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Economy & National Budget

By

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June 04, 2015
Islamabad

Outline of the Presentation

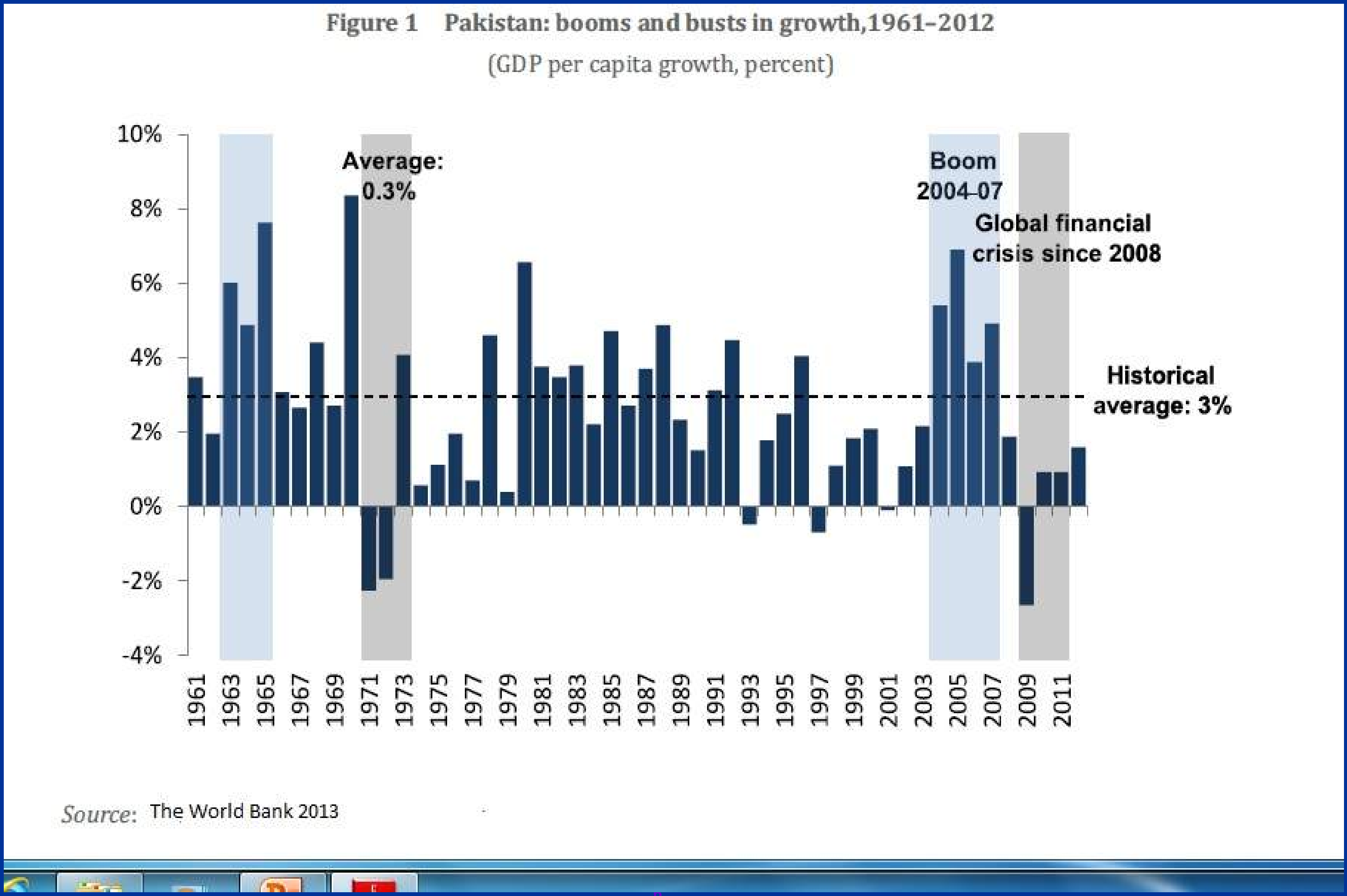
- Fiscal Developments
  - Issues in Public Finance
    - Issues on revenue side
    - Issues on expenditure
    - Issues on financing Fiscal deficit
  - Trends in revenue
    - Structure of revenue
  - Trends in expenditure
    - Structure in expenditure
  - Trends in fiscal deficit
  - Process of budget making/formulation of expenditure plan
  - Medium term budgetary framework

