IPP Policy Paper Series

A Risky Budget

June, 2008

Institute of Public Policy
Beaconhouse National University

A RISKY BUDGET

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1. Macroeconomic Backdrop to the Budget

The Federal Budget of 2008-09 comes at a time when macroeconomic conditions have substantially deteriorated with the inflation rate at an all-time peak and people's expectations are high about relief from the newly elected coalition government. The question is, how grave is the current macroeconomic situation? Pakistan is, in fact, facing serious economic challenges in terms of high inflation, unsustainable fiscal and current account deficits and a declining growth rate as shown in Table 1.

Table 1
Economy at a Glance

	2006-07	2007-08 (Rs. Billion)		
		Budgeted Target	Revised	Deviation[c]
Growth (%)				
GDP Growth rate	6.8	7.2	5.8	-1.4
Agriculture	3.7	4.8	1.5	-3.3
Manufacturing	8.2	9.9	5.4	-4.5
Services	7.6	7.1	8.2	1.1
Inflation Rate (%)				
CPI	7.8	6.5	11.0	-4.5
Food Inflation	10.4		15.0	
Growth in Money Supply (M2) (%)	19.3	13.7	15.5	1.8
Fiscal Deficit as % of GDP	4.3	4.0	7.0	3.0
Current Account Balance As % of GDP	4.9	4.5	-8.8[b]	-4.3

[a] SBP Projections, Second Quarterly Report for FY08.
[b] July-April 2008.
[c] Revised – Budgeted/Target

The revised estimate of fiscal deficit for 2007-08 is 7 percent of GDP as revealed by the Ministry of Finance in the budget documents, in relation to the target deficit of 4 percent of GDP. The higher deficit has been financed largely by borrowing from SBP which has put pressure on monetary policy, resulting in higher growth in monetary aggregates. This monetary expansion together with higher international oil and food prices has already translated into high double-digit inflation. Moreover, the projected estimate of current account deficit for 2007-08 has crossed 8 percent of GDP, soaking up foreign savings and resulting in depletion of foreign exchange reserves and increase in foreign debt. These deficits and the alarming level of inflation have affected the pace of economic growth. GDP growth is 5.8 percent in 2007-08, below the year's target and less than last year.

It appears that our present economic predicament is due to a combination of domestic and external factors, of a short and long term nature. The GDP growth rate tapered- off following the peak of 9 percent attained in 2004-05. Both agriculture and manufacturing have demonstrated a gradual decline in the growth rate since that year.

Inflation has been threatening the economy since 2004-05. Cumulative inflation from 2004-05 to 2006-07 has been 27 percent in the overall CPI and 33 percent in food prices. In recent months the inflation rate has spiralled, as shown in Table 2, with the overall rate of inflation rising to 19 percent and in food prices to 29 percent on a year-to-year basis.

Table 2
Monthly Rate of Inflation (Year to Year)

Year	Month	CPI Inflation (Overall)	CPI Inflation (Food)
2007	July	6.4	8.5
	August	6.5	8.6
	September	8.4	13.0
	October	9.3	14.7
	November	8.7	12.5
	December	8.8	12.2
2008	January	11.9	18.2
	February	11.3	16.0
	March	14.1	20.6
	April	17.2	25.5
	May	19.3	28.5

Source: SBP, Monthly Statistical Bulletin.

On the fiscal side, the government did a good job of fiscal stabilization up to 2003-04. Thereafter, the deficit started increasing as public expenditure built up once again with rising PSDP and higher non-interest current expenditure. Revenues did not respond with corresponding buoyancy, and remained stagnant at around 10-11 percent of the GDP. By 2006-07, revenue and primary deficits had emerged, indicating that the government was borrowing to sustain its day-to-day operations.

As far as the balance of payments is concerned, we witness a transformation from surpluses on the current account between 2001-02 to 2003-04 to a deficit of over 8 percent of GDP in the out-going fiscal year. Strong growth in aggregate demand, liberalization of imports due to falling tariffs, declining interest rates and emergence of consumer financing increased demand for imported consumer durables, and private investment (mostly with imported machinery) resulted in an unprecedented growth in imports. Non-oil, non- food imports increased by over 30 per cent in 2004-05 and 2005-06 respectively. To finance these rising imports, exports responded up to 2005-06. Thereafter, exports began to falter. The result is pressure both on the foreign exchange reserves, which have declined by US $ 6.3 billion in the last 7 months, and the exchange rate, which has depreciated by 6.4 per cent in 2007-08 upto the end of April.

