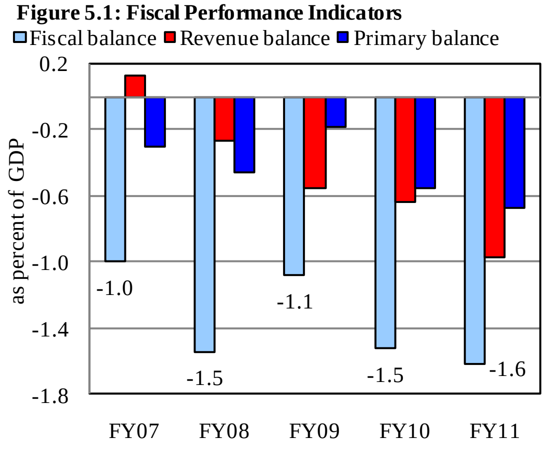
5 Fiscal Developments

5.1 Overview

Despite visible contraction in expenditure growth, the size of consolidated fiscal deficit increased to 1.6 percent of GDP in Q1-FY11 compared to 1.5 percent in Q1-FY10 (see **Table 5.1**). Being conscious of the spending needs for reconstruction and rehabilitation activities, the government scaled down and re-prioritized spending introducing steep cuts in development spending. However, the potential gains from these measures could only be partially realized due to sharp fall in non-tax revenues during Q1-FY11.[1] Hence, the weak performance of revenues resulted in deterioration of all fiscal performance indicators during Q1-FY11 (see **Figure 5.1**). Further, the financing difficulties witnessed during Q1-FY11 also exposed the fragility of government's fiscal stance as in the absence of ample alternate resources government relied heavily on deficit monetization.

Figure 5.1: Fiscal Performance Indicators



The fiscal deficit recorded during Q1-FY11 also obscured the aggregate 0.5 percent of GDP budget surplus recorded by provinces during this period.[2] This situation highlights the structural rigidities in federal government's spending requirements. During Q1-FY11 while a part of spending pressures were contributed by the flood relief and rehabilitation activities, the disbursement of subsidies, defense and security related spending were some of the major claimants on fiscal resources. In this context, going forward, while the gradual removal of power tariff subsidies, which comprised 6 percent share of country's total fiscal spending during Q1-FY11,[3] will provide some respite to the government, the increase in current expenditures with pick up in relief and rehabilitation task is likely to offset some of these gains.

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[1] While tax revenue recorded 6.2 percent YoY increase during Q1-FY11, non-tax revenues growth recorded a steep 35.5 percent YoY fall during this period.

[2] In aggregate, provinces recorded Rs 81.3 billion surplus during Q1-FY11 compared to Rs.10.1 billion deficit registered during Q1-FY10.

[3] Government has announced 2 percent hike in the power tariff subsidies November 2010 onwards.

Thus, the experience of Q1-FY11 highlights the grave pitfalls faced by the country in the absence of serious and urgent reforms in the taxation system for broadening the tax base and plugging leaks in the revenue collection. Given the significant spending pressures, failure to bring improvements in revenue performance implies disruption in the fiscal adjustment agenda of the government and hence a sharp increase in fiscal deficit.

Table 5.1: Summary of Consolidated Public Finance

billion Rupees

	Q1				YoY Change (%)	
	FY08	**FY09**	**FY10**	**FY11**	**FY10**	**FY11**
Total revenue	312.6	385.0	427.3	400.0	11.0	-6.4
Tax revenue	215.6	276.8	298.8	317.3	7.9	6.2
Nontax revenue	97.0	108.1	128.5	82.9	18.8	-35.5
Total expenditure	470.7	522.8	650.9	676.3	24.5	3.9
Current	340.0	456.1	521.0	566.7	14.2	8.8
Development and net lending	129.8	57.6	115.7	62.8	100.8	-45.7
Unidentified expenditure	0.9	9.1	14.2	46.8	56.3	229.9
Fiscal balance	-158.1	-137.9	-223.7	-276.2	62.2	23.5
As percent of GDP						
Total Revenue	3.1	3.0	2.9	2.3	--	--
Tax revenue	2.1	2.2	2.0	1.9	--	--
Nontax revenue	0.9	0.8	0.9	0.5	--	--
Total expenditure	4.6	4.1	4.4	4.0	--	--
Current	3.3	3.6	3.6	3.3	--	--
Development and net lending	1.3	0.5	0.8	0.4	--	--
Fiscal balance	-1.5	-1.1	-1.5	-1.6	--	--
Revenue balance	-0.3	-0.6	-0.6	-1.0	--	--
Primary balance	-0.5	-0.2	-0.6	-0.7	--	--

