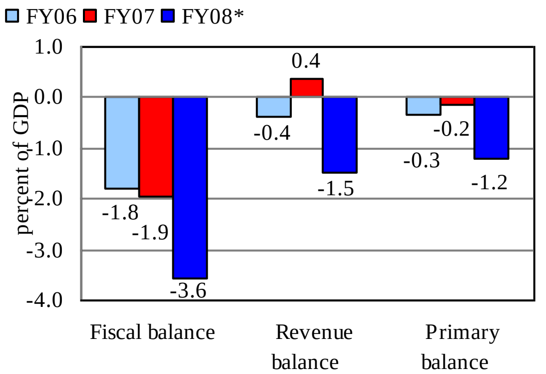
5 Fiscal Developments

5.1 Overview

The deterioration in key fiscal indicators seen during Q1-FY08, accelerated sharply in the next quarter as revenue growth stagnated, even as expenditures continued to rise. As a result, the cumulative fiscal deficit for H1-FY08 as a share of (estimated) annual GDP, was almost twice than seen in the previous two years, reaching a seven-year high for the period. Similarly, the revenue deficit and the primary deficit ratios for H1-FY08 increased substantially compared with the preceding years (see **Figure 5.1**).

Figure 5.1: Fiscal Performance Indicators (Jul-Dec)



*based on estimated full-year GDP

A quarter-by-quarter analysis of the data reveals that nearly 55.6 percent of the Jul-Dec FY08 fiscal deficit was generated in the second quarter of FY08. The buildup of fiscal deficit during Q2-FY08 is largely associated with an unusual fall in total revenues, contributed by decline in both tax and non-tax sources. Growth in total expenditures during Q2-FY08 has been relatively moderate at 15.8 percent YoY compared to the abrupt 37.5 percent YoY surge in Q1-FY08 (see **Table 5.1**).

Table 5.1: Buildup of Fiscal Balance

billion Rupees

	Jul-Sep		Oct-Dec	
	FY07	**FY08**	**FY07**	**FY08**
Total revenue	**255.7**	**312.6**	**359.1**	**313.0**
Tax revenue	191.6	215.6	241.8	235.1
Non-tax	64.1	97.0	117.3	77.9
of which defence	*0.6*	*1.3*	*6.6*	*2.3*
Total expenditure	**342.4**	**470.7**	**441.4**	**511.2**
of which grants (other than provinces)	*9.7*	*7.7*	*16.6*	*37.5*
Budget Balance	**-86.7**	**-158.1**	**-82.3**	**-198.3**

Source: Ministry of Finance , Islamabad

The weakness in Q2-FY08 fiscal revenues stemmed from a variety of factors. For example, direct taxes declined due to a fall in expected taxable profits of key industries (e.g., banks, cement, etc.). Similarly, the weakness in non-tax revenues mainly reflected the delayed disbursement of logistic support grant (indicated by a fall in defence receipts), and low collections of surcharges on petroleum and gas. The fiscal performance is expected to improve in the remaining two quarters of the fiscal year, with greater discipline in spending[1] being complemented by a relative improvement in revenues. In particular, aggregate taxable profits of corporates (particularly for banks) are expected to improve somewhat in H2-FY08 even as non-tax revenues are bolstered by the realization of defence receipts, and an anticipated increase in dividends, etc.

Table 5.2: Summary of Consolidated Public Finance

billion Rupees

	Jul-Dec				YoY change (%)	
	FY05	**FY06**	**FY07**	**FY08**	**FY07**	**FY08**
Total revenue	423.8	497.8	614.8	625.6	23.5	1.8
Tax revenue	284.4	343.3	433.4	450.7	26.3	4.0
Non-tax revenue	139.4	154.6	181.3	174.9	17.3	-3.6
Total expenditure	503.3	634.5	783.8	981.9	23.5	25.3
Current	427.5	525.3	581.4	775.1	10.7	33.3
Development and net lending	86.3	127.8	147.9	225.8	15.7	52.6
Unidentified expenditure	-10.4	-18.6	54.4	-18.9	-391.9	-134.7
Budget balance	-79.6	-136.7	-169.0	-356.3	23.6	110.9
As percent of GDP						
Total revenue	6.6	6.6	7.1	6.3	--	--
Tax revenue	4.4	4.5	5.0	4.5	--	--
Non-tax revenue	2.2	2.0	2.1	1.8	--	--
Total expenditure	7.8	8.4	9.0	9.8	--	--
Current	6.6	6.9	6.7	7.8	--	--
Development and net lending	1.3	1.7	1.7	2.3	--	--
Unidentified expenditure	-0.2	-0.2	0.6	-0.2	--	--
Budget balance	-1.2	-1.8	-1.9	-3.6	--	--

Source: Ministry of Finance

But, notwithstanding this anticipated relative improvement, revenue growth for FY08 is likely to remain below target. Moreover, the fiscal concerns are also

[1] The incentive to accelerate development spending ahead of the elections will no longer hold. Indeed, media reports indicate that concerned by the ballooning fiscal deficit the government has sharply curtailed expenditure growth in H2-FY08.

heightened by the large Rs 54.6 billion issuance of contingent liabilities by the government in the first six months of FY08.

