AERC-SPDC Research Report

Pakistan's Economic Outlook and the Federal Budget 2023-24

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Applied Economics
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This Research Report is jointly prepared by the
Applied Economics Research Centre (AERC), University of Karachi
and Social Policy and Development Centre (SPDC).

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Foreword

Pakistan's economy is confronted with a severe economic crisis characterized by high levels of inflation, low economic activity, low foreign reserves, a depreciating currency, and enormous public finance imbalances. The prevailing political uncertainty is further contributing to the problem. The Federal Budget 2023-24 was presented against this challenging macroeconomic backdrop and a complex political situation. Moreover, the budget has been prepared by an outgoing government as the tenure of the current assembly is set to end on August 13, 2023. Consequently, effective implementation of the policy measures introduced in the budget will depend on the ownership of the future government.

This research report presents an overview of the current state of Pakistan's economy and analyzes the macroeconomic policy in light of the Economic Survey 2022-23 and the Federal Budget 2023-24. The analyses presented in this report cover several aspects of Pakistan's economic policy, including recent macroeconomic policies for stabilization and growth, current account balance and international trade, fiscal policy and poverty reduction.

The research was jointly conducted by the Applied Economics Research Centre (AERC), the University of Karachi and the Social Policy and Development Centre (SPDC). AERC and SPDC have recently signed an MoU to develop a long-term relationship between the two institutions to promote collaborative research and enhance knowledge on issues surrounding national development goals to achieve social and economic progress in the country. We sincerely hope that the analyses presented in the report will benefit policy formulators, advocacy groups and civil society.

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Acronym

AERC	Applied Economics Research Centre
AJK	Azad Jammu Kashmir
APL	Attock Petroleum Limited
BISP	Benazir income Support Program
Brl	Barrel
CAD	Current account deficit
CAGR	Compound Annual Growth Rate
CPI	Consumer Price Index
ERE	Employee-related expenditures
ERRA	Earthquake Reconstruction & Rehabilitation Authority
EU	European Union
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FED	Federal Excise Duty
FTPL	Fiscal Theory of Price Level
FY	Fiscal Year
GB	Gilgit Baltistan
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GPS	General Public Services
GRR	Gross Revenue Receipts
HEC	Higher Education Commission
HIES	Household Integrated Economic Survey
IMF	International Monetary Fund
IPPs	Independent Power Producers
ISI	Import Substitution Industrialization
IT	Information Technology
KG	Kilogram
LNG	Liquefied Natural Gas
LSM	Large Scale Manufacturing
MoU	Memorandum of Understanding
MP	Market Price

MPC	Monetary Policy Committee
MT	Metric Ton
NEPRA	National Electric Power Regulatory Authority
NFC	National Finance Commission
NRR	Net revenue receipts
NTDC	National Transmission and Despatch Company
PASSCO	Pakistan Agricultural Storage & Services Corporation
PBS	Pakistan Bureau of Statistics
PEPCO	Pakistan Electric Power Company
PKR	Pakistani Rupee
PPP	Public-Private Partnership
PSDP	Public Sector Development Programs
PSO	Pakistan State Oil
SBP	State Bank of Pakistan
SNGPL	Sui Northern Gas Pipelines Limited
SPDC	Social Policy and Development Centre
SROs	Statutory Regulatory Orders
STPF	Strategic Trade Policy Framework
TDS	Tax Deducted at Source
TT	Telegraphic Transfer
UAE	United Arab Emirates
UK	United Kingdom
USA	United States of America
USD	United States Dollar
VGF	Viability Gap Funding
WAPDA	Water and Power Development Authority

Executive Summary

Macroeconomic Policies for Stabilization and Growth

The government has attributed the poor performance of the country's economy during the fiscal year 2022-23 to a number of factors, including international supply shocks, a downturn in the global economy, and the impacts of the 2022 floods. However, the evidence does not support most of these claims. For instance, international commodity prices have declined over the past 12 months. Similarly, the official perspective suggests that the decline in the textile sector growth is due to losses in cotton production, but the data reveals a 16.3 percent increase in raw cotton imports during the last fiscal year. Similarly, the negative growth in the manufacturing sector is attributed to the floods, as agriculture has backward and forward linkages with other commodity sectors. The agricultural sector growth stood at 3.4 percent compared to 4.7 percent in the previous year, which raises the question of how a relatively small decline in the agricultural sector's growth could severely impact other sectors. In this way, the Economic Survey 2022-23 ignores domestic structural issues and inconsistent policies related to demand-side management and instead attributes the economy's lackluster performance to international factors and natural disasters.

Pakistan's economy experienced reasonable GDP growth in fiscal years 2017-18, 2020-21, and 2021-22, but abrupt downturns were observed in 2018-19, 2019-20, and 2022-23. Overall, the real GDP growth rate has declined from 6.1 percent in 2017-18 to 0.29 percent in 2022-23. The industrial sector witnessed a negative growth rate of 2.94 percent during 2022-23, with the textile sector contracting by 16.3 percent. However, an increase in textile exports from India during the same period suggests that macroeconomic policies such as a contractionary monetary policy and import restrictions are likely responsible for the decline in the textile sector growth.

The State Bank of Pakistan has been implementing a contractionary monetary policy. Despite the gradual tightening of monetary policy, the growth of broad money stood at 84.3 percent during the last fiscal year. This expansion of broad money and money in circulation could be another contributing factor to the mounting inflationary pressure.

The depreciation of the currency and the implementation of a higher policy rate are factors contributing to the surge in production costs, resulting in increased prices of goods and services.

Pakistan is currently experiencing cost-push inflation, and the recent measures taken by the government to achieve the growth target are likely to stimulate demand, potentially leading to demand-pull inflation. Given the prevailing high inflationary, expansionary demand-side policies can lead to a further increase in the price level without a proportional increase in output. When the economy is already experiencing pre-hyperinflationary conditions, policymakers should be more cautious and vigilant when implementing expansionary demand-side policies.

Fiscal and monetary policies are in contradiction with each other which has negative implications for achieving the macroeconomic and fiscal. While the State Bank of Pakistan expects a reduction in inflationary expectations through contractionary policies, fiscal policy simultaneously fuels inflationary expectations. It targets a higher growth rate by increasing current and development expenditures, which could exacerbate the volatility of macroeconomic variables.

Fiscal Policy and Budget 2023-24

The Federal Budget 2023-24 was presented against a challenging macroeconomic backdrop and an uncertain economic and political outlook, further complicated by the expectations associated with an election year. Several concerning trends have emerged on the fiscal front, including a decline in the tax-to-GDP ratio, disproportionate growth in current expenditures, and a high federal fiscal deficit.

Regarding the overall resource mobilization in 2022-23, the federal government collected Rs 8.8 trillion instead of the targeted Rs 9.4 trillion, indicating a shortfall of Rs 587 billion. Both tax and non-tax revenues contributed to this shortfall, but the shortfall in non-tax revenues was higher than the tax revenues. For 2023-24, over 40 percent growth in total revenue is budgeted. The targeted growth is higher in non-tax revenues (83 percent) than in tax revenues (31 percent).

A rather disappointing aspect of the resource mobilization performance is the significant decline in the overall tax-to-GDP ratio. Revised estimates for 2022-23 indicate a total tax collection of 8.5 percent of GDP, which is below the target (9.55 percent) and lower than the actual collection of 9.18 percent of GDP in 2021-22. For the fiscal year 2023-24, the tax-to-GDP ratio target is set at 8.9 percent. However, considering the historical trend of the FBR falling short of its targets and the overly ambitious direct tax targets for 2023-24, prospects of achieving the revenue objectives do not appear favourable.

The analysis based on tax buoyancy and autonomous growth reveals that except for direct taxes, all other tax revenue targets can be considered feasible. However, direct taxes may require further attention as their autonomous growth rates might not be as high as the targeted growth rates. This suggests the need for additional measures or strategies to ensure that the revenue target for direct taxes is attainable in 2023-24.

The non-tax revenue target of Rs 2.9 trillion seems attainable primarily due to heavy reliance on SBP profit. The dependence on SBP profit suggests a shift in the federal government's fiscal deficit financing strategy, which involves monetizing the fiscal deficit by more than Rs 3.5 trillion.

As far as current expenditures are concerned, there is a significant deviation of more than 21 percent in 2022-23 – an estimated outlay of Rs 10.5 trillion compared to the initial allocation of Rs 8.7 trillion. Another concern is mark-up payments that account for more than half of the current expenditures in both years – 2022-23 (revised) and 2023-24 (budget). There is also a substantial overrun of 40 percent in the markup payment in 2022-23. Moreover, subsidies show a notable increase of Rs 439 billion in outlays compared to the allocations of Rs 664 billion.

Despite the financial resource crunch, there is double-digit growth in each major category of current expenditures, except subsidies. This surge is primarily due to around a 30 percent increase in markup payments, pensions, and civil service allocations, the latter driven mainly by a rise of 30-35 percent in salaries and a lack of emphasis on fiscal austerity. With regard to development expenditure, PSDP allocations for 2023-24 demonstrate a substantial growth rate of 46 percent. However, the pattern of expenditure growth suggests that the federal government is focusing on election-related objectives rather than addressing economic imbalances.

The budgeted federal fiscal deficit for 2022-23 was Rs 4.5 trillion or 5.8 percent of the GDP. However, due to a decline in net revenue receipts and an increase in current expenditures, it rose to Rs 6.4 trillion or 7.6 percent of the GDP. Notably, the net revenue receipts of the federal government constitute only 5.5 percent of the GDP. A similar trend emerges in the outlook for 2023-24. Despite an anticipated substantial 50 percent growth in net revenue receipts (NRR), the federal interest payments, all other federal expenditures, and federal budget deficit are projected to exceed 100 percent of NRR. The level of fiscal deficit is unsustainable, and the situation calls for careful and responsible financial management, effective resource mobilization and expenditure planning.

Pakistan is going through another balance of payment crisis with depleting foreign reserves. While the current account deficit (CAD) was reduced from US$ 17.5 billion to US$ 2.5 billion, the goal of lowering CAD has been achieved mainly by restricting imports, which hampered the industrial sector's growth. The reduction in imports by UD$ 19.5 billion was coupled with a decrease of US$ 4.6 billion in exports and US$ 4.7 billion in secondary income (including remittances).

Trade and Current Account Balance

Pakistan's exports declined by 12.7 percent (US$ 4.6 billion) between 2021-22 and 2022-23, with a major decline in the textile sector mainly due to a drop in global prices as the quantity of exports increased, but their value decreased. For instance, the export of readymade and knitted garments showed a 12 percent decline in terms of dollar value, whereas the quantity of exports was over 21 percent higher than the previous year. Imports declined by 29 percent, with the largest decrease in the machinery group, affecting the manufacturing sector's performance. The export of services remained almost the same during the last two years, while workers' remittances declined by 14 percent.

The measure taken in the Federal Budget reflects a hybrid import substitution industrialization strategy broadly similar to that adopted during 1955-68, except that the new strategy is contextualized with a new liberal policy regime, whereas the former used import licensing and exchange rate management. Similar to the earlier strategy, the new regime is most likely to face the same fate because there is no motivation for enhancing productivity for capital goods industries, establishing a domestic supply chain for exportation and putting in place a monitoring and evaluation system for assuming the maturing of the new strategy.

Poverty Trends

The predicted incidence for 2022-23 is 40.3 percent suggesting that 93 million persons are below the poverty line. About 15 million persons have been added to the population below the poverty line during the period 2018-19 and 2022-23. Given the scale of the poverty challenges, the government's response is not encouraging.

1 STATE OF THE ECONOMY AND MACROECONOMIC POLICIES FOR STABILIZATION AND GROWTH

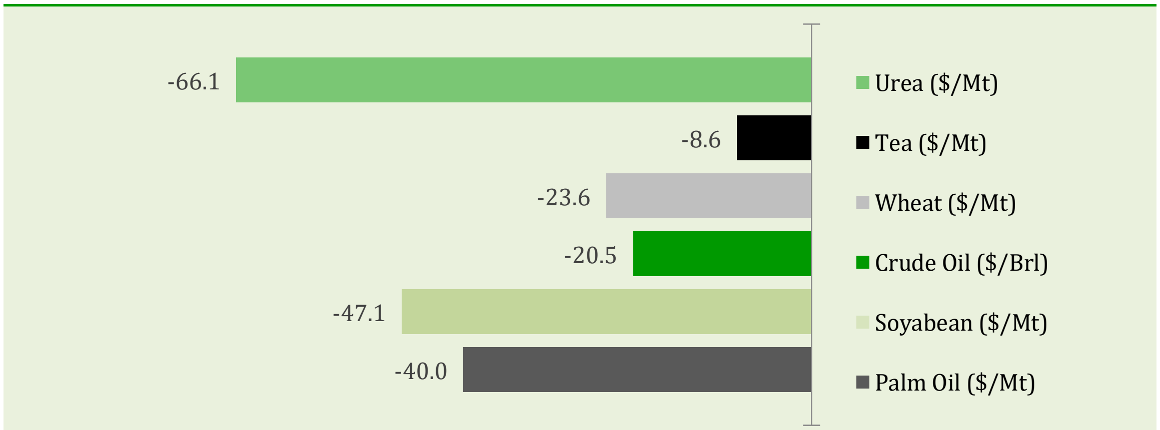
Tehseen Iqbal

INTRODUCTION

The Pakistan Economic Survey 2022-23 attributes the poor performance of the country's economy during the fiscal year 2022-23 to several factors. These include international supply shocks, a downturn in the global economy, and the impacts of the 2022 floods. From the government's perspective, the conflict between Russia and Ukraine has had adverse effects on global growth and inflation, which in turn affected Pakistan's economy. According to the official standpoint, the effect of the above factors was manifested through increased food and energy prices, supply chain disruption, and decreased business confidence. These factors also pose a significant risk to the fiscal consolidation efforts and have led to the abysmal performance of the Pakistan economy.

However, the evidence does not support most of these claims. For instance, international commodity prices have declined over the past 12 months (April 2022–April 2023). For example, the price of palm and soybean oil experienced a substantial reduction of 40% and 47%, respectively. There was an over 20% decline in crude oil prices during the same period. Wheat prices also declined by 23%, while tea and urea prices decreased by 8.6% and 66%, respectively (Figure 1.1). The downward trend in the prices of major commodities, including food and energy, suggests that international price pressures are easing, and there is an improvement in the supply chain disruption.

Figure 1.1 | Change in the international prices of major commodities – April 22-April 23 (%)



Source: Pakistan Economic Survey 2022-23, Government of Pakistan

Economic Survey 2022-23 tends to ignore domestic structural issues, internal supply chain disruptions, and inconsistent policies related to demand-side management.

In the Economic Survey of Pakistan 2022-23, the negative growth in the manufacturing sector is also attributed to the 2022 floods, as agriculture has backward and forward linkages with other commodity sectors. The official perspective suggests that the decline in the textile sector growth is due to losses in cotton production. However, the data reveals a 16.3 percent increase in raw cotton imports during the last fiscal year. Additionally, reports suggest that some locally produced cotton remained unsold. An increase in textile exports from India during the same period indicates that the downturn in the global economy cannot be solely attributed to the negative growth observed in Pakistan's textile sector. Moreover, the agricultural sector growth stood at 3.4 percent compared to 4.7 percent in the previous year, which raises the question of how a relatively small decline in the agricultural sector's growth could severely impact other sectors.

