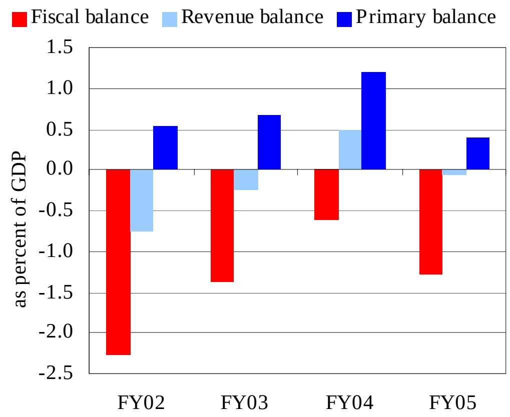
5 Fiscal Developments

5.1 Overview

A deceleration in the consolidated H1-FY05 revenue growth (largely due to a freeze on domestic oil prices)[1], and acceleration in the consolidated expenditures in the same period, caused the overall budgetary deficit to rise to Rs 79.6 billion, up 136.0 percent YoY. This is also reflected in the overall fiscal balance indicators, all of which saw a visible deterioration (see **Figure 5.1**).

The growth in revenue receipts during H1-FY05 slowed down principally due to a decline in tax revenues during Q2-FY05 which dragged the overall revenue growth for the quarter to a mere 3.8 percent YoY, down sharply from the 22 percent YoY rise in Q1-FY05 and the 19.1 percent YoY growth witnessed in Q2-FY04. In fact, it was only the exceptionally strong receipts of Q1-FY05 that kept the aggregate H1-FY05 revenues on-track to meet the annual target.[2]

Figure 5.1: Balance Indicators (Jul-Dec)



The impact of the Q2-FY05 slowdown in receipts on the overall budgetary deficit was amplified by the 30.9 percent YoY jump in expenditures during the same period. While developmental expenditures rose by a welcome 43.7 percent YoY (to Rs 81.6 billion) during H1-FY05,[3] the dominant contribution to the increase was by a (21.27 percent YoY) Rs 75.0 billion increase in current expenditures. As a result, total consolidated expenditures registered a 21.9 percent YoY increase during the first half of FY05. Finally, a comparatively improved position of Pak-

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[1] Government has to suspend the collection of petroleum development levy (PDL) during the entire second quarter to keep the prices of POL products at the May 1, 2004 level.

[2] A part of the exceptional rise in tax receipts simply owed to a procedural change that shifted some receipts to September that had earlier been collected in October and November. Moreover, the Q1 collections also benefited from the introduction of the *Universal Self-Assessment Scheme* (USAS).

[3] As a result development expenditures as percent of GDP rose to 1.3 percent in H1-FY05 compared to the same period last year.

Steel, WAPDA, KESC and Railways led to 32.6 percent reduction in net lending to PSEs.

5.2 Revenues

Consolidated revenue receipts rose by a modest 11.8 percent YoY to reached 423.8 billion[4] during H1-FY05. The relatively low growth was principally due to 1.5 percent decline in tax collection during Q2-FY05, while it was fortunately offset by a healthy 23.9 percent YoY growth in non-tax receipts during the half year (see **Table 5.1**).

The deceleration in the growth of H1-FY05 tax receipts owed principally to the fall in collection of the Petroleum Development Levy (PDL) following a freeze on domestic prices of many POL products between May and December 2004 even as international prices rose to record highs. During Q1-FY05, the impact of this revenue shortfall was covered by the exceptional rise in CBR tax receipts as well as strong non-tax revenues (including a large one-off component)[5]. Unfortunately, this buffer was not as strong in Q2-FY05 (see **Section on CBR taxes**).

Box 1: Tax Collection from POL during H1

Collection from petroleum development levy during H1-FY05 was Rs 19.6 billion lower than in H1-FY04 (when there was no freeze in place) although the total consumption of POL products stood at 6.7 billion liters during the same period[1]. However, on the other hand, due to the increase in both international and domestic prices of POL products, CBR's tax collection from import duty, CED and sales tax on POL increased by 24.8 percent during H1-FY05.

Box 1:Tax Collection from POL in H1

billion Rupees

	FY04	**FY05**	**YoY % Δ**
Customs	2.5	3.7	48.7
Excise	1.9	2.2	18.1
Sales	25.7	31.6	23.0
Tot. CBR tax collection	30.0	37.5	24.8
PDL	24.3	4.7	-80.5
Total tax collection	**54.3**	**42.2**	**-22.2**

Source : Central Board of Revenue

[4] Based on provisional numbers.

[5] In total non-tax receipts of Rs 125.6 billion, major contribution came from defence services receipts (Rs 40.6 billion), dividends on Government investment (Rs 32.4 billion), receipts from Pakistan Telecommunication Authority due to sale of telecom licences (Rs 17.7 billion) and other miscellaneous receipts (Rs 18.7 billion).

