5 Fiscal Developments

5.1 Overview

An expansionary fiscal stance and relatively low non-tax receipts are clearly reflected in the downtrend in key fiscal indicators during Q1-FY07. The fiscal deficit as a percent of GDP (mp),[1] doubled from the previous year to 1.0 percent of GDP, while the primary balance[2] moved from a surplus of 0.1 percent of GDP to a deficit of 0.3 percent of GDP. The revenue balance fares a little better, recording a surplus of 0.1 percent of GDP during Q1-FY07, only a little lower than that in Q1-FY06. However, even this positive may be deceptive, given the large size of "unidentified" expenditures. If the latter are included in current expenditures, even the revenue surplus would slip into a significant deficit (see **Figure 5.1a**).

Figure 5.1: Fiscal Balance Indicators During Q1

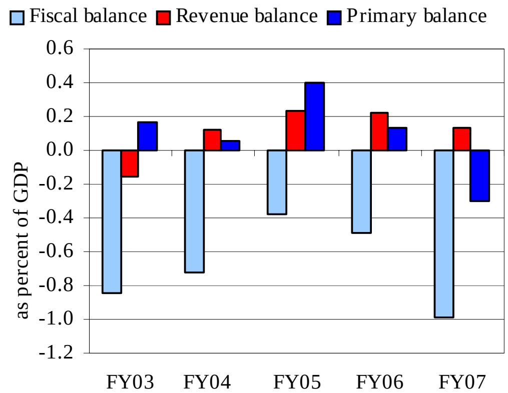
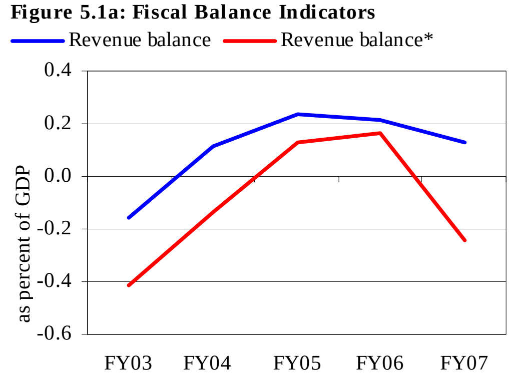


Figure 5.1a: Fiscal Balance Indicators



* Revenue balance after adding unidentified expenses

The Q1-FY07 fiscal deficit (as percent of GDP) is not yet inconsistent with meeting the annual target of 4.2 percent of GDP. For example, the Q1-FY03

[1] Figures for GDP (mp) for FY07 refer to estimated amount of Rs 8,808 billion as given in the Annual Plan 2006-2007.

[2] Primary deficit measures the effects of current discretionary policy by excluding interest payments from the conventional measure of the fiscal deficit. Generally, total interest payments are subtracted from total expenditure to calculate the primary balance, which indicates how the recent fiscal actions of the government affect the government's net debt and therefore is important in assessing the sustainability of the government deficit.

fiscal deficit had been 0.8 percent of GDP, but full year outcome was 3.7 percent of GDP. However, in that year the growth in CBR taxes had been exceptionally strong at 9.6 percent of GDP (a level achieved in FY97 but never since). The FY07 tax target is close to this level, at 9.5 percent of GDP, and attaining it will be important to meeting the overall fiscal deficit target for the year. Unfortunately, given the recent moderation in import growth, and the high dependence of tax receipts on import-based taxes, achievement of the CBR tax target may prove challenging.

Nonetheless, it is very important that the fiscal deficit target for FY07 is achieved, as it would send a strong signal of the government's commitment to fiscal

