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Khyber Pakhtunkhwa Revenue Mobilization

This Policy Brief is based on the section written by Anjum Nasim, Institute of Development and Economic Alternatives (IDEAS), in "Reclaiming Prosperity in Khyber Pakhtunkhwa" on Fiscal Space.

Provincial GDP of KP in 2013-14 is estimated to be Rs2661 billion.[1] KP, with income per household of Rs7709, was the poorest province of Pakistan in 2010-11 (see Table 1)[2]. Its share in the provincial share of divisible pool of tax revenues is 14.62 percent. The provincial government relies heavily on revenues collected by the federal government or on federal or foreign grants. In 2013-14 the own-tax and non-tax revenues[3] of KP were 6.4 percent of the total general revenue receipts.[4]

Table 1: Household Monthly Income by Provinces: 2010-11

	Average Monthly Household Income
Punjab	8541
Sindh	8746
KP	7709
Balochistan	9439
Pakistan	8540

Source: Pakistan Khyber Pakhtunkhwa Public Expenditure Review p. 14 World Bank, 2013.

In the last few years, the KP government has enjoyed arrears from hydel power profits amounting to Rs25 billion per annum, which the federal government was expected to pay up by 2013-14.[5] After KP has received all its arrears, it will find itself short of a very substantial annual flow of funds. The provincial government would, therefore, have to make a major effort to increase its own-source revenues including Agriculture Income Tax (AIT), Urban Immovable Property Tax (UIPT) and Sales Tax on Services.

Expenditure and Revenue Forecast for KP 2015-2020

For financing KP growth 2015 to 2020, it is important to determine the deficits that need to be financed and surpluses that need to be invested. For forecasting, it has been assumed that the public investment will increase as projected in Vision 2025 (Discussion Draft), average GDP growth will be 4.3 percent between 2014-15 and 6.79 percent between 2015-20[6], annual inflation will be 8 percent and the current expenditure will grow at an annual average real rate of 8 percent. The revenue requirement to meet development expenditure and current

[1] This is assuming the provincial GDP was
[2] Expenditure Review, p. 14, The World Bank, Washington, D.C., 2013.
[3] Excluding straight transfers, federal and foreign grants and hydel profits or arrears.
[4] Provinces do not use consistent definition of general revenue receipts; federal/foreign grants have been included to general revenue receipts as done in Punjab.

[5] White Paper 2011-12 (P. 41), Finance Department, Government of Khyber Pakhtunkhwa.
[6] The 4.3 percent is the GDP growth projected by IMF in its press release, 'Statement on Pakistan', on August 18, 2014. The 6.79 percent GDP growth rate during 2015-2020 is projected in the Vision 2025 document (Discussion Draft).

revenue expenditures for 2014 and the forecast period is given in Table 2.

Table 2: Development Expenditure and Current Expenditure (Rs billion)

	2014	2015	2020
Development Expenditure	105	132	285
Current Revenue Expenditure	222	258	541
Revenue Requirement	327	389	826

Source: Budget White Paper, Finance Department, Government of Khyber Pakhtunkhwa 2014-15 and author's calculations.

To determine the revenues of the KP government, it has been assumed that federal tax-to-GDP ratio will increase by 0.7 percent per year from its current level to 12.9 percent till 2019-20 and provincial tax-to-GDP ratio will increase at 0.1 percent per year till 2019-20[7]. It has also been assumed that KP's share in provincial tax revenue in 2013-14 (5.8 percent) will remain unchanged. The revenues of the KP government for 2014 and for the forecast period are given in Table 3.

Table 3: Projected KP Revenues (Rs billion)

	2014	2015	2020
Federal tax transfers	184	223	609
Federal transfers on account of war on terror	22	27	73
KP's own tax receipts	13	16	48
KP's non-tax revenue	8	9	17
Straight transfers	29	29	64
Federal/ Foreign grants	35	28	58
Profit from hydel generation[8]	31	44	15
KP Revenues	322	375	885

Source: Budget White Paper, Finance Department, Government of Khyber Pakhtunkhwa 2014-15 and author's calculations.

From the preceding analysis, it is estimated that KP will have a budget deficit of Rs14 billion in 2015 and a budget surplus of Rs60 billion in 2020.

Expenditure Management[9]

The expenditure management reforms that KP government should consider include:

[7] The assumptions underlying these tax simulations are in line with the federal government's medium term budgetary framework but conservative compared with the recommendation in *Pakistan: Finding the Path to Job-Enhancing Growth*, World Bank Report No. 75521-PK, Washington D.C. 2013.

[8] Includes arrears on hydel profit.

[9] This section draws from "Pakistan Khyber Pakhtunkhwa Public Expenditure Review" by the World Bank.

- Developing a well-designed debt-management strategy
- Improving pension fund management
- Implementing output-based budget allocation for new schemes
- Improving effectiveness of public expenditure by providing a better balance between development and O&M budgets
- Comprehensively tackling the issue of payroll and pension budget
- Revising release procedures to ensure smooth implementation of the budget
- Expanding the current partnership with local stakeholders to monitor progress made on budget output indicators

Potential from Tax Revenue

KP tax revenue amounted to Rs12.6 billion in 2013-14, which was 0.47 percent of provincial GDP (PGDP). In comparison, the provincial tax revenue as a percentage of provincial GDPs in Punjab, Sindh and Balochistan was 0.81 percent, 1.31 percent and 0.16 percent respectively.

