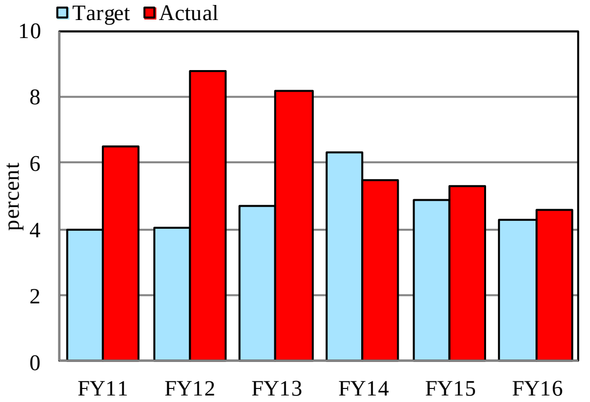
4 Fiscal Policy

4.1 Overview

The essence of recent fiscal efforts is to sustain macroeconomic stability in the country while ensuring a conducive environment for economic growth. This entails a reduction in fiscal deficit without cutting development spending. Accordingly, fiscal deficit continued to fall for the fourth year in a row. The deficit of 4.6 percent recorded in FY16, though slightly higher than the target set for the year, was 0.7 percentage points lower than last year (**Figure 4.1**). This reduction was attributed primarily to: (i) over 20 percent growth in FBR tax collections; (ii) a fall in debt servicing expense that helped contain the growth in federal current expenditures; and (iii) higher surpluses recorded by provincial governments (**Table 4.1**). Encouragingly, development expenditure by federal and provincial governments maintained their pace despite this fiscal consolidation. Such pro-growth public sector development programs (PSDP) provided the needed stimulus to the economy during the year (**Chapter 2** and **3**).

Figure 4.1: Fiscal Deficit - Target and Actual (percent of GDP)



Source: Ministry of Finance

Table 4.1: Summary of Fiscal Operations
Billion rupees

		Target FY16	FY15	FY16	YoY growth
A.	Gross federal revenue receipts	4,313	3,663	4,080	11.4
	of which: FBR tax revenue	3,104	2,588	3,112	20.2
B.	Transfer to provinces (net)	1,849	1,539	1,862	21.0
C.	Net federal revenue receipts (A-B)	2,463	2,124	2,218	4.4
D.	Total federal expenditure	4,089	3,762	3,921	4.2
	1. Current expenditure	3,389	3,166	3,178	0.4
	i. Interest / mark-up payments	1,280	1,304	1,263	-3.1
	ii. Defence	781	698	758	8.6
	iii. Others	1,328	1,164	1,157	-0.6
	2. Development expenditure	700*	691	743	7.4
E.	Federal budget balance	-1,626	-1,544	-1,557	0.8
	% of GDP	-5.3	-5.6	-5.3	
F.	Provinces balance	297	87	207	137.9
G.	Overall fiscal balance	-1,328	-1,457	-1,349	-7.4
	% of GDP	-4.3	-5.3	-4.6	
Memorandum items:					
H.	Consolidated revenues		3,931	4,447	13.1
I.	Consolidated expenditures		5,388	5,796	7.6
	of which Current expenditures		4,425	4,694	6.1
	Statistical discrepancy		-178	-212	19.1
J.	Consolidated primary balance (Revenues – non-interest expenditures)		-153	-86	
K.	Consolidated revenue balance (Revenues – current expenditures)		-494	-247	

*PSDP target for FY16
Source: Ministry of Finance

At its core, the improvement in tax collection was a direct outcome of new tax measures announced in Budget 2015-16, as well as additional measures that were taken in November 2015 in response to an expected revenue shortfall (**Section 4.2**). Higher revenue collection in FY16 also represented the momentum in construction, transport and trading activities in the country. That said, despite higher collections, the composition of taxation underscores the need to get through structural constraints.

For instance, direct tax collection still relies heavily on withholding taxes; in fact, the share of withholding tax has increased further, which downplays the role of revenue authorities on the one hand, and increases the compliance costs of businesses on the other. Furthermore, on sectoral basis, the incidence of overall tax collection continues to fall disproportionately on industry and trade activity. Contributions from other sectors are quite insignificant; e.g., agriculture income tax constitutes only 0.8 percent of the total tax collection, and stands at around 0.03 percent of agriculture GDP (**Table 4.2**).

Table 4.2: Agriculture Income Tax (AIT) in Perspective

	AIT	Total tax revenues	Agri GDP	AIT/total prov. taxes	AIT/Agri GDP
	million rupees			percent	
FY12	0.9	205.3	4,753	0.4	0.019
FY13	1.3	219.9	5,335	0.6	0.024
FY14	1.1	256.5	5,976	0.4	0.019
FY15	1.7	301.8	6,563	0.6	0.026
FY16	1.9	248.1	7,041	0.8	0.028

Source: Provincial budgetary statements; SBP calculations

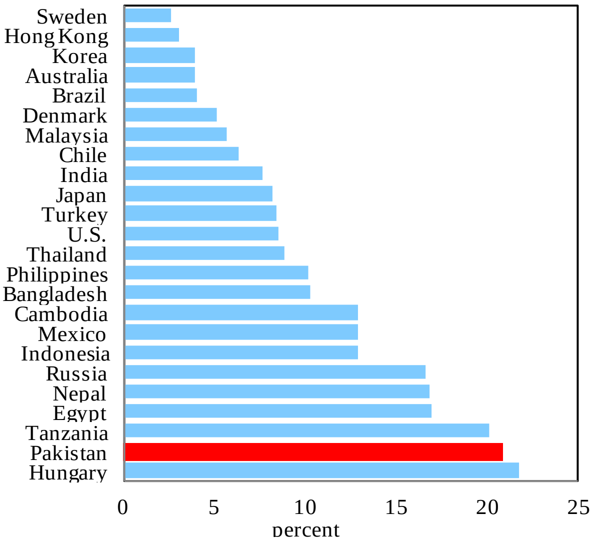
Table 4.3: Changes in Cash Preferences in Pakistan (end-period)

