4 Fiscal Policy & Public Debt

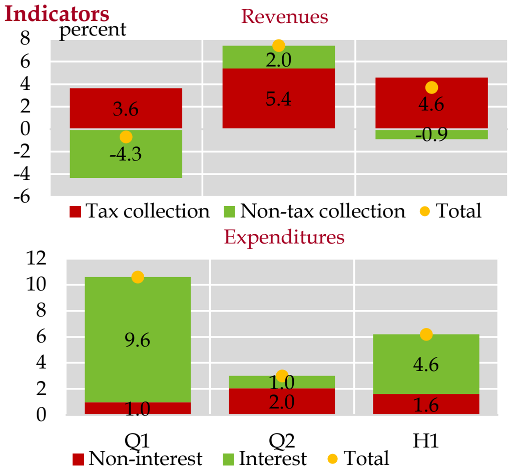
The primary balance recorded a higher surplus during H1-FY21, as the growth in revenue collection was strong enough to offset the weak momentum in non-interest expenditures. While the FBR's tax collection remained almost on target throughout the first half, non-tax revenues rebounded strongly in the second quarter after posting a YoY decline in the first quarter. Nonetheless, the fiscal deficit remained at almost last year's level, as higher markup payments, especially in the first quarter, offset the gains in the primary balance. This resulted in an increase in the stock of public debt; nonetheless, its pace remained slower as compared to last year, primarily due to lower volume of incremental government deposits with the banking system and revaluation gains on external debt in Rupee terms. With higher debt mobilization through flexible mark-up based long-term instruments, the government's repricing risk has increased.

4.1 Fiscal Trends and Policy Review

The rebound in economic activity and a slowdown in non-interest expenditures helped improve the overall fiscal position during the first half of FY21. The revenue momentum, which started building in the first quarter following the ease in lockdowns and resumption of economic activity, strengthened further in the second quarter, with collections accelerating from both tax and non-tax sources (**Figure 4.1**). While tax collections picked up as domestic manufacturing and imports gathered pace, the improvement in non-tax collections was attributed to the transfer of balance surplus profit of the SBP and the continued growth in revenues under the petroleum levy. On the expenditure side, the government exercised restraint on non-interest spending; the growth in total expenditures was driven primarily by mark-up spending during the period.

As a result, a primary surplus was recorded for the second consecutive quarter, against the deficit envisaged for the full-year. Although the surplus volume was quite low in Q2-FY21 as compared to the preceding quarter, its accumulation

Growth Contribution in Fiscal Indicators **Figure 4.1**



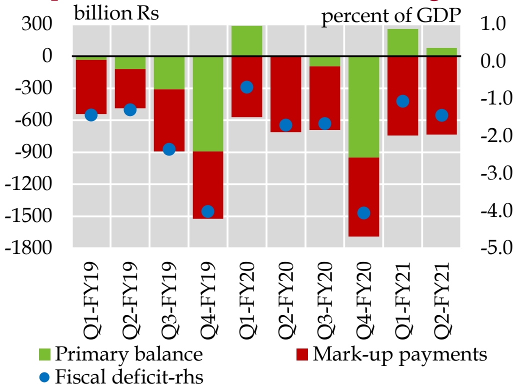
Source: Ministry of Finance

was much stronger than the same quarter last year (**Figure 4.2**). On a cumulative basis, therefore, the primary surplus recorded a 17.7 percent improvement in H1-FY21 over H1-FY20. In terms of GDP, the accumulated surplus stood at 0.7 percent during H1-FY21, which was a 17-year high.[1]

Importantly, mark-up payments, which had posted a significant year-on-year acceleration in the first quarter, stabilized

[1] The nominal GDP (at market price) envisaged by the Planning Commission for FY21 has been used to assess the performance of fiscal indicators.

Composition of Fiscal Deficit **Figure 4.2**



Source: Ministry of Finance

(albeit at an elevated level) during the second quarter. This helped improve the overall fiscal position (as well as the revenue balance) in Q2-FY21: the recorded deficit was 7.8 percent lower compared to last year.[2] As a result, the cumulative fiscal deficit was contained at 2.5 percent of GDP in H1-FY21, almost the same level as observed during the same period last year. Also, the first half deficit was only 35 percent of the target envisaged for the full year. This compared favorably with the past three years, when, on average, nearly 41 percent of the full-year deficit was recorded during the first half.

As a result, the pace of public debt accumulation during Jul-Dec FY21 remained almost unchanged from last year; however, on an annualized basis, the growth nearly halved from 22.8 percent in December 2019 to 11.1 percent in December 2020. The public debt to GDP ratio also posted a relatively moderate (1.4 percentage point) annualized increase and reached 82.2 percent by end-December 2020, against a sharp 8.5 percentage point increase a year earlier.[3]

While the external debt increased marginally (in Rupee terms), the domestic debt contributed the most to the nominal increase in the public debt. About two-thirds of the increase in domestic debt was meant for deficit financing; the rest was to maintain the preferred level of deposits/liquidity.

Gains emerging from reforms in public financial management and FBR's efforts

Developments in the fiscal sector during H1-FY21 were important from two aspects. First, in addition to exercising fiscal discipline similar to FY20, the FY21 budget also made provisions for Covid-related expenditures and to provide support to the vulnerable segments. Also, the government had lowered customs duties and announced construction-related incentives to stimulate the economy. These considerations were reflected in the budgeted deficit (of 0.5 percent of GDP) in the primary balance for the full year.

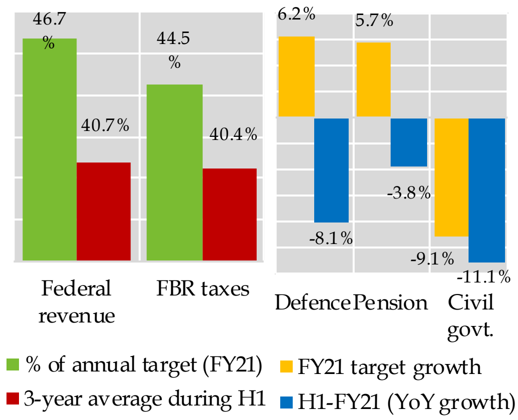
As it turned out, although the social transfers and other support measures increased government outlays, the activity-driven momentum in tax collection and the

---

[2] The revenue deficit, which stood at Rs 396.4 billion in Q2-FY20, declined to Rs 344.3 billion in Q2-FY21.
[3] It may also be noted that after touching 80.8 percent at end December 2019, the public debt to GDP ratio had increased further in Q4-FY20 to 87.2 percent by end-June 2020, reflecting the impact of Covid-19 on the fiscal position. The decline in the ratio between end-June and end-December 2020 stems primarily from the difference in GDP estimates: for the period ending December 2020, the ratio is based on the nominal GDP target set by the government for FY21, whereas for end-June 2020, the ratio is based on GDP estimates for the year FY20.

restraint on non-interest expenditures were strong enough to absorb them (**Figure 4.3**).

Fiscal Performance - H1-FY21 **Figure 4.3**



Source: Ministry of Finance

In fact, the FBR almost achieved its half-year target, whereas the proportion of full-year federal collections (actual or budgeted) realized in the first half remained notably higher as compared to the average of the past three years.

Second, the FBR's administrative efforts and progress on public financial management (PFM) reforms started to show gains in H1-FY21. On the FBR front, an important development was the steep rise in collections-on-demand. While the size of collections still remains low, this development implies that the Board has been able to make recoveries against notices issued to potential tax payers. Moreover, the number of taxpayers filing returns till end-December 2020 was 6.0 percent higher than the level observed during the same period last year.

Similarly, the impact of PFM reforms has also started appearing on the expenditure side. This is particularly evident in the decline in expenditures pertaining to pensions and the running of civil administration compared to last year. Perhaps a restraint on protocols (traveling-related, etc.) and better accounting practices and oversight, have facilitated the expenditure control.

But vulnerabilities continue to persist calling for expediting the reform process

Notwithstanding the improvement in revenue collection, it is important to note that the overall tax-to-GDP ratio continues to remain one of the lowest among the emerging market economies. Moreover, nearly 87 percent of taxes are still being collected under indirect mode (including via withholding taxes), of which nearly 60 percent is concentrated in import-related collections. Even within the formal sector, concessions and exemptions do not allow optimal collection and diversification of the revenue base.

Second, exercising cuts on development spending – or compromising project timelines – can prove costly. Not only does this limit the growth in productive (and debt repayment) capacity of the economy, it may also be seen as a constraint to private investment. Furthermore, delays can potentially escalate the cost of civil work. In this context, capacity constraints in relevant ministries need to be addressed, which could help expedite the execution of project-related tasks.

