Structural Character of the Budget Deficit

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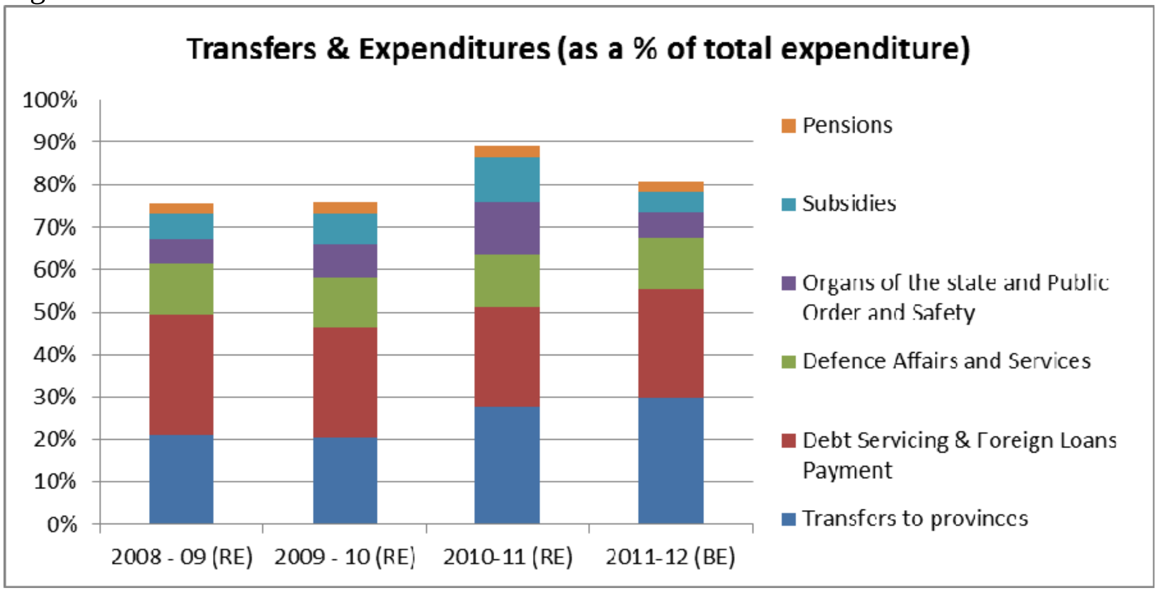
It is often correctly claimed that the Federal Government's budget deficit is the prime cause of a number of macro economic ailments that afflict Pakistan today. Persistent double digit inflation, low levels of private and public investment and thereby low growth can all be linked to the persistently high budget deficits and the mode of financing adopted for it.

There are three ways to finance the budget deficit. One is to borrow internationally. Pakistan has done plenty of it in the past but presently the tap on budgetary support from the international community appears to have dried up. The Friends of Democratic Pakistan forum has turned out to be a non-starter, at least for this purpose, and other bi-lateral and multilateral support is minimal for a host of reasons. The other two options to finance the deficit are for the government to borrow from the banking sector or ask the State Bank to print money for the government. The former results in crowding out private investment and the latter fuels an already existent inflationary spiral.

While this diagnosis may be correct, the prescriptions that are usually peddled are prejudiced at best and flippant at worst. To say that the government should reduce its expenditure by improving governance or raise taxes (while shooting down every effort at tax reform), ignores the elephant in the room, so to speak, of the effects of the 7th NFC award. This article argues that since the NFC was signed, the federal government budget deficit has acquired a structural character and unless there is a national compact on taxation that enhances the tax GDP ratio significantly, this situation is going to persist.

The structural nature of this deficit renders the reduction of the federal government's deficit in-substantive given the increase in transfers to provinces. Whereas provincial transfers before the 2009 NFC award constituted less than 21% of the total Federal government expenditure outlay, through the stroke of a pen it increased to close to approximately 30% of federal government expenditure. If we see the change in terms of total federal government revenues (tax as well as non-tax), whereas 31% of revenue would go provincial transfers, this has increased to more than 40% of total revenue in the last 2 years. The NFC award, thus, is the unambiguous game changer so far as the stickiness of the budget deficit is concerned.

