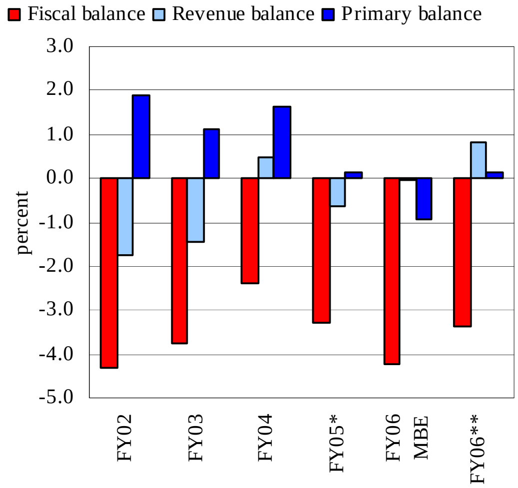
5 Fiscal developments

5.1 Overview

Figure 5.1: Balance Indicators (Annual)



* Adjusted for statistical discripancy of Rs 78.5 billion
** Adjusted for "Earthquake" expenditure

Fiscal indicators computed using the Revised budgetary Estimates (MBE) depict a weakening for the second successive year in FY06; not only has the fiscal deficit widened, the revenue and primary balances have also declined visibly. However, a significant part of the FY06 deterioration in fiscal indicators reflects the impact of the earthquake relief and rehabilitation expenditures. Adjusting for these, the fiscal picture improves somewhat, with the re-emergence of primary and revenue surpluses, but the fiscal deficit continues to show a marginal weakening (see **Figure 5.1**). Moreover, it is encouraging to note that the increase in deficit stemmed substantially from a strong growth in development spending rather than a surge in current expenditure.

The FY06 tax data also reveals continued structural weaknesses in the tax regime, as evident in the continued low tax-to-GDP ratio, the heavy reliance on import-related taxes and potentially volatile non-tax revenues, and inability to broaden the tax base. The risk to the country's fiscal profile from these weaknesses is compounded by the gradual weakening, evident in expenditure management.

The FY07 attempts to address some of the weaknesses, with measures to expand the tax net and thereby the dismal tax-to-GDP ratio. The CBR has been given a target of Rs 835 billion for FY07, which is Rs 131 billion (or 18.6 percent) higher than the revised target of Rs 704 billion for FY06. Moreover, the government appears to be seeking to lower its reliance petroleum surcharges (and cushion the domestic economy partially from a rise in international oil prices). Unfortunately, the continued requirements for earthquake rehabilitation expenditure, and the massive increase in PSDP mean that the budgetary deficit will remain high at 4.2 percent of GDP in FY07.

In this context, it is also important that the government lays before the National Assembly the fiscal policy statement in compliance with section 6 of the Fiscal Responsibility and Debt Limitation Act, 2005. Such statements would have helped explaining the government's position on how emerging fiscal indicators accord with the principles of sound fiscal and debt management.

5.2 Revenues

Total revenue is estimated to reach at Rs 1095.6 billion during FY06, up 21.7 percent YoY as compared to the growth of 13.8 percent YoY in FY05. The major contribution in this relatively high revenue growth was equally strong from both tax revenues and non-tax revenues (see **Table 5.1**).

