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Political Economy of Fiscal Reforms in the 1990s

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1. INTRODUCTION

Throughout the decade of the 1990s, major emphasis in Pakistan remained on fiscal reform as a part of the reform programmes undertaken by the various governments of Pakistan. Fiscal reform assumes significance considering the high budget deficits that Pakistan has been experiencing. These have added to Pakistan's total debt burden in general and external debt in particular. Increase in the burden of debt adds to debt-servicing expenditure which further feeds back into the issue of high fiscal deficit. Debt-servicing increased to almost 47 percent[1] by the middle of the decade of 1990s and comprised 8.3 percent of the GDP, up from less than 1 percent mid-1960s. Pakistan's external debt at over $32 billion[2] in 1998 was 41 percent of its GNP which was amongst the highest in the South Asian region with India's at 20 percent of GNP in the same year and Sri Lanka's also at 41 percent[3] of its GNP.

In this paper, we attempt to explore the rationale behind the emphases on the improvement in both the deficit-to-GDP and the tax-to-GDP ratios that have remained the cornerstones of Pakistan's fiscal reform effort in the decade of the 1990s. Section 2 is a discussion of the extent of successes and failures of the fiscal reform effort thus far and explores the relationship between tax generation and budget deficit. Section 3 discusses the impact of expenditures on budget deficit. Section 4 shows the rise in dependence on external sources of financing. Section 5 gives the conclusions.

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[1]Hafiz A. Pasha and Mahnaz Fatima "Fifty Years of Public Finance in Pakistan: A Trend Analysis" in Shahrukh Rafi Khan (ed). 1999. *Fifty Years of Pakistan's Economy*. Oxford University Press, Karachi. p. 210.

[2]The World Bank. 2001. *World Development Report 2000-2001*. Oxford University Press, New York. pp. 314–5.

[3]Ibid.

2. PERFORMANCE EVALUATION OF PAKISTAN'S FISCAL REFORM EFFORT IN THE 1990s

Impact on the Tax-to-GDP Ratios

Pakistan's tax-to-GDP ratio increased from a low of 4.2 percent[4] in 1959-60 to 6.4 percent in 1969-70. By 1979-80, the same ratio increased to 14.0 percent[5] but fell to 11.82 percent[6] in 1990-91. During the decade of the 1990s, there was intensified effort to increase the tax-to-GDP ratio. The measures ranged from increase in the rate of direct taxation so as to shift emphasis from indirect to direct taxes to even decrease in the rate of direct taxes when the former did not yield the desired results. The latter measure was taken with a view to increasing the share of direct taxes by broadening the tax base. While the share of direct taxes in total taxes did increase significantly, the tax-to-GDP ratio did not increase significantly during the 1990s. Rather, the tax-to-GDP ratio ranged between 10.48 percent in FY1999 to 12.26 percent in FY1995-96. However, the share of direct taxes in total taxes increased from 16.6 percent in 1990-91 to 25.7 percent in 1993-94 to 36.4 percent in 1998-99. This share of direct taxes fell to 32.9 percent again by 2000-01 despite an intense tax reform programme undertaken under the auspices of the military government that assumed office in October 1999. Even the growth rate of direct taxes turned negative in the FY2000 following which direct taxes increased by 21.9 percent in FY2001 mainly because the base had shrunk the previous year. This was, however, not comparable with the growth rates of direct taxes experienced in FY1992, 1993, and 1994 when these exceeded 30 percent in each one of the three years mentioned. While the overall tax-to-GDP ratio did not record an impressive increase during the decade of the 1990s, the direct tax-to-GDP ratio did increase steadily and significantly from 1.96 percent in FY1991 to 3.86 percent in FY2001. As mentioned earlier, the share of direct taxes in total taxes also increased from 16.6 percent in FY1991 to 32.9 percent in FY2001. While the share of indirect taxes in total taxes decreased accordingly, there was considerable variation in the contribution made by the various types of indirect taxes.