Finally, challenges with respect to public debt management have deepened. Interest payments are now consuming nearly half of the federal revenues and comprise around 53 percent of federal current expenditures. Also, the rollout of new debt instruments on flexible mark-up has

Consolidated Fiscal Indicators **Table 4.1**

billion Rupees, growth in percent

			YoY growth		Q1		Q2	
	H1-FY20	H1-FY21	H1-FY20	H1-FY21	FY20	FY21	FY20	FY21
1. Total Revenue (a+b)	3,231.9	3,351.2	38.9	3.7	1,489.0	1,478.7	1,742.9	1,872.4
(a) Tax Revenue	2,307.8	2,455.9	16.4	6.4	1,068.8	1,122.4	1,239.0	1,333.5
Federal	2,093.4	2,210.0	16.6	5.6	964.4	1,010.6	1,129.0	1,199.4
Provincial	214.4	245.9	14.2	14.7	104.5	111.8	109.9	134.1
(b) Non-Tax	924.1	895.3	168.7	-3.1	420.2	356.3	503.9	538.9
Federal	864.2	848.0	174.6	-1.9	389.3	336.3	474.9	511.7
Provincial	59.9	47.2	104.8	-21.2	30.9	20.0	29.0	27.2
2. Total Expenditure (a+b+c)	4,226.6	4,489.1	25.9	6.2	1,775.1	1,963.1	2,451.6	2,526.0
Non-interest expenditure	2,945.5	3,013.9	-20.2	-8.9	1,203.4	1,221.0	1,742.1	1,792.9
(a) Current Expenditure	3,721.4	4,029.3	24.7	8.3	1,582.2	1,812.6	2,139.2	2,216.8
Of which : Mark-up Payments	1,281.2	1,475.2	46.1	15.1	571.7	742.1	709.5	733.1
Defence	529.5	486.6	10.4	-8.1	242.6	224.5	286.9	262.1
Non-markup	2,945.5	3,013.9	18.8	2.3	1,203.4	1,221.0	1,742.1	1,792.9
(b) Development Expenditure & Net Lending	473.3	457.9	28.1	-3.3	147.2	215.2	326.1	242.6
(c) Statistical Discrepancy	32.0	1.9	884.3	-94.1	45.7	-64.7	-13.7	66.6
3. Overall Budget Balance	-994.7	-1,137.9	-3.4	14.4	-286.0	-484.3	-708.7	-653.6
4. Primary Balance	286.5	337.2	-287.0	17.7	285.7	257.7	0.8	79.5
5. Financing (a+b)	994.7	1,137.9	-3.4	14.4	286.0	484.3	708.7	653.6
(a) External (Net)	513.6	454.4	135.6	-11.5	166.5	161.4	347.1	293.1
(b) Domestic (Net)	481.1	683.5	-40.7	42.1	119.5	323.0	361.6	360.5
Non-Bank	439.4	132.2	87.5	-69.9	242.5	92.1	196.9	40.1
Bank	41.7	551.3	-92.8	1,220.8	-123.0	230.8	164.7	320.4

Source: Ministry of Finance

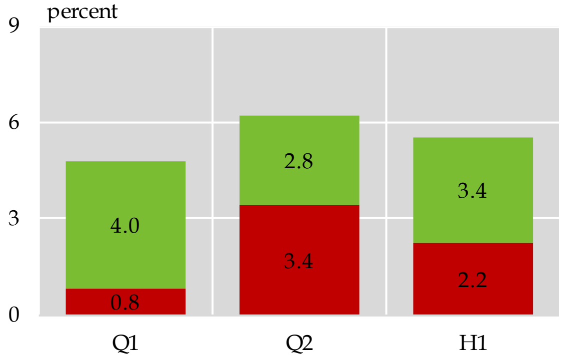
increased the repricing risk for the government.

In this context, the government should now recalibrate its policy mix and devise a workable short- and medium-term strategy with well-defined timelines. Though progress has been observed in select reform areas over the past two years, the area where the most rigorous reforms are still needed is the narrow revenue base. In the short term, the government should be focusing on removing or rationalizing concessions to plug the existing tax gap. Then in the medium-to-long term, it should devise ways to improve the documentation of the economy. In this regard, pushing further on the showing of CNIC on high-end sales would help. Moreover, the federal and provincial governments should also devise a collective workable strategy to mobilize revenues from the agriculture and services sectors.

4.2 Federal Revenues

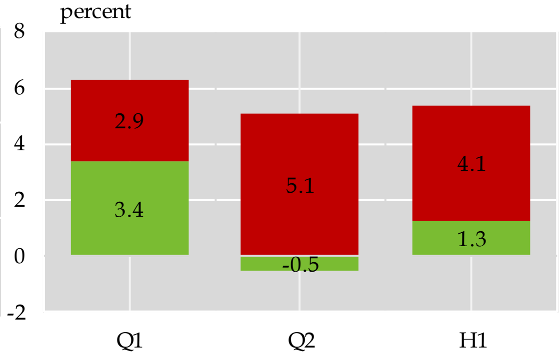
Following the pick-up in economic activity, overall revenues grew by 3.4 percent in H1-FY21, against the 40.2 percent growth observed during the same period last year. This growth entirely came from tax revenues, which more than offset the decline in non-tax revenues (NTRs) due to lower profits of the SBP and the Pakistan

Growth Contribution in Federal Taxes - FY21 **Figure: 4.4**



Source: Ministry of Finance

Growth Contribution in Indirect Taxes - FY21 **Figure: 4.5**



Source: Federal Board of Revenue

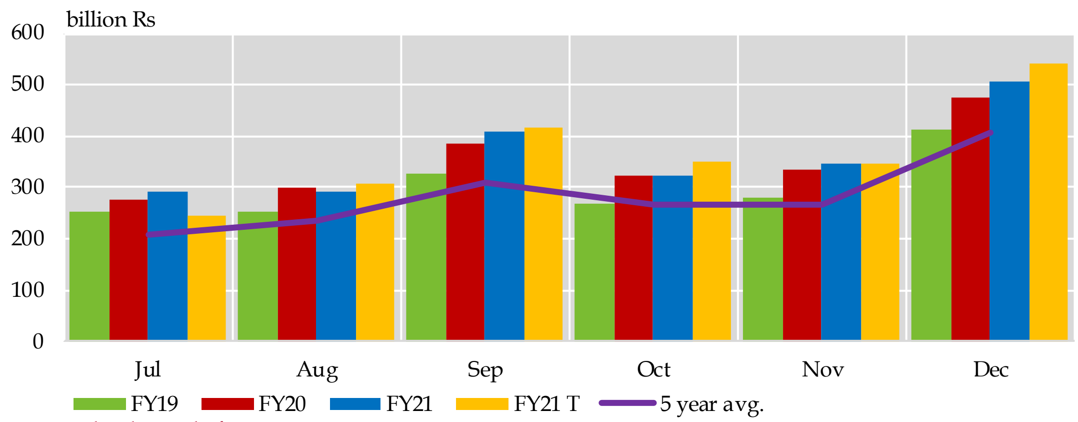
Telecommunication Authority (PTA). However, it is important to note that the decline in NTRs was concentrated mainly in the first quarter, as these posted a YoY increase in Q2-FY21 on the back of a balance surplus profit of the last fiscal year.

On the other hand, the growth in tax collections was spread evenly across the first half of FY21, though the composition of taxes underwent significant changes across the two quarters. Specifically, in Q1-FY21, most of the growth in overall taxes came from indirect collections, whereas in Q2-FY21, the growth was dominated by direct taxes. Also, within indirect taxes, the contribution from import-related collections increased significantly from Q1 to Q2 (**Figure 4.4 & 4.5**).

