Fiscal Policy Statement
2006-07

Debt Policy Coordination Office (DPCO),
Ministry of Finance,
Government of Pakistan

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LIST OF ACRONYMS

FRDL	Fiscal Responsibility and Debt Limitation Act 2005
GDP	Gross Domestic Product
PSDP	Public Sector Development Program
Q1	First Quarter of 2006-07 (July-September 2006)
PIB	Pakistan investment Bonds
T-Bills	Treasury Bills
CBR	Central Board of Revenue
SBP	State Bank of Pakistan
NSS	National Saving Scheme
DPCO	Debt Policy Coordination Office
MoF	Ministry of Finance, Government of Pakistan
BE	Budget Estimate
RE	Revised Estimate
FED	Federal Excise Duty
IT	Income Tax
ST	Sales Tax
NAM	New Accounting Model
WHT	Withholding Tax
POL	Petroleum, Oil and Lubricants
MTBF	Medium-Term Budget Framework
COD	Collection on Demand
VP	Voluntary Payments

I. INTRODUCTION

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

a) The key fiscal measures and rationale for any major deviation in fiscal measures pertaining to taxation, subsidy, expenditure, administered pricing and borrowing;

b) An update on key information regarding macroeconomic indicators;

c) The strategic priorities of the Federal Government for the financial year in the fiscal area;

d) The analysis to the fullest extent possible of all policy decisions made by the Federal Government and all other circumstances that may have a material effect on meeting the targets for economic indicators for that fiscal year as specified in the medium term budgetary statement; and

e) An evaluation as to how the current policies of the Federal Government are in conformity with the principle of sound fiscal and debt management and the targets set forth in the medium term budgetary statement in section 5 of the Act.

2. The central objective of government's economic policy is to build a strong economy with a view to creating employment opportunities for all and improve the standards of living of the people of Pakistan. The policies pursued thus far have injected fiscal discipline, reduced the country's debt burden, created a stable macroeconomic environment, revived economic activity and most importantly have created a strong platform of economic stability which is vital for building prosperity and achieving social justice. Economic stability allows businesses, individuals and the government to plan more effectively for the long term improvement in the quantity and quality of investment. The Government is committed to locking in stability and investing in the country's

future, enabling it to meet the challenges and rise to the opportunities of the global economy.

3. Fiscal policy primarily deals with the levels and composition of taxation, spending and borrowing by the Government. Fiscal policy encompasses several fundamental policy issues, including the proper role and size of the state, the role of the Government in promoting growth, creating jobs, social development and redistribution of benefits of economic growth, the nature and extent of public services and fairness between the present and future generations. Government's fiscal policy has both microeconomic and macroeconomic objectives.

4. Microeconomic objectives include an improved distribution of income and wealth, equitable access to social services, meeting the basic needs of the poor, promoting investment in public goods, and enhancing the efficiency with which the public and private sectors produce goods and services and their responsiveness to the needs of consumers. Macroeconomic objectives relate to evolution of the economy as a whole – national income and output, jobs, inflation and the balance of payments. Fiscal policy must also ensure that the level and structure of taxes while promoting equity and redistribution do not interfere unduly in people's investment and consumption decisions.

II. WHY RULE-BASED FISCAL POLICY?

5. The importance of a prudent fiscal policy cannot be overemphasized. A sound fiscal policy is essential for preventing macroeconomic imbalances and realizing the full growth potential. Pakistan has witnessed serious macroeconomic imbalances in the 1990s mainly on account of its fiscal profligacy. Persistence of large fiscal deficit resulted in unsustainable levels of public debt, adversely affecting the country's macroeconomic environment. Pakistan accordingly paid a heavy price for its fiscal indiscipline in terms of deceleration in economic growth and investment, and the associated rise in the levels of poverty. Considerable efforts have been made over the last six years to inculcate financial discipline by pursuing a sound fiscal policy. Pakistan's hard earned macroeconomic stability is underpinned by fiscal discipline.

6. Over the past several decades, there has been increasing acceptance worldwide that financial discipline over a prolonged period is essential for maintaining macroeconomic stability. There is also a general consensus that a prolonged commitment to financial discipline can only come from a rule-based fiscal policy. What is a rule-based fiscal policy? The rule essentially represents the constraints and prevents governments taking fiscally irresponsible route. International experience suggests that countries that have adopted well-designed fiscal rules and implemented effective operational

mechanism for enforcing them have made important credibility gains, reflected by cheaper access to financial markets and greater electoral support.

7. The rational for fiscal policy rules mainly rests on the need for achieving objectives of macroeconomic stability, longer-term sustainability of growth, support for other policies, and overall policy transparency and credibility. In theory, most of these objectives can be met with discretionary fiscal measures within the ambit of a medium-term budgetary framework. However, many fiscal consolidation plans undertaken to correct persistent budget deficits over the past two decades, have not been successful; suggesting that well designed fiscal policy rules may offer a useful solution to counter pressures on fiscal policy making.

8. Though, discretionary fiscal policy can achieve the same outcomes as fiscal rules and should in theory be superior because it allows greater flexibility. However, that is not always the case in practice as discretionary fiscal policy has an inherent deficit bias. This is because benefits of a profligate fiscal stance accrue entirely today and that too only to the targeted group; while its costs show up after a lag and are borne by everyone in terms of higher taxes and lower spending.

9. Additionally, excessive borrowing of the past curtails the government's ability in the future to invest in important development programs relating to health, education, population planning, nutrition, and employment creation. However, it has been observed that fiscal adjustment only comes when the cost of accruing more debt becomes inordinately high and there is no option but to make an adjustment. A fiscal policy rule can therefore be used as an instrument to get round this bias and encourage fiscal sustainability and macroeconomic stability, while leaving room for maneuverability in times of exigencies through the provision of safeguards or escape clauses.

10. The evidence is clear at least in the Pakistani case: prudent fiscal policy is an essential pre-requisite for macroeconomic stability. High budget deficits and large and rising public debt burdens undermine growth, and crowd out the private sector investment, so important for growth. It is in this perspective that a considerable efforts were made over the last six years to bring fiscal deficit down to a sustainable path. Pakistan succeeded in reducing fiscal deficit down from an average of 7 percent of the GDP in the 1990s to an average of 3.5 percent during the last six years. The associated public debt burden also declined sharply from over 100 percent of GDP to 56.0 percent in the last fiscal year (2005-06).

11. Notwithstanding these successes, the government believes that there is no alternative to a rule-based fiscal policy. Accordingly, a rule-based fiscal policy, enshrined in the Fiscal Responsibility and Debt Limitation Act 2005, was passed by the Parliament

in June 2005. This Act ensures responsible and accountable fiscal management by all governments— the present and the future, and would encourage informed public debate about fiscal policy. It requires the government to be transparent about its short and long term fiscal intension and imposes high standards of fiscal disclosure. Given the difficult past that Pakistan's macroeconomic environment had reached by the end of the 1990s, a rule-based fiscal policy was considered essential for maintaining macroeconomic stability and promoting growth on a sustained basis.

