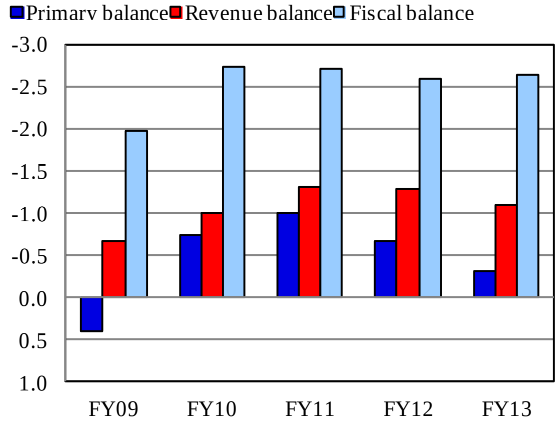
4 Fiscal Policy and Public Debt

4.1 Fiscal Policy

The overall fiscal deficit in H1-FY13 is likely to remain the same (2.6 percent of GDP) as in H1-FY12.[1] However, both the primary and revenue deficits decreased during the period under review, which is largely attributed to CSF receipts of Rs 172 billion, and a surplus of Rs 96.5 billion in provincial budgets (**Figure 4.1**).[2] [3]

Figure 4.1: Fiscal Indicators - H1 (as percent of GDP)



Source: Ministry of Finance

With no further CSF inflows in the pipeline for the rest of the year, and the likelihood that provinces would spend their cash balances in the third quarter, meeting the annual budget deficit target of 4.7 percent of GDP seems very unlikely.

This challenging fiscal situation can be traced to the following factors: (a) the sluggish growth in tax revenues, which grew by only 12.0 percent during the first half of the year, compared with 25.4 percent in H1-FY12 (**Table 4.1**); (b) mounting interest payments on domestic public debt, which increased from Rs 363.5 billion in H1-FY12 to Rs 508.0 billion in H1-FY13; and (c) inappropriate financing mix of the budget deficit with heavy reliance on expensive domestic sources due to drying up of external funds.

During H1-FY13, the entire budget deficit was financed through domestic sources, particularly the banking system, which has implications for inflation and available funding for the private sector. The resource mobilization through non-bank sources declined during this period mainly because institutional investors reduced

[1] The final nominal GDP number for FY13 is likely to be different from the beginning-of-the-year projection put out by the Federal government.
[2] Despite the improvement, the revenue balance is still negative, which is against the revenue surplus requirement in the FRDL.
[3] CSF receipts were $1.12 billion in August 2012, and $0.69 billion in December 2012.

their holdings of treasury bills.[4] Investment in national saving schemes, however, increased significantly in H1-FY13 (see **section 4.2** for detail).

Table 4.1: Summary of Public Finance –H1 (billion Rs.)

	BE FY13	FY12	FY13	% growth FY12	% growth FY13
Total revenue	**3376**	**1135.3**	**1461.8**	**14.7**	**28.8**
Tax revenue	2626	904.6	1012.7	25.4	12.0
Non-tax receipts	750	230.6	449.1	-14.0	94.7
Total expenditure	**4480**	**1667.8**	**2086.5**	**12.7**	**25.1**
Current	3430	1399.2	1721.7	14.1	23.1
Development	1050	231.0	277.8	11.1	20.3
Unidentified		*37.6*	*87.0*	*-17.1*	*131.3*
Overall deficit	**1105**	**532.5**	**624.7**	**8.6**	**17.3**
Financing through:					
External resources	135	34.0	-1.4		
Internal resources	971	498.5	626.1		
Banking system	484	302.0	557.9		
Non-bank	487	196.5	68.1		
As % of GDP					
Overall fiscal deficit	4.7	2.6	2.6		
Revenue deficit	0.2	1.3	1.1		
Primary deficit	0.8	0.7	0.3		

Note: The overall, revenue and primary deficits in H1-FY12 become 4.5 percent, 3.0 percent and 2.5 percent when Rs. 391 paid for PSEs debt consolidation in November 2011 are included

