FINANCIAL ANALYSIS

1. Investing in social protection can yield fiscal savings for the government in the medium term. As the poorest households become more resilient to shocks, build their human capital, and are able to improve their employment potential, their need for government support lessens. In the short-term, resources spent through the cash transfer program of the Benazir Income Support Program (BISP) can have important positive multiplier effects, and actually result in additional tax revenue.[1] However, substantial investment in social protection in the short term can be difficult in countries such as Pakistan where balance of payment difficulties and exchange-rate policy choices constrain the size of fiscal deficits and impose fiscal consolidation challenges. In addition, for political reasons, rebalancing government expenditure priorities to free up resources from alternative budget categories may not be easy. However, current support for it in Pakistan is significant. This is a key part of the ongoing policy dialogue between the government, the International Monetary Fund (IMF) and other development partners—the Asian Development Bank (ADB) and World Bank.

2. Expansion of the targeted BISP intervention can allow the government to reduce its untargeted subsidies while protecting the poorest part of the population from the economic effects of fiscal consolidation. Inefficient and untargeted power subsidies are currently equal to 2.25% of gross domestic product (GDP), while the targeted BISP intervention equals 0.4% of GDP. The continuation of new enrollments (with perhaps an increase in the poverty score cutoff) and a minimum of indexation to past inflation are expected to gradually bring BISP expenditures to 0.7% of GDP in the medium term. Despite significant development partner support (ADB, the Department for International Development [DFID] of the United Kingdom, and World Bank), the government has been financing (from own resources) close to 90% of the BISP's overall expenditures since inception

A. Fiscal Context

3. With an average annual GDP growth rate of 2.9% since 2008, Pakistan’s economy is facing several key challenges.[2] Actual revenue collection is far below potential collection, and expenditure management needs improvement. The country’s tax–GDP ratio has hovered at or just below 10% since 2003, and was estimated at 9.1% in fiscal year (FY) 2012.[3] Indirect (and highly regressive) taxes constitute the bulk of revenue collection, at 64% of total tax revenue. Of these, sales tax alone constitutes 40% of total tax revenue. Income tax is the only major direct tax levied in Pakistan, constituting about 97% of total direct tax collection. Tax authorities essentially rely on three main taxes: sales tax, income tax, and customs duties. Two of these (sales tax and customs duties) are regressive taxes, and collections of the only progressive tax in the mix (income tax) are suboptimal due to widespread evasion. The poor performance of

[1] Even though the tax ratio in Pakistan is very low, the tax structure of the country is quite regressive, such that indirect taxation incidence on the poor (through consumption) and on the economic activities that could well have to respond to additional increases in consumption demand by BISP beneficiaries may result in some leakage to taxes. The Economic Analysis (ADB. 2013. *Report and Recommendation of the President: Proposed Loan to the Islamic Republic of Pakistan for the Social Protection Development Project.* Manila, Linked Document 7.) provides a short discussion of the characteristics of BISP expenditures and why they may have a potential to actually “pay for themselves” to some extent. Unfortunately, Pakistan does not publish necessary data to enable the undertaking of a Social Accounting Matrix exercise (i.e. with comprehensive input-output tables) to estimate the different effects of BISP.

[2] Unless stated otherwise, all figures are from various issues of annual reports of the State Bank of Pakistan.

[3] The fiscal year in Pakistan is from 1 July to 30 June. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2012 ends on 30 June 2012.

Pakistan's tax authorities is at least partially responsible for the country's fiscal deficit—estimated at an average of 7% of GDP during 2008-2013, and 8.5% of GDP in FY2012.

4. Even though combined domestic and foreign debt has now stabilized at little above 62% of GDP, 28% of current expenditure of the federal budget during FY2012 was devoted to debt servicing (of both foreign and domestic debt). Servicing the domestic debt, at 37% of GDP, is now a major component of the federal budget, a direct consequence of the very high real rates that have prevailed in interbank markets since 2008.[4] The country also ran a primary deficit (the difference between total revenue and noninterest current expenditure) of 2% in the last fiscal year. Recent improvements in public debt management are nonetheless noteworthy, with the bulk of recent growth in debt coming from the increase in domestic debt (rather than foreign-currency denominated debt, which limits exchange-rate policy choices), which increased by 30% in the last fiscal year alone.

B. Rationale for the Benazir Income Support Program

5. Pakistan's external balance began to deteriorate in 2008; the lack of exchange-rate flexibility forced the country to seek balance of payment support from the IMF in November 2008. One of the conditions of the stand-by arrangement was the need to institutionalize a social protection program—a practice the IMF has been following since it initiated the Poverty Reduction and Growth Facility loans. Programs such as those for distribution of Zakat (alms to the poor as per Islamic injunctions) and other welfare programs for the dispossessed (such as grants for health and education, and provisions for orphanages) had been operating under government institutions such as the Pakistan Baitul Mal for some time. However, these are generally poorly targeted and weakly and inconsistently monitored.