2. The Fiscal Outcome in 2007-08

Table 3 gives the budgeted figures for 2007-08 and the revised figures presented in the budget announced by the Finance Minister, Mr. Naveed Qamar. The year started with a budgeted deficit of Rs 398.8 billion, which was projected at 4 per cent of the GDP. The budgeted net revenue receipts of the federal government were 902 billion while the current expenditure projection was Rs 993 billion. Three-quarters into the fiscal year, the then Finance Minister, Mr. Ishaq Dar, informed the nation that current expenditure were likely to exceed the budgeted target by as much as Rs 521 billion, thereby enhancing the budget deficit to Rs 956 billion, equivalent to 9.5 percent of the GDP.

Table 3
Fiscal Outcome in 2007-2008

(Rs in Billion)

Heads		2006-07 Revised	2007-08	
			Budgeted	**Revised**
	Current Expenditure (Federal)	1033.5	1056.4	1516.3
Minus	Repayment of Foreign Loans	54.0	62.9	61.7
	Current Expenditure (Excluding Repayment of Foreign)	979.5	993.5	1454.6
Plus	Development Expenditure (PSDP) (Federal + Provincial)	394.5	493.3	431.8
Minus	Net Revenue Receipts (Federal)	823.1	902.2	941.7
Minus	Self-Financing of PSDP by Provinces	95.5	122.7	129.8
Minus	Recovery of Loans from Provinces	40.2	14.6	25.4
Minus	Provincial Surplus	22.2	51.8	32.6
Minus	Net Lending to others (Federal)	6.9	-3.2	23.0
	Fiscal Deficit	**386.1**	**398.8**	**733.9**
	Budget Deficit as % of GDP	**4.4**	**4.0**	**7.0**

As compared to this, the deficit for 2007-08 revealed in the budget documents is Rs. 734 billion, or 7 per cent of GDP. How was such a large adjustment of 2.5 per cent of GDP achieved in only three months, during the last quarter of the fiscal year? It appears that there was a Rs. 51 billion additional inflow of non-tax receipts due to higher profits of SBP and larger defense receipts. Also, the PSDP has been cut back by Rs 50 billion or so. In addition, a decline of Rs. 100 billion approximately is reported in current expenditure in relation to the estimate made in early April 2008, by excluding the additional defense expenditure of 75 billion incurred on military operations in the North and a lower outlay on research and development support to the textile sector by Rs. 24 billion. Clearly, either the expenditure estimates of April were overstated or the more recent estimates in the budget documents understate the expenditure in 2007-08.

Despite the above adjustments made in the last three months, the fiscal outcome for 2007-08 indicates a high and unsustainable fiscal deficit of 7 percent of the GDP. The jump of 3 percent of GDP in relation to the target for 2007-08 is due to massive overruns in current expenditure, especially on subsidies and interest payments.

3. Fiscal Policy Objectives in the Budget

Given the macroeconomic backdrop and the burgeoning fiscal deficit, the fiscal policy objectives in the 2008-09 budget are as follows:

1) ***Macroeconomic stabilization:*** The fiscal deficit has to be brought down from the current high level in line with the requirements of the Fiscal Responsibility Act and to preserve the sustainability of the debt burden. The containment of aggregate demand through contractionary fiscal policy should also have a favourable impact on the external balance of payments.

2) ***Contain inflation:*** Fiscal policy has to reinforce the recent monetary measures introduced by the State Bank of Pakistan. In a precipitate set of actions, it has moved to tighten monetary policy. This represents a reversal of the growth-oriented monetary policy over the last five years, whereby money supply continued to expand rapidly, increasing by as much as 19 percent in 2006-07. To curb inflation and contain aggregate demand, SBP has opted to raise interest rates sharply in the economy. Whether this will contain aggregate demand hinges crucially on the nature of fiscal policy measures in the federal budget of 2008-09. If the fiscal deficit is brought down sharply and less reliance placed on borrowing from the Central Bank then monetary and fiscal policies could reinforce each other not only in restoring confidence but

also in containing inflation.

