5 Fiscal Developments

5.1 Overview

Although fiscal indicators showed some improvement in the second quarter of FY11 with substantial growth in non-tax revenues, the overall fiscal position during H1-FY11 deteriorated. Consequently, the fiscal deficit increased to 2.9 percent of GDP from 2.7 percent in the same period last year (see **Table 5.1).**

Table 5.1: Fiscal Situation - A Snapshot

	FY10		FY11		H1	
	Q1	Q2	Q1	Q2	FY10	FY11
YoY Growth (in percent)						
Total revenue	**11.0**	**7.4**	**-6.3**	**22.1**	**9.0**	**8.8**
Tax revenue	7.9	19.7	6.2	12.2	14.0	9.5
Nontax revenue	18.8	-17.6	-35.5	51.5	-2.2	6.9
Total expenditure	**24.5**	**18.0**	**3.9**	**21.4**	**21.1**	**12.7**
Current	14.2	16.1	8.8	22.8	15.2	15.9
Development and net lending	100.8	64.5	-45.8	17.3	80.3	-13.2
as percent of GDP						
Fiscal balance	-1.5	-1.2	-1.6	-1.3	-2.7	-2.9
Revenue balance	-0.6	-0.4	-1.0	-0.4	-1.0	-1.4
Primary balance	-0.6	-0.1	-0.7	-0.3	-0.7	-1.0

Persistent growth in expenditures driven primarily by flood relief activities and failure to implement tax reforms, have rendered the fiscal imbalance unsustainable. As such, achieving the deficit target of 4.7 percent set for FY11 seems highly unlikely in the absence of a clear strategy to increase the tax base by bringing untaxed sectors into the tax net; there is also a need to rationalize electricity tariffs and subsidies on POL product.

Financing the deficit has become all the more challenging in the absence of external financing due to non-observance of IMF conditions on fiscal consolidation. The government, as a result has resorted to heavy borrowing from the banking system, which in turn has not only exerted pressure on short-term interest rates, but also has adverse implications for inflationary expectations, private sector credit and overall macroeconomic stability.

The only way out for the government is to show political will to prioritize its expenditure heads and implement tax reforms aimed at removing tax exemptions e.g., taxing agriculture and services. Even if this does not deliver immediate tax revenues, it would close the door for tax avoidance.

5.2 Expenditures

As noted in SBP's first Quarterly Report for FY11, the restraint in spending exercised during this period was unsustainable. There were risks that spending limits at the federal and provincial level would be breached; this materialized in Q2-FY11 (see **Figure 5.1**). The ratio of total expenditures to GDP rose to 8.6 percent in H1-FY11, which was relatively lower than the level observed in the same period last year (see **Table 5.2**).

Figure 5.1: A Breakup of Fiscal Performance (YoY Growth-FY11)

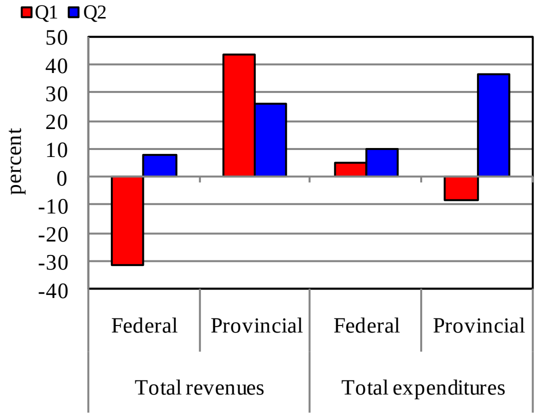

Table 5.2: Assessment of Expenditures

YoY growth

	FY11		H1		H1-FY11	Percent of GDP	
	Q1	**Q2**	**FY10**	**FY11**	**YoY Growth**	**FY10**	**FY11**
Total Expenditures	**676.3**	**803.7**	**1313.2**	**1480.0**	**12.7**	**9.0**	**8.6**
Current Expenditures	**566.7**	**660.0**	**1058.6**	**1226.8**	**15.9**	**7.2**	**7.1**
of which							
Interest payments	161.6	148.8	294.2	310.4	5.5	2.0	1.8
Domestic	146.6	129.8	262.0	276.4	5.5	1.8	1.6
Foreign	14.9	19.0	32.2	33.9	5.4	0.2	0.2
Grants to others	39.1	59.4	133.7	98.5	-26.3	0.9	0.6
Defense	93.1	121.8	166.0	215.0	29.5	1.1	1.3
Running of federal government*	39.2	57.1	78.1	96.4	23.4	0.5	0.6
Provincial	147.7	203.2	284.8	350.8	23.2	1.9	2.0
Development and net lending	**62.8**	**145.1**	**239.4**	**207.8**	**-13.2**	**1.6**	**1.2**
Development	**59.4**	**85.1**	**224.7**	**144.5**	**-35.7**	**1.5**	**0.8**
PSDP	43.1	81.7	175.6	124.9	-28.9	1.2	0.7
Other development expenditure	16.3	3.3	49.1	19.6	-60.1	0.3	0.1
Net lending	**3.4**	**60.0**	**14.7**	**63.4**	**330.1**	**0.1**	**0.4**
Un identified expenditure	**46.8**	**45.4**	**15.1**	**45.4**	**200.2**	**0.1**	**0.3**

