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Pakistan Faces a Widening Fiscal Imbalance

Pakistan's budget for the fiscal year 2017-18 presents a bleak financial picture. This paper discusses the underlying causes for persistent fiscal deficits that threaten the country's recent economic recovery.

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Introduction

The federal budget of Pakistan for fiscal year 2017-18 (FY18), beginning 1 July 2017, was unanimously passed by the Parliament last month (June 2017). It has a total outlay of US$45.16 billion (S$62.04 billion). As an 'election year' budget, it carries immense significance for the current government, which is hopeful of winning the 2018 general elections. In recent months, the government has laid great emphasis on the steady improvement in the economy. In particular, it has pointed towards real gross domestic product (GDP) growth of 5.28 per cent in 2016-17 (FY17) from 3.68 per cent four years ago, with the size of the economy surpassing US$300 billion (S$412.27 billion). This optimism has been backed by a step-up in China Pakistan Economic Corridor (CPEC)[2] led investments, an improvement in the country's credit

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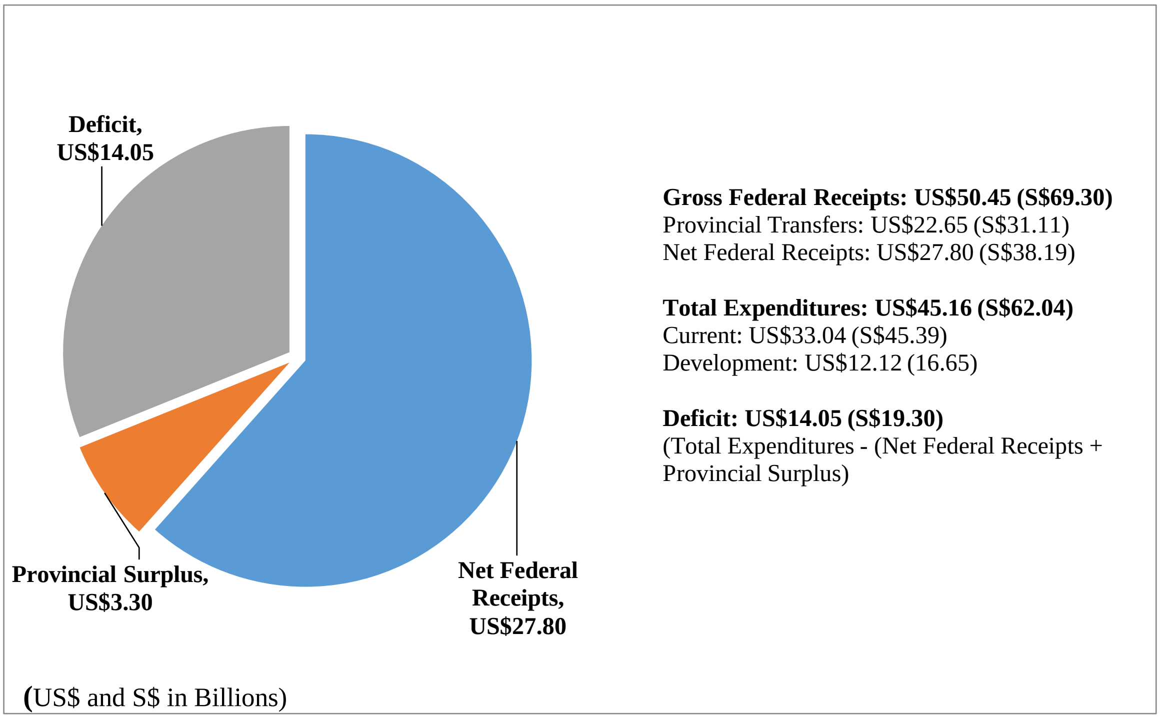
[2] China Pakistan Economic Corridor (CPEC) is a collection of infrastructure projects across Pakistan, aimed at boasting regional connectivity, currently valued at US$62 billion (S$85.1 billion).

rating,[3] and positive predictions from the International Monetary Fund (IMF) and Price Waterhouse Coopers about the country's future outlook.

<u>Figure 1</u>: FY18 Budget Outlays = $45.16 billion (S$62.04 billion)



Source: Ministry of Finance and Budget Documents

The economy has indeed seen a consistent improvement over the last four years. Yet, an inspection of the budget document offers a bleak picture of the country's financial health. This discrepancy points to the fundamental problem of a revenue-expenditure imbalance. A deficit occurs when the federal government's expenditures are in excess of its revenues. Figure 1 shows that, in this financial year, the government estimates a deficit of US$14.05 billion (S$19.3 billion) or 4.1 per cent of GDP, up from US$13.11 billion (S$18.01 billion) in FY17.

