Pakistan’s Persistence in Fiscal Deficit and Structural Economic Woes

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1. Introduction

Amid recent stagflation, Pakistani economy is trapped into a scenario where the country is faced with low growth prospects, persistent macroeconomic imbalances, and enlarged vulnerabilities of a sizeable fraction of the populace. Among these, fiscal deficit is one of the fundamental causes of Pakistan’s structural economic woes. Pakistan is faced with a fiscal deficit of around 7.6% of GDP for financial year 2023-24, calling for more borrowing in the current fiscal year and enlarging the future liability. Persistence in fiscal deficit is caused by both a flawed tax system and unproductive spending behavior of the successive governments. Pakistan’s tax system is regressive, complex, and inefficient which is not only costly but also encouraging a wider tax evasion and informality in the system. Likewise, Pakistan’s public expenditure system is characterized by a huge volume of current outlay exacerbated mainly by a huge size of the public sector, excessive interest payments, loss-making State Owned Enterprises (SOEs), and burgeoning circular debt, all implying little fiscal space for development spending. This setup has cumulatively caused the country’s debt to GDP ratio to reach to around 80% of GDP, which is much higher than the limit of 60% as is fixed by the Pakistan’s Fiscal Responsibility and Debt Limitation Act of 2005. Persistence in fiscal deficit has also inflamed the default prospects which has recently been looming on the country, leading to Pakistan’s Stand-By Arrangement (SBA) with the IMF. Deficit financing or the IMF’s programs are, however, only short run cushions and Pakistan needs fiscal sustainability and persistent economic growth in the long run. Fiscal sustainability can be attained by introducing structural reforms like enhancing efficiency of the tax system, removing exemptions and distortions, and rationalizing public spending etc. Furthermore, the growth-gearing policies such as raising human capital and productivity, and encouraging investment and competitive practices in markets can put the economy on the paths of sustainable growth and overall macroeconomic stability.

2. What does Cause Persistence in Fiscal Deficit?

As far as recent trends in fiscal deficit are concerned, three factors, i.e. the Covid-19 pandemic, the Russia-Ukraine conflict, and the last year devastating floods have contributed in this regard. Due to these factors, economic activities across the country stalled as a result of global slow-down and widespread destruction of the agriculture sector and other infrastructure due to floods. Especially, the public spending for social protection, reconstruction, and rehabilitation ballooned. Nevertheless, keeping the impacts of these shocks aside, Pakistan has been facing persistence in fiscal deficit since 2007-08, as is depicted in figure 1. Both a flawed tax system and unproductive expenditure are equally attributable to persistent fiscal deficit. Pakistan has one of the World’s lowest tax-to-GDP ratio (around 10.4% for financial year 2022-23), stemming from a tax system

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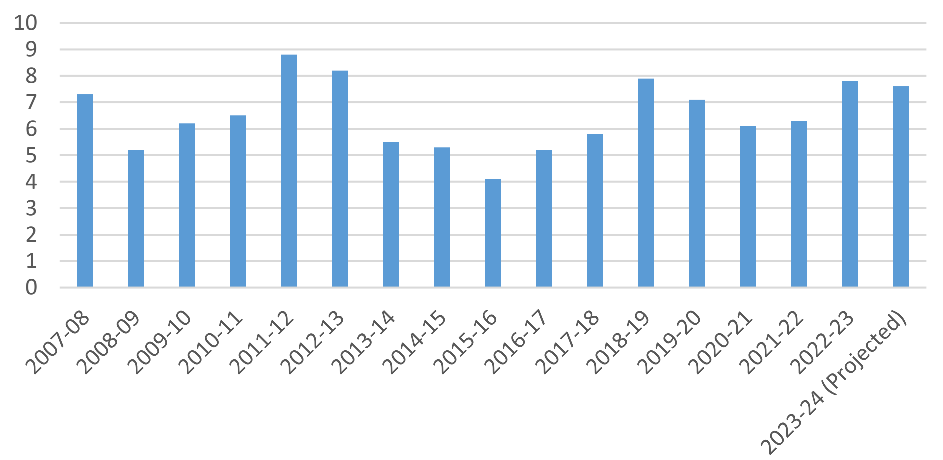
which is characterized by complexity, narrowness in base, low compliance, inefficient administration, and declining provincial tax revenues (Ahmed and Mangla, 2018). It has led to widespread discretion and corruption, with inequitable exemptions and preferential treatments, low tax registration, and massive tax evasion. The outcome is a regressive tax system (indirect taxes make up around 60% of total taxes)[1], with too much dependence on withholding taxes. Indirect taxes combined with a corporate income of around 29% create anti-growth bias by shaping distortions in resource allocation. Likewise, tariff policy has strangled competition and growth, with the average effective tariff rate (11.2%) being the highest in the region. Moreover, 68% of direct taxes are derived from withholding taxes, with the share of direct taxes in total revenue decreases significantly if we exclude withholding taxes. Along with these issues, Pakistan's tax collection is costly as from around Rs. 35 billion in 2000, tax expenditures have been swelled to Rs. 1.5 trillion in financial year 2022-23 (Khalid, 2023). Further, excessive documentation raises the cost of compliance too; PIDE estimated, on average, for each business the annual compliance cost is more than Rs. 250,000, irrespective of the business size (PIDE, 2020).

