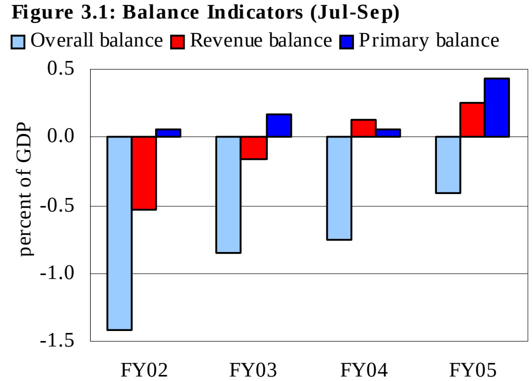
3 Fiscal Developments

Overview

Q1-FY05 saw a remarkable improvement in the country's fiscal performance with a surprisingly strong 22.1 percent YoY growth in revenues offsetting a 10.0 percent YoY rise in expenditures to push the quarterly fiscal deficit to 0.4 percent of GDP. This is the lowest first quarter deficit since the availability of quarterly data in 2001, and continues a steady trend improvement in the fiscal indicators over the previous four years (see **Figure 3.1**).

Figure 3.1: Balance Indicators (Jul-Sep)



The exceptional growth in total consolidated revenues is supported by an encouraging rise in tax collections (19.1 percent YoY) as well as an unexpectedly strong 30.3 percent YoY surge in non-tax receipts. CBR once again put up an excellent performance during the quarter with a tax collection of Rs 125.7 billion, against the target of Rs 110 billion. The overall tax performance is all the more impressive given that the government revenues from the oil development levy fell sharply during Q1-FY05 (due to the appreciable decision to buffer the economy from a significant part of the hike in international oil prices). The large jump in non-tax revenues, while welcome, is less sustainable, as a substantial contribution came from one-time exceptional receipts.

The growth in total consolidated expenditures accelerated during the quarter, but most of this rise in not worrisome:

(1) in fact, the 28.4 percent YoY rise in developmental spending seems very encouraging. As a result, the share of development expenditures (Rs 32.0 billion in absolute terms) in total expenditures increased from 12.1 percent in Q1-FY04 to 14.5 percent;

(2) the 17.6 percent YoY rise in current expenditure, at first sight seem disappointing. However, this includes a large one-off payment of accumulated interest on external debt;

(3) finally, the improved financial position of Pak-Steel, WAPDA, KESC and Railways led to a drastic reduction in net lending to PSEs and acted as a balancing factor.

As a result of the sharp rise in revenues, the financing requirements dropped by 39.2 percent YoY to Rs 24.9 billion during Q1-FY05. These were met through a rise in net external borrowings, privatization proceeds and non-bank borrowings.

While the growth in non-tax revenues is expected to decline in the quarters ahead due to the likely absence of many one-off flows, the impact of this on aggregate revenues will likely be partially offset by the resumption of Petroleum Developments Levy (PDL) receipts.[1] Moreover, CBR tax revenues are expected to remain strong amidst the continuing strength of the economy (which is expected to show above-target growth), and rising corporate profitability. Thus, while revenue growth is expected to decline relative to Q1-FY05, a reasonable degree of fiscal discipline should keep the annual budgetary deficit in line with the annual target for FY05.

3.1 Revenues

In Q1-FY05, the consolidated revenue receipts stood at Rs 202.3 billion,[2] showing a net improvement of 22.1 percent YoY (Rs 36.7 billion) over the corresponding period of the preceding fiscal year. Total tax revenues during Q1-FY05 increased by 19.1 percent, while non-tax revenues registered a growth of 30.3 percent (see **Table 3.1**).

The rise in CBR taxes was impressive, with collections under all major heads exceeding the respective targets for the period. While this increase in CBR tax revenues is not unexpected given the continuing acceleration in economic activities, rising imports and above-target inflation, it is particularly encouraging to note the large rise in voluntary income tax receipts during Q1-FY05. If the latter is sustained, it would vindicate the tax reforms enacted in recent years and particularly those that reduced the discretionary powers of tax officials.[3]

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[1] As the cost of Pakistan's oil imports has already dropped substantially in recent weeks and this trend is expected to accelerate by Q2-FY05 as international oil prices fall with the advent of spring. However, the government will probably not reduce domestic prices accordingly in order to recover at least part of the revenues lost through its decision to keep domestic prices unchanged in the face of a sharp spike in international prices. In fact Government has again started reviewing the domestic prices on fortnightly basis and raised the prices of fuel substantially on December 15, 2004.

[2] Based on provisional numbers.

[3] The number of individual tax payers has risen 9.4 percent YoY by August 2004.

