Roadmap For Economic Growth of Pakistan

Islamabad Policy Research Institute

CHAPTER 2

Fiscal Challenges and Response

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Background

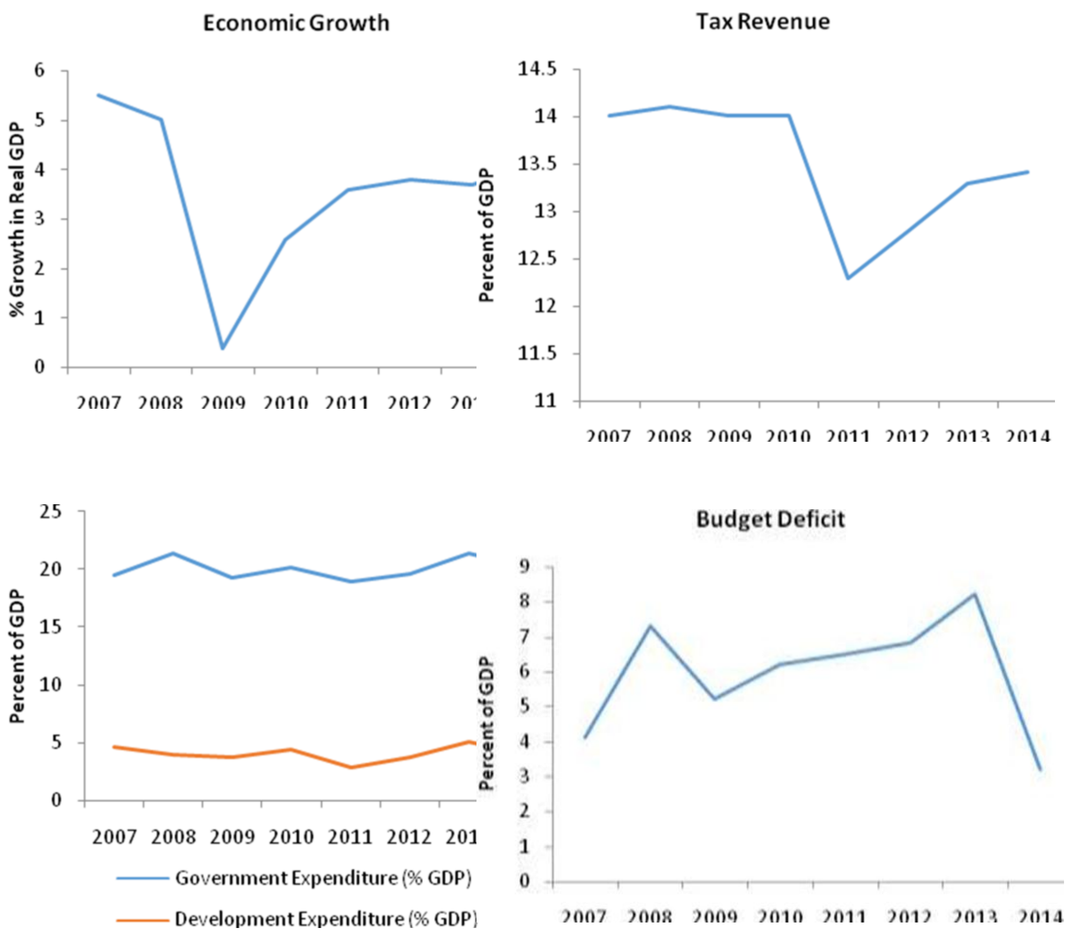
Pakistan‘s fiscal balance is currently challenged on account of two key issues namely — low capacity of the state to raise public sector‘s revenues and inability to cut down government expenditures. With a growing debt liability it is important to note that the additional costs of debt servicing will also continue to be a burden on the Pakistan economy in terms of pressures arising from higher interest rates, overvalued exchange rate and continuous upward pressure on consumer prices.

This issue is exacerbated by the low economic growth levels seen in Pakistan since 2007 (Box 1). The national income in the country has not even grown at a rate which can absorb the growing number of labour force in the country. This impacts the budget as the low levels of output imply depressed revenue collection and in turn reduced fiscal space to fund government‘s current and development expenditures. With an on-going IMF programme, Pakistan has committed to keep its deficit under check and on several occasions since 2007 it is the development expenditure on infrastructure and social sectors that faces a cut in order to meet the deficit targets set with the IMF.

Unlike the 1980s and 1990s Pakistan has financed the recent fiscal deficit relatively more through domestic sources of borrowing. The share of external borrowing has been on a decline. However, this has implications for the domestic financial sector. The loanable funds that were supposed to be available for the private sector for production and trade activities were acquired from the banking sector by the government. In fact the commercial banks found lending to the government relatively less risky and remained averse to lending capital to the private sector. The small and medium enterprises were particularly hit hard due to the difficulties in acquiring funds for this working capital.

