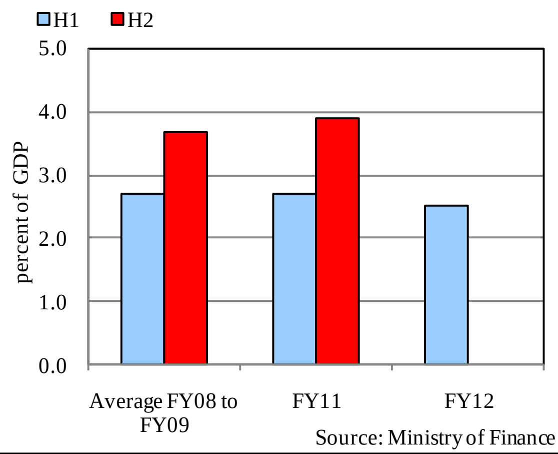
4 Fiscal Policy and Public Debt

4.1 Fiscal Policy

Although some degree of fiscal restraint was observed in the first half of the current fiscal year with a budget deficit of 2.5 percent of GDP – lower than that in H1-FY11, tougher fiscal discipline will still be needed in the second half to achieve the full year target.

Figure 4.1: Half Yearly Fiscal Deficit



Source: Ministry of Finance

The target for FY12 budget deficit has been revised upward to 4.7 percent; however, it will be challenging to achieve because:

(a) An analysis of the trend in the deficit within a year shows that it is relatively higher in the second half of the year than the first (**Figure 4.1**); and

(b) During the last two years the government managed expenditure growth through cuts in PSDP. Since containing development expenditure for a longer period hurts long-term economic growth, the government may not choose to exercise this option for the ongoing year. In fact, on the back of robust inflows for project-based external loans, the government has indicated that it may spend more than the budgeted PSDP amount to compensate for the loss in economic growth during the last two years.

Moreover, the government had to takeover PSEs' debt of Rs 391.0 billion in November, 2011. Although this amount will not appear in current year's budget, it has adverse implications for long-run fiscal sustainability.[1]

[1] During FY11, the fiscal deficit rose to 6.6 percent against the budget target of 4.0 percent. This was due to higher than budgeted subsidies including arrears of electricity subsidies on expenditure side, and less than target FBR revenue and lower inflows into Coalition Support Fund on the reveue side.

Table 4.1: Summary of Public Finance
billion Rupees

		H1		
	BE FY12	**FY11**	**FY12**	**Growth (%)**
Total revenue	**2,870.5**	**989.6**	**1135.3**	**14.7**
Tax revenue	2,151.2	721.6	904.6	25.4
Non tax receipts	719.3	268.0	230.6	-14.0
o/w SBP profit	200.0	80.0	104.0	30.0
Defense	118.7	66.9	4.6	-93.1
Total expenditure	**3,721.2**	**1,480.0**	**1,667.8**	**12.7**
Current	2,976.3	1,226.8	1,399.2	14.1
Dev and net lending	744.9	207.8	231.0	11.1
Unidentified		45.4	37.6	-17.1
Overall deficit	**850.6**	**490.4**	**532.5**	**8.6**
Financing through				
External resources	134.5	47.0	34.0	-27.7
Internal resources	716.1	443.4	498.5	12.4
Banking system	303.5	286.0	302.0	5.6
Non-bank	412.6	157.4	196.5	24.8
As % of GDP				
Overall fiscal deficit	4.0	2.7	2.5	
Revenue deficit		1.3	1.3	
Primary deficit		1.1	1.9	

On the revenue side, FBR collected Rs 840.7 billion during H1-FY12 showing a healthy growth of 27.1 percent over the same period last year. While it indicates increased tax efforts by the FBR when compared with its earlier performance, the amount still falls short of the seasonal projections for H1-FY12 by Rs 40.0 billion.

Within non-tax revenues, uncertainty still prevails over Coalition Support Fund CSF proceeds. On the positive side, SBP profit, which was expected to decline due to the reduction in policy rate, is likely to reach the budget target of Rs 200 billion owing to the exchange rate depreciation and increased borrowing requirements of the government from SBP.