III. PRINCIPLES OF TAX POLICY

12. Widening the tax base by reducing exemptions, incentives and concessions, reducing multiplicity of rates, lowering tax rates, shifting the incidence of tax burden from production to consumption, moving away from the excessive reliance on manufacturing and taxing all value additions including services, enhancing the neutrality between present and future consumption, enhancing the neutrality of the tax system to forms of business organizations and sources of finance, and reengineering business process of the tax system to overcome the culture of tax avoidance and evasion; effecting business process changes in tax administration to establish an effective and efficient tax system are the guiding principles of the tax policy. It is the continuing endeavour of the Government to operationalize these principles.

Table-1: Sharing Tax Burden among Various Sectors (FY 2004-05)

Description	**Share in GDP**	**Share in Taxes**	**Point Contribution to GDP Growth**
Agriculture	***22.5***	***1.2***	***1.5***
Manufacturing	***17.9***	***62.2***	***2.2***
Construction	2.1	2.9	0.4
Electricity & Gas Distribution	3.5	5.3	0.1
Transport, Storage & Communication	***10.4***	***4.5***	***0.4***
Wholesales & Retail Trade	***18.6***	***2.8***	***2.0***
Finance & Insurance	4.0	3.9	1.0
Public Administration & Defense	5.9	5.0	0.04
Social & Community Services	9.5	7.8	0.6
Others	5.6	4.4	0.1
Total	**100.0**	**100.0**	**8.6**

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

13. The current phase of high growth provides us an opportunity that should be used to improve the fiscal health of the country. We must increase our revenues without hurting the growth momentum. It is Government's intention to undertake major tax reforms to improve the tax-to-GDP ratio, expand the tax payer base, increase tax compliance and make tax administration more efficient. Government is moving to a tax

system that is based on moderate rates and wider base through rationalization of exemptions. Despite recent reforms, the tax effort remained modest in Pakistan owing to various structural problems. The administrative reforms envisaged by the CBR, especially moving toward a functional organizational structure, has helped to enhance tax efficiency, as well as improving the tax climate and governance. However, expanding taxation gradually into the agricultural and service sectors would bring greater yields, and would help reduce tax evasion.

14. Why is tax-to-GDP ratio in Pakistan low in comparison to many developing countries? Why amidst highest ever growth performance in recent past Pakistan's tax-to-GDP ratio has fallen in 2004-05? The answer is simple, nominal GDP grew at a faster pace than tax revenue but actually one has to look into the anatomy of economic growth to find the answer. Table-1 gives some break-up of growth and tax incidence into various sectoral contributions. Almost three-fourth of contribution to growth (8.6%) came from agriculture (1.5%) and services sector (4.1%) but their contribution to tax revenue is less than 10 percent whereas the contribution in growth from manufacturing is less than one-fourth but its contribution in tax revenue is close to two-third of the total. This uneven mismatch between sectoral contributions to growth and tax revenue tells the story of the fate of all tax reforms ranging from administrative reforms to broad basing the tax revenue.

IV. FISCAL POLICY DEVELOPMENTS

16. The fiscal policy stance remained decidedly growth-oriented yet prudent and sustainable with a focus on declining debt service, alleviating poverty and investing in infrastructure. Pakistan has made considerable progress in recent years on fiscal side. The overall fiscal deficit that averaged nearly 7.0 percent of the GDP in the 1990s has declined to 3.4 percent (excluding earthquake spending) in 2005-06. The underlying fiscal deficit is targeted at 3.7 percent of GDP (excluding earthquake spending) for the current fiscal year (2006-07) which is slightly higher than the deficit level of the previous year (3.4% of GDP)[*]. Higher deficit was targeted to finance higher public sector development program (PSDP), particularly towards financing infrastructure projects. Pakistan needs to strengthen its physical and human infrastructure to sustain growth momentum.

[*] With earthquake spending, the overall fiscal deficits for 2005-06 and 2006-07 are at 4.2 percent of GDP

Table 2: Fiscal Indicators as Percent of GDP								
Year	**Real GDP Growth**	**Overall Fiscal Deficit**	**Expenditure**			**Revenue**		
			Total	**Current**	**Development**	**Total Rev.**	**Tax**	Non-Tax
1990-91	5.4	8.8	25.7	19.3	6.4	16.9	12.7	4.2
1991-92	7.6	7.5	26.7	19.1	7.6	19.2	13.7	5.5
1992-93	2.1	8.1	26.2	20.5	5.7	18.1	13.4	4.7
1993-94	4.4	5.9	23.4	18.8	4.6	17.5	13.4	4.1
1994-95	5.1	5.6	22.9	18.5	4.4	17.3	13.8	3.5
1995-96	6.6	6.5	24.4	20.0	4.4	17.9	14.4	3.5
1996-97	1.7	6.4	22.3	18.8	3.5	15.8	13.4	2.4
1997-98	3.5	7.7	23.7	19.8	3.9	16	13.2	2.8
1998-99	4.2	6.1	22.0	18.6	3.4	15.9	13.3	2.7
1999-00	3.9	5.4	18.7	16.5	2.2	13.5	10.7	2.8
2000-01	1.8	4.3	17.2	15.5	1.7	13.3	10.6	2.7
2001-02	3.1	4.3	18.8	15.9	2.9	14.2	10.9	3.3
2002-03	4.7	3.7	18.6	16.3	2.3	14.9	11.5	3.4
2003-04	7.5	2.4	16.7	13.5	3.2	14.3	11.0	3.3
2004-05	8.6	3.3	18.0	14.3	3.7	13.7	10.0	3.7
2005-06	6.6	4.2*	18.4	14.2	4.2	14.2	10.4	3.8
2006-07 B	7.0	4.2*	17.4	12.8	4.7	13.2	10.1	3.1

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

17. A cursory look at Table 2 reveals important structural shift in patterns of revenue and expenditures. On the revenue side, the tax-to-GDP or revenue –to-GDP exhibits a secular decline over the last one and a half decade. On the expenditure side, total expenditure and its components also exhibit a secular decline as percentage of GDP. Fiscal deficit as percent of GDP also declined substantially during the period. However, reduction in fiscal deficit owes mainly to sharper reduction in expenditure – more so to development expenditure – rather than improvement in revenue effort. Reduction in fiscal deficit since 1999-2000 owes partly to the improvement in revenue side and partly to the rationalization of expenditure – particularly in the shifting of expenditure from current to development and leaving the total expenditure to remain stagnant at around 18 percent of GDP. Going forward, a further reduction in fiscal deficit must come from improvement in revenue. The improvement in tax effort should not be limited to Federal Government alone. The Provincial Governments will have to do much more to enhance their provincial tax-to-GDP ratio from the current stagnant level of 0.5 percent to at least 1.0 percent of GDP in the medium-term.

IV-I. Fiscal Performance during July-December 2006-07

18. Total revenue for the fiscal year 2006-07 is estimated at Rs.1163.0 billion as against Rs.1087.0 billion in the previous year (2005-06) — thus projecting a growth of 7.0 percent. Tax revenue, accounting for 76.1 percent of total revenue is targeted at Rs.885.7 billion which is 15.5 percent higher than last year. Tax collection by the Central Board of Revenue (CBR) is targeted at Rs.835 billion and accounts for 94 percent of the total tax revenue. The CBR tax collection is projected to rise by 17.0 percent over last year.

