ISAS Insights
No. 33 – Date: 9 July 2008

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The First Budget by the New Coalition Government in Pakistan: Economic Situation and Policy Directions

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The troubled coalition government passed its first federal budget (Fiscal Year 2008-09)[2] on 22 June 2008, after being in office for a hundred days, amid growing economic woes, political instability, and a deteriorating law and order situation. This paper analyses the budget in a broader macroeconomic framework and examines the policy initiatives that could put the economy back on track and provide the much needed relief to the common man.

This is the first budget presented jointly by two major rival parties, the right-centre, the Pakistan Muslim League Nawaz (PML-N), and the left-centre, the Pakistan People's Party (PPP). Despite the fact that the PPP, the leading coalition party, is perceived as a populist party and the PML-N as pro-business, there are no major differences, if at all, between the two on the economic front. Moreover, their economic policies do not differ from the previous government. Consequently, the budget is, by and large, a continuation of the policies set forth by the previous government. However, the budget has been overshadowed by the overall macroeconomic challenge of slowing growth, soaring inflation and widening fiscal and current account deficits.

> *The PPP has come a long way to believe in "private sector as engine of growth", "open markets", and "deregulated, decentralised and privatised economy"; since sweeping away its first elections in 1970 with an agenda of establishing a "socialist order" (by "nationalising all major industries", while "accepting the possibility of existence of a private sector").*

Following the 18 February 2008 polls, the new government was faced with a political and economic crisis, along with a deteriorating law and order situation. The year 2007 saw Pakistan suffering from chaos and economic abyss, starting with the judicial crisis in March 2007, growing terrorist acts in urban areas, emergency rule, and the assassination of the PPP's leader, Benazir Bhutto. Besides domestic issues, global developments such as the slowdown in the United States' economy, the liquidity crisis, and soaring oil and primary commodity prices, also added to the Pakistan's economic woes, given the historical vulnerability of the country's economy to external shocks.

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2 The fiscal year in Pakistan starts from 1 July and ends on 30 June.

Budget Highlights

Against all odds, Pakistan's economy has once again shown extraordinary resilience. The FY2007-08 registered a respectable 5.8 percent gross domestic product (GDP) growth, though far below the target of 7.2 percent, and the actual growth rate of 6.8 percent in FY2006-07, pulling down the seven percent average GDP growth of the last four years.[3] Other macroeconomic indicators also showed a reverse trend.

Explaining the troubled economic situation, the Finance Minister, Syed Naveed Qamar, charged the previous government of "policy inaction" in the face of economic crisis shifting the "brunt of all ills that were associated with these crises" to the current government. Nevertheless, he acknowledged the economic achievements of the outgoing administration, alluding it to the "windfalls of the aftermath of 9/11", an apparent hint to the increased formal remittances and a sizeable support, both in kind and in cash, from the partners in the "war on terror".[4]

> ***The Targets***
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> *The budget FY 2008-09 presents a "long term perspective" in the backdrop of the following "key assumptions about the macroeconomic conditions" in the year ahead:*
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> - *The GDP will grow by 5.5 percent in the year 2008-09.*
> - *Inflation will be contained at 12 percent.*
> - *Gross investment to GDP ratio will be maintained at 25 percent.*
> - *The fiscal deficit will be contained to 4.7 percent.*
> - *The current account deficit will be reduced to six percent of the GDP.*
> - *Foreign exchange reserves will be increased to US$12 billion.*

The total outlay is estimated at Rs.2,010 billion (US$29.55 billion),[5] a 7.4 percent increase from Rs.1,871 billion last year. The budget includes development spending of Rs.550 billion (US$8.08 billion), as compared to a revised spending of Rs.458 billion last year. This reflects a 20 percent increase. Keeping in view the worsening domestic and international economic situation, it would have taken extraordinary structural initiatives to make the current budget "poor-friendly". Nevertheless, the budget announced some meager populist measures, such as the Rs.34 billion (US$500 million) "Benazir Income Support Program"; and the Rs.28 billion (US$411 million) "People's Works Program", along with a 20 percent increase in basic pay of all federal and defence personnel with a similar increase in pensions.

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3 The data in this paper, unless otherwise stated, is from the "Economic Survey of Pakistan, FY 2007-08", "Finance Minister Budget FY 2008-09 Speech", and "Budget FY 2008-09 in Brief". These three documents are published by the Ministry of Finance, Government of Pakistan. They are available online at http://finance.gov.pk/admin/images/budget/budget[1].pdf.