Although 12.7 percent growth in total expenditure during H1-FY12 was the same as in the previous year, a more than 50 percent increase in the development expenditure is indeed encouraging as the country needs investment to stimulate and support economic growth.
In fact, the government increased its reliance on borrowing from the central bank during Q2-FY12, on account of liquidity shortages in the market, which impeded

commercial banks' ability to invest in government paper. During the second quarter of the fiscal year, the government borrowed Rs 227.9 billion from SBP while retiring Rs 45.0 billion to the commercial banks in the same period. This is exactly opposite of what occurred in the first quarter when there was a net retirement of Rs 103.5 billion to SBP while borrowing from commercial banks was recorded at Rs 223.0 billion.

Furthermore, although the government envisaged a net amount of Rs 134.5 billion in terms of net external borrowing during FY12, it has received only Rs 34.0 billion so far. The dearth of external financing is likely to further aggravate the burden of borrowing on domestic sources.

Stepping back, the ability of the provinces to show surpluses as envisaged in the budget, seems unlikely. In view of these pitfalls, even the revised budget deficit target is likely to be missed. This will be the fourth consecutive year of high budget deficit, which has adverse implications for growth and macroeconomic stability. In our reports, we have emphasized the importance of fiscal consolidation which requires an effective tax system and restraining unproductive expenses, particularly those related to PSEs and subsidies.

FBR taxes

Comparing FBR's performance with last year, collection during the first half of FY12 is encouraging. The 27.1 percent YoY growth in the total collection was mainly supported by direct taxes and the import component of sales tax.

The rise in direct taxes came mainly from its *collection on demand* component. The improved collection under this head suggests that FBR has accelerated its efforts in terms of audit and assessment of the tax returns filed. However, a sustainable increase in collection from direct taxes requires widening the tax base and FBR needs to increase efforts in this direction.

Sales tax collection was helped by a robust growth in the import component owing to an increase in the rupee value of imports. Also, the withdrawal of a number of sales tax exemptions and limiting the applications of zero-rating regime to a few sectors helped sales tax collection.[2]

[2] Sales tax exemptions were withdrawn on a number of items including, fertilizers, CNG kits and cylinders, machinery and equipments, canola seed and some organic chemicals. Regarding the main items to which zero rating no longer apply includes poultry products, some vehicles and bicycles.

However, the withdrawal of special excise duty and reducing the overall scope of the federal excise duty (introduced as relief measures in the FY12 budget)

Table 4.2: FBR Tax Collection During Jul-Dec

billion Rupees

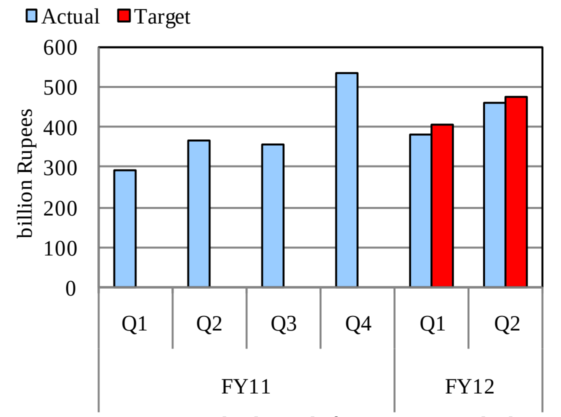
	Net Collection		Growth		% of Annual Target	
	FY11	FY12	FY11	FY12	FY11R	FY12
Direct taxes	240.9	312.6	13.9	29.8	38.4	42.0
Indirect taxes	420.8	528.2	13.5	25.5	43.8	43.7
Sales tax	282.6	381.0	16.4	34.8	43.2	45.5
Federal excise duty	58.1	53.5	2.6	-8.1	43.8	32.3
Custom duty	80.0	93.7	12.3	17.1	46.2	45.4
Total	**661.7**	**840.7**	**13.7**	**27.1**	**41.7**	**43.1**

Source: Federal Board of Revenue

translated into a negative growth for the federal excise duty (FED) collection.

Custom duty collection, in general, follows the trend in the rupee value of imports. Specifically, receipts from custom duty grew by 17.1 percent in response to the 21.1 percent growth in the rupee value of imports during H1-FY12.