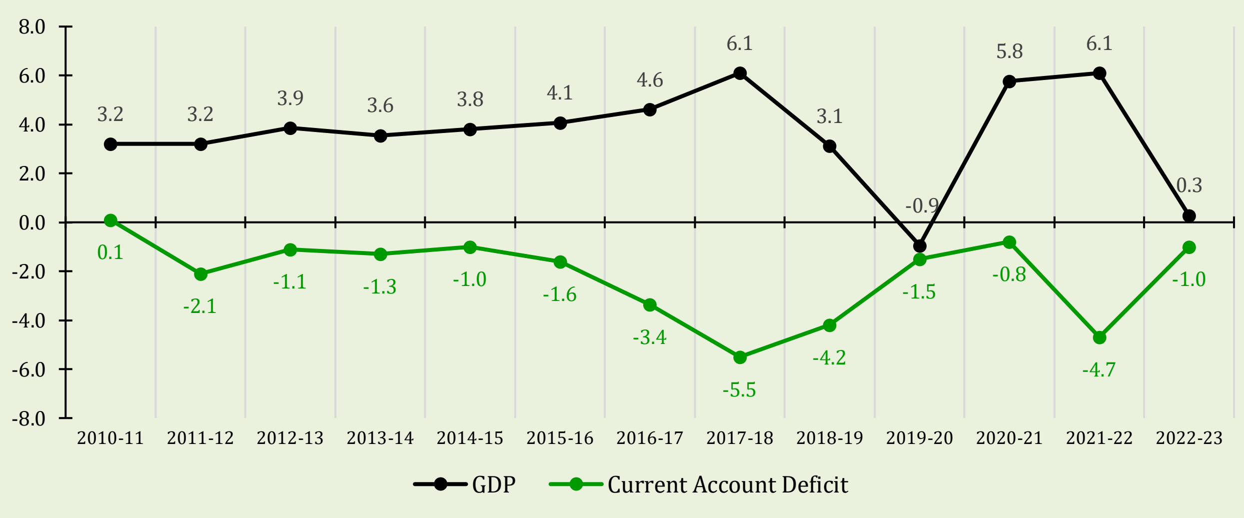
It is evident from the above analysis that while explaining the causes of low growth, Economic Survey 2022-23 tends to ignore domestic structural issues, internal supply chain disruptions, and inconsistent policies related to demand-side management. Instead, it solely and incorrectly attributes the economy's lackluster performance to international factors and natural disasters. This approach creates a fundamental problem for economic policy management because without accurately diagnosing the real issues, it becomes difficult to develop effective and appropriate remedies or policies to overcome the longstanding challenges faced by Pakistan's economy.

AN OVERVIEW OF PAKISTAN'S ECONOMY AND MACROECONOMIC POLICIES

The economy of Pakistan witnessed reasonable GDP growth in fiscal years 2017-18, 2020-21 and 2021-22. However, an abrupt downturn in growth was observed in 2018-19, 2019-20 and 2022-23, indicating volatility in the growth trajectory. The real GDP growth rate has declined from 6.1 percent in 2021-22 to 0.29 percent in 2022-23. While there might be several factors influencing this trend, the burgeoning current account deficit can potentially be one of the major contributing factors to the unsustainability of GDP growth. As shown in Figure 1.2, the current account deficit appears to have a strong negative correlation with the GDP growth rate.

A substantial current account deficit can adversely affect GDP growth, primarily through domestic currency depreciation and inflation. The currency depreciation may discourage foreign investors, encouraging them to withdraw their investments. The resulting inflation and the potential risk of capital flight put pressure on the central bank to increase the interest rates, which, in turn, may crowd out private investment. Moreover, a large current account deficit can constrain the government's ability to allocate the funds to productive resources because a large portion of the available funds may be required for foreign debt repayment and interest debt services. Consequently, a substantial and persistent current account deficit can negatively affect GDP growth.

Figure 1.2 | GDP growth and current account deficit as a percentage of GDP



Source: Pakistan Economic Survey 2022-23, Government of Pakistan

During the last fiscal year, the economy experienced a meager GDP growth rate of 0.29 percent and an unprecedented, all-time-high inflation rate of 38 percent in May 2023. These figures indicate that the country has entered a stagflation period – low economic growth and high inflation.

Table 1.1 | GDP growth rates (%)

Sectors	2021-22 (R)	2022-23 (P)
GDP	6.10	0.29
Agriculture	4.27	1.55
Crops	8.19	(2.49)
Livestock	2.25	3.78
Industry	6.83	(2.94)
Large-scale	10.60	(7.98)
Small-scale	8.90	9.03
Services	6.59	0.86
Wholesale and retail Trade	10.32	(4.46)

P = Provisional | R = Revised

Note: The figures in the parenthesis indicate negative growth.

Source: Pakistan Economic Survey 2022-23

The industrial sector witnessed a negative growth rate of 2.94 percent, whereas the large-scale manufacturing sector, which recorded a growth of 10.6 percent during 2022, experienced a negative growth of 8.71 percent in 2022-23. A significant contributor to this decline was the textile sector, which contracted by 16.3 percent. However, an increase in textile exports from India during the same period suggests that the global demand for textile products cannot be solely attributed to the negative growth observed in Pakistan's textile sector. Instead, macroeconomic policies such as a contractionary monetary policy and import restrictions are likely responsible for the decline in the textile sector growth.

As per the medium-term macroeconomic framework, the growth target for 2023-24 is set at 3.5 percent, while inflation is projected at 21 percent. The achievement of these goals is contingent upon the situation of macroeconomic indicators, cautious monetary policy, the implementation of fiscal discipline and the performance of the external sector.

Monetary Policy

Contractionary monetary policy and its effect on industrial growth

The industrial sector encountered a significant liquidity shortage attributed to a higher policy rate. In the first nine months of the current fiscal year, the growth in private sector credit was only 3.3 percent, whereas it stood at 15.7 percent during the same period in the previous fiscal year. The textile sector experienced the highest decline in credit demand, where private credit for working capital decreased from Rs. 235 billion to Rs. 100.5 billion, while credit for fixed investment declined from Rs. 94.6 billion to Rs. 46.3 billion. The loan provided to private sector businesses plunged by a massive 73 Percent during the first nine months of the fiscal year 2022-23 (Table 1.2).

Table 1.2 | Loan to Private Sector Credit *(Rs billion)*

	Total Credit *July to March*		Working Capital *July to March*		Fixed Investment *July to March*	
	2021-22	2022-23	2021-22	2022-23	2021-22	2022-23
Loan to private sector business	1002.2	271 *(-73%)*	608.7	113.4 *-(81.3%)*	331.1	147.5 *(-55.5%)*
Agriculture	22.4	12.5	12.9	-1.2	8.5	13.8
Manufacturing	789	277.4	566.3	139.6	213.9	136.1
Wholesale and retail	46.1	-28.2	38.2	-24.4	6	-16.8

Note: The figures in parenthesis show the percentage growth.

Source: Pakistan Economic Survey 2022-23

Other contributing factors to the lackluster performance of the industrial sector are the government's initiatives to reduce imports to improve the current account balance and the depreciation of Pakistani currency. Throughout the fiscal year 2021-22, the Pakistani rupee depreciated by approximately 23 percent, whereas in 2022-23, it further depreciated by 28.4 percent – from Rs 204.7 at the end of June 2022 to Rs 285.9 on June 30, 2023. As a result of import restrictions and currency depreciations, the machinery and raw materials imports declined by 48 percent and 25 percent, respectively.

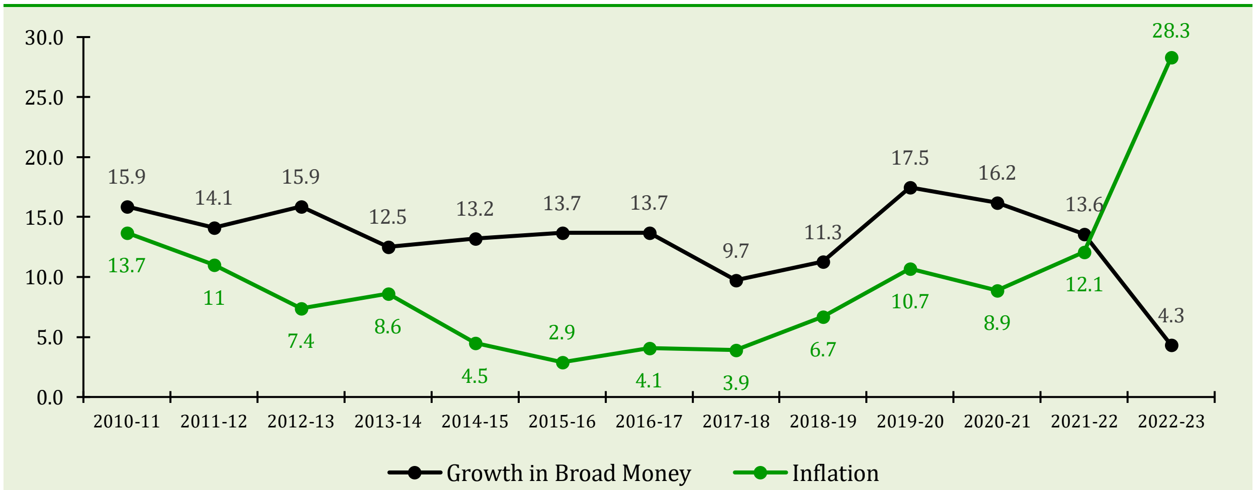
Inflation as a monetary phenomenon

The past year witnessed an inflation rate of 38 percent in May, the highest in 59 years. Among various commodity groups, food prices experienced the highest increase of 39.49 percent compared to housing (including water and fuel) and clothing & footwear, which also rose by 11.64 percent and 20.96 percent, respectively.

Transportation costs also surged by 20.30 percent. The quarter-wise trend of the Consumer Price Index (CPI) shows a consistent increase in inflation over the past seven quarters. Thus, it is likely that there will be a further rise in inflation during the last quarter of the current fiscal year. While the inflation rate may decrease in the next fiscal year due to the large base effect from the current year, achieving the targeted rate of 21 percent would yet be challenging.

The current inflationary spiral in Pakistan is primarily attributed to the rise in food and energy prices and the depreciation of the Pakistani rupee. However, some other contributing factors also need attention. To curb the inflation, the State Bank of Pakistan (SBP) has been implementing a contractionary monetary policy; it raised the policy rate from 7 percent to 22 percent between September 2021 and June 2023. Interestingly, despite the gradual tightening of monetary policy, the growth of broad money stood at 8.3 percent during the last fiscal year. Additionally, despite higher interest rates, there has been a decline in time deposits. During 2022-23, money in circulation has also increased by 14.71 percent, while it grew by 9.5 percent during the previous fiscal year. This expansion of broad money and money in circulation could be another contributing factor to the mounting inflationary pressure. As illustrated in Figure 1.3, inflation tends to move in the same direction as growth in broad money. However, this positive relationship appears to deviate from 2021-22. In 2021-22 and 2022-23, the inflation surged by a staggering rate of 12 percent and 28 percent, respectively, despite a decline in broad money growth. This indicates that in the economy of Pakistan, the growth rate of broad money might have a role in the persistence of high average inflation, but structural problems and supply-side issues have now emerged as the predominant cause of current inflationary pressure.

Figure 1.3 | Relationship between the growth in broad money and inflation (%)



Source: Pakistan Economic Survey 2022-23, Government of Pakistan

Cost-push inflation

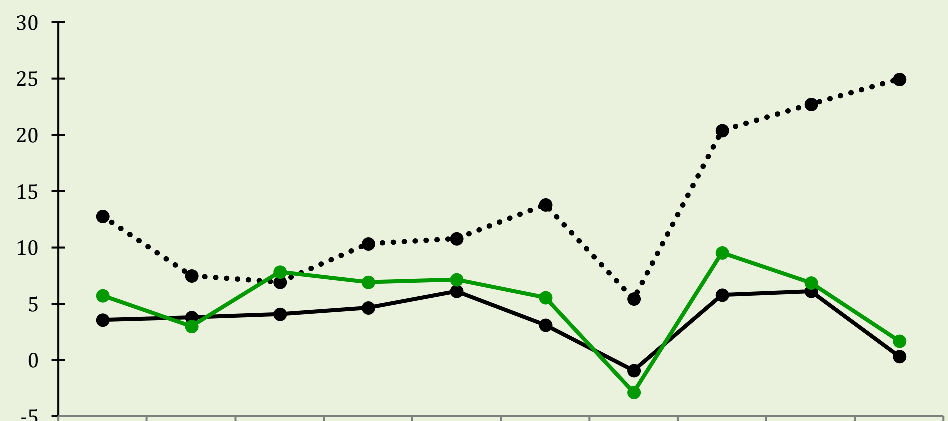
The depreciation of the currency and the implementation of a higher policy rate are the factors contributing to the surge in production costs, which results in increased prices of goods and services. During the fiscal year 2022-23, the cost of production escalated due to a significant 60 percent increase in machinery prices, a 52 percent increase in transportation costs, and a 14 percent increase in energy expenses.

Demand-pull inflation

The proportion of household consumption in the GDP of Pakistan exceeds 90 percent, and despite an uninspired average growth rate and increased inflationary pressure, this share continues to rise. Moreover, despite low growth in income and high interest rates, prices of durable and luxury goods also demonstrated an upward trend. The increasing share of consumption in the GDP could potentially help explain the inflationary nature of Pakistan's economy.

Figure 1.4 illustrates the trends in real and nominal consumption over the last decade. The graph shows that the growth in real consumption aligns with the expansion in real GDP, while nominal consumption exhibits an upward trajectory during most of the years. Although there was a decline in nominal consumption during the Covid-19 pandemic, it quickly recovered and continued to increase at a rapid pace. Interestingly, nominal consumption continues to rise even with the decline in growth during the last fiscal year.

Figure 1.4 | Trend of nominal and real consumption growth (%)

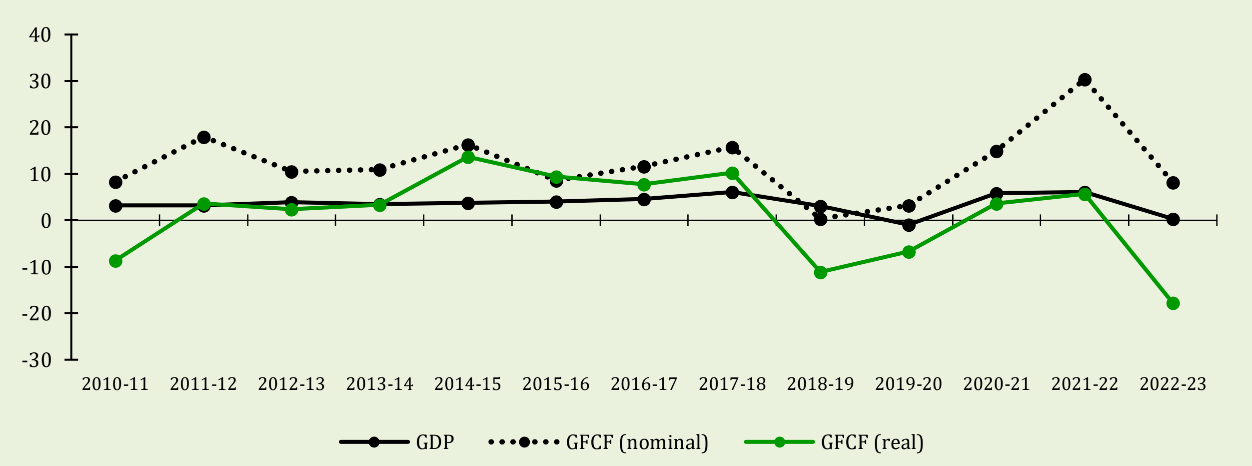


	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
GDP	3.56	3.81	4.07	4.61	6.1	3.12	-0.94	5.77	6.1	0.29
Consumption (nominal)	12.8	7.5	6.9	10.3	10.8	13.8	5.4	20.4	22.7	24.9
Consumption (real)	5.7	3.0	7.8	6.9	7.2	5.6	-2.9	9.5	6.8	1.7

Source: Pakistan Economic Survey 2022-23, Government of Pakistan

Investment is the most volatile component of aggregate output, which is depicted by the oscillation in the growth of real fixed capital formation over the last 12 years (Figure 1.5). In 2022-23, when the GDP growth rate declined significantly, the real gross fixed capital formation growth turned negative. However, the nominal gross fixed capital formation, which exhibited a massive growth of 30 percent in 2021-22, grew by 8 percent despite a significant decline in output growth. In the presence of high interest rates and an economic downturn, the rise in nominal expenditures for both consumption and investment may indicate demand-side pressure on prices.