Table 5.1: Summary of Public Finance

billion Rupees

		FY02	FY03	FY04	FY05	FY06	YoY Change	
					R.E	MBE	FY05	FY06
1	Revenue Receipts (a+b)	624.1	720.8	791.1	900.0	1095.6	13.8	21.7
	a) Tax Revenue	478.1	555.8	608.4	659.4	805.6	8.4	22.2
	b) Non-Tax Receipts	146.0	165.0	182.7	240.7	290.0	31.7	20.5
2	Total Expenditure (a+b+c)	826.3	898.2	955.8	1117.0	1423.0	16.9	27.4
	a) Current	700.2	791.7	774.9	864.6	1097.9	11.6	27.0
	b) Development	126.3	129.2	160.5	227.7	326.7	41.9	43.5
	c) Net Lending to PSEs etc.	-0.2	-22.7	20.4	24.8	-1.6	21.4	-106.5
	d) Statistical discrepancy	-11.7	3.2		78.5			-100.0
3	Revenue Surplus/Deficit (1-2.a)	-76.1	-70.9	16.2	35.4	-2.3	118.8	-106.5
4	Overall Deficit (1-2)	-190.5	-180.6	-164.7	-217.0	-327.4	31.8	50.8
As per cent of GDP (mp)								
1	Revenue Receipts (a+b)	14.2	14.9	14.0	13.7	14.2	…	…
	a) Tax Revenue	10.9	11.5	10.8	10.0	10.4	…	…
	b) Non-Tax Receipts	3.3	3.4	3.2	3.7	3.8	…	…
2	Total Expenditure (a+b)	18.8	18.6	16.9	17.0	18.4	…	…
	a) Current	15.9	16.4	13.7	13.1	14.2	…	…
	b) Development	2.9	2.7	2.8	3.5	4.2	…	…
	c) Net Lending to PSEc etc.	0.0	-0.5	0.4	0.4	0.0	…	…
3	Revenue Surplus/Deficit (1-2.a)	-1.7	-1.5	0.3	0.5	0.0	…	…
4	Overall Deficit (1-2)	-4.3	-3.7	-2.9	-3.3	-4.2	…	…

Source: Up to FY04 Economic Survey 2004-05, for FY05 and FY06 Economic Survey 2005-06 due to inconsistent data series

* Adjusted the statistical discrepancy of Rs 78.5 billion for the purpose of analysis

The 22.2 percent rise in tax revenues is primarily realized through the taxes on goods and services (sales tax, excise, and surcharges) that rose to Rs 391 billion from Rs 323.5 billion in FY05. Though excise duty (FED) collection grew slowly (1.5 percent), the high growth in sales tax (up 26.0 percent) and surcharges (up 19.9 percent) contributed to the sharp rise in tax revenues. It is notable, that revenue from surcharges is likely to be higher than the modified budget estimates of Rs 32.6 billion, because of exceptionally high revenue generation from PDL in the third quarter as the Government achieved its PDL revenue target of Rs 15.9 billion full year FY06 by the third quarter, while the gas development surcharge provided Rs 15.7 billion accounting for 94.5 percent of the annual modified budgetary target.

Non-tax revenue is also estimated at Rs 290 billion, of which Rs. 247.2 billion is from federal resources while the rest from the provincial resources. The analysis in this respected is limited due to data constraints, but quarterly data indicates that the significant contributor to the 31.7 percent rise in the non-tax revenues are logistic supports payments, SBP profits and dividend receipts.

5.3 Expenditure

Total expenditure in FY06 is estimated at Rs 1423.0 billion, up 27.4 percent YoY (see **Table 5.1**), led mainly by a 43.5 growth in development expenditure.

Almost 55 percent of the total expenditure was accounted for by interest payments (19.2 percent), defense, (16.9 percent), current subsidies and general administration (17.6 percent) (see **Table 5.2**). However, encouragingly, the growth in both the interest payments and defense expenditures was visibly lower than in the previous year (the spending has not increased, in real terms). The deceleration in the growth of interest payments was essentially due to declines in foreign debt payments and provincial interest payments.

Table 5.2: Composition of Current Expenditure
billion Rupees

			Growth	
	FY05	**FY06**	**FY05**	**FY06**
Current Expenditures	943.1	1097.9	21.7	16.4
Of which				
Interest Payments	257.2	273.1	11.8	6.2
Federal	222.7	241.2	13.5	8.3
Domestic	180.1	200.6	16.3	11.4
Foreign	42.6	40.6	2.9	-4.7
Provincial	34.6	31.9	1.9	-7.7
Defense	211.7	241.1	17.4	13.9
General Administration	130.5	157.4	8.8	20.5
Current Subsidies	66.7	92.7	-1.8	39.0
Development and Net Lending	252.5	325.1	39.6	28.8
PSDP	227.7	326.7	41.9	43.5
Net Lending	24.8	-1.6	21.4	-106.5

Source: Economic Survey 2005-06

However, substantial growth is visible in current subsidies and general administration.

