4 Fiscal Policy and Public Debt

4.1 Fiscal Operations

The overall budget deficit for Q1-FY13 increased slightly to Rs 283.8 billion from Rs 257.2 billion in the first quarter of last year (**Table 4.1**). As a percentage of GDP, the deficit remained unchanged at 1.2 percent, compared to Q1-FY12.[1]

Table 4.1: Summary of Public Finance
billion Rs

	BE FY13	Q1 FY12	Q1 FY13	Growth (%)
Total revenue	**3,376**	**533.6**	**692.1**	**29.7**
Tax revenue	2,626	409.0	451.3	10.3
Non-tax receipts	750	124.7	240.8	93.2
Total expenditure	**4,480**	**790.9**	**975.9**	**23.4**
Current	3,430	656.6	812.4	23.7
Development	1,050	87.7	74.9	-14.6
Unidentified		46.6	88.7	90.6
Overall deficit	**1,105**	**257.2**	**283.8**	**10.4**
Financing through:				
External resources	135	-4.4	-1.6	
Internal resources	970	261.6	285.4	
Banking system	484	119.5	151.5	
Non-bank	487	142.1	133.9	
As % of GDP				
Overall fiscal deficit	4.7	1.2	1.2	
Revenue deficit	0.2	0.6	0.5	
Primary deficit		0.4	-0.1	

Source: Ministry of Finance

The key development this quarter was the sharp increase in interest payments, which can be explained by a significant rise in domestic debt in recent years. These payments alone now constitute over 38 percent of the overall current spending, and have consumed more fiscal space, which the government could have utilized to stimulate the domestic economy. Therefore, our concerns regarding the looming debt trap stays, as the government domestic debt has increased by Rs 482 billion in Q1-FY13, compared to Rs 208 billion in Q1-FY12.

Fiscal management became more challenging following a slowdown in tax collection during the quarter. However, a large inflow of US$ 1.12 billion in August 2012 under the Coalition Support Fund (CSF), and a hefty surplus of Rs 85.4 billion posted by the provinces (compared to a *full-year* target of Rs 80 billion) helped the government contain the fiscal deficit.[2,3]

[1] The overall fiscal deficit for FY12 was 8.5 percent of GDP. This deficit includes the one-off payment of Rs 391 billion (1.9 percent of GDP) for PSEs' debt settlement. Excluding this one-off, the deficit narrows to 6.6 percent of GDP (see *SBP's Annual Report* for FY12).
[2] Financing numbers shown in **Table 4.5** provide actual budgetary position of provinces.
[3] There was no inflow under Coalition Support Fund during the entire FY12 (see *Chapter 5 on external sector*); similarly, provinces posted a small surplus of Rs 3.9 billion in Q1-FY12.

Given the exceptional nature of these inflows, it remains to be seen what would have happened in their absence. Excluding CSF inflows, fiscal deficit for the quarter would have reached Rs 389.5 billion, against the realized deficit of Rs 283.8 billion (up by 37.2 percent). Furthermore, though we see the better performance of provinces as the potential from fiscal devolution, we do not expect such surpluses in the remaining three quarters, since this has already exceeded the full year target.

As expected, the burden of financing this deficit fell entirely on domestic sources – particularly on the banking system – as external sources of finance were not forthcoming. Nevertheless, government was able to meet the quarterly limit on budgetary borrowing from the central bank which is stipulated under the revised SBP Act. The government, in fact, retired a total of Rs 412 billion to SBP during Q1-FY13.[4] The burden on commercial banks, however, increased quite sharply.[5]

Revenue

Total revenues grew sharply by 29.7 percent during Q1-FY13, following the 33.4 percent growth in Q1-FY12. However, the underlying reasons are quite different: while the surge in Q1-FY12 was driven by a sharp growth (28.9 percent) in tax revenues, the rise in FY13 was on account of substantial inflows under the CSF (**Table 4.2**).[6]

