4 Fiscal Policy

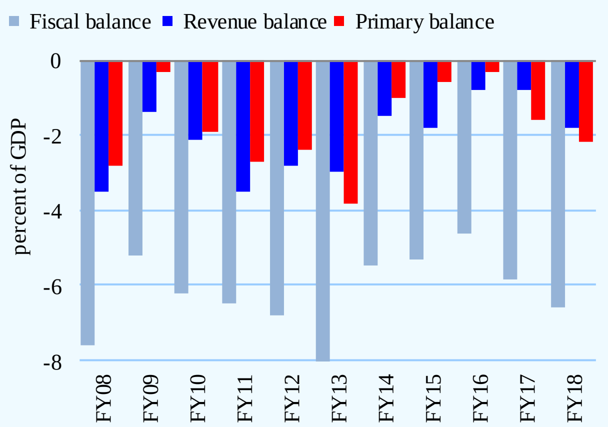
4.1 Overview

A sharp deceleration in revenue growth compared to expenditure, led to an increase in the fiscal deficit to the highest level during the past five years (**Figure 4.1**). Other indicators of fiscal performance also saw a deterioration. For instance, increase in primary deficit shows higher growth in non-interest expenditures compared to revenue growth. Similarly, increase in revenue deficit points to higher growth in current expenditures vis-à-vis revenue.

Half yearly break-up shows that fiscal deficit in the second half increased to almost twice that of first half of the FY18. Though the pace of increase in both the government expenditure and revenue slowed down, higher deficit in H2-FY18 was mainly due to slower revenue growth (**Figure 4.2**).

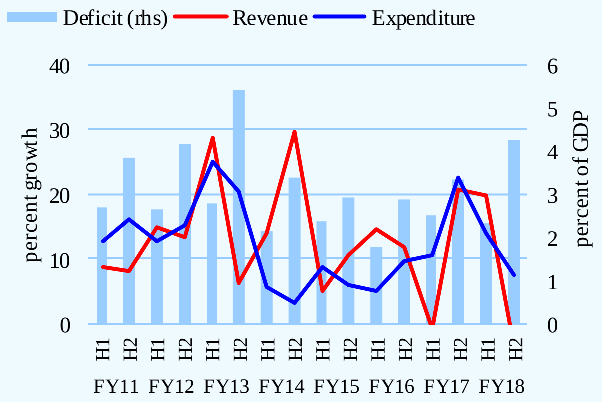
The drag in revenue collection came from a contraction in non-tax revenues. All the components, except for SBP profit and royalties/windfall levy from oil and gas production, recorded lower revenue in FY18. In particular, defense related revenue in the absence of Coalition Support Fund (CSF), mark-up/dividend income, and PTA/postal service profit recorded declines.

Figure 4.1: Fiscal Indicators



Data sources: Ministry of Finance and SBP calculations

Figure: 4.2: Trends in Revenue, Expenditure and Fiscal Deficit



Data source: Ministry of Finance

On the other hand, tax collection witnessed a broad-based acceleration in growth. The FBR tax collection, in particular, recorded a double-digit growth during FY18. This was despite a marked slowdown in the FBR tax collection within the year from 22.0 percent in the first quarter to 10.6 percent in the fourth quarter of FY18. This deceleration was primarily due to a sluggish growth in indirect taxes in the fourth quarter on account of slowdown in manufacturing activity, especially in the cement, cigarettes and beverages sectors.

Despite reduction in the corporate tax rate (other than banks) and low bank profitability, the direct tax collection grew at a higher pace and was supported by one-off receipt under the tax amnesty scheme. Moreover, provincial tax collection led by General Sales Tax on Services (GSTS), continued to maintain the momentum achieved during the last few years.

On the expenditure side, the deceleration was primarily due to a decline in development expenditure. This is opposite to the trends observed during the previous few years where fiscal policy focused on supporting economic growth through a sustained increase in development spending. The decline in development expenditure was mainly due to slower PSDP releases towards the end of FY18, especially during the interim government period. The growth in current expenditures, as was expected in an election year, accelerated largely due to a sharp increase in provincial current spending.[1]

The resulting higher financing requirements during FY18 were met through both domestic and external sources. In case of external, government heavily relied on commercial borrowing, bonds/Sukuk and bilateral loans. On the domestic front, borrowing increased from both the bank and non-bank sources. Within the bank borrowing, government primarily depended on SBP borrowing; this was not only to meet its additional financing requirements, but also to retire the maturing long-term debt owed to banks during the year.

Table 4.1: Summary of Fiscal Operations

billion rupees

		Actual		% of GDP	
	Budget FY18	**FY17**	**FY18**	**FY17**	**FY18**
A. Total revenue	6,167.2	4,936.7	5,228.0	15.4	15.2
Tax revenue	4,912.5	3,969.2	4,467.2	12.4	13.0
Non-tax revenue	1,254.7	967.5	760.9	3.0	2.2
B. Total expenditure	7,646.8	6,800.5	7,488.4	21.3	21.8
Current	5,393.9	5,197.9	5,854.3	16.3	17.0
Interest payments	*1,363.0*	*1,348.4*	*1,499.9*	*4.2*	*4.4*
Defence	*920.2*	*888.1*	*1,030.4*	*2.8*	*3.0*
Development	2,265.2	1,693.5	1,584.1	5.3	4.6
Net lending	-12.3	-12.8	37.6	0.0	0.1
Statistical discrepancy	0	-78.0	12.4	-0.2	0.0
Fiscal balance (A-B)	-1,479.6	-1,863.8	-2,260.4	-5.8	-6.6
Revenue balance	773.3	-261.1	-626.3	-0.8	-1.8
Primary balance	-116.6	-515.4	-760.5	-1.6	-2.2
Financing	*1,479.6*	*1,863.8*	*2,260.4*	*5.8*	*6.6*
External sources	511.4	541.4	785.2	1.7	2.3
Domestic sources	968.1	1,322.4	1,475.2	4.1	4.3
Banks	390.1	1,045.8	1,120.5	3.3	3.3
Non-bank	528.0	276.6	352.7	0.9	1.0
Privatization	50.0	0.0	0.0	0.0	0.0
% Growth					
Total revenue		11.0	5.9		
Tax revenue		8.4	12.5		
Non-tax revenue		23.0	-21.4		
Total expenditure		17.3	10.1		
Current		10.7	12.6		
Development		30.1	-6.5		

Data sources: Ministry of Finance and SBP calculations

4.2 Revenue

The total revenue grew by 5.9 percent during FY18, almost half of the 11.0 percent growth realized in the previous year. This deceleration was mainly caused by a drag in non-tax revenues. The growth in

[1] The growth in current expenditure was expected to increase like in previous election years. For instance, the growth in current expenditure accelerated to 35.1 percent in FY08 from 22.7 percent in FY07. Similarly, current expenditures grew by 17.2 percent in FY13 compared to 7.6 percent in FY12.

tax revenue, on the other hand, remained fairly broad-based as tax collection by both FBR and provinces accelerated during FY18.

