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BURDEN OF STABILIZATION ON PROVINCES AND ITS IMPLICATION ON SOCIAL SECTORS

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ABSTRACT

Our analysis shows that the process of shifting the burden of stabilization to the lower tiers of the government has seriously shrank the capacity of the provincial governments to invest in social services. This resulted in low social expenditures and consequently poor social conditions in Pakistan.

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1. INTRODUCTION

An agenda of economic reform encompassing a broad range of structural adjustment policies (SAP) is underway in Pakistan since 1987-88. These policies have an adverse impact on the pace of economic growth and created more poverty and inequality in the country (see Bengali and Ahmed (2002), Kemal (2003)). These studies argues that during the last fifteen years each government is trying to stabilize the economy even at the cost of economic growth and delivery of social services. The negative impact of stabilization policies on economic growth of the country is reflected in the decline of GDP growth from an average annual growth of 4.6 percent during 1990s as compared to 6.5 percent during 1980s. Similarly, negligence of social services delivery is reflected in the recent UNDP Report (2003), which, show that the ranking of Pakistan has slipped from 136 to 141 along with the decline in many other social sector statistics. The top government officials now also recognize these facts and the relapse of growth oriented policy can be heard more often.

Trend in public finance statistics of the country clearly indicate that one of the important victim of stabilization policies are the expenditures of provincial governments. In last several years the significant portion of onus of containment of fiscal deficit has been shifted towards the provincial governments. The onus of containment of fiscal deficit by all four provincial governments during the last decade has increased from 18 percent to 50 percent, which has devastating impact on the service provision and poverty reduction.

Despite, the vast body of literature on stabilization policies and its impact on economy and social sector expenditures, it is one of the pioneering work in Pakistan to explore the mechanism through which federal government stabilization policies affect the social sector expenditures of the provincial government which subsequently result in decline in social sector indicators. The rest of the paper is organized as follow. Section two provides the details related to the calculation of fiscal deficit and highlight the mechanism through which burden of stabilization transfers on provincial governments. Section three analyzes the impact of the burden of stabilization on the social services and poverty reduction. Section four offers policy implications and conclusions.

2.1 Computation of Fiscal Deficit

Conceptually, fiscal deficit is simply the difference between total revenues and total expenditure, with the former including both tax revenues and non-tax revenues and the latter including both current and development expenditure. However, the computation of the fiscal deficit in practical world is slightly complicated and there are many issues, which require consideration prior to the computations of fiscal deficit at aggregate level. On the expenditure side, repayments of foreign debt are not the part of fiscal deficit computation because it is used for reduction in outstanding debt and, thereby, contributes to reducing liabilities and therefore it is excluded from the total expenditures of the government. Another important issue is related to the inclusion of development expenditures in federal or provincial expenditures.

On the revenue side, both tax and non-tax revenues are added after deduction of provincial share in revenues to obtain federal net revenue receipts then federal fiscal deficit is compute. Subsequently the combined fiscal deficit is simply the sum of the overall deficit of the federal government minus the revenue surplus of the provincial governments. Therefore, we have the formula for computing the consolidated fiscal deficit of the federal and provincial governments as follows:

Fiscal deficit = federal current expenditure + development expenditure (PSDP)
- net federal revenue receipts - self-financing of PSDP by provinces
- repayment of foreign debt - loan recovery from provinces + net lending to others - Provincial Surplus

2.2 Containment of Fiscal Deficit by Provinces

Table-1 presents a comprehensive overall fiscal deficit and details of the provincial component, which play a significant role in the reduction of overall fiscal deficit. It shows that if the provincial contribution is removed, the overall fiscal deficit increases by the amount equal to the provincial component. The provincial contribution to fiscal deficit containment comes from four major heads.

- Interest payment by the provinces to the federal government,
- Recoveries of loan from provinces by the federal government,
- Self- financing of PSDP by provinces and
- The surplus in the provincial budget.

Table 1 shows fiscal deficit was Rs. 65.3 billion in 1990-91 was increased to 181.3 billion in 2002-03. Over the same period, containment of fiscal deficit by provinces increased from Rs. 15 billion to Rs. 92 billion. Thus while the fiscal deficit has grown at an annual average rate of 8.8 percent, the containment of fiscal deficit by provincial governments has grown at 16.3 percent. As a result of this sharp increase in the provincial contribution the share of containment of fiscal deficit increased from 23 percent of fiscal deficit in 1990-91 to 51 percent in 2002-03. This implies that if this contribution were not there, the budget deficit would have increased by 23% in 1990-91 and by 51% in 2002-03. This clearly shows that the onus of containment of budget deficit is placed on the provincial governments.

