Medium Term Budgetary Statement

I. Background

The outgoing fiscal year 2010-11 once again tested the capacity of Pakistan's economy to withstand internal and external pressures of extreme nature. The economy remained under stress in the aftermath of the devastated floods which engulfed one-fifth of the country at the start of the fiscal year and tried to jeopardize fiscal consolidation efforts of the government. The situation was further compounded by paucity of resources as a result of slow response from development partners. The macro-economic environment carried unresolved structural problems, the most important being acute energy shortage. The domestic environment is still affected by volatile security situation while external environment is affected by uncertainties surrounding external inflows and oil prices. Notwithstanding substantial improvement in the current account deficit, the external sector vulnerabilities needs a review especially in the backdrop of spike in international crude oil prices which increased from $74 per barrel in June 2010 to beyond $120 per barrel since March 2011.

2. The economy started improving in the second half of CFY and showed some signs of recovery mainly driven by external sector buoyancy. Pakistan's economy still faces pressures from higher inflation driven mainly by rising food prices, acute power shortages, modest growth in tax revenues amidst rising security related expenditure, thereby, putting pressure on fiscal deficit; lower than anticipated inflows and growing absolute financing requirements. The intensification of domestic security challenge exerted high cost on the economy both in terms of direct costs of fight against extremism as well as in terms of a knock-on effect on investment inflows and market confidence. A significant collateral impact has been born by Pakistan in terms of squeezing of fiscal space

for critical development and social sector expenditures that hampered growth prospects in future.

3. The cumulative effect of these challenges has been significant loss of growth momentum in the last few years. Real GDP growth during 2010-11 is now estimated to grow at 2.4 percent compared to 3.8 percent in the previous year, on the back of strong performance (4.1%) of service sector (Public administration & defence and social services) while the commodity producing sector is estimated to grow at 0.5%, which is lower than Annual Plan 2010-11 target of 4.5 percent. This deviation from the target is attributed to slower growth in the manufacturing and agriculture sector. The latter sector has been hard hit by international and domestic factors. Besides law and order and acute power outages resulting in loss of working hours, this sector also fell victim to rising cost of production. Large-scale manufacturing during July to March 2010-11 grew by 1.7 percent against 4.9 percent of last year but is expected to pick-up on the back of capacity enhancement in some industries like fertilizer, steel, and likely improvement in the sugar production to 4.1 million tons this year as Large Scale Manufacturing grew by 6.75 percent during March 2011 over the same month of last year. The impact of these positive developments will feed into the overall economic growth. The positive terms of trade shock has helped improved competitiveness for textile sector in particular and other conventional export based small and medium manufacturing sector. In the agriculture sector, the sluggish performance is mainly attributed to a sharp downturn in the value addition in major crops owing to devastating floods that negatively impacted rice and cotton output but helped recovery in wheat output. The sugarcane benefitted from excess availability of irrigated water. The growth in the agriculture sector is estimated at 1.2 percent on the back of 3.7 percent growth in the livestock sector.

4. Inflation as measured by the changes in Consumer Price Index (CPI) has increased by 14.1 percent during July–April 2010-11 against 11.5 percent in the comparative period of last year. During the last 10 months food inflation has remained the major driver of overall inflation on the back of major supply disruptions owing to devastating floods as well as spike in imported food stuff prices. *Food inflation* was recorded at 18.4 percent while *non-food* component increased by 10.4 percent in this period. The SBP raised the policy rate by 150 basis points (bps), staggered in three stages of 50 bps each, since July 2010 and the policy rate reached 14 percent up to 30th November 2010. While keeping in view the risks to inflation and economic growth, SBP has kept the policy rate unchanged at 14 percent in last three monetary policy announcements in January, March and May 2011. During July 01, 2010 to April 30th , 2011, money supply (M_2) expanded by 9.6 percent against expansion of 8.1 percent in the comparable period of last year. The YOY change in CPI for the month of April 2011 stood at 13 percent though lower than post flood peak of 15.7 percent in September 2010, however the underlying inflationary pressures are still strong. This inflationary environment will be further strengthened going forward by the growing output gap owing to declining real capital formulation by the private sector because of acute power shortages and high domestic interest rates.

