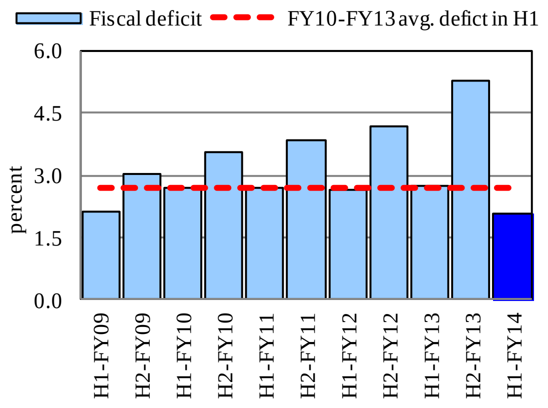
4 Fiscal Policy and Public Debt

4.1 Fiscal Operations

According to the Ministry of Finance data, fiscal indicators continued to show improvement during Q2-FY14, as the fiscal deficit for the first half fell to a four-year low of 2.1 percent of GDP (**Figure 4.1**). This was lower than the average deficit in the preceding four years.[1] More encouragingly, this was the first time after four years that primary balance turned to a surplus in the first half of a year.

Figure 4.1: Fiscal Deficit



Source: Ministry of Finance

This improvement was on account of a slowdown in expenditures and an increase in revenues (**Table 4.1**). Worryingly, development expenditures fell sharply during H1-FY14, declining by 10.5 percent YoY against an increase of 19.5 percent during the same period last year. Both, provincial and federal PSDP contributed to this decline. However, current expenditures also slowed down due to lower subsidies.

On the revenue side, FBR tax receipts posted growth of 16.8 percent for H1-FY14, against a nominal increase of 4.5 percent during the same period last year, which was mainly due to increase in tax rates and rise in general price level in the economy. However, according to our estimates FBR collections for H1-FY14 are short by around Rs 80 billion relative to the half year target, and will need to grow by 36.6 percent in the second half to achieve the target set for FY14. This would be challenging, given the pattern of revenues collection and the nature of tax reforms undertaken so far.[2]

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[1] Fiscal deficit in H1-FY14 was 2.1 percent of GDP against 4 year average of 2.6.

[2] During the past five years, on average, FBR revenues recorded 13.4 percent YoY growth in the second half.

For the financing of the budget imbalance, the government mostly relied on domestic banking system during H1-FY14 (**Table 4.2**).[3] As regards public debt, the country witnessed Rs 996.9 billion addition in its stock of debt during H1-FY14. However, this entire increase was recorded in the first quarter, whereas Pakistan's public debt witnessed a marginal decline during the second quarter. This can be attributed to the narrowing of the fiscal deficit. Furthermore, repayments to IMF, and favourable exchange rate movement also improved the public external debt situation.[4]

Table 4.1: Summary of Fiscal Operations during H1
billion Rupees, growth in percent

	Absolute		YoY Growth	
	FY13	FY14	FY13	FY14
A. Revenue	1,461.8	1,684.5	28.8	15.2
Tax revenue	1,012.7	1,172.0	12.0	15.7
o/w FBR revenues	883.2	1,031.4	4.5	16.8
Non-tax	449.1	512.5	94.7	14.1
B. Expenditure	2,086.5	2,224.7	25.1	6.6
Current	1,721.7	1,887.6	23.1	9.6
Development	272.1	243.5	19.5	-10.5
Net lending	5.7	82.7	72.0	N-A
Statistical discrepancy	87.0	11.0	N-A	-87.4
Overall deficit (A-B)	624.7	540.1	17.3	-13.5
Deficit as % of GDP [1]				
Fiscal	-2.7	-2.1		
Revenue	-1.1	-0.8		
Primary	-0.3	0.2		

[1]Fiscal deficit for FY13 is calculated with the GDP with new base
Source: Ministry of Finance

Notwithstanding the small decline in public debt, the significant shift towards the shortest tenor (i.e., 3-month securities), raises serious concerns about the maturity profile of Pakistan's public debt.[5] The over-reliance on short-term debt increases the vulnerability of the country's debt servicing to adverse movements in the interest rates, because the bulk of the debt

