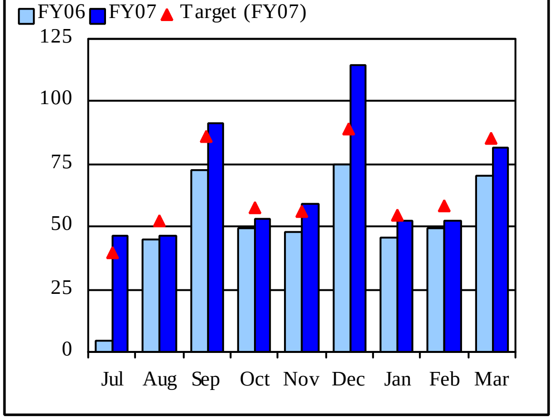
5 Fiscal Developments

Overview

Data on consolidated fiscal accounts will only be available by end-May 2007 but the government has indicated that it remains committed to achieving the fiscal deficit target of 4.2 percent of GDP for FY07. The strong growth in direct taxes seen in the first half of FY07 lends confidence that fiscal deficit would be within limits, however, the relative slowdown in the CBR taxes January 2007 onwards (see **Figure 5.1**) indicates that expenditure growth would need to be monitored closely.

Figure 5.1: Monthly Tax Collection vs Targets

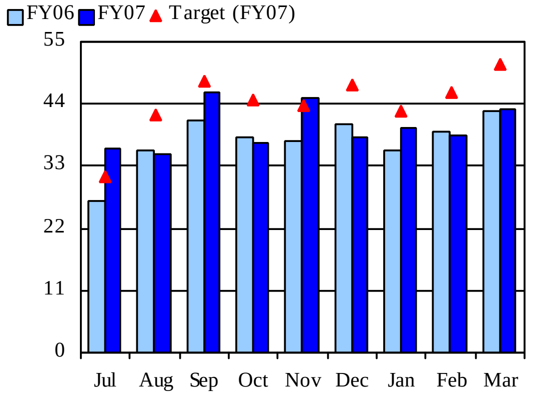


The growth in CBR taxes (which contribute the bulk of government revenues) has dipped from 26.7 percent in H1-FY07 to 12.3 percent in Q3-FY07. It may be noted that H1-FY07 receipts had been bolstered by an exceptional (unanticipated) 65.6 percent rise in direct taxes that more than offset the below- target indirect tax receipts. The resulting exceptionally strong revenue growth helped contain the fiscal deficit during H1-FY07.

Another significant development is the sharp rise in government borrowings from the domestic sources during Jul-Mar FY07, which mainly reflected the relatively lower availability of external financing compared to the corresponding period of FY06. However, external borrowings are expected to increase in future due to an expected sovereign debt issue later in FY07, and the government is planning to retire a part of the outstanding stock of domestic debt. An encouraging development in FY07 was that, unlike the previous year, the government was able to substantially increase its non-bank borrowings during Jul-Mar FY07, as well as sourcing a greater proportion of its banking system borrowings from scheduled banks.

5.1 CBR Tax Collection

Figure 5.2: Indirect Tax Collection (monthly)



The CBR significantly surpassed its tax collection target of Rs 579.8 billion during Jul-Mar FY07 with actual collection of Rs 597.0 billion (21.9 percent YoY growth). However, the fact that monthly collections from indirect taxes continued to fall below the target, except for two months, during Jul-Mar FY07 is a point of disquiet (see **Figure 5.2**). Indeed, were it not for the substantially above-target direct taxes in December 2006, aggregate collection would have been below target by Q3-FY07.

The shortfall in the indirect taxes was principally due to weak growth in the customs duty and the sales tax receipts (see **Table 5.1**). This volatility in collections is essentially caused by a narrow tax base, and underlines the need to diversify the tax base so that aggregate receipts are not disproportionately impacted by adverse developments in any segment of the economy.

