



# PAKISTAN FISCAL POLICY STATEMENT 2010-11

2010-11



Debt Policy Coordination Office  
Ministry of Finance

# FISCAL POLICY STATEMENT 2010-11

DEBT POLICY COORDINATION OFFICE

MINISTRY OF FINANCE  
PAKISTAN

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## Acknowledgements

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This Policy Statement has been prepared to fulfill the requirement laid out under Section 6 of the Fiscal Responsibility and Debt Limitation Act 2005. I would like to acknowledge the input of various Ministries, Departments, Divisions and Agencies, particularly, timely data provision by Budget Wing (MoF), Corporate Finance Wing (MoF), Economic Reform Unit (MoF), MTBF Secretariat (MoF) and the Federal Board of Revenue. I would like to recognize the effort put in by Mehwish Ashraf, Financial Analyst (DPCO) in the realization of this comprehensive document.

**Masroor Ahmed Qureshi**  
Director General  
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## List of Acronyms

|          |   |
|----------|---|
| AJ&K     | Azad Jammu & Kashmir                          |
| BODs     | Board of Directors                            |
| BoP      | Balance of Payments                           |
| BSP      | Budget Strategy Paper                         |
| CCOR     | Cabinet Committee on Restructuring            |
| CDNS     | Central Directorate of National Savings       |
| CFAO     | Chief Finance & Accounting Officer            |
| COD      | Collection on Demand                          |
| CSF      | Coalition Support Fund                        |
| CVT      | Capital Value Tax                             |
| DISCOs   | Distribution Companies                        |
| DPCO     | Debt Policy Coordination Office               |
| ENDA     | Emergency Natural Disaster Assistance         |
| FATA     | Federally Administered Tribal Areas           |
| FBR      | Federal Board of Revenue                      |
| FED      | Federal Excise Duties                         |
| FELs     | Foreign Exchange Liabilities                  |
| FODP     | Friends of Democratic Pakistan                |
| FPS      | Fiscal Policy Statement                       |
| FRDL Act | Fiscal Responsibility and Debt Limitation Act |
| FY       | Fiscal Year                                   |
| GDP      | Gross Domestic Product                        |
| GoP      | Government of Pakistan                        |
| GST      | General Sales Tax                             |
| IDPs     | Internally Displaced Persons                  |
| IMF      | International Monetary Fund                   |
| IRS      | Inland Revenue Service                        |
| KESC     | Karachi Electric Supply Company               |
| MTBF     | Medium-Term Budget Framework                  |
| NEPRA    | National Electric Power Regulatory Authority  |
| NFC      | Nation Finance Commission                     |
| NTDC     | National Transmission & Despatch Company      |
| OGDCL    | Oil & Gas Development Company Ltd.            |
| OZT      | Octroi & Zilla Tax                            |
| PATA     | Provincially Administered Tribal Areas        |
| PEPCO    | Pakistan Electric Power Company               |
| PSDP     | Public Sector Development Programme           |
| PSEs     | Public Sector Enterprises                     |
| PSO      | Pakistan State Oil                            |
| PTA      | Pakistan Telecommunication Authority          |
| PTCL     | Pakistan Telecommunication Company Ltd.       |
| RGST     | Reformed General Sales Tax                    |
| SBA      | Stand by Agreement                            |
| SBP      | State Bank of Pakistan                        |
| SDR      | Special Drawing Rights                        |
| SED      | Special Excise Duty                           |
| TPD      | Total Public Debt                             |
| USAS     | Universal Self Assessment Scheme              |
| VAT      | Value-Added Tax                               |
| VP       | Voluntary Payments                            |
| WAPDA    | Water and Power Development Authority         |
| WHT      | Withholding Taxes                             |

## I. Introduction

The importance of fiscal policy in pursuance of a government's principal economic objective of seeking rising levels of prosperity for all members of the society by achieving high, sustainable and equitable economic growth cannot be overemphasized. However, formulation and implementation of fiscal policy is a complex subject with eventual outcomes of policy measures at times being markedly different from their short-term effects and even contrary to the very objectives that fiscal policy seeks to achieve.

In response to the worst worldwide economic and financial crisis since the Great Depression, government budgets and central banks around the world have provided substantial support. Fiscal deficits widened significantly in 2009, with advanced economies experiencing a larger—and likely long lasting—deterioration. With fiscal deficits above 9 percent of GDP in 2009, the scale of the problem in advanced G-20 countries is unprecedented. Emerging economies also experienced large deficits in 2009, but the impact of the crisis was on average less severe than in the advanced G-20 economies.

Looking back over the past decade, Pakistan's fiscal performance was relatively sound during FY2001-06. The fiscal balance was in deficit averaging around 3.9 percent in terms of GDP and the primary balance remained in positive for the first four consecutive fiscal years, approximating to 1.2 percent of GDP.

However, in recent years, Pakistan's fiscal performance has remained very weak. While the reported fiscal deficit per se has consistently breached the targets, it does not fully reflect the costs associated with quasi fiscal activities such as commodity operations and unrecognized portions of subsidies especially relating to the power sector funded directly by Public Sector Entities (PSE) borrowings from banks.

The origin of current fiscal predicament can be traced back to FY2006-07 when fiscal policy became subservient to political exigencies as government extended wholesale subsidies on oil, electricity, food and fertilizer products in an apparent effort to protect the economy (especially the more vulnerable segments of the society) from the effects of global commodity price shock. However, such measures actually resulted in pressure on balance of payments, fiscal account (in shape start of circular debt build-up) and banking system liquidity. The economy finally paid the cost in shape of currency devaluation with rupee losing more than a third of its value, inflation reaching multi-decade highs of 25 percent in 2nd quarter of FY2008, benchmark interest rates being hiked to 15 percent and GDP growth falling to 3.7 percent in FY2008 and further to 1.2 percent in FY2009 from an average of 6.8 percent during



FY2003-07. Unlike most parts of the world, Pakistan remained relatively unhurt by the global economic crisis that unfolded in 2008. If anything, post crisis collapse of commodity prices helped in reducing burdens on external and fiscal accounts. Nevertheless, post FY2006 events taught a very expensive lesson on the need to maintain fiscal discipline as measures haphazardly designed to provide 'relief' eventually caused more 'pain' for the public in general.

The deteriorating external position on account of diminishing foreign exchange reserves forced the Government of Pakistan to access International Monetary Fund (IMF) and enter into a Stand-by Arrangement (SBA). In November 2008, Pakistan signed a 23-month SBA program with the IMF amounting to US\$ 7.61 billion, which was later augmented to US\$ 11.33 billion in August 2009 and subsequently extended to September 2011.

The macro-economic stabilization agenda pursued under this facility benefitted the country's Balance of Payments position. However, fiscal slippages continued on account of current expenditure and lower revenue collection. Security spending, including IDP related expenditures, coupled with electricity subsidies were the highlighting factors in FY2009 and FY2010 while efforts to reform the existing revenue structure by increasing tax net, reducing exemptions and eliminating zero/special ratings have meant a compromise on fiscal management. Such temporary constraints stress the importance of maintaining sufficient fiscal space by undertaking timely adjustments during periods of reasonable economic growth.

Economic growth remained subdued in FY2010 owing to a multitude of factors like widening of fiscal deficit, double-digit inflation, high interest rates, low levels of non-debt creating foreign exchange flows, and a rising debt burden. The hard earned fiscal consolidation achieved during FY2009 could not be sustained in FY2010 due to reduced tax revenue growth of 22.3 percent against a target of 29.8 percent. Non-tax revenue, although healthy, was not able to mitigate the tax shortfall. On the spending side, the major cause of slippage was increased expenditure on security related expenses and subsidies. Total expenditure was up by 18.8 percent against a budgeted growth of 13.7 percent. The government curtailed development spending in order to dilute the impact of higher than budgeted current expenditure. In spite of this inter-expenditure adjustment, fiscal deficit increased from 5.3 percent of GDP in FY2009 to 6.3 percent in FY2010.

This Fiscal Policy Statement (FPS) will review the overall fiscal developments during fiscal year 2009-10 in order to fulfill the legal requirement of Section 6 of the FRDL Act 2005. Furthermore, the Act requires the FPS to analyze the performance of some key fiscal indicators such as the total revenues, overall fiscal deficit, primary and revenue deficits, as well as the public debt burden. The Act also requires that the FPS analyze whether there was any deviation from the fiscal targets and if federal government policies have remained in conformity with the principles of sound fiscal and debt management, and the targets set forth in the medium-term budgetary statement in Section 5 of the Act.

## II. Fiscal Policy Statement

The Fiscal Policy Statement is presented to fulfill the requirement in Section 6 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. The statement provides an overview of government revenues and expenditures during the course of the fiscal year and explains the changes in key macroeconomic indicators during 2009-10. Section 6 of the FRDL Act 2005 requires that:

- 1) The Federal Government shall cause to be laid before the National Assembly the Fiscal Policy Statement by the end of January each year.
- 2) The Fiscal Policy Statement shall, *inter alia*, analyze the following key macroeconomic indicators, namely:-
  - a) Total expenditures;
  - b) Total revenues;
  - c) Total fiscal deficit;
  - d) Revenue deficit; and
  - e) Total public debt
- 3) The Federal Government shall explain how fiscal indicators accord with the principles of sound fiscal and debt management.
- 4) The Fiscal Policy Statement shall also contain:-
  - a) The key measures and rationale for any major deviation in fiscal measures pertaining to taxation, subsidy, expenditure, administrated pricing and borrowing;
  - b) An update on key information regarding macroeconomic indicators;
  - c) The strategic priorities of the Federal Government for the financial year in the fiscal area;

- d) The analysis to the fullest extent possible of all policy decisions made by the Federal Government and all other circumstances that may have a material effect on meeting the targets for economic indicators for that fiscal year as specified in the Medium-Term Budgetary Statement; and
- e) An evaluation as to how the current policies of the Federal Government are in conformity with the principle of sound fiscal and debt management and the targets set forth in the Medium-Term Budgetary Statement.

### III. Principles of Tax and Expenditure Policy<sup>1</sup>

#### III.i. Principles of Tax Policy

Tax reform must be considered as a package, but in light of common lessons and challenges on key instruments. What matters for the fairness of a tax system, for instance, is not the distributional impact of any tax considered in isolation, but that of all taxes combined. While ‘tax-by-tax’ policy design is thus to be avoided, effective reform does require recognizing the limits and potential of each instrument. The Value-Added Tax (VAT) is a mainstay of the tax systems of almost all advanced and emerging countries. It has proved a relatively efficient source of revenue. Reducing exemptions and eliminating reduced rates is generally the best way to increase VAT revenue, unless low efficiency is caused by weak administration.

Improving the medium-term fiscal position requires reshaping revenue administration. There are three priorities: *developing sound risk-based compliance strategies; strengthening legal frameworks*, including the powers of revenue agencies (e.g., in accessing information and conducting audits); and *exploiting new information technology* to better align tax compliance management with businesses’ lifecycles. Fundamental strengthening of compliance improvement strategies is crucial. Tackling endemic tax abuses to enhance the taxpaying culture requires significant capacity building in core systems of revenue administration (including in compliance-related areas of risk management, audit, collection enforcement, taxpayer services, and dispute resolution).

Through comprehensive reform efforts, revenue agencies (in Pakistan, the Federal Board of Revenue) can play an important role in fostering formalization, by helping new entrepreneurs and taking visible enforcement action against the shadow economy to establish tax discipline. These compliance risks

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<sup>1</sup> “From Stimulus to Consolidation : Revenue and Expenditure Policies in Advanced and Emerging Economies” (IMF, 2010)

require novel approaches, like the recent Universal Self Assessment Scheme (USAS) aimed at bringing taxpayers into voluntary compliance. Another initiative entails Inland Revenue Service (IRS) that includes a harmonized tax management structure and an integrated database that will improve efficiency and help increase the tax-to-GDP ratio in the medium term. These programs are an integral part of wider strategies to achieve enduring tax compliance.

Legal frameworks need to be enhanced to address compliance risks and pervasive tax abuse. Intensifying the use of modern information technology in delivering revenue administration will significantly improve compliance management and reduce compliance costs. Besides basic internet-based services (e.g. tax information and e-filing), FBR should intensify the adoption of electronic solutions to automate and align economic agents' tax compliance and business cycles.

### III.ii. Principles of Expenditure Policy

Expenditure reviews help guide the design of specific strategies. These reviews can provide valuable input to guide long-term reform by addressing fundamental questions on the role of government and the cost effectiveness of different policy interventions. These reviews should also identify expenditure inefficiencies and be integrated with performance-based budgeting.

Expenditure reforms should be guided by two objectives:

*Improving the efficiency of spending:* Governments should seek to reduce the cost of producing existing public sector outputs. In addition, spending should be allocated to activities that provide the greatest marginal benefits to society as a whole; and

*Ensuring equity:* Growth without equity is less durable. Expenditure policy must reflect the need for both intra- and intergenerational equity. Greater targeting of social spending may also be necessary to ensure that the poor are protected as spending levels are reduced.

Medium-term expenditure reforms will need to improve the composition and efficiency of expenditure. The freeze in real spending is an overall policy goal, not a tool. Targeted structural reforms would be needed to achieve this goal. Reductions in general public services, economic affairs, and defense spending comprise an important element of adjustments. Better targeting of social welfare spending, including social benefits, could provide substantial fiscal savings. Sizable savings are also possible in

spending on subsidies. This spending should be reexamined and replaced, where possible, with more targeted instruments to provide income support. In particular, priority should be given to phasing out energy subsidies. Coordination with provincial government will be crucial for ensuring successful expenditure reform.

#### IV. Historical Perspective on Fiscal Developments

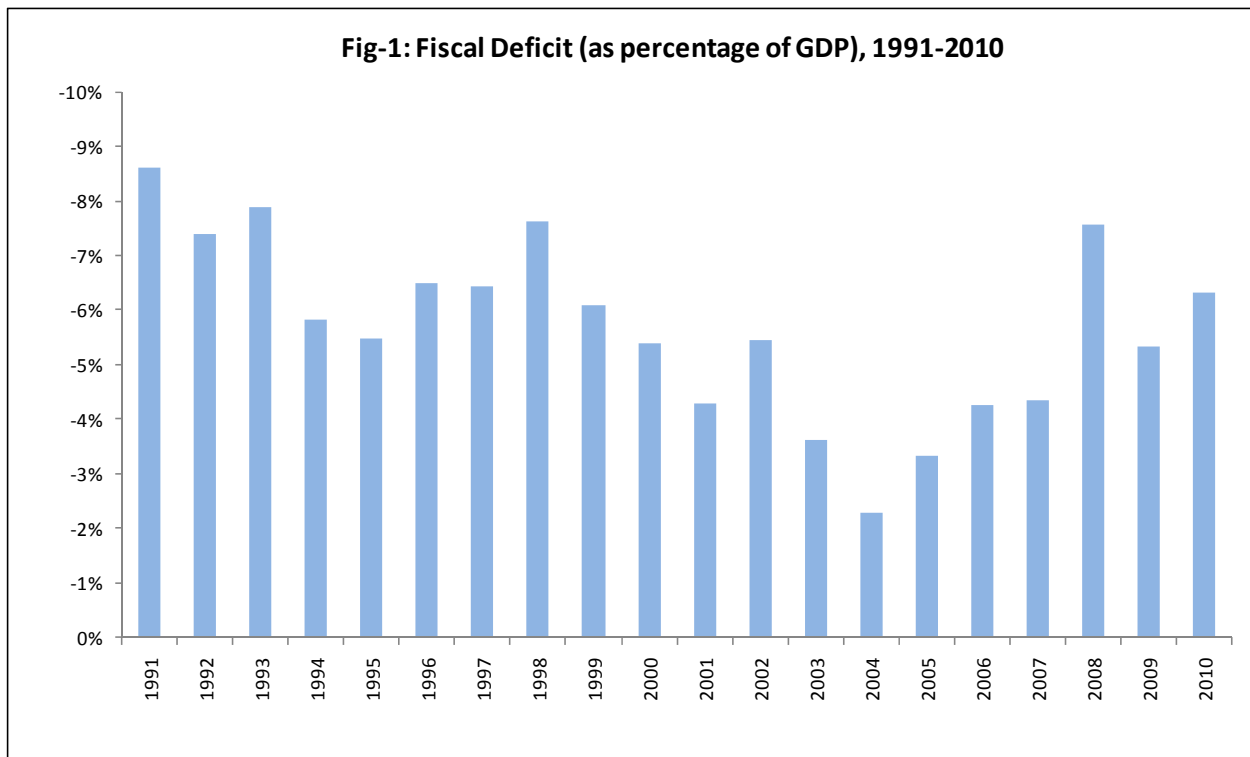
A review of long-term fiscal performance spanning over the past two decades i.e., 1991-2010 provides a good perspective on how different variables in the fiscal equation moved and yielded results. Such an analysis is more meaningful when fiscal numbers are expressed as percentage of GDP as opposed to absolute amounts. However, as GDP re-basing in FY2000 increased the size of nominal GDP for that year by 21.6 percent, the pre-FY2000 GDP series was also adjusted to achieve data consistency, which is imperative for an accurate analysis.

| <b>Table-1: Fiscal Performance, 1991-2010 (in percent of GDP)</b> |                  |                  |                    |                    |                      |
|---|------------------|------------------|--------------------|--------------------|----------------------|
|   | <b>Period 1</b>  | <b>Period 2</b>  | <b>Period 3</b>    | <b>Period 4</b>    | <b>Period 5</b>      |
|   | <b>Improve</b>   | <b>Stability</b> | <b>V. improve</b>  | <b>Poor</b>        | <b>Consolidation</b> |
|   | <b>5 years</b>   | <b>3 years</b>   | <b>6 years</b>     | <b>4 years</b>     | <b>2 years</b>       |
|   | <b>1991-1995</b> | <b>1996-1998</b> | <b>1999 - 2004</b> | <b>2005 - 2008</b> | <b>2009-2010</b>     |
| <b>TOTAL REVENUES</b>   | <b>15.6%</b>     | <b>14.0%</b>     | <b>13.9%</b>       | <b>14.5%</b>       | <b>14.3%</b>         |
| Tax Revenues  | 11.8%            | 11.6%            | 10.9%              | 10.6%              | 10.1%                |
| Non-Tax Revenues  | 3.4%             | 2.3%             | 3.0%               | 3.8%               | 4.2%                 |
| <b>TOTAL EXPENDITURE</b>  | <b>21.6%</b>     | <b>19.9%</b>     | <b>18.1%</b>       | <b>20.5%</b>       | <b>20.3%</b>         |
| Current Expenditure   | 16.7%            | 16.5%            | 15.5%              | 16.0%              | 16.2%                |
| Defence   | 5.3%             | 4.5%             | 3.4%               | 3.0%               | 2.6%                 |
| Debt Servicing  | 4.8%             | 5.8%             | 5.5%               | 4.1%               | 4.8%                 |
| Current Subsidies   | 0.5%             | 0.4%             | 0.8%               | 2.0%               | 1.7%                 |
| General Administration  | 1.4%             | 1.8%             | 2.2%               | 2.7%               | 2.8%                 |
| Development Expenditure   | 4.8%             | 3.3%             | 2.6%               | 4.5%               | 4.0%                 |
| <b>FISCAL DEFICIT</b>   | <b>-6.0%</b>     | <b>-5.8%</b>     | <b>-4.2%</b>       | <b>-5.1%</b>       | <b>-5.9%</b>         |

Pakistan’s fiscal performance during 1991-2010 period exhibited periodic swings between stints of relative improvement and deterioration although some trends remained fairly persistent. Based on the overall direction of change in fiscal deficit, the 20-year period could be divided into 5 intervals of unequal durations. These are: 1991-1995 (improvement), 1996-1998 (stability), 1999-04 (improvement), 2005-2008 (poor) and 2009-2010 (consolidation).

