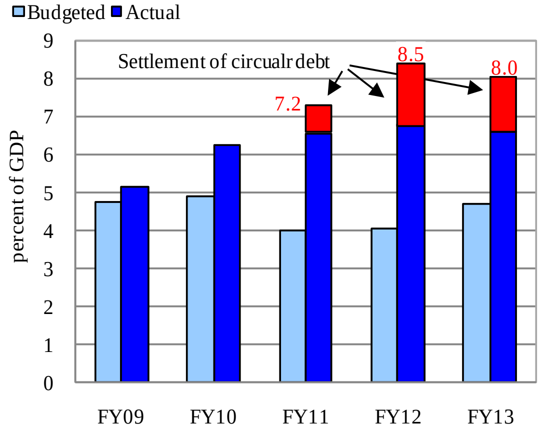
5 Fiscal Policy

5.1 Overview

The budget deficit target was missed yet again in FY13. Though this has now become more or less a norm, FY13 was the second year in a row when the actual gap diverged from the target by such a wide margin (**Figure 5.1**). More specifically, against a target of 4.7 percent, the realized deficit was 8.0 percent of GDP. Moreover, similar to the previous year, a large part of the fiscal slippage was due to a heavy payment for the resolution of the circular debt that was not initially budgeted for. Excluding these payments, the budget deficit for FY13 declines to 6.6 percent of GDP, slightly lower than the 6.8 percent deficit recorded in FY12. Furthermore, the fiscal deficit exceeded the target despite an inflow of Rs 180.4 billion under Coalition Support Fund (CSF), which counted directly as government revenues during FY13.[1]

Figure 5.1: Fiscal Deficit



Source: Minstry of Finance

A cursory look at the projected and realized FY13 budget shows that revenues fell short of target, whereas expenses exceeded their budgetary allocations (**Table 5.1**). The deviation from initial estimates was largely on account of three factors: (1) underestimation of subsidies; (2) underestimation of interest payments; and (3) overestimation of FBR tax revenue.

Table 5.1: Budgeted and Actual Estimates for FY13
billion Rupees

	Budget	Actual
Total revenues	**3,376.0**	**2,982.4**
Tax	**2,626.0**	**2,199.2**
FBR	2,381.0	1,936.1
Non-Tax	**750.0**	**783.2**
Total expenditures	**4,480.0**	**4,816.3**
Current expenditures	**3,430.0**	**3,660.4**
Interest	925.8	991.0
Others	1,686.2	2,669.5
Subsidies*	208.6	367.5
Development expenditures	**1,050.0**	**777.1**
PSDP	873.0	695.1
Net lending (includes Rs 322.2 bln for settlement of CD)*		362.8
Memorandum items:		
Provincial surplus	79.5	52.7
Bank borrowing	484	1,457.5

* 2013-14 Budget in brief.
Source: Data on Government Fiscal operations. MOF website:

Underestimation of subsidies: For FY13, the fiscal authorities had set aside Rs 208.6 billion for subsidies; most of this was related to the power sector. The federal government, however, used around 80.0 percent of this allocation halfway through FY13. In total, the government ended up spending Rs 671.4 billion on the power sector *alone* during the year (i.e., more than thrice the budgeted amount).[2] This included Rs 322.2 billion for the settlement of the circular debt, while most of the remaining amount was the inter-discos tariff differential.[3] In addition to subsidies and the settlement of circular debt, the government also made transfer payments worth Rs 334.6 billion in FY13 (against Rs 277.7 billion in FY12), which included grants to Pakistan Railways (Rs 33.4

[1] Pakistan did not receive any amount under coalition support fund in FY12.
[2] The actual subsidies to power sector in FY12 were also high at Rs 464.3 billion, i.e., more than threefold of the budgeted amount of Rs 147.3 billion.
[3] The government applies uniform tariff across all the discos, despite wide variation in their cost of services. The resulting gap in revenues is financed by the tariff differential subsidy that the government allocates to each disco.

billion), and Pakistan Steel (Rs 2.0 billion). Collectively, the three heads, i.e., subsides, transfers and current investment, contributed almost a third of overall expenditures.

Untargeted subsidies and inefficient PSEs are a major drain on government resources.[4] A country, which is borrowing to pay its debt servicing, cannot afford spending this much on subsidies and transfers. As we have shown in **Chapter 3**, untargeted subsides in the power sector benefit large consumers, who can easily do without subsidies. In Pakistan, indirect taxes and blanket subsidies benefit the affluent class, instead of the more deserving segments of society.[5] Any serious effort to reign in the fiscal deficit, should start by phasing out blanket subsidies and enlarging the tax base.

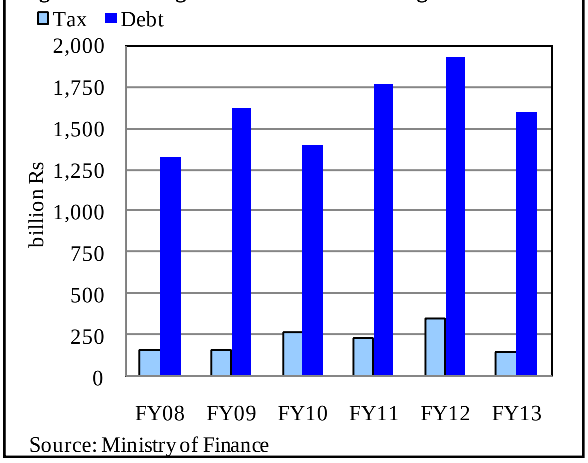
Underestimation of interest payments: In line with the initial 4.7 percent fiscal deficit target for FY13, the fiscal authorities anticipated interest payments of Rs 846 billion on domestic debt. However, as the deficit climbed and external financing remained scarce, reliance on bank borrowings increased sharply. Specifically, against the initial estimate of Rs 483.8 billion, the government *actually* borrowed Rs 1,508.5 billion from the banking system, primarily via short-term T-bills.[6] Consequently, interest payments on domestic debt reached Rs 910 billion (a YoY increase of 11.4 percent over target) during FY13 – accounting for a third of total revenues.

