4 Fiscal Policy and Public Debt

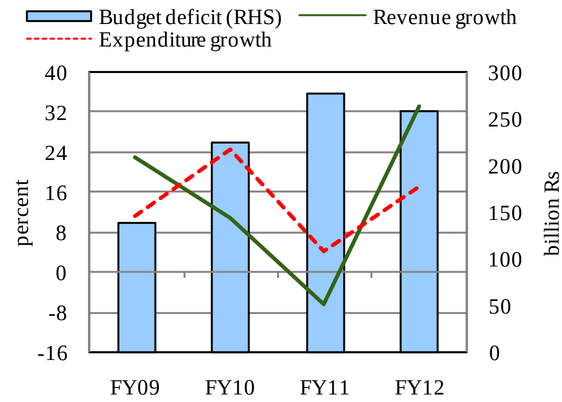
4.1 Fiscal Situation

The budget deficit in the first quarter of FY12 was 1.2 percent of GDP, compared with 1.5 percent during the same quarter of the last year **(Figure 4.1)**. The reduction in the budget deficit was caused primarily by sharp rise in tax collection on the back of increased tax collection efforts as well as high growth in taxes on imports. While expenditures also showed higher growth than the last year, the upside is that some of this growth was tilted towards development expenditures **(Table 4.1)**.

Financing of the deficit, however, remained an issue. The government could not mobilize external resources to finance the budget deficit. During the quarter, repayments of external loans were higher than receipts of new loans, resulting in net external financing of negative Rs 4.4 billion in Q1-FY12. As a result all the burden of financing fell on domestic sources.

Going forward, it will be challenging for the government to achieve its fiscal deficit

Figure 4.1: Fiscal Developments



Source: Ministry of Finance

Table 4.1: Summary of Public Finance
billion Rupees

		First quarter		
	BE FY12	**FY11**	**FY12**	**Growth (%)**
Total revenue	**2870.5**	**400.1**	**533.6**	**33.4**
Tax revenue	2151.2	317.3	409.0	28.9
Non-tax receipts	719.3	82.9	124.7	50.4
Total expenditure	**3721.2**	**676.3**	**790.9**	**16.9**
Current	2976.3	566.7	656.6	15.9
Development & net lending	744.9	62.8	87.7	39.6
Unidentified	0	46.8	46.6	-0.4
Overall deficit	**850.6**	**276.2**	**257.2**	**-6.9**
Financing through:				
External resources	134.5	56.9	-4.4	
Internal resources	716.1	219.3	261.6	
Banking system	303.5	120.9	119.5	
Non-bank	412.6	98.4	142.1	
As % of GDP				
Overall fiscal deficit	4.0	1.5	1.2	
Revenue deficit	-	0.9	0.6	
Primary deficit	-	0.6	0.4	

Source: Ministry of Finance

target of 4.7 percent of GDP mainly because; (1) the strong growth in tax revenue was largely due to import related sales tax, which was supported by higher unit value of crude oil and fertilizers during the quarter; however, this gain in taxes could be offset by subsidies both on fertilizer and POL in the months ahead; (2) heavy dependence (Rs 150 billion) on the realization of CSF and 3G licences; and (3) the expected surplus of Rs 125 billion in the provincial balances. While issuances of 3G licences are scheduled for Mar 2012, the CSF and provincial surpluses are already lagging.

Revenue

The growth in overall revenue was 33.4 percent during Q1-FY12, compared with a negative growth during Q1-FY11. While the non-tax component also contributed to this growth (particularly Rs 54.0 billion transferred as SBP profit), the main contributing factor is high growth in sales tax **(Table 4.2)**.[33]

Table 4.2: Tax and Non-tax Revenues – during Q1
billion Rupees

	FY11	FY12	Abs Δ
Tax revenue	**317.3**	**409.0**	**91.7**
Direct taxes	94.4	127.6	33.2
Taxes on goods and services	156.9	204.3	47.4
Excise duty	24.4	28.8	4.4
Sales tax	132.5	175.5	43.0
Taxes on international trade	36.5	42.4	5.9
Other taxes	14.1	19.0	4.9
Petroleum levy	15.3	15.6	0.3
Nontax revenue	**82.9**	**124.7**	**41.8**
Interest and dividends	0.9	14.5	13.6
SBP profits	40.0	54.0	14.0
Defense	1.4	1.8	0.4
Development surcharge on Gas	5.0	5.7	0.7
Royalties	19.6	15.0	-4.6
Miscellaneous	15.9	33.7	17.8
Total revenue	**400.1**	**533.6**	**133.5**

Source: Ministry of Finance

Although FBR could not carry forward tax reform agenda during FY11 (except some ad hoc measures in the latter part of the year), removal of exemptions in the FY12 budget, and the tax authority's resolve to improve enforcement, helped shore up federal tax revenues.

