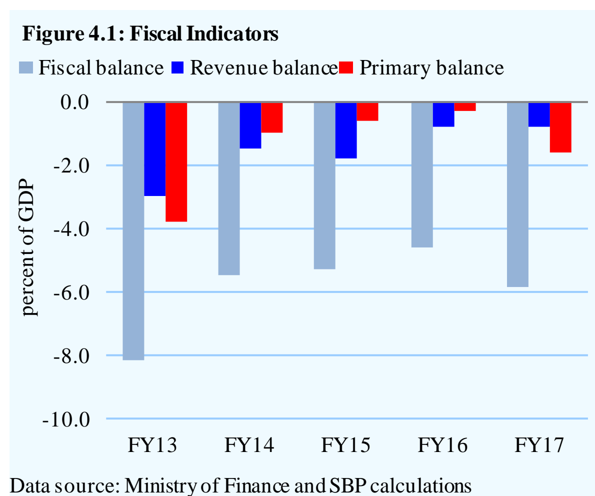
4 Fiscal Policy

4.1 Overview

The fiscal deficit was recorded at 5.8 percent of GDP in FY17, against the target of 3.8 percent and 4.6 percent recorded in FY16. The primary deficit, which excludes interest payments, increased to 1.6 percent of GDP from 0.3 percent in FY16. The revenue deficit, which excludes development expenditure, was 0.8 percent of GDP in FY17, the same as in FY16 (**Figure 4.1**).

The contained revenue deficit shows that current expenditure grew in line with the growth in revenues. Thus, from the expenditure side, the fiscal deficit in FY17 was driven largely by an increase in development expenditures.

Figure 4.1: Fiscal Indicators



Data source: Ministry of Finance and SBP calculations

The consolidated development expenditures maintained the momentum observed during the last three years. Within these, provincial development expenditures increased sharply, likely reflecting efforts by provinces to complete various social and infrastructure uplift projects before the upcoming elections. The capital spending by the federal government was already high because of ongoing work on a number of infrastructure projects under CPEC. The relatively contained interest payment during the last three years, in the prevailing low interest rate environment, created additional fiscal space to increase its development spending. However, maintaining these trends in development spending, and supporting general economic activity going forward, would require revenue generation at a much faster pace than what was observed during FY17.

Meanwhile, the pace of revenue collection slowed considerably during FY17 compared to last year. This was largely due to a sluggish growth in tax revenue while non-tax revenue recovered sharply during FY17. The slower growth in tax collection, particularly by the FBR , was partially due to various tax incentives announced to support exporting industries and agriculture and for encouraging investment and employment generation (**Box 4.1**). In addition, the government absorbed some of the increase in international oil prices by reducing the sales tax on domestic POL prices, which had significant impact on sales tax collection.[1] These measures added to the FBR's challenges in achieving even the revised target of Rs 3,550 billion for FY17**.**

Provincial revenue mobilization also slowed down from the impressive growth achieved during the last couple of years. The provinces continued to depend on GSTS, motor vehicle tax and stamp duty. In fact, the growth in provincial revenue during the previous two years was bolstered by GSTS. As a result of a slower growth in FBR and provincial tax collection, the tax to GDP ratio declined marginally during FY17, after steadily rising during FY14 to FY16 (**Box 4.2**). This is not an encouraging situation for keeping the fiscal deficit low and, at the same time, creating space for growth-oriented capital spending. It underscores the need to address structural issues in the taxation

[1] For details, see Sales tax in the Section "Indirect taxes".

system, such as the still narrow base and heavy reliance on withholding taxes on industrial and trade sectors and salaried individuals.

Box 4.1: Key Tax Incentives Provided in FY17[2]

Several tax incentives were provided to support exporting industries and the agriculture sector. The government also incentivized investment and employment generation by allowing firms tax credits. The important incentives are summarized below:

Exporting industries

- Five major export-oriented sectors (textiles, leather, sports goods, surgical goods and carpets) exempted from sales tax (zero-rating) on purchase of raw material.
- Under the Prime Minister's Package of Incentives for Exporters, the government: (i) allowed duty draw back up to 7.0 percent on the export of garments, home textiles, processed fabric, Greige fabric and yarn manufacturing cum exporters units[3]; exempted customs duty on the import of raw material for textile[4] and; exempted sales tax on the import of textile machinery. [5]

Agriculture

- Abolished seven percent sales tax on pesticides.
- Off peak electricity tariff rates were reduced to Rs 5.35 per unit from Rs 8.85 per unit.
- Custom duty on incubators, brooders and on machinery for animal feed-stuff was reduced from 5.0 percent to 2.0 percent.
- Custom duty on import of fish feed pellet machines and water aerators was also reduced from 5.0 percent to 2.0 percent.
- Custom duty on fish feed and live baby fish was abolished.

Industrial raw material

- Customs tariff slabs for import of industrial raw material were reduced from 5 to 4, by merging 2.0 and 5.0 percent slab to a new 3.0 percent slab, 10.0 and 15.0 percent slabs were substituted with 11.0 percent and 16.0 percent slabs and the 20.0 percent slab was kept unchanged.
- To provide incentive to local tyre manufacturers, bead wires were exempted from custom duty.
- Custom duty on import of LED lights was reduced to 5 percent; and solar panel was exempted.

Investment and employment generation

- Facility of 1.0 percent tax credit for industrial undertaking employing every 50 persons was increased to 2.0 percent, and the setting up period was extended till June 30, 2019,
- Tax credit facility for investment in Balancing Modernization and Replacement was revised upward to 20.0 percent from the existing 10.0 percent and period to avail this facility was extended till June 30, 2019.
- The condition of 100.0 percent of fresh equity raised through shares to avail 100.0 percent tax credit was relaxed up to 70 percent fresh equity raised with proportionate tax credit facility and, the time period for this measure was extended till June 30, 2019;
- The exemption period for investment in green-field industrial undertakings was extended up to June 30, 2019.

Others

- The corporate tax rate was further reduced to 31.0 percent.
- Tax credit for making sales to registered sales persons was increased to 3.0 percent from existing 2.5 percent.
- Tax credit facility of 20.0 percent for enlistment on the stock exchange was extended up to two years.

In the backdrop of a higher fiscal deficit, the government's financing requirements also increased. While borrowings from external sources increased considerably during FY17, the bulk of financing was raised from domestic sources. The composition of domestic borrowing also changed, both in terms of source and maturity: the government switched its borrowing away from scheduled banks to SBP; and, most of the borrowing from scheduled banks was concentrated in short-term T-bills.

4.2 Revenue

The growth in revenues decelerated to 11.0 percent in FY17 from 13.1 percent in FY16. This was largely due to sluggish growth in tax revenue, as non-tax revenue recovered strongly in FY17 against a sharp decline seen in FY16 (**Table 4.1**). However, despite a substantial increase in non-tax revenues due to one-off revenue receipts like sale proceeds from the Pakistan Security Printing Corporation and LNG power plants (acquired under the Pakistan Development Fund), these remained

[2] Source: Budget Speech of Minister of Finance; Finance Bill FY17
[3] Vide Ministry of textile SRO No. 1(42) TID/17-RDA.
[4] Vide FBR S.R.O. No. 39(I)/2017.
[5] Vide FBR S.R.O. No.36 (I)/2017.

short of the target due to lower than expected SBP profit and receipts under the Coalition Support Fund (CSF).