	FY14	FY15	FY16
Currency in circulation (CIC) as percent of GDP	8.7	9.3	11.3
CIC + prize bonds as percent of GDP	10.4	11.2	13.4
Deposits growth	12.9	13.7	11
of which: Government	18.5	19.4	25.4
Private businesses	15.6	9.4	1.2
Personal	12.3	17.2	10.2

Source: SBP and Central Directorate of National Savings

Similarly, certain measures announced in FY16 Budget – which were taken to widen the differential taxation structure for filers and non-filers – had an unintended negative fall-out. For instance, the imposition of withholding tax on banking transactions for non-filers led to a decline in deposits growth (particularly those of private businesses); increase in the use of hard cash (and prize bonds) for the settlement of transactions, leading to 2 percentage points increase in currency in circulation to GDP ratio; and a fall in investments in savings instruments (**Table 4.3**). Here it is important to recall that Pakistan already has one of the highest currency-to-overall money supply ratios in the world (**Figure 4.2**); with the imposition of withholding tax on non-cash banking transactions, the use of cash would increase further. Not only would these developments constrain future tax collection, these may also undermine financial inclusion efforts of the government and SBP.

Figure 4.2: Currency in Circulation as Percent of Total Money Supply (end-December 2015)



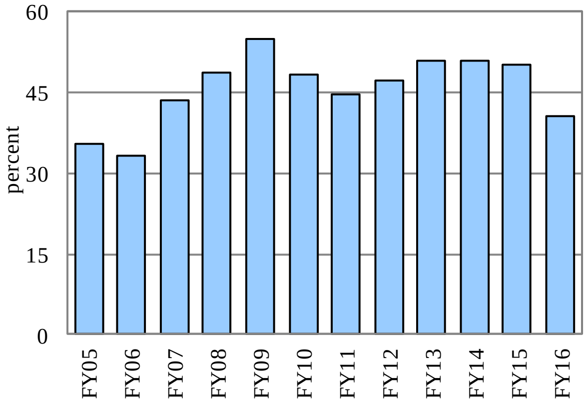
Source: International Financial Statistics, IMF

As for expenditures, the federal government gained primarily from low interest rates, which significantly reduced its debt servicing burden during the year. Federal government spent 41 percent of its tax revenues for interest payments in FY16; last year it had spent half of its revenues for these payments (**Figure 4.3**).[1] Although non-interest current expenditures posted a YoY increase, the growth was much contained compared to last year (**Section 4.3**). The federal government spent particularly less on energy subsidies, as it further

[1] It is important to acknowledge here that the decline in interest burden during FY16 was due to both a fall in overall interest payments during the year, as well as a sharp rise in FBR's tax collections.

scaled up the electricity and gas tariffs during the year for industrial and commercial users.[2] Other expenditures also grew modestly in FY16 compared to last year, including the defence expenses. The space provided by a low growth in current outlays was partially used to shore up development expenses during the year. PSDP spending, in particular, grew by 20 percent YoY during the year, over and above the 14 percent growth recorded last year.

Figure 4.3: Interest Expenses as percent of FBR Revenues



Source: MoF & FBR

While deficit reduction was already visible at the federal level, surpluses in provincial accounts further consolidated the fiscal position. Though they missed the target for the year by Rs 90 billion, provincial surpluses more than doubled in FY16 compared to last year. This performance was supported by a higher collection of sales tax on services and a much better control over current expenditures (**Section 4.4**). Similar to federal government, provincial governments – especially Punjab – also revved up their development spending during the year.

Thus with a reduced deficit both in nominal terms as well as with respect to GDP, the government's financing requirements fell during FY16. As usual, the bulk of financing came from domestic sources, though borrowings from external sources also increased during the year and even exceeded the target (**Table 4.4**).

Table 4.4: Financing of Fiscal Deficit

Billion rupees

	FY15	FY16
Financing	1,457	1,349
External	181	370
Domestic	1,276	979
Bank	892	787
Non-bank	366	192
Privatization	18	0

Source: Ministry of Finance

While recent efforts of the government to bring fiscal deficit in line with its debt reduction strategy are welcome, efforts to mobilize resources from under-taxed economic segments should be strengthened further. Despite an obvious improvement during FY16, tax-to-GDP ratio in Pakistan still stands as one of the lowest in the world and calls for wide-ranging reforms in the country's tax regime. Given the low revenue elasticity, Pakistan cannot achieve its potential without broadening the tax base, bringing down tax evasion, and strengthening tax administration across all levels of the government.[3] However, to ensure uniformity in the system, tax collection should improve without further burdening the already compliant taxpayers. In this context, provincial governments should particularly gear up their administrative capacities, because most under-taxed sectors like agriculture, services and immovable property, come under their domain. Federal government should also enhance its efforts in identifying non-compliant taxpayers and minimize under-declarations of incomes and transactions.

[2] Subsidy expenditures dropped from Rs 243.2 billion in FY15, to Rs 196.5 billion in FY16 (source: Federal budget documents for 2016-17).

[3] Pakistan's revenue elasticity and buoyancy is estimated at a lower level compared to other developing countries. Therefore, increase in GDP growth and/or the tax rate would not help achieving the country's potential tax-to-GDP ratio. For details, see Cevik, Serhan (2016), "Unlocking Pakistan's Revenue Potential" IMF Working Paper, WP/16/82, August 2016.

4.2 Revenues

The pace of revenue mobilization accelerated to 13.1 percent during FY16 (**Table 4.5**). The entire improvement was seen in tax revenues, as non-tax revenues tapered during the year. The major impetus came from higher sales of oil and gas products (both local and imported) in the country, which not only pushed up the collections of sales tax on these items, but also scaled up collections under GIDC, GDS and petroleum levy. Meanwhile, taxation measures during the year also proved effective in expanding the resource base.