4 a) Pakistan received US$10 billion from the United States since 9/11, though two-thirds of this amount is reimbursement payments for the expenses of 100,000 troops deployed on the Pakistan-Afghanistan border.
b) The International Financial Institutions rescheduled Pakistan's debt after it joined "the war on terror" in the aftermath of 9/11. Similarly, the military assistance given to Pakistan for being a major non-North Atlantic Treaty Organization (NATO) ally reduced pressures on the domestic resources. Pakistan's Paris Club debt of US$12.5 billion was rescheduled in 2002. In April 2003, US$1 billion American bilateral debt was written-off. This is a clear signal for the capital markets that Pakistan is "too important to default" for geo-strategic reasons.
c) In another development, increased economic activity was witnessed, particularly in the transport, construction and commodity sectors, due to the supplies to NATO's International Security Assistance Force in Afghanistan.

5 By current interbank rates, Rs.68 = US$1. The June 2008 average was Rs.67.50.

However, these measures are undermined by the two most important policy changes; one, the phasing out of several subsidies, including petroleum, electricity, textile and food, which currently amounts to Rs.407 billion (US$6 billion); and second, a blanket increase in the General Sales Tax from 15 to 16 percent. Both these measures are bound to add to the existing double-digit inflation in the short-run, irrespective of the distortive character of subsidies and long-run benefits of doing away with them.

Another major policy shift in the current budget was the discussion over defence spending in the National Assembly for the first time since the defence budget was classified in 1965. Despite Prime Minister Gillani's veiled promise to "freeze the defence budget at current levels", the actual defence budget jumped seven percent to Rs.296 billion (US$4.35 billion) from last year's Rs.277 billion. Nonetheless, as compared to last year's 11 percent increase, this is a welcome move.

The budget seeks to restore economic stability, growth momentum and investor's confidence by fiscal austerity; increasing agriculture and manufacturing productivity and competitiveness; spurring infrastructure development; reducing current account deficit; increasing revenue generation; and building up foreign exchange reserves while focusing on higher exports, employment generation, and increased social spending for a "meaningful change" in the social indicators.

However, the targets ("assumptions") actually reveal the limited space for maneuverability for the government in the face of evolving structural changes and external shocks. The targets, to begin with, are very modest, which, even if met successfully, would only slightly decelerate the economic downturn. But more significantly, many of the rhetorical measures adopted could simply fail in the face of waning state capacity to execute these policies.

The Twin Deficits: Impact of International Energy and Food Crisis

The fiscal deficit grew to seven percent of GDP, with an equally large current account deficit, against the target of 4.7 percent in FY 2007-08.[6] Both the deficits are largely due to international oil and commodity price hikes; apart from less than targeted revenue collections and export growth.[7]

A lack of appropriate demand estimation and price foresight on the previous government's end contributed to the wheat crisis earlier this year. The government allowed wheat exports

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6 The current account deficit is expected to be well above 7.3 percent of GDP far above the targeted five percent, a 40 percent increase from the previous year. This was a direct result of 28 percent increase in imports, fuelled by strong demand and high oil prices, and only 7.6 percent increase in exports, far below the target of 12.9 percent but still impressive as compared to last year's three percent. Nonetheless, the adverse effect on overall balance of payments was cushioned by an impressive growth in remittances. Remittances grew by 19 percent, totaling US$5.9 billion (July 07-May 08).
Note: The impact of the rising current account deficit on the balance of payments was further compounded by capital outflows and delays in the planned floatation of a sovereign bond. Subsequently, the exchange reserve buildup began to shrink from US$16.5 billion in October 2007 to less than US$11.2 billion at the end of May 2008. The Rupee depreciated against the United States dollar by 6.4 percent between July 2007 and April 2008, despite the United States dollar's own depreciation against major currencies.

7 Oil prices surged from US$55 per barrel in January 2007 to US$140 per barrel in May 2008, a jump of more than 155 percent. Similarly international food price index increased by roughly 40 percent in 2007 and, in the first three months of 2008, prices rose by about 50 percent. The prices of rice, wheat and palm oil have also increased by 78 percent, 120 percent and 102 percent respectively between April 2007 and April 2008. (Islam 2008; "Of Agflation and Agriculture")

when prices were still low in June last year, only to be imported again at much higher prices earlier this year. Food and petroleum contributed to two-thirds of the increase in import bill.[8]

However, much of this increase in import bill was borne by the government in the form of subsidies, resulting in a large fiscal deficit. The outgoing administration funded deficit through borrowings from the central bank – the State Bank of Pakistan (SBP).[9] The result was compounded inflation, making monetary management difficult.[10] Inflation was precisely the reason, in the first place, for not passing the burden to the consumer.