*The running of the federal government expenditure is adjusted for federal government expenditure on flood rehabilitation efforts.

At the federal level, about 69.5 percent of the increase in spending was driven by *defense*, *running of the government* and *net lending activities*. [1] Expenses under the *running of the government* head increased 23.4 percent YoY, mainly reflecting the impact of higher salaries and allowances for federal government employees in the FY11 budget. [2] Additionally, flood relief measures claimed an unbudgeted 2.7 percent of consolidated public expenditures during H1-FY11.[3]

At the provincial level, both current and development spending recorded a hefty increase in Q2-FY11 which largely offset transfer of resources to provinces under the 7th NFC award.[4] Due to a sharp rise in expenditures, the consolidated fiscal surplus of provinces dropped from 0.5 percent in Q1-FY11 to 0.1 percent of GDP during Q2-FY11. As the government moves forward with its agenda to transfer key ministries to provinces under the 18th Amendment, the fiscal balance could deteriorate further in the absence of strict discipline on spending.[5]

Development spending has remained conspicuously low in H1-FY11. Although some improvement was visible on a quarterly basis in Q2-FY11, the overall level of spending was 18.3 percent lower than average PSDP spending recorded during July-December in the years FY06-10. In nominal terms this implies that real spending is sharply down. Distressingly, spending for PSDP as percent of GDP is at the same level as expenditure on war on terror, and provision of loans and subsidies to the power sector during H1-FY11.

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[1] Net lending was primarily to power sector: the disbursement of subsidies and loans to this sector alone contributed 7.9 percent to total expenditures during H1-FY11. Due to closure of canals, demand for thermal power generation was higher in Q2-FY11, leading to an abnormal increase in inter-disco tariff differentials and receivables for WAPDA & PEPCO.

[2] Government announced a 50 percent and 15 percent increase in the salaries and pensions of federal government employees respectively in the federal budget for 2011.

[3] Reportedly under the *watan card* scheme government has disbursed Rs. 31 billion in H1-FY11, whereas the provision of funds for Rabi crop for the flood relief measures stood at Rs 8 billion in this period.

[4] Up to 57.5 percent of the divisible pool of resources will be transferred to provinces. Multiple criteria will be adopted for the distribution of resources. Concerns over payment of net hydel profit to KP and Punjab, distribution of gas development surcharge and imposition of GST on services were also resolved.

[5] Already during Q2-FY11 five ministries namely Zakat and Usher, Population Welfare, Youth Affairs, Local Government and Rural Development and Special Initiatives were devolved to provinces.

5.3 Revenues

Total revenues increased by 8.8 percent YoY to Rs. 989.6 billion during H1-FY11 (see **Table 5.3**). Majority of this increase was attributable to: (1) advance income tax payments under the head of *direct taxes*; and, (2) growth in taxes on *goods and services* and *international trade* due to the increase in Rupee imports.

Table 5.3: Composition of Tax and Non-Tax Revenues (Jul-Dec)

