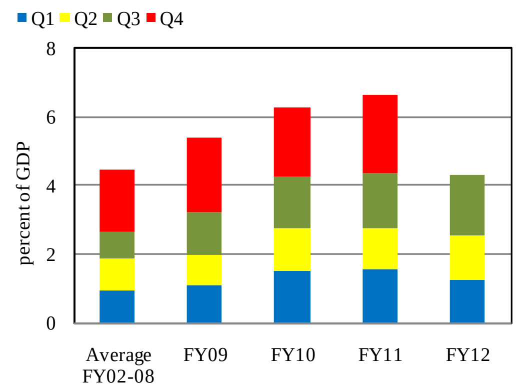
4 Fiscal Operations and Public Debt

4.1 Fiscal Operations

Another fiscal year is about to end without any significant change in the fiscal structure of the economy. Current information suggests a budget deficit of 4.3 percent of GDP for Jul-Mar FY12 which is the same level as last year. To put this in perspective, the government had targeted to contain fiscal deficit to 4.7 percent of GDP for FY12, which is significantly lower from 6.6 percent realized in the previous year.

Figure 4.1: Trend in Quarter-wise Budget Deficit



Source: Ministry of Finance

Given that fiscal pressures are highest during the last quarter (**Figure 4.1**), the budgetary gap for the full year is likely to exceed the target. However, a number of developments will determine whether the deficit will exceed the last year's level. For example:

1. The budget for FY12 was based on an ambitious outlook for tax revenues; receipts from coalition support fund; and earnings from the auction of 3G spectrum licenses. While FBR has been able to achieve 25.2 percent YoY growth in tax collection during Jul-Mar FY12, this may not be sufficient to meet the annual target.[65] Similarly, receipts from 3G licenses and the coalition support fund have not materialized as expected. Furthermore, revenues from petroleum development levy are at Rs 38 billion for the first three quarters, which is far lower than the annual target of Rs 120 billion.[66]

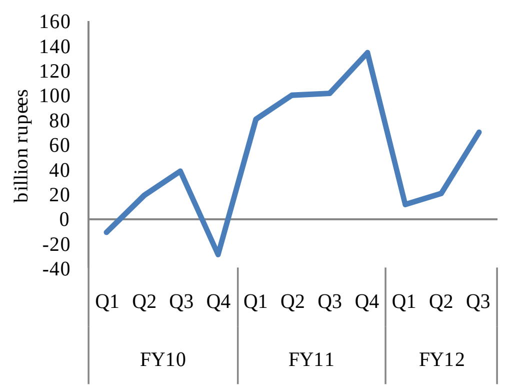
[65] By the end of third quarter, FBR has been able to mobilize only 65.7 percent of its annual target – falling behind from its average collection of 69 percent in past years. In this situation, meeting the annual target for tax collection seems quite challenging for FBR.

[66] PDL is currently charged on quantity consumed (per liter) with fixed rate of Rs 10 on Motor gasoline, Rs 14 on HOBC, Rs 6 on Kerosene and Rs 3 on Light Diesel Oil. However, in order to mitigate the impact of high global oil prices, the government has been mostly charging less than the

2. With this uncertainty surrounding revenues, some restraint in terms of current expenditure was expected, especially as the government plans to fully utilize development expenditure allocated in the budget.[67] However, current spending, including subsidies to the power sector, payments to flood victims, and general government expenditure, etc. are now testing the government's resolve to show fiscal restraint during the remaining part of FY12.

3. On the other hand, provinces, which were expected to show a surplus of Rs 125 billion for the year, are unlikely to meet the target. The provinces could manage to post a surplus of only Rs 69.9 billion during Jul-Mar FY12, which is significantly less than the Rs 101.8 billion surplus recorded in Jul-Mar FY11 (**Figure 4.2**).

Figure 4.2: Provincial Fiscal Balances (Quarterly Cumulative)



Source: Ministry of Finance

The more worrying aspect is the way the deficit is being financed. Specifically, faced with limited external financing, the government has relied heavily on domestic sources, particularly the banking sector during H1-FY12. Although non-bank borrowing showed a sharp rise in the third quarter, its continuity is uncertain in the months ahead.

Moreover, the self imposed limit of 'zero' net quarterly borrowing from SBP was breached for the second time by the government at the end of Q3-FY12.[68] The government borrowed Rs 70.8 billion from SBP during Q3-FY12, in addition to Rs 227.9 billion borrowed during the second quarter of FY12. As shown in **Table 4.1**, total borrowing from SBP stood at Rs 195.6 billion in Jul-Mar FY12.

fixed rate. Yet demand for petroleum products was sluggish due to higher prices than the last year and widely conversion of coasters and buses to CNG.