Box-1

Economic Growth, Government Revenues and Expenditures



Source: Economic Survey of Pakistan 2013-14

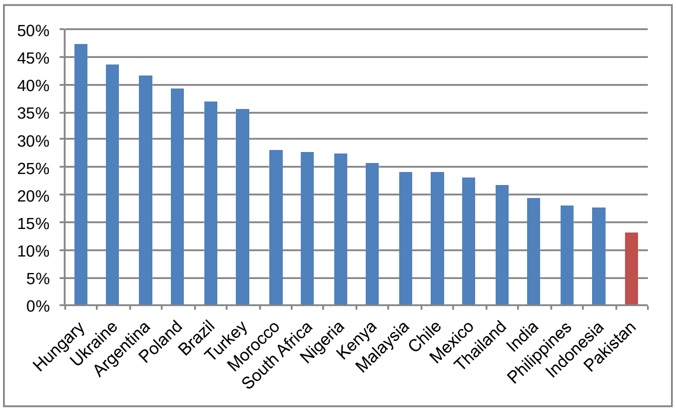
In this policy note we look at two specific issues under fiscal policy which directly impact the growth process. We will take up the issue of tax reform in the next section and will explain how various forms of tax exemptions, lack of capacity in tax administration and missing political will to broaden the tax base is keeping domestic resource mobilization weak. The third section will then explain the government‘s expenditure priorities where we will give particular attention to structural issues impeding the effectiveness of development expenditures in the country. Finally we conclude with some policy recommendations on improving revenue collection and effectiveness of government expenditures.

Tax Reforms

In 2013, the World Bank had noted that the total revenue collected by tax and other sources, was 13 per cent of GDP[1] — lowest across emerging economies (Figure 1). Over 80 per cent of government revenues are earned by imposing taxes. This is around 10 per cent of GDP out of which 9 per cent of GDP is collected through Federal Board of Revenue (FBR)[2] — lowest collection by any Federal government excluding oil-producing countries (Ishtiaq 2013).[3] State capacity to collect taxes has also weakened. The tax to GDP ratio declined from 14 per cent in the mid-1980s to 10 per cent.

Figure-1

Revenue to GDP Ratio in Emerging Economies (2013)



Source: World Development Indicators 2013

Despite increased fiscal administration powers with the provinces in a post-18th Amendment milieu, most provinces have struggled to increase their own tax receipts in recent years. On average 0.4 per cent of GDP is collected by the provinces. Politicians at the provincial level do not wish to see increased taxes in their constituencies. Second, provincial tax collection in rural areas lacks institutional capacity to audit incomes and wealth. This in turn makes it difficult to validate the tax liability.

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[1] World Development Indicators

[2] Average of past 5 years. For 2012-13 the FBR collected tax equivalent to 8.3% of GDP

[3] Ishtiaq, Nohman (2013) Tax Reforms in Pakistan, Policy Symposium on Tax Reforms in Pakistan. Sustainable Development Policy Institute.

Various governments in Pakistan allowed tax exemptions and preferential treatments to select sectors and even organizations. These exemptions were provided through Statutory Regulatory Order (SRO) by the FBR. Independent studies have estimated the loss from such exemptions to be around PKR 800 billion. If tax evasion, estimated to be 4 per cent of GDP is added to this amount, the leakage in revenues is equal to the annual government borrowing.

The distorting aspect of SROs is that these are being issued without parliamentary approval and can over-write the federal budget provisions approved by the parliament at least for a temporary period. There is also no binding to report value of these exemptions to the Parliament.

The process of tax collection has also been described as non-transparent and prone to rent-seeking. The Tax Administration Reform Project started in 2005 has largely failed to achieve its objectives. Tax administration continues to suffer from inefficient and fragmented human resource, lack of automated systems, and misuse of discretion by officials. A weak tax monitoring also results in high levels of tax avoidance.

