5 Fiscal Developments

5.1 Overview

The overall fiscal position continued to be under stress during the first three quarters of FY11. The consolidated deficit during Jul-Mar 2011 reached 4.5 percent of GDP, slightly higher than the 4.3 percent for the same period last year. Given that the budgetary gap usually peaks in the last quarter, meeting the revised annual target of 5.5 percent of GDP will be challenging.[1]

Table 5.1: Key Fiscal Aggregates (Rs in billion) and Performance Indicators (percent)

	Jul-Mar		YoY Growth	
	FY10	FY11	Q3FY11	3-year average
Revenue	**1,401.8**	**1,495.3**	**6.7**	**17.1**
Tax	1,014.6	1,117.6	10.1	18.3
Non-tax	387.2	377.7	-2.5	15.9
Expenditure	**2027.8**	**2278.5**	**12.4**	**22.0**
Current	1,659.9	1,909.8	15.1	20.6
Development	364.0	352.7	-3.1	16.9
Budget deficit	**626.0**	**783.3**	**25.1**	**43.3**
Financing				
External	92.6	83.1	-10.3	0.3
Domestic				
Non-bank	322.5	383.8	19.0	5.7
Banks	210.8	316.4	50.1	-12.6
As % of GDP				
Budget deficit	4.3	4.5		
Revenue deficit	1.8	2.4		
Primary deficit	1.0	1.6		

On a positive note, the government has managed to control its spending. Expenditures grew by 12.4 percent in Jul-Mar 2011, considerably lower than the average growth of over 20 percent of the past three years (see **Table 5.1**). More importantly, growth in non-interest, non-defence spending remained at 12 percent compared to the average growth of 25 percent, despite unexpected outlays – both by the Federal and provincial governments – on flood related activities. However, as in past years, the brunt of this curtailment in spending was borne by development expenditure, which will hurt the long-run growth potential of the economy.

Despite this restraint, the budget deficit could not be contained due to weak revenue collection and outlays on subsidies to the power sector. Total revenues showed a growth of just 6.7 percent during Jul-Mar 2011 which was considerably

[1] Overall fiscal deficit target announced in the federal budget was 4 percent of GDP. However, this number rose to 5.3 percent of GDP as per announced consolidated Federal and provincial budgets. In March 2011, government projected the fiscal deficit for FY11 at 5.5 percent of GDP.

lower than the nominal GDP growth of 21.8 percent. As a result, the *revenue deficit* rose sharply, i.e., revenues are not enough to finance even current expenditures. In other words, the government is shifting the burden of current expenditure to future generations. It may be noted that the Fiscal Responsibility and the Debt Limitation Act of 2005 required the government to reduce revenue deficit to zero in FY08. This is being breached since then.

Furthermore, the financing of the budget gap has also become complicated with waning external resources. The government only received Rs 83.1 billion during the first nine months of FY11, which represents less than half of the full year target of Rs 185.8 billion. Hence, domestic bank and non-bank sectors largely financed the budget deficit. So far, the weak demand for private sector credit and the rupee liquidity stemming from a buildup in FX reserves, helped reduce the pressure on interest rates, while banks financed the government.

As an upside, the government was able to contain its borrowing from SBP. However, one major departure occurred in April 2011, when the government paid-off quasi-fiscal expenses in the energy sector (i.e., circular debt) by increasing its borrowing from the central bank. This one-off adjustment of Rs 120 billion – a carryover of the deficit from previous years – will add approximately 0.6 percent of GDP over the target deficit.

While the government has initiated steps to resolve the long-standing issue of circular debt in the energy sector, other key structural reforms that are critical for fiscal consolidation (e.g. expanding the base of GST through the withdrawal of exemptions, tax on agri-income, and restructuring and privatization of PSEs) are pending and await multi-partisan consensus. Unless significant steps are taken to address these structural issues, containing the fiscal deficit below 4.5 percent in FY12 will be difficult.

