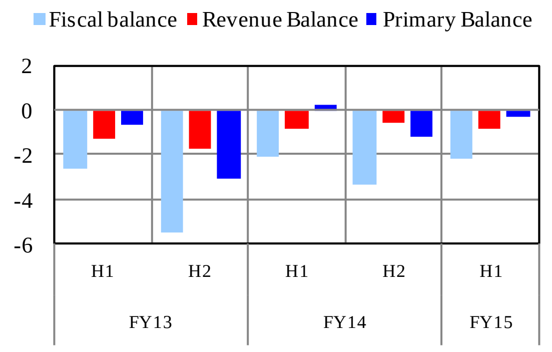
4 Fiscal Policy and Public Debt

4.1 Overview

The budget deficit during H1-FY15 was 2.2 percent of GDP – slightly higher than the same period last year (**Figure 4.1**). While some fiscal consolidation efforts are visible in the expenditure side, revenue mobilzation was not upto the mark. Growth in total tax collection (federal and provincial) during H1-FY15 remained lower than the same period last year (**Section 4.2**), despite the introduction of a number of taxation measrues, like removing concessions and exemptions; sending notices to potential tax payers; expanding the scope of withholding tax; and increasing various tax rates.

Figure 4.1: Budget Deficits (Percent of GDP)



Source: Ministry of Finance

On the spending side, growth in total expenditure was 4.8 percent during the first six months of the year, which was less than half the growth witnessed in the same period last year. While the reduction in interest payments was the main factor in containing expenditure, the growth in non-interest expenditure was also lower in H1-FY15, compared with H1-FY14.[1] Encouragingly, the governemnt has controlled current expenditures, while development expenditures have shown a very high growth of 32 percent during this period. Spending on both overall PSDP and BISP, increased significantly in H1-FY15 (**Table 4.1**).

The pattern of financing the fiscal deficit also improved, as reliance on the banking system was reduced, while domestic non-bank and external resources of finance increased. Particularly, the availability of external resources through the issuance of Sukuk (US$ 1.0 billion), and inflows from international financial

[1] Growth in total expenditure, excluding interest payments, was 8.1 percent in H1-FY15, which was about 4 percentage points less than the last year.

institutions, provided much needed support to the financing needs of the government. Moreover, privatization proceeds of Rs 15.2 billion also appears to be used for financing the budget deficit during this period.[2]

Table 4.1: Summary of Fiscal Operations
billion rupees

	Budget FY15	Actual		% Growth	
		H1-FY14	H1-FY15	H1-FY14	H1-FY15
A. Total revenue	4,218	1,665.6	1,749.1	13.9	5.0
Tax revenue	3,344	1,206.9	1,361.1	15.5	12.8
Non-tax revenue	874	458.7	388.0	10.0	-15.4
B. Total expenditure	5,640	2,213.7	2,320.0	10.7	4.8
Current[1]	4,420	1887.6	1,989.0	9.6	5.4
Of which					
Interest payments	1,325	597.7	572.7	8.2	-4.2
Development	1,220	243.5	321.4	-10.5	32.0
PSDP	1,175	212.6	269.4	-15.5	26.7
Other (incl BISP)		30.9	52.0	49.9	68.3
Net lending		82.7	9.6	1360	-88.4
C. Statistical discrepancy		-8.1	80.9		
Fiscal balance (A-B-C)	-1,422	-540.0	-651.8		
Financing					
External sources	508	-43.5	141.5		
Domestic sources	914	583.5	510.4		
Banks	228	483.2	199.1		
SBP	0	443.1	-413.4		
Commercial banks	228	40.1	612.5		
Non-bank	686	100.3	296.1		
Privatization	198		15.2		
% of GDP					
Overall fiscal balance	-4.9	-2.1	-2.2		
Revenue balance	-0.7	-0.9	-0.8		
Primary balance	-0.3	0.2	-0.3		

Source: Ministry of Finance

4.2 Revenues

The growth of total revenue collection (tax plus non-tax) remained modest at 5.0 percent during H1-FY15, compared with 13.9 percent in the same period last year.

