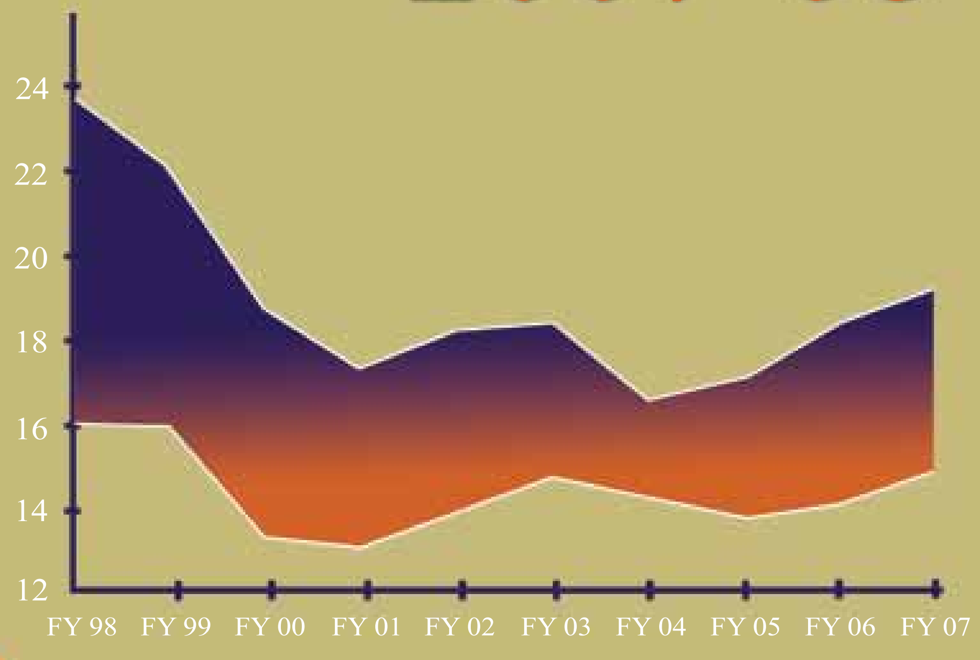
FISCAL Policy Statement 2007-08



Debt Policy Coordination Office (DPCO)
Ministry of Finance, Government of Pakistan,
Islamabad. January 31, 2008

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TABLE OF CONTENTS

LIST OF TABLES

Acknowledgement

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Director General (Debt Office)
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LIST OF ACRONYMS

FRDL	Fiscal Responsibility and Debt Limitation Act 2005
GDP	Gross Domestic Product
PSDP	Public Sector Development Program
Q1	First Quarter of 2007-08 (July-September 2007)
PIB	Pakistan investment Bonds
T-Bills	Treasury Bills
FBR	Federal Board of Revenue (formerly Central Board of Revenue)
SBP	State Bank of Pakistan
NSS	National Saving Scheme
DPCO	Debt Policy Coordination Office
MoF	Ministry of Finance, Government of Pakistan
BE	Budget Estimate
RE	Revised Estimate
FED	Federal Excise Duty
IT	Income Tax
ST	Sales Tax
NAM	New Accounting Model
WHT	Withholding Tax
POL	Petroleum, Oil and Lubricants
MTBF	Medium-Term Budget Framework
COD	Collection on Demand
VP	Voluntary Payments

I: INTRODUCTION

1. Over the last year there have been several political and economic events that occurred unexpectedly, for which the Government had to adjust its policies in order to counter the effects on the domestic economy. Such events include sky-rocketing international oil prices, the domestic as well as global food inflation phenomena, the sub-prime crisis in the United States and the resultant slowdown of worldwide economic activity, and the disturbed law and order situation in the country. An important tool that the Government can use to counter such events and minimize the impact of these developments on the domestic economy is to maintain financial discipline which is enriched in the Fiscal Responsibility and Debt Limitation Act 2005 (FRDL).

2. Government typically aims to promote strong and sustainable economic growth with a view to creating employment opportunities and lasting poverty reduction. It is generally argued that a sound fiscal position is key to achieving macroeconomic stability, which is increasingly recognized as critical for sustained economic growth and poverty reduction. A sound fiscal policy also helps to mobilize domestic savings, increase the efficiency of resource allocation, and help meet development goals. A loose fiscal policy, on the other hand, can lead to higher inflation, higher interest rates and crowding out of private investment, all of which can hamper growth and poverty reduction efforts. Economic growth and human development critically depend on accumulation of physical and human capital, which in turn requires an adequate level of national savings. As private sector savings are often low in developing countries, a sound fiscal policy can play a central role in mobilizing resources by raising revenue on the one hand and reducing less productive spending on the other. The importance of sound and rule based fiscal policy therefore cannot be over emphasized in a developing country like Pakistan.

3. Pakistan has witnessed serious macroeconomic imbalances in the 1990s mainly on account of its fiscal profligacy. Persistence of large fiscal deficit resulted in unsustainable levels of public debt, adversely affecting the country's macroeconomic environment. Pakistan accordingly paid a heavy price for its fiscal indiscipline in terms of deceleration in economic growth and investment, and the associated rise in the levels of poverty. Considerable efforts have been made over the last seven/eight years to inculcate financial discipline by pursuing a sound fiscal policy. Pakistan's hard earned macroeconomic stability is underpinned by fiscal discipline.

4. There has been increasing acceptance worldwide that financial discipline over a prolonged period is essential for maintaining macroeconomic stability. There is also a general consensus that a prolonged commitment to financial discipline can only come from a rule-based fiscal policy. What is a rule-based fiscal policy? The rule essentially aims to imposing durable fiscal discipline and overcoming the problem of "deficit bias". Such rules attempt to impose an underlying constraint of varying degrees on fiscal policy and often on those that make it. The rule typically requires that the government commit to a fiscal policy strategy or to specific fiscal targets that can be monitored. International experience suggests that countries that have adopted well-designed fiscal rules and implemented effective operational mechanism for enforcing them have made important

credibility gains, reflected by cheaper access to financial markets and greater electoral support.

5. The Government believes that there is no alternative to a rule-based fiscal policy. Accordingly, a rule-based fiscal policy, enshrined in the Fiscal Responsibility and Debt Limitation Act 2005, was passed by the Parliament in June 2005. This Act ensures responsible and accountable fiscal management by all governments - the present and the future, and would encourage informed public debate about fiscal policy. It requires the government to be transparent about its short and long term fiscal intension and imposes high standards of fiscal disclosure. Given the difficult past that Pakistan's macroeconomic environment had reached by the end of the 1990s, a rule-based fiscal policy was considered essential for maintaining macroeconomic stability and promoting growth on a sustained basis.

The present Fiscal Policy Statement is prepared to fulfill the legal requirement of Section 6 of the FRDL Act 2005. The Act specifies that the Fiscal Policy Statement (FPS) shall analyze the key macroeconomic indicators such as total expenditure, total revenues, total fiscal deficit, revenue deficit and total public debt. The Act requires that the Federal Government shall explain how fiscal indicators accord with the principles of sounds fiscal and debt management. The Act also requires that the FPS, besides analyzing key macroeconomic indicators stated above, must also contain:

a) The key fiscal measures and rationale for any major deviation in fiscal measures pertaining to taxation, subsidy, expenditure, administered 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 in section 5 of the Act.

II: PRINCIPLES OF TAX AND EXPENDITURE POLICY

II-*i:* Principles of Tax Policy

6. It should be the continuing endeavour of the Government to implement the following principles of tax policy: (i) widening the tax base, (ii) reducing exemptions, (iii) providing incentives and concessions wherever required, (iv) reducing multiplicity of tax rates, (v) lowering tax rates, (vi) shifting the incidence of tax burden from production to consumption, (vii) moving away from the excessive reliance on manufacturing and

taxing all value additions including services, (viii) enhancing the neutrality between present and future consumption, (ix) enhancing the neutrality of the tax system to forms of business organizations and sources of finance, (x) re-engineering the business process of the tax system to overcome the culture of tax avoidance and evasion, (xi) effecting business process changes in tax administration to establish an effective and efficient tax system. These are the guiding principles of the tax policy which the Government should focus on and employ.

7. The current phase of high growth provides us an opportunity that should be used to improve the fiscal health of the country. We must increase our revenues without hurting the growth momentum. It is Government's intention to undertake major tax reforms to improve the tax-to-GDP ratio, expand the taxpayer base, increase tax compliance and make tax administration more efficient. Government is moving to a tax system that is based on moderate rates and wider base through rationalization of exemptions. Despite recent reforms, the tax effort remained modest in Pakistan owing to various structural problems. The administrative reforms envisaged by the FBR, especially moving toward a functional organizational structure, has helped to enhance tax efficiency, as well as improving the tax climate and governance. However, expanding taxation gradually into the agricultural and service sectors would bring greater yields, and would help reduce tax evasion.

Table-1: Sharing Tax Burden among Various Sectors (FY05)

Description	Share in GDP	Share in Taxes	Point Contribution to GDP Growth
Agriculture	**22.5**	**1.2**	**1.5**
Manufacturing	**17.9**	**62.2**	**2.2**
Construction	2.1	2.9	0.4
Electricity & Gas Distribution	3.5	5.3	0.1
Transport, Storage & Communication	**10.4**	**4.5**	**0.4**
Wholesales & Retail Trade	**18.6**	**2.8**	**2.0**
Finance & Insurance	4.0	3.9	1.0
Public Administration & Defense	5.9	5.0	0.04
Social & Community Services	9.5	7.8	0.6
Others	5.6	4.4	0.1
Total	**100.0**	**100.0**	**9.0**

Source: Quarterly Report of FBR April-June 2005 & Pakistan Economic Survey 2004-05

8. Why is tax-to-GDP ratio in Pakistan low in comparison to many developing countries? Why amidst highest ever growth performance in recent past Pakistan's tax-to-GDP ratio has fallen in 2004-05? The answer is simple, nominal GDP grew at a faster pace than tax revenue but actually one has to look into the anatomy of economic growth to find the answer. Table-1 gives some break-up of the contributions of various components of GDP in overall GDP and taxes for financial year 2004-2005. Although the figures are for a different year, sectoral composition of tax contribution has remained almost unchanged and the numbers can be used to make significant inferences. Almost three-fourth of contribution to real GDP growth (8.6%) came from agriculture (1.5%) and

services sector (4.1%) but their contribution to tax revenue is less than 10 percent whereas the contribution in growth from manufacturing is less than one-fourth but its contribution in tax revenue is close to two-third of the total. This uneven mismatch between sectoral contributions to growth and tax revenue tells the story of the fate of all tax reforms ranging from administrative reforms to broad basing the tax revenue.

