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EVALUATION OF THE FEDERAL BUDGET, 1999-2000

SOCIAL POLICY AND DEVELOPMENT CENTRE

RESEARCH REPORT

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FOREWORD

The Social Policy and Development Centre (SPDC) has a tradition of bringing out a Research Report every year containing analysis of the proposals for expenditure and taxation in the Federal Budget from the viewpoint of their impact on the economy and people of Pakistan. This year's report contains seven articles on various aspects of the Budget of 1999-2000, written by staff members of SPDC. We hope that government officials, private sector, members of NGOs and civil society at large will find this report useful in understanding the implications of the Budget.

Dr. Hafiz A. Pasha
Managing Director

CONTENTS

BUDGET 1999-2000: MYTH OR REALITY By Dr. Hafiz A. Pasha

The budget for 1999-2000 comes as a big surprise. Pre-budget speculations were that in an effort to achieve the tough deficit target of about Rs 112 billion, equivalent to 3.3 per cent of the projected GDP, the government would be compelled to restrain expenditure growth and resort to fundamental broad-basing of the tax system, especially by withdrawing the sectoral exemptions from general sales tax. Instead, the public sector development program has been increased by over 26 per cent, a number of significant exemptions have been announced to promote investment in housing, urban transport, etc., and a major relief has been given to consumers in the form of a 40 per cent reduction in the excise duty on telephones. While some minor rate enhancement and broadbasing has been attempted of the income tax, no major initiative has been announced for extension of GST to services, electricity and gas, POL products, agricultural inputs, etc, as contained in the policy framework agreed with the IMF in the revived ESAF/EFF program.

How has the deficit target been reached with such a soft budget? The answer to this is to be found in the traditional practice adopted by most governments of initially overstating the level of projected revenues and understating expenditures at the time of budget-making. In the event the resource gap increases during the fiscal year, either mini budgets are resorted to or the development program, which represents the discretionary component of expenditure, is scaled down appropriately to reach the deficit target. The difference this time is the large magnitude of potential bias in the budget estimates. As demonstrated below, revenues, in particular, have been substantially over-projected while current expenditures are likely to exceed the estimates for 19992000 for a variety of reasons.

OVERSTATEMENT OF REVENUES

Tax Revenues

The problem starts with the revised estimates of tax revenues collected by CBR during the current fiscal year of Rs 308 billion. These revenues have shown a growth of only 2 per cent during the first ten months. On this basis, the likely revenue for the year as a whole is a maximum of Rs 303 billion. Therefore, there is an overstatement initially of about Rs 5 billion, unless the government resorts to collecting taxes in advance, which serves only to worsen the prospects for increase in collection next year. Beyond this, the problem becomes even more pronounced, especially in the case of customs duties and sales tax.

Customs duties: Revenues from import duties fell precipitously by over 22 per cent in 1998-99. This is attributed to the severe import contraction and fall in unit values (in dollars) during the year. However, it may be noted that the rupee value of dutiable imports increased by over 5 per cent in the first nine months, due to the steep depreciation in the exchange rate. Therefore, there are other factors like collection efficiency, tariff reforms (with the maximum duty rate down from 45 per cent to 35 per cent), the substitution of import duties by the GST (as on edible oil imports) and the higher quantum of refunds to exporters which explain the fall in revenues from customs duties.

Despite the prospect of the full-year negative impact (of about Rs 10 billion) of tariff reforms in 19992000, customs duties are projected to yield an increase in revenues of 7 per cent. The rupee value of imports will probably rise by about 15 per cent, but given the fact that the entire tariff structure has been cascaded down earlier this year, it is unlikely that revenues will show an absolute increase, and may even show some decline, especially if the impact of the large reduction in import duties on vehicles, etc., announced in the budget are allowed for. Therefore, instead of the projected revenues of Rs 67 billion, the likely level is about Rs 61 billion (same as 1998-99), an overstatement of about Rs 6 billion.

General Sales Tax: The GST has, no doubt, been the most buoyant source of revenue in 199899, with an expected growth rate of over 32 per cent. But this increase has to be attributed to a number of special factors like the enhancement in tax rate (from 12½ per cent to 15 per cent in December 1998) and the substitution of sales tax for excise duties and import duties (on sugar and edible oil). These special factors account for over 80 per cent of the increase. No meaningful extension of the GST has yet been made to retail trade and the textile sector.

Some of the growth momentum is likely to be sustained next year due to the full-year effect (of Rs

14 billion) of the rate enhancement. Against this, however, are the negative impacts of tariff reforms (with consequential effects on the sales tax) and the higher rates of export rebates. GST revenues are projected to increase by almost 35 per cent next year. This appears very ambitious in light of the negative factors.

There are two possibilities. Either the government has decided on a phased program of broadbasing of the GST during 1999-2000 in line the with its commitments to the IMF, starting with the GST on services, followed by imposition on electricity, gas and POL products and finally by removal of the exemption on fertilizer and pesticides. However, for political reasons, it has not announced this program of broad-basing of GST in the budget, which must be a source of great consternation to the visiting IMF mission. The other possibility is that there is some overstatement of the projected level of revenue. In the absence of a program of broad-basing, it is more likely that GST revenues will not exceed Rs 86 billion, implying excess budgeting of over Rs 10 billion.

On the basis of the above analysis, there seems to be a significant overstatement of CBR revenues in 1999-2000. From a base of about Rs 303 billion in 1998-99, a more realistic projection is Rs 337 billion. Even this estimate may be on the optimistic side because it is based on the assumption that the economy will recover strongly in 1999-2000 with a GDP growth rate of 5 per cent, manufacturing sector growth rate of 6 per cent and imports growth rate of 8 per cent. The government's estimate of Rs 356 billion is higher by about Rs 19 billion. Like this year, we can look forward to a series of downward revisions in CBR targets during 1999-2000.

Surcharges

Surcharges, especially on petroleum products, have performed exceptionally well in 1998-99. Budgeted receipts of Rs 43 billion have been exceeded by almost Rs 30 billion , and have been one of the major factors responsible for the deficit containment. Despite the fall in landed cost (in rupees) of imported POL products of about 19 per cent during the first nine months of the year, there was no corresponding decrease in retail prices. Instead, these prices have been raised twice during the year, once in July 1998 after the sanctions and more recently in May 1999. The latter was justified on the grounds that following the unification of the exchange rate, the cost of POL imports has increased because of the change in the exchange rate on such imports from Rs 46 to Rs 51 per dollar.

Revenue from surcharges has been projected at about Rs 63 billion in 1999-2000, showing a drop of about Rs 10 billion in relation to the current year's level. This projection hinges on three factors, first, the international prices of POL products, which have shown a tendency to rise sharply in recent months (for example, the price of Brent crude has gone up from $ 11 to $ 15 per barrel during the last few months), second, the exchange rate of the rupee with respect to the dollar during 19992000 and, third, the government's policy with regard to the retail pricing of POL products. If the policy is to maintain stability in these prices at the recently established level, then the projected revenue of Rs 63 billion appears optimistic. For every 10 per cent increase in international prices (in $) the loss in revenue is about Rs 7 billion and for every one rupee depreciation in the exchange rate the loss in revenue is about Rs 1.3 billion, if retail prices are not raised correspondingly. Based on projections of international POL prices (increase of about 20 per cent over the average level of

1998-99) and a 7 per cent depreciation in the exchange rate the projected revenues from the surcharges is about Rs 50 billion, and not Rs 63 billion as indicated by the government. This represents an overstatement of revenues of Rs 13 billion.

Here again, there is the possibility that the government is contemplating periodic upward adjustments in retail prices of POL products in line with the rise in landed costs (in rupees) of imports. This will help in recovering the shortfall. Apparently, agreement has been reached with the IMF that the development surcharge on individual products will be converted into a fixed specific tax and any increase in import prices will be transferred into higher retail prices, with such adjustments proposed on a quarterly basis during 1999-2000. If such an agreement has been reached then we have the prospect of rapidly rising POL prices, which will literally fuel inflationary pressures in the economy. Alternatively, if price stability is the goal then revenues from the surcharges have been overstated by over Rs 13 billion.

