3 Fiscal Developments

Building on the improvement in Pakistan's fiscal performance during FY03, the FY04 policy focus has continued to stress the need for further fiscal consolidation, greater transparency, and improvement in tax compliance. This attention to fiscal discipline is clearly visible during Q1-FY04, as the consolidated budgetary deficit of the federal and provincial governments for Q1-FY04 not only dropped as a share of GDP (to 0.9 percent), but also in absolute terms (Rs 0.1 billion) relative to the same quarter last year. This improvement was supported by both, a rise in revenue receipts and lower growth in expenditures.

3.1 Revenue Receipts

As evident in **Table 3.1**, the consolidated revenue receipts witnessed a moderate growth of 7.9 percent during Q1-FY04 over the corresponding period last year. This was primarily driven by non-tax revenues, which contributed 65.3 percent of the total increase witnessed during the quarter. A break up of non-tax revenues indicates that the growth was primarily led by higher *interest* and *other civil administration* receipts, whereas the contribution from *sale proceeds* and other *miscellaneous* receipts was relatively low. However, this impressive rise from the above mentioned sources was significantly masked by the absence of SBP profits (Rs 6.0 billion for Q1-FY03).

Table 3.1: Fiscal Operations during the Q1 Consolidated Federal and Provincial Governments

billion Rupees

			YOY change	
	FY03	FY04	Absolute	Percent
1. Revenue receipts	153.5	165.6	12.1	7.9
a) Tax revenue	115.6	119.7	4.2	3.6
b) Non-tax receipts	38.0	45.8	7.9	20.7
2. Total expenditures	194.5	206.5	12.0	6.2
a) Current	161.2	158.9	-2.2	-1.4
b) Development	21.7	24.9	3.2	14.6
c) Net lending to PSEs etc.	-0.6	8.3	8.9	-1444.2
d) Unidentified	12.3	14.5	2.2	18.0
3. Revenue balance (1-2.a)	-7.6	6.6	14.3	-186.9
4. Overall balance (1-2)	-41.0	-40.9	0.0	-0.1

Further analysis suggests that the rise in interest receipts reflects the improving financial health of both, the financial and non-financial institutions. While interest receipts from the provinces, which usually account for approximately 70 percent of total interest receipts, saw a decline of Rs 0.7 billion during Q1-FY04 as compared to Q1-FY03,[1] interest receipts from other sources (financial and non-financial institutions) surged by Rs 6.7 billion during the quarter under review, taking Q1-FY04 interest receipts (other than provinces) to Rs 8.6 billion.

[1] Lower interest receipts from provinces are largely explainable by the re-pricing of provincial governments debt and improving financial health.

The rise in *other civil administration* receipts during Q1-FY04 is the upshot of higher payments by USA for the provision of logistics support to international forces operating in Afghanistan.

The healthy growth in non-tax revenues during the quarter under review was not equaled by the tax revenues; the 3.6 percent YoY increase in the tax revenue was significantly lower than 33.1 percent growth in the corresponding period FY03. Moreover, a compositional break-up of tax revenues shows that relatively low YoY growth in CBR tax collections (although above the quarterly target) is the prime factor behind this phenomenon. A detailed analysis of CBR tax collections is presented in **Section 3.4**.

3.2 Expenditures

The consolidated expenditures of the federal and provincial governments recorded a rise of Rs 12.0 billion during Q1-FY04 over the Q1-FY03. A quick glance at **Table 3.1** shows that changes in major components of overall expenditure reveals that: (1) current expenditure encouragingly saw a decline of Rs 2.2 billion; and (2) both the net lending to PSEs and developmental expenditures have increased.

A break-up of current expenditures shows that debt servicing and in particular, interest payments, declined for yet another quarter, primarily on account of: (1) re-profiling of the public debt; (2) the impact of lower domestic interest rates; and (3) relatively slower growth in overall debt, as a portion of deficit is also financed through privatization proceeds (see **Table 3.2**).