Table 4.5: Summary of Consolidated Revenues

	Billion rupees			% Growth	
	FY14	**FY15**	**FY16**	**FY15**	**FY16**
Total revenue* (A+B)	3,620	3,925	4,441	8.4	13.1
A. Tax revenue (i to iv)	2,547	3,012	3,654	18.3	21.3
i. Direct taxes	877	1,033	1,217	17.8	17.8
ii. Taxes on goods & services	1,134	1,250	1,491	10.2	19.3
Excise duty	138	162	188	17.4	16.0
Sales tax	996	1,088	1,303	9.2	19.8
iii. Taxes on international trade	243	306	404	25.9	32.0
iv. Other taxes	293	423	542	44.4	28.1
Stamp duties	22	29	35	31.8	20.7
Motor vehicles tax	16	16	19		18.8
Gas dev. surcharge	NA	26	33		26.2
GIDC**	NA	57	80		39.9
Petroleum levy	104	131	149	26.9	13.7
Other taxes	152	164	225	7.9	37.5
B. Non-tax revenue	1,073	913	787	-14.9	-13.8

*Total revenues in this table will not tally with those reported in Table 4.1 due to revisions in FBR tax numbers.
** GIDC was the part of non-tax revenue before FY15
Source: Ministry of Finance

Assessment of FBR tax collection

Surpassing the annual target for the first time in seven years, FBR revenues posted a growth of over 20 percent during FY16 (**Table 4.6**). This sharp growth can be traced to various tax measures introduced by the government from time to time: (i) increase in customs duties; (ii) upward revision in regulatory duties on a range of consumer items; (iii) change in the duty structure of petroleum products;[4] (iv) increase in FED on cigarettes; and (v) 0.4 percent withholding tax rate for non-filers on financial transactions.[5] The FBR's revenue generation gained further momentum from ongoing infrastructure activity that boosted the demand for cement, steel and other building material. FBR has also taken advantage from a relatively low responsiveness of Pakistan's imports to prices (e.g. POL, food items, and capital goods with no local substitutes) that helped it collect more resources from taxing these items further. Importantly, the country's tax-to-GDP ratio reached a 17-year high level of 10.5 percent in FY16 (although it is still significantly lower than the country's potential).

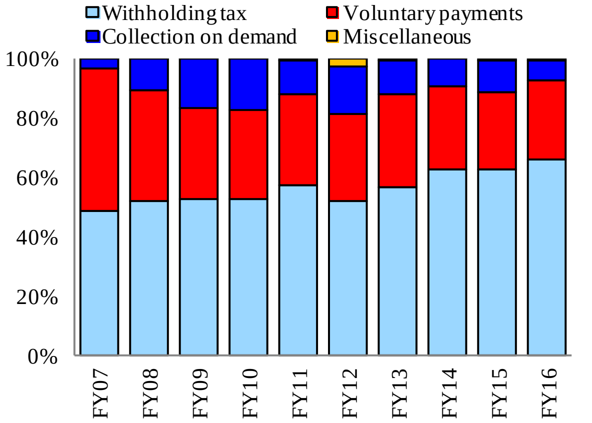
Table 4.6: FBR Tax Collection
Billion rupees

		FY 16		% Growth	
	FY 15	**Budget**	**Actual**	**FY15**	**FY16**
Direct tax	1,033	1,347.9	1,217	17.8	17.8
Sales tax	1,088	1,250.3	1,303	9.2	19.8
Customs duty	306	299.1	404	26.1	32.1
Federal excise	162	206.4	188	17.5	16.0
Total	2,589	3,103.7	3,112	14.9	20.2

Source: Federal Board of Revenue

Notwithstanding these improvements, the developments during the years also exposed some inherent weaknesses in our tax system. At first, continuing with the trend over the past few years, withholding taxes constituted the bulk of overall FBR tax collection (**Figure 4.4**). Importantly, its share has been increasing steadily over the past few years. These withholding taxes become indirect taxes when

Figure 4.4: Composition of Total FBR Taxes



Source: Federal Board of Revenue

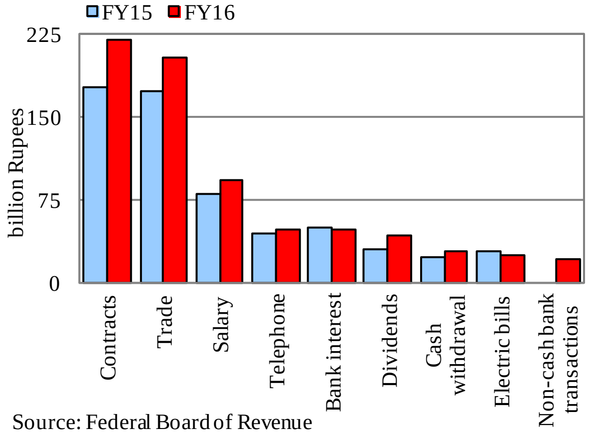
[4] Federal Board of Revenue vide SRO 57(I)/2016 fixed the sales tax rate on petroleum instead of previously applicable ad valorem rates to secure additional revenues from petroleum sales, despite fall in prices.
[5] A 0.6 percent withholding tax introduced on financial transactions for non-filers during Q1-FY16, was reduced to 0.3 percent during Q2- FY16, and finally revised upward to 0.4 percent during Q3-FY16.

these are treated as final tax and are passed on to the ultimate consumers – for example when these are built in the quoted price of contracts and services rendered. Secondly, the government has settled fewer refunds during the year: the government repaid only Rs 109.9 billion refunds in FY16, compared to Rs 115.2 billion paid last year (some of these dues have been settled post June 2016).[6] Thirdly, the government had to resort to multiple *adhoc* taxation measures during the year, which highlighted the inelasticity of our taxation system.

