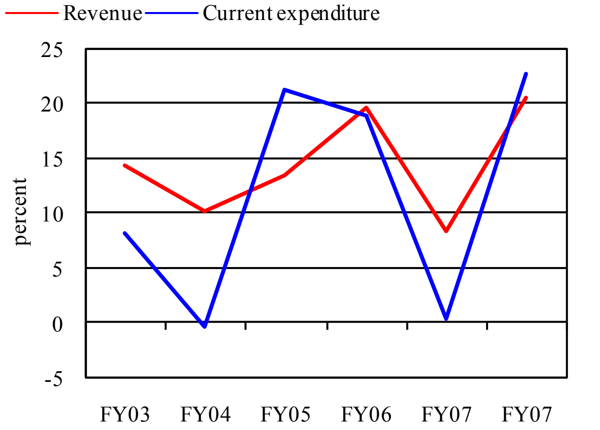
4 Public Finance and Fiscal Policy[1]

4.1 Overview

Despite a significant increase in direct tax collections and in non-tax revenues during FY07, the fiscal deficit for the year remained at the FY06 level of 4.3 percent of GDP, a little higher than the budgeted target of 4.2 percent of GDP for the year. This is the second consecutive year when fiscal deficit surpassed its budgeted target. While higher fiscal deficit during FY06 was primarily associated with higher expenditure on account of relief and rehabilitation of earthquake affected areas, the above target deficit in FY07 is principally attributed to a strong growth in current expenditure (see **Figure 4.1**).

Figure 4.1: Growth in Revenue and Expenditure



The higher growth in current expenditure also overshadowed an above target increase in CBR tax collection during FY07. Importantly, 18.6 percent growth in CBR tax collection was substantially higher than the growth in nominal GDP (14.6 percent) and hence resulted in an encouraging improvement in tax to GDP ratio during FY07.

The strong growth in CBR taxes was a result of unprecedented growth in direct tax collection of 48.2 percent during FY07. However, the weak performance in indirect taxes partially offset the impact of this rise. Encouragingly, the record direct tax collection came from voluntarily payments, which recorded an exceptional growth of 89.1 percent in FY07.

The exceptional tax collection was equally supported by 26.2 per cent YoY growth in non-tax revenue. The key factor was the SBP profit of Rs 69.2 billion, which was about four times higher than FY06 contribution in non-tax revenues. Moreover, development surcharges on petroleum and gas, interest income and income from defense services also played significant role in the growth of non-tax revenue.

The extra-ordinary performance in revenues, however, could not make it possible to reduce the fiscal deficit to GDP ratio during FY07, because of a significant rise in total expenditure (19.5 per cent YoY). The share of current expenditure hovered around three fourth of the total expenditure during FY07 and FY06, after showing a decline in earlier years. The key factors causing huge expansion in expenditure were general public services, debt servicing, subsidies and development expenditure.

The fiscal deficit of Rs 377.5 billion was financed by almost evenly by external and domestic resources during FY07. Like FY06, the major sources of external financing during FY07 were program loans/commodity aid, project aid and borrowings from international capital market through the issuance of various bonds. From domestic resources the government obtained a net amount of Rs 177.8 billion; almost the same as FY06 net domestic financing (Rs 176.4 billion). However, there was a compositional shift in financing from domestic sources. While FY06 witnessed 55 per cent contribution from privatization proceeds and the rest was contributed by the borrowings from banks and non-bank, the FY07 witnessed 89.4 percent contribution from borrowings sources and only 10.6

[1] For analysis Data on Ministry of finance Webpage (http://www.finance.gov.pk) has been used.

percent came from privatization proceeds. Also, the borrowing mix saw a significant change in FY07 from preceding year; nearly one-third was shared by non-bank borrowings during FY07, which was only 10.2 percent in FY06. Within the banking system borrowings, the government relied entirely on scheduled bank borrowings during FY07, in sharp contrast to FY06 borrowing mix, which was heavily biased towards borrowing from SBP (see **Table 4.1**).