II-*ii:* Principles of Expenditure Policy

9. The effectiveness and credibility of government policies is critically dependent on the availability of timely and accurate financial and management information, a framework of financial and accounting principles and procedures designed according to internationally accepted standards, and a system of public accountability that includes a strong and independent legislative audit function. The Government has made significant progress in its efforts to separate its accounting and auditing functions and re-engineer its economic and financial management function to include as key elements of its strategy:

- A modern accounting system designed according to internationally recognized accounting principles and standards, and based on modern information technology to ensure ready availability of relevant, accurate and timely information required by economic managers as a decision support system.
- A governance structure and legal framework consistent with international standards for an independent comprehensive audit function which supports public accountability by timely reporting to the legislature for effective and appropriate action;
- Increasing professionalism of the elements of its civil services which deal with financial and economic management, requiring key competencies in staff training and appropriate human resource management policies emphasizing performance, experience and knowledge; and,
- Increasing partnership between the private and public sectors in their respective areas of comparative advantage

10. The separation of audit and accounts, and improvement in financial reporting would help produce accurate, timely and meaningful accounts which cater to the needs of the users and could be used to produce analysis of budgeted data reported in monthly accounts producing significant deviation between actual budgeted account and total actual expenditures and receipts. This would help budget formulation in a more constructive manner and promote the idea of good governance. The improvements envisaged in the Audit component would help in enhancing accountability on the part of the Government and, consequently, more effective and efficient government. More specific benefits of reforms include:

- Modernized government audit procedures and adoption of internationally accepted auditing standards will eradicate program oversights and improve evaluation capabilities.
- Effective accounting and reporting systems will enable the government to better formulate, control, and monitor its budget.
- Strengthened financial management practices will increase the effectiveness of development programs and related external assistance.

- Financial information generated by the improved accounting and information systems will be more useful, complete, reliable and timely. Improved data will facilitate program management by government decision-makers.

11. The Government is moving ahead on its agenda to improve expenditure management and fiscal transparency. The New Accounting Model (NAM) had been used for 2004/05 federal budget. However, because of capacity constraints at the provincial level, the NAM is used in parallel with the existing model except only in the North West Frontier Province (NWFP), while implementation in other provinces will take some time. Pakistan is moving to develop a medium-term budget framework (MTBF) amidst some capacity constraints. Reforms of fiscal reporting and expenditure management have been put to fast track to increase the efficiency of public expenditure. The fiscal reforms during the last seven years focused on improved resource mobilization, public expenditure reform, more effective use of government resources, and improved public sector management.

III: FISCAL POLICY DEVELOPMENTS

12. Pakistan has made considerable progress in recent years on the fiscal side. The overall fiscal deficit that averaged nearly 7.0 percent of the GDP in the 1990s has steadily declined to 2.3 percent in 2002-03 but increased to 3.3 percent in 2003-04 on account of higher development spending. Fiscal deficit has remained above 4.0 percent of GDP for the last two years (2005-06 and 2006-07) mainly on account of earthquake related spending and higher development expenditure, particularly towards financing of physical and human infrastructure projects. The target set for 2007-08 shows a decrease in the fiscal deficit to 4.0 percent of GDP as the government anticipates higher tax revenues due to a wider tax base. Pakistan, as a developing nation, needs to spend more to strengthen its physical and human infrastructure so that the growth momentum in the coming years becomes sustainable.

13. A look at Table 2 reveals some important structural shifts in patterns of revenue and expenditures. On the revenue side, the tax-to-GDP or revenue-to-GDP ratio exhibits a secular decline over the last one and a half decade. On the expenditure side, total expenditure and its components also exhibit a secular decline as percentage of GDP. Fiscal deficit as percent of GDP also declined substantially during the same period. However, reduction in fiscal deficit owes mainly to sharper reduction in expenditure – more so to development expenditure – rather than improvement in revenue effort. Reduction in fiscal deficit since 1999-2000 owes partly to the improvement in revenue side and partly to the rationalization of expenditure – particularly in the shifting of expenditure from current to development and leaving the total expenditure to remain stagnant. Going forward, a further reduction in fiscal deficit has been targeted for 2007-08 which translates from an improvement in revenue. The improvement in tax effort should not be limited to Federal Government alone. The Provincial Governments will have to do much more to enhance their provincial tax-to-GDP ratio from the current stagnant level of 0.5 percent to at least 1.0 percent of GDP in the medium-term.

Table 2: Fiscal Indicators as Percent of GDP								
	Real	Overall	Expenditure			Revenue		
Year	GDP Growth	Fiscal Deficit	Total	Current	Development	Total Rev.	Tax	Non-Tax
FY91	5.4	8.8	25.7	19.3	6.4	16.9	12.7	4.2
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†	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	18.7	16.5	2.2	13.5	10.7	2.8
FY01	1.8	4.3†	17.2	15.5	1.7	13.3	10.6	2.7
FY02	3.1	4.3†	18.8	15.9	2.9	14.2	10.9	3.3
FY03	4.7	3.7	18.6	16.3	2.3	14.9	11.5	3.4
FY04	7.5	2.4	16.7	13.5	3.2	14.3	11.0	3.3
FY05	8.6	3.3†	18.4	14.5	3.9	13.8	10.1	3.7
FY06	6.6	4.2*†	18.7	14.4	4.3	14.2	10.4	3.8
FY07	7.0	4.3*†	20.2	15.8	4.4	14.9	11.0	3.9
FY08 Q1		1.6	4.7	3.4	1.3	3.1	2.2	1.0

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.
† 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.

III-*i*: Fiscal Performance during 2006-07

14. The Government maintained financial discipline with regards to expenditure while surpassing revenue collection targets set for the financial year 2006-2007. Reforms to the taxation system have been successful in increasing revenues, but the gains are somewhat lower than expected.

III-*i-a*: Overall FBR Tax Collection and Refunds during 2006-07

15. The provisional collection (as per reconciliation certificates) of Rs. 846.4 billion during FY07 exceeds the target of Rs. 835 billion by Rs. 11.4 billion or 1.4%.The fact that FBR has surpassed the start-of-the-year revenue target for the fifth year in a row is not only encouraging from effective economic management standpoint, it is even more inspiring as it reflects improved tax management and compliance without putting undue burden on taxpayers. Nonetheless, it is also pertinent to mention that in view of the unprecedented performance of income and corporate taxes during FY07 and sluggish growth of Sales Tax and customs duties, the start-of-the-year targets of individual taxes were revised during the year without altering the overall target. The outcome reveals that the provisional net collection of direct taxes has exceeded the original target by 26% and the upwardly revised target has also been surpassed by 4.1%. Regrettably, a similar performance could not be recorded for indirect taxes. Whereas the collection of excise duties exceeded the original target by 3.5%, it remained short of the revised target by a small margin of Rs. 0.5 billion only. On the other hand, the year-end collection of sales

tax and customs duties missed the respective original as well as revised targets due to constantly shrinking base.

16. The gross and net collection during FY07 has been Rs. 928.6 billion and Rs. 846.4 billion, showing an increase of 15.8% and 18.6%, respectively over FY06. In the process of crossing the Rs. 800 billion threshold, several interesting features have emerged, some of which are presented below. Firstly, the net collection has more than doubled within a short span of five years starting from Rs. 404.6 billion in FY02. The increase of Rs. 133 billion over and above last year's net collection of Rs. 713.4 billion has been the highest ever in the country's history. This confirms that there is a definite improvement in the tax collection effort.

Secondly, the buoyant tax collection has not only enabled FBR to surpass its target, it has also resulted into an improvement in Tax/GDP ratio from 9.4% in FY06 to 9.7% in FY07. In fact, this is the 2nd consecutive year that the Tax/GDP ratio has increased by 0.3% per year, which is consistent with the ten-year revenue vision of the organization.

Thirdly, the income and corporate taxes have emerged as the leading contributors to federal tax receipts followed fairly closely by sales tax. There is a subtle change in the tax mix as 76% of entire net collection now originates from income and consumption taxes.

Fourthly, riding on the overwhelming performance of the corporate sector, especially banking and, oil and gas sectors, the direct taxes have recorded an unprecedented growth of 48.2% during the year. Similarly, the continuous strong domestic demand was largely instrumental in achieving 29.4% growth in excise duties. However, a similar strength was not achieved in the case of domestic Sales Tax, as quite unexpectedly, the growth in gross as well as net collection remained below 10%. Regarding import related taxes, namely, Sales Tax at import stage and customs duties, there has been an adverse revenue impact of slowdown of imports and dutiable imports, even though some might appreciate this decline on account of improvement in the balance of trade position.

Table-3: Net Tax Collection (Rs. Billion)

	July-June		
	2005-06	**2006-07**	**% Change**
A. Direct Taxes	**224.6**	**333.4**	**48.4**
B. Indirect Taxes	**487.9**	**513**	**5.1**
- **Sales Tax**	294.6	309.3	5.0
▪ **Import Related**	171.7	175.8	2.4
▪ **Domestic Production**	123.0	133.5	8.5
- **Customs Duty**	138.2	132.2	-4.4
- **Central Excise**	55.0	71.5	30
Total Taxes (net) A+B	**713.4**	**846.4**	**18.8**

Source: Federal Board of Revenue

Finally, it will not be out of merit to mention that a number of additional factors have also been responsible for improved revenue performance during the past few years. These include the lowering of tax and tariff rates of capital goods to promote investment and boost economic activity in the country, reduction of up-front cost of doing business through automation of business processes, continuous reduction in corporate tax rates to cultivate corporate culture, drastic reduction in litigation burden, and most importantly, offering a hassle-free environment to the taxpayers through dedicated tax units and efficient workforce.

