



PAKISTAN

Fiscal Policy Statement

— 2009-10 —



Debt Policy Coordination Office
Ministry of Finance

Table of Contents

Table of Contents	i
Acknowledgements.....	ii
List of Acronyms.....	iii
I. Introduction	1
II. Fiscal Policy Statement	4
III. Principals of Tax and Expenditure Policy	5
III-i: Principles of Tax Policy.....	5
III-ii: Principles of Expenditure Policy.....	6
IV. Fiscal Policy Developments	7
IV-i: Fiscal Performance during 2008-09.....	10
IV-i-a: FBR Tax Collection and Refunds during 2008-09.....	13
Direct Taxes	15
Indirect Taxes.....	18
Sales Tax	18
Custom Duty.....	20
Federal Excise Duties (FED)	21
Projections for Fiscal Year 2009-10	22
IV-i-b: Review of Expenditure during 2008-09	23
IV-i-c: Slippages in Budget 2008-09	26
IV-ii: Fiscal Projections for 2009-10	30
IV-iii: Revenue and Expenditure during July-September 2009.....	32
V. Review of Public Debt	34
Servicing of Public Debt	37
VI. Sustainability of Fiscal Policy.....	39
VII. Medium-Term Budgetary Framework (MTBF).....	39
VIII. Public – Private Partnership	40
IX. Report on Compliance with FRDL Act 2005	42
X. Concluding Remarks.....	44

Acknowledgements

This Policy Statement has been prepared to fulfill the requirement laid out under Section 6 of the Fiscal Responsibility and Debt Limitation Act 2005. I would like to acknowledge the input of various Ministries, Departments, Divisions and Agencies, particularly, timely data provision by Budget Wing (MoF), Corporate Finance Wing (MoF), and the Federal Board of Revenue. I would like to recognize the effort put in by Syed Jaffer Askari, Economist (DPCO), and Mehwish Ashraf, Financial Analyst (DPCO) in the realization of this comprehensive document. This report also benefited from the input of Zafar-ul-Hassan, DS-EF (Programme) and Fahd Zaidi, formerly of the DPCO.

Masroor Ahmed Qureshi
Director General
Debt Policy Coordination Office
Ministry of Finance

List of Acronyms

AEDB	Alternative Energy Development Board
AOP	Association of Persons
BOP	Balance of Payment
CDNS	Central Directorate of National Savings
CDR	Currency to Deposit Ratio
COD	Collection on Demand
DSC	Defence Savings Certificates
DPCO	Debt Policy Coordination Office
FED	Federal Excise Duties
FPS	Fiscal Policy Statement
FRDL Act	Fiscal Responsibility and Debt Limitation Act
FY	Fiscal Year
GDP	Gross Domestic Product
GST	General Sales Tax
IDPs	Internally Displaced Persons
IMF	International Monetary Fund
IPDF	Infrastructure Project Development Facility
IPFF	Infrastructure Project Financing Fund
IPPs	Independent Power Producers
IRS	Inland Revenue Service
KESC	Karachi Electric Supply Company
LTUs	Large Taxpayer Units
MOF	Ministry of Finance
MTBF	Medium-Term Budget Framework
MTDF	Medium Term Development Framework
NSS	National Saving Schemes
NTN	National Tax Numbers
PASSCO	Pakistan Agricultural Storage and Services Corporation Ltd.
PIFRA	Project for Improving Financial Reporting and Auditing
POL	Petroleum, Oil and Lubricant
PPIB	Private Power Infrastructure Board
PPP	Public-Private Partnerships
PRGF	Poverty Reduction and Growth Facility
PSEs	Public Sector Enterprises
R&D	Research and Development
RTOs	Regional Tax Offices
SBA	Stand by Agreement
SBP	State Bank of Pakistan
SED	Special Excise Duty
TCP	Trading Corporation of Pakistan
TPD	Total Public Debt
USAS	Universal Self Assessment Scheme
VAT	Value-Added Tax
VP	Voluntary Payments
WAPDA	Water and Power Development Authority
WHT	Withholding Taxes

I. Introduction

The economic policy of a government is centered on ensuring macroeconomic prosperity in order to uplift the living standards of its people. Thus, sustainable economic growth is an essential ingredient for job creation, poverty alleviation and developing physical and human infrastructure in the country. Given this backdrop, it is vital for a country like Pakistan to achieve macroeconomic stability over the long term through a prudent fiscal policy that instills the responsibility of fiscal discipline for future governments as well.

Countries that enjoy fiscal freedom have adopted vigilant fiscal regulations and implemented them effectively. These nations have also made their system more transparent which can be reflected by cheaper access to financial markets and greater electoral support. Emerging market economies often face considerably greater macroeconomic volatility, as is the case with Pakistan. This inherent volatility combined with poor macroeconomic management can have devastating consequences for economic activity, employment, and the overall welfare of the state. Accordingly, the establishment of rules signals a commitment to sound fiscal policy and to macroeconomic stability that both present and future governments will be responsible for.

Given the overwhelming need to inculcate fiscal discipline in Pakistan, the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005 was passed in Parliament in June 2005. The Act requires the government to commit to fiscal prudence and a reduction in the debt burden. The rules stress the need for achieving objectives of macroeconomic stability, long-term sustainability of growth, support for and the harmonization between different government policies, as well as policy transparency and credibility.

Fiscal year 2008-09 saw some mitigation in the macroeconomic imbalances that were carried from the legacy of previous years, which yet again reinforces the importance of fiscal prudence for sustainable economic growth. The overlooking of power sector over the years has piled up immense pressure on the fiscal account and it could not be abruptly undone. Fiscal year 2008-09 saw elimination of many subsidies but fiscal year 2009-10 has been assigned to undo all power tariffs. Fiscal adjustment to the tune of 2.4 percentage points was done amidst crucial developments. Fiscal consolidation efforts on behalf of the government were constantly challenged by deteriorating security environment; domestic political uncertainties; deepening of the global financial crisis; persistent inflationary pressures in the economy; monetary overhang of previous years; supply-side shocks; massive exchange rate adjustment; and an uncertain macroeconomic environment. Lax fiscal stance of the last eight years has a definite bearing not only on the fiscal adjustment process but macroeconomic stability as well. The period 2000-07 was the best period

for expenditure rationalization and resource management efforts which was not capitalized upon and hence, put additional strain on fiscal policy in 2008-09. The outgoing fiscal year was not best suited for fiscal adjustment because all sorts of internal and external pressures were testing resilience of the economy.

The monetary tightening started since April 2005 but fiscal expansion neutralized gains from tightening. The loose coordination between monetary and fiscal policies as well as short-fall in government revenues complicated the macroeconomic stabilization efforts. The maturity of high cost zero-coupon Defence Savings Certificates (DSCs) sold in the aftermath of Nuclear detonation of 1998, undermined the fiscal deficit in the past but overstated the fiscal deficit in recent years. In a bid to revive a struggling economy, Pakistan entered into a stabilization program with the IMF in November 2008 as major macroeconomic indicators were at precarious levels. The government recognizes the consequences of fiscal indiscipline and has committed to a policy of fiscal consolidation, which is placed at the top of their overall macroeconomic stabilization agenda.

The need for fiscal discipline cannot be overstated as many years of fiscal profligacy in the past ultimately led to unsustainable macroeconomic imbalance in 2007-08. Had there been rationalization of superfluous expenditures during the fiscal comfort period of 2000-07, the extent of adjustment seen during 2008-09 could have been less painful. The fiscal response and crisis management measures and the subsequent improvement in macroeconomic stability have been remarkable. However, there is a need to re-orient policy towards resource management. Successful resource management, as opposed to adjustments made in response to crises, will play a fundamental role in addressing structural weaknesses of the economy. Such policy orientation will also limit the need for adjustments in times of distress as these adjustments pose serious implications for investment-hungry infrastructure bottlenecks. Economic growth fell drastically in 2008-09 owing to factors like widening of the fiscal and current account deficits, double-digit inflation, high cost of doing business associated with high interest rates, low levels of foreign exchange reserves, an ever-rising debt burden and widespread poverty and unemployment in the county. Going forward, we need to strike a balance in development expenditure on account of infrastructure and improvement in social sector indicators to align expenditure with social responsibility.

In fiscal year 2008-09, under the IMF-SBA, the government took several budgetary measures to achieve fiscal consolidation. Such measures included a net-zero borrowing strategy from the State Bank of Pakistan (SBP) for budgetary support at the end of each quarter, the gradual removal of oil and power subsidies by partial pass-on to end-users, and curtailing of development expenditure.

These measures brought down the fiscal deficit to 5.2 percent of GDP for 2008-09 as compared to 7.6 percent of GDP in 2007-08. It is pertinent to note that out of the total fiscal deficit of 5.2 percent of GDP, 0.9 percentage points were contributed by exogenous expenditures that were not budgeted. For instance, 0.7 percentage points were added because the Punjab government over-drafted Rs 99 billion from the State Bank of Pakistan in the last quarter of fiscal year 2008-09, while 0.2 percentage points were added to accommodate expenditure on Internally Displaced Persons (IDPs) due to the on-going operation against terrorism in the country. Otherwise, the government remained committed to underlying fiscal deficit of 4.3 percent of GDP for 2008-09.

However, there remains much room for improvement; given its potential, Pakistan needs to significantly increase its revenues from both tax and non-tax sources. The Federal Board of Revenue (FBR) missed both its original and revised collection targets in fiscal year 2008-09. The FBR collected Rs 440.3 billion in Direct Taxes as compared to the revised target of Rs 461 billion while Sales Tax (Rs 452.3 billion) also missed its revised target (Rs 457 billion) mainly on account of less collection from oil. On the other hand, Federal Excise Duty (Rs 116.1 billion) and Customs Duties (Rs 148.4 billion) surpassed their revised targets of Rs 116 billion and Rs 145 billion, respectively. Overall, the FBR missed its revised target of Rs 1,179 billion and ended the year with a total collection of Rs 1,157 billion primarily due to erosion of base.

Being a developing economy, Pakistan needs to augment its development efforts. Development efforts crucially hinge upon additional resource mobilization that can be generated by extending the tax net to untapped areas of the economy. FBR is responsible for a major portion of revenues and currently it is undergoing a tax reforms program. The restructuring of the FBR has taken place and the establishment of the Inland Revenue Service (IRS) will serve as a single entity within the FBR that will merge the tasks of all domestic taxes, namely the sales tax, income tax, and excise taxes. This harmonized tax administration will include an integrated tax management structure and a unified database that will improve efficiency and help increase the tax-to-GDP ratio in the medium term.

This Fiscal Policy Statement (FPS) will review the overall fiscal developments during fiscal year 2008-09 in order to fulfill the legal requirement of Section 6 of the FRDL Act 2005. Furthermore, the Act requires the FPS to analyze the performance of some key fiscal indicators such as the total revenues, overall fiscal deficit, primary and revenue deficits, as well as the public debt burden. The Act also requires that the FPS analyze whether there was any deviation from the fiscal targets and if federal government policies have remained in conformity with the principles of sound fiscal and

debt management, and the targets set forth in the medium-term budgetary statement in Section 5 of the Act.

II. Fiscal Policy Statement

The Fiscal Policy Statement is presented to fulfill the requirement in Section 6 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. The statement provides an overview of government revenues and expenditures during the course of the fiscal year and explains the changes in key macroeconomic indicators during 2008-09. Section 6 of the FRDL Act 2005 requires that:

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

on meeting the targets for economic indicators for that fiscal year as specified in the Medium-Term Budgetary Statement; and

- e) An evaluation as to how the current policies of the Federal Government are in conformity with the principle of sound fiscal and debt management and the targets set forth in the Medium-Term Budgetary Statement.

III. Principles of Tax and Expenditure Policy

For a developing country like Pakistan, resource mobilization is vital for economic and social development over a sustained period of time. However, throughout its economic past, like a typical developing country there has almost always remained a revenue-expenditure gap that hinders social welfare programs while stifling development projects. This requires additional resource mobilization that adds to the public debt stock. The current expenditure of the government depicts an inelastic behavior because of some committed expenditures such as defence spending and debt servicing. Consequently development spending has always borne the brunt of fiscal adjustment which is a counterproductive strategy as it hampers growth. Going forward, the government needs to boost its revenue generation capacity, streamline and prioritize its expenditures while overcoming structural weaknesses and internal inefficiencies.

III-i: Principles of Tax Policy

In Pakistan, the Federal Board of Revenue (FBR) is primarily responsible for levying and collection of almost all federal taxes. Over the years, gradual changes to the tax structure have produced mixed results which are far from the desirable objectives and properties of an efficient tax system. In the recent past, some new initiatives like the development of a strong taxpayer facilitation culture with a view to promote voluntary tax compliance in a self-assessment system of tax administration; taxpayer education and facilitation; development of IT systems in some critical areas; significant progress in e-filing and establishment of a modern Large Taxpayer Units (LTUs) / Regional Tax Offices (RTO's) with upgraded infrastructure at many centers have raised the standards of the tax system. But despite these changes, the system continues to under-perform as the challenge to raise adequate revenues each year falls short of expectations, mainly because the bases of major revenue spinners — personal and corporate income taxes and the General Sales Tax (GST), continue to be very narrow in addition to the level of tax evasion.

