

4 Fiscal Policy and Public Debt

4.1 Fiscal Policy

The target for FY13 fiscal deficit was set at 4.7 percent of GDP by the Ministry of Finance (MoF), which included Rs 80 billion consolidated provincial surplus. Given that actual fiscal deficit for the previous five years averaged 6.8 percent (and for FY12 it was 8.5 percent), the target for FY13 was ambitious (**Figure 4.1**). A large part of the improvement needed was to be achieved by increasing the FBR tax collection, which was targeted to grow by 26.4 percent during FY13. On the expenditure side, the government planned to reduce subsidies by Rs 300 billion compared to the previous year.

Unfortunately, many of the tax proposals to increase revenue could not be implemented. In addition to a slowdown in formal economic activity, the frequent changes in FBR management during Jul-Mar FY13 also hampered the efficiency of this tax collecting authority. As a result, growth in tax collection during the first three quarters of FY13 was lower than the average of the

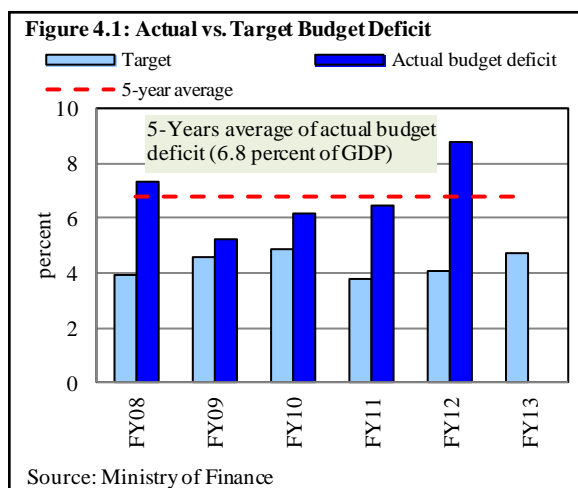


Table 4.1: Summary of Public Finance
billion Rupees

	FY13 BE	Jul-Mar		Growth
		FY12	FY13	
Total revenue	3,387.6	1,739.4	2,124.9	22.2
Tax revenue	2,626	1,371.6	1,527.8	11.4
Non-tax receipts	750	367.9	597.0	62.3
Total expenditure	4,480	2,634.3	3,171.1	20.4
Current	3,430	2,154.1	2,642.0	22.7
Development & net lending	1,050	428.0	445.8	4.2
Unidentified	-	52.2	83.3	59.4
Overall deficit	1,105	894.9	1,046.2	16.9
<i>Financing through:</i>				
External resources	135	47.4	-4.1	-108.7
Internal resources	971	847.5	1,050.3	23.9
Banking system	484	443.8	856.7	93.0
Non-bank	487	403.7	193.7	-52.0
<i>As % of GDP</i>				
Overall fiscal deficit	4.7	4.5	4.6	
Primary deficit	0.8	1.3	1.2	

Source: Ministry of Finance

last ten years, registering a mere 11.4 percent YoY increase. On the other hand, subsidies paid as of end Mar FY13, were also well over what had been budgeted for the full year. As a result, the reported fiscal deficit for the first three quarters of FY13 again touched the last year level (which was 4.5 percent of GDP). In fact the availability of Rs 172 billion on account of Coalition Support Fund has contained the deficit to some extent.

However, as no further CSF flows are expected in remaining part of FY13, and both revenue and expenditure are deviating significantly from their targets, the budget deficit target for the full year is likely to be missed by a large margin.

Data on government expenditures for Q3-FY13 show an increase of 20.4 over the same period last year (**Table 4.2**).¹ The pattern of government expenditures is similar to the previous year – power subsidies and debt servicing account for more than half of Federal Government expenditures.

Development spending by the provinces posted a sharp increase during Jul-Mar FY13. The highest increase of 75.0 percent was recorded by Sindh, followed by Punjab with a 12.2 percent increase. Compared to the provinces, development expenditures by the Federal Government posted a decline.

Table 4.2: Break-up of Expenditures

billion Rupees

	Jul-Mar		%
	FY12	FY13	growth
Current (a+b)	2,154.1	2,642.0	22.6
a. Federal	1,478.7	1,887.1	27.6
Interest payments	624.5	772.0	23.6
Subsidies	103*	270.0	162.1
Non-interest, non-subsidy	751.2	844.9	12.5
o/w defense	348.0	405.8	16.6
b. Provincial	675.4	754.9	11.8
Development	428.0	445.8	4.2
PSDP	375.6	407.4	8.5
Federal	200.6	187.5	-6.5
Provincial	175.0	219.9	25.7
Others dev & net lending	52.3	38.4	-26.6
Unidentified	52.2	83.3	59.6
Total expenditure*	2,634.3	3,171.1	20.4

*Excluding Rs 391 billion debt consolidation in FY12

Source: Ministry of Finance

¹ Adjusting for one off debt consolidation of Rs 391 billion in FY12, growth in expenditures, however, falls to 4.8 percent.