Table 3.1: Fiscal Operations (Jul-Sep)
Consolidated Federal and Provincial Government
billion Rupees

			FY02	FY03	FY04	FY05	YoY change Absolute	YoY change Percent
1	Revenue receipts		115.3	153.5	165.6	202.3	36.7	22.1
	a)	Tax revenue	94.4	115.6	119.7	142.5	22.8	19.1
	b)	Non-tax revenue	20.9	38.0	45.8	59.7	13.9	30.3
2	Total expenditures		178.0	194.5	206.5	227.1	20.6	10.0
	a)	Current	138.8	161.2	158.9	186.9	28.0	17.6
	b)	Developmental	13.5	21.7	24.9	32.0	7.1	28.4
	c)	Net lending to PSEs etc.	5.7	-0.6	8.3	1.5	-6.8	-82.5
	d)	Unidentified	20.0	12.3	14.5	6.8	-7.7	-53.0
3	Revenue balance (1-2.a)		-23.5	-7.6	6.7	15.4	8.7	129.3
4	Overall balance (1-2)		-62.7	-41.0	-40.9	-24.9	16.0	-39.2
***As percentage of GDP**								
1	Revenue receipts		2.6	3.2	3.0	3.3	0.2	
	a)	Tax revenue	2.1	2.4	2.2	2.3	0.1	
	b)	Non-tax revenue	0.5	0.8	0.8	1.0	0.1	
2	Total expenditures		4.0	4.0	3.8	3.7	-0.1	
	a)	Current	3.2	3.3	2.9	3.0	0.1	
	b)	Developmental	0.3	0.4	0.5	0.5	0.1	
	c)	Net lending to PSEs etc.	0.1	0.0	0.2	0.024	-0.128	
	d)	Unidentified	0.5	0.3	0.3	0.1	-0.2	
3	Revenue balance (1-2.a)		-0.5	-0.2	0.1	0.2	0.1	
4	Overall balance (1-2)		-1.4	-0.8	-0.7	-0.4	0.3	

Source: Ministry of Finance
* Rebased GDP of 2000 has been used

It is also important to note that the total tax revenues would have been much higher had the Government raised the retail price of POL products in accordance with the policy of keeping domestic prices aligned with international price. The government did not adhere to this policy from mid-May 2004 onwards as it was thought desirable to protect the economy from the exceptionally strong surge in international prices. As a result, receipts under the petroleum development surcharge, which essentially represent the difference between the international and domestic prices, fell sharply. Petroleum surcharges collected during Q1-FY05 were Rs 7.7 billion lower than in Q1-FY04 (when there was no freeze in place)[4] although the volume of petroleum product imports rose.

Similarly, non-tax revenue receipts have performed exceptionally well during Q1-FY05. In contrast to the growth profile of tax revenues, the rise in non-tax receipts, though welcome, is less encouraging due to the large share of non recurring receipts. About 30 percent (Rs 17.7 billion) of the total non-tax revenues of Rs 59.7 billion stemmed from the sales of telecom licenses by Pakistan Telecommunication Authority (PTA).[5] Yet another potentially one-off element is *defence receipts* of Rs 17.2 billion during the quarter.

3.2 Expenditures

Consolidated expenditures during Q1-FY05 increased by 10.0 percent YoY to reach Rs 227.1 billion. While total current expenditures saw a rise of 17.6 percent, federal expenditures increased by 14.4 percent and provincial expenditures rose quite sharply by 25.0 percent.[6] Development expenditures also showed a healthy growth of 28.7 percent YoY to reach Rs 32.0 billion.

Total expenditures as a percentage of GDP decreased to 3.7 percent in Q1-FY05 compared to 3.8 percent in the corresponding quarter last year. This reduction in expenditures resulted due to reduced requirement for net lending to PSEs, which declined by Rs 6.8 billion. Other than PIA,[7] all the other large PSEs e.g., WAPDA Railways, KESC and Pak-Steel depicted an improvement in their financial position. However, it is worth noting that although WAPDA has reduced its liabilities by Rs. 1.0 billion towards fuel & power suppliers and payment of net hydle profits to NWFP, it did not service its federal government debt amounting to Rs 5.5 billion for Q1-FY05.