III-*i-b:* Detailed Analysis of Individual Taxes during 2006-07

17. It is encouraging that the target of Rs.835 billion has been surpassed by Rs.11.4 billion. However, the variation in performance of the different types of taxes requires individual analysis of their performance. The tax-wise details are provided below.

Direct Taxes: The direct taxes have surpassed the original as well as upwardly revised targets of Rs. 264.7 billion and Rs. 318 billion, respectively. The provisional net collection so far has recorded an all time high growth of 48.2% whereas the overall growth in gross collection has been 41.2%.In terms of value, the net collection has reached Rs. 333.4 billion, which is Rs. 108.4 billion higher than last year. Some of the important features of direct taxes are as follows.

Firstly, compared to 2003-04 when the net collection was Rs. 165 billion, there has been more than 100% increase in net collection within a short span of three years, which is a sure sign of improvement in the taxation system in general and of direct taxes in particular. Consequently, the direct tax to GDP ratio has increased from 3% in FY06 to 3.8% in FY07.

Secondly, with improved tax effort and effective implementation of tax policy and administrative reforms, the share of direct taxes in federal tax receipts has increased from around 15% in early 1990s to 32% in 2000-01. It has now touched new heights of 39.4% in 2006-07. One of the implications of this change has been that direct taxes have now emerged as the leading revenue contributors of federal taxation receipts – a transition that has always been desired on equity and efficiency grounds.

Thirdly, through a combination of policy interventions, such as the introduction of Universal Self-assessment (USAS) and revised regime of advance tax Payments on the one hand, and better human resource management on the other, the voluntary compliance has improved tremendously.

Fourthly, with improvement in voluntary compliance, the reliance of income and corporate taxes on withholding taxes (WHT) has decreased from 57.3% in FY06 to 49.2% in FY07. This feature together with improvement in the share of direct taxes in total federal tax receipts confirms that the overall taxation system in Pakistan is becoming less and less regressive as compared to earlier years.

Finally, two additional achievements during FY07 include the enhancement of direct tax base and the completion of the process of re-organization of field offices on functional lines. With 20% increase in tax base, the number of National Tax Number (NTN) holders has jumped from 2.1 million to 2.52 million during the last two years.

Contribution of Corporate Sector in Income and Corporate Taxes:

18. Despite the continuous reduction of corporate rates for banking and private companies, the income tax collection from corporate sector has increased at an accelerated pace during the past few years. Due to enhanced profitability of this important sector, the gross income tax collection has increased from around 60% in FY05

to 76% in FY06. According to provisional collection, it has maintained its share of around 76% during 2006-07 as well.

The breakup of the corporate sector contribution is quite interesting. To start with, the overall contribution has increased from Rs. 171 billion during the last fiscal year, to Rs. 250 billion during the current fiscal year. The collection from public, private and banking companies has increased by 47.6%, 36.9%, and 69.6% respectively, reaching Rs. 92.9 billion, Rs.112.1 billion and Rs. 44.6 billion. Whereas the improved profitability of the banking sector has been instrumental for improved performance of banking companies, the robust growth of public companies has mainly originated from the oil and gas sector. On the other hand, private companies have registered the weakest growth among the corporate sector. In fact, the share of private companies in total corporate sector contribution has declined to 45% in FY07 from 48% in FY06. This outcome highlights the need of revisiting the extent of tax compliance by the private sector, which incidentally is quite appalling in view of the fact that only one third of the corporations in the past have declared taxable income.

Voluntary Compliance:

19. As stated above, with the passage of time voluntary compliance has shown dramatic improvement. The gains so far accrued is a reflection of many factors including superior tax effort and better facilitation, simplification of returns, implementation of self-assessment, and introduction of a simplified procedure of advance tax payments. As a result, there is a tremendous increase in payments with returns and advance taxes. On the whole, the voluntary payments have increased by 89% -- an increase from Rs. 87.4 billion in FY06 to Rs. 165.1 billion in FY07. Of the two components of voluntary compliance, payments with returns have increased by 100.8% and the advance tax payments have reached Rs. 117.9 billion during the current fiscal year, as compared to Rs. 63.4 billion during the last fiscal year.

Within the advance tax payments category, the combined share of banking, oil and gas, and telecom companies has increased from 48.6% during the present FY to 54% during the current FY. Nonetheless, major improvement has come from banking companies whose share has jumped to 27.5% during 2006-07 from 13.9%, showing a remarkable increase of about 265% from Rs. 8.8 billion in FY06 to Rs. 32.1 billion in FY07.

The oil and gas sector has also recorded a healthy growth of 63%, but the same has not been the case for the telecom sector where advance tax payments have declined despite a strong growth in the telecom business. Whereas the overall performance of the corporate sector has been encouraging, the narrowness of tax base remains a concern that is being sorted out actively. Another indicator of voluntary compliance is the number of returns and statements filed by the taxpayers during the year. There has been an increase of 21% in this area against the target of 20% set under the Prime Minister’s Goal–Target initiative.

The returns have registered a growth of 11.4%, while the statements have increased by 29.5% during the year. Within the returns-category, while the voluntarily submitted corporate returns have increased by about 9%, this number continues to remain short of the corporate NTN base by a wide margin. Regarding statements, the largest increase has been on account of salary certificates, while the statements submitted by traders and retailers have maintained a normal growth trend.

Collection through Demand Creation:

20. The collection on account of demand creation has reduced to a minor component. It has declined during FY07 by 34.5% as compared to the preceding year.

Table 4: Contribution of Corporate Sector in Income Tax (Gross) Collection (Rs. Billion)

Heads	Gross Collection		Growth (%)	Share (%)	
	2006-07	2005-06		2006-07	2005-06
Corporate Sector	**250**	**171.1**	**46.1%**	**76%**	**70.0**
- Advance	116.9	62.3	87.6%	N/A	25.5
- Others	133.1	108.8	22.3%	N/A	44.5

Source: FBR

Withholding Taxes (WHT): WHT is the second important component of income and corporate taxes. Even though its share in gross income tax collection has declined from 57.3% in FY06 to 49.2% in FY07, the magnitude of the overall collection has increased since 2005-06. In absolute terms, Rs. 170.7 billion has been collected from this source against Rs. 139.4 billion during last year, showing a growth of 22.4%. The decline in the share of WHT in total gross income tax has been due to the fact that voluntary compliance has improved at much faster rate than the increase in WHT. However, notwithstanding this rationale, the outcome is consistent with the overall policy environment that envisions less and less reliance on WHT and promotion of voluntary compliance.

It is evident that the deduction on contracts and supplies is the major source of revenue generation. Given that the pace of economic development and government spending is expected to increase further in coming years due to higher PSDP allocations, this source will continue to hold a dominating position for quite some time to come. This source is followed by deductions on international trade activities. The combined share of WHT on imports and exports of about 22% is indicative of a position that, by and large, traders are 'satisfied' with the present presumptive and adjustable WHT regimes. Deductions on salaries continue to constitute nearly 10% of WHT receipts.

Finally, with deductions on electricity bills and telephones on one hand, cash withdrawals and bank interest on the other, do confirm that there is a large undocumented sector in the economy that prefers compulsory deductions at source rather than becoming a part of the taxation system by submitting regular returns. The revenue analysis of the components of WHT confirms that most of the WHT heads have performed according to their respective tax bases. For instance, the robust growth in WHT deductions at source on account of contracts and supplies is consistent with increased federal and provincial government spending on infrastructure development and social sector projects to reduce the incidence of poverty in the country. Similarly, the decline in WHT on imports is aligned with the deceleration import growth. The higher growth in deductions on telephone reflects the ever-expanding use of mobile phones and the general growth in the telecom sector. The improved corporate profitability has been instrumental in higher collection from dividends. Finally, deductions on savings instruments have increased due to enhanced profits.

Table 5: Withholding tax Collection (Rs. Million)				
Collection Heads	2006-07	2005-06	Difference	
			Absolute	Percent
Contracts	60,700	46,770	13,930	29.7
Imports	26,100	26,878	-778	-3.0
Salary	16,500	15,521	979	6.3
Export	10,900	8,678	2,222	25.6
Electricity	5,300	5,118	182	3.5
Telephone/mobiles	13,100	7,583	5,517	72.7
a. Sub-Total (Six Major Items)	**132,600**	**110,548**	22,052	20.0
Percentage Share in Total WHT	77.7%	79%		
b. Other WHT	38,100	28,878	9,222	32.0
c. Total WHT	***170,700***	***139,426***	***31,274***	***22.4***
%Share in Gross IT	51%	57%		
				Source: FBR

Indirect Taxes: Despite rapid growth in direct taxes, indirect taxes are still the largest contributor to federal tax revenues. The indirect taxes are comprised of Sales Tax, customs duty and federal excise duty. Major individual spinners of the indirect taxes are documented and a detailed account of its sub-components is given in subsequent paragraphs.