So, one prong of the tax reform strategy was to shift emphasis to direct taxes. The other prong was to incorporate the requirements of an internationally liberalising trade regime made mandatory for us under the IMF structural adjustment programmes on conditions more stringent than the WTO's itself. As a part of this condition of IMF's balance of payment support, the import duties had to be reduced whether or not Pakistan's industry was ready for foreign competition on home ground. As the governments of Pakistan complied, the share of import duties in total taxes decreased from 40.8 percent in FY1991 to 15.9 percent in FY2001. The loss in

[4]Hafiz A. Pasha and Mahnaz Fatima. *Op cit*., p. 204.
[5]Ibid.
[6]Our calculations based on.

revenues would be compensated by an increase in the sales tax whose share in total taxes increased from 16.6 percent in FY1991 to 38.3 percent in FY2001. The progressivity in the taxation structure supposedly introduced from a greater share of direct taxes would thus be offset by the regressivity from an increasing share of sales tax. A taxation structure that remains iniquitous would thus not help in broadening the base of taxation significantly. Resistance to tax reform mounted which could partly explain why the tax-to-GDP ratio did not register a significant increase during the decade of the 1990s despite intense tax reform effort. While the effort did result in a significant increase in the direct tax-to-GDP ratio; on the front of indirect taxes, it merely substituted revenues from import duties with revenues from sales tax. As the import duties-to-GDP ratio declined from 4.82 percent in FY1991 to 1.86 percent in FY2001, the sales tax-to-GDP ratio went up from 1.96 percent in FY1991 to 4.49 percent in FY2001. The inability to raise the overall tax-to-GDP ratio was compensated by surcharges from natural gas' and petroleum products' sales. Highest contribution from surcharges at 2.49 percent of GDP came in FY1999 when the tax-to-GDP ratio was at its lowest at 10.48 percent during the period reviewed. The share of surcharges in total revenues was 19.2 percent in FY1999 with the share of petroleum products' surcharge being over 90 percent of the total surcharge in the same year.

The overall policy thrust during the decade of the 1990s was, therefore, to increase the overall tax-to-GDP ratio by focusing on generating a greater share of direct taxes. There was commensurate emphasis on liberalisation. The assumption was that decrease in custom duties would discourage smuggling and would thereby enable higher domestic production that would, in turn, contribute to higher tax generation overall. This assumption did not bear out as it was appeared that smuggling in Pakistan more an administrative issue than a economic issue. By and large, domestic industry was still ill-equipped to compete with imported finished goods. Import duty reduction would, therefore, have an adverse impact on domestic production capability thereby adversely affecting tax revenue generation The upshot, therefore, was a lower share of custom duties which would be offset through a higher share of sales tax and periodically through petroleum surcharge, as reviewed above.

The thrust of the effort remained pretty much the same irrespective of the government in the office. However, the elected governments prior to 1996 resisted a rapid reduction in import duties more than the ones that followed after the caretaker government of 1996-97. A closer look reveals that the share of import duties during the Nawaz Sharif government remained at 4.82 percent of GDP during FY1991 to FY1993. During the first Benazir year of FY1994, the policy was accommodative and the share of import duties fell to 4.27 percent of the GDP. During its second year, the Benazir government resisted the pressure to reduce import duties when their share was at 4.3 percent of GDP in FY1995. It was in FY1996 that the Benazir government yielded somewhat at a time when the government had become too

unstable to continue. The import duty-to-GDP ratio in FY1996 fell to 4.07 percent (Table 1). It is, however, noteworthy that the overall tax-to-GDP ratio had increased to a maximum of 12.05 percent in FY1993 which was the last year of the first Nawaz Sharif government. It fell to 11.65 percent during the first year (FY1994) of the second Benazir government. It rose back by FY1996 which was the last year of this government when it touched 12.26 percent that remains the highest of this ratio achieved during the decade of the 1990s or since the tax reform effort was undertaken. While these governments resisted pressure to reduce import duties significantly, they managed to achieve a steady increase in the ratio of direct taxes-to-GDP. While the first Nawaz Sharif government had managed to increase this ratio from 1.96 percent in FY1991 to 2.68 percent in FY1993, the second Benazir government managed to pull this ratio up from 3.0 percent in FY1994 to 3.51 percent in FY1996. In addition, the second Benazir government had managed to increase the sales tax-to-GDP ratio from 2.04 percent in FY1994 to 2.34 percent in FY1996 which ratio had actually declined during the first Nawaz Sharif government from 1.96 percent in FY1991 to 1.79 percent in FY1993 (Table 1). A rather aggressive pursuit of sales tax and direct tax generation, inter alia, contributed to an erosion of the second Benazir government's popularity eventually resulting in its premature removal. The composition of each tax is given in Table 2.

