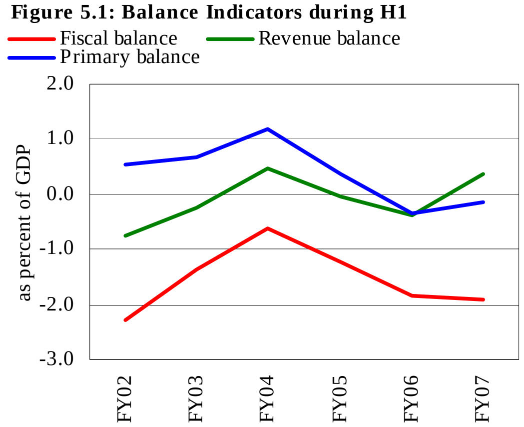
5 Fiscal Developments

5.1 Overview

The recent fiscal numbers show that the government is comfortably placed to meet the FY07 targets, with exceptionally strong direct tax collections and robust non-tax revenues offsetting a substantial increase in expenditures.

Figure 5.1: Balance Indicators during H1



While the H1-FY07 fiscal deficit is marginally higher than in the previous year (see **Figure 5.1**), the H2-FY07 picture is likely to see an improvement given that the earthquake-related H2-FY07 spending is expected to be a little lower and revenue growth stronger, than the respective H2-FY06 figures. In other words, the rising trend in the fiscal deficit seen in the past two years is expected to end in FY07. A similar trend is already evident in the primary balance, and more strikingly, in the revenue balance. Indeed, the latter depicts a small surplus in H1-FY07, after recording deficits in first half of each of the previous two fiscal years.

The improvement in the revenue balance is particularly noteworthy, indicating that the fiscal deficit is essentially being incurred for developmental spending, as envisaged in the FRDL Act 2005[1]. However, given that the performance on the revenue balance is already far ahead of the targets set in the Act, it is important to look for further improvements by revising these targets upwards to reflect the improvement in economic prospects.

Moreover, this needs to be done, even as the government raises development spending on education, health and infrastructure, in order to increase the

[1] The Fiscal Responsibility and Debt Limitation Act, 2005 (FRDL) target of achieving zero revenue balance by the end of FY08 has already been achieved in H1-FY07. Similarly, the FRDL target of achieving a public debt to GDP ratio below 60 percent by the end of FY13 has already been achieved by FY06.

productive capacity of the economy and attract investment. Therefore, it is imperative that the tax-to-GDP ratio be improved, and the tax net broadened, in order to sustainably create the required fiscal space. The H1-FY07 revenue performance is already on the right track, with revenues growing 23.5 percent YoY, due to strong tax and non-tax revenues, bringing the tax-to-GDP ratio for the period to 4.9 percent, as compared to 4.5 percent for H1-FY06.

The growth in tax revenues – the strongest for the last five years – is quite encouraging, particularly given that the indirect tax receipts of the CBR have grown by only 8.3 percent in H1-FY07, much lower than the 16.8 percent growth target for the period, and 17.2 percent rise recorded in corresponding period last year. The risk of a deceleration in the growth of these receipts has already been evident in the previous year, given the high dependence of the growth in these receipts on imports and the likelihood that the extraordinary rise in imports could not continue for long. Fortunately, even as this risk materialized in H1-FY07, the impact of the resulting weakness in CBR indirect tax collections was offset by the exceptional strength of direct tax receipts in the period.

The rise in direct tax collections is certainly very welcome. However, the abrupt shift in the profile of CBR tax receipts underscores three points:

(1) It is important to diversify the tax base, so that underperformance in a portion of the economy does not cause disproportionate revenue losses.
(2) One must carefully examine the underlying causes of the revenue growth to separate one-off factors from underlying (sustainable) factors.
(3) It is crucial for fiscal discipline that expenditure growth is kept at levels consistent with sustainable revenue growth.

The expenditures grew by 23.5 percent YoY during H1-FY07, slightly lower than the 26.1 percent seen in H1-FY06. At face value, the greater discipline in expenditures appears essentially to reflect lower than anticipated development expenditures of Rs 149.3 billion (only 34 percent of the annual target). However, this interpretation is rendered uncertain by the large block of unidentified expenditure (Rs 54.4 billion or 0.6 percent of GDP). If this unidentified spending essentially comprises of development expenditure, this would be quite welcome. On the other hand, if it largely comprises current spending, greater fiscal discipline would clearly be warranted.

5.2 Revenues

The strong growth in both tax and non-tax revenues during H1-FY07, has meant that total receipts already account for 52.8 percent of the annual revenue target (see **Table 5.1**). Thus, given that larger part of the tax collections is typically

Table 5.1: Consolidated Fiscal Operations during H1 (billion Rupees)

