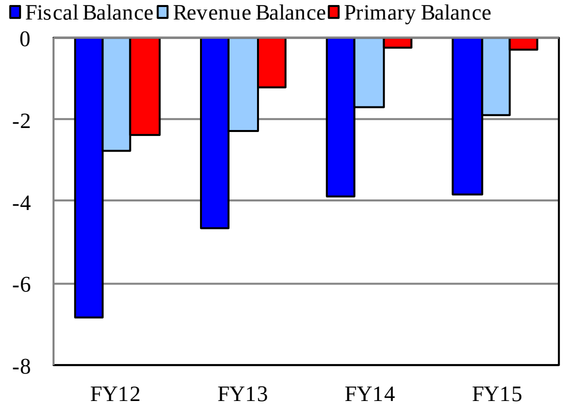
4 Fiscal Policy and Public Debt

4.1 Fiscal operations

The budget deficit during Jul-Mar FY15 was 3.8 percent of GDP, compared with 3.9 percent in the same period last year (**Figure 4.1**). The deficit was contributed by a slow growth in revenue collection as well as sharp increase in development spending. While increased spending on development is encouraging, sluggishness in revenue collection is a source of concern. There is a need for more serious revenue mobilization efforts to support fiscal consolidation.

Figure 4.1: Balances in Jul-Mar (Percent of GDP)



Source: Ministry of Finance

Table 4.1: Overview of Fiscal Operations (Jul-Mar)
Amount in billion rupees, growth in percent

	FY14	FY15	YoY Growth FY14	YoY Growth FY15
A. Revenue	2,477.4	2,682.6	16.6	8.3
Tax revenue	1,841.8	2,063.2	18.2	12
o/w FBR taxes	1,574.8	1,775.1	17.9	12.7
Non-tax	635.6	619.5	12.1	-2.5
B. Expenditure	3,446.3	3,731.6	8.7	8.3
Current	2,904.6	3,199.1	9.9	10.1
Development	469.9	579.7	5.7	23.4
Net lending	85.9	14.3	-	-
St. discrepancy	-14.1	-61.4	-	-
Overall balance	-968.9	-1,048.9	-7.4	8.3
Balance as % of GDP				
Fiscal	-3.9	-3.8		
Revenue	-1.7	-1.9		
Primary	-0.2	-0.3		

Source: Ministry of Finance

The consolidated revenue position saw a modest increase of 8.3 percent during the first nine months of FY15, which is half the growth achieved last year. While structural problems in the taxation system (like narrow base and administrative issues) persisted, a sharp decline in oil prices also adversely affected revenue mobilization. FBR, which collects more than 80 percent of total taxes, again missed its target.[1] Furthermore, the non-tax revenues decreased by 2.5 percent, which was already

[1]The FBR tax collection during Jul-Mar FY15 was Rs 71 billion short of IMF indicative target for this period (indicative target for end-March FY15 was Rs 1,846 billion).

[2] The Federal budget FY15 set the FBR target at Rs 2,810 billion, which was revised downward to

expected, as certain one-off receipts of last year, were not available this year (**Table 4.1**).

Meanwhile, the expenditures grew by 8.3 percent in Jul-Mar FY15, as against 8.7 percent during the same period last year. The current expenditures increased by 10.1 percent mainly due to public order & safety related expenditures and administrative expenses by the provinces. However, the salient feature of the fiscal developments has been an upsurge in development spending, specifically by the provinces, which increased by 46 percent during the review period.

Financing mix of the deficit

The financing mix of the budget deficit improved with higher availability of external resources. A net inflow of Rs 137.8 billion from external sources was recorded in Jul-Mar FY15, compared with Rs 107.1 billion last year. This included issuance of Sukuk in international financial markets amounting US$ 1.0 billion, and multilateral flows.

Table 4.2: Financing of Budget Deficit (Jul-Mar)

Billion rupees

	FY13	FY14	FY15
Total Financing	1,046.2	968.9	1,048.9
External	-4.1	107.1	137.8
Domestic	1,050.3	861.7	911.1
Bank	856.6	436.9	469.4
Non Bank	193.7	424.8	426.5
Privatization			15.2

Source: Ministry of Finance

The trend of financing from domestic sources (banks and non-banks) remained almost the same in FY15 as in the last year (**Table 4.2**). However, within the banking system, the government relied on commercial bank financing, and retired heavily to the central bank (as already discussed in **Chapter 3**).

