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In this Issue

Budget 2019-2020: Inequality and Public Policy

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Introduction

Inequality is believed to drive conflict and destabilize society, and thus indirectly retard economic growth. On a more fundamental level, though, inequality undermines the principles of social justice and preservation of basic human rights. It is for this reason that extreme inequality, even when accompanied by high growth, is simply not acceptable. Inequality can also be perpetuated by social and cultural traditions, which result in marginalization of certain ethnic, sectarian and religious groups, or even people with certain political beliefs or affiliations to particular groups. Any form of systemic marginalization will perpetuate inequality, and eventually impact income and earning power.

Even economic inequality, which has been measured in economic literature on a regular basis over the past many decades, now includes not just income and consumption inequality, but also inequality across regions, rural and urban areas, and inequalities in provision of public services to name just a few. In short, the literature now recognizes that there are multiple forms of inequality, and that many if not all of these have an impact on household socio-economic status.

Key Literature

Thomas Piketty's book, Capital in the 21st Century, brought the debate on inequality into the mainstream economic literature, after a long period when inequality was being dismissed as a natural consequence of development.[1] Although Piketty focused only on Europe and the US, his central thesis was ground-breaking. He maintained that inequality is a feature of capitalism, and results from the disparity between the rate of return on capital and the rate of economic growth, which in turn results in a concentration of wealth. More recently, Jason Hickel's work argues that the widening global income inequality, as well as inequality within countries results from the existing global political order.[2] On a less radical note, recent work from UNDP, which focuses on the causes of inequality, posits that the integration of developing countries into world trade and financial markets has, while promoting growth, intensified inequality of incomes.[3] The report also points out that the share of wages and employee compensation in national GDP has been steadily declining in developing countries. But this is only part of the picture. National policies in a number of developing countries have also contributed to growing inequality. These include labour policies that limit collective bargaining powers; and fiscal policies that limit public investment. The report advocates for creation of productive employment, institution of social protection systems, and legislative or administrative reform to repeal discriminatory provisions in policy.

The World Bank estimated the Gini coefficient in Pakistan at 33.5% in 2015, which was an all time high.[4] While income inequality, measured mainly through Gini coefficients, has frequently been measured in Pakistan, there is relatively less work on inequality of opportunity, or other forms of inequality and marginalization. A recent paper that measures inequality of opportunity in Pakistan, finds that gender is the highest contributor to inequality in earnings, followed by regional disparity and then parental education.[5] Another recent study on multiple forms of inequality finds that income, education and occupational choice are strongly linked, and upward mobility is low in Pakistan, and that the most effective space for government intervention is in improving quality of education at all levels and in all regions and types of schools.[6]

While the literature points to a range of forms of inequality present in Pakistan, how does public policy tackle the issue, or otherwise? Does the government seem cognizant of inequality and is there a conscious effort to do something to correct these imbalances? This paper is an attempt to answer this question using the lens of the federal budget, the government's prime economic policy statement.

Inequality and Budgetary Proposals

How would a government proceed to correct inequality through economic and social policy? The most obvious set of measures relate to taxation; specifically, instituting a regime of progressive taxation of income; and systems of impartial and consistent indirect taxation. Inequality is also addressed through the government's expenditure patterns, specifically through spending on social services, both in terms of extending access and/or improving quality. Extending social protection benefits to vulnerable sections of the population, if not universal coverage, is also a measure of intent to reduce inequality. Lets see how all of these add up in the federal budget just presented for the coming fiscal year (2019-20).

The budget presented in June 2019 is a classic austerity budget. Rather than populism aimed at an election victory, this is the first budget for a new regime that is in the process of negotiating a crucial bailout package with the IMF, to avert a possible default on the external account. While the merits of the IMF's approach can of course be debated, the Fund's policy is based on the "first stabilization, then growth" mantra – being the lender of the last resort, it is typically called in when imbalances are severe and its stabilization prescriptions are fairly stringent. The budget is thus strongly oriented towards raising revenue, and while there is less room to manoeuvre on the expenditure side, there have been attempts to cap current expenditure, and keep development expenditure (or public investment) at minimally acceptable levels.

