

5 Fiscal Developments¹

5.1 CBR Tax Collections

At first look, the Jul-Mar FY05 CBR performance looks quite impressive, with net receipts totaling Rs 401.3 billion, up 13.5 percent YoY and exceeding target for the period by 1.3 percent. Moreover, other than sales tax, cumulative Jul-Mar FY05 receipts for all tax categories were in line with the targets for the period (see **Table 5.1**).

Table 5.1: CBR Tax Collection

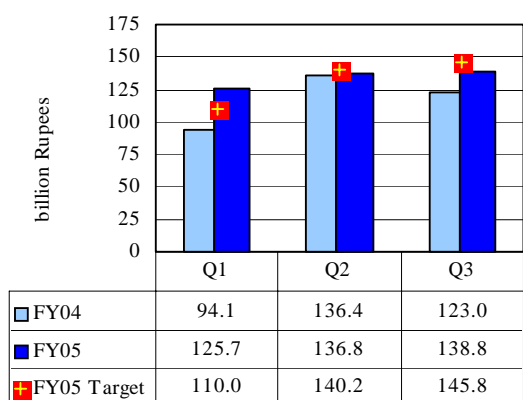
billion Rupees

Head	Target		Net tax collection Jul-Mar		Percent of target	
	FY05	Jul-Mar FY05	FY04	FY05	FY05	Jul-Mar FY05
Direct taxes	181.9	114.7	104.4	119.5	65.7	104.2
Indirect taxes	398.1	281.3	249.0	281.8	70.8	100.2
Sales tax	249.2	174.1	155.7	165.4	66.4	95.0
Central excise	45.7	33.2	30.4	36.3	79.5	109.4
Customs duty	103.2	74.0	62.8	80.1	77.6	108.2
Total	580.0	396.0	353.4	401.3	69.2	101.3

Source: Central Board of Revenue

However, a more detailed analysis reveals some points of disquiet. Only in the first quarter of FY05 did collections exceed targets (see **Figure 5.1**) helped by exceptionally strong direct tax receipts (a massive 46.4 percent above the target for the quarter). Unfortunately, in the succeeding two quarters, net receipts for both direct tax and the sales tax have dropped below the respective quarterly targets, which were only partially offset by the above-target receipts of other taxes.² As a

Figure 5.1: Quarterly Tax Collection

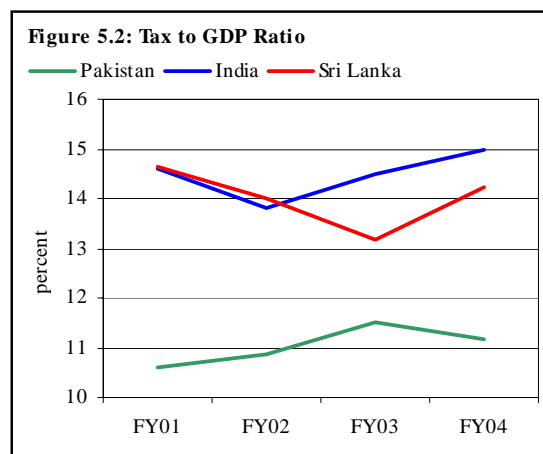


¹ Since the quarterly budgetary data is not yet available, the analysis in this section pertains only to revenue generation by CBR during the period Jul – Mar 2005.

consequence, the aggregate tax receipts for Q2-FY05 and Q3-FY05 were respectively 2.4 percent and 4.8 percent below the target. Key concerns here are:

- The achievement of the cumulative Jul-Mar FY05 CBR tax target owes in large part to the unusually high direct tax receipt during Q1-FY05. The large variance between the projected receipts and actual collections is disturbing, raising concerns that achieving the annual target may prove stiff.
- Similarly, the below-target 6.2 percent YoY growth in the receipts of sales tax could *potentially* also be a source of concern given the above target 15 percent YoY growth in LSM production, unanticipated high inflation, greater-than-expected depreciation of the Rupee, etc. However, it must be noted that at least a part of the shortfall could be explained by the removal of the tax on ginned cotton. Unfortunately, due to lack of data it is difficult to say how much of the shortfall is due only to this one-time factor.

The below target tax receipts in the face of above-target GDP growth means that the *tax-to-GDP* ratio is likely to drop for a second successive year. This is disturbing, given that this ratio is already one of the lowest in the region (see **Figure 5.2**). In recent years, the government has made significant gains in containing expenditure growth, while simultaneously increasing developmental spending. However, the latter needs to accelerate if economic growth is to be maintained over 6 to 7 percent and poverty rates are to decline. Unfortunately, the required increase in developmental spending will not be possible unless the *tax to GDP* ratio can be stabilized at significantly higher levels.