In comparison to the largest economies in the world, Pakistan, with a much smaller economy, has a high fiscal deficit (Table 1).[4] Within South Asia, Bangladesh and Sri Lanka are also struggling to contain deficits. The IMF, on the other hand, has cautioned that Pakistan's deficit

[3] "Pakistan's B3 Rating". *Moodys.Com*, 2016, https://www.moodys.com/research/Moodys-Pakistans-B3-rating-reflects-strengthening-growth-progress-on-structural--PR_347953.
[4] "Government Budget – Countries – List." *Tradingeconomics.Com*, 2017, https://tradingeconomics.com/country- list/government-budget.

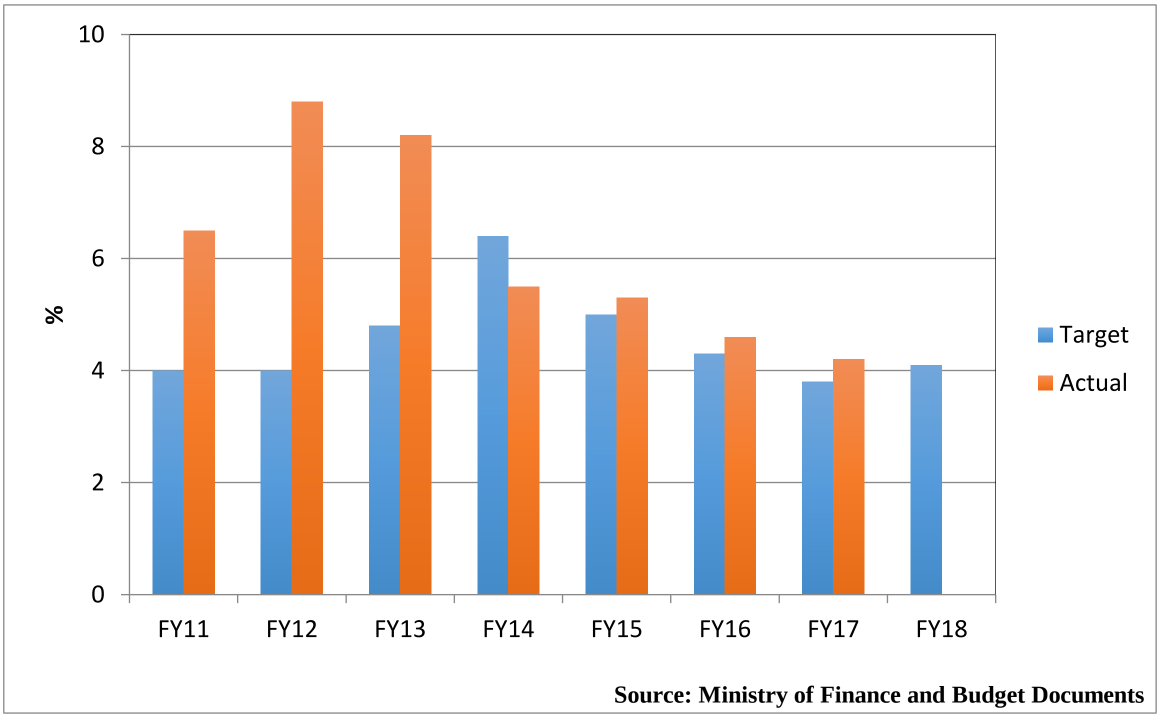
may reach US$14.36 billion (S$19.73 billion) or 4.5 per cent of GDP.[5] Successive governments have in the past missed deficit targets, so this may well be the case. If that happens, it will be the first time after FY11 that deficits start to rise again (Figure 2).

Table 1: Comparison of Fiscal Deficits (% of GDP) with other countries

Country	Fiscal Deficit (% of GDP)
United States	-3.2
India	-3.5
China	-3.8
Pakistan	**-4.2**
Bangladesh	-4.7
Sri Lanka	-5.4

Note: Figures to Dec 2016

Figure 2: Fiscal Deficit - Target and Actual (% of GDP)



Source: Ministry of Finance and Budget Documents

[5] "Budget Deficit Target Likely To Be Set At Rs. 1.44 Tr". Profit, 2017, https://profit.pakistantoday.com.pk /2017/04/18/budget-deficit-target-likely-to-be-set-at-rs1-44tr-for-fy-2017-18/.

