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Public Expenditure in Pakistan

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International Growth Centre

About the project

Funded by: International Growth Center

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Impact: This work has been used to advocate to the Federal government for improved public expenditure management. It has been presented at various platforms in Islamabad.

This policy brief is based on the policy notes authored by Dr. Hanid Mukhtar (CDPR Fellow) for Adam Smith International (ASI), titled "Public Expenditure Management in Pakistan - Issues and Reforms" and "Adequacy and Effectiveness of Public Expenditure in Pakistan". It has been compiled by Mehroz Alvi (CDPR).

In brief

- There is a significant gap between the demand for public goods and services and their provision. This has impacts on social development as well as overall productivity of the labor force.
- Inefficient use of budgetary funds has been an important contributor to the slow development of public infrastructure and social indicators in Pakistan. This is compounded by the increase in overhead costs as a result of managing multiple large development schemes.
- A strong bias in favor of development spending at the expense of recurrent expenditure also results in a suboptimal mix of public expenditure that leads to insufficient provision of funds to maintain existing structures.

Justification for Increasing Public Expenditure

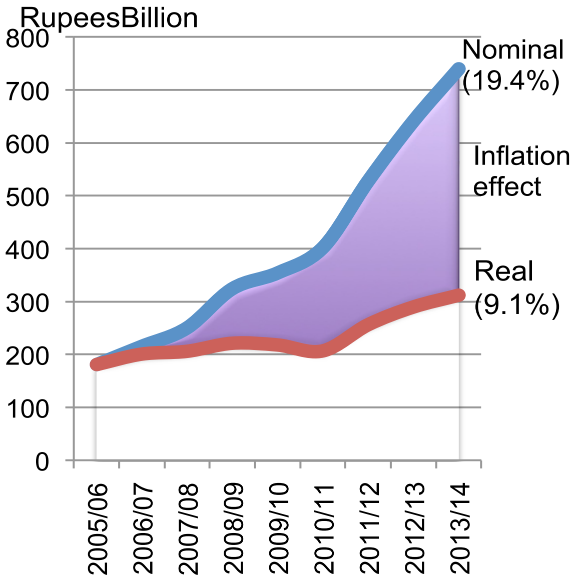
The gap between the demand for public goods and services necessary for inclusive growth and their provision has widened in Pakistan over the past two decades. This is primarily because many public goods and services remain underfunded.

Energy deficit has emerged as a key binding constraint on Pakistan's economic growth and productivity. The ongoing energy shortfall has rendered high losses to the economy, estimated to be around Rs1.5 trillion (or 7 percent of GDP) in 2011---12.[1] Pakistan currentlyhas the second highest electricity deficit in South Asia with the electricity gap reaching 20 percent of the overall demand. Improvements in the quality of Infrastructure alone, with major Contributions from electricity (1.9 percent), transportation (0.6 percent) and telecommunication (1.2 percent) sectors, can boost Pakistan's per capita GDP growth by 3.7 percent.[2]

Pakistan already lags substantially behind comparable nations in the Human Development Index (HDI), and the gap has been increasing over time. Poor human development in Pakistan indicates both Weak social development and low overall productivity of the labor force.

The Seventh NFC Award substantially increased the share of provinces in federal revenue (divisible pool) leading to a marked increase in spending on health and education (at 19.4 percent per annum between 2005-06 and 2013-14). However, most of this increase was eaten away by high inflation and a considerable raise in government salaries of employees as shown in Figure1.

Figure 1. Trends in Public Expenditure on Education and Health



Expenditure Inefficiencies

Inefficient use of budgetary funds has been an important factor contributing to the slow development of Pakistan's infrastructure and social indicators. Management of a large number of ongoing development schemes has increased the overhead costs leading to additional inefficiencies in the system. In fact, a World Bank study has determined that, on average, Pakistan takes twice the originally projected time and almost twice theoriginally Estimated cost to complete a development project. Hence, apart from expanding the fiscal space, the government must also enhance the efficiency of public expenditure.

A strong bias in favor of development spending at the expense of recurrent expenditure also results in a suboptimal mix of public expenditure that leads to insufficient provision of funds to maintain existing structures.

Persistent Expenditures

The Debt Burden

In June 2014, Pakistan's public debt stood at Rs.16 trillion (63 percent of GDP), of which two-thirds was domestic debt, carrying an average interest rate of 10.7 percent per annum.[3] Contrary to popular belief, domestic debt is substantially more expensive than foreign debt, with an average interest rate of only 1.9 percent. However, in the past 15 years, the government has had to resort to domestic borrowing because of the ongoing security and financial crisis, suspension of support from international donors and low fiscal cost of borrowing from the central bank. Of the total cost of interest paid on debt (Rs.1.3 trillion), domestic debt contributes 92 percent (Rs.1.2 trillion) while foreign debt adds only 8 percent (Rs.100 billion).

