4 Public Finance and Fiscal Policy

4.1 Overview

The improvement in fiscal accounts seen in recent years witnessed a small reversal during FY06, as the fiscal deficit rose to 4.2 percent of GDP compared with 3.3 percent of GDP in the preceding year. Encouragingly, the larger part of this deterioration is explained by either a one-off factor (i.e. the unanticipated expenditure incurred on account of relief and rehabilitation efforts following the October 2005 earthquake), or a very welcome rise in development expenditures. However, some weaknesses are nonetheless evident, such as the fact that the FY06 fiscal deficit, even adjusted for earthquake-related expenses, is higher than witnessed in FY05. Also, the primary and revenue balances, measured as a percentage of GDP, posted deficit in FY06 while these had shown surpluses in preceding years. In this context, it is important that fiscal management be disciplined, especially when there remain structural weaknesses in the tax system, including a narrow tax base, over-reliance on import-related taxes, privatization proceeds, and potentially non-recurring sources of non-tax revenue.

While revenue witnessed a strong growth of 19.6 percent during FY06, a 25.5 percent rise in expenditure overshadowed this above-target performance. Specifically, an above-target CBR tax collection of Rs 712.5 billion, owing much to the strong economic activity and extraordinary growth of imports, enabled the government to follow an expansionary fiscal policy. As a result of this, development spending witnessed an exceptional growth of 60.3 percent. Although the current expenditure grew by nearly 19 percent YoY, this was principally owed to the rehabilitation activities in the earth-quake hit areas. Adjusting for this expenditure of Rs 65.8 billion, the total deficit stands at 3.4 percent of the GDP, only a little greater than that in FY05.

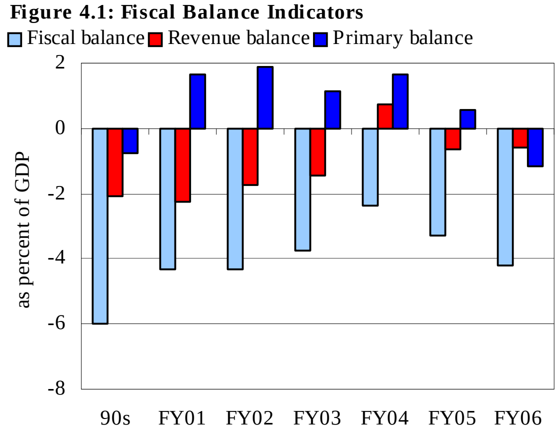
Looking ahead, the federal budget FY07 has taken various measures to increase the tax-to-GDP ratio and broaden the tax base (for example, by subjecting certain financial services to the sales tax and federal excise duty, and the marginally increasing the CVT on capital gains). This objective may prove challenging given the absence of revenue from the Petroleum Development Levy and the risk to timely realization of privatization receipts, and the possibility of a deceleration in tax revenue growth following a slowdown in imports.

4.2 Fiscal Performance Indicators

4.2.1 Balance Indicators

Overall fiscal balance indicators depict a relative weakness as all the balance indicators (fiscal, primary and revenue) present deterioration during FY06. This suggests the need to focus on sustaining fiscal discipline.

Figure 4.1: Fiscal Balance Indicators



Fiscal Balance, that is the broadest measure of fiscal performance, deteriorated sharply during the year, as the fiscal deficit rose from 3.3 percent of GDP in FY05 to 4.2 percent in FY06 (see **Figure 4.1**). A part of this weakness is understandable, representing the unavoidable cost of relief and rehabilitation operations in the wake of the October 2005 earthquake. Much less desirable however, is the fact that even adjusting for earthquake-related spending the fiscal deficit still remains a little higher than that for the pervious year.

Table 4.1: Summary of Public Finance
billion Rupees

		FY01	FY02	FY03	FY04	FY05 R.E	FY06 M.B.E	FY06	YoY Change FY05	YoY Change FY06
1	**Revenue receipts (a+b+c)**	**553.0**	**624.1**	**720.8**	**805.8**	**900.0**	**1095.6**	**1076.6**	**11.7**	**19.6**
	a) Tax revenue	411.4	423.2	487.6	555.5	632.2	773.0	753.0	13.8	19.1
	of which CBR taxes	392.3	403.9	461.6	518.8	588.4	690.0	712.5**	13.4	21.1
	b) Surcharges*	30.2	54.9	68.2	62.4	27.1	32.6	50.8	-56.5	87.0
	c) Non-tax receipts	111.4	146.0	165.0	187.9	240.7	290.0	272.9	28.1	13.4
2	**Total expenditure (a+b+c+d)**	**717.9**	**826.3**	**898.2**	**940.4**	**1117.0**	**1423.0**	**1401.8**	**18.8**	**25.5**
	a) Current	645.7	700.2	791.7	763.1	943.1	1097.9	1121.0	23.6	18.9
	b) Development	89.8	126.3	129.2	161.0	227.7	326.7	365.0	41.5	60.3
	c) Net lending to PSEs etc.	-17.6	-0.2	-22.7	16.3	24.8	-1.6	2.1	52.0	-91.4
	d) Statistical discrepancy	14.8	-11.7	3.2	0.0	78.5	0.0	-86.3		-209.9
3	**Revenue surplus/deficit (1-2.a)**	**-92.7**	**-76.1**	**-70.9**	**42.8**	**-43.0**	**-2.3**	**-44.4**	**-200.6**	**3.1**
4	**Overall deficit (1-2)**	**-179.7**	**-190.5**	**-180.6**	**-134.5**	**-217.0**	**-327.4**	**-325.2**	**61.3**	**49.9**
5	**Financing through:**	**179.7**	**190.5**	**180.6**	**134.5**	**217.0**	**327.4**	**325.2**	**61.3**	**49.9**
	a) External resources (net)	120.7	83.1	113.0	-4.5	120.4	118.3	148.9	-2791.2	23.6
	b) Internal resources (i+ii+iii)	59.0	107.4	67.6	139.0	96.6	209.1	176.3	-30.5	82.6
	i) Domestic non-bank	92.0	85.0	119.5	64.1	8.1	22.4	8.1	-87.4	0.7
	ii) Banking system	-33.0	14.0	-55.6	63.7	60.2	96.7	70.9	-5.5	17.9
	iii)Privatization proceeds	-	8.4	3.7	11.2	28.3	90.0	97.3	152.9	243.3
As percent of GDP										
1	**Revenue receipts**	**13.3**	**14.2**	**14.9**	**14.3**	**13.7**	**14.2**	**14.0**	**…**	**…**
	a) Tax revenue	9.9	9.6	10.1	9.8	9.6	10.0	9.8	…	…
	of which CBR taxes	9.4	9.2	9.6	9.2	8.9	9.2	9.2	…	…
	b) Surcharges	0.7	1.2	1.4	1.1	0.4	0.4	0.7	…	…
	c) Non-tax receipts	2.7	3.3	3.4	3.3	3.7	3.8	3.5	…	…
2	**Total expenditure**	**17.2**	**18.8**	**18.6**	**16.7**	**17.0**	**18.4**	**18.2**	**…**	**…**
	a) Current	15.5	15.9	16.4	13.5	14.3	14.2	14.5	…	…
	b) Development	2.2	2.9	2.7	2.9	3.5	4.2	4.7	…	…
	c) Net lending to PSEs etc.	-0.4	0.0	-0.5	0.3	0.4	0.0	0.0	…	…
3	**Overall deficit (1-2)**	**-4.3**	**-4.3**	**-3.7**	**-2.4**	**-3.3**	**-4.2**	**-4.2**	**…**	**…**
4	**Financing through:**	**4.3**	**4.3**	**3.7**	**2.4**	**3.3**	**4.2**	**4.2**	**…**	**…**
	a) External resources (net)	2.9	1.9	2.3	-0.1	1.8	1.5	1.9	…	…
	b) Internal resources	1.4	2.4	1.4	2.5	1.5	2.7	2.3	…	…