Source: Ministry of Finance

Revenue

Although total revenue collection grew by 28.8 percent in H1-FY13, the growth in tax collection was only 12.0 percent. The major reason for this was the slowdown in federal tax revenue collection, which grew by just 8.6 percent in H1-FY13, compared to 25.0 percent in the corresponding period of last year (**Table 4.2**). Even this growth was supported primarily by the receipts from the Petroleum Development Levy, as the growth in FBR tax collection was even lower. Provisional numbers for FBR taxes show a growth of only 5.7 percent in H1-FY13, compared with 27.1 percent last year. Under these circumstances, achieving the end-year tax collection target (of Rs 2,381 billion) will be a formidable task for FBR.[5]

This task will be even more challenging given the slowdown in sales tax and direct tax collections. Sales tax, which is the single largest source of revenue for the government, grew by only 1.7 percent in H1-FY13, compared with 36.0 percent in the corresponding period last year. Apart from the inability to introduce a broad-based value added tax, tax collection was undermined by the number of exemptions granted to various industries; tax evasion, and fake claims for refunds

[4] With falling interest rates on treasury bills, the equity market has become an attractive alternate. Moreover, some banks had been routing investments through mutual funds, because the tax rate on mutual funds was significantly lower than that on banks' income. However, with the reduction of the gap between the two tax rates in FY13 budget, banks now have little incentive to channel their money through mutual funds.

[5] FBR has recently revised its target downward to Rs 2,191 billion; however, achieving this target may also be challenging.

and rebates. Surprisingly, FBR has recently cut tax rates on certain products (including beverages, cement, and sugar), which have been important sources of revenue in the past; it also removed the 1 percent withholding tax on manufacturing entities, further affecting overall tax collection. Moreover, sluggish growth in the domestic production of sugar, consumer electronics, auto products, and a fall in imports, have adversely impacted revenue collection of the Federal government. One must also realize that FBR no longer collects sales tax on services, which has been devolved down to the provincial governments (Sindh started in FY12, and Punjab launched it in FY13).

Table 4.2: Tax and Non-tax Revenues – H1

	Rs billion		% growth	
	FY12	FY13	FY12	FY13
Tax Revenue	**904.6**	**1,012.7**	**25.4**	**12.0**
Direct Taxes	312.9	331.3	30.9	5.9
Taxes on goods & services	439.3	446.0	29.3	1.5
Excise duty	53.7	53.8	-4.5	0.2
Sales Tax	385.7	392.2	36.0	1.7
Taxes on international trade	94.2	108.0	17.0	14.6
Other taxes	37.9	69.8	41.3	84.4
Petroleum Levy	20.3	57.6	-42.7	183.8
Nontax Revenue	**230.6**	**449.1**	**-14.0**	**94.7**
Interest and dividends	24.0	26.4	6.6	10.1
SBP profits	104.0	100.0	30.0	-3.8
Defence	4.6	176.8	-93.1	3,715.6
Dev. surcharge on Gas	8.9	7.6	-48.5	-15.3
Royalties	26.4	29.8	-0.7	12.8
Miscellaneous	62.7	108.6	14.7	73.2
Total Revenue	**1,135.3**	**1,461.8**	**14.7**	**28.8**
Memorandum				
Federal Taxes	867.4	942.0	25.0	8.6
Provincial taxes	37.2	70.7	33.9	89.7

Source: Ministry of Finance

The other important source of revenue collection is direct tax. Growth in direct tax collection declined from 30.9 percent in H1-FY12 to 5.9 percent in the same period this year because: (a) FBR could not bring more people into the tax net; (b) income tax brackets were rationalized to benefit small taxpayers; and (c) the taxable limit on cash withdrawals from banks, was doubled to Rs 50,000.

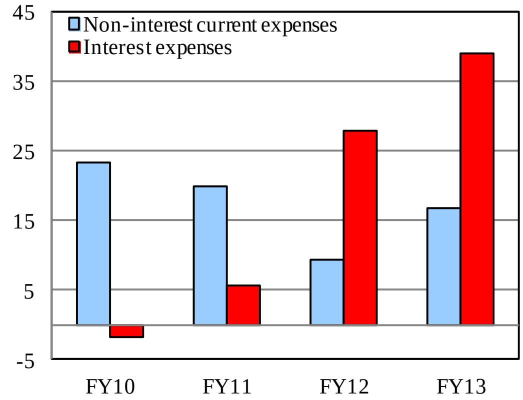
As a result, there was a shortfall of about Rs 154 billion in tax collection during the first half of the year.[6] However, this shortfall was more than offset by non-tax revenues mainly due to the receipt of Coalition Support Funds.

