5 Fiscal Policy

5.1 Overview

Overall budget deficit in FY14 was 5.5 percent of GDP, compared with 8.2 percent a year earlier. After a number of years of slippages, the budget deficit fell well within the target set for the year (6.5 percent of GDP - **Figure 5.1**). This performance was possible because of several improvements on the fiscal front:

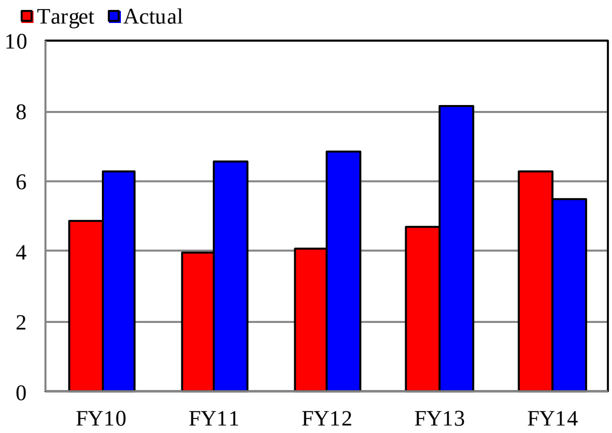
- Total revenues posted growth of 22.0 percent in FY14, compared to the 16.2 percent rise in the previous year. This was based on strong growth in both tax and non-tax revenues;

- The growth in current expenditures fell sharply from 17.2 percent in FY13, to 9.4 percent this year. This was mainly because of a decline in subsidies;

- After showing sluggish growth last year, development expenditures recovered strongly, posting a 46.2 percent growth in FY14 against, 6.2 percent a year earlier.[1]

- As shown in **Table 5.1**, the primary deficit narrowed to 0.9 percent of GDP, which was significant improvement over the past many years.

Figure 5.1: Fiscal Deficit - Target and Actual (Percent of GDP)



Source: Ministry of Finance

Table 5.1: Fiscal Indicators

	FY10	FY11	FY12	FY13	FY14
billion Rupee					
Fiscal balance *	-929.4	-1,194.4	-1,760.7	-1,833.9	-1,388.7
Revenue balance	-308.2	-647.9	-556.0	-678.0	-367.3
Primary balance	-287.1	-496.3	-480.7	-842.9	-240.9
% of GDP					
Fiscal balance	-6.3	-6.5	-8.8	-8.2	-5.5
Revenue balance	-2.1	-3.5	-2.8	-3.0	-1.4
Primary balance	-1.9	-2.7	-4.3	-3.7	-0.9

*: Including payments for settlement of circular debt.
Source: Ministry of Finance

- Provinces recorded a combined surplus of Rs 149.5 billion in FY14, against a target of Rs 23 billion. This was also much higher than Rs 62.8 billion recorded in the previous year;[2] and

- On the financing side, the availability of external financing coupled with a smaller deficit, sharply reduced pressure on the banking system.

There are, however, several caveats to this improved performance. For example:

- The strong growth in revenues was supported by a number of one-off inflows: (1) a grant under the Pakistan Development Fund (PDF); (2) receipt of mark up on lending to PSE;[3] and (3)

[1] This includes Rs 157 billion of unutilized Pakistan Development Fund as of end-June 204. Adjusting this, the development expenditures show a growth of 26 percent in FY14.

[2] Provinces are expected to generate surpluses to support the federal government narrow the fiscal deficit. For example, the federal government's revenues (net of provinces) was Rs 2,006 billion in FY14: after allocating Rs 1,771 billion for debt servicing and defence, the government was left with only Rs 235 billion to meet the remaining current expenditures of Rs 1,113.9 billion. This gap is financed either by borrowing, or by having provinces post a larger than target surplus.

[3] The non-cash component of the circular debt settlement, which took place in July 2013, also included a recovery of Rs 56 billion markup payable from PSEs (NTDC, Atomic Energy Commission and Wapda) to the federal government. Hence, the

utilizing the Universal Service Fund (USF) to ease the burden on domestic sources of finance.[4] Furthermore, unlike the previous several years, the government did not settle the circular debt in FY14 despite its growing size during the year. Adjusting for these factors, the budget deficit exceeds the target by a significant margin, though it still remains lower than the previous year (**Table 5.2**).

- Although the larger use of withholding tax, and the increase in sales tax rate explain higher collections, a significant reason for the high growth was the base effect of FY13, when tax collections remained weak

Table 5.2: Fiscal Deficit - Some Calculations

	billion Rupee	% of GDP
Budget deficit FY13	1,833.9	8.2
Budget deficit FY14:		
Target→	1,650.6	6.5
Actual as reported by MoF→	1,388.7	5.5
Adjustments on revenue side:		
Grant under PDF	157.2	
Utilization of USF	67.7	
Mark up on PSEs	56.0	
	280.9	1.1
Adjusted deficit FY14	**1,669.6**	**6.6**
Adjustment on expenditure side:		
Non-payment of circular debt	235.0 *	
Overall adjusted deficit FY14	**1,904.6**	**7.5**

* Media reports suggest circular debt stock in the range of Rs 235 to 370 billion; we have taken a conservative number in these calculations.

