

RGST and flood tax

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Time to swallow the bitter pill

Event

- Under increasing pressure from IMF and international donors, the government has finally decided to levy RGST and a one-off flood surcharge from January 2011. After its endorsement by the federal cabinet, the draft legislation has been introduced in the National Assembly for debate and approval in the next session starting from December 20th.

Impact and analysis

- **Government finally coming into action to address persistent fiscal issues.** To address the chronic problem on the fiscal side mainly due to abysmally low tax collection, the government has decided to broaden the scope of existing GST regime to erstwhile exempt goods and services barring a few essential items. Under an agreement with the IMF, the government has decided to impose a uniform 15.0% GST on a broad range of goods and services instead of a variable 17.0%-25.0% rate applied on selected items at present. For FY11, the above measure should yield Rs25-30bn in additional taxes. However, the benefits will be immense in the coming years as, through documentation of the economy, it is estimated to increase tax GDP ratio to 12% over the next 3 years from 9.0% now.
- **Additional taxes to allay donor criticism.** To address donor criticism that it is not mobilizing domestic resources to fund additional flood related expenditure, the government has decided to 1) levy a one-off 10% flood surcharge on income tax and 2) increase the rate of special excise duty from 1 percent to 2 percent under the Federal Excise Act, 2005. The above should result in collection of Rs42bn additional taxes (Rs10 billion from increase in SD, Rs32 billion from flood surcharge). Further, provincial governments are also contemplating to tax property and agriculture to raise additional funds for flood rehabilitation.
- **Flood tax to hit current year earnings.** Due to levy of 10% surcharge on income tax, current year earnings of FSL universe companies (excluding Hubco) will decline by 3.0-6.0%.
- **RGST-impact on listed sectors and the economy**
- **Economy.** In the short-term, it will create inflationary pressures. However, an improved fiscal position should contribute to macroeconomic stability and sustained growth in the long-term.
- **Fertilizer:** Assuming that 15% RGST will be applied, total impact on urea price increase comes out to be PKR125/bag. However, since the companies are already charging farmers GST on the gas (main raw material for urea), the price impact after adjusting for value addition comes out to be PKR76/bag, which means a price increase of 9%. Even after adjusting for this new tax we feel that urea producers will easily be able to pass on this price increase due to lower local prices compared to landed international urea price. For DAP production, gas has a very low contribution in terms of cost. Hence, price increase will be higher than that for urea. With DAP prices already being high, we feel that RGST will likely hurt demand in CY11.

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- **Power:** IPPS will have no impact since they have a guaranteed return structure.
- **Consumer goods:** Packaged milk prices will increase due to RGST which will likely hurt its sales i.e. negative impact on Nestle and Engro Foods. Since packaged juice and ice-cream already fall under GST regime, there will be no impact on sales.
- **Cements:** Current rate of GST is 17% which will be reduced to 15%. However new RGST could create liquidity problems for companies with higher export sales due to refund issues.
- **Autos:** Auto assemblers were taxed at 17%, which will be reduced to 15%.
- **Textiles:** Textile units were zero-rated. However imposition of 15% RGST on local sales would increase prices across the board, including that of PSF. Moreover liquidity issues will arise for the units with higher export sales due to 15% tax deduction at the time of sale which will be refunded later.
- **Banks.** No impact as FED on fee-based services will be replaced by GST.
- **Oil exploration:** E&P companies will remain unaffected by the imposition of RGST as their net realized prices (on both gas and oil) will remain unchanged. Currently, sales tax is only applicable on gas which is a pass through to the gas marketing companies.
- **Oil refining:** RGST will not have any direct impact on refineries as it is a pass through to the OMCs. However, imposition of sales tax on crude oil purchased from E&P companies would result in input tax adjustment procedure which may create slight liquidity issues.
- **Oil marketing:** The prices of end products will come down owing to reduction in tax rate from 17% to 15%. This will not improve margins of OMCs though any demand uptick owing to reduced POL prices will benefit OMCs.
- **Telecom:** Imposition of RGST will greatly reduce incidence of taxation on cellular companies from 19.5% to 15%. This should provide them ample room to expand their margins as well as reduce the cost of service to the customers.

GST on services-further broadening of scope to have additional impact

- At present, GST (in whatever form e.g. FED) is levied on only a number of services such as telecom, financial services, hotels, restaurants, clubs, catering, marriage lawns, advertisement on TV and Radio, customs agents, ship handlers, courier services and stevedores services. Should provinces decide to broaden the scope of GST to other services, it will have additional impact on different listed sectors.

Outlook

- **RGST a tough pill, but the government has no choice.** We expect the government to face strong resistance from opposition and its allies on imposition of RGST and flood surcharge. However, given the uncompromising stance shown by IMF and international donors on RGST implementation, we feel the government will have to bite the bullet this time around or risk a halt to all foreign assistance which, at current juncture, is so crucial for the economy.