[6] As per seasonal trend 44.4 percent of annual tax revenues are usually collected in the first half of a year; however, this year tax collection was 38.6 percent of the target.

Expenditure

The persistent budget deficit during the past several years, coupled with deficit financing from expensive domestic sources, has resulted in a sharp rise in interest expenses (**Figure 4.2**). Domestic interest payments have increased from 22.2 percent of the current expenditure in H1-FY11 to 26.0 percent in H1-FY12 and then to 29.5 percent in H1-FY13. This rise signals the growing unsustainability of the fiscal account, with the increased risk of entering a debt-deficit spiral.

Figure 4.2: Componants of Current Expenditures - H1
(% growth)



Source: Ministry of Finance

The other major fiscal outflow is subsidies to loss-making PSEs and the power sector. The fiscal authorities envisaged a total subsidy bill of Rs 208.6 billion in the FY13 budget, but about 80 percent of this amount has already been spent in the first half of the fiscal year. Absence of decisive reforms in PSEs, the persistent circular debt in the power sector and outstanding receivables under commodity financing, will necessitate further subsidy payments. It thus appears likely that total subsidies will significantly exceed the budgeted amount once again.

Table 4.3: Break-up of Expenditures – H1

	Rs billion		% growth	
	FY12	FY13	FY12	FY13
Current	**1399.2**	**1721.7**	**14.1**	**23.1**
Federal	948.2	1253.3	8.3	32.2
General public service	630.7	919.4	13.9	45.8
Interest payments	397.2	552.6	28.0	39.1
Pension	63.8	74.1	52.4	16.1
Grants.	82.7	94.6	-28.4	14.4
Other services	87.1	198.2	1.0	127.5
Defense	243.3	256.6	13.2	5.5
Public orders & safety	31.6	33.5	19.6	6.2
Others	42.7	43.8	-47.1	2.7
Provincial	451.0	468.4	28.5	3.9
Development	**231.0**	**277.8**	**11.1**	**20.3**
PSDP	206.7	251.5	65.6	21.7
Federal	117.3	129.0	75.8	10.0
Provincial	89.4	122.5	53.8	36.9
Others dev & net lending	24.3	26.3	-70.8	8.3
Unidentified	**37.6**	**87.0**	**-17.1**	**131.3**
Total	**1667.8**	**2086.5**	**12.7**	**25.1**

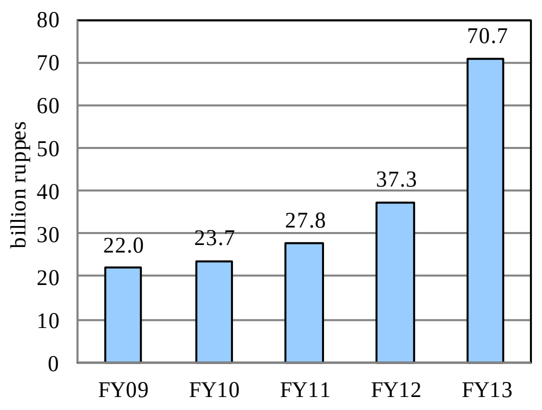
Source: Ministry of Finance

Expenditures like pension payments, defense, and PSDP remained under control; however the sharp increase in unidentified expenditures is another cause for concern (**Table 4.3**). The compilers of Pakistani fiscal accounts were unable to identify the Rs 87.0 billion in H1-FY13, which makes a thorough analysis of fiscal outlays rather difficult.

Provincial fiscal operations

Provincial resource mobilization during the first six months of the current year resulted in sharp growth in their tax revenues, increasing by 89.7 percent to Rs 70.7 billion in H1-FY13 (**Figure 4.3**). As mentioned earlier, part of this growth came from the collection of sales tax on services by Punjab and Sindh, which was earlier mobilized by FBR. Although it was a new tax for both provinces, the growth in tax collection by them (110.1 and 79.0 percent, respectively) shows that provinces are perhaps better placed to mobilize this type of tax, as compared to FBR.