FBR Collections

The FBR tax collection showed a broad-based increase in H1-FY21 and almost achieved its target for the period (**Figure 4.6**). Moreover, a strong YoY growth in the FBR tax collection is expected in the last

Monthly FBR Tax Collection **Figure: 4.6**



Source: Federal Board of Revenue

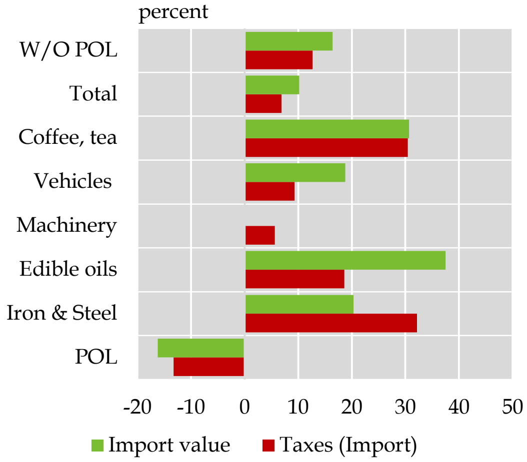
four months of FY21 due to the low base effect from last year.[4]

A broad-based increase in indirect taxes during H1-FY21

Collections through indirect taxes, which had grown by 16.7 percent in H1-FY20 on account of a number of measures announced in the budget, gained further momentum in H1-FY21. These collections posted a YoY increase of 5.4 percent during the period, despite the concessions given to a number of industries (including construction) for the import of raw materials. Both import-related and domestic taxes contributed equally to this growth. This performance can be attributed to the recovery of the domestic economy, higher prices of sugar and electricity, and higher demand for raw materials in the construction industry (especially iron and steel).

Import-related taxes, having a share of around 60 percent in indirect taxes, posted a YoY growth of 6.9 percent in the first half of FY21.[5] This growth was recorded despite the decline in global crude oil prices and the exemption from additional customs duty on more than 1,600 tariff lines (mainly raw material items, including chemical, leather, textile and fertilizer). However, their impact was more than offset by higher collections from iron and steel, food items and vehicles (**Figure 4.7**).

Growth in Import Related Taxes and Import Values-FY21 **Figure 4.7**



Source: Federal Board of Revenue

In case of iron and steel, growth in the construction industry (as evident from higher local cement dispatches) has propelled their imports. While the demand for finished steel products also remained strong, the growth in import of scrap was more pronounced, which reflects vibrancy in the domestic steel industry. As a result, higher collections were recorded from both sales tax and custom duty at the import stage. In case of vehicles also, the growth in the import of both CBUs and CKDs remained strong. The growth in CBUs was more pronounced (127 percent YoY), as new entrants penetrated the market initially through foreign-assembled units. It is important to note here that CBUs attract a higher customs duty compared to the one applicable on CKDs (though green-field investors get concessions at an early stage).[6]

[4] The FBR collected Rs 2,570 billion against the target of Rs 2,550 billion in Jul-Jan FY21. The tax revenues grew by 6.4 percent YoY during the period. The collection was Rs 2,416 billion during the same period last year.
[5] The Rupee value of imports grew by 10.2 percent in H1-FY21, against 0.1 percent growth last year.
[6] The Automotive Development Policy 2016-21 has provided incentives for new entrants, including: concessional rate of custom duty of 10 percent on non-localized parts and 25 percent on localized parts for

The impetus in collections from food imports was mainly price-led. Collections grew particularly strongly from edible oil and ghee, where bullish international prices significantly increased the import values. Similarly, international prices of tea and coffee also remained higher than last year, which pushed up their import values and helped increase collections this year.

Increase in both energy and non-energy related items increased the domestic tax collection

With the recovery in economic activity, the domestic tax collection grew (in gross terms) by 14.7 percent YoY during H1-FY21. Both energy and non-energy related taxes contributed to this growth (**Table 4.2**).

Sales Tax Domestic Collection during H1 **Table 4.2**

billion Rupees; growth in percent

	FY20	FY21	Growth
Energy-related	**201.1**	**238.0**	**18.4**
Discos	56.2	79.1	40.8
Oil refinery	83.3	71.1	-14.7
Oil exploration	47.3	44.3	-6.5
OMCs	11.0	40.7	270.7
LPG/LNG	3.3	2.9	-12.3
Non-Energy	**356.2**	**401.2**	**12.6**
of which			
Cement	46.8	54.3	16.0
Sugar	16.5	29.7	79.9
Textile	20.0	29.5	47.8
Motor cars	5.4	12.9	138.9
Iron and steel	4.2	5.0	18.9
Cigarettes	43.4	52.6	21.2
Total	**557.2**	**639.2**	**14.7**

Source: Federal Board of Revenue

Within non-energy items, cigarettes contributed the most. This is due to the intensified crackdown against smuggled cigarettes, which made these products more expensive in the market and led to an increase in the consumption of local brands. In addition, higher cigarette prices over last year also contributed to the increase in collections. A similar price-driven growth was observed in the case of sugar.[7] In contrast, the increase in collections from the textile sector was attributed primarily to the vibrancy in activity, especially export-related.[8] It must be recalled here that the zero-rating regime for the sector was withdrawn last year, which led to a 47.8 percent growth in sales tax collection during H1-FY21 on YoY basis. The activity-led pick up in indirect taxes collection was also observed in cement and steel industries.

Among energy items, the collection from Discos remained the major source of the YoY increase in collections. This was attributed to the rise in power generation from last year, as well as the increase in power tariffs during the period. Moreover, the increased sales of petroleum products also led to higher collections (up by 10.2 percent).

Improvement in direct taxes due to higher WHT and Collection on Demand

Direct taxes grew 5.6 percent in H1-FY21, compared to an increase of 17.4 percent during the same period last year (**Table 4.3**). The growth came from better

five years for the manufacturing of cars and LCVs; and duty-free import of plant and machinery for setting up the assembly and/or manufacturing facility (one-time basis).

[7] A 25.8 percent YoY increase was observed in sugar prices during H1-FY21.

[8] As per PBS data, textile exports grew by 7.8 percent in H1-FY21, compared to 3.9 percent in the same period last year.

collections under withholding taxes and collections-on-demand, as the growth in voluntary payments remained lower than last year.

Direct Taxes - H1 **Table 4.3**

billion Rupees, growth in percent

	FY20	FY21	Growth
Collection on demand	**19.7**	**38.5**	**95.3**
Voluntary payments	**248.2**	**256.7**	**3.4**
Withholding taxes	**544.8**	**569.3**	**4.5**
Imports	105.8	90.8	-14.2
Salaries	57.5	69.4	20.6
Dividends	30.4	30.1	-1.2
Bank interest and securities	56.7	64.8	14.3
Contracts	112.8	115.7	2.6
Export	19.9	20.2	1.6
Cash withdrawals	8.6	7.2	-16.4
Electric bills	24.9	25.9	4.1
Telephone	27.0	30.8	13.8
Other withholding taxes	100.9	114.4	13.4
Total	**784.9**	**829.2**	**5.6**

Source: Federal Board of Revenue

The rise in withholding taxes was attributed to higher collections from the telecom and banking sectors. The usage of telecom services rose significantly after the Covid-19 outbreak (for virtual meetings and online educational activities, etc.), which translated to higher earnings of telecom firms. Consequently, the collections from WHT on telephone usage increased. Meanwhile, the rise in savings deposits in H1-FY21 over last year led to an increase in collections from bank interest and securities.

Collections-on-demand, on the other hand, more than doubled during H1-FY21 on YoY basis. While the level of these collections is still very low compared to other revenue sources as well as their potential, this improvement reflects the impact of a number of administrative steps taken by the FBR to expand the revenue base. For instance, the Board has expedited the issuance of demand notices to potential taxpayers for the discharge of tax liability.

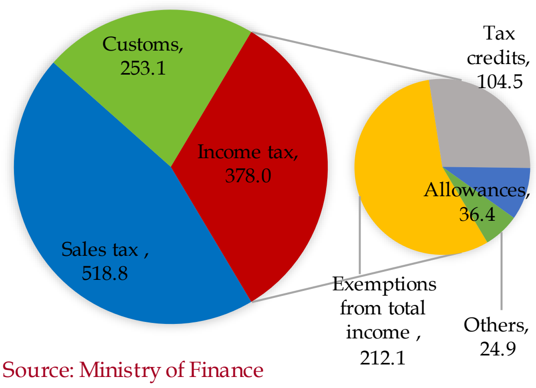
Furthermore, the FBR has also launched *Maloomat Tax-Ray*, under which it collects the information of individuals' assets and withholding deductions from third-party sources (such as banks and Nadra) and shares the same with the individuals. On one hand, the use of third-party data sources helps the FBR to better determine the tax liability of high net-worth individuals (and issue demand notices). On the other hand, it facilitates tax filers in accurately evaluating their assets and withholding claims while filing returns.

