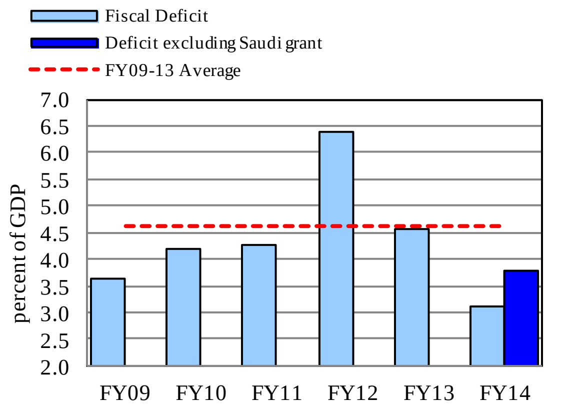
4 Fiscal Policy and Public Debt

4.1 Fiscal operations

The budget deficit was 3.2 percent of GDP during Jul-Mar FY14, according to the fiscal operations data. This was significantly lower than the level observed in the same period last year (**Figure 4.1**), and the ceiling agreed with IMF.[1] This reduced gap includes US$ 1.5 billion grant received from a friendly country in Q3-FY14; its rupee counterpart increased the overall deposits of government which decreased the government budgetary borrowing from SBP.[2] Had this grant not been received, the fiscal deficit for Jul-Mar FY14 would have been 3.8 percent of GDP, which is still lower than the level observed in the same period last year, and the average for the past five years.

Besides the grant, this improvement can be traced to a slowdown in current expenditures and an increase in

Figure 4.1: Fiscal Deficit (Jul-Mar)



Source: Minsitry of Finance

Table 4.1: Summary of Fiscal Operations during Jul-Mar
billion Rupees, growth in percent

	FY13	FY14	YoY Growth FY13	YoY Growth FY14
A. Revenue	2,124.9	2,477.4	22.2	16.6
Tax revenue	1,527.8	1,786.2	11.4	16.9
o/w FBR revenues	1,335.2	1,574.8	4.9	17.9
Non-tax	597.0	691.2	62.3	15.8
B. Expenditure	3,171.1	3,289.0	20.4	3.7
Current	2,642.0	2,904.6	22.7	9.9
Development	444.7	469.9	5.6	5.7
Net lending	1.1	85.9	NA	NA
Statistical discrepancy	83.3	-171.3	59.4	NA
Overall deficit (A-B)	-1,046.2	-811.7	16.9	-22.4
Balance as % of GDP				
Fiscal	-4.7	-3.2	2.5	-31.6
Revenue	-2.3	-1.7	9.4	-27.2
Primary	-1.2	0.4	-11.1	NA

Source: Ministry of Finance

[1] The budget deficit, in absolute terms, was Rs 811.7 billion during Jul-Mar FY14, compared to the IMF ceiling of Rs 1,209 billion (excluding grants) for this period. Even after adjusting for the capital grant, the deficit remains lower than this ceiling.

[2] Rupee counterpart was deposited in "Pakistan Development Fund (PDF)" – a special account with SBP. Fiscal operations data shows this as "statistical discrepancy" with a negative sign in the expenditure side. However, the recently released Budget documents for FY15, reflects this under non-tax revenue as well as under other development expenditures.

tax revenues (**Table 4.1**). The improvement in current spending is broad based, as almost all heads of spending showed lower growth. On the other hand, growth in overall tax revenues was also higher in Jul-Mar FY14 than that in the same period last year. However, this does not provide room for complacency, as the resurfacing of energy sector payables and the government's continued support to PSEs, may lead to a surge in current spending at the end of FY14. On the revenues side, while tax collection by FBR showed a increase of 17.9 percent in Jul-Mar FY14, the annual FBR target has been revised downward by Rs 200 billion, given the difficulty in achieving the initial target announced by the tax authority.

Within the overall fiscal position, the consolidated provincial surplus posted a marked increase during this period. This largely came from cuts in development expenditure, while growth in tax receipts remained sluggish during Jul-Mar FY14, compared to the same period last year (**Section 4.4**).

To address the deep seated structural issues facing the economy, a number of reform initiatives have been announced by the government so far: the National Power Policy announced in June 2013 aims at resolving energy sector issues;[3] and the restructuring plans for Pakistan Steel, PIA, Pakistan Railways (PR) and other PSEs are in the pipeline. Similarly, to improve FBR revenues, tax authorities are in the process of formulating a plan to eliminate tax exemptions over a period of three years. Importantly, FBR has identified that these tax exemptions cause Rs. 500 billion loss of tax revenues annually.[4]

In our view, while the government has set its priorities in the right direction, implementation is what matters to achieve a sustainable improvement in the fiscal accounts. This requires strong commitment and some difficult decisions.

Financing mix of the deficit

The financing of the budget deficit during Jul-Mar FY14, came almost equally from the bank and the non-bank sources (**Table 4.2**). Although, external financing remained negative during the first three quarters of the year, this has change significantly in the fourth quarter.

[3] In June, 2013, the GoP announced a National Power Policy, 2013 (NPP 2013). This policy proposed to eliminate load shedding; decrease cost of generation; reduce transmission and distribution losses from 25 percent to 16 percent; and improve collection of bills to 95 percent, by FY17.

