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Fiscal Imbalances as an Obstacle to Privatization Effort

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I. INTRODUCTION

Pakistan has been pursuing privatization policies including market liberalization and divestiture of public corporations for the last ten years with a view to raising levels of investment and improving efficiency levels. However, privatization efforts so far have not been very successful in increasing the level of investment in the country. The failure of privatization to boost investment in general, and private investment in particular, is generally attributed to an ambivalent attitude of the government towards privatization. It is argued that even though import and export policies have been liberalized, investment sanctioning requirements have been by and large waived and price controls have been lifted, yet the trade regime continues to be restrictive, the establishment of large industrial projects remain subject to investment sanctions and price controls can be invoked on one pretext or another. Moreover, despite the government's pronouncements no public sector corporation could be divested during the last few years. These cast serious doubts on the efficacy of the government's privatization policy.

Privatization, defined broadly, may not be restricted to just divestiture; it encompasses all such measures which aim at the enhancement of efficiency levels in the economy by restricting the size of government economic activities and indirect public intervention in the economy. It, therefore, is significant to examine the privatization policies of the government with a view to determining whether the private investment was in fact encouraged by the privatization policies or not. It is argued that even if liberalization and divestiture policies are pursued vigorously, the government's other policies, particularly the huge fiscal deficit, would nullify the positive impact of such policies on private investment. Accordingly, it is explored in this paper to what extent efforts to enhance private investment through privatization policies have been successful in Pakistan and to what extent growing fiscal deficits have been responsible for the failure of such policies.

The paper is divided into five sections. Section II examines privatization policies pursued in the Eighties. Trends in fiscal deficits, private investment and the transfer of private savings to the public sector are explored in Section III. The effect of fiscal deficits both directly and through credit rationing indirectly on private investment is analyzed in Section IV. The Main conclusions of the study

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are summarized in the final section.

II. PRIVATIZATION POLICIES IN PAKISTAN*

Privatization policies pursued by the government of Pakistan may be classified into two broad groups. The first includes policies such as liberalizing trade regimes, easing investment licensing and extending lavish incentives to the private investors. The second relates to complete or partial divestiture of public investment. All these measures aim at enhancing the profitability of private enterprises and opening up of new areas for the private sector. In this section, privatization policies are examined with a veiw to ascertaining whether they have raised the profitability and/or opened new vistas for private investment or not. It also includes discussion of various measure taken by the government. For a detailed review, [see Heald (1989); Kemal (1989) and UNDP (1989)].

Trade regimes have always been restrictive in Pakistan. While import substitution industries grew at a rapid rate in their initial stages, the high growth rates could not be sustained because of limited domestic demand and slow growth of exports mainly due to low efficiency levels. Besides, imports of a number of intermediate goods were not allowed and as such the industries based on such inputs could simply not be established in the country. Restrictions on the import of capital goods had similar results. However, over the last five years, the negative list of import policy has been reduced by 50 percent and restrictions on imports of other goods have been removed. It is, therefore, obvious that the easing of trade regimes must have helped investments into a large number of industries.

Besides trade liberalization four other privatization measures may have boosted private investment. Firstly, exempting all but three types of industries and all projects not exceeding Rs 1000 million from investment licensing. Second, simplification of investment sanctioning procedures; the government has set up a Board of Industrial Investment under the chairpersonship of the prime minister which meets regularly every month and promises the decision on the approval of a project within three months. Third, opening new areas of investment to the private sector; for example, chemicals, light and heavy engineering, automobiles, petrochemicals, petroleum refining, vegetable ghee and cement not allowed to private sector since 1972 when they were nationalized, have been opened to the private sector. Moreover, private investment has also been encouraged in the other sectors including energy and transport. Fourth, extremely liberal tax incentives in the form of tax holidays, tax credits and depreciation allowances have been provided to raise post-tax profits. Moreover, the tariff structure has been rationalized and institutional reforms have been effected for prompt removal of fiscal anomalies.

Divestiture policies have been pursued in Pakistan to realize different objectives including increases in the efficiency of operations, the alleviation of fiscal deficits

and the broad-basing of equity capital. The post-tax rate of return on equity in the public sector during the Eighties has averaged around only 5 percent – well below both the interest rate government offers on its financial instruments and the average return on equity in the private sector. Such low rates of return despite heavy protection indicate gross inefficiency in the public sector operations. Therefore, the government decided to divest a number of firms in the mid-Eighties. With a view to expediting this the government also established a National Disinvestment Authority in 1988. The authority did identify 14 loss-making industrial units with assets of Rs 1464 million for disinvestment but these units could not be divested due to a number of actions (or inactions) on the part of both the private investors and the government. The investors in Pakistan seem to have a short horizon, and as such are interested in buying only those units which are already making profits. They do not seem to be interested in buying loss-making units at lower prices and making profits later through improvements in productivity. Besides the private sector is scared away by the employment of excessive labour in the units which they find difficult to get rid of after the take-over. Moreover, public corporations have incurred huge debts which need to be settled. Furthermore, the sale prices of these industrial units fixed by the government exceeds substantially their replacement costs. It is, therefore, no wonder that government's efforts to denationalize loss-making units have failed.