For improving revenue performance government is moving to introduce Reformed General Sales tax (RGST), to enlarge tax base and tax revenue of the economy. In addition, revenue mobilization efforts also include some stopgap measures, for

Table 5.2: Composition of Tax and Non-tax Revenue
billion Rupees

	Jul-Sep			YoY change (%)		
	FY09	**FY10**	**FY11**	**FY09**	**FY10**	**FY11**
Tax Revenue	278.7	298.8	317.3	26.8	7.2	6.2
Direct taxes	89.7	84.1	94.4	13.3	-6.3	12.3
Taxes on property	1.8	1.7	2.1	73.1	-9.1	28.5
Taxes on goods and services	136.6	146.1	156.9	39.4	7.0	7.4
Taxes on international trade	38.2	33.1	36.5	31.0	-13.4	10.4
Petroleum levy	1.8	24.1	15.3	-55.6	1206.1	-36.4
Other taxes	10.5	9.9	12.0	28.2	-6.5	21.8
Nontax Revenue	106.3	128.5	82.9	14.5	20.9	-35.5
Profit of Post office / PTA	0.0	0.0	0.0	--	--	--
Interest	1.6	0.1	0.5	-87.1	-93.5	337.7
Dividends	9.5	18.9	0.5	372.2	98.7	-97.6
SBP profits	28.0	70.0	40.0	-40.8	150.0	-42.9
Defense	29.2	1.9	1.4	2070.2	-93.4	-25.7
Royalty on gas and oil	10.4	9.2	19.6	-7.8	-10.9	111.7
Development surcharge on gas	6.4	5.7	5.0	37.4	-9.9	-12.2
Discount retained on crude oil	4.1	0.0	3.0	--	--	--
others	17.1	22.6	12.9	24.7	31.9	-42.6
Total Revenue	**385.0**	**427.3**	**400.1**	**23.1**	**11.0**	**-6.3**

Source: Ministry of Finance

instance, introduction of a flood surcharge and increase in special excise duty on luxury items during FY11. Due to huge political opposition, the decision on these measures, however, has been postponed to a later date.

The fiscal space created by diverting development expenditures to reconstruction task is only a short term remedy because of its downside implications for economic growth. Therefore, efforts for improving revenue mobilization should also be complemented by sincere efforts for introducing stringent fiscal discipline on both the federal and provincial levels. In this context government's decision of devolution of five ministries to provinces in line with the 18th amendment is a positive step which is likely to induce greater fiscal responsibility in the provinces.

5.2 Revenues

Total revenues amounted to Rs 400.1 billion during Q1-FY11 compared to Rs 427.3 billion in the same period last year, showing a YoY negative growth of 6.3 percent.

The decline in total revenues was brought about by both a considerable fall in non-tax revenues and deceleration in tax revenues (see **Table 5.2**).

The tax revenue showed a decelerated growth of 6.2 percent and reached Rs 317.3 billion during the period under review. A compositional analysis of tax revenue showed that although FBR taxes showed an accelerated growth during Q1-FY11 compared to the same period last year, the decline in collection from petroleum levy drag the growth in total tax revenue. The collection from petroleum levy declined in line with the decline in sale of petroleum products particularly high speed diesel (HSD) oil during Q1-FY11 compared to the same period last year. The decline in sale of petroleum products was more pronounced in industrial, agriculture, and power sector compared to domestic, transport, and government sector.

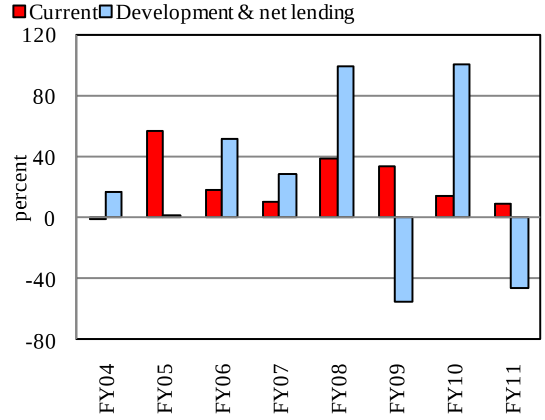
The encouraging growth in voluntary payments turned the growth rate in direct taxes from negative in the last year to positive in the ongoing fiscal year. The enhanced collection under the head of taxes on international trade stemmed from the accelerated growth in rupee value of imports during Q1-FY11. In fact, the growth in rupee value of imports also helped raise the collection under the head of taxes on goods and services.