[2] However, this amount is very low as compared to the target of Rs 198 billion, set in Federal Budget for FY15 under privatization head.

Within this, tax collection by FBR increased by 13.6 percent during this period, against 16.0 percent in H1 last year (**Table 4.2**). As said earlier, the government introduced a number of measures in the Federal Budget FY15 to increase tax collection, like enhancing the scope of withholding tax, imposition of advance income tax on various transactions, increasing sales tax and FED rates, and making a distinction between filers and non-filers in the application of tax rates.[3] Despite these measures, FBR tax revenues during H1 of the year were short of its half yearly target.

While the decline in international oil prices and resulting reduction in domestic retail fuel prices, adversely affected the tax revenues, but the entire shortfall in revenue cannot be attributed to this factor.[4] The efficiency of tax administration, lack of documentation, and persistent tax leakages, continued to take a toll on tax collection. As per past practice, FBR target for tax collection has been revised downward to Rs 2,691 billion for the year from an original target of Rs 2,810 billion. Even this revised target requires tax collection to increase by 24.2 percent in the second half of the year, which is considerably higher than the average growth in tax collection observed in H2 of the last five years.[5]

Recently, the government has introduced additional tax measures to increase revenues, which include: (i) increase in sales tax rate on POL products from 17 to 27 percent; (ii) imposition of regulatory duty on imports of more than 300 items; (iii) levying a 2 percent withholding tax on non-filers at the time of registering immovable property worth over three million; and (iv) imposition of withholding tax for non-filers in respect of import of goods and services of various items, including iron, iron ore, urea, pulses, ship breaking, etc. While these measures may increase tax collection, to some extent; a broad-based tax reforms program is still needed to address structural issues.[6]

[3] See SBP First Quarterly Report FY15 for detail of new tax measures.
[4] According to our estimates, the impact of reduced oil prices will be around Rs 100 billion for the whole year (which can vary according to the consumers' demand for POL products). During the second quarter, when fuel prices started declining, the estimated shortfall due to oil prices was not more than Rs 15 billion. However, shortfall in FBR tax collection during H1-FY15 was around Rs 70 billion.
[5] Average YoY growth in tax collection during the second halves of the last five years (i.e., FY10 to FY14) was 15.3 percent. If we exclude one outlier, i.e, FY13 (when growth was just 1.5 percent), the average becomes 18.7 percent. It implies a challenging task for FBR to show a growth of 24.2 percent in H2-FY15.
[6] The government has set up a Tax Reforms Commission, who is currently in the process of preparing its recommendations.

Table 4.2: FBR Tax Collection

billion rupees

	Budget FY15	Actual		% Growth	
		H1-FY14	H1-FY15	H1-FY14	H1-FY15
Direct	1,149	382.0	458.9	15.3	20.1
Indirect	1,661	649.5	713	17.9	9.8
Customs	284	110.1	135.3	2.0	22.9
Sales tax	1,206	481.7	513.8	22.8	6.7
FED	171	57.7	63.9	11.6	10.7
Total taxes	**2,810**	**1031.5**	**1171.9**	**16.0**	**13.6**

Source: Federal Board of Revenue

It is encouraging to note that direct taxes increased by 20.1 percent during H1-FY15 – thanks mainly to increase in the coverage of withholding tax. Some improvement was also seen in the number of tax returns filed by individuals (with a growth of 8 percent), though growth in returns filed by companies remained only 1.2 percent. Moreover, FBR has made efforts to broaden the tax base and strengthen tax compliance by collecting data on financial transactions of prospective taxpayers in terms of purchasing land, insurance policies as well as details of motor registration and international travel. FBR has also issued notices to around 154,000 prospective tax payers and as a result more than 30,000 new tax payers have registered and filed the tax returns.

