4 Public Finance and Fiscal Policy

4.1 Introduction

The emphasis on fiscal reforms encompassing documentation, transparency, and improving tax compliance, initiated by the present government, continued during FY02. However, unlike FY01, which saw a notable fiscal consolidation, the efforts to reduce the budget deficit during FY02 to the targeted 4.9 percent of GDP were not successful as the overall deficit rose to 6.6 percent of GDP. The specific factors driving this outcome include the negative impact of international political developments, unanticipated defense expenditures, and some one-off adjustments. Importantly, adjusting for the latter expenses of Rs 168.4 billion, the "*baseline*" deficit for FY02 falls to 4.6 percent of GDP. This is well below the FY02 target, as well as the FY01 deficit of 5.3 percent of GDP (see **Table 4.1**).

A compositional breakdown of the overall FY02 deficit is instructive; while revenue collections were admittedly lower than the target, the primary contribution to the above-target deficit was from a sharp rise in expenditures. The decline in revenues was, to a degree, explainable by a slowdown in domestic economic activity, a consequent decline in imports, as well as the negative impact of two unexpected trends that altered key tax bases, i.e. a continuing decline in domestic inflation and the appreciation of the Rupee against US Dollar, both of which contributed to a decline in ad-valorem tax receipts. However, the fact that the tax-to-GDP ratio remains weak suggests that the tax base needs to be broadened.

On the expenditure side, while higher defense spending was to be expected given the escalated tensions on borders with India (following the December 13 incident),[1] the larger drain was on account of three additional *one-off* expenditures; a grant to the CBR allowing it to clear accumulated income tax arrears owed to banks, a substantial investment in KESC to restructure its finances before privatization, and a settlement of WAPDA arrears.

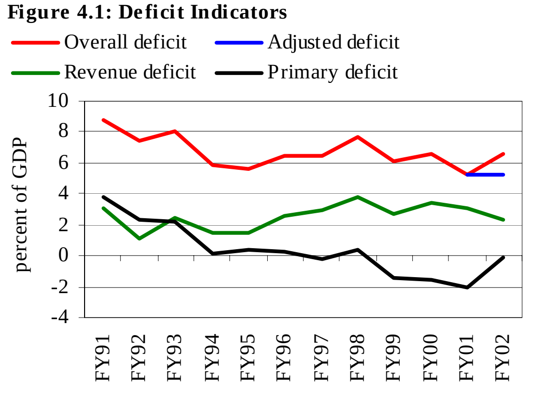
4.2 Fiscal Performance Indicators[2]

As no single indicator can properly assess the overall fiscal performance of a country, a set of indicators has been presented to gauge the consolidated fiscal operations of the federal and provincial governments during FY02.

4.2.1 Deficit Indicators

The unadjusted *overall budgetary deficit* has clearly deteriorated during FY02; not only is it higher than the actual budgetary deficit in FY01, the rise clearly disturbs the overall downward trend visible since FY99 (see **Figure 4.1**). However, the increase in the deficit over the FY02 target is almost entirely attributable to exceptional expenditures; excluding these gives an "adjusted" deficit of 4.6 percent of GDP (see **Table 4.2**), i.e. maintaining the recent downtrend.

Figure 4.1: Deficit Indicators



[1] India accused Pakistan of complicity in an attack on the Indian Parliament – an accusation that Pakistan vehemently denied. Nonetheless, India increased its military presence on the borders with Pakistan and threatened to take military action across the Line of Control to attack the alleged bases of the militants. This forced Pakistan to undertake pre-emptive defensive measures that raised military expenditures during FY02.

[2] Discussion in this section is based on consolidated data of the federal and provincial governments.

Table 4.1: Summary of Public Finance
Consolidated Federal and Provincial Governments
billion Rupees

	FY99	FY00	FY01	FY02		FY03
				Budget	Provisional	Budget
1. Revenue receipts (a+b)	468.6	536.8	546.4	657.9	630.3	691.9
a) Tax revenue	390.7	406.0	445.0	528.2	476.6	n.a.
b) Non-tax receipts	77.9	131.0	102.0	129.8	153.7	n.a.
2. Total expenditures (a+b+c)	647.8	743.6	726.9	844.8	873.1	854.4
a) Current	547.3	642.9	650.7	714.6	717.7	720.4
b) Development	98.3	95.6	92.5	130.0	123.6	134.0
c) Net lending to PSEs etc.	2.2	5.1	-16.3	0.2	31.9	
3. Revenue surplus/deficit (1-2.a)	-78.7	-106.1	-104.3	-56.6	-87.3	-28.5
4. Overall balance (1-2)	-179.2	-206.8	-180.5	-186.9	-242.8	-162.5
5. Adjusted balance	-	-	-	-	-168.4	-
6. Financing through:	179.2	206.8	180.4	186.9	242.8	162.5
a) External resources (net)	97.1	67.0	118.8	121.6	106.6	129.1
b) Internal resources (i+ii)	82.1	139.9	61.6	65.3	136.2	33.4
i) Domestic non-bank	155.9	100.0	93.9	54.8	123.7	64.5
ii) Banking system	-73.8	40.0	-32.3	10.5	12.5	-31.1
As per cent of GDP (mp)						
1. Revenue receipts (a+b)	15.9	17.1	16.0	17.3	17.1	17.1
a) Tax revenue	13.3	12.9	13.0	13.9	12.9	n.a.
b) Non-tax receipts	2.7	4.2	3.0	3.4	4.2	n.a.
2. Total expenditures (a+b+c)	22.0	23.6	21.3	22.3	23.7	21.1
a) Current	18.6	20.4	19.0	18.8	19.5	17.8
b) Development	3.3	3.0	2.7	3.4	3.4	3.3
c) Net lending to PSEs etc.	0.1	0.2	-0.5	0.0	0.9	0.0
3. Revenue surplus/deficit (1-2.a)	-2.7	-3.4	-3.1	-1.5	-2.4	-0.7
4. Overall balance (1-2)	-6.1	-6.6	-5.3	-4.9	-6.6	-4.0
5. Adjusted balance	-	-	-	-	-4.6	-
6. Financing through:	6.1	6.6	5.3	4.9	6.6	4.0
a) External resources (Net)	3.3	2.1	3.5	3.2	2.9	3.2
b) Internal resources (i+ii)	2.8	4.4	1.8	1.7	3.7	0.8
i) Domestic non-bank	5.3	3.2	2.7	1.4	3.4	1.6
ii) Banking system	-2.5	1.3	-0.9	0.3	0.3	-0.8

Source: Ministry of Finance

The performance of the overall budget deficit is similar to that of another indicator, the *revenue deficit*, i.e. the gap between revenues and current expenditures, which indicates the portion of the government's revenues consumed by non-development expenditures.[3]

Borrowings undertaken to meet current expenditures are a matter of some concern, as the expenditures do not add to the repayment capacity of the country, but they increase the debt burden. Pakistan has been experiencing a revenue deficit for last two decades, but this has declined significantly in FY02 to 2.4 percent of GDP (see **Figure 4.1**).

[3] Revenue balance figure for FY02 must be read with caveat, as it excludes Rs 30 billion investment in KESC because it is classified under Net Lending to PSEs according to accounting standards.