Table 4.2: Financing of the Fiscal Deficit during H1
billion Rupees

	FY13	FY14
Total	624.7	540.1
External	-1.4	-43.5
Domestic	626.1	583.6
Bank	557.9	483.3
Nonbank	68.1	100.3

Source: Ministry of Finance

[3] These numbers will not match with the government borrowing numbers reported in **Table 3.1**. This is because MoF reports government borrowing on *cash basis*, while SBP's monetary survey is compiled on *accrual basis*.
[4] Transactional gains emerging from (6.8 percent) depreciation of Japanese Yen against US Dollar during Q2-FY14 resulted in Rs 78.9 billion reduction in the stock of public external debt in Q2-FY14. Furthermore, an appreciation in PKR during Q2-FY14 resulted in further Rs 16. 2 billion decline in the Rupee value of public external debt stock in this period.
[5] On end-December 2013, the share of 3m T-bills in public domestic debt stock rose to 19.5 percent, compared to a mere 1.8 percent on end-June 2013. Due to uncertainty about SBP's policy rate, banks shied away from investing in 6 & 12m paper, and focused primarily on 3m paper in Q2-FY14.

will be repaid within 3 months. This said, the trend has improved in the subsequent quarter.

The developments during H1-FY14 indicate that a reduction in subsidies, and increase in tax rates have succeeded in achieving the desired reduction in the fiscal deficit for now. However, we believe a sustainable improvement in the country's fiscal situation would require wide ranging reforms that address the following issues: (i) a sustainable increase in tax collection requires widening the tax net by removing exemptions;[6] (ii) while the phasing out of power subsidies is urgently required, there is a simultaneous need to initiate comprehensive energy sector reforms, to rule-out the build up of circular debt; (iii) to achieve a substantial reduction in the burden emanating from loss making PSEs, these entities need to be restructured/disinvested on a priority basis;[7] (iv) fiscal austerity based on curtailing development spending is not a desirable option, as it will further suppress growth, which would be counterproductive for debt reduction efforts;[8] (v) rebalance the maturity profile of domestic debt, to minimize interest-rate and roll-over risk, and spread out the debt servicing burden; and (vi) revitalize NSS products and make them more dynamic.

In overall terms, we maintain our view that the full-year fiscal performance will depend on subsidies and the possible need to again pay off the circular debt in the power sector; the performance of FBR; the inflows of CSF and proceeds from the auction of 3G licenses. Typically, budget deficits sharply increase during the second half of the year; our analysis shows that if the fiscal authorities succeed in containing the H2-FY14 deficit at the same level as the last four year (as a percentage of GDP), the deficit target of 6.0 -7.0 percent of GDP will not be exceeded.

4.2 Revenues

FBR Taxes

The increase in tax rates announced in the budget of FY14 helped FBR in improving tax collection during H1-FY14.[9] More specifically, tax collection by

[6] On a positive note, however, realizing the need of expanding the tax net, a committee has been constituted by the government to spell out a strategy to phase out some of these tax exemptions.
[7] The government has met the structural benchmark on formulating the strategic plans for 31 PSEs.
[8] Inflation, interest rates, and stock-flow adjustments are some important determinants of debt dynamics. However, historically, output growth and fiscal adjustment were the main factors in 26 episodes of large debt reversals in advanced economies since 1980s. Source: Abbas S. Ali, Akitoby Bernardin, Andritzky Jochen, Berger Helge, Komatsuzaki Takuji, and Tyson Justin (2013), " Dealing with High debt in an Era of Low Growth", IMF Discussion Note IMF SDN/13/07
[9] For details, see **Box 4.1** in SBP's *1st Quarterly Report* for FY14.

FBR rose by 16.8 percent YoY in H1-FY14, compared to a meager 4.5 percent witnessed in the same period last year (**Table 4.3**). Around two-third of the entire increase in tax collection came from sales tax during H1-FY14. This was the only category that surpassed the half-year target on account of collection from sales of domestic goods and imports. In domestic sales, most of the increase can be traced to petroleum products, fertilizer, and cement, while the GST collection on imports improved due to pickup in imports of petroleum products, machinery and fertilizer. Custom duties, however, remained sluggish during this period.

