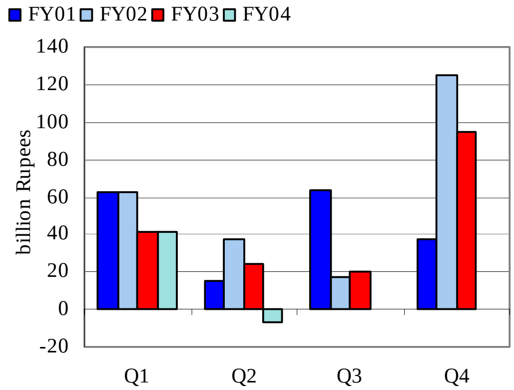
3 Fiscal Developments

At face value, the Q2-FY04 fiscal performance seems quite remarkable, as the Rs 33.7 billion consolidated budget deficit reported for H1-FY04 is *lower* than the Rs 40.9 billion recorded for Q1-FY04 i.e., the period under review recorded the first fiscal surplus since quarterly data was made available in FY01 (see **Figure 3.1**).[1] As a consequence, the consolidated budgetary deficit for H1-FY04 is a mere 0.8 percent of GDP, substantially below the corresponding FY03 figure (see **Table 3.1**) and comfortably within the 4.0 percent of GDP annual target.

This achievement was due to both, disciplined expenditures as well as a robust growth in revenues, during H1-FY04. On the one hand, spending growth was contained to 3.6 percent (vs. the 4.0 percent average target for FY04), while on the other the 13.9 percent revenue growth for the period substantially exceeded the 5.3 percent average growth target for FY04.

Figure 3.1: Quarterly Budget Deficit



While both tax and non-tax receipts contributed strongly to the aggregate revenue growth, the performance of the former is particularly encouraging as: (1) tax revenues constitute a larger and more stable source of revenues; (2) the growth has been largely based on the resurgent economy and without resort to a major expansion of the tax net; and,

Table 3.1: Consolidated Fiscal Operations during H1
billion Rupees

Head	FY02	FY03	FY04
Revenues	263.9	332.9	379.1
Expenditures	363.8	398.6	412.8
Budgetary balance	-99.9	-65.7	-33.7
As percent of GDP			
Revenues	7.3	8.3	8.6
Expenditures	10.0	9.9	9.3
Budgetary balance	-2.8	-1.6	-0.8

Source: Ministry of Finance
Note: a. Figures may not tally due to separate rounding off.
b. Full year GDP figures are used to calculate ratios.
c. For FY04, estimated GDP figure is used.

[1] The apparent surplus may simply reflects leads and lags in fiscal flows, and therefore unlikely to persist.

(3) it does not appear to incorporate one-time factors (unlike the H1-FY04 non-tax revenue growth, which is bolstered by potentially non-repeating payments for logistics support).

It is possible that the *scale* of the Q2-FY04 improvement in the fiscal performance may not persist in subsequent quarters, as expenditures do usually pick up in the third and most notably in the forth quarters. This also requires that the pace of revenue collections does not take a downward trend either due to slackness of efforts or other exogenous factors. However, the magnitude of the H1-FY04 YoY changes suggests that the aggregate annual performance is likely to better than the annual targets. In other words, the government reforms in past years to increase fiscal transparency, improve tax compliance and widen the tax net coupled with the resurgent economy are finally providing the government with the fiscal space for sorely needed investments in infrastructure and human capital.

3.1 Revenue Receipts

Acceleration in consolidated revenue receipts during Q2-FY04, helped the aggregate H1-FY04 receipts post a strong YoY growth of 13.9 percent (see **Table 3.2**). Both, the tax and non-tax revenues contributed to this strong growth. The former, in particular, surged on the back of higher CBR tax collections, which returned to double digit growth after witnessing a *one-time* settlement of advance tax payments for select items during the first quarter.[2] A detailed analysis of CBR tax collections is provided in **Sections 3.4**.

Table 3.2: Consolidated Revenue Receipts during H1
billion Rupees

				YoY growth	
	FY02	**FY03**	**FY04**	**Absolute**	**Percent**
Total revenue	263.9	332.9	379.1	46.2	13.9
Tax revenues	209.0	253.2	277.7	24.5	9.7
Non-tax revenues	54.9	79.7	101.4	21.7	27.2
Interest	8.8	4.6	12.4	7.8	169.4
Dividend	15.2	24.3	25.5	1.2	4.8
Post office profits	0.0	0.0	0.4	0.4	
SBP profits	12.0	6.0	0.0	-6.0	-100.0
Sales proceeds & royalties	6.6	7.7	6.5	-1.3	-16.3
Other civil admin.	1.7	20.9	35.7	14.9	71.2
Miscellaneous	10.6	16.1	20.9	4.8	29.6

Source: Ministry of Finance
Note: Figures may not tally due to separate rounding off.