Table 5.3: Summary of Fiscal Operations
billion Rupee

	FY13	FY14		% of GDP		% Growth	
		Budget	Provisional	FY13	FY14	FY13	FY14
Total Revenue	**2,982.4**	**3,646.7**	**3,637.3**	**13.3**	**14.3**	**16.2**	**22.0**
Tax revenue	2,199.2	2,768.1	2,564.5	9.8	10.1	7.1	16.6
Non-tax revenue	783.2	878.6	1,072.8	3.5	4.2	52.5	37.0
Total Expenditure	**4,800.3**	**5,297.3**	**5,241.1**	**21.3**	**20.6**	**24.2**	**9.2**
Current	3,660.4	3,963.0	4,004.6	16.3	15.8	17.2	9.4
Interest payments	991.0	1,153.5	1,147.8	4.4	4.5	11.5	15.8
Defence	540.6	627.2	623.1	2.4	2.5	6.6	15.3
Subsidies	367.5	240.4	305.7	1.6	1.2	-28.3	-16.8
Other federal *	666.2	756.9	754.7	3.0	3.0	170.5	13.3
Provincial	1,095.2	1,185.0	1,173.3	4.9	4.6	13.2	7.1
Development	777.1	1,326.8	1,135.9	3.5	4.5	6.2	46.2
PSDP	695.1	1,155.0	865.5	3.1	3.4	4.6	24.5
Others	82.0	171.8	270.5	0.4	1.1		
Net lending	362.8	7.5	100.6	1.6	0.4		
Statistical discrepancy#	16.0		-215.1	0.1	-0.8		
Budget Deficit	**1,833.9**	**1,650.6**	**1,388.7**	**8.2**	**5.5**	**33.9**	**-24.3**
Financing							
External sources	-1.7	168.7	511.7	-0.01	2.0		
Domestic sources							
Banks	1,457.5	975.0	323.7	6.5	1.3		
SBP	505.9	0.0	159.8	2.2	0.6		
Commercial banks	951.6	975.0	163.9	4.2	0.6		
Non-bank	378.0	506.8	553.3	1.7	2.2		
Revenue balance	-678.0	-316.3	-367.3	-3.0	-1.4		
Primary balance	-842.9	-497.1	-240.9	-3.7	-0.9		

*: Including general government expenses.
#: Includes the impact of one-off grant of US$ 1.5 billion (Rs 157 billion) in FY14.
Source: Ministry of Finance

overall receipts under the head of markup from PSEs, increased to Rs 67.0 billion in FY14, compared to just Rs 12.3 billion a year before.

4 Universal Service Fund (USF) was created in 2006, and became operational in 2007, as a public-private partnership, with contributions coming from telecom operators. Its objective was to expand the telecom infrastructure to rural areas.

during the election year.[5] FBR was unable to meet its tax collection target, even though the target had twice been revised downward during the course of the year.

- Similarly, the strong growth in development spending was also due to the base effect from FY13, when development expenditures grew only by 6.2 percent. Despite strong growth in FY14, development spending still remained well below the target – about a quarter of the funds allocated for PSDP remained unutilized during FY14, as both federal and provincial governments missed their development targets (**Table 5.3**). In contrast, subsidy payments, which are untargeted and concentrated in the power sector, were 27.1 percent higher than the target of Rs 240.4 billion.[6]

Table 5.4: FBR Tax Collection

	billion Rupee		Growth	
	FY13	**FY14**	**FY13**	**FY14**
Direct tax	743.4	884.0	0.7	18.9
Sales tax	842.5	1,002.1	4.7	18.9
Customs duty	239.5	241.0	10.4	0.6
Federal excise	121.0	139.1	-1.2	15.0
Total FBR taxes	**1,946.4**	**2,266.2**	**3.4**	**16.4**

Source: Federal Board of Revenue

5.2 Revenue

Total revenues (tax and non-tax) grew strongly in FY14 and came very close to the budgetary target (**Table 5.3**). This was only possible due to above-target non-tax revenues; while the shortfall in tax collection continues to be a policy concern.

Specifically, the performance of FBR (which is responsible for collecting about 90 percent of total federal and provincial taxes) remained below expectations. The initial tax target was twice revised downward to Rs 2,275 billion, yet actual tax collection was a little lower at Rs 2,266.2 billion (**Table 5.4**).[7]

The shortfall in FBR collection was unsatisfactory, particularly when key areas of the FY14 taxation policy were: (i) taxing those who were not paying any tax; (ii) enhancing the efficiency of tax machinery; (iii) removing anomalies and distortions in the tax system; (iv) simplifying tax procedures; (v) rationalizing tax rates and exemptions; (vii) encouraging documentation; (vii) facilitating taxpayers; and (viii) addressing weak administration and leakages in FBR.