Figure 1: Pakistan's Financial Year-Wise Fiscal Deficit as Percent of GDP



Source: Author's Calculation from Pakistan Economic Survey 2022-23

Similar is the case with public expenditure, especially the current expenditure, which are increasing consistently. Over time, Pakistan has experienced spread in size of the government, with proliferation of ministries, government departments, and various agencies, which has imposed a substantial cost in terms of salaries, benefits, and pensions (PIDE, 2023). In addition, interest payments, defense spending, and subsidies has been ballooned. As is evident from table 1, which is exhibiting the budget of financial year 2023-24, of the gross revenue of Rs. 9.415 trillion, the federal government will have a net amount of Rs. 6.979 trillion after transferring Rs. 5.399

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[1] Total tax revenue in financial year 2022-23 was Rs. 7470 billion, out of which Rs. 4430 billion was coming from indirect taxes.

trillion to the provinces under the National Finance Commission (NFC) award. Given an allocation of Rs. 7.303 trillion to debt-servicing, it implies that all other heads like defense spending, pensions, running of the civil government, Public Sector Development Program (PSDP) etc. will be financed by borrowing.[2] Likewise, there is a sizable footprint of the government in the economy, with around 212 State-Owned Enterprises (SOEs) are operating in various sectors (Government of Pakistan, 2023).[3] It not only restricts competition in the market but also puts a significant drain on the budgetary resources, with their annual losses reaches to around Rs.1.8 trillion for the financial year 2022-23 (Khan, 2021).[4] Further, Pakistan's power sector, dominated mainly by public limited companies, is facing severe financial crisis as their circular debt, the amount of money that the government owes to power producers and fuel suppliers, has reached to Rs. 2.6 trillion by the end of October, 2023. Similarly, faulty regulatory mechanism is wasting budgetary resources, with cost of the regulation is 45% of GDP as is recently estimated by PIDE (PIDE, 2022). All these factors are cumulatively restricting private-sector led growth by limiting competition and creating regulatory hurdles (PIDE, 2021).

[2] Around 52% of the total outlay would be financed through borrowing.

[3] The government's footprint in the economy exceeds 60% of the GDP as is estimated by PIDE.

[4] The budgetary impact of SOEs has climbed from 9.2% of the budget in 2000 to 46.2% in 2022-23 because of payments to Independent Power Producers (IPPs).

Budget 2023-24 at a Glance

Table-1 presents position of overall Resources and Expenditure for the FY 2023-24.

(Rs. in Billion)

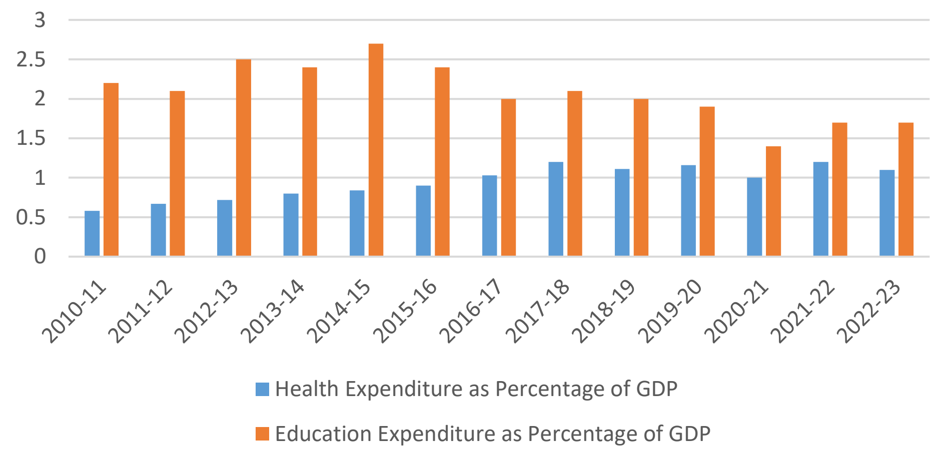
RESOURCES		EXPENDITURE	
Tax Revenue (FBR) - Federal Consolidated Fund	9,415	A. Current	13,344
		Interest Payments	7,303
Non-Tax Revenue	2,963	Pension	801
		Defence Affairs & Services	1,804
a) Gross Revenue Receipts	12,378	Grants and Transfers to Provinces & Others	1,408
b) Less Provincial Share	5,399	Subsidies	1,064
I. Net Revenue Receipts (a-b)	6,979	Running of Civil Govt.	714
II. Non Bank Borrowing	1,906	Provision for Emergency and others	250
III. Net External Receipts - Fed. Consolidated Fund	2,724		
IV. Bank Borrowing (T-Bills, PIBs, Sukuk) - Fed. Consolidated Fund	2,860	B. Development & Net Lending	1,140
V. Privatization Proceeds - Fed. Consolidated Fund	15	Federal PSDP	950
Total (II + III + IV + V)	7,505	Net Lending	190
TOTAL RESOURCES (I to V)	14,484	TOTAL EXPENDITURE(A+B)	14,484

