Fiscal Policies of Pakistan and Kazmi's Hypothesis

AQDAS ALI KAZMI

Pakistan has maintained an average GDP growth rate of about 5.5 percent during the period 1981–98. An analysis of the growth experience of Pakistan, however, indicates that some basic macroeconomic imbalances have been built in the economy during this period, which have serious implications for long-term sustainability of the economic growth of the country. The growth performance of Pakistan has synchronised with declining rate of domestic savings, erratic and inconsistent variations in the national savings ratios, low level of domestic investment and excessive dependence on the external resource inflow (current account deficit) to finance the gap between national savings and the level of gross investment. In other words, Saving-Investment and Import-Export Gaps in the economy have widened during this period. These macroeconomic imbalances have been highlighted from time to time in numerous studies such as Burki (1996, 1998); Hasan (1998); Hussain (1999); Kazmi (1991, 1994, 1998); Papanek (1996) and Qureshi (1989).

Pakistan's national savings as a percentage of GDP, have fluctuated around a low level of 14 percent with a downward trend in 1990s while the private savings during the period 1981–98 have failed to register any significant upward movement.

Since the public sector investment has been a multiple of the level of public savings, the public sector continues to draw heavily from the private savings, and to supplement these savings through internal and external borrowings, as well as deficit financing.

The critical factor in public finance and fiscal management of Pakistan is the growing deficit in the revenue budget which also is the main cause of the low public sector savings.

Another notable aspect of fiscal developments in Pakistan is that whereas the overall fiscal deficits is declining, there is percetible decline in the development expenditure in the public sector. Therefore while evolving our fiscal policy options, detailed analysis of financing of fiscal deficit and the consequent Resource Gap in the public sector is required.

In the specific macro-fiscal terms, our concern is with the question: How could the Resource Gap (R_G) i.e. the gap between the size of the PSDP (D_O) and the total resources (R_T) generated by the fiscal system be minimised by the public authorities? Or otherwise, if Resource Gap (R_G) of a magnitude has finally emerged, how efficiently it could be covered by the budgetary system of the country? In other words, our concern would be the decomposition of the equation:

$$D_O = R_T + R_G \qquad \ldots \qquad \ldots \qquad \ldots \qquad \ldots \qquad \ldots \qquad \ldots \qquad (1)$$

Where $D_O =$ The overall size of the Public Sector Development Programme (or PSDP).

$R_T =$ Total Resources generated by the fiscal system.

$R_G =$ The gap between the size of the PSDP and the available resources.

Equation (1) could be further elaborated as:

$$D_O = R_{INT} + R_{EXT} + R_G \qquad \ldots \qquad \ldots \qquad \ldots \qquad \ldots \qquad \ldots \qquad (2)$$

or $$D_O = R_B + R_{NC} + R_{SF} + R_{EXT} + R_G \qquad \ldots \qquad \ldots \qquad \ldots \qquad \ldots \qquad (3)$$

or $$D_O = (R_C - E_C) + (R_{GC} - R_P) + R_{SF} + R_{EXT} + R_G \qquad \ldots \qquad \ldots \qquad (4)$$

The symbols of the equations denote the following:

$R_{INT} =$ Internal Resources.

  $= R_B + R_{NC} + R_{SF}$.

$R_B = R_C - E_C$.

$R_C =$ Net Revenue Receipts.

$E_C =$ Current Expenditure.

$R_{NC} =$ The Net Capital Receipts $= R_{GC} - R_P$.

$R_{GC} =$ Gross Capital Receipts.

$R_P =$ Gross Capital Payments.

$R_{SF} =$ Self-financing by the autonomous bodies.

$R_{EXT} =$ External Resources comprising of foreign assistance, loans etc.

$R_G =$ Resource Gap.

