FISCAL POLICY FOR ECONOMIC GROWTH

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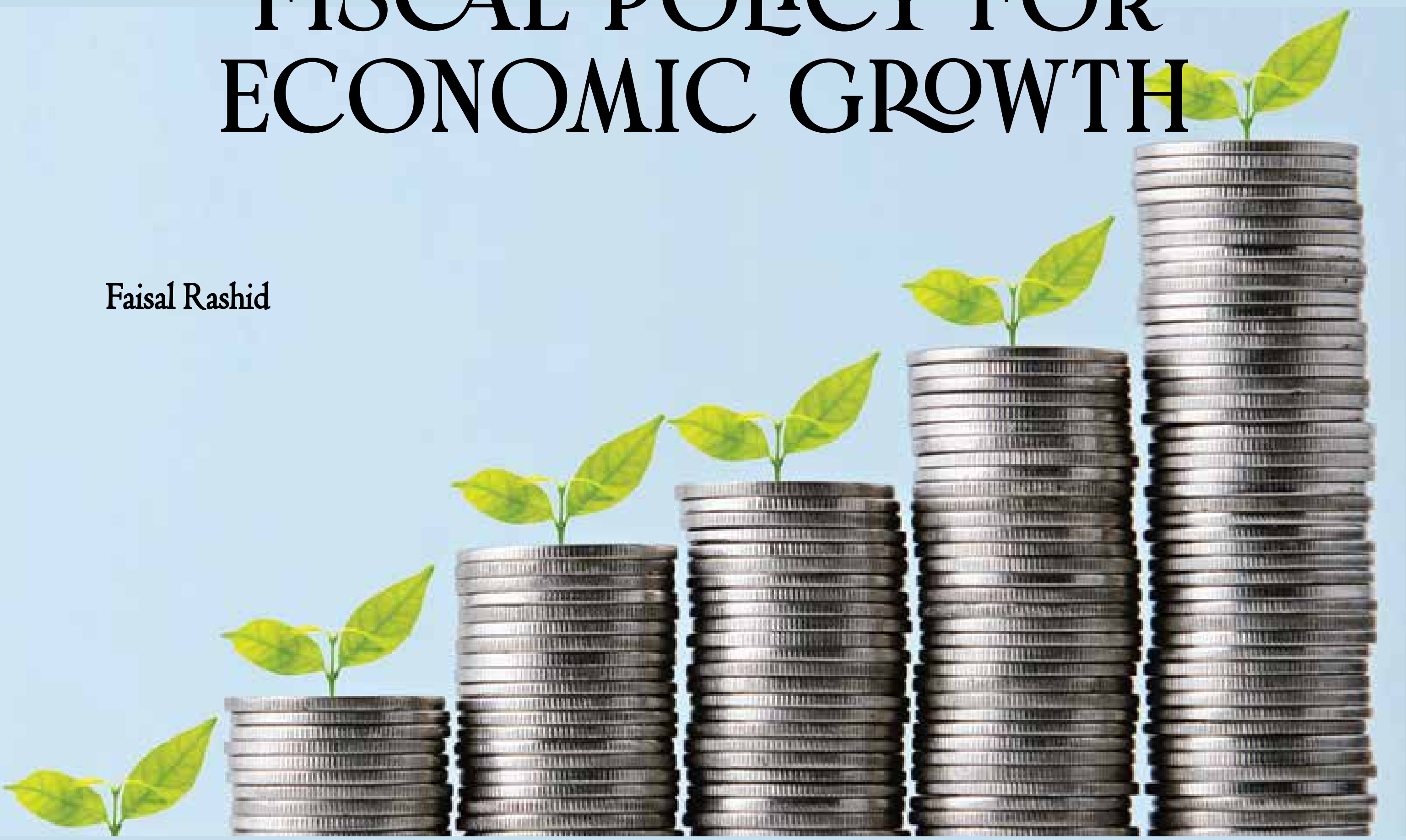

Pakistan is experiencing a deep economic and financial crisis, characterised by runs on international reserves, high inflation, high interest rates, extremely low economic growth rate, falling remittances and stagnant exports. While many contributory causes for the poor performance can be identified (security, poor governance, ineffective political parties, dominant interest groups, role of the establishment in the economy etc.) it is argued here that there is a fundamental underlying cause – the persistent practice of high budget deficits. This view is supported by the strong empirical relationship between the public sector deficit and the performance of the current account of the Balance of Payments (BoP). It is important to note that while the relationship is empirical, the direction of causation is from the fiscal deficit to the BoP, not vice versa. The implication of this causality is that if the country is to escape from the poor and declining economic performance, a key policy priority must be to radically reduce the fiscal deficit.