This paper seeks to understand the inconsistency between economic growth projections and the fiscal imbalance highlighted in the budget. It takes an in-depth look at both revenues and expenditures of the federal government, in order to capture the vulnerabilities that perpetuate deficits and threaten the country's financial health.

Revenues

In FY18, the gross revenue receipts (tax and non-tax revenue) of the federal government are budgeted at US$50.45 billion (S$69.30 billion), an increase of 12.1 per cent over revised estimates of FY17. Out of this, US$22.65 billion (S$31.11 billion) shall be transferred to provinces under the National Finance Commission Award.[6] The total available resources of US$31.10 billion (S$42.72 billion) include net revenue receipts and estimated provincial surplus that shall be transferred back to the central government (Figure 1).

Revenue receipts of the government are comprised of tax and non-tax revenues. Between the two, the major component is tax revenues, making up 81.5 per cent of gross revenue receipts. This makes them crucial for the smooth running of the government. However, governments have traditionally struggled to meet revenue targets. In this financial year, the government aims to collect tax revenues of US$41.14 billion (S$ 56.51 billion), up by 9.5 per cent from budget estimates of FY17 – a target it missed by US$1.24 billion (S$1.70 billion).

Tax revenues remain low and underutilised in Pakistan. Despite recent improvements, the tax-to-GDP ratio stands at 12.4 per cent, below the average for emerging market economies.[7] The improvements have come from higher rates on non-compliant individuals and withdrawal of tax concessions. Therefore, the underlying weaknesses in the revenue system have not been addressed, which leaves limited scope for a radical improvement in the ratio. Five fundamental issues that explain low revenue generation are briefly discussed below:

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[6] The National Finance Commission was established under the constitution for the equal distribution of resources between the federal and four provincial governments of Pakistan.

[7] Hussain, Tehreem. "Untaxed Sectors: Reforms Needed To Boost Tax-To-GDP Ratio". *The Express Tribune*, 2016, https://tribune.com.pk/story/1175997/untaxed-sectors-reforms-needed-boost-tax-gdp-ratio/.

1. Narrow tax base:

The small number of taxpayers in the country is one of the key reasons for low revenues. The most recent figures released by the Federal Bureau of Revenues (FBR) note that only 1.9 per cent of the population is registered for income tax, about 60 per cent of the potential tax base. Of this, only 0.45 per cent filed a tax return, corresponding to 15 per cent of the potential tax base. Among those who filed a tax return, 0.24 per cent of the population or 534,000 citizens actually paid taxes. In addition, only 37,000 Pakistanis paid more than US$5,000 (S$6,869) in personal income tax per annum.[8]

2. Revenues skewed towards indirect taxes:

In the budget document understudy, the FBR taxes include direct and indirect taxes. In FY18, indirect taxes (sales tax, customs duties, and federal excise) are estimated to be US$22.97 billion (S$31.55 billion) or 55.8 per cent of total taxes receipts. Sales tax is the single largest revenue-generating source for the government – it is expected to contribute 66.4 per cent to indirect taxes and 37 per cent to total tax revenues this year. There are two problems with a heavy reliance on indirect taxes. Firstly, they are regressive in nature, as they equally impact the poor and rich. Secondly, the government collects indirect taxes from a narrow base focusing on imported goods (for example, petroleum, oil and lubricants, food items and capital goods) thus making revenues vulnerable to fluctuations in import prices.[9]

3. Extensive tax concessions:

The generous concessions in the tax system in Pakistan lead to horizontal and vertical inequalities.[10] At the same time, complex tax laws increase enforcement costs while also encouraging non-compliance and evasion. Tax expenditures reached their peak of 1.9 per cent of GDP in 2014.[11] Since then reforms introduced by the government have led to the elimination

8 Sherani, Sakib. "Ultimate Tax Haven". *DAWN*, 2016, https://www.dawn.com/news/1258002.

9 Cevik, Serhan. *Unlocking Pakistan's Revenue Potential*. IMF, 2016, p 6.

10 Horizontal inequality between taxpayers emerges when concessions allow people with similar incomes to pay different amounts of taxes depending on whether they engage in tax-subsidised activities. Vertical inequality occurs when not all taxpayers qualify for tax reductions or disproportionately benefit those at higher taxable income level. For more see: *Why Worry About Tax Expenditures?*.World Bank, 2003, p 2, http://www1.worldbank.org/prem/PREMNotes/premnote77.pdf.