[4] http://www.fbr.gov.pk/PressRelease.aspx?view=Press Release&ActionID= &ArticleID=

Public debt increased by Rs 277.9 billion in the third quarter, with the significant additions to the domestic debt stock. On a positive note, with the active interest of banks in long-term PIBs, the maturity profile of domestic debt is likely to improve significantly in Q4-FY14 and FY15. Moreover, the share of external financing has increased significantly after the receipt of the US$ 2 billion from Eurobonds and US$ 1.4 billion from International Financial Institutions (IFIs) during Q4-FY14 (S**ection 4.5**).[5]

Table 4.2: Financing of the Budget Deficit during Jul-Mar
billion Rupees

	FY13	FY14
Total financing	1,046.2	811.7
External	-4.1	-50.1
Domestic	1,050.3	861.7
Bank	856.7	436.9
Non Bank	193.7	424.8

Source: Ministry of Finance

Although, the shift towards external financing will help reduce the roll-over and interest rate risks from over reliance on short-term domestic financing, this will lead to an increase in external debt servicing. Given Pakistan's history of external deficits, its external debt repayment capacity has been a source of some concern. It is not surprising that the mobilization of US$ 2 billion through the Eurobonds has raised concerns about the buildup of external debt. Although, Pakistan's market debt has increased from US$ 1.6 billion to US$ 3.6 billion in recent month, the debt vulnerability is far less than many emerging market countries and members of the OECD. However, looking at overall debt (domestic and external), the country has already surpassed the limit set in the Fiscal Responsibility and Debt Limitation (FRDL) Act (2005), which required public debt to be less than 60 percent of GDP by end-June 2013 and falling subsequently. Since, this has not happened, only a structural improvement in the country's fiscal indicators can put the country's debt burden on a sustainable path.

4.2 Revenues

Tax collection by FBR posted a 17.9 percent increase in Jul-Mar FY14, compared to 4.9 percent growth witnessed in the same period last year. Despite this improvement, given the below target tax collection in the previous two quarters, the fiscal authorities revised downward the annual tax collection target to Rs 2,275 billion in Q3-FY14 (**Table 4.3**).[6] FBR receipts will now have to grow by 16.5 percent in Q4-FY14 on YoY basis, to achieve the revised target.[7] Furthermore,

[5]Pakistan has also signed US$ 11 billion Country Partnership Strategy with the World Bank for the period FY15-19.
[6] FBR tax receipts missed the half-yearly target by Rs 80 billion, during H1-FY14.
[7] FBR has to collect Rs 700.2 billion in Q4-FY14, compared with the actual collection of Rs 600.9 billion in Q4-FY13.

the inflows from the auction of 3G/4G licenses in April 2014, although fell short of target, should bolster overall revenues in Q4-FY14.

Table 4.3: FBR Tax Collection during Jul-Mar (Provisional)

billion Rupees

	Actual		% Growth		FY14 Target		% achievement	
	FY13	FY14	FY13	FY14	Jul-Mar[1]	Total	Of Jul-Mar target	Of full year target
A. Indirect taxes	844.0	975.9	5.1	15.6	1,001.3	1,434.7	97.5	68.0
Sales Tax	594.7	716.8	4.3	20.5	673.1	959.2	106.5	74.7
FED	78.8	89.9	-7.0	14.0	129.9	191.2	69.2	47.0
Customs	170.5	169.3	15.0	-0.7	198.2	284.3	85.4	59.5
B. Direct taxes	491.3	598.8	4.6	21.9	600.9	910.3	99.7	65.8
Total (A+B)	**1,335.2**	**1,574.8**	**4.9**	**17.9**	**1,602.2**	**2,345.0**	**98.3**	**67.2**

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

Around 51.0 percent of the increase in total collection was contributed by sales tax in Jul-Mar FY14, which was mainly due to the increase in tax rates. According to our estimates, 34.5 percent of the total increase in sales tax receipts was driven by one-percentage point increase in GST rate that was announced in the FY14 Budget. While collection from direct taxes also remained strong, custom duties posted a 0.7 percent fall during Jul-Mar FY14, compared to 15.0 percent increase in the same period last year. This shift in tax incidence away from imports is required as part of trade reforms, but its impact on the fiscal side cannot be ignored.

A more detailed look shows that around one-third of total custom duties are collected from imports of vehicles, petroleum products and edible oil. Growth in the import value of these items has been subdued during the year: the import of automobiles (completely built units) is declining as the age limit of re-conditioned cars was reduced from five to three years in December 2012; the import

Table 4.4: Non-tax Revenues during Jul-Mar

billion Rupees; growth in percent

			Growth	
	FY13	**FY14**	**FY13**	**FY14**
Non-tax Revenue	**597.0**	**691.2**	**62.3**	**15.8**
Interest	7.9	62.3	9.3	na
Dividend	40.6	46.3	22.6	14.3
SBP profits	150.0	205.0	-2.6	36.7
Defense (incld. CSF)	178.5	77.8	na	-56.4
Royalties on Gas and Oil	51.1	59.5	12.8	16.5
Development surcharge on Gas	12.7	34.6	-13.3	na
Gas Infrastructure Development cess	30.0	20.9	na	-30.2
Universal Support Fund	0	67.7	0	na
Others	126.3	117.1	18.8	-7.2
Non- tax revenues excluding defense	418.5	613.4	16.1	46.6

Source: Ministry of Finance

value of petroleum products was lower in Q3-FY14 compared to the previous two quarters (due to stable international prices); and palm oil import fell in Jul-Mar FY14, mainly due to a rise in international prices.

Non-tax revenues

Non- tax revenues posted a healthy increase in Jul-Mar FY14. While CSF inflows remained weak, non-tax receipts were shored up by other factors during Jul-Mar FY14 (**Table 4.4**).[8] For instance, SBP profits witnessed a sharp increase due to the transfer of arrears from the previous year; the one-off markup from PSEs as part of circular debt adjustment along with transfer in Universal Service Fund (USF) and Research & Development Fund (RDF);[9] and the collection of Gas Infrastructure Development Cess (GIDC) resumed in January 1, 2014. [10]

4.3 Expenditures

Growth in fiscal spending eased in Jul-Mar FY14, compared to the same period last year, mainly because of a reduction in current spending growth (**Table 4.5**). The growth in development expenditures, on the other hand, was the same as last year, despite the increase in federal development expenditures. Net lending of the federal government also increased sharply, mainly to settle the circular debt during FY14.