Table 5.5: Break-up of Direct Taxes
billion Rupee

	FY13	**FY14**	**Growth**
Voluntary payments	244.9	262.6	7.2
Collection on demand	89.4	80.6	-9.9
Deductions at source (WHT)	436.1	578.4	32.6
Imports & exports	126.4	150.5	19.1
Contracts	111.5	136.6	22.5
Salary	50.1	64.6	29.0
Bank interest & securities	35.3	40.5	14.5
Cash withdrawal	12.4	19.1	53.2
Dividends	19.2	24.2	26.0
Electric bills	16.0	19.8	23.3
Telephone	27.1	52.0	91.8
Other WHT	38.0	71.2	87.5
Miscellaneous	5.6	4.0	-28.0
Total Income tax	776.0	925.6	19.3
Other direct taxes	20.8	22.1	6.3
Total direct taxes (Gross)	796.8	947.7	18.9
Rebates	53.4	63.7	19.3
Total direct taxes (Net)	743.4	884.0	18.9

Source: Federal Board of Revenue

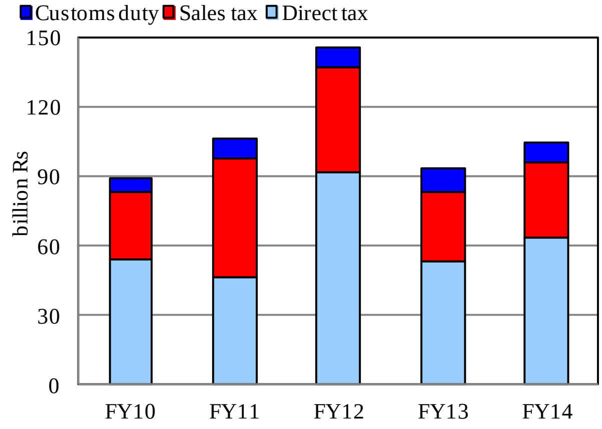
Direct taxes

Direct taxes collected by FBR increased by 18.9 percent in FY14, compared to just 0.7 percent last year. This was despite the fact that FBR paid higher rebates during FY14, compared with the last

[5] This is supported by the fact that the overall growth in tax collection decelerated to 7.1 percent in FY13 from 20.8 percent in FY12.
[6] More than 70 percent of these payments were on account of Inter-Discos tariff differential in the power sector.
[7] The initial target for FY14 was Rs 2,475 billion that shows a growth of 27.2 percent over FY13.

year (**Figure 5.2**). As a matter of convenience, rebates are sometimes delayed to meet quarterly targets. Hence, paying higher rebates and yet posting higher collection is quite an achievement. As usual, the largest contribution to direct taxes came from withholding tax (**Table 5.5**). The scope of withholding tax was increased further by introducing a number of measures in FY14 budget.[8] In fact, the government is increasingly relying on withholding tax to collect direct taxes, as voluntary payments are low because tax payers do not feel compelled to pay.

Figure 5.2: Refunds/Rebates Paid by FBR



Source: Federal Board of Revenue

There is an urgent need to increase income tax base and introduce creative schemes to increase voluntary payments. Currently, a large segment of the working population is outside the tax net, which is evident from the fact that only 6.3 percent of the employed labor force has a National Tax Numbers. Even among those who have NTNs, less than 40 percent actually file tax returns.[9]

On the other hand, *collection on demand* (which reflects FBR's tax efforts) declined during the year (**Table 5.5**). FBR issued notices to 120,000 new potential tax payers (who were identified with the help of NADRA and other sources), but it could hardly mobilize additional revenues. It is, therefore, critical to enforce these notices more effectively.

Table 5.6: Sales Tax on Domestic and Import Stage

billion Rupee

	FY13	FY14	Growth
Sales Tax Domestic			
POL Products	180.6	231.0	27.9
Natural Gas	36.8	31.6	-14.1
Fertilizers	19.9	24.0	20.5
Cement	11.5	20.1	75.5
Electrical Energy	10.1	19.9	98.2
Cigarettes	14.5	17.7	21.6
Aerated Waters/Beverages	10.7	13.5	26.7
Other food products	17.0	22.5	32.3
Other sectors	111.6	126.4	13.2
Total	**412.7**	**506.8**	**22.8**
Sales Tax Imports			
POL Products	156.3	169.6	8.5
Edible Oil	32.3	33.9	4.9
Machinery	34.0	44.9	31.8
Chemicals	16.5	22.3	35.5
Vehicles	26.8	26.0	-2.8
Fertilizers	10.6	12.8	21.7
Others	153.4	185.9	21.2
Total	**429.8**	**495.4**	**15.2**

Source: Federal Board of Revenue

Sales tax

Sales tax collection increased by18.9 percent in FY14, compared to 4.7 percent in FY13. This was primarily because of an across-the-board increase in the tax rate from 16 to 17 percent announced in the budget FY14.