Table 4.3: FBR Tax Collection during H1(Provisional)
billion Rupees

	Actual		% Growth		FY14 Target		% of Target Achieved	
	FY13	FY14	FY13	FY14	H1[1]	Total	H1	Total
A. Taxes on imports	317.7	356.8	3.0	12.3	374.0	800.0	95.4	44.6
Sales tax	209.7	246.7	-2.1	17.6	239.0	500.0	103.2	49.3
Custom duty	108.0	110.1	14.6	2.0	134.9	300.0	81.6	36.7
B. Tax on domestic businesses	234.1	292.7	4.8	25.0	323.4	715.0	90.4	40.9
Sales tax	182.4	235.0	6.4	28.8	233.7	513.0	100.5	45.8
FED	51.7	57.7	-0.5	11.5	89.7	202.0	63.8	28.5
C. Total indirect taxes (A+B)	551.8	649.4	3.8	17.7	697.4	1,515.0	93.1	42.9
D. Direct taxes	331.3	382.0	5.9	15.3	413.0	960.0	92.5	39.8
Total tax collection (C+D)	883.2	1,031.4	4.5	16.8	1,110.3	2,475.0	92.9	41.7

[1]SBP's internal estimates, based on FBR's performance in the past five years.
Source: Ministry of Finance

Revenues from direct taxes posted a 15.3 percent increase in H1-FY14, compared to 5.9 percent recorded in the same period last year. Furthermore, around one-third of the entire increase in FBR taxes came from direct taxes. Most of this increase can be traced to an increase in withholding tax collection on imports, telephone bills and salaries due to increase in rates.[10]

Non-tax revenues

Growth in non-tax revenues witnessed a sharp slowdown in H1-FY14 compared to the same period last year. Lower CSF inflows during this period, compared to the same period last year, resulted in a YoY slowdown in non-tax revenues in this period.[11]

[10] The withholding tax rate on mobile phone subscribers and prepaid card users was raised from 10 percent in FY13 to 15 percent in budget FY14.
[11] CSF inflows stood at Rs 34 billion in H1-FY14, compared to Rs 172 billion in the same period last year.

4.3 Expenditures

As mentioned above the pace of fiscal spending recorded slowdown in H1-FY14, compared to the same period last year. This was due to a decline in development spending and a decrease in the growth of current spending (**Table 4.4**).

A fall in the growth of debt servicing and subsidies, were responsible for lower current spending during H1-FY14.[12] However, debt servicing rose significantly in the second quarter mainly due to an increase in domestic debt payments.[13]

Table 4.4: Fiscal Spending during H1

billion Rupees; growth in percent

			YoY Growth	
	FY13	**FY14**	**FY13**	**FY14**
Current expenditures	1,721.7	1,887.6	23.1	9.6
of which				
Interest payment	552.6	597.7	39.1	8.2
Domestic	508.0	559.3	39.7	10.1
Foreign	44.6	38.4	32.6	-13.9
Subsidies	166.0	136.0	N-A	-18.1
Defense	256.6	295.3	5.5	15.1
Provinces	476.1	541.4	3.9	14.2
Others	278.1	323.9	13.2	16.5
Development expenditures & net lending	277.8	326.2	20.3	17.4
Development	272.1	243.5	19.5	-10.5
-Federal	149.6	149.5	8.2	-0.1
-Provincial	122.5	94.0	37.0	-23.3
Net lending	5.7	82.7	72.0	N-A
Statistical discrepancy	87.0	11.0	N-A	-87.4
Total	2,086.5	2,224.7	25.1	6.6

Source: Ministry of Finance

The reduction in power subsidies happened in conjunction with the re-accumulation of payables in the power sector.[14] This raises concerns about the sustainability of the improvement witnessed in the fiscal account. Although, the rationalization of power tariffs for residential and agricultural users in October 2013, is an important step towards eliminating fiscal burden of the power sector, there is a need to introduce broad based reforms in the energy sector to reduce transmission and distribution losses, improve the collection of bills, and ensure that subsidies are well targeted. In this regard, the increase in subsidies to the industrial sector is surprising (**Figure 4.2**). Tackling losses and improving

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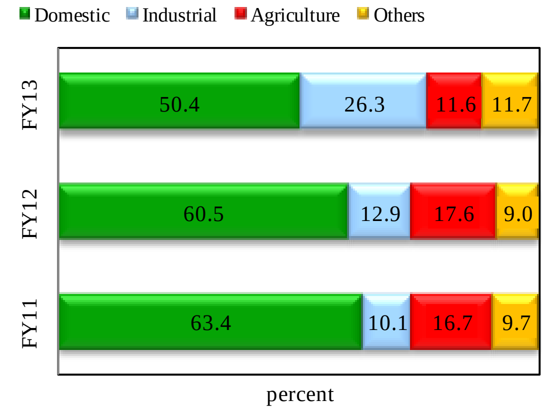
[12] Current expenditures, excluding subsidies and interest payment, recorded 15.0 percent YoY increase in H1-FY14.