The Inland Revenue Service (IRS) will include a harmonized tax management structure and an integrated database that will improve efficiency and help increase the tax-to-GDP ratio to 12-14

percent in the medium-term. The purpose of this harmonized structure is to increase the efficiency of tax administration and lay the foundation for the implementation of the Value-Added Tax (VAT). The implementation of the VAT is a central component of the government's revenue enhancing strategy over the medium to long term to help finance the needed increase in public outlays without having to recourse towards external borrowing or crowding out private sector investment. The goal of these measures will be to boost revenue collection in the short term while reinforcing the long-term objectives of increasing the effectiveness, efficiency, fairness and flexibility of the overall tax system

III-ii: Principles of Expenditure Policy

Public expenditure is one of the critical components of a country's development goals that include economic and social objectives. To make expenditure policy effective, it is necessary that resource allocation decisions are based on the availability of timely and precise financial data, a set framework of financial and accounting principles that are recognized internationally, and a system of public accountability that is backed by audit legislation. The government is committed to strengthen its expenditure controls through implementing the Medium-Term Budget Framework (MTBF) where policies are considered in a medium-term context which will provide greater predictability in the budgetary process.

The government is also committed to extending the operations of the Project for Improving Financial Reporting and Auditing (PIFRA) to monthly federal and provincial fiscal reporting. PIFRA was introduced to computerize the whole accounting and auditing system of the country. The idea is to generate timely, accurate and reliable financial statements; monitor the fiscal deficit; forecast the flow of cash; manage public debt; achieve effective financial controls and the auditing all transactions of the Federal, Provincial and District governments relating to Public Accounts through the Auditor General of Pakistan. Also, the transition to a Treasury Single Account will be completed gradually. The government has already introduced key elements of a Treasury Single Account, requiring that all disbursements pass through a zero balance assignment account. The private sector can also aid the government in development projects through Public-Private Partnerships (PPP) where each has a comparative advantage in their specific areas.

An expansionary public expenditure policy is only sustainable if it is financed by higher revenues. Given the current level of the fiscal deficit, any additional expenditure without commensurate increase in revenue could lead to macroeconomic instability, as witnessed in the recent past, which in turn will reduce the growth prospects of the economy.

IV. Fiscal Policy Developments

For every government, achieving high economic growth rate is a primary national objective as it helps in accomplishing the extremely important socio-economic goals of expanding employment and reducing poverty. Fiscal Policy should focus on generating primary surplus and ensuring that real rate of growth of revenues should be higher than the real growth in debt servicing obligation.

The fiscal policy should explore opportunities for augmenting the resource envelop rather than cutting down the expenses, however the expenses should be rationalised and non-productive expenditure should be curtailed that bring improvement in the national investment climate, saving incentives and opportunities and competitiveness of the real economy. Institutionalization of policy coordination cannot be overemphasized for growth and sustainability of national economy.

Pakistan's fiscal deficit vastly improved over the years after averaging 7.0 percent of GDP during the 1980s and 1990s, to 4.0 percent on average during 2000-2007. Given the predicament being faced by Pakistan's economy during fiscal year 2007-08 and its effects carried forward into 2008-09, the fiscal policy stance of the government remained geared towards fiscal consolidation and stabilization.

Revenue growth in real terms has been an underlying concern over the past years. While real growth in non-interest expenditure has remained substantial, growth of revenues in real terms has lagged behind (See **Table-1**), contributing to the high deficit registered in the 2007-08. Furthermore, the persistence of a high saving-investment gap has meant that crucial investments have had to be financed through debt creation as opposed to access to increased savings. The impact of these two vital developments is not only reflected in the fiscal deficit, but also the increasing debt burden of the country. Additionally, as the outstanding stock of debt increases at a faster pace than real revenues, the drain placed by debt servicing on government resources has also become more severe. The presence of significant primary and revenue deficits further illustrates the consequences of lackluster performance of revenues and the inability to increase the national savings pool in order to meet the investment needs of the economy.

The artificially maintained fiscal prudence exploded in 2007-08 and absence of policy response further complicated the problem of fiscal adjustment in 2008-09. The financial improvement plan of major power companies during 2000-2004 under Poverty Reduction and Growth Facility (PRGF) was seriously jeopardized by the premature withdrawal from PRGF program with the IMF in December 2004, contributing to the abandonment of restructuring program of the power sector

which continues to pose serious implications for fiscal deficit as well as elimination of tariff differential in 2009-10.

Table-1: Selected Fiscal Indicators				
	FY06	FY07	FY08	FY09
Real Growth of Debt	-3.2%	2.6%	8.5%	1.7%
Real Growth of Revenues	9.1%	12.9%	-0.7%	-1.5%
Real Growth of Tax Revenue	11.4%	3.0%	1.9%	-10.2%
Real Growth in Non-interest Exp.	16.5%	6.7%	9.0%	-19.2%
Real Growth of GDP	5.8%	6.8%	4.1%	2.0%
Saving Investment Gap	-4.4%	-5.1%	-8.6%	-5.4%
Primary Balance	-2.3%	-1.5%	-2.8%	-0.3%
Revenue Balance	0.6%	-0.9%	-3.5%	-1.5%
Public Debt/ GDP	57.2%	55.5%	58.4%	58.1%
Debt/Revenue	405.3	370.8	400.2	410.5
Debt Service / Revenue	39.4%	41.5%	45.3%	43.5%

Source: Budget Wing, and DPCO Staff Calculations

Fiscal year 2008-09 also saw the fiscal deficit target being missed. Initially set at 4.7 percent of GDP, the fiscal deficit target was revised down to 4.3 percent of GDP but eventually stood at 5.2 percent of GDP by the end of the year owing to combination of factors like intensification of war on terror and over-draft from Punjab government in the final quarter. If it were not for these additional expenditures, the fiscal deficit could have been contained at 4.3 percent of GDP for 2008-09.

Table-2 illustrates the historical trend of some important fiscal indicators with respect to GDP. On the revenue side, the tax-to-GDP as well as revenue-to-GDP ratios have either remained stagnant or shown a steady decline because of structural deficiencies in the tax system and the way it is administered, both in federal and provincial governments. Being a developing country, Pakistan needs resources that can contribute towards uplifting physical and human infrastructure. In this regard, the tax to GDP ratio must improve to 12-14 percent over the medium term. The provincial governments' contribution to tax-to-GDP is stagnated at 0.4 percent which is well below their potential. Nevertheless, with reforms in the tax system envisaged, this ratio should improve by 0.6 percentage points each year over the next few years.

During 1999-2000 to 2008-09, revenues depicted topsy-turvy behavior with fluctuations from 14% to 15% of GDP while spike in expenditures remained unabated from 2003-04 to 2007-08 with consequent persistent rise in the fiscal deficit. The onus of fiscal adjustment indiscriminately

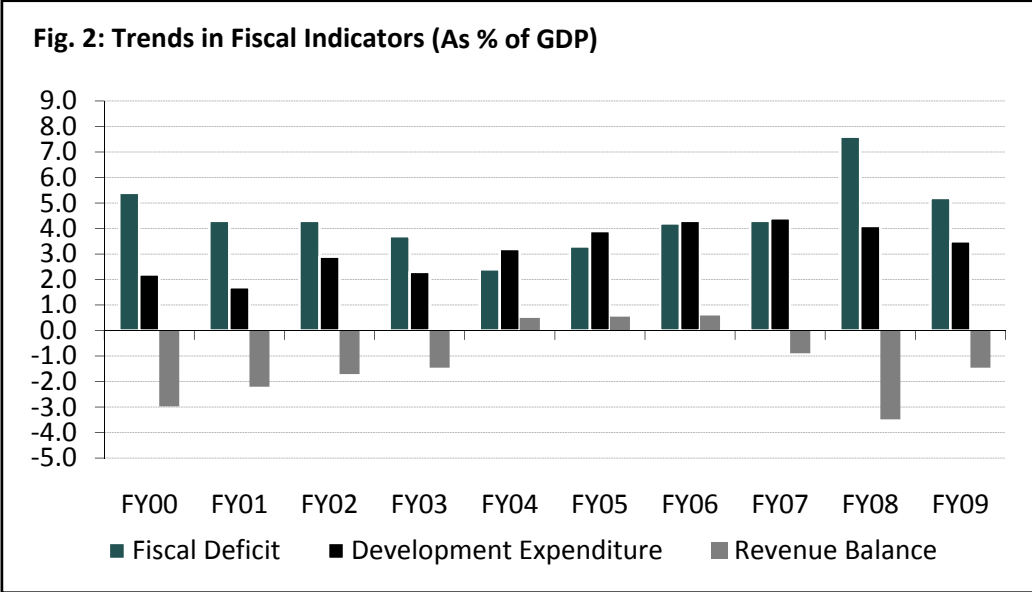
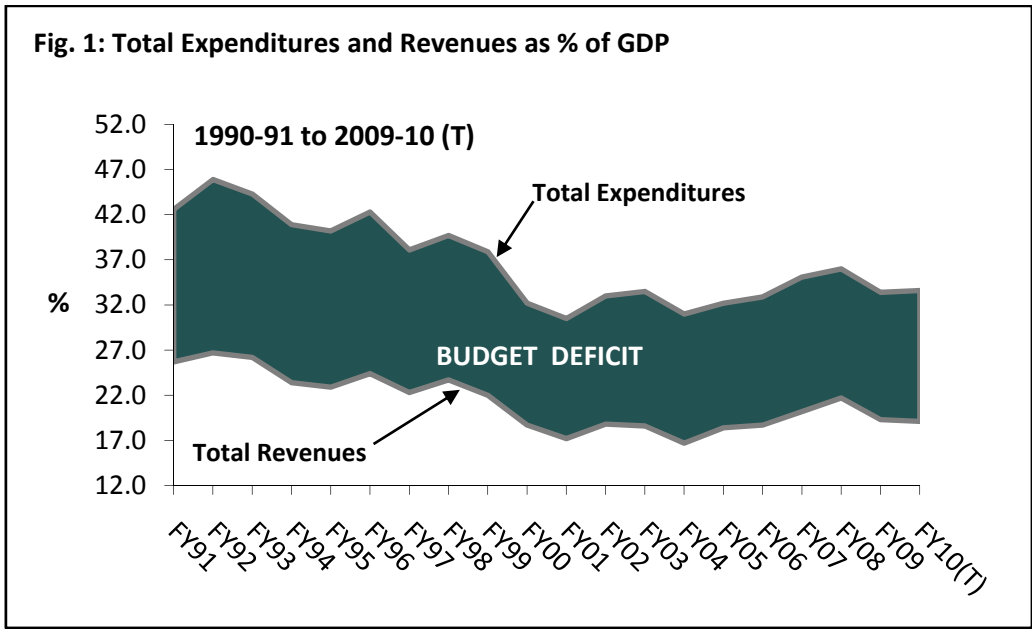
Table-2: Fiscal Indicators as Percent of GDP								
Year	Real GDP Growth	Overall Fiscal Deficit	Expenditure			Revenue		
			Total	Current	Development	Total	Tax	Non-Tax
FY91	5.4	8.8	25.7	19.3	6.4	16.9	12.7	4.2
FY92	7.6	7.5	26.7	19.1	7.6	19.2	13.7	5.5
FY93	2.1	8.1	26.2	20.5	5.7	18.1	13.4	4.7
FY94	4.4	5.9	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	9.0	3.3 [†]	18.4	14.5	3.9	13.8	10.1	3.7
FY06	5.8	4.2* [†]	18.7	14.4	4.3	14.2	10.4	3.8
FY07	6.8	4.3* [†]	20.2	15.8	4.4	14.9	11.0	3.9
FY08	4.1	7.6	22.2	18.1	4.1	14.6	10.6	4.0
FY09	2.0	5.2	19.3	15.6	3.5	14.1	9.2	4.9
FY10(T)	3.3	4.9	19.4	14.2	5.2	14.5	10.5	4.0

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.

fell on the development expenditure in 2008-09 with rigidity in current expenditure and stagnancy in revenues. Fiscal year 2008-09 saw a consolidation of the government's fiscal position at the expense of development expenditures. Encouragingly, the revenue deficit improved considerably and going forward, the government will need to ensure that total revenues should be enough to at least finance their current expenditures. In the coming years, a greater effort is needed to reduce the fiscal deficit through higher revenues, generated primarily through an efficient and well structured tax system, as opposed to cutting back on development expenditures.



IV-i: Fiscal Performance during 2008-09

Pakistan’s economy faced headwinds like political instability, a deteriorating law and order environment, supply shocks, a weakening of external demand, turmoil in international financial markets and high prices for oil, food and other commodities during fiscal year 2008-09 resulting in modest GDP growth of 2.0 percent which is relatively satisfactory, when looked at in the context of

the prevalent global financial crisis and economic slowdown. In addition, monetary overhang from previous years due to excessive government borrowing from the central bank to finance the large fiscal deficit led to inflationary pressures in the economy and the crowding out of the private sector. The fiscal deficit was financed mainly through combination of non-bank and commercial banks financing which replaced SBP financing. However, due to non-existence of appetite from the private sector, the crowding out impact was not a cause for concern. After keeping exchange rate artificially low during 2004-08, the exchange rate plunged by around 22 percent in the period of July-October 2008. Such a massive depreciation had potential threat to culminate into a balance of payment crisis. The depreciation of the rupee and a rapid draw-down of reserves at a pace of almost over \$1 billion per month threatened macroeconomic stability of the country.

A weak Rupee compounded the problem of inflation which also posed a serious threat to the economy and society at large during 2008-09. The inflation rate averaged a substantial 20.8 percent for the fiscal year as against 12.0 percent in the last year. The factors that contributed to the surge and then persistence of high inflation in 2008-09 included monetary overhang from the previous years; supply shocks in commodity markets; an upward adjustment in the support price of wheat; depreciation of the rupee against the dollar; and the gradual withdrawal of subsidies on gas, POL products and electricity. Pakistan needs a low and stable inflation to persist over a sustained period in order to stay on a desirable growth path.

Fiscal consolidation crucially hinges upon improvement in the power sector. Pakistan has to rationalize the generation mix for provision of cost effective energy supplies. The government has to eliminate power tariff differential either through financial improvement, cost efficiency and complete pass-through to attract more investment in the sector. The fiscal cost of the power sector may jeopardize the macroeconomic stability in the country; devastate prudent debt management and result in unbearable consequences for economic growth. The power sector has become a thorny issue of economic management and to leap forward we need to resolve this issue as early as possible.

