Fixing Fiscal Policy in Pakistan

Prepared by MacroPolicy Lab

Fiscal indiscipline has posed a persistent and complex challenge for Pakistan's federal and provincial governments, creating economic hurdles and limiting development. To address this critical issue, a significant attempt is underway in the form of the "Fixing Fiscal Policy" Round Table Conference. This conference gathered diverse key stakeholders, including policymakers, thought leaders, academics, and experts, to collectively deliberate and devise effective strategies for revitalizing the nation's fiscal framework.

In a time where fiscal stability is imperative for sustained growth, Pakistan faces various issues in its fiscal policies, tax administration, and debt management. Based on conference proceedings, the policy note delves into these challenges and offers recommendations to steer Pakistan towards a future characterized by fiscal prudence, economic vibrancy, and sustainable growth.

Section I: Role of Government and Economic Stagnation:

The government's expenditures have been consistently increasing without matching revenue growth, leading to fiscal deficits that have become a chronic issue. The growth of government in recent times has been nothing short of exponential, and this expansion is occurring at a pace that far outstrips its revenue base. Several factors contribute to this alarming trend. The proliferation of ministries, government departments, and various agencies has imposed a substantial cost burden in terms of salaries, benefits, and pensions. The size of social welfare programs has also ballooned, with subsidies and social protection program allocations witnessing a significant surge.

Furthermore, the government's presence in the market has created distortions within the economy. This intervention comes in two forms: first, through the operation of over 200 State-Owned Enterprises (SOEs), many of which are inefficient and financially draining entities; and second, through a regulatory regime enforced by numerous government agencies and regulatory authorities. The government's footprint in the economy exceeds 60% of the GDP, while the cost of regulations for just 24 different activities consumes a staggering 45% of the GDP.

Following Policy Recommendations emerge from discussion:

1. Reduce the size of the government:

Immediate action is required to streamline government operations. Firstly, ministries should be transferred to the provinces as mandated by the 18th amendment to the constitution. Secondly, redundant government agencies must be shut down, and those performing overlapping tasks should be merged to eliminate inefficiencies.

2. Improve the NFC (National Finance Commission) Award

The NFC award allocations need a comprehensive revision to enhance revenue mobilization while adhering to the constitutional guidelines regarding NFC award revision.

3. Revisit Public Sector Development Program (PSDP):

The growth of the PSDP portfolio has reached unsustainable levels, further exacerbating fiscal pressures. It is essential to halt the addition of new schemes until ongoing projects are urgently completed, particularly those that have exceeded their gestation periods.

4. Implement civil service reforms:

The current bureaucratic structure is inadequate for modern governance standards. The excessive perks and privileges extended to bureaucrats are not commensurate with performance. All perks must be monetized based on market-driven competitive packages. Subject specialists should be appointed in relevant areas, and lateral entry into the civil service must be allowed.

5. Follow public finance management rules:

To ensure rationalized expenditures, it is crucial to adhere to established rules and regulations governing public finance management.

6. Reduce government footprint in the economy:

Addressing the issues with SOEs is imperative. Four options must be considered: complete privatization, partial privatization, merging of SOEs offering overlapping services, or corporatization of governance structures for SOEs that the government retains in its ownership and management.

Section II: Taxation and Tax Administration:

Pakistan's tax policy lacks clarity and consistency. Taxation primarily revolves around meeting tax-to-GDP targets, often sidelining fundamental principles like fairness, certainty, efficiency, and convenience. The Taxation Policy focuses more on achieving revenue targets than fostering an environment conducive to investment and growth. Complex tax structures, excessive documentation requirements, and high compliance costs have become significant impediments to economic activity. Withholding taxes have proliferated, increasing the administrative burden on businesses. Revenue collection remains heavily concentrated within a few sectors.

Following Policy Recommendations are emerged from discussion.

1. Develop a clear tax policy:

Pakistan urgently needs a clear and consistent tax policy that outlines the objectives, rationale, and methods of taxation. Tax policies should promote investment, economic growth, and fairness, avoiding arbitrary changes driven solely by revenue targets.