The above conclusions are also evident from Tables 3 and 4 when the highest average overall tax-to-GDP ratio of 11.95 percent was attained during the second Benazir government (1994–96). While the average direct tax-to-GDP ratio was pulled up to 3.2 percent by the above government, the average import duties-to-GDP ratio had declined marginally to 4.21 percent during the above period. And, the average sales tax-to-GDP ratio had been increased to 2.22 percent by the second Benazir government. During the second Nawaz Sharif government (1997–99), while the average direct tax-to-GDP ratio increased marginally, the average sales tax-to-GDP ratio did not record a significant increase. However, led by the direction given by the caretakers, there was a significant reduction in the average import duties-to-GDP ratio to 2.8 percent. Consequently, the average overall tax-to-GDP ratio declined to 11.08 percent during the second Nawaz Sharif government.

This ratio would then not rise very significantly even under the military government that assumed office in October 1999 even though they started a tough tax drive soon after taking charge. So, even though the average sales tax-to-GDP ratio increased considerably to 4.13 percent during the above period, the average direct tax-to-GDP ratio fell to 3.66 percent. Under the IMF's diktat, the import duties-to-GDP ratio also fell significantly to 1.95 percent. The upshot was the inability to significantly increase the overall tax-to-GDP ratio.

The financial results of FY1997 were influenced by the policies of the caretaker government that had taken charge in the Fall of 1996. Their disposition steered the policy through FY1997 and even beyond as the second Nawaz Sharif

Table 1

Revenue Heads as Shares of GDP, Pakistan's

(Percent)

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02
Tax Revenue and Surcharges	13.12	13.16	13.00	13.24	13.10	13.43	12.65	12.87	12.97	12.20	12.66	13.31
Tax Revenue	11.82	11.81	12.05	11.65	11.95	12.26	11.64	11.11	10.48	11.05	11.71	12.07
Income, Corporate and Wealth Tax	1.96	2.23	2.68	3.00	3.08	3.51	3.58	3.80	3.81	3.45	3.86	3.95
Import Duties	4.82	4.82	4.82	4.27	4.30	4.07	3.38	2.94	2.09	2.04	1.86	1.84
Export Duties	0.48	0.34	0.07	0.06	0.000	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Federal Excise	2.60	2.64	2.68	2.29	2.73	2.34	2.40	2.35	2.11	1.79	1.50	1.40
Sales Tax	1.96	1.77	1.79	2.04	2.28	2.34	2.28	2.02	2.47	3.77	4.49	4.88
Improvements in Tax Administration	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Surcharges	1.30	1.35	0.96	1.59	1.14	1.17	1.02	1.75	2.49	1.15	0.95	1.24
Natural Gas Surcharges	0.55	0.62	0.56	0.59	0.45	0.45	0.22	0.24	0.23	0.32	0.43	0.40
Petroleum Surcharge/Levy	0.75	0.73	0.40	1.00	0.69	0.72	0.79	1.52	2.26	0.83	0.52	0.84
Non-Tax Revenues	4.93	5.24	5.61	5.34	4.14	4.40	3.16	3.91	4.04	4.07	3.41	3.67
Net Capital Receipts	2.53	–0.79	1.38	2.55	1.38	1.42	0.09	2.27	2.23	1.95	2.75	–015
Total External Resources	3.69	4.19	4.10	5.59	4.75	4.28	4.93	4.62	6.25	5.56	6.24	6.89
A. Internal Sources	18.05	14.01	15.38	16.13	14.27	14.65	11.13	14.77	15.24	13.96	14.53	12.26
Budget Deficit as % of GDP	5.86	6.58	7.09	6.54	5.36	5.47	6.37	5.6	3.85	3.9	5.36	5.37

Source: Authors' calculations based on *Economic Survey* Data.

