5 Fiscal Developments

5.1 Overview

Although official statistics on public finance for July-Mar FY08 are not yet available[1], SBP forecast suggests that the budget deficit for July-Mar FY08 (as a percentage of the estimated FY08 GDP) is likely to be significantly higher than the full-year FY07 figure. Moreover, the quality of Q3-FY08 fiscal performance can only be judged once consolidated fiscal accounts are released.

The growth in government revenues in Q3-FY08 was expected to recover from the low of 1.8 percent seen during H1-FY08 as: (1) FBR tax receipts, which contribute the bulk of government revenues, have increased by 31.3 percent in Q3-FY08 compared to 6.0 percent during H1-FY08, and (2) non-tax revenues have been bolstered with the disbursement of budgetary support grants of US$ 281.7 million and US$ 300 million from USA and Saudi Arabia respectively.

Government domestic borrowing during July-Mar FY08 grew strongly, reflecting a strong year-on-year increase in the deficit, and little change in external financing from FY07. Thus, with net retirements of borrowings from commercial banks and only Rs 1.7 billion in privatization proceeds (against Rs 75 billion budgeted for FY08), the government borrowings from the central bank continued to rise sharply. Indeed, incremental government borrowings from SBP as of May 10, 2008 have reached Rs 551.0 billion, pushing the outstanding stock of MRTBs with SBP to Rs 940.6 billion. This development has significantly augmented inflationary pressures in the economy, and raised risks to macroeconomic stability.

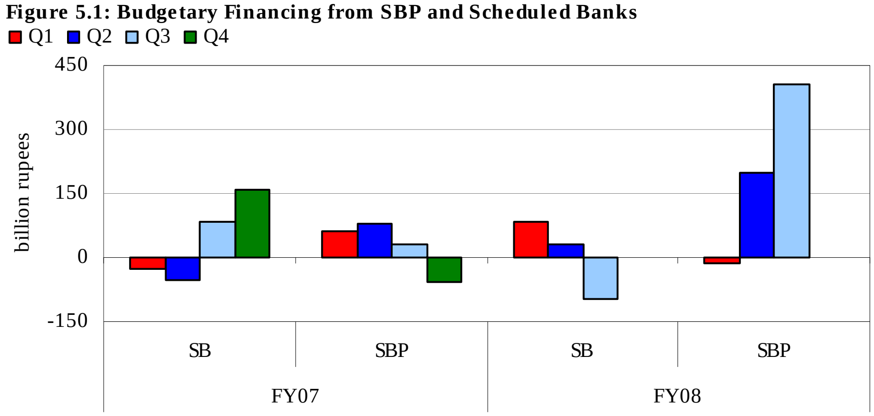
Realizing these concerns, the government has indicated its intention to broaden the tax base and rein-in expenditure growth for macroeconomic stability. The government has also indicated that it intends to diversify its financing base and reduce dependence on the central bank borrowings. For the economy to retain its high growth momentum, it is important that these goals are achieved.

[1] being scheduled for release by end-May 2008

5.2 Domestic Budgetary Financing[2,3]

Budgetary financing from domestic sources continued to rise, touching a record Rs 420.6 billion in Jul- Mar FY08. Also, the structure of financing remained a source of concern for the central bank as SBP solely had to finance the increased requirement in third quarter of FY08[4]. Commercial banks in this quarter, on the other hand resorted to net retirement of the government paper.

Figure 5.1: Budgetary Financing from SBP and Scheduled Banks



5.2.1 Financing from the Banking Sector

In Jul-Mar FY08 period SBP provided for budgetary financing Rs 404.8 billion, compared to Rs 33.1 billion in the same period of FY07 (see **Figure 5.1**). Analysis of borrowing from the SBP shows that Rs 371.2 billion were provided through issuance of new T-bills while the government availed Rs 33.5 billion from the deposit accounts including the 'other deposits' with the SBP. Commercial banks' retirement of government papers, (besides slowdown in the revenue growth) stretched the financing requirement from the SBP, as the central bank has to finance any shortfall in revenue between the issuance of new and the maturing bills in the T-bill auctions.