The non tax revenue in Q1-FY11 stood lower than the same period last year by Rs 45.6 billion. This decline was triggered largely by fall in; (a) transfer of SBP profits to government; and (b) dividends receipts from public sector financial and non-financial institutions during Q1-FY11 compared to the same period last year. In fact during Q1-FY10, the amount of SBP profits transferred to government also included payment of Rs 31 billion from government's reserve fund with SBP. The absence of this factor resulted in reduction in transfer of SBP profits during Q1-FY11. The fall in dividends might be the result of both lower earnings of public sector financial and non-financial institutions and a delay in dividend income receipts from these institutions. The collection from royalty on gas and oil was encouraging during the recent quarter. Decline in non-tax revenues under the head of defense probably reflects the holding back of reimbursements by the US for logistic support services provided by Pakistan to the coalition forces.

5.3 Expenditures

After recording double-digit YoY growth in the first quarter of FY05-FY10, growth in expenditures recorded a sharp deceleration to 3.9 percent in Q1-FY11. This substantial slowdown in expenditures was a result of conscious government effort to create fiscal space for the huge spending needs for reconstruction and rehabilitation task. As a result of this drastic cut in spending, total expenditures to GDP ratio also recorded a marginal improvement from the level of 4.4 percent in Q1-FY10 to 4 percent in Q1-FY11. The cut-down in total expenditures was obtained by introducing a steep slash in the development & net lending expenditures. Current expenditures, however, recorded a smaller deceleration in growth during the first quarter (see **Figure 5.2**). This pattern emanates from structural rigidities, for instance, spending for debt servicing and defense, which have rendered the demand for current spending relatively less elastic (see **Table 5.3**). Further breakup of data highlights that around two-third of the total increase in current spending was contributed by federal government, whereas provincial governments' expenditures recorded only a marginal increase during this period. This might be in response to the central government's advice to the provinces for freezing their expenditures at last year's level.

Figure 5.2: YoY Growth in Expenditures (Q1)



Current expenditures during Q1-FY11 remained under pressure on account of a number of factors, which include; (a) Flood related expenses for initial relief efforts. In this regard one particular initiative undertaken by government was *Watan cards* scheme. Under this initiative federal and provincial governments have planned to distribute Rs 20,000 among flood affected families[4]. Of the total funds required for expenses on *watan cards*, 50 percent expenses will be shared by the federal government, while provincial governments will arrange for the rest by curtailing their provincial development budgets. (b) In addition to this, provision of power tariff subsidies, commodity finance and security operations also remained a large drag on country's resources during Q1-FY11. Specifically, the total provision of subsidies amounted to Rs 65.8 billion during Q1-FY11, which was 51.9 percent of the total annual target set for subsidies during FY11.

[4] Till November 24, 2010, NADRA processed 1,215,672 *Watan cards* through which a total of Rs 22.4 billion was disbursed.

Table 5.3: Composition of Current Expenditures (Q1)
billion Rupees

				YoY Change		Shares	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**	**FY10**	**FY11**
Current Expenditure	**456.1**	**521.0**	**566.7**	**14.2**	**8.8**	**100.0**	**100.0**
of which							
Interest payments	142.3	141.5	161.6	-0.6	14.2	27.2	28.5
Domestic	128.1	129.3	146.6	0.9	13.4	24.8	25.9
Foreign	14.2	12.2	14.9	-14.2	22.5	2.3	2.6
Pension	9.2	16.4	14.3	78.1	-12.3	3.1	2.5
Grants to non-govt.	16.4	60.1	39.1	266.0	-34.9	11.5	6.9
Other general public service	26.3	47.3	53.9	79.8	13.9	9.1	9.5
Defense	82.2	86.2	93.1	4.9	8.1	16.5	16.4
Economic affairs	50.6	11.0	29.6	-78.2	169.1	2.1	5.2
Health	1.1	1.4	1.7	22.0	24.6	0.3	0.3
Educational affairs and services	5.3	6.8	7.0	28.8	2.7	1.3	1.2
Provincial	115.1	139.6	147.7	21.3	5.8	26.8	26.1

Going forward, the payment of power tariff subsidies may record some deceleration as the government has further announced gradual removal of this subsidy November 2010 onwards by introducing monthly increases in the power tariffs. However, current expenditures are likely to increase due to the spending needs for reconstruction activities.

5.4 Domestic Budgetary Financing

In the absence of adequate external assistance, domestic sources contributed a hefty 79.4 percent share in deficit financing during Q1-FY11. Specifically a little less than half of the total financing requirements were met through deficit monetization during the first quarter, whereas a greater share of the remaining deficit was financed by non-bank sources (see **Table 5.4**).