Direct taxes

The government had envisaged a 30 percent growth in direct taxes for FY16; however, it could achieve only 17.8 percent growth during the year. As mentioned before, major contribution came from withholding taxes, which grew by over 20 percent.[7] This increase stemmed from both a rise in tax rate (especially for non-filers), as well as an increase in the volume of activity.[8] Collections from contracts in particular made strongest gains, which probably reflected increased pace of public development projects and their onward delegation to private contractors (**Figure 4.5**). Collections from trade were the close next. These were explained by higher import of cotton, steel and LNG during the year.[9] Voluntary tax payments contributed 26.8 percent to direct tax collection. Collections with returns contributed only a small portion of total voluntary payments, but these more than doubled during the year, as various financial disincentives were put in place for non-filers.[10] To reduce the dependence on withholding taxes, the government should continue its efforts to increase documentation in the economy, which would help generate revenues from untapped sources.

Figure 4.5: Major Revenue Spinners of Withholding Tax



Source: Federal Board of Revenue

Table 4.7: Sales Tax on Domestic and Import Stage
Billion rupees

			Growth	
	FY 15	**FY 16**	**FY15**	**FY 16**
Domestic	**534.0**	**619.0**	**6.0**	**15.9**
POL products	242.2	269.8	4.8	11.5
Electrical energy	24.4	37.4	20.0	55.8
Cement	23.3	28.3	15.0	23.0
Aerated waters/beverages	8.8	13.2	-2.2	50.0
Cigarettes	20.9	24.0	16.1	14.8
Fertilizers	23.0	12.0	-4.2	-47.8
Natural gas	14.4	18.2	-54.8	28.6
Others	175.3	216.3	18.4	23.4
Imports	**553.1**	**683.6**	**11.7**	**23.6**
POL products	166	219.1	-2.4	32.0
Iron and steel	41.9	54.0	49.6	28.9
Mechanical machinery	38.0	50.6	46.2	33.2
Electrical machinery	35.4	42.3	96.7	19.5
Vehicles	34.3	42.2	31.9	23.0
Plastic resins etc.	30.7	33.5	9.6	9.1
Organic chemicals	13.0	13.3	0.0	2.3
Fertilizers	13.7	12.8	5.4	-6.6
Others	180.0	215.9	4.0	19.9

Source: Federal Board of Revenue

Sales tax

Sales tax – the single largest revenue generating source – contributed 69 percent of indirect taxes, and 42 percent of the overall tax collection during FY16. Collection under this head grew by 19.8 percent as compared to 9.2

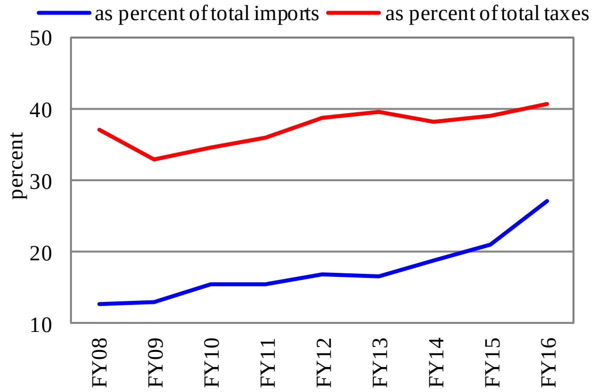
[6] This decline is despite the increase in total stock of outstanding tax refund claims from Rs 212 billion in March 2015 to Rs 215 billion in March 2016 (source: IMF Country Report on Eleventh Review of Pakistan, July 2016).
[7] Within withholding taxes, the contribution of contracts, trade and salary was over 60 percent of the collection, which represents too much reliance on few items.
[8] For instance, FBR collected Rs 21.6 billion during FY16 in advance on non-cash banking transactions. This tax was imposed only on non-filers in the Budget for 2015-16.
[9] The import of these items is subject to 1 and 1.5 percent withholding tax for filers and non-filers, respectively.
[10] For instance, the government has created wide distinctions between tax rates paid by filers and non-filers with respect to banking transactions; capital gains on investments in NSS instruments; and capital gains on property.

percent increase in FY15. This sharp increase in sales tax collection can be traced to a change in petroleum tax structure and higher sale of petroleum products in the country (**Table 4.7**).[11] Other important revenue spinners were steel, machinery & vehicles, where the government benefited from higher imports. Similarly, sales tax collection at domestic stage witnessed a positive growth of 15.8 percent, led primarily by POL products. Meanwhile, as domestic cement sales firmed up, the government's revenue collection from this source also increased.

Customs and federal excise duties

Custom duty collection surged by 32.1 percent during FY16, on top of 26.1 percent growth recorded in the previous year. The sharp rise can be attributed to upward revision in duty structure of certain import items.[12,13] As shown in **Figure 4.6**, customs duty and sales tax on imported items are becoming increasingly important components of the government's revenue collection strategy. The revenue collection as percent of imports has almost doubled in the last 9 years, helped primarily by price inelastic nature of imported raw materials and capital goods. Major revenue spinners in FY16 were vehicles, POL products and steel. Revenue collection from FED amounted to Rs 188.1 billion during FY16, compared to Rs 162 billion during last year. The increase in FED is attributed to revision in duty structure of cigarettes and beverages.[14,15] Additional revenues were realized from travel services and increased cement sales.

Figure 4.6: Taxes on Imported Items *



*This includes customs duties; sales tax on imports; and withholding tax on imports. Source: Federal Board of Revenue

Finally, it must be recognized that the government is trying to maintain a fine balance between raising revenues from the system and side by side supporting the economic recovery. For instance, it has reduced corporate income taxes from 32 to 31 percent for FY17, and also introduced tax credits for new investments. Similarly, the government has also re-introduced zero rating for 5 major export-oriented sectors (i.e., textile, leather, sports, surgical and carpets) to help these sectors navigate global adversities. Export sector has also been provided a very low refinance rate of 3.0 percent in FY17, as compared to 4.5 percent for non-textile and 3.5 percent for textile in FY16. The government also introduced a subsidy of Rs 46 billion under the Kisan package, along with exemption of sales tax on pesticides to ensure a fast recovery of agriculture sector.