FBR taxes

FBR tax collection was recorded at Rs 3,842 billion during FY18, showing a 14.3 percent increase during the year against 8.0 percent growth realized in the previous year (**Table 4.2**). Though higher than last year, the growth remained below the FY18 target (19.4 percent) despite a contribution of around Rs 89.6 billion collected under tax amnesty scheme up to 30th June 2018.[2]

Nevertheless, higher tax collection compared to last year provided necessary space to gear up tax refunds to ease cash constraints of the exporting industries. The tax authority cleared Rs 154.7 billion during FY18, compared to Rs 87.0 billion in the previous year.

Direct Taxes

The direct taxes grew by 14.4 percent during FY18 compared to a 12.7 percent increase observed during the last year (**Table 4.3**). The major contribution came from withholding taxes notwithstanding its slower growth. Within WHT, collection from rising trade volumes, contracts, salaries and dividend income increased while revenue from mobile recharge and subscription declined.[3] The collection on demand (COD) also increased, though its share in total direct taxes is only 6.7 percent. This is an outcome of improvement in the audit process from random selection to risk based audit.

However, voluntary payments (VP), having a share of 25 percent in total direct taxes, increased by only 1.9 percent during FY18 compared to a growth of 8.7 percent in the previous year (**Table 4.3**). This was largely

Table 4.2: FBR Tax Collection

billion rupees

	Budget FY18	Collections FY17	Collections FY18	% Growth FY17	% Growth FY18
Direct taxes	1,594.9	1,343.2	1,536.6	12.7	14.4
Indirect taxes	2,418.1	2,017.8	2,305.5	5.1	14.3
Customs duty	581.4	496.0	608.3	22.1	22.6
Sales tax	1,605.2	1,323.3	1,491.3	0.0	12.7
FED	231.5	198.6	205.9	4.2	3.7
Total taxes	**4,013.0**	**3,361.0**	**3,842.1**	**8.0**	**14.3**
Total taxes (% of GDP)	**11.2**	**10.5**	**11.2**	-	-

Data sources: Federal Board of Revenue and Ministry of Finance

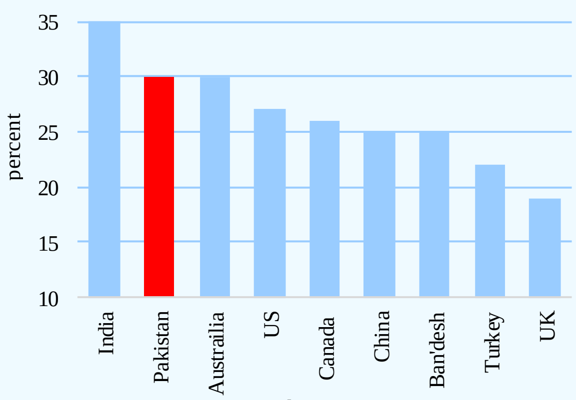
Table 4.3: Break-up of Direct Taxes

billion rupees

	FY17	FY18	Growth (%) FY 17	Growth (%) FY 18
A. Voluntary payments	**370.5**	**377.4**	**8.7**	**1.9**
B. Collection on demand	**92.8**	**104.1**	**5.6**	**12.2**
C. Withholding taxes	**940.6**	**1,004.0**	**13.1**	**6.7**
of which				
Imports and exports	221.3	247.0	8.1	11.6
Contracts	259.5	283.2	24.3	9.1
Salary	111.2	133.4	28.0	19.9
Interest & securities	42.6	45.6	11.6	7.2
Cash withdrawal	30.8	34.0	7.7	10.3
Dividends	49.5	57.8	17.7	16.9
Electric bills	25.8	33.8	1.2	30.9
Telephone	51.8	47.4	8.6	-8.5

Data source: Federal Board of Revenue and SBP calculations

Figure 4.3: Corporate Tax Rate in Selected Countries



Data source: KPMG International

[2] The amnesty scheme was introduced for the declaration of assets through two separate ordinances: Foreign Assets (Declaration and Repatriation) Act 2018 and Voluntary Declaration of Domestic Assets Act 2018. The scheme offered minimum tax rate of 2 to 5 percent depending on the nature of assets. The scheme helped add around 75,000 new tax payers into the formal system to raise the number of tax filers to 1.46 million. It is worth mentioning that the scheme was extended up to 31st July 2018.

[3] This is due to reduction in WHT rate from 14.0 percent to 12.5 percent on mobile phone subscription and suspension of WHT on mobile phone recharge under Supreme Court orders in June 2018.

due to lower bank profitability and a reduction in corporate tax rate (other than banks) from 31 to 30 percent.[4]

It is important to mention here that the government has gradually scaled down the corporate tax rate from 35 percent to 30 percent over the span of five years. The move was critical in creating a competitive business environment in line with international practices (**Figure 4.3**). Going forward, it is planned to reduce the corporate tax rate further to 25 percent in next 5 years. The move is expected to encourage investment and increased voluntary payments, which will contribute to higher revenue collection along with better prospects for economic growth and employment generation. Nevertheless, encouraging digitization by avoiding human interface i.e. connecting people with revenue authority through the use of technology will be crucial in overcoming leakages (**Box 4.1**).

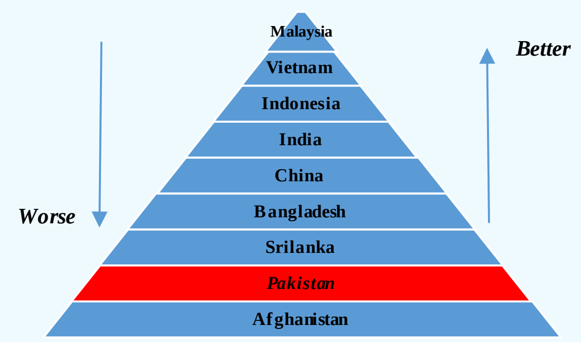
Box 4.1: Digitization of Tax Collection in Pakistan: A Welcome Initiative

State Bank of Pakistan and Federal Board of Revenue have jointly introduced the online collection of Government taxes and duties through one-link facility.[5] This would be applicable for the payment of income tax, sales tax, excise, and custom duties. Such a scheme is aimed at improving payment systems especially in the context of revenue collection besides facilitating tax payers and minimizing incidence of leakages.