Overestimation of FBR revenue: FBR taxes were set to grow by 26.4 percent during FY13. Given the structural bottlenecks in the taxation system, this was a tall order in the best of times; with the economy already sluggish, this was made all the more difficult. To make matters worse, a number of proposals made in the FY13 budget to increase tax revenues, could not get parliamentary approval.[7] As a result, FBR revenue targets were revised downward a number of times during FY13,[8] but still FBR failed to achieve its revised target.

Actual tax collection by FBR was Rs 1,936.1 billion, which was only 3.0 percent over what was collected in the previous year. Given that FBR has not been able to achieve more than 21 percent growth in revenues during the previous ten years, the 27.8 percent growth in target envisaged for FY14, seems to be optimistic, which implies a replay of the fiscal problem this year.

Despite obvious problems in the taxation system in Pakistan, there appears to be a lack of willingness on the part of the authorities to take decisive action to resolve long standing issues. Successive governments have conceded to pressure groups, and instead of trying to tax the untaxed, have opted either for regressive indirect taxation or taking on more debt. This situation is clearly unsustainable. To put this in perspective, while tax revenues have increased by Rs 218 billion per year on average during the last five years, debt has increased by Rs 1.6 trillion per

Figure 5.2: Change in Tax Revenue vs Change in Public Debt



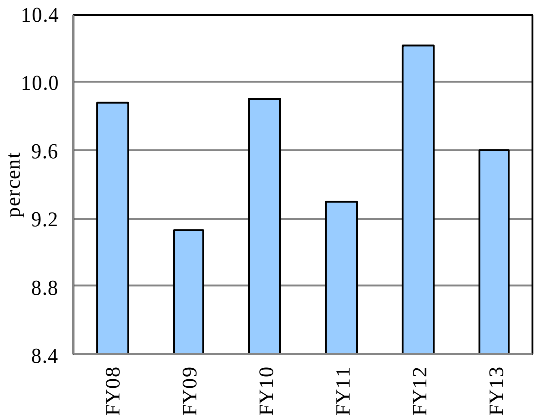
Source: Ministry of Finance

[4] Combined losses of PIAC, PR and PSMC, which were Rs 70.3 billion in FY11, exceeded Rs 85.0 billion in FY12 as per latest available financial statements of these corporations.
[5] During FY11 to FY13, while government paid around Rs 1.2 trillion to WAPDA, PEPCO and KESC, it spent only Rs 143.0 million on BISP.
[6] This is based on fiscal operations data, released by the Ministry of Finance, and does not necessarily match with Monetary Survey data shown in **Chapter 4**.
[7] For instance, income tax amnesty bill.
[8] The initial revenue target for FBR was Rs 2,381 billion. Government downward revised this target to Rs 2,191 billion halfway through the year, and further to Rs 2,007 billion towards the end of the FY13.

annum over the same period (**Figure 5.2**). Consequently Pakistan's total public debt has increased from 59.4 percent of GDP to 63.3 percent in last five years (**Chapter 6**).[9]

As things stand, Pakistan not only has one of the lowest tax-to-GDP ratios in the world, but one that is around 10 percent for the past several years (**Figure 5.3**). In our view, the country's economic problems cannot be resolved without bringing the fiscal house in order, for which a significant improvement in the tax regime is a prerequisite. The reluctance to take up measures to broaden the tax-base, encourages the informal economy that is already substantial and growing.[10] As the informal sector grows, it becomes increasingly difficult to improve tax revenue without further burdening those who are already paying (i.e., the captive payers)

Figure 5.3: Tax-GDP Ratio



Source: Minstry of Finance

5.2 Revenues

Although revenues increased by 16.2 percent in FY13, a major part of this increase came from the rise in the non-tax revenues, chiefly, Coalition Support Fund and SBP profit.[11] Growth in taxes, on the other hand, recorded a significant slowdown during FY13. Even this small growth in the tax revenues owed almost entirely to rise in indirect taxes (**Table 5.2**).

Table 5.2: Consolidated Revenues
amount in billions Rupees, growth and shares in percent

			Growth		Share in
	FY12	FY13	FY12	FY13	FY13
Total (A+B)	**2,566.5**	**2,982.4**	**13.9**	**16.2**	**100.0**
A-Tax	**2,052.9**	**2,199.2**	**20.8**	**7.1**	**73.7**
Direct	731.9	735.8	23.1	0.5	24.7
Indirect	1,320.9	1,463.5	19.6	10.8	49.1
B-Non-	**513.6**	**783.2**	**-7.2**	**52.5**	**26.3**

Source: Ministry of Finance, data on fiscal operations

Indirect taxes are universally considered regressive; however, ease in their collection makes them indispensable. In Pakistan, 60-70 percent of the increase in the tax revenues during last six years has been realized through rise in the indirect taxes. As a result, people with small incomes are burdened relatively more than those having higher incomes. Persistence of this situation would gradually reduce capacity to generate incremental taxes, as is happening in Pakistan. Indeed, the incidence of indirect taxes has reached to an extent where it now forms a significant part of the final price of products, especially in the case of fuel, public utilities and telecommunication services.[12] This makes tax reforms all the more important.