5.2 Expenditures

As mentioned earlier, the government was able to contain overall expenditures during Jul-Mar 2011. While this is indeed a positive development, there are some disconcerting observations:

1. Though the government has pledged to reduce power sector subsidies, subsidies reached Rs 136.5 billion as of March 2011, against a full year target of Rs 126.7 billion.[2]

2. Development spending of Rs 353 billion during the first nine months of FY11 was not only below target, but also less than the expenditure during the corresponding period of last year (see **Table 5.2**). It may be noted that the original budget for development was Rs 740.1 billion. However, when the floods hit in August 2010, the government decided to re-allocate development funds to disaster management and rehabilitation activities. Although this strategy helped the government cope with the unexpected shock, it has adverse implications for investment in productive capacity of the country.[3]

Table 5.2: Break-up of Expenditure
billion Rupees

	Jul-Mar		%
	FY10	**FY11**	**Growth**
Total expenditure	**2,023.9**	**2,262.6**	**11.8**
Current expenditure	**1,659.9**	**1,909.8**	**15.1**
Federal	1,222.6	1,345.7	10.1
Interest payments	473.5	507.4	7.2
Defense	269.8	335.1	24.2
Public orders and safety	32.1	43.3	35.0
Economic affairs	43.2	63.7	47.6
Health and education	25.6	34.1	33.2
Social protection	3.9	19.0	388.9
Provincial	437.3	564.1	29.0
Development expenditure & net lending	**364.0**	**352.7**	**-3.1**
PSDP	286.5	246.5	-13.9
Federal	169.3	130.4	-23.0
Provincial	117.2	116.1	-0.9
Other than PSDP	61.0	35.7	-41.5
Net lending	16.5	70.5	
As % of GDP			
Total expenditure	13.8	13.1	
Current	11.3	11.0	
Development	2.5	2.0	

3. Loss-making public sector enterprises continue to be a significant drag on fiscal resources. For example, the poor financial health of Pakistan Railways resulted in injection of Rs 25.1 billion during Jul-Mar 2011 which is higher than the budget allocation of Rs 21.9 billion for the entire

[2] It may be noted that the government has recently decided to divert gas supplies from the power sector to fertilizer producers. The expected increase in domestic urea production would reduce government expenses on imports and potential subsidy on imported fertilizer.
[3] While the share of development expenditure in total expenditure declined from a 5-year average of 25 percent to 12 percent in FY11, it is not surprising to note that investment to GDP ratio also declined from over 20 percent to 12 percent during the same period.

year.[4] Likewise, the government is paying a mark-up on commercial loans acquired by Pakistan Steel Mills and PIA.[5] In overall terms, provision of grants to Pakistan Railways and mark-up to PIA and Pakistan Steel Mills, constitutes 1.6 percent of current expenditure (or 0.2 percent of GDP) during Jul-Mar 2011. It is therefore critical to push the re-structuring of these PSEs to stop hemorrhage.

One key development is the transfer of resources from the Federal Government to provinces following the NFC award. This shift is clearly reflected in the rising share of provinces in total expenditure from 28 percent in Q3-FY10 to 32 percent in Q3-FY11.

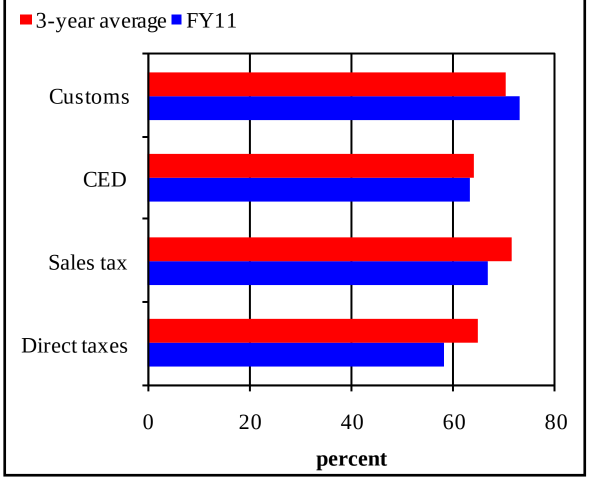
Table 5.3: FBR Tax Collection (Jul-Mar)
billion Rupees