19. During the first quarter (July-September) of the current fiscal year (2006-07) total revenue amounted to Rs.255.7 billion as against Rs.236.6 billion in the same period last year, thus registering an increase of 8.1 percent. Tax revenue stood at Rs.191.6illion which is 20.9 percent higher than the corresponding period of the last year. Similarly, non-tax revenue amounted to Rs.64.0 billion and declined by 10.7 percent in the same period. CBR tax collections are important component of tax collections and account for lions share in overall tax collection. The analysis of the CBR tax collection is presented below:

IV-I-i. CBR Revenue Projections for 2006-07

20. The CBR tax collection target for the fiscal year 2006-07 has been set at Rs. 835 billion, showing an increase of 17.2 percent over Rs. 712.5 billion collected in 2005-06. Direct taxes are projected to rise by 17.8 percent to Rs.264.7 billion. Accordingly, the share of direct taxes in total taxes is projected to rise marginally from 31.5 percent to 31.7 percent in the same period. Indirect taxes are projected to increase by 16.9 percent to Rs.570.3 billion. Within indirect taxes the sub-components sales tax, excise, and FED are projected to rise by 16.7 percent, 25.5 percent and 13.9 percent, respectively.

Table 3: Comparison of CBR Revenue [*] **(Rs. *Billion*)**

	2005-06 R.E	2006-07 B.E	Growth (%)
Direct Taxes	**224.6**	**264.7**	**17.8**
Indirect Taxes	**487.9**	**570.3**	**16.9**
- Sales Tax	294.6	343.8	16.7
- Federal Excise	55.0	69.0	25.4
- Customs Duties	138.2	157.5	14.0
All Taxes	**712.5**	**835.0**	**17.2**

Source: CBR

[*] Nominal GDP is projected to grow by 14.2 percent in 2006-07

IV-I-ii. CBR Revenue Performance: July-December 2006-07

21. CBR has significantly surpassed the revenue target (Rs.381.1 billion) fixed for July -December 2006 by collecting Rs. 410.0 billion which is Rs.86.1 billion or 26.6 percent higher over corresponding period of last year. The revenue collection by the CBR has exceeded the July-December target by Rs.29 billion. This commendable performance has been the result of reforms implemented in tax system and tax administration over the last several years. Whereas the reforms measures have been mostly facilitating in nature — promoting voluntary tax compliance and confidence building, the tax policy initiatives were mostly concessionary in nature to promote economic activity in the country. Particularly, the measures like zero-rating of the entire chain of major export oriented industries, reduction of duty on smuggling-prone items, rationalization of tariff structure and reduction of corporate tax rates have been instrumental in promoting foreign trade activities, discouraging tax evasion, and accelerating industrial growth. CBR has created history by collecting Rs.114.2 billion in December 2006 alone which is highest ever collection in a single month by the CBR. Direct taxes also registered highest ever growth of 65.9 percent during the first half of the current fiscal year and resultantly its share in tax revenue increased to 42.2 percent in sheer contrast to its historical level of below 30 percent for the last so many years. Indirect taxes registered modest growth of 7.9 percent, mainly due to deceleration in the pace of imports growth [See Table 4]. Within indirect taxes, sales tax is up by 9.5 percent mainly on account of 4.6 percent increase in this tax

Table-4: CBR Revenue Collection (July-December 2006) ***(Rs. Billion)***

	Direct Taxes	Indirect Taxes				Total Tax Collection
		Sales	Excise	Customs	Total	
July	10.1	24	4	8.1	36.1	46.2
August	11.1	20.9	4.6	9.7	35.2	46.3
September	45.3	30.6	5.4	10.1	46.1	91.4
October	16.1	22	5.5	9.8	37.2	53.3
November	14.3	27.3	5.5	11.4	44.3	58.6
December*	76.2	20.5	5.8	11.6	38	114.2
July-Dec. 06	**173.1**	**145.3**	**30.8**	**60.7**	**236.9**	**410**
July-Dec. 05	**104.3**	**132.7**	**25.4**	**61.5**	**219.6**	**323.9**
% Change	65.9	9.5	21.5	-1.2	7.9	**26.6**

Source: Central Board of Revenue

at the import stage. Sales tax collected from domestic economic activity grew by 17.2 percent. Thus, slower growth in imports impacted the performance of the sales tax collection. Slower growth in imports also adversely impacted the performance of customs collection as it registered a decline of 1.2 percent. Beside slower growth in imports, the reduction and/or rationalization of import tariff are also responsible for less than satisfactory performance of customs collection. Central excise duty, however registered an impressive growth of 21.5 percent in the first half of the current fiscal year.

22. Based on the performance of the first half it is safe to suggest that the CBR is likely to achieve its collection target for the year. The slower growth in indirect taxes is well compensated by tremendous growth in collections from direct taxes. CBR has already recorded 26.6 percent growth in tax revenue during the first half which is higher than the annual target growth of 17.2 percent.

IV-I-iii. Overall Tax Collection and Refunds during 2005-06

23. The gross and net collection during the outgoing fiscal year 2005-06 has been Rs. 797.6 billion and Rs. 712.5 billion, indicating an increase of 15.5% and 20.7%, respectively over the corresponding period of last year. The refund payments during this period were Rs. 85.1 billion against Rs. 100.1 billion during the comparable period of last year. The overall performance of tax collection during 2005-06 has been extra-ordinary compared to the last year due to a number of factors. The most significant of these has been the double digit growth in income and corporate tax receipts due to improved profitability of the corporate sector, especially banks, insurance companies, and oil and gas sector. Similarly, the impact of zero-rating of the entire chain of five export-oriented industries has enhanced economic activities in two leading commodity groups, i.e., textile and leather. Consequently, the net sales tax collection has also increased. Finally, despite some slowdown in certain categories of imports, the growth momentum in the collection of customs duties and sales tax at import stage has been maintained. This performance provides the required confidence that the revenue collection will remain on track during the current fiscal year provided the economy also maintains its steady course.

24. Further breakdown of tax collection provides interesting information. The collection of direct taxes has increased by 22.5 percent on net basis – rising from Rs.183.4 billion to Rs.224.6 billion [See Table 5]. The performance of indirect taxes has also been impressive. Net collection of indirect taxes grew by 19.9 percent – rising from Rs.407.0 billion to Rs.487.9 billion. Within indirect taxes, the performance of sales tax has been equally impressive. Sales tax on net basis grew by 20.8 percent – rising from Rs 238.5 billion to Rs 294.6 billion. Custom collection has been in line with other taxes in terms of its performance. Custom collection on net basis stood at Rs 138.2 billion as against Rs 115.4 billion of last year, thereby registering an increase of 19.8 percent. The collection of central excise stood at Rs.55.0 billion during 2005-06 as against Rs.53.1 billion in last year, thus registering a growth of 3.6 percent [See Table-5].