Sovereign deficit is not uncommon but it is pertinent to identify the appropriate level of fiscal deficit for Pakistan as the current level in Pakistan is leading to an unsustainable debt. Important to note that it has two components – one, the budget deficit, which is quite well known, whereas the other is the off-budget deficit, usually not on government books. The off-budget deficit results from deficits of public sector enterprises e.g. circular deficit arising from power sector companies. At present, both components add up to 9-10 percent of national GDP, clearly too high for Pakistan. Considering the macro-fiscal situation of the country, we really need to curtail this deficit and bring it to close to GDP growth rate of the country, which on average, is likely to be in the range of 4% (at best) as with our current productive capacity, we cannot sustain a higher growth rate. Such a reduction may not be possible immediately as we are passing through a period of interest rate shock.

To reduce the public sector deficit from the current 9-10 percent down to 2 percent (4 percent including off-budget debt) appears to imply a mountain to climb. To be sure this adjustment cannot be achieved without difficult and likely unpopular fiscal policies and would need to be approached over several years.

Pakistan has an exceptionally low revenue-to-GDP ratio. In agreements with the IMF, the government has a basically sound approach to enhancing the revenue function aimed at expansion of the proportion of individuals and businesses filing with the revenue authorities and administrative improvements in the revenue function. Similarly, use of information technology for improvements in customs and in-land revenue along with measures to control smuggling could help add 2-3 percent in Pakistan's tax revenue.

Expenditures of the Federal Government have grown progressively in a period when in principle the federal spending as a proportion of GDP should have declined as part and parcel of the reforms initiated through the 18th Amendment of the Constitution. The federal budget has become bloated as the staff payroll has increased significantly when there was a need to cut back. In part this is the result of a steady increase in the number of ministries. Other contributing factors have included increases in social security/protection payments falling on the federal budget, and subsidies relating to energy and agricultural inputs and products and pension liabilities. Measures to meet the required expenditure objectives should include:

- Privatisation of loss-making enterprises
- Thorough review of grants by the government currently standing way above 1 percent of GDP. Many of these grants could be cut if a thorough review of revenue and expenditure of recipient entities is undertaken. There is a general tendency and incentive for these entities not to tap their own revenues when they can access the easier option of grant-in-aid by the government.
- Sharing of expenditure on devolved functions with provincial governments (could save something like 1 percent of GDP if BISP, HEC, etc. is funded equally by federal and provincial governments).
- Federal government should not have development schemes related to provincial functions in its PSDP.
- Rationalisation of pensionary benefits and initiation of a contributory scheme for new hires.
- Bringing down inflation and interest rates.
- Elimination of inefficient and distortionary subsidies, e.g. subsidy on wheat, tubewell subsidy, etc.
- Scaling down the federal government apparatus in line with its reduced functional mandate following the decentralisation of functions to provinces and abolition of the concurrent list of government functions achieved through the 18th Amendment of the Constitution of 2010. This should ideally involve a reduction in the number of ministerial portfolios from the recent excess of 40 ministries to the order of 10 to 15 ministries.
- Rationalisation of staff numbers in the federal government.

At present there is a lot of discussion on how investments could help Pakistan get out of economic problems. Investment is essential for sustained growth. This truth has led some countries to seek sustained growth through maintaining exceptional levels of public investment. However, there are potential pitfalls in this approach, especially if investment strategy is not accompanied by a clear strategy for sustainable debt. Ethiopia followed an investment-led growth strategy from 2010 to 2020. However, in the Ethiopian case the massive public investment, which reached 30 percent of GDP was mainly debt-based, including external debt. By 2020, the investment-led growth process had run its course. Faced with impending debt distress the country has had to curtail its spending with an accompanying collapse of the economic growth rate. The investment led growth was able to proceed for a considerable period, as it benefitted from an initially low debt/GDP ratio following extensive debt forgiveness that the country received. Ethiopia is now faced with high debt service which limits the fiscal scope for policy initiative, whether investment or services/social development. Egypt has also experienced a massive economic deterioration in the past decade. This is largely attributed to a lavish programme of public investment spending under the Sisi government. The associated buildup of public debt has created the ongoing situation of difficulty in obtaining adequate public debt rescheduling terms from creditors. Public investments could be helpful if made in productive sectors and financed through non-debt avenues. However, this will require greatly enhancing our quality of public investment through improvements to the strategic planning phase, robust project appraisal and effective monitoring and evaluation systems for public investment.

Recovery from Pakistan's recurrent economic and fiscal crises can only be achieved through the adoption of difficult reform measures which will need to be applied consistently over a longer period than the lifetime of a single parliament. Such reforms will only be successfully pursued if there is agreement on the basics of the reform measures across the leading political parties, through what has been referred to as a Charter of Economy. The design and technical definition of the Charter of Economy calls for the establishment of a high level Macroeconomic Advisory Committee which brings together the principal stakeholders in government, the legislature, the establishment, academia, and the private sector.

The author is a Principal Consultant at Oxford Policy Management, and has over 15 years of experience implementing public financial management reforms. His areas of expertise include fiscal transfer systems, provincial taxation, cash and debt management, legal and regulatory reforms, budget transparency, and medium-term budgetary frameworks.