Table 5.1: Summary of Consolidated Public Finance During Q1

billion Rupees

						YoY change	
	FY03	**FY04**	**FY05**	**FY06**	**FY07**	**FY06**	**FY07**
Total revenue	153.5	165.6	202.2	236.5	255.7	17.0	8.1
Tax (Net)	115.6	119.7	142.5	164.8	191.6	15.6	16.2
Non-tax	38.0	45.8	59.7	71.7	64.1	20.1	-10.7
Total expenditure	194.5	206.5	227.1	274.3	342.4	20.8	24.8
Current	161.2	158.9	186.9	219.8	244.2	17.6	11.1
Development and net lending	21.1	33.1	33.4	50.6	65.2	51.3	28.8
Unidentified expenditure	12.3	14.5	6.8	3.9	33.0	-43.1	751.5
Budget deficit	-41.0	-40.9	-24.9	-37.7	-86.7	51.5	130.0
Financing	41.0	40.9	24.9	37.7	86.7	51.5	130.0
External	34.6	4.9	19.6	5.0	27.8	-74.3	453.2
Domestic	5.6	34.0	5.3	32.7	58.9	512.8	80.3
Bank	-14.1	9.9	-19.9	14.9	34.5	-174.7	132.4
Non-bank	19.7	24.1	19.1	14.3	24.4	-25.0	70.1
Privatization proceeds*	0.8	2.0	6.1	3.5	14.4	-42.8	313.0
As percent of GDP							
Total revenue	3.2	2.9	3.1	3.1	2.9	--	--
Tax (net)	2.4	2.1	2.2	2.1	2.2	--	--
Non-tax	0.8	0.8	0.9	0.9	0.7	--	--
Total expenditure	4.0	3.7	3.5	3.6	3.9	--	--
Current	3.3	2.8	2.8	2.8	2.8	--	--
Development and net lending	0.4	0.6	0.5	0.7	0.7	--	--
Unidentified expenditure	0.3	0.3	0.1	0.1	0.4	--	--
Budget deficit	-0.8	-0.7	-0.4	-0.5	-1.0	--	--
Financing	0.8	0.7	0.4	0.5	1.0	--	--
External	0.7	0.1	0.3	0.1	0.3	--	--
Domestic	0.1	0.6	0.1	0.4	0.7	--	--
Bank	-0.3	0.2	-0.3	0.2	0.4	--	--
Non-bank	0.4	0.4	0.3	0.2	0.3	--	--
Privatization proceeds	0.0	0.0	0.1	0.0	0.2	--	--

* Privatization proceeds are the part of non-bank financing from FY07

Source: Ministry of Finance

discipline and macroeconomic stability, particularly given the perception in some quarters that expenditure control may be difficult in an election year. This means that in case revenues prove to be below target, FY07 expenditures will need to be scaled accordingly. Such a clear demonstration of commitment to fiscal discipline would likely be crucial in reassuring international investors, thereby helping further improve the country's credit ratings, and help domestic companies access international capital markets on more favorable terms.

5.2 Revenues

Total revenue increased to Rs 255.7 billion, rising 8.1 percent YoY during Q1-FY07 as compared to the impressive growth of 17.0 percent in Q1-FY06. This deceleration is basically due to a dip in non-tax revenues that partially offset the impact of a small acceleration in the growth of tax revenues (see **Table 5.1**).

The acceleration in the growth of tax revenues largely owes to a 38.0 percent[3] increase in the direct tax collections by the CBR, which helped compensate for the weakness in indirect tax receipts and relatively low non-tax revenues. The decline in the latter stems from a steep fall in both, defence receipts (that plummeted from Rs 28.9 billion in Q1-FY06 to just Rs 0.6 billion in Q1-FY07), and profits from PTA (which dropped from Rs 10.2 billion to Rs 0.1 billion). The decline in both is consistent with budgetary expectations.

A significant change in public policy was witnessed when government decided that Petroleum Development Levy would not form part of its revenues from FY07, as this remained a major source of revenue for federal government previously. This levy was to be used only to subsidize the prices of petroleum products, but surprisingly, the revenue from this head (a sub-set of non-tax revenues) still stood at Rs 7.6 billion during Q1-FY07.

5.3 Expenditure

The consolidated public expenditure in the first quarter of FY07 jumped to Rs 342.4 billion, up by 24.8 percent YoY as compared to a rise of 20.8 percent YoY in Q1-FY06. Development expenditure in particular, grew by a welcome 28.8 percent YoY.

However, the classification of 0.4 percent of total Q1-FY07 expenditures in "unidentified expenditure" hampers a more meaningful analysis. To put this in perspective, a rise of 11.1 percent on current expenditure during Q1-FY07 seems quite reasonable, particularly if compared with the 17.6 percent growth seen in

[3] This growth is up till September 2007.