As far as distribution of tax revenues is concerned, the slowdown was more pronounced in case of federal government. This is because, an increasingly autonomous provinces, are now claiming a greater portion of the resource pool. Specifically, Sindh and Punjab took on the responsibility of

[9] For detailed discussion on Pakistan's debt profile, see **Chapter 6**.
[10] Shadow Economies All over the World: New Estimates for 162 Countries from 1999 to 2007. *Friedrich Schneider, Andreas Buehn, Claudio E. Montenegro.* The World Bank Development Research Group WPS5356. July 2010.
[11] Nominal revenues grew by 16.2 percent in FY13, compared to the past decade average of 14.2 percent. In real terms (i.e., adjusted for inflation using GDP deflator at base prices), FY13 revenue growth was 8.7 percent, against the average of 3.5 percent during the period FY03-FY12.
[12] According to our estimates, around 26 percent of the petrol price and 36 percent of the mobile phone charges are government taxes.

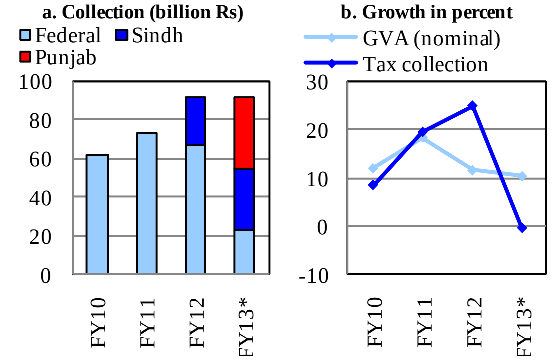
collecting sales tax on services.[13,14] While this reduced FBR tax collection, tax revenues of the provinces recorded a healthy growth of 40.6 percent during FY13; claiming 6.8 percent share in the national resource pool, compared to 5.2 percent last year.

While the decentralization of sales tax collection may not affect overall revenues, this has reduced revenues generated by FBR. Specifically, share of sales tax on services in FBR sales tax declined to 3.4 percent in FY13 from previous three year average of 6.3 percent.[15] The relative importance of the federal exchequer is likely to decline as provinces exercise greater autonomy.[16] However, devolving tax collection would have been more effective if provincial authorities had geared up their capacity to collect taxes on services (**Box 5.1**).

Box 5.1: Are Provinces More Efficient at Taxing Services?

Although services general sales tax (GST) is declared a provincial subject under the Constitution of Pakistan, provinces have only recently begun collecting this tax. In FY12, Sindh claimed sales tax collection of this sector, and in the following year, Punjab also started collecting GST on several services. Sales tax on telecommunication services has still not been devolved to any of the provinces.

Figure 5.1.1: Analysis of Services Sales Tax



* FBR services revenue for FY13 is approximated. Source: FBR Quarterly Review (various issues); FY14 budget of Punjab and Sindh; Pakistan Bureau of Statistics.

It has been argued that provinces could be 'more efficient' in collecting services sales tax, because provincial administrations – having a wider and deeper outreach than FBR – are in a better position to document this largely informal sector. However, so far, evidence is inconclusive: when Sindh began tapping services in FY12, sales tax revenue increased substantially despite a 6.8 percentage point slowdown in (nominal) services GDP growth. But conversely, tax collection declined sharply in FY13 when two provinces had begun collection, even though GDP growth posted only a marginal decline of 1.2 percentage points **(Figure 5.1.1**).

In our opinion, rather than reflecting the capability of tax administrators, varying degrees of documentation of different services is a better explanation of this discrepancy. For example, FY13 services GDP growth was driven by the poorly documented transport sector; whereas the well-documented financial sector's growth declined in nominal terms during FY13. Therefore, despite similar levels of economic activity, the increased share of informal activity in this year's services growth could be the cause of decline in revenue collection.

In overall terms, FBR tax collection fell short of target by 18.7 percent. Besides the devolution of services tax to provinces, the following factors also explain this below-target performance:

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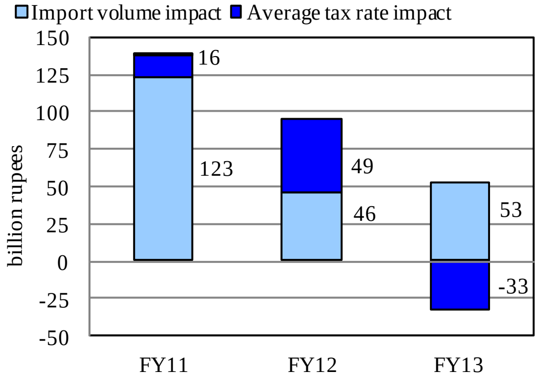
[13] In order to make provinces truly autonomous in the long-run, the 7th National Finance Commission had set targets for federating units to raise their own tax collection. Source: 7th National Finance Commission (NFC) Award 2010; online http://www.financekpp.gov.pk/FD/attachments/article/154/7th%20NFC%20AWARD%202010.pdf.

[14] Since sales tax on services is a provincial subject under Pakistan's Constitution, the formula for distribution of these receipts is not the same as for other sectors. Specifically, instead of following normal practice of retaining 42.5 percent of total receipts, the federal government only charges a fee of one percent of collection under this head.

