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Pakistan's Fiscal and Monetary System

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Abstract

The paper addresses the structural rigidities in the fiscal system. The fiscal rigidity has resulted in a fiscal overhang over the monetary policy of the SBP. The author contends that policy should be geared to reduce the fiscal tax burden on the formal sector and to reduce the fiscal domination over monetary policy.

Overview

As part of wide-ranging economic reforms started in the late 1980s, Pakistan's financial sector has moved from operating under a regime of financial repression to one which operates under an enhanced degree of liberalisation. The lynch-pin of the reform effort in the financial sector was the granting of *de jure* independence to the central bank, underpinned by an Act passed by parliament in 1997.

The key features of the statutory independence granted to the State Bank of Pakistan (SBP) included independent oversight of the banking system, free from government interference (which was endemic earlier); the granting of a fixed tenure to the central bank governor; and functional independence to the central bank in the formulation and conduct of monetary policy.

While reform of the financial sector has largely been successful, the lack of similar progress in public finances has meant that government efforts to enhance its revenue by widening the tax base have consistently fallen short of expectations. As a result, the shortfall in revenue has partly been financed by government borrowing, including recourse to the central bank via monetisation. It has also led to an almost systemic tolerance by the SBP of higher-than-targeted credit needs of the government throughout the 1990s.

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Potentially complicating the central bank's pursuit of its "primary" objective of maintaining price stability is the institutional arrangement whereby, on paper at least, the central bank is required to "coordinate" its monetary policy with the fiscal authorities. Taken together, these actions have resulted in significantly undermining the attainment of the central bank's principal focus: achieving and maintaining price stability as well as anchoring long run inflationary expectations at an "acceptable" level.[1]

After a period of fiscal restraint on the part of government, manifested in a steep reduction in the fiscal deficit from 2001 onwards and culminating in the lowest budgetary imbalance recorded in three decades (2.4% in FY04), the tide appears to have turned. The fiscal deficit has increased sharply since (4.2% in FY06, and targeted at the same level for FY07), while the composition of deficit financing has skewed heavily towards recourse to the central bank. This outcome appears to be partly due to the low buoyancy in tax revenues combined with a sharp increase in both development and non-development budgetary expenditures. As a consequence, the stock of net domestic assets (NDA) of the central bank has risen dramatically over this period, reflected in a steep increase in reserve money (M0) growth.

The sharp increase in the monetary base has come at an unwelcome time for the central bank. After recording a decline in the 2000-2003 period, from an average of 9.7% during the 1990s, inflation measured by the Consumer Price Index (CPI) jumped to 9.3% in FY05, and a provisional 8% in FY06. The GDP deflator has risen from 2.5% in FY02 to 10.3% in FY06, reflecting the strength of underlying price pressure.

While the rise in inflationary pressures over this period appears to be related more to non-monetary "shocks" such as a steep increase in international oil prices, it is only rational to believe that the monetary overhang built over the last few years - characterised by M2 growth well in excess of growth in nominal GDP - will increasingly exert a greater influence on underlying inflation trends. Such an outcome would also conform to the observed pattern over the 1990s, where high M2 growth appeared to lead to a rise in inflation.

The apparent reversal of fiscal rectitude displayed by the government during the 2000-2004 period is against a backdrop of the ratification by

[1] It should be noted that SBP's charter, however, places equal emphasis on supporting government efforts to promote economic growth and employment-generation, as well as on the attainment of price stability.

parliament of a fiscal responsibility and debt limitation law in 2004. The key features of the law, as it currently stands, are:

- The government is mandated to reduce public debt to 60% of GDP or below by 2013;

- In the interim, it is required to ensure a decline in public debt equivalent to 2.5% of GDP each year, at the minimum;

- The government is also required to ensure the elimination of a revenue deficit by FY2007 (current fiscal year).

The fiscal responsibility law currently does not legislate on the composition of government borrowing – i.e. theoretically the government could meet all the stipulations of the law and still be fiscally "irresponsible" if for example it were to choose to completely monetise its fiscal deficit for a particular year.

