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MACROECONOMIC FRAMEWORK AND DETERMINANTS OF BENCHMARK FOR RECEIPTS AND EXPENDITURES

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Macroeconomic Framework and Determinants of Benchmark for Receipts and Expenditures

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Introduction

Macroeconomic framework[2] and how an optimal level of receipts and expenditures can be achieved at federal and across provinces is one of the fundamental issues the prevailing National Finance Commission (NFC) negotiation is figuring it out. The optimal level of receipts and expenditures can help the provinces to maintain fiscal balance. Similarly, optimal level of receipts and expenditures will also help to develop homegrown macroeconomic framework. To avoid the complexities involved in macroeconomic framework, and remain in line with NFC discourse we focused our discussion on fiscal side of macroeconomic framework. Over the years, narrow tax base, heavy concessions and exemptions, challenges in tax administration and inadequate tax compliance have resulted in a low tax-to-GDP ratio. To address these challenges and weaknesses, there is a dire need to introduce necessary fiscal measures. Fiscal reforms are needed to ensure a fair and efficient tax system to generate sufficient revenues, which however seems a big challenge in the presence of substantially low tax-to-GDP ratio.

There are several existing opportunities to enhance tax-to-GDP ratio such as implementation of a full value-added tax (VAT), eliminating SRO power, bring the services sector into the tax net, improvement in the tax administration system (Pakistan Vision 2025). By 2025, all these actions will increase the tax-to-GDP ratio to 16-18% in line with comparable countries, (for instance it was 16.8% in India, 18.8% in Thailand and 19.7% in Turkey in 2012). A broader tax base along with essential reforms in the taxation system can be helpful to increase the tax-to-GDP ratio in Pakistan. Further, a simplified tax procedure will also promote investment, less barriers to businesses, simplified legal requirements, less corruption, convenience to small and medium enterprises (SME). To harness its full potential of the prevailing tax system, there is a need to incentivize the mechanism of our tax system.

Maintaining a fiscal balance at provincial level can be the first step towards country fiscal stability, which however is not the case in Pakistan. Four important and relevant questions were brought to the table during provincial meetings to contemplate on homegrown macroeconomic framework and to have an optimal level of receipts and expenditures. First: Do the provinces need an expenditure framework? Second: In order to have transparency and accountability do the provinces need public expenditure and financial accountability assessments? Own revenues as a share of provincial expenditures are falling. Third: how the provinces can be incentivized to have greater access to own tax bases, and produce stronger tax collection performance? At present there is no framework for the fiscal responsibility of the whole federation. Existing Federal Debt Limitation Law (2016) is only binding on federal government. Finally: Do the provinces need fiscal responsibility law?

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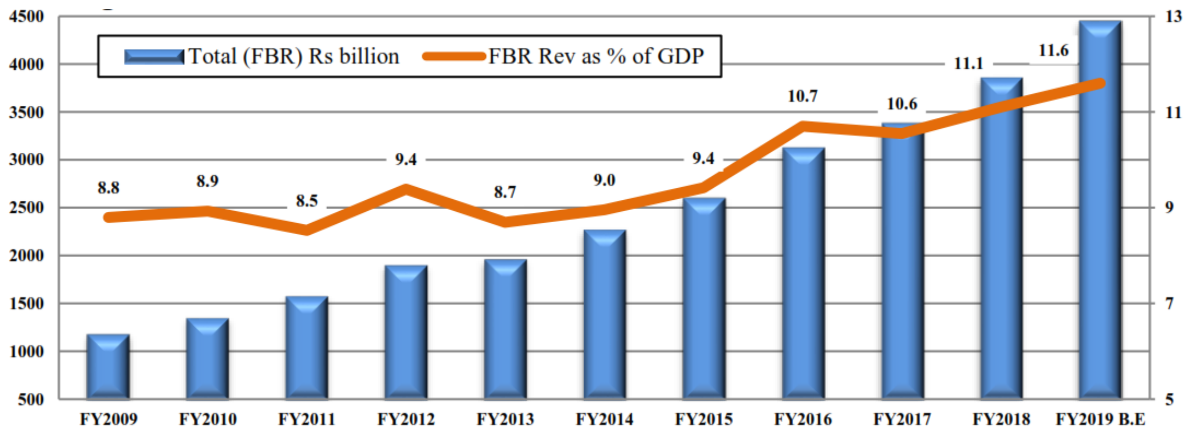
[2] Includes real sector, external sector, fiscal and monetary components of the economy

The 'Homegrown' Macroeconomic Framework proposes the need of additional revenues to be generated and expected expenditures that might incur. It proposes the additional taxes of PKR 650 billion during the next two years (2019-20 and 2010-21). The government is taking into consideration more options available to increase the tax revenues. The main sources of revenues are Federal Board of Revenues (FBR) tax revenues, other federal taxes, provincial tax revenues and non-tax revenues. The revenues are expected to rise mainly because of expected growth in the FBR tax revenues, while other kinds of taxes are stagnant.