Table 5.1: Fiscal Operations (Jul-Dec)

Consolidated Federal and Provincial Government

billion Rupees

		FY02	FY03	FY04	FY05	YoY change	
						Absolute	Percent
1	**Revenue receipts**	**263.9**	**332.9**	**379.1**	**423.8**	**44.7**	**11.8**
	a) Tax revenue	209.0	253.2	277.7	298.2	20.5	7.4
	b) Non-tax revenue	54.9	79.7	101.4	125.6	24.2	23.9
2	**Total expenditures**	**363.8**	**398.6**	**412.8**	**503.3**	**90.5**	**21.9**
	a) Current	296.7	345.1	352.5	427.5	75.0	21.3
	b) Developmental	50.9	51.5	56.8	81.6	24.8	43.7
	c) Net lending to PSEs etc.	6.8	2.7	7.0	4.7	-2.3	-32.6
	d) Unidentified	9.4	-0.8	-3.4	-10.4	-7.0	204.4
3	**Revenue balance (1-2.a)**	**-32.7**	**-12.3**	**26.6**	**-3.7**	**-30.3**	**-114.0**
4	**Overall balance (1-2)**	**-99.9**	**-65.7**	**-33.7**	**-79.6**	**-45.8**	**136.0**
*As percentage of GDP							
1	Revenue receipts	6.0	6.9	6.9	6.9	0.7	
	a) Tax revenue	4.7	5.3	5.1	4.8	0.3	
	b) Non-tax revenue	1.2	1.7	1.9	2.0	0.4	
2	Total expenditures	8.3	8.3	7.6	8.2	1.5	
	a) Current	6.7	7.2	6.5	6.9	1.2	
	b) Developmental	1.2	1.1	1.0	1.3	0.4	
	c) Net lending to PSEs etc.	0.2	0.1	0.1	0.1	0.0	
	d) Unidentified	0.2	0.0	-0.1	-0.2	-0.1	
3	Revenue balance (1-2.a)	-0.7	-0.3	0.5	-0.1	-0.5	
4	Overall balance (1-2)	-2.3	-1.4	-0.6	-1.3	-0.7	

Source: Ministry of Finance

* Re-based nominal GDP (MP) of 2000 has been used

5.3 Expenditures

During H1-FY05, consolidated expenditures stood at Rs 503.8 billion, registering a 21.9 percent YoY increase. As a result, total expenditures as a percentage of GDP increased to 8.2 percent in H1-FY05 compared to 7.6 percent in the corresponding period last year. Similarly, Development expenditures showed a strong 43.7 percent rise, increasing its share in total expenditures from 13.8 percent in H1-FY04 to 16.2 percent in H1-FY05.

Also encouraging, was the decline in the requirement for net lending to PSEs, which fell to Rs 4.7 billion as against Rs 7.0 billion net lending in H1-FY04 mainly due to comparatively improved financial position of PSEs.

Unfortunately, these gains were more than offset by a sharp rise in current expenditures during H1-FY05, which jumped 21.3 percent YoY compared to a much smaller increase of 2.1 percent YoY in H1-FY04. More specifically, federal expenditures (which account for about two-thirds of the expenditure) recorded a 23.3 percent YoY growth during H1-FY05 while provincial expenditures rose by a moderate 16.1 percent YoY.

Within the federal current expenditures, defense expenditure growth was 15.8 percent YoY while debt servicing rose by 5.5 percent YoY during H1-FY05 (compared to a smaller rise of 0.8 percent YoY in the corresponding period of last year). This increase in debt servicing entirely reflected the impact of rising rupee interest rates and a jump in the stock of domestic debt (especially arising from the substitution of expensive external debt). The interest payments on external debt declined, despite a rise in the debt stock (see **Table 5.2**). A detailed breakup of the current expenditure is not available at this point of time.

Table 5.2: Composition of Current Expenditure for H1

billion Rupees

			YoY change	
	FY04	**FY05**	**Absolute**	**Percent**
Current expenditures	352.5	427.5	75.0	21.3
Of which				
Interest payments	98.8	104.2	5.4	5.5
Domestic	76.3	82.9	6.6	8.6
Foreign	22.5	21.3	-1.2	-5.2
Defence	87.3	101.1	13.8	15.8
Development and net lending	63.7	86.3	22.6	35.4
PSDP	56.8	81.6	25	44
Net lending	7.0	4.7	-2.3	-32.6

Source: Ministry of Finance

5.4 Financing

As evident in **Table 5.3**, approximately half of the H1-FY05, financing requirements was met through external sources, reflecting the higher disbursements by the ADB and World Bank.