Furthermore, now that almost 90 percent of the annual fiscal deficit target of 4.0 percent of GDP has already been reached in the first six months of FY08 (see **Table 5.2**), the government needs to act swiftly in order to curtail the fiscal deficit within manageable limits. The government also needs to take corrective steps to avoid a breach of targets set in Fiscal Responsibility and Debt Limitation Act, 2005.

5.2 Revenues

Revenue growth in H1-FY08 decelerated to extremely low levels. Total revenues increased by 1.8 percent YoY in H1-FY08 as compared to 23.5 percent YoY in H1-FY07 and an average 18.6 percent YoY for the corresponding period in last six years. The dull growth in revenue receipts during H1-FY08 is contributed by a deceleration in tax revenues as well as an actual decline in non-tax receipts.

Table 5.3: Composition of Tax and Non-tax Revenues

billion Rupees

	Jul-Dec			YoY change (%)	
	FY06	**FY07**	**FY08**	**FY07**	**FY08**
Tax revenues	**343.3**	**433.4**	**450.7**	**26.3**	**4.0**
Direct taxes	104.2	176.6	162.8	69.5	-7.8
Taxes on property	3.3	1.7	2.0	-46.7	15.6
Taxes on goods and services	158.4	178.0	207.2	12.4	16.4
Taxes on international trade	61.5	60.7	61.5	-1.4	1.4
Other taxes	16.0	16.5	17.3	3.0	4.8
Non-tax revenues	**154.6**	**181.3**	**174.9**	**17.3**	**-3.6**
Profits from PTA/post office department	10.5	0.1	0.0	-99.5	-70.0
Interest (PSE and others)	7.6	4.3	15.2	-44.2	257.5
Dividends	27.3	33.8	32.4	23.6	-4.2
SBP profits	3.9	39.2	47.3	905.1	20.7
Defence	46.5	27.2	2.3	-41.5	-91.7
Surcharges	19.2	33.8	19.5	75.9	-42.4
Petroleum	9.4	18.0	7.3	92.6	-59.3
Gas	9.9	15.8	12.2	60.1	-23.2
Royalty on oil/gas	10.2	14.1	21.5	37.8	52.1
Others	29.3	28.9	36.7	-1.4	27.2
Total revenue	**497.8**	**614.8**	**625.6**	**23.5**	**1.8**

Source: Ministry of Finance

A breakup analysis illustrates that the deceleration in tax receipts is largely on account of an exceptional fall in direct tax collections (see **Table 5.3**). As indicated earlier, this reflected a fall in expected profitability of the corporate sector (the largest contributor to direct tax receipts).

On the other hand, the decline in non-tax revenues in H1-FY08 was likely in the wake of non-receipt of logistic support grant from US. The resulting declines in defence and surcharge receipts more than offset the improvement in interest income, SBP profits and collection on account of royalty on oil and gas.

5.3 Expenditures

Though the increase in total expenditures has been relatively moderate in second quarter of FY08 (15.8 percent YoY in Q2-FY08 compared to 37.5 percent YoY in Q1-FY08), still the growth in total expenditures during H1-FY08 is greater than the increase recorded in H1-FY07. The strong growth in total expenditures during H1-FY08 was due to substantial rises in both current and development spending.

Table 5.4: Composition of Current Expenditure

billion Rupees

	Jul-Dec			YoY change (%)	
	FY06	**FY07**	**FY08**	**FY07**	**FY08**
Current expenditures	**525.3**	**581.4**	**775.1**	**10.7**	**33.3**
of which					
Interest payments	111.4	155.8	237.7	39.8	52.6
Domestic	89.8	131.3	208.8	46.2	59.1
Foreign	21.6	24.5	28.9	13.4	18.0
Defence	119.1	114.9	131.8	-3.4	14.7
Economic affairs	24.7	18.6	50.9	-24.5	173.3
Health	2.2	2.3	2.7	3.6	19.1
Education affairs and services	7.4	10.6	10.5	44.8	-1.0
Provincial	149.0	176.7	210.1	18.6	18.9

Source: Ministry of Finance

The upsurge in current expenditures witnessed in the first quarter of FY08 persisted during H1-FY08, and for almost the same reasons: (1) interest payments grew by 52.6 percent YoY during H1-FY08 to reach at 2.4 percent of GDP compared to 1.8 percent in H1-FY07, (2) though defence spending as a percent of GDP remained unchanged (1.3 percent) during H1-FY08, actual expenditures showed a sizeable growth in H1-FY08 compared to a decline in the corresponding period last year, and (3) spending under *economic affairs* reached Rs 50.9 billion in H1-FY08, up by 173.3 percent YoY compared to a fall in H1-FY07 (see **Table 5.4**).