3) ***Sustain Medium-Term Growth.*** The contractionary monetary and fiscal policies required for stabilization can temporarily at least imply some loss of growth. The process of adjustment, should, to the extent feasible, rely on measures that do not suffocate growth due, for example, to sharp increases in tax rates or a precipitous fall in the level of development expenditure. Also, the fiscal deficit has to be financed in a way that does not significantly 'crowd-out' the private sector.

4) ***Achieve redistribution.*** Recent research on poverty consequences of the current economic situation undertaken by IPP (2008) shows that whatever gains in poverty reduction were achieved in the earlier part of the decade have largely been washed out. "The evidence shows that after a decline in poverty during the period, 2000-01 to 2005-06, the poverty levels have increased to neutralize the earlier gains, as food inflation accelerated and GDP growth declined. The central policy lesson of the economic performance during the last eight years is that poverty levels increased in spite of high GDP growth in later years because of the fact that growth was heavily tilted in favor of the rich and high food inflation was not controlled. The analysis highlights the importance of controlling food inflation and at the same time bringing about the institutional changes necessary for pro-poor growth".

   As the process of adjustment continues, vulnerable groups are likely to be further burdened. Therefore along with achieving stabilization, the budget for 2008-09 will also have to focus on a package of relief for the poor. There is need to ensure that the aggregate demand management of the economy and the withdrawal of subsidies does not lead to a sharp rise in poverty. Strong social safety nets will have to be put in place to ensure that there is adjustment with a human face. In particular, food security of the poor will have to be protected to avoid a big fall in nutrition levels. This can best be achieved by a combination of various types of social safety nets so that different categories of vulnerable groups are adequately targeted. Currently, Pakistan is spending only about 0.1 percent of GDP on various social safety net programs. There clearly is a strong case for increasing this proportion manifold.

4. The Fiscal Outlook for 2008-09

Turning to the budget of 2008-09, Table 4 presents the budgetary estimates:

Table 4
Budgetary Estimates for 2008-09

(Rs. in Billion)

		2007-08 (Revised)	**2008-09 (Budget)**
	Current Expenditure (Federal)	1516.3	1493.2
Minus	Repayment of Foreign Loans	61.7	96.2
	Current Expenditure (Excluding Repayments of Loans)	1454.6	1397.0
Plus	Development Expenditure (PSDP) (Federal + Provincial)	431.8	516.6
Minus	Net Revenue Receipts (Federal)	941.8	1110.9
Minus	Self-Financing of PSDP by Prov.	129.8	124.4
Minus	Recovery of Loans from Prov.	25.4	16.2
Minus	Provincial Surplus	32.6	78.9
Minus	Net Lending to Others	23.0	1.0
	FISCAL DEFICIT	733.9	582.3
	as % of GDP	**7.0**	**4.7**

The sharp reduction in the fiscal deficit to 4.7 percent of GDP is predicated on a reduction in current expenditure of 4 percent and a big jump in net revenue receipts of 18 percent. Consequently, even with the large deficit reduction, there appears to be scope for increasing the overall PSDP of the federal and provincial governments combined by almost 20 percent.

One of the major failures of the Budget is the lack of quantification and setting of targets for savings in non-salary expenditure of ministries, divisions and departments. This is a major area where economy could be exercised especially in light of the extravagance and waste that has characterized public spending during the last five years when significant ‘fiscal space’ emerged in the Budget.

The Finance Minister has indicated that the government proposes to ban the purchase of motorcars, airconditioners and other office equipment. Also, freezing of non-development, non-salary expenditure will take place at the 2007-08 level. It is indeed unfortunate that the Finance Minister had to indicate that this policy could not be reflected in the preparation of the Pink Book (relating to the demand for grants and appropriations). As presented currently, no government entity has followed the example set by the Prime Minister of taking a cut of 40 percent in the costs of his Secretariat. The government must try to achieve a minimum saving of Rs 50 billion in non-salary expenditure in 2008-09 from the estimates currently presented in the budget if a true commitment to 'austerity' is to be demonstrated to the people.

Beyond this, we believe that the budget estimates from 2008-09 include same overstatement of revenues and a substantial understatement of expenditure. IPP estimates for 2008-09 under different heads are as follows:

Tax Revenues: Budget estimates show a high growth rate of 25 percent. This does not include normally the impact of taxation proposals (discussed in Section 7). However, the tax-to-GDP ratio has largely remained constant during the last few years. Therefore, the normal growth in tax revenues would be about 17.5 percent in line with the expected growth of nominal GDP next year. We attribute the higher growth to the additional revenue likely to be generated from the taxation measures announced by the Finance Minister.