	FY10	FY11	FY11 (year target)	% Growth	% of target
Direct taxes	342.3	381.6	626.9	11.5	60.9
Indirect taxes	567.3	638.5	960.8	12.6	66.5
Sales tax	371.2	422.7	654.6	13.9	64.6
FED	84.4	89.1	132.9	5.6	67.0
Customs	111.7	126.8	173.3	13.5	73.2
Total collection	**909.6**	**1,020.1**	**1,588**	**12.2**	**64.3**

5.3 Revenues[6]

Revenue collection remained weak throughout most of the year, and FBR was only able to collect Rs 1,020 billion during Jul-Mar 2011, which represent 64 percent of the annual tax collection target (see **Table 5.3**).[7]

Figure 5.1: FBR Target Achievement upto March



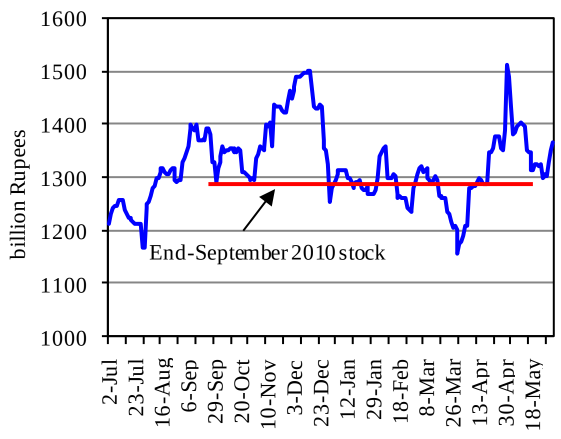
More importantly, tax collection did not show any growth in real terms, as it remained lower than the current inflation of 14 percent. Furthermore, the sectors experiencing growth still remain outside the tax net or are lightly taxed (e.g. agriculture and services).

[4] In addition to this grant, the government has provided Rs 2.3 billion to railways as PSDP funding during this period.
[5] This amount is afterwards treated as government equity in these entities.
[6] FBR collects about 90 percent of total taxes (federal plus provincial).
[7] FBR collection during Jul-Mar has averaged 68 percent during the last three years.

The underperformance is more evident for direct tax collection. During Jul-Mar 2011, FBR was able to collect only 58 percent of the annual target set for direct taxes. This is very low compared to the past average of 65 percent target achievement in nine months (see **Figure 5.1**). Frequent postponement of deadlines for income tax returns, poor tracking of withholding taxes[8] and institutional inefficiencies in raising 'collection-on-demand' through audits and inspections are key factors underlying the shortfall in direct taxes.[9]

In the prevailing scenario, even achieving the revised target of Rs 1,588 billion will be challenging. Specifically, this would require FBR to collect Rs 189 billion per month during the last quarter; in April 2011, FBR was able to collect only Rs 127 billion.

Figure 5.2: GoP Borrowing from SBP (Daily stock)



The revenue shortfall is not peculiar to the current year; for the last several years growth in tax has lagged nominal GDP growth. As a result, the tax/GDP ratio has fallen to below 10 percent, which is considerably lower than the average tax/GDP ratio in comparable countries like India, Indonesia, and Sri Lanka.[10]

5.4 Budgetary Financing

Since external financing remained below expectations, the burden of financing the budget deficit fell on domestic sources (bank and non-bank). Specifically, the government borrowed Rs 700 billion from domestic sources during Jul-Mar 2011 – showing a growth of 31.3 percent over Rs 533.3 billion during the same period last year. Total domestic financing of the deficit during the three quarters, is 4 percent of GDP.

[8] According to a performance audit report by Auditor General of Pakistan, a number of public listed companies, banks and national saving centers do not deposit the full amount of tax withheld on profits and dividends to government accounts.

[9] Tax collection-on-demand was only Rs 34.3 billion in Jul-Mar FY11 compared with Rs 60.1 billion in the same period last year.

[10] IMF Policy Paper on "Revenue Mobilization in Developing Countries", March 8, 2011.