5. Fiscal performance is marred by revenue shortfall and expenditure overrun on account of subsidies in this period, thereby surpassing the original fiscal deficit target. The fiscal deficit is likely to remain at 5.3 percent of GDP in the current fiscal year which is higher than post flood deficit target of 4.7 percent for the year; however, an adjustment of 1.0 percent over the last year's fiscal deficit of 6.3 percent is significant given the challenging environment. Government took a bold step in May 2011 by clearing the backlog of power sector dues of Rs.120 billion, related to previous years, with a view to reduce the

power sector circular debt, this will increase the envisaged fiscal deficit for FY11 by 0.7 percent however would go a long way in resolving the energy crises being faced by the country. Pakistan is facing the issue of stagnant tax to GDP ratio for more than a decade. The overall tax-to-GDP ratio fluctuated in a narrow band of 10-11 percent owing mainly to structural deficiencies in the tax system and administration both at federal and provincial government level. Similarly, total expenditure although showing an overall decline since FY08 as a percentage of GDP, is expected to reach at Rs 3386 billion or 18.7 percent of GDP in FY11. On the other hand, total revenue is expected to rise to Rs 2349 billion or 13.0 percent of GDP.

6. During July-April 2010-11, *Federal Board of Revenue (FBR)* has collected Rs 1156 billion net taxes as compared to Rs 1027 billion in the comparable period of last year, posting an increase of 12.6 percent. This implies erosion of revenue collection in real terms as nominal GDP is estimated to grow by around 21.6 percent. In order to contain the fiscal deficit at minimal level amidst revenue shortfalls, certain tax measures have been taken including withdrawals of some exemptions and zero-ratings w.e.f. 15th March 2011. These tax measures are likely to generate additional revenue of Rs 53 billion during the remaining period of 2010-11. With the introduction of austerity measures government plans to curtail expenditures by Rs 20 billion. These steps would be helpful in maintaining revised fiscal target of 5.7% against previous year’s deficit of 6.3%.

7. As originally envisaged in budgetary targets for FY2010-11, 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 deviations against the budgeted current expenditure targets mainly on account of power sector subsidies, making an undesirable adjustment to development spending goals.

8. Pakistan's current account balance turned to surplus $748 million in the first ten months of 2010-11 from deficit of $3456 million in the comparable period of last year. This improvement is broad based as improvements witnessed in trade balance of goods, services and income account while buoyancy in current transfers helped current account to shrink by 121.6 percent during July-April 2010-11. Current account absorbed extraordinary commodity and oil price shock without impacting exchange rate or reserve depletion. This is mainly because of higher inflow of worker's remittances and sharp reduction in trade of goods and services deficit. The trade deficit is down due to rise in unit prices of traditional exports and could stagnate once prices normalize. Substantial increase of 27.0 percent in exports outstripped buoyant growth of 13.2 percent in imports, which caused the trade deficit to improve by 10.8 percent. Workers' remittances totaled $ 9.05 billion in the first ten months (July-April) of 2010-11 as against $ 7.3 billion in the comparable period last year, depicting an increase of 23.8 percent. Foreign Exchange Reserves amounted to $ 17.1 billion by the end of April 2011. Foreign direct investment (private) stood at $1230 million during July-April 2010-11 as against $1725 million in last year, thereby showing a decline of 28.7 percent, primarily due to volatile security condition in the country.

9. Drying-up of external inflows exacerbated pressure on fiscal account during the fiscal year 2010-11. During the first three quarters of the current fiscal year, the fiscal deficit was primarily financed through domestic sources in absence of any privatization proceeds and around USD 650 million from external sources. Heavy reliance on domestic currency to finance fiscal deficits 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. Moreover, such practice crowds out availability of private sector credit. In absence of robust private sector credit demand Government was able to shift its borrowings from SBP to schedule banks, during the period and retired Rs.16 billion from SBP credit.

10. External Debt and Liabilities stood at $ 60.2 billion by end-April 2011 up from end-June level of $55.9 billion showing an increase of 7.7%. The major chunk originates from translational impact of weaker dollar against major currencies such as Euro and Yen. The outstanding stock of IMF debt stood at $9.1 billion as against $8.1 billion at end-June 2010. Similarly, Paris Club debt went up to $15.5 billion as against $14 billion, primarily on account of USD depreciation against other major global currencies rather than fresh net disbursements.

II. Medium Term Budgetary Statement

11 Thrust of the government would be to pave the path of economic consolidation by overcoming the challenges of previous year and by maintaining macroeconomic stability through fiscal discipline. In order to strengthen the economic growth the government will introduce additional revenue measures, lower subsidies, address issues influencing productivity such as access to energy and water, over-coming gaps in physical and human infrastructure through targeted investments by rationalizing its public sector development expenditures.

12. The Government is laying before the Parliament a Medium Term Budgetary Statement (MTBS) 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. The rolling targets for various fiscal and macroeconomic indicators, as required by the Act are given in Table-1.