Interest Payments: Interest payments are expected to increase from Rs 502 billion to Rs 523 billion, showing a modest growth of only 4 percent. As in the last two years, there is the likelihood of a significant understatement of this expenditure, especially since domestic debt is likely to increase by over 20 percent this year in view of the large fiscal deficit. Also, interest rates are on the rise and the return on national savings schemes has been enhanced. The hump of maturity of Defence Savings Certificates continues next year. Overall, we estimate that interest payments in 2007-08 may be underestimated by least Rs 60 billion in 2008-09.

Salary Increase: The Finance Minister has announced the following increases in pay and allowances of government employees:

a) A 20 percent increase in basic pay is proposed to all Federal Government employees with a similar increase also for defence services.
b) A 20 percent increase in net pension is proposed for all civilian and defence pensioners.
c) Minimum pension increased from Rs 300 to Rs 2000/-.

d) 100 percent increase in conveyance allowance, for government employees from BS-1 to BS-19.
e) Medical allowance for BS-1 to BS-16 increased from Rs 425/- to Rs 500/- per month.
f) Increase in minimum wages level from Rs 4600/- to Rs 6000 per month.

The impact of these increases in pay and allowances has not been incorporated in the current expenditure estimates for 2008-09. Based on the figures contained in the *Demand for Grants and Appropriations* we estimate that the pension and salary hike will add about Rs 15 billion to defence expenditure and Rs 20 billion on the civilian side at the federal level. The additional cost to the four provincial governments could approach Rs 30 billion, thereby reducing the provincial surplus accordingly.

PSDP: The combined PSDP of the four provincial governments has been projected at Rs 150 billion. But the provincial governments of Punjab, Sindh and NWFP have already announced PSDPs of Rs 160 billion, Rs 77 billion and Rs 41 billion respectively. Therefore, the combined PSDP of the four provinces could exceed Rs 290 billion, which is Rs 140 billion more than the size mentioned in the budget documents.

Subsidies: The budget proposes a significant reduction in the subsidy bill from Rs 407 billion in 2007-08 to Rs 302 billion in 2008-09. As discussed in Section 6, there are limits to the extent to which the subsidy, especially on oil and wheat, can be reduced in the short run. As such, we project that the cost of subsidies could be almost Rs 100 billion higher and approach the level attained in 2007-08. Also, if the R&D support to the textile sector is restored then this would involve an additional outlay of upto Rs 45 billion.

TABLE 5
IPP Estimates of Understatement of Expenditure in Budget of 2008-09

	(Rs. in Billion)
Interest Payments	50
Salary Bill:	
Federal	35
Provincial	30
Subsidies	145
PSDP	140
Total	**410**
Less Saving in Non-Salary Exp	-50
Net Total	360

Overall, we believe that the level of expenditure, current and development, could exceed the budget estimates for 2008-09 by almost Rs 360 billion, as shown in Table 5. *This implies that the fiscal deficit in 2008-09 could rise substantially beyond the projected level of 4.7 percent of the GDP to almost 7.5* *percent of the GDP.* In this scenario, there will be no fiscal adjustment and the fiscal deficit will remain very high. Of course, in this case, efforts will be made to scale down the PSDP to the budgeted size.

5. Financing of the Budget Deficit

An important reason why the country is in the grip of high inflation is that a large proportion of the deficit was financed by borrowing from the State Bank of Pakistan. In 2007-08 government borrowing from SBP will reach 455 billion, approaching 4.3 per cent of GDP. This type of financing does not crowd-out the private sector through preemption of capital and therefore, is considered more conducive to growth, but by adding to the stock of reserve money strongly expands money supply and increases inflationary pressures.