State of Federal Revenues and Expenditures

Federal tax revenues since 2009 are slowly and gradually increasing. In 2009 it was 8.8 % of GDP. It was increased to 11.6 % of GDP in 2019. Since 2009 the increase in tax collection as percent of GDP is 31.81 %. Around 98% of the revenues is collected at the federal level, but still the federal government faces incredible fiscal challenges. The 7th NFC award and the 18th amendment put an unprecedented pressure on intergovernmental transfers. The federal government increased the size of divisible pool by reducing collection charges from 5.2% to 1%. In addition, the federal government accepted the provincial governments demand to provincialize the sale tax on services.

Figure 1. FBR Tax Collection



Source: Economic Survey of Pakistan, 2018-19

These two interventions increased the vertical transfer to 57.5% from 46.25%. On top of these interventions the federal government accepted the provincial governments demand to enhance straight transfers (hydel electricity profits, royalty on natural gas and crude oil, and excise duty on natural gap). Further, 1% of the divisible pool is given to the KPK for war on terror. Provincial shares were also affected by diversifying (other factors poverty, revenue generation efforts, and inverse population density are considered along with population) the basis of resource distribution (see table 1).

Table 1: Provincial Shares

Provinces	Presidential Order 2006	7th NFC Award
Punjab	53.01 %	51.74 %
Sindh	24.94 %	24.55 %

KPK	14.88 %	14.62 %
Balochistan	7.17 %	9.09 %

After the application of the 7th NFC award the federal government realized that larger transfers to the provincial governments are not only causing the federal fiscal deficit but it is also triggering debt and liability financing, federal defense expenditures, and social safety nets programs run by the federal governments like Benazir Income Support Program (BISP).

Debt and Liability Financing

The FBR's revenue target for FY 2018-19 is Rs. 4,435 billion. The required growth in revenue collection to achieve this target is 15.4% as in the last FY 2017-18 revenue collection was Rs. 3,842.1 billion. The total debt and liability servicing was around 52% of the total revenue collection in 2018. The State Bank of Pakistan (SBP) only released first quarter figure so far, but it seems the total debt and liability servicing will be close to 60% in FY 2019. A huge chunk (more than 90%) of divisible pool consists of the FBR's revenue. If we calculate the provincial share (57.5%) out of the total FBR's targeted revenue (4,435)[3] it amounts to Rs. 2,550 billion. In this scenario the FBR will be left with Rs. 1,885 billion, which is much less than the total debt and liability serving for the year 2018. The federal government is in dire need of financial resources to pay the debt and liability servicing. If the provincial governments are inflexible on the federal government concerns, the federal government needs to spring up on how to share the debt and liabilities among the provincial governments. It may strengthen the provincial government demand on borrowing autonomy to the provincial governments, but at the same time it will provide an opportunity to the federal government to put a liability on provincial governments.

Table 2: Pakistan debt and liability Profile (In Billion Rs.)

	2018	Q1FY2019
Total debt and liability	29,892	30,875.8
Pakistan Total Debt	28,450	29,446.2
Government domestic debt	16,416.3	16,919.8
PSEs domestic debt	1,068.2	1,128.9
External debt	10,965.5	11,397.4
Total liabilities	1,442	1,429
Total debt and liability servicing	1,996.2	504.6

Source: State Bank of Pakistan

Federal Security Related Expenditures

The 7th NFC award stretched out the federal government financing. Federal government requires 7% for FATA, Kashmir, Gilgit-Baltistan, rehabilitation of internally displaced people

[3] Assuming the FBR will meet its revenue target.

(IDPs) and CPEC security from the divisible pool before application of next NFC awards. If we include 1% committed for KPK against war on terror, then the total share requires for the federal government is 8%. The exact security related cost is not known, but it seems hefty amount. If an appropriate required fund is not disbursed timely, it may damage the tireless efforts of the security agencies to stabilize the security situation. Until, FATA is fully merged its financial responsibility lies with the federal government.