Table 1: KEY MACROECONOMIC INDICATORS – ROLLING TARGETS

	Items	**Provisional Estimates 2010-11**	**Budget Estimates 2011-12**	**Target for**	
				2012-13	**2013-14**
1	Real GDP Growth (%)	2.4	4.2	4.5	4.7
2	Inflation (%)	15.5	12.0	9.5	8.0
		(As percent of GDP)			
3	Total Revenue	13.0%	13.6%	13.4%	13.2%
	- Tax Revenue	9.8%	10.3%	10.5%	10.8%
	- FBR Revenue	8.8%	9.3%	9.6%	9.9%
4	Total Expenditure	18.7%	17.7%	16.9%	16.2%
	- Current Expenditure	16.0%	13.7%	12.8%	11.8%
	- Development Expenditure	2.7%	4.0%	4.1%	4.4%
5	Fiscal Deficit	-5.7%	-4.0%	-3.5%	-3.0%
6	Revenue Deficit/Surplus	-3.0%	0.0%	0.6%	1.4%
7	Total Public Debt	57.2%	53.2%	48.7%	45.9%
8	GDP (mp) Rs. Billion	18,063	21,041	24,200	27,464

13. Total revenues are estimated at 13.6 percent of GDP for 2011-12. With regards to FBR tax revenue, the government, in the medium term, will introduce additional revenue and administrative measures led by rationalization of taxation system. These measures are likely to raise additional revenue of Rs.125 billion in the coming year which would increase the tax to GDP ratio from existing 8.8 percent to 9.9 percent during the next three years. Besides, the federal government intends to raise more than Rs.600 billion annually from non-tax revenue efforts.

14. In order to overcome the structural problems which are main obstacles in economic growth government's priority would be to undertake direct and indirect and short to medium term measures to be implemented by the public sector development programme. The short-term measures are aimed at providing relief from energy and water shortages, and a holistic medium-term plan to overcome structural issues in energy and infrastructure sectors through enhancing the pace of existing projects. Further, indirect measures will be geared towards increased access and improved delivery of social services in urban and rural areas. With the ablution of concurrent list most of the service delivery functions (health, education, population welfare and social welfare and social services) have been devolved. Provinces would be encouraged to invest in these sectors. Role of the BISP would be further diversified in the medium term and assistance to Internally Displaced Persons (IDPs) would be met through flood assistance. For this purpose, 4.0 percent of GDP has been allocated for development spending in 2011-12 that is 1.3 percentage points higher than in 2010-11. In the medium term government plans to increase its development expenditure to 4.4 percent of GDP by 2013-14. To create more fiscal space for these measures, government will refine its expenditure priorities over the medium-term with increased focus on improving expenditure management at the same time improved service delivery mechanism will be accorded high priority. The government would continue working on restructuring of Public Sector Enterprises (PSEs) over the medium – term with an aim to make these organizations economically viable and less dependent on national budget. On average over Rs.300 billion annually is paid to PSEs to cover their losses. In order to provide room for private sector investment, government will adopt fiscal tightening policy and net zero quarterly borrowings from the State Bank which will assist reducing inflationary pressure leaving some fiscal space for government's service delivery and investments due to fall in interest rates.

15. Under the 7th NFC Award, 62.7 % of consolidated fund revenue would flow to the provinces. As a result, the provinces will have ample funds to address the socio-economic needs and meet vital development requirements within their jurisdictions. However, the ability of provinces to generate surplus remains critical in maintaining the envisaged overall deficit, unless, they raise taxes to the tune of 15% of GDP by the end of NFC Awards period (2015-16). Provinces may need to undertake necessary legal and administrative measures to effectively tax the agriculture and property sectors. However, to date little progress is noted in this regard.

16. Prudent fiscal policy together with strong implementation and accountability principles are prerequisites for economic rebound. For the 2011-2012, the government plans to lower its deficit target to around 4.0 percent of GDP with a policy to further reduce it by 0.5 percent of GDP each year to bring it to 3.0 percent of GDP by 2013-14. This policy requires committed implementation efforts together with regular monitoring of the key macroeconomics indicators. The fall in the fiscal deficit is based on successful implementation of revenue generation and expenditure tightening measures. Besides it is estimated that provincial governments would maintain a surplus of 0.6, 0.4 and 0.3 percent of GDP over the next three years respectively. It is suggested that there should be a workable mechanism between federal government and the provincial governments on the surpluses. Devolution of certain functions to provinces and targeted reduction in current expenditure will allow the provincial governments to increase their social sector and pro-poor budgetary outlays, in the medium-term, which are essential to the economic growth and social development of the country.

17. The Article 79 of the constitution allows provision for introduction of an Act that regulates management of public finances. The government is working on introducing the Public Finance Administration Act with laws related to the budget preparation, budget execution, accounting, reporting and monitoring and auditing. The act will become the overarching public financial management of public finances.