Collection of sales tax on domestic goods & services, and imports showed strong growth during the year under review (**Table 5.6**). The major impetus came from petroleum products, which have a combined share of around 40 percent in total sales tax receipts.

Besides increasing the tax rate, FBR introduced a dual sales tax rate for registered and unregistered businesses. Specifically, an additional sales tax of 5 percent was imposed on unregistered industrial and commercial firms (through electricity and gas

[8] For example, (i) withholding tax on marriage halls, hotels, restaurants, educational institutions with annual fee above Rs 200,000, foreign-based films and TV dramas, and traders; and (ii) making registered sales tax payers as withholding tax agents.

[9] FBR has been trying for the last several years to bring more people in the tax net. However, the pace of broadening tax base is very slow. During FY14, the number of NTN holders increased to 3.6 million showing a growth of 2.1 percent over the previous year, which is almost the same as population growth rate.

bills) until they were formally registered. To encourage registration, all taxable supplies to unregistered firms were to incur an additional tax of 2 percent.

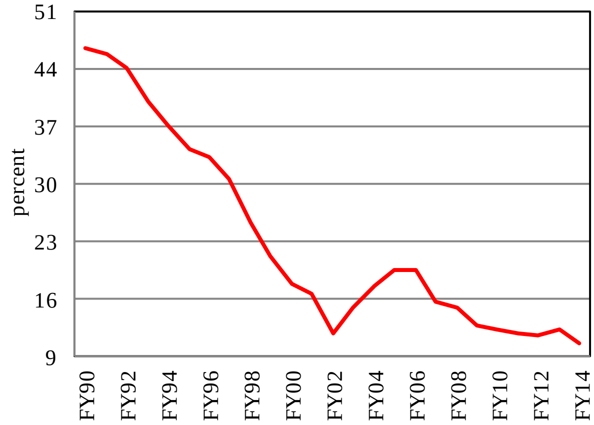
The other federal taxes (customs and federal excise duties) contributed less than 20 percent of total FBR revenues. Particularly, customs duties, once the biggest revenue source in the country, have lost importance (as a source of tax collection) following the trade liberalization policies of the 1990s (**Figure 5.3**).

Non-tax revenues compensated for the shortfall in tax revenues

Non-tax revenues (federal and provincial) were Rs 1,072.8 billion during FY14, showing an increase of 22.1 percent over the target. This was primarily due to a sharp increase in the transfer of SBP profit to the federal government (which included Rs 31 billion on account of proceeds of UBL's divesture), and the Rs 67 billion markup from PSEs. In addition, the government also utilized Rs 67.7 billion from the Universal Service Fund, which was initially not part of the budget estimates.[10]

Other major heads under non-tax revenues were: Rs 89 billion against the auction of 3G/4G licenses; Rs 108 billion from the Coalition Support Fund; and various government charges on energy sector (**Table 5.7**). In terms of latter, the government collected Rs 202.1 billion from the oil and gas sector on account of: (i) Gas Development Surcharge; (ii) royalties on oil and gas; (iii) discount retained on crude oil production; (iv) windfall levy against crude oil; and (v) the Gas Infrastructure Development Cess. These amounts were in addition to sales tax on petroleum products that provided over Rs 400 billion during the year.

Figure 5.3: Share of Customs Duties in FBR Taxes



Source: Federal Board of Revenue

Table 5.7: Non-Tax Revenues

billion Rupee

	FY12	FY13	FY14
Profits (Including 3G/4G fee)[1]			94.8
Mark Up (PSEs & others)	12.5	12.3	67.0
Dividend	49.7	63.5	65.9
SBP profits	204.0	220.0	326.2
Defence (Including CSF)[2]	9.8	180.4	117.2
Citizenship, naturalisation & passport fee	10.9	16.2	19.0
Gas development surcharge	23.0	32.2	38.5
Royalties on oil and gas	62.8	65.2	76.4
Discount retained on crude oil[3]	20.0	15.5	40.7
Windfall levy against Crude oil[4]	-	23.8	14.6
Gas infrastructure development cess	-	33.6	31.8
Foreign Grants	-	-	12.3
Other profits (C-01010) - USF	-	-	67.7
Other federal non-tax receipts	72.8	49.4	51.2
Provincial non-tax receipts	48.0	71.3	49.4
Total non-tax revenues	**513.6**	**783.2**	**1,072.8**

1: Receipts from auctions of 3G/4G licenses were Rs 89 billion, against the target of Rs 120 billion. However, the government has still to auction one more license of each of 3G & 4G spectrums.

2: The government received Rs 108 billion under CSF in FY14.

3: Discount retained on crude oil is the share of government in selling price of local crude oil produced by exploration companies.

4: Windfall levy against crude oil is the gain realized in case of fluctuations in international oil prices.