Financing

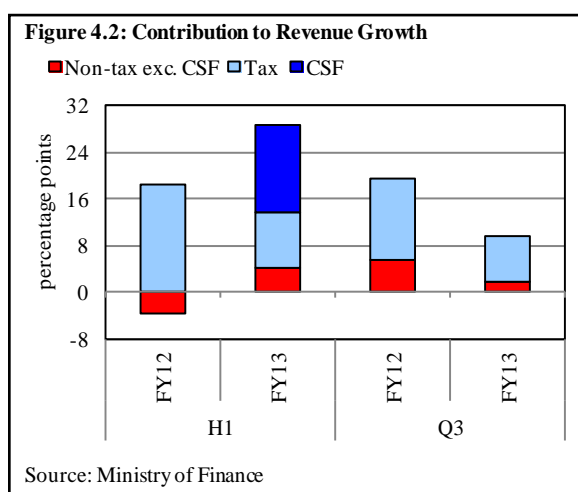
Lack of external financing shifted the entire burden of funding the fiscal deficit on domestic sources during Jul-Mar FY13.² Thus, in order to meet its budgetary requirements, the government had to borrow Rs 856.7 billion from the banking system during this period – more than double the same period last year.^{3,4}

In addition to the banking system, government also borrowed Rs 193.7 billion from non-bank sources, mainly NSS during Jul-Mar FY13, compared to Rs 403.7 billion in the corresponding period last year.

4.2 Revenues

Due to the absence of coalition support funds (CSF) in Q3-FY13, revenue growth slowed substantially to 9.7 percent against 28.8 percent in H1-FY13 (**Figure 4.2**).

With FBR facing difficulties in achieving its collection target, the combined share of non-FBR duties and levies on energy grew to 10.1 percent of total revenues, up from 6.7 percent last year.⁵ The government increased duties and charges (on various heads) and imposed a levy on LPG in Q3-FY13.⁶



FBR Revenues

Although authorities set an ambitious growth target of 26.4 percent in tax revenues for FY13, realized growth of 5.0 percent in net tax collection during Jul-

² Net external financing for Jul-Mar FY13 was Rs -4.1 billion.

³ Including Rs 391.0 billion of one time debt consolidation government borrowed Rs 932.8 billion from the banking system during Jul-Mar FY12.

⁴ Government borrowing numbers may differ from those given in **Chapter 3**; see **Annexure A** for explanation.

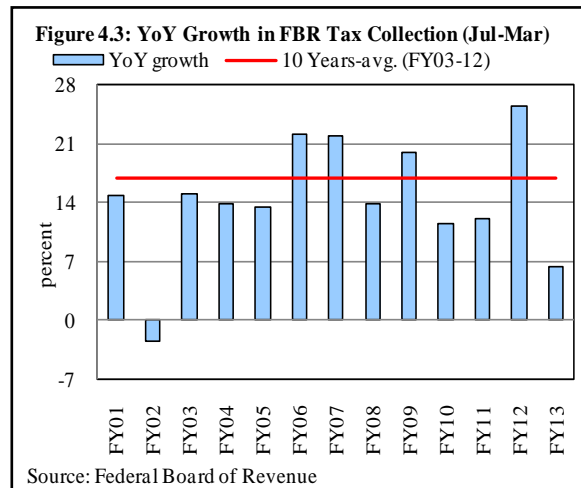
⁵ These revenue sources include: Gas Infrastructure Development Cess; Petroleum Development Levy (PDL), discount retained on crude price, development surcharge on gas, royalties on oil and gas, windfall levy against crude oil, and petroleum levy on LPG.

⁶ The rates of GIDC were increased in September 2012. The rate on PDL were doubled in September 2012 (PDL was reduced in March 2013, but was again increased by an average 25 percent in May 2013). PDL on LPG was imposed in February 2013.

Mar FY13 was the lowest since FY02 (**Figure 4.3**). Specifically against the revised target of Rs 2,043.4 billion, FBR could collect only Rs 1,335.2 billion up to end March 2013, i.e., 65.6 percent of the revised target.

In disaggregated terms while FED collection registered a nominal decline, growth in all other categories declined, with the slowdown in sales tax having a prominent contribution (**Table 4.3**).

This shortfall in FBR collection contributed significantly to the overall fiscal deficit in FY13, making revenue collection one of the most pressing fiscal issues.



In spirit, FY13 was a year of positive tax reforms, targeting four broad issues:

Table 4.3: Summary of FBR Revenue Collection (billion Rupees)

billion Rupees

Type of tax	Jul-Mar Collection			Annual Target			% of Target Reached		
	FY11	FY12	FY13	FY13			FY13		
				FY12	Budget	Revised	FY12	Budget	Revised
Direct	374.2	469.6	491.3	744	932	758	63.1	52.7	64.8
Sales	426.6	570.2	594.7	837	1,077	904	68.1	55.2	65.8
FED	89.5	84.8	78.8	166	125	131	51.1	63.1	60.2
Custom duty	128.6	148.3	170.5	206	248	250	72.0	68.7	68.2
Total	1,017	1,272	1,335.2	1,952	2,381	2,043	65.2	56.1	65.4

Source: Ministry of Finance

- 1) The income tax rate was made more progressive and the turnover tax rate was reduced from 1 percent to 0.5 percent. The resulting revenue deficit was expected to be offset by increase in the tax base. The proposed Amnesty Bill was a key measure in this regard.⁷