To its credit, the government appears to recognize that even the FY02 *revenue deficit* figure is high. This concern is explicitly accepted in the government's proposed Fiscal Responsibility and Debt Limitation Ordinance, 2002 that aims to gradually eliminate the revenue deficit by FY07.

A troubling development for FY02 is the abrupt reduction in the *primary surplus* to 0.1 percent of GDP from 2.0 percent of GDP in the previous year (see **Figure 4.1**). This indicator is arrived at by deducting interest expenses from the overall budgetary deficit, and is used to gauge a country's ability to finance its expenditures in the absence of a debt burden. Pakistan has been running primary surpluses (or almost negligible deficits) since FY94, but it was only in the last few years that substantial primary surpluses had been generated, reflecting the increased emphasis on containing the debt burden.

Table 4.2: Adjusted Budget Deficit for FY02

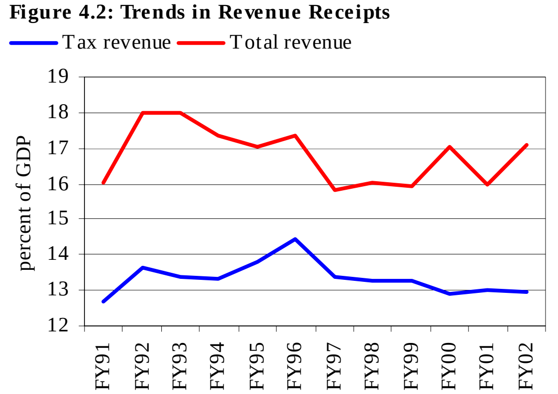
	billion Rupees	Percent of GDP
Budget target	186.9	4.9
Budget deficit [P]	242.8	6.6
Exceptional expenditures		
Grants to CBR	22.0	0.6
Investment in KESC	30.0	0.8
Defense expenditures	17.4	0.5
Wapda arrears	5.0	0.1
Total	74.4	2.0
Adjusted deficit[1]	168.4	4.6

[P]: Provisional

[1]: Adjusted exceptional expenditures only

The abrupt loss of this surplus in FY02 is largely attributable to the exceptional expenditures witnessed during the year (see **Table 4.2**). The absence of these in future years could therefore lead to the re-appearance of large primary surpluses.

Figure 4.2: Trends in Revenue Receipts



4.2.2 Revenue Indicators

FY02 has seen a surprisingly strong jump in the revenue-to-GDP ratio, which rose by 1.1 percentage points even as the tax revenue to GDP ratio remained almost unchanged (see **Figure 4.2**). In other words, the buoyant 15.4 percent growth in revenues is primarily driven by rising non-tax collections, which is based on three main sources: (1) interest income on government loans, (2) dividends from corporations, and (3) profits from other organizations such as the SBP.[4] None of these has traditionally been a stable income source, as evident from the high variance in these receipts over the last 12 years (see **Table 4.3**). As seen in **Figure 4.2**, tax revenues as a percent of GDP showed some growth from FY92 to FY97 and afterward remained worryingly stagnant despite the considerable efforts over the years to broaden the tax base of the economy. Clearly, the efforts to capture the tax potential of the economy have not succeeded so for.

To gain more insight, the buoyancy of revenues has also been computed for a 12-year period to assess the overall growth in revenue receipts. The estimated buoyancy of tax revenues averaged 0.9 as compared to 1.3 for non-tax revenue (see **Table 4.3**). In other words, the average growth and volatility in non-tax revenues remained significantly higher than for tax revenues over the estimation period.

[4] Within non-tax revenues, interest income from loans and advances to provincial governments is relatively stable with a share of around 23 percent in total non-tax revenues.

During FY02, the share of non-tax revenues and its buoyancy estimates were higher than the average for the 1990s. However, the concern due to the historical volatility may be misplaced, as the restructuring of public sector enterprises in recent years may finally permit them to regularly service their debt to the government. If so, this would add greatly to the stability of non-tax revenues going forward.

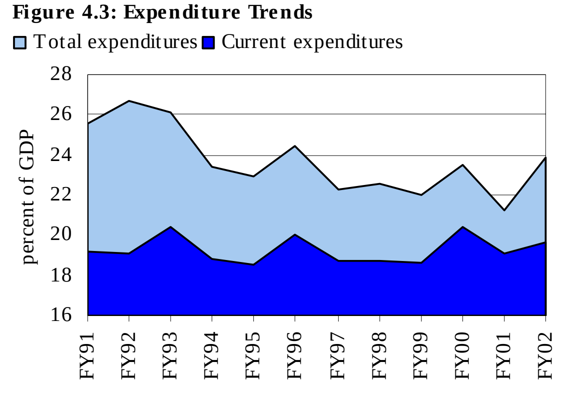
Table 4.3: Selected Fiscal Indicators (FY91 to FY02)

	Average	Standard deviation	Co-efficient of variation
As percent of GDP			
Tax revenues	13.4	0.5	3.6
Non-tax revenues	3.6	0.8	21.7
Total revenues	16.9	0.9	5.3
Current expenditures	19.3	0.8	3.4
Defense	5.5	0.9	17.0
Interest payments	6.3	1.0	16.5
Development expenditures	4.6	1.5	33.4
Total expenditures	23.9	1.7	7.0
As percent of budget targets			
Revenue receipts	92.1	3.7	4.0
Current expenditures	102.0	5.1	5.0
Development expenditures	95.7	12.5	13.1
Buoyancy estimates			
Tax revenues	0.9	0.3	34.3
Non-tax revenues	1.3	2.8	217.8
Total revenues	1.0	0.6	61.0
Current expenditures	1.1	0.6	55.5
Development expenditures	0.5	1.6	300.6
Total expenditures	1.0	0.8	75.8

4.2.3 Expenditure Indicators

The *total expenditure to GDP ratio* approximates the government's share in the overall economy and provides information on the fiscal stance of the government. As evident from **Figure 4.3**, after falling sharply in the first half of the 1990s, it depicts a gradual downtrend in succeeding years. Unfortunately, this gradual slide was almost exclusively at the cost of development expenditures.

Figure 4.3: Expenditure Trends



The average buoyancy of total (1.0), current (1.1), and development (0.5) expenditures computed for the preceding 12 years reinforces the conclusions drawn above (see **Table 4.3**). While expenditures kept pace with GDP on average, it is current expenditures that grew at the faster pace, driven mainly by a sharp rise in interest payments, and fiscal adjustments were largely made by cutting development expenditures.

During FY02, the *total expenditures to GDP* ratio has jumped sharply from 21.3 to 23.7 percent, largely on account of current expenditures (see **Figure 4.3**).[5] However, for once, this rise is not at the expense of development expenditures, which has also rose by 0.7 percent of GDP. Moreover, incorporating the one-off spending, the "adjusted" FY02 expenditures to GDP ratio falls to 21.7 percent.

A compositional breakdown of current expenditures over the years also provides interesting insights. As a ratio to GDP, expenditure on public sector development programs and defense recorded considerable declines since the early 1990s. However, the realized reductions did not lower the overall budget deficit, as the interest payments picked up over the same period (see **Figure 4.4)**. On the positive side, over the last three years, the interest payments to GDP ratio has also witnessed a notable decline, reflecting the government's emphasis on better debt management.

4.2.4 Management Indicators

The ratio of budgetary targets to actual performance, for various revenue and expenditure heads, provides interesting insights on the government's ability to set realistic targets and perform within

[5] Current expenditure increased by 1.9 percentage points (including net lending to PSEs) over the same period.

these budgetary parameters. It is pertinent to note here that both large positive or negative deviations from the target are not desirable.