TABLE - 1
WHO IS BEARING THE BURDEN OF STABILIZATION

(Revised Estimates in Rs. Billion)

Heads / Years	Provincial Component					Fiscal Deficit	Provincial Component % of Fiscal Deficit
	Total	Interest payments from Provinces	Recovery of Loans from Provinces	Self-Financing of PSDP by Provinces	Provincial Surplus		
1990-91	15.0	13.5	1.5	0.0	0.0	65.3	23.0%
1991-92	17.6	15.9	1.7	0.0	0.0	93.7	18.8%
1992-93	20.1	18.0	2.1	0.0	0.0	95.6	21.1%
1993-94	22.5	20.1	2.4	0.0	0.0	99.1	22.7%
1994-95	29.7	21.9	2.8	5.0	0.0	109.6	27.1%
1995-96	36.8	22.7	3.4	10.7	0.0	132.4	27.8%
1996-97	43.2	24.2	5.0	14.0	0.0	153.3	28.2%
1997-98	35.7	26.1	5.8	3.9	0.0	141.0	25.3%
1998-99	35.7	25.5	6.4	3.9	0.0	103.4	34.6%
1999-00	57.8	28.3	8.0	6.8	14.8	122.0	47.4%
2000-01	59.3	29.4	9.0	20.5	0.4	185.6	32.0%
2001-02	56.6	29.5	10.1	15.4	1.6	257.1	22.0%
2002-03	92.0	28.0	18.8	28.7	16.6	181.3	50.7%
2003-04*	96.7	26.9	11.8	30.0	28.0	175.3	55.2%

* Budget Estimates
Source: Federal Budget in Brief and Explanatory Memorandum of Federal Receipts

Among the provincial components, maximum growth has registered in the recoveries of loans segment, with its share in the containment of fiscal deficit rising from 2 percent in 1990-91 to 10 percent in 2002-03. Self-financing of Public Sector Development Programme (PSDP) commenced in 1994-95 and its share in the containment of fiscal deficit has risen from less than 5 percent to about 16 per cent in 2002-03. The provincial budget surplus commenced in 1999-2000 and constituted 9 per cent of the fiscal deficit in 2002-03. For 2003-04, its share of provincial budget surplus is projected to nearly double, reaching 16 percent.

2.3 Implications of NFC Awards 1991 and 1997

Changes in the 1991 and the 1997 National Finance Commission (NFC) Awards are the major instruments that curtailed provincial fiscal space. Prior to the 1990 NFC Award, the provincial governments were allowed to have deficit in their budgets which then were financed by the federal government in the form of deficit grants. The 1990 NFC Award deleted the provision for federal deficit grants to the provinces. This deletion requires provinces to limit expenditures correspond to their resources and since the establishment expenditures are more or less fixed, the only scope for expenditure reduction lies in social sector expenditures and impacted directly on social service delivery. However the federal government decided to continue to cover the expenditures of the provincial component of the PSDP, which meant that provincial development activities continued to proceed.

The 1997 NFC Award introduced few major changes having far reaching impacts on provincial finances. First, provision for federal financing of the provincial component of PSDP was withdrawn and provinces were required to finance their own development expenditures. Second, no tax bases were transferred to the provinces to enable them to finance this additional burden and therefore every rupee of development expenditure incurred by the provincial governments needs a cut into other expenditures.

Thirdly, before the 1990 Award the customs duties did not form part of the divisible pool and the federal government used to retain the entire proceeds. However the Income tax and sales tax were part of the divisible pool and the federal government after retaining 20 per cent of the proceeds and 80 per cent were distributed among the provinces. The 1997 Award redefined the federal divisible pool and the revenue sharing formula. The Award included all taxes in the federal divisible pool and changed the federal and provincial share to 62.5% and 37.5% respectively.

At this point of time the federal government began to implement the crucial part of its structural adjustment reforms- scaling down customs duties drastically and expanding sales taxes significantly. Had the 1991 Award distribution arrangement continued, the provinces would have borne no burden of the decline in customs duty revenues and would have received 80 per cent of the additional revenues from sales tax? With the courtesy of the 1997 Award the federal government shifted one-third of the loss from customs duties to the provinces and enhanced its share in the sales tax revenues by over 40 percentage points. Therefore, from the provincial viewpoint, the NFC 1997 brought two bad news on revenue side. First the provincial governments now have to share with the federal government the fall in the custom duties and second allow federal government to share with them in the increase in sales revenues.