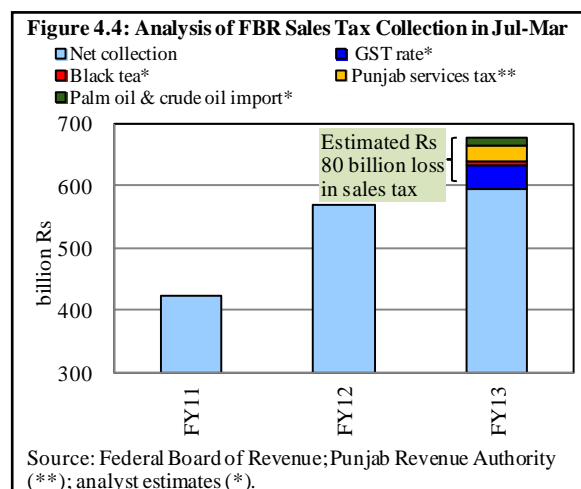
⁷ The Bill guaranteed no further investigation or legal action to tax evaders who wished to register with FBR. It envisaged bringing 3.1 million more taxpayers into the tax net and generating additional revenue of Rs 150 billion. The Bill was tabled in the National Assembly in December 2012, but was not passed.

- 2) The rate of sales tax was brought down from 17 to 16 percent. The resulting loss was expected to be compensated by bringing more commercial agents into the tax net.
- 3) Sales tax on black tea – a major commodity smuggled via the Afghan Transit Trade (ATT) route – was lowered from 16 to 5 percent. Tax rebates on palm oil and petroleum exports via the ATT were disallowed in Q3-FY12, to discourage sales tax evasion.⁸
- 4) In pursuance of having a uniform tax rate by reduction/elimination of FEDs; it was proposed to remove zero-rating on some products; and where fixed value estimates were used for sales tax calculation (fertilizer and steel), these were made variable.⁹

However, when it came to execution, these reforms failed to deliver. In the case of direct taxes, the biggest set back was the non-passage of the Amnesty Bill which aimed to bring more taxpayers in the net. On the other hand, withholding taxes, which comprise 60 percent of total direct tax collection, were lowered in response to pressure from industrial lobbies. Furthermore, the 0.5 percent withholding tax on the manufacturing sector was exempted in December 2012, while in February 2013, withholding tax on raw material imports (ranging from 1-3 percent) was eliminated.

The slowdown in sales tax can be traced to both policy and external factors (**Figure 4.4**). This included: (i) lowering of GST rate by 1 percentage point; (ii) tax concession on black tea;¹⁰

(iii) shifting of tax collection on 17 services (including telecom) to Punjab Revenue Authority (PRA), leading to a federal revenue loss of Rs. 28.3 billion in



⁸ Vide SROs 136(1)/2012 and 137(1)/2012. Technically, these SROs were issued in February FY12. However, the impact was greater in FY13 due to base effect.

⁹ Vide SROs 594(1)/2012 and 596(1)/2012.

¹⁰ Full 16 percent general sales tax was resumed on black tea in end-Feb 2013.

the first nine months of this fiscal year;¹¹ and (iv) a failed tax registration drive (instead of increasing registration of taxpayers, it resulted in protests against the stricter tax rules). As a result of lobbying, the requirement of CNIC for allowing rebates was withdrawn in Q1-FY13,¹² while in March 2013, zero-rating on textile exports (which was limited to registered taxpayers), was extended to include unregistered persons as well.¹³

Import-related sales taxes were driven down by a series of factors.¹⁴ One, remeltable steel scrap and wastepaper (input for paper and board industry) were given sales tax exemption on imports. Two, petroleum import mix shifted towards crude oil, which is zero-rated. Although both locally manufactured and imported POL products are equally taxed, rebates are allowed on local products, which eat into net revenue collection. And three, revenue from palm oil imports declined, during Jul-Mar FY13, due to a drop in (rupee) import prices.

Table 4.4: Revenue Generated by Income Tax Amnesty Schemes in Pakistan

Revenues are in billion Rupees, share in percent

Year	Revenue generated	Share in total revenue
FY58	0.0013	0.1
FY69	0.92	12
FY76	1.5	7.8
FY00	10	2.0
FY09	2.5	0.1
FY13*	150	4.4

*Proposed scheme.

Source: Ministry of Finance (revenues); Pakistan Economist, Feb 21-27, 2000 (FY58-FY76 schemes); Dawn newspaper, Dec 24, 2012 (FY00 and FY09 schemes)

Nevertheless, some positive efforts from the revenue authorities (particularly in the third quarter), brought some relief. These include: resumption of full sales tax on black tea;¹⁵ imposition of sales tax on textile sector from the spinning stage onwards;¹⁶ a rise in sales tax on tractors from 5 percent to 10 percent;¹⁷ and an amnesty schemes for sales tax defaulters on smuggled vehicles.¹⁸ According to media reports, the two amnesty schemes had a marginal revenue impact: only Rs 2

¹¹ The FBR tax collection target for FY13 had already been adjusted for sales tax on services in Sindh. In overall terms however, shifting of tax collection to provinces will have no impact on total government revenues.

¹² Vide SRO 880(1)/2012.

¹³ Vide SRO 221(1)/2013.

¹⁴ Import-related sales tax – 50 percent of the total sales tax collection – grew by 0.6 percent YoY during Jul-Mar FY13, compared to 47.6 percent growth in the same period last year.

¹⁵ Vide SRO 153(1)/2013.

¹⁶ Vide SRO 154(1)/2013.

¹⁷ Vide SRO 70(1)/2012.

¹⁸ Vide SRO 179(1)/2013 and SRO 172(1)/2013.

billion revenues were generated by the textile amnesty scheme, while custom duty on over 50,000 vehicles was collected as opposed to expected 100,000 to 150,000.

