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Coping of Structural Imbalances

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This brief paper contends that we will have to learn to live with budget deficits of 6% plus of GDP, accept that the economy will grow slowly, that our rate of inflation will be persistently higher than that of our competitors (i regard this as a new 'normal') and that the rupee will continue to be under pressure. And these macro indicators simply reflect the structural and systemic crises resulting from weak political and economic governance, poor work ethic and deferral of long overdue fundamental reforms. Getting out of this mess will take some doing. It will be particularly agonizing for a new government taking office on heightened expectations. With the future outlook of the balance of payments looking grim the country has little choice but to sign a new and difficult programme with the IMF; as night follows day we will be knocking on their doors well before the year is out.

Let's look at the indicators for this year that manifest these structural issues. Following the last NFC Award the provincial share in taxes will be in excess of 63% this year, Rs.1.2 trillion of the budgeted tax revenues of Rs.1.9 trillion, leaving Islamabad Rs.100 billion short of the cost of just one expenditure obligation, debt servicing. This means that, at least for the next 2 years, the provinces will have neither political nor economic incentives (it is easy to be a populist) to raise additional revenues. This is important since most sectors/activities of the economy (e.g. agriculture, properties, economic services, etc.) that are currently under-taxed, form the tax bases of the provinces under the Constitution. These can be taxed productively and effectively using IT and innovative techniques, e.g. by introducing a single stage (un-adjustable) sales tax at the retail level at a per sq ft rate based on location of shop, its size and nature of business.

Since the governance system protects defaulters it compounds the issue of low collections owing to unbridled tax evasion. In other words, growth in tax revenues is constrained by structural factors and bad governance. Add to the unwillingness of the elite (in its own enlightened self-interest) to pay taxes simply as a way to maintain some its privileges and you get a feel of the nature of the crisis facing the Pakistani State. This issue is best reflected in a) Pakistan's tax to GDP ratio at 9% being lower than that of Ethiopia and around that of Afghanistan; b)a country of 180 million people having a fewer number of taxpayers than say Guatemala with a total population of 14.5 million!; c) Out of 3.1 million entities with tax registration numbers less than 800,000 million filed their tax returns in FY11; d) Of the 47,800 corporates registered for tax purposes less than 16,800 filed tax returns in FY11, numbers that contrast sharply with the 400,000 industrial electricity connections; and d) while there are 3.2 million commercial electricity connections only 34,000 retailers and whole-sellers either filed a tax return last year or had tax deducted at source from payments made to them! No wonder, there is a tax gap of 79% (the difference between potential revenues under the existing system and that actually collected).

The Federal Budget, as always, overestimates revenues- receipts from the State Bank, the Americans against CSF (for re-imbursement of war on terror expenditures), auction of 3-G licenses or other inflows to finance the deficit, like outstanding receipts from Etiasalat for its purchase of PTCL or external assistance from the World Bank and ADB and bilaterals like USAID, DFID, etc. Simultaneously it under-provides for expenditures (see discussion below). All this merely worsens the environment for the budget deficit and it's financing.

Moving to expenditures, defence (on a consolidated basis more than Rs.800 billion), requires a fundamental review of our failed frameworks of security state and strategic depth (by influencing developments in Afghanistan) for a re-assessment of security related funding requirements.

Next is debt servicing of close to Rs.800 billion (much of which is in respect of loans that financed physical infrastructure in the provinces) which requires that Islamabad should in future only be constructing inter-provincial infrastructure and not, say, provincial roads and local water supply schemes. It should also be obvious that if revenues do not grow at a faster pace or expenditure management does not become more prudent debt servicing costs will balloon, pushing the budget deficit and inflation even higher, placing the exchange rate under greater stress (see discussion further below). Estimates suggest that unless specific reforms are launched urgently debt servicing alone will exceed 120 percent of the net tax revenues of the Federal Government by next year.

The next major expenditure item is subsidies, starting with imported fertilizer (whose bill this year will cross Rs.50 billion while the budget allocates nothing for it) and the cost of trading operations of agricultural commodities like wheat, cotton and sugar simply to please powerful lobbies (which for the last two could cost more than Rs. 10 billion this year with nothing earmarked in the budget). These functions/bills should be performed/picked up by the provinces whose farmers are being subsidized-and who are supposed to pay taxes on their incomes to the respective provincial government. Islamabad should be getting out of this business and close down agencies like TCP and PASSCO, which are also dens of corruption.

