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Government Budget and the Current Economic State: Challenges and the Way Forward

Summary

1. GDP growth rate averaging below 5%

2. High Inflation

3. Fiscal and current account deficits

4. What reform initiatives the policymakers must prioritize?

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Summary

Pakistan's economy faces challenges in achieving sustainable growth, with a GDP growth rate averaging below 5% over the past five decades. The country struggles with macroeconomic imbalances, including fiscal and current account deficits, and inflation rates averaging 10.4% over the past two decades. Investment-to-GDP ratio has declined since 1992, and public expenditure on health and education has decreased. Social indicators, such as literacy rate and human development index, remain low. To address these issues, policymakers must prioritize reform initiatives, including institutional autonomy, policy transparency, and human capital development, to foster sustainable growth and improve living standards.

1. Introduction

The evaluation of an economy's performance encompasses both short-term and long-term perspectives. Over time, policymakers strive to enhance the populace's living standards by sustaining robust GDP growth rates and improving social indicators. Short-term policy objectives involve stabilizing economic activity to mitigate cyclical budget deficits, interrupted economic growth, and cyclical unemployment. In contrast, long-term growth policies aim to elevate living standards. Annually, the government formulates a budget outlining its revenues and expenditures for the fiscal year, aligning them with long-term objectives and priorities and establishing annual goals for various economic and social indicators.

It is crucial to acknowledge that no government can fulfill all its objectives within a single fiscal year or even a five-year span. Therefore, rational expectations are essential. Policy objectives often entail trade-offs. For instance, achieving a higher GDP growth rate may result in heightened inflation, while maintaining price stability may necessitate reduced output. Likewise, stabilizing the exchange rate could deplete foreign exchange reserves and disrupt exports and imports due to an overvaluation or undervaluation of the domestic currency. Furthermore, a significant portion of expenses, such as salary payments, principal and interest payments, defense expenditures, and ongoing project financing, cannot be substantially adjusted within a single budget. Consequently, the government has limited flexibility to modify budgeted amounts. Considering these factors, let's explore the challenges confronting the Pakistani economy.

GDP[1] Growth Rate and Inflation Rate[2]

Over the past five decades, the Pakistani economy's average annual GDP growth rate has remained below 5%, translating to less than 3% per capita. While this performance does not fall into the poor category, it falls short of the 7 to 8% growth rate required to generate adequate employment opportunities for the country's unemployed youth3. It is essential to consider the influence of various conflicts, shifting demographics, and the transitions of power between civilian and military regimes when evaluating the overall economic performance, which can be perceived as satisfactory.

The Pakistani economy has displayed significant fluctuations in economic activity, accompanied by a low GDP growth rate. Despite achieving a peak growth rate of 5.5 percent in FY2018 and an average growth rate of 4.7 percent from FY2014 to FY2018, the sustainability of this growth has been compromised by macroeconomic imbalances,

[1] GDP is defined as market value of all goods and services newly produced in one year in the economy or sum of private sector and government sector incomes.

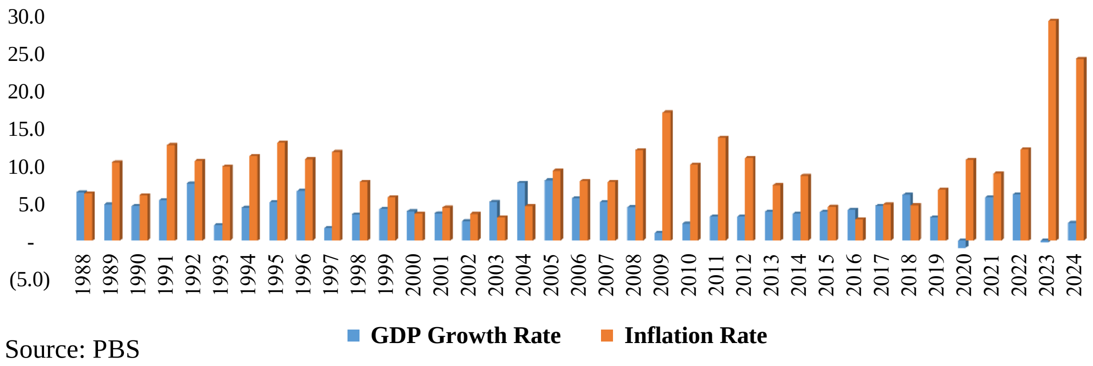
[2] Inflation rate is defined as the percentage growth rate of a price index that measures average change (compared to base year) in prices of goods and services.