The Economy of Pakistan

in the Light of Macroeconomic Policies

- **Pakistan's growth performance is typical of an <u>underperforming economy</u>. It has recorded only three episodes of growth acceleration since 1960 when GDP per capita exceeded 3% per annum (1963-66, 1980-83, 2004-07);**
- **Its long-term 'structural' growth trend is declining from 6-7% in 1960s to less than 3% in late 2000;**
- **Pakistan's current growth rate is below its potential level and significantly diverging from its most competitive neighbors, China and India;** (continued)

Booms and Busts in Growth



Frightening Divergence!

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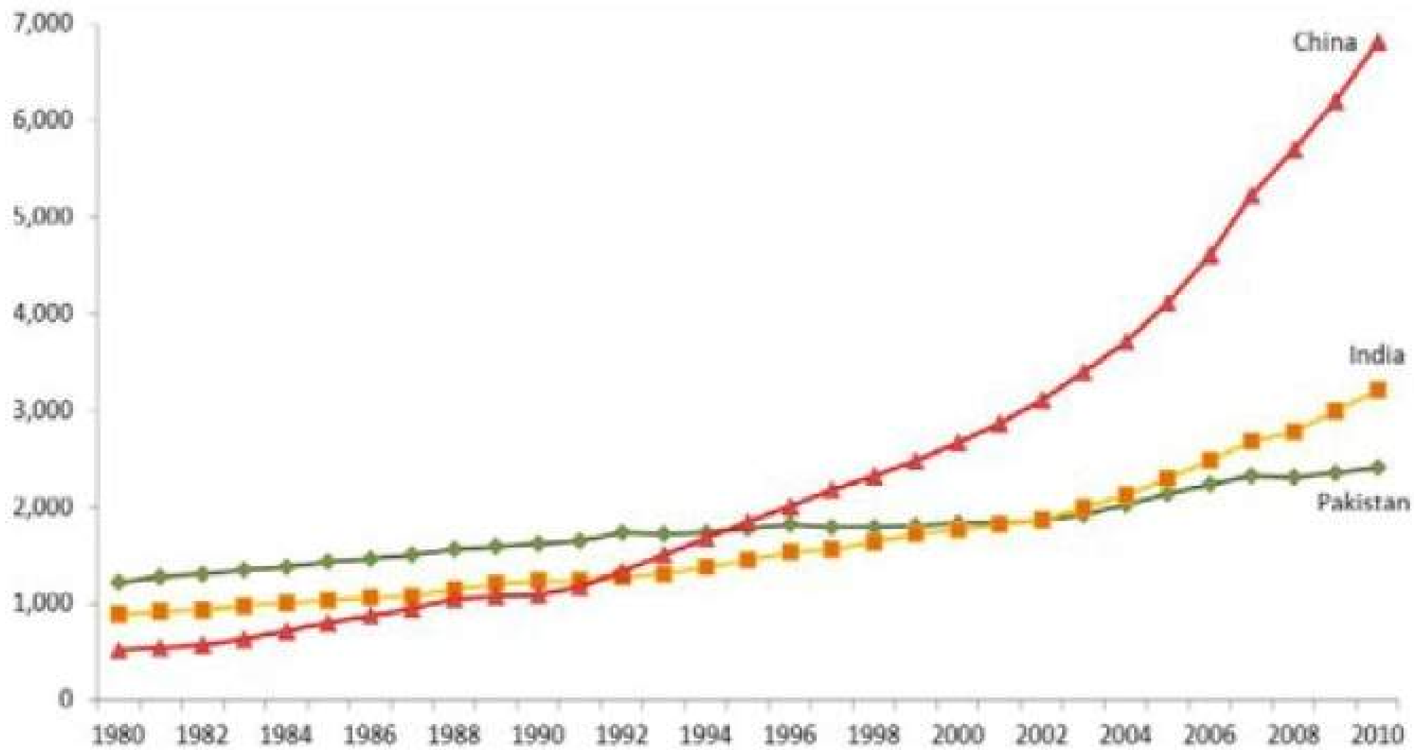
Figure 2: Diverging GDP per capita between Pakistan and world's fast-growing economies
(purchasing power parity, 2005 $)



Source: World Bank2012e.

