4 Fiscal Policy and Public Debt

Fiscal indicators resumed their pre-Covid trajectory during Q1-FY21, as tax collections improved with the resumption of economic activity, and the government started unwinding its crisis spending on healthcare and social protection. As a result, the primary balance turned into a surplus again after recording a deficit in the preceding quarter, and the size of the overall fiscal deficit also shrank on a quarter-on-quarter basis. However, the fiscal position was weaker compared to the same period last year due to higher interest payments and provincial development spending, as well as a sharp decline in non-tax revenues. As a result, the stock of public debt ticked up further during the quarter; nonetheless, the pace of public debt accumulation was considerably contained compared to Q1-FY20, primarily due to lower volume of incremental government deposits with the banking system. Also, following the introduction of new long-term instruments in the domestic debt market, the government was able to lengthen the maturity profile of public debt. Furthermore, the surplus in the current account, debt relief under the Debt Service Suspension Initiative (DSSI), and available funding from multilateral sources eased the pressure on external debt management.

4.1 Fiscal Indicators

The improvement post lockdowns of the first Covid pandemic wave

With the ease in domestic lockdowns in Q1-FY21, fiscal indicators began to revert to their pre-Covid trends. While tax collection picked up as economic activity resumed, crisis spending to extend health facilities (purchase of medical equipment and testing kits) and social protection subsided as number of infections dropped in the country. The resultant decline in non-interest current spending (on QoQ basis) more than offset the increase in development spending which both the federal and provincial governments deemed crucial to accelerate the pace of economic recovery. As a result, the government partially regained the consolidation momentum of the first three quarters of FY20, and recorded a healthy primary surplus in Q1-FY21 compared to a deficit recorded in the preceding quarter. Moreover, the overall fiscal deficit in Q1-FY21 was only a quarter of the deficit recorded in Q4-FY20.[1]

Nonetheless, compared to the same period last year, the primary surplus recorded in Q1-FY21 was 9.9 percent lower due to a steep fall in non-tax revenues and a sharp rise in development spending of the provincial governments. Additional strain to fiscal accounts came from a 29.8 percent growth in interest expenses as bulky coupon payments for longer tenor instruments as well for 12-month instruments fell due. As a result, the overall fiscal deficit recorded almost 70 percent growth in Q1-FY21 over last year (to reach 1.1 percent of the targeted GDP for the year). However, these developments must be viewed in the context of a shift in fiscal policy from last year: while deficit reduction was at the core of Budget FY20 that introduced a number of tax-enhancement and expenditure-control measures, relief provision to vulnerable segments and growth support had set the broad contours of Budget FY21.

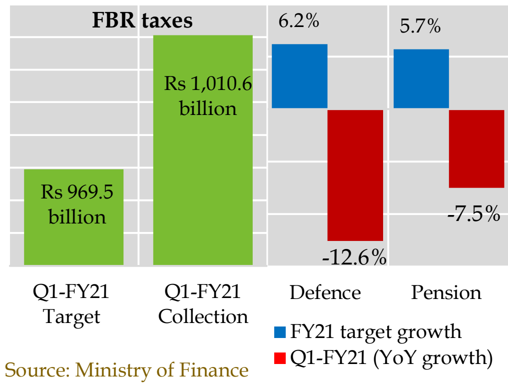
[1] There is an element of seasonality in quarter-wise accumulation of fiscal deficits, as the deficit in the fourth quarter is mostly on the higher side. However, the 249 percent reduction in the deficit in Q1-FY21 compared to Q4-FY20 was more than double the average reduction of 104.0 percent over the last 5 years (FY16-FY20) for the same quarters.

Transition from a consolidation budget to a relief budget

The fiscal policy objective for FY21 was to strike a challenging balance between containing the deficit and public debt levels, and managing Covid-related expenses. Efforts were also put in place to adequately provide for social protection and growth stimulus for the economy. Therefore, on the revenue side, while the government kept intact the tax measures it had announced last year – such as the elimination of zero-rated and reduced rate regimes in certain sectors – it did not push further ahead on the reform agenda to expand the tax base and also avoided rolling out additional measures to enhance collections (except for the increase in petroleum levy on motor fuels, and the increase in FED rates for cigarettes and energy drinks). Instead, the government announced incentives for the construction industry and introduced tariff concessions on multiple industrial raw materials to support exports and general economic activity.

Similarly, on the expenditure side, protection of social spending remained the government's utmost priority. Significant provisions were also made for locust control, hospital services, and disaster management. In addition, the government increased PSDP allocations for FY21 compared to actual spending in FY20, especially to expedite infrastructure projects including dams/hydel power, logistics, and development of underserved regions. To carve out fiscal space for these expenditures, the government cut allocations for untargeted subsidies on power and petroleum, and exercised a nominal freezing of salaries and pensions for the year.

Fiscal over-performance during Q1-FY21 **Figure 4.1**



Source: Ministry of Finance

In overall terms, the government has set the fiscal deficit target at 7 percent of GDP for FY21, lower than the actual deficit last year (8.1 percent). For the primary deficit, the government has set a target of 0.5 percent of GDP compared to the actual deficit of 1.8 percent last year.

Fiscal over-performance in Q1-FY21 and the debt trajectory

When seen in the context of targets, the fiscal sector over-performed during Q1-FY21. Compared to the deficit targeted for the full year, the government recorded a primary surplus during the first quarter. This performance was attributed primarily to FBR tax collections (4.2 percent higher than the quarterly target), which partially offset the expected decline in non-tax revenues – these had risen exceptionally strongly last year due to one-off collections of license fee by PTA as well as SBP profits. On the expenditure side, the government was also able to curtail its non-interest spending such as pensions and defence, against the increases targeted for the full year under these heads **(Figure 4.1)**.

In overall terms, though higher than the same period last year, the fiscal deficit recorded during Q1-FY21 was 15.2 percent of the deficit envisaged for the full year. During the past five years, the average contribution of the first quarter has remained around 18.3 percent of the full-year deficit. This performance, along with the debt management strategy the government rolled out last year, was instrumental in keeping debt accumulation at a manageable level.

Specifically, despite higher financing needs during Q1-FY21, the rise in public debt was almost one-third of the increase recorded in the same period last year. This improvement primarily reflects the impact of lower deposit accumulation by the government (Rs 74.2 billion in Q1-FY21 compared to Rs 1.8 trillion in Q1-FY20). The Medium-term Debt Strategy (2020-23) of the government allowed provision for a revolving cash buffer in the wake of its commitment of zero fresh borrowings from SBP (including rollovers).[2] In addition, revaluation gains on the existing debt stock due to appreciation of the PKR against the US dollar also helped contain debt accumulation.

Moreover, the overall profile of public debt has also improved during Q1-FY21, as the maturity profile was lengthened, rollover risks were contained, and the share of concessional external funding increased. The government achieved this primarily via the introduction of long-term instruments with floating returns in the domestic debt market, which helped keep investments in long-term papers intact. Moreover, the appetite for foreign funding from commercial creditors remained subdued, as the surplus generated in the current account and servicing relief from G-20 countries under the DSSI helped alleviate pressure on external debt management. Nonetheless, the repricing risk of the public debt stayed at an elevated level.

Fiscal challenges and the needed reforms

Notwithstanding these improvements, a high amount of uncertainty persists with respect to the Covid trajectory and possible policy adjustments that it might necessitate. Although the government has made significant provisioning against contingencies in the Budget, the trends in Q1-FY21 call for a tighter control on discretionary spending. Specifically, mark-up payments are already weighing heavily on limited fiscal resources (73.4 percent of FBR taxes), and these could put further pressure on public financial management if debt accumulation is not sustainably contained.

In this context, it is important for the government to strictly adhere to its medium-term fiscal strategy that is centered on broadening the tax base, reducing informality in the economy, and simplifying the tax system (via harmonization of the tax base and rates across provinces and elimination of exemptions, among other measures). As things stand, FBR's tax base is concentrated heavily on indirect sources, within which import- and energy-related collections dominate, making the revenue stream excessively vulnerable to business-cycle and external shocks. Furthermore, quasi-fiscal pressures in the areas of energy (circular debt) and losses in other PSEs also warrant decisive policy actions. PSE debt

[2] Ministry of Finance (2020). Management Strategy (2019/20-2022/23). Islamabad: Debt Policy Coordination Office, Ministry of Finance.

(including energy-related entities) had already touched 5.0 percent of GDP at end Q1-FY21, and convincing progress in this area is still awaited.