Compared to the tax revenues, non-tax receipts were a little less impressive during Q2-FY04,[3] but the cumulative H1-FY04 non-tax revenues nonetheless saw a 27.2 percent rise over H1-FY03 figures (see **Table 3.2**). A compositional break up of non-tax revenues showed that higher civil administration and interest receipts were the major contributing factors to this impressive performance. While the former benefited from higher defense receipts on account of logistic support provided to US led forces operating in Afghanistan, the improving health of public sector financial and non-financial institutions probably helped raise interest receipts and dividend income.

The rise in non-tax receipts look particularly encouraging given the absence of SBP profits that had pushed up the corresponding figures for FY03. To put this in perspective, had SBP contributed the same amount as it transferred to the government last year, the non-tax revenues growth would have reached 34.8 percent.

3.2 Expenditures

Like in Q1-FY04, strict control over the government expenditures was visible during the quarter under review. As a consequence, the H1-FY04 consolidated expenditures registered a growth of only 3.6 percent over H1-FY03 figures, well within the 4.0 percent average growth budgeted for FY04. Looking at **Table 3.3**, the YoY growth in major categories of expenditures seems to be in line with the government policy to curtail current expenditures and increase development expenditures.

While the overall rise in current expenditures was subdued, a considerable variation in various components was evident. Interest payments increased after witnessing persistent decline over the last two years. However, this rise was entirely attributed to higher interest payments on foreign debt that were payable following the finalization of the debt rescheduling agreement.[4] Moreover, interest on domestic debt continued to decline benefiting from low interest rates and relatively low growth in debt.

Defense spending, the second largest component of current expenditures, recorded a 13.9 percent YoY rise during H1-FY04. This rise seems troubling at first sight

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[2] CBR tax collections recorded 22.8 percent YoY growth in Q2-FY04 compared to a mere 4.1 percent for Q1-FY04 (see SBP **First Quarterly Report for the yea 2003-2004** for a detailed analysis of Q1-FY04 tax collections).

[3] Non-tax revenues are usually volatile as a considerable portion of these receipts consists of those payments which are made once or twice in a year.

[4] For details, please see **Sections** on **Balance of Payments**.

as the defense spending was kept approximately unchanged at FY03 revised level in the federal budget for FY04. This rise is the upshot of increased military activities to combat terrorism along Afghan border. These unusual operations are partially financed through receipts from US, which show up in higher defense receipts. Netting of higher defense receipts with higher expenditures is expected to leave the government summary figure (budget deficit) unchanged.

Table 3.3: Total Expenditures during H1

billion Rupees

				YoY Change	
	FY02	**FY03**	**FY04**	**Absolute**	**Percent**
Current expenditures	296.7	345.1	352.5	7.3	2.1
Federal	226.7	240.0	252.3	12.4	5.1
Interest payments	123.7	98.1	98.8	0.7	0.8
Domestic	95.7	79.8	76.3	-3.4	-4.3
Foreign	28.0	18.3	22.5	4.2	22.8
Defense	54.2	76.7	87.3	10.7	13.9
G. Administration and services	32.9	39.9	41.3	1.4	3.5
Grants	9.4	8.5	13.3	4.8	56.7
Subsidies	6.3	16.6	11.3	-5.4	-32.2
Others	0.2	0.2	0.3	0.1	56.0
Provincial	69.9	105.2	100.2	-5.0	-4.8
Development expenditures	50.9	51.5	56.8	5.3	10.3
Net Lending	6.8	2.7	7.0	4.2	154.0
Unidentified	9.4	-0.8	-3.4	-2.7	340.4
Total expenditures	363.8	398.6	412.8	14.2	3.6

Source: Ministry of Finance
Note: Figure may not tally due to separate rounding-off.

Among other components, the rise in expenditures on general administration and services was subdued and remained well below the estimated increase of 12.4 percent for the whole FY04. Since spending on these heads depends relatively more on the government discretion as compared to other components of current expenditures, lower growth reinforced the earlier argument that the government has continued to exercise strict fiscal discipline.

