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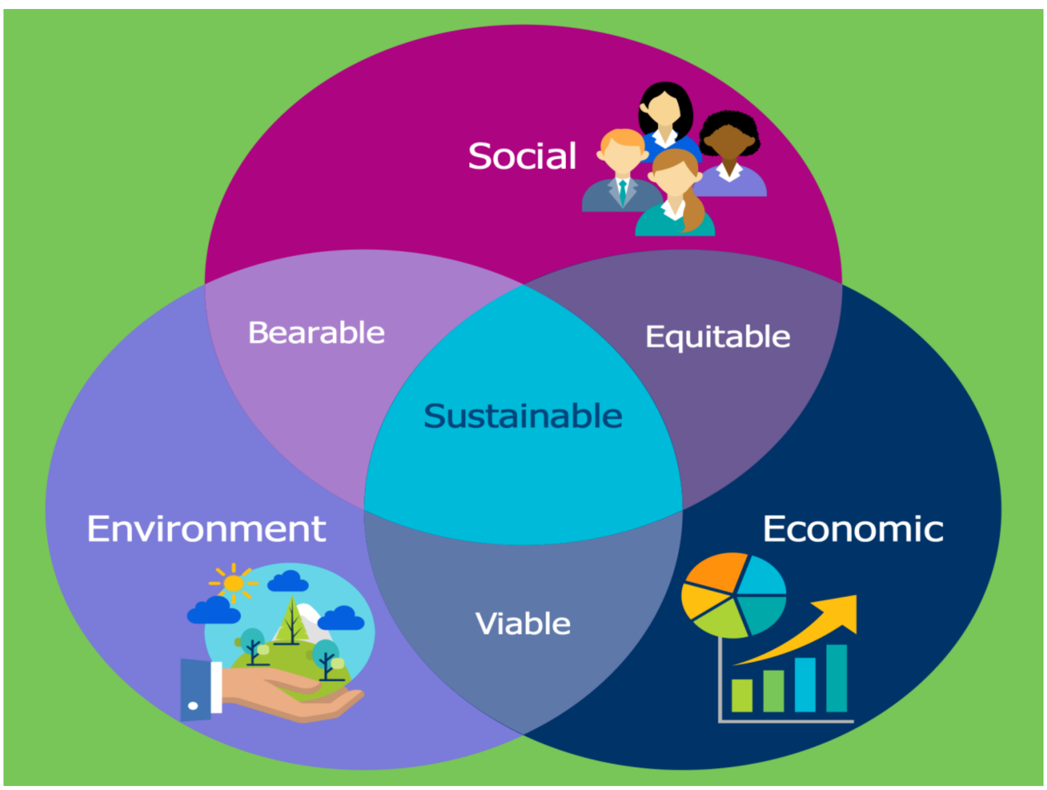

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State of the Economy and Appraisal of the Federal Budget 2024-25

Dr. Hafiz A. Pasha*[1]

Summary

Pakistan's economy faces a mixed picture in 2023-24, with a reduced current account deficit and positive GDP growth rate of 2.4%. However, the manufacturing sector continues to decline, and inflation remains high. The budget deficit may exceed targets, and external inflows have been lower than projected. The living conditions of people have been severely affected by cumulative inflation and rising food prices, leading to increased poverty and unemployment. The Federal Budget of 2024-25 aims to increase revenues and achieve fiscal stabilization, but its reliance on indirect taxation may lead to contractionary effects and rising inflation.

1. State of the economy

The year, 2023-24, will end with a very mixed picture of the national economy. The positive development is the virtual elimination of the current account deficit in the external balance of payments. It is down to only $202 million in the first ten months.

The other welcome change is the return to a positive GDP growth rate of 2.4%, from a negative 0.2% in 2022-23, due largely to the devastation caused by the floods. The crop sector has shown an exceptional recovery with a growth rate of 16.8%. But the manufacturing sector continues to be in trouble. It declined by 10% in 2022-23 and is likely to show zero growth this year.

Also, the rate of inflation has been showing a declining trend since December 2023. It is now down to only 11.8% in May 2024, partly due to a 'high-base effect' of the peak rate of inflation in May 2023 of 38%. However, the Sensitive Price Index for last week continues to show a high year-to-year rate of inflation of 21.7%. The year is likely to conclude with an overall rate of inflation close to 23%.

The level of foreign exchange reserves has remained in the range of $8 to $9 billion after the commencement of the IMF Stand-by Facility in July 2023. The stability has been achieved by the big reduction in the current account deficit. However, external inflows have been much lower than projected. The annual target of $17.5 billion has been met only to the extent of 62% in the first ten months. Private creditors have stopped lending to Pakistan.

