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THE USAID DOMESTIC RESOURCE MOBILIZATION PROGRAM

A. Introduction

The FY88-93 CDSS identified Domestic Resource Mobilization (DRM) as one of the 10 development problems that USAID would address. The USAID objective is to improve public sector revenues and mobilize greater financial resources for private sector investment. The low level of public revenues, and the associated budget deficit, help to explain many economic and social problems in Pakistan such as poor support for primary education and public health, the deteriorating physical infrastructure and a general shortage of most public goods. The low level of domestic savings threatens long term growth prospects because total savings are inadequate to finance private sector investment, maintain productive capital investment, and provide the physical and social infrastructure necessary for a rapidly growing population. A continued low level of DRM is a serious threat to sustained economic growth, price stability and improvement of social services. After the summary, this paper reviews major problems, government revenues and expenditures, private sector resource mobilization, identifies constraints to expanding DRM and presents the USAID strategy and program.

B. Summary

1. Problems: The two basic problems associated with DRM are the poor job that the Government does in providing public services and inadequate savings for long run, sustained growth. Public services are deficient both in quantity and quality. The savings that occur often are short term and not readily transformed into long term investment. In fact, private savings are used to finance public consumption. Public services like education, roads, etc. and larger, private sector investments are essential for economic and employment growth, which in turn are necessary requirements for stability, the goal of the U.S. economic assistance program.

The Government, at the federal, provincial and local levels, has been unable to increase the supply of public services in line with population growth and also close the gaps in education, health, sanitation and electricity services. The 3.1 percent annual rate of population growth will result in the population increasing from approximately 100 million in 1987 to 120 million in 1993, the last year of the CDSS and 7th Five-year Plan. Continuation of this growth rate will produce a population of approximately 150 million in the year 2000, which is only 12 years away. This 50 million increment is an enormous number of people to feed, educate and employ.

The labor force is growing faster than the population. The labor force participation rate is grossly underestimated because most women are not included even though many rural women engage in farm activities. There is an increasing tendency for women to work in paid employment when they move off the farm. Thus the work force could be growing at a 4 to 5 percent annual rate rather than the 3.4 percent listed in official statistics, which would nearly double it by the year 2000 with consequent social problems if employment does not keep pace.

The rapid population growth creates an enormous burden on the government to provide education to the rapidly growing school age population. The greatest domestic pressure has been to increase enrollments at the college and the secondary level, which is much more expensive on a per pupil basis than primary education. The greatest need, however, is at the primary level (40-50 percent of that age group attend school), which until recently has been starved for funds. The government has tried several innovative methods to increase enrollments at the primary level, but success in both quantitative and qualitative terms is unknown. Because of inadequate revenues and rapid population growth, the absolute number of illiterates is increasing.

The population growth rate is unlikely to decline over the next 5-10 years regardless of changes in the birth rate. One reason is the success of the Expanded Program of Immunization and Oral Rehydration Therapy, which are lowering the still high infant mortality rate. These cost-effective measures are keeping many children alive who otherwise would die. This reduction in infant mortality is a necessary condition for a subsequent reduction in the birth rate and ultimately the population growth rate. The lack of government revenues, however, is impinging on the ability to deliver other types of health services and basic education, which also would contribute to a reduction in the birth rate.

The quality of various public services has been declining, largely as a result of efforts to meet the large demand with limited revenues. For example, due to inadequate funds for proper supervision, classroom attendance by teachers is very poor, which results in poor performance by students. This poor performance cumulates through the entire education process so the quality of university graduates is substantially lower than it was 15 or 20 years ago. The quality of health services in both city hospitals and rural health centers also has declined because funds are inadequate to supply drugs and pay salaries adequate to keep people on the job. Inadequate maintenance and falling construction standards have resulted in a deterioration of the transportation and irrigation systems. The capacity to supply reliable electricity and gas service has fallen behind demand. Without adequate human and physical infrastructure, long run self-sustained growth is not possible. Inadequate domestic resource mobilization (DRM) is at the heart of these problems.