The major sources of tax revenue for KP in 2014 were: (1) land revenue (Rs1300 million), (2) GST on services (Rs8000 million), (3) motor and vehicle tax (Rs1075 million), (4) stamp duty (Rs670 million) and (5) electricity duty (Rs507 million).

The KP government has begun to implement sales tax on services at the provincial level but agricultural income tax and UIPT should also be made more buoyant sources of revenue.

1) Agricultural Income Tax (AIT)

Agriculture Income Tax needs to be exploited as a source of revenue. In the financial year 2012-13, the agriculture sector's share in GDP was about 21 percent but the tax revenue generated amounted to less than Rs1 billion. In comparison, direct tax revenue (mostly income tax) generated from the nonagricultural sector of the economy[10] was Rs736 billion. This is due to the constitutional provision that empowers the federal government to tax all sources of income barring agricultural income, which is the preserve of provincial government. Additionally, agricultural income and land tax rates were low to begin with and have not been revised periodically to reflect changes in the nominal income of farmers and landowners.

Potential revenue that can be raised by taxing income from crop farming in KP amounts to Rs2.05 billion in 2013-14[11] (see Table 4).

Table 4: Revenue Estimates from AIT in KP, 2012–14

Category	2011/12	2012/13	2013/14
Owner farmers	1.7	1.1	1.45
Owner-cum-tenants	0.07	0.029	0.043

[10] The nonagricultural sector has a share of about 79 percent of GDP.
[11] Applying the tax rates applicable to similar incomes in other sectors of the economy

Tenants	0.04	0.02	0.032
Land rental	0.2	0.3	0.52
Total	2.06	1.39	2.05

Source: Author's calculations.

The NWFP Land Tax and Agricultural Income Tax (Amendment) Ordinance 2001 allows the taxation of agricultural incomes. Though it allows tax to be collected as a land tax if the tax assessed as AIT is less than the tax calculated as land tax, the tax is collected largely as a land tax. Changing the current form of tax collection from a land tax to an income tax will require building modern income tax machinery. This could take several years.

In the interim, land tax rates could be revised in a way that tax collection from land is comparable with income tax collection in other sectors of the economy. These measures will:

- hold important symbolic value in terms of fairness and equity;
- add another Rs2 billion (in 2014 prices) to provincial government finances[12].

2) Urban Immovable Property Tax (UIPT)

Unlike Punjab and Sindh where UIPT is based on the rental values of properties, property taxation in KP has been area-based since 1997[13]. The total collection of UIPT per property was only Rs230 per annum in 2013-14. Considering the average income per household in KP in 2010-11 was Rs92500, property tax collected per household is low.[14]
Tax collection from Urban Immovable Property Tax (UIPT) in KP in 2013-14 was Rs108 million which amounts to 0.85 percent of provincial tax revenues. In comparison, Punjab's UIPT is 4.7 percent of provincial tax revenue. To reach the level in Punjab, UIPT must increase to over *nine* times the present level of collection in KP.

The recommendations to improve tax collection include[15]:

- Separating valuation from rate setting
- Developing a system of periodic revaluation of properties
- Broad basing the tax system by eliminating tax exemptions, taxing vacant plots and removing tax preference for owner occupiers
- Indexing the tax rate to the rate of inflation
- Upgrading skills and size of the UIPT tax collection and assessment staff

[12] It amounts to about 16 percent of the provincial government's own tax revenue in 2013-14.
[13] Bahl, R., S. Wallace and M. Cyan, Pakistan: Provincial Government Taxation, International Studies Program, Working Paper 08-07, Andrew Young School of Policy Studies, Georgia State University, December 2008.
[14] It is important to note that average tax rate can be very misleading because there are a large number of exemptions for various categories of properties and there is a large variation in property tax rates. Tax rates per property vary from as little as Rs150 for 5 marla property to Rs10600 for properties of above 40 marlas.
[15] Bahl et al (2008). *Ibid.*

- Decentralizing property tax policy and administration to local governments.

3) Sales Tax on Services

Until 2012-13 sales tax on services for KP was collected by the federal government on behalf of the provincial government and consisted of GST on telecom services. The provincial government has established a KP Revenue Authority that has started collecting sales tax on services since June 2013.

In KP, sales tax collection on services was Rs8 billion in 2013-14 out of total tax collection of Rs12.6 billion. As a comparison, Punjab raised Rs52 billion in sales tax on services in 2013-14, which is 47 percent of its tax revenues.

The value added by the service sector in KP is estimated to be Rs1557 billion in 2013-14. If a value added tax (VAT) of 16 percent is applied to all services, the potential tax revenue is Rs249 billion. The current tax collection is targeting only 3.2 percent of the full potential, compared with collection efficiency of 26 percent of sales tax on goods levied at the federal level.

The federal government levies sales tax on goods and the provincial government taxes sales tax on services. Even if both taxes were to be implemented in the VAT mode, there is a high likelihood of tax cascading due to the absence of coordination between FBR and provincial revenue authorities working out a clearinghouse arrangement. This issue needs to be resolved.

Conclusion and Recommendations

The current and development expenditures of the provincial government exceeded its general revenue receipts by Rs5 billion in 2013-14. The KP government needs to:

- Rely on own source revenues by strengthening AIT, Urban immovable property tax and tax on services.
- Make a strong case for the payment of arrears of net hydel profits to KP and for the revision of hydel profit rate.
- Curtail real growth rate of current expenditure
- Focus on good governance to attract businesses, investment, jobs and prosperity to the province. A buoyant economy would help the provincial government realize greater tax and non-tax revenues, which in turn will provide the provincial government the fiscal space to expand the provision of public goods, including education, health and law and order.