It is important to highlight here that the existing income tax structure is characterized by heavy exemptions and concessions to various sectors. It is estimated that the tax expenditures in Pakistan stand at around Rs 1.0 trillion (FY20), distributed almost evenly across sales tax, income tax and customs duties (**Figure 4.8**).[9] The government has committed to transform the existing GST into a more broad-based VAT structure and to eliminate tax credits and deductions for the higher income brackets under the personal income tax. However,

[9] Tax expenditures are special provisions of the tax code, such as exclusions, deductions, deferrals, credits, and tax rates, which benefit specific activities or groups of taxpayers.

meaningful steps are yet to be taken in this regard.

Estimated Tax Expenditure - FY20 (billion Rs) **Figure 4.8**



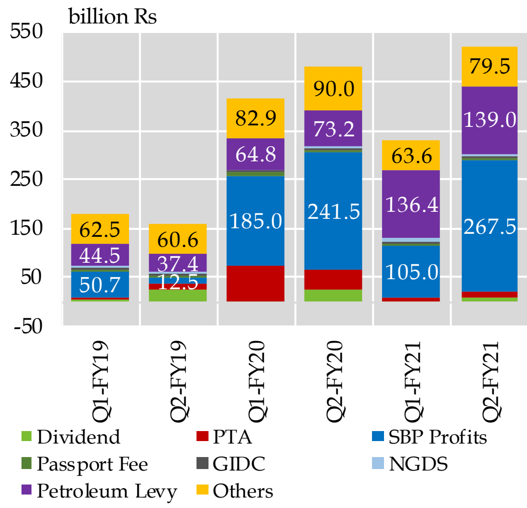
Source: Ministry of Finance

Decline in non-tax revenues due to the absence of one-off flows in H1-FY21

Federal non-tax revenues posted a decline in H1-FY21 on YoY basis. This decline was contributed mainly by lower transfers of SBP and PTA profits to the Ministry of Finance (MoF), which more than offset a YoY increase in collections from petroleum levy and mark-up receipts from public sector enterprises (PSEs) (**Figure 4.9**).

The decline in transfer of the SBP's profits was observed only in the first quarter. This was mainly attributed to lower interest rates and partly to the retirement of some debt owed by the government. Although the SBP's earning profile did not undergo any visible change in the second quarter, the bank was able to transfer higher amount of profits as compared to last year. This was mainly on account of transfer of around Rs 150 billion to the government during the quarter from the balance surplus profit of the previous fiscal year, as some of the profit is retained till the finalization of the audit of financial statements.

Quarterly Non-Tax Revenues **Figure 4.9**



Source: Federal Board of Revenue

Receipts from the PTA also remained lower in H1-FY21 than in H1 -FY20. It may be recalled that last year, cellular companies had paid half of their GSM license renewal fee to the PTA, which had resulted in higher collections under this head (Rs 112.1 billion). The remaining payment tranches are scheduled to be received in a staggered form over the next five years. Hence, the overall transferred receipts were limited to Rs 18.6 billion only in H1-FY21.

In contrast to the above-mentioned NTR sources, collections from petroleum levy almost doubled in H1-FY21 from the same period last year.[10] This reflects the increase in the levy rate on petrol and diesel at the start of the fiscal year, along with higher

[10] The government collected around 60 percent of the full year target for petroleum levy (Rs 450 billion) during H1-FY21.

consumption during the period. Similarly, mark-up receipts from PSEs more than doubled from last year, on account of a 520 basis points increase in the mark-up charged on loans to PSEs and other local bodies.[11]

4.3 Federal Expenditures[12]

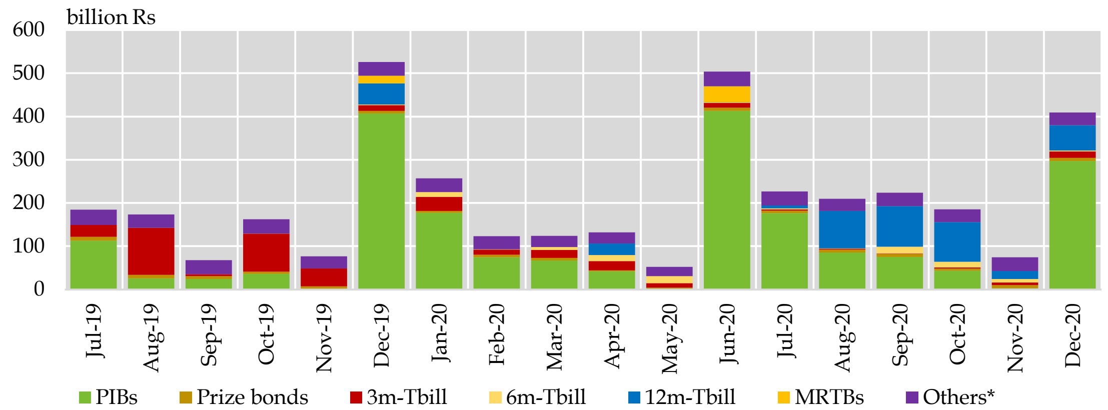
Federal expenditures grew by 5.0 percent during H1-FY21, compared to the 33.6 percent growth observed in H1-FY20 and the 4.7 percent overall increase envisaged for the full-year. Major contribution to this growth came from mark-up spending, as the non-mark-up spending (including development, defence, pensions and running of civil government) declined in both quarters.

Federal Current Expenditures

Within current spending, most of the increase came from mark-up payments, which grew by 15.1 percent during H1-FY21 as compared to the 46.1 percent growth recorded during the same period last year. A large portion of this growth was registered in the first quarter; however, its pace slowed down in the second quarter on YoY basis.

In case of external debt, the interest payments dropped in both quarters of FY21. This was due to: (i) an appreciation of the PKR, which shrunk the volume of foreign debt servicing in Rupee terms; (ii) a drop in foreign interest rates (Libor) in the aftermath of Covid-19, which favorably repriced floating rate debt contracts; and (iii) the relief provided under the Debt Service Suspension Initiative (DSSI), which lowered mark-up payments to multilaterals, including the Paris Club and the ADB. In case of the DSSI, Pakistan is expected to receive potential savings of US$ 3.6 billion (1.3 percent of its GDP) up till June 2021.[13]

Instrument wise Mark-up Payments **Figure 4.10**



Source: State Bank of Pakistan

[11] Circular No. F.8(2)GS-I/2018-1645, dated December 9, 2020 (Finance Division, Budget Wing).
[12] The discussion in this section is based on expenditures excluding statistical discrepancy.
[13] The scheduled payment of both the principal component and interest payments has been suspended for the year under the DSSI. These payments would now be made in a staggered form between FY22 and FY24 (plus one year grace period). Source: World Bank, as of February 19, 2021. worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative

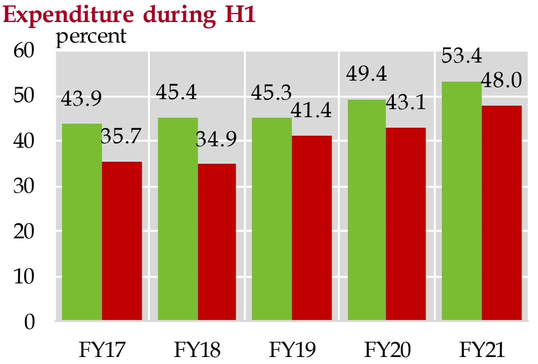
Within the domestic debt servicing, the weakening pace in the second quarter primarily reflects a YoY decline in PIB coupon payments. It is important to recall here that last year, coupon payments in the second quarter had included the impact of the re-profiling exercise, which had converted nearly 93 percent of the SBP's debt stock into PIBs in June 2019.[14] The first coupon payment of these PIBs had fallen due in December 2019, and had pushed up the quarterly payments to Rs 443 billion (nearly 3 times the payments in the preceding quarter). Although the government continued to mobilize PIBs in the subsequent months, they were largely priced at floating rates. This meant that their coupon payments contained the impact of the steep decline in interest rates from March 2020 onwards. Thus, the base effect, coupled with lower interest rates, led to a slowdown in the growth of mark-up payments in Q2-FY21 on YoY basis (**Figure 4.10**).

This slowdown notwithstanding, it is worth highlighting that the level of mark-up payments is still quite high, constituting nearly 53 percent of the federal current expenditures. Importantly also, mark-up payments ate up almost 48 percent of the total federal revenues (**Figure 4.11**), and were nearly six times the volume of the federal development expenditures. These numbers basically reflect the magnitude of the fiscal stress stemming from mark-up payments.

Sizable curtailment in non-markup current expenditures

The non-markup federal expenditures saw a contraction during H1-FY21 on a YoY basis. The decline in three major heads was more prominent: defence, pensions, and running of civil government. It is pertinent to note that despite higher budgetary allocations for FY21, spending under these heads remained lower than last year. Moreover, a reduction in defence expenditures was observed in both the quarters.