From the previous discussion, it is clear that to enhance the ability of the central bank in achieving price stability and anchoring long term inflationary expectations at the low end of an "acceptable" range, the fiscal performance of the government, both in terms of raising revenue as well as in terms of expenditure restraint, needs to improve significantly. Further, greater stringency needs to be introduced in the fiscal responsibility and debt limitation law in Pakistan, specifically with regard to the degree to which the government can take recourse to the central bank in monetising its deficit. Perhaps a "logical" extension of the argument for greater functional independence of the central bank in terms of formulation and conduct of monetary policy would be a regime shift towards inflation-targeting. While the pursuit of price stability should remain the primary objective of the central bank, it is perhaps true to observe that the underlying conditions do not exist for such a regime shift as yet, especially given the weaknesses in the fiscal system. However, a move over the next few years should be made towards an explicit target, which could, it can be argued, increase the pressure on the government to reduce the inefficiencies in public finances.

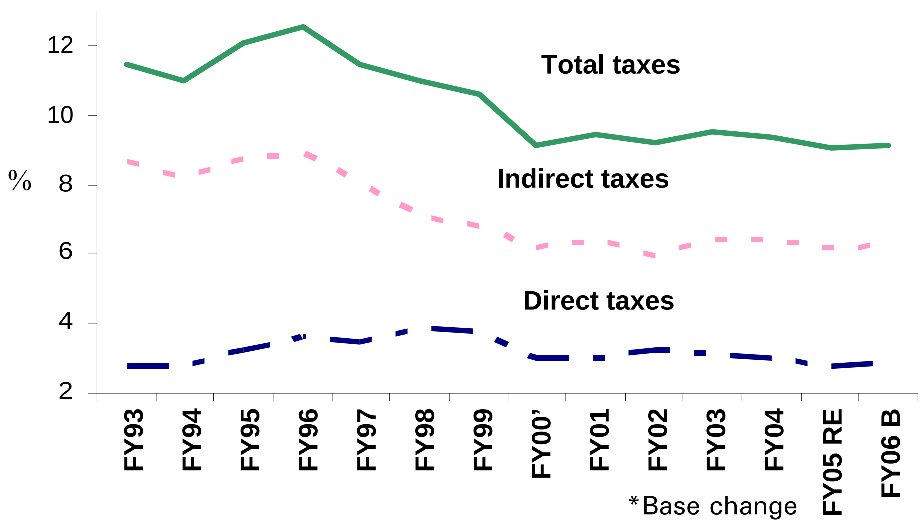
Backdrop

Pakistan's Fiscal Structure

Briefly, Pakistan's fiscal system is characterised by a weak tax base and an inequitable incidence of taxation, combined with structural rigidities on the expenditure side. The following points underscore the vulnerability associated with Pakistan's public finances.

- Pakistan's tax effort remains poor as reflected in a tax-to-GDP ratio that is amongst the lowest in the region. Despite robust economic growth since 2003, the tax-to-GDP ratio has actually declined to under 9.5% (**Fig.-1**).

Figure-1: Pakistan's historical tax performance



Sources: Ministry of Finance

- Mapping the sources of value-addition in the economy by major economic sector, to each sector's contribution to total tax collection, it is clear that the economy's tax effort is heavily dependent on the manufacturing sector. As shown in Table-1, while *agriculture* accounts for 23% of value-addition in the economy, its share in tax revenues is estimated at only 1.2%. *Services,* with a weight of 53% in terms of contribution to total value-addition accounts for approximately 26% of tax revenue. The bulk of tax revenue is collected from ***industry***, primarily from ***large scale manufacturing***, which provides almost 63% of the annual collection.

Table-1: Sectoral shares in value addition and tax revenue

	Share in GDP	Share in revenue
Agriculture	23.3%	1.2%
Services	52.6%	25.6%
Manufacturing	17.6%	61.0%
Other	6.5%	12.2%

Sources: Ministry of Finance

Underscoring the magnitude of "non-taxation" of productive sectors in the Pakistani context, even in the formal sphere of the economy, is the case of real estate. Despite the phenomenally large volume of real estate transactions over the past few years, this activity generated approximately Rs. 6.5 billion in taxes during FY05, or the equivalent of around 0.1% of GDP.