Development expenditure increased to Rs 326.7 billion with a YoY increase of 43.5 percent. Of the total PSDP outlay, the federal government expenditure is estimated at Rs 92.9 billion on infrastructure development while 85.3 billion is on social development. On the other hand, quite surprisingly, the net lending to PSE is estimated to be –1.6 billion, which appears inconsistent with the fiscal data for July-Mar FY06, in which all the PSEs except Pak Steel, declared losses for the period.

5.4 Financing

The overall budgetary deficit of Rs 327.4 billion during FY06 is estimated to be financed by Rs 118.3 billion from external resources while the rest is estimated to be financed from the internal resources (see **Table 5.3**).

Table 5.3: Financing of Budget Deficit

billion Rupees

	FY05	FY06
Total financing	217	327.4
External resources (net)	120.4	118.3
Internal resources	96.6	209.1
Banking system	60.2	96.7
Domestic non-bank	8.1	22.4
Privatization proceeds	28.3	90.0

Source: Ministry of Finance

Of the internal resources, the government is likely to meet the financing gap of Rs 96.7 billion from the banking sector, Rs 22.4 billion from the non-bank, while the Rs 90 billion from the privatization proceeds of which Rs 55.2 billon has already been realized by end Q3-FY06.

5.5 CBR Tax Collection

Aided by strong growth in economic activities and an exceptional rise in imports, the CBR tax collections have been substantially above the original targets for FY06. The growth in the CBR net tax receipts July-May FY06 have averaged 22 percent YoY, and are likely to comfortably exceed the original Rs 690 billion annual target. The growth in CBR revenues is quite encouraging, as it is significantly higher than the 13.6 percent growth in the same period of FY05, and given that the ratio of CBR taxes to GDP has improved in FY06.

If this trend persists in FY07 onwards, it will be a good omen for the public finances as it would help increase the country's dismal tax-to-GDP ratio and reverse the decline in the elasticity estimates witnessed in FY05.

The analysis of monthly tax collections show that except for the months of Nov, Jan, Feb and Apr, CBR met all its monthly targets set for the year (see **Figure 5.2**). In terms of individual taxes, the direct taxes and sales-tax surpassed their targets, while the collection on account of Federal Excise Duty (FED) and Customs remained quite below the target (see **Table 5.4**). Further, customs and federal excise duty lagged behind their targets in seven months up to May in the current fiscal year.

Figure 5.2: Monthly Tax Collection

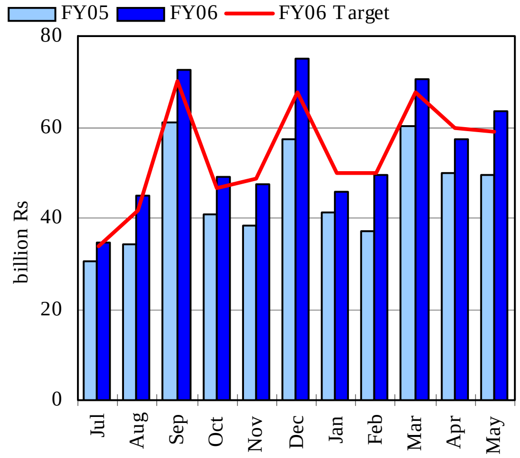


Table 5.4:Tax Collection up till May

billion Rupees

Head	Target		Net tax collection up to May		Percent of target		Growth	
	FY06	**May**	**FY05**	**FY06**	**Annual**	**May**	**FY05**	**FY06**
Direct taxes	214.0	169.8	146.4	181.9	85.0	107.2	9.8	24.3
Indirect taxes	476.0	425.4	354.1	428.6	90.0	100.8	15.3	21.0
Sales tax	276.5	248.0	207.8	259.1	93.7	104.5	8.9	24.7
Federal excise duty	59.5	53.2	47.1	51.5	86.6	96.9	18.7	9.5
Customs	140.0	124.2	99.3	118.0	84.3	95.0	29.3	18.8
Total	690.0	595.2	500.5	610.6	88.5	102.6	13.6	22.0

Source: Central Board of Revenue

Structural analysis reflects that the share of import-related taxes in total tax collection has continuously grown in the last five years. These taxes contributed Rs 238.7 billion in the revenue up to Q3-FY06, accounting for almost 48.7 percent of total CBR taxes. The trend shows that although overall share of the import-based taxes in total taxes has slightly fallen in Q3-FY06 yet it remains of considerable size, suggesting the vulnerability of tax receipts if the import growth falls back to the relatively low historical norms (see **Figure 5.3**).