Non-Tax Revenues

Contrary to all expectations, non-tax revenues are on target in 1998-99 at close to Rs 121 billion. A major shortfall was anticipated on the grounds, first, that profits of the State Bank of Pakistan would be severely eroded by the conversion costs of foreign currency accounts and exchange losses incurred in maintaining the dual exchange rate regime, second, that interest income from property and enterprises would be significantly below target because of the inability of public enterprises/utilities like WAPDA, KESC, etc., to service their debt obligations with the government.

The profit of SBP is, infact, only Rs 8 billion in relation to the budget estimate of Rs 29 billion for 1998-99, while the shortfall in interest income is over Rs 14 billion. But these losses have been compensated for substantially by higher miscellaneous receipts. In the residual category of ‘others’, within miscellaneous receipts, revenues of almost Rs 41 billion have been shown against budgeted receipts of Rs 6 billion.

What explains the massive jump in miscellaneous non-tax receipts? Apparently, this includes the receipts on account of refund of F-16 money and the value of the Saudi oil facility. In addition, arrears of over Rs 10 billion on account of various receipts (especially related to oil and gas) have also been included in this head. In an attempt to show exceptional budget deficit reduction in 199899, the government has included these items in revenues. The Saudi oil facility was essentially like a supplier's credit with payment on a deferred basis (to facilitate our liquidity following the sanctions). Therefore, this is not a revenue but a financing item. Also, it is extremely unusual to include arrears as revenue when the government budgeting is on cash flow (and not accrual) basis. May be the Auditor General of Pakistan will comment eventually on the legitimacy of including the value of the Saudi oil facility and arrears as receipts. If these are not included as receipts then the budget deficit for 1998-99 will be well above 4 per cent of the GDP, and not 3.4 per cent of the GDP as asserted by the Finance Minister.

Turning to non-tax revenue estimates for 1999-2000, these are projected at almost Rs 21 billion above the revised estimates for 1998-99, which are already very high because of the above mentioned reasons. The component of overstatement appears to be the largest in the two heads mentioned earlier) interest income and SBP profits.

<u>**Interest Income:**</u> Interest income is projected to increase by Rs 18 billion, even though there was a large shortfall this year. Most of the increase (of almost Rs 16 billion) is expected from public sector enterprises. In 1998-99, the interest due from such enterprises was over Rs 30 billion, whereas the actual payment was less than Rs 17 billion. The 1999-2000 Budget assumes that these

enterprises, including WAPDA and KESC, will be in a position to, more or less, double their interest payments in one year. This is highly unlikely given the severely impaired financial position of most public enterprises/utilities (with the possible exception of PTCL). At the minimum, the overstatement of interest income in 1999-2000 is Rs 10 billion.

<u>Profits of SBP:</u> SBP profits are projected at Rs 35 billion, as compared to Rs 8 billion in 1998-99. No doubt the profit outlook for SBP is better following the unification of the exchange rate and the large scale conversion of FCAs that has already taken place. But, some FCAs (almost $ 3 billion or more) still remain to be converted (at the prevailing official exchange rate) and the SBP continues to intervene in the inter-bank market to prop up the rupee. What the implication of these factors are on SBP profits is not known.

Altogether, it appears that the minimum amount of overstatement of non-tax revenues in Rs 10 billion. We turn now to an examination of the fiscal position of the provincial governments as reflected in their ability to finance their PSDP out of their revenue surpluses.

<u>Self-Financing of PSDP by provinces</u>

It is assumed in the Budget that the provinces will be able to self-finance their PSDP of about Rs 28 billion in 1999-2000 to the extent of about Rs 4 billion. This will represent no change in the level of financing as in 1998-99. We will have to wait for the provincial budgets in the next few days to determine if, despite the shortfall in divisible pool transfers of over Rs 13 billion, the four provinces combined have been able to generate a revenue surplus of Rs 4 billion or not.

The outlook for provincial governments has probably worsened significantly as a result of a number of announcements in the latest federal budget. First, the granting of a special allowance of 20 to 25 per cent of initial basic pay to federal employees may also have to be given by provincial governments to their employees (especially those on deputation from the federal government) in order to preserve parity. The resulting liability is likely to be much larger because provincial governments have about five to six times the employment of the federal government. A preliminary estimate is that if all provincial governments follow suit, the additional salary bill will be at least Rs 10 billion. In addition, provincial governments will be expected to make a subvention of Rs 6 billion to local governments in lieu of the abolition of the octroi and export taxes. Further, there may be some revenue losses to provincial governments due to reduction in the rate of stamp duty announced in the federal budget.

As opposed to this, provincial governments are likely to enhance the professional tax (following empowerment in the Finance Bill) and possibly in other areas like agricultural income tax (in line with IMF conditionalities). They will also get their revenue share (of about Rs 6 billion) from the revenue generated by federal taxation proposals. Nevertheless, due primarily to the granting of special allowances to employees and subventions to local governments, the financial position of provincial governments is likely to deteriorate significantly in 1999-2000. A projected revenue surplus of Rs 4 billion may easily be converted into a revenue deficit of over Rs 6 billion.

We turn now to an examination of the current expenditure projections by the federal government for 1999-2000.

UNDERSTATEMENT OF EXPENDITURE

During the last four years, current expenditure has increased by about 11 per cent per annum. The anticipated growth rate in 1999-2000 is about 10 per cent. Therefore, the projected growth rate is close to trend and, prima facie, there does not appear to be significant overstatement. But if the new expenditure head of a grant of Rs 13 billion in lieu of abolition of octroi and export taxes is excluded then the growth rate in 1999-2000 falls to only 7 per cent. This raises doubts about the credibility of the expenditure projections, especially in the two large heads of debt servicing and defence expenditure.

Debt Servicing: While some growth is projected in interest and repayment of foreign debt, the budget envisages, more or less, constancy in interest payments on domestic debt at about Rs 160 billion. Clearly this is based on the fact that there has been domestic debt retirement (from the banking system) of almost Rs 63 billion in 1998-99 and of Rs 13 billion anticipated in 1999-2000.

But domestic non-bank borrowing (through government savings schemes) continues to take place, and while the domestic debt to GDP ratio has declined the absolute quantum of domestic debt continues to increase. According to the Pakistan Economic Survey, the level of outstanding domestic debt was Rs 1157 billion at the end of 1997-98 which is expected to increase by about 6 per cent to Rs 1226 billion by the end of 1998-99. Much of the increase is in relatively high cost permanent debt.

Therefore, given the growth in domestic debt, despite some retirement, it is unlikely that interest payments on domestic debt will remain unchanged next year, even if at the margin interest rates on new debt have been brought down.

With about 5 per cent growth, interest payments are likely to increase by about Rs 8 billion. This is the amount of understatement under this head.

Defence Expenditure: Defence expenditure was brought down sharply in 1998-99 by almost Rs 17 billion in relation to budget estimates and was actually lower than the previous year's level by almost Rs 6 billion. This was achieved despite the sharp depreciation in the exchange rate, big increase in POL prices and enhancement in the allowances of armed forces personnel (in the beginning of 1999). What this implies in terms of defence preparedness of Pakistan at this time is not known. The government has been under pressure from international agencies to reduce military expenditure, and it appears to have yielded to this pressure.

However, given the full-year impact of the increase in allowances, continuing depreciation of the rupee, higher POL prices and the warlike situation in Kashmir, it is difficult to visualise how the defence budget can be limited to Rs 142 billion next year (which is even below the budgeted allocation of Rs 145 billion for 1998-99). In the immediate aftermath of the budget, the finance minister has announced in his press conference that the defense budget will be enhanced if national security considerations so demand. Given the prevailing circumstances, an increase in defence budget of at least Rs 10 billion is more than likely. If the warlike situation persists or escalates then the amount required may be much larger.

We are now in a position in the table below to summarise the extent of divergence between government and our estimates of revenues and expenditures under major budgetary heads.