Table-5: Net Tax Collection			*(Rs. Billion)*
	July-June		**% Change**
	2004-05	**2005-06**	
A. Direct Taxes	***183.4***	***224.6***	*22.5*
B. Indirect Taxes	***407.0***	***487.9***	*19.9*
- Sales Tax	*238.5*	*294.6*	*20.8*
▪ Import Related	144.8	171.7	18.5
▪ Domestic Production	93.7	123.0	31.3
- Customs Duty	*115.4*	*138.2*	*19.8*
- Central Excise	*53.1*	*55.0*	*3.6*
Total Taxes (net) A+B	***590.4***	***712.5***	***20.7***
			Source: Central Board of Revenue

IV-I-iv. Detailed Analysis of Individual Taxes during 2005-06

25. It is encouraging that the target of Rs.690.0 billion has been surpassed by Rs.22.5 billion or about 3%. The two leading taxes, i.e., income and corporate taxes and sales tax have exceeded their respective targets. While the customs duties are right on the target, the collection of excise duties has been short by Rs. 1.2 billion. However, this shortfall has been more than compensated by other taxes. The tax-wise details are provided below.

a. Direct Taxes: The direct taxes are the second major source of federal tax revenues after sales tax. This source has contributed about 31.5% of total receipts during 2005-06. The net collection has been Rs. 224.6 billion against the target of Rs. 215.0 billion. In response to completely liquidation of refund pendency, the refund payments of Rs. 34 billion during the year were 17.1 percent higher than last year. It may be recalled that the collection of direct taxes comprises of withholding taxes (WHT), voluntary payments (VP) and collection on demand (COD). The collection during 2005-06 reveals that the share of WHT, VP and COD in income and corporate tax gross collection has been 57 percent, 36 percent and 7 percent, respectively. This pattern is consistent with the way the taxation system has been re-designed in recent years.

Table 6: Sectoral Composition of Income Tax (Gross) Collection					**(Rs. Billion)**
Heads	**Gross Collection**		**Growth (%)**	**Share (%)**	
	2005-06	**2004-05**		**2005-06**	**2004-05**
Corporate Sector	***171.1***	***145.0***	***18.0***	***70.0***	***71.1***
- Advance	62.3	58.6	*6.3*	*25.5*	*28.8*
- Others	108.8	86.4	*25.9*	*44.5*	*42.4*
Non-Corporate Sector	***73.5***	***58.8***	***24.8***	***30.0***	***28.9***
- Advance	1.0	1.0	*2.0*	*0.4*	*0.5*
- Others	72.4	57.8	*25.3*	*29.6*	*28.4*
Total	**244.6**	**203.8**	***20.0***	***100.0***	***100.0***
					Source: CBR

a-i. Withholding Taxes (WHT): The importance of Withholding Tax (WHT) is evident from its 57 percent contribution in gross income tax receipts. There are 25 heads of WHT where deductions are made at source; however, only six of these heads contribute nearly 80 percent of total WHT receipts [See Table 7]. These six heads include; contracts/ supplies, imports, salary, exports, electricity and telephones including mobile phones. The major contributors in terms of their share in the WHT collection are: contracts (34%), imports (19%), salary (11%), exports (6%), telephones/ mobiles (5%) and electricity (4%). The collection from telephones, contracts, salary, imports and exports, and electricity, has increased by 49.9%, 34.8%, 16.8%, 9.8% and 7.3% respectively during 2005-06. The unprecedented growth in telephone/ mobile services in the country has contributed higher collection on this count during 2005-06. The recent surge in interest rates due to tightening of money to control inflation has contributed towards 42 percent growth in WHT on interest income. The collection on account of securities has also increased by 6.2 percent because of monetary tightening during the year. This increase is also consistent with enhanced level of economic activities in the economy and enhanced level of imports quantum.

Table 7: Withholding tax Collection **(Rs. Million)**

Collection Heads	2005-06	2004-05	Difference	
			Absolute	Percent
Contracts	46,770	34,703	12,067	34.8
Imports	26,878	24,485	2,393	9.8
Salary	15,521	13,351	2,170	16.3
Export	8,678	7,903	775	9.8
Electricity	5,118	4,768	350	7.3
Telephone/mobiles	7,583	5,057	2,526	49.9
a. Sub-Total (Six Major Items)	110548	90,268	20,280	22.5
Percentage Share in Total WHT	79%	81%		
b. Other WHT	28,878	21,231	7,647	36.0
c. Total WHT	***139,426***	***111,499***	***27,927***	***25.0***
%Share in Gross IT	57%	55%		

Source: CBR

b. Indirect Taxes: The indirect taxes are the largest contributor to federal tax revenues. The collection from this source increased by 19.9 percent and accounted for 68.5 percent. The indirect taxes are comprised of sales tax, customs duty and federal excise duty. Major individual spinners of the indirect taxes are documented in Table-8 and detailed account of its sub-components is given in subsequent paragraphs.

Table 8: Contribution of Major Revenue Spinners in Indirect Taxes					***(Rs. Billion)***
Sector	Indirect Taxes			Share in Gross (%)	
	2005-06	2004-05	Growth (%)	2005-06	2004-05
1. Petroleum	105.1	67.1	56.8	19.5	14.0
2. Auto Sector	63.1	41.5	51.8	11.7	8.7
3. Machinery	32.1	30.8	4.2	6.0	6.4
4. Cigarettes	28.9	27.9	3.1	5.3	5.8
5. Telecom	28.3	23.3	21.4	5.2	4.9
6. Iron & Steel	27.3	21.9	25.0	5.1	4.6
7. Edible Oils	23.0	18.5	24.2	4.3	3.9
8. Natural Gas	19.8	17.3	14.5	3.7	3.6
9. Cement	17.6	14.8	18.6	3.3	3.1
10. Plastic	14.9	13.5	10.4	2.8	2.8
11. Sugar	15.3	9.4	63.0	2.8	2.0
12. Chemicals	15.3	22.9	-33.0	2.8	4.8
13. Electrical Energy	13.4	15.6	-14.4	2.5	3.3
14. Beverages	8.9	7.0	27.4	1.7	1.5
15. Textile	5.2	21.3	-75.5	1.0	4.5
16. Fertilizer	5.1	4.9	3.8	0.9	1.0
17. Coffee, Tea, etc	4.4	4.3	2.4	0.8	0.9
Sub Total	427.6	362.1	18.1	79.3	75.8
Others	111.2	116.0	-4.1	20.7	24.3
Gross	**539.0**	**478.1**	**12.7**	**100.0**	100.0
Refund/Rebates	51.1	71.1	-28.1		
Net Collection	487.9	407.0	19.9		
					Source: CBR

b-i. Sales Tax: The sales tax has emerged as the leading revenue sources in recent years. Due to its buoyant nature, the share of sales tax has jumped to 41.4 percent in the total federal tax collection during 2005-06 from merely 18.6 percent in 1995-96. The gross sales tax collection of Rs. 327.1 billion and net collection of Rs. 294.6 billion during 2005-06 was higher by 11.5 percent and 23.5 percent respectively over the last fiscal year.

26. The gross and net tax receipts from sales tax on domestic production have increased by 4.6 percent and 31.3 percent respectively during 2005-06. Around 31

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

b-i-i. Domestic Sales Tax Collection and Major Revenue Spinners:

27. The performance of Sales Tax collected on domestic activity indicates that around 71% of gross collection has been generated by ten major revenue spinners during 2005-06 as against 65.4% during last year. The detailed analysis confirms that out of ten major commodities, eight have recorded a positive growth over the corresponding period (Table 9). Among the leading resource generators, the shares of telecom and petroleum products have been around 36%. Similarly, the collection from natural gas and electrical energy was close to 9% each. The reason for this performance has been multi-faceted. For instance, the increase in collection from POL by 16.5% was mainly due to the price factor. It is now common observation that international prices of energy are constantly increasing over the last few years. The higher value has two impacts. For final products, the higher value is yielding higher revenues, but wherever POL products are being used as inputs, they result into huge refund claims. Resultantly, the outcome is mixed.