Amnesties are not uncommon in Pakistan. In the past, the government has granted several amnesties in the form of exemption from penalties and prosecution to sales and income tax evaders. However, arguably, Income Tax Amnesty Bill of 2012 (unsuccessfully tabled in the National Assembly in December 2012), was the most significant legislative effort in this regard. The scheme could have reportedly generated Rs. 150 billion revenue with the addition of 3.1 million tax filers; in these terms, this would have been the most significant amnesty scheme the state has ever offered (**Table 4.4**). However, regardless of their revenue potential, amnesty schemes are not robust solutions to the persistent problem of non-compliance (**Box 4.1**).

Table 4.5: Provincial Fiscal Operations – Jul-Mar

billion Rupees

	All provinces	Punjab	Sindh	KPK	Balochistan
<i>FY13</i>					
Total revenue	1,125.0	506.0	326.0	181.0	111.8
Share in federal revenue	893.0	417.0	236.0	146.0	94.2
Taxes	110.0	56.0	50.0	3.0	0.8
Non-taxes	49.0	22.0	17.0	6.0	3.7
Federal loans and transfers	74.0	11.0	23.0	26.0	13.1
Total expenditure	986.0	474.0	272.0	149.0	90.9
Current	766.0	374.0	213.0	110.0	69.1
Development	220.0	100.0	59.0	39.0	21.8
Overall balance	139.0	32.0	54.0	32.0	20.9
Financing *	-103.0	-42.0	-20.0	-19.0	-21.9
<i>FY12</i>					
Total revenue	932.0	411.5	263.8	159.0	97.8
Share in federal revenue	762.2	355.1	205.3	123.3	78.5
Taxes	57.6	27.8	26.7	2.4	0.8
Non-taxes	36.0	19.0	10.8	2.8	3.3
Federal loans and transfers	76.2	9.6	21.0	30.4	15.2
Total expenditure	862.1	406.7	235.8	137.7	81.9
Current	687.1	317.8	202.0	101.9	65.3
Development	175.0	88.8	33.8	35.8	16.5
Overall balance	69.9	4.8	27.9	21.2	16.0
Financing *	-65.4	-22.5	-6.9	-17.9	-18.1

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

Source: Ministry of Finance

Provincial fiscal operations

While provincial revenues continued to grow throughout FY13, their expenditures did not increase much. As a result, all provinces put together witnessed a surplus of Rs 103.0 billion in Jul-Mar FY13, which is higher than their full year target (**Table 4.5**). Although 80 percent of provincial revenues come from the federal divisible pool, their own mobilization has been impressive: Punjab increased revenues by 101.8 percent (YoY), while Sind managed a YoY increase of 87.1 percent – these numbers are mainly due to sales tax on services.

Box 4.1: Tax Amnesty as Public Policy

A tax amnesty is any change in the law which grants lenience to tax evaders on the condition that they pay (in part or full) their outstanding liabilities to the state. Amnesties give evaders a chance to review their past decisions. And by availing this offer, non-tax-compliant citizens can avoid prosecution.

For governments, the most common motive for offering tax amnesty is to quickly generate additional revenue in times of fiscal stress.¹⁹ Indeed, recent papers by Luitel and Tosun (2013) and Le Borgne (2006) have found that tax amnesty decisions are strongly linked with weak fiscal indicators.

What is wrong with amnesty?

In favor of amnesty, it can be argued that it brings Pareto improvements: although the evaders benefit, tax compliant citizens do not lose in pecuniary terms, and the additional revenue generated can be utilized for providing more public goods (the debate is summed up by Luitel and Tosun, 2013).

But three strong arguments can be made against amnesties: Firstly, the fact that the need for amnesties arose (and taxes were successfully being evaded) points to problems with the tax collection system. In the worst cases, the situation may even have arisen from the connivance of tax authorities and the offenders. Secondly, amnesties defy basic principles of equity and fairness by rewarding dishonest behavior.

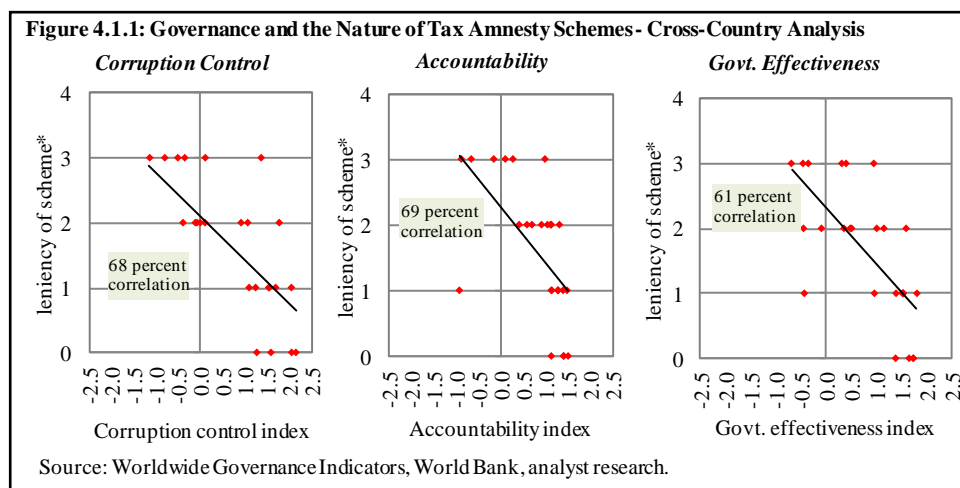
A corollary fact is that the ‘unfairness’ of amnesty programs increases with poor governance. Countries with weak governments have more lenient amnesty schemes (offering reduced penalties and outstanding liabilities), as opposed to countries with strong state controls like Australia or USA. This relationship between the quality of governance and leniency of amnesty schemes is illustrated in **Figure 4.1.1**. We have ranked 26 amnesty schemes in 19 countries on a ‘leniency scale’: an ordinal measure calibrating a scheme on four parameters: protection from criminal charges, concession in penalty, concession in principal liability and interest, and backing of a credible threat. The first three parameters are assigned a value of 1 for yes and 0 for no. The last parameter (of strictness) is assigned a value of -1 for yes and 0 for no. The y-axis plots the sum of these, termed here as ‘leniency measure’. The scale ranges from 3 (most lenient) to 0 (most stringent). This leniency measure is plotted against three measures of good governance taken from World Bank’s Worldwide Governance Indicators. The three governance criteria are rated on an index ranging from