							YoY % change	
Head	**FY02**	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**	**FY06**	**FY07**
Revenues	**263.9**	**332.9**	**379.1**	**423.8**	**497.8**	**614.8**	**17.5**	**23.5**
Tax revenue*	184.7	219.6	244.5	284.4	343.3	433.4	20.7	26.3
Non-tax revenue	79.3	113.2	134.5	139.4	154.6	181.3	10.9	17.3
Expenditure	**363.8**	**398.6**	**412.8**	**503.3**	**634.5**	**783.8**	**26.1**	**23.5**
Current	296.7	345.1	352.5	427.5	525.3	581.4	22.9	10.7
Development	50.9	51.5	56.8	81.6	128.3	149.3	57.2	16.4
Net lending to PSEs	6.8	2.7	7.0	4.7	-0.4	-1.3	-108.9	-
Unidentified	9.4	-0.8	-3.4	-10.4	-18.6	54.4	79.3	-
Fiscal balance	**-99.9**	**-65.7**	**-33.7**	**-79.6**	**-136.7**	**-169.0**	**71.8**	**23.6**
As percent of GDP**								
Revenues	6.0	6.9	6.7	6.4	6.5	7.0	-	-
Tax revenue	4.2	4.6	4.3	4.3	4.5	4.9	-	-
Non-tax revenue	1.8	2.3	2.4	2.1	2.0	2.1	-	-
Expenditure	8.3	8.3	7.3	7.6	8.2	8.9	-	-
Current	6.7	7.2	6.2	6.5	6.8	6.6	-	-
Development	1.2	1.1	1.0	1.2	1.7	1.7	-	-
Net lending to PSEs	0.2	0.1	0.1	0.1	0.0	0.0	-	-
Unidentified	0.2	0.0	-0.1	-0.2	-0.2	0.6	-	-
Fiscal balance	**-2.3**	**-1.4**	**-0.6**	**-1.2**	**-1.8**	**-1.9**	-	-

Source: Ministry of Finance
* Surcharges are subtracted from tax revenue and added to non-tax revenue for analysis purpose as per MoF format.
** GDP base 1999-2000.

made during the second half of the fiscal year, it appears that revenue targets for FY07 are likely to be comfortably achieved.

The improved revenue performance is particularly driven by CBR tax collections, which typically account for over 90 percent of tax collections. These rose 26.3 percent YoY in the period, exceeding the target by 7.0 percent.[2]

Similarly, non-tax revenues at Rs 181.3 billion were 17.3 percent higher than last year, mainly due to strong increases in dividend receipts, transfer of profits from SBP and oil & gas surcharge collections, all of which offset the decline in profits from PTA, defense receipts and interest receipts (see **Table 5.2**).

5.3 Expenditures

Total expenditure reached to Rs 783.8 billion with a YoY growth of 23.5 percent of which current expenditure stood at Rs 581.4 billion while the development

[2] The data for Jul-Jan FY07 continues to support the view that annual collections will considerably exceed the target, with receipts of Rs 462.7 billion, about 6.1 percent above the targets for the period.

Table 5.2: Non-tax Revenue (Jul-Dec)
billion Rupees

	FY02	FY03	FY04	FY05	FY06	FY07
Profit of post office / PTA	0.0	-	0.4	17.7	10.5	0.1
Interest	8.8	4.6	12.4	7.1	7.6	4.3
Dividend	15.2	24.3	25.5	32.4	27.3	33.8
SBP profit	12.0	6.0	0.0	0.0	3.9	39.2
Defence	0.0	0.0	0.0	40.6	46.5	27.2
Royalties on gas & oil					10.2	14.1
Sales proceeds & royalties	6.6	7.7	6.5	8.1		0.0
Citizenship, naturalizations & passport fee					2.7	2.7
Development surcharge on petroleum	7.1	11.6	8.9	9.0	9.9	18.0
Development surcharge on gas	17.2	21.9	24.3	4.7	9.4	15.8
Other civil administration	1.7	20.9	35.7	0.9	0.9	0.0
Miscellaneous	10.6	16.1	20.9	18.7	25.7	26.2
Total	**79.3**	**113.2**	**134.5**	**139.4**	**154.6**	**181.3**

Source: Ministry of Finance

expenditure remained low at Rs 149.3 billion (see **Table 5.1**). However, unidentified expenditure was very high, at Rs 54.4 billion (0.6 percent of GDP), which adds considerable uncertainty to the analysis of fiscal trends.[3]

Based on booked expenditure, the overall growth in current expenditure is quite modest relative to the previous year.[4] This rise is essentially caused by a steep rise in domestic interest payments and an increase in *other general public service* spending. While the former is a function of the high reliance on short term debt and rise in interest rates as well as the maturities of high yield long term debt issued a decade ago; the increase in the latter needs to be carefully reviewed as it could imply weakening in fiscal discipline. Encouragingly, defence expenditure declined to Rs 114.9 billion in H1-FY07 as compared to Rs 119.0 billion in H1-FY06 (see **Table 5.3**).

Development expenditure at Rs 149.3 billion remained 1.7 percent of GDP, the same as in H1-FY06. Total PSDP during H1-FY07 works out to be only 34

[3] To illustrate, adding this unidentified expenditure to the current expenditure, drastically increases the growth of current expenditure from 10.7 percent to a disquieting 25.5 percent. On the other hand, if entirely categorized under development expenditure, the growth jumps from 16.4 percent to 58.8 percent YoY.

[4] It may be noted that current expenditure for FY07 is not strictly comparable with the previous year, as the expenditure incurred on earthquake hit areas was a part of current expenditure in FY06, while for FY07 it has been added to budgeted allocations for development expenditure. The impact cannot be disentangled as details of the earthquake related spending have not been provided separate for the two periods.

Table 5.3: Composition of Expenditure (Jul-Dec)
billion Rupees

					YoY percent change	
	FY04	**FY05**	**FY06**	**FY07**	**FY06**	**FY07**
Current expenditure	352.5	427.5	525.3	581.4	22.9	10.7
of which						
Interest payments	98.8	104.2	111.4	155.8	6.9	39.8
Domestic	76.3	82.9	89.8	131.3	8.3	46.2
Foreign	22.5	21.3	21.6	24.5	1.4	13.4
Defence	87.3	101.1	119.0	114.9	17.8	-3.4
Other general services	-	21.5	20.8	50.6	-3.2	143.6
Development and net lending	63.7	86.3	127.8	147.9	48.2	15.7
PSDP	56.8	81.6	128.3	149.3	57.2	16.4
Net lending	7.0	4.7	-0.4	-1.3	-108.9	216.2

Source: Ministry of Finance
* GDP base 1999-2000

percent of the target set for FY07 being far lower than that of 45 percent of the budgeted target achieved during H1-FY06. However, this may simply reflect that the development spending has not yet been booked appropriately.

