ISAS Insights

No. 74 – Date: 3 July 2009

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Pakistan: Making the Budget in Difficult Times

Shahid Javed Burki[1]

These are extremely difficult times for Pakistan. It is not only the challenge thrown at the state by the Islamic extremists that has caused so much anxiety inside and outside the country. Many people that have influence in shaping world politics have called this challenge an "existential threat" for Pakistan. Among them is Hillary Clinton, America's Secretary of State, who issued the warning that, unless Islamabad realises the enormity of the threat extremism poses to the very existence of the country, the Pakistani state may simply unravel. There is certainly some exaggeration in this assessment – it was made, most probably, to draw the attention of the policymakers in Islamabad. It seems to have served that purpose. In mid-May 2009, the military was ordered into Swat, a district in the North-West Frontier Province, and it seems to have taken the area back from the extremists. The armed forces have now been told to go after the leadership of the group that goes by the name of the *Tehrik-e-Taliban Pakistan*. It is loosely associated with Al-Qaeda, and in Baitullah Mehsud, it has his own charismatic leader.

There is a reason why I have begun this assessment of the 2009-10 budget with a reference to the ongoing struggle between the state and the non-state actors and why I said that extremism is not the only problem the country is faced with today. There is also the problem of an economy that has suffered perhaps the most severe shock in the country's history. The budget is supposed to address that situation and bring the economy back to health, or at least set the stage for its recovery. Will it meet these objectives?

The government's own estimate is that the rate of gross domestic product (GDP) growth will be only two percent in 2008-09, a rate lower than the more pessimistic assessments made earlier in the year. When a decline occurs in economic activity, it usually takes the economy down fast. That was the experience of the countries which faced what is generally referred to as the Asian Financial Crisis of 1996-97. This is precisely what has happened in Pakistan. When the final numbers for 2009-10 are posted, I will not be surprised if the GDP growth is even lower than the one indicated in the *Pakistan Economic Survey, 2008-09*, released a few days before Hina Rabbani Khar, Minister of State for Finance, made the budget speech in the national assembly.[2] In fact, the economy may not show any increase at all. A fast plunging economy needs firm and quick public policy response. The budget is a good place to begin.

---

1 Mr Shahid Javed Burki is a Visiting Senior Research Fellow at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He was the Former Vice President of the World Bank, and the Former Finance Minister of Pakistan. He can be contacted at isassjb@nus.edu.sg.

2 Government of Pakistan, *Pakistan Economic Survey, 2008-09*, Islamabad, Ministry of Finance, June 2009.

Reviving the economy is, therefore, an urgent task for the government. If it succeeds, this will aid its efforts against extremism. If it fails, it will only drive more young people towards extremist causes. This is one reason why the two struggles – against extremism and economic stagnation – are tied so closely to each other. Failure in one will lead to the failure of the other. Although Ms Khar, in her speech, tried to draw some cheer from an otherwise cheerless situation, she communicated a sombre message to her audience. What she thought should bring comfort to those who were desperate to see Pakistan modernise rather than be shoved back into the Middle Ages was the fact that she was the first woman in the country's history to present the budget in an assembly presided over by the first ever woman Speaker of the House. And both are members of the Pakistan Peoples Party, once headed by Benazir Bhutto who was assassinated in December 2007. Ms Bhutto was the first female prime minister of Pakistan. "These are important milestones in our quest for women empowerment and gender equality", she told the assembly.[3] This was also some sort of a challenge to the extremists whose one goal is to keep women socially and economically backward.

Does the budget reveal a strategy aimed at economic revival? I believe, given the grim situation the country is confronted with, the government has done a credible job of focusing on the right areas. I will identify six of them in this assessment.

Firstly, the government has pointed out to the people the enormous cost to the economy of continuing terrorism. This should certainly help to build support for the action by the army. There has to be recognition in the country that indifference towards the rise of Islamic extremism and associated terrorism also has an economic cost. According to Ms Khar, the cost to the economy is of the order of US$35 billion since 2001-02, an average of US$6 billion a year. And it is increasing. The government's estimate keeps increasing, presumably because of the better understanding of how the economy is suffering from the impact of terrorism. Earlier in the year it had estimated the cost at Rs 376 billion (US$4.7 billion) for 2007-08. The Institute of Public Policy, a Lahore-based think-tank, estimated the cost at Rs 230 billion (US$2.9 billion).[4] Even the lower estimates are fairly high in terms of the proportion of the GDP.

