Federal Budget 2023-24: An Unsustainable Fiscal Path

Policy Brief

June | 2023

This Policy Brief is jointly prepared by the Applied Economics Research Centre (AERC), University of Karachi and Social Policy and Development Centre (SPDC). The views expressed in this document are those of the authors, and cannot be attributed to, nor do they represent, the view of AERC or SPDC.

Pakistan's economy is confronted with a severe economic crisis, which is 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 policy brief presents an overview of the current state of Pakistan's economy and analyzes the fiscal policy in light of the Economic Survey 2022-23 and the Federal Budget 2023-24. The analyses presented in this brief 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.

STATE OF THE ECONOMY

According to the Pakistan Economic Survey 2022-23, the poor performance of the country's economy during the fiscal year 2022-23 can be attributed to several factors, including 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 adversely affected global growth and inflation, affecting Pakistan's economy. According to the official standpoint, the effect of the above factors was manifested in increased food and energy prices, supply chain disruption, and a decline in business confidence.

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). The price of palm and soybean oil, for example, 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. 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.

As far as the 2022 floods are concerned, the negative growth in the manufacturing sector is also attributed to the flood, as the agricultural sector 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% increase in raw cotton imports during the last fiscal year. Additionally, reports suggest that a portion of the locally produced cotton remained unsold. Moreover, the agricultural sector growth stood at 3.4% compared to 4.7% 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 tend 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 lacklustre performance to international factors and natural disasters. This approach creates a fundamental problem for economic policy management.

AN OVERVIEW OF ECONOMY AND MACROECONOMIC POLICIES

As per the medium-term macroeconomic framework, the growth target for 2023-24 is set at 3.5%, while inflation is projected at 21%. 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. During the last fiscal year, the economy experienced a meager GDP growth rate of 0.26% and an unprecedented, all-time high inflation rate of 36%. These figures indicate that the country has entered a stagflation period – low economic growth and high inflation.

The industrial sector has witnessed a negative growth rate of 2.94%, whereas the large-scale manufacturing sector, which recorded a growth of 10.6% during 2022, experienced a negative growth of 8.71%. A significant contributor to this decline was the textile sector, which contracted by 16.3%. 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.

Contractionary Monetary Policy and Inflation

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%, whereas it stood at 15.7% 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 (Figure 1).

Figure 1: Loan to Private Sector Credit (Rs. Billion)

	July to March			
	Loan to Private Sector Business	Agriculture	Manufacturing	Wholesale and Retail
Total Credit				
2021-22	1002.2	22.4	789	46.1
2022-23	271 **(-73%)***	12.5	277.4	-28.2
Working Capital				
2021-22	608.7	12.9	566.3	38.2
2022-23	113.4 **(81.3%)**	-1.2	139.6	-24.4
Fixed Investment				
2021-22	331.1	8.5	213.9	6.0
2022-23	147.5 **(-55.5%)**	13.8	136.1	-16.8

*The figures in parenthesis show the percentage growth.

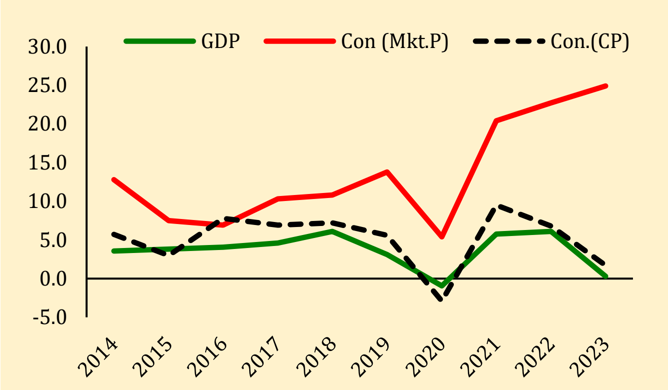
Another contributing factor to the lacklustre performance of the industrial sector is the government's initiatives to reduce imports to improve the current account balance. As a result, machinery and raw materials imports declined by 48% and 25%, respectively. The past year witnessed an inflation rate of 36.4%, the highest in 59 years. Throughout the fiscal year 2022-23, the Pakistani rupee depreciated by approximately 23.0%, whereas in the current fiscal year, it further depreciated by 28.4% – from Rs 204.6 at the end of June 2022 to Rs 285.4 on June 1, 2023.