Collections under direct tax and sales tax – which together make 81.4 percent of the total FBR revenue – grew by 30.1 and 38.6 percent, respectively. As mentioned earlier, healthy sales tax collection has been supported by higher import prices. Although detailed commodity-wise data for sales tax collection is

[33] Within non-tax revenues, the biggest increase was in SBP profit followed by interest and dividend (on government investments). There are other numerous small heads including different kinds of fees, licenses, etc. showing a combined increase of Rs 17.8 billion during Q1-FY12; the sustainability of such receipts is a question.

yet not available, we can attribute this growth to the import of two commodities – fertilizer and petroleum products.

The import of both these commodities grew by more than 50.0 percent during the first quarter. Moreover, the value of total imports also increased by 24.3 percent during Q1-FY12, compared with 10.3 percent in the same quarter last year, which also led to growth in import related taxes **(Table 4.3)**.

Table 4.3: FBR Tax Collection during Q1

	Rs billion		% Growth	
	FY11	**FY12**	**FY11**	**FY12**
Taxes on imports	**105.0**	**148.8**	**19.4**	**41.7**
Sales tax	64.0	104.1	22.7	62.8
FED	3.9	2.2	41.2	-44.0
Custom duty	37.2	42.5	12.4	14.4
Domestic taxes	**92.7**	**107.4**	**2.4**	**15.8**
Sales tax	69.7	81.2	7.4	16.4
FED	23.0	26.2	-10.2	14.1
Total indirect taxes	**197.8**	**256.3**	**10.8**	**29.6**
Direct taxes	**95.718**	**124.5**	**12.2**	**30.1**
Total tax collection	**293.5**	**380.8**	**11.2**	**29.7**

Source: Federal Board of Revenue

FBR's annual tax collection target for FY12 is Rs 1,952.3 billion, which means an additional Rs 394.3 billion over the last year tax collection. On the basis of seasonal trend in tax collection, the FBR should have collected Rs 406.4 billion in Q1-FY12 – implying a shortfall of Rs 25.6 billion. Similarly, FBR data shows tax collection of Rs 840.1 billion as of end-Dec 2011, which indicates that FBR would have to make considerable efforts to achieve the end-year target.

Table 4.4: Break-up of Expenditures during Q1

	Rs billion		% Growth	
	FY11	**FY12**	**FY11**	**FY12**
Current	**566.7**	**656.6**	**8.8**	**15.9**
Federal	**419.1**	**436.4**	**9.9**	**4.1**
General public service	274.5	292.8	3.5	6.7
Interest payments	161.6	177.3	14.2	9.7
Pension	14.3	27.9	-12.3	94.7
Grants.	44.7	47.8	-25.5	6.9
Other services	53.9	39.8	13.9	-26.1
Defense	93.1	107.2	8.1	15.1
Public orders& safety	11.9	14.5	21.6	22.2
Provincial	**147.7**	**220.2**	**5.8**	**49.1**
Development	**59.4**	**88.9**	**-65.4**	**49.7**
PSDP	43.1	78.9	-67.4	82.9
Federal	27.2	47.3	-68.3	73.7
Provincial	15.9	31.6	-65.7	98.7
Others	16.3	10.0	-58.7	-38.4

Source: Ministry of Finance

Expenditure

The devolution of a number of public services from federal to provincial governments has clearly changed the pattern of current expenditures. While the federal current expenditure grew by only 4.1 percent, provincial expenditures increased by 49.1 percent in Q1-FY12 **(Table 4.4)**. The provinces have also doubled their development spending during the quarter.

In fact, both federal and provincial governments are expected to increase outlays substantially to satisfy local constituents. Although we expect pressure on both the current and development expenditures, development spending will be welcomed as long as it adds to key physical infrastructure that support the long term growth.

Provincial fiscal operations

A glimpse of provincial finances shows that with the exception of Baluchistan, the other three provinces have posted a sharp growth in expenditure in the first quarter. As a result, the provincial surplus declined from Rs 81.3 billion in Q1-FY11 to Rs 11.6 billion in Q1-FY12.[34] While the other provinces managed a surplus, Sindh witnessed a deficit during the quarter primarily due to unexpected outlays for rehabilitation in flood-affected areas. Expenditure in other provinces also increased substantially, but those were mostly development related **(Table 4.5)**.