TABLE
EXTENT OF OVERSTATEMENT OF REVENUE AND UNDERSTATEMENT OF EXPENDITURE IN 1999-2000 BUDGET

(Rs in Billion)

	Government Estimate	Our Estimate	Difference
Revenue			
Tax Revenues (CBR)	561	519	-42
Surcharges	356	337	-19
Non-Tax Revenue	63	50	-13
Self Financing of PSDP by Provinces	142	132	-10
Current Expenditure	4	-6	-10
Debt Servicing	525	543	+18
Defence	287	295	+8
Others	142	152	+10
Overall Impact on Budget Deficit	96	96	0
			+70

Therefore, in aggregate terms the estimated component of overstatement of revenues is about Rs 52 billion (equivalent to about 9 per cent of projected revenues) while the likely magnitude of understatement of expenditure is Rs 18 billion (equivalent to about 3 per cent of projected current expenditure) in the budget of 1999-2000. Clearly, revenue estimates are more frought with downside risks. On this basis, the budget deficit is likely to be almost Rs 70 billion higher than the projected level or Rs 112 billion. Clearly, the prospects are for a series of mini budgets and/or substantial scaling down of the development budget (like previous years).

However, the government has committed itself to attaining a CBR revenue target of Rs 373 billion (inclusive of taxation proposals of Rs 17 billion) on the basis of proposals contained in the budget announced on the 12th of June 1999. This will imply a growth in tax revenues of almost 23 per cent next year. Achievement of this target will perhaps constitute the single most important test of the performance of the Ministry of Finance and the CBR in 1999-2000. We wish the government all success in its efforts.

BUDGET 1999-2000: A QUASI ANALYSIS OF A QUASI-BUDGET

By Dr. Sajjad Akhtar

The current budget is a challenge for the economic analyst. It hides more than it reveals. Perhaps it was announced to regain the eroding popularity of the present government and is thus framed as a hybrid of a formal budget and party's economic manifesto. A common perception is that ESAF/EFF consistent mini-budgets will flow in bits and pieces at quarterly intervals. The analyst is therefore faced with an unpleasant task of commenting on policy directions which are themselves less than transparent and complete. At the outset it will be useful to briefly dilate on the implications of presenting a quasi budget. From a political perspective a populist or a tax free budget (in a sense that items in the ordinary consumption basket are not taxed) is 'damage control' for government's popularity. Till the time of budget presentation, government's plea that provinces need to be consulted on the imposition of GST on services indicates a need to repair political damage of last one year through political consensus. It also leaves the possibility of a well-planned strategy to trade in ESAF/EFF commitments with signing CTBT during the first quarter of the new fiscal year. Alternatively it may be the case that the government firmly believes that fiscal led informal/smallscale sector recovery may translate into sizeable revenue generation in the next 3 to 4 months, thereby obviating the need for broad basing and enhancement of consumption taxes. It may also not want the fiscal stimulus to be short changed or diluted by inflationary expectations and speculation generated by presenting any up front sequencing of taxation proposals. However, this strategy is not without pitfalls. In the absence of major structural reforms it further weakens the confidence factor a crucial ingredient for reviving investment activity in the country. As a by-product, increased speculative tendencies in the country will be reflected in increased volatility in the stock and foreign exchange market.

Growth

The above strategy has left the analyst somewhat bemused. Either one can build in the ESAF\EFF commitments for the year 1999-2000 in the announced set of measures and conjecture on the macro implications for the next year, or take the budget seriously as a transparent road map of policies for the next year. Taking cue from the government's strategy we also adopt a hybrid approach and present quasi impact analysis of a quasi budget. As in the past years, next year overall growth will crucially depend on agriculture performance, specifically cotton and wheat. As table 1 shows the agriculture growth target for next year is slightly below the average for 1991-97. Attaining 9.5 million bales of cotton and 19.5 million tons of wheat can bring us close to the targets for year 2000. The fiscal stimulus through PSDP and other measures are tilted in favor of strengthening the economic activity in construction, transport, small-scale manufacturing and retail trade rather than large-scale manufacturing. Given that the former sectors are poorly documented, any buoyancy as a result of relying on the maxim "small is beautiful" may only be partly reflected in the measured GDP of the manufacturing sector and not in higher tax revenues. However, if the government withdraws the PM's subsidy on electricity and meaningfully extends the tax net to retail level it will depress the growth prospects also in the informal/small-scale sector.

TABLE 1
MACRO ECONOMIC INDICATORS (%)

	1991-97 Average	**1997-98**	**1998-99**	**1999-2000 (Projected)**
Growth Rate of GDP	4.9	4.3	3.1	5.0
Growth Rate of Agriculture	4.7	3.8	0.4	4.3
Growth Rate of Manufacturing	5.0	7.9	4.7	5.8
Growth Rate of Services	4.9	3.2	4.1	)
Inflation Rate	11.4	7.8	6.1	6.0
Budget Deficit/ GDP	6.9	5.4	3.4	3.3
Public Investment/GDP	8.1	4.9	3.0	3.2
Private Investment/GDP	9.4	9.6	8.2	9.3
National Saving/GNP	13.9	14.2	11.2	-

Growth Rate in Private Investment	17.3	13.3	-5.0	25.0
Growth Rate in National Saving	14.6	34.7	-13.2	-
Current Account Deficit/GDP	5.1	3.0	3.7	2.7
Growth in Import	6.8	-8.4	-11.1	8.0
Growth in Export	7.7	4.2	-10.2	18.0

Inflation

Some analysts would regard 6% inflation rate as floor for the indicator. This has been possible in the recent past by recessionary conditions at home and deflationary trends abroad. However, the possibilities of containing next year's inflation at 6% are slim. As stated in the budget the government plans to bring the overall subsidies from roughly Rs. 9 billion to Rs.2 billion in 19992000. Implicitly it has decided to honor the ESAF/EFF conditionalities regarding the reduction of wheat subsidy and PM's subsidy on electricity. The question is will the inflation rate be closer to the double-digit figure? With a combination of fiscal stimulus, emergence of inflationary trends (specifically oil prices) internationally, GST of 18 percent on non-registered traders and a marketbased exchange rate system in the presence of a large current account deficit, it should not be surprising if next year inflation is closer to the double digit figure. Relative to cost push and imported inflation the contribution of demand pull inflation may remain relatively small.

International Trade

Foreign trade and current account deficit targets will be the most difficult to achieve next year. In absence of any plan to increase exports on war footing, the 18% target for increase in exports is likened to a perpetual joke. Increased requirements of imported wheat as compared to last year, and increase in international petrol prices will put our current account under continuous pressure. If inter-bank exchange rate is allowed to truly reflect these pressures, expected exchange rate depreciation may increase speculative imports thereby further increasing the pressure on current account. IPP imbroglio continues to cast shadow on the prospects of Pre-nuclear blasts level of FDI.

Private Investment

In the current economic and political scenario and with a warlike situation in Kashmir the future investment is not easy to forecast as it depends on a host of economic and non-economic factors. Compared to a positive 13.3% in 1997-98, the growth rate of private investment in 1998-99 is estimated to be -5%. The target for investment growth next year at 25 percent is much higher than the average of 17.3% during 1991-97. As a share of GDP this target implies a full percentage point increase to 9.3% from the current 8.2%. Clearly these targets are ambitious and a priori depend on the anticipated success of low cost housing, transport and self-employment schemes to generate a substantial investment responses. With excess capacity in large-scale manufacturing it is difficult to visualize the achievement of the overall investment target from the productive sectors. The measures for capital market are likely to influence the modes of financing the new fixed or portfolio investment rather than the decision to invest per se and prove largely ineffective given the uncertainities (the stock market has fallen by over 83 points in the first two days of trading after the budget). Demand conditions also play a significant role in such decisions. The vehicle for implementation of public investment policy is the Public Sector Development Program. A 26% increase in the size of PSDP over last year raises its share in GDP from 3 to 3.2% still far below the average attained in the nineties. Given the prospect of revenue shortfall, this stimulus is unlikely to be sustained and development allocations may be slashed later in the year.

From an equity angle the enhancement of income tax rates of top income brackets may be commendable but are likely to depress private and personal savings in the country. It will become even more difficult to attract highly qualified executives, managers and administrators to this country causing a set back to the objective of good governance and efficiency in public enterprises and government departments.

In summary the populist strategy will deteriorate the stabilization indicators such as inflation and exchange rate. The expected short-run gain in employment and growth may only be achieved at high cost of only creating further distortions in the economy and jeopardizing the prospects for improvement in the long run.