11 Cevik, Serhan. *Unlocking Pakistan's Revenue Potential*. IMF, 2016, p 8.

of some exemptions, amounting to 0.6 per cent of the GDP, but there is room for further reductions.

4. Large informal economy:

Significant revenue losses are incurred due to informal economic activity and under-reporting of formal income. This problem is exacerbated by lack of proper documentation throughout the economy. For instance, it is a common practice in the Food and Beverages, Construction and Retail sectors to produce a 'temporary bill', so consumers avoid paying tax on goods or serviced purchased while businesses can avoid income tax by not recording the sale. This leads to the presence of a large informal economy. Estimates suggest it may range from 74 to 91 per cent of the formal economy.

5. Weak revenue administration:

The main tax revenues for the central government come from personal and corporate income tax and indirect taxes such as sales tax, customs and excise duties etc. Weak administration prevents revenue mobilisation because legal checks and balances are missing and revenue officials are coerced and bribed by powerful individuals and businesses that do not want to pay taxes. This leaves officials with little or no incentive (or protection from the law) to collect revenues. At the same time, central government transfers revenues to provinces. Each year 45-55 per cent of gross revenues are transferred to provinces. Even though provinces have substantial potential revenue sources in the form of agriculture and property tax, the reliance on central government revenues discourages mobilization of revenues at the provincial level. As a result, approximately 92 per cent of the country's total tax revenues are collected by the central government.[12]

These interconnected issues plague the taxation system and in turn the revenue generation capacity of the government. Despite recent improvements in the tax-to-GDP ratio, the government will need to address these fundamental shortcomings to reach the true revenue potential of the country. Until now, successive governments have not found it politically

[12] Cevik, Serhan. *Unlocking Pakistan's Revenue Potential*. IMF, 2016, p 5.

feasible to address them and similarly this election year budget is also devoid of necessary and painful measures to correct the taxation system.

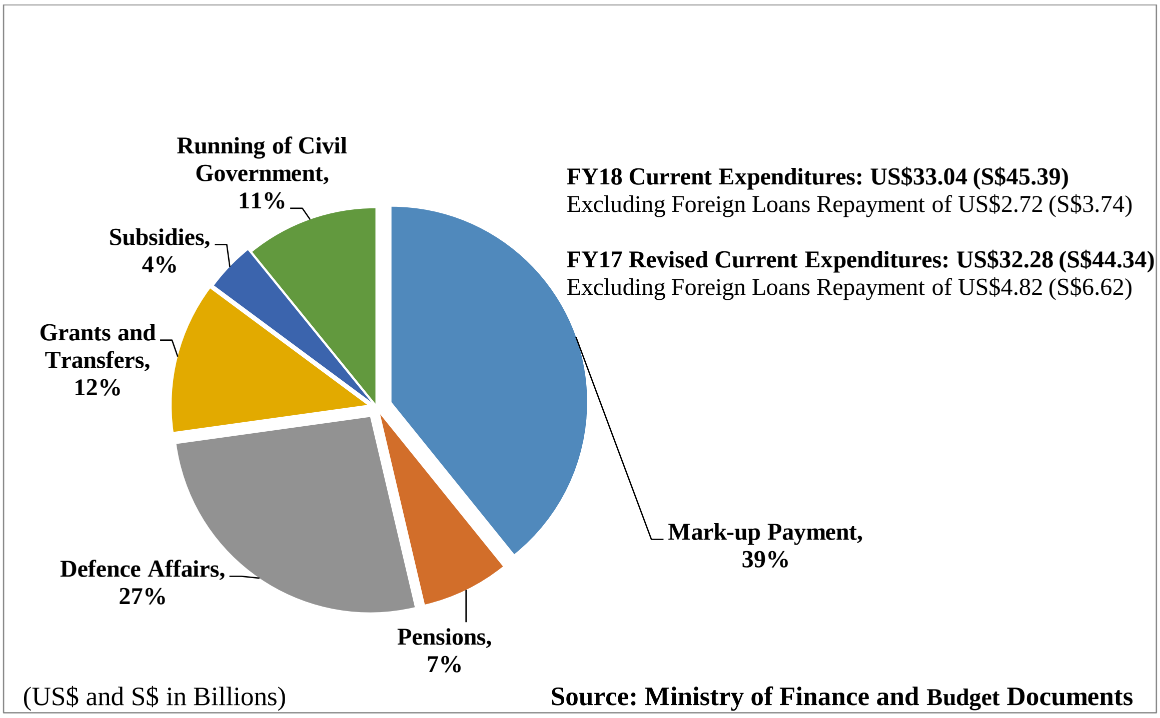
Expenditures

Federal expenditures are estimated at US$45.16 billion (S$62.04 billion) of which current and development expenditures are estimated to be US$33.04 billion (S$45.39 billion) and US$12.12 billion (S$16.65 billion) respectively. While current spending has increased by only two per cent, development spending is over 25 per cent higher compared to revised estimates of FY17.