billion rupees

	Collection		Absolute Growth				
	FY10	**FY11**	**FY07**	**FY08**	**FY09**	**FY10**	**FY11**
Tax revenue	**659.2**	**721.6**	**98.3**	**6.6**	**148.8**	**52.4**	**62.4**
Direct taxes	211.4	239.1	72.4	-12.2	46.4	0.6	27.7
Taxes on property	2.8	3.8	-1.5	0.3	0.5	0.3	1.0
Taxes on goods and services	301.2	339.7	19.7	29.2	65.4	28.6	38.5
Taxes on international trade	71.2	80.6	-0.8	0.9	11.9	-2.2	9.3
Petroleum levy	51.9	35.4	8.1	-10.7	21.5	23.0	-16.4
Other taxes	20.7	23.0	0.5	-0.8	3.0	2.0	2.3
Non-tax revenue	**250.7**	**268.0**	**18.6**	**4.2**	**60.1**	**23.1**	**17.3**
Profit of PTA/PO	0.0	0.0	-10.4	0.0	0.0	0.0	0.0
Interest (PSE and others)	4.6	5.0	-3.4	10.6	-11.2	1.0	0.4
Dividends	26.5	17.5	6.5	-1.4	2.0	-7.8	-9.1
SBP profits	135.0	80.0	35.3	8.1	24.6	63.1	-55.0
Defense	3.2	66.9	-19.3	-24.9	27.9	-27.0	63.7
Development surcharges on gas	10.0	17.4	6.5	-3.7	-3.6	1.5	7.3
Discount retained on crude oil	2.5	10.5	0.0	0.0	6.0	-3.5	8.0
Royalties on oil/gas	22.6	26.6	3.9	7.4	4.3	-3.2	3.9
Others	46.1	44.1	-0.4	8.3	10.0	-1.0	-2.0
Total revenue	**909.9**	**989.6**	**116.9**	**10.8**	**208.9**	**75.5**	**79.7**

Source: Ministry of Finance

However, revenues from the *petroleum development levy*[6] declined YoY as prices of POL products have been higher on average in H1-FY11 resulting in weaker sales of High-Speed Diesel (HSD) and Kerosene.

Growth in non-tax revenues dampened somewhat, largely due to a decline in transfer of SBP profits. Receipts under the head of *dividends* showed a decline for

[6] Per liter petroleum levy was fixed at Rs. 10 for Motor gasoline, Rs. 14 for HOBC, Rs.6 for Kerosene and Rs. 3 for Light Diesel Oil. Since December 2011, these amounts have been adjusted downwards to manage ex-depot sales price for end-consumers in the wake of rising crude oil prices.

the second consecutive year, due to lower earnings of public sector institutions and delay in dividend income receipts from these institutions. Receipts under the head of *defense*, however, increased appreciably in H1-FY11compared to the same period in the last five year as US$ 743 million were received on account of logistics support.

FBR Tax Collections

Within overall revenues, FBR tax collections registered a growth of 13.7 percent YoY during H1-FY11, as compared to 5.1 percent in the corresponding period of the previous year (see **Table 5.4**). Although this increase appears to be significant, FBR will have to collect Rs. 942.7 billion in H2-FY11 to meet its end-year target. This amounts to a growth of 26.3 percent over collections in H2-FY10. Although tax collection tends to improve significantly during the second half of a fiscal year, this target may be difficult to achieve.

Table 5.4: FBR Tax Collection (net) (Jul-Dec)
billion rupees; growth in percent

	Net collection		Growth		Average growth of the last		% of annual target	
	FY10	**FY11**	**FY10**	**FY11**	**5 years**	**10 years**	**FY10**	**FY11**
Direct taxes	211.4	240.9	0.5	13.9	21.9	14.0	37.4	36.7
Indirect taxes	370.8	420.8	7.9	13.5	15.0	11.7	49.4	56.0
Sales tax	242.9	282.6	11.8	16.4	17.3	15.0	48.6	44.6
FED	56.7	58.1	5.8	2.6	19.2	7.1	37.1	41.2
Customs	71.2	80.0	-2.1	12.3	6.8	7.7	43.9	46.2
Total collection	**582.2**	**661.7**	**5.1**	**13.7**	**17.3**	**12.4**	**42.2**	**41.2**

Source: Federal Board of Revenue

Although increase in tax collection is a welcome development, heavy reliance on imports to generate tax revenues is not encouraging, as this is a captive payer.

Some of the key developments related to FBR taxes in H1-FY11 are: (1) income tax collection was higher since advance voluntary payments increased substantially (up Rs 20.1 billion), reflecting rising corporate sector profitability; (2) collection of income taxes on demand declined, suggesting that FBR was unable to effectively utilize its new audit system; (3) growth in withholding tax collection decreased marginally; and (4) revenues from customs duty increased by 12.3 percent YoY, mainly due to imports of vehicles and edible oil.

5.4 Domestic Budgetary Financing

The government relied heavily on domestic resources to finance the fiscal deficit during H1-FY11 (see **Table 5.5**), whereas net inflows from external sources merely amounted to Rs. 47 billion during H1-FY11, compared to Rs. 110.3 in H1-FY10.