Additionally, expenditure under *superannuation allowance and pension* increased by Rs 10.1 billion in H1-FY08 to reach Rs 22.8 billion compared to a fall of Rs 5.3 billion in H1-FY07. Furthermore, *grants (other than provinces)* jumped to Rs 45.2 billion in H1-FY08, up by 71.5 percent, probably on account of non-receipt of logistic support grant from the US.

Development expenditures also increased significantly during H1-FY08 (48.2 percent YoY during Jul-Dec FY08 compared to 16.4 percent during Jul-Dec FY07). However, while the revised data for Q1-FY08 suggest that provinces undertook almost 54.7 percent of the development expenditures in that period, the numbers for H1-FY08 reveal federal government taking a lead in development spending (52.9 percent for federal government to 47.1 percent for provinces) in H1-FY08.

5.4 Budgetary Financing[2]

The increase in fiscal deficit during H1-FY08 was coincided with a sharp decline in external financing inflows. This forced the government to substantially increase reliance on domestic sources for budgetary financing (see **Table 5.5**).

Table 5.5: Sources of Financing

(billion Rupees)

	Jul-Dec			Growth (%)		Percent share[1]	
	FY06	FY07	FY08	FY07	FY08	FY07	FY08
Total financing of budget	**136.7**	**168.9**	**356.3**	**23.6**	**110.9**	**100.0**	**100.0**
External resources (net)	39.8	96.2	68.0	141.7	-29.3	57.0	19.1
Domestic resources (net)	96.9	72.7	288.3	-25.0	296.5	43.0	80.9
Banking system	84.9	31.5	228.6	-62.9	625.7	(43.3)	(79.3)
Non-bank	-6.7	25.3	58.0	-477.6	129.2	(34.8)	(20.1)
Privatization proceeds	18.7	15.9	1.7	-15.0	-89.6	(21.9)	(0.6)

Source: Ministry of Finance

[1] Numbers in parenthesis represent share in domestic source of financing

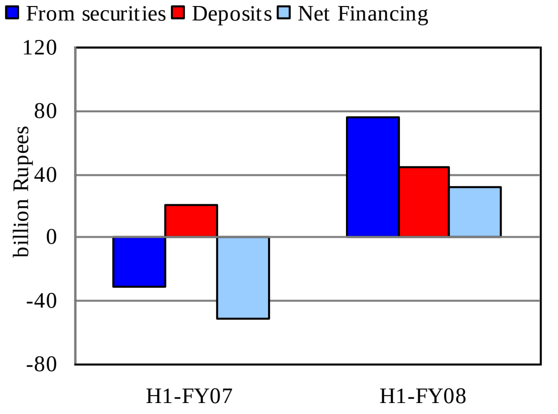
[2] The budgetary financing numbers do consider the impact of government deposits with the banking system whereas the debt numbers do not.

5.4.1 Financing from the Banking Sector[3]

Budgetary financing availed from the banking sector increased by 625.7 percent to Rs 228.6 billion in H1-FY08 compared to Rs 31.5 billion in H1-FY07. SBP remained the major source for this deficit financing which provided Rs 200.6 billion, 153 percent more compared to H1-FY07.

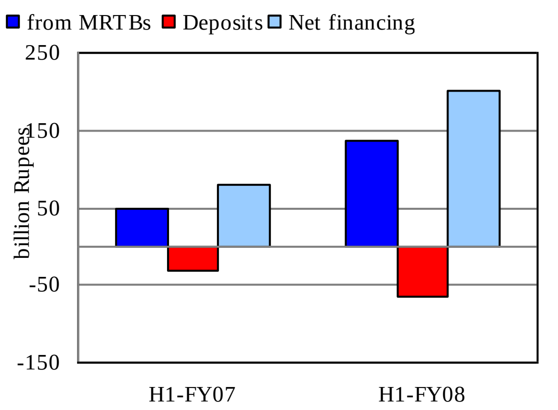
Commercial banks also supplied Rs 31.8 billion in H1-FY08 for budgetary support to the government in contrast to H1-FY07, where it had net retirement of Rs 51.0 billion (see **Figure 5.2**).

Figure 5.2: Financing from Scheduled Banks



It is important to note that the quoted budgetary financing figure is net of government deposits. Hence, some discussion about deposits is necessary to understand the dynamics of this banking sector financing.

Figure 5.3: Financing from SBP



Disaggregated data shows that the government deposits with SBP (including other deposits) decreased by Rs 63.6 billion in H1-FY08 which has magnified the borrowings of Rs 137.0 billion to Rs 200.6 billion in freshly created MRTBs from SBP (see **Figure 5.3**).

On the other hand, the deposits with the scheduled banks increased by Rs 44.4 billion which diluted the impact of

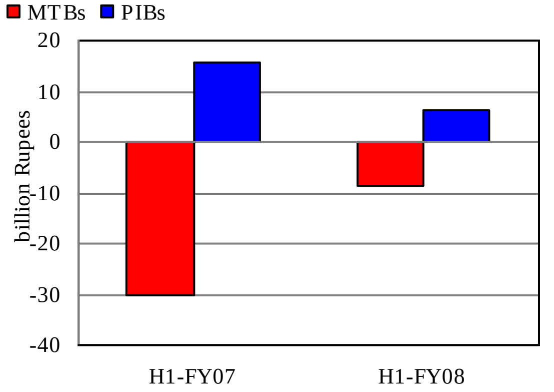
[3] The separate figures for SBP and scheduled bank financing are based on SBP data and might deviate marginally from Ministry data.

actual financing of Rs 76.2 billion received in terms of government securities, taking the net financing to Rs 31.8 billion.