Table 6
Financing of the Deficit
(Rs. in Billion)

	2007-08		2008-09
	Budgeted	Revised	Budgeted
Financing of the deficit	**398.8**	**733.9**	**582.3**
Non-bank Borrowings	49.7	115.9	259.3
Share (%)	12.5	15.8	44.5
Bank Borrowings	193.1	192.3	148.8
Share (%)	48.4	26.2	25.6
Privatization Proceeds	75.0	1.7	25.1
Share (%)	*18.8*	*0.2*	*4.3*

What is the proposed deficit financing strategy in the 2008-09 budget? Initial indications are that the government proposes to adopt a more balanced strategy of financing in 2008-09. Subject to containment of the deficit to 4.7 percent of the GDP, it has budgeted a decline in borrowings from SBP to Rs 149 billion in 2008-09. Simultaneously the government has announced an enhancement in the return on National Saving Schemes (NSS) of 2 percentage points to increase inflow to almost 2 percent of the GDP, from the current level of Rs 116 billion to Rs 259 billion in 2008-09, as shown in Table 6.

Therefore, if the fiscal deficit is successfully brought down sharply, then borrowing proposed from SBP is within “safe limits” of just over 1 percent of GDP, and this level of deficit financing will not be significantly inflationary in nature. However, if the budget deficit is substantially higher as projected in the previous section, as per IPP’s estimates, then borrowing from SBP could once again approach 4 percent of GDP, thereby perpetuating and even intensifying inflationary pressures in the economy. Also, a roughly 20 percent increase in the return on NSS is expected to induce more than doubling of inflows, which appears optimistic. The returns on NSS will have to be reviewed periodically in 2008-09 to determine if further enhancements in returns is necessary or not.

We turn next to the two key areas of action in the Budget, first, the proposed big reduction in the subsidy bill and, second, the incremental resource mobilization effort.

6. The Reduction in Subsidy Bill

As mentioned earlier, the linchpin of government's fiscal adjustment strategy is the reduction in subsidies. Altogether, the subsidy bill is projected to fall by over Rs 105 billion. The government's commitment to reduce subsidies is reflected in the Finance Minister's budget speech, which states *"there is an unbearable burden of subsidies currently carried by the budget. Much of it is unintended and benefiting such groups who are neither needy nor should they be subsidized. It is estimated that at present more than Rs. 400 billion are provided in subsidies of all kinds from the budget. A detailed pruning of subsidies is, therefore, necessary and inevitable to preserve country's finances."*

Which are the subsidies that the government is proposing to prune and what are the likely implications on prices? Table 7 presents the subsidy levels proposed and the level of reduction compared to the 2007-08 level. As shown in the table, the government proposes to reduce subsidy to oil refineries/ oil marketing companies (OMCs) from Rs 175 billion to Rs 140 billion, a decline of 20 percent. If such a decline was not proposed, the oil subsidy for 2008-09 is projected to be Rs 350 billion. 95 percent of subsidy is on high speed diesel (HSD) and 5 percent on kerosene and light diesel oil (LDO). Since the budget proposes to bring down the oil subsidy bill to Rs 140 billion, this will require a decrease in subsidy of Rs 210 billion from the projected level, which tantamounts to an increase early in 2008-09 of over Rs *20 per litre in price of HSD* (on the assumption that price of kerosene & LDO is unchanged). This implies an increase of 40 percent in HSD price on the back of 33 per cent increase since March 1, 2008. Overall, therefore, the price may have to raised by almost 86 percent from Rs 37.73 to 70.13 per liter during the calendar year, 2008.

Table 7
Reduction in Subsidy Bill in 2008-09
(Rs. In Billion)

	2007-08 (R)	2008-09 (P)	% Change
WAPDA	113.7	74.6	-34.4
KESC	19.6	13.8	-29.6
Import of Wheat	40.0	20.0	-50.0
Utility Stores Corporations	1.8	2.7	50.0
Oil Refineries/OMCs	175.0	140.0	-20.0
R&D Support to Textiles	19.0	0.0	-100.0
Fertilizer Import Subsidy	29.5	42.0	42.4
Others	8.9	9.1	2.2
Total	**407.5**	**302.2**	**-25.8**
% of GDP	**3.9**	**2.4**	**-1.5**

A big increase in the price of HSD will raise transport costs and consequently the prices of food items and construction materials as well as road and railway fares. Obviously, the measure is likely to hit the lower income groups disproportionately, and therefore, will be regressive in incidence. Reactions to higher fuel prices are currently being witnessed both in developed and developing countries in the form of strikes and street protests. The big question is whether the government will be able to successfully orchestrate such a big price hike, especially in HSD. It appears more likely that a modest price increase will be implemented gradually in 2008-09. This will make it difficult to achieve the large target of oil subsidy reduction.