28. The collection from telecommunication services grew by 31.7% which is attributable to the boom in the telecom sector which is thriving at a tremendous pace on the back of new entrants and phenomenal expansion in new connections. Resultantly the teledensity of the country has increased to 23.1% in April 2006 as compared to 11.9% in 2005. The collection from natural gas has increased by 14% owing to increase in consumption, production and sales by 8.3%, 4.5% and 3.2% respectively over last year. In the case of cement, a remarkable growth of 42.3% in collection has been recorded due to higher taxable sales by around 15% and production by 6.2%. Both these increases have, in turn, been due to the construction boom prevailing in the country. In the case of sugar the growth in collection has been 7.4% whereas the increase in its sales during 2005-06 was only 2%. The growth in Sales Tax on domestic activity from aerated waters has been around 21%, which is backed by 17.5% growth in its taxable sales and 28.1% growth in production during the period under consideration. Finally, due to improvement in the living standard of middle class and availability of easy financing from banks, the demand for automobiles has increased at a rapid pace in recent years. Therefore, the collection from motor cars has also registered an impressive growth of 28.7% during 2005-06 [Table-9]. Among commodities that have registered negative growth included

cigarettes and electrical energy. In both these cases, there has been an adjustment made for advances.

Table 9: Comparison of Sales Tax Collection from Domestic Activity by Major Commodity ***(Rs. Million)***			
	2005-06	**2004-05**	**Growth (%)**
Telecom	26,873	20,397	31.7
POL Products(Including LPG)	29,390	25,223	16.5
Electrical Energy	13,383	15,640	-14.4
Natural Gas	13,285	11,589	14.6
Sugar	8,703	8,102	7.4
Major Ten Commodities	110,356	97,114	13.6
Cigarettes	5,759	5,942	-3.1
Cement	5,369	3,774	42.3
Motor Cars	2,638	2,049	28.7
Aerated Waters	2,612	2,160	20.9
Auto parts	2,344	2,238	4.7
All Commodities	**155,318**	**148,546**	**4.6**
Source: Central Board of Revenue			

b-i-ii. Sales Tax at Import Stage:

29. The sales tax collection at import stage depends on the structure of imports and its share in total sales tax revenue. During the last eleven years (1995-96 to 2005-06), the share of sales tax at import stage in gross sales tax has ranged between 54 percent and 64 percent. The share of sales tax from imports has reached to 24 percent in 2005-06 as compared to around 10 percent in 1995-96, implying heavy dependence on imports rather than domestic activity. Recent surge in imports, a double-digit growth in ST on imports has been recorded in POL products, vehicles and parts, iron and steel, plastics, edible oil, sugar, articles of iron and steel, paper and paperboard, and oil seeds [See Table-10].

30. The electrical and mechanical machinery witnessed negative growth due to the zero rating of these items during 2005-06; the downward revision in customs duties has its impact on sales tax collection due to the cascading nature of taxation, notwithstanding the modest growth in the value of imports.

Table 10: Value of Imports and Sales Tax Collection at Import Stage: Major Items							
							(Rs. Million)
	Tariff Description	**Import Value** 2005-06	2004-05	Growth (%)	**ST (M) Collection** 2005-06	2004-05	Growth (%)
1	POL Products	380,863	223,095	70.7	59,669	34,813	71.4
2	Vehicles	105,843	71,031	49.0	19,562	12,510	56.4
3	Iron and Steel	97,022	64,646	50.1	14,516	9,897	46.7
4	Plastics and Articles thereof	65,970	49,176	34.2	8,940	7,515	19.0
5	Edible oil and Waxes	49,876	44,239	12.7	6,191	5,030	23.1
6	Sugar and Sugar Confectionery	46,430	9,045	413.3	6,680	1,361	390.8
7	Electrical Machinery	167,095	121,490	37.5	5,825	6,636	-12.2
8	Mechanical Machinery	202,393	171,858	17.8	5,532	6,290	-12.1
9	Organic chemicals	81,713	80,736	1.2	3,408	8,986	-62.1
10	Paper and Paperboard	19,530	14,929	30.8	3,224	2,455	31.3
11	Misc. Chemical products	22,077	20,684	6.7	2,627	2,985	-12.0
12	Oil seeds etc	18,361	14,676	25.1	2,259	1,966	14.9
13	Coffee, tea and spices	16,708	15,903	5.1	2,474	2,350	5.3
14	Rubber and articles.	19,007	15,055	26.3	2,208	2,365	-6.6
15	Articles of Iron and Steel	21,763	11,773	84.9	1,430	1,110	28.8
	Sub-total	*1,314,651*	*928,336*	41.6	*144,545*	*106,269*	36.0
	Others	401,028	378,181	6.0	27,219	38,631	-29.5
	Grand Total	**1,715,679**	**1,306,517**	**31.3**	**171,764**	**144,900**	**18.5**
							Source: CBR

31. The overall share of major 15 items listed above in ST on imports has increased from around 73 percent to 84 percent in 2005-06 showing narrow range of ST collection. Because of escalation in prices, the share of POL products has increased from 24 percent in 2004-05 to 35 percent in 2005-06. Other major contributors include: vehicles and parts (11%), iron and steel (8%), and plastic and articles (5%). Nearly 60% of GST at import stage comes from only four commodity groups, and the remaining eleven commodity groups out of the 15 major items contribute only 24 percent of ST collected at import stage. The remaining amount is contributed by a large number of commodities which implies narrowness of the base.

b-ii. Customs Duties: Despite emergence of sales tax and income tax as important sources of collection, the customs duties continue to contribute significantly to tax revenues amidst massive rationalization of tariff structure since 1988. Recently, tariff has been rationalized on machinery, motor vehicles and raw materials and resultant higher demand fueled upsurge in imports for these items. However, the demand for imports was moderated after the boom in the first quarter of 2005-06. The imports growth rebounded in the fourth quarter of 2005-06; however, it remained below than the first quarter growth. Gradual decline in growth of dutiable imports since first quarter (July-September) resulted in expansion of the share of duty free imports, especially the POL products and food items, thereby contributing towards worsening of the trade balance.

Table 11: Growth in Major Revenue Spinners of Customs Duty

(Rs. Million)

	Tariff Description	**2005-06 Growth (%)**			**Effective Rates (%) with Dutiable Imports**	
		Import Value	Dutiable Imports	Customs Duties	2005-06	2004-05
1	Vehicles	49.0	51.3	57.5	38.0	36.5
2	Animal or vegetable fats	12.7	15.2	19.0	32.1	31.1
3	POL Products	70.7	109.5	110.6	10.3	10.2
4	Mechanical Machinery	17.8	21.9	6.2	7.1	8.1
5	Electrical Machinery	37.5	28.1	3.9	7.7	9.5
6	Iron & Steel	50.1	16.0	21.8	10.5	10.0
7	Plastics	34.2	35.5	-2.5	8.6	11.9
8	Organic Chemicals	1.2	-18.9	-26.8	8.2	9.1
9	Paper & Paperboard	30.8	28.5	27.9	18.4	18.5
10	Articles of Iron & Steel	84.9	68.2	50.0	12.9	14.5
11	Misc. Chemical Products	6.7	5.8	-12.5	8.6	10.5
12	Rubber products	26.2	-1.6	-0.7	11.8	11.7
13	Man made filaments	102.4	113.1	10.3	9.1	17.5
14	Coffee, Tea, Mate and Spices	5.1	1.7	-5.5	10.0	10.8
15	Dyes, Paints etc.	21.7	10.6	2.0	13.0	14.1
	Sub-total	**34.5**	**31.7**	**28.2**	**13.7**	**14.1**
	Others	26.5	-12.8	-2.9	20.5	18.4
	Grand total	31.3	21.0	19.1	14.9	15.1