Source: Ministry of Finance

5.3 Expenditures

The 9.2 percent growth in total expenditures in FY14 was considerably lower than the 24.2 percent increase recorded in FY13. Adjusting for the expense relating to settlement of the circular debt during

[10] Consumption of USF for budgetary purposes is against the objectives of this Fund. However, this amount is likely to be returned to the Ministry of IT for its proper utilization.

the last two years, total expenditures show a rise of 14.0 percent, compared to 15.8 percent in FY13 (**Table 5.8**).[11]

Table 5.8: Break-up of Current Expenditures
billion Rupee

	FY13	FY14		% Change over	
	Actual	Budget	Actual	FY13	FY14 Budget
Total expenditures	**4,800.3**	**5,297.3**	**5,241.0**	**9.2**	**-1.1**
Current expenditures	3,660.4	3,963.0	4,004.6	9.4	1.0
Federal	2,565.2	2,778.0	2,831.2	10.4	1.9
General public services	1,823.9	1,962.6	2,008.0	10.1	2.3
Debt servicing	991.0	1,153.5	1,147.8	15.8	-0.5
Domestic	920.4	1,064.5	1,072.8	16.6	0.8
Foreign	70.6	89.0	75.0	6.2	-15.8
Pension	172.6	171.3	180.2	4.4	5.2
Subsidies*	367.5	240.4	305.7	-16.8	27.1
Grants (other than provinces)	232.7	285.8	283.2	21.7	-0.9
Others	60.1	111.6	91.1	51.5	-18.4
Defence	540.6	627.2	623.1	15.3	-0.7
Public order and safety	80.4	78.5	86.2	7.3	9.9
Education	56.9	59.3	65.4	14.9	10.3
Health	9.5	9.9	10.1	6.5	2.7
Others	53.9	40.5	38.3	-28.9	-5.4
Provincial	1,095.2	1,185.0	1,173.3	7.1	-1.0
Total expenditures (excl. power sector debt settlement)	**4,478.1**	**5,297.3**	**5,103.0**	**14.0**	**-3.7**

*: Provisional estimates taken from budget documents.
Source: Ministry of Finance

Despite higher growth in debt servicing, defence spending, and grants; the growth in current expenditure in FY14 remained low compared to the previous year, mainly due to a decline in subsidies. While the increase in debt servicing reflects growing stock of domestic debts, the increase in grants & transfers were on account of larger than budgeted payments to Pakistan Railways and the Pakistan Remittance Initiative.

Subsidies, on the other hand, declined during the year, as the government raised power tariffs for all categories of consumers.[12] Nevertheless, power subsidies were much higher than target.

Development expenditures & net lending recorded growth of 8.5 percent to reach Rs 1,236.5 billion, against a 9.9 percent increase in FY13.[13] Excluding net lending, development expenditures rose by 46.2 percent compared to a meager 6.2 percent rise in FY13 (**Table 5.9**). This growth in development spending was expected as the Election Commission had put a freeze on development expenses before the May 2013 elections. Despite this strong growth, development spending still missed the FY14 target.

[11] The government settled Rs 322 billion of the circular debt in June 2013, and Rs 138 billion (non-cash component) in July 2013.

[12] Electricity tariffs were increased in the range of 15.5 to 23.8 percent for domestic users with monthly consumption above 200 kWh.

[13] Net lending is a part of overall development expenditure. This includes development loans and advances to Provinces, Government of Azad Jammu & Kashmir, Public Sector Enterprises (PSEs), Financial / Non-Financial Institutions, District Governments / TMAs, and Others to assist them in carrying out their development programs.

Public Sector Development Program (PSDP) showed marked improvement at both the federal and provincial levels, posting an increase of 34.4 percent and 15.9 percent respectively – nonetheless, PSDP fell short of target. Moreover, the government also spent on its development programs outside PSDP, like the Benazir Income Support Program (BISP), Pakistan Poverty Alleviation Fund, Citizen Damage Compensation Program, Textile Policy 2009-14, and subsidy to TCP for the import of Urea.[14]

Table 5.9: Break-up of Development Expenditure and Net Lending
billion Rupee

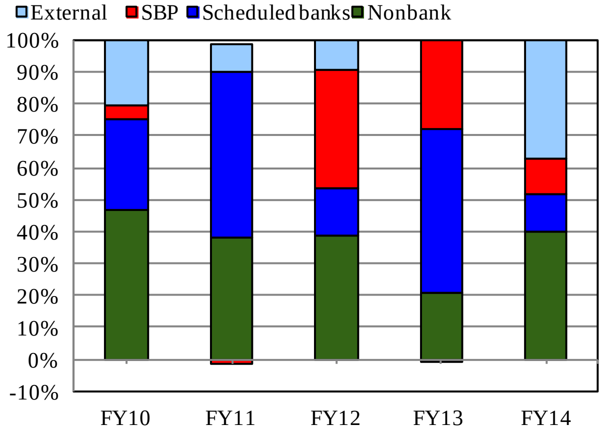
	FY13	FY14		% Change over	
	Actual	Budget	Actual	FY13	FY14 Budget
Development expenditures and net lending	**1,139.9**	**1,334.3**	**1,236.5**	**8.5**	**-7.3**
Development expenditures	777.1	1,326.8	1,136.0	46.2	-14.4
PSDP	695.1	1,155.0	865.5	24.5	-25.1
Federal#	323.5	540.0	434.9	34.4	-19.5
Provincial	371.5	615.0	430.5	15.9	-30.0
Other development expenditures	82.0	171.8	270.5	229.8	57.5
of which BISP	58.0	75.0	63.9	10.2	-14.8
Net lending	362.8	7.5	100.6	-72.3	