Figure 1.5 | Trend of growth in nominal and real gross fixed capital formation (%)



Source: Pakistan Economic Survey 2022-23, Government of Pakistan

Headline and core inflation

The headline inflation ($\pi_{h,t}$) comprises two key elements, as shown in equation 1: the trend component ($\pi_{c,t}$), also referred to as core inflation, and the temporary component (ε_t) that captures the transitory impact of price increases, particularly in food and energy.

$$\pi_{h,t} = \pi_{c,t} + \varepsilon_t \text{ …………. (1)}$$

The above equation shows that the effects of rising food and energy prices are short-lived and eventually reverse over time, whereas core inflation serves as an unbiased indicator of headline inflation. This suggests that core inflation can provide valuable insights into the direction of overall inflation (headline inflation) in the future. In the case of Pakistan, core inflation, which excludes volatile food and energy prices, has been recorded at 15.6 percent (during July 2022-April 2023) and exhibits a consistent and significant upward trend. Therefore, when core inflation rises, monetary theory suggests an increase in the interest rate is needed to prevent a corresponding increase in headline inflation. Since the prices of energy and food are susceptible to supply shocks, which tend to be mitigated in due course, it is argued that central banks should disregard these price hikes.

Does changes in headline inflation or food and energy prices have an effect on core inflation? In other words, can headline inflation cause core inflation? To shed light on this matter, we conducted a Granger causality test using annual data on changes in headline and core inflation throughout the period spanning from 2002 to 2020. The findings for Pakistan indicate that headline inflation Granger-causes core inflation, implying that changes in food and energy prices may impact all other prices in the country. This effect of the transitory change in energy and food prices on the trend component or core inflation can be explained by the wage-price spiral. As a consequence of higher energy and food prices, employees may demand higher wages, resulting in higher producers' costs that can be passed on to consumers through increased prices of goods and services. In the Federal Budget 2023-24, the proposed increase of 30 to 35 percent in the salaries of government employees is an obvious indication of the robust wage-price spiral in Pakistan, which may potentially aggravate this inflationary spiral further.

Inflation and the role of inflationary expectations

Once inflation reaches a certain level, it becomes increasingly challenging to control. One form of inflation often leads to another form of inflation. While not definitive, there is a prevailing belief that Pakistan is currently experiencing cost-push inflation. During a period of stagflation, the recent measures taken by the government to achieve the growth target, such as increasing current and development expenditures and raising government employee salaries, are likely to stimulate demand, potentially leading to demand-pull inflation. Hence, it can be argued that cost-push inflation has compelled policymakers to generate demand-pull inflation.

When inflationary expectations are high, expansionary demand-side policies can lead to a further increase in the price level.

The current level of inflation plays a significant role in shaping people's expectations about future price developments. The expectations influence economic behaviour. For instance, due to higher expected inflation, firms may increase the prices of their goods and services faster, and workers may demand higher wages to offset the expected decline in their purchasing power.

According to well-established economic theories, when inflationary expectations are high, expansionary demand-side policies can lead to a further increase in the price level without a proportional increase in output. In such cases, firms tend to raise prices rapidly in response to increased demand, followed by higher wages and capital costs. As a result, firms have little incentive to increase the output level. Therefore, in economies with high inflation expectations, expansionary demand-side policies can have more negative effects than positive ones. Thus, contractionary demand management measures may temporarily reduce output, but they can potentially anchor inflationary expectations in the long run.

Over the past 15 years, inflation in Pakistan has consistently remained above 6 percent, except for two or three years. This rising trend in inflation has also led to an increase in inflationary expectations. During the last two decades, we have witnessed three or four episodes where expansionary demand-side policies have always resulted in a strong and significant inflation spiral. Therefore, when the economy is already experiencing pre-hyperinflationary conditions, policymakers should be more cautious and vigilant when implementing expansionary demand-side policies.

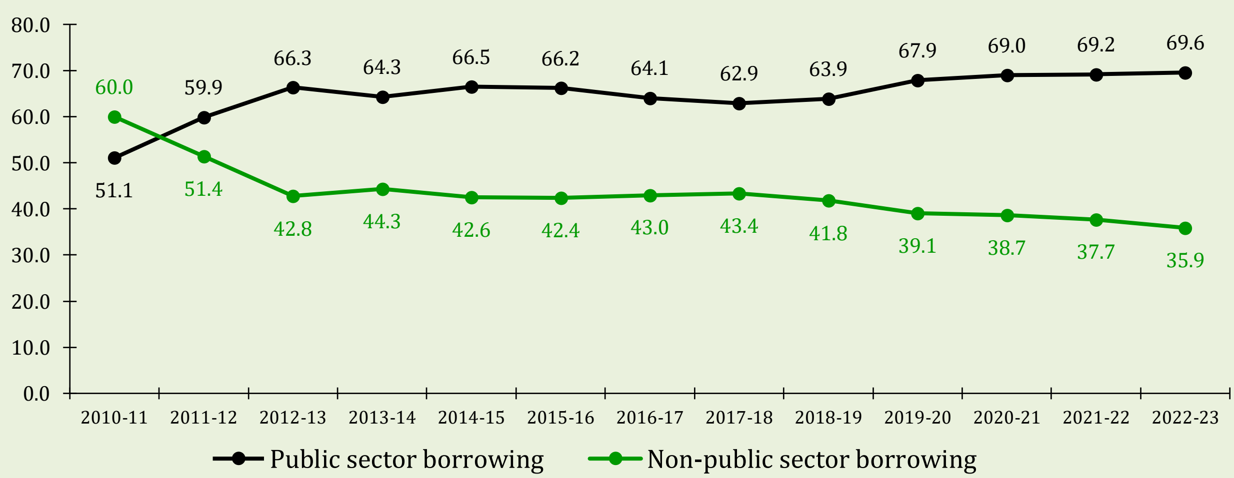
The Role of Fiscal Policy in Shaping the Inflationary Trend

Due to weak resource mobilization and a lack of effective expenditure planning, the government has been running a large fiscal deficit over the last few years. For instance, the overall fiscal deficit has remained over 6 percent of GDP since 2018-19, which has resulted in massive borrowings to finance the deficit.

The government borrowing for budgetary support has surged to Rs 2.4 trillion in 2022-23 (July-March), as opposed to Rs 939 billion during the same period in the previous year. This substantial increase in borrowing from the banking sector could potentially have positive impact on the current upward trajectory of inflationary trend.

In 2020-211, the share of public sector borrowing as a percentage of domestic credit was 51 percent, while non-public sector borrowing accounted for 60 percent. However, over the course of 12 years, the share of public sector borrowing has increased to 70 percent, whereas the share of non-public sector borrowing has significantly contracted to a mere 36 percent of total domestic credit. This shift in the distribution of domestic credit could potentially have inflationary effects and crowd out private investment (Figure 1.6).

Figure 1.6 | Public sector and non-public sector borrowing as a percentage of domestic credit



Source: Pakistan Economic Survey 2022-23, Government of Pakistan

The fiscal policy is discussed in detail in the next chapter. In summary, the total budgetary allocation for 2023-24 is set at Rs. 14.5 trillion, which includes a substantial increase in current expenditures. Most of the increase in current expenditure is due to the rise in the cost of debt servicing. Massive borrowing to finance the fiscal deficit would further increase borrowing costs and put upward pressure on inflation. The expansionary fiscal stance may exacerbate the twin deficit situation, contribute to higher inflation, and lead to further currency depreciation.

In addition to tax collection and expenditure management, the essential role of fiscal policy is ensuring the effective and equitable distribution of resources. However, the tax structure in Pakistan is highly regressive. A significant burden of direct taxes falls on the manufacturing sector. Many sources of income are either exempted or underreported. The second-largest sector, livestock, is largely undocumented. Despite their significance, the construction and real estate sectors are not adequately reflected in the recorded GDP. The provision of tax exemptions to certain sectors, coupled with high taxes imposed on the manufacturing sector, results in an uneven redistribution of resources. Income earned from the undocumented sectors is used to purchase goods from the formal sector, which puts upward pressure on prices. Moreover, income derived from the informal sector also increases the demand for imported goods, which further explains the depreciation of the domestic currency and the rising trend of the consumer price index.

CONCLUSION

Overall, while the increase in food and energy prices and rupee depreciation play a significant role in the current inflationary situation, factors such as the growth of broad money and money in circulation, government borrowing, regressive taxation, distorted allocations of resources and a large share of the consumer spending also warrant attention as potential contributors to the elevated inflation levels. Considering several factors contributing to inflation, a multifaceted approach is required to address and curb inflationary pressures effectively. Simply relying on increasing interest rates and putting the entire burden on the central bank may not be a desirable option.

Three days after the announcement of an expansionary budget by the federal government, SBP announced a strict monetary policy stance, maintaining the policy rate at a high level of 21 percent. The Monetary Policy Committee (MPC) anticipated a decrease in inflation after reaching its peak at 38% in May this year, which is expected to occur due to the implementation of a tighter monetary policy and the subdued demand from consumers and businesses. It is obvious that the objectives and the current paths of both macroeconomic stabilization policies contradict each other. While the SBP expects a reduction in inflationary expectations through contractionary policies, fiscal policy simultaneously fuels inflationary expectations. It targets a higher growth rate by increasing current and development expenditures. The proposed increase in the salaries of government employees could lead to a wage-price inflation spiral that could exacerbate the volatility of macroeconomic variables.

In a period characterized by stagflation, effective communication and coordination between monetary and fiscal policies are crucial for managing twin deficits and exchange rate volatility.

There is a need for the relevant stakeholders and policymakers to jointly formulate short-to-medium-term policies to move the economy towards sustainability and growth.

Annexure 1.1

Four distinct theories of inflation attribute its causes to various factors. Below, a chart is compiled summarizing these four theories of inflation and their applicability in the context of Pakistan. Upon examining the state of Pakistan's economy, it becomes evident that the high inflation experienced in the country cannot be solely attributed to supply-side shocks or increases in energy prices. In addition to these factors, other contributors to high inflation in Pakistan include demand-side factors, fiscal indiscipline, and elevated inflationary expectations. Taking into account the various contributors to inflation, it is evident that a multifaceted approach is required to effectively address and curb inflationary pressures.

Monetary Theory of Inflation:	
Inflation is always and everywhere a Monetary Phenomenon (Milton Friedman). When monetary Policy expands faster than the growth of productive capacity, it leads to inflation. According to Milton Friedman, a stable and fixed growth rate of money is required to avoid excessive inflation.	The Rapid expansion in Broad money and money in circulation can be accounted for the higher inflation observed in Pakistan.
Fiscal Theory of Price Level:	
According to FTPL, expansionary fiscal policy plays a crucial role in determining the price level through its influence on the monetary policy. The lack of fiscal discipline may force the central bank to pursue an accommodative monetary policy, leading to an expansion of the money supply.	The high rate of inflation in Pakistan can be attributed to the factors such as the massive growth in government expenditures, the increase in public sector borrowing as a percentage of domestic credit and the rise in indirect taxation.
Demand-Pull and Cost-Push Inflation:	
Demand-Pull inflation arises when the aggregate demand for goods and services surpasses the aggregate supply; on the other hand, cost-push inflation refers to upward pressure on the overall price level caused by rises in the costs of goods and services.	Over the last few years, there has been an upward trend in the growth of nominal consumption and nominal gross fixed capital formation. Meanwhile, during the last year, the cost of production escalates due to a significant 60 percent increase in machinery prices, a 52 percent increase in transportation costs, and a 14 percent increase in energy expenses.
Expectation Driven Inflation:	
Expectations play important roles because they can influence economic behaviour. If firms expect higher inflation in the future, they may increase the prices of their goods and services faster. Similarly, if workers expect future inflation to rise, they may demand higher wages to offset the expected decline in their purchasing power.	The high inflationary expectation in Pakistan can be attributed to factors such as weak regulatory bodies and institutions, an inconsistent monetary policy, a large informal sector, and a history of high average inflation in the past.

2 PERFORMANCE AND OUTLOOK OF THE FEDERAL BUDGET 2023-24

Muhammad Sabir

The Federal Budget 2023-24 was presented against a challenging macroeconomic backdrop and an uncertain economic and political outlook, further complicated by the expectations associated with an election year. Since the budget has been prepared by an outgoing government, effective implementation of the policy measures introduced in the budget will depend on the ownership of the future government.

As discussed in the previous chapter, the macroeconomic situation is characterised by a host of challenges, including unprecedented high inflation, low real GDP growth, high interest rate, and foreign reserves that remain relatively low despite a decline in the current account deficit.

Several concerning trends have emerged on the fiscal front. Tax-to-GDP ratio has declined, while non-tax revenues lack the expected momentum. Current expenditures have grown disproportionately, fuelled by mounting debt servicing obligations, rising subsidies, and increasing pension and salary expenditures. Notably, the federal government has shown a strong commitment to protecting development expenditures. All these factors have contributed to a high federal fiscal deficit. While the fiscal deficit as a percentage of GDP may not appear extraordinary, the absolute quantum is unprecedented and poses a significant challenge to fiscal sustainability.

As an election year, the Federal Budget for 2023-24 carries significant expectations from diverse segments of society. The inflation-affected population eagerly anticipated relief packages and income support measures from the government. With the negative growth observed in large-scale manufacturing (LSM), which likely would have led to an increased unemployment rate, there is a pressing need for incentive packages to boost GDP and create employment opportunities. Moreover, the contractionary monetary policy has failed to curb inflation, prompting the need for taking concrete steps towards price stability, especially concerning food and energy prices.

In this context, this chapter evaluates the budgetary performance in 2022-23 and the fiscal outlook for 2023-24, considering the notion of fiscal sustainability and analysing the extent to which the budget estimates align with fiscal targets.

THE MACROECONOMIC CONTEXT AND ITS IMPACT ON FISCAL INDICATORS

Preliminary estimates of GDP growth for 2022-23 reveal a challenging situation, with actual growth expected to be around 0.3 percent, significantly lower than the target of 5 percent. This underperformance is particularly notable in large-scale manufacturing, which experienced a negative growth of 8 percent instead of the expected growth of 7.4 percent. Despite the bleak GDP growth statistics, the economy experienced unprecedented high inflation, which resulted in a substantial increase in nominal GDP growth –more than 26.4 percent against the target of 16.8 percent.

The high growth in nominal GDP could have a significant positive impact on key budgetary indicators. The expansion in nominal GDP has surpassed initial expectations, leading to an expanded tax base and, subsequently, higher revenue collection. Although the precise impact on the tax-to-GDP ratio is not yet evident in theory, it is anticipated to yield increased tax revenue for the government. Furthermore, the greater-than-expected growth in nominal GDP will contribute to a decline in the expenditure-to-GDP ratio and the fiscal deficit as a percentage of GDP. This outcome arises because the growth rate of the denominator (nominal GDP) is significantly higher than the targeted level.

FEDERAL RESOURCE PICTURE

The financial resources of the federal government encompass both tax and non-tax revenues. Tax revenues are derived from income and corporate tax, sales tax, customs duties, and federal excise duty (FED). The responsibility for designing and implementing federal tax policies and collecting these taxes lies with the Federal Board of Revenue (FBR). However, after deducting collection charges, 57.5 percent of the taxes collected are shared with provinces as per the resource distribution formula determined by the seventh National Finance Commission (NFC), which has remained unchanged since July 2010.

Non-tax revenues consist of levies and fees, profits from autonomous bodies, including the State Bank of Pakistan (SBP), surcharges, user charges, markup payments, dividends, and other similar receipts. Apart from royalties on oil and gas and the gas development surcharge, these revenues solely belong to the federal government. The combined tax and non-tax revenues collected by the federal government are referred to as gross revenue receipts (GRR). Transfers to provinces are deducted from GRR to obtain net revenue receipts (NRR), which serve as the federal government's financial resources to cover current and development expenditures.

Table 2.1 illustrates the trend in GRR, NRR, and transfers to provinces from 2019-20, including budget and revised estimates for 2022-23 and budget estimates for 2023-24. The data reveals that the federal government collected Rs 8.8 trillion instead of the targeted Rs 9.4 trillion, indicating a shortfall of Rs 587 billion, which accounts for over 6 percent of the target. Both tax and non-tax revenues contributed to this shortfall, but the shortfall in non-tax revenues was higher than the tax revenues. While the causes of the revenue shortfall will be discussed in the following sub-sections, it is noteworthy that the impact of the shortfall was greater on the federal government than on provincial governments (Table 2.1). As a result, the federal government had only Rs 4.7 trillion available in 2022-23 to finance its expenditures, representing a 40 percent increase compared to 2019-20, despite an 80 percent growth in FBR tax revenues. In contrast, non-tax revenues in 2022-23 were lower than the collection in 2019-20.