Source: CBR

32. The gross and net collection of customs duties has registered growth of 19.1 percent and 19.8 percent respectively during 2005-06 and the gross and net collection stood at Rs.156.7 billion and Rs.138.2 billion, respectively. This is remarkable increase, since the customs duty rates for a large number of items have been revised downward

from higher to lower slabs, and the effective rate has come down from 14.1% to 13.7% for major 15 items, and from 15.1% to 14.9% for all commodities during 2005-06 as compared to last year [See Table-11].

b-iii. Federal Excise:

33. The Federal Excise Duty (FED) is being gradually withdrawn from a number of commodities. However, despite its shrinking base, the FED is contributing positively to tax revenue. The collection of FED stood at Rs. 55 billion during 2005-06 as against Rs. 53.1 billion last year, showing an increase of 3.6 percent. The FED collection mainly depends on five commodities, namely cigarettes, cement, natural gas, POL products and beverages and these five commodities contributed 93.2 percent of the total FED collection during 2005-06 as against 89.6 percent in last fiscal year. Performance of five major revenue spinners of FED is given in Table- 12.

Table 12: Performance of FED Major Revenue Spinners *(Rs. Million)*

	2005-06	2004-05	Difference			2005-06	2004-05	Difference	
			Absolute	(%)				Absolute	(%)
Cigarettes	23,010	21,958	1,052	4.8	*Natural Gas*	6,491	5,683	808	14.2
Cement	12,188	11,061	1,127	10.2	*Beverages & Concentrate*	5,707	4,542	1,165	25.6
POL Products	4,141	4,385	-244	-5.6	*Total (Major Commodities)*	51,537	47,629	3,908	8.2
Share of Five Major in Gross Excise Collection						93.2%	89.6%		

Source: CBR

V. EXPENDITURE POLICY

V-I. Public Expenditure Management Reforms

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

- a modern accounting system designed according to internationally recognized accounting principles and standards, and based on modern information technology to ensure ready availability of relevant, accurate and timely information required by economic managers as a decision support system.
- a governance structure and legal framework consistent with international standards for an independent comprehensive audit function which supports public

accountability by timely reporting to the legislature for effective and appropriate action;

- o increasing professionalization of the elements of its civil services which deal with financial and economic management, requiring key competencies in staff training and appropriate human resource management policies emphasizing performance, experience and knowledge; and,
- o increasing partnership between the private and public sectors in their respective areas of comparative advantage

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

- ➢ Modernized government audit procedures and adoption of internationally accepted auditing standards will eradicate program oversights and improve evaluation capabilities.
- ➢ Effective accounting and reporting systems will enable the government to better formulate, control, and monitor its budget.
- ➢ Strengthened financial management practices will increase the effectiveness of development programs and related external assistance.
- ➢ Financial information generated by the improved accounting and information systems will be more useful, complete, reliable and timely. Improved data will facilitate program management by government decision-makers.

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

expenditure reform, more effective use of government resources, and improved public sector management.

V-II. Review of Public Expenditure

37. Pakistan continues to maintain fiscal discipline for the last several years. **Total expenditure** is targeted at Rs. 1536.56 billion or 17.4 percent of GDP for the fiscal year 2006-07. Total expenditure was projected to be 8.6 percent higher than last year (2005-06). During the outgoing fiscal year (2005-06) total expenditure stood at Rs. 1414.6 billion as against Rs. 1117.0 billion last year, thus registering an increase of 26.6 percent [See Table 13]. **Current Expenditure** is targeted at Rs. 1126.19 billion for the current fiscal year (2006-07). During the outgoing fiscal year (2005-06) current expenditure amounted to Rs. 1106.5 billion and was 0.2 percent higher than the last year.

Table-13: Consolidated Revenue & Expenditure of the Government *(Rs. Billion)*

	Revised Estimate	Budget Estimate	Jul-Sep
	2005-06	2006-07	2006
A. Total Revenue	**1087.0**	**1163.0**	**255.7**
a) Tax Revenue	**766.9**	**885.7**	**191.6**
CBR Revenue	712.5	835.0	183.9
Provincial Tax Revenue	51.2	44.8	7.7
Others	3.2	5.9	-
b) Non-Tax Revenue	**320.0**	**277.3**	64.0
B. Total Expenditure	**1414.6**	**1536.6**	**342.4**
a) Current Expenditure	**1104.5**	**1106.5**	**244.2**
i) Federal	**791.7**	**794.2**	**161.1**
- Interest	241.2	239.5	60.3
- Defense	241.1	250.2	45.6
- Others	309.4	304.5	55.2
ii) Provincial	**312.8**	**312.3**	**83.1**
b) Development Expenditure & Net Lending	**310.1**	**430.0**	**65.1**
PSDP**	313.7	**435.0**	**67.5**
Less Operational Shortfall	3.6	5.0	-2.3
C. Overall Fiscal Deficit	**327.6**	**373.5**	86.7
As % of GDP	4.2	4.2	1.0
Financing of Fiscal Deficit	**327.6**	**373.5**	**86.7**
i) External Sources	148.5	171.7	27.8
ii) Domestic	179.1	201.8	58.9
- Bank	66.8	140.1	34.5
- Non-Bank	22.3	6.7	24.4
- Privatization Proceeds	90.0	75.0	-
GDP at Market Prices	**7713.0**	**8808**	**8808.0**

Source: Budget Wing, Ministry of Finance

The higher increase in current expenditures during the last year to the extent of 27.8 percent was mainly on account of earthquake-related spending amounting to Rs. 65 billion or 0.8 percent of GDP. The major components of current expenditure include interest payments and defense spending. **Interest payments** are targeted at Rs. 239.5 billion for the current fiscal year. During the outgoing fiscal year, the interest payments amounted to Rs. 241.2 billion and were lower marginally by 0.7 percent over the last year. **Defense spending** for the year is targeted at Rs. 250.2 billion — 3.8 percent higher than last year [See Table 13].

38. Development expenditure is targeted at Rs. 435 billion for the year 2006-07 as against revised estimate of Rs.313.7 billion. During the first quarter (July-September 2006) development expenditure amounted to Rs.67.5 billion. Substantially large growth in development spending during the last six years, points towards growth-oriented fiscal policy stance adopted by the Government. There is a paradigm shift in fiscal policy towards social sector spending and infrastructure development.