2. Symptoms: An examination of government budgets quickly points out the symptoms of inadequate DRM. The most obvious indicator is the growing budget deficit, i.e. the difference between total expenditures and total tax and non-tax revenues. For example, the deficit grew at an annual rate of 45 percent between 1980 and 1987 while total revenues were growing at a rate of 17 percent, slightly lower than the nominal GDP growth rate (see Table 1). The budget deficit was 8.9 percent of gross domestic product (GDP) in 1986/87, up from 5.3 percent in 1980/81. The major method of financing this deficit has been borrowing from the non-bank sector, which increased at an annual average rate of 97 percent during the 6-year period. This financing is very expensive in terms of annual interest charges and is unlikely to yield much in the way of net additional revenues in the near future. In 1986/76, interest costs on

Table 1

Revenues, Expenditures, Deficits and Financing

	1980/81	1986/87	Annual Growth Rate	Percentage of GDP	
	(Billion Rupees)		(%)	80/81	86/87
Total Revenues	49.0	100.0	17.3	16.9	17.1
Tax Revenues	38.8	78.1	16.8	14.0	13.0
Expenditures	63.3	156.4	24.5	22.9	26.1
Current	40.3	113.5	30.2	14.5	18.9
Development	23.3	42.9	14.0	8.4	7.1
Deficit	14.6	53.7	44.6	5.3	8.9
External Financing	7.7	11.3	7.7	2.8	1.9
Non-Bank Financing	4.5	30.6	96.6	1.6	5.1
Bank Financing	2.4	11.8	65.2	0.8	2.0
Total Internal Debt	62.5	243.4	48.2	22.5	40.3
Internal Debt Service	3.6	15.3	54.1	1.3	2.5
Average Interest Rate	6.0%	13.5%	20.8	-	-
Taxes as Share of Expenditures	61.3%	50.0%	(3.0)	-	-
Gross Domestic Product	278.0	602.1	19.4	-	-

the domestic debt were Rs.15 billion while the amount raised was Rs.30.6 billion. Another problem is that government borrowing may crowd out the private sector or raise the cost of capital for the private sector. Without a significant increase in the rate of revenue growth, the government will be forced to further finance the deficit from the banking system, with a probable increase in the rate of inflation.

Another symptom of inadequate revenues has been the growing share of current expenditures compared with development expenditures. During this 6-year period, current expenditures grew at an annual average rate of 30 percent, whereas development expenditures grew by only 14 percent. Current expenditures went from 64 percent of total expenditures to 73 percent while development expenditures declined from 36 to 27 percent. Current expenditures reflect the rapid growth in public employment and salaries. The quantity and quality of public services on a per capita basis, however, are declining because of slow growth in the development budget despite the growth in employment. The other large items in the current budget are defense expenditures and interest payments. Interest on the domestic debt is the most rapidly growing item in the budget and results from the budget deficit. Defense expenditures, although very large, are declining slightly as a percentage of total government expenditures. While there are opportunities for expenditure reductions, they must be accompanied by revenue enhancement measures to reduce the deficit significantly.

3. Programs: USAID has been concerned about the problems of poor maintenance of the physical infrastructure, inadequate investment, government subsidies and parastatal costs since our bilateral development program resumed in 1982. The CDSS has broadened these concerns and set sub-objectives and targets to address these items, e.g.:

- Budget deficits averaging not more than 4.5 percent of GDP by 1993;
- Major tax reforms introduced;
- Inauguration of private investment institutions;
- Movement of autonomous public sector institutions off the government budget.

The policy dialogue, conditions precedent and analytical studies in projects and programs have begun to address some of these issues. DRM issues have been at the forefront of the annual economic policy reviews with the Government of Pakistan since its inception in 1986. Reductions in subsidies and privatization of public enterprises can help to alleviate the DRM problem by shifting costs from the public to the private sector, with a consequent increase in efficiency. For example, the share of the private sector in fertilizer distribution grew from 30 to 60 percent during this period, thus reducing distribution costs in the budget. The ration system for wheat has been eliminated, cutting the subsidy bill for wheat by about one-third. Increased electricity rates generated large revenues for the parastatal, thus lowering its demand for budget allocations.