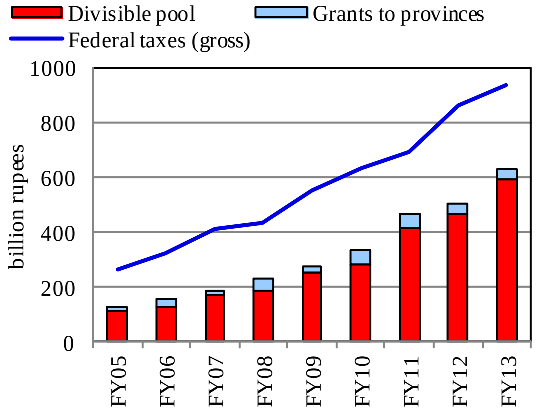
Figure 4.3: Provincial Tax Collection



Source: Ministry of Finance

Provinces also received higher amount of funds in H1-FY13 from the federal government as their share from divisible pool plus additional grants (**Figure 4.4**).[7] Thus their overall revenues grew by an impressive 30.2 percent in the first half of the year, compared with 10.0 percent during the corresponding period last year.

Figure 4.4: Federal transfers to Provinces -H1



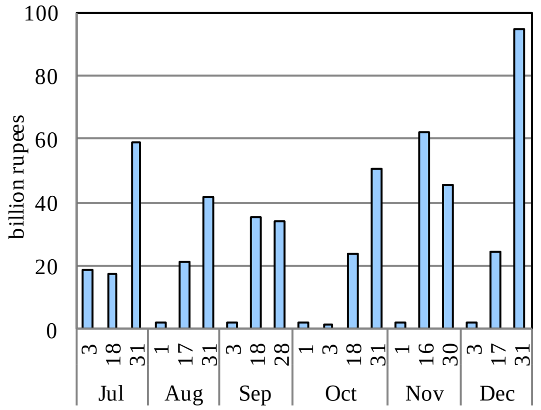
Source: Ministry of Finance

Interestingly, despite the high growth in revenue, provincial

[7] Interestingly, transfers to provinces from divisible pool in H1-FY13 were 27.1 percent higher than that in H1-FY12 despite low growth in FBR taxes. These transfers also include some arrears from the previous year.

expenditures did not increase in step. Growth in total expenditures by provinces was only 9.2 percent in H1-FY13, compared with 31.4 percent last year. The growth in both current and development expenditures were considerably lower in the period under review.

Figure 4.5: Date-wise Federal Transfers to Provinces - H1



Source: State Bank of Pakistan

As a result, provinces showed a surplus of Rs 96.5 billion by the end of H1-FY13 (**Table 4.4**). However, from the pattern of federal transfers to provinces we can infer that they had a balanced budget until 30th December 2012. [8] On 31st December 2012 they received Rs 94.8 billion which is almost equal to their surplus recorded for H1-FY13 (**Figure 4.5, Table 4.5**).

[8] Provinces had a surplus of Rs 85.4 billion in Q1-FY13. It appears that they had a deficit of almost the same amount until second last day of Q2-FY13.

Table 4.4: Provincial Fiscal Operations – H1 (billion Rs.)

	All provinces	Punjab	Sindh	KPK	Balochistan
FY13					
Total revenue	740.9	340.4	213.9	112.4	74.2
Share in federal revenue	592.2	278.6	154.1	96.4	63.2
Taxes	70.7	36.0	32.3	1.9	0.5
Non-taxes	34.5	16.8	13.6	2.2	1.9
Federal loans and transfers	43.5	9.0	13.9	11.9	8.7
Total expenditure	598.6	274.1	168.3	100.5	55.7
Current	476.1	218.7	139.1	75.4	43.0
Development	122.5	55.3	29.3	25.1	12.7
Overall balance	142.3	66.4	45.6	11.9	18.5
Financing *	-96.5	-39.6	-20.5	-14.2	-22.1
FY12					
Total revenue	568.9	248.6	158.8	97.6	64.1
Share in federal revenue	466.0	214.6	124.2	74.6	52.7
Taxes	37.3	17.2	18.1	1.6	0.5
Non-taxes	23.8	13.6	2.9	6.7	0.6
Federal loans and transfers	41.9	3.2	13.6	14.7	10.4
Total expenditure	548.4	256.8	154.6	87.4	49.5
Current	458.9	207.7	144.0	66.0	41.3
Development	89.4	49.1	10.6	21.5	8.3
Overall balance	20.6	-8.2	4.1	10.1	14.5
Financing *	-11.8	9.1	-11.6	3.8	-13.1