Source: Federal Budget 2023-24, Government of Pakistan

3. What Does Fiscal Deficit Imply for Structural Economic Woes?

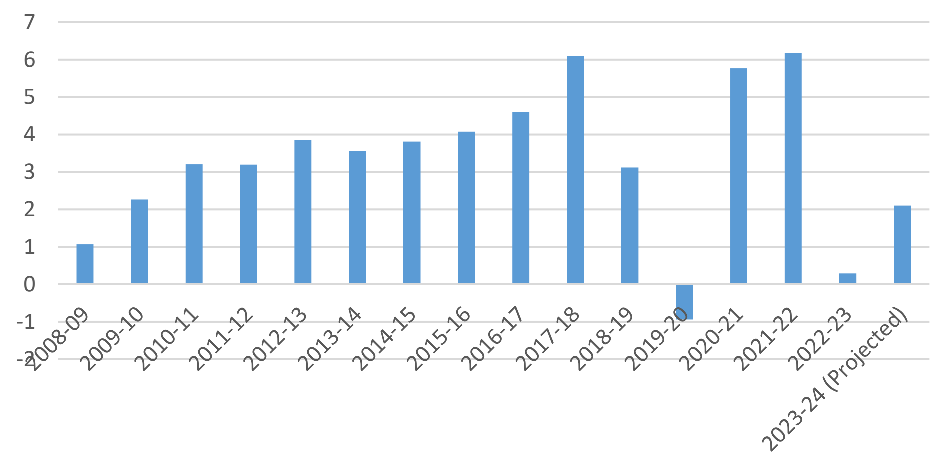
Pakistan has been facing serious consequences, owed largely to persistence in fiscal deficit. First, Pakistan has not been able to spend much on the provision of social services which is restricting fiscal policy oriented growth in the country (Khan, 2022). Pakistan has been cumulatively spending less than 5 percent of GDP on health and education, putting serious dents on the development of human capital (see figure 2). Human capital, being an important ingredient in the growth process, is very essential for overall growth of the economy and poverty reduction. This has resulted in a truncated growth performance of the country (see figure 3). Even, the growth prospects are not very bright in the near future, with the World Bank’s estimated growth rates of 1.7% and 3.2% for financial years 2023-24 and 2024-25, respectively. It would cause more unemployment, with 31% of Pakistan’s youth are already unemployed as is recently estimated by a PIDE study. Likewise, it would intensify poverty, with 39.3% of the populace is under the lower-middle-income poverty line ($3.2 per day).

Figure 2: Health and Education Expenditures as Percentage of GDP



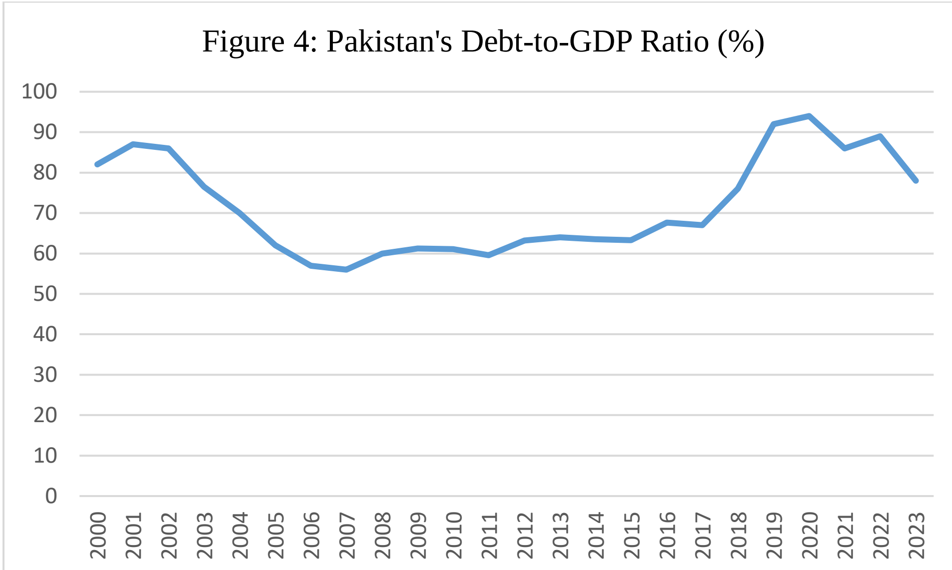
Source: Author's Calculation from Pakistan Economic Survey 2022-23