Table 6: Contribution of Major Revenue Spinners in Indirect Taxes (Rs. Billion)					
Sector	Indirect Taxes			Share in Gross (%)	
	2006-07	2005-06	Growth (%)	2006-07	2005-06
1. Petroleum	119.5	105.1	14.2	21.2	19.5
2. Auto Sector	47.3	63.1	-24.8	8.4	11.7
3. Machinery	29.5	26.4	11.6	5.2	4.9
4. Cigarettes	34.2	28.9	17.5	6.1	5.4
5. Telecom	38.1	28.3	34.5	6.8	5.2
6. Iron & Steel	23	27.3	-15.9	4.1	5.1
7. Edible Oils	25.9	23.2	11.6	4.6	4.3
8. Natural Gas	18.4	19.8	-7.2	3.3	3.7
9. Cement	20	17.6	13.8	3.6	3.3
10. Plastic	16.1	14.9	7.3	2.9	2.8
11. Sugar	13.5	15.3	-12.1	2.4	2.8
12. Chemicals	14.4	13.7	5.2	2.6	2.5
13. Electrical Energy	13	13.4	-3.1	2.3	2.5
14. Beverages	10.6	8.9	18.9	1.9	1.6
15. Textile	5.4	5.2	2.8	1	1
16. Fertilizer	12.8	12.1	5.8	2	0.9
17. Coffee, Tea, etc	4.4	4.4	0	0.8	0.8
Sub Total	446.1	427.6	4.3	79.2	79.3
Others	116.8	111.2	4.4	20.8	20.7
Gross	**562.9**	**539.6**	**4.3**	**100**	**100**
Refund/Rebates	49.9	51.1	-2.4		
Net Collection	**513**	**488.5**	**5**		
					Source: FBR

Sales Tax: Sales Tax is now operating as a value added tax and a vital source of federal tax revenue collection. The gross and net collection of Sales Tax during FY07 stood at Rs. 346.9 billion and Rs. 309.3 billion, entailing growth of 5.8% and 4.9% respectively over last year. Although the revised target of Sales Tax has been achieved to the extent of 99.6%, but the overall collection has remained below the expected level – for both of the components of Sales Tax i.e., Sales Tax domestic and Sales Tax imports. Consequently, the share of Sales Tax in FBR tax collection has also declined from 41.3% in FY06 to 36.5% in FY07. Some of the factors that have impeded the desired outcome were: (a) less than expected growth in imports, (b) decline in collection from two leading revenue spinners, namely, the automobile industry and the iron/steel industry, and (c) large refund payments to the energy sector combined with significant refunds to the textile sector despite the zero-rating of the five export oriented industries.

21. The gross and net tax receipts from Sales Tax on domestic production has increased by 4.6 percent and 31.3 percent respectively during 2005-06. Around a 31 percent increase in net collection from domestic economic activity can also be attributed to lesser refund payments (41.0 percent) as compared to last year. On the other hand, Sales Tax collected at import stage has increased by 18.5 percent, which is consistent with 32 percent growth in total imports. In terms of value, the net collection stood at Rs. 171.7 billion in 2005-06 as against Rs.144.9 billion last year.

Domestic Sales Tax Collection and Major Revenue Spinners:

22. The performance of Sales Tax collected on domestic activity indicates that around 71% of gross collection has been generated by ten major revenue spinners during 2006-07 as against 65.4% during last year. The detailed analysis confirms that out of ten major commodities, eight have recorded a positive growth over the corresponding period. Among the leading resource generators, the shares of telecom and petroleum products have been around 36%. Similarly, the collection from natural gas and electrical energy was close to 9% each. The reason for this performance has been multi-faceted. For instance, the increase in collection from POL by 16.5% was mainly due to the price factor. It is now a common observation that international prices of energy have been constantly increasing over the last few years. This higher value has two important impacts. For final products, the higher value is yielding higher revenues, but wherever POL products are being used as inputs, they result in enormous refund claims. Resultantly, the outcome is mixed.

Collection of Sales Tax (Domestic) and Major Revenue Spinners:

23. The net collection from Sales Tax (domestic) [ST (D)] recorded an overall growth of 8.2% partly due to 14.3% increase in refund payments. It appears that improved economic activity could not be translated into better compliances by the Sales Tax registered personnel. It could very well be due to the prevalent stagnation in ST (D) operations, whereby the continuous risk of heavy dependence on small number of revenue spinners has not been mitigated. The sectoral analysis confirms the premise that the Sales Tax base remains narrow. Around 90% of net receipts (Rs. 119.8 billion out of Rs. 133.5 billion), and 80% of gross receipts (Rs. 135.9 billion out of Rs. 170.5 billion) have been generated by only fifteen revenue spinners. The major players include telecom services, POL products, natural gas, sugar, cigarettes, services, LPG, cement, beverages,

auto parts, iron & steel and gases & acids. Of the fifteen major commodities, eleven have recorded a positive growth while there has been a decline in gross receipts on account of two utilities: cement, and motor cars.

24. The detailed analysis of individual sectors reveals that the major stumbling block has been the energy sector, where gross collection of Rs. 13 billion turned into negative net receipts due to unprecedented refund claims and payments during FY07. Similarly, the decline in collection from cement continued throughout the year despite a double-digit growth recorded in federal excise receipts from the source. Whereas a downward revision in its retail-sale price, cement could be one of the reasons for this outcome, but a thorough investigation is needed to find a 'reasonable' explanation for the decline. Finally, the decline in tax collection from motor cars has been due to the slowdown in one of the major brands of the industry, which was responsible for the overall lackluster performance.

25. On the positive side, the continued robust growth in collection from the telecom sector has largely compensated the shortfalls originating from electrical energy, cement, natural gas, and motor vehicles. Among the leading resource generators, the contribution of the telecom and petroleum sectors has been close to 38%. Within the telecom sector, the 37.1% growth in collection has been due to ever escalating demand for telephony and fierce competition among service providers. Not only has the number of mobile phone subscribers increased by about 2.4 million since July 2006, the telephone-density has also increased from 22.2 in June 2006 to 40.6 in June 2007. Furthermore, the land area coverage has also reached 73% in recent months. Besides the telecom sector, strong growth in ST (D) has also been recorded in iron and steel, sugar, cigarettes, services (hotels, customs agents and couriers etc.) auto parts and gases/acids. This performance is consistent with the overall growth in the country and sustained domestic demand.

Table 7: Comparison of Sales Tax Collection from Domestic Activity by Major Commodity (Rs. Million)

	2006-07	2005-06	Growth (%)		2006-07	2005-06	Growth (%)
Telecom	36,868	26,895	37.1	Cigarettes	6,942	5,759	20.5
POL Products(Incl. LPG)	27,811	26,284	5.8	Cement	4,938	5,377	-8.2
Electrical Energy	12,998	13,411	-3.1	Motor Cars	1,874	2,638	-29.0
Natural Gas	12,427	13,286	-6.5	Aerated Waters	3,005	2,614	15.0
Sugar	11,010	8,731	26.1	Auto parts	2,823	2,342	20.5
Major Ten Commodities	120696	107,337	12.4	All Commodities	170,471	155,695	9.5

Source: Central Board of Revenue

Sales Tax at Import Stage:

26. For clarity sake, it is worthwhile to state that the collection of Sales Tax at import stage [ST (M)] crucially depends on the composition and volume of imports. Many items including raw materials have been zero-rated in recent years to promote industrial activity. Others, including food items and related essential products, are Sales Tax exempt. Since the share of ST (M) in total Sales Tax collection has always been significant, fluctuations in imports leaves an impact on tax receipts. This is precisely what happened during FY07, when a lower growth in value of imports has been

registered and consequently, the share of ST (M) has declined by around three percentage point as compared to last year.

Table 8: Sales Tax Collection at Import Stage: Major Items

	Tariff Description	ST (M) Collection		
		2006-07	**2005-06**	**Growth (%)**
1	POL Products	72,454	59,669	21.4
2	Vehicles	14,156	19,562	-27.6
3	Iron and Steel	11,438	14,516	-21.2
4	Plastics and Articles thereof	10,023	8,940	12.1
5	Edible oil and Waxes	9,029	6,191	45.8
6	Sugar and Sugar Confectionery	2,457	6,680	-63.2
7	Electrical Machinery	5,354	5,825	-8.1
8	Mechanical Machinery	7,409	5,532	33.9
9	Organic chemicals	3,816	3,408	12.0
10	Paper and Paperboard	3,646	3,224	13.1
11	Misc. Chemical products	2,698	2,627	2.7
12	Oil seeds etc	3,432	2,259	51.9
13	Coffee, tea and spices	2,403	2,474	-2.9
14	Rubber and articles.	2,171	2,208	-1.7
15	Aluminum Products	2,100	1,583	32.7
Sub-total		*152,586*	*144,698*	*5.5*
Others		23,246	26,846	-13.4
Grand Total		**175,832**	**171,543**	**2.5**

In fact, the overall growth of 8.1% in the value of imports further declined to 6.8% as far as the Sales Taxable value is concerned. This has been due to the decline in custom duty collection which is included in the base value to determine the Sales Taxable value. Moreover, a decline in the effective rate of ST (M) from 9.2% in FY06 to 8.8% in FY07, is partly due to the on-going process of tariff rationalization and improvement in tariff escalation, and had further contributed towards lowering the growth of collection to 2.5% only.

The contribution of major commodity groups of ST (M) collection shows that nearly 87% of tax receipts have been generated by fifteen items. Within these, a double-digit growth has been recorded in POL products, edible oil, mechanical machinery, plastic products, organic chemicals, aluminum products, and paper & paper board. Nine out of the 15 revenue spinners have added Rs. 21.2 billion to this collection as compared to last year. However, a sharp decline in collection has been noticed in the case of vehicles (by Rs. 5.4 billion), iron and steel (by Rs. 3.1 billion), as well as sugar (by Rs. 4.2 billion).

The outcome of the latter two had been anticipated, as the extra demand during the preceding year was due to domestic shortages and has since leveled-off. However, while ST (M) from iron & steel sector has declined by Rs. 3.4 billion, the ST (D) has increased by only Rs. 700 million, indicating that contrary to expectations, a 100% substitution between the two components did not take place. Contrary to this, the decline in collection from sugar has been as per *a priori* expectations; it declined from Rs. 15.4 billion in

FY06 to Rs. 13.5 billion in FY07 due to less import requirements. The decline in ST (M) from vehicles has been due to change in policy regime whereby the age of imported old and second-hand vehicles was restricted to five years.

Moreover, the slowdown in one of the manufacturing/assembling units was also responsible for decreased imports of Complete-Knock-Down (CKD)/Semi-Knock-Down (SKD) units, thereby resulting into reduced import-related taxes. Similarly, the decline in collection on account of electrical machinery has been due to policy changes that resulted in zero-rating most of these products. Finally, the increase in international prices of fuels appears to have a significant impact on the relative strength of POL products – the share of this group has increased from 35% in FY06 to 41% in FY07.

Customs Duties:

27. Historically, the collection of Customs Duties (CD) has been an important source of federal tax revenues. Within the new international environment of globalization and the emergence of Sales Tax, the reliance on customs duties in indirect taxes has already declined as a source of revenue. In Pakistan as well as other countries, the structure of tariff has undergone extensive changes during the past one and a half decades. The tariff rates have been rationalized and reduced to a great extent to encourage local industries to be more competitive. After reducing the maximum rate to 25%, the issue of tariff escalation has been dealt quite extensively during the last three years. Resultantly, more and more primary and semi-manufactured commodities are drifting down to lower slabs.