This pattern was in sharp contrast to the experience of Q1-FY10, when borrowing from scheduled banks contributed 54.6 percent share in financing of the deficit. During Q1-FY11, although, government raised 106 percent of the target amount in the T-bill auctions,[5] this amount was not sufficient to finance the deficit and government had to tap the option of borrowing from the central bank for deficit

[5] The targets for t-bill auctions are set by the government on quarterly basis. The T-bill auction target for Q1-FY11 was set at Rs. 535 billion while government raised Rs 567.7 billion.

financing. Further, the share of financing from non-bank institutions also recorded fall during Q1-FY11, because of lower investment in NSS instruments.

Table 5.4: Sources of Financing (Q1)

billion Rupees

				Share	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**
Total financing of budget	137.9	223.7	276.2	100.0	100.0
External resources (net)	6.2	77.1	56.9	34.5	20.6
Internal resources (net)	131.7	146.6	219.3	65.5	79.4
Banking system	104.6	39.0	120.9	17.4	43.8
SBP	211.1	-82.6	118.3	-36.9	42.9
Scheduled banks	-106.5	122.2	2.6	54.6	0.9
Non-bank	27.1	107.6	98.4	48.1	35.6
NSS	21.0	53.0	33.8	23.7	12.8
Others*	6.1	54.6	64.6	24.4	24.4

* Others include non bank borrowing (MTBs, PIBs etc), prize bonds minus NSS

5.5 FBR Tax Collection

Aided by a substantial growth in rupee value of imports, the FBR tax receipts reached Rs 494.7 billion during Jul-Nov FY11 maintaining growth rate of above 7 percent as in the last year despite disruption in the economic activities due to floods and rains (see **Table 5.5**). Sales tax was the largest contributor to the growth in overall tax collection (5.8 percentage points) followed by custom duty collection which contributed 1.3 percentage points to the overall growth. Import related tax collection accounted for 6.4 percentage points of the total growth in FBR taxes. As a percent of annual target, FBR tax collection remained below the previous year amount.

Table 5.5: FBR Tax Collection (Jul-Nov)

billion Rupees

	Net Collection		Growth (%)		% of annual target	
	FY10	**FY11**	**FY10**	**FY11**	**FY10**	**FY11**
Direct taxes	155.9	159.5	14.0	2.3	28.9	24.3
Indirect taxes	303.7	335.2	3.9	10.4	36.2	35.4
Sales tax	199.0	225.7	6.9	13.4	36.9	35.6
FED	48.0	46.7	7.6	-2.7	35.7	33.1
Customs duty	56.7	62.8	-8.0	10.8	34.4	36.2
Total	**459.6**	**494.7**	**7.1**	**7.6**	**33.3**	**30.8**

Source: Federal Board of Revenue

Direct Taxes

Direct tax collection reached Rs 95.7 billion during Q1-FY11 showing a growth of 12.4 percent over the collected amount in the same period last year.
A break up of the income tax collection for Q1-FY11 indicate an overall increase of 13.4 percent in gross collections, mainly on the back of higher contributions from voluntary payments and withholding taxes (WHT) while collections on demand witnessed an enormous decline over the preceding year (see **Table 5.6**).

Table 5.6: Components of Income Tax Collection
billion Rupees

	Jul-Sep		% Δ	
	FY10	**FY11**	**FY10**	**FY11**
Coll. on demand	10.9	2.4	21.9	-78.0
	(11.8)	(2.3)		
Voluntary	19.5	31.8	-38.7	63.0
	(21.2)	(30.4)		
Withholding	61.7	70.2	19.3	13.6
	(67.0)	(67.1)		
Miscellaneous	0.0	0.2	54.3	342.7
	(0.0)	(0.2)		
Gross Income Tax	**92.2**	**104.5**	-0.3	13.4
Refunds	9.3	11.3	59.3	21.3
Net collection	**82.9**	**93.3**	-4.4	12.5

Note: Figures in the brackets show the shares of the components in gross income tax

More encouraging is the 63 percent YoY rise in voluntary payments resulting in an increase in the relative share of voluntary payments in the gross income tax collection. The decline in the arrear component of collection on demand (COD) is explained by the fact that FBR could not realize tax collection through audit. The current component of the COD also witnessed a decline which corresponds to the fact that FBR announced an extension of one month upto October 30, 2010 for filing of income tax return due at end-September 2010.