Debt retirement from commercial banks probably reflected (1) a slowdown in their deposit growth; and (2) better returns on alternative opportunities. Consequently,

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[2] The budgetary financing numbers do consider the impact of government deposits with the banking system whereas the debt numbers do not.
[3] This section is mainly based on SBP estimates, derived from Monetary Survey and outstanding stock of domestic debt as MoF numbers will only be available by end-May 2008.
[4] It is important to note that at the start of the fiscal year SBP advised the government to retire Rs 62.5 billion of government debt.

Rs 129 billion worth of government securities were retired in Q3-FY08 alone – the highest in any quarter since FY05. During July-Mar FY08 net retirement from the commercial banks stands at Rs 95.5 billion.[5] While commercial banks retired their holdings of short term instruments (T-bills), they continued to invest in the long term instruments (PIBs) (see **Figure 5.2)**.

Figure 5.2: Commercial Banks' Financing (Jul-Mar)

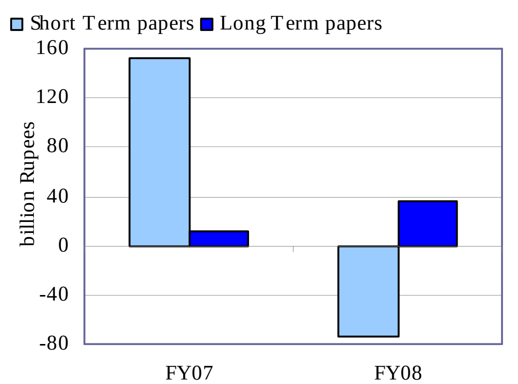
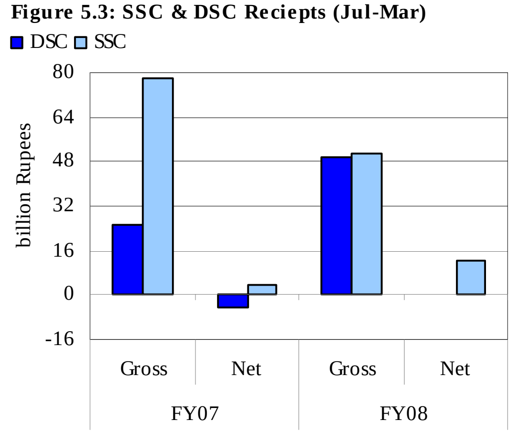


Figure 5.3: SSC & DSC Reciepts (Jul-Mar)



5.2.2 Financing from the Non-banks

Non bank financing, with a large share of NSS, increased from Rs 73.9 billion during July-Mar FY07 period to Rs 111.3 billion in Jul-Mar FY08.

Within NSS instruments, Behbood Saving Certificates (BSCs) and Pensioners Benefit Accounts (PBAs) continued to perform as a better financing source, due to their special interest rate structure[6]. Together the two instruments fetched Rs 47.8 billion for budgetary financing in Jul-Mar FY08.

Performance of the other active NSS instruments which offer returns competitive with the market based instruments, remained mixed in the period under review. For instance, investments in Defense Saving Certificates (DSC) remained subdued; showing a mere Rs 0.4 billion increase since June 2007 despite

[5] This figure incorporates the impact of Rs 47.9 billion added to government deposits with the commercial banks during Jul-Mar FY08.

[6] Both instruments offer highest profit rates (11.64 percent per annum) among NSS Instruments.

an increased gross receipt of Rs 49.6 billion. In Jul- Mar FY07 the gross receipt in DSCs was Rs 25.2 billion. High gross receipts but low net receipts probably reflect the pressure from the maturing high-yield DSCs issued a decade ago. Given that current yields are significantly lower, and the universe of competitive investments has expanded, not all of the maturing amounts would be reinvested.