Source: Economic Survey 2005-06 and www.finance.gov.pk
* Surcharges are deducted from the old tax revenue series to make the series comparable with the new data series
** Source: Central Board of Revenue (for FY06)

However, a silver lining to rising fiscal deficit is the fact that practically all of the deficit is due to a sharp rise in development spending, which would presumably help increase the productive capacity (and the tax-potential) of the economy in years ahead.

Revenue balance, an indicator of the saving capacity of the economy, remained negative at 0.6 percent of GDP in FY06, higher than the target of zero for the year.[1] However, this is entirely due to the unexpected earthquake related expenses. Adjusting for these, the revenue balance reverts to a surplus of 0.3 percent of GDP during FY06.

Primary balance helps assess the sustainability of the fiscal deficit. It highlights the *current* discretionary budgetary stance by excluding the impact of interest payments (that are caused by past policies). The primary balance that had remained in surplus over the preceding four years, turned into a deficit in FY06, declining to -1.1 percent of the GDP. Though the interest payments have declined sharply in recent years and the public debt to GDP ratio at 57.8 percent has already fallen below the

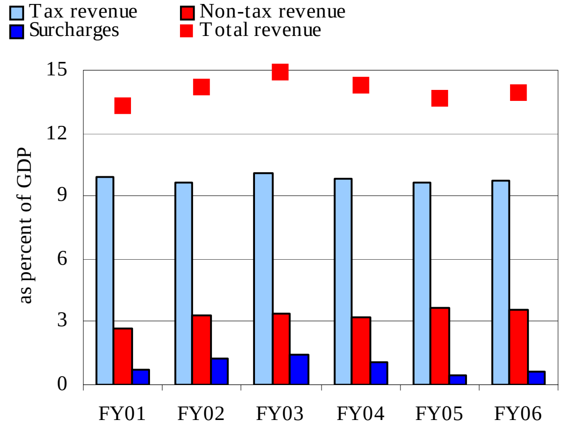
[1] FY06 Modified Budget Estimates, (Economic Survey 2005-06).

60 percent target set by "The Fiscal Responsibility and Debt Limitation Act, 2005" (FRDLL), the worsening of the primary balance is mainly attributable to high development expenditure.

4.2.2 Revenue Indicators

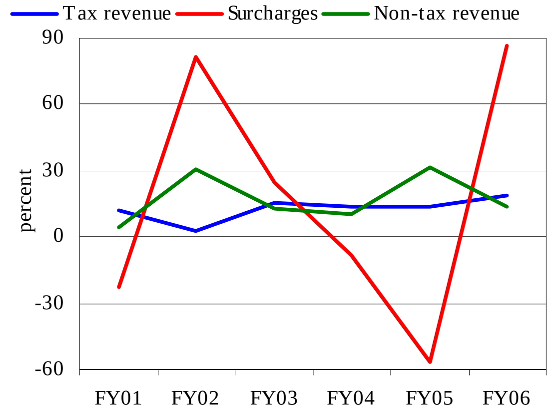
Total revenue stood at Rs 1076.6 billion with a YoY increase of 19.6 percent as compared to the 11.7 percent increase seen in FY05. Though the revenue receipts slightly lagged behind their modified target, yet the growth in revenues was higher than the growth in nominal GDP. Therefore, the *revenue to GDP* ratio increased to 14.0 percent in FY06 as compared with 13.7 percent in FY05 (see **Figure 4.2**). However, this improvement does not seem to be sustainable in the coming years as the major impetus to this increase was from the non-tax revenue (a part of which may not be repeated in FY07) and surcharges (the latter is mainly from the Petroleum Development Levy, the government has not budgeted any revenue from this head in FY07).

Figure 4.2: Revenue Indicators



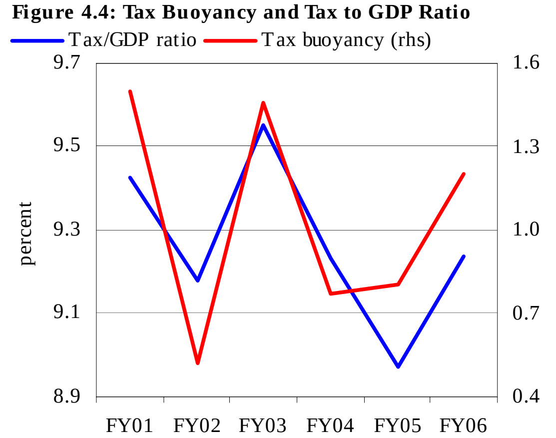
A break-up of the FY06 revenues reveals that tax revenues rose by 19.1 percent YoY to Rs 753.0 billion during FY06 (see **Figure 4.3**). This was mainly due to CBR taxes, which contributed Rs 712.5 billion. The strong revenue growth led to an encouraging improvement in *tax buoyancy* (from 0.8 percent in FY05 to 1.2 percent in FY06 – see **Figure 4.4**), but this nonetheless remains quite low compared to those of the developing countries.[2]

Figure 4.3: Growth in Revenue



Non-tax revenue contributed Rs 272.9 billion in FY06, witnessing a rise of 13.4 percent. The non-tax to GDP ratio declined from 3.7 percent in FY05 to 3.5 percent in FY06 while the government was expecting it to be at 3.8 percent in FY06. This decline is mainly due to less than the expected receipts from PTCL that stood at Rs 11.5 billion (only 46 percent of the FY06 target of Rs 25 billion). However, the main contribution to non-tax revenues came from defense receipts (Rs 67.5 billion), dividends (Rs 64.2 billion), SBP profits (Rs 13.9 billion), interest receipts (13.8 billion), and miscellaneous receipts (Rs 69.7 billion).