Table 4.5: Fiscal Spending during Jul-Mar

billion Rupees; growth in percent

			YoY Growth	
	FY13	**FY14**	**FY13**	**FY14**
Current expenditures	2,642.0	2,904.6	22.7	9.9
Interest payment	772.2	909.1	23.6	17.7
Domestic	724.7	855.0	25.3	18.0
Foreign	47.5	54.1	3.3	13.9
Other general public services[1]	323.0	254.2	na	-21.3
Defense	405.8	451.7	16.6	11.3
Grants (other than provinces)	140.4	188.9	10.8	34.5
Pensions	120.0	133.0	21.6	10.8
Others	178.7	198.6	21.4	11.1
Provinces	754.9	821.4	11.8	8.8
Development	444.7	469.9	5.6	5.7
PSDP	407.4	393.0	8.5	-3.5
Federal	187.5	193.3	-6.5	3.1
Provincial	219.9	199.7	25.7	-9.2
Other development	37.3	77.0	-18.0	106.4
Net lending	1.1	85.9	na	na
Total Expenditure[2]	**3,087.8**	**3,460.4**	**19.6**	**12.1**

Source: Ministry of Finance

[1]This head mostly includes subsidies; [2] Total is not adjusted for statistical discrepancy, and will not match with the expenditures in Table 4.1

The current expenditures posted a growth of 9.9 percent during this period, compared with 22.7 percent last year same period. However, this improvement is not based on fundamentals, as

[8] Pakistan received US$ 675 million CSF inflows during Jul-Mar FY14, compared to US$ 1.8 billion in the same period last year.

[9] In Q1-FY14, federal government made Rs 138 billion non-cash adjustment of circular debt in the power sector. This receipt is a part of that adjustment.

[10] For details see, SBP 1st Quarterly Report for FY14.

discussed below:

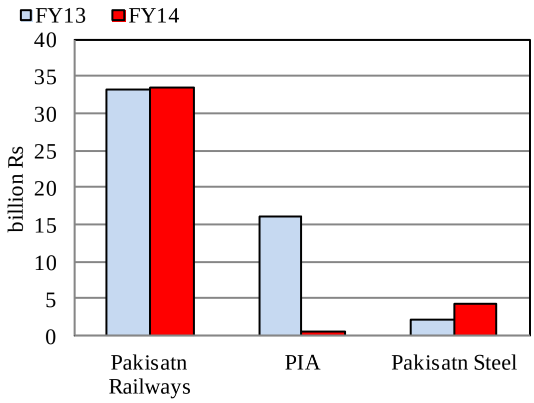
i) Subsidies eased significantly in Jul-Mar FY14, compared to the same period last year. However, this decline was accompanied by a rapid accumulation of payables in the power sector, which will have to be settled going forward;[11]

ii) The servicing of domestic debt posted a YoY slowdown in Jul-Mar FY14, but this cannot hide the sharp increase in interest payments on domestic debt in Q3-FY14, which is likely to continue in Q4-FY14;[12]

iii) Grants given by the federal government to different institutions (other than provinces) posted a sharp increase in Jul-Mar FY14, compared to the same period last year.

In terms of the last point, despite a slight improvement in Pakistan Railways' financials, the government had to increase its financial support to this entity compared to the same period last year (**Figure 4.2**).[13] In the case of PIA, the government earmarked a substantial amount of money in Jun 2013, which is being released in the current fiscal year.[14] In addition, expenses linked to the on-going war against

Figure 4.2: Government Financing Provided to PSEs



Source: Minsitry of Finance

[11] In response to a question in the National Assembly on March 7, 2014, the Minister of Water and Power informed the National Assembly that payables of the power sector stood at Rs 246.2 billion as of end-December 2013. However, the Council of Common Interest (CCI) has agreed in May 2014, to deduct the outstanding power sector payables of the provinces at source from FY15. However, the mechanism for settlement of old dues is still to be finalized.

[12] The main thrust came from payments on government borrowing from SBP and 3m T-bills. In Q1-FY14, sensing a hike in policy rate, banks mostly shied away from investing in government paper, which caused government to meet its deficit financing requirements from SBP, the payment of which fell due in Q3-FY14. However, in Q2-FY14, with the revival in banks' interest in the government paper, the government mobilized Rs 2.3 trillion, through 3m T-bills, with payments also due in Q3-FY14. Furthermore, around one-third of the total increase in domestic debt during FY13, was seen in the fourth quarter, through 12m T-bills, with payments due in Q4-FY14.

[13] The losses of Pakistan Railways stood at Rs 13.8 billion during H1-FY14, compared to Rs 15.0 billion in the same period last year.

[14] Rs 16.0 billion were placed in a separate account to provide financial support to PIA on Jun 29th 2013. This amount was charged in the fiscal operations for FY13. Out of this amount, Rs 14.65 billion have been released to PIA for different payments in Jul-Mar FY14.

terrorism, captured a greater share in grants. Given the current security situation that is linked to the withdrawal of NATO troops from Afghanistan these expenses have also undergone a substantial increase, which is likely to continue into FY15.

Coming back to PSEs, it is important to mention that PIA and Pakistan Steel are included in the list of entities up for strategic private sector participation. The fiscal authorities are in the process of appointing financial advisers for these entities, who will be responsible for preparing comprehensive restructuring and privatization plans for these entities. Furthermore, the government is in the process of reviving the board of Pakistan Railways to oversee the restructuring activities. There is, however, a need to speed up these efforts to minimize the fiscal drain caused by these loss making enterprises. In addition, the government has also identified eleven companies for divestment through capital market transactions. Out of these entities, government's shares in United Bank Limited were divested in June 2014. Furthermore, the divestment process of Pakistan Petroleum Limited has also been approved.