BUDGET 1999-2000: TOWARDS ECONOMIC REVIVAL

By Dr. Sajjad Akhtar

In the budget of 1999-2000 the economic managers claim that the economy has recovered. The yearly macro performance of the economy as revealed by the official statistics belie their claims. All the major economic indicators, except inflation not only failed to achieve the targets set at the beginning of FY1999 but are also below the economy's performance in 1997-98. If the economy's performance was judged on six monthly basis probably there is some merit in asserting that we performed better in the first half of 1999 than the second half of 1998. There is also no denying the fact that the economy performed better, in the sense that it did not fall steeper under sanctions as per doomsday predictions. Resilience of the informal sector, favorable external circumstances and successful crisis management during sanctions cushioned the economy from South East Asian like scenarios but we are still away from any sign of recovery.

In framing the strategy for revival the policy makers were apparently faced with two strategic options. Either to continue with the supply side (tax breaks) stimulus begun in 1997 or to provide demand stimulation through expansionary fiscal policy and reap the benefits of easy monetary policy under the umbrella of debt rescheduling. Last two years experience showed that supply-side stimulus failed to jump start the economy, as large-scale manufacturing and private investment failed to pick up substantially. The strategy is therefore to provide a direct fiscal stimulus, the costs cushioned by outgoing year's low inflation rate and interest rates. How far it will invite IFIs chagrin remains a big question mark.

The budget 1999-2000 announced in the wake of deep recessionary conditions prevailing in the economy begs the following questions:- Will the fiscal measures taken in the budget revive the economy and investor's confidence? Will GDP, manufacturing, agriculture grow by 5%, 5.8% and

4.3% respectively in the coming year? The corresponding numbers for this year are 3.1%, 4.7% and 0.35%. Are exports likely to register an 18 percent growth?

Agriculture

Let us evaluate the prospects for agriculture. Apparently the last year's strategy to divert resources to agriculture in the form of credit, tractors and free distribution of state land did not pay off. Cotton and wheat productions were below the last year's level inspite of 31.8 percent increase in credit during the July-Mar'99 period over the corresponding period of 1997-98. Over the years it is a common practice of policy makers to blame weather for poor performance and attribute above average growth rates to their own sharp acumen. Interestingly this year sanctions are also being cited as a cause of poor agriculture performance although its dependence on imported raw material (except DAP fertilizer) is not significant. The observation that sugar-cane production increased for the second year (partly because of the ratoon crop) in a row and cotton production fell do indicate that agriculture performance is sensitive to relative profitability than to input price signals. Probably the government will have to re-think the existing wheat pricing policy to achieve the agriculture production targets for the next year. Some of the measures announced in the budget to revive the agriculture sector have already proven to be weak e.g., substantial increase in credit facilities and tax exemptions on tractors and substantial reduction in their prices. Others such as promotion of edible oil seed and agricultural research are structural and institutional in nature.

These require sustained commitment and yield results over a longer period. However profitability of livestock sector, a poorly documented sub-sector of the agriculture economy will receive a boost as input costs, (cattle feed is exempted from GST) are lowered. In summary the strategy for revival in the agriculture is to rely on lowering input costs, announce mid-year upward revisions in wheat support prices and hope for good weather conditions.

Manufacturing

Does the budget portray a well-defined strategy for the revival of large-scale manufacturing? Is it demand oriented (i.e., aimed at directly improving demand for its output) or focuses on reducing costs in order to improve competitiveness and thereby also boost exports. The budgetary measures indicate a two-pronged strategy by the government to boost overall (large as well smallscale) industrial production. The first is an increase of 26% (from Rs.92 billion to Rs.116 billion) in the overall size of the Public Sector Development Program. Nearly 1/3rd of the increase will go into Physical Planning and Housing. Combined with farm-to-market roads (Rural Development) this should boost the demand for large-scale industry output, i.e., cement, steel and allied industry. Lowering the import duties on inputs of fertilizer industry will reduce costs and boost demand (if translated into lowering of final price) in this industry. Rationalization of import tariffs (it has led to slight enhancement in tariff rates) in engineering, yarn, chemical and paper industry will increase protection although at a cost of likelihood of increased smuggling.

Services

The second element of the strategy is to create private demand through absorption of liquidity or expanding private credit in the banking sector. Since the economic managers are relying heavily on this second plank to promote economic revival it will be useful to analyze their likely chances of success. The success of low cost housing crucially hinges on whether there is private demand at the lower income scale for houses? If the pent-up demand in the past was purely constrained by lack of savings then the availability of funds through the banking sector will encourage housing investment. However rising poverty and unemployment may discourage low income households to take on additional servicing liabilities. To act as catalyst for revival much also depends on the location and quality of free land and response of private construction companies which may be motivated by profits and speculation in the short and long-run. If it is developed land a conservative estimate is that it may cost Rs.50 billion to the exchequer to hand it over free to the construction companies. The backward linkages of PM Urban transport scheme to employment depend on the relative demand for import of CKD versus CBU vehicles in the country. If it is the latter the employment and income generation impacts are fairly weak, along with adverse impacts on the Balance of Payments and average level of fares. In the former case it will generate demand in the domestic transport body fabrication plants and thereby employment. Moreover the CKD imports can be undertaken by medium size investors as opposed to substantial investment required for import of CBU. In this case the success depends on the derived demand for such investment via demand for cheaper and efficient transportation.

Exports

The budgetary measures are the weakest in spelling out a strategy for revival of export growth. Either the forthcoming trade policy will announce such measures or the policy makers are banking on exportable surpluses (i.e., cotton crop/sugar-cane) and fiscal led informal sector/small-scale growth to attain a 18 percent improvement in exports. With plethora of packages already announced for the textile sector the government may have gone into a ‘wait and see’ mode in evaluating their impacts on exports and output. Will the host of measures for the capital market contribute to the economic revival? Although they promote the portfolio investment activity in the formal large-scale manufacturing sector, they are meant as a last ditch effort by the government to boost the stock market on a sustained basis and thus revive the scuttled privatization process.

Informal Sector

Raising exemption limit for small manufacturers and retailers under sales and turnover tax and abolition of Octroi and export tax favors small enterprises and improves the profitability of the informal sector. These and above measures imply a tilt towards re-invigorating and strengthening the informal sector. The resilience of the informal economy during short duration of sanctions may have provided a cue to policy makers to experiment with this growth strategy for the coming year. The question then remains is that given the implicit bias of budgetary measures towards the “informalisation” i.e., transport, construction, small enterprises and retail trade, of the economy, will the sector be an engine to revival of the formal economy? These depend on the strength of interdependencies and inter-temporal linkages between formal and informal sectors of the economy. Absence of sound research prevents us to give an unambiguous answer to this question.

In conclusion three broad implications of this growth strategy be noted. Firstly the revival would only be partly reflected in the next year measured GDP growth. Since large part of the revival will originate and/or spill over to the informal/small-scale sector. As this sector by definition is not documented its new found buoyancy will remain a subjective conjecture. Secondly the revived activity may not translate into higher revenues for the government simply because of narrow tax base. Consequently leading to mid-year downward revision of revenues and thereby PSDP. This will further restrict the magnitude of fiscal stimulus to the formal sector. If the government resorts to increased bank borrowing to maintain the original expenditure targets, the interest rate advantage may weaken. Thirdly banking sector will need to be extra efficient and resist 'political lending' in order to prevent further build-up and broad-basing of bad loans without any collaterals.

THE DEBT TRAP

by Dr. Aisha Ghaus-Pasha

The Federal Budget 1999-2000 is unique, being the first to be announced following external debt rescheduling by the Paris Club. Our inability to honor our external debt commitments is reflective of the ‘debt trap’ the country stands entangled in whereby we have had begun to borrow more to service the existing debt obligations. The Finance Minister was proud to announce the retirement of domestic debt of Rs 62 billion in his budget speech. Prior to that the government was very pleased about its success is getting the external debt rescheduled. In 1998-99, over Rs.90 billion of external debt has been rescheduled. The question is through these measures are we coming out of the debt trap or are we just postponing the problem and slipping deeper into the quagmire?

According to the State Bank of Pakistan, Annual Report, 1997-98, the total outstanding public debt is Rs.2518 billion, equivalent to over 91 per cent of the GDP. Out of this, Rs.1367 billion or 51 per cent is external in nature. Total interest payment on public debt is Rs. 278 billion which accounts for about 55 per cent of the recurring expenditure and pre-empts almost 62 per cent of total government revenues.