* Numbers of overall balance and financing do not match due to statistical discrepancies.

Source: Ministry of Finance

Table 4.5: Transfers of Funds in Provincial Accounts with SBP

(Billion Rupees)

Punjab		**Sindh**		**KPK**		**Balochistan**	
Fund transfer date	Amount	Fund transfer date	Amount	Fund transfer date	Amount	Fund transfer date	Amount
Q1	**98**	**Q1**	**65.6**	**Q1**	**45**	**Q1**	**23.1**
03.07.2012	10.3	03.07.2012	5	03.07.2012	3.3	18.07.2012	1.4
18.07.2012	8.2	18.07.2012	4.7	18.07.2012	2.9	30.07.2012	3.7
31.07.2012	29.7	31.07.2012	16.1	31.07.2012	9.5	17.08.2012	1.7
17.08.2012	11	17.08.2012	5	01.08.2012	2.1	31.08.2012	7.5
31.08.2012	17.8	31.08.2012	9.9	17.08.2012	3.4	17.09.2012	1.1
17.09.2012	21	18.09.2012	7.5	31.08.2012	6.5	28.09.2012	7.7
		28.09.2012	17.3	03.09.2012	2.1		
				18.09.2012	6		
				28.09.2012	9.4		
				Q2	**57.2**		
				01.10.2012	2.1		
Q2	**144.6**			18.10.2012	3.9		
03.10.2012	1.7	**Q2**	**79.3**	31.10.2012	8.5	**Q2**	**29.2**
17.10.2012	11.7	18.10.2012	6.4	01.11.2012	2.1	18.10.2012	2
31.10.2012	21.9	31.10.2012	12.8	16.11.2012	11.4	31.10.2012	7.4
16.11.2012	31.9	16.11.2012	16.7	30.11.2012	7.2	16.11.2012	2.5
30.11.2012	20.3	30.11.2012	11.2	03.12.2012	2.1	30.11.2012	7.1
17.12.2012	12.2	17.12.2012	6.7	17.12.2012	3.6	17.12.2012	2
31.12.2012	44.9	31.12.2012	25.4	31.12.2012	6.3	31.12.2012	8.1
Total (Jul-Dec)	**242.6**		**144.9**		**102.2**		**52.3**

Source: State Bank of Pakistan

4.2 Total Debt & Liabilities

Pakistan's public debt increased by Rs 108.7 billion during Q2-FY13, reaching Rs 13.6 trillion as of end-December 2012. The pace of accumulation in Q2 was, slower compared to Q1-FY13, when the debt had increased by Rs 535.4 billion (**Table 4.6**). The data shows that the domestic debt created during the first quarter of FY13, was greater than the federal government's financing requirements for the period. In Q2-FY13 therefore, the government opted to finance part of its needs by drawing down its bank deposits, which reduced the need for fresh borrowing.[9]

Table 4.6: Debt Burden

billion Rs

	End Period Stock		Change in FY13	
	Jun-12	Dec-12	Q1	Q2
Total Debt & liabilities	**14,587**	**15,235**	**561**	**87**
Public Debt	**12,924**	**13,568**	**535**	**109**
Total Debt	**13,922**	**14,600**	**549**	**129**
A. Domestic - government	7,638	8,329	482	209
B. Domestic - PSEs	281	322	16	25
C. External	6,002	5,949	52	-105
Total Liabilities	**665**	**635**	**12**	**-42**
D. Domestic	438	400	9	-47
E. External	227	236	3	5