Table 4.1: Summary of Fiscal Operations
billion rupees

	Budget FY17	Actual		Percent of GDP	
		FY16	FY17	FY16	FY17
A. Total revenue	5347.0	4,447.0	4,936.7	15.3	15.5
Tax revenue	4,306.0	3,660.4	3,969.2	12.6	12.5
Non-tax revenue	1,041.0	786.6	967.5	2.7	3.0
B. Total expenditure	6,623.0	5,796.3	6,800.5	19.9	21.3
Current	5,198.0	4,694.3	5,197.9	16.1	16.3
Interest payments	1,360.0	1,263.4	1,348.4	4.3	4.2
Defence	860.2	757.7	888.1	2.6	2.8
Development	1,435.0	1,301.5	1,693.5	4.5	5.3
Net lending	-10	12.6	-12.8	0.0	0.0
C. Statistical discrepancy	0	-212.1	-78.0	-0.7	-0.2
Fiscal balance (A-B-C)	-1,276.0	-1,349.3	-1,863.8	-4.6	-5.8
Revenue balance	149.0	-247.3	-261.1	-0.8	-0.8
Primary balance	84.0	-85.9	-515.4	-0.3	-1.6
Financing	1,276.0	1,349.3	1,863.8	4.6	5.8
External sources	234.0	370.5	541.4	1.3	1.7
Domestic sources	1,042.0	978.9	1,322.4	3.4	4.2
Banks	453.0	787.0	276.6	2.7	0.9
Non-bank	539.0	191.8	1,045.8	0.7	3.3
Privatization	50.0	0.0	0.0	0.0	0.0
Percent Growth					
Total Revenue		13.1	11.0		
Tax revenue		21.3	8.4		
Non-tax revenue		-13.9	23.0		
Total Expenditure		7.6	17.3		
Current		6.1	10.7		
Development		16.9	30.1		

Data source: Ministry of Finance and SBP Calculations

The sluggishness in tax collection was broad-based as the pace of both FBR taxes and provincial taxes was significantly slower in FY17. Tax revenue grew by 8.4 percent during FY17 – about half the rate envisaged in the budget (17.6 percent), and around one-third of the impressive 21.3 percent growth achieved in FY16. This was despite release of fewer sales tax refunds against advance tax payments during FY17.[6]

Box 4.2: Putting the Low Tax-to-GDP Ratio in Perspective

The tax and administrative reforms implemented during the last few years led the growth in tax collection to remain consistently higher than the growth in nominal GDP. This resulted in the tax-to-GDP ratio rising to 12.6 percent in FY16 from the low of 9.3 percent in FY11. This performance, however, could not be sustained in FY17. Despite the improvement in recent years, Pakistan's tax-to-GDP ratio still remains one of the lowest in the region, only better than Bangladesh's (**Figure 4.2.2**).

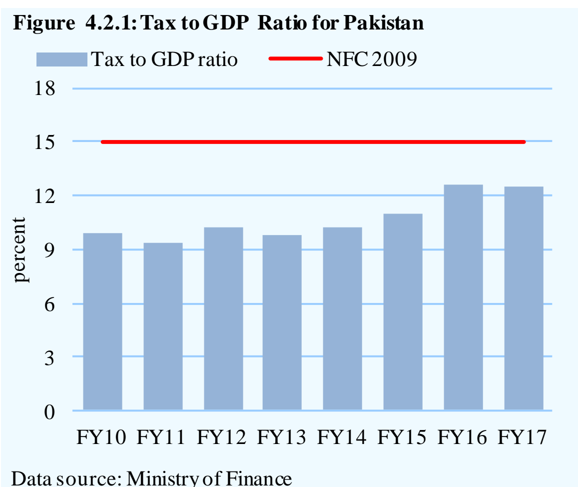
Notwithstanding the improvement in general economic activity, the-tax to-GDP ratio fell to 12.5 percent in FY17 from 12.6 percent in FY16. This is also significantly lower compared to 13.6 percent target for the year. Moreover, it fell far short of

[6] According to FBR data, sales tax refunds declined by 48.7 percent in FY17, partly due to deceleration in sales tax collection and presence of unsettled refunds. FBR settled the tax refunds in two stages: claims up to Rs 1.0 million were settled by mid-July, while claims worth over Rs 1 million were settled in mid-August through direct electronic transfer (source: http://www.fbr.gov.pk/Press-Release).

the 15.0 percent benchmark envisioned in the National Finance Commission (NFC) Award 2009 (**Figure 4.2.1**).[7]

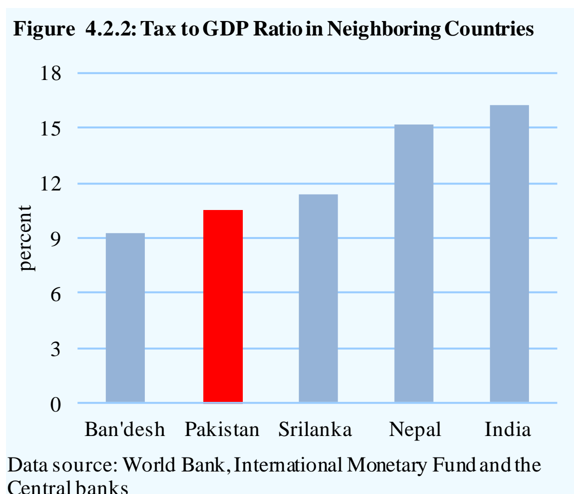
Although the NFC Award expected both the federal and provincial governments to step up efforts to increase the tax-to-GDP ratio to 15.0 percent by FY15, it specifically emphasized that the provinces initiate steps for mobilizing revenue effectively through taxing agriculture and real estate sectors. However, the performance of provincial tax authorities has been below par: the combined provincial tax revenues increased to Rs 321.7 billion in FY17 from Rs 54.8 billion in FY10. Against this, federal tax collection increased from Rs 1.42 trillion to Rs 3.38 trillion. Moreover, provincial revenue collection under agricultural tax has remained stagnant.

Figure 4.2.1: Tax to GDP Ratio for Pakistan



Data source: Ministry of Finance

Figure 4.2.2: Tax to GDP Ratio in Neighboring Countries



Data source: World Bank, International Monetary Fund and the Central banks

Nevertheless, the low tax-to-GDP ratio indicates the country's low capacity to make involuntary savings; these savings are essential for resource redistribution and economic development. The situation warrants a deepening of structural reforms, both by the federal and provincial governments. As the tax on agriculture and services sectors has become a provincial matter following the 18th Amendment, provincial governments need to bring the largest contributors to GDP, having equally large tax potential, under the tax net.

FBR taxes

The growth in FBR's tax collection fell to 8.0 percent in FY17 from 20.2 percent achieved last year (**Table 4.2**). The deceleration was broad-based, as growth in both direct and indirect tax collection was much lower as compared to FY16. The pace of direct tax collection was affected by a decline in corporate profitability – especially profitability of the banking sector as well as reductions in tax rates and announcement of tax incentives (**Box 4.1**). The growth in indirect tax collection, on the other hand, was dragged by a considerable fall in sales tax collection, which remained subdued due to reduction in sales tax rates on POL products in a bid to protect domestic consumers from rising international oil prices.

