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Estimating the Footprint of Government on the Economy

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ABSTRACT

Government's footprint on the economy in Pakistan is more than what annual general government spending (22 percent of GDP) suggests. In addition to spending; about 200 State Owned Entities, SROs culture and cumbersome business regulations combine towards a footprint of the government amounting to approximately 67 percent on Pakistan's Economy.

INTRODUCTION

Total Government Expenditure and the percentage that it represents of the total Gross Domestic Product (GDP) is often taken as a measure of the size of the *government's footprint* and its involvement in the economy. A low percentage reflects that the government capacity to influence the economy through fiscal instruments is limited, and low rates are often cited as prime reasons for governments pursuing aggressive taxation policies to build their financial muscle. In Pakistan, the general government expenditure as percentage of GDP stands at about 22 percent. Many quarters, including multilateral donors' agencies have persistently called for the government to increase its tax revenue collection capacity through either increasing its tax rates and/or through increasing the number of total tax filers in the country because the government is always in a deficit. The issue of tax system in Pakistan is a separate matter and has been discussed through various other PIDE publications over the years.¹

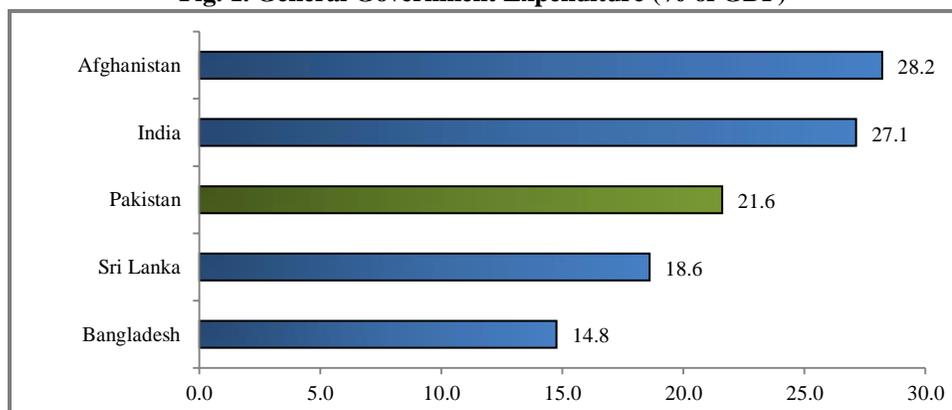
Box 1

**Total General Government Expenditure =
Final Consumption Expenditure (A) + Capital Expenditure (B)**

- (A) Government spending on goods & services for current use.
- (B) Government spending on goods & services intended to create future benefit e.g. investment in infrastructure, research etc.

For a start, if we look at the General Government Expenditure (2019), the current figure as a percentage of GDP for Pakistan is indeed below the World Average; having said that, the percentage is not out of line with other countries in the region. (See Figure 1).

Fig. 1. General Government Expenditure (% of GDP)²



¹Doing taxes better: simplify, open and grow economy (2020), Policy Viewpoint 17, PIDE.

²World Economic Outlook (2019), IMF.

THE FOOTPRINT OF THE GOVERNMENT³

The government is far more than what it spends. Yet the common discourse does not support it. Here we estimate the *footprint of the government*. This would be a measure of what the government controls in the economy beyond mere regulation and policy. Alternatively, it could be seen as the economy that is market competition without government involvement other than market developing regulation and monitoring.

For a start it should be explicitly stated that the practice of using government expenditure as the only indicator of the *government's footprint* on the overall economy is misleading. This is particularly true in Pakistan where the government has significant influence on the economy than what the government spending as percentage of GDP figures might suggest. This is true due to a combination of reasons listed in the sections below.⁴

- (1) **State Owned Entities (SOEs) & Public Sector Companies (PSCs)**—The government still owns over 200 State Owned Entities (SOEs) of which majority are Public Sector Companies (PSCs) also listed on the stock exchange. In fact many of the large companies listed on the Pakistan Stock Exchange are PSCs owned and managed by the government. Figure 2 gives sectorial distribution of all SOEs according to the latest report on State Owned Enterprises published by the Finance Division.

