Research Report No. 22

Essays on the Federal Budget 1998-99

SOCIAL POLICY AND DEVELOPMENT CENTRE

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1999

Social Policy and Development Centre

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CONTENTS

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FOREWORD

The budget each year provides an important opportunity for the government to highlight its policies and priorities for the coming year. It also gives the public an opportunity to review these policies. This year the budget has been presented amidst much speculation domestically and globally, coming almost in the immediate aftermath of the nuclear explosions and the government's declaration to persue a path of self-reliance. The Nation looks at the budget as a major statement of government's strategy to operate in the post-sanctions environment.

Social Policy and Development Centre has been playing an active role in the evaluation of the federal budget each year. This year the report compiles a dozen essays relating to the state of the economy, budgetary trends, accuracy of budgetary proposals, evaluation of the taxation proposals, development priorities and the macro economic impact of the budget on growth, inflation, savings and investments, external sector, poverty and inter-governmental fiscal relations. Special effort has been made to highlight the impact of the sanctions.

We hope that our analysis will provide an objective and an insightful appraisal of the budget of 1998-99 and will prove useful to policy analysts and policy makers alike.

ESSAYS
ON
THE FEDERAL
BUDGET
1998-99

PART I

THE BACKDROP

A YEAR OF RESURRECTING SUPPLY SIDE ECONOMICS

Dr. Sajjad Akhtar

A YEAR OF RESURRECTING SUPPLY SIDE ECONOMICS

By

Dr. Sajjad Akhtar

In contrast to traditional demand management policies, the fiscal year 1997-98 began with major policy shift aimed at restoring the supply capacities of the economy. To restore growth, reduce inflation and achieve internal and external balance the supply side paradigm of Reagan era also popularly known as “voodoo economics” was resurrected by the policy managers. Tax rates on incomes, and domestically produced commodities were lowered. Tariff rates on imports were scaled down to further liberalize trade and bring down costs of imported inputs. These and some other measures were supposed to motivate production, exports and thereby generate ‘Laffer curve’ phenomena to increase overall revenues. Unfortunately four months down the fiscal year this strategy was diluted with a demand management instrument of devaluation thereby pushing up the costs of inputs. By mid-year it became apparent that ‘laffer curve’ failed to materialize. Consequently annual development plan was scaled downwards, using another powerful instrument of Keynesian demand management policy. Basically the year ended with an early demise of pure supply-side strategy and its dilution with strict demand management. No doubt many regard the debate of supply versus the demand side as simplistic and fallacious. This is simply a misnomer.

A jump of GDP growth from 1.3 to 5.4 percent (although some would challenge the base figure of 1.3 versus 3.1 percent for 1996-97 quoted till May 1998) and overall success at containing the budget deficit and improving the current account balance would be regarded in the official circles as a success of a unique combination of supply and demand side management. A relevant question is that whether a 39 percent increase in the support price of wheat and 47 percent increase in the support price of sugar cane fall under the rubric of ‘supply-side economics’. These pricing policies are conventional short-run pricing policies meant to temporarily raise the profitability of growers through largely by substitution and additional cultivation of marginal lands. Consequently improvements in the productivity levels may be short-lived. The latter improvements need truly 'structural supply-side measures'. Empirically the supply elasticities of price increases are fairly low. Between FY92-94 the support price of wheat was increased by 23 percent and actually its total production decreased from 16.12 to 15.23 million tons. The recent increases has brought about only a 15 percent temporary increase in the yield levels of sugar-cane. A good supply-side pricing policy should reflect the resource cost use efficiency and increases in productivity levels. Inability to export our sugar based on highly inflated sugar-cane prices without export subsidy is a litmus test whether the pricing increase policy is structural or 'superficial' in nature. Theoretically supply-side measure are meant to reduce input costs. In this regard maintaining the lid on fertilizer price increases during 97-98 clearly fall in the realm of 'supply-side' economics. During 93-94 total credit to the agriculture sector was increased by 47 percent but output of wheat and sugarcane increased by 12 and 6 percent respectively. The assertion that it is the unique combination of credit and pricing policies finds little support historically. Critics on the other hand would like to give more credit to weather than is due. Wheat and sugar-cane are more 'weather robust' than cotton. Consequently cotton targets suffered due to unfavorable weather conditions.

As is well known by now, the growth in large-scale manufacturing is a derived growth. Excluding sugar, the July-March'98 growth is only 1.4 percent. One is willing to accept that availability of credit may have temporarily boosted the production of tractors as also reduction in CVT did have salutory effect on car assembly industry and motor tyre industry in the latter half of the fiscal year. Once again it is debatable whether these monetary and fiscal incentives genuinely reflect 'supply-side' paradigm or are temporary growth inducing gimmicks. Whether the supply side policies lowered the input prices sufficiently to boost competitiveness and production to generate a laffer curve phenomena should be reflected in excise duties, sales tax and custom duties. The nominal collection under the latter two heads was below last year with only a marginal increase in excise duties. Moreover the phenomena of excess capacity in sectors like textile which the supply-side strategy was meant to redress still continues unabated. If increases in sugar and wheat production are sustained without affecting cotton or other competing crops, this year pricing policies can be credited with invoking a structural shift in the agriculture production. Otherwise these policies are no superior than their predecessors.

How did the outgoing year fare on the internal and external balance front? Should one credit the shrinking of budget deficit/GDP ratio from 6.2% to 5.6% and current account deficit from 6.2 to 2.3% to supply-side initiatives or strict demand management. Ex-ante the government started the year with announced contractionary fiscal policy and ambiguous monetary policy, both inconsistent with achieving the objective of stagflation. Ex-post both fiscal and monetary policy turned out to be contractionary. The real growth (excluding inflation effect) in M1 was -4.3 percent during July-Mar'98 and real growth in expenditures minus revenues was -12.3 percent. The fact that in the final tally the tax revenue would almost remain at the last year level rather than increase, support the view that supply side strategy at least did not work in the short-run. Were it not for the receipts under petroleum surcharges and strict demand management our internal balance would have deteriorated. However the benefit of short-run improvement in internal balance need to be weighed by the long-run costs of loosing an opportunity of being competitive in the world market by passing the saving in imported energy costs to industry and services sector. Improvements in external balance was a consequence again of strict demand management and partly favorable external factors such as increased remittances and depressed growth in import prices. Fortunately the South East Asian crisis and resultant dampening of exports did not fully offset the above favorable impacts. Thus in summary one can attribute the perceived revival in growth and success in short-run macro stabilization to short-run pricing policies, favorable external factors and contractionary fiscal and monetary policies. Theoretically Pakistan fails to satisfy the pre-conditions to implement a successful supply side strategy i.e., existence of a broad-based tax system. A secondary starting condition that an economy should have low real interest to generate a 'laffer curve' phenomena is not met in the case of Pakistan.

Assuming a pre-sanction scenario what is the flavor of economic strategy emanating from the budget 1998-99? Will it boost growth, stabilize inflation and further improve internal and external balance? Broadly speaking the strategy is to rely on good weather (for cotton), continue and consolidate with past year combination of supply-side incentives in the form of agriculture credit, stable input prices and output support prices with slight loosening of previous year's strict demand management approach. I would consider it slightly growth enhancing rather than growth neutral. Anti-smuggling tariff measures and custom duty rationalisation of consumer durables may dampen their domestic production in the short-run. Increase in ADP, agriculture credit and tariff reductions on bulk imports may boost up cement, fertilizer and paper and paper product industry. Inflation rate as compared to the last year may inch up partly as a result of loosening government demand and partly as rural demand generated by increase in rural incomes this year translates into increased purchasing power. Inspite of increase in development expenditure, ex-ante the fiscal policy as a whole is contractionary. However given that revenue targets border on the ambitious side and measures to broad base taxes will remain intentions, ex-post the fiscal policy can easily turn expansionary if the expenditure side is implemented. Loosening of demand management will adversely affect the external balance as development expenditure has high import content. However positive spill over effects of increased wheat and sugar production this year will create less pressure on our BOP than last year.

Under post-sanction scenario, the external balance is the most vulnerable. In those circumstances the onus will entirely fall on the demand management strategy of contractionary fiscal and monetary policies to further restrict demand both physically and financially to see the economy through the next fiscal year.

THE BUDGETARY OUTCOMES OF 1997-98

Zafar H. Ismail and Imran Ashraf Toor

THE BUDGETARY OUTCOMES OF 1997-98

By

Zafar H. Ismail & Imran Ashraf Toor

The federal budget for 1997-98 was a reflection of the basket of economic reforms announced by Nawaz Sharif after he took charge of Government. The strategy was to encourage domestic production and expand the tax base through tax reductions and control inflation by reducing the deficit. The year witnessed an impressive 5.4% growth in the economy up from a revised estimate of 1.3%, a reduction of inflation to 8.95% from 11.5% an improvement in the current account of the balance of payments, a reduction in bank borrowing for budgetary support. However, the government could not arrest the weak performance of the tax collection machinery.

RECEIPTS

To maintain the fiscal deficit pegged at Rs. 148 billion, the revenue target for 1997-98 was set at Rs. 460.1 billion. The revised estimate place receipts at Rs. 404.2 billion, that is 6.5% lesser than the target. In the overall context, it would appear that the shortfall of Rs. 26.4 billion was through a substantially lower than target collection from taxes. The saving grace in the fiscal year performance has been the receipts from petroleum surcharges. This surcharge in the cushion which absorbs any adverse impact of an increase in POL prices worldwide. The international demand of POL was depressed throughout the year, thereby keeping prices low. This yielded a windfall profit of Rs. 15.4 billion for Pakistan.

A closer examination of tax receipts shows that the bulk of the slippage was caused by a decline in the revenue from imports. The underlying cause for this slippage was the effect of lower than target changes in international prices. This has translated into a Unit Value Index of imports which was only marginally higher than last year. Moreover, the budget had announced a reduction in the sales tax rate on imports generally, and a substantial decline in the customs duty rate on intermediate goods to encourage domestic production. In addition, the budget also contained a number of duty concessions to reduce smuggling - such as the reduction in Sales Tax on tea. The cumulative revenue shortfall from imports was Rs. 24.1 billion. It would appear from the figures available that the government's target to expand the base of Sales Tax through an overall on domestic production has yielded the desired result. Revenue on this account has increased by 8.1 percent. This is in spite of the fact that the GST on retail trade could not be implemented, and the yield from the Trade Enrollment Certificate, which was introduced to replace the GST on retail trade, was less than optimal.

The budgetary outcome from non-tax revenues showed a near-target performance. However, the impact of the devaluation in October, 1997 and the subsequent changes in foreign exchange trading resulted in an erosion of about Rs. 4 billion in the profits from the State Bank of Pakistan.

TABLE 1

(Rs. Billion)

Classification	**1996-97 Actual**	**1997-98 Budget**	**1997-98 Revised**	**Slippage from Budget**
Total Receipts	384.3	460.1	449.2	-2.4%
Total Tax	282.1	324.0	297.6	-8.2%
Direct Taxes	85.1	104.3	101.8	-2.4%
Income Tax	80.4	97.8	95.6	-2.2%
Wealth Tax	2.4	3.4	3.6	
Capital Value Tax	0.8	2.3	1.7	-26.0%
Workers Welfare Tax	1.5	0.8	0.9	
Indirect Taxes	197.1	219.7	195.8	-10.9%
ST on Domestic Production	19.8	22.3	24.0	
ST on Imports	35.9	41.9	30.1	-28.1%
Custom Duty	86.1	91.0	78.7	-13.5%
Federal Excise	55.7	64.5	63.0	-2.3%
Surcharges	27.3	30.2	47.0	
Petroleum	22.5	25.2	40.6	
Natural Gas	4.8	5.0	6.4	

Non-Tax Revenue	74.8	105.9	104.6	-1.2%
Profits on SBP	10.0	25.0	21.0	-16.0%

CURRENT EXPENDITURES

In 1997-98, the government projected that its current expenditure of Rs. 464.9 billion would be 16.8% higher than last year. However it has been able to curtail this to Rs. 456.6 billion or 98.2% of budget. An analysis of the expenditure profile Table 2 shows that most expenditures were below target levels, commendably the defence services. They were able to restrain their expenses to within 0.1 percent of their budgetary allocations. This translates into reduction of 8.9% in real terms. Commendably also, expenditure on general administration was curtailed by 4.8% and on subsidies by 11.4%. From the numbers given, see Table 2, it would appear that government was able to reduce debt servicing by 1.5%. Apparently savings on interest alone was 4%. In other words, government was able to borrow at a lower rate than budgeted.