5.4.2 Non-Bank Financing[4]

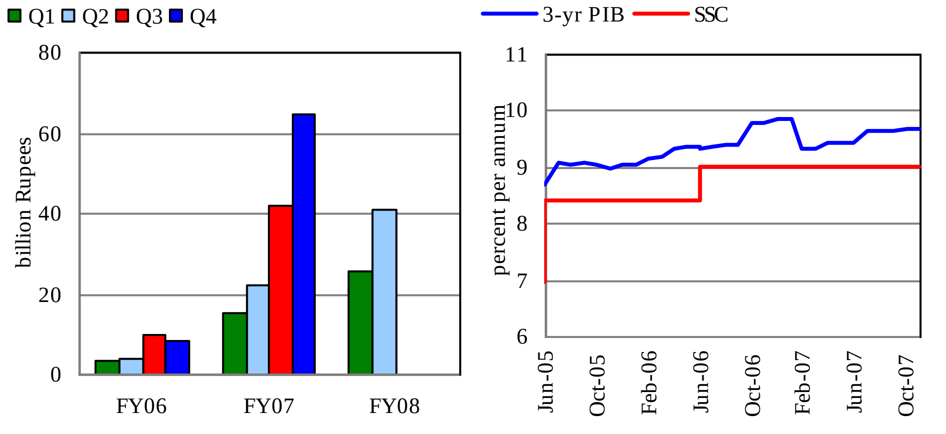
Budgetary financing received from the non-banks increased by 129.2 percent in H1-FY08 compared to financing received in the same period of H1-FY07. NSS with Rs 40.7 billion was the larger contributor to the total financing of Rs 58.0 billion received from non-banks in H1-FY08.

Figure 5.5: Non-bank Investment in Government Securities



It is worth noting that the performance of the NSS instruments is improving persistently over time despite a trivial upward revision in return on these instruments after FY05 (see **Figure 5.4**). The improved performance of the NSS

Figure 5.4: Quarterly NSS Financing and Return on 3-yr PIB & SSC



instruments is due to slowdown in the retirements of the SSCs and DSCs as

[4] The separate figures for NSS, PIBs and MTBs financing are based on SBP data.

indicated by the persistent gross receipt in both the NSS instruments.[5]

Non-bank participation in the budgetary financing through government securities remained low possibly due to availability of alternative investment opportunities such as mutual funds. In H1-FY08, financing received from PIBs declined to Rs 6.2 billion compared to Rs 15.8 billion in H1-FY07 while the retirement of T-bills continued (see **Figure 5.5**).

5.5 FBR Tax Collection

Although data on monthly targets is not available, all indicators hint at Federal Board of Revenue (FBR) having troubles in meeting its revenue targets since December 2007. Net tax collection till January 2008 lags behind the FY08 annual target by a wide margin; nearly 55.4 percent of the FY07 annual target had been achieved by January 2007 while in FY08 Jul-Jan tax collections amount to about 49.9 percent of FY08 annual target (see **Table 5.6**). To still achieve FY08 target of Rs 1025.0 billion would require FBR to amass 51.1 percent of the target amount in remaining five months; indicating that the revenue target of Rs 1025.0 billion for FY08 will be hard to achieve.

Table 5.6: FBR Tax Collection (Jul-Jan)

billion Rupees

	Net tax collection			YoY change (%)	
	FY06	**FY07**	**FY08**	**FY07**	**FY08**
Direct taxes	114.4	185.2	190.7	61.9	3.0
Indirect taxes	255.4	277.5	320.9	8.6	15.6
Sales tax	154.9	171.0	199.2	10.4	16.5
FED	29.5	36.2	46.3	22.6	27.9
Customs	71.0	70.3	75.4	-1.0	7.2
Total taxes	**369.8**	**462.7**	**511.6**	25.1	10.6
Memorandum item:					
Targets (annual)	690.0	835.0	1025.0		
Tax collection (annual)	713.4	847.2	1025.0*		
Jul-Jan collection as % of					
Annual target	*53.6*	*55.4*	*49.9*		
Actual annual collection	*51.8*	*54.6*	*49.9*		

Source: Federal Board of Revenue, Islamabad

* assumed for calculations.

[5] In FY03, deposits through SSCs increased by Rs 85.0 billion due to substantial price differential existed at that time. The average return on the PIBs in FY03 was 3.71 percent while average return on SSC was 10.4 percent.