During the CDSS period, USAID will continue its efforts to: 1) reduce subsidies; 2) increase user charges; 3) enhance tax recovery; and 4) improve the financial sector. We will try to shift investment and production activities from the public to the private sectors, or at least off the budget. We will expand our efforts to persuade the government to reduce expenditures, which may be easier to accomplish than raising taxes. We also will be supporting revenue research and programs of the multilateral banks to raise tax revenues. Finally, we will continue our efforts to promote private sector investment companies and housing finance institutions as ways of mobilizing resources.

The World Bank has been the lead institution in carrying out a policy dialogue with government on DRM. It is now concentrating on tax revenues while continuing its efforts to increase user charges. USAID has supported, and will continue to support all such efforts by the World Bank. Both the World Bank and the Asian Development Bank have been carrying out studies on the financial sector, but these have not yet been published in final form or resulted in policy change. USAID has been following these activities very closely and will be ready to seize the opportunity to pursue particular items where we have a comparative advantage.

C. Government Revenues, Expenditures and the Deficit

Major emphasis in Pakistan has focussed on the budget deficit and public revenues rather than on expenditures. The reason is that government expenditures, with some notable exceptions, have been seen as not unreasonable (one-fourth of GDP), although there is growing discontent with the government services provided. While there is scope for a reduction in subsidies and restraint on administrative expenditures, major categories such as defense and debt servicing are essentially uncontrollable. In fact, these two categories plus grants for education and grants to the provinces account for more than 82 percent of current expenditures (see Table 3). Thus, the major solution to the necessary reduction in the budget deficit must be growth in revenues, particularly taxes.

Revenue performance over the last eight years has been very poor in relation to the growth of the economy. Total revenues have risen almost as fast as GDP (see Tables 1 and 2) but expenditures (see Table 3) have risen much faster. Direct taxes, primarily personal and corporate levies on income, have been the worst performing of all categories, rising at only half the rate as the economy. In 1980 the income tax was equal to about 22 percent of indirect taxes, but by 1987 it had fallen to about 16 percent. This is the category that is expected to increase most rapidly as an economy grows and develops. The major reason is a failure to assess and collect taxes that are due. Some small part of the shortfall may be due to black (illegal) money, but most of this money is not included in GDP. Rates have been lowered in an effort to make payment of taxes more attractive than tax evasion, which creates more black money, but the results to date have been disappointing. One reason is a regulation that prevents audits so long as the annual increase is at least 20 percent. Starting from extremely low and artificial bases, many tax payers will never (in their lifetime) pay anywhere near the normal, legal rate. The current estimate is that about one-fourth of the individuals who have sufficiently high incomes to pay income tax actually pay any income tax. About 40 percent of remittances and 30 percent of economic output lie outside the recorded economy and thus outside the tax net.

Table 2
Consolidated Tax Revenues, Growth Rates, Share of GDP and Buoyancy

	Revenues		Annual Growth Rate	Revenues as a % of GDP		Buoyancy-with respect to GDP a/
	1980/81	1986/87		1980/81	1986/87	
	(Billion Rupees)		%	%	%	
Income Tax	7.0	11.1	9.7	2.5	1.9	0.5
Major Indirect Taxes	31.1	69.1	12.7	11.2	11.6	0.7
Import Duties	13.6	24.6	13.4	4.9	4.1	0.7
Excise Duties	10.5	16.8	10.0	3.8	2.8	0.5
Sales Tax	2.9	5.5	14.9	1.0	0.9	0.8
Surcharges	1.7	14.9	129.4	0.6	2.5	6.8
Petroleum	0.9	11.1	188.8	0.3	1.9	10.0
Export Taxes	0.7	0.9	4.7	0.3	0.2	0.2
Other	1.9	2.4	4.3	0.7	0.4	0.2
Total Taxes	38.8	81.8	18.4	14.0	13.8	1.0
Non-Tax Revenues	8.1	21.8	28.1	2.9	3.7	1.5
Total	47.0	103.7	20.1	16.9	17.5	1.1
Autonomous bodies	2.0	3.7	14.1	0.7	0.6	0.8
Grand Total	49.0	107.4	19.8	17.6	18.1	1.1
Provincial Taxes and Non-Tax Revenues	2.9	5.2	13.2	1.0	0.9	0.7
Gross Domestic Product	278.0	592.5	18.5	-	-	-

