5 Fiscal Developments

5.1 Overview

The budgetary data for Q3-FY10 is not yet available, but some preliminary information suggests that the fiscal sector is under stress and the government is likely to miss its budget deficit target. Although the FBR has regained its revenue path in the third quarter of the year and non-tax revenue also propped up by appropriation of SBP profit and realization of coalition support fund of US$ 349.0 million, the budget deficit is expected to be higher than the target primarily because of higher than budgeted public expenditure.

After revenue shortfall in H1-FY10, FBR improved its performance in the third quarter of the year with 26 percent growth in the tax receipts. However, going forward, achievement of tax revenue target for FY10 will remain challenging for the FBR as it would require a YoY growth of 37.6 percent during Q4-FY10 to attain Rs 1.38 trillion tax collection (budget) target for the year; compared with 5-year average tax revenue growth in the last quarter at 15.7 percent.

The widening budgetary imbalance was predominantly financed by banking system during Jul-Mar FY10 raising risks of crowding out of private investment. The government needs to take steps for fiscal consolidation challenged by high security outlays and severe external financing shortfalls. The government has indicated that it intends to slash non-priority development spending to handle these fiscal risks. This suggests the need to urgently work towards broadening the tax base to provide required essential services and public goods. It remains to be seen if the current drive by FBR to replace general sales tax by a value added tax (VAT) will significantly help expand the tax base and curb leakages in the revenue stream.

5.2 Domestic Budgetary Financing[1]

Budgetary financing from domestic sources stood at Rs 535.3 billion during Jul-Mar FY10 compared to Rs 321.2 billion in the same period a year earlier. Apart from showing a rise in fiscal deficit, the sharp increase in financing from domestic sources was due to the shortfall in financing from external sources. Within

[1] This section is mainly based on SBP estimates, derived from Monetary Survey and outstanding stock of domestic debt, as MoF numbers will only be available by end-May 2010. Also, budgetary financing numbers consider the impact of government deposits with the banking system whereas the debt numbers do not.

domestic sources of budgetary finance, non-bank contribution witnessed a strong expansion with its share in the total domestic source of financing jumping to 60.6 percent in Jul-Mar FY10 from 44.7 percent in the same period last year. Moreover, financing from the banking system, during this period, increased by 19.6 percent YoY.

Financing from Banking System[2]

Net budgetary financing from the banking system was Rs 210.8 billion during Jul-Mar FY10 compared to Rs 176.2 billion during the same period last year. Although, government financing from the SBP decreased compared to the same period last year, it exceeded the quarterly limit imposed by IMF for the first time since the inception of the program. During Jul-Mar FY10, the SBP provided Rs 66.8 billion through issuing of fresh MRTBs to the government. However the net budgetary financing amounts to Rs 30.0 billion, as government deposits with the SBP (including other deposits) stood at Rs 36.8 billion during the period (see **Figure 5.1**).

Figure 5.1: Borrowing from the Banking System

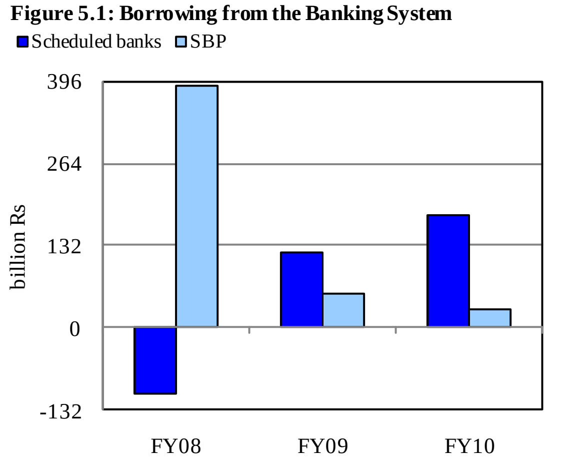
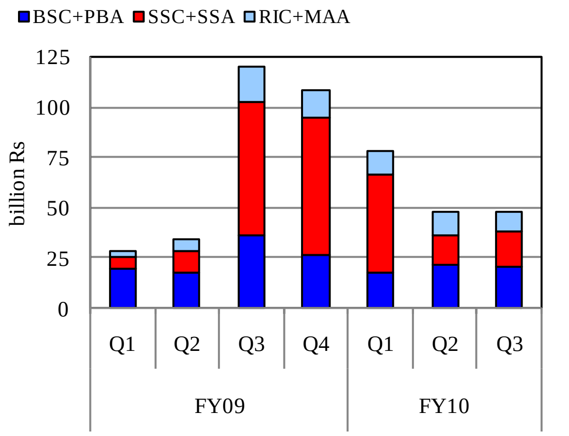