[15] Even an incomplete shift of services taxes resulted in a revenue loss of Rs 48.9 billion for the FBR – 2.0 percent of this year's original collection target of Rs 2,381 billion. To put this in perspective, FBR missed its total tax collection target by Rs 444.9 billion, or 18.7 percent.

[16] Provinces have the potential of raising additional revenues through capital value taxes on property and estate, and through inheritance taxes and environmental taxes and charges. All these areas are currently either underexploited or unexploited.

Figure 5.4: Analysis of Import-related taxes*



*Includes: custom duties, sales tax on imports, and FED on imports.
Source: Pakistan Bureau of Statistics

1. While the government introduced several tax relief measures in the FY13 budget;[17] some of the offsetting proposals did not materialize. For example, the federal government had to abort the taxpayer registration drive after resistance from businesses and trade association. Similarly, the income tax amnesty bill, which aimed to bring more taxpayers into the net, could not get through the Parliament.[18] To make matters worse, the government lowered the withholding tax on selected categories[19] after a campaign was orchestrated by influential lobby groups.

2. The government issued a number of SROs (statutory revenue orders) during the year. While individual SROs may appear to be innocuous, the collective impact can be considerable. For example, despite an increase in imports (in rupee terms), growth of import-related taxes declined to 3.0 percent from 27.9 percent in FY12. This translated into a revenue loss of Rs 33 billion during FY13 (**Figure 5.4**).

   The main reason for duty reduction on imports was lobbying by domestic interest groups, specifically the manufacturers of steel, paper, textile, electronics and motorcycles, and also used-car dealers. As a result of these policies, Pakistan has the most liberal import regime compared to other regional economies, like India and Bangladesh – an attribute that entails a significant revenue cost (**Box 5.2**).

Box 5.2: The Revenue Cost of Trade Liberalization

With the ever increasing pursuit of a globalized economy, trade-related taxes are becoming less important as a revenue tool over time. However, at least for now, custom duties remain an important source of tax for most developing economies.

Figure 5.2.1: A Comparison of Average Import Duty in Selected Countries

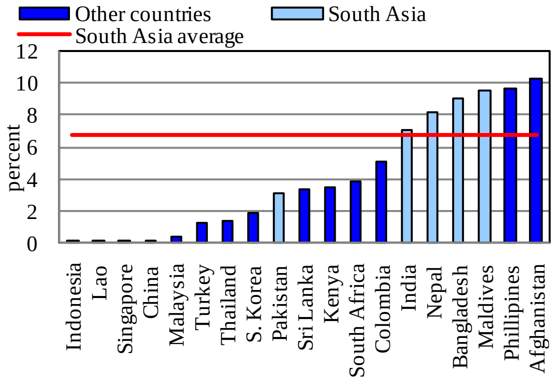
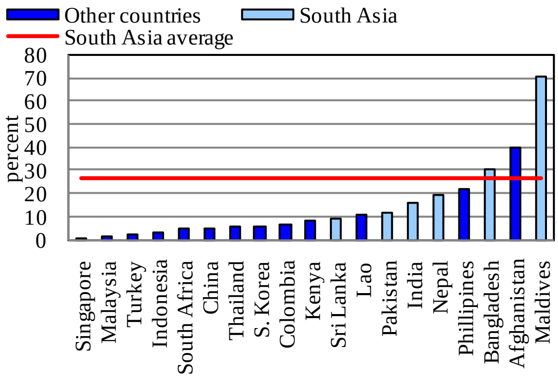


Figure 5.2.2: A Comparison of Custom Duty to Tax Revenue Ratio in Selected Countries



Based on calender year 2011; ; 2010 data for China and Maldives; 2007 number for Singapore.
Source: Haver Analytics; analyst calculations; FBR

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[17] For example, one percentage point reduction in GST rate (from 17 percent to 16 percent); reduction in sales tax on black tea; reduction in FED on certain services; reduction in sales tax on steel scrap and wastepaper; and leniency in the income tax schedule.

[18] The Income Tax Amnesty Bill was unsuccessfully introduced in the Parliament in November 2012. For a detailed assessment of tax amnesty schemes, see "Tax Amnesty as Public Policy", *Third Quarterly Report on The State of Pakistan's Economy FY13*, pp. 50-52.

[19] Government provided exemption on 0.5 percent withholding tax on manufacturing sector, and eliminated the withholding tax on raw material imports.

Interestingly, unlike other countries in the region, Pakistan has shown an aversion for exploiting custom duties as a revenue tool. Pakistan's tariff schedule is particularly lenient, compared to other countries in the region: though import duties in Pakistan can sometimes range up to 100 percent, the *average* import duty (ratio of total custom revenues to imports) is the lowest in South Asia (**Figure 5.2.1**). Not surprisingly, the share of custom duties in Pakistan's tax revenues was just 11.4 percent in 2011 (the latest year for which cross-country data is available),[20] compared to South Asian average of 26.1 percent (**Figure 5.2.2**).

All this implies that imports are relatively under-taxed in Pakistan. The government could consider making use of this tax avenue, at least until regional peers catch up with our pace of liberalization.

While imports and direct taxes were under-used, there was excessive dependence on revenue from defense (due to CSF) and utilities. Together, CSF and utilities related revenues explain 84.3 percent of total (federal plus provincial) increase in revenues during FY13.

The obvious problem with sources such as CSF is that they are effectively a windfall. For example, in FY12, the government had to compensate the non-availability of CSF inflows by imposing a multitude of taxes and duties. In our opinion, such one-off sources of revenue should not be accounted for in the computation of the primary deficit to get a clear picture of fiscal management.

