



Fiscal Risks Statement

FY 2021-22

Finance Department
Government of the Punjab

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List of Acronyms & Abbreviations

MTFF	Medium-term Fiscal Framework
FBR	Federal Board of Revenue
GDP	Gross Domestic Product
LG	Local Government
PFD	Punjab Food Department
GSDP	Gross Sub-national Domestic Product
PPPs	Public Private Partnerships
PSE	Public Sector Enterprises
PSCs	Public Sector Corporations
QATPL	Quaid-e-Azam Thermal Power (Private) Limited
PTPL	Punjab Thermal Power (Private) Limited PTPL
RMU	Risk Management Unit
PSTS	Punjab Sales Tax on Services

1. Introduction

Fiscal risks can be broadly defined as any potential differences between actual and expected fiscal outcomes¹. Fiscal risks carry the potential to result in financial distress for a Government in the future. They can adversely impact the projected fiscal path and targets which, in turn, can adversely impact related macroeconomic variables such as inflation, interest rates, external account and GDP growth, along with the undesirable impact on consumer and business confidence.

Governments may not be able to completely prevent or avoid fiscal risks. However, it is in their long-term interest to manage fiscal risk exposures by adopting sustainable policies, purchasing insurance and/or hedging products, or by maintaining buffers.

The purpose of this document is to identify fiscal risks relevant to Government of Punjab, assess their fiscal implications, review the policies and mechanisms already in place to deal with such risks, and explain the fiscal risk management strategy.

¹ Public Sector Debt Statistics: Guide for Compilers and Users (IMF 2011)

2. Key Fiscal Risks

2.1 Growth in Government Revenues at the Federal Level

Following the fiscal structure in Pakistan, the Provincial Governments still rely heavily on inter-Governmental transfers from Federal Government for revenue. In the last five years, on average, the Provincial share in Federal Revenue contributed to 81% of the total Provincial revenue for Punjab, whereas around 17% was collected from own source revenue, and approximately 2% came from Federal Loans and Grants. Since the Divisible Pool transfers constitute the primary proportion of General Revenue Receipts, even a small percentage variation between Federal Board of Revenue's Budgeted Estimates and Actual Collection leads to a major re-adjustment in Provincial Receipts. This can be a major concern for Provincial Government as in last fifteen years the gap between budget and actual collection has widened.

