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Examining the ”””””Duty Draw Back Bonds”””””

The Government of Pakistan is planning to issue "Federal Government Duty Draw Back Bonds" with a view to settling past obligations that became due a long time ago but were not discharged. In this connection draft rules are presently under circulation for seeking stakeholders""""" views. We examine the proposed scheme within the context of regal regime that regulates such initiatives and the applicable general accounting and financial rules. Our conclusion is that the scheme suffers from a number of infirmities and may lead to significant risks in its implementation.

Before we do the examination, it would be useful to recall what is it exactly that the government is aiming to achieve. There is a certain amount of government obligations, such as drawback for local taxes and levies (DLTL) that need to be returned to the exporters. This amount is overdue for several years. Responding to the demands of exporters, the government wants to settle this amount in such a manner that its impact on the budget is prevented, as there is no fiscal space. To accomplish these twin objectives - settle overdue obligations and avoid fiscal recognition - the said bonds scheme has been designed. The issuance of bonds is found to be a desired scheme. The holders of the overdues would be given the bonds to settle their dues, which has a three-year maturity, issued at a discount, tradable in the market and redeemable only at maturity. This means that the actual settlement of money in the budget would be effected at the time of redemption, i.e., after three years.

Although it looks simple, there are many considerations impinging on the efficacy and legality of the proposed arrangement. We first examine the provisions of the Public Debt Act, 1944, under which the Rules of Bonds have been published, and the meaning of """""debt""""" thereof.

Section-2(2) provides the definition of the government security, which is as follows: "Government security " means- (a) a security, created and issued, whether before or after the commencement of this Act, by the Government for the purpose of raising a public loan, and having one of the following forms, namely:- (i) stock transferable by registration in the books of the Bank; or (ii) a promissory note payable to order; or (iii) a bearer bond payable to bearer; or (iv) a form prescribed in this behalf; or notified by government from time to time. (b) any other security created and issued by the Government in such form and for such of the purposes of this Act as may be prescribed.[emphasis and italics added]

The fundamental premise of the Act is """""raising of public loan""""". The examples contained in the law (i to iv) are the standard instruments of raising loans, such as by issuance of promissory notes payable to order, bearer bond payable to bearer or any other form prescribed, or any other security created and issued by the government in such form and for such of the purposes of this Act as may be prescribed. The promissory notes include treasury bills. But regardless of form, purpose is to raise public loan. But when you raise a loan, some consequences inevitably flow. The most significant is that in the process of """""raising public debt""""" proceeds are realized. These proceeds of loan are required to to be credited to the Federal Consolidated Fund (FCF).

Article 78 of the Constitution provides as follows: (1) All revenues received by the Federal Government, all loans raised by that Government, and all moneys received by it in repayment of any loan, shall form part of a consolidated fund, to be known asthe Federal Consolidated Fund. (2) All other moneys- (a) received by or on behalfof the Federal Government; or (b) received by or deposited with the Supreme Courtor any other court established under the authority of the Federation; shall be credited to the Public Account of the Federation. [emphasis and italics added]

Evidently, there is no escape from the need for realizing proceeds if a debt instrument is issued. But, curiously, there is no proceeds to be realized by issuance of duty drawback bonds, which are purportedly issued to settle the overdue amounts of the exporters. Under the circumstances, proposed settlement of liabilities through issuance of bonds under the Public Debt Act doesn""""t appear to be tenable.

Second, there is another complication. It is proposed under the scheme that the bonds will be settled after three years on maturity. This means that an expenditure will be incurred after three years. This is tantamount to sanctioning today an expenditure that would be incurred three years later. Under the general financial principles regulating expenditures, only such expenditures can be sanctioned against which a proper budgetary provision is made in the budget approved by the National Assembly during the on-going year, or a proper supplementary budget has been approved by the competent authority. It is untenable to guarantee a payment after three years when a proper loan has not be issued entailing proceeds duly received in FCF. Since proceeds"""" part is missing, a future assembly would have the authority to decide about approving the expenditure for payment and cannot be preempted by the government today.

Finally, we would submit that there is a much easier way to accomplish the above twin objectives than to enter into an arrangement which is unprecedented and would pose insurmountable legal challenges. In fact, the well-tested method for delaying recognition of liabilities is to form a special purpose vehicle (SPV), like Power Holding Company Limited (PHPL) under the Power Division, and provide it a sovereign guarantee to borrow the money from commercial banks and use the proceeds to settle the obligations. The SPV can issue zero coupon bonds to be realized on maturity. The Government can make an equity contribution in the year of the maturity through a budgetary grant to SPV at the maturity of the bond and subsequently dissolve the SPV.

A word of caution is in order. The federal government has already piled up a gigantic stock of unpaid bills, and only some of the most prominent ones such as the notorious circular debt in the power sector, are visible to people. A durable solution would call for a one-off recognition of these liabilities properly in the budget, no matter how high a fiscal deficit it would lead to. This has to be done by a government either today or tomorrow. The earliest it is done the more orderly it would be.

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