Under the new scenario of the reduced provincial receipts from the federal divisible pool and the additional burden of PSDP expenditure, the provincial governments were allowed to take loans from the federal government to finance their deficits. The situation is further aggravated when the federal government charges a very high interest rate on these loans. This high interest rate was also not justified on economic grounds because the federal government borrowed at lower rates from abroad and lends it to provincial governments at higher rates.

In last several years, such developments have squeezed the fiscal space for the provinces, leaving little to spend on the provision of social services. The provincial share of financing the federal fiscal deficit, as a percentage of total provincial expenditures, has risen from 17 percent in 1990-91 to 29 percent in 2002-03. If the provinces were not pressed to share the federal fiscal deficit, they would have had Rs. 92 billion, or 29 per cent, more at their disposal in 2002-03.

3. IMPACT ON SOCIAL SERVICES EXPENDITURES

Adequate provision of social services is a concurrent function of federal and provincial governments, however, in Pakistan, the financing and delivery of social services largely rest with the provinces but major sources of revenues in the hand of federal government. The changes in 1991 and 1997 NFC Awards (discussed in previous section) and other efforts of federal government to transfers burden of stabilization on provincial governments put uneasy pressure on provincial finances. This left provincial governments with three options: increase efforts to mobilize higher revenues from own resources, curtailed expenditure and finally increase borrowing. Since federal government collects all buoyant taxes, the scope for increase in tax collection from provincial own resources is minimum. The persistent higher burden of debt, debt servicing and limited power of loan negotiation minimizes the scope for option three. Therefore, the only option left with provinces is to reduce services delivery. An empirical study (Sabir, 2001) shows that the impact of shortfalls in federal transfers to the provinces largely affected provincial social sector expenditures than any other provincial expenditures.

Table – 2 presents the average annual growth rates in provincial expenditures during three periods prior to 1991 NFC award (1981-1990), after 1991 NFC Award and finally after 1997 NFC Award. Table-II shows that average growth in provincial expenditures has declined from 16.7 percent prior to 1991 NFC Award to 15.3 percent after 1991 NFC Award. Moreover after the 1997 NFC Award the growth rate further decline to 9.3 percent. The same trend persists in both recurring and development expenditures.

TABLE – 2
IMPACT OF FISCAL DEFICIT CONTAINMENT ON PROVINCIAL EXPENDITURES
(Average Growth in Real Expenditures-Four Province Combined)

	1981-1990	1991-1997	1998-2002
Provincial Recurring Expenditure			
Social Service	19.1%	18.9%	6.4%
Non-Social Service	16.8%	15.3%	10.9%
Total	**17.5%**	**16.5%**	**9.2%**
Provincial Development Expenditure			
Social Services	15.6%	11.0%	-5.4%
Non-Social Service	14.5%	15.5%	20.6%
Total	**14.9%**	**13.0%**	**10.2%**
Total Provincial Expenditure			
Social Services	17.7%	16.7%	4.3%
Non-Social Service	16.2%	14.5%	12.3%
Total	**16.7%**	**15.3%**	**9.3%**

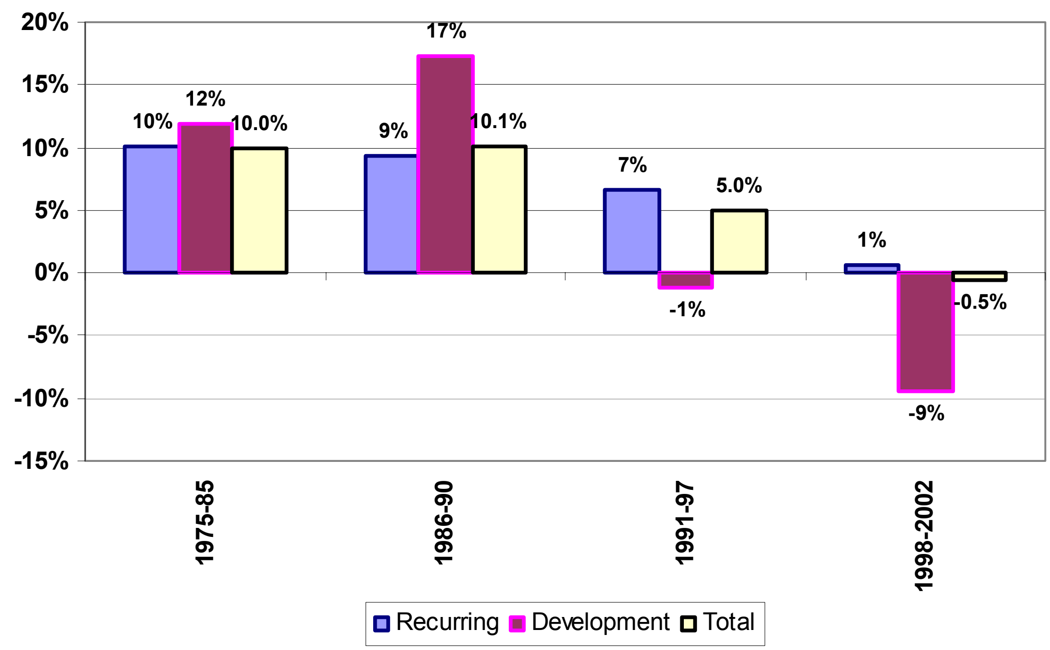
Source: Estimates based on Provincial ABS various Issues