Table 4.3 shows that revenue receipts remained persistently lower than the target, and strikingly, there has been very little deviation from the mean, i.e. there is a very consistent upward bias in the government's budgetary revenue estimates.

The expenditure ratio shows greater variability; current spending has seen both positive and negative deviations from targets, but on average, positive deviations (realized figures greater than budget targets) have dominated (see **Figure 4.5**). On average development expenditures are over-estimated (see **Table 4.3**).

Figure 4.4: Pattern of Key Expenditures

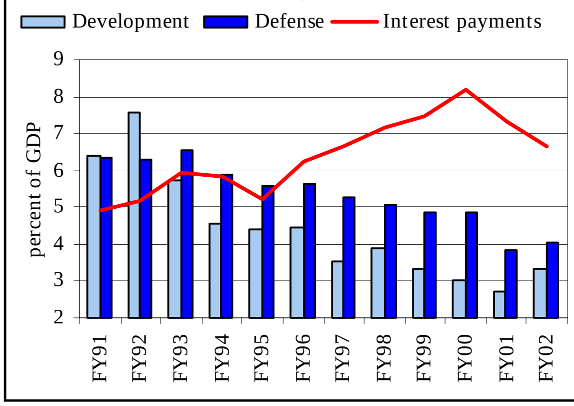


Figure 4.5: Management Indicators

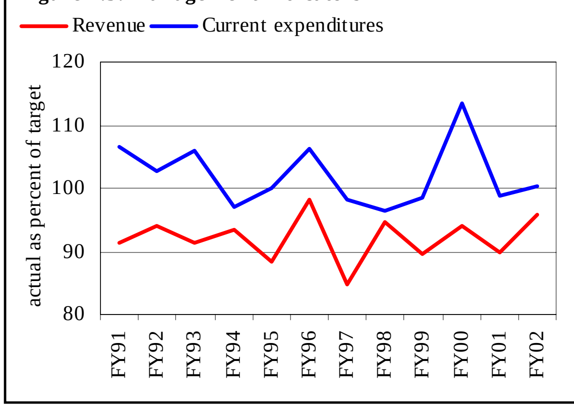
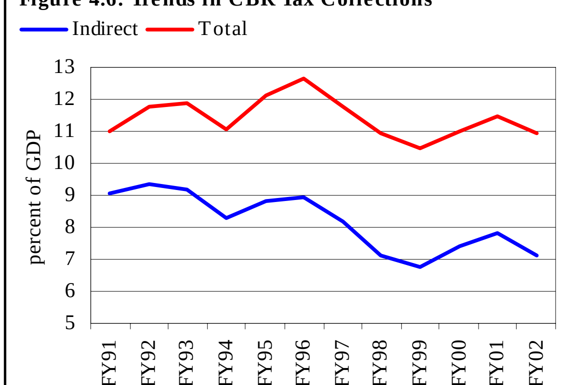


Figure 4.6: Trends in CBR Tax Collections



4.3 Fiscal Developments at Federal Level

The revised FY02 federal government revenue receipts stand at Rs 632.8 billion. While below budget target, this figure is still 18.3 percent higher than the collections during FY01. The improvement is almost entirely based on higher non-tax revenues.

4.3.1 CBR Performance[6]

Tax Efforts

The overall performance of the taxation system depends on its revenue generation, which is generally gauged by the *tax to GDP* ratio. Historically, the Federal *tax to GDP* ratio fluctuated in a band of about 2 percentage points around a mean of 11.4 percent (see **Figure 4.6**). The fact that post-1996, this ratio has generally remained below the average, despite lower GDP growth, indicates a continuing weakness in the taxation system.

Within total taxes, there is a structural shift from indirect taxes to direct taxes as reflected in the rising *direct tax to GDP* ratio (see **Figure 4.7**). During first half of 1990s, a sharp rise in this ratio was largely explained by the increasing resort to withholding taxes. However, recent tax reforms reduced the role of these taxes, and therefore the continuing marginal up trend in direct tax collections over the past three years is quite encouraging.

[6] In this section, data on actual tax collections are utilized, which are different from revised estimates reported in **Table 4.8**.

As can be seen from **Figure 4.6,** the variation in the indirect taxes to GDP ratio explains most of the variation in total tax collections. This co-movement also highlights the government's heavy dependence on indirect tax revenues despite the regressive nature of such taxes.

The present government has initiated wide-ranging taxation reforms to correct structural weaknesses, which include a Tax Survey and Registration Scheme supplemented with Tax Amnesty Schemes to ease public concerns, introduction of new Income Tax Law, a new Self-Assessment Scheme, etc.

Broadening the tax base and improving efficiency in tax administration remained the main planks of taxation policy. These were implemented by reducing the number of taxes, rationalizing tax rates and penalties, and simplifying collection procedures. All these measures helped the government realize double-digit growth in tax collections during FY00 and FY01, as also reflected in the rising tax to GDP ratio (see **Figure 4.6**). However, lower growth in FY02 primarily due to slowdown in economic activity, lower imports and higher tax refunds undermined the government efforts to record buoyant growth for a third year in a row.

Figure 4.7: Direct Taxes to GDP Ratio

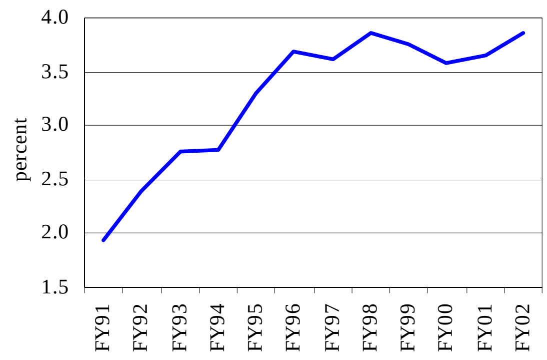


Table 4.4: Buoyancy Estimates

Category	Buoyancy	t-Stat	R^2
GDP as base			
Total taxes	0.95	30.28	0.99
Direct taxes	1.47	19.50	0.99
Indirect taxes	0.76	19.68	0.97
Sales taxes	1.70	11.85	0.98
CED	0.55	4.26	0.91
Customs	0.86	2.94	0.60
On alternative bases			
Total taxes (adjusted GDP)	0.98	28.99	0.99
Direct taxes (adjusted GDP)	1.55	16.99	0.99
Indirect taxes (private consumption)	0.72	19.72	0.97
Sales taxes (private consumption)	1.44	13.45	0.95
CED (large scale value added)	0.68	4.96	0.92
Customs (imports)	0.99	7.30	0.83

Buoyancy Estimates of Federal Taxes

Buoyancy is used to measure the relative increase in revenue collection (including the effects of discretionary changes in tax system) compared with the relative increase in the base. The buoyancy estimates for various federal taxes with respect to GDP, as well as with alternative bases, are reported in **Table 4.4**.[7] The buoyancy for total tax receipts is less than one for both GDP and non-agricultural GDP. This means that the CBR tax collections could not keep pace with growing national income over the period of estimation, despite discretionary tax measures.

