4 Public Finance and Fiscal Policy

4.1 Overview

The CBR achieved its revenue target for the third successive year in FY05, helping raise the aggregate revenues well above the Rs 851.3 billion revised target. However, expenditure exceeded the target substantially, pushing the overall budgetary deficit to 3.3 percent of GDP, slightly above the target of 3.2 percent of GDP, and higher than the 3.0 percent of GDP in FY04. To put this in perspective, the rise in the budgetary deficit in FY05 ended a 6 year downtrend. While the overall budgetary deficit is still low, the increase in the deficit is disquieting, given the weak buoyancy in tax receipts, and the seeming inability to widen the tax base substantially.

The cause of concern is the complacent tax effort and overall revenue mobilization despite the collection of Rs 900 billion in FY05; the 8.4 percent YoY growth in the above-target tax collection fell behind the 18.3 percent growth of the economy. The weak buoyancy is reflected in the continuing fall in the tax-to-GDP ratio (see **Special Section 1**). Admittedly, the weak FY05 growth in tax receipts is, in part, understandable, as it stems from the loss of the PDL revenues, following the government's decision to buffer the economy from at least a part of the rise in international oil prices. However, it is instructive to note that the FY05 tax-to-GDP figure declines even when adding back the full budgeted PDL revenue for the year. Had the revenue-to-GDP ratio attained in FY04 been repeated in FY05 the revenue collection would have been higher by Rs 75 billion and all the fiscal indicators would have looked quite solid.

Another point of weakness is the structure of government revenues. More than half of the increase in government revenues during FY05 over the preceding year is from a sharp jump in non-tax revenues, as a result of which the share of tax receipts in total revenues declined from approximately 77 percent in FY04 to 73.3 percent in FY05. Also, within non-tax revenues, a significant contribution is from non-recurring items, such as unexpectedly large contributions from defense receipts, payments from the UN, SBP profits, PTA receipts, etc. Given that these flows cannot be relied upon and are unlikely to repeat themselves in the future to the same extent, the concerns over the trend of the overall budgetary deficit in the years ahead are quite legitimate. A related weakness in the revenue structure is an almost total dependence of all tiers of government on Federal taxes. Although the National Finance Commission would examine the nature of inter-governmental fiscal relationships, the revenue mobilization efforts by the Provincial and local governments, particularly in the relatively well-off provinces such as Punjab and Sindh, have to be stepped up.

In short, the FY05 fiscal developments have exposed weaknesses in the tax systems that need to be addressed if the improvement in fiscal indicators in the current decade is to be sustained. In particular, the importance of raising revenues from sectors that have traditionally remained under-taxed cannot be overstressed. Moreover, the responsibility for this cannot lie solely with the CBR or, indeed the Federal government. Provinces enjoy constitutional authority in respect of agriculture income tax and sales tax on services – these two sectors contribute over 75 percent of GDP, but their share in total revenues remains negligible. The taxation of agricultural income has already received considerable attention at the policy level, but the tax yields remain low. More surprisingly however, there has been little debate on the poor growth in the services sector taxes (see **Special Section 2**). As highlighted in the subsequent sections, sustainable growth will depend heavily on tapping resources from all economic activities equitably, and the efficient usage of these resources. The provinces will have to significantly enhance their tax collecting capacity to meet their financing requirements. Such efforts will greatly improve the tax-to-GDP ratios, and will also meet the objective of fiscal decentralization.

Finally, while it is encouraging to note that a strong contribution to the FY05 expenditure growth is through a large rise in development spending, the apparent sharp (21.7 percent YoY) increase in FY05 current expenditure is clearly less desirable. However, it must be acknowledged that this rise may be over stated. The provisional consolidated expenditure for FY05 includes a massive negative Rs 78.5 billion (i.e. 1.2 percent of GDP) statistical discrepancy. If the total expenditure is adjusted for this, i.e. this expenditure did not take place, the expenditure growth drops to only 1.4 percent – which would suggest an exceptionally good performance. On the other hand, if the statistical discrepancy only represents the lack of expenditure allocation to the appropriate categories and thus lack of reconciliation without affecting the level of aggregate spending then this rise in current expenditure is indeed highly worrisome (see **Table 4.1**).

Table 4.1: Summary of Public Finance

billion Rupees

	FY00	FY01	FY02	FY03	FY04	FY05	YoY Change	
					R.E	R.E	Absolute	Percent
1 Revenue receipts (a+b)	512.5	553.0	624.1	720.8	791.1	900.0	108.9	13.8
a) Tax revenue	405.6	441.6	478.1	555.8	608.4	659.4	51.0	8.4
of which CBR revenue	347.1	392.3	404.1	460.6	518.9	588.4	69.5	13.4
b) Non-tax receipts	106.9	111.4	146.0	165.0	182.7	240.7	58.0	31.7
2 Total expenditure (a+b+c)	709.1	717.9	826.3	898.2	955.8	1195.5	239.7	25.1
a) Current	626.4	645.7	700.2	791.7	774.9	943.1	168.2	21.7
b) Development	95.6	89.8	126.3	129.2	160.5	227.7	67.2	41.9
c) Net lending to PSEs etc.	-12.9	-17.6	-0.2	-22.7	20.4	24.8	4.4	21.4
d) Statistical discrepancy	9.7	14.8	-11.7	3.2		-78.5		
3 Revenue surplus/deficit (1-2.a)	-113.9	-92.7	-76.1	-70.9	16.2	-43.0	-59.2	-365.6
4 Overall deficit (1-2)	-206.3	-179.7	-190.5	-180.6	-164.7	-217.0	-52.3	31.8
5 Financing through:	206.3	179.7	190.5	180.6	164.7	217.0	52.3	31.8
a) External resources (Net)	69.7	120.7	83.1	113.0	28.8	120.4	91.6	318.2
b) Internal resources (i+ii)	136.6	59.0	107.4	67.6	135.9	96.6	-39.3	-28.9
i) Domestic non-bank	96.7	92.0	85.0	119.5	61.0	8.1	-52.9	-86.8
ii) Banking system	39.9	-33.0	14.0	-55.6	63.7	60.2	-3.5	-5.5
iii)Privatization proceeds	n.a.	n.a.	8.4	3.7	11.2	28.3	17.1	152.9
As per cent of GDP (mp)								
1. Revenue receipts (a+b)	13.5	13.3	14.2	14.9	14.3	13.7	…	…
a) Tax revenue	10.7	10.6	10.9	11.5	11.0	10.1	…	…
of which CBR revenue	9.2	9.4	9.2	9.6	9.4	9.0	…	…
b) Non-tax receipts	2.8	2.7	3.3	3.4	3.3	3.7	…	…
2. Total expenditure (a+b)	18.7	17.2	18.8	18.6	17.3	18.3	…	…
a) Current	16.5	15.5	15.9	16.4	14.0	14.4	…	…
b) Development	2.5	2.2	2.9	2.7	2.9	3.5	…	…
c) Net lending to PSEs etc.	-0.3	-0.4	0.0	-0.5	0.4	0.4	…	…
3. Revenue surplus/deficit (1-2.a)	-3.0	-2.2	-1.7	-1.5	0.3	-0.7	…	…
4. Overall deficit (1-2)	-5.4	-4.3	-4.3	-3.7	-3.0	-3.3	…	…
5. Financing through:	5.4	4.3	4.3	3.7	3.0	3.3	…	…
a) External resources (net)	1.8	2.9	1.9	2.3	0.5	1.8	…	…
b) Internal resources (i+ii)	3.6	1.4	2.4	1.4	2.5	1.5	…	…
i) Domestic non-bank	2.5	2.2	1.9	2.5	1.1	0.1	…	…
ii) Banking system	1.1	-0.8	0.3	-1.2	1.2	0.9	…	…
iii) Privatization proceeds	n.a.	n.a.	0.2	0.1	0.2	0.4	…	…

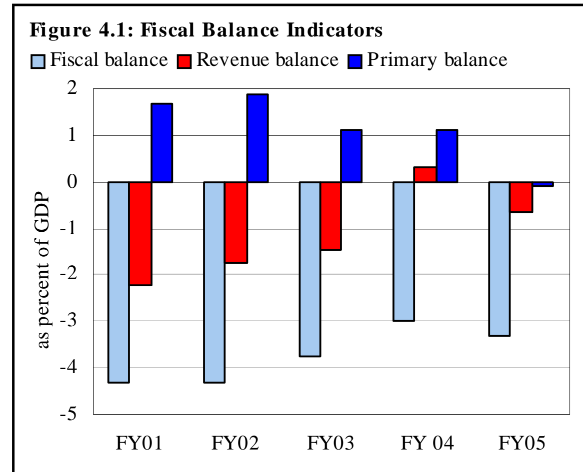
Source: Up to FY04 Economic Survey 2004-05, for FY05 MoF

4.2 Fiscal Performance Indicators
Fiscal performance can be gauged through the following quantitative indicators.

4.2.1 Balance Indicators
All three major balance indicators (fiscal balance, revenue balance and primary balance) that had depicted an improvement in recent years, witnessed a visible deterioration in FY05, highlighting the weaknesses in revenue mobilization efforts.

- ***Fiscal balance*** is the key balance indictor for monitoring fiscal strength. An improvement in the fiscal discipline and expansion in the tax net have both been instrumental in reducing the fiscal deficits in the current decade from the high levels during the 1990s (see **Figure 4.1**). In FY05, above-target expenditure, and the decline in the tax-to-GDP ratio, both contributed to a reversal in the trend decline in the fiscal balance ratio. This is troubling, even though not yet a source of serious concern (as the ratio is still quite low).

Figure 4.1: Fiscal Balance Indicators



- ***Revenue balance***, an indicator to judge the saving capacity of the economy, once again turned negative in FY05, after a positive drift of 0.3 percent of GDP in FY04 (see **Figure 4.1**). While the reversion of the FY04 revenue surplus was not expected to be sustained in FY05 (as per budgetary estimates), the actual negative balance is larger than anticipated, and again points to a weakness in fiscal discipline.

- ***Primary balance***, the third balance indicator, measures the effects of current discretionary budgetary policy by excluding interest payments. It shows how recent fiscal policy affects the government's net debt and helps in assessing sustainability of the fiscal deficit. During the 1990s, the primary balance was around -0.5 percent of GDP, but with a gradual improvement in other fiscal performance, it remained in surplus each year during the FY01-FY04 period. Unfortunately, this too turned negative in FY05.

According to "The Fiscal Responsibility and Debt Limitation Act, 2005" (FRDLL), the government has targeted to reduce the revenue deficit to zero by FY08 and to maintain public debt-to-GDP ratio at 60 percent by FY13. The fiscal picture suggests that while the government is still on the right track to meet these targets,[1] this owes more to the sustained growth of the economy rather than an improvement in the fiscal performance. Any drop in GDP growth due to unexpected exogenous shocks can adversely affect these targets.