Pressure on fiscal account may also be lowered through increasing savings ratio in the country. Savings is a vital component of a country's economy in terms of creating a pool of available resources to finance macro-economic objectives. Pakistan has historically witnessed a substantial saving investment gap. Over the years this gap as a percent of GDP has widened from 1.6 percent in 2004-05 to 5.4 percent in 2008-09 (See **Table-3**). A low level of savings has contributed to this vacuum over the years and this decline reflects a build-up of inflationary pressures in the economy. This plunge also speaks of the non availability of innovative financial instruments and

underdeveloped secondary markets in the country. The government has been a primary contributor to this mismatch between saving and investment. The private sector has, to some extent, compensated for this dis-saving behavior of the government. However, efforts should be made to reduce government dis-saving on one hand while increasing the pool of private sector saving in the economy on the other. The cash deposit ratio, calculated by dividing the currency in circulation by the total deposits in the banking sector of a country, is a true measure of the idle resources being piled up out of the system.

Table-3: Saving-Investment Gap, FY05-FY09					
(In percent of GDP)	FY05	FY06	FY07	FY08	FY09
Total National Savings	17.5	17.7	17.4	13.4	14.3
<i>Public Sector</i>	<i>3.4</i>	<i>2.3</i>	<i>0.8</i>	<i>(1.8)</i>	<i>1.2</i>
<i>Private Sector</i>	<i>14.1</i>	<i>15.4</i>	<i>16.6</i>	<i>15.1</i>	<i>13.2</i>
Gross Total Investment	19.1	22.1	22.5	22.0	19.7
<i>Changes in Stock</i>	1.6	1.6	1.6	1.6	1.6
<i>Total Fixed Investment Public Sector</i>	<i>4.3</i>	<i>4.8</i>	<i>5.6</i>	<i>5.4</i>	<i>4.9</i>
<i>Total Fixed Investment Private Sector</i>	<i>13.1</i>	<i>15.7</i>	<i>15.4</i>	<i>15.0</i>	<i>13.2</i>
Saving-Investment Gap	(1.6)	(4.4)	(5.1)	(8.6)	(5.4)

Source: SBP and DPCO Staff Calculations

Pakistan has experienced a surge in the currency to deposit ratio (CDR) since 2007-08, indicating significant funds lying in the informal sector (see **Table-4**). Soaring inflation coupled with a relatively weak intermediary role of banks resulted in a deceleration in deposit growth and an increase in currency in circulation growth during 2007-08 and 2008-09. The returns offered on deposits appeared negative in real terms and led to a liquidity preference of holding currency among the masses. Therefore, a large amount of resource was available out of the system which was not capitalized upon.

In order to lower the cost of borrowing and broaden the financial resource base of the country, a strong need is felt on the part of the banks to offer innovative or diversified instruments. To this end positive real interest rates over a sustained period are very crucial. The banking sector enjoys high earning spreads alongwith shrinking liquidity and may capitalize upon the idle resources of the economy by increasing financial penetration and outreach and incentivizing the high rural population to unlock their potential savings. There is a dire need to introduce mortgage refinancing schemes, funded pension plans, Islamic financial products and property tax proposals. Moreover, the institutionalization of the informal sectors of economy will help augment the banking system. With a current money multiplier of 3.14 (as of December 5, 2009), transfer of even a small amount

of out-of-the-system money to the formal banking channels will enhance the regeneration capacity of the monetary system to more than three times. Such efforts will help bridge the saving investment gap, make fiscal and monetary policy more effective, while simultaneously developing the resource envelope. Going forward, a reasonable compensation for savings is a prerequisite in this regard.

Table-4: Currency to Deposit Ratio and Money Multiplier						
	FY05	FY06	FY07	FY08	FY09	FY10^P
Currency in Circulation (Rs Billion)	666	740	840	982	1,152	1,308
Total Private & PSE Deposits	2,291	2,662	3,218	3,703	3,980	4,445
Currency to Deposit Ratio (%)	29.1%	27.8%	26.1%	26.5%	28.9%	29.4%
Broad Money (Rs Billion)	2,961	3,407	4,065	4,689	5,137	5,753
Reserve Money (Rs Billion)	909	1,001	1,210	1,480	1,508	1,732
Money Multiplier	3.26	3.40	3.36	3.17	3.41	3.32
P: Projections		Source: State Bank of Pakistan Annual Report 2008-09 FY10 Projections from IMF Country Report January 2010				

IV-i-a: FBR Tax Collection and Refunds during 2008-09

Fiscal year 2008-09 was a challenging year for the economy as a whole as most of the macroeconomic targets fixed for fiscal year 2008-09 were missed. Since revenue realization is linked with the macroeconomic framework of the country, the adverse impact on the economy disturbed revenue realization to a great extent during the course of the year. The FBR was assigned a challenging revenue target of Rs 1250 billion, requiring a growth of 24% over the collection of Rs. 1008.1 billion during fiscal year 2007-08. This target was then revised down to Rs. 1179 billion. However, despite best efforts, the FBR fell short of this target, to record Rs. 1157 billion at the end of the fiscal year, which constitutes 98 percent of the revised target.

It is clear from **Table-5** that the performance of the FBR was broad based as all the taxes exhibited double digit growth during fiscal year 2008-09, except for custom duties. Sales tax has regained top position in the collection of federal taxes due to a better performance from the domestic sales tax component.

It is relevant to mention that while the increase in the FBR tax receipts has been substantial in absolute terms, it has however lagged behind the growth in nominal GDP, thereby exhibiting a decline in FBR tax-to-GDP ratio from 9.8 percent in 2007-08 to only 8.8 percent in 2008-09.

Table-5: Net Tax Collection (in Rs Billion)				
Revenue Heads	Collection		Difference	
	FY09	FY08	Absolute	Percent
Direct Taxes	440.3	387.9	52.4	13.5
Indirect Taxes	716.8	620.2	96.6	15.6
- Sales Tax (GST)	452.3	377.4	74.9	19.8
- Federal Excise	116.1	92.1	24.0	26.1
- Customs Duties	148.4	150.7	-2.3	-1.5
Total Taxes	1,157.1	1,008.1	149.0	14.8

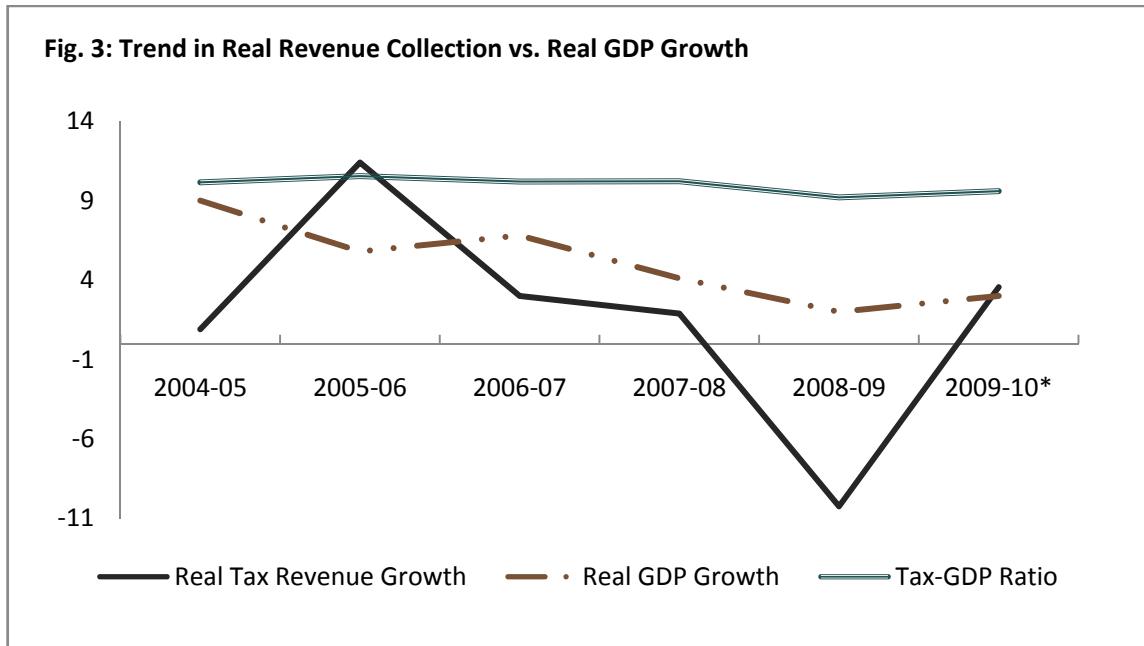
Source: Federal Board of Revenue

The low tax-to-GDP ratio highlights a few key issues in the economy's tax structure, and the inability to translate higher economic growth in to increased tax revenue collection. When taken in real terms, tax revenue has grown by a meager average of 1.4 percent for the last five years, as compared to average real GDP growth of 5.5 percent during the same period (See **Table-6**).

Table-6: Real Growth of Tax Revenue			
	Tax Revenue (Rs Billion)	Real Growth of Tax Revenue (%)	Real GDP Growth (%)
2004-05	659.4	0.9	9.0
2005-06	803.7	11.4	5.8
2006-07	889.7	3.0	6.8
2007-08	1,050.7	1.9	4.1
2008-09	1,204.7	-10.2	2.0
2009-10*	1,380.0	3.6	3.0

*Projections Source: DPCO Staff Calculations

Periods of high economic growth have not been translated into higher revenue collection. Consequently, the tax-to-GDP ratio has declined from 10.1 percent in 2004-05 to 9.2 percent in 2008-09 (See **Figure-3**). This may be attributed to the tax structure of Pakistan; specifically the issue of major contributors to GDP growth being outside the purview of the tax net. In order to realize the gains from economic growth, facilitate its transmission into increased revenues, and to ensure availability of ample resources going forward, major contributors of economic growth must be brought in to the tax system. By doing so, the government will be able to increase its tax-to-GDP ratio, align its goals of higher economic growth and increased revenue collection, while creating sustainable fiscal space.

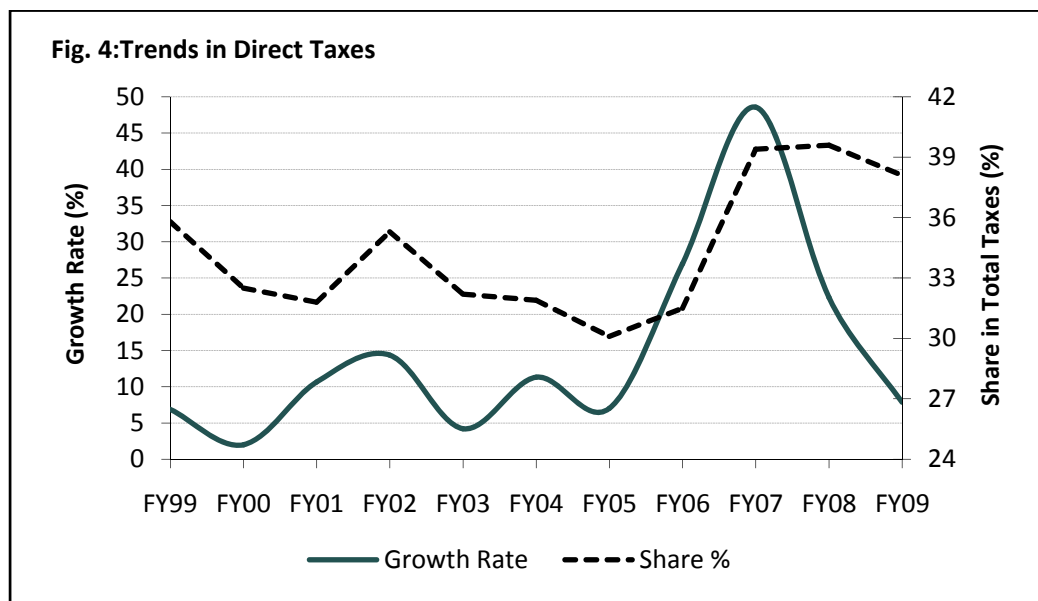


DIRECT TAXES

The direct tax has contributed 38.1 percent in total tax receipts during fiscal year 2008-09 with a net collection of Rs. 440.3 billion against the target of Rs. 461 billion. An amount of Rs. 38.8 billion refunds has been paid back to the claimants as against Rs. 25.8 billion during fiscal year 2007-08.

If we look at the performance of direct taxes in a historical perspective, the improved tax effort and effective implementation of tax policy and administrative reforms has geared up the collection over the years. The share of direct taxes in total federal tax receipts has increased from around 15 percent in early 1990s to 32 percent in fiscal year 2000-01. It has touched new heights of 39.4 percent in fiscal year 2006-07, but declined slightly to 38.1 percent in fiscal year 2008-09. Similarly, the growth pattern had an increasing trend during the past few years rising from 7.0 percent in fiscal year 2004-05 to 27.0 percent in 2005-06 and further to 48.3 percent in 2006-07. However, the rate then showed a declining trend as it fell to 22.3 percent in fiscal year 2007-08 and further to 7.9 percent in 2008-09. A number of reasons can be attributed to this slowdown in revenue realization: apart from the general economic slowdown and load-shedding during the period under review, the major set back has been due to significant reduction in voluntary compliance. The fluctuations in the growth rate can also be attributed to the base effect. This means that if the growth in direct taxes from one year started from a lower level, it will generate a higher growth number for the

following year. Consequently, growth rates for the next year will start from a higher base effect, causing a lower growth number the following year.



It may be recalled that the collection of direct taxes includes income tax and other direct taxes such as capital value tax, worker welfare fund and worker participatory fund. However, the contribution of income tax in total direct taxes has been 95.6 percent, making it our main focus.