¹⁹ Another objective of an amnesty scheme may be to give tax evaders a ‘second chance’ to change their behavior before stringent tax reforms are implemented. More recently, countries like USA and the Netherlands introduced tax amnesties to attract repatriated savings.

-2.5 (very poor) to 2.5 (very good). We found our leniency measure highly correlated (above 60 percent correlation) with all three governance indicators.

Naturally, tax amnesty is an unpopular policy tool. In fact, Le Borgne (2006) found that due to their unpopular nature, amnesty programs were mostly introduced in the first year of a government's coming to power; and if introduced in the last year, these schemes do not help in re-election.

However, the most important *economic* argument against amnesty is lack of evidence of higher post-amnesty revenue growth in either the short or long run (Baer and Le Borgne, 2008). One obvious reason is that amnesty is a short-sighted measure, treating only the symptom (revenue shortage) but not the cause (large-scale non-compliance). In worst cases, it can create a moral hazard as citizens may decide to evade current taxes in the hopes of a future amnesty scheme,²⁰ which can even decrease compliance in long-run.



Lessons for Pakistan

Revenue-increasing measures that can worsen future compliance are ill-advised in any country, but perhaps particularly so in a country like Pakistan where tax evasion is a problem of significant magnitude.²¹

However, since tax enforcement is costly and time consuming any sound tax reform plan will necessarily involve a 'cut-off date': older liabilities will have to be either completely written-off, or can be partly recovered through a 'voluntary payment' scheme. Thus, some kind of tax amnesty is inevitable.

A good amnesty scheme will be part of a reform agenda to clear past liabilities as much as possible, and move ahead with a stronger taxation system. It would offer minimum perks, and instead be made

²⁰ The benefit would be greater if interest is not charged on outstanding tax liability, as is the case in Pakistan.

²¹ There are only 3 million income tax payers in Pakistan. Source: Budget Speech 2012.

‘attractive’ by increasing the cost of non-payment (setting examples by prosecuting non-filers, media campaigns portraying tax evasion as unethical, and by publicly ‘naming and shaming’ evaders). Finally, a successful reform program would facilitate non-compliers when they do come clean: helpful measures could include a fair payment installment plan (adjusted for interest) to ease the cash flow burden,²² and assuring against harassment by tax officials.²³

References:

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2. Kellner, M. (2004), “Tax Amnesty 2004/2005 – An Appropriate Revenue Tool?”, *German Law Journal*, Vol 5(4).
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5. Prof. Dr. Khawaja Amjad Saeed, “Tax evasion”, article published in *Pakistan Economist*, Feb 21-27, 2000. Online: <http://www.pakistaneconomist.com/issue2000/issue8/f&m6.htm>

4.3 Total Debt & Liabilities

Pakistan’s public debt stock increased by Rs 297 billion during the third quarter, reaching Rs 13.9 trillion as of end-March 2013 (**Table 4.6**).²⁴ The entire increase in public debt was on account of domestic debt, as Pakistan’s external debt continued to decline. Moreover, the pace of debt accumulation increased in Q3-FY13, after a slowdown in the second quarter. More importantly, public debt is subject to the limit imposed in the FRDL Act (2005), which states that public debt should not exceed 60 percent of GDP on end-June 2013. Our internal estimates, however, indicate the risk of missing the FRDL target this year (**Box 4.2**).

On the face of it, the absolute increase in domestic debt during Jul-Mar FY13 is lower than the rise in same period last year. However, adjusting for the one-off settlement of circular debt last year, the increase in domestic debt this year is 44.6 percent higher.²⁵

The worsening debt dynamics in the country can be seen in the heavy interest payments on domestic debt, which is squeezing out development spending. In

²² Brazil and Singapore governments made successful tax recoveries through payment installment agreements with their citizens.

²³ For example, assurance against harassment was an important feature of the 2007 Russian income tax amnesty scheme.

²⁴ This analysis is based on SBP’s definition of public debt, which differs from MoF. For details, see Data Explanatory Notes. 5(b), **Annexure A**.