Figure 5.2: Net Financing through Major NSS Instruments



During Jul-Mar FY10, financing from scheduled banks through government securities amounted to Rs 261.2 billion which is more than twice the amount

[2] Budgetary financing from the banking system is worked out on cash basis and hence, these will differ from government financing numbers reported in the section on Money and Credit where data is measured on accrual basis.

invested a year earlier during the same months. The increase in financing from scheduled banks through government securities reflect their interest in relatively risk free government T-bills compared to risk prone credit to private sector. The increase in government deposits with the scheduled banks limited the net financing to Rs 180.8 billion. Although a reduction in financing from SBP would be helpful in containing inflationary pressures to some extent, a rise in government financings from the scheduled banks will have negative implications for liquidity and will place upward pressure on interest rates.

Financing from Non-bank

Net receipts from NSS instruments (including prize bonds) during Q3-FY10 stood lower than that of the same period last year. However, due to higher net receipts in the first two quarters of FY10, net financing through NSS instruments during Jul-Mar FY10 reached Rs 169.4 billion compared to Rs 163.6 billion during the same period last year.

Within NSS instruments, Behbood Savings Certificates (BSC) and Pensioners Benefit Account (PBA) together fetched Rs 59.2 billion during Jul-Mar FY10 for budgetary financing that is less by an amount of Rs 14.7 billion from the previous year (see **Figure 5.2**). Special Savings Certificates (SSC) and Special Savings Account (SSA) together fetched an amount almost equal to that of the corresponding period a year earlier. Also the government issued a new NSS instrument 'National Savings Bonds' (NSB) in January 2010 through which an amount of Rs 3.7 billion was mobilized up to March 2010.

5.3 FBR Tax Collection

During third quarter of FY10, FBR tax revenue showed robust performance largely due to increased collection under the head of direct taxes and import-based indirect taxes. During Jul-Mar FY10 total tax collection stood at 65.9 percent of

Table 5.1: FBR Tax Collection (Net) during Jul-Mar
billion Rupees; change in percent

	Annual target		Net collection		Percent of annual target		YoY change	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Direct taxes	498.9	565.6	307.6	342.3	61.7	60.5	19.4	11.3
Indirect taxes	751.1	814.4	507.5	567.3	67.6	69.7	20.2	11.8
Sales tax	469.9	499.4	321.1	371.2	68.3	74.3	24.2	15.6
FED	112.0	152.8	81.0	84.4	72.3	55.2	31.1	4.2
Customs	169.2	162.2	105.4	111.7	62.3	68.9	3.4	6.0
Total collection	**1,250.0**	**1,380.0**	**815.1**	**909.6**	**65.2**	**65.9**	**19.9**	**11.6**

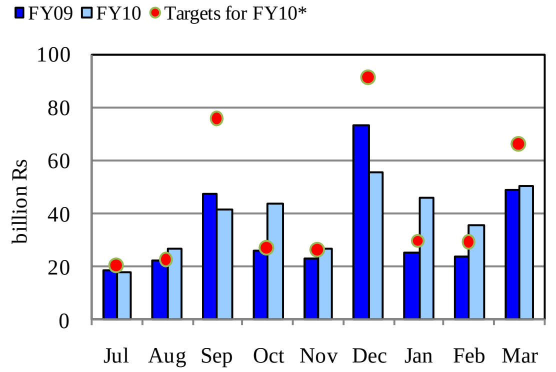
Source: Federal Board of Revenue

the annual budget target (see **Table 5.1**). To achieve the annual target, FBR is required to collect Rs 157.0 billion per month on the average in the remaining three months of FY10.