Equations (3) and (4) reflect "autonomous" conditions of the fiscal system in the sense that they do not incorporate the impact of the new budgetary measures which may be introduced by the budget authorities to partially or wholly meet the Resource Gap (R_G) of the country in a given fiscal year. The volume of external resources (R_{EXT}) is

exogenously given but the revenue surplus (R_B), the amount of self-financing by the autonomous organisation (R_{SF}), the magnitude of net capital receipts (R_{NC}) are endogenous variables of the fiscal system and thus are amendable to change with the variation in fiscal policies. The new fiscal measures, can assume the form of imposition of new taxes, a cut in non-development revenue expenditures, enhanced tariffs, etc., or under certain circumstances, an ad hoc cut on the budgeted Development Outlays (D_O) could be levied by the fiscal authorities with a view to bringing the size of the Public Sector Development Programme in line with the availability of total resources. Presently, however, we assume that Development Outlays (D_O) remain unchanged, but adjustments are made in other budgetary parameters.

Once the impact of the new budgetary measures has been incorporated into the fiscal system, the magnitude of the various fiscal variables and co-efficients would change accordingly. If the new measures generate additional resources equivalent to the projected Resource Gap (R_G), the term (R_G) would be eliminated from Equation (3). On the other hand, if the new measures fail to generate adequate resources to fully cover the Resource Gap (R_G), the final gap would have to be covered by the Budgetary Support (B_S) i.e. deficit financing by an equivalent amount. Equation (3) would then be reduced to

$$D_O = R_B + R_{NC} + R_{SF} + R_{EXT} + B_S \qquad \dots \qquad \dots \qquad \dots \qquad (5)$$

The variables with the sign (*) of the equation reflect their final magnitudes with the incorporation of the impact of new budgetary measures. The Equation (5) can be rewritten as:

$$1 = R^*_B/D_O + R^*_{NC}/D_O + R^*_{SF}/D_O + R_{EXT}/D_O + B_S/D_O \qquad \dots \qquad \dots \qquad (6)$$

In Equation (6), the relative weight of each source of financing of public sector development outlays would be given by the co-efficients:

$$R_B/D_O, \ R^*_{NC}/D_O \text{ --------- and so on.}$$

The ratio R^*_B/D_O is of particular significance in fiscal management as it helps to understand the interrelationship between the Revenue Budget and the Capital Budget and indicates the extent to which the Revenue Budget generates resources for financing Development Outlays of the Public Sector.

Equation (6) signifies that those countries which have weak resource base (small revenue surplus) have to depend heavily upon external loans and foreign assistance as well as on budgetary support to bridge the resource gap. With a view to emphasising the importance of revenue surplus as a source of financing development expenditure, the author has developed a parameter called Resource Base Co-efficient (RBC) which is defined as the ratio between revenue surplus/deficit (difference between the gross revenue receipts and the current expenditures) and the public sector development

outlays for a given period of time. The Resource Base Co-efficient (RBC) can be interpreted either in 'ex ante' or 'ex post' terms. In 'ex ante' terms it would indicate the ratio between the anticipated revenue surplus and the proposed size of the public sector development expenditure as provided in the budget, while in 'ex post' terms it would be defined as a ratio between the actual revenue surplus/deficit and the actual development expenditure incurred by the public sector during a specified period.

The basic use of the concept of resource base co-efficient (RBC) is that it serves as one of the reference parameters to measure the overall efficiency of the fiscal system overtime in the context of its resource generating capacity.

Kazmi's Hypothesis

Making use of the concept of RBC, the author has put forward Kazmi's Hypothesis of fiscal efficiency which postulates:

> "If the resource base co-efficient of a country, after incorporating the
> effect of new budgetary measures, remains below the critical minimum
> limit of 20 percent for a given period, that country would fail to meet
> one of the basic conditions of fiscal efficiency. By implication, the
> magnitude of the resource base co-efficient which is defined as the ratio
> between the surplus in the revenue budget and the public sector
> development outlays would reflect the relative efficiency of the fiscal
> system of a country".[1]

The essential condition of fiscal efficiency as envisaged in Kazmi's Hypothesis could be expressed in a simple mathematical form:

$$(R^*_c - E^*_c) / D_O = 20.0 \text{ percent.}$$

Where R^*_c = Net Revenue Receipts with budgetary measures.