Box 5.3: Why it is Easy to Tax Energy

The federal government collects revenue from the energy sector under at least nine different (tax and non-tax) heads,[21] while provinces also impose smaller levies of their own. This year, the government introduced two new taxes – on natural gas and LPG – and jacked up the petroleum development levy rates in the last quarters in a move to generate instant revenues.

When it comes to quick-fix revenue solutions, energy is a choice candidate: for one, it is well-documented, and therefore easier to tax; and two, it is less responsive – or inelastic – to price changes, which means that tax led price hikes will not reduce consumption.

Table 5.3.1: Price Elasticity of Petrol and Diesel

	Petrol	Diesel
Price elasticity		
Short-run	-0.40	-0.06
Long-run	-1.86*	-0.16*
Cross-price elasticity (CNG)		
Short-run	-0.32	--
Long-run	6.97*	--

*Significant at 5 percent level.
Source: analyst's estimates

To test this notion of price inelasticity of energy demand, we estimated an elasticity model for two widely used petroleum products, petrol (motor spirit) and high speed diesel, using monthly data of real (inflation adjusted) prices and sales for the period 2006-2013.[22] Our results (summarized in **Table 5.3.1**) confirmed that demand is indeed not responsive to real price changes (elasticity coefficients are small and insignificant in the short run).

However, when a cheaper substitute product is available – like CNG in lieu of petrol – long-run elasticity becomes significant. That is, although people do not modify behavior immediately, they are more likely to adjust to cheaper options over time. Our study showed that in the long run, petrol demand could plunge by almost 7 percent in response to just a one percent drop in CNG price. The option of a substitute also makes petrol more elastic to its own price: in the long run, if petrol price increases by one percent, sales plunge by twice as much.

[20] Custom duties comprised 12.3 percent of FBR revenues in FY13.
[21] These are (1) custom duty on diesel import; (2) general sales tax on petroleum products, natural gas, and electricity; (3) Federal Excise Duty (FED) on natural gas; (4) petroleum development levy (PDL); (5) gas infrastructure development cess (GIDC); (6) development surcharge on gas; (7) discount retained on crude price; (8) windfall levy against crude oil; and (9) royalties on oil and gas. Energy sector revenues quoted in this analysis do not include corporate income tax collected from oil refineries, oil marketing companies, and electricity and gas distribution companies.
[22] We estimated a vector error correction model using data for the period July 2006 to February 2013. Prices were deflated by the consumer price index. Data sources: Oil Companies Advisory Committee (sales); Pakistan Bureau of Statistics (prices and CPI).

So far, this energy-centered tax policy has helped in meeting revenue objectives largely because people have limited alternatives: such as public transportation to replace private vehicles; alternative energy to substitute gas- or diesel-powered generators; and a reliable railway service to carry the load of thousands of trucks and prime movers. However, as conditions on these fronts improve government would have difficulty in sustaining growth in revenues from this source. It is therefore important that the government initiate long awaited tax reforms to broaden the tax base at the earliest.

5.3 Expenditures

Total expenditures (including one-off payment of Rs 322.2[23] billion for the power sector debt settlement) increased by 22.4 percent YoY during FY13, compared to 14.2 percent in FY12. Excluding the one-off payment, total expenditures still increased by 26.8 percent. This rise is attributed to an increase in debt servicing; compensation to pensioners; and higher public sector development spending (**Table 5.3**).

Current expenditures grew by 17.2 percent (to reach 16 percent of GDP) in FY13, against 7.6 percent last year. Persistently large fiscal deficits over a number of years have substantially increased debt servicing, which now accounts for over a quarter of current expenditures, or roughly one trillion rupees each year. Subsidies and transfers are the second largest head in current expenditures.[24]

Table 5.3: Break-up of Current Expenditure

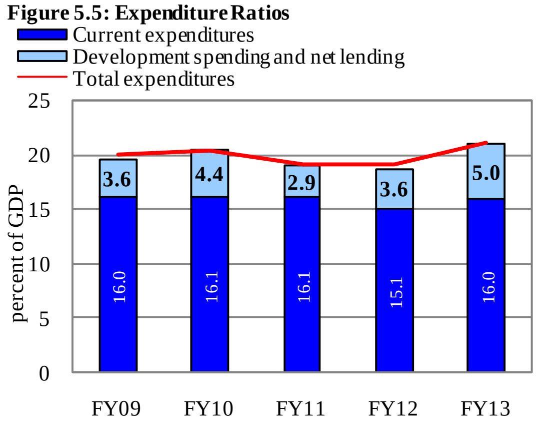
billion Rupees

	FY12	FY13		% Change over	
		Actual	Budget	FY12	FY13 Budget
Total expenditure	**3,936.2**	**4,816.3**	**4,480.0**	**22.4**	**7.2**
Current expenditure	**3,122.5**	**3,660.4**	**3,430.0**	**17.2**	**6.4**
Interest payments	889.0	991.0	925.8	11.5	7.0
Domestic debt	821.1	920.4	845.6	12.1	8.8
Foreign debt	67.9	70.6	80.2	3.9	-11.9
Defence	507.2	540.6	545.4	6.6	-0.9
Pension	140.4	172.6	129.1	22.9	33.6
Subsidies*	512.3	367.5	208.6	-28.3	76.2
Education	45.2	56.9	47.9	25.9	18.9
Health	7.8	9.5	7.8	21.8	21.2
Environment	0.6	0.8	0.7	34.4	5.2

*Provisional estimates taken from Budget documents.