Table 4.2: FBR Tax Collection

billion rupees; growth in percent

	Budget FY17	Collections		Growth	
		FY16	FY17*	FY16	FY17
Direct taxes	1,558.0	1,217.5	1,343.2	17.8	10.3
Indirect taxes	2,063.0	1,895.0	2,017.8	21.8	6.5
Customs duty	413.0	404.6	496.0	32.1	22.6
Sales tax	1,437.0	1,302.4	1,323.3	19.7	1.6
FED	213.0	188.1	198.6	15.9	5.6
Total taxes	**3,621.0**	**3,112.5**	**3,361.0**	**20.2**	**8.0**
Total tax (% of GDP)	*10.8*	*10.7*	*10.5*	-	-

Data Source: Federal Board of Revenue and SBP calculations
*Estimated data

[7] Clause 2 of Article 9 of President's order No.5 of 2010 (No. F. 2(2)/2010-Pub) dated 10th May 2010, states;
"The NFC recommended that the Federal Government and Provincial Government should streamline their tax collection systems to reduce leakages and increase their revenues through efforts to improve taxation in order to achieve a 15% tax to GDP ratio by the terminal year i.e., 2014-15. Provinces would initiate steps to effectively tax the agriculture and the real estate sectors. Federal Government and Provincial Government may take necessary administrative and legislative steps accordingly."

Importantly, the focus of direct taxes continues to remain narrow, largely relying on withholding tax from salaried class and corporate sector, despite several rounds of reforms. Therefore, the burden of increasing tax collection disproportionally falls on compliant tax payers. The situation becomes even more complicated when existing tax payers have to share the additional burden of foregone taxes due to tax incentives.

Direct taxes

Direct tax collection grew by 10.3 percent against 28.0 percent growth target envisaged in the budget for FY17 and 17.8 percent growth achieved in FY16 (**Table 4.3**). This slowdown was also broad-based as the growth in all the components – voluntary payments, collection on demand, and withholding tax – was lower during FY17 as compared to last year.

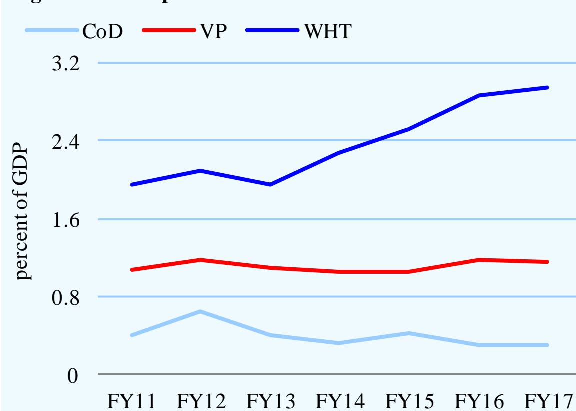
Table 4.3: Break-up of Direct Taxes*
billion rupees; growth in percent

	FY16	FY17	Growth	
			FY 16	FY 17
Voluntary payments	340.8	370.5	29.8	8.7
Collection on demand	87.9	92.8	9.0	5.6
Withholding tax	831.6	940.6	45.5	13.1
Imports and exports	204.6	221.3	36.2	8.1
Contracts	208.9	259.5	60.8	24.3
Salary	86.9	111.2	34.5	28.0
Interest & securities	48.2	42.6	18.4	-11.6
Cash withdrawal	28.6	30.8	49.8	7.7
Dividends	42.0	49.5	73.7	17.7
Electric bills	25.5	25.8	28.9	1.2
Telephone	47.7	51.8	-8.4	8.6
Others	10.4	6.5	158.3	-37.6
Total direct taxes	**1,270**	**1,410**	**38.2**	**11.0**

*Based on gross receipts which may not match with those reported in Table 4.2
Data source: Federal Board of Revenue and SBP Calculations

The growth in withholding tax, which contributes about two-thirds to the direct tax collection, fell to 13.1 percent during FY17 from 45.5 percent in FY16. Within withholding taxes, collection under all sub-heads witnessed either a deceleration in growth or a decline. The growth in collection on demand (CoD) and voluntary payments (VP) decelerated to 5.6 percent and 8.7 in FY17 compared to their respective growth rates of 9.0 percent and 29.8 percent in FY16. The slowdown in CoD, in particular, is despite increased audit by tax authorities to push evaders to file returns.

Figure 4.2: Composition of Direct Taxes in Pakistan



Data source: Federal Board of Revenue and SBP Calculations

In this backdrop, direct tax collection continues to remain dependent on withholding taxes (**Figure 4.2**). Too much dependence on withholding taxes is considered undesirable due to their regressive nature. These have strong implications for the low income group. Moreover, though differential withholding tax rates for filers and non-filers have proved helpful in encouraging more individuals to file income tax returns. However, it had some unintended consequences: for instance, the withholding tax on financial transactions has led to increased use of currency and a decline in bank deposits since its introduction in 2015 (**Special Section 1**).

Indirect taxes

The impact of fiscal incentives was even more pronounced in case of indirect tax collection, which grew by 6.5 percent in FY17, compared to a hefty 21.8 percent increase registered in FY16.[8] The major drag came from slowdown in the sales tax and lower than expected FED collection.

[8] FBR has estimated a revenue loss of around Rs 170 billion: Rs 111 billion from petroleum items; Rs 16.5 billion from

Sales tax

Sales tax collection, which accounts for two-thirds of indirect taxes, grew by merely 1.6 percent during FY17, compared to around 20 percent increase in FY16 (**Table 4.2**). While sales tax collection from imports grew marginally, it declined in case of domestic sales. Mainly the fall in collections from POL, fertilizer and cigarettes reduced the overall sales tax collection.[9] Specifically, the decline in collection from POL can be attributed to the government's decision to reduce sales tax rate to keep domestic POL prices stable (**Box 4.3**). Lower collection in case of fertilizer was due to reduction in sales tax rate under the Kissan Package, whereas collection from cigarettes was affected by substantial decline in production and sale of domestically manufactured cigarettes following an increase in FED.

Box 4.3: POL Pricing and Sales Tax Collection

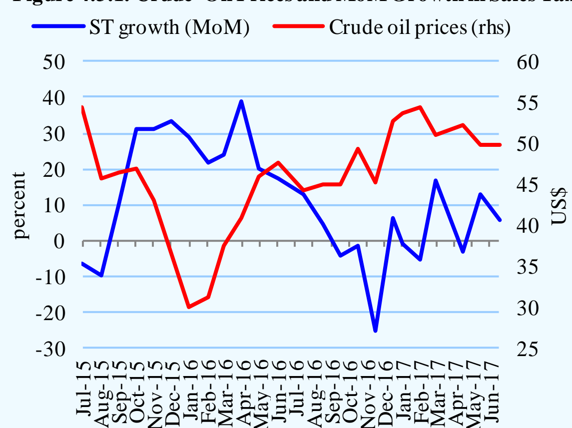
Though POL product prices have been deregulated since 2011, when oil refineries and marketing companies were allowed to fix and announce ex-refinery and ex-depot prices of POL products (including motor spirit, HOBC, light diesel oil, and jet fuels). Yet, the government has a considerable control over the fixing of retail prices through changes in sales tax rates.[10] The ex-refinery or ex-depot prices of POL products for regular consumers consists of ex-refinery import parity price or PSO weighted average cost of purchases, inland freight equalization margin (IFEM), distribution margin of oil marketing companies, dealer's commission, petroleum levy (PL) and general sales tax on depot price.