Lagging Behind thy Neighbors!

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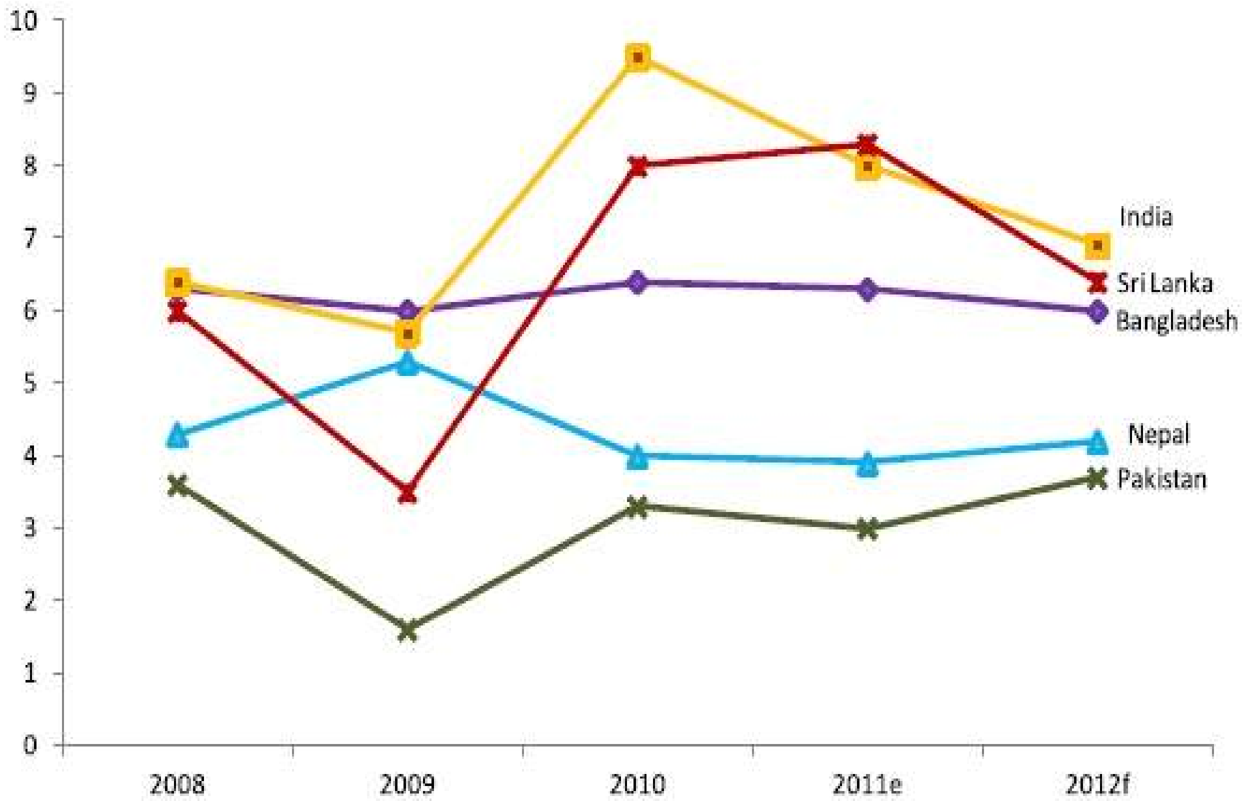
Figure 3: GDP growth inPakistan and other South Asian countries, 2008–12

(2005 $)



Source: World Bank 2012b.