Table 4.6: Provincial Fiscal Operations during Jul-Mar
billion Rupees

	Punjab		Sindh		KPK		Balochistan		All Provinces	
	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
A. Total revenue	506.1	549.6	326.2	358.1	181.3	212.3	111.8	128.0	1125.3	1248.0
Share in federal revenue	416.6	460.9	236.4	280.4	146.0	168.8	94.2	107.6	893.2	1017.8
Taxes	56.1	69.0	49.8	56.1	2.9	9.0	0.8	2.0	109.6	136.2
Non-taxes	22.0	15.5	16.9	3.9	6.4	11.5	3.7	3.8	49.0	34.7
Federal loans & transfers	11.4	4.1	23.1	17.7	26.0	23.0	13.1	14.6	73.7	59.4
B. Total expenditure	473.8	486.6	272.1	299.5	149.5	158.7	90.9	86.3	986.3	1031.1
Current	374.2	397.8	212.9	228.8	110.1	130.0	69.1	74.8	766.3	831.4
Development	99.6	88.8	59.2	70.7	39.4	28.7	21.8	11.5	219.9	199.7
Overall balance (A-B)	32.3	63.0	54.1	58.6	31.8	53.6	20.9	41.7	139.1	216.9

Source: Ministry of Finance

4.4 Provincial fiscal operations

The consolidated provincial fiscal accounts, show a marked improvement in Jul-Mar FY14, with a 56.0 percent YoY increase in the budget surplus (**Table 4.6**). This performance reflects the agreement in the Council of Common Interest (CCI) whereby the provincial governments agreed to post surpluses in FY14, to support the federal government's fiscal consolidation efforts.[15],[16] In overall terms, this

[15] http://www.finance.gov.pk/mefp/MEFP_201314_201516_1stReview.pdf

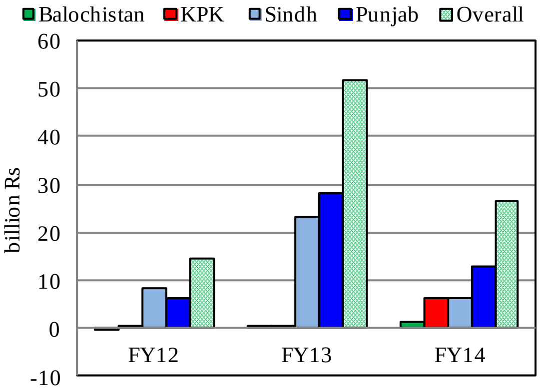
[16] The Council of Common Interest consists of the Chief Ministers of the provinces and an equal number of ministers of the federal government. The 18th amendment strengthened its role as a mechanism for resolving conflicts.

improvement was mainly due to decline in development expenditures. In fact, Sindh was the only province that posted an increase in development spending, while low growth in current spending was contributed by the Punjab.

Low growth in provincial tax collection

After rising substantially in the previous year, the pace of tax collection weakened in Jul-Mar FY14. In terms of individual provinces, tax receipts by Sindh and the Punjab posted a sharp slowdown during this period. However, collections by KPK almost doubled in Jul-Mar FY14, following the establishment of KPK Revenue Authority in August 2013. In our view, the growth in provincial tax revenues is likely to settle down, after witnessing an initial spurt following the devolution of sales tax collection (**Figure 4.3**).[17] Having said this, we believe the improvement in tax administration and widening the tax base, can lead to a significant increase in provincial tax receipts. In this context, a look at the details of taxable services in Sindh and the Punjab, provides some important insights:[18,19]

Figure 4.3: Absolute Change in Tax Collection (Jul-Mar)



Source: Ministry of Finance

- The rate of GST on services is 16 percent, compared to 17 percent in the rest of the country;
- The base of sales tax on services is wider in Sindh (150 services) compared to the Punjab (105 services);
- The scope of telecommunication services is much broader in Sindh, with 65 services in the tax net, compared to 29 in the Punjab;
- Services provided by the financial sector, hotels, restaurants, advertising agencies, professional and consultants, and couriers, are almost fully covered in both these provinces;

[17] The growth in cumulative provincial tax revenues fell from 90.1 percent in Jul-Mar FY13 to 24.3 percent in Jul-Mar FY14.

[18] Tax collection by Sindh and Punjab had 91.9 percent share in overall provincial tax collection in Jul-Mar FY14. The detailed data for KPK and Balochistan is not available.

[19] Source: Second Schedule of the Sindh Sales Tax on services Act, 2011; First & Second Schedule of the Punjab Sales Tax Act on services Act 2012.

- The tax net can be enhanced by expanding the coverage to untaxed (or under-taxed) services.[20]

This analysis suggests there is a significant scope for widening the tax base on services for GST collection at the provincial level. In this regard, it should be noted that under the 7th NFC award, 57.5 percent of total tax revenue are to be transferred to the provinces. Although this has been complemented by the devolution of spending responsibilities, the substantial increase in the provincial share of federal revenues, in the absence of binding fiscal targets for provincial revenue generation, may discourage them to increase their own revenue generation efforts. This anomaly should be taken into account, while finalizing the new NFC award with the provinces.

Priorities in development spending: As anticipated, provincial development spending had to bear the brunt of the fiscal consolidation efforts, falling by 9.2 percent in Jul-Mar FY14, compared to the same period last year. Such development spending had grown substantially in the last two years, after the complete transfer of additional spending responsibilities was implemented in FY12.[21] However, there is an urgent need to enhance provincial capacity if the provinces are to make a contribution to national economic growth by channeling fiscal resources to priority areas, like education and health.