Refund and Gross Collection

Trends in gross collection depict consistent growth over the last six years. Up to May FY06 gross collection increased by 16 percent as compared to 14.1 percent during the same period last year (see **Figure 5.4**). Refunds, however, sharply declined by 16.3 percent as compared to 16.5 percent increase in the corresponding period last year, reflecting the impact of various policy measures, principally the zero rating of sales tax on key export-oriented products and universal self-assessment scheme.

Figure 5.3: Import Taxes

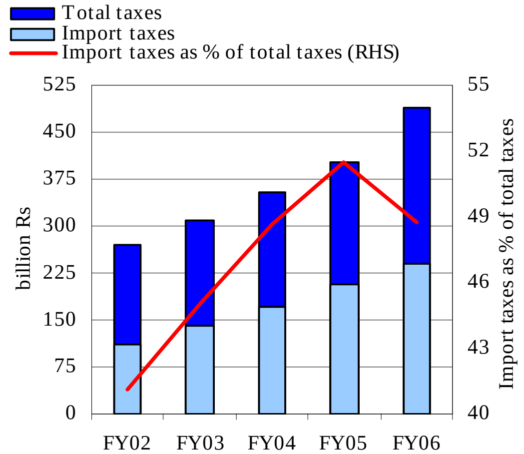
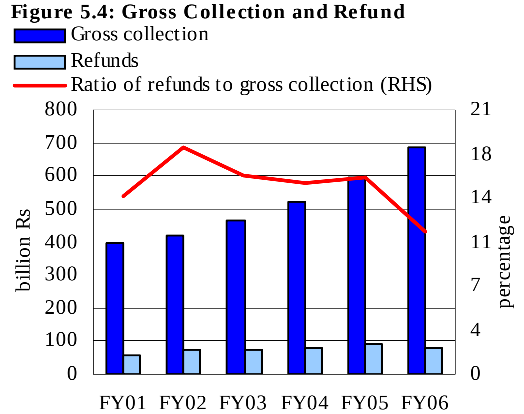


Figure 5.4: Gross Collection and Refund



Direct Taxes

During July to May FY06, direct tax collection stood at Rs 181.9 billion against the period target of Rs 169.8 billion with a YoY growth of 24.3 percent (see **Table 5.4**). A break-up of direct taxes, which is available only for the Jul-Mar period, shows that around 95 percent of total direct taxes were contributed by income tax.

Within the income tax, withholding taxes contributed 55 percent of receipts while the share of voluntary payments was 39.5 percent, as both the components also registered strong growth (see **Table 5.5**). It is, however, interesting to note that the share of various components of income tax has not shown any significant structural change over the last five years (see **Figure 5.5**) suggesting that the tax reforms of recent years have yet to contribute significantly to improving the tax collection profile.

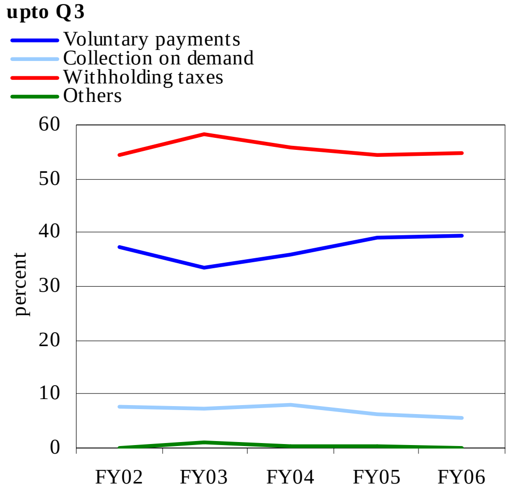
Table 5.5: Major Components of Income Tax during Q3
billion Rupees