39. The **overall fiscal deficit** is targeted at Rs. 373 billion or 4.2 percent of the projected GDP. The Government is well placed to meet this target. On the basis of the developments on revenue and expenditure front, the overall fiscal deficit during the first quarter (July-September) of the current fiscal year stood at Rs. 86.7 billion or 1.0 percent of GDP. Furthermore, fiscal deficit stood at 23.0 percent of the full year deficit target. Earthquake accounted for sizeable amount of fiscal deficit and underlying fiscal deficit excluding earthquake expenditure is targeted at 3.7 percent of GDP for 2006-07. Had there been no earthquake devastation in the country, Pakistan fiscal deficit during 2005-06 would have been less than the targeted 3.8 percent and would have played significant rise in further fiscal consolidation. **Revenue balance** (revenue minus current expenditure) a measure of government's savings or dis-savings, had reached at 3.0 percent of GDP deficit by the end of the 1990s but averaged 0.4 percent of GDP surplus during 2003-04 to 2006-07 (BE). It implies fiscal prudence on the part of the government. Revenue balance turned into marginal deficit of 0.2 percent of GDP in 2005-06 owing to extraordinary events like devastating earthquake and higher oil prices. However, it is targeted to be in the surplus to the extent of 0.6 percent of GDP in 2006-07. The FRDL Act 2005 requires the government to achieve revenue balance by 2007-08. The government is likely to achieve this target one year ahead of the time.

VI. SUSTAINABILITY OF FISCAL POLICY

40. Unsustainable fiscal policy is the first step towards unsustainable debt path that may eventually lead to macroeconomic crisis. There is a consensus that the sustainability of fiscal policy could be gauged by simply answering the following questions: "Can the current course of fiscal policy be sustained without exploding debt? Or will the

government have to sharply increase taxes, decrease spending, have recourse to monetization, or even repudiation of debt?" The sustainability of fiscal policy is built-in in the Fiscal Responsibility and Debt Limitation Act 2005. The Act envisages a 2.5 percentage points reduction in debt-to-GDP ratio every year and not borrowing for consumption. The Government is on the track and debt-to-GDP ratio is declining at a faster pace than envisaged in FRDL and the requirement of elimination of revenue deficit by 2008 is likely to be met this year. Pakistan needs to generate primary surpluses for some years to consolidate its fiscal indicators. The important thing with fiscal consolidation is that it is not at the expense of slashing social sector spending. Fiscal policy is fully aligned with mandatory requirements of the FRDL Act 2005.

VII. MEDIUM-TERM BUDGETARY FRAMEWORK (MTBF)

41. Presently the budget process is structured to provide an annual budget. This does not permit spending agencies to formulate their programs more than a year with uncertainty regarding the availability of resources beyond the annual budget. In order to allow spending agencies to plan their programs in a consistent and coherent manner the Government has initiated the process of putting in place a Medium–Term Budgetary Framework (MTBF). This will indicate to the line ministries an estimated resource envelop over the three years time framework. This will enable ministries to prioritize their spending plan within the indicated envelop and will, to a great extent, reduce the uncertainties that impede effective planning. This will be a rolling resource envelop and will target outcome rather than financial input and expenditure. The MTBF process is already underway and the Government expects a complete switch over by the fiscal year 2008-09.

VIII. PUBLIC – PRIVATE PARTNERSHIP

42. Adequate infrastructure is vital for sustaining a strong growth momentum. Pakistan therefore needs to invest far more in its human and physical infrastructure. Global experience suggests that the magnitude of investment required is such that it is neither prudent nor efficient to fund this from the Budget. The Government therefore, plans to make far greater use of public–private partnership in developing infrastructure to a level that is consistent with the Governments' economic growth target of 6-8 percent over the long-run. The Government has already progressed in developing a framework for this purpose in collaboration with the Asian Development Bank (ADB). The Infrastructure Project Development Facility (IPDF) has already been set up as a company. Currently, it is evaluating 14-15 projects. The next step is to set up a financing facility- the Infrastructure Project Financing Facility (IPFF) for which the work is already at an advanced stage. With this arrangement the process of building up Pakistan's infrastructure to world class level will be achieved.

IX. REVIEW OF THE PUBLIC DEBT

43. Public debt consists of debt denominated in Rupees and debt denominated in foreign currency. Pakistan's public debt grew by 6.7 percent in the 2005-06 which translates into an annual average growth rate of 6.1 percent since 1999-2000 while the nominal GDP showed a growth rate of 12.4 percent over the same period. This is in sharp contrast to the experience in the last two decades where Pakistan's public debt grew at an average rate of 18 percent and 15 percent per annum during the 1980s and 1990s, respectively – much faster than the growth in nominal GDP (11.9% and 13.9% respectively).

Table-14: Trends in Public Debt *(Rs Billion)*

	End June								End Sep
	1980	**1990**	**1995**	**2000**	**2003**	**2004**	**2005**	**2006**	**2006***
Debt Payable in Rupees As % of i) Public Debt ii) GDP	59.8 (38.5) [21.5]	373.6 (46.6) [42.8]	789.7 (47.5) [42.3]	1575.9 (52.2) [41.5]	1853.7 (51.2) [38.4]	1978.8 (52.3) [35.1]	2132.6 (52.7) [32.4]	2296.4 (53.2) [29.8]	2346.3 (53.2) [26.6]
Debt Payable in F.Exchg. As % of i) Public Debt ii)GDP	95.6 (61.3) [34.0]	427.6 (53.4) [48.9	872.5 (52.5) [46.8]	1442.0 (47.8) [38.0]	1769.4 (48.8) [36.7]	1807.7 (47.7) [32.0]	1912.6 (47.3) [29.1]	2021.6 (46.8) [26.2]	2064.7 (46.8) [23.4]
Total Public Debt	155.4	801.2	1662.2	3017.9	3623.1	3786.6	4045.1	4318.0	4411.1
Public Debt As % of i) GDP (MP) ii) Total Revenue	55.9 317.1	91.7 504.6	89.1 514.7	79.6 562.5	75.1 502.7	67.1 469.9	61.5 449.4	56.0 394.3	50.1 356.0

** End September* *Source: Debt Office, Ministry of Finance*

Note: Beginning from 1999-2000, Pakistan's GDP was rebased at 1999-2000 Prices from two decades old base of 1980-81. Therefore, wherever, GDP appears in denominator the numbers prior to 1999-2000 are not comparable.

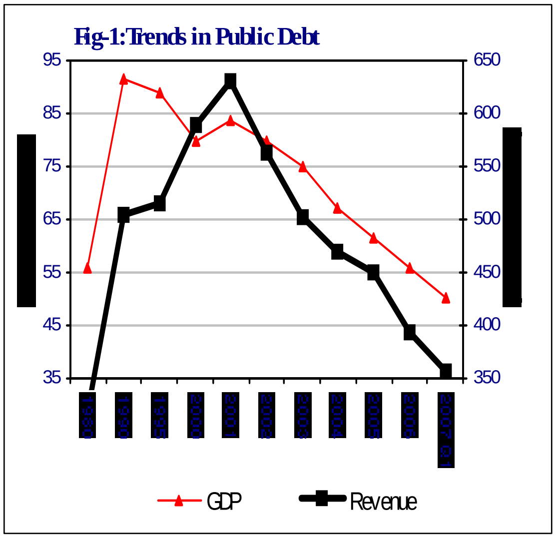
4. As a result of slower pace of growth in pubic debt than the nominal GDP, public debt as a percentage of GDP has continued its declining trend. Public debt as share of GDP fell from 61.5 percent at the end of June 2005 to 56 percent at the end of June 2006 which is similar to the level of debt during the 1970s. The low level of debt is even more remarkable because just 7 years ago at the end of 1999, debt stood at just over 100 percent of GDP. The slower pace of growth in debt is partly a result of lower average fiscal and current account deficits compared to 1990-99 where average fiscal and current account deficits were almost 7 percent and 5 percent of GDP, respectively.