Public Debt

TABLE 1
PUBLIC DEBT-TO-GDP RATIO **[%]**

Years	Total Debt	Domestic Debt	External Debt

1993-94	92.2	44.6	47.6
1994-95	84.1	42.4	41.7
1995-96	85.9	42.0	43.9
1996-97	89.2	43.3	45.9
1997-98	88.4	42.3	46.1
1998-99	93.8	40.5	53.3
Sources: State Bank of Pakistan, Annual Report, 1997-98. Pakistan Economic Survey, 1998-99.			

Evolution of public debt shows a relative decline in the domestic debt to GDP ratio (see Table 1). The ratio in the last five years has declined by 4 percentage points. This is a good development as domestic debt has high interest costs. Over the period 1992-93 to 1997-98, the effective interest cost on domestic debt has increased from 10.2 per cent to 14.3 per cent, a 40 per cent increase. The effective interest rate has however, fallen to 13.4 per cent in 1998-99. This may be consequence of a change in composition of domestic debt.

Despite the fall in the domestic debt-to-GDP-ratio, overall public debt increased much faster than the GDP, largely because of the rapid increase in the external debt. This pattern is also observed in 1998-99. As highlighted by the Finance Minister, the domestic debt to GDP ratio has declined. But what he failed to mention is that the overall public debt to GDP ratio has increased in 1998-99, because of the big increase in the external debt to GDP ratio of almost eight percentage points in 1998-99. The external debt to GDP ratio for 1999-2000 is projected to be about 58 per cent, implying a further increase of 4 percentage points of the GDP next year. This is a direct consequence of debt rescheduling. What is happening is as follows: As per the Paris Club negotiations, we are allowed to postpone the repayment of our external debt by two years. Consequently, the inflow of net external resources (external resources minus debt repayment) increases. The need to resort to bank and non-bank borrowing to finance the budget deficit is thereby lower. Alternatively, a surplus can be generated which can then be used to retire some of the domestic debt) the route currently adopted by the government. As such, a clear shift in the composition of public debt is taking place whereby external debt increases while simultaneously domestic debt is retired. What are the pros and cons of this strategy?

Debt Reduction Strategy

On the positive side, domestic debt is relatively more expensive compared to external debt and therefore, some argue it is prudent to retire the more expensive debt. This is particularly true in periods of exchange rate stability which imply minimum capital losses which form part of the interest cost on external debt. On the negative side, accumulation of external debt implies higher dependance on foreign financial institutions and thereby goes contrary to the whole theme of greater self-reliance. Secondly, unlike domestic debt, external debt has to be repaid in foreign exchange, increasing the balance of payments vulnerability of the country. On top of this, the instability in the exchange rate can lead to substantial capital losses, increasing the effective interest cost on external debt substantially. Therefore, this shift in the composition of debt indicates that the country is slipping into a more deeper, a more dangerous debt quagmire.

What will the nation do in year 2001 when the postponed repayment has to be made? It appears that we have two options. First we negotiate another rescheduling on even tougher and more unreasonable terms. Alternatively, if we don't want to do that, we will have to go in for strong structural adjustment in the interim period to increase the debt servicing capacity of the economy, especially of external debt. This primarily implies that the current account deficit has to be brought down from the current level of 3.7 per cent of the GDP to 1.5 per cent by 2001. To achieve this (while simultaneously pulling the economy

out of recession) means that exports will have to be raised manifold. Does the budget of 1999-2000 aim to achieve this? Analysts have their doubts.
We will have to wait for the Trade Policy.

TAX REFORMS AND
THE RESOURCE MOBILISATION STRATEGY

By Dr. Hafiz A. Pasha

Pakistan's tax revenues, consisting of taxes collected by CBR and the surcharges (on petroleum products and natural gas), have undergone a major structural transformation during the decade of 90s. Taxes like the income tax, general sales tax and surcharges which were secondary in importance at the beginning of the decade of 90s have now emerged as the principal sources of revenue. (See Table 1). Customs duties which were traditionally the largest source of revenue now make a much smaller contribution to the total tax collection.

TABLE 1
THE TAXATION STRUCTURE OF PAKISTAN

		1990-91		1998-99		Annual Growth Rate (%)
		Revenue (Rs in Billion)	Share (%)	Revenue (Rs in Billion)	Share (%)	
A.	CBR Tax Revenue	101.5	89.2	308.0	80.8	14.9
	Direct Taxes	19.1	16.8	112.0	29.3	24.7
	Indirect Taxes	82.4	72.4	196.0	51.4	11.4
	Customs Duties	50.5	44.4	61.3	16.1	2.5
	General Sales	6.9	6.1	72.7	19.1	29.9
	Excise Duties	25.0	22.0	62.0	16.3	12.0
B.	Surcharges	12.3	10.8	73.2	19.2	25.0
C.	Total Tax Revenues (C = A + B)	113.8	110.0	381.2	100.0	16.3

These changes are primarily a reflection of the on-going process of tax reforms in the country, which have changed the focus from taxing international trade transactions to that of taxing domestic incomes and consumption. The basic questions are as follows: How has the structural transformation in the tax system been achieved? What are the implications of the changes on the certainty, elasticity, equity and efficiency of the taxation system? Based on the answers to these questions, we analyse the taxation proposals in the Budget of 1999-2000 to determine their consistency with the objectives of the tax reform agenda.

Tax Reforms

Starting from the initial years of the 90s, the tax reforms first focused on increasing the buoyancy of revenues from direct taxes, which had tended to stagnate during the 80s, whereby the contribution to total tax revenues had declined to only 17 per cent in 1990-91. The thrust of the tax reforms was on effectively tapping the income tax base and cutting into tax evasion by spreading wide the net of withholding and presumptive taxes. Consequently, deductions at source were applied on various streams of income including interest income, rental income, income of exporters, importers, suppliers, contractors, etc., either in the nature of withholding taxes or as presumptive taxes representing final settlement of tax liabilities. In addition, primarily from the viewpoint of reducing tax evasion, fixed levies have been introduced either on ownership and trading in assets (like property, automobiles, etc.) or on consumption of services (like electricity and telephones).

These reforms involving development of the withholding and presumptive tax regime have been remarkably successful in generating higher tax revenues. From 1990-91 to 1998-99 direct tax revenues have increased almost six times and the share in tax revenues has risen from 17 per cent to 29 per cent. It has been argued, however, that these reforms have converted direct taxes into a form of indirect taxation and consequently the progressive feature of such taxes has largely been sacrificed. Also, these reforms have undermined seriously the system of income taxation based on assessment of global incomes of tax payers as declared in tax returns. It is not surprising therefore, that while revenues have risen rapidly the number of income tax returns filed has risen only slowly, and even now there is only one tax payer per 100 persons in Pakistan.

The second phase of the tax reforms, starting effectively in the mid-90s, has focused primarily on indirect taxes, whereby an attempt has been made to bring down the level of customs tariffs and simultaneously develop the system of taxation of domestic consumption generally through value added taxation in the form of the GST and energy consumption in particular through the mechanisms of surcharges.

The primary objective of the tariff reforms is to eliminate the anti-export bias and liberalise trade. The high level of tariffs had traditionally provided extreme effective protection to inefficient import substituting activities and discouraged investment in export promotion, resulting in severe distortions in the process of resource allocation in the economy. High tariffs had also led to illicit activities like smuggling and under invoicing of imports. The nature of the tariff reforms was to cascade down the entire tariff structure by reducing the maximum tariff rate while simultaneously broad-basing the tax base by withdrawing exemptions and concessions embodied in the various SROs.

Despite the various disadvantages of customs duties, one big advantage of this source of revenue was its ease of collection. The issue, therefore, was one of finding other sources of revenue to substitute for the loss of revenue associated with the tariff reforms. The tax chosen for this purpose was the GST, a tax on consumption. In the VAT mode this tax had the merit of being largely neutral and, therefore, unlike customs duties, not interfering with the process of resource allocation in the economy.

Although, the process of reforms in indirect taxes was initiated in the first half of the 90s most of the early moves were tentative and inconsequential in character. The credit for fundamental changes in the tax system goes largely to the two PML governments. The first PML government initiated the development of direct taxes through extension of withholding and presumptive taxes. The present government of Mr. Nawaz Sharif has pursued deep and wide ranging tariff reforms. Soon after its induction into power in 1997, the PML government brought down the maximum tariff rate from 65 per cent to 45 per cent. More recently, in March 99, the maximum tariff has been dropped further to 35 per cent. Revenue losses from these reforms have been sizeable, approaching almost 2 per cent of the GDP.