The most noticeable but undesirable trend persisting through these 5 periods (except Period 4) has been a decline in total fiscal revenues as percentage of GDP, which decreased from 15.6 percent during 1991-1995 to 14.3 percent during 2009-2010. An even more unwelcoming steady slide in tax-to-GDP ratio (from 11.8 percent to 10.1 percent) has been the prime reason behind this declining trend over the 20-year period. Even during 1999-2004, which witnessed the lowest average fiscal deficit of the 5 periods, the reduction in deficit came about on account of lower fiscal expenditure and not higher revenues.

While tax-to-GDP ratio showed a steady decline during 1991-2010, non-tax revenues-to-GDP registered a modest increase during this period. However, the trend would have been quite different in recent periods, had it not been for large SBP profit transfers and hefty external receipts for military services that boosted non-tax revenues.



Total expenditure as percentage of GDP showed a relatively favourable trend over the past 20 years. It decreased from a high of 21.6 percent during 1991-1995 to a low of 18.1 percent during 1999-2004 before rising moderately to over 20 percent in the recent periods. Even more positive had been the declining trend in expenditure on defence and debt servicing as percentage of GDP, although the latter has started to creep up again in recent years. Defence expenditure declined steadily from 5.3 percent in

1991-1995 to 2.6 percent in 2009-2010. Debt servicing which peaked at 5.8 percent during 1996-1998 hit a low of 4.1 percent during 2005-2008 before increasing to 4.8 percent in 2009-10.

The most undesirable trends in current expenditures have been the rising costs of current subsidies and general administration. Spending on general administration showed a hefty increase from only 1.4 percent during 1991-1995 to 2.8 percent during 2009-2010. Likewise, current subsidies increased from a low of 0.4 percent during 1996-1998 to a peak of 2.0 percent during 2005-2008 and remained fairly high at 1.7 percent during 2009-2010.

Development expenditure showed a noteworthy decline from a peak of 4.8 percent in 1991-1995 to 4.0 percent in 2009-2010 reflecting the lack of fiscal space on account of declining revenues and increased spending on subsidies and general administration.

## V. Recent Fiscal Policy Developments

Pakistan's public finances are primarily dominated by a stagnant tax-to-GDP ratio while rigid government spending patterns have furthered the fiscal delinquencies. These structural weaknesses have lead to sizable, and at times unsustainable, budget deficits posing risks to fiscal solvency. Availability of fiscal space is vital to foster development and to embark upon pro-poor expenditure in a developing country like Pakistan. A compromise on development spending for the sake of meeting temporary and urgent demands is indeed a compromise on better living standards for future generations.

**Table-2: Consolidated Revenue & Expenditure of the Government (Rs. Billion)**

|                                  | Prov. Actual<br>July-June<br>2008-09 | Budget<br>Estimate<br>2009-10 | Prov. Actual<br>July-June<br>2009-10 | Budget<br>Estimate<br>2010-11 |
|----------------------------------|--------------------------------------|-------------------------------|--------------------------------------|-------------------------------|
| <b>A. Total Revenue</b>          | <b>1,851</b>                         | <b>2,155</b>                  | <b>2,078</b>                         | <b>2,574</b>                  |
| a) Tax Revenue                   | 1,205                                | 1,564                         | 1,473                                | 1,859                         |
| b) Non-Tax Revenue               | 646                                  | 592                           | 605                                  | 716                           |
| <b>B. Total Expenditure</b>      | <b>2,531</b>                         | <b>2,877</b>                  | <b>3,007</b>                         | <b>3,259</b>                  |
| a) Current Expenditure           | 2,042                                | 2,104                         | 2,386                                | 2,519                         |
| b) Development Expenditure       | 449                                  | 763                           | 613                                  | 734                           |
| c) Net Lending                   | 7                                    | 11                            | 39                                   | 7                             |
| d) Unidentified Expenditure      | -34                                  | 0                             | 32                                   | 0                             |
| <b>C. Overall Fiscal Balance</b> | <b>-680</b>                          | <b>-722</b>                   | <b>-929</b>                          | <b>-685</b>                   |
| - As % of GDP                    | -5.3                                 | -4.9                          | -6.3                                 | -4.0                          |

Source: Budget Wing, Ministry of Finance

Historically, revenues have been flat and no major improvement in tax revenues over the years has been the dampening factor on this front. Total revenue witnessed a massive turn-around in the fiscal year 2007-08 as it registered a negative growth in real terms (double-digit inflation also contributed to this downfall). The economy was decelerating and this plunge was very well communicated through the fiscal account in the form of dismal revenue collection. Tax revenue also suffered from the same hitch but managed to remain above the line by achieving a real growth of 1.6 percent. However, it went negative by a large margin the next fiscal year whereas more than budgeted collection on account of non-tax revenues assisted in attaining a positive 2.6 percent inflation-adjusted growth in total revenue in 2008-09.

**Table-3: Selected Fiscal Indicators (in percent)**

|                                  | FY06 | FY07 | FY08 | FY09  | FY10 |
|----------------------------------|------|------|------|-------|------|
| Real Growth of Public Debt       | -3.0 | 2.3  | 8.3  | 4.9   | 5.9  |
| Real Growth of Revenues          | 8.3  | 11.9 | -0.6 | 2.6   | 2.0  |
| Real Growth of Tax Revenue       | 10.3 | 2.8  | 1.6  | -4.7  | 11.1 |
| Real Growth in Non-interest Exp. | 14.9 | 6.2  | 7.7  | -12.1 | 13.5 |
| Real Growth of GDP               | 5.8  | 6.8  | 3.7  | 1.2   | 4.1  |
| Saving Investment Gap            | -4.4 | -5.1 | -8.7 | -5.8  | -2.8 |
| Primary Balance                  | -2.3 | -1.5 | -2.8 | -0.3  | -2.0 |
| Revenue Balance                  | -0.6 | -0.9 | -3.5 | -1.5  | -2.1 |
| Public Debt/GDP                  | 57.2 | 55.4 | 59.0 | 59.9  | 60.6 |
| Public Debt/Revenue              | 405  | 370  | 403  | 412   | 428  |
| Debt Service/Revenue             | 29.6 | 33.8 | 37.2 | 46.6  | 40.4 |

Source: Budget Wing, MoF and DPCO Staff Calculations

The economy showed a slight recovery in the previous fiscal year 2009-10 and recorded a modest GDP growth of 4.1 percent with inflation subsiding to 11.7 percent (as against 20.8 percent in FY 2008-09). Consequently, tax revenue, although short of the target, recorded a healthy increase of 11.1 percent (after adjusting for inflation). However, non-tax revenues were not enough to compensate for the shortfall and observed lesser collection in absolute terms over FY2008-09. Hence, the real growth in total revenues dropped to 2.0 percent.

Since the advent of this decade, the tax-to-GDP ratio has been hovering around at an average 10.4 percent. The FBR tax collection performance has been weak, evidenced by a low FBR tax-to-GDP ratio of 9.3 percent (annualized over the years FY2001-2010). For 2009-10, the FBR tax-to-GDP ratio stood at 9.0 percent down by a 100 bps from the 2008-09 level. The inability of economic growth to fully translate

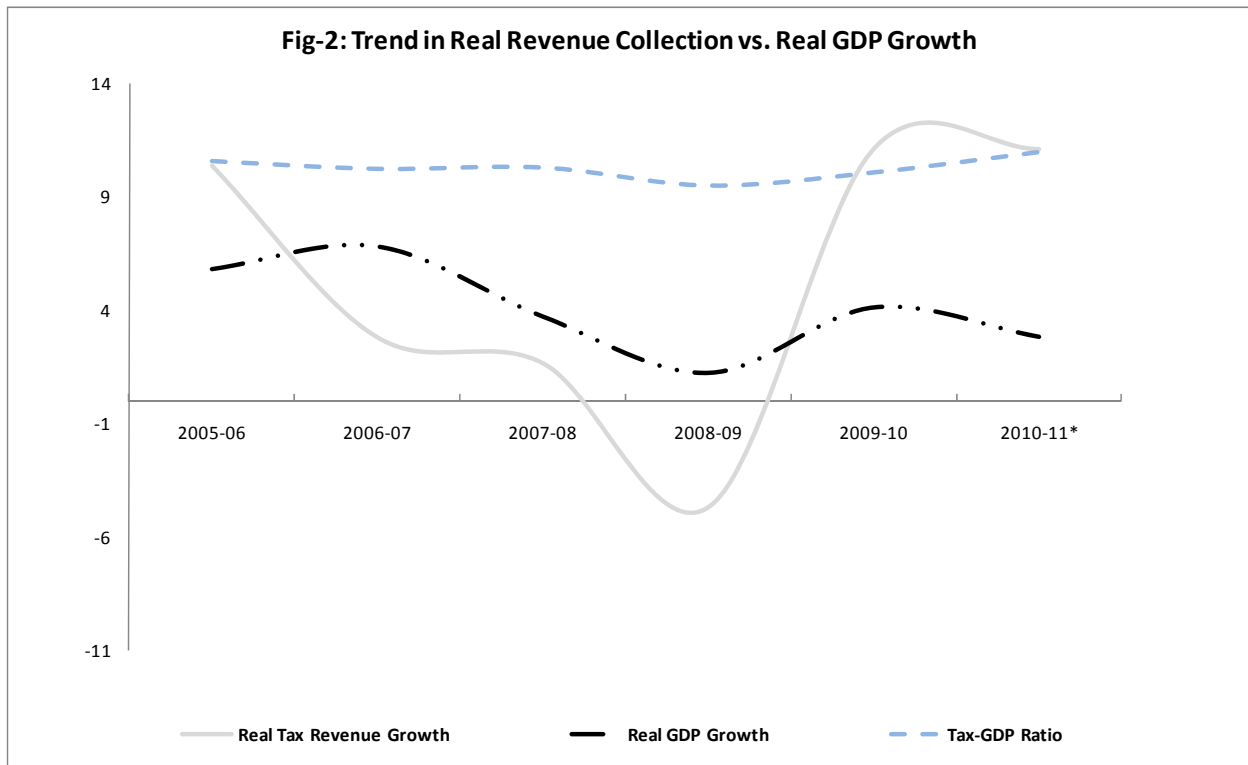


into revenue, the persistence of a narrow tax base and undocumented informal sector are the underlying reasons. Equally important is weak audit and enforcement, low tax compliance as well as tax evasion prevalent in the system.

**Table-4: Real Growth of Tax Revenue**

|          | Tax Revenue (Rs. Billion) | Real Growth of Tax Revenue (%) | Real GDP Growth (%) | Tax-GDP (%) |
|----------|---------------------------|--------------------------------|---------------------|-------------|
| 2005-06  | 804                       | 10.3                           | 5.8                 | 10.5        |
| 2006-07  | 890                       | 2.8                            | 6.8                 | 10.2        |
| 2007-08  | 1,051                     | 1.6                            | 3.7                 | 10.3        |
| 2008-09  | 1,205                     | -4.7                           | 1.2                 | 9.5         |
| 2009-10  | 1,473                     | 11.1                           | 4.1                 | 10.0        |
| 2010-11* | 1,881                     | 11.1                           | 2.8                 | 10.9        |

\*Projections  
Source: DPCO Staff Calculations



On the other hand, government expenditures lack flexibility. Over the recent past, current spending on account of subsidies has exposed the dearth of viable options available to government for managing public sector enterprises/state owned entities. The power sector has specifically emerged as a constant

drag on limited budgetary resources as a substantial portion of revenues has been eaten away by electricity subsidies, leaving behind less room for fiscal maneuvering. Particularly, 24.7 percent of revenues were used up in providing subsidies in the FY 2007-08 while this ratio stood at 10.3 percent (for 2009-10). This together with the security related and IDP outlays has raised the levels of current expenditure beyond acceptable thresholds. Current spending averaged around 15.7 percent of GDP over FY2000-FY2010 whereas a meager 3.2 percent of the country's output is spent on development programmes (averaged for the same period). This is by no means a sustainable situation.

**Table-5: Fiscal Indicators as Percent of GDP**

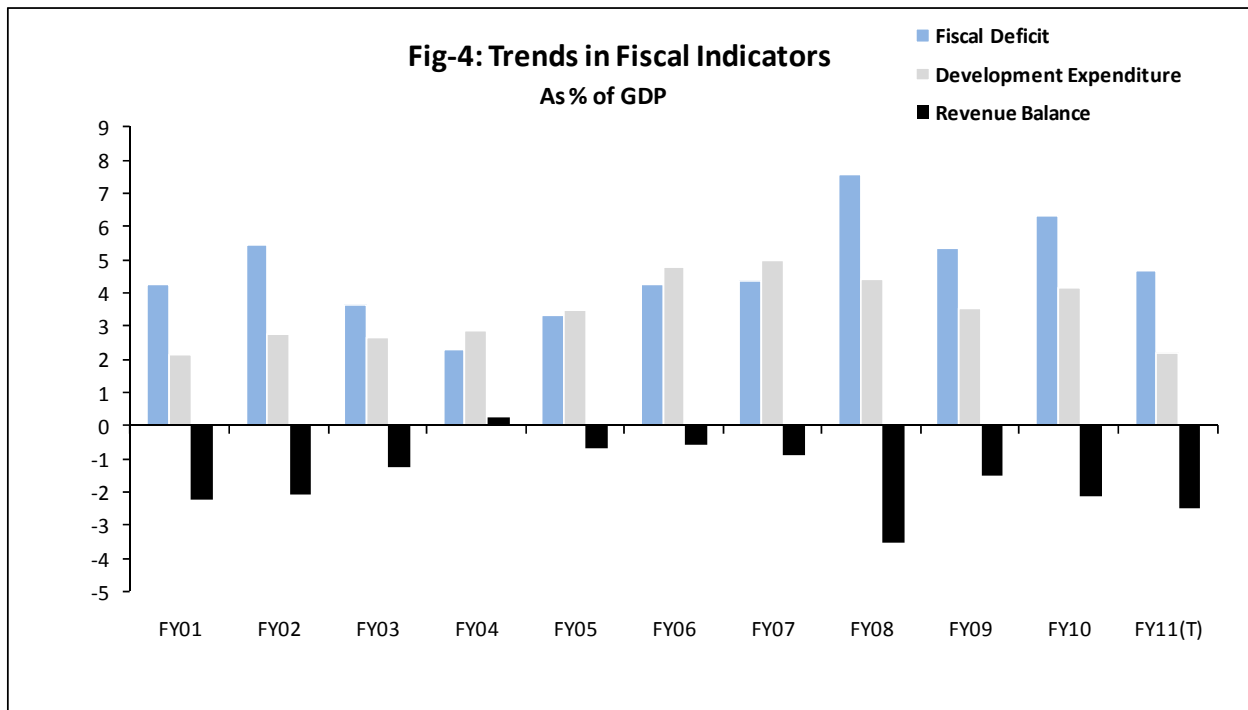
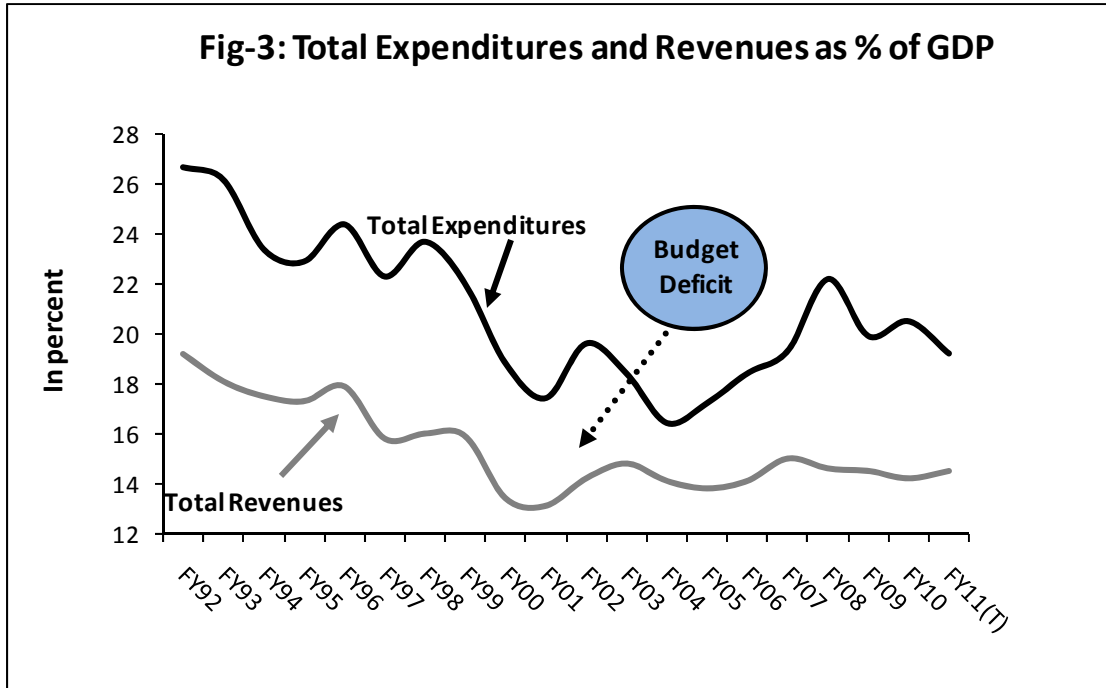
|         | Real GDP | Overall Fiscal    | Expenditure |         |           | Revenue |      |         |
|---------|----------|-------------------|-------------|---------|-----------|---------|------|---------|
|         | Growth   | Deficit           | Total       | Current | Developme | Total   | Tax  | Non-Tax |
| FY92    | 7.6      | 7.5               | 26.7        | 19.1    | 7.6       | 19.2    | 13.7 | 5.5     |
| FY93    | 2.1      | 8.1               | 26.2        | 20.5    | 5.7       | 18.1    | 13.4 | 4.7     |
| FY94    | 4.4      | 5.9               | 23.4        | 18.8    | 4.6       | 17.5    | 13.4 | 4.1     |
| FY95    | 5.1      | 5.6               | 22.9        | 18.5    | 4.4       | 17.3    | 13.8 | 3.5     |
| FY96    | 6.6      | 6.5               | 24.4        | 20.0    | 4.4       | 17.9    | 14.4 | 3.5     |
| FY97    | 1.7      | 6.4 <sup>†</sup>  | 22.3        | 18.8    | 3.5       | 15.8    | 13.4 | 2.4     |
| FY98    | 3.5      | 7.7               | 23.7        | 19.8    | 3.9       | 16.0    | 13.2 | 2.8     |
| FY99    | 4.2      | 6.1               | 22.0        | 18.6    | 3.4       | 15.9    | 13.3 | 2.7     |
| FY00    | 3.9      | 5.4               | 18.8        | 16.4    | 2.4       | 13.4    | 10.6 | 2.8     |
| FY01    | 2.0      | 4.3 <sup>†</sup>  | 17.4        | 15.3    | 2.1       | 13.1    | 10.5 | 2.6     |
| FY02    | 3.1      | 5.5 <sup>†</sup>  | 19.6        | 16.2    | 3.4       | 14.2    | 10.7 | 3.5     |
| FY03    | 4.7      | 3.6               | 18.4        | 16.0    | 2.4       | 14.8    | 11.4 | 3.4     |
| FY04    | 7.5      | 2.3               | 16.4        | 13.8    | 2.6       | 14.1    | 10.8 | 3.2     |
| FY05    | 9.0      | 3.3 <sup>†</sup>  | 17.2        | 14.5    | 2.7       | 13.8    | 10.1 | 3.7     |
| FY06    | 5.8      | 4.3* <sup>†</sup> | 18.4        | 14.7    | 3.7       | 14.1    | 10.5 | 3.6     |
| FY07    | 6.8      | 4.4* <sup>†</sup> | 19.3        | 15.9    | 3.3       | 15.0    | 10.3 | 4.7     |
| FY08    | 3.7      | 7.6               | 22.2        | 18.1    | 4.1       | 14.6    | 10.3 | 4.4     |
| FY09    | 1.2      | 5.3               | 19.9        | 16.0    | 3.8       | 14.5    | 9.5  | 5.1     |
| FY10    | 4.1      | 6.3               | 20.5        | 16.3    | 4.2       | 14.2    | 10.0 | 4.1     |
| FY11(T) | 2.8      | 4.7               | 19.2        | 17.0    | 2.2       | 14.5    | 10.9 | 3.5     |