Interest Payments as Percent of Federal Revenue and Current Expenditure during H1 **Figure 4.11**



Source: Finance Division

Spending on the running of civil government declined sharply during the second quarter, mainly due to the austerity drive initiated in the beginning of FY21. This included a complete ban on the purchase of all vehicles (except motorcycles) for current expenditures; the creation of new vacancies; and restrictions on other official protocols – such as the entitlement of magazines and newspapers; rationalization of utility consumption; and constrictions on other operational expenditures.[15]

[14] Under the debt re-profiling exercise carried out in June 2019, around 70 percent of the SBP debt was converted into floating-rate PIBs and about 23 percent into fixed-rate PIBs.

[15] Circular No. 7(1) Exp. IV/2016-430, dated August 6, 2020, Expenditure Wing, Finance Division.

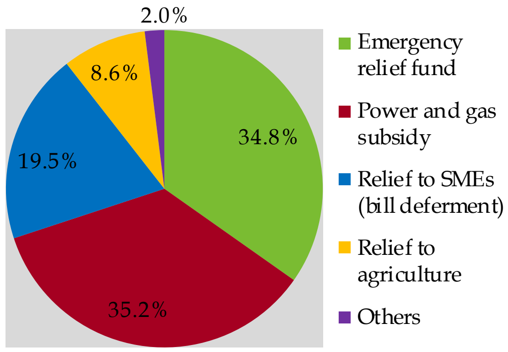
In addition, checks and balances on expenditure management have also been introduced under the Public Finance Management Act of 2019. In this context, the employee-related expenses are monitored and managed by the designated principal accounting officers to ensure that all expenditures are made within the allocated budget for prudent budget and cash management of the fiscal accounts.[16] To meet any additional requirements, ministries and divisions have been allocated technical supplementary grants, primarily from the re-appropriation of funds in the budget. [17]

Within the social protection programs, disbursements under the *Ehsaas Emergency Cash Program* dominated. By end-December 2020, Rs 179.2 billion was disbursed to 14.83 million beneficiaries.[18] Likewise, Rs 1.7 billion was disbursed till October 2020 under the *Kamyab Jawan Youth Entrepreneurship Scheme (KJYES)* to the youth for starting various businesses**.** In addition to these, other social welfare programs have also been initiated, including the *Ehsaas Kafalat* policy for special persons and underprivileged women. As a result, the total spending against the Benazir Income Support Program under *Ehsaas* reached Rs 66.8 billion during H1-FY21, compared to Rs 28.5 billion last year.

Meanwhile, of the Rs 1,240 billion allocated under the Economic Stimulus Package (ESP) announced in the wake of Covid-19, [19] Rs 700 billion were spent in FY20 and the remaining (Rs 540 billion) were re-allocated for FY21. Of this, the government spent only 21.6 percent in H1-FY21, with disbursements concentrated in SME (utility bills' deferment) and agriculture sectors, emergency relief fund, release of pending refunds to exporters, and subsidy to power and gas sectors (**Figure 4.12**).

It is important to highlight here that provisions under the relief for daily-wage workers (Rs 200 billion) remained largely unspent, due to a temporary suspension of the self-registration process for the relief, and the earlier-than-expected resumption of economic activities in the country. [20]

Spending under Economic Stimulus Package's Remaining Tranche - H1-FY21 **Figure 4.12**



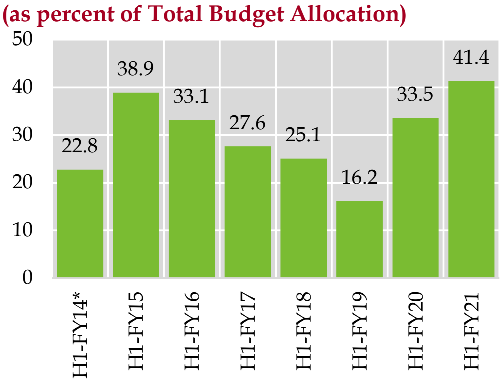
Source: Finance Division

[16] Circular No. F.1(3)-CAO(MoF)/2020/447, Budget Wing, Finance Division.
[17] Mid-year Budget Review for 2020-2021, Finance Division. http://www.finance.gov.pk/budget/mid_year_Budget_review_2020_21.pdf.
[18] finance.gov.pk/economic/economic_update_december_2020.pdf
[19] The term "Economic Stimulus Package" has been named differently in various government documents. At some places, this is referred to as the *Economic Stimulus Package*, whereas in others, it has been referred to as the *Corona Stimulus Package*.
[20] The process of self-registration for the relief (Rs 15,000 per month) of daily-wage workers was temporarily suspended in May 2020.

Federal development spending and net lending

The activity in development spending remained passive during H1-FY21, posting a YoY decline of 14.4 percent. The decline was observed in both quarters, though the magnitude was more pronounced in the second quarter. Within development spending, PSDP expenditures were most affected, as capacity issues in line ministries continued to cause project delays, including hiring, procurements and contracts for civil work. Therefore, while the proportion of budgetary allocations realized during the first half in FY21 was the highest in at least seven years, the actual spending remained lower (**Figure 4.13**). In contrast, nearly 92 percent of the allocations under the foreign-funded PSDP projects was already realized during the first half.

PSDP Releases (Rupee Component) (as percent of Total Budget Allocation) **Figure 4.13**



* the data before H1-FY14 is not available
Source: Planning Commission

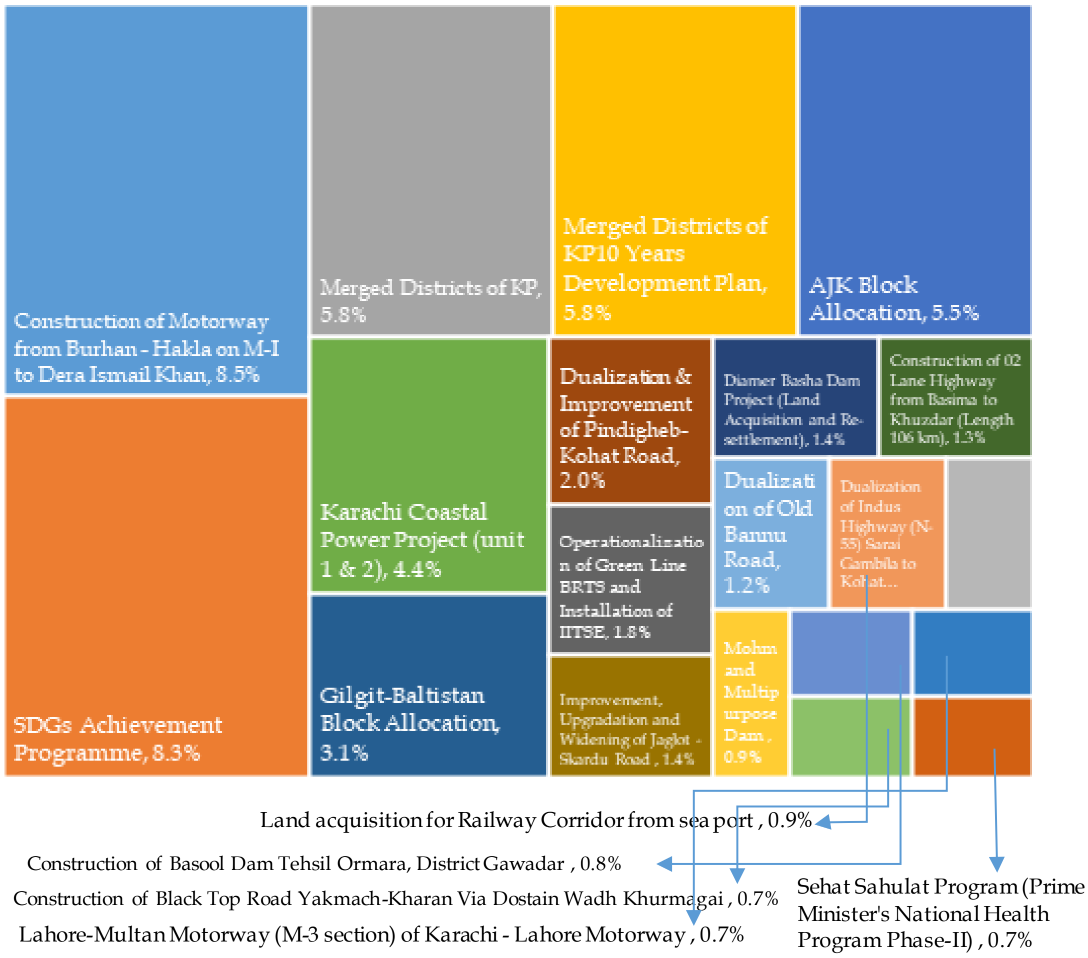
Social and infrastructure development (especially for the under-privileged areas, including FATA, AJK and Gilgit Baltistan) remained the key priorities of the federal PSDP during the review period. The available information suggests that about 55 percent of the total PSDP was released for top 20 projects, including for the regional development in KP, Gilgit Baltistan and AJK. In addition, funds were released for the construction and improvement of roads, mainly in KP and Balochistan (**Figure 4.14**).