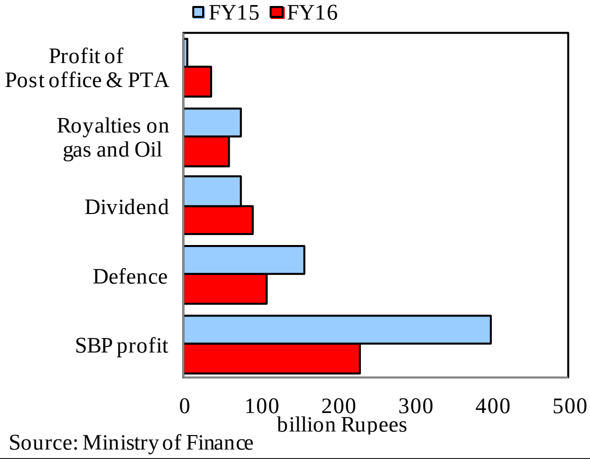
Non-tax revenues

Non-tax revenues fell by 13.9 percent in FY16. This trend is primarily explained by a fall in interest earnings on government papers and reduced budgetary borrowings from the central bank, which led to lower transfer of SBP profit during the year.[16] Despite lower transfers of SBP profit, this was still the

[11] Petrol sales grew by 22.7 percent in FY16, after rising 21 percent in FY15 (source: Oil Companies Advisory Committee).
[12] FBR raised customs duty by 1 percent on import of tractors, non-CNG buses, auto-rickshaws (except four-stroke ones), and other vehicles vide SRO 1190(I)/2015 and SRO 1178(I)/2015.
[13] FBR vide SRO 1177(I)/2015 introduced additional regulatory duty on 400 consumer items with varying rates. These included food items such as poultry, fish, milk products and fruits, and personal care items like cosmetics and shampoos.
[14] For cigarettes with price exceeding Rs 3,600 per thousand sticks, the duty was increased to Rs 3,155 from Rs 3,030. The duty on low-value cigarettes (priced below Rs 3,600 per thousand sticks), was raised to Rs 1,420 from Rs 1,320 (source: Federal Board of Revenue vide SRO 1181(I)/2015).
[15] FED rate on beverages increased from 9.0 percent in FY15 to 10.5 percent during FY16.
[16] Though fall in interest earnings has reduced non-tax revenues (in the form of lower SBP profit), it also helped in the reduction of government expenditures (interest payments).

largest source of non-tax revenues for the government. Lower receipts under the coalition support fund (defence) also contributed to a fall in non-tax revenues during the year (**Figure 4.7**).

Figure 4.7: Collections under Major Non-tax Heads

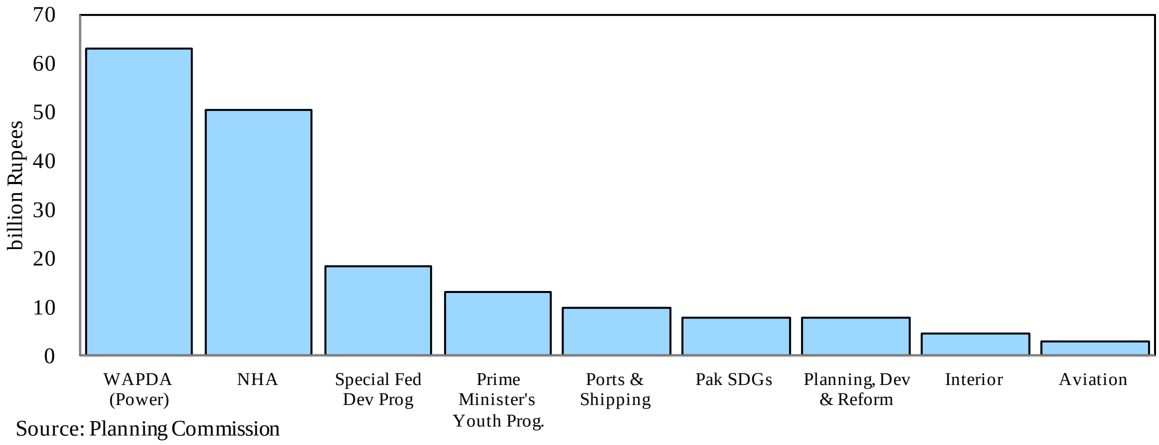


Source: Ministry of Finance

4.3 Federal expenditures

As mentioned earlier, expenditure containment by the federal government has been enabled mainly by a fall in debt servicing burden. In addition to this, subsidy expenses were also cut back via increases in energy tariffs (both power and gas); better payment recoveries; and imposition of surcharges for cost recovery. Incidentally, lower oil prices and better performance of distribution companies during FY16 as compared to preceding year also led to a containment in the accumulation of additional arrears in the power sector.

Figure 4.8: Federal PSDP Expenditures during FY16 (YoY increase)



Source: Planning Commission

Federal PSDP spending posted an increase of 21.4 percent during FY16. Power and transport sectors were prime beneficiaries of increased development work (**Figure 4.8**); Wapda was the major recipient of federal PSDP. The authority carried out a number of development projects during the year, including raising of Mangla dam; construction of Neelum-Jhelum hydro-power project; construction of Diamer Bhasha dam; and 4th extension of Tarbela dam.[17] Similarly, the federal government also spent on a number of transport projects via the National Highway Authority (NHA). Key projects included the construction of Faisalabad-Khanewal expressway; Thakot-Havelian section under the CPEC; Islamabad-Peshawar Motorway; Multan-Sukkur section and Lahore-Sialkot motorway. In addition to these, the government also spent on various on-going projects like the provision of coal conveying system from Pakistan International Bulk Terminal (PIBT) to railway network at Port Qasim, and the construction of airports in Gwadar and Mansehra.