5.4 Financing

The total financing requirements of the government stood at Rs 169 billion during H1-FY07 (see **Table 5.4**). Almost 57 percent of this was met through external resources in which gross receipts from program loans provided Rs 43.5 billion while project aid added Rs 17.6 billion.

Table 5.4: Financing of Budget Deficit (Jul-Dec)
billion Rupees

			Share in percent	
	FY06	**FY07**	**FY06**	**FY07**
Financing through	136.7	169.0	100.0	100.0
External resources (net)	39.8	96.2	29.1	57.0
Internal resources	96.9	72.7	70.9	43.0
Domestic non-bank*	-6.7	28.5	-4.9	16.9
Banking system	84.9	28.3	62.1	16.7
Privatization proceeds	18.7	15.9	13.7	9.4

Source: Ministry of Finance
*Adjusted for FY07

Of the total domestic financing, bank and non-banks contributed equally with Rs 28.3 and Rs 28.5 billion respectively.[5] Finally, privatization proceeds also helped in financing the fiscal deficit by Rs 15.9 billion.

[5] For further details see sections on *Government Borrowings and Domestic Debt*

Table 5.5: Tax Collection
billion Rupees

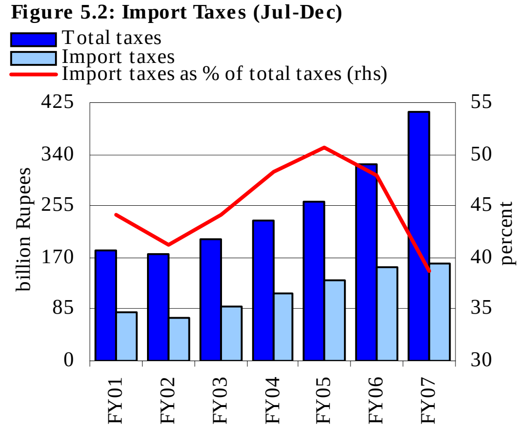
Heads	Target		Net tax collection (Jul-Jan)		YoY percent change		Percent of target	
	FY07	**Jul-Jan**	**FY06**	**FY07**	**FY06**	**FY07**	**FY07**	**Jul-Jan**
Direct taxes	264.7	136.0	114.4	185.2	30.8	61.9	69.9	136.1
Indirect taxes	570.3	300.0	255.4	277.5	18.1	8.6	48.7	92.5
Sales tax	343.8	182.3	154.9	171.0	20.5	10.4	49.7	93.8
Federal excise duty	69.0	35.6	29.5	36.2	6.2	22.6	52.4	101.6
Customs	157.5	82.1	71.0	70.3	18.5	-1.0	44.7	85.7
Total	835.0	436.0	369.8	462.7	21.8	25.1	55.4	106.1

Source: Central Board of Revenue

5.5 CBR Tax Collection

The CBR surpassed the Jul-Jan target of Rs 436.0 billion, with a collection of Rs 462.7 billion, up 25.1 percent YoY (see **Table 5.5**). Although import-related taxes,[6] that typically contribute over half of the CBR tax receipts, suffered due to a deceleration in import growth[7] (see **Figure 5.2**), the impact of this was offset by the unanticipated strong surge in direct taxes as a result of strong corporate profitability (see **Figure 5.3**).

Figure 5.2: Import Taxes (Jul-Dec)



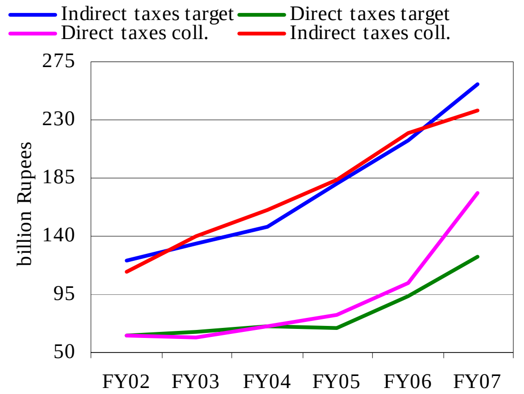
The strong tax receipts are expected to push up the FY07 tax buoyancy and the tax-to-GDP ratio significantly, but Pakistan's performance continues to lag regional benchmarks, as well as those in developing countries.[8]

[6] These include customs duty, sales tax and withholding tax on imports.
[7] The revenue loss during Jul-Dec is estimated to be Rs 19 billion due to fall in imports (CBR Quarterly Review vol. 6, No.2, October – December 2006).
[8] According to Government Finance Statistics of the IMF, the ratio is around 40 percent for high income countries, 25 percent for middle income countries and about 18 percent in low income countries.

Gross Collection and Refunds

The gross tax collection rose sharply by 23.0 percent YoY in Jul-Jan FY07 - the highest collection growth rate for the last 7 years - to reach Rs 517.0 billion, even as the growth in refunds fell from 11.9 percent of gross tax collection in Jul-Jan FY06 to 10.5 percent during Jul-Jan FY07 (see **Figure 5.4)**. However, the sharp downtrend in refunds seen in the last two years does not seem likely to continue in forthcoming years as the affect of zero-rating of inputs for export-oriented products, that was introduced in FY04, has already been realized. Therefore, the refund-to-gross-collection ratio is likely to stabilize at the current levels.