[67] Last year's deficit of 6.6 percent of the GDP was despite large cuts in the development expenditure (actual development spending was 70 percent of the original allocation in the budget).

[68] See more on government borrowing in **Chapter 3**.

This over-reliance on deficit monetization and the rising share of short-term borrowing suggests that the current fiscal situation is not sustainable, particularly due to rising rollover risks and persistent inflationary expectations. Under a recent initiative, the government is now focusing on raising more privatization proceeds instead of measures to enhance fiscal revenues.[69]

Table 4.1: Composition of Financing for FY12

billion rupees

	Q1	Q2	Q3	upto Q3
Financing	**257.2**	**275.3**	**362.3**	**894.9**
External	-4.4	38.4	13.4	47.4
Domestic	261.6	237.0	348.9	847.5
Non Bank borrowing	142.1	54.4	207.2	403.7
Bank borrowing	119.5	182.5	141.8	443.8
SBP	-103.5	227.9	70.8	195.2
Scheduled Banks	223.0	-45.4	71.0	248.6

Source: Ministry of Finance and SBP.

4.2 Expenditure

Total expenditure grew by 15.6 percent during Jul-Mar FY12, against 12.4 percent growth during Jul-Mar FY11. This higher growth was driven by increased development spending that showed a rise of around 50 percent (**Table 4.2**).

Table 4.2: Break of Expenditure (Jul-Mar)

	billion rupees		As % of target	
	FY11	FY12	FY11	FY12
Total expenditure	**2,278.5**	**2,634.3**	**69.9**	**70.8**
Current	**1,909.8**	**2,154.1**	**75.8**	**72.4**
Of which				
Interest payment	507.4	624.5	72.6	78.9
Defense	335.1	348.0	75.8	70.3
Social services *	39.3	36.5		
Development	**282.2**	**421.0**	**38.5**	**57.1**
PSDP	246.5	375.6	40.4	58.7
Other (including BISP)	35.7	45.4	79.9	46.8
Net lending	70.5	6.9		

* Includes expenditure on health, education, recreation and social protection

Source: Ministry of Finance

Unlike to previous years, both the federal and provincial governments utilized larger amounts for developmental projects. Although such spending should improve the country's long term growth, it will create financing pressures in the last quarter of the year.

[69] The Cabinet Committee on Privatization (CCOP), in the third week of March 2012, approved to sell 2.5 percent government's shareholdings in Pakistan Petroleum Limited (PPL). The government intends to sell-off parts of its share holdings in other public sector entities as well, .e.g., NBP, Kot Addu Power Company, State Life Insurance, Pak-Arab Refinery Company, etc..

4.3 Revenue

Growth in total revenue was 16.3 percent during Jul-Mar FY12, compared with 6.7 percent last year. However, even with this high growth, revenue receipts are 60.6 percent of their annual target and there is only one quarter left (**Table 4.3**).

This growth was mainly because of taxes; non-tax collection remained sluggish primarily due to below target receipts under coalition support fund. The transfer of SBP profits – another important head of nontax revenues – however, remained higher during Jul-Mar FY12 compared to the corresponding period of FY11.

Table 4.3: Tax and Non-tax Revenues (Jul – Mar)

	Billion rupees		% of Target	
	FY11	FY12	FY11	FY12
Total revenue	**1495.3**	**1739.4**	**62.0**	**60.6**
Tax revenue	1117.6	1371.6	62.8	63.8
of which				
Petroleum levy	56.6	38.2	51.5	31.8
Nontax revenue	**377.7**	**367.9**	**59.7**	**51.1**
of which				
Interest & dividend	36.3	40.3	30.5	32.9
SBP profit	125.0	154.0	67.6	77.0
Defence	68.5	7.3	51.3	6.2
Dev surcharges on gas	21.9	14.7	73.0	58.9
Discount retained on crude oil	17.0	15.8	141.3	62.8
Royalty on oil/gas	40.9	45.3	86.1	94.3

Source: Ministry of Finance, Federal Board of Revenue

FBR taxes

FBR has been able to show 25.5 percent YoY growth in tax collection during Jul-Mar FY12, which is a marked improvement over the 12.2 percent growth realized in the corresponding period of FY11. An analysis of the past three quarters shows that it was greatly helped by the import component of sales tax and direct taxes (**Table 4.4**).