Social Safety Net

Social Safety Nets Programs run by the federal government to meet national priority targets (poverty alleviation) including Sustainable Development Goals (SDGs). BISP is one of the largest social safety net programs. Since its inception the total budget released until December 2017 was Rs. 622.21 billion. The number of beneficiary families are substantially increasing in 2017-18 it was 5.6 million. Although, its allocation criteria, and impact is debatable. Number of other social safety net programs are operating by the federal government to meet the national priority poverty alleviation targets. These programs may be affected if an appropriate funds are not released timely.

Debt and liability financing, federal security related expenditures, and federal society safety net programs seem the most important reasons for deadlock. To dust off the deadlock the provincial governments need to realize federal government financial constraints (see table 3). Consolidated fiscal deficits remain 6% on average in since fiscal year 2012-13. Federal government also require to expedite and make the taxation reforms (direct taxes) more affective to increases their revenues. Similarly, to rely less on the federal government the provincial governments through imposition of agriculture and property taxes can increase their tax revenues.

Table 3: The state of Public finance- 2012-13 to 2017-18 (% of GDP)

	2012-13	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**
A. Total REVENUES (NET)	**7**	**8**	**7.7**	**7.6**	**8.1**	**7.2**
A. 1. Tax Revenue	9.1	9.4	10	11.6	11.6	11.8
FBR Revenue	8.6	9	9.4	10.7	10.5	11.2
Other taxes	0.5	0.4	0.8	0.9	0.9	0.6
A.2. Non-Tax Revenue	3.3	4.1	3.1	2.4	2.8	1.8
Defense Receipts	0.8	0.5	0.6	0.4	0.2	
Other Sources	2.5	3.6	2.5	2	2.6	
A.3. Transfers	-5.4	-5.5	-5.6	-6.4	-6.2	-6.4
B. TOTAL EXPENTURE	**15.4**	**14.9**	**13.7**	**13.5**	**13.6**	**13.7**
B.1. Current Expenditure	11.7	11.5	11.2	10.9	10.9	11.1
Debt Servicing	4.4	4.6	4.8	4.3	4.2	

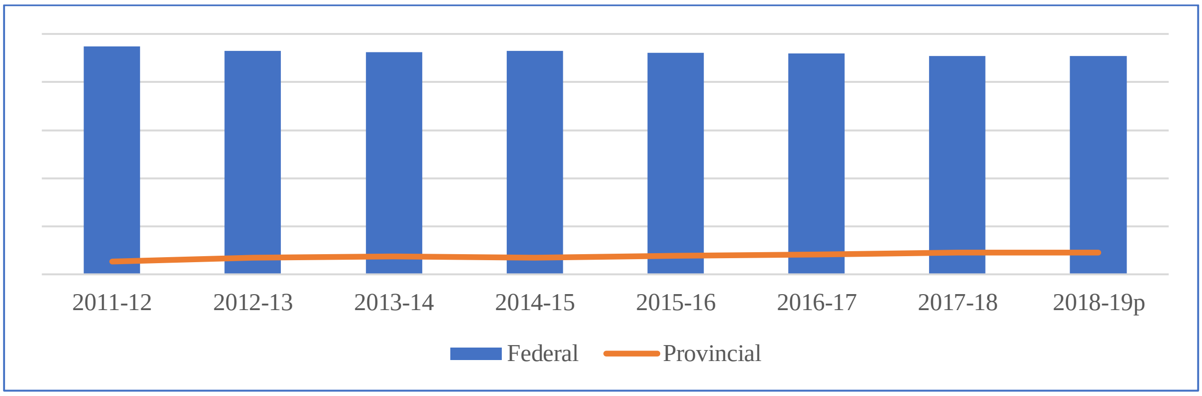
Defense	2.4	2.5	2.5	2.6	2.8	
Pensions	0.8	0.7	0.7	0.8	0.9	
Grants/Subsides	3.2	2.8	2.4	2.2	2	
Other	0.9	0.9	0.8	1	1	
B.2. Development Exp.	3.7	3.4	2.5	2.6	2.7	2.6
PSDP	1.6	1.7	1.8	2.1	2.3	
Other development Exp	0.4	1	0.5	0.4	0.4	
Net Lending	1.7	0.7	0.2	0.1	0	
C. STATISTICAL DISCREPANCY	**0**	**-0.6**	**-0.4**	**-0.5**	**0.2**	
Federal Fiscal Deficit	-8.4	-6.3	-5.6		-5.7	-6.5
Provincial Cash Surplus/Deficit	0.2	0.8	0.3	0.7	-0.1	-0.1
Consolidated Fiscal Deficit	-8.2*	-5.5	-5.3	-4.6	-5.8	-6.6