H1-FY04 expenses on subsidies were substantially lower than in H1-FY03, as the government has utilized only 20 percent of amount budgeted for FY04. However, this may simply represent back loaded expenditures i.e. these may rise during the second half of the year due to increased support price of wheat and/or payments to WAPDA or KESC.

Encouragingly, expenditures on public sector developmental programs have witnessed a rise of Rs 5.3 billion during H1-FY04 as compared to the same period last year. However, these seem to be low, as the government has utilized only 35.5 percent of the FY04 budgeted expenditures of Rs 160.0 billion. Given that the government does not face fiscal constraint in expanding development expenditures, it is hoped that this shortfall will be corrected.

This said, it should be acknowledged that at least some of slowdown in development spending is attributable to a commendable prudence, as the government focuses on plugging leakages and waste. Meeting expenditure targets without ensuring efficient deployment of funds is clearly not desirable. However, the relative lack of management skills etc. also cannot be credibly used indefinitely to defer development investment.

3.3 Financing of deficit

In sharp contrast to the previous two years, the H1-FY04 budget deficit was largely financed through domestic sources, as net external receipts during H1-FY04 fell 79.2 percent YoY (see **Table 3.4**). This decline, in turn, stemmed principally from the lower disbursement of project aid, a fall in the rupee counterpart of the Saudi oil facility,[5] as well as higher debt repayments. Accordingly, H1-FY04 domestic borrowings increased by Rs 13.2 billion relative to the corresponding period of FY03, but this rise was muted by the lower budgetary deficit.

Table 3.4: Financing of Budget Deficit during H1
billion Rupees

	FY02	FY03	FY04
External (net)	72.0	48.3	10.0
Domestic	27.9	8.8	22.0
Banks	-10.9	-34.0	-8.3
Non-banks	38.8	42.9	30.3
Privatization proceeds	0.0	8.5	1.7
Total financing	99.9	65.7	33.7

Within domestic sources, non-bank borrowing remained the major source of financing and the government continued to retire its borrowings from the banking system. However, the retirement during H1-FY04 was substantially lower compared to that in the previous years, as the conventional major source of non-banks borrowing (national savings schemes)[6] witnessed a Rs 46.3 billion decline in net inflows compared to H1-FY03.

[5] During H1-FY04, the Rupee counterpart fell to Rs 11.7 billion as compared to Rs 20.8 billion during H1-FY03.
[6] For discussion, NSS do not include the Prize Bonds.

National savings schemes recorded net outflows of Rs 5.1 billion in H1-FY04 compared to Rs 41.3 billion net inflows seen during the same period of FY03. This sharp fall in receipts from NSS was largely attributed to: (1) downward revision in profit rates of various NSS instruments to make them consistent with the corresponding market rates; and, probably (2) to the higher maturity/encashment of SSCs stemming from the reversal of the arbitrage that had boosted collections during H2-FY03.[7]

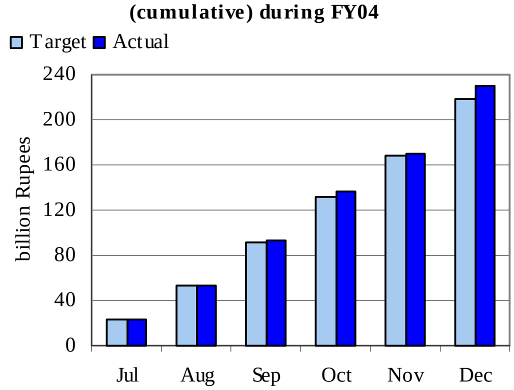
3.4 CBR Tax Collections

Q2-FY04 CBR tax receipts jumped to Rs 136.4 billion, up an impressive 22.8 percent YoY, pushing the cumulative H1-FY04 tax revenues to Rs 230.4 billion. The latter represents a 14.4 percent YoY increase during the half-year, which is comfortably higher than the 10.0 percent annual average growth rate required to meet the Rs 510 billion FY04 target. Moreover, the impressive rise in Q2-FY04 collections clearly suggests that the anemic 4.1 percent YoY growth in Q1-FY04 tax collections was indeed largely due to the adjustment of excess advance taxes of prior periods. The fact that both direct and indirect taxes made proportionate contributions to the growth in aggregate H1-FY04 receipts suggests that the rise is fueled by a broad-based growth in the economy.