Although external inflows are welcome in a resource-constrained economy, the servicing of external debt may pose additional risks in future. Similarly, heavy reliance on commercial banks may affect the credit supply to the rest of the economy, and promote risk-averse behavior in the banking sector.

4.2 Revenues

Despite the imposition of additional tax measures, including increase in sales tax rate on petroleum products, imposition of regulatory duties, and sending notices to prospective taxpayers, the FBR tax collection did not increase as per expectations. The tax collection saw a modest growth of 12.7 percent during Jul-Mar FY15, compared to 17.9 percent in the same period last year. The FBR receipts will now have to grow by 20.6 percent in the last quarter of FY15, to achieve the revised target of Rs 2,605 billion.[2]

Within total FBR revenues, direct taxes showed a growth of 17.2 percent – a major part of which came from withholding taxes.[3] The largest source of FBR revenues is sales tax, which has showed a growth of only 6.1 percent during Jul-Mar FY15, compared with 20.5 percent in the same period last year (**Table 4.3**). Main reasons for this sluggish growth are: (a) lower collection from POL products and edible oil (which make about 50 percent of total sales tax) due to a sharp fall in prices; and (b) decline in sales tax collected from fertilizer and natural gas due to lower supplies.

Table 4.3: FBR Tax Collection (Jul-Mar)

Billion rupees

		Actual		% Growth	
	BE FY15	**FY14**	**FY15**	**FY14**	**FY15**
Direct	1,149.0	598.8	701.5	21.9	17.2
Indirect	1,661.0	975.9	1,073.6	15.6	10.0
Customs	284.0	169.3	208.9	-0.7	23.4
Sales tax	1,206.0	716.8	760.3	20.5	6.1
FED	171.0	89.9	104.3	14.0	16.0
Total	**2,810.0**	**1,574.8**	**1,775.1**	**17.9**	**12.7**

Source: Federal Board of Revenue

Table 4.4: Non-tax Revenues

Billion rupees

	Budget FY15	Actual Jul-Mar	
	(full-year)	**FY14**	**FY15**
Mark-up (PSEs & others)	26.0	62.3	5.1
Dividends	82.0	46.3	54.8
SBP profits	270.0	205.0	222.5
Defence (incl. CSF)	140.0	77.8	154.3
Royalties on gas & oil	81.0	59.5	61.0
Passport & other fees	20.0	13.1	12.0
Discount retained on crude oil	20.0	13.6	6.7
Windfall levy against crude oil	17.0	11.0	10.7
Foreign grants	35.0	12.3	26.7
Other federal	125.0	32.8	28.8
Provincial	58.0	34.7	36.9
Total non-tax revenue	874.0	**635.6**	**619.5**

Source: Ministry of Finance

Non- tax revenues posted a YoY decline of 2.5 percent during Jul-Mar FY15, mainly on account of reduction in the mark-up on loans extended by the government (**Table 4.4**).[4] Meanwhile, higher CSF inflows, dividends and SBP profits, continued to shore up the non-tax revenues.

[2] The Federal budget FY15 set the FBR target at Rs 2,810 billion, which was revised downward to Rs 2,691 billion in Dec 2014, which was further reduced to Rs 2,605 billion.

[3] Withholding tax is levied on a wide range of economic activities, including imports, exports, salaries, dividends, bank interest & securities, cash withdrawal, contracts, electricity bills, phone, etc. It constitutes 65 percent of the total direct taxes.

[4] Last year, there was a sharp jump in mark-up income from PSEs due to one-off adjustment of circular debt in the power sector (during Q1-FY14).

4.3 Expenditure

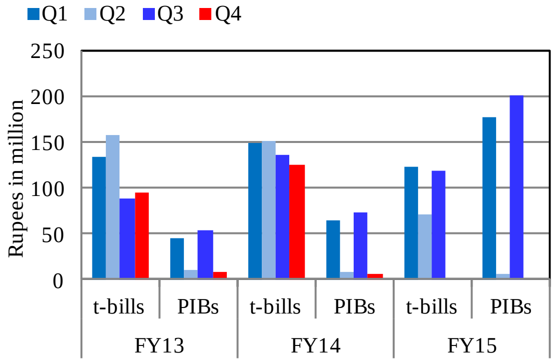
During Jul-Mar FY15, growth in consolidated expenditures (excluding statistical discrepancy) recorded 9.6 percent, compared with12.1 percent in the same period of FY14 (**Table 4.5**). Almost all the major expenditure heads showed smaller increase except overall PSDP and provincial current spending. Interest payments increased by only 7.2 percent during this period, compared with 17.7 percent in the same period last year, despite a sharp rise in PIB coupon payments in January 2015.[5] In fact, the negative growth in the interest payments in H1-FY15, largely offset the increase in the interest payments in Q3 (**Figure 4.2**).

