

Annual Review  
June 2005

# **An Overheating Economy?**

## Foreword

The Social Policy and Development Centre is pleased to present its annual review of the state of the economy in the light of the Pakistan Economic Survey 2004-05 and the Federal Budget 2005-06. As soon as the Survey and the Budget are released, the SPDC team goes to work in analyzing the new data, assessing the macroeconomic and fiscal policies, and examining the implications for the macroeconomic situation and for the poverty and social development picture. Our goal is to conduct a thorough and detailed analysis, including inputting the new data into our large-scale Integrated Social Policy and Macro model and conducting any model simulations and other econometric work that are necessary to shed light on the major issues that we see as being pertinent. The research has been conducted over a period of two to three weeks, and the Review has been completed within a month of the release of the Survey and the Budget.

The Review is an effort to objectively present the situation with respect to the state of the economy. It highlights the impressive growth performance and the Government's role in achieving that. But it also emphasizes that some signs of overheating and stress are now emerging in the economy that policy makers and other economic participants would be ill-advised to ignore. We hope that all stakeholders will find this annual review of Pakistan's economy useful.



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### **MACROECONOMIC ANALYSIS**

**A**ccording to data reported in the Government of Pakistan's Economic Survey 2004-05, Pakistan's economy grew a solid 8.4 percent in FY 2005, one of the highest growth rates in the world and surpassing expectations for the third straight year. Unlike last year, the growth is more balanced, with the agriculture, manufacturing, wholesale and retail trade, and services sectors all making significant contributions. Our analysis, suggests that there have been some gains in productivity and, to some extent, in employment as well. The performance is impressive and no doubt is bolstered by the macroeconomic stability that the government has engendered over the past few years.

However, there are signs of stress and, in particular, overheating now emerging in the economy that policy makers and other participants in the economy would be ill-advised to ignore. The most obvious one is inflation, which, based on 12-month changes in consumer prices, surpassed 11 percent in April. Although supply-side factors, which have kept food prices and world oil prices high, account for a significant chunk of the increase in inflation, there are underlying demand-side pressures building up as well, which we document in this report. The State Bank of Pakistan seems well aware of these pressures, and the loose stance of monetary policy has begun to reverse--appropriately to us--and more tightening is probably in order. The provisions in the Federal Budget 2005-06 announced on June 6 also pose a significant challenge for the macroeconomic situation. In particular, the proposed increase in the budget deficit exacerbates inflationary pressures and makes the central bank's task all the more difficult over the coming quarters.

Another development to keep a watchful eye on is the widening trade deficit, which has turned a current account surplus

into a deficit in FY 2005. Some outpacing of exports by imports is to be expected in an economy which is growing faster than its trading partners and in which the growth is not being led by exports. But the difference between the growth rate of real imports in the national income accounts (44 percent) and real exports (8 percent) seems excessive and is also suggestive of an overheating economy. Financing of the current account deficit is not an issue in the short run, but a continuing trend of a widening current account deficit will have adverse effects on expectations that could threaten the hard-earned credibility on the macroeconomic front. The argument that much of the increase in imports is going towards buying up of machinery and other capital goods which will engineer future growth and future exports is only partly comforting. This is because the overall investment position does not look all that rosy with real private investment as a share of real GDP continuing to fall. With rising interest rates and a continued increase in the relative price of capital, a reversal in the investment-output ratio does not appear to be on the cards any time soon.

The long-term prospects of the economy depend, of course, on how much of the growth momentum is sustainable. Only per capita growth that results from an increase in the productive capacity of an economy can, and should be, sustained. Quantifying the notion of productive capacity--in other words, potential output--is notoriously difficult for any economy. Qualitatively, in the case of Pakistan, one can discern a combination of transient, e.g. the contribution of weather to a bumper cotton crop, and more persistent, e.g. policy stability, in the recent surge in economic activity. Some illustrative quantitative estimates that we have made using statistical techniques suggest a significant gain in the growth rate of Pakistan's potential output over the past few years, for which the present government deserves

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due credit. But the estimates also suggest that potential growth may not quite have reached 7 percent yet. While admittedly these estimates are highly uncertain, we emphasize that overestimating potential growth runs the risk of allowing aggregate demand, particularly consumption demand, to elevate to a level that cannot be maintained in the long run with its attendant problems.

On the poverty front, in the absence of up to date data, it is difficult to say what the recent acceleration in per capita real income has done to poverty. The forces at work in the Social Policy and Development Centre's (SPDC's) Integrated Social Policy and Macro (ISPM) model suggest only a modest net reduction in poverty as a result of the high per capita growth rate—the gains from the size of the pie increasing are being partially offset by factors such as rapid increases in food prices and a decrease in the investment-output ratio, which our model documents to be poverty-increasing. Moreover, we have also computed a new Social Development Index based on indicators of health, education, and access to services such as telephones and electricity. Unfortunately, the growth in this Social Development Index has been relatively weak over the 2000-2004 period, despite remarkable progress on the growth front.

We continue to maintain, based on our model simulations, that direct interventions to reduce income and asset inequality are required to make a significant dent into poverty at an acceptable pace. While improvements have been made in this regard by budgeting additional development outlays in the new Federal Budget, there is still a long way to go down the road of

utilizing these effectively and channeling them to the components, e.g. education and health, which matter most for poverty reduction and social sector development.

### Growth

Output accelerated significantly in FY2005, with real GDP at factor cost measured in FY2000 prices expanding by 8.4 percent, compared with 6.4 percent the

**TABLE 1  
GROWTH BY SECTOR**

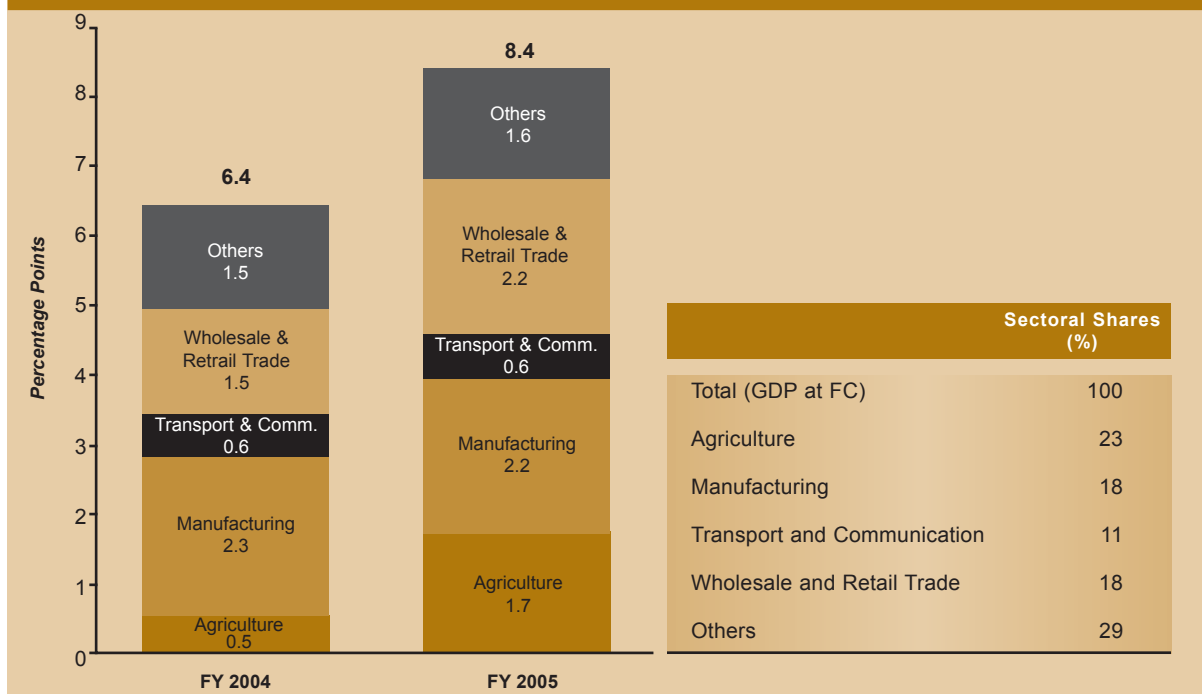
Sector	Growth Rates (Percent)				
	At constant factor cost of FY 2000				
	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005
Total (GDP at Factor Cost)	1.8	3.1	4.8	6.4	8.4
Agriculture	-2.2	0.1	4.1	2.2	7.5
Manufacturing	9.3	4.5	6.9	14.1	12.5
Transport and Communication	5.3	1.2	4.3	5.5	5.6
Wholesale and Retail Trade	4.5	2.8	6.0	8.1	12.0
Others	-1.2	5.9	3.8	5.0	5.4

Source: Pakistan Economic Survey 2004-05

previous year (Table 1). The growth is well-balanced with the manufacturing and wholesale and retail trade sectors growing at double-digit rates, agricultural output increasing by 7.5 percent, and other sectors also expanding significantly.

The supply-side sectoral contributions to growth (in percentage points) are shown in Chart 1. These are obtained by multiplying the sectoral growth rates by their respective share in total output. The manufacturing sector adds the same, about 2¼ percentage points, to total output growth in each of the past two years. However, the contribution of agriculture has more than tripled from ½ percentage points of growth last year to about 1¾ percentage points this year, and the contribution of wholesale and retail trade has also increased by ¾ percentage points. Thus, manufacturing has continued to perform, and output in agriculture, wholesale and retail trade, and in other (primarily service-oriented) sectors has accelerated.

**CHART 1**  
**SECTORAL CONTRIBUTION TO GROWTH**



Source: SPDC estimates based on data from Pakistan Economic Survey 2004-05

Table 2 reports the demand-side components of real GDP measured at market prices. Real private consumption grew a striking 16.8 percent in FY2005, according to data reported in the Economic Survey, double the rate posted last year. Real imports, after declining significantly last year surged 44.1 percent this year. By

contrast, private fixed investment increased only a modest 4.8 percent from the rather low base implied by last year's 11 percent contraction. And, with the decline in public investment of more than 5 percent, the overall investment picture is a cause for concern. The very high growth rates of private consumption and imports in FY2005

relative to those of private fixed investment and exports are suggestive of an overheating economy.

The decline of 11 percent in private fixed investment in FY2004 shown in Table 2 is puzzling, as against the 8 percent expansion reported for the same year in the previous Economic Survey (not shown here). Similarly, a decline of

**TABLE 2**  
**GROWTH BY EXPENDITURE**

Sector	Growth Rates (Percent)				
	At constant market prices of FY 2000				
	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005
Total (GDP at market price)	1.7	3.1	4.8	6.4	7.9
Private Consumption	2.3	1.2	0.8	8.2	16.8
Public Consumption	-20.1	15.0	7.2	2.1	2.3
Private Fixed Investment	2.9	13.2	5.7	-11.0	4.8
Public Fixed Investment	7.4	-24.5	-0.2	14.0	-5.6
Exports	12.2	10.0	28.4	-1.5	7.6
Imports	2.2	3.0	11.2	-8.6	44.1

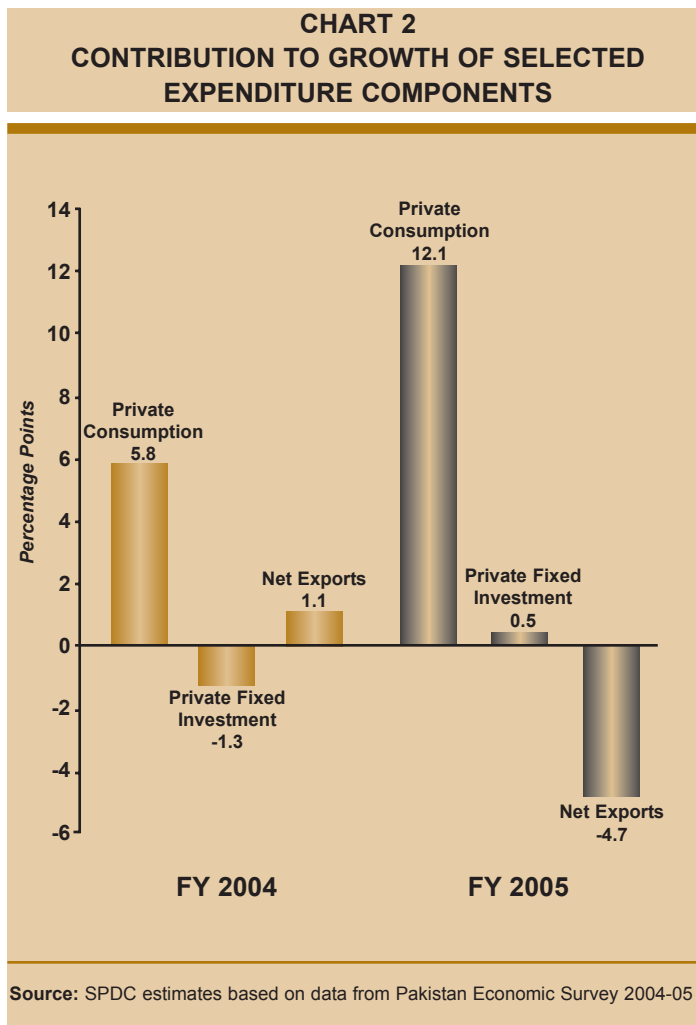
Source: Pakistan Economic Survey 2004-05



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nearly 6 percent in private consumption in FY2004 reported last year has been revised to an expansion of more than 8 percent, as reported in this year's Economic Survey. It seems difficult to rationalize such large data revisions in a single year.

Chart 2 depicts the contributions to growth of different types of expenditure.



The contribution of final private domestic demand--the sum of the private consumption and private investment bars--is about 12½ percentage points of growth in FY2005, of which only about ½ percentage points is accounted for by private fixed investment. With the growth in real imports surpassing that of exports by a wide margin,

real net exports shaved off almost 5 percentage points from growth. The magnitude of growth in private consumption recorded in FY2005 is likely not sustainable and, in fact, attempts to sustain it might prove counterproductive.

As part of SPDC's large-scale ISPM model, we have estimated aggregate and sectoral production functions. The estimates can be used to do a growth accounting exercise that decomposes growth into that due to changes in the quantity of inputs used and that which can be attributed to shifts in the production function (i.e. productivity gains--the ability to get more output from any given amount of inputs). In principle, shifts to the production function can be a result of both transient factors (such as weather-related shocks) and more permanent gains in productivity (such as due to technological improvements and government policies).

The results of the growth accounting exercise for overall growth and for agricultural growth are presented in Table 3. The increase in inputs added 2.1 percentage points to overall growth in FY2005, three-fourths of which was the contribution of capital. The shifts in production function accounted for 6.2 percentage points of the growth, of which almost a half can be attributed to the increase in cotton production. In the case of agricultural output, all but about 1 percentage point of the 7.5 percent growth in FY2005 resulted from production function shifts, of which cotton production contributed 5 percentage points. However, the contribution of inputs--specifically labour--to agricultural growth was a substantial 2.6 percentage points of growth during the previous year.

**TABLE 3  
GROWTH ACCOUNTING**

Sector	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005
Total Growth (%)	1.8	3.1	4.8	6.4	8.4
Contribution (%Points) of:					
Inputs	2.8	3.2	2.6	2.9	2.1
Of which					
Capital	2.4	2.2	2.2	1.9	1.6
Labor	0.5	0.9	0.5	1.0	0.5
Production function shifts	-1.0	-0.1	2.2	3.5	6.2
Of which:					
Change in cotton production	-0.3	-0.1	-0.2	-0.1	2.8
Agricultural Growth (%)	-2.2	0.1	4.1	2.2	7.5
Contribution (% Points) of :					
Inputs	1.3	-3.4	0.4	2.6	0.8
Of which					
Capital	0.0	0.0	0.0	-0.1	-0.1
Labor	0.9	-3.7	0.8	2.6	0.9
Production function shifts	-3.5	3.5	3.7	-0.4	6.6
Of which:					
Change in cotton production	-0.5	-0.1	-0.4	-0.2	5.0

**Source:** SPDC estimates.

The large share of growth accounted for by production function shifts this year indicates significant gains in total factor productivity. A substantial portion of these shifts, however, came in the shape of a bumper cotton crop. To the extent that this is plausibly partly a result of transient factors, such as good weather and a relatively favourable virus position, it should not lead to excessive euphoria or misplaced complacency.

This brings us to a key question about the state of the economy: How much of the growth momentum is sustainable going forward? Ideally one would want to compute the productive capacity (or potential output) of an economy under the assumption of full employment of all available factors of production and with all the policy and structural changes that have taken place built

in. The growth rate of this potential output could then be interpreted as the sustainable rate of economic growth. This is a difficult exercise to accomplish, particularly for developing countries. One crude alternative that is often used is to determine, using statistical methods, where the long-run trend in output seems to be headed, given the actual historical behavior. Assuming the government's achievement of the target growth rate of 7 percent for 2006 and 2007, the picture that emerges from such an exercise for Pakistan is depicted in Chart 3.

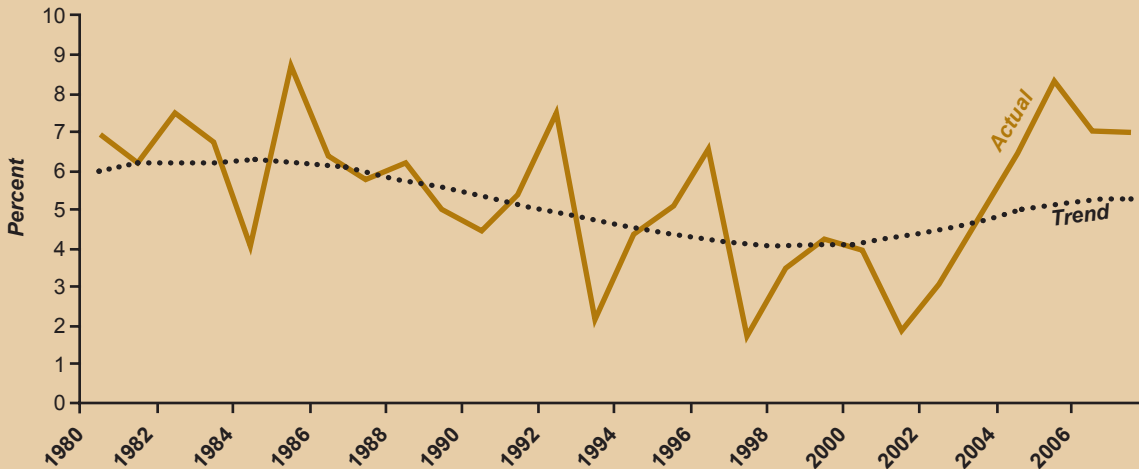
Several features of this chart are noteworthy. First, the actual growth pattern for Pakistan has been quite volatile.

Second, during the 1980s and 1990s, trend growth appears to have declined, from about 6 percent in 1981 to just 4 percent in 2000. There has been a notable shift toward growth since then, which has pulled up potential growth from its low point of 4 percent to about 5½ percent. The exact numbers here are highly uncertain and only meant to be illustrative. The main point is that while it seems very plausible that the government has facilitated a turnaround in potential growth in recent years, it seems equally plausible that potential growth has not quite reached rates of 7 percent to 8 percent yet.

Some other telling evidence that it might be difficult to immediately sustain growth rates in the range of 7 percent to 8 percent from now onwards comes from the behaviour of the investment-to-GDP ratio,

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**CHART 3  
ACTUAL\* AND TREND REAL GDP GROWTH**

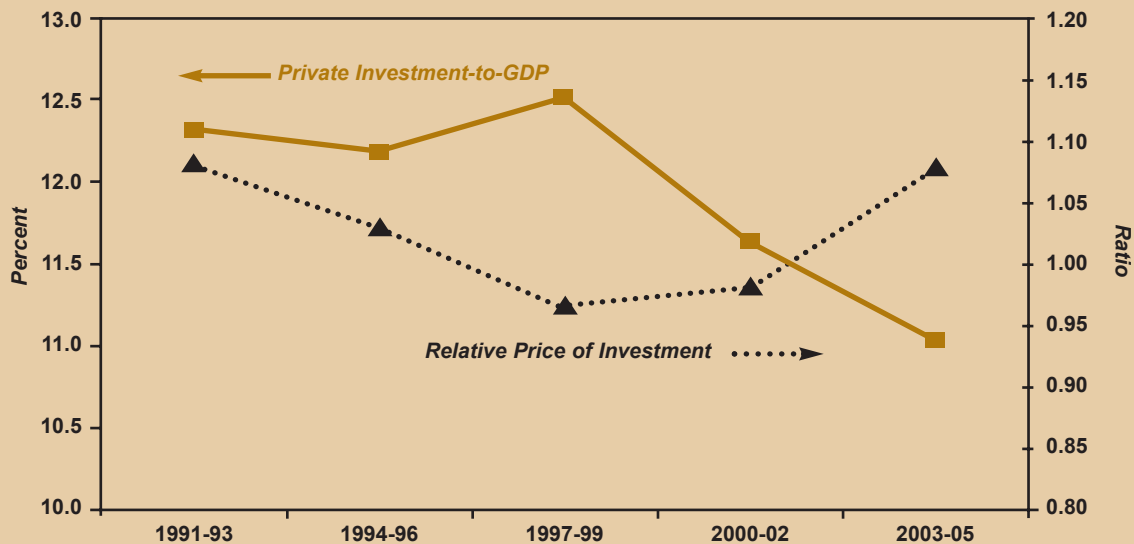


\*For 2006, 2007 projected growth of 7% has been used  
**Source:** Actual is from Pakistan Economic Survey 2004-05  
 Trend is SPDC estimate based on popular statistical filter (Hodrick-Prescott Filter)

displayed in Chart 4. Investment, which was hovering at an already modest 12½ percent of GDP during the 1990s, has declined further, to about 11 percent of GDP, on average, during the period 2003-05. This

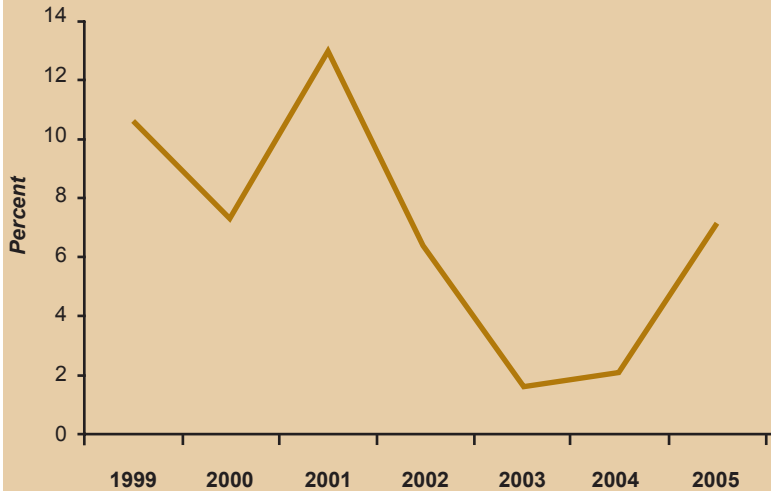
has occurred despite strong imports of machinery and capital goods. The fall is probably due in part to an increase in interest rates, from a low of 2 percent in FY2003 to more than 7 percent in FY2005,

**CHART 4  
INVESTMENT**



**Source:** SPDC estimates based on data from Pakistan Economic Survey, 2004-05 and 2002-03.

**CHART 5  
INTEREST RATE (T-BILL RATE)**



Source: State Bank of Pakistan (<http://www.sbp.org.pk/ecodata/sir.pdf>).

in order to combat inflationary pressures (Chart 5). Also contributing, probably, to a decline in the investment-to-GDP ratio, is the rise in the relative price of investment (Chart 4). Both a rise in interest rates and

an increase in the relative price of capital increases the user cost of capital, thus discouraging investment.

### Employment

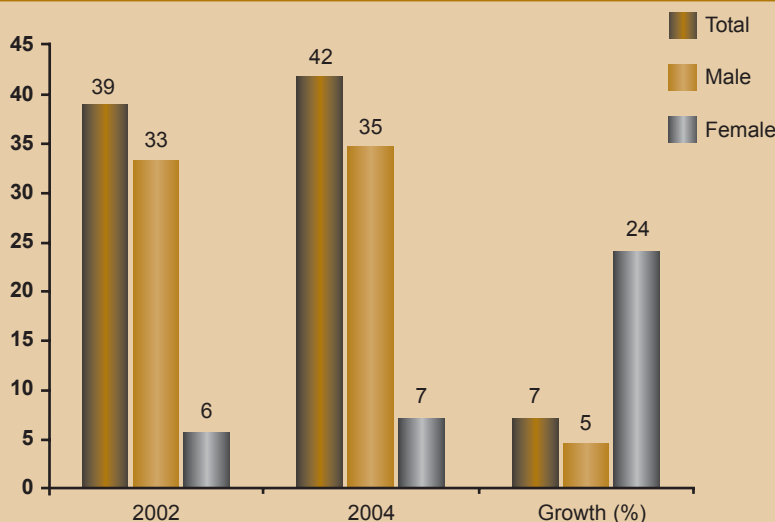
More direct evidence of what the sharp expansion of economic activity has done to employment can be gathered from analyzing the changes in sectoral and overall labour force participation rates from two consecutive Labour Force Surveys (2001-02 and 2003-04). As shown in Chart 6, the latest Survey implies a fairly robust 7 percent growth of the employed labour force during the

period. While the male employed labour force grew by 5 percent, it is surprising that the employment of female workers grew at an extraordinarily high pace of 24 percent.

Interestingly, about 85 percent of the recorded gains in female employment and over half of the recorded gains in male employment occurred in rural areas. Out of the overall 7 percent growth in labour force participation, only 2 percentage points of this could be attributed to growth recorded in urban areas.

Chart 7 relates growth in sectoral GDP to the growth in sectoral employed labour force during the period FY2002 to FY2004. The growth in employment of 10 percent recorded in agriculture over this period--and the rural employment growth patterns discussed

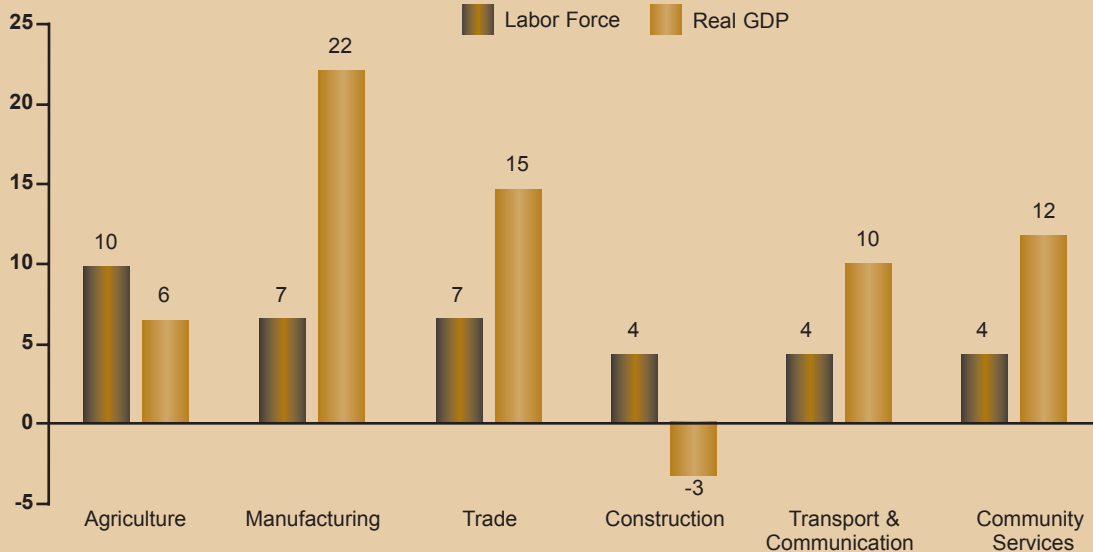
**CHART 6  
DYNAMICS OF EMPLOYED LABOUR FORCE  
[2002-2004, Million Persons]**



Source: Labour Force Survey (various issues)

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**CHART 7**  
**SECTORAL GROWTH 2002-2004**  
*[Percentage]*



Source: SPDC estimates

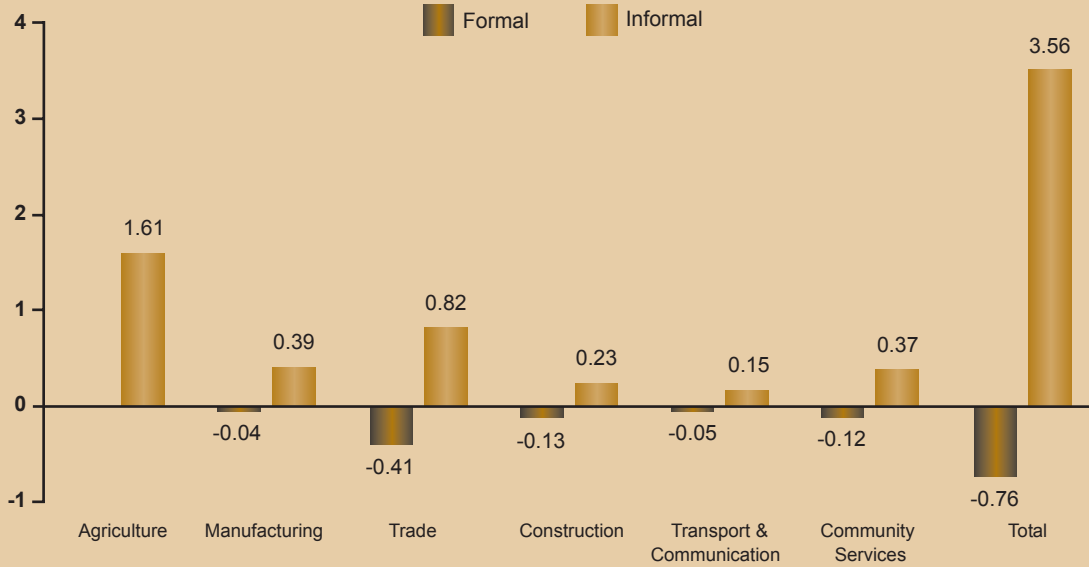
above--translated into only a 6 percent increase in agricultural sector GDP. This suggests that other factors, such as capital, might have been lagging behind in the agriculture sector over the period. By contrast over the same period of 2002-2004, while the employed labour force in manufacturing grew only about 7 percent, real GDP of manufacturing increased a solid 22 percent, the highest gain of all the major sectors shown. This is suggestive of higher productivity and/or more capacity utilization in this sector, which were also hinted at by our growth accounting exercise discussed earlier. However, the phenomenon merits further detailed investigation and research. Another interesting aspect of the dynamic behaviour of employment and GDP is visible in the construction sector. Despite 4 percent growth in the labor force from 2002 to 2004 in this sector, a decline in real GDP is recorded.

Growth of the non-agricultural labour force disaggregated into formal and informal

sectors, exposes another area of concern. For statistical purposes, the non-agriculture informal sector in Pakistan is defined as follows: all household enterprises owned and operated by own-account workers, irrespective of the size of the enterprises; or household enterprises owned and operated by employers with less than 10 persons engaged. As shown in Chart 8, all non-agriculture formal sectors registered declines in employment over the period 2002-2004. Apparently, all of the growth in the non-agriculture employed labor force (about 2 million) is recorded in the informal sector. Thus the employment-generating part of the high GDP growth in the manufacturing and service sectors observed during the period appears to be due to expansions in informal sectors only, which raises some questions.

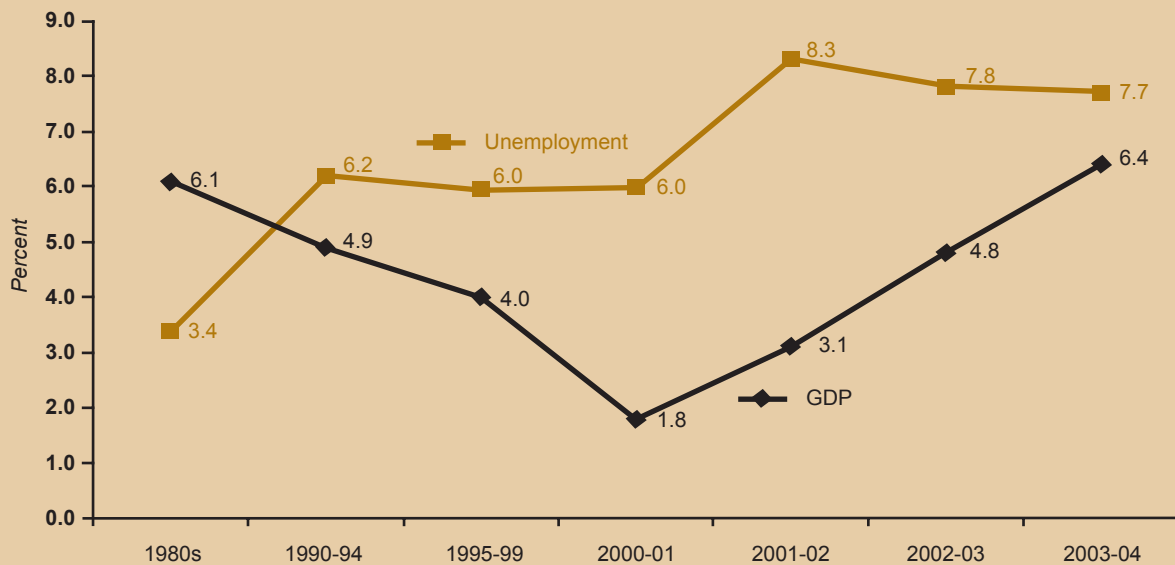
There is an evident decline in the unemployment rate, as depicted in Chart 9. The data show that the overall unemployment rate has decreased from 8.3

**CHART 8**  
**CHANGE IN LABOR FORCE 2002-2004**  
*[Million Persons]*



Source: Labour Force Survey (various issues)