The implications of other reductions in subsidy bill are also likely to be inflationary in character. The subsidy on import of wheat is being halved from Rs 40 billion in 2007-08. This implies a reduction in subsidy of Rs 15 per kg on imported wheat, with the likelihood of an impact on the retail price. Likewise, the proposed reduction in WAPDA and KESC subsidies is 34 per cent and 30 percent respectively. These reductions imply electricity tariff increases in 2008-09 of 25 to 30 percent. The budget also assumes no R&D support to textile sector. Is this being withdrawn? There is no clear policy statement by the government on the export promotion strategy in the Budget. Altogether the strategy of large subsidy reduction is fraught with political and economic risks. This will be a crucial element in determining the degree of success in attaining the budgetary targets in 2008-09.

7. Resource Mobilization Strategy

In the 2008-09 Budget, government proposes to significantly raise its revenues from Rs 1000 billion to Rs 1250 billion, implying an increase of about 25 percent. As compared to this, growth in revenues last year was 18 percent. Clearly the government intends to make a big effort at additional resource mobilization this year (see Table 8). The government estimate of enhancement in direct taxes in the coming year is of Rs 111 billion. Our assessment is that this is an ambitious target and may not materialize. As compared to this, targeted revenue increase from sales tax of about Rs 97 billion appears achievable, so do the targets for customs and excise duties.

Table 8
Tax Revenue Projection for 2008-09

(Rs. in Billion)

	2007-08	2008-09	Comment
Direct Taxes	385.0 (15.3)*	496.0 (28.8)	Difficult
Customs	148.0 (12.1)	170.0 (14.9)	Achievable
Sales Tax	375.0 (21.4)	472.0 (25.9)	Achievable
Federal Excise	92.0 (27.8)	112.0 (21.7)	Achievable
FBR Total	**1000.0** (18.1)	**1250.0** (25.0)	
% of GDP	**9.5**	**10.0**	

***Figures in brackets are annual growth rates.

The Budget proposes a significant additional resource mobilization effort. The revenue generating potential of the taxation proposals is estimated at about Rs 75 billion (see Table 9). The big revenue proposals are the enhancement in import duty rates on luxury items and the sales tax rate from 15 to 16 percent. Both proposals can potentially raise Rs 25 billion each. Enhancement in excise duty rates on goods and services and in withholding income tax rates together can mop up an additional Rs 25 billion.

Table 9 Major Taxation Proposals and Fiscal Incentives/Breaks in 2008-09 Budget	
	Estimated Revenue Impact (Rs. in Billion)
TAXATION PROPOSALS	**75**
Import Duty Enhancement in Import Duty from 25% to 35% on luxury items and by 10% on luxury cars	25
Sales Taxes Enhancement of rate from 15% to 16%	25
Excise Duty Enhancement in tax rates on telecommunication services, cement, motor cars, banking and insurance, etc.	15
Income Tax Enhancement in Withholding Taxes on electricity bills, phone bills, cash withdrawals, etc.	10
INCENTIVES AND RELIEFS	**-9**
Income Tax Enhancement in Exemption Limit	-3
Sales Tax Exemption of Fertilizers and Pesticides	-6
Net Revenue	**66**

Besides mobilizing additional revenues, the budget also proposes some tax breaks, especially fiscal incentives to promote agriculture and provide relief to lower income salary earners. These will cost the exchequer Rs 9 billion. Therefore, overall the net additional resource mobilization effort proposed is Rs 66 billion, close to 0.5 percent of the GDP.

A look at the resource mobilization strategy proposed in the budget leads to some conclusions. First, 86 per cent of the additional revenue is proposed to be generated from indirect taxes – 33 percent from import duty, 33 percent from sales tax, and 20 percent from excise duty. Second, virtually all the additional revenue mobilization is from enhancement in tax rates, rather than broadening of tax bases. Finally, most of the additional revenue in income tax is from enhancement in withholding tax rates. This represents a retreat from promotion of voluntary compliance by taxpayers.

The resource mobilization strategy adopted by the government, as such has some clear implications. While the government deserves credit for proposing a significant fiscal effort, of about 0.5 percent of GDP, its strategy is not only regressive, but also inflationary. In a period of spiraling inflation and rising inequality, the government may have demonstrated more sensitivity to the potential impact of the taxation proposals and focused more on taxing the undertaxed sectors and tax payers with greater ability-to-pay.