Figure 4.2: Quarterly FBR Tax Collection



Source: Federal Board of Revenue, SBP calculations

Relative to the estimate (based on seasonal projections) of Rs 883.9 billion in the first half, overall collection was only Rs 840.7 billion (**Figure 4.2**). This shortfall does not augur well for meeting the annual tax collection target which is already facing various risks. In fact, at the time of setting the target, the federal government had planned to collect sales tax on services. However, benefiting from the 18th amendment, Sindh has started collecting sales tax on services independently, which has dented the basic assumptions behind FBR target.[3] The FBR is,

[3] Although the provinces were allowed to collect GST on services on their own in the constitution even before the 18th amendment, this right was further endorsed with this amendment. Despite this fact, except Sindh, the other provinces have surrendered their right of collecting sales tax on services

however, determined to meet its target of Rs 1952.3 billion and has not revised as yet.

Provincial fiscal operations

Compared to same period of the previous year, the overall surplus of the provincial governments during H1-FY12, amounting to Rs 20.6 billion, does not portray a healthy picture. Last year, the provincial surplus stood at Rs 100.0 billion after the provinces started to receive a greater share of the federal revenue due to the 7th NFC award.

In terms of the budget target of Rs 125.0 billion for FY12, the overall balance of the first half means that only 16.5 percent has been achieved so far. Factors related to both the expenditure side as well as revenues account for this poor performance.

Table 4.3: Provincial Finances for H1

billion Rupees

	Punjab		Sindh		KP		Balochistan		Consolidated	
	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12
Total revenue	**210.9**	**248.6**	**135.3**	**158.8**	**107.1**	**97.6**	**64.1**	**64.1**	**517.4**	**569.0**
Share in federal revenues	186.4	214.6	118.6	124.2	64.0	74.6	49.6	52.7	418.6	466.0
Taxes	14.3	17.2	11.6	18.1	1.5	1.6	0.4	0.5	27.8	37.3
Non-tax revenues	10.2	13.6	2.7	2.9	10.5	6.7	1.9	0.6	25.3	23.8
Federal loans & transfers	0.0	3.2	2.4	13.6	31.1	14.7	12.1	10.4	45.6	41.9
Total expenditure	**194.2**	**256.8**	**121.6**	**154.6**	**67.3**	**87.4**	**34.2**	**49.5**	**417.3**	**548.4**
Current	172.5	207.7	103.3	144.0	54.6	66.0	28.8	41.3	359.2	458.9
Development	21.8	49.1	18.4	10.6	12.7	21.5	5.4	8.3	58.2	89.4
Overall balance	**16.7**	**-8.2**	**13.6**	**4.1**	**39.8**	**10.1**	**29.9**	**14.5**	**100.0**	**20.6**
As % of GDP	*0.09*	*-0.04*	*0.08*	*0.02*	*0.22*	*0.05*	*0.17*	*0.07*	*0.55*	*0.10*

Although the increase in expenditure of all provincial governments was expected after the 18th amendment, the actual increase is quite skewed. Of the total increase of Rs 99.8 billion in current expenditure, Sindh alone witnessed an increase of Rs 40.7 billion followed by Punjab with an increase of Rs 35.2 billion. In terms of development expenditures, Punjab is well ahead of the three provinces, while Sindh experienced a decline under this head.

The 18th amendment encouraged the provinces to enhance their own revenues. However, the provinces appeared to be lagging behind in this regard. Sindh has

to the federal government. If the federal government collects this tax, it would distribute the revenue according to the NFC award. Sindh, however, expects greater revenue compared to its share based on the NFC award if it collects the sales tax on services by itself due to considerable business activities in the province.

showed some increase in provincial taxes, after starting to collect revenue under the head of sales tax on services. Concerted efforts by other provinces to mobilize their own resources have not borne fruits yet.

Table 4.4: Changes in Debt Profile
billion Rupees

		FY11		FY12	
	Dec-11	**Q1**	**Q2**	**Q1**	**Q2**
Total debt & liabilities	12832.2	556.4	282.7	322.7	363.4
Total debt	12269.8	577.1	308.4	324.9	420.4
Domestic government	6866.3	304.7	335.9	207.6	641.7
Domestic PSEs	130	-15.9	31.6	25.2	-306.8
External	5273.6	288.3	-59.1	92.9	85.5
Total liabilities	562.4	-20.7	-25.8	-2.2	-57
Domestic	335.9	-27.5	-22.9	-2.8	-60.9
External	226.5	6.8	-2.9	0.6	3.9
Memorandum items;					
Public debt[1]	11992.8	587.2	288.8	267.9	729.3
Adjusted public debt[2]	11601.8	587.2	288.8	269.5	336.7

[1]Public debt includes government domestic and external debt, debt from IMF and external liabilities

[2] Adjusted public debt excludes the impact of one-off increase in November 2011.