Fig. 2. Sectoral and Sub-sectoral Distribution of State Owned Entities (SOEs)⁵

Energy PSCs		Financials		
1	Hydrocarbons	16	1 Banks	17
2	Power DISCOs	10	2 Insurance	7
3	Power GENCOs	6	3 NBFCs & DFIs	9
4	Power Others	9		
Industry and Engineering		Trading		
1	Chemicals	5	1 Trading	3
2	Engineering and Industrial Metals	15		
Services		Promotional and Advocacy		
1	Services	26	1 Agriculture	1
			2 Arts	1
Transportation			3 Auto	3
1	Aviation	4	4 Food	1
2	Ports and Shipping	23	5 Funds and Foundations	16
3	Railways	6	6 Industries and Production	17
4	Roads and Highways	2	7 Information Technology	1
			8 Minerals and Mining	1
			9 Rural Development	1

³Haque, Nadeem Ul (2013), Estimating the Footprint of the Government on the Economy. [Blog] Development 2.0.

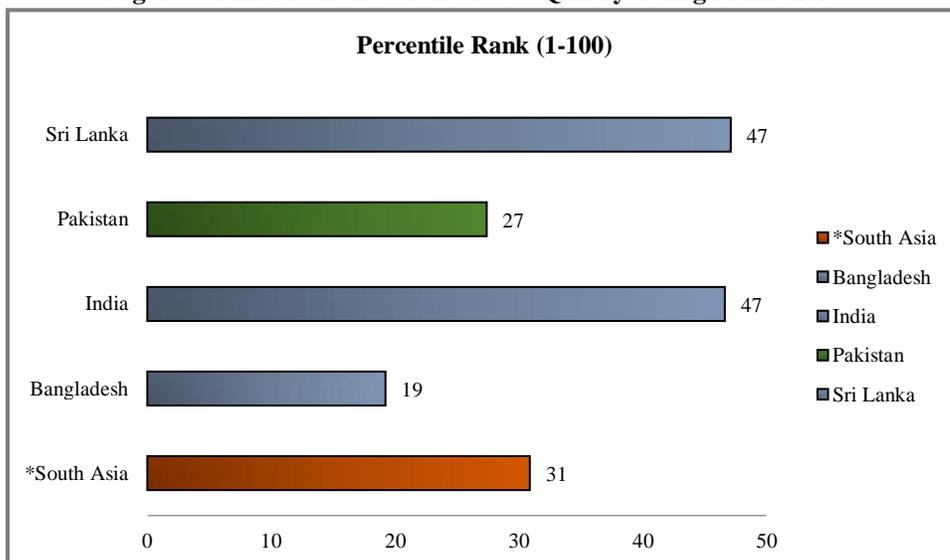
⁴Ibid.

⁵SOE Report (2017), Finance Division, pg. 25.

- (2) **Government Transactions in Markets as Dominant Player**—The government through its influence over large Public Sector Companies (PSCs) engages in market transaction often as a dominant player. This is particularly true for sectors such as energy and engineering & construction where PSCs have entrenched monopolies. There are about 41 PSCs in the energy sector alone giving the government control of energy generation and distribution in the country. The dominant position of PSCs in important sectors like energy and construction come at the cost of stifling private investment in these sectors at the expense often loss making PSCs which are protected through recourse to taxpayers' money. One crisp example of this is the energy sector, of top 10 loss-making PSCs according to the Finance Division Report on performance of state owned entities, 7 were public companies involved in the energy sector.⁶
- (3) **Statutory Regulatory Orders (SROs) and Taxes & Subsidies** —According to the Constitution of Pakistan, the tax regime and any changes to it are required to have legislative approval. Despite this, the executive and in particular the Federal Board of Revenue (FBR) frequently issues SROs to grant tax subsidies and subsidies on regulatory duties. This practice is unconstitutional and creates a complex political economy of vested stakeholders influencing the government to take advantage of the system at the expense of the government treasury.⁷ The practice of issuing SROs positions the FBR in an overwhelming influential position in the economic landscape of Pakistan and ultimately increases the total *footprint of the government* on the economy.
- (4) **Extensive Regulatory Frameworks**—Government expenditure alone, or even the totality of government influenced transactions in the economy, cannot reflect the entirety of *government's footprint*. Other important factors that determine the total footprint are both the number and nature of government regulations that affect business activities. In Pakistan, many sectors of the economy are heavily regulated, something that is reflected in country's percentile ranking on World Bank's Worldwide Governance Indicator (WGI) on 'Quality of Regulation', with Pakistan ranked below the South Asian average and being third on the list of four major South Asian economies i.e. India, Bangladesh, and Pakistan & Sri Lanka. (See Figure 3).