The Economy of Pakistan

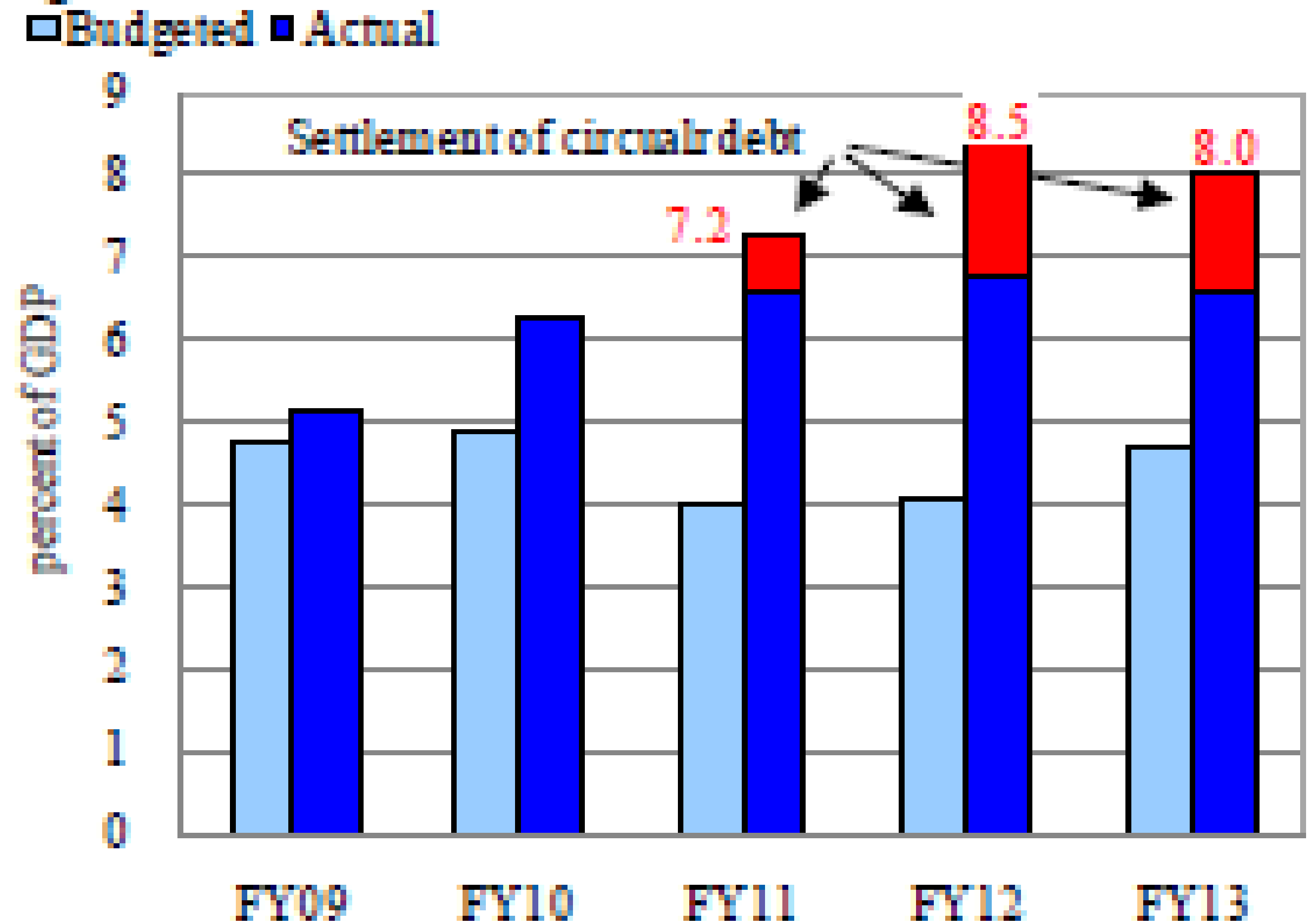
in the Light of Macroeconomic Policies

- There is <u>marked deterioration in many structural areas</u> such as revenue collection, energy sector, social protection, and overall environment for private investment,
- The backbone of the economy, i.e., the industrial sector is performing dismally, it has shown only a modest recovery after serious slide in recent years;
- <u>Macroeconomic instability</u> in the shape of fiscal and trade deficits, and unemployment has reached an disturbing stage; (continued)

The Economy of Pakistan

- Constraints on fiscal space and continuous security risk have put the economy on the brink of degeneration;
- Increasing debt burden reflects serious flaws in economic management. Not to mention that there is gross violation of Fiscal Responsibility and Debt Limitation Act; and most importantly
- There are worrying signs of rising levels of poverty and worsening of income distribution across regions.

Figure 5.1: Fiscal Deficit



Source: Ministry of Finance

Fiscal Development

- Importance of prudent fiscal policy cannot be overemphasized. A sound fiscal policy is essential for preventing macroeconomic crisis and realizing the full growth potential.
- Pakistan has paid and is now paying a heavy price for its fiscal indiscipline in terms of declining investment and economic growth, and the associated rise in unemployment and poverty.
- Over the past several decades, there has been increasing acceptance worldwide that fiscal discipline over a prolonged period is essential for maintaining macroeconomic stability and Growth.
- Fiscal discipline is therefore ***sine quo non*** for promoting growth and alleviating poverty

- ***Problems in Budget Making Exercise***
  - Revenue is treated as residual
  - We first formulate our expenditure plan then we **subtract** the size of the budget deficit. The difference is targeted as revenue.