Table 4.2: Tax and Non-tax Revenues (Jul-Sep)
billion Rs

	FY12	FY13	Absolute △
Tax Revenue	409.0	451.3	42.3
Direct Taxes	127.6	136.5	8.9
Taxes on goods & services	204.3	213.1	8.8
Excise duty	28.8	22.8	-6.0
Sales Tax	175.5	190.3	14.8
Taxes on int'l trade	42.5	50.8	8.4
Other taxes	18.9	28.0	9.0
Petroleum Levy	15.6	22.8	7.2
Nontax Revenue	**124.7**	**240.8**	**116.1**
Interest and dividends	14.5	16.0	1.5
SBP profits	54.0	50.0	-4.0
Defence (incl. CSF)	1.8	107.3	105.5
Dev. surcharge on gas	5.7	3.9	-1.8
Royalties	15.0	14.8	-0.2
Miscellaneous	33.7	48.9	15.2
Total Revenue	**533.6**	**692.1**	**158.4**

Source: Ministry of Finance

[4] These borrowings are on the basis of *actual cash* realized by the government through debt issuance in the primary auctions. We have excluded the impact of any subsequent change in the market value of the debt, either due to accrued interest or change in the secondary market price.
[5] In net terms, the federal government borrowed Rs 564 billion (on cash basis) from commercial banks in Q1-FY13, compared to Rs 264 billion in Q1-FY12.
[6] Hence, non-tax revenues registered a growth of 93.2 percent during the quarter, following a rise of 50.4 percent during Q1-FY12.

Tax revenue could grow only by 10.3 percent during Q1-FY13,[7] compared to 28.9 percent in the corresponding quarter of FY12. More importantly, the slowdown is concentrated in FBR tax collections, which make up a dominant part of the total tax collection.[8]

Unlike FY12, the federal budget for FY13 relies more on increasing tax compliance to achieve the full-year tax target of Rs 2,381 billion.[9] Any shortfall in subsequent quarters would make the annual target more demanding.

The task for FBR became more complicated with a fall in inflation during the first quarter. This, together with elimination of federal excise duties (FED) in the Federal Budget for FY13, led to a decline of 1.7 percent in tax collection from domestic businesses, compared to 15.8 percent growth last year (**Table 4.3**).[10] Furthermore, falling international prices of petroleum products during the first quarter of FY13, reduced the growth in import taxes.[11]

At the same time, the growth in direct tax collection also slowed to 11.4 percent during Q1-FY13, compared to 30.1 percent last year. A number of factors explain this slowdown: the reduction in the number of income tax slabs and rates; and increase in exemption limit of withholding tax on cash withdrawal from banks.[12]

Table 4.3: FBR Tax Collection (Jul-Sep)

	Billion Rs		% Growth	
	FY12	**FY13**	**FY12**	**FY13**
Taxes on imports	**148.8**	**166.6**	**41.7**	**12**
Sales tax	104.1	111.9	62.8	7.4
FED	2.2	2.5	-44	12.7
Custom Duty	42.5	52.3	14.4	23
Tax on domestic businesses	**107.4**	**105.6**	**15.8**	**-1.7**
Sales tax	81.2	85.6	16.4	5.5
FED	26.2	20	14.1	-23.8
Total indirect taxes	**256.3**	**272.3**	**29.6**	**6.2**
Direct taxes	124.5	138.8	30.1	11.4
Total tax collection	**380.8**	**411**	**29.7**	**7.9**

Source: Federal Board of Revenue

[7] This is considerably lower than the 27.9 percent growth envisaged for the year as stated in the FY13 budget.
[8] FBR collections, which are over 95 percent of total tax revenues, showed a YoY growth of only 7.9 percent in Q1-FY13, compared with 29.7 percent during the same period last year.
[9] The federal budget for FY13 provides a number of tax relief and incentives (e.g., increase in exemption limit on income tax, reduction in maximum tariff, rationalization of sales tax etc.). This means, achieving the full year target requires FBR to improve tax compliance and to plug leakages.
[10] As a part of strategy to phase out excise duties, the fiscal authorities eliminated FED on 10 items (including base lube oil, lubricating oils, filter rods, and skin care products) in the Federal budget for FY13. It may be noted that the government had already abolished FED on 15 items in FY12 budget.
[11] Tax collection from imports saw a lower growth of 12.0 percent in Q1-FY13 compared to 41.7 percent in Q1-FY12.
[12] The budget for FY13 enhanced the exemption limit from Rs 25,000 to Rs 50,000 for withholding tax on cash withdrawal from commercial banks.