Among various commodity groups, food prices experienced the highest increase of 28.2% compared to housing, water, and fuel, which also rose by 13.6%. Transportation costs also surged by 52%. 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% is challenging.

In addition to the rise in food and energy prices and the depreciation of the Pakistani rupee, some other factors also need attention. To curb inflation, the State Bank of Pakistan (SBP) has been implementing a contractionary monetary policy; it raised the policy rate from 7% to 21% between September 2021 and April 2023. Interestingly, despite the gradual tightening of monetary policy, the growth of broad money has reached 4.3%, compared to only 2.9% in the previous year. Additionally, despite higher interest rates, there has been a decline in time deposits. Over the last nine months, money in circulation has increased by 9.2%, while it grew by 5.8% during the same period in the previous year. This expansion of broad money and money in circulation could be another contributing factor to the mounting inflationary pressure. Despite low-income growth and a high interest rate, prices of durable and luxury goods also demonstrated an upward trend. Moreover, the proportion of household consumption in the GDP of Pakistan exceeds 90%, and despite a low average growth rate and increased inflationary pressure, this share continues to rise. The increasing share of consumption in the GDP could help explain the inflationary nature of Pakistan's economy.

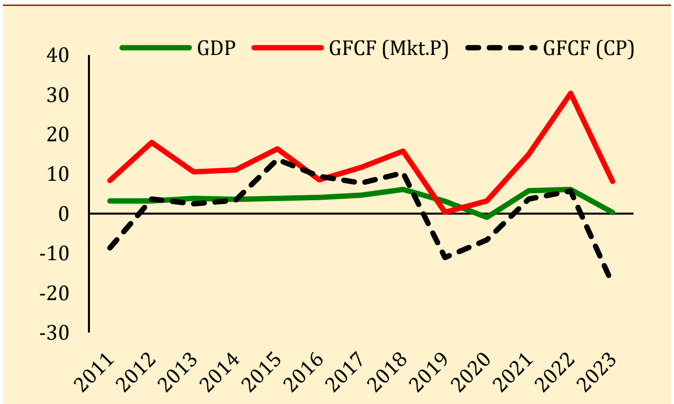
Figure 2 illustrates the trends in real and nominal consumption over the last decade. The graph shows that the growth in real consumption aligns with the expansion in real GDP, while nominal consumption exhibits an upward trajectory during most of the years. Although there was a decline in nominal consumption 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 2: Trend of Nominal and Real Consumption Growth, %



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 3). 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 exhibited an increase of 8% despite a significant decline in output growth. With a high interest rate and an economic downturn, the rise in nominal expenditures for both consumption and investment may indicate demand-side pressure on prices.

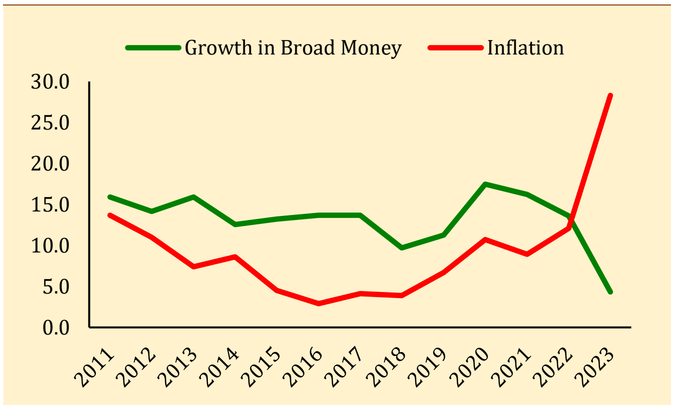
Figure 3: Trend in Nominal and Real Gross Fixed Capital Formation Growth, %



Current core inflation can be considered an unbiased predictor of future headline inflation. The empirical analysis indicates that Granger causality runs from core inflation to headline inflation, which suggests that core inflation can provide valuable insights into the direction of overall inflation in the future. In the case of Pakistan, core inflation, which excludes volatile food and energy prices, has been recorded at 15.6% and exhibits a consistent and significant upward trend. An increase in current core inflation suggests the need for a restrictive monetary policy. Figure 4 depicts that inflation tends to move in the same direction as growth in broad money. However, this positive relationship appears to deviate starting from the fiscal year 2021-22. In 2021-22 and 2022-23, the inflation surged by a staggering rate of 12% and 28%, 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.

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.

Figure 4: Relationship between the Growth in Broad Money and Inflation, %



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.