- ***Issues On Revenue Side***
  - Inability to forecast revenue
  - Lack of expertise in FBR
  - Too many exogenous shocks affecting revenue target
  - Structural weaknesses in our tax system
  - Weak fiscal role of provinces in resource mobilization

What is an Efficient Tax System?

- A tax system that is capable of financing the necessary level of public spending in the most efficient and equitable way possible is known as efficient tax system.

- An Efficient tax system should raise enough revenue to finance essential expenditures without recourse to excessive public sector borrowing; and raise the revenue in ways that are equitable minimizes its disincentive effects on economic activities and is least distortionary.

- ***Efficient Tax System: What are the Challenges?***
  - Establishment of effective and efficient tax system faces some formidable challenges
    - Structure of economy makes it difficult to impose and collect certain taxes.
      - Large share of agriculture in output and employment
      - Large informal sector activities
      - Low literacy rate
      - Low human capital
- All these characteristics reduce the possibility of relying on certain modern taxes such as income tax and sales tax

Structural Weaknesses in our Tax System

- Narrow and perforated tax base
- Too many small tax sources
- Higher tax rates
- Multiplicity of taxes
- Complex and tedious tax system
- Over dependence eon Indirect taxes
- Heavily reliance on trade related taxes
- Few sectors contributing bulk of FBR revenue
- Weak tax Administration
- Non-availability of reliable statistics from the businesses makes it difficult for tax administration to asses the potential taxes to be collected
- Marginal changes are often preferred over major structural changes

Economic activity has had little relationship with optimal tax collection in Pakistan

- **Weaknesses of Pakistan’s Tax system can therefore be summarized as follows:**

- **Complex:** It is difficult to administer and comply with
- **Inelastic:** Unresponsive to growth and discretionary policy measures. In other words, elasticity of taxes with respect to their bases are, in general, less than unity
- **Inefficient:** It raises little revenue but introduces serious economic distortions
- **Inequitable:** It treats individuals and business in similar circumstances differently
- **Unfair:** Tax administration and enforcement are selective and skewed in favor of those with the ability to defeat the system.

Consequences

- Low and stagnant tax-to-GDP ratio
- Low elasticity and buoyancy of taxes
- The above two compelled the successive governments to generate resources through surcharges and not tax revenues

Issues in Expenditure

- Interest payment is the largest single item of the expenditure
- Security related expenditure will continue to rise, why?
- Continuation of war on terror
- Adverse security developments
- Exchange rate depreciation
- No resolution of Power Sector Subsidies
- No resolution of Circular Debt
- No resolution of PSEs
- Fiscal indiscipline of Provincial governments

Issues On Financing Budget Deficit

- Persistence of large budget deficit itself an issue
- Decline in grant assistance
- No privatization proceeds
- Commercial Banks exploiting situation
- Debt moving towards shorter maturity end
- Refinancing of domestic debt is emerging as a serious issue.

Process of Budget Making/Formulation of Expenditure Plan

- Budget making is basically the formulation of Expenditure Plan by the different ministries/divisions
- Budget formulation process starts at the lowest level of the Government and is completed at the highest level.
- Budget call circular
  - MOF issues Budget call to all the administrative Ministries/Divisions and Department of the Federal Government in October every year.
  - It contains comprehensive instructions for the preparation and scrutiny of the budget estimates
  - It also sets out the target dates by which the various stages of budget formulation are to be completed.
- Preparation of Estimates
  - All the line Ministries/Divisions/department will prepare **revised** estimates for current year and will prepare **budgetary** estimates of the next year.

Contd…..

Process of Budget Making/Formulation of Expenditure Plan

- Must provide documentary evidence and duly approved by the competent authority in case there is over or under expenditure. In each case, reason (s) must be given for over spending or under spending, and also the manner in which this excess expenditure is met, i.e., whether by reappro-priation of savings in the existing grants/appropriations or by allocation from other items. In case of under spending the reasons for short utilization of the grants are to be stated
- Budget is based on Cash Accounting System
  - That is, estimates are required to be prepared on the basis of what is expected to be **actually** received or paid and not merely the revenue or the liability of expenditure falling due in that year

Contd…..