⁶SOE Report (2017), Finance Division, pg. 21.

⁷According to Article 77 of the Constitution of Pakistan "no tax shall be levied for the purposes of the Federation except by or under the authority of the Act of the Parliament". Supreme Court Judgments have also declared the practice of issuing SROs unconstitutional. [*Engineer Iqbal Zafar Jhagra & Senator Rukhsana Zuberi vs. Federation of Pakistan (2013)*; and *Messers Mustafa Impex, Karachi vs. Federation of Pakistan (2016)*]. Yet changes in tax laws through Finance Act 2017 have meant that the FBR and the executive continue to exercise unconstitutional powers in contradiction of both the Article 77 of the constitution and Supreme Court Judgments.

Fig. 3. World Governance Indicators: Quality of Regulation 2018⁸

One direct influence that increased and poorly thought-out regulations have is that they are a significant impediment to ease of doing business in the country. The easier it is for private investors to open and run businesses, more are the chances of vibrant competitive markets leading to sustained economic growth. Unfortunately, according to World Bank's Doing Business Unit that ranks countries worldwide for business regulation, Pakistan is ranked 108th in the world in terms of 'Ease of Doing Business'.⁹ When it comes to business regulations, Pakistan government's regulatory influence on the economy is not only limited to the taxation system—there are other important facets such as trade barriers, excessive documentation, excessive paperwork and permissions and obstacles to investment. It should be noted that the aim here is not to criticise all business regulations as some regulations are necessary to make markets function; however there are also other regulations that make transactions difficult and inhibit competition. The latter add to the regulatory burden and increase the *government footprint* while the former makes markets to create competition, jobs and growth.

The entire breadth of the regulatory framework and how it establishes a footprint of the government is an overarching topic that requires detailed explication. Here we will just give a few representative examples of how the government influences the economy through regulation in Pakistan.

(i) Creating a Permission Economy

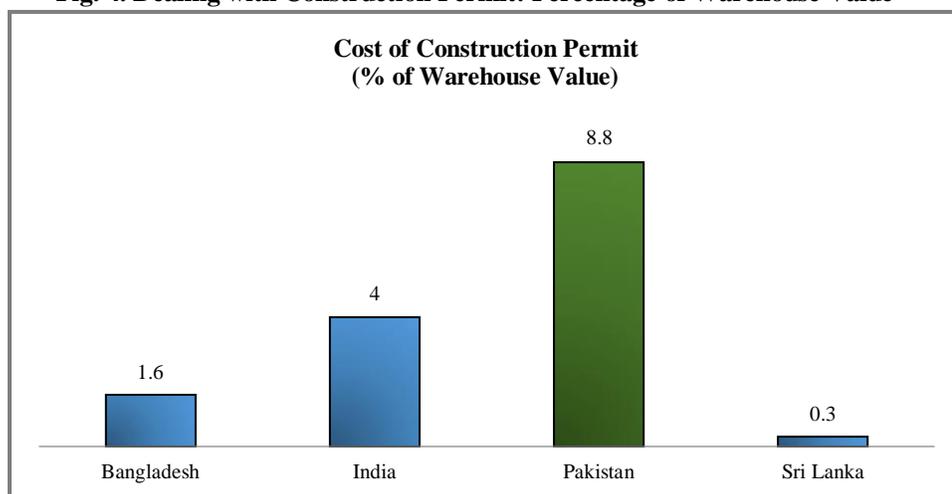
In Pakistan there is an extensive system that requires businesses to go through government regulatory agencies and other related government bodies to gain permission to do business in almost all sectors of the economy. Although most countries have permissions and licensing frameworks in place, in Pakistan these frameworks often

⁸Worldwide Governance Indicators (2018), World Bank Group.