Figure 3: Pakistan's Financial Years Annual GDP Growth Rate



Source: Author's Calculation from Pakistan Economic Survey 2022-23

As is stated earlier, Pakistan has been continuously borrowing for budgetary support, with worsening balance of payments situation (Wahid, 2023). The twin deficits, i.e. fiscal and current account deficits, has collectively caused public debt to surge, with domestic debt reaches to Rs. 40.96 trillion and external debt reaches to around $127 billion as of November, 2023, both amounting roughly 78% of the country's GDP. Since 2000, Pakistan's debt-to-GDP ratio has been more than 60% for most of the time as is shown in figure 4. So, fiscal indiscipline is not only upsetting our budgetary process, but is also escalating our risks of default on external front with rising public debt.



Source: Author's Calculation from Pakistan Economic Survey 2022-23

4. The Way Forward

What needs to be done in order to ensure fiscal sustainability, come out of the debt-trap, and avert the risks of default? Pakistan has to introduce structural reforms in true letter in spirit, with clear goals of macroeconomic stability, fiscal sustainability, and sustainable economic growth. In the very short run, the focus must be on two targets. First, additional revenue streams should be found to stay on-budget as is also desired recently by the IMF. Measures such as removing preferential tax credits and exemptions, enhancing tax base and registration by simplifying the mechanism, introducing agricultural income tax, harmonizing the sales tax regime, and rationalizing public spending would serve the purpose. Second, circular debt of the power sector and losses of the SOEs must be curtailed. Reducing generation cost and capacity charges, cost-effective pricing, improving transmission and distribution mechanism, introducing competitive practices in energy market, ensuring energy efficiency along with corporate governance would ameliorate the circular debt. Likewise, reforms like corporate governance, market-based induction of CEOs, joint-ownership structure, and privatization of irremediable SOEs would eliminate leakages in SOEs.

In the medium and long terms, the focus must be on sustainable growth along with macroeconomic stability. For this, we need investment, especially Foreign Direct Investment (FDI), which can raise our labor productivity and overall growth capacities. Likewise, we need exports which, along with upscaling our growth potentials, can cope with our external sector shortages. We have been an investment deficient country, with investment-to-GDP ratio remaining below 20 percent over the last four decades. In particular, private investment has remained around 10 percent of GDP which is roughly half of regional peers and only one-third of more dynamic emerging markets in Asia (Khan, 2022). Likewise, FDI has been averaged around 0.8 percent of GDP since 2010. Around 95 percent of the FDI to Pakistan is driven by market-seeking motive, with negligible shares of those of the efficiency-seeking and natural resources based. Alternatively, we need to enhance our skills and productivity to augment efficiency seeking and natural resources based FDI in Pakistan. Recently, the World Bank has estimated the untapped potential of FDI in Pakistan to be around $2.8 billion. However, macroeconomic stability is crucial to realize such potentials. In this regard, reforms that can guarantee external sector liquidity, maintain market-determined exchange rate, improve our sovereign credit rating, and mobilize domestic revenues are of upmost importance (Khan, 2023). Likewise, market must be opened to global firms by providing them with level-playing field in terms of regulatory procedures, clearly-defined tax and trade policies, and investment friendly infrastructure.

Most of these reforms, however, need a certain political will. In other words, economic viability of the country needs to be the fundamental theme of political discourse. Reforms in political market must be initiated that can enhance the accountability of our political elite, on one hand, and solve the problems of collective action and free riding with regard to unbridled subsidies, Statutory Regulatory Orders (SROs) and several other forms of regulatory abuse, on the other.

5. Conclusion

It is concluded that fiscal indiscipline is one of the fundamental causes of Pakistan's structural economic woes such as rising public debt, poor human capital, truncated growth etc. Thus, reforms should be initiated to come out of fiscal indiscipline, unbridled debt profile, and low growth trajectory. Making an efficient, simple, predictable, and transparent tax system along with rationalizing public spending through removing subsidies and exemptions, and managing circular debt along with controlling losses of the SOEs can be instrumental in ensuring fiscal sustainability. Alongside, growth-gearing policies such as investment, especially FDI, human capital development, and competitive practices in the markets can put us on the path of a sustainable growth.

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