This move is also expected to contribute positively towards revenue generation by lowering the chances of inefficiencies in the tax collecting machinery. Empirical studies show a strong correlation between electronic tax collection and revenue growth. Therefore, advancements in tax collecting mechanism in terms of digitization is expected to facilitate tax payers and enhance revenue collection.

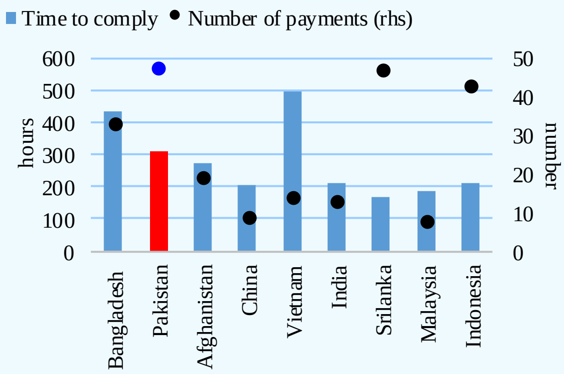
More importantly, the initiative would be helpful in minimizing the time involved in tax payments through traditional methods. For instance, many small and medium businessmen argue that there is a cost incurred on visiting banks and tax offices for the payment of various taxes hence exacerbating their overall tax compliance costs. Thus, it will reduce cost for the tax payers as well.

Figure 4.1.1: Overall Ranking in Paying Taxes 2018: Selected Economies in Asia Pacific



Data source: Paying Taxes 2018, World Bank

Figure 4.1.2: World Bank Indicators Regarding Electronic Tax Payments*



*The higher values of these two indicators show the absence of electronic tax paying systems installed and vice versa.

According to World Bank's *Paying Taxes* report, the sub-indicators of the overall paying taxes' measure such as *number of payments*[6] and *time to comply*[7] particularly assess the progress regarding online filing and tax payments. The lower the extent of these indicators, the higher the IT enabled procedures installed in the tax system. For instance, Estonian tax payers

[4] Banking sector profit fell by 18.9 percent to Rs 245.0 billion during FY18 compared to Rs 302 billion in last year.
[5] See *"Online Collection of Government Taxes and Duties Launched"*. Source: www.sbp.org.pk/press/2018/Pr-Online-Taxes-20-Mar-18.pdf
[6] According to the *number of payments'* indicator, the frequency of payments are counted keeping in view the mode of tax payments. A payment is counted as once where majority taxpayers use online tax filing and payment systems and even make frequent payments. Therefore, less number of payments means that the tax payers use the electronic systems for tax payment.
[7] The indicator measures the time taken to prepare, file, and pay three major types of taxes and contributions.

spend only 81 hours per year in preparing, filing, and paying their taxes such as VAT and labor taxes including mandatory contributions. [8]

As per this report, Pakistan falls lower in the ranking among the Asian pacific countries in the overall tax paying category **(Figure 4.1.1)**. In other words, absence of efficient IT based systems in tax collection mechanisms is reflected in higher magnitude of 'number *of payments' and 'time to comply'* indicators as in case of Pakistan (**Figure 4.1.2**). Therefore, the initiative holds the potential to improve Pakistan's ranking in *paying taxes* and reflect better in terms of ease of doing business.

However, some concerns need to be taken care of to ensure the effective implementation of the system. From the tax payers' side, "computer literacy" can be achieved by making every actor (tax payers and tax officials) capable of using the digitized processes through trainings. Whereas, digitization processes such as electronic payment and filing should be further simplified by the tax collecting authorities.

Furthermore, digital risks emanating from this system also need to be addressed carefully. Cyber security and privacy issues should be prudently tackled for developing taxpayers' trust and making digitization more progressive.

References:

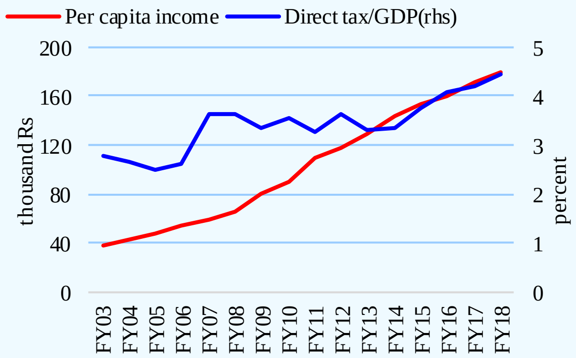
- Bett, B.K., Yudah, O.A. (2017). Contribution of i-Tax System as a Strategy for Revenue Collection at Kenya Revenue Authority, Rift Valley Region, Kenya. *International Journal of Scientific and Research Publication*, 7(9), 389-396
- Gitaru, K. (2017). The Impact of System Automation on Revenue Collection in Kenya Revenue Authority (A Case Study of SIMBA).
- Ndayisenga, E., Shukla, J. (2016). Effect of Electronic Tax Management System of Tax Collection in Rwanda: A Case Study of Rwanda Revenue Authority. *International Journal of Business and Management*, 4(5), 38-49

However, despite higher direct tax collection during FY18, its share in total taxes as well as in terms of GDP remains lower relative to rising income level and the actual potential.[9] Besides bringing in the principle of equity in taxation, exploiting the direct tax potential would also contribute significantly to the overall tax revenue collection **(Box 4.2)**.

Box 4.2: Exploiting Direct Tax Potential in Pakistan

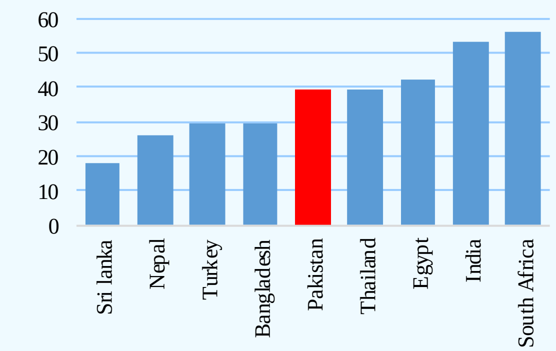
Generally, direct taxes are considered as fair and equitable way of raising revenues for the governments. Direct taxes make the system more progressive through balancing income distribution and narrowing down the inequality gap. In Pakistan, the use of such redistributive tools has remained under-utilized and the tax structure remained tilted towards the regressive indirect taxes, contributing around 60 percent of total taxes.