3.4.1 Collections vs. Targets

With the exception of November 2003 receipts, which fell short of target by Rs 3.7 billion, monthly tax collections have remained above target throughout H1-FY04.[8] Moreover, even the November 2003 shortfall was more than offset by substantially above-target receipts in other months. As a result, the cumulative monthly receipts never dropped below the cumulative target, with the

Figure 3.2: Targets vs Actual Tax Collections (cumulative) during FY04



[7] During first half of FY02 and FY03, total maturity/encashment of SSCs were Rs 34.1 and Rs 33.7 billion respectively. However, this amount has surged up to Rs 43.0 billion for H1-FY04. This, in the presence of normal gross mobilizations during the same period three years back suggest that higher repayments during H1-FY04 involves a considerable amount of early encashment.

[8] Latest data on tax collections shows that Jan 2004 tax receipts were also well above the target, adding more to the cushion available for the CBR.

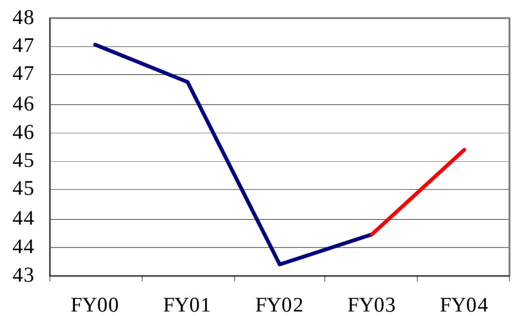
H1-FY04 total exceeding the Rs 218.1billion target for the period by Rs 12.3 billion (see **Figure 3.2**). The strength of the CBR performance is also underlined by the fact that, other than direct taxes, all other tax receipts comfortably achieved the H1-FY04 targets (see **Table 3.5**).

Table 3.5: Tax Collections in H1
billion Rupees

	Target		Net tax collection in H1		Percent of target	
Head	**FY04**	**H1**	**FY03**	**FY04**	**FY03**	**H1**
Direct taxes	161.1	70.3	61.7	70.0	43.4	99.6
Indirect taxes	348.9	147.8	139.7	160.4	46.0	108.5
Sales tax	223.1	94.4	92.2	100.7	45.2	106.7
Central excise	47.7	19.4	19.8	19.4	40.7	100.2
Customs	78.1	34.0	27.7	40.3	51.5	118.4
Total	510.0	218.1	201.4	230.4	45.2	105.7

In terms of the annual budget target, CBR has collected 45.2 percent of the FY04 annual target by end-H1-FY04, in comparison to the 43.7 percent of the FY03 annual receipts collected during H1-FY03.

Figure 3.3: H1 Tax Revenues as Percent of Annual Tax Collections



Note: For FY04, Budget target is used.

Thus, going by historical tax collections patterns, which generally see receipt rising in the second half of a fiscal year, it seems likely that the annual tax collections target will be comfortably met (see **Figure 3.3**).

3.4.2 Refunds and Gross Collections

Analysis of gross collections and refunds is important to assess the true tax collections performance as net collections can, in theory, be boosted somewhat by simply withholding accrued refunds. In fact, while the gross collections witnessed a robust growth of 11.4 percent during H1-FY04, the refunds during the period declined by 4.0 percent YoY. Thus, on face value, it seems that a portion of higher net tax collections was indeed attributable to lower refunds.

However, an analysis of the collection trends suggests that the decline in refunds was probably not used to inflate receipts artificially.

- Firstly, the H1-FY04 refunds constitute 13.9 percent of gross collections, which is in line with historical trends (other than FY02 and FY03, which had seen the payments of unpaid tax arrears). This appears consistent with a draw down in the stock of tax arrears.
- Moreover, tax collections for the period already exceed targets by a very substantial Rs 12.3 billion, there appears little need for receipts to be inflated. In fact, the monthly patterns for both, tax refunds do not show a dip at quarter ends, as had been evident during years when refunds were withheld.
- Finally, sales tax refunds, in particular, would be expected to be a little muted in FY04 relative to the preceding year because of administrative measures to curtail fraudulent claims.

In this backdrop, it is evident that the double digits growth in gross collections of major taxes guided the strong rise in net tax collections.

3.4.3 Analysis of Major Taxes

Direct Taxes

Collections from direct taxes were almost on target during H1-FY04, rising 13.4 percent YoY (see **Table 3.5**). This double digit growth in direct taxes is largely attributable to higher collections from withholding tax on imports and receipts from contracts. While the former benefited from increased imports, the higher developmental expenditures and increased domestic economic activity helped the latter.