The impact of the shortfall was greater on the federal government than on provincial governments.

For 2023-24, the federal government is aiming for more growth in non-tax revenues compared to tax revenues. If both tax and non-tax revenue targets are achieved, the federal government would have nearly Rs 7 trillion at its disposal, which would be almost 50 percent higher than the NRR in 2022-23. However, it remains highly doubtful whether this substantial revenue growth will be sufficient to cover the alarmingly escalating expenditures and place the federal fiscal policy on a sustainable path.

Table 2.1 | Gross and net revenues of the federal government *(Rs billion)*

	2019-20 Actual	2020-21 Actual	2021-22 Actual	2022-23		2023-24 BE
				BE	RE	
Gross revenue receipts						
FBR taxes	3,997	4,745	6,149	7,470	7,200	9,415
Non-tax revenue	1,784	1,480	1,152	1,935	1,618	2,963
Gross revenue receipts	5,782	6,225	7,300	9,405	8,818	12,378
Growth (%)		*7.7*	*17.3*	*28.8*	*-6.2*	*40.4*
Transfer to provinces	2,504	2,742	3,589	4,373	4,129	5,399
Growth (%)		*9.5*	*30.9*	*21.8*	*-5.6*	*30.8*
Net revenue receipts	3,278	3,483	3,711	5,032	4,689	6,979
Growth (%)		*6.3*	*6.5*	*35.6*	*-6.8*	*48.8*

BE = Budget estimates, RE = Revised estimates

Source: Budget and revised estimates from Federal Budget in Brief 2023-24, Actual tax collection from FBR Yearbook 2021-22

FEDERAL TAX REVENUES: PERFORMANCE AND OUTLOOK

The tax collection performance and outlook are intricately connected to the macroeconomic performance of a country and the discretionary changes implemented in tax policies throughout the fiscal year. The macroeconomic factors play a crucial role in influencing the tax bases, which can result in autonomous positive or negative growth in tax revenues. When the tax system is broad-based and synchronized with the overall economy, this autonomous growth helps maintain a relatively stable tax-to-GDP ratio.

The changes made to tax policies and tax rates are referred to as discretionary changes, which are implemented through deliberate decisions to achieve specific economic, fiscal, or political objectives. These changes are made to either increase revenues, steer the direction of the macroeconomy, or offer incentives to different segments of society based on the government's priorities and policy direction.

The federal budget documents reveal a shortfall of Rs 270 billion in the revised estimates of FBR tax revenues against the target of Rs 7.47 trillion for 2022-23.

The Finance Act serves as the primary document containing discretionary changes. It is approved by the parliament at the end of the fiscal year for implementation in the following fiscal year. Occasionally, urgent changes in tax rates or bases are introduced and implemented through Statutory Regulatory Orders (SROs) in Pakistan. In rare cases, mini-budgets are announced to incorporate the discretionary changes in the Finance Act.

The fiscal year 2022-23 stands out as a unique year in terms of frequent changes in tax policy. In addition to the discretionary changes introduced in July 2022 through the Finance Act 2023, three mini or supplementary budgets were announced, mainly introducing upward revisions in various indirect tax rates. The most significant revision occurred on February 14, 2023, when the sales tax was enhanced from 17 percent to 18 percent, along with substantial increases in the rates of FED on cigarettes and similar items. These upward revisions are expected to help the FBR exceed its tax target for 2022-23, which was set in June 2022.

Table 2.2 | Analysis of the growth in FBR tax collection *(Rs billion)*

	2019-20 Actual	2020-21 Actual	2021-22 Actual	2022-23		2023-24 BE
				BE	RE	
FBR's total tax revenue	3,997	4,745	6,149	7,470	7,200	9,415
Growth (%)		*18.7*	*29.6*	*21.5*	*-3.6*	*30.8*
Direct taxes	1,523	1,731	2,285	3,039	2,851	4,255
Growth (%)		*13.6*	*32.0*	*33.0*	*-6.2*	*49.2*
Indirect taxes	2,474	3,014	3,864	4,431	4,349	5,160
Growth (%)		*21.8*	*28.2*	*14.7*	*-1.9*	*18.6*
Customs	627	748	1,011	953	1,084	1,211
Growth (%)		*19.4*	*35.0*	*-5.7*	*13.7*	*11.7*
FED	251	277	321	402	457	538
Growth (%)		*10.6*	*15.8*	*25.4*	*13.7*	*17.7*
Sales tax	1,597	1,988	2,532	3,076	2,808	3,411
Growth (%)		*24.5*	*27.4*	*21.5*	*-8.7*	*21.5*

BE = Budget estimates, RE = Revised estimates

Source: Budget and revised estimates from Federal Budget in Brief 2023-24, Actual tax collection from FBR Yearbook 2021-22

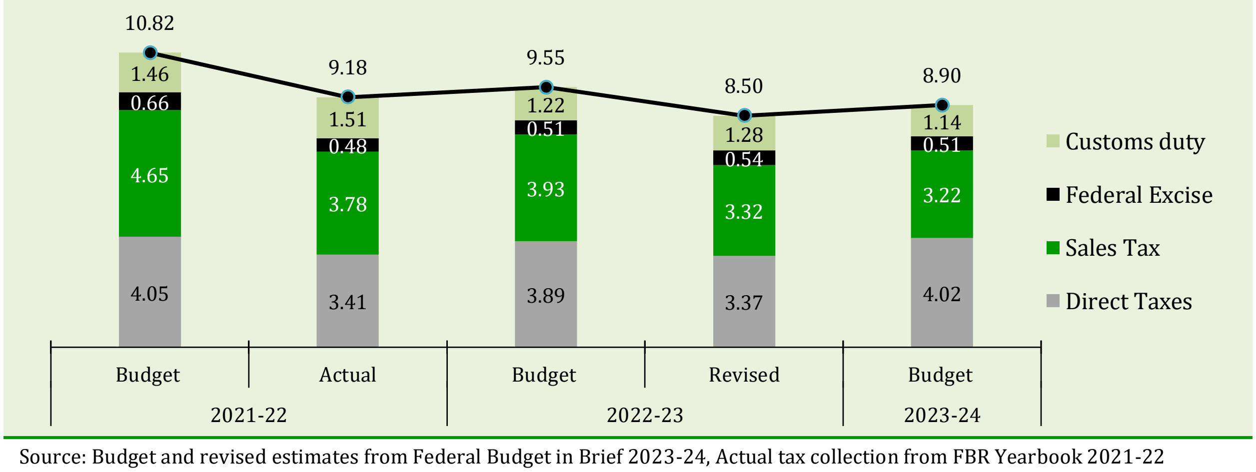
Against this backdrop, Table 2.2 illustrates the trend in FBR tax collection from 2019-20, including budget and revised estimates for 2022-23, as well as the budget estimates for 2023-24. Despite the government's claims of achieving the tax targets, the federal budget documents reveal a shortfall of Rs 270 billion in the revised estimates of FBR tax revenues against the target of Rs 7.47 trillion for 2022-23. While the shortfall was experienced in both direct and indirect taxes, it is more prominent in direct taxes, as about 94 percent of the targeted revenue from direct taxes could be collected, leading to a shortfall of Rs 188 billion. The shortfall in the indirect tax revenue is estimated to be Rs 82 billion. Direct taxes primarily include income and corporate taxes, while indirect taxes include sales tax, FED, and customs duties. Among indirect taxes, collection from customs duties and FED exceeded their tax targets by Rs 131 billion and Rs 55 billion, respectively. In comparison, the sales tax target of Rs 3 trillion was missed by Rs 268 billion.

The government aims to collect tax revenue of Rs 9.4 trillion in 2023-24, with a substantial growth rate of almost 31 percent over the previous year. This includes Rs 4.26 trillion from direct taxes and Rs 5.16 trillion from indirect taxes, representing growth rates of 49 percent and 19 percent, respectively. Notably, FBR has placed greater emphasis on direct taxes rather than relying heavily on indirect taxes. If this target is achieved, the share of direct taxes in total tax revenue will increase to 45 percent in 2023-24 compared to 40 percent in 2022-23. Among indirect taxes, customs, FED, and sales tax are projected to show reasonable growth rates of 11.7 percent, 17.7 percent, and 21.5 percent, respectively. While the target for direct taxes appears ambitious, the target for indirect taxes seems achievable, considering the prevailing high inflation in the country.

A rather disappointing aspect of the resource mobilization performance is the significant decline in the overall tax-to-GDP ratio.

A rather disappointing aspect of the resource mobilization performance is the significant decline in the overall tax-to-GDP ratio. As shown in Figure 2.1, revised estimates for 2022-23 indicate a total tax collection of 8.5 percent of GDP, which is below the target (9.55 percent) and lower than the actual collection of 9.18 percent of GDP in 2021-22. The shortfall is experienced in both direct and indirect taxes. The shortfall in tax revenue not only poses challenges to fiscal sustainability but also raises questions about the effectiveness of the tax system in achieving equitable outcomes.

Figure 2.1 | Tax-to-GDP ratio (%)



Source: Budget and revised estimates from Federal Budget in Brief 2023-24, Actual tax collection from FBR Yearbook 2021-22

For the fiscal year 2023-24, the tax-to-GDP ratio target is set at 8.9 percent. However, considering the historical trend of the FBR falling short of its targets and the overly ambitious direct tax targets for 2023-24, prospects of achieving the revenue objectives do not appear favourable. This situation emphasizes the need to thoroughly examine the interconnections between macroeconomic indicators and tax collection, which is presented in the subsequent subsections. An assessment is also provided regarding the feasibility of the tax targets.

Tax Revenue Estimation and Forecasting

In the past two years, the FBR has released two separate documents entitled "Evidence Based Revenue Forecasting 2020-21" and "Evidence Based Revenue Forecasting 2021-22." These documents aim to provide insights into the forecasting methods employed to estimate tax targets for the respective fiscal years. Similarly, the Social Policy and Development Centre (SPDC) has adopted a comparable methodology to understand the factors contributing to the decline in the tax-to-GDP ratio.

This methodology consists of four key steps. Firstly, it establishes a linkage between taxes and their respective tax bases, considering the sectoral growth rates. This step helps identify the connection between tax revenues and the performance of different sectors of the economy. The second step involves estimating the buoyancy and autonomous growth. By analyzing the historical data, the estimation provides insights into the responsiveness of tax revenues to changes in the tax base (buoyancy) and the autonomous growth in tax revenues unrelated to changes in the tax base. The third step entails comparing the estimated revenues with the revised revenue figures to assess the shortfall or increase in revenues. Finally, the feasibility of the tax targets is evaluated by comparing the autonomous growth rate derived from the analysis with the projected rates of the FBR. This comparison sheds light on the achievability of the set tax targets and offers insights into the potential factors influencing their feasibility.

FBR taxes and tax bases

As mentioned earlier, FBR is responsible for collecting four major taxes, which are categorized based on their collection stages: imports and domestic transactions. Of these four taxes, direct taxes, sales tax, and FED are collected on domestic transactions and imports, while customs duties are solely collected on imports.

Table 2.3 provides information on the targeted growth rates for the years 2022-23 and 2023-24, as well as the provisional growth rate for 2022-23. The ideal tax base for the collection of direct taxes within the country is the non-agricultural Gross Domestic Product (GDP). This is because agricultural income tax falls outside the constitutional domain of the FBR. However, according to FBR methodology, the entire value of the nominal GDP at market price is considered the tax base for domestic direct taxes. Similarly, the nominal values of large-scale manufacturing are utilized as the tax base for domestic FED and sales tax. In contrast, the tax base for all taxes collected at the import stage is determined by the nominal value of imports in Pakistani Rupees (Rs).

Table 2.3 | Growth in FBR taxes, tax bases, and their respective macroeconomic targets (%)

Tax head	Tax base	Target 2022-23	Provisional 2022-23	Target 2023-24
Direct taxes (imports)	Imports (nominal Rs)	7.80	0.77	21.96
Direct taxes (domestic)	GDP (nominal)	16.80	27.07	25.00
Sales tax (imports)	Imports (nominal Rs)	7.80	0.77	21.96
Sales tax (domestic)	LSM	20.20	23.82	24.87
FED (imports)	Imports (nominal Rs)	7.80	0.77	21.96
FED (domestic)	LSM	20.20	23.82	24.87
Custom duties	Imports (nominal Rs)	7.80	0.77	21.96

Source: Derived from Annual Plan 2023-24, Ministry of Planning, Development & Special Initiatives

The comparison of the targeted and provisional growth rates reveals a mixed pattern. For instance, the growth target for imports in 2022-23 was set at 7.8 percent, while the provisional estimates for the first nine months are only 0.77 percent. In contrast, despite experiencing negative real growth in the large-scale manufacturing sector, the nominal growth rate reached 23.82 percent, surpassing the target of 20 percent. Similarly, although real GDP exhibited less than one percent growth, the nominal GDP showed a growth rate of 27 percent, exceeding the target of 16.8 percent.

Tax buoyancy and autonomous growth

Table 2.4 presents the estimates of tax-wise buoyancy and autonomous growth. The buoyancy estimates are obtained through econometric analyses utilizing twenty years of data from the FBR to examine the relationship between the natural logarithm of taxes and their corresponding tax bases. The analysis helps understand how tax revenue responds to changes in the tax base. Higher buoyancy values indicate that tax revenue grows faster than the growth in the tax base.

As shown in Table 2.4, domestic direct taxes exhibit the highest buoyancy with a magnitude of 1.16, followed by domestic sales tax (1.12) and direct taxes on imports (1.11). On the other hand, the rest of the buoyancy estimates are less than 1, indicating that the growth in tax revenues is lower than the growth in the corresponding tax bases.

Autonomous growth estimates are derived by multiplying tax-wise buoyancy with the growth rate of their respective tax bases. These estimates capture the inherent growth in tax revenue independent of any discretionary changes. As anticipated, domestic taxes show higher autonomous growth rates (based on provisional estimates) compared to the autonomous growth rates targeted for 2022-23.

Table 2.4 | Tax Buoyancy and estimates of autonomous growth (%)

Tax Head	Buoyancy	Autonomous growth		
		Target 2022-23	Provisional 2022-23	Target 2023-24
Direct taxes (imports)	1.11	8.67	0.85	24.40
Direct taxes (domestic)	1.16	19.54	31.48	29.07
Sales tax (imports)	0.96	7.46	0.74	21.00
Sales tax (domestic)	1.12	22.53	26.58	27.75
FED (imports)	0.74	5.76	0.57	16.22
FED (domestic)	0.90	18.21	21.48	22.42
Custom duties	0.95	7.43	0.73	20.91

Source: Federal Budget in Brief 2023-24, Actual tax collection from FBR Yearbook 2021-22

Conversely, taxes collected on imports demonstrate significantly lower autonomous growth rates compared to the autonomous growth rates targeted. For instance, domestic direct taxes indicate an estimated autonomous growth of 31.5 percent, surpassing the targeted autonomous growth rate of approximately 20 percent. Similarly, domestic sales tax and domestic FED display autonomous growth rates of 26.6 percent and 21.5 percent, respectively, whereas the targeted autonomous growth rates are 22.5 percent and 18.2 percent, respectively. In contrast, taxes collected on imports demonstrate autonomous growth rates of less than one percent, which is considerably lower than the targeted autonomous growth rates (Table 2.4).

Impact of macroeconomic performance on tax revenues

After obtaining the estimates of autonomous growth, the impact of macroeconomic performance on tax revenues can be estimated by considering the tax collection in the base year, which, for 2022-23, is the tax collected during 2021-22.

As presented in Table 2.5, the estimated impact of macroeconomic performance on tax revenues is as follows:

- Domestic direct taxes, domestic sales tax, and domestic FED have a positive impact on tax revenues, which amounts to Rs 28.7 billion, Rs 27.4 billion, and Rs 10.4 billion, respectively.
- However, taxes collected on imports have a negative impact on macroeconomic performance. For example, the sales tax collection on imports falls short of the targeted revenues by Rs 119 billion. Similarly, other taxes collected on imports also have a negative impact due to a decline in imports compared to the targets.

