improve revenue documentation.

Going forward, much will depend on the government's execution machinery, now more frequently referred to as "enforcement", which will likely come under increased scrutiny. While real estate appears to have been granted some leeway and taxation of the agriculture sector remains largely absent despite its economic weight, the real test lies in the follow-through on the formalization agenda. In many ways, the government has now made its most decisive signal yet. And with traditional revenue streams nearing their limit, the path forward now inevitably points toward broadening the tax base, especially as the easier sources of taxation have already run their course.

Tariff Reform: Theory vs. Timing

One of the most thought-provoking developments tied to this year's budget is the government's renewed emphasis on tariff rationalization. What stood out, however, was not just the policy itself but the visible polarization it sparked, where economic experts and think tanks appeared to champion the cause. At the same time, segments of the domestic industry and local chambers expressed strong reservations. From a pure economic theory standpoint, the rationale for rationalizing tariffs is well-established: without it, domestic industries may never attain the competitiveness required to stand on their own. Yet, ground realities cannot be overlooked. With global tariff tensions escalating, there is a real risk that countries like China, Vietnam, and Bangladesh may redirect excess production toward alternative markets, including Pakistan, potentially leading to dumping and intensifying competition both domestically and abroad. Against this backdrop, any move toward phasing out protectionist measures must be carefully timed and strategically managed. A hasty or inconsistent approach, something not unfamiliar in our policy environment, could come at a significant cost to the domestic industry.

The Rebuild Portfolio

As we look beyond the fiscal proposals and into the investment landscape, the imperative to channel domestic savings into productive assets has never been greater. In our view, the path to financial resilience lies in disciplined, long-term investing across a well-diversified portfolio. Equities remain well-positioned for a re-rating, particularly as valuations continue to reflect deep discounts relative to historical norms, and sentiment improves on the back of macro stabilization. Within fixed income, the anticipated shift toward a single-digit policy rate reinforces our constructive view on debt markets, offering attractive yield opportunities with a calibrated approach to duration and credit. Meanwhile, alternative asset classes like REITs merit greater investor attention, not only as a potent inflation hedge but also as a scalable investment avenue aligned with formal real estate development. A thoughtfully diversified strategy across these segments can help investors navigate uncertainty while participating in Pakistan's long-term economic recovery.

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