Table 3.2: Composition of Current Expenditure for Q1

billion Rupees

			YoY change	
	FY03	**FY04**	**Absolute**	**Percent**
Current expenditures	161.2	158.9	-2.2	-1.4
Of which				
Interest payments	49.1	44.2	-5.0	-10.1
Domestic	41.0	36.1	-5.0	-12.2
Foreign	8.1	8.1	0.0	0.1
Defense	32.6	45.7	13.1	40.3
General Admin.	17.3	18.4	1.2	6.7
Grants	9.8	11.5	1.7	17.0
Provinces	6.3	5.8	-0.4	-6.8
Others	3.6	5.7	2.1	58.9
Subsidies	13.7	2.6	-11.1	-81.2

Another component, the expenditure on subsidies, constituted a mere 3.7 percent of the budgeted amount thereby registering a substantial decline of Rs 11.1 billion relative to Q1-FY03. This decline played a key role in curtailing overall growth in current expenditures, and therefore, questions over the sustainability of this trend are a matter of concern. In particular, subsidies could rise as: (1) if the financial health of

WAPDA and KESC deteriorates; and (2) as a result of the higher support price for wheat (if the government purchases do not decline).

The discipline in current expenditure could potentially also be jeopardized by a continual increase in defense spending. Specifically, while the FY04 defense budget had been maintained at the (revised) FY03 level, Q1-FY04 spending witnessed a huge rise of Rs 13.1 billion compared to the same quarter of the previous year. In the event it simply reflects increased expenditures on Afghan border operations financed by US logistic support receipts, this trend is not worrisome.

More importantly, the fact that development expenditure in the quarter was 14.6 percent higher than the previous year is more encouraging and if it is sustained the fiscal policy priority of achieving higher development spending will be met after a long time. The expense on the running of civil administration shows that the government maintained the strict fiscal discipline in this area, as spending witnessed a rise of Rs 1.2 billion during Q1-FY04.

3.3 Financing of Budget Deficit

Although budget deficit of Rs 40.9 billion in Q1-FY04 is almost unchanged as compared to Q1-FY03, its financing pattern witnessed substantial changes. A look at **Table 3.3** shows that the Q1-FY04 deficit was largely met through domestic sources, as the share of net external receipts in total financing was only 12 percent. This pattern of financing is in sharp contrast to that of Q1-FY03, when more than 80 percent of deficit was financed through external sources. Further analysis indicated that a substantial decline in the Rupee counter part of gross external receipts stemmed largely from lower inflows from the World Bank, decline in Special budgetary Support Grant and decrease in the Rupee value of the Saudi Oil facility. In addition to this, net receipts were also dampened due to relatively higher Q1-FY04 debt repayments. As a result, the government was forced to increase its reliance on domestic financing.

Table 3.3: Financing of Budget Deficit during Q1
billion Rupees

	FY03	FY04	Percent share	
			FY03	FY04
Financing through	41.0	40.9	100.0	100.0
External resources (net)	34.6	4.9	84.4	12.0
Internal resources	6.4	36.0	15.6	88.0
Domestic non-bank	19.7	24.1	48.0	58.9
Banking system	-14.1	9.9	-34.4	24.1
Privatization proceeds	0.8	2.0	2.0	4.9

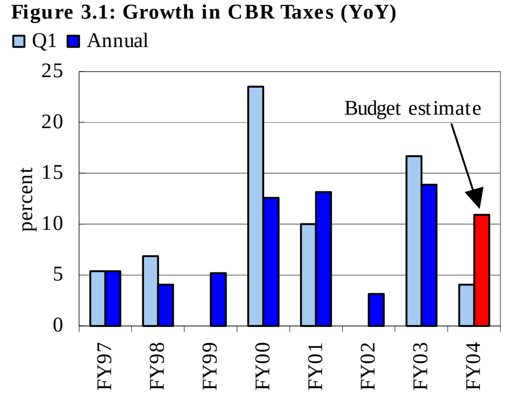
Moreover, the Q1-FY04 domestic financing mix was also in sharp contrast to that of Q1-FY03. The government borrowed Rs 9.9 billion from the banking system in Q1-FY04 compared to a net retirement of Rs 14.1 billion during the same quarter last year. However, this sharp recourse to borrowing from the banking sector did not put any visible pressure on interest rates, as the banking sector was quite liquid in the initial months of FY04.[2] Although non-banking sector remained an important source of deficit financing during Q1-FY04, the mobilization from national savings schemes (typically the major source of non-bank borrowing) posted a negative figure for the quarter under review. Finally, the share of privatization proceeds in financing of the budgetary deficit has also jumped up from only 2.0 percent in Q1-FY03 to 4.9 percent Q1-FY04.