In contrast, though the gross receipt in medium term Special Saving Certificate (SSC) declined to Rs 50.8 billion from Rs 78.1billion in Jul-Mar FY07, the instrument succeeded in fetching Rs 12.1 billion for budgetary financing in Jul-Mar FY08 (see **Figure 5.3**).

5.3 FBR Tax Collection

The FBR has formally abandoned the Rs 1025 billion revenue target set for FY08 but a new target has not been disclosed. Instead, media reports indicate that the tax authority is aiming at maximizing revenue collection for the remaining months of the fiscal year, hoping to cross the Rs 1 trillion mark by end-June 2008. Available data for the current fiscal year suggest a significantly large shortfall in tax receipts, indicating that achievement of Rs 1 trillion in tax collections for FY08 will be challenging.

Table 5.1: FBR Tax Collection
billion Rupees

	Annual target		Net collection (Jul-Apr)		YoY change (%)		% of Annual target	
	FY07	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**
Direct taxes	264.7	405.0	252.9	284.6	50.9	12.5	95.5	70.3
Indirect taxes	570.3	620.0	403.6	479.0	6.4	18.7	70.8	77.3
Sales tax	343.8	375.0	245.8	293.7	7.5	19.5	71.5	78.3
Federal excise duty	69.0	91.0	54.7	70.6	20.7	28.9	79.3	77.5
Customs	157.5	154.0	103.1	114.8	-2.3	11.4	65.4	74.6
Total	**835.0**	**1,025.0**	**656.5**	**763.6**	**20.0**	**16.3**	**78.6**	**74.5**

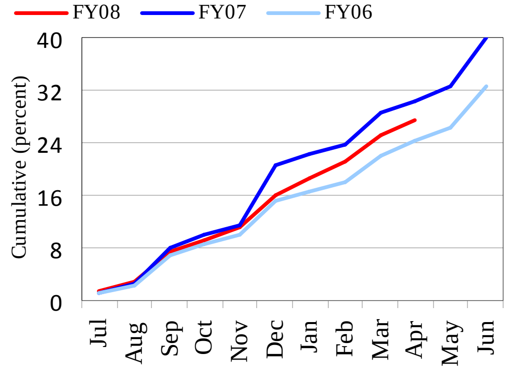
Source: Federal Board of Revenue

The severe shortfall in net tax collections during the current fiscal year is primarily caused by the unexpectedly poor performance of direct taxes (see **Table 5.1**). It may be recalled that the above-target tax revenue collection in FY07 was driven by direct tax receipts as well. In fact, direct tax receipts in FY07 remained substantially higher than the historical averages.

5.3.1 Direct tax collection

Since December 2007, direct tax collection has fallen behind the target path for FY07, resulting in massive shortfall in direct tax receipts (**see Figure 5.4**). During July-Apr FY08, direct tax receipts rose by 12.5 percent YoY to Rs 284.6 billion, compared to an impressive 50.9 percent increase during the corresponding period last year.

Figure 5.4: Contribution of Direct Taxes towards Annual Target



A break up of the direct tax collection, available for July-Mar FY08, reveals that despite a 360.8 percent growth in collection on demand, gross income tax increased by a mere 4.3 percent compared to a 48.6 percent rise during first nine months of FY07 (**see Table 5.2**).