a/ Calculated by dividing the annual growth rate of the tax by the annual growth rate of GDP.

Sources: World Bank, Pakistan: Sixth Plan Progress and Future Prospects, Feb 26, 1987, Tables, 5.01, 5.03, 5.04.

The major source of government revenues is taxation of foreign trade. Import duties now are 30 percent of tax revenues, but excise taxes, sales taxes and surcharges, which mainly result from imported materials, amount to nearly 45 percent of tax revenues. The imposition of surcharges on import duties in the last few years, the markup on petroleum imports since 1986 and increased revenues resulting from imported edible oil price declines are the major sources of revenue growth. The surcharges on imports for some items are larger than the normal duties and have raised the rate of protection at a time when Pakistan is trying to lower duties in order to make industry better able to compete on the export market. This added protection is an undesirable byproduct of the need for additional resources.

Provincial and local government revenues have been declining as a percentage both of GDP and total revenues (see Table 2). One major reason is the readiness of the federal government to provide non-obligatory grants to the provinces to cover their deficits. Another reason is the institution of Ushr, which reduced land revenues and is ostensibly used for charitable activities (see Table 3). As a result, provincial and local government revenues were reduced, leading to a fall in the local/provincial share of total government revenues from about 6 percent in 1980/81 to about 5 percent in 1986/87. Another reason has been the slow growth in collections for irrigation water compared with the growth in expenditures for canals and tubewells. Provincial revenues now finance about 20 percent of current expenditures, down from 70 percent fifteen years ago.

In recent years much of the growth in revenues has come from surcharges that produce a large amount in the first year but then grow at a rate equal to or less than the economy. Revenue growth from imports at a time when total imports have declined demonstrate the short-term nature of this source of revenues.

While revenues have been growing at a slightly lower rate than GDP, expenditures, particularly current expenditures, have been growing much more rapidly (see Tables 1 and 3). In 1986/87, current expenditures rose by 17.8 percent while revenues went up by 10.8 percent. Taxes as a

TABLE 3

GOP BUDGET EXPENDITURES
in billions of rupees

ITEM	1980-81	1987-88	Annual Growth Rate (%)	As % of Budget 1980-81	As % of Budget 1987-88
CURRENT					
Defense	14.08	44.25	15.00	24.36	25.29
Gen Admin	1.68	5.25	14.88	2.91	3.00
Alloc. Prov.					
Normal	0.48	2.09	23.48	0.83	1.19
Non-obligatory	0.62	11.52	123.06	1.07	6.58
Debt Service					
Domestic	2.52	18.43	44.19	4.36	10.53
Foreign	5.49	17.42	15.21	9.50	9.96
Subsidies	2.58	5.67	8.38	4.46	3.24
Econ/Social Ser	2.94	7.71	11.36	5.09	4.41
Other	0.96	2.92	14.29	1.66	1.67
Total	31.35	115.26	18.74	54.23	65.88
DEVELOPMENT					
Departments	8.12	13.04	4.24	14.05	7.45
Auton. Bodies	9.80	20.10	7.36	16.95	11.49
Fertilizer Sub.	2.42	1.67	-2.17	4.19	0.95
MNA Program	0.00	2.50	0.00	0.00	1.43
Spec. Dev. Prov	0.00	1.19	0.00	0.00	1.68
Prov. Dev.	4.89	14.50	13.76	8.46	8.29
Other	1.23	0.00	-7.00	2.13	0.00
Total	26.46	53.00	7.02	45.77	30.29
DEV GRANT PROV FOR ED	0.00	6.70	0.00	0.00	3.83
GRAND TOTAL	57.81	174.95	14.18	100.00	100.00