Net excluding development grants to provinces
Source: Ministry of Finance

Financing of the deficit

The financing of the fiscal deficit witnessed some favorable developments during the year. First, external financing that had stopped in FY13 after declining consistently for the past several years, revived in FY14 (**Figure 5.4**). Not only did funding from the IFIs increase sharply during the year, the government was also able to mobilize US$ 2 billion via Eurobonds in the international market. In fact, Pakistan re-entered the global capital markets after a gap of 7 years (see ***External Debt section in Chapter 6***, for more details).

Figure 5.4: Financing Mix of Budget Deficit



Source: Ministry of Finance

Second, the availability of external funding helped reduce the government's reliance on domestic sources, which in turn, improved the maturity profile of Pakistan's domestic debt. Thus, not only did the government borrow less in FY14, compared to previous year, its borrowing from commercial banks also fell. More importantly, the composition of bank lending changed in favor of long-term government bonds (PIBs), which will help reduce the *roll-over* and *interest rate* risks arising from short-term financing (see ***Domestic Debt in Chapter 6***).

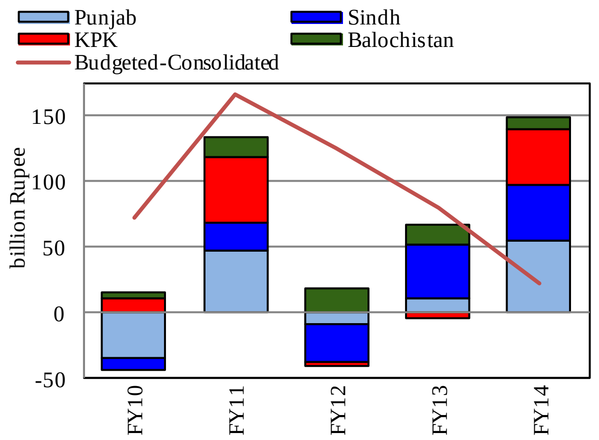
5.4 Provincial Fiscal Operations

The overall surpluses posted by the provincial governments, increased sharply to Rs 149.5 billion in FY14, against a target of only Rs 23 billion for the year (**Figure 5.5**). The higher surplus can be traced to the following factors:

[14] Other development expenditure also included Rs 157.2 billion of PDF.

(1) There is an understanding that provincial governments will support the overall fiscal consolidation efforts by posting surpluses (particularly after the 7th NFC Award, when provincial shares in the divisible pool increased sharply);
(2) There is a view that transfers from the federal government are unpredictable, especially at the end of the fiscal year, which dampened PSDP spending by provinces;
(3) Hard limits on provincial government borrowings from SBP, incentivized provinces to remain conservative in their spending;[15] and
(4) There are capacity issues within the provincial governments to take on enhanced fiscal responsibilities after the 18th Amendment.

Figure 5.5: Provincial Balance



Source: Ministry of Finance & Budget Documents

Having said this, though a sharp increase in provincial surpluses helped contain overall fiscal deficit, this was perhaps not the intended policy objective. Indeed, there is a need to further push fiscal devolution, whereby revenue collection is increasingly done by the provinces, so that a more assured revenue stream would allow provincial government to better manage their development spending.

Table 5.10: Provincial Fiscal Operations

billion Rupee

	Punjab		Sindh		KPK		Balochistan		All Provinces	
	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
A. Total revenue	**701.8**	**803.6**	**445.7**	**490.6**	**243.9**	**302.8**	**153.1**	**170.6**	**1,544.4**	**1,767.4**
Share in divisible pool	569.3	646.3	320.7	383.7	199.6	234.4	125.3	141.9	1,215.0	1,406.3
Taxes	77.4	96.5	68.1	79.1	4.1	11.7	1.1	2.8	150.7	190.0
Non-taxes	28.1	23.0	24.7	5.4	10.1	16.8	8.4	4.2	71.3	49.4
Federal loans & grants	27.0	37.8	32.1	22.4	30.1	39.8	18.3	21.7	107.4	121.8
B. Total expenditure	**690.9**	**748.0**	**404.3**	**449.1**	**248.1**	**259.7**	**138.4**	**161.1**	**1,481.6**	**1,617.9**
Current	536.3	551.7	301.9	328.2	173.8	187.1	98.0	120.4	1,110.0	1,187.4
Development	154.6	196.3	102.3	120.9	74.3	72.6	40.1	40.7	371.4	430.5
C. Overall balance (A-B)	**10.9**	**55.6**	**41.4**	**41.4**	**-4.2**	**43.0**	**14.7**	**9.5**	**62.8**	**149.5**