Interestingly, when considering the overall macroeconomic performance, there is a positive impact of Rs 68.6 billion on total FBR tax collection. This implies that a shortfall in total taxes cannot be attributed to macroeconomic performance and the growth in tax bases. The overall macroeconomic performance has a positive impact on the total FBR tax collection.

Table 2.5 | Tax revenue estimates based on autonomous growth *(Rs billion)*

	2021-22	Target 2022-23	Provisional 2022-23	Difference
Direct taxes (imports)	288.0	313.0	290.5	-22.5
Direct taxes (domestic)	1,915.0	2,289.1	2,517.8	228.7
Sales tax (imports)	1,775.0	1,907.4	1,788.1	-119.4
Sales tax (domestic)	678.0	830.8	858.2	27.4
FED (imports)	25.5	27.0	25.6	-1.3
FED (domestic)	318.0	375.9	386.3	10.4
Custom duties	817.0	877.7	823.0	-54.7
Total	5,816.5	6,620.9	6,689.4	68.6

Source: Federal Budget in Brief 2023-24, Actual tax collection from FBR Yearbook 2021-22

Tax revenues leakages

A comparison is made between the tax revenues reported in the budget documents as revised estimates for 2022-23 and the SPDC estimates of tax revenues for the same period. The SPDC estimates are based on the provisional tax revenue estimates presented in Table 2.6 and the impact of discretionary changes. The discretionary changes are derived by subtracting the tax-wise targets presented in Table 2.5 from the budget estimates of tax revenues for 2022-23 obtained from the federal budget in brief 2023-24. The analysis reveals that the revised estimates of direct taxes fall short by Rs 394 billion compared to the SPDC estimates. Similarly, sales tax and FED also indicate shortfalls of Rs 176 billion and Rs 5 billion, respectively. On the other hand, customs duties show additional revenue of Rs 186 billion. Therefore, assuming all other factors remain constant, the FBR is likely to surpass the tax target for 2022-23 by more than Rs 100 billion. Any shortfall in tax collection can be attributed to collection inefficiencies, for which macroeconomic performance cannot be solely blamed.

Any shortfall in tax collection can be attributed to collection inefficiencies, for which macroeconomic performance cannot be solely blamed.

Table 2.6 | Tax revenue shortfalls *(Rs billion)*

	SPDC estimates without measures	Discretionary changes	SPDC estimates	Revised estimates	Difference
Direct taxes	2,808	437	3,245	2,851	-394
Sales tax	2,646	338	2,984	2,808	-176
FED	412	50	462	457	-5
Custom duties	823	75	898	1,084	186
Total	6,689	900	7,589	7,200	-389

Source: Federal Budget in Brief 2023-24, Actual tax collection from FBR Yearbook 2021-22

Direct taxes may require further attention as their autonomous growth rates might not be as high as the targeted growth rates.

Tax revenues: Outlook and Feasibility

Table 2.7 provides insights into the feasibility of tax revenue targets for 2023-24. It indicates that, except for direct taxes, all other tax revenue targets are considered feasible. This feasibility is determined by comparing the targeted growth rates with the corresponding autonomous growth rates. According to Table 7, the autonomous growth rates for taxes other than direct taxes are significantly higher than the targeted growth rates. This implies that these tax categories have the potential to exceed their revenue targets for 2023-24, based on their expected autonomous growth. However, it should be noted that direct taxes may require further attention as their autonomous growth rates might not be as high as the targeted growth rates. This suggests the need for additional measures or strategies to ensure that the revenue target for direct taxes is attainable in 2023-24.

Table 2.7 | Assessing the Feasibility of Tax Revenue Growth Rates (%)

	Autonomous Growth	Targeted Growth	Required Discretionary Changes
Direct Taxes	28.46	49.25	20.78
Customs	20.91	11.72	-9.19
Federal Excise	21.96	17.72	-4.24
Sales Tax	22.87	21.47	-1.39

Source: Table 2 and Table 4

As anticipated, an examination of the discretionary changes brought in the Finance Act 2023 reveals a significant emphasis on direct taxes. Noteworthy alterations in direct taxes comprise an upward adjustment in income tax rates for both salary and non-salary individuals, and the addition of new brackets for super income tax. Additionally, the FBR now possesses the authority to levy an extra 50% tax on windfall gains and similar transactions. Moreover, a tax on bonus shares has been introduced. Nevertheless, there remains uncertainty as to whether these changes will succeed in achieving the intended direct tax revenue target.

NON-TAX REVENUES: PERFORMANCE AND OUTLOOK

Non-tax revenues primarily originate from three major sources: petroleum levy, SBP profit, and dividends from public enterprises, along with the markup on federal loans. Other sources encompass various fees, fines, and user charges.

In 2019-20, non-tax revenues amounted to Rs 1.8 trillion and gradually declined to Rs 1.15 billion in 2021-22, primarily due to SBP profit and the petroleum levy. The decrease in SBP profit indicates the government's efforts to demonetize fiscal deficit financing and borrow from private banks. Similarly, the decline in petroleum levy reflects the government's decision to contain the impact of higher petroleum prices on domestic retail prices by reducing the rate of the petroleum levy, particularly in 2021-22.

For the fiscal year 2022-23, the federal government set a target of Rs 1.9 trillion for non-tax revenues. However, the revised estimates indicate a significant decline of over Rs 300 billion compared to the targeted amount. This underperformance can primarily be attributed to a substantial decrease in petroleum development levy revenues, which amounted to only Rs 542 billion, significantly lower than the target of Rs 855 billion (Table 2.8).

The dependence on SBP profit suggests a shift in the federal government's fiscal deficit financing strategy.

The non-tax revenue target set for the fiscal year 2023-24 indicates a substantial growth rate of over 83 percent compared to the revised estimates for 2022-23. The target of Rs 2.9 trillion is attainable primarily due to heavy reliance on SBP profit. The dependence on SBP profit suggests a shift in the federal government's fiscal deficit financing strategy, which involves monetizing the fiscal deficit by more than Rs 3.5 trillion. This strategy aims to bridge the fiscal gap by increasing money supply.

Table 2.8 | Stagnant non-tax revenues *(Rs billion)*

	2019-20 Actual	2020-21 Actual	2021-22 Actual	2022-23		2023-24 BE
				BE	RE	
Non-tax revenues	1,784	1,480	1,152	1,935	1,618	2,963
Growth		-17.0	-22.2	68.0	-16.4	83.1
Petroleum levy	294	425	128	855	542	869
Growth (%)		*44.6*	*-70.0*	*570.4*	*-36.6*	*60.3*
SBP profit	936	651	474	300	371	1,113
Growth (%)		*-30.5*	*-27.2*	*-36.7*	*23.7*	*199.8*
Markup and dividends	298	150	234	280	305	398
Growth (%)		*-49.7*	*55.9*	*19.5*	*9.2*	*30.3*
Others	257	255	317	500	400	583
Growth (%)		*-0.7*	*24.2*	*58.0*	*-20.1*	*45.9*

Source: Budget and Revised Estimates from Federal Budget in Brief 2023-24,
Actual from Pakistan Fiscal Operations.

CURRENT EXPENDITURES

There are various ways to categorize public expenditures, including economic, functional, and object-based classifications. Under the economic classification, expenditures are categorized based on their impact on the economy. This classification distinguishes between current expenditures, which include day-to-day expenses like employee-related expenditures (ERE) and operating expenses, and capital expenditures, which include investments in long-term assets or infrastructure.

In Pakistan, the economic classification includes current and development expenditures. These are further classified into functional categories, which group spending based on the purpose or function it serves, such as education and health, and object categories, which classify spending based on the specific goods, services, or objects acquired or paid for, such as ERE and utilities.

However, for the analysis of current expenditures in Pakistan, the existing classification does not provide valuable insights. The majority of the current budget is classified as General Public Services (GPS), and when combined with defence, it accounts for approximately 92 percent of the budget allocation for 2023-24. Therefore, a hybrid approach using functional and object classifications is being utilized to divide the current expenditures into six categories.

Another concern is related to mark-up payments that account for more than half of the current expenditures.

Table 2.9 presents an overview of the federal government's current expenditures for 2022-23 and 2023-24. There is a significant deviation of more than 21 percent between the budget and revised estimates of current expenditure, as estimated outlays for the fiscal year 2022-23 are projected to reach Rs 10.5 trillion, compared to the initial allocation of Rs 8.7 trillion. This may reflect either mismanagement of current expenditure or deliberate underestimation of certain expenditure categories, undermining the credibility of government expenditure planning and reporting.

Another concern is related to mark-up payments that account for more than half of the current expenditures in both years – 2022-23 (revised) and 2023-24 (budget). There is also a substantial overrun of 40 percent in the markup payment in 2022-23; in absolute terms, markup payments exceed the allocation by a staggering Rs 1.5 trillion in 2022-23. Moreover, subsidies show a notable increase of Rs 439 billion in outlays compared to the allocations of Rs 664 billion.

It is interesting to note that the allocations and outlays for running the civil government and pensions are precisely the same, indicating relatively better estimations in these areas. However, it did not reflect the impact of austerity measures announced during the fiscal year.

Table 2.9 | Current expenditures performance and outlook *(Rs billion)*

	2022-23			2023-24	
	Budget	Revised	Growth (%)	Budget	Growth* (%)
Markup Payments	3,950	5,520	**40**	7,303	**32**
Defence	1,563	1,587	**2**	1,804	**14**
Transfers and Grants	1,174	1,155	-2	1,409	**22**
Subsidies	664	1,103	**66**	1,064	-4
Pensions	609	609	0	801	**32**
Running of Civil Government	553	553	0	714	**29**
Others	195	0	-100	250	
Total current expenditure	8,709	10,528	**21**	13,344	**27**

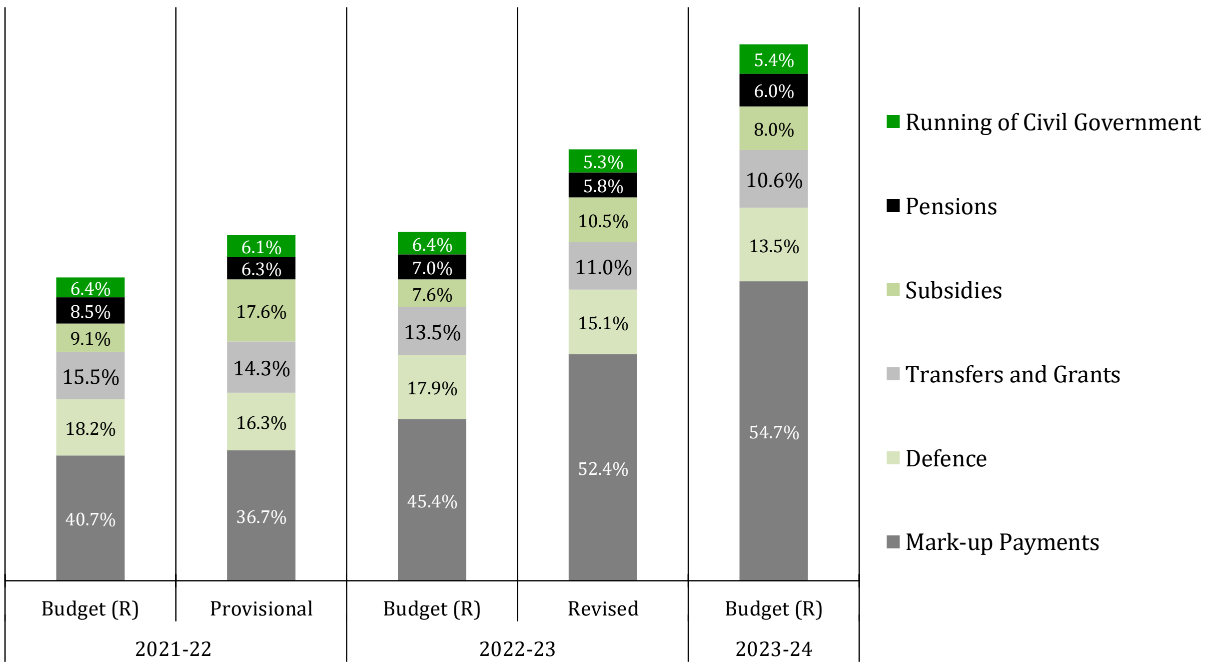
* Percent growth over revised estimates of 2022-23.

Source: Federal Budget in Brief 2023-24

Given the financial resource crunch, the government was expected to implement stringent measures to control the escalating current expenditures. However, the outlook for 2023-24 presents a different picture. Except for subsidies, there is double-digit growth in each major category of current expenditures. This surge is primarily driven by around a 30 percent increase in markup payments, pensions, and civil service allocations, the latter driven mainly by a rise of 30-35 percent in salaries and a lack of emphasis on fiscal austerity.

The priorities in current expenditures during three fiscal years are depicted in Figure 2.2. Compared to the allocations and outlays in 2021-22, the relative share of each expenditure category has declined, except for markup payments. According to 2021-22 outlays, markup payments accounted for approximately 37 percent of the total, which rose to 52 percent in 2022-23 and is projected to increase further to 55 percent in 2023-24. The share of markup payments surpasses the federal government's net revenue receipts (NRR). Following markup payments, the top three priorities of the federal government are defence, transfers and grants, and subsidies. All three categories receive allocations exceeding Rs 1 trillion. While detailed information about defence is limited, analyzing subsidies, transfers, and grants is essential.

Figure 2.2 | Priorities in current expenditures (%)



Source: Estimates based on Federal Budget in Brief 2023-24

Grants and transfers during the election year

Federal grants and transfers encompass three distinct types: grants to provinces and regions, grants to public entities, and transfers and grants for achieving specific objectives. The federal government provides grants to the governments of Sindh, Khyber Pakhtunkhwa, Gilgit Baltistan, and Azad Jammu & Kashmir. As shown in Table 2.10, in the 2023-24 allocations, these grants exhibit a significant growth rate ranging from 10 to 20 percent compared to the outlays of 2022-23.

An intriguing pattern is also observed in grants allocated to other entities. Despite the significant inflation and salary increase announcements in budget 2023-24, the Higher Education Commission (HEC) stands out as the only entity with no growth in grants for 2023-24. Conversely, contingent liabilities, Pakistan Railways, and miscellaneous grants demonstrate substantial growth in the 2023-24 allocations. The notable increase in grants allocated to the Election Commission of Pakistan indicates that the government is aware of the upcoming general election and has allocated Rs 48 billion for this purpose.

Under the third category of grants, the Benazir Income Support Programme (BISP) and the reimbursement of Telegraphic Transfer (TT) charges also exhibit substantial growth rates of 10.3 and 157 percent, respectively.

In 2023-24, the overall transfers and grants display a substantial growth rate of 21 percent when compared to the outlays of 2022-23. Given the absence of revenue buoyancy and the significant increase in markup payments, applying fiscal austerity measures to transfers and grants would be a suitable option. However, the budget for 2023-24 fails to capitalize on this opportunity, primarily due to the prioritization of election-related expenditures. The emphasis on election-related priorities and expenditures seems to overshadow the potential for implementing fiscal austerity measures in transfers and grants. As a result, despite the need for fiscal discipline and curbing expenditure growth, the budget allocation for transfers and grants does not fully address these concerns.