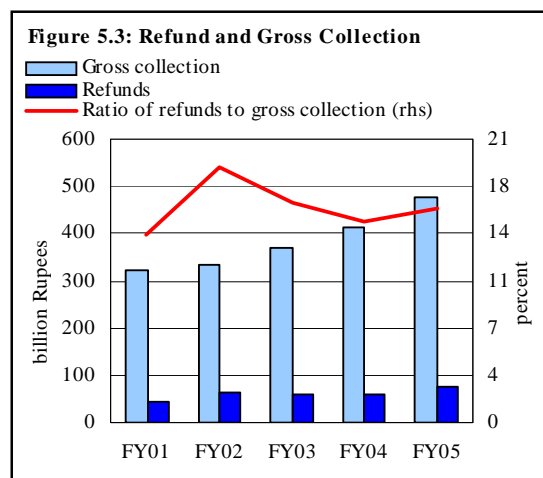
² During Q2-FY05, CBR tax collection was 2.4 percent below the target. Direct taxes were 9.5 percent below target while receipts from sales tax fell short of the target by 5.6 percent.

The importance of broadening the CBR tax base and improving buoyancy is also underlined by the high dependence of overall government revenues on potentially unsustainable or uncertain sources. For example:

- A substantial contribution to the government's non-tax revenue is from payments for logistic support. These disbursements are, by definition, not likely to continue in the long term.
- The oil development surcharge has also emerged in recent years as a major source of revenue. However, the current high international prices and the impact of these on the domestic economy, indicate that this levy may be insupportable at current levels.
- The number of taxpayers in the country remains dismally low³ and thus the proportion of regressive indirect taxes remains quite high.

5.2 Refunds and Gross Collection

Interestingly, the growth in *gross* tax collections during Jul-Mar FY05 was a more reasonable 14.9 percent YoY as compared to the *net* collections of 13.5 percent YoY. This shows that the CBR did, in fact, capture a part of the higher GDP growth, but the impact of this was diluted by a jump in refunds and rebate disbursements.⁴ This is most evident for direct taxes, where refunds jumped by a massive Rs 8.1 billion during Jul-Mar FY05 compared to the corresponding period of FY04.



Total refunds and rebates disbursed during the first nine months of FY05 depicted a rise of 23.0 percent over the corresponding period last year and stood at Rs 75.6

³ Reportedly, only 1.14 million people (including corporate sector) filed their tax returns during FY04.

⁴ Interestingly, to the extent that the rise in refunds during FY05 reflects excess tax collections during FY04, this means that the tax performance in the preceding fiscal year had been artificially inflated. In other words, FY05 may be the *second* year in which the CBR is under performing.

billion. Refunds as a percentage of total gross collection during the period rose to 15.8 percent as against 14.8 percent recorded in FY04 (see **Figure 5.3**).

The delayed payment of refunds due to manual processing, lack of a central referral database, bogus invoices and verification issues have been a contentious problems for both the taxpayers and the CBR. To streamline the refunds, CBR has developed a nationwide database of all refund claimants, i.e., Sales Tax Automated Refund Repository (STARR).⁵ CBR has also designed an enhanced version called Sales Tax Risk Evaluation and Management System (STREAMS) for refunds processing.⁶

5.3 Direct Taxes

Direct taxes contributed Rs 119.5 billion in total revenue receipts against the target of Rs 114.7 billion during the first nine months of FY05 registering a growth of 14.4 percent over the corresponding period last year (see **Table 5.1**).

The component-wise breakup given in **Table 5.2** reveals that the growth in the gross collection of income tax emerged principally from withholding taxes and voluntary payments. This reflects both, the strengthening economic activity in the country as well as the impact of the government tax liberalization measures (see **Figure 5.4**). Specifically, the share of 'voluntary payments' in the total income tax receipts rose to 39.0 during Jul-Mar FY05, as against 35.9 percent recorded in the comparable period of last year. At the first glance, it appears that the

Table 5.2: Major Components of Income Tax During Jul-Mar

billion Rupees

	FY01	FY02	FY03	FY04	FY05	YoY change	
						Absolute	Percent
Voluntary payments	22.5	36.9	25.2	40.4	52.4	12.1	29.8
Collection on demand	6.5	7.7	5.4	9.0	8.3	-0.7	-8.2
Withholding taxes	57.0	53.6	44.0	62.7	73.3	10.6	16.9
Others	3.4	0.1	0.7	0.4	0.5	0.2	42.9
Gross total	89.5	98.3	75.3	112.5	134.5	22.1	19.6
Refund/Rebate	6.9	8.3	5.4	11.7	19.8	8.1	69.1
Total net	82.6	90.0	69.8	100.7	114.7	14.0	13.9

