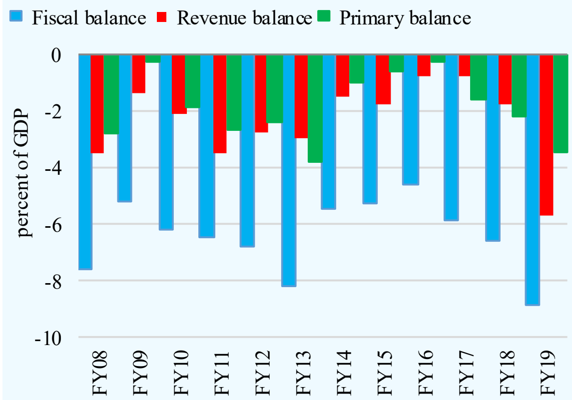
4 Fiscal Policy

4.1 Overview

An unusual decline in revenue collection and steep rise in current expenditures caused a deterioration in all major fiscal indicators during FY19. The overall budget deficit during the year stood at a historic high of 8.9 percent of GDP, which was also in excess of the 4.9 percent target set in the Budget 2018-19.[1] Meanwhile, the primary and revenue balances worsened substantially, highlighting growing debt stress for the government and a shrinking space for the needed development expenditures (**Figure 4.1**).

Figure 4.1: Major Fiscal Indicators



Data sources: Ministry of Finance and SBP calculations

Admittedly, the deterioration in these indicators could be partly attributed to factors beyond the control of the fiscal authorities, such as a steep rise in interest rates (that escalated the debt servicing burden); the shift in the political regime; legal constraints on the revenue side; and an overall slowdown in the economy. While these factors may well have contributed to the weak fiscal performance during the year, the fact remains that unless the institutional and structural faultlines are corrected, fiscal outcomes will remain excessively vulnerable to business cycle and non-economic factors, leaving a considerable scope for slippages. The case in point is the decline in revenue mobilization during the year, and the stagnation in tax collection.

Compared to a double-digit growth last year, tax revenues recorded a marginal growth of 0.1 percent in FY19 **(Table 4.1)**. On the face of it, this was mainly an outcome of: (i) a decline in PSDP expenditures, which not only led to lower collection from withholding tax on contracts, but also affected revenue mobilization from construction-allied industries; and (ii) court orders to substantially reduce the sales tax rate on major petroleum products and suspend the deduction of withholding tax on mobile phone top-ups. However, a deeper assessment holds responsible the country's fragile revenue structure, characterized by narrow base and excessive reliance on few sources. Specifically, the entire decline in the single-largest revenue source for the government, i.e., sales tax, during FY19 was attributed to lower collections from petroleum; excluding this one item, the growth in sales tax collection rises to 7.2 percent. Similarly, heavy loss incurred by SBP in the fourth quarter wiped out more than a third of overall non-tax revenues collected during the first three quarters. Taken together, the fiscal cost of the decline in revenues under these heads (petroleum and SBP profits), stood at 1.1 percent of GDP.

Besides the tax structure, the budgeting exercise also needs to be rationalized and brought in line with the revenue targets. For instance, the federal government had envisaged a sharp increase in tax revenues without specifying any fresh measures to boost collections. This optimism was centered primarily on an upbeat growth outlook for FY19, better tax administration, and the revenue impact of import compression measures (imposition of regulatory duties and additional customs duty). Given

[1] However, the target was revised up to 7.2 percent of GDP in March 2019.

Table 4.1: Summary of Fiscal Operations
billion Rupees, growth in percent

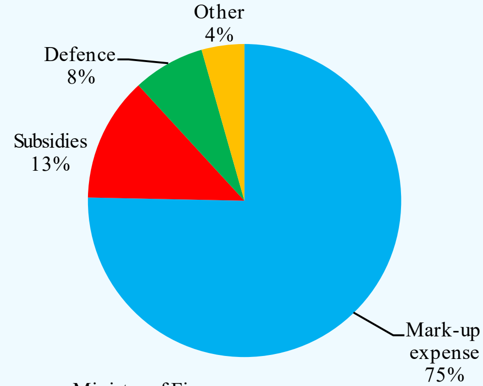
		Actual		Percent of GDP	
	Budget FY19	FY18	FY19	FY18	FY19
A. Total revenue	6,257.3	5,228.0	4,900.7	15.2	12.7
Tax revenue	5,336.0	4,467.2	4,473.4	13.0	11.6
Non-tax revenue	921.3	760.9	427.3	2.2	1.1
B. Total expenditure	8,138.3	7,488.4	8,345.6	21.8	21.6
Current	6,334.0	5,854.3	7,104.0	17.0	18.4
Interest payments	*1,620.2*	*1,499.9*	*2,091.1*	*4.4*	*5.4*
Defence	*1,100.3*	*1,030.4*	*1,146.8*	*3.0*	*3.0*
Development	1804.2	1,584.1	1,178.4	4.6	3.1
Net lending	-0.2	37.6	40.8	0.1	0.1
Statistical discrepancy		12.4	22.4	0.0	0.1
Fiscal balance (A-B)	-1,881.0	-2,260.4	-3,444.9	-6.6	-8.9
Revenue balance	-76.7	-626.3	-2,203.3	-1.8	-5.7
Primary balance	-260.8	-760.5	-1,353.8	-2.2	-3.5
Financing		*2,260.4*	*3,444.9*	*6.6*	*8.9*
External sources		785.2	416.7	2.3	1.1
Domestic sources		1,475.2	3,028.2	4.3	7.9
Banks		1,120.5	2,263.2	3.3	5.9
Non-bank		352.7	765.0	1.0	2.0
Privatization		2.0	0.0	0.0	0.0
Growth					
Total revenue		5.9	-6.3		
Tax revenue		12.5	0.1		
Non-tax revenue		-21.4	-43.8		
Total expenditure*		10.1	11.4		
Current		12.6	21.3		
Development		-6.4	-25.6		

* Including statistical discrepancy
Data sources: Ministry of Finance and SBP calculations

the fact that the economic activities had already lost steam by the time the budget was being finalized and it had become abundantly clear that the macroeconomic stabilization policies would stay in place, the growth assumption of 6.2 percent was optimistic. Furthermore, while it was quite ambitious to expect governance-centric measures to deliver in a short span of time, the impact of import compression measures could have gone either side; revenues can actually fall if these measures lead to a sizable import contraction.

The revenue-led fiscal stress was reinforced by overall weak expenditure controls at both the federal and provincial levels. The current spending of the federal government surged by a quarter in FY19 compared to last year, and also surpassed the targeted spending. Around 60 percent of the YoY increase was due to mark-up payments, which was attributed to higher interest rates and the depreciation of the Pak rupee. In fact, the overrun in the mark-up expense alone explained 75 percent of the slippage in federal current expenditures from the target during FY19, compared to 40 percent last year (**Figure 4.2**). Within the non-interest spending, the burden of energy-related subsidies was heavier than expected, as power generation cost continued to increase (mainly due to capacity payments[2]) and the government had to compensate for inefficiencies across the power generation and distribution sectors. In addition to these, outlays for public order and safety affairs, defence and pensions also rose susbtantially. Moreover, struggling with suboptimal public financial management, the provincial governments also found it challenging to cope with inherent rigidities in their current expenditures.