percentage of expenditures declined from 61 percent in 1980/81 to 50 percent in 1986/87. Non-tax or other extraordinary revenues in the last few years have taken up some of the slack. The decline in imported petroleum and edible oil prices boosted revenues by about 10 billion rupees annually in the 1985-87 period because of trading profits by public agencies and adjustible duties. The high price for cotton and cotton yarn exports will generate large revenues (Rs. 5-10 billion) in 1987/88 because the government taxes the producer surplus through its monopoly on exports of cotton and a duty on yarn exports. None of these revenues is likely to last more than a few years because current prices are deviating from longer run projections.

The situation of stagnant growth in real revenues is exacerbated by the rapid growth in current expenditures, primarily those of debt servicing and defense. Although defense expenditures have not increased as a percentage of GDP, they have not gone down either. Furthermore, some defense expenditures probably are hidden, particularly imports of weapons on credit. The amount of funds being transferred to the provinces also has risen rapidly, leaving little extra for the federal government and reducing the incentive for provinces to raise their own funds or control their expenditures.

The budget deficit has been increasing as a result of the above trends (Table 1). The deficit in 1986/87 was 34 percent of total expenditures, compared with 23 percent in 1980/81. The deficit as a percentage of GDP rose from 5.3 percent in 1980/81 to 8.9 percent in 1986/87. The 1987/88 projection is 7.8 percent, but the actual figure may be higher.

The GOP finances the budget deficit by external borrowing (foreign aid), borrowing from the private sector and borrowing from the banking system (monetary expansion). Table 1 contains data for two different years. Banking system financing is considered to be the most significant because of the inflationary impact. This percentage rose from 0.8 percent of GDP in 1980/81 to 2.0 percent in 1986/87. Non-bank borrowing is equally important, however, because it creates a domestic debt on which interest must be paid and reduces the funds available to the private sector for investment. Government domestic debt has been growing at a 45 percent average annual rate over the past six years, and interest payments by 54 percent. Domestic interest charges have risen from 8 percent to 16 percent of current expenditures (see Table 3) and are the largest item after defense. Total interest payments, both foreign and domestic, are projected to rise from 20 percent of current expenditures in 1986/87 to 30 percent in 1994/95. As a share of GDP, they would rise from 3.8 percent to 6.3 percent. Total debt service is estimated to be 20.5 percent of total expenditures in 1987/88 or 31 percent of current expenditures.

Non-bank borrowing reduces the amount of amount of money available to the private sector and raises its cost. The government increased its borrowing from Rs. 4.5 billion in 1980/81 to Rs 29.6 billion in 1986/87, mainly by paying interest rates in the 12-16 percent range. These rates are higher than what most firms pay for credit from the banks (average rate for working capital is 13 1/2 percent). This borrowing has risen from about one-quarter of private savings in 1980/81 to 45 percent in 1985/86 and could go as high as 58 percent in 1994/95.

The World Bank has taken and continues to take the lead among donors in urging action on the DRM problems. The World Bank President sent a letter to the Prime Minister of Pakistan in August 1987 suggesting a substantial cut in the lending program if Pakistan did not take measures to reduce its budget deficit. The growing deficit is one manifestation of the GOP's inability to increase revenues in line with modest increases in expenditures. The ADB and the IMF also are concerned about the budget deficit. The IMF has not provided any new funds in the last five years, primarily because the GOP would not agree to the attached conditions. The World Bank has clarified its August position and defined minimum targets that Pakistan should meet by July 1988.

USAID concern with DMR has manifested itself in the past six years through efforts to reduce subsidies in certain sectors such as agriculture (fertilizer, wheat, irrigation) and to raise revenues through higher user charges for electricity and irrigation water. During the current six-year program, the Mission will continue to push a broad based program to increase domestic resource mobilization both in terms of government revenues and also in the private sector.