Table 4.1 Pakistan: Summary of Consolidated Public Finance

billion Rupees

	FY03	FY04	FY05	FY06	Budget FY07	FY07	Budget FY08
Total revenue	**720.7**	**794.1**	**900.0**	**1,076.6**	**1,165.8**	**1,298.0**	**1,476.0**
Tax revenue	487.5	550.1	632.6	753.0	901.2	889.7	1,095.5
Non-tax revenue	233.2	244.0	267.4	323.6	264.7	408.3	380.4
Total expenditure	**898.1**	**923.6**	**1117.0**	**1,401.8**	**1,539.3**	**1,675.5**	**1,874.7**
Current	781.9	778.4	943.1	1,121.0	1,124.3	1375.3	1,378.2
of which; Interest	*199.8*	*196.3*	*210.2*	*237.1*	*239.5*	*368.8*	*374.6*
Defence	*159.7*	*180.4*	*211.7*	*242.0*	*250.2*	*249.9*	*275.0*
Development expenditure & net lending	106.5	181.0	252.5	367.1	435.0	424.7	546.5
Unidentified expenditure shortfall	*-9.8*	*35.8*	*78.5*	*86.3*	*20.0*	*124.5*	*50.0*
Budget deficit	**-177.4**	**-129.4**	**-217.0**	**-325.2**	**-373.4**	**-377.5**	**-398.7**
Financing	**177.4**	**129.4**	**217.0**	**325.2**	**373.4**	**377.5**	**398.7**
External	88.3	-6.5	120.4	148.9	171.7	199.7	193.1
Domestic	77.7	124.7	68.2	79.1	126.7	158.9	130.6
Bank	-69.1	63.7	60.2	70.9	120.0	102.0	80.9
Non-bank	146.8	61.0	8.1	8.1	6.7	56.9	49.7
Privatization proceeds	11.3	11.2	28.3	97.3	75.0	19.0	75.0
Memorandum item:							
Expenditure by ERRA in earthquake affected areas				37.7		40.0	

Source: Ministry of Finance, Islamabad

The strong growth in expenditure turned the revenue surplus envisaged in budget FY07 into revenue deficit, leaving the development expenditure to be financed entirely by government borrowings. The primary balance remained in deficit; the deficit level nevertheless dropped significantly to Rs 8.7 billion from Rs 88.1 billion in the preceding year. The overall fiscal deficit stayed at the preceding year level, as high as 4.3 per cent of GDP. However, it should be noted that on adjusting for expenditure on account of relief and rehabilitation of earthquake affected areas, a better picture emerges with overall fiscal deficit in FY07 increasing only marginally to 3.9 per cent of GDP from 3.8 per cent the preceding year.

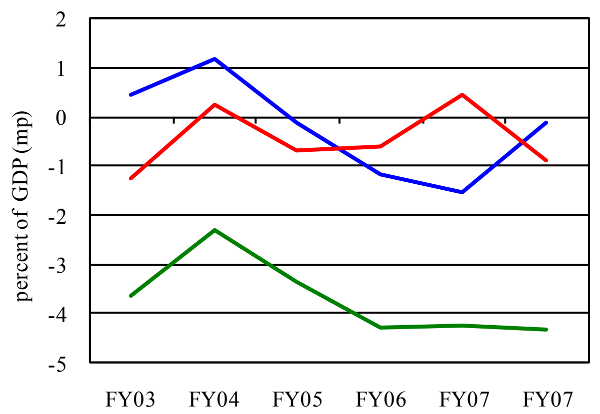
The FY08 sets the fiscal deficit target at 4.0 percent of GDP, owing much to: 1) a strong anticipated 23.1 percent YoY growth in tax revenue and 2) almost zero YoY growth in current expenditure. Focusing on the pro-growth policy, allocations for development expenditure are higher by 28.7 percent than FY07.

4.2 Fiscal Performance

The fiscal performance in the medium term of FY03 - FY07 presents a mixed trend which can be seen through several indicators. The most commonly used indicator of overall fiscal performance, the fiscal balance, has remained at 4.3 percent of GDP for yet another year, after touching a low of 2.3 percent in FY04.