**Note 1:** The base of Pakistan's GDP has been changed from 1980-81 to 1999-2000, therefore, wherever GDP appears in denominator the numbers prior to 1999-2000 are not comparable.

<sup>†</sup> Statistical discrepancy (both positive and negative) has been adjusted in arriving at overall fiscal deficit numbers.

\* Include earthquake related expenditure worth 0.8 and 0.5 percent of GDP for 2005-06 and 2006-07 respectively.

As a result of these revenue-expenditure gaps, fiscal deficits have remained highly volatile. For instance, in FY2008 the deficit ballooned to 7.6 percent of GDP. Major corrections were undertaken on this front and fiscal consolidation was evident by a large relief in this ratio for FY2009 that stood at 5.3 percent in terms of GDP. However, this positive tendency appeared temporary and the fiscal deficit to GDP ratio inched up to 6.3 percent in the succeeding fiscal year 2009-10.



For the fiscal year 2010-11, the government has revised its projection for the budget deficit which is now expected to be around 4.7 percent of the projected nominal output. Nonetheless, the attainment of this highly optimistic target especially in the aftermath of floods and the associated rehabilitation costs,

crucially hinges upon additional revenue generation measures, particularly the implementation of Reformed General Sales Tax (RGST) in true spirit.

## **VI. Fiscal Performance 2009-10**

Developments during 2009-10 have undermined the gains realized in the preceding year. A rise in fiscal imbalances throughout the year has been a major failing of the economy. Strains placed on budgetary resources by subsidies, defence related spending, and debt servicing increased, whereas envisaged increases in revenue collection failed to materialize. The resulting high fiscal deficit, in spite of adjustments to development expenditure, has put at risk the fiscal sustainability of the country. The following is an analysis of revenues and expenditure during 2009-10:

### **VI.i. Revenue**

The government in the Federal Budget 2009-10 focused primarily on improving the tax culture in the country and announced a firm commitment to increase revenues. The hard-earned fiscal consolidation of 2008-09 went missing in the ensuing fiscal year owing to a dismal revenue growth.

Total revenue for FY2009-10 summed to Rs. 2,078.2 billion, up by 12.3 percent over the fiscal year 2008-09. A shortfall of Rs. 77.2 billion was seen against the budgeted estimates. Tax revenue registered a growth of 22.3 percent, adding Rs. 1,472.8 billion to the revenue side in 2009-10. However, this head diverged from the original budget by 5.8 percent. FBR was not able to meet the target of Rs. 1,380 billion and fell short by Rs. 52.6 billion.

Non-tax revenue exhibited noticeable performance primarily owing to SBP profits by attaining above budget inflows during the fiscal year 2009-10. Rs. 605.4 was collected which is lower by 6.3 percent against the 2008-09 receipts. However, this healthy growth of 2.3 percent over original projections mitigated the impact of tax revenue shortfall to some extent in the context of meeting budget targets.

Provincial performance in mobilizing revenues was not up to the mark as they collected Rs. 122.7 billion that was short by Rs. 42.3 billion against the estimated revenue. Major heads of revenue are discussed in detail below:

**VI.i.a. FBR Tax Collection and Refunds 2009-10**

FBR revenue target for the fiscal year 2009-10 was fixed at Rs. 1,380 billion at the time of announcement of Federal Budget. The target was linked with expected growth in GDP, the rate of inflation, tax buoyancy and other key economic indicators such as growth in the Large Scale Manufacturing sector and imports. To reach the target, 18.9 percent growth was required over the actual collection of around Rs. 1,161 billion during 2008-09.

**Table-6: FBR Tax Collection (Rs. Billion)**

| Revenue Heads         | Collection   |              | Difference |             |
|-----------------------|--------------|--------------|------------|-------------|
|                       | FY10         | FY09         | Absolute   | Percent     |
| <b>Direct Taxes</b>   | <b>529</b>   | <b>444</b>   | <b>85</b>  | <b>19.2</b> |
| <b>Indirect Taxes</b> | <b>799</b>   | <b>718</b>   | <b>81</b>  | <b>11.3</b> |
| - Sales Tax (GST)     | 516          | 452          | 64         | 14.3        |
| - Federal Excise      | 121          | 118          | 4          | 3.1         |
| - Customs Duties      | 162          | 148          | 13         | 8.8         |
| <b>Total Taxes</b>    | <b>1,327</b> | <b>1,161</b> | <b>166</b> | <b>14.3</b> |
| - As %age of GDP      | <b>9.0</b>   | <b>9.1</b>   |            |             |

Source: Federal Board of Revenue

The fiscal year 2009-10 was a difficult and challenging year for the government and FBR. Despite economic slowdown and declining imports, power crisis and law and order situation, FBR has managed to collect a sum of around Rs. 1,327.4 billion which was Rs. 166.2 billion or 14.3 percent higher than the collection of previous year; although 22.4 percent higher refunds were paid back during 2009-10. It may also be highlighted that during the period of high and stable economic growth (2003-04 to 2006-07), FBR was never able to generate an additional revenue of this magnitude in a single year. The overall target has been achieved to the extent of 96.2 percent. Reasons of shortfall are highlighted below:

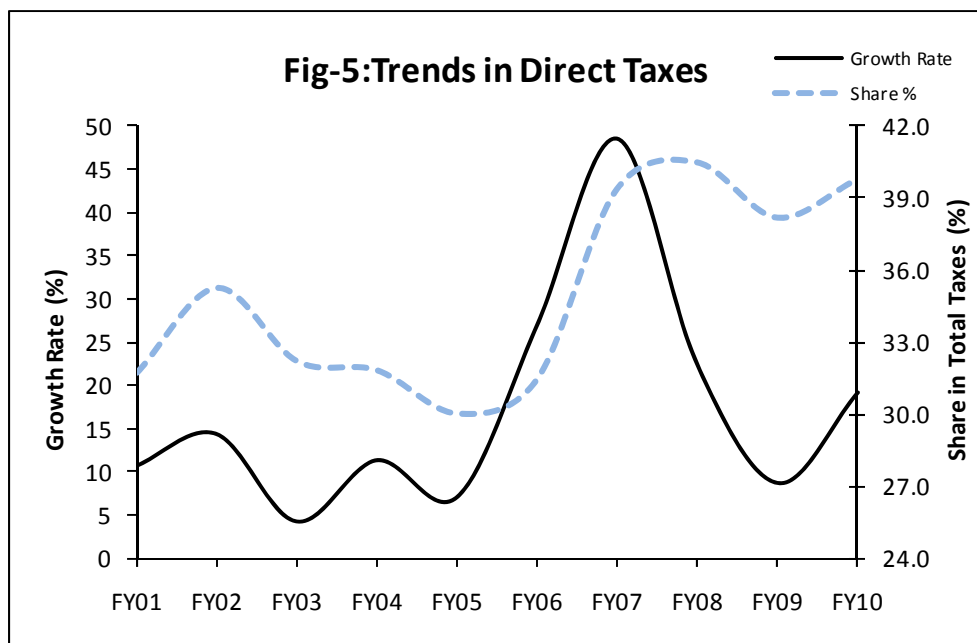
- General economic slowdown during the first half of the year has hampered resource mobilization.
- Negative growth in the manufacturing sector during the first half of the year has impacted revenue collection on account of FED. However, gradual increase in the manufacturing sector was witnessed during the second half of the year.
- Energy crises throughout the year have badly affected the production process and ultimately revenue realization.

- Negative growth in imports during the first half of the year resulted in less revenue realization on account of sales tax on imports. However, imports did pick up during second half of the year, but did not generate sufficient revenue to make up the losses.
- CVT generated negligible additional amount of Rs. 1.1 billion against the projected amount of Rs. 15 billion due to increase in the CVT rate from 2 percent to 4 percent.
- GST on sugar was reduced from 16 percent to 8 percent from August, 2009, which negatively affected revenue realization by about Rs. 10 billion during fiscal year 2009-10.
- Reduction of GST rate on telecommunication from 21 percent to 19.5 percent negatively affected revenue realization by 11 percent.

### **1. Direct Taxes**

The direct tax has contributed 40 percent of total tax receipts during FY2009-10. The net collection has been Rs. 528.6 billion during 2009-10 against the target of Rs. 540.4 billion. An amount of Rs. 54.2 billion refunds has been paid back to the claimants as against Rs. 38.8 billion during FY2008-09.

The improved tax effort and relatively effective implementation of tax policy and administrative reforms has geared up the collection over the years. The share of direct taxes in total federal tax receipts has increased from around 15 percent in early 1990s to 32 percent in FY2000-01. It has touched new heights of 40 percent in FY2009-10. Similarly, the growth pattern which was uneven but on the rise during the past few years, has also declined from 48.3 percent in FY2006-07 to 19.2 percent in FY2009-10. A number of reasons contribute to this slowdown in revenue realization. Apart from general economic slowdown and energy crisis during the period under review, CVT was projected to generate additional revenue of Rs. 15 billion on account of increase in the CVT rate from 2 percent to 4 percent. However, it has yielded insignificant amount at the end of the year mainly due to slump in the property business and also fragmentation in the size of property by the property dealers to avoid CVT etc.



|                            | 2009-10    | 2008-09    | Change (%)  |
|----------------------------|------------|------------|-------------|
| Voluntary Payments         | 166        | 142        | 17.0        |
| Collection on Demand       | 98         | 77         | 27.5        |
| Deductions at Source (WHT) | 298        | 242        | 23.2        |
| Miscellaneous              | 0.1        | 0.3        | -53.7       |
| Gross Income Tax Receipts  | 563        | 461        | 22.0        |
| Refunds                    | 54         | 39         | 39.7        |
| Other DT                   | 20         | 21         | -5.7        |
| <b>Net Direct Taxes</b>    | <b>529</b> | <b>444</b> | <b>19.1</b> |

Source: FBR Data Bank

It may be recalled that the collection of direct taxes includes income tax and other direct taxes i.e. capital value tax, worker welfare fund and worker profit participatory fund. The contribution of income tax in total direct taxes has been 95.6 percent. The structure of income tax is based on withholding taxes (WHT), voluntary payments (VP) and collection on demand (COD). The collection during FY2009-10 shows that the share of WHT, VP and COD in gross collection has been 53 percent, 29.5 percent and 17.5 percent respectively. Details of these components of income tax are presented in **Table 7**.

a. Voluntary Payments

This component includes payments with return and advances. In net terms, Rs. 165.8 billion have been generated during FY2009-10 as compared to Rs. 141.7 billion in the corresponding period last year, 17

percent growth has been witnessed in collection from this important component. It may be recalled that the basic objective behind implementation of USAS was to minimize interface between the taxpayer and tax administration, repose confidence in the system and eliminate the element of corruption. No doubt, the USAS has been successful since its implementation in achieving these objectives. Till FY2006-07, VP had emerged as a leading source of revenue. However, since FY2007-08 this important source of revenue is on the declining trend. A sum of Rs. 156.3 billion advance taxes has been collected in FY2009-10 against Rs. 127.2 billion in FY2008-09, and consequently, its share in total VP has jumped to 94.3 percent from 89.8 percent. The second component of VP is payment with returns which has declined significantly during the period under review. During FY2009-10, Rs. 9.5 billion were collected against Rs. 14.5 billion in FY 2008-09, indicating a decline of 34.4 percent. Since payment with returns contributes around 6 percent in total voluntary payments, the decrease has little impact on the overall voluntary payments.

**b. Withholding Tax**

WHT continues to be the leading source of direct tax receipts in view of the large undocumented sector of the economy. However, despite its large contribution, there is ample scope to further enhance this collection. The WHT collection during FY2009-10 has been Rs. 298.4 billion against Rs. 242.1 billion during FY2008-09, indicating a healthy growth of 23.2 percent. The nine major withholding taxes contributed around 92 percent of total WHT collection. These are: contracts, imports, salary, telephone, export, bank interest/securities, electricity, cash withdrawal and dividends. The performance of each category is given in **Table 8**.

|                          | 2009-10    | 2008-09    | Change (%)  |
|--------------------------|------------|------------|-------------|
| Contracts                | 95         | 84         | 13.0        |
| Imports                  | 50         | 30         | 66.8        |
| Salary                   | 34         | 27         | 26.1        |
| Exports                  | 17         | 14         | 16.0        |
| Telephone Bills          | 23         | 22         | 6.4         |
| Bank Interest/Securities | 18         | 14         | 24.9        |
| Electricity Bills        | 15         | 13         | 21.7        |
| Dividends                | 9          | 7          | 41.3        |
| Cash Withdrawal          | 13         | 11         | 13.5        |
| <b>Sub-Total</b>         | <b>274</b> | <b>222</b> | <b>23.6</b> |
| Other WHT                | 24         | 20         | 19.9        |
| <b>Total WHT</b>         | <b>298</b> | <b>242</b> | <b>23.2</b> |

Source: FBR Data Bank



On the other hand, the highest growth in WHT collection has been from imports (66.8 percent), dividends (41.3 percent), salary (26.1 percent), bank interest (24.9 percent), electricity (21.7 percent), cash withdrawal (13.5 percent), contracts (13 percent), export (16 percent) and telecommunication (6.4 percent). The highest growth registered in collection from import is due to rationalization of WHT rate from 2 percent to 4 percent during FY2009-10. Similarly, the reason of more than 40 percent growth in collection from dividend is due to increase in the profitability of companies. Like wise, growth of 26.1 percent from salary is mainly on account of increase in the salary of employees.

## 2. Indirect Taxes

### a. Sales Tax

Sales tax has been the second major revenue generation source of the country during 2009-10. It constitutes around 65 percent and 39 percent of the collection of indirect taxes and total federal taxes respectively during 2009-10. A growth of around 14.3 percent has been recorded in the net collection of sales tax. The collection is realized from two components i.e. sales tax on imports and sales tax on domestic sector.

| Sources of GST | Collection/ Refunds |           |            | Growth (%)  |             |             |
|----------------|---------------------|-----------|------------|-------------|-------------|-------------|
|                | Gross               | Refund    | Net        | Gross       | Refund      | Net         |
| Import Stage   | 247                 | 0         | 247        | 21.3        | -57.1       | 21.3        |
| Domestic Stage | 298                 | 29        | 269        | 9.2         | 11.3        | 8.9         |
| <b>Total</b>   | <b>545</b>          | <b>29</b> | <b>516</b> | <b>14.3</b> | <b>11.2</b> | <b>14.5</b> |

Source: FBR Data Bank

Comparatively better performance by sales tax on imports against domestic sector has improved its share in the total collection of sales tax from 45 percent in 2008-09 to 47.8 percent in 2009-10. The tax collection of sales tax by components is presented in **Table 9**.