Development expenditures include spending by the government on federal programmes, including development loans and grants to provinces. The Public Sector Development Programme (PSDP) is the main instrument of the government for projects and investments across the country and this year estimates highlight the special emphasis placed on development spending. Federal Public Sector Development Programme (PSDP) is estimated at a record US$9.51 billion (S$13.06 billion), 40 per cent higher than FY17's revised estimates.

Current expenditures on the other hand include key categories such as mark-up payments, defence, operational expenditures and subsidies. Figure 3 shows that the highest among these is mark-up on government borrowings, contributing to 39 per cent of current expenditures. The main expense categories have been tightly capped, with current expenditures increasing by only US$0.76 billion (S$1.04 billion) from revised budget estimates of FY17.

<u>Figure 3</u>: Summary of FY18 Current Expenditures



Source: Ministry of Finance and Budget Documents

While it is clear that the government aims to control current spending, the budget strategy document does not reflect long-term planning to reduce expenditures. Therefore, ad-hoc changes may be made throughout the year. These are then reflected in supplementary budgets, presented at the end of the financial year. For instance, a supplementary budget of US$2.95 billion (S$4.05 billion) was presented to the Parliament, along with the FY18 budget.[13] It was asked to approve grants for expenditures made by the government during the year. Although officially the supplementary budget is for unforeseen expenditures but in practice it includes subsidies, discretionary grants by the Prime Minister, purchase of vehicles and various development schemes. This way the government remains flexible with current expenditures as the supplementary budget is presented after the expenditures take place.

[13] Mehboob, Ahmed Bilal. "Law To Regulate Budget". *DAWN*, 2017, https://www.dawn.com/news/1340547/law-to-regulate-budget.

Three key factors explain how high expenditures contribute to the fiscal imbalance:

1. High debt servicing costs:

In the FY18 budget, the biggest category in current expenditures is 'mark-up payments' of US$12.95 billion (S$17.79 billion) on domestic and foreign debt, of which US$11.7 billion (S$16.07 billion) is for domestic debt alone.

Fiscal deficits drive countries to take on debt that in turn increases interest payments. For instance, the FY18 deficit of US$14.05 billion (S$19.30 billion) can be funded through borrowing (debt), taxes or increased fees on government services and money supply. Increasing the money supply or printing notes to pay debt creates inflationary pressures in the economy so it is not always a favourable choice. Charging citizens through increased taxes or fees is a difficult choice, and can prove to be unpopular in an election year. Therefore, governments in developing economies such as Pakistan choose to borrow and finance the deficit.

Persistent budget deficits in the last 70 years have created a vicious cycle of high debt levels and cumulative interest payments that feed into federal expenditures. The rising expenditures and corresponding low revenues then create deficits that are met by taking on more debt. This vicious cycle hampers economic growth as the funds needed for stimulating the economy (through government spending) are spent on servicing debt. In addition, high debt levels make it difficult for the government to raise additional funds. As the debt-to-GDP ratio rises, creditors start to demand higher interest rates for the increased risk they take on. Therefore, interest payments continue to rise.

In the last financial year, the government targeted a debt-to-GDP ratio of 58.1 per cent but revised estimates show that it jumped to 61.3 per cent as the government took on additional debt due of weak export growth and a sudden decline in revenues. In FY18, the government aims to bring down the debt-to-GDP ratio to 59.2 per cent. This may be problematic because of the large fiscal deficit. Therefore, in the short run debt servicing costs are expected to rise.

2. Extensive development spending:

Development expenditures of US$12.12 billion (S$16.65 billion) are driven primarily by CPEC-led projects. For instance, the transport and communications sector, followed by the energy sector will see the largest investments of US$3.9 billion (S$5.36 billion) and US$3.81 billion (S$5.23 billion) respectively. An additional US$1.71 billion (S$2.35 billion) have been set aside for the same initiative.