	FY02	FY03	FY04	FY05	FY06	Growth	
						FY05	FY06
Voluntary payments	36.9	25.2	40.4	52.4	67.2	29.8	28.2
Collection on demand	7.7	5.4	9.0	8.3	9.3	-8.2	13.0
Withholding taxes	53.6	44.0	62.7	73.3	93.5	16.9	27.5
Others	0.1	0.7	0.4	0.5	0.1	42.9	-84.6
Gross total	98.3	75.3	112.5	134.5	170.1	19.6	26.5
Refund	8.3	5.4	11.7	19.8	24.3	69.1	22.5
Total Net	90.0	69.8	100.7	114.7	145.8	13.9	27.1

Source: Central Board of Revenue

A break-up of the income tax, up to March FY06, shows that almost half of the collection on demand comprises of arrears (Rs 4.4 billion) while the current demand contributed Rs 4.9 billion. Of the withholding taxes, major revenue heads were contracts (Rs 29.4 billion), imports (Rs 19.5 billion), salaries (Rs 10.2 billion), and exports (Rs 7.5 billion).

Figure 5.5: Share of the Components of Income Tax upto Q3



Indirect Taxes

Collection from indirect taxes rose 19.6 percent YoY to Rs 337.1 billion by end Q3-FY06. Approximately 60 percent of the indirect taxes were accounted for by sales tax collection with federal excise duty (12 percent) and the customs (28 percent) contributing the remainder.

Sales Tax

With a net collection of Rs 202.4 billion during first three quarters of FY06, sales tax surpassed period target of Rs 196.6 billion registering a YoY growth of 22.4 percent.

Sales tax on imports contributed around Rs 121.1 billion, approximately 59.8 percent, that portrays high dependence on consumption of imported commodities. Major revenue came from POL (Rs 17.1 billion), vehicles other than railway/ tramway (Rs 13.6 billion), vegetable oil (Rs 4.7 billion), and electrical machinery (Rs 4.2 billion). On the other hand, domestic sales tax provided Rs 81.3 billion, of which major revenue spinners were POL (Rs.36.8 billion), services (Rs 21.4 billion) and sugar & sugar confectionery (Rs 6.0 billion).

Customs Duty

During July-March FY06, collection from customs stood at Rs 95.1 billion with a YoY increase of 18.7 percent. The growth in customs duty, however, does not seem to be compatible with the 43.2 percent growth in imports during Q3-FY06.

Major revenue sources were vehicles, vegetable oil, POL, mechanical appliances and electrical machinery.

Federal Excise Duty (FED)

With a shift to VAT- mode sales tax, federal excise duty is considered as a dying tax, but it continues to remain an important source of revenue. During Q3-FY06, the FED collection remains below the target in five months and also lags behind its overall target of Rs 41.3 billion with a collection of Rs 39.6 billion.

Major revenue spinners of the FED remained the same as in the past, that is, beverages, beverages concentrates, cigarettes & tobacco, cement, natural gas and POL products, constituting around 96.5 percent of the revenue generated from the locally produced goods. It is noteworthy that there is a 10 percent YoY decline in the revenues from the POL products and a further 9.4 percent decline in revenues from beverages concentrates (see **Table 5.6**), while industrial growth depicts a YoY increase of 2.3 percent

Table 5.6: FED Collection up to Q3

billion Rupees

Major commodities	FY04	FY05	FY06	Growth	
				FY05	FY06
Beverages	1.6	1.7	2.6	4.9	53.6
Beverages concentrate	0.8	1.1	1.0	42.4	-9.4
Cigarettes & tobacco	12.1	14.6	16.4	20.9	12.0
Cement	6.7	7.9	9.1	17.4	14.6
Natural gases	3.6	4.1	4.0	12.2	-1.0
POL products	2.5	2.9	2.6	14.1	-10.0
Sub-total	*27.4*	*32.3*	*35.7*	*17.9*	*10.5*
Others	2.2	2.0	1.3	-7.0	-36.6
Local goods (gross)	*29.6*	*34.4*	*37.0*	*16.1*	*7.7*
Imported goods (gross)	*0.9*	*2.0*	*2.9*	*129.2*	*42.7*
Total (gross)	*30.5*	*36.4*	*39.9*	*19.3*	*9.6*
Refund & rebates	*0.1*	*0.0*	*0.2*	*-42.3*	*490.6*
Total (net)	**30.4**	**36.4**	**39.6**	**5.9**	**19.5**