TABLE 2

(Rs. Billion)

Classification	1996-97 Actual	1997-98 Budget	1997-98 Revised	Variation from Budget
Federal Current Expenditure	397.1	464.9	456.6	-1.8%
General Administration	20.7	20.5	19.5	-4.8%
Defence	127.4	134.0	133.8	-0.1%
Law and Order	7.2	8.1	8.2	+1.9%
Community Services	4.9	5.7	5.8	+0.8%
Social Services	9.0	9.3	9.5	+2.6%
Economic Services	2.0	2.7	2.9	+4.6%
Subsidies	6.8	7.4	6.6	-11.4%
Debt Servicing of which:	203.1	247.9	244.2	-1.5%
Interest on Domestic Debt	125.5	153.9	152.4	-1.0%
Interest on Foreign Debt	28.5	31.5	29.7	-5.7%
Repayment of Foreign Debt	49.0	62.5	62.1	-0.6%
Grants and Unallocable	6.4	26.3	26.1	-0.7%

While there was an overall reduction in current expenditure, some slippage was observed in the expenditure on law and order (1.9%), economic services (4.8%) and social and community services.

On the whole, government should be commended for the successful expenditure management throughout the year.

DEFICIT

The efficiency of budget management is measured by the variance in the deficit budgeted at the beginning of the year. Table 3 shows that in 1997-98 the deficit was only to 0.2 billion higher than budgeted. This was managed by changing the emphasis on borrowing. Net interest resources (that is foreign aid net of repayments) were 8% lower. This, therefore, indicates that the government was successful in mobilizing savings, effected by more than doubling the receipts from saving schemes and short term treasury bills.

TABLE 3

(Rs. Billion)

Classification	1997-98 Budget	1997-98 Revised	Variation from Budget
Budget Deficit	-153.0	-153.2	
Financing by:			
Non-Bank Borrowing	27.9	60.7	+217.6%
Net External Resources	67.1	61.7	-8.0%
Bank Borrowing	49.8	30.7	-38.4%

It would appear that on the whole the overall budgetary performance by the government was mare than satisfactory.

PART II

FEATURES
OF
THE BUDGET

‘HARD’ DEFICIT TARGETS, BUT ‘SOFT’ TAXATION

Zafar H. Ismail and Aisha Bano

‘HARD’ DEFICIT TARGETS, BUT ‘SOFT’ TAXATION

By

Zafar Ismail and Aisha Bano

The last two budgets have witnessed a remarkable new phenomenon of major budget deficit reductions with soft taxation measures. During 1997-98 we have seen the budget deficit decline from 6.2 per cent of the GDP to 5.4 per cent despite the fact that in early 1997 the government had announced a major tax and tariff reforms package involving steep cuts in tax rates, implying a revenue loss of more than one per cent of the GDP, while the Budget of 1997-98 contained no new taxation. The Budget 98-99 was presented in an environment of heightened expectations about heavy taxation in lieu of the sanctions. The budget making team of Sartaj Aziz and Hafiz Pasha chose instead to levy new taxes aggregating to only 0.4 per cent of the GDP while targeting simultaneously for an increase of 0.3 per cent of the GDP in the size of the PSDP, but were able nevertheless to project a major reduction in the budget deficit from 5.4 per cent in 1997-98 to 4.6 per cent next year. What is the secret formula that the government has discovered for achieving ‘hard’ deficit targets, never achieved before, with ‘soft’ taxation measures? Is there some sophisticated jugglery of numbers? These questions are upper most in the minds of budget analysts.

An obvious way to resolve the apparent contradiction is to argue that while the government has been soft on taxation it has perhaps been exceptionally tough on the expenditure side as a whole. Alternatively, it may have opted for greater resource mobilisation from non-tax sources and surcharges. The apparent retreat from heavy new taxation, involving sizeable increases in tax rates, is justified on the grounds that such a strategy failed in recent years in raising the tax-to-GDP ratio. What is required are structural reforms involving improvements in tax administration and broad-basing of the tax bases, which will inevitably take time to yield dividends. Meanwhile, other avenues have to be found for reducing the fiscal deficit. The aversion to raising tax rates can also be understood from the viewpoint that this fundamentally runs counter to the supply-side strategy adopted by the government for stimulating the process of economic revival, which has already yielded some results in 1997-98. Apparently, the strategy is not one any more of collecting revenues by raising tax rates on stagnant tax bases but of raising more revenue by reducing tax rates and thereby increasing the buoyancy of the tax base, a dynamic version of the 'Laffer curve view of the world.

Let us now try and see what strategy has, in fact, been followed for bringing the budget deficits down in 1997-98 and 1998-99. This involves quantification of the nature of fiscal adjustment year-to-year, which is attempted in Table 1.

TABLE 1
NATURE OF FISCAL

(% OF GDP)

	1996-97 (R.E.)	1997-98 (R.E)	Fiscal Adjustment in 1997-98	1998-99 (B.E.)	Fiscal Adjustment in 1998-99
TOTAL RESOURCES	**11.1**	**12.0**	**0.9**	**12.4**	**0.4**
Gross Receipts	16.4	16.3	-0.1	16.7	0.4
Less					
Transfers to Provinces	5.3	4.3	1.0	4.3	0.0
TOTAL EXPENDITURE	**17.3**	**17.4**	**0.1**	**17.0**	**-0.4**
Current Expenditure	13.8	14.2	0.4	13.5	-0.7
Development Expenditure	3.5	3.2	-0.3	3.5	0.3
BUDGET DEFICIT	**-6.2**	**-5.4**	**0.8**	**4.6**	**0.8**

FISCAL ADJUSTMENT IN 1997-98

The budget deficit has declined by 0.8 per cent of the GDP in 1997-98, to the lowest level in the decade of the 90s. This has happened despite a fall in the tax-to-GDP ratio from 11.4 per cent in 1996-97 to 10.8 per cent, a reflection of the cost of the tax reforms. Gross receipts have, more or less, remained unchanged at just above 16 per cent of the GDP. The government has been able to compensate for the fall in tax revenues by raising the contribution of surcharges, which are up by 0.7 per cent of the GDP and non-tax revenues by about 0.1 per cent of the GDP, due primarily to higher SBP profits.

On the expenditure side, there is again little change in relation to GDP. An increase in current expenditure by 0.3 per cent of the GDP, due primarily to higher interest payments on debt, has been compensated, more or less, by a decline in development expenditure as a percentage of the GDP.

Given the constancy, therefore, is gross receipts and total expenditure how has the deficit reduction been achieved in 1997-98? The answer lies in a unique and unexpected factor of a once-and-for-all nature) the bonus to the federal government arising from the 1997 NFC Award. Transfers to provinces have fallen by a full one percentage point of the GDP, from 5.3 per cent in 1996-97 to 4.3 per cent in 1997-98. The 1997 award expanded the divisible pool but reduced the overall provincial share drastically, leading in the short run to a major contraction in the quantum of transfers, such that with unchanged gross revenue receipts (in relation to the GDP) of the federal government, net revenue receipts are actually significantly higher. The Nawaz Sharif government has clearly been a free beneficiary of the favourable NFC award for the federal government finalised by the Caretaker government. Apparently, the burden of fiscal adjustment in 1997-98 has been transferred to the provincial governments who have consequently witnessed little growth in transfers. It is not surprising, therefore, that the fiscal position of the provincial governments has deteriorated dramatically as indicated by the build up of overdrafts with the central bank, cut back in development activities and deferment of obligations. It is possible that when the consolidated fiscal deficit for 1997-98 is worked out for the federal and provincial governments combined it may turn out to be significantly in excess of 5.4 per cent of the GDP.

FISCAL ADJUSTMENT IN 1998-99

How is the budget deficit reduction from 5.4 per cent to 4.6 per cent of the GDP being achieved in 1998-99? We have here a more conventional explanation. Half the fiscal adjustment is on the taxation side and half on the expenditure side. With a return to normal growth in CBR tax revenues and an incremental fiscal effort of over Rs 16 billion in the Budget, the tax-to-GDP ratio is expected to start rising once again, by about 0.4 per cent of the GDP in 1998-99. Any likely fall in surcharges is expected to be compensated by higher SBP profits, in particular. Therefore, while transfers to the provinces will remain unchanged at 4.3 per cent of the GDP, not revenue receipts of the federal government are expected to be higher by 0.4 per cent of the GDP, equivalent to the rise in the tax-to-GDP ratio.

On the expenditure side, the increase in development expenditure by 0.3 per cent of the GDP necessitates a bigger cut in current expenditure. The latter is, in fact, projected to fall by 0.7 per cent of the GDP due to, first, a reduction of 0.3 per cent of the GDP in defence, second, a fall by 0.2 per cent of the GDP in subsidies and grants and, third, a fall of 0.2 percent of the GDP in other heads including debt servicing and civil administration (due to the 50 per cent cut in non-salary expenditures).

The year 1998-99, therefore, represents a reversion back to a conventional strategy of deficit reduction operating both on the revenue and expenditure side. By achieving an overall cut of 0.4 per cent of the GDP in total expenditure, budget makers were able to reduce the additional taxation requirement by half, to 0.4 per cent of the GDP. In other words, in the absence of tighter management of expenditure, the target for additional resource mobilisation would have been about Rs 32 billion, instead of Rs 16 billion. Therefore, the taxation impact of the budget of 1998-99 has been softened by resort to expenditure controls in current expenditure, which have been hard enough to allow for a big increase in development expenditure, after a lapse of many years. It remains to be seen, however, if the proposed deficit reduction strategy succeeds in 1998-99, especially in view of the impending impact of the sanctions.

ACCURACY OF BUDGETARY PROJECTIONS

Dr. Aisha Ghaus-Pasha

ACCURACY OF BUDGETARY PROJECTIONS

By

Dr. Aisha Ghaus-Pasha

There are two views about the nature of government budgeting prior to the start of any financial year. The first view is that `conscious biases' are built in whereby an effort is made to overstate revenues and understate expenditures so as to keep down the budget deficit and consequently the requirement of additional revenues to be generated from taxation proposals which are announced in the budget. This implies that over the year there will generally be shortfall in revenues while expenditures would rise above target levels. Either the budget deficit would be higher or development and discretionary component of expenditures would be curtailed so as to come close to achieving the deficit target.

The other view is that there are no systematic biases but only `random errors' in government budgeting. In the case of any budgetary magnitude, some years the actual magnitude would exceed the budget estimate and in other years be less. On the average, over time these deviations would tend to cancel out. According to this view, as a whole, government would be close each year to achieving its deficit target unless there are identifiable unanticipated shocks to the system like war or the international sanctions that we currently face following the nuclear blasts.

The motivation behind the latter view is that projections of budgetary magnitudes are linked to projections of changes next year in macro economic variables like GDP (and individual sectoral value added), inflation, exchange rate, interest rates, etc. It is impossible to predict economic developments precisely and, therefore, the noise or error in budgetary projections is a reflection of this uncertainty. According to this view, governments are seen as essentially `benign' with no ulterior motives behind manipulating the budgetary numbers.

HISTORICAL PERFORMANCE OF GOVERNMENT BUDGETING

Results of analysis of the extent of deviation of revised estimates of key budgetary magnitudes from budget estimates are presented in Table 1 for the period, 1993-94 to 1997-98. The results lend at least partial credence to the first view. Revenue receipts appear to be generally overstated, on the average by about five percent. This problem is particularly acute in years when the component of additional taxation is high and there is a tendency to overstate the revenue contribution of taxation proposals. Within revenue receipts, it is interesting to note that revenues expected from CBR have always been overstated each year during the last five years, and 1997-98 is no exception. The shortfall reached a peak of 15 per cent in 1996-97 and is estimated at about 8 per cent in 1997-98.