Direct Tax Collection

Growth in direct tax collection which remained very subdued in H1-FY10 accelerated to 11.3 percent during Jul-Mar FY10. The collection of the direct taxes during Jan-Mar 2010 remained robust compared with the same months of the last year. This reflects the effect of the extension announced by the FBR in the due date of filing the income tax returns.[3]

Figure 5.3: Month-wise Direct Tax Collection



* Monthly targets worked out by SBP on the basis of annual targets and monthly seasonal pattern of tax collection.

The FBR administration introduced a change in the advanced tax payment system according to which the quarterly advanced tax payment is now to be paid by 15th of the following month. As a result, we see a shortfall in direct tax collection compared to interpolated monthly targets in last month of each quarter and a corresponding increase in next month, i.e., October 2009, January 2010 and expectedly April 2010 (see **Figure 5.3**).

Indirect Tax Collection

Collection from indirect taxes also improved in the third quarter of FY10 largely due to increase in tax receipts from import source (see **Table 5.2)**. During Jul-Mar FY10, indirect tax collection reached 69.7 percent of the annual budget

Table 5.2: Indirect Tax Collection (Net) during Jul-Mar
billion Rupees, growth in percent

	Collection		Growth rate	
	FY09	FY10	FY09	FY10
Imports	**263.3**	**294.0**	**3.7**	**11.6**
Sales tax	147.3	172.9	3.9	17.4
FED	10.7	9.4	4.2	-12.1
Customs duty	105.4	111.7	3.4	6.0
Domestic	**244.2**	**273.3**	**44.9**	**11.9**
Sales tax	173.9	198.3	48.7	14.0
FED	70.3	75.0	36.3	6.7
Total collection	**507.5**	**567.3**	**20.2**	**11.8**

Source: Federal Board of Revenue

[3] FBR extended the date for filing of income tax returns up to January 25, 2010. This is why income tax payment shifted to month of January 2010, resulting in an increase in direct tax collection during January 2010.

target reflecting 11.8 percent YoY growth. Within indirect taxes the performance of sales tax remained encouraging.

Sales Tax

During Jul-Mar FY10 sales tax collection registered YoY growth of 15.6 percent, while collection amounted to 74.3 percent of the annual target. This was contributed by sales tax from imports that showed a growth of 17.4 percent during Jul-Mar FY10 compared with 3.9 percent growth in the corresponding period last year. Although sales tax collection from domestic goods and services has not been encouraging so far compared to the last year, a revival in the economy coupled with increase in prices of electricity are likely to increase collection from domestic sources in the months ahead.

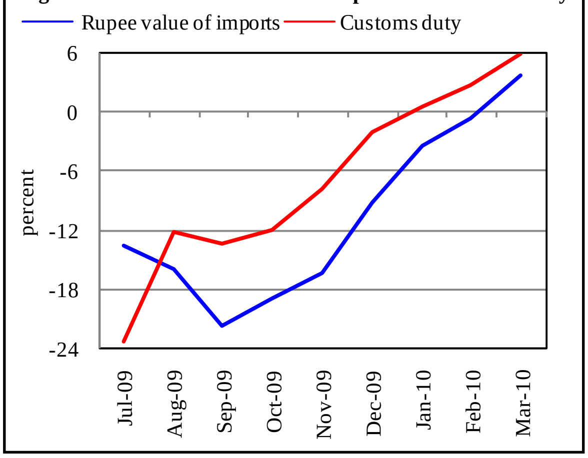
Federal Excise Duty (FED)

Federal excise duty registered the lowest growth of all the FBR taxes during Jul-Mar FY10. Unlike other FBR taxes, collection from FED during Q3-FY10 remained slightly below than the first two quarters of FY10.

Customs Duty

Growth in collection from customs duty which remained negative upto H1-FY10 turned positive during January 2010, resulting in an overall growth of 6.0 percent during Jul-Mar FY10. This is in line with recent growth in rupee value of imports (see **Figure 5.4**). A higher growth in customs duty than the growth in its base, i.e., imports, indicates the buoyant nature of the tax. However, actual performance of this tax can be analyzed with disaggregated information of dutiable and non-dutiable imports that is not available yet.