Source: Ministry of Finance

In particular, the element of certainty in provincial cash flows needs more attention. About 80 percent of provincial revenues come from their shares in the divisible pool, which depends upon the pace of FBR tax collection. It is, however, encouraging that provinces' *own revenue generation* is also gathering pace, mainly due to GST collection on services. The share of provincial tax collection in total revenues has increased from 5.3 percent in FY11 (before the 18th Amendment), to 10.7 percent in FY14. Although this is a good sign, we believe more efforts are needed on this front, as provinces are too dependent on sales tax on services. Agriculture income tax, which is also under the provincial domain, is still untapped given its potential.

Province-wise details reveal that the budget surplus generated by Punjab was the largest, followed by KPK, Sindh and Balochistan (**Table 5.10**). In relative terms, Punjab and Sindh performed better compared to others, in being able to post surpluses while increasing their development spending over

[15] Currently, the provincial limits for overdraft with SBP are: Rs 37.2 billion for Punjab; Rs 15.0 billion for Sindh; Rs 10.1 billion for KPK; and Rs 7.0 billion for Balochistan.

the previous year. On the other hand, Balochistan's surplus declined by Rs 5.3 billion compared to last year, because of an increase in their current expenditures.[16]

Revenue generation by Sindh and Punjab was also encouraging. More than 90 percent of total provincial tax collection was contributed by Sindh and Punjab, as they have strengthened their collection machinery for sales tax on services (**Table 5.11**). While KPK has established its own revenue authority (following Punjab and Sindh), Balochistan is in the process of setting up a similar authority. This is a welcome step as provinces are exercising their revenue raising powers that has been conferred by the Constitution.

Table 5.11: Sales Tax on Services

billion Rupee

	FY11	FY12	FY13	FY14	BE-FY15
Punjab	34.0	26.8	34.4	52.0	95.0
Sindh	16.6	23.9	33.7	42.0	49.0
KPK	-	8.9	4.3	8.0	12.0
Balochistan	-	-	-	1.8	1.9
Total	**50.6**	**59.7**	**72.3**	**103.8**	**157.9**

Source: Provincial Budget Documents

Table 5.12: Agriculture Income Tax

million Rupee

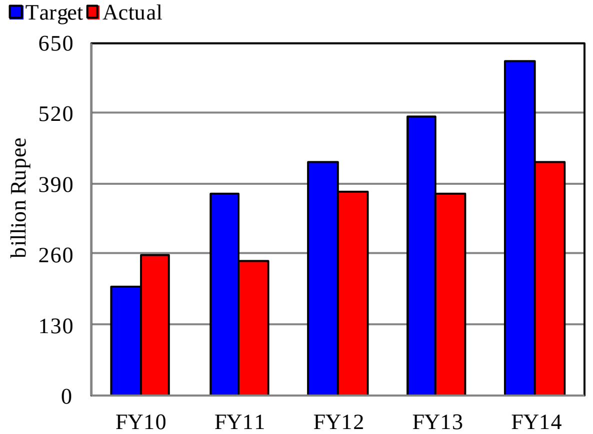
	Annual Target					Actual Collection				
	FY10	**FY11**	**FY12**	**FY13**	**FY14**	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**
Punjab	1,100	1,200.0	927.2	720.5	2,018.9	770.3	717.2	762.4	827.3	830.0
Sindh	200.0	220.0	500.0	500.0	550.0	200.0	210.2	122.8	406.5	500.0
KPK	90.0	21.0	21.0	22.0	22.0	15.7	17.5	20.1	22.0	24.0
Balochistan	0.0	0.0	5.0	0.0	2.0	0.0	1.5	0.0	0.0	0.5
All provinces	1,390.0	1,441.0	1,453.2	1,242.5	2,592.9	986.0	946.3	905.3	1,255.8	1,354.5
Total collection as percent of :										
Target						71.1	72.2	62.4	101.1	52.2
Agriculture GVA						0.03	0.02	0.02	0.02	0.02

Source: Provincial budget documents & PBS

However, there is a need to focus on other sources of taxes, apart from sales tax on services. Although the provinces have been setting targets for agriculture income tax collection, actual realization is much lower than the understated targets (**Table 5.12**). Currently, tax collection from this head is only 0.02 percent of the value added by the country's agriculture sector.[17]

Interestingly, Punjab set a target of Rs 2.0 billion for agriculture tax, compared with less than 1 billion collected in FY13. This was, probably in response to the federal government's decision to restrict the exemption on agricultural income, to only those who have

Figure 5.6: Provincial PSDP



Source: Ministry of Finance

[16] Rise in Balochistan's current expenditure was mainly due to education sector. Teachers, recruited under banner of *Aghaz-e-Haqooq-e-Balochistan*, were regularized during the year; and absorbed in the Education Department of the province (Source: White Paper 2014-15, Finance Department - Government of Balochistan).