While this does not necessarily mean deterioration in fiscal performance as most of increase in expenditure that caused widening of deficit came from development expenditure. The revenue balance (difference between total revenue and total current expenditure), representing the saving capacity of the government has also remained in deficit for third consecutive year during FY07. Given that the Fiscal Responsibility and Debt Limitation (FRDL) Act, 2005 requires a revenue surplus by FY08 onwards, the deficit points to the need to contain the rise in current spending.

Figure 4.2: Fiscal Balance Indicators



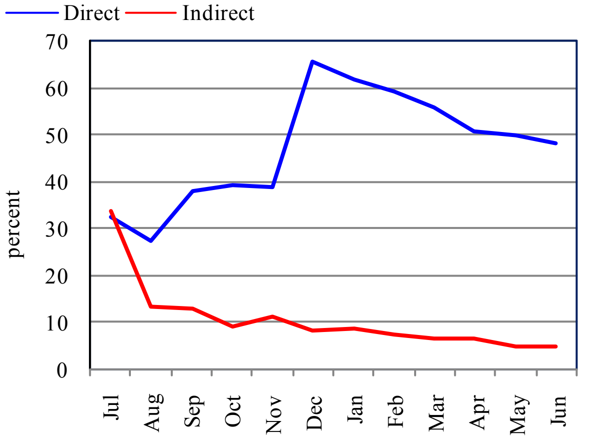
The primary balance (total revenue less total expenditure excluding interest payment) indicates current discretionary budgetary stance. This balance has also remained in deficit for yet another year, on account of both current and development expenditure, but the deficit has narrowed significantly in FY07 compared to the previous year (see **Figure 4.2**).

The fiscal performance can also be gauged through revenue indicators, for example tax to GDP ratio or tax buoyancy. As mentioned earlier, the tax to GDP ratio recorded an improvement during FY07, as it improved in FY06. The FY06 improvement was mainly due to direct taxes and sales tax. However, by international standards, the level of this ratio is still very low about which SBP has been indicating the need to broaden the tax base widening the tax – net and diversify the tax-base, so that under performance of one sector could not have severe impact on overall tax collection.

4.2.1 Tax Buoyancy

Total revenue to GDP ratio shows a continual improvement since FY05. The improvement came from both tax as well as non-tax revenue. A remarkable performance in tax revenue was primarily due to an exceptionally Rs 337.6 billion collected under direct tax head by the CBR, equally supported by non-tax revenue. The later was backed by SBP profit (Rs 69.2 billion), recording 397.8 per cent YoY growth; income from defense services Rs 79.6 billion (logistic support) and development surcharges on petroleum (Rs 29.7 billion) and gas (Rs 34.9 billion) during FY07. It is important to note that budget FY07 envisaged only Rs 18.1 from development surcharges; the actual collection was nearly four-times higher, indicating a total under estimation in this account.

Figure 4.3: Growth in Taxes



These developments indicate that though the direct tax collection improved, the one-off items also played a key role in the improvement of total revenues, which may not be repeated in coming years for example SBP profit. This implies that the government should focus on the sources having long-term sustainability, mainly based on direct taxes.

4.2.2 Expenditure Indicators [1]

The total expenditure of Rs 1,675.5 billion during FY07 was 19.5 percent higher than FY06 expenditure of Rs 1,401.8 billion, sourced by a strong rise in both current and development expenditure. This trend is continued since FY05. However, it is encouraging to note that the strong growth in expenditure during FY04-07 was primarily due to rise in development expenditure, which rose by an average of 37.8 per cent. Consequently, the development expenditure as percent of GDP rose from 3.9 percent in FY05 to 4.9 percent in FY07. It is important to note that government continued to focus on development expenditure even after incurring earthquake related expenditure during FY06. However, a worrisome factor in current expenditure is rising share of interest payments on domestic public debt.