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. With high inflationary expectations, 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, when the economy is already experiencing pre-hyperinflationary conditions, policymakers should be more cautious and vigilant when implementing expansionary demand-side policies.

TRADE AND CURRENT ACCOUNT BALANCE

Pakistan is going through another balance of payment crisis with depleting foreign reserves. Figure 4 presents the Current Account Balance position of Pakistan for a period of 10 months (July-April) of fiscal years 2021-22 and 2022-23. There has been a substantial improvement in the current account deficit (CAD), which was reduced from US$ 13.7 billion to US$ 3.3 billion. However, the goal of reducing CAD has been achieved mainly by restricting imports, which had a negative impact on the industrial sector's growth. The reduction in imports (by US$ 13.5 billion) was coupled with a reduction of US$ 3.6 billion in exports and US$ 3.7 billion in secondary income (including remittances).

Figure 4: Current Account Balance, US$ billion *(July-April)*

	2021-22			2022-23		
	Exports	Imports	Net	Exports	Imports	Net
Current Account	**60.9**	**74.5**	**-13.7**	**53.9**	**57.1**	**-3.3**
Commodity trade	26.9	58.7	-31.8	23.2	45.2	-22.0
Services trade	5.9	10.6	-4.7	6.0	6.4	-0.4
Primary Income*	0.5	4.9	-4.4	0.8	5.3	-4.4
Secondary income**	27.6	0.2	27.3	23.8	0.3	23.6

*Including investment. | **Including remittances.

Source: SBP

Trade Performance 2022-23 (July-May)

Pakistan's exports during the current fiscal year for July-May were US$ 25.4 billion, which is 12% lower than the same period of 2021-22. In terms of Pak Rupees, it was 6.2 trillion with a growth rate of over 22%. This difference is because of currency depreciation. The average exchange rate per US$ was Rs. 243.8 during the 11 months of the current fiscal year, as compared to Rs. 175.5 in 2021-22.

The total decline in export (Jul-May 2021-22 to Jul-May 2022-23) is US$ 3.5 billion. The decline in textile exports remained the largest – US$ 2.6 billion, which is almost 74% of the total decline. The detailed analysis indicates that the decline in global prices of garment products is a major cause of the negative growth in Pakistan's textile exports. The export of readymade garments was US$ 3.2 billion and showed a 10% decline in terms of dollar value, but the quantity of export was 46% higher than the previous year.

As far as imports are concerned, the total decline is US$ 21 billion (29%). The biggest decline is observed in the Machinery group (US$ 4.9 billion or 59%), while another important decline is observed in Agriculture & Chemical group and Metal group. These sectors provide raw materials for the manufacturing industries. Therefore, a sharp decline has affected the performance of the manufacturing sector.

Trade in Services 2022-23 (July-April):

The export of services remains almost the same during the first 10 months of the last two years – US$ 6.0 billion in 2022-23 and US$ 5.9 billion in 2021-22. The export performance in all subsectors of services remained constant. IT export services were the major sector contributing 35% of the total services export revenue. On the other hand, the import of services has declined by almost 40%, from US$ 10.6 to US$ 6.4 billion; the largest decline (of 47%) was observed in transport services. The balance of trade in services also remained in deficit. However, it has been reduced to US$ 0.4 billion as compared to US$ 4.7 billion in the previous year.

Trade-related Measure in the Federal Budget 2023-24

The commodity export target for 2023-24 is set to be US$ 30 billion, showing a minor growth of 4% over the last year, which is even lower than the export performance of 2021-22. The expected remittance income in 2022-23 is around US$ 25.5 billion, while the target for the next year is US$ 32 billion. So, the growth target for remittance is around 20%. 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.
- Exemption of duty on import of raw materials for rice machines tools.
- 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 apparently are for the promotion of the export of shrimps and other fisheries products. The incentives for the import of raw materials for these goods are not sufficient 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, it 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.

FEDERAL BUDGET 2023-24: STRATEGIES AND PRIORITIES

As discussed earlier, the Federal Budget 2023-24 was presented against a challenging macroeconomic backdrop and an uncertain economic and political outlook. 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% against the target of 16.8%. It was expected that this high growth in nominal GDP would significantly impact fiscal policy targets, leading to higher tax revenues and reduced magnitudes of indicators relative to GDP, such as tax revenue, expenditures and fiscal deficit. In this context, this section provides an overview of budgetary performance in 2022-23 and fiscal outlook for 2023-24.