⁹Doing Business Rankings (2020), World Bank Group.

involve countless procedures, lengthy delays and high transaction costs to go along with complex rent-seeking games between businesses and regulators. For instance, in the construction industry which other than being an important industry in its own right is further integrated with other industries, it takes an average of 9 procedures to gain a construction permit in the country.¹⁰ Furthermore, the cost of these procedures is at average 8.8 percent of the actual value of the intended construction project. This percentage cost is highest for Pakistan when compared to other three major South Asian economies i.e. India, Bangladesh and Sri Lanka. (See Figure 4).

Fig. 4. Dealing with Construction Permit: Percentage of Warehouse Value¹¹



(ii) Regulations Increasing Transaction Costs

In addition to domestic transactions, the associated transaction costs of both cross-border money and goods transfers are high for Pakistan. One egregious example of high transaction costs affecting economy are the costs associated with remittances to Pakistan. This is an important facet as in 2018-19 financial year these remittances stood at approximately \$ 21 Billion, nearly equivalent to the total exports receipts for Pakistan.¹² These high transaction costs are partly the reason why many foreign Pakistanis prefer to send money through informal channels such as the ‘hawala’ system and so forth.

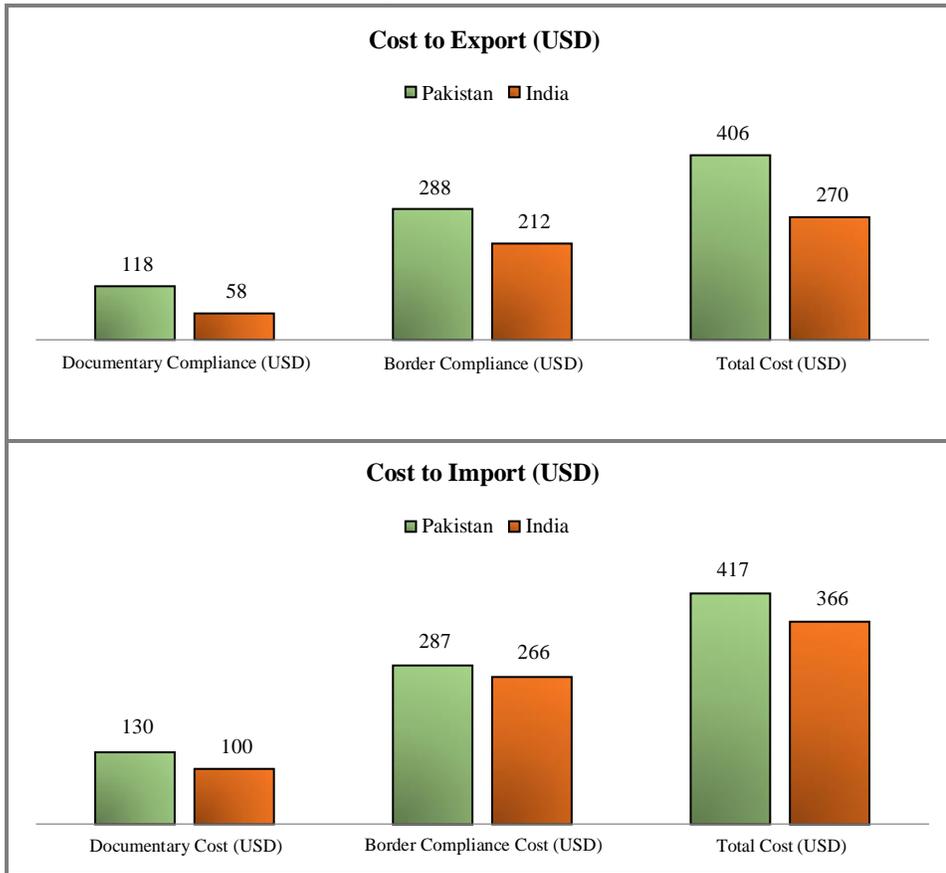
Furthermore when it comes to across the border trade, despite high tariffs being the primary obstacle, transaction costs amounting to documentary and border compliance are also another reason why it is difficult for businesses in Pakistan to trade across border. This particularly affects SMEs that represent 90 percent of all businesses in Pakistan more pronouncedly than larger businesses because of economies of scale. The documentary and border compliance costs of both importing and exporting are significantly higher for Pakistan than neighbouring India. (See Figure 5).