In addition to utilizing the privatization proceeds[6], Government borrowed Rs 16.8 billion from the banking system[7] during H1-FY05. Domestic non-bank borrowings that include both public debt (net Rs 13.4 billion mainly from Government securities and prize bonds) and public account (net Rs 2.3 billion mainly from deposits and reserves) was much lower in this period relation to H1-FY04.

Table 5.3: Financing of Budget Deficit During H1

billion Rupees

	FY04	FY05	Percent share	
			FY04	FY05
Financing through	33.7	79.6	100.0	100.0
External resources (net)	10.0	40.4	29.8	50.7
Internal resources	22.0	39.2	65.2	49.3
Domestic non-bank	30.3	15.7	89.8	19.7
Banking system	-8.3	16.8	-24.7	21.1
Privatization proceeds	1.7	6.8	5.0	8.5

Source: Ministry of Finance

5.5 CBR Tax Collections

During the first seven months of FY05, total net CBR tax collection surpassed the target set for the period by 3.5 percent to reach Rs 303.7 billion (see **Table 5.4**). Except for sales tax receipts, which fell short of the target by 3.2 percent, all other CBR tax receipts exceeded the collection targets for the period.

Table 5.4: CBR Tax Collection

billion Rupees

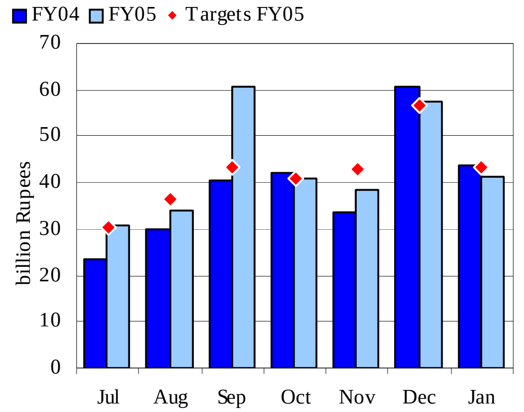
Head	Target		Net tax collection upto January		Percent of target	
	FY05	Upto January	FY04	FY05	FY05	Upto January
Direct taxes	181.9	79.8	82.2	87.5	48.1	109.6
Indirect taxes	398.1	213.6	192.0	216.3	54.3	101.3
Sales tax	249.2	132.9	120.4	128.6	51.6	96.8
Central excise	45.7	25.1	23.1	27.8	60.8	110.7
Customs	103.2	55.6	48.5	59.9	58.1	107.7
Total	580.0	293.4	274.2	303.7	52.4	103.5

Source: Central Board of Revenue

However, a closer look at this seemingly impressive performance reveals some points of concern.

[6] Rs 6.1 billion realized through sale of GoP shares in PIA, PPL, Falleti's hotel and Kohat cement during Q1-FY05.
[7] Government borrowed Rs 36.6 billion from the banking system in Q2-FY05, as it actually retired Rs 19.9 billion in Q1-FY05.

Figure 5.2: Monthly Tax Collection

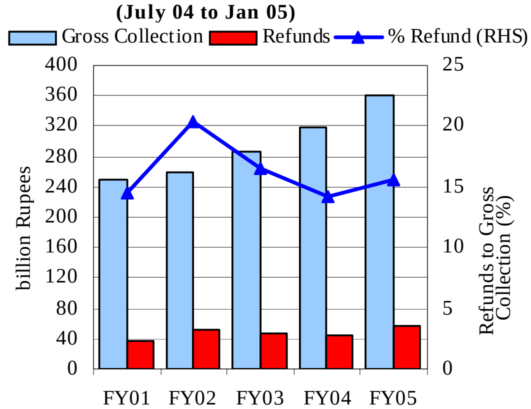


A look at **Figure 5.2** suggests that the above-target H1-FY05 cumulative collection were largely possible only due to the Rs 60.8 billion September 2004 receipts (i.e. Rs 17 billion above the target for the month) on the back of higher voluntary payment of direct taxes.

More seriously, while the achievement of the tax targets is appreciable, the CBR tax collections are clearly not keeping pace with the growth of the economy. The FY05 tax growth rate should at least keep up with nominal growth that is projected to exceed 16 percent. Had the tax collection matched the nominal growth of the economy, the level of development spending could have been raised higher than the budgetary targets.

5.6 Refunds and Gross collection

Table 5.3: Refunds and Gross Collection (July 04 to Jan 05)



During the first seven months of FY05, total refunds and rebates amounted to Rs. 56.0 billion, registering an increase of 23.4 percent over the same period last year. The delayed payment of refunds has been a contentious issue between the tax payers and CBR. However, the latest statistics suggest that CBR is making serious efforts to resolve the issue. Refunds as percentage of total gross collection during the first seven months of FY05 rose to 15.6 percent as against 14.2 percent level in the same period last year (see **Figure 5.3**).

Gross collection by CBR have shown a persistent rising trend over the years and total gross collection during the first seven months of FY05 registered a significant increase of 12.6 percent over the same period of FY04.