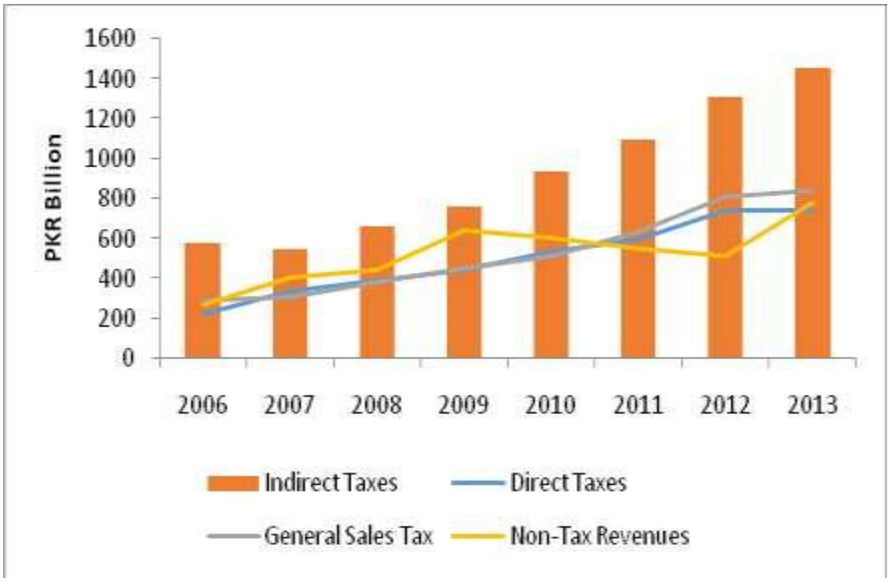
Another challenge is that of a narrow tax base. Out of 58 million work force in Pakistan, a meagre 2 million are registered taxpayers, and in 2013 only 0.7 million had paid taxes. An unfortunate statistics is that 61 per cent elected public representatives in the National and Provincial Assemblies did not pay taxes in the year they contested the elections. There were 51 per cent of Senators who did not pay tax and 62 per cent Cabinet Ministers who had not filed tax returns.

A key reason of elite not paying taxes is weak enforcement. There is no example where someone convicted of not paying taxes in Pakistan has ever gone to jail. FBR in 2011 had access to 3 million people who were frequent foreign travellers, had multiple bank accounts, and multiple vehicle and property registration in their names, however had not paid taxes. Such cases have never been awarded exemplary punishment.

It is important to note that the manner in which the government raises its revenues has implications for the poorest of the poor. We observe in Figure 2 that the growth in direct taxes (supposed to be progressive and less burdensome for poor) has been much lower than the indirect taxes. Even non-tax revenues earned by the government are now posting a higher value than direct taxes. The general sales tax is the main contributor to the indirect taxes which makes this type of taxes along with non-tax revenue measures, regressive and having a higher burden on the poor. This also implies that the role of fiscal policy in mitigating inequality also diminishes.

Figure-2

Composition of Consolidated Federal & Provincial Government Revenues



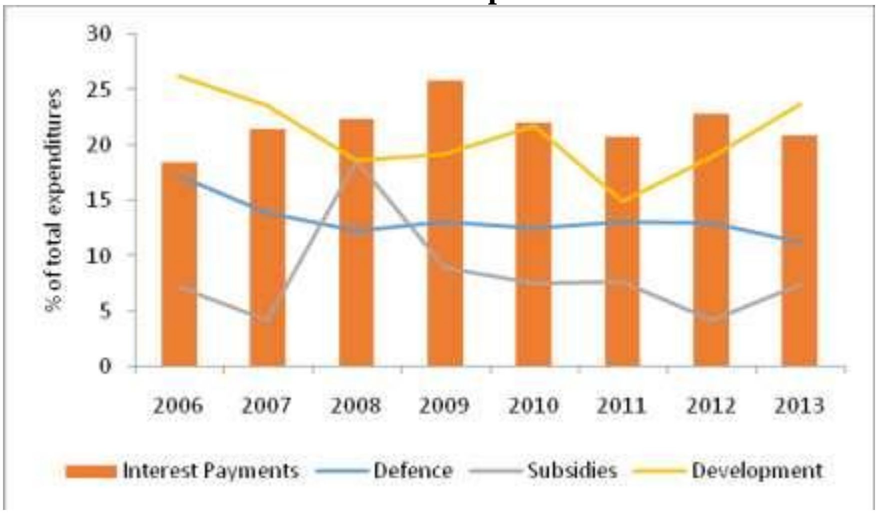
Source: Economic Survey of Pakistan

Government Expenditures

It remains a challenge for the government to balance the recurrent and development priorities in the country. We see in Figure 2 that interest payments have occupied a majority share since 2006. While the defence spending has been on a decline since the same year, however, it still occupies a little over 11 per cent of the total government expenditure. The subsidies allowed for commodity operations and energy has remained volatile. A large amount of this outlay is politically motivated. The current and past governments have not been able to fully eliminate the circular debt in the energy sector. These expenditures collectively are responsible for unplanned spending on infrastructure and social sector priorities. It is usually these sectors, which face a cut in their allocation or disbursements owing to increases in governments' defence, administration or subsidy related budgets.