The basic problem with the reforms in indirect taxation has been their inability to sustain the level of revenues. Due to problems of complexity in collection, lack of political willingness to spread the tax net and widespread resistance (due to need for documentation) from potential tax payers, the GST has not yet emerged as a viable substitute for customs tariffs. Some attempts have been made to develop the tax by transiting to the VAT mode (with proper tax invoicing) in 1996-97, by raising tax rates (which reached a peak of 18 per cent to 23 per cent) and by converting some of the excise taxes into GST. But, large segments of the economy, especially services, still remain outside the GST net. As a reflection of its commitment to supply-side economics, the PML government brought down the GST tax rate sharply to 12½ per cent. But given the lack of a full production response, there was a resulting loss of revenues from the GST at a time when tariff reforms were on-going. This is the primary reason for the lack of growth in revenues in 1997-98.

The failure of the GST to adequately substitute for customs duties largely explains the emergence of surcharges, especially on petroleum products. Faced with revenue shortages, during the period of tariff reforms, the government has resorted to higher taxation of POL products. This has fortunately been rendered possible by the fall internationally in oil prices, which has widened the margin between landed import costs and domestic retail prices. Rather than transfer the benefits to consumers, the government has found it expedient to pick up the difference as a windfall in revenues.

While there is a case for some taxation of imported POL products, especially from the viewpoint of conservation of energy and scarce foreign exchange, it is clear that the policy of reliance on surcharges has gone too far. It has placed Pakistani industry at a disadvantage and explains some of the loss of competitiveness. In addition, it is an unreliable and highly variable source of revenue, as epitomised by recent events. Oil prices have started rising once again from the deep trough attained earlier this year. This is depleting sharply the revenues from the surcharge. Further, the continuing exchange rate depreciation also cuts into the surcharge. The government has had to react by raising retail prices by 10 per cent to 15 per cent in May.

OUTLOOK FOR REVENUES

the basic problem highlighted above is that the process of trade liberalisation (involving cuts in import tariffs) is conferring major revenue losses, because of the inability of the rest of the tax system to substitute fully and in a sustained manner for these losses. The outlook of revenues for 1999-2000 is also conditioned by this factor. The full-year impact of the reforms in March 99, whereby tariffs were cascaded down by about 10 percentage points, will be felt in 1999-2000 and the revenue loss could be in excess of ½ per cent of the GDP. In addition, as mentioned above, revenues from the petroleum surcharge are likely to be severely eroded in 1999-2000 due to rising international oil prices and exchange rate depreciation.

The key concern of the resource mobilisation strategy for 1999-2000, as embodied in the Budget, must be on how these revenue losses will be made up. Already, some substitution will take place due to the full-year effect of the enhancement (in December 1998) of the standard GST rate from 12½ per cent to 15 per cent. But this only partially compensates for the revenue losses, at lot more needs to be done.

TAXATION PROPOSALS FOR 1999-2000

Do the taxation proposals in the Budget adequately compensate for the revenue losses? What is the implicit resource mobilisation strategy behind the specific taxation proposals? The first impression from the Budget Speech is that the taxation proposals are generally weak, lack innovation and do not represent any coherent strategy for reform of the tax system.

The general expectation was that the Budget for 1999-2000 would incorporate strong moves for development of the GST system, through major broad-basing initiatives. As such, it was being anticipated that the Budget would involve removal of most of the sectoral exemptions from GST like services, electricity and gas, POL products, etc. Given the need for revenues, some of this extension had to be revenue) enhancing in character and not involve merely a substitution of other existing taxes. But this has not happened in the Budget.

Instead, the government has effectively moved in the opposite direction. More exemptions have been granted, especially to the smallscale manufacturing and trading sectors, thereby not only implying some further revenue loss but also retarding the process of documentation in the economy. In addition, specific exemptions have been granted to items like cattle feed, raw materials for fertilizer, etc.

It is also significant to note that the government has largely retreated from its supply-side philosophy of 1997 of tax cuts. Perhaps, this a reflection of its disillusionment with the lack of an adequate production and investment response from the business community of Pakistan. Consequently, the GST rate was enhanced earlier (in December 98) from 12½ per cent to 15 per cent, while the maximum personal income tax rate has been increased in the Budget from 20 per cent to 35 per cent. Both these rates had been reduced sharply in the tax and tariff reforms announced in early 97.

The government has also opted for a strategy of resource mobilisation which is reminiscent of the actions taken by the first Nawaz Sharif government of the early 90s, involving extension of withholding and presumptive taxes within the income tax, as follows:

(i) introduction of withholding tax on gas bills
(ii) introduction of presumptive tax on indirect exporters
(iii) extension of presumptive tax to petrol pump operators, etc.
(iv) extension of minimum tax to all assessees at ½ per cent of turnover
(v) introduction of minimum tax on sales tax assessees at 1 per cent of turnover

Beyond this, the proposals involve tax reliefs, with a distinctly populist character. These include:

(i) reduction in excise duty on telephones from 25 per cent to 15 per cent

(ii) fiscal incentives for investment in housing and urban transport

(iii) increase in exemption limit from sales tax to small manufacturers and retailers.

(iv) reduction in customs duties on automobiles

These are to be compensated by a somewhat blind and crude extension of excise duties to advertisements in print media and credit card sales and enhancement in the excise duty on cigarettes, bank cheques and courier services.

Altogether, the resource mobilisation strategy in the 1999-2000 budget contributes little to achieving the objectives of tax reforms that have been on-going in Pakistan during the 90s. No major structural initiatives are proposed and the overall taxation package is essentially soft, with a tinge perhaps of populism. It is difficult to see, given the losses in revenues from the tariff reforms and erosion of surcharges, how such a 'soft' package can yield revenues of about Rs 419 billion (Rs 356 billion from CBR revenues and Rs 63 billion from surcharges) in 1999-2000.

FEDERAL BUDGET 1999-2000: IMPLICATIONS FOR PROVINCIAL AND LOCAL GOVERNMENTS

by Dr. Aisha Ghaus-Pasha

Higher levels of government in Pakistan have generally had few qualms about announcing policy measures directly impacting upon the autonomy and/or financial position of lower tiers of government. Examples include salary increases announced by federal government which have to be adopted by the provincial governments and specification of local government tax rates by provincial governments. This year's federal budget takes this tradition a step further, whereby the federal government has not only intervened into the provincial fiscal jurisdiction but has also announced measures fundamentally affecting local fiscal powers.

The federal budget of 1999-2000 impacts upon sub-national governments in a number of ways, as discussed below.

Divisible Pool or Revenue Sharing Transfers

Provincial governments rely on revenue sharing transfers from the federal government to finance their on-going operations. These revenue transfers take place according to the provisions of the National Finance Commission (NFC) award, which according to constitutional provisions is to be announced once every five years. Currently, the revenue transfers are taking place in line with the 1996 NFC Award. According to this 37.5 per cent of the net proceeds of all federal taxes (which includes direct taxes, sales tax, excise duty and import duty) is the share of the provinces. Therefore, the level of federal fiscal effort has a direct bearing on the financial position of provincial governments.

This year's federal budget announces additional taxation proposals of Rs 17 billion. How these will be generated is a mystery because in the budget speech further exemptions and little additional taxation was announced. This is despite the fact that federal government revenues have stagnated in the last few years, especially in the aftermath of the 1996 NFC award. In the very first year of the new award, revenue transfers to the provinces fell short of projections by Rs 40 billion. Cumulatively, in the three years in which the award has been operational, revenue transfers to the provinces are lower by over Rs 79 billion, or 34 per cent. How are the provinces expected to manage their finances in such a situation? Why have federal revenues shown little growth and why does the federal government take pride in announcing tax free budgets under the circumstances?

The provinces know little and have even less to say in the matter.

Encroachment of Fiscal Powers

The federal government over the years has shown a tendency of encroaching on tax bases which fall under the domain of the provincial governments as per constitutional provisions. For example, sales taxation of services has been included in provincial fiscal powers. However, the federal government has found the alternative route of levying excise duties on services. Initially it introduced an excise duty on telephones and then slowly the net was extended to include bank cheques, travel agents, advertising agents, advertisements, professional services like shipping agents, etc. In the budget for 1999-2000 excise duty has now been extended to include advertisements on print media and credit cards, which essentially fall in the provincial domain.