Besides complete divesture of loss-making units, the government has also announced sale of public shares amounting to Rs 2 billion in 1985, but has failed to divest any equity so far. Government has recently announced the divesture of minority shares of six profit-making units. It also intends to broad-base equity shares through divestiture. A divestiture policy which aims at providing only minority shares has failed to excite the private businessmen, see UNDP (1989). Similarly, effective broad-basing of equity capital in a country with low per capita incomes may turn out to be wishful thinking.

Despite the fact that the trade regime continues to be restrictive and big industrial projects still require approval, there has been a considerable liberalization of the market and the options of the private investors have been considerably widened. The present environment is definitely more conducive to private investment than that prevailing a decade ago. Therefore, demand for private investment must have gone up considerably. However, higher desired levels of investment has not led to higher levels of investment in Pakistan.

III. TRENDS IN PRIVATE INVESTMENT AND FISCAL DEFICIT

Private investment as a percentage of both the GDP and total investment fell in the first half of the Seventies when the government nationalized a large number of the manufacturing industries. However, the adoption of privatization policies

in 1977-78, led to a substantial increase in the share of the private sector by the early Eighties. However, private investment as a percentage of GDP failed to increase during the Eighties.

Table 1 shows that share of private investment which had declined rather sharply from 54.8 percent in 1970-71 to 32.1 in 1974-75 rose to 39.3 percent by 1979-80. Even though it did slip down in the early Eighties, it shows a rising trend since 1981-82. On the other hand, after a sharp increase in the ratio of private investment to GDP from 4.6 to 6.3 percent in the second half of the Seventies, the share of the private sector in GDP has stagnated around that level throughout the Eighties. The somewhat constant ratio of private investment to GDP contrasts sharply with the expected sharp increase in private investment due to privatization policies recounted in the preceding section.

While the government pursued privatization policies in the Eighties, budgetary deficits continued to grow rather sharply. To some extent, the growing budgetary deficits are a reflection of tax exemptions granted to encourage private investors. The slow growth of public revenues and sharp increase in non-development expenditures despite a fall in public investment resulted in sharp increases in the overall fiscal deficit.

Table 1

Trends in Investments

Years	Share in Total Investment		Share in GDP	
	Private	Public	Private	Public
1960-61	57.9	42.1	7.6	5.5
1965-66	54.8	45.2	9.7	8.0
1970-71	50.1	49.9	7.0	6.9
1974-75	32.1	67.9	4.6	9.8
1979-80	39.3	60.7	6.3	11.3
1980-81	39.3	60.7	6.1	9.4
1981-82	36.4	63.6	5.6	9.7
1982-83	38.4	61.6	6.0	9.6
1983-84	40.4	59.6	6.1	9.0
1984-85	41.4	58.6	6.2	8.7
1985-86	41.2	58.8	6.1	8.7
1986-87	40.7	59.3	6.3	9.2
1987-88	42.1	57.9	6.2	8.6

Source: Based on data obtained from Economic Survey (Various Issues).

Table 2 shows that fiscal deficits have assumed alarming proportions during the Eighties. These growing deficits have necessitated the resource flow from private sector to public sector especially because of the limited availability of external resources for financing the budgetary deficits. That there has been a huge net transfer of resources – equalling to one-half of private savings from the private sector to the public sector – is quite obvious from Table 3. The enhancing of

Table 2

Fiscal Deficits in Pakistan

Years	Fiscal Deficit as Percentage of GDP	Budgetary Support as Percentage of GDP
1980-81	5.3	0.8
1981-82	5.3	1.7
1982-83	7.1	1.7
1983-84	6.0	1.9
1984-85	7.7	3.9
1985-86	7.6	1.2
1986-87	7.7	1.9
1987-88	8.6	2.0

Source: Economic Survey (Various Issues).