Ms Khar stated that, "We have to meet the maintenance and rehabilitation costs of almost 2.5 million brothers, sisters and children displaced as a result of the insurgency". The government has allocated US$6.25 billion for "relief, rehabilitation, reconstruction and security" as part of its relief effort. This is equivalent to 3.4 percent of the GDP. Adding that to the cost of terrorism means that the fight against extremism is costing the country 6.7 percent of the GDP. Commitments from its own resources notwithstanding, the government was banking on receiving a fairly generous amount of assistance from the international community for this effort. The message from Islamabad, in other words, was clear. The war against terrorism was not just Pakistan's war. It was a war being fought on the Pakistani territory on behalf of the world. The country was prepared to sacrifice but it was incumbent upon its many friends to be generous in providing financial assistance. The country did not need foreign soldiers but it needed foreign aid. Without adequate support, the effort could fail and would create a tsunami that will hit many shores across the globe.

The second message of the speech concerned the need to raise domestic resources for investment. Pakistan recognised that it had not done enough in this area. Ms Khar stated that,

---

3 The quotes from her speech are taken from the text posted on the official website of the Ministry of Finance, Government of Pakistan.

4 Institute of Public Policy, *State of the Economy: Emerging from the Crises*, Lahore, May 2009, p. 15.

"In the outgoing year, we were only able to attain tax revenues equivalent to nine percent of our GDP". A number of actions were indicated that would be taken to remedy the situation but that would take time. Read any speech by a Pakistani Finance Minister over the last two to three decades, and one would find many references to the need to increase the tax base and reform the tax collection system. Many development agencies have written reports on how the tax-to-GDP ratio could be improved. None of these has worked. The trend continues to be downward which means that growth in the economy depends upon the ability to raise resources from outside the country. This is what has produced a roller-coaster ride for the economy. The economy does reasonably well when large amounts of external flows are available. The growth plunges when external savings decline.[5] The fact that this time around the rate of increase in the GDP has declined significantly despite the flow of large amounts of foreign money is even more worrying.

Some simple arithmetic would illustrate Pakistan's dependence on foreign flows at this critical time in its history. If the war against terrorism is costing the country 6.7 percent of the GDP and if the expenditure on one of the programmes aimed at caring for the poor – the Benazir Income Support Program (BISP) discussed below – is to cost 0.6 percent of the GDP, then not much is left with the government – only 2.3 percent of GDP – even if it raises the tax-to-GDP ratio to 9.6 percent, a target set for 2009-10. The situation, in other words, is grim from the perspective of government finance.

The third element in the financial strategy unveiled in the budget is the promise to protect the poor against the fallout from the severe economic recession in the country. With very little increase in the GDP growth, there may not be any increase in income per head of the population. We know from the empirical work done at some development institutions that the GDP must increase at the rate equal to twice the rate of increase of the population for the incidence of poverty to remain unchanged.[6] For the incidence to decline, Pakistan's rate of GDP increase has to be higher, perhaps as much as six percent. It needs to be even higher when income distribution is inequitable, as is the case in Pakistan. This means that the dismal performance of the economy in 2008-09 must have added to the number of people living in poverty. The incidence may have increased from 50 million to 55 million. This is an untenable situation, which could have severe political and social consequences. A rising incidence of poverty means a higher rate of unemployment. In Pakistan's case, with a very young population – the median age now is 18.2 years – this means a very large number of young people without productive jobs. The problem Pakistan faces today has two dimensions. The government needs to assist the poor to meet their basic needs and it needs to engage the youth in productive work. The government has shown considerable sensitivity about this development. It is adding more resources to a number of programmes aimed at alleviating poverty as well as providing relief to the poor.