Source: Ministry of Finance

Figure 5.5: Expenditure Ratios



Source: Minstry of Finance

Pension payments increased by 22.9 percent in FY13 to give relief to retired civil and military employees.[25] Apart from these major heads, an uptrend was also observed in social sectors spending, as expenditure on education, health and environment exceeded the budget targets for FY13. Having said this, spending on education and health as a percent of GDP in Pakistan is one of the lowest in the world as per World Bank data; it is even lower than the countries like Sierra Leon and Congo.

Development expenditure & net lending posted strong growth of 53.2 percent during FY13 (**Figure 5.6**).[26] A significant part of the increase came from net lending that has been clubbed with development spending in the FY13 budget. Net

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[23] The settlement made on 28th June 2013 by raising financing from PIBs and some government accounts. Details of the transactions are available on the following link:http://www.finance.gov.pk/press/circular_debt.pdf

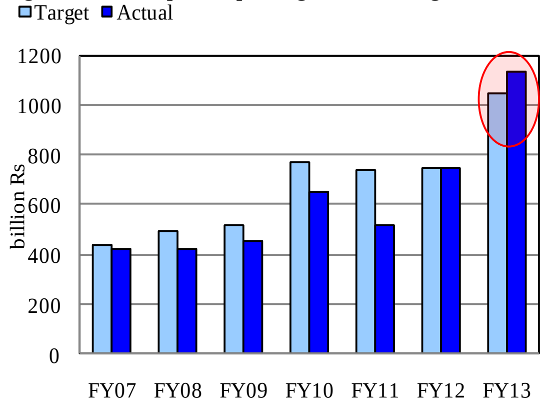
[24] The budget document reports total subsides of Rs 367.4 billion; whereas Rs 322.2 billion that has been paid to power companies and PSEs for the settlement of the circular debt has been reported under net lending, unlike the earlier practice of reporting such payments under current expenditure.

[25] Of the total pension bill, more than 75 percent goes to retired servants of armed forces.

[26] 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.

lending is basically power sector debt settlement; in FY12, payments on this account were part of the current expenditures. Excluding net lending, development expenditures grew by only 6.2 percent against 44.6 percent in FY12. A large part of this increase came in the last quarter of FY13, which coincided with the general elections in May 2013.

Figure 5.6: Development Spending & Net Lending



Source: Ministry of Finance

The fiscal authorities had increased the budget for PSDP from Rs 665 billion in FY12, to Rs 873 billion in FY13. Unfortunately, as has been the case in the past, development spending was cut short to accommodate more pressing current expenditures while trying to limit the overall fiscal deficit. Consequently, PSDP spending was also curtailed to Rs 695.1 billion during the year.

Table 5.4: Break-up of Development Expenditure

billion rupees

	FY11	FY12	FY13
Development exp. & net lending	**514.0**	**743.9**	**1,139.9**
Total dev. exp.	506.1	731.9	777.1
PSDP	461.2	664.8	695.1
Federal	215.6	289.3	323.5
Provincial	245.6	375.4	371.5
Other development exp.	44.6	67.1	82.0
Net lending	7.9	12.0	362.8
PSDP as % of total expenditure	13.5	16.9	14.4

Source: Ministry of Finance.

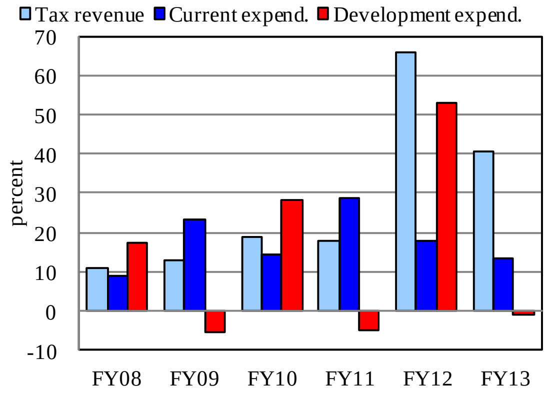
This decline in PSDP largely came from a sharp reduction in provincial PSDPs, which added up to Rs 371.5 billion against the target of Rs 513 billion.[27] Federal PSDP also fell short of the Rs 360 billion target, despite showing a positive growth of 11.8 percent over FY12 (**Table 5.4**).

Federal corporations like, WAPDA (Rs 34.7 billion); NHA (Rs 71.1 billion); Water and power division (Rs 45.3 billion); Pakistan Atomic Energy Commission (Rs 44.1 billion); Railways (Rs 25.8 billion); and Finance (Rs 29.0 billion) accounted for more than one-fourth of federal PSDP budget. Interestingly, spending on Defense, Interior, and Planning & Development declined during FY13, despite the challenging law and order situation in the country.

5.4 Provincial Fiscal Operations[28]

Compared to a Rs 39.1 billion deficit recorded in FY12, provinces posted an impressive Rs 52.7 billion surplus in FY13 (**Table 5.5**). This improvement was brought about by both containment in expenditures and a healthy growth in revenues (**Figure 5.7**). Given the need for fiscal discipline at the provincial level, this performance is encouraging; however, as is always the case, the fiscal austerity axe again fell on development spending in FY13, which is not a very desirable policy option.[29] Nonetheless, the overall provincial surplus falls below the annual budget target of Rs 79.5 billion, this was expected in view of a weak growth in FBR revenues and the

Figure 5.7: Provincial Revenue & Spending Growth



Source: Ministry of Finance

[27] Provincial PSDP registered a negative growth of 1.0 percent in FY13, compared to 52.9 percent growth in FY12.
[28] For details, see Data Explanatory Notes.
[29] Development spending fell below the budget estimates for FY13, in all provinces except Balochistan.