4.2.2 Revenue Indicators
Overall revenue grew by 13.8 percent YoY during FY05 to Rs 900 billion. Although this growth was a little higher than the 9.8 percent YoY rise seen in FY04 as well as the average for recent years (see **Figure 4.2**), it was nonetheless substantially lower than the growth in nominal GDP, and therefore the

[1] The debt-to-GDP ratio in FY05 has declined to 64 percent, while public debt to GDP ratio to 62.7 percent, which is compatible to FRDLL.

revenue to GDP ratio fell to 13.7[2] percent in FY05 from the 14.3 percent recorded in FY04 (see **Figure 4.3**).

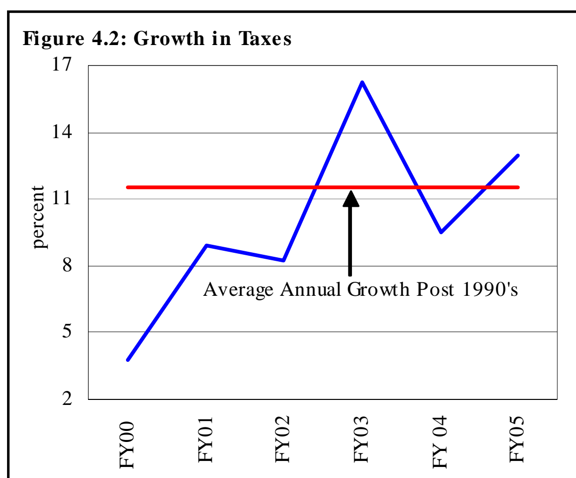


Figure 4.2: Growth in Taxes

The low buoyancy in revenues stemmed entirely from tax revenues, which rose only 8.4 percent YoY during FY05, slower than the 9.5 percent YoY growth in FY04. Specifically, not only did the growth of CBR taxes fail to keep pace with the growth in the economy, the collection of surcharges witnessed a decline (reflecting the government's decision not to raise the domestic prices of many oil products in proportion to the rise in their international prices). As a result, the tax to GDP ratio dropped to 10.1 percent, the lowest since FY78 (see **Table 4.1**).

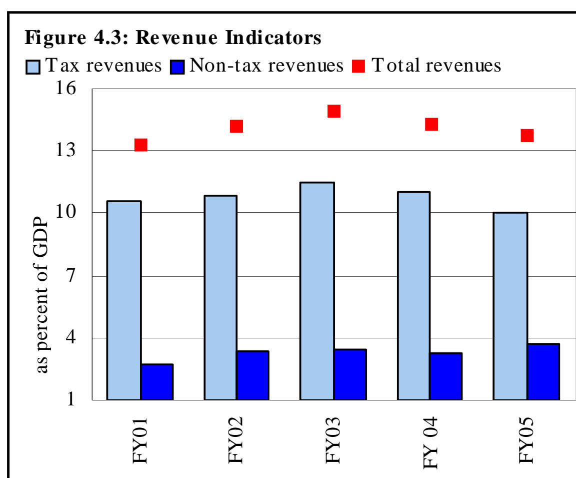


Figure 4.3: Revenue Indicators

One silver lining in the FY05 revenue profile was the strong rise in non-tax receipts. These rose by 31.7 percent YoY during the period, in contrast to the 10.7 percent YoY increase in the preceding year. As a result, the share of non-tax revenues in total revenues increased to 27 percent in FY05. The major contributions to this increase were from: (1) defence service receipts that contributed Rs 52.5 billion, (2) above-budget profits of the SBP, which contributed Rs 10 billion; and, (3) Rs 17.7 billion of revenue from PTA.[3] However, dividend income declined from Rs 74.3 billion in FY04 to Rs 56.8 billion in FY05.

In summary, revenue indicators demonstrate a very stagnant condition. Tax buoyancy estimates show a persistent decline over the last three years, falling to 0.5 in FY05, from 1.7 percent in FY03. All these factors suggest stagnancy in the tax base and weaknesses in resource mobilization efforts.

4.2.3 Expenditure Indicators

Total expenditure rose by 25.1 percent YoY to reach Rs 1,195.5 billion in FY05 compared to a growth of 6.4 percent in FY04. As result, the expenditure to GDP ratio rose to 18.3 percent in FY05, as compared to 17.3 percent in FY04, but remained below the historical levels (see **Figure 4.4**).

Encouragingly, this strong rise in expenditure growth is primarily on account of development spending rather than current expenditure. Current expenditure, which rose to 21.7 percent YoY to Rs 943.1 billion, exceeded the budgeted target of Rs 856.5 billion. However, when seen as a percentage of GDP, the rise is small – from 14 percent in FY04 to 14.4 percent in FY05. A substantial contribution to this relatively positive expenditure profile is the subdued growth in both defence spending and interest payment. Interest payments as a percentage of GDP actually continued to

[2] However, it is notable that BE for FY05 were set to mobilize revenue at 13.7 percent of GDP.
[3] PTA through LDI, FLL and WLL license fees has generated revenue of about Rs 17.7 billion.

decline in FY05, while defence spending remained static as a percentage of GDP. In fact, defence expenditure has remained stagnant throughout the last six years, i.e. FY00-FY05 (see **Figure 4.5**). Net lending to PSEs increased by 21.4 percent; this rise in lending was mainly due to huge losses in the energy sector (see **Box 4.1**).

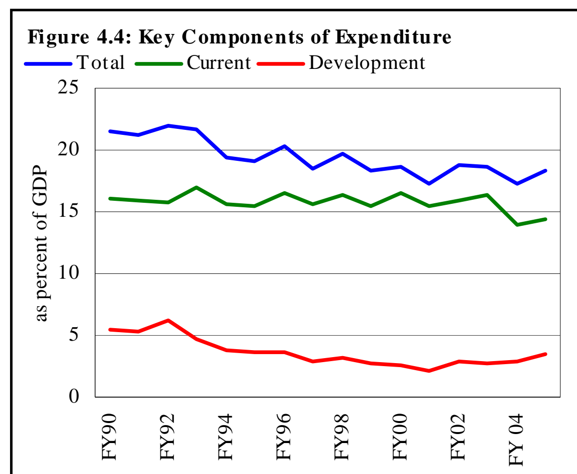


Figure 4.4: Key Components of Expenditure

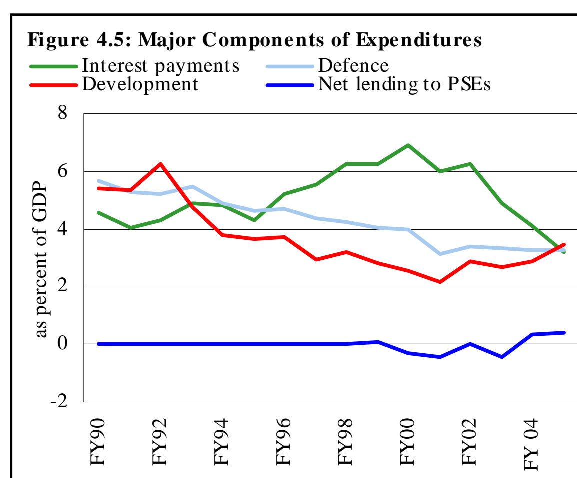


Figure 4.5: Major Components of Expenditures

4.3 Fiscal Developments at the Federal Level

The federal government surpassed the revenue collection target of Rs 796.3 billion for FY05, with the actual receipts of Rs 867.6 billion, representing a YoY increase of 14 percent. Out of the FY05 collection, Rs 624.8 billion were from taxes, while Rs 242.8 billion comprised of non-tax revenues.

4.3.1 CBR Tax Performance

CBR contributed around Rs 591.1 billion in total revenue collection against the revised target of Rs 590 billion during the year, showing a growth of 13.5 percent YoY, as compared to a growth of 13.1 percent in the preceding year (see **Table 4.2**), but below the nominal GDP growth rate of 18.3 percent during the year.

The causative factor seems to be the inflexibility in the tax system as the CBR tax buoyancy estimates are around 0.7 in FY05 as compared to the 0.9 percent for the last year, depicting the resultant stagnancy in revenue mobilization efforts and a contracting tax base. Nonetheless, CBR with its tax reforms strategies (see **Box 4.2**), is projecting to collect revenues of almost Rs 690 billion in FY06, improving the tax buoyancy to 1.1.

Table 4.2: Actual Tax Collections (net) by CBR

billion Rupees

	Collection	Budgeted Targets	Revised Targets	Collection	Abs. Difference with		Targets	Growth over
	FY 04	FY05	FY05	FY 05	FY04	Target	FY06	FY04
Direct Taxes	165.1	181.7	182.7	183.1	18.0	0.4	215.4	10.9
Indirect Taxes	355.8	398.4	407.3	408.0	52.2	0.7	474.6	14.7
Sales Tax	219.2	249.2	239.5	240.0	20.8	0.5	294.0	9.5
Central Excise	45.6	46.9	52.8	52.9	7.3	0.1	59.4	16.0
Customs	91.0	102.3	115.0	115.1	24.1	0.1	121.2	26.5
Total	**520.8**	**580.1**	**590.0**	**591.1**	**70.2**	**1.1**	**690.0**	**13.5**

Source: Central Board of Revenue

Assuming that the total revenue to GDP ratio should have matched at least the 14.9 percent achieved last year the decline of 1.4 percentage points in FY05 has to be assessed (see **Table 4.3**).

Box 4.1: Public Sector Enterprises (PSEs)
Net lending to PSEs is one of the critical issues faced by the government. Despite different Financial Improvement Plans (FIPs), financial position of PSEs presents a dwindling picture over time.

WAPDA registered a huge deficit of Rs 22.6 billion in FY05. The first financial improvement plan for WAPDA was made in FY02, which was subsequently revised in FY03 due to the further deteriorating financial condition. GOP provided continuing support to WAPDA in the form of loans, equity injection and subsidies. In FY04, Rs 13.6 billion was allocated on account of PSDP which increased to Rs 14.2 billion in FY05, while the budgeted support for FY06 is around Rs 16.1 billion. Federal investment, however, decreased to Rs 28.9 billion in FY05 from Rs 34.5 billion in FY04. The volume of subsidies in FY05 was reported as Rs 22.0 billion that is estimated to rise to Rs 24.0 billion in FY06. Despite these measures, WAPDA could not service its debt liabilities of Rs 21.6 billion due to a higher financing gap in FY05, which were converted into Government equity.

KESC faced a deficit of Rs 3.7 billion during FY05. In order to meet FIP targets, GOP provided subsidies of around Rs 9.7 billion in FY05 that is likely to decline to Rs 9.6 billion in FY06. In FY04, government allocated Rs 6.7 billion on account of PSPD, while the equity injection of Rs 9.2 billion is made in FY05. Government attempted to sell around 73 percent of KESC shares through the privatisation process, which remained unrealized.

Pakistan Railways reduced its overall deficit to Rs 3.6 billion in FY05 from Rs 5 billion in FY04. Its over all losses are gradually declining through continuous resource allocation through FIP programmes. GOP's resource allocation to Railways division on account of PSDP was around Rs 8.1 billion in FY04 that rose to Rs 9.3 billion in FY05, and is estimated to be Rs 9.8 billion in FY06. In FY04, Railways' actual losses, Rs 1.8 billion, were below the FIP target and in FY05 railways maintained its losses to Rs 3.6 billion that are Rs 4.2 billion lower than the FIP targets of Rs 7.8 billion.