3.4 CBR Tax Collections

As in FY03, the CBR tax collections for Q1-FY04 (Rs 94.1 billion) were slightly above the quarterly target, but it should be noted that this out-turn represents a lower share of the actual collection target relative to the historical trend. These receipts are only 18.4 percent of the annual target compared to 19.6 percent achieved during Q1-FY03 (see **Table 3.4**).

The quarterly receipts represent a mere 4.1 percent growth relative to the 16.6 percent increase recorded during Q1-FY03. Furthermore, this meager growth in tax collection is significantly lower than the average growth of 8.5 percent seen during the previous five years. This does not bode well for the annual target; as seen in **Figure 3.1**, weak Q1 growth in tax collections has typically also accompanied by relatively weak annual performance.

Figure 3.1: Growth in CBR Taxes (YoY)



The CBR has implicitly recognized that the Q1-FY04 target is relatively low, stating that this is in accordance with the traditional pattern of low receipts during the first quarter of a fiscal year (see **Figure 3.2**). It is worth noting that a significant contributor to the traditional weakness in first quarter tax receipts had

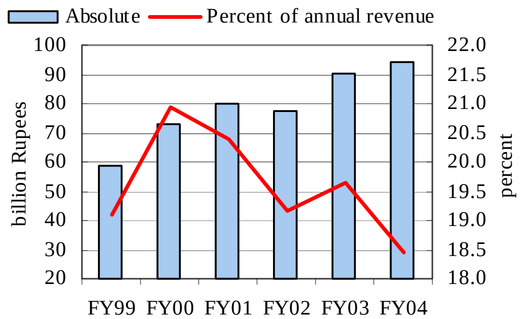
[2] On the other hand, banking sector found the way to employ their funds as strong private sector credit demand was proving insufficient to absorb liquidity with the banking sector.

been the seasonal disbursement of tax refund arrears for the preceding fiscal year.[3] Thus, following the reforms to prevent a build-up of tax refund arrears, this pattern would have been expected to be less visible. More to the point, the weakness in Q1-FY04 net collections is a reflection of weak gross receipts rather than high refunds.

The refunds, a difference between the gross collections and the net receipts, have witnessed a decline of Rs 3.3 billion during Q1-FY04. This is in sharp contrast to the behavior observed during the last three years, which witnessed a persistent rise in refunds during this quarter. However, this decline was not unexpected, as the refund amount for the last couple of years was on rise due to: (1) CBR efforts to do away the outstanding amount of refunds in a bid to stream line the refund system; and (2) adoption of VAT mode sales tax with more vigor.

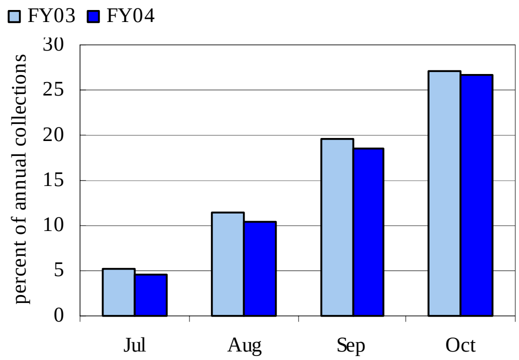
Notwithstanding the above concerns, a look at the relative monthly performance does provide *some* comfort; there is an evident steady acceleration in tax collections during each succeeding month (see **Figure 3.3**).

Figure 3.2: CBR Tax Collections during Q1



Q1-FY04 collection is percent of annual CBR target

Figure 3.3: Cumulative Monthly Tax Collections



[3] Towards the end of fiscal year, tax officials seeking to meet annual targets often delayed the payments of accrued tax refunds in order to inflate their performance. These arrears would then be disbursed in the initial months of the succeeding fiscal year, depressing *net* collections in the initial quarter.

3.4.1 Analysis by Tax Components

The subdued Q1-FY04 tax performance owes largely to the weakness in indirect tax receipts. In particular, while the direct tax, customs duty and excise collections exceeded the corresponding quarterly targets; sales tax collections fell short of the envisaged target. Given that the GST is expected to be the major contributor to the aggregate CBR tax collections, this is obviously a source of some concern.