Process of Budget Making/Formulation of Expenditure Plan

- The line Ministries/Divisions/Departments will prepare their budgets; will pass them to their administrative ministries and divisions; who will then pass them over to the Financial Adviser/Ministry of Finance with their recommendations. Financial Adviser/Ministry of Finance will undertake detailed scrutiny of their Budgets before these are finally accepted for inclusion in the budget

◆ Budget is divided in two main sections

- Revenue Budget/Current Expenditure
- Capital Budget/Development Expenditure

Current Expenditure is basically the day-to-day expenditure such as debt servicing, defense, running civil administration, grants, subsidies and pension.

Contd…..

Process of Budget Making/Formulation of Expenditure Plan

and other activities which are financed from current revenues derived through taxes, duties and other miscellaneous receipts.
Current expenditure is non-productive in nature.

Development Expenditure is designed to create material assets which add to the economic potential of the country. Expenditures on physical and human infrastructure are capital budget or development spending. Capital expenditure is generally met from revenue surplus (from revenue budget), miscellaneous capital receipts and borrowing for specific or general purpose.

Contd…..

Process of Budget Making/Formulation of Expenditure Plan

- Development expenditure is productive expenditure and prepared by the Planning Commission (PC) under Annual Development Program (ADP)
  - PC prepares ADP in consultation with the Ministry of Finance and Provincial Governments and finally approved by the National Economic Council (NEC), headed by the Prime Minister.
  - Projects first approved by Development Working Party after careful technical scrutiny. Submitted to ECNEC and finally approved by the NEC.

Medium-Term Budgetary Framework (MTBF)

- Traditionally, budgets have been formulated according to a bottom-up approach.
- The bottom-up approach confers centralized authority for resource allocation on the ministry of finance, which manages public finance by controlling individual appropriations and budget items.
- However, the bottom up approach has a number of recognized weaknesses and many countries have modernized the traditional approach to address these weaknesses.
- The new system, which emphasize fiscal discipline and strategic management of the budget, are collectively known as ‘top-down’ budgeting.

Traditional vs Modern Budget Management

Traditional	Modern
Annual focus	Medium Term focus
Ignores economic forecast	Based on economic forecast
Dominated by Finance	Strategic
Inefficient (time consuming)	Ministry empowerment
Limited ownership	Efficient (delegated authority)
Concentration on inputs (resources)	Joint ownership
Separate recurrent/development	Concentration on output (services)
Reactive and unpredictable	Harmonized recurrent/development
	Proactive and predictable

Identifying the Problem Areas

- **A cursory look at budget document would reveal that <u>revenues collected fall short of target</u> whereas <u>expenses exceeded their budgetary allocations</u>. The deviation from initial estimates is largely on account of following factors:**

i. **Under-estimation of subsides;**

ii. **Underestimation of interest payments on debt; and**

iii. **Over-estimation of FBR tax revenue.**

A Quick Glance on

Budget FY 13

Budgeted and Actual Estimates for FY13			
	Budget	Actual	Difference
Total Revenues	3,376.0	2,982.4	-393.6
Tax Revenue	2,626.0	2,199.2	-426.8
FBR	2,381.0	1,936.1	-444.9
Non-Tax	750.0	783.2	33.2
Total Expenditure	4,480.0	4,816.3	336.3
Current Expenditures	3,430.0	3,660.4	230.4
Interest	925.8	991.0	65.2
Others (General Admn & Defense)	1,686.2	2,669.5	983.3
Subsidies*	208.6	367.5	158.9
Development Expenditures	1,050.0	777.1	-272.9
PSDP	873.0	695.1	-177.9
Net lending (including Rs. 322.2 bn for Settlement of Circular Debt)*		362.8	362.8
Budget Deficit	-1,104.0	-1,833.9	-729.9
Memorandum items:			
Provincial Surplus	*79.5*	*52.7*	*-26.8*
Bank borrowing	*484*	*1,457.5*	*973.5*
*2013-14 Budget in brief.			
Source: Data on Government Fiscal Operation, MOF website:			