Table 4.5: Analysis of Fiscal Spending during Jul-Mar FY15
Billion rupees

	FY14	FY15	Growth FY14	Growth FY15
Current expenditures	**2,904.6**	**3,199.1**	**9.9**	**10.1**
Federal	2,083.2	2,255.8	10.4	8.3
of which				
Interest payment	909.1	974.5	17.7	7.2
Defense	451.7	485.9	11.3	7.6
Public order and safety	60.0	66.4	12.1	10.6
Others	662.4	729.0	1.0	10.1
Provincial	821.4	943.2	8.8	14.8
Development expenditures	**469.9**	**579.7**	**5.7**	**23.4**
PSDP	393.0	499.4	-3.5	27.1
Other development exp.	77.0	80.2	106.6	4.3
Net lending	**85.9**	**14.3**	-	-
Total expenditures*	**3,460.4**	**3,793.0**	**12.1**	**9.6**

*: Excluding statistical discrepancy
Source: Ministry of Finance

Figure4.2: Quarterly Interest Payments on t-bills and PIBs During Jul-Mar 2015



Source: Ministry of Finance

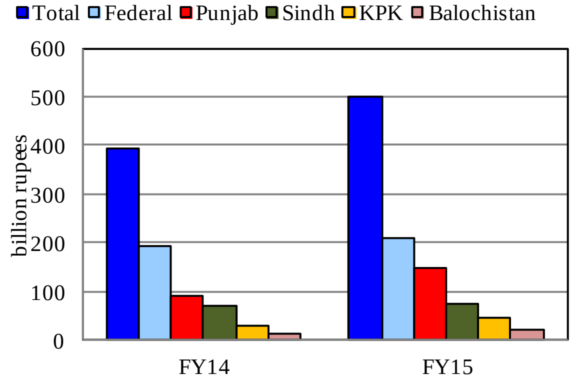
During Jul-Mar FY15, federal non-interest current expenditures increased by 9.1 percent, compared with 5.3 percent in the same period of FY14. This was primarily driven by increase in grants (other than provinces), spending on defense, and public order & safety. The provincial current expenditures also increased by 14.8 percent during the period, against 8.8 percent growth in the same period last year – an indication of their increasing role after

[5] With the recent increase in the share of PIBs in the government's domestic debt, debt servicing experiences a jump in July and January when 6-month coupon payment on PIBs fall due. If we look only at Q3, domestic debt servicing showed a YoY increase of 30.6 percent in this quarter due to PIB coupons. The next payment of six-monthly coupon of PIBs will fall in July, 2015.

18th amendment of the constitution. Defense spending during Jul-Mar FY15 registered an increase of 7.6 percent (Rs 34.4 billion) over the same period last year. Similarly, spending on "public order & safety affairs" increased by 10.6 percent to combat terrorism and improve overall security situation in the country.

It is, however, encouraging to observe that federal and provincial government's development spending increased by 23.4 percent during Jul-Mar FY15 compared with 5.7 percent growth registered in FY14 (**Figure 4.3**). Particularly, provincial governments increased their development outlays sharply, and utilized about 45 percent of their annual budgetary allocations in this period, compared with 32.5 percent in the same period last year.

Figure 4.3: Public Sector Development Plan Spendings During Jul-Mar FY15



Source: Ministry of Finance

4.4 Provincial Fiscal Operations

Provinces continued to show budget surpluses during Jul-Mar FY15, albeit lower than that during the same period last year (**Table 4.6**). It appears that the provinces, instead of accumulating surpluses, focused on development expenditures. Moreover, their current expenditures showed more than 6 percentage points higher growth in this period than the same period last year.

Further, the provinces continued to rely on transfers from federal revenues, and no province, except Sindh, could show notable efforts in their own revenue generation. This situation is a source of concern for overall resource mobilization in the country, which already has the lowest tax-to-GDP ratio in the region. Putting it in perspective, agriculture and services (having a significant share in GDP) are not contributing to national exchequer according to their potential because: (a) FBR cannot levy sales tax on services and income tax on agriculture, as they come under the purview of provinces; and (b) the provinces are not putting much effort to generate revenue from these sources. In order to address this structural issue, there is an urgent need for coordination among federal and provincial tax authorities.