The disbursements under the foreign-funded PSDP projects paced up around 92 percent of the foreign budgeted allocation for the year. These were tilted towards power projects, such as the construction of the Japan-funded Guddu-Sibbi Single Transmission Line for the improvement of the power supply system in the southern areas. Also, releases for the US-funded refurbishment of Mangla power station and World bank-funded Dasu hydropower project were notable. Together, these projects constituted around 75 percent of the total foreign PSDP releases during H1-FY21.

Within the non-PSDP development spending, federal development grants to provinces grew sharply in Q2-FY21, reaching Rs 44.9 billion, from only Rs 16.9 billion during the same period last year. Similarly, development spending for grant relief and rehabilitation of IDPs also rose significantly during the first half of FY21.

Similarly, net lending to the PSEs showed a marked increase during H1-FY21, which mainly reflected loans to the Pakistan International Airlines (PIA) and the Pakistan Steel Mills (PSM) for restructuring purposes. It is important to note here that the triage of state-owned enterprises, committed under the IMF program, has been completed, which means that the restructuring/privatization plans for these entities has reached an advanced stage.

Priorities of Federal PSDP - Top 20 projects in terms of releases - H1-FY21 **Figure 4.14**



Source: Planning Commission

It is also important to highlight here that the government has downsized the PSM's labor force before putting it up for sale.

4.4 Provincial Fiscal Operations

During H1-FY21, the provinces posted a combined surplus of Rs 255.1 billion, which was 26.8 percent lower than the same period last year (**Table 4.4**). However, since the budgeted surplus for the year was already on the lower side (to accommodate the needed Covid-related spending), the accumulated surplus during the first half turned out to be in excess of the annual target. This over-performance relative to the target was observed predominantly in the second quarter, when higher federal transfers under the NFC pushed up revenues for all the provinces. Moreover, one-off sales tax adjustments with the federal government improved the

Provincial Fiscal Operations **Table 4.4**

billion Rupees; growth in percent

					Growth			
	H1-FY20	**H1-FY21**	**Q1-FY21**	**Q2-FY21**	**H1-FY20**	**H1-FY21**	**Q1-FY21**	**Q2-FY21**
A. Total revenue	1,683.4	1,658.3	658.9	999.4	14.4	-1.5	-16.7	12.0
Provincial share in fed. revenue	1,325.8	1,280.1	504.0	776.1	10.5	-3.5	-17.7	8.8
Provincial own revenue	274.3	293.1	131.8	161.3	26.4	6.8	-2.7	16.1
Taxes	214.4	245.9	111.8	134.1	14.2	14.7	6.9	22.0
Non-taxes	59.9	47.2	20.0	27.2	104.8	-21.2	-35.3	-6.1
Fed loans and transfers	83.2	85.2	23.1	62.1	50.0	2.3	-46.4	54.8
B. Total expenditure	1,335.0	1,403.2	614.5	788.7	11.4	5.1	2.1	7.6
Current	1,140.4	1,281.0	565.9	715.1	7.9	12.3	9.2	15.0
Development	219.4	227.7	89.8	137.8	30.8	3.8	27.2	-7.3
Statistical discrepancy	-24.8	-105.5	-41.2	-64.2				
Overall balance (A-B)	348.4	255.1	44.4	210.7	27.5	-26.8	-76.5	32.1
Financing	-348.4	-255.1	-44.4	-210.7				

*Negative sign in financing means surplus.

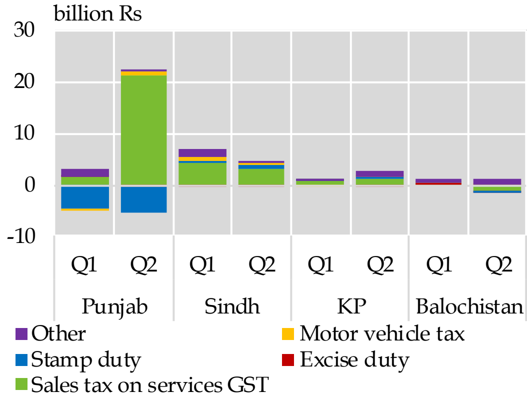
Source: Ministry of Finance

provincial governments' (Punjab and KP) own collections during the quarter. Although expenditure growth also accelerated during Q2-FY21 compared to the preceding quarter (especially current expenditures), it was only able to partially offset the revenue impact. As a result, all the provinces recorded surpluses in Q2-FY21, including Sindh and KP (which had posted deficits in the preceding quarter).

Provincial Revenues

The provincial revenue mobilization recorded a slight decline during the first half of FY21 due to lower transfers from the federal government under the NFC, mainly in the first quarter. As mentioned earlier, revenues rebounded strongly in the second quarter, growing by 12 percent YoY. This improvement was evident in both the higher federal transfers as well as the increase in the provinces' own collections. Federal loans and transfers exclusively for development purposes also increased during this period, after recording a negative YoY growth in the first quarter. However, non-tax revenues recorded a YoY decline in both the quarters, primarily as KP and Punjab received lower profits from hydroelectricity during the period. In overall terms, the share of provincial tax collections increased to 14.8 percent in total provincial revenues, which is the largest in the first half of any year since the rollout of the 18th Amendment.

Absolute Change in Provincial Tax Revenues - H1-FY21 **Figure 4.15**



Source: Ministry of Finance

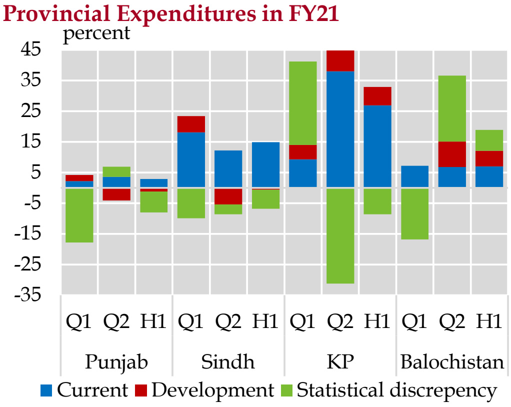
Apart from Balochistan, all other provincial revenue authorities recorded an increase in the collection of sales tax on services during H1. For Sindh, the growth stemmed from higher activity in ports and shipping services amid a rise in import activity, as well as recoveries from pending payments under franchise and insurance services. In Punjab also, a significant increase in sales tax collection was observed in Q2-FY21 (**Figure 4.15**).

According to the provincial authorities, this improvement was primarily due to the incorporation of cross-input tax adjustment (from 2012-13 to 2018-19) of Rs 16.6 billion between the provincial revenue authority and the FBR. A similar adjustment (though of lesser magnitude, of Rs 1.4 billion) contributed to the YoY increase in KP's tax collection. Excluding these adjustments, the growth in tax revenues of these provinces was relatively modest.

Provincial Expenditures

During H1-FY21, the total provincial expenditures recorded a growth of 5.1 percent on YoY basis. This growth mainly came from an increase in the current expenditures, and partly from a slight increase in development expenditures. Province-wise breakdown of expenditures shows that KP, Sindh and Balochistan contributed to the growth, whereas Punjab recorded a decline in spending. The bulk of the consolidated spending growth was observed in the second quarter, when current expenditures' growth accelerated to 15.0 percent from 9.2 percent in Q1. Meanwhile, development spending dropped 7.3 percent YoY in the second quarter.