Figure 1



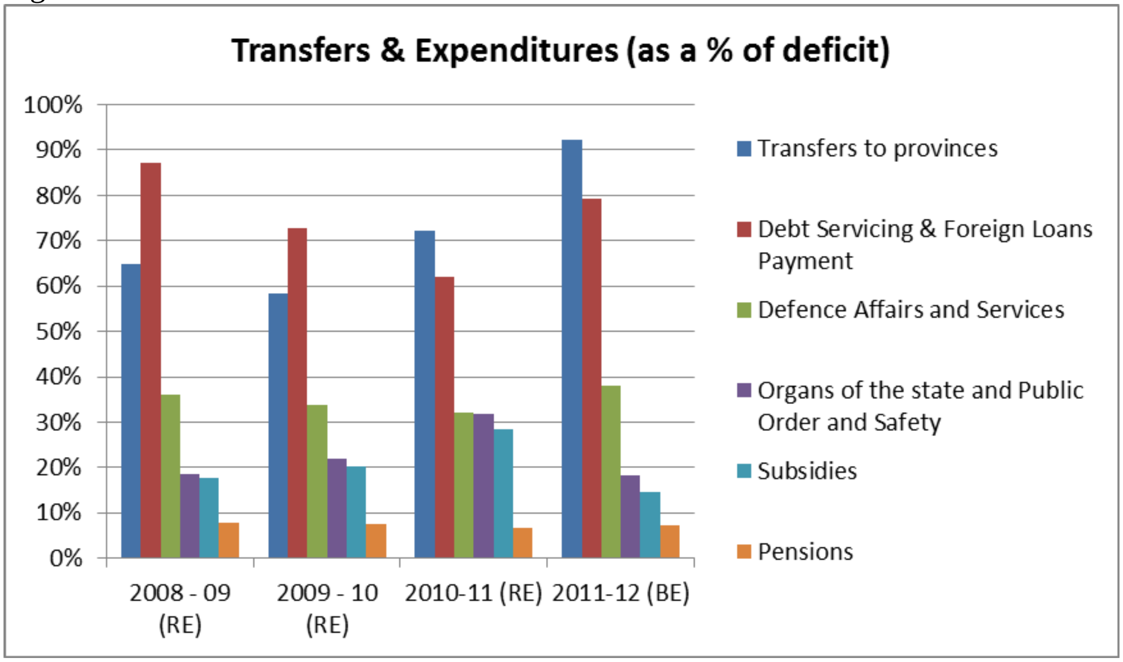
(Sources: Annual Budget Statement and Budget in Brief, various issues)

The standard refrain in the media and amongst opposition political parties is that it is not the NFC award per se but the lavish spending of the government and public sector losses that are responsible for the high budget deficit. Table 1 gives the breakup of federal government expenditure along 6 categories. Once we take out provincial transfers, four categories – defence, debt servicing, pensions, and expenditures on organs of the state (that constitute the Assemblies, the President and PM houses, the secretariats, the courts and constitutional offices like the Election Commission, the Mohtasib's office, the Council of Islamic Ideology, etc) – make up 46.2% of federal government expenditure.

These four expenditure heads should be considered as the locked-in component of federal government expenditure. While debt servicing and charged expenditure of some organs of the state are by law locked in expenses – as the National Assembly does not have the powers to vote on them – in actual fact there is little control of the civilian government on defence expenditure and pensions. If we add up this locked-in expenditure to provincial transfers, more than two thirds of expenditure is not amenable to policy changes.

It can still be argued, however, that expenditure on organs of the state, such as the assemblies, the President and PM Houses, various ministries, etc. is where extravagance exists and should thus be trimmed. Ministers gallivanting in four wheelers with a large security detail is in bad taste, but its effect on reducing the budget deficit will not be substantial. This can best be illustrated by the fact that even if we wipe out all the expenditure on 'organs of the state', this will only reduce the budget deficit by approximately 18%. In reality, of course, the organs of the state will function so long as the state exists and pruning of expenditure will make a minimal impact on the deficit. The abolishment of the Concurrent list under the 18th Amendment, has however, reduced expenditure by the federal government on 'organs of the state' somewhat, but without any significant savings so far as the deficit is concerned.