Much of the effort will be focused on a relatively new mechanism created by the present government. This is the BISP and it is named after Ms Bhutto. Under this programme, the government is providing direct cash transfers to the poor. This is in keeping with the approach developed in institutions such as the World Bank that favour cash payments rather than subsidies directed to the poor. Development institutions have learnt through experience

---

5 I have developed this theme at some length in my most recent book on Pakistan. See Shahid Javed Burki, *Changing Perceptions, Altered Reality: Pakistan's Economy under Musharraf, 1999-2006*, Karachi: Oxford University Press, 2007.

6 See, for instance, The World Bank, *World Development Report: Poverty*, New York, Oxford University Press, 2000.

that subsidies, more often than not, do not reach the intended beneficiaries. In countries such as Pakistan where the state is weak, there are enormous leakages in such programmes. Cash transfers can be better monitored. The component of "conditional cash transfers" is being added to the BISP, I suspect, at the urging of the World Bank that has tried this approach in several countries in the Middle East that have fallen behind the rest of the developing world in terms of human development. The idea is to provide cash to the families in return for taking actions such as sending girls to school; keeping children in school for periods that are long enough not only to learn to read and write but to make them responsible citizens; immunise children against communicable diseases; and provide health-preserving and health-improving services to all citizens. There is one additional advantage to adopting this approach. It encourages the people to use the private sector to obtain some of the services on which cash flows are conditioned. In this, the burden is not placed on the public sector which is very weak in countries such as Pakistan.

The government is making a very large commitment to the BISP. "During fiscal year 2008/09, Rs 22 billion was distributed to 1.8 million families", said Ms Khar in the budget speech. "During fiscal year 2009/10, it is proposed to increase the allocation to the BISP to Rs 70 billion...this would constitute more than a 200 percent increase…and five million families would benefit." Each eligible family would receive, on average, Rs 14,000 cash in 2009-10. This is 14.5 percent more than the Rs 12,222 provided in the previous year. As was the experience in other parts of the world where such programmes have been tried – they are popular in Latin America and the Middle East – care needs to be taken to ensure that money reaches the right pockets. A number of targeting mechanisms have been tried and some of them have worked. Those that have succeeded are based on good information about the poor. This is done by building what are called "poverty maps" based on censuses and household surveys. The government seems to be moving in that direction. According to Ms Khar, "a census would be completed within three months in 16 districts of Pakistan as a pilot to benchmark incomes. This would be extended to the entire country within the calendar year. The Benazir Income Support cards would serve as vehicles of transparent management and addressing the needs of the vulnerable."

The fourth and fifth elements of the government's programme, as revealed in the budget, are aimed at reviving the economy by focusing on the sectors that suffered from neglect in the past. A serious effort will be made to increase the productivity and output of the agricultural sector. This is still an important part of the economy. In 2008-09, it contributed 21.8 percent to the GDP as against 24.3 percent by industry and 53.8 percent by services. Some 60 percent of the population live in the countryside and about 45 percent of the total workforce is engaged in the agricultural sector. In spite of the considerable potential of agriculture – Pakistan has the world's largest contiguous irrigated area – several generations of policymakers in the country's history have ignored this sector. It has neither played the role of being a major determinant of economic growth nor contributed much to alleviating poverty. This is unfortunate since a large majority of the country's poor reside in towns and villages.

Agriculture did well in 2008-09 – its output increased by 4.7 percent as against an increase of only 1.1 percent in the previous year. However, the increase was not because of any much-needed structural changes. It was largely due to good weather and the price incentives given to the producers of cash crops. The price policy measures "undertaken by the government have led to an estimated transfer of resources of about Rs 294 billion (US$3.7 billion) to the rural economy", Ms Khar told the national assembly. That transfer had helped in increasing incomes in the countryside. That this has happened is corroborated by some independent evidence such as a large increase in the sale of bicycles and motorbikes in towns and villages. Wheat and rice support policies help but if they are determined by government action and not by market forces, it would create a sector that would not be able to compete in the global market place. This is what Pakistan's agricultural sector needs to do. Given its extraordinary resource endowment, Pakistan should not be concentrating on the production of cash crops but on high value-added crops for export.