4.4 Provincial fiscal accounts

Provincial governments were able to put together a better fiscal performance in FY16 compared to last year. Not only did their surpluses increase, these were generated via stricter control over current

[17] Source: Public Sector Development Programme 2016-17, Planning Commission.

expenditures (**Table 4.8**). On the revenue side, while provinces' dependence on federal resources remained high, they were able to supplement that with a sharp increase in tax collections.

Table 4.8: Summary of Provincial Fiscal Operations

	Billion Rs		% growth	
	FY15	**FY16**	**FY15**	**FY16**
Total revenue	1,902.4	2,293.9	7.6	20.6
Share in Federal revenue	1,538.7	1,862.2	9.4	21
Provincial taxes	205.8	283.3	8.3	37.6
Total expenditure	1,898.9	2,152.2	17.4	13.3
Current expenditure	1,400.1	1,559.8	17.9	11.4
Development expenditure	498.8	592.4	15.9	18.8
Overall balance	3.5	141.7		
Financing*	**-87.3**	**-207.4**		

*Negative sign in financing implies fiscal surplus.
Source: Ministry of Finance

Provincial taxes

Provincial tax collection posted an impressive growth of 37.6 percent during FY16. As shown in **Table 4.9**, the bulk of revenues were collected from GST on services, in which Sindh and Punjab recorded notable improvements. In fact, Sindh – which has an edge over other provinces in terms of wider range of taxable services available like shipping and ports – was able to exceed its annual revenue target on account of higher collection from this source. As for Punjab, some improvement was also seen in other collections, especially from stamp duties. KPK missed its annual target due to difficult law and order situation in the province, and the continuation of operation Zarb-e-Azb in adjacent parts of the province.

Table 4.9: Provincial Fiscal Operations during FY16
Billion rupees

	Punjab		Sindh		KPK		Balochistan		All provinces	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
A. Total revenue (i+ii+iii+iv)	892.1	1,091.5	533.7	641.2	288.7	364.3	187.9	196.8	1,902.4	2,293.9
i. Share in federal revenue	726.9	901.5	406.2	488.7	250.7	302.1	154.9	170.0	1,538.7	1,862.2
ii. Provincial revenues	98.1	142.9	93.8	123	11.4	13.1	2.6	4.3	205.8	283.3
o/w GST on services*	42.7	58.7	49.0	61.5	12.0	7.3	1.0	2.4	104.7	129.8
Excise duties	1.8	2.7	3.8	3.8	0.0	0.0	0.4	0.4	6.0	6.9
Stamp duties	21.8	27.2	6.6	7.2	0.8	0.8	0.3	0.3	29.5	35.5
Motor vehicle tax	10.1	11.8	4.2	5.3	1.0	1.3	0.5	0.6	15.9	19.1
iii. Non-tax revenues	45.3	31.3	8.4	9.2	18.4	45.8	3.5	7.0	75.6	93.3
iv. Federal loans & transfers	21.9	15.8	25.3	20.4	8.2	3.4	26.9	15.6	82.3	55.1
B. Total expenditure	872.9	990.3	516.5	590.7	326.9	359.8	182.7	211.5	1,898.9	2,152.2
Current	662.9	705.5	383.4	456.3	221.8	246.9	131.9	151	1,400.1	1,559.8
Development	210.0	284.8	133.0	134.4	105.1	112.8	50.7	60.2	498.8	592.4
Gap (A-B)	19.3	101.2	17.2	50.6	-38.2	4.6	5.3	-14.7	3.5	141.7
Financing**	-43.0	-76.1	-27.5	-84.0	7.9	-74.1	-24.7	26.9	-87.3	-207.4

*The data on GST on services for FY15 has been taken from respective provincial budget documents.
** Negative sign in financing implies fiscal surplus.
Source: Ministry of Finance and provincial budget documents

Within each province, the nature and level of tax collection varies, based on its particular environment and kind of business activity (**Box 4.1**). Therefore, the amount of work required to mobilize revenues also differs. However, provinces are at various stages of reforming their tax collection mechanisms, with the hope of higher returns. Particularly, Punjab – being the largest province – has strengthened its tax policy and administration to increase revenue mobilization as per its potential. Sindh has posted a sharp increase in its collection from sales tax on services with the help of the Sindh Revenue Board, but its collection from other sources remains insignificant. Meanwhile, Balochistan and KPK are gradually aligning their tax collection machineries to streamline their revenue collection.

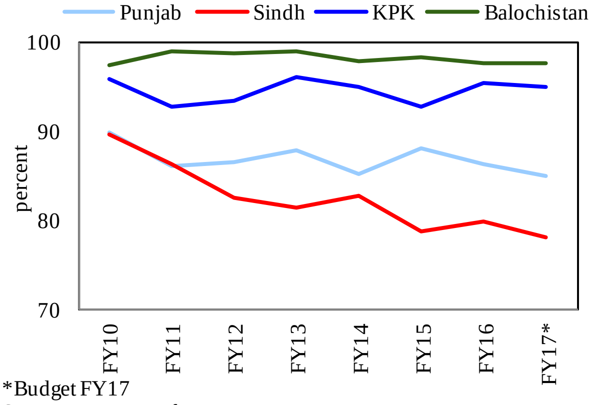
The contribution of two biggest components of GDP, i.e., services (59.2 percent share) and agriculture (19.8 percent share) in provincial collection remains very small, indicating a sizable room for improvement. However, we expect some increase in provincial collection in upcoming years due to creation of dedicated structures for collection of sales tax on services; revision in property valuation system; and computerization of land records. In addition, motor vehicle taxes, stamp duties and provincial welfare taxes have significant unrealized potential to compliment provincial revenues.