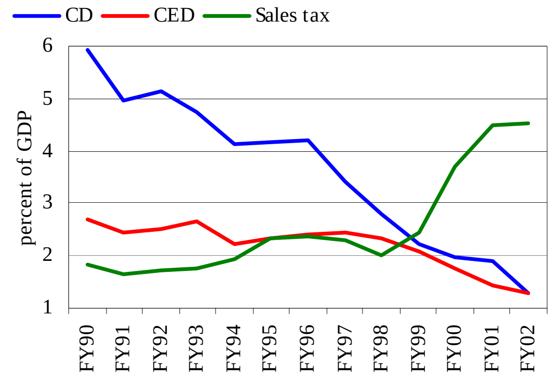
Within total taxes, buoyancy estimates for direct taxes are significantly greater than one, both with respect to GDP and non-agricultural GDP.[8] This implies that the growth in direct tax collection remained healthy over the period of estimation, reflecting the success of the government policy to increasingly shift the tax burden to direct taxes.

In contrast, indirect taxes could not grow in proportion to either overall GDP or private consumption; only sales tax witnessed buoyant growth, while the central excise duty and customs duty could not record any significant increase over the period of estimation. This behavior of indirect taxes is largely explainable by the taxation policies.

[7] Data from FY91 to FY02 is used to estimate the value of parameters ***a*** and ***b*** of Ln (Tax) = *a* + *b* Ln (Base), which contains an important assumption that income elasticity is constant over the range of income. In other words, this implies that the proportionate response of the tax to an income change of one percent will be same regardless of the level of income.

[8] GDP adjusted for agricultural value added is used as a base for total taxes and direct taxes.

Figure 4.8: Trend in Indirect Taxes



Customs duty collections fell as the maximum tariff rates were slashed from over 100 in FY91 to just 30 percent by FY02, driving the share of custom duties in total tax revenues from 48.6 percent in FY91 to 11.9 percent in FY02. The government attempted to offset this loss by imposing sales tax, but this effort was not too successful until FY99 (see **Figure 4.8**). Thereafter, the sales tax receipts have risen strongly amidst the broadening of the tax base, through elimination of exemptions, and shifting of CED collections. The central excise duty (CED), which had a 25.8 percent share in indirect taxes during FY91, was also gradually phased out for most commodities, being replaced by sales tax. As a result, the CED collection fell from 2.1 percent of GDP in FY99 to just 1.3 percent during FY02.

The buoyancy estimates also reflect these developments, being greater than one for sales tax and less than one for customs duties and CED. The low buoyancy for indirect taxes thus simply reflects that the government failed to offset revenue losses from tariff cuts during the 1990s. However, the situation has witnessed tremendous improvement during FY00 and FY01.

FY02 CBR Tax Performance

Compared to buoyant growth in CBR tax collections during FY01, receipts increased by only 3.0 percent during FY02 (see **Table 4.5**). This marginal net growth was weaker than real GDP growth and the inflation rate, mainly due to an unexpected decline in import-based taxes, and exceptionally high tax refunds (that dragged down the net collections).

Both factors primarily pertain to indirect tax collections, which consequently saw a decline of 2.4 percent. Thus, in sharp contrast to low growth in total tax collections during FY02, revenues from direct taxes recorded a healthy growth of 14.5 percent over the preceding year (see **Table 4.5**).

Table 4.5: Actual Tax Collections (Net) by CBR

billion Rupees

				Growth rates		
	FY00	**FY01**	**FY02**	**FY00**	**FY01**	**FY02**
Direct taxes	113.0	124.6	142.6	2.5	10.3	14.4
Indirect taxes	234.2	267.7	261.3	18.1	14.3	-2.4
Sales tax	116.7	153.6	166.3	61.9	31.6	8.3
Central excise	55.8	49.1	46.9	-8.4	-12.0	-4.5
Customs	61.7	65.0	48.1	-5.6	5.3	-26.0
Total	**347.1**	**392.3**	**403.9**	**12.5**	**13.0**	**3.0**

Source: Central Board of Revenue

A compositional break down of direct taxes showed that the growth was largely driven by higher collections on account of both *normal returns* and *on demand* payments (arrears).[9] The compositional change is more encouraging given that the collections from withholding taxes have remained almost at the FY01 level. This is due to abolition of five types of withholding taxes, lower collections from interest/profit income on securities (largely driven by lower T-bill rates during the year), as well as a fall in receipts of import-based withholding taxes. The double-digit growth in direct taxes is thus quite creditable and indicates that the government taxation reforms have started paying dividends.[10]

[9] Collections with normal returns include amounts received from periodic returns filed by the businesses, while 'on demand' collections include receipts from outstanding arrears and amount detected by the auditors of the CBR. A rise in the former generally implies an increasing tax base of income tax, while the latter reflects the CBR efforts to collect arrears as well as improving audit capabilities.

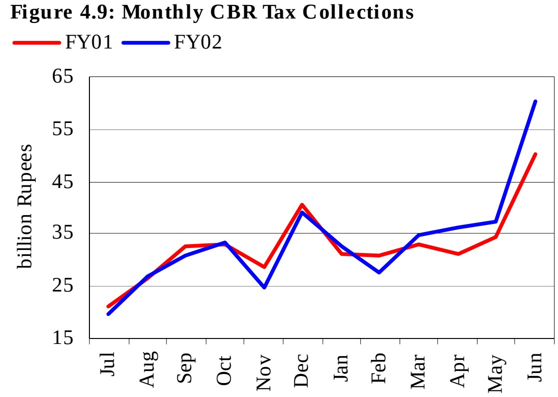
[10] Due to Survey and Registration drive, 234,189 new income tax payers and 34,000 sales tax payers have been added to the tax base.

The breakup of indirect taxes showed that only sales tax collections recorded positive growth as compared to FY01, while the customs collections were the hardest hit with a steep decline of 26.1 percent (see **Table 4.5**). In fact, the sales tax collections maintained moderate positive growth for the year, both on domestic and import related items. Specifically, while FY02 sales tax collections on domestic goods and services registered healthy growth of 13.1 percent over a year ago, sales tax collections on import related items rose only 4.8 percent, which lowered the overall growth rate to 8.3 percent.

Higher sales tax collections on domestic goods and services are largely attributable to the broadened tax base, both due to new sales tax payers and the government's efforts to substitute CED with sales tax. Also, it must be noted that relatively low growth in import-related taxes is not too discouraging, in the presence of dwindling dutiable imports and appreciating local currency.[11] Additionally, a one-time distortion caused by exceptional GST refunds was a key FY02-specific dampener on net collections. In absolute terms, FY02 sales tax refunds were Rs 6.1 billion higher than in FY01.

FY02 custom revenues too, were a major drag on CBR net tax collections. In absolute terms, these alone contributed Rs 21.5 billion to revenue shortfall of Rs 53.8 billion from the budget target. In fact, in proportion to its 11.9 percent share in actual tax collections, the contribution to overall shortfall is exceptionally large at 40.0 percent. The reasons for the fall are the same as for sales tax.