As expected, non-tax revenues were lower in H1-FY15 than that in H1-FY14 mainly due to the absence of one-offs (like USF and mark up on PSEs loans), which were available last year. The transfer from SBP profit during first half of the year was also lower as compared to the same period last year, though it was in line with the target set for the year (**Table 4.3**). The receipts of CSF (US$ 735 million), however, supported non-tax revenues.

Table 4.3: Non-tax Revenues

billion rupees

	Budget	Actual in H1	
	FY15	FY14	FY15
Mark-up (PSEs & others)	26	58.4	4.1
Dividends	82	28.3	39.5
SBP profits	270	145.0	137.5
Defence (incl. CSF)	140	38.2	80.2
Royalties on gas & oil	81	36.8	40.9
Passport & other fees	20	7.3	7.2
Discount retained on crude oil	20	8.3	5.4
Windfall levy against crude oil	17	8.0	8.7
Foreign grants	35	12.3	20.6
Other federal	125	67.7	43.8
Of which USF	--	67.6	--
Provincial	58	25.4	24.6
Total nontax revenue	874	**458.7**	**387.9**

Source: Ministry of Finance

4.3 Expenditure

During H1-FY15, total consolidated expenditures of federal and provincial governments grew only by 4.8 percent as compared to an increase of 10.7 percent in the same period last year due mainly to lower interest payments and net lending. Unlike the first quarter of the year, when domestic interest payments increased sharply due to six-monthly coupon payments on PIBs, the second quarter witnessed a negative growth in the interest payments (**Table 4.4**).[7]

Table 4.4: Analysis of Fiscal Spending during H1-FY15
billion Rupees

			% Growth	
	FY14	FY15	FY14	FY15
Current expenditures	**1,887.6**	**1,989.0**	**9.6**	**5.4**
Federal	1,352.8	1,385.7	7.9	2.4
of which				
Interest payment	597.7	572.7	8.2	-4.2
Defense	295.3	329.6	15.1	11.6
Public order and safety	38.7	43.8	15.6	12.9
Others	421.1	439.6	2.6	4.4
Provincial	534.7	603.3	14.2	12.8
Development expenditures	**243.5**	**321.4**	**-10.5**	**32.0**
PSDP	212.6	269.4	-15.5	26.7
Federal	118.6	125.5	-8.1	5.8
Provincial	94.0	143.9	-23.3	53.2
Others (incl BISP)	30.9	52.0	49.9	68.3
Net lending	**82.7**	**9.6**	--	--
Total	**2,213.7**	**2,320.0**	**10.7**	**4.8**

Source: Ministry of Finance

While the change in maturity profile of the government's domestic debt has altered the quarterly pattern of interest payments, to some extent (i.e., more payments falling due in Q1 and Q3), the overall domestic interest payments also contained due to lower interest rates as well as low volume of domestic borrowing. On the other hand, external interest payments picked up as the share of external resources in budgetary financing increased. During H1-FY15, growth in external interest payments was 25.6 percent, compared with -14.0 percent in H1-FY14.

The current expenditure showed a growth of 5.4 percent in H1-FY15, which was significantly lower than the last year. Both the federal and provincial governments remained frugal in their current spending. Even if interest payments are excluded, the growth in the current expenditure was 9.8 percent during this period, compared with 10.3 percent in the last year.

However, development expenditures increased sharply during first half of the year, which is encouraging. Particularly, provincial expenditures on public sector development programs showed a sharp increase of 53.2 percent in H1-FY15, compared with the negative growth (-23.3 percent) in H1 last year. While federal

[7] However, in the third quarter, there can be again a jump with the payment of six-monthly coupon in January 2015.

government's PSDP also increased, its spending on other heads, like BISP, showed a tremendous growth.[8]

4.4 Provincial fiscal operations

The overall provincial surplus reached Rs 143.3 billion by the end of H1-FY15, which is almost half the full year target (i.e., Rs 289 billion). This surplus was 13.0 percent lower than the surplus observed in the first half of the last year. The reduction in provincial surplus was mainly caused by increase in expenditures. Growth in total expenditures (all provinces combined) increased sharply to 18.6 percent in H1-FY15 from 6.1 percent in the same period last year. The share of provinces in consolidated expenditures (federal plus provincial) was 32.5 percent during this period, compared with 28.7 percent last year, while their share in total revenue (including federal transfers) remained almost unchanged. The increase in total expenditures was primarily driven by higher growth in the development expenditures, whereas the current expenditure grew in proportionate to revenues.