	2008-09	2007-08	Change (%)
Voluntary Payments	141,680	145,616	-2.7
Collection on Demand	77,166	42,779	80.4
Deductions at Source (WHT)	240,546	205,144	17.3
Miscellaneous	255	242	5.4
Gross income tax Receipts	459,647	393,782	16.7
Refunds	38,798	25,822	50.2
Other DT	19,442	19,902	-2.4
Net Direct Taxes	440,291	387,862	13.5

Source: FBR Data Bank

The structure of income tax is based on withholding taxes (WHT), voluntary payments (VP) and collection on demand (COD). The collection during fiscal year 2008-09 shows that the share of WHT,

VP and COD in gross collection has been 52.3 percent, 30.8 percent and 16.8 percent respectively. Details of these components of income tax are presented in **Table-7**.

Voluntary Payments (VP)

This component includes payments with returns and advances. In net terms, Rs. 141.6 billion were generated during fiscal year 2008-09 as compared to Rs. 145.6 billion in the corresponding period last year, registering a 2.7 percent decline. It is pertinent to note that the basic objective behind the implementation of the Universal Self Assessment Scheme (USAS) was to minimize the interface between taxpayers and the tax administration in order to repose confidence in the system and eliminate the element of corruption.

Income Tax Returns Analysis

The number of income tax returns and statements received by the end of fiscal year 2008-09 were 2,214,561, higher by 75,164 as compared to the corresponding period last year, indicating a growth of about 3.5%. The number of corporate returns increased from last year, yielding Rs. 6.6 billion in collection. A similar outcome has been noticed for other categories of taxpayers including individuals and Association of Persons (AOPs).

It seems that the USAS is on track as it has been functioning successfully for the past few years yielding substantial revenue through it. However, the problem lies with audit which needs to be initiated for selected corporate cases. Unfortunately, the enormous gap between corporations who have got National Tax Numbers (NTN) and those who actually file returns continues to derail voluntary compliance. It is essential that the audit teams take a leadership role, which regrettably remains the missing link in the entire equation.

Withholding Taxes (WHT)

WHT continues to be the leading source of direct tax receipts. However, despite its large contribution, there is ample scope to enhance this collection further. The WHT collection during fiscal year 2008-09 has been Rs. 240.5 billion against Rs. 205.1 billion during fiscal year 2007-08, indicating a healthy growth of 17.3 percent (see **Table-8**). The nine major sources of withholding tax contributed around 93 percent of total collection. These include: contracts, imports, salary, telephone, export, bank interest/securities, electricity, cash withdrawal and dividends. Rationalization of income tax rate for the salaried individuals and enhanced salary packages, especially in the private sector, has yielded higher revenue.

Table-8: Withholding Tax Collection (Rs Million)			
	2008-09	2007-08	Change (%)
Contracts	82,507	77,166	6.9
Imports	30,101	27,675	8.8
Salary	27,405	22,651	19.2
Exports	14,360	11,502	24.9
Telephone Bills	21,726	18,146	19.7
Bank Interest/Securities	16,119	9,682	14.4
Electricity Bills	12,722	5,894	115.8
Dividends	6,565	6,483	1.3
Cash Withdrawal	11,338	4,098	176.7
<i>Sub-Total</i>	<i>222,430</i>	<i>187,699</i>	<i>18.5</i>
Other WHT	18,116	17,445	3.8
Total WHT	240,546	205,144	17.3

Source: FBR Data Bank

INDIRECT TAXES

Contributing nearly two thirds to overall tax collection, indirect taxes recorded a healthy growth of 15.6 percent in 2008-09 over last year's collection (See **Table 8**). Indirect taxes consist of Sales Tax, Custom Duty and Federal Excise Duty. The major revenue spinners in indirect taxes are petroleum, telecom, automobiles, edible oil and cigarettes which have traditionally contributed nearly half of the gross collection. This is evidence that the tax base in Pakistan is too narrow and in the long run, tax collection cannot increase substantially without bringing more areas of the economy under the tax net.

I. Sales Tax:

General Sales Tax (GST) has again emerged as the top revenue generation source of the country constituting 39.1 percent of the total collection of federal taxes. A growth of around 20 percent has been recorded in the net collection of sales tax. The collection of sales tax has two components i.e. sales tax on imports and sales tax on domestic activity. Due to better performance by the domestic sales tax, especially petroleum products during 2008-09, its share in total sales tax has improved from 48.1 percent to around 55 percent in 2008-09. On the other hand, slow down in imports during 2008-09 has vastly affected the collection of sales tax from imports. (See **Table-9**)

Table-9: Collection and Growth of Sales Tax: Fiscal Year 2008-09 (Rs Billion)						
Sources of GST	Collection/ Refunds			Growth (%)		
	Gross	Refund	Net	Gross	Refund	Net
Import Stage	203.3	0.1	203.3	3.7	-29.2	3.7
Domestic Stage	275.9	26.9	249.0	31.7	-4.1	37.3
GST (Total)	479.2	26.9	452.2	18.2	-4.2	19.8

Source: FBR Data Bank

I. i. Sales Tax: Domestic Collection

There are ten major commodities that contribute 89.3 percent of the total sales tax domestic sector. These include petroleum products, telecom services, natural gas, sugar, cigarettes, services, electrical energy, beverages, cement and tea (See **Table-10**).

Table-10: Comparison of Sales Tax Domestic (Net) Collection by Major Commodity (Rs Million)					
Major Commodities	Collection 2008-09	Collection 2007-08	Growth Realized (%)	Share (%) 2008-09	Share (%) 2007-08
POL Products	106,812	57,160	86.9	42.9	31.5
Services by Telecom Sector	50,087	45,105	11.0	20.1	24.9
Natural Gas	18,799	13,219	42.2	7.5	7.3
Sugar	11,969	12,117	-1.2	4.8	6.7
Cigarettes	9,642	7,861	22.7	3.9	4.3
Electrical Energy	6,391	2,398	166.5	2.6	1.3
Services	6,357	6,193	2.6	2.6	3.4
Cement	4,506	3,578	25.9	1.8	2.0
Beverages	4,242	4,409	-3.8	1.7	2.4
Tea	3,671	2,879	27.5	1.5	1.6
<i>Sub-Total</i>	<i>222,476</i>	<i>154,919</i>	<i>43.6</i>	<i>89.3</i>	<i>85.4</i>
Others	26,554	26,477	0.3	10.7	14.6
Net Collection	249,030	181,396	37.3	100	100

Source: FBR Data Bank

I. ii. Sales Tax: At Import Stage

Sales tax on import is an important source of collection of federal taxes. It has contributed 44.9 percent, 28.4 percent and 19.9 percent in sales tax, indirect taxes and total federal taxes

respectively during 2008-09. The collection of sales tax has posted an increase of only 3.7 percent during 2008-09 mainly due to the slow down in imports and the zero-rating of crude oil for sales tax purpose effective November 30, 2007. Like sales tax domestic, the receipts of sales tax on imports are also concentrated in a few sectors. Petroleum products alone contributed around 37.4 percent of overall collection of sales tax on imports. Similarly, ten major spinners including petroleum constituted 80.9 percent of the sales tax import (See **Table-11**).

Table-11: Collection of Sales Tax (Import) - Major Items (Rs Million)					
Description	Collection 2008-09	Collection 2007-08	Realized Growth (%)	Share (%)	Share (%)
POL Products (27)	76,081	74,266	2.4	37.4	37.9
Edible Oil (15)	17,824	15,440	15.4	8.8	7.9
Plastic (39)	16,606	14,627	13.5	8.2	7.5
Vehicles and Parts (87)	10,736	13,538	-20.7	5.3	6.9
Iron and Steel (72)	15,117	11,573	30.6	7.4	5.9
Mechanical Machinery (84)	6,813	7,383	-7.7	3.4	3.8
Electrical Machinery (85)	5,883	6,964	-15.5	2.9	3.6
Organic Chemicals (29)	5,917	5,313	11.4	2.9	2.7
Paper & P. Board (48)	5,829	4,835	20.6	2.9	2.5
Oil seeds etc (12)	3,763	3,783	-0.5	1.9	1.9
Sub Total	164,569	157,722	4.3	80.9	80.4
Other	38,758	38,401	0.9	19.1	19.6
Gross	203,327	196,123	3.7	100	100
Refund/Rebate	63	89	-29.2		
Net	203,264	196,034	3.7		

Source: FBR Data Bank

II. Custom Duty

The collection of other taxes on imports like sales tax imports, WHT and FED, depends on the collection of customs duty as it is a component of their bases. During 2008-09, custom duty contributed 12.8 percent of the federal taxes and 32.8 percent of indirect taxes. The collection of customs duty surpassed the revised target of Rs. 145 billion by collecting Rs. 148.4 billion. On the other hand, the net collection of customs duty has reduced from Rs. 150.7 billion in 2007-08 to Rs. 148.4 billion during 2008-09 yielding negative growth of 1.5 percent. The reasons for this reduction

are exemption of wheat from customs duty, decline in international petroleum prices (especially High Speed Diesel) in the second half of 2008-09 and the overall slowdown in the imports.

Major part of the receipts of customs duty has been contributed by 15 major revenue spinners. The collection of these fifteen leading commodities is highlighted in **Table-12**. Around three-fourth of the collection has been fetched from these items during 2008-09. Apart from collection, these items shared 74.1 percent of the total imports and 84.7 percent of the dutiable imports.

Table-12: Collection of Customs Duties during 2008-09 (Rs Million)					
Description	Collection 2008-09	Collection 2007-08	Realized Growth (%)	Share (%) During 08-09	Share (%) During 07-08
1. POL Products (27)	19,369	24,032	-19.4	12.4	14.7
2. Vehicles and Parts (87)	17,554	25,810	-32	11.3	15.8
3. Edible Oil (15)	17,134	17,213	-0.5	11	10.6
4. Mechanical Machinery (84)	13,794	11,634	18.6	8.8	7.1
5. Electrical Machinery (85)	13,334	13,568	-1.7	8.5	8.3
6. Iron and Steel (72)	7,887	6,198	27.2	5.1	3.8
7. Plastic (39)	6,784	6,379	6.4	4.3	3.9
8. Paper & P. Board (48)	5,120	4,390	16.6	3.3	2.7
9. Organic Chemicals (29)	3,743	3,586	4.4	2.4	2.2
10. Articles of Iron & Steel (73)	2,899	2,438	18.9	1.9	1.5
11. Dyes and Paints(32)	2,238	2,005	11.6	1.4	1.2
12. Coffee, Tea, and Spices (9)	2,193	1,860	17.9	1.4	1.1
13. Misc Chemicals Products (38))	2,190	1,714	27.8	1.4	1.1
14. Cosmetic and Perfumery(33)	2,162	1,319	63.9	1.4	0.8
15. Soap and Artificial Waxes (34)	2,046	1,720	19	1.3	1.1
Sub Total	118,447	123,866	-4.4	75.9	76
Other	37,582	39,206	-4.2	24.1	24
Gross	156,029	163,071	-4.3	100	100
Refund/Rebate	7,647	12,408	-38.4		
Net	148,382	150,663	-1.5		

Source: FBR Data Bank

III. Federal Excise Duties (FED)

Among all the taxes, the collection of federal excise has manifested the highest growth of 26 percent during 2008-09 as compared to the previous year. Moreover, the revised target of Rs.116

billion was also achieved. The collection of Rs 116.1 billion was realized as FED against 92.1 billion collected in fiscal year 2007-08 (See **Table-13**).

Apart from the traditional major revenue spinners, it is encouraging that the services sector emerged as the third highest revenue spinner of FED. Only six major items contributed around 80 percent of the collection during 2008-09. Among these major items, cigarette was the top most revenue generator with around 31.8 percent share in FED collection, followed by cement (15.2%), services (15.1%), beverages (9.1%), natural gas (5.3%) and POL products (3.6%).

Table-13: FED Collection from Major Commodities (Rs Million)						
Commodities	2008-09	2007-08	Difference		Share(%) 2008-09	Share(%) 2007-08
			Absolute	Percent		
Cigarettes	36,860	28,538	8,322	29.2	31.8	31.0
Cement	17,618	15,094	2,524	16.7	15.2	16.4
Services	17,485	12,418	5,067	40.8	15.1	13.5
Beverages	10,587	7,241	3,346	46.2	9.1	7.9
Natural Gas	61,04	5,866	238	4.1	5.3	6.4
POL Products	41,21	3,181	940	29.6	3.6	3.5
<i>Sub Total</i>	<i>92,775</i>	<i>72,338</i>	<i>20,437</i>	<i>28.3</i>	<i>79.9</i>	<i>78.5</i>
Other	23,280	19,799	3,481	17.6	20.1	21.5
Total	116,055	92,137	23,918	26.0	100	100

Source: FBR Data Bank

1% Special Excise Duty (SED)

An amount of Rs. 14.2 billion has been realized as special excise duty during 2008-09 reflecting a growth of around 30 percent as compared to previous year collection of Rs 10.9 billion. Details of SED on domestic and imports are spotlighted in **Table-14**.

Table-14: Collection from 1 % SED (Rs Billion)			
1% SED Domestic	2008-09	2007-08	Growth (%)
SED Domestic	6.2	4.0	55.0
SED Imports	8.0	6.9	15.9
Total	14.2	10.9	30.3

Source: FBR Data Bank

Projections for Fiscal Year 2009-10

Foreseeing that the economy will improve and major taxes will display some buoyancy, the budgetary target for fiscal year 2009-10 has been set at Rs. 1,380 billion, requiring an increase of

19.3 percent over the provisional collection of Rs. 1,157 billion of fiscal year 2008-09 (See **Table-15**). Furthermore, the projections for fiscal year 2009-10 also include the impact of budgetary and relief measures announced at the time of Federal Budget.