Pak-Steel illustrated a relatively better position in its profitability over the last three years. The net profit of Rs 1.1 billion in FY03 increased to Rs 4.9 billion in FY04 and to Rs 6 billion in FY05 with a capacity utilization of 89 percent. However, it is notable that the capacity utilization was 91 percent in FY03, 93 percent in FY04, while it declined to 89 percent in FY05. Therefore, the net profit of Rs 6 billion in FY05 could have further improved if maximum production capacity was utilized.

PIA, one of the main public sector enterprises, bore huge losses from 1998 to 2000. Therefore, government introduced a comprehensive financial plan to help it recover from further losses. As a result its financial position improved in the 2nd half of 2001. Thereafter, financial accounts of PIA presented a profitable position; however, currently PIA is facing some loss due to high fuel prices. Government had approved the financial package of Rs 20 billion for long term financing & TFCs, while the amount equal to mark-up was provided from time to time, as equity injection. The federal government injected equity amounting to Rs 5 billion in FY05 that is estimated at Rs 1.3 billion in FY06.

Box 4.2: Tax Administration Reforms in Pakistan
CBR is implementing tax administration reforms in Pakistan since 2001. A number of positive steps have been taken to provide a taxpayer friendly environment in the country with the ultimate view to promote voluntary compliance and enhance resource base in the country. Following is the outline of such measures:

- Simplification of tax laws through promulgation of income tax ordinance, 2001
- Universal self assessment introduced in income tax regime
- Minimum interface between the tax official and taxpayer
- Re-structuring of CBR on functional lines
- Automation of assessments and refunds
- Establishment of Large Taxpayers Units (LTU) /Medium Taxpayers Unit (MTU)/ Tax facilitation Centres (TFCs)
- Integration of income tax and sales tax functions
- Effective dispute resolution systems
- Customs Administration Reforms (CARE) to reduce the cost of doing business

Table 4.3: Decomposition of Revenue to GDP Ratios[4]
percent

	Total Revenues			Total Tax Revenue			Total Non-tax Revenue		
	Total	**Federal**	**Provincial**	**Total**	**Federal**	**Provincial**	**Total**	**Federal**	**Provincial**
FY00	13.5	12.6	0.9	10.7	10.2	0.5	2.8	2.4	0.4
FY01	13.4	12.4	1.0	10.7	10.2	0.5	2.7	2.2	0.5
FY02	14.2	13.3	0.9	10.9	10.5	0.4	3.3	2.8	0.5
FY03	14.9	13.9	1.0	11.5	11.0	0.5	3.4	2.9	0.5
FY04	14.9	13.5	1.4	11.6	10.6	1.0	3.3	2.9	0.4
FY05	13.5	11.9	1.6	10.6	9.6	1.0	2.9	2.3	0.6
Average	**14.1**	**12.9**	**1.1**	**11.0**	**10.4**	**0.7**	**3.1**	**2.6**	**0.5**

Source: CBR Year Book 2004-05

Thus, the main causative factors behind the weaknesses in revenue collection are the lower Federal revenue collection, and that too in the tax and non-tax components. In the Federal tax component, the surcharges/GDP dropped by 0.6 percentage points due to a deliberate policy of reducing the Petroleum Development Levy to offset the cushion of higher international oil prices. The reduced CBR revenue-to-GDP ratio has arisen due to lower collection on account of direct taxes (3.0 to 2.8 percent of GDP) and sales tax (4.0 to 3.7 percent of GDP) (see **Table 4.4**).

Table 4.4: Decomposition of Tax/GDP Ratio
percent

	Total Taxes	Federal Taxes	CBR Revenues	Surcharges	Provincial Tax
FY00	10.7	10.2	9.2	1	0.5
FY01	10.7	10.2	9.4	0.7	0.5
FY02	10.9	10.5	9.2	1.2	0.4
FY03	11.5	11.0	9.6	1.4	0.5
FY04	11.6	10.6	9.4	1.1	0.5
FY05	10.6	9.6	9.0	0.5	0.5

Source: CBR Year Book 2004-2005

Tax Analysis by Components

Direct Taxes

With a growth of 10.9 percent YoY, direct taxes contributed around 31.0 percent of the FY05 revenue collection as compared to 31.7 percent in FY04. As this was the first full year in which the impact of Universal Self Assessment Scheme can be gauged it would be useful to disaggregate the corporate and individual tax payer categories. Of Rs 172.5 billion collected under income tax (Rs 10.6 billion being other direct taxes), the corporate sector's share was Rs 110.4 billion (or 64 percent) while that of individuals was Rs 61.1 billion (or 36 percent). This compares with Rs 102.6 billion paid by the corporate (an increase of 7.6 percent) and Rs 53.3 billon paid by the individuals (an increase of 14.2 percent) in FY04. The refunds under income tax jumped from Rs 19.8 billion to Rs 26.8 billion this year as the arbitrary advance tax regime was rationalized. A total number of 1.23 million returns were filled during FY05 showing an increase of 19.4 percent over the previous year but the number of income tax non-filers is also on rise.

With in the direct tax category, withholding taxes increased to Rs 109.6 billion in FY05, with a growth rate of 20.3 percent. Major heads contributing to this tremendous growth are contracts Rs

[4] The slight variation in the tax related statistics in the chapter is due to the different sources of data used.

33.4 billion (30 percent), imports Rs 24.5 billion (22 percent), salaries Rs 13.3 billion (12 percent), and telephone & electricity Rs 9.8 billion (9 percent).

Indirect Taxes

Sales Tax

The sales tax has been a major contributor in revenue mobilization in recent years, but unexpectedly weak growth receipts meant that its share in total collections dropped in FY05 (see **Figure 4.6**); while the GST receipts of Rs 240 billion were slightly higher than the revised target of Rs 239.5 billion, these were significantly below the original FY05 target of Rs 249.2 billion. Of the FY05 receipts, Rs 94.6 billion were collected from domestic resources and the remaining were collected on imports. The net collection from domestic sales tax grew by only 1.5 percent at the time when large scale manufacturing growth was 15.6 percent. Had it not been for 15.3 percent increase in sales tax on imports the overall outcome would have been even more dismal.

Figure 4.6: CBR Revenue Composition Over Time

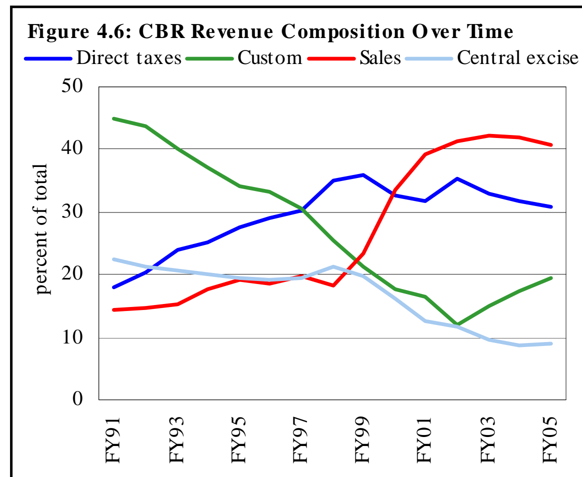
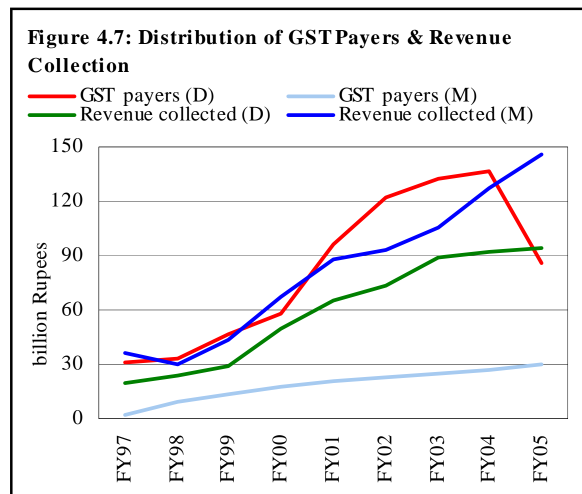


Figure 4.7: Distribution of GST Payers & Revenue Collection



Various policy measures, like deregistration of retailers/manufacturers having annual turnover of less than Rs 5 million, zero-rating & exemption of duty on various products, contributed to the weak GST collections in FY05. However, the amendment in taxpayers slab drastically reduced the number of taxpayers on one hand, and decreased the *sales tax to GDP* ratio from 4 percent during FY04 to 3.7 percent in FY05 on the other, lowering the buoyancy of tax collection (see **Figure 4.7**).

Apart from these facts, a 5 percent growth in refunds (from Rs 52.2 billion in FY04 to Rs 54.9 billion in FY05) is observed, against an 8 percent increase in gross collection (from Rs 271.4 billion in FY04 to Rs 294.9 in FY05) during the year.

Customs Duty

Customs duty collections demonstrated a relatively better performance, with a revenue collection of Rs 115.1 billion, registering a growth rate of 26.5 percent YoY in FY05 (see **Table 4.2**) as compared to a 32.3 percent rise in FY04. The increased receipts are principally the result of the sharp rise in imports during the year, which overshadowed the impact of a continuing decline in the effective tariff rate.

Indeed, during FY05, duty relief over various commodities[5] has led to a drastic increase in the import value of certain commodities like vehicles (up 70.5 percent), machinery and mechanical appliances (up 70 percent), electric machinery and equipment (up 117.5 percent), iron & Steel (up 102 percent), contributing not only to an acceleration in economic activity, but also higher customs duty collections.

Central Excise Duty

Although this tax is being replaced with sales tax, and very few heads are left within the network of Central Excise Duty, the revenue collection showed an upward trend and surpassed its target of Rs 52.8 billion slightly with a collection of Rs 52.9 billion (see **Table 4.2).**

Table 4.5: Central Excise Duty Collection

billion Rupees

Major Commodities	**FY04**	**FY05**	**YoY change**	
			Absolute	**Percent**
Beverages	2.7	2.8	0.1	5.3
Beverages concentrate	1.3	1.7	0.4	29.4
Cigarettes & tobacco	18.4	21.9	3.5	18.9
Cement	9.4	11.1	1.7	17.7
Natural gases	5.5	5.7	0.1	2.3
POL products	3.7	3.9	0.2	5.6
Sub-total	*41.0*	*47.0*	6.0	14.6
Others	3.0	2.8	-0.2	-5.9
Local goods (gross)	*44.0*	*49.8*	5.8	13.2
Imported goods (gross)	*1.7*	*3.1*	1.4	87.3
Total (gross)	*45.6*	*52.9*	7.3	15.9
Refund & rebates	*0.1*	*0.0*	0.0	-31.2
Total (net)	**45.6**	**52.9**	**7.3**	**16.1**

Source: Central Board of Revenue

A commodity wise breakup shows that the biggest contribution to this FY05 increase was from *cigarettes & tobacco* (that comprised 41 percent of the gross annual receipts), followed by that from *cement* (21percent of the gross annual receipts). While the increase in receipts from the first was driven by growth in output (along with price and duty adjustments), the 17.7 percent rise in CED collections on cement reflect the corresponding rise in production following a strong recovery by the construction sector in FY05 and rising exports (see **Table 4.5**).