D. Private Sector Resource Mobilization

The government deficit and non-bank borrowing to cover it are especially worrisome because of the low savings rate (see Table 4). The domestic savings rate is estimated to have risen from 6.2 percent of GDP in 1980/81 to 9.1 percent in 1986/87, after a decline to 4.8 percent of GDP in 1984/85. The accuracy of savings figures is rather low so the trend may not be conclusive. These figures do not include the activities of the large, informal capital market, so the rising trend may represent a shift into the recorded economy but not a change for the total economy.

Savings can be defined either as national savings or as domestic savings. National savings includes foreign assistance and remittances. It is clear from studies that only a small part of remittances are invested, even if the purchase of land for the construction of housing is defined as savings. Although domestic savings apparently now are on an upward trend, they still are low compared to other developing countries such as India, where the figure is 20 percent of GDP or more. The fact that public sector savings have ceased reduces the impact of improvements in private savings.

Although the share of the private sector in savings has increased, data on domestic resource mobilization by the private sector are more difficult to interpret. Much of the industrial investment is financed by bank loans using lines of credit furnished by donor agencies or credit allocations provided by the State Bank, rather than on the basis of domestic bank deposits. Foreign banks can increase their credit allocation by bringing in foreign exchange and depositing it in Pakistan. The National Development Finance Corporation (NDFC) and Bankers Equity Ltd. (BEL) can expand their credit ceilings through growth in domestic deposits, but most other financial institutions are not interested in expanding deposits because this raises costs but not credit allocations. Success in making loans can result, however, in a larger credit allocation.

Table 4

Economic Growth, Savings and Investment

	1978/83	1986/87
	(Percent of GDP)	
GDP at market prices (annual growth rate)	6.1	4.9
-Gross Investment	16.6	17.2
-Fixed Investment	14.9	15.6
--Private	5.6	6.3
--Public	9.3	9.3
Inventories	1.5	1.6
Domestic Savings	6.2	9.1
National Savings	12.7	15.0
-Public	2.2	0.3
-Private	10.5	14.7
--Remittances	6.5	6.4
Foreign Savings	3.7	2.2
National savings as share of gross domestic investment	77.4	96.1
Domestic Savings as share of gross domestic investment	37.3	58.1

Relatively small amounts of stock are issued on the stock exchanges in Pakistan. These stock offerings do not maximize the return to the company because the price is based on book value rather than on the demand for the shares and the expected rate of return. As a result, share prices usually rise sharply immediately after issuance so that very large benefits accrue to the first time buyers rather than to the issuing companies. This practice and more questionable practices limit the effectiveness of the stock exchanges as a means for mobilizing capital.

E. Constraints to Increased DMR

The current government, although it was elected in fair nonparty elections, is reluctant to take unpopular measures such as tax increases (The martial law government used to justify its refusal to act on it not being an elected government and thus without popular support). The federal government currently collects about 20 percent or less of what it should be collecting in income tax. The corruption associated with this tax evasion benefits large industrialists, professionals, tax collectors, traders and almost every influential person in Pakistan. Income arising from agriculture, regardless of the amount involved is exempt from income tax. This exemption provides another reason why government has not acted to increase taxes, the argument being that since income from agriculture is not taxed, why should the rest of the country pay even more. The national and provincial assemblies are dominated by land owning interests who are unwilling to tax themselves. The Prime Minister recently withdrew a tax bill by agreeing that small traders will not be taxed on more than Rs.50,000 income ($2,900) and that the income liable for tax would not increase. The traders had carried out a strike and threatened the Prime Minister by reminding him that they had been responsible for the downfall of the Bhutto government, which led to Zia's martial law and Junejo's non-party government. The result of the above situation is a narrow base of taxpayers compared with a much larger group of potential taxpayers.