Table 3.4 CBR Q1 Collections

billion Rupees

	Target for		Actual collections			Percent of target		YoY change	
	FY04	Q1	FY02	FY03	FY04	FY04	Q1	Absolute	Percent
Direct taxes	161.1	25.3	22.1	23.6	25.6	15.9	101.1	2.0	8.4
Indirect taxes	348.9	66.9	55.4	66.8	68.5	19.6	102.4	1.7	2.6
Sales tax	223.1	42.3	34.6	43.8	41.6	18.6	98.3	-2.2	-5.0
Central excise	47.7	8.5	9.9	9.6	9.0	18.9	105.9	-0.6	-6.4
Customs	78.1	16.1	10.8	13.4	17.9	22.9	111.1	4.5	33.9
Total	**510.0**	**92.2**	**77.5**	**90.4**	**94.1**	**18.4**	**102.0**	**3.7**	**4.1**

Source: Central Board of Revenue

3.4.2 Direct taxes

Direct taxes rose by an impressive 8.4 percent in Q1-FY04 relative to Q1-FY03, which is well above the required annual average growth of 6.2 percent. As a result, the quarterly receipts under this head totaled Rs 25.6 billion, a little above the Rs 25.3 billion target for the period under review (see **Table 3.4**).

A quick glance at **Table 3.5** shows that the entire rise in direct tax collections was contributed by withholding taxes and other miscellaneous taxes, as the gross collections from both, the *voluntary payments* and *collection on demand* categories witnessed a significant fall during Q1-FY04 compared to Q1-FY03.

Table 3.5: Major Components of Direct Taxes during Q1

billion Rupees

			Change over FY03	
	FY03	FY04	Absolute	Percent
Voluntary payments	7.4	5.2	-2.2	-29.4
Collection on demand	1.4	1.1	-0.3	-20.4
Withholding taxes	18.1	19.2	1.2	6.5
Others	0.5	1.8	1.4	298.2
Gross total	27.3	27.4	0.1	0.3

Source: Central Board of Revenue

Note: Others are calculated as residual.

Income tax collections through *voluntary returns* nearly doubled relative to Q1-FY03, which is attributed largely to the improved profitability of larger corporates (the Karachi LTU contributed significantly to the higher collections).[4] However, the impact of this exceptional growth on aggregate *voluntary payments* was overshadowed by the steep 67.4 percent decline in *advance payments*.

Another component, though small, the *collections on demand*, also witnessed a (Rs 0.3 billion) fall during Q1-FY04 as compared to the corresponding period last year, due to weaknesses in both, the *collections from the arrears* and *current on demand receipts*. Although the quantum of the decline is not substantial, it is difficult to overlook the fall, as the *on demand collection* is an important indicator to gauge the performance of the assessment and audit capacity of the taxation collection system.

Receipts of *withholding taxes*, which generally constitute around 70 percent of income tax collections, rose by 6.5 percent during the quarter under review relative to Q1-FY03. This made a significant contribution to the higher than target aggregate direct tax receipts during the period. A break-up of withholding taxes indicates that the bulk of the Q1-FY04 increase was contributed by four major categories, including *contracts*, *securities*, *imports*, and *salary* (see **Table 3.6**).

Table 3.6: Collection from Withholding Taxes during Q1

million Rupees

	FY03	FY04	YoY change	
			Absolute	**Percent**
Contracts	4,263	4,588	325	7.6
Securities	973	1,304	331	34.0
Imports	5,309	5,808	500	9.4
Salary	1,958	2,005	47	2.4
Interest	1,447	1,038	-408	-28.2
Sub-total (Five items)	13,949	14,743	794	5.7
Other WHT	4,112	4,486	374	9.1
Total WHT[#]	18,061	19,229	1,168	6.5

Source: Central Board of Revenue

[#] Withholding Taxes

The rise in *withholding taxes on contracts* is largely explainable by the higher development expenditures of the government as well as the rising activity in the domestic economy, while the increasing quantum of dutiable imports, stemming from a rising aggregate demand drove the rise in *withholding taxes on imports*.

The growth in withholding tax on salaries is relatively lower but this is to be expected given the upward revision in the tax threshold from Rs 60,000 to Rs 80,000 incorporated in the federal budget for FY03.

[4] Interestingly, while tax collections jumped up, the number of income tax returns filed under the Universal Self Assessment Scheme dropped by approximately 19 percent.

