REIMAGINING ECONOMICS IN THE PAKISTAN CONTEXT

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FISCAL SIDE ISSUES FACING PAKISTAN

- The government does not collect enough taxes. Thus, it cannot invest enough in human development and welfare.
- Given our low investment in human resource, we are inefficient and not productive enough to compete with the world. We have accumulated foreign debt to supplement our savings and to meet our basic needs; we are very highly import dependent and do not earn enough foreign exchange.
- A large portion of private savings actually end up financing the government directly or indirectly, the bulk of which is spent inefficiently and not invested. Thus, citizens' savings do not figure in national accounting. Though some individuals add to Dubai's, UK's and Switzerland's savings these are not Pakistan's savings.
- Allocation of the tax pool between the federal government and the provinces is a continuing cause of discontent.

The crux of the issue seems to be that the government does not collect enough taxes and is unable to invest enough in infrastructure and human development, both of which are required to grow the economy. This leads to borrowing from other countries to fill the gap.

Put another way, out of total money creation, the government needs to somehow get its hands on enough to allow for investment.

MYTHS ABOUT MONEY CREATION

- Money is not created by economic activity. Nor does the government create money, although it can borrow if need be. The SBP creates or destroys money only to the extent of net foreign flows. However, the net foreign exchange flows are a small percentage of the overall economic activity.
- The only money that can be created (or destroyed) is by commercial bank lending/recovery activity. This new money is created by banks through lending to the government or to the (already wealthy) private sector. The SBP does create some very short-term temporary money to tide over the time gap in the creation of new money by banks.
- Money creation by banks is rooted in Fractional Reserve Banking (FRB), in the absence of which banks would be recirculating money. To elaborate, if a business asks for a ten-year loan, the bank does not block our deposits for ten years, it will simply deposit a small fraction of our deposits with the SBP. This is called the Cash Reserve Ratio (CRR) and the SBP will allow it to lend the rest.

SOME WHAT/IF SCENARIOS

1. If the CRR was 100%, i.e. no FRB, banks would only be able to recirculate the deposits they hold and not create new money.
2. But the economy will need growth in money supply for it to grow. And we need the economy to grow to finance higher per capita consumption (better lifestyles) and finance that consumption by a larger number of people owing to population growth. This higher aggregate consumption requires new money.
3. On the supply side, in order to support the higher consumption, we need the new money to flow towards the addition of productive assets (investment), as well as additional procurement of material, energy and labour.
4. With no FRB, the government could, through the SBP, ostensibly create the same amount of new money that the SBP would have allowed the commercial banks to create through qFRB.
5. If the aggregate money supply is controlled by the SBP within certain limits that ensure it does not become inflationary, one can be agnostic as to how the new money is created.

MYTH-BUSTING: CHARTING OUT A NEW PATH

Addressing Myth-1, i.e. Economic activity (markets) create money (wealth, i.e., what we save as a surplus of what we produce over what we consume). Since the government can create money by fiat, we are not dependent on wealth creation, i.e. out of the aggregate money supply created by the government, some would flow towards the wealth accumulation (investment) bucket, while the rest would flow to spending towards consumption. The money created by government fiat can ostensibly be allocated between the two in the same proportion as it would have been under a FRB regime.

Addressing Myth-2: We need savings do be able to invest. The same amount of newly created money that would be saved under the FRB regime and not be spent towards consumption could be put aside and invested if created by fiat. It would not matter if banks had no part in creating that money.

Addressing Myth-3: If we collected enough taxes, we would not have deficits, and could have savings that would solve our problems to a great extent. Presently the government is first expected to pull money out of circulation through taxation and thereafter put it back in circulation through spending. Since the expenditure proposed in the Budget and approved by the parliament is in excess of tax collection, the excess is financed through borrowing from domestic markets (primarily banks) and some through borrowing in foreign exchange. Assuming that instead of doubling taxes, the government were to print that amount and invest the additional amount in infrastructure and human development, the SBP would need to reduce that amount of money creation by banks. The aggregate money supply would not change.

Currently, of the total money creation in the year by banks, some is for lending to the private sector, while more than half is created and lent to the government, and some is created by the SBP in conversion of the government's borrowing from abroad. The government could forgo collecting taxes and not borrow from banks or foreign entities but create fiat money. (Bridging the CAD is a separate matter and any borrowings for that need not be converted to PKR – similar to IMF loans). If the government were to follow this, it would more or less be the equivalent of the amount of sales tax it collects, thus relieving the average consumer of this burden.

Of course, the government can continue with this black tax on the average consumer, but still not borrow and create a similar quantum of fiat money to invest in the economy.

Addressing Myth-4: Commercial banks recirculate savings, while new money (and deposits) is created by the growth in the economy (market activity).

The fact as explained above is that new money is created by bank lending owing to FRB, or through net foreign exchange inflows converted into PKR. If the government did not borrow from domestic banks or from abroad, an equivalent to that money creation could be through government fiat. That would require significant reduction in money creation by the banks through a significant increase in the CRR. We could go one step further and do away with FRB altogether and replace the entirety of money creation by government fiat. This would allow us to do away with income tax as well. (Some taxation may be required to manage money supply, which could be in the form of sin taxes and wealth redistribution taxes, and potentially some anti-dumping taxes).

Addressing Myth-5: Our Current Account Deficit (CAD) would be reversed if we did not run a fiscal deficit and did not have to rely on foreign savings owing to a lack of our domestic savings. Given that we have not developed our export competitiveness and ability, both in terms of production capacities of exportable goods (industrial as well as agricultural) – and the fact that low productivity does not allow us to earn enough foreign exchange to meet our import requirements, whether of key essentials or things that are nice to have – the rent generating economic structure will have to be addressed. Owning assets generates more wealth. Why do anything else then, especially industrial activity, which is bound to trigger the wrath of the officialdom? On the other hand, being an absentee landlord works just fine, while tillers earn a pittance.

WAY FORWARD: A GOVERNMENT THAT CREATES MONEY AND ELIMINATES FRB

If money is created exclusively by the government and not by banks, which allocate it under a market economy, it will mean allocation by bureaucrats under a policy framework established by the political government, which, we have enough evidence of as being inefficient, as well as prone to corruption and cronyism.

Other than the parliament approving a budget covering defence, civilian administrative structures and investment in people, the government should refrain, as far as is possible, from grandiose development projects and encourage the private sector into project development. The government should do away with taxing efficiency (earning incomes/profits), and tax wealth: not as a money supply managing exercise, but an exercise towards curbing inequality. This would thereby reduce the potential unearned income on that wealth (assets).

In the absence of FRB, some of the new money created, within the overall target of aggregate money supply, which is in excess of budgeted expenditure, can be auctioned to the private sector for specific development projects. It could be an inverse auction, where some portion of that auctioned money would be the purchaser's equity in the business in which it is deployed, while the rest of it would be owned by a Pakistan Sovereign Fund. All such businesses would have to be listed for transparency and governance reasons. The rest of the new money could be auctioned to banks for onward lending in the normal course of business.

Fiscal deficit is not the real issue. And if it is, then reimagining money creation can fix it. All economic activity requires money flows. Money flows can be virtuous or parasitic, resulting in good or bad economics.

It is up to us to make all new money creation and its flows virtuous.

The author is affiliated with the Arif Habib Consultancy – all views expressed in these pages are his own.