TABLE 1
ACCURACY OF BUDGETARY PROJECTIONS?
(%)

BUDGET HEADS	1993-94	1994-95	1995-96	1996-97	1997-98	Average Deviation
REVENUE RECEIPTS	**1**	**-10**	**-2**	**-14**	**-2**	**-5**
CBR Tax Revenues	-4	-13	-1	-15	-8	-8
Surcharges	26	-17	43	-5	55	20
Non-Tax Revenues??	7	2	-14	-15	-1	-4
EXPENDITURE	**4**	**-2**	**4**	**-3**	**-1**	**0**
Current	6	0	5	1	-1	2
Development	-1	-9	-2	-19	-1	-6
BUDGET DEFICIT	**7**	**44**	**27**	**54**	**0**	**26**
External Borrowing (Net)	10	2	53	-7	N.A.	14
Domestic Non-Bank	13	82	-4	-21	N.A.	17
Bank Borrowing	-21	23	76	343	-47	78

? Measured as the percentage difference between budget estimates and revised estimates

?? Inclusive of surplus of autonomous bodies and use of privatisation proceeds

Surcharges are subject to a lot of variation. In some years like 1997-98 they are substantially above target while in other years like 1994-95 there could be significant shortfalls. This is a reflection of underlying short-run uncertainty about the future path of international prices of POL products. Non-tax revenues were above target in the first two years but have fallen below target in the last three years. This is perhaps the consequence of the increasing difficulties that public enterprises like WAPDA, KESC, etc., are having in fulfilling their committed debt servicing obligations with government.

On the expenditure side, it appears that governments generally do a good job of management. Current expenditure targets do tend to be bust somewhat, especially with domestic debt servicing obligations turning out to be higher than anticipated, but this is generally compensated by a corresponding out in development expenditure, which could be as much as 19 per cent in 1996-97.

Therefore, the performance in budgeting by governments during the last five years is characterised by initial overstatement of revenues, especially of CBR, and, more or less, accurate budgeting of public expenditure. Depending on the size of the revenue shortfall, this has implied higher budgetary deficits than originally anticipated of almost 26 per cent on the average. The year 1997-98 is a clear exception and the budget deficit in the revised estimates has been shown as exactly equal to the projected deficit of Rs 148 billion. Of course, there is still some uncertainty about June 1998 collections by CBR and the ability of WAPDA and KESC to fully meet their debt servicing obligations to government this year. It also appears that the incremental deficits are largely financed by higher bank borrowings.

PROJECTIONS FOR 1998-99

Based on the experience of the last few years, the vulnerable spots in the budget for 1998-99 can be identified. The first is CBR revenues, which are projected to increase by almost 20 per cent in the face of a nominal GDP growth rate of about 14 per cent and hardly any growth in the dollar value of imports. The tax-to-GDP ratio has been declining over the last few years and it remains to be seen whether 1998-99 will mark the beginning of a change in the trend.

The other element of uncertainty relates to non-tax revenues. Given the acute financial problems of WAPDA and KESC, will they be able to make interest payments to government of over Rs 17 billion next year? On the current expenditure side, which have been historically understated, there is some doubt about the government's ability to restrict the growth in interest payments on domestic debt. These have been projected to increase by only 8 per cent in 1998-99, as compared to 32 per cent in 1997-98. Of course, there always exists the possibility that in the event of budgetary difficulties, the PSDP will be slashed once again and we may not see any spurt in the pace of development activity in the country in 1998-99.

Altogether, if recent economic history is any guide, the projected budget deficit of 4.6 per cent of the GDP could rise to almost 6 per cent. But if the good performance shown in 1997-98 is sustained, then the divergence could be less.

IMPACT OF SANCTIONS ON THE PROJECTIONS

The uncertainty associated with the budgetary projections has been greatly compounded by the likely impact of sanctions announced recently by G-8 countries in the aftermath of nuclear blasts by Pakistan. The initial impact of these sanctions is likely to be less on the size of the budget deficit and more on the pattern of financing of the deficit. The Finance Minister has indicated that the shortfall in aid inflows due to sanctions is of the order of $ 1.5 billion. If this is all reflected in the budget and the country continues to honor all its international debt servicing obligations then the net inflow of external assistance will be substantially negative. Clearly, domestic borrowings will have to be correspondingly enhanced, especially from the banking system.

If the sanctions persist for some time and foreign exchange reserves start plummeting then the assumption about the exchange rate in 1998-99 implicit in the budgetary numbers may change dramatically. In that event the 38 per cent growth in SBP profit contribution to the government may not materialise. The rupee equivalent of international interest and debt repayments could rise, tax revenues could be adversely affected if import restrictions are introduced down the road, and so on. Altogether, the post-sanctions budgetary environment is plagued with a high degree of uncertainty. Given the emerging problems, the government will do well if it can contain the fiscal deficit to below 6 per cent of the GDP next year.

STRATEGY OF ADDITIONAL RESOURCE MOBILISATION: DOES IT OFFER ANYTHING NEW?

Dr. Aisha Ghaus Pasha and Abdul Rauf Khan

STRATEGY OF RESOURCE MOBILISATION: DOES IT OFFER ANYTHING NEW?

By

Dr. Aisha Ghaus-Pasha and Abdul Rauf Khan

Contrary to general expectations, Federal Budget 1998-99, presents taxation proposals of Rs only 16.4 billion (see Table 1). Following the Prime Ministers' address in the immediate aftermath of the nuclear tests, in which he spoke of "tightening of belts" the general anticipation was that additional taxation of Rs 40 to Rs 50 billion was on the anvil. So on 12th of June the nation was pleasantly surprised. Public finance experts were, however, not disappointed as recent history indicates that resort to ad-hoc additional taxation through enhancements in tax rates has done nothing to raise the tax-to-GDP ratio, which remains stuck at about 13 per cent. This is because our taxation structure is narrow and inelastic, our tax administration is slack and the revenue yield from the proposal is more often than not overestimated. Higher tax rates only contribute to higher evasion and corruption in the tax system.

TABLE 1

REVENUE IMPACT OF TAXATION PROPOSALS

Heads	Rs in Billion	% Share
Direct Taxes	**8.2**	**50**
Indirect Taxes	**8.2**	**50**
Sales Tax	6.6	40
Customs Duty	1.6	10
Excise Duty	)	)
TOTAL	**16.4**	**100**

The key questions therefore are: is the taxation package offered this year any different from previous years and to what extent does it address the systemic ills of the taxation system?

Specifically, are the taxation proposals structural in character which will broaden the tax base and make it buoyant? Are they easy to administer and will increase tax compliance, reduce leakage and thereby attain revenue targets? and finally, which segments of the population will bear their burden) the lower and middle classes or the richer and the more privileged ones?

The first key proposal is to extend sales tax to the retail level and cover all outlets with a turnover of Rs 5 million and more. Also, where sales are made to non-registered persons an additional tax of 1 per cent will be levied. Government has in recent years been making numerous efforts to introduce retail sales tax, without much success. So the idea is not new although a more comprehensive and viable scheme has been presented this time. Initially retail sales tax was introduced for specific consumer items, at the manufacturing stage now it has been extended to all taxable items (except basic food stuff) but the tax net has been limited to large retail outlets with a turnover of Rs 5 million or more. As such, the tax net will be extended to include a few thousand additional payers. The chances of mopping up big additional revenues from the measure are, however, limited. The proposal that is likely to generate significant revenue, however, in the short run is 1 per cent tax on those who make sales to non-registered persons. These will cover commercial importers, manufacturers and wholesalers. It is recommended, however, that the rate be raised gradually to 2 per cent to encourage documentation of the economy.

Another measure which is likely to swing big revenues for the exchequer, even though it can be criticised vociferously on grounds of equity and foreign exchange concerns, is the lifting of the ban on luxury vehicles. The custom duty rate reduction from 265 per cent to 125 per cent is likely to generate Rs 6 billion, due to the lifting of the ban and liberalisation of imports. Payment will have to be made in foreign exchange, which may imply some diversion from currency inflows at a time of scarce foreign exchange resources. Also, it sends wrong signals from the viewpoint of austerity.

Another important structural measure is the resort to major reductions in import tariffs in the budget as an anti-smuggling devise, coupled with a cascading down of duties on imported raw materials and components to protect local industry. In some cases, local industry has been given higher protection by withdrawal of excise duties. Over 60 items have been subject to tariff reductions of 10 per cent to 20 per cent to reduce smuggling. The list includes crockery, toys, betel nuts, toiletries, coffee, spices, auto parts (not manufactured locally), TVS, air conditioners, photographic films, stationery, etc. This proposal tantamounts effectively to an admission by the government that it cannot control smuggling into Pakistan by administrative measures. Also, the extent that prices of luxury goods and consumer durables come down domestically it will run counter to the goal of austerity. If it is successful, it will involve a higher import bill at a time when foreign exchange resources are increasingly scarce. Also, the budget assumes a revenue yield of Rs 1.6 billion from the enhancement of legal imports. The prospects for achieving this target are highly uncertain.

Key measures on the direct taxation side include: a) 10 per cent surcharge on income and wealth; b) removal of preferential treatment to salary perquisites and c) freezing of corporate income tax rates which as per past years' commitment should have been reduced this year. Major potential criticisms against these measures are twofold: first, policy reversals lead to loss of government credibility and, second, it essentially tantamounts to higher taxation of the already taxed sectors. Both of these can perhaps be defended on grounds of the existing political (post-sanction) environment whereby the burden of additional taxation is targeted towards the `better-off' segments of the population. The question then is what about horizontal equity which requires equal taxation of equals (all better-offs) in the society. It seems that the rural segment will remain outside the tax net as not much has been done to effectively tax agricultural income this year also.

Extension of the withholding income-tax to telephones enhancement in the case of motor vehicles is another proposal aimed at extension of the income tax net. This is consistent with the scheme of compulsory filing of returns by all owners of big plots, cars, telephone connections and foreign travel. India this year has extended the compulsory filing of returns to credit card holders and club members also. This is a good measure to broaden the tax base which was indeed the basic philosophy for the introduction of the withholding tax regime. However, the government needs to be reminded that this regime was originally promoted to identify additional tax payers, consolidate the data base and then revert back to assessed income taxation. Withholding taxation was never to be a permanent substitute for assessed income taxation on the basis of filing of returns. Therefore, it is important that efforts be made to consolidate the database thus generated and grounds be prepared for a phased switchover to assessed income tax.

In summary, it appears that taxation proposals announced this year by and large focus on base-broadening and are therefore, structural in character. Except for the retail sales tax these are generally easy to administer. The revenue impact is, by and large, likely to materialise. However, some of the proposals are unsustainable, in the sense that their high yields are essentially temporary and they do not intrinsically enhance the buoyancy of tax structure.

DEVELOPMENT PRIORITIES IN THE 1998-99 PSDP

Zafar H. Ismail, Abu Nasar and Asif Usman

DEVELOPMENT PRIORITIES IN THE 1998-99 PSDP

By

Zafar Ismail, Abu Nasar and Asif Usman

Public sector expenditure has been viewed historically as the primer used to stimulate economic growth. This is largely owing to the basket of investment made. Public expenditure is normally restricted to the expansion of the infrastructure needed to provide inputs to private sector investments into the productive sectors and the basic facilities needed to improve the social well-being of a nation. As development cannot be uniformly spread owing to a shortage of resources, a case is made by the less developed regions or the under-provided segments of society for special consideration when resources are being allocated for development.

Pakistan's Public Sector Development Programme each year reflects these considerations. However, the priority given to any particular sector reflects the underlying considerations which the government feels must be addressed. The outlay on the PSDP during the nineties has been increasing in value each year, but its proportion in the GDP has been declining from 6.5% in 1991-92 to 3.2% in the current year. Next year, however, the government plans to increase the outlay from last year's allocations of Rs. 90.1 billion to Rs. 110.1 billion, that is by 22.7%. This would increase the Development Expenditure : GDP ratio to 3.5%, that is effectively by 0.3%. Where lies the change in priority?

In quantum terms the highest increase in the allocation has been for expanding the economic infrastructure (irrigation, power, fuels, highways and roads) followed by the social sectors (education, health, etc). Table 1 shows also that in growth terms, the highest increase has been for the latter (nearly 41%) followed by the productive sectors (agriculture, industry, etc), which are budgeted to increase by nearly 26% next year. It would appear, therefore, that unambiguously, government's priority is still continuing to shift towards allocation for improving the social sectors. Moreover, as in the past this is the only sector which enjoys immunity from cuts. The share of the social sectors in the PSDP has been increased from 17.4% in the current year to 19.9% next year. This is the only sector which has seen a substantial shift in its favour. However, the share of the allocations to economic infrastructure continues to preempt the bulk of investment next year also.