Table 4.2: Consolidated Expenditure
million Rupees

				Growth (percent)	
	FY05	FY06	FY07	FY06	FY07
Total expenditure	**1,117.0**	**1,401.8**	**1,675.5**	**25.5**	**19.5**
Current	943.1	1,121.0	1,375.3	18.9	22.7
Of which: Interest	210.2	237.1	368.8	12.8	55.5
Defence	211.7	242.0	249.9	14.3	3.3
Development	252.5	367.1	424.7	45.4	15.7

Source : Central Board of Revenue

The current expenditure stood at Rs 1375.3 billion during FY07, showing 22.7 percent increase YoY; following the trend visible in FY05 and FY06. The huge rise in interest payments was due to: (1) a rise in interest payment on domestic debt;[2] (2) rise in interest payment on external debt, (3) maturity of long-term debt instrument of defence savings certificates, and (4) larger maturities of short term domestic debt. Moreover, the defense spending increased modestly during FY07, recording 3.8 percent rise Y0Y; much smaller rise relative to 17 percent average increase recorded during FY03-FY06.

In addition, the current subsidies recorded 17.1 percent YoY increase during FY07; and other general administration grew by 42 percent over FY06 level. The only point of concern in current expenditure was the abrupt changes in current expenditures under other general public services during FY01-FY07, recording a change of 32.7 percent every year on average.

4.3 CBR Performance

The CBR collected Rs 846.4 billion during FY07, showed 18.6 percent growth YoY, surpassing FY07 revised target of Rs 835.0 billion by a substantial margin (see **Table 4.3**). This was the fifth consecutive year when the CBR revenues recorded handsome growth of more than 13 percent, but more importantly, this is the third year that the share of CBR taxes to GDP has increased from 9.1 percent in FY05 to 9.7 percent in FY07.

Table 4.3: Actual Tax Collections (net) by CBR
billion Rupees

	Actual	Revised targets	Actual	Growth		Target
	FY06	FY07	FY07	FY06	FY07	FY08
Direct taxes	225.0	318.0	333.4	21.7	48.2	405.0
Indirect taxes	488.5	517.0	513.1	20.2	5.0	620.0
Sales tax	294.8	311.0	309.3	23	4.9	382.0
Central excise	55.3	72.0	71.5	9.2	29.4	98.0
Customs	138.4	134.0	132.2	19.6	-4.4	140.0
Total	**713.4**	**835.0**	**846.4**	**20.7**	**18.6**	**1025.0**

Source: Central Board of Revenue

The strong CBR performance was mainly due to a 48.2 percent YoY rise in direct tax collection; an unprecedented achievement in CBR history. Had it not been for a decline in dutiable imports during FY07 (which fell 4.1 percent YoY), the growth in CBR tax collections would have exceeded the exceptional FY06 growth of 20.8 percent YoY.

[1] The break up in development and current expenditures may not be compared directly during FY06 and FY07, since former contains earthquake expenditure as current expenditure and later treats it as development expenditure.
[2] For details, see chapter on Public Debt, section on Domestic Debt.

4.3.1 Direct Taxes

The direct tax collection stood at Rs 333.4 billion in FY07, showing an exceptional growth of 48.2 percent YoY, and comfortably surpassing its target of Rs 318 billion. This second successive year of strong growth in direct tax collections has pushed its share in total tax collection from 31.8 percent in FY01 to 39.4 percent in FY07 – the highest level in two decades.

Both advance tax collection and tax collected with tax returns recorded nearly 100 percent YoY growth during FY07. Collections from the corporate sector have accelerated during recent years, mainly due to enhanced corporate profitability. A significant portion of the robust growth in tax collections was from banking companies, and oil and gas sector (see **Table 4.4**).

Table 4.4: Direct Tax Performance - Head wise

billion Rupees

	FY06	FY07	Growth
Voluntary	87.4	165.2	89.0
On demand	16.8	11.0	-34.5
At source	139.6	170.7	22.3
Gross	243.7	346.9	42.3
Refund	34.0	32.2	-5.3
Others	15.3	18.7	22.2
Net direct taxes	**225.0**	**333.4**	**48.2**

Source: Central Board of Revenue

4.3.2 Indirect Taxes

The sales tax has been the largest component of indirect taxes since FY00 and is growing by an average of 17.0 percent per annum. However, during FY07 it recorded an increase of merely 4.9 percent YoY, lower the FY06 strong growth of 23.6 percent YoY. The slow down came from sales tax on domestic goods as well as import related goods, reflecting a broad moderation in aggregate demand pressures in the economy.