[3]The average GDP growth rate of Asian Tigers was about 6% over the period 1960 – 90.

particularly the escalating fiscal and current account deficits. These persistent twin deficits have posed consistent challenges to the Pakistani economy, with the substantial trade deficit and fiscal deficit values causing concern in the fiscal year 2018. These fluctuations can be attributed to political instability, heavy reliance on external capital inflows, inconsistency in domestic policies, and external factors beyond the control of domestic policies. For instance, the GDP growth rate in the 1990s remained volatile due to political instability, dropped following the nuclear blast, rose significantly after 9/11 due to increased remittances and monetary expansion, and reached historic lows in 2009 due to an oil price hike, financial crisis, and monetary contraction stemming from the depletion of foreign exchange reserves.

Including strategies in future budgets that focus on achieving inclusive GDP growth and long-term sustainability is crucial. This can be accomplished by aligning domestic policies with the government's long-term objectives and priorities and ensuring they are consistent over time. To increase government autonomy, it is essential to implement institutional reforms that promote transparency in policy actions and hold the government accountable when objectives are unmet. In addition to boosting exports, the government should prioritize domestic commerce, especially small enterprises, and develop policies to reduce the cost of doing business. Decentralizing government authority and devolving it to the local level will improve the delivery of public services. Urban planning should transform municipalities into catalysts for growth. The aim of domestic policy should be to decrease the economy's vulnerability to external disruptions. It is essential to gradually increase investments in human capital by providing better health facilities and improving the literacy rate. Addressing energy scarcity should be a top priority.

Figure 1: GDP Growth Rate and Inflation Rate



Source: PBS

The average inflation rate over the past two decades has stood at 10.4%, experiencing fluctuations ranging from 3% to 29%. During periods of stable exchange rates, there was an observed increase in domestic demand, leading to heightened government spending and consumption, consequently resulting in a notable surge in imports. Delays in implementing necessary adjustments for energy prices, the exchange rate, and fiscal accounts have led to the depletion of foreign reserves and an escalation in borrowing. To avert similar crises in the future, Pakistan must address fundamental structural challenges and expeditiously execute fiscal, monetary, and exchange rate measures to stabilize the economy. Inflation diminishes the purchasing power of individuals whose incomes are not fully indexed to inflation. It impacts the wealth distribution between borrowers and lenders while augmenting the tax burden on salaried individuals. A low but positive inflation rate is imperative for sustaining economic growth, whereas high and volatile inflation creates uncertainty and impedes economic progress.

In Pakistan, monetary expansion/contraction and external factors such as exchange rates and oil prices have significantly influenced the inflation rate. During the 1990s, the inflation rate rose due to currency devaluation. Following the events of 9/11, the inflation rate increased due to a rise in remittances and subsequent monetary expansion. The price hike in 2009 was attributed to a significant increase in world oil prices. The inflation rate is relatively low due to decreased oil prices worldwide.