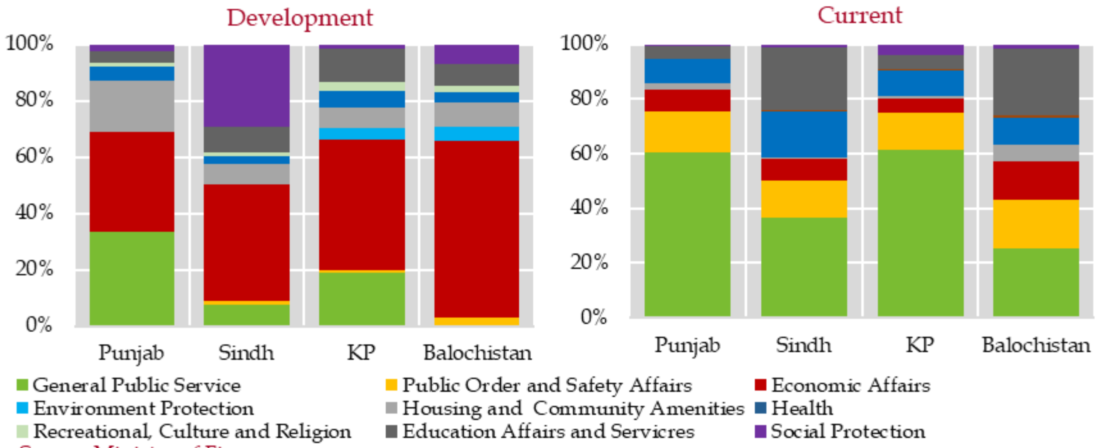
Contribution in Growth of Provincial Expenditures in FY21 **Figure 4.16**



Source: Ministry of Finance

Current expenditures of all the provinces increased in H1-FY21, in line with the growth trend witnessed over the past few years (**Figure 4.16**). However,

Composition of Provincial Expenditures- H1-FY21 **Figure 4.17**



Source: Ministry of Finance

development expenditures increased on YoY basis in only KP and Balochistan. In case of Punjab, spending related to housing and community, general public service and economic affairs was visible during H1-FY21.

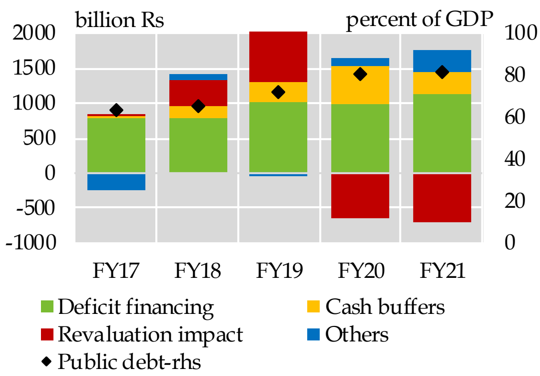
KP's development spending came primarily from economic affairs, which included construction, transport, food, and agriculture (**Figure 4.17**). KP was apparently able to increase its development spending on the back of higher development loans and grants from the federal government during the quarter. Meanwhile, Balochistan also reported an increase in overall development expenditures during H1, despite the slight decline in these expenditures in Q1-FY21.

4.5 Public Debt

The outstanding stock of public debt increased by Rs 1.1 trillion during H1-FY21 and reached 82.2 percent of GDP by end-December 2020, representing an increase of 1.4 percentage points on an annualized basis. Compared to end-June 2020, when the public debt to GDP ratio had touched 87.2 percent, the end-December number shows a drop of 5.0 percentage points.[21]

The pace of public debt accumulation observed a slight deceleration compared to the growth observed during the same period last year.[22] This deceleration mainly represented: (i) lower mobilization of deposits by the government during H1-FY21 over last year; and (ii) the revaluation gains due to the appreciation of the PKR against the US dollar, which helped contain the pace of external debt accumulation (**Figure 4.18**).[23] The deficit financing, on the other hand, remained higher than last year, as reflected in the nominal increase in budget deficit.

Sources of Change in Public Debt - H1 **Figure 4.18**



Source: State Bank of Pakistan

Almost the entire increase in public debt emanated from domestic sources, as the stock of government external debt (including debt from the IMF) increased by only Rs 29.9 billion during H1-FY21. In fact, the stock of public external debt declined in the second quarter, as the PKR appreciated by 3.7 percent against the US Dollar, thereby lowering the public external debt stock in Rupee terms. In Q1-FY21 also, the Rupee had appreciated against the dollar, but the magnitude of the

[21] As mentioned before, the end-December 2020 ratio is based on the targeted GDP for the year.
[22] Public debt recorded an increase of 2.9 percent compared to a rise of 3.1 percent in the same period last year. In absolute terms, public debt increased by Rs 1.1 trillion in H1-FY21, as compared to a rise of Rs 1.0 trillion in the same period last year.
[23] Public debt as per FRDLA definition posted a higher growth of 2.3 percent in H1-FY21, compared to 1.5 percent last year.

revaluation gains was not strong enough to offset the impact of fresh borrowings. Furthermore, it is important to note that apart from net external inflows, revaluation losses due to the depreciation of the US dollar against other currencies (especially the SDR) also contributed towards this increase. The increase in domestic debt, on the other hand, remained almost the same across the two quarters.

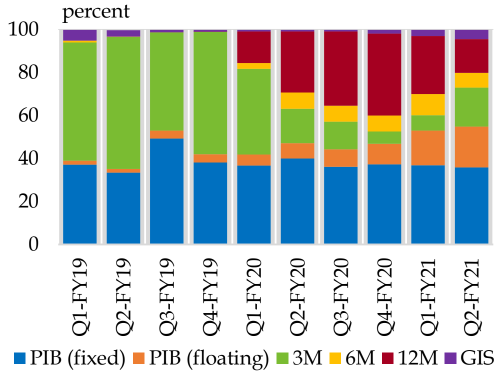
From the institutional perspective, the government adhered to its commitment of zero fresh borrowing from the central bank and relied on scheduled banks for domestic financing needs. National Saving Schemes (NSS) contributed only Rs 4.8 billion during the period under review compared to 269.9 billion in H1-FY20. As for the external debt and liabilities, nearly 83 percent of the increase (in dollar terms) represented Pakistan's increased engagement with multilateral and bilateral sources. The government also borrowed through commercial sources during the period. These borrowings were long-term in nature, but concentrated primarily in Q2; in Q1, the outstanding stock of commercial borrowings had declined, as the government had retired its short-term obligations.

The overall maturity profile of the public debt improved, as the entire increase during H1-FY21 came from long-term instruments. At end-December 2020, the share of long-term instruments in the outstanding central government debt stood at 85.7 percent, as compared to 83.1 percent at end-December 2019. This improvement reflects the impact of the measures taken by the government to make long-term instruments attractive in a low interest rate environment. Specifically, the government introduced floating rate PIBs with new tenors and also rolled out a new coupon structure (allowing quarterly coupon payments and fortnightly coupon resetting). This was done not only to diversify the outstanding stock of the government securities, but also to improve the average time to maturity. From the demand side also, market participants seemed keen to invest in these instruments due to the embedded coupon flexibility (see **Chapter 3** for details).

Domestic Debt

The ownership structure of domestic debt indicated that the financing was done almost entirely through the commercial banks. The rise in domestic debt through non-banks was quite minimal (16 percent, against 37 percent last year), as institutions were barred from investing in instruments offered by the NSS. As highlighted earlier, the government avoided deficit monetization throughout the period, and instead retired Rs 0.3 trillion to the SBP. Hence, the SBP's share in the outstanding debt stock declined by 6.1 percentage points between December 2019 and December 2020.

Instrument-wise Share in Domestic Debt **Figure 4.19**



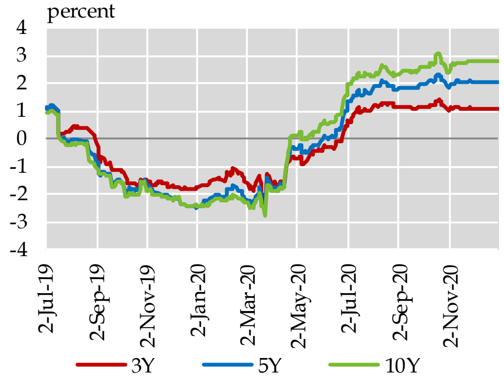
Source: State Bank of Pakistan

As mentioned earlier, the government was able to lengthen the maturity profile of domestic debt and also diversify it across various instruments (including PFL and Ijara Sukuk instruments), as indicated in **Figure 4.19**.[24] Quarterly analysis of government securities shows that banks' preference for short-term instruments had started to increase from the start of Q1-FY21; this was also reflected in the increasing term premium of the long-term bonds (**Figure 4.20**). Subsequently, as the expectations of a bottoming out in interest rates gained traction in Q2-FY21, the demand for 3m T-bills increased further, while the demand for 12m T-bills and fixed-rate PIBs declined (**Chapter 3**).