The government separately notifies the sales tax rates for POL products at varying rates. For example, sales tax on the motor spirit was 20 percent on June 30 2017, while the same was levied at the rate of 14.5 percent and 33.5 percent on HOBC and HSD (**Figure 4.3.1**). Moreover, the government keeps changing the sales tax rates over time, depending on its policy and/or revenue objectives. For example, to provide relief to low income segments, sales tax rate on kerosene and LDO was brought down, from almost 30 percent in August 2015, to zero by December 2016 (**Figure 4.3.2**).

Besides sales tax, the government can also indirectly influence POL product prices through adjustment in the petroleum levy. The petroleum levy, which was originally designed to finance development and up gradation activities of the petroleum sector, had been used actively in the past to finance the fiscal deficit, and it continues to contribute significantly to the exchequer; in FY17, it yielded revenues of almost Rs 167 billion. The IFEM, which is supposed to maintain equalized prices at the 29 depots located across the country, can also be employed to influence retail prices.

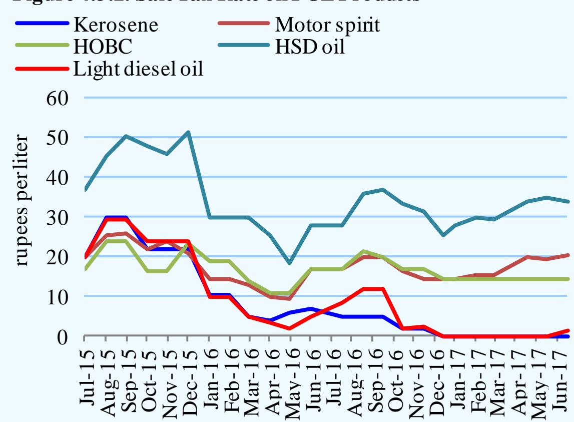
More recently, the government has used the sales tax on POL products more actively to keep domestic retail prices stable. During FY16, when international oil prices were declining (**Figure 4.3.1**), the government raised sales tax rates on POL

Figure 4.3.1: Crude Oil Prices and MoM Growth in Sales Tax



Data source: Federal Board of Revenue and World Bank

Figure 4.3.2: Sale Tax Rate on POL Products



Data source: Federal Board of Revenue and World Bank

fertilizer; Rs 11.5 billion from the textile package; Rs 28 billion from zero-rating and Rs 3 billion from relief on pesticides.

[9] The reduction in GST rates on fertilizer from 17 to 5 percent under the Prime Minister's Kissan package, coupled with the cut in feedstock prices to lower the per bag cost of fertilizer, led to lower GST collection from the commodity. Lower sales tax collection from cigarettes was due to the decline in demand for locally manufactured cigarettes following the increase in FED rates on the commodity, which induced brand substitution with counterfeit alternatives.

[10] The Oil and Gas Regulatory Authority (OGRA) only notifies kerosene oil prices.

products instead of fully passing-on the impact of lower international prices to domestic consumers (**Figure 4.3.2**). As a result, collection from POL increased to Rs 275 billion, raising its contribution to 40.3 percent in overall domestic sales tax collection during FY16.

During FY17, the government absorbed most of the increase in international oil prices (which had bottomed out by Q3-FY16) by reducing the sales tax on POL products. While some upward adjustments to the tax rates has been made, for full-year FY17, the sales tax collection from POL declined sharply by 17.7 percent to Rs 226.6 billion, from Rs 275.3 billion in FY16.

Federal excise duty

FED grew by 5.6 percent during FY17, compared to 15.9 percent growth witnessed last year (**Figure 4.3**). This increase was notable despite 27.1 percent decline in collection from cigarettes (which accounts for one-third of total collection under this head). In fact, following an increase in FED rates, cigarettes production fell significantly as people switched to non-duty paid counterfeit brands available in the market.

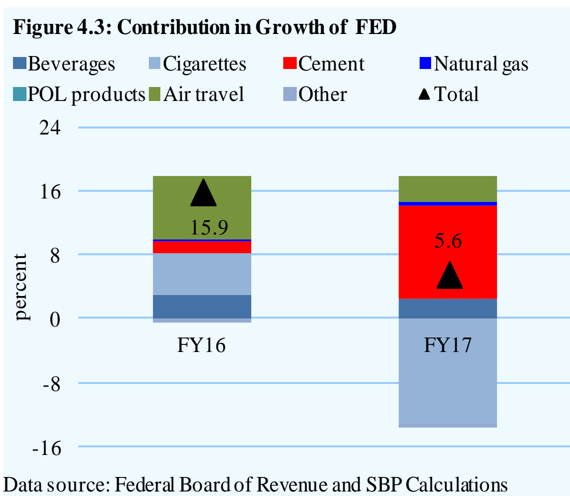
In response, FBR set up a task-force to confiscate illicit brands and impose penalty on businesses making illegal sales. This measure brought some recovery in the falling FED revenue from cigarettes. Moreover, a system of online tracking and monitoring of e-stamped cigarettes has been introduced to discourage the use of duty unpaid brands.

However, the decline in FED on cigarettes was more than offset by a significant rise in FED on beverages. Meanwhile, the cement sector contributed 12.6 percent to FED growth during FY17. Higher collection from cement reflects both higher dispatches (on the back of increased domestic demand, especially from ongoing CPEC-related infrastructure projects), and an increase in FED rates. Similarly, FED collection from beverages registered a 24.6 percent growth, contributing 2.6 percent in growth in FY17. This was an outcome of upward revision in duty structure, as well as, an increase in consumption of aerated water.[11]

Custom duty

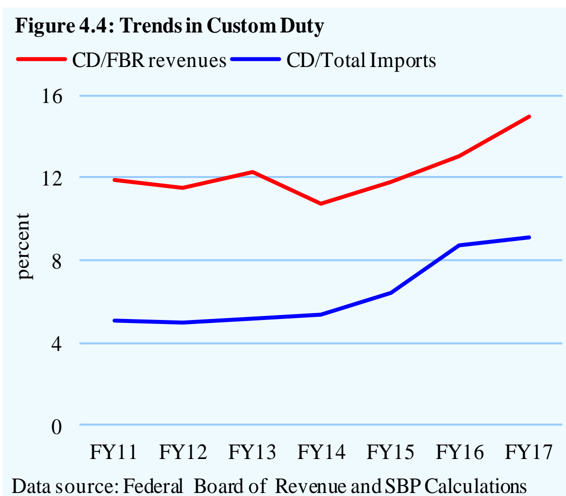
Custom duty collection surged by 22.6 percent in FY17 on top of the 32 percent growth observed last year. This rise can be attributed to a sharp increase in imports, coupled with upward revision in duty structure. Yet the slower growth compared to last year was due to relaxation allowed in duty on machinery imports (see **Box 4.1**). Consequently, the ratio of customs duty to total imports flattened in FY17. In other words, a wedge was created between growth in duty collection and growth in the total

Figure 4.3: Contribution in Growth of FED



Data source: Federal Board of Revenue and SBP Calculations

Figure 4.4: Trends in Custom Duty



Data source: Federal Board of Revenue and SBP Calculations

[11] Federal excise duty on aerated water was revised to 11.5 percent in FY17 from 10.5 percent.

imports (**Figure 4.4**).