TABLE 1
PSDP ALLOCATIONS

Sectors	Allocations (Rs. Bln)		Share in PSDP (%)		Growth over 97-98 (%)
	1997-98	1998-99	1997-98	1998-99	
Productive Sectors	1.6	2.1	1.8	1.9	25.9
Economic Infrastructure	51.9	61.7	57.6	55.8	18.9
Social Sectors	15.6	22.0	17.4	19.9	40.8
Special Areas/Programmes	20.3	24.1	22.5	21.8	18.9
Others	0.6	0.7	0.7	0.6	9.4
TOTAL	**90.1**	**110.6**	**100**	**100**	**22.7**

There is a general perception by donors and by the public at large that the overall basket of development projects is very large. This was confirmed by the interim government's task force on public expenditure that the size of the PSDP equals about 7 years or more of allocations. One would, therefore, expect that government's priority would be to allocate to existing projects with short gestation periods and bring them on-stream before undertaking long gestation or new projects. Table 2 shows that the government was able to restrict pressures for new starts in the current year, but succumbed to this for the next year. The share in the overall PSDP has increased from 0.6% to 4.1% next year. The largest share in both quantum terms and in the share of new allocations is for the construction of economic infrastructure projects. One asks why? This is best answered by a micro-examination of the projects themselves, which immediately establishes their priority.

In agriculture, 9 of the 14 new schemes are for research into increasing productivity. As these are investments into the future, they would apparently pass all criteria for inclusion. Moreover, such investment is needed to ensure future crop autarky. The remainder are either for replacing existing equipment which is hired out or for bricks and mortar projects, none of which can be said to be essential. Even though the planned new projects in the water sector are chunky, they are required to increase the availability of water which in turn will help increase the output of crops.

Allocations for new projects in the economic infrastructure are for airport and motorway construction, the building of mass transit projects and for oil exploration. Contrary to general perception, the motorway is the Pindi Bhatian-Faisalabad Motorway and not the Islamabad-Peshawar Motorway. The latter is an on-going scheme which has been revived. All other new projects are for R&D or are bricks and mortar projects. One asks were any of these, other than the oil exploration and R&D projects really needed? Could they not have been justified for being executed as a BOT project? If we remember correctly each of the motorway projects and the airport projects were approved initially as BOT projects. If they failed the market test, why should scarce public resources be used for this purpose? Moreover, the concentration of these projects is such that they favour only one province.

TABLE 2
NEW PROJECTS IN THE PSDP

Sectors	Allocations (Rs. Mln)		Share in New (%)	
	1997-98	1998-99	1997-98	1998-99
Productive Sectors	0.0	383.3	0.0	8.4
Economic Infrastructure	419.6	3,838.5	82.4	84.2
Social Sectors	24.4	216.4	4.8	4.7
Special Areas/Programmes	0.0	0.0	0.0	0.0
Others	65.0	118.7	12.8	2.6
TOTAL	**509.0**	**4,557.0**	**0.6**	**4.1**

A major fear that has been oft expressed is - Was such a large PSDP really necessary, particularly in the light of sanctions which may be imposed? If these are tough, then there would be substantial pressures on the current account portion of the balance of of payments. In other words, government would need to look around for other sources of foreign exchange to foot the import bill and the repayment of interest and current portions of loans. The economic management team of Sartaj Aziz and Hafiz Pasha may well have realised that one source could well be through accelerating foreign aided projects. While these could well run into the historical block of adequate matching rupee funds, there is always the alternative available for printing money. The total value of foreign aided projects is Rs. 65.8 billion, that is nearly 60% of the total PSDP. Of this foreign assistance accounts for nearly 71% or Rs. 46 billion (equivalent to US$ 1 billion). By doubling the speed of the draw-down, particularly in the case of SAP and other low-interest loans, Pakistan could well ride out the worst of the impacts resulting from sanctions.

TABLE 3
FOREIGN AIDED PROJECTS IN THE PSDP

Sectors	FAP (Rs Million)		Share of (%)	
	Total	Foreign Aid	Forex in FAP	FAP in PSDP
Productive Sectors	625.7	570.0	91.1	1.1
Economic Infrastructure	38,625.4	29,534.0	76.4	58.1
Social Sectors	18,690.5	9,756.1	52.2	28.4
Special Areas/Programmes	7,845.0	6,276.0	80.0	11.9
Others	344.0	322.1	93.6	0.5
TOTAL	**65,770.6**	**46,458.2**	**70.6**	**59.5**

Some philosophical issues which need to be considered when framing the PSDP have apparently not been adequately addresses. For instance, in the transport and communications sector, there is the on-going argument - Should investment be directed to an expansion in the network or consolidation of the existing network? and whether investment should be made for the development of tertiary roads rather than on inter-city highways? It is now a generally accepted practice that new highways should not be a burden on scarce public resources, but should be undertaken through a true BOT arrangement - totally dissimilar to what was attempted for M-1. If there are no takers for such projects there is an unambiguous case for not going ahead with such projects. A similar argument applies to the development of international airport and facilities for international travel. Innumerable studies have established that the best value for money in highway development is attained through a "*to standard*" maintenance of existing networks, followed by an upgrading of an existing network either by rehabilitation or by a dualisation of existing carriageways. Tertiary roads, as represented by farm-to-market roads yield far more benefits and are more equitous than are inter-city highways. The former also help in greater access to social infrastructure through which tertiary benefits such as high literacy rates, better health, etc can be attained by the disadvantaged segment of civil society.

There is no argument which can today set aside the impression that dams are ecological disasters and mini-hydel projects can be more beneficial for the production and distribution of electricity. It also cannot be gainsaid that the benefits from hydro-electric projects far outweigh the benefits from fossil fired generation. While the latter are of much shorter gestation and, therefore, spew benefits in the short-run, their costs to the ecology and a fragile imported fuel-dependent economy are much more in the long run. It is estimated that 30% or more of the electricity generated is lost in the process of distribution. Investments into improving the distribution network are certainly seen to be more beneficial for a variety of reasons. These include, but are not limited to, that they are less capital intensive, they have a shorter gestation period, they are more efficient as the cost of power outages in an over loaded system are substantial.

PART III

IMPACT
OF
THE BUDGET

BUDGET 1998-99:
SIGNALING SHIFTS IN GROWTH STRATEGY

Dr. Sajjad Akhtar, Mansoor Ahmed and Naveed Aamir

BUDGET 1998-99: SIGNALING SHIFTS IN GROWTH STRATEGY

By
Dr. Sajjad Akhtar, Mansoor Ahmed and Naveed Aamir

The year 1997-98 experienced a unique combination of economic policies in order to achieve the twin objectives of growth and macro stability through supply side and demand management policies. The real GDP growth of 5.4 percent can be mainly attributed to outstanding (compared historically) performance in the agricultural sector which grew by 5.9 percent. As a consequence manufacturing sector also grew by 6.96 percent during the year. The actual growth in the manufacturing sector is due to sharp growth of 6.19 percent in the large scale manufacturing on account of 46 percent increase in the output of sugar industry.

Cotton yarn and cotton cloth showed a nominal growth. The reasons for this marginal growth is below target cotton crop during the last couple of years, entry of new competitors in the international arena, antidumping duty on cotton yarn in Japan and on cotton cloth in European Union markets and massive devaluation of South East Asia currencies. Textile sector requires structural changes in order to rationalize its input -costs as in the current year its major competitors India and China have captured some shares of its traditional markets that of Canada, USA and Turkey etc. Smuggling also distorts the domestic demand /supply balance. Industries experiencing negative growth in the outgoing year can be conveniently categorized in three groups. Construction related industry including cement, paint and varnishes and steel industry experienced a negative growth. Industrial output i.e., electric meters, switch gears and electric transformers linked to demand generated by WAPDA and KESC also experienced a decline. The third group consisting of tube and tyres (motor and cycles), tea, footwear and safety razor blades industry faced competition from smuggled goods. With tighter control on governments expenditure and State Bank's improved vigilance over the financial institutions the average growth in the service sector was 4.8 percent compared to the annual average of 6.7 in the 80s. The impact of reduction and rationalisation in tax rates and tariffs generated a 'laffer curve' phenomena whereby beverages, tobacco and consumer durable goods industry e.g., refrigerators, airconditioners and TV sets recorded a positive growth over the last year.

As we enter the fiscal year 1998-99, the budget has to be evaluated from the following perspectives:-What type of growth strategy is being implicitly or explicitly promoted by the budgetary proposals. Is there a shift towards agriculture or industry led growth? Within industry are policies focused towards reducing excess capacity or creating new capacity? If one catches the overall flavor of sectoral budgetary proposals they are tilted towards agriculture. Ironic it may seem coming from a government of industrialists and businessmen but in the short-run is it a rational shift in growth paradigm and does it have serious pitfalls in the long-run? Many development economists may not find this shift and reliance terribly misconceived as it follows the principle of comparative advantage (static not dynamic!). After all our industry still relies on agriculture commodities for its raw material. Cotton and sugar-cane are the prime examples. This tilt or bias receives support from seemingly phenomenal response of agriculture sector to pricing (both input and output), and credit policies. Consequently, meager resources are once again allocated to where the return is the highest. It is equally interesting to ask that by favoring agriculture are we maximizing short term or long term returns to the economy. Historically we have not been successful in converting these high short term returns to sustainable long-term returns by generating a dynamic comparative advantage in the agriculture sector. But so has been the case with industry? Without getting into the endless debate of industry versus agriculture as engine of short-term growth, this strategy in the context of Pakistan is questionable from two angles. Agriculture's capacity to generate employment remains debatable. With liberal credit policies, tractorization will displace labor. Canada, Australia, New Zealand, Argentina and to some extent USA where they continue to have dynamic comparative advantage are relatively land abundant and sparsely populated countries. In the medium to long run this strategy could have political costs. Secondly the short-run maximization of growth eases pressure to structurally reform the industrial sector and thereby restore its dynamic comparative advantage. It can be easily likened to the employment situation of 70s and early 80s when windfall labor migration to the Middle East eased pressure on the government to under take long term policies to permanently reduce unemployment in the country. Some would interpret this shift in paradigm as an explicit admittance on the part of the government in its inability to overall and revive the industrial sector in the shortest possible time.

The issue of allocating resources and policy incentives to reduce excess or enhance capacity is complex and cannot be addressed without looking into the reasons for excess capacity. These reasons can be structural and/or temporal in nature. The limited success that government has had in reviving the sick industries inspite of bold announcements suggest that the problems faced by sick industries are more structural in nature rather than simple lack of resources. Excess capacity or poor performance in non-sick industries is more temporal in nature and intimately linked to fluctuations and/or insufficiency in demand and supply. Fiscal anomalies leading to smuggling or high costs of production may be another set of reasons for poor performance. For instance, sugar industry capacity at 5.4 million tons against the local demand of 2.9 million tons is a clear case of eco-political rent seeking. Encouraging sugar-cane production or smuggling at distorted prices in order to increase supply/demand, and thereby capacity utilisation is gross mis-allocation of resources. Similarly, growth in Vegetable Ghee production declined from positive 7.71 percent in 96-97 to -0.73 percent in 97-98. The reason for this decline is that its production exceeded 0.2 million tonnes from the annual national requirement of about 1.4 million tonnes. Should we subsidize export of vegetable ghee or be lax on smuggling in order to improve the capacity utilization of this industry? A third example of how eco-political interest in the past determined the expansion of specific industries, is the cement industry. Once the PSDP began to shrink the excess capacity in cement industry emerged. It has recorded a negative growth in the last two years. Under the excuse of excess capacity eco-political interests have joined hands to extract maximum fiscal concessions to generate foreign demand.