Figure 4.4: Tax Buoyancy and Tax to GDP Ratio



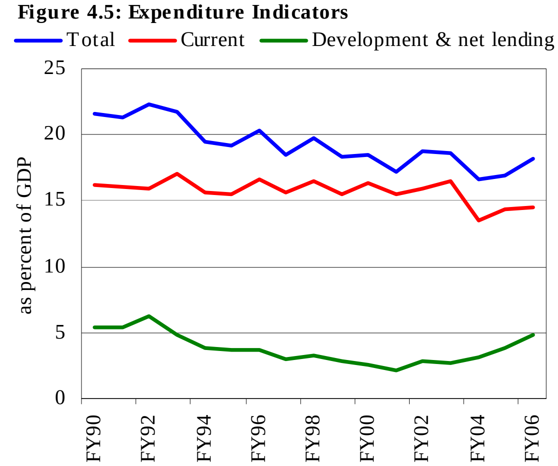
[2] The tax buoyancy of regional countries excluding Pakistan was 1.33 in FY05.

In a nutshell, revenue indicators demonstrate relatively better position in FY06 though there is a risk to sustainability due to the elimination of the PDL, an important source of revenue in FY06. Moreover, the continued heavy reliance on import taxes is an issue of concern. Recent data shows that import growth has slowed significantly, which could lead to a slower growth in tax revenues as well. Therefore, it is imperative that the government increases its resource mobilization efforts, by expanding the tax base and curtailing tax evasion.

4.2.3 Expenditure Indicators

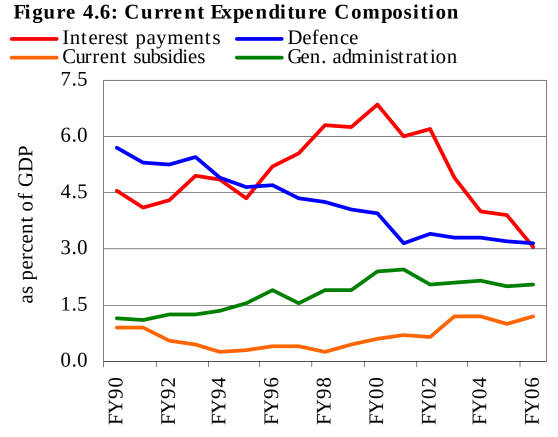
Total expenditure in FY06 rose to Rs 1,401.8 billion, showing an increase of 25.5 percent (the highest rise in the last 31 years) compared with the growth of 18.8 percent in FY05. However, it is encouraging to note that the jump in FY06 expenditure is mainly due to developmental outlays that rose from 3.5 percent of GDP in FY05 to 4.7 percent in FY06 (see **Figure 4.5**). Despite the fact that the earthquake rehabilitation expenditure, amounting to Rs 65.8 billion in FY06, put pressure on current expenditure, the rise in the latter is relatively quite moderate. Specifically, the current expenditure stood at Rs 1,121.0 billion, with a growth of 18.9 percent in FY06 as compared to the higher growth of 23.6 percent in FY05.

Figure 4.5: Expenditure Indicators



The analysis of current expenditures shows that the ratio of interest payments to GDP has declined sharply from the peak of 6.9 percent in FY00 to 3.1 percent in FY06. Moreover, defense expenditure, which historically absorbed a major part of resources, has declined steadily from 5.7 percent of GDP in FY90 to 3.1 percent of GDP in FY06 and seems to have stabilized in recent years. On the other hand, the share of current subsidies has increased somewhat over the years (see **Figure 4.6**).

Figure 4.6: Current Expenditure Composition



Net lending to PSEs stood at Rs 2.1 billion in FY06, against the modified budget estimate of (-)Rs 1.6 billion. This is mainly on account of huge losses borne by WAPDA, Pak Railways and PIA. Apart from this, the statistical discrepancy of Rs -86.3 billion during FY06 (1.1 percent of GDP) is another point of interest.

4.3 Fiscal Developments at the Federal Level

The federal government exceeded the revenue target of Rs 927.4 billion by 10.3 percent during FY06, collecting Rs 1022.7 billion. This represents an increase of 16.8 percent YoY, compared to a 15.0 percent rise in FY05.

4.3.1 CBR Tax Performance

CBR surpassed its revised revenue target of Rs 690.0 billion with actual receipts of Rs 712.5 billion demonstrating an excellent YoY growth of 20.7 percent as compared to the 13.4 percent rise in FY05 (see **Table 4.2**).

Table 4.2: Actual Tax Collection (net) by CBR

billion Rupees

	Collection	Revised targets	Collection	Growth		Targets
	FY05	FY06	FY06	FY05	FY06	FY07
Direct taxes	183.4	215	224.6	11.1	22.5	264.7
Indirect taxes	407.0	475.0	487.9	14.4	19.9	570.3
Sales tax	238.5	282.5	294.6	8.8	23.5	343.8
Central excise	53.1	57.5	55	16.6	3.6	69.0
Customs	115.4	135	138.3	26.8	19.8	157.5
Total	**590.4**	**690.0**	**712.5**	13.4	20.7	**835.0**

Source: Central Board of Revenue

In fact, low compliance and narrow tax base calls for new administrative measures in order to improve the tax to GDP ratio. Interestingly, the distributional analysis of the income tax return filers show that the ratio of return filers is very low in the upper slabs, and the majority of the corporate as well as non-corporate (individuals and associations of persons) declared their income below Rs 150,000 (see **Table 4.3**). Out of 1,065,044 returns filed for TY05, only 2 percent (21,148) taxpayers declared their income above Rs 1 million annually, suggesting that the under declaration of incomes is rampant in the country. The lack of effective and transparent audit and complete dependence on voluntary compliance in an environment where the issues of corruption, fake claims for refunds, declining tax to GDP ratio are accepted realities, calls for effective measures to check the tax evasion in the country.