Table 5.7: Major Components of Income Tax

billion Rupees	Jul-Dec				YoY % change	
	FY05	FY06	FY07	FY08	FY07	FY08
Voluntary payments	35.9	48.8	105.1	66.9	115.3	-36.3
Collection on demand	3.7	5.6	4.5	11.3	-20.3	152.8
Withholding taxes	46.8	60.3	77.0	91.7	27.7	19.2
Others	0.4	0.1	0.1	0.1	-19.4	2.5
Gross collection	***86.9***	***114.7***	***186.6***	***170.1***	***62.7***	***-8.9***
Refund/rebate	10.5	15.3	19.6	13.4	27.9	-31.4
Total net	**76.4**	**99.5**	**167.0**	**156.6**	**67.9**	**-6.2**

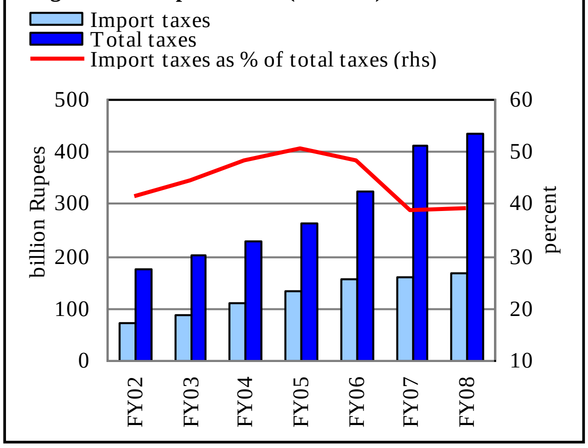
Source: Federal Board of Revenue

Growth in net tax collections during Jul-Jan FY08 slowed considerably compared to the same period last year, mainly due to a sharp decline in growth of direct taxes. The collection from direct taxes rose only 3.0 percent YoY in Jul-Jan FY08 to Rs 190.7 billion compared to a spectacular 61.9 percent increase during the corresponding period last year.

A break up of the direct tax collection, available for H1-FY08, reveals that despite a significant decline in refunds, net income tax had actually dropped by 6.2 percent during the period (see **Table 5.7**). The decline in net income tax collection is entirely attributable to 36.3 percent fall in voluntary payments.

Worryingly, voluntary payments with return witnessed a fall of 86.7 percent while voluntary payments on account of advance tax recorded an increase of 1.6 percent over the previous period. The substantial decline in voluntary payments with returns caused its share in total voluntary payments to fall to just 9.0 percent in H1-FY08 against 42.9 percent in H1-FY07.

Figure 5.6: Import Taxes (Jul-Dec)



Encouragingly, collection on demand witnessed an increase of 152.8 percent in H1-FY08, reflecting an improvement in recovery drive of the FBR. Receipts under arrear demand increased to Rs 4.7 billion, up by 136.7 percent in H1-FY08 while receipts under current demand rose by 166.0 percent to reach Rs 6.5 billion in H1-FY08. However, FBR needs to further strengthen its recovery drive as Rs 22.4 billion still stand pending on account of arrear demand.

Table 5.8: Summary of Consolidated Provincial Finance

billion Rupees

	Jul-Dec		
	FY06	**FY07**	**FY08**
Total revenue	**192.8**	**215.7**	**285.2**
Provincial share in Federal revenue	126.2	170.2	187.4
Provincial taxes	17.2	17.0	18.2
Property taxes	3.3	1.7	2.0
of which: agriculture tax	0.3	0.3	0.2
Excise duties	1.0	1.0	1.3
Stamp duties	4.6	4.7	5.3
Motor vehicle tax	3.4	3.9	3.9
Other	5.1	5.8	5.8
Provincial non-tax	18.0	18.3	34.2
Interest	0.2	0.1	10.2
Profits from hydro electricity	1.5	1.5	3.3
Irrigation	0.9	0.9	1.0
Others	15.4	15.8	19.8
Federal loans and transfers/grants	31.4	10.3	45.4
Loans (net)	1.5	-4.4	3.7
Grants	29.9	14.7	16.3
Grant for development expenditure	0.0	0.0	25.4
Total expenditure	**204.9**	**242.7**	**322.4**
Current expenditure	160.2	187.2	218.3
Interest payments to federal govt	11.2	10.5	8.2
Other current expenditure	149.0	176.7	210.1
Development expenditure	44.7	55.4	104.2
Overall balance	**-12.1**	**-26.9**	**-37.2**

Source: Ministry of Finance

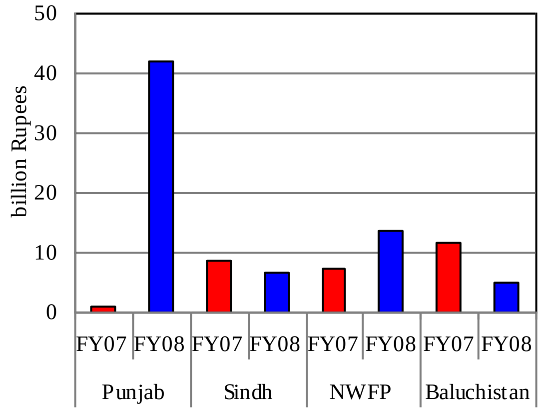
Withholding tax receipts grew by a respectable 19.2 percent in H1-FY08 against 27.7 percent in H1-FY07. Major heads contributing to withholding tax receipts were imports (Rs 12.7 billion, down 4 percent), salaries (Rs 8.7 billion, up 18.3 percent), and contracts (Rs 31.6 billion, up 31.1 percent).