In Pakistan, inflation has become a significant economic challenge. This issue has been developing over the past thirty years and has been exacerbated by fiscal measures implemented since August 2019 to address rising fiscal and current account deficits. In November 2021, food and non-food components of inflation exceeded single digits, drawing attention to the problem. By fiscal year 2023, the average CPI inflation rate had risen to 29.2 percent, peaking at 38 percent year-over-year in May 2023. This increase affected all CPI components, with food and energy exceeding core inflation. The Russia-Ukraine conflict in fiscal year 2023 triggered the global economic crisis, leading to energy and food supply chain disruptions. Depleted foreign exchange reserves in Pakistan led to currency depreciation, worsening inflation. Additionally, the 2022 flooding caused significant economic damage, particularly in the agricultural industry. The floods disrupted the supply of perishable goods, driving up their prices. Furthermore, inflationary pressure was fueled by excessive aggregate demand driven by political and economic uncertainty.

2. Public and Private Investment

The investment-to-GDP ratio has consistently declined since 1992, when it was 26.5% of GDP. Currently, it stands at about 13% (Figure 2).

Figure 2: Investment (% of GDP) and Average Interest Rate

Source: PBS & SBP

Developing countries have a lower capital-output ratio than developed countries, meaning that capital in developing nations is more productive. Increasing capital leads to learning-by-doing, which boosts labor productivity and encourages business expansion. According to economic theory, investment is influenced by three key factors: GDP growth rate, interest rates, and share prices on the stock market. Factors such as low interest rates, high GDP growth rates, and high share prices motivate firms to increase their investments in physical capital. Despite low interest rates and a strong stock market performance, investment has not picked up. The investment-to-GDP ratio remains insufficient to promote sustainable growth. This suggests that other important factors, beyond interest rates and stock market performance, determine investment in Pakistan. The following are potential explanations for the low investment-to-GDP ratio.

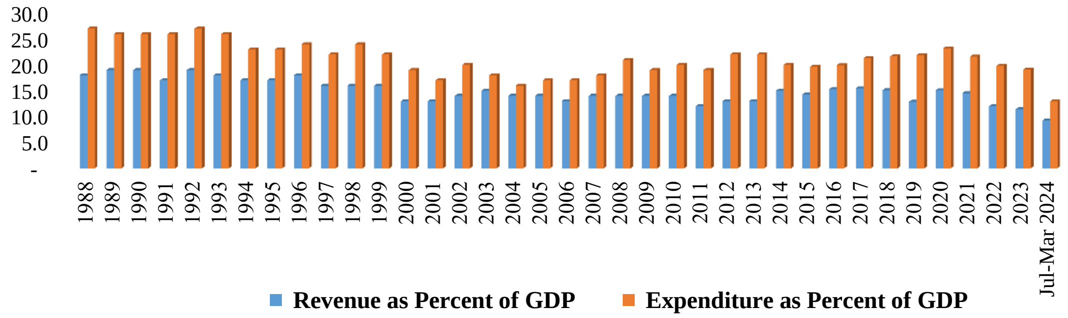
I want to emphasize that in Pakistan, there is a focus on rent-seeking activities rather than wealth-creating activities. Economic agents in the country generate revenue through innovation, creation, or extracting value from existing resources and knowledge. However, Pakistan's incentive structure, policies, and institutions encourage rent-seeking activities and discourage innovation. Working as a civil servant or real estate agent is more advantageous than working as an entrepreneur or scientist. Additionally, conducting business in Pakistan is expensive and time-consuming, as it can take up to 3 months to get an electricity connection through the regular procedure, and the process for other utilities can be even lengthier. This discourages investment and hinders economic development.

Similarly, excessive government regulation restricts the availability of commercial land in urban areas, making it challenging for small businesses to find a location to operate. Additionally, public investment as a percentage of GDP remains high and displaces private investment, although it is significantly lower than it was until the early 1990s. While the government should not be involved in business operations, it continues to provide private products in Pakistan that could be more efficiently supplied by the private sector, thus degrading the delivery of public services. Furthermore, private-sector credit has been replaced by government-provided financing via the banking sector. The government is a client that purchases loans in quantity and assumes no default risk. Banks find it more convenient to extend loans to the government rather than engage in high-risk lending activities to retail consumers in the private sector.