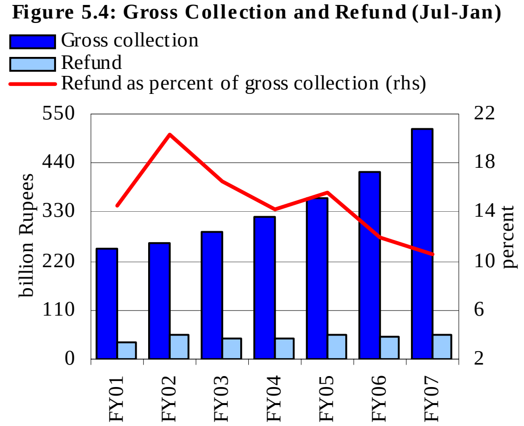
Figure 5.3: CBR Targets vs. Collection (Jul-Jan)



Direct Taxes

The collection from direct taxes rose 61.9 percent YoY in July-Jan FY07 to Rs 185.2 billion, 36.1 percent higher than the target for the period. As a result, the share of direct taxes in total revenue increased from an average of 33 percent for the pervious three years to 40 percent in Jul-Jan FY07 (see **Table 5.5**).

Figure 5.4: Gross Collection and Refund (Jul-Jan)



A break up of the direct tax collection, available for the H1-FY07 period, shows that about 97 percent of the direct tax collection of Rs 172.7 billion came from income tax. Of this, Rs 104.3 billion were realized through voluntary payments that rose by 113.6 percent over the last year (see **Table 5.5a**), superseding withholding tax, as the major contributor to income tax collections. This sharp jump in voluntary payments is mainly due to the higher corporate profits that increased the overall tax collection from direct taxes. Private companies provided Rs 54.6 billion, public companies Rs 47.2 billion, while banking companies provided Rs 35.5 billion to the gross receipt of Rs 137.3 billion during HI-FY07. The gross receipts were up 66.4 percent YoY compared to the previous year (see **Table 5.5b**).

Withholding tax receipts remained strong, providing Rs 77.9 billion to national exchequer during H1-FY07 contributing 46.7 percent to the total income tax collection. Of the withholding taxes major contributor remained contracts (Rs 26.2 billion), salaries (Rs 7.4 billion) and imports (Rs 13.1 billion).

Table 5.5a: Major Components of Income Tax during H1
billion Rupees

							YoY % change	
	FY02	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**	**FY06**	**FY07**
Voluntary payments	26.7	24.2	26.5	35.9	48.8	104.3	35.9	113.6
Collection on demand	4.7	4.5	5.6	3.7	5.6	4.4	50.1	-20.7
Withholding taxes	35.1	37.0	42.2	46.8	60.3	77.9	28.9	29.2
Others	3.1	2.5	0.6	0.4	0.1	0.0	-75.0	-100.0
Gross total	69.6	68.3	74.9	86.9	114.7	186.6	32.1	62.6
Refund/rebate	6.9	6.6	4.9	10.5	15.3	19.7	45.9	28.9
Total net	62.8	61.7	70.0	76.4	99.5	166.9	30.2	67.8

Source: Central Board of Revenue

Indirect Taxes

The collections from indirect taxes totaled Rs 277.5 billion during Jul-Jan FY07 falling 7.5 percent short of the target. This shortfall is mainly attributable to the slowdown in the import growth that hit the collections from customs duty and the import-related sales tax receipts (see **Table 5.5**).

Table 5.5b: Income Tax Collection from Corporate Sector
billion Rupees

			YoY change	
	FY06	**FY07**	**Absolute**	**Percent**
Public companies	27.8	47.2	19.4	69.8
Private companies	38.7	54.6	15.9	41.1
Banking companies	16	35.5	19.5	121.9
Gross corporate tax	82.5	137.3	54.8	66.4

Source: Central Board of Revenue

Sales Tax

Sales tax collection stood at Rs 171.0 billion against the target of Rs 182.3 billion during Jul-Jan FY07. This amount is however 10.4 percent higher than the FY06 collection during the same period. A breakup of the sales tax shows that due to a slowdown in imports, import-related sales tax collections lagged Rs 8.6 billion

(9.2 percent) behind its target of Rs 93.9 billion for the first half of FY07. Apart from import related sales tax, domestic sales tax also slightly lagged behind its target (by Rs 1.3 billion) due to higher refunds to the power sector. The major revenue spinners of domestic sales tax remained telecom, POL, natural gas, sugar, cigarettes, cement and beverages (see **Table 5.5c**).

Federal Excise Duty
Collection from federal excise duty surpassed its target of Rs 35.6 billion and reached to Rs 36.2 billion. Of the indirect taxes, federal excise duty is the only tax head that could meet the target for the period.

The major revenue spinners in excise duty remained cigarettes and tobacco (Rs 10.6 billion), cement (7.0 billion), beverages and concentrates (Rs 3 billion) and natural gas (Rs 2.8 billion). The collection from the natural gas is not as high as its historical perspective, mainly due to the substantial input claims on major explores and suppliers during the first half of the fiscal year 2007.

