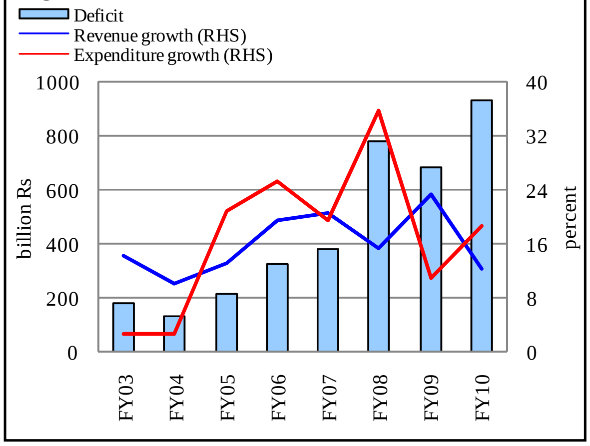
5 Public Finance and Fiscal Policy

5.1 Overview

Fiscal consolidation seen in FY09 could not be sustained in FY10 primarily because of deceleration in revenue generation growth, continued law and order related pressure on public expenditures, and greater than budgeted subsidies. Fiscal deficit increased from 5.3 percent of GDP in FY09 to 6.3 percent in FY10; in absolute terms it was Rs 929.1 billion that was about 30 percent higher than the target for the year and 37 percent higher than the actual deficit of last year (see **Figure 5.1**). Uncertainty in the availability of external resource inflow during the year also made financing such a huge deficit, a difficulty hard to surmount.

Figure 5.1: Fiscal Deficit Performance



An anatomy of fiscal performance against targets

To achieve fiscal deficit target, the government had envisaged a sharp increase in revenues, particularly tax revenues, and containment of current expenditures in the budget estimates for FY10. Although development expenditures were projected to record substantial widening during FY10, their fiscal impact was likely to be partially offset by increase in revenues. But all these targets could not be achieved during the period under review (see **Table 5.1**):

Table 5.1: Fiscal Performance against Targets

billion rupees

	FY10 BE	FY10 Actual	Abs Δ against target
Total revenue	**2155.4**	**2078.2**	**-77.2**
Tax revenue	1563.6	1472.8	-90.8
Non-tax revenue	591.8	605.3	13.5
of which			
Transfer of SBP profits	150.0	233.0	83.0
Total expenditures	**2877.4**	**3007.2**	**129.8**
Current	2103.8	2386.0	282.2
of which			
Power tariff subsidy	12.0	125.2	113.2
Grants to non-govt/ others*	168.7	250.5	81.8
Defense	342.9	375.0	32.1
Development and net lending	773.6	652.8	-120.8
Budget deficit	**-722.1**	**-929.1**	**-207.0**
Fiscal balance as % of GDP	-4.9	-6.3	-1.4
Primary balance as % of GDP	0.3	-2.0	-2.3

* This includes expenses on war on terror.

Source: Ministry of Finance.

BE: Budget estimate

1. Taxes fell short of the annual target, and thus total revenues could not meet the projections for FY10. However, the impact of this failure was partly offset by non-tax revenues due to increase in the transfer of SBP profits to the government during this period.

2. Current expenditures during FY10 exceeded the FY09 level as well as the projected amount by a wide margin. The amplification of current expenditures was caused by higher than projected spending on defense and war-on-terror along with a significant breach in the target for disbursement of electricity subsidies during this period. In fact the electricity subsidies alone contributed 54.7 percent diversion in fiscal deficit against target for FY10.

Table 5.2: Summary of Consolidated Public Finance
billion rupees

	FY07	FY08	FY09	BE FY10	FY10	BE FY11
Total revenue	**1,298.0**	**1,499.4**	**1,850.9**	**2,155.4**	**2,078.2**	**2,574.4**
Tax revenue	919.3	1065.2	1316.7	1,563.6	1,472.8	1,858.7
Non-tax receipts	378.6	434.2	534.2	591.8	605.3	715.6
Total expenditure	**1,675.5**	**2,276.5**	**2,531.3**	**2,877.4**	**3,007.2**	**3,259.3**
Current	1,375.3	1,857.6	2,041.6	2,103.8	2,386.0	2,519.1
Development and net lending	424.7	423.4	455.7	773.6	652.8	740.1
Unidentified	-124.51	-4.4	34	0	-31.6	0
Overall deficit	**-377.5**	**-777.2**	**-680.4**	**-722.1**	**-929.1**	**-684.9**
Financing through:	377.5	777.2	680.4	722	929.1	684.9
External resources	147.2	151.3	149.7	312.3	188.9	185.8
Internal resources	158.9	624.2	530.8	390.4	740.2	499.1
Banking system	**102**	**519.9**	**305.6**	**144.1**	**304.6**	**166.5**
Non-bank	56.9	104.3	223.8	246.3	435.6	332.6
Privatization proceeds	71.5	1.7	1.3	19.4		0
Memorandum item:						
Fiscal deficit as percent of GDP	4.4	7.6	5.3	4.9	6.3	4

Source: Economic Survey 2009-2010 and www.finance.gov.pk
BE: Budget estimate

3. To neutralize the impact of higher than projected current expenditures, the government was forced to contain development spending during FY10.

Financing the deficit: an unwelcome mix

A review of quarterly numbers of fiscal performance indicates that the public accounts remained under pressure throughout the year due to non-availability of budgeted external financing (see **Table 5.3**). Although around 60 percent of the total financing requirements were met through non-bank sources, the government had to borrow from the central bank as well. As a result, the limits imposed by IMF on borrowings from the SBP were breached during the last two quarters of FY10.