Table 5.7: Components of Withholding Tax
billion Rupees

	Jul-Sep			%Δ	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**
Imports	8.0	10.4	13.7	30.2	31.8
Salaries	5.4	7.1	9.3	32.6	29.9
Dividends	1.6	1.4	1.8	-10.7	31.9
Bank interest	2.5	3.5	4.2	41.3	19.3
Technical fee	1.2	1.2	1.1	4.1	-9.6
Contracts	17.2	18.1	17.3	5.4	-4.3
Export	3.6	3.7	4.5	3.2	21.0
Cash withdrawal	2.2	2.9	3.0	30.0	2.3
Electricity bills	1.6	3.4	3.4	111.1	1.6
Telephone	4.9	5.3	6.2	6.5	17.3
Others	3.6	4.8	5.7	31.3	19.4
WHT total	**51.7**	**61.7**	**70.2**	**19.3**	**13.6**

Source: Federal Board of Revenue

As collection from WHT roughly grew at the same rate as that of the gross income tax, its share remained the same in the income tax collection. Major heads that contributed to the growth in WHT includes import, salaries, securities and telephone (see **Table 5.7**).

Growth contributed by salaries probably reflects the increase in the salaries of employees; especially the substantial increase in that of the government employees as well as the increase in the number of employees compared to the previous year. However, the enhancement of the minimum income threshold announced in the budget FY11 limited the growth under the head of salaries[6]. The deceleration in collection under the head of bank interest probably reflects the decrease in deposit rates compared to the last years. The amount added under the head of telephone corresponds to the number of prepaid cards used by mobile phone subscribers.

WHT from contracts witnessed a decline largely due to the cut in PSDP by the government. Also, the possible cuts in development expenditures in the remaining months of FY11 could intensify the declines in withholding tax receipts from contracts. Decelerated growth in collection from cash withdrawal points towards the increased transactions in the informal economy due to increase in the withholding tax on the cash withdrawal from banks. The deceleration in the growth in collection from electricity bills might be due to the effect of flood on electricity consumption

Table 5.8: Major Revenue Spinners of CD and Import Based Sales Tax

billion Rupees

	Customs Duty (Jul-Sep)				**Sales Tax (import) (Jul-Sep)**			
	FY08	**FY09**	**FY10**	**FY11**	**FY08**	**FY09**	**FY10**	**FY11**
Vehicle (Non-Railway)	6.2	5.7	4.4	6.7	3.2	3.3	2.8	4.5
Edible oil	4.3	3.5	3.2	4.5	3.4	4.7	3.6	6.4
Machinery & mechanical appliances	2.5	3.1	2.6	2.8	1.5	1.8	1.6	2.1
POL Products	2.2	7.6	3.7	2.3	19.9	23.2	21.4	20.9
Electrical machinery	3.0	4.1	2.5	2.2	1.5	1.6	1.5	1.8
Plastic resins etc	1.5	1.9	1.5	2.0	3.3	4.6	3.9	5.6
Iron and steel	1.3	1.4	1.5	1.6	2.6	2.7	3.1	3.9
Paper & paperboard	1.0	1.0	1.1	1.3	1.1	1.3	1.1	1.4
Tea & coffee	0.4	0.6	0.7	0.8	0.5	1.0	1.1	1.5
Organic chemicals	0.7	1.0	0.9	0.8	1.1	1.7	1.5	1.6
Dyes and paints	0.5	0.7	0.6	0.7	0.3	0.4	0.4	0.5
Subtotal	**23.6**	**30.7**	**22.7**	**25.7**	**38.5**	**46.4**	**42.1**	**50.1**
Others	5.3	7.5	10.4	11.4	9.1	9.3	10.0	13.9
Total	**29.0**	**38.2**	**33.1**	**37.2**	**47.6**	**55.7**	**52.1**	**64.0**

Source: Federal Board of Revenue

[6] The limit of the Basic exemption in respect of salaried taxpayers was enhanced from Rs 200,000 to Rs 300,000 in the budget FY11.

and on payment of electricity bills.

Indirect Tax Collection

The indirect tax collection reached Rs 197.8 billion showing an accelerated growth of 10.8 percent. Of the total growth in indirect tax collection 9.6 percent was brought by import component of the indirect tax collection. Also the share of import component in indirect tax collection increased to 53.1 percent from 49.3 percent during the same period last year. Commodity wise analysis shows that the growth in collection from import was mainly brought by vehicles (motors), edible oil and plastic resins. POL products contributed negatively (see **Table 5.8**).

Table 5.9: Major Revenue Spinners of sales Tax Domestic

billion Rupees

	Jul-Sep			Growth (%)	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**
POL Products	27.4	26.9	29.4	-2.0	9.3
Telecommunicat ions services	10.4	10.9	11.5	4.7	5.6
Natural Gas	4.5	5.2	6.6	14.9	26.5
Sugar	2.3	3.8	1.5	69.2	-60.0
Cigarettes	1.9	1.8	1.9	-6.1	10.6
Electrical energy	2.0	3.5	4.5	75.7	30.8
Services	1.5	2.9	4.8	92.9	66.2
Beverages	1.3	1.8	2.2	35.0	27.0
Cement	1.0	1.4	0.8	50.8	-47.7
Tea	0.2	0.7	1.3	171.7	87.4
others	10.0	12.3	13.9	23.2	12.9
Total	**62.5**	**71.2**	**78.5**	**13.9**	**10.3**

Sales Tax

Collection from sales tax stood at Rs 133.7 billion with a growth rate of 14.2 percent during Q1-FY11. Of the total addition of Rs 16.6 billion in sales tax, Rs 11.8 billion came from imports.