*Sales Tax Domestic Collection:* The collection of sales tax has been highly concentrated in some commodities. This is confirmed by the fact that only petroleum products and telecom sector contribute more than three-fifth of the total sales tax domestic. Major ten commodities contribute 87.9 percent of the total net sales tax from domestic. The major revenue spinners of sales tax domestic include petroleum products, telecom services, natural gas, other services, cigarettes, sugar, electrical energy, beverages, tea and cement.

**Table-10: Comparison of Sales Tax Domestic (Net) Collection by Major Commodity (Rs. Billion)**

| Major Commodities          | 2009-10    | 2008-09    | Growth<br>Realized (%) | Share (%)<br>2009-10 | Share (%)<br>2008-09 |
|----------------------------|------------|------------|------------------------|----------------------|----------------------|
| POL Products               | 114        | 107        | 7.1                    | 42.5                 | 43.1                 |
| Services by Telecom Sector | 45         | 50         | -10.8                  | 16.6                 | 20.2                 |
| Natural Gas                | 19         | 19         | -1.2                   | 6.9                  | 7.6                  |
| Sugar                      | 17         | 6          | 158.0                  | 6.2                  | 2.6                  |
| Cigarettes                 | 11         | 10         | 11.1                   | 4.0                  | 3.9                  |
| Electrical Energy          | 9          | 12         | -22.4                  | 3.5                  | 4.9                  |
| Services                   | 7          | 8          | -8.0                   | 2.8                  | 3.3                  |
| Cement                     | 7          | 5          | 37.2                   | 2.6                  | 2.1                  |
| Beverages                  | 5          | 4          | 24.4                   | 1.7                  | 1.5                  |
| Tea                        | 4          | 5          | -15.1                  | 1.5                  | 1.9                  |
| <b>Sub-Total</b>           | <b>237</b> | <b>226</b> | <b>5.3</b>             | <b>88.2</b>          | <b>90.9</b>          |
| Others                     | 32         | 23         | 40.9                   | 11.8                 | 9.1                  |
| <b>Net Collection</b>      | <b>269</b> | <b>248</b> | <b>8.5</b>             | <b>100</b>           | <b>100</b>           |

Source: FBR Data Bank

*Sales Tax at Import Stage:* Sales tax on imports is a significant component of federal tax receipts. The collection of sales tax has posted an increase of 21.6 percent during 2009-10 mainly due to higher collection from petroleum products and automobile. Like sales tax domestic, the receipts of sales tax on imports have also concentrated mainly in few sectors. Petroleum products alone contributed around 40 percent of overall collection of sales tax on imports during 2009-10. Similarly, ten major spinners including petroleum constitute 82.4 percent of the sales tax import.

**Table-11: Collection of Sales Tax (Import) - Major Items (Rs. Billion)**

| Description               | 2009-10    | 2008-09    | Realized<br>Growth<br>(%) | Share<br>(%)<br>2009-10 | Share<br>(%)<br>2008-09 |
|---------------------------|------------|------------|---------------------------|-------------------------|-------------------------|
| POL Products (27)         | 100        | 76         | 30.8                      | 40.3                    | 37.4                    |
| Edible Oil (15)           | 19         | 18         | 5.0                       | 7.6                     | 8.8                     |
| Plastic (39)              | 19         | 17         | 14.5                      | 7.7                     | 8.2                     |
| Vehicles and Parts (87)   | 16         | 11         | 49.9                      | 6.5                     | 5.3                     |
| Iron and Steel (72)       | 18         | 15         | 16.3                      | 7.1                     | 7.4                     |
| Mechanical Machinery (84) | 8          | 7          | 19.9                      | 3.3                     | 3.4                     |
| Electrical Machinery (85) | 7          | 6          | 11.1                      | 2.6                     | 2.9                     |
| Organic Chemicals (29)    | 7          | 6          | 14.6                      | 2.7                     | 2.9                     |
| Paper & P. Board (48)     | 5          | 6          | -15.8                     | 2.0                     | 2.9                     |
| Dyes and Paints (32)      | 6          | 4          | 70.6                      | 2.6                     | 1.9                     |
| <b>Sub Total</b>          | <b>204</b> | <b>165</b> | <b>23.8</b>               | <b>82.4</b>             | <b>80.9</b>             |
| Other                     | 43         | 39         | 12.1                      | 17.6                    | 19.1                    |
| <b>Gross</b>              | <b>247</b> | <b>203</b> | <b>21.6</b>               | <b>100.0</b>            | <b>100.0</b>            |
| Refund/Rebate             | 0.0        | 0.1        | -57.1                     |                         |                         |
| <b>Net</b>                | <b>247</b> | <b>203</b> | <b>21.6</b>               |                         |                         |

Source: FBR Data Bank

b. Custom Duty

Despite large scale tariff rationalization<sup>2</sup> in the last two decades, the customs duty is still an important component of federal tax receipts. It contributed around 20.2 percent and 12.2 percent of indirect taxes and total federal tax receipts respectively during 2009-10. The gross and net collection of customs duty has been Rs.167.3 billion and Rs. 161.5 billion respectively during 2009-10. The gross and net collection grew by 7.2 percent and 8.8 percent respectively during 2009-10. The difference between the growth of gross and net collection is the lesser payments of refunds/rebates by around Rs. 1.9 billion. The target of customs duty was Rs.164.9 billion against which collection of Rs. 161.5 billion has been realized. The shortfall is mainly due to decline of 0.3 percent in the dutiable imports.

**Table-12: Collection of Customs Duties during 2009-10 (Rs. Billion)**

| Description                        | Collection 2009-10 | Collection 2008-09 | Realized Growth (%) | Share (%) 2009-10 | Share (%) 2008-09 |
|------------------------------------|--------------------|--------------------|---------------------|-------------------|-------------------|
| 1. POL Products (27)               | 25                 | 18                 | 43.8                | 15.1              | 11.2              |
| 2. Vehicles and Parts (87)         | 19                 | 19                 | -1.8                | 11.4              | 12.4              |
| 3. Edible Oil (15)                 | 16                 | 17                 | -9.5                | 9.3               | 11.0              |
| 4. Mechanical Machinery (84)       | 10                 | 14                 | -24.1               | 6.3               | 8.8               |
| 5. Electrical Machinery (85)       | 9                  | 13                 | -29.2               | 5.6               | 8.5               |
| 6. Iron and Steel (72)             | 8                  | 8                  | 6.1                 | 5.0               | 5.1               |
| 7. Plastic (39)                    | 7                  | 7                  | 6.4                 | 4.3               | 4.3               |
| 8. Paper & P. Board (48)           | 5                  | 5                  | -5.1                | 2.9               | 3.3               |
| 9. Organic Chemicals (29)          | 4                  | 4                  | 1.4                 | 2.3               | 2.4               |
| 10. Articles of Iron & Steel (73)  | 3                  | 2                  | 24.8                | 1.6               | 1.4               |
| 11. Dyes and Paints (32)           | 3                  | 3                  | -12.0               | 1.5               | 1.9               |
| 12. Coffee, Tea, and Spices (9)    | 2                  | 2                  | 8.0                 | 1.4               | 1.4               |
| 13. Misc Chemicals Products (38)   | 2                  | 2                  | -1.9                | 1.3               | 1.4               |
| 14. Cosmetic and Perfumery (33)    | 2                  | 2                  | 5.5                 | 1.4               | 1.4               |
| 15. Soap and Artificial Waxes (34) | 2                  | 2                  | -1.1                | 1.2               | 1.3               |
| <b>Sub Total</b>                   | <b>118</b>         | <b>118</b>         | <b>-0.3</b>         | <b>70.6</b>       | <b>75.9</b>       |
| Other                              | 49                 | 38                 | 30.8                | 29.4              | 24.1              |
| <b>Gross</b>                       | <b>167</b>         | <b>156</b>         | <b>7.2</b>          | <b>100</b>        | <b>100</b>        |
| Refund/Rebate                      | 6                  | 8                  | -24.4               |                   |                   |
| <b>Net</b>                         | <b>161</b>         | <b>148</b>         | <b>8.8</b>          |                   |                   |

Source: FBR Data Bank

<sup>2</sup> See for more details "Tariff and Trade in Pakistan- A Preliminary Assessment", published in FBR Quarterly Review Vol.10.No.3. January-March 2010 and is also available at [www.fbr.gov.pk](http://www.fbr.gov.pk)

c. Federal Excise Duties

Federal excise duty is levied on imports and domestic stages. The major portion of the receipts emanates from domestic sector. The base of the federal excise duty is quite narrow and is limited to few commodities. Despite narrow base, federal excise duty has been an important revenue generation source of federal taxes. Federal excise duty has contributed 9.1 percent of total tax collection during 2009-10. The tax collection realized has been Rs. 121.2 billion in 2009-10 against Rs. 117.5 billion in 2008-09 yielding a growth of 3.2 percent.

Following are some of the measures taken in the Budget 2009-10 which are also responsible for this low growth:

- i) Transfer of banking & insurance services from FED to sales tax net.
- ii) Exemption of motor vehicles from FED.
- iii) The downward revision of FED rates for cement.

As far as 1 percent SED is concerned, a double digit growth has been recorded. Its share has also improved from 12.1 percent in 2008-09 to 13.3 percent during 2009-10.

**Table-13: FED Collection from Major Commodities (Rs. Billion)**

| Commodities      | 2009-10    | 2008-09    | Difference |            | Share(%)    | Share(%)    |
|------------------|------------|------------|------------|------------|-------------|-------------|
|                  |            |            | Absolute   | Percent    | 2009-10     | 2008-09     |
| Cigarettes       | 45         | 37         | 8          | 21.2       | 36.9        | 31.4        |
| Cement           | 16         | 18         | -2         | -10.5      | 13.0        | 15.0        |
| Services         | 15         | 17         | -2         | -12.5      | 12.6        | 14.9        |
| Beverages        | 11         | 11         | 1          | 7.4        | 9.4         | 9.0         |
| Natural Gas      | 6          | 6          | 0          | 8.7        | 5.1         | 4.9         |
| POL Products     | 5          | 4          | 1          | 14.6       | 3.9         | 3.5         |
| 1% SED           | 16         | 14         | 2          | 13.6       | 13.3        | 12.1        |
| <i>Sub Total</i> | <i>114</i> | <i>107</i> | <i>8</i>   | <i>7.1</i> | <i>94.2</i> | <i>90.7</i> |
| Other            | 7          | 11         | -4         | -35.4      | 5.8         | 9.3         |
| <b>Total</b>     | <b>121</b> | <b>117</b> | <b>4</b>   | <b>3.2</b> | <b>100</b>  | <b>100</b>  |

Source: FBR Data Bank

**VI.i.b. Non Tax Revenue**

Non tax revenue in FY2009-10 reached Rs. 605.3 billion exceeding the budget target by Rs. 13.5 billion, largely helped by transfer of SBP profit which stayed Rs. 83 billion above the budget target. Receipts under the head of defence were budgeted at Rs. 128.2 billion during FY2010 originating mainly from

logistic support services provided to the coalition forces. However, Rs. 115.6 billion could be realized under this head leaving the receipts under the head of defense below the target by Rs. 12.6 billion. The dividends receipts from financial and non financial institutions remained below the budget target by Rs. 22.4 billion. Many state owned enterprises have launched the Benazir Employees Stock Option Scheme in the outgoing fiscal year wherein GoP shares are transferred to employees in order to enhance employee participation in corporate decision-making. The dividend income was partly diverted to the public owing to this initiative and this along with the power sector circular debt has principally been at the back of a slump in dividend receipts. Major non financial institutions which provided dividend below the target include OGDCL, Pak Arab Refinery Ltd., PTCL, PSO and Pakistan Steel Mill. Of the total dividend receipts during FY2010, OGDCL contributed 39 percent followed by Government Holding Private Ltd. with 13 percent while dividends receipts from financial institutions having government equity amounted to one percent of the total.

## **Vi.ii. Expenditure**

As originally envisaged in budgetary targets for FY2009-10, enhanced revenue generation would be used to fuel additional outlays on socio-economic development and social protection. Containment of current expenditure was targeted in order to keep the fiscal deficit at sustainable level. However, the government witnessed massive slippages against the budgeted current expenditure targets, making an adjustment to development spending goals necessary for the third consecutive year.

Total expenditure for 2009-10 approximated to Rs. 3,007.2 billion; Rs. 129.8 billion above the spending targets while the growth over the previous fiscal year remained 18.8 percent. A 13.4 percent slippage on account of current expenditure has been the main culprit. The outgoing fiscal year underwent a significant downward adjustment of 19.6 percent in respect of development expenditure, although growth in this head has encouragingly been 36.7 percent over 2008-09.

**Table-14: Consolidated Budgetary Position of the Government (Rs. Billion)**

|                                       | Prov. Actual<br>July-June<br>2008-09 | Budget<br>Estimate<br>2009-10 | Prov. Actual<br>July-June<br>2009-10 | Budget<br>Estimate<br>2010-11 |
|---------------------------------------|--------------------------------------|-------------------------------|--------------------------------------|-------------------------------|
| <b>A. Total Revenue</b>               | <b>1,851</b>                         | <b>2,155</b>                  | <b>2,078</b>                         | <b>2,574</b>                  |
| a) Tax Revenue                        | 1,205                                | 1,564                         | 1,473                                | 1,859                         |
| - Federal                             | 1,159                                | 1,494                         | 1,418                                | 1,779                         |
| <i>of which FBR Revenue</i>           | 1,157                                | 1,380                         | 1,327                                | 1,667                         |
| - Provincial                          | 46                                   | 70                            | 55                                   | 80                            |
| b) Non-Tax Revenue                    | 646                                  | 592                           | 605                                  | 716                           |
| - Federal                             | 562                                  | 497                           | 538                                  | 616                           |
| - Provincial                          | 84                                   | 95                            | 68                                   | 100                           |
| <b>B. Total Expenditure</b>           | <b>2,531</b>                         | <b>2,877</b>                  | <b>3,007</b>                         | <b>3,259</b>                  |
| a) Current Expenditure                | 2,042                                | 2,104                         | 2,386                                | 2,519                         |
| - Federal                             | 1,496                                | 1,514                         | 1,759                                | 1,769                         |
| <i>of which:</i>                      |                                      |                               |                                      |                               |
| <b>Interest Payments</b>              | 638                                  | 647                           | 642                                  | 699                           |
| - Domestic                            | 559                                  | 577                           | 578                                  | 622                           |
| - Foreign                             | 79                                   | 70                            | 64                                   | 77                            |
| <b>Defense Expenditure</b>            | 330                                  | 343                           | 375                                  | 442                           |
| - Provincial                          | 546                                  | 590                           | 627                                  | 750                           |
| b) Development Expenditure            | 449                                  | 763                           | 613                                  | 734                           |
| - PSDP                                | 398                                  | 606                           | 518                                  | 610                           |
| Federal                               | 196                                  | 381                           | 260                                  | 280                           |
| ERRA                                  | -                                    | 25                            | -                                    | 10                            |
| Provincial                            | 202                                  | 200                           | 258                                  | 320                           |
| - Other Development Expenditure       | 51                                   | 157                           | 96                                   | 124                           |
| c) Net Lending                        | 7                                    | 11                            | 39                                   | 7                             |
| d) Unidentified Expenditure           | -34                                  | 0                             | 32                                   | 0                             |
| <b>C. Overall Fiscal Balance</b>      | <b>-680</b>                          | <b>-722</b>                   | <b>-929</b>                          | <b>-685</b>                   |
| - <i>As % of GDP</i>                  | -5.3                                 | -4.9                          | -6.3                                 | -4.0                          |
| <b>D. Financing of Fiscal Balance</b> | <b>680</b>                           | <b>722</b>                    | <b>929</b>                           | <b>685</b>                    |
| a) External Sources                   | 150                                  | 312                           | 189                                  | 186                           |
| b) Domestic                           | 529                                  | 391                           | 740                                  | 499                           |
| - Bank                                | 306                                  | 144                           | 305                                  | 167                           |
| - Non-Bank                            | 224                                  | 246                           | 436                                  | 333                           |
| c) Privatization Proceeds             | 1                                    | 19                            |                                      | 0                             |
| <b>E. GDP at Market Prices</b>        | <b>12,739</b>                        | <b>14,824</b>                 | <b>14,668</b>                        | <b>16,975</b>                 |
| <b>Memo Items</b>                     |                                      |                               |                                      |                               |
| Revenue Balance                       | -191                                 | 52                            | -308                                 | 55                            |
| - <i>As % of GDP</i>                  | -1.5                                 | 0.3                           | -2.1                                 | 0.3                           |
| Primary Balance                       | -42.6                                | -74.9                         | -286.7                               | 13.7                          |
| - <i>As % of GDP</i>                  | -0.3                                 | -0.5                          | -2.0                                 | 0.1                           |

Source: Budget Wing, Ministry of Finance

Details of government expenditure are given below:

### VI.ii.a. Current Expenditure

For the fiscal year 2009-10, current expenditure over-run reached an alarming magnitude of Rs. 282.2 billion or 13.4 percent. About Rs. 2,386 billion were consumed on current spending, almost 19 percent more than the previous year. Major heads are explained as follows:

|  | <b>Prov.Actual<br/>July-June</b> | <b>Budget<br/>Estimate</b> | <b>Revised<br/>Estimate</b> |
|--|----------------------------------|----------------------------|-----------------------------|
| <b>Federal</b>                         | <b>1,758.8</b>                   | <b>1,513.8</b>             | <b>1,787.2</b>              |
| <b>General Public Service</b>          | <b>1,200.4</b>                   | <b>1,003.7</b>             | <b>1,241.7</b>              |
| Serving of Domestic Debt               | 578.3                            | 576.8                      | 595.8                       |
| Serving of Foreign Debt                | 64.0                             | 70.3                       | 70.8                        |
| Superannuation Allowances & Pension    | 74.7                             | 69.8                       | 85.1                        |
| Grants to Others                       | 250.5                            | 168.7                      | 259.1                       |
| Others General Public Services         | 232.9                            | 118.1                      | 231.0                       |
| <b>Defence Affairs and Services</b>    | <b>375.0</b>                     | <b>342.9</b>               | <b>378.1</b>                |
| <b>Public Order and Safety Affairs</b> | <b>49.5</b>                      | <b>34.6</b>                | <b>37.4</b>                 |
| <b>Economic Affairs</b>                | <b>83.6</b>                      | <b>84.9</b>                | <b>80.6</b>                 |
| <b>Others</b>                          | <b>50.2</b>                      | <b>47.6</b>                | <b>49.4</b>                 |
| <b>Provincial</b>                      | <b>627.2</b>                     | <b>590.0</b>               | <b>560.0</b>                |
| <b>Current Expenditure</b>             | <b>2,386.0</b>                   | <b>2,103.8</b>             | <b>2,347.2</b>              |
| <b>PSDP</b>                            | <b>517.9</b>                     | <b>606.0</b>               | <b>450.0</b>                |
| Federal                                | 259.5                            | 406.0                      | 250.0                       |
| Provincial                             | 258.4                            | 200.0                      | 200.0                       |
| <b>Other Development Expenditure</b>   | <b>95.5</b>                      | <b>157.1</b>               | <b>118.3</b>                |
| <b>Development Expenditure</b>         | <b>613.4</b>                     | <b>763.1</b>               | <b>568.3</b>                |
| <b>Net Lending</b>                     | <b>39.4</b>                      | <b>10.5</b>                | <b>27.2</b>                 |
| <b>Total Expenditure</b>               | <b>3,038.9</b>                   | <b>2,877.4</b>             | <b>2,942.8</b>              |

Source: Budget Wing, Ministry of Finance

#### 1. General Public Service

Originally, expenses with regards to general public service were budgeted at Rs. 1,003.7 billion for FY2009-10. However, this category ended up with an escalation to the tune of Rs. 196.7 billion mainly on account of poorly targeted subsidies and growing security expenditures.