4.3.2 Surcharges

Surcharges are one of the most important sources of revenue for the government. In FY05, as against the target of Rs 65.3 billion, the collection could hardly reach Rs 26.8 billion, out of which Rs 16.2 billion were collected from gas, whereas Rs 10.6 billion were from the Petroleum Development Levy (PDL).

The shortfall in *surcharge from PDL* is because of a hike in international oil prices that put the government with the difficult choice of passing on in full the higher prices to domestic consumers (and risking a sharp rise in inflation and slower growth) or reducing its fuel taxes (and worsening its fiscal position). The government chose the latter, and consequently, its PDL receipts of Rs 10.6 billion were well short of the Rs 47.4 billion budget target.[6]

4.3.3 Non- Tax Revenues

Non-tax revenues surpassed the target of Rs 141.5 billion in FY05 with an outstanding collection of Rs 240.7 billion, representing a 70 percent rise over the budget estimates. Therefore, the non-tax to GDP ratio rose to 3.7 during FY05 from the 3.3 percent in FY04. This helped out in offsetting the high expenditure during the year.

[5] Duty on plant & machinery was reduced to 5 percent, while agricultural equipment were exempted from any duty, duty rates on vehicles were also slashed in FY05, but even then vehicle remain major revenue spinner during the year.

[6] In addition according to the OCAC, in order to subsidize consumers, and meet the cost of oil companies and oil refineries, it made some adjustments through PDC (Price Differential claimed), keeping PDC positive over MS 87 RON and HOBC, and transferred this impact to the large group of consumers especially, HSD, by maintaining PDC negative over the time Despite all these adjustments government has paid around Rs 9.7 billion on account of PDC to OMCs and Oil refineries in FY05. On the other hand, government's collection through CED and customs duty showed a growth of 9 percent and 10 percent respectively, against the 10 percent growth in the consumption of POL products.

This remarkable growth in non-tax revenue is due mainly to (a) unexpectedly strong profits of the SBP, which allowed a transfer of Rs 10 billion in FY05, compared with Rs 1 billion estimated for the year, (b) unexpectedly strong receipts in defence services, Rs 61.4 billion against the budgeted Rs 11.6 billion, (c) PTA receipts of Rs 17.7 billion against the projected Rs 6.2 billion, (d) and more than expected royalties on gas and oil - Rs 18.3 billion compared with budgeted figure of Rs 16.6 billion, and (e) receipts of Rs 10.4 billion from the United Nations against the estimated figure of Rs 5 billion.

Table 4.6: Federal Government Expenditure

billion Rupees

				Excess/Shortfall over			Change	
	FY04	**FY05**	**FY05**	**FY05**	**FY04**	**FY06**	**FY05 over FY04 RE**	
	RE	BE	RE	BE	RE	BE	Absolute	Percent
I. Revenue expenditure (A+B)	773.2	786.2	866.8	10.2	12.1	961.1	94.3	10.9
A. Current expenditure	714.0	700.8	784.7	12.0	9.9	826.5	41.8	5.3
(i) General public service	448.4	423.8	469.0	10.6	4.6	503.1	34.1	7.3
Debt servicing	317.7	265.3	274.7	3.5	-13.5	301.4	26.6	9.7
(ii) Defence affairs and services	180.5	193.9	216.3	11.5	19.8	223.5	7.2	3.3
(iii) Public order and safety affairs	14.0	15.1	17.5	16.4	24.9	18.7	1.2	6.7
(iv) Economic affairs	54.8	48.8	62.2	27.5	13.5	56.4	-5.7	-9.2
(v) Environment protection	0.1	0.1	0.1	0.0	3.0	0.1	0.0	8.1
(vi) Housing & comm. amenities	0.9	0.8	0.9	4.1	-6.5	0.9	0.0	-0.3
(vii) Health services	2.8	3.3	3.3	0.8	16.8	4.1	0.8	25.9
(viii) Rec., culture & religion	2.0	2.2	2.2	2.2	12.1	2.3	0.1	2.9
(ix) Education affairs and services	9.6	12.2	12.3	1.0	28.0	16.6	4.3	34.9
(x) Social protection	0.7	0.5	0.9	60.1	17.1	0.6	-0.2	-27.8
B. Development expenditure	59.1	85.5	82.1	-4.0	38.8	134.6	52.5	64.0
II. Capital disbursements (A+B)	125.3	122.1	119.7	-2.0	-4.5	132.6	12.9	10.8
A. Current expenditure	65.0	38.7	52.7	36.2	-18.8	36.4	-16.3	-31.0
B. Development expenditure	60.4	83.4	66.9	-19.8	10.8	96.4	29.5	44.0
III. Estimated adjustments in PSDP	-	-	14.6			-		
Total expenditure (I+II)	**898.5**	**908.4**	**1001.0**	**10.2**	**11.4**	**1093.6**	**92.6**	**9.3**

Source: Annual Budget Statement, Government of Pakistan

BE: Budget Estimates, RE: Revised Estimates,

4.3.4 Federal Expenditure

The Federal government spending rose to Rs 1001 billion in FY05, representing an increase of Rs 11.4 percent YoY. Revenue expenditure for FY05 amounted to Rs 866.8 billion with an increase of Rs 12.1 billion; while capital disbursements declined to Rs 119.7 billion (see **Table 4.6**).

The increase in revenue expenditure from 12.8 percent of GDP to 13.2 percent in revised estimates was mainly because of current expenditure that rose to Rs 784.7 billion against the BE of Rs 700.8 billion during FY05. This rise is principally because of public order and safety affairs (up 16.4 percent YoY) defence affairs (up 11.5 percent YoY) and general public services (up 10.6 percent YoY) that grew due to higher debt servicing.[7] Developmental expenditure on Revenue Account (RE) was though 39 percent higher than FY04 but it remained below the budgetary estimate for FY05. This decline is attributable to (a) expenditure on *public health services*, which fell from Rs 5.2 billion to Rs 4.7 billion, (b) a fall in *education affairs and services* expenditure, from Rs 3.8 billion to Rs 2.4 billion (c) a decline in expenditure on *economic affairs*, especially agro *food, irrigation, forestry & fishing*, from Rs 23.7 billion to Rs 21.5 billion.

[7] Debt servicing, however, declined to 4.2 percent of GDP in FY05 from 5.7 percent of GDP in FY04.

Capital disbursements declined 4.5 percent YoY in FY05 to Rs 119.7 billion. This was predominantly because of current expenditure on the capital account, which dropped 19 percent YoY to Rs 52.7 billion in FY05, in contrast to developmental expenditure, which rose 10.8 percent YoY to Rs 66.9 billion (i.e. 20 percent lower than the budgeted outlay) during the same period.

4.3.5 Financing of Federal Budget

Despite a larger deficit, the financing from domestic sources declined sharply in FY05, principally due to a 36.5 percent YoY jump in external finance during the year (see **Table 4.7**).

4.7 Financing of the Federal Government Expenditure

billion Rupees

					Excess/Shortfall over			Change over FY05 RE	
		FY04 RE	FY05 BE	FY05 RE	FY05 BE	FY04 RE	FY06 BE	Absolute	Percent
I.	Revenue receipts (net)	549.6	557.2	630.0	13.1	14.6	643.1	13.1	2.1
II.	Internal resources (i+ii)	104.8	103.2	76.4	-25.9	-27.1	86.7	10.3	13.5
	i) Capital receipts	116.1	102.7	79.8	-22.3	-31.2	70.1	-9.8	-12.2
	ii) Public account	-11.4	0.5	-3.4	-851.2	-69.8	16.6	20.1	-584.4
III.	External resources	144.8	156.4	197.6	26.4	36.5	212.4	14.7	7.5
IV.	Total receipts (i+ii+iii)	799.1	816.7	904.1	10.7	13.1	942.2	38.1	4.2
V.	Change in provincial cash balance	14.3	31.6	6.2	-80.5	-57.0	33.5	27.3	442.5
VI.	Privatization proceeds	11.0	15.0	10.0	-33.3	-9.1	20.0	10.0	100.0
VII.	Credit from banking system	74.0	45.2	80.8	78.9	9.1	98.0	17.3	21.4
Total resources (iv+v+vi+vii)		**898.5**	**908.4**	**1001.0**	**10.2**	**11.4**	**1093.6**	**92.6**	**9.3**

Source: Annual Budget Statement, Government of Pakistan

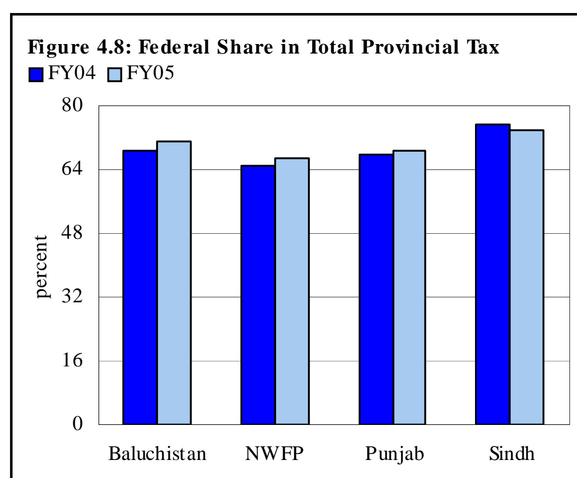
The external resources included (1) commodity aid (Rs 78.6 billion); (2) project aid (Rs 40.8 billion); (3) Issue of *sukuk* (Rs 35.8 billion); and (4) IDB loans (Rs 17.9 billion). Grants provided an additional Rs 18.6 billion, of which commodity aid comprised Rs 12.9 billion. These were supplemented by Privatization proceeds of Rs 10 billion in FY05 (see **Table 4.7**).

The domestic borrowings of Rs 80.8 billion were entirely from the banking system, borrowings from the public account declined (reflecting the net outflow from the NSS instruments).

4.4 Provincial Budgetary Operations FY05

In aggregate, the fiscal position of the provinces depicts an improvement in FY05, with an 18 percent growth in revenues outstripping the 12 percent YoY rise in current expenditures. As a result, the aggregate revenue surplus increased 84.6 percent during the year, which was used to finance the development expenditure of the provinces. Due to large amount of surplus on revenue account and receipt of larger amount of development grants from the federal government, recourse to net capital receipts during FY05 was almost half of that in FY04. Major contribution was from the federal tax transfer from the divisible pool (see **Figure 4.8**), followed by non-tax revenue. Provinces' own FY05 tax collection was only marginally higher than that in FY04 (see **Box 4.3**).