Expenditure

The pressure on expenditures increased during Q1-FY13, as overall spending grew by 23.4 percent, which is significantly higher than 16.9 percent last year (**Table 4.4**). These are some of the key observations relating to the expenditure account:

Table 4.4: Break-up of Expenditures (Jul-Sep)

	Billion Rs		% Growth	
	FY12	**FY13**	**FY12**	**FY13**
Current	**656.6**	**812.4**	**15.9**	**23.7**
Federal	436.4	609.7	4.1	39.7
General public service	292.8	458.7	6.7	56.6
Interest payments	177.3	312.8	9.7	76.5
Pension	27.9	34.3	94.7	22.7
Grants.	47.8	39.0	6.9	-18.4
Other services	39.8	72.5	-26.1	82.3
Defense	107.2	117.4	15.1	9.5
Public orders & safety	14.5	15.3	22.2	5.7
Others	21.9	18.3	-44.7	-16.1
Provincial	220.2	202.6	49.1	-8.0
Development	**87.7**	**74.9**	**39.7**	**-14.6**
PSDP	78.9	68.3	82.9	-13.4
Federal	47.3	30.3	73.7	-35.8
Provincial	31.6	38.0	98.7	20.2
Others dev & net lending	8.8	6.5	-55.3	-25.9
Total	**744.3**	**887.2**	**18.2**	**19.2**
Unidentified expenses	46.6	88.7	-0.6	90.6
Overall expenses	**790.9**	**975.9**	**16.9**	**23.4**

Source: Ministry of Finance

- The increase in current expenditures was mainly due to the rise in federal spending, which grew by 39.7 percent during Q1-FY13, compared to 4.1 percent in Q1-FY12. The acceleration can be traced to substantial interest payments on the country's domestic debt.[13] Indeed, over 50 percent of current spending of Federal government during Q1-FY13 was channelled for interest payments only; this ratio was only 40.2 percent for FY12 (**Figure 4.1**). This rising debt burden is now dominating the government's fiscal accounts.

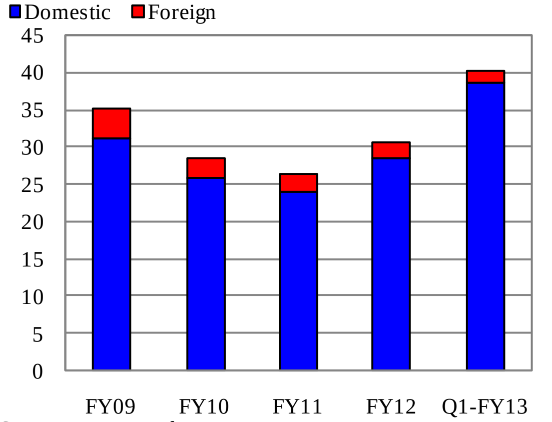
- Overall development spending, on the other hand, fell during the quarter under review. Although the provinces increased their development outlays, this was more than offset by a decline in development spending by the federal government.

- A noteworthy development is the increase in *unidentified* expenses which almost doubled to Rs 88.7 billion during the Q1-FY13, from Rs 46.6 billion in the corresponding quarter of FY12. Theoretically, unidentified expense

[13] The domestic debt of the government has almost doubled from Rs 4.6 trillion at end-June 2010 to Rs 8.1 trillion at end-September 2012.

reflects statistical discrepancies that one could expect in quarterly accounts; but such expenses should remain in a narrow range. The increase in this expense head during the quarter is fairly abnormal.[14]

Figure 4.1: Debt Servicing (% of Current Expenses)



Source: Ministry of Finance

Provincial fiscal operations

A key feature of the provincial accounts is the sharp increase in the combined surplus from just Rs 3.9 billion in Q1-FY12 to Rs 85.4 billion in the first quarter of FY13. This surplus is more than the *full-year* target of Rs 80.0 billion. The combined revenues of the provinces increased by 32.0 percent, which was mainly due to greater transfers from the divisible pool, and better tax mobilization by provinces. Current expenses of the provincial governments, on the other hand, fell by 7.9 percent during the quarter (**Table 4.5**).