2. Improve coordination between provincial and federal revenue authorities:

A transition to a single, harmonized, and integrated VAT-based sales tax system should be considered. Such a system can enhance efficiency, reduce tax evasion, and address the problem of jurisdictional disputes between provinces and the federal government.

3. Minimize compliance costs:

The multiplicity of taxes and complex documentation requirements impose significant compliance costs on businesses. Simplification of the tax system, especially reducing the complexity of withholding taxes, is essential to alleviate the compliance burden.

4. Universalize income tax:

All sources of income should be treated uniformly, eliminating differentiation among various forms of income. The minimum turnover tax should be withdrawn, and an adjusted corporate income tax should be introduced to move towards an integrated business tax regime.

5. Reduce reliance on indirect taxes:

Pakistan's revenue collection strategy should gradually shift away from overreliance on indirect taxes. Sectors with low revenue contributions should be consolidated or phased out of the tax system.

6. Enhance tax administration efficiency:

Revenue authority staffing should be based on merit and relevant academic and professional qualifications. This ensures that tax collection is conducted efficiently and fairly.

7. Mandatory tax filing:

Distinctions between filers and non-filers should be abolished, and tax filing should become mandatory for all eligible entities. This should be implemented gradually to allow businesses and individuals to adapt.

8. Rationalize tax exemptions and concessions:

The culture of Statutory Regulatory Orders (SROs) granting exemptions and concessions should be abolished. Exemptions and concessions should be subject to rigorous evaluation, and their scope should be limited to sectors that support education and health, with all other exemptions and concessions rationalized or eliminated permanently.

Section III: Pakistan's Debt Management:

Pakistan faces a rising public debt burden driven by various factors, including persistent fiscal and current account deficits, extensive borrowing, exchange rate imbalances, and exogenous economic challenges. The total public debt-to-GDP ratio has consistently exceeded 70% in recent years, raising concerns about fiscal sustainability. High debt servicing costs limit resources available for development initiatives and public services. The composition of public debt has also shifted significantly, with greater reliance on domestic debt since FY 2010 due to limited external funding sources. However, this shift has brought its own challenges, notably the high cost of servicing domestic debt, which has increased due to frequent policy rate revisions. Moreover, the Pakistani government often fails to adhere to established fiscal regulations, such as the Fiscal Responsibility and Debt Limitation Act (2005), which mandates maintaining the total public debt to GDP ratio within 60%.

Following Policy Recommendations are emerged from discussion on debt:

1. Debt restructuring:

As a short-term solution, Pakistan should consider bilateral debt restructuring to extend debt maturities, reduce debt servicing burdens, and provide immediate relief to the fiscal situation. However, policymakers should be mindful of the potential consequences, such as credit rating downgrades.

2. Fiscal discipline:

Adherence to fiscal rules, including limits on budget deficits and debt levels, is essential to prevent unsustainable debt accumulation. Implementing austerity measures, such as reducing government spending, can generate additional revenue to service debt and reduce budget deficits. Transparency in debt-related matters is vital for building trust and confidence in government efforts.

3. Promote economic growth:

Economic growth is a fundamental solution to the debt problem. Policies should focus on enhancing productivity, innovation, and access to international markets, as these factors contribute to increased government revenue and reduce the relative size of the debt as a percentage of GDP.

4. Debt management/utilization framework:

A comprehensive framework for managing public debt, evaluating the necessity of specific loans based on their return on investment, is essential. Establishing a centralized debt office with oversight over domestic and foreign debt would enhance decision-making capabilities and risk identification.

Conclusion

The "Fixing Fiscal Policy" Round Table Conference serves as a beacon of hope in the quest for comprehensive solutions to Pakistan's fiscal challenges. By fostering collaboration, innovative thinking, and rigorous debate, the conference aspires to steer Pakistan towards a future characterized by fiscal prudence, economic vibrancy, and sustainable growth. It is an opportunity to shape policies that will not only address current issues but also lay a robust foundation for the nation's enduring prosperity. In the face of fiscal challenges, Pakistan has the potential to enact meaningful reforms and achieve economic stability. These recommendations, covering the role of government, taxation, and debt management, provide a roadmap for policymakers to navigate towards a fiscally responsible and prosperous future for the nation.

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