Source: MOR, Fiscal Operations | Estimated for 2017-18

State of Provincial Tax Revenues and Expenditures

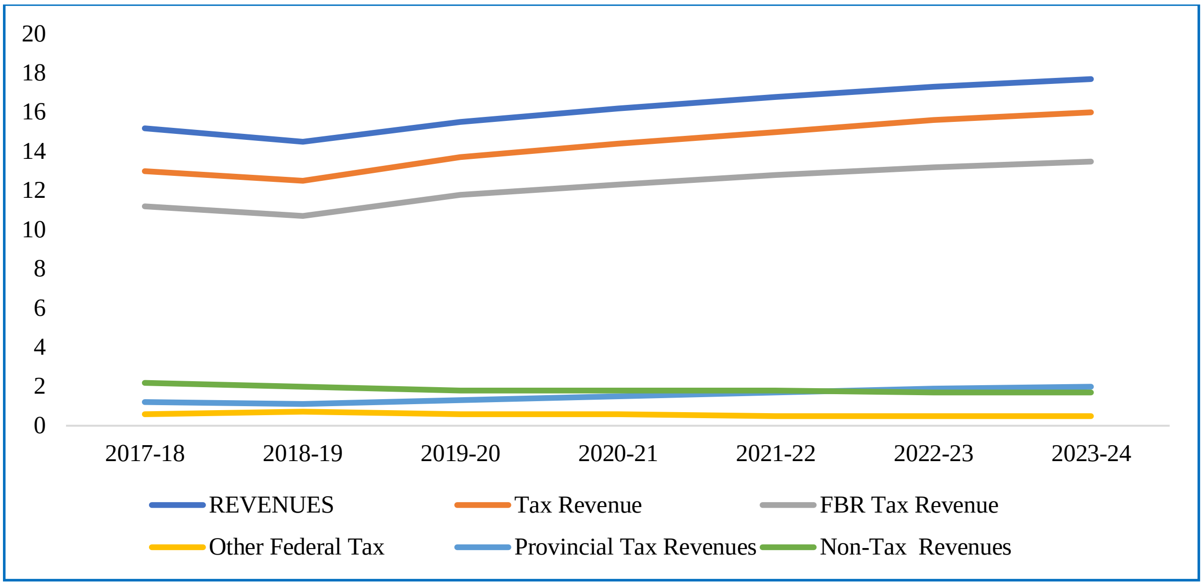
Under the provincial tax revenues, the key share came from Sales tax on Services (GSTS), and Stamp duties in FY2018. In the same year, provincial expenditures increased by Rs. 369.40 billion compared to FY2017, where the current expenditures amplified by Rs. 341.40 billion and development expenditures amplified by Rs. 27.9 billion. The provinces faced a cumulative deficit of around Rs. 17.5 billion. The real concern for the provinces is the total share of the provinces in total federal tax revenues is less than 2%. The provincial share curve is almost flat since 2012-13 (see Figure 2). To address the fiscal deficit problem in a continuous basis the provincial governments are required to increase the provincial revenues. Figure 3 clearly depicts the contribution of non-tax revenues in total taxation. Unfortunately, the contribution of non-tax revenue across provinces is minimal.

Figure 2: Share in Tax Revenues



Source: Economic Survey of Pakistan, 2018-19

Figure 3. Sources of Revenues (% of GDP)



Source: BCPR (Beaconhouse National University, Center for Policy Research), 2019

Table 3 explains provincial fiscal deficits. Sindh government in the fiscal year 2017-18 has the highest fiscal deficit of Rs. 100 billion, followed by Balochistan Rs. 35 billion, Punjab around Rs. 5 billion. Only KPK government has fiscal surplus of around Rs. 5 billion. The main reason for the provincial deficit is less revenue both tax and non-tax generation of their potential, and exponential increase in the expenditures. The total fiscal deficit across all the provinces is around Rs. 120 billion (see Figure 4). However, this total fiscal deficit is 0.25% if we compare with the federal fiscal deficit of an average of 6% in last decade (see table 3).