Taxation

The previous government's last budget (for fiscal year 2018-19) was marked by a significant lowering of maximum income tax rates to just 15% for the highest income bracket, and a commitment to lowering corporate tax rates to a maximum of 25% over five years. This reduction, a classic example of supply-side economics, was supposed to boost economic activity by placing more disposal income in the hands of owners of capital. Not surprisingly, given the general lack of evidence on the success of trickle-down economics in Pakistan, the only tangible result of this policy was a slowdown in tax collection, with little to show in terms of productive investment. It was also a negation of the concept of progressive taxation, with high income brackets facing a minimal tax liability.

In contrast, the Finance Bill for 2019-20 has re-instituted new rates, with higher income groups once again in the cross-hairs, as a progressive taxation system would require. The income tax rate for the highest salary bracket has been raised to 35% again, and the applicability of salary rates has been increased to apply to at least 75% of the salary income as compared to the 50% rate that was in force previously. As such, people with taxable incomes of Rs. 100,000 per month will pay Rs. 28000 more in tax in 2019-20 than in the previous fiscal year, while those with a taxable monthly income of Rs. 500,000 will pay about Rs. 200,000 more in tax in 2019-20.[7] While the maximum tax rate falls far short of maximum effective tax rates in countries with the lowest levels of inequality (56% in Sweden and 60% in Denmark), the new regime is a move towards a more progressive system.

Other direct taxes will also target higher income brackets. Capital gains taxes have been reinstituted much to the chagrin of speculators. Rates will vary based on the holding period and whether the property is a plot or a constructed building. In another important move, property valuations for tax purposes will be significantly increased to reflect market values, instead of being determined by local administrators. Income from rents will be considered almost at par with salary income. Corporate tax rates remain relatively low though, at 29%, compared to 33% just four years ago. But at least further reductions, which were originally on the cards, are being ruled out.

Some important policy decisions have also been taken. The category of "non-filers" of income tax will no longer exist per se – all earners above a certain bracket will be required to file taxes or face criminal charges instead of simply getting away with paying higher rates on withholding taxes as was previously the case.

All of the above are steps in the right direction when it comes to instituting a more progressive system of taxation, with its implications for social equity. But the government continues to shy away from touching an area that would target entrenched wealth, i.e. inheritance tax (as it is called in the UK, or estate tax in the US). These taxes, or death duties as they are popularly known, are typically applied to the estates of the deceased, and in the UK at least, have been considered as key policy tools to discourage inter-generational accumulation of wealth.[8] While the formulation of such taxes has been criticised in Europe in particular, with critics alleging that they are easily evaded, the institution of the tax itself was an important social reform, and the tax could theoretically be made more effective if a sitting government so wills.

The closest thing to this in Pakistan was the wealth tax first introduced in 1963, which was levied at rates of 0.5% to 2.5% on net wealth exceeding a certain level (Rs 2.5 million in 2013). But wealth tax was abolished in 2003, and after one halfhearted attempt in 2013, not reinstated. The problem was enforcement – so few filed the tax and revenue was so low that it was not worth the cost of collection.

Pakistan's reliance on indirect taxes is significant, with this category constituting 60% of all taxes collected by the Federal Board of Revenue (FBR) according to the revised estimates of 2018-19.[9] Sales tax is estimated as the single largest source of revenue for the coming fiscal year, with collection estimated at Rs. 2108 billion, just outstripping income tax, collections of which are estimated at Rs. 2073 billion.[10] With real GDP growth rate expected to slow down to 2.4% in the coming fiscal year,[11] it is difficult to see how consumption levels will be maintained at levels that warrants this sort of tax collection. Nevertheless, a taxation structure that relies on indirect taxes is essentially regressive. More so when indirect taxes not only target consumption, but, as in Pakistan, target consumption of essential commodities like edible oils, food items and condiments sold in packaged form, and even some medical supplies. Indirect taxation, which targets such a range of commodities, hits low and middle income consumers particularly hard, and perpetuates a regressive economic ethos.