3. Fiscal Issues

In the previous fiscal year, Pakistan had a budget deficit of around 7.7% of GDP, resulting from government expenditures exceeding revenues. This percentage is slightly lower than the three-decade average of 6% and significantly less than the level recorded in 2012, which was 9.0%. Despite experiencing economic expansions and contractions in the past, Pakistan continues to have a budget deficit, indicating the presence of underlying structural issues. To address this, the government has focused on a combination of strategies to reduce government expenditures and increase the revenue-to-GDP ratio (refer to Figure 3).

Figure 3: Revenue - Expenditures Gap (% of GDP)



Source: Ministry of Finance

The current issue with revenue targets is not because revenue collection agencies are underperforming but rather due to the process of establishing these targets. The process starts with creating an expenditure plan, estimating anticipated aid/grants, determining a budget deficit target, and only then setting a revenue target from the remaining amount (planned expenditures minus grants and budget deficit). However, since revenues are treated as a residual, they often do not meet the intended targets, leading to significant consequences in fund allocation. When revenues fall short, expenses are reallocated, prioritizing nearly fixed costs like salaries while cutting back on development expenditures. This flawed approach disrupts the declared fiscal policy in the annual budget and undermines the budget's credibility. Additionally, in the early 1990s, the ratio of development expenditures to current expenditures was over 0.3, but it progressively declined to 0.11 in 2002. It started to recover in 2003 and is now close to 0.3 again.

Expenditures for development significantly contribute to economic growth by improving physical infrastructure and human capital. After the 7th National Finance Commission (NFC) Award, the provincial share of the federal divisible pool increased to 57.5%. Additionally, following the 18th amendment to the Constitution of Pakistan, provinces are now responsible for collecting certain taxes, such as the Goods and Services Tax (GST) on services. However, this increased share may reduce provinces' incentive to generate revenue. The combination of reduced effort at the provincial level and inadequate revenue target setting at the federal level has severe consequences for provincial budgets. For example, the target set by the Federal Board of Revenue (FBR) was Rs 9,415 billion, while the budgeted expenditure amounted to Rs. 14,485 billion. Revenues in July and March totaled Rs 6,712 billion, while expenditures stood at Rs 13,683 billion. It is likely to be challenging to achieve the FBR target, which will impact the allocation of resources to provinces and influence decisions in the annual budgets of provincial administrations.

4. External Accounts

External accounts involve financial activities such as grants, portfolio investments, and transactions related to the real sector, including importing and exporting goods and services. The external sector is closely connected to the domestic real and monetary sectors. Additionally, fluctuations in exchange rates are influenced by external sector activities, making them a significant macroeconomic indicator. The government implemented measures to control imports in response to ongoing macroeconomic imbalances. This improved the current account's performance and helped offset external pressures. As a result, risks associated with difficulties in external financing were reduced. Consequently, the trade deficit of goods decreased substantially, amounting to $15.8 billion. The significant decline in the trade deficit of goods can be attributed to a sharp reduction in imports (8.0 percent), driven primarily by decreased domestic demand, import management strategies, and lower global commodity prices.

While increasing imports could be seen as a positive development, the lack of export growth is worrying. When a nation's economy grows, it typically leads to an increase in the importation of machinery and raw materials, which can benefit the economy. However, despite the focus on promoting exports, they are declining. One factor contributing to this imbalance between imports and exports is the overvaluation of the country's currency. Over the past thirty years, the value of the Pakistan Rupee has decreased against the US Dollar by an average of 6.7% annually, while the inflation rate has averaged 8.6% annually during the same period. This has led to the Rupee becoming overvalued, resulting in a trade imbalance due to the rising cost of products compared to the dollar's appreciation.

Figure 4: Exports and Imports of Pakistan ($ billion)

Source: SBP

Foreign remittances have increased significantly over the past fifteen years. Before 2001, annual remittances were less than $2 billion, but now they exceed $18 billion. These remittances play a significant role in financing the trade deficit. The large influx of foreign currency helps stabilize the exchange rate and promote monetary expansion, stimulating economic activity. Currently, the exchange rate remains stable, and this stability was supported by the accumulation of foreign exchange reserves fueled by substantial remittances, an IMF loan, and a decrease in crude oil prices.