Table 5.1: Tax Collection (Jul-Mar)
billion Rupees

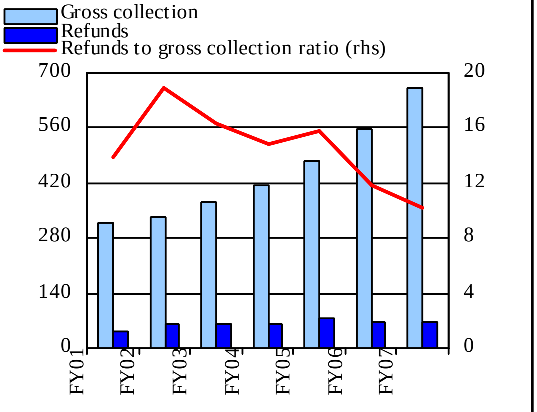
	Target		Net tax collection		Percent of target		Growth	
Head	**FY07**	**Up to Mar**	**FY06**	**FY07**	**Annual**	**Mar**	**FY06**	**FY07**
Direct taxes	264.7	183.03	152.7	237.8	89.8	129.9	27.8	55.7
Indirect taxes	570.3	396.8	337.1	359.2	63.0	90.5	19.6	6.5
Sales tax	343.8	238.8	202.4	218.8	63.6	91.6	22.4	8.1
FED[1]	69.0	47.7	39.6	47.7	69.2	100.0	9.1	20.4
Customs	157.5	110.3	95.1	92.7	58.8	84.0	18.7	-2.5
Total	835.0	579.8	489.8	597.0	71.5	103.0	22.1	21.9

Source: Central Board of Revenue, [1] Federal Excise Duty
Figures may not tally due to separate round off.

5.2 Gross Collections and Refunds

Jul-Mar FY07 gross tax collections reached Rs 664.2 billion, up 19.6 percent YoY from the Rs 555.2 billion collected during the corresponding period of FY06, but refunds increased by merely 2.9 percent. Consequently, the ratio of refunds to gross tax collections dropped from 12 percent at end-March 2006 to 10 percent by end-March 2007, continuing the downtrend seen in recent years (see **Figure 5.3**).

Figure 5.3: Gross Collection and Refunds



5.3 Direct Tax Collection

Direct tax collection stood at Rs 237.8 billion during Jul-Mar FY07 against the target of Rs 183 billion showing a growth of 55.7 percent YoY. Moreover, the direct tax collection remained above the target in all months, but the December 2006 receipts were exceptionally strong, up 118.7 percent from that in December 2005, and accounting for 32.5 percent of the overall direct tax collections during Jul-Mar FY07.

Almost half of the direct tax revenue was under the head of "*voluntary payments*" that were nearly doubled during Jul-Mar FY07 as compared to the same period last year. On the other hand, collection "*on demand*" declined during the said period.

5.4 Indirect Tax Collection

Indirect tax collection stood at Rs 359.2 billion against the target of Rs 396.8 billion during Jul-Mar FY07. This shortfall is the result of a sharp deceleration in the import growth, which fell from 43.2 percent YoY during Jul-Mar FY06 to 8.1 percent YoY during Jul-Mar FY07, reducing the import-related taxes substantially.

Sales Tax

The cumulative Jul-Mar receipts from *General Sales Tax* (GST) stood at Rs 218.8 billion, 8.4 percent (Rs 20 billion) short of the target for the period. The sharp deceleration in the growth of GST collections is visible in

Table 5.2:Sales Tax Collection (Jul-Mar)

billion Rupees

	FY05	FY06	FY07
Sales Tax	165.4	202.4	218.8
Domestic	59.4	81.3	93.0
Import-related	106.0	121.1	125.7

Source: Central Board of Revenue

Figures may not tally due to separate round off.

the receipts from imports as well as in collection from domestic sources (see **Table 5.2**), and is evident in all but three months of the period.

Of the sales tax from domestic sources, the major revenue came from telecom (Rs 26.4 billion), POL products (Rs 20.1 billion), electrical energy (Rs 11.5 billion), natural gas (Rs 8.7 billion), sugar (Rs 8.4 billion) and cigarettes (Rs 4.6 billion), while POL products, vehicles, iron and steel, plastic remained major revenue spinners of import related sales tax.

The biggest drag on the year-on-year growth of sales tax through imports was from vehicle and iron & steel imports. The revenue from the former fell by 23.2 percent YoY (Rs 3 billion), while that from the latter dropped 26.9 percent YoY during Jul-Mar FY07.