[13] The increase in debt servicing was mostly led by a sharp increase in the payments on MRTBs and 3m T-bills. Due to unexpected fiscal slippages, government increased its reliance on SBP funding in the last quarter of FY13. Hence, the government borrowed a hefty Rs 530.7 billion from SBP in this period alone and the interest payments of this sum fell due in Q2-FY14. Furthermore, due to heavy reliance on 3m T-bills during Q1-FY14, compared to the same period last year, debt servicing burden for these securities also increased in Q2-FY14.

[14] In response to a question in the National Assembly on March 7, 2014, the Minister of Water and Power informed that the payables of the power sector stand at Rs 246.2 billion as of end-December 2013. A part of this amount may decline going forward, if the government decides to deduct the outstanding payables of the provinces to power sector at source.

collection, is also one of the core objectives of the National Power Policy announced by the government in Jun 2013.[15] However, there is a need to pace up the efforts to achieve these objectives to minimize the fiscal burden posed by the power sector. To put things into perspective, the amount of power subsidies, including the one-off settlement of circular debt stood at 2.9 percent of GDP in FY13.

Figure 4.2: Sector-Wise Distribution of Power Subsidies



Source: Ministry of Finance

4.4 Provincial Fiscal Operation

The consolidated financial position of the provinces has been improving since the devolution of powers to collect sales taxes on services. In FY12, Sindh started collecting these taxes followed by Punjab in FY13; KPK followed suit in FY14.

Table 4.5: Provincial Fiscal Operations during H1

billion Rupees

	Punjab		Sindh		KPK		Balochistan		All Provinces	
	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
A. Total revenue	340.4	349.6	213.9	230.7	112.4	132.5	74.2	87.2	740.9	800.1
Share in federal revenue	278.6	286.5	154.1	179.2	96.4	106.8	63.2	74	592.2	646.5
Taxes	36	45	32.3	36	1.9	5.7	0.5	0.9	70.7	87.6
Non-taxes	16.8	14.2	13.6	2	2.2	6.5	1.9	2.7	34.5	25.4
Federal loans & transfers	9	3.8	13.9	13.5	11.9	13.5	8.7	9.7	43.5	40.6
B. Total expenditure	274.1	295.7	168.3	186.7	100.5	99.7	55.7	53.2	598.6	635.4
Current	218.7	258.4	139.1	149.3	75.4	85.2	43	48.5	476.1	541.4
Development	55.3	37.3	29.3	37.4	25.1	14.5	12.7	4.7	122.5	94
Overall balance (A-B)	66.4	53.9	45.6	44	11.9	32.8	18.5	34	142.3	164.7

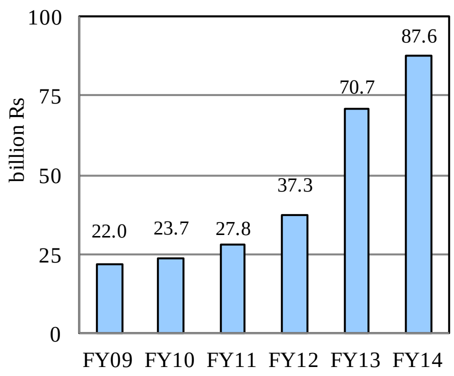
Source: Ministry of Finance

In this regard, KPK has shown exceptional performance, as tax collection more than doubled, after KPK established its Revenue Authority in August 2013.

[15] The National Power Policy aims at reducing the transmission losses from 25 percent to 16 percent and improvement in the collection of bills to 95 percent by FY17.