Figure 4.2.1: Income Tax Collection and viz-a-viz Per Capita Income



Data source: Federal Board of Revenue and Economic Survey of Pakistan

Figure 4.2.2: Share of Income, Profit and Capital Gain in Total Tax Revenue



*Share of direct taxes in total for Pakistan and latest numbers available in WDI for ohers

Data source: FBR for Pakistan and WDI for

In terms of GDP, the revenue from direct taxes reached 4.3 percent in FY18 from an average of 2.9 percent during FY03-FY17. However, the growth in tax collection was low, when compared to growing income levels in the country (**Figure**

[8] World Bank Group; PwC. 2018. Paying Taxes 2018. World Bank, Washington, DC

[9] According to a study by IMF, Pakistan's tax potential is estimated at 22.3 percent of GDP; Source: Pessino, C., and R. Fenochietto (2013), "*Determining Countries' Tax Effort*" IMF Working Paper 13/244, Washington DC; IMF.

4.2.1). In terms of its share in total taxes, Pakistan falls somewhere in middle, when compared with other emerging economies (**Figure 4.2.2**).

Within the direct taxes, around 70 percent comes from withholding taxes that sometimes becomes indirect when passed onto consumers. For example, around half of the WHT is collected through advance tax on imports and contracts that add to the final price of good and services.[10] Excluding WHT, the share of direct taxes in total FBR Taxes falls to 12.5 percent form 40 percent.

Pakistan's low collection from direct taxes is primarily due to weak tax compliance and large number of exemptions
The main source of income tax is the personal and the corporate income tax, contributing about 92 percent in direct taxes. Though the number of active income tax payers increased to 1.46 million in FY18 from 0.98 million in FY14; it looks too small when compared to 57.4 million employed labor force. One of the reason is that out of the total employed labor force, 42.3 percent are dependent on the agriculture sector, which is either exempted from income tax or contributes very little.

The agriculture sector contributes 19.2 percent to GDP, but its share in taxes is negligible **(Table 4.2.1)**. After the 18th amendment, the provinces were authorized to collect taxes from the agriculture sector. During FY17, the consolidated revenue from the agriculture income tax from the provinces stood at 0.03 percent of gross value addition **(Table 4.2.2)**. In case of Punjab, which accounts for 73 percent of the cultivated land, agriculture income tax is charged either on the basis of per acre cultivated or income declared under income tax ordinance. As per Punjab Agricultural Income Tax Act 1997, the income is exempt for tax if cultivated area is less than 12.5 acres, charged Rs150 per acre if area is between 12.5 and 25 acres, and Rs 250 per acre for the area exceeding 25 acres. In case of declared agriculture income, the exemption limits is Rs 80000, and the rate increases with rising income. The World Bank study on revenue mobilization in Punjab reveals that the province collected agriculture income tax of Rs 1.4 billion during FY16, only 10 percent of its revenue potential of Rs 14 billion.

Table 4.2.1: Sectoral Share in GDP viz-a-viz Tax Collection
percent

	Share in GDP	Share in Tax
Agriculture	19.2	0.6
Industry	20.9	69.6
Services	59.9	29.8
Total	**100**	**100**

Data sources: PBS and MoF, Fiscal Policy Statement 2017-18

Table 4.2.2: Agriculture Income Tax
million rupees

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Punjab	770.3	717.2	762.4	827.3	934	1,027.7	1,383.8	1,280.3
Sindh	200	210.2	122.8	406.5	276.4	341.5	410	650
KPK	15.7	17.5	20.1	22	24	49	80	88
Balochistan	0	1.5	0	0	0.5	1	9.4	12
All provinces	986	946.3	905.3	1,255.8	1,234.9	1,419.2	1,883.2	2,030.3
Total collection as percent of :								
Target	70.0	59.8	82.2	114.8	46.3	50.9	60.2	55.7
Agriculture GVA	0.03	0.02	0.02	0.02	0.02	0.02	0.03	0.03

Data source: Provincial Budget Documents & PBS

Table 4.2.3: Tax Expenditures
billion rupees

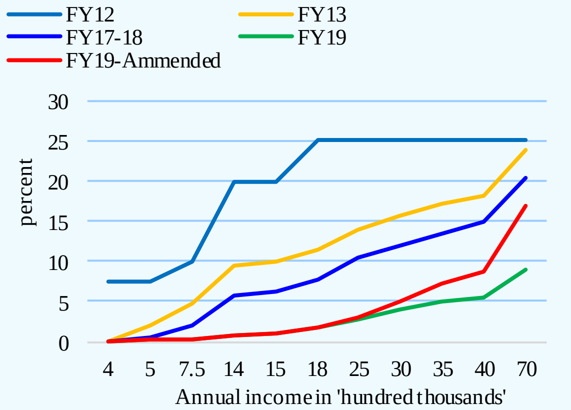
	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Income tax	46.5	69.6	82.4	96.6	83.6	67.3	14	61.8
Sales tax	33.7	24.3	37.4	249	225.4	207.3	250	281.1
Custom duty	94.9	91.5	119.7	131.5	103	120	151.7	198.2
Total	**175.2**	**185.5**	**239.5**	**477.1**	**412**	**394.6**	**415.8**	**541.0**
Memorandum Item								
Total as % of GDP	1.0	0.9	1.1	1.9	1.5	1.4	1.3	1.6
Total as % of FBR taxes	11.2	9.9	12.3	21.2	15.9	12.7	12.3	14.2

Data source: Economic Surveys

[10] Section 148 of the income tax ordinance provide comprehensive list of imported goods eligible for advance tax in addition to custom duties. Similarly advance tax on sales of good, services and the execution of contract are charged at different rates specifies under section 153 of the Income Tax ordinance.

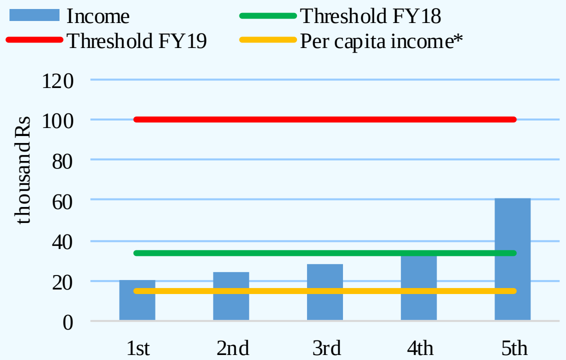
Moreover, the Income Tax Ordinance provides exemptions and preferential treatments to different segments of the society. These are called tax expenditures and their annual loss stood at 1.6 percent of GDP or around 14 percent of total FBR taxes in FY18 **(Table 4.2.3)**. To the extent of income tax, the second schedule of the Income tax ordinance gives comprehensive list of exemption both for individuals and the corporates. Importantly, 56 percent of the total expenditure were made under section 56/B of the income tax ordinance 2002 during FY18, which provides the tax exemption on the payable tax by the companies on investment made for the purchase of plant and machinery, and the extension, expansion, balancing, modernization and replacement of the plant.