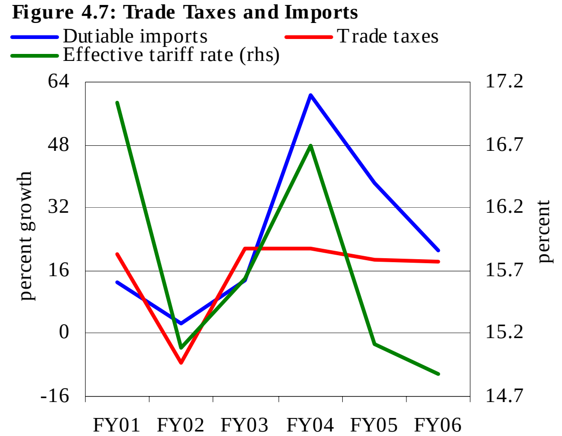
Table 4.3: Number of Income Tax Returns Filed for TY 2005

Total income declared	Corporate income tax	Non-corporate income tax
Up to Rs 150,000	9,888	645,204
Rs 150,000 to Rs 300,000	492	254,668
Rs 300,001 to Rs 500,000	334	89,313
Rs 500,001 to Rs 1 million	474	43,523
Over Rs 1 million	1,714	19,434
Total	**12,902**	**1,052,142**

Source: CBR

Apart from this fact, it is important to mention that almost half of the tax revenue came from the import-related commodities, while the domestic taxes to GDP ratio is as low as 4.9 percent of GDP. This needs to be improved. Although, the revenue from trade taxes contributed 47.2 percent in total taxes in FY06, but it is highly correlated with the growth in trade (see **Figure 4.7**). Moreover, given that the effective tariff rate is declining, the increase in the volume of the trade has been a key factor driving the increase in revenues from trade taxes. This suggests that any slowdown in the trade could also adversely hit the growth in tax revenues.

Figure 4.7: Trade Taxes and Imports

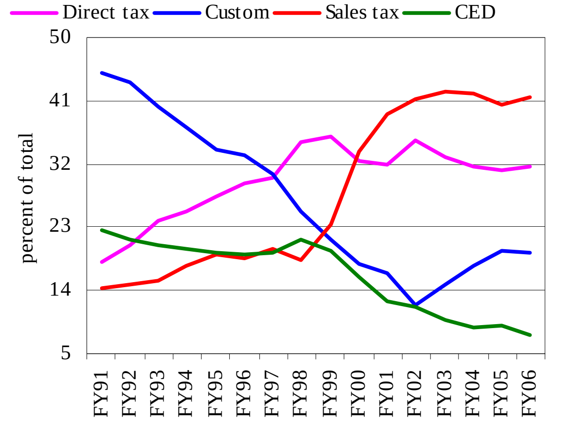


Tax Analysis by Components

Direct Taxes

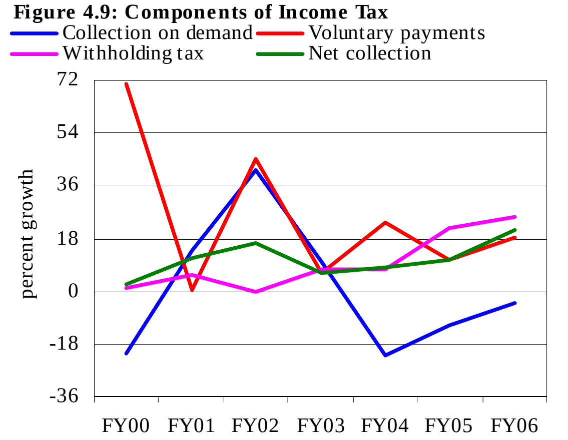
Direct taxes easily surpassed the target of Rs 215.0 billion for FY06 with an actual collection of Rs 224.6 billion. Though the direct taxes grew strongly in FY06, rising by 22.5 percent as compared to 11.1 percent in FY05, their share in total taxes increased only marginally to 31.5 percent, still far lower than the 35.3 percent seen in FY02 (see **Figure 4.8**).

Figure 4.8: CBR Revenue Composition



Within direct taxes, income tax collection stood at Rs 209.5 billion with a YoY growth of 20.6 percent during FY06, the highest in more than last 7 years. The major chunk of this growth came from the withholding taxes, which rose by 25.4 percent, while voluntary payments witnessed a relatively moderate growth of 18.3 percent (see **Figure 4.9**). The absence of full-fledged income tax audit resulted in the lower collection of income tax on demand for the third consecutive year, as the current demand fell to Rs 10.6 billion in FY06 from the Rs 13.4 billion in FY05. This suggests that tax reforms have not yet significantly contributed to increasing direct taxes. Within withholding income tax, major contributors during FY06 remained contracts (accounting for about one-third of the total) followed by imports (19.3 percent), and salaries (11.2 percent).

Figure 4.9: Components of Income Tax



Indirect Taxes

<u>*Sales Tax*</u>

The sales tax has been one of the major sources of tax collection in recent years. The collection under this head surpassed its revised target of Rs 282.5 billion with an actual collection of Rs 294.6 to show a strong growth of 23.5 percent as compared to the 8.8 percent growth in FY05. This however, has helped in increasing its share from 40.4 percent to 41.3 percent in total taxes.

The major contributors to sales tax collection remained the import-related component that demonstrated the growth of 18.6 percent with a collection of Rs 171.8 billion during FY06, while the domestic sales tax collection stood at Rs 121.6 billion. Of the domestic sales tax, the major revenue came from telecommunications (Rs 26.9 billion) followed by POL products (Rs 29.4 billion), electrical energy (Rs 13.4 billion) and the natural gas (Rs 13.3 billion). Within import related sales tax, the prime contributors were POL products (Rs 24.4 billion), vehicles (Rs 19.6 billion), iron and steel (Rs 14.5 billion). The strong collections reflect the strength of domestic economic activity, high POL prices as well as capacity constraints in key domestic industries (which pushed up imports and therefore import-based taxes). It is worth mentioning that with the introduction of zero tax rating on export oriented commodities, the sales tax refunds further fell to Rs 32.4 billion in FY06 from Rs 54.9 billion in FY05.

Apart from the fact that sales tax collection has met its revised target, this can be attributable to the little increase of 13,063 new registrants during FY06, however, this increase would have been more significant if CBR had not revised its slabs resulting in a sharp decline in the number of sales tax registered persons in FY05.[3]

Customs Duty

Revenue from custom duty stood at Rs 138.3 billion, up by 19.8 percent YoY during FY06 compared with a higher growth of 26.8 percent in the preceding period. Despite a significant reduction in effective tariffs and an evident deceleration in imports, the strength of growth in customs duties is commendable.