[17] True potential of this tax can only be assessed, if we have some information about the distribution of agriculture income among farmers. If incomes earned by majority of farmers lie within the exemption limit; we should not expect much tax revenue from this sector. However, an effective implementation of this tax can help reducing tax leakages in the overall system.

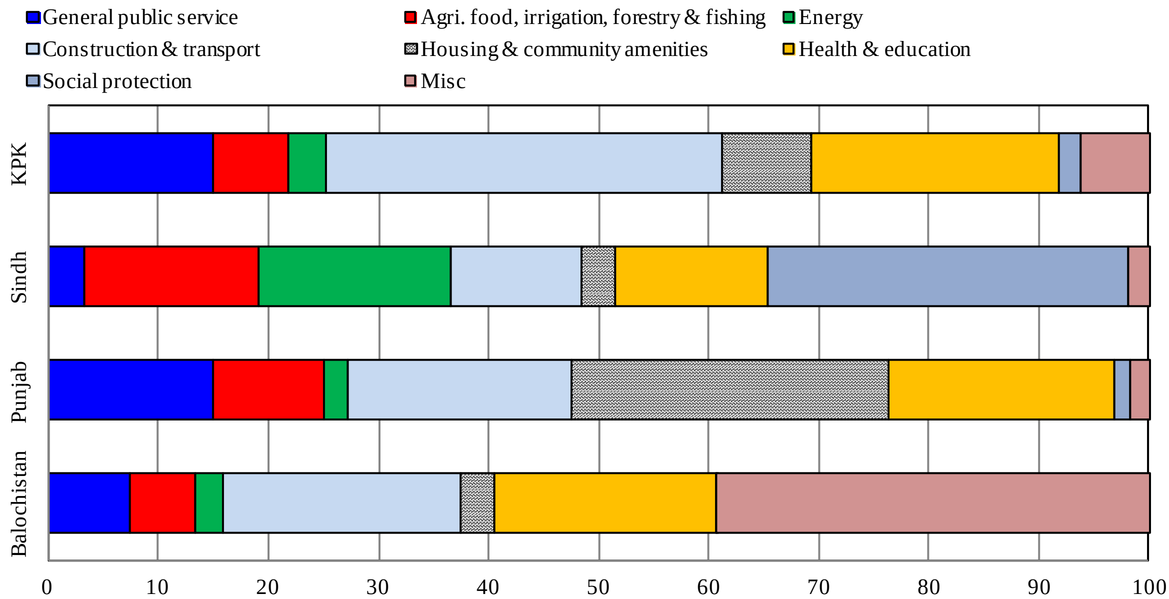
paid provincial income tax on agri income. However, the actual tax collection by Punjab was only Rs 830 million under this head in FY14 – almost the same as in the previous year.

Focusing on expenditure, the growth in provincial expenditures was 9.2 percent in FY14, almost the same as last year. A disturbing aspect of provincial fiscal operations is the under-utilization of the development budgets. When the annual budget for FY14 was prepared, Rs 615 billion were allocated for provincial Public Sector Development Programs (PSDP), but provinces could utilize only 70 percent of this amount during the year. In fact, provinces have been unable to meet their development targets for the last several years (**Figure 5.6**). As mentioned earlier, capacity constraints; uncertain inflow of revenue from divisible pool; and an understanding with the federal government to show surpluses, are some of the factors for shortfall in PSDP spending.

Priorities in development spending:[18]
While spending priorities vary across provinces, expenditure on infrastructure (construction and transport) is given priority in development outlays by all provinces.[19] Encouragingly, Sindh spent 32.9 percent of total development expenditure during the year on social protection (**Figure 5.7**), which was the highest amongst the provinces.

Punjab, on the other hand, focused more on housing and community amenities, as reflected in the 28.8 percent of total development outlays allocated for this head. The combined share of health & education was 20.6 percent – the same as for construction & transport.

Figure 5.7: Composition of Development Spending - FY14 (percent share)



Source: Provincial Budget Documents

The KPK government allocated 22.5 percent of its development outlays on health and education, which is the highest within the provinces. Interestingly, its allocation for construction & transport was also the higher (36.0 percent) than other provinces.

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[18] The sectoral distribution of development expenditures by provinces has been taken from their respective budget documents. Since there is no standard format of presenting details in these documents, we face difficulties in getting comparable numbers under different heads. Therefore, there may be some difference in our calculations regarding shares of different sectors.

[19] See also SBP **3rd Quarterly Report of FY14 (Chapter 4)** for a discussion on motives behind priorities of development expenditures.

These differing priorities are a positive outcome of the devolution of fiscal powers to the provinces. Going forward, all provincial governments must upgrade their capacity to deliver the specific services that the people of the province require.