Figure 4.2.3: Income Tax Rates for Different Income Groups



Data source: Finance Acts

Figure 4.2.4: Average Monthly Household Income by Quintiles viz-a-viz Income Tax Threshold



* Calculated on monthly basis from yearly per capita income
Data source: Household Integrated Economic Survey 2015-16, Pakistan Economic Survey 2017-18 and Finance Acts

Recently, the minimum taxable income has been increased, leaving out a number of potential taxpayers

The Finance Act 2018 made substantial changes to taxes in Pakistan. The personal income tax rate was reduced for various tax brackets for the salaried class. The threshold level was raised from 0.4 million to 1.2 million for the salaried class and households having income from 14 to 70 hundred thousand (**Figure 4.2.3**).[11] The Finance Supplementary (Amendment) Act, 2018 has maintained the threshold but partially reversed this benefit for the upper slabs.

Now, the threshold level stands six times of the GDP per capita and three times that of FY18. These changes have resulted in exempting sizeable population relative to FY18 threshold that was hardly touching top two quantile average monthly income in FY18 (**Figure 4.2.4**). As per IMF estimates, the average tax rate for a number of economies was 15 percent at per capita income level and becomes flat at 25 percent, when income reaches three to four times of GDP per capita. In addition, the government also cut corporate income tax (other than banks) to 30 percent from 35 percent five years ago, while remained same at 35 percent for the banking sector. Again this trend is in contrast to the emerging economies, where average corporate income tax stood 22.3 percent for 2015.

Conclusion

In Pakistan, the tax reform must be aimed at increasing tax bases, rather than imposing taxes on existing tax payers. The recent reduction in tax rates is a welcome development that may encourage voluntary tax payments, however, this might exclude a large number of potential tax payers. On the flip side, the reduction in rates would help increase savings or consumption that would, in turn, support higher economic activity. Given the large tax gap, provinces must enhance their efforts to bring untapped sources into tax net in order to reduce reliance on federal transfers. Moreover, Pakistan income tax system is based on universal self-assessment schemes and revenue capacity is limited due to the large informal sector. In FY13, 73.3 percent of employment was generated by informal sector, which means only a part of the remaining quarter would be paying taxes. A well thought policy aiming to improve tax compliance across existing sectors and bringing the informal sector into tax net can make the system more progressive.

References:

- The World Bank, 2017, Pakistan Development Update: A Shared Responsibility.
- International Monetary Fund, 2016, Pakistan, Selected Issues Paper.
- The World Bank, 2014, Study on Tax Expenditures in Pakistan.
- International Monetary Fund, 2017, Fiscal Monitor: Tackling Inequality.
- Ilzetzki, Ethan, and David Lagakos (2017). *The Macroeconomic Benefits of Tax Enforcement in Pakistan*. MPRA Paper No. id: 12130.

[11] However, there is a nominal tax payable of Rs 1,000 for the taxable income between 0.4 million and 0.8 million, and Rs 2,000 for the taxable income between Rs 0.8 million and 1.2 million.

- Martinez-Vazquez, Jorge, and Kaspar Richter (2009). Pakistan Tax Policy Report: Tapping Tax Bases for Development. No. paper0908. International Center for Public Policy, Andrew Young School of Policy Studies, Georgia State University.

Indirect taxes

The indirect tax collection grew by 14.3 percent during FY18, compared to a subdued growth of 5.1 percent last year. Buoyant domestic demand helped mobilize revenue from healthy manufacturing activity, increase in domestic sales and a surge in import volume. Meanwhile, increase in international commodity prices as well as the depreciation of exchange rate also supported higher revenue collection, especially from customs and sales tax on imported goods.

Table 4.4: Sales Tax on Domestic and Import Stage*

billion rupees

	FY17	FY18	Growth FY17	Growth FY18
Domestic				
POL products	225.8	283.0	-18.0	25.3
Electrical energy	45.7	45.3	22.3	-0.9
Cement	29.7	24.1	5.0	-18.9
Beverages	18.7	17.7	42.0	-5.6
Cigarettes	17.6	20.5	-26.1	16.9
Natural gas	11.7	20.3	-35.9	73.7
Others	277.2	265.7	24.4	-4.1
Total	**626.4**	**676.6**	**1.2**	**8.0**
Imports				
POL products	212.0	264.2	-3.2	24.6
Iron and steel	55.3	68.3	2.5	23.5
Mech. machinery	62.9	68.6	24.2	9.2
Elec. machinery	50.0	51.7	18.1	3.5
Vehicles	53.0	66.8	25.6	25.9
Plastic resins etc.	35.6	45.1	6.4	26.8
Organic chemicals	13.4	17.6	0.9	31.0
Others	219.8	232.4	1.7	5.7
Gross	**702.0**	**814.7**	**4.6**	**16.1**

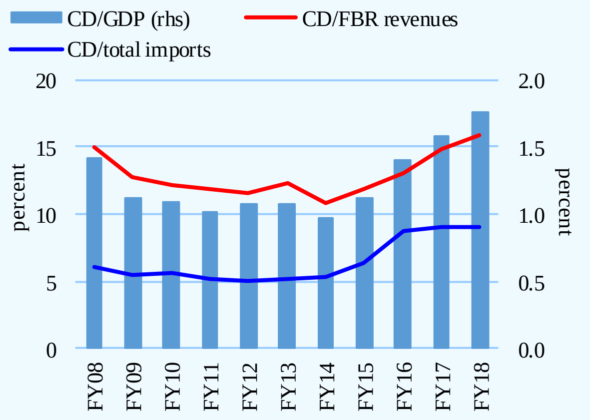
*: Break-up is based on provisional data

Data source: Federal Board of Revenue

Sales tax

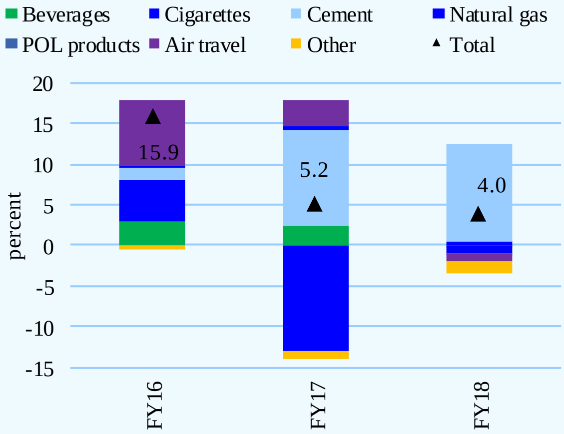
Sales tax collection rebounded with 12.7 percent increase recorded during FY18 against collection showing no change in FY17 **(Table 4.4)**. This recovery in sales tax collection was in line with the rise in domestic demand bolstered by growing income level in the country. Moreover, pass through of increased global oil prices also helped to generate higher sales tax revenue from this source given ad-valorem tax structure.[12] However, some increase in POL prices was absorbed by the government through lowering sales tax rates with an objective to ensure stability and to give a relief to domestic consumers.