Table 4.4: FBR Tax Collection during Jul-Mar FY12
billion rupees

	Net Collection		Annual target		Growth %	
	FY11	FY12	FY11	FY12	FY11	FY12
Direct taxes	381.6	478.7	626.9	743.6	11.5	25.4
Sales tax	422.7	568.4	633.4	836.7	13.9	34.5
Import related	212.0	312.9	-	-	22.6	47.6
Domestic	210.7	255.5	-	-	6.3	21.3
Federal Excise	89.1	84.8	137.4	165	5.5	-4.80
Import related	12.4	6.6	-	-	31.6	-46.5
Domestic	76.7	78.2	-	-	2.3	-1.9
Customs Duty	126.8	148.5	184.9	206.4	13.5	17.2
Total	**1020.1**	**1280.4**	**1558**	**1952.3**	**12.2**	**25.5**

Source: Federal Board of Revenue

Although this growth is promising, it should be viewed with caution as tax collection was Rs 131.3 billion short of the cumulative target for the first three quarters. Interestingly, unlike the past, when FBR used to revise its annual target downwards during the course of the year, this year's target remains unchanged.

The annual target of Rs 1,952 billion for FBR tax collection assumes some improvement in procedures to minimize evasion. Specifically, the target looks to include 700,000 new taxpayers into the tax net which would contribute Rs 70-80 billion as additional revenue. However, FBR has only collected less than Rs 1 billion so far from new taxpayers.

The annual target also assumes that GST on services would be collected by the FBR. However, benefiting from the 18th Amendment, the Sindh government decided to collect GST on services by using its own systems. Thus, the GST on services collected by Sindh is another reason for the gap between FBR's target and actual tax collection.

4.4 Provincial Fiscal Accounts

The provinces were required to show a combined surplus of Rs 125 billion in the budget FY12. With three quarters already gone, the surplus has reached Rs 69.9 billion – only 56 percent of the annual target (**Table 4.5**).

Punjab has posted the lowest surplus among all provinces, while Sindh has shown the highest. The fiscal position of Sindh has been supported mainly by its decision to collect sales tax on services by itself. Other provinces have not shown much progress in raising revenues after the 18th amendment, which stresses that

Table 4.5: Provincial Finances for Jul-Mar
billion Rupees

	Punjab		Sindh		KP		Balochistan		Consolidated	
	FY11	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**
Total revenue	**338.8**	**411.5**	**209.5**	**263.8**	**153.9**	**158.9**	**92.3**	**97.8**	**794.6**	**932.0**
Share in federal revenues	296.3	355.1	182.8	205.3	100.9	123.3	74.4	78.5	654.5	762.2
Taxes	21.7	27.8	18.2	26.7	2.0	2.4	0.8	.8	42.8	57.6
Non-tax revenues	17.0	19.0	5.0	10.8	19.9	2.8	1.3	3.3	43.2	35.9
Federal loans & transfers	3.9	9.6	3.5	20.9	31.0	30.4	15.7	15.2	54.1	76.2
Total expenditure	**320.2**	**406.7**	**199.7**	**235.8**	**109.2**	**137.7**	**63.7**	**81.9**	**692.7**	**862.1**
Current	267.8	317.8	170.5	202.0	86.9	101.9	51.3	65.3	576.6	687.1
Development	52.4	88.8	29.2	33.8	22.2	35.8	12.3	16.5	116.1	174.9
Overall balance	**18.6**	**4.8**	**9.9**	**27.9**	**44.7**	**21.2**	**28.6**	**15.9**	**101.8**	**69.9**
As % of GDP	*0.10*	*0.02*	*0.05*	*0.14*	*0.25*	*0.10*	*0.16*	*0.08*	*0.56*	*0.34*

Source: Ministry of Finance

provinces mobilize their own resources.