On the revenue side, provinces largely remained dependant on federal transfers, while their own efforts resulted in a marginal increase in tax collection during the period. Particularly, Punjab could not boost its own revenue mobilization efforts. In fact, it witnessed YoY declines in property tax, motor vehicle tax, and other taxes (including GST on services) during H1-FY15 – only stamp duties managed to show growth during the period. However, Punjab was the largest recipient of transfers from divisible pool as well federal loans and grants, which helped it show a higher budget surplus, despite aggressive spending on development projects (**Table 4.5**).

Punjab allocated significant amount of resources for construction of roads and other urban development programs (including Rawalpindi-Islamabad Metro Bus Project, having Rs 10.7 billion provision in Punjab Budget 2014-15). It also increased its spending on health and education sectors. On the other hand, the development spending by the Sindh province remained almost at H1-FY14 level, while KPK and Baluchistan also increased their development spending.

Coming again towards revenue, the provinces' own revenue mobilization is around 10 percent of their total revenues despite the fact they have constitutional powers to levy tax on major part of the GDP, i.e., services (which is more than 50 percent of the GDP) and agriculture income (25 percent of the GDP). Provinces

[8] Rs 43 billion have been disbursed among 4.83 million beneficiaries (families) under BISP during H1-FY15. The government aims to extend its outreach to over 5 million beneficiaries by the close of the current fiscal year. The full year target for BISP is Rs 97.2 billion.

have to develop capacity and make institutional reforms to strengthen revenue mobilization. Currently, different provincial departments have been entrusted to collect tax from various sectors. However, they have varying degrees of efficiency level – the most efficient being the newly established provincial revenue authorities for sales tax on services, which are also using information technologies in their processes.

Table 4.5: Provincial Fiscal Operations during H1

billion Rupees

	Punjab		Sindh		KPK		Balochistan		All Provinces	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
A. Total revenue	349.6	412.5	230.7	249.8	132.5	141.4	87.2	93.2	800.1	897.0
Share in federal revenue	286.5	336.0	179.2	189.7	106.8	118.9	74.0	79.1	646.5	723.7
Taxes	45.0	46.0	36.0	42.3	5.7	5.5	0.9	1.2	87.6	95.0
Non-taxes	14.2	10.8	2.0	3.0	6.5	9.4	2.7	1.4	25.4	24.6
Federal loans & transfers	3.9	19.7	13.5	14.9	13.5	7.5	9.7	11.5	40.6	53.6
B. Total expenditure	295.7	351.4	186.7	208.5	99.7	125.5	53.2	68.3	635.4	753.6
Current	258.4	274.5	149.3	170.6	85.2	104.8	48.5	59.8	541.4	609.8
Development	37.3	76.9	37.4	37.9	14.5	20.6	4.7	8.5	94.0	143.9
Overall balance (A-B)	53.9	61.1	44.0	41.4	32.8	15.9	34.0	24.9	164.7	143.3

Source: Ministry of Finance

4.5 Public debt

Pakistan's public debt recorded an increase of Rs 565.3 billion during H1-FY15, reaching Rs 17.0 trillion as of end-December 2014 (**Table 4.6**). This increase in the public debt was almost half the increase seen during the same period last year. While the domestic debt increased in H1-FY15 by a significantly lower amount compared with the same period last year, the external debt witnessed net retirement during this period, aided by hefty revaluation gains from the appreciation of the US Dollar against other major currencies.