E^*_c = Current Expenditure.

D_O = Total Development Outlays of the Public Sector.

The critical minimum limit assigned to the resource base co-efficient equivalent to 0.20 or 20 percent is the focal point of the Hypothesis.

The Hypothesis, in its essence, symbolises one of the methods which emphasise that the proposed development outlays in the public sector must bear some relationship with the availability of domestic resources or internal savings of the country. Under sound fiscal conditions, we would expect that a country would finance 40 percent–50 percent of its development expenditure in the public sector from the revenue surplus,

[1]This Hypothesis was originally presented at the Meeting of All Pakistan Economic Conference held at Pakistan Administrative Staff College, Lahore on October 19-20, 1981 in a paper entitled "Financing of the Public Sector Development Programmes and Fiscal Efficiency: An Exposition of Kazmi's Hypothesis".

supplemented by the net capital receipts, self-generated funds of autonomous bodies and foreign loans and assistance. This would be a case of an "ideal" resource base. Under less than ideal but progressive conditions, the development outlays would be financed from the revenue surplus to the extent of say 30 percent–40 percent, supplemented by the capital savings and external resources—implying a "strong" resource base. The range of resource base co-efficient between 20 percent and 30 percent could be considered as "reasonable" and coming down the scale, the resource base co-efficient between 0–20 percent could be considered as "viable". However, a negative RBC would indicate a weak resource base which would reflect either of the conditions such as relative under-development of economic structure, general fiscal indiscipline in the economy or some uncontrollable economic imbalance necessitated by unwarranted exigencies forcing heavy non-development expenditure on sub-heads like defence, debt-servicing, public administration etc.

The significance of the hypothesis as a tool of evaluating budgetary policies of Pakistan can be gauged from Table 1 which shows that the Resource Base Coefficients

Table 1

Pakistan: Consolidated Budgetary Position and Estimates of Resource Base Coefficient

(Rs Billion)

Year (1)	Revenue Receipts (2)	Current (3)	Expenditures Development (4)	Total (5)	Overall Deficit (6)	Revenue Surplus (7)	RBC % (8)=(7)/(4)
1980-81	49.03	40.32	23.32	63.64	14.61	8.71	37.35
1981-82	53.84	46.37	24.64	71.01	17.17	4.47	30.32
1982-83	61.47	59.69	27.43	87.12	25.65	1.78	6.49
1983-84	74.85	71.55	28.06	99.61	24.76	3.3	11.76
1984-85	80.04	83.77	33.05	116.82	36.78	–3.73	–11.29
1985-86	92.81	94.69	39.78	134.47	41.66	–1.88	–4.73
1986-87	105.70	116.24	36.16	152.40	46.77	–10.54	–29.15
1987-88	122.81	133.65	46.73	180.38	57.57	–10.84	–23.20
1988-89	144.30	153.07	48.11	201.18	56.88	–8.77	–18.23
1989-90	165.59	165.60	56.05	221.65	56.06	0.01	–0.02
1990-91	171.78	195.68	65.29	260.97	89.19	–23.90	–39.61
1991-92	231.50	230.12	91.35	321.47	89.97	1.38	1.51
1992-93	241.13	272.46	76.20	348.66	107.53	–31.33	–41.12
1993-94	272.73	293.46	71.45	364.91	92.18	–20.73	–29.01
1994-95	322.93	345.94	82.34	428.28	105.35	–23.01	–27.95
1995-96	380.26	423.87	94.23	518.10	137.84	–43.61	–46.28
1996-97	348.33	455.41	85.51	540.92	156.59	–71.08	–83.12
1997-98R	452.15	510.45	89.11	599.56	147.41	–58.30	–65.42

(RBC) which was positive in early eighties had turned into a negative figure from 1984-85 onwards. It remained negative for all the years till 1997-98 except for the year 1991-92. The magnitude of the RBC has fallen very significantly from –4.73 percent in 1985-86 to –65.42 percent in 1997-98 which is preceded by the lowest RBC of –83.12 percent for 1996-97.