Federal Excise Duty (FED)

Of the indirect taxes, only the federal excise duty met its revenue target. The collections for the Jul-Mar FY07 stood at Rs 47.7 billion, showing a YoY growth of 20.4 percent (see **Table 5.1**). The major revenue came from the cigarettes (Rs 17.5 billion), cement (Rs 11.0 billion), natural gas (Rs 4.4 billion), beverages (Rs 4.3 billion) and POL (3.4 billion).

Customs

Due to a deceleration in import growth, customs duty receipts fell short of the target by 16.0 percent, adding Rs 92.7 billion to the national exchequer during Jul-Mar FY07 against the target of Rs 110.3 billion (see **Table 5.1**).

Despite 19.2 percent YoY decline in duty on vehicles, it remained the major source of custom duty collection, contributing Rs 20.9 billion during Jul-Mar FY07 as compared to Rs 25.8 billion last year. Among the other major sources, edible oil contributed Rs 12.3 billion, POL products Rs 9.9 billion, and electrical machinery Rs 7.5 billion during Jul-Mar FY07.

5.5 Government Budgetary Borrowings

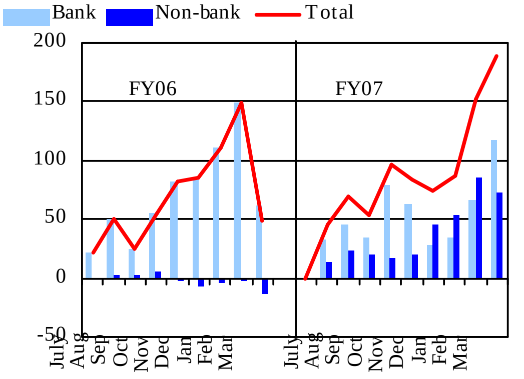
The aggregate government borrowings for deficit financing from domestic sources stood at Rs 190.5 billion during Jul-Mar FY07, which was nearly four-times the Jul-Mar FY06 borrowings (see **Figure 5.4**).

Primarily, this sharp increase seems to be the result of lower availability of external financing during the first nine months of FY07 compared to the same period of FY06, which led the government to increase reliance on domestic resources.[1]

Non-bank Borrowings

Non-bank borrowings (net) rose by Rs 73.9 billion during Jul-Mar FY07 in contrast to a (net) repayment of Rs 12.7 billion in the corresponding period of the previous year. The trend reversal owed to renewed issuance of PIBs during FY07, as well as a resurgence in NSS receipts.

Figure 5.4: Bank and Non-bank Borrowings



The government mobilized Rs 15.9 billion[2] through PIB auctions, from non-bank sources, during Jul-Mar FY07. This is in sharp contrast to net repayments of Rs

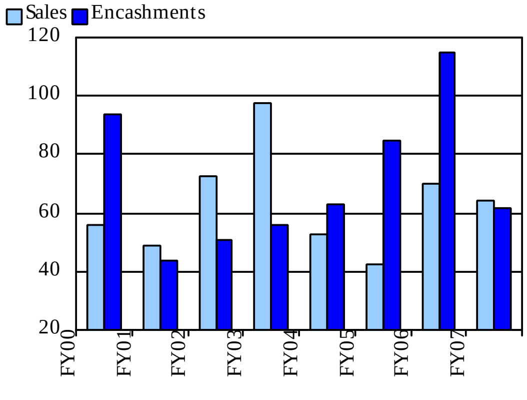
Table 5.3: Gross and Net Mobilization through Major NSS Instruments (Jul-Mar)

million Rupees

	FY06		FY07	
	Gross	Net	Gross	Net
NSS Instruments	**293,649.0**	**8,922.2**	**356,964.2**	**42,102.2**
Defence Saving Certificates	13,807.7	-5,200.1	25,227.2	-4,528.1
Special Saving Certificates	69,862.9	-45,274.9	78,090.4	3,738.3
Regular Income Certificates	12,982.9	-11,440.0	14,548.0	-12,435.7
Bahbood Savings Certificates	61,044.0	50,121.9	73,298.0	38,793.7
Saving Accounts	25,019.4	-1,887.8	51,563.8	499.9
Special Saving Accounts	19,395.9	-911.5	24,159.8	3,191.8
Mahana Amdani Accounts	94.5	12.5	110.1	51.3
Pensioners' Benefit Accounts	18,760.0	13,997.4	23,571.3	9,403.5
Prize Bonds	65,258.9	3,312.2	66,391.3	4,620.4