Table 5.5: Deficit Financing

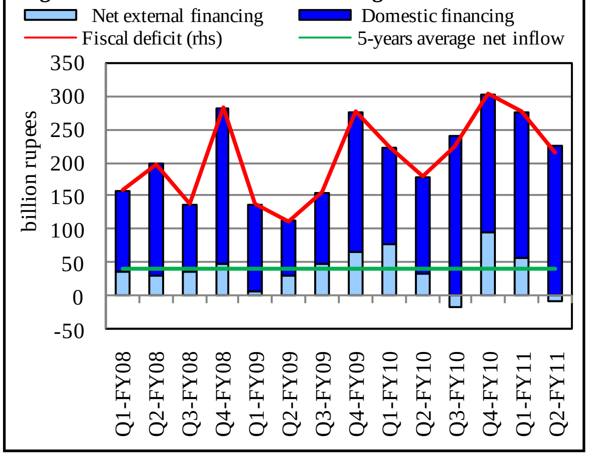
billion rupees, percent

	FY11		H1		Percent share	
	Q1	**Q2**	**FY10**	**FY11**	**FY10**	**FY11**
Total financing of budget	**276.2**	**214.2**	**403.3**	**490.4**	**100.0**	**100.0**
External resources (net)	**56.9**	**-9.9**	**110.3**	**47.0**	**27.3**	**9.6**
Internal resources (net)	**219.3**	**224.1**	**293.0**	**443.4**	**72.7**	**90.4**
Banking system	**121.0**	**165.1**	**107.2**	**286.0**	**26.6**	**58.3**
SBP	118.3	-38.3	-63.9	80.1	-15.8	16.3
Scheduled banks	2.6	203.3	171.0	205.9	42.4	42.0
Non-bank	**98.4**	**59.0**	**185.8**	**157.4**	**46.1**	**32.1**
NSS	33.8	31.7	98.0	65.5	24.3	13.4
Others*	64.6	27.3	87.8	91.9	21.8	18.7

*Others include non-bank borrowing through MTBs, PIBs, Prize bonds, etc.

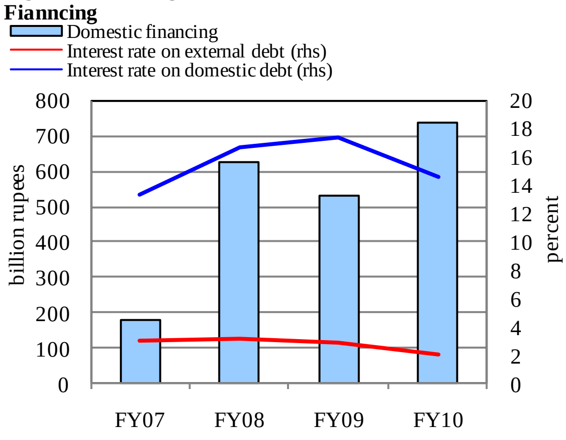
A historical analysis of the budget financing mix reveals that inflow of external financing witnessed till Q1-FY11 was closer to the historical average of the last five years (see **Figure 5.2**). However, by Q2-FY11, key structural reforms agreed with the IMF had not been implemented, as a result of which the sixth tranche under the IMF SBA was delayed. Although the tranche did not include funds for budgetary support, the delay raised concerns amongst other multilateral institutions, making it difficult for the government to borrow externally in Q2-FY11. As a result, the government had to rely on domestic sources for finance.

Figure 5.2: Fiscal Deficit and Financing Mix



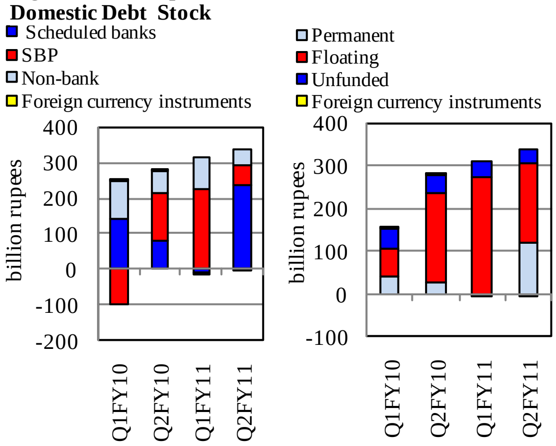
However, not all the domestic sources of finance could be availed by the government as the government committed to avoid deficit monetization in Q2-FY11, and non-bank borrowing through NSS instruments also declined in response to rising market interest rates. Non-bank investors showed greater interest in *other* securities, particularly *Ijara sukuk* issued in Q2-FY11, primarily to meet portfolio diversification requirements. This took some pressure off scheduled banks to finance the deficit in Q2-FY11

Figure 5.3: Average Interest Rates on Debt and Domestic Fianncing



Nevertheless, the government had to rely on borrowing from scheduled banks. Government borrowing exceeded MTB auction targets in Q2-FY11 and banks successfully increased bid-rates further in all tenors.[7] The decision to finance the deficit from domestic sources, however, comes at the cost in terms of debt servicing burden; even after accounting for rupee depreciation, the wide differential between interest rates on domestic and external debt makes it cheaper to borrow externally (see **Figure 5.3**).