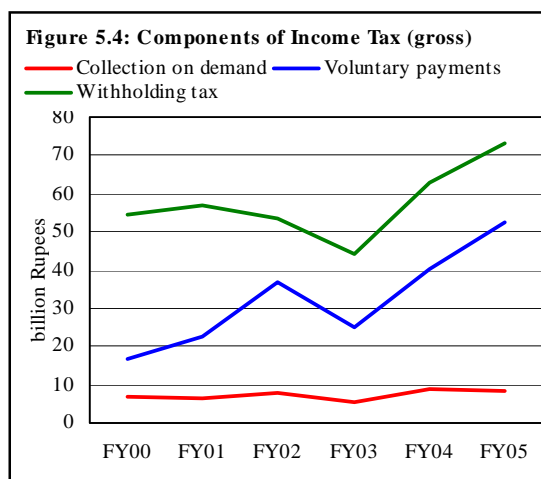
Source: Central Board of Revenue

⁵ Using the application software provided by the CBR, the refund claimants can file and check the status of their refund claims (source: CBR Year Book 2003-2004).

⁶ This system will maintain profiles of the taxpayers based on multi tax data of the regular refund claimants and their suppliers, and will introduce a comprehensive risk analysis and risk management. Refund claims will either be classified into a "green channel" (resulting into further scrutiny) or into

introduction of Universal Self Assessment Scheme (USAS) is beginning to change the composition of income tax collection in the desirable direction.

The only impact of increased economic activities that can be discerned is in the growth in withholding tax from major heads (see **Table 5.3**), such as *contracts and supplies* (20.3 billion), *electricity & telephone bills* (Rs 6.9 billion),⁷ and *imports and exports* (Rs 23.8 billion).⁸



5.4 Indirect Taxes

During the first nine months of FY05, indirect taxes totaled Rs 281.8 billion, up 13.2 percent YoY.

Surprisingly, in contrast to recent years, this growth emerges principally from robust customs duty collections (up 27.4 percent YoY) and CED receipts (up 19.3 percent YoY) rather than growth in sales tax receipts (up only 6.2 percent YoY).

Table 5.3: Withholding Tax (Jul-Mar)

	FY04	FY05	% Growth
Withholding tax	62.7	73.3	16.9
Salaries	7.7	8.6	11.4
Contracts	16.2	20.3	25.1
Imports & exports	21.8	23.8	9.3
Electricity & telephone bills	5.4	6.9	27.5
Others	11.6	13.7	18.5

5.4.1 Sales Tax

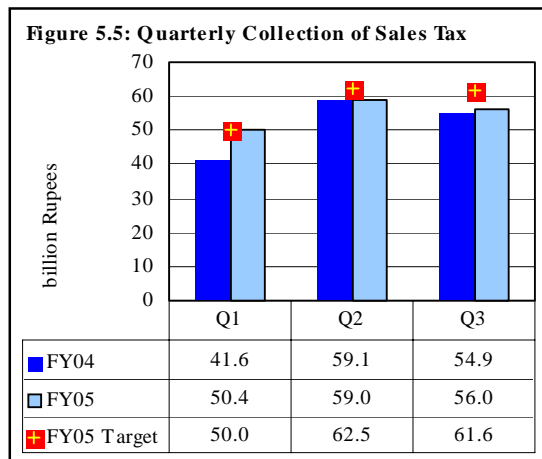
Although the sales tax remained the largest contributor to CBR taxes, with receipts of Rs 165.4 billion during Jul-Mar FY05, these were short of the target for the period by 5.0 percent.

a "red channel" (suspending the payment and initiation of audit) [source: CBR Year Book 2003-2004].

⁷ The increased electricity consumption as well as greater use of mobile phones & pre-paid phone cards resulted in 27.5 percent more deduction of withholding tax.

⁸ The unprecedented rise in international trade during FY05 resulted in 9.3 percent increase in the deductions on imports and exports.