Table 2

Revenue Heads as Shares of Total, Pakistan's

(Percent)

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02
Tax Revenue and Surcharges	1	1	1	1	1	1	1	1	1	1	1	1
Tax Revenue	0.90	0.89	0.92	0.88	0.91	0.91	0.91	0.86	0.80	0.90	0.92	0.90
Income, Corporate and Wealth Tax %of Tax	0.16	0.18	0.22	0.25	0.25	0.28	0.30	0.34	0.36	0.31	0.32	0.32
Import Duties % of Tax Revenues	0.40	0.40	0.40	0.37	0.36	0.33	0.29	0.26	0.19	0.18	0.15	0.15
Export Duties % of Tax Revenue	0.04	0.023	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Federal Excise % of Tax Revenues	0.21	0.22	0.22	0.19	0.19	0.19	0.20	0.21	0.20	0.16	0.12	0.11
Sales Tax	0.16	0.15	0.14	0.17	0.19	0.19	0.19	0.18	0.23	0.34	0.38	0.40
Improvements in Tax Administration	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Surcharges	0.09	0.10	0.07	0.11	0.08	0.08	0.08	0.13	0.19	0.09	0.07	0.09
Natural Gas Surcharges	0.42	0.46	0.58	0.37	0.39	0.38	0.21	0.13	0.09	0.27	0.45	0.31
Petroleum Surcharge/Levy	0.57	0.53	0.41	0.62	0.60	0.61	078	0.86	0.90	0.72	0.54	0.68

Source: Authors' calculations based on *Economic Survey* Data.

Table 3

Periodic Average Revenue Heads as Shares of GDP

(Percent)

	1991-1993	1994-1996	1996-1997	1997-1999	2000-2001
Tax Revenue and Surcharges	13.9	13.25	12.65	12.83	12.43
Tax Revenue	11.89	11.95	11.64	11.08	11.38
Income, Corporate and Wealth Tax	2.29	3.20	3.58	3.72	3.66
Import Duties	4.82	4.21	3.38	2.80	1.95
Sales Tax	1.84	2.22	2.28	2.26	4.13
Surcharges	1.20	1.30	1.02	1.75	1.05
Natural Gas Surcharges	0.58	0.50	0.22	0.23	0.38
Petroleum Surcharge/Levy	0.62	0.80	0.79	1.52	0.68
Total External Resources	4.00	4.87	4.93	5.27	6.23
A. Internal Resources	15.81	15.01	11.13	13.71	13.58

Source: Authors' calculation.

Table 4

Budget Deficit/Tax/PSDP/Debt Ser.-to-GDP Ratios, At a Glance

Year	Budget Deficit-to-GDP	Overall Tax-to-GDP	PSDP-to-GDP	Debt Ser.-to-GDP
1990-91	5.86%	11.82%	6.17%	6.25%
1991-92	6.58	11.81	6.53	6.61
1992-93	7.09	12.05	5.21	7.57
1993-94	6.54	11.65	4.71	8.19
1994-95	5.36	11.95	4.35	7.07
1995-96	5.47	12.26	4.07	7.68
1996-97	6.30	11.64	3.47	8.08
1997-98	5.60	11.11	3.33	9.12
1998-99	3.85	10.48	3.14	9.20
1999-2001	3.90	11.05	3.16	9.86
2000-01	5.36	11.71	2.94	8.87

Source: Authors' calculations.

government elected in the Spring of 1997 took some time before assuming charge of the country's economy. Most notable development was a drastic reduction in the top rate of import duty with the result that the import duties-to-GDP ratio fell to 3.38 percent in FY1997 from 4.07 percent in FY1996. While an attempt was being made to compensate this loss through intense sales tax drive, the sales tax-to-GDP ratio fell to 2.28 percent in FY1997 from 2.34 percent in FY1996. Sales tax could not be pushed hard enough under a business-friendly Nawaz Sharif government. The direct tax-to-GDP ratio increased marginally from 3.51 percent in FY1996 to 3.58 percent in FY1997 as the rates of direct taxes were reduced with a view to increasing the tax base. The assumption was that a decrease in tax rates would raise the tax revenues as the tax base would expand. Since it was not borne out in reality as was the case in the US too during the Reagans' supply-side experiment, the direct tax-to-GDP ratio did not increase significantly, as discussed above. The combined effect of a decrease in the sales tax-to-GDP ratio, a significant decrease in the import duties-to-GDP ratio, and only a marginal increase in the direct tax-to-GDP ratio that could not offset the decrease in the former was that the overall tax-to-GDP ratio fell to 11.64 percent in FY1997 from 12.26 percent in FY1996.