Table 4.6: Provincial Fiscal Operations during Jul-Mar
Billion rupees

	Punjab		Sindh		KPK		Balochistan		All Provinces	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
A. Total revenue	549.6	626.7	358.1	387.8	212.3	208.4	128.0	138.3	1248.0	1361.1
Share in federal revenue	460.9	515.3	280.4	295.5	168.8	180.1	107.6	116.6	1017.8	1107.5
Taxes	69.0	70.0	56.1	65.8	9.0	7.5	2.0	1.8	136.2	145.1
Non-taxes	15.5	16.8	3.9	6.3	11.5	11.6	3.8	2.1	34.7	36.8
Federal loans & transfers	4.1	24.6	17.7	20.1	23.0	9.2	14.6	17.7	59.4	71.6
B. Total expenditure	486.6	598.7	299.5	338.5	158.7	201.8	86.3	105.5	1031.1	1244.5
Current	397.8	449.0	228.8	264.0	130.0	156.7	74.8	83.3	831.4	953.0
Development	88.8	149.7	70.7	74.5	28.7	45.1	11.5	22.2	199.7	291.5
Overall balance*	63.0	28.0	58.6	49.3	53.6	6.6	41.7	32.8	216.9	116.7

*: Provincial balances obtained from financing side may be different than these numbers due to statistical discrepancies.
Source: Ministry of Finance

4.5 Public Debt

Pakistan's public debt stock increased by Rs 933.6 billion during Jul-Mar FY15, reaching Rs 17.4 trillion as of end-March 2015 (**Table 4.7**). The entire increase in public debt was on account of domestic debt, whereas external debt recorded net decline during the period due to revaluation gains. Encouragingly, addition to public debt during Jul-Mar FY15 was significantly lower than that in the same period last year.

Table 4.7: Pakistan's Public Debt Profile
Billion rupees

	Stock		Flow				
			Jul-Mar		FY15		
	Jun-14	**Mar-15**	**FY14**	**FY15**	**Q1**	**Q2**	**Q3**
Public Debt	**16,442.3**	**17,375.9**	**1,322.9**	**933.6**	**220.5**	**332.9**	**380.2**
Public domestic debt	11,028.3	12,044.8	1,314.5	1,016.5	191.3	412	413.4
Public external debt	5,414.0	5,331.0	8.4	-83.0	29.3	-79.0	-33.2
Govt. external debt	4,791.3	4,633.8	62.3	-157.6	20.3	-126.3	-51.6
Debt from the IMF	298.4	378.2	-78.2	79.8	1.7	58.3	19.8
External liabilities	324.2	319.0	24.3	-5.2	7.2	-11.1	-1.4

Source: State Bank of Pakistan

Domestic Debt

Unlike the previous year, when the fiscal deficit was entirely financed through domestic sources; nearly 13.1 percent of the budget deficit was financed through external borrowing in Jul-Mar FY15. Realization of privatization proceeds; resumption of multilateral flows; and issuance of Sukuk, have reduced the pace of domestic debt accumulation (**Table 4.8**).

In absolute terms, Pakistan's domestic debt expanded by Rs 1.0 trillion in Jul-Mar FY15, compared with an increase of Rs 1.3 trillion in the previous year. The composition of domestic debt has changed significantly compared to the last year, as the government borrowed heavily through PIBs and T-bills, and used these funds to retire some of its debt with the central bank.

Table 4.8: Absolute Change in Government Domestic Debt

Billion rupees

	Jul-Mar FY14	Jul-Mar FY15
Government	**1314.5**	**1016.6**
Permanent debt	**948.4**	**829.5**
of which		
PIBs	1043.4	779.7
Floating debt	237.4	-33.1
of which		
MTBs*	-263.6	571.6
MRTBs	501	-604.7
Unfunded debt	128.8	220
Foreign currency	-0.07	0.12