Q1-FY06 (see **Table 5.1**). However, if unidentified spending comprises current expenditures, this growth would jump to a disturbing 23.9 percent.

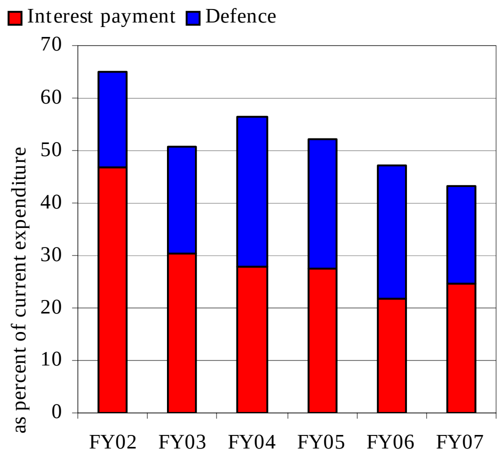


Figure 5.2: Major Components of Current Expenses

Within Q1-FY07 current expenditures, the impact of a strong increase in interest payments was mitigated by the decline in defense spending (see **Table 5.2**). As a result, the aggregate share of defence and interest payments in total current expenditure continued to drop, falling from 47.3 percent in Q1-FY06 to 43.4 percent in Q1-FY07, thus creating additional fiscal space for development spending (**Figure 5.2**). The increase in interest cost reversed a downtrend visible in the previous five years, and reflects both an increase in the absolute value of the debt stock, as well as rising interest rates.

A sharp increase of 28.8 percent in the development expenditure (net lending) is in line with the government's commitment to provide better infrastructure to the economy, and to reconstruct the areas hit by the October 2005 earthquake.[4] It is also noteworthy that of the development expenditure of Rs 67.5 billion, there was a net negative lending of Rs 2.3 billion from public sector.

Table 5.2: Composition of Current Expenditure During Q1

billion Rupees

				YoY change	
	FY05	**FY06**	**FY07**	**FY06**	**FY07**
Current expenditures	**186.9**	**219.8**	**244.2**	**17.6**	**11.1**
Of which					
Interest payments	51.5	48.0	60.3	-6.7	25.6
Domestic	42.4	39.8	49.1	-6.3	23.5
Foreign	9.0	8.2	11.2	-8.9	36.2
Defense	46.1	55.9	45.6	21.4	-18.5
Provincial	52.7	67.0	83.1	27.1	24.1

Source: Ministry of Finance

[4] While the development expenditure has been raised from 4.7 percent of GDP in FY06 to 4.9 percent of GDP in FY07, the figure for the latter year includes earthquake relief and reconstruction expenditure. On a comparable basis, excluding earthquake related spending the FY07 development expenditure dips to 4.4 percent GDP.

5.4 Financing

Financing requirements surged from Rs 37.7 billion in Q1-FY06 to Rs 86.7 billion during Q1-FY07. These requirements were largely met from financial resources generated domestically. However, external financing was also substantially higher than in the previous year (see **Table 5.3**).

Table 5.3: Financing of Budget Deficit During Q1

billion Rupees

			Percent share	
	FY06	FY07	FY06	FY07
Financing through	**37.7**	**86.7**	**100.0**	**100.0**
External resources (net)	5.0	27.8	13.3	32.1
Internal resources	32.7	58.9	86.7	67.9
Banking system	14.9	34.5	39.5	39.8
Non-bank	17.8	24.4	47.2	28.1
Privatization proceeds	3.5	14.4	9.3	16.6

Source: Ministry of Finance

Government raised Rs 34.4 billion through bank borrowing and Rs 24.4 billion from the non-bank to fill the budgetary gap. The bank borrowing was entirely from the SBP, as borrowings from commercial banks saw a net retirement (essentially reflecting the maturity of long-term paper, i.e., PIBs and FIBs). The share of non-bank borrowings through the National Savings Scheme (NSS) also declined, and investors' interest remained concentrated in a few schemes that offered preferential (higher) rates. Moreover, privatization proceeds of Rs 14.4 billion significantly contributed to non-bank financing of the fiscal deficit.