Figure 4.2: Composition of Federal Current Expenditures in Terms of Slippages from the Actual Targets during FY19



Data source: Ministry of Finance

Thus, with limited fiscal space available, the federal and provincial governments had to cut down their development spending. Encouragingly, the progress on ongoing CPEC projects was not compromised, as reflected by the higher spending on these projects compared to last year. Nonetheless, the overall control on development spending was insufficient to plug the large fiscal gap stemming from the subpar revenue performance and higher debt servicing. Therefore, the government had to finance the gap by accumulating a record-high level of debt during the year. It is important to note that while mark-up payments are already weighing heavily on limited and uncertain fiscal resources, public financial management could soon become very challenging if debt accumulation continues at such a rapid pace. Therefore, it is important for the government to strictly adhere to its medium-term fiscal strategy[3], which is centered on restoring the public debt sustainability and bringing the fiscal deficit down, in line with the Fiscal Responsibility and Debt Limitation Act, 2017.

Encouragingly, the entire strategy rests on gains from wide-ranging tax policy and administration reforms that, in addition to revenue growth, will also ensure progressivity of the tax system. The federal budget FY20 has already rolled out some of these reforms. For instance, it has eliminated the preferential tax treatment for certain sectors (e.g., sugar, steel and edible oil), and also ended the zero-rating regime for the five export-oriented sectors to generate revenue from their domestic sales. Side by side, to facilitate hassle-free refunds to exporters, the FBR has introduced the Fully Automated Sales Tax e-Refund procedure to dispose-off refund claims within 72 hours of their submission. Another important step was to instruct registered businesses to record CNIC numbers of unregistered buyers and suppliers in their invoices while filing their sales tax returns (**Box 4.1**). Furthermore, the FBR has gradually been increasing the valuation rates of immovable properly to align them with market rates; this is likely to enhance the revenue stream from this high-potential sector. On the expenditure side, the strategy focuses on containing the growth in the wage bill and implementing energy sector reforms to reduce the fiscal and quasi-fiscal burden.

Finally, an important agenda on fiscal reforms should be the capacity building of the provincial authorities, which are responsible for mobilizing revenue via the agriculture income tax, sales tax on services and property taxes, and carrying out crucial spending on important sectors like education, health, social spending and regional infrastructure. However, nine years after the 18th Amendment, the provinces still seem to lack capacity to adequately assume these responsibilities. Their revenue efforts have been unimpressive to say the least, whereas their allocation on social development has been much less than what is required to bridge the existing service delivery gap. Therefore, it requires

[2] For further details, please see Special Section 1: "Why are Power Tariffs in Pakistan Consistently High?", published in SBP's Third Quarterly Report for FY19 on State of Pakistan's Economy.

[3] For details, see "A Roadmap for Stability, Growth, and Productive Employment, published by Government of Pakistan, Finance Division.

strong commitment from the provincial governments to support the fiscal consolidation efforts, bring the needed diversification in the revenue base, and gear themselves up to carry out effective public financial management to improve the quality of public spending.

Box 4.1 FBR's Recent Documentation Measures

Motivation behind the proposed measures

The FBR is actively working to reduce sales of registered businesses to unregistered enterprises/individuals. According to the revenue authority, the share of such transactions in the overall sales of registered enterprises was around 40 percent between July 2014 and March 2019. Furthermore, 50 percent of sales of 17 out of 35 sectors are made to unregistered buyers. The persistently high share of unregistered sales results in further expansion of the shadow economy, all the while hurting the revenue potential of the government authorities. It is also important to note here that, according to the FBR, only 41,484 persons registered for sales tax purposes are actually paying some tax with their returns. For reference, the total industrial electricity connections in the country are more than 300,000. This means that an overwhelming majority of the businesses are operating in the informal economy.

Introduction of the CNIC Condition

As part of the Finance Bill 2019, the federal government proposed an amendment in the Sales Tax Act of 1990. Initially, the registered persons were required to issue a serially numbered tax invoice at the time of the sale of goods. The invoices had to include the name, address and registration number of the supplier and recipient of the goods; the date of issue of the invoice; the description and quantity of goods; value of the sales tax applied; and the price inclusive and exclusive of the GST. According to the amendment, which was to become effective from 1st August, 2019 (but was later delayed), the requirements were elaborated further and the registered persons were instructed to record NIC number or NTN of the recipients unregistered with FBR for sales tax in addition to the details being recorded of the registered recipients. A relaxation from this clause was granted for sales up to Rs 50,000, provided that the recipient is an ordinary customer (i.e. a person who is buying goods for his or her own consumption and not for the purpose of reselling).

The amendment caused significant unrest in the market, with a majority of the businesses taking a stance against it. Protests were arranged by the associations across the country and the government was asked to abolish the CNIC restriction. However, much of the opposition against the reforms arose because of the misunderstanding about the announced measures. In this regard, the following points are important:

- **The CNIC/NTN condition only pertains to sales of businesses that are registered with FBR**. Those firms which are working informally do not need to ask for CNIC details from their purchasers, as they do not file tax returns. However, if those firms procure raw material from a registered firm, then they would have to provide the requisite CNIC details to the supplier.
- **The buyer does not have to be a registered person.** Registered firms can continue to transact with unregistered buyers; the only addition is that they would have to document the CNIC of the buyer in question.
- **Sellers only have to record the NTN/CNIC number on the invoice; physical copies of the identity cards are not required**. According to news reports, some businesses were fearing that they would have to keep photocopies of the recipients' CNIC for record purposes, stating that such a measure would unjustly increase their operating and storage costs. However, no such provision has been proposed in the Finance Act.
- **No action will be taken against the business if the CNIC/NTN details are found to be incorrect upon subsequent inspection**. The following provision is to be made part of the Sales Tax Act upon its revision: *"Provided also that if it is subsequently proved that CNIC provided by the purchaser was not correct, liability of tax or penalty shall not arise against the seller, in case of sale made in good faith."* It was later clarified that no action would be undertaken without the approval of the Chief Commissioner of the respective jurisdiction. Lastly, even if action against the seller is warranted, it would be taken only after necessary action has been taken against the person who provided the non-genuine CNIC. A further clarification released by FBR explained that the NIC/NTN of the buyer with respect to taxable supplies to an unregistered person shall be deemed to have been reported in good faith provided that:

(i) The tax invoice complies with the requirements ofsection 23(b) of the Act;
(ii) Payment made by or on behalf of the unregistered purchaser of the amount of the tax invoice, inclusive of sales tax and applicable further tax, is deposited into the supplier's declared business bank account;
(iii) The NIC provided by the purchaser is found authenticated by NADRA; and
(iv) The NIC/NTN provided is not of the employee of the seller or of his associates as defined under the Income Tax Ordinance, 2001.

- **The documentation clause would not result in the halt of purchasing by end-consumers**. This is because ordinary buyers are exempted from such a condition, provided that the value of their purchases is up to Rs 50,000.
- **The amendment would not result in any price hike**, given that no additional tax measures have been adopted under the Finance Bill 2019.
- **Sales tax filers feel that registered businesses have been unfairly tasked with the burden of identifying the non-filers**. According to FBR, if the documentation efforts are not expanded to identify those individuals that are not paying any taxes, then the tax burden on existing registered enterprises would continue to remain high.

- **The condition would not be enforced on small businesses in the cottage industry**. According to the revised definition followed by FBR, a cottage industry player is one that: does not have an industrial gas or electricity connection; is located in a residential area; does not have a total labor force of more than ten workers; and has an annual turnover from all supplies not exceeding two million rupees.