Since the NFC Award has made the provincial governments responsible for their deficits and surpluses and in the wake of stagnant revenue transfers, provincial governments should be encouraged to make an effort to mobilise higher revenues from taxes in their fiscal domain. Therefore, given that the federal government has already pre-empted the broad-based and buoyant taxes like income tax, sales tax etc. whatever remaining tax bases fall under the purview of the provincial governments should, in principle, not be encroached upon by the federal government. This is important for the financial autonomy and long run sustainability of the provincial governments in the country.

On top of this, the federal government has announced about a 70 per cent reduction in taxes on transfer of property (stamp duty, etc.). These taxes accounted for about 37 per cent of provincial own tax revenues. This measure not only creates a big dent in provincial revenues but also in provincial autonomy. Even if there was consensus between the provinces to reduce the tax rates, it should have been announced as a part of each provincial budget and not by the Federal Finance Minister in his budget speech. The signals from this act are counter to the spirit of autonomy among the federating units.

Turning now to the expenditure side, the budget announces measures which will substantially enhance the recurring expenditure liabilities of the provincial government. These include the following:

<u>Increase in Wages of Government Employees</u>

To give relief to the salaried classes the federal government has tended to unilaterally announce increase in the wages and salaries of government employees. The provincial governments generally have to honour these commitments (especially in view of federal employees on deputation) resulting in unanticipated increases in their recurring expenditures. Also, this increase has to be financed entirely from provincial own revenues leading to an increase in the provincial budgetary gap. The financial impact is larger on provincial governments because of their five to six times larger employment in relation to the federal government.

In the 1999-2000 budget the federal government has announced an increase of 20-25 per cent in the initial basic pay of all its employees. Implementation of the same increase by the provincial governments will have substantial implications on combined provincial current expenditure, increasing it by upto Rs 10-12 billion.

Octroi and zila Tax Grant to Local Government

The federal government has in a major move abolished Octroi and Zila tax, the mainstay of local governments in the country. The revenue loss is to be compensated by a grant of Rs 19 billion, 31 per cent of which will come from the provincial kitty. This tantamounts to a substantial rise in provincial expenditure liabilities. In an environment of slowly increasing revenue-sharing transfers, (which are much lower than the level promised to the provincial governments at the time of the announcement of the NFC award), federally announced salary expenditure hikes, lack of political will to adequately expand the provincial tax base (a classic example is the inability to attain agricultural income tax revenue targets), how the provincial governments will finance this additional grant is not known.

On top of this, it is assumed that the provinces will be able to self finance their PSDP of about Rs 28 billion in 1999-2000 to the extent of about Rs 4 billion. Given that the outlook for provincial governments has worsened because of the latest federal budget and that two out of the four provincial governments had already burst their overdraft ceiling with the SBP, how this magnitude of self-financing will be achieved is anyone's guess. In case of the inability of the provincial governments to generate a revenue surplus, development activities will be further curtailed which to begin with have been held constant at the 1998-99 level.

One the whole, the outlook for provincial finances for 1999-2000, especially in view of the federal announcements, does not look favourable. The federal budget, not only opts overall for a soft resource mobilisation strategy but also erodes the provincial revenue generation capabilities both by announcing provincial tax rate cuts and eroding into their tax base (the services sectors). On top of this, major new liabilities have been created through an increase in salaries and higher grants to local governments.

We next turn to analyse the implications of the abolition of octroi/zila tax on local governments.

ABOLITION OF OCTROI/ZILA TAX

Despite the apparently popular support, especially from business and trading interests, for abolition of octroi and zila tax, this move by the federal government has been accompanied by a strong negative reaction by opposition political parties which see this as part of the process of centralisation of decision making in the country and a major loss of local autonomy. Within local governments there is great uncertainty about the future quantum of grants from higher levels of government and about the potential liquidity problems arising from any irregular flow of grants, while employees in the octroi/zila tax departments are legitimately worried about their future job prospects. We support the abolition of these taxes on the grounds that they had become a major impediment to the development of a national common market and the flow of goods within the country. They were generally regressive in character and imposed high costs of collection and compliance.

However, the basic problem is that an apparently popular reform has been presented in a somewhat crude and incomplete manner, without showing a concern for appropriate packaging of the proposal so as to allay the fears of different segments of the population. There is danger now that the move will be blocked by vested interests and by strong political pressures.

We suggest below the elements of a comprehensive and integrated package which should be announced for elimination of octroi and zila tax.

First, in the spirit of respecting provincial autonomy, the proposal for abolishing octroi and zila tax should ideally have been announced by each provincial government in the Budget Speech instead of the federal government. These fiscal powers have been granted through the promulgation of Local Government Ordinances by the provincial governments and legally they are the appropriate entities to withdraw these powers. Unfortunately, the hasty announcement by the Finance Minister of the abolition of the two taxes, without adequate preparation and consensus building, has strengthened the perception of increasing encroachment by the federation into affairs of the provinces. Clearly, this was done to gain political capital with the traditional vote bank of the PML of business and trading interests. Perhaps, there was a feeling in Islamabad that if the provinces had been given the option to legislate this change, some provincial governments may have opted out. Already, the government of Balochistan has indicated that it will not support and implement the reform unless adequate guarantees are provided by the federal government.

Second, details of the grant system for substituting the income from octroi and zila tax should be announced to allay fears about the viability, sustainability and fairness of the scheme. These details should include the following:

earmarking of revenue: The viability and sustainability of the grants scheme will be firmly established if there is explicit earmarking of a revenue source for financing the grants. Clearly, tax payers are going to benefit substantially from the abolition of the octroi and zila tax. According to the Finance Minister, given the degree of extortion in tax payments, the benefit to tax payers of about Rs 80 to Rs 100 billion is about four to five times the actual revenue collected. Therefore, tax payers are probably willing to pay extra in some other (less extortionary) tax to get relief from octroi and zila tax.

The original proposal prepared by the Multiplicity of Taxes committee (of which the author was a member), was that the standard GST rate be enhanced by an amount adequate to cover the total cost of grants to local governments. The GST was chosen for earmarking because of the similarity of the octroi, in particular, to a local sales tax. Given the projected GST revenues of 1999-2000 this will require an increase in the standard rate of three percentage points (15 per cent to 18 per cent). Earmarking of revenue has a number of advantages:

(i) Both the federal and provincial governments do not have to dip into their existing pool of revenues to finance the grants, which affect their fiscal position adversely

(ii) Given the NFC revenue sharing arrangements, effectively 62.5 per cent of the grants will come from the federal government and 37.5 per cent from provincial governments respectively

(iii) The size of the grants will no longer be discretionary in nature. The local councils will not be at the mercy of higher levels of government in terms of the likely quantum of grants depending upon the financial position of these governments and their attitude towards local governments.

(iv) Earmarking will ensure built-in buoyancy in the grants in coming years. The GST is, in fact, currently the fastest rising source of revenue (35 per cent growth projected in 1999-2000) and linkage of grants to revenues from this source will ensure buoyancy in the income of local councils

(v) Earmarking of grants to revenues from a federal tax, which is part of the divisible pool, will tantamount to greater constitutional recognition of the role of local governments in the country.

Formula-driven grants: The grants system can be made more transparent and fair by specifying a clear cut formula for determination of the size of the grant to each local council in lieu of the abolition of octroi and zila tax. In order to facilitate the transition and to provide some support especially to smaller local councils in backward areas, factors relating to the existing level of revenue from octroi/zila tax and the degree of backwardness should jointly be built into the formula.

One possible version of the formula is as follows: in the first year after transition:

Metropolitan/Municipal Corporation	:	existing level of revenue (indexed for] inflation)
Municipal Committee/Town Committee/ District Councils	:	Either existing level of revenue (indexed for inflation) Or a per capita grant of fixed amount multiplied by the population whichever is higher

This formula has the merit of incorporating an element of fiscal equalisation and providing more resources to local councils which had a limited tax base for collecting octroi or zila tax.