Table-15: A Comparison of Baseline Collection and Projections (Rs Billion)				
	Prov. Collection 2008-09	Projections 2009-10	Addition	Growth (%)
Direct Taxes	440.3	565.6	125.3	28.5
Sales Tax	452.3	499.4	47.1	10.4
Federal Excise	116.1	152.8	36.7	31.6
Customs Duties	148.4	162.2	13.8	9.3
All Taxes	1,157.1	1,380.0	222.9	19.3
Source: FBR Data Bank				

The projections for fiscal year 2009-10 will result into following tax mix of federal taxes: direct taxes 41.0 percent, sales tax 36.2 percent, federal excise duty 11.1 percent and customs duty 11.8 percent.

The FBR revenue target for fiscal year 2008-09 was fixed at Rs. 1,250 billion which was higher by 24.1 percent over the collection of fiscal year 2007-08. The target was subsequently revised twice; first upwards from Rs. 1250 billion to Rs. 1360 billion and then downwards to Rs. 1179 billion. The earlier enhancement in target was done in the wake of promising growth witnessed in the first quarter (July-September, 2008) of the fiscal year. However, due to the global economic meltdown and resultant adverse effects on Pakistan's economy, the target was again revised, this time downwards, to Rs. 1179 billion. Even this target appeared to be ambitious in view of continued shrinkages in imports and negative growth in the domestic large-scale manufacturing sector. However, with great efforts, FBR collected Rs 1157 billion at the end of the year 2008-09. The tax-to-GDP ratio ended with a very low level of 8.8 percent, lower by 1 percent point as compared to last year. The declining tax-to-GDP ratio is an alarming situation for the country and needs to be addressed if higher revenues are to be generated in the future.

IV-i-b: Review of Expenditure during 2008-09

Total expenditures stood at Rs. 2531.3 billion for the fiscal year 2008-09, up from Rs 2281 billion last year, thus registering an increase of 11.0 percent. Total expenditures as a percentage of GDP stood at 19.3 percent — down from 22.2 percent last year. The original target for total expenditure in 2008-09 was Rs. 2391.5 billion or 19.5 percent of GDP, which was exceeded by Rs. 139.8 billion

by the end of fiscal year 2008-09. Total expenditure consists of current and development expenditures.

Current expenditures for fiscal year 2008-09, current expenditures stood at Rs 2041.6 billion against the budgeted amount of Rs. 1875.8 billion, and last years level of Rs 1858 billion. The 9.9 percent increase in current expenditures from last year was contributed by both the federal government, whose share was Rs 1495.9 billion, as well as the provincial governments whose contribution was Rs. 545.7 billion. Resultantly, current expenditures for entire fiscal year suffered a slippage of Rs 165.8 billion over the budgeted amount for 2008-09 (See **Table-16**).

Table-16: Consolidated Revenue & Expenditure of the Government (Rs Billion)				
	Prov. Actual July-June 2007-08	Budget Estimate 2008-09	Prov. Actual July-June 2008-09	Budget Estimate 2009-10
A. Total Revenue	1499.4	1809.2	1850.9	2155.4
a) Tax Revenue	1050.9	1308.5	1204.7	1563.6
- Federal	1009.9	1251.5	1158.6	1493.6
<i>of which FBR Revenue</i>	1007.0	1250.0	1157.0	1380.0
- Provincial	41.0	57.0	46.1	70.0
b) Non-Tax Revenue	414.0	500.8	646.2	591.8
- Federal	336.0	410.8	562.4	496.8
- Provincial	78.0	90.0	83.8	95.0
B. Total Expenditure	2281.0	2391.5	2531.3	2877.4
a) Current Expenditure	1858.0	1875.8	2041.6	2103.8
- Federal	1420.0	1358.8	1495.9	1513.8
<i>of which: Interest Payments</i>	489.7	523.2	637.8	647.1
- Domestic	430.2	459.1	558.7	576.8
- Foreign	59.5	64.1	79.1	70.3
Defense Expenditure	285.0	296.1	329.9	342.9
- Provincial	437.1	517.0	545.7	590.0
b) Development Expenditure	452.0	516.6	448.8	763.1
- PSDP	452.0	549.7	397.5	646.0
Federal	238.0	373.0	195.7	421.0
ERRA	-	26.7	-	25.0
Provincial	214.0	150.0	201.8	200.0
- Other Development Expenditure	-	43.9	51.3	157.1
Net Lending	-28.0	-1.0	6.9	10.5
C. Overall Fiscal Deficit	777.2	582.3	680.4	722.1
- As % of GDP	7.6%	4.7%	5.2%	4.9%

Table-16: Consolidated Revenue & Expenditure of the Government (Rs Billion)				
	Prov. Actual July-June 2007-08	Budget Estimate 2008-09	Prov. Actual July-June 2008-09	Budget Estimate 2009-10
D. Financing of Fiscal Deficit	777.2	582.3	680.4	722.1
a) External Sources	151.3	165.2	149.7	312.3
b) Domestic	625.9	391.9	530.8	390.4
- Bank	519.9	149.0	305.6	144.1
- Non-Bank	106.0	242.9	223.8	246.3
c) Privatization Proceeds	-	25.1	1.3	19.4
E. GDP at Market Prices	10,284	12,280	13,095	14,972
Memo Items				
Revenue Deficit	-358.6	-66.6	-190.7	51.5
- As % of GDP	-3.5	-0.5	-1.5	0.3
Primary Deficit	-291.9	-59.1	-42.6	-74.9
- As % of GDP	-2.8	-0.5	-0.3	-0.5

Source: Budget Wing, Ministry of Finance

Development expenditure (after adjusting for net lending) was targeted at Rs 516.6 billion in 2008-09 — 14.3 percent higher than last year. However, significant slippages in current expenditure forced the government to cut development spending by Rs. 67.8 billion to Rs. 448.8 billion – which is lower than the fiscal year 2007-08 level. On the basis of revenue and expenditure for the year, the overall **fiscal deficit** was Rs 680.4 billion or 5.2 percent of GDP against Rs 777.2 billion or 7.6 percent from last year. As stated earlier, the main reasons for slippage in fiscal deficit were unanticipated overdraft from the Punjab government and additional expenditure on account of IDPs.

As opposed to fiscal year 2007-08, the current fiscal year saw a change in the composition of government borrowing for **budgetary financing**. Instead of heavy borrowing from the State Bank of Pakistan, which is highly inflationary in nature, the government was able to tap commercial banks as well as non-bank sources. The borrowing from commercial banks was not responsible for crowding out private sector mainly because of limited appetite for credit during the year. Larger than expected inflows from National Saving Schemes brought the non-bank sources contribution in domestic financing up from just 16.9 percent in 2007-08 to 42.2 percent in 2008-09. The bulk of this increase occurred in the second half of 2008-09, as the market perception of an interest rate peak

in the economy and relatively higher rates offered on various schemes under the NSS provided an arbitrage opportunity.

IV-i-c: Slippages in Budget 2008-09

The performance of Pakistan's economy in fiscal year 2008-09 has been vastly influenced by the macroeconomic imbalances created in the past few years. As a result of social, political and economic shocks on both external and internal fronts, Pakistan's economy was impacted with regards to its overall performance resulting in moderate slippages in the budget (See **Table-17**).

Table-17: Variation in Budget 2008-09 (Rs Billion)				
	(I)	(II)	(III)	(IV)
	Original Budget 2008- 09	Revised Budget 2008- 09	Prov. Actual 2008-09	Variations (III) - (I)
A. Total Revenue	1809.2	1882.5	1850.9	41.7
- Tax Revenue	1308.5	1231.5	1204.7	-103.8
<i>Of which FBR Revenue</i>	1250.0	1179.0	1157.0	-93
- Non-Tax Revenue	500.8	651.0	646.2	145.4
B. Total Expenditure	2391.5	2445.3	2531.3	139.8
- Current Expenditure	1875.8	2004.3	2041.6	165.8
<i>Of which - Interest Payment</i>	523.2	630.3	637.8	114.6
- Subsidies	295.2	252.0	257.0	-38.2
a) Power Sector	88.4	111.5	109.2	20.8
- WAPDA	74.6	92.8	90.5	15.9
- KESC	13.8	18.7	18.7	4.9
b) Oil	140.0	70.0	67.7	-72.3
c) Wheat	20.0	20.0	20.0	0
d) R & D Textile	5.7	4.8	3.1	-2.6
e) Fertilizer	32.0	28.7	26.3	-5.7
f) TCP (Sugar)	6.3	6.3	6.3	0
- Development Expenditure	516.6	437.8	448.8	-67.8
- Budget Deficit (A-B)	582.3	562.8	680.4	98.1
<i>As % of GDP</i>	4.7	4.3	5.2	0.5

Source: Budget Wing

Total expenditure for fiscal year 2008-09 was targeted at Rs 2391.5 billion, however the year ended with Rs 2531.3 billion expenditure -- Rs 139.8 billion more than the target, mostly due to over spending of Rs 165.8 billion in current expenditures. Interest payment is the single largest component of current expenditure. A sum of Rs 523.2 was budgeted for interest payments in 2008-09 but the year, however, ended with interest payments surpassing the target by Rs 114.6 billion to Rs 637.8 billion. The increase in domestic debt servicing is partly the result of a tight monetary stance taken in order to arrest the monetary overhang caused by previous policies. The attractive zero-coupon DSCs of the late 1990s started maturing in the last three years, exerting persistent pressure on the government budget. The reclaim on account of this liability can not be forecasted or budgeted with accuracy. Also, the profit rates on major NSS instruments increased thrice in 2008-09 translating into higher interest payments, but there was some respite as a cut in profit rates in the last quarter of 2008-09 eased the interest payments pressure.

In sheer contrast to fiscal year 2007-08, the variation in subsidies positively contributed on the budget in fiscal year 2008-09 by the extent of Rs 38.2 billion. Having entered into an IMF program in November 2008, Pakistan committed itself to the gradual elimination of subsidies in the oil and power sector. However, because of public pressure, there is hesitance in complete elimination of power subsidy until end of fiscal year 2009-10. Nevertheless, given the drastic fall in international oil prices over the course of fiscal year 2008-09, and the planned withdrawal of oil subsidies, the government found itself saving Rs 72.3 billion from the budgeted Rs 140 billion for the oil sector. Power sector subsidies, in contrast, had a slippage of Rs 20.8 billion, mainly due to the logjam of circular debt problem that has engulfed the industry.

Owing to the intensification of war on terror during the course of 2008-09, the government had to spend Rs 33.8 billion more than the budgeted amount on defence related expenditures. As a result of all these developments, current expenditure surged to Rs 2041.6 billion – Rs 165.8 billion more than the targeted amount.

In order to adjust the slippages in current expenditure, development expenditure was cut for the second consecutive year to the extent of Rs 67.8 billion by postponing various slow moving projects as well as by rationalizing expenditure.

On the revenue side, the FBR failed to meet its target collection amount of Rs 1250 billion and ended the year collecting Rs 1157 billion, a slippage of Rs 93 billion which contributed to the overall slippage in tax revenue to the extent of Rs 103.8. However, the government made significant efforts in non-tax revenue and collected an impressive Rs 145.4 billion more than the targeted amount. This was mainly contributed by more than anticipated SBP profit as well as collection of

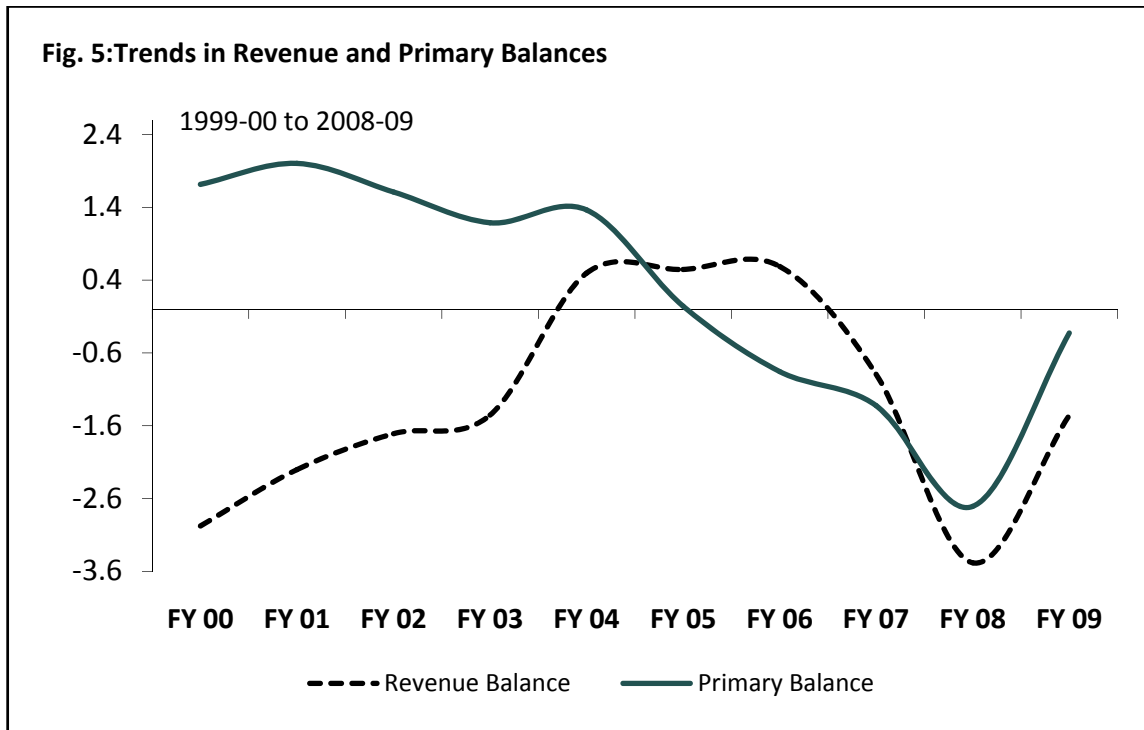
PDL on oil. Resultantly, total revenue passed its budgeted amount by Rs 41.7 billion which mitigated the slippages on expenditure side to that extent. Notwithstanding, fiscal year 2008-09 ended with a revenue-expenditure gap of Rs 680.4 billion – Rs 98.1 billion more than the target for the year. In other words, fiscal deficit for 2008-09 as percentage of GDP stood at 5.2 percent against the targeted value of 4.7 percent, which is still a marked improvement from fiscal year 2007-08 fiscal deficit of 7.6 percent. Expenditure cuts have allowed the government some space to achieve fiscal consolidation. However, reductions in expenditure, particularly development and social sector outlays, have direct consequences for future economic growth and social development. To achieve the government's goals of growth and development, while maintaining a sound and sustainable fiscal position, emphasis must be placed on revenue generation as opposed to expenditure cuts. Fiscal sustainability can only be ensured when real growth of revenue outpaces the growth in real expenditures over a period of time.