- Towards the end of the 1990s, the total number of income tax payers in Pakistan hovered around the 1.1 million mark, of which nearly 0.5 million were salaried workers. Since 2001, the total number of income tax payers has grown moderately, from around 1.9 million to 2.5 million at the end of FY05.

- However, according to the Central Board of Revenue, 46% of the income tax payers holding NTNs were ***non-filers***, suggesting a much narrower tax base than the headline number indicates.

- A recurring source of weakness of the tax base has been its dependence on indirect taxes. Hence, indirect taxes, such as sales taxes, have contributed, at their peak, up to 76% of overall tax collection (in FY93). Despite a fairly vigorous tax effort over the past few years, the share of indirect taxes has declined to 69%, while the share of direct taxes has stagnated around 31%, well below its peak of 36% in FY99.

Recently, direct tax collection has begun to record a fairly substantial increase, rising 10.5% in FY05, though at current levels it still stands at the equivalent of 2.8% of GDP. In addition, the increase has occurred mainly on account of greater recovery from the existing base rather than a meaningful increase in the number of new tax-filers. Deductions at source (i.e. withholding taxes) continue to constitute a very large part of *direct taxes* in Pakistan.

As a telling indictment of the state of play in terms of tax compliance and enforcement, non-salaried income tax payers (individuals) contribute less than 28 percent to direct taxes, and pay the equivalent of 0.7 percent of GDP as tax.

- After experiencing a decline from the early 1990s onwards, the share in total collection of taxes on external trade (via import levies etc.) has gone up quite significantly over the past 2 years. For the first six months of FY06, import-based taxes accounted for 48 percent of total collections, representing a critical dependence by CBR on this source to achieve its demanding full-year target.

While there are hopeful signs emerging over the past two years with regard to dividends from the reform of tax administration and policy, it is too early to be unguardedly optimistic. Obviously quite a lot of ground needs to be covered before Pakistan's tax system yields tax-to-GDP ratios consistent with its development needs. Without the needed broader reform of the political economy, achieving a desirable outcome on the tax front will continue to face severe headwinds.

While, so far, the paper has dealt with weaknesses in the fiscal system mainly from the perspective of the inability to raise tax revenue, clearly the system is affected by demands on the expenditure side. To set the stage for the next section of the paper, it would suffice to point out that while total expenditure (as percent of GDP) had begun to display a favorable trend between FY00 and FY04, that trend appears to have reversed somewhat since then.

Inter-play of fiscal and monetary system

In the backdrop of persistent structural weaknesses in the fiscal system, some of which have only recently begun to be addressed, the issue of **fiscal domination** is ever-present. Despite the fact that the policy autonomy of the central bank is written into law, starting first with the administrative and operational independence legislated in 1994, followed by the completion of its *de jure* independence in 1997, it has had to operate with limitations to its *functional* independence arising in large part from the abovementioned weaknesses in the fiscal system.

How does the fiscal system influence the formulation and conduct of monetary policy, even for a central bank that is independent through an act of parliament? In the case of Pakistan, this can potentially show up in a number of ways.

First, fiscal domination has traditionally manifested itself in the formulation of the annual credit plan where the government's budgetary borrowing needs take precedence over the rest of the economy. Since SBP conducts monetary policy by targeting overall monetary aggregates, with broad money or M2 as the intermediate target, and base money or reserve money as the operational target, accommodation of the government's needs ***in toto*** can result in credit-constraining the non-government sectors, for a given level of Net Foreign Assets (NFA) build-up – i.e. if changes in NFA are as per target, and government net borrowing is higher, the only way to accommodate Credit Plan targets on money supply growth would be to curtail credit to the private sector.