Non-tax revenues
Bolstered by one-off receipts – including Rs 100 billion from disinvestment of government stakes in the Pakistan Security Printing Corporation and Rs 64 billion from the sale of two LNG power plants under the Pakistan Development Fund – non-tax revenue grew by 23 percent in FY17 after declining sharply by 13.9 percent in FY16 (**Table 4.4**). Besides, the increase in markup from PSEs, royalties received on oil and gas also contributed sizably to non-tax revenues. The revenue collections from other heads mostly remained below target for the year.

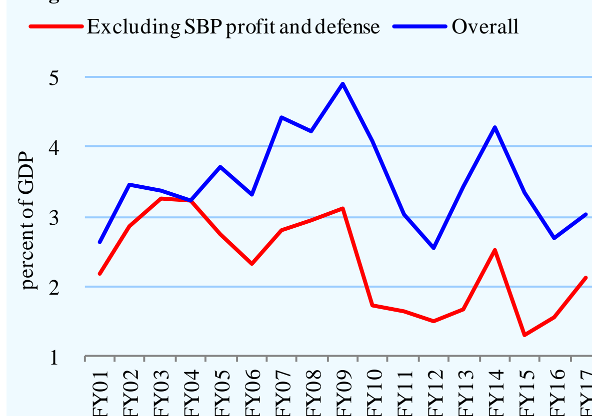
Adjusting for 'one-off' revenue items, non-tax revenues were significantly lower compared to last year, as SBP's profit was almost same as in FY16, and CSF inflows had declined from last year. In fact, non-tax revenue collection has become volatile over time due to increased dependence on these two sources (**Figure 4.5**). Thus, non-tax revenues remain a constant source of uncertainty in achieving the overall revenue target. In this backdrop, there is a need to diversify the revenue resources for non-tax collection, which may help bring down the effective rate for taxpayers.

Table 4.4: Non-tax Revenues
billion rupees

	Budget	Actual	
	FY17	FY16	FY17
Mark-up (PSEs & others)	81.1	57.7	99.7
Dividends	85.0	88.5	69.7
SBP profits	280.0	227.9	227.8
Defense (including CSF)	171.0	107.0	67.8
Profits from post office/PTA (3G)	81.0	34.3	33.6
Royalties on gas & oil	43.0	57.7	53.0
Passport & other fees	25.0	20.8	20.1
Discount retained on crude oil	10.0	9.1	9.1
Windfall levy against crude oil	10.0	1.6	1.6
Other	254.9	181.8	385.1
Total non-tax revenue	**1,041.0**	**786.6**	**967.5**

Data source: Ministry of Finance

Figure 4.5: Non-Tax Revenues



Data source: Ministry of Finance and SBP Calculations

4.3 Expenditure

Total expenditure grew by 14.5 percent in FY17, compared to 8.0 percent in FY16 (**Table 4.5**). Although growth in both current and development expenditure was higher during FY17, current expenditure contributed the most. The current expenditure grew by 10.7 percent (to 16.3 percent of GDP) in FY17 compared to 6.1 percent increase in FY16. Encouragingly, development expenditure grew much faster by 30.1 percent, compared to 16.9 percent last year.

This sharp rise in total expenditure indicates that fiscal consolidation efforts seen during the last few years have lost some steam. Since FY13, the growth in expenditure, in terms of GDP, remained subdued compared to growth in revenue (**Figure 4.6**). The ratio of total

Table 4.5: Consolidated Fiscal Spending
billion rupees; growth in percent

	Spending		Growth	
	FY16	FY17	FY16	FY17
Current expenditures	**4,694**	**5,198**	**6.1**	**10.7**
Federal	3,144	3,472	3.5	10.4
Interest payment	1,263	1,348	-3.1	6.7
Defense	758	888	8.6	17.2
Public order and safety	96	128	15.6	32.7
Others	1,027	1,108	7.8	7.9
Provincial	1,550	1,726	11.7	11.3
Development expenditures	**1,302**	**1,693**	**16.9**	**30.1**
PSDP	1,186	1,578	20.0	33.1
Federal	593	726	21.4	22.3
Provincial	592	852	18.8	43.9
Others (including BISP)	116	116	-8.0	0.2
Net lending	**13**	**-13**	-54.0	-201.7
Statistical discrepancy	-212	-78	19.4	-63.2
Total expenditure*	**6,008**	**6,879**	**8.0**	**14.5**

* Excludes statistical discrepancy but includes net lending
Data source: Ministry of Finance

expenditure to revenue sharply declined from 161.5 percent in FY13 to 130.3 percent in FY16, indicating the impact of fiscal consolidation efforts. However, this trend reversed in FY17, as the expenditure-to-revenue ratio increased to 137.8 percent (**Figure 4.6**).

Within current expenditure, interest payments increased by 6.7 percent in FY17 compared to the 3.1 percent decline witnessed last year (**Chapter 5**). Yet, its share in total expenditure fell below 20 percent in FY17, from the peak of 24.2 percent in FY15. This lower share of interest payment in total spending provided some fiscal space for higher development expenditure (**Figure 4.7**).

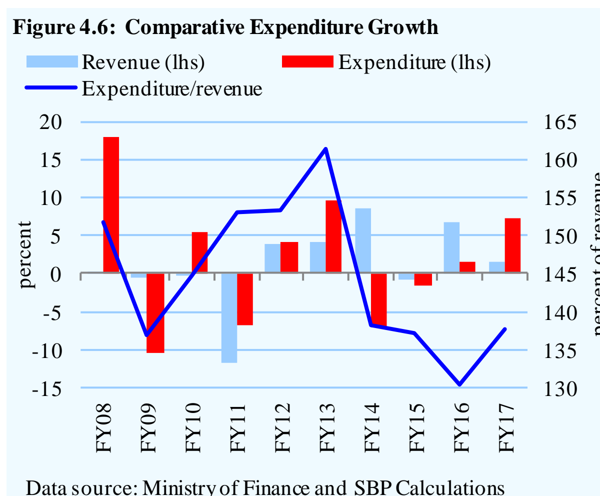
The development expenditure edged above five percent of GDP for the first time since FY07. Both the federal and the provincial governments accelerated work on development projects in the wake of upcoming general elections (**Figure 4.8**).

4.4 Provincial Fiscal Operations

The provincial fiscal position weakened considerably during FY17 as compared to the previous few years. Against a targeted surplus of Rs 339 billion, the provinces posted a deficit of Rs 15.9 billion. This was largely due to a significant increase in provincial expenditures, with own revenue collection growing at a slower rate (**Table 4.6**).