An international comparison suggests that the spending on education and health is lower in Pakistan compared to regional countries.[22] In this regard, the analysis of provincial development spending in Pakistan provides some insights (**Figure 4.4**):[23]

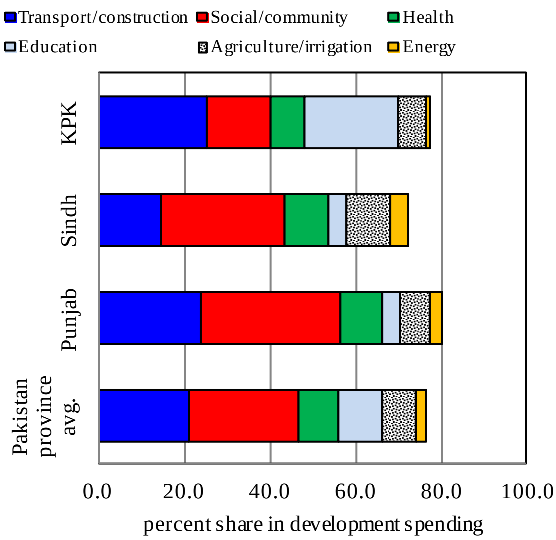
In terms of average provincial expenditure in Pakistan, social and community spending is the biggest claimant on development funds, followed by transport and

[20] For example, travel services, specialized workshops (partially covered in Sindh), cable TV operators, rent a car (taxed in Punjab), designers, auctioneers, prize bond dealers, commission agents, art painters, fumigation services, property and automobile dealers, internet cafes, coaching & training centers, corporate law and tax consultants, building maintenance and service providers, etc.
[21] Under the 18th amendment, the functions of 17 ministries were transferred to provinces in FY11 and FY12.
[22] According to the World Bank database, the spending on education and health (as a percent of GDP) stood at 5.2 percent in Pakistan in 2012, compared to 7.2 percent in India, 9.8 percent in Malaysia, and 5.8 percent in Indonesia.
[23] Source: Provincial Budget Documents for FY14. This analysis is based on the revised estimates of development spending in FY13, for Sindh, Punjab and KPK.

construction.[24] Furthermore, education, agriculture and health seem to get equal importance at the provincial level.

Provinces in Pakistan allocate a significant amount of resources to transport and construction. In fact, one-fourth of the entire development budget in Punjab and KPK is allocated to this head. However, there is some difference when it comes to spending on education – this critical social service captures a large share of development spending in KPK, while it accounts for a small share in Punjab and Sindh (**Figure 4.4**). Furthermore, spending on agriculture & irrigation is low in Punjab and KPK, while health captures about the same share of the development budget across all provinces.

Figure 4.4: Composition of Development Spending - FY13



Source: Provincial Budget Documents

The sharp contrast in the provincial allocations for education is surprising. This could be traced to the fact that education was recently transferred to the provinces as a result of the fiscal devolution process that started in FY11. Hence, the provincial capacity to identify development needs in this area will take some time to develop.

Similarly, the importance given to transport and construction at the provincial level is also intriguing. While the differences in sub-national development priorities can be attributed to individual provincial needs, a review of literature on the determinants of public spending provides another perspective. According to this literature, the composition of government spending is often shaped by the degree of inefficiencies and wastages of financial resources in a country. The types of government expenditure that creates opportunities for bribe taking and other types of rent seeking behavior are often prioritized when governance is poor.

[24] Social and community spending includes the areas of rural and urban development, housing, rural works program, etc.

As a result, investments in huge projects (buildings, highways, airports, etc.) attract more public funds compared to social sector [Reference: Mauro (1998), Delavallade (2006)].[25]

4.5 Public debt

With an addition of Rs 1.3 trillion during Jul-Mar FY14, Pakistan's public debt reached Rs 15.9 trillion as of end-Mar 2014 (**Table 4.7**). A large part of this increase was seen in Q1-FY14. However, government debt resumed its upward trajectory in Q3-FY14, after falling slightly in the second quarter of FY14. The recent increase was entirely because of domestic debt.[26,27]

Table 4.7: Public Debt

(billion Rupees)	Stocks		Absolute Change				
			Jul-Mar		FY14		
	13-Jun	14-Mar	FY13	FY14	Q1	Q2	Q3
Public debt	**14,574.7**	**15,882.1**	**937.5**	**1,307.4**	**1,052.7**	**-23.1**	**277.9**
Public domestic debt	9,520.9	10,820.0	1,162.3	1,299.0	634.0	72.7	592.3
Public external debt	5,053.7	5,062.2	-224.8	8.4	418.7	-95.8	-314.4
Government external debt	4,311.1	4,373.4	-60.3	62.3	361.1	-34.3	-264.4
Debt from the IMF	434.8	356.6	-172.4	-78.2	6.5	-61.9	-22.7
External liabilities	307.8	332.1	7.9	24.3	51.1	0.4	-27.3

Source: State Bank of Pakistan

Composition of domestic debt

With the fall in inflation in December 2013, banks changed their interest rate outlook; and sharply increased their participation in PIBs during Q3-FY14. Out of the entire amount mobilized via PIBs in the third quarter (Rs 977.5 billion), around one-half was raised through 3 year paper, with an effective maturity of slightly more than two years.[28] The significance of the change in sentiments can

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[25] Mauro Paolo (1998), Corruption and the Composition of Public Expenditure; *Journal of Public Economic;* 69, 263-279. Paolo presented a significant negative relationship between corruption and spending on education. Delavallade Clara (2006), Corruption and Distribution of Public Spending in Developing Countries; *Journal of Economics and Finance*; 30:2. Clara provided empirical evidence using a dataset of 64 countries from 1996-2001 to prove that corruption plays an important role in distributing government spending between various sectors. Specifically, it favors spending on defense, fuel, public services, law and order at the cost of spending on social sector.