Never again during the decade of the 1990s would the overall tax-to-GDP ratio touch 12 percent. During the second Nawaz Sharif government, it fell steadily from 11.64 percent in FY1997 to 11.11 percent in FY1998 to 10.48 percent in FY1999 which was the lowest in the decade of the 1990s. While the second Nawaz Sharif government complied with the IMF's requirement to reduce the rates of import duties rapidly, it was unable to offset this decrease through significant increase in either direct tax or sales tax. The import duties-to-GDP ratio fell to 2.09 percent by FY1999. While the direct tax-to-GDP ratio did increase to 3.8 percent in FY1998, it remained at 3.81 percent in FY1999 also which was the last year of this government. The more trader-friendly Nawaz Sharif government could not make a dent in the sales tax effort also. The sales tax-to-GDP ratio actually fell to 2.02 percent during FY1998 and then rose to 2.47 percent in FY1999 when no other avenue could be found to increase the tax-to-GDP ratio. Even though this increase was not significant, the second Nawaz Sharif government could achieve this only at the expense of its popularity with its major constituency. However, even though the overall tax-to-GDP ratio fell during the Nawaz Sharif years, no serious problem cropped up with the IMF as the rates of import duties were being reduced in compliance with its strictest conditionality. This is in stark contrast with the FY1996 when the IMF tranche had been held up despite the fact that the overall- and the direct tax-to-GDP ratios were both showing upward trends. The sticky issue at that time was the reduction in import duties which was not in line with the IMF's requirements and thus the tough time given to the then elected government.

Since the overthrow of the second Nawaz Sharif government in October 1999, the military government of General Pervez Musharraf went all out to plug tax

evasion and to increase both direct tax and sales tax revenues. While the direct tax-to-GDP ratio increased only marginally to 3.86 percent in FY2001 from 3.81 percent in FY1999 after actually falling to 3.45 percent in FY2000, the import duties-to-GDP ratio decreased to 1.86 percent in FY2001 after a marginal decrease to 2.04 percent in FY2000 as time had been bought by the new government for this purpose in FY2000. The sales tax effort was pursued more vigorously which resulted in an increase of sales tax to 3.77 percent of GDP in FY2000 and 4.49 percent of GDP in FY2001. However, the overall tax-to-GDP ratio could only be restored to 11.71 percent by FY2001 which was slightly better than its level in FY1997. The income tax returns for FY2001 registered a negative growth of 17.14 percent[7] The total returns filed in the Income Tax department by October 1, 2001, which is the last date for the filing of returns, were 0.87 million as against 1.05 million filed in the previous year.[8] The income tax deposited with the returns also decreased to Rs.1.8 billion in FY2001 from a level of Rs.2.0 billion deposited in the preceding year.[9]

The decade of the 1990s can, therefore, be seen as the one throughout which there was a great emphasis on increase in direct taxes, reduction in import duties, and compensation of the loss in revenue due to the latter through increase in sales tax. The combined effect of the above moves, however, did not make a dent in the overall tax-to-GDP ratio which not only fluctuated between 10.48 percent and 12.26 percent but actually fell from 11.82 percent in FY1991 to 11.71 percent in FY2001. Clearly, there were gaps not just in implementation but also in the taxation policy that was adopted under the influence of the IMF that emphasised rapid reduction in import duties which had been a major source of revenues in a country ill-equipped to increase direct tax collection efficiently and equitably. The effort during the decade of the 1990s can be characterised as one that aimed more at offsetting the loss from import duties' reduction rather than attempting to increase tax revenue generation as such. As is evident from Table 4, while the share of direct taxes increased from 16.6 percent in FY1991 to 32.9 percent in FY2001 and that of sales tax increased from 16.6 percent in FY1991 to 38.3 percent in FY2001, the share of import duties in total taxes fell from 40.8 percent in FY1991 to 15.9 percent in FY2001. The upshot was a bare minimum ability to maintain the overall tax-to-GDP ratio which may be viewed as an achievement given the reduction in import duties. Or, it may be viewed as a failure given the inability to increase direct taxes and/or sales taxes in proportions greater than the decrease in import duties.

It is worth mentioning that the import duty reduction required by the IMF is at a rate higher than that mandated under the WTO agreement. Under the WTO agreement, countries are not allowed to increase tariffs beyond the ceiling which is known as tariff binding. Tariff binding is set higher than the applied rates for developing countries and is given in the Schedule of Commitments for each country.