5.7 Direct Taxes

CBR collected Rs 87.5 billion rupees against the target of Rs 79.8 billion from direct taxes during the first seven months of FY05 registering a growth of 6.4 percent over the same period last year.

The latest available (end-December, 2004) component-wise breakup of the collection from direct taxes given in **Table 5.5** reveals that although withholding tax (deducted at source) account for more than 50.0 percent of direct taxes, the relative share of voluntary payments is gradually increasing. (see **Figure 5.4**).

Table 5.5: Major Components of Direct Taxes (July, 04 to December, 04)

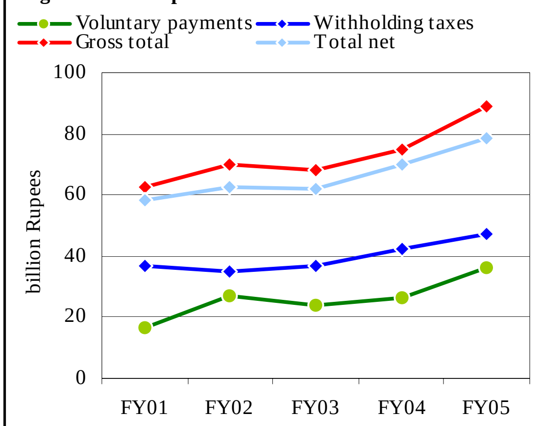
billion Rupees

	FY04	FY05	Shares in gross	
			FY04	FY05
Voluntary payments	26.5	35.9	35.4	40.4
Collection on demand	5.6	3.8	7.5	4.3
Withholding taxes	42.2	46.9	56.3	52.8
Others	0.6	2.2	0.8	2.5
Gross total	74.9	88.9	--	--
Refund/rebate	4.9	10.5	--	--
Total net	70.0	78.4	--	--

Source: Central Board of Revenue

This was possible because collection from voluntary payments, registered a significant increase of 35.4 percent YoY during July-January FY05 over the corresponding period last year. Decline in the collection under the head "collection on demand" reflects comparatively prudent tax policies and effectiveness of recent tax measures like risk based audit (see **Table 5.5**).

Figure 5.4 Component of Direct Taxes



5.8 Indirect Taxes

Indirect taxes contributed Rs 216.3 billion rupees to the over all tax collection effort during the first seven months of FY05, registering a 12.7 percent increase over the same period last year.

5.8.1 Sales tax
Sales tax collection totaled Rs.128.6 billion during the first seven months of FY05, up 6.8 percent YoY, however, falling 3.2 percent short of the target for the period (while sales tax on imports rose 14.2 percent YoY to Rs 80.9 billion, but collections on domestic items declined 3.8 percent YoY to Rs.47.7 billion).

It is important to note that the fall in domestic sales tax receipts is principally due to the end of the tax on ginned cotton. Not only have gross receipts declined on this count, but net receipts have been further depressed due to the refunds to upstream industry on their earlier purchases. Since these refunds will not be required in future periods, the GST is expected to resume its buoyancy in the coming months.

5.8.2 Central Excise Duty
Central excise duty which Government planned to phase out gradually contributed Rs.27.8 billion in CBR revenues during the first seven months of FY05, showing 20.5 percent increase over the same period last year.

A breakup of collections (available upto December, 2004) shows that only six commodities provided 90.4 percent of total revenues, of which 38.9 percent is contributed by cigarettes and tobacco.[8] Higher collection of CED on cement during the first half of FY05 resulted due to 21.4 percent increase in its production recorded during the period.

5.8.3 Customs Duty
Collection from customs duties during July to January FY05 accounted for 27.7 percent of the total revenue generation from indirect taxes and comfortably achieved the target set for the period. This simply reflects the sharp rise in the country imports during the period.

Item-wise breakup (latest available upto December 2004) shows that major contributors to the revenue collection from custom duties were vehicles, edible oils and POL. Despite the decline in import tariffs on vehicles[9], import of vehicles has emerged as the top revenue-generating source of customs duties and

[8] The duty on cigarettes and tobacco has been increased in this fiscal year.
[9] Earlier CBU units were subject to the duty that range from 75% to 15%, but the government has rationalized the duty as under:

Upto 800cc	75% to 50%	Upto 1000cc	75% to 50%
Upto 1300cc	100% to 50%	Upto 1600cc	100% to 70%
Upto 1800cc	125% to 80%	above 1800cc	150% to 100%

provided additional revenues of Rs.3.6 billion compared to the same period last year.

Collection from customs duties on edible oils accounted for 12.2 percent of total gross collection, while import of POL products contribution stood at 6.6 percent. The breakup of collection from custom duties reveals that only nine few commodity groups accounted for 67.8 percent of gross collection of customs duties during the first half of FY05.