Conclusion

It is important to note that such structural reforms are unpopular in nature (and were thus delayed earlier) as these might increase businesses' transaction costs, create liquidity issues, and affect overall economic activity in the short term. In particular, the introduction of the CNIC condition for sales tax purposes has faced serious resistance (including threats of lockdowns and protests) from traders across the country. The FBR has since then issued clarification circulars and engaged with the businesses on various forums to help clarify the matters and take feedback. Therefore, it is important to build capacity within the FBR and to further digitize its functions to streamline procedures. Moreover, the authority needs to continue the dialogue with relevant stakeholders for ensuring smooth implementation of policies, and alleviate regulatory and policy mistrust.

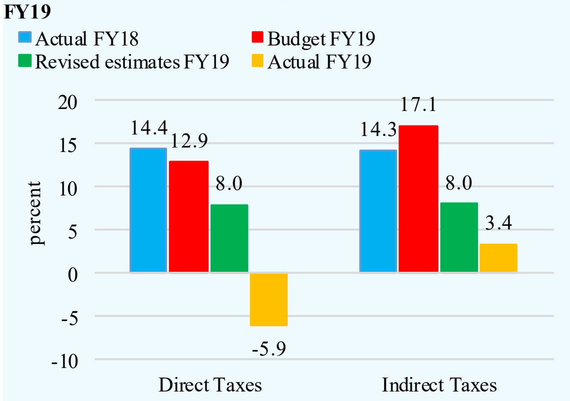
4.2 Revenues

Total revenues declined by 6.3 percent during FY19. This decline stemmed entirely from an unprecedented reduction in non-tax revenues during the year, which was attributed primarily to a sharp decline in transfer of SBP profits to the government. Tax revenues also stagnated as FBR's collection fell significantly short of the target set for the year. Provincial collection improved but its level still remains too low to make an impact.

Tax revenues

FY19 was an election year and fiscal targets were set much earlier (in April 2018), before the interim government took over. At this stage, the FBR had set a revenue target that showed an overall growth of 15.4 percent. Most of the improvement was envisaged in indirect taxes, whereas direct taxes were expected to grow modestly (**Figure 4.3**). According to budget documents, the FBR was expecting higher collection without any new tax measures; its estimates were based on: (i) the government's optimism with respect to the economic growth momentum – the budget committee had envisaged the real GDP growth for FY19 at 6.2 percent against initial estimate of 5.8 percent in FY18; (ii) expected success of the proposed tax reforms, including an improvement in tax base, better administration and compliance; (iii) the persistent impact of asset declaration and tax amnesty scheme and improved regulation of the real estate sector; and (iv) the positive revenue impact of import compression policies and the depreciation of Pak rupee.

Figure 4.3: Growth in FBR Targets and Actual Collection during FY19



Data source: Ministry of Finance

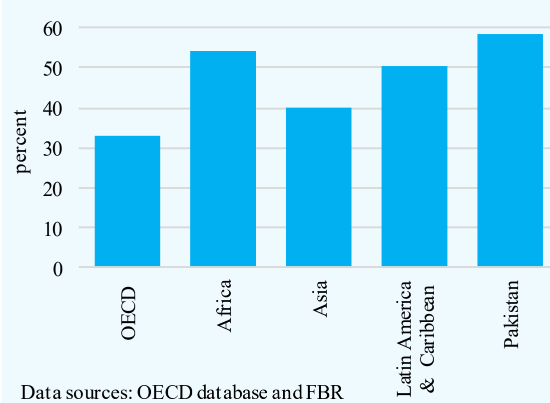
However, as the year progressed, nearly all the government's macroeconomic projections went off-track. Economic activity slowed down considerably right from the start of FY19 with the impact of regulatory and macroeconomic stabilization measures taking hold, and inflation surged more than the targeted 6 percent, necessitating a tighter monetary policy. Naturally with these trends, the overall revenue generation capacity of the economy weakened. Moreover, the revenue impact of tax measures and import compression policies also fell short of target. Making things more challenging, the government had to significantly lower tax rates on various petroleum products following the Court decision, and suspend withholding tax collection on mobile top-ups – these measure were taken in the first quarter. Given the fact that petroleum products constitute almost a third of the indirect tax collection, this decision severely dented the revenue mobilization.

Therefore, by the time the new government took over, achieving the revenue targets had already become quite challenging. The new fiscal managers came up with two supplementary budgets comprising of partial revision in income tax concessions, and the imposition of additional custom duties to compress imports and generate revenue. Moreover, realizing the growing revenue slippages, the government made downward revisions in the revenue targets. However, as things turned out, the supplementary measures proved insufficient and even the revised estimates could not be achieved (**Figure 4.3**). Indirect taxes slowed down considerably, whereas direct taxes declined. Compared to the revised estimates, FBR revenues fell short by Rs 321.5 billion, which turned out to be a major factor in the overall weak fiscal outcome and growing debt sustainability issues during the year.

The key takeaway from the revenue performance is to expedite documentation and taxation efforts, so that the revenues become more diversified and fiscal vulnerabilities be contained. Following points are important:

(i) There is an excessive reliance on indirect taxation in Pakistan, which makes the taxation system not only regressive, but also pro-cyclical (**Figure 4.4**). These taxes are very responsive to the economic activity, especially in the industrial sector. Therefore, any weakening in the industrial activity can have a more pronounced effect on their collection.[4] The composition of indirect taxes is also heavily skewed towards a few items. More than 30 percent of the collection comes from petroleum products, where revenues are very responsive to changes in global crude prices, domestic consumption, and regulatory changes in the tax rates.

Figure 4.4: Share of Indirect Taxes in Total Taxes across Various Regions



Data sources: OECD database and FBR

(ii) The composition of direct taxes is quite suboptimal reflecting lack of sufficient tax effort. The government relies heavily on withholding taxes, which downplays the role of revenue authorities. Furthermore, when these taxes are treated as final and are passed on to final consumers, they gain properties of indirect taxes. Despite a large tax machinery, comprising regional tax officers, nearly 64.1 percent of the income tax is collected via withholding agents such as banks, telecom companies, utility companies and car dealers. As for voluntary payments and collection on demand, their contribution is quite minimal. And even within the voluntary payments, around 90 percent collections are made in the form of advance tax; less than 10 percent comes through return filing.

Provincial authorities need to scale up their efforts in identifying their tax potential, devising adequate policies, and strengthening their capacities for implementation and collection. For instance, provincial tax authorities are responsible for collecting agriculture income tax, but so far they have been unable to devise a mechanism for collection. Similarly, anecdotal evidence suggests that there also exists a large potential for the collection of property income tax. If provincial authorities tap

[4] Qazi and Muhammad (2010) estimated Pakistan's tax buoyancy at 1.25 (Ahmed, Q. M., & Muhammad, S. D. (2010). Determinant of tax buoyancy: empirical evidence from developing countries. *European Journal of Social Sciences*, *13*(3), 408-418). Likewise, a study by IMF also estimated the short-term and long-term tax buoyancy for Pakistan i.e. 0.981 and 0.909, respectively (Dudine, P., & Jalles, J. T. (2018). How buoyant is the tax system? New evidence from a large heterogeneous panel. *Journal of International Development*, *30*(6), 961-991).

high-potential sectors, not only will they be able to reduce their dependence on the federal divisible pool, but will also diversify the revenue base across different sectors of the economy.[5]

Performance of FBR

Within FBR taxes, direct taxes declined by 5.9 percent during FY19 against a growth of 14.3 percent reported in FY18 **(Table 4.2)**. While voluntary payments fell the most, it was the decline in withholding taxes that pushed down the overall direct taxes.