Finally, the declining interest rates over the last two years have been a major drag on *withholding taxes from the securities.* However, in Q1-FY04, the increased volume of fixed income investments by commercial banks (and other financial institutions) appears to have offset the impact of the low interest rates. A key factor here is the impact of SBP sterilization of forex market interventions that shifted a substantial proportion of SBP T-bill holdings to commercial banks.[5] Another contribution could be through the downward revision in the exemption limit for the levy of withholding tax on profits from NSS (particularly as the inflows in NSS schemes had risen sharply in prior periods).

The only major category of withholding taxes that witnessed a decline was *tax receipts from interest income*. This appears to be attributable largely to the downward revision in the tax rates for commercial banks.[6]

3.4.3 Indirect Taxes

The total Q1-FY04 revenue of Rs 68.5 billion from indirect taxes exceeded the quarterly target by Rs 1.7 billion (2.4 percent), but this represents a modest 2.5 percent rise over the corresponding FY03 figure. More significantly, even this reasonable aggregate performance was only made possible by exceptionally strong customs duty receipts, which compensated for a fall in sales tax collections.

Sales Tax[7]

As sales tax is the single largest component of CBR tax collections in recent years, it is troubling to note that the Q1-FY04 GST receipts were significantly below target (see **Table 3.4**). This fall in collections, in the face of strong industrial activity and rising dutiable imports, lends credence to the CBR assertion that the decline is caused by a technical correction (due to the adjustment of advance payments).[8] If this is indeed the case, sales tax receipts would be expected to accelerate in subsequent quarters. Another factor partially explaining the relatively weak Q1-FY04 collections could be the absence of the GST on medicine (that had been imposed for a short while during Q1-FY03).

[5] The SBP is exempted from taxes, but the income from the T-bills held by commercial banks is taxable.

[6] The income tax on banking corporations has also been reduced by 3 percent from the current 47 percent to 44.

[7] One of the steps introduced in the FY04 budget is, the import duty on oil seed, which was 10 percent, has been replaced with 20 percent GST on oil seed imports. Further, a 20 percent GST on oil produced from such seeds has also been levied. This measure is meant for encouraging the local farmers producing oil seeds.

[8] The CBR Quarterly Review, Central Board of Revenue, Government of Pakistan, Vol. 3, No. 1, July-September 2003.

The decline in Q1-FY04 GST collections was due entirely to a 21.2 percent YoY fall in collections on domestic items, as GST on imports during the period witnessed a 6.5 percent growth over the corresponding FY03 figure (largely due to higher imports).

A break-up of gross domestic sales tax collections indicates that only four out of ten major revenue spinners contributed positively. Of these, the stronger contributions were from POL, and cigarettes, as the growth in GST receipts from natural gas and cotton yarn was subdued (see **Table 3.7**).

Table 3.7: Item Wise Gross Collection of GST (Domestic)

million Rupees

			YoY change	
	FY03	**FY04**	**Absolute**	**Percent**
POL products	4,278	4,841	563	13.2
Services *	4,894	2,210	-2,684	-54.8
Electrical energy	2,691	1,342	-1,349	-50.1
Cotton	749	625	-124	-16.5
Natural gas	2,128	2,263	135	6.3
Sugar	1,889	1,698	-191	-10.1
Cigarettes	968	1,078	110	11.3
Cement	1,016	968	-49	-4.8
Cotton yarn	1,021	1,042	22	2.1
Fertilizers	1,013	943	-70	-6.9
Sub total	20,647	17,010	-3,638	-17.6
Others	10,436	10,286	-150	-1.4
All commodities	31,084	27,295	-3,788	-12.2

Source: Central Board of Revenue

*Including telephone/ fax

In contrast, revenue from services and electrical energy each saw a reduction of over 50 percent during Q1-FY04 as compared to Q1-FY03 collections. This decline, according to the CBR, is due to the adjustment of advance payments. Other major items that saw a decline in collections include sugar and cement.

1. The lower receipts from sugar are primarily due to large unsold inventories with the manufacturers, in anticipation of exports. Moreover, the sugar prices also declined during the quarter when the anticipated exports did not materialize, further depressing the collections.

2. A 4.8 percent decline in sales tax collections on cement during Q1-FY04, despite a substantial rise in the sale of cement (17.1 percent) is probably the result of the rising exports of cement (the resulting rise in refunds may have reduced the net collections).

Central Excise Duty (CED)
Although central excise duty (CED) collections exceeded the quarterly target of Rs 8.5 billion during Q1-FY03, this total represented a negative growth of 6.4 percent in year-on-year terms (see **Table 3.4**).[9] However**, t**his decline is not surprising, as the tax is being phased out, being substituted by the GST and customs duty.

