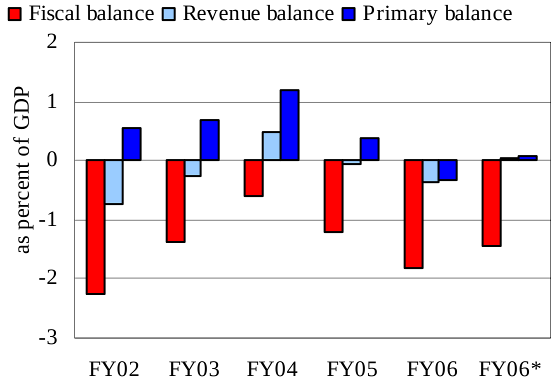
5 Fiscal Developments

5.1 Overview

Figure 5.1: Balance Indicators (Jul-Dec)



* Adjusted for the earthquake expenditure of Rs 30 billion

The government's fiscal position witnessed a moderate deterioration during H1-FY06 despite recording the strongest growth in tax revenues in recent years. Not only did the CBR surpass its tax collection target for the period by 4.7 percent, POL receipts and non-tax revenues also remained above budgetary expectations. Unfortunately, the impact of these gains was offset by the rising expenditures, and therefore key fiscal indicators all recorded deterioration during the first half; alongside the decline in fiscal and revenue balances, the primary balance also slipped into deficit after recorded surpluses over the years (see **Figure 5.1**).

The weakness in the fiscal indicators latter was primarily due to the spending required for relief and rehabilitation efforts for the earthquake struck regions of the country. However, this increased spending does not explain all of the deterioration; the Ministry of Finance has put the earthquake-related increase in spending at Rs 30 billion, and even after adjusting for this amount, the fiscal indicators for H1-FY06 continue to depict a weakening *trend*, relative to corresponding periods of the preceding two years.

Going forward, not only does the government need to maintain low fiscal deficits, these should primarily be caused by developmental rather than current expenditure. While development spending generates economic activity to pay off the debt, current spending only adds to the debt burden. Moreover, the mode of financing the fiscal deficit is also important. Borrowings from domestic sources other than SBP simply result in a shift of demand from the private sector to the government, but borrowings from SBP are more inflationary as they add to aggregate demand, and therefore financing of the deficit should be through a healthy mix of bank and non-bank borrowings. It should be recalled that the large

Rs 178.2 billion increase in budgetary borrowing from SBP during July-Feb FY06 was an important driver of monetary expansion in the period. A part of the government's greater reliance on SBP borrowings was driven by weak non-bank receipts, but another contribution was also due to the non-issuance of long-term treasury bonds; almost half of the Rs 31.0 billion net retirement of government borrowings from scheduled banks was due to maturities of these instruments.

Some key risks in the fiscal management include:

- The high dependence on import-based taxes, accounting for 48.0 percent of the share in collections. Receipts could therefore slow if, as expected, import growth falls back to historical norms in future periods.
- Potentially volatile non-tax revenues.

Thus, there is clear need for further tax effort to raise the tax-GDP ratio substantially over the next few years. In this context, the reported plan of the CBR to seek a one percentage point increase in the tax-GDP ratio in the next five years needs to be vigorously implemented. Particular attention needs to be given to the broad-basing of the tax net and improving collections from under-taxed areas of the economy such as agriculture, the services sectors, and equity markets.

5.2 Revenues

The growth in total revenues accelerated during H1-FY06, with both tax collections and non-tax receipts contributing to the improvement. Given that the larger part of annual tax collections have traditional been recorded in the second half of the fiscal year, it seems likely that aggregate FY06 revenues will exceed the Rs 990.3 billion budgetary target.

The improvement in the growth of tax revenues during H1-FY06 was due to above target CBR receipts, as well as a substantial improvement in surcharges. CBR tax receipts grew 21.6 percent during the period, accounting for 64.9 percent of the total revenues (see **Table 5.1**). However, the acceleration in the revenue growth was mainly due to the recovery in the Petroleum Development Levy (PDL) [1]which accounts for the bulk of the surcharge collections (see **Table 5.2**). PDL receipts had declined sharply in FY05 as increases in domestic oil prices failed to keep pace with the rise in international prices, and the subsequent partial recovery in these collections during FY06 reflects the increase in domestic prices as well as a decline in international prices. The continuation of the FY06 recovery

[1] The PDL is a tax, levied on key fuels, the value of which essentially reflects the difference between the cost of these products (including other taxes and distribution costs etc.) and the domestic sales price.