Under a regime of direct monetary control, that is when the SBP directly regulated the money supply or credit growth in the economy varyingly via a change in the cash-reserve ratio or SLRs, or changes to the credit ceilings and/or to the Credit-Deposit ratio, it was easier to curtail credit to the private sector. However, to SBP's credit, the non-government sector does not appear to have been significantly squeezed at least during the mid-1990s onwards as a result of the accommodation of the government's substantial deviations from the original credit plans targets on budgetary borrowing. Nonetheless, this has meant that Credit Plan targets for overall M2 growth have been consistently exceeded (barring one or two instances) since the late 1980s, significantly retarding the central bank's fight against inflation.

As shown in Table-2, the principal causative factor for substantial deviations (excess) from Credit Plan targets has been government borrowing from the banking system. Since 1988, on only one occasion has government borrowing for budgetary support been lower in net terms than SBP's target for the year (in FY98).[2] On each other occasion since, government bank borrowing (including from SBP) has overshot the Credit Plan targets by a wide margin, with the annual deviation ranging from 26% to 1215%.

[2] It should be noted that actual outcomes are being compared to *revised* targets for each of the years, which were substantially higher than original credit plan targets.

Table-2: Annual Credit Plan – Target versus Actual (Rs. million)

	Government Borrowing (Net)				Private Sector			
Year	Target (R)	Actual	Over/ (Under)	% variance	Target (R)	Actual	Over/ (Under)	% variance
FY88	13,000	18,234	5,234	40%	12,050	19,708	7,658	64%
FY89	9,494	15,910	6,416	68%	13,987	15,349	1,362	10%
FY90	10,030	23,203	13,173	131%	16,274	20,587	4,313	27%
FY91	12,086	27,438	15,352	127%	16,203	22,786	6,583	41%
FY92	25,375	68,991	43,616	172%	20,707	28,416	7,709	37%
FY93	59,000	75,003	16,003	27%	31,092	54,298	23,206	75%
FY94	22,500	28,266	5,766	26%	31,147	39,871	8,724	28%
FY95	20,000	53,086	33,086	165%	47,000	59,584	12,584	27%
FY96	44,900	68,527	23,627	53%	56,570	54,749	-1,821	-3%
FY97	57,700	80,933	23,233	40%	60,800	61,105	305	1%
FY98	63,500	56,723	-6,777	-11%	81,000	75,497	-5,503	-7%
FY99	-48,088	-74,455	26,367	55%	82,100	83,775	1,675	2%
FY00	-7,000	78,049	85,049	1215%	119,000	18,265	-100,735	-85%
FY01	-14,700	-46,225	31,525	214%	84,900	55,860	-29,040	-34%
FY02	-54,000	22,177	76,177	141%	105,100	52,970	-52,130	-50%
FY03	-44,201	-78,362	34,161	77%	50,200	167,723	117,523	234%
FY04	10,600	58,106	47,506	448%	85,000	325,215	240,215	283%
FY05	65,000	91,985	26,985	42%	350,000	428,800	78,800	23%

Sources: State Bank of Pakistan

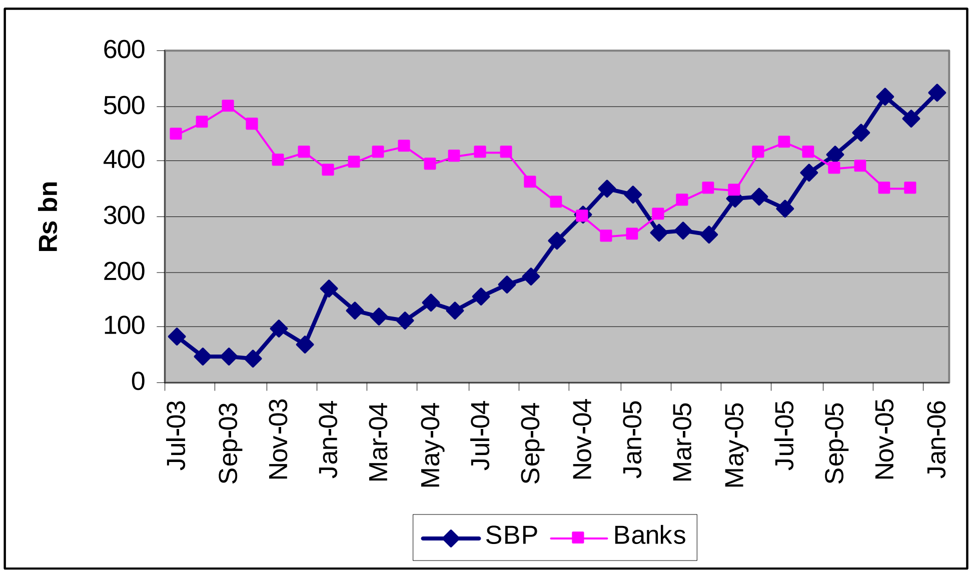
Over the past two years, SBP has tolerated significant deviations in NDA expansion from its stated Credit Plan targets, on account of accommodating ***both*** the government as well as the non-government sectors.