A disaggregated analysis of customs duties reveals that the major revenue spinners during FY06 remained vehicles (Rs 37.8 billion), edible oil (Rs 15.9 billion), POL product (Rs 15 billion), machinery and mechanical appliances (Rs 12 billion).

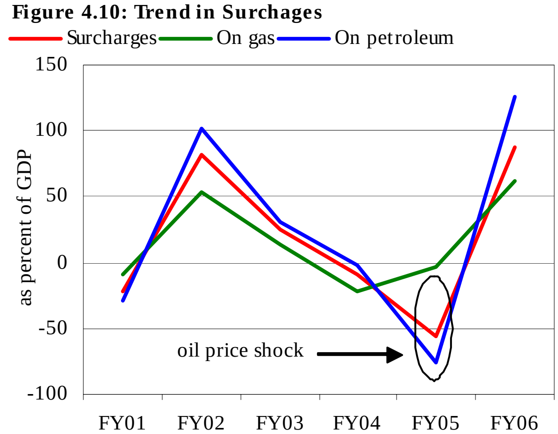
Federal Excise Duty

The revenue from federal excise duty fell a little short of the target of Rs 57.5 billion for FY06 with an actual collection of Rs 55.0 billion (see **Table 4.2**) as the 3.6 percent growth in this period in federal excise duty was lower than that of 16.6 percent in FY05. The pace of this deceleration is however compatible with the slowdown in LSM growth during the period. The major revenue came from cigarettes and tobacco (Rs 23 billion), cement (Rs 12.2 billion) and natural gases (Rs 6.5 billion). The revenue measures like, levying excise duty on international air travel, non-fund services provided by financial services sector, commission and brokerage on foreign exchange dealers, exchange companies and money changers, 'franchise' services and enhancing the rate of excise duty on insurance service, and cigarettes, taken in federal budget FY07 will, however, help in generating more revenue from the federal excise duty.

4.3.2 Surcharges

Surcharges have always been a major source of revenue for the government. The oil price hike put government in a perplexed situation as oil price regulation resulted into zero revenue from petroleum surcharges in FY05 (see **Figure 4.10**). While in FY06, the government initially increased the petroleum development rates, but continued with cross-subsidy to the sector; in the second half of the fiscal year, the government left it to the market forces to stabilize its prices. Moreover, the government intends to cease collecting revenue from the petroleum development levy from FY07.

Figure 4.10: Trend in Surcharges



The total collection from surcharges stood at Rs 50.8 billion with a YoY increase of 87 percent over the preceding period. Of which, PDL remained the key component with receipts of Rs 24.5 billion against the target of Rs 15.9 billion, helping the government to meet the overall surcharges target of Rs 32.6 billion with a wide margin. The gas development surcharge also depicted a robust growth of 61.4 percent mainly attributable to the revision in gas prices from Jan 2006 as well as increased use of CNG, LPG and the domestic gas.

[3] The sales tax registered persons sharply declined from 163,118 persons in FY04 to 114,952 thousand persons in FY05.

4.3.3 Non-Tax Revenues

Non-tax revenues witnessed a rise of 13.4 percent YoY during FY06, significantly lower than the strong 28.1 percent rise seen in FY05, with collection falling Rs 58.8 billion short of the Rs 306.9 billion revised annual target. The major reasons for this disappointing performance were, (1) lower profits from PTA (Rs 10.9 billion against targeted Rs 16.3 billion); , (2) lower defense receipts (Rs 67.4 billion against Rs 74.8 billion); and (3) the inability of WAPDA to service its debt liabilities of Rs 11.1 billion towards the GoP.

4.3.4 Federal Expenditure

The total federal government expenditure stood at Rs 1196.4 against the revised target of Rs 1,093.6 billion, recording a YoY growth of 19.5 percent (see **Table 4.4**). This overall rise in federal expenditure is quite lower than the 25.5 percent increase in consolidated expenditure. Revenue expenditure increased by 11.6 percent over the budget estimates, while the capital disbursements fell short of target by 6.3 percent, although remaining higher than that for the previous year.

Table 4.4: Federal Government Expenditure

billion Rupees

					Excess/shortfall over		
	FY04 RE	**FY05 RE**	**FY06 BE**	**FY06 RE**	**FY05 RE**	**FY06 BE**	**FY07 BE**
I. Revenue expenditure (A+B)	773.2	866.8	961.1	1072.2	23.7	11.6	1115.9
A. Current expenditure	714.0	784.7	826.5	918.8	17.1	11.2	879.8
(i) General public service	448.4	469.0	503.1	563.7	20.2	12.0	504.3
Debt servicing	317.7	274.7	301.4	304.8	10.9	1.1	295.8
(ii) Defence affairs and services	180.5	216.3	223.5	241.1	11.5	7.9	250.2
(iii) Public order and safety affairs	14.0	17.5	18.7	20.4	16.0	8.8	22.5
(iv) Economic affairs	54.8	62.2	56.4	67.6	8.7	19.7	74.7
(v) Environment protection	0.1	0.1	0.1	0.1	8.1	0.0	0.2
(vi) Housing & comm. amenities	0.9	0.9	0.9	0.9	2.9	3.2	1.0
(vii) Health services	2.8	3.3	4.1	4.4	33.0	5.6	4.7
(viii) Rec., culture & religion	2.0	2.2	2.3	2.4	8.8	5.8	2.7
(ix) Education affairs and services	9.6	12.3	16.6	16.7	35.7	0.6	18.8
(x) Social protection	0.7	0.9	0.6	1.5	77.6	146.1	0.7
B. Development expenditure	59.1	82.1	134.6	153.4	86.9	14.0	236.2
II. Capital disbursements (A+B)	125.3	119.7	132.6	124.1	3.7	-6.3	137.8
A. Current expenditure	65.0	52.7	36.4	38.5	-27.0	5.8	24.6
B. Development expenditure	60.4	66.9	96.4	85.6	27.9	-11.2	113.2
III. Estimated adjustments in PSDP	-	14.6	-	-			0.0
Total expenditure (I+II)	**898.5**	**1001.0**	**1093.6**	**1196.4**	**19.5**	**10.2**	**1253.8**

Source: Annual Budget Statement, GoP.