Table 5.1:Consolidated Fiscal Operations (Jul-Dec)

billion Rs

						YoY change	
Head	**FY02**	**FY03**	**FY04**	**FY05**	**FY06**	**FY05**	**FY06**
Revenues	**263.9**	**332.9**	**379.1**	**423.8**	**497.8**	**11.8**	**17.5**
Tax Revenue	209.0	253.2	277.7	298.2	362.5	7.4	21.6
Non-Tax Revenue	54.9	79.7	101.4	125.6	135.3	23.9	7.8
Expenditure	**363.8**	**398.6**	**412.8**	**503.3**	**634.5**	**21.9**	**26.1**
Current	296.7	345.1	352.5	427.5	525.3	21.3	22.9
Development	50.9	51.5	56.8	81.6	128.3	43.7	57.2
Net Lending to PSEs	6.8	2.7	7.0	4.7	-0.4	-32.9	-108.9
Un identified	9.4	-0.8	-3.4	-10.4	-18.6	205.9	79.3
Fiscal Balance	**-99.9**	**-65.7**	**-33.7**	**-79.6**	**-136.7**	**136.0**	**71.8**
As percent of GDP*							
Revenues	6.0	6.9	6.9	6.5	6.7	-	-
Tax Revenue	4.7	5.2	5.0	4.6	4.9	-	-
Non-Tax Revenue	1.2	1.7	1.8	1.9	1.8	-	-
Expenditure	8.3	8.3	7.5	7.7	8.5	-	-
Current	6.7	7.2	6.4	6.5	7.0	-	-
Development	1.2	1.1	1.0	1.2	1.7	-	-
Net Lending to PSEs	0.2	0.1	0.1	0.1	0.0	-	-
Un identified	0.2	0.0	-0.1	-0.2	-0.2	-	-

Source: Ministry of Finance

* GDP Base 2000

as well as an expected rise in the gas development surcharge from January 2006 onwards[2] suggests that the aggregate receipts of surcharges during FY06 will remain substantially above the annual target.

Finally, the improvement in the contribution of the non-tax revenues was also substantial. This was mainly on account of *logistic support* receipts that rose to Rs. 46.5 billion against the budgetary projection of Rs 12.1 billion in FY06. Inflows under other major revenue heads such as interest income and dividend payments declined as compared to H1-FY05.

[2] Oil and Gas Regulatory Authority, Ordinance, 2002 and Natural gas tariff rules, 2002, Decision November 21, 2005 & November 18, 2005, that shows an increase in gas tariffs along with an overall increase of 15.5 percent in gas prices effective from Jan 01, 2006.

5.3 Expenditure

H1-FY06 recorded an exceptional expenditure growth of 26.1 percent as compared to the 21.9 percent growth during H1-FY05. However, this higher growth is not too disquieting in as much as it came from the 57.2 percent growth in development expenditure during the period (see **Table 5.1**), and that a part of rise in the current spending probably pertained to earthquake relief efforts and therefore does not reflect a loosening of fiscal discipline.

Table 5.2: Surcharges During H1
billion Rs

				YoY change	
	FY04	**FY05**	**FY06**	**FY05**	**FY06**
Surcharges	33.2	13.8	19.2	-58.5	39.7
Gas	8.9	9.0	9.9	1.6	9.4
Petroleum	24.3	4.7	9.4	-80.5	97.6