The information for recommending DRM measures is rapidly increasing. Several years ago the ADB carried out a study of the financial sector and recently sponsored another. The World Bank and the Asian Development

Banks are developing industrial credit loans that may have conditionality associated with the financial sector. As part of project preparation, the World Bank is carrying out a study of the financial sector, which was completed in January 1988, but has not been released. Furthermore, the World Bank assisted the government in the selection of consultants to help with the analysis of specific revenue measures. USAID is about to undertake a study of local government administration and financing that will identify sources of revenue at the district level and below (there are approximately 92 districts in Pakistan and they are the major administrative units below the provinces). The National Taxation Reform Commission published its final report January, 1987 which has been reviewed by various parliamentary committees, but significant legislative proposals have yet to come out of the study. The proposals submitted in the June, 1987 budget called for a number of measures, but none were measures recommended in the NTRC report. The public outcry that resulted, especially in the National Assembly, caused almost every revenue increase to be withdrawn. The government had to take a meat axe approach to cutting expenditures in order to keep the deficit under control. The National Finance Commission soon will release its report on how to allocate revenues between the central government and the provinces--it may contain revolutionary suggestions.

F. The USAID Strategy

The USAID strategy in the past was to support multilateral institutions that took the lead in DRM discussions while we attempted to increase user charges, reduce subsidies and encourage private investment through our various projects. The strategy presented here is broader in an attempt to achieve the subobjectives listed above in Section B. The USAID effort falls into three categories: (1) reduction in subsidies and other current expenditures and increases in user charges; (2) larger tax revenues; and (3) improvement in the financial sector. Each of these will be addressed in turn.

1. Reduction in Subsidies and Other Government Expenditures and Increases in User Charges

USAID will continue its effort to reduce subsidies and unnecessary government expenditures as a means of limiting the budget deficit. The major subsidies that we considered were wheat, fertilizer, irrigation water, electricity for tubewells and edible oil. Success has been achieved in the edible oil sector ($ 30 million), primarily because world prices fell. About one-third of the wheat subsidy has been eliminated (a savings of about $ 50 million), largely because of studies sponsored by USAID. Our program over the next few years will attempt to eliminate the remaining subsidy on wheat consumption by increasing the spread between the procurement price and the wholesale issue price, which now are identical. Success will reduce the drain on the budget in the short run, while inducing the private sector to enter the grain storage business, thus reducing the burden on government for additional storage capacity in the long run.

The subsidy situation for fertilizer has improved. USAID was successful in reducing factors such as incidentals related to the subsidized distribution of fertilizer by the public sector. Not only were these subsidies removed, but the overall subsidy on the production and distribution of nitrogenous fertilizer was eliminated for a total savings of perhaps $ 30 million. Less success was experienced in phosphatic fertilizer where the retail price is approximately one-half of the cost of imported fertilizer. Although the government has agreed to a schedule with the ADB to phase out the current subsidy of $ 90 million over a four year period, increases in world prices may make this schedule ineffective. Therefore, USAID will work through the Agriculture Sector Support Project (ASSP) and the overall policy dialogue to bring about a steady reduction of these subsidies.

USAID has only recently drawn its attention to subsidies on irrigation water. During the last six years, we have concentrated on quantifying the level of needed O&M expenditures and persuading the provinces to increase expenditures to the level necessary for long term efficient and equitable operation of the irrigation system. The World

Bank and ADB have concentrated on urging increases in water charges so they cover O&M cost. Thus far they have been unsuccessful, but we will join in the effort. Our proposed strategy is to increase rates for canal sub-commands that have been rehabilitated and now are working more effectively. The probable amendments to the parallel financed USAID and World Bank irrigation rehabilitation projects may call for funding cut-offs if rates are not increased.

The subsidy on tubewells results in excessive and inefficient use of water and excessive use of electricity at a time when electricity shortages are reducing output and employment. The USAID contribution has been to carry out studies on the cost of providing electricity to various classes of customers. The World Bank has taken the lead on overall electricity pricing, while USAID has concentrated on the structure of rates. We are particularly concerned about the factors that affect conservation. For example, domestic consumption is growing very rapidly, to a large degree because of rapid increases in the use of airconditioners made possible by residential rates that are lower than industrial rates. A very low rate for tubewells encourages the conversion of diesel powered pumps to electric pumps. The electric pumps are no more efficient on an energy basis and deprive industry of electricity. USAID has not used any of its project funds for rural electrification because the shortage of generation capacity would be exacerbated with little growth in economic output. In addition, WAPDA has not completed a master plan for rural electrification that would maximize the benefit-cost ratio.