Table 5.2: Direct tax collection during Jul-Mar

billion Rs

	FY06	FY07	FY08	% change FY07	% change FY08
Gross Income tax	170.8	253.8	264.8	48.6	4.3
Collection on Demand	9.3	5.5	25.5	-40.8	360.8
Voluntary Payments	67.2	132.2	97.6	96.6	-26.2
Withholding taxes	94.2	116.0	141.6	23.2	22.1
Others	0.1	0.1	0.1	50.4	-17.5
Other direct taxes	6.1	9.7	12.1	59.7	25.0
Gross direct taxes	176.9	263.5	277.9	49.0	5.5
Refunds	24.2	25.7	20.2	6.1	-21.2
Net direct taxes	152.7	237.8	257.6	55.7	8.3

Source: Federal Board of Revenue

Voluntary payments dropped by 26.2 percent during Jul-Mar FY08, as compared to the incredible 96.6 percent rise in the corresponding period last year. However, it is important to remember that voluntary payments in FY07 were exceptionally high due to large profits booked by banks, telecommunication, and oil and gas sectors. The situation has not been repeated in FY08; for example banks' earnings during current fiscal year have been adversely affected by the forced-sale value regulation[7]. Similarly, PTCL has actually

[7] Earlier banks were allowed to avail benefit of forced-sale value of collateral held against loans and advances while making provisions against their assets portfolio. The forced sale value benefit of collateral was however restricted initially against financing of Rs 5 million and above effective November 01, 2005 and then against financing of Rs 10 million and above effective December 31,

booked a net loss (before tax) of Rs 8.3 billion for Jul-Mar FY08 due to huge expenses incurred on voluntary separation scheme (VSS).[8] Amid this sizeable fall in voluntary receipts, withholding taxes reclaimed its dominant share in gross income tax collections (see **Figure 5.5**).

Withholding tax receipts grew by a respectable 22.1 percent during Jul-Mar FY08 against 23.2 percent during the corresponding period last year. Together, imports and contracts (which relates mainly to projects and supply of goods and services) contributed nearly 50 percent in withholding tax collections during Jul-Mar FY08 (see **Table 5.3**). Other major heads contributing to withholding tax receipts include: telephone, electricity bills, salaries and securities. The withholding tax on profit on government securities declined by Rs 136 million during Jul-Mar FY08, probably reflecting the revenue cost of shift in budgetary financing from commercial banks to SBP, as SBP is exempt from payment of withholding tax on profit on government securities.

Figure 5.5: Share in Gross Income Tax (Jul-Mar)

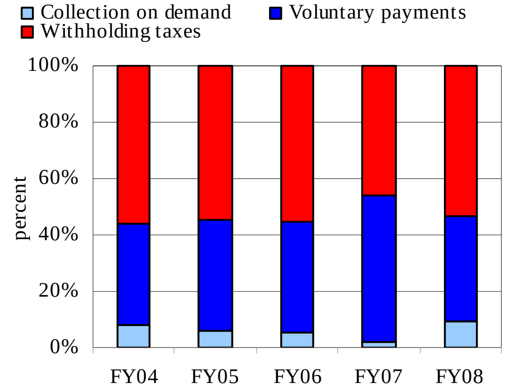


Table 5.3: Withholding tax collection during Jul-Mar

billion Rs

	FY07	FY08	Growth (%)
Imports	19.1	20.1	5.3
Salaries	11.4	14.5	27.2
Dividends	3.5	4.3	23.3
Securities	9.9	11.2	13.4
Technical fee	5.2	4.1	-20.8
Contracts	36.6	49.8	36.3
Exports	8.0	7.9	-1.8
Cash withdrawal from banks	3.4	4.2	23.8
Stock exchanges	2.0	1.8	-6.9
Electricity bills	3.8	4.4	16.4
Telephone	9.3	12.9	39.0
Others	4.0	6.5	60.1
Withholding tax (gross)	**116.0**	**141.6**	**22.1**

Source: Federal Board of Revenue

Withholding tax receipts from mobile phone subscribers recorded an increase of 57.8 percent during Jul-Mar FY08,

2006. The forced sale value benefit against all NPLs for calculating provisioning requirement was altogether abolished with effect from December 31, 2007.