Customs Duty
Due to slowdown in imports from 50.0 percent YoY growth during Jul-Jan FY06, to 9.1 percent YoY growth in Jul-Jan FY07, the customs duties collection (Rs 70.3

Table 5.5c: Major Revenue Spinners of Sales Tax (domestic)
billion Rupees

			YoY change	
	H1-FY06	**H1-FY07**	**Absolute**	**Percent**
Telecom services	11.8	17.1	5.3	44.8
POL products including LPG	12.6	14.6	2.0	15.8
Natural gas	6.3	5.7	-0.6	-9.6
Sugar	3.3	4.8	1.4	42.6
Cigarettes	2.0	2.9	0.9	42.8
Cement	2.3	2.5	0.2	8.3
Services excluding telecom	1.9	2.2	0.2	12.3
Beverages	1.4	1.7	0.3	20.1
Auto parts	1.1	1.3	0.2	21.5
Iron & steel products	0.8	1.0	0.2	26.8
Sub total	43.6	53.8	53.8	23.2
Others	25.6	34.7	54.8	35.8
Gross	**69.2**	**88.5**	**55.8**	**27.9**
Refund	17.2	23.0	56.8	34.0
Net sales tax (domestic)	**52.0**	**65.4**	**57.8**	**25.8**

billion) fell 14.3 percent short of target (see **Table 5.5**). However, the major revenue came from vehicles, edible oil and waxes, POL products and electrical machinery.

5.6 Provincial Finance

Aggregate provincial revenues rose 11.9 percent YoY to Rs 215.7 billion during H1-FY07. The larger part of these revenues represented the federal tax assignments,[9] while the aggregate collections from provincial taxes remained low at Rs 17.0 billion, witnessing a 1.4 percent YoY decline. On the other hand, non-tax revenues rose slightly by 1.8 percent to Rs 18.3 billion. The lower tax base and revenue mobilization by provinces poses a serious fiscal risk to their efforts to retire expensive cash development loans in order to increase their fiscal space, and expand development expenditure (see **Table 5.6**).

On the other hand, relatively moderate growth is evident in all provinces as the expenditure growth in H1-FY07 fell to 18.4 percent YoY as compared to 27.9 percent YoY in the corresponding period last year. The trend of premature retirement of the CDL remains in progress and the net repayment of all provinces on account of cash development loan stood at Rs 4.4 billion, which would further help improve the fiscal position of the provinces.

The aggregate overall deficit of provinces increased sharply from 12.1 billion in H1-FY06 to Rs 26.9 billion in H1-FY07. The details of provincial finance show that this is principally due to the Punjab whose deficit increased from Rs 5.7 billion in H1-FY06 to Rs 33.0 billion in H1-FY07. In contrast, the other three provinces saw improvements in their overall fiscal position during H1-FY07. The prime reason for the increase in the overall deficit of the Punjab is the rise in both the current and the development expenditure. The current expenditure increased from Rs 70.9 billion in H1-FY06 to Rs 100.3 billion in H1-FY07, while the development expenditure rose from Rs 44.7 billion to Rs 55.4 billion (up 24 percent YoY).

[9] One of the major contributing factors to the improvement in provincial finance is the revision of NFC award that increased the provincial share in federal tax receipts**.** For details see **Box: Revenue Sharing** in the *The State of Pakistan's Economy - First Quarterly Report 2006-2007.*

Table 5.6: Summary of Consolidated Provincial Finance during H1
billion Rupees

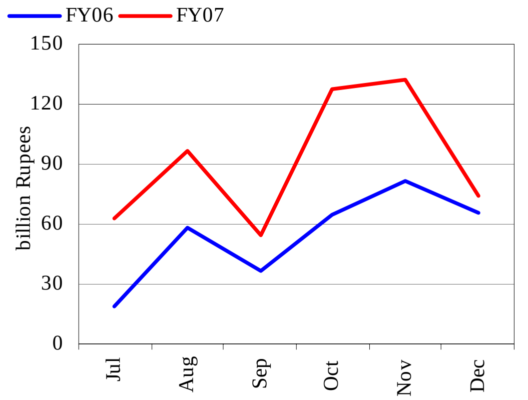
						YoY % change	
	FY03	**FY04**	**FY05**	**FY06**	**FY07**	**FY06**	**FY07**
Total revenue	**118.7**	**126.5**	**153.5**	**192.8**	**215.7**	**25.6**	**11.9**
Provincial share in federal revenue	81.5	90.5	113.2	126.2	170.2	11.5	34.8
Provincial taxes	10.7	13.7	16.5	17.2	17.0	4.6	-1.4
Provincial non-tax	8.4	11.2	9.7	18.0	18.3	85.7	1.8
Federal loans and transfers/grants	18.1	11.1	14.1	31.4	10.3	122.0	-67.1
Total expenditure	**139.7**	**135.2**	**160.2**	**204.9**	**242.7**	**27.9**	**18.4**
Current expenditure	119.7	113.6	129.3	160.2	187.2	23.8	16.9
Development expenditure	20.0	21.6	30.9	44.7	55.4	44.8	24.0
Overall balance	**-21.0**	**-8.7**	**-6.8**	**-12.1**	**-26.9**	**78.9**	**122.8**
Financing	**2.7**	**-2.0**	**8.8**	**-8.2**	**-0.8**	**-193.0**	**-90.1**
Domestic	2.7	-2.0	8.8	-8.2	-0.8	-193.0	-90.1

Source: Ministry of Finance

5.7 Government Borrowings[10]

While the government's overall financing needs from domestic resources during H1-FY07 were almost same as they were in H1-FY06 (see **Figure 5.5**), the sources were more diverse, as the availability of non-bank resources to the government during H1-FY07 reduced the dependence on bank borrowings.