Since development spending is not met for the country's own resources/revenues, the government has set a target of obtaining foreign loans and grants (federal PSDP and Outside PSDP) of US$7.96 billion (S$10.93 billion). The cost and tenor of external borrowings is not detailed in government documents, which highlights the lack of transparency in the terms negotiated by the government. China has overcome the United States as the biggest lender to Pakistan, slated to provide US$1.59 billion (S$2.18 billion) in FY18. This is 26 per cent higher than FY17. Among provinces, Punjab, the ruling base of the PML-N government is the only one to receive Chinese loan assistance. Of the US$1.11 billion (S$1.52 billion) allocated in loans to Punjab, US$0.89 billion (S$1.22 billion) or approximately 80 per cent are from China. These are for the construction of Orange Line Metro Project, which shall only serve the residents of Lahore.

Apart from international partners and development organisations, the government is also borrowing from commercial lenders. While loans from the former have longer maturity and lower costs, commercial lenders usually charge high interest rates with short tenors. The share of short-term public debt (external) rose from 5.2 per cent in FY15 to 6.2 per cent in FY16. In the last financial year, revised estimates of borrowings from commercial banks were 55.6 per cent above budgeted estimates.

3. Obligatory current expenditures:

Obligatory spending, such as debt servicing, defence, pensions and subsidies are 'inflexible' in nature, making it difficult for the government to cap them entirely. For instance, defence spending is one of the highest expense categories for the government, accounting for 27 per cent of current expenditures this financial year. It is necessitated by the volatile security situation within the country and at its borders. Remarkably, the FY18 budget is set at US$8.74

billion (S$12.01 billion), 9.4 per cent higher than last year. Compared to a historical average of 11 per cent per annum, this is the smallest increase in decades.[14] The government has plugged operating expenditures of defence services – transportation, fuel costs and medical treatment to bring down the budget. However, the current defence budget does not include undeclared expenditures on nuclear and defence arsenal, as well as approximately US$0.95 billion (S$1.31 billion) per annum on security operations.[15] Therefore, there may be an upward revision of this category during the year.

Subsidies are another important component of current expenditures. During FY17, the government spent US$1.60 billion (S$2.20 billion) in subsidies, an increase of 20 per cent from budget estimates. In the FY18 budget, it has removed US$0.24 billion (S$0.33 billion) fertilizer subsidy and brought down overall spending in this category by US$0.29 billion (S$0.40 billion). Power and wheat subsidies have been reduced slightly but remain in place. Given the nature of these subsidies, this expense category is unpredictable and political pressures often sway the government to introduce new ones during the year.

Overall, the government aims to keep current expenditures at 15 per cent of GDP. While appreciable attempts have been made to control spending in some categories e.g. removing fertiliser subsidy and capping of operational expenditures of defence services, the biggest expenditure categories such as interest payments are expected to increase as the government funds deficits and development projects with borrowings, while obligatory expenditures remain unpredictable.

Conclusion

Persistent structural problems and lack of fiscal discipline affect both revenues and expenditures of the government. CPEC-led development initiatives, combined with a stable democratic government have encouraged economic growth in the last four years but large fiscal deficits, as seen in FY17 and FY18 budget, threaten to stem this momentum. Weak revenues, debt-dependent investments and ballooning interest payments will further increase deficits and put pressure on the economy, unless the government course corrects immediately.

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[14] DAWN. "Defence Gets Lowest Hike In Decades". 2017, https://www.dawn.com/news/1335734.
[15] Ibid.

Enhancing revenues of the central and provincial governments must be the first priority. This will come through expansion of the tax base, countering non-compliance and strengthening of revenue administration. As economy-wide checks and balances increase, greater documentation will allow more individuals and businesses to become part of the formal economy. Without multi-pronged revenue generating strategies, fiscal problems shall not be resolved.

Controlling expenditures needs an equal emphasis and will arguably be more difficult due to obligatory expenditures such as defence and political pressures to continue subsidies. The country's public debt is rising, with interest payments at 39 per cent of current expenditures. In the short run, the government will need policies that control current expenditures, such as food subsidies, reduction in number of civil government personnel, pension cuts etc. Other expenditures included in the supplementary budget such as Prime Minister's publicity campaigns, development scheme for Parliamentarians need to reviewed and controlled as well. Revenue enhancements with stringent control of expenditures will lower pressure on the government to finance deficits through borrowing, but other strategies including deepening of the local debt market may also be required.

Lastly, this analysis points to the fact that the budgetary process is haphazard; it is not geared toward reforming the economy and maintaining fiscal discipline. The process needs an overhaul, with greater input and coordination between financial institutions and policy makers in the government. Only then can Pakistan hope to achieve sustained economic growth.

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