[8] Excluding VSS, PTCL registered a before-tax profit of Rs 14.9 billion in the same period.

increasing from Rs 7.9 billion during Jul-Mar FY07 to Rs 12.5 billion in the corresponding period of FY08. Such high growth and the fact that almost 97 percent of withholding tax on telephone was collected from mobile phone subscribers indicate large growth potential of the cell phone market. Withholding tax receipts on account of cash withdrawal from banks stood at Rs 4.2 billion during first nine months of FY08 compared to Rs 3.4 billion in the same period last year. In contrast, with trading of shares subject to withholding tax rate of only 0.01 percent, Rs 1.8 billion was collected from stock exchanges during Jul-Mar FY08.

As a result of the FBR's recovery drive on the back of decline in voluntary payments, collection on demand was recorded at Rs 25.5 billion during Jul-Mar FY08 compared to Rs 5.5 billion in the corresponding period last year. Receipts under arrear demand increased to Rs 5.4 billion, up by 125.9 percent during Jul-Mar FY08 while receipts under current demand rose by 538.3 percent to reach at Rs 20.1 billion during Jul-Mar FY08.

5.3.2 Indirect tax collection

Indirect tax receipts grew by a handsome 18.7 percent during Jul-Apr FY08 as compared to 6.4 percent in the same period last year. Encouragingly, this particular performance was driven by strong growth in all the heads (see **Table 5.1**). Also, indirect tax collection during Jul-Apr FY08 comprised of 77.3 percent of annual target as compared to 70.8 percent collection of FY07 target during the same period of last year.

Sales tax

The Jul-Apr FY08 receipts from sales tax stood at Rs 293.7 billion, up by 19.5 percent as compared to a rise of 7.5 percent in corresponding period last year. The acceleration in the growth of sales tax collection is visible in the receipts from imports as well as in collection from domestic sources (see **Table 5.4**).

Table 5.4: Sales tax collection (Jul-Apr)

				YoY change (percent)	
	FY06	**FY07**	**FY08**	**FY07**	**FY08**
Sales tax	228.6	245.8	293.7	7.5	17.6
Domestic	93.7	104.6	135.7	11.6	27.5
Import-related	134.9	141.2	158.0	4.7	10.2

Source: Federal Board of Revenue

Federal Excise Duty

The FED collection for Jul-Apr FY08 increased by a healthy 28.9 percent as compared to a rise of 20.7 percent in the corresponding period last year. A breakup of FED available for Jul-Mar FY08 reveal that major revenue contributions were made by cigarettes (30.6 percent), cement (16.9 percent), natural gas (7.4 percent), POL products (3.6 percent), beverages (4.0 percent), and collection on account of 1% special excise duty (11.3 percent). In addition, services contributed Rs 8.4 billion (13.6 percent) during Jul-Mar FY08, of which Rs 6.0 billion came from FED on international travel by airlines.

Customs

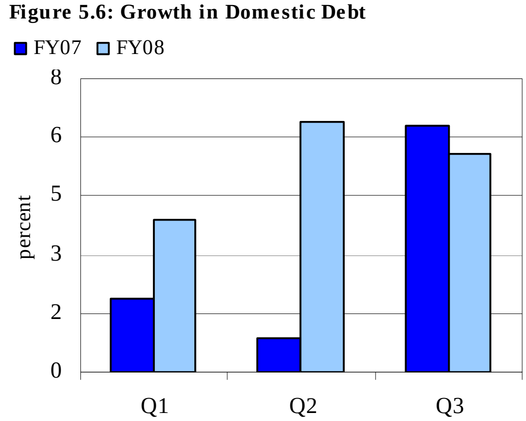
Customs duty added Rs 114.8 billion to the national exchequer during Jul-Apr FY08, up by 11.4 percent against a decline of 2.3 percent in the corresponding period last year.

Details of customs duty for Jul-Mar FY08 show that despite 11.9 percent decline, customs duty on vehicles remained the major source of customs receipts, contributing Rs 18.4 billion during Jul-Mar FY08 as compared to Rs 20.9 billion during Jul-Mar FY07. Other major sources of customs duty comprise of POL products (Rs 14.0 billion), edible oil (Rs 12.9 billion) and electrical machinery (Rs 9.2 billion).