4.2 Federal Fiscal Accounts

Before discussing the federal fiscal accounts, it is important to mention that the government has introduced a number of changes in fiscal data disclosure in Q1-FY21, as part of the public finance management reforms. While the treatment of refunds has been modified both in terms of reporting as well as for the calculation of the divisible pool, a number of heads have been reclassified under different categories. Details of these changes are presented in **Box 4.1**.

Box 4.1: Implementation of Public Financial Management Rules and Data Reclassification in Q1-FY21

Public Financial Management (PFM) Act was introduced in Pakistan in 2019. The prime objective of introducing PFM Act was "to strengthen management of public finances with the view to improving definition and implementation of fiscal policy for better macroeconomic management, to clarify institutional responsibilities related to financial management, and to strengthen budgetary management." Last year, the government had introduced significant changes in the procedures with respect to PSDP spending in accordance with the PFM. These had included delegation of the execution of development projects (especially those not classified as core projects) to relevant ministries or divisions instead of the Planning Commission. Importantly, the criteria for PSDP authorization was also introduced on a quarterly basis.

In Q1-FY21, the most significant development with respect to the implementation of PFM procedures was the reclassification of fiscal accounts. This reclassification was done through Parliament's approval of the Public Finance Management Act (Amended as on 30th June 2020), notified by the Ministry of Finance on July 29, 2020. Major amendments included the following:

1) Tax refunds through Finance Division

In the past, sales tax refunds to businesses were made by the Federal Board of Revenue (FBR). However, these refunds will be made through the Ministry of Finance from FY21 onwards. These refunds have now been included under the head "grants to others" within the current expenditures of the federal government.

2) Deduction of Refunds from the Divisible Pool

Previously, the payment of tax refunds was the sole responsibility of the federal government. Provinces despite taking 57.5 percent share in the federal taxes were not contributing to disbursements of refunds. Therefore, the PFM Act allowed for the deduction of refunds from the divisible pool.

3) Reclassification of federal taxes (not collected by FBR) as Non-tax revenues

Federal collections including GIDC, petroleum levy, natural gas development surcharge and some other federal receipts (including airport fees) were earlier part of the federal taxes. These have now been classified under non-tax revenues.

4) PSDP allocation in compliance with PFM

The projects managed previously by the finance division are now reclassified outside PSDP in other federal development expenditures. These included spending against security enhancement as well as development initiatives by the PM office, especially those related to youth development and rehabilitation of internally displaced persons.

5) Adjustment in provincial expenditures to reflect statistical discrepancy

Prior to the PFM reforms, an implicit discrepancy was observed in the balance of provincial fiscal accounts: the reported deficit/surpluses (gathered from the movement in balances held in bank accounts of provincial governments) did not equal the difference between provincial revenues and expenditures. Now, this discrepancy has been explicitly included under provincial expenditures.

Therefore, the Q1-FY21 data reported by the MoF needs to be evaluated carefully, especially when comparing it with the same period last year. While **Table 4.1** presents the data as per the classification in respective years, the data reported in subsequent sections have been largely adjusted to make it comparable across years. Nonetheless, where needed, data reclassification will be discussed in order to bring clarity in the underlying trends.

Summary of Fiscal Operations (Q1) Table 4.1

billion Rupees

	Actual	
	FY20*	**FY21**
A. Total revenue (1+2)	1,489.1	1,478.7
a. Tax revenue	1,142.9	1,122.4
FBR taxes	964.4	1,010.6
Refunds' adjustments^	0	40.0
Other federal taxes	74.1	0
b. Non-tax revenue	346.1	356.3
SBP profit	185.0	105.0
Items moved from federal taxes (other than FBR)	0	149.5
B. Total expenditure (a+b+c+d)	1,775.1	1,963.1
a. Current spending	1,582.2	1,812.6
Interest payments	571.7	742.1
Non-interest expenditures	1,010.5	1,070.5
Defence	242.6	224.5
Grants to others	68.9	108.3
of which Refunds^	0	40.0
Subsidies	0	2.8
b. Development spending	142.5	164.5
c. Net lending to PSEs/provinces	4.7	50.7
d. Statistical discrepancy	45.8	-64.7
C. Fiscal balance (A-B)	-286.0	-484.3
Revenue balance**	-93.1	-333.8
Primary balance***	285.7	257.7
Financing	286.0	484.3
External sources	166.5	161.4
Domestic sources	119.5	322.9
Banks	-123.0	230.8
Non-bank	242.5	92.1

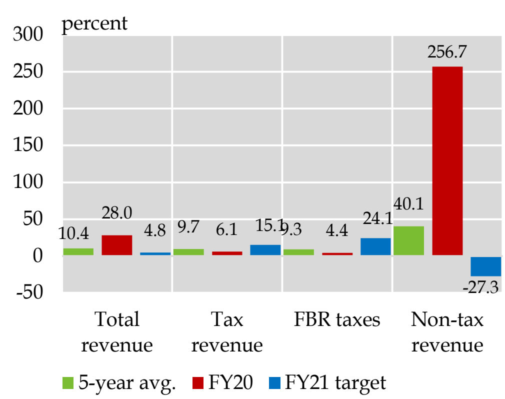
*The numbers quoted are based on the older format. **Revenue balance is total revenue less current expenditures. ***Primary balance is fiscal balance excluding interest payments. ^Changes in accounting treatment under PFM Act 2019

Source: Ministry of Finance

Federal Revenues

Keeping in view the expected pick-up in economic activities, the government anticipated an annual growth of 4.8 percent in revenue collection during FY21. This growth was expected to come from tax revenues as their target was set higher than the five-year average growth **(Figure 4.2)**. However, non-tax revenues were expected to present a major drag in revenue collection due to one-off nature of PTA profit that had increased the overall non-tax revenues (NTRs) last year. SBP profits were also expected to remain low due to prevailing low interest rates.

Growth in Revenues Figure: 4.2



Source: Ministry of Finance

During the first quarter of the year, the overall revenue collection saw a slight decline compared to Q1-FY20. This was a result of the expected fall in non-tax revenues, which more than offset the improvement in tax collection during the quarter.

FBR Taxes

The target for FBR tax collection (net of refunds) for Q1-FY21 was set lower compared to Q1-FY20 in the wake of uncertainties associated with the Covid trajectory **(Figure 4.3)**.

Composition of Domestic Taxes (Q1) Table 4.2

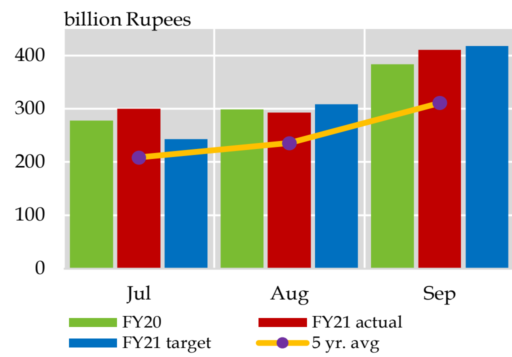
billion Rupees; growth in percent

			Growth	
	FY20	**FY21**	**FY20**	**FY21**
Sales tax (gross)	200.2	242.6	41.3	21.2
Sales tax (net)	184.1	198.7	29.9	7.9
Sales tax refunds	16.3	43.9	--	169.3
Energy related	89.6	111.9	31.2	24.8
of which				
POL	65.5	74.0	23.0	13.0
Electrical energy*	24.1	37.8	60.3	56.9
Non-energy	110.5	130.7	50.6	18.3
of which				
Textile sector	11.9	16.9	--	42.3
Sugar	7.7	16.7	99.4	116.4
Federal excise duty	47.2	53.2	21.6	12.7
Cement	14.6	17.8	31.1	21.7
Cigarettes	11.6	18.8	9.1	61.2
Beverages	7.2	8.5	19.1	18.8
Total (gross)	247.3	295.7	37.0	19.6
Total (net)	231.3	251.8	28.2	8.9

* electrical energy also includes collection from IPPs

Source: Federal Board of Revenue

FBR Tax Collection and Targets Figure 4.3



Source Federal Board of Revenue

However, as it turned out, these collections posted a growth of 3.9 percent on top of 15.2 percent growth in the same period last year. This performance can be attributed to an early recovery in the domestic economy; pent up collections from the preceding quarter; impact of higher prices (electrical energy and sugar); and crackdown on illegal trade (diesel and cigarettes). Meanwhile, the import-related taxes also showed a marginal improvement due to an increase in import values during the quarter (6.2 percent YoY in Pak rupees).