Next there are the power subsides costing Islamabad on average Rs.700,000 a minute (more than Rs. 1 billion a day compared with the budgeted amount of Rs.50 billion for the entire year), because of a) the provision of free electricity to WAPDA employees; b) expensive fuel mix (a subject of a separate debate); c) lower tariff than cost of electricity production to consumers of 100 kwhs and above; d) power theft (in collusion with employees of the distribution companies); e) unmetered supply; f) government departments and the private sector not paying bills and still not being disconnected; g) and Rs.35 billion worth of free provision of electricity to FATA and tubewell owners in Balochistan (the political repercussions of eliminating such subsidies should be obvious). Addressing this will also require an adjustment of pricing for power and gas-especially CNG (easier said than done) and the provision of electricity at a uniform rate at the entry point of all provincial boundaries with the distribution companies (DISCOs) being handed over, in a phased manner (after some investment in missing infrastructure in the case of some DISCOs-in Balochistan (QESCO) and Sindh (HESCO)), to the provincial governments or being privatised on agreed parameters. And then there is PIA, Railways and Steel Mills losing Rs.200,000 a minute. They will have to be bailed out repeatedly unless we can reduce their overstaffing and tackle their governance issues, with privatisation the only pragmatic solution; all such initiatives being politically intimidating.

Finally, there is the oversized state structure represented by the civil bureaucracy (even after the 18th Amendment under which several functions have been transferred to the provinces) whose weight is still being shouldered by the Federal Government- with no prioritisation of functions that the State should retain and pay from the public purse. And these adjustments need to be supplemented with greater austerity, requiring abandoning of VIP planes, bullet-proof and luxury cars, opulent housing, subsidised plots and facilities, Hajj, Umrah, etc for public representatives and functionaries at government expense (replacing it with the monetisation of all perks), economy class travel on flights less than 5 hours, etc.

Therefore, for the reasons articulated above, and plagued by misgovernance, we will have to learn to live with budget deficits that are likely to exceed 6% of GDP in the foreseeable future. Financing budget deficits of such magnitude-at least Rs.1.3 trillion for this year- would be a daunting proposition even at the best of times, which is not the case today.

In my view, for a variety of reasons (ranging from the tension in relations with the Americans to failure to stay the course on the IMF programme) inflows from abroad cannot in the foreseeable future be enough to finance a significant share of the budget deficit, while those holding cash will not easily part with it because they are earning returns (from speculative, or other, activities) that are higher than those that will be on offer on financial instruments of the National Savings

Schemes (especially after the recent 200 basis point reduction in interest rates). Therefore, a substantial share of the financing of such large budget deficits will have to come from the commercial banks if the State Bank is not to be called upon to print more photographs of Mr. Jinnah, the Father of the Nation.

However, when the government seeks more funds from commercial banks to finance its huge budget deficit it crowds out the private sector, in particular the more labour intensive small and medium sized enterprises struggling to survive without adequate supplies of reliable energy at affordable rates. With the sovereign queuing up for money the risk-averse banking sector will understandably lend to the government rather than to private businesses. Since June 2006 the share of government securities in credit of banking system has increased from 33% to 56%, - having more than quadrupled. It is staggering since over the same period the share of the private sector in bank credit has declined from 62% to below 39.5%-at the margin, the GoP is taking almost 98% of all additions to bank deposits. That the private sector is also unwilling to dilute its ownership or does not have the market credibility to raise funds from non-banking sources (it is note-worthy that Rs.1.7 trillion, 33% of rupee deposits, is currency in circulation) merely aggravates the conditions for investment and production, which provides one of the explanations why we will continue to see the economy settling at a low growth high inflation equilibrium (for the argument on continued high inflation see below).

Unfortunately for Islamabad, even if it takes the bulk of the increase in deposits from the banking system (this year it will essentially be the interest earned on existing deposits and not new deposits) -with all its implications for private investment and production, it will fall short of funds required to finance the remainder of the budget deficit from the formal banking system after inflows from abroad and non-bank receipts have been accounted for. In other words, the State Bank will have little choice but to print money, which will have its own inflationary consequences. Hence my argument that a significant proportion of the inflation that we are facing, and will continue to experience going forward, is/will be for structural reasons.

With our inflation likely to be higher than that of our trading partners or competitors, our manufacturing sector, already struggling to maintain production volumes given acute energy shortages, will find it difficult to compete internationally with a rising cost curve. This will make imports cheaper at the prevailing exchange rate, at least in the short-term, widening the trade deficit. Financing and narrowing it will not be sustainable without an adjustment in the value of the rupee. This continuing pressure on the rupee will, therefore, also be an outcome of the imbalances requiring structural adjustments for pushing the economy onto a higher growth path and thereafter nourishing it so that it can accommodate the burgeoning population of the youth looking for gainful employment opportunities. And, in the short-term, a strategy for easing the strain on the balance of payments may well have to include higher LC margins, regulatory duties on imports, etc.

The arguments above have attempted to demonstrate that the issues relating to revenue mobilization and seemingly uncontrolled expenditures are not specific to this financial year but are structural in nature. They can only be tackled over time and through painful reforms of a fundamental nature (along the lines proposed above) since we as a nation have been living on borrowed time, way beyond our means for far too long. Distributing this pain equitably, based on the ability of the different socio-economic groups to bear the burden of adjustment, will test the capability and the resolve of our political leadership, an aptitude that it has not shown hitherto.