Table 9 : Sectoral Collection and Growth in Custom Duties (Rs. Million)

	Tariff Description	2006-07	2005-06	Growth (%)
1	Vehicles& Parts	28,246	37,764	-25.2
2	Animal or vegetable fats	15,743	15,947	-1.3
3	POL Products	15,128	15,011	0.8
4	Electrical Machinery	11,138	8,932	24.7
5	Mechanical Machinery	10,526	12,047	-12.6
6	Plastics	5,427	5,436	-0.2
7	Iron & Steel	5,365	7,224	-25.7
8	Paper & Paperboard	3,477	3,292	5.6
9	Organic Chemicals	3,350	3,676	-8.9
10	Articles of Iron & Steel	1,889	1,999	-5.5
11	Misc. Chemical Products	1,742	1,830	-4.8
12	Dyes, Paints etc.	1,581	1,532	3.2
13	Rubber products	1,569	1,579	-0.6
14	Coffee, Tea, Mate and Spices	1,554	1,548	0.4
15	Man made filaments	1,460	1,559	-6.4
	Sr. No. 16-99	18,338	17,953	2.1
	Defense	7,711	6,744	14.3
	Export Dev. Surcharge	2,404	2,287	5.1
	Sub-total	**136,647**	**146,360**	**-6.6**
	Others	8,321	10,455	-20.4
	Gross	144,968	156,815	-7.6
	Refund/Rebate	12,738	18,430	-30.9
	Grand total	**132,230**	**138,384**	**-4.4**

Of course, these changes are not without revenue cost. Nonetheless, these policy measures are necessary to generate greater efficiency in the system.

28. Regarding revenue collection during FY07, it may be recalled that during the past few years the imports were growing in excess of 30% due to unprecedented surge in domestic demand. The expansion of the economy, particularly the industrial sector, was taking place at a rapid pace. However, during FY07, despite reduction in tariff rates for raw materials and machinery, the overall growth in the imports has slowed down to around 8% and the rate of growth of dutiable imports retarded to -4.1%. Consequently, a hefty shortfall in CD collection was recorded during the year. The gross and net collection reduced to Rs. 145 billion and to Rs. 132.2 billion respectively, yielding a decline in CD by 7.6% and 4.4%, respectively.

Performance of Major Revenue Spinners of Customs:

29. An in-depth sectoral analysis has been carried out in the following 15 major commodity groups that constitute around 75% of the CD. The significance of these items can be judged from the fact that they cover 75% of total import value and 84% of dutiable import value.

<u>Automobile Sector</u>: Traditionally, the automobile sector is the largest revenue source of CD. A decline of 21.7% in the dutiable imports has reduced collection by 25.2% during FY07. Since a major chunk of custom duty revenue from this sector is contributed by the import of motor-vehicles, therefore, any change of policy related to motor vehicles, especially old cars/jeeps has serious repercussions on collections from this source. It may be recalled that a revised policy regime restricting the import of motorcars older than 5 years was introduced in the Budget 2006-07. As a consequence, not only the number of imported cars declined, it also adversely impacted the import value and customs duty. This was also evident from an overall loss of Rs. 7.6 billion which was recorded during FY07. Moreover, zero-ratings of agricultural tractors in the Budget of 2006-07, has also resulted in a further loss of Rs. 0.4 billion.

<u>Edible Oils</u>: Despite a significant growth of 22% in imports and 20% in dutiable imports, the collection of CD from edible oils has dropped by 1.3% due to the specific rate of duty. Secondly, the switchover from Refined-Bleached-Deodorized (RBD) palm oils to crude palm oils has also been responsible for the reduction in customs duties. The reason being is that the rate of duty on crude is less than it is on palm oil. Thus, despite a 7% growth in the import of palm oil, a 13% decline in the collection of CD has been registered. Nonetheless, the loss in revenue is not so significant as the imports of crude oil have increased substantially. Therefore the duty on crude oil had, to a large extent, compensated for the loss incurred on the account of palm oil imports.

<u>Petroleum Sector</u>: As far as the collection of Petroleum-Oil-Lubricants (POL) products is concerned, it is relevant to point out that most of the items listed in PCT Chapter 99 under HS 99.28 are custom duty exempt. These include crude oil, motor spirit, aviation spirit, spirit type jet fuel, JPI, furnace oil and MTBE. However, of all these items, the import of crude petroleum and furnace oil is quite significant. In view of this exemption, the modest growth in CD collection originates from the following two reasons. Firstly, dutiable POL products listed under (HS 27.10) recorded a low growth of only 5% during FY07. Secondly, the collection from coal also declined during the year as it was zero-

rated at the time of the announcement of the Federal Budget for 2006-07. It appears that the loss of revenue on account of this policy initiative has been quite instrumental in changing the overall complexion of growth from POL products.

Machinery Group: Electrical machinery and parts exhibited a robust growth of 22% and 27% in imports and dutiable imports, leading to a similar growth of 25% in CD during July-June FY07. The main items that generated this growth were transmission apparatus of line telephony, generating sets and rotary converters with exceptional growth of 30% and 70%, respectively. On the other hand, the import of mechanical machinery and parts was adversely impacted by decline in imports. Hence, collection of CD declined by 12.6%. A deeper analysis confirmed that major machinery items belonging to the textile sector, construction and consumer goods experienced a drop in CD by 43%, 26% and 13% respectively. Moreover, the exemption of computers from CD during the Budget of 2006-07 has also affected the collection during 06-07.

Iron and Steel Sector: Higher growth in import of iron and steel articles was recorded during FY07 due to domestic supply constraints. With the restoration of the domestic supply chain, the imports of products listed under this group have reduced considerably. Resultantly, the CD also declined by 25.7%. Compared to this, the import of articles of iron and steel recorded a positive growth of 13.2%, but the collection declined by 5.5%, due to reduction in tariffs. The items that experienced such an outcome were containers of compressed or liquefied gas, and other articles of steel.

Federal Excise Duty (FED):

30. This source of revenue has started to regain importance due to widening of its base by the inclusion of additional services into the FED net. Its share has increased from 7.7% in FY06 to 8.5% in FY07. The provisional net collection indicates that Rs. 71.5 billion have been collected during FY07, showing an increase of Rs. 16.3 billion over previous year. The growth in collection has been 29.4%.

Traditionally the major sources of FED revenue are cigarettes, cement, natural gas, POL products and beverages. The inclusion of services in this group has been a recent phenomenon. These six items have contributed around 90% of total FED collection during FY07. Among these commodities, cigarettes were the top most contributors followed by cement, natural gas, and beverages. The collection from cigarettes has recorded a 17.1% growth during FY07. A robust growth of over 20% has also been witnessed by cement, POL and beverages. Looking at the rationale, it has been found that a significant growth of 23.4% in cement was due to higher production to cater rising demand. Incidentally, the production of cement increased by 21.1% during July-May 2006-07. The higher collection from cigarettes was possible due to increase in the retail prices of the cigarettes during FY07. The outcome also reveals that the anti-smoking drives are falling on deaf ears, as there is no visible decline in demand. The growth in FED from beverages can be attributed to more than 28% growth in production, which also, albeit indirectly, confirms a rising demand of beverages in the country. Finally, the FED collection has declined in the case of natural gas due to its reduced extraction from fields located in the Balochistan province.

FED on Services: In the Federal Budget of 2006-07, FED was levied on a number of services including: international air travel, non-fund financial services, franchise services, money changers, and cable TV operators. The revenue projection from these additional sources was Rs. 7.4 billion.

31. Compared to the overall estimate, the collection fell short by 54%. The major services like international air travel, non-fund financial services, and franchise services could accomplish only 60.7%, 30.4% and 70.3% of projected collection, respectively. This outcome shows that improved compliance through an effective enforcement will be the real issue in the coming months. This concern is expected to get serious in view of the fact that many additional services have been added to the FED net in the Federal Budget for 2007-08.

Table 10: Performance of FED Major Revenue Spinners (Rs. Million)

	2006-07	2005-06	Difference	
			Absolute	(%)
Cigarettes	27,050	23,097	3,953	17.1
Cement	15,004	12,154	2,850	23.4
POL Products	4,459	3,576	883	24.7
Natural Gas	5,927	6,491	-564	-8.7
Beverages & Concentrate	6,990	5,619	1371	24.4
Total (Major Commodities)	59,430	50,937	8,493	16.7
Share of Five Major in Gross Excise Collection	**89.8%**	**93.3%**		

III-*i-c:* Review of Public Expenditure 2006-07

32. Pakistan has continued to maintain fiscal discipline for the last several years. During fiscal year 2006-07 **total expenditure** stood at Rs. 1675 billion or 19.2% of GDP, which is an increase of Rs. 273 billion or 19.4 percent over last year. As a percentage of GDP, total expenditure increased by 1.1 percentage point from that of FY06. The original target for total expenditure in FY07 was Rs. 1536.6 billion or 17.6% of GDP which was exceeded by a hefty Rs. 138.4 billion. In order to investigate this rise in total expenditure, it is important to analyze the components that make up total expenditure, i.e. current expenditure and development expenditure and their respective sub-components.

Current Expenditure includes defense, debt servicing and civil administration. During fiscal year 2006-07, current expenditure amounted to Rs. 1375 billion or 15.8% of GDP and it exceeded its target for the fiscal year by Rs 268.5 billion. The higher current expenditure figures stemmed from larger than budgeted interest payments, including: (i) a rise in interest payment on domestic debt, (ii) rise in interest payment on external debt, (iii) maturity of long–term debt instrument of Defense Saving Certificates (DSCs) from a decade ago, and (iv) larger maturities of short term domestic debt. Current expenditure stood at Rs. 1375 billion, which shows an increase of Rs. 254 billion or 22.7 percent over last year.

The major components of current expenditure include interest payments and defense spending.

