DATA FOR DEVELOPMENT (D4D)

POLICY BRIEF

Leveraging Fiscal Policy to Enhance the Quality of Population: A Political Economy Lens

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Relationship between population dynamics and fiscal policy in Pakistan, especially within the context of political economy, is often overlooked. Pakistan's rapidly growing population—expected to reach a quarter of a billion soon—requires more nuanced policies adjusted for population dynamics. Conversely, the future of the population depends crucially on how the elite who rule and govern Pakistan today and over the next few years derive policies which integrate population welfare as a core principle, going beyond ad-hoc economic stabilization at the cost of increased poverty, unemployment and inequality.

1. *This is a critical time to mainstream the population agenda in economic policy*

Pakistan's economy has hit its lowest point in decades, with a growth rate of negative 0.4 per cent in 2022-23, falling far below the population growth rate. The GDP growth target of 2.5 per cent for 2024-25 is almost equal to the population growth rate. The inflation rate in Pakistan has been over 20 per cent annually since May 2022 and hit 38 per cent a year later,[1] stabilising to a high of 24 per cent for FY2023-24.

This high inflation, combined with shocks such as the 2022 floods, has pushed the poverty headcount to 39.4 per cent by 2023[2]. Almost 40 per cent of Pakistan's population is below the poverty line. This proportion has grown over time,[3] with unemployment, which affects the young significantly, rising to an unprecedented 10.3 per cent from 6.3 per cent just three years ago.[4]

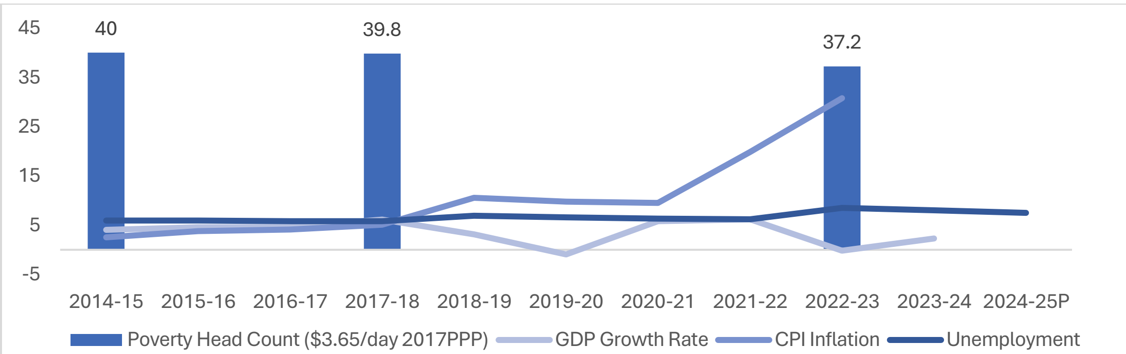

Figure 1: Poverty headcount[5], GDP growth rate[6], CPI inflation[7], and unemployment rate[8] (2014-15 to 2024-25)

Box-1
IMF Conditionalities

- *Increase in tax/tax base*
- *Increase in energy tariffs*
- *Free-floating exchange rate*
- *Monetary tightening*

Undoubtedly, a significant portion of the population has been excluded from the benefits of development for economic stabilisation. Pakistan holds the dubious distinction of turning to the IMF 23 times—more than any other nation. The economic policies embedded in these stabilisation programmes, particularly fiscal measures, have often stifled economic growth, exacerbating unemployment, income loss, and poverty. This is due to higher indirect taxes, enhanced energy tariffs, increased interest rates, and a depreciated exchange rate.

While stabilisation is needed, it must not come at the cost of people. Fiscal policies should be designed to mitigate the adverse effects of stabilisation on vulnerable populations. A singular focus on stabilisation has led to a sharp decline in social spending, resulting in a contrast between the development outcomes of the rich and the poor. The Human Development Index of the richest 20 per cent of the population in Pakistan, at

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[1] https://www.reuters.com/markets/asia/pakistan-inflation-slows-118-may-lowest-30-months-2024-06-03/
[2] World Bank. *Pakistan Development Update*. https://thedocs.worldbank.org/en/doc/cfd9113f24c548efdc86dba482a5e2cf-0310062023/pakistan-development-update-october-2023-restoring-fiscal-sustainability#
[3] https://www.worldbank.org/en/news/press-release/2024/04/01/pakistan-implementing-an-ambitious-credible-and-clearly-communicated-economic-reform-plan-critical-for-robust-recovery-p
[4] https://tribune.com.pk/story/2478919/govt-admits-unemployment-rising-to-103
[5] https://databankfiles.worldbank.org/public/ddpext_download/poverty/987B9C90-CB9F-4D93-AE8C-750588BF00QA/current/Global_POVEQ_PAK.pdf
[6] Economic Survey of Pakistan.
[7] WDI
[8] https://www.imf.org/external/datamapper/LUR@WEO/PAK