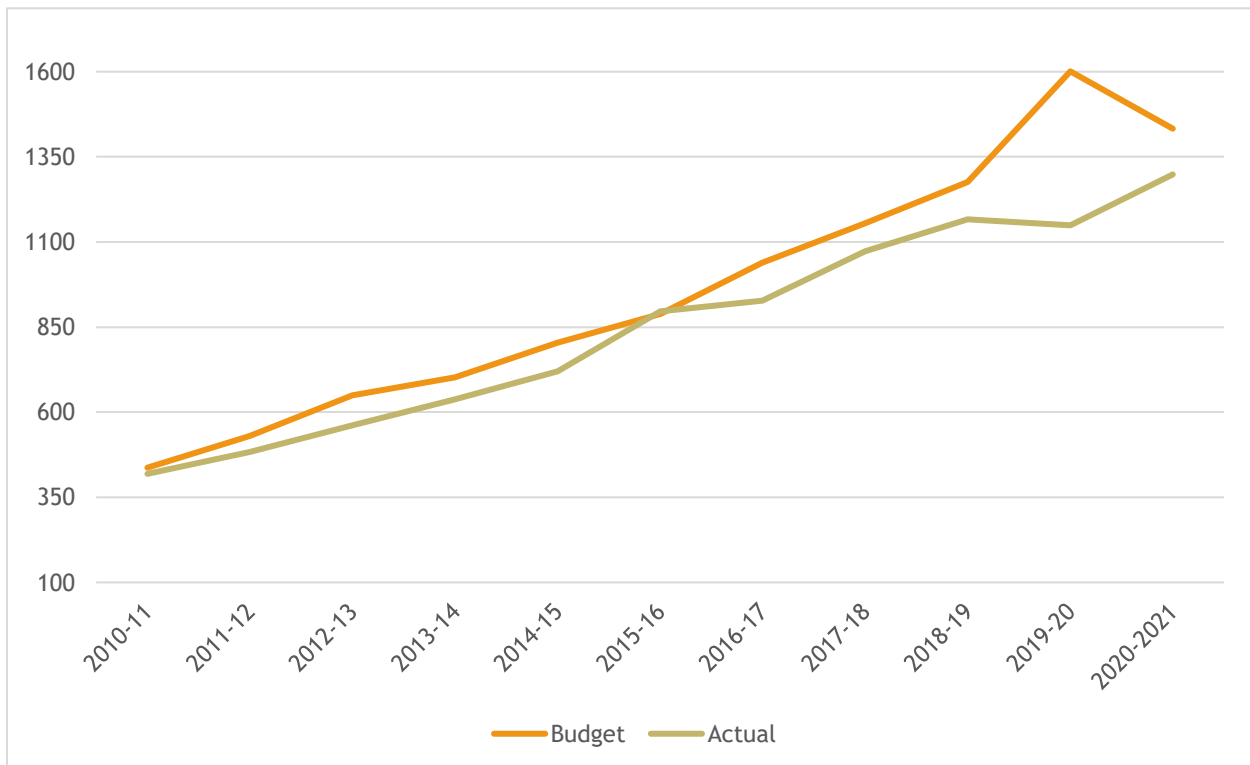


Figure 1: Difference between budget and actual Federal Divisible Pool Transfers

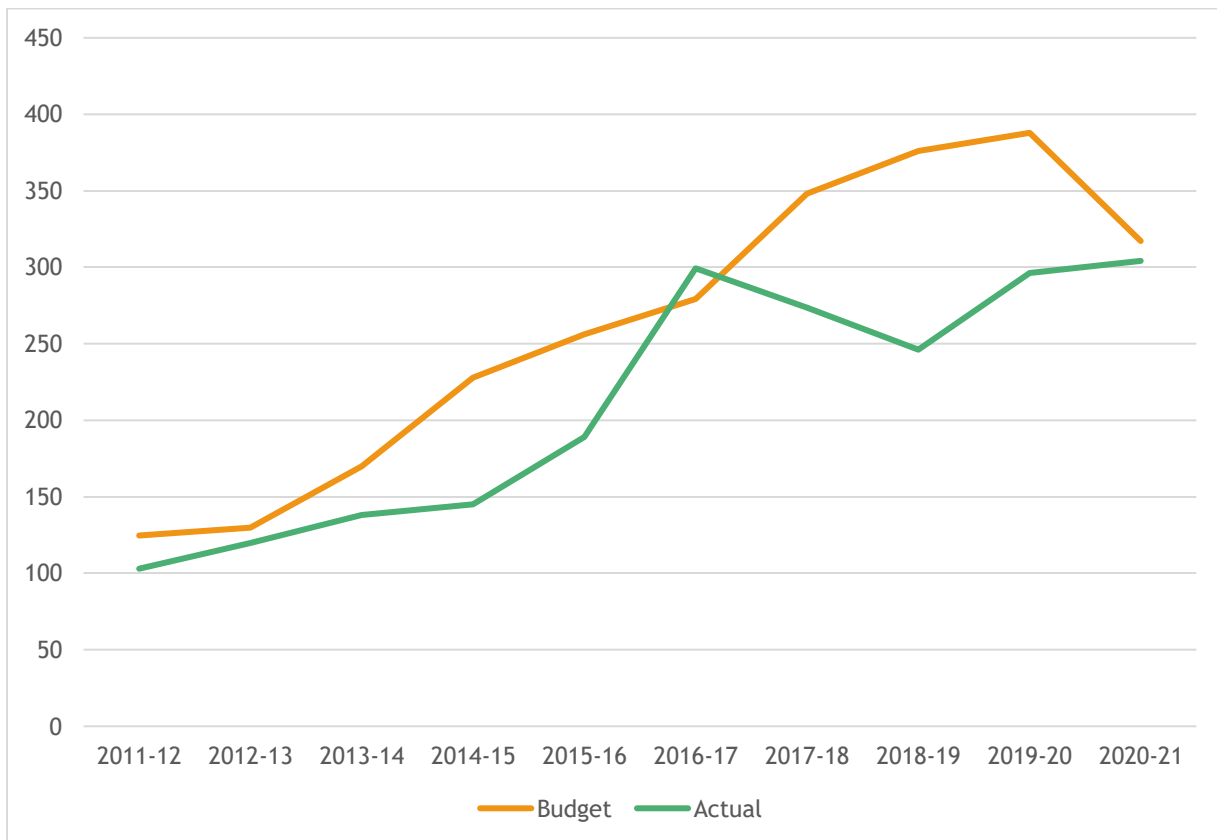
Over the last five years, there was an average difference of PKR 178 billion in the budget and actual Federal divisible pool transfers. During the same period, the average variance between budget and actual estimates was 12.83%. In the last ten years, the highest difference of Rs 453 billion (Variance: 28.29%) was recorded in 2019-20, which can be partially explained by unprecedented shortfall in FBR collections due to COVID-19. In the 2020-21 mid-year Budget