In July 2020, FBR collected noticeably more than its target for the month as well as from the last year's collection for the same month. This was possibly due to the delayed tax receipts of last year amid the operational constraints caused by lockdowns. This provided a cushion in the month of August 2020 when tax collection faced a setback due to heavy rainfalls in Karachi – the Karachi-based collectorates mobilize around 56 percent of the FBR taxes.[3]

[3] Average of previous five years. Source: FBR Year book 2018-19

The increase in domestic sales tax collection was attributed to the economic recovery

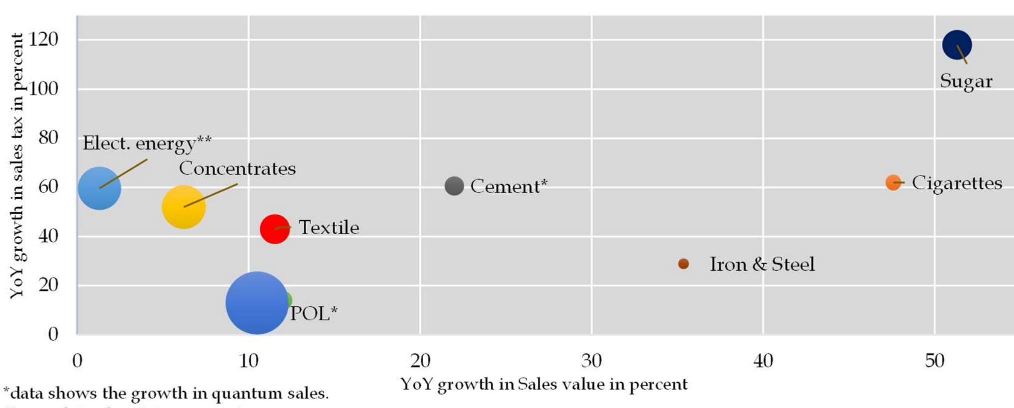
In gross terms, sales tax (domestic) grew by 21.2 percent on top of 41.3 percent growth last year despite no major increase in tax rates and higher refunds. This increase mainly represents growing economic activity as evident in rise in sales of both energy and non-energy items **(Table 4.2 & Figure 4.4)**.

Within the energy items, the increase came majorly from the electrical energy. This stemmed from both the partial pass-through of pending adjustments in fuel cost in power tariffs during the quarter, as well as increase in electricity generation. In the petroleum sector, consumption of high speed diesel remained the main contributor, which more than offset the negative price effect. Also, anecdotal evidence suggests that controlling the illegal trade of diesel from Iran has led to increased consumption of documented HSD, which contributed to higher sales tax collection.

Among the non-energy items, sugar contributed the most. This growth primarily represents a sharp rise in sugar prices (23.5 percent YoY in urban centers) during the quarter, which inflated the overall sales value of the commodity. A similar price-driven growth was observed in the sales of cigarettes, which significantly improved FED collections on the commodity. It is also important to mention here that the intensified crackdown against the illicit trade of internationally produced cigarettes has made these brands more expensive in the retail market; resultantly, the consumers shifted to local brands.

Textiles was another sector where the tax collections posted improvement during the quarter. It is important to recall here that last year, the government had eliminated the zero-rating regime for this sector, which took the collections to Rs 11.9 billion in the first quarter. This year, collections improved further as domestic sales values of textile items and cotton yarn remained

Growth in Sales Value and Domestic Sales Tax Collection during Q1-FY21 **Figure 4.4**



*data shows the growth in quantum sales.
**growth in electricity generation.
Note: Bubble size represents the share in total sales tax collection
Source: FBR, NEPRA, OCAC and APCMA

Sector-wise Collection of Import Related Taxes (Q1) **Table 4.3**

billion Rupees; growth in percent

			Growth	
	FY20	FY21	FY20	FY21
Sales tax	220.5	228.1	14.0	3.4
POL	65.4	52.2	16.0	-20.2
Iron and steel	20.3	23.1	17.1	13.8
Animal or veg. oils	11.0	16.2	-2.8	48.2
Vehicles	12.7	10.3	-29.5	-18.6
Custom duty	155.2	153.2	-0.8	-1.3
POL	21.8	18.7	19.8	-13.9
Vehicles	16.8	14.0	-32.0	-16.8
Iron and steel	10.4	13.6	-14.3	31.3
Animal or veg. oils	7.1	8.5	-7.5	19.6
Federal excise duty	2.8	3.0	-14.5	7.3
Total	378.5	384.3	6.8	1.6

Source: Federal Board of Revenue

11.5 percent and 8.5 percent higher, respectively, than the last year.

Finally, in wake of the government's support for the construction sector, the demand for cement increased significantly in the country. The growth in local dispatches was strong enough to offset the impact of reduction in FED rates; as a result, collections grew by 21.7 percent over last year.[4]

Import-related taxes rose marginally

Compared to a 6.8 percent YoY growth in imports during the quarter, the growth of 1.6 percent in the import-related tax collections appears subdued. The growth is also significantly lower than the one observed last year. This performance is attributed primarily to a steep decline in global crude prices, which led to a drop in POL-related collections this year **(Table 4.3)**;[5] excluding these, the growth in import-related collections increases to 7.5 percent. However, it is important to note here that the government compensated the decline in POL-related import taxes with higher mobilization of petroleum levy during the quarter (now classified as NTR).

In addition to POL products, a drag in import-related collections may also have come from the exemptions on additional customs duty on 1,600 tariff lines (which include around 20,000 items).[6] These items include the raw material used in the chemical, leather, textile, and fertilizer industries.

Among the items where customs collections improved over last year, iron and steel featured prominently. Attributed primarily to construction-related incentives announced by the government, there has been a rise in import quantum of associated materials like iron and steel. Due to this, the customs duty and sales tax collection at import stage for iron and steel increased.

Another segment where the collections posted improvement was edible oils. This improvement primarily reflects a significant rise in the import value of palm oil and soybean oil (partly due to higher international prices), which more than

[4] Source: FBR and Ministry of Finance (2020). *Yearbook 2018-19*. Islamabad: Revenue Division, Ministry of Finance.

[5] The quantum of oil imports increased in Q1-FY21 owing to high domestic demand.

[6] These tariff lines constitute around 20 percent of all imports (Source: Ministry of Finance (2020). *Federal Budget Speech 2020-21*. Islamabad: Ministry of Finance.).

Major Revenue Drivers of Direct Taxes (Q1) **Table 4.4**

billion Rupees; growth in percent

	FY20	FY21	Growth FY20	Growth FY21
Withholding taxes	256.5	266.7	19.7	4.0
Imports	50.7	41.2	-11.5	-18.7
Salaries	25.4	33.6	64.9	32.3
Bank int. & securities	29.8	38.5	112.7	29.1
Contracts	51	52.4	3.6	2.9
Electricity bills	11.4	11.9	22.5	4.1
Telephone	12.6	15.1	562	20.2
Collection on demand	5.8	12.0	-48.3	105.8
Voluntary payments	109.4	95.2	68.8	-13.0
Gross direct taxes	374.0	385.1	15.4	3.0
Refunds	24.8	25.2	-2.6	1.6
Net direct taxes	349.2	359.9	17.0	3.1

Source: Federal Board of Revenue

offset the impact of exemption of additional customs duty under the PM's Covid relief program (**Chapter 5**).

Higher collection from WHT and collection on demand improved the direct tax collection

Direct taxes grew marginally in Q1-FY21 compared to the corresponding period of last year **(Table 4.4)**. The major contribution to direct taxes came from withholding taxes and collection on demand. The increase in withholding taxes could be traced to salary, telephone, and bank interest and securities. Saving deposits increased in Q1-FY21 compared to corresponding period of last year, which added to the collection from profit on debt.[7]

Meanwhile, the collection from WHT on telephone rose on account of higher consumption of telecom services, as evident from the higher revenues of telcos compared to the first quarter of last year.[8] In addition, the improvement in the collection on demand shows enhanced administrative measures by FBR as higher demand notices have been issued to taxpayers.