The growth in domestic source of sales tax was mainly contributed by POL products, natural gas, and services (see **Table 5.9**). The increased collection from POL and natural gas compared to the previous year mainly reflects the increase in prices. The collection realized from sugar has come down

Table 5.10: Major Revenue Spinners of FED Domestic

billion Rupees

	Jul-Sep			% Δ	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**
Cigarettes	7.0	7.8	7.3	10.8	-6.8
Cement	4.2	4.2	3.2	0.0	-22.8
Natural Gases	1.5	1.5	2.6	3.4	70.5
Beverages	1.4	1.7	1.3	19.5	-20.1
Concentrates	1.9	1.5	1.4	-17.0	-7.1
POL Products	0.9	1.0	0.9	18.2	-9.5
Cosmetics	0.1	0.2	0.3	35.6	71.2
1 % Special FED	1.2	2.0	2.1	70.0	4.4
Subtotal	**18.1**	**19.9**	**19.2**	**10.0**	**-3.6**
Others	3.3	5.7	3.8	71.0	-33.3
Total	**21.4**	**25.6**	**23.0**	**19.5**	**-10.2**

by 60 percent due to lower sales of sugar and slashing down of sales tax rate on sugar from 16 to 8 percent in August 2009. A 47.7 percent decline in sales tax collections from cement during Q1-FY11, despite an increase in prices, probably reflects the lower sales of cement.

Federal Excise Duty

Collection from FED declined by 5.2 percent compared to the last year due to its domestic component. The import based FED which accounted for 10 percent of the total collection during Q1-FY10 rose to 14.5 percent in the period under review.

The decline in domestic component was mainly brought by collection from cigarettes, cement, and beverages (see **Table 5.10**). After the government enhanced the FED on cigarettes in the budget FY11, the export of raw tobacco rose during Q1-FY11 hence bringing the domestic production of the cigarettes lower and resulting in lower collection under this head. The setback of the collection from cement suggests the decline in its sales in the country.

Table 5.11: Provincial Finance -Q1

billion Rupees

	Punjab		Sindh		KP		Baluchistan	
	FY10	**FY11**	**FY10**	**FY11**	**FY10**	**FY11**	**FY10**	**FY11**
Total revenue	**73.8**	**96.4**	**48.0**	**60.2**	**32.7**	**59.5**	**18.7**	**33.0**
Provincial share in fed. revenue	65.0	82.5	40.1	52.8	15.7	28.8	11.4	26.0
Provincial taxes	6.1	8.0	4.4	5.3	0.5	0.9	0.2	0.2
Provincial nontax	3.1	3.4	1.0	0.8	5.7	3.5	0.2	1.0
Federal Loans and transfers/Grants	-0.4	2.5	2.4	1.3	10.8	26.3	6.9	5.7
Total expenditure	105.5	73.1	35.0	49.4	30.9	29.4	11.8	15.9
Current expenditure	81.0	64.8	31.5	46.0	20.4	26.5	10.9	14.5
Development expenditure	24.5	8.3	3.6	3.4	10.4	2.9	0.9	1.4
Overall balance	-31.7	23.3	13.0	10.9	1.8	30.1	6.9	17.1

Customs Duty

Collection from customs duty amounted to Rs 37.2 billion, up by 12.4 percent YoY compared to the decline of 13.4 percent YoY during the same period last year. This rise simply reflects the increase in the country’s import bill during the period. A break-up of the collections shows that motor vehicles continued to remain a major revenue spinner, followed by edible oils.

5.6 Provincial Fiscal Operations

Provincial public finances witnessed noticeable improvement recording Rs 81.3 billion surplus during Q1-FY11 compared to the 10.1 billion deficit registered during Q1-FY10. As a ratio to GDP this amounts to a surplus of 0.5 percent compared to the deficit of 0.1 percent in the same period last year. This improvement was witnessed mainly on the back of increase in provincial shares in federal revenues during this period (see **Table 5.11**). In the wake of 7th NFC award, the revenue position of provinces was already expected to improve because of increased share of provinces in the divisible pool. The impact of this development was complemented by improved fiscal discipline in the provinces of Punjab and KP.