5. Social Sector

Over the past fifty years, Pakistan's GDP growth rate has been below the level needed to address youth unemployment. However, the country's economic performance has not been extremely poor or exceptionally strong. Despite this, social indicators have remained at a low level. Pakistan's Human Development Index (HDI) stands at 0.540, placing the country at 164 out of 193 countries in the global ranking, categorizing Pakistan as having 'low' human development. The 2023/2024 Report highlights that Pakistan's HDI and global ranking have been negatively affected by ongoing social, economic, and political challenges, including macroeconomic difficulties and the long-term impact of the 2022 floods, despite effectively managing the COVID-19 pandemic. Table 1 presents the current status of some social indicators.

Table 1: Social Indicators

Item	Current Situation
Literacy Rate 2021	62.2
Infant Mortality Rate (per 1000 live births) 2021	52.8
Birth rate (Crude) -(per 1000 people) 2021	7
Maternal mortality ratio (per 100,000 births) 2019	186

Source: PBS

The Ministry of Finance provides estimates of the total public expenditure on health and education in its PRSP progress reports. According to the reports, there has been a significant decrease in the proportion of GDP allocated to education expenditures, dropping from 2.1% of the GDP in 2017-18 to 1.3% in 2021-22. On the other hand, health expenditures have increased from 1.1% to 1.4% of the gross domestic product. The World Bank's Pakistan Development update, April 2024[4], anticipates that the poverty headcount rate, as assessed at the lower-middle-income country poverty line of US$3.65/day in 2017 purchasing power parity (PPP), is expected to remain around 40 percent during FY24–26. The report also highlights anticipated adverse effects on human development outcomes,

[4] "Pakistan Development Update," World Bank Group, May 15, 2024, https://thedocs.worldbank.org/en/doc/140b30353b40dbb294cca42bcb86529a-0310062024/pakistan-development-update-april-2024-fiscal-impact-of-the-federal-state-owned-enterprises

including suboptimal growth, elevated inflationary pressures resulting from ongoing import management measures, and potential cuts to public spending on social sectors.

6. Concluding Remarks

Pakistan possesses a developing economy with an approximate GDP per capita of $1680. The GDP growth rate has historically lagged, averaging 4.5 percent annually and maintaining volatility. Over the last five decades, the annual inflation rate has averaged more than 8% while historically fluctuating between 2% and 30%.

In light of the prevailing economic circumstances, policymakers are presented with a distinctive and advantageous opportunity to prioritize reform initiatives that foster sustainable development in the long run. Throughout the economic history of Pakistan, policies have consistently centered on stabilizing economic activity and short-term governance. In contrast, expansionary policies leading to substantial yet unsustainable increases in the GDP growth rate have minimal impact on future living standards. However, significant outcomes can be derived from a modest but sustained rise in the GDP growth rate, with greater emphasis on enhancing human capital and developing social infrastructure.

The potential reforms encompass granting autonomy to institutions such as research institutes, hospitals, and law enforcement agencies, ensuring policy transparency to garner public support and minimize uncertainty, holding policymakers accountable for unmet objectives and targets, and bolstering the economy through human capital development and social infrastructure enhancement, among others. While these examples do not encompass all possible changes to expedite Pakistan's economic growth, they provide a foundation for reform initiatives. Although it is improbable that all these issues will be immediately resolved, the reform process can be set in motion with the forthcoming budget.

References:

1. "Pakistan Development Update," World Bank Group, May 15, 2024, https://thedocs.worldbank.org/en/doc/140b30353b40dbb294cca42bcb86529a-0310062024/pakistan-development-update-april-2024-fiscal-impact-of-the-federal-state-owned-enterprises

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