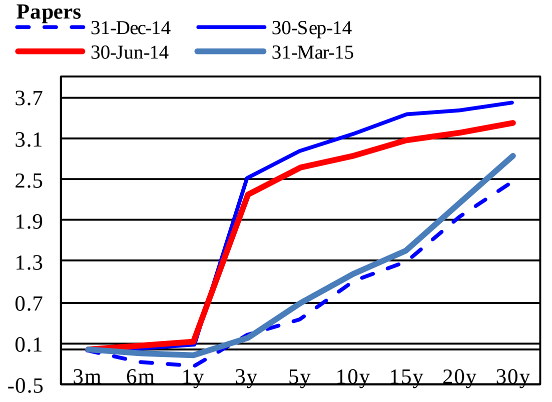
* includes outright sale of MTBs of worth Rs 276.1 billion for FY14

Source: State Bank of Pakistan

Mobilization through T-bills witnessed revival

While banks were locking their funds in PIBs during H1-FY15 due to a sharp decline in inflation along with the term premium, there seems to be a revival in banks' interest in T-bills during the third quarter of the year. With a sharp increase of Rs 506.9 billion in Q3 only, the share of T-bills in total domestic debt has jumped to 19.3 percent by end-March 2015, from 15.8 percent at end-June 2014. Market expectations about the interest rate cut has played its part in increasing the demand for T-bills, which was also reflected in the sharp decline in term premium for PIBs.[6] Specifically, the term premium between PIBs over 3 month T-bills reduced significantly during the first nine months of the year (**Figure 4.4**).

Figure 4.4: Change in Term Premium of Government Papers

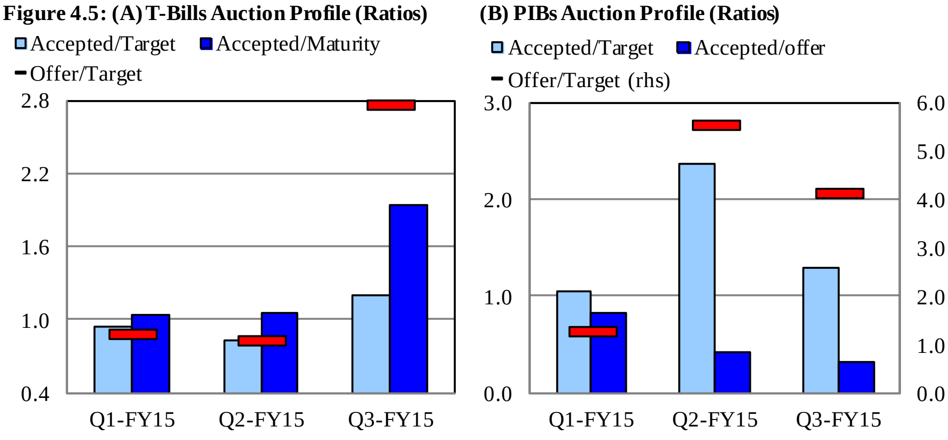


Source: State Bank of Pakistan

[6] Term premium on government paper of different tenure is calculated with reference to 3-month T-bill.

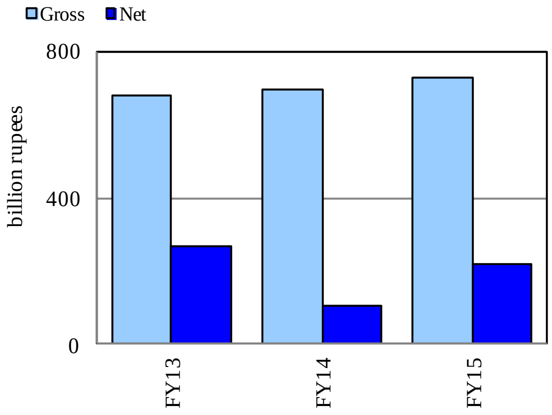
Within the T-bills, 12-month T-bills remained the preferred instrument for commercial banks. The amount offered by commercial banks in T-bill auctions, was significantly higher than the targets for third quarter of FY15 (**Figure 4.5**). Similarly, the government also accepted more than the targeted volumes.

Figure 4.5: (A) T-Bills Auction Profile (Ratios) **(B) PIBs Auction Profile (Ratios)**



Source: State Bank of Pakistan Source: State Bank of Pakistan

Figure 4.6: Flows into NSS (Jul-Mar)



Source: Central Directorate of National Savings

Like T-bills, the offered amount from PIBs was also well above the target for the third quarter.[7] Similarly, the government also accepted a higher amount of PIBs than the target, though it was significantly lower in Q3, compared with Q2, as the government moved towards short-term instruments.