5.5 CBR Tax Collection

The overall CBR tax collection surpassed the target of Rs 236.2 billion by a margin of Rs 1.1 billion during Jul-Oct FY07 (see **Table 5.4**). However, this was possible only because considerably above-target direct tax receipts offset shortfalls in indirect tax receipts.

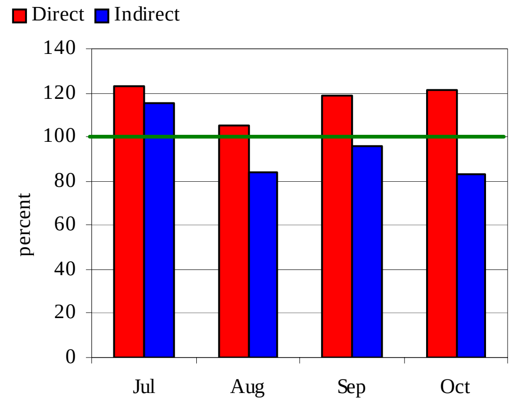
Table 5.4: CBR Tax Collection (Jul-Oct)

billion Rupees

	Targets FY07		Net Tax Collection			As % of target		YoY Change	
	Annual	Jul-Oct	FY05	FY06	FY07	Annual	Jul-Oct	FY06	FY07
Direct taxes	264.7	70.1	48.5	59.3	82.5	31.2	117.7	22.3	39.2
Indirect taxes	570.3	166.1	118.1	141.9	154.7	27.1	93.1	20.1	9
Sales tax	343.8	101.7	70.1	86.6	97.6	28.4	95.9	23.5	12.7
FED	69	19.8	15.5	16.9	19.5	28.2	98.3	8.9	15.3
Customs	157.5	44.6	32.6	38.5	37.7	23.9	84.5	18.2	-2.1
Total taxes	**835**	**236.2**	**166.6**	**201.2**	**237.3**	**28.4**	**100.4**	**20.8**	**17.9**

Source: Central Board of Revenue

Figure 5.3: Collection as Percent of Target



Direct taxes exceeded targets in each of the first four months of FY07 by significant margins, which compensated for the continuing below-target receipts on indirect taxes since August 2006. In particular, the collections from customs duty and federal excise duty fell short of the respective targets throughout Jul-Oct FY07 (see **Figure 5.3**).

The below target performance in sales tax and the customs duty receipts is mainly due to the deceleration in the growth of imports, that fell from 53.9 percent in Q1-FY06 to 7.7 percent in Q1-FY07. Not surprisingly, therefore the sales tax collections on imports for the period declined by 3 percent YoY, while customs duty collections fell by 2.1 percent.

Box 1: CBR Tax Performance and the Impact of Target Revision

During FY06 CBR tax collection marked an improvement in all heads except sales tax and the federal excise duty. The above-target collection in customs was noticeable (suggesting that the growth was driven by the upsurge in imports), while, sales tax collection fell short of the targets by Rs 2.1 billion (see **Table 1**).

However, the data received from CBR[1] shows that the modified budget targets have been revised *ex post facto* to show the outstanding performance of CBR to have an above target collection. Also the target of sales tax collection stands revised; the new target is set just below the achieved collection. These revised targets do not represent any indicator of performance.

Table 1: Revision of Targets by CBR During FY06

	Initial Targets	Revised Targets*	Ex post facto Revision	Collection
Direct taxes	214.0	217.6	215.0	225.0
Indirect taxes	476.0	492.5	475.0	488.5
Sales tax	276.5	296.7	282.5	294.8
Federal excise	59.5	58.8	57.5	55.3
Customs	140.0	137.0	135.0	138.4
Total	**690.0**	**710.1**	**690.0**	**713.4**

Source: Central Board of Revenue

* Source: Economic Survey 2005-06

Similarly, the government's hopes of increasing revenue from federal excise duty, through the new FY07 budgetary measures did not materialize, as key contributing industries either saw production decline (e.g., POL production that fell by 9.5 percent YoY) or saw growth deceleration (e.g., cement, natural gas).

On the other hand, there is significant increase of 17.9 percent in total tax collection YoY when compared with the actual collection in Q1-FY06 (see **Table 5.4**). Component-wise analysis shows that the 39.2 percent growth of direct taxes in this period helped increasing its share in total tax collection from 29.5 percent in Jul-Oct FY06 to 34.8 percent in Jul-Oct FY07, while lower growth of 9.0 percent in indirect taxes is worrisome factor if compared with the 14.2 percent estimated growth of nominal GDP set for the FY07.