On the other hand, indirect taxes grew by 15.6 percent during Jul-Jan FY08 as compared to 8.6 percent in the same period last year. Encouragingly, this increase is driven by sizeable growth in all the categories (see **Table 5.6**). As growth in direct taxes faltered, its share in total taxes declined to 37.0 percent during Jul-Jan FY08 from 40.0 percent in the corresponding period last year. Finally, import taxes grew by 6.4 percent in Jul-Dec FY08 compared to a mere 2.0 percent in the same period last year. However, the apparent acceleration in growth is misleading as the average growth recorded for the corresponding periods of FY02-FY06 turns out to be 21.2 percent. As import taxes and total taxes grew at roughly the same rates (total taxes grew by 6.0 percent in Jul-Dec FY08), the share of import taxes in total taxes remained effectively unchanged (see **Figure 5.6**).

5.6 Provincial Fiscal Operations

Notwithstanding a substantial rise in total expenditures, provincial public finance exhibited a deceleration in the fall of overall balance; thanks largely to Rs 25.4 billion federal grant for development spending (see **Table 5.8**). Province-wise analysis shows that while all the four provinces experienced revenue surpluses, Punjab and NWFP exhibited substantial improvements in their respective revenue balances during H1-FY08 (see **Figure 5.7**). With slight increases in current expenditures, the sharp rise in revenue balance of both these provinces was directly associated with a substantial revenue inflow on account of provincial share in federal revenue and provincial non-tax receipts (see **Table 5.9**).

Figure 5.7: Provincial Revenue Balance (Jul-Dec)



The fall in revenue balance for Sindh in H1-FY08, however, results from strong growth of current expenditures under head *other than interest payments to federal government*.

Table 5.9: Provincial Finance during Jul-Dec

billion Rupees

	Punjab		Sindh		NWFP		Balochistan	
	FY07	FY08	FY07	FY08	FY07	FY08	FY07	FY08
Total revenue	**101.1**	**144.1**	**64.4**	**78.4**	**29.9**	**39.3**	**20.3**	**23.4**
Provincial share in Federal revenue	80.4	94.2	56.1	56.8	19.2	23.0	14.5	13.4
Provincial taxes	8.7	9.8	6.9	7.0	1.1	1.0	0.4	0.4
Provincial non-tax	11.5	22.8	1.7	3.9	4.1	6.8	1.0	0.7
Federal loans and transfers/grants	0.6	17.3	-0.3	10.6	5.6	8.6	4.4	8.9
Total expenditure	**134.1**	**173.9**	**65.3**	**86.1**	**30.8**	**38.6**	**12.5**	**23.9**
Current expenditure	100.3	102.3	55.8	71.9	22.6	25.6	8.6	18.5
Development expenditure	33.9	71.6	9.5	14.2	8.2	12.9	3.9	5.4
Overall balance	**-33.0**	**-29.8**	**-0.9**	**-7.7**	**-0.9**	**0.8**	**7.9**	**-0.5**

Source: Ministry of Finance

Finally, development expenditures saw a massive 87.9 percent growth, to reach at Rs 104.2 billion in H1-FY08 compared to 24.0 percent in the corresponding period last year.

5.7 Domestic Debt

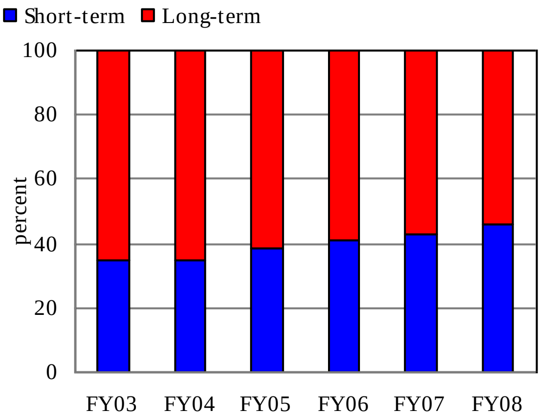
Growth in outstanding stock of domestic debt accelerated sharply (10.6 percent) in H1-FY08 (see **Table 5.10**) reflecting an increase in the fiscal deficit, as well as weaker than expected external financing.

Table 5.10 : Key Developments of Domestic Debt

	Jul-Dec	
	FY07	FY08
Growth in domestic debt (percent)	2.8	10.6
Contribution of LT debt (billion Rs)	39	74
Contribution of ST debt holding (billion Rs)	25	206.5
Domestic debt (billion Rs)	2363.5	2877.8

Greater reliance on borrowings from the central bank led to a rise in short-term debt. Consequently, the share of short-term debt reached to 45.7 percent in total debt during H1-FY08 compared to 40.8 percent during H1-FY07 (see **Figure 5.8**). Though the government also borrowed a substantial amount from long-term debt instruments during H1-FY08, its share in total debt retained the declining trend seen since FY04.