- During fiscal year 2006-07, **Interest Payments** amounted to Rs 369 billion or 4.2% of GDP, surpassing the budget estimate of Rs. 239.5 billion by 54 percent or Rs. 129.5 billion. For FY06 total interest payments were Rs. 237 billion. Interest payments accounted for 26.8 percent of current expenditures during FY07 but the slippages caused by higher-than-budgeted interest payments made up for almost 50% of slippages in current expenditure. These slippages stemmed from the maturities of Defense Saving Certificates (DSCs) sold in FY97 in addition to the remaining Public debt servicing. This shows that the government's additional expenditure was due to past financing commitments and not excessive spending in fiscal year 2006-07.
- **Defense Spending** for fiscal year 2006-07 was Rs. 250 billion or 2.9% of GDP which was consistent with its targeted level. Defense spending for FY06 was Rs. 242 billion, showing a 3.3% increase for this fiscal year.

Table-11: Consolidated Revenue & Expenditure of the Government (Rs. Billion)

	Prov. Actual July-June 2005-06	Prov. Actual July-June 2006-07	Budget Estimate 2007-08	Prov. Actual July-Sept. 2007
A. Total Revenue	1077	1298	1476	312.6
a) Tax Revenue	804	890	1096	215.6
FBR Revenue	713.4	846.4	1025	206.1
Provincial Tax Revenue	37	37	65	9.5
Others	54	7	6	0
b) Non-Tax Revenue	273	408	380	97
B. Total Expenditure	1402	1675	1875	470.8
a) Current Expenditure	1121	1375	1378	339.9
i) Federal	788	973	962	237.3
- Interest	237	369	375	111.1
- Defense	242	250	275	57.5
- Others	309	354	312	68.7
ii) Provincial	333	402	416	102.6
b) Development Expenditure & Net Lending	367	425	496	129.9
PSDP	365	434	543	127.9
Net Lending	2	-9	3	2
Operational Shortfall	0	0	-50	0
c) Unidentified Expenditure	-86	-125	0	1
C. Overall Fiscal Deficit	325	377	398	158.2
As % of GDP	4.2	4.3	4.0	1.6
Financing of Fiscal Deficit	325	377	399	158.1
i) External Sources	149	147	193	36.8
ii) Domestic	79	159	131	121.3
- Bank	71	102	81	69.9
- Non-Bank	8	57	50	51.4
- Privatization Proceeds	97	71	75	0
GDP at Market Prices	7594	8707	9970	9970

Source: Budget Wing, Ministry of Finance

Development expenditure is productive expenditure, and it saw Rs. 425 billion being spent during fiscal year 2006-07 or 4.9% of GDP. Substantially large growth in development spending during the last seven years points towards a growth-oriented fiscal policy stance adopted by the Government. There has been a paradigm shift in the fiscal policy towards social sector spending and infrastructure development. The financial year 06-07 however saw development expenditure miss its original target of Rs. 430 billion by Rs 5 billion. The amount spent, however, was still higher than FY06 where it was Rs 367 billion.

III-*i-d:* Overall Fiscal Deficit 2006-07

33. The **overall fiscal deficit** in fiscal year 2006-07 was 4.3% of GDP. Had there been no earthquake devastation in the country in recent times, Pakistan's fiscal deficit during 2006-07 and 2005-06 would have been less than 4.3 percent and thus, would have played a significant role in further fiscal consolidation. This exogenous shock to the economy played a major role in raising overall fiscal deficit. Underlying budget deficit for FY06 excluding earthquake related expenditure was 3.4% (earthquake expenditure amounting to 0.9% of GDP) and 3.9% (earthquake expenditure at 0.5% of GDP) for FY07.

Revenue balance (Total revenue minus current expenditure) is a measure of the government's savings or dis-savings. Revenue balance remained in deficit to an average of 3.1 percent of GDP during the last three years (1997-98 to 1999-00) of the 1990's. The deficit in revenue balance was reduced to an average of 1.0 percent of GDP during the last seven years (2000-07). Revenue balance was in deficit to the extent of 0.9 percent of GDP in 2006-07. However, in order to meet the requirement of the FRDL Act 2005, the Government has targeted revenue surplus to the extent of 1.0 percent of the projected GDP for the year 2007-08.

The **Primary Balance** (Total revenues minus non-interest expenditure) is an indicator of fiscal "effort", in that interest payments are pre-determined by the size of previous deficits. The primary balance measures as to how the current fiscal policy stance affects the net indebtedness of the country. That is, since interest payments are the result of past deficits, excluding them from the fiscal balance provides a clearer picture of current efforts of the Government. The primary balance is therefore a critical variable for debt sustainability analysis. The debt stabilizing primary balance is the primary balance necessary to keep the debt-to-GDP ratio stable. The primary balance was in deficit by Rs. 8 billion or 0.1 percent of GDP in 2006-07.

III-*ii:* Fiscal Projections 2007-08

III-*ii-a*: Revenue Projections 2007-08

34. Anticipating that the economy will maintain the high growth trajectory and major taxes will also continue to display a buoyant posture, the revenue target for FY08 has been set at Rs. 1476 billion, requiring an increase of 12% over the provisional collection of Rs. 1298 billion of FY07. FBR revenue is projected at Rs. 1025 billion requiring a 21.1% increase over the provisional collection of Rs 846.4 billion of FY07. The

projections for FY08 assume that GDP will grow by 7.2% in real terms; inflation will stabilize at around 6.5% and total imports to increase by 10%. Buoyancy estimate of unity is assumed for all federal taxes except for excise duties. Furthermore, the projections for FY08 also include the expected impact of budgetary and relief measures announced at the time of Federal Budget.

Given that the outturn of individual taxes and growth trajectories are materialized, the projections for FY08 will result into following tax mix of individual taxes: Direct Taxes 39.5%, Sales Tax 37.3%, Federal Excise 9.6%, and Customs Duties 13.7%. The most significant change in this outcome is that there will be a further decline in the share of customs duties compared to FY07 at the expense of FEDs, whose share will increase due to the expansion of the tax base – from an imposition of 1% additional duty and an extension of FED to all non-fund services of financial institutions.

Table 12: Comparison of Revenue (Rs. Billion)

	2006-07 R.E	2007-08 B.E	Growth (%)
Total Revenue	**1298**	**1476**	**13.7**
Tax Revenue	890	1096	25.4
FBR Revenue	846.4	1025	21.6
Direct Taxes	333.4	405	21.5
Indirect Taxes	513	620	20.8
• Sales Tax	309.3	382	23.5
• Federal Excise	71.5	98	37.1
• Customs Duty	132.2	140	5.9

III-*ii-b:* Targets for Expenditure 07-08

Total expenditure is targeted at Rs.1875 billion or 18.8 percent of GDP for the fiscal year 2007-08. Total expenditure was projected to be 11.9 percent higher than last year (2006-07). From total expenditures, **current expenditure** is targeted at Rs. 1378 billion or 13.8% of GDP for the current fiscal year (2007-08). Within the category of current expenditures, **interest payments** are targeted at Rs. 375 billion or 3.8% of GDP for the current fiscal year whereas **defense spending** for the year is targeted at Rs. 275 billion or 2.8% of GDP. **Development Expenditure adjusted for net lending** is targeted at Rs. 546.5 billion or 5.5 percent of GDP for the year 2007-08. Operational shortfall in development expenditure is anticipated at Rs. 50 billion; therefore, development expenditure adjusted for net lending and operational shortfall is targeted at Rs. 496 billion or 5.0% of GDP

III-*ii-c*: Targets for Fiscal Deficit 07-08

35. The fiscal deficit for the year 2007-2008 is targeted at 4.0% of GDP or Rs.399 Billion. The government has also projected a Revenue surplus of Rs. 98 billion or just less than 1% of GDP. The primary balance for the year is projected to be in deficit by Rs. 39 billion or 0.3 percent of GDP.

III-*iii:* Fiscal Performance July- Sept 2007-08

36. The first quarter of the current fiscal year has witnessed a steady growth in revenues with a 12.5 percent growth in tax revenues and an encouraging 51.5 percent increase in non-tax revenue. The latter were driven in part by surging profits for the State Bank and a rise in interest income. However, figures reported also show a significant rise in total expenditure; a 37.5 percent increase from the same period last year. Development expenditure grew by a handsome 89.5 percent. Current expenditures also registered a high growth of 39.2 percent on account of a 100 percent rise in the servicing of domestic debt.

III-*iii-a*: Revenue Collection July-November 07

37. The FBR has significantly surpassed the revenue of last year (Rs. 296.3 billion) fixed for July -November 2007 by collecting Rs. 339.7 billion which is Rs. 43.4 billion or 14.6 percent higher over the corresponding period. This commendable performance has been the result of reforms implemented in the tax system and tax administration over the last several years. Whereas the reform measures have been mostly facilitating in nature, promoting voluntary tax compliance and confidence building, the tax policy initiatives were mostly concessionary in nature to promote economic activity in the country. Particularly, the measures like zero-rating of the entire chain of major export oriented industries, reduction of duty on smuggling-prone items, rationalization of tariff structure and reduction of corporate tax rates have been instrumental in promoting foreign trade activities, discouraging tax evasion, and accelerating industrial growth.

Direct taxes also registered a growth of 17.5 percent during the first five months (July-November) of the current fiscal year. Indirect taxes registered a growth of 13.4 percent, which is higher than last year, mainly due to an increase in the pace of import growth [See Table 13]. Within indirect taxes, Sales Tax is up by 14.4 percent mainly on account of a 14.3 percent increase in this tax at the import stage. Sales Tax collected from domestic economic activity grew by 13.6 percent. Thus, this growth in imports impacted the performance of the Sales Tax collection. Growth in imports also impacted the performance of customs collection as it registered an increase of only 3.7 percent. Central excise duty, also registered a notable growth of 26.4 percent during the period under consideration.