The decline in WHT, having a share of nearly 65.0 percent in direct taxes, came from prominent reductions in the collection from salaries, contracts, cash withdrawals, and telephone. While collection from salaries took a hit from concessions on income tax granted in the FY19 budget, the decline in PSDP spending lowered the collection from contracts **(Table 4.3)**.

Voluntary payments, having a share of 25.7 percent in overall direct taxes, posted a steep YoY decline during FY19. Within voluntary payments, the downside push came from payments via return filing, which had seen an unusual increase last year when a large number of individuals took advantage of the asset declaration and tax amnesty scheme. Although a similar amnesty scheme was also introduced in FY19, its response seemed rather modest. Therefore, the share of collection via advance tax in total voluntary payments again reached 90 percent (**Figure 4.5**).

Collection on demand remained unchanged during FY19 compared to last year. The extension in the deadlines of e-filing during FY19 may have played a role in stagnation under this head.

Table 4.2: FBR Tax Collection

billion Rupees; growth in percent

			Growth	
	FY18	**FY19**	**FY18**	**FY19**
Direct taxes	1,536.6	1,445.5	14.3	-5.9
Indirect taxes	2,307.2	2,383.0	14.0	3.3
Customs duty	608.3	685.6	22.4	12.7
Sales tax	1,485.3	1,459.2	11.8	-1.8
FED	213.5	238.2	7.9	11.6
Total FBR taxes	**3,843.8**	**3,828.5**	**14.1**	**-0.4**
FBR taxes (% of GDP)	**11.2**	**9.9**		

Data source: Federal Board of Revenue

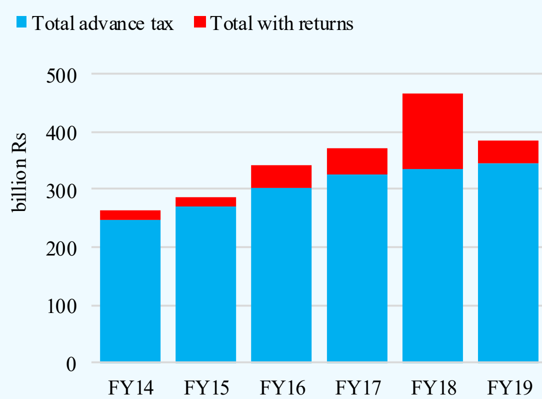
Table 4.3: Break-up of Direct Taxes

billion Rupees; growth in percent

			Growth	
	FY18	**FY19**	**FY18**	**FY19**
Voluntary payments	**467.0**	**384.7**	26.0	-17.6
Collection on demand	**102.9**	**102.9**	10.9	0.0
Withholding taxes	**1,046.9**	**960.7**	11.3	-8.2
of which				
Imports	218.7	221.8	11.0	1.4
Exports	28.3	34.4	16.6	21.8
Contracts	282.9	234.7	9.0	-17.0
Salary	133.4	76.4	19.9	-42.7
Interest & securities	45.6	58.1	7.2	27.4
Cash withdrawal	34.0	31.8	10.3	-6.6
Dividends	57.8	57.2	16.9	-1.2
Electric bills	33.8	35.6	30.9	5.1
Telephone	47.4	17.2	-8.5	-63.7

Data source: Federal Board of Revenue and SBP's calculations

Figure 4.5: Composition of Voluntary Payments



Data source: Federal Board of Revenue

[5] The provincial governments are made responsible for taxation of services, agriculture, and immovable property hence representing a significant share of economic activity and a substantial pool of potential tax revenues.
Reference: Cevik, S. (2018). Unlocking Pakistan's Revenue Potential. *South Asian Journal of Macroeconomics and Public Finance*, *7*(1), 17-36.

Sales tax

Sales tax collection declined by 1.8 percent during FY19 as compared to a growth of 11.8 percent during FY18. As mentioned before, the entire decline came from the POL segment, from which collections reduced by 16.9 percent for domestic sales and 16.2 percent for imported products on a YoY basis **(Table 4.4)**. While POL sales in value terms posted a 6.0 percent growth during the year, a steep reduction in sales tax rates on petroleum products during H1-FY19 led to a contraction in revenues (**Table 4.5**).

Meanwhile, collection from the cement sector contracted by 10.2 percent during FY19. Similar to last year, this decline was attributed to lower cement dispatches in the domestic market, primarily as the government further cut down its non-CPEC PSDP expenditures. Other than PSDP, factors like the increase in FED (from Rs 1.25/kg to Rs 1.50/kg), proposed limitations on the axle load (to counter overloading transport practice) and absence of any notable crackdown on cement smuggled from Iran, may also have dented domestic demand for cement in FY19.

Table 4.4: Sales Tax on Domestic and Import Stage

billion Rupees; growth in percent

			Growth	
	FY18	FY19	FY18	FY19
Domestic				
POL Products	299.1	248.5	32.4	-16.9
Cement	24.1	21.6	-18.9	-10.2
Aer. water/beverages	17.7	12.2	-5.5	-30.9
Cigarettes	20.5	23.1	16.9	12.6
Natural Gas	4.9	4.4	-58.0	-10.3
Others	294.8	354.5	-8.7	20.2
Imports				
POL Products	264.2	221.3	24.6	-16.2
Iron and Steel	68.3	69.6	23.5	1.8
Vehicles	66.8	63.0	25.9	-5.6
Plastic resins etc.	45.1	52.1	26.8	15.4
Organic Chemicals	17.6	20.2	31.0	14.9
Total Sales Tax	**1,485.3**	**1,459.2**	**11.8**	**-1.8**

Data source: Federal Board of Revenue

Table 4.5: Sales Tax Rate Applied on Major Petroleum Products

percent

Motor spirit excl. HOBC				High speed diesel			
FY18		FY19		FY18		FY19	
Effective from		***Effective from***		***Effective from***		***Effective from***	
1st July 2017	20.5	1st July 2018	17.0	1st July 2017	33.5	1st July 2018	31.0
1st Aug 2018	23.5	8th Jul 2018	12.0	1st Aug 2018	40	8th Jul 2018	24.0
6th Aug 2019	20.5	1st Aug 2018	9.5	6th Aug 2019	35.5	1st Aug 2018	22.0
1st Sep 2017	17.0	1st Oct 2018	4.5	1st Sep 2017	30	1st Oct 2018	17.5
1st Oct 2017	17.0	1st Nov 2018	4.5	1st Oct 2017	31	1st Nov 2018	12.0
1st Jan 2018	17.0	1st Dec 2018	8.0	1st Jan 2018	25.5	1st Dec 2018	13.0
1st Feb 2018	17.0	1st Jan 2019	17.0	1st Feb 2018	25.5	1st Jan 2019	17.0
1st Mar 2018	17.0	5th May 2019	12.0	1st Mar 2018	25.5	5th May 2019	17.0
1st Apr 2018	21.5	1st June 2019	13.0	1st Apr 2018	27.5	1st June 2019	13.0
1st May 2018	15.0			1st May 2018	27.5		
1st Jun 2018	7.0			1st Jun 2018	17		
12th Jun 2018	12.0			12th Jun 2018	24		

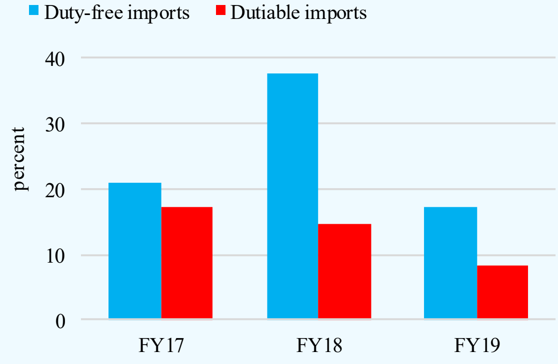
Data source: Federal Board of Revenue

Customs and Federal Excise Duties

The imposition of additional regulatory duties and PKR depreciation (which led to an increase in value terms of imports despite lower quantum) helped customs duties grow by 12.7 percent as compared to 22.4 percent last year. All the major drivers of custom duty collection recorded growth, with the exception of vehicles.