Figure 2:



(Sources: Annual Budget Statement and Budget in Brief, various issues)

Public sector losses, on the other hand, are gratuitous and should not exist. If we take the losses of WAPDA/PEPCO, KESC and Pakistan Railways (state support for PIA or the Pakistan Steel Mills are not mentioned in budget documents) that are picked up by the Federal Government, they amount to 4.7% of the federal government expenditure and contributed 29% to the federal government deficit in 2010-11. There is considerable room for improvement in this area. The energy sector in particular - WAPDA/PEPCO - and KESC contributes more than 90% of these losses. One way of reducing this deficit is to increase electricity tariffs, reduce theft and for federal and provincial governments to pay their accumulated dues to the distribution companies.

The government has an ambitious plan of reducing the subsidy given to the energy sector entities by more than half in the current fiscal year but if we go by past experience, it is unlikely to make much of a dent in the short run. The important point to remember, however, is that even if public sector losses are almost completely wiped out, it will only reduce a fourth of the budget deficit. The deficit will still remain uncomfortably high, essentially because of the steep increase in federal government expenditures as a result of the increase in transfers to provinces.

The only manner in which this new reality of enhanced transfers to the provinces can be squared up with a reduction in the deficit is through increasing tax revenues. While there is realization by the population at large and policy makers that Pakistan's tax-GDP ratio needs to be improved, the debate on this issue is vitiated by and large by shallow and unsubstantiated sloganeering.

The loudest voice in this regard is about the imposition of the agricultural income tax. While it is true that agricultural income is barely taxed in Pakistan and that it should be taxed, it needs to be remembered that agricultural income is not a federal subject. Under the constitution, tax on income earned through agriculture comes under the jurisdiction of provinces. The common refrain that the federal government's budget deficits can be curtailed through extending the tax net to include agriculture is false as even if agricultural income tax is increased, the revenue will go to provincial governments, with no impact on the federal fiscal deficit.

Tax collection for the federal government can only be increased by eliminating exemptions and improving tax compliance by corporations. According to a study done by World Bank, the tax gap (measured as potential collection compared with actuals) in 2008 amounted to over Rs. 796 billion which is 79 per cent of actual tax receipts. The largest contributor to this tax gap was evasion on corporate income tax, which in 2008 was over 200 per cent of actual receipts under this head. In 2006, around 40 per cent of firms incorporated with the Securities and Exchange Commission of Pakistan (SECP) were not even registered with the FBR and half of those registered with the tax authorities did not file returns. One of the motives behind introducing the Reformed General Sales Tax (RGST) Act last year was to increase registration of firms so as to make them liable to pay their due share to the exchequer.

Besides the non-compliance of tax, the government loses out large amounts of revenue by granting exemptions. Till very recently, tax on income earned through capital gains was exempted from income tax and stock brokers were able to get away without paying income tax on their earnings. Five major exporting industries (textiles, carpets, surgical instruments, leather and sports goods) are practically exempt from paying sales tax on domestic sales. Attempts to levy sales tax or force registration of retail businesses have been met with large scale protests, and policy initiatives related to it have either been withdrawn or significantly watered down.

It is thus obvious that Pakistan's middle class traders are not willing to pay sales tax while the rich continue to evade corporate income tax through peddling their influence with governments. As a consequence growth in tax-to-GDP ratio has remained virtually non-existent.

There is general agreement that the 7th NFC award, along with the removal of the Concurrent List through the 18th Constitutional Amendment, has gone a long way in strengthening the federation. However, its economist cost, in the form of a structural deficit problem with the Federal Government, has never been seriously discussed or addressed. It is time that the contours of the debate move away from exclusively addressing governance to this structural issue at hand.