6. The IMF's insistence in 2008 on a targeted and well-documented social protection program compelled the government to work with the World Bank to design a transparent, data-based system of beneficiary identification, which relied on a household poverty scorecard survey and a proxy means test. The survey was expensive to implement (the survey was near the size of a national census, surveying 90% of the population). Its strength lies in its use of objective criteria and the transparency of its processes, which have made it one of the most intensively monitored public sector programs in Pakistan. ADB also supported the BISP by allocating funds from program lending.

7. In spite of the country's external balance difficulties and ensuing need to control the fiscal deficit (by decreasing expenditure),[5] the BISP budget has been increased every year. The budget allocation for the program increased from PRs34 billion (around $425 million) in FY2009 to PRs70 billion (or about $700 million) in FY2013. Expenditure on the BISP constituted 2.7% of the total budget outlay, and about 0.4% of the GDP in FY2013—higher than any other social safety net program in the country's history (in FY2012, the government provided PRs464 billion for power subsidies, equal to 2.25% of GDP).[6] In addition to protecting BISP budgetary

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[5] Pakistan did not complete the stand-by arrangement signed with the IMF in November 2008, and did not receive the last two tranches of the program due to noncompliance with key conditionalities, including the requirement to boost revenue generation by imposing a general sales tax based on a value-added tax. The last tranche of the stand-by arrangement was received in May 2010. On 4 September 2013, the IMF approved a 3-year arrangement under the Extended Fund Facility in an amount equivalent to $6.64 billion to support the country's economic reform program to promote inclusive growth.

[6] Social protection programs other than the BISP were given a budget allocation of PRs1.3 billion in the federal budget for FY2013. However, the amount spent on non-BISP social protection during FY2012 was PRs30 billion

allocations, the outgoing government demonstrated its commitment to the program by piloting graduation programs on health insurance, skills development training, small business development and primary education co-responsibility cash transfers.[7]

8. Protecting social safety net expenditure and providing additional assistance through graduation programs can yield dividends in protecting consumption of the lowest income quintiles. Data from the household income and expenditure survey show that the cash transfer amounts to about 7% of the average monthly income of the lowest income quintile.[8] In a country where income losses due to shocks are frequent and often significant, this amount, though small, can help stabilize basic consumption. Further, the data shows that households falling in the lowest income quintile typically spend 60% of their monthly income on food, with rent, fuel, and lighting next at approximately 8% of monthly income each (footnote 8, Table 15). For expenditure on food, the lowest income quintile spent 24% on cereals (mainly wheat flour and rice), 20% on milk and milk products, and 11% on edible oil (footnote 8, Table 16). Given that processed foods are subject to sales tax in Pakistan, the government is actually earning revenue from the continued consumption of these items.

9. The new government, elected in May 2013, confirmed its commitment to social protection and the expansion of the cash transfer program, while developing additional programs to help beneficiaries to get out of poverty. The government recognizes that international development agencies have invested heavily in the program and are keenly following its progress. While the need for fiscal consolidation will remain, the new government is likely to consider other avenues of expenditure reduction. This may include eliminating untargeted subsidies and the substantial expenditures they mobilize, reducing nonsalary current expenditure and reviewing schemes funded under the development budget. A revamping of the tax collection apparatus to check tax evasion is also expected to increase revenues and create some fiscal space.

C. Financial Scenarios

10. The number of BISP beneficiaries is estimated at about 4.8 million as of June 2013. The government hopes to increase this to 7.2 million by December 2018, thus covering close to 40% of households living below the poverty line in 2013. As of 2013, the government is covering 90% of BISP disbursements; the Department for International Development (DFID) of the United Kingdom and the World Bank fund the remaining 10%. The development partners are looking into a series of scenarios where their funding is maintained at 10%–20% of total disbursement in the next 3 fiscal years, and then tapers off to 2%–0% by 2018. Given that the bulk of BISP expenditure is funded from the federal budget, the sustainability of the program is dependent on the extent of the government's commitment to social protection; as well as the government's will to implement fiscal policy reforms that free up resources for the program by ensuring savings in other budget categories, and implementing tax reform, as well as sustaining economic growth.

($300 million). This spike in expenditure was due to compensation paid to flood-affected people in the Citizens' Damage Compensation Program.

[7] All this under the BISP umbrella during 2011 and 2012, using the BISP's poverty scorecard database to more effectively target beneficiaries.

[8] Pakistan Bureau of Statistics. 2012. *Household Income and Expenditure Survey 2010–11*. Table 11. http://www.pbs.gov.pk/sites/default/files/pslm/publications/hies10_11/tables/table11.pdf