Table 5.3: Composition of Fiscal Deficit FY10
billion Rupees

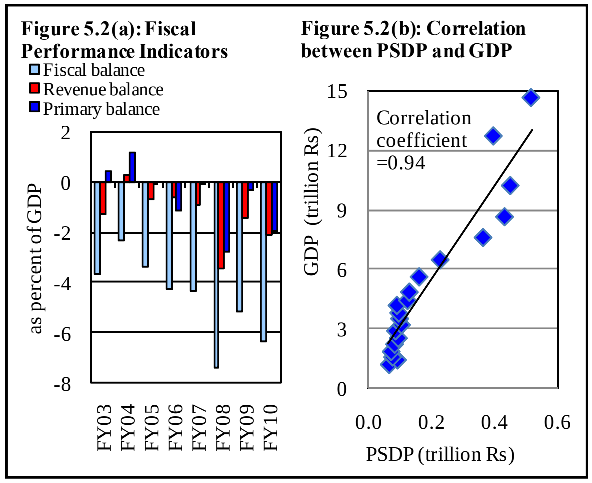
	Q1	Q2	Q3	Q4
Total revenue	**427.3**	**482.7**	**491.9**	**676.6**
Tax revenue	298.8	360.4	355.4	458.5
Non-tax receipts	128.5	122.3	136.5	218.1
Total expenditure	**650.9**	**662.2**	**714.6**	**979.4**
of which				
Current	521.0	537.6	601.2	726.2
Development	115.7	123.7	124.6	288.8
Budget deficit	-223.6	-179.6	-222.7	-303.1
Financing				
Domestic	146.6	146.4	240.3	206.9
External	77.1	33.2	-17.6	96.2

Source: Ministry of Finance

Borrowing from central bank is always an unwelcome source of financing due to its negative implications for inflation. The only way this can be avoided is the fiscal consolidation in the form of austerity in government spending and efforts in generation of tax revenues. In November 2008, Pakistan initiated a fiscal adjustment program under an SBA with the IMF. Resultantly the fiscal performance of the government was quite impressive during FY09. However, during FY10 expenditures far outweigh the targets and the fiscal deficit target could not be achieved.

All fiscal performance indicators recorded deterioration during FY10

The widening of deficit resulted in deterioration of all fiscal performance indicators during FY10 (see **Figure 5.2 A**). Fiscal balance as a percent of GDP was 1 percentage points higher than that in FY09.[1] Further, the primary balance to GDP ratio which had improved by a significant margin during FY09 again experienced large worsening during FY10.[2] The erosion of this indicator implies that fiscal spending undertaken during FY10 was not in line with the availability of resources during this period, hence government had to contract further debt obligations to finance these activities.



Finally, revenue balance to GDP ratio also recorded deterioration during FY10. Revenue balance which reflects the difference between total revenue and current expenditures is a measure of availability of fiscal space for undertaking development spending during a year. A view of the trend of this indicator reveals that government resources were insufficient for financing not only the development expenditures, but the current expenditures' needs also required financing from borrowed resources.

A break-up of expenditures reveals large increases in the heads of both current and development expenditures during FY10. While the increase in PSDP is vital for economic growth (see **Figure 5.2B**), it is a serious issue in current expenditures particularly in the heads of subsidies given the scarcity of resources.[3] In the scenario of a negative primary and revenue balance, disbursement of subsidies implies that government is creating debt obligations for financing inefficiency in the economy.

Outlook for FY11

The catastrophe caused by the recent flood is likely to widen the fiscal deficit with two-pronged impact: on the one hand, demand on fiscal accounts will rise due to relief and rehabilitation support to flood affectees, and on the other, there could be a hit on both federal and provincial revenues with slow down in production and aggregate demand. As a result, the reallocation of resources is in the offing in all the four provinces; there is already a plan to divert a significant part of PSDP for FY11 to the rehabilitation activities.

Although widespread support was extended, mostly in kind, by internal and external sources for rescue and relief operations; the country still needs strong financial support for the more challenging phase of rehabilitation. The IMF has committed a US$450 million immediate emergency financing to Pakistan under its Emergency Natural Disaster Assistance (ENDA). The government is also deliberating imposition of some new taxes temporarily to augment its revenue generation. However, it must be understood that the government has neither the capacity nor the resources to deliver on all public expectations for relief and support. A large part of the reconstruction

[1] Fiscal deficit to GDP ratio stood at 6.3 percent during FY10 as compared to the level of 5.3 percent in FY09.
[2] Primary balance presents the impact of current fiscal activities by subtracting interest payments on loans acquired in the past.
[3] The actual disbursement of subsidies was 72.9 percent higher than the targets set in budget for FY10.

effort over the years will therefore depend substantially on private enterprises and on the broad support of civil society.

The expected increase in fiscal pressures in FY11 is also an opportunity to undertake fundamental changes. There is a need for political consensus on widening the tax base to hitherto untaxed (or under-taxed) segments of the economy and plugging leakages in the existing tax system.

5.2 Revenues

The government could generate total revenue of Rs 2078.2 billion during FY10 that were short of the target by Rs 77.2 billion mainly because of shortfall in FBR tax collection (see T**able 5.4**). Unlike the previous year when the healthy growth in non tax revenue compensated for the shortfall in tax

Table 5.4: Composition of Tax and Non-Tax Revenue

billion Rupees

				Absolute change		
	FY08	**FY09**	**FY10**	**FY08**	**FY09**	**FY10**
Tax revenue	**1,065.2**	**1,316.7**	**1,472.8**	**145.8**	**251.5**	**156.1**
Direct taxes	387.9	440.3	528.6	53.8	52.4	88.3
Taxes on property	4.1	4.6	5.7	0.6	0.5	1.1
Taxes on goods and services	472.0	571.8	641.5	88.8	99.8	69.7
Taxes on international trade	150.5	148.4	161.5	18.3	-2.1	13.1
Petroleum levy	14.5	112.0	88.7	-15.2	97.5	-23.3
Other taxes	36.1	39.6	46.8	-0.5	3.5	7.2
Nontax revenue	**434.2**	**534.2**	**605.3**	**55.6**	**100.0**	**71.1**
Profit of post office / PTA	5.0	0.0	0.0	-0.8	-5.0	0.0
Interest	40.4	24.3	10.5	20.8	-16.1	-13.7
Dividend	76.0	58.5	52.8	16.0	-17.5	-5.7
Transfer of SBP profits	87.3	161.2	233.0	18.1	73.9	71.8
Defense	47.5	73.7	115.6	-32.1	26.2	41.9
Development surcharge on Gas	20.7	14.0	25.9	-14.2	-6.7	11.9
Discount retained on crude Oil	18.6	25.6	12.5	18.6	7.0	-13.1
Royalties on gas and oil	34.9	49.2	33.0	6.4	14.3	-16.2
Miscellaneous	103.9	127.8	122.0	22.8	23.9	-5.8
Total revenue	**1,499.4**	**1,850.9**	**2,078.2**	**201.4**	**351.5**	**227.3**

Source: Ministry of Finance

receipts, the non-tax revenues in FY10 were not enough to help the total revenue meet the annual budget target.