Habit Persistence

	FY10	FY11	FY12			FY13
			Budget	Actual	Difference	Budget*
Total Revenue	2,078.2	2,252.9	2,870.0	2,566.5	-303.5	3,376.0
Tax revenue	1,472.8	1,699.3	2,151.0	2,052.9	-98.1	2,626.0
Non-tax receipts	605.3	553.5	719.0	513.6	-205.4	750.0
Total Expenditure	3,007.2	3,447.3	3,721.0	4,327.2	606.2	4,480.0
Current	2,386.0	2,900.8	2,976.0	3,122.5	146.5	3,430.0
Development and net lending	652.8	514.0	745.0	743.9	-1.1	1,050.0
PSEs debt consolidation				391.0	391.0	
Unidentified	-31.6	32.5	0.0	69.8	69.8	
Overall Deficit	**929.0**	**1,194.4**	**851.0**	**1,760.7**	**909.7**	**1,105.0**

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A Quick Review of Summary of Consolidated Public Finance (Rs. Billion)

	FY10	FY11	FY12			FY13
			Budget	Actual	Difference	Budget*
Financing Through:						
External Resources	188.9	107.7	135.0	128.7	-6.3	135.0
Internal Resources	740.2	1,086.7	716.0	1,632.1	916.1	971.0
Bank	304.6	615.1	304.0	711.7	407.7	484.0
Non-bank	435.6	471.6	413.0	529.4	116.4	487.0
PIB issues for PSEs debt				391.0	391.0	
Privatization proceeds						
Percent of GDP						
Overall Budget Deficit	**6.3**	**6.6**	**4.0**	**8.5**		**4.7**
Revenue Deficit	2.1	3.6		2.7		
Primary Deficit	1.9	2.8		2.3		

Source: Ministry of Finance

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What to do? Why Re-inventing Wheel?

- The Growth Commission (Michael Spence Report) has given the 'recipe' for strong economic growth.
- The <u>experience of thirteen economies</u> that experienced sustained high growth - those economies that had achieved 7% or more growth for 25 years or more reveals that, among few other things the <u>five common elements for sustained high growth are</u>:

1. Fully exploited world economy (No ISI but EPP);
2. Ensured macroeconomic stability (Contained Macro Imbalances, particularly FD);
3. High rates of saving and investment;
4. Market allocated resources; and
5. Committed, credible, and capable governments.

Success Requires ……

- The Investment to GDP ratio should be around 25% as has been the case for High Growth Economies (HGEs);
- The HGEs put substantial public investment, at least 7-8 percent of GDP, into their people, health, education, and infrastructure development.
- However, such high rate of investment for growth is next to impossible without a well targeted **Resource Mobilization Strategy –** an aggressive approach to tap internal as well as external funds.

Actions Needed: Domestic Front

- **Ensuring Fiscal Discipline should be the number one priority**
- **Improvement in Tax Collection**
  - Why tax collection remains so low despite huge tax gap?
  - Why the structural weaknesses cannot be addressed?
  - Why TARP remained unsatisfactory?
- **Serious Control over Expenses (Management of expenses in no more a solution now)**
  - Debt Reduction and Exit Strategy

Actions Needed: Domestic Front

- **Maintaining Price and Exchange Rate Stability**
- **Reducing cost of doing business in Pakistan**
- **Incentivizing and Promoting domestic savings**
  - Why National Saving Scheme is losing glamour?
  - What is the role of financial institutions (Banks, Mutual Funds, Islamic FIs) – ineffective channels or what?
  - Why savings are going to Real Estate!

Actions Needed: External and Regional Fronts

- **Improving Sources of External Funding (mostly long-term)**
  - Substantial increase in foreign savings through exportable surpluses – efficiency and productivity concerns
  - Attracting FDI and Remittances – learning from Korea, Taiwan, China and India
- **Striving for regional peace despite repeated setbacks from either side**

Concluding Remarks

- A fluctuating growth is highly undesirable. How long to continue with agriculture and agro-based industries. Why structural transformation not taking place?
- China in the past and others more recently have gained from ‘out-sourcing’. Is there any lesson to learn? Shift towards services sector.
- Energy shortages and Law and Order are genuine excuses but do we have enough resources (savings) for physical and human capital development? Do we have skilled labor to produce technologically advanced equipment, if not why not. There is a lot to ponder!

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Thank You

for your attention

Now Questions/ Answer Session

June 06, 2015