Current expenditures during Q1-FY05 increased substantially by 17.6 percent YoY as against a *reduction* of 1.4 percent YoY registered in Q1-FY04. The major rise in current expenditures was due to a large jump in provincial spending. Another item that rose was debt servicing (16.4 percent in Q1-FY05 compared to the corresponding quarter last year). This owes mainly to the uptrend in domestic and international interest rates. The sharper rise in the cost of domestic debt owes to: (1) a larger change in the average cost of rupee debt; (2) the greater rise in the

[4]The gains in-respect of higher GST on POL due to higher import prices are nullified to a larger extent because oil companies /refineries claim GST rebates at the input level from CBR.
[5] PTA has issued 12 LDI licenses, 73 FLL licenses and 20 WLL licenses.
[6] Significant growth in the current expenditures of NWFP and Baluchistan were witnessed in '*Other expenditures*' during Q1-FY05.
[7] Higher POL prices are one of the reasons for the loss born by PIA.

stock of domestic debt over the last two years particularly as a portion of expensive external debt was substituted with domestic debt (see **Table 3.2**).

3.3 Financing

Principally as a result of the exceptional rise in revenues during the quarter, the financing requirements during Q1-FY05 dropped to a mere Rs 24.9 billion (down 39.2 percent YoY). As a result, during the quarter the revenue surplus not only offset the unidentified expenditures, but also financed a substantial part of development expenditures (22.2 percent). If this trend persists, it will have important implications regarding debt accumulation (financing through debt creation) and debt sustainability.[8]

Table 3.2: Composition of Current Expenditure (Jul-Sep)

billion Rupees

			YoY change	
	FY04	**FY05**	**Absolute**	**Percent**
Current expenditures	158.9	186.9	28.0	17.6
of which				
Interest payments	44.2	51.5	7.3	16.4
Domestic	36.1	42.4	6.3	17.5
Foreign	8.1	9.0	0.9	11.6
Provincial expenditure	42.2	52.7	10.5	25.0
Defense	45.7	46.1	0.4	0.8

Source: Ministry of Finance

In Q1-FY05, Government relied heavily on external sources to finance the budget deficit (78.6 percent). The remainder was financed through internal resource especially privatization proceeds.[9] Resource mobilization through domestic non-banks was entirely utilized to retire the borrowing from the banking system (see **Table 3.3**). Resources mobilized through borrowing from the domestic non-banks included public debt (net Rs 9.9 billion mainly from prize bonds and Government securities) and public account (net Rs 9.2 billion).

Table 3.3: Financing of Budget Deficit (Jul-Sep)

billion Rupees

			Percent share	
	FY04	**FY05**	**FY04**	**FY05**
Financing through	40.9	24.9	100.0	100.0
External resources (net)	4.9	19.6	12.0	78.6
Internal resources	36	5.3	88.0	21.4
Domestic non-bank	24.1	19.1	58.9	76.8
Banking system	9.9	-19.9	24.2	-79.9
Privatization proceeds	2.0	6.1	4.9	24.5

Source: Ministry of Finance

[8] It is generally accepted that as long as accumulation of public debt is for development expenditures, it is not worrisome because it enhances the productive capacity of the economy.

[9] Rs 6.1 billion realized through sale of GoP shares in PIA, PPL, Falleti's hotel and Kohat cement during Q1-FY05.

3.4 CBR Tax Collections

The monthly CBR tax collection witnessed a remarkable growth of 22.5 percent YoY in July-October FY05, compared to the 8.9 percent YoY in the same period last year. Except for October 2004, collections showed an increasing trend, especially in September 2004, which saw growth of about 50 percent. The remarkable growth in September was on the back of higher collection of direct taxes that achieved a target of 128.6 percent due to higher voluntary payments. Compared to the July-October FY04, revenue collection from the sales tax (major contributory to CBR revenues) rose by 15.8 percent YoY during the period. Revenues collected from custom duties showed significant improvement and exceeded the July-October target by 10.4 percent. *Central Excise Duty* (CED) collection that had been declining over the years due to conscious policy decision to replace it with sales tax, registered a surprising 20.5 percent growth over July-October FY04 (see **Table 3.4**).

Table 3.4: Monthly Tax Collections (net)

billion Rupees

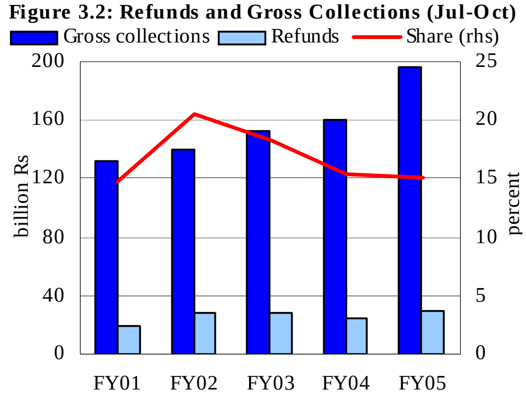
	FY03	FY04	FY05	FY04	FY05
July	23.6	23.4	30.7	-1.2	31.3
August	29.6	30.1	34.2	1.9	13.5
September	37.2	40.6	60.8	9.2	50.0
October	34.6	42.0	40.9	12.9	-2.5
Jul-Oct	125.0	136.1	166.6	8.9	22.5