The total tax revenue collected during FY10 amounted to Rs 1472.8 billion, having a growth rate of 11.9 percent compared to 23.6 percent a year earlier. Receipts under the head of direct taxes stand out as a factor causing deceleration in the tax revenue followed by petroleum levy and taxes on goods and services. The decline in collection under the head of petroleum levy[4] might be on account of fixing petroleum levy as a flat consumption tax that was significantly lower than average rate last year.[5] On

[4] Surcharges on POL have been replaced with petroleum levy and are now treated as part of tax revenue. However, surcharges on POL are added in tax revenues and subtracted from non-tax revenues from FY07 to FY09 to make figures comparable.

[5] For example PDL on motor spirit stood fixed at a flat rate of Rs 10 / litre during FY10 compared with average of Rs 17.7/litre during FY09; PDL on HSD remained fixed at Rs 8 /litre during FY10 compared with an average of Rs 11.3/litre in FY09 while that on HOBC was fixed at Rs 14/litre during FY10 compared with an average of Rs 23.9/litre in FY09.

the other hand, growth in taxes on goods and services declined from 21.1 percent in FY09 to 12.2 percent in FY10 that was in line with the reduction in inflation in the year under review compared with the preceding year.

Although the collection of direct taxes remained below the annual budget target, it showed an encouraging growth of 20.1 percent compared to 13.5 percent a year earlier. The acceleration in growth of direct tax collection reflects the FBR enhanced audit and assessment work as well as

Table 5.5: FBR Tax Collection (Net) during Jul-Jun

billion Rupees, change in percent

	Annual target		Net collection		Percent of annual target		Percentage change YoY	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Direct taxes*	498.9	565.6	443.5	528.9	88.9	93.5	14.4	19.3
Indirect taxes	751.1	814.4	717.6	798.8	95.6	98.1	15.9	11.2
Sales tax	469.9	499.4	451.8	516.1	96.3	103.3	20.0	14.1
FED	112	152.8	117.5	121.2	104.9	79.3	27.5	3.2
Customs	169.2	162.2	148.4	161.5	87.7	99.6	-1.5	8.8
Total collection	**1,250.0**	**1,380.0**	**1,161.1**	**1,327.7**	**92.9**	**96.2**	**15.2**	**14.3**

*Actual net collection of direct taxes as provisionally reported by FBR slightly differs than that given by Ministry of Finance.

Source: Federal Board of Revenue

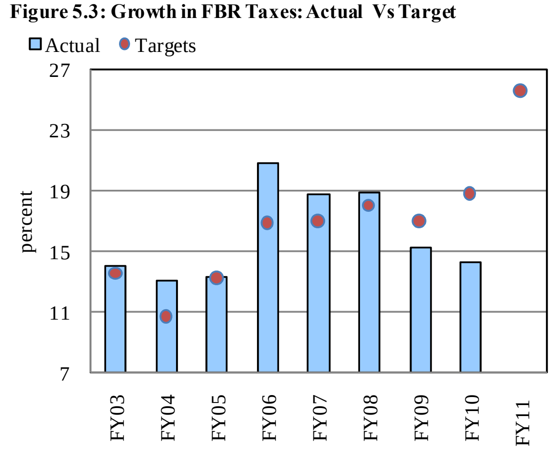
normal growth with the economic recovery during the year. The acceleration in growth of taxes on international trade could be explained by the encouraging growth of dutiable imports though overall imports registered a decelerating growth during FY10.

Non tax revenue in FY10 reached Rs 605.3 billion exceeding the budget target by Rs 13.5 billion, largely helped by transfer of SBP profit which stayed Rs 83 billion above the budget target. Receipts under the head of defence was budgeted at Rs 128.2 billion during FY10 mainly on the back of receipts from logistic support services provided to the coalition forces. However, US$ 1.3 billion could be realized under this head leaving the receipts under the head of defense below the target by Rs 12.6 billion. The dividends receipts from financial and non financial institutions remained below the budget target by Rs 22.4 billion. Major Non financial institutions which provided dividend below the target include OGDCL, Pak Arab Refinery Ltd, PTCL, PSO and Pakistan Steel Mill. Of the total dividend receipts during FY10, OGDCL contributed 39 percent followed by Government Holding Private Ltd with 13 percent while dividends receipts from financial institutions having government holdings amounted to one percent of the total.

5.2.1 FBR Taxes

The FBR missed its tax collection target for the second consecutive year with tax revenues of Rs 1327.7 billion in FY10 compared with the target of Rs1380 billion for the year (see **Table 5.5**). While only marginally less than that of the previous year, the growth rate for the FBR taxes was 4.5 percentage points lower than that required meeting the target (see **Figure 5.3**). Although sales tax collection showed an encouraging performance and exceeded the target by Rs 16.7 billion, this was not sufficient to make up for the below target growth rate of direct

Figure 5.3: Growth in FBR Taxes: Actual Vs Target



taxes and federal excise duty (FED) collection. This shortfall may be attributed in the first instance to relatively higher budget estimates of the FBR tax collection. The target growth rate of FBR tax collection remained 1.7 percentage points higher on the average than GDP growth rate during FY05 to FY09. However, for FY10 the growth rate for collection of FBR taxes was set at 18.8 percent which remained 5.9 percentage points above the target growth rate of GDP.

Figure 5.4: Month-wise Direct Tax Collection for FY10

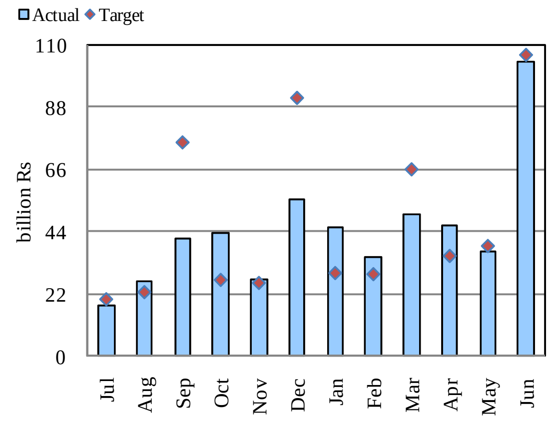
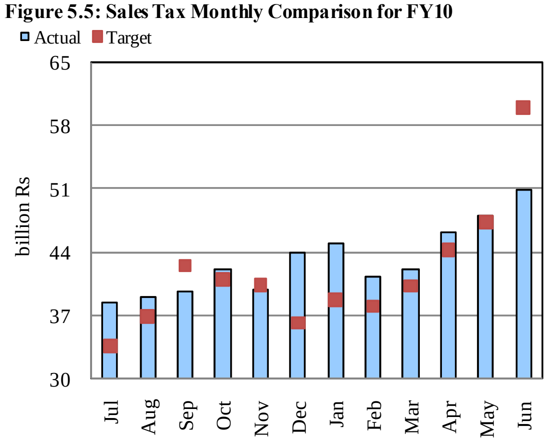


Figure 5.5: Sales Tax Monthly Comparison for FY10



Direct Taxes

The monthly target for direct tax collection was met during FY10 except for the months of September, December, and March (see **Figure 5.4**). But the shortfall during each of these three months was so large that the overall direct tax collection stayed below the annual target by Rs 36.7 billion taking the total direct tax collection to Rs 528.9 billion during FY10.