Source: Central Board of Revenue

growth in POL production, 4.7 percent in Cigarette, 9.8 percent in Cement, and 2.3 percent in POL.

5.6 Federal Budget FY07

The budgetary measures announced in the Federal Budget 2006-07 broadly focus on providing a conducive environment for economic activity in the country. In addition, the Government’s policy of increasing revenues through broadening the tax base is implemented through various budgetary measures.

The Government has announced a substantial increase in development spending in subsidies on essential foodstuffs. From the budgetary outlay of more than Rs 1.5 trillion, Rs 435 billion have been allotted to public sector development; a 60 percent increase from the Rs 272 billion allocated in FY06 and 38.7 percent higher than the revised (Rs 325.1 billion) (see **Table 5.7**). About Rs 8 billion have been allocated for subsidizing household essentials, particularly foodstuffs, in state-run utility stores, up from Rs 2 billion currently, to ease the impact of inflation, currently at around 8 percent.

Table 5.7: Summary of Public Finance

Rs. in billion

	FY05	FY06	FY07
Total revenue receipts	**900.0**	**1095.6**	**1188.0**
Tax revenue	659.4	805.6	954.0
Non-tax revenue	240.7	290.0	233.0
Total expenditure	**1117.0**	**1423.0**	**1561.5**
Current	943.1	1097.9	1152.0
Development and Net Lending	252.5	325.1	435.0
Statistical discrepancy	78.5	-	25.5
Overall fiscal deficit	**217.0**	**327.4**	**373.5**
Without earthquake spending	-	**262.4**	**323.5**
Financing of fiscal deficit	**217.0**	**327.4**	**373.4**
External (net)	**120.4**	**118.3**	**171.7**
Domestic	**96.6**	**209.1**	**201.7**
Non-bank financing	8.1	22.4	6.7
Bank financing	60.2	96.7	120.0
Privatization proceeds	28.3	90.0	75.0
(as percent of GDP)			
Total revenue	13.7	14.2	13.5
Tax revenue	10.0	10.4	10.8
Total expenditure	17.0	18.4	17.7
Current expenditure	14.3	14.2	13.1
Development expenditure	3.8	4.2	4.9
Overall fiscal deficit	3.3	4.2	4.2
Fiscal Deficit (without earthquake)		3.4	3.7

The budget is pro-poor and is aimed at sustaining growth. Over the period from 2001 to 2005 regardless of the fact that poverty has declined, the income distribution has worsened in the country. The ratio of the highest to the lowest quintile which measures the gap between the rich and the poor also widened to some extent from 3.76 in 2001 to 4.15 in 2005. At regional level, the gap between the rich and poor in urban areas has widened relatively at higher pace – increase from 10.40 to 12.02. In contrast, the gap between the rich and poor in rural area remained more or less unchanged, that is, from 2.22 to 2.19. In this backdrop, the budget aims to address the issue of growing rich-poor gap by taxing the richer segments of the society and by providing relief and concession to the poor amounting to Rs 109 billion. The grant of subsidies in various sectors is to attain the objective of pro-poor growth.

The Budget may be regarded as 'industry-neutral' as it places little emphasis on industry and trade. However, it is ultimately going to benefit the businesses as the budget focuses more on the sustained growth of the economy.

On the expenditure side, defence spending has been increased to Rs 250 billion (3 percent of the GDP), up Rs 27 billion from the Rs 223.5 billion in FY06. The Federal budget on education and health shows YoY net increase of Rs 2.1 billion and Rs 0.3 billion, respectively; but in terms of GDP there is no improvement. However, we should recognize that the overall impact of the government spending on education, health, and population welfare sectors would be available after the provincial budgets come out.