The budgetary proposals in addressing the issue of excess capacity of non-sick industries versus creating new capacity are neutral although in the current environment of low investor's confidence, ex-post these may lead to greater utilisation of existing capacities. Fiscal and monetary instruments to maximize short term growth of agriculture will continue to favor cotton, fertilizer, sugar, tractor and fruit packing industry. The enhancement of PSDP program by over 22 percent over the last year and its composition will directly boost the cement industry and revive the construction sector. Anti-smuggling measures in the form of tariff reduction on number of labor-intensive final consumer goods industry are ambiguous in their impact. Industries such as toiletries, crockery, footwear, TVs Airconditioners, Refrigerators, Toys, stationery which were facing competition from smuggled goods may face similar competition from legal imports at reduced rates. So one is not sure whether 'Laffer curve' in form of increased production will be generated. However paper and paper board industry will receive a boost with lowering of tariffs on bulk imports.

Fiscal measures aimed at creating new capacity are mostly focused on specialized industries and rely on private sector initiatives. Liberal first year accelerated depreciation allowances have been offered to industries ranging from consumer goods industries to manufacture of process control equipments, fibre-optic communication equipment, shipping and raw materials for rubber and textile industry.

Similarly strengthening capital market by extending exemptions of capital gains tax due to insurance companies, encouragement to stock brokers to turn into corporate entities, restoring tax exemption incentives to modarabas , allowing mutual funds to attract provident fund and raising investment limits in shares of industrial undertakings to Rs200,000 for wealth tax exemptions will can boost portfolio investments with spillover effects on the services sector particularly the banking and insurance sector.

BUDGET 1998-99:
WILL IT STABILIZE INFLATION?

Naeem Ahmed and Mohammed Arshad

BUDGET 1998-99 : WILL IT STABILIZE INFLATION?

By

Naeem Ahmed and Mohammed Arshad

In developed economies inflation rate is regarded as a sacrosanct number. In a liberalised and open economy, it is the single most important indicator even determining interest rates and exchange rates. Apart from the governments it is also researched and calculated by independent research organizations. However in most developing countries only governments have the necessary administrative machinery and financial resources to estimate yearly inflation rate. Consequently the masses either accept it or remain permanently cynical about the credibility of numbers. In fact the trust in accuracy of inflation rates generated by the government moves in tandem with the credibility, transparency and efficiency of the political governments. Pakistan is no exception. One of the highlights of this year's economic performance is a reduction in inflation rate from 11.8 percent in 96-97 to 8.5 percent in 1997-98. Food group (weight of 49.35 percent) contributed about 52% in 8.2% (July-April) of price inflation. While non-food (weight of 51.65 percent) contributed the remaining 48%. Among non-food groups house rent group (weight of 18.98) is relatively prominent with contribution of 21.6% toward price increase during the year.

Critics would dismiss this as a combination of jugglery of numbers and/or weaknesses in the estimation methodology. However due to reasons cited above nobody except the government is able to generate hard numbers. The economic strategy followed in the outgoing year does suggest a prior that it should lead to reduction in the inflation rate what ever its magnitude. By now it is apparent that the government followed a demand management strategy with contractionary fiscal and monetary policies as its two major planks. Bank borrowing which is more inflationary in the short-run than non-bank borrowing was kept at Rs.25.5 billion compared to the actual levels of Rs.84.3 billion in 1996-97. Annual Development Plan scaled down to meet budget deficit targets, through multiplier effect lead to dampening of demand. External factors such as slower increase in the Unit value of imports of 6.7 percent as compared to 15.4 percent in 1996-97 contributed to containing the rise in imported inflation. Huge imports of wheat in the last four months of FY 1996-97 and good crop of rice and minor crops continued to decelerate the rise in prices of food items during the year. However Fuel and lighting group in CPI grew by 14.02 percent in 1997-98 as compared to 10.9 percent in 1996-97. This is the only group which registered higher growth this year as compared to previous year. The group contributed 3.2% towards 8.5 percent inflation due to its smaller weight of 6.13 percent in CPI. An interesting question in the current deceleration of prices is that whether it came from the demand or supply side. In fact it came about through both the interaction of demand and supply side factors. However achieving lower rate of inflation through slowing demand generally has long-run costs to the economy in terms of growth and productivity.

Now we address a more crucial question:- How well does the budget augur for the next year inflation? Interestingly the monetary growth at approximately 15 percent in 1997-98 is higher than the previous two years. It was 13.8 and 12.2 percent in 1995-96 and 1996-97 respectively. This 'monetary overhang' carried by FY 98-99 can push up the inflation rate during the year. If the government succeeds in maintaining bank borrowing at Rs.43 billion for 98-99, though higher than this year, it will still be non-inflationary. The selective imposition of GST on retailers with an annual turnover of over Rs.5 million will be by and large non-inflationary. The behavior of import prices and its impact on the domestic price level will remain a unclear till the end of the year. The energy analyst expect that international oil prices having hit the bottom are now likely to start moving the other way round. This is more likely if demand revives in the South East Asian countries. Thus government may come under pressure to adjust prices of energy if it does not want to sacrifice receipts from petroleum surcharges. Just as import prices remain a question mark externally, devaluation and increases in administered prices remain unpredictable domestically. Devaluation will again lead to build up of inflationary pressures unless offset by lower international prices. Upward revision in administered prices specifically wheat, electricity and gas can have pervasive negative impacts on the inflation rate. From a supply angle and particularly in the context of

Pakistan improved food availability will continue to put downward pressure on the domestic price level. In a pre-sanctions environment the objective of stable inflation would dictate prudent fiscal and monetary policy. Their continuation can set in motion also permanent downward revision of inflationary expectations but then these also imply costs to the economy in terms of growth. However with shocks to the system in the form of sanctions, inflationary expectations can easily take the actual inflation to double digit number.

FEDERAL BUDGET 1998-99:
IMPACT ON INVESTMENT AND SAVINGS

Rao Asif Iqbal and Abu Nasar

FEDERAL BUDGET 1998-99:
IMPACT ON INVESTMENT AND SAVINGS

By

Rao Asif Iqbal and Abu Nasr

In the preceding year, despite the PM's economic revival package, an investor friendly budget and other incentives, investment activity in the economy remained below the desired level. In real terms, growth in total investment during 1997-98 was only 4.5 percent as compared to the target of 18.6 percent. Nevertheless, it reflects a positive trend when compared to the negative growth in real investment expenditures during 1996-97. Apparently private sector is the main contributor to this positive revival as public investment fell in real terms by 3.5 percent. Private investment showed a faster growth of 7 percent especially in large-scale manufacturing sector which grew by 19 percent in 1997-98. Excluding power sector, it performed even better, registering a growth of over 11 percent. The share of total investment in GDP at 17.4 percent is still lower than the last five years average of about 19 percent (see Table 1). Fixed Public investment's share in GDP decreased by a percentage point (from 6.9 percent to 5.9 percent) while the share of fixed private investment remained almost stagnant at about 9 percent during the last fiscal year. However, a positive development is the increase in nominal savings of about 53 percent against only a 13.8 percent increase in nominal total investment. There has been a dramatic increase of Rs 144 billion in national savings during 1997-98 pushing the savings to GDP ratio to 15 percent from 11.3 percent in 1996-97. A gain of almost 3.7 percentage points in a single year. The increase

Table 1
Investment and Savings
(as % of GDP)

	1996-97	1997-98 (Provisional)	1998-99 (Target)
Total Investment	**17.5**	**17.4**	**18.7**
Public	6.9	5.9	6.1
Private	9.0	8.9	11.1
Changes in Stock	1.6	2.6	1.5
Total Savings	**17.6**	**17.3**	**18.7**
National Savings	11.3	15.0	17.2
Foreign Savings	6.3	2.3	1.5

Sources:
1. Economic Survey, Government of Pakistan, 1997-98.
2. Annual Plan 1998-99, Planning Commission, Government of Pakistan.

in savings pushed the marginal saving rate to 40 percent against an historic average of 12 to 16 percent and last year's rate of 8 percent.

SAVINGS:

Savings being a derived estimate from investment expenditures one needs to look closely at the latter and its composition to understand the former's improved performance. Fixed investment and inventory investment (changes in stock) constitute total investment. Due to improved performance of agriculture sector inventory investment increased from Rs.38.3 billion in 96-97 to Rs.71.4 billion in 97-98. Thus nearly 57 percent of increase in nominal total investment of Rs.57.9 billion is explained by the increase in inventory investment. Another feature of the accounting identity is that the gap between total investment and national savings is closed by net inflow of external resources. Due to improvements in our current account the inflow of external resources fell from Rs.150 billion in 96-97 to Rs.63.4 billion in 1997-98. As mentioned earlier this decline of about 3.15 percent of GDP is more than compensated by an increase of 3.7 percentage points in the saving to GDP ratio. Since saving and investment are two sides of the same coin, the increase in inventory investment can easily be translated as temporary savings in the form of physical goods. That basically leaves 2.5 percent points increase in saving/GDP or Rs.69 billion to be explained by financial savings. Only a detailed flow-of-funds analysis would be able to indicate the various sources of these savings. However there are indirect indicators that suggest that the economy was able to generate this amount of savings if not more. Net inflow into government savings schemes increased from Rs.43.01 billion to Rs.76.52 billion, an increase of nearly 78 percent over the previous year. Similarly time deposits of scheduled banks show an increase of Rs.63 billion. Dollarisation of the economy continued at rapid pace and equivalent of Rs.100 billion were added in foreign currency to the banking system. Incorporating negative public savings (budget deficit) though less than last year and negative net factor income from abroad would bring us closer to Rs.69 billion figure.

Behavioral factors which contributed in improving the overall savings were a reduction in quasi-fiscal deficit and lower inflation rate improving the real rate of returns on government saving schemes.. PTCL's announcement of higher dividend are indicative of higher earning and therefore reduced deficit. Government has also been successful at bringing down the rate of public dissavings. At a more micro level rural disposable incomes increased substantially. Theoretically agriculture households always save a larger portion of their incomes, as compared to their urban counterparts given the uncertainty attached to their income profile. In urban areas, bringing down of income tax rates last year increased disposable income in the hands of the tax payers. However if most of the households regarded them as temporary windfall then additional incomes are likely to be saved. If they regarded the tax cuts as permanent the additional income is unlikely to go into savings. At lower income brackets the increases in disposable income are likely to be consumed because of inflationary effects. By and large successful enforcement of limiting marriage expenditures may have contributed to increase in the savings at the margin.

What is the outlook for next year? Are we likely to attain the target of 17.1 percent of GDP? Two features of the target need to be noted. It is much above the average of 13.6 percent of last six years. Secondly it is ten percent higher than 15.6 percent achieved in 1993-94. Saving behavior is difficult to change in the short-run. As regards public dissavings , the intentions of the government to bring it down to 4.7 percent of GDP if enforced vigorously will improve overall savings. After recent instructions from SBP for de-dolarisation, the issue is what impact it will have on saving behavior at the macro level. To the extent that inflows into the FCAs financed our net factor income from abroad, they improved our savings. Now with freeze on FCAs this will reduce this form of savings but are likely to be offset by an increase in rupee denominated bank deposits and government saving schemes. So the net affect will cancel out if leakages in the form of opening of accounts in foreign countries can be prevented and previous levels of inflows are maintained. What is the impact of down-sizing of public enterprises and government departments on savings?. Golden hand shakes funded through long-term foreign loans increase the foreign liabilities of the government/public enterprises but in the short-run are matched by an increase in the asset base of the affected households. In order to substitute for loss of regular income, most of these will again find their way into regular saving schemes. In rupee terms they will increase the domestic debt as well future debt servicing cost of the government with implications for budget deficits, inflation and real rate of returns. The budget's impact on disposable income is visible thorough enhanced taxation of perquisites, allowances and surcharge on income and wealth. The extent to which these budgetary measures will impact on savings depend on the individual household's perception of whether these changes are permanent or temporary as well as his income level. If most of the top income households regard them as a permanent cut in income, savings will not go down. If these are regarded as a temporary cut in incomes, in view of the imposition of a surcharge savings will go down. At lower income brackets tax increases will reduce household savings.