Table 3: Overview of Provincial Budgets (2017-18 RE, Rs. Billion)

Rev/Exp	Punjab	Sindh	KPK	Balochistan	Total
A. Tax Revenue	1,329.5	713.2	376.6	212.1	2,631.4
Provincial Taxes	197.6	176.1	18.3	9.4	401.4
Share in Federal Tax	1,131.9	537.1	358.3	202.7	2,230
B. Non Tax Revenue	73.4	63.4	85.2	14.3	236.3
C. All other	218	90.3	102.1	18.9	429.3
Total Revenue (A+B+C)	1,620.9	866.9	563.9	245.3	3,297
a) Current Expenditure	1,048.9	685.2	389	204	2,327.1
b) Development Exp	576.8	282.4	150.2	76.9	1,086.3
Total Exp (a+b)	1,625.7	967.6	539.2	280.9	3,413.4
Surplus/Deficit	-4.8	-100.7	24.7	-35.6	-116.4

Source: Provincial Finance Wing, Financing Division

Figure 4: Provincial Deficit/Surplus (Rs. Billion)

Source: Provincial Finance Wing. Financing Division

After discussing provincial receipts and expenditure scenarios, the provincial government were interested in disaggregated analysis of expenditures to chalk out the entities that are consuming the highest budget. Table 4 provides this disaggregated analysis across the provinces. For example, Punjab current expenditures priority is general public services, followed by public order and safety affairs, and health. On development expenditure front the highest budget is allocated to economic affairs, followed by housing and community amenities. We can see rest of the provinces priorities are different. This brings in complexities to formulate homegrown macroeconomic framework that speaks for optimal level of fiscal allocations.

Table 4: Current and Development Expenditure Breakdown (2018 revised, Rs. Million)

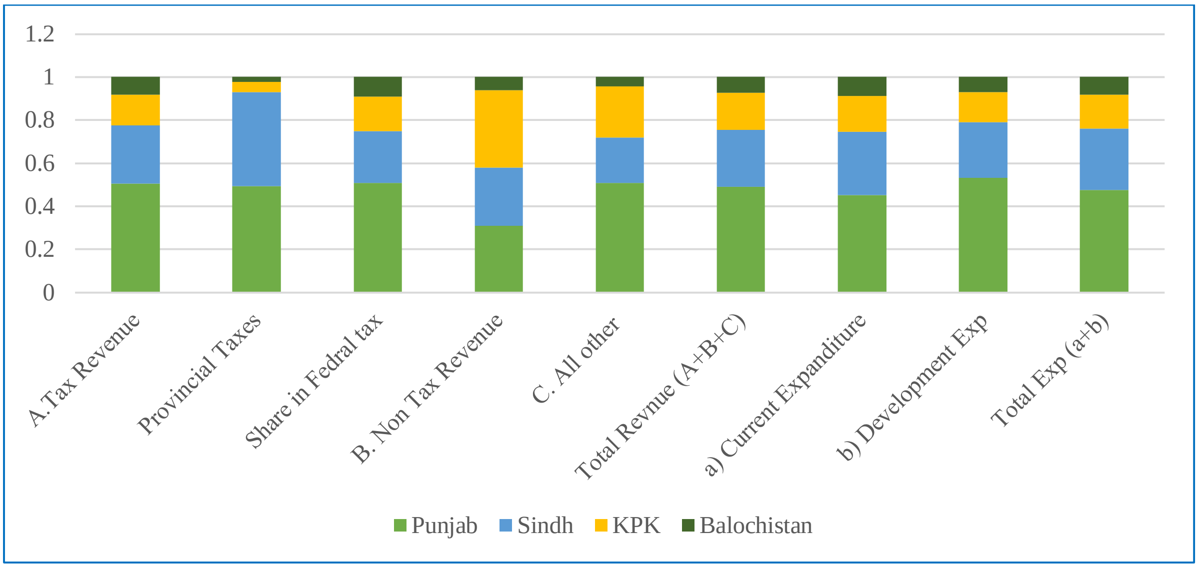
Items	Punjab	Sindh	KP	Baluchistan
Current (Revenue) Expenditures	**1,048,992**	**685,173**	**348,042.52**	**251,990**
General Public Services	569,944	203,736	225,552	85,026
Civil Defense			105	
Public Order and Safety Affairs	144,244	102,883	47,921	34,438
Economic Affairs	116,530	99,512	17,913	54,896
Environmental Protection	404	757	70	279
Housing and Community Amenities	13,867	5,140	4,856	8,512
Health	128,364	87,540	26,902	17,770
Recreational, Culture and Religion	3,615	10,650	938	2,649
Educational Affairs and Services	64,134	165,117	22,769	46,181
Social Protection	7,888	9,838	1,015	2,238
Development Expenditure (Current and Capital)	**576,841**	**282,374**	**117,367**	**76,869**
General Public Services	86,507	9,604	14,428	10,494
Public Order and Safety Affairs	9,088	2,974	590	2,217