Province wise details show that largest improvement of fiscal accounts was registered in Punjab, which was brought about by a steeper cut in both current and development expenditures. Resultantly, the fiscal balance of Punjab turned into Rs. 23.3 billion surplus during Q1-FY11, compared to Rs 31.7 billion deficit recorded during Q1-FY10. The province of Khyber Pakhtunkhwa (KP) also witnessed sizeable improvement in fiscal balance. This was mainly an off shoot of greater receipts of provincial share and loans/grants from federal government, while, the total expenditures of KP also registered a nominal fall during Q1-FY11.

Table 5.12: Composition of Total Domestic Debt & Liabilities (Jul-Nov)

	FY10	FY11
as percent of GDP		
Total domestic debt & Liabilities stock	33.7	33.9
Government domestic debt	28.9	29.7
PSE debt	2.5	2.0
Domestic liabilities	2.3	2.2
Growth over end-June stock (percent)		
Total domestic debt & liabilities	10.1	7.6
Government domestic debt	9.8	9.2
PSE debt	26.3	-7.3
Domestic liabilities*	-0.1	-8.6
Memorandum item:		
Total domestic debt & liabilities stock	4940.3	5857.9

* Include commodity finance operations loans to provincial governments & PSE borrowings for commodity operations.

The provinces of Balochistan and Sindh also recorded surplus in overall balance despite increases in total expenditures during Q1-FY11.

5.7 Total Domestic Debt & Liabilities

Reflecting the expansion in fiscal deficit, and inadequate availability of external financing, country's total domestic debt & liabilities stock recorded a 7.6 percent increase over the end-June 2010 stock, reaching Rs 5.9 trillion on end-November FY11 (see **Table 5.12**). The increase originated from rise in government domestic debt while PSE debt and domestic liabilities owed due to commodity finance operations witnessed retirement during this period.[7]

5.7.1 Government Domestic Debt

For financing of the fiscal deficit, the government relied heavily on borrowing from central bank during Jul-Nov FY11, which comprised 61.8 percent share in net flows in the government debt stock during this period (see **Table 5.13**). This was in sharp contrast to the experience of the same period last year, when government borrowing needs were largely met from scheduled bank sources.

Table 5.13: Components of Change in Government Domestic Debt Stock (Jul-Nov)

billion Rupees, shares: in percent

	Net flows		Share in net flows	
	FY10	**FY11**	**FY10**	**FY11**
Government domestic debt	**377.5**	**478.4**	**100.0**	**100.0**
Institution- wise				
A. Through banking system	207.1	337.9	54.9	70.6
From scheduled banks	193.2	42.3	51.2	8.8
From SBP	13.9	295.6	3.7	61.8
B. Through non-bank debt	170.2	141.8	45.1	29.6
C. Foreign currency instruments	0.1	-1.3	0.0	-0.3
Instrument- wise				
A. Permanent debt	59.6	60.0	15.8	12.5
B. Floating debt	233.2	363.6	61.8	76.0
C. Unfunded debt	84.5	56.1	22.4	11.7
D. Foreign currency Instruments	0.1	-1.3	0.0	-0.3

This might be attributed to mis-judgment of the government regarding the extent of deficit and availability of funds from alternate channels, e.g., external assistance, logistic support, and NSS instruments. This is partly reflected from the pre-auction targets of MTBs set by the government at 105.2 percent of the upcoming maturity of MTBs in Jul-Oct FY11, which showed government's intention to roll-over the existing debt stock of scheduled banks during this period (see **Table 5.14**). Although, the offered amount of scheduled banks stood at 201 percent of T-bills maturities during Jul-Oct FY11, government did not raise this amount to avoid higher cost of borrowing.

Table 5.14: Analysis of MTB Auctions (Jul-Oct)

billion Rupees

			As percent of maturity			As percent of target
	Target	**Maturity**	**Target**	**Offer**	**Acceptance**	**Acceptance**
FY10	380.0	205.9	184.6	447.5	203.7	110.3
FY11	710.0	674.6	105.2	201.0	114.7	109.0

[7] For details on PSE debt and commodity finance operations see Chapter 4, *Money and Banking.*

Resultantly, when adequate financing from alternate channels was not forthcoming, the government relied on monetization of deficit during the first quarter.