Trends in the latest available information (upto October FY07) reveal that CBR has to make enormous efforts to meet the tax targets for the year in the light of slower activity in key manufacturing industries and a sharp deceleration in the growth of imports.

Refunds and Gross Collection

Gross collection increased by 19.4 percent during Jul-Oct FY07, to reach Rs 270.4 billion, as compared to the 15.4 percent growth in the corresponding period last year. However, while the refunds had declined by 14.8 percent in Jul-Oct FY06, these increased by 31.1 percent in Jul-Oct FY07. This rise is however due to the increased refund on domestic sales tax that rose from Rs 11.1 billion to Rs 15.3 billion in this period, leading to an increase of 1.1 percent in refunds to gross collection ratio.

5.6 Provincial Fiscal Operations

An improvement in the provincial public finance is visible during Q1-FY07 as the total revenue increased to Rs 98.7 billion compared to Rs 76.7 billion in Q1-FY06 with a YoY increase of 28.7 percent, while the growth in expenditure relatively slowed down during the quarter, exhibiting a prudent fiscal management.

Better provincial fiscal position stemmed from new formula of revenue sharing from the federal divisible pool of tax revenue (see **Box 2**) that has increased provincial share from 37.5 percent to 41.5 percent. As a result, federal tax assignments during Q1-FY07 rose by 42.3 percent. Under provincial tax heads, property tax dropped drastically from Rs 2.0 billion in Q1-FY06 to Rs 1.5 billion in Q1-FY07 with a decline of 24.6 percent, while this decline is offset by an increase in other revenue that increased from Rs 2.1 billion to Rs 3.5 billion. It is encouraging to note that the agriculture tax increased from Rs 0.09 billion to Rs

0.12 billion, while all the provinces made net repayment of loans to the federal government.

Table 5.5: Summary of Consolidated Provincial Finance During Q1
billion Rupees

						YoY Change	
	FY03	**FY04**	**FY05**	**FY06**	**FY07**	**FY06**	**FY07**
Total Revenue	**57.4**	**58.9**	**65.9**	**76.7**	98.7	16.3	28.7
Provincial share in Federal revenue	35.7	39.4	46.0	55.2	78.5	19.9	42.3
Provincial taxes	5.9	8.5	8.7	8.9	9.8	2.3	10.3
Provincial non-tax	3.9	5.7	5.1	5.7	4.9	11.7	-14.5
Federal Loans and transfers/grants	11.9	5.2	6.1	6.8	5.4	12.8	-20.7
Total expenditure	**59.3**	**59.1**	**70.1**	**90.4**	111.7	29.1	23.5
Current expenditure	52.2	48.9	59.2	72.6	88.2	22.7	21.4
Development expenditure	7.1	10.2	10.9	17.8	23.5	63.4	31.9
Overall balance	**-1.9**	**-0.3**	**-4.1**	**-13.8**	**-13.0**	**232.5**	**-5.7**
Financing	**2.9**	**3.4**	**-1.3**	**6.9**	**-6.9**		
Domestic	2.9	3.4	-1.3	6.9	-6.9		
Bank	2.9	3.4	-1.3	6.9	-6.9		

Source: Ministry of Finance

Table 5.6: Provincial Finance up to Q1
billion Rupees

	Punjab		Sindh		NWFP		Balochistan	
	FY06	**FY07**	**FY06**	**FY07**	**FY06**	**FY07**	**FY06**	**FY07**
Total Revenue	**35.7**	**45.5**	**23.4**	**31.8**	**9.4**	**12.5**	**8.2**	**8.9**
Provincial share in Federal revenue	26.5	37.2	17.3	26.2	6.4	8.7	5.0	6.4
Provincial taxes	5.0	5.2	3.1	3.9	0.6	0.6	0.2	0.2
Provincial non-tax	2.2	3.0	1.1	0.9	0.5	0.9	1.9	0.1
Total expenditure	**46.3**	**59.5**	**22.8**	**29.5**	**14.8**	**13.8**	**6.6**	**8.8**
Current expenditure	33.7	41.9	20.3	27.7	12.6	10.7	6.1	7.8
Development expenditure	12.6	17.6	2.5	1.8	2.2	3.1	0.5	1.0
Overall balance	**-10.6**	**-14.0**	**0.6**	**2.2**	**-5.4**	**-1.3**	**1.6**	**0.1**