Table 4.5: Provincial Fiscal Operations (Jul-Sep)
billion Rs

	Punjab		Sindh		KPK		Balochistan		All provinces	
	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
Total revenue	**120.3**	**159.3**	**68.5**	**103.5**	**45.5**	**51.3**	**33.1**	**38.9**	**267.4**	**353.0**
Share in federal revenue	94.3	128.7	55.2	73.0	33.1	43.3	27.9	32.8	210.5	277.8
Taxes	9.2	10.8	8.9	16.3	0.9	0.9	0.2	0.2	19.2	28.2
Non-taxes	10.4	12.3	0.3	9.2	7.9	1.3	0.3	1.6	18.8	24.4
Federal loan & transfers	6.5	7.6	4.1	5.0	3.6	5.8	4.7	4.3	18.9	22.7
Total expenditure	**117.0**	**105.8**	**77.5**	**66.1**	**42.5**	**49.9**	**18.7**	**22.7**	**255.8**	**244.5**
Current	100.4	87.6	73.8	61.7	32.5	37.9	17.5	19.2	224.1	206.5
Development	16.6	18.2	3.8	4.4	10.1	12.0	1.2	3.4	31.6	38.0
Overall balance	**3.3**	**53.6**	**-9.0**	**37.4**	**3.0**	**1.4**	**14.3**	**16.2**	**11.6**	**108.5**
Financing *	-1.1	-30.5	-0.6	-29.6	10.5	-10.4	-12.8	-15.0	-3.9	-85.4

* Numbers of overall balance and financing do not match due to statistical discrepancies. The financing numbers give actual budgetary position of provinces.

The Punjab government posted the highest surplus of Rs 30.5 billion, largely reflecting the greater transfer from the divisible pool during the quarter, and a

[14] Interestingly, *unidentified* expenses for the full year of FY12 were Rs 69.8 billion.

decline in current spending. Tax efforts by this province, however, will take time to yield results as the newly formed Punjab Revenue Authority faces challenges in capacity building, registering taxpayers, and dealing with inter-provincial issues.[15]

The Sindh government also posted a surplus of Rs 29.6 billion. A reduction in current spending and the doubling of its own tax revenues in Q1-FY13 drove this surplus. Surpluses were also shown by the KPK and Balochistan governments, despite an increase in their expenses during the quarter.

4.2 Total Debt & Liabilities

Continuing fiscal imbalances led to a sharp rise of Rs 535.4 billion in Pakistan's public debt during Q1-FY13, pushing the total stock to Rs 13.5 trillion by end-September 2012 (**Table 4.6**). In line with recent trends, external inflows remained weak, while Treasury bills held by the banking system contributed significantly to the growth in debt.

Table 4.6: Debt Burden (Absolute change)

billion Rs

	June-12	Sep-12	Q1-FY12	Q2-FY12	Q3-FY12	Q4-FY12	Q1-FY13
Total Debt & liabilities	**14,587.0**	**15,148.1**	**341.4**	**439.3**	**439.9**	**836.5**	**561.1**
Total Public Debt	**12,924.3**	**13,459.7**	**268.2**	**734.3**	**296.6**	**634.6**	**535.4**
Total Debt	**13,921.6**	**14,470.8**	**343.5**	**496.0**	**466.4**	**707.5**	**549.1**
A. Domestic - Govt.	7,638.3	8,120.1	207.7	646.4	341.0	431.0	481.9
B. Domestic - PSEs	281.1	296.7	25.2	-306.8	137.2	13.8	15.7
C. External	6,002.3	6,053.9	110.6	156.3	-11.9	262.6	51.6
Total Liabilities	**665.4**	**677.3**	**-2.1**	**-56.7**	**-26.4**	**129.0**	**11.9**
D. Domestic	438.1	447.1	-2.8	-60.9	-29.3	131.6	9.0
E. External	227.3	230.2	0.6	4.2	2.9	-2.5	2.9