Figure 4.8: Federal Share in Total Provincial Tax



Box 4.3: Vertical Imbalance[1] in Pakistan

In Pakistan, the vertical imbalance has increased since the process of decentralization began in FY01. On the one hand, the share of provincial revenues in total revenue receipts has increased only marginally from an average of 6.8 percent during FY95-00 (pre-devolution period) to 7.0 percent during FY01-05 (the devolution period), and on the other hand, the share of current expenditures increased from 23.8 percent during FY95-00 to 26.3 percent during FY01-05 stretching the vertical imbalance. As a result, contrary to the objective of the fiscal devolution exercise, the reliance of provinces on receipts from the federal government has only increased over the period. The increase in current expenditures of the provincial governments due to the devolution plan has further deepened this dependence.

Table B1: Vertical imbalance billion Rupees

	FY96-00 (pre-devolution)	FY01-05 (post devolution)
Total revenues	**2175.1**	**3540.3**
Provincial receipts	147.7	248.0
Share	6.8	7.0
Total expenditure	3049.9	4448.6
Current expenditure	2582.9	3778.5
Share	84.7	84.9

Source: Economic Survey

[1]Vertical imbalance is defined as degree of which provincial governments rely on federal government revenues to support their expenditure. In other words, this indicates the magnitude of transfers required from one level of government to the other in order to balance the budget.

A look at the performance of individual province reveals that an improvement is visible for all provinces but NWFP; however, all of the *increase* in the revenue surplus during FY05 is from the budgetary operations of the Punjab (see **Table 4.8**). The fiscal performance of each province is discussed below:

Balochistan

Through the years, financing of the developmental budget has been an issue for Balochistan. In FY05, total resources mobilized by Balochistan amounted to Rs 29 billion, with a YoY increase of 22.6 percent; approximately 71 percent comprised the provincial share in federal taxes. The federal

Table 4.8 : Provincial budgets at a glance

billion Rupees

Receipts/Expenditures	Balochistan FY 04	Balochistan FY 05	NWFP FY 04	NWFP FY 05	Punjab FY 04	Punjab FY 05	Sindh FY 04	Sindh FY 05	All Provinces FY 04	All Provinces FY 05
I. Total revenue receipts	**23.7**	**29.0**	**39.6**	**45.3**	**155.6**	**181.3**	**85.6**	**102.6**	**304.4**	**358.2**
(i) Total tax revenue	17.0	21.4	27.7	32.6	123.9	143.7	73.9	86.4	242.5	284.0
(ii) Non-tax revenue	6.7	7.7	11.9	12.7	31.6	37.6	11.6	16.2	61.9	74.2
II. Current expenditure	24.4	26.2	30.4	42.7	130.9	136.4	93.1	105.7	278.8	310.9
Revenue surplus (+) / deficit (-)	-0.7	2.8	9.2	2.6	24.6	44.9	-7.5	-3.1	25.6	47.3
III. Ttotal development expenditure	**13.5**	**14.9**	**12.9**	**15.9**	**39.4**	**62.8**	**16.0**	**29.8**	**81.8**	**123.4**
(i) Development revenue expenditure	0.0	0.0	2.1	2.5	25.8	39.0	2.7	4.5	30.6	46.0
(ii) Development capital expenditure	13.5	14.9	10.8	13.3	13.6	24.0	13.3	25.3	51.2	77.5
(iii) Outside ADP/ Foreign project assistance/ Operational shortfall	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0		-0.1
Development expenditure financed by										
(i) Revenue surplus (+)/ deficit (-)	-0.7	2.8	9.2	2.6	24.6	44.9	-7.5	-3.1	25.6	47.3
(ii) Net capital receipts	-0.8	-5.0	-12.6	-2.8	-5.7	1.5	-3.6	-4.6	-22.7	-10.9
(iii) Net public account receipts	3.5	2.3	2.3	5.0	4.2	1.3	19.1	5.4	29.1	14.0
(iv) Development revenue receipts / grants	1.9	2.6	0.8	2.3	4.9	5.2	5.1	9.0	12.8	19.1
(v) Federal government loans / public debt	1.5		9.6	4.1	8.3	8.7	2.0	2.5	21.3	22.4
(vi) Cash balance utilization /improvement	8.1	5.0	0.0	0.0	3.2	1.3	-8.0	2.3	3.3	8.6
(vii) Adjustment outside ADP / other sources	0.0	0.0	3.5	4.6	0.0	0.0	8.9	18.3	12.4	22.9
IV. Total ADP resources	**13.5**	**14.9**	**12.9**	**15.9**	**39.4**	**62.8**	**16.0**	**29.8**	**81.8**	**123.4**

Source: Annual Budget Statements of provinces

transfers (Rs 20.6 billion) comprised mainly sales tax (Rs 4.3 billion), surcharges on gas (Rs 4.6 billion), CED and royalties on natural gas & crude oil (Rs 3.2 billion) and custom duties (Rs 2.1 billion).

Current expenditure amounted to Rs 26.2 billion, up 7.3 percent YoY, while developmental expenditure rose 10.2 percent YoY to Rs 14.9 billion in FY05. During the year the revenue balance turned into a surplus (Rs 2.8 billion) from the previous year's deficit of Rs 0.7 billion; the improvement was mainly due to an increase in receipts by 22.6 percent compared to a 7.3 percent YoY increase in current expenditure. With the development expenditure of Rs 14.9 billion, the gap reached at Rs 12.1 billion during FY05, showing an improvement relative to the Rs 14.2 billion in FY04. This gap was financed through public debt (Rs 7.1 billion), net public account receipts (Rs 2.3 billion) and grants (2.6 billion).

Balochistan has accumulated a debt of Rs 44.5 billion at end June FY05, at an annual growth rate of 7.1 percent per annum since 1997.This sharp increase in debt liability has seriously undermined the debt carrying capacity of the province. In FY05 the quantum of domestic debt was amounted to Rs 10.1 billion extended by the federal government as Cash Development Loans (CDL) at a high interest rate ranging from 10.75 percent to 17.71 percent, while the quantum of foreign debt liability was estimated to Rs 25.1 billion, most of which are soft loans. Therefore, government is trying to tackle this issue by prematurely retiring cash loans and replacing them with soft loans. In this regard, it is seeking soft loan from the ADB under Balochistan Resource Management Program (BRMP).[8] The 2nd trench of Rs 4.1 billion under this program was disbursed in FY05. The fiscal weaknesses exposed the government to continuous liquidity problems and consequently it breached its OD limits[9] with the SBP, which added to its debt liabilities over time. In FY05, due to worsening of the situation, the federal government had to create a blocked loan[10] of Rs 9.3 billion.

N.W.F.P

Total revenue receipts of NWFP during FY05 rose 14.4 percent YoY to Rs 45.3 billion (see **Table 4.8**), just 2 percent lower than the budgetary estimate for the period. This shortfall is due to significantly below-target non-tax revenues (Rs 12.7 billion versus a Rs 14.6 billion target), that was only partially compensated by above target tax receipts (Rs 32.6 billion against the target of Rs 31.6 billion).

The current expenditure for the year was Rs 42.7 billion, 40.4 percent higher than in FY04, while total developmental expenditure amounted to Rs 15.9 billion almost 23.1 percent higher than in FY04. Both the revenue and capital expenditure presented large growths of 22.4 percent and 23.2 percent respectively. Allowing for developmental expenditure of Rs 15.9 billion, there was a net gap of Rs 13.3 billion, which was financed through net public account receipts of Rs 5 billion, federal loans/ public debt Rs 4.1 billion, adjustments outside ADP Rs 4.6 billion.

Total debt outstanding by end FY05 was Rs 61.1 billion, inclusive of Rs 23.6 billion owed to the federal government (see **Table 4.9**). Historically, the government loans were obtained at a mark-up rate of over 17 percent which severely undermined the debt sustainability of the province. Realizing

[8] BRMP comprises of two program loans, (i) US$ 110 million equivalent from ordinary capital resources of 15- year term, and (ii) US$ 20 million equivalent from SDRs of 24-year term for public resource management, while a support of US$ 3.0 million will also be financed by ADB under TA project loan.

[9] The OD limit for Balochistan was Rs 700 million in FY04 that it breached to Rs 6 billion. This limit was revised to Rs 1.7 billion in FY05, however, despite having a blocked loan, it stood at Rs 2.2 billion.

[10] The province had crossed the ways and means limits with SBP, and was charged punitively at market rates for an OD of over Rs 10 billions that shot up to Rs 13 billion in Oct 2004. Therefore, with the support of the federal government it was first brought down and then converted into a blocked loan of Rs 9.3 billion in Dec, 2004, however, this blocked loan stood at Rs 8.7 billion at Jun FY05.

the heavy debt servicing costs, the provincial government chalked out an early debt retirement strategy in FY01. Accordingly, it prematurely retired debt of Rs 5.7 billion in FY03, Rs 2.0 billion in FY04, and Rs 2.5 billion in FY05. Thus, total savings from early debt retirement programme have been Rs 1.1 billion, Rs 384 million and Rs 448 million in respective fiscal years. The government aims to retire a total domestic debt of Rs.15 billion until FY11, including Rs 3.2 billion in FY06.

Table 4.9: NWFP Outstanding Debt
billion Rupees

			Change	
	FY04	FY05	Absolute	Percent
Total debt	61.1	61.1	0.0	0.0
Domestic	27.4	21.1	-6.3	-23.0
External	33.7	40.0	6.3	18.6

Punjab

The Punjab showed an impressive performance in financial management in FY05, registering a revenue surplus of Rs 44.9 billion, with a YoY increase of 82.3 percent. This was achieved through a higher revenue growth of 16.5 percent and a relatively slower growth of 4.2 percent in current expenditure. The rise in revenues is equally attributable to both the tax (16 percent) and the non-tax revenues (18.9 percent).

The FY05 showed a massive increase of 59.3 percent in total developmental expenditure. The major chunk of the development expenditure was allocated to local government (Rs 20.8 billion), roads (Rs 14.5 billion), water and power (Rs 6 billion) and rural development (Rs 4.6 billion). The higher revenue surplus, coupled with substantial increase in developmental expenditure resulted in a manageable gap of Rs 17.9 billion, which was primarily financed through foreign multilateral loans of Rs 8.7 billion and development revenue receipts/grants of Rs 5.2 billion.

Total debt liability stood at Rs 162.7 billion in FY05, of which expensive CDL comprised 41.5 percent. Like other provinces, the Punjab government is also replacing these high cost loans with soft loans; it has already retired CDL worth Rs 11.7 billion through programme loans.

Sindh

Overall budgetary performance for the year showed an improvement, as revenue deficit declined by 58.4 percent reaching Rs 3.1 billion. This progress on revenue balance is mainly due to 20 percent increase in revenue receipts, against a growth of 13.6 percent in current expenditure. The rise in revenues principally came from both tax and non-tax sources that significantly increased by 17 and 39 percent respectively.