Figure 5.5: Total Borrowing (Jul-Dec)



As shown in **Table 5.7**, non-bank resources were bolstered by sales of PIBs worth Rs 16.3 billion during H1-FY07 (none were sold in the corresponding period last year), and higher net mobilization from NSS.

[10] The government borrowing numbers do consider the impact of government deposits with the banking system whereas the debt numbers do not.

Table 5.7: Bank and Non-bank Borrowings - Cumulative
billion Rupees

	FY06		FY07	
	Bank	**Non-bank**	**Bank**	**Non-bank**
Jul	21.2	-1.4	32.3	13.1
Aug	51.0	2.5	45.9	23.4
Sep	24.5	2.5	38.1	14.5
Oct	54.9	5.1	78.8	17.6
Nov	81.6	4.3	63.7	20.8
Dec	84.9	1.1	28.3	21.6

The latter rose by Rs 22.2 billion during H1-FY07, against a net retirement of Rs 2.3 billion during H1-FY06. This change was seen even before the government's decision to allow institutional investment in NSS,[11] and to remove the lock-up period of one month for Defence Saving Certificate (DSCs), Special Saving Certificates (SSCs), and Special Saving Accounts (SSAs). Indeed, these decisions do not appear to have resulted in any substantial increase in NSS net receipts, so far.

As a result of the net surplus from non-bank resources, the government budgetary borrowing from the banking system during H1-FY07 witnessed a fall of 66 percent YoY. However the government continued to borrow exclusively from the SBP and retired debt held by scheduled banks (see **Table 5.8**).

Table 5.8: Composition of Banking System Borrowing – Cumulative
billion Rupees

	FY06		FY07	
	SBP	**Sch banks**	**SBP**	**Sch banks**
Jul	-16.1	37.3	14.9	17.5
Aug	55.8	-4.8	49.9	-4.0
Sep	67.9	-43.4	60.1	-22.0
Oct	93.3	-38.3	117.1	-38.3
Nov	161.0	-79.4	62.0	1.7
Dec	142.4	-57.5	79.3	-51.0

5.8 Domestic Debt

The 2.8 percent YoY rise in domestic debt during H1-FY07 was substantially lower than the 6.3 percent rise in H1-FY06. In absolute terms, H1-FY07 recorded an increase of Rs 64.3 billion in domestic debt, which was only 48.2 percent of H1-FY06 increase in domestic debt. Primarily, this lower domestic debt growth was a result

Table 5.9: Domestic Debt
billion Rupees

	Jun-05	**Dec-05**	**Jun-06**	**Dec-06**
Permanent	500.9	484.7	499.8	517.5
Floating	778.2	926.8	940.2	965.2
Unfunded	854.0	855.1	859.2	880.8
Total	2133.1	2266.6	2299.2	2363.5

[11] Following institutions are allowed to invest in NSS: Non-profit bodies, registered charities, public sector enterprises excluding banks, private educational and health institutions, Employees Old Age Benefit Institution (EOBI), private corporate sector registered with the SECP excluding banks.

of larger external sector borrowings (including GDRs), that lowered the government domestic borrowing needs.

Another significant change in H1-FY07 was the marginal increase in average debt maturity profile as a result of the greater long term non-bank borrowings and the retirement of short-term debt.

According to NSS data, the gross sale of NSS instruments[12] was Rs 191.8 billion during H1-FY07, which was marginally smaller than the H1-FY06 gross sale. However, the gross encashments of these instruments (including early encashment) was lower in H1-FY07 compared to the corresponding period. The decline in encashments was primarily due to smaller encashment of Special Savings Certificates (SSCs). The heavy encashment of SSCs during H1-FY06 may be connected to heavy buying during FY03 due to interest rate arbitrage opportunities at that time.[13]

Table 5.10: Gross Payments and Receipts of Treasury Bills (Jul-Dec)

billion Rupees

	FY06		FY07	
	Payments	**Receipts**	**Payments**	**Receipts**
MTBs	542.6	493.9	378.9	354.7
MRTBs*	420.9	619.1	697.5	746.7

* MRTBs are used for replenishment and MTBs are issued in auctions.

In sharp contrast to a net decline of Rs 9.9 billion in the stock of PIBs recorded during H1-FY06, there was an increase in PIB stock by Rs 21.4 billion during H1-FY07.[14] Since the short-term Rupee interest rates were on the rise during H1-FY06, the government was unable to conduct successful PIB auctions, therefore the maturity of older PIBs during this period resulted in decline in PIB stock. In comparison, as the short-term rates were stable during H1-FY07, the government was able to mobilize Rs 36.6 billion, which more than off-set PIB maturities of Rs 15.1 billion in this period.

The net fund mobilization from NSS coupled with higher net government borrowings through PIBs during H1-FY07 resulted in marginally lower dependence on financing through treasury bills. There was a net increase of Rs 24.9 billion in the stock of total treasury bills during H1-FY07, which was substantially lower than Rs 148.6 billion increase recorded in H1-FY06.

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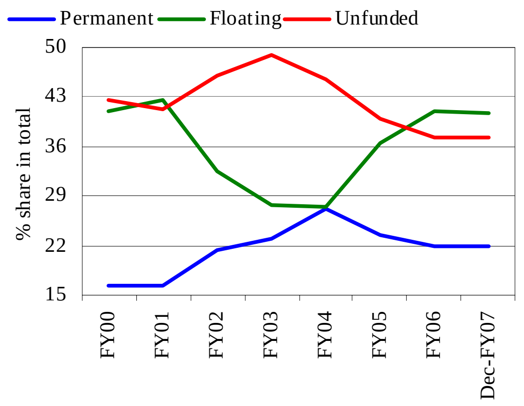
[12] Including Prize Bonds.
[13] See **SBP Annual Report 2002-03** for details.
[14] A bank-non-bank break up reveals that around 75 percent of the H1-FY07 PIB issues were held by non-bank.