The FBR administration introduced a change in the advanced tax payment system during FY10 according to which the quarterly advanced tax payment was to be paid by 15th of the following month. As a result, we see a shortfall in direct tax collection compared to interpolated monthly targets in last month of each quarter (September, December and March) and a corresponding increase in the following month of the quarter (October, January and April).

Table:5.6 Indirect Tax Collection (Net) during Jul-Jun

billion Rupees, growth in percent

	Collection		Growth rate	
	FY09	**FY10**	**FY09**	**FY10**
Imports	**366.0**	**422.2**	**1.4**	**15.3**
Sales tax	203.2	247.2	3.7	21.6
FED	14.4	13.6	0.2	-5.7
Customs duty	148.4	161.5	-1.5	8.8
Domestic	**352.1**	**380.3**	**36.1**	**8.0**
Sales tax	248.0	268.9	37.6	8.4
FED	103.1	108.4	32.5	5.2
Total collection	**717.6**	**798.8**	**15.9**	**11.8**

Source: Federal Board of Revenue

A compositional analysis of the income tax collection which comprises more than 95 percent of the direct tax collection shows that withholding tax (WHT) continue to hold more than 50 percent of the income tax collection. Income tax comprises three major components, i.e., voluntary payments (VP), collection on demand, (CoD) and withholding tax (WHT). The second major component, i.e., VP although declined by 5.8 percent YoY till Q3-FY10 showed a positive growth rate of 17 percent during FY10.
This was largely due to a healthy growth in corporate profits in the second half of FY10. Last year corporate profits witnessed a declining trend that was reflected in the negative

growth rate of 2.7 percent in VP for FY09. However, the share of VP in the overall income tax collection stood marginally lower compared to the last year resulting in an increased share for collection on demand during FY10.

Indirect Tax Collection

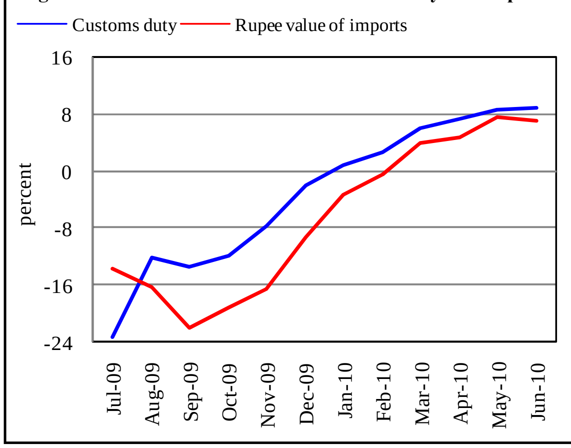
The overall indirect tax collection fall short of the target by Rs 15.6 billion to drop to Rs 798.8 billion during FY10 (see **Table 5.6**). Although the shortfall in indirect taxes was largely driven by FED which fell short of the annual target by a wide margin of Rs 21.6 billion, receipts from sales taxes partially offset this effect by reaching Rs 16.7 billion above the target collection.

Sales Tax

The robust performance of the sales tax with respect to its annual target during FY10 reflects the buoyant nature of this tax. Analysis of the month wise collection showed that sales tax collection from November to May FY10 greatly helped the overall sales tax collection to exceed its target (see **Figure 5.5**).

The required growth rate to meet the target of sales tax was largely brought by import related component of the sales tax that grew by 21.6 percent compared to 3.7 percent a year earlier. Of the total collection under the head of import related sales tax, one third was contributed by POL products followed by edible oil and iron & steel.

Figure 5.6: Cumulative Growth in Custom Duty and Imports



The domestic collection under the head of sale tax exhibited a decelerating growth of 8.4 percent compared to 37.6 percent a year earlier. Like import related sales tax, POL products contributed more than one third of the total tax collection under domestic head. Services provided by telecommunication services, natural gas, electrical energy, sugar, and cigarettes remained other major contributors to the domestic sales tax collection.

Federal Excise Duty (FED)

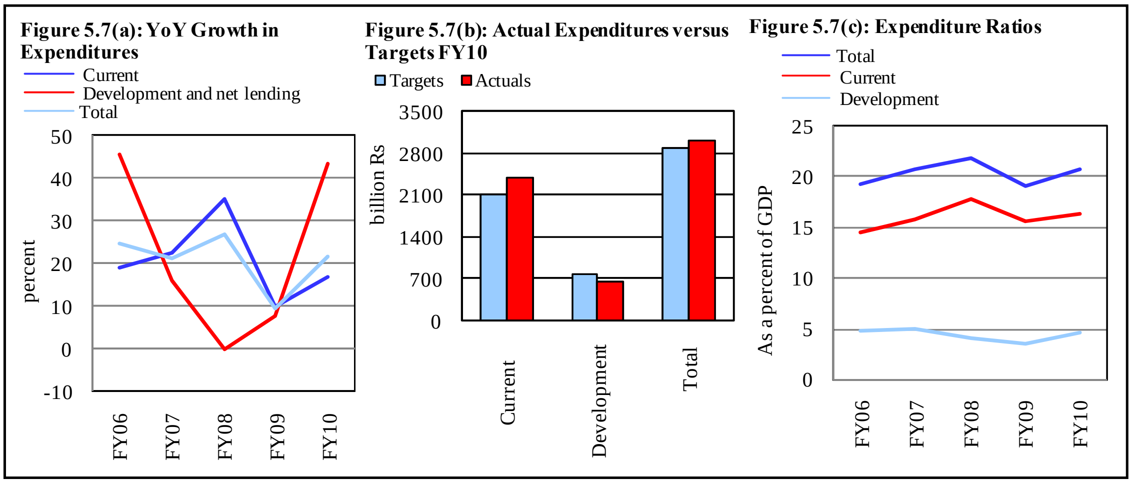
The federal excise duty (FED) remained below the annual target largely due to its domestic component as the import related component of the FED is not much significant in terms of contributing to the overall FED collection. Of the total domestic collection of FED, one third was contributed by the head of cigarettes & tobacco. The head of services and cement together contributed more than one fourth of the total domestic FED collection although these two heads faced a decelerating growth. One percent special FED contributed more than ten percent.