Despite having a revenue deficit of Rs 3.1 billion, the provincial government increased the volume of developmental expenditure to Rs 29.8 billion with an annual increase of 86.4 percent, leading to a financing gap of Rs 32.9 billion. Financing of this gap was principally made through adjustment outside ADP resources (Rs 18.3 billion), grants (Rs 9 billion), and net public account receipts of Rs 5.4 billion (see **Table 4.8**).

Sindh is also faced with high indebtedness. The debt liability as on June 30, 2005 stood at Rs 110.3 billion, comprising of Rs 35.75 billion of CDL and Rs 74.51 billion in foreign loans. Cash development loans by the Federal government are the biggest problem for the province.[11] So the government is focusing on premature debt retirement of expensive loans and replacing them with soft loans. It has already retired about Rs 6.2 billion in the last two years, saving an amount of Rs 1 billion. The government has projected to retire CDL of Rs 2.4 billion in FY06 that will further save Rs 380 million. The financial position of Sindh is likely to remain poor if its revenue receipts do not exhibit substantial improvements.

[11] Out of Rs 110.2 billion paid to the Federal government in FY05, Rs 92.66 billion (84 percent) was the mark-up.

Special Section 4.1: Analysis of Tax Reform in Pakistan

At present, the government is implementing reforms in the tax administration that were approved in November 2001 in consultation with (and with the financial assistance of) the World Bank. The reform strategy aims at increasing effectiveness of CBR, reducing corruption opportunities and raising the buoyancy of the tax system through organizational re-structuring, self-assessment, reduction of personal contact between taxpayers and tax collectors, simplified processes, revised terms and conditions for employment of CBR officials and improved IT management.[12]

There are certain missing links in the reform process. Tax avoidance and evasion still appears to be widespread.[13] To quote an example, out of 12,526 returns filed by corporate sector[14] in FY04, only 3,888 or 31 percent have paid some income tax and the rest 69 percent taxpayers have either declared business losses or there is nil income to declare, yet there seems to be little effort to increase the tax compliance and reduce the tax gap in the country. Indeed, quite to the contrary, it appears that the suspension of sales tax and income tax audit in FY05 and 100 percent reliance on taxpayers' version of their income, may have weakened the capacity of the tax administration to collect due taxes, as reflected in the declining tax buoyancy in recent years. Penal provisions in the income tax ordinance, 2001 have also become ineffective.

Therefore, in order to meet the declared objectives of the reforms, it is necessary to highlight the tax performance of CBR in an objective manner using key economic indicators, and to monitor progress over time. The following analysis aims to make an objective assessment of the tax reform process, and to make evidence-based policy recommendations to accelerate resource mobilization and tax compliance in the country.

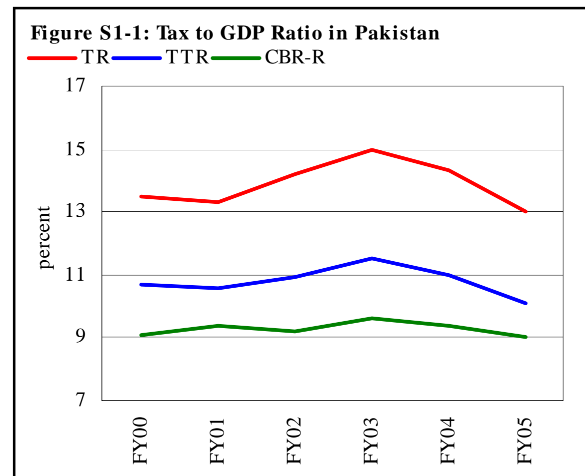
1.1 Resource Mobilization

(a) Tax-to-GDP ratio

The tax-to-GDP ratio, which reflects the efficiency of a tax system, had remained stagnant over the years reflecting the inelasticity of the tax system (see **Figure S1-1**). Ironically, in the wake of the tax reforms, this ratio has deteriorated, falling from 9.6 percent in FY03 to 9.0 percent in FY05.

To put this in perspective, it is worth pointing out that according to the Government Finance Statistics of the IMF, this tax ratio is around 40 percent for high income countries, 25 percent for middle income countries and about 18 percent in low income countries.

Figure S1-1: Tax to GDP Ratio in Pakistan



The low tax-to-GDP ratio for Pakistan not only reflects inefficiency, but also indicates the inequities of our tax system, as many sectors of the economy do not bear the proportionate burden in revenue generation. Prominent examples of these are agriculture and the service sectors.

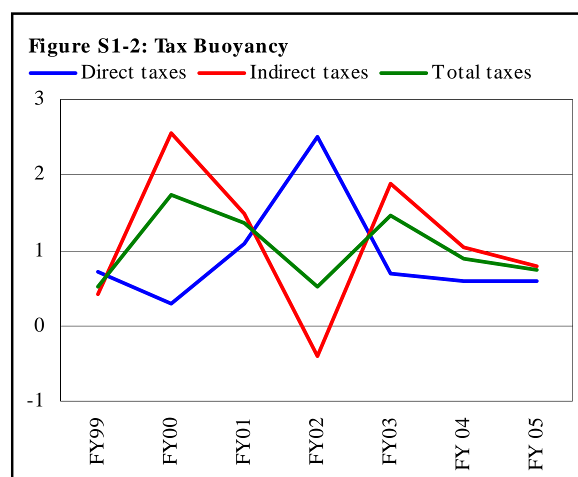
[12] CBR Yearbook 2003-2004, Islamabad.

[13] **Box 4.1.1** looks at different approaches to reducing tax evasion and their application to the Pakistan's tax environment.

[14] There are 45,415 companies registered with the SECP in Pakistan, out of these only 23,090 exist on the NTN register of income tax.

(b) *Tax buoyancy*

The efficiency of a tax system depends on its built-in flexibility, that is, it should be elastic with respect to tax base, so that increase in the GDP can automatically lead to proportionate increase in tax revenues. But in case of Pakistan, the volatility in tax buoyancy estimates suggests that revenue growth over the years has been the result of ad hoc taxation measures, and inconsistent policies.



While the volatility in the tax buoyancies appears to have decreased in recent years, the reforms appear to have reduced the buoyancies, which appear to be trending downwards. In other words, the trends suggest that while tax policies may be more consistent, the growth in receipts is less and less proportionate to the growth in income (see **Figure S1-2**).

1.2 Enforcement and Compliance

(a) ***Number of tax payers in Pakistan.***

In the income tax regime, the gap between the NTN holders and those actually filing returns has substantially widened in the last four years (see **Table 4.1.1**). It must be remembered that the number of registered taxpayers is already low in Pakistan, amounting to approximately 1.5 percent of the population. This problem is exacerbated by the rising trend of non-filing of returns, throughout the period of tax administration reforms.[15] Clearly, the increasing reliance on voluntary compliance, in the absence of effective enforcement, appears to be having perverse consequences for the stability of the tax receipts and documentation of the economy. Appropriate enforcement of compliance is required to check this negative trend in the wake of USAS.

Table 4.1.1: Number of tax payers and return filers in Pakistan

	Total taxpayers		Return Filers		Non-Filers		% Non-filers	
	Income tax (NTN)	Sales Tax (RPs)	Income tax	Sales tax	Income tax	Sales tax	Income tax	Sales tax
FY00	1142373	75538	972873	56771	169500	18767	14.8	24.8
FY01	1230199	117416	1050602	108879	179597	8537	14.6	7.3
FY02	1359778	144537	973638	131031	386140	13506	28.4	9.3
FY03	1521939	156417	1019108	137714	502831	18703	33.0	12.0
FY04	2099638	163188	1029279	143738	1070359	19450	51.0	11.9
FY05	2276395	114952	1229952	105042	1046443	9910	46.0	8.6

Source: Central Board of Revenue

The sales tax has relatively performed better on this count as the percentage of non-filers has considerably decreased. However, as the data shows, the number of sales tax net-registrants has also declined (see **Table 1**), and the total registered sales tax payers have dropped to a five-year low. This is principally due to the increase in the threshold limit for registration of retailers & turnover manufacturers, from Rs 1 million and 0.5 million respectively, to Rs 5 million in FY04; this measure,

[15] The low tax compliance is acknowledged by the CBR. Please see CBR Quarterly Review, Vol. 4, No.4, April-June 2005, p-47-48. The rise in non-filers of income tax return defaulters is attributed, in part, to the presence of a large number of infructuous cases. In other words, the rising percentage of non-filers may simply be due to fake NTNs for which no returns are filed. However, if this is the case, then the number of registered NTNs will significantly decline, suggesting even narrower tax base.

resulted in de-registration of 48,236 registered taxpayers in FY05 (see **Table 4.1.2**).

This has a number of problems. The decision resulted in a sharp erosion of the potential GST tax base. This is clearly evident from the sharp reduction in the taxpayers in many categories (see **Table 4.1.2**) following the policy change. Moreover, the resulting inequitable tax burden on different categories of taxpayers, will only create added incentive for tax avoidance and evasion, and discourage documentation of the economy.

Table 4.1.2: Category-wise Sales tax Registered Person s in Pakistan

thousand persons

Categories	FY01	FY02	FY03	FY04	FY05
Manufacturers	43.1	48.9	50.5	52.1	30.9
GST manufacturers	33.6	32.2	33.5	34.9	30.9
Turnover manufact.	9.6	16.6	17.0	17.1	0.0
Importers	21.1	22.4	24.5	26.7	29.5
Exporters	6.7	7.7	9.7	10.2	10.1
Wholesale/Distributors	24.0	28.9	33.0	34.4	35.0
Retailers	16.8	30.0	31.7	32.6	1.7
GST retailers	3.1	5.9	6.6	7.4	1.7
Enrolled retailers	13.7	24.1	25.1	25.2	0.0
Services	5.7	6.7	7.0	7.1	7.8
Grand total	**117.4**	**144.5**	**156.4**	**163.2**	**115.0**

Source: Central Board of Revenue

The above analysis suggests that reliance on voluntary compliance, in the absence of effective enforcement, has in fact jeopardized the government's efforts for widening the base of all taxes, particularly income tax and sales tax and lowered the level of tax compliance in the country. This also suggests that the capacity of the tax administration to widen the tax base and check unreported incomes has weakened, at least during the initial phase of the tax reforms.