Figure 5.4: Composition of Net Flows in Government Domestic Debt Stock

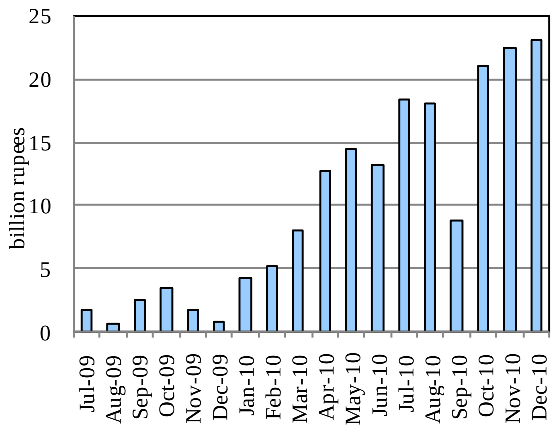


[7] The average bid rates for 3-Month, 6-Month and 12-Month bills recorded 4.6, 5.5 and 6.4 percent increase in Q2-FY11 over Q1-FY11.

5.5 Government Domestic Debt

As a result of government borrowing in H1-FY11, total domestic debt & liabilities increased by 1.3 percentage points to 35.4 percent of GDP in December 2011.[8] Trends show an increasing reliance on short-term floating debt, particularly from the banking sector, which is characteristic of underdeveloped debt markets (see **Figure 5.4**). In response, SBP introduced some important initiatives in H1-FY11 to facilitate non-bank investment in government floating & permanent debt securities through non-competitive bids.[9] The volume raised through non-competitive bids in MTB auctions has recorded a consistent increase from July 2009 when SBP allowed non-competitive bids in MTBs (see **Figure 5.5**).

Figure 5.5: Non-Competitive Bids in MTB Auctions



Some of the key highlights in H1-FY11 are as follows:

Floating debt (T-bills)

- Around 72 percent of the total increase in government debt stock was contributed by floating debt instruments during H1-FY11.
- In overall terms, 3-Month T-bills captured 62.9 percent in the total amount raised in MTB auctions during H1-FY11 – a higher share of shorter tenor securities implies continued upward pressure on debt servicing costs in the near term, which will affect current expenditures and the fiscal deficit.

[8] This increase is primarily attributable to domestic government borrowing, since PSE debt and liabilities decreased during H1-FY11.

[9] The specific measures were: (a) Introduction of electronic bond trading platform from January 2010 to improve pricing mechanism in the secondary market; and, (b) to diversify the debt market, SBP also allowed participation of individuals and small institutional investors in both MTBs and PIB auction by non-competitive bids through its circulars FSCD Circular No.07 &18, dated June 06, 2009 and December 04, 2010.

Permanent debt (PIBs)

- In overall terms, the stock of permanent debt recorded a 14.5 percent increase by end-December 2010 over the end-June 2010 stock.
- A new three-year issue of *Ijara sukuk* bond was launched in November 2010, after a gap of thirteen months. During Q2-FY11 a sum of Rs. 89 billion was raised through this issue.
- Net inflows via PIBs also increased by Rs. 16.8 billion during H1-FY11.

Unfunded debt

- Stock of unfunded debt showed a weak 4.7 percent growth in H1-FY11 over June FY10.
- Rates of return on NSS instruments were revised upwards in October 2010 and January 2011 in response to an increase in the benchmark discount rate. Consequently, some improvement in gross inflows was visible in Q2-FY11, but the delayed discount may be responsible for the anemic growth**.**
- However, with the exception of SSCs and BSCs, both the net and gross inflows to almost all unfunded instruments recorded YoY declines in H1-FY11. Participation by institutional investors, in particular, has been affected due to rising interest rates, undermining incentives to lock funds in long term maturity instruments.

Interest payments on government domestic debt

- Interest payments on government domestic debt recorded 7.2 percent YoY growth during H1-FY11, as compared to the 6.7 percent YoY growth registered during the same period last year.
- Although YoY increase in interest payments did not change substantially in H1-FY11, their composition has undergone a significant shift towards T-bills recently from NSS.