Box 4.1: Provincial Resource Mobilization

Fiscal decentralization brings efficiency with the involvement of local resources in service delivery. It increases transparency and accountability of financial resources due to empowerment of people at grass root level and therefore, facilitates swift decision making. In line with this ideology, the first major step was the promulgation of the seventh NFC award, which increased the provinces' share in the divisible pool from 47.5 percent to 57.5 percent.[18] Secondly, the 18th amendment was introduced in Pakistan's constitution, which devolved certain functions from the federation to provinces. Specifically, provincial tax domain was enhanced to include coverage of sales tax on services. It was expected that over time provinces will enhance their capacity to collect taxes by modifying their institutional structures and reduce their dependence on federal transfers. Accordingly, in 2011, Sindh Revenue Board was formed to collect sales tax on services in the province. Similarly, Punjab, KPK and Balochistan followed suit and developed dedicated structures for collection of sales tax on services. These services pertain to hotels, clubs, caterers, stockbrokers, advertisement agencies, couriers and telecommunication companies etc.

However, till now, the federal share in revenue mobilization continues to dominate, though provinces are gradually striving to increase their respective shares of tax collection. The size of provincial share varies and its composition also differs within different provinces, reflecting their progress so far. As shown in **Figure 4.1.1**, Sindh stands out in terms of reducing the federal share with increase in its own share from 10 percent in 2010 to 22 percent in 2016 (**Table 4.1.1**). In fact, Sindh was the first province to translate this opportunity to increase its revenues by promulgating a dedicated institution to collect sales tax from services. Apart from that, it had the rare advantage of channeling funds from the country's main sea port and financial hub.

Figure 4.1.1: Share of Federal Transfers in Total Provincial Revenues



*Budget FY17
Source: Ministry of Finance

By contrast, Punjab was able to increase the share of its revenue mobilization from 14 percent to 15 percent during the same period. KPK and Balochistan have yet to show progress in this regard. Services sector, being the largest contributor to GDP (59.2 percent share), has enormous untapped potential to increase provincial revenue collection. Sindh has impressively diversified its tax base and increased collection from sales tax on services in recent years. All provinces need to invest more in capacity building and streamlining their tax collection machineries.

Another important item is agriculture tax, which is collected either in the form of a tax on agriculture income or on land revenue, whichever is higher.[19,20] Therefore, agriculture income tax and land revenue tax must be combined to have a fair picture of tax from agriculture. Accordingly, Punjab receives biggest contribution from agriculture sector, followed by KPK (which receives significant amount from land revenue). Similarly, it contributed around 6 percent of provincial collection in Balochistan, while Sindh received only 1 percent of its collection from this source. Moreover, the provincial collection from this source appears to be highly volatile over time due to continuous threat of physical damages (pest attacks), economic losses (price fall) or adverse climate changes (floods and extreme weather).

Lower collection from this sector basically represents difficulties in assessing agriculture income, with high chances of corruption and also capacity issues with provincial revenue authorities (which administer agriculture taxes). On the contrary, farmers argue that they are heavily burdened by taxes in the form of *abiana*, land revenue, and taxes on inputs including purchase of seeds, fertilizers, pesticides and machinery. Going forward, an emphasis on capacity building along with introduction of incentives, such as re-investments of tax receipts for the improvement of agriculture infrastructure, may substantially raise collections from this sector.

[18] See Special Section 2: National Finance Commissions Awards—A Review; SBP First Quarterly Report for FY10.
[19] Source: 2011, Taxing agriculture income in Pakistan , Pakistan Institute of Legislative Development & Transparency (www.pildat.org)
[20] On the basis of land ownership, holding size up to 12.5 acres is exempt, and there are three slabs: (i) From 12.5 up to 25 acres at Rs 100 per acre; (ii) from 26 to 50 acres at Rs 250 per acre; and (iii) above 50 acres at Rs 300 per acre. On the basis of agri. income, up to Rs 80,000 is exempt and there are four slabs: (i) income up to Rs 100, 000 at 5 percent -Rs 5000; (ii) income from Rs100,000 to Rs 200, 000 at Rs 5000 + 7.5 percent on over Rs 100,000; (iii) for income from Rs 200,000 up to Rs 300,000 at Rs 12,500+10 percent on over 200,000; and (iv) for income more than Rs 300,000 at Rs 22,500+15 percent on over Rs 300,000.

Moving on, share of property tax in provincial revenue collection is fairly small despite enormous activity in real estate. In Punjab despite the fact that the share of property tax in the province has dropped from 7.8 in 2011 to 7.1 percent in 2016, this head has a larger contribution. In Balochistan, it has been reduced to a third of its 2011 level. A declining share of property taxes in provincial collection was demanding attention of governments to restructure property tax regime and address the understatement of property values. Accordingly, the government has recently put in place a new system of property valuation through a consultative process to determine the fair value of property. Given the tendency, that people usually

Table 4.1.1: Share of Various Taxes in Provinces' Total Tax Collection
percent, otherwise mentioned