With the introduction of the 5-year Ijara Sukuk (both fixed and variable-rate options), the government mobilized Rs 363.2 billion during the period under review. This instrument not only helped diversify the domestic debt portfolio, but also improved the maturity profile and provided an investment avenue to Islamic banks.

As mentioned earlier, debt mobilization through non-bank sources was quite limited in both the quarters of H1-FY21. In particular, non-banks' participation in T-bills and PIBs remained lower than last year. Moreover, the weak activity in NSS instruments - an increase of only Rs 4.8 billion in H1-FY21 compared to Rs 269.9 billion in H1-FY20 - stemmed primarily from the imposition of a ban on institutional investments and a decline in profit rates on these instruments (**Figure 4.21**). Although supply-side issues also prevailed in the first quarter when CDNS outlets were closed due to lockdowns, the investment continued to remain weak in the second quarter, when all the outlets were operational.

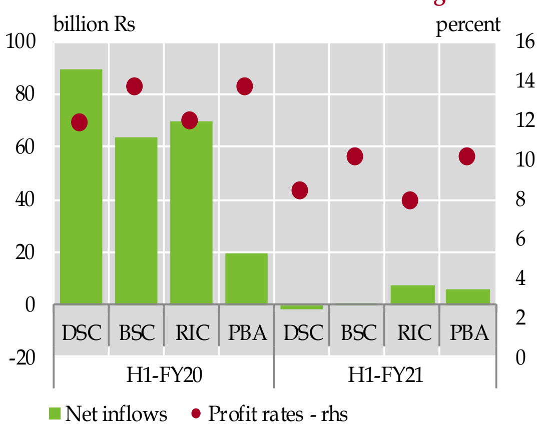
Term Premium with respect to 3-Month T-bills **Figure 4.20**



Source: MUFAP

Fund mobilization through prize bonds also recorded a net outflow of Rs 13.8 billion during H1-FY20, as the government discontinued the sale of Rs 25,000

NSS Net Inflows and Profit Rates **Figure 4.21**



Source: Central Directorate of National Savings

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

denomination national prize bond. The holders were provided three options in this regard: (i) convert to premium prize bond; (ii) replace with Special Savings Certificates (SSC)/Defence Savings Certificate (DSC); and (iii) encash at face value. It appears that most of the holders opted for the encashment of these bonds, as the rise in sales of the premium prize bonds and the SSC/DSC was marginal.

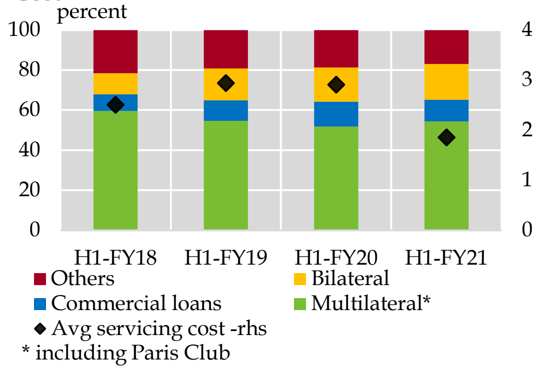
Notwithstanding this improvement in the profile, challenges have emerged with respect to debt management. First, as mentioned before, markup payments have become a major strain on the fiscal accounts. Effectively, nearly 23 percent of mark-up payments were financed by the accumulated primary surplus during H1-FY21, with the rest being financed by additional debt accumulation.

Second, although the floating rate instruments have allowed the government to extend the maturity profile of public debt, their increasing share in the public debt stock has increased the repricing risk for the government. This is because the returns on PFL are repriced in line with any change in the benchmark interest rates. With the introduction of more frequent coupon resetting (fortnightly), this repricing risk has heightened further. Also, the quarterly coupon payments (introduced in October 2020) would increase the liquidity risk for the government.

Public External Debt & Liabilities

In absolute terms, public external debt and liabilities (PEDL) increased by US$ 2.7 billion in H1-FY21, compared to a rise of US$ 3.7 billion in H1-FY20. Improvement in the current account balance kept the financing requirements lower compared to the previous year. It is important to note that revaluation losses due to the depreciation of the US Dollar against other international currencies alone added US$ 1.9 billion, which is equivalent to 70 percent of the total increase in the outstanding stock of public external debt and liabilities (in dollar terms) during the period. Currency-wise revaluation impact indicates that one-half of the revaluation losses emerged due to the depreciation of the US Dollar against the Special Drawing Rights. Excluding the revaluation impact, the increase in PEDL was relatively low (US$ 0.8 billion).

Category-wise Share in External Debt and Avg. Servicing Cost **Figure 4.22**



Source: State Bank of Pakistan

Here, it is important to mention that in gross terms, Pakistan had received external inflows of US$ 5.7 billion (46 percent of annual estimates) compared to US$ 5.9 billion during the same period last year.[25] However, a much smaller increase was observed in the outstanding stock of external debt and liabilities (US$ 0.8 billion,

[25] Source: Economic Affairs Division, Monthly Bulletin Foreign Economic Assistance, December 2020.

after adjusting the impact of revaluation losses). This implies that most of the disbursements during H1-FY21 were used for financing the repayment of maturing debt and liabilities (including sovereign deposits). Multilateral donors, such as the ADB, IBRD, IDA, IDB and AIIB, contributed these inflows for various ongoing projects and budgetary support.

The composition of PEDL also changed from last year. Four developments merit a mention in this regard. First, the entire increase in external debt and liabilities was sourced through long-term loans during H1-FY21, in contrast to H1-FY20, when almost 40 percent of external debt accumulation was attributed to short-term loans. Second, the share of multilateral loans increased further during H1-FY21, and these were mobilized at a lower servicing cost (**Figure 4.22**).[26] Third, the share of commercial borrowings declined compared to last year; more importantly, short-term commercial loans were repaid during the period under review, which improved the maturity profile. And last, one-third of the rise in external debt during H1-FY20 was attributed to foreign investment in government securities; this source of funding was not available in H1-FY21.

External debt sustainability indicators posted improvement over last year

In line with the deceleration in PEDL accumulation, all the solvency and liquidity indicators of external debt sustainability recorded an improvement at end-December 2020 compared to end-December 2019 (**Table 4.5**). Total external debt and liabilities (TEDL) and public external debt in terms of GDP reduced by 0.6 and 0.8 percentage points, respectively. As highlighted earlier, the improvement in the current account balance kept the financing needs lower compared to last year. Similarly, the ratios of total reserves to TEDL and SBP reserves to TEDL improved further by end-December 2020. This primarily reflects both an increase in reserves and a lower growth in TEDL.

Indicators of External Debt Sustainability **Table 4.5**

percent

	Dec-16	Dec-17	Dec-18	Dec-19	Dec-20
Solvency indicators					
Total external debt and liabilities/GDP	24.9	28.5	36.3	41.1	40.5
Public external debt/GDP	20.2	22.5	28.7	32.5	31.7
Total reserves/total external debt & liabilities	30.6	22.6	13.9	16.2	17.7
SBP reserves/total external debt & liabilities	24.1	15.8	7.3	10.2	11.6
External debt servicing/FX earnings*	9.2	10.6	13.3	18.6	12.7
External debt servicing/export earnings*	21.6	24.3	31.1	42.3	33.7
Liquidity indicators					
Short-term public external debt/PEDL	1.9	1.9	1.3	3.2	1.0
Short-term external public debt/total reserves	5.1	6.6	7.5	15.7	4.5
Short-term public external debt/SBP reserves	6.4	9.4	14.4	24.8	6.8

*External debt servicing excludes the liabilities component

Source: SBP staff calculations

[26] The average servicing cost has been estimated by taking the actual interest payments in the current half as percent of the average of the total outstanding stock of external debt in the current and previous half.

Likewise, liquidity indicators also recorded an improvement, and the share of short-term debt decreased. Last year, foreign investment in government securities had ticked up, which had increased the share of short-term debt in the overall external debt. However, with the decline in short-term external debt, the maturity profile of external debt had lengthened during H1-FY21.

Lastly, debt relief provided under the DSSI, along with improvements in FX earnings, also improved the debt servicing indicators. External debt servicing to FX earnings ratio reduced by 5.9 percentage points. This ratio implies that, effectively, only 12 percent of FX earnings were required to pay off the maturing obligations during the period under review. If seen in the context of export proceeds, external debt servicing was almost equivalent to one-third of exports. However, to ensure external debt sustainability, there is a need to shore up the level of country's foreign exchange reserves and earnings to smoothly pay off the debt obligations.