However, despite the slowdown in debt accumulation, Pakistan's public debt is still significantly above the average level of emerging and developing economies.[9]

[9] According to World Economic Outlook (WEO) data, the general government gross debt as percent of GDP for Emerging & Developing economies stood at 40.1 percent, while the same ratio for Pakistan stood at 63.7 percent in FY14.

Domestic debt

The domestic debt increased by Rs 603.2 billion during H1-FY15, compared with Rs 717 billion during the same period last year. The government decision to tap on international debt market, resumption of multilateral inflows, and bilateral arrangements, have helped reduce pressure on domestic sources of funding.

Table 4.6: Pakistan's Public Debt Profile

billion Rupees

	Stock		Flow			
			H1		FY15	
	Jun-14	Dec-14	FY14	FY15	Q1	Q2
Public Debt	**16,445.2**	**17,010.5**	**1,039.9**	**565.3**	**234.0**	**331.3**
Public domestic debt	11,028.3	11,631.5	717.0	603.2	191.3	412.0
Public external debt	5,417.0	5,379.0	322.9	-37.9	42.8	-80.7
Govt. external debt	4,794.3	4,700.2	326.8	-94.1	33.8	-128.0
Debt from the IMF	298.4	358.4	-55.4	60.0	1.7	58.3
External liabilities	324.2	320.4	51.5	-3.8	7.2	-11.1

Source: State Bank of Pakistan

In addition to some deceleration, the composition of domestic debt also changed. Specifically, the share of permanent debt (medium to long term in nature) has increased to 39.7 percent by end-December 2014, compared with 36.3 percent at the beginning of the year. This increase was attributed to both the government efforts to lengthen the maturity profile of its debt, and the commercial banks aggressive participation in PIBs auctions. In this context, the following points are worth noting:

Table 4.7: Domestic Debt

billion Rupees

	Stock	H1	Stock	H1
	Jun-13	FY14	Jun-14	FY15
T-bills (Auctions)	2,920.2	39.7	1,747.4	64.7
T-bills (SBP)	2,275.2	548.4	2,852.3	-331.0
PIBs	1,321.6	57.9	3,222.0	587.4
NSS	2,006.3	32.3	2,156.2	167.6
Others	1,098.3	38.8	1,050.5	114.6
Total Domestic Debt	**9,621.5**	**717.0**	**11,028.3**	**603.2**

- An exceptionally high term premium between 3-year PIBs and 12-month T-bills, and expectation of decline in the interest rate, attracted commercial banks to lock-in their funds in high yielding PIBs. Commercial banks offered

Rs 1,216.4 billion in six PIBs auctions held during H1-FY15, against the cumulative target of Rs 450 billion: i.e. 2.7 time of the target (Table 4.8).[10]

- During Q2-FY15, commercial banks offered Rs 1,035.5 billion in T-bill auctions against the target of Rs 1,245.0 billion. The government accepted Rs 969.7 billion (competitive bids) in these auction, which was lower than the maturing amount of Rs 978.9 billion during the period under review (**Table 4.9**). It means, the commercial banks were not too keen to invest in T-bills.

Table 4.8: PIBs Auction Profile (Face Value)

billion rupees

	Target	Offer (All)	Accepted (Competitive)	Accepted (All)
Jul	100	82.1	58.22	63.33
Aug	100	93.8	86.8	89.82
Sep	100	207.6	157	160.43
Q1-FY15	**300**	**383.5**	**302.02**	**313.58**
Oct	50	338.7	50.3	57.27
Nov	50	157.8	141.7	144.72
Dec	50	336.4	148.3	152.27
Q2-FY15	**150**	**832.9**	**340.3**	**353.81**

Source: State Bank of Pakistan

Table 4.9: T-bills Auction Profile (Face Value)

billion rupees

			Competitive bids	
	Target	**Maturity**	**offer**	**Accepted**
Jul	225	190.1	254.6	253.6
Aug	225	180.4	163.4	163.1
Sep	250	259.6	201.6	200.6
Q1-FY15	**700**	**630.1**	**619.6**	**617.3**
Oct	550	482.7	351.7	349.3
Nov	520	399	504.5	498.8
Dec	175	97.1	179.3	121.6
Q2-FY15	**1,245**	**978.9**	**1,035.5**	**969.7**