The aggregate FY07 collections of Rs 309.2 billion were a little short of the revised target of Rs 311.0 billion. As a result, the share of sales tax in total CBR revenues shrunk to 36.5 percent during FY07 from 41.3 percent in FY06.

The major contributors in the growth of sales tax collection were telecom services, sugar, beverages, cigarettes, and POL. The strong growth in the sales tax collection from these sectors was subdued by a decline in sales tax collection from some other sectors like motor cars, cement, natural gas and electricity.

Customs Duty

Against a revised target of Rs 134.0 billion, the collection of customs duty was Rs 132.2 billion, recording a decline of 4.4 percent YoY. The below target receipts reflected the decline in dutiable imports, which were 4.1 percent lower in FY07 compared to that in FY06. As a result, the share of dutiable imports in total imports fell to 54.5 percent in FY07 from 61.4 percent in the previous year. The major decline came in vehicles import due to change in government policy of restriction on import of motorcars older than 5 years.

Table 4.5: Central Excise Duty Collection

billion Rupees

			YoY change	
Major Commodities	**FY06**	**FY07**	**FY06**	**FY07**
Beverages & its concentrate	5.6	7.0	25.6	24.4
Cigarettes & tobacco	23.1	27.1	4.8	17.1
Cement	12.2	15.0	10.2	23.4
Natural gases	6.5	5.9	14.2	-8.7
POL products	3.6	4.5	-5.6	24.7
Services	0.8	4.9	…	485.3
Others	3.7	7.3	25.8	95.9
Total (net)	**55.5**	**71.7**	9.2	29.1

Source: Central Board of Revenue

Federal Excise Duty (FED)

FED has lowest share in indirect taxes. However, the collection of FED during FY07 was 29.5 per cent up YoY, and stood at Rs 71.6 billion. The changes in FED rules during FY07 led to this strong growth, consequently raising its share to 8.5 percent of total CBR revenue from 7.7 percent in FY06. The major contributing sectors were cigarettes, cement, POL products and beverages (see **Table 4.5**).

4.4 Provincial Budgetary Operations FY06

The total revenue receipts of all provinces stood at Rs 483.4 billion during FY07, of which tax revenue contributed Rs 400.1 billion (see **Table 4.6**). All the provinces recorded revenue surpluses accompanied with a substantial rise in development expenditure. This is an encouraging development given that the provincial share in federal tax receipts increased from 89.1 percent in FY06 to 91.6 percent in FY07. Heavy reliance of provincial governments on federal tax assignments can not be considered a healthy aspect of fiscal system in the light of under going process of devolution plan.

Provincial tax base is at such a low level that it is even less than 1 percent of GDP. Provinces have potential to generate money from taxation on the major sectors of the economy like agriculture and services that are out of the jurisdiction of federal government.

Table 4.6 Provincial Government Operations
billion Rupees

	FY05	FY06	FY07R
Total Revenue	**338.1**	**450.3**	**483.4**
Provincial share in Fed revenue	**257.4**	**300.7**	**400.1**
Provincial taxes	**34.6**	**36.8**	**36.8**
Property taxes	9.5	9.1	3.5
Of which: Agricultural tax	*0.9*	*0.9*	*0.9*
Excise duties	2.1	2.3	2.5
Stamp duties	10.6	10.2	10.3
Motor vehicles tax	5.7	7.1	7.7
Other	6.6	8.1	12.9
Provincial nontax	**22.4**	**47.6**	**45.4**
Interest	0.5	0.3	1.4
Profits from hydro electricity	6.0	6.0	4.2
Irrigation (receipts only)	2.7	2.5	2.7
Forest other	13.2	0.0	0.0
Others	0.0	38.8	37.1
Federal loans and transfers/grants	**23.7**	**65.2**	**1.1**
Loans(net)	-6.9	-0.1	-28.4
Grants	30.6	65.3	29.5
Total expenditure	**371.5**	**496.6**	**602.9**
Current expenditure	**279.0**	**355.6**	**420.3**
of which: interest to federal govt	24.6	22.9	18.1
Other (incl. irrigation exp.)	254.5	332.7	402.2
Development expenditure	**92.5**	**141.0**	**182.6**
Overall balance	-33.4	-46.3	-119.5

Source: www.finance.gov.pk

Province wise analysis shows that overall balance has been deteriorated in the case of Punjab and Sindh while it has improved in Balochistan with NWFP more or less on previous position of deficit. The deterioration was mainly on account of higher expenditure in Punjab and Sindh while in NWFP both revenue and expenditure declined.