In the absence of one-off flows, non-tax revenues remained lower during Q1-FY21

Non-tax revenues declined in Q1-FY21 compared to last year on account of relatively low profit transfers from SBP and PTA **(Table 4.5)**. In case of transfer of SBP profits, two factors played an important role: (i) Throughout FY20 (and first quarter of

Federal Non-Tax Revenues (Q1) **Table 4.5**

billion Rupees, growth in percent

	FY20	FY21	Growth FY20	Growth FY21
Mark-up (provinces)	6.0	6.8	43.7	12.1
Mark-up PSEs	3.3	25.7	187.4	674.7
PTA profits	71.8	8.2	1078.8	-88.7
SBP profits	185.0	105.0	264.8	-43.2
Discount retained on crude oil	3.7	1.5	17.7	-60.7
Royalties on oil\gas	23.8	14.6	0.5	-38.4
Others	14.2	19.1	-1.1	34.6
Sub Total (A)	321.2	189.3	175.8	-41.1
NGDS	1.7	8.1	-33.2	376.8
Petroleum levy	64.8	136.4	45.7	110.4
GIDC	2.7	5.0	-54.3	83.3
Receipts of ICT	4.8	4.4	90.3	-9.3
Sub Total (B)	74.1	153.8	66.5	107.7
Total (A+B)	395.3	343.1	131.4	-13.2

Source: Ministry of Finance

[7] Saving deposits grew by 20.6 percent in Q1-FY21 compared to 7.7 percent growth last year.
[8] The revenues of major telecom companies (Mobilink, Telenor and PTCL) grew by 4.9 percent YoY on Q1-FY21 (source: financial statements data of respective firms available on their websites).

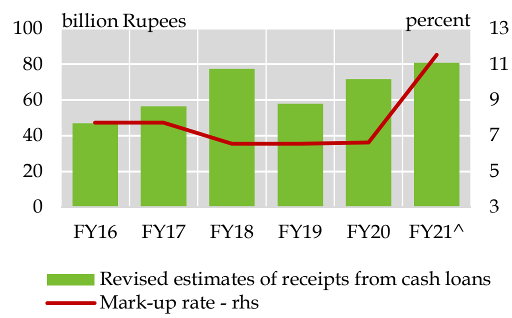
FY21), the government had adhered to its commitment of zero fresh borrowing from the SBP, and instead made net retirements through borrowings from other domestic and external sources. This had led to a Rs 600 billion decline in the SBP debt stock between June 2019 and June 2020; and (ii) the impact of lower debt stock was reinforced by lower interest rates. Specifically, market interest rate (yield of 6m paper) in Q1-FY21 was on average 674 bps lower compared to Q1-FY20. Since the bulk (70 percent) of the SBP debt was converted into floating rate PIBs (with yields benchmarked with the 6-month paper) at end June 2019, the impact of the fall in policy rate was quite pronounced on SBP's interest earnings. As a result, the transfer of SBP profits to the government posted a YoY decline of 43.2 percent in Q1-FY21.

PTA, on the other hand, had transferred receipts of around Rs 70 billion to government on account of GSM license renewal fee in the same period last year. It is important to recall here that the telcos had to pay half of the renewal fee in FY20 while the rest of the amount has to be paid in five-year installments. Therefore, the government had targeted only Rs 27 billion under PTA profits for the full FY21, of which Rs 8.2 billion has been transferred in the first quarter. This also caused a drag in the overall non-tax revenues.

Another major development was that the GIDC, petroleum levy, natural gas surcharge and some other federal receipts are now classified as non-tax revenue. Among these items, a prominent development was the doubling of collections from petroleum levy during Q1-FY21 compared to the same period last year. This improvement reflects the increase in the rate of this levy to Rs 30 per liter on petrol and diesel by the government at the start of the year.

Meanwhile, mark-up receipts from PSEs and other local bodies increased significantly compared to last year. This rise is explained by the higher mark-up rate charged by the federal government from these entities compared to last year **(Figure 4.5)**. It is important to mention here that the government had last changed mark-up on loans to PSEs and other local bodies back in December 2019, increasing it by 491 basis points from December 2018, based on the change in policy rate during the same period. Since then, although policy rates have been revised downwards, the mark-up on PSE loans has remained unchanged – this basically represents a general lag involved in aligning these rates with the policy rate.[9]

Receipts from Development Loans and Mark-up Rate* **Figure 4.5**



*notification No. F.8(2) GS-I/2018-1775, MoF
^budgeted
Source: Ministry of Finance

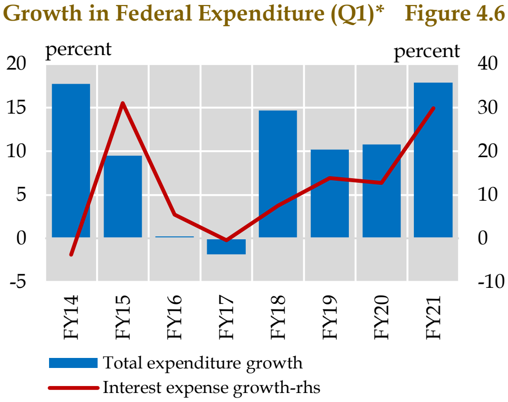
[9] The Budget Wing of Finance Division determines mark-up on loans to PSEs and other local bodies during July-December every year, and notifies the same around December.

Federal Expenditures[10]

On aggregate, the federal government set the expenditure growth at 4.7 percent compared to 21.8 percent recorded in FY20. This growth was expected to come entirely from interest payments, as non-interest expenditures are targeted to remain roughly at the last year's level (a negative growth of 0.2 percent).

The Q1-FY21 outcome was to a large extent in line with the targets set for the year. Although the growth in total federal expenditures almost doubled from the last year, this was entirely due to interest payments which grew by 29.8 percent YoY during the quarter **(Figure 4.6)**. Non-interest expenditures on the other hand, grew by 6.8 percent; but it is important to mention that after excluding the impact of reclassification of FBR refunds (now classified under grants), these expenditures stayed at almost last year's level. This containment in the non-interest expenditures was reflected primarily in two major heads under these expenditures – defence and pensions – which posted a YoY decline. Nonetheless, spending for social protection (BISP under Ehsaas program) remained at an elevated level compared to the last year.

Growth in Federal Expenditure (Q1)* Figure 4.6



* excluding statistical discrepancy
Source: Ministry of Finance

As a result, the entire growth in federal expenditures was visible in current spending and higher lending to PSEs and provinces, as development spending by the federal government remained lower than the last year (as explained in subsequent section, this trend was primarily attributed to lower disbursement of development grants to provinces by the federal government; excluding this, development expenditures, including net lending, of the federal government remained higher than last year).

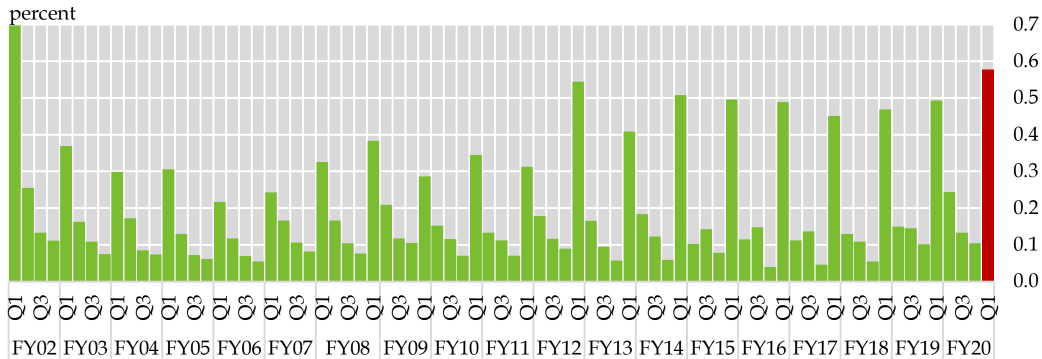
Federal Current Expenditures

Within current spending, most of the increase came from interest payments; these payments contributed 95.2 percent to the YoY increase in total current spending during Q1-FY21. In terms of growth, the overall interest payments increased by 29.8 percent as compared to 12.7 percent recorded last year. Importantly also, this is the first time since Q1-FY02 that the share of interest expenses has approached almost 60 percent of the total expenditures **(Figure 4.7)**. This implied that nearly half of the total revenues and 73.4 percent of FBR taxes were consumed by interest payments during Q1-FY21.

The higher interest payments primarily came from: (i) increased level of public debt stock; (ii) lengthening of the maturity profile of public debt (which added term premium to the borrowing cost); and (iii) scheduled coupon payments of longer tenor

[10] The discussion in this section is based on expenditures excluding statistical discrepancy.

Interest to Non-Interest Expenditure Ratio during Q1* **Figure 4.7**



*this is calculated by subtracting interest payments from consolidated expenditures
Source: Ministry of Finance

instruments and 12-month papers that were mobilized last year.

In terms of social protection, BISP under Ehsaas increased to Rs 13.9 billion in Q1-FY21, compared to Rs 5.8 billion in Q1-FY20. *Ehsaas Emergency Cash program* was exclusively designed to lessen the adversities of the most vulnerable pandemic-stricken segments. In this regard, Rs 178.9 billion has been disbursed to 14.8 million beneficiaries under the program up till 22-09-2020.[11] In addition to BISP, the federal government has also been spending on various programs under the Pakistan Poverty Alleviation Fund.