It is important to note that while the overall import values have increased, their growth has slowed down considerably compared to last year. Also, from revenue perspective, the structure of imports has been unfavorable: during the past 3 years, the growth in duty-free imports has outpaced the growth in dutiable imports (**Figure 4.6**). In FY19 also, this trend continued; even in absolute terms, the increase in duty-free imports was higher than the increase in dutiable imports, taking the share of duty-free imports to 32.6 percent in total imports during the year.

Figure 4.6: Trend in Import Growth with Respect to Custom Duty Collection



Data source: Federal Board of Revenue

FED collection also increased by 11.6 percent during FY19 compared to a 7.9 percent growth witnessed during FY18. However, a significant part of this collection was recovered from the cigarette industry following an upward revision in the rate of excise; excluding these revenues, FED growth dips to 0.6 percent during the year. This is in contrast to the situation in FY18, where the yearly growth in excise duties was 7.9 percent while FED excluding cigarettes had risen by 11.2 percent (**Table 4.6**). Collections under this head excluding cigarettes contracted during the second and third quarter on a YoY basis, on the back of subdued or declining collection from beverages, natural gas, vehicles and cement segments, indicating the overall slowdown in economic activity in the country.

Table 4.6: Impact of Outliers in Sales Tax and FED Collection
billion Rupees; growth in percent

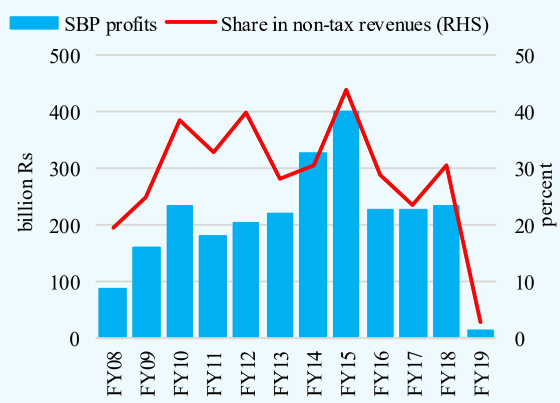
	Collections		Growth	
	FY18	**FY19**	**FY18**	**FY19**
Sales tax	**1,485.3**	**1,459.2**	11.8	-1.8
o/w POL products	563.2	469.8	28.6	-16.6
Total FED	213.5	238.2	7.9	11.6
o/w Cigarettes	67.1	91.0	1.2	35.5
Sales tax excl. POL	891.1	922.1	3.5	7.3
FED excl. cigarettes	131.6	146.4	11.2	0.6

Data source: Federal Board of Revenue

4.3 Non-tax Revenues

Non-tax revenue declined sharply during FY19, which is largely explained by a steep decline in SBP profits (**Table 4.7**). It is important to note that SBP profits have lately become an important revenue source for the government, as these have constituted nearly one third of non-tax revenues over the past 5 years **(Figure 4.7)**. Since mark-up earned on government debt constitutes the bulk of central bank's earnings, the transfer of SBP profit effectively represents a partial reimbursement of interest payments. In FY19, however, the profit of SBP took a steep plunge as it incurred heavy exchange rate losses on external liabilities.

Figure 4.7: Trends of SBP Profits in Non-Tax Revenue



Data sources: Ministry of Finance and SBP calculations

Moreover, the decline in PSDP spending for two consecutive years (which involves government's lending to public sector institutions), led to lower mark-up payments from PSEs. Most of the decline was visible in collections from National Highway Authority, Wapda, Discos, and Chashma Nuclear Power Plant. The cumulative decline in revenue from these sources more than offset the higher collections from energy-related components of non-tax revenues, including royalties on gas and oil, discount retained on crude oil and other levies (**Table 4.7**). The increase in these revenues mainly stemmed from a rise in rupee value of crude oil.

Table 4.7: Non-tax Revenues
billion Rupees

	Actual	
	FY18	**FY19**
Mark-up (PSEs & others)	87.8	35.7
Dividends	57.5	60.2
SBP profits	233.2	12.5
Defence	12.8	15.6
Royalties on gas & oil	58.2	87.9
Profits Post Office Dept./PTA	15.9	18.2
Passport & other fees	15.9	23.0
Discount retained on crude oil	9.1	14.0
Windfall levy against crude oil	3.9	7.7
Petroleum levy on LPG	2.1	3.7
Other	264.5	148.7
Total non-tax revenue	**760.9**	**427.3**

Data source: Ministry of Finance

4.4 Expenditures

Even with a steep decline in development spending, total spending grew by 11.3 percent during FY19. The major push came from current expenditures, which grew by 21.3 percent on top of 12.6 percent growth last year **(Table 4.8)**.

Current expenditures

The growth in current expenditures accelerated mainly due to higher interest payments (up by 39.4 percent), primarily attributed to increase in domestic interest rates. Mark-up payments on external debt also increased, but their level remained quite low. Importantly, the government had initially envisaged the debt servicing target that represented an increase of only 6.2 percent over FY18. Given the projected trajectory of inflation and interest rates and the growth in size of public debt stock last year (revised estimates), the government had clearly underestimated the increase in debt servicing for FY19. It was not before March 2019, when the government made significant upward revision in interest payments; however, it was too late by then to devise a counter strategy. The overall mark-up payments during FY19 were 29.1 percent higher compared to expense targeted in the Budget 2018-19. The resultant fiscal stress can be seen from the fact that interest payments alone ate up nearly 55 percent of the total FBR's taxes during FY19.

Table 4.8: Fiscal Spending
billion Rupees; growth in percent

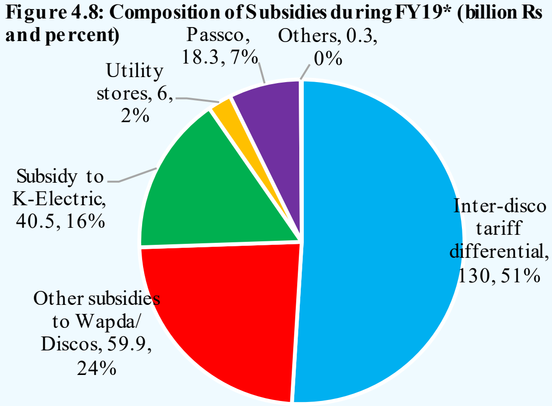
	FY18	**FY19**	**Abs. change**	**Growth**	
				FY18	**FY19**
Current expenditures	**5,854.3**	**7,104.0**	**1,249.8**	**12.6**	**21.3**
Federal	3,789.8	4,776.2	986.4	9.1	26.0
of which					
Interest payments	1,499.9	2,091.1	591.2	11.2	39.4
(i) Domestic	1,322.6	1,820.8	498.2	8.4	37.7
(ii) Foreign	177.3	270.3	93.0	38.3	52.5
Defence	1,030.4	1,146.8	116.4	16.0	11.3
Public order and safety	124.7	171.6	46.9	-2.5	37.6
Others	1134.8	1,366.6	231.9	2.4	20.4
Provincial	2,064.5	2,327.9	263.4	19.6	12.8
Development expenditures	**1,584.1**	**1,178.4**	**-405.6**	**-6.5**	**-25.6**
PSDP	1,456.2	1,008.2	-448.0	-7.7	-30.8
Others (including BISP)	127.8	170.2	42.4	10.4	33.2
Net lending	37.6	40.8	3.1	-393.6	8.3
Total Expenditure*	**7,475.9**	**8,323.2**	**8,47.3**	**8.7**	**11.3**