Custom Duty

The custom duty collection showed an encouraging performance near the end of FY10 although it missed the annual target marginally (see **Figure 5.6**). The growth in customs duty largely depends on the growth in rupee value of imports and collection from customs duty move in tandem with the rupee value of imports. Vehicles (non-railway) stand out as the major head contributing to the collection of customs duty during FY10 followed by POL Products and edible oil.

5.3 Expenditures

After witnessing deceleration during FY09, fiscal spending recorded a large 18.8 percent YoY increase during FY10 on the back of both higher current and development expenditures (see **Figure**



5.7A). Particularly current expenditures did not only record a large 16.9 percent YoY growth but also surpassed the FY10 target set in the budget by 13.4 percent. Therefore, to partially mitigate the impact of this huge increase in the current spending, government had to resort to curtailing development spending at the below target level during FY10 (see **Figure 5.7B**). On a positive note, however, despite the containment of development expenditures the growth recorded in this head during FY10, was highest ever since FY06, which also led to improvement in the ratio of development expenditures as a percent of GDP during FY10 (see **Figure 5.7C)**.

As regards current expenditures, according to detailed analysis large increases were broadly concentrated in the areas of general public services, grants to non-governments, and defense (see **Table 5.7**). Specifically, large expenditures on war-on-terror, defense, and subsidies were big drags on country's resources. Ironically, while the expenditure on subsidies captured on average around 1 percent share of GDP during FY06-FY10, the expenditures on the health and education sectors was only slightly higher than this amount during the same period.[6] This comparison highlights the need for a change in the pattern of spending of country's scarce resources towards the development of human resources instead of financing inefficient projects in the economy.

Table 5.7: Break-up of Expenditures

billion rupees

	FY09	FY10	FY10 BE	Δ over FY09	Δ over FY10 Target
Current	**2,041.6**	**2,386.0**	**2,103.8**	**344.5**	**282.2**
General public service	954.7	1,200.4	1,003.7	245.8	196.7
Interest payments	637.8	642.3	647.1	4.5	-4.8
Pension	63.8	74.7	69.8	10.9	5.0
Grants to non-govt.*	114.4	250.5	168.7	136.2	81.8
Other general public service**	138.7	232.9	118.1	94.2	114.7
Defense	329.9	375.0	342.9	45.1	32.1
Public orders & safety affairs	33.3	49.5	34.6	16.2	14.9
Provincial	545.7	627.2	590.0	81.5	37.2
Others	178.0	133.9	132.6	-44.1	1.3
Development	**448.8**	**613.4**	**763.1**	**164.6**	**-149.7**
PSDP	397.5	517.9	606.0	120.4	-88.1
Federal***	195.7	259.5	406.0	63.8	-146.5
Provincial	201.8	258.4	200.0	56.6	58.4
Others	51.3	95.5	157.0	44.2	-61.5

*This head also includes expenditure on war-on-terror
**This head includes spending on current subsidies.
***Net excluding development grants to provinces.

5.4 Fiscal Operations of Provinces

5.4.1 Combined Picture of FY10

The consolidated fiscal balance of the provinces deteriorated further in FY10 and reached almost double the deficit amount recorded a year earlier (see **Table 5.8**). Although total revenue of the

[6] The average fiscal spending to GDP ratio stood at 0.6 percent for health and 2.3 percent for education during FY06-FY09.

provinces registered a healthy growth, the unprecedented increase in overall development expenditure and consequent increase in total expenditure culminated in a deficit balance of Rs 28.6 billion.

Table 5.8: Summary of Combined Provincial Finance
billion Rupees

	FY08	FY09	FY10
Total revenue	**667.2**	**750.5**	**876.0**
Provincial share in fed revenue	457.4	525.6	633.5
Provincial taxes	40.8	46.1	54.8
Property taxes	4.1	4.6	5.7
Excise duties	2.9	3.5	4.2
Stamp duties	11.3	11.3	11.7
Motor vehicles tax	7.8	7.5	10.2
Other	14.6	19.2	23.0
Provincial non-tax	78.0	83.8	67.9
Interest	10.2	0.2	0.6
Profits from hydro electricity	7.8	3.5	7.3
Irrigation	2.8	3.2	2.7
Others	57.2	76.9	57.3
Federal loans and transfers/grants	91.0	95.0	119.9
Loans(net)	15.3	36.9	3.6
Grants	33.0	40.6	81.8
Federal grants (developmental)	42.7	17.5	34.4
Total expenditure	**671.1**	**766.0**	**904.7**
Current expenditure	457.0	564.2	646.2
Interest to federal government	19.9	18.5	19.0
Other current expenditure	437.1	545.7	627.2
Development expenditure	214.1	201.8	258.4
Overall balance	**-3.9**	**-15.5**	**-28.6**

Source: Ministry of Finance

The total revenue of the provinces registered a growth of 16.7 percent compared to 12.5 percent a year earlier. The acceleration in growth was largely driven by increase in provincial share in federal revenue coupled with federal and foreign developmental grants to the provinces. The increase in provincial share in federal revenue is largely in line with the growth in FBR taxes.

A province wise break up shows that the deterioration in overall balance was exclusively caused by Punjab and Sindh as the other two provinces managed to have a surplus balance in FY10 (see **Table 5.9**). Despite an increased share in the federal revenue, the substantial increase in development expenditure left Punjab with a deficit balance.

While KP experienced an accelerating growth of 43.6 percent in its current expenditure, the large sum received in the form of federal loans and grants coupled with the profit from hydro electricity helped the province to end with a surplus balance for FY10.

The deficit balance of Sindh remained almost the same as seen in the previous fiscal year, the reason being an equal amount stood added to the total revenue and total expenditure during FY10.