Source: State Bank of Pakistan

4.2 Domestic & external debt

After registering a modest increase during the first quarter, Pakistan's public debt stock recorded a sharp increase in Q2-FY12, reaching Rs 12.0 trillion by end December 2011 (**Table 4.4**). The surge in debt burden, during the second quarter, was the outcome of a one-off settlement of circular debt of power sector PSEs and public procurement agencies by the government. After removing this factor, the pace of public debt accumulation during H1-FY12 shows a slowdown.

Though this one-off factor has raised the public debt burden to 61.1 percent of GDP at end December 2011, this measure entails some savings to the government, resulting from lower interest rate on government securities compared to the TFCs issued by PSEs (**Box 4.1**). Having said this, power sector losses are a huge drag on country's meager fiscal resources. According to the budget documents the tariff differential subsidy paid to WAPDA and KESC, along with the interest payments on TFCs, created with the Power Holding (Private) Limited company (PHPL) for the resolution of circular debt, alone amounted to 1.8 percent of GDP during FY11, having 27.2 percent contribution in the fiscal deficit of the preceding year.

Box 4.1: Circular Debt Settlement –Fiscal Relief to the Government

In November 2011, the government borrowed Rs 391 billion from the commercial banks to partially settle circular debt through 12-m T-bills and 5-year PIBs. This one-off settlement is a fiscal reform measure that will help government in making substantial savings on interest payments.

According to details, out of the total amount Rs 312.8 billion were raised for settling power sector claims – mainly the power holding company created by the government in mid 2009, for resolving the circular debt problem through the issuance of TFCs. These TFCs carried government guarantees and the liability of their interest payments also rested with the government. The investment in these TFCs, however, raised bank's exposure in power sector and acted as a disincentive for further bank lending to this sector. In addition, since these TFCs were issued at a market rate of around 200 bps above Kibor, they entailed huge liability of interest payments for the government. The budget estimates for interest payments on TFCs during FY12 stood at Rs 55.7 billion. To address this issue, the government decided to take these loans on its books by transforming them into sovereign debt. With this objective, a hefty amount of Rs. 391 billion was raised through 12-m T-bills and 5-year PIBs. The 12-m T-bills raised on November 4, 2011 entail interest payments of Rs 22 billion in the second quarter of FY13. Similarly for PIBs, the government will have to pay Rs 11.4 billion in interest payments biannually for the next five years. In overall terms, the interest payment for both of these instruments in FY13 will amount to around Rs 44.5 billion, which is less than the payments projected only for the power sector circular debt in FY12. Assuming the interest payments on TFCs to stay at the level projected for FY12, if there had been no settlement of circular debt in FY13, this arrangement implies more than Rs 10 billion saving in interest payments for the government in the upcoming year (**Table 4.1.1**).

Table 4.1.1 : Partial Savings Resulting From Circular Debt Settlement of Power Sector in FY13

billion Rupees

	Interest Payments		
	Pre-reform	**Post reform**	**Savings**
TFCs	55.7		
T-bills		22.0	
PIBs		22.8	
Total	**55.7***	**44.8**	**10.9**

*For the calculation of government savings we have assumed the interest payments on TFCs in FY13, to stay at the level projected during FY12

Source: Budget documents & SBP calculations

In the absence of external financing, excessive reliance on costlier domestic resources for financing these fiscal imbalances is increasing the country's debt servicing burden, and hence complicating debt management.[4] In the presence of persistent revenue and primary deficits incurred by the country during the past several years, such an increase in debt servicing implies further increase in borrowing requirements – a situation which may push the country into a debt trap.