Table 5.5: Summary of Provincial Fiscal Operation

billion Rupees

	Punjab		Sindh		KPK		Balochistan		All	
	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
Total revenue	**593.9**	**701.8**	**383.8**	**445.7**	**222.1**	**243.9**	**134.2**	**153.1**	**1,334.0**	**1,544.4**
Share in federal revenue	518.3	569.3	285.2	320.7	178.9	199.6	107.4	125.3	1,089.9	1,215.0
Provincial taxes	42.1	77.4	60.4	68.1	3.7	4.1	1.0	1.1	107.2	150.7
Provincial nontax	25.8	28.1	12.2	24.7	5.0	10.1	5.0	8.4	48.0	71.3
Federal loans/grants	7.6	27.0	26.0	32.1	34.5	30.1	20.8	18.3	88.9	107.4
Total expenditure	**602.9**	**690.9**	**412.3**	**404.3**	**225.8**	**248.1**	**115.1**	**138.4**	**1,356.1**	**1,481.6**
Current expenditure	445.1	536.3	298.1	301.9	151.2	173.8	86.3	98.0	980.6	1,110.0
Development expenditure	157.8	154.6	114.2	102.3	74.6	74.3	28.8	40.3	375.4	371.5
Overall balance	**-9.0**	**10.9**	**-28.5**	**41.4**	**-3.7**	**-4.2**	**19.1**	**14.8**	**-22.1**	**62.9**
Total financing of deficit	*(3.1)*	*(14.0)*	*56.1*	*(5.0)*	*(6.0)*	*(14.4)*	*(7.8)*	*(19.3)*	*39.1*	*(52.7)*

Source: Table 5: Provincial Government Fiscal Operations. Ministry of Finance.

resultant contraction in provincial share.[30]

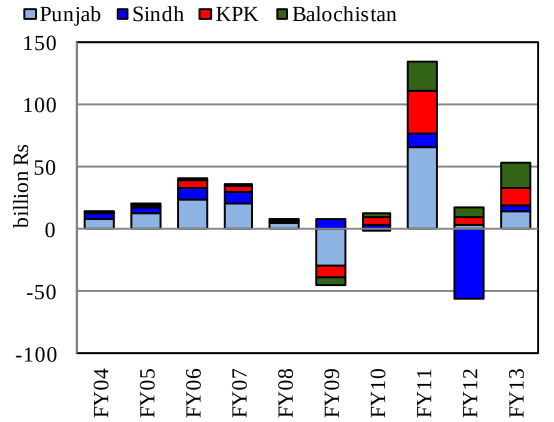
In terms of individual provinces, the budget surplus in Balochistan was the largest, followed by Punjab. Furthermore, Sindh posted a surplus of Rs 5.0 billion this year, which was largely due to a steep cut of Rs **11.9** billion in development spending, whereas current expenditures recorded relatively small increase of Rs 3.8 billion in FY13 – the lowest in nine years. In fact, with the exception of Balochistan, development expenditure in all provinces remained lower than in FY12. In addition, the growth in provincial current expenditures also witnessed a slight slowdown in FY13,[31]despite a sharp Rs 91.2 billion increase in current spending by Punjab, on account of salaries, pensions and ad hoc relief to government employees.

On the revenues side, provinces' own revenue generation increased by 43.0 percent in FY13.[32] However, a greater share of this improvement was contributed by Punjab, as it began collecting sales tax on services from this year.

Furthermore, FY13 was the first complete year after the fiscal devolution, when provinces posted an overall budget surplus (**Figure 5.8**). However, there is a need to sustain this performance, and introduce reforms so that provincial surplus is achieved without the need of curtailing development spending.

The fiscal devolution, which involves larger provincial shares in federal revenues as well as increased spending responsibilities, has enhanced provinces' ability to influence the country's overall fiscal performance. In this setting, we believe that the recent agreement with the IMF,

Figure 5.8: Provincial Deficits



Source: Minstry of Finance

30 The federal government had targeted provincial share amounting to Rs 1458.9 billion in the budget for FY13. However, as FBR taxes fell short of target, the actual transfer to provinces fell to Rs 1215 billion.
31 The growth in overall provincial spending fell to 13.2 percent in FY13, compared to 18 percent in FY12.
32 This includes both tax and non-tax revenues.

which explicitly mentions the commitment by provinces to post budget surpluses in FY14, will ensure greater fiscal responsibility at the provincial level. In this regard, however, to streamline the budget making process at the provincial level, there is a need to address gaps in policy formulation emanating from fiscal decentralization. Two of the most important issues are: the lack of a mechanism to ensure that provinces adhere to fiscal targets outlined by the centre; and lack of emphasize on revenue generation through provinces' own resources. Following discussion further elaborates these issues:

Need to set binding fiscal rules for provinces: The federal government has targeted a combined provincial surplus of Rs 23.1 billion for FY14. However, looking at provincial budgets for the current year, Balochistan was the only province that targets a budget surplus.[33] This anomaly casts some doubt about the credibility of the combined fiscal picture put forward by the federal government, and reflects a lack of coordination between the centre and provinces.