Table 2.10 | Grants and transfers *(Rs billion)*

	2022-23			2023-24	
	Budget	Revised	Growth (%)	Budget	Growth (%)*
Sindh	22.0	22.0	0.0	26.4	**20.0**
Khyber Pakhtunkhwa	60.0	60.0	0.0	66.0	**10.0**
Gilgit Baltistan government	47.0	47.0	0.0	51.7	**10.0**
AJK government	59.5	59.5	0.0	70.0	**17.6**
BISP	360.0	408.0	**13.3**	450.0	**10.3**
Contingent liabilities	291.0	235.0	-19.2	280.0	**19.1**
Reimbursement of TT charges & others	20.0	35.0	**75.0**	90.0	**157.1**
HEC	65.0	65.0	0.0	65.0	0.0
Pakistan Railways	45.0	45.0	0.0	55.0	**22.2**
Election Commission of Pakistan	5.5	5.0	-9.1	48.0	**860.0**
Security enhancement	40.0	0.0	-100.0	40.0	
Miscellaneous grants	100.0	100.0	0.0	120.0	**20.0**
Other grants	59.5	73.7	**23.9**	46.5	-36.9
Total grants and transfers	1,174.5	1,155.2	-1.6	1,409	21.9

* Percent growth over revised estimates of 2022-23. Source: Federal Budget in Brief 2023-24

The burden of federal subsidies

In 2022-23, total outlays on subsidies exceeded the allocated amount by more than 66 percent, significantly contributing to the higher current expenditures (Table 2.11). Most subsidies are concentrated towards energy suppliers, namely WAPDA and KE, with a combined share of over 79 percent and 83 percent of the total subsidies in 2022-23 and 2023-24, respectively. Out of the total Rs 894 billion of the electricity subsidies, Rs 321 billion is allocated for household tariff differential subsidies to bridge the gap between the NEPRA proposed tariff rate and the approved tariff. Another Rs 310 billion is allocated for Independent Power Producers (IPPs). It is worth noting that power subsidies to AJK also experienced a significant increase, rising from Rs 3 billion in allocations to Rs 75 billion in outlays for 2022-23.

Table 2.11 | The burden of federal subsidies *(Rs billions)*

	2022-23			2023-24	
	Budget	Revised	Growth (%)	Budget	Growth* (%)
Electricity subsidies to WAPDA	455.0	677.0	*48.8*	579.1	*-14.5*
IPPs	180.0	180.0	*0.0*	310.1	*72.3*
Tariff differential	225.0	225.0	*0.0*	150.0	*-33.3*
AJK	3.0	75.0	*2400.0*	80.0	*6.7*
Ex FATA districts	20.0	20.0	*0.0*	25.0	*25.0*
FATA subsidy arrears	0.0	0.0		14.0	
Others	27.0	177.0	*555.6*	0.0	*-100.0*
Electricity subsidies to KE	80.0	193.0	*141.3*	315.0	*63.2*
Tariff differential	60.0	173.0	*188.3*	171.0	*-1.2*
TDS KE arrears	0.0	0.0		127.0	
Others	20.0	20.0	*0.0*	17.0	*-15.0*
Subsidy to petroleum	71.0	102.0	43.7	53.6	-47.5
SNGPL (domestic Consumers)	*25.0*	*25.0*	*0.0*	*30.0*	*20.0*
PSO, APL others	*6.0*	*6.0*	*0.0*	*12.6*	*110.0*
Others	*40.0*	*71.0*	*77.5*	*11.0*	*-84.5*
Others	0.0	27.0		0.0	-100.0
PASSCO	7.0	4.0	-42.9	10.0	150.0
Utility Stores Corporation	17.0	30.0	76.6	35.0	16.6
Additional for floods	0.0	44.0		32.6	-25.9
Others	34.0	26.1	-23.4	49.0	88.1
Wheat subsidy to GB	15.0	15.0	*0.0*	30.0	*100.0*
Metro Bus subsidy	8.0	4.0	*-50.0*	10.5	*162.5*
Fertilizer plants subsidy	6.0	6.0	*0.0*	6.0	*0.0*
Others	5.0	1.1	*-79.0*	2.5	*138.1*
Total subsidies	664.0	1,103.1	66.1	1,074.3	-2.6

*Percent growth over revised estimates of 2022-23.

Source: Federal Budget in Brief 2023-24

In an effort to provide relief to the economically disadvantaged segment of society, the government increased subsidies for Utility Stores Corporation from an initial allocation of Rs 17 billion to Rs 30 billion in the outlays for 2022-23. A puzzling addition to the subsidy category named 'others' emerges in the outlays for 2022-23, with a cost of Rs 27 billion, despite having no allocations in either 2022-23 or 2023-24.

Unfortunately, these subsidies are unlikely to provide meaningful relief to the general public, who bear the burden of taxes and experience the impact of soaring inflation. The persistently high burden of subsidies contributes to the economic challenges faced by the public since the cost of these subsidies ultimately trickles down to them. This situation highlights the need for more sustainable and targeted approaches to subsidy management, ensuring that they effectively address the population's needs while minimizing their adverse effects on the economy and public finances.

DEVELOPMENT EXPENDITURE

Contrary to the previous trends, the revised estimates of federal development expenditure in 2022-23 indicate a notable increase of 8.3 percent compared to budget allocations (Table 2.12). This highlights the sustained focus on development despite the substantial rise in current expenditure. Initial budget estimates for the 2022-23, Public Sector Development Programme (PSDP) were set at Rs 727 billion. However, the revised estimates now indicate a higher allocation of Rs 787 billion, including an additional Rs 73 billion designated for the Viability Gap Funding (VGF) of Public-Private Partnership (PPP) projects. The development expenditure under the Cabinet Division has also experienced significant growth, exceeding budgetary estimates by over 58 percent. This growth emphasizes the pivotal role of the Cabinet Division in driving development priorities.

Despite resource constraints, the PSDP allocations for 2023-24 demonstrate a substantial growth rate of 46 percent.

Despite resource constraints, the PSDP allocations for 2023-24 demonstrate a substantial growth rate of 46 percent. However, the pattern of expenditure growth suggests that the federal government is focusing on election-related objectives rather than addressing economic imbalances. Notably, infrastructure allocations witness a significant increase of 40 percent, with the construction of national highways being the top priority, having a share of over 13 percent in the PSDP and a remarkable growth rate of 55 percent compared to the revised estimates of 2022-23. Additionally, a new allocation of Rs 80 billion is earmarked for the Prime Minister's initiatives in 2023-24. Furthermore, the PSDP allocation for Cabinet divisions has increased to Rs 70 billion, compared to Rs 46 billion in 2022-23. Moreover, Rs 200 billion are allocated for VGF for PPP. Collectively, these figures highlight the expansionary nature of the budget in an election year.

Table 2.12 | Priorities in Public Sector Development Program (*Rs billion)*

	2022-23			2023-24		
	Budget	Revised	Growth (%)	Budget	Growth (%) *	Share (%)
Federal Ministries/Divisions	565.0	562.2	-0.5	653.0	**16.1**	56.8
Water Resources Division	103.5	90.6	-12.5	99.6	**9.9**	8.7
Cabinet Division	46.2	64.0	**38.7**	70.1	**9.5**	6.1
Special Areas (AJK & GB)	0.0	0.0		52.6		4.6
Higher Education Commission	42.5	26.3	-38.0	44.2	**67.7**	3.8
Merged Districts of Khyber Pakhtunkhwa	0.0	0.0		50.2		4.4
Provincial Projects	0.0	0.0		33.0		2.9
Housing & Works Division	24.2	14.3	-40.8	14.0	-2.4	1.2
Railways Division	30.0	17.8	-40.6	32.6	**83.1**	2.8
Pakistan Atomic Energy Commission	27.0	18.9	-30.0	26.0	**37.5**	2.3
Planning, Development Division	19.2	6.6	-65.6	42.2	**537.7**	3.7
National Health Services Division	21.7	12.6	-42.0	12.7	**0.4**	1.1
Other Federal Ministries	250.7	311.0	**24.1**	175.8	-43.5	15.3
Corporations	161.5	151.5	-6.2	212.1	**40.0**	18.4
National Highway Authority	118.4	101.4	-14.4	157.5	**55.4**	13.7
NTDC / PEPCO	43.1	50.1	**16.2**	54.6	**8.8**	4.7
ERRA and others	0.5	0.5	0.0	5.0	**900.0**	0.4
PM Initiatives	0.0	0.0		80.0		7.0
VGF for PPP Projects	0.0	73.0		200.0	**174.0**	17.4
Total federal PSDP	**727.0**	**787.2**	**8.3**	**1,150.0**	**46.1**	**100.0**

* Percent growth over revised estimates of 2022-23.
Source: Federal Budget in Brief 2023-24

UNSUSTAINABLE FISCAL DEFICIT

The fiscal balance represents the variance between total revenues and total expenditures, with a deficit arising when expenditures surpass revenues and a surplus occurring when revenues exceed expenditures. The primary balance, obtained by deducting markup payments from the fiscal balance, serves as a critical indicator illuminating fiscal sustainability. A primary surplus signifies that the government finances all its expenses through its own resources and borrowing, aiming to repay a portion of the interest payments. Conversely, a primary deficit highlights an unsustainable fiscal situation, as the government resorts to borrowing not only for interest payments but also to finance other expenditures.

Table 2.13 provides an overview of the components of computing the federal and overall fiscal and primary deficits. The net revenue receipts, current expenditures, and development expenditures have been previously discussed and are reiterated to demonstrate the calculation of the fiscal deficit.

The budgeted federal fiscal deficit for 2022-23 was Rs 4.5 trillion or 5.8 percent of the GDP. However, due to a decline in net revenue receipts and an increase in current expenditures, it rose to Rs 6.4 trillion or 7.6 percent of the GDP. Notably, the net revenue receipts of the federal government constitute only 5.5 percent of the GDP. Moreover, in absolute terms, this is the first time that the fiscal deficit has exceeded net revenue receipts by Rs 1.7 trillion.

Table 2.13 | Federal and the overall budget deficit *(Rs billions)*

	2022-23			2023-24	
	Budget	Revised	Growth (%)	Budget	Growth* (%)
Revenue receipts					
Gross revenue receipts	9,405	8,818	-6.2	12,378	40.4
(Minus) Transfer to provinces	4,373	4,129	-5.6	5,399	30.8
I Net revenue receipts	*5,032*	*4,689*	*-6.8*	*6,979*	*48.8*
Federal expenditure					
Mark-up payments	3,950	5,520	39.8	7,303	32.3
Other current expenditures	4,758	5,007	5.2	6,042	20.7
Development expenditure & net lending	871	562	-35.4	1,141	102.8
II Federal expenditure & net lending	*9,580*	*11,090*	*15.8*	*14,485*	*30.6*
Federal budget surplus (+)/deficit (-)	*-4,547*	*-6,401*	*40.8*	*-7,506*	*17.3*
Federal primary surplus (+)/deficit (-)	*-597*	*-880*	*47.4*	*-203*	*-76.9*
III Provincial budget surplus/deficit	*750*	*459*	*-38.8*	*600*	*30.7*
Overall budget surplus (+)/deficit (-)	*-3,797*	*-5,942*	*56.5*	*-6,906*	*16.2*
Overall primary surplus (+)/deficit (-)	*153*	*-421*	*-375.7*	*397*	*-194.1*
As of GDP					
Federal budget deficit	-5.8	-7.6		-7.1	
Overall budget deficit	-4.9	-7.0		-6.5	
GDP (MP)	*78,197*	*84,658*		*105,817*	

* Percent growth over revised estimates of 2022-23.

Source: Federal Budget in Brief 2023-24

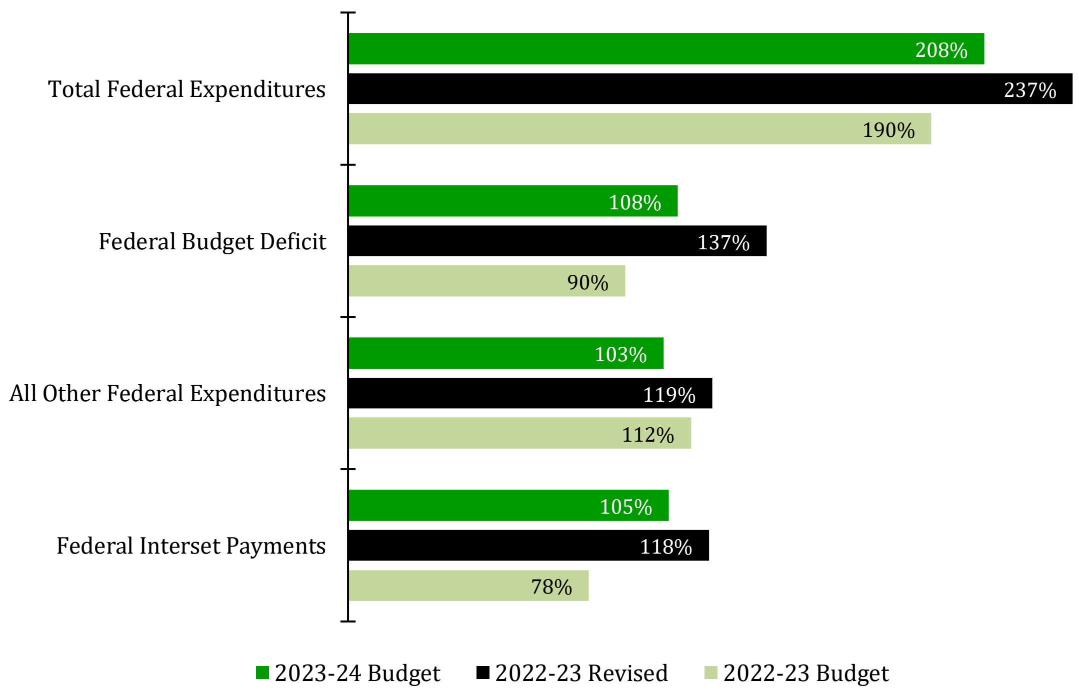
With the expansion of the fiscal deficit predominantly attributable to increased interest payments, the hope for sustainability lies in achieving a primary surplus. However, instead of a surplus, federal finance exhibits a primary deficit of Rs 880 billion in 2022-23. Despite an ambitious budgeted growth of 50 percent in net revenue receipts, the federal fiscal outlook does not appear sustainable as the fiscal deficit is projected to rise to an alarming level of Rs 7.5 trillion or 7.1 percent of the GDP in 2023-24. Furthermore, the federal fiscal outlook for 2023-24 also indicates a primary deficit of Rs 203 billion, underscoring the unsustainability of the federal fiscal position even if all targets were met.

The discussion above raises several concerns regarding the federal government's financial position. It emphasizes the importance of evaluating key fiscal indicators in relative terms, either as a percentage of GDP or as a percentage of revenues, because relying solely on absolute numbers could be misleading.

Figure 3 illustrates the crucial budgetary magnitudes as a percentage of net revenue receipts (NRR). This visual representation demonstrates that in 2022-23, the revised federal expenditures were 237 percent of NRR, while interest payments alone accounted for 118 percent of NRR. Moreover, all other expenditures collectively constitute nearly 119 percent of NRR. These figures indicate a worrisome situation where the net revenue receipts fall short of covering the markup payments, necessitating additional borrowing to finance the remaining federal expenditure.

A similar trend emerges in the outlook for 2023-24. Despite an anticipated substantial 50 percent growth in NRR, the federal interest payments, all other federal expenditures, and federal budget deficit are projected to exceed 100 percent of NRR. This highlights that even with the expected increase in revenue, the government's financial obligations, particularly interest payments and other expenditures, surpass the available resources, resulting in a reliance on additional borrowing. This situation calls for careful and responsible financial management and effective resource mobilization.

Figure 2.3 | Key budgetary magnitude as a percentage of net revenue receipts



Source: Estimates based on Federal Budget in Brief 2023-24

CONCLUSION

The analysis presented in this chapter highlights the pressing need for resource mobilization strategies and structural reforms to address enormous fiscal challenges. The substantial increase in current and development expenditures, coupled with a widening fiscal deficit, raises doubts about the fiscal sustainability of the federal budget. To ensure a viable fiscal policy path, key reforms should be implemented, such as enhancing tax collection efficiency and minimizing tax expenditures to improve revenue generation. More importantly, measures to rationalize government spending, optimize resource allocation, and explore investment subsidies can help reduce the budget deficit and support long-term economic growth. Efforts to rationalize debt management techniques and prioritize green energy initiatives can also contribute to fiscal sustainability.

While being an election year, the budget for 2023-24 disappointingly lacks substantial measures to tackle the persistently high inflation rate, provide tax relief to the general public, or introduce packages to stimulate growth in the large-scale manufacturing sector.

3 TRADE AND CURRENT ACCOUNT BALANCE

Aamir Hussain Siddiqui

Pakistan is going through another balance of payment crisis with depleting foreign reserves. Table 3.1 presents Pakistan's Current Account Balance position for the fiscal years 2021-22 and 2022-23. There has been a substantial improvement in the current account deficit (CAD), which was reduced from US$ 17.5 billion to US$ 2.5 billion. However, the goal of lowering CAD has been achieved mainly by restricting imports, which had a negative impact on the industrial sector's growth. The reduction in imports (by UD$ 19.5 billion) was coupled with a decrease of US$ 4.6 billion in exports and US$ 4.7 billion in secondary income (including remittances).