More recently, the central bank's fight against inflation has been complicated by two factors. First, as a result of the positive shock the economy experienced in the aftermath of "9/11", Pakistan received capital inflows of over US$ 9 billion between 2001 and 2004. The resulting liquidity injection in the domestic economy was partly sterilised by SBP, due to: 1) the belief that the economy could be kick-started by this course of action; and 2) partly due to IMF pressure to cap the fiscal costs of sterilisation.

The second factor that has significantly impaired the central bank's efforts to maintain price stability over the past two years, has been the increasing recourse by the government to monetising the fiscal deficit.

Hence, from a level of Rs. 261 billion in June 2004, SBP's net claims on the government – consisting almost entirely of lending for budgetary support – crossed Rs. 405 billion by June 2005, before touching a peak of Rs. 538 billion (over 7% of GDP, or 17% of the M2 stock) by January 2006.

Figure-2: Stock of government securities held by SBP



Sources: State Bank of Pakistan

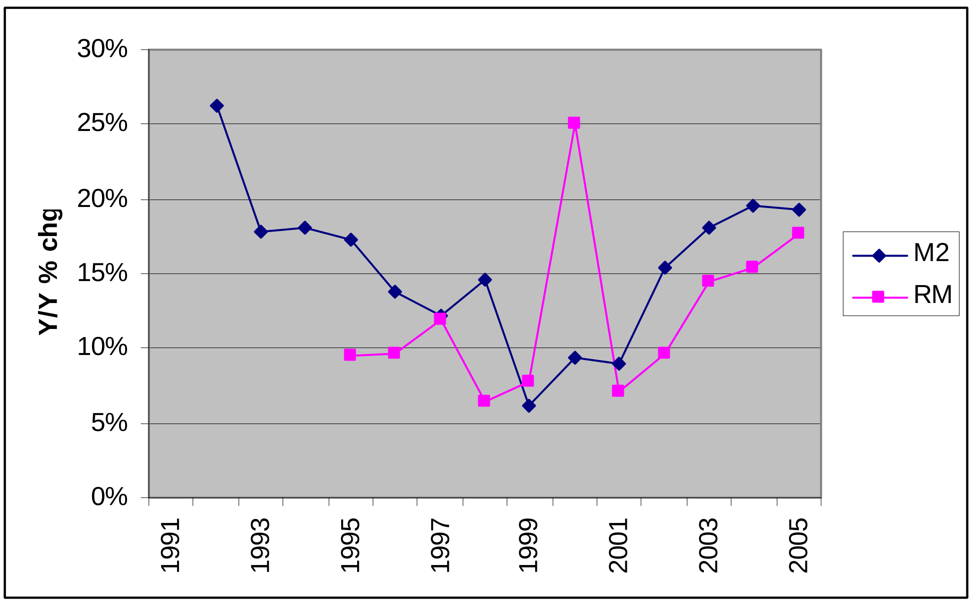
The motivation for this policy course on the part of the government was clear. By diverting its ever-growing financing requirement away from the market and to the central bank, it wanted to avoid a steep rise in interest rates. Such an increase could have been detrimental to private investment decisions, but would also have adverse ramifications for the government's fiscal position.[3]

[3] The government partially reversed this process at the margin, by utilising capital inflows in early 2006 from PTCL's privatisation and an international bond issue to pay down its borrowing from SBP to the extent of around Rs. 80 billion.