* Excluding statistical discrepancy
Data sources: Ministry of Finance and SBP calculations

The second big item within the current expenditures was defence, which showed an increase of 11.3 percent compared to last year. The entire increase was recorded in the first three quarters, as there was a YoY decline in defence spending during the fourth quarter. Moreover, the overall defence spending was largely aligned with the targeted spending for the year.

In contrast, subsidy expenditure exceeded the target set for the year by a wide margin. The overall subsidy expenditure increased by 72.8 percent during the year (revised estimates), which mainly represented the government's reluctance to pass on the full impact of financial weaknesses of power generation and distribution to end-consumers (**Figure 4.8**). The overall power generation cost continued to increase in FY19 both due to a rise in capacity payments as well as continued thermal generation from inefficient plants.[6] At the distribution end, Discos were unable to meaningfully control their transmission and distribution losses, and improve recoveries. Therefore, while some increase in power tariffs was allowed during the year to alleviate the fiscal burden, the government continued to compensate for most of the financial challenges faced by institutions across the energy value-chain. It is also noteworthy that subsidies only represent a part of energy sector weaknesses; a big chunk is also accumulated as quasi-fiscal expense in the form of circular debt.

Figure 4.8: Composition of Subsidies during FY19* (billion Rs and percent)



*Revised estimates for FY19
Data source: Budget in Brief (FY20)

Development expenditure
Development spending sharply declined by 25.6 percent as compared to a reduction of 6.5 percent during last year. The steeper decline in development expenditure owes to a sharp reduction in PSDP spending both at the federal and provincial fronts.

The federal development expenditures shrank by 12.9 percent as compared to a 20.6 percent decline last year. Within the development expenditures, a marked weakening was recorded in PSDP expenditures, which after growing at a double-digit pace from FY14 till FY17, dropped for the second consecutive year. Importantly, while the decline in PSDP expenditure in FY18 was primarily attributed to establishment of interim government and pre-election moratorium on PSDP releases during the fourth quarter, the decline in FY19 was spread out across all quarters.

Here, it is worth mentioning that despite a reduction in federal PSDP during FY19, the spending on CPEC-related PSDP projects remained robust. More specifically, spending on some projects including the Peshawar-Karachi motorway (Sukkur-Multan section), KKH Phase-II Havelian-Thakot, and the motorway from Burhan-Hakla on M-I to Dera Ismail Khan increased considerably. Taken together, these three infrastructure projects constituted more than 60 percent of total CPEC-related spending during FY19.

Within non-PSDP development expenditure, expenditure on BISP, one of the biggest social safety nets, expanded by 5.0 percent to Rs 118.7 billion as compared to a growth of 1.4 percent in FY18. This growth was contained in comparison with the previous years (the growth rates in FY16 and

[6] Source: Special Section 1: "Why are Power Tariffs in Pakistan Consistently High?", SBP's Third Quarterly Report for FY19 on The State of Pakistan's Economy.

FY17 were 11.1 and 9.3 percent, respectively), reflecting the impact of fiscal tightening on development expenditure.

4.5 Provincial Fiscal Operations

The provinces adhered to a better fiscal discipline and posted a combined surplus of Rs 190.0 billion during FY19, compared to a deficit of Rs 17.5 billion recorded last year. The main contribution came from Punjab, which provided a record-high surplus during the year. While the other three provinces also recorded surpluses, their contribution was not sufficient to meet the target of Rs 285.6 billion for the year **(Table 4.9)**.

Table 4.9: Provincial Fiscal Operations

billion Rupees

	Punjab	Sindh	KP	Balochistan	Total	Growth
FY19						
A. Total Revenue (i+ii+iii)	1421.2	820.6	489.2	264.9	2995.9	2.0
(i) Provincial share in federal revenue	1167.4	599.7	393.0	237.6	2397.8	8.1
(ii) Provincial Revenue (I+II)	232.4	187.4	50.8	17.5	488.1	-10.9
I. Taxes	192.6	177.9	19.8	11.5	401.8	0.1
II. Non-tax revenue	39.7	9.4	31.0	6.1	86.3	-41.2
(iii) Federal loans and transfers	21.4	33.5	45.4	9.7	110.0	-36.4
B. Total expenditure	1372.4	765.0	472.1	247.6	2857.0	-3.5
Current**	1129.8	656.7	358.3	206.0	2350.8	13.0
Development	242.5	108.3	113.8	41.6	506.2	-42.5
Gap (A-B)	48.8	55.6	17.1	17.3	138.9	-720.8
Financing* (overall balance)	**-122.3**	**-42.1**	**-6.6**	**-19.1**	**-190.0**	**-1183.7**
FY18						
A. Total Revenue (i+ii+iii)	1,412.0	802.8	481.5	242.3	2,938.5	21.0
(i) Provincial share in federal revenue	1,078.8	562.3	363.5	212.9	2,217.4	12.8
(ii) Provincial Revenue (I+II)	259.1	192.7	82.2	14.0	548.1	36.6
I. Taxes	197.5	176.1	18.3	9.4	401.4	24.7
II. Non-tax revenue	61.6	16.6	63.9	4.6	146.7	84.5
(iii) Federal loans and transfers	74.1	47.8	35.8	15.3	173.0	182.9
B. Total expenditure	1,418.6	845.1	447.1	250.1	2,960.9	14.3
Current**	948.8	619.7	329.7	182.5	2,080.7	19.6
Development	469.8	225.4	117.4	67.6	880.1	3.3
Gap (A-B)	-6.6	-42.3	34.4	-7.8	-22.4	-86.3
Financing* (overall balance)	**17.4**	**34.7**	**-10.1**	**-24.4**	**17.5**	**10.5**

*Negative sign in financing means surplus. ** Current expenditure data may not match with those given in Table 4.8 as numbers reported here include the markup payments to federal government.

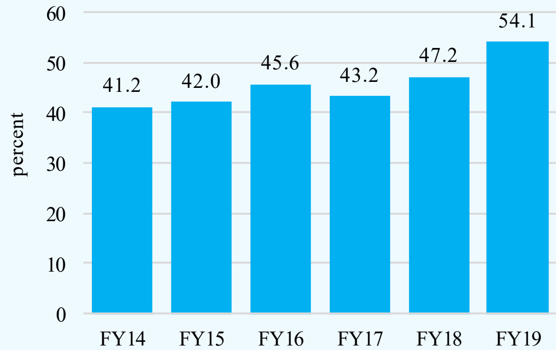
Data source: Ministry of Finance and SBP calculations

Provincial revenues

Despite the fact that the federal government collected less revenue during FY19, it was able to transfer 8.1 percent more funds to provinces from the divisible pool (**Figure 4.9**). However, this increase was largely offset by a decline in the provinces' own revenue collection and lower receipts of development loans and transfers from the federal government. As a result, total provincial revenues grew by only 2.0 percent during FY19 as compared to 21.0 percent growth recorded last year.