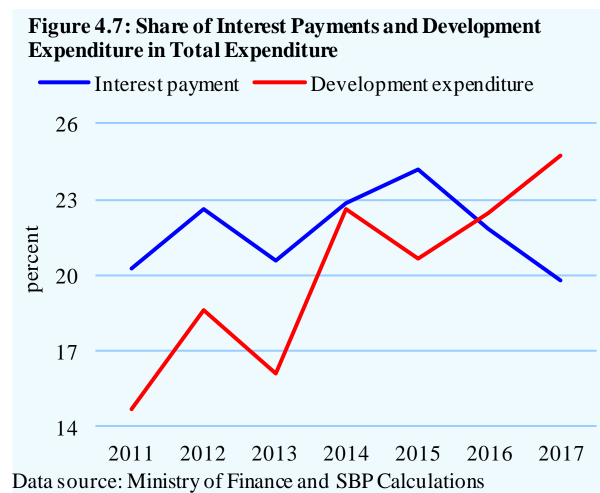
It is also worth noting that weakening in the provincial fiscal position was concentrated in Q4-FY17. The fiscal operations up to Q3-FY17 indicated that the provinces were well on-course to achieve the annual surplus target (**Figure 4.9**). However, in the last quarter, the expenditures jumped by Rs 992.9 billion, largely due to higher development spending (**Figure 4.10**). In fact, all the provinces posted deficits in Q4, with the largest contribution coming from Sindh (**Figure 4.9**). Similar to the trends in expenditure, against improved revenue position witnessed up to Jul-Mar FY17, the growth in provincial revenue mobilization also deteriorated during Q4-FY17.

Figure 4.6: Comparative Expenditure Growth



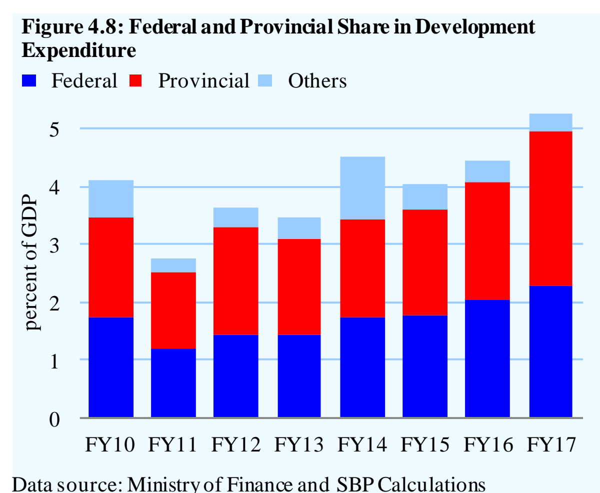
Data source: Ministry of Finance and SBP Calculations

Figure 4.7: Share of Interest Payments and Development Expenditure in Total Expenditure

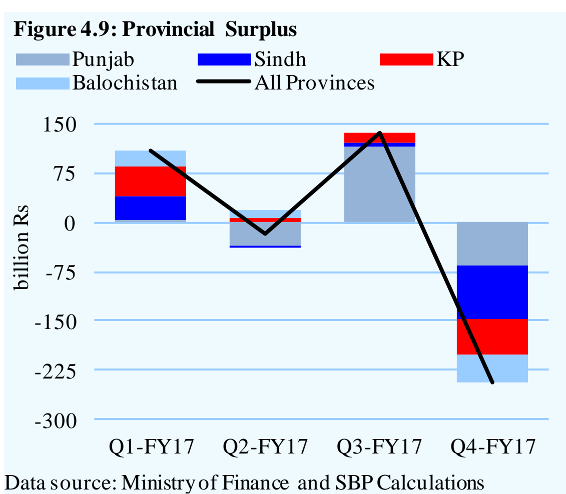


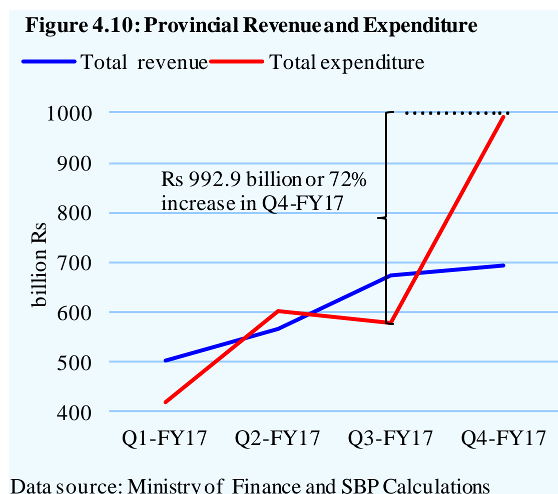
Data source: Ministry of Finance and SBP Calculations

Figure 4.8: Federal and Provincial Share in Development Expenditure



Data source: Ministry of Finance and SBP Calculations





Provincial expenditures

The provincial expenditures grew by 20 percent during FY17 as compared to 13.3 percent in FY16 (**Table 4.6**). The major contribution came from development expenditures which grew by 43.8 percent, while current expenditures almost maintained their last year's growth. The break-up of development expenditure shows that general public administration and economic affairs accounted for most of the share in total provincial expenditures.[12]

Table 4.6: Provincial Fiscal Operations
billion rupees; growth in percent

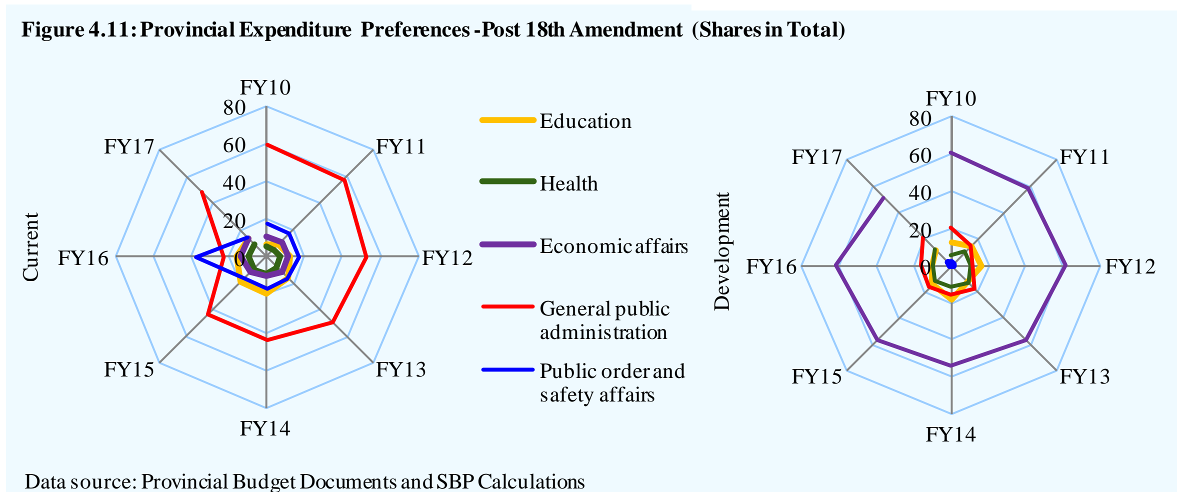
	Punjab	Sindh	KP	Balochistan	Total	Growth
FY 17						
A. Total revenue	1,149.5	692.6	361.8	224.3	2428.2	5.9
Provincial share in federal revenue	928.8	516.9	315.2	204.9	1965.8	5.6
Provincial revenues (I+II)	187.7	153.1	49.7	10.9	401.3	6.6
I. Taxes	155.4	144.5	15.7	6.3	321.8	13.6
II. Non-tax revenues	32.3	8.6	34.0	4.6	79.5	-14.8
Federal loans and grants	33.0	22.7	-3.1	8.6	61.2	11.0
B. Total expenditure	1,154.5	754.1	436.7	246.2	2591.5	20.4
Current	716.1	550.9	299.0	173.3	1,739.3	11.5
Development	438.4	203.2	137.7	73.0	852.2	43.8
Gap (A-B)	-5.0	-61.5	-74.9	-21.9	-163.2	-215.2
Financing (overall balance)*	**-15.7**	**39.0**	**-13.5**	**6.0**	**15.9**	**-107.7**
FY 16						
A. Total revenue	1,091.5	641.2	364.3	196.8	2,293.9	20.6
Provincial share in federal revenue	901.5	488.7	302.1	170.0	1,862.2	21.0
Provincial revenues (I+II)	174.2	132.2	58.9	11.3	376.6	33.8
I. Taxes	142.9	123.0	13.1	4.3	283.3	37.6
II. Non-tax revenues	31.3	9.2	45.8	7.0	93.3	23.4
Federal loans and grants	15.8	20.4	3.4	15.6	55.1	-33.0
B. Total expenditure	990.3	590.7	359.8	211.5	2,152.2	13.3
Current	705.5	456.3	246.9	151.0	1,559.8	11.4
Development	284.8	134.4	112.8	60.4	592.4	18.8
Gap (A-B)	101.2	50.6	4.6	-14.7	141.7	3,951.0
Financing (overall balance)*	**-76.1**	**-84.0**	**-74.1**	**26.9**	**-207.4**	**137.6**