5.4.2 Provincial Fiscal Stance: Post 7th NFC Award

Like the developed nations, many developing and transitional economies are turning to fiscal

Table 5.9: Provincial Finance
billion Rupees

	Punjab		Sindh		KP		Balochistan	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Total revenue	**364.4**	**401.7**	**209.9**	**241.0**	**111.9**	**152.3**	**64.1**	**81.0**
Provincial share in federal revenue	265.2	325.1	161.6	188.4	65.6	80.1	33.3	40.0
Provincial taxes	22.1	29.9	21.0	21.6	2.1	2.3	0.8	1.0
Provincial nontax	53.0	28.3	5.9	13.2	21.9	24.1	2.9	2.3
Federal loans and transfers	24.1	18.4	21.4	17.8	22.3	45.8	27.2	37.8
Total expenditure	**383.3**	**435.5**	**220.3**	**251.5**	**103.2**	**142.0**	**59.2**	**75.6**
Current expenditure	276.5	303.2	172.3	184.6	71.3	102.3	44.1	56.1
Development expenditure	106.8	132.3	48.1	66.9	31.9	39.7	15.0	19.5
Overall balance	**-18.9**	**-33.8**	**-10.4**	**-10.5**	**8.7**	**10.3**	**5.0**	**5.4**

Source: Ministry of Finance

decentralization. It is due to the fact that decision-making at lower levels of government is believed to better understand the diversified local preferences and needs, and, therefore, help in efficient allocation of economic resources. The process of fiscal decentralization also brings the authorities closer to citizens and thus allows for the provision of better public services. It also facilitates coordination at national and local level.

Table 5.10 : Provincial Share in Divisible Pool

Share in percent

Fiscal Year	Provincial Share	Federal Share
FY07	41.5	58.5
FY08	42.5	57.5
FY09	43.8	56.3
FY10	45.0	55.0
FY11	56.0	44.0
FY12 onwards	57.5	42.5

In Pakistan, greater efforts have been made recently to restructure the equation between the federation and provinces and remove the trust deficit between them. The 7th NFC award is a great leap in this context that promises the provinces to have their share in the divisible pool increased from 48.8 percent during FY10 to 56 percent in the first year of the award, i.e., FY11 (see **table 5.10**). This share would increase to 57.5 percent in the remaining period of the NFC award. In addition, to ensure more fiscal autonomy for the provinces, sales tax on services has been recognized as a provincial subject under the Constitution of Pakistan and is now allowed to be collected by provinces. The NFC also decided to reduce collection charges from 5 percent of gross collection to 1 percent. Apart from awarding more fiscal autonomy to the provinces, the NFC is also expected to rationalize the intergovernmental fiscal relations and encourage the process of national reconciliation in the country.

Table 5.11: Major Heads of the Budget of Punjab

billion rupees

	RE FY09	RE FY10	BE FY11	% change FY10	% change FY11
Total receipts	**788.5**	**765.7**	**805.7**	**-2.9**	**5.2**
of which					
Divisible pool taxes	268.6	323.1	435.5	20.3	34.8
Straight transfers	5.8	5.1	6.3	-12.1	23.5
Grants	17.3	8.6	2.8	-50.3	-67.4
Provincial taxes	28.1	36.8	91.6	31.0	148.9
Provincial non taxes	39.9	49.8	22.2	24.8	-55.4
Total expenditure	**975.9**	**770.7**	**816.7**	**-21.0**	**6.0**
of which					
Debt management	23.0	47.3	53.3	105.7	12.8
Pension payment	21.0	21.0	27.9	0.0	32.9
Subsidy	2.4	15.0	21.0	528.8	40.0
Education sector	32.0	21.5	28.9	-32.9	34.3
Health sector	15.3	22.3	22.0	45.9	-1.1

Source: Annual Budget Statement of Punjab for FY10 and FY11

However, the true goal of fiscal decentralization cannot be achieved unless the provinces exercise fiscal discipline and maturity in their economic management. Without effective management of the resources, the requisite fiscal space cannot be reached that is necessary for investments in social, economic, and industrial sectors. In this context, the provincial governments in Pakistan are required to employ the additional resources in an efficient and optimal way. The provincial governments are also expected to reduce their excessive dependence on the federal transfers and mobilize their own resources as there is a wide room available to them to revise the tax lists and enhance their revenue base. Plugging leakages in the tax collection process and with the inclusion of the agriculture and real estate sectors into the tax net, the provincial governments can help improve the tax to GDP ratio.

The budgets of FY11 presented by the four provinces after the promulgation of 7th NFC award reflects some initiation of fiscal decentralization as outlined below.

Punjab

The government of Punjab estimates to have total resources of Rs 805.7 billion for FY11 against the revised estimates of Rs 765.7 billion last year (see **Table 5.11**). The increase in total receipts has been projected on the back of increase in divisible pool taxes coupled with increase in provincial tax revenue that is largely attributed to the new arrangement under the 7th NFC award. The biggest source for all the provinces is their share from the divisible pool taxes. The increase in share of the divisible pool taxes for FY11 is estimated in line with the FBR target of Rs 1667 billion. The major increase in the divisible pool taxes is expected to come from the income tax and sales tax as these two taxes would collectively contribute 79 percent of the share each province bears in the divisible pool.

The government of Punjab aims to collect Rs 91.6 billion during FY11 against the revised estimates of Rs 36.8 billion last year. The projected 148 percent increase in taxes is based on the collection from GST on services which is to be collected by the provinces under the new NFC award. While the share of GST on services had been around 10 percent in the past, it is estimated to reach more than 55 percent during FY11. Also, the government of Punjab expects to receive foreign loan worth Rs 52.3 billion, of which Rs 12.6 billion will be used for development projects in the province. Grants worth Rs 3.5 billion have also been estimated to add to the total receipts of the province.

The budget FY11 estimates the total expenditures at Rs 816.7 billion reflecting a growth rate of 6 percent against the revised estimates of FY10. The rise in expenditures can be partly attributed to rise in prices and the consequent increase in salaries warranting an increase in current expenditures. Of the total expenditure 3.4 percent (Rs 27.9 billion) has been budgeted for pension payment in the province against the revised estimates of Rs 21 billion during the last year. The higher allocation for pension has been made on the basis of actuarial forecasts of pension expenditures and increase in the pension and other fringe benefits including medical allowance announced in the federal budget FY11. The estimates of expenditure on account of interest payment in FY11 are pitched at Rs 21.3 billion while Rs 32 billion has been set aside for repayment of principal amount of the loans. Both interest and principal payment make up 6.5 percent of the total expenditure for FY11.

In the wake of inflationary trend in the country that have adversely affected the purchasing power of the impoverished class, the government of Punjab has decided to make a provision of Rs 21 billion for pro- poor initiatives. Out of the total amount for subsidy, Rs 13 billion has been allowed to subsidy on wheat, Rs 5 billion to Sasti Roti program, Rs 2 billion to Ramadan package and Rs 1 billion to subsidy on public transport.