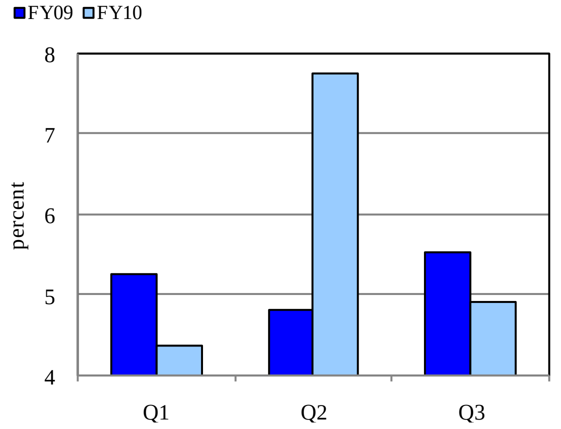
Figure 5.4: Cumulative Growth in Imports and Customs Duty



5.4 Domestic Debt[4]

After sharp rise of 7.0 percent in Q2-FY10, the growth in domestic debt moderated to 4.4 percent during Q3-FY10 (see **Figure 5.5**). The slowdown in the growth of domestic debt was despite the increase in the fiscal deficit and weak external financing inflows. The apparent disconnect is explained by huge withdrawals of government deposits with the central bank.

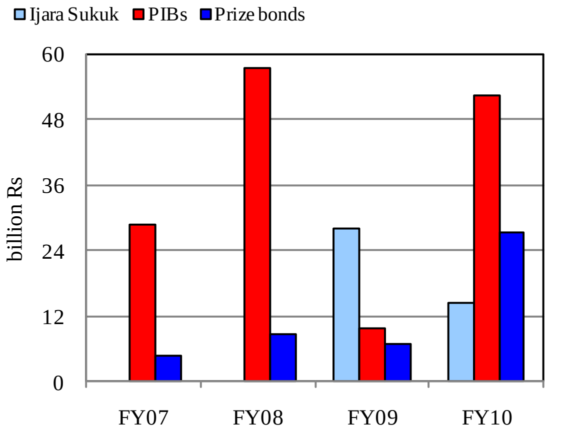
Figure 5.5: Growth in Domestic Debt



Composition of Domestic Debt

With shortfall on account of budgeted external financing in the presence of higher fiscal deficit, the government had to rely on additional financing from domestic sources. In the absence of substantial inflow from NSS, financing structure remained skewed toward banking system during Jul-Mar FY10. Scheduled banks' increased participation in T-bills auctions; funded Rs 310.6 billion government budget deficit compared to Rs 159.1 billion in the same period last year. Consequently, dominance of short term debt in total domestic debt continued for the second consecutive year. This reflects increased vulnerability to adverse short-term interest rate movements that could introduce uncertainty in future debt management.

Figure 5.6: Net Flows in PIBs, Ijara Sukuk and Prize Bonds



[4] It includes FEBCs, FCBCs, DBCs and Special US Dollar Bonds held by the residents. Previously, these were the part of External Debt Liabilities which are now in Domestic Debt.

The breakup of permanent debt data reveals that PIBs retained its dominant share in outstanding stock of permanent debt by adding Rs 52.4 billion during Jul-Mar FY10 against Rs 9.7 billion in the same period last year. Mobilization through prize bonds also saw significant improvements during Jul-Mar FY10 by adding Rs 27.3 billion in total deficit financing (see **Figure 5.6**). Although the government received Rs 94.4 billion through fresh creation of prize bonds during Jul-Mar FY10, huge encashment has reduced the net receipts to much lower level.

Table 5.3: Domestic Debt (Jul-Mar)
debt in billion Rupees, growth and share in percent

	Debt		Growth rate		Share	
	FY09	**FY10**	**FY09**	**FY10**	**FY09**	**FY10**
Permanent	652.3	771.2	7.2	13.7	17.4	17.2
Floating	1,923.5	2,299.8	17.5	20.8	51.2	51.2
of which						
MTBs	696.1	1,106.7	*29.6*	*39.0*	18.5	24.6
*MRTBs**	1,227.3	1,193.1	*11.5*	*7.7*	32.7	26.6
Unfunded	1,174.7	1,411.7	15.1	11.1	31.3	31.4
Foreign currency	8.0	8.0	-5.9	0.0	0.2	0.2
Domestic debt	**3,758.4**	**4,490.7**	**14.8**	**19.5**	**100.0**	**100.0**

*Includes outright sale of MRTBs to commercial banks.