Figure 4.4: Trends in Custom Duty Collection



Data source: Federal Board of Revenue and SBP calculations

Figure 4.5: Contribution in Growth of FED



Data source: Federal Board of Revenue and SBP calculations

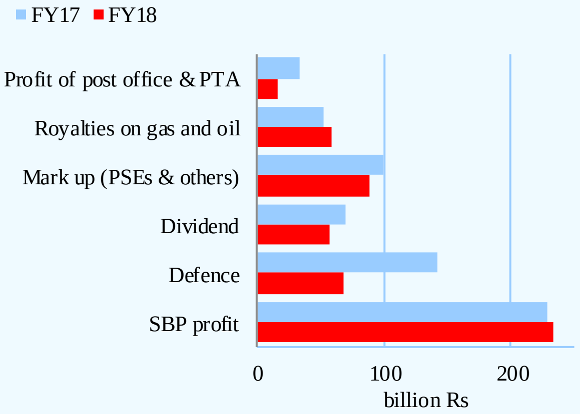
Custom duty

The custom duty collection grew by 22.6 percent in FY18, slightly higher than 22.1 percent growth in last year. This persistent higher growth during the last few years reflects rising imports, a sustained

[12] According to IMF commodity prices data, the international POL prices bottomed out in August 2017, and started inching up from September 2017 onwards.

improvement in economic activity, rise in general income level, increase in additional custom duty by 1 percent and regulatory duty on a number of non-essential items. In particular, import of vehicles, POL products, iron and steel in particular contributed significantly to custom duty collection during FY18. In addition, higher commodity prices combined with depreciation of rupee, which pushed up the landed price of imported items, also added to custom duty collection. As an outcome, the share of custom duty in FBR taxes rose to 16.0 percent and around 1.8 percent of GDP in FY18 **(Figure 4.4)**.

Figure 4.6: Trends in Non-tax Revenue



Data source: Ministry of Finance and SBP calculations

Table 4.5: Fiscal Spending
billion rupees

	FY17	FY18	Abs. change	Growth FY17	Growth FY18
Current expenditures	**5197.9**	**5,854.3**	**656.4**	**10.7**	**12.6**
Federal	3,472.2	3,789.8	317.6	10.4	9.1
of which					
Interest payments	1,348.4	1,499.9	151.5	6.7	11.2
(i) Domestic	1,220.3	1,322.6	102.4	6.0	8.4
(ii) Foreign	128.2	177.3	49.1	13.9	38.3
Defense	888.1	1,030.4	142.3	17.2	16.0
Public order and safety	127.8	124.7	-3.2	32.8	-2.5
Others	1107.8	1134.8	27.0	7.9	2.4
Provincial	1,725.7	2,064.5	338.8	11.3	19.6
Development expenditures	**1,693.5**	**1,584.1**	**-109.4**	**30.1**	**-6.5**
PSDP	1,577.7	1,456.2	-121.5	33.1	-7.7
Federal	725.6	576.1	-149.5	22.3	-20.6
Provincial	852.2	880.1	28.0	43.8	3.3
Others (including BISP)	115.7	127.8	12.1	0.1	10.4
Net lending	-12.8	37.6	50.4	-201.5	-393.6
Total Expenditure*	**6,878.5**	**7,475.9**	**597.4**	**14.5**	**8.7**

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

Federal Excise Duty

Federal excise duty grew by 4.0 percent during FY18 compared to 5.2 percent increase in the previous year (**Figure 4.5**). The deceleration in FED collection was due to a decline in collection from cigarettes and a slowdown in manufacturing activity especially of cement, cigarettes and beverages sectors during Q4-FY18. Particularly in cigarettes, a reduction in FED rate on lower tier cigarettes dragged FED collection without a proportionate increase in revenue. The situation warrants an upward revision in tariff structure to achieve the dual objective of higher revenue along with better health outcomes. Nevertheless, an increase in collection from cement helped offset the drag in FED collection for FY18.

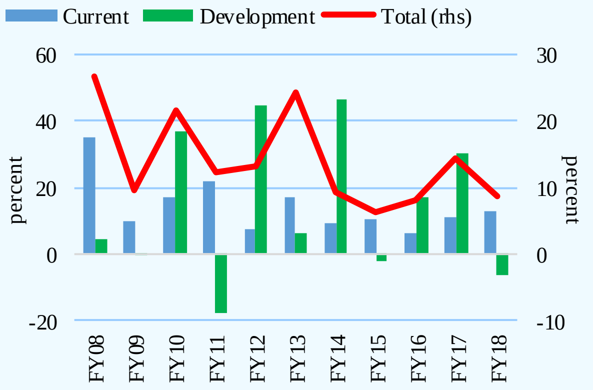
Non-tax revenues

The non-tax revenues declined by 21.4 percent during FY18 compared to a 23.0 percent increase in the previous year. This contraction was broad-based except for SBP profit, which almost maintained the last year's level. Moreover, an uptick in royalties on oil and gas and windfall levy on crude oil, which have relatively smaller share, could not offset the drag in non-tax revenues (**Figure 4.6**). That said, the decline in non-tax revenue is largely attributed to decline in defense related revenue, especially CSF.

4.3 Expenditure

The growth in consolidated fiscal spending decelerated to 8.7 percent during FY18 as compared to 14.5 percent observed in FY17. This was primarily due to a decline in development spending as growth in current expenditure accelerated **(Table 4.5)**. This was in contrast to the past trends, where growth in current expenditures was contained to enhance development spending **(Figure 4.7)**. This might be a consequence of government's concern regarding containment of fiscal deficit amid weak revenue position.