Execution Report, the Finance Department has cautioned that FBR might fail to achieve its target of collection even this year as well.

2.2 Own Source Revenue

Government of Punjab has been making increased efforts to increase revenue collection from Provincial sources. In last five years, the own source revenue contributed to around 17% of the total Provincial revenue. Over last fifteen years there was a 16% growth in this source, which has reduced to 14% over last five years.

Figure 2: Difference between Budget and Actual Own Source Revenue Collection



The gap between budgeted and actual collections of own source revenue has been widening in recent years. Over the previous five years, actual collections were, on average, PKR 57.74 billion (Variance: 15.3%) less than the budget estimates. Lower collection of own source revenue increases reliance on Federal Divisible Pool transfers, which are estimated without input of provinces and have been transferred less than the budget estimates in last years. Own source

revenue is a considerable portion of the total revenues and a shortfall in collection can have a significant impact on Provincial budget execution.

2.3 Policy on Commodity Financing

Annual wheat procurement and storage by the Provincial Government carries huge costs for the Provincial exchequer. The direct costs include buying, storing, releasing wheat as well as the interest payments, both on current borrowing and accumulated debt. The Punjab Government meets this cost through commercial borrowing from the banks every year to purchase wheat from the farmers. Borrowing on account of commodity financing is not included in the domestic debt of Government of Punjab because such borrowing is secured by underlying wheat stocks as well as the Guarantee of Federal Government.

In December 2020, Punjab Food Department expressed its intent to raise Rs. 420 billion² from financial institutions under Cash Credit Financing for Commodity Operation of wheat for the quarter Jan-Mar 2021. Wheat procurement operation causes huge financial loss every year because of the difference between cost of procurement and storage and the sale price under the wheat release policy. Annual financial loss in Punjab was Rs. 73 billion in 2019- 2020. The cumulative financial loss in Punjab from 2005-2006 to 2019- 2020 amounts to Rs. 377 billion, growing at compound annual growth rate (CAGR) of 23%. Cumulative outstanding debt for commodity operation as of June 30, 2020 in Punjab was Rs. 462.8 billion while mark-up payable on the outstanding debt is Rs. 55.2 billion.³

Although the Federal Government's sovereign guarantee is backing the commodity operations, it is acknowledged that it is essentially a legal liability for the Provincial Government. The justifiably intensifying debate over the subject demands a responsible and consistent policy on commodity operations; continuity of purchase or phasing out of it, co-financing by the Federal Government and federating units, and consistency of release and purchase prices across Pakistan. The looming risk of withdrawal of Federal guarantee and at-source deductions from the NFC shares, non-participation of federating units in the commodity operations of Punjab exposes the Provincial Government to a higher risk in future.

² www.eproc.punjab.gov.pk/Tenders/50485049/4849/0401202106182412754173149203.pdf

³ A Study of Commodity Debt: The Case of Punjab Province-Pakistan, IFPRI, 2021

2.4 Pension Expenditure

The existing defined benefit pension scheme is rapidly becoming an unaffordable financial obligation for the Government. The burgeoning annual expenditure on pensions has squeezed the fiscal space available for public investments and service delivery to citizens. The pension liability (present value of future pension payments) in Punjab has increased to PKR 6,598 billion in 2019. The annual expenditure on account of pension has grown to approximately PKR 255.7 billion in FY 2020-21 and has been growing at an annual compound growth rate of 21.5% since FY11. The annual Pension Expense as percentage of Revenue has increased from 8.3% in FY12 to 14.9% in FY21 and is projected to increase further if the current policy continues.