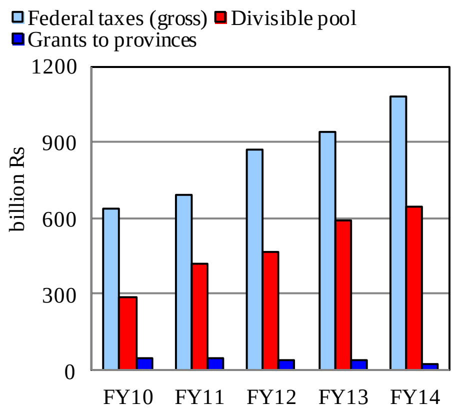
Resultantly, the consolidated provincial surplus has grown significantly from FY12 onwards. During H1-FY14, following an increase in federal transfers and a 23.9 percent increase in tax collections, provincial surpluses posted a 15.8 percent growth over the same period last year (**Table 4.5, Figure 4.3 a &4.3 b)**.

Figure 4.3a: Provincial Tax Collection



Source: Ministry of Finance

Figure 4.3b: Federal Transfers to Provinces-H1



Source: Ministry of Finance

Notwithstanding this increase, the expenditure side is a bit disconcerting due to a 23.3 percent YoY decline in the development expenditures. This can improve as the year progresses and the impact of last year's election related spending wears off. Current expenditures on the other hand, have increased by 13.7 percent; most of this increase came from Punjab, followed by Sindh and then Balochistan.

In terms of individual performances, Sindh posted the largest growth in expenditures, followed by Punjab during H1-FY14, compared to the same period last year. On the other hand, spending by the KPK government remained almost at the last year's level, whereas total expenditure declined by 4.5 percent in Baluchistan.

4.5 Public Debt

Pakistan's public debt recorded a large Rs 996.9 billion increase during H1-FY14, reaching Rs 15.5 trillion on end- December 2013. However, this entire increase was witnessed in the

Table 4.6: Pakistan's Public Debt Profile

billion Rupees

	Stock		Flows	
	Jun-13	**Dec-13**	**Q1**	**Q2**
Public Debt	**14,494.0**	**15,491.0**	**1,020.4**	**-23.5**
Public domestic debt	9,520.9	10,227.6	634.0	72.7
Public external debt	4,973.1	5,263.3	386.5	-96.2
Govt. external debt	4,311.1	4,637.9	361.1	-34.3
Debt from the IMF	434.8	379.4	6.5	-61.9
External liabilities	227.2	246.1	18.9	0.0

Source: State Bank of Pakistan

first quarter, as public debt recorded a marginal decline during Q2-FY14 (**Table 4.6**).[16] This was led by a sharp slowdown in the pace of accumulation of domestic debt stock in Q2-FY14, as well as a decline in the public external debt stock. Within domestic debt, almost the entire increase came from short-term debt (**Table 4.7**).[17]

Table 4.7: Domestic Debt- Change in Stock
billion Rupees

	H1	Q1	Q2
Domestic debt	706.7	634.0	72.7
Permanent debt	-4.5	-3.0	-1.5
Short-term debt	674.7	611.1	63.6
Unfunded debt	36.3	25.6	10.7
Foreign currency loans	0.2	0.3	0.0

Source: State Bank of Pakistan

Increasing reliance on 3m T-bills continued to complicate debt management

The stock of short-term debt posted Rs 674.7 billion increase in H1-FY14. The bulk of the increase was seen in the first quarter, which was driven by government borrowing from the central bank (**Table 4.8**).

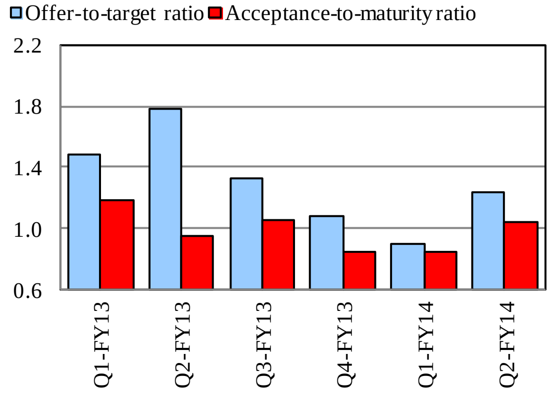
Table 4.8: Short-Term Debt – Change in Stock (FY14)
billion Rupees

	H1	Q1	Q2
Short-term	674.7	611.1	63.6
T-bills (Auctions)	39.7	-138.6	178.3
T-bills (SBP)	548.4	749.7	-201.3