BE: Budget estimates, RE: Revised estimates,

Note: The Federal budget for FY05 has been prepared according to new accounting model that is different from the previous system. The exact correspondence between historical data available on old classification system and estimates developed on the new system is not technically feasible.

The rise in the current expenditure on revenue account is mainly due to increase in general public service. Within general public service, while FY06 increase in the debt servicing is close to budgetary estimates for the year despite rise in interest rates, transfers to provinces were 9.2 percent above the target in this period. Apart from this, military defence expenditure also exceeded the target by 7.9 percent during probably due to extended troop movement on Northern boarders as well as participation of army in earthquake relief activities. In contrast to a decline in expenditure on account of economic affairs envisaged in budgetary estimates for FY06, it rose by 19.7 percent YoY and surpassed the annual target percent of Rs 56.4 billion.

4.3.5 Financing of Federal Budget

The financing from external resources shows a big jump in FY06, as the external receipts increased from Rs 197.6 billion in FY05 to Rs 233.9 billion in FY06, while the financing from internal resources witnessed a 25 percent YoY decline (see **Table 4.5**).

Table 4.5: Financing of the Federal Government Expenditure

billion Rupees

		FY05	FY06	FY06	Excess/shortfall over		
		RE	**BE**	**RE**	**FY06 BE**	**FY05 RE**	**FY07 BE**
I.	Revenue receipts (net)	630.0	643.1	721.3	12.2	14.5	704.6
II.	Internal resources (i+ii)	76.4	86.7	57.3	-33.9	-25.0	41.0
	i) Capital receipts	79.8	70.1	31.7	-54.7	-60.3	23.4
	ii) Public account	-3.4	16.6	25.5	53.5	843.8	17.6
III.	External resources	197.6	212.4	233.9	10.1	18.4	239.3
IV.	Total receipts (i+ii+iii)	904.1	942.2	1012.5	7.5	12.0	984.8
V.	Change in provincial cash balance	6.2	33.5	27.0	-19.2	338.2	53.8
VI.	Privatization proceeds	10.0	20.0	90.0	350.0	800.0	75.0
VII.	Credit from banking system	80.8	98.0	66.8	-31.8	-17.3	140.1
Total resources (iv+v+vi+vii)		1001.0	1093.6	1196.4	9.4	19.5	1253.8

Source: Annual Budget Statement, Government of Pakistan

Table 4.6: Provincial Budgets at a Glance

billion Rupees

	Punjab		Sindh		NWFP		Balochistan		All provinces	
Receipts/Expenditures	**FY05**	**FY06**	**FY05**	**FY06**	**FY05**	**FY06**	**FY05**	**FY06**	**FY05**	**FY06**
I. Total revenue receipts	181.3	225.1	102.6	127.0	45.3	65.5	29.0	32.2	358.2	449.8
(i) Total tax revenue	143.7	173.3	86.4	108.8	32.6	38.1	21.4	22.7	284	343.0
(ii) Non-tax revenue	37.6	51.8	16.2	18.2	12.7	27.3	7.7	9.5	74.2	106.8
II. Current expenditure	136.4	160.5	105.7	126.2	42.7	60.7	26.2	30.3	278.8	377.8
Revenue surplus (+) / deficit (-)	44.9	64.6	-3.1	0.8	2.6	4.8	2.8	1.9	25.6	72.0
III. Total development expenditure [@]	62.8	89.7	29.8	42.7	15.9	25.2	14.9	19.3	81.8	176.9
(i) Development revenue expenditure	39.0	45.4	4.5	6.2	2.5	4.3	0.0	0.0	30.6	56.0
(ii) Development capital expenditure	24.0	44.2	25.3	36.5	13.3	20.8	14.9	19.3	51.2	120.9
(iii) Outside ADP/foreign project assistance/ operational shortfall	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0	0.0
Development expenditure financed by										
(i) Revenue surplus (+)/ deficit (-)	44.9	64.6	-3.1	0.8	2.6	4.8	2.8	1.9	25.6	72.0
(ii) Net capital receipts	1.5	6.9	-4.6	0.9	-2.8	4.9	-5.0	-0.9	-22.7	11.8
(iii) Net public account receipts	1.3	11.6	5.4	3.2	5.0	3.0	2.3	-2.8	29.1	15.0
(iv) Development revenue receipts / grants	5.2	0.0	9.0	10.9	2.3	3.5	2.6	4.7	12.8	19.1
(v) Federal government loans / public debt	8.7	6.5	2.5	4.4	4.1	7.6	7.1	2.5	21.3	21.0
(vi) Cash balance utilization /improvement	1.3	0.0	2.3	-4.9	0.0	-4.4	5.0	14.1	3.3	4.8
(vii) Adjustment outside ADP / other sources	0.0	0.0	18.3	27.4	4.6	5.8	0.0	0.0	12.4	33.2
IV. Total ADP resources	62.8	89.7	29.8	42.7	15.9	25.2	14.9	19.3	81.8	176.9

Source: Annual Budget statements of provinces, various issues

Note: The data on provincial receipts and expenditure include transactions between the federal and provincial governments (e.g., grants/ foreign project assistance, interest paid etc). However net provincial data used in consolidated federal and provincial governments budget excludes inter-governmental transactions.

@ Including Foreign Project Assistance

Main sources of external financing during FY06 remained commodity aid (Rs 98.7 billion), project aid (Rs 63.3 billion) and sovereign bonds (Rs 47.9 billion). The overall financing from internal resources declined from Rs 76.4 billion in FY05 to Rs 57.3 billion during FY06. This is mainly because of a sharp decline in capital receipts that fell from Rs 79.8 billion in FY05 to Rs 31.7 billion in FY06, while public account financed for Rs 25.5 billion. Privatization proceeds of Rs 90 billion also played a key role in financing the budget deficit during the year.

4.4 Provincial Budgetary Operations FY06

The total revenue receipts of all provinces stood at Rs 449.8 billion during FY06, of which tax revenue contributed Rs 343 billion (see **Table 4.6**). Unlike the previous year, all the provinces recorded revenue surpluses accompanied with a huge rise in development expenditure. This is encouraging, given that the provincial share in federal tax receipts declined from 88 percent in FY05 to 82 percent in FY06. As the share of provincial governments is expected to resurge again to 84 percent in FY07, it is hoped that their good fiscal performance continues this year as well.