The cause of increasing pension liability can be traced to the excessively generous features of the pension policy of the Government. The Finance Department is deliberating on recommendations for reforming the pension scheme along with actuarial analysis of Punjab Government's pension liability. However, any changes will need to be institutionalized through an amendment to laws and rules governing the subject. Owing to regular agitation by Government officials on employee benefits, judgements by the courts on reform initiatives and lack of support across party lines, the Provincial Governments do not feel encouraged to introduce pension reforms. The Federal Government needs to take the lead and set the stage for pension reforms by all Governments.

2.5 Public Debt and Financing of Fiscal Deficit

Punjab's debt levels are currently low when measured as a percentage of its GSDP (Gross Sub-national Domestic Product) or its annual revenue. The outstanding debt as percentage of Punjab's GDP was 3.8% in December 2020 and the interest payment was only 0.1% as percentage of Punjab's GDP. Punjab's debt stock as of June 30, 2020 was PKR 945.5 billion. Redemption Profile for Punjab is expected to remain the same till FY 2023, however a sudden increase in repayment is evident from FY 2024 onward, which is mainly due to the start of repayment of the Orange Line Loan which will continue through FY 2036. An estimated amount of PKR 16 billion will be required for yearly loan repayment installment of the Orange Line Loan (based on FX rate of 31.12.2020).

The major challenge for the province is to manage its debt operations to finance its large and growing development needs without impairing its capacity to repay the debt. Punjab's debt

consists mainly of long-term foreign loans obtained on concessional terms from international institutions by the Federal Government and on-lent to Government of the Punjab. Government of the Punjab obtained multilateral loans from international financial institutions and a few bilateral loans to support the development needs of the province. The following Table provides summary of Redemption Profile of Principal Amount of Loan:

Table 1: Redemption Profile of Principal Amount (PKR billion)

Redemption of Principal Amount⁴	2020-21	2021-22	2022-23	2023-24
External Loans Repayment	22.71	47.72	60.39	57.95
Domestic Loans Repayment	0.77	1.62	1.01	0.39
Total	23.48	49.34	61.4	58.34

The significant increase in Debt Service payments within a few years requires an even higher focus on increasing the own-source Revenue of the province.

2.6 Adequate Buffers for Liquidity Management

Liquidity buffers refer to banks' stock of liquid assets, such as central bank reserves or high-quality Government debt that can be easily used to repay obligations as they fall due. They are available to meet unexpected changes in cash flows. Currently, the Government of Punjab does not follow a practice of maintaining buffers for liquidity management, however, it is now prudent to maintain a cash buffer to meet unexpected liquidity requirements on account of cashflow mismatches and/or other contingencies. Therefore, the Finance Department has drafted the Punjab Public Financial Management Law that contains the provisions on cash management to effectively anticipate cash needs of the Government. Moreover, a policy to maintain a certain amount of cash balance on average in order to meet unexpected cash needs is under consideration.

2.7 Contingent Liabilities

Explicit and implicit contingent liabilities pertaining to Public Corporations are a major source of fiscal risk. In the past, the Government had to bail out two Public Financial Corporations (Bank of Punjab and Punjab Cooperative Bank) through a combination of loans, equity investments and guarantees. In addition, there are significant amount of loans made by the Government to a number of Public Non-Financial Corporations (mainly the Waste Management Companies) whose recovery seems unlikely.

⁴ Debt bulletin, Finance Department, Punjab

Currently, Government of Punjab's outstanding guarantees amounting to Rs 48.9 billion pertain mainly to two Public Corporations in Energy sector (Rs 44 billion) and a Public Private Partnership project in Roads and Transportation Sector (Rs 4.6 billion).