Source: State Bank of Pakistan

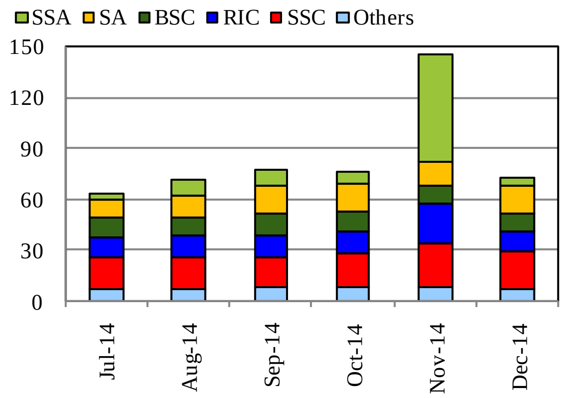
The above developments not only helped improving maturity profile of the domestic debt, but also shifting government borrowing away from SBP. The improvement in the maturity profile of debt would help reduce re-pricing and roll-over risks. However, the benefits of this transformation, especially before the decline in interest rates, should be discounted by the increase in the cost of debt servicing, in the medium to long run.

Contrary to the borrowing from the banking sector, the mobilization of domestic debt from the non bank sector, mainly through National Savings Scheme (NSS), showed a sharp increase during H1-FY15. Net receipts in NSS posted a 7.8 percent growth during this period, compared with 1.6 percent in the same period

[10] However, the term premium declined in December 2014, following the change in monetary policy stance in November, 2014.

last year. The growth in NSS was mainly supported by 63.7 billion inflows in Special Saving Account in November 2014 (**Figure 4.2**). Among other factors, this exceptional increase reflects institutional investment on the expectation of potential cut in profit rate following the reduction in policy rate in November 2014, and decline in PIB yields.[11]

Figure 4.2: Gross Inflows in NSS (billion rupees)



Source: Central Directorate of National Savings

External debt & liabilities

Pakistan's public external debt and liabilities saw a net reduction of US$ 1.3 billion during the first half of year to US$ 53.5 billion by end December 2014 (**Table 4.10**). Quarterly data indicates that the reduction was entirely concentrated during first quarter of the year, while an increase was witnessed in the second quarter. Although the government received external inflows from IMF, international debt market, and other sources during the period under review, the impact of these inflows was more than offset by US$ 3.1 billion revaluation gains from the appreciation of the US Dollar against major currencies.

Table 4.10: External Debt

million US Dollar

	Stock Jun-13	Flow H1-FY14	Stock Jun-14	Flow – FY15		
				Q1	Q2	H1
Public debt & liabilities	50,989.1	-112.0	54,822.7	-,1635.3	357.2	-1,278.0
Government debt	43,496.1	390.6	48,521.1	-1,486.3	-247.7	-1,734.0
From IMF	4,387.0	-797.0	3,020.2	-96.8	644.6	547.8
Foreign exchange liabilities	3,106.0	294.0	3,281.4	-52.2	-39.7	-91.9

Source: State Bank of Pakistan

While main sources of external inflows during were IMF (US$ 1.1 billion) and Sukuk issued in the international market (US$ 1.0 billion), inflows from other creditors during H1-FY15 include: US$ 457.6 million from China mostly for

[11] Following 50 bps cut in policy rate in November 2014, the government revised downward profit rate on NSS in December 2014.

power sector projects;[12] US$ 86.3 million from ADB for *Social Protection Development*; US$ 70.7 million also from ADB for *Flood Emergency Reconstruction* project; and US$ 793.8 million from IDB as a short term loan based on Murabaha arrangement.

[12] Of total amount disbursed, US$ 242.8 million were on account of *GCL Karachi Nuclear Power K2/K3 project* and US$ 74.5 million for *Neelum Jehlum Hydro power project*