The government's non-bank borrowing through national savings schemes (NSS) maintained last year's pace despite downward revision in profit rates on these schemes.[8] While the gross mobilization, increased by 4.7 percent during Jul-Mar

[7] Although offer-to-target ratio decline in Q3 compared to Q2, it remained close to 4 which reflects that scheduled banks' interest in PIBs still persists.
[8] In aggregate, the NSS rate saw a reduction of approximately 200 bps, to reach at a decade's low on April 01, 2015.

FY15, net inflows through NSS almost doubled during this period, as encashment was significantly lower than that in the last year (**Figure 4.6**).

Public External Debt

Pakistan's stock of external debt & liabilities (EDL) recorded a significant decline of US$ 2.5 billion during Jul-Mar FY15, reaching US$ 52.3 billion as of end-March 2015 (**Table 4.9**). This was mainly due to revaluation gain of US$ 4.4 billion owing to appreciation of the US dollar against major currencies, which more than offset the increase in external debt & liabilities during the period.[9]

Table 4.9: Public External Debt & Liabilities

Billion US$

	Stock		Flows				
			Jul-Mar		FY15		
	Jun-14	Mar-15	FY14	FY15	Q1	Q2	Q3
Public external debt	54.8	52.3	0.6	-2.5	-1.8	0.4	-1.1
Govt. debt	48.5	45.5	1.0	-3.0	-1.6	-0.2	-1.2
IMF	3.0	3.7	-0.8	0.7	-0.1	0.6	0.1
Foreign exchange liabilities	3.3	3.1	0.3	-0.2	-0.1	0.0	-0.1

Source: State Bank of Pakistan

Upon successful completion of the IMF's sixth review, Pakistan received US$ 498.3 million under Extended Fund Facility in March 2015. Total inflows from IMF during Jul-Mar FY15 were higher than the repayments made to it during this period. Similarly, external loan disbursement to the government sector posted 67.3 percent increase during Jul-Mar FY15 (**Table 4.10**). In addition to Sukuk issued during Q2, large increase came from credit disbursement by IDB, ADB and China.[10]

Pakistan's external debt servicing declined by 31.9 percent during Jul-Mar FY15 compared to the same period last year, which includes repayment to the IMF and other multilateral creditors.[11]

[9] Among other currencies, depreciation of Euro and Japanese Yen against US$ resulted in US$ 1.0 and 1.2 billion reduction in EDL respectively.

[10] Disbursement by China mainly includes financing for power sector projects, while ADB extended loans for Social Sector development. Borrowings from IDB include short term financing based on murabaha arrangement to finance import of crude oil.

[11] Principal repayment includes US$ 1.0 billion to the IMF and US$ 935 million to other multilateral creditors during Jul-Mar FY15.

Decline in the debt repayment together with growth in foreign exchange (FX) reserves, led to an improvement in the country's repayment capacity. Specifically, external debt servicing to FX earnings ratio went down from 13.3 percent in Jun 2014 to 9.0 percent in March 2015. However, in the medium term, the risks associated with the country's ability to service its external debt, need to be managed carefully. More specifically, instead of relying on debt creating FX inflows to service the external debt, there is a need to focus more on non-debt creating inflows like FDI, exports, etc. It must also be kept in mind that debt servicing will increase going forward as:

Table 4.10: External Loan Disbursement (Jul-Mar)

Million US$

	FY14	FY15	Absolute Δ
Total	**2,259.9**	**3,781.2**	**1,521.2**
Bond Holder (Sukuk)	0.0	1,000.0	1,000.0
IDB	408.8	987.4	578.7
China	303.9	564.9	261.0
ADB	325.0	364.3	39.3
UK	245.6	244.5	-1.2
IDA	238.4	209.4	-29.1
IBRD	112.0	16.9	-95.1
Japan	78.4	108.2	29.8
USA	78.0	77.5	-0.5
Consortium of Commercial Banks	322.5	50.0	-272.5
Saudi Arabia	52.8	18.0	-34.8
Others	94.5	140.2	45.7

Source: Economic Affairs Division, Islamabad

(i) 10 years Eurobonds issued in 2005-06 (US$ 500 million) and 2006-07 (US$ 750 million) will mature in FY16 and FY17; and

(ii) Repayment of rescheduled Paris Club debt under Official Development Assistance (ODA) will start from FY17.[12]

[12] Pakistan entered into a debt rescheduling agreement for its entire stock of US$ 12.5 billion owed to the Paris Club creditors in December 2001. This included US$ 8.8 billion of ODA loans and US$ 3.6 billion non-ODA loans.