The budget deficit in the first three quarters of 2023-24 was 3.7% of the GDP, compared to 3.5% of the GDP in the corresponding quarters of 2022-24. It may exceed somewhat the target of 7.7% of the GDP for the year and the primary surplus may be very small. This is attributable to shortfall in FBR revenues and Federal non-tax revenues. Also, there may be a shortfall in the generation of the cash surplus by the Provincial Governments.

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The level of fixed investment in Pakistan has fallen to its lowest level in the last 50 years. It is down to 11.4% of the GDP. Five years ago, it was 15.4% of the GDP. Both public and private investment have fallen sharply.

The living conditions of people have been badly affected by the cumulative inflation of 59% since 2021-22 and the rise cumulatively in food prices by 69%. The low growth in the economy has severely restricted labor demand, while the labor force increases annually by 2 million. Consequently, while the unemployment rate was 6.5% in 2020-21, it has now approached a high of 10%. The youth unemployment rate has risen to 17.5%.

The fall in real per capita income and the jump in food prices and utility tariffs during the last two years have also resulted in a quantum jump in the incidence of poverty to 43% of the population. Today, almost 103 million people are below the poverty line in Pakistan.

Therefore, the Federal and Provincial Budgets have to be framed in a socio-economic environment characterized by low growth and investment, continuing high double-digit inflation, large budget deficit, low foreign exchange reserves and decline in inflows of external financing. The people have seen a fall in living standards due to big increases in the incidence of unemployment and poverty. The fundamental question is how far will the budgetary operations in 2024-25 help in reducing these problems.

2. Appraisal of the Federal Budget FY 2024-25

The Federal budget of 2024-25 is an ingenious exercise in increasing the overall envelope of resources such that the wide range of competing claims can be reconciled and fulfilled. Simultaneously, IMF's expectation of fiscal stabilization through a big increase in the primary surplus of the Federal and Provincial Government budgets combined is to be more than achieved.

This is being accomplished by an unprecedented jump anticipated in FBR tax revenues and Federal non-tax revenues combined of almost 45%. The target is to raise Federal revenues from a likely 11.2% of the GDP in 2023-24 to 14.4% of the GDP next year. An increase in total revenues of as much as 3.2% of the GDP has never been achieved before. Further, 66% of the increase in tax revenues is to come from indirect taxes.

Needless to say, this will lead to severe contractionary effects on the economy, making the 3.5% GDP growth rate difficult to attain. Further, the proposed big increase in, for example, income tax on exports will greatly handicap our exporters. The large component of indirect taxation, with a bigger levy on POL products and higher rates of sales tax and excise duty on goods hitherto subject to reduced rates of tax, along with forthcoming increase in energy tariffs, will lead to the inflation rate rising well above the target rate of 12%.

Various claims and pressures are being handled through the larger expected revenues. Defense expenditure is budgeted to increase by over 18%, significantly above the projected rate of inflation. Subsidies and grants, especially to the SOEs, are being raised by over 25%. Competing claims for projects in different sectors and regions are being reconciled by a more than doubling of development spending. Interests and real incomes of Federal employees are being protected by 22% to 25% increase in salaries and 15% in pensions. There is no evidence whatsoever at efforts to economize in current expenditure.

The good news is that despite all these large increases, the consolidated budget deficit is expected to come pummeling down to 5.9% of the GDP, as compared to the likely 7.7% of the GDP in 2023-24. The primary surplus will approach 2% of the GDP. This is based also on a more than doubling of the cash surplus of the Provincial Governments. This is highly unlikely as these governments will also have to give big increases in salaries and pensions like the Federal Government, with a combined cost of over Rs 600 billion.

This process of satisfying competing claims, has, however, left the people out in the cold. As highlighted above, the rate of inflation is likely to rise well above 12% due to the widespread increases in indirect taxes and energy tariffs. Further, as opposed to the other big increases, there is only a moderate enhancement in the BISP program to Rs 590 billion. This is a at a time when the ‘poverty gap’ in the country has exceeded Rs 2800 billion. As a signal of equity and concern for the poor, the BISP program should have been increased by at least 40%, equivalent to the increase in the tax burden, such that its size would have exceeded Rs 700 billion, equivalent to 25% of the poverty gap.

The budget has been designed to get the blessings of the IMF. This is likely given the targeted big increase in revenues and generation of a large primary surplus of 2% of the GDP. However, it is a fragile budget with a number of risk factors especially related to the achievement of almost 40% growth in FBR revenues and 64% growth in Federal non-tax revenues. As there will be significant shortfalls, then we are likely to see a spate of mini budgets in 2024-25, so as to keep operational the IMF program.