[26] In US Dollar terms, however, the public external debt & liabilities stock recorded a US$ 0.6 billion increase during Jul-Mar FY14, over the end-Jun 2013 level. The reduction in the Rupee value of debt was caused by a sharp appreciation of the PKR.

[27] After taking into account Rs 309.9 billion government deposits with SBP as on end-March 2014, the net increase in domestic debt during Jul-Mar reduces to Rs 989 billion.

[28] This amount was raised through re-opening of 3-year PIB, which was originally issued in July 2013. The re-opening of a bond refers to the practice of offering the same maturity bond in the consecutive auctions for a year or more. This is a normal practice in a number of countries to develop benchmark issues.

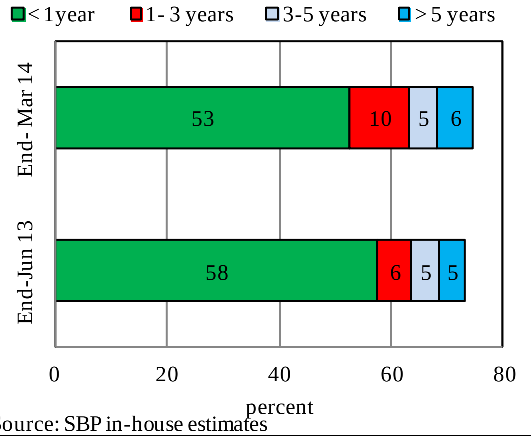
be gauged by comparing Q3 with what happened in the first two quarters of FY14 (as discussed in **Chapter 3**).

This change in banks' behavior led to an improvement in the tenor-wise composition of domestic debt (**Figure 4.5**). The share of medium term debt with maturity between 1 – 3 years, increased to 10.4 percent in end-Mar 2014 compared to 5.8 percent as of end-Jun 2013; correspondingly, short term-debt fell from 57.6 percent on end-Jun 2013, to 52.6 percent as of end-Mar 2014. These movements are significant, when one looks at the growing volume of outstanding domestic debt.

Short-term debt declines in Q3

As mentioned above, Pakistan's short-term debt declined in Q3-FY14 by Rs 437.3 billion after rising sharply in the first two quarters (**Table 4.8**).[29] Both the stock of debt owed to SBP (MRTBs), and commercial banks (T-bills) fell in this period.

Figure 4.5: Maturity Profile of Domestic Debt



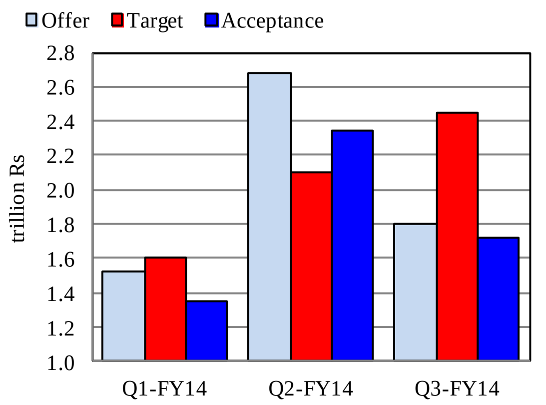
Source: SBP in-house estimates

Table 4.8: Government Domestic Debt (Change in Jul-Mar)
billion Rupees

	Jul-Mar		FY14		
	FY13	FY14	Q1	Q2	Q3
Total domestic debt	1,162.3	1,299.0	634	72.7	592.3
Permanent debt	260.6	948.4	-3.0	-1.5	952.9
Floating debt	633.1	237.4	611.1	63.6	-437.3
T-bill auction*	564.6	-263.6	-138.6	264.9	-389.9
SBP	68.5	501	749.7	-201.3	-47.4
Unfunded debt	265.6	113.3	25.6	10.7	77
FC loans	3.1	-0.1	0.3	0	-0.3

*: Including outright sale of MTBs by SBP
Source: State Bank of Pakistan

Figure 4.6: T-bills Auction Profile



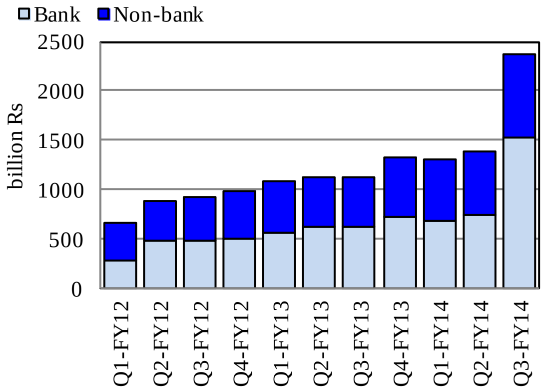
Source: State Bank of Pakistan

[29] The numbers reported in Table 4.8, refer to change in stock of debt. In actual terms, government retired Rs 384.3 billion to SBP in Q3-FY14, compared to Rs 443.1 billion borrowing during H1-FY14.

T-bills also lost their attractiveness following the change in market perception about interest rates in Q3-FY14: as shown in **Figure 4.6,** there was a sharp reversal in the behavior of banks in Q3 compared to Q2. Offered amounts were much lower, despite the increase in targets. During Q3, the net-of-maturity acceptance of T-bills stood at negative Rs 730.6 billion compared to Rs 98.2 billion in Q2. On the other hand, banks' PIB holdings more than doubled from Rs 744.3 billion in Q2 to Rs 1.5 trillion in Q3 (**Figure 4.7**).