0.698, is similar to that of countries with high human development, compared to 0.419 for the poorest 20 per cent of Pakistanis, where the top 1.0 per cent of the population own (a severely underreported) 9.0 per cent of the national income.[9]

2. *A fair taxation system is the first step*

Pakistan's fiscal problems exist because of slow economic activity and poor tax infrastructure—far too many tax exemptions and outright tax avoidance. The total tax gap—the difference between tax collected and tax payable—stood at Rs128 billion[10] in 2022 (Figure 2). Tax exemptions, on the other hand, cost the public sector Rs3879 billion in FY 2023/24[11].

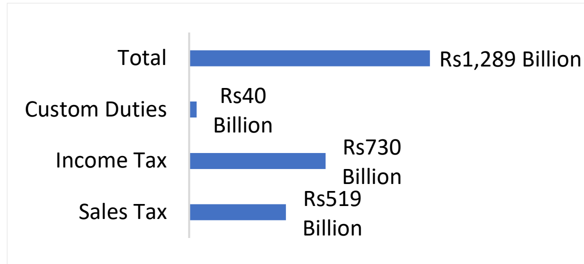

Figure 2 - Tax Gap
Source: FBR

Moreover, most economic indicators suggest that not enough resources are being put into investment in the future. Overall foreign investment in Pakistan was a mere 13.1 per cent in FY24, the lowest in almost half a century[12] (Figure 3). One reason for such low investment is that Pakistan's tax-to-GDP ratio is a mere 8.5 per cent[13], also the lowest in over a decade. Low revenue mobilisation, in conjunction with rising population, means that per capita social spending remains low, translating into poor human capital development.

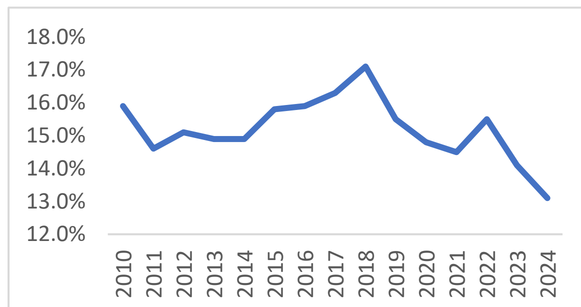

Figure 3 - FDI Inflows (% of GDP)
Source: CIEC

The main reason why tax collection is so dismally low is that only 1.0 per cent of Pakistanis pay income tax[14]. Those who can either avoid paying taxes or are officially exempt from doing so, creating a very limited resource base and hence a fiscal platform on which to invest for the future. Such practices, in turn, result in a tenth of the population not having access to clean drinking water, a third without toilet facilities, and both possibly resulting in nearly 40 per cent stunting in under-five children[15]. Moreover, with public spending on both health and education around or under 2.0 per cent of GDP, the future of Pakistan has been severely compromised.

3. *Setting the fiscal policy right—with emphasis on taxation—is fundamentally a political economy issue in Pakistan*

The data above highlights key aspects of Pakistan's political economy. A minuscule proportion of Pakistan's population pays direct income tax, while indirect taxes make up a significant portion of the total tax revenue. The poor pay a disproportionate share of their incomes as tax compared to the rich. In

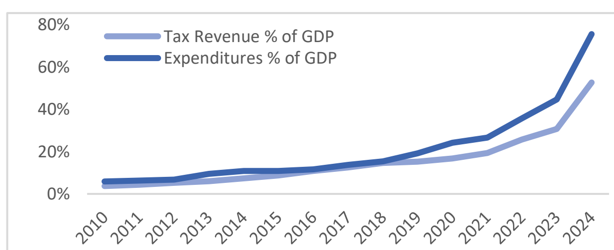

Figure 4 – Federal Tax Revenue & Expenditures (% of GDP)
Source: State Bank of Pakistan