The Subsidy and Grants Morass

Subsidies and grants had been relatively small (less than 2 percent of GDP) until 2006-07. A rise in 2007-08 was observed mainly due to the rapid increase in subsidies on oil and electricity to cushion the international price increase (Figure 2). However, subsequent moderation in the power subsidy made the payments fall to 2.8 percent of GDP in 2013-14.

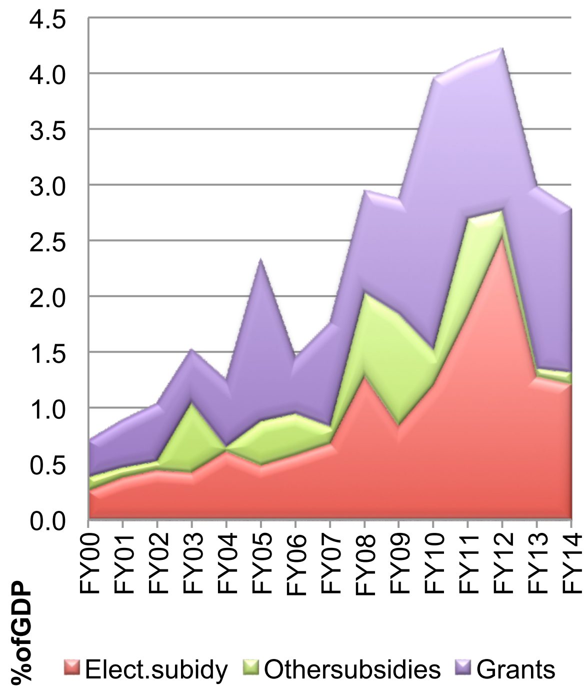
Other Issues with Budget and Expenditure Management

More than 53 percent of federal government's expenditure is incurred on interest payments, defense and wage bills and another 29 percent

[1] Pasha, Hafiz, A. Et al "Economic Costs of Power Load shedding in Pakistan", Institute of Policy Studies, Beaconhouse National University, Lahore;2013
[2] World Bank, "Pakistan: Investment Climate Analysis" Washington DC. 2013
[3] This is the average of all government domestic borrowings over a period of last 15 years.

Is allocated towards subsidies and grants. These expenses are unlikely to lower in the short run. The remaining expenditure that is fully adjustable stands at only 18 percent. Misplaced priorities have also diverted funds from high priority areas such as physical infrastructure Investment.

Figure 2. Trends in Subsidies & Grants



With a tax-to-GDP ratio of only 10.4 percent, Pakistan's rank falls close to the bottom in ranking of countries on the basis of revenue collection with a tax-to-GDP ratio of only 10.4 percent. This low revenue collection can be attributed to a) inefficient tax administration, b) a narrow tax base with only 10 percent of those employed paying taxes, c) skewed tax structure with 68 percent of the tax revenue being generated from indirect taxes, d) a complex and non-transparent tax system, e) corruption and tax evasion and f) a non-supportive political environment. In the current setting, tax exemptions and concessions granted to the rich taxpayers further exacerbate the issue. Furthermore, every successive government is forced to make additional tax concessions to maintain the support of wealthy interest groups. The whole system is focused on short-term benefits at the expense of long-term national interests.

Key growth supporting public expenditure has been financed mainly through borrowing. However, non-revenue sources are now becoming available at a very high cost and the government must explore alternate options to finance public expenditure.

Recommendations

To conclude, introducing reforms to enhance fiscal space is necessary to bear the additional cost of the government's commitments towards improving infrastructure and expanding pro-poor and social spending. Some of these reforms can include:

A. Enhancing revenue generation through integrated tax policy and administration reforms. To date, the government has adopted a segregated approach towards improving the taxation system, where tax policy and tax administration reforms are viewed and implemented separately. By removing the isolation between these two kinds of reforms, improvements can be expedited.
B. Similar efforts must be made at the provincial level as well to improve provincial resource mobilization.
C. Improving debt and cash management practices at the federal and provincial levels to reduce the cost and term structure of government debt and borrowing.
D. Reducing the cost of electricity subsidies by rate adjustment and improved governance, and improving their efficiency through better targeting.
E. Lowering the burden on the budget of inefficiencies of State-Owned Enterprises (SOEs) through an appropriately designed program of corporatization and/or privatization.

A tentative estimate of the fiscal impact of these reforms is given in Table 1. This shows that a significant portion of government's future financing needs could be met by these reforms.

Table 1. Estimated Impact of Government Reforms

ReformArea	**Fiscal Impact *(PercentofGDP)***
Federal and Provincial LevelTaxReforms	0-5% - 1.0%
DebtManagementReforms	0.4% - 0.8%
PowerSectorReforms	0.5%
SOEsReforms	0.5%
Total	**1.9% - 2.8%**