On the revenue side, the growth in the provincial share in federal revenue has fallen sharply. This shows the dilution of the one-off increase in provincial revenues due to the 7th NFC award last year. In terms of provinces' own resource mobilization, only Sindh presented a strong growth in tax revenue during Q1-FY12, while the tax growth in other three provinces was less than the previous year.

Table 4.5: Provincial Fiscal Operations during Q1
billion Rupees

	Punjab		Sindh		KPK		Balochistan		All provinces	
	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12
Total revenue	**96.4**	**120.3**	**60.2**	**68.5**	**59.5**	**45.5**	**33.0**	**33.1**	249.1	267.4
Share in federal revenue	82.5	94.3	52.8	55.2	28.8	33.1	26.0	27.9	190.1	210.5
Taxes	8.0	9.2	5.3	8.9	0.9	0.9	0.2	0.2	14.4	19.2
Non-taxes	3.4	10.4	0.8	0.3	3.5	7.9	1.0	0.3	8.7	18.8
Federal loans and transfers	2.5	6.5	1.3	4.1	26.3	3.6	5.7	4.7	35.8	18.9
Total expenditure	**73.1**	**117.0**	**49.4**	**77.5**	**29.4**	**42.5**	**15.9**	**18.7**	**167.7**	**255.8**
Current	64.8	100.4	46.0	73.8	26.5	32.5	14.5	17.5	151.8	224.1
Development	8.3	16.6	3.4	3.8	2.9	10.1	1.4	1.2	15.9	31.6
Overall balance	**23.3**	**3.3**	**10.9**	**-9.0**	**30.1**	**3.0**	**17.1**	**14.3**	**81.3**	**11.6**

Source: Ministry of Finance

[34] The budget FY12 envisaged a surplus of Rs 125 billion on the part of provinces.

4.2 Total Debt & Liabilities

The settlement of circular debt of power sector PSEs and public procurement agencies resulted in a substantial Rs 572.2 billion increase in the stock of total debt & liabilities (TDL), during the first five months of FY12, that reached Rs 12.7 trillion **(Table 4.6)**. However, after adjusting for this one-off factor, the increment in TDL stock shows a lesser magnitude during Jul-Nov FY12 as compared to the same period last year.

Table 4.6: Debt Burden
billion Rupees

	Jun-11	Nov-11^p	Change
Total debt & liabilities	**12,146.1**	**12,673.3**	**527.2**
Total public debt	**10,995.5**	**11,826.4**	**830.9**
Total debt	**11,524.5**	**12,132.6**	**608.1**
Domestic - government	6,017.0	6,778.7	761.7
Domestic - PSEs	411.5	134.8	-276.7
External	5,096.0	5,219.1	123.1
Total liabilities	**621.5**	**540.7**	**-80.8**
Domestic	399.5	316.8	-82.7
External	222.0	223.9	1.9
Memorandum item:			
After adjusting for circular debt	6017.0	6387.7	370.7

P: Provisional
Source: State Bank of Pakistan

Furthermore, as external inflows tapered, the pressure of financing the fiscal deficit has fallen on domestic banking and nonbanking sources.[35] While this trend may bode well in terms of external indebtedness, it has adverse implications for the private sector. Moreover, declining foreign inflows is also putting pressure on Pakistan's FX reserves to finance current account deficit.[36]

Table 4.7: Absolute Change in Government Domestic Debt during Jul-Nov
billion Rupees

	FY11	FY12
Government domestic debt	**477.1**	**761.7**
Instrument-wise		
Permanent debt	60.0	274.9
Floating debt	363.6	421.0
of which		
MTB	114.8	566.3
MRTBs	295.6	-45.0
Unfunded Debt	54.8	65.8
Institution wise		
Through banking system	337.9	500.7
Scheduled banks	42.3	545.7
SBP	295.6	-45.0
Through non-bank debt	140.5	261.0
Foreign currency instruments	-1.3	0.0

Source: State Bank of Pakistan

Government domestic debt

The rising borrowing needs of the government were largely met from the banking system

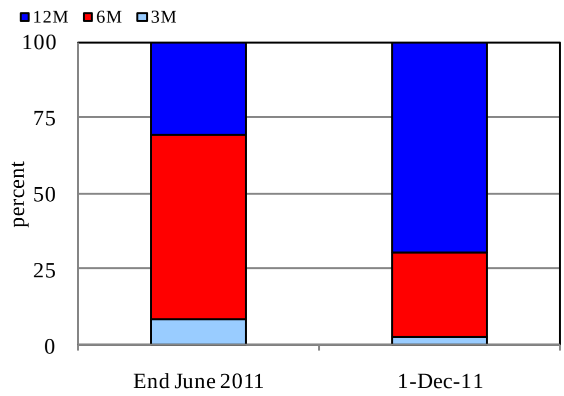
[35] The share of the domestic component was 76.3 percent of total expansion in debt and liabilities during Jul-Nov FY12 compared with 69.1 percent during the same period last year.