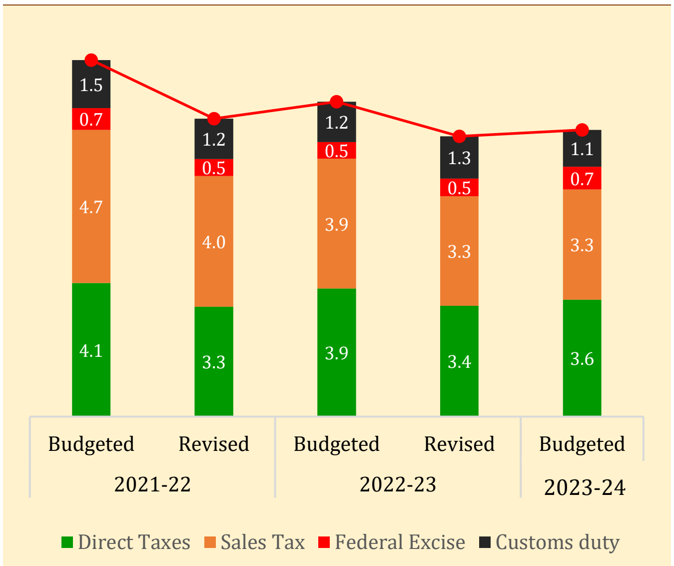
Federal Taxes

As per the revised estimates, the Federal Board of Revenue (FBR) is likely to miss its tax target of almost Rs 7.5 trillion by more than Rs 270 billion in 2022-23. Initial expectations suggested that direct taxes, sales tax, and federal excise duty (FED) would surpass their targets, while customs duty would likely fall behind. These assumptions were based on the anticipation that an increase in nominal GDP growth would lead to higher direct tax revenues, and the inflationary pressures would contribute to greater sales tax collection. Furthermore, revisions in FED rates and sales tax rates were expected to generate additional revenues.

Contrary to expectations, income tax and sales tax, the two major taxes, experienced significant shortfalls of Rs 208 billion and Rs 268 billion, respectively. The decline in income tax can be attributed to lower real GDP growth, but the reasons behind the drop in sales tax remain unclear. An upward revision of the sales tax rate from 17% to 18%, a high inflation rate and subsequent price increases of goods did not translate into higher sales tax collection. In contrast, despite a marginal increase of less than 1% in imports, customs duties surpassed their target by Rs 131 billion. On the other hand, federal excise duty (FED) was the only tax category that followed the projected trajectory, surpassing its target by Rs 55 billion.

The overall tax-to-GDP target of 9.6% was missed by 1.1 percentage points, resulting in a total of only 8.5% (Figure 5). Regrettably, both direct and indirect taxes failed to meet their respective tax-to-GDP targets of 3.9% and 5.7%, falling short at 3.4% and 5.1%, respectively. This outcome highlights a compromise on equity and progressivity, as there was a heavy reliance on indirect taxes.

Figure 5: Tax-to-GDP Ratio, %



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

The reliance on indirect taxes has led to a significant burden on the country's population, particularly in the form of inflation tax. This burden is regressive, exacerbating income distribution disparities. Consequently, the overall impact on equity and fairness within the tax system is a matter of concern.

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. Addressing these issues becomes crucial to ensure a fair and progressive taxation framework that promotes economic growth while reducing inequalities.

Federal non-tax revenues

The revised estimates for federal non-tax revenues in 2022-23 indicate a lack of significant growth. Non-tax revenues for the federal government amounted to Rs 1.6 trillion, falling short of the target of Rs 1.9 trillion. 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 targeted Rs 855 billion.

Federal own Revenues and Transfers to Provinces

When it comes to revenue distribution, the provinces receive a larger share of tax revenues, whereas non-tax revenues are solely owned by the federal government. However, there have been shortfalls in both areas in relation to the targets. The federal government's net revenues fell short by approximately Rs 343 billion, compared to the target of Rs 5 trillion. This shortfall poses challenges to the federal government's financial objectives and may necessitate a closer examination of revenue sources and collection mechanisms. Similarly, federal transfers to the provinces also faced a shortfall, with a deficit of Rs 243 billion against the target of Rs 4.4 trillion. This shortfall in transfers can impact the ability of provinces to effectively carry out their responsibilities and deliver essential services to their constituents.