The experts are convinced that energy and food prices will stay higher than their current levels in the foreseeable future. Therefore, it is imperative for the governments, as well as international institutions, to formulate policies for long-term solutions. [11]

The current government, upon assuming office, has adopted a multi-pronged strategy to tackle the challenges. In the long-run, subsidies on petroleum and food will be phased out and resources will be enhanced through increased productivity, infrastructure development and a shift towards other alternatives of oil. In the short run, a tight monetary policy, foreign assistance and borrowings are the only options. As a first move, the government has sought

The Way Forward

- *Phasing out subsidies on petroleum and electricity.*
- *Further shift towards natural gas for transportation and electricity generation.*
- *Exemption from tax and custom duty for energy saving equipment/CNG buses.*
- *Accelerated efforts to import natural gas and build dams, in addition to increasing domestic exploration and production.*
- ***Inviting foreign investments in the farm sector.***
- ***Large tracts of land will be made available to foreign investors to induct capital and technology.***
- *Exemption from sales tax and other duties on imported and local supply of fertilizers, pesticides and machinery.*
- *Exemption from the 10 percent custom duty on import of rice seeds.*
- *Availability of farm credit on easy terms.*
- *Increased subsidy on fertilizer from Rs.25 billion to Rs.32 billion.*

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8 Pakistan imported 80 percent of its 127.75 million barrels of oil in FY2006-07, constituting 27 percent of its import bill. Petroleum imports grew by 41 percent between July 2007 and May 2008 to reach US$9.39 billion, as compared to US$6.63 billion over the same period last year. Food and dairy imports grew by 45 percent to US$3.28 billion from July 2007 to May 2008, as compared to US$2.26 billion over the same period last year, mainly due to wheat and palm oil.

9 "Interim Monetary Policy Measures", State Bank of Pakistan, May 2008, p. 10. http://www.sbp.org.pk/m_policy/MPS-MAY-FY08-EN.pdf.
Note: a) The subsidies increased from a provision of Rs.114 billion (US$1.67 billion – 1.1 percent of GDP) in last year's budget to Rs.407 billion (US$6 billion – 3.9 percent of GDP). As much as Rs.551 billion (US$8.10 billion - up to May 2008) has been borrowed from the Central Bank against the full year budgeted estimate of Rs399 billion (US$5.86 billion), which is unprecedented in the country's history.
b) The shortfall in external financing receipts due to tight liquidity and strong credit demand made it difficult for the government to mobilise substantial amounts through treasury bills, which could have eased up inflationary pressures.

10 Consumer Price Index (CPI) inflation soared to 10.8 percent in May 2008, as compared to 7.8 percent last year on a 12-month moving average. The highest rise was registered in May 2008 when CPI inflation jumped to 19.3 percent on year-on-year basis, while food inflation touched 28.5 percent during the same month – the highest in three decades.

11 Islam, M. Shahid, "Of Agflation and Agriculture: Time to Fix the Structural Problems", ISAS Insight No. 30, 5 May 2008 - Quoted International Monetary Fund. http://www.isasnus.org/events/insights/31.pdf.

Saudi Arabia's support for the deferred payments on oil, a one-time US$300 million waiver, and future help in building strategic oil reserves.

Monetary Stance

The SBP, in a knee-jerk reaction to the mounting pressures, tightened its monetary policy in the last week of May 2008, the second time within four months.[12] In addition, to manage the exchange rate effectively and to stabilise the volatile stock exchange, the SBP introduced new regulations.[13] Despite the fact that the current inflationary pressures are largely due to higher government borrowings, a monetary response alone is not enough, given the lag between monetary adjustments and the real economy's response. Moreover, a tight monetary policy is likely to affect only non-energy-non-food inflation at the cost of growth. Therefore, government's decision to phase out subsidies and other announced initiatives point towards the right direction.

Fiscal Developments

The tax revenue collection fell substantially short of its targets last year. The budget aims to raise tax revenues by 25 percent in the year ahead.[14]

Pakistan's tax-to-GDP ratio has stagnated at about 10 percent in the last decade, as compared to 17 percent average of developing countries. The previous government embarked on a large-scale reform agenda but remained unsuccessful in raising the tax-to-GDP ratio to any significant level. Despite a 20 percent annual increase in the number of tax payers in the last three years, less than two percent of the population pays tax, among the minimum in the region. There is a dire need to broaden the tax base. However, how the government tackles this problem has not been described in any specific terms.