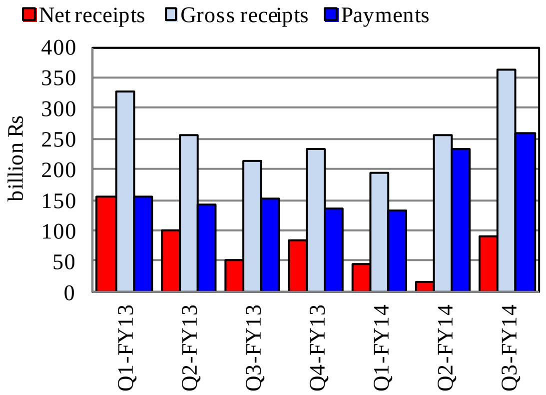
Furthermore, the US$ 1.5 billion grant in Q3-FY14 alleviated the financing pressures on the central bank. This, along with the substantial mobilization through PIBs, was instrumental in the large retirement to the central bank during Q3-FY14.

Figure 4.7: PIB Holdings



Source: State Bank of Pakistan

Figure 4.8: Net Receipts in NSS Recover



Source: State Bank of Pakistan

NSS revived in Q3

Net receipts in National Savings Scheme (NSS) posted a 50.9 percent decline in Jul-Mar FY14, compared to the same period last year. This does not capture the recovery in Q3-FY14, following the upward adjustment in profit rates in October 2013 and January 2014 (**Figure 4.8**). Nevertheless, the rise in return on NSS that allowed for a healthy increase in gross mobilization, was more than offset by large volumes of encashment. Higher encashment were likely the result of the income support levy, announced in the budget FY14, which discouraged individuals from keeping their savings in NSS, and the withdrawal of the minimum threshold of withholding tax on profits in some saving schemes. [30,31]

Public external debt

The stock of Pakistan's public external debt and liabilities posted a US$ 0.6 billion increase in Jul-Mar FY14, compared to a US$ 4.5 billion decline in the same period last year (**Table 4.9**). Although principal repayments increased by 25.3 percent during this period, the debt stock still increased on the back of US$ 1.7 billion inflows from the Fund under the EFF, and increase in loan disbursement from IFIs during Jul-Mar FY14.[32] Furthermore, the country also incurred US$ 173 million revaluation losses in this period because of the depreciation of the US Dollar against major currencies. Going forward, the external debt & liabilities stock is expected to record a significant increase on account of the Eurobonds and program loan disbursements from the IFIs.

Table 4.9: Public External Debt & Liabilities

billion US$

	Stock		Flows				
			Jul-Mar		FY14		
	13-	**14-Mar**	**FY13**	**FY14**	**Q1**	**Q2**	**Q3**
Public external debt	51	51.5	-4.5	0.6	0.6	-0.7	0.7
Govt. debt	43.5	44.5	-2.4	1	0.6	-0.2	0.6
IMF	4.4	3.6	-2	-0.8	-0.2	-0.6	0
Monetary authority liabilities	3.1	3.4	0	0.3	0.3	0	0

Source: State Bank of Pakistan

<u>Disbursements</u>

Inflows from external creditors posted a 12.8 percent increase during Jul-Mar FY14, compared to the same period last year (**Table 4.10**). This increase came from the financing agreements prior to the start of this fiscal year.[33] Having said this, fresh commitments by international donors also witnessed a sizeable increase

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

[31] The exemption from withholding tax, which was available on maximum investment of Rs 150,000, on Defense Savings Certificates, Special Savings Certificates, Savings Accounts or Post Office Savings Accounts or Term Finance Certificates (TFCs), was withdrawn in the FY14 budget.

[32] The principal repayments to IMF stood at US$ 2.5 billion in Jul-Mar FY14 compared to US$ 2.0 billion in the same period last year.

[33] Out of the entire disbursements during Jul-Mar FY14, the inflows from fresh commitments made in this fiscal year stood at US$ 237 million during this period.

during H1-FY14, compared to the same period last year.[34] Already, the country has received US$ 3.4 billion inflows from Eurobonds and other IFIs under the new arrangements during April and May 2014 (**Table 4.11**). Particularly, IDA has disbursed two loans worth US$ 1 billion in May 2014, while ADB has disbursed US$ 400 million in April 2014, as discussed in the following:[35]

- The *Power Sector Development Credit* from IDA, aims at developing an efficient and consumer-oriented power system in the country. It seeks to reduce subsidies and rationalize tariffs; improve performance of the sector and ensure greater accountability and transparency;
- The economic reforms loan (*Fiscally Sustainable and Inclusive Growth*) obtained from IDA aims to support the government's reforms for improving economic growth, ensuring fiscal consolidation and increasing investment;
- *Sustainable Energy Sector Reform Credit* from ADB

Table 4.10: External Loans Inflows (Jul-Mar)

US$ million

	FY13		FY14	
	BE	**Actual**	**BE**	**Actual**
A. Bilateral	**963.4**	**761.9**	**1,816.9**	**464.9**
of which				
China	451.7	413.1	1,365.5	303.9
Japan	422.4	210.8	284.5	78.4
S. Arabia	20.3	31.5	12.8	52.8
B. Multilateral	**1,810.7**	**912.5**	**2,779.3**	**1,102.1**
of which				
ADB	450.9	277.1	991.7	325.0
IBRD	33.8	40.2	126.8	84.8
IDA	695.5	271.7	951.6	237.9
IDB	592.5	315.2	680.6	408.8
IFAD	22.0	2.1	19.2	6.3
OPEC	16.1	6.3	9.4	17.6
C. Commercial banks		**--**		**322.5**
Total [2](A+B+C)	**3,274.2**	**1,674.5**	**5,096.2**	**1,889.5**

BE = Budget estimates for the entire fiscal year.
Note: The totals budget estimates also include US$ 500 million of Eurobonds.
Source: : EAD Status Reports