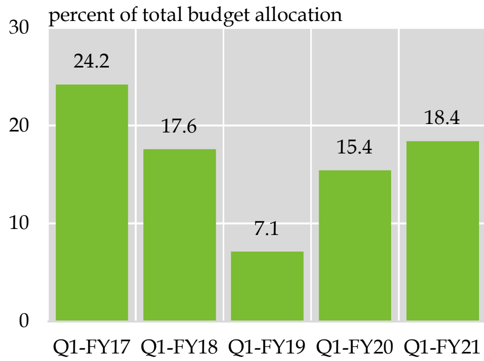
Two heads where a decline was visible on a year on year basis, included defence and pensions, as mentioned earlier. For both these heads, the government has envisaged higher spending in FY21 compared to last year. In case of pensions, while the government had kept the allowances unchanged in the Budget, the overall expenditures were set at a slightly higher level due to expected increase in number of pensioners. In case of defence, it is important to note that FY21 is the second consecutive year when the government has targeted a containment in expenditure.

Federal development expenditures and net lending

The focus of development spending in the FY21 budget was on ongoing public sector development projects (about 73 percent of the total projects), with 27 percent allocated for new projects. This allocation was attributed to a large number of incomplete projects in the last fiscal year, as the relevant government departments – which were delegated the responsibility to execute PSDP spending as part of the PFM reforms – could not initiate the committed projects. Hiring of project directors was delayed and needed procurements also fell behind the schedule. It was earlier expected, therefore, that the progress will pick up in the later part of the year. However, lockdowns and restricted mobility from March 2020 onwards delayed the progress on these projects further. Thus,

[11] Ministry of Finance (2020). *Monthly Economic Updates & Outlook September, 2020*. Islamabad: Economic Advisor's Wing, Ministry of Finance.

PSDP Releases (Rupee component) during Q1 **Figure 4.8**



Source: Planning Commission

most of the projects spilled over to FY21. In addition to the phased projects, the federal government also initiated new projects in less developed regions of the country.

In Q1-FY21, the federal government spending against its own development projects remained higher than last year, but due to a drop in its development grants to the provinces (a component of federal PSDP), the overall number showed a decline of 7.6 percent YoY. Another factor that dragged down the growth in federal PSDP during Q1-FY21 was the impact of data reclassification: spending against security enhancement, which was earlier included in PSDP spending, has been taken out and shifted to other development expenditures under the revised PFM guidelines.

Here it is important to mention that the first quarter of FY21 was also affected by Covid-related restrictions. Throughout July and most of August 2020, social distancing norms were followed and strict SOPs were exercised for projects' execution. Still, the releases of rupee component by the federal government was around 18.4 percent of the annual allocations. Though this ratio is much lower than the release ratio of 43.0 percent for foreign component in Q1-FY21, it is much higher than the releases of rupee component in the first quarter of last three years (**Figure 4.8**).

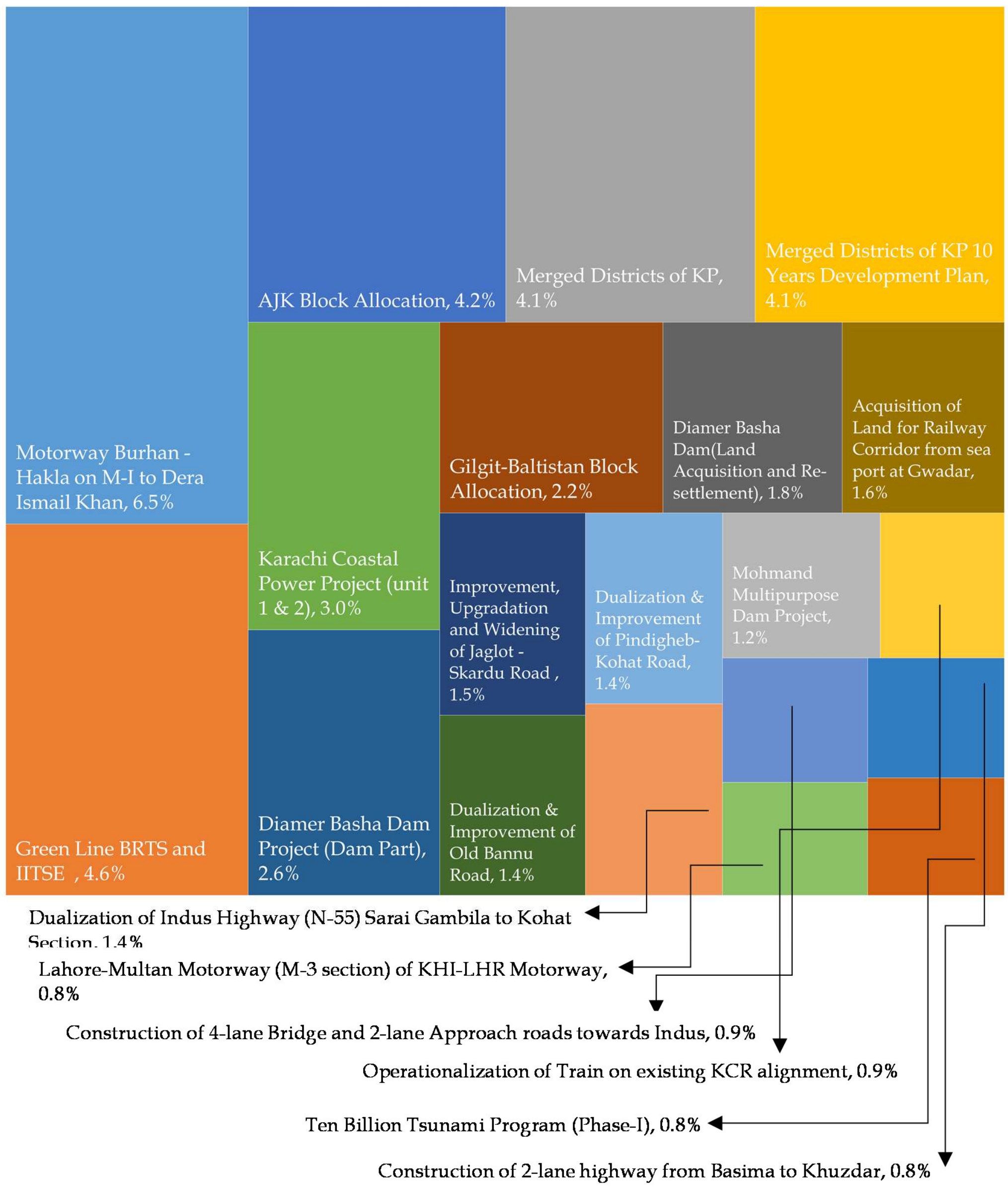
The available project-wise information on PSDP releases suggests that road infrastructure, development of AJK, GB and merged areas of KP, and construction of dams were prioritized by the federal government. Importantly, the top-20 projects in terms of releases of rupee component, which together constitute around 46.0 percent of the total releases during the quarter, had a balanced geographical spread across the country **(Figure 4.9)**. For instance, these projects included the transport upgradation project in Sindh, railway-related project in Balochistan, dam construction in KP, road projects that cover areas in Punjab and KP, and then regional development of underserved areas of AJK, GB and merged districts of KP.

Among the foreign funded projects, two major projects stood out – both in the power sector: (i) ADB-funded coal-fired power station in Jamshoro; and (ii) US-funded refurbishment of Mangla Power Station. Together, these two projects constituted two-thirds of the PSDP releases against foreign disbursements. Out of the total authorization up to September 2020, around 90.0 percent of disbursement came from national exchequer while the remaining from foreign aid.