8. Overall Assessment of Budgetary Impact

Based on the above, we are in a position to make an initial assessment of the impact of the proposed budget on the key objectives enunciated in the Section 3, as follows:

Stabilisation: The government proposes to bring down the fiscal deficit from 7 percent of the GDP in 2007-08 to 4.7 percent in 2008-09. This represents a sizeable adjustment of over 2 percent of the GDP. But the budgetary outcome is characterized by a high level of risk and uncertainty. Not only are the revenue targets ambitious in the context of an economy which has slowed down perceptibly but the sharp containment required in expenditure, especially on subsidies, will be difficult to achieve politically and otherwise. There is a fairly high probability that the budget deficit could be significantly higher, even approaching 7.5 percent of the GDP. If this happens then the level of aggregate demand will remain high, if not compensated for by an even more draconian monetary policy, and pressure will persist on the external balance of payments of the country, leading to a further drawdown of the foreign exchange reserves and exchange rate depreciation.

Inflation: If the target of fiscal deficit of 4.7 percent of the GDP is achieved then the degree of ‘monetisation’ of the deficit and the inflationary consequences thereof are limited. But if the deficit rises significantly then there is the likelihood that at the margin there will have to be increased resort once again to borrowings from SBP, thereby putting pressure on monetary aggregates and fuelling inflation further.

Also, the direct consequences of the budget on the price level in the form of the hike in indirect tax rates and withdrawal of subsidies are substantial. The rise in salaries and allowances will contribute to the wage-price spiral. It appears that while inflation historically has been due more to ‘demand-pull’ factors, it will increasingly acquire a ‘cost-push’ character, especially due to higher fuel and energy prices. The government recognizes the possibility and has targeted for an even higher rate of inflation in 2008-09 of 12 percent.

Growth: It is reassuring that at least in the initial Budget statement the federal and provincial governments are proposing substantially larger PSDPs than in 2007-08. This will not only preserve the growth momentum but provide for sustained growth in the medium run. But if there is failure during 2008-09 in containing current expenditure then there is very likelihood that the PSDPs will be slashed by perhaps as much as 25 to 30 percent.

The strong positive aspect of the budget is the high priority being attached to revival of the growth process in the agricultural sector, especially through cheapening the cost and improving access to inputs. These measures could be instrumental, alongwith higher prices, in helping the sector achieve a growth rate of 4 percent in 2008-09.

However, the industrial sector and manufactured exports appear to have been largely ignored in the budget, although some incentives have been provided for investments in power to alleviate the existing energy constraint on production. The implicit decision to withdraw the R&D support to the textile sector at this time is problematic in character. Although export profitability has probably improved significantly due to the sizeable depreciation of the rupee, textile exporters face stiff competition in international markets and are operating with a series of handicaps like relatively high interest rates, power load shedding, import margin requirements, etc. At a time when Pakistan desperately needs to boost exports to contain the large trade deficit, withdrawal of the R&D support may be an ill-advised move. A better strategy might have been to gradually phase out the withdrawal over a period of, say, three years. Therefore, success in achieving the manufacturing sector growth targets of over 8 percent in 2008-09 will hinge on how well the textile sector performs.

Redistribution: The government must be complimented for presenting a substantial relief package in the budget for the poor. This includes the introduction of a cash transfer of Rs 1000 per month per household through the Benazir Income Support Program, initially to about 3 million households. In addition, the government proposes to initiate or continue with other programs like the People’s Works Program, National Internship Program and People’s Rozgar Program. However, it is important to ensure that there are enough financial resources and that targeting of the poor through these programs is done efficiently.

But while some redistribution is being attempted on the expenditure side, the taxation system is moving in a regressive direction. Of particular concern is the decision to raise the standard GST rate from 15 percent to 16 percent which will increase the burden of taxation on basic consumer goods like sugar, ghee, tea, etc. A better option would have been to tax undertaxed sectors, especially rapidly growing services consumed by the well-to-do and corporate entitles.

Overall, the budgetary impact on key macroeconomic magnitudes is unclear at this time due to the considerable uncertainty that exists about successful implementation of policies proposed in the budget. In the best case scenario, we could see significant stabilization of the economy but in the more plausible scenario the deficit could remain high, inflationary pressures could even intensify in the economy and Pakistan could move to the brink of a financial crisis, especially if political stability remains elusive over the next few months.

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