[1] External Financing is expected to gain momentum in coming months of the fiscal year which is discussed in Money & Banking in detail)

Figure 5.5: Special Saving Certificates (Jul-Mar)



0.2 billion in corresponding period of FY06, when no PIB auctions were held.[3]

The recovery in the net receipts from NSS reflects both, a decline in the outflows, as well as high gross sales, (the later probably owes to an increase in offered yields), and possibly the return of institutional investment (as the government ended a ban on institution investment in NSS instrument in September 2006). Specifically the government mobilized Rs 42.1 billion through the NSS during Jul-Mar FY07, which is substantially higher than Rs 9.7 billion borrowed during Jul-Mar FY06 (see **Table 5.3**).

Net mobilization through *Special Savings Certificates* (SSCs) and *Special Savings Accounts* was Rs 6.9 billion during Jul-Mar FY07, against a net retirement of Rs 46.2 billion during the corresponding period last year (see **Figure 5.5**). Also while the *Bahbood Saving Certificates* (BSCs) and *Pensioners Benefit Accounts* (PBAs) together witnessed a substantial rise in gross inflows, the net inflows were relatively lower during the Jul-Mar FY07 compared to the corresponding period of FY06 as earlier issues of these instruments started maturing during FY07.

Banking System Borrowings

Bank borrowings (net) reached Rs 116.6 billion[4] during Jul-Mar FY07, which is significantly higher than the Rs 61.2 billion borrowed during Jul-Mar FY06[5]. Moreover, while the government borrowed essentially from the SBP during FY06, the FY07 borrowings included non-bank borrowings as well as government borrowings from commercial banks.

[2] Gross amount of PIBs issued during Jul-Mar FY07 is Rs 53.8 billion while after adjustment of repayments, net amount realized through PIBs remained Rs 28.9 billion. Out of this, Rs 15.9 billion is from non-bank and Rs 12.7 billion is from banks.
[3] FY06 witnessed only one PIB auction in May 2006
[4] This includes the impact of government deposits. Borrowing from banking system works-out to be at Rs 138.9 billion excluding the impact of government deposits.
[5] Jul-Apr 28 FY07 data show that borrowing from banking system reached Rs 170.6 billion.

Borrowings from the scheduled banks showed a substantial increase to reach Rs 83.5 billion during Jul-Mar FY07 against a net retirement of Rs 3.0 billion in the corresponding period of FY06 (see **Figure 5.6**). As a result, borrowings from the SBP dropped sharply to Rs 33.1 billion during Jul-Mar FY07 compared to Rs 64.2 billion during Jul-Mar FY06. A declining trend in borrowing from SBP is quite visible over the period (see **Figure 5.7**).

Figure 5.6: Composition of Scheduled Banks Borrowings (cumulative)

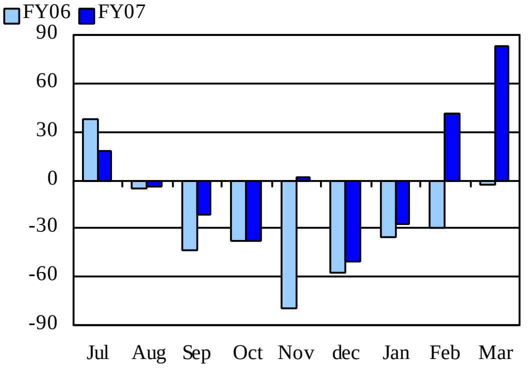
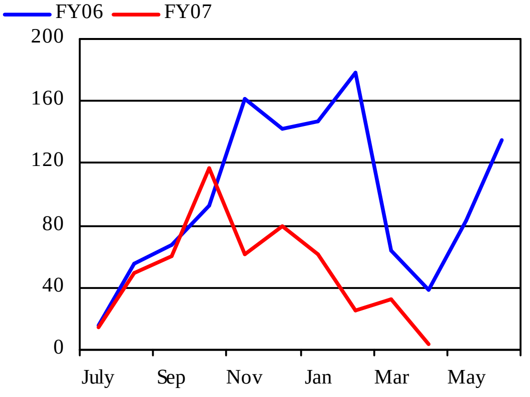


Figure 5.7: Government Borrowings from SBP



5.6 Domestic Debt Developments

The Jul-Mar FY07 period witnessed few important changes in domestic debt growth pattern. First, there was significantly higher growth in the stock of domestic debt instruments during Jul-Mar FY07 compared to the corresponding period last year. Second, the government borrowed a substantial amount from long-term debt instruments. Third, the ownership composition of short-term debt saw a shift, with a fall in SBP holding (see **Table 5.4**).