Table 4.6: Debt Profile
billion Rupees

	End Period Stock		Abs. Change FY11			FY12		
	Jun-11	Mar -12	Q1	Q2	Q3	Q1	Q2	Q3
Total debt & liabilities	**12,146.0**	**13,248.8**	**556.4**	**282.7**	**70.7**	**322.7**	**363.4**	**416.6**
Total debt	**11,524.5**	**12,712.7**	**577.1**	**308.3**	**256.6**	**324.9**	**420.4**	**442.9**
Domestic	**6,428.6**	**7,474.5**	**288.8**	**367.5**	**182.0**	**232.8**	**334.9**	**478.2**
Government	6,017.0	7,207.2	304.7	335.9	167.9	207.6	641.7	341.0
PSEs	411.5	267.3	-15.9	31.6	14.1	25.2	-306.8	137.2
External	**5,095.9**	**5,238.2**	**288.3**	**-59.2**	**74.6**	**92.2**	**85.5**	**-35.3**
Total liabilities	**621.5**	**536.1**	**-20.7**	**-25.7**	**-68.9**	**-2.2**	**-56.9**	**-26.3**
Domestic	399.5	306.5	-27.5	-22.9	-71.7	-2.8	-60.9	-29.3
External	222.0	229.6	6.8	-2.9	2.8	0.6	3.9	3.0
Memorandum								
Public debt [1]	10,995.5	12,289.5	587.2	288.8	231.8	268.1	729.3	296.7
Adjusted public debt[2]	10,995.5	11,898.5	587.2	288.8	231.8	268.1	338.3	296.7

[1]Public debt includes government domestic and external debt, borrowing from IMF and external liabilities. This does not tally with the public debt numbers reported by the Ministry of Finance, as the latter does not include military debt, short-term multilateral debt and external liabilities.
[2] Adjusted public debt excludes the impact of one-off circular debt settlement in November 2011.
Source: State Bank of Pakistan

4.5 Public Debt

A higher fiscal deficit and settlement of circular debt led to a sharp Rs 1.3 trillion increase in the public debt burden during Jul-Mar 2012, which reached at Rs 12.3 trillion as of end-March 2012 (**Table 4.6**). This increase in public debt was led by a surge in government domestic debt that posted a historic Rs 1.2 trillion rise during Jul-Mar 2012.[70] As expected, withering external inflows and amortization of IMF debt resulted in US$ 1.6 billion decline in the external debt stock during Jul-Mar 2012, compared to the end-Jun 2011 position. Short term borrowing –

Table 4.7: Government Domestic Debt
billion Rupees

	End Period Stock		Change in FY12		
	Jun 2011	Mar 2012	Q1	Q2	Q3
Domestic	**6017**	**7207.2**	**207.6**	**641.7**	**341**
Permanent	1124.4	1553.6	56.2	281.9	90.9
Floating	3235.4	3926.9	106.5	325.9	259.1
Unfunded	1655.8	1725.4	44.8	33.9	-9.1
Foreign currency instrument	1.4	1.4	0	0	0

Source: Ministry of Finance and State Bank of Pakistan

[70] This includes one-off settlement of Rs 391 billon of circular debt in the power and commodity sector during the second quarter of the year.

particularly 3-month T-bills, was the main source of financing for the government during Q3-FY12 (**Table 4.7**).[71]

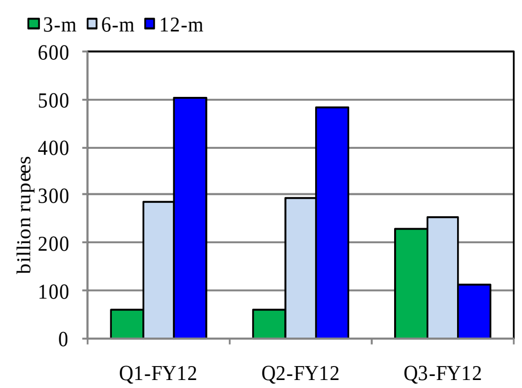
Government Domestic debt

Floating debt

Within domestic debt, around 75 percent of the increase during Q3-FY12 was contributed by floating debt (i.e., the issuance of government paper). However, as witnessed in Q2-FY12, commercial banks' investment in T-bills remained short of the target for Q3-FY12. As a result, government borrowing from SBP continued during Q3-FY12 as well.

Commercial bank investment in government securities is determined by various factors: (a) liquidity conditions in the market; (b) banks' view on the policy rate; (c) trading in the secondary market; and (d) the need to correct mismatches in asset-liabilities, etc. Since Q2-FY12, tight liquidity conditions in the market have been constricting bank's ability to invest in government paper. In addition, with the stability in policy rate since October 2011 and persistence in inflation expectations, banks are now anticipating policy rate to remain unchanged (or in extreme case may even increase). This change in sentiments has impacted banks' behavior in two ways: Firstly, banks have limited incentive to trade securities in the secondary market. Resultantly, commercial bank investment in government paper has slowed down. Secondly, banks are now more interested in 3-month T-bills during Q3-FY12, instead of longer tenor paper, which was the case during first two quarters of FY12 (**Figure 4.3**).