4.3 Provincial Fiscal Operations

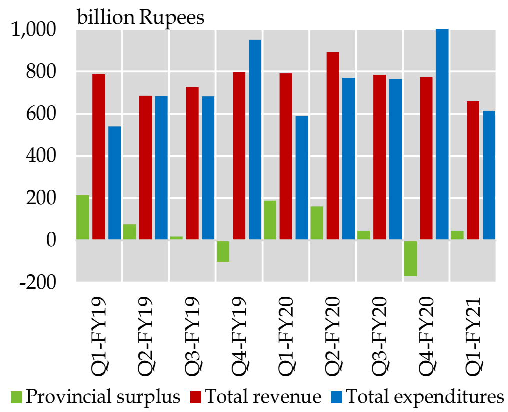
The Covid-19 and its fall-out on government's healthcare and associated expenditures had caused a heavy strain on provincial fiscal accounts as well. While

Top 20 Federal PSDP Projects in terms of Release Authorization during Q1-FY21 **Figure 4.9**



Source: Planning Commission

Provincial Fiscal Indicators **Figure 4.10**



Source: Ministry of Finance

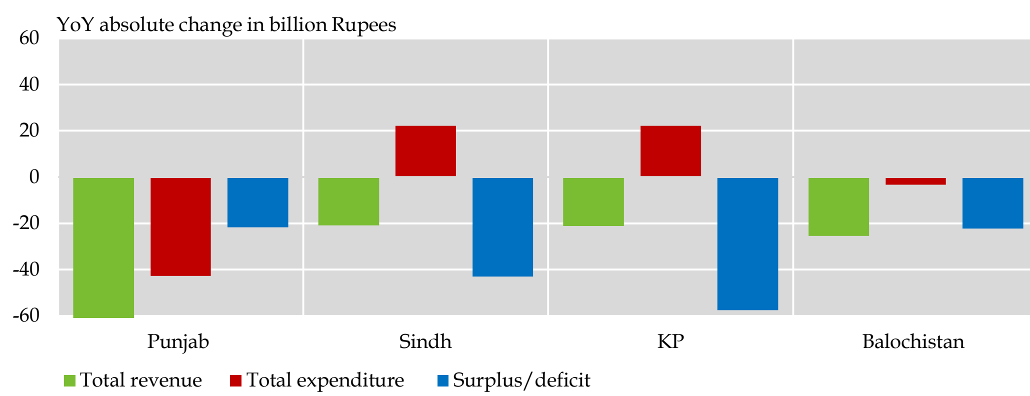
transfers from the divisible pool declined as federal tax collection weakened, this was largely offset by a significant increase in federal loans and grants. However, higher spending needs led to a provincial deficit during Q4-FY20 **(Figure 4.10)**.

During Q1-FY21, provinces posted a combined surplus of Rs 44.4 billion, which is one-fourth of the surplus recorded in Q1-FY20 and around 18 percent of the full-year target of FY21. This lower surplus was contributed both by a decline in their revenues as well as increase in their expenditures from last year on a consolidated basis. This performance was attributed to deficits recorded by Sindh and KP during Q1-FY21, as well as lower surpluses recorded by Punjab and Balochistan compared to last year. While revenues posted a decline for all the provinces, expenditures recorded an increase for deficit-accumulating provinces and a decline for surplus-accumulating provinces **(Figure 4.11)**.

Provincial Revenues

The provincial revenue mobilization remained subdued during the first quarter of FY21 due to lower transfers from federal government under the NFC **(Figure 4.12)**. This development is explained by the deduction of Rs 100 billion of refunds (those pertained to Q1-FY21 and also pent-up disbursements from Q4-FY20) from the federal divisible pool – as mentioned earlier, these deductions were made in accordance with the PFM reforms. It is important to note here that the government had targeted refunds' deduction of Rs 50 billion for the full year, but due to faster processing system of outstanding claims by the FBR, Rs 100

State of Provincial Accounts during Q1-FY21 **Figure 4.11**



Source: Ministry of Finance

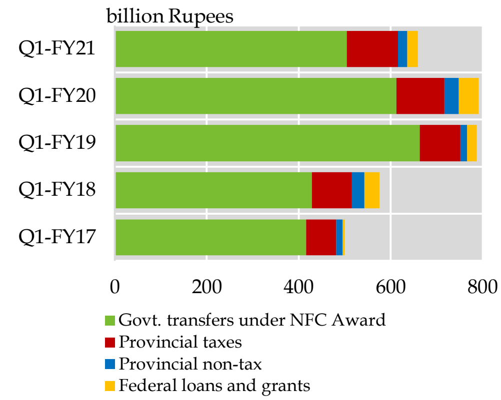
billion were disbursed to businesses during the quarter.

As far as provincial own revenue collection is concerned, these also recorded a decline over the last year. The decline is explained entirely by a drag in provincial non-tax revenues (NTRs), as their tax collections improved over last year. The decline in NTRs was due to the lower payments of net hydel profits to the KP government. While the issue of delayed disbursements of net hydel profit has been around for the last couple of years, this year the decline in hydel generation over the past couple of quarters may also have contributed.

Nonetheless, total provincial taxes remained higher in Q1-FY21 on a YoY basis, which can be attributed to an improvement in collection of general sales tax on services (GSTS) and motor vehicle tax (MVT).

This improvement reflects the pick-up in domestic activity in the economy, especially cellular and other telecom services which improved provinces' GSTS collections.[12] Similarly, higher sales of automobiles in the country have increased the MVT. Yet, this growth is relatively lower as compared to the five-year average growth. This is because the provinces announced tax relief measures in Q4-FY20 amid Covid-19 which continued in the first quarter of FY21.

Structure of Provincial Revenues **Figure 4.12**



Source: Ministry of Finance

For instance, the government of Punjab announced a tax relief package of Rs 56.5 billion for FY21, which included various exemptions in the services sector and stamp duty.[13,14] Sindh also exempted payment of taxes relating to property, motor vehicles, professions, trades, callings and employment amid Covid-19.[15] Furthermore, KP also provided exemption on stamp duty and capital value tax for FY21.[16]

Provincial Expenditures[17]

Similar to federal government, budgetary priorities of the provincial governments for

[12] The revenues of Telcos grew by 4.9 percent during Q1-FY21 which shows a higher activity in telecom services

[13] Notification No. SO (TAX) 1-110/2020 (COVID-19), Government of Punjab.

[14] The stamp duty on various property transactions have been slashed to 1 percent from the existing 2 to 5 percent. Source: Punjab Finance Act, 2020.

[15] Government of Sindh (2020). *Budget 2020-21: Budget Speech*. Karachi: Finance Department, Government of Sindh.

[16] Notification No. AS(S)3/240/2020-21/20210-90 dated August 25th, 2020.

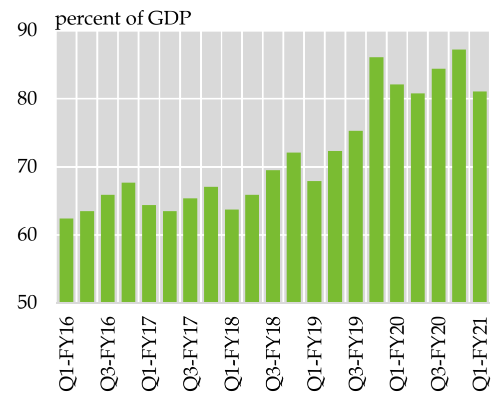
[17] This section is based on information available on current and development expenditures only. Statistical discrepancies are not included while analyzing the expenditures of provincial governments.

FY21 were also targeted towards Covid-related spending along with supporting the economic growth. Here, it is important to mention that all the provinces have aimed to create fiscal space for the development expenditures to help the economy back to pre-Covid path and supporting the most vulnerable during the pandemic period. This was done by containing the unnecessary expenditures while extending resources to the most needed sectors such as health and social protection.

During the first quarter of FY21, the total provincial expenditures grew by 11.3 percent compared to last year. This growth stemmed from both current and development expenditures. Province-wise data suggests that the higher growth in expenditures came primarily from Sindh and KP, as Punjab and Balochistan spent less than last year.

Within Punjab, a slowdown was observed both in current and development expenditures. The development expenditures in Sindh more than doubled as compared to the corresponding period last year. The major increase came from higher expenditure on agriculture, housing, education, and health. Likewise, KP also increased its development spending by around 50 percent in the quarter, mainly in the areas of construction, transport and education. Meanwhile, Balochistan reported a decline in development expenditure during the quarter. Both Sindh and KP also showed a higher increase in current expenditures during the quarter. The priorities remained tilted towards administrative affairs, transfers to districts, public order, and health.