Table 5.12: Major Heads of the Budget of Sindh

billion rupees

	RE FY09	RE FY10	BE FY11	% change FY10	% change FY11
Total receipts	**268.3**	**305.8**	**397.1**	**14.0**	**29.9**
of which					
Divisible pool taxes	104.2	125.2	207.3	20.2	65.6
Straight transfers	53.4	53.7	51.2	0.6	-4.7
Grants	17.3	8.6	2.8	-50.3	-67.4
Provincial taxes	24.3	25.4	56.5	4.5	122.4
Provincial non taxes	6.1	14.2	19	133.4	34.0
Total Expenditure	**267.6**	**321.8**	**422.3**	**20.3**	**31.2**
of which					
Debt management	16.6	15.3	15.5	-8.2	1.8
Pension payment	11.5	18.0	18.7	55.7	4.0
Subsidy	2.4	2.9	1.6	18.7	-43.4
Dev. Expenditure	87.1	98.5	153.1	13.1	55.4

Source: Annual Budget Statement of Sindh for FY10 and FY11

Allocations for Education sector stands increased at Rs 28.9 billon in the current budget against the revised estimates of Rs 21.5 billion last year reflecting the provincial government priority for the education sector. The provincial government has proposed an amount of Rs 193.5 billion to spend on development projects. Out of the total development expenditure, Rs 52 billion has been earmarked for 11 districts of southern Punjab in order to remove inter-regional disparities. Also Rs 15 billion is allocated for female specific program to narrow down the gender inequality in the province.

Sindh

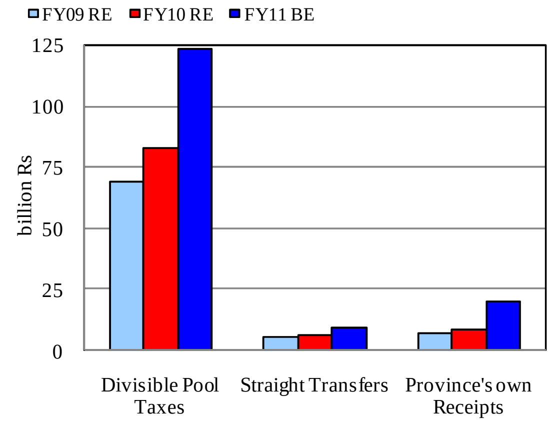
The provincial budget of Sindh for FY11 put the total receipts of the province at Rs 397.1 billion representing a growth of 29.9 percent over the revised estimates of the total receipts in the previous year (see T**able 5.12**). The increase in share in the federal transfers of the province provides a reason for the total resources to increase.

The provincial government set tax collection target at Rs 31.5 billion for FY11 against the revised estimates of Rs 25.4 billion for the last year. As provinces are now allowed to levy sales tax on services, the Sindh government places Rs 25 billion as collection target under this head taking the total tax collection target for FY11 to Rs 56.5 billion. The total collection for non tax receipts is estimated to reach Rs 19 billion for FY11.

Receipts under the head of development surcharge and Royalties for the current fiscal year have been placed at Rs 46.2 billion; lower than the revised estimates of the previous year by Rs 1.7 billion.

Total grants which the provincial government expects to receive during FY11 amounts to Rs 21 billion. Of this Rs 14.8 billion has been put under the head of development resources to be used for development projects of the province.

Figure 5.8: Trend in the Major Heads of Receipts for KP



Foreign loan worth Rs 24.2 billion is also estimated to add to the total receipts of the province during the current fiscal year. Of this Rs 4.8 billion has been earmarked for development purposes and has been classified as development resources.

The total expenditures of the province during FY11 have been budgeted at Rs 422.3 billion which takes the budget deficit to Rs 25.2 billion or 0.1 percent of the estimated GDP. The total budgeted expenditure for the current year represents a growth of 31.2 percent over the revised estimate of the previous year. A detailed analysis of the total expenditure shows that 4.4 percent of the total expenditure goes to Pension payment, 2 percent to interest payment, 1.7 percent to principal payment of the debt while 0.4 percent is allowed to spend on subsidy.

Other heads that lead to increased expenditure are education and health. Development expenditure of the province has also increased.

Khyber Pakhtunkhwa (KP)

For FY11 the government of Khyber Pakhtunkhwa (KP) expects its total resources to reach Rs 294.3 billion against the revised estimates of Rs187.8 billion last year. The increase in the total receipts is largely based on the increase in federal transfer for the provinces agreed under 7th NFC award (see **Figure 5.8**). An extra amount of Rs 15.2 billion equal to one percent of the net divisible pool has been earmarked for KP to realize its role played in the war on terror. Also the KP government estimates an increase of Rs 2.9 billion under the head of development surcharge and royalties that will take the total receipts from surcharges and royalties to Rs 9.2 billion for FY11.

The provincial government is set to collect Rs 3.2 billion under the head of provincial tax revenue during FY11. As the provinces are allowed now to collect sales tax on services under the 7th NFC award, the budget is targeted to collect Rs 12.3 billion under this head. This will take the total tax collection target of the province to Rs 15.5 billion for the current fiscal year while non tax collections are expected to remain around Rs 4 billion. Foreign loan worth Rs 5 billion and foreign grants worth Rs 4.3 billion have also been budgeted to meet the provincial expenditure.

Unlike other provinces, the government of KP aims to keep its spending equal to the total available resources placing the budget deficit of the province at zero (see **Table 5.13**).

Table 5.13: Major Heads of Expenditure for KP

billion rupees

	BE FY10	RE FY10	% Δ	BE FY11	% Δ over RE FY10
Total expenditure	**214.2**	**203.2**	**-5.2**	**294.3**	44.9
of which					
Salaries	48.2	55.8	15.9	76.0	36.2
Repair & maintenance	1.1	1.5	40.5	2.0	32.5
Pension	7.2	7.3	1.9	11.0	50.4
Subsidy	2.0	2.0	0.0	2.5	25
Debt servicing	11.3	10.2	-10.3	17.6	73.6
Dev. Expenditure	40.5	39.8	-1.9	69.3	74.2

Source: White Paper issued for Budget FY10 and FY11 by KP Government

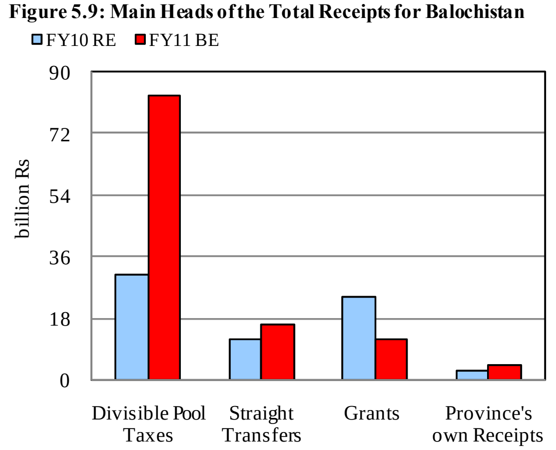
A break up analysis of the budgeted expenditures of Rs 294.3 billion shows that spending under the head of salaries stands at 25.8 percent of the total expenditure while that for pension payment is expected to reach 3.7 percent. Debt management including both interest and principal payment is estimated to be 6 percent of the total expenditure.