Table 3

Net Private Savings, Private Investment and Transfers from Private Sector

Years	In Million Rs			As Percentage of GDP		
	Private Savings	Private Investment	Net Out flow from Private Sector	Private Saving	Private Investment	Net Out-flow from Private Sector
1980-81	33,083	24,608	8,475	11.9	8.8	3.1
1981-82	38,747	28,570	10,117	12.0	8.8	3.4
1982-83	58,423	31,225	27,198	16.0	8.8	7.4
1983-84	60,991	36,412	24,579	14.5	8.7	5.8
1984-85	64,192	41,573	22,619	13.6	8.8	4.8
1985-86	80,809	45,959	34,850	15,7	8.9	6.8
1986-87	104,932	50,682	54,250	18.3	8.9	9.4
1987-88	111,410	58,702	52,708	16.6	8.8	7.8
1988-89	127,797	70,179	57,618	16.5	9.1	7.4

profit rates on private investment and matching it with higher return on its own financial assets only resulted in a higher cost of debt servicing without any positive impact on private investment.

IV. OVERALL BUDGETARY DEFICIT, CREDIT EXPANSION AND PRIVATE INVESTMENT

That the overall budgetary deficit has assumed grave proportions and that it has led to huge capital transfer from private to the public sector are evident from Tables 2 and 3. The transfer has been effected both directly through the sale of government financial instruments and indirectly through the advances of the banking sector to finance the budgetary deficits.

Table 4 clearly brings out the fact that not only the public sector has been instrumental in pre-empting large amounts of private savings, but also relied rather heavily on bank financing. Given the government's preference to contain the money supply for price stability, it has had serious implications for credit availability to the private sector.

Money supply and credit are controlled by the State Bank through a credit plan rather than by resorting to changes in bank rate, reserve requirements or open-market operations. Credit expansion is controlled by setting targets of credit expan-

Table 4

Financing of Budgetary Deficit

Years	Financing of Budgetary Deficit (Million Rs)				As Percentage of Overall Budgetary Deficit		
	Overall Deficit	External Financing	Non-Bank Financing	Bank Financing	External Financing	Non-Bank Financing	Bank Financing
1980-81	14,618	7,741	4522	2355	53.0	30.9	16.1
1981-82	17,175	5,645	6014	5516	32.9	35.0	32.1
1982-83	25,639	5,700	13810	6129	22.2	53.9	23.9
1983-84	25,153	4,894	12393	7866	19.5	49.3	31.3
1984-85	36,777	5,169	12873	18735	14.1	35.0	50.9
1985-86	41,644	10,971	24575	6098	26.3	59.0	14.6
1986-87	46,710	9,522	26273	10915	20.4	56.2	23.4
1987-88	57,563	13,272	30350	13941	23.1	52.7	24.2
1988-89	51,170	15,000	32424	3746	29.3	63.4	7.3

Source: Based on Economic Survey data (Various Issues).

sion by each financial institution and implementing it through administrative controls. Since the main consideration of the government has been to contain the expansion of money supply within safe limits, the increase in credit to finance budgetary deficit implies a reduction in the availability of credit to the private sector. Trends in money supply, budgetary support and private credit presented in Table 5 show that the increase in credit for budgetary support slowed down the increase in credit to the private sector.

Table 5

Budgetary Support and Credit to Private Sector

Years	Increase in Money Supply	Budgetary Support	Credit to Private Sector
1980-81	12197	5568	6635
1981-82	11889	6756	8986
1982-83	29515	9199	10923
1983-84	17242	7513	15176
1984-85	20638	18273	13919
1985-86	27206	8623	19355
1986-87	28912	10612	21252
1987-88	29321	18324	21799
1988-89	12681	8004	18183

Source: Economic Survey (Various Issues).

In order to assess the impact of fiscal deficits on private investment it has been postulated that the budgetary deficit affects credit availability to the private sector which in turn is a major factor in determining the level of private investment. In order to analyze the impact of the budgetary deficit it has alternatively been proxied by overall budgetary deficit, bank financing of the budgetary deficit and total domestic financing of the deficit. Accordingly, a two-equation recursive system has been set up as follows:

$$CR = F(OD, D_{78}) \quad \ldots \quad \ldots \quad \ldots \quad \ldots \quad (1)$$

$$Ip = F(Y, Ig, CR, D_{78}) \quad \ldots \quad \ldots \quad \ldots \quad \ldots \quad (2)$$

where

Ip = Private Investment;

Ig = Public Investment;

Y = Change in GDP;
CR = Growth rate of credit; and
D_{78} = Dummy variable taking value equal to one for years from 1977-78 to 1987-88.

In Equation (1), *OD* is alternately defined as the budgetary deficit financed by the banking sector (*BD*) and the budgetary deficit financed domestically (*TD*). The impact of the budgetary deficit on private investment in the manufacturing sector (*IMp*) has also been analyzed.

The results show that the model fits the data quite well. A very high proportion of variations both in the change in credit and private investment has been explained by the variables postulated earlier. The relationship between credit and budgetary deficit turns out to be negative and significant irrespective of the definition of the budgetary deficit employed.