Figure 4.9: Monthly CBR Tax Collections

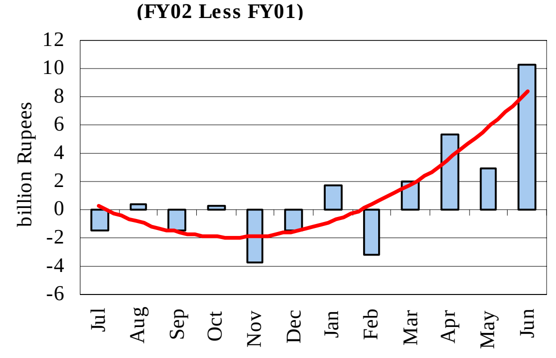


Trends in Monthly Tax Collections

Although overall growth in net tax collections was disappointing during FY02, trends in monthly tax collections are insightful. Despite exceptional developments during the year under review, the seasonality remained unchanged, with peaks in revenue collections coinciding with quarter ends (see **Figure 4.9**).

Another important point is the clear improvement in revenue collections during the last quarter of the year (see **Figure 4.10**). This suggests a waning of the negative September 11 impacts, with the passage of time. Specifically, revenue collection during Q4-FY02 witnessed impressive growth of 16 percent over the same period a year ago, with both direct and indirect taxes contributing to the improvement.

Figure 4.10: Incremental Tax Collections (FY02 Less FY01)



[11] Specifically, FY02 imports recorded a decline of 3.6 percent in US Dollar terms, and the Rupee appreciated by 6.7 percent during the year as compared to the deprecation of 18.6 percent in FY01. The past three-year average growth in imports is over 12 percent. The rough estimates based on three-year average growth showed that actual imports in terms of the Rupee were around Rs 74 billion lower during FY02, which had obvious implications for CBR tax collections as import related taxes constitute around 40 percent of CBR tax collections, which include customs, sales tax on imported items, withholding taxes and central excise duty on imports.

Expectations Fell Short of Targets

As in the previous year, the CBR tax targets saw three revisions during FY02, but the actual collections of Rs 403.9 billion were still quite low compared to the final revised target of Rs 414.2 billion, as well as the budget target of Rs 457.7 billion (see **Table 4.6**).

The initial budget target of Rs 457.7 billion was revised downward to Rs 444.7 billion in August 2001 to account for the shortfall realized in actual tax collections during FY01.[12] However, the impact of the September 11 shocks, and realized shortfall during Q1-FY02 forced CBR to resort to another downward revision of the FY02 target to Rs 429.9 billion by October 2001, based on preliminary projections of further revenue losses.

However, the mid-year collections again fell short of the revised target, as the economic assumptions proved too optimistic. To adjust for the shortfall accumulated upto January 2002, and to incorporate revisions in economic assumptions, the annual target was again adjusted downward to 414.2 billion, which was only 5.6 percent higher than the actual collections during FY01.[13] Unfortunately, the actual collections still fell short of this final revised target (see **Table 4.6**).

Table 4.6: CBR Revenue Targets

billion Rupees

	Budget	Revisions			
	target	1st	2nd	3rd	Actual
Direct taxes	149.8	143.1	142.4	146.5	142.6
Indirect taxes	307.9	301.6	287.5	267.7	261.3
Sales tax	185.2	183.1	176.8	170.1	166.3
Central excise	53.1	49.6	49.4	47.1	46.9
Customs	69.6	68.9	61.3	50.5	48.1
Total	**457.7**	**444.7**	**429.9**	**414.2**	**403.9**

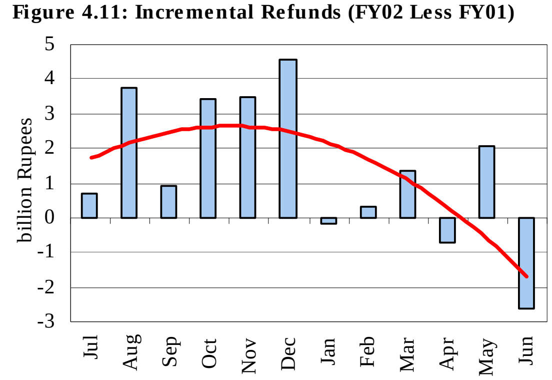
Table 4.7: Quarterly Collections and Refunds by CBR

billion Rupees

	Gross collections		Refunds		Growth rates	
	FY01	FY02	FY01	FY02	Collections	Refunds
Q1	95.6	98.5	15.7	21.1	3.0	34.4
Q2	114.1	120.6	12.0	23.5	5.7	95.8
Q3	111.5	113.6	16.8	18.3	1.9	8.9
Q4	133.2	150.4	17.6	16.3	12.9	-7.4
Total	**454.4**	**483.2**	**62.1**	**79.3**	**6.3**	**27.7**

Source: Central Board of Revenue

Figure 4.11: Incremental Refunds (FY02 Less FY01)



Refund/Rebate and Gross Collections

During FY02, gross tax collections rose by 6.3 percent year-on-year, but net collections rose by only 3.0 percent due to a sharp increase in the payment of tax refunds/rebate. Specifically, refunds rose to Rs 79.3 billion during FY02 compared to Rs 62.1 billion a year before (see **Table 4.7**). Consequently, refunds/rebate as a percentage of gross collections jumped from 13.7 percent in FY01 to 16.4 percent during FY02.

The massive growth in refunds/rebates was the upshot of government efforts to substantially reduce the accumulated arrears of refunds/rebates. The government also streamlined the refund/rebate claims process, in a bid to help exporters remain competitive.

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[12] For each fiscal year, the budget targets are generally computed toward the end of the preceding fiscal year, mostly on the basis of cumulative collections of 11 months and the estimated June collections. Therefore, any significant shortfall realized in the tax collections of the earlier year has to be incorporated into the budgetary target for the next year.

[13] During FY01, CBR revenue target witnessed three downward revisions, while the actual collections fell short of around Rs 12 billion from the revised target.

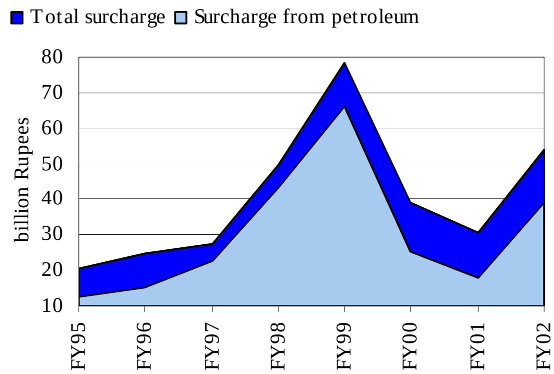
The monthly data on the disbursement of refunds shows that the bulk of the incremental refunds were concentrated in Q2-FY02 when business confidence was probably at its lowest ebb (see **Figure 4.11**).[14] During H2-FY02, refunds disbursements were in line with the corresponding period last year. However, substantial incremental payments are also visible in August (Rs 3.8 billion), March (Rs 1.4 billion) and May (Rs 2.1 billion), which suggest that this was not merely an effort to help out the exporters, but was also a genuine effort to eliminate the payments arrear overhang.[15] If the latter view is correct, this would be reflected in a relative increase in net collections in the next year.

4.3.2 Surcharges

Revised estimates of surcharges stood at Rs 53.9 billion for FY02 compared to the budget target of Rs 47.0 billion. The entire increase is attributed to higher development surcharges on petroleum products (see **Figure 4.12**).

The rise is the result of a Rs 0.75 per litre increase in petroleum development surcharge on diesel and Rs 0.25 per litre on other oil products.[16] This revenue generation measure was specifically designed to improve overall revenue receipts in the presence of a binding fiscal deficit target under the PRGF.