During the Eighth Five Year Plan the fiscal performance has been quite poor especially when evaluated in terms of the mode of financing total outlays for the plan period. Whereas target for the Eighth Plan was fixed at Rs 49 billion for the revenue surplus at constant prices of 1992-93, the actual outcome has been a revenue deficit of Rs 147 billion showing a steep decline in resource mobilisation in the country and larger dependence on net capital receipts, bank borrowing and external resources.

Implications of Negative RBC

The implications of the negative RBC are as follows:

(i) The large but negative value of RBC is an indicator of serious budgetary imbalances which have dominated the macroeconomic developments from mid 1980s onwards. The primary reason for the large negative value of RBC is the disproportionate growth in current expenditure which has risen from 13.6 percent of GDP in 1980-81 to 18.6 percent of GDP in 1997-98.

(ii) The steep decline in the development expenditure (PSDP) as a ratio of GDP clearly shows that the phenomenal growth in the current expenditure is crowding out the development expenditure—an outcome which becomes quite significant from 1992-93 onwards with the development expenditure falling from 5.7 percent of GDP in 1992-93 to 4.5 percent in 1993-94 and 3.4 percent in 1996-97.

(iii) The reduction in the budget deficit from 8.0 percent of GDP in 1992-93 to only 5.4 percent of GDP in 1997-98 is not a major achievement in fiscal management because it only camouflages the steep decline in the development expenditure in the public sector.

(iv) The negative value of RBC for many years indicates that Government of Pakistan is financing from debt not only its development expenditure but a part of its current expenditures.

(v) Changes in the volume of revenue surplus are critical in determining the overall savings in the public sector. This is substantiated when we find that public savings as a ratio of GDP had risen significantly in 1980-81 (3.8 percent) and in 1981-82 (3.1 percent). These two years were characteristic for major effort at resource mobilisation in the form of increased tax revenues growing by 20 percent in 1980-81 and 11 percent in 1981-82.

Tax Revenues in Pakistan

The present predicament is the natural consequence of the Government failure to increase its revenue receipts commensurate with the rising expenditure especially the current component. It is a paradox that the revenue receipts of the Government which were 16.9 percent of GDP in 1980-81 had dropped to 15.4 percent in 1996-97 and were only 16.5 percent of GDP in 1997-98.

Tax revenues have shown little improvement in the 18 years period from 1980-81 to 1997-98 inspite of the fact that during this period per capita income of Pakistan has risen from $350 to $450. The total tax revenue as a ratio of GDP have remained almost static at 13.1 percent from 1980-81 to 1997-98. However, there has been a transformation in tax collection reflected in an increase in the revenues under direct taxes from 2.5 percent of GDP in 1980-81 to 3.8 percent in 1997-98 but at the same time the revenues from the indirect taxes have declined from 10.6 percent of GDP to 9.4 percent in the comparable period. This is despite the fact that the share of surcharges on Gas and POL have increased substantively as revenue spinners for the Government. Surcharges which had negligible contribution to total revenues in 1980-81 had gone up to 1.7 percent of GDP in 1997-98.

Level of Tax Effort in Pakistan

It is generally recognised that tax effort in Pakistan is extremely low. Four factors have been identified for the low income tax collection in Pakistan:

(i) Agricultural income which accounts for about 23 percent of the national income is exempt from income tax.
(ii) In relation to the average income in the country, the minimum exemption limit for purposes of income tax is fairly high.
(iii) A large number of persons whose income are somewhat in excess of the minimum exemption limit do not seem to pay income tax at all.
(iv) Those who do pay tax, often understate their taxable income.

The first two factors restrict the tax base owing to which not more than 5-7 percent of the households in Pakistan would appear to be liable to pay income tax.