²⁵ Q3-FY13 again witnessed a dependence on short tenor (3m) securities, as banks were reluctant to lock funds in longer term paper, consequently borrowing from central bank continued unabated.

fact, Pakistan's debt repayment capacity for both domestic and external debt, deteriorated during Q3-FY13.²⁶

Table 4.6: Debt Burden

billion Rupees

	Stocks		Absolute Δ				
	Jun-2012	Mar-2013	Jul-Mar		FY13		
			FY12	FY13	Q1	Q2	Q3
Total debt & liabilities	14,553	15,446	1,204	892	595	87	211
Total public debt	12,924	13,865	1,299	941	535	109	297
Total debt	13,888	14,885	1,289	997	583	129	286
A. Domestic - government	7,638	8,801	1,195	1,162	482	209	472
B. Domestic - PSEs	281	326	-144	45	16	25	5
C. External	5,969	5,759	238	-210	85	-105	-190
Total liabilities	665	560	-85	-105	12	-42	-75
D. Domestic	438	325	-93	-113	9	-47	-75
E. External	227	235	8	8	3	5	-0.3

Memorandum items:

Total public debt adjusted for one-off settlement (of Rs 391 billion) in FY12	12,533	13,878	908	941
Domestic-government debt adjusted for one-off settlement of circular debt	7,247	8,801	804	1,162

Source: State Bank of Pakistan

Composition of domestic debt

Banks' reluctance in investing in long term securities (PIBs), the absence of *Ijara Sukuk* auctions, and falling institutional investment in NSS, meant that floating debt was the only option available for the government to finance its deficit during Q3-FY13.²⁷ As a result, 80 percent of the entire increase in domestic debt, in Q3-FY13 was due to these short term securities.²⁸

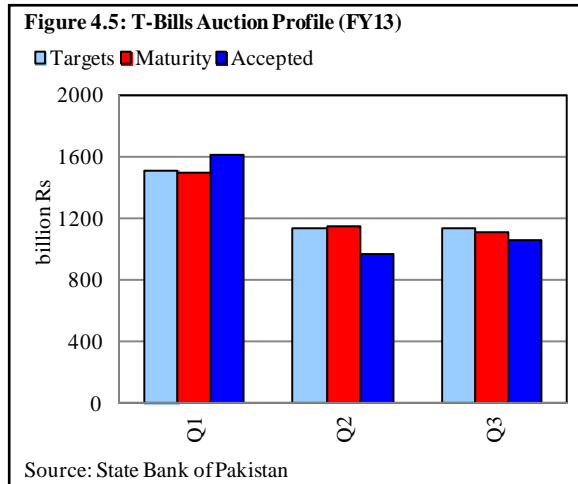
²⁶ To put things in perspective, as opposed to a 26.5 percent YoY surge in the interest payments on domestic debt during Jul-Mar FY13, FBR tax revenue recorded a meager 5.0 percent YoY increase during this period. Similarly, the ratio of external debt servicing to foreign exchange earnings continued to deteriorate during the third quarter of FY13 also.

²⁷ During Q1-FY13 last *Ijara sukuk* auction was held against M3 highway. M3 was identified as an asset in December 2011. Government raised Rs 233.8 billion against this asset compared to the target of Rs 195 billion.

²⁸ In overall terms, floating debt had 54.5 percent share in the government domestic debt increase during Jul-Mar FY13.

Floating Debt

As in the first half of FY13, T-bills auction targets in Q3-FY13, aimed at merely rolling over the maturing T-bills stock (**Figure 4.5**). Thus the acceptance of T-bills remained closed to the target level during most of the third quarter of FY13. However, banks anticipating a rise in the discount rate shifted their interest almost entirely to 3-m T-bills.

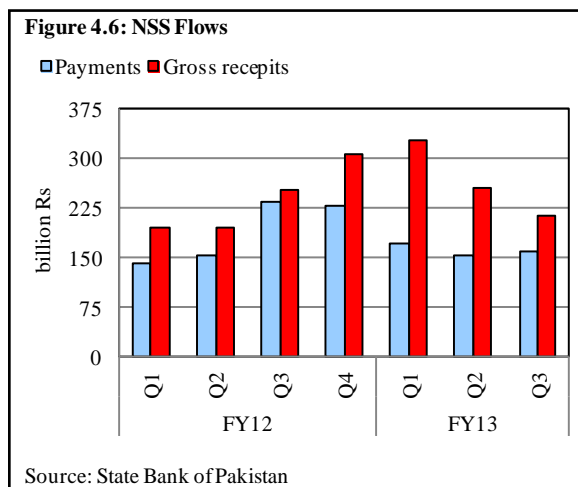


Unfunded debt

Net NSS flows declined during Q3-FY13, compared to the first half of FY13. This was expected, as the impact of allowing institutional investment in April 2012, had already started to taper off in Q2- FY13

(**Figure 4.6**). In overall terms, however, net inflows in NSS during Jul-Mar FY13, were significantly (Rs 200 billion) above the level observed during the same period last year.²⁹

More importantly, the gross inflows to these schemes proved resilient to the rate reductions announced during FY13, showing that NSS instruments still dominate other channels of savings for households.³⁰

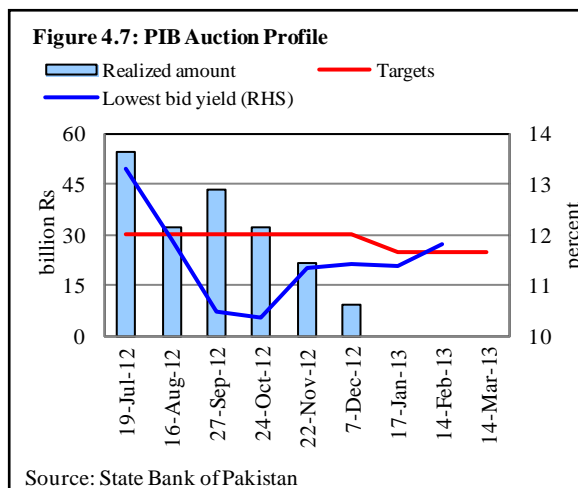


²⁹ The net inflows in NSS during FY12 were compressed because of huge payments, after the ECC decision in April 2011 that barred institutional investors from investing in NSS.