It may be noted that provinces have a low tax base; the aggregate contribution of the provinces to tax revenue is not more than 0.8 percent of GDP in FY06 and only 0.5 percent in FY05. It is budgeted to decline again to 0.7 percent in FY07. Provinces have tremendous scope for tapping the revenue potential given that the taxation of the major sectors of the economy (agriculture and services) rests with them. Also the tax collecting capacity of the provinces needs to be strengthened to improve the overall tax-to-GDP ratio of Pakistan. Another important issue relates to the expensive Cash Development Loans (CDLs) of the provinces. This issue has further exacerbated in FY06 as the federal government has now disallowed the provinces to prematurely retire high interest bearing CDLs. Such CDLs, bearing interest in the range of 15 to 18 percent per annum, are increasing the debt liability of the provinces and thereby worsening their fiscal position. In this backdrop, the revision of share in NFC may not provide any significant net benefit to the provinces.

Province wise analysis shows that overall improvement is visible in every provinces, especially in Sindh, whose revenue deficit turned into surplus in FY06, while the other provinces also demonstrate a relatively better position this year. The improvement is largely attributed to a significant increase in tax revenue evident in the increase in provincial tax-to-GDP ratio. The fiscal performance of each province is discussed below:

Balochistan

The overall revenue receipts reached Rs 32.2 billion as compared to the Rs 29.0 billion in FY05, with a YoY increase of 10.9 percent against a 22.6 percent growth in the preceding year. The major source of revenues remained the provincial share in tax revenue that rose by 5.3 percent (from Rs 20.6 billion in FY05 to Rs 21.7 billion) in FY06; these are estimated to decline in FY07. While the FY06 deceleration was mainly a result of a decline in other revenues, the decline in FY07 is envisaged due to an anticipated fall in land revenue (see **Table 4.7**). However, the major source of revenue for the province in FY06 remains land revenue (Rs 268 million), motor vehicle (Rs 223 million) and stamp duty (Rs 162.1 million), while the contribution of non-tax revenue remained nominal.

Table 4.7: Resource Mobilization in Balochistan
million Rupees

				YoY change	
	FY05	**FY06**	**FY07 B**	**FY06**	**FY07**
GST on services (collected by CBR)	145.2	191.3	220.0	31.7	15.0
Motor vehicle	190.6	223.0	233.5	17.0	4.7
Property tax	41.4	40.0	40.0	-3.4	0.0
Land revenue	45.5	268.0	224.2	489.4	-16.4
Stamp duty	141.5	162.1	191.5	14.6	18.1
Excise	54.6	82.8	81.1	51.6	-2.1
Others	287.4	261.8	278.8	-8.9	6.5
Provincial tax receipts	761.0	1037.6	1049.0	36.3	1.1

Source: Annual Budget Statements , Government of Balochistan

Balochistan also posted revenue surplus in FY06 though it fell to Rs 1.9 billion from 2.8 billion in FY05, but this decline is due to the 15.7 percent rise in current expenditure against the 10.9 percent increase in the revenue receipts. However, it is encouraging to note that the total development expenditure jumped to Rs 19.3 billion (up 29.9 percent) and the whole increase is on account of development capital expenditure. This development expenditure is primarily financed by cash balance utilization, development revenue receipts / grants and federal government loans. Therefore, the total ADP resources available for the year stood at Rs 19.3 billion. The total outstanding debt of the province stood at Rs 51.1 billion by end-June FY06, witnessed acceleration since FY04 (see **Table 4.8**).

Table 4.8: Balochistan's Debt Position
billion Rupees

	CDL (30th June)	FEL (30th June)	BRMP loan	Market loan	Blocked loan	Over draft	Total loans	Growth	Interest payments
FY01	16.7	21.0	-	1.0	1.8	-	40.5		2.9
FY02	16.4	22.2	-	0.9	1.2	-	40.7	0.5	3.1
FY03	15.9	25.2	-	0.9	0.6	-	42.6	4.6	2.8
FY04	15.4	24.8	-	0.9	0.0	-	41.1	-3.5	2.6
FY05	11.0	24.0	-	-	9.3	-	44.4	8.0	2.4
FY06	10.5	23.0	4.1	-	7.5	6.0	51.1	15.0	2.8

Source: White paper, finance department, Government of Balochistan

Though the province paid Rs 2.8 billion on account of interest payments and Rs 2.3 billion as the principal but the position is still weak. This is mainly due to the high interest bearing CDLs, and cap on provincial governments to acquire loans form the market at the relatively lower interest rates. The situation is likely to worsen with the federal government's decision to disallow the premature retirement of the expensive CDLs, when the provincial government is already following the Debt Management Strategy based on premature retirement of expensive CDLs through foreign program loans arranged by the Asian Development Bank for budgetary support through BRMP. On the other hand, the province is already breaching the Over Draft limit with the SBP. Keeping in view the fiscal situation of the province, it is foremost important to reduce the overall debt burden and tap the maximum resources through prudent fiscal management in order to create more fiscal space.

N.W.F.P.

The NWFP showed an impressive performance in financial management during FY06, registering a revenue surplus of Rs 4.8 billion, with a YoY increase of 82.3 percent. This exceptional growth is derived through 44.6 percent growth in revenue receipts against a lower growth of 42.3 percent in current expenditure. The total tax receipts reached to Rs 38.1 billion from Rs 32.6 billion in FY06 during the preceding year. Moreover, the contribution of provincial tax receipts rose from Rs 2.3 billion to Rs 3.5 billion (up 49.1 percent).

Though the share of federal tax receipts declined slightly from 93 percent in FY05 to 91 percent in FY06, but the ratio of dependence to the share in federal tax receipts does not change much. Analysis of provincial tax receipts shows that most of the revenue is generated through motor vehicle, land revenue and stamp duties while the revenue from potential sectors like agriculture income tax show only marginal change over the years (see **Table 4.9**).

Table 4.9: Resource Mobilization in NWFP
million Rupees

	FY05	FY06	FY07	YoY change	
				FY06	FY07
Agriculture income tax	46.9	50.0	75.0	6.5	50.0
Motor vehicle	546.8	693.0	791.4	26.7	14.2
Property tax	74.0	107.4	126.3	45.1	17.6
Land revenue	375.0	330.0	380.0	-12.0	15.2
Stamp duty	333.1	300.0	350.0	-9.9	16.7
Excise	20.4	30.0	45.0	47.4	50.0
Others	455.8	606.1	682.7	33.0	12.6
Provincial tax receipts	1852.1	2116.5	2450.3	14.3	15.8

Source: Annual Budget Statements, Government of NWFP

Total development expenditure stood at Rs 25.2 billion (up 58.7 percent), of which almost 82.7 percent was accounted under development capital expenditure. This expenditure is financed mainly through the federal government loans (Rs 7.6 billion), net capital receipts (Rs 4.9 billion), grants (Rs 3.5 billion).