[7]*Dawn*, October 11, 2001.
[8]Ibid.
[9]Ibid.

While an intense sales tax drive had been undertaken in the middle of the decade of the 1990s, the budget for FY2000-01 focused specially on tax strategy with a view to plugging tax evasion and reforming the CBR. A tax survey was undertaken to determine the actual expenditures of the people and to compare them with their declared incomes. The exercise did not yield the desired results and was then placed on slow burner. It was expected that about Rs 100 billion in taxes would be mobilised through the tax survey in FY2001. State Bank of Pakistan reported that taxes mobilised through the tax survey were limited.[10] The SBP shied away from providing actual figures. As for the CBR reform drive, it was not based on sound principles of change management and was, therefore, not successful.[11] No significant effort could be made even in the direction of agricultural income taxation. The taxation system and structure remained about as inefficient and inequitous[12] as it had been prior to the fiscal reform effort undertaken in the 1990s and intensified around the turn of FY2000-01.

Impact on the Budget Deficits

While the IMF kept emphasising the budget deficit targets as percentage of the GDP, these requirements were more stringent during the second Benazir government (1994–96) than they have been since the caretakers assumed office late-1996. During the caretakers' influenced year of FY1997, the budget deficit-to-GDP ratio increased to 6.3 percent from 5.47 percent in FY1996 as the overall tax-to-GDP ratio fell in FY1997 mainly because of a significant reduction in import duties in that year. However, generally during the decade of the 1990s, there appears to be a lack of a correlation between the overall tax-to-GDP and the budget deficit-to-GDP ratios.

The budget deficit-to-GDP ratios depicted an upward trend during the first Nawaz Sharif government even though the overall tax-to-GDP ratio increased from 11.82 percent in FY1991 to 12.05 percent in FY1993. The budget deficit-to-GDP ratio increased from 5.86 percent in FY1991 to 7.09 percent in FY1993 showing a lack of relationship between tax effort and budget deficit. While the budget deficit-to-GDP ratio fell during the second Benazir government as the overall tax-to-GDP ratio increased from FY1994 to FY1996, the budget deficit-to-GDP ratio increased from FY1995 to FY1996 even though the overall tax-to-GDP ratio increased year-on-year as shown in Table 3.

The budget deficit-to-GDP ratio declined during the second Nawaz Sharif government even though the overall tax-to-GDP ratio registered a decline too from

[10]Mahnaz Fatima. "Tax 'strategy' implementation in 2000-01." *Dawn*, Economic and Business Review. June 11-17, 2001. III.

[11]Ibid.

[12]Qazi Masood Ahmed. "Structure of Public Finances: Historical Perspectives and Future Prospects". *Pakistan Journal of Applied Economics*. Vol. 14, Nos. 1 & 2. 1998. pp. 89–105.

11.64 percent in FY1997 to 10.48 percent in FY1999. The budget deficit-to-GDP ratio declined from 6.3 percent in FY1997 to 3.85 percent in FY1999. The lowest budget deficit-to-GDP ratio for the period studied is recorded in the year which also had the lowest overall tax-to-GDP ratio during the decade of the 1990s. And, when the overall tax-to-GDP ratio was pulled back up to 11.71 percent during the military government, the budget deficit-to-GDP ratio also increased to 5.36 percent. The decade of the 1990s clearly shows a lack of relationship between Pakistan's overall tax-to-GDP ratio and the budget deficit-to-GDP ratio. Clearly, there is more to Pakistan's budget deficit reduction than the impact of an increase in tax generation. It would be important to next study the expenditures' pattern during the decade of the 1990s.

3. IMPACT OF EXPENDITURES ON BUDGET DEFICIT

While a relationship between PSDP and budget deficit cannot be ascertained in isolation from a trend analysis of their levels during the decade of the 1990s, it can be concluded that budget deficit-to-GDP ratio was kept contained by also reducing the PSDP significantly. The debt servicing-to-GDP ratio increased from 6.25 percent in FY1991 to 9.2 percent in FY1999 but the budget deficit-to-GDP ratio declined from 5.86 percent in FY1991 to 3.85 percent in FY1999, as shown in Table 4. While this decrease in the budget deficit-to-GDP ratio was, inter alia, contributed by a decrease in defence expenditure-to-GDP ratio from 6.23 percent in FY1991 to 4.36 percent in FY1999, the PSDP-to-GDP ratio also fell from 6.17 percent in 1990-91 to 3.14 percent in FY1999. However, while the PSDP-to-GDP ratio declined since FY1992, the budget deficit-to-GDP ratio fluctuated during the period studied. (Table 4.)