To add to these concerns, Q2-FY12 also witnessed a significant increase in deficit monetization by the government. In the face of tight liquidity conditions in the

[4] The interest payments on domestic debt saw a sharp 21.7 percent YoY increase during H1-FY12.

market, commercial banks investment in government securities fell short of the government's requirements. Resultantly, during Q2-FY12 the government could not meet the self imposed limit of 'zero' net quarterly borrowing from central bank.[5]

On the upside, however, the roll-over of external debt payment, worth 420 million Euros, owed to IDB during Q2-FY12, provided a breather to the government.

Table 4.5: Government Domestic Debt
billion Rupees

	End Period Stock		Change in FY12	
	Jun-11	**Dec-11**	**Q1**	**Q2**
Domestic debt	**6,017.0**	**6,866.3**	**207.6**	**641.7**
Permanent debt	1,124.4	1,462.6	56.2	281.9
Floating debt	3,235.4	3,667.8	106.5	325.9
Unfunded debt	1,655.8	1,734.5	44.8	33.9
FC instruments	1.4	1.4	0.0	0.0

FC: Foreign Currency
Source: State Bank of Pakistan

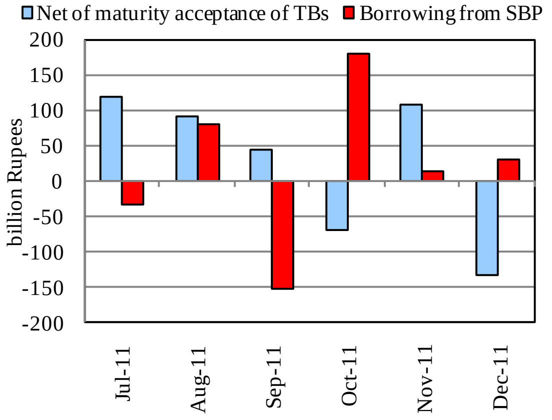
Government domestic debt

Deficit financing requirements, along with the circular debt settlement by the government, resulted in a hefty Rs 849.2 billion increase in the domestic debt stock during H1-FY12. Some of the key features are discussed below.

Floating debt

50.9 percent of the total increase in domestic debt stock during H1-FY12 was contributed by short term debt instruments (**Table 4.5**). Specifically, the government raised around Rs 195 billion, through 12-m T-bills, for circular debt settlement in the auction held on November 4, 2011. However, with this increase in the stock of 12-m T-bills, the maturity profile of domestic debt has slightly improved – the share of less-than-one-year maturity T-bills in government domestic debt has declined from 21.4 percent at end-June 2011, to 9.2 percent at end-December 2011.

Figure 4.3: Bank Borrowing



Source: State Bank of Pakistan

Another important issue is

[5] Government borrowed Rs 227.9 billion from SBP in the second quarter of FY12.

the resumption of deficit monetization on account of liquidity shortages in the market. Commercial banks' investment in T-bills witnessed a decline during Q2-FY12 and the net of maturity acceptance of T-bills stood at negative Rs 96.5 billion during this period (**Figure 4.3**). This forced the government to turn to central bank borrowing for financing. Resultantly, the net quarterly government borrowing from SBP stood at Rs 227.9 billion in the quarter ending on end-December 2011, after remaining negative during the last four quarters.

Permanent debt

The stock of permanent debt recorded a significant increase of Rs 338.2 billion during H1-FY12. As mentioned above, a greater share of this increase was because of Rs 195 billion raised through five-year PIBs for the settlement of the circular debt. However, similar to what happened with T-bills, commercial banks' investment in PIBs also lost fervor in December 2011, as the government could raise only 41.7 percent of the targeted amount in the PIB auction held in this month (**Table 4.6**).

Table 4.6: PIB Auctions

billion Rupees

	Aug-11	Sep-11	Oct-11	Nov-11*	Dec-11
Targets	30.0	20.0	15.0	15.0	15.0
Acceptance	40.5	25.9	18.9	11.2	6.3

*During November 2011 government also raised Rs 195.3 billion for circular debt settlement through PIBs.