However the growth pattern in social and non-social sector expenditures indicate that the main victim of the containment of fiscal deficit by province is social services expenditure and not the non-social sector expenditures. The growth in social expenditure has declined from 17.7 percent prior to 1991 NFC Award to a meager 4.3 percent in after 1997 NFC Award.

3.1 Impact on Provincial Public Spending on Education

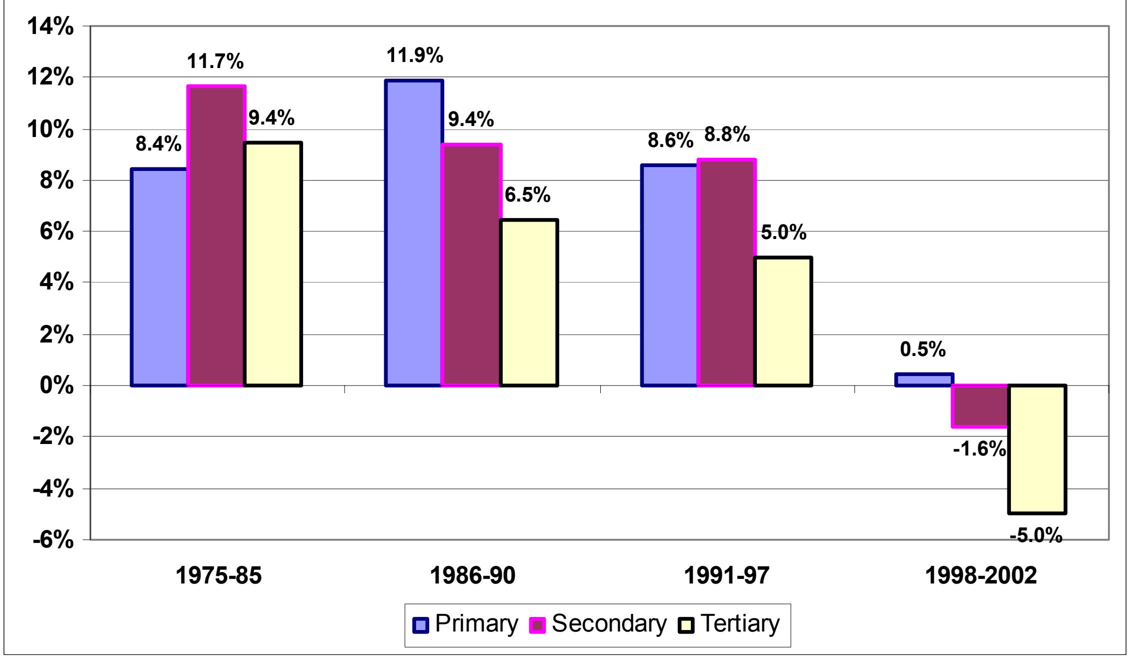
The impact of containment of fiscal deficit can also be seen from the trends in expenditures on education. Education expenditure data for all the provinces combined have been organized along four time periods: 1975-85, 1986-90, 1991-97, and 1998-2002. The rationale for the time periods is determined by four events: the 1974 NFC Award, the launching of the Five Point Programme in 1985-86, the 1991 NFC Award, and the 1997 NFC Award. As such, 1975-85 represents the pre-Five Point Programme period; 1986-89 represents the post-Five Point Programme and pre-1991 NFC Award period; 1991-97 represents the period under the 1991 NFC Award; and 1998-2002 represents the period under the 1997 NFC Award.