Taxing consumption is relatively simpler to administer given the visibility of the paying agents, although FBR sources admit that sales tax evasion in Pakistan is also considerable.[12] In a constitutional democracy, an inability to, or laxity in exercising the power to tax incomes is a serious admission of failure of governance. A reliance on indirect taxes and on advance income tax and withholding taxes, is essentially a negation of the social contract between the contract and its citizenry wherein the government agrees to provide essential services and protect the most vulnerable sections of society, in return for the citizens' cooperation in financing such endeavours. In terms of reducing inequality, the continued skewing of revenue collection towards consumption taxes does not bode well.

Expenditure

Pakistan's tax structure tends to be regressive as discussed above, in spite of recent attempts to ramp up the collection of direct taxes. But even with such a structure, it is possible to employ public policy in favour of a more equal distribution of wealth by consistently implementing a credible public investment program. Here again Pakistan's record has been less than impressive as, at the federal level at least, the Public Sector Development Program (PSDP) tends to be used as the balancing item when deficits have to be controlled. In other words, if current expenditure overshoots or revenue targets are not met, it is inevitably the public investment or PSDP budget that is adjusted downwards to compensate. This is once again apparent in this year's federal budget. The PSDP was budgeted at Rs. 800 billion at the beginning of the last fiscal year.[13] However, with the economy taking a downturn, and net revenue receipts plunging (from a budgeted Rs. 3070 billion to Rs. 2569 billion actually collected as per revised estimates), bank borrowing requirements for deficit financing went up by Rs. 341 billion.[14] Not surprisingly, the PSDP was adjusted downwards accordingly, with revised estimates showing expenditure of Rs. 500 billion under this head compared to the Rs. 800 budgeted.

Even if one accounts for the fact that the bulk of the national PSDP is spent in the provinces and not through federal institutions, the PSDP expenditure is disappointing. The amount allocated for provinces in the national PSDP was Rs. 850 billion in the budget for 2018-19, out of which only Rs. 700 billion was actually spent.[15]

The federal government also budgets for key social protection related expenditures, with the Benazir Income Support Program (BISP) being the largest program in Pakistan under this head. The bulk of BISP expenditure is in the form of an unconditional cash transfer program disbursed quarterly in the names of female members of households. The households, who were first questioned through a nationwide survey of assets holdings, are ranked through a proxy means test, and only those whose asset scores place them below a certain cutoff point are eligible for the transfer. While the BISP Secretariat also runs conditional cash transfer programs, notably the Waseela-e-Taleem which rewards enrolment, it is the cash transfer program which is it's flagship initiative. The program was funded at Rs. 120 billion for the fiscal year 2018-19, but allocations this year have been substantially increased to Rs. 180 billion.[16] Informal queries suggest that the protection of this expenditure is a result of the direct intervention of the IMF, which, in recent years, has been keen to show that social spending does not decrease significantly under its watch.[17] In any event, allocations under this head are typically disbursed in a timely manner given the nature of the program, so the additional funds are also likely to find a way into the budgets of the lowest income households.

In terms of social expenditure, while Pakistan continues to fund its premier social protection program which takes the form of a cash transfer, its record on financing public investment has been lacking, and the development budget has become an accounting head which takes the brunt of deficit related adjustments. Planning any long-term development activity is difficult under these circumstances. Not only are budget allocations subject to changes, but release of funds is not systematic, and implementation capacity at the lowest levels is questionable. These issues tend to multiply at sub-national levels where the bulk of grassroots development activities are carried out.

Fiscal constraints, in short, tend to overwhelm development planning and shift the emphasis from long-term investments, to meeting essential current expenditure (debt servicing, defence, expenses of civil government functions). In a country with severe infrastructure and human resource constraints, all of this has implications for the long-term growth trajectory, and for the reduction of inequality.