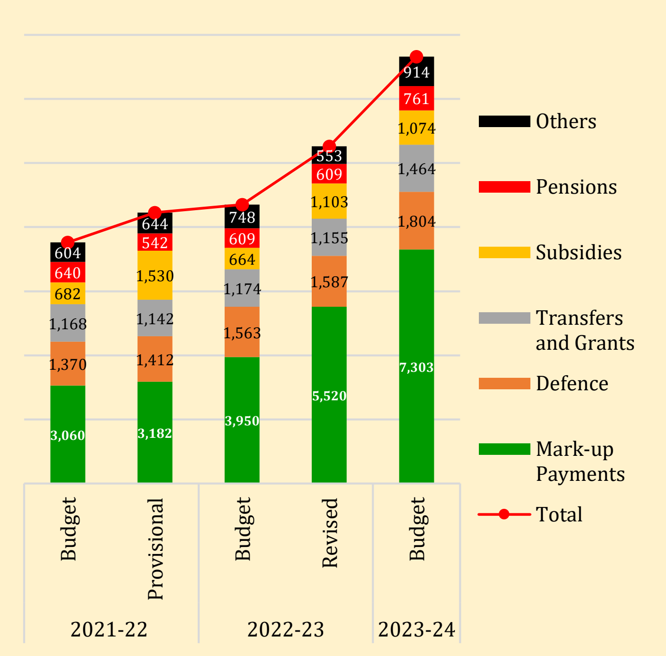
Current Expenditures: Significant Deviations

The current expenditure estimates for the fiscal year 2022-23 are anticipated to reach Rs 10.5 trillion, surpassing the target of Rs 8.7 trillion by a substantial margin of Rs 1.8 trillion. The rise in subsidies has led to a significant budgetary adjustment, deviating by Rs 439 billion from the targeted figure. Similarly, defence expenditures have slightly deviated by Rs 24 billion.

Markup payments exhibit the most substantial deviation, surpassing the target by a staggering Rs 1.5 trillion. In fact, markup payments for 2022-23 amounted to Rs 5.5 trillion, constituting over half of the current expenditures (Figure 6).

These variations in current expenditure estimates reflect the complexities and challenges in managing public finances. It is essential for policymakers to closely examine the factors contributing to these deviations and ensure effective allocation and utilization of resources. Strategies aimed at optimizing subsidy programs, evaluating defence spending priorities, and implementing prudent debt management practices should be considered to mitigate the deviations and achieve a more sustainable fiscal position.

Figure 6: Current Expenditures: Over-Runs, %



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

Resilient Growth in Federal Development Expenditure

In contrast to past practices where a significant decline was often observed, the revised estimates for federal development expenditure in 2022-23 indicate a notable increase of 8.3%. Despite the massive rise in current expenditures, the focus on development has been maintained.

The initial budget estimates for the Public Sector Development Programme (PSDP) stood at Rs 727 billion. However, the revised estimates now reflect 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. Moreover, the development expenditure under the Cabinet Division has experienced remarkable growth, surpassing budgetary estimates by over 58%. This exceptional expansion signifies the importance of the Cabinet Division in driving the development priorities.

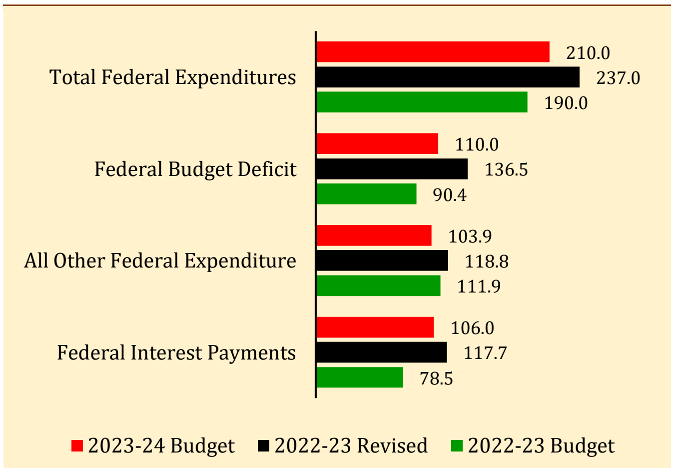
Federal Fiscal Deficit: Out of Control

The preceding discussion highlights several concerning issues in the federal government's financial situation. Firstly, the net revenues of the federal government are lower than anticipated, while both current expenditures and development expenditures have exceeded the budgetary estimates. As a result, there has been significant and worrisome slippage in the fiscal deficit, surpassing Rs 1.85 trillion or 2.2% of GDP compared to the budget estimates. The absolute value of the federal budget deficit has reached a staggering Rs 6.4 trillion.