Figure 5.8: Tenure of Domestic Debt (Jul-Dec)



5.7.1 Components of Domestic Debt

The most striking development in domestic debt during H1-FY08 has been the oversized contribution of *floating debt* to the rise in domestic debt. Floating debt rose by 18.6 percent in H1-FY08 as compared to a modest increase

Table 5.11: Gross Sales & Net Receipts of NSS Instruments (Jul-Dec)

billion Rupees

	FY07		FY08	
	Gross sales	Net receipts	Gross sales	Net receipts
DSC	9.0	-3.8	35.0	1.8
SSC	56.4	0.0	34.8	8.3
BSC	52.2	27.1	47.4	22.3
SA	25.7	-2.4	60.1	-7.0
PBA	16.6	6.3	16.4	5.4

Source: CDNS

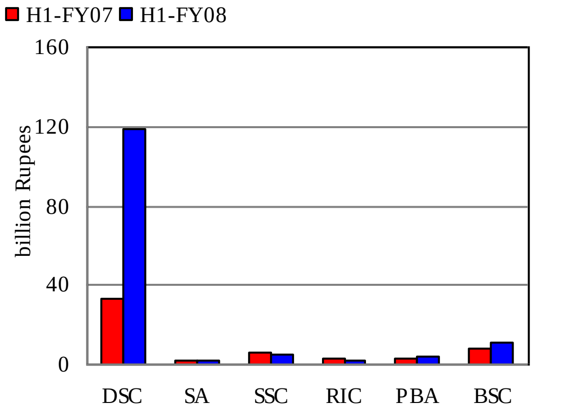
of 2.7 percent in H1-FY07, reflecting government's dependence on central bank to finance the budget deficit.

Outstanding stock of *permanent debt* went up by 7.1 percent in H1-FY08. A break up of the permanent debt instruments data reveals that this rise stemmed largely from PIBs and the prize bonds. The government fetched (net) Rs 41.2 billion through five successful PIB auctions in H1-FY08 and (net) Rs 4.48 billion from Prize Bonds.

Unfunded debt showed an increase of 3.7 percent in H1-FY08 to reach at Rs 34.9 billion from Rs 21.6 billion in H1-FY07. Despite significant repayments, NSS showed a net increase of Rs 31.7 billion. Gross sales of major NSS instruments, i.e., defence saving certificates (DSCs), saving accounts (SA) and pensioners benefit account (PBA) went up during the period **(**see **Table 5.11)**.

Domestic debt servicing cost declined to 1.0 percent of GDP in H1-FY08 from 1.5 percent of GDP in H1-FY07. However with sustained rise in the stock of domestic debt coupled with hikes in interest rate, the debt servicing cost is expected to rise substantially in the future. In particular, debt servicing on short-term instruments will probably swell considerably given that short-term debt comprises 45.1 percent of the total stock of domestic debt.

Figure 5.9: Profit Payment on Unfunded Debt



Increasing reliance on bank borrowings to finance government deficits under tight monetary policy stance caused the share of debt servicing on floating instruments to reach 64.4 percent during H1-FY08, outstripping both the permanent and unfunded categories. Permanent debt instruments claimed nearly 10.0 percent in domestic debt servicing while unfunded debt contributed about 25.6 percent. The highest expenditure on unfunded debt servicing is on the bullet maturities of DSCs sold in 1996-97. This reflects that part of the government's additional expenditure on domestic debt servicing is due to past financing commitments and not excessive spending in H1-FY08. Other major repayments were made on SAs, Special Saving Accounts, and Bahbood Saving Certificates **(**see **Figure 5.9)**.

5.8 Contingent Liabilities and Government Guaranteed Loans

Contingent liabilities are the obligation triggered by an event that may or may not occur in future. A common example of the contingent liabilities are the government guaranteed loan. These guarantees are not directly associated with any existing budgetary program so these are not recognized as the direct liabilities. The government often issues guarantees to cover part or all of the risk that a borrower fails to repay a loan. However, the probability of the contingency occurring and its magnitude depends on some exogenous conditions (natural disaster or banking crises) or some endogenous conditions (contracts of state guarantees and enforcement of regulation and supervision). These contingent forms of government support can create moral hazard in the markets and can potentially raise the risks of fiscal instability. The government must have capacity to deal with such fiscal risks.

Table 5.12:Guarantees Issued by the Government

billion Rupees

	FY07	H1-FY08
PIA	45.0	8.1
WAPDA	6.5	7.8
PNSC	0.4	0.0
MINFAL/TCP	0.0	8.3
Local currency	17.0	30.4
Total	**69.0**	**54.6**
as percent of GDP	0.8	0.55

Source: Debt Policy Statement 2008

Table 5.12 shows that the guarantees issued by the government during first six months of FY08 were Rs 54.6 billion, almost 80.0 percent of the total guarantees issued in FY07. The share of guarantees issued in domestic currency is about 55.7 percent while guarantees issued in foreign currencies constitute about 44.3 percent of the total guarantees. The major recipients among the guarantees issued in foreign currencies are MINFAL/TCP (15.2 percent), PIA (14.8 percent) and WAPDA (14.0 percent). However, the MoF is still of the view that the government will remain within the limits set by fiscal responsibility and debt limitation (FRDL) Act 2005.