Change in income, credit to private sector and public investment are positive and significant variables in explaining variations in private investment. Moreover, public investment is complementary to the private investment but in the manufacturing sector, the two are negatively related. It, therefore, follows that constraining aggregate public investment instead of raising the level of private investment in fact, may lower the aggregate private investment. Therefore, the focus should be on restricting public investment in the manufacturing sector only rather than restricting aggregate public investment.

Credit is positively related to aggregate private investment and to private investment in the manufacturing sector. Since the deficit in the budget is negatively related to credit availability to the private sector, it implies that budgetary deficits have a negative impact on private investment.

The most surprising result of the study is that the dummy variable has a negative sign and is significant in case of aggregate private investment. However, the coefficient is insignificant in case of private investment in the manufacturing sector though the sign remains negative.

The preceding discussions lead us to an unmistakable conclusion that the budgetary deficits have had a significant negative impact on private investment. It is a pity that while the privatization initiatives resulted in higher profitability, they did not lead to higher private investment because of credit constraints necessitated by the huge budgetary deficits. It brings out basic inconsistencies in public policy. Moreover, higher desired investment levels generated higher demand for credit but because of the restraints on credit it had to be rationed. Consequently, privatization has become a source of patronage and corruption rather than an instrument of promoting private investment.

V. CONCLUSIONS

The main findings of the study are summarized below:

(i) Even though trade policies and investment sanctioning policies are still restrictive they have been considerably liberalized over the last ten years. The liberal policies along with lavish incentives to private investment has enhanced the private profitability and hence the demand for investment;

(ii) The divesture policies have not met with success due to ambivalent attitude of the government;

(iii) The budgetary deficits have grown rather sharply necessitating huge resource transfers from the private to the public sector. The budgetary deficits have not only crowded out investible funds from the private sector, but have also pre-empted large amounts of bank credits;

(iv) The budgetary deficit has led to considerable slowing down of the increase in credit to the private sector;

(v) Public investment is positively related to private investment. However, public investment in the manufacturing sector leads to lower private investment in manufacturing. Accordingly, rather than restricting public investment focus should be on the changes in composition of public investment;

(vi) The limited availability of credit to the private sector has constrained the growth of private investment; and

(vii) The increase in demand for credit due to enhanced profitability on private investment on the one hand and the limited availability of credit on the other has led to credit rationing. This leads to an unmistakable but rather unfortunate conclusion that privatization instead of leading to higher level of investment and efficiency has become an instrument of corruption and patronage.

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Comments on "Fiscal Imbalances as an Obstacle to Privatization Effort"

Dr Kemal's paper discusses a topical issue of relevance not only to Pakistan but in a global context as well. The push for privatization comes, although in different forms, from all parts of the world – the industrial countries, the 'socialist and centrally planned' economies and LDCs. The paper is a much needed contribution at an appropriate time.

The paper argues that despite some liberalization of trade and investment sanctioning policies and incentives to private investment over the last ten years, as well as divestiture policies, the fiscal deficits have constrained the growth of private investment by limiting the availability of credit to the private sector. In other words, the positive effect of privatization has been nullified by fiscal policy.

Although Dr Kemal recognizes that the trade regime continues to be restrictive and big industrial projects subject to investment approvals, he still concludes that the demand for private investment must have gone up considerably. What he perhaps ignores is other factors in the investment environment such as realities of labour laws and practices, subsidized access to credit resources, wage and price controls, the overall regulatory environment – all of which create special problems – not to mention the law and order and political situation. Accordingly, the positive effect on investment may be less than has been claimed for these reasons.

Similarly, divestiture has been more difficult and less than was expected. For example, 14 loss-incurring industrial units could not be divested for various reasons. Successful divestiture releases pressures on the budget. Its partial success, therefore, is a drain on budget and credit resources on the one hand adding to fiscal imbalance, and on the other dampening the increase in demand for investment. In fact, there is a need for a case by case study of losers. Some may need to be liquidated (those that will never succeed), some rehabilitated, some partially privatized, some totally. If this distinction is not made, private investment may not increase irrespective of fiscal imbalances. This has not been discussed by the author. A related minor point is that investors in Pakistan may not have a short horizon as claimed, but may have the right perception that they will never make profits.

The final conclusion of the author that privatization has become an instrument of corruption and patronage is not focussed. It is not privatization *per se* but credit rationing which has led to this.

The conclusion of the author that public and private investment are complementary on the whole but substitutes in manufacturing is an important one but has not been substantiated. A greater disaggregation of data and a deeper analysis would be helpful.

A minor point is that the author has not highlighted why public revenues have grown so slowly.

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