Table 5.4: Gross & Net Receipts of Major NSS Debt Instruments (Jul-Mar)
billion Rupees

	FY09		FY10	
	Gross	**Net**	**Gross**	**Net**
DSCs	53.5	-15.7	37.4	-35.1
SSCs	220.5	69.0	95.4	52.0
RICs	67.3	26.4	48.3	33.9
BSCs	285.2	57.6	72.7	45.1
SSAs	57.4	13.4	46.5	29.8
others	210.4	5.9	140.0	16.4
Total	**894.3**	**156.6**	**440.8**	**142.1**

Source: Central Directorate of National Savings (CDNS)

Floating debt, comprising treasury bills recorded relatively higher growth in Jul-Mar FY10 compared to last year (see **Table 5.3**). The sharp rise in floating debt stemmed from commercial banks' holding of T-bills which increased by 39.0 percent in Jul-Mar FY10 compared to 29.6 percent increase in the corresponding period last year. On the other hand, T-bills for replenishment grew by 7.7 percent in Jul-Mar FY10 compared to 11.5 percent a year earlier. The growth of MRTBs, however, remained a source of concern, as it has breached the quarterly limit on government financing from the central bank imposed by IMF under Stand-By Arrangement.

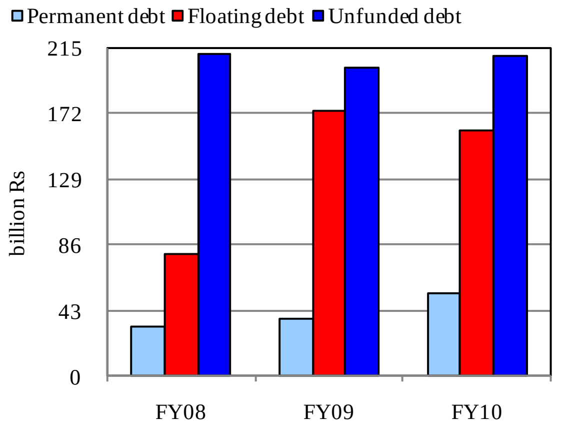
Quarterly growth in the outstanding stock of unfunded debt continued its downward slide in Q3-FY10. The main cause of this slowdown was lower net sales of National Savings Schemes instruments. The outstanding debt against all major NSS instruments recorded positive growth except for DSCs which showed a net retirement of Rs 35.1 billion. It is important to note that the net mobilization through NSS stood at Rs 141.1 billion during Jul-Mar FY10, which constitutes only 61.4 percent of the government budgetary estimates for FY10. As a result, the government financing requirement from the banking system increased sharply during this period.

Gross mobilization through NSS stood at Rs 440.8 billion during Jul-Mar FY10, almost three times compared with the net receipts in the same period (see **Table 5.4**). Secondary market information on domestic debt reveals that the non banks investment in the government securities (T-bills & PIBs) increased abruptly during the period. For instance, non bank holding of the T-bills stood at Rs 96.7 billion during Jul-Mar FY10 compared to Rs 4.7 billion in the same period last year. This reflects investors' preferences to invest their funds in the short term debt instruments.

Interest Payment on Domestic Debt

Interest payment on domestic debt registered 3.1 percent growth in Jul-Mar FY10, considerably moderate compared to 27.2 percent recorded in the same period last year. The deceleration in the growth of interest payment on domestic debt is attributed to decline in interest payment on floating debt in the period under discussion (see **Figure 5.7**).

Figure 5.7: Interest Payments on Domestic Debt (Jul-Mar)



A further break up shows that debt servicing cost of permanent debt rose sharply during Jul-Mar FY10. This increase was largely due to interest payment on 10-year PIBs, in line with its increasing share in the total outstanding stock of PIBs. On the other hand, interest payment on floating debt registered a decline of 7.1 percent during Jul-Jan FY10 compared to a rise of 115.6 percent in the same period last year. This slowdown largely came from reduced interest payments on MRTBS, as government was able to retire substantial amount in the initial period of current fiscal year. However, increased reliance on commercial banks' financing by the government through T-bills can boost the interest payments on floating debt in the remaining months of current fiscal year.