Figure 4.3: Realized Amount in T-Bill Auctions



Source: State Bank of Pakistan

Permanent debt

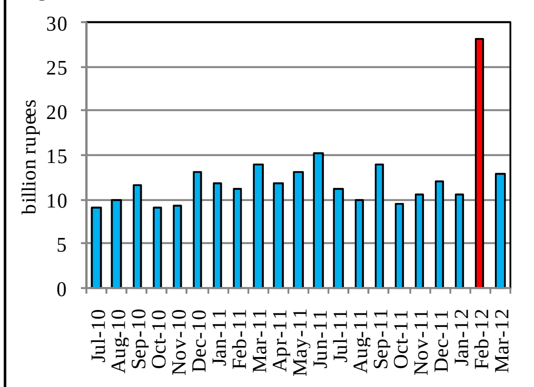
In line with the rising borrowing needs of the government, the stock of permanent debt recorded a substantial Rs 429.1 billion increase during Jul-Mar 2012, raising

[71] The 3-month securities had 38.6 percent share in the total realized amount of T-bills during Q3-FY12, against an average 7.3 percent share during H1-FY12.

its share in domestic debt to 21.6 percent at end-Mar 2012 from 18.7 percent at end-June 2011. This includes Rs 195 billion 5-year PIBs issued for the settlement of the circular debt during Q2-FY12. In addition to PIBs, government also raised Rs 108.4 billion through the issue of 3-years Ijara Sukuk during Jul-Mar 2012.

At the same time, the stock of prize bonds also recorded a sizeable Rs 41.3 billion increase during Jul-Mar 2012 over the end-June 2011 stock. Around 42 percent of this increase was registered in the month of February 2012. This was due to the launch of a new Rs 25,000 denomination prize bond by Central Directorate of National Savings (CDNS) in February 2012, which attracted heavy inflows during this month (**Figure 4.4**).

Figure 4.4: Inflows in Prize Bonds

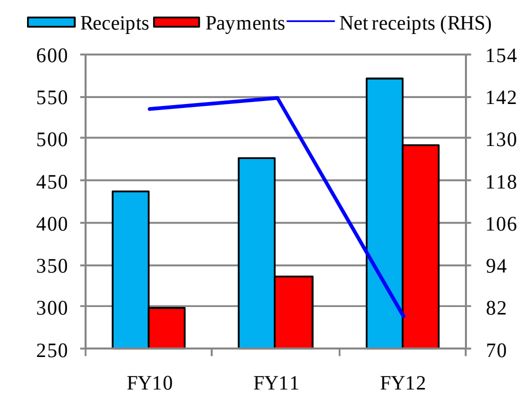


Source: State Bank of Pakistan

Unfunded debt

Despite higher investment in NSS, net receipts in unfunded debt recorded a decline during Jul-Mar 2012 compared to Jul-Mar 2011 (**Figure 4.5**). This was due to heavy payments to institutional investors, following the government's decision that barred institutional investment in these schemes in April 2011. Interestingly, despite downward adjustments in NSS rates in the months of October 2011 and January 2012, fresh receipts did not register a major decline.

Figure 4.5: NSS Flows (Jul-Mar) - Billion Ruppes



Source: State Bank of Pakistan

Interest payments on domestic debt

Interest payments on domestic debt recorded a sharp 25.7 percent YoY increase during Jul-Mar 2012. Banks' focus on 12-month T-bills, during H1-FY12, provided some relief to the government in terms of lower interest payments on floating debt during the third quarter (**Table 4.8**). However, with the recent shift in banks' preferences towards 3-month T-bills, along with the interest payments on PIBs, which were raised for the settlement of circular debt, the debt servicing burden is likely to post a sharp growth in the final quarter of FY12.

Table 4.8: Interest Payments

billion rupees

	Jul-Mar		FY12		
	FY11	**FY12**	**Q1**	**Q2**	**Q3**
Permanent Debt	65.4	112.4	33.0	27.1	52.3
Floating Debt	248.3	258.0	77.0	99.7	81.3
Market Treasury Bills	124.9	131.9	34.8	58.9	38.2
3-Months	28.5	8.6	5.0	2.1	1.5
6-Months	27.6	95.6	23.7	52.9	19.0
12-Months	68.8	27.7	6.1	3.9	17.7
Market Related Treasury Bills	123.4	126.1	42.2	40.8	43.1
Unfunded Debt	145.3	206.8	55.4	59.0	92.3
Total Domestic Debt	459.0	577.1	165.3	185.9	226.0

Source: State Bank of Pakistan