5.4 Domestic Debt

After sharp rise of 6.4 percent in second quarter, the growth in the domestic debt moderated to 5.5 percent in Q3-FY08 (see **Figure 5.6**). Although government availed substantial financing from SBP in this quarter, growth in floating debt decelerated due to significant retirements by the commercial banks, resulting in a moderation in debt growth during Q3-FY08.

Figure 5.6: Growth in Domestic Debt



Another important development is the continued shift in the debt structure towards the shorter term instruments, and away from the longer term instruments. This raises interest rate risk, by increasing sensitivity of the cost of borrowing to short-term interest rates.

5.4.1 Components of Domestic Debt

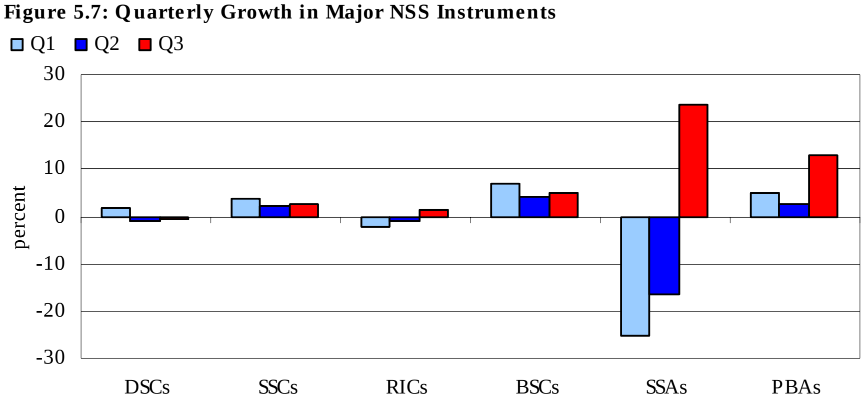
A disaggregation of total domestic debt shows that the floating debt, characterized by the debt instruments of less than a year, continued to dominate the debt structure. During Jul-Mar FY08 the increase in floating debt substantially outpaced the rise in other components of domestic debt, resulting in 3.9 percentage points addition to its share in total debt (see **Table 5.5**).

Table 5.5: Domestic Debt (Jul-Mar)
debt in billion Rupees, growth and share in percent

	Debt		Growth rate		Share	
	FY07	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**
Permanent	529	607	5.8	9.8	21.1	20.0
Floating	1,087	1,432	15.5	29.2	43.3	47.2
of which						
MTBs	557	584	28.6	-10.9	22.2	19.2
MTBRs	530	847	4.4	87.4	21.1	27.9
Unfunded	897	997	4.4	6.1	35.7	32.8
Domestic Debt	**2,512**	**3,036**	**9.2**	**16.7**	**100**	**100**

It is pertinent to note that in Q3 FY08 there was a sharp increase in the monetization of the deficit due to shift in the government borrowing from commercial bank to the SBP. The outstanding debt with SBP increased by 87.4 percent in Jul-Mar FY08, while the same with the commercial banks declined by 10.9 percent. The share of the external financing is expected to increase somewhat by end of the current fiscal year.[9]

Figure 5.7: Quarterly Growth in Major NSS Instruments

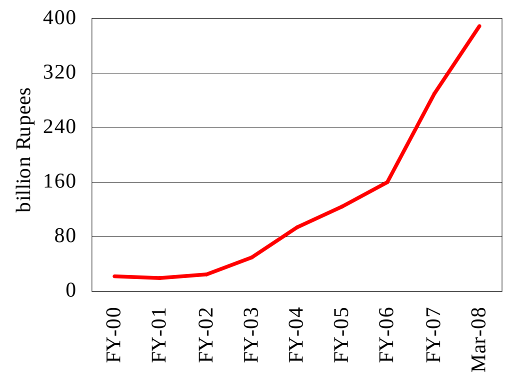


[9] GOP has received budgetary support from China and KSA, and expecting the widening fiscal deficit of FY08 to narrow down as receipts due on account of the Logistic support would be received. Furthermore GoP is planning to float the Exchangeable Eurobond in FY08 that would also be providing the budgetary support.