Table 4.11: New Arrangements in Apr-May FY14

US$ million

Source	**Amount**	**Maturity**	**Terms**
A. Bonds			
Eurobond	1,000	5 years	Market
Eurobond	1,000	10 years	Market
B. IDA			
Power sector development policy credit	600	25 years	Soft
Fiscally sustainable inclusive growth	400	25 years	Soft
C. ADB			
Sustainable energy sector reform project	400	25 years	Soft
Total (A+B+C)	**3,400**		

Source: Economic Affairs Division

[34] During H1-FY14 new commitments worth US$ 2,081.7 million were made by the external creditors, compared to US$ 864.9 million commitments made in the same period last year.
[35] Pakistan has also signed US$ 11 billion Country Partnership Strategy with the World Bank for the period FY15-19. This strategy aims to achieve the twin goals of poverty reduction and shared prosperity. The four strategic reform areas are: energy, economy, extremism, and education.

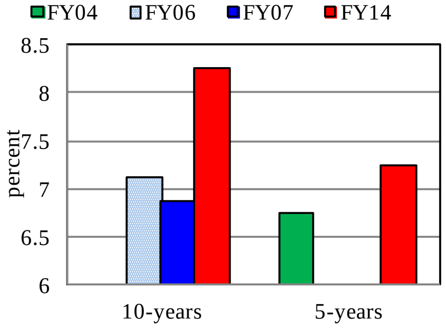
aims to support the National Power Policy 2013. [36]

Issuance of Eurobonds

After a gap of seven years, Pakistan entered the international capital market in April 2014, raising US$ 2 billion through two issues of US$ 1 billion each, with 5 and 10 years maturity, respectively. In fact, Pakistan received bids amounting to US$ 7 billion from international investors, against an initial target of US$ 0.5 billion. This strong response of the international market can be traced to the availability of funding and the high return that was offered by the government.

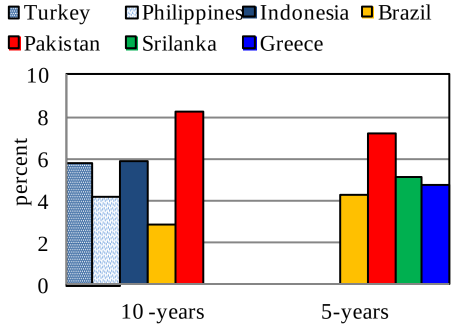
The higher rates compared to similar bonds issued by a number of other countries in 2014[37] can be attributed to the lower credit ratings assigned to Pakistan (**Figures 4.9 & 4.10**).

Figure 4.9: Coupon Rates of Eurobonds Issued by Pakistan



Source: Ministry of Finance and Bloomberg

Figure 4.10: Coupon Rates of Eurobonds



Source: Bloomberg

This is because of the country's external and fiscal outlook, and security risks due to the war in Afghanistan.[38] The interest payments on these two issues will add US$ 155 million annually to Pakistan's external debt servicing from FY15. It may be noted that increased access to external borrowing creates more room for private sector credit expansion.

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[36] Another US$ 438 million loan from ADB is in the pipeline for social protection development project. This program aims to support the Benazir Income Support Program, by increasing the coverage of cash transfers. This loan is likely to be disbursed in FY15.

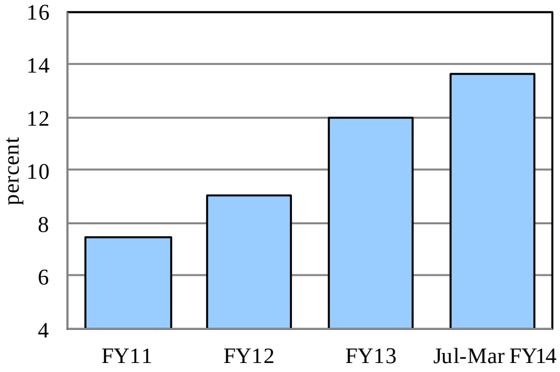
[37] Turkey, Indonesia, and Philippines issued 10 year Eurobonds in January 2014, whereas Brazil issued the same tenor bond in April 2014. Similarly, Brazil and Sri Lanka issued 5 year Eurobonds in April 2014.

[38] Pakistan was assigned Caa1 rating by Moody's, compared to Vietnam's B2 and Baa3 of Philippines and Indonesia.

External debt sustainability

External debt sustainability is gauged by a county's ability to repay external liabilities without recourse to debt rescheduling.[39] Furthermore, the IMF has identified that most of the debt correction episodes in emerging economies with high inflation and previous history of defaults has occurred when the external debt-to-GDP ratio was higher than 35 percent.[40] Pakistan's external debt as a percentage of GDP, declined from 29.1 percent in FY12 to 25.3 percent in FY13. This declining trend is likely to reverse in FY14, with the external inflows from the IFIs and the Eurobond issue. Furthermore, the servicing capacity of Pakistan has been deteriorating in the past few years (**Figure 4.11**). This pressure may increase as repayments of the re-scheduled Paris Club debt come online following the end of the grace period that was agreed upon in late 2001.[41] With this background, unless the country's FX earnings (exports and remittances) improve significantly, the government should be conservative in raising funds from the international capital market.

Figure 4.11: The Ratio of External Debt Servicing with Foreign Exchaneg Earnings



Source: State Bank of Pakistan

[39] Akyüz Yilmaz (2007), Debt Sustainability in Emerging Markets: A Critical Appraisal; *DESA Working Paper*; 61, UNCTAD.

[40] IMF (2003), "Sustainability Assessments—Review of Application and Methodological Refinements", June 2003; http://www.imf.org/external/np/pdr/sustain/2003/061003.htm.

[41] The repayments for rescheduled Paris Club debt under Official Development Assistance (US$ 8.8 billion) will start from FY17.