INVESTMENT:

In the current economic and political scenario the future investment climate is not easy to forecast as it depends on a host of economic and non-economic factors. Gross investment for the year 1998-99 is projected at Rs 589 billion, 23.6 percent higher than the current year expected investment of Rs 476 billion. At an inflation rate of 8 percent real investment expenditures are expected to go up by 15.6 percent. By historical standards this target is ambitious. With imbroglio on the IPP front, near collapse of stock market, foreign investors burning their fingers in South East Asian crisis and the impact of sanctions uncertain, investment activity is unlikely to revive before the beginning of next calender year. In a pre-sanctions scenario, consolidation of previous years policy should not have de-stabilizing impact on interest rates. With bank borrowing within manageable limits the real interest cost of capital should remain at 1997-98 levels. There are also positive measures in the budgetary proposals to induce private investment. Industry specific first year accelerated depreciation allowance, re-investment allowance for established industries and industrial building allowance can attract private investment in productive sectors. Extension in exemptions of capital gains tax due to insurance companies, encouragement to stock brokers to turn into corporate entities, restoration of tax exemption incentives to modarabas , allowing mutual funds to attract provident fund and raising investment limits in shares of industrial undertakings to Rs200,000 for wealth tax exemptions will encourage portfolio investments.

The vehicle for implementation of public investment policy is the Public Sector Development Programme while the private sector investment is influenced indirectly by fiscal incentives and directly by monetary policy. The size of PSDP is Rs 110.6 billion, about 23 percent higher than the revised allocation of Rs 90.1 billion in 1997-98. This significant rise in PSDP reflects the government's commitment towards accelerating development process through investing in economic infrastructure, a sector which enjoys a share of more than 54 percent in total PSDP. Nevertheless, to the extent that overall public investment acts as a multiplier for the private investment activity, the rise in PSDP will stimulate private investment demand and thus may help in achieving overall investment target.

In summary while the budget is full of fiscal incentives for bolstering private investment including increase in public investment it is the non-economic factors affecting confidence that will mainly determine the investor's behavior in undertaking investment expenditures.

BUDGET 98-99, DEVALUATION AND EXTERNAL SECTOR

Dr. Sajjad Akhtar and Ejaz Rasheed

BUDGET 98-99, DEVALUATION AND EXTERNAL SECTOR

By

Dr.Sajjad Akhtar and Ejaz Rasheed

Following the testing of nuclear devices by India in the second week of May 1998 and by Pakistan in the last week of May 1998, the nuclear arms race began in the sub-continent that would have serious impact on these economies. Already USA, Japan and a few other industrialised countries have imposed economic sanctions. Though it is too early to make a detailed assessment of the negative impact of the economic sanctions for the short and medium-term development prospects, one thing is clear: To the extent to which these reactions rendered economic environment less friendly, it becomes more urgent to implement the policy decisions necessary for macro economic stability and rapid and sustainable economic growth. Before we go into the details of the extent of adverse impact of economic sanctions let us have a quick look (Table-1) into the state of external sector and balance of payment which would help us to assess the strength and weakness of the economy.

TABLE 1: BALANCE OF PAYMENT

	1996-97	1997-98 (Target)	Jul-March 1996-97	Jul-March 1997-98	Growth
Exports (fob)	8,096	8,662	6,013	6,294	5%
Imports (fob)	11,241	10,592	8,526	7,706	-10%
Trade Balance	**(3,145)**	**(1,930)**	**(2,513)**	**(1,412)**	**-44%**
Services (Net)	3,659		2,865	2,507	-13%
Private Transfer	2,958		2,090	2,792	34%
Workers Remittances	1,409		992	1,175	18%
C/A Balance	**(3,846)**		**(3,288)**	**(1,127)**	**-66%**
Private Capital (Net)	1482		1030	(351)	
Public Capital (Net)	1266		911	1591	
Changes in Reserves	-1032		-1422	220	

Pakistan's external sector has been under pressure over the last few years, resulting in a steady deterioration of trade and current account balances (C/A). A surge in imports due to trade liberalisation and tariff reductions accompanied by a deceleration of exports worsened trade balance. By 1996-97 the current account deficit trade at $ 3.846 billion swelled to 6.1 percent of the GDP. To stabilize the current account deficit export and import targets for 1997-98 was set at US$

9769 m and US$ 12961 m respectively. However, in the trade policy for 1997-98 these targets were marginally lowered to US$ 9,575 m and US$ 11,900 m respectively. Due to east Asian crises and deeper recession in the Japanese economy, targets were further revised downwards in the mid-year fiscal year. The new export and import targets were set at US$ 8662 m and US$ 10592 m respectively. The final targets represented a 7 percent increase over actual exports of 1996-97 and 11 percent decline over the actual imports of 1996-97. As the attached table reveals we are closer to achieving the last version of the revised targets. A dramatic 66 percent improvement in current account balance as compared to the last year July-March 1996-97 figure is largely predicated on slow increase in price index of non-oil imports, actual decline in international price of oil, depressed demand for overall imports due to strict demand management policies and 18 percent rise in remittances. Commodities which recorded increase in exports in rupee terms are fish products (35.9%), rice (40.1%), cotton waste (21.3%), raw cotton (1437.8%), cotton cloth(15.1%), synthetic textiles (35.1%), ready made garments (12.9%), sport goods (37.8%) and other textiles (22.4%). Interestingly in rupee terms our exports to ASEAN countries increased by 58.4%, to OIC group by 23.5%, and to OECD by 14.2%.

Unfortunately improvements in the current account balance did not translate into increase in reserves and they continued to be at $1-1.5 billion level throughout 1997-98. South East Asian crisis with the resultant loss of investor's confidence lead to net outflow of private capital of $351 million as compared to $1.030 billion private capital inflow during the July-March period last year. Current's year private outflow was compensated partly by an increase in capital inflows under the public account. As against $911 million in 1996-97 they stood at $1.591 billion this year. The latter inflows partly reflect official inflows from the international institutions i.e., World Bank/IMF under ESAF/EFF programs and partly increase in short term commercial borrowing by the government to the tune of $180 million.

In analyzing the impact of budgetary proposals and trade policy two approaches can be adopted. One is the 'business-as-ususal' approach as reflected in the budget and specifically in its forecast of net and gross inflow of external resources to finance the budget deficit. Under this scenario lower tariffs to discourage smuggling of specific goods can be primarily interpreted as a revenue generation measure via trade liberalization. The extent to which it impacts on current account balance depends on the assumptions made regarding the foreign exchange financing of smuggled goods as well as there magnitudes. So far similar measures in the past have not extraordinarily strained our external account. If one assumes that drug money was and is being used to finance smuggling and under the new tariff rates smuggling of these goods becomes unprofitable, the drug payments will be remitted through a combination of 'hundi' and official channels. In the latter case it may add to foreign exchange which can then be used to finance legal imports of these very goods. A strong possibility is that it may come through the former channel and thus be dissipated in trading and non-trading activities. Assuming that smuggling is a profession like any other, a stronger possibility is that with time a new set of imported goods will be discovered whose smuggling can continue to generate super normal profits. An alternate working of foreign exchange market for smuggled goods is as follows:- Legitimate remittances via 'hundi' end up as foreign currency accounts in foreign countries. These are then sold at a premium to smugglers here or the smugglers themselves have direct access to these funds to finance purchase of smuggled goods. It should therefore not come as surprise that with recently officially introduced distortions in the foreign exchange market we might also witness increase in smuggling. In summary the net impact on legal imports and/or current account balance of these anti-smuggling tariff reductions remain ambiguous.

However as post-sanction instrument of neutralizing the impact on current account deficit this budget raises a lot of questions? Is the assumption of gross foreign inflow of Rs.142 billion or $3.08 billion (at the exchange rate of Rs.46/$) realistic? Doesn't the post sanctions scenario warrant a more protectionist trade policy in order to conserve on our valuable foreign exchange? And also to jump start our industrial sector? The fact that the budget doesn't reflect the post-sanctions economic policy indicate that the government will continue to follow "adaptive" expectations, after its only 'rational' or some would like to call it 'irrational' measure of freezing FCAs. Interestingly the external sector will be more and more governed by the "rational" expectations of economic agents which may also become self-fulfilling unless countered by reverse shocks. It is a common view that if the sanctions begin to bite and/or are permanent, the trend in liberalisation of trade would have to be reversed leading to a presentation of a more realistic budget. The policy makers are then confronted with an array of policy instruments on the import and/or export side which should enable them to compensate for the loss of foreign exchange in the short-run. On the import side these include devaluation, dual exchange rate regime, increase in import tariffs, increase in margin requirements of import L/Cs and instituting import quotas. Apart from devaluation, increase in import tariffs and import quotas will not find favor with international agencies unless by invoking the emergency clauses. Even if these agencies are sympathetic the required increases in across the board import tariffs can not be marginal. They have to be substantial and mostly borne by non-essential items. Even if in one go they are raised from 45 to 65%, input costs will jump, and render non-traditional exports non-competitive. We will be back into the import substitution backed industrialisation, with all sorts of distortions in the form of smuggling and rent seeking. The economy-wide model at SPDC indicates that a 10 percent devaluation only leads to 1.2 percent reduction in imports. Here again we are talking about substantial devaluation to compress imports in order to compensate for the foreign inflows. Consequently the recent devaluation of 4.42 percent is timid, delayed and will be ineffective in achieving dramatic fall in imports. Increase in margin requirements of L/cs does put pressure on the liquidity of importers and the banking sector and may discourage imports at the margin. The increased costs of tying up liquidity are eventually passed on to the final consumers.

To enhance exports in the short-run, the instruments available to the policy makers are devaluation, dual exchange rate, export rebates (or export subsidies), duty drawbacks to exporters and subsidized mark-up rates on export re-financing. As per analysis from the SPDC's macro model a 10 percent devaluation leads to approximately 3 percent increase in exports. To achieve the ambitious target of 15 percent growth in exports for the coming year if we assume an automatic increase of 5 percent we still need a 30 percent devaluation to achieve the target. Consequently even from the export perspective, the impact of recent devaluation is questionable. Given the primary nature of our value added exports, these are mainly determined by the existence of exportable surpluses rather than price incentives and administrative measures. However non-traditional exports are affected by the latter measures. Explicit export subsidies or rebates are not approved by the WTO.

The trade policy announced recently reflects a strategy aimed at reducing the costs of exports rather than direct price incentives in the form of hefty devaluation. Sales tax and duty drawback refunds within 30 days, arrangement of Rs.25 billion credit line for export finance at 8 percent, a progressive scale for manufacturing exporters for importing duty free inputs and exports to Central Asian Republics via the land route are basically 'structural' measures and rely on the efficiency of the administrative and institutional machinery of the government to yield quick results. There short-run effectiveness is yet to be confirmed empirically. Industry and commodity specific measures announced in the trade policy slightly tilt in favor of primary and agriculture goods rather than value-added goods exports.

In the short run dual exchange rate regime for international trade is another effective instrument to compress imports and expand exports if the economy is to be insulated from across-the-board inflationary affects of heavy devaluation. Historically the country experimented with such a regime in the sixties under the Export Bonus Voucher scheme to boost exports and restrict import demand. Implicitly the scheme implied a subsidy to exporters. It introduced flexible exchange rate for selected export and import commodities. Export gains by the newly favored commodities are partly offset by losses among existing exports. As an example, while the scheme is credited with boosting export of textile manufactures it raised the price of cotton yarn thereby affecting the then cotton handloom industry. As we approach the year 2000 the production and export structure has changed visibly from that of sixties. If we are to adopt a dual regime the policy maker will have to devise a criteria to select commodities for awarding export bonuses. Although non-traditional exports is the obvious choice, there share at around 15% of exports is relatively small to boost exports or discourage imports. Consequently high value added items from the textile manufacturing group would have to be included to make the scheme viable and purposeful. On the import side, commodities to be imported under the scheme need to be identified. These should exclude industrial raw materials and essential items like wheat, edible oil, petroleum and pharmaceuticals products. No doubt the scheme is administratively cumbersome and may gradually encourage rent-seeking by specific interest groups , but to great extent it is a market determined system of export subsidies. Its success largely depends on the efficiency of the relevant administrative machinery and a water tight detailed classification of commodities not subject to frequent changes..

In passing the readers may be interested to know that Dual Exchange Rate regimes are usually adopted to insulate the economy from the effects of foreign capital flows. It involves separate exchange rates for the current and capital account transactions. It is usually a short to medium term arrangement followed by devaluation. In the post-sanction era the balance of trade account is likely to be more stable than overall balance of payment account. Thus a dual exchange rate which has fixed commercial exchange rate for current account transactions (except remittances) and a floating financial rate for capital account transactions may be a superior instrument than a dual exchange rate in the trade account..