External resource inflows fell short of their target during fiscal year 2008-09 due to global financial meltdown, and the non-materialization of anticipated inflows from multilateral and bilateral donors. As against the budgeted external financing of Rs 165.2 billion, Rs 149.7 billion could be materialized. Thus, the burden of adjustments for financing fell on domestic sources. The borrowing requirements from domestic sources increased from Rs 391.9 billion to Rs 530.8 billion (with negligible privatization proceeds) — an increase of Rs 138.9 billion. Pakistan has successfully attained one of the conditions of the IMF program which was to have net zero borrowing from the State Bank of Pakistan on a quarterly basis. Thus, only 42 percent of domestic financing came from bank sources while the majority came from non-bank sources.

The **Revenue balance**, which is defined as the difference between the total revenue and current expenditures, representing the government's savings or dis-savings behavior, was in deficit to the extent of Rs 190.7 billion or 1.5 percent of GDP in fiscal year 2008-09 against the targeted deficit of 0.5 percent of GDP. Under the FRDL Act 2005, the government was required to achieve zero revenue deficit. In other words, total revenue should have been sufficient to finance current expenditure by June 30, 2008. The government was compelled by the internal and external developments in 2008-09 to breach this very important parameter.

The revenue balance signifies the inter-generational distribution of resources because borrowing for current consumption places additional burden on future generations while borrowing for development spending or building assets is justified when viewed in the context of future consumption. The additional expenditure requirements are created in security related matters or interest payments which means current expenditure is to go up. The revenue balance is revenue-

current expenditure gap, thus without commensurate increase in revenues, any increase in the current spending will put strain on the revenue balance. The extraordinary developments in 2008-09 do permit temporary breach, but this must be balanced in the longer horizon. This reinforces the need to generate additional revenues in the medium-to-long run.



The **Primary balance**, which is the difference between the total revenues and non-interest-total expenditure, measures the current fiscal policy stance of the government affecting the country's indebtedness. During the fiscal year 2008-09, the primary balance remained in deficit to the extent of Rs. 42.6 billion or 0.3 percent of GDP. In order to stabilize or reduce public debt, it is necessary for the government to maintain a primary surplus. However, with smaller slippages in total expenditure, the primary deficit for 2008-09 is a vast improvement from last year when the primary deficit stood at 2.7 percent of GDP. Nonetheless, the sooner Pakistan achieves a primary surplus, the better it is for stabilizing the country's debt burden.

The economy needs resources for recovery and as long as revenue resources do not finance expenditures, there will be pressure on debt burden in the country. Going forward, public debt management will be very crucial. To professionally manage public debt, there is dire need to enhance cooperation among various stakeholders. The Debt Management Committee (DMC) has

already been constituted with a mandate to take important decisions regarding public debt management and suggest fiscal measures which entails reorientation of prudent revenue-expenditure decisions, so that it can exert less pressure on debt management.

IV-ii: Fiscal Projections for 2009-10

The lessons learnt from fiscal year 2007-08 and the consolidation and stabilization agenda pursued by the government has contained the fiscal deficit for 2008-09. Budget 2009-10 has been prepared with a view to further consolidate the fiscal position while moving towards a higher economic growth path and enhanced tolerance of deficit financed by increased external inflows.

Table-18: Consolidated Government Budget July-Sept 2009 (Rs Billion)				
Items	July-Sept 2009	July-Sept 2009	2009-10	2009-10
	(Prov. Actual)	(Target)	(Projection)	Revised Projections
Total Revenue	427.3	490	2155.4	2187.0
	<i>2.9</i>	<i>(62.7)</i>	<i>14.5</i>	<i>14.6</i>
Tax Revenue	298.8	334	1563.6	1600.0
	<i>2.0</i>	<i>(35.20)</i>	<i>10.5</i>	<i>10.7</i>
- FBR Revenue	262.6	286	1380.0	1396.0
	<i>1.8</i>	<i>(23.40)</i>	<i>9.3</i>	<i>9.3</i>
Total Expenditure	650.9	684	2877.4	2913.0
	<i>4.4</i>	<i>(33.10)</i>	<i>19.4</i>	<i>19.5</i>
- Current	521.0	576	2103.8	2403.0
	<i>3.5</i>	<i>(55.00)</i>	<i>14.2</i>	<i>16.0</i>
- Development	115.7	134	763.1	510.0
	<i>0.8</i>	<i>(18.30)</i>	<i>5.1</i>	<i>3.4</i>
Fiscal Deficit	223.7	194	722.1	740.0
- as % of GDP	<i>1.5</i>	<i>(-29.7)</i>	<i>4.9</i>	<i>4.9</i>
Note: Figures in italics are as percentage of GDP, Figures in paranthesis are variation from target				
Source: Budget Wing, Finance Division				

The fiscal deficit is projected to decline to 4.9percent of GDP in 2009-10 down from 5.2percent in 2008-09. In order to achieve fiscal deficit target for the year 2009-10, tax revenue is targeted to increase by 1.5 percentage points to 10.7 percent and current expenditure is projected to decline

by 0.6 percentage point of GDP, mainly through the elimination of power subsidies by June 2010. At the same time, the size of development expenditures in 2009-10 is set to remain at 3.4 percent of GDP, the same level in the last year. Key fiscal targets for the fiscal year 2009-10 are documented in **Table-18**.

The overall revenues are projected to grow by 18.15 percent in 2009-10 -- rising from Rs. 1850.9 million or 14.1 percent of GDP to Rs. 2187 billion or 14.6 percent of GDP. Tax revenue is projected to grow by 32.8 percent -- rising from Rs. 1204.7 million or 9.2% of GDP to Rs. 1600 million or 10.7 percent of GDP. The revenue collected by the FBR is the single largest component of the tax revenue, accounting for 96 percent. The FBR is targeted to collect Rs. 1396 billion in 2009-10, 20.6 percent more than last year. The revenue targets are arguably ambitious in the current domestic and international environment. The government will be taking steps to strengthen tax system and administration during fiscal year 2009-10 by introducing the IRS which will formalize the introduction of the VAT. The government has reaffirmed its commitment to meet tax revenue target, however, this is subject to certain risks and challenges. The economy has to pick-up to be close to its desired growth path to attain revenue target. The tax target is tied with certain important assumptions regarding outcome of tax and administration reforms. **Table-19** documents the breakdown of various components of taxes to be collected by the FBR in 2009-10 in comparison to those collected during fiscal year 2008-09.

Table-19: Comparison of Revenue (Rs Billion)				
	2008-09 R.E	2009-10 Budget Estimates	2009-10 Revised Projections.	Growth (%)
Total Revenue	1,851	2,156	2,187	18.2
- Tax Revenue	1,205	1,563	1,600	32.8
- FBR Revenue	1,157	1,380	1,396	20.6
a) Direct Taxes	440	566	522	18.6
b) Indirect Taxes	717	814	874	21.9
- Sales Tax	452	499	547	20.9
- Federal Excise	116	153	161	38.7
- Customs Duty	148	162	166	11.9
Source: Federal Board of Revenue				

IV-iii: Revenue and Expenditure during July-September 2009

Reflecting the extent of the slowdown in the economy in 2008-09, and the impact of a change in tax filing dates, FBR tax collection for the first quarter of 2009-10 is up nominally. A sharp fall in sales and corporate profitability in prior periods, a 19 percent decline in the value of dutiable imports during July to September 2009, the impact of the internal restructuring of FBR, the fall out of the internal security situation on business conditions, and a change in the dates for filing advance tax (from September 30 to October 15), have all contributed to a nominal increase of 0.2 percent in overall tax collection (See **Table-20**). The total amount of tax collection by the FBR has now reached Rs. 262.6 billion as against a first quarter target of Rs. 286 billion. The slippage in tax revenue is solely due to direct taxes failing to meet the target set for the first quarter by Rs. 32 billion.

However, tax collection for the first quarter should be viewed in the context of a 35 percent increase during July-September 2008 (versus corresponding period 2007), providing an unusually high base for comparison. In addition, adjusted for the estimated impact of advance tax collection shifted to next quarter (approximately Rs. 25-29 billion), the tax collection effort has been above par under challenging circumstances. A pick up in economic activity, an early resolution of the energy crisis, an improvement in the internal security situation, a continuation of the trend of improvement in the global economy, and results of the restructuring of tax administration should all contribute towards achievement of the full year tax revenue target.

Revenue Head	Target 2009-10	July-Sept		% Change
		2008-09	2009-10	
Direct Tax	522	88.2	84.1	-4.7
Sales Tax	547	110.2	117.1	6.2
Federal Excise	161	25.5	28.4	11.5
Customs Duty	166	38.2	33.1	-13.4
Total Collection	1396	262.1	262.6	0.2

Source: FBR

Total revenue collection, which includes FBR collection, provincial taxes, and non-tax revenues, reached Rs. 427.3 billion by end-September 2009. As a percentage of projected GDP for the year, total revenues at the end of Q1FY10 stood at 2.9 percent. However, with regards to revenue generation, the government missed its quarterly target of Rs. 490 billion by approximately Rs. 62.7

billion. With the economic slowdown taking its toll, this slippage can be attributed to lower than expected performance of federal and provincial tax collection, as well as non-tax revenue.

On the expenditure side, total expenditure during the first three months of the current fiscal year amounted to Rs. 651 billion as opposed to a first quarter target of Rs. 684 billion. Out of this total, Rs. 521 billion was on account of current expenditure, whereas Rs.115.7 billion and Rs. 14.2 billion were classified as development expenditure and unidentified expenditure respectively. While major heads of expenditure have been reduced, the brunt of fiscal adjustment has been borne by current expenditure, which was Rs. 55 billion lower than its targeted amount. Consequently, a relatively smaller adjustment of Rs. 18.3 billion was made with respect to development expenditure.

Given the substantial gap between expenditure and revenue during the first quarter of 2009-10, the budget deficit stood at Rs. 223.7 billion, or approximately 1.5 percent of the projected GDP for the year (See **Table-18**). The government's quarterly fiscal deficit target was set at Rs.. 194 billion, highlighting a slippage of approximately Rs. 30 billion, mostly on account of lower than expected revenue collection. The government registered a revenue deficit of approximately Rs. 93.3 billion or 0.6 percent of GDP during the same period, whereas the primary balance was in deficit by Rs.. 67.6 billion or 0.45 percent of projected GDP for 2009-10. The advance salary payments in light of Eid-ul-Fitar are also reflected in the first quarter deficit.

Owing to a higher than anticipated deficit in the first quarter, and lower than expected external inflows, the deficit financing targets have not been achieved in the first three months of 2009-10. Originally, the targeted deficit of Rs. 159 billion was to be financed mostly through external inflows of Rs. 100 billion, with the remainder being split between domestic bank (Rs. 32 billion) and non-bank sources (Rs.. 28 billion). However, with the first quarter deficit reaching Rs. 223.7 billion, and with expected external inflows not materializing, a greater emphasis has been placed on domestic sources, which accounted for Rs. 146.6 billion of the financing (See **Table-21**). Rs. 39 billion of budgetary borrowings were from bank sources, whereas non-bank borrowing amounted to Rs. 107 billion. With private sector credit demand currently at low levels, the government has been able to borrow from the banking sector; however the consequences of such borrowing will be more severe once private sector credit demand is revitalized. Furthermore, the added emphasis placed on non-bank sources, primarily the CDNS, has highlighted the need to reform this institution in order to efficiently access low-cost financing. Such borrowing tendency may prove to be counter-productive for the monetary policy goals of the government. In the absence of policy coordination and persistent domestic borrowing, there remains an upward pressure on interest rates even if the SBP continues to relax its monetary policy stance.

Table- 21: Budgetary Financing, July-September 2009		
	July-Sept 2009 (Prov. Actual)	July-Sept 2009 (Target)
Financing of Fiscal Deficit	223.7	159.0
a) External Sources	77.1	100.0
b) Domestic	146.6	59.0
- Bank	39.0	32.0
- Non Bank	107.6	27.0
c) Privatization Proceeds	0.0	0.0

Source: Budget Wing, Finance Division

V. Review of Public Debt

Total public debt (TPD) is a measure of government indebtedness. It includes all government and government guaranteed Rupee debt as well as foreign currency denominated debt, excluding private sector external debt which is not guaranteed by the government.