Source: State Bank of Pakistan

Anticipating a hike in the policy rate, banks were reluctant to invest in T-bills throughout Q1-FY14. However, the second quarter of FY14 witnessed a revival in commercial banks' interest in T-bills; the offer-to-target ratio improved to 1.28 after dropping below 1 in the preceding quarter (**Figure 4.4**). Furthermore, after net retirement in the two preceding quarters, the net-of-maturity acceptance stood

Figure 4.4: T-Bills Auction Profile



Source: State Bank of Pakistan

[16] Compared to end-September 2013 position, public debt recorded Rs 23.6 billion decline on end-December 2013.
[17] The change in domestic debt stock during H1-FY14, will not match with the financing of fiscal deficit from domestic sources. This is because the change in debt stock takes into account gross borrowing of the government, while the financing numbers are net of government deposits.

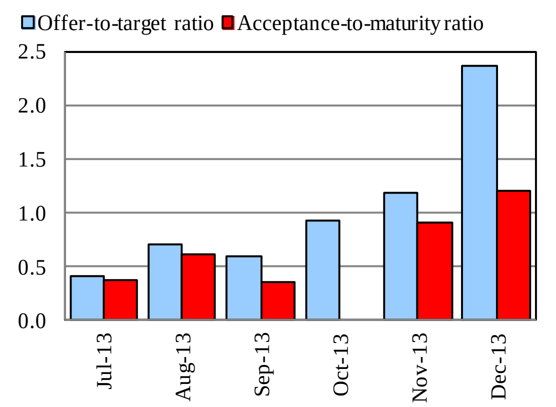
at Rs 98.2 billion in the second quarter of FY14.[18] However, due to market uncertainty about SBP's policy rate, banks shied away from investing in 6 & 12m paper, and focused primarily on 3m paper.[19] Hence, as of end-December 2013, the share of 3m T-bills in the entire T-bills stock increased to 67.3 percent from a mere 5.9 percent as of end-June 2013.

During Q2-FY14, the government mainly aimed at rolling over the T-bills, which is reflected in acceptance-to-maturity ratio of 1.[20] As a result, the fiscal authorities had to rely on borrowing from the central bank to meet the deficit financing requirements. This caused the government to breach both the net borrowing target set by the IMF, as well as the zero quarterly borrowing limit from the central bank.[21]

Mobilization through PIBs witnessed revival

The stock of PIBs witnessed Rs 57.9 billion increase in H1-FY14, compared to Rs 145.1 billion increase posted in the same period last year. In fact Q1-FY14 witnessed Rs 21.2 billion decline in the PIB's stock, however, there was a change in the market sentiment in the second quarter, which led to the addition of Rs 79.1 billion in the PIBs stock in Q2-FY14.

Figure 4.5: PIB Auction Profile



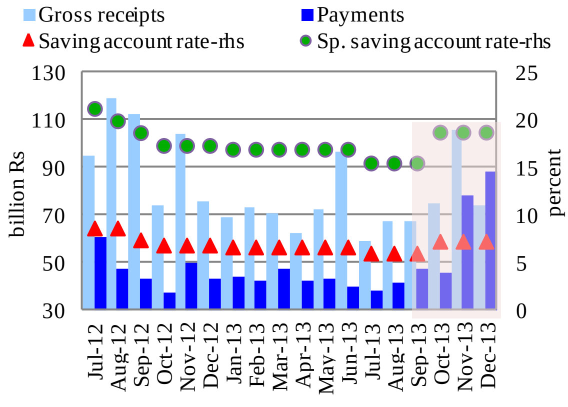
Source: State Bank of Pakistan

According to detailed analysis, the government mobilized Rs 105.6 billion through PIBs during Q2-FY14, which was the highest amount raised after four quarters. In anticipation of an increase in interest rates, market participation in PIB auctions remained moderate in Q1-FY14. The first auction in the second quarter was scrapped, due to a higher rate demanded by the

[18] Specifically, in the three auctions held after the MPS announcement in November 18, 2013, government mobilized greater than targeted amount.
[19] Of the entire amount offered in the T-bill auctions during Q2-FY14, 98.8 percent was offered for 3m bills alone.
[20] For the T-bills auctions, the target-to-maturity ratio stood at 0.93 in Q2-FY14.
[21] With the bilateral external inflows in February and March 2014, and other external inflows expected in H2-FY14, it will be easier to meet these targets going forward.