¹⁰Ibid.

¹¹Dealing with Construction Permits (2020), Doing Business, World Bank.

¹²Mughal, M. and Ahmed, J. (2019), *Cost of remitting to Pakistan across major corridors*, PIDE, p.1.

Fig. 5. Trading Across Border: Documentary & Border Compliance Costs (USD per Container Deflated)



(iii) Regulations that Limit Competition

The country has over the decades followed policies that have centered around granting tax rebates and subsidies to many industries, particularly those that are involved in the production of potentially exportable goods. However, despite the export of high value added goods showing little growth, the government has insisted with the protectionist policies for these industries who themselves have often been not able to make their goods neither high-value nor competitive in the international market. Similarly, through high tariffs and other non-tariff barriers the government regulation has protected many industries at the expense of the consumers and overall growth of the economy. The full length of how protectionist policies have inhibited growth of competitive markets is not in the purview of this brief, but in order to clarify, below are two examples of how business regulation has affected competition.

- If we take the case of the automobile industry in Pakistan, it is heavily protected through imposition of very high import duties on imported cars to a point that they are significantly more expensive than locally assembled cars. Due to this

protection, the industry itself is now only dominated by a handful of big manufacturers who have often resorted to price-setting tendencies due to almost non-existent competition from imported cars.¹³

- The engineering sector in Pakistan is another example. The sector is regulated by the Pakistan Engineering Council (PEC), that along with being in-charge of recognising engineering qualifications, is also tasked with granting licenses to contractors. As of now, foreign contractors are not allowed to operate in the country without a partnership with a local contractor and are required to renew their licenses every year.¹⁴ This has over the years served as a significant barrier to entry of foreign engineering firms and contractors, while local firms without serious competition have lagged behind in innovation and betterment of their quality standards.

(5) **Controlling Cities and Investment in Cities: The Burden on Government**

Ownership—There is excess demand and shortage of supply of city and urban space for commercial activities in Pakistan which leads to lost opportunities and cost to the economy. The shortage of city space stems from government regulations on zoning and also due to government ownership of large tracts of prime urban land that can instead be used for more productive commercial activities.

- (i) **City Zoning Regulations**—Most urban space in Pakistani cities is governed by zoning regulations that divide space between distinct categories: ‘residential’ and ‘urban’. The current zoning regulations due to their biases against mixed-use of land and high-rise building have led to a shortage of urban space for commercial activities and are a significant opportunity cost to the economy as a whole.¹⁵
- (ii) **Government Ownership of Urban Space**—Furthermore, to go along with cumbersome zoning regulations, the government also owns large tracts of land in and around city centers. In addition to being used as public offices, this land is also predominantly used to provide housing for public sector officials.¹⁶ There are valid arguments to be made that either public sector officials’ housing should be shifted to cheaper land out of city centers or that these housing benefits for public sector officials should be monetised and the prime land vacated in city centers as a result can be used for commercial purposes. These changes can not only increase commercialisation of city centers but also be a source of income for the government that can potentially rent out such prime real estate to private sector bidders.

¹³Automobile Sector of Pakistan, Pakistan Institute of Trade and Development

¹⁴Foreign Operators, Pakistan Engineering Council at https://www.pec.org.pk/Foreign_Firms.aspx

¹⁵Haque, Nadeem (2014), Achieving Progress, Growth, and Development through Urban Renewal, Policy Brief Series, Wilson Center, pg. 1-5

¹⁶Haque, Nadeem & Nayab, Durre (2007), Renew Cities to be the Engines of Growth, Policy Viewpoint 2, PIDE, pg. 3

Box 2**Zoning Regulations in Action: Lahore's Urban Dilemma**

- City space is largely divided into two mutually exclusively categories: Commercial and Residential.
- Mixed-uses of land i.e. for both residential and commercial purposes are rare and often prohibited by regulations.
- Added to these restrictions on mixed-use of land, all localities including those parts of the city still under LDA's control have arbitrarily set height restrictions that restrict high-rise development.
- No mixed-use of land, low-rise development and restrictions on doing business in 'residential zones' leads to a shortage of city space for commercial and economic activities.
- Lahore's urban landscape is dominated by single-unit housing/residential localities with businesses forced into commercial zones.
- The ultimate cost is to the economy in shape of lost commercial and economic activities.