Figure. 4.12 : Revenue from Surcharges



Unlike tax revenues, surcharges remained a volatile source of government revenue receipts in the past. The development surcharges are the difference between production costs and the fixed sales price of the commodities, and the latter were not readily adjusted as international prices changed.

However, the volatility in surcharges is attributable entirely to the fluctuations in petroleum surcharges given the smaller share of gas surcharges. With the deregulation of petroleum prices from the FY02, it is envisaged that surcharges will emerge as a more consistent source for the exchequer.

4.3.3 Non-Tax Revenues

In sharp contrast to the tax revenue picture, revised non-tax receipts stood at Rs 164.7 billion, which are Rs 25.6 billion higher than the budget target and over Rs 50.0 billion higher than the actual receipts during FY01 (see **Table 4.8**). The breakup of non-tax revenue showed that all three heads posted a healthy growth over a year ago, but the major driving force was higher receipts from civil administration.

Receipts from property and enterprise were almost in line with the budget target, but Rs 13.4 billion higher as compared to the previous year. This improvement was shared by interest income from provinces and institutions (the biggest component was the higher dividend income received from OGDCL).[17]

[14] Exporters were particularly vulnerable as: (1) prospects for exports were bleak in the aftermath of the September 11 incidents, and (2) an appreciating Pak Rupee was eating into exporters margins.
[15] Additionally, the government also helped CBR to clear accumulated income tax refunds to the banks of Rs 22 billion during the year, which are not included here as these were directly absorbed in federal budget for FY02. This again reflects government efforts to do away with the accumulated refunds.
[16] With the deregulation of petroleum products prices through Finance Act 2001, the old mechanism of development surcharges was replaced with a fixed petroleum levy at per liter price of various products.
[17] The higher dividend income from OGDCL is largely attributed to the clearance of accumulated arrears.

Table 4.8: Federal Government Revenue Receipts
billion Rupees

	FY00	FY01	FY02 Target	FY02 Revised	FY02 Excess/ Shortfall from Target	FY02 Excess/ Shortfall from Last year	FY03 Target	FY03 Excess over last year
1. Revenue receipts (I+IV)	**531.3**	**535.1**	**643.8**	**632.8**	**-11.0**	**97.7**	**674.9**	**42.1**
I. Total taxes and surcharges (II+III)	386.0	422.8	504.7	468.1	-36.6	45.3	521.1	53.0
II. Total taxes (i+ii)	347.1	392.3	457.7	414.2	-43.5	21.9	460.6	46.4
i) Direct taxes	113.0	124.6	149.8	146.5	-3.3	21.9	148.4	1.9
a) Taxes on income	105.4	117.5	144.2	142.0	-2.2	24.5	143.2	1.2
b) Wealth tax	3.9	1.5	0.2	0.4	0.2	-1.1	0.0	-0.4
c) Workers welfare tax	3.0	5.0	4.6	3.4	-1.2	-1.6	4.3	0.9
d) Capital value tax	0.7	0.6	0.8	0.7	-0.1	0.1	0.9	0.2
ii) Indirect taxes	234.1	267.7	307.9	267.7	-40.2	0.0	312.2	44.5
a) Customs	61.7	65.0	69.6	50.5	-19.1	-14.5	56.5	6.0
b) Central excise	55.8	49.1	53.1	47.1	-6.0	-2.0	50.0	2.9
c) Sales tax	116.7	153.6	185.2	170.1	-15.1	16.5	205.7	35.6
III. Surcharges	38.9	30.5	47.0	53.9	6.9	23.4	60.5	6.6
a) Petroleum	25.4	17.9	32.0	39.0	7.0	21.1	45.5	6.5
b) Natural gas	13.5	12.6	15.0	14.9	-0.1	2.3	15.0	0.1
IV. Non-tax revenue	145.3	112.3	139.1	164.7	25.6	52.4	153.8	-10.9
a) Property and enterprises	91.6	67.6	81.5	81.0	-0.5	13.4	79.5	-1.5
b) Civil administration	34.9	23.2	28.6	54.6	26.0	31.5	50.3	-4.3
c) Miscellaneous	18.7	21.5	29.0	29.1	0.1	7.6	24.0	-5.1
2. Less: transfers to provinces	**143.6**	**163.1**	**190.0**	**175.1**	**-14.9**	11.9	**193.5**	**18.4**
Revenue receipts (net) (1-2)	**387.7**	**372.0**	**453.8**	**457.7**	**3.9**	**85.8**	**481.4**	**23.7**

Source: Annual Budget Statement of the Federal Government

The increase in interest income was primarily driven by higher loan recoveries from financial and non-financial institutions. The increase in the former was largely on account of interest received on foreign loans of NDFC (which has now been merged with National Bank of Pakistan), while the surge in latter was due to loan recoveries from KESC, WAPDA and NHA.[18]

Civil administration receipts witnessed remarkable improvement during FY02 as compared to FY01. This increase of over Rs 30.0 billion was attributed to two factors: (1) a Rs 5.5 billion increase in transfers from SBP, and (2) a Rs 23.0 billion increase in defense receipts, largely on account of the logistic support to US forces operating in Afghanistan. The SBP profits largely depend on interest income and exchange gains or losses. Due to net exchange gains, the SBP was able to transfer an amount of Rs 28.5 billion to the government during FY02. As can be seen from **Table 4.8**, miscellaneous receipts also posted an increase of Rs 7.6 billion over a year before, largely on account of higher income from sale proceeds of oil and gas (on account of the government share in joint ventures).

4.3.4 Transfers to Provinces

The transfers to provincial governments are revised downwards to Rs 175.1 billion compared to Rs 190.0 billion in budget estimates (see **Table 4.8**). This downward revision is entirely on account of lower receipts in the divisible pool.[19] The underlying reasons for lower collections of these taxes are discussed in **Section 4.3.1**.

[18] During FY02, the government picked up Rs 83 billion accumulated losses of KESC and Rs 20 billion of WAPDA, which enabled these organizations to reduce their liabilities and honor their financial obligations.

[19] The divisible pool includes taxes on income, capital value tax, taxes on sales and purchase, export duty on cotton, customs duties, federal excise duty excluding gas duty charged at well-head, and any other tax that may be levied by the federal

4.3.5 Federal Expenditures

Revised FY02 federal government expenditures on the revenue account stand at Rs 697.7 billion, which is Rs 35.1 billion higher than the FY02 budget estimates and Rs 85.0 billion higher than the actual expenditures during FY01 (see **Table 4.9**). Both, current and development expenditures, shared in this increase, as the former surged by Rs 55.0 billion and the rest was absorbed by the latter.