##### a. Interest Payments

A major chunk of Pakistan's scarce resources are dedicated to making hefty payments in respect of debt obligations. For FY2009-10, nearly 31 percent of total revenues have been consumed in servicing of domestic and foreign debt against a ratio of 34.5 percent and 32.7 percent in 2008-09 and 2007-08

respectively. Even though this indicator has improved in the fiscal year 2009-10, an increasing concentration of financing mix towards internal sources and higher domestic interest rates on account of tight monetary policy indicate a persistent burden of servicing expense on the government’s budgetary position.

b. Grants

During the fiscal year 2009-10, transfer by the federal government to provinces in the form of grants aggregated to Rs. 82 billion. When analyzing the break-up of grants provided to other institutions amounting to Rs. 250.5 billion, it becomes clear that security related expenses in the wake of deteriorating security situation contributed a huge portion to the expenditure bottom line.

c. Subsidies

During 2009-10, government subsidized the power sector by a large amount. Out of a total subsidy of Rs. 213.5 billion, Rs. 178.8 billion or 83.8 percent were granted to WAPDA/PEPCO and KESC against a budgeted target of Rs. 66.7 billion for the fiscal year 2009-10. A whopping slippage of 168 percent in this respect underlines the absence of prominent reforms in the power sector during the previous fiscal year.

Last year, the government decided to implement efficiency measures and cost recovery tariff for power sector. The government transferred the bank loans

| Organization       | Prov.Actual<br>July-June | Budget<br>Estimate | Revised<br>Estimate |
|--------------------|--------------------------|--------------------|---------------------|
| Power Sector       | 179                      | 67                 | 180                 |
| Food & Agriculture | 22                       | 37                 | 37                  |
| Oil Refineries     | 11                       | 15                 | 11                  |
| Others             | 1                        | 2                  | 2                   |
| <b>Total</b>       | <b>213</b>               | <b>120</b>         | <b>229</b>          |

Source: Budget Wing, Ministry of Finance

of PEPCO/NTDC/WAPDA, obtained against the non payment of tariff differential over a period of years, to a special purpose vehicle named Power Holding Pvt. Limited with a view to deleverage the balance sheet of these organisations, and issued NEPRA ordinance to automatically adjust monthly fuel price similar to that of oil sector. However, the reforms were not fully implemented and as a result, the power sector continues to strain fiscal position.



Restoring fiscal sustainability will require addressing with greater vigor existing challenges in the resource-stricken power sector to reduce unnecessary and unproductive burden on government budgets. **Table 16** shows a break-up of subsidies for 2009-10.

## 2. Other Current Expenditure

Defence affairs accounted for 15.7 percent of current expenditure for the fiscal year 2009-10. Rs. 49.5 billion were spent on public order and safety affairs against a budgeted estimate of Rs. 34.6 billion. Economic affairs registered Rs. 83.6 billion, a decline of 1.5 percent in comparison to budget. On the

|                                | Prov.Actual<br>July-June | Budget<br>Estimate | Revised<br>Estimate |
|--------------------------------|--------------------------|--------------------|---------------------|
| Environment Protection         | 0.3                      | 0.4                | 0.4                 |
| Health                         | 7                        | 6                  | 7                   |
| Education Affairs and Services | 33                       | 32                 | 32                  |
| <b>Total</b>                   | <b>40</b>                | <b>38</b>          | <b>39</b>           |
| - As % of GDP                  | 0.3                      | 0.3                | 0.3                 |

Source: Budget Wing, Ministry of Finance

contrary, government spending on social safety nets had been abysmally low and access to social services by the vulnerable remains a challenge. A combined total of only Rs. 40.2 billion was incurred on education, health and environment sector (See **Table 17**).

This spending translated into only 0.3 percent of GDP for FY2009-10, indicating the government's lack of attention towards targeted social transfers. Government must ensure intergenerational equity and an adequate social safety net, and provision of public services that allow a level playing field, regardless of conditions at birth.

### VI.ii.b. Development Expenditure

Development spending was contained for the fiscal year 2009-10 in relation to budgetary targets to mitigate the damage done to the fiscal account in the form of higher than projected non-development outlays. However, this head registered a healthy expansion of 36.7 percent in absolute terms when compared to the 2008-09 level.

Rs. 613.4 billion was spent for development purposes in FY2009-10 in comparison to Rs. 448.8 billion during 2008-09. Out of it, Public Sector Development Programme (PSDP) was slashed to Rs. 518 billion against a budgeted estimate of Rs. 606 billion, while other development expenditures summed to Rs. 95.5 billion and witnessed a cut of 39.2 percent (in comparison to budget estimates) in the fiscal year 2009-10. Among PSDP, provincial share increased by 29.2 percent in comparison to budgeted outlay whereas federal portion was curtailed by a massive Rs. 146.5 billion in the period under review.

It is worth noting here that such a fiscal adjustment largely compromises on the development prospects for future generation in a country like Pakistan that needs to build upon its existing social sector.

### **VI.iii. Fiscal Deficit**

Developments in the fiscal sector during the fiscal year 2009-10 finally culminated to a budget deficit of Rs. 929 billion or 6.3 percent of GDP that was 1 percent higher than the last fiscal year's deficit and 1.5 percent more than the budget estimate for 2009-10.

This performance has come at a time when the country is pursuing a macro-economic stabilization agenda supported by the IMF. Notwithstanding, the fiscal consolidation witnessed in 2008-09 appeared to be vanishing in 2009-10. Unless serious corrective measures to induce flexibility in government expenditure especially subsidies are taken, the fiscal outlook is bound to remain fragile in the near term. Similarly, enhanced revenue generation efforts need to be the top-most priority going forward.

The current trajectory of fiscal deficit will continue to exert pressure on the external account and will fuel inflationary expectations in the economy as it creates demand in the system. Simultaneously, meeting the financing requirement placed by the higher deficit will limit the prospects of private sector growth and the economic benefits it brings.

### **VI.iv. Financing of Fiscal Deficit**

External inflows were budgeted at Rs. 312.3 billion for 2009-10. However, only 60.5 percent of the projected amount was realized in the course of the fiscal year 2009-10. Non-materialization of Tokyo pledges had been the underlying theme as only Rs. 25.3 billion were received against a projection of Rs. 145.1 billion made in the federal budget (revised down to Rs. 66.1 billion later). A widening fiscal balance, was, therefore, mainly financed through domestic sources in the absence of any proceeds accruing from privatization. This avenue is costly as this borrowing is conducive to inflationary pressures and at the same time, translates into higher debt servicing in view of higher domestic interest rates.

In the course of the fiscal year 2009-10, Rs. 740 billion was mobilized through domestic sources against a budgeted target of Rs. 390.5 billion. Of this, much came from non-bank sources (58.8 percent of domestic financing). Interestingly, the bank deficit financing was frozen to almost the same level of 2008-09 (in absolute terms) nearing Rs. 305 billion. Despite this, government relied on central bank

borrowing and was not able to comply with the “net zero quarterly borrowing limits” policy during FY2009-10. This trend is undesirable and needs to be reversed as deficit monetization (printing of money) is one of the factors influencing inflationary expectations in the economy.

The non-bank inflows amounted to Rs. 435.6 billion, 76.9 percent higher than the estimated magnitude. This segment of deficit financing underwent an increase of nearly Rs. 212 billion as compared to FY2008-09. Higher accruals in retail instruments offered by the Central Directorate of National Savings (CDNS) coupled with a resurgence of non-banking financial institutions’ interest in government papers were the prime reasons behind this strong growth.

### VI.v. Revenue Deficit

Revenue balance is the total revenue adjusted for current expenditure. Governments require fiscal space to spur development activities in the economy. For development spending, however, governments need to generate a revenue surplus or at least maintain revenue balance. In Pakistan, the government has not been able to achieve a zero revenue balance by June 30, 2008, a critical provision of FRDL Act 2005. In fact, the revenue deficit mushroomed to Rs. 358.2 billion or 3.5 percent of GDP during 2007-08.

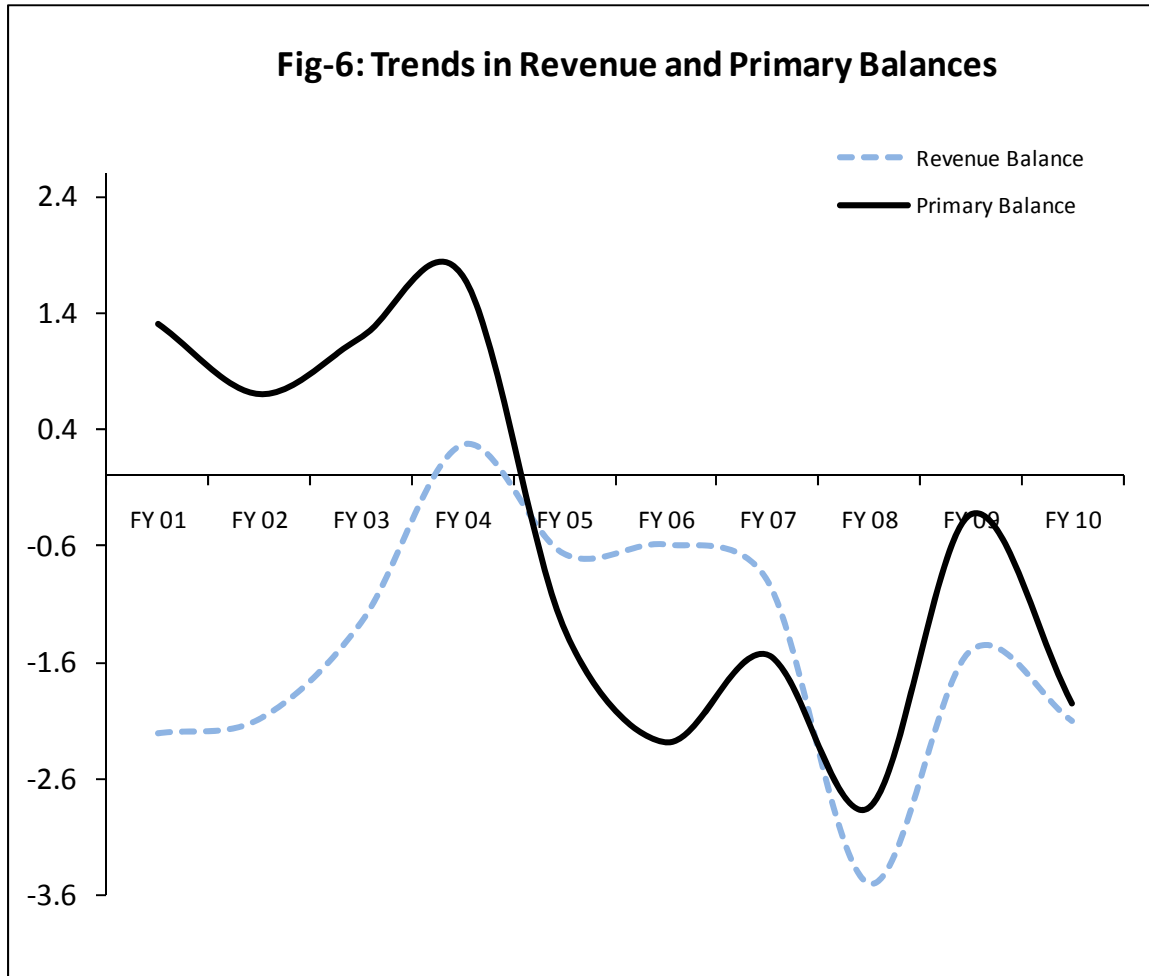
While the same indicator improved sharply by 200 bps in 2008-09 over 2007-08, the fiscal year 2009-10 saw a reversal of this declining tendency and recorded a revenue deficit of 307.8 billion approximating to 2.1 percent of GDP. This implies that the revenue balance worsened by 61.4 percent in comparison to FY 2008-09. Government has not been able to achieve a surplus of 0.3 percent of GDP as envisioned in the Federal Budget 2009-10. This is an alarming situation and by no means, a sustainable scenario.

The existence of a high and persistent revenue deficit points out the government’s inability in maintaining fiscal discipline and instilling austerity measures in order to curtail increasing current expenditures. Higher subsidies in the absence of fiscal space have meant that “government is creating debt obligations for financing inefficiency in the economy”<sup>3</sup>. So far, government has not been able to bring current expenditures in line with the revenues. On the contrary, persistent revenue deficit implies that the borrowed money is mostly being spent on current outlays that otherwise should be available solely for development purposes. This trend needs to be arrested by undertaking an aggressive

<sup>3</sup> “Public Finance and Fiscal Policy”, State Bank of Pakistan Annual Report FY10

expenditure reform action plan. At the same time, it calls for greater emphasis on exploiting other avenues in terms of resource mobilization.

Revenue balance is critically important for inter-generational shift of burden. Revenue deficit implies borrowing for current consumption or shifting burden of current consumption on future generations. If we borrow for development, it means creation of assets for future generation.



### VI.vi. Primary Deficit

Primary balance is the total revenue adjusted for non-interest expenditure. In line with the revenue deficit, the primary deficit aggregated to Rs. 286.7 billion or 2 percent of GDP in FY2009-10 against a budgeted target of Rs. 74.9 billion or 0.5 percent of GDP. This indicator has eroded by a large margin when compared to the FY2008-09 position of 0.3 percent of GDP. Although the primary deficit in the

fiscal year 2009-10 is slightly lower from the precarious level of 2.8 percent of GDP witnessed in 2007-08, the comeback of the rising pattern is not at all favorable.

A negative primary balance essentially means that the government is borrowing monies to pay interest payment on the debt stock, debt trap. Action to arrest such a trend is politically difficult, but the effects of the needed measures could be phased in over time. Indeed, to the extent that long term spending trends are ameliorated by structural reforms, a smaller improvement in the primary balance could then be targeted.

## VII. Fiscal Projections 2010-11

The Federal Budget 2010-11 painted a portrait of fiscal consolidation for the current fiscal year but that was harshly washed away as devastating floods hit the country early into the fiscal year. Even before this catastrophe, the announcement of a fiscal deficit of 4 percent (in terms of GDP) lost its significance at the very onset owing to deficit budgets announced by two of the provinces.

Budget 2010-11 encompassed various revenue generation and fiscal austerity measures. An increase of 1 percentage point in the GST rate was proposed and a freezing of non-wage current expenditure at the FY2009-10 level was propagated. Non-tax revenue was estimated at Rs. 715.6 billion, almost Rs. 110 billion more than the actual collection in 2009-10. Out of the increase, Rs. 50 billion were to come from PTA proceeds in respect of issuing 3G Licence to cellular companies in Pakistan. Total outlay as per the budget was Rs. 3,259.3 billion equal to 19.2 percent of the projected GDP. A reduction of 1.4 percent was envisaged in the category of current expenditures, while development spending was enhanced to Rs. 733.5 billion, up by 19.6 percent from the actual outlay in 2009-10. These numbers hold no more importance as sharp adjustments were needed to divert a sizable portion of the PSDP to the relief and rehabilitation tasks in the post-flood scenario. Resultantly, budget targets were revised and a new fiscal deficit of 4.7 percent was agreed upon recently.

As per the revised projections, the size of the budget has expanded to Rs. 3,297 billion. Total revenue collection is projected at Rs. 2,485 billion (14.5 percent of revised nominal GDP) for the current fiscal year. The government is mulling over the imposition of flood surcharge of 10 percent on the salaried class with annual incomes exceeding Rs. 300,000 for a period of January-July 2011. This temporary measure will certainly boost the revenues in the short term. However, given the severity of the crisis, a more rigorous approach to taxation was needed. The time was opportune to undertake fundamental

changes in the tax structure by bringing into the tax net, sectors that have enjoyed tax freedom so far or are under-taxed.

| <b>Table-18: Consolidated Government Budget, 2010-11 (Rs. Billion)</b> |                            |                                    |
|--|----------------------------|------------------------------------|
| <b>Items</b>   | <b>2010-11 Projections</b> | <b>2010-11 Revised Projections</b> |
| <b>Total Revenue</b>   | 2574<br><i>15.2</i>        | 2485<br><i>14.5</i>                |
| Tax Revenue  | 1859<br><i>10.9</i>        | 1881<br><i>10.9</i>                |
| - FBR Revenue  | 1667<br><i>9.8</i>         | 1655<br><i>9.6</i>                 |
| Non-Tax Revenue  | 716<br><i>4.2</i>          | 605<br><i>3.5</i>                  |
| <b>Total Expenditure</b>   | 3259<br><i>19.2</i>        | 3297<br><i>19.2</i>                |
| Current  | 2519<br><i>14.8</i>        | 2910<br><i>16.9</i>                |
| Development  | 740<br><i>4.4</i>          | 387<br><i>2.3</i>                  |
| <b>Fiscal Deficit</b>  | 685                        | 811                                |
| - as % of GDP  | <i>4.0</i>                 | <i>4.7</i>                         |

Note: Figures in italics are as percentage of GDP

Source: Budget Wing, Finance Division

Public expenditure is kept at the same level of 19.2 percent of revised output as planned out in the original budget 2010-11. However to adapt to societal preferences and needs for greater flood-related spending, the government has no option but to go for a drastic cut on development outlays in order to free up the scarce resources for rehabilitation and reconstruction costs. Consequently, development expenditure is slashed by 48 percent, meaning thereby a fourth consecutive year of cut in social spending. Current expenditure is augmented by 15.5 percent over the original target and is now projected to attain 16.9 percent of revised GDP, up from a budgeted 14.8 percent of GDP, whereas development expenditure is down to 2.3 percent of GDP. It is worth mentioning here that this cut has been done in budgetary targets and with a known history of slippage on this front, the actual realization of social spending will be too low. This tendency is detrimental to the ever-increasing development needs of the country. Furthermore, continued power tariff differential will raise the current spending levels.