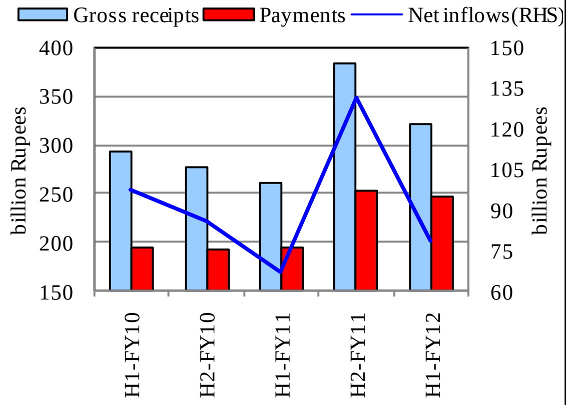
Source: State Bank of Pakistan

Furthermore, the government also raised Rs 70.3 billion through 3-year Ijara Sukuk, during the auction held in December 2011, against a targeted amount of Rs 50 billion. Greater than target acceptance in this issue reflects investment demand from Islamic debt instruments and bodes well for the diversification of debt market.

Unfunded debt

The downward revision in NSS rates in October 2011, have apparently not discouraged gross investment in NSS instruments, which recorded a substantial increase of Rs 59.5 billion during the first half of FY12 as compared to the

Figure 4.4: NSS Flows



Source: State Bank of Pakistan

same period last year (**Figure 4.4**). Healthy inflows in these schemes helped curtail a drop in net investment after large payments to institutional investors, following the ECC's decision that barred institutional investment in these schemes in April 2011.[6] Nonetheless, NSS rates have been revised downwards further in January 2012. While heavy payments are likely to continue going forward, the impact of further cut in NSS rates on investment in unfunded debt is yet uncertain.

Table 4.7: Interest Payments on Domestic Debt During Jul-Dec
billion Rupees

	FY10	FY11	FY12	Change
Permanent debt	40.9	42.9	60.1	17.2
Floating debt	86.2	154.5	176.6	22.1
3-months	1.5	15.6	7.1	-8.6
6-months	12.2	17.8	76.5	58.7
12-months	3.0	39.2	10.1	-29.1
MRTBs	69.4	81.9	83.0	1.1
Unfunded debt	141.2	91.2	114.4	23.3
Total domestic debt	268.2	288.6	351.2	62.6

Source: State Bank of Pakistan

Interest payments on domestic debt

In tandem with the rising borrowing needs of the government and partly due to the higher cost of debt during the preceding year, interest payments on domestic debt recorded a sharp 21.7 percent YoY increase during H1 FY12 – 6-m T-bills had the highest share in these payments (**Table 4.7**). Due to the recent improvement in maturity profile of domestic debt, the pace of debt servicing may register a slowdown during Q3-FY12. However, this respite is likely to be short-lived as the interest payments on the PIBs, raised for settling circular debt, will start in the final quarter of FY12. In fact, interest payments on domestic debt are likely to post substantial growth from Q4-FY12 onwards, as around one-quarter of the entire debt stock has a maturity of one year, with payments scheduled in the upcoming year.

Table 4.8: Change in External Debt Stock in Jul-Dec^P
million US Dollar

	FY11	FY12
Public debt	2,590.0	-915.0
Government debt	1,893.0	-355.0
From IMF	659.0	-496.0
Foreign exchange liabilities	38.0	-64.0
PSEs external debt	-136.0	51.6
Private sector external debt	98.0	152.6
Total external debt	2,552.0	-710.8

P: Provisional
Source: State Bank of Pakistan

External debt & liabilities

External loan inflows declined for yet another year, with EDL stock recording a fall of US$ 710.8 million during H1-FY12 over the end June 2011 position (**Table 4.8**). Out of the budget estimates of inflows of US$ 3.7 billion for

[6] Net investment in unfunded debt recorded Rs 11.9 billion increase during H1-FY12, despite a sharp Rs 49.9 billion YoY increase in payments of these instruments.

loans and grants during FY12, only 30.4 percent could be realized during H1-FY12.

On a positive note however, the government was able to rollover a significant debt payment worth 420 million Euros to IDB, which was due in December 2011, for a period ranging between 6 to 18 months. In addition to this, the roll-over of China deposits, worth US$ 500 million, which were due in January 2012, is also in process. This arrangement will ease pressure on the country's foreign exchange reserves, which have declined from 27.9 weeks of imports in end-June 2011 to 23.6 weeks of imports as of end-December 2011.