[36] Pakistan's FX reserves fell from the level of 27.9 weeks of imports on end-Jun 2011 to 23.6 weeks of imports on end-Nov 2011.

through short term floating debt instruments **(Table 4.7)**. This resulted in further amplification of scheduled banks holding of domestic debt to 37.7 percent on end-Nov 2011 from 33.4 percent on end-Jun 2011.

***Floating debt**:* MTBs held by scheduled banks were one of the chief sources of financing the circular debt settlement in Nov 2011. Specifically, government raised around Rs 200.0 billion from 12-M MTBs in the auction held on Nov 4, 2011.

Figure 4.2: Composition of Outstanding MTBs Stock



Source: State Bank of Pakistan

On the upside, the maturity profile of floating debt has seen an improvement, after the monetary policy loosening by SBP in Jul and Oct 2011. This is, due to a shift in commercial banks investment towards 12M T-bills instead of the shorter tenor bills (**Figure 4.2**). This shift towards longer tenor securities will reduce the roll-over and interest rate risk faced by the government. Furthermore, as a result of the SBPs efforts to diversify investors, the amount raised though the non-bank sector in MTBs auctions has also increased sharply.[37]

Encouragingly, the stock of government debt held by SBP registered Rs 45.0 billion reduction during Jul-Nov FY12 over the end Jun 2011 position. As the government is trying to keep additional budgetary borrowing from SBP at zero level, Rs 103.5 billion were retired to SBP during Q1-FY12. However, it had to resume borrowing from SBP in Oct 2011 as the cut in policy rate and the resultant fall in MTB yields has dented scheduled banks incentives for investing in government paper.[38] Resultantly, government had to borrow from SBP to settle the maturing amount.

[37] During Jul-Nov FY12, government raised Rs 59.1 billion through MTBs from non-bank sector, as compared to the retirement of Rs 208 billion to non-bank sector during the same period last year.
[38] The net of maturity acceptance of MTBs was negative in the auctions held on Oct 20, 2011 and Dec 14, 2011.

***Permanent Debt*:** The inflows through permanent debt continued the rising trend witnessed since Q2-FY11. Specifically, in the auctions held during Q1-FY12, Rs 52.2 billion were raised through PIBs, against a target of Rs 50.0 billion. However, permanent debt stock recorded a surge in Nov 2011, as the government raised a hefty amount of Rs 195.0 billion for the circular debt settlement through 5-year PIBs.

Unfunded Debt: The inflows into NSS instruments recorded a healthy 20.1 percent increase in Jul-Nov FY12 over the same period last year. An analysis of monthly inflows shows that the downward revision in NSS rates (in Oct 2011) has not, so far, discouraged investment in these instruments.

External debt

Pakistan's external debt stock fell by US$ 255.0 million on end-Nov 2011, from its Jun 2011 position, as compared to the hefty increase witnessed during the same period last year (**Table 4.8**).[39] However, after the suspension of the IMF program in FY11, the weakening of external loan inflows was anticipated. The early suspension of the IMF program sent negative signals about country's macro-economy to other IFIs, which has halted their pipeline assistance.

Table 4.8: Absolute Change in External Debt Stock during Jul-Nov
million US Dollar

	FY11	FY12^{P}
Public debt	1832.0	-780.0
Government debt	1230.0	-352.0
From IMF	578.0	-380.0
Foreign exchange liabilities	24.0	-48.0
PSEs external debt	-42.0	54.0
Private sector external debt	165.0	471.0
Total external debt	**1955.0**	**-255.0**

P: Provisional

Source: State Bank of Pakistan

Going forward

With the risks mentioned to fiscal outlook above and weakening of external inflows, the stock of domestic debt is likely to continue the rising trend. As regards the servicing of debt, although the cut in policy rate has reduced the cost of borrowing, these gains are likely to be partially offset by the adverse movement in the Pak Rupee with rise in Rupee cost of external debt servicing **(Box 4.1)**. Thus, in overall terms, debt servicing as a share of government's revenues, which already stood at 43.3 percent in FY11, is likely to increase further going forward.

[39] Pakistan's external debt increased in Rupee terms due to depreciation of Pak Rupee during Jul-Nov FY12 as shown in Table 4.6 of this chapter.