* Negative sign means surplus.
Data source: Ministry of Finance and SBP Calculations

[12] *General Public Administration* includes the management of executive and legislative organs, financial and fiscal affairs, transfers, and general public services. *Economic affairs* include expenditures by the government mainly on the following items: (i) general economic affairs (commercial, labor and state trading); (ii) agriculture, irrigation, food, forestry and fishing; (iii) fuel & energy; (iv) construction and transport; and (v) communication and storage.

This trend is not limited to development expenditures. The provincial current expenditures also remained skewed in the same fashion. Even when looked in the context of fiscal federalism and devolution after the 18th Amendment, there is hardly any change in the pattern of provincial spending. After the 18th Amendment, *health*, *education* and *public order and safety affairs* were made provincial subjects. However, since then, provincial spending on health and education has remained quite negligible **(Figure 4.11)**.[13] However, Balochistan and Sindh have increased the share of education and health related spending in their total expenditure while it fell in case of Punjab and KP (**Figure 4.12**).

Figure 4.11: Provincial Expenditure Preferences - Post 18th Amendment (Shares in Total)



Data source: Provincial Budget Documents and SBP Calculations

Moreover, the allocations for education have been more inclined towards infrastructure development rather than improving educational quality, which ought to be the ultimate objective for better human capital in the long run.[14] Given that Pakistan ranks low at 118 out of 130 countries in the Human Capital Index, the provincial governments should invest more resources in education and health to produce effective human capital.[15]

Provincial revenue

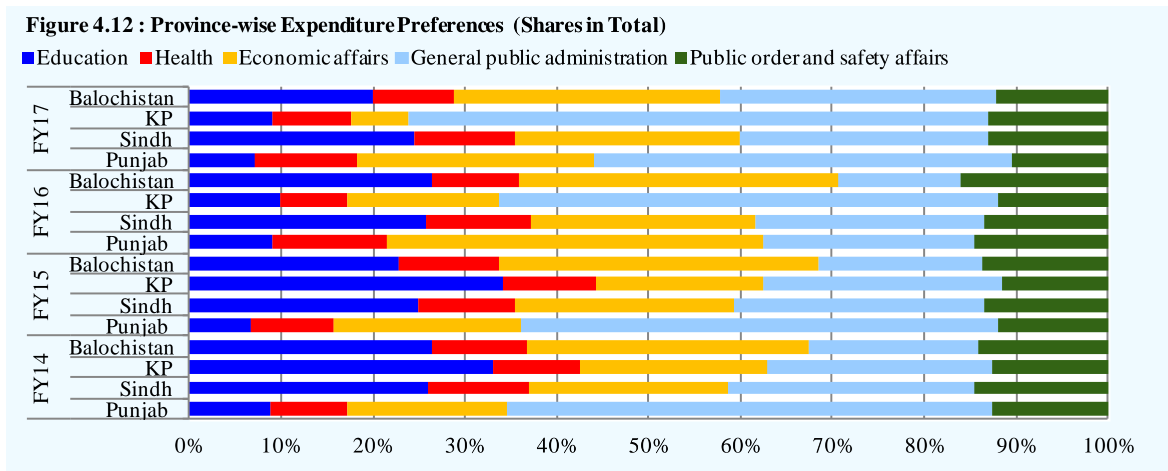
The trends in provincial revenue mirrored those of federal revenue. The growth in provincial revenue decelerated to 5.9 percent in FY17, after persistently rising for the last two years. This was largely due to declining growth in provincial non-tax revenue, while growth in tax revenue also tapered off.

General Sales Tax on Services (GSTS), motor vehicle tax, and stamp duties were the major contributors to provincial revenue during FY17 **(Figure 4.13)**. Property taxes also posted a growth which is due to the revenue efforts by provinces (**Box 4.4**) such as Land Automation Systems and Invoice Monitoring System on various services.[16,17] However, revenue from excise duties and other sources of provincial tax collection registered a decline as compared to last year.

[13] In the second and third phases of devolution under the 18th Amendment, the ministries of education and health were devolved respectively.
Source: 'Status of Implementation of Eighteenth Amendment in KP in Health, Education and Agriculture sector'; a study conducted by USAID and Centre for Peace and Development Initiatives (CPDI).
[14] Fatima Khaliq and Waqas Ahmad, Quality and Effectiveness of Public Spending on Education in Pakistan, SBP Staff Notes 02/16.
[15] Source: Human Capital Report (2016), World Economic Forum.
[16] The Punjab government, in collaboration with the Punjab Information Technology Board (PITB), has launched the Invoice Monitoring System on various services, especially restaurants and beauty parlors (source: Notification No.PRA/Orders.06/2012, Dated January 13th, 2015).