With a budgeted revenue of Rs 1083 billion, the overall budget deficit (Rs 373.5) is estimated to be 4.2 percent of the GDP (including earthquake rehabilitation expenditure), mainly due to the increase in PSDP. This is consistent with the Fiscal Responsibility and Debt Limitation Act, 2005.

CBR has been assigned a target of Rs 835 billion for FY07, which is Rs 131 billion (or 18.6 percent) higher than the revised target of Rs 704 billion for FY06. This will increase the tax-GDP ratio of CBR taxes from the current 9.1 percent to 9.5 percent. This is a very positive development.

The tax system in Pakistan is characterized by narrow tax base, disproportionate tax burden on different sectors and low tax buoyancy, contributing to the low tax-to-GDP ratio. It may be recognized; however, that the Federal Government and CBR have limited ability to increase the tax/GDP ratio for the reason that the taxability of two important sectors of the economy offering enormous revenue potential (agriculture income tax and sales tax on services) are provincial subjects. Unfortunately, the receipts from these provincial taxes are not reflective of the share of these sectors in the total economy. Tax/GDP ratio for the federal government is 9.9 percent, whereas it is only 0.6 percent for provincial governments.

It is instructive to note that sales tax is the most prolific tax in terms of revenue generation in Pakistan. Its widespread acceptability has increased its share in federal tax receipts from 23.4 percent in FY99 to 40.0 percent in FY06. The ratio of sales tax to GDP has also increased from 2.45 percent in FY99 to 3.7 percent in FY06. However, the services sector, which contributed 52.3 percent in the GDP in FY06, mostly remains outside the scope of sales tax and the collection of sales tax/federal excise duty from this sector is very low. During FY05, the sales tax/CED collection on services amounted to Rs 27.9 billion only. The main portion of Rs 20.4 billion was generated through telecommunication services. Other services contributed Rs 3.6 billion to the total sales tax collection of Rs 240 billion. The contribution of retail and wholesale trade to the sales tax collection was very dismal (Rs3.3 billion), representing 0.26 percent of its value added in the GDP (mp) which amounted to Rs 1251 billion.

To meet the growing challenge of higher revenue collection, the Budget FY07 has introduced some new taxation measures which are aimed at improving resource mobilization and broadening of tax base in the country.

A welcome development has been the move to bring some of the services (financial services, franchise services, services provided by foreign exchange and money changer) into the excise regime. Such taxation measures would broaden the tax base, mobilize resources, and make the tax system more equitable. It would be desirable to bring *all* other services with significant revenue potential into the tax net, so as to increase the tax-GDP ratio and make the tax system more equitable.

Another Wealth-tax Act, 1963 was suspended (held in abeyance) from July 1, 2001. Prior to its suspension, wealth tax contributed nearly Rs 4.0 billion (in FY00) to the exchequer. In the absence of wealth tax and given the fact that enormous capital gains (on sale of property, land, shares, etc.) are made by the rich segment of society, it may be prudent to impose and implement capital gains tax seriously. This will improve income distribution in the economy as the rich will pay more taxes. This year, the Government has increased the rate of CVT on shares from 0.01 to 0.02 percent but this will hardly generate significant additional revenues. The CVT collected from stock exchanges in Pakistan in FY05 amounted to Rs 2.068 billion, and in FY06 Rs 0.922 billion have been collected up to March. We can roughly estimate that this raise in tax rate would fetch additional Rs 1.5 billion in FY07.

It is important that taxes fall proportionately on all the sectors. The risk of deterioration in fiscal performance also needs to be guarded against. Some key risks include: (1) heavy dependence on import-related taxes, accounting for nearly half of the share in collections (receipts could therefore slowdown if, as expected, import growth falls back to historical norms); and (2) dependence on potentially volatile non-tax revenues. Thus, there remains a clear need for further tax effort to raise the tax-GDP ratio substantially over the next few years. In this context, the estimated increase in the tax-GDP ratio in the next year needs to be monitored, and 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 sector.