The higher growth in domestic debt seems to be the result of significantly lower availability of external sector financing, which forced the government to rely more on domestic sources. However,

Table 5.4: Key Developments of Domestic Debt

	Jul-Mar	
	FY06	**FY07**
Growth in domestic debt (percent)	5.4	9.3
Contribution of LT debt (billion Rs)	-12.0	66.5
Contribution of SBP debt holding (billion Rs)	119.6	22.4

following an expected increase in external receipts during the later months of FY07, the growth in domestic debt is expected to decelerate.

A break up of the debt instruments data reveals that the government issued PIBs of Rs 53.8 billion during Jul-Mar FY07 through three successful auctions, which was more than offset the impact of maturing PIB/FIB in the period (see **Table 5.5**).

Table 5.5: Rise in Domestic Debt

billion Rupees

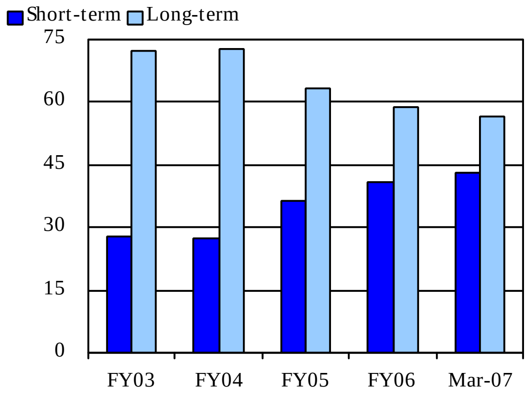
	Jul-Mar	
	FY06	**FY07**
PIB/FIB	-19.0	25.4
T-bills	128.1	146.3
NSS	5.6	37.5
Domestic Debt	116.1	212.8

In addition to the net increase in PIB stock, the stock of NSS instruments[6] also recorded an increase of Rs 42.1 billion during Jul-Mar FY07, in contrast to a rise of only Rs 9.7 billion during the same period of FY06. Not only the gross sales of NSS instruments during Jul-Mar FY07 recorded a YoY increase, but also the encashment witnessed a decline in this period.

The greater issuance of LT debt (PIBs and NSS instruments) meant that the growth in the stock of ST debt instrument fell marginally to 15.6 percent during Jul-Mar FY07 compared to 16.5 percent in the corresponding period of FY06, however, share of LT instruments in total domestic debt continued to decline (see **Figure 5.8**).

Another significant development was the change in the composition of T-bill holdings in the Jul-Mar periods of FY06 and FY07. In the former period, there was a net increase of Rs 8.5 billion in T-bills holding of scheduled banks and non-bank compared to a substantial net increase of Rs 123.9 billion during Jul-Mar FY07.
The SBP T-bill holding (on

Figure 5.8: Composition of Domestic Debt



[6] Including Prize Bonds

net basis) increased by Rs 119.6 billion during Jul-Mar FY06. In contrast, it increased by only Rs 22.4 billion during Jul-Mar FY07. However, the relatively larger maturities during Jul-Mar FY07 resulted in higher gross issuance of SBP T-bills for replenishment (see **Table 5.6**).

Table 5.6: Gross Payments and Receipts of T-bills (Jul-Mar)

billion Rupees

	FY06		FY07	
	Payments	**Receipts**	**Payments**	**Receipts**
MTBs	641.0	649.5	529.3	653.1
MRTBs*	729.9	849.5	879.2	901.6
Totals	1,370.9	1,499.0	1,408.5	1,554.7

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

While the growth of ST debt instrument declined to 15.6 percent during Jul-Mar FY07 from 16.4 percent recorded in Jul-Mar FY06, the servicing of its stock of over Rs 1 trillion is still vulnerable to upward movements in ST interest rates. It is probably desirable to increase reliance on LT debt instruments in order to reduce the risks associated with ST interest rate movements.