Table 4.1.3: Components of Income Tax Collection

billion Rupees

	FY01	FY02	FY03	FY04	FY05
Collection on demand	16.5	23.2	25.5	19.9	17.5
Current demand	12.3	18.7	22.1	15.8	13.4
Arrear demand	4.2	4.5	6.0	4.1	4.1
Voluntary payments	35.0	50.9	53.9	66.5	73.9
Withholding tax	79.2	78.9	85.0	91.1	109.6
Gross collection	**130.6**	**153.0**	**164.4**	**178.2**	**201.6**
Refunds	13.2	16.4	19.0	20.8	29.1
Net collection	**117.5**	**136.5**	**145.4**	**157.4**	**172.5**

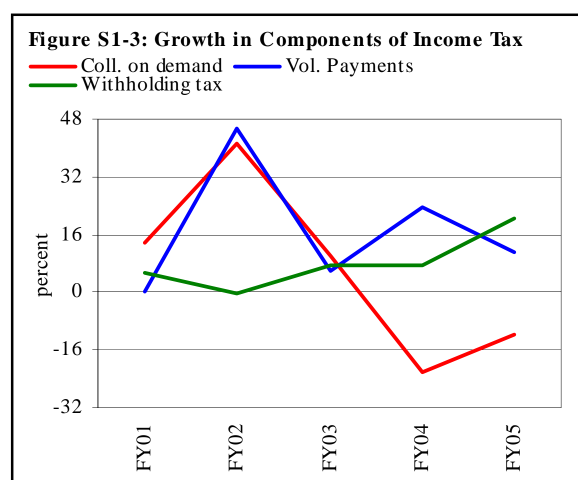
Source: Central Board of Revenue

(b) ***Income tax collection on demand***

Additional tax liability generated and collected as a result of audit of taxpayers is an important indicator of efforts made by tax administrations in detecting under-reporting of incomes/sales or over-reporting of expenditure or claiming inadmissible expenses/reliefs.

Income tax collection on demand in Pakistan has declined for the last two years (see **Table 4.1.3**), during which the income tax audit activity remained almost suspended and no audit of cases under the USAS was carried out.

More troublingly, the growth in voluntary payments of income tax failed to even offset the decline in the collection on demand during the last two years. The number of defaulters of income tax returns also jumped by 51 percent and 46 percent during FY04 and FY05, respectively.



Indeed, it seems that much of the growth in income tax receipts in recent years has been through withholding taxes; the collection of these taxes increased by 20.3 percent in FY05 and 7.2 percent in FY04. Since the broad policy on these taxes has remained essentially unchanged, it can be argued that the rise in the overall income tax collections

in recent years is mainly a result of the boom in economic activity in the country (see **Figure S1-3**).

There is little evidence to suggest that the system of voluntary compliance has induced higher tax collection as a consequence of tax reforms. Conversely, the data shows that the over-reliance on voluntary compliance, without a strong deterrence of effective audit, may have increased the tax gap in the country. Similar trends were visible in the sales tax regime where audit remained suspended in FY05 and the overall sales tax collection could not meet its target. The number of sales tax cases audited during the last four years has shown a steady and sharp decline, from 22,267 cases audited in FY02 to merely 4437 in FY05.

(c) ***Gross compliance ratio and productivity of sales tax***

One measure for assessing the degree to which the VAT is applied is the Gross Compliance Ratio (GCR).[16] The gross compliance ratio (GCR) and productivity of the sales tax in Pakistan have been computed (see **Table 4.1.4**). Comparing with the international benchmark value of 69 percent for advanced countries, the GCR of 50.1 percent for Pakistan is very low. Another very commonly used indicator of how well a VAT is applied in a country is the VAT productivity rate.[17] VAT productivity of Pakistan, at 24 percent is much lower than that of UK (39.9 percent), Japan (50.5 percent), Turkey (40.3 percent), and Hungary (30 percent). These indicators of efficiency of sales tax regime are less than satisfactory in Pakistan primarily because of disproportionate burden of sales tax across various sectors of the economy.[18]

Table 4.1.4: Gross compliance ratio and productivity of sales tax

	FY05
Private Consumption (excluding food) as % of GDP	48.8
VAT collection as % of GDP	3.7
Potential Collections as % of GDP	7.3
Nominal VAT rate	15.0
GCR	50.1
Productivity %	24.4

1.4 Administrative cost of taxation

This is a rather gross indicator of administrative efficiency. Internationally, tax administrative costs vary widely, with the richest countries generally having the lowest costs with respect to how much they collect, whereas the poor countries have the highest costs. During mid-1990s, the administrative costs of taxation at national level in the UK, Canada and the US were 1.8, 1.8 and 0.83 per 100 Dollars respectively. In countries like Nicaragua, Peru and El Salvador the compliance costs were highest, at 3.86, 3.0 and 3.0 percent respectively.

Table 4.1.5: Revenue, expenditure and cost of collection in Pakistan

billion Rupees

	Revenue Collected	Cost / Expenditure Incurred	Cost as Percent of Revenue Collected
FY97	282	1.9	0.67
FY98	294	2.1	0.71
FY99	308.5	2.6	0.84
FY00	347.1	2.3	0.66
FY01	392.3	2.5	0.64
FY02	404.1	2.5	0.62
FY03	460.6	3.1	0.67
FY04	520.8	3.1	0.60
FY05	591.1	3.3	0.56

Source: Central Board of Revenue

Pakistan's tax authority has been collecting revenues at a very low cost even before the reform process began (see **Table 4.1.5**). The government has obtained $150 million assistance from the WB to implement the on-going tax reform program. However, the revenue-expenditure ratio is still much

[16] The GCR is merely the actual VAT collection in ratio, or as percentage, to the total, potential VAT collection. Total conceivable collection is that collection that would be achievable in the absence of evasion or exemptions. The GCR is only related to private consumption rather than total consumption. This neglects government consumption, which is usually not subject to tax.
[17] This is the ratio of VAT collections to GDP divided by the nominal VAT rate.
[18] In this regard, the example of El Salvador can be cited, where the GCR rose significantly from 45 percent in 1994 to 63 percent in 1995. This resulted from strenuous tax efforts, including the incarceration of tax evaders and shutting down of businesses for non-compliance. (USAID (2004), Assessing tax systems using a benchmarking methodology, p.10-11)

lower than international standards.

1.5 Conclusion

Tax culture that promotes voluntary compliance and inculcates taxpayer friendly environment is always assumed as a key to success; however, it also needs to be complemented by effective audit, and a system of penalties and prosecution for tax evaders and dodgers, otherwise, it is likely that the tax delinquents will betray the trust and confidence reposed on them by taking advantage of the self-assessment scheme and automated refund systems. Therefore, the tax policy in Pakistan needs to strike a balance between these two important aspects.

The view taken that "broad-based policy and tax reforms have substantially improved the revenue collection and opened new avenues of revenue generation"[19] has yet to be substantiated in actual practice. It is quite conceivable that in the initial stage of reforms there may be a temporary dip but as long as the structural changes raise the threshold level of collection, the dip may be tolerable. But if the buoyancy, elasticity estimates do not improve and enforcement is not strengthened the dip may persist. The increase in tax revenues in recent years cannot be attributed to the tax reform. On the contrary the data shows that the system of voluntary compliance has not been instrumental in yielding more resources at least in the initial years of tax reform due to absence of effective audit, enforcement and penal actions.

[19] CBR Year Book 2003-2004, p.41.

Box 4.1.1: Curbing Tax Evasion in Pakistan

The future of income tax and sales tax (which are the leading taxes in the country) depends on reducing tax evasion in Pakistan. Tax evasion is rampant and takes many forms. It is, therefore, essential that we look at the means by which we can reduce evasion to increase the resource base in the country. While on-going tax reform aims at inculcating a culture of voluntary compliance and simplification of tax laws, it is equally incumbent that the tax administration creates and maintains a deterrence (through strong audit system and a severe penalty structure) to check tax frauds, concealments of income, fraudulent claims of refunds, and misuse of the Government's goodwill gesture to the taxpayers.

Tax evasion is the failure, by an individual or organization, to pay legally due tax. It takes one or both of two forms:

(1) Under-reporting of taxable income, profits, or sales and receipts;
(2) Over-reporting of tax exemptions, allowances, reliefs, credits.

To reduce tax evasion, tax policy can have *two* choices.

(a) Put more resources into tax administration to increase revenue (capacity enhancement)
(b) Increase revenues (reduce the tax gap) for any given level of administrative cost.

The choice (a) suggest that resources should continue to be employed in tax administration up to the point at which marginal cost equals marginal revenue, i.e. more resources should be put into tax administration as long as the incremental addition to tax revenues exceeds the incremental addition to administrative cost. Now if we look at the data on the cost of collecting revenues in Pakistan (see **Special Section 1**), we see that by any international standards the expenditure incurred on the tax machinery in Pakistan is too low.

Methods of increasing revenues for the same administrative cost employ three approaches[1].

- The Administrative approach - *minimizing evasion opportunities*
- The Socio-psychological approach - *reducing willingness to evade*
- The Economic approach - *reducing the net advantages of tax evasion*

The Administrative Approach suggests that evasion opportunities can be minimized through the following ways:

1) Simplified tax structures which minimizes number of exemptions, reliefs, concessions and rebates, all of which can be a source of false claims;
2) Honest tax administration. Corrupt officials invite evasion. Therefore, increased compensation package to tax officials can minimize evasion.
3) Withholding tax regime
4) Unique tax identification number to be used for any economic transaction; for example, opening a bank account.
5) Exchange information with other tax administrations.

The Socio-psychological Approach aims at reducing willingness to evade and focuses on attitudes and motivations to behaviour. Reducing willingness to evade means fostering a positive attitude towards taxpayers and the tax collectors. So it is a matter of researching into why people wish to evade taxes and then doing something about it. Particularly we should look at cultural background influences, which formed early attitudes, such as family values, civics, peer group, aspirational group attitudes and personal experiences. Following issues are important in this regard.

1) *Commitment to obey the law*. to promote voluntary compliance it is very important to foster commitment to obey the law or the individual's perceived moral obligations to obey.
2) *Conviction of the integrity of government;* and
3) *Efficiency and equity of government expenditure and taxation*.

Unfavorable to tax compliance are a series of negative perceptions of government:

- That the government is corrupt.
- That it is wasteful in its Expenditure;
- That in its Expenditure it favours certain ethnic groups or economic classes over others;
- That taxation lacks horizontal and vertical equity; and
- That there is a lack of transparency.

Tax avoidance, being a legal activity, is rampant. However, there is a link between avoidance and evasion. If the poor see the rich avoiding taxes on a large scale, the poor who lacks avoidance opportunities and perceives the tax system as inequitable are more likely to engage in evasion.

The Economic Approach aims at reducing the net advantages of evasion by increasing the risk: gain ratio. This approach views the taxpayer as amoral (if not immoral) rational being concerned to maximize his/her expected utility. This approach takes into account four elements.

1) The probability of being caught;
2) Penalty if being caught;
3) The level of income; and
4) The tax rate

The risk of being caught is increased by more effective audits, that is, by making evasion less attractive. It is generally taken that the higher the income, the more gain from the evasion, and the lower the tax rate the less the gain. However, there are some complicated interconnections too. For example, the higher the penalty, the higher the bribe.

In this backdrop, it may be noted that suspension of sales tax and income tax audit in Pakistan (though temporarily) in the FY05 would have only increased evasion opportunities. The income tax collection data for the FY05 shows a decline of 15.04 percent in the collection of tax on current demand. Further, the Finance Act 2004 increased the threshold limit for registration of retailers from Rupees one million to five million. As a result of this, the number of Registered Persons (RPs) of sales tax decreased from 163,188 in FY04 to 114,952 as on June 30, 2005. We are of the view that the threshold limits for registration should be reduced to ensure horizontal equity. Already, there is a tendency amongst taxpayers to under-report turnover. This may have further increased the tax gap in the country.