Extent of Tax Evasion

Adopting the methodology used by Prof. Nicholas Kaldor for estimating tax evasion in India, Beg (1979) calculated that the ratio of income assessed to tax vis-à-vis income which has escaped taxation in Pakistan falls in the range of 1:1.6 and 1:2.0. A conservative estimate is made by Beg that the income which is not assessed is about 1 1/2 times the income which is assessed. This clearly reflects that a large share of income remains outside the tax net and by bringing the excluded portion of the taxable

but adverse developments in the external sector. According to State Bank of Pakistan Annual Report 1997-98, Pakistan's ratio of external debt to exports of goods and services (including workers' remittances) at 256.1 percent during 1997-98 was much higher than 135.8 percent of developing countries and 186.7 percent of South Asia as a group. At the same time, debt service ratio at the level of 40.8 percent was also higher when compared with 17.0 percent of developing countries and 21.5 percent of South Asia. Pakistan's external debt and debt service ratios also exceeded the prescribed debt sustainability normal limits of 225–250 percent and 20–25 percent respectively.

The Ricardian Equivalence Approach

The ever-increasing reliance of the Government on internal and external borrowing to finance its expenditure indicates that the Government is following policies which are in line with the well-known Debt-Neutrality Hypothesis or Ricardian Equivalence Doctrine. Whether this is by default or by design, the pursuit of this path is beset with serious macroeconomic consequences. The earlier study by Kazmi (1991) followed by Kazmi (1992, 1994, 1995) have highlighted the basic weaknesses of the Debt-Neutrality Hypothesis and therefore the need for the Government to review its present fiscal stance of accumulating public debt without carefully examining its long term implications for the economy. The simple extrapolation of the present trends in debt financing, however, indicate that Pakistan's GNP and the national debt would coverage by the year 2002-3.

Limitations of the Hypothesis

The Hypothesis has its limitations. The main limitation of the Hypothesis relates to the choice of Resource Base Coefficient (RBC) of 20 percent as the critical minimum limit for defining the fiscal efficiency of a country. If the minimum limit was reduced to 10 percent, it would have lowered the fiscal effort which would be required to increase the tax yield and other revenues to meet the development expenditure of a given country. If the minimum limit of RBC was raised above 20 percent, it would have been difficult for many developing and even developed countries to meet this higher level of fiscal efficiency. In this sense, the choice of 20 percent as the critical minimum limit of RBC for the fiscal efficiency looks reasonable and would reflect the prevailing fiscal conditions of the developing as well as developed countries.

The Hypothesis can be applied with reasonable convenience in those countries which prepare their Annual Budgets showing current expenditure and development expenditures as two distinct components of budgetary system. However, in some of the developed countries, the annual budgetary allocations are made for each Ministry/Department without specifying the development and the non-development components. Under such conditions, the application of the Hypothesis is not possible. In

other words, the availability of budgetary data classified into Revenue Budget and Capital Budget is a necessary condition for testing and applying Kazmi's Hypothesis.

CONCLUSIONS AND RECOMMENDATIONS

Considering the various factors discussed in the paper such as growing non-development expenditure in the public sector, low resource base co-efficient, higher debt servicing on external loans, it can be easily concluded that the aggregate resources to be mobilised by the fiscal system will not be adequate to sustain the growth rate of the Pakistan economy, historically maintained.

There is an urgent need for Government of Pakistan to reform the tax structure of the country so as to increase the revenues substantially to minimise its dependence on internal and external debt. A number of reports on tax reforms and tax administration prepared in recent years can be of immense help in this regard.

The issue of black economy, smuggling and tax evasion need a thorough examination for evolving a lasting solution to stop the revenue haemorrhage.

The need for reviewing the entire spectrum of public sector expenditure cannot be overemphasised. The large programmes such as motorways, airports projects, Social Action Plan (SAP) and other related projects need an indepth evaluation for effective use of scarce public resources.

The Government must set up a high powered Debt-Management Committee to monitor the ever-exploding public debt with a view to defining a clear-cut strategy for reducing both debt and debt-servicing in Pakistan.

The experiment of market-based monetary policy must be thoroughly reviewed with a focus on its impact on domestic debt.

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