Table 4.9: Federal Government Expenditures
billion Rupees

			FY02				FY03	
					Excess/shortfall			
	FY00	FY01	Target	Revised	Target	Last year	Target	Excess over Last year
I. Revenue expenditures (A+B)	604.4	612.7	662.6	697.7	35.1	85.0	647.3	-50.4
A. Current expenditures	592.5	593.6	621.7	648.6	26.9	55.0	608.0	-40.6
1. Debt servicing	330.6	312.7	329.2	320.1	-9.1	7.4	289.7	-30.4
i. Interest on domestic debt	207.1	188.4	197.9	192.6	-5.3	4.1	191.8	-0.8
ii. Interest on foreign debt	44.9	51.3	62.3	60.8	-1.5	9.5	53.0	-7.7
iii. Repayment of foreign debt	78.6	73.0	69.1	66.8	-2.3	-6.2	44.8	-22.0
2. Defense	152.8	131.1	131.6	151.7	20.1	20.5	146.0	-5.6
3. Civil government	47.9	83.2	80.6	84.7	4.1	1.5	92.7	8.0
General administration	19.6	50.8	47.6	51.2	3.6	0.4	54.9	3.7
Law and order	9.0	10.1	10.2	10.3	0.1	0.3	11.6	1.3
Social services	10.5	9.9	12.3	12.3	0.0	2.4	13.9	1.6
Economic services	3.0	5.9	3.4	3.7	0.3	-2.3	4.1	0.4
Community services	5.8	6.5	7.1	7.2	0.1	0.7	8.2	0.9
4. Grants and subventions	33.3	36.9	49.3	66.3	17.0	29.3	56.3	-9.9
5. Subsidies	20.4	20.4	20.7	25.6	4.9	5.2	20.8	-4.8
6. Un allocable	7.5	9.2	10.3	0.3	-10.0	-8.9	2.5	2.2
B. Development expenditures	11.8	19.1	40.9	49.1	8.2	30.0	39.4	-9.7
II. Capital disbursements (a+b)	137.1	95.4	173.5	259.2	85.8	163.8	121.5	-137.8
a. Current expenditures	59.6	30.8	99.8	196.5	96.7	165.7	55.5	-141.0
b. Development expenditures	77.5	64.5	73.7	62.8	-10.9	-1.8	65.9	3.2
Total expenditures (I+II)	741.4	708.1	836.1	956.9	120.8	248.8	768.8	-188.1

Source: Annual Budget Statement of the Federal Government

Within the current expenditures, changes in debt servicing, defense, grants and subsidies are notable. Debt servicing, which accounts for approximately half of current expenditures of the federal government, was Rs 9.1 billion lower than the budget target for the year (see **Table 4.9**). This unexpected saving was largely driven by lower interest payments (on domestic debt and foreign debt) as well as a fall in the repayment of foreign debt.

The savings on domestic debt were facilitated by lower-than-expected T-bill rates prevailing during the year and the retirement of Market Related Treasury Bills of worth Rs 193.0 billion in July 2001.[20] Although rates on long-term domestic debt also declined, the substantial budgetary impact of the lower profit rates on DSCs and PIBs will be realized only when existing stock matures and fresh

government. Under the current National Finance Award, provinces are given 37.5 percent of the total divisible pool in fixed ratios, after deducting 5 percent collection charges by the federal government. Additionally, royalty on crude oil and development surcharges on natural gas is also passed on to provinces after deducting 2 percent collection charges.

[20] For details, see **Section 8.2**.

issuances gain a larger share in the overall stock of such debt. Finally, the decline in the servicing cost of foreign debt simply reflects its re-profiling and re-scheduling during FY02.

Defense expenditures, the second major component of federal current expenditures, was revised up by Rs 20.1 billion during FY02 (see **Table 4.9**). This exceptional increase reflected the tension on borders with India. However, the government showed remarkable discipline in terms of expenditure on the running of civil government during FY02, as the spending was in line with the budget target.[21]

Revised expenditures on the grants to provinces and other organizations witnessed a stunning increase of Rs 17.0 billion over the budget target and Rs 29.3 billion over the actual spending during FY01 (see **Table 4.9**). This increase is primarily due to a Rs 22 billion grant to the CBR to clear accumulated income tax refunds to banks. Other than this, the grants to other organizations were in-line with the budget targets.

As can be seen from **Table 4.9**, expenditures on subsidies also played a role in pushing up the current expenditures of federal government. Specifically, subsidies were around Rs 5.0 billion higher than the budget target as well as the FY01 figure. This significant increase was primarily driven by higher payments to WAPDA (for GST adjustments), clearing arrears of AJK, and payments to oil refineries. However, this increase should be interpreted with caution as a large portion simply reflects the government efforts to eliminate accumulated arrears of WAPDA against provincial government and other government organizations.

The increase in development expenditures of the federal government on the revenue account is a welcome measure (see **Table 4.9**). The bulk of this increase came from higher expenditures on education, health and irrigation projects.

The revised current expenditures on the capital account saw a large increase of Rs 96.7 billion over the target to reach Rs 196.5 billion, representing a massive Rs 165.7 billion rise over the FY01 figure (see **Table 4.9**). These expenditures largely pertain to repayments of loans and advances by the government. The FY02 increase was mainly attributed to: (1) a Rs 100 billion repayment of short-term credit totaling over Rs 100 billion, and (2) a Rs 86 billion increase in government investment in public sector enterprises. The latter primarily driven by the government decision to pick up accumulated losses of KESC, and inject capital to prepare it for privatization.

4.3.6 Financing of Federal Budget

The revised data of federal government financing recorded considerable changes on account of factors affecting the inflow of receipts from internal and external sources, and changing borrowing requirements of the government due to shortfall in revenue receipts and overrun in expenditures.

On the external front, the improved track recorded with IFIs, bilateral grants from friendly countries and relief from debt rescheduling helped the government realize higher receipts from external sources. On the domestic side, higher receipts from the public account are mainly from the national savings schemes. Changes in underlying profit rates on these schemes and increased national savings in the economy were the main factor behind higher public account receipts. The remaining gap was financed by bank borrowings (see **Table 4.10**).

[21] Expenditures on the running of civil government include, general administration, law and order, social, economic and community services.

Table 4.10: Financing of the Federal Government Expenditures
billion Rupees

			FY02				FY03	
			Target	Revised	Excess/shortfall		Target	Excess over last year
	FY00	FY01			Target	Last year		
I. Revenue receipts (net)	387.7	372.0	453.8	457.7	3.9	85.8	481.4	23.7
II. Internal resources (i+ii)	144.2	135.0	94.5	131.5	37.1	-3.5	103.4	-28.1
(i) Capital receipts	53.0	93.3	57.4	66.9	9.4	-26.4	44.2	-22.7
(ii) Public account	91.1	41.7	37.0	64.7	27.6	22.9	59.3	-5.4
III. External resources (1+2+3)	164.8	209.3	262.1	304.0	41.9	94.7	198.1	-106.0
1. Plan resources	99.3	170.3	239.3	236.4	-2.9	66.0	188.7	-47.7
2. Debt rescheduling	64.3	34.4	21.8	65.7	43.8	31.2	9.4	-56.3
3. Non-plan resources	1.2	4.5	1.0	2.0	1.0	-2.5	0.0	-2.0
IV. Total receipt (I+II+III)	696.7	716.3	810.4	893.3	82.9	177.0	782.9	-110.4
V. Credit from banking system	40.0	-33.0	10.5	62.0	51.5	95.0	-31.1	-93.1
VI. Provincial surplus (+)/deficit (-)	4.8	24.7	15.2	1.6	-13.6	-23.1	17.0	15.4
VII. Total resources (IV+V+VI)	741.4	708.1	836.1	956.9	120.8	248.8	768.8	-188.1

Source: Annual Budget Statement of the Federal Government

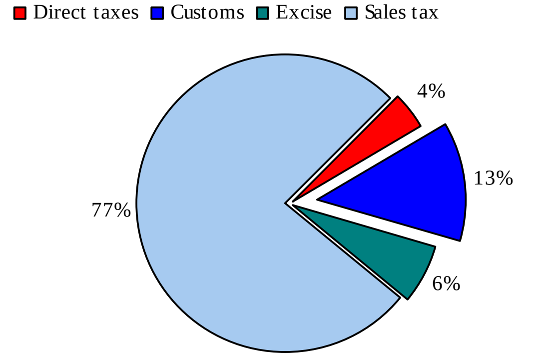
4.4 Budget Estimates for FY03

4.4.1 Consolidated Position

The budget for FY03 is also focused on fiscal consolidation. It envisages that higher revenues and a reduction in expenditures will help reduce the budget deficit to 4.0 percent of GDP (see **Table 4.1**). The massive fiscal consolidation of 2.6 percentage points of GDP is not ambitious given the expected absence of exceptional expenditures that bloated the FY02 deficit.