Source: Ministry of Finance

A breakup of the provincial public statistics shows that overall balance deteriorated in case of the Punjab and Balochistan, while Sindh and NWFP saw an improvement (see **Table 5.6**); this improvement is mainly due to the rise in provincial revenue receipts. However, looking at the deterioration in fiscal balance of Balochistan, it is worrisome to note that Balochistan is persistently breeching its OD limits[5] that may be alarming in the next quarters. The premature retirement of expensive Cash Development loans not only impacted the interest

[5] Balochistan persistently breeching its OD limits, and by the end of Q1-FY07 the outstanding position of Balochistan stood at Rs 8.6 billion against the OD limit of Rs 1.7 billion.

payments of the provinces but also helped in creating more fiscal space for development projects.

Box 2: Revenue Sharing

The National Finance Commission (NFC) Award is a mechanism for the distribution of financial resources among the federation and the provinces (Punjab, NWFP, Sindh and Balochistan) of Pakistan by the federal government on annual basis. Since the Constitution governs the relationship between the federation and provinces with respect to the distribution of a divisible pool of revenue, therefore, after every 5 years the President of Pakistan forms a National Finance Commission (NFC) which consists of finance ministers of the federal and provincial governments and other appointees by the President.

Main objectives of the commissions are:

- The distribution of net proceeds of the taxes between the federation and provinces
- Making of grants-in-aid by the federal government to provincial governments
- Payment of royalties on crude oil and of surcharge on natural gas
- Distribution of share of taxes between the federal government and provincial governments

The last NFC Award announced in 1996 went into effect in July 1997 for a 5 years time span. It is still in force despite expiration of the specific period because consensus could not be created among all the concerned parties over the proposed formula. According to the Constitution of Pakistan, the President has powers to amend or modify the distribution of revenues. Whereas NFC could not submit its recommendations with regard to distribution, the President promulgated “Distribution of Revenues and Grant-in-Aid (amendment) Order 2006” effective from July 1, 2006.

Under this Order, the percentage share of the provinces from the net proceeds of taxes and duties in each year shall be as under:-

2006-07	41.50%
2007-08	42.50%
2008-09	43.75%
2009-10	45.00%
2010-11 and onward	46.25%

Allocation of shares to the Provincial Governments: Out of the sum assigned to the provincial governments, an amount equal to the net proceeds of 1/6th of Sales Tax shall be distributed amongst the provinces at the following ratio and the provincial governments shall further transfer the whole of such amounts to the district governments and cantonment boards without retaining any part of this amount:-

The Punjab	50.00%
Sindh	34.85%
The NWFP	9.93%
Balochistan	5.22%
Total	**100.00%**

The balance shall be distributed amongst the provinces on the basis of their respective population in the percentage specified against each:-

The Punjab	57.36%
Sindh	23.71%

The NWFP	13.82%
Balochistan	5.11%
Total	**100.00%**

Grants-in-Aid to the Provinces: Rs 27.75 billion shall be charged upon the Federal Consolidated Fund each year as Grants-in-Aid of the revenues to be distributed amongst the provinces according to following shares:

The Punjab	11.00%
Sindh	21.00%
The NWFP	35.00%
Balochistan	33.00%
Total	**100.00%**

The Grants-in-Aid will be increased annually in line with the growth of net proceeds of divisible taxes for each year. However, the provinces had demanded that the federal government increase the provincial share of the Federal Divisible Pool (FDP) to 50 percent, in addition to special grants and subvention pool. According to federal budget 2006-07, the royalty on crude oil & development surcharge on natural gas after deducting 2 percent collection charges is transferred to the provinces on the basis of well head production. The royalty and excise duty on natural gas after deducting 2 percent collection charges is also transferred to the provinces in accordance with article 161(1) of the Constitution. The GST on services (provincial) is also transferred to the provinces after deducting 2 percent collection charges.