Economic Affairs	287,270	71,063	44,269	32,411
Environmental Protection	128	231	4,372	6,380
Housing and Community Amenities	88,389	20,314	20,788	10,302
Health	56,462	7,678	12,809	5,950
Recreational, Culture and Religion	5,249	5,117	3,192	1,257
Educational Affairs and Services	40,850	13,425	15,789	7,458
Social Protection	2,898	124,351	1,130	401
Foreign Project Assistant		27,617		

Source: Provincial Budget Documents

To explore the determinants of benchmark for receipts and expenditures we teased out further provincial shares in national revenues and expenditures (see figure 4). We are not going to discuss the details mentioned components, but two of the components are important to be discussed. If we look into the non-tax revenue bar KPK is generating more than rest of the provinces. In term of tax revenue Punjab is dominating the bar. Similarly, if we look into the development expenditure bar Punjab is occupying the maximum share. This provincial share disaggregation also indicates along with tax revenues efforts, non-tax revenue generation efforts are also needed across the provinces to stand on its own or at least the provinces remain less dependent on the federal government. Based on their size of the provincial economies and provincial governments priorities the development expenditures can also be curtailed to an optimal fiscal resources allocation.

Figure 5: Provincial Shares in National Revenues and Expenditures

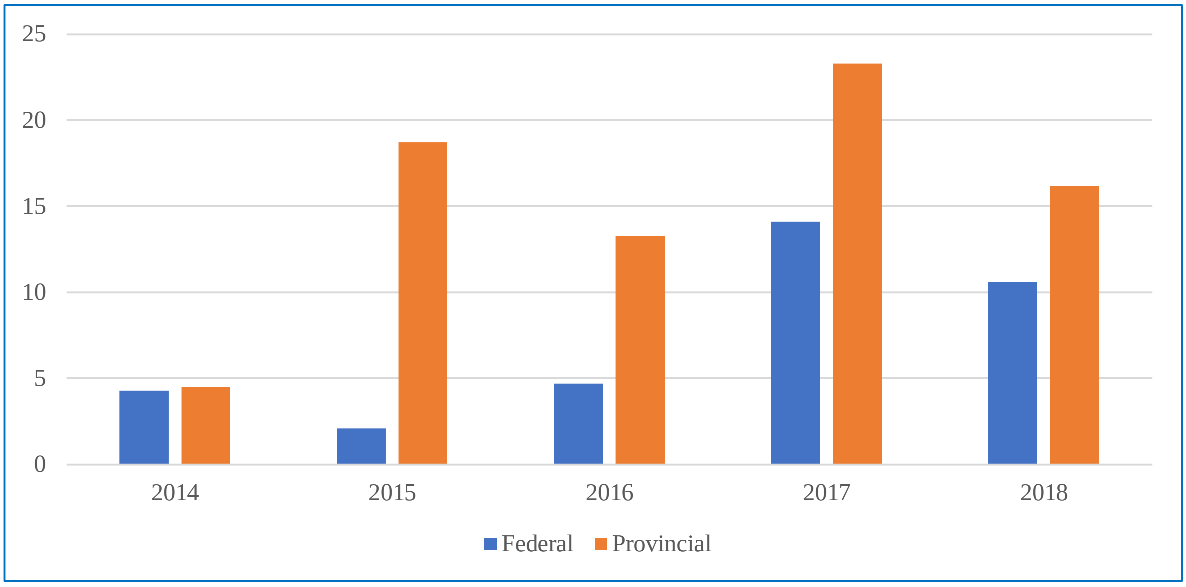


Source: Provincial Finance Wing, Financing Division

Comparison of Federal and Provincial Receipts and Expenditures

Growth of federal and provincial expenditures are putting pressure to imbalance the fiscal resources allocation. The annual growth rate of federal and provincial expenditures were in par in 2014 (see Figure 6). But in 2015 the annual growth rate of provincial expenditures increased exponentially to 19 %, however, the annual growth rate of federal expenditures was dropped to 2%. The gap between the federal and provincial expenditures were around 17 %. The gap was reduced to 10% in 2017, and remains 5% in 2018. The increase in the provincial annual growth rate of expenditures was mainly because of 18th amendments, and 7th NFC award resources allocations. The reduction in the gap is not only related to 18th amendments, and 7th NFC award but overall economy situation does matter.