Source: Central Board of Revenue

3.4.1 Refunds and Gross Collections

Trend analysis shows that over the last few years, the ratio of refunds in gross collection is gradually declining. During July-October FY05 gross tax collection rose by 22.1 percent, while refunds depicted a smaller increase of 19.9 percent over the same period last year (see **Figure 3.2**). The gradual decline in refunds as a percentage of the gross collection can be attributed to the various steps taken by the CBR during last few years as a part of tax reforms policy. These include a) Universal Self Assessment Scheme (USAS); b) Sales Tax Automated Refund Repository (STARR); and d) duty rationalization.

Figure 3.2: Refunds and Gross Collections (Jul-Oct)



3.4.2 Analysis by Tax Components

Direct Taxes

Collections from direct taxes registered remarkable growth of 28.0 percent YoY in July-October FY05, compared to the corresponding period last year (see **Table 3.5**). The introduction of universal self-assessment scheme by CBR not only helped in broadening the tax base but also enabled more efficient monitoring of tax collection through risk based audit. The ongoing tax reforms have led to an increase in the tax base and thus higher overall tax revenues.[10]

Table 3.5: Tax Collection (Jul-Oct)

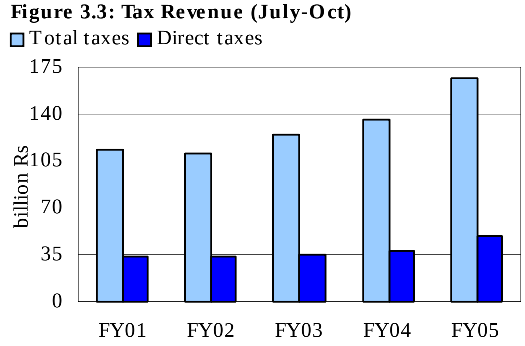
billion Rupees

	Targets FY05		Net tax collection in Jul-Oct			As % of target		YoY change	
	Annual	**Jul-Oct**	**FY03**	**FY04**	**FY05**	**Annual**	**Jul-Oct 04**	**Absolute**	**Percentage**
Direct taxes	181.7	37.8	35.1	37.9	48.5	26.7	128.3	10.7	28.0
Indirect taxes	398.1	113.0	89.8	98.2	118.1	29.7	104.6	5.1	20.3
Sales tax	249.2	70.1	58.8	60.5	70.1	28.1	100.0	0.0	15.8
CED	46.9	13.4	13.0	12.9	15.5	33.1	115.7	2.1	20.5
Customs	102.3	29.5	18.0	24.8	32.6	31.8	110.4	3.1	31.3
Total taxes	580.0	150.8	125.0	136.1	166.6	28.7	110.5	15.8	22.5

Source: Central Board of Revenue

The contribution of direct taxes in total tax collection over the years had remained stable in the 27 to 28 percent range. By contrast, direct taxes contributed 29.1 percent of total tax revenues during July-October FY05 (see **Figure 3.3**).

Figure 3.3: Tax Revenue (July-Oct)



Indirect Taxes

July-October FY04 saw an exceptional growth in indirect

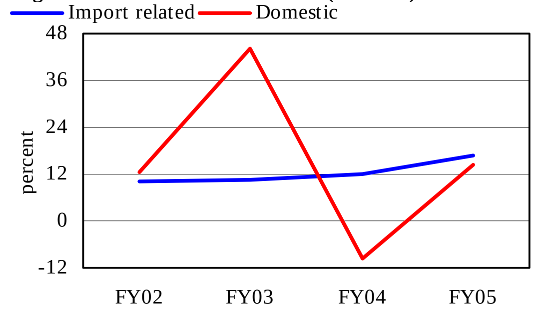
[10] CBR has exempted the import of machinery for commercial purposes from withholding tax, however, it has also decreased the rate on import of certain smuggling-prone goods, DAP, tractors and increased the limit on certain heads. Further, CBR has also increased the basic threshold from Rs.80,000 to Rs100,000, exempted income form vocational, technical and poly-technical institutes from income tax and removed/relaxed certain tax boundaries.

taxes relative to the preceding years. On the one hand, the rise in dutiable imports, as well as a weakening rupee boosted collections of customs duty and sales tax on imports, while on the other hand higher domestic demand (and prices) also boosted collection from domestic sources. A particularly notable development is a sharp rise in CED collections, in contrast to the persistent declines witnessed in recent years.