Table 3.1 | Current account balance *(July-June)* *US$ billion*

	2021-22			2022-23		
	Exports	Imports	Net	Exports	Imports	Net
Current Account	73.19	90.67	-17.48	64.35	66.9	-2.55
Commodity trade	32.49	71.54	-39.05	27.91	51.99	-24.08
Services trade	7.10	12.94	-5.84	7.30	8.02	-0.72
Primary Income*	0.65	5.90	-5.25	0.86	6.58	-5.72
Secondary income**	32.95	0.29	32.66	28.28	0.31	27.97

* Including investment | ** Including remittances

Source: SBP

TRADE PERFORMANCE

Pakistan's exports during the current fiscal year were US$ 27.9 billion, which is 12.7 percent lower than the same period of 2021-22. In terms of Pak Rupees, it was 6.9 trillion with a growth rate of over 21.2 percent. This difference is because of currency depreciation. The average exchange rate per US$ was Rs. 247.4 during the current fiscal year, compared to Rs. 209.59 in 2021-22.

Pakistan's export performance during the last two years is presented in Table 3.2, which shows a total decline of US$ 4.0 billion in exports between 2021-22 and 2022-23 (July-June for each fiscal year).

Table 3.2 | Pakistan's exports in 2021-22 and 202-23 *(July-June)* *US$ million*

Groups	2022-23	2021-22	Change	
			Value	%
Food	5,023	5,415	-392	-7.25
Textile	16,502	19,330	-2,828	-14.63
Petroleum/Coal	221	334	-113	-33.94
Manufactures	3,841	4,104	-263	-6.41
All other items	2,149	2,598	-449	-17.31
Total	27,735	31,782	-4,047	-12.73

Source: State Bank of Pakistan (SBP)

The decline in textile exports remained the largest, amounting to US$ 2.3 billion, almost 60 percent of the total decline. The detailed analysis indicates that the decline in global prices of garment products is a significant cause of the negative growth in Pakistan's textile exports. The export of readymade and knitted garments was US$ 7.9 billion in 2022-23 compared to US$ 9.0 billion in 2021-22. While the exports showed a 12 percent decline in dollar value, the quantity of exports was over 21 percent higher than the previous year. There were a few more commodities whose quantity of export were higher than the previous year, but the export earning was negative; these include vegetables, oilseeds, cotton carded, petroleum products, carpets, electric fans and guar gums. The negative growth in international prices of these commodities has severely affected Pakistan's export earnings. The export data reveals that international prices of almost all commodities which Pakistan exports declined. In addition to the commodities mentioned above, several products experienced a decline in terms of quantity of exports as well as a relatively higher decline in revenue. For instance, cotton yarn exports declined by 22 percent from 358 thousand MT to 2941 MT, while the earning declined by 30% from US$ 1,266 million to 889 million – a fall of 17 percent in price, from US$ 3.6 per Kg to US$ 3.0 per Kg was a major factor contributing to reduced revenues. A similar situation was observed in the exports of electric fans, guar gums, etc.

The decline in global prices of garment products is a significant cause of the negative growth in Pakistan's textile exports.

Table 3.3 presents the country-wise export receipts of Pakistan for the top 25 export destinations, which account for more than 84 percent of total exports. In 2022-23, total export receipts from these top 25 countries declined by US$ 2.6 billion (or 10 percent) compared to 2021-22.

There has been a substantial decline of 13 percent (US$ 879 million) in export receipts from the USA, which is Pakistan's largest export destination accounting for 21 percent of the total export supply of Pakistan. The same trend is visible in exports to other countries which rank among the top five destinations, including China, UK, Germany and UAE. The total decline of the top five destinations makes up about 55 percent of the total decline in export receipts. Other countries where the export receipts have significantly declined include Bangladesh, Malaysia, Sri Lanka, Singapore, Portugal and Denmark.

On the other hand, export receipts from several countries have increased, which include Spain, Italy, France, Saudi Arabia, Canada, Kenya and Japan. However, the decline volume is much higher than the increase – the total decline of the above top-25 countries is US$ 2.6 billion, while the increment is US$ 0.5 billion.

As far as imports are concerned, the total decline is US$ 25 billion, resulting in a negative growth of 31 percent. As shown in Table 3.4, the largest drop is observed in the machinery group (US$ 5.1 billion or 47 percent), while another significant decrease is observed in agriculture & other chemicals and metal groups. These sectors provide raw materials for the manufacturing industries. Therefore, a sharp decline has affected the performance of the manufacturing sector.

Table 3.3 | Country-wise export receipts *(July-June)* *US$ million*

#	Countries	2022-23	2021-22	Change	
				Value	%
	TOTAL	27,911	32,493	-4582	-14.1
1.	U.S.A.	5,929	6,808	-879	-12.9
2.	China	2,029	2,783	-754	-27.1
3.	U.K.	1,966	2,201	-235	-10.7
4.	Germany	1,600	1,751	-151	-8.6
5.	U.A.E	1,476	1,849	-373	-20.2
6.	Netherlands (Holland)	1,447	1,500	-53	-3.5
7.	Spain	1,374	1,151	223	19.4
8.	Italy	1,151	1,087	64	5.9
9.	Bangladesh	769	873	-104	-11.9
10.	Belgium	701	717	-16	-2.3
11.	France	570	532	39	7.2
12.	Afghanistan	522	553	-31	-5.6
13.	Saudi Arabia	503	420	83	19.7
14.	Canada	427	404	23	5.6
15.	Poland	345	359	-13	-3.7
16.	Turkiye	323	355	-31	-8.9
17.	Australia	305	303	3	0.9
18.	Malaysia	299	433	-134	-30.9
19.	Singapore	291	375	-84	-22.5
20.	SriLanka	284	375	-92	-24.4
21.	Vietnam	244	261	-18	-6.8
22.	Kenya	242	204	38	18.6
23.	Portugal	222	271	-49	-18.1
24.	Denmark	208	295	-87	-29.5
25.	Japan	205	200	5	2.3
Sub-Total (Top 25 Countries)		23,432	26,059	-2,627	-10.1

Source: SBP

Table 3.4 | Pakistan's imports *(July-June)* *US$ million*

Groups	2022-23	2021-22	Change	
			Value	%
A. Food	8,937	9,016	-79	-0.9
B. Machinery	5,808	10,920	-5,112	-46.8
C. Transport	1,758	4,454	-2,696	-60.5
D. Petroleum	17,015	23,319	-6,304	-27.0
E. Textile	3,742	4,787	-1,045	-21.8
F. Agricultural and other Chemicals	8,929	14,086	-5,157	36.6
G. Metal	4,152	6,524	-2,372	-36.4
H. Miscellaneous	869	1,191	-322	-27.1
All others items	4,121	5,839	-1,718	-29.4
Total	55,330	80,136	-24,806	-31.0

Source: SBP

A significant reduction occurred in import payments during the same period. As shown in Table 3.5, import payments were reduced by US$ 18.5 billion or almost 27 percent. Imports payments to China, Pakistan's largest import source, decreased by US$ 7.6 or over 44 percent. This is nearly 41 percent of the total import decline. UAE, the second largest source of Pakistan's imports, showed a decrease of 15 percent. Other countries with a substantial reduction in import payments include Saudi Arabia, Singapore, USA, Malaysia, Japan, Germany, South Korea, Thailand and the UK. These countries supply most of the capital goods and raw materials to Pakistan.

Table 3.5 | Import payments *(July-June)* *US$ million*

#	Countries	2022-23	2021-22	Change	
				Value	%
	TOTAL	51,453	69,985	-18,532	-26.5
1.	China	9,662	17,301	-7,639	-44.2
2.	U.A.E	7,457	8,752	-1,295	-14.8
3.	Qatar	3,788	2,687	1,102	41.0
4.	Saudi Arabia	3,324	4,231	-907	-21.4
5.	Singapore	2,763	3,412	-649	-19.0
6.	Indonesia	2,644	2,676	-32	-1.2
7.	Kuwait	2,546	2,304	242	10.5
8.	U. S. A.	2,215	3,055	-840	-27.5
9.	Malaysia	1,022	1,519	-497	-32.7
10.	Germany	906	1,251	-345	-27.6
11.	Japan	889	1,986	-1,097	-55.2
12.	South Korea	808	1,541	-733	-47.6
13.	Oman	780	475	305	64.3
14.	Netherlands (Holland)	745	753	-8	-1.1
15.	Brazil	718	1,120	-401	-35.8
16.	Thailand	712	1,469	-757	-51.5
17.	Australia	701	356	345	97.0
18.	Morocco	665	520	145	27.8
19.	U. K.	639	870	-231	-26.6
20.	Russian Federation	627	254	373	146.6
	Sub-total (Top-20)	43,611	56,530	-12,919	-22.9
	Share in the grand total	85%	81%		

Source: SBP

On the other hand, some countries with significant growth in import payments include Qatar, Oman, Morocco, Australia and Russian Federation. Pakistan has restarted the import of LNG from Qatar and found some other sources for its fuel requirement, including Oman, Russian Federation, and Australia.

The trade deficit in 2022-23 remained at US$ 27.6 billion compared to US$ 48.4 billion in 2021-22. However, the reduction in the trade deficit was mainly driven by the contraction of imports, which had negative implications for industrial sector growth.

Trade in Services

The export of services remained almost the same during the last two years – US$ 7.3 billion in 2022-23 and US$ 7.1 billion in 2021-22. The export performance in all subsectors of services remained constant. IT export services were the major sector contributing 35 percent of the total services export revenue. On the other hand, the import of services has declined by 38 percent, from US$ 12.9 to US$ 8.0 billion; the largest decline (of 48 percent) was observed in transport services. The balance of trade in services also remained in deficit. However, it has been reduced to US$ 0.7 billion compared to US$ 5.8 billion in the previous year.

Table 3.6 | Trade in services *(July-June)* *US$ million*

	Exports		Imports		% change	
	2022-23	2021-22	2022-23	2021-22	Exports	Imports
Manufacturing services on physical inputs owned by others	0	0	0	0	Nil	Nil
Maintenance and repair services	0	3	62	38	-100.0	63.2
Transport	893	814	3,883	7,405	9.7	-47.6
Travel	947	542	1,869	1,413	74.7	32.3
Construction	36	94	15	40	-61.7	-62.5
Insurance and pension services	61	42	261	293	45.2	-10.9
Financial services	61	201	211	420	-69.7	-49.8
Charges for the use of intellectual property	12	13	56	209	-7.7	-73.2
Telecommunications, computer, and information services	2,605	2,619	298	612	-0.5	-51.3
Other business services	1,567	1,690	1,153	1,957	-7.3	-41.1
Personal, cultural, and recreational services	15	13	1	1	15.4	0.0
Government goods and services	1,102	1,071	210	554	2.9	-62.1
Total	7,299	7,102	8,019	12,942	2.8	-38.0

Source: SBP

WORKERS' REMITTANCES

The workers' remittances declined by about 14 percent in 2022-23 over the previous year 2021-22. Overall, remittances from six countries/groups of countries constitute about 90 percent of the total remittance received by Pakistan. Countries of the Gulf Cooperation Council (GCC) are the major contributors (more than 50 percent) to Pakistan's remittances – Saudi Arabia is the largest contributor (24-25 percent), followed by UAE (17-18 percent). As shown in Table 3.7, remittances from Saudi Arabia and UAE declined by 17 percent and 21 percent, respectively. Altogether, remittances from GCC countries reduced from US$ 17.2 billion in 2021-22 to US$ 14.3 billion in 2022-23, reflecting a decline of US$ 2.9 billion, which is 70 percent of the total decline in the remittance inflow. Similarly, remittances from the UK decreased by 10 percent. Among the top-six countries, the USA is the only exception, with a small increase of 2.8 US$ million or 0.1 percent.

Table 3.7 | Country-wise workers' remittances during July-June period *US$ million*

#	Countries	2022-23	2021-22	Change	
				Value	%
	TOTAL	27,024	31,279	-4,255	-13.6
1.	Saudi Arabia	6,445	7,754	-1,309	-16.9
2.	UAE	4,649	5,846	-1,197	-20.5
3.	U.K.	4,056	4,493	-437	-9.7
4.	Other GCC Countries	3,191	3,625	-434	-12
5.	EU Countries	3,121	3,362	-241	-7.2
6.	USA	3,090	3,087	3	0.1
7.	Australia	593	753	-160	-21.3
8.	Canada	551	708	-157	-22.2
9.	South Africa*	211	349	-138	-39.6
10.	Norway	110	146	-36	-24.5
11.	Malaysia*	105	145	-40	-27.6
12.	South Korea*	97	98	-1	-0.9
13.	Japan	73	79	-6	-7.3
14.	Switzerland	44	46	-2	-4.6
15.	Other Countries #	689	788	-99	-12.6

Source: SBP

Strategic Trade Policy Framework 2020-25

The Federal Government had set different export targets for different years from 2021 to 2025 under its first medium-term trade policy framework entitled 'Strategic Trade Policy Framework (STPF) 2020-25'. The export target set by the Federal Ministry of Commerce for 2021-22 and 2023-24 were US$ 31.2 billion and US$ 37.9 billion, respectively. While the target was achieved in 2021-22, the presumed scenario was utterly absent. The exports in 2022-23 remained substantially lower (US$ 27.7 billion) than the target of US$ 37.9 billion (Table 3.8). Apparently, the targets were based on superficial assumptions and baseless scenarios (see Annexure-I). For instance, the most important unrealistic assumptions were an exchange rate of Rs 160/US$ and a domestic inflation rate of 5 percent from 2022 to 2025.

Table 3.8 | Export performance, estimates and targets under STPF 2020-25 *US$ billion*

	2021-22	2022-23	2023-24	2024-25
Scenario-1	23.08	25.21	26.70	28.57
Scenario-2	27.15	30.19	32.55	35.46
Scenario-3	29.10	32.98	36.26	40.27
Targets by the Ministry of Commerce	31.20	37.88	45.82	57.03
Actual exports	31.78	27.74		

Sources: STPF 2020-25, PBS

Trade-related measures in the Federal Budget 2023-24

The commodity export target for 2023-24 is set to be US$ 30 billion, showing a modest growth of 8 percent over the export level of US$ 27.7 in 2022-23. This target is even lower than the export performance of 2021-22. The expected remittance income in 2022-23 is around US$ 27.5 billion, while the target for the next year is US$ 32 billion. So, the growth target for remittance is about 16 percent. However, no export target for services exports is provided.

From some measures introduced in the Federal Budget 2023-24, more emphasis is given on import substitution, which implies that government is more inclined towards restricting imports. For example, import by the manufacturers of solar panels and related components are given duty-free import facility for the raw material and components. Regulatory duty on various raw materials has also been either eliminated or substantially reduced. Some of the major policy measures are as follows:

- Exemptions have been given to all kinds of duty on the import of all components and parts for the production of solar panels and batteries. It appears that the government policies are more inclined towards import-based industries, which implies that the growth of this industry would increase the import bill.

The production of solar panels and allied products is meant for local consumption and not for export purposes. Therefore, some other measure would be required to finance the import of these raw materials.

The other measures include:

- Exemption of duty on import of harvesting machines, raw materials for rice and mining machinery, and machine tools.
- Exemption of duty on import of seeds used for sowing.
- Reduction of customs duty on import of pet scrap for manufacturers of polyester filament yarn.
- Import of juvenile shrimp/fish etc., which are major export items in the fisheries sector.
- Removal of regulatory duty on synthetic filament yarn of polyester not manufactured locally.

The above measures are for controlling or substituting the import of diapers, fuel, and agriculture products and reduction in the cost of some important export products such as rice and synthetic textiles. Import incentives for juvenile shrimp/fish are for the promotion of the export of shrimps and other fisheries products. The incentives for importing raw materials for these goods are insufficient as the exports of fish and synthetic textiles are not very substantial.