Table-13: FBR Revenue Collection (July-November 2007)
(Rs. Billion)

	Direct Taxes	Indirect Taxes				Total Tax Collection
		Sales	Excise	Customs	Total	
July	14.1	26.2	1.8	8.7	36.8	50.9
August	15.0	28.8	6.5	9.7	45.1	60.1
September	48.4	27.6	7.4	10.5	45.6	94.0
October	17.1	31.5	7.4	10.2	49.1	66.2
November	18.7	29.7	8.3	11.8	49.8	68.5
July-Nov. 07	**113.4**	**143.8**	**31.6**	**50.9**	**226.5**	**339.7**
July-Nov. 06	**96.5**	**125.7**	**25.0**	**49.1**	**199.8**	**296.3**
% Change	17.5	14.4	26.4	3.7	13.4	14.6

Source: Central Board of Revenue

38. Based on this current performance, it is safe to suggest that the FBR is likely to achieve its collection target for the year. Both the growths in indirect taxes as well as growth in collections from direct taxes have contributed to good FBR performances so far.

39. There was a significant increase of non tax revenues during Q1-FY08. Non-tax revenues showed an impressive 51.5 percent increase from the same time period of last year and stood at Rs. 97 billion. This is largely on account of a sharp rise in State Bank of Pakistan's profits and interest income. The rise in transfers of SBP profits and interest income helped compensate for a decline in dividend income, gas surcharge and the PDL.

III-*iii-b:* Overall Expenditure July-September 07

40. Total expenditure at the end of the first quarter of the current fiscal year stood at Rs. 470.8 billion or 4.7% of GDP. Current Expenditure amounted to a total of Rs. 340 billion or 3.4% of GDP. The two sub components of Current Expenditure, i.e. Interest Payments and Defence Spending amounted to 1.1% and 0.6% of GDP respectively. Development Spending from July-September 2007 amounted to Rs. 129.9 billion or 1.3% of GDP.

41. The consolidated public expenditure jumped sharply due to strong increases in both current and development spending. The exceptional 89.5% YoY increase in the latter would be particularly encouraging, if it translates into an improvement in the country's infrastructure and human capital resources. The handsome growth in current expenditures reflects a few major developments. First, interest payments on domestic debt doubled to reach Rs. 98.5 billion quashing the favorable impact of decline in interest payments on foreign debt. The increase in servicing of domestic debt reflects both, an increase in the absolute value of the debt stock, and rising interest rates, as well as the impact of large one-off bullet maturities (principal and interest) of long term bonds (Defence Saving Certificates) issued in the late 1990's (1996-97 and 1997-98).

42. Defence expenditures saw a surge of 26.3 percent in Q1-FY08. This perhaps reflects greater engagement of armed forces to maintain the law and order situation in parts of NWFP and tribal areas. Health and education expenditures observed a welcome increase of 24.1 percent and 34.8 percent respectively. Also, the impact of large subsidies extended by the government to various sectors, such as fertilizers (DAP), food (wheat) and energy (particularly diesel) contributed to a rise in current expenditures.

III-*iii-c:* Overall Fiscal Deficit July-September 07

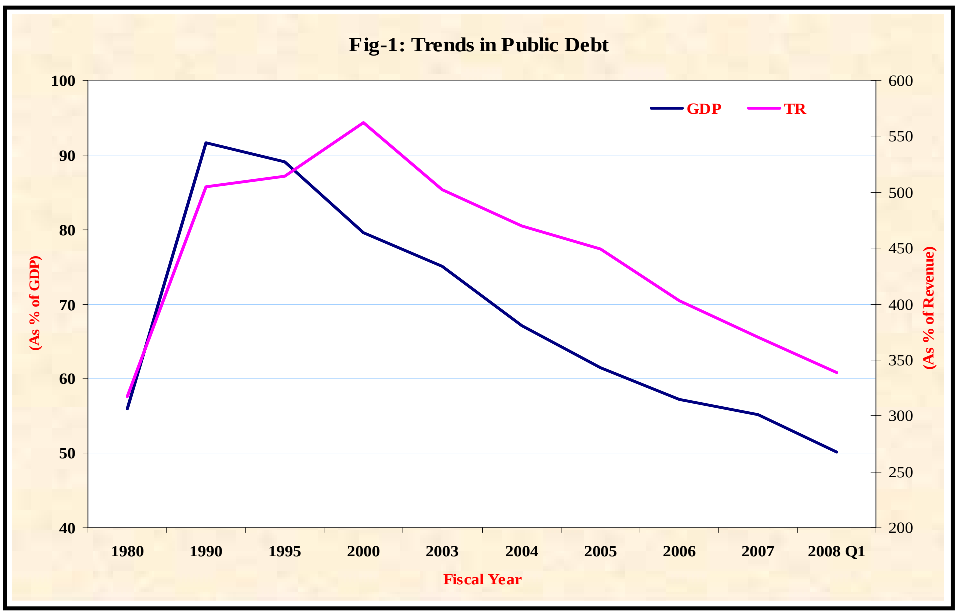
43. The Fiscal Deficit for Q1 of FY08 stood at Rs.158 billion which is 1.6% of the projected GDP. The revenue balance for the first quarter is in deficit by Rs 27.3 billion. If current trends persist, and strong corrective measures are not undertaken promptly, the annual fiscal deficit target of 4.0 percent of GDP for FY08 may not be met. Furthermore, the target of achieving revenue balance, as dictated by the FRDL Act 2005, by the end of the current fiscal year may also not be achieved unless corrective measures to curtail current expenditures or to increase revenues are taken during the remaining period of the fiscal year. It is very crucial that the government makes an effort to achieve the fiscal

deficit target as this would send a strong signal of the government's commitment to fiscal discipline and macroeconomic stability.

IV: REVIEW OF THE PUBLIC DEBT

44. Public debt consists of debt denominated in Rupees and debt denominated in foreign currency. Pakistan's public debt grew by 10.7 percent in 2006-07 while the nominal GDP showed a growth rate of 14.5 percent over the same period. This is in contrast to the experience in the last two decades where Pakistan's public debt grew at a faster rate (18 percent and 15 percent during the 1980s and 1990s) than nominal GDP (11.9% and 13.9% respectively).

45. As a result of slower pace of growth in pubic debt than the nominal GDP, public debt as a percentage of GDP continues to exhibit declining trend. Public debt as percentage of GDP fell from 57.2 percent at the end of June 2006 to 55.2 percent at the end of June 2007. The low level of debt is even more remarkable because just 8 years ago at the end of 1999, debt stood at just over 100 percent of GDP. The slower pace of growth in debt is partly a result of lower average fiscal and current account deficits compared to 1990-99 where average fiscal and current account deficits were almost 7 percent and 5 percent of GDP, respectively.



46. There are clear indications that the debt strategy put in place by the government is bearing fruit as indicated by declining trends in debt. It may be recalled that the government had set-up a high level Debt Committee in 2000, which examined the root cause of the rising debt burden and suggested debt reduction strategy to stabilize debt situation. The government is following the debt strategy as suggested by the Committee. Reduction in the fiscal and current account deficits, lowering the cost of borrowing, raising revenue and foreign exchange earnings, and debt re-profiling from the Paris Club have been the key features of the debt reduction strategy. To provide legal cover to debt

reduction strategy a Fiscal Responsibility and Debt Limitation Act 2005 has been promulgated in June 2005.

47. As a result of the credible debt strategy followed by the Government, the public debt-to-GDP ratio, which stood at almost 79.6 percent at the end-June 2000, declined substantially to 55.2 percent by the end-June 2007 which implies a 24.4 percentage points decline in country's debt burden in 7 years. By end September 2007, public debt further declined to 50.1 percent of the projected GDP for the year 2007-08.

Table 14 Trends in Public Debt
(Rs Billion)

	End June								End Sep
	1980	**1990**	**1995**	**2000**	**2004**	**2005**	**2006**	**2007**	**2007**
Debt Payable in Rupees	59.8	373.6	789.7	1575.9	1978.8	2132.6	2321.6	2596.8	2695.9
As % of									
i) Public Debt	(38.5)	(46.6)	(47.5)	(52.2)	(52.3)	(52.7)	(53.4)	(54.1)	(53.9)
ii) GDP	[21.5]	[42.8]	[42.3]	[41.5]	[35.1]	[32.4]	[30.5]	[29.8]	[27.2]
Debt Payable in F.Exchg.	95.6	427.6	872.5	1442	1807.7	1912.6	2021.4	2211.1	2302.1
As % of									
i) Public Debt	(61.3)	(53.4)	(52.5)	(47.8)	(47.7)	(47.3)	(46.6)	(45.9)	(46.1)
ii) GDP	[34]	[48.9]	[46.8]	[38]	[32]	[29.1]	[26.6]	[25.4]	[23.2]
Total Public Debt	155.4	801.2	1662.2	3017.9	3786.6	4045.1	4343	4807.9	4998.0
Public Debt as % of									
i) GDP	55.9	91.7	89.1	79.6	67.1	61.5	57.2	55.2	50.1
ii) Total Revenue	317.1	504.6	514.7	562.5	469.9	449.4	403	370.4	338.6

Source: *DM Wing, Finance Division, SBP and DPCO Staff Calculations*

48. The capacity to carry debt is dependent on the size of the economy (GDP) as well as the resources available to the government to service that debt, therefore debt should also be considered in relation to government revenue. As shown in Table 14, public debt at the end-June 2000 was as high as 562.5 percent of total revenue. Following the debt reduction strategy, which included raising revenue as one of the key elements, the public debt burden in relation to total revenue has declined substantially to 370.4 percent by end-June 2007 and further to 338.6 percent of the projected revenue of 2007-08 by end-September 2007.

49. The structure of public debt has witnessed marginal change over the last 7 years. The share of Rupee debt in total public debt stood at 52.2 percent, while foreign currency denominated debt accounted for 47.8 percent of total debt at the end of June 2000. By end June 2007, the share of Rupee debt stood at 54.1 percent of total debt while those of foreign currency debt declined to 45.9 percent. Pakistan's debt servicing liabilities also improved over the last seven years owing to reduction in the country's debt burden. The debt servicing liabilities declined sharply from 65.4 percent of revenue in 1999-2000 to 26.8 percent of total revenue and from 53.5 percent of current expenditure to 25.3 percent of current expenditure by end June 2007. The subsequent fiscal space created by bridging the revenue-expenditure gap and low debt servicing cost has enabled the government to increase the size of the public sector development program (PSDP) as well as poverty and social sector related expenditures.