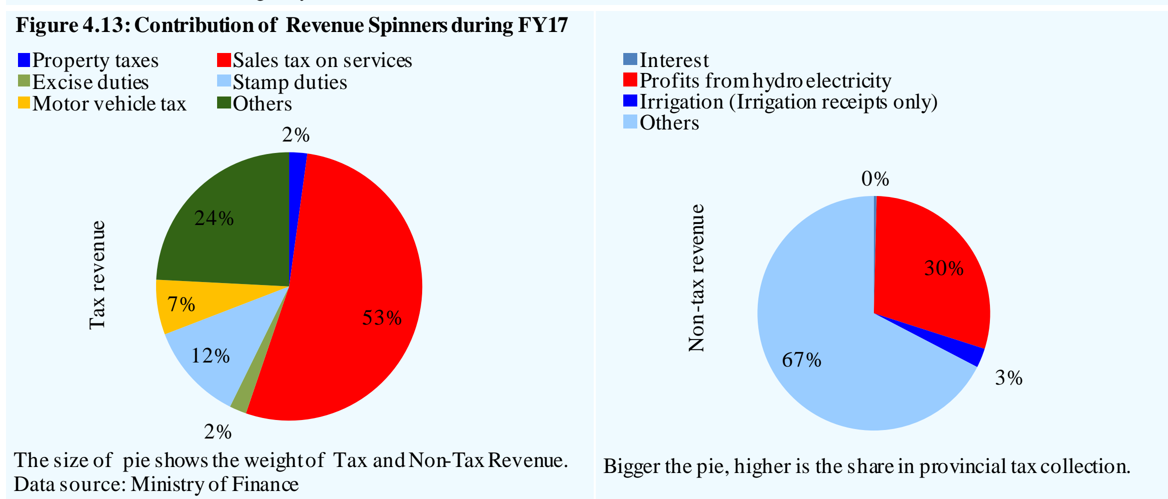
Meanwhile, the provincial non-tax revenue declined sharply by 14.8 percent during FY17 against a 23.4 percent growth witnessed in FY16. This contraction was due to diminution in profits from hydroelectricity, the main source of non-tax revenue of KP (**Table 4.6**).

Figure 4.12 : Province-wise Expenditure Preferences (Shares in Total)



Data source: Provincial Budgetary Documents and SBP Calculations

Figure 4.13: Contribution of Revenue Spinners during FY17



The size of pie shows the weight of Tax and Non-Tax Revenue.
Data source: Ministry of Finance

Bigger the pie, higher is the share in provincial tax collection.

Box 4.4 Provincial Revenue Mobilization in the Context of 18th Amendment

Under the provincial autonomy and fiscal decentralization introduced after 18th Amendment in 2009, the provinces were allowed to collect sales tax on services, and to tax real estate and agriculture income. As a result, the provinces' own tax revenue started to increase both in terms of GDP and total provincial revenue with the introduction General Sales Tax on Services (GSTS), first by Sindh in 2011 and then by Punjab in 2012. The provincial revenue further received impetus from reforms and tax measures introduced by Punjab and Sindh during the last two years.[18,19]

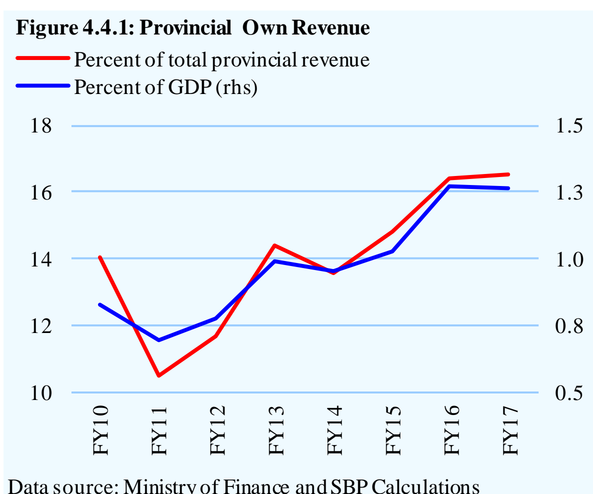
Notwithstanding some improvement in recent years, the progress in provincial own tax collection has been less encouraging when looked in the context of its contribution to overall tax collection (**Figure 4.4.1**). Since FY11, the provincial own tax revenue increased by 0.5 percentage points to 1.2 percent of GDP in FY17.

[17] Land Administration and Revenue Management Information System (LARMIS), Board of Revenue, Government of Sindh.

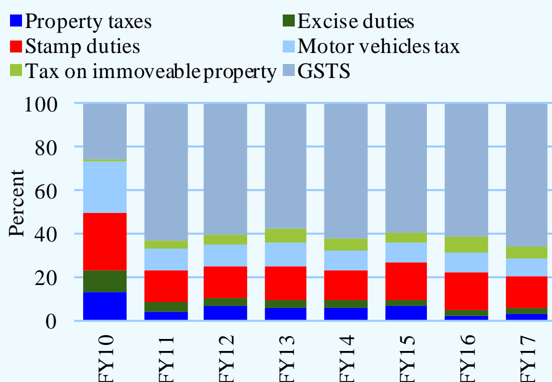
[18] Computerization of Land Record under LARMIS Order No. 1298-2013/568-LR-(I) Board of Revenue, Punjab. Land Administration and Revenue Management Information System (LARMIS), Board of Revenue, Government of Sindh.

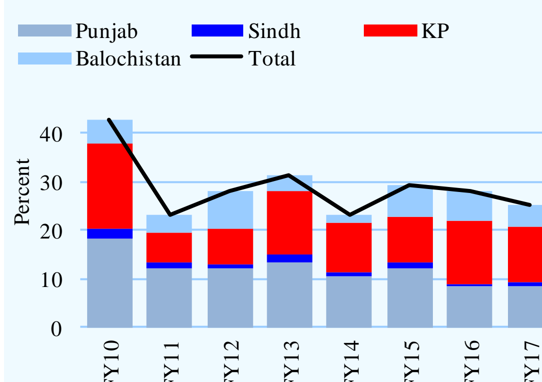
[19] The Government of Punjab, in collaboration with PITB, has launched Invoice Monitoring System on various services especially restaurants and beauty parlors (Source: Notification No.PRA/Orders.06/2012, Dated January 13th, 2015).

Within this, the large part of the increase was contributed by GSTS, about 0.4 percentage points in the provincial tax collection. This is very small compared to close to 60 percent share of services in GDP. Thus, there is a large potential of raising revenue from certain sectors. The collection from property and agriculture continues to remain insignificant **(Figure 4.4.2)**. Provincially, the share of tax collection from agriculture income has in fact remained somewhat stagnant.



The reasons for this below par performance can be traced to delayed implementation (of tax initiatives) due to lack of institutional structure and capacity constraints. In fact, the provinces started to establish provincial tax authorities well after the announcement of devolution and 18th Amendment. Sindh was the first to establish its revenue board immediately after the constitutional amendment. The Punjab Revenue Authority was established in 2012, followed by KP in 2013 and Balochistan in 2015. Moreover, there are multiple revenue departments within the provinces with overlapping authorities for revenue collection.





The other major reason has been lack of documentation, which has created difficulties in authorities' access to potential taxpayers. This has been particularly true in case of tax on services. However, in case of agriculture, tax collection has fallen even after computerization of land record in KP, Punjab and recently in Sindh. It can be reasoned that the difficulties in gauging agricultural income, due to both the nature of income (which is mostly informal) and the lack of expertise on the part of authorities, remains the main hurdles **(Figure 4.4.3)**.

Besides operational constraints on raising revenue by the provinces, the increase in provincial share in federal divisible pool from 47.5 to 57.5 percent in the 7th NFC Award, which constitute about 80 percent of total provincial revenue, has also created a sense of complacency. This brings us to conclude that the effective resource mobilization at provincial level cannot be overlooked especially when it comes to macroeconomic stability and containment of overall fiscal deficit.