In summary in a pre-sanction scenario the budget and trade policy do provide incentives for exports but are not revolutionary in character as to ensure the 15 percent increase in exports in a single year. In a post-sanction environment both these instruments of economic policy would have to under go a dramatic shift to face the new realities.

IMPACT OF THE BUDGET ON POVERTY

Dr. Aisha Ghaus-Pasha, Rao Asif Iqbal and Asif Usman

IMPACT OF THE BUDGET ON POVERTY

By

Dr. Aisha Ghaus-Pasha, Rao Asif Iqbal, Asif Usman

There is a general consensus that poverty has declined in Pakistan in the decade of the 80s, but is on the upturn during the 90s. The Economic Survey, 1997-98 reports that the proportion of the population with incomes below the poverty level has increased from 17 per cent in 1987-88 to over 22 per cent in 1992-93 (See Table 1). Also the 90s have witnessed a higher rise in urban compared to rural poverty with almost a 45 per cent increase in the head counts in the former. The distribution of income has also worsened in the urban areas as reflected in the rise in the Gini Coefficient (See Table 2). As compared to this, the Gini Coefficient for the rural areas has infact declined.

TABLE 1
POVERTY IN PAKISTAN: HEAD COUNTS

(%)

Years	Total	Rural	Urban
1979	30.7	32.5	25.9
1987-88	17.3	18.3	15.0
1990-91	22.1	23.6	18.6
1992-98	22.3	26.2	21.7

SOURCE: Economic Survey, Government of Pakistan, 1997-98.

TABLE 2
INEQUALITY IN INCOME DISTRIBUTION: GINI-COEFFICIENT

Years	Rural	Urban
1979	0.32	0.40
1987-88	0.31	0.37
1990-91	0.41	0.39
1993-94	0.35	0.40

SOURCE: Economic Survey, Government of Pakistan, 1997-98.

These are ominous developments. The basis of these need to be understood and tackled in an effective and timely manner. The objectives of this paper are; first, to understand the underlying factor for the decline and then subsequent rise in poverty over the last two decades or so, taking a macro perspective. Second, is to understand the basis for regional differential in the trend of poverty. Specifically, why has there been more success in poverty alleviation (alternatively less increase in poverty) in the rural areas? Finally, what, if any, is the likely impact of the Federal Budget, 1998-99, on poverty?

A two pronged approach is generally adopted to mitigate the spread of poverty. First is the encouragement of broadly based economic growth whereby policies that absorb and make productive use of the poor's most abundant resource - labour - are promoted. Second, is a series of targeted actions which provide opportunities to the poor in gaining access to opportunities to improve their lot, through direct poverty alleviation measures or anti-poverty programmes. The reduction of poverty in Pakistan during the 80s, however, appears largely to be an outcome of the former. As will be demonstrated subsequently, the impact of the latter is at best limited.

Some of the key underlying determinants of poverty have been: GDP growth and its sectoral distribution, employment and real wage rates, and remittances. We trace the movement in these over the last two decade to determine as to what might be happening in the 90's

TABLE 3
GROWTH PATTERN IN SECTOR-WISE VALUE ADDED
Constant Factor Cost

Heads	Decade of 80s	Decade of 90s	Share in Value Added 1997-98
Agriculture	4.1	3.0	24.6
Mining and Quarrying	9.0	0.3	0.4
Manufacturing	7.7	4.5	18.3
Construction	4.8	2.4	3.7
Transport and Comm.	6.0	4.1	9.9
Wholesale and Retail Trade	7.0	3.4	15.9
Services	6.5	6.5	8.7
Others	6.8	4.6	18.4
TOTAL GDP	6.1	4.0	100.0

SOURCE: Economic Survey, Government of Pakistan (Various Issues).

GROWTH IN PER CAPITA INCOME AND EMPLOYMENT

Growth in per capita income has a poverty reducing affect because for any given distribution of income, consumption of the lower deciles of population also increase. A crucial determinant of the profile of poverty in Pakistan in the 80s has been a respectable rate of growth in incomes. More importantly, it has been the growth in employment-intensive sectors (agriculture, manufacturing, construction, transport and communications and wholesale and retail trade) which has contributed to a reduction in poverty (See Table 3). Post 1991, there has been a waning off

TABLE 4
CHANGE IN LABOR FORCE AND EMPLOYMENT

(Million)

Heads	**Decade of 80's**	**Decade of 90's**
Increase in Labor Force	6.75	6.36
Increase in Employment	6.67	5.31
Increase in Unemployment	0.08	1.05
Marginal Unemployment Rate (%)	**1.2**	**16.5**
Sectoral Increase in *Employment*		
Agriculture	3.05	1.13
Manufacturing	0.49	-0.17
Construction	0.79	0.63
Trade	0.94	1.57
Services	1.05	1.70
Others	0.35	0.45

SOURCE: Economic Survey, Government of Pakistan (Various Issues).

of the growth momentum in these sectors, leading to an increase in the marginal unemployment rate from 1.2 per cent in the 80's to 16.5 per cent in the 90's (See Table 4). As shown in the table, sectoral increase in employment in all the key sectors has waned in the post-1991 period. The most alarming in this regard is the negative increase in the manufacturing sector which has a large number of backward and

TABLE 5
GROWTH RATES OF EXPORTS

	Decade of 80's	**Decade of 90's**
Total Export	**16.8**	**14.1**
Cotton Cloth	20.3	18.6
Surgical Instruments	21.8	16.4
Carpets and Rugs	8.3	7.4
Sports Goods	25.8	29.7
Others	16.7	13.0

SOURCE: Economic Survey, Government of Pakistan, 1997-98.

forward linkages. Also, in the case of labour intensive small scale sector there are signs of tapering-off of the buoyancy in the 90's. The growth rate of exports of cotton cloth, surgical instruments, carpets and rugs, infact total exports is lower than the 80s (See Table 5).

REMITTANCES

Remittance from the Middle East was a major sustaining feature of our economy in the 80s. The contribution of remittance incomes in reducing poverty is borne out by the occupational and regional profile of migration. Over 80 per cent of the migrants belonged to the occupational category of services and production/construction, typically sectors where the proportion of poor and unskilled would be high. Also, a substantial proportion migrated from districts with significant barani areas like Kohat, Bannu, Pindi, Jhelum, Gujrat, Abbotabad etc. As such, poor regions and individuals were primarily the beneficiaries of remittance income.

TABLE 6
TREND IN REMITTANCES

Years	Remittances US $ Million	SHARE OF REMITTANCES (%) IN		
		GDP	Trade	National Savings
1980	2116	7.8	86.3	56.3
1990-91	1848	4.1	124.2	29.1
1997-98	1669	2.8	90.9	17.3
Average:				
1980/81 - 1990/91	2271	6.5	97.5	51.1
1991/92 - 1997/98	1554	3.1	65.0	19.5

SOURCE: Economic Survey, Government of Pakistan, 1997-98.

Table 6 indicates that on an average annual remittance were about US $ 2.3 billion during the 80s. This average has declined to US $ 1.6 billion in the 90's. As a percentage of GDP, these have come down from 6.5 to 3.1. Therefore, the poverty mitigating effect of remittance has tapered off in the 90's.

SOCIAL SAFETY NETS

Targeted actions by government to improve the living conditions and to increase the capacity of the poor to respond to opportunities arising from economic growth have been limited. The existing social safety nets include the Zakat/Ushr, Baitul Maal Schemes and food subsidies. The coverage of Zakat is very narrow - limited to widows, orphans and disabled individuals. This subset comprises only 12 per cent of the lowest two expenditure deciles. As regards Baitul Maal even though its scope may be larger the amount allocated is so small that it can hardly be considered an effective safety net (Rs 450 million in 1995-96). Therefore, these welfare measures either targets a very small proportion of the poor or the total quantum allocated is woefully inadequate to counter poverty is any meaningful manner.

In the past government's food subsidies did contribute to cushioning the real consumption levels of the poor particularly in the urban areas. The largest component of these was earmarked for wheat (See Table 7). However, under fiscal pressure these have essentially been phased out and therefore unlikely to be a major contributing factor to the reduction in poverty. In all, the safety nets have not been an effective source of poverty alleviation in Pakistan, more so in the 90's.

TABLE 7
GOVERNMENT SUBSIDY ON FOOD ITEMS
(Rs in Million)

Years	Nominal	Real
1980-81	1718	1718
1990-91	6534	3201
1996-97 (R)	11526	3000
ACGR (%)		
1980/81 - 1990/91	14.3	6.4
1991/92 - 1997/98	9.9	-1.1

SOURCE: Economic Survey, Government of Pakistan, 1997-98.

FISCAL POLICY

Fiscal policy can be an effective tool for improving the distribution of income in the country and thereby alleviating poverty. The mechanism through which this can be achieved is twofold: first, higher taxation of the richer segments of the population and, second, enhanced expenditure on services, in particular, social services which largely benefit the poorer section of the populations. In Pakistan, the taxation structure is regressive with a heavy domination of indirect taxes which may be shifted forward to the consumer, including the poorer sections of the population. However, during the 90's there is some decrease in the share of indirect taxes. To that extent, the 90's has witnessed a deceleration in the taxation policy contribution to inequality in the country.

On the expenditure side, government expenditure on social sector as a percentage of total government expenditure and GDP has remained, more or less, constant (See Table 8). Although it is a relief that the social sectors are not the direct causality of the fiscal crunch, the meager increase in the ratios does not match the hype regarding governments' commitment towards social sectors, reflected in the launching of the Social Action Program. In fact, expenditures on social sectors as a percent of the GDP are lower than their level during the Five Point Program in the mid 80's. Nevertheless, in totality it appears that over the last two decades or so fiscal policy has had a poverty alleviating flavour, more so in the 90s than in the 80s.

TABLE 8
GOVERNMENT EXPENDITURE ON SOCIAL SERVICES

Years	**SHARE OF TOTAL GOVERNMENT EXPENDITURE ON SOCIAL SERVICES IN**	
	Total Government Expenditure	**Gross Domestic Product**
1980-81	11.3	3.1
1990-91	13.2	4.6
1997-98 (B)	13.2	4.0
Average		
1980/81-1990/91	12.2	4.0
1991/92 - 1997-98	12.9	4.2

SOURCES: (1) Budget in Brief, Government of Pakistan (Various Issues).
(2) Annual Development Programmes of Provincial Governments (Various Issues).
(3) Annual Budget Statements of Provincial Governments (Various Issues).

RURAL-URBAN DIFFERENTIAL IN POVERTY

Regional profile of changes in poverty overtime indicates that while there was a somewhat slower decline in rural poverty in the 80's, the rise in the 90's is also slower than in the urban areas. Why? It appears that while the impact of the decline in remittances is perhaps regionally neutral, the loss of growth momentum and consequently its adverse employment consequences has been far more exaggerated in the urban areas in the 90s. For example, the decline in manufacturing) the key externality emanating sector; has been 55 percent higher than in agriculture (see Table 2). On top of this, inflation (which has been in double digit in most of the years) has further eroded the consumption power of the urban poor. As such, it appears that loss in real income growth, decline in food subsidy and absence of effective poverty cushions have resulted in a rapid increase in urban poverty in the 90's.

TABLE 9
PERCENTAGE CHANGE IN POVERTY: HEAD COUNTS

	Rural	**Urban**
Decade of 80s	-27.4	-28.2
Decade of 90s	11.0	16.7

SOURCE: *Economic Survey, Government of Pakistan, 1997-98*

On the other hand, in additions to the above factors, price liberalisation in agriculture coupled with an increase in credit facility might have had a poverty mitigating affect in the rural areas particularly among small landlords. As shown in Table 10, there has been a significant increase in the support prices of major crops like wheat, paddy, surgarcane, and cotton. Also, agricultural credit has increased at the rate of 14 percent per annum over the last seventeen years, which may have at least partially benefited small farmers.

In addition, a few direct support programmes to alleviate rural poverty have also been initiated, which aim at improving the quality of life and capacity of the less privileged sections of population. These include programmes focussed at improving access to basic social and economic services like education, health, water supply and sanitation, population welfare etc. Examples include SAP, Rural Development Programme and Rural Support Programme (RSP). Some of these, like the RSPs have started to have an impact.