Gross Public Debt **Figure 4.13**



Source: State Bank of Pakistan

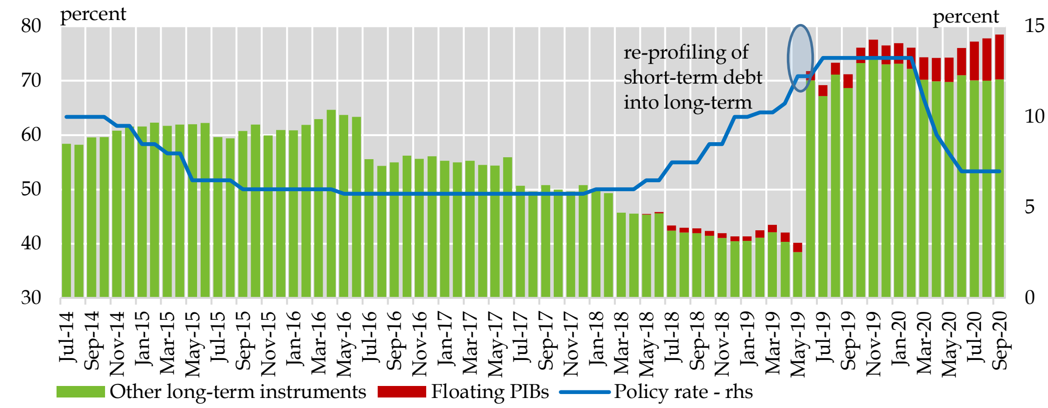
4.4 Public Debt

With the start of the Extended Fund Facility (EFF) program of the IMF, fiscal constraints with respect to debt sustainability have come to the forefront. The government had committed to bring the public debt ratio down by 0.5 percent every year[18]. In the first two quarters of the preceding year, the downward trend in public debt to GDP ratio was steeper than projected, as the ratio had fallen to 80.8 percent by end-December 2019. However, due to Covid-related fiscal strain emerging from March 2020 onwards, this ratio rose again to reach 87.2 percent at end-June 2020 (**Figure 4.13**).

Thus, at the start of FY21, rising debt was a major constraint for Pakistan's fiscal

[18] According to the Debt Policy Statement 2019-20, within a period of five financial years, beginning from the FY19 total public debt shall be reduced by 0.5 percent every year and from 2023-24 and going up to FY33 a reduction of 0.75 percent every year to reduce the total public debt to fifty percent of the estimated GDP.

Share of Long-Term Instruments in Domestic Debt **Figure 4.14**



Source: State Bank of Pakistan

operations. However, the government accommodated a deficit budget and a rise in public debt for FY21 in order to extend pandemic-related relief and to accelerate the pace of economic recovery. Compared to the estimates available at the time of budget preparation, the government envisaged an increase of 0.2 percent of GDP in gross public debt.[19] Therefore, the debt management strategy during FY21 was centered primarily on reducing the borrowing cost, extending the maturity profile and improving the liquidity position of the government.

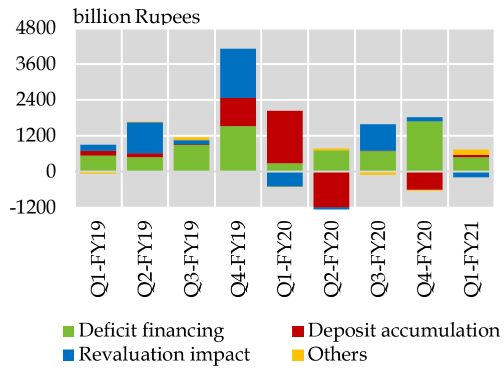
In this context, three developments were important. First, with the introduction of floating rate long-term instrument (PFL), the government has effectively deepened the domestic debt market.[20] Market participants are now keen to invest in long-term paper even in the low interest rate environment, since their returns will be repriced in line with any change in the benchmark interest rate (in most cases, it is 6-month T-bill cut-off rate). In Q1-FY21, almost the entire domestic debt accumulation came from these long-term floating rate PIBs. While higher investment in these instruments have kept the repricing risk at an elevated level, this has significantly lengthened the maturity profile of public debt: the share of long-term instruments in total domestic debt increased further by 2.4 percentage points to reach 78.5 percent at end September 2020 (**Figure 4.14)**.

Second, the government's appetite for external funding was quite low during the quarter due to a surplus in the current account, the availability of multilateral funding (especially from ADB and IDA to make progress on on-going projects), and relief on principal payments by G-20 countries under the DSSI. Therefore, the government retired commercial loans to foreign creditors during the quarter both under the short-term as well as long-term facilities. This improved the cost profile of the public external debt.

[19] Ministry of Finance (2020). *Medium Term Budgetary Statement 2020-21 to 2022-23*. Islamabad: Fiscal Division, Ministry of Finance.

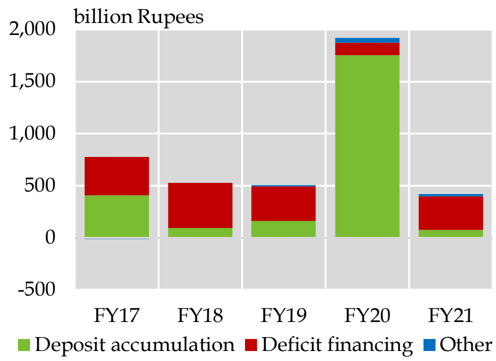
[20] Floating rate PIBs (PFL) were initially introduced in May 2018 with a maturity of 10 years, subsequently in Jun 2020, 3-year and 5-year PFLs were also launched.

Source of Change in Public Debt **Figure 4.15**



Source: State Bank of Pakistan

Source of Change in Domestic Debt during Q1 **Figure 4.16**



Source: State Bank of Pakistan

Third, given the government's commitment to avoid SBP borrowing (including rollovers), liquidity management has come to the forefront of the overall public debt sustainability. To manage the expected constraints, the government had resorted to increasing its deposits with the banking system (to the tune of Rs 1.8 trillion) in Q1-FY20 through fresh borrowings. It is important to recall here that these deposits were quite useful in managing Covid-related expenditures in the fourth quarter of FY20, as government was able to increase its spending without a significant strain on the overall fiscal deficit. This year, the government deposited an additional Rs 74.2 billion with the banking system. The overall government deposits reached Rs 3.2 trillion by end-September 2020. Replenishment of these deposits has further improved liquidity profile of public debt; this would facilitate the government in plugging its financing needs and payment obligations in a timely manner.

Therefore, despite a higher fiscal deficit (in nominal terms) during the first quarter of FY21, the pace of public debt accumulation weakened considerably compared to the same period last year. As evident in **Figure 4.15**, key contribution in debt came from financing needs of the government, as deposit accumulation was quite limited compared to last year. Similar to Q1-FY20, revaluation gains due to appreciation of the PKR against the US dollar contained the rise in public debt during Q1-FY21.

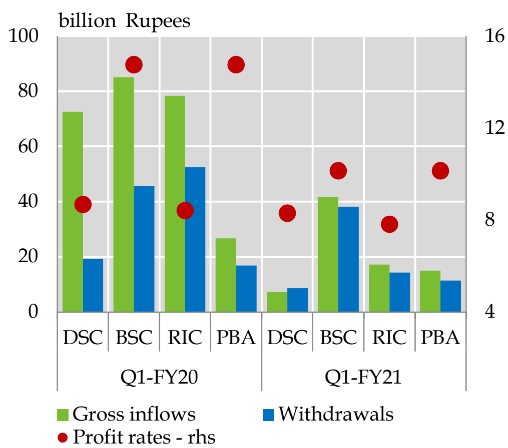
Domestic Debt

The rise in domestic debt during Q1-FY21 was only one-fourth of the increase recorded in the same quarter last year. As highlighted earlier, the government increased its deposits with the banking system as part of its debt management strategy during Q1-FY20. These deposits helped the government smoothly manage its debt obligations as well as other expenditures during FY20. Nonetheless, the volume of deposit accumulation was much lower in FY21, which helped contain the domestic debt accumulation (**Figure 4.16**).

Institution-wise breakup shows that almost 75 percent of the rise in government domestic debt was sourced from the banking system. Within the banking system, the entire mobilization came from scheduled banks as the government continued to retire SBP debt during the quarter. Non-banks, especially insurance companies and non-financial corporates, provided for the remaining 25 percent of the government's financing needs (**Table 4.6**).

In terms of instruments, permanent debt instruments dominated the domestic debt accumulation during Q1-FY21. No major activity was observed in other categories except for heavy retirements in floating debt instruments. The weak activity in NSS instruments stemmed primarily from limited operations of sales centers during lockdown (July and August 2020), imposition of ban on institutional investments, and a cut in profit rates (**Figure 4.17**).

NSS Flows and Profit Rates **Figure 4.17**



Source: Central Directorate of National Savings

Auction profile of government securities suggests that the government as well as the market participants were inclined towards long-term instrument, as evident by the offer and acceptance amount of floating rate PIBs (**Table 4.7**). An important determinant for banks' preference for long-term instruments over short-term instruments was the rise in the term premium for PIBs.

