**Pakistan’s path forward**

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Saturday, May 25, 2024

Pakistan’s economy has been grappling with the twin deficit dilemma for years. On the one hand, we are stuck with scarce foreign exchange inflows because of low exports and limited foreign direct investment (FDI).

On the other, the government is unable to collect enough revenue to finance its expenditures. As a result, the country faces a recurrent issue of fiscal deficit. In 2023, the deficit was recorded at 7.8 per cent of the GDP and registered a 35 per cent YoY increase during first eight months of the ongoing fiscal year. It has now reached a level where it demands immediate attention.

While public discourse mostly focuses on the current account deficit, the fiscal deficit demands equal attention due to its far-reaching implications. Experiences of regional countries such as India, Vietnam and Malaysia are evidence that to enhance productivity and achieve long-term sustained economic growth the fiscal deficit alarm bell needs to be heard. These countries have demonstrated that centralizing efforts to control fiscal deficits can significantly bolster economic reform.

In Pakistan, owing to high fiscal deficit, the government has to take loans from internal and external sources. Over the years, the share of credit to the government out of the total credit has increased and reached nearly 80 per cent. This increases the debt servicing burden on the government.

In the ongoing budget, interest payments make over 50 per cent of estimated expenditures in FY2024. Total resources left with the federal government after transferring due share to the provinces are unable to finance this single expenditure. Thus, resulting in the government taking further loans, pushing the country deep into the debt trap.

Excessive government borrowings to bridge the revenue-expenditure gap leaves behind little liquidity, which banks comfortably lend to large corporations. As a result, the financial sector does not feel any need to review and relax their requirements and extend their services to small but critical sectors such as agriculture, SMEs, and startups.

These sectors are the engine of employment, exports and inclusive growth, and therefore, the advancement of these sectors is critical. Besides, underdevelopment of these sectors leads to low aggregate supply resulting in more dependence on imports leading to currency depreciation and price hikes.

All of this adds to high inflation, which is then responded by increasing the policy rate. While this increase temporarily attracts foreign investment in government securities, it raises the cost of production as well as the cost of borrowing for the government. It ends up increasing debt servicing and burdening individuals and businesses with more taxes, making the monetary policy less effective in arresting inflation.

Subsequently, this suppresses investment and consumption, dampening the productive capacity of the economy and negatively impacting individual welfare. The vicious cycle of high inflation, high-interest rates and low economic growth erodes investor confidence, triggering capital outflows and diminishing productive capacity over time.

Moreover, this will also enable the government to better invest in health, education, skill development and social welfare, thereby enhancing the quality of the country’s human resources. According to the International Labour Organization (ILO), Pakistani workers generate a per-hour output of $7, the lowest among its peer economies.

Addressing fiscal deficit is in our hands and requires decisive political action which is not taken because of the political backlash it may attract. However, addressing this will open a window for the government to make better investments in human capital which can help reduce out-of-pocket expenditures on health and education and increase people’s income. These gains then can help earn political capital for decision-makers.

To address Pakistan’s persistent fiscal deficit, a multi-pronged approach is required. First, a comprehensive review and rationalization of expenditures, both current and development-related, is required to ensure their effective targeting. Second, the duplication of ministries at the provincial and federal levels must end; government footprint in the economy needs to be scrutinized and development expenditures need to be prioritized and focused to do away with the cost overrun.

Similarly, subsidies should be evaluated in terms of their beneficiaries. For example, it is essential to calculate how much of the subsidy on urea fertilizer benefits small farmers and how much lands in the pockets of large land holders. In this way, moving towards targeted subsidies can help arrest public expenditures as well as improve their effectiveness.

Lastly, enhancing tax revenues through tax reforms aiming at broadening the tax base, simplifying tax structures, reassessing the tax expenditures and improving tax administration is vital. End-to-end digitization and use of artificial intelligence and data analytics will also help improve tax collection and documentation of the economy. These measures, if taken wisely and effectively, can boost revenue generation and reduce dependency on borrowing.

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