Source: Ministry of Finance

Table 5.3: Composition of Current Expenditure (Jul-Dec)
billion Rs

				YoY change	
	FY04	**FY05**	**FY06**	**FY05**	**FY06**
Current Expenditures	**352.5**	**427.5**	**525.3**	**21.3**	**22.9**
Of which					
Interest Payments	98.8	104.2	111.4	5.5	6.9
Domestic	76.3	82.9	89.776	8.6	8.3
Foreign	22.5	21.3	21.635	-5.2	1.4
Defence	87.3	101.1	119.05	15.8	17.8
Development and Net Lending	**63.7**	**86.3**	**127.8**	**35.4**	**48.2**
PSDP	56.8	81.6	128.3	43.7	57.2
Net Lending	7.0	4.7	-0.4	-32.6	-108.9

Source: Ministry of Finance

The composition of current expenditure reveals that neither the interest payments nor the defense posed an issue for the government during H1-FY06 (see **Table 5.3**). The interest payment stood at 111.4 billion, up only 6.9 percent YoY as compared to the 5.5 percent YoY increase seen in H1-FY05. While defense expenditure accelerated to 17.8 percent YoY as compared to the 15.8 percent YoY growth during H1-FY05, the major contribution to this probably reflects the fiscal impact of the Army's substantial role in relief, [3] reconstruction and rehabilitation activities in the earthquake-affected areas.

[3] Grant payments during H1-FY06, even crossed the full year budgetary target of Rs. 38.4 billion by a wide margin (61.1 percent).

A very encouraging development in H1-FY06 is the strength of the development expenditures; these rose by 57.2 percent YoY even over the exceptional 43.7 percent YoY growth in the corresponding period last year. Finally, for the first time in the last five years, lending to Public Sector Enterprises (PSEs) shows a net retirement, falling by Rs 0.42 billion during H1-FY06.

5.4 Financing

In contrast to the preceding year, the major part of the H1-FY06 financing requirement was met through the internal resources, and particularly the banking sector (see **Table 5.4**). In fact, the net borrowings of Rs 84.9 billion are very close to the Rs 88 billion annual targets. Moreover, all of the growth in the government borrowings has been through SBP; borrowings from scheduled banks witnessed a net retirement of Rs 57.5 billion, even as those from the SBP rose by Rs 142.2 billion.

Table 5.4: Financing of Budget Deficit (Jul-Dec)

billion Rs

			Percent share	
	FY05	**FY06**	**FY05**	**FY06**
Financing through	**79.6**	**136.7**	**100.0**	**100.0**
External resources (net)	40.4	39.8	50.7	29.1
Internal resources	39.2	96.9	49.3	70.9
Domestic non-bank	15.7	-6.7	19.7	-4.9
Banking system	16.8	84.9	21.1	62.1
Privatization proceeds	6.8	18.7	8.5	13.7

Source: Ministry of Finance

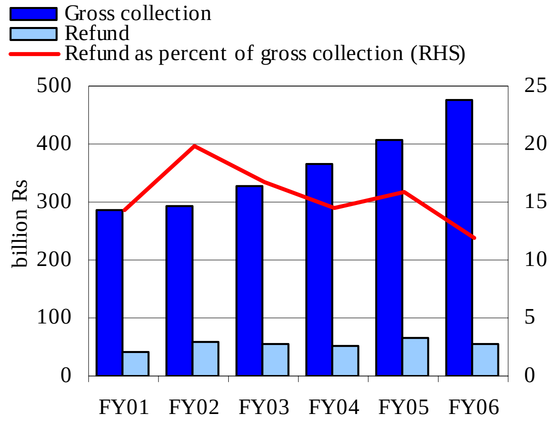
The higher budgetary borrowing from the central bank is certainly not desirable, but it remains to be seen to what extent the higher borrowings reflect lags in external funding receipts. If, as expected, external receipts surge in the second half of the fiscal year, and significant planned privatization/disinvestment transactions are completed, the monetization of the deficit through SBP debt could be significantly reduced.

However, at least a part of the government's rising dependence on borrowings from the banking system is due to the failure to issue long-term bonds (PIBs). The absence of PIB issues probably reflects a reluctance to raise the cost of funding the deficit, particularly as the yields on these instruments act as a benchmark for returns on the government's National Savings Schemes. The last 10-year PIB issue was at 8 percent, and is quite likely that any current issue would be at significantly higher yields, with a consequent impact on NSS returns.