**ESTIMATING THE GOVERNMENT'S ACTUAL FOOTPRINT
ON THE ECONOMY IN PAKISTAN**

- **Government Share in the Economy**—Given that the *government's footprint* on the economy amounts to more than just annual government expenditure numbers, Planning Commission brought together a core group of economists, practitioners and other experts in 2011 to formulate a new framework for economic growth in Pakistan. As a part of the process of developing the new framework, the working group also attempted to first estimate the actual *footprint that government* has on the economy in Pakistan. The team estimated that in Pakistan the government directly influences about 44 percent of the total economy.¹⁷ The revised calculation adjusted for minor changes in sectoral share percentages yields a similar figure of approximately 43 percent. (See Figure 6). This number of approximately 43 percent is what the government directly controls in the economy; "decisions in these areas are dependent on the government."¹⁸

Fig. 6. Estimating the Government's Share of the Economy

Sector	Govt. Share in Sector (%)	Sector Share in Economy (%)	Govt. Share in Economy (%)
Agriculture	43.1	19.3	8.3
Manufacturing	11.9	12.5	1.5
Mining & Quarrying	79.6	2.5	2.0
Construction	75.0	2.5	1.9
Transport & Communication	73.4	12.3	9.0
Electricity Oil & Gas	77.6	1.8	1.4
Wholesale & Retail	7.9	18.2	1.4
Health & Education	49.3	6.5	3.2
Finance & Insurance	45.5	3.6	1.6
Other Services	60.0	20.8	12.5
Total		100	42.8

Authors' Calculations

¹⁷Haque, Nadeem Ul (2013). Estimating the Footprint of the Government on the Economy. Development 2.0.

¹⁸Ibid.

- **Government Footprint through Regulation**¹⁹—Estimating the cost of government regulations to the economy in general and compliance costs incurred by businesses in Pakistan are complex processes. Existing research on the issue is either absent or limited at best, both in Pakistan and at an international level. Having said that, an interesting study was conducted by Crain & Crain (2014) to estimate the costs of government regulation on the economy of the United States. The study was commissioned by National Association of Manufacturers and in its latest version put the total cost of regulation at 12 percent of the total national income in the United States in 2012.²⁰

For the purpose of estimation, we are going to use the study in the United States as a proxy from which we can make a logical conclusion about the cost of government regulation in Pakistan. Pakistan's percentile score on Worldwide Governance Indicator's 'Quality of Regulation' indicator is 27.40 compared to United States' score of 92.31. Considering this statistic, which is calculated by taking in account various measures that influence effectiveness of regulation, one can logically assume that the regulatory burden and the associated regulatory costs are markedly more in Pakistan than in the United States. If one were to double the 12 percent cost of regulation as estimated by Crain & Crain (2014) to 24 percent and take that as an estimate for Pakistan, it would still amount to a relatively conservative estimate to what the cost actually is for the Pakistan economy.

- **Total Estimate of the Government's Footprint on Pakistan's Economy**—For sake of discussion and simplicity,²¹ let's take the estimated total *footprint of the government* on the economy in Pakistan to be a sum of the percentage of the economy that the government directly controls through its influence on State Owned Entities (SOEs), and the percentage of the costs that are incurred by the economy as result of government regulations including trade barriers, impediments to investment, building restrictions and cumbersome land-use and zoning policies among others. The combined total estimate for the *footprint of the government* in Pakistan then comes to 67 percent of the GDP. (43 percent directly controlled and 24 percent in regulatory costs).