Chart-I: GROWTH IN PROVINCIAL REAL EXPENDITURES ON EDUCATION



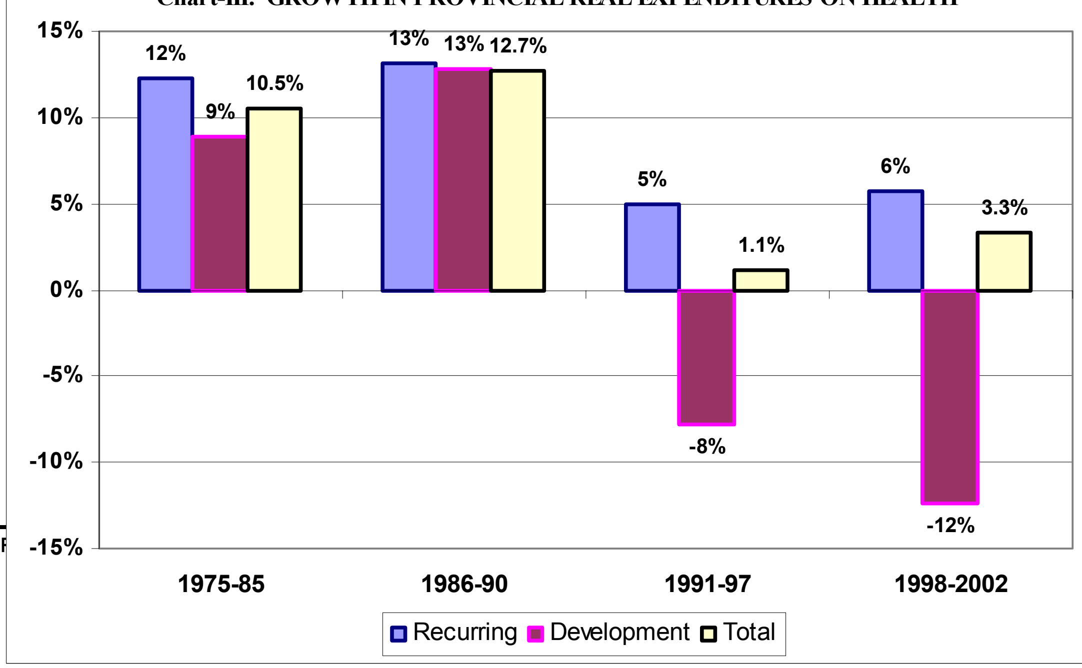
The trends in annual average growth rates in real education expenditures, presented in chart-I and II, show that growth in real expenditures on education peaked across the board from 1986 to 1990. By contrast, there were declines across the board during 1991-97 period, and growth collapsed from 1998 to 2002. During the 1998-2002 period, real recurring expenditure on education increased by only 1 percent, while real development expenditure declined by 11 per cent. In primary and secondary education, growth was reduced from about 9 per cent during the 1991-97 period to less than one percent for primary education and a negative two percent for secondary education.

Chart-II: GROWTH IN LEVEL-WISE RECURRING EXPENDITURE ON EDUCATION



It appears that the thrust of macroeconomic policy, with its excessive stress on stabilization objectives, has seriously affected the capacity of the provincial governments to invest in education. Clearly, a change of direction is warranted. It is imperative that macroeconomic policy should not contradicts the objectives of social and economic growth.

Chart-III: GROWTH IN PROVINCIAL REAL EXPENDITURES ON HEALTH



3.2 Impact on Health Expenditures

Similar to the growth pattern in education, growth in real expenditures on health reached its peak during 1986-90, which is the period prior to 1991 NFC Award. After 1991 NFC Award and 1997 NFC Award development expenditures on health experience negative growth ranges negative 8 percent to 12 percent. During 1990s growth in recurring expenditures on health also decline from 13 percent prior to 1991 NFC Award to 6 percent after 1991 NFC Award.

4. CONCLUSION AND POLICY IMPLICATIONS

Our analysis shows that the process of shifting the burden of stabilization to the lower tiers of the government has seriously shrank the capacity of the provincial governments to invest in social services. This resulted in low social expenditures and consequently poor social conditions. It is imperative that macroeconomic policy should not contradict the objectives of social-economic growth. Therefore, some alternative mechanism to support provinces on fiscal front may be suggested. For instance, so far the federal government only enjoyed the fruit of rescheduling of foreign debt and reduction in interest rate on borrowing. This benefit must be transmitted to the provinces by offering them the opportunity to refinance their debt burden on present low interest rate. Similarly the social sector expenditure of the provincial government may be protected in new NFC Award and the federal government must finance part of the public sector development of the provinces.

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