Sales Tax

Sales tax has acquired a central place in the federal tax collections during the last five years. Its coverage has substantially been increased both by: (1) imposing sales tax on previously exempted goods and services; and (2) substituting sales tax with excise duty on various items.[9] As a consequence, H1-FY04 sales tax collections accounts for 43.7 percent of total taxes and 62.8 percent indirect taxes compared to 32.2 and 47.2 percent in FY00.

[9] This must be noted that rise in sales tax collections is not just a replacing factor, as the sales tax and excise collections jointly registered a YoY rise of 7.3 percent during H1-FY04. Had government not adjusted the advance tax collected during Q1-FY04, the rise would have been much stronger.

Figure 3.4: Monthly Sales Tax Collections

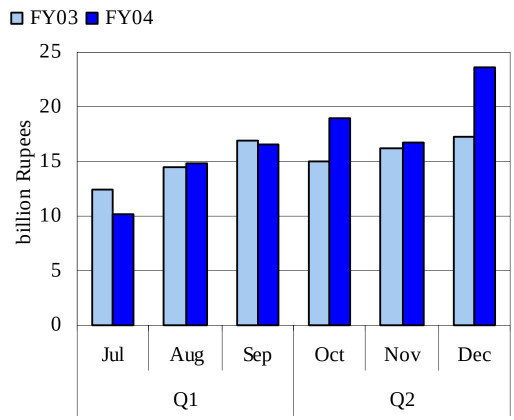
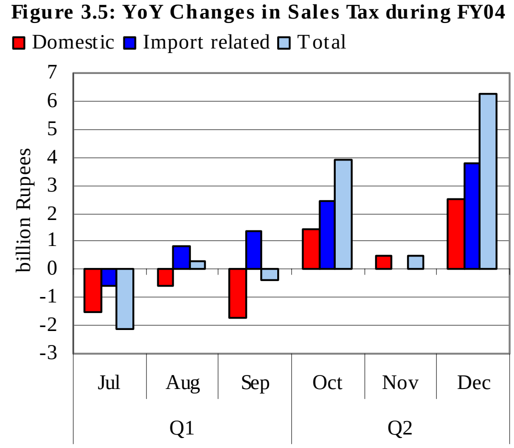


Figure 3.5: YoY Changes in Sales Tax during FY04



Although H1-FY04 sales tax collection has met the required target with a clear margin of Rs 6.3 billion and posted a 9.2 percent YOY increase; there have been some perceptible changes in the timing of collections (see **Table 3.5**). A quick glance at **Figure 3.4** shows that sales tax collections remained weaker during the first quarter of the year and the entire rise in receipts came during the second quarter of the year.[10]

A bifurcation of sales tax collections into import related and domestic items indicates that the pattern of monthly receipts during H1-FY04 significantly differs from H1-FY03. Moreover, it also shows that weaker sales tax collections during Q1-FY04 were primarily explainable by the lower receipts from domestic items (see **Figure 3.5**), which were depressed by the adjustment of excess advance payments for select items.[11] The absence of this *one-time* adjustment pushed the sales tax receipts back on higher growth track during Q2-FY04.

[10] As highlighted in **First Quarterly Report for the year 2003-2004**, the sales tax collections not only fell short of quarterly target, also recorded a YoY negative growth of 5 percent.
[11] For details, see **First Quarterly Report for the year 2003-2004**.

Further analysis suggests that while the higher imports supported import related sales tax collections, increased consumption of POL products, services and the electricity pushed up the sales tax collection on domestic items.

Central Excise Duty

Excise collections continued to post negative growth due to its replacement with the sales tax. Specifically, while excise receipts recorded a decline of 1.8 percent during H1-FY04 over the same period last year, these were enough to meet the quarterly collection target (see **Table 3.5**). In other words, excise collections were on track and the negative growth is not a point of concern.

Customs

Consistent with import data, custom receipts were higher than monthly targets throughout H1-FY04, largely owing to a strong rise in dutiable imports. These robust receipts were critical to meeting the overall monthly tax collections targets, especially during the first quarter, when sales tax receipts were curtail due to *one-time* adjustments of advance taxes.

Custom collections are well placed to surpass the annual budget target for FY04 with a visible margin. Specifically, custom collections during H1-FY04 constitute over 50 percent of the annual target and recorded an impressive YoY rise of 45.4 percent (see **Table 3.5**).