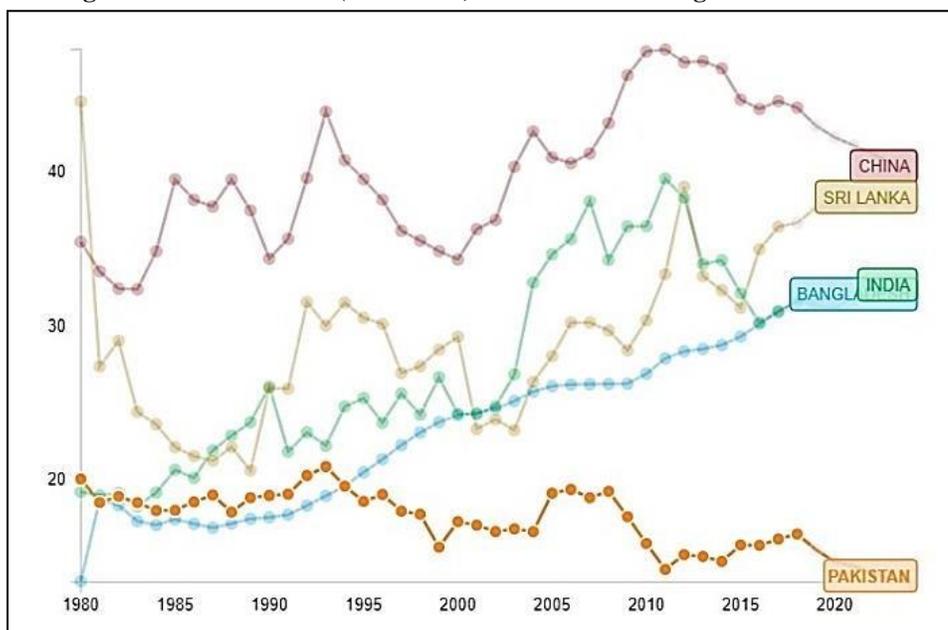
Why the Government's Footprint is Important?

The calculation can and should be refined continually. Knowing the *footprint of the government* clarifies the role of the market and the space for private investment. Every leader (dictator or otherwise) and every donor talks of private sector led growth without understanding what the *Government's Footprint* on Pakistan's economy is.

¹⁹Ibid.

²⁰Crain, William. & Crain, Nicole (2014), The Cost of Federal Regulation to US Economy. National Association of Manufacturers.

²¹Adding the two percentages is not a straightforward process, because 43 percent represents Government's share as a percentage of GDP, whereas 24 percent represents loss/cost as a result of regulation as a percentage of GDP. The addition is done for discussion purposes only, while particularly keeping in mind that there is only negligible difference in two calculations and that the conceptual underpinnings of the argument do not change.

Fig. 7. Total Investment (% of GDP) of Pakistan and Regional Countries²²

The question however is that with the government involved in most markets and with a huge burden of regulation, where is the space for private investment? Perhaps this is the reason that our investment-to-GDP ratio remains the lowest in the region and is on a declining trend. (See Figure 7). The ratio is now very close to the accounting depreciation rate. It seems new investment to expand the economy is virtually not happening.

Our estimate shows that the *footprint of the government* may be as large as 67 percent of the economy. The government is substantially involved in agriculture, construction, finance and banking, electricity and gas, and even in wholesale and retail.

One important area that we have not included is the government large holding of prime real estate for housing of officials and old offices. What was once low-priced suburban land that the colonial government used for housing and offices is now downtown valuable land. Instead of reducing the size of these holdings or relocating them to cheaper areas or even eliminating these through “monetisation of perks” initiatives, the government under pressure from a growing officialdom is increasing the use of valuable land for these purposes.

Furthermore, regulations prohibit building around these estates and offices prohibit large tracts from development on commercial lines. The “wealth of cities” and nations is severely taxed as a result of such policies is significantly eroded. We at PIDE are taking steps to evaluate the wealth of cities and how the official holding of valuable land and the regulations that support it impact through furthering the *government’s footprint* on the economy.

²²World Economic Outlook (2020), IMF.

For the moment we can assume that the *footprint of the government* on the economy is more than 67 percent and that there is an urgent need to decrease it.

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