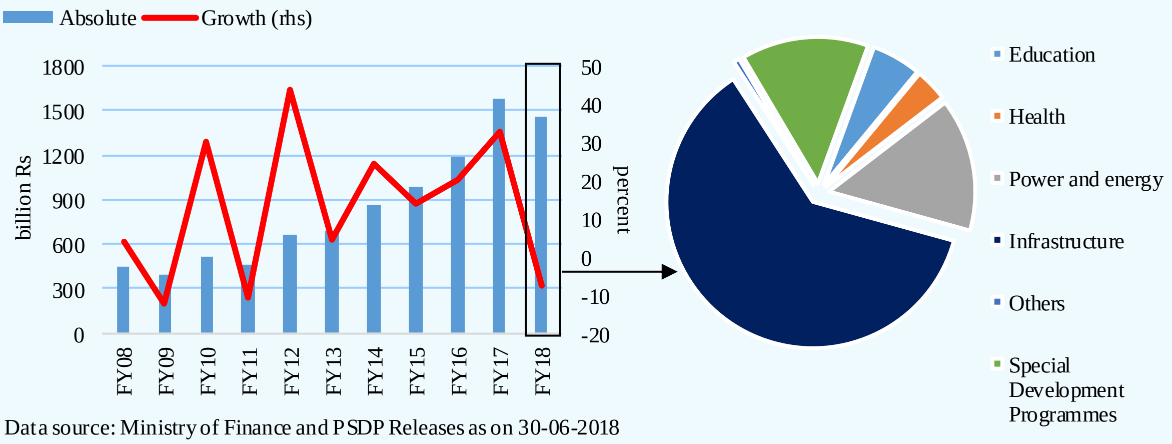
Figure 4.7: Trends in Spending Growth



Data source: Ministry of Finance and SBP calculations

The disaggregated data shows that decline in development spending was due to a substantial reduction in federal PSDP because of slower releases during the interim government's term towards the end of FY18. Provinces, nonetheless, saw some growth but lower than that of the previous corresponding period **(Table 4.5)**. Notwithstanding this decline, infrastructure spending followed by power and energy and special development program remained the priority areas during FY18 **(Figure 4.8)**. Likewise, Rs 122.7 billion were spent out of Rs 187.3 billion allocated for CPEC projects under PSDP **(Figure 4.9)**.

Figure 4.8: PSDP Growth Trends and its Composition during FY18

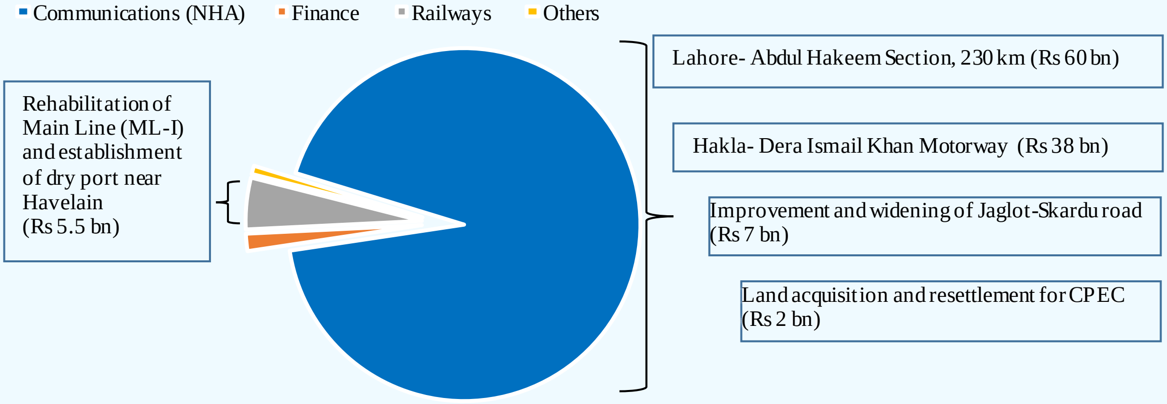


Data source: Ministry of Finance and PSDP Releases as on 30-06-2018

The other development expenditure including Benazir Income Support Program (BISP) and Poverty Reduction Strategy Paper (PRSP), however, stayed robust and grew by 10.4 percent to Rs 127.8 billion during FY18.

The current expenditures, on the other hand, grew by 12.6 percent during FY18 as compared to 10.7 percent in previous year. The growth in federal current expenditure, albeit increase in interest payments and defense expense, decelerated **(Table 4.5)**. This was largely due to decline in expenditure related to public order and safety affairs. However, provincial current expenditure grew sharply during FY18.

Figure 4.9: Actual Realization of Funds under PSDP for CPEC Projects during FY18



Data source: PSDP releases as on 30-06-2018 and CPEC official website

4.4 Provincial Fiscal Operations

Despite a slower pace of provincial spending vis-à-vis revenue growth, the provincial fiscal situation turned out to be opposite to that envisaged in the FY18 budget. The provinces posted a consolidated deficit of Rs 17.5 billion against the target surplus of Rs 347 billion which was also higher than the previous year's deficit of Rs 15.9 billion (**Table 4.6**). This was mainly contributed by Sindh and

Table 4.6: Provincial Fiscal Operations

billion rupees

	Punjab	Sindh	KP	Balochistan	Total	Growth
FY18						
A. Total Revenue	1,412.0	802.8	481.5	242.3	2,938.5	21.0
Provincial share in federal revenue	1,078.8	562.3	363.5	212.9	2,217.4	12.8
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
Fed 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**
FY17						
A. Total Revenue	1,149.5	692.6	361.8	224.3	2,428.2	5.9
Provincial share in federal revenue	928.8	516.9	315.2	204.9	1,965.8	5.6
Provincial Revenue (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 revenue	32.3	8.6	34.0	4.6	79.5	-14.8
Fed loans and transfers	33.0	22.7	-3.1	8.6	61.2	11.0
B. Total expenditure	1,154.5	754.1	436.7	246.2	2,591.5	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**

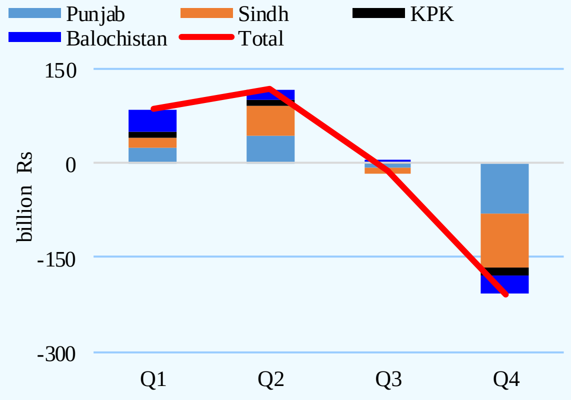
*Negative sign in financing means surplus. ** Current expenditure data may not match with those given in Table 4.5 as numbers reported here include the markup payments to federal government.