18. To ensure financial discipline Government is committed to adhere to policy of net zero quarterly borrowing from SBP and intends to pay off the outstanding stock of SBP credit in 8 years. Furthermore to reduce pressure from domestic interest rate, efforts will be made to augment domestic liquidity envelop by devising strategy to reduce currency in circulation, diversifying investor base and unlock personal equity. Government also intend to announce annual foreign currency borrowing calendar that will also help to reduce the domestic interest rate and will also provide some balance of payment support, while ensuring against consequences of a rebound in international commodity prices and weaker than expected export performance.

19. The future of debt sustainability presents an optimistic outlook in the wake of tight fiscal policy as envisaged by the government over the medium-term. Due to repayments to the IMF, the total debt to GDP ratio is projected to fall below 46% of GDP during 2013-14. Real growth of revenues has been projected higher than the real growth of debt that will ensure reduction in total public debt as times of revenue. Provision of fiscal space by bridging the revenue-expenditure gap, sustaining growth momentum and achieving robust real growth in revenue collection will allow for a significant reduction in the debt burden in the medium-term. Total public debt as a percentage of GDP is estimated to reach 57.2 percent by the end of the current fiscal year as opposed to 59.9 percent in 2009-10. A

reduction of 2.7 percentage points in this debt indicator is encouraging. In the next fiscal year, total public debt ratio is expected to improve further to 53.2 percent of the projected GDP in 2011-12. In the medium term this ratio would further improve to 45.9 percent in 2013-14. These targets indicate the adherence of government to comply with the Debt to GDP threshold of 60 percent stipulated under the FRDL Act 2005.

III. Conclusion

20. Economic consolidation while maintaining macroeconomic stability through fiscal vigilance requires prudent fiscal policy together with strong implementation and accountability principles. It will help reduce inflation, strengthen economic growth, mitigate risks of falling foreign reserves and debt burden. This policy requires committed implementation efforts together with regular monitoring of the key macroeconomics indicators. Implementation of the medium-term framework will create fiscal space for investment in physical and human infrastructure and extending social protection to least developed areas of the country and vulnerable segments of society. Accomplishment of these goals requires additional revenue and expenditure tightening measures, led by the rationalization of tax regime. A greater share of provinces in the federal revenue as a result of new NFC award necessitates the generation of provincial surpluses to maintain fiscal deficit at targeted levels which can be achieved through undertaking necessary legal and administrative measures to effectively tax the agriculture and property sectors.

21. A shift from generalized to targeted subsidies will ensure more efficient use of government resources and relief to the poor and vulnerable. Further, by addressing issues in the power sector, the burden placed on government resources by power subsidies will be significantly reduced. Over the medium – term

restructuring of Public Sector Enterprises with an aim to make them economically viable and less dependent on national budget would further consolidate the fiscal governance. Enhanced fiscal space, protect the pro-poor budgetary outlays, including direct and indirect relief for society, while reducing the quantum of current expenditure will assist in achieving the twin objectives of creating a conducive environment for growth and development as well as maintaining macroeconomic stability.

Government of Pakistan
Finance Division
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STATEMENT OF RESPONSIBILITY UNDER SECTION 10(1)(a) OF FISCAL RESPONSIBILITY AND DEBT LIMITATION ACT 2005.

Stated that all policy decisions with material economic, or fiscal implications that the Federal Government has made before 3rd June 2011, the day on which the contents of the Medium Term Budgetary Statement were finalized and all other circumstances with material economic or fiscal implications of which I was aware before that day, have been communicated to the Secretary of Finance.

The statement to the best of our knowledge provides for.

a) The integrity of the disclosures contained in the economic policy statements:

b) The consistency with the requirements of this Act of the information contained in the economic policy statements; and

c) The omission from the economic policy statement of any decision or circumstance specified in sub-section 3 of section 8.

(Dr. Abdul Hafeez Shaikh)
Minister for Finance, Revenue,
Economic Affairs and Statistics
and Planning & Development

Government of Pakistan

Finance Division

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STATEMENT OF RESPONSIBILITY UNDER SECTION 10(1) (a) OF FISCAL RESPONSIBILITY AND DEBT LIMITATION ACT 2005.

Stated that Ministry has supplied to the Minister using its best professional judgment on the basis of economic and fiscal information available to it before 3rd June 2011, the day on which the contents of the Medium Term Budgetary Statement were finalized, incorporating the fiscal and economic implications of those statements and circumstances, but any decisions or circumstances that the Minister has determined under Sub-section (3) of Section 8 of the Fiscal Responsibility and Debt Limitation Act 2005, have not been incorporated in the Medium Term Budgetary.

(Waqar Masood Khan)
Secretary Finance