Expenditures are planned to decline by 2.6 percent of GDP, largely on account of lower current expenditures. On the other hand, development expenditure to GDP ratio has been kept unchanged at the FY02 level. Although development expenditures are budgeted at Rs 134.0 billion, it is envisaged that additional grant assistance received from bilateral donors will be used to increase development expenditures by another Rs 10.0 billion.

Figure 4.13: Share in Planned Increase



The financing of the budget deficit for FY03 is envisaged to be mainly through external sources (see **Table 4.1**). Domestic borrowings are to be entirely through non-banks (mainly from NSS), while banks borrowings are expected to see substantial retirements.

4.4.2 Federal Budget for FY03

Revenue Receipts

Gross revenue collections are budgeted at Rs 674.9 billion, 6.7 percent higher than the revised estimates of FY02 (see **Table 4.8**). The bulk of this increase is anticipated from tax revenues, which are Rs 46.4 billion higher than the revised FY02 estimates and indirect taxes are expected to contribute the greater share (see **Figure 4.13**). As in previous years, rationalization of tax rates, broadening the tax base and reduction in number of taxes remain the key elements of the government taxation strategy.[22]

Despite revenue loss from reduction in tax rates and elimination of withholding taxes, the direct tax collections are projected to increase by 1.3 percent during FY03 mainly on account of an enlarged income tax base.

The increase in indirect taxes is envisaged through higher GST collections, stemming from higher imports, and a broader base for the tax. Although growth in custom duties and central excise duty (CED) is also envisaged, the revenue impact is smaller in absolute terms. The former is likely to grow on account of expected increase in,[23] while the projected 6.0 percent growth of large-scale manufacturing sector is expected to help CED collections.

Surcharges

Petroleum surcharge receipts are also expected to grow strongly due to the full year impact of a FY02 revision in surcharge rates, and normal growth in the base. The gas surcharge receipts are expected to be unchanged at FY01 levels (see **Table 4.8**).

Non-Tax Revenues

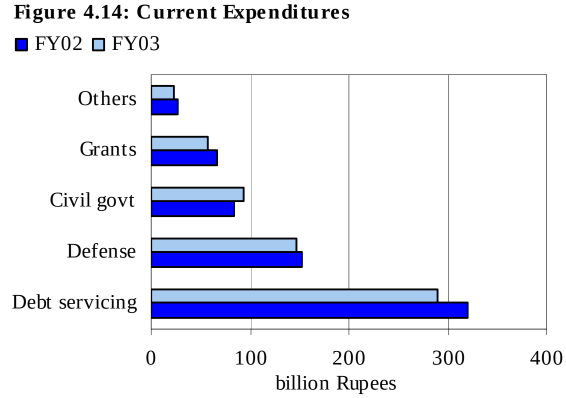
All three components of non-tax revenues are projected to fall below FY02 revised estimates. The high FY02 *dividend income* from OGCL and other corporations is expected to fall, even as the revenue from *income and property* declines following the elimination of the guaranteed profit for refineries. Also, *civil administration* receipts are expected to be lower in FY03.

Lower dividend income from the corporations, particularly from OGDCL, on account of the elimination of granted profit to few oil refineries is expected to reduce the revenue from income and property. The receipts from civil administration are likely to be effected by lower defense receipts. While expected decline in sales proceeds on oil and gas will impact the miscellaneous receipts.

Federal Government Expenditures

On the expenditure side, a reduction of Rs 188.1 billion is estimated on both, the capital and the revenue, accounts. Within expenditures on the revenue account, the more significant decline is anticipated in current expenditures (Rs 40.6 billion lower than revised estimates for FY02), most of which is expected from lower debt servicing costs following the rescheduling of external debt during FY02 (see **Table 4.9**).

Figure 4.14: Current Expenditures



Defense expenditures are also likely to come down by 3.7 percent due to the expected de-escalation on borders tensions with India (see **Figure 4.14**). If the escalation does persist than this reduction becomes doubtful.

A decline of Rs 9.9 billion in expenditures on grants and subventions is envisaged in the federal budget for FY03. Expenditures on the

[22] Income tax rates on banking sector have been slashed from 50 percent to 47 percent; withholding tax on interest from securities has been reduced from 30 percent to 20 percent; elimination of CED on electric batteries, metal containers, polyester chips, filament yarn, shipping agents and travel agents; and impositions of GST on vegetable ghee and cooking oil. For further details, please see **Appendix V: Fiscal Measures proposed in Federal Budget FY03**.

[23] Customs budget targets exclude revenue loss from lowering maximum tariff rates from 30 percent to 25 percent.

banking sector reforms and population development forum are likely to increase, while a marginal decline is anticipated on all other heads, which include Bait-ul-Maal, People Steel Mills and Saindak Metals Ltd. Subsides are also expected to decline by Rs 4.8 billion in FY03. This is largely on account of planned lower payments to WAPDA for GST adjustment.

Federal government development expenditures on revenue and capital accounts are budgeted at Rs 105.3 billion, which are Rs 6.5 billion lower than the revised estimates for FY02 (see **Table 4.9**). While the consolidated expenditures of federal and provincial governments are estimated to increase from Rs 123.6 billion to Rs 134.0 billion, this clearly shows that the federal government is shifting its development responsibilities to the provincial governments.[24]

Financing of the Federal Expenditures

Revenue receipts remained the prime source of financing; an increase of Rs 23.7 billion is anticipated in the budget for FY03, largely on account of higher tax revenues (see **Table 4.10**).[25] In contrast, in both internal and external receipts are expected to decline in line with the lower overall budgetary requirements.

Decline in both capital and public accounts receipts (internal receipts) is envisaged in the federal budget for FY03. The bulk of this reduction is anticipated from capital receipts. Since, government has little control over public accounts receipt, which largely comprise of National Savings Schemes, therefore capital receipts necessarily the brunt of adjustments.

Gross financing from external receipts is estimated at Rs 198.1 billion for FY03 budget as compared to FY02 revised estimates of Rs 304.0 billion (see **Table 4.10**). This is largely attributed to two factors: (1) overall lower financing needs of the federal government in the wake of anticipated decline in budget outlay; and (2) absence of extraordinary gains of rescheduling and re-profiling of external debt and expected lower grants.

[24] Specifically, development expenditures of the federal government are allocated Rs 90.0 billion, which is less than the revised estimates of Rs 95.5 billion for FY02, while an upsurge of Rs 10.8 billion is anticipated at the provincial level.
[25] For detailed discussion on Revenue Receipts, please see **Section 4.4.2**.