Some measures focus on the export of IT services. For this purpose, training of 50,000 IT graduates and some tax exemption and other administrative measures are also proposed in the budget. However, any particular amount of export earnings is not targeted. One important measure is the permission for duty-free import of IT-related hardware and software purchases equal to 1% of total service export earnings. However, there are no incentives for IT-related hardware production or technological upgrade in this sector or upward movement in the global IT supply chain. Also, no measures are proposed for promoting the immigration of IT-trained workforce.

In summary, the measure taken in the Federal Budget is a hybrid Import Substitution Industrialization (ISI) strategy broadly similar to that adopted during 1955-68, except that the new strategy is contextualized with a new liberal policy regime, whereas the former used import licensing and exchange rate management. Similar to the earlier strategy, the new regime is likely to fail because (a) there is no motivation for moving from low productivity to high productivity for capital goods industries or (b) to set up the domestic supply chain for exportation or (c) to set up a monitoring and evaluation system for assuming the maturing of the new strategy.

Annexure 3.1

SCENARIO 1:

The following assumptions are made for export projections under the first scenario:

- World GDP Growth is -4 percent in 2019-20, followed by 2 percent in FY 2020-21, 6 percent in FY 2021-22,4.4 percent in FY 2022-23 as per IMF forecasts and following CAGR until FY 2024-25.
- Pakistan's GDP Growth is -0.50% in FY 2019-20 (as given by Government of Pakistan), followed by 3.92 percent in FY 20-21, 4.8 percent in FY 21-22, 5.2 percent in FY 22-23, 5.5 percent in FY 23-24 and 5.8 percent in FY24-25
- Exchange rate is 158 PKR/USD in FY 2019-20 (as per Pakistan Economic Survey), 159.4 in FY20-21 (based on current value) and then remain stable at 160 until FY 2024-25.
- Pakistan's Domestic Price increases by 10.8 percent in FY2020-21, 8 percent in FY 2021-22 and the following CAGR (6.5 percent) until FY 24-25.
- World Price (Export weighted average of Pak competitors) declining by 2 percent in FY 2019-20 (on account of falling petrol prices and general deflation across the world), increasing by 4.9 percent in FY2020-21 and then following CAGR until FY 24-25.

SCENARIO 2:

The second scenario is built under the assumption that Pakistan would be able to reduce its cost of production and become a more competitive player in the global market. The assumptions developed for Scenario 1 are carried forth in Scenario 2, except the assumption regarding domestic prices. Scenario 2 is developed on the following assumption on domestic prices:

- Pakistan's Domestic Price increases by 8% in FY20-21, 6.5% in FY 21-22 and then by 6% until FY 24-25. Efforts by the National Tariff Commission to reduce tariffs will contribute to improved competitiveness (tariff down by 1 percentage point in FY 19-20).

SCENARIO 3:

The third scenario is built under the hope that a further increase in competitiveness may be achieved. Under Scenario 3, all assumptions remain the same as the previous two except for domestic prices. Scenario 3 assumes:

- Pakistan's Domestic Price increasing by 7.2% in FY20-21 and then increasing by 5.5% until FY24-25. Further efforts to bring down tariff will contribute to this.

4 THE INCIDENCE OF POVERTY

Poverty continues to remain a significant and persistent development issue for many years in Pakistan. Despite the various initiatives and efforts of poverty alleviation by the respective government, the situation of poverty has not improved. A review of the literature on poverty and inequality in Pakistan suggests the following propositions:

- Pakistan has a consistently high poverty rate, with a large portion of the population living below the poverty line, irrespective of the method of estimation.
- There is a significant disparity in poverty rates between rural and urban areas. Poverty is more prevalent in rural regions, where access to basic services, infrastructure, and employment opportunities is limited.
- Pakistan also experiences high levels of income inequality, with a significant wealth gap between the rich and the poor. The rich tend to accumulate wealth while a large portion of the population struggles to meet their basic needs.
- Poor access to basic social services such as education, healthcare, clean water, and sanitation fuels the vicious cycle of poverty in Pakistan. Many impoverished communities lack proper infrastructure and social services, which hinders their social and economic development.
- High levels of unemployment and underemployment further exacerbate poverty in Pakistan. The country faces challenges in generating enough jobs to accommodate its growing population, resulting in a large informal sector with low-paying and unstable jobs.
- Gender inequality is another factor that perpetuates poverty in the country. Women face various barriers to economic opportunities and access to basic services, which limits their ability to escape poverty and achieve financial independence.
- A significant portion of the population faces food insecurity. Insufficient access to nutritious food leads to malnutrition and health issues, particularly affecting children and vulnerable groups.
- The government of Pakistan has implemented various unconditional cash transfer programs to address poverty, such as the Benazir Income Support Program (BISP), which provides cash transfers to eligible families. However, the coverage and effectiveness of these programs have faced challenges in reaching the most vulnerable populations.

Efforts to reduce poverty require a multi-faceted approach that focuses on improving access to education, healthcare, clean water, and employment opportunities while addressing systemic issues such as income inequality and gender disparities. International assistance and collaboration can also play a crucial role in supporting poverty alleviation efforts in the country.

Detailed information on the income and expenditure of households is required to estimate monetary or traditional poverty incidence and the extent of income inequality. In the context of Pakistan, Household Integrated Economic Survey (HIES) is the only source which provides such household data that is representative at the national and regional levels. Since the latest HIES was carried out in 2018-19, current official poverty estimates are not available. However, given the deteriorating macroeconomic situation and natural disasters (such as the 2022 floods), a general perception is that the poverty incidence in the country might have increased. The expected increase in poverty is also acknowledged by the government as the Pakistan Economic Survey 2022-23 states:

> *The floods of 2022 have caused a significant loss to poverty reduction efforts and would result in increase in poverty and vulnerability of affected population who live below or just around the national poverty line. Preliminary estimates suggest that as a direct consequence of the floods, the national poverty rate may increase by 3.7 to 4.0 percentage points, potentially pushing between 8.4 and 9.1 million more people into poverty. Moreover, the depth and severity of poverty will increase for households that were already poor prior to the floods.*

The data reveals a relatively higher incidence of rural poverty in most of the years since 1987-88, except for 2005-06 and 2007-08.

Given this backdrop, an attempt is made here to predict current poverty estimates for 2022-23 using an econometric analysis, which measures the responsiveness of poverty estimates to GDP, income inequality and inflation.

POVERTY TREND IN PAKISTAN

Figure 4.1 portrays the trends in poverty incidence since 1985. All these poverty numbers were estimated using unit record household level HIES data and by applying a consistent and identical methodology for estimating the poverty line.[1] The data reveals a relatively higher incidence of rural poverty in most of the years since 1987-88, except for 2005-06 and 2007-08.

Overall, the poverty incidence from 1984-85 to 2018-19 shows an increasing trend with some fluctuations. During the last two decades (2010-11 to 2018-19), the

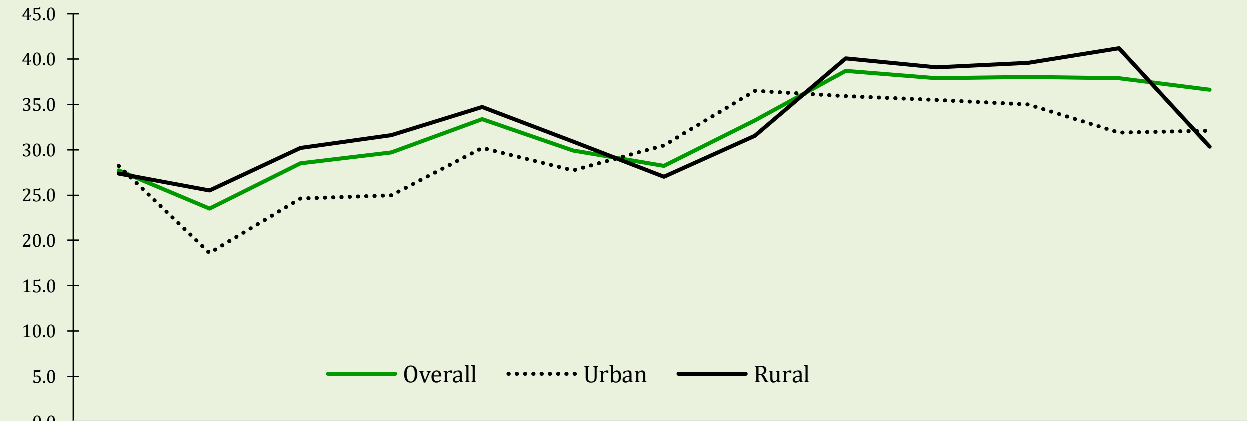
[1] This research follows the methodology used by Jamal (2002) for estimation of poverty through Food Energy Intake Approach. Various options for estimating level of poverty are provided in the paper, "On the Estimation of an Absolute Poverty Line: An Empirical Appraisal", *The Lahore Journal of Economics*.

incidence of poverty has remained over 35 percent – fluctuating between 36.6 percent and 38.7 percent.

It is widely believed that economic growth may not always be a sufficient condition for poverty reduction, but it certainly is a necessary one. To illustrate the point in the context of Pakistan, the growth in GDP and poverty incidence are also plotted in figure 4.1. In general, there appears to be an inverse relationship between poverty and economic growth.

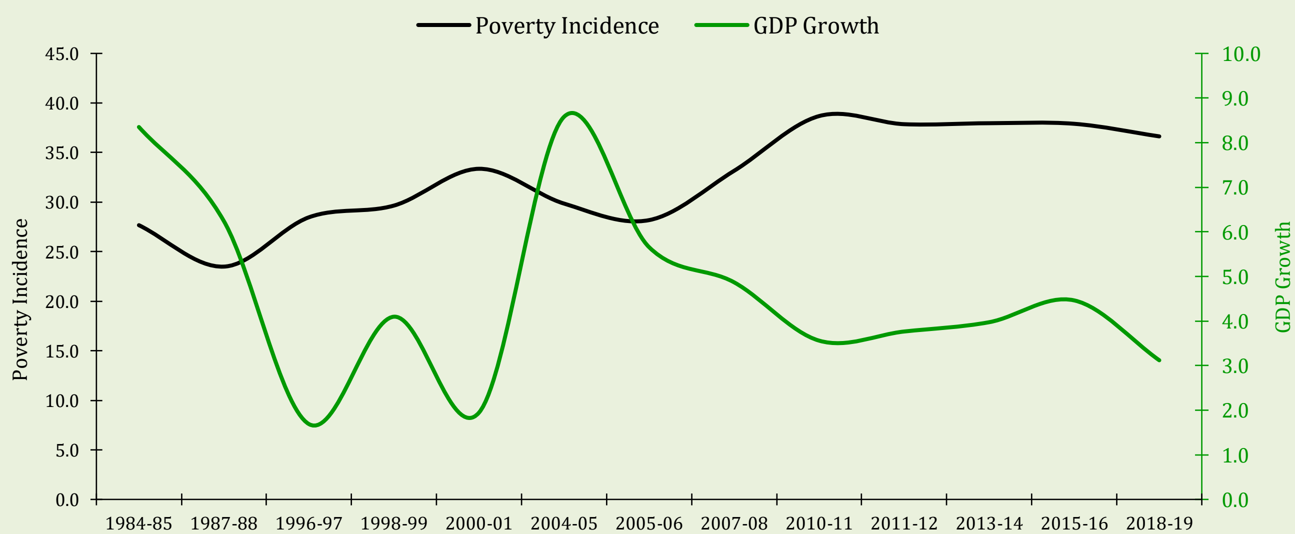
Figure 4.1 | Historical estimates of poverty incidence

Poverty incidence *(percentage of population below the poverty line)*



	1984-85	1987-88	1996-97	1998-99	2000-01	2004-05	2005-06	2007-08	2010-11	2011-12	2013-14	2015-16	2018-19
Overall	27.7	23.5	28.5	29.7	33.4	29.9	28.2	33.2	38.7	37.9	38.0	37.9	36.6
Urban	28.2	18.6	24.6	25.0	30.2	27.7	30.5	36.5	35.9	35.5	35.0	31.9	32.1
Rural	27.4	25.5	30.2	31.6	34.7	30.9	27.0	31.5	40.1	39.1	39.6	41.2	30.3

Poverty and GDP growth



Source: Pakistan Economic Survey 2022-23, Government of Pakistan

Estimates of Current Poverty Incidence

The responsiveness of poverty estimates to GDP, income inequality and inflation is investigated through an econometric model, which quantifies the relationship among poverty, inequality, GDP growth and inflation using interpolated time series. [2] According to the empirical literature, these are the major determinants and high correlates of monetary poverty.

The summary statistics of the estimated model, presented in Table 4.1, show a good fit with adjusted R2 value of 0.93. All determinants of poverty included in the estimation model are statistically significant with a priori expected signs. A negative relationship between poverty incidence and GDP growth rate of preceding year is evident with the estimated elasticity of 1.193 percent. In contrast, the elasticity of poverty with respect to inequality (Gini) is significantly higher (5.127) than the elasticity with respect to growth. Inflation, as represented in the model by the GDP deflator, is also highly statistically significant. However, low (0.2) elasticity of poverty is observed with respect to inflation as compared with GDP growth and inequality.

Table 4.1 | Responsiveness of poverty to growth, inequality and inflation
[Dependent Variable: Log (Poverty Incidence)[3]]

Explanatory variables	Coefficient	Standard Error	t-Statistic	Probability	Elasticity of poverty [%]
Intercept (Constant)	1.404	0.394	3.560	0.001	--
GDP growth (with Lag 1)	-0.012	0.004	-2.895	0.007	-1.193
Inequality (GINI coefficient)	0.050	0.010	4.988	0.000	5.127
Inflation (GDP deflator)	0.002	0.000	6.348	0.000	0.200
R-squared	0.933	Adjusted R-squared		0.927	
F-statistic	139.745	Probability (F-statistic)		0.000	
Durbin-Watson stat	1.918				

Source: Author's estimates based on regression function for the period 1985 to 2023

[2] For details, see SPDC Research Report number 102 "Smoothing Sporadic Poverty and Inequality Estimates: Pakistan, 1985-2016".

[3] The logarithmic transformation is a monotone transformation which preserves the ordering between x and f (x). In the log-linear model, the literal interpretation of the estimated coefficient β is that a one-unit increase in X will produce an expected increase in log Y of β units. In terms of Y itself, this means that the expected value of Y is multiplied by e^{β}. To be more precise, the relationship between the percent change in y and change in x may be estimated as $[(e^{\beta i} - 1) * 100]$.

Current poverty incidence is estimated with the help of elasticities estimated through the econometrical model. As shown in Table 4.2, the predicted incidence for the year 2023 is 40.3 percent suggesting that over 97 million persons are below the poverty line. About 15 million persons have been added to the population below the poverty line during the period 2018-19 and 2022-23.

Table 4.2 | Predicted poverty incidence in Pakistan
(Population below the poverty line)

	Poverty Incidence (Headcount)	Poor Population (Million)
Estimated from HIES 2018-19	36.6%	78.3
Predicted Poverty Incidence – 2022-23	40.3%	97.2

Note: Poverty figures for the year 2018-19 are taken from Jamal (2021) "Updating Pakistan's Poverty Numbers for the Year 2019" MPRA Paper Number 105135.
https://mpra.ub.uni-muenchen.de/105135/

THE TEAM

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The Applied Economics Research Centre (AERC), University of Karachi was established in 1973. AERC is a research institute devoted to imparting post-graduate level education, conducting academic and policy-oriented research in applied economics and related disciplines, and providing advisory services to the government. The Centre undertakes research on issues in applied economics with a focus on urban and regional economics, agriculture economics, human resource development, public finance, poverty, health and nutrition, industrial economics, trade, environment and gender issues. The Centre conducts quantitative and qualitative research to provide evidence-based support for public policy-making.

The Social Policy and Development Centre (SPDC) is a policy research think tank. Since its establishment in 1995 as a private non-profit company, SPDC has made significant intellectual contributions in placing pro-poor growth and social development issues on Pakistan's policy-making agenda. With a focus on issues related to poverty and inequality, governance, social service delivery, gender, and macroeconomic policy, it contributes to the national goal of social development through research, policy advice, and advocacy. Being an independent and non-partisan organization, it determines its own agenda and has successfully maintained its independence and balance between responsive and proactive research. SPDC is governed by a voluntary Board of Directors.

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