The ownership profile of the short term debt also changed slightly. The stock of treasury bills with scheduled banks and non-bank (MTBs) was depleted by Rs 24.2 billion during H1-FY07 compared with a depletion of Rs 49.6 billion in the corresponding period last year. The stock of treasury bills with SBP (MRTBs) increased by only Rs 49. 2 billion during H1-FY07, which was around one-fourth of H1-FY06 rise. Despite the fact that maturity of MTBs was substantially smaller in FY07 relative to FY06, the short term debt portfolio continued to tilt towards SBP debt (replenishment) (see **Table 5.10**).

As a result of the developments mentioned above, the domestic debt profile marginally changed. Specifically, the shares of *Permanent Debt* and *Unfunded Debt* slightly increased on the cost of *Floating Debt* share during H1-FY07. If this pattern continues in H2-FY07, it would alter the trend observed during last few years (see **Figure 5.6**).

Figure 5.6: Composition of Domestic Debt



This change also has implications for debt servicing costs. Specifically, the debt servicing cost may increase initially as the longer term debt is costlier than short term debt in general, however the debt servicing burden would be less vulnerable to adverse interest rates movements.

5.9 Debt Management Strategy

A key development in Pakistan debt management is *'The Fiscal Responsibility and Debt Limitation (FRDL) Act, 2005'*, which came into effect from June 20, 2005. This Act envisaged a reduction in debt to GDP ratio by 2.5 percentage points every year and bringing down it to 60 percent by end-June 2013. Remarkably, this target was met within one year of the promulgation of the Act; by end of FY06, when debt to GDP ratio was as low as 57.8 percent despite the fact that the budgetary expenditures increased substantially on account of earthquake relief. The developments in FY07 so far suggest that the debt to GDP ratio further declined reflecting the continual improvement in economy's ability to sustain debt.

On the country's debt sustainability position, the Debt Policy Coordination Office (DPCO), Ministry of Finance issued the first *Debt Policy Statement 2006-07 (DPS)* on January 31, 2007 as required by the FRDL Act 2005.[15] According to Section 7 of the Act, this statement has to provide an assessment of federal government's debt policies in the light of sound fiscal and debt management principles, evaluation of external and domestic borrowing strategies (and advice on them), evaluation of nominal and real cost of borrowing and suggestions on cost reduction ways, and assessment of government debt exposure.

The first DPS claims that due to credible debt reduction strategies followed by the government after the Debt Committee recommendations coupled with successive high GDP growth rates, Pakistan's debt burden reduced substantially during last 7 years. The subsequent fiscal space enabled the government to increase PSDP spending. The Statement also warns that the country's debt burden will increase in next decade if sufficient revenues are not generated to finance future large infrastructure projects.

Moreover, the DPCO staff calculations reveal that real cost of public debt was -1.7 percent during July 2003-September 2007 period, which was substantially lower than 2000-03 debt cost. The Statement also defends the massive government borrowings through treasury bills (both MTBs and MRTBs) during FY05-FY06. According to the Statement, there were two reasons for this strategy. First, due to an unstable interest rate environment, there was limited issuance of PIBs in this period (the Statement also argues that the government borrowing needs from the banking sector was low which is self-contradictory). Second, there was lower than expected net inflow in NSS in same period.

In fact, initially the government opted to borrow through cheaper short term papers (at very low rate at that time) and avoided to pay term premium. However the increasing short term debt became more vulnerable to short-term interest rate movements. This strategy might be treated as short sighted, which is evident in the fact that the short term interest rates climbed to nearly 9 percent per annum by August 2006, nearly 300 basis points higher than the cost of 10-year PIB in June 2003. The government probably missed the opportunity of locking long-term funds at very low cost in a low interest rate scenario during FY03-FY04; this was highlighted in SBP Annual Report FY05. As soon as the government realized this fact, it resumed PIBs sales; since May 2006, the government has mobilized Rs 59.7 billion through 4 successful PIB auctions[16].

[15] A summary of DPS is placed in **Box 5.2**.
[16] Latest auction was held on March 5, 2007 in which government realized Rs 14.9 billion.

Under FRDL Act 2005, Ministry of Finance is required to present Fiscal Policy Statement and Debt Policy Statement by the end of January each year. Following boxes (**Box 5.1 and 5.2**) are the summaries of the statements.

Box 5.1: Summary of Fiscal Policy Statement 2006-07

Debt Policy Coordination Office (DPCO), Ministry of Finance has issued first *Fiscal Policy Statement (FPS) 2006-07* on January 31, 2007 to fulfill the requirement laid out under Section 6 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. The Act requires preparing the FPS having analysis of key macroeconomic indicators and how fiscal indicators accord with the principles of sound fiscal and debt management. The Act also requires setting of strategic priorities of federal government for the financial year.

After discussing the rationale for rule-based fiscal policies and principles of taxation, the statement focuses on recent fiscal policy developments. A growth-oriented prudent and sustainable fiscal policy stance has been adopted. This stance focuses on lowering debt service, alleviating poverty and investing in infrastructure. The report mentions that in recent years, Pakistan made considerable improvement on fiscal front squeezing fiscal deficit from an average 7.0 percent of GDP during 1990s to 3.4 percent in FY06 (4.2 percent including earthquake spending).