The provincial own revenue collection declined by 10.9 percent as compared to a growth of 36.6 registered last year. This decline was mainly attributed to a sharp reduction in provincial *non-tax* revenues, reflecting delays in payments against profits from hydroelectricity from federal to provincial bodies. Compared to Rs 61.3 billion transferred last year, profit from hydroelectricity stood at only Rs 21.1 billion in FY19, despite the fact that hydel generation was 14.6 percent higher compared to last year. Khyber Pakhtunkhwa was affected the most since these profits are a major revenue source for the province. It is important to note that presently, an interim arrangement is at work between the federal and KP governments, according to which a notional fixed rate of Rs 1.1 per kWh (indexed at 5 percent per annum) is being charged from power consumers to generate funds to transfer net hydel profits. However, due to liquidity constraints, the federal government was unable to pass the collected funds to the provincial governments.

Figure 4.9: Share of Resources Transferred to Provinces in Gross Revenue Receipts of the Federal Government

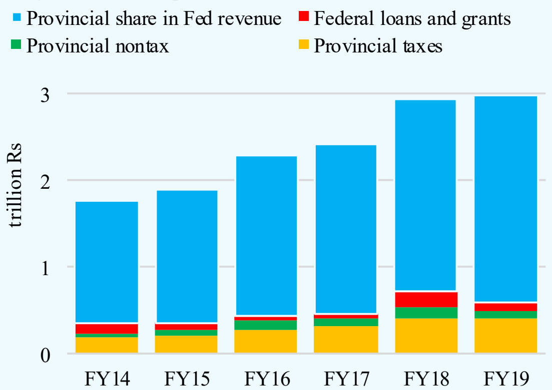


Data source: Ministry of Finance

In contrast, the provincial tax revenues grew by a meagre 0.1 percent during FY19 as compared to 24.7 percent increase recorded last year. This stagnation was explained by a sharp 9.4 percent decline in collections from General Sales Tax on Services (GSTS), which more than offset healthy collections against stamp duties, property taxes, excise duties and other sources. The decline in GSTS probably stemmed from an overall deceleration in the services sector growth during the year.

While the slowdown in the provinces' own revenue collection in FY19 could be linked to overall weak growth momentum, the performance of provincial governments in general has not been impressive since the introduction of the 18th Amendment. It was expected that over time, the provinces will enhance their capacity to collect taxes by modifying their institutional structures and reduce their dependence on federal transfers. Despite the fact that all provinces have dedicated institutions to mobilize revenues, they are still overly reliant on federal transfers (both from the divisible pool as well as development loans and transfers) (**Figure 4.10**). Importantly, these institutions are responsible to collect sales tax on the largest sector of Pakistan's economy, i.e. services, and collect income tax from the agriculture sector. The provincial governments have failed to put in place a workable strategy to improve collection.

Figure 4.10: Composition of Provincial Revenue Base



Data source: Ministry of Finance

At first, it is important to understand that the process of devolution itself is incomplete, as the financial autonomy to raise and spend revenues has not spread out to district levels. This limits the potential of revenue mobilization and also compromises the spending quality. From revenue point of view, there appears to exist an excess fragmentation of agencies within the provincial governments, which complicates the taxation mechanism: (i) the Excise and Taxation Departments, which collect the urban immovable property tax, the tax on professions, the motor vehicle tax, and provincial excises; (ii) the Boards of Revenue, which collect the agriculture income tax, land taxes, stamp duty and other taxes on property transactions; and (iii) the revenue authorities that collect the GSTS (Sindh Revenue Board, Punjab Revenue Authority, KP Revenue Authority, and the Balochistan Revenue Authority). These institutions are responsible for implementing the policies devised by the provincial finance ministries. All these institutions need to be integrated in order to improve efficiency and make it more convenient for taxpayers.

The provincial governments should also rationalize the incentive structures in these agencies as no serious tax effort is observed on their part so far; these agencies are still relying only on an old tax base that include property taxes, stamp duties and/or motor vehicle tax, and are struggling to tap high-potential sectors.[7] Capacity issues also exist, especially with respect to the collection of the agriculture income tax, which is collected either in the form of a tax on net income, or on land holding, whichever is higher. Lower collection under this head basically represents difficulties in assessing net agriculture income, and identifying individuals with net incomes above the threshold level. Therefore, whatever revenue is collected from agriculture, is based on landholding. As for the services, it appears that the informal nature of a large number of services concerns hinders in collections. Furthermore, due to differences in the GST structure and rates on services between provinces, the taxation mechanism gets very complicated for firms that operate across the country.

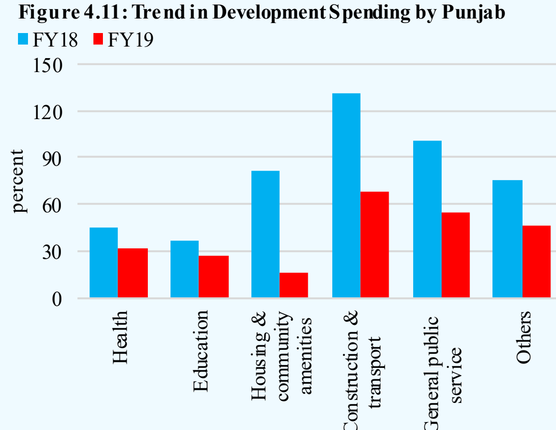
Here, it is important to highlight that agriculture and services, despite having 74.4 percent share in Pakistan's GDP, contribute negligibly to tax collection.[8] Therefore, the provincial governments have a more crucial role to play when it comes to improving the country's tax-to-GDP ratio, expand and diversify the revenue base, and tap revenue resources equitably. These governments have the constitutional authority; all they need is a serious commitment to support the sustainable growth objective, and strengthen their institutions with technical specialization of their staff and systems.

Provincial Expenditures

On the expenditure side, the provinces registered a decline of 3.5 percent during FY19 as compared to an increase of 14.3 percent recorded last year. This decline reflects the provincial governments' efforts to create surpluses to support the fiscal consolidation efforts. Punjab and Sindh tightened their belts more than the other two provinces because they had recorded large deficits last year, and had committed to contributing high surpluses in FY19. However, the entire expenditure control was observed in development spending, as current spending of the provincial governments grew by 13.0 percent during the year.