participants. However, the offered and the realized amounts improved in the subsequent two auctions, after the 50 bps increase announced on November 18, 2013 (**Figure 4.5**). The third auction, witnessed sizeable participation from non-bank institutions. Hence, the acceptance-to-target ratio reached 1.1 after dropping below 1 in all the earlier auctions held in FY14.[22]

Figure 4.6: Increase in Returns Driving up Gross Inflows



Source: State Bank of Pakistan

Upward revision in profit rates boosted gross inflows into NSS

Following the increase in the policy rate, profit rates on National Savings Schemes were also revised upwards on October 1, 2013. The 150 bps increase in the NSS rates, helped stem the downward trend in gross mobilization into these schemes (**Figure 4.6**).[23]

However, large encashment partly neutralized the impact of higher gross inflows, resulting in lower net inflows. More specifically, net mobilization stood at a mere Rs 58.9 billion in H1-FY14, compared to Rs 254.6 billion in the same period last year. This can be traced to the income support levy announced in the FY14 budget, which discouraged individuals

Table 4.9: Public External Debt & Liabilities

billion US$

	Stock		Flows	
	Jun-13	**Dec-13**	**Q1**	**Q2**
Public external debt	50.2	49.8	0.4	-0.8
Govt. debt	43.5	43.9	0.6	-0.2
IMF	4.4	3.6	-0.2	-0.6
Monetary authority liabilities	2.3	2.3	0.0	0.0
Memorandum item				
Debt servicing/FEE[1]	12	15.6		

[1]FEE: Foreign exchange earnings, which include exports of goods, services and income and current transfers.

Source: State Bank of Pakistan

[22] Result of the auction held on 30th January 2014 was even more encouraging, in which, the government raised Rs 199.2 billion.

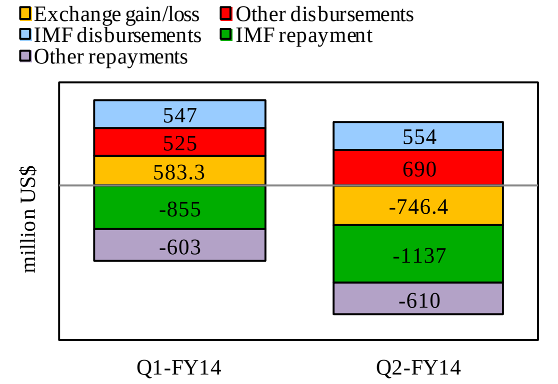
[23] For instance, the profit rates on savings account, special savings accounts, special savings certificates (registered) and regular income certificates were raised by 130 bps, 200 bps, 180 bps and 174 bps in October 2013, leading to Rs 62.5 billion increase in gross inflows in these schemes during Q2-FY14, compared to the preceding quarter.

from keeping their savings in the formal sector.[24]

Public External Debt & Liabilities

Pakistan's public external debt & liabilities posted US$ 370.5 million decline in H1-FY14, reaching US$ 49.8 billion as of end-December 2013. A detailed view reflects that after witnessing an increase during the first quarter, Pakistan's public external debt recorded US$ 755.5 million decline in Q2-FY14 (**Table 4.9**).

Figure 4.7: Factors of Change in Public External Debt Stock



D: Disbursement; R: Repayment

Source: State Bank of Pakistan and Economic Affairs Division

As discussed above, this improvement followed the large repayments to the IMF and favorable exchange rate movement during this period (**Figure 4.7**).[25]

In terms of debt servicing, the country's foreign exchange earnings could not keep pace with the huge debt payment which led to deterioration in the debt servicing-to-FEE ratio to 15.6 percent in H1-FY14, from 11.9 percent on end- June 2013.

[24] S.R.O No. 904(I)/2013. The government has imposed 0.5 percent income support levy in the budget for FY14 on movable assets. However, the recovery of this levy was stopped due to legal issues.

[25] The country has witnessed US$ 891 million net outflows to the IMF in H1-FY14, because of lumpy repayments, which more than offset US$ 1.1 billion inflows from the Fund during this period.