The provincial government intends to procure 2.5 MT of wheat for FY11 allowing Rs 14.1 billion as a subsidy. However, Rs 2.5 billion have been earmarked by the provincial government and the balance of Rs 11.6 will be managed through arranging receipts of Rs 2.4 billion by FATA and Rs 9.2 billion will be demanded from the federal government as a grant.

The prevailing law and order situation in KP has forced the provincial government to increase its expenditure on Police department. Expenditure under the head of Police is pitched at Rs 21.2 billon against the revised estimates of Rs 17.9 billion representing an increase of 18.5 percent. The increase in expenditure on Police is mainly because of the increase in salaries.

Education sector has been allocated Rs 6.2 billion compared to the revised estimates of Rs 4.4 billion a year earlier. Expenditure on health has been proposed to increase to Rs 4.2 billion in the budget FY11 from Rs 3.7 billion from a year earlier. Also, the development expenditure of the province has grown by two-third compared to the previous fiscal year and now stands at 23.5 percent of the total expenditure.

Figure 5.9: Main Heads of the Total Receipts for Balochistan



Balochistan

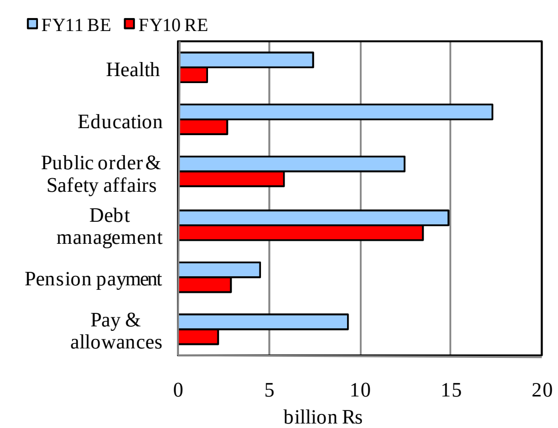
The government of Balochistan expects to have total resources worth Rs 144.9 billion during FY11 placing the growth rate of total receipts at 43 percent over the revised estimates for FY10. The growth in total receipts has been estimated on the back of increase in federal transfers for the provinces due to new revenue sharing arrangements agreed under 7th National Finance Commission (NFC) Award. The federal divisible pool of taxes continue to stand as the biggest source of revenue for the provincial government and is projected to contribute more than 57 percent of the total receipts for FY11 (see **Figure 5.9**). Revenue from straight transfers that earlier served as the third largest component in terms of contributing to the total revenue would now stand as second largest component largely due to decline in federal grants to the provinces following the new NFC award.

The increase in straight transfers is predominantly on account of levy of the sales tax on services allowed to the provinces. It merits mentioning here that Balochistan include the GST on services under the head of straight transfers unlike other provinces that consider it a part of provincial tax revenue. The provincial government expects to receive Rs 4.6 billion under the head of GST on services. The decline in the head of grants reflect the abolition of subvention and other budgetary support grant for the provinces and to make the provinces to rely more on its own resources. The provision of GDS and royalty arrears committed by the federal government in NFC award 2009 and Aghaz-e-Huqooq Balochistan package, however, compensates revenue loss incurred due to decline in federal grants. The GDS and royalty arrears will be provided on yearly basis in the form of special grants by the federal government.

Apart from this, the government of Balochistan expects to receive Rs 14.4 billion as loan from the domestic sources and Rs 3.3 billion from foreign sources that will take the total loan receipts during FY11 to Rs 17.7 billion for the province. Foreign grants worth Rs 1.5 billion are also expected to add to the development receipts of the province.

The total expenditures of the province for FY11 have been pitched at Rs 152.02 billion showing an increase of 77.9 percent over the revised estimate for FY 2009-10. The budget deficit of the province is, therefore, calculated to be Rs 7.1 billion or at 0.04 percent of the estimated GDP for FY11.

Figure 5.10: Main Heads of the Total Expenditure for Balochistan



Pay and other allowances have been estimated to increase to 6.2 percent of the total expenditure during FY11 from 2.6 percent of the actual expenditure during FY2009-10 (see **Figure 5.10**). The alarming growth in the salary budget of the province is attributed to the creation of new posts and 50 percent salary increase announced in the federal budget for public sector employees along with increase in other emoluments. It is pertinent to mention here that the growth in expenditure on salaries is predominantly contributed by the expenditure on salaries of staff below officer grade reflecting the creation of large number of new posts of the lower rank. Expenditure on account of pension payment is projected to consume 3 percent of the total expenditure while debt management (both interest and principal payment) would get lower to 9.8 percent from 15.8 percent a year earlier. In addition, the expenditure on public order and safety affairs has been budgeted to increase to 8.2 percent of the total expenditure for FY11 from 6.8 percent of the total revised expenditure during FY10. This was expected in the wake of fragile security situation in the province. Police, Levies Force and Balochistan constabulary are the major component of the expenditure (90 percent) on Public order and safety affairs The expenditure on Levies mainly includes resources kept for fresh recruitments, provision of lump sum funds for meeting pay increase, purchasing of patrolling vehicles/arms and ammunitions, etc.

The education and health sector have been provided with sufficient resources in the budget FY11. The increase under these two heads is mainly due to shifting of devolved setup from the defunct district government to respective provincial departments. An allocation of Rs 2.4 billion has been made for subsidies including Rs 2 billion for tube wells and Rs 0.4 billion for wheat. The subsidy on flour has been decreased compared to the previous year due to lesser target set by food department for purchase of wheat and to allow the market forces work efficiently. Of the total expenditure, development expenditure amounts to17.6 percent equal to the revised estimates in the previous fiscal year.