50. Although public debt is now on a solid downward footing, sustaining the momentum will be a continuing challenge. The coming years will see an increased borrowing requirement particularly in the foreign currency component to finance the infrastructural development program. The large infrastructure projects envisaged in the next decade will increase the debt burden if sufficient revenues are not generated from within the country. Therefore, a supportive yet prudent fiscal policy based on principles of sound macroeconomic fundamental is critically important to lead the country to a higher growth trajectory

V: SUSTAINABILITY OF FISCAL POLICY

51. A loose fiscal policy is the first step towards an unsustainable debt path that may eventually lead to a macroeconomic crisis. There is a consensus that the sustainability of fiscal policy could be gauged by simply answering the following questions: “Can the current course of fiscal policy be sustained without exploding debt? Or will the government have to sharply increase taxes, decrease spending, have recourse to monetization, or even repudiation of debt?”

52. The sustainability of fiscal policy is built-in in the Fiscal Responsibility and Debt Limitation Act 2005. The Act envisages a 2.5 percentage point’s reduction in debt-to-GDP ratio every year and not borrowing for consumption purposes. The Government is on track and the debt-to-GDP ratio is declining at a faster pace than envisaged in FRDL, whereas the requirement of elimination of revenue deficit by end June 2008 can be met if government takes corrective measures to keep budget deficit at the targeted level. Pakistan needs to generate primary surpluses for some years in order to consolidate its fiscal indicators. The important thing with fiscal consolidation is that it is not at the expense of slashing social sector spending. Thus far, the fiscal policy has been fully aligned with the mandatory requirements of the FRDL Act 2005.

VI: MEDIUM-TERM BUDGETARY FRAMEWORK (MTBF)

53. The Budget 2007-08 has been prepared within the Medium Term Budgetary Framework (MTBF) which is consistent with the country’s overall macroeconomic framework and legal obligation under Section-5 and 6 of the Fiscal Responsibility and Debt Limitation Act 2005. To enable ministries/spending agencies to prioritize their spending plan within the indicated envelope in a consistent and coherent manner, the Government has initiated the process of putting in place a Medium–Term Budgetary Framework (MTBF). Such a framework will, to a greater extent, reduce the uncertainties that impede effective planning. This will be a rolling resource envelope and will target outcome rather than financial input and expenditure. The MTBF process is already underway and the Government expects a complete switch over by the fiscal year 2008-09.

VII: PUBLIC – PRIVATE PARTNERSHIP

54. Adequate infrastructure is vital for sustaining a strong growth momentum. Pakistan therefore needs to invest far more in its human and physical infrastructure. The

Government of Pakistan has entered into a number of contracts with the private sector for the development of infrastructure. It has decided to expand its Public-Private Partnerships (PPP) program as part of its strategy for reducing Pakistan's infrastructure deficit. In order to develop its PPP program in a way that is fiscally responsible, the government has issued guarantees to some of these infrastructure PPP projects, and has made the necessary provisions in its budget to cover these liabilities and avoid fiscal risk.

Global experience suggests that the magnitude of investment required is such that it is neither prudent nor efficient to fund this from the Budget. The Government therefore, plans to make far greater use of public–private partnership in developing infrastructure to a level that is consistent with the Governments' economic growth target of 6-8 percent over the long-run. The Government has already progressed in developing a framework for this purpose in collaboration with the Asian Development Bank (ADB). The Infrastructure Project Development Facility (IPDF) has already been set up as a company. The next step is to set up a financing facility --- the Infrastructure Project Financing Facility (IPFF) for which the work is already at an advanced stage. With this arrangement the process of building up Pakistan's infrastructure to a world class level will be achieved.

The principal benefit of using PPPs to develop infrastructure is that they allow governments to allocate risks more efficiently than if the infrastructure were developed and operated only by the government. Sharing risks between the two parties means that each party will bear those project risks that is it best placed to manage.

Some of these infrastructure projects have been in the development of power plants contracted by the Private Power and Infrastructure Board (PPIB), roads and tunnels contracted by the National Highway Authority (NHA) and the development of Pakistan's three main ports, namely the Port of Karachi, Port Qasim and Gwadar Port.

The government has also expressed interest in developing PPPs in the near future for:

- **Transport and Logistics ---** including provincial and municipal roads, rail, seaports, airports, fishing harbors, warehousing, wholesale markets, slaughter houses and cold storage
- **Mass urban public transport ---** including buses and intra/inter city rail
- **Municipal services ---** including water supply and sanitation, solid waste management, low cost housing, and health & educational services**.**
- **Small scale energy ---** hydroelectric and captive power generation projects other than those facilitated by PPIB.

VIII: <u>REPORT ON COMPLIANCE WITH FRDL ACT 2005</u>

55. The Fiscal Responsibility and Debt Limitation 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.

56. The FRDL Act 2005 requires the following:

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

Revenue balance (Total Revenue minus current expenditure) remained in deficit to an average of 0.6 percent of GDP during the last four years (2002-03 to 2005-06). Revenue balance remained in deficit to the extent of 0.9 percent of GDP in 2006-07. In order to meet the FRDL Act 2005 requirement the Government has, however, budgeted a revenue surplus to the extent of Rs. 98 billion or 1.0 percent of the projected GDP for the year 2007-08. During the first quarter (July-September) of the current fiscal year (2007-08) the revenue balance remained in deficit to the extent of Rs. 27.3 billion or 0.3 percent of the projected GDP for the year. Although it is too early to make any judgment about the outcome of this element of the Act there are, however, signs that unless some serious corrective measures are taken to curtail current expenditure or raise revenue, the target to reduce revenue deficit to nil by the end of 2007-08 may not be achieved.

> ***(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."***

Government has already met and actually exceeded the requirement on the level of public debt as a percentage of GDP. The Government has achieved the goal of reducing public debt as percentage of GDP below 60 percent well ahead of time. Furthermore, this limit has been realized within three financial years instead of ten years as envisaged by the FRDL Act. At the beginning of July 2003, the total public debt stood at 75.1 percent of GDP while at the end of June 2007, the same figure stood at 55.2 percent of GDP. By the end-September 2007, the public debt-to-GDP ratio stood at 50.1 percent of the projected GDP for 2007-08.

> ***(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."***

The government has not successfully met this requirement in fiscal year 2006-07. Public debt stood at 57.2 percent of GDP by end June 2006 and decreased to 55.2 percent of GDP by end-June 2007, which implies a 2.0 percentage point reduction in public debt-to-GDP ratio against specified reduction target of 2.5 percentage points. Even though the reduction in public debt-to-GDP ratio did not meet the target of 2.5 percent per year, this part of the FRDL Act 2005 was meant to be a vehicle in achieving the more important target of reducing the public debt-to-GDP ratio to less than 60 percent within a ten year span. Having already brought the public debt-to-GDP ratio below 60 percent in a mere three years instead of ten, under-achieving the target of yearly reduction of 2.5 percent is negligible. By end September 2007, the public debt-to-GDP ratio went down further to 50.1 percent of the projected GDP for 2007-08. This is an indication that the government has remained fiscally prudent thus far, as required by the FRDL Act 2005. The important thing about this fiscal prudence is that it is not achieved at the expense of reduction in social sector and poverty related expenditure. These expenditures were 5.7 percent of GDP in 2005-06 and increased further to 5.8 percent of GDP in 2006-07. Poverty and social sector related expenditure is targeted at 6 percent of GDP for the year 2007-2008. It means legal obligation to keep these expenditures at 4.5 percent of GDP is well taken care of. Expenditure on education and health are also growing briskly, and there are indications that expenditure on these items will be doubled in terms of percentage of GDP by 2012-13.

> ***(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."***

The government remained within this required limit of 2% of GDP by issuing Rs. 69.0 billion new guarantees which is 0.8% of GDP for fiscal year 2006-07. For the first half of the current fiscal year of 2007-08, the government issued Rs. 54.6 billion of new guarantees which amounts to 0.6% of GDP which is fraction of what is required by FRDL 2005.

IX: CONCLUDING REMARKS

57. A sound fiscal policy is essential for preventing macroeconomic imbalances and realizing full growth potential. Pakistan has made considerable progress in fiscal consolidation over the last seven years. The overall fiscal deficit is down from an average of 7.0 percent of GDP in the 1990s to 3.5 percent during the last seven years (2000-07). The underlying deficit has remained below 4.0 percent of GDP during the last two years (2005-06 and 2006-07) despite massive spending on the development program. The Government has targeted fiscal deficit at 4.0 percent of GDP for the fiscal year 2007-08. With the decline in fiscal deficit, the associated public debt has also exhibited sharp decline from over 100 percent of GDP to 55.2 percent of GDP during the last eight years.

58. Fiscal consolidation has undoubtedly contributed to a sharp recovery in economic growth within a stable macroeconomic framework. Every effort should be made to continue to improve the fiscal balance, notwithstanding the pressure generated by the extraordinary increase in the international price of oil. Going forward, Pakistan will have to allocate substantially large resources for strengthening the country's physical and human infrastructure to sustain the growth momentum. The challenge will be to significantly enhance Pakistan's tax-to-GDP ratio in order to generate the resources required to finance the development of both human and physical infrastructure. The government will therefore, have to make efforts to broaden the tax base i.e. to hitherto untaxed or under taxed sectors. Broadening of tax base will enable the government to reduce marginal tax rates which will help further stimulate investment and production and will promote voluntary tax compliance. Broadening of tax base will also ensure the fair distribution of the tax burden among various sectors of the economy. The overall

services sector including wholesale and retail trade as well as agriculture are potential candidates for broadening the tax bases.

59. Fiscal year 2007-08 appears to be a challenging year for Pakistan’s economy. This year has, so far, witnessed heightened political activity, disturbed law and order situation, rising food inflation, extraordinary rise in global oil prices and the spillover from the United States sub-prime issues and credit crunch. This year will also witness a new Government taking charge of the affairs of the State. Maintaining financial discipline in such an extraordinary environment will indeed be a difficult task for the Government. But at the same time, there is no alternative of financial discipline to sustain the current growth momentum. If there be a need to take difficult decisions to achieve key fiscal targets for the year 2007-08, the Government should not hesitate in the larger interest of sustaining growth momentum in a stable macroeconomic environment.