³⁰ NSS rates have been revised downwards on three occasions in FY13 i.e., August 27, 2012; October, 12 2012; and Jan 1, 2013.

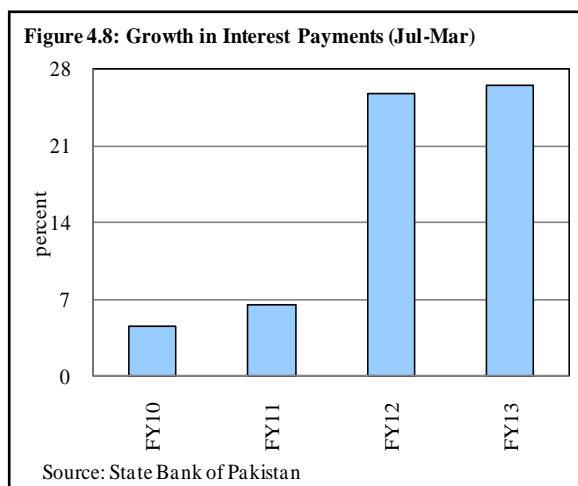
Permanent debt

Government had planned to raise Rs 75.0 billion from PIBs during the third quarter of FY13, but no funds could be raised in the auctions. Given the already significant exposure to PIBs (Rs 1.1 trillion), banks appeared reluctant to lock funds into long term paper. More to the point, banks viewed that the phase of interest rate cuts was over, as BoP compulsions would begin to dominate in the remainder of FY13. In fact, the increasing yields demanded by banks show up quite clearly in the bid patterns. However, this effort by the banks to bid up medium and long term rates was not acceptable to the government, which simply opted to reject the PIB offers (**Figure 4.7**).³¹



Interest Payments on Domestic debt³²

In tandem with the rising stock of domestic debt, interest payments swelled by 26.5 percent during Jul-Mar FY13, compared to the same period last year (**Figure 4.8**). Around 84.6 percent of this rise came from the increase in payments on floating debt. Due to the government's reluctance to accept more expensive longer term debt, shorter maturity T-bills have become the main driver of



³¹ The lowest bid yield in Figure 4.6 pertains to 10-year PIBs.

³² This analysis is based on SBP's numbers for interest payments on domestic debt, which do not match with the information provided by MOF. For details, see Data Explanatory Notes 5(c), **Annexure A**.

Pakistan's domestic debt servicing.³³

Specifically, short-term borrowing increased the stock of floating debt by Rs 910.3 billion during FY12, resulting in a hefty Rs 294.0 billion addition to debt servicing in Jul-Mar FY13. Similarly, the Rs 633.1 billion increase in floating debt during the first nine months of FY13 is likely to increase interest payments by Rs 179.9 billion during the next fiscal year. This mechanical increase in debt servicing compounded by the short term nature of this debt, has pushed the country into a debt trap.

The increase in interest payments is a part of the domino effect, of the growing needs of the government, which is increasing the debt burden of the country. This has been highlighted repeatedly in past SBP reports: increasing debt servicing burden in the absence of a corresponding increase in tax revenues, reveal the increased risk of a debt-deficit spiral for the country.

External Debt

More specifically, Pakistan paid US\$ 2.0 billion to the IMF during first nine months of FY13. This impact was reinforced by the 15.5 percent depreciation in the value of the Yen vs. US Dollar, which resulted in US\$ 2.1 billion fall in the country's external debt as of end-Mar 2013, compared to end-Jun 2012.

Pakistan's external debt & liabilities (EDL) posted a US\$ 4.6 billion decline during Jul-Mar FY13 (**Table 4.7**). Both, scheduled repayments to the IMF and some gains from appreciation of US\$ contributed to this decline.

Table 4.7: External Debt & Liabilities Stock
billion US\$

	Jun-12	Mar-13	Δ
Total external debt & liabilities	65.5	60.9	-4.6
Government external debt	46.1	43.7	-2.4
Debt from IMF	7.3	5.3	-2.0
External liabilities	2.4	2.4	0.0
Private sector external debt	5.4	5.1	-0.4
PSEs external debt	1.5	1.8	0.3
Intercompany debt	2.7	2.5	-0.1
Memorandum items:			
Public external debt	55.9	51.4	-4.4
External debt servicing/foreign exchange earnings (percent)	9.5	12.4	

Source: State Bank of Pakistan

External inflows, on the other hand, recorded a 25.2 percent YoY increase during Jul-Mar FY13, compared to the same period last year. A large share of this

³³ Floating debt constituted more than one-half share in the total additions to domestic debt stock during past five years.

increase can be traced to credit disbursements by IDB (US\$ 256 million).

However, project and program loan inflows also recorded increases (**Table 4.8**).