USAID also will continue to urge the Government of Pakistan to reduce expenditures that are unessential in carrying out its activities. For example, we have provided assistance to examine the issue of public sector agencies raising funds commercially rather than depending upon the government budget. The effort to move agencies completely off the budget will continue. For example, it will be a major topic for discussion in the 1988 Economic Policy Review. The Government recently announced plans to move the Telephone and Telegraph Department off-budget and make it an autonomous organization. USAID will attempt other ways to reduce public expenditures such as the promotion of power generation in the private sector and private commercial health services. We have been doing exploratory work in the area of toll roads to be built by the private sector and financed by user charges.

USAID together with other major donors has been encouraging the government to increase charges for electricity, gas and irrigation water. For example, the Energy Commodities and Equipment project has a condition calling for self-financing (based on user charges) of 40 percent of the expansion costs of electricity supply. User charges are a way to reduce subsidies for government services on public sector enterprises, which reduces government expenditures. User charges not only encourage more economic use of services but also could be a way of collecting revenues in a society that does not pay very much in taxes. We also have tried to increase user charges for health services and higher education, so far without success. This is an area where we will continue to devote attention.

2. Tax Revenues

USAID and other donors have not asked the government to raise tax rates. In fact, the government reduced income tax rates in an effort to increase the number of companies and persons that declare their entire income. The success of this effort has been rather limited in terms of growth in tax revenues. The World Bank has been carrying on a policy dialogue about the need for additional taxes and some progress is expected by July 1988. USAID is about to initiate a study of local government administration and financing that will attempt to identify and quantify additional revenues that could be raised at the sub-provincial level. USAID will carry on a policy dialogue in this area and will attempt to support the efforts of the World Bank. We also will be responsive to GOP requests for technical assistance in the tax field.

3. Improvements in the Financial Sector

USAID has been calling for additional private financial institutions for the last two or three years. We first became familiar with the sector as a result of an attempt to establish a private investment company. Since then the government has issued regulations for such companies but has not yet implemented this policy. We will continue to work with the government through our policy dialogue to bring it about. These companies have the potential to mobilize much higher levels of savings and match them with productive investment. Unfortunately, illegal companies that have absconded with deposits are souring the environment for possible legal companies.

Commercial banks often do not seek deposits because they cannot make additional loans and must invest their excess funds in government securities that pay lower returns than the cost of deposits. USAID may sponsor research on this issue.

USAID has also been talking to the government about financing public sector agencies through capital issues in the financial market. We brought out officials from the Federal Reserve System to work with State Bank of Pakistan officials on this issue; their advice was important for the issuance of bonds by WAPDA. We expect to do much more in moving public sector enterprises off the budget. Another activity still under consideration is privatization, which has the potential for increasing DRM in the private sector.

USAID just completed a study of the adequacy of rural credit. We expect to follow it with a policy dialogue and perhaps additional studies or a project if justified. Counterpart funds might be used to correct deficiencies. The Mission has been investigating the housing financial sector and has brought out several teams. A Housing Investment Guarantee program may be implemented, but only in conjunction with new private financial institutions. Our work on private sector power is as much a financing project as an energy project. One objective is to mobilize more resources through the private sector than the government could accomplish. We also are investigating the potential for toll roads in which the private sectors would mobilize the financial resources.

The USAID effort in DRM is very broad, cutting across all the sectors in which we have projects and interests. Conditions precedent and policy dialogue are the major tools for bringing about change. We may have a few specific projects in which DRM is at the heart, but they will be listed as energy, housing, health, etc. projects. A small possibility exists that DRM might be associated with policy based cash transfers.