Of particular concern is that the federal government's net revenue receipts amount to only Rs 4.6 trillion, which is significantly lower than the total expenditure depicted in Figure 7. The figure clearly shows that the revised federal expenditures for 2022-23 are 237% of the net revenue receipts. This alarming situation implies that the net revenue receipts are insufficient to cover even the markup payments, necessitating additional borrowing to finance the rest of the federal expenditure.

Furthermore, it is worth noting that the non-mark-up expenditures also surpass the net revenue receipts, indicating a primary deficit and highlighting the unsustainability of the current fiscal policy.

Figure 7: Key Budgetary Magnitude as a percentage of Net Revenue Receipts, %



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

The Uncertain Fiscal Outlook

The expectations for the federal budget of 2023-24 were centered around addressing key macroeconomic challenges and implementing significant measures to achieve macroeconomic stability. The budget was anticipated to take decisive steps towards fiscal sustainability by ensuring a primary surplus, reevaluating the debt-servicing strategy, and rationalizing the public sector development program. However, the Federal Budget 2023-24 presents an entirely contrasting picture.

The budget portrays a weak resource mobilization strategy, accompanied by substantial growth in both current and development expenditures, leading to a significantly high fiscal deficit. Furthermore, the financing strategy reveals that the federal government intends to finance the fiscal deficit by borrowing from the State Bank of Pakistan, with an amount exceeding Rs 3.5 trillion. This approach raises concerns, particularly considering the prevailing high inflationary conditions.

Over-ambitious Tax targets

The announced income tax measures for 2023-24 by the federal government appear to be relatively lenient, accompanied by an ambitious target of 32% growth in income tax. However, achieving such a significant increase in income tax seems overly ambitious. Similarly, the target for indirect tax shows a massive 25% growth without any major tax measures, which also appears unrealistic considering the performance of the current fiscal year. As a whole, the tax target of Rs 9.2 trillion seems nearly impossible to attain during the upcoming 2023-24 period.

Fiscal Expenditures: Election Year Expansion

Expectations were in place for the federal government to implement strict measures to curb the upward trajectory of current expenditures. However, the outlook for 2023-24 tells a different story. The budget estimates for current expenditure indicate a significant increase of over 26.5%. This surge is primarily driven by rapid growth in debt servicing, a 30–35% rise in salaries, and a lack of emphasis on fiscal austerity. Similarly, despite resource constraints, development expenditures demonstrate a massive growth of 46%. The expenditure growth pattern suggests that the federal government is prioritizing election-related concerns over addressing economic imbalances.

Enormous Federal Fiscal Deficit

The fiscal outlook for 2023-24 reflects a scenario influenced by the upcoming elections, resulting in a larger federal budget deficit. Considering the federal government's inclination to underestimate current expenditures and overestimate revenues, the projected deficit of Rs 6.9 trillion is susceptible to slippage. The heightened reliance on borrowing from private banks to finance the fiscal deficit carries significant implications for monetary policy and is likely to contribute to extensive monetary expansion.

THE INCIDENCE OF POVERTY

Poverty has been a significant and persistent development issue for many years in Pakistan. While there have been efforts to alleviate poverty, it remains a substantial challenge for 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. As the latest HIES available data is for the year 2018-19, an attempt is made to predict current poverty estimates for the year 2022-23.

Poverty Trend in Pakistan

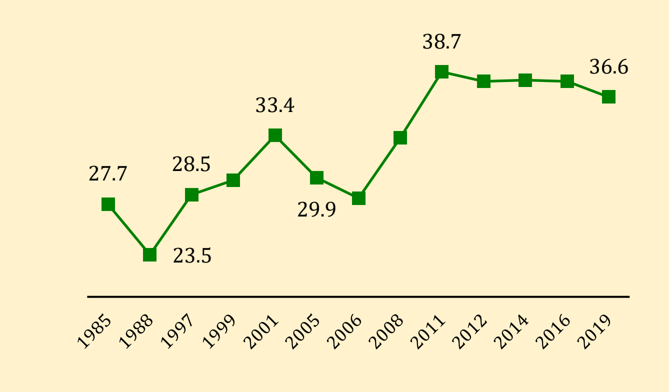
Figure 8 portrays the trends in poverty incidence since 1985. All these poverty numbers were estimated using unit record household level HIES data and by applying a consistent and identical methodology for estimating the poverty line[1]. It is widely believed that economic growth may not always be a 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 general, the figure clearly suggests an inverse relationship between poverty and economic growth.

