ADJUSTMENT WITH AN AUSTERE FACE

Pervez Tahir

The experience of Pakistan's stop-go 23rd programme with the IMF and the twenty-two programmes before reveals a common thread. In each case, the burden of adjustment was pushed mainly to the tax side of the budget, with the expenditure side contributing negligibly through routine economy drives. The nature, size and the composition of expenditure reflects the structural rigidity of the public economy more than the tax side. This is where any serious structural reform has to take place. It is the failure to reform on the expenditure side that has forced the frequent resort to the IMF. Quick-fix action on the side of taxation is designed to finance the increasing rigidity of expenditures. Taxing the already taxed, overextending the withholding regime, subsidising the non-competitive sectors and increasing the tax expenditures of the rich and powerful have earned the tax regime the aphorism of, "the more things change, the more they stay the same".

What is wrong with the expenditure side? The largest expense, debt servicing at 4.8% of GDP in FY22, is the outcome of the ceaseless imprudence in other heads of expenditure. The large bulk of debt is domestic, viewed by our policy makers as less problematic than the external debt that must be serviced in dollars that fiscal policies disincentivise to earn. Bilateral external debt can be restructured, as was done in 2000s. Debt servicing declined for some time, but shot back as no reform took place during the period of respite. In any case, bilateral reliance is a small portion of the external debt. With a massive 4.2% of GDP, domestic debt servicing is the real problem. It was hoped that discontinuation of cheaper borrowing from the State Bank, the so-called currency printing, under the IMF pressure would discourage the government from excessive borrowing in view of the higher cost of commercial bank lending. In reality, the opposite happened, creating a situation where domestic debt has a stronger case for restructuring.

Development is the next big expenditure claiming 2.5% of GDP. This is entirely financed by borrowing and is, therefore, largely responsible for the rising debt servicing and fiscal deficit. Conceptually, development expenditure is sold as necessary to accelerate growth and create jobs. Governments take pride in increasing its size and the opposition is critical when it is otherwise.

However, growth is generated by fixed investment. All development expenditure is not fixed investment. Out of the development expenditure of 2.5% of GDP in FY22, fixed investment was a mere 0.72% of GDP. Indeed, the total government expenditure of 19.9% of GDP includes only 3.42% of GDP as fixed investment. Borrowing for spending that does not yield any return flows makes a net addition to the debt burden. Over the years, this has pushed the economy into the traditional debt trap: borrowing more to pay off past loans. There is not just the external debt problem, but also and more worryingly, a public debt problem.

External debt was not a problem so long as the loans were contracted for specific projects with good rates of return. Most lending was concessional with long maturities. The mid-1990s foreign exchange crisis brought in short term lending at higher cost. Following the Washington Consensus of 1989, even the concessional

loans from multilateral agencies shifted from projects to the soft agenda of policies, programmes and reform. A significant part of the development budget consisted of counterpart funding for external loans, itself financed by costlier domestic borrowing. Direct budget support also began. With no returns to pay back and misuse by governments due to fungibility of the funding, debt servicing could not but rise substantially. For the first time, overall interest payments exceeded the development spending in FY93 by 3.4% and by 124% in 1999. The trend has continued since, fuelling a never ending debt story. In FY22, the excess is 92%. In other words, development as well as a significant part non-development expenditure is being financed by borrowing. Salaries, perks, pensions are funded by expensive borrowing. A fiscal deficit of 7.9% of GDP exceeding the expenditure of 4.8% on debt servicing plus development expenditure of 2.5% of GDP reflects this.

Defence is normally the third largest expenditure, but this position was assumed by subsidies in FY22. The former claimed 2.1% of GDP and the latter 2.3% of GDP. (However, defence remains the third largest expenditure at 2.7% of GDP when military pensions and the expenditure of defence production division are added.)These subsidies covered tariff differentials payments to IPPs under the circular debt management plan, reduction in POL prices announced in February 2022 in violation of the IMF programme, provision of cheaper LNG to industry, cheaper electricity to zero-rated export sector and abolition of peak and off-peak tariff structure under the industrial support package. Obviously, these are subsidies for the rich and powerful to protect them from competition.

The cost of the running of the civilian side of the federal government is 0.8% of GDP. It has come down from around 1% of GDP before the 18th Amendment of the Constitution in 2010, but is still far above the expenditure implications of its strict application, which is 0.5% of GDP. In the 7th NFC award, the share of the provinces was substantially increased from 45% to 57.5% to take up the load shed by the federal government and the abolition of the Concurrent List of subjects. An examination of the Federal Legislative List, Part I and II shows that the federal government needs only ten administrative divisions compared to the existing 46. The number of ministries will be even smaller, as some will have more than one administrative division under them.

If the state of the play is as bad it is, reducing expenditure is a quicker, more efficient and less inflationary measure of economic adjustment. For instance, the fiscal deficit in FY22 was as high as 7.9% of the GDP. At a time when the imposition of financial emergency is under consideration and the risk of default is looming large, why should a development programme depending wholly on borrowing should even be considered? Making it zero should be the starting point of any serious austerity plan. This would bring the fiscal deficit down to 5.4% in one go. Next, subsidies of 2.3% of GDP to energy and industrial sector make no economic sense even in normal times. These should have been eliminated forthwith to bring the deficit further down to 3.1% of GDP. Then starts the hard, but doable, part. Implement the 18th Amendment in letter and spirit to gain an additional space of 0.3% of GDP. This will reduce the deficit further down to 2.8%. Instead of imposing new taxes to make the life of existing tax payers and consumers miserable, do away with the tax expenditures of 2.2% of GDP. That brings the deficit to a perfectly manageable 0.6% of GDP, without entering the no-go area of defence. But if the civilian side can demonstrate the will to bring the fiscal deficit to as low as 0.6%, the military would be under a moral compulsion to follow suit by improving the tooth to tail ratio to wipe out the remaining deficit altogether.

Cutting expenditures and tax expenditures, rather than raising taxes, is the route to sustainable adjustment. It will entail the reform of the archaic structure of government, encourage investment and promote productivity.

The author is a senior political economist and President of the Council of Social Sciences (COSS), Pakistan.