It cannot, therefore, be said that there is a direct relationship between development expenditure reduction and the reduction in budget deficit. At best, development expenditure reduction may have kept the budget deficit contained when all other measures failed to do so in various years or when rising debt-servicing and decreasing import duties created additional pressure on budget deficits.

4. INCREASE IN EXTERNAL DEPENDENCE

Tables 5 and 6 shows various expenditure heads as percentage GDP and of total current expenditures during the period studied from FY1991 to FY2001. While the share of expenditures on defence, social services, economic services, and subsidies declined during the period studied; the share of debt-servicing rose from 37.2 percent in FY1991 to 53.2 percent in FY2001.

And, while the interest on foreign debt was kept contained mainly through rescheduling, the interest on domestic debt showed an increasing trend. However, reliance on external resources to finance the budget deficit more than doubled during the period studied as shown in Table 8. As the share of internal resources in total resources declined from 83 percent in FY1991 to almost 70 percent in FY2001, the

Table 5

Various Expenditure Heads as Percent of GDP

(Percent)

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01
Federal Current Expenditure	16.82	16.42	17.52	17.31	15.65	16.49	16.20	17.05	16.28	17.76	16.70
General Administration	0.71	0.82	0.82	0.92	0.98	0.91	0.86	0.73	0.59	0.61	1.43
Defence	6.23	6.25	6.52	5.96	5.33	5.38	5.19	5.00	4.36	4.50	3.79
Debt Servicing	6.25	6.61	7.57	8.19	7.07	7.68	8.08	9.12	9.20	9.86	8.87
Interest on Domestic Debt	3.29	3.87	4.70	4.98	4.06	4.57	4.71	5.69	5.43	5.78	5.34
Interest on Foreign Debt	1.35	1.17	1.23	1.31	1.21	1.25	1.21	1.11	1.32	1.59	1.46
Repayment of Foreign Debt	1.61	1.57	1.64	1.90	1.80	1.87	2.16	2.32	2.45	2.49	2.08
Community Services	0.22	0.22	0.25	0.24	0.25	0.24	0.21	0.22	0.19	0.20	0.20
Social Services	0.55	0.49	0.55	0.47	0.47	0.41	0.36	0.36	0.30	0.33	0.30
Economic Services	0.44	0.12	0.15	0.13	0.13	0.16	0.10	0.11	0.08	0.08	0.09
Subsidies	0.80	0.68	0.39	0.33	0.20	0.49	0.31	0.24	0.33	0.45	0.65
PSDP	6.17	6.53	5.21	4.71	4.35	4.07	3.47	3.33	3.14	3.16	2.94
Budget Deficit	–5.86	–6.58	–7.09	–6.54	5.36	–5.47	–6.30	5.66	3.85	–3.89	–5.36

Source: Authors' calculations based on *Economic Survey* Data.

Table 6

Various Expenditure Heads as Percent of Total Current Expenditures

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01
Federal Current Expenditure	1	1	1	1	1	1	1	1	1	1	1
General Administration	0.04	0.05	0.040	0.05	0.06	0.54	0.53	0.04	0.03	0.03	0.08
All Other Expenditures											
Defence	0.37	0.38	0.37	0.34	0.34	0.32	0.32	0.29	0.26	0.25	0.22
Law and Order	0.01	0.02	0.01	0.01	0.02	0.02	0.01	0.01	0.01	0.01	0.01
Community Services	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Social Services	0.03	0.03	0.03	0.02	0.02	0.02	0.02	0.02	0.01	0.01	0.01
Economic Services	0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Subsidies	0.04	0.04	0.02	0.01	0.01	0.02	0.01	0.01	0.02	0.02	0.03
Debt Servicing	0.37	0.40	0.43	0.47	0.45	0.46	0.49	0.53	0.56	0.55	0.53
Interest on Domestic Debt	0.52	0.58	0.62	0.60	0.57	0.59	0.58	0.62	0.59	0.58	0.60
Interest on Foreign Debt	0.21	0.17	0.16	0.15	0.17	0.16	0.14	0.12	0.14	0.16	0.16
Repayment of Foreign Debt	0.25	0.23	0.21	0.23	0.25	0.24	0.26	0.25	0.26	0.25	0.23
Grants and Unallocable	0.07	0.05	0.05	0.04	0.05	0.05	0.04	0.05	0.05	0.08	0.06
Cut in Non-salary Expenditures											

Source: Authors' calculations based on *Economic Survey* Data.