Source: State Bank of Pakistan

In the case of Pakistan's external debt, repayment of IMF loan and the absence of fresh disbursements, led to a US$ 2.2 billion decline in *external debt & liabilities* during H1-FY13.[10]

Nevertheless, both debt repayment capacity indicators deteriorated during the period under review, on account of heavy interest payments on domestic debt and sluggish foreign exchange earnings. [11]

[9] The extent of fiscal deficit i.e., Rs 340.8 billion, during Q2-FY13, was much larger than the rise in domestic debt stock (Rs 208.6 billion) during this period, as the government resorted to the use of its deposits with the central bank instead of raising funds through borrowing. Government deposits with the central bank inflated after receiving a significant CSF payment of around 106 billion in Q1-FY13 along with the large amount of debt raised from commercial banks. The availability of this amount reduced government's borrowing requirements during the second quarter of FY13.

[10] The Rupee value of the fall in external indebtedness was, however, a bit muted due to 2.6 percent depreciation in the value of Rupee vs. US Dollar on end-December 2012 compared to end-June 2012.

[11] For domestic debt sustainability, federal tax revenue to domestic debt servicing and for external debt sustainability, external debt servicing to foreign exchange earnings ratios are used.

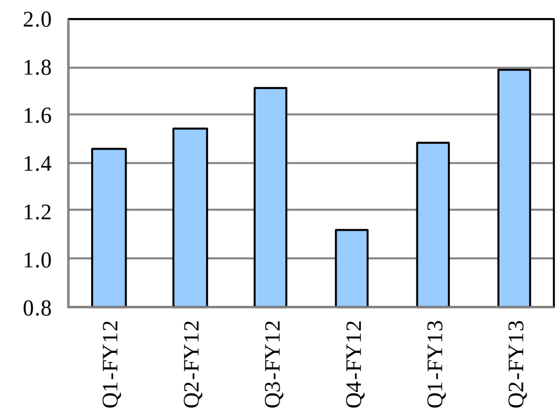
Composition of domestic debt

Within domestic debt, the improvement in maturity profile observed in Q1-FY13, continued during the Q2-FY13 as well. [12]

Floating Debt

In addition to 1.5 trillion T-bill maturities in Q1-FY13, another Rs 1.1 trillion fell due during the second quarter of FY13.[13] As reflected from rising offer-to-target ratio, although banks were keen to invest in T-bills during Q2-FY13 as well, federal government perhaps anticipating further fall in interest rates opted to finance its deficit from relatively cheaper sources such as drawing down its deposits and borrowing from SBP (**Figure 4.6**). Resultantly, the net of maturity acceptance of T-bills stood at negative 64 billion during Q2-FY13, compared to Rs 276.4 billion raised during Q1-FY13.

Figure 4.6: Offer-to-Target Ratio in T-bills

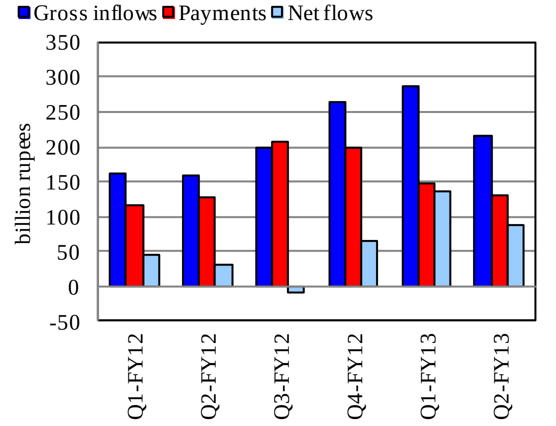


Source: State Bank of Pakistan

Unfunded debt

Net inflows via NSS remained strong during Q2-FY13 compared to the same period last year. The impact of selective resumption of institutional investment that was allowed in April 2012, appears to have peaked in Q1-FY13 (**Figure 4.7**). Furthermore, NSS repayments have declined after peaking in Q3-FY12, a possible reflection

Figure 4.7: NSS Flows



Source: State Bank of Pakistan

[12] The share of floating debt in domestic debt recorded 0.6 percentage point reduction in end-December 2012, compared to the same period last year.