Box 5.1: Summary of Fiscal Policy Statement 2007-08

The Fiscal Policy Statement 2007-08 was issued by the Debt Policy Coordination Office (DPCO), Ministry of Finance on 31st January 2008 as required by section 6 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. This Act requires from the federal government to explain the compliance of main fiscal indicators with the principles of sound fiscal and debt management. This Act also requires the setting of strategic priorities by the federal government for the financial year in the fiscal area.

The Statement rightly argues that the effectiveness and credibility of government policies depends crucially on the availability of timely and accurate financial and management information supplemented by a framework of financial and accounting principles designed according to internationally accepted standards. Moreover, a system of public accountability, that includes a strong and independent legislative audit function, ensures fiscal discipline by the government. The Statement claims that the government has made considerable progress in the efforts to separate its accounting and audit functions. Strengthened financial management practices are expected to increase the effectiveness of development programs and related external assistance.

The New Accounting Model (NAM) has been used for federal budget since FY05. However, except for NWFP, NAM is being used in parallel with existing model in other provinces. Its implementation in the remaining provinces will take some time due to certain capacity constraints. Pakistan is moving to develop a medium-term budgetary-framework (MTBF). In this regard, reforms of fiscal reporting and expenditure management have been put to fast track to increase the efficiency of public expenditures.

As a percent of GDP, the fiscal deficit remained around 4 percent in last two years which was nearly 7.0 percent in 1990s. The report maintains that the decline was mainly on account of a decrease in expenditures rather than the increase in revenues. The Statement affirms the intention of the government to undertake tax reforms to help improve tax-to-GDP ratio. In this context, more emphasis will be given on tax revenue potential of the provincial governments.

The government has succeeded in reducing the debt burden by following the strategy suggested by the Debt committee in 2000. As a result the debt-to-GDP ratio decreased much more than what is envisaged in FRDL. The resulting fiscal gap enabled the government to increase the size of PSDP, poverty and social sector related expenditures.

Looking forward, the government needs to take important decisions in order to avoid a breach of targets envisaged in FRDL Act. Given that as a percent of GDP, the revenue balance has already reached -1.5 percent in H1-FY08, the government is likely to breach the FY08 zero percent revenue balance requirement provided in FRDL Act. The government has to search for ways to enhance the tax-to-GDP ratio and bring discipline in the expenditures in order to return back solidly on the path to fiscal sustainability.

Box 5.2: Summary of Debt Policy Statement 2007-08

The Debt Policy Statement 2007-08 was issued by Debt Policy Coordination Office (DPCO), Ministry of Finance on 31st January 2008 in order to fulfill the requirement in section 7 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. The purpose of the Debt Policy Statement is to allow the assessment of the federal government's debt policies against the principles of sound fiscal and debt management and debt reduction path.

The Statement asserts that the capacity of Pakistan to carry more debt has increased as: (1) GDP grew at much faster pace than that of public debt in last 6 years; and (2) as the real cost of borrowing reduced, the resources available to service the debt have grown considerably since FY01. In particular, the real cost of public debt declined to 4.4 percent during FY00-04 and further to -1.3 percent during FY04-08. In addition, after reaching a high of 589 percent of total revenue in FY00, public debt declined substantially to 371 percent by FY07 and further to 338 percent in Q1-FY08.

The public debt to GDP ratio dropped from 83.8 percent in FY01 to 55.2 percent in FY07, below the 60 percent limit envisaged for 2013 in the FRDL Act. However, the public debt to GDP ratio reduced by 2 percentage point in FY07 which is less than the 2.5 percentage point decline in the ratio fixed in FRDL Act 2005. On the other hand, the sum of new guarantees issued by the government was 0.8 percent of GDP in FY07, which is much smaller than the room (of 2 percent) provided in FRDL Act 2005.

The Statement also reveals government's intention to put in place several measures in order to meet the twin objectives of borrowing at minimum cost while keeping risk in check and of developing an efficient local currency sovereign debt market. These include:

- The DPCO will publish an analytical report on debt on a quarterly basis.
- The government will continuously provide the supply of long-term securities in order to establish an efficient government yield curve.
- The investor base will be diverse by encouraging different sectors like insurance and pension.
- Work with the SBP to reconsider the held-to-maturity (HTM) category for sovereign bonds.
- The government will work on its long-term funding resource (NSS) to make them market based instruments.
- Debt capital market will be developed to have alternative sources of financing rather than just to rely on banking system.
- Provision of electronic media can expedite the financial processes.
- The government will follow the external debt strategy to ensure the sustainability of debt.
- The government will ensure that its guarantees are in limit imposed by FRDL Act, 2005.