In contrast, both permanent and unfunded debt, categorized with the medium and long term instruments, witnessed a decline in their respective shares. Specifically the share of the permanent debt reduced from 21.1 percent in Jul- Mar FY07 to 20.0 percent in FY08 while that of unfunded debt declined by 2.9 percent to 32.8 percent of the total debt in Jul- Mar FY08.

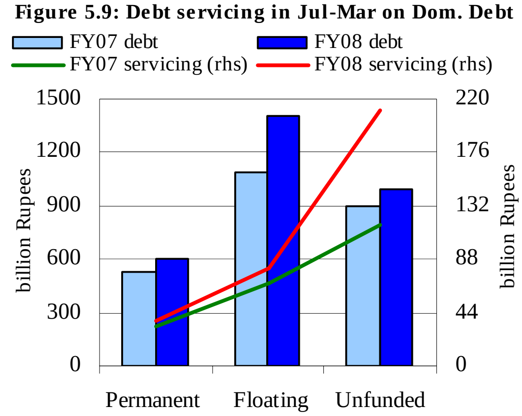
The growth in the outstanding debt raised through the major NSS instruments is shown in **Figure 5.7**. The outstanding debt against all but DSC recorded positive growth. Furthermore, DSC and SSC, which compete with other market instruments like PIBs and corporate bonds, registered a fall of 0.5 percent and a paltry rise of 2.4 percent in Q3-FY08.

Figure 5.8: Aggregate Net Assets of Mutual Funds in Pakistan



The major reason for the weak growth in receipts through these instruments probably include: (1) the increase in the market depth that has provided diversified investment opportunities, such as mutual funds, to the investors (see **Figure 5.8**); and, (2) the rigidities in profit payment structure of these instruments that penalizes investors seeking pre-mature encashment by denying them profit on the broken periods.

Figure 5.9: Debt servicing in Jul-Mar on Dom. Debt



Debt Servicing[10]

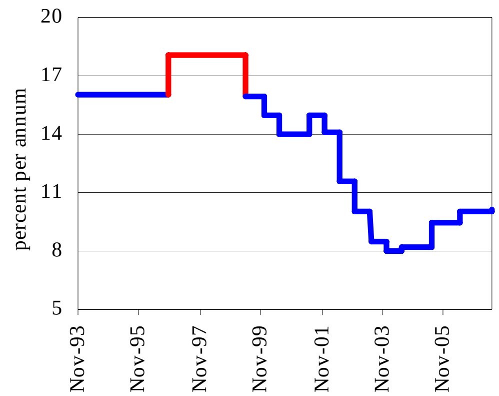
In July- Mar FY08 period, debt servicing cost of the domestic debt increased by 52.1 percent reaching to Rs 328 billion. A disaggregation shows that there is a sharp

[10] SBP estimates

increase in the unfunded debt servicing cost (see **Figure 5.9**).

A further break-up reveals Rs 172 billion costs being incurred against DSCs in debt servicing, more than half of the total servicing cost of the domestic debt for this period. In contrast in Jul-Mar FY07 the debt servicing of DSCs were Rs 80.44 billion.

Figure 5.10: Profit Rates on DSCs



The recent surge in debt servicing cost of DSCs is attributed to bullet maturities of high yield DCS issued in the later years of the 1990s. The profile of profit rates on DSCs reveal that, between November 1996 and May 1999, DSCs were sold at up to a rate of 18.04 percent (see **Figure 5.10**).