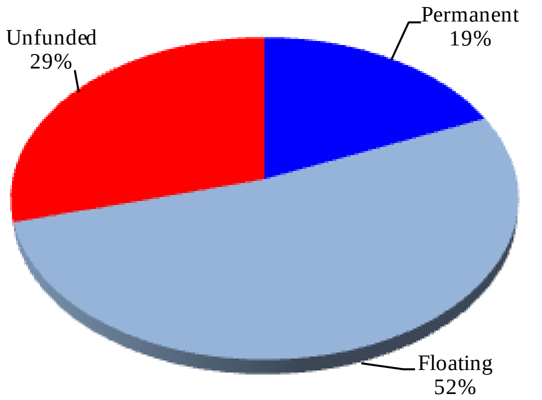
Such a large volume of domestic financing has obvious implications for availability of financing private investment through its crowding out.[11]

On a positive note, the government was able to broadly contain its borrowings from SBP within end-September 2010 level (see **Figure 5.2**).

5.5 Domestic Debt

The impact of a widening fiscal deficit and the government's heavy reliance on domestic sources for its financing, is clearly visible in terms of the sharp increase in domestic debt. Outstanding domestic debt reached Rs 5,463 billion (30.2 percent of estimated GDP for FY11) by end-Mar 2011, which is Rs 809 billion higher than at the end of FY10.[12] Back-of-the-envelope calculations indicate a monthly rise of Rs 90 billion in domestic debt in the first three quarters of the year. This growing stock is fueling concerns about government debt management and macroeconomic stability. Some of the key issues related to domestic debt management are summarized in the following discussion.

Figure 5.3: Composition of Domestic Debt



Rollover Risk:[13]

An analysis of the composition of domestic debt reveals that the share of debt maturing within a year (known as floating debt) in total outstanding domestic debt reached 52.2 percent by end-Mar 2011 (see **Figure 5.3**). This implies that the government must rollover the entire floating debt stock of Rs 2,854 billion at least once a year. A surge in credit demand from other sectors of the economy, or reduction in liquidity in the banking system can play a role in intensifying the rollover risk.

[11] It may be noted that subdued credit demand from the private sector and sufficient rupee liquidity stemming from a build-up in reserves allowed government to easily meet even large financing needs.
[12] Numbers do not include provincial governments' borrowings from banks for commodity operations. Commodity operations of the government are discussed in "Money and Credit".
[13] Countries face rollover risk when their debt is about to mature and needs to be converted into a new debt, but liquidity shortage makes this rollover very costly.

***Interest Rate Risk*[14]:**

In addition to rollover risk, the government is also exposed to significant interest rate risk. Specifically, the entire stock of floating debt will be re-priced at least once a year. Hypothetically, a 100 bps increase in the average interest rate on T-bills will push up interest payments by Rs 28.5 billion. Although it can be argued that interest earned on T-bill holdings of SBP is transferred back to the government as 'profits' of the SBP, one should not overlook the domestic debt held by commercial banks.

Maturity Profile of Unfunded Debt

While the government is increasing its exposure to short term debt, it continues to borrow through the National Savings Scheme (categorized as unfunded debt), which had risen to Rs 1.6 trillion by end-Mar 2011 (see **Table 5.4**). Unfunded debt witnessed a net inflow of Rs 142 billion during Jul-Mar 2011. It is important to note that unfunded debt is difficult to manage; early encashment of unfunded debt instruments allows investors to re-price their investments at any point in time. This not only complicates debt management for the government, but also creates unnecessary volatility in the money market.

Table 5.4: Government Domestic Debt
billion Rupees

	June 2010	March 2011	Change
Permanent debt	794.3	1,007.6	213.3
Floating debt	2,399.1	2,853.9	454.8
Unfunded debt	1,457.5	1,599.5	142.0
Foreign currency instruments	3.1	1.5	-1.6
Total	**4,654.0**	**5,462.6**	**808.6**

[14] A risk attached to movement in interest rate, i.e. changes in interest rates affect the debt servicing of the country.

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