### VII.i. FBR Targets

The FBR revenue is fixed at Rs. 1,667 billion against an actual realization of Rs. 1,327.4 billion in 2009-10. This target appears optimistic as a growth of 25.6 percent far outweighs the average growth of 18.3 percent over the last five years and a relatively anaemic growth of 12.3 percent in the fiscal year 2009-10. As a result of revision in the budget targets, this head has been scaled down to Rs. 1,655 billion due to a general slowdown in production and aggregate demand after the floods.

|                      | 2009-10<br>Revised<br>Estimates | 2010-11<br>Budget<br>Estimates | 2010-11<br>Revised<br>Projections | Growth<br>(%) |
|----------------------|---------------------------------|--------------------------------|-----------------------------------|---------------|
| <b>Total Revenue</b> | <b>1,851</b>                    | <b>2,574</b>                   | <b>2,485</b>                      | <b>34.3</b>   |
| - Tax Revenue        | 1,538                           | 1,859                          | 1,881                             | 22.3          |
| - FBR Revenue        | 1,380                           | 1,667                          | 1,655                             | 19.9          |
| a) Direct Taxes      | 540                             | 658                            | 702                               | 29.9          |
| b) Indirect Taxes    | 840                             | 1,009                          | 953                               | 13.5          |
| - Sales Tax          | 540                             | 675                            | 639                               | 18.2          |
| - Federal Excise     | 134                             | 154                            | 141                               | 4.9           |
| - Customs Duty       | 165                             | 181                            | 173                               | 5.1           |

Source: Budget Wing, Finance Division

Direct taxes are projected to increase by 29.9 percent while indirect taxes have been estimated at Rs. 953 billion. Sales tax has been revised down to Rs. 639 billion, federal excise to Rs. 141 billion, and customs duty to Rs. 173 billion owing to post-flood budget adjustments.

### VII.ii. Reformed General Sales Tax (RGST)

It was pledged at the time of budget presentation that a reformed and broad-based GST will be implemented from October 2010 following the consensus of provinces on the subject as well as completion of its implementation mechanism. However, the General Sales Tax Bill 2010 to reform the sales tax regime by introducing and implementing a broad-based and integrated tax regime on consumption in Pakistan has only recently been submitted to the Federal parliament. This bill will replace the existing Sales Tax Act, 1990.

Provincial governments have yet to deliver on this reform by submitting bills with regards to RGST on services in their respective assemblies. Taxation of services remains the subject matter of provincial autonomy after passage of the 18<sup>th</sup> Constitutional Amendment.

**Box-1: Salient Features of RGST**

- GST will replace the existing regimes of sales tax and excises on services.
- GST will apply on both at import and local supply stages.
- Standard rate of 15% has been proposed instead of the present rate of 17% or multiple other rates going upto 25%.
- There shall be no fixed tax, reduced tax, enhanced tax, retail price-based tax or special tax scheme under the new GST system.
- A uniform enhanced annual exemption threshold of Rs.7.5 million (which is presently Rs. 5 million) shall be applied to keep small businesses including small traders/retailers/cottage industry out of mandatory tax compliance.
- All exports shall be zero-rated.
- Input tax adjustment of both direct and indirect constituents shall be allowed on “totals” basis (excluding entertainment and non-business use passenger vehicles).
- Sales tax on goods and services where so authorized by the Provinces shall be mutually adjustable so that double taxation does not occur.
- No general zero-rating shall be admissible on any commercial form of domestic supply or on any local consumption.
- The GST system will work purely on “self-assessment and self-policing” basis.
- Cash flow of businesses shall be facilitated through expeditious centralized (**Electronic**) refund payment system.
- Tax compliance shall be encouraged through transparent and fair audit system with increased use of modern information technology.
- Adjudication, appeal and alternative dispute resolution (ADR) systems have been provided as before.
- FBR will issue simplified rules to regulate the GST procedures and processes.
- The GST Bill 2010 shall take effect from such date as may be notified by the Federal government.
- The new GST system will be applied in FATA/PATA, the Province of Gilgit-Baltistan and AJ&K in due course.

Source : Federal Board of Revenue

**VII.iii. 7th NFC Award**

A remarkable development in the fiscal year 2009-10 was the announcement of 7<sup>th</sup> NFC award after a gap of 19 years. This award lays the basis for resource distribution between the Center and the



Provinces (vertical distribution), and between the Provinces (horizontal distribution). The 7<sup>th</sup> NFC Award marks a watershed since it has adopted by consensus a set of multiple criteria for determining horizontal distribution of resources against a historical trend of using a single criterion of Population (see **Box 2**). Resultantly, the transfer to provinces has been projected to rise to Rs. 1,077 billion, an increase by 69.8 percent in the fiscal year 2010-11 over the actual transfer of Rs. 634.2 billion in FY2009-10. Apart from awarding more fiscal autonomy to the provinces, the NFC is also expected to rationalize intergovernmental fiscal relations and encourage the process of national reconciliation in the country.

**Table-20: Transfers to Provinces (Rs. Billion)**

|                                     | 2004-05    | 2005-06    | 2006-07    | 2007-08    | 2008-09    | 2009-10    | 2010-11<br>(BE) |
|-------------------------------------|------------|------------|------------|------------|------------|------------|-----------------|
| Divisible Pool                      | 215        | 244        | 326        | 390        | 458        | 565        | 866             |
| Straight Transfer                   | 42         | 56         | 75         | 68         | 67         | 68         | 168             |
| Special Grants/Grant in Aid         | 10         | 10         | 28         | 32         | 38         | 43         | 86              |
| Distt Support Grant                 | 21         | 28         | -          | -          | -          | -          | -               |
| <b>Total Transfers to Provinces</b> | <b>289</b> | <b>339</b> | <b>428</b> | <b>490</b> | <b>563</b> | <b>677</b> | <b>1,120</b>    |
| Interest Payment                    | 24         | 22         | 18         | 20         | 19         | 19         | 17              |
| Loan Repayment                      | 29         | 15         | 40         | 25         | 21         | 24         | 26              |
| <b>Transfers to Provinces (Net)</b> | <b>236</b> | <b>302</b> | <b>370</b> | <b>445</b> | <b>524</b> | <b>634</b> | <b>1,077</b>    |

Source: PF Wing, Ministry of Finance

**Box-2: Salient Features of 7<sup>th</sup> NFC Award**

- The distribution of resources has been made on multiple criteria instead of single criteria of population.
- The agreed sharing of the divisible pool will now take place on the basis of the following:
  - Population 82.0%
  - Poverty and backwardness 10.3%
  - Revenue collection / generation 5.0%
  - Inverse population density 2.7%
- Federal Transfers to the provincial governments on the basis of the percentage specified against each:-

|                    | Existing | 7th NFC Award |
|--------------------|----------|---------------|
| Balochistan        | 7.17%    | 9.09%         |
| Khyber Pakhtunkhwa | 14.88%   | 14.62%        |
| Punjab             | 53.01%   | 51.74%        |
| Sindh              | 24.94%   | 24.55%        |
| Total              | 100.00%  | 100%          |

Source: Provincial Finance Wing, Finance Division.

4. In vertical distribution Federal government has allowed an increase in the share of the provinces with 56 percent for first year and 57.5 percent for the remaining years. The share of the Federal Government in the net proceeds of divisible pool shall be 44 percent during the financial year 2010-11 and 42.5 percent from the financial year 2011-12 onwards.
5. In addition, the Federal government agreed to a reduction of collection charges from 5% to 1%, increasing the pool for distribution by 4%.
6. Baluchistan will receive 9.1 percent instead of 5.1 percent and will receive total Rs. 83 billion for the first year. Any shortfall in this amount shall be made up by the Federal Government from its own resources.
7. One percent of the net proceeds of divisible pool taxes shall be assigned to government of Khyber Pakhtunkhwa to meet the expenses on war on terror.
8. Each province shall be paid in each financial year as a share in the net proceeds of the total royalties on crude oil an amount which bears to the total net proceeds the same proportion as the production of crude oil in the province in that year bears to the total production of crude oil.
9. Each Province shall be paid in each financial year as a share in the net proceeds to be worked out based on average rate per MMBTU of the respective province.
10. There shall be charged upon the Federal Consolidated Fund each year, as grants-in-aid of the revenues of the province of Sindh an amount equivalent to 0.66 % of the provincial share in the net proceeds of divisible pool as a compensation for the losses on account of abolition of octroi and zilla tax (OZT).
11. It has also been recommended in NFC award that the Federal government and Provincial governments should streamline their tax collection system to increase their revenues in order to achieve 15 percent tax to GDP ratio by the terminal year i.e. 2014-15.
12. Similarly Federal Government and Provincial governments would develop and enforce mechanism for maintaining fiscal discipline at the Federal and Provincial levels through legislative and administrative measures.

Source : Economic Survey of Pakistan 2009-10

#### VII.iv. 18th Amendment

The 18<sup>th</sup> Amendment recommended abolition of the concurrent list. However, the concurrent list is proposed to be abolished up to 1<sup>st</sup> July 2011. This has resulted in increased fiscal deficit for the Federal Government that has transferred revenues to provinces under the 7<sup>th</sup> NFC award in the current fiscal year but has to bear the expenditure on the provincial subjects for this year. On the other hand, provincial governments will have an increased amount of revenues at their disposal with no functional

transfer. This will incline the provincial governments to increase expenditure on the existing functions. There is, accordingly, a disparity for the fiscal year 2010-11, and this inconsistency can be a potential threat to fiscal prudence and the ability of the federal government to maintain a level of consolidated fiscal deficit which is consistent with fiscal sustainability and economic stability.

### VII.v. Provincial Budgets

The goal of fiscal decentralization envisioned under the 7<sup>th</sup> NFC award cannot be achieved in true spirits unless the provinces exercise fiscal discipline and maturity in their economic management. Without effective management of the resources, the requisite fiscal space cannot be reached that is necessary for investments in social, economic, and industrial sectors. In this context, the provincial governments in Pakistan are required to employ additional resources in an efficient and optimal way. The provincial governments are also expected to reduce their excessive dependence on federal transfers and mobilize their own resources as there is a wide room available to them to revise the tax lists and enhance their revenue base.<sup>4</sup>

**Table 21** shows a comparison of the provincial budgets 2009-10 and 2010-11. It can be seen that provinces have projected more than 50 percent increase in revenue from own sources for the current fiscal year. Rs. 215.3 billion has been budgeted for FY2009-10 against Rs. 142.8 billion estimate and Rs. 112 billion actual in 2008-09. The budgets of Balochistan and Khyber Paktunkhwa hinge mainly on massive revenue generation that has been at the back of a healthy overall increase. For 2010-11, provincial expenditures have been budgeted at Rs. 1,290.7 billion, 42.1 percent more than the actual provincial spending in 2008-09. Emphasis has been placed at development outlays that have been approximated to be 60.4 percent higher than the preceding fiscal year.

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<sup>4</sup> "Public Finance and Fiscal Policy", State Bank of Pakistan Annual Report FY10

| <b>Table-21: Provincial Own Receipts and Expenditure, 2009-10 and 2010-11 (Rs. Billion)</b> |                           |                                |                                     |                              |                                |                                     |
|---|---------------------------|--------------------------------|-------------------------------------|------------------------------|--------------------------------|-------------------------------------|
|   |                           | <b>Budget Estimate 2009-10</b> | <b>Prov. Actual Jul-Jun 2009-10</b> | <b>Variations (II) - (I)</b> | <b>Budget Estimate 2010-11</b> | <b>Prov. Actual Jul-Sep 2010-11</b> |
| <b>Punjab</b>   | <b>Prov. Own Receipts</b> | <b>87</b>                      | <b>66</b>                           | <b>-21</b>                   | <b>119</b>                     | <b>11</b>                           |
|   | Tax Receipts              | 50                             | 33                                  | -17                          | 90                             | 8                                   |
|   | Non-Tax Receipts          | 37                             | 33                                  | -4                           | 29                             | 3                                   |
|   | <b>Prov. Expenditure</b>  | <b>490</b>                     | <b>435</b>                          | <b>-55</b>                   | <b>580</b>                     | <b>73</b>                           |
|   | Current Expenditure       | 315                            | 301                                 | -14                          | 387                            | 65                                  |
|   | Development Expenditure   | 175                            | 134                                 | -41                          | 194                            | 8                                   |
| <b>Sindh</b>  | <b>Prov. Own Receipts</b> | <b>43</b>                      | <b>36</b>                           | <b>-7</b>                    | <b>69</b>                      | <b>6</b>                            |
|   | Tax Receipts              | 27                             | 23                                  | -5                           | 50                             | 5                                   |
|   | Non-Tax Receipts          | 15                             | 13                                  | -2                           | 19                             | 1                                   |
|   | <b>Prov. Expenditure</b>  | <b>311</b>                     | <b>245</b>                          | <b>-66</b>                   | <b>403</b>                     | <b>49</b>                           |
|   | Current Expenditure       | 213                            | 179                                 | -35                          | 268                            | 46                                  |
|   | Development Expenditure   | 98                             | 67                                  | -31                          | 135                            | 3                                   |
| <b>Khyber Pakhtunk</b>  | <b>Prov. Own Receipts</b> | <b>10</b>                      | <b>7</b>                            | <b>-3</b>                    | <b>19</b>                      | <b>1</b>                            |
|   | Tax Receipts              | 6                              | 3                                   | -3                           | 16                             | 1                                   |
|   | Non-Tax Receipts          | 4                              | 4                                   | 0                            | 3                              | 1                                   |
|   | <b>Prov. Expenditure</b>  | <b>131</b>                     | <b>145</b>                          | <b>14</b>                    | <b>197</b>                     | <b>29</b>                           |
|   | Current Expenditure       | 80                             | 104                                 | 24                           | 128                            | 26                                  |
|   | Development Expenditure   | 51                             | 40                                  | -11                          | 69                             | 3                                   |
| <b>Balochistan</b>  | <b>Prov. Own Receipts</b> | <b>4</b>                       | <b>3</b>                            | <b>0</b>                     | <b>9</b>                       | <b>3</b>                            |
|   | Tax Receipts              | 1                              | 1                                   | 0                            | 6                              | 0                                   |
|   | Non-Tax Receipts          | 3                              | 2                                   | 0                            | 3                              | 2                                   |
|   | <b>Prov. Expenditure</b>  | <b>72</b>                      | <b>83</b>                           | <b>12</b>                    | <b>110</b>                     | <b>16</b>                           |
|   | Current Expenditure       | 53                             | 60                                  | 7                            | 83                             | 15                                  |
|   | Development Expenditure   | 19                             | 23                                  | 5                            | 26                             | 1                                   |
| <b>Provinces (com)</b>  | <b>Prov. Own Receipts</b> | <b>143</b>                     | <b>112</b>                          | <b>-31</b>                   | <b>215</b>                     | <b>22</b>                           |
|   | Tax Receipts              | 84                             | 59                                  | -25                          | 162                            | 14                                  |
|   | Non-Tax Receipts          | 59                             | 53                                  | -6                           | 54                             | 7                                   |
|   | <b>Prov. Expenditure</b>  | <b>1,004</b>                   | <b>908</b>                          | <b>-95</b>                   | <b>1,291</b>                   | <b>168</b>                          |
|   | Current Expenditure       | 661                            | 644                                 | -17                          | 866                            | 152                                 |
|   | Development Expenditure   | 343                            | 264                                 | -78                          | 424                            | 16                                  |

Source: PF Wing, Ministry of Finance

## VIII. Fiscal Performance July-September 2010-11

A total of Rs. 400.2 billion was collected in terms of revenue while Rs. 676.4 billion was the aggregate government spending till September 2010. A revenue shortfall of Rs. 27 billion and an expenditure overrun by Rs. 25 billion over July-September 2009 was observed. The first quarter of the current fiscal year observed a budget deficit of 1.6 percent of GDP. A welcome development in this quarter was a 0.3 percent (of GDP) budget surplus generated by provincial governments. However, the spill-over effects of flood spending are to be painfully felt in the coming quarters.

| <b>Table-22: Consolidated Government Budget, July-Sept 2010 (Rs. Billion)</b> |   |   |
|---|---|---|
|   | <b>Prov. Actual<br/>July-Sept<br/>2009-10</b> | <b>Prov. Actual<br/>July-Sept<br/>2010-11</b> |
| <b>A. Total Revenue</b>   | <b>427</b>                                    | <b>400</b>                                    |
| <b>a) Tax Revenue</b>   | <b>299</b>                                    | <b>317</b>                                    |
| - Federal   | 288   | 303   |
| <i>of which FBR Revenue</i>   | 263   | 287   |
| - Provincial  | 11  | 14  |
| <b>b) Non-Tax Revenue</b>   | <b>129</b>                                    | <b>83</b>                                     |
| - Federal   | 119   | 74  |
| - Provincial  | 10  | 9   |
| <b>B. Total Expenditure</b>   | <b>651</b>                                    | <b>676</b>                                    |
| <b>a) Current Expenditure</b>   | <b>521</b>                                    | <b>567</b>                                    |
| - Federal   | 381   | 419   |
| <i>of which:</i>  |   |   |
| <b>Interest Payments</b>  | 142   | 162   |
| - Domestic  | 129   | 147   |
| - Foreign   | 12  | 15  |
| <b>Defense Expenditure</b>  | 86  | 93  |
| - Provincial  | 140   | 148   |
| <b>b) Development Expenditure</b>   | <b>109</b>                                    | <b>59</b>                                     |
| - PSDP  | 86  | 43  |
| Federal   | 46  | 27  |
| ERRA  | -   | -   |
| Provincial  | 39  | 16  |
| - Other Development Expenditure   | 23  | 16  |
| <b>c) Net Lending</b>   | <b>7</b>                                      | <b>3</b>                                      |
| <b>d) Unidentified Expenditure</b>  | <b>-14</b>                                    | <b>-47</b>                                    |
| <b>C. Overall Fiscal Balance</b>  | <b>-224</b>                                   | <b>-276</b>                                   |
| - <i>As % of GDP</i>  | -1.5  | -1.6  |
| <b>D. Financing of Fiscal Balance</b>   | <b>224</b>                                    | <b>276</b>                                    |
| <b>a) External Sources</b>  | 77  | 57  |
| <b>b) Domestic</b>  | 147   | 219   |
| - Bank  | 39  | 121   |
| - Non-Bank  | 108   | 98  |
| <b>c) Privatization Proceeds</b>  |   |   |
| <b>E. GDP at Market Prices</b>  | <b>14,837</b>                                 | <b>17,106</b>                                 |
| <b>Memo Items</b>   |   |   |
| <b>Revenue Balance</b>  | <b>-94</b>                                    | <b>-167</b>                                   |
| - <i>As % of GDP</i>  | -0.6  | -1.0  |
| <b>Primary Balance</b>  | <b>-82</b>                                    | <b>-115</b>                                   |
| - <i>As % of GDP</i>  | -0.6  | -0.7  |

Source: Budget Wing, Ministry of Finance

### VIII.i. Tax Revenue

Tax revenue accrued to Rs. 317.3 billion during the first three months of the ongoing fiscal year 2010-11. Petroleum Development Levy witnessed Rs. 15.3 billion, 36.4 percent lower in comparison to July-September 2009. On the other hand, provinces collected tax revenue of Rs. 14.4 billion which is 28.4 percent higher than the corresponding period of FY2009-10.