<u>Third, adequate institutional arrangements should be put in place.</u> Alongwith the announcement of the abolition of octroi/zila tax the provincial governments should notify the setting up of respective Provincial Finance Commissions (PFC) to study and recommend ways of sustaining the financial operations of the local governments by focusing, in particular, on the following:

(i) handing over of taxes of local nature, which are currently being levied and collected by provincial governments, to local governments. A prime candidate for fiscal decentralisation is the property tax, which is the main source of local income in most countries. This process of handing over some of the fiscal powers to local governments will avoid the perception of loss of fiscal autonomy due to the withdrawal of the powers to levy octroi/zila tax. It will also enable the local councils to divert their present tax collection machinery to other areas of local taxation and thereby minimise the need for any retrenchment of staff.

(ii) devise the appropriate formula (on a five yearly basis) according to which grants should be made to local councils in lieu of the abolition of octroi/zila tax.

The Provincial Finance Commissions should be staffed by retired members of the higher judiciary and representatives from civil society. In order to avoid any political victimisation of particular local councils through withholding of grants, the Secretariat of the PFCs should be charged with the task of routinely distributing grants on the basis of the prescribed formula to all the local councils within a province. The provincial governments should remit the overall grant (received from the federal government) in advance to the PFCs on a quarterly basis for onward distribution.

The above proposals will greatly help in ensuring success of the scheme for abolishing octroi/zila tax. Genuine opposition to the transition will be minimised and most of the fears and concerns allayed. Unfortunately, the federal government, in an urge to get political gains, has come up with an inadequately developed scheme which has exacerbated tensions at various levels in Pakistan.

DOES THE BUDGET HAVE A HUMAN FACE?

By Zafar H. Ismail

The Budget 1999-2000 was announced in an atmosphere of high expectations by the people of Pakistan for substantial relief from the burden of rising poverty, erosion in living standards and growing unemployment. What, in fact, has the government given or promised? Have allocations to alleviate poverty been increased? Have the social sectors benefited from a sudden awakening in the corridors of political power that the performance of the social indicators has been abysmal compared to other countries in the region? Have measures been adopted to curtail an increase in prices? What measures have been introduced to generate employment?

Social Safety Nets

The budget itself is generally lacklustre. It contains taxation proposals which are expected to yield about Rs. 17 billion largely through an enhancement of rates. It does not specify the quantum and source of this expected increase, and has little or no relief for the poor. In fact one of the major social safety nets - the subsidy on imported wheat - has been reduced as a consequence of one condition contained in the Policy Framework Paper agreed to between the IMF/World Bank and the government in December 1998. It is expected that wheat prices will rise in the domestic market for two principal reasons: one, the unified exchange rate has already resulted in an erosion of over 11 percent in the rupee’s value which is expected to erode further, and two, wheat imports are expected to be higher in 1999-2000 as a consequence of a lower than expected production caused by poor weather and the impact of sanctions on the import of phosphatic fertilizers. The effect of a further fall in the rupee’s value can be very damaging. For instance, if the wheat price were to increase by three to four rupees per kilo, then Indonesian style food riots cannot be ruled out.

The Finance Minister’s speech contains several passing references to poverty alleviation. He refers to the Pakistan Poverty Alleviation Fund and its objectives, but does not provide any allocation in next year’s budget for its activities. As part of the Policy Framework Paper, the government was committed to endowing the Fund with Rs. 500 million by the year 2000. The FM may have committed additional funds for increasing the endowment of the Fund. Additionally, the recent Supreme Court judgement will probably reduce the amount deducted at source as Zakat. There is no mention of this nor has a provision been made to ensure that the existing *mustahqeen* do not suffer as a result. The FM may have at the very least announced that the federal government would make up the difference. Some relief has, however, been provided for widows - their housing and other loans and mark-ups have been written off.

The strategy for poverty alleviation appears to revolve largely around credit measures and not budgetary measures. Employment generation is planned to be created though micro-credits for establishing small enterprises, the purchase of specified buses and taxis and the construction of houses. This is the correct approach as it involves the removal of the structural causes of poverty but may flounder due to lack of institutional capacity for effectively channelling micro-credit (as was the earlier experience with the Yellow Cab Scheme) and lack of demand due to inability of potential small borrowers to offer adequate collateral and guarantees and pay back the high interest payments. The only significant budgetary measure to alleviate poverty by creating employment is this year's planned construction of 5,000 kilometres of farm-to-market roads. However, unless local governments are involved and they employ self-construction labour intensive techniques, then the benefits accruing to the target poor will not be large. Contractors and vested interests will reap most of the benefits.

Salary Increase

The real incomes of government employees and pensioners have been falling over the years as pays and pensions have not been revised for some time. To mitigate this erosion of income, particularly for the less well off, the budget proposals contain a special additional allowance of a 20 percent of pay (for officers) and 25 percent (for staff). There was instantaneous rejoicing by the employees only to be let down the next day by the Finance Minister - that the increase was linked to initial basic pay. This means that the actual special additional allowance amounted to only about 12 to 14 percent increase in basic pay which is inadequate to compensate for the rise in cost of living during the last five years.

Social Sector Allocations

In his speech the FM proudly claimed that development allocations for the social sectors had been increased by 122 percent. This is a historic high. But is this actually the case? In the Table below the revised estimates for the current year have been compared to the development allocations for the next year.

DEVELOPMENT ALLOCATIONS TO SOCIAL SECTORS			(Rs in Million)
Sectors	**1998-99 Revised**	**1999-2000 Allocation**	**Increase**
Physical Planning and Housing	1,417.0	3,044.7	114.9%
Education and Training	908.2	1,622.7	78.7%
Health and Nutrition	2,847.3	2,690.3	-5.5%
Manpower and Employment	54.3	84.4	55.6%
Women's Development	50.0	50.0	0.0%
Population Welfare	2,000.0	2,200.0	10.0%
Social Welfare	78.6	95.1	21.0%
TOTAL FEDERAL GOVERNMENT	**7,355.4**	**9,787.2**	**33.1%**
Social Action Programme	16,000.0	16,000.0	0.0%
TOTAL DEVELOPMENT ALLOCATIONS FOR SOCIAL SECTORS	**23,355.4**	**25,787.2**	**10.4%**

The Table clearly shows that the overall increase has been only 10.4 percent, with a zero growth in allocations for SAP by the provinces, who are constitutionally mandated to deliver social sector services. The federal outlay has, however, increased by nearly one-thirds. Compared to this the total PSDP financed through budgetary resources of both the federal and provincial governments will be more than 26 percent over the current year's revised estimates. And yet the government claims that its priorities have veered towards the social sectors. There is no evidence to support the assertion by the government that development allocations for social sectors have increased by 122 percent in 1999-2000.

A number of such dichotomies exist in the Finance Minister's speech. To wit : he has claimed that government is encouraging NGOs to deliver health services to the people of Pakistan. Yet, the PML-led government in the Punjab is engaged in de-registering NGOs.

In addition the salary increase has major implications on the pattern of social sector spending. Salaries account for about 70 percent of total current expenditure on social and community services by the federal government. An increase of 12 to 14 percent would mean that the additional allowance given would erode total allocations by about 9 percent. The federal budget has shown that for 1999-2000 the recurring allocations are only 1.3 percent higher than the current year's allocations, not even enough to absorb the increase in salaries. Thus the expenditure on nonsalary items would be cut back and the brunt would be felt in critically needed repairs and maintenance of equipment, purchase of quality enhancing inputs such as books, teaching and medical/surgical supplies and instruments, etc., in effect a substantially lower level of the already very poor services.

Further, provincial and local governments will be obliged to follow suit in providing the same level of relief for their employees and pensioners. They are faced with an uncertain future regarding their revenues : the uncertain yield from pooled resources and a directive to cut back on various taxes levied on housing in the case of the provincial governments and the replacement of octroi and export tax (*chungi & zila*) for local governments by an unclear mechanism of grants. The resulting resource crunch is bound to impact on non-salary expenditure generally and the tradition of a higher cut back in social sector spending will once again be visible.

In summary, the government is relying primarily on employment generation for poverty alleviation. No direct interventions, to help those disadvantaged segments of society who have been most adversely impacted by the recent economic crisis, through widening and deepening social safety nets are proposed in the Budget. Given the uncertain outcome of the employment generation strategy, the country faces the prospect of rapidly increasing poverty and unemployment in the short run.