Punjab

FY07 data on Punjab public finance reflects an expansionary fiscal policy adopted by the provincial government. This is evident from a meager growth in revenue and drastic rise in expenditure resulting into substantial reduction in revenue surplus and huge expansion in the overall deficit compared to FY06.

The revenue receipts of Punjab grew only by 5.9 percent from Rs 221.8 billion in FY06 to Rs 235.0 billion in FY07. The reliance of the province on the share in federal tax receipts also grew to 90.7 percent compared with 87.9 percent last year. The main sources of tax revenue remained stamp duties and motor vehicle tax with negligible improvement in agriculture tax collection.

Total expenditure grew by a sharp rate of 33.6 percent with 30.0 percent rise in current expenditure. It is encouraging to note interest payment to federal government has started to decline that will provide some room to finance the priority areas. The total development outlay at Rs 109.6 billion was 41 percent higher than FY06 reflecting government’s approach towards development.

Sindh

Although there was a substantial amount of Rs 20.1 billion surplus on revenue account in FY07, performance of public finance in Sindh remained weak as overall deficit widened on account of lower increase in revenue and higher increase in expenditure.

Growth in revenue receipts remained 13.1 percent against 19.0 percent growth in the expenditures. The increase in revenue mainly stemmed from federal tax assignments that increased from Rs 96.3

billion in FY06 to Rs 131.3 billion in FY07 while provincial tax only grew to Rs 14 billion from Rs 13.4 billion in FY06. This development has increased the provincial dependency on federal resources from 87.7 percent in FY06 to 90.3 percent in FY07. The main contribution in provincial taxes came from stamp duties and motor vehicle tax.

Rise in expenditure was largely attributed by 21.7 percent increase in current expenditure while development expenditure grew moderately by 10 percent. The total development outlay for the year remained at Rs 35.1 billion compared to Rs 31.9 percent in FY06. Federal government loans were negative during the year showing a net repayment of Rs 9.5 billion loan to the federal government.

NWFP

Overall balance position of NWFP did not change much in FY07, with a deficit of Rs 8.9 billion compared to Rs 8.6 billion in FY06. A revenue surplus of Rs 14.7 billion compared to Rs 8.6 billion in FY06 showed an improved performance in financial management. This improvement is witnessed despite the fact that total revenue receipts have declined but current expenditure has dropped by a larger margin causing an increase in the revenue surplus. The total tax receipts stood at Rs 48.4 billion increasing from Rs 37.7 billion in FY06. The contribution of provincial tax receipts declined from 6.3 percent to 4.9 percent in FY07. Analysis of provincial tax receipts shows that most of the revenue is generated through motor vehicle, stamp duty and other taxes.

Total development expenditure was recorded at Rs 23.6 billion (up 37.8 percent). To finance the expenditure, the federal government loans availability was much lower than in FY06 (Rs 4.3 billion for FY07 compared with Rs 16.8 billion in the earlier year).

Balochistan

The overall revenue receipts remained at Rs 37.7 billion as compared to the Rs 30.5 billion in FY06, with a YoY increase of 23.9 percent. Provincial share in federal tax assignments was the major contributor in the rise in revenue receipts that rose by 53.9 percent (from Rs 20.3 billion in FY06 to Rs 31.3 billion) in FY07. There was slight decline in provincial tax collection by 1.5 percent compare to last year. This decline was a result of a decline in excise duty, stamp duty and other revenues. However, the major source of provincial tax revenue for the FY07 remains motor vehicle tax (Rs 345 million) while the contribution of non-tax revenue increase significantly from other non-tax heads.

Balochistan experienced revenue deficit in FY07 though it fell to Rs 0.7 billion from 2.9 billion in FY06. This decline is attributed by lower growth of 15.3 in current expenditure compared to higher growth of 23.9 percent in revenue receipts. However, development expenditure is little changed from the level of the previous year.