**Table-23: FBR Tax Collection, July-September 2010 (Rs. Billion)**

| Revenue Head            | Target<br>2010-11 | July-Sept  |            | % Change   |
|-------------------------|-------------------|------------|------------|------------|
|                         |                   | 2009-10    | 2010-11    |            |
| Direct Tax              | 702               | 84         | 94         | 12.2       |
| Sales Tax               | 639               | 117        | 133        | 13.2       |
| Federal Excise          | 141               | 28         | 24         | -16.5      |
| Customs Duty            | 173               | 33         | 37         | 10.3       |
| <b>Total Collection</b> | <b>1,655</b>      | <b>263</b> | <b>287</b> | <b>9.3</b> |

Source: FBR

The FBR was able to reach Rs. 287.1 billion in July-September 2010, an increase of 9.3 percent over the same period last year against the annual budget target of 24.7 percent. Proceeds from Sales Tax contributed heavily to the bottom line as Rs. 132.5 billion was collected against a weak collection of Rs. 117.1 billion in July-September 2009. Custom Duties exhibited a growth of 10.3 percent whereas Federal Excise Duties were down by 16.5 percent in comparison to Q1 FY2009-10. Rs. 94.4 billion was collected under the head of Direct Taxes, which is 12.2 percent more than the first quarter collection in FY2009-10 in this category.

### VIII.ii. Non Tax Revenue

This sub-head of revenue portrayed a slow progress in July-September 2010 as only Rs. 82.9 billion was received against a healthy collection of Rs. 128.5 billion in Q1 FY2009-10. A closer look of this fall to the tune of 35.5 percent shows lower SBP profits and fewer receipts in respect of Coalition Support Fund. A

**Table-24: Non-Tax Revenue, July-Sept 2010 (Rs. Billion)**

|  | Prov. Actual<br>July-Sept<br>2009-10 | Prov. Actual<br>July-Sept<br>2010-11 |
|--|--------------------------------------|--------------------------------------|
| <b>Non-Tax Revenue</b>                     | <b>128</b>                           | <b>83</b>                            |
| Interest (PSEs & Others)                   | 0                                    | 0                                    |
| Dividend                                   | 19                                   | 0                                    |
| SBP Profit                                 | 70                                   | 40                                   |
| Defence                                    | 2                                    | 1                                    |
| Citizenship, Naturalization & Passport Fee | 3                                    | 2                                    |
| Development Surcharge on Gas               | 6                                    | 5                                    |
| Discount Retained on Crude Oil             | 0                                    | 3                                    |
| Royalty on Oil/Gas                         | 9                                    | 20                                   |
| Others                                     | 20                                   | 11                                   |

Source: Budget Wing, Ministry of Finance

negligible dividend income was received, partly owing to lower corporate profitability and mostly on account of a diminishing share of government in state-owned enterprises (due to Benazir Employee Stock Option Scheme adopted recently). A healthy collection of Rs. 19.6 billion on account of royalty on gas/oil is the only positive aspect of non-tax revenue during Q1 FY2010-11. However, nothing has been done so far with regards to new measures laid out in the Federal Budget 2010-11, mainly the issuance of 3G license to Pakistani telecom sector.

### VIII.iii. Expenditure

Current spending was Rs. 566.8 billion in July-September 2010. Interest payments on public debt stock were higher than in the same period of the preceding fiscal year by 14.1 percent while defence outlays consumed Rs. 93.1 billion. Subsidies took away Rs. 65.8 billion with the bulk of it (Rs. 40.4 billion) incurring on power sector, while grants made up 6.7 percent of current expenditure. The share of provincial outlays in current expenditure aggregated to 26 percent and this head witnessed an increase of 5.8 percent over Q1 FY2009-10. This modest surge nullified, to some extent, worries arising out of a mismatch due to a combined effect of 7<sup>th</sup> NFC Award and 18<sup>th</sup> Amendment (discussed in the relevant sections before).

On the other hand, public investment levels have declined sharply as only Rs. 43.1 billion was spent on Public Sector Development Programme (PSDP) against Rs. 85.5 billion in July-September 2009. This huge reduction reflects the government's plan to divert a significant part of PSDP to relief and rehabilitation activities. Despite international assistance and large-scale public mobilization, government is left with inadequate resources to meet increasing needs on this front. Hence, the government has initiated a tightening of development expenditure to effectively manage this mammoth task. Although limited policy options are available to the government to adjust to one-off and urgent needs on budgetary resources, the shrinkage in social sector outlays is not at all a desirable course of action. In contrast to this fiscal trend, fundamental structural changes are necessary to instill flexibility in public spending so as to create space for temporary demands on government's sparse funds.

### VIII.iv. Fiscal, Revenue and Primary Deficit

The overall fiscal balance has observed a 23.5 percent increase in the first quarter of FY2010-11 when compared to July-September 2009. A budget deficit of Rs. 276.2 billion was registered that approximated to 1.6 percent of GDP. It must be noted that spending on account of flood and related activities has yet to show its effect on the fiscal bottom line.

A revenue deficit of Rs. 166.6 billion or 1.0 percent of projected GDP was recorded in the first three months of FY2010-11. In the same spell, primary balance was in negative Rs. 114.7 billion or 0.7 percent of estimated GDP for FY2010-11. A sustained deterioration of these fiscal indicators over the years calls for increased revenue mobilization efforts while undertaking reforms to government spending patterns at the same time. To improve these fiscal indicators, it is imperative to tap additional sectors such as

agriculture, stock market, real estate, etc. for broadening the tax net as well as to rationalize and more importantly, re-prioritize its spending areas.

### VIII.v. Financing of Fiscal Deficit

The government is increasingly relying on domestic avenues for budgetary financing owing to a slow pace of materialization of FODP pledges and a general drying up of foreign funding sources. US\$ 451 million received under the IMF Emergency Natural Disaster Assistance (ENDA) for flood-related immediate outlays dominated the external sources of budgetary financing in the first quarter. More importantly, a greater dependence on banking sector may lead to fears of possible crowding-out of private sector credit. Banks contributed Rs. 121 billion to the financing of budgetary gap during July-September 2010, while non-banking sector provided Rs. 98.4 billion. Of the banking proceeds, much came through central bank borrowing. This is in sharp contrast to a 27/73 bank-nonbank financing mix during July-September 2009. In an environment of high domestic interest rates, this tilt towards banking industry is an expensive act. The government was able to get just Rs. 56.9 billion from external sources.

## IX. Review of Public Debt

Public debt has important influence over the economy both in the short and the long run. Higher public debt raises solvency risks, constrains the capacity to use fiscal policy as a countercyclical tool, and can increase borrowing costs for sovereigns. Ultimately, increase in public debt may reduce output growth and productivity. Pakistan managed to temporarily reverse the upward debt trend during FY2006 and FY2007, but this reduction has been dwarfed by the surge in the debt ratio by nearly 5.3 percentage points since. Out of this increase of 5.3 percent, borrowing for balance of payments (BoP) support including IMF contributed 3.0 percent of GDP since FY2007.

The total public debt stood at Rs. 8,894 billion as of June 30, 2010, an increase of Rs. 1,265 billion or 16.6 percent higher than the debt stock at the end of last fiscal year (See **Table 25**). Government borrowed Rs. 798 billion from domestic sources and Rs. 189 billion from external sources to finance the fiscal operations. Additionally, government borrowed SDR 2,145 million or Rs. 271 billion from IMF for balance of payment support (that included budget support under the bridge financing facility) and incurred an exchange loss of Rs. 200 billion on the external debt portfolio owing to rupee depreciation against US dollar. The Pak Rupee depreciated by 5 percent during FY2010 compared to 19.2 percent in FY2009.



| <b>Table-25: Public Debt, FY06-FY11*</b> |                                   |              |              |              |              |              |
|--|-----------------------------------|--------------|--------------|--------------|--------------|--------------|
|  | <b>FY06</b>                       | <b>FY07</b>  | <b>FY08</b>  | <b>FY09</b>  | <b>FY10</b>  | <b>FY11*</b> |
|  | <b>(In billions of Rs.)</b>       |              |              |              |              |              |
| Domestic Currency Debt                   | 2,320                             | 2,600        | 3,266        | 3,853        | 4,651        | 4,956        |
| Foreign Currency Debt                    | 2,038                             | 2,201        | 2,778        | 3,776        | 4,243        | 4,517        |
| <b>Total Public Debt</b>                 | <b>4,357</b>                      | <b>4,802</b> | <b>6,044</b> | <b>7,629</b> | <b>8,894</b> | <b>9,473</b> |
|  | <b>(In percent of GDP)</b>        |              |              |              |              |              |
| Domestic Currency Debt                   | 30.4                              | 30.0         | 31.9         | 30.2         | 31.7         | 28.8         |
| Foreign Currency Debt                    | 26.7                              | 25.4         | 27.1         | 29.6         | 28.9         | 26.3         |
| <b>Total Public Debt</b>                 | <b>57.2</b>                       | <b>55.4</b>  | <b>59.0</b>  | <b>59.9</b>  | <b>60.6</b>  | <b>55.1</b>  |
|  | <b>(In percent of Revenue)</b>    |              |              |              |              |              |
| Domestic Currency Debt                   | 215                               | 200          | 218          | 208          | 224          | 199          |
| Foreign Currency Debt                    | 189                               | 170          | 185          | 204          | 204          | 182          |
| <b>Total Public Debt</b>                 | <b>405</b>                        | <b>370</b>   | <b>403</b>   | <b>412</b>   | <b>428</b>   | <b>381</b>   |
|  | <b>(In percent of Total Debt)</b> |              |              |              |              |              |
| Domestic Currency Debt                   | 53.2                              | 54.2         | 54.0         | 50.5         | 52.3         | 52.3         |
| Foreign Currency Debt                    | 46.8                              | 45.8         | 46.0         | 49.5         | 47.7         | 47.7         |
| <b>Memo:</b>                             |                                   |              |              |              |              |              |
| Foreign Currency Debt (in US\$ Billion)  | 33.8                              | 36.4         | 40.7         | 46.4         | 49.6         | 52.4         |
| Exchange Rate (Rs./US\$, E.O.P)          | 60.2                              | 60.4         | 68.3         | 81.4         | 85.5         | 86.3         |
| GDP (in Rs. Billion)                     | 7,623                             | 8,673        | 10,243       | 12,739       | 14,668       | 17,182       |
| Total Revenue (in Rs. Billion)           | 1,077                             | 1,298        | 1,499        | 1,851        | 2,078        | 2,485        |

\*end-September 2010

Source: EAD, SBP, Budget Wing, MoF and DPCO staff calculations

Fiscal consolidation witnessed during FY2009 was reversed in FY2010 due to lower growth of revenue compared to budgeted growth, higher subsidies and security related expenditures; the fiscal deficit increased from 5.3 percent of GDP in FY2009 to 6.3 percent in FY2010. The current account deficit was 2.3 percent of GDP compared to 5.7 percent of last fiscal year. Fall in international commodity prices coupled with import compression measures resulted in restrained growth of imports, whereas exports grew by 2.9 percent that resulted in significantly reduced current account deficit. However faster global economic recovery and increase in international commodity prices will limit or reverse the gains achieved this year, going forward.

Non-materialization of Tokyo pledges forced the government to request IMF for bridge finance to cover the financing shortfall. This facility was made available in FY2010 on the pre-text that the budget will draw on this account to finance its priority needs until Tokyo-related pledges are disbursed and that the budget will replenish the dedicated account to the amount borrowed from the Fund as Tokyo-related pledges are disbursed.

The primary source of increase in public debt during 2009-10 has been a rapid increase in local currency component that accounted for 63.1 percent of the total increase in TPD. The main reasons for this shift

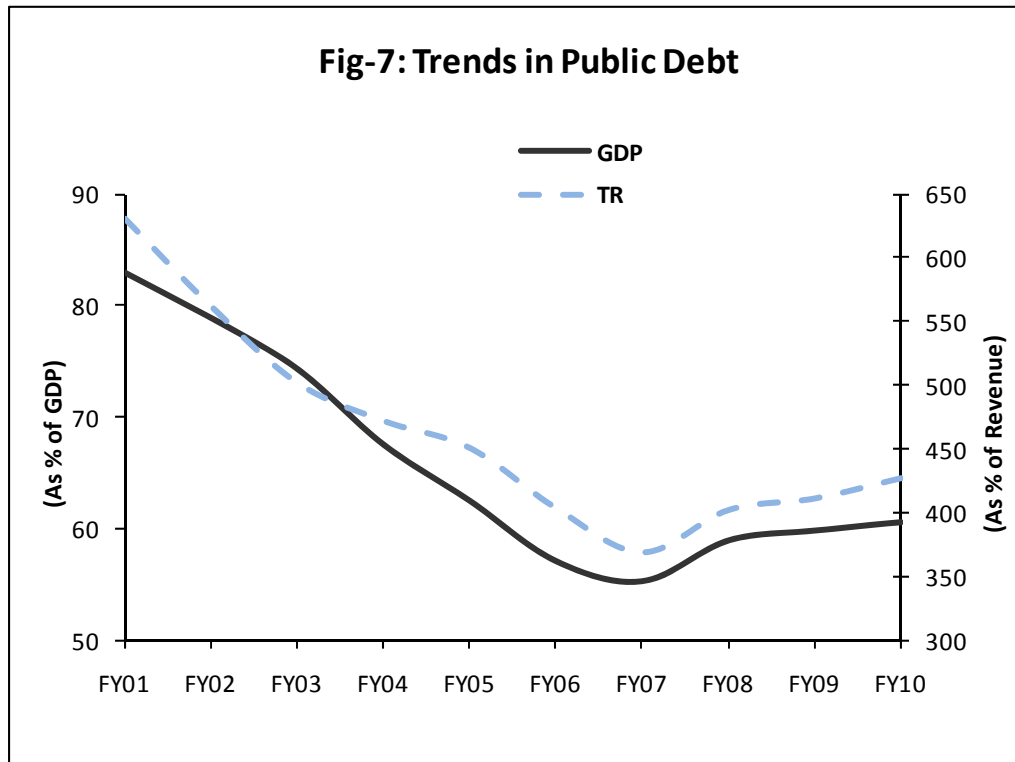
in borrowing were the non-materialization of Tokyo pledges, slow disbursement from multilateral and bilateral donors and higher than budgeted fiscal deficit.

The external debt component grew by Rs. 467 billion or 12.4 percent due to increased foreign public debt inflows on the one hand, and depreciation of the Rupee on the other hand. Rupee lost approximately 5 percent of its value against the US dollar during 2009-10. An increase of around Rs. 200 billion, approximately 16 percent of the total increase in TPD, was due to the exchange rate movement. Appreciation of the US Dollar against other major currencies caused the foreign currency component of public debt to decrease by US \$440 million. However, capital gain on foreign currency debt was mitigated by 5 percent depreciation of Pak Rupee against US Dollar. This capital loss on foreign currency debt, however, is mitigated by the strong concessionality element associated with Pakistan's external loans. The impact of any currency shock should not be looked at in isolation, but rather be analyzed in the context of interest rate differential. The increase in the foreign currency component of TPD also includes IMF BoP support that is not used to fund budgetary operations, but to strengthen Pakistan's foreign exchange reserves.

TPD stood at Rs. 9,473 billion at the end of first quarter FY2011, registering an increase of Rs. 579 billion or 6.5 percent in just three months of the current fiscal year. Depreciation of US dollar against other currencies has added approximately US \$2.4 billion to the external debt; US dollar depreciation combined with 1 percent rupee depreciation against US dollar caused the foreign currency component of TPD to increase by approximately Rs. 208 billion or 76 percent of the total increase of Rs. 274 billion. The rupee component of total public debt increased by Rs. 305 billion or 6.6 percent in the first quarter of FY2011.