Table 5.15: Auction Summary (Jul-Oct)
billion Rupees

					Average Bid rate in	
	Offered	**Accepted**	**Maturity**	**Net (of maturity) acceptance**	**FY10**	**FY11**
3M	848.2	524.0	198.7	325.3	11.7	12.6
6M	367.7	257.2	180.3	77.0	12.5	12.7
12M	141.8	61.5	305.3	-243.8	12.4	12.9
Total	930.9	842.7	684.3	158.4	---	---

Scheduled banks debt stock recorded a nominal increase during Jul-Oct FY11 over the end-June 2010 position, while the composition of net flows shifted towards shorter tenor securities. Being aware of the fiscal constraints of the government, scheduled banks were anticipating further tightening of monetary policy and offered large amounts in T-bill auctions at higher rates, with the greater interest in the short tenor-bills (see **Table 5.15**). Government responded to this behavior by accepting larger amounts in the 3-month maturities, and retired its 12-month t-bills. Thus, the composition of net flows tilted towards shorter tenor securities during Jul-Oct FY11.

Growth in unfunded debt instruments decelerated during Jul-Nov FY11.[8] This was in continuation of the trend observed in FY10. The inflows into NSS schemes have been declining since Q4-FY09 after the downward adjustment on the rates of return on these schemes, due to fall in the policy rate. However, the net flows in NSS schemes during Q1-FY11 were still higher than the quarterly average observed prior to the hike in interest rates (see

Figure 5.3a: NSS Flows vs Average Rate of Return

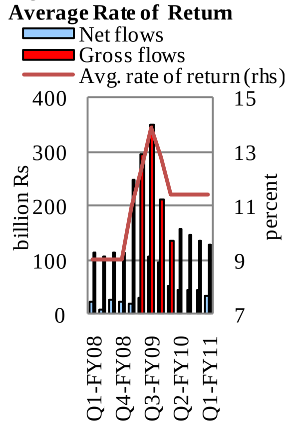
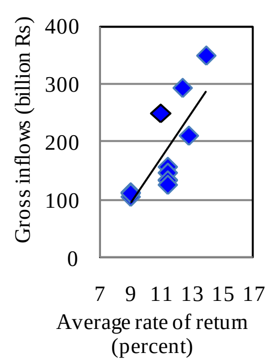


Figure 5.3b: Correlation between Profit Rates and NSS Gross Inflows



[8] The growth in the stock of unfunded debt instruments decelerated to 3.9 percent on end-November FY11 from 6.7 percent in end-Nov FY10 over the respective end June stock.

Figure 5.3a). In this context this is worth mentioning here that as monetary policy tightened, the rates of return on all NSS instruments were also adjusted upward in October 2010. Based on the strong positive correlation in the rates of returns and inflows into NSS schemes, this highlights the possibility of a healthy growth in unfunded debt stock Q2-FY11 onwards (see **Figure 5.3b**).

Permanent debt stock also had a lower contribution in net inflows in domestic debt stock during Jul-November. This was despite a substantial Rs. 51.8 billion increase in the stock for the three year's Ijara Sukuk during November FY11.[9] This is due to unwillingness of government to raise funds through PIBs because of their higher cost. According to the PIB auction calendar, government had targeted to raise Rs 65 billion through three auctions in the Jul-Oct FY11 period. However, due to higher bid rates offered by banks, only Rs. 7.9 billion were raised in these auctions.

Table 5.16: Interest payments on Government Domestic Debt (Jul-Oct)

billion Rupees

	Absolute amount			Percent growth	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**
Total	**200.7**	**217.7**	**229.8**	**8.5**	**5.6**
Permanent debt	14.3	26.0	26.3	81.9	1.1
Floating debt	88.3	72.6	127.9	-17.8	76.2
Treasury bills					
3-months	8.7	0.8	10.6	-90.3	1156.1
6-months	2.0	11.6	13.4	494.6	15.6
12-months	22.8	2.6	37.4	-88.4	1319.8
MRTBs	54.8	57.5	66.4	4.8	15.6
Unfunded debt	98.1	119.1	75.6	21.4	-36.5

Interest payments on government domestic debt recorded a decelerated 5.6 percent YoY rise in Jul-Nov FY11. The slowdown in interest payments on domestic debt was mainly the impact of extinguishing stock of DSCs which resulted in a substantial Rs. 51.7 billion YoY fall in interest payments on these certificates during Jul-Nov FY11. The interest payments on floating debt instruments, however, recorded a significant increase during the first five months of FY11, which was led by heavy reliance of government on these instruments for financing the fiscal deficit during FY10 (see **Table 5.16**).

Going forward, the pressure of interest payments is likely to grow further in the

[9] The Ijara sukuk auction was held after a gap of 13 months. This long gap might be attributed to technicalities involved in the launching of this bond. Being an Islamic bond this needs to be backed by a real asset. After the asset is identified, its value is evaluated, which is then purchased by an asset company comprising of Islamic banks. This asset is then rented to the government in the Ijara sukuk auction on 6-monthly basis.

floating debt instruments. However, a sizeable part of this surge is likely to be offset by falling interest payments on DSCs.