These alarming trends suggest that in its reliance on voluntary compliance the government has compromised on the effectiveness of the tax system, at least during the initial years of the tax reform process. The more successful a country in implementing these policy measures and balancing the “carrot and stick”, the smaller of the tax gap likely to be.

It is safe to conclude that the tax reform in Pakistan is following both the administrative and the socio-psychological approaches to reduce the tax gap, but it is ignoring some of the key aspects of the economic approach. To check leakage of revenue and plug loopholes in the tax system, it is about time the CBR now shifts its focus on to curbing tax evasion in the country and adopts the economic approach, in conjunction with the other measures, to tackling this menace. CBR needs to increase the risk: gain ratio of indulgence in tax evasion through creation of databases of economic transactions of tax payers and its utilization through an effective system of audit and investigation, and a stringent penalty structure.

Special Section 2: Taxability of Services under the Sales Tax Act, 1990

In recent years, the sales tax has been 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 the FY99 to 40.6 percent in the FY05. The ratio of sales tax to GDP has also increased from 2.45 percent in FY99 to 4.00 percent in FY04. This ratio decreased to 3.7 percent in the FY05. Similarly, its base also widened from 32,697 registered persons (RPs) in FY97 to 163,188 in FY04. However, with the increase in the threshold limit for retailers and turnover manufacturers, from Rs 1 to Rs 5 million in FY04, the number of RPs for sales tax have gone down 29.5 percent YoY to 114,952 as on June 30, 2005.

No doubt the performance of sales tax regime has been impressive in Pakistan in recent years; however, the growth of sales tax in future will largely depend on expansion of its base, particularly in extending the tax net to the services sector, reducing inequities in applicability of sales tax to various sectors, and minimising evasion opportunities through policy measures.

During the last three decades, the share of the services sector in the GDP has increased from 38.4 percent to 52.4 percent in FY05. The contribution of services sector to the 8.4 percent growth during FY05 was 4.2 percentage points (52.4 percent) while agriculture and industry contributed 1.74 and 2.46 percentage points respectively.

The services sector on the whole remains under-taxed. During FY05, the sales tax/CED collection on services amounted to Rs 27.9 billion. The main chunk of Rs 20.4 billion came from telecommunication services where tax is collected from the telephone/fax bills. Other services contributed Rs3.6 billion to the total sales tax collection of Rs 240 billion The contribution of retail and wholesale trade to the sales tax collection was also very small (Rs3.3 billion), representing 0.26 percent of its value added in the GDP (mp) which amounted to Rs 1251 billion (see **Tables 4.2.1** & **4.2.2**).

Table 4.2.1: Sectoral Contribution to GDP – FY05

	% Sectoral Share	Value Added (billion Rupees)
Commodity Producing Sector	**47.6**	3116.8
Agriculture	23.1	1512.6
Services Sector	**52.4**	3431.2
Transport, Storage, Communication	11.1	726.8
Wholesale and Retail	19.1	1250.7
Finance and Insurance	3.7	242.3
Ownership of dwellings	2.9	189.9
Public Admn. & Defence	6.0	392.9
Other Services	9.6	628.6

Source: Economic Survey 2004-2005

The obvious implication of above is that a sector of the economy, which in terms of long term perspective is poised to become the dominant sector, is presently not geared to carry its expected weight in revenue generation. At present, the service sector is being taxed in the following three manners.

- Services subject to Central Excise duty
- Services subject to Central Excise duty which is collected as if it were sales tax[20]
- Services subjected to provincial sales tax

The reasons for this piecemeal and ad-hoc approach are rooted in the legislative provisions of the constitution of Pakistan. The Federal Legislative list (Item No.49 of the Fourth Schedule) of the Constitution provides for levy of tax on sales and purchases of goods, but not on services. The sales tax act, 1990 is accordingly applicable only to *supply of goods*. Services are, therefore, considered to be a Provincial subject. In case of eleven services,[21] Provincial Ordinances have been promulgated

[20] These include telephone/telegraph/fax; advertisements on TV; travel by air/train,; shipping agents.

[21] These include: services provided or rendered by Hotels; Marriage halls/lawns, Clubs; Caterers; Advertisements on TV and Radio; Customs agents; Ship chandlers; Stevedores; Courier Services; Beauty parlours / beauty clinics/slimming clinics; Laundries and Dry cleaners.

authorizing the Federal Government to collect tax on services as if it were sales tax under the Sales Tax Act, 1990.

Table 4.2.2: Collection of Sales Tax /CED from Services

million Rupees	Collection		Share	
	FY04	**FY05**	**FY04**	**FY05**
Retail and whole sale	5272.0	3261.0	24.9	11.7
Services provided by telecommunication	12119.2	20397.4	57.2	73.2
Other Services	**3334.3**	**3595.1**	15.7	12.9
Advertisement (Radio/TV/News papers)	336.2	536.6	1.6	1.9
Beauty parlor/Clinics/Slimming clinics)	10.1	7.2	0.0	0.0
Hotels/Restaurants/Caterers/Suppliers of food/Drinks	1224.8	1464.6	5.8	5.3
Courier services	493.2	378.9	2.3	1.4
Custom agents	312.5	470.7	1.5	1.7
Laundry/Dry cleaners (Services)	2.4	3.3	0.0	0.0
Services(Architects, Town planners, Conductors)	0.6	26.0	0.0	0.1
Ship chandlers	0.6	0.6	0.0	0.0
Stevedores	168.1	140.2	0.8	0.5
Travel agents	0.0	0.0	-	-
Travel by air/ train	785.8	567.1	3.7	2.0
Total GST collected	**20725.6**	**27253.4**	97.8	97.8
CED	**476.6**	**601.8**	2.2	2.2
Insurance	475.3	601.7	2.2	2.2
Others	1.3	0.1	0.0	0.0
Total GST/CED Collected	**21202.1**	**27855.2**		

Source: Central Board of Revenue

There is a strong case for taxability of services in Pakistan. The sales tax in Pakistan is based on the mode of value added tax (VAT). One of the objectives of VAT is that the tax should apply unexceptionally to all economic entities. Therefore, excluding services from this regime creates distortions and is against the spirit of a VAT mode tax. There appears to be no sound reasons for keeping other services out of the tax net. Because consumption of services varies considerably with income, inclusion of services in the tax base has substantial revenue and distributional implications. If any area of consumption is untaxed, other spending must be taxed at a higher rate to raise a given amount of revenue and this accentuates the distributional impact of any exclusions. Moreover, the importance of services sector and its share in the GDP, which is likely to increase over time, calls for bringing it into the sales tax net. Finally, the extension of the GST net on services is also supported by cross-country experience where it has provided enormous scope for resource mobilization and expansion of sales tax base. The extension of the sales tax net will significantly improve the tax/ GDP ratio.

The real incidence of sales tax would be relatively lower because of the facility of adjustment of sales tax paid on the supplies received and services utilized which are already subjected to sales tax @ 15 percent. Moreover, the common impact of levy of sales tax on services will be on the richer segments of society while the low/middle income groups will generally not be affected.

The services with huge revenue potential, presently outside tax net, include legal services, renting/leasing, engineers, stock brokers, private schools/universities, banking, finance, doctors.

In this regard, it is important to formulate a clear strategy for extending the GST net to services. The policy options that can be considered are:

- Amend the item No. 49 of the Federal Legislative List so as to provide for levy of sales tax on services.
- Introduce a new entry in federal legislative list for introducing altogether a new tax on

services as has been done in India.[22]

- Extend Provincial sales tax on remaining services including real estate, except residential rent, health and education.

While extending the GST net to services, it must be borne in mind that services have been traditionally difficult to tax. A system based on voluntary compliance would best suit the taxation of this sector. The rate of tax is an important factor in inducing voluntary compliance as in services the input tax adjustment may not be able to neutralize the impact of the tax. It is well established that the service sector, with high value added at the principal stage of production, is the one that could least benefit from the VAT. Further, the degree of compliance is in proportion to the applicable tax rate, especially for developing countries where a considerable quantum of business is carried out informally due to a variety of reasons such as illiteracy, lack of documentation as well as weak enforcement by the tax authority.

A lower rate of tax has been demonstrated to have a significant impact in inducing voluntary compliance in India where the Union government imposed a **service tax** in 1994 initially on three services[23] at the rate of 5 percent which was subsequently increased to 8 percent with effect from 14.5.2003 and further increased to 10 percent[24] in FY05. The service tax collection in India have shown steady rise since its inception. The tax collection has grown manifold since FY95, from 4.10 billion Rupees to 141.34 billion Rupees in FY05. There has also been a substantial growth in the taxpayer base. The number of persons subject to service tax increased from 3943 in FY95 to 774,988 in FY05 (see **Table 4.2.3**). The number of services in its net has gradually increased to 71. In order to integrate the tax on goods and services Indian government has extended credit of service tax and Excise duty across good and services.

Table 4.2.3: Collection of Service tax in India

	Revenue (billion Rupees)	**% Growth**	**No. of Services taxed**	**No. of Assesses**	**% Growth**
FY95	4.1	Base year	3	3,943	Base year
FY96	8.46	101	3	4,866	19
FY97	10.22	24	6	13,982	187
FY98	15.15	49	18	45,991	228
FY99	17.87	18	30	107,479	133
FY00	20.72	16	27	115,495	7.45
FY01	25.4	23	26	122,326	5.91
FY02	33.05	26	41	187,577	53
FY03	41.25	25	51	232,048	24
FY04	78.9	91	58	403,856	74
FY05	141.34	71	71	774,988	91

Source: http://www.servicetax.gov.in

From the Indian experience, it can be seen that the case for such a new levy at a reduced rate, which can be gradually enhanced, is not only based on sound reasoning but has been practically demonstrated to be effective.

In budget FY06, the Government has decided to withdraw the levy of Provincial Sales Tax on the services provided/rendered by beauty parlours, slimming clinics, laundries & dry cleaners and marriage halls/lawns.[25] Necessary amendments in the respective Provincial ordinances are being made. The primary reason for this decision appears to be the negligible revenues from these services. However, considering the revenue potential of services sector, and to ensure fairness and equity in the tax system, it is appropriate if the CBR focuses on enforcement to tax this sector effectively. Policy measures, such as withdrawal of the sales tax on these services would only makes the tax system more

[22] To enable parliament to formulate by law principles for determining the modalities of levying the Service Tax by the Central Govt. & collection of the proceeds there of by the Central Govt. & the State, the amendment vide constitution (95th amendment) Act, 2003 has been made.
[23] Telephone, stockbroker, general insurance.
[24] Source: Budget Speech 2004-2005, by P. Chidambaram, Indian Minister of Finance, July 8, 2004
[25] CBR' letter C. No. 1/33-STB/2005, dated 6th June, 2005.

inequitable and inefficient. The number of sales tax registered persons is already small and has shown downward slide due to policy measures. The CBR needs to gradually bring more and more services into the sales tax net rather than withdrawing those already subject to sales tax.