Box 4.1: Debt Servicing - Interest Rate and Exchange Rate Impact in FY12

The fall in policy rate is likely to result in reduction of debt servicing to the extent of around 0.1 percent of GDP in FY12. However, these gains can be partially offset by rise in Rupee cost of external debt servicing with an adverse movement in Pak Rupee vs. US Dollar exchange rate.

Interest Rate Impact: According to our estimates, maximum impact of Monetary Policy easing, on interest payments of domestic debt will be witnessed in floating debt instruments which have slightly greater than 50 percent share in total domestic debt stock. However, the impact is likely to be modest in FY12, because of the nature of debt instruments.

Table 4.1.1: Savings in Auctions of Floating Debt Instruments (billion Rupees)

	3M	6M	MRTBs
Weighted average yields*			
Scenario1	13.2	13.4	13.6
Scenario2	11.8	11.8	11.9
Interest payments			
Scenario1	2.29	23.7	58.3
Scenario2	1.6	17.7	51.2
Savings	**0.7**	**6.0**	**7.1**

*Scenario 1: Before 150bps cut in policy rate

*Scenario 2: After 150bps cut in policy rate

Analyst estimates based on State Bank of Pakistan data

A detailed analysis shows that the fall in MTB rates will not affect the interest payments for 12M T-bills in FY12, as they are derived from MTB holdings of FY11. Similarly, the impact on interest payments for 6M T-Bills as well as MRTBs is likely to be realized only from Q4-FY12 onwards, as the payments from Jul-Mar 2012 correspond to the TBs raised during Jan-Sep 2011 i.e., mostly Monetary Policy tightening phase. The fall in policy rate could have stronger impact on interest payments for 3M T-Bills, if banks had been willing to invest in shorter tenor securities, which is not the case.[40] Therefore, government savings, in interest payments during FY12, are likely to originate mostly from 3 & 6M T Bills and MRTBs created during Q2-FY12.

After the 150 bps reduction in policy rate announced in Monetary Policy, on Oct 8, 2011, the weighted average yields of MTBs recorded a significant 140-160 bps fall in Q2-FY12 as compared to that in Q1-FY12. This is likely to translate in a saving of Rs 13.8 billion in interest payments during FY12, which implies a 0.1 percent of GDP reduction in fiscal deficit in this period **(Table 4.1.1)**.

Table 4.1.2: Exchange Rate Depreciation & Debt Servicing Burden in FY12 (amount in billions)

	Principal	Interest	Total
Debt servicing (US$)	**3.0**	**0.5**	**3.5**
Debt servicing in (Pak Rupee*)			
Scenario 1	258.0	42.4	300.4
Scenario 2	261.6	43.0	304.7
Scenario 3	262.4	43.2	305.6

*Scenario 1: Average exchange rate in FY11 @ 85.5

*Scenario 2: Average exchange rate in Q1-FY12 @86.7

*Scenario 3: Average exchange rate in Oct-Nov 2011 @ 87.0

Analyst estimates based on Economic Affairs Division data

Exchange Rate Impact: According to the Debt Office Islamabad, government's estimated external debt servicing payments for FY12 stand at US$ 4.1 billion. In terms of currency composition 85 percent of these obligations are denominated in US Dollar, while the rest of the payments are due in currencies as Euro, yen, etc. The huge share of US Dollar makes country's debt servicing burden, in Rupee terms, highly vulnerable to adverse movements in Pak Rupee/ US Dollar exchange rate.

[40] The outstanding 3M TBs holding fell from the level of Rs 168.0 billion in End Jun 2011 to Rs 64.7 billion On Dec 1, 2011.

The Rupee-dollar exchange rate after remaining relatively stable in FY11,[41] has come under increasing pressure in FY12, with the current account turning into deficit in FY12 from a surplus position in FY11 – Pak Rupee shed 1.4 percent value against US dollar during Q1-FY11 and a further 1.7 percent during Oct & Nov 2011. The depreciation of Pak Rupee is inflating the Rupee cost of external debt servicing payments of the country. According to calculations, a 1.4 percent depreciation in Pak Rupee/US$ average exchange rate as compared to that in FY11 is likely to result in around Rs 4.2 billion increase in country's Rupee debt servicing burden during FY12, while a larger 1.7 percent depreciation will expand the debt servicing burden by Rs 5.1 billion **(Table 4.1.2)**.[42]

[41] The Pak Rupee depreciated nominally by 0.6 percent during FY11 against 4.7 percent in FY10.
[42] These calculations incorporate external debt servicing obligations denominated in US Dollar.