[13] Specifically, the maturity of 12-m T-bills worth Rs 195 billion, raised for the settlement of circular debt, fell due in this period.

of the ECC decision (in April 2011) to ban institutional investment in NSS schemes.

Permanent debt

During Q2-FY13, mobilization through permanent debt witnessed a sharp fall, as the government raised only Rs 62.9 billion compared to Rs 130.5 billion in the previous quarter. This was the first time in last six consecutive quarters that total amount accepted in PIB auctions fell short of target. On one hand, banks that already had exposure of Rs 1.1 trillion in PIBs as on end September 2012 were reluctant to increase their exposure, while on the other, government was also not interested in the borrowing through long term instrument at higher rates in the presence of cheaper avenues .[14] [15]

Interest payments on domestic debt

Interest payments on domestic debt recorded a significant 42.4 percent YoY increase during H1-FY13.[16] A part of this increase was on account of payments on 12 m T-bills (**Table 4.7**).[17]

However, federal tax revenues (adjusted for transfers to provinces), which is a determinant of the domestic debt servicing capacity, could not keep pace with the rising interest payments during H1-FY13, indicating an erosion in the debt sustainability of the country (**Table 4.7**).

Table 4.7: Interest Payments on Domestic Debt -H1

billion Rupees

	FY12	FY13	Abs Δ
Permanent	**48.0**	**78.7**	**30.7**
Floating	**176.6**	**286.1**	**109.5**
Treasury Bills (Auctioned)	**93.6**	**196.1**	**102.4**
3-months	7.1	22.6	15.5
6-months	76.5	24.7	-51.8
12-months	10.1	148.8	138.8
MRTBs	**83.0**	**90.1**	**7.1**
Unfunded	**114.7**	**121.0**	**6.3**
Total Interest Payment*	**351.4**	**500.2**	**148.8**
Memorandum items:			
Domestic debt interest payment/Federal tax revenues (after transfer to provinces)	87.6	143.0	

*See footnote 16 explaining difference between SBP and MoF data.

Source: State Bank of Pakistan

[14] The offer-to-target ratio declined from 2.9 times in Q1-FY13 to 1.6 times in Q2-FY13.

[15] Against a target of Rs 90 billion, government raised Rs 62.9 billion in PIB auctions during Q2-FY13.

[16] These numbers do not match with the amount of interest payments reported in Section 4.1. Since, MoF takes actual interest paid on T-bills during the year, while SBP calculates interest payment on accrual basis.

[17] This was expected in view of the substantial investment that went into 12 m T-bills during H1-FY12

As regards the impact of incremental borrowing during FY13, around 45 percent of the entire T-bills stock as on end-December 2012 was 12-m securities with repayments falling due in FY14; this suggests a slight relief in debt servicing during the second half of FY13.

External Debt

Encouragingly, the stock of Pakistan's *external debt & liabilities* continued to decline further, falling by US$ 2.2 billion during H1-FY13 (**Table 4.8**). This is largely because of repayment to IMF.

Table 4.8: External Debt & Liabilities

million US$

	End-Jun 2012	End-Dec 2012	Change
Total External Debt & Liabilities	**65,833.5**	**63,662.5**	**-2,171.0**
Government External Debt	46,123.1	45,351.2	-771.9
Debt from IMF	7,337	6,164.4	-1,172.6
External Liabilities	2,402.2	2,424.6	22.4
Private Sector External Debt	6,346.9	5,873.3	-473.7
PSEs External Debt	1,523.9	1,775.6	251.7
Intercompany debt	2,100.30	2,073.30	-27.0
Memorandum items:			
DS/FEE*	9.0	12.0	
WoM**	19.9	18.1	

*: External debt servicing/foreign exchange earnings, wom: reserves week of imports

Source: State Bank of Pakistan

Despite the decline in external debt stock, Pakistan's external vulnerability increased compared to end-June. Specifically, external debt servicing to foreign exchange earnings deteriorated from 9.0 percent in Jun- 2012, to 12.0 percent in Dec-2012 (**Table 4.8**). Furthermore, import coverage as measured in terms of weeks of imports also fell from 19.9 weeks as of end-June 2012, to 18.1 weeks as of end-December 2012.