Indeed, failure to raise return on NSS instruments, together with the prohibition of sales from banks, has probably been an important reason for the government's failure to raise non-bank borrowings. The government could only generate a meager amount of Rs 3.6 billion from the National Savings Scheme, during H1-

FY06, and since the Public debt account stood at Rs -18.0 billion, non-bank borrowings saw a net retirement of Rs 6.7 billion during H1-FY06.

Figure 5.2: Gross Collection and Refund upto Feb



In contrast to non-bank borrowings, privatization proceeds rose sharply, contributing approximately Rs 18.7 billion during H1-FY06 as against the annual budget of Rs 20 billion. These receipts are expected to rise further due to forthcoming privatization transactions[4] in the latter half of FY06 (SSGC, Pakistan Steel, a further 5 percent public offering of the UBL shares, and the delayed PTCL receipts).

Table 5.5: Tax Collection

billion Rs

Head	Target	Net tax collection up to Feb			Percent of target	
	FY06	Feb	FY05	FY06	Annual	Feb
Direct taxes	214.0	115.6	96.3	124.9	58.4	108.0
Indirect taxes	476.0	293.0	244.7	294.4	61.9	100.5
Sales tax	276.5	172.0	145.2	178.5	64.6	103.8
Federal excise duty	59.5	36.1	31.5	34.4	57.8	95.2
Customs	140.0	84.9	68.0	81.5	58.2	96.0
Total	690.0	408.6	341.0	419.3	60.8	102.6

Source: Central Board of Revenue

5.5 CBR Tax Collection[5]

The performance of CBR remained up to the mark during the first eight months of FY06, as it collected Rs 419.3 billion, up 102.6 percent of the Jul-Feb target. Except for federal excise duty and customs duty, all the taxes surpassed their revenue targets for the Jul-Feb FY06 period (see **Table 5.5**). This implies that CBR will probably comfortably meet the revenue budget target of Rs 690 billion

[4] According to the Economic Outlook document of the MoF, privatization receipts for FY06 are projected to be around Rs 60 billion.

[5] Jul-Feb data is used in overall CBR tax analysis, while due to unavailability of the breakup on various taxes, the detailed analysis is limited to HI-FY06 collection.

for FY06, though collections of custom duty and federal excise duty may fall short of target.

Table 5.6: Major Components of Income Tax (Jul-Dec)
billion Rs

	FY01	FY02	FY03	FY04	FY05	FY06	YoY change FY05	YoY change FY06
Voluntary payments	16.6	26.7	24.2	26.5	35.9	48.8	35.4	35.9
Collection on demand	3.5	4.7	4.5	5.6	3.7	5.6	-33.5	50.1
Withholding taxes	36.8	35.1	37.0	42.2	46.8	60.3	10.9	28.9
Others	5.9	3.1	2.5	0.6	0.4	0.1	-30.3	-75.0
Gross total	62.8	69.6	68.3	74.9	86.9	114.7	15.9	32.1
Refund/rebate	4.5	6.9	6.6	4.9	10.5	15.3	113.4	45.9
Total (net)	58.3	62.8	61.7	70.0	76.4	99.5	9.1	30.2

Source: CBR

5.5.1 Gross and Refund Collection

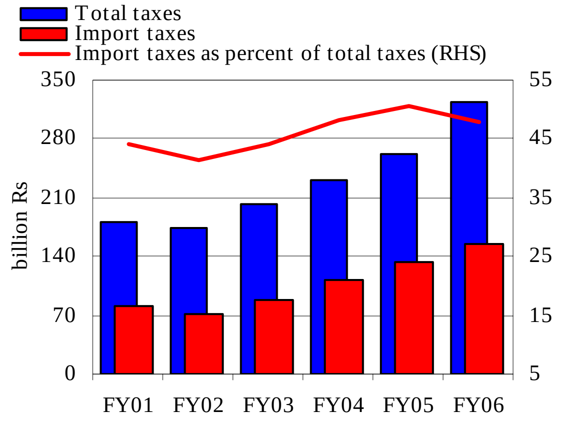
Gross collection during Jul-Feb FY06 rose to Rs 476.0 billion as compared to Rs 405.3 billion during Jul-Feb FY05, while the refunds declined to Rs 56.7 billion as compared to Rs 64.3 billion during the corresponding period last year. The 11.8 percent YoY decline in refunds probably reflects the zero rating on same key export products, particularly textiles, that was introduced in FY05.