On the contrary, the current budget plans to raise direct taxes ostensibly to balance the "mismatch" between direct and indirect taxes, since the latter make up 62 percent of total taxes. As a first step, the government has withdrawn 35 different income tax exemptions, in addition to introducing a

Direct Taxes

- ***Withdrawal of 35 income tax exemptions.***
- *A liberal "Investment Tax Scheme" whereby taxpayers can voluntarily declare assets and pay two percent on their market value.*
- *The lower bracket for tax exemption raised by 20 and 30 percent for salaried men and women taxpayers respectively.*
- *A progressive 5 to 15 percent tax on property income rather than the existing fixed five percent.*
- *A Rs.100 per square foot tax on real estate developers.*

Indirect Taxes

- *Increase from 15 – 25 percent import duty on luxury items to 30 – 35 percent.*
- *Increase from 90 to 100 percent custom duty on luxury vehicles.*
- ***Increase in the sales tax from 15 to 16 percent.***
- *Increase in the Federal Excise Duty on telecommunication services from 15 to 21 percent and on banking, insurance and franchise services from 5 to 10 percent.*

12 The SBP has raised its lending rate by 1.5 percentage points to 12 percent and the cash reserve ratio requirement by one percentage point to nine percent for all deposits with a maturity of more than 12 months.

13 For details of regulations see "Interim Monetary Policy Measures", State Bank of Pakistan, May 2008. http://www.sbp.org.pk/m_policy/MPS-MAY-FY08-EN.pdf

14 To Rs.1,250 billion (US$ 18.38 billion) from Rs.1,000 billion (US$14.70 billion) in FY 2007-08.

progressive property tax. On the other hand, import duty on luxury items has also been raised along with a one percent increase in sales tax. Resultantly, any proportional change is unlikely to transpire. The measures essentially mean an increased tax burden rather than an emphasis on broadening the tax base.

In addition to increasing revenue, the government targets to reduce expenditure substantially by phasing out subsidies and drastic cuts on non-development, non-salary expenditure, along with freezing the defence budget.[15] However, reining in expenditure could prove difficult as the need for large infrastructure investments and on-going large scale administrative reforms would require extra resources.[16] Moreover, besides political costs, the plans for a phased end to subsidies will not be trouble free. For example, the big business lobby in the textile sector has already made inroads to avail Rs.30 billion discriminatory subsidies, without any such provision in the current budget.[17]

On the other hand, public debt, which was brought down to 55 percent of GDP at the end of FY2006-07 from 85 percent in 2000, has started to grow due to a sharp depreciation of the rupee vis-à-vis the United States dollar, besides the twin deficits. This trend is likely to continue as the current government would have to bear the brunt of increased interest payments, payments on maturity of the sovereign bonds, and Paris Club payments.[18] The privatisation proceeds are also likely to decline. Although the budget announces 10 percent shares for the workers of privatised enterprises, the government still runs into the danger of a political backlash during the process.[19]

To finance the debt and deficit, following the footsteps of the outgoing administration, the current government plans to introduce different short-term sovereign bonds and to encourage global depository receipts (GDRs) by public (and private) entities. It also plans to increase interest rates on national saving certificates.[20] These steps intend to curtail borrowings from the SBP, which reached "alarming levels".[21] However, the recent degrading of Pakistan's credit ratings by Moody's and Standard & Poors (S&P), and looming political and economic uncertainties have already eroded investor confidence, making it difficult for the coalition government to pursue such policies with greater success.[22]

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15 Some of the proposed measures include ban on purchase of assets, and budgetary cuts for the Prime Minister Secretariat, National Assembly and Senate.

16 The revised total expenditure for FY2007-08 stands at Rs.2,228.9 billion (US$32.77 billion), actually budgeted at Rs.1875 billion (US$27.5 billion).

17 "ECC set to grant Rs30bn subsidy to textile sector", Pak Tribune, 1 July 2008, http://www.paktribune.com/news/index.shtml?202627

18 The oversubscribed US$500 million Eurobond will mature in 2009 and Sukuk will mature in 2010. Moreover, The Paris Club payments that were rescheduled in 2002 will be due in 2009.

19 The privatisation proceeds stand at Rs.1.65 billion in FY2007-08 against the actual target of Rs.75 billion. All the public entities, which were privatised, witnessed workers strikes in which the PPP trade unions played an active role. Pakistan Telecommunication Corporation Limited incurred huge costs in laying off workers after Dubai-based Etislat purchased 26 percent shares. The privatisation of Pakistan Steel Mills was stopped by the Supreme Court on charges of a non-transparent process.

20 The previous government launched controversial sovereign bonds (Euro 2004, Sukuk 2005) and a number of GDRs by public and private entities, to raise capital from international markets.

21 The SBP also advised the government to amend the *Fiscal Responsibility and Debt Limitation Act 2005* to disallow borrowings from the SBP. The law introduced greater fiscal discipline and transparency along with guidelines on social sector spending.