Table 3.8: Central Excise Collection in Q1
million Rupees

	FY03	FY04	YoY Change		Share
			Absolute	Percent	FY04
Cigarettes	2,681	2,964	283.2	10.6	32.9
Cement	2,618	2,168	-450.1	-17.2	24.1
POL	865.6	789.3	-76.3	-8.8	8.8
Natural gas	1,086	1,162	75.5	7.0	12.9
Beverages	613	648.1	35.1	5.7	7.2
Sub total	7,864	7,731	-132.7	-1.7	85.9
Others	1,757	1,272	-485.3	-27.6	14.1
Total gross	9,621	9,003	-618	-6.4	100.0

Source: Central Board of Revenue

A disaggregation of CED collections shows that the major contributors to this performance are natural gas, cigarettes, and the beverages (see **Table 3.8**). While the establishment of four new units that started natural gas production during this period contributed the to 12.4 percent growth in the first, while the 15.3 percent rise in the production of the cigarettes (largely for exports) is consistent with the higher CED receipts.

Table 3.9: Custom Duties and Effective Tariff rates
percent

	Growth rates		Effective tariff rates	
Items	Dutiable imports	Customs duties	FY03	FY04
Animal or vegetable fats	31.1	20.6	32.4	35.1
Vehicles	33.0	47.1	35.8	32.4
Machinery	14.3	14.5	10.3	10.3
Plastic resins	21.0	21.4	18.6	18.6
Chemicals	17.4	19.7	9.8	9.6
Electrical machinery	27.2	29.7	13.5	13.3
POL products	-19.1	-18.9	10.2	10.2
Iron & steel	46.8	44.3	16.0	16.3
Coffee and tea etc.	-4.1	-22.8	18.9	23.5
Misc. chemical products	18.1	6.7	11.1	12.3
Paper and paper board	20.6	16.1	18.0	18.7
Dyes, paints	-4.3	-4.3	18.4	18.4
Rubber products	26.5	17.7	14.0	15.0
Man made filaments	26.9	14.9	16.5	18.3
Pharmaceutical products	13.8	11.6	10.2	10.4
Sub-total	15.9	18.3	17.0	16.7
Others	13.2	5.3	12.1	13.0
Grand total	**15.3**	**16.1**	**16.0**	**15.9**

Source: Central Board of Revenue

On the other hand, the declining growth in collection from cement can be explained by a reduction in the rate of

[9] A 25 percent (Rs 250 per ton) reduction in the CED per ton of cement was introduced to boost the construction activity, as the cement price per bag will reduce by Rs 12-14/50 kg bag by this measure. Furthermore, the government has abolished 5 percent CED on paper & board. This step has been taken to reduce prices of books and stationery and to promote overall exports. Additionally, abolishment of the 5 percent CED on paper and board will reduce the prices of packing material. These measures are estimated to effect CED collection to the tune Rs 5 billion in FY04.

CED on the product, while the lower collection on POL product reflects the shrinking tax base (the excise duty on many POL products has been transformed into a customs duty in FY03).

Customs[10]

Q1-FY04 custom collections witnessed an exceptionally strong growth of 33.9 percent compared to the corresponding Q1-FY03 receipts (see **Table 3.4**). This Rs 4.5 billion YoY increase, despite an appreciation of the Rupee, reflects a surge in dutiable imports (this, in turn, appears to be driven by an acceleration in economic activity, and possibly by the tariff rationalization undertaken in recent years).[11]

A compositional break-up of the custom receipts reveals that the jump in receipts primarily came from the strong growth in those dutiable items, that are subject to high tariff rates, such as animal or vegetable fats, vehicles, machinery, electrical machinery, and rubber products (see **Table 3.9**). In addition, lower refunds disbursed during the quarter also contributed a portion of the impressive growth in customs duties during the quarter.

[10] The customs duty on vehicles of above 1800 cc capacity has been reduced from 200 percent to 150 percent. The announcement of a reduction in the custom duty on tea from 25 percent to 20 percent would discourage tea smuggling.

[11] Tariff rationalization efforts of the government are also a contributing factor to this rise. Although the government reduced the duty rate on 259 items like raw materials in a bid to protect the industrial growth, rate on selected items was raised also for the same purpose.