Data source: Ministry of Finance and SBP calculations

Punjab; whereas KP and Balochistan reported surpluses. However, the quarter wise analysis reveals that all the provinces recorded deficits in the last quarter of FY18 (**Figure 4.10).**

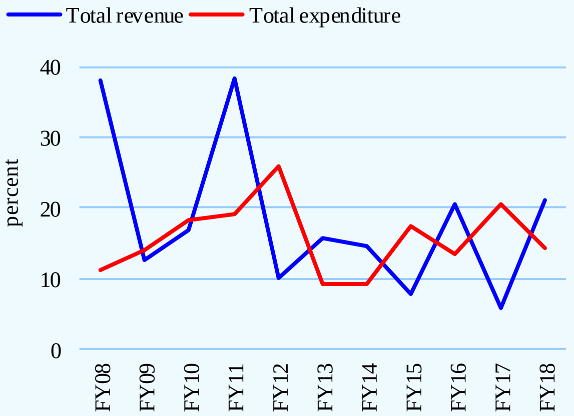
Though expenditures grew at a slower rate compared to last year, total expenditures rose to Rs 2,960.9 billion. This was still higher compared to the provincial revenue, which grew at a relatively higher rate of 21.0 percent but reached to Rs 2938.5 billion. Thus, the revenue-expenditure gap has been narrowed during FY18. Nevertheless, the time lag involved in realization and settlement of funds allocated for spending purposes during the whole year has, therefore, made provinces the *net-borrower* at end June FY18 (**Table 4.6**).

Figure 4.10: Province-wise Surplus during FY18



Data source: Ministry of Finance and SBP calculations

Figure 4.11: Growth in Provincial Revenue and Expenditure



Data source: Ministry of Finance and SBP calculations

Higher growth in overall provincial revenue also reflects provinces' efforts to enhance their own revenue collection. This is particularly reflected in a sustained increase in GSTS that improved by Rs 223.9 billion during FY18 on top of Rs 170.8 billion increase in FY17. A sharp 64.4 percent growth in collection from stamp duties with the introduction of e-stamping, especially in Punjab, also contributed handsomely to provincial tax collection.[13] However, property taxes declined by 21.1 percent mainly due to lower collection from Punjab, where it fell to almost half of the amount collected in the previous year.

The provincial non-tax revenue rose to Rs 146.7 billion as compared to Rs 79.5 billion in previous year as a result of higher revenue generated from *profits from hydroelectricity* mainly from KP and Punjab; Sindh also collected Rs 16.6 billion. In addition, *federal loans and transfers* recorded a decade high increase mainly to finance development projects especially Orange Line Train (OLT) in Punjab.

The growth in provincial spending slowed down to 14.3 percent as compared to 20.4 percent last year (**Figure 4.11**). This is mainly attributed to considerably slower growth in development spending mainly on account of Balochistan and KP. However, growth in provincial current expenditures accelerated to 19.6 percent during FY18 from 11.5 percent in the previous year. The current provincial spending preferences continued to be inclined towards public order and general public services; however, a higher spending was noted in social protection (**Figure 4.12**).

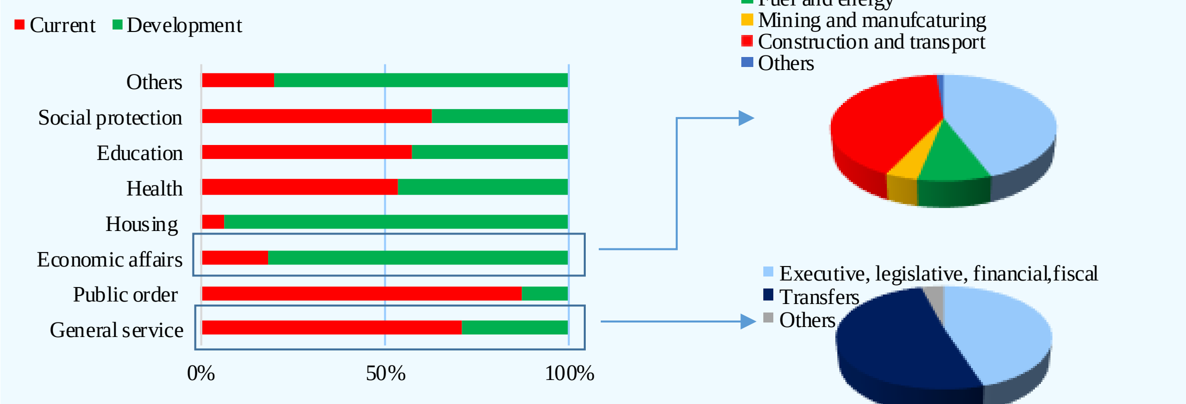
Even with a slight growth in development expenditure, provinces spent more on housing, community development, and economic affairs. Within economic affairs, priority was given to agriculture, livestock, and construction **(Figure 4.12)**. For instance, Punjab provincial development working

[13] In 2016, PITB collaborated with Punjab government and introduced e-stamping facilities in order to minimize the leakages out of long procedures for legal requirements.

party (PDWP) has approved various projects regarding irrigation, construction, health, and education sectors[14]. In the case of KP, the main focus was agriculture, livestock, manufacturing, and construction.[15]

In broader terms, provincial governments increased their current and development spending on health and education during FY18. On a positive note, Sindh in collaboration with the World Bank started a program aimed at reducing child stunting and malnutrition from 48 percent to 30 percent by year 2021.[16]

Figure 4.12: Provincial Spending Priorities during FY18



Data source: Ministry of Finance

Having said that, the provincial deficit situation has put further burden on the stressed federal position. This happened in two ways. First, the total provincial revenue has always been supported by higher provincial share (57.5 percent) as per NFC Award; also, the federal government is liable to transfer funds and federal transfers and grants to provinces. Second, the provincial deficit further debilitates the overall deficit situation instead of providing some cushion for containing fiscal deficit. Therefore, institutional reforms in the context of provincial revenue maximization by tapping the unexplored avenues (such as agriculture and property taxes) and expenditure management should be aligned with the provision of funds.

[14] Project highlights, Planning and Development Department, Government of Punjab.
[15] Reclaiming Prosperity in Khyber Pakhtunkhwa, Medium Term Inclusive Growth Strategy 2015-18
[16] *Sindh Enhancing Response to Reduce Stunting Project (2018)*, Urban Policy and Strategic Planning, Planning and Development Department, Government of Sindh.