In FY10, the Government set up a Risk Management Unit (RMU) in Finance Department to analyze and manage the fiscal risks pertaining to Public Private Partnership projects. Over the years, the Unit has provided valuable advice regarding such projects.

In FY19, the Government set up a Corporate Finance Unit in Finance Department for effective oversight of Public Sector Companies, improving their governance, risk management and compliance practices. The Unit has made considerable progress in establishing a consolidated database of the accounting and financial information pertaining to the Public Sector Companies and to identify the major challenges faced by these companies.

The Government is also considering formulating a policy regarding financial support to Public Corporations. This policy shall identify the types of financial support that can be provided to these companies and the conditions to be met by such companies to be eligible for such support.

2.8 Natural Disasters and Continuation of COVID Restrictions

Punjab hosts 55 percent of the country's population and is one of the worst affected provinces by the COVID-19 pandemic. With the threat of COVID still looming, it will continue to pose a fiscal hurdle to the Government. The economic downturn is projected to increase unemployment in Punjab by 5-8 million⁵, pushing many households below the poverty line. The economic fallout from the pandemic is, however, expected to reduce the province's Own-Source Revenue, leaving it with fewer resources to finance its emergency response and to sustain the already modest investment in human capital and infrastructure.

In year 2019-20, to compensate for economic slowdown, the Government of Punjab provided a Tax Relief Package worth more than PKR18 billion. Last year it was estimated that COVID-19 mitigation expenditure would be PKR 68.3 billion⁶ for FY21. Tax expenditures are special tax provisions in the tax law that are exceptions to the normal structure of the tax system. They represent revenue the Government forgoes through exemptions and reduced rates to achieve

⁵ World Bank

www.documents1.worldbank.org/curated/en/822851601408278557/pdf/Final-Technical-Assessment-Punjab-Resource-Improvement-and-Digital-Effectiveness-P171417.pdf

⁶ White Paper 2020-2021

various social and economic objectives by favouring a particular industry, activity, or class of persons. The main features of tax relief package were:

- Punjab Sales Tax on Services (PSTS) will not be charged on Construction Services provided by Property Developers, Builders and Promoters
- PSTS on Health Insurance and Services provided by doctors and hospitals at 0%.
- PSTS reduced to 5% for 14 sectors affected by COVID-19
- Adoption of new Valuation Table for (Urban Immovable Property Tax) UIPT postponed for 1 year
- COVID-19 centric administrative relief measures in collection of UIPT, Token Fee and Vehicle Registration Fee etc.

Apart from special exemptions during the COVID pandemic, the tax exemptions provided under Punjab Urban Immovable Property Tax Act, 1958 have foregone an accumulated value of PKR 3.9 billion in terms of UIPT while the number in case of PSTS stands at PKR10 billion.

Punjab was expected to establish Provincial Disaster Management Funds (PDMFs) and allocate PKR 8 billion for this purpose, with a plan to contribute an additional PKR 1.5 billion annually. However, Punjab continues to rely on grants from National Disaster Management Fund for projects of disaster management and rehabilitation. Recent experiences indicate that compensation after a disaster can be 14 to 15 times higher than the cost of ex-ante approaches to disaster risk financing. Through better considered disaster risk financing instruments, the disaster burden on the Government can be reduced. In the ongoing Punjab Resource Improvement and Digital Effectiveness (PRIDE) programme, the World Bank is going to provide support to the Finance Department for the establishment of a disaster mitigation fund for a dynamic approach towards disaster risk financing.

3. Conclusion

Assessment of potential fiscal risks can provide valuable insights to the Government to plan and execute appropriate risk management strategies. Key fiscal risk exposures of the Government include shortfalls in revenue, steep rise in pension expense, rising burden of debt pertaining to commodity operations, sudden increase in expenses due to natural disasters or pandemics, and implicit contingent liabilities in the form of bailouts of loss-making Public Corporations.

The Government is mindful of these risks and is weighing various policy options and administrative measures and strategies to cope with these risks. The Government is committed to achieving consistently high growth in own-source revenues, introducing meaningful pension reforms, formulating a plan to gradually repay the debt related to commodity operations, improving disaster risk management framework and improving oversight of Public Sector Companies and Public Private Partnership projects.