Sales Tax

The GST remained the most important component of CBR taxes; rising 15.8 percent YoY during July-October FY05 to account for a 42.0 percent share in the total. The compositional break-up of GST collections shows that the sales tax collection from both the domestic and imported goods has increased during the period. While the former rose by 14.4 percent YoY, the latter saw a bigger jump of 16.6 percent YoY during July-October FY05 (see **Figure 3.4**).

Figure 3.4: Growth in Sales Tax (Jul-Oct)



The rise in GST collections from domestic sources is in welcome contrast to the 9.7 percent decline in July-October FY04. Of the total collections from domestic sources during Q1-FY05, 35.4 percent was generated through POL products, and 15.4 percent from GST on services.[11] Other major products such as sugar, cotton, and fertilizers saw their contributions decrease relative to Q1-FY04 mainly due to government measures. For example, the GST receipts on cotton declined due to the abolishment of a 15 percent levy on supply of ginned cotton. Similarly, the receipts from fertilizer were lower due to a Rs 100 per bag reduction in the deemed price for DAP. The large share of

Table 3.6: Central Excise Collection (Jul-Sep)
billion Rupees

			YoY change	
	FY04	**FY05**	**Absolute**	**Percent**
Cigarettes & tobacco	3.0	3.9	1.0	32.8
Cement	2.2	2.6	0.5	21.9
Natural gas	1.2	1.3	0.2	15.3
Beverages & concentrates	0.9	1.1	0.2	18.3
POL products	0.8	1.1	0.3	34.0
Others	0.7	0.6	-0.1	-10.9
CED on imported goods	0.3	0.5	0.2	80.0
Total gross	**9.0**	**11.2**	**2.2**	**24.8**

Source: Central Board of Revenue

[11] Commodity-wise break-up of sales tax data is only available up to Q1-FY05.

total GST collections was from imports (Rs 44.5 billion) largely petroleum products, machinery, and chemicals.[12]

Central Excise Duty

Collections of CED witnessed a surprisingly sharp 20.5 percent YoY jump in July-October FY05, in contrast to the usual decline.[13] Net collections amounted to Rs 15.5 billion, a healthy 15.7 percent above the target for the period.

Over 90 percent of the CED collections are from just five products cigarettes & tobacco, cement, petroleum products, natural gas, and beverages (see **Table 3.6**). The rise in collections represents both, higher production volumes (particularly in cement, natural gas and beverages) as well as changes in some CED rates.

Table 3.7: Customs Duties Collection (Jul-Sep)
billion Rupees

			Percent	
Items	**FY04**	**FY05**	**Growth**	**Share**
Animal and vegetable fats and oil	3.6	3.8	6.0	15.0
Mineral fuel oils and products thereof	1.0	1.6	64.9	6.1
Chemicals and chemical products	1.8	2.1	17.6	8.1
Iron & steel and manufactures thereof	1.1	1.7	51.6	6.7
Machinery and mechanical appliances	1.5	2.0	29.9	7.8
Electric machinery and equipment	1.2	1.5	30.8	5.9
Motor and other vehicles	2.9	4.6	56.1	17.7
All other items	8.4	8.4	-0.6	32.6
Total import duty	**21.5**	**25.7**	**19.2**	
Other charges	0.4	0.9	101.4	
Gross collection	**22.0**	**26.5**	**20.9**	
Refund/rebate	4.1	4.2	1.8	
Net collections	**17.9**	**22.4**	**25.2**	

Source: Central Board of Revenue

Custom Duty

Revenue generation from custom duties showed significant increase of 31.3 percent YoY during July-October FY05 over the corresponding period last year

[12] Zero-rating on import and supply of capital good, exemption on import of agricultural equipments, levy of upfront sales tax on value addition on commercial importers.
[13] CED collections had been declining in recent years due to a substitution of this by the GST.

despite some duty rationalization by the Government[14] (see **Table 3.7**). This reflects both, a rise in the dutiable imports during the period as well as the weakness of the domestic currency (which raised the rupee value of imports).

The main contributory items included transport equipment,[15] animal and vegetable fats & oil, chemicals, machinery, iron and steel, and POL[16] that together accounted for 67.4 percent of total collection from import duties in Q1-FY05.

[14] Government has rationalized the duty on import of industrial raw materials, smuggling prone items, reduction of custom duty on the import of plant and machinery not produced locally to 5 percent.
[15] Despite the new duty structure for the import of vehicles introduced this year reducing the maximum duty.
[16] Due to higher international prices of POL.