5.5.2 Direct Taxes

The direct tax collection stood at Rs 104.2 billion during H1-FY06 as compared to Rs 78.4 billion in the corresponding period of FY05 with an impressive growth rate of 33 percent, of which income tax contributed Rs 99.5 billion (see **Table 5.6**).

The composition of income tax demonstrates a big recovery in *collections on demand* which had deteriorated during FY05. However, this improvement is mainly on account of *arrear demand* reflecting a strong arrear collection drive by the CBR; the receipts under current demand

Figure 5.3: Import Taxes



remained almost unchanged from the corresponding period of the preceding year. More encouraging is the 35.9 percent YoY rise in *voluntary* payments that corresponding to an increase in the filing of tax returns in December 2005. Other major heads contributing to the rise in income taxes were imports (Rs 13.2 billion, up 22percent YoY), contracts (Rs 18.0 billion, up 30 percent YoY), and salaries (Rs 6.4 billion, up 11 percent YoY). Apart form this strong tax collection, the refunds of Rs 15.3 billion during H1-FY06 also showed a YoY growth of 45.9 percent.

5.5.3 Indirect Taxes

Indirect taxes contributed Rs 218.9 billion to the over all tax collection effort during the first six months of FY06, registering a 18.9 percent increase over the same period last year. Almost half of the tax revenue is generated from the import-related taxes - Rs 155.4 billion in the total CBR tax collection of Rs 323.7 billion in H1-FY06 (see **Figure 5.3**). The impressive growth in import related taxes is in line with the 53.1 percent growth in imports during the half year.

Sales Tax

With a net collection of Rs 132.1 billion, sales tax surpassed the overall target of Rs 126.7 billion; however, the domestic sales tax collection of Rs 68.5 billion fell short of its gross target of Rs 70.5 billion. Sales tax on import-related products reached at Rs 80.7 billion with a growth of 16.5 percent over the year. Accordingly, almost 61 percent of the sales tax revenue came from import-related sales taxes.

Federal Excise Duty

Federal excise duty, a dying tax, could not meet its target of Rs 26.6 billion and recorded collection of Rs 25.3 billion during H1-FY06. Just six products accounted for almost 95 percent of the total FED collection (see **Table 5.7**).

Customs Duty

Customs duty receipts remained up to the mark with the collection of Rs 61.5 billion against the target of Rs 61.4 billion for H1-FY06, and up approximately 20 percent YoY. Major revenue spinner remained vehicles (Rs 15.7 billion), POL (Rs 6.9 billion), and mechanical appliances (Rs 5.6 billion).

Table 5.7: Collection from Federal Excise Duty During H1
billion Rs

	FY04	FY05	FY06*	Share FY05	Share FY06
Locally produced goods					
Major commodities					
Beverages	1.06	1.23	1.2	5.6	5.5
Beverages concentrate	0.50	0.86	0.9	3.9	3.9
Cigarettes & tobacco	7.51	9.04	9.0	41.3	40.7
Cement	4.32	5.19	5.2	23.7	23.4
Natural gasses	2.32	2.66	2.7	12.1	12.0
POL products	1.63	2.05	2.1	9.4	9.3
Sub total	*17.34*	*21.03*	*21.0*	*96.1*	*94.8*
Miscellaneous	1.08	0.86	1.2	3.9	5.2
Gross total	*18.42*	*21.89*	***22.2***	*100.0*	*100.0*
Refund and rebate	*0.06*	*0.01*	***0.0***	*0.1*	*0.1*
FED from domestic goods	**18.36**	**21.88**	**22.2**	**99.9**	**99.9**
FED from imported goods	**0.63**	**1.38**	**1.4**	**-**	**-**
Total gross (imported + domestic)	**19.05**	**23.27**	**23.6**	**-**	**-**
Grand total (net)	**18.99**	**23.26**	**23.6**	**-**	**-**

*Provisional
Source: CBR