The total debt outstanding of the provincial government as on end June 2006 is around Rs 49.3 billion (see **Table 4.10**), of which the volume of CDL is estimated at Rs 22.3 billion. The province has paid Rs 3.6 billion on account of CDL markup as well as a principal repayment of Rs 3.4 billion during the current fiscal year and is expected to pay another Rs 5.0 billion under this head during FY07. The province has also prematurely retired CDL amounting to Rs 10.1 billion up to FY06 thereby saving Rs 2.1 billion per annum. Keeping the high debt profile in view, the province is also enjoying the soft loans from various donor agencies, like IDA, ADB, IFAD, and OPEC for various development projects. The tranche of loans for the year is amounted to Rs 4.1 billion, while the grant is amounted to Rs 0.8 billion during FY06. Despite all these positive avenues, the federal government's decision regarding cap on premature retirement of the CDL has put pressure on the fiscal space of the province.

Table 4.10: NWFP Outstanding Debt
billion Rupees

	FY04	FY05	FY06
Total debt	61.1	61.1	71.6
Domestic	27.4	21.1	22.3
External	33.7	40	49.3

Source: White Papers, Government of NWFP

Punjab

Punjab depicts a relatively stronger position amongst all the provinces. The revenue surplus reached to Rs 64.6 billion in FY06 from Rs 44.9 billion in FY05, registering a significant annual growth of 43.8 percent during the year.

The revenue receipts grew sharply from Rs 181.3 billion in FY05 to Rs 225.1 billion in FY06. Like other provinces, the reliance of the province on the share in federal tax receipts is almost 85 percent, supplement by an impressive growth of 39.5 percent in provincial tax receipts during the year. The main sources of tax revenue remained stamp duties, motor vehicle, property tax and land revenue, while the share of agricultural income tax remained nominal during the year (see **Table 4.11**).

Table 4.11: Resource Mobilization in Punjab
million Rupees

	FY05	FY06	FY07	YoY change	
				FY06	FY07
Agriculture income tax	735.0	1312.0	1493.0	78.5	13.8
GST on services	1630.2	2147.3	2469.4	31.7	15.0
Motor vehicle	3362.0	4210.0	4692.0	25.2	11.4
Property tax	1700.0	3788.0	4689.0	122.8	23.8
Land revenue	3136.3	3674.6	4046.3	17.2	10.1
Stamp duty	6728.4	7762.5	8497.7	15.4	9.5
Excise	790.9	888.7	1026.2	12.4	15.5
Others	4326.1	5084.0	5899.0	17.5	16.0
Provincial tax receipts	20778.7	26719.8	30343.1	28.6	13.6

Source: Annual Budget Statement, Government of Punjab

The total development outlay reached to Rs 89.7 billion of which almost half of the expenditure (Rs 45.4 billion) was on account of development revenue expenditure. The total ADP resources are estimated at Rs 89.7 billion, of which almost 72 percent (Rs 64.6 billion) are financed by the provincial revenue surplus, while the major source of financing for the rest of the expenditure was the net public account receipts.

The total debt outstanding as on end June reached to Rs 171.5 billion, with an average interest rate of 6.7 percent. The provincial government is also making premature retirement of expensive CDLs with the cheaper foreign budgetary support from international donor agencies. Therefore, the provincial government has retired the total loans amounted to Rs 17.5 billion under this head that has provided the fiscal space to the province. During the current year, the retirement of Rs 5.7 billion is made for the CDL borrowed in FY99. As a result of this, the interest payments (on account of CDL and foreign loans) as percent of the current expenditure dropped down from 21 percent in FY94 to 4.1 percent in FY07. Apart from this, Punjab has also received the loans and grants of Rs 6.6 billion from various donor agencies during that year that helped in completing various developmental projects.

Sindh

Overall budgetary performance for the year showed an improvement, as revenue deficit of Rs 3.1 billion in FY05 turned positive by 778 million in FY06. The causative factor behind this change was mainly the 23.8 percent growth in revenue receipts that outpaced the 19.4 percent growth in the current expenditure. Sindh had been facing with the acute problem of revenue deficit since FY05 when the surplus of Rs 21.6 billion in FY03 abruptly dropped down to Rs -7.5 billion in FY04, however, with the persistent efforts the provincial government has been able to reduce the revenue deficit, and the province is expected to have increasing revenue surplus over the next years.

The total revenue receipts realized during FY06 were Rs 127 billion, of which tax revenue stood at Rs 108.8 billion while the rest came from the non-tax revenue. The share in federal tax receipts Rs 77.8 billion contributed around 71 percent in tax receipts. Of the rest of the share, the main contribution came from stamp duties, land revenue, property tax and motor vehicle tax (see **Table 4.12**).

Table 4.12: Resource Mobilization in Sindh
million Rupees

	FY05	FY06	FY07	YoY change	
				FY06	FY07
Agriculture income	197	300	450	52.6	50.0
Motor vehicle	1636	1850	2000	13.0	8.1
Property tax	599	700	700	16.9	0.0
Land revenue	121	110	110	-9.3	0.0
Stamp duty	3775	4308	4800	14.1	11.4
Excise	1160	1300	1400	12.1	7.7
Others	3089	22443	20031	626.4	-10.7
Provincial tax r	10578	31011	29491	193.2	-4.9

Source: Annual Budget Statement, Government of Sindh

The total development outlay for the year was marked at Rs 42.7 billion with a YoY increase of 43.5 percent. The development capital expenditure stood at Rs 36.5 billion during the year. It is encouraging to note that the development capital expenditure of the province has sharply increased from Rs 6.5 billion in FY03 to Rs 36.5 billion in FY06.

As of end-June 2006, Sindh has repaid Rs 117.3 billion of the debt, including a principal repayment of Rs 19.6 billion and the interest of Rs 97.7 billion, leaving behind an outstanding principal of Rs 33.9 billion. During FY06, the province repaid a sum of Rs 7.1 billion on account of principal and interest payment of CDL, while it had paid an amount of Rs 7.0 billion in FY05 on this account. The total foreign aid and loans disbursed during FY06 stood at Rs 4.5 billion. The province is striving to reduce the overall debt liability by replacing the expensive loans with the soft loans from donor agencies, which will considerably improve the fiscal position of Sindh.