Source: State Bank of Pakistan

On a positive note, the maturity profile of the incremental debt improved somewhat over Q1-FY12, as the government was able to mobilize more resources through longer-term instruments (e.g., Sukuk, Pakistan Investment Bonds (PIBs), National Saving Schemes (NSS)). Furthermore, most of the T-bills issued were also of longer duration (e.g., 6-12 months).[16]

[15] The Punjab Revenue Authority Act was passed by provincial assembly on 21st June 2012, and approved by the Governor of the Punjab on 26th June 2012.
[16] During Q1-FY13, government mobilized a total of Rs 270.2 billion through Sukuk, PIBs and Saving Schemes, substantially higher than Rs 89.5 billion during the corresponding quarter of FY12.

The fiscal authorities were also able to replace expensive debt with slightly cheaper debt when they borrowed Rs 564 billion (on cash basis) from commercial banks during Q1-FY13, and retired Rs 412 billion to the central bank.

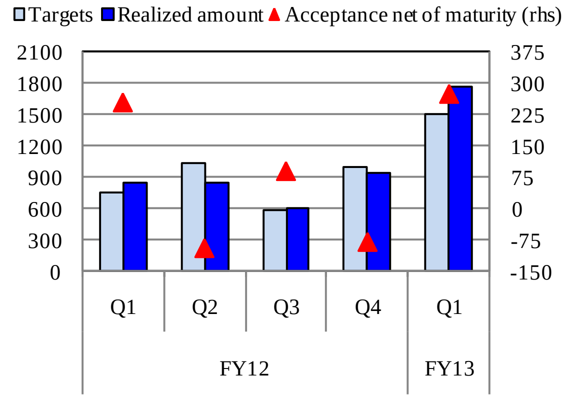
The government continued to face interest payment pressures in Q1-FY13, reflecting the impact of fresh borrowings during FY12. However, the benefits of an improvement in the maturity profile of the country's debt are contingent on the extent of borrowings and the resulting increase in domestic debt during the forthcoming quarters.

Composition of Government Domestic Debt

Floating debt: Continuing the trend observed in FY12, a large share of government borrowing during Q1-FY13 was met through floating debt (i.e., T-bills).

The eagerness of commercial banks to invest in longer term T-bills also allowed the government to retire its debt to the central bank.[17]

Figure 4.2: T-Bills Auction Profile (billion Rs)



Source: State Bank of Pakistan

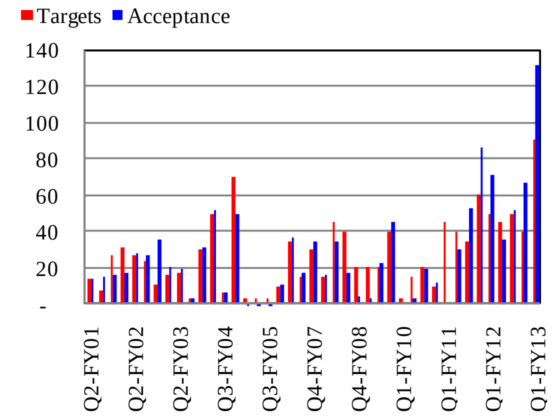
With this focus on shifting the debt away from SBP, the primary auction targets were set at fairly high levels during Q1-FY13. Nevertheless, the bids from commercial banks were well above targets, indicating banks' preference to lend to the government. Hence, the net amount the government raised in the T-bill auctions during Q1-FY13, was 64.8 percent higher than the net amount raised in all of FY12 (**Figure 4.2**).

Following the cut in policy rate during Q1-FY13, banks also shied away from 3-month securities, with the share of 3-months T-bills in the total stock falling from 26.4 percent in end-June 2012, to just 7.1 percent as on end-September 2012.

[17] Resultantly, the stock of debt held by SBP fell to 19.5 percent of the government domestic debt stock at end-September 2012, compared to 23 percent at end-June 2012.