In this regard, a review of the literature identifies a number of arrangements adopted by other countries to ensure consistent fiscal policy formulation by various tiers of the government (i.e., sub-national and the central government; **Box 5.4**). This review suggests that in the post devolution stage in Pakistan, there is a need to strengthen fiscal discipline at the provincial level by formulating binding fiscal targets. These arrangements will induce some certainty in the fiscal environment by minimizing the risks of deviation from the government's overall fiscal stance. Any delay in addressing this policy lacuna could aggravate the fiscal position of the country. It should be noted that the current NFC award that was made operational in July 2010, has a life of five years. In our view, even this award should include explicit fiscal performance targets for each province, to guide the fiscal decentralization process started in FY12.

Box 5.4: Coordination between Central and Sub-National Fiscal Policies – International Experience

Many policy options are used internationally to ensure that sub-national priorities are consistent with the central government fiscal policy objectives. Some of the examples are discussed below:

- In the case of Nordic countries (Denmark, Finland, Iceland, Norway and Sweden), annual negotiations are held between local government associations and the national governments. In Denmark, these negotiations are concluded with an agreement concerning fiscal policy targets, and this approach has been the chief instrument of government control. According to the agreement, the national government obtains parliamentary approval of the agreed amount of grants, which also ensures that the local government associations respect the agreed tax rates and the level of spending.
- The local government associations in the Nordic countries play an important role in advising on national legislation related to delegated functions and in following macroeconomic signals from the central government to the local governments.
- From the central government side, most often the Ministry of Interior is responsible for the legislation relating to the organization of local governments, and it is the responsibility of the Ministry of Finance to ensure that local policies are in accordance with central priorities and macroeconomic objectives.
- In Finland, the basic instrument for macroeconomic control is the block grant system and a system of negotiations between central government ministers and the local government association.[34]
- In Sweden, rules are in place for ensuring balanced budgets of local governments.

Source: Lotz, Joergen, 2006, Local Government Organization and Finance: Nordic Countries, in Anwar Shah (ed.), Local Governance in Industrial Countries (Washington: World Bank).

Capacity building to Improve Provincial Revenue Generation: Revenue generation by provinces stood at 1 percent of GDP in FY13, which is very low by international standards (**Figure 5.9**). The availability of funds from the divisible pool, and the absence of specified targets for revenue generation, could create an incentive problem for the provinces. Although, the ability of provinces to step up revenue collection is hampered by their limited administrative capacities, the need for institutional strengthening cannot be ignored. With the right to collect GST on services; agriculture

[33] Reportedly, in a meeting of the Council of Common Interests (CCI) provinces agreed to post a surplus of Rs 105 billion in FY14, given that the FBR succeeds in collecting the targeted tax revenue and the agreed budgeted share is transferred to provinces.

[34] Block grant is consolidated grant of federal funds, formally allocated for specific programs, such as education or urban development, which a state or local government may use at its discretion.

income tax; and other taxes on immovable assets, these are precisely the avenues that have the potential to allow Pakistan to break free of its fiscal strait-jacket (**Box 5.5)**.[35]

Box 5.5: Financing Choices for Sub-National Governments

The literature on fiscal devolution suggests consideration of following factors in assigning taxing powers to various levels of the government:

(1) According to the economic efficiency criterion, taxes on mobile factors and tradable goods should be assigned to the center. Regional collection of taxes from these sources may result in wasteful policies by attracting resources to own areas by regional and local governments;

(2) National equity considerations require that progressive redistributive taxes (e.g., income tax) should be assigned to the center. There is, however, a possibility of imposing local charges on residence-based national income taxes;

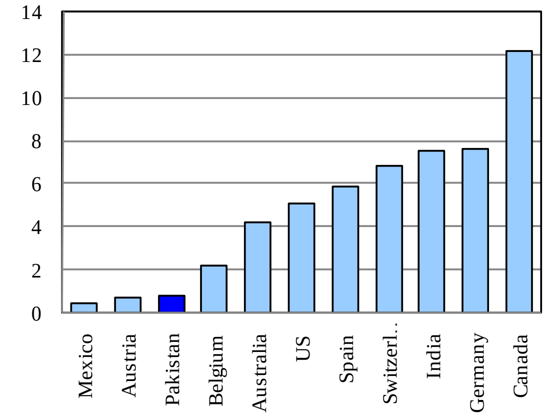
(3) The administrative feasibility criterion suggests that taxes should be assigned to the authority with the best ability to monitor relevant assessments, with minimum costs. According to this principle, property, land, and betterment taxes are good candidates for sub-national assignment.

(4) The revenue adequacy criterion indicates that the ability to raise revenues from own sources should be matched as closely as possible with expenditure needs.

According to these four principles, user charges; property and land taxes; betterment taxes and charges; poll taxes; single-stage (retail) sales taxes; flat tax on residence-based national income taxes; duties on hotel rooms, airport use, entertainment, taxis, and rental cars; vehicle registration fees; single business or profession permits; resource royalties; severance taxes; local conservation charges, etc., can be assigned to state/local governments. In addition, the literature also argues that long-lived capital assets should be financed by raising debt, as these large investments cannot be financed by current revenues.

Furthermore, in the struggle for increasing revenue generation from provincial level, the tradeoff between increased accountability and increased economic costs should also be considered. Too much fragmentation of tax system can increase economic costs, thus the selection regarding which taxes to decentralize should be made with care.

Figure 5.9: Provincial (states) Revenue as Percent of GDP



Source: Central Banks & OECD Website

Source: Shah, A & Shah, S, 2006, The New Vision of Local Governance and the Evolving Roles of Local Governments, in Anwar Shah (ed.), Local Governance in Developing Countries (Washington: World Bank).

[35] IMF Country Report No. 12/35, February 2012 on Pakistan.

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