TABLE 10
INCREASE IN AGRICULTURAL SUPPORT PRICES
(Percentage)

	Decade of 80s	**Decade of 90s**
Wheat	7.8	11.5
Rice		
Paddy	7.2	10.9
Clear	7.5	7.2
Sugarcane	4.7	12.6
Seed Cotton		
Desi	3.5	10.8
Niab etc.	3.7	13.0

SOURCE: *Economic Survey, Government of Pakistan, 1997-98*.

On the whole, it appears that trend in macro parameters coupled with poverty alleviating interventions may have been instrumental in curtailing the spread of poverty in the rural areas during the decade of the 90s.

On the whole, the above analysis clearly demonstrates that reduction in poverty during the 80s was largely a spillover of growth and exogenous developments and was not policy induced. Since these key contributing factors have lost momentum in the 90's, we witness an increase in poverty. The increase in the rural areas has, however, been restrained by policy intervention. But these interventions have not been effective enough to preserve the trend set in the 80's. Therefore, it is now time to devise policies which tackle the issue of poverty explicitly. Some imperatives can be initiated through the Budget. Let us see if the budget offers anything in this regard.

BUDGET 1998-99 AND POVERTY

What is likely to be the impact of the budget on poverty? The experience of the 80's demonstrates that economic growth which trickles down is the most effective long-term strategy for reducing poverty. The contribution of the budget in this regard can be both direct and indirect. Through stimulation of public sector development activity, the budget can directly contribute to enhancement of economic growth. The decade of the 90s has witnessed a substantial decline in the public sector development expenditure in relation to the economy. This strengthened the already prevailing recessionary tendencies. The 1998-99 budget reverses this trend by budgetting a 22 percent increase in PSDP (which has been increased to Rs 110 billion). This will in particular energize the services sector (specifically construction, public administration and defence) which has been slow on the upturn in relation to manufacturing and agriculture. The concomitant employment generating effects will particularly mitigate urban poverty, which as discussed earlier, is on a rapid rise.

Also, the budget can provide fiscal incentive to boost private sector led growth. This year's budgetary proposals implicitly promotes agriculture and agro-based industrialisation. Consequently some analyst believe that the budget signals a shift in growth strategy (see the essay on page 26). The budget also contains measures to boost stock markets, some specific industries like shipping, paper and paper products and provides liberal first year accelerated depreciation allowances which will benefit to wide range of industries ranging from consumer goods to manufacture of process control equipments.

In addition, the federal budget also contains some direct poverty alleviating measures. These include, first, sustained commitment to SAP, with some extension in scope. Second, enhanced allocations to irrigation, particularly secondary canals. This will improve water availability to tailend small landholders. Third, increased allocations to rural development, a subset of which is farm to market roads. These improve access of small farmers to large markets who are, therefore, able to negotiate a better bargain for their production. Fourth, incentives to promote the financial sustainability of NGOs. The above will be effective instruments to curtail the spread of rural poverty.

Besides, Poverty Alleviation Fund Company, with an initial endowment of Rs 100 million has been created to provide financial assistance to the poor segments of the urban areas, in particular, to enable them to gain access to resources for their productive self-employment. The focus would be the creation of micro-enterprises and local level infrastructure, thorugh NGOs, on a cost sharing basis.

As such, it appears that the Budget 1998-99 contains some strategic interventions which facilitates sector and sub-sectors where employment and technological externalities are high and growing. Also, there are some targetted policy initiatives aimed at poverty alleviation, the focus, however, continues to be on rural poverty. Effective measures to counter poverty in the urban areas remain an area of concern.

FEDERAL TRANSFERS TO PROVINCES

Dr. Aisha Ghaus Pasha

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By
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The year, 1997-98, has turned out to be an exceptionally difficult year for the provincial governments. Development activities have had to be curtailed, arrears have built up with agencies like WAPDA, SAP expenditures have been restricted to levels generally lower than those committed with donors and overdrafts with the SBP have increased to unsustainably high levels. Why has the financial health of the provinces deteriorated so rapidly? Given that over 80 per cent of provincial expenditures are financed by federal transfers, the answer essentially lies in the lack of buoyancy of these transfers in 1997-98.

There are three factors which have contributed to this lack of buoyancy. First, the new NFC award announced in early 1997 by the caretaker government expanded the divisible pool of taxes but reduced the overall provincial share, resulting in an overall contraction in transfers. Second, soon after the announcement of the NFC award, one of the first steps taken by the Nawaz Sharif government following its induction into power in February 97 was a major reduction generally in federal tax rates to provide a supply-side stimulus for industrial revival. Part of the costs of the reforms had to be borne by the provinces. Third, the performance of federal tax revenues during 1997-98 has been disappointing and there has been a large shortfall in relation to targets. Divisible pool transfers have also been linked on a monthly basis to actual collections. Therefore, transfers to provinces have also been lower than anticipated. We take up below the impact of each of the factors.

THE 1997 NFC AWARD

The 1997 NFC award expanded the divisible pool of taxes to include all federal taxes. Prior to this, according to the 1991 NFC award, only revenues from income tax, sales tax and excise duties on sugar, tobacco and tobacco manufactures were shared with the provinces. However, the expansion in the pool was accompanied by a contraction in the overall provincial share from 80 per cent to 37.5 per cent. Also, in recognition of relative backwardness and lack of taxable capacity, the NFC award of 1997 greatly increased the quantum of special grants to Balochistan and NWFP. The magnitude of the grant in 1997-98, the first year of the award, was set at Rs 4.1 billion for Balochistan and at Rs 3.3 billion for NWFP with annual growth projected at 11 per cent. Special grants, of a relatively small magnitude, adding up to a total of Rs 2 billion for the four provinces combined, had been provided for in the 1991 NFC award. These had come to an end in 1996-97. Beyond this, the coverage of straight transfers and the revenue sharing formula among provinces embodied in the 1991 NFC award were left unchanged.

The short run consequence of the change in the pattern of inter-governmental fiscal relations among the provinces and the federation arising from the new NFC award is a major contraction in the implied transfers from the divisible pool. If the 1997-98 budgeted receipts from federal taxes are taken as a basis, then the 1991 NFC formula for sharing in the divisible pool would have resulted in transfers to the four provinces combined of Rs 136.8 billion, whereas the magnitude indicated by the 1997 award is Rs 111.3 billion, a fall of as much as Rs 25.5 billion. This has been compensated for partially by the special grants of Rs 7.4 billion and the institution of a special soft loan facility of Rs 12 billion. Therefore, in aggregate the 1997 NFC award implied a fall in transfers to the provinces of over Rs 6 billion.

THE IMPACT OF TAX REFORMS

It can, in fact, be argued that the expansion of the divisible pool of taxes incorporated in the 1997 NFC award provided the impetus for the major tax reforms announced by the Nawaz Sharif government in March 1997. Previous governments had been reluctant to undertake tariff reforms, involving a general cascading down of the rates of import duty, because customs duties were outside the divisible pool and the entire cost of the reforms would have to be picked up by the federal government. With the expansion of the divisible pool to cover all taxes, a significant part of the costs could be shared with the provinces. The package announced in March 1997 resulted in deep tariff reforms, involving a fall in the maximum tariff from 65 per cent to 45 per cent, the scaling down in the GST rate from 18 per cent and 23 per cent to 12½ per cent and a virtually halving of personal income tax rates. Conservatively, the once-and-for-all revenue loss due to these reforms in 1997-98 is estimated at Rs 34 billion, with the prospect subsequently of some recovery due to expansion in the tax bases resulting from the supply-side stimulus. The dynamic effects have not been visible in 1997-98. The cost of the tax reforms borne by the provincial governments is, therefore, of the order of Rs 13 billion.

THE REVENUE SHORTFALL OF 1997-98

The projected revenue from taxes collected by CBR, which form part of the divisible pool, was Rs 324 billion in 1997-98. As shown in Table 1, this implied transfers from the divisible pool to the provinces of Rs 111.3 billion. In addition, special grants of Rs 7.4 billion and straight transfers of Rs 13 billion were also envisaged. The disappointing performance of CBR tax revenues in 1997-98, with a minimum likely shortfall in relation to target of Rs 27 billion, means that transfers to provinces will be significantly below budgeted levels. It is now expected that divisible pool transfers will be lower by about Rs 7.3 billion while straight transfers will be somewhat higher by Rs 1.3 billion, implying an overall short fall in NFC mandated transfers of Rs 6 billion in relation to budget estimates in 1997-98.

TABLE 1
FEDERAL TRANSFERS TO PROVINCES

(Rs in Billion)

Heads	1996-97	1997-98		1998-99
	R.E	B.E	R.E	B.E
Divisible Pool Transfers	119.2	111.3	104.0	124.4
Straight Transfers	12.4	13.0	14.3	16.6
Special Grants	)	7.4	7.4	8.2
Soft Loans for PSDP	)	12.0	12.0	15.0

TABLE 1 FEDERAL TRANSFERS TO PROVINCES *(Rs in Billion)*				
TOTAL FEDERAL TRANSFERS	**131.6**	**143.7**	**137.7**	**164.2**

OVERALL TRANSFERS IN 1997-98

The cumulative effect of the above mentioned factors is that even after inclusion of the ad-hoc soft loans, total transfers from the federation to the provinces will increase only marginally from Rs 131.6 billion in 1996-97 to Rs 137.7 billion in 1997-98, a rise of less than 5 per cent. Given the underlying inflation rate of over 8 per cent, this implies a real contraction in the quantum of transfers. The provinces have made some effort to adjust to the fall in transfers. Current expenditures of the four provinces have been controlled to about Rs 9 billion less than the NFC projections for 1997-98 while the resource mobilisation is about Rs 1 billion in excess of these projections. Nevertheless, it has not been possible to compensate fully for the reduction of Rs 6 billion due to the change in NFC formula, Rs 13 billion due to the tax and tariff reforms and another Rs 6 billion due to the revenue shortfall in 1997-98, a total revenue loss of Rs 25 billion.

It is not surprising, therefore, that the financial position of the provinces has altered dramatically in 1997-98. Overdrafts with SBP have increased in some cases, especially in Sindh, to unsustainably high levels. Development programs have had to be curtailed and allocations for the Social Action Program (SAP) have generally been below levels committed with donors, thereby affecting the inflow of concessional assistance. WAPDA arrears have accumulated and other obligations have also been deferred. Altogether, persistence of the financial crunch for the provinces experienced in 1997-98 has fundamental implications for the provision of basic social and economic services in the country. It represents a major breakdown which needs to be tackled on a priority basis.

THE OUTLOOK FOR 1998-99

Fortunately, the prospects for growth in federal transfers to the provinces are much better in 1998-99. Now that the cost of the tax reforms has been taken in 1997-98, we are back to a period of normal growth in revenues. As such, CBR tax revenues, which constitute the divisible pool, are expected to show growth from Rs 297 billion to Rs 338 billion in 1998-99, in the absence of any taxation proposals. In addition, the federal budget has announced a resource mobilisation package of over Rs 16 billion. Therefore, CBR tax revenues are projected at Rs 355 billion, representing growth of almost 20 per cent over the level in 1997-98. Consequently, transfers from the divisible pool to the provinces are expected to show a sizeable increase of over Rs 20 billion, from Rs 104 billion in 1997-98 to Rs 124.4 billion in 1998-99.

Simultaneously, straight transfers are expected to increase by Rs 1.3 billion. In addition, the federal government has generously offered not only to continue with the soft loans but to increase them to Rs 15 billion for the four provinces combined from Rs 12 billion in 1997-98. The overall consequence is that total transfers will rise from Rs 137.7 billion to Rs 164.2 billion, an increase of over 19 per cent. Therefore, if the projections are accurate, then the buoyancy in federal transfers will be restored once again in 1998-99. The provinces can thus get back to their development programming and improving their financial position by reducing their outstanding liabilities with SBP and other entities.

However, this is no time for complacency. CBR revenue targets are notorious for not being achieved. Difficult times are ahead as the country braces itself to face up to the sanctions imposed by the donors. Aid inflows will be affected. Revenues may be adversely impacted by shocks to the economy. The provinces must continue to maintain high standards of financial discipline and practice austerity wherever possible in their expenditure, so as to divert the maximum component of federal transfers to development activities by generating larger revenue surpluses in 1998-99.