Table 7

Financing of the Deficit

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01
Financing of the Deficit											
Non-Bank Borrowings as Percent of Deficit	0.43	–0.11	0.17	0.24	0.25	0.29	–0.01	0.39	0.57	–0.01	0.43
Net External Resources as Percent of Deficit	0.35	0.39	0.34	0.56	0.55	0.44	0.44	0.40	0.96	0.79	0.77
Bank Borrowings as Percent Deficit	0.21	0.72	0.47	0.19	0.18	0.26	0.57	0.20	–0.54	0.22	–0.21

Source: Authors' calculations based on *Economic Survey* Data.

Table 8

Internal and External Resources as % age of Total Resources

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01
Resources											
A. Internal Resources	0.83	0.76	0.78	0.74	0.75	0.77	0.69	0.76	0.70	0.71	0.69
Revenue Receipts Percent of Total Internal Res	0.81	0.97	0.89	0.82	0.84	0.83	0.94	0.83	0.84	0.84	0.76
Capital Receipts Percent of Total Internal Res	0.14	–0.05	0.08	–0.15	0.09	0.09	0.00	0.15	0.14	0.13	0.18
Autonomous Bodies Percent of Total Internal Res	0.04	0.08	0.00	0.00	0.01	0.03	0.05	0.00	0.00	0.15	0.04
Financing of SAP Percent of Total Internal Res	0.0	0.00	0.00	0.01	0.04	0.03	0.00	0.00	0.00	0.00	0.00
B. External Resources	0.16	0.23	0.21	0.25	0.25	0.22	0.30	0.23	0.29	0.28	0.30

Source: Authors' calculations based on *Economic Survey* Data.

share of external resources in total resources increased from about 17 percent in FY1991 to 30 percent in FY2001. Despite an intense fiscal reform effort, the increase in external dependence demonstrates the lack of success of fiscal reform.

5. CONCLUSIONS

The analysis demonstrates that the efforts to increase the overall tax-to-GDP ratio did not prove to be successful. However, the contribution of various types of taxes to total tax collection did change. While the share of direct taxes and sales tax increased, that of import duties fell significantly. Import duties underwent drastic reduction mainly under IMF's pressure to liberalise trade more than that required even under the WTO agreements. While this measure definitely affected domestic industrial production adversely as most domestic producers are still ill-prepared to compete with imported finished goods, domestic production effort also experienced the negative impact of increase in direct and sales taxes. As the IMF prescribed tax effort was deflationary, significant increases in output could not be recorded that could have fed back favourably into tax generation and budget deficit reduction.

The upshot was that a relationship between the tax-to-GDP ratio and the budget deficit-to-GDP ratio could not be ascertained. Despite this, the governments mostly remained determined to follow the IMF prescriptions about tax reforms too. The second Benazir government that resisted the IMF in import duty reduction soon found itself out of the office. Pakistan's taxation reform was, therefore, driven not just by domestic politico-economic considerations but also by those of the countries which are the major financiers of the IMF. These countries would like to have our economic frontiers thrown open so that their manufactured products and services find easy passage into the markets of developing countries.

As the overall tax-to-GDP ratio could not be increased appreciably, budget deficits had to be kept contained by decreasing the development expenditure. This was required all the more also because of increasing pressure on debt-servicing. As percentage share of internal resources in total resources declined due to the reasons discussed herein, the share of external resources increased. Pakistan's reliance on external financing increased due to a tax reform effort that remained unsuccessful not only intrinsically as it failed to generate more resources internally but also because it affected the production potential of the country adversely. This latter effect fed back into the issue of budget deficits and rising external dependence. More requirement of external financing means more of the financiers' conditionalities. That is, the above cycle stands reinforced when the need is to break away from it. While the fiscal reform exercise has been self-defeating, we pursue more of it as it suits both domestic and international politico-economic agendas.

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