Prediction of Current Poverty Incidence

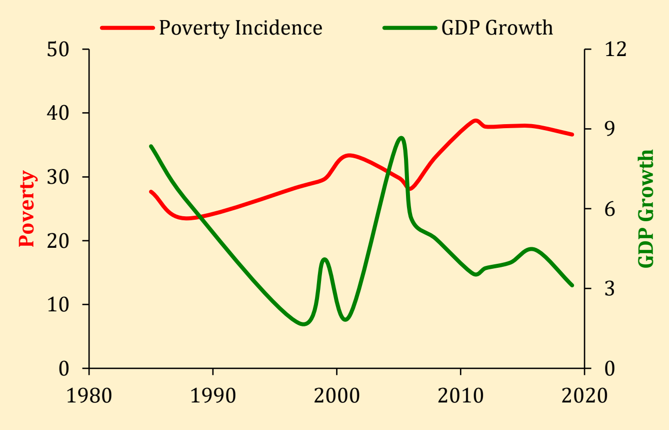
The responsiveness of poverty estimates to GDP, income inequality and inflation is investigated through an econometric model, which quantifies the relationship among poverty, inequality, GDP growth and inflation using interpolated time series[2]. According to the empirical literature, these are the major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

Figure 8: Historical Estimates of Poverty

Overall Poverty Incidence (%)



Poverty and GDP Growth



Current poverty incidence is estimated with the help of elasticities which the estimated econometrical model provides. According to Figure 9, the predicted incidence for the year 2023 is 40.3% suggesting that 93 million persons are below the poverty line. About 15 million persons have been added in the population below the poverty line during the period 2018-19 and 2022-23.

Figure 9: Predicted Poverty Incidence in Pakistan [Population Below Poverty Line]

	Poverty Incidence [Headcount]	Poor Population [Million]
Estimated from HIES 2018-19	36.6%	78.3
Predicted Poverty Incidence – 2022-23	**40,3%**	**93.2**

Given the scale of the poverty challenges, the government's response is not encouraging. The major initiative for poverty alleviation is unconditional BISP cash transfers under the umbrella of Ehsaas program. The government has increased budgetary allocation for BISP from Rs 408 billion in 2022-23 to Rs 450 billion in 2023-24 – an increase of 10.3% against the inflation target of 21%.

THE WAY FORWARD

After the announcement of an expansionary budget, SBP has announced a strict monetary policy stance, maintaining the policy rate at a high level of 21%. The Monetary Policy Committee (MPC) anticipates a decrease in inflation after reaching its peak at 38% in May this year. This is expected to occur due to the implementation of a tighter monetary policy and the subdued demand from consumers and businesses. The objectives and the current paths of both macroeconomic stabilization policies contradict each other. 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. 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.

Fiscal policy needs to be disciplined and prudent, focusing on targeted subsidies for productive sectors, the export industry and the underprivileged segments of society. Reducing current expenditure and shrinking the size of the government is a must to create fiscal space.

Current expenditure overruns are a matter of grave concern. By carefully analyzing and addressing the expenditure patterns, the government can strive for greater fiscal discipline, improve efficiency in resource allocation, and create a more balanced budgetary framework that aligns with national priorities and long-term financial sustainability.

Given a very high poverty incidence where more than 40% (or above 90 million people) are below the poverty line, it is imperative to increase pro-poor expenditures. The coverage of BISP should be increased substantially. Since the provincial governments are primarily responsible for social protection under the 18th Constitutional Amendment, they can use the BISP system for their initiatives of poverty reduction in their respective provinces.

Contributors to the Policy Brief

Muhammad Sabir

Tehseen Iqbal

Aamir Hussain Siddiqui

Haroon Jamal

Editing: Muhammad Asif Iqbal and Naveed Aamir

Graphics and Designing: Muhammad Rizwanullah Khan

NOTES:

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

AERC
www.aerc.edu.pk

SPDC
www.spdc.org.pk