22 Both Moody's and S&P cut Pakistan's credit ratings to five levels below investment-grade from B1 to B2. Though Moody's maintained a stable outlook, S&P, however, opted for a negative outlook. Moody's report read; "weak governance, political tensions and flaws in the legal system will undermine institutions…sharply widening [twin] deficits … are reversing a multi-year trend of fiscal consolidation and

Growth and Investment

A dismal performance of the agriculture sector significantly contributed to a lower GDP growth where it grew by only 1.5 percent against 3.7 percent last year. While the services sector grew by 8.2 percent, the manufacturing sector registered a modest growth of 5.2 percent, with the major share coming from construction. The agriculture sector, despite its decline in overall GDP to 19 percent, still employs half of the labour force and contributes directly or indirectly to 60 percent to the total exports. Therefore it is imperative to enhance its productivity.

The government has prioritised agriculture and allocated Rs.75 billion for improved water access, along with doubling subsidies on fertilizers and raising wheat support price, in addition to tax incentives and inviting foreign investment. The acute power shortages and a poor infrastructure significantly reduced productivity of the manufacturing and agricultural sectors. Besides measures to deal with infrastructure deficiencies, custom duty on many raw materials and equipments such as port dredgers and power plants has been reduced to zero. In addition, investments of more than US$50 million are made free from any domestic partnership. Capital gain tax exemptions on foreign capital and tax holidays are expected to attract more foreign investment.

Investment has been the main driver of recent economic growth, followed by consumption, standing at above 20 percent of GDP. However, this level of investment is unsustainable, due to political uncertainties and the international situation. Economic hardship has visibly affected national and domestic savings, which declined to 14 and 11.7 percent of GDP from 18 and 16 percent respectively. Moreover, there has been an increase in share of private vis-à-vis public investment from 64 percent to 74 percent in the last five years, making the economy more sensitive to investor confidence. Foreign investments have declined to US$3.6 billion (July-April) against US$5.3 billion in the same period last year, largely due to the decline in portfolio investments. If the political uncertainties continue, direct investments are likely to decline.

Social Sector

Pakistan, being a classic example of "growth without development", attracts special attention. Despite maintaining an average five percent GDP growth over the last 50 years, it ranks relatively very low (136) on the human development index. For decades, successive governments have neglected the social sector due to huge interest payments and defense budget. There have been some achievements in terms of increased per capita income and reduced poverty incidence in recent years.[23] However, spending on education and health remains low. The demographic dividend poses major challenges in terms of employment generation, given the seven percent unemployment, and a large underemployment incidence.[24]

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debt reduction … renewed political discord is unlikely to provide the stable and orthodox policy framework necessary for quickly limiting these macroeconomic imbalances". "Pakistan Risks Losing Investor Confidence", Business Recorder, June 14, 2008. http://www.brecorder.com/latestindex.php?latest_id=8152&cindex=23&current_page=1

[23] The per capita income has grown at an average rate of 13.5 percent per annum during the last six years rising from US$586 in 2002-03 to US$1,085 in 2007-08, thanks to a four-fold increase in remittances. Poverty (headcount ratio on Rs.994 per month poverty line) incidence has fallen from 28 percent to 23 percent during the same period.

[24] Since 60 percent of the population is under 25 years of age.

The government has decided to double the development budget for education. However, there is no substantial change in the health budget, which stands at 0.6 percent of gross national product. The "Benazir Income Support Program" is introduced to protect the poorest of poor through distributing Rs.1,000 per month cash grants to each qualifying household. The "People's Works Program" will provide employment while engaging in local infrastructure development. However, both of these programs run the danger of bureaucratic red tapes and corruption. It is highly likely that the benefits would not reach to the target groups.[25] Nevertheless, only doubling of the development budget for education seems to be the step forward.

Conclusion

Pakistan's economy has shown resilience, and despite all odds, it has continued to grow. However, international oil and commodity prices, along with a slow growth in agriculture and exports have posed serious challenges. Continued political instability, violence, and wrangling over power between the PPP and the PML-N have put economic management on the back burner. The economic challenges are compounded by the fact that both parties do not have a commendable record on economic management. Increased policy uncertainty is likely to impede both domestic and foreign investment.

Moreover, the lack of political direction can further weaken the government's capacity to implement the policies spelt out in the budget. However, the previously-initiated structural changes in the economy are unlikely to be reversed. The budget FY2008-09 has set modest targets but remains largely rhetorical. The coalition partners have repeatedly made similar promises in their earlier tenures. What would make the results different this time around remains anybody's guess.

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[25] There are empirical studies showing the number of such programs, which failed to do what they intended to.