Figure-3

Government Expenditures

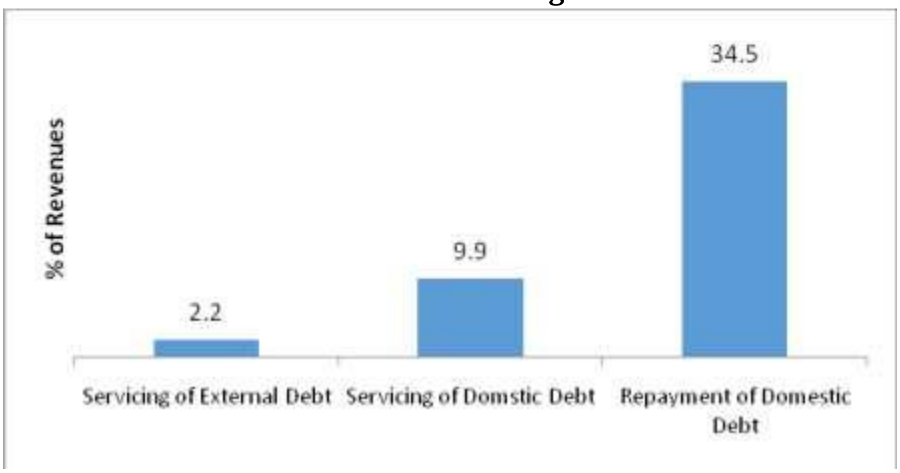


Source: Economic Survey of Pakistan

The debt crisis is coming back into picture and IMF has asked Pakistan to appoint a dedicated directorate to monitor debt levels and restructure the expensive debt. Figure 3 indicates that almost 47 per cent of total revenue is lost to repayment and servicing of external and domestic debt. This is 40 per cent of recurrent government expenditures. The domestic debt to GDP ratio is now as high as 43 per cent.

Figure-4

Public Debt Servicing 2014



Source: Economic Survey of Pakistan

In the remaining part of this section we will limit our discussion to the leakages in the public sector development programme — a crucial element for promoting human development and inclusive growth in any country. One of the key reasons for non-optimal spending of development budgets is the lack of monitoring and evaluation (M&E). Both technical and human capacity to monitor projects is missing in federal and provincial planning and development departments. The entire planning machinery is understaffed and technically under-capacitated. While the manifestos of all governments talk about outcomes based budgeting, none have acted upon this proposal. The result based management of projects with emphasis upon outcomes and long term impacts is missing.

The throw forward in development budget (i.e. approved projects awaiting cash flow) should be reduced through alternate financing modes, such as a) public private partnerships, b) built to operate and transfer, and c) built to operate and own schemes. Throw forward in public sector development programme (PSDP) is over PKR 3 trillion mostly because of cut in PSDP, increased number of new schemes and lower resource mobilization for projects. With the current rate, projects approved today could on average take around 17 years to complete.

Bypassing of Planning Commission or the provincial planning bodies in project approval and award has become a norm. There is an absence of rigorous feasibility studies and appraisal in several major projects initiated in political haste. What is missing here is a strong financial and technical appraisal, b) social analysis reflecting beneficiary population, dislocation, resettlement and livelihoods c) economic analysis, estimating EIRR, B/C ratio, NPV and domestic resource cost, and d) risk analysis, including time delays, cost variations, design and content modifications.

Policy Recommendations

On the taxation side there is an immediate need to phase out exemptions and related preferential treatment given to select sectors. The government has already committed to the IMF that it will get rid of the SRO regime. This commitment should be expediently implemented. Any future SROs should be subject to the approval of parliament. This will allow public representatives to monitor any loss accruing due to tax expenditures. The value of such exemptions and preferences should be regularly calculated and presented as part of the budget.

On tax administration side FBR should be allowed full autonomy including control over its human resource and management. The functional expertise should be improved across all levels in FBR. A medium-term strategic plan should drive this department and this plan should be monitored on the basis of well-defined key performance indicators. At the provincial level, the revenue authorities should gradually take control of functions currently exercised by excise, revenue and board of revenue departments. There should be a specific focus on broadening of tax base through agriculture tax, property taxes and taxing new sources of incomes in services sectors.

On the expenditure side the social sector development is now a domain of provincial governments. It is, therefore, important that the provinces should avoid politically driven projects that lack any economic reasoning. The priorities committee of the finance department must see that duplication of new projects is avoided. As the Federal government continues to fund some higher education initiatives and provide for vertical programmes of health and population, it is important that the inter-provincial coordination should be improved in order to ensure monitoring and cost-effective implementation of such programmes across provinces.

There is also a need to minimize leakages in PSDP and projects under provincial annual development plans. The project management costs in public sector are high and should be rationalized by having human resource from the private sector which is trained in project delivery. Dedicated professionals must be appointed as project heads instead of civil servants working on additional charge basis. The consultancy charges that largely go to foreign countries should be checked by the Economic Affairs Division and must be rationalized. All public sector projects should have exemption from the general sales tax.