As a result of the two factors outlined – first, strong capital inflows, and second, government borrowing from SBP – the monetary base has increased by 84% between 2001 and April 2006, while overall M2 more than doubled. As a percent of GDP, reserve money has increased by 1.2% of GDP during this period, from 12.8% to approximately 14%, while M2 has risen by 8.6 percentage points, from almost 37% to 45% of GDP.

During this period, the annual increase in both M2 and RM has outstripped growth in nominal GDP, resulting in the prevalence of a monetary overhang, which is exerting significant upward inflationary pressure (**Fig.-3**).

Figure-3: Growth in M2 versus nominal GDP (annual % change)



Sources: State Bank of Pakistan

Underscored both by past practice as well as by recent experience is the fact that without underlying structural improvements in the fiscal system, the temptation to finance fiscal shortfalls via the central bank will remain strong for any government in power. This policy path also highlights the trade-offs the central bank faces between accommodating the government's preferred objective of growth and investment, and the central bank's own mandate to ensure price stability (though one should add that the State Bank of Pakistan's charter actually emphasises *growth* over *price stability*).

While the central bank has consistently pointed out through its widely-covered publications, chiefly the quarterly and annual reports on the state of the economy, the lack of desirability of this policy course, it has also fully accommodated the government's demands.

In this sense, the current policy regime bears some important resemblance to the pre-reform era of financial repression, in which the government was not constrained in its borrowing from the banking system *either* in terms of volume or pricing, since the government could theoretically choose to borrow without limit from the central bank at non-market interest rates, or from the banking system via SLRs.

One significant improvement to the current fiscal responsibility law could perhaps be the introduction of a ceiling on direct recourse to the central bank by the government to finance its budgetary needs. Currently, the Fiscal Responsibility and Debt Limitation Law has no such provision, as it seeks to limit the government's overall debt financing, without influencing its composition.

In another distortion emanating from the fiscal system, the government, as the issuer of securities, has also chosen to directly influence the yield curve, especially long-term yields. By initially rejecting bids over a "desired" level in the long-term Pakistan Investment Bond (PIB) auctions, and then subsequently not holding auctions for a two year period (2004-2006), the government starved financial markets of long-term paper. This has had detrimental consequences for investors with a "natural" demand for Long Term government paper, such as insurance companies and pension funds, in addition to depriving market participants of a pricing benchmark for the long term.

Conclusion

The foregoing discussion raises a number of important issues with regard to a central bank's formulation and conduct of monetary policy under conditions of fiscal domination, namely relating to:

1) Central bank independence (de facto versus de jure)

2) Policy objectives (singular versus multiplicity)

The above discussion leads us to the following conclusions:

The government's inability or unwillingness to properly document the economy, or to raise the tax-to-GDP ratio by taxing its constituents, places a disproportionate tax burden on the formal sector, especially on the large scale manufacturing sector, while maintaining an insatiable appetite for bank financing on the part of the government.

Almost as an aside, both the tax policy and the monetary policy in place over the past three years at least, have provided strong disincentives to financial savings. While monetary policy has led to negative real rates of returns to depositors, under Pakistan's tax laws interest income on deposits is taxed, while capital gains on equities or real estate transactions is tax-exempt.

This issue gains importance when viewed in light of the fact that the savings rate is low in Pakistan, while financial savings is even lower, at approximately 50% of total savings.

Finally, and most importantly, the ability of the central bank to conduct monetary policy efficiently and effectively, especially with regard to its fundamental objective of ensuring *price stability*, has been undermined by fiscal domination. A further strengthening of both public finances as well as institutional arrangements are needed to grant SBP de facto independence in addition to its *de jure* policy autonomy.