The interest payments on unfunded debt stood at Rs 210.0 billion during Jul-Mar FY10 compared to Rs 202.1 billion in the same period last year. The disaggregation of data reveals that the interest payments on BSCs, SSCs and PBAs increased significantly during the period. This seems in line with their increased share in the outstanding stock of unfunded debt. On the other hand, monthly outflow in the form of interest payment on DSCs observed a persistent declining trend. However with net addition of Rs 126.2 billion in total interest cost, DSCs still remained the largest contributor among servicing of unfunded debt components.

Box 5.1: Government Guarantees-A Risk to Fiscal Sustainability

Countries with higher and persistent budget deficits have serious implications of government guarantees for fiscal outlook of the country. Most recently, many governments have introduced new methods of public support by issuing guarantees to many public sector enterprises and government institutions. These off-budget activities result in additional burden on the government outlays and consequently can lead to increasing debt/GDP ratios.

In case of Pakistan, government guarantees normally exist in the form of contingent liabilities. These liabilities are not recognized as direct, as the actual cost of the government is linked with the occurrence of any particular event in future. The element of uncertainty in the contingent liabilities results in several complications in fiscal analysis. The coverage of government guarantees in fiscal analysis is also important, as government normally covers all risks that in turn can increase the possibility of default. Although it is impossible for the government to avoid all fiscal risks, however, these risks can be minimized by recognizing and considering these issues in their policy choices.

Table 5.1.1 shows that the new guarantees issued during Jul-Mar FY10 reached Rs 177.9 billion reaching at 1.18 percent of GDP, less than the full year limit of 2 percent imposed by FRDL Act 2005. It is important to note that the volume of government guarantees issued during FY09 has reached Rs 274.3 that has breached the limit imposed by FRDL Act 2005.

Table 5.1.1: Guarantees Issued by Government
billion Rupees

	FY09	Jul-Mar FY10
PIA	25.0	6.8
WAPDA	228.3	133.0
PAF Shahbaz Air H.Q	1.0	6.0
NIT	20.0	
Railways division		17.0
PSM		10.0
KESC		3.0
Pak Textile City Ltd.		1.0
TIP		1.1
Total	**274.3**	**177.9**
As % of GDP	2.1	1.18

Source: Budget Wing, EF Wing and DPCO staff calculations

Information on new liabilities incurred by the government suggests that WAPDA remained the major recipient among the guarantees issued during the period, as government provided guarantees of Term Financing Certificates (TFCs) issued by Pakistan Electric Power Company (PEPCO) in settling the circular-debt. The power holding company, established by the GoP has partially owed the power companies debt by issuing Rs 85.0 billion worth of TFCs on 30th September 2009. The volume of these guarantees can increase in the coming months due to extension in the deadline for the elimination of remaining stock of circular debt and delays in the power tariff differentials adjustments. These steps would result in additional burden on the government outlays and could lead to ever increasing debt to GDP ratios.

In addition to the guarantees already issued to many PSEs, the government is now issuing guarantees on TCP, PASSCO and provincial governments commodity financing loans. These guarantees, however, were never included in the limit of 2 percent of GDP imposed by FRDL Act 2005. Such activities not only understate the volume of the public debt stock and pose a risk of increasing future liabilities but also potentially crowed out private investment.

Moving forward, government should re-examine the role of numerous public sector entities involved in quasi-fiscal activities. Specifically, the efficiency of these public sector entities can be enhanced by strengthening governance structures. The government needs to remain transparent while issuing guarantees to PSEs and should provide estimates of resulting stock of its hidden debt. Also, there should be a clear policy initiative to deal with such contingencies. Although in FRDL Act 2005, the government control over issuance of new guarantees is restricted, the solution must include the creation of a legal and institutional framework that forces proper accounting of these hidden costs to the government.

The problem in this case is the fiscal accounting that sometimes misrepresents the effect of the government's stance. Usually, public finance data is recorded on cash basis. In case of Pakistan, guarantees are usually adjusted in the fiscal accounts when contingency occurs and cash payment is actually made. International accounting standards require the recording of the guarantees on accrual based accounting. The government needs to judge the guarantees to be recorded as liability or contingent liability at the time of budgeting and if the probability that the expense will be realized is high, government can estimate the expected cost and can make provisions in the budget.