In the 2009-10 budget, the government is making large outlays for two activities critical to increasing agricultural productivity. These are water management and technological improvements. One example of the latter is the belated permission given to Monsanto, an American firm, to produce and market biologically transformed cotton seeds. Monsanto is widely credited for the very large increases in cotton output in India in recent years. As a result of the introduction of what is generally referred to as the BT cotton, India has gone from being a cotton importing to a cotton-exporting country while Pakistan has moved in the opposite direction.

Energy is another sector that has received attention in the budget. This is appropriate since for the last couple of years, Pakistan has experienced a severe shortage of electricity. This has resulted in long periods of brownouts and mandated load shedding. These have caused an enormous amount of discomfort to the people affected by it, which is most of the country's population. The rich have protected themselves by investing in small generators, switched on when power goes out. All this has taken a heavy toll on the economy. In its annual report for 2009, the Institute of Public Policy estimated the loss to the economy at two percent of the the GDP. "Costs could be even higher if (the) impact on other sectors like energy and agriculture are allowed for, which account for almost the same share in power consumption as industry."[7]

The reason for this crisis is the hard-to-explain failure of the administration of President Pervez Musharraf (1999-2008) to invest in electricity generation. The government assumed that the country had a surplus capacity in the power sector which would be tapped to meet the growing demand. It also miscalculated demand elasticity for electricity assuming that it was less than one, meaning that the demand for power would increase at a rate less than that of the GDP growth. This was contrary to the experience of countries at Pakistan's level of development. For these countries, growth in the demand for electricity was 20 to 25 percent more than the increase in GDP. In other words, electricity supply should have increased by at least 8.5 percent per annum during the closing years of the Musharraf period when the GDP increased at an average rate of seven percent a year.

Historically, Pakistan has developed the energy sector by responding to periodic crises that produced large demand-supply gaps rather than by following a well designed strategy. This time around, the government has gone half the distance in using a long-term strategy rather than only emergency measures adopted to address the immediate crisis. The budget for 2009-10 promises to meet the persistent energy crisis in two ways. It hopes to divert the source of electricity generation away from imported fuels and take it towards the resources in which there is abundant domestic supply. These include water, wind, coal and the sun. At the same time, the government will seek to rent production facilities by bringing in power-generating barges to places such as Karachi.

[7] Institute of Public Policy, Pakistan's Economy: *op. cit.*

It is not clear how the shift towards the new sources of generating electric power would be accomplished. Would it be done by using public funds to invest in the projects that use the sources of power which will not put pressure on balance of payments? Or would the government use subsidies to encourage the private sector to invest in the right kind of projects? These questions have been left unanswered.

There is only a slight hint in the direction of the sixth element in the strategy the government is evolving to address the present crisis. The reference here is the need to devolve more economic and financial responsibility and authority to the governments at the sub-national levels. The budget promises to reactivate the National Finance Commission which, during the Musharraf period, was unable to develop a consensus among the provinces and between the provinces and the federal government on the division of the federal financial pool. The budget promises to increase the provinces' share from the present 47 percent to 49 percent. The share should be higher if the provinces are to have greater financial authority to manage their development. Also, the provinces should be allowed to tax the sources of income that are currently in the federal domain. In return for this concession, the better-off provinces should allow the less developed provinces a larger share in the federal divisible pool.

In conclusion, it is important to underscore one additional point. Some of the economic growth projections in the budget, albeit relatively modest given the high rates of growth in the early 2000s, are still ambitious in light of the severe economic downturn of 2008-09. Also, a number of public sector interventions in critical areas such as providing relief to the victims of domestic terrorism, including the internally displaced persons; meeting the grave shortages in energy; ensuring food security; and reviving economic growth will need more resources than would become available even with a 6.7 percent increase in the tax-to-GDP ratio from nine percent to 9.6 percent of the GDP.

The budget has placed great faith in the flow of foreign funds – in the continuation of the increase in remittances, the revival of foreign direct investment and the generosity of the country's friends. In case these turn out to be excessively optimistic assumptions, Pakistan may be faced with tough economic times in the foreseeable future.

oooOOOooo