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17*
Punjab								
Share in divisible pool (Rs billion)	325.1	460.8	518.3	569.3	646.3	726.9	896.5	1,045.0
Federal share	89.8	86.0	86.5	87.9	85.3	88.1	85.6	85.0
Provincial taxes (Rs billion)	36.8	75.3	80.9	78.4	111.8	98.0	150.8	184.4
Shares of various heads								
Tax on income (agriculture)	2.7	1.0	0.9	1.1	0.7	1.0	1.0	1.2
Property tax	18.7	7.8	9.4	5.7	8.9	2.6	6.1	7.1
Land revenue	15.6	11.0	11.4	12.5	9.9	11.2	7.5	7.8
Sales tax (GST provincial)	9.2	48.2	45.2	43.8	46.5	43.5	41.1	46.1
Stamps duty	23.1	11.4	13.1	16.0	12.5	22.3	16.8	17.1
Sindh								
Share in divisible pool (Rs billion)	188.4	279.9	285.1	320.7	383.7	406.2	483.0	547.8
Federal share	89.7	86.4	82.5	81.4	82.8	78.7	79.4	78.1
Provincial taxes (Rs billion)	21.6	44.2	60.5	73.3	79.7	109.9	125.3	154.0
Shares of various heads								
Tax on income (agriculture)	0.9	0.5	0.2	0.7	0.3	0.5	0.3	0.4
Property tax	3.9	1.9	3.5	5.0	1.2	4.1	3.0	3.2
Land revenue	1.2	0.8	0.3	0.7	0.3	0.5	0.2	0.4
Sales tax (GST provincial)	32.4	37.6	39.6	43.7	49.5	44.6	48.7	50.6
Stamps duty	16.7	9.7	7.9	8.2	7.4	6.4	6.0	6.2
KPK								
Share in divisible pool (Rs billion)	80.1	157.9	178.9	199.6	234.4	250.7	301.3	346.2
Federal share	95.9	92.7	93.4	96.1	94.9	92.7	95.5	95.0
Provincial taxes (Rs billion)	3.4	12.4	12.6	8.2	12.6	19.8	14.3	18.2
Shares of various heads								
Tax on income (agriculture)	0.5	0.2	0.2	0.3	0.2	0.4	0.6	0.5
Property tax	1.9	1.1	1.3	2.1	1.6	1.2	2.1	2.0
Land revenue	16.9	6.1	7.3	13.0	10.3	9.0	12.6	10.2
Sales tax (GST provincial)	24.0	73.3	71.0	52.5	63.3	60.5	55.9	55.0
Stamps duty	10.6	4.4	4.4	7.0	5.3	3.7	5.7	4.9
Balochistan								
Share in divisible pool (Rs billion)	40.0	100.7	107.4	125.3	141.9	154.9	171.2	196.8
Federal share	97.3	98.9	98.8	99.0	97.8	98.2	97.6	97.6
Provincial taxes (Rs billion)	1.1	1.2	1.4	1.2	3.2	2.8	4.2	4.8
Shares of various heads								
Tax on income (agriculture)	0.0	0.1	0.0	0.0	0.0	0.0	0.1	0.2
Property tax	3.8	6.1	5.9	7.1	1.5	2.1	1.7	1.9
Land revenue	5.1	3.5	8.0	3.4	1.6	6.7	5.8	6.0
Sales tax (GST provincial)	0.0	0.0	0.0	0.0	55.9	36.4	51.9	52.1
Stamps duty	15.4	12.2	12.3	14.1	6.5	13.0	10.6	10.0

*Budgeted, Source: Annual budget statements

prefer to keep their savings in property, we believe it is a step in the right direction to generate additional revenues from this highly under-taxed sector.[21] Moreover, the government has extended the holding period of property for the purpose of capital gain tax, which is applicable on the seller of property. This will discourage speculative activity in real estate and also generate some additional revenues. Therefore, it is expected that collection under this head in provincial revenues will substantially increase with the implementation of these measures.

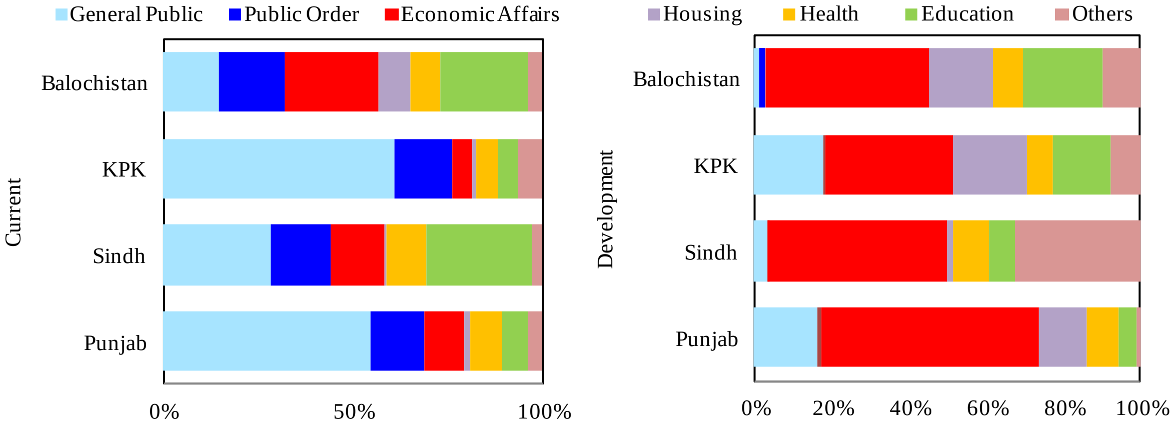
[21] FBR vide SROs 662-682(I)/2016 has revised rules of property valuation for different regions/cities for the purpose of collection of withholding tax and capital gain tax.

Finally, stamp duty applicable under Stamp Act 1899, for authenticating documents, is one of the most definite but decelerating forms of provincial revenues. As provinces are attempting to automate stamp duty collection system, its share will increase. Other sources of provincial revenues, such as motor vehicle tax, provincial excise and provincial welfare taxes etc. also have the enormous potential to compliment provincial revenues. Therefore, each provincial government should invest in capacity building of their respective departments and automating their systems in order to increase in provincial collections.

Provincial expenditures

In broader terms, the sector-wise breakdown of expenditures is similar across provinces: while *general public services* constitute the bulk of current expenditures in most provinces, *economic affairs*[22] dominate their development outlays. However, some variations also exist. For instance, within development expenditures, Punjab's emphasis on *economic affairs* (particularly construction and transport) is quite prominent, whereas KPK's development priorities appear more balanced (**Figure 4.9**).

Figure 4.9: Composition of Provincial Expenditures in FY16



Source: Provincial budgetary documents

The consolidated provincial expenditures grew by 13.3 percent YoY in FY16. This increase, visible both in current as well as development expenditures, was attributed to multiple factors:

- (i) A big chunk of the increase in expenditures was contributed by Punjab's current expenditures. This reflects higher storage and interest expenses associated with wheat procurement program of the Punjab Food Department.
- (ii) Punjab's development spending for *economic affairs* increased further in FY16, which mainly represents initiation of construction and transport projects in the province.
- (iii) The third big item in FY16 was local bodies' elections in Sindh during FY16, which increased its spending on *general public services* during the year.

[22] 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.