Change in Government Domestic Debt (Q1) **Table 4.6**

billion Rupees

	Net Flows	
	FY20	FY21
Government domestic debt	1,918.0	419.3
institution-wise		
A. Through banking system	1,631.7	312.0
From scheduled banks	1,631.7	597.0
From SBP	0.0	-285.0
B. Through non-banks	286.6	107.4
Instrument-wise		
A. Permanent debt	754.1	898.6
B. Floating debt	1,028.2	-480.0
C. Unfunded debt	136.0	0.8
NSS (net of prize bonds)	137.7	5.7
D. Foreign currency instruments	-0.2	-0.1

Source: State Bank of Pakistan

As stated earlier, the government imposed a ban on institutional investment in National Saving Instruments effective from the start of FY21, which resulted in limited mobilization of funds through these instruments. However, with the introduction of 3Y and 5Y PFL (floating rate PIBs) and with market perception of bottoming out interest rates, non-banks' investment in PIBs remained intact (**Figure 4.18**). Here, it must be recalled that profit rates on NSS are already linked with the market yields on long-term government paper. Hence it was more suitable for non- banks to shift their investment portfolios in favor of PIBs.

Keeping in view the market appetite for long-term instruments, unmet investment needs of Islamic banks and to diversify the domestic debt portfolio, the government also introduced a new instrument in Q1-FY21: the 5-year GoP Ijara Sukuk with both fixed- and

Auction Profile of Government Securities (Face Value) **Table 4.7**

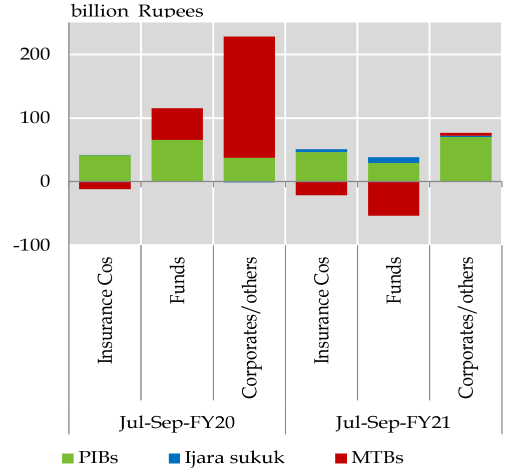
billion Rupees

	Q1-FY20				Q1-FY21			
	Offer (competitive)	Maturity	Accepted	Accepted net of maturity	Offer (competitive)	Maturity	Accepted	Accepted net of maturity
MTBs								
3-M	4,805.2	5,178.1	4,548.9	-629.2	2,298.9	722.8	945.8	223.0
6-M	396.1	1.5	289.9	288.4	1,529.6	337.2	674.1	336.9
12-M	3,514.4	-	1,643.8	1643.8	1,283.9	1,643.8	427.3	-1,216.5
Total	8,715.7	5,179.6	6,482.7	1,303.1	5,112.4	2,703.8	2,047.3	-656.5
PIBs (fixed rate)	2,521.3	275.9	878.9	603.0	448.8	101.4	241.0	139.6
PIBs (floating rate)	334.2	-	219.4	219.4	1,970.4	-	870.6	870.6

Source: State Bank of Pakistan

flexible-rate options. The overall mobilization against these instruments stood at Rs 162.0 billion during the quarter. Market participation was more inclined towards variable rental rate – more than two-third of funds were raised through variable rental Sukuk. Mobilizing funds through such long-term instruments not only bodes well from maturity profile point of view, but also from the perspective of diversification of the investor base.

Change in Non-Banks Holdings of Govt. Securities (Face Value) **Figure 4.18**



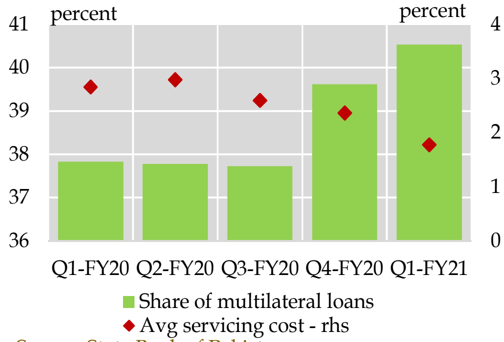
Source: State Bank of Pakistan

Public External Debt & Liabilities

The stock of public external debt and liabilities increased by US$ 1.05 billion in Q1-FY21, compared to US$ 0.58 billion in Q1-FY20. Revaluation losses due to depreciation of US dollar against other currencies had a significant role in inflating the external debt stock in dollar terms.[21] In addition, high fresh disbursements from multilateral donors (ADB, IDA) and bilateral sources more than offset the retirements in commercial loans and foreign exchange liabilities (**Table 4.8**).

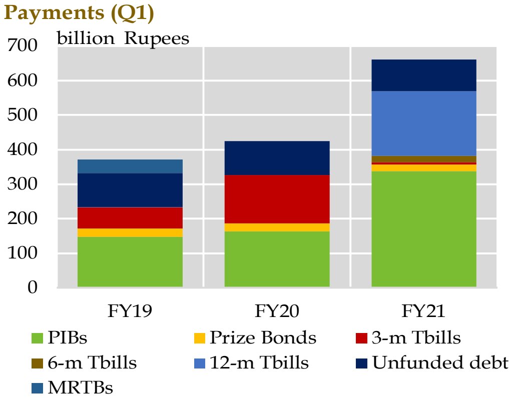
[21] Compared to revaluation gains of US$ 0.7 billion during Q1-FY20, the country suffered revaluation losses of US$ 0.9 billion during Q1-FY21 on the existing outstanding stock of external debt (in US$ terms). One-half of the revaluation losses emerged due to appreciation of special drawing rights (SDR) against the US dollar

Avg. Servicing Cost of Govt. External Debt & Share of Multilateral Loans **Figure 4.19**



Source: State Bank of Pakistan

Instrument-wise Interest Payments (Q1) **Figure 4.20**



Source: State Bank of Pakistan

On a positive note, most of the incremental borrowing was sourced through multilateral donors. As shown in **Figure 4.19**, the share of concessional multilateral debt has increased over the previous two quarters(along with a corresponding decline in the share of commercial loans), which has contributed to reducing the average servicing cost for the government.[22]

Change in Public External Debt & Liabilities (Q1) **Table 4.8**

million US Dollar

	FY20	FY21
Public external debt & liabilities	581.9	1,052.7
1. Government external debt	7.3	1,987.5
of which		
i) Long term (>1 year)	-299.6	2,357.5
Paris club	-157.9	278.4
Multilateral	268.3	1,487.3
Other bilateral	70.7	984.0
Commercial loans/credits	-493.1	-425.5
ii) Short term (<1 year)	307.0	-370.0
Multilateral*	144.1	-303.7
Local currency securities	359.8	-39.9
Commercial loans/credits	-197.0	-26.5
2. From IMF	703.2	-75.4
3. Foreign exch. liabilities	-128.6	-859.3
Central bank deposits	-	-1,000.0

Source: State Bank of Pakistan

External loan disbursements saw an increase of 25.4 percent during Q1-FY21 over the same period last year. These disbursements amounted to almost 22 percent of the annual budget estimate, as opposed to 17.0 percent during Q1-Y20. Disaggregated analysis indicates that almost half of the inflows were for program/budgetary support; one-third inflows were in the form of bilateral deposits; and roughly 12 percent were received as project assistance to finance the development projects.

[22] It is important to mention here that the average servicing cost in this Figure is based on actual interest payments during the quarter. To compute the overall cost of external debt, however, it is more useful to look into the interest rates at which different loans were contracted. But due to unavailability of this data, average servicing cost has been estimated by taking actual interest payments in the current quarter as percent of average of total outstanding stock of external debt in the current and previous quarters.

Total Debt & Liabilities Servicing

Servicing of total debt and liabilities stood at Rs 1.2 trillion during Q1-FY21 compared to Rs 0.9 trillion during the same quarter last year. Total servicing during Q1-FY21 was equivalent to 2.7 percent of GDP. Within public debt servicing, interest payments on domestic debt increased by Rs 661 billion during Q1-FY21 against the rise of Rs 426.5 billion during Q1-FY20. This increase primarily stemmed from higher coupon payments of fixed-rate PIBs and 12-month T-bills **(Figure 4.20)**.

On the other hand, servicing of external debt and liabilities increased by US$ 0.5 billion in Q1-FY21, compared to an increase of US$ 0.8 billion in the same period last year. This rise in external debt servicing is largely attributed to the repayment of US$ 1.0 billion. However, debt relief provided under the G-20 DSSI eased some pressures on overall servicing.[23]

[23] Pakistan is expected to get a debt relief of US$ 3.6 billion in total (updated 8th November 2020).