Government has made a significant progress in designing the framework of financial accounting principles and procedures according to international standards and has modernized the audit procedures also. Now government is moving ahead on its agenda to improve expenditure management and fiscal transparency. Government has re-engineered its economic and financial management functions, e.g., adoption of internationally recognized standards of accounting and legal framework. The New Accounting Model (NAM) has been used for the federal budget.

Sustainability of fiscal policy is vital for a sustainable debt path and government has included this in FRDL Act.2005. As a result, debt to GDP ratio is declining and revenue deficit targets are likely to be met by 2008. Fiscal discipline is maintained and government is in position to meet the projected target of overall fiscal deficit. Process of Medium Term Budgetary Framework (MTBF) has initiated in order to allow spending agencies to plan their programs in a consistent and coherent way.

Being aware of the importance of public private partnership, the government is in progress to develop a framework in collaboration of ADB to develop an infrastructure level consistent with government's economic growth targets. The infrastructure project development facility has been set up with for this purpose. Debt management strategy of the government is showing positive results visible by declining trends in public debt to GDP ratio. Reduction in fiscal deficit and current account deficits, lowering the cost of borrowing, raising revenues and foreign exchange earnings are the key features of government strategy.

Going forward, Pakistan will have to allocate substantially larger resources for strengthening the country's physical and human infrastructure to sustain the growth momentum. The challenge will be to enhance tax-to GDP ratio in order to generate the resources required to finance human and infrastructure development. Tax base also needs broadening and this will enable the government to reduce marginal tax rates which will help to stimulate investment and production in the country and ensuring a fair distribution of the tax burden among various sectors of the economy.

Box 5.2: Summary of Debt Policy Statement 2006-07

First *Debt Policy Statement 2006-07* was issued on January 31, 2007 by Debt Policy Coordination Office (DPCO), Ministry of Finance to fulfill the requirement of Section 7 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. This Act ensures responsible and accountable fiscal management by all governments –present and future—and would encourage informed public debate about fiscal policy. The statement provides an overview of the public debt as well as external debt and liabilities. The *Statement* highlights that:

1. In the last 5 years, Pakistan has recorded some of the highest growth rates in recent history, which has enhanced the country's ability to carry debt.
2. As a result of government's credible strategy, the public debt to GDP ratio dropped to 56 percent by the end of FY06 from almost 80 percent at the end of FY02.
3. The public debt as percent of GDP reduced by 5.5 percentage points during FY06, which was significantly higher than 2.5 percentage points decline as required by FRDL Act 2005.
4. The public debt as percent of total revenue also declined from 562 percent to 394 percent during FY02-FY06.
5. There was a rise of 7.1 percent in domestic debt during FY06, which came primarily from floating debt.
6. The debt servicing as percent to total revenue as well as current expenditure declined substantially during FY02-FY06.
7. The external debt to GDP ratio decreased to 28.9 percent at end-FY06 from 51.0 percent at end-FY02.
8. Pakistan received US$ 2.6 billion external loans and borrowed US$ 0.8 billion through long term papers sold in global capital market.
9. Pakistan's sovereign foreign bond rating was revised in November 2006 by Moody's firm from B2 to B1 which is just 3 notches below investment grade.
10. Sum total of new guarantees issued by the government on loans during FY06 were less than 0.2 percent of GDP, which is much smaller than the room (of 2 percent) provided in FRDL Act 2005.
11. Although the current trend in debt indicators is positive, sustaining this momentum will be continuing challenge. The large infrastructure projects envisaged in the next decade will increase the debt burden if these projects are largely financed by external borrowings.
12. The real cost of public debt during July 2003-September 2007 was -1.7 percent partly because of high domestic inflation as well as low domestic interest rates.
13. The maturity profile of external debt till FY37 shows a fairly smooth payment schedule—maximum payment in any given year is around US$ 1.6 billion—assuming that all agreed loans are disbursed completely and no new loans are taken.

The statement also reveals the government plans to put in place several measures to meet its twin objective of borrowing at minimum cost while keeping risks in check and of developing an efficient local currency sovereign debt market. The salient features of the debt management strategy are:

1. The DPCO will publish every quarter an analytical report on debt.
2. The DPCO will establish links with the four debt management units (SBP, EAD, NSS and Budget Wing) in order to develop an updated e-database.
3. The government will announce a regular calendar for PIB auction, most likely on a quarterly basis clearly indicating the targets.
4. The government will reconsider the primary dealers (PDs) system for PIB auction since many PDs have held onto PIBs instead of selling to non-bank investor.
5. The government will reduce the stock of MRTBs at a measured pace by replacing them with PIBs/MTBs.
6. The government will adopt a more balanced approach for borrowings through NSS instruments and consider to modify them in order to make them more market-based.
7. The government will develop a comprehensive external borrowing strategy in coming years, which is consistent with borrowing constraints such as saving-investment gap, amortization payments, reserve targets and, most importantly, government's medium-term development priorities.
8. The government will continue to tap international capital market through issuance of sovereign bonds (both conventional and Islamic) and keep Pakistan on the radar screen of global investor.

9. The DPCO will develop a framework for regularly assessing the revaluation of debt arising from changes in cross-country exchange rates as well as changes in estimated debt servicing.
10. The government will closely monitor that portion of external debt, which is on floating rates, and develop a framework to assess the forthcoming risks arising in global capital market.
11. The government will use various interest rates and cross-country swap arrangements that would hedge the exposure to external debt.
12. The government will undertake a study to document the current process of approval and reporting of government guarantees in the Government of Pakistan.
13. The DPCO will create mechanisms for exchange of information on regular basis with those units in the government which issue or approve guarantees.