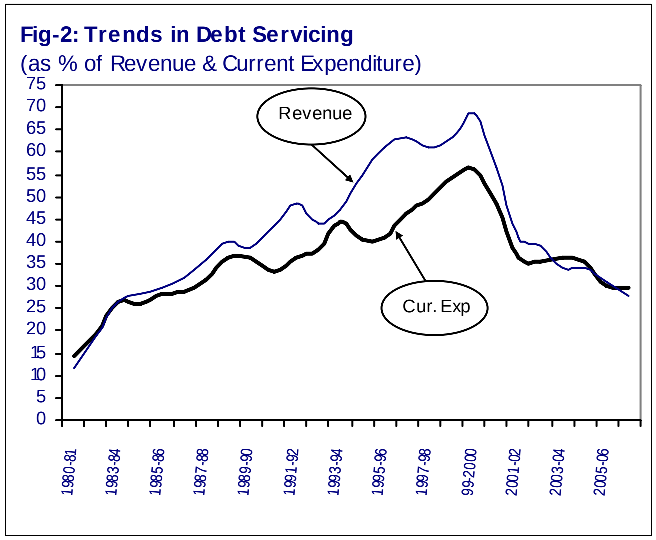
45. There are clear indications that the debt strategy put in place by the government is bearing fruit as indicated by declining trends in debt. The government had set-up a high level Debt Committee in 2000, which examined the root cause of the rising debt burden and suggested debt reduction strategy to stabilize debt situation. The government is following the debt strategy as suggested by the Committee. Reduction in the fiscal and current account deficits, lowering the cost of borrowing, raising revenue and foreign exchange earnings, and debt re-profiling from the Paris Club have been the key features of the debt reduction strategy. To provide legal cover to debt reduction strategy a Fiscal Responsibility and Debt Limitation Act 2005 has been promulgated in June 2005.

46. As a result of the credible debt strategy followed by the Government, the public debt- to-GDP ratio, which stood at almost 80 percent at the end-June 2002, declined substantially to 56 percent by the end-June 2006 which implies a 24 percentage points decline in country's debt burden in 5 years. By end September 2006, public debt further declined to 50.1 percent of the projected GDP for the year 2006-07. In absolute terms public debt grew by a meager 6.7 percent during 2005-06.

47. The capacity to carry debt is dependent on the size of the economy (GDP) as well as the resources available to the government to service that debt, therefore debt should also be considered in relation to government revenue. As can be seen in Table 14, public debt at the end-June 1999 was as high as 629 percent of total revenue. Following the debt reduction strategy, which included raising revenue as one of the key elements, the public debt burden in relation to total revenue has declined substantially to 394 percent by end-June 2006 and further to 356 percent of the projected revenue of 2006-07 by end-September 2006.

48. The structure of public debt has seen a subtle change over the last 5 years where share of Rupees debt in total public debt has been increasing. At the end of 2001-02, Rupees debt represented 48.9 percent of total debt while foreign currency loans accounted for 51.1 percent of total debt. By end of 2005-06, the shares had shifted where the Rupees debt stands at 53.2 percent of total debt while the share of foreign currency debt has been reduced to 46.8 percent.





49. The rising stock of public debt during the 1990s had serious implications for debt service obligations. In 1980-81, public debt servicing accounted for just12 percent of total revenues but by 1989-90 this had increased to almost 39 percent. During the last six years, the debt servicing liabilities have declined sharply from 65.4 percent of revenue in 1999-2000 to 27.8 percent of revenue and from 53.5 percent of current expenditure to 27.8 percent of current expenditure in 2005-06. The subsequent fiscal space created by bridging the revenue-expenditure gap and low debt servicing cost has enabled the government to increase spending on the public sector development program (PSDP) as well as poverty and social sector related expenditures.

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

X. REPORT ON COMPLIANCE WITH FRDL ACT 2005

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

52. The FRDL Act 2005 requires the following:

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

Revenue balance (Total Revenue minus current expenditure) averaged 0.4 percent of GDP for the last four years (2003-04 to 2006-07). However, it is fractionally in deficit by 0.2 percent of GDP but budgeted 0.6 percent of GDP in surplus for 2006-07. It implies that the government has already eliminated revenue deficit ahead of target date 2007-08 envisaged in FRDL Act 2005.

(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. Further, 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 2006, the same figure stood at 56 percent of GDP. By the end-September 2006, the public debt-to-GDP ratio stood at 50.1 percent of the projected GDP for 2006-07.

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

The government has successfully met and exceeded this requirement in fiscal year 2005-06. Public debt stood at 61.5 percent of GDP by end June 2005 and declined to 56.0 percent of GDP by end-June 2006, which implies 5.5 percentage point reduction in public debt to GDP ratio against specified target of 2.5 percentage points. By end September 2006, the public debt-to-GDP ratio further went down to 50.1 percent which implies a further reduction of 5.9 percent of GDP in one quarter of 2006-07. This is an indication that the government is fiscally prudent as required by the FRDL 2005. Important thing about this fiscal prudence is that it is not achieved at the expense of reduction in social sector and poverty related expenditure. These expenditures are 4.9 percent of GDP in 2005-06 and are targeted to rise further to 5.1 percent of GDP in 2006-07. It means legal obligation to keep these expenditures at 4.5 percent of GDP is well taken care of. Expenditure on education and health are also growing briskly.

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

The government met and exceeded this requirement for fiscal year 2005-06 where the total number of new guarantees issued amounted to Rs. 14 billion or 0.18 percent of GDP which is fraction of what is required by FRDL 2005.

XI. CONCLUDING REMARKS

53. A sound fiscal policy is essential for preventing macroeconomic imbalances and realizing full growth potential. Pakistan has made considerable progress in fiscal consolidation over the last six years. The overall fiscal deficit is down from an average of 7.0 percent of GDP in the 1990s to 3.4 percent last year (2005-06) and underlying fiscal deficit is still below 4 percent of GDP in 2006-07. The associated public debt burden also declined sharply from over 100 percent of GDP to close to 50.1 percent in the same period.

54. Fiscal consolidation has undoubtedly contributed to a sharp recovery in economic growth within a stable macroeconomic framework. Every effort will be made to continue to improve the fiscal balance, notwithstanding the pressure generated by the earthquake of October 2005. Revenue performance on the other hand is better than the target and will help ease some pressure on the earthquake-related spending. Going forward, Pakistan will have to allocate substantially large resources for strengthening the country's physical and human infrastructure to sustain the growth momentum. The challenge will be to significantly enhance Pakistan's tax-to-GDP ratio in order to generate the resources required to finance the development of both human and physical infrastructure. The government will therefore, have to make efforts to broaden the tax base i.e. to hitherto untaxed or under taxed sectors. Broadening of tax base will enable the government to reduce marginal tax rates which will help further stimulate investment and production and will promote voluntary tax compliance. Broadening of tax base will also ensure the fair distribution of the tax burden among various sectors of the economy. The overall services sector including wholesale and retail trade as well as agriculture are potential candidates for broadening the tax bases.