Notwithstanding the decline in external debt stock, Pakistan's external debt repayment capacity weakened during Q3-FY13, compared to end-June 2012. External debt servicing to foreign exchange earnings, deteriorated from 9.5 percent in Jun 2012 to 12.4 percent in Mar 2013.

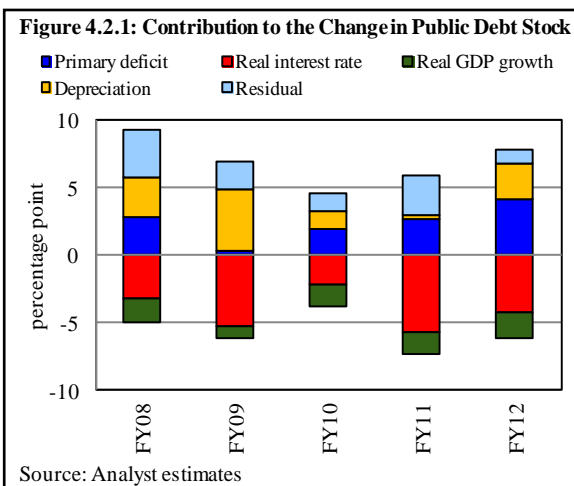
Table 4.8: External Loan Disbursement (Jul-Mar)
million US\$

	FY12	FY13	Absolute Δ
Total	1,337.8	1,674.5	336.7
<i>of which</i>			
Project	1,255.5	1,359.5	104.0
Program loans	30.7	36.4	5.7
IDB	--	256.0	256.0

Source: Economic Affairs Division, Islamabad

Box 4.2: What Caused Public Debt to Rise In Pakistan during Last Five Years (FY08-FY12)?

Government debt in Pakistan is subject to limits prescribed in the FRDL Act (2005), which stipulates a ceiling of 60 percent on the public debt-to-GDP ratio, which is to be reached by end-FY13.³⁴ However, Pakistan's public debt stock has been rising consistently since FY07 (with the exception of FY11) and reached 62.6 percent of GDP as of end-June 2012 from 56.4 percent in FY07. Given the continued increase in the fiscal deficit and, hence, the public debt during the first three quarters of the current fiscal year, there is a risk that the country is likely to miss the FRDL target this year. In this context, this note attempts to understand the underlying dynamics of the persistent increase in the public debt burden of Pakistan.



The evolution of a country's public debt is based on the following identity:³⁵

³⁴ The Act also envisages an annual 2.5 percentage point reduction in this ratio after achieving the 60 percent benchmark by end FY13.

³⁵ (IMF 2008), "Staff Guidance Note on Debt Sustainability Analysis for Market Access Countries", Prepared by the Policy Development and Review Department.

$$d_t - d_{t-1} = \left(\frac{r - \Pi(1+g) - g + \varepsilon\alpha(1+r)}{(1+g + \Pi + \Pi g)} \right) d_{t-1} + pb_t + z_t \quad (1)$$

where d is country's public debt-to-GDP ratio, pb is the primary balance, r is the average nominal interest rate paid on government debt, g is real GDP growth, Π_t is the change in the domestic GDP deflator, α is the share of foreign-currency denominated public debt and changes in the exchange rate are denoted by ε , whereas z_t is other debt creating or debt reducing flows, such as cross country movements, recognition of contingent liabilities, errors and omissions, etc.

Based on (1), and the behavior of the determinants of public debt during past five years, our estimates identify the primary deficit and the Rupee depreciation as the chief contributors to the persistent increase in the country's debt burden during FY08-FY12 (**Figure 4.2.1**). These findings correspond with the general perception about the sources of increase in Pakistan's public debt – a deficit in the primary balance directly translates into increased financing requirements, and hence the level of debt, whereas exchange rate depreciation inflates the Rupee value of external debt of the country. Our results indicate that both these important factors had contributed almost equally to the additions in the country's debt stock over the past five years. In addition to these two factors, however, exchange rate movements of US Dollar against other major currencies (as captured by a *residual*) also had a sizeable contribution to the annual increments in government debt stock during this period.

The impact of these factors was partially offset by the negative average real interest rates on debt (which was led by strong double digit inflation in this entire period), as well as the rate of economic growth in the country.

What level of primary deficit could have achieved the FRDL public debt target in FY13? We have used (1) to determine the level of primary deficit which would have been required to achieve the desired reduction in the public-debt-to-GDP ratio this year. For this estimation, our assumptions about the determinants of public debt in FY13 are given in **Table 4.1.1**. Our

Table 4.1.1: Assumptions Regarding the Behavior of Economy in percent

	Avg. real interest rate	Real GDP growth	Inflation
FY13	1.4	3.2	7.4

Source: SBP Calculations

estimates indicate that a primary surplus of roughly 1.6 percent of GDP could have resulted in obtaining the required i.e., 60 percent of GDP, public debt ratio by the end of this fiscal year. Compared with the actual primary deficit (4.2 percent of GDP, including the one-off payment of circular debt) last year (FY12), the required surplus this year indicates the need for substantial fiscal consolidation. As opposed to this requirement, however, the primary balance recorded a deficit equal to 1.2 percent of GDP during Jul-Mar FY13. The result indicates that delays in undertaking fiscal consolidation measures, will result in aggravating the government's debt burden, which implies a significant cost associated with the increase in debt servicing and a subsequent squeeze on development spending, which further shrinks the chances of a decent real economic growth.