There has been a major shift in fiscal deficit financing patterns. Since FY2008, almost 80 percent of the fiscal deficit has been financed from the domestic sources whereas during FY2002-07 only 47 percent of fiscal deficits were financed through local currency borrowing. This huge borrowing need of the government in absence of liquid debt capital markets and policy of net zero quarterly borrowing from SBP has increased the domestic interest rates. This along with borrowing from SBP has also strengthened the already strong inflationary expectations in the economy; FY2011 would be the fourth consecutive year of double digit inflation, unprecedented in the history of the country. There is a need to reduce fiscal deficit to avoid imbalance in the external account as excess demand created by large

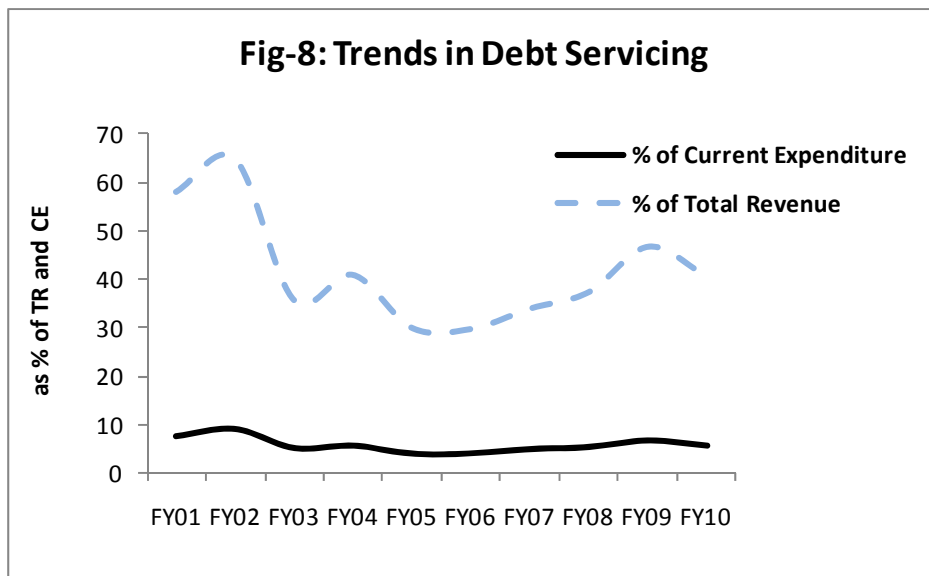
fiscal deficits will put the current account under pressure and will trigger further monetary tightening and currency depreciation to secure the external account.



## X. Servicing of Public Debt

For the fiscal year 2009-10, public debt service aggregated to Rs. 839.1 billion against a budgeted estimate of Rs. 779.6 billion. Interest payments on domestic debt were Rs. 578.3 billion, while the same for foreign debt stood at Rs. 64 billion. An expense of Rs. 196.8 billion was incurred to repay maturing foreign debt during the year in comparison to an estimated Rs. 132.4 billion. This slippage mainly arises on account of currency depreciation. A significant development was the repayment of US\$ 600 million International Sukuk Bond in January 2010. The share of public debt service in current expenditure was 35.2 percent, whereas about 40.4 percent of government revenues were consumed in this regard during 2009-10.

Even though these indicators have improved in comparison to previous years, an increasing concentration of financing mix towards internal sources and higher domestic interest rates on account of tight monetary policy indicate a persistent burden of



servicing expense on the government’s budgetary position.

## XI. Medium-Term Budgetary Framework (MTBF)

The Ministry of Finance has taken an important step to further enhance fiscal discipline through the introduction of budgetary reform programme called the Medium-Term Budgetary Framework (MTBF). The MTBF has received endorsement from the Cabinet in January 2009 and since then has been implemented across the Federal Government. For the fiscal year 2009-10, the MTBF produced two documents; the two-staged Budget Strategy Papers (2010-13), which were endorsed by the Cabinet, and Medium-term Budget Estimates for Service Delivery 2010-13, which was tabled at the Parliament together with the Budget 2010-11.

### XI.i. Budget Strategy Paper

The two-staged Budget Strategy Paper process has been started with aims to enhance fiscal discipline and link government’s strategic priorities with the budget. The aim to enhance fiscal discipline is achieved through creation of Medium-Term Fiscal Framework, which is a 3 year forward looking fiscal forecast of the Federal and Provincial Governments. The Medium-Term Fiscal Framework helps the government in determining the fiscal deficit targets. While it is understood that the fiscal decisions impact the macroeconomic situation in the country, the Finance Division has established a macroeconomic working group to understand the implications of fiscal decisions on other sectors of the economy and to enhance coordination in decision making between various stakeholders.

The macroeconomic forecasts together with policies of the government and the reforms agenda are presented in shape of Budget Strategy Paper (BSP). This year the Finance Division intends to discuss the BSP with the provinces. While the 18<sup>th</sup> Amendment empowers the provinces to take fiscal decisions, fiscal prudence can be achieved if the federal government and provincial governments collaborate on decision making. Discussions with the provinces will help create a more realistic picture of the fiscal deficit target and understanding the mechanisms required to achieve it. In addition, this year the Finance Division intends to include the citizens of Pakistan in budget making process. They will be encouraged to provide their inputs on the fiscal decision making and recommend how the government should priorities its expenditure.

### **XI.ii. Medium-term Budget Estimates for Service Delivery**

Before the MTBF budget preparation system, the budget was prepared to present the resources required for the upcoming year. While the budget thoroughly explained the budget required by each organisation in the Federal Government, it did not present the services that will be delivered by using the resources. The Medium-Term Budgetary Framework (MTBF) initiative requires the Ministries to prepare an 'output-based budget'. The 'outputs' are the Services delivered by the Ministries. The MTBF 'output-based budgeting' also requires the Ministries to present the 'outcomes'. The outcomes are the effects of Services on the target population. The focus on Service delivery will be enhanced once the budget is prepared and appropriated by Services and monitoring of the Services delivery performance takes place on annual basis.

## **XII. Economic Reforms**

Rigidity in government expenditure and losses suffered by many public sector enterprises has been persistent impediments to attaining fiscal sustainability. With the aim of creating fiscal space and easing pressure on budgetary resources, Government of Pakistan has initiated a number of economic reforms. Successful implementation of these reforms will enhance resource mobilization while strengthening principles of prudent expenditure management in public finances.

### **XII.i. Austerity (Expenditure Reform) Plan**

To stem the growth in government expenditure, the government has formulated an Austerity Plan which is under implementation. The key objective of the plan is to provide a road map to achieve austere and cost effective governance based on the following principles:

- i) Rationalization of Expenditure;
- ii) Optimization of Available Resources;
- iii) Process Re-engineering; and
- iv) Efficiency of Operation

Rationalization of government size through a reduction in the number of Federal Ministries and devolution of subjects to the provinces is being undertaken. The budgetary process is undergoing a major improvement by increased parliamentary oversight, limit on appropriations and introduction of professional financial management. The process of PSDP is to be overhauled by introducing benchmarks for timely completion and program audits among other initiatives. Appointment of professional Chief Finance and Accounting Officers (CFAO) would be made in each Ministry/Division in place of existing system of Financial Advisor's organization of Finance Division in order to improve financial management and planning.

### **XII.ii. Restructuring Of Public Sector Enterprises**

Acknowledging the severe burden placed by loss making PSEs on the government budget, a Cabinet Committee on Restructuring (CCOR) has been constituted and given the mandate to formulate and implement a restructuring plan for PSEs. The plan envisages a restructuring of Public Sector Enterprises for value creation and ultimate divestment of strategic interest to the private sector. Restructuring of PSEs may be viewed in terms of a roadmap for improved economic governance. An institutional framework has been put in place to carry forward restructuring effort.

### XII.iii. Power Sector Reform

Implementation of the power sector plan is under way. Boards of Directors (BODs) of DISCOs, GENCOs and NTDC have been dissolved in order to reconstitute professional and autonomous BODs as per the guidelines of CCOR. Auditing of power sector companies has been initiated to create financial improvement. Two conferences for knowledge sharing and improving communication among the power sector have been held. At the same time the dissolution of PEPCO is moving ahead and human resource transfer plan of PEPCO employees is under way.

Work on NEPRA amendment to empower NEPRA to notify all tariffs as determined from July 2011 is in progress. Additionally, monthly tariff adjustments to reach cost recovery levels have been undertaken. This will ensure financial viability for the DISCOs. The above and other restructuring efforts of the power sector are expected to contribute in improving financial, governance and business viability of power sector companies. The effort is to deal with regulatory, structural as well as financial issues of the sector to ensure stabilization taking a holistic view of the sector. These reforms will have the dual benefit of increasing the efficiency of the country's power sector, while limiting the drain placed on budgetary resources.

### XIII. Report on Compliance with FRDL Act 2005

The Fiscal Responsibility and Debt Limitation (FRDL) Act, 2005 was approved on 13 June 2005. The FRDL Act, 2005 requires that the federal government take measures to reduce total public debt and maintain it within prudent limits thereof. The following sections identifies the various limits prescribed by the FRDL Act 2005 and reports on progress thereof.

The FRDL Act 2005 requires the following:

- (1) Reducing the revenue deficit to nil not later than the thirtieth June, 2008 and thereafter maintaining a revenue surplus***

As of June 30, 2010, the revenue deficit approximated to Rs. 308 billion or 2.1 percent of GDP.

|                 | FY03  | FY04 | FY05  | FY06  | FY07  | FY08  | FY09  | FY10  |
|-----------------|-------|------|-------|-------|-------|-------|-------|-------|
| Revenue Balance | -1.5% | 0.3% | -0.7% | -0.6% | -0.9% | -3.5% | -1.5% | -2.1% |

**(2) Ensure “that within a period of ten financial year, beginning from the first July, 2003 and ending on thirtieth June, 2013, the total public debt at the end of the tenth financial year does not exceed sixty percent of the estimated gross domestic product for that year and thereafter maintaining the total public debt below sixty percent of gross domestic product for any given year.”**

As of 30<sup>th</sup> June 2010, the total public debt stood at 60.6 percent of GDP. It must be noted here that the limit of 60 percent of total public debt-to-GDP is applicable from the fiscal year 2012-13 onwards.

|  | FY03          | FY04         | FY05         | FY06         | FY07         | FY08         | FY09         | FY10         |
|--|---------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
|  | (Rs. Billion) |              |              |              |              |              |              |              |
| Domestic Currency Debt                 | 1,852         | 1,995        | 2,152        | 2,320        | 2,600        | 3,266        | 3,853        | 4,651        |
| Foreign Currency Debt                  | 1,771         | 1,816        | 1,913        | 2,038        | 2,201        | 2,778        | 3,776        | 4,243        |
| <b>Total Public Debt</b>               | <b>3,623</b>  | <b>3,810</b> | <b>4,065</b> | <b>4,357</b> | <b>4,802</b> | <b>6,044</b> | <b>7,629</b> | <b>8,894</b> |
| GDP                                    | 4,876         | 5,641        | 6,500        | 7,623        | 8,673        | 10,243       | 12,739       | 14,668       |
| <b>Total Public Debt (as % of GDP)</b> | <b>74.3</b>   | <b>67.6</b>  | <b>62.5</b>  | <b>57.2</b>  | <b>55.4</b>  | <b>59.0</b>  | <b>59.9</b>  | <b>60.6</b>  |

**(3) Ensure “that in every financial year, beginning from the first July, 2003, and ending on the thirtieth June 2013, the total public debt is reduced by no less than two and a half percent of the estimated gross domestic product for any given year, provided that social and poverty alleviation related expenditures are not reduced below 4.5 percent of the estimated gross domestic product for any given year and budgetary allocation to education and health, will be doubled from the existing level in terms of percentage of gross domestic product during the next ten years.”**

During the fiscal year 2009-10, 0.7 percentage point of GDP was added to the stock of total public debt.

|   | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 |
|---|------|------|------|------|------|------|------|------|
| Social sector and poverty related expenditure (as % of GDP) | 3.6  | 3.9  | 4.2  | 4.9  | 4.9  | 9.3  | 6.9  | 6.7  |
| Expenditure on education (as % of GDP)                      | 1.6  | 1.7  | 1.8  | 1.9  | 1.9  | 1.8  | 1.9  | 1.8  |
| Expenditure on health (as % of GDP)                         | 0.5  | 0.5  | 0.5  | 0.5  | 0.6  | 0.6  | 0.7  | 0.8  |

Social and poverty alleviation related expenditure (as given by pro-poor budgetary expenditure excluding non-development outlays on law and order) remained at 6.72 percent of GDP in 2009-10. Additionally, expenditure on health and education in 2009-10 amounted to 0.76 percent and 1.77 percent of GDP respectively.



***(4) Not issue “new guarantees, including those for rupee lending, bonds, rates of return, output purchase agreements and all other claims and commitments that may be prescribed, from time to time, for any amount exceeding two percent of the estimated gross domestic product in any financial year: Provided that the renewal of existing guarantees shall be considered as issuing a new guarantee.”***

New guarantees issued by the government in 2009-10 amounted to Rs. 224 billion or 1.53 percent of GDP. Moreover, the government rolled over existing guarantees equal to 0.71 percent of GDP issued against borrowing of different power sector entities to facilitate transfer of their loans into Power Holding Pvt. Ltd. The government also issued letter of comfort equivalent to 0.52 percent of GDP against commodity finance.

Since last few years, Pakistan is faced with serious challenges both at the domestic and international fronts. Serious internal security situation, energy shortages, rehabilitation of IDPs, severe floods and rising inflation combined with global economic & credit crises and higher commodity prices have all put enormous pressure on government’s limited fiscal resources. Given the severity of these constraints, the government has been able to manage the fiscal deficits at reasonable levels though was unable to totally comply with some provisions of FRDL Act 2005. However, the government remains fully committed to adhere to all the provisions of FRDL Act 2005 in future.

#### **XIV. Concluding Remarks**

Pakistan’s fiscal deficit increased to 6.3 percent of GDP in FY2009-10 against the budgeted target of 4.9 percent whereas fiscal deficit for FY2008-09 was 5.3 percent. Lower revenue collection and higher than budgeted expenditure on security and subsidies were the main reasons for this undesirable increase in fiscal deficit. Developments during FY2010 reversed the macroeconomic consolidation achieved in the last fiscal year.

Revenue collection remained weak throughout the year. Pakistan’s tax-to-GDP ratio has slightly improved to 10.0 percent of GDP in FY2009-10 compared to 9.5 percent in FY2008-09, though still lower than desired. Growth in real revenues is a prerequisite to successful implementation of the government’s socio-economic targets. The performance of Pakistan’s revenue collection in real terms has been weak at best i.e. 2.0 percent in the fiscal year 2009-10. Furthermore, real growth of 7.9 percent in expenditure has been higher than the real growth of revenues which has had significant

consequences for the fiscal deficit. Persistent divergence between growth of revenues and expenditure has led to escalating revenue deficit to the tune of 2.1 percent of GDP. The primary balance also remains in deficit by 2.0 percent of GDP. Going forward, significant growth in real revenues is essential to maintain fiscal sustainability, and to finance the government's economic plans.

In last three fiscal years Pakistan's fiscal deficit has averaged 6.4 percent of GDP which has resulted in declining national savings and investments in the economy, jeopardizing the economic and social stability of the country. FY2009-10 was the third consecutive year of double digit inflation and higher fiscal deficits have contributed towards this rise. The energy shortages and security concerns have considerably reduced the non-debt creating external flows; fortunately a sharp narrowing of current account deficit has deferred the pressure on balance of payment in the presence of higher deficits. Increase in commodity prices in the wake of global economic recovery and drying external finance account flows will pose serious risk to external account sustainability of the country. With the international price of oil rising, it is imperative that the government maintains its market-based pricing policy for POL products and avoid additional strains on limited budgetary resources. Government should take corrective measures to augment the foreign currency inflows.

The fiscal policy must balance the need to support a still fragile economic recovery and the potential for financial stress, underscoring the criticality of firm dedication to credible strategies that lower fiscal deficits over time and where funding pressures are present or seem imminent, supported by upfront measures.

Fiscal policy should explore opportunities for augmenting the resource envelop rather than cutting expenses. At the same time, expenditure should be rationalised and non-productive outlays should be curtailed that will bring improvement in the national investment climate, saving incentives and opportunities, and competitiveness of the real economy. Institutionalization of policy coordination cannot be overemphasized for growth and sustainability of national economy. The pool of national savings must be enhanced, allowing for required investments to be made without putting the government's fiscal position at risk. Positive real interest rates are essential as they will attract substantial funds currently outside the purview of the official monetary system. Moreover, budgetary borrowing options need to be revisited to ensure that financing of future deficits does not dilute monetary policy's efforts to keep money supply in check and tackle inflation.

There is a need to re-orient policy towards resource management. Successful resource management, as opposed to adjustments made in response to crises, will play a fundamental role in addressing structural weaknesses of the economy. Such policy orientation will also limit the need for adjustments in times of distress as these adjustments pose serious implications for investment-hungry infrastructure bottlenecks. Going forward, we need to strike a balance in development expenditure on account of infrastructure and improvement in social sector indicators to align expenditure with social responsibility.

A considerable drain on government resources has been an increasing burden of contingent liabilities in order to cover the losses incurred by public sector enterprises (PSEs). Accordingly, the contingent responsibility of the government has, most of the times, transformed to a reality as these bodies lacked the capacity to service their obligations. In order to allow efficient fiscal adjustments, the root cause of these public sector entities' losses must be tackled by comprehensive restructuring and introduction of corporate management structures, rather than absorbing their liabilities into the government budget. In essence, encouragement to explore and develop alternate financing mechanisms is a viable solution to this problem. Increasing the capacity for financial management as well as ensuring private sector participation will allow for cost-efficient access to funds to cover the obligations of the PSEs, as well as to finance infrastructure upgrades.

For Pakistan, a daunting fiscal challenge lies ahead, particularly after the recent devastating floods that have left the policy makers with little options to undertake crucial fiscal adjustment measures. Put it another way, a balancing act lies ahead for fiscal policy in creating fiscal space while meeting new demands on the budget. The focus for creating fiscal space should be on revenue mobilization and optimization of the composition of budgetary expenditure by reprioritizing public expenditure, improving the efficiency of spending, as well as reforms which could help limit future fiscal pressures.

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The background of the page is a light, faded image of a tree branch with several oval-shaped leaves. The leaves have visible veins and are arranged along the branch. The overall tone is soft and natural.

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