Permanent debt: Expecting further cuts in the policy rate, banks preferred longer-term securities, and the government set PIB auction targets at historically high levels during Q1-FY13 (**Figure 4.3**). Hence, the total amount accepted by the government in PIB auctions during Q1-FY13, was 59 percent of the entire amount raised during FY12.

Figure 4.3: PIB Auctions Profile (billion Rs)

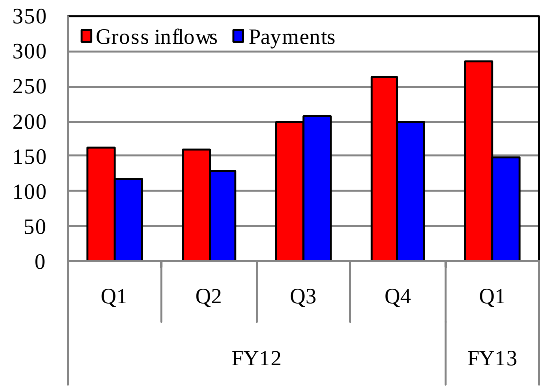


Source: State Bank of Pakistan

In addition, the government also raised Rs 47 billion through Ijara Sukuk bonds during this period. Even here, banks offered a Rs 111 billion, against an auction target of Rs 45 billion. However, as this *sukuk* was the last auction against the asset identified for issuing this debt, the government could not exceed the target by a significant margin. [18]

Unfunded debt: Net inflows into NSS remained strong as in April 2012, the government allowed some institutional investors to participate in these schemes; [19] and rates of return on NSS were increased in April and July 2012, which spilled-over into FY13. Furthermore, as evident from **Figure 4.4**, payments under NSS have tapered off after peaking in Q3-FY12; it may be recalled that the ECC in April 2011, barred institutional investors from investing in NSS, which inflated NSS repayments. However, as

Figure 4.4: NSS Flows (billion Rs)



Source: Central Directorate of National Savings

[18] In December 2011, government decided to raise funds through *sukuk* offering against its asset of M3 highway. So far in the five auctions, the government has raised Rs 233.8 billion against the target of Rs 195 billion.

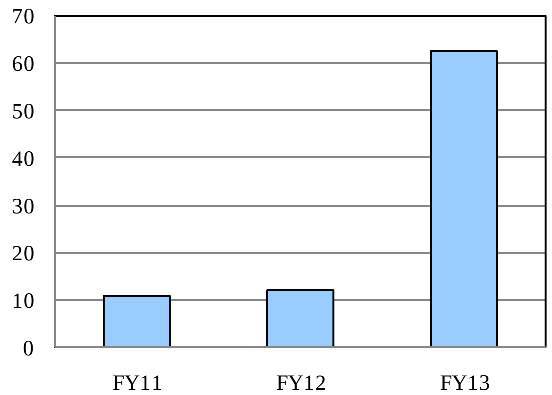
[19] In April 2012, the government allowed institutional investment comprising of individual funds (such as pension, gratuity, superannuation, contributory provident funds and trusts etc.) in NSS.

the bulk of the resulting repayments have already been made, net mobilization by NSS is likely to remain strong in forthcoming quarters.

Interest payment on domestic debt

In line with the growth in Pakistan's debt, interest payments on domestic debt posted a substantial increase during Q1-FY13 (**Figure 4.5**). More specifically, the sharp increase in the stock of T-bills last year, resulted in significant additions in debt servicing payments in Q1-FY13.

Figure 4.5: YoY Growth in Interest Payments on Domestic Debt - Jul-Sep (percent)



Source: State Bank of Pakistan

The recent improvement in the maturity profile of domestic debt, and the cuts in policy rate, may offer some relief to the government.[20] However, given the extent of borrowing and the resulting increase in domestic debt during Q1-FY13, this could be a temporary respite.

[20] According to estimates, a100 bps reduction in the weighted average T-bill rates alone would save around Rs 37 billion in servicing the debt raised during the current fiscal year. Certainly, a larger than the target deficit of 4.7 percent of GDP would eat into this benefit.