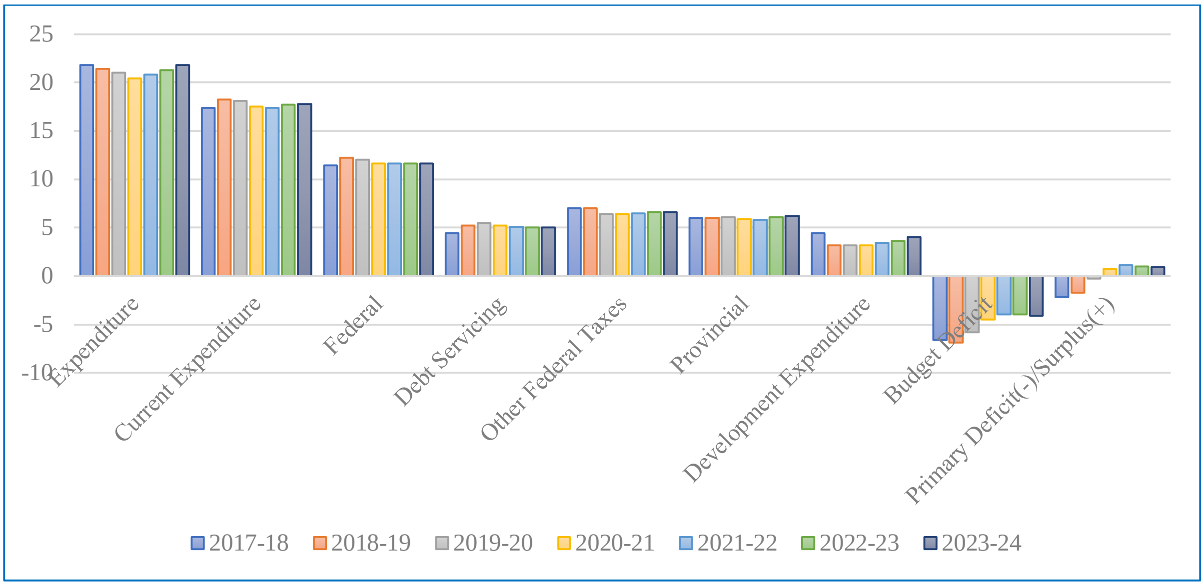
Figure 6: Annual Growth Rate of Federal and Provincial Expenditures (%)



Source: Ministry of Finance (MoF), Fiscal Operations

The overall macroeconomic imbalances severely affect the economy that eventually exert pressure on resource allocations. Based on the projections (see Figure 7) by Beaconhouse National University, the total current (federal and provincial) expenditures are expected to decrease slightly in near future. The total expenditure would be the lowest in 2010-21 mainly because of the lower budget deficit, and a positive primary surplus. The lower budget deficit provides more funds available for development expenditures in later years. Although the development expenditures are expected to rise, but increasing incidence of poverty would be a major challenge in the coming years. It is expected that the incidence of poverty may increase by 2% in 2019-20. The biggest challenge for the federal government macroeconomic framework and optimal resources allocation is to reduce the fiscal deficit to have fair distribution of resources in the federation. Expenditure framework of provinces, own sources revenues, and fiscal responsibility are the main determinants to decide the shape of homegrown macroeconomic framework.

Figure 7: Expenditures and Deficits (% of GDP)



Source: Beaconhouse Center for Policy Research, 2019

Conclusion

Pakistan is a federation, with bulk of revenue collected at the federal level and major service delivery expenditures carried out at the provinces, creating a vertical imbalance by requiring the federal government to transfer resources to provinces. The distribution of revenues between the federal government and the provinces have been setup as per Pakistan Constitution (article 160) by forming an intergovernmental and inter-legislative body called the NFC. Federal government is always in need of additional resources to support national and provincial economic objectives such as setting national standards, securing an economic union and above all ensuring inter-regional and inter-local fiscal equity, however provinces feel otherwise. Overtime, the needs of the provinces are changing and the NFC Award should be made more flexible to address the needs of the provinces, which are discusses below.