Conclusion

The budget document is an important indicator of how the government intends to implement its development policy. Long term plans and development visions typically find expression in this annual accounting framework, which reveals if the government is actually willing to fund its campaign promises and lofty pronouncements. Inclusive growth, poverty reduction, equal opportunities for all and the provision of essential social services are just some of the pledges that appear on every political party's agenda and in every government's policy plans. The analysis of the latest budget document shows, though, that these goals are held hostage to socio-political as well as economic considerations.

Socio-political considerations are apparent when the taxation structure is reviewed. Political parties draw support from a range of economic stakeholders, and when in power, are obliged to fulfil the expectations of their constituents. If this means slashing tax rates for the highest income groups in the hope of implementing supply side growth, so be it. That particular policy was reversed in this year's budget, and a more progressive structure has been envisioned. Nevertheless, the continued reliance on regressive indirect taxes which disproportionately affect lower income groups, remains. There is no attempt to shake up inter-generational wealth holdings, and absolutely no mention of large-scale asset re-distribution. However, there are indications that there will be serious attempts this year to expand the tax net, which is long overdue.

On the economic front, major expenditure heads such as debt servicing and defence leave little room for manoeuver, and the development budget, which is the vehicle for public investment in infrastructure and human resources, is vulnerable to the need to balance the books. It is typically the component from which funding is withdrawn when current expenditure cannot be further adjusted. This has implications not only for potential new projects but also for completion of programs that are under construction, or in a stage of advanced planning. In these circumstances, the continuation and in fact the increased funding for the government's premier social protection program is a blessing. It should be clear though, that while cash transfers under BISP enable a degree of relief from extreme poverty, these are not a substitute for long-term public investment. Nevertheless, to the extent that the cash transfer has served to ensure that social protection remains on the radar of government policy, its ring-fencing is a positive step.

To sum up, there are some indications of a more progressive taxation structure being introduced in the new budget, but little evidence of public investment being used as a tool of inequality-reducing public policy. In the short run at least, Pakistan's long-entrenched elites will maintain their unassailable positions.

References

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[3] UNDP. 2015. Humanity Divided: Confronting Inequality in Developing Countries.

[4] See https://www.ceicdata.com/en/pakistan/poverty/pk-gini-coefficient-gini-index-world-bank-estimate. A coefficient of 0 represents perfect equality while 100 shows perfect inequality.

[5] Shaheen, Safana et. al. 2016. Measuring Inequality of Opportunity in Pakistan: Parametric and Non Parametric Analysis. Pakistan Economic and Social Review, Vol 54, No., 2 (pp 165-190).

[6] Burki, Abid A. et . al. 2015. Multiple Inequalities and Policies to Mitigate Inequality Traps in Pakistan. Oxfam Research Report in collaboration with the Lahore University of Management Sciences.

[7] Ernst and Young Ford Rhodes. 2019. Impact of Change in Rates of Tax.

[8] As it stands now, inheritance tax is applied at a rate of 40% on estates above the value of 325,000 pounds and above. However, as with all taxes, accountants can devise ways to keep taxable incomes below the threshold, particularly using trust instruments.

[9] Ministry of Finance. 2019. Budget in Brief. Table 9: Tax Revenue.

[10] Ibid.

[11] Ministry of Finance. 2019. Budget in Brief. Table 34: Macroeconomic Indicators.

[12] According to news reports, FBR detected tax evasion in sales tax amounting to Rs. 14 billion over a two month period alone, at the beginning of this year. See https://www.dawn.com/news/1458484

[13] Ministry of Finance. 2019. Budget in Brief. Table 1: Summary of Estimates 2018-19.

[14] Ibid.

[15] Ministry of Finance. 2019. Budget in Brief. Table 32: Size of PSDP.

[16] Ministry of Finance. 2019. Budget in Brief. Tables 28 and 33.

[17] See Clements, Benedict., Sanjeev Gupta and Masahiro Nozaki. 2011. What Happens to Social Spending in IMF Supported Programs? IMF Staff Discussion Note 11/15 for a discussion on how the IMF perceives this issue.