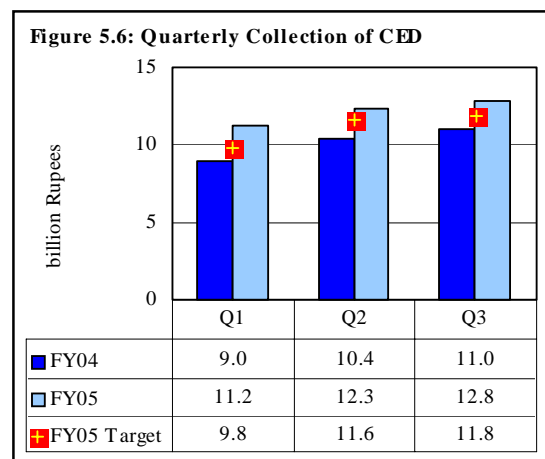
The shortfall was principally evident in the collections from domestic sources. Sales tax (net) collection from imported items during FY05 (Jul-Mar) stood at Rs 106.0 billion, registering a significant improvement of 16.0 percent YoY. This is in line with the higher imports (due to improved economic activity) as well as unprecedented rise in the international price of crude oil during the period.



By contrast, gross sales tax receipts from domestic items recorded a decline of 7.7 percent YoY despite the increase in economic activity. This divergence is probably explainable by the removal of the sales tax on ginned cotton – this is supported by the fact that the shortfall emerges in the second and third quarters of the fiscal year, when receipts from cotton peak (see **Figure 5.5**).

5.4.2 Central Excise Duty

Collection from central excise duty showed a remarkably healthy growth of 19.3 percent YoY to reach Rs 36.3 billion during Jul-Mar FY05.⁹ The revenue collection from this head remained consistent during the entire period and except for February 2005 CBR achieved all its monthly targets (see **Figure 5.6**). As a result, CBR easily surpassed the cumulative collection



⁹ Government has shifted a number of excisable items under the purview of sales tax and currently CED collection is based on few major items.

target (up to March FY05) with a comfortable margin of 9.4 percent.

A disaggregated analysis of CED shows that only six commodities provided 94.1 percent of total gross revenues collected from the domestically produced goods, of which 42.6 percent is contributed by cigarettes and tobacco,¹⁰ followed by cement (23.0 percent), natural gas (11.9 percent), POL (8.4 percent), beverages¹¹ (5.0 percent) and beverage concentrate (3.2 percent) (see **Table 5.4**). Higher collection of CED on cement during the first nine months of FY05 resulted due to higher growth (17.7 percent) recorded in its production during Jul-Feb, FY05.

5.4.3 Customs Duty

During the first nine months of FY05, receipts from customs duties rose by an impressive 27.4 percent YoY to reach Rs 80.1 billion (see **Figure 5.7**).

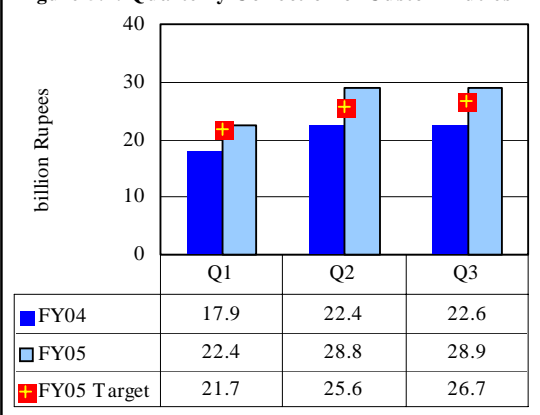
While this owes principally to the exceptional growth in imports and unprecedented higher international price of crude oil, it is nonetheless impressive given the reduction in the effective tariff rate.

Table 5.4: Central Excise Duty Collection up to March, 2005
billion Rupees

Major commodities	FY04	FY05	YoY change	
			Absolute	Percent
Beverages	1.6	1.7	0.1	4.9
Beverages concentrate	0.8	1.1	0.3	42.4
Cigarettes & tobacco	12.1	14.6	2.5	20.9
Cement	6.7	7.9	1.2	17.4
Natural gas	3.6	4.1	0.4	12.2
POL products	2.5	2.9	0.4	14.1
Sub-total	27.4	32.3	4.9	17.9
Others	2.2	2.0	-0.2	-7.0
Gross total (domestic)	29.6	34.4	4.8	16.1
Gross total (imported)	0.9	2.0	1.1	129.2
Gross total (overall)	30.5	36.4	5.9	19.3
Refunds & rebates	0.1	...		
Total collection (net)	30.4	36.4	5.9	19.5

Source: Central Board of Revenue

Figure 5.7: Quarterly Collection of Custom Duties



¹⁰ The duty on cigarettes and tobacco has been increased in this fiscal year.

¹¹ CED collection from beverages and beverage concentrates increased despite the withdrawal of CED on fruit juices in the FY05 budget.