In the case of Punjab, the targeted development spending was set at half the level recorded in FY18. The government attributed this large cut to the sharp increase in operational expenses related to projects completed in recent years; large scale recruitment over the past few years; and the deferral of funding for subsidies relating to commodity operations and pension liabilities. The envisaged expenditure control was spread out across all the sectors including infrastructure, transport services, education and health **(Figure 4.11)**. While the government achieved its target on the whole, some across-the-sector variations were observed that reflected provincial priorities (**Figure 4.12**). For instance, the government had

Figure 4.11: Trend in Development Spending by Punjab



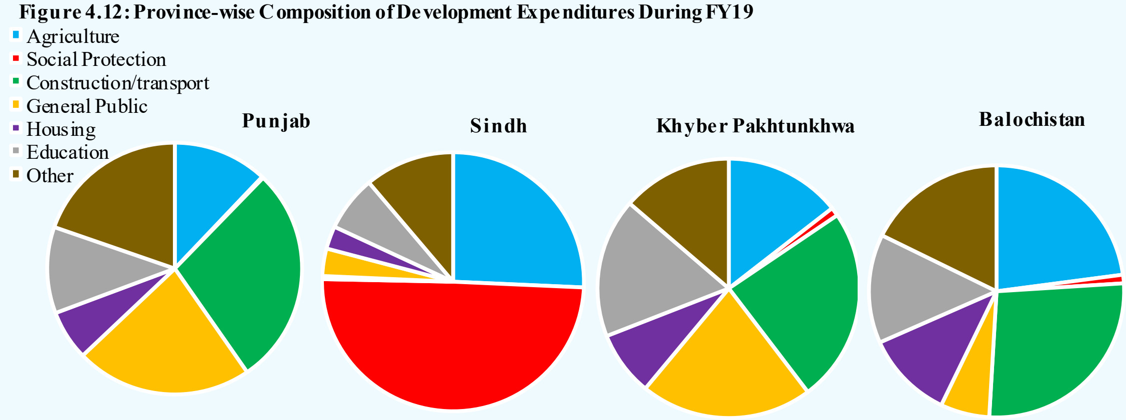
Data source: Ministry of Finance

[7] For instance, in the case of Sindh, 22 percent is collected from six sources: stamp duty, capital value tax, provincial excise duty, motor vehicle tax, property transfer tax, and urban immovable property tax. Source: Sindh Public Expenditure Review, World Bank (2016)

[8] On average, provincial own revenue (provincial tax and non-tax) contributed 1.0 percent of GDP since FY10 (Source: Ministry of Finance)

envisaged the steepest cut in expenditures on construction and transport in the Budget 2019 compared to last year; however, the actual spending was even less. On the contrary, Punjab's spending on education, health and public order and safety was according to the target.

Figure 4.12: Province-wise Composition of Development Expenditures During FY19



Data source: Ministry of Finance

In contrast, Sindh's target of achieving 11.8 percent growth in its development expenditures during FY19 seemed a little out of sync with the consolidation efforts. However, its actual spending stood at only 43.0 percent of the budgeted expenditures. Importantly, Sindh received higher transfers from the government during the year (divisible pool and development loans/grants combined), but the austerity objectives and uncertainty associated with the timing of these transfers did not allow the provincial government to spend according to its plan. Capacity issues with respect to project implementation, overall slow pace of execution of development schemes and delays in the approval of new projects, also led to the government's contained spending. Furthermore, it must be noted that the development outlay of Sindh government stands out among all the provincial governments for its heavy inclination towards two sectors: social spending and agriculture. The share of infrastructure development and transport is not even 1 percent of its development spending; other provinces allocate on average at least a quarter of their development spending outlay for these two sectors. In absolute terms, the province spent less than Rs 500 million on construction and transport. Given the state of infrastructure and public transport in the province, even in its major urban centers, the provincial government needs to reshape its development spending portfolio.

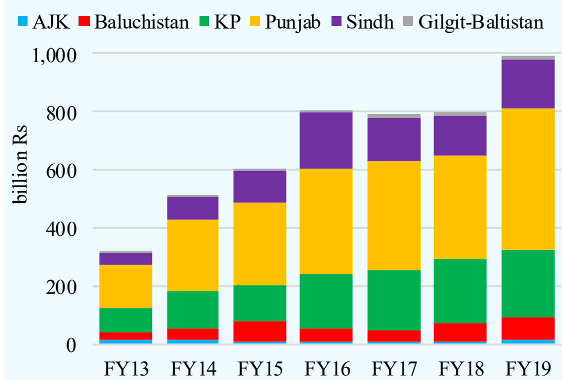
KP had also allocated a higher budget for development spending during FY19, but ended up spending 69 percent of it. Nonetheless, KP turned out to be the only province which was able to maintain the level of its development spending to a large extent. Importantly, out of the actual spending under its Annual Development Plan for the year, the bulk of the improvement was visible in district-level spending, which posted a three-time increase over last year; development spending of the provincial government (excluding foreign project assistance) actually fell during the year. As a result, the share of district-level spending in the total development plan increased from 13.5 percent in FY18, to 17.7 percent in FY19. Another important aspect which singled out KP from the rest of the provinces was the large volume of foreign assistance it received. Over 30 percent of its development projects were financed via foreign project loans, which included Rs 30 billion assistance from the Asian Development Bank; these funds were mainly spent on Peshawar Mass Transit, rehabilitation of roads, and construction of micro-hydroelectric power plants on rivers and tributeries. In addition to loans, foreign grants worth Rs 24.0 billion also supported development works in the province. Within these, the UK/DFID's spending on up-gradation of healthcare facilities and education infrastructure were the most prominent.

Finally, in case of Balochistan, the development spending outlay envisaged in the budget for FY19 was 30.5 percent higher than the spending in FY18. However, only 47 percent of the targeted development spending was realized during the year, with construction and transport recording the highest volume of underspending. On a year-on-year basis, nearly all the expenditure heads posted a decline, except for education. The Balochistan government did not compromise on this sector keeping in view the challenging state of education in the province compared to the other provinces.[9]

From the analysis of provincial development expenditures, two important trends can be identified: first, all the provinces curtailed their expenditures on transport and construction sectors. While these areas are important from the perspective of improving infrastructure in the economy, a temporary compromise can be made for initiating new projects, especially to create room for other important expenditures of social importance. The only concern is with respect to delays in the ongoing projects. For instance, the ongoing bus rapid transit projects in Sindh, Punjab and KP have all missed their completion deadlines (for reasons ranging from insufficient funds to implementation capacities), and reportedly this delay is partly responsible for an increase in project costs. Second, despite heavy cuts in infrastructure spending, all the provinces have struggled to scale up their spending on education and health. It is important to recall here that after the 18th Amendment, spending on these areas is the responsibility of the provincial governments. The federal government transfers over half of its revenues to provinces and can hardly meet its expenditures on debt servicing, defence and other important expenses. However, due to capacity issues and weak provincial revenue collection, the provincial governments have been underspending in these important areas; spending on education currently stands at only 2.4 percent of GDP, whereas spending on health is not even 1 percent. These numbers put Pakistan at a disadvantageous position when compared with 3.4 and 3.6 percent, respectively, for South Asia.[10]

Here it is also important to mention that the provinces are required to show fiscal surpluses to keep the consolidated fiscal deficit under check. Therefore, they had been underutilizing the resources coming from the divisible pool during the past few years, and depositing the excess funds with the banking system. As shown in **Figure 4.13**, the overall deposits of provincial governments have consistently been increasing over the past few years, and touched Rs 1.0 trillion by end-FY19. Putting this in perspective, this amount is even higher than the consolidated development expenditures incurred by the provinces during the year.

Figure 4.13: Deposits of Provincial Governments with Banking System



Data source: State Bank of Pakistan

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[9] The literacy rate in the province at around 41 percent is much lower than the literacy rates in Punjab, Sindh and Khyber Pakhtunkhwa (at 62 percent, 55 percent and 53 percent respectively). Source: Balochistan White Paper for FY19.

[10] The average government expenditure on education and health portfolios (as a percent of GDP) was 3.4 percent (2017) and 3.6 percent (2016) respectively for South Asia. Source: World Development Indicators