Developments in TPD during 2008-09 have been driven mainly by a combination of five distinct factors. Increased demands on the government budget during 2008-09 for purposes of security and war on terror meant that expenditure was fairly rigid even in the face of a committed effort to rationalize expenditure and curtail the fiscal deficit. Secondly, lower than expected GDP growth, acute energy shortages, and a high cost of doing business led to a revenue shortfall. The global economic slowdown, and the resultant fall in commodity prices, had a positive impact on Pakistan's trade balance. In addition to these external developments, import compression measures reduced the import bill significantly. Exports also witnessed a deceleration as demand from advanced economies contracted, along with a slump in domestic productivity. However, the fall in imports has outpaced the drop in exports. Still, a fairly high current account deficit, although falling, prevailed throughout the year. In the absence of ample domestic resources and an unfavorable environment in international capital markets and limited foreign non-debt creating flows, the government entered into a Stand by Agreement (SBA) with the International Monetary Fund (IMF), paving the way for an inflow of financing to reverse a drawdown of foreign exchange reserves and provide much needed economic stability. Lastly, depreciation of the Rupee against the US dollar throughout the year ended in a substantial increase in the existing stock of foreign currency denominated public debt expressed in Rupee terms.

Table-22. Public Debt, FY05-FY10Q1*						
	FY05	FY06	FY07	FY08	FY09	FY10Q1*
(In billions of Rs.)						
Domestic Currency Debt	2152	2320	2600	3266	3853	4010
Foreign Currency Debt	1913	2041	2213	2739	3752	4090
Total Public Debt	4064	4361	4814	6005	7605	8100
(In percent of GDP)						
Rupees Debt	33.1	30.4	30.0	31.8	29.4	26.8
Foreign Currency Debt	29.4	26.8	25.5	26.6	28.7	27.3
Total Public Debt	62.5	57.2	55.5	58.4	58.1	54.1
(In percent of Revenue)						
Rupees Debt	239	215	200	218	208	183
Foreign Currency Debt	212	190	170	183	203	187
Total Public Debt	452	405	371	401	411	370
(In percent of Total Debt)						
Rupees Debt	52.9	53.2	54.0	54.4	50.7	49.5
Foreign Currency Debt	47.1	46.8	46.0	45.6	49.3	50.5
Memo:						
Foreign Currency Debt (in US\$ Billion)	32.1	33.9	36.5	40.7	46.3	49.4
Exchange Rate (Rs./US\$, E.O.P)	59.7	60.2	60.6	67.3	81.0	82.8
GDP (in Rs. Billion)	6500	7623	8673	10284	13095	14972**
Total Revenue (in Rs. Billion)	900	1077	1298	1499	1851	2187**
* Provisional ** Projected for FY10			Source: EAD, SBP, EA Wing, MoF and DPCO staff calculations			

During the year 2008-09, total public debt increased by Rs. 1600 billion (26.6 percent). As of end-June 2009, Pakistan's total public debt stood at Rs. 7605 billion (See **Table- 22**). Rupee denominated public debt increased from Rs. 3266 billion to Rs. 3853 billion during the same period, increasing by Rs. 587 billion or 18 percent during the period. The increase in the domestic component of public debt accounted for 37 percent of the total increase in public debt.

The primary source of increase in public debt during 2008-09 has been a rapid increase in the foreign currency component which accounted for 63 percent of the total increase in TPD. This component grew by Rs. 1013 billion or 37 percent due to increased foreign public debt inflows on one hand, and significant depreciation of the Rupee vs. the US dollar on the other hand. The rupee lost approximately 20 percent of its value against the US dollar during 2008-09. An increase of Rs. 633 billion, approximately 39.6 percent of the total increase in TPD, was solely due to the depreciation of the Rupee against the US Dollar. Furthermore, depreciation of the US Dollar against

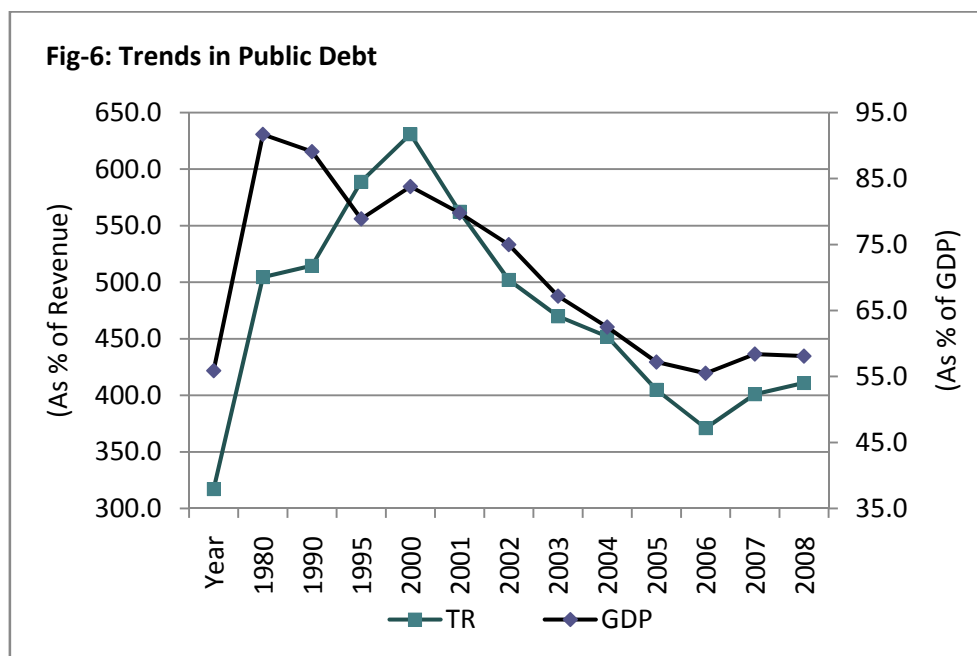
other major currencies caused the foreign currency component of public debt to increase by US \$53 million. This capital loss on foreign currency debt, however, is mitigated by the strong concessionality element associated with Pakistan's external loans. Although the increase in the foreign currency component of TPD might appear to be alarming, it must be noted that the increased inflows mainly in the form of the IMF SBA have been used not to fund budgetary operations, but to strengthen Pakistan's foreign exchange reserves.

Similar changes have been witnessed to the stock of Pakistan's TPD during the first three months of the current fiscal year. Outstanding TPD rose to Rs. 8100 billion, registering an increase of Rs. 495 billion or 6.5 percent, mostly on account of considerable inflows of foreign currency denominated debt. Disbursements under the third tranche of the IMF-SBA and from multilaterals caused the foreign currency component of TPD to increase by Rs. 338 billion by end-September 2009. The funds from the IMF SBA have been used primarily to shore up the foreign exchange reserves of the country. However, out of the third tranche of US\$ 1.2 billion which was disbursed in August 2009, approximately \$745 million has been allocated for budget financing. Depreciation of the rupee against the US dollar caused the foreign currency component to increase by Rs. 91 billion, approximately 18.4 percent of the total increase in TPD. The remaining increase of approximately Rs. 157 billion was on account of domestic borrowing.

The composition of TPD underwent a significant shift during 2008-09; as the share of foreign currency denominated debt increased for the first time since 2001-02, rising from 45.6 percent of TPD in 2007-08 to 49.3 percent in 2008-09. The share of Rupee denominated debt at 50.7 percent of TPD is significantly lower than the contribution of 54.4 percent during 2007-08. A coordinated effort to reduce borrowing from the State Bank of Pakistan (SBP) and substantial foreign currency inflows through the IMF SBA program to avert a BoP crisis, are the major causes behind this shift in composition. While limiting the increases in SBP borrowing will help in controlling inflationary pressures, the increase in foreign currency component will leave the economy more vulnerable to external shocks, specifically, the effect of Rupee depreciation on the outstanding stock of TPD. However, the impact of any currency shock should not be looked at in isolation, but rather be analyzed in the context of interest rate differential.

Total public debt as a percentage of GDP was as high as 62.5 percent at the end of 2004-05, but steadily reduced to 55.5 percent by the end of 2006-07. Following the volatile economic conditions witnessed in 2007-08 accentuated by policy inaction on key expenditures (i.e. energy subsidy), a burgeoning fiscal deficit led to a rapid escalation of TPD as a percentage of GDP, reaching 58.4 percent by end-June 2007-08. Fiscal consolidation, rationalization of expenditure, and a net zero

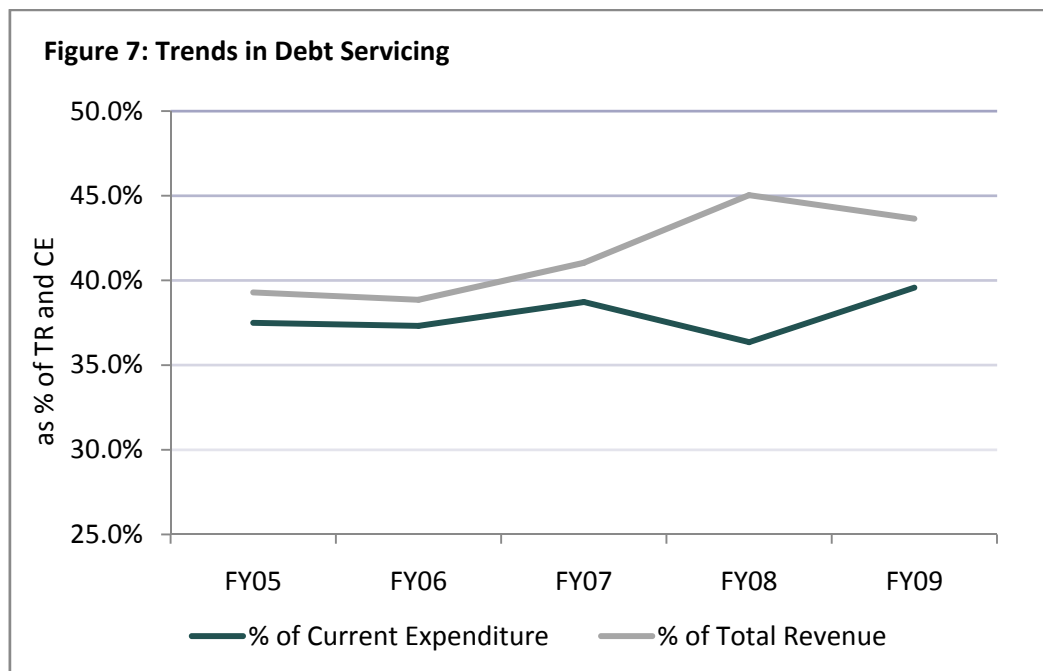
quarterly limit on borrowing from the SBP have all assisted in restraining total public debt to GDP ratio even in the face of lower than expected growth. By end-June 2009, TPD stood at 58.1 percent of GDP.



A similar historic trend is seen in TPD as a percentage of Government Revenues, with TPD falling from as high as 4.52 times of the Government Revenues in 2004-05 to 3.71 times by 2006-07. However due to the prevalent conditions in the economy, both domestic and international, TPD increased to 4.01 times of Government Revenues by the end of 2007-08. Government policies restricted the increase in TPD during 2008-09, but less than expected tax collection has further deteriorated this indicator to 4.11 times, i.e. TPD is now more than four times the government's tax revenue (See **Figure-6**).

Servicing of Public Debt

Increases in the outstanding stock of Total Public Debt have implications for the economy in the shape of a greater amount of resource allocation towards debt servicing in the future. In order to meet debt servicing obligations, an extra burden is placed on limited government resources and might have costs in the shape of foregone public investment or expenditure in other sectors of the economy.



During the year 2008-09, servicing of public debt amounted to Rs. 807.8 billion as opposed to a budgeted amount of Rs. 619.4 billion. The slippage of Rs. 188.4 billion has mostly been due to depreciation of the rupee, which increased the amount used for interest and principal repayments of foreign loans in rupee terms. The more than budgeted increase in fiscal deficit of 2007-08 also translated into higher debt servicing. Repayment of foreign loans stood at Rs. 158.4 billion as opposed to a target of Rs. 96.2 billion; while interest payments on foreign loans, which were budgeted at Rs. 64 billion, reached to Rs. 69.4 billion by end-June 2009. At its root, the currency depreciation, which led to the slippages in debt servicing targets, should be viewed as an adjustment against the unsustainable parity of the Rupee vis-à-vis the US dollar witnessed during 2001-2007. An amount of Rs. 580 billion was spent on account of servicing of domestic debt against the budgeted estimate of Rs. 459.1 billion. The increase in domestic debt servicing is partly the result of a tight monetary stance taken in order to arrest the monetary overhang caused by previous policies. Additionally, the high cost zero-coupon Defence Savings Certificates (DSCs) sold in the late 1990s led to an inaccurate budgeting on interest payments. These instruments started maturing in the last three years, undermining the servicing of domestic debt in the initial years of their issue but inflated the service payments on domestic front in recent years as the interest is paid at maturity.

VI. Sustainability of Fiscal Policy

Sustainability of fiscal policy is vital for a sustainable debt path. The fiscal deficit is a key indicator as it has significant ramifications on a country's macroeconomic position. The shortfall in revenues is usually bridged by domestic and foreign borrowings by the government causing the accumulation of debt. The primary balance measures how the current fiscal policy stance of the government affects the net indebtedness of a country. Hence, in order to reduce public debt, it is necessary for the government to maintain a primary surplus. The government recognizes that in order to have a sustainable fiscal policy, the fiscal deficit needs to be reduced over the medium term. The revenue-expenditure gap that Pakistan has faced over the years needs to be addressed by generating higher revenues while containing its expenditures.

The government, through the FBR, is in the process of taking measures that will improve revenue generation in the country by broadening the tax base and improving the overall tax system and administration. The high cost of interest payments deters resources from the priority sectors in the economy such as social welfare and development projects. Consequently, in order to achieve a primary surplus, a reduction in the interest burden is also important. All in all, a prudent fiscal policy comprises of (i) a balanced tax structure based on rational and affordable rates with minimal exemptions covering a broad range of taxpayers, (ii) an expenditure policy that aims to moderate growth in non-developmental expenditure and adequately accommodate the pressing social and infrastructure needs of a developing economy, and (iii) a prudent debt management policy.

VII. Medium-Term Budgetary Framework (MTBF)

The Budget 2009-10 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. The current budgeting system in Pakistan makes it difficult to align budgetary resources with strategic priorities. The aim of the MTBF is to make the budget system better. The MTBF will help channel resources to the Government's key strategic priorities. It will make more transparent the link between resources allocated through the federal budget and the results to be achieved in terms of service delivery (outputs) and impact (outcomes). It will facilitate the scrutiny of the existing allocation of resources through the federal budget in terms of economy, efficiency and effectiveness - by the relevant ministry, the Ministry of Finance, the Planning Commission, the Cabinet, the National Assembly,

and by other stakeholders including the general public. In this way, the MTBF aims to support and strengthen the delivery of public services by the Federal Government.

The MTBF has three main objectives:

- I. To further strengthen fiscal discipline by creating an orderly framework for management of the annual budget over the medium term;
- II. To strengthen the alignment of federal resources by the government to the government's policies and strategies;
- III. To build the capacity in federal ministries to prepare and manage their budgets in a manner which provides cost-effective service delivery (outputs) and efficient use of public funds (value for money).

At the individual ministry level, the MTBF hopes to improve methodologies for aligning budgets with available resources and encourage ministries to take greater control of their own financial management. As far as provinces are concerned, the MTBF will not directly address issues of budget reform, since provincial governments are responsible for their own initiatives. However, appropriate linkages are being made by the MTBF to provincial budget reforms.

When taken together, the outputs of the MTBF will help to ensure that policy objectives determine the overall framework for the budgetary process and individual budgetary allocations are more clearly linked to strategic priorities. Thus, policies are considered in a medium-to-long term context which will provide greater predictability in the budgetary process.

VIII. Public – Private Partnership

The Government recognizes the importance of improving and expanding infrastructure services for sustaining economic and social development in its Medium Term Development Framework 2005-2010 (MTDF). Improved quality and service coverage in power and water supply, sewerage treatment, transport and logistics are vital for Pakistan's economy and the livelihood of its people. Tight fiscal constraints require innovative approaches - away from the traditional role of the Government as the service provider - to ensure that the massive investment needs are financed with the assistance of the private sector. A combination of policy reforms, institutional support, incentives and financing modalities is required to encourage private-sector participation in financing, constructing and managing infrastructure projects.

Public-Private Partnerships (PPPs) permit the public sector to reduce their capital expenditure (and redirect to promote urgent social needs) and convert the infrastructure costs into affordable operating expenditure spread over time. PPPs allow each partner to concentrate on activities that best suit their skills. For the public sector that would mean focusing on developing policies and identifying service needs, while for the private sector the key is to deliver those needs efficiently and effectively.

The government has set up the Infrastructure Project Development Facility (IPDF) under the auspices of the Ministry of Finance (MoF), to generate projects with public sector institutions (line ministries, provincial governments, local bodies, state owned enterprises etc.) undertaking PPPs. IPDF provides direct access to a professional PPP Unit that will help institutions to improve proposals and prepare them for tendering, without becoming a contract signatory to those transactions. Once approved by IPDF's Project Feasibility Committee, the project may be submitted for any necessary complementary financing to a proposed independent financing body – the Infrastructure Project Financing Fund (IPFF) – for any ‘residual’ financing needs that are not available in the market. Both IPDF and IPFF are tasked to provide easy and timely access for institutions, to ensure that viable good quality PPP deals are concluded in a timely manner to meet Pakistan’s increasing infrastructure demands. The day to day operations of both institutions will be independent from the government and reporting to the government will be made through their respective Board of Directors.

PPP project evaluations will focus on, but will not be limited to, the following sectors:

- **Transport and logistics** including provincial and municipal roads, rail, seaports, airports, fishing harbors as well as warehousing, wholesale markets, slaughter houses and cold storage.
- **Mass Urban Public Transport** including buses, and intra and intercity rail.
- **Municipal Services** including water supply and sanitation; solid waste management; low cost housing, and health / education facilities.
- **Small Scale Energy Projects** such as hydroelectric and captive power generation projects - other than those being facilitated by Private Power Infrastructure Board (PPIB) and the Alternative Energy Development Board (AEDB).

Although PPPs will become an integral component of the government’s overall strategy for the provision of public services and public infrastructure across all sectors, this does not imply they are

the preferred option for improving the efficiency of services delivery but that they enjoy equal status among a range of possible service delivery options available to the government.

IX. Report on Compliance with FRDL Act 2005

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

89. The FRDL Act 2005 requires the following:

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

Revenue balance (Total Revenue minus current expenditure) **breached the performance target** in fiscal year 2007-08 as it did not achieve a revenue deficit of zero but, infact, deteriorated significantly to 3.4 percent of GDP. Fiscal year 2008-09 saw a vast improvement in the revenue deficit as it was brought down to **1.5 percent of GDP or Rs. 190.7 billion**. Revenue deficit is considered the dis-saving of the government which contributed to reducing overall national saving rate (national savings as percent of GDP). Serious corrective measures are required to bring current expenditures at least at the level of total revenue. In other words, total revenue should be sufficient to finance at least the current expenditure and if there is a need to borrow, the government can borrow for development purposes.

90. ***(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 2009, the same figure stood at 58.1 percent of GDP. However, public debt is better analyzed in relation to total revenue, as GDP

is only a measure of size of the economy and does not necessarily translate to easily accessible resources. The erosion of this indicator emphasizes the need to concentrate efforts on revenue generation in order to meet the additional requirements placed by increasing amounts of debt.

91. ***(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.”***

This requirement 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. Achieving the target of debt-to-GDP ratio ahead of time notwithstanding, the reversal of the declining trend in debt burden during 2007-08 and again in 2008-09 is a cause for concern. The government should be vigilant in ensuring that the rise in the debt to GDP ratio during 2007-08 is not allowed to continue otherwise it will breach the 60 percent targeted level as required by the FRDL Act 2005. Public debt stood at 58.4 percent of GDP by end June 2008, and declined to 58.1 percent by end-June 2009. Fiscal restraint and a limit on borrowing from SBP enabled the government to reduce the public debt-to-GDP ratio following the increase in 2007-08, thus avoiding a sustained deterioration of this indicator. These efforts have been commendable given the fact that GDP growth was slower than expected.

Social sector and poverty related expenditure (as given by Pro-poor budgetary expenditure excluding outlays on law and order) remained well above the target of 4.5 percent of GDP as laid out in the FRDL Act 2005. These expenditures stood at **6.7 percent of GDP in 2008-09**; a remarkable fact given the higher amount of outlays required on behalf of law and order. However, expenditure on health and education remains a cause for concern. The FRDL Act 2005 requires that these outlays as a percentage of GDP reach 1.18 percent and 3.72 percent of GDP respectively by 2013; effectively doubling the allocation towards these sectors from the levels of F2002-03. In sharp contrast to the target, expenditure on health and education in 2008-09 at 0.3 percent and 1.5 percent respectively, has been lower than 2002-03. If the government is to meet this target, it is necessary that superfluous expenditure be substituted with targeted and effective investments in health and education.

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

New guarantees issued by the government to Public Sector Enterprises in 2008-09 amounted to Rs 274.3 billion or 2.09 percent of GDP, which was higher than the stipulated limit of 2 percent imposed by the Fiscal Responsibility and Debt Limitation Act 2005. Finance Division has been issuing continuing guarantees against the commodity financing operations undertaken by TCP, PASSCO, and provincial governments. Commodity financing is secured against hypothecation of commodities and letter of comfort from the Finance Division. The quantum of these guarantees depends on the supply-demand gap of various commodities, their price stabilization objectives, volume procured, and domestic and international prices, therefore these guarantees were never included in the limit of 2 percent imposed by the FRDL Act 2005. For 2008-09, Rs. 192.6 billion worth of new guarantees were issued on behalf of commodity financing operations.

The government intends to introduce world class warehousing facilities in the near future that will allow the entities involved in the commodity operations to secure financing against the warehouse receipt without explicit guarantee or letter of comfort from the government.

X. Concluding Remarks

For every government, achieving high economic growth rate is a primary national objective as it helps in accomplishing the extremely important socio-economic goals of expanding employment and reducing poverty. Fiscal Policy should focus on generating primary surplus and ensuring that real rate of growth of revenues should be higher than the real growth in debt servicing obligation.

The fiscal policy should explore opportunities for augmenting the resource envelop rather than cutting down the expenses. At the same time, the expenses should be rationalised and non-productive expenditure should be curtailed that will bring improvement in the national investment climate, saving incentives and opportunities, and competitiveness of the real economy. Institutionalization of policy coordination cannot be overemphasized for growth and sustainability of national economy.

Fiscal consolidation has been one of the main themes of 2008-09. The consequences of a lax fiscal attitude over the years, exacerbated by a non-conducive external environment, meant that crucial

fiscal adjustments had to be made by the government to align itself on a sustainable fiscal path. A reduction in expenditure and gradual withdrawal of subsidies (in addition to lower commodity prices which eased pressure on government resources) translated to a deficit of 5.2 percent of GDP. When compared to a deficit of 7.6 percent in 2007-08, the extent of this adjustment is highlighted. Although the government was not able to meet its initial deficit target, the circumstances causing the slippage were mostly unprecedented and exogenous.

Revenue collection, however, remained weak throughout the year. Lower than expected economic growth; volatile trade environment; and domestic disruptions caused by the power crisis and security concerns have all hampered revenue generation efforts of the government. Pakistan's tax-to-GDP ratio is now at a precariously low level of 9.2 percent. Growth in real revenues is a prerequisite to successful implementation of the government's socio-economic targets. The performance of Pakistan's revenue collection in real terms has been weak at best. When taken in real terms, tax revenue has grown by a meager average of 1.4 percent for the last five years, as compared to average real GDP growth of 5.5 percent during the same period leading to an erosion of the tax-to-GDP ratio. Furthermore, real growth in expenditure has been higher than the real growth of revenues which has had significant consequences for the fiscal deficit. Persistent divergence between growth of revenues and expenditure has led to escalating revenue deficit to the tune of 1.5 percent of GDP. The primary balance, although vastly improved from 2007-08, remains in deficit by 0.3 percent of GDP. Going forward, significant growth in real revenues is essential to maintain fiscal sustainability, and to finance the government's economic plans.

The implementation of the government's recovery efforts and gradual resurgence of economic stability has been remarkable. However, in the course of the recent economic performance, a few key issues have emerged. Firstly, the importance of addressing key structural issues during times of relative fiscal soundness has been highlighted. While giving due credit to the government's crisis management efforts, it must be noted that had there been an implementation of resource management and revenue generation efforts in periods of relative stability, the consequences of fiscal adjustment would have been less severe. Proactive efforts need to be concentrated on addressing these weaknesses, as opposed to tackling difficult economic situations witnessed in the previous two years in a re-active mode. By doing so, the government will be able to ensure that periods of high economic growth, stable domestic environment, and substantial external inflows can be translated to rising real revenues and creation of ample fiscal space. By shifting from a reactionary stance to reform and efficiency oriented resource management policies, the government will be able to rid the system of the inefficiencies that are painfully brought to the surface in times of crisis.

Secondly, emphasis must be placed on revenue generation, instead of adjustments made through cuts in expenditure. Inability to translate relative economic prosperity into a structural advancement of revenue generation has meant that fiscal adjustments have been made by reduction in outlays, which hampers future prospects and might have dire consequences for socio-economic development. Changes in the tax structure to include major sectors of the economy that have so far not matched their contribution to economic growth by a proportionate increase in tax revenue will be a significant step in this regard.

On the expenditure side, long-run sustainability can be ensured not by cutting down on expenditure during times of economic turmoil, but by undertaking a thorough classification and rationalization of expenses. The dampening effects on economic conditions placed by drastic cuts in expenditure have been highlighted in 2008-09. Progressing in the future, the government intends to employ fiscal outlays as a stimulus to regain growth momentum and to increase the access and quality of facilities provided to the most vulnerable. By quantifying development expenditures, removing superfluous outlays, making targeted and efficient investments in crucial areas, while maintaining the integrity of pro-poor and social sector activities, the government will be able to meet these goals and avoid placing strains on its resources as severe as those recently witnessed.

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

Envisaged future investments in key sectors and budgetary outlays will be essential in regaining the lost growth momentum of the economy, improving the business environment, and ensuring sustained social development. To overcome the savings-investment gap present in the economy and finance these outlays, broadening the resource envelope of the economy will play a vital role. While enhanced tax revenue effort from the center as well as the provinces will be welcome measures, financial innovation and positive real interest rates will also assist in increasing the savings pool of the economy. Attractive financing schemes, deeper penetration of financial

institutions in rural areas, and increasing the incentives provided to the public will enable substantial funds lying outside the system in to formal banking channels. With a money multiplier of 3.14 (as of December 2009), even a small injection of funds in to the formal financial sector will translate in to a greater resource envelope of the economy, and provide space for planned investments to be made efficiently.

Most importantly, in attempting these reforms, a holistic policy approach and thorough coordination is required. The goals of increased revenue generation and targeted budgetary investments must be brought in line with the monetary policy objectives. The pool of national savings must be enhanced, allowing for required investments to be made without jeopardizing the government's fiscal position. Positive real interest rates are essential as they will attract substantial funds currently outside the purview of the official monetary system. Moreover, budgetary borrowing options need to be revisited to ensure that financing of future deficits does not dilute monetary policy's efforts to keep money supply in check and tackle inflation. In this regard, amplified revenue generation and reduction in primary deficit will also limit the emphasis placed on debt creation. By placing a high priority on structural reform and revenue generation, and establishing a comprehensive framework for management of PSEs, the government will be able to finance the envisaged expenditure which will be crucial in the coming years, while containing excessive borrowing and maintaining fiscal sustainability.