An extensive deliberation is carried out across the provinces to pin down ways to achieve homegrown macroeconomic framework, and optimal level of receipts and expenditures. Four important questions that we already highlighted in the introduction were tabled. Based on thorough deliberation the following conclusion is drawn.

Expenditure Frameworks of Provinces

Current NFC formula considers factors: population, poverty, revenue generation and inverse population density but these are not reflected in the expenditure frameworks of provinces. Therefore, there is a requirement to include the possible expenditure priorities while deciding for the revenue sharing scenarios. These could include equality in federating units, internal revenue efforts (not only the level), SDGs, efficiency and fiscal responsibility, provincial per capita GDP, health, education, safe drinking water, etc. In order to have transparency and accountability something on the pattern of *Public Expenditure and Financial Accountability* (PEFA) assessments should be considered for the NFC award.

Own-Source Revenues

Provincial budget making is dependent on federal transfers. Almost 80% of their expenditure needs are met from these transfers. Own revenues as a share of provincial expenditures are falling. Any systematic issue such as overestimation of revenue collection by FBR, delays or withheld deposits can create complication for provincial budget making. There should be incentives and authorizations allowing provincial governments to have greater access to own tax bases, produce stronger tax collection performance, help FBR in tax recovery and improve on cost recovery policies to create fiscal space. The FBR should have provincial representation, sharing the responsibility of both policy-making and revenue collection.

Fiscal Responsibility

At present there is no framework for the fiscal responsibility of the whole federation. Existing law (FRDLL-2016) is binding only on the federal government. Whereas provinces collectively spend more than the federal government. There should be a fiscal framework for the whole federation with NFC being part of it. Debt based financing of development programs by federal government for the provinces should have a shared responsibility.

Matching Grants from the federating units

The provinces in Pakistan are free to use the transfers from the federal government in the manner they deem fit. Such block unconditional transfers, though in accord with the spirit of the provincial autonomy, do not provide any guarantee that funds will be used to provide a minimum level of public service, especially in respect to essential needs like healthcare and education. Conditional or matching grants from the federating units, especially for social needs like healthcare and education, should be a key element of any viable transfer program.

Appendix

Definitions

Tax revenue:
The revenues collected from both direct and indirect tax on different items like income and profits, corporate tax, wealth tax, customs, union excise, service, tax on union territories like land revenue, stamp registration, etc.

Provincial Tax: A provincial tax that levied on agriculture tax, capital value tax, property tax, motor vehicle, land tax, cesses like cotton cess, sugar cane cess, excises on hotals, cinamas etc.

GST on Services: GST is known as general sales tax. The goods and services tax (GST) is a value-added tax levied on most goods and services sold for domestic consumption.

Provincial share in Federal Taxes: The provincial share of revenue in federal revenue tax that is collected by federal government.

Non-Tax Revenue:
The non-tax revenue of the federal government is administered by various ministries / divisions / departments and comprises of following sources:

i) Income from property and enterprise (railway, Pak. telecommunication authority and markup);

ii) Receipts from civil administration and other functions

iii) Miscellaneous receipts

All Others: It include the all capital receipts; current capital receipts and foreign project assistance in account I and account II.

Current Expenditures: Current expenditure is expenditure on goods and services consumed within the current year, which needs to be made recurrently to sustain the production of educational services. It includes general administration, defense, law and order, community services, social services, subsidies, debt servicing, investible funds and grants, unallocable.

Development Expenditures: It refers to the expenditure of the government which helps in economic development by increasing production and real income of the country such as federal PSDP, and other development expenditures, etc.

Economic Affairs

The allocation under the head of Economic Affairs in the budget are:[4]

[4] Federal Budget Document

1 General Economic, Commercial and Labor Affairs,
2 Agriculture, Food, Irrigation, Forestry and Fishing
3 Fuel and Energy
4 Mining and Manufacturing
5 Construction and Transport
6 Communications
7 Other Industries

General Public Services

The bulk of expenditure falls under General Public Service:[5]

1 Executive & Legislative Organs, Financial, Fiscal Affairs & External Affairs
  a. Superannuation Allowances & Pensions
  b. Servicing of Foreign Debt
  c. Foreign Loans Repayment
  d. Servicing of Domestic Debt
  e. Others
2 Foreign Economic Aid
3 Transfers
4 General Services
5 Basic Research
6 Research and Development General Public Services
7 Administration of General Public Services
8 General Public Services not elsewhere defined

[5] Federal Budget Document