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[9] https://www.undp.org/pakistan/inequality-inevitable
[10] FBR. *Tax Gap Report 2022*. https://download1.fbr.gov.pk/Docs/20231181413627488Tax-Gap-Report-2022-Final.pdf
[11] FBR. *Tax Expenditure Report 2024*. https://fbr.gov.pk/Budget2024-25/FinanceBill/Tax-Exp-Report.pdf
[12] Pakistan Economic Survey 2023/24.
[13] FBR. https://www.finance.gov.pk/survey/chapter_24/4_fiscal%20development.pdf
[14] CDPR. *Unlocking Pakistan's Income Tax Potential*. https://cdpr.org.pk/unlocking-pakistans-income-tax-potential/
[15] https://www.theigc.org/blogs/taxing-effectively/why-does-pakistan-tax-so-little

some ways, given numerous tax exemptions and means to avoid taxes, one could make the argument that in reality the poor subsidise the rich.[16]

A recent UNDP report shows that "economic privileges accorded to Pakistan's elite groups, including the corporate sector, feudal landlords, the political class and the country's powerful military, add up to an estimated $17.4bn, or roughly 6% of the country's economy".[17]

For some of the reasons identified above, Pakistan collects just about a third of its potential 26 per cent of revenue to GDP, and regressive indirect taxes contribute around 70 per cent of the revenue collected.[18] Yet, government spending is twice as high as tax collection as Figure 4 shows, although most of this spending is for interest payments, salaries, and consumption of other kinds, leaving only 2–3 per cent for development spending.

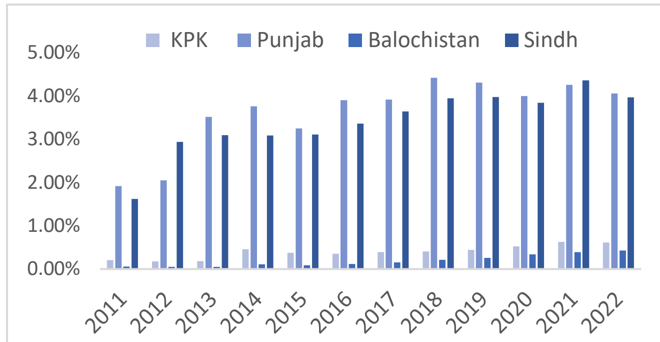

Figure 5 – Provincial tax collection as % of total federal tax collected
Source: State Bank of Pakistan

Despite fiscal devolution under the 18th Amendment, provinces still rely heavily on federal resources instead of raising their own funds. Provinces 'collected only 9% of what the federation collected and only 12.9% of what they spent'.[19] The provinces seem to be flushed with resources without having to raise them while the federal government is forced to borrow domestically and from international donors like the IMF with strict conditionalities. A new arrangement, redefining resource distribution known as the National Finance Commission (NFC) is necessary to correct this problem (Javed and Ahmed, 2019)[20].

A World Bank Report summarises Pakistan's fiscal issues succinctly: "Public finances in Pakistan have been characterized by unsustainably, high fiscal deficits; poor revenue mobilization; a persistent trend of centralization; massive vertical imbalances between the federal, and provincial governments; problematic expenditure structures; weak financial management; the atrophy of local governments; and lack of accountability"[21].

4. The way forward-some priority recommendations

The experience of many countries shows that when a crisis occurs, the elite grapple with alternative ways to address such crises, frequently necessitating a departure from the very policies that led to the crisis.[22] Pakistan's resilient elite has avoided such possibilities, often relying on bailouts and support from international financial institutions, particularly the IMF. While there has been some realignment amongst the ruling elite, their composition and underlying structures have remained remarkably stable and entrenched. Consequently, policies and recommendations remain elusive and much of what needs to be done remains a wish-list.

[16] https://www.youtube.com/watch?v=BLCQGgD3kg4
[17] UNDP. *Pakistan National Human Development Report 2020. https://www.undp.org/sites/g/files/zskgke326/files/migration/pk/NHDR-Inequality-2020---Overview-Low-Res.pdf*
[18] World Bank, *Pakistan Revenue Mobilization Project (P165982)*, World Bank, Washington, 22 April 2019, p 4.
[19] https://www.thenews.com.pk/print/1170210-comment-fiscal-realities-a-case-for-nfc-reform
[20] Ahmed and Javed (2019). *NFC Award: Devising formula for horizontal distribution. https://sdpi.org/nfc-award-devising-formula-for-horizontal-distribution-w-173/publication_detail*
[21] https://documents.worldbank.org/en/publication/documents-reports/documentdetail/847441468763222869/pakistan-reforming-provincial-finances-in-the-context-of-devolution-an-eight-point-agenda
[22] Dercon, S., *Gambling on Development: Why Some Countries Win and Others Lose*, Hurst, London 2022.

To have effective policies, the political power dynamics that obstruct reform—primarily because the ruling elite benefit most from maintaining the status quo—must be challenged. Addressing this requires a shift in the government's approach to spending on education. This would require far greater taxation and revenue from lucrative sectors and wealthy individuals who currently evade taxation. In a country where only 1.0 per cent of the population pays taxes, rather than taxing the already taxed, the government needs to shift its focus towards increasing the tax net rather than raising tax rates. Although suggestions for this have been made numerous times, they have always backfired due to political economy factors[23].

Nevertheless, some recommendations are presented which require urgent address:

Ensure just fiscal policies, particularly tax justice, to reduce social and economic inequalities

The tax system needs to be revamped with taxation policies being equally implemented across all income groups, regardless of the source of income, while eliminating the privileges and exemptions that are seen to be biased and unfair. Attention must be diverted away from GST, with gradual reductions in the GST rate, in favour of broadening the tax net through progressive direct taxation. Real estate, agriculture, and the retail sector all need to be included in the tax net based on the income of individuals, not based on occupation or source of income. This will reduce the financial burden on the salaried class, increasing disposable income while directing additional revenue to essential services like education, health, and support for vulnerable populations.

Eliminate subsidies solely benefiting the elite class and transition towards targeted subsidies

To improve allocative efficiency, the government must phase out subsidies that disproportionately benefit the elite and redirect resources toward targeted support for vulnerable groups. This transition involves conducting a thorough review of existing subsidy programmes, coupled with the implementation of reforms to ensure more equitable distribution. The utilisation of digital systems is crucial for increased effectiveness and transparency.

Increase social spending in key sectors to match the regional average

Pakistan's total social sector spending, amounting to 4.1 per cent of GDP, is significantly lower than that of Sri Lanka (6.1 per cent), India (6.3 per cent), Nepal (7.5 per cent), and Bhutan (9.9 per cent). It also falls below the South Asian average of 5.22 per cent, ranking just above Bangladesh, which spends 2.6 per cent of its GDP on social sectors[24]. To improve upon human development outcomes, the government must increase health, education, and social welfare spending to align with regional averages. These investments will allow for higher labour productivities overtime that translate into higher wages, resulting in poverty reduction. Public-private partnerships (PPPs) can be essential in this regard.

[23] https://www.thenews.com.pk/print/1095768-couldn-t-tax-retailers-due-to-internal-politics-miftah

[24] https://www.unicef.org/rosa/media/10016/file/Social%20spending%20in%20South%20Asia.pdf

Modify NFC to incentivise provinces to raise more finances from their own resources to enhance social spending

Provinces depend entirely on government revenues, reducing their tax collection incentives, which limits funds for public services. Reforms to the NFC Award should incentivise provinces to actively participate in tax collection. Efficiency-based indicators such as provincial tax efforts, captured through the difference between tax collected and estimates of tax potential, must be included as one of the determinants of the size of the award. Moreover, the weightage for the population must be reduced while also shifting away from absolute poverty as an indicator of backwardness, in favour of relative poverty[25].

Move towards resilient and adaptive social protection

Pakistan needs to develop a robust and adaptive framework for social protection programs capable of addressing evolving socio-economic challenges. This involves creating a comprehensive social safety net that delivers timely support while integrating diverse forms of assistance, including income support, healthcare access, and education subsidies. It should also incorporate mechanisms to swiftly adapt to changing conditions and emerging needs. While current cash transfer programmes have been successful, conditional cash transfers that link support to education and health investments are better aligned with long-term social development and reduce fund misappropriation.

Prioritise sustainable economic growth through a diverse base

Policies to reduce Pakistan's unsustainably high population must be implemented on a priority basis. Whether this is through reforms in the social sector or policies that raise awareness, an integrated population planning policy needs attention. A lower, more skilled and educated population will have a huge impact on economic and fiscal policies as well. Reform in population policies and fiscal policies is urgently needed. This cannot be an either/or.

Empowering women through decent jobs to balance the quality and quantity of the population

Increasing female labour force participation in decent jobs can significantly contribute to reducing fertility rates by empowering women with economic independence and decision-making power[26]. Access to stable employment and career opportunities encourages women to delay childbearing, invest in their education, and prioritise smaller family sizes, ultimately leading to lower fertility rates.

[25] See: Javed, S. A., and Ahmed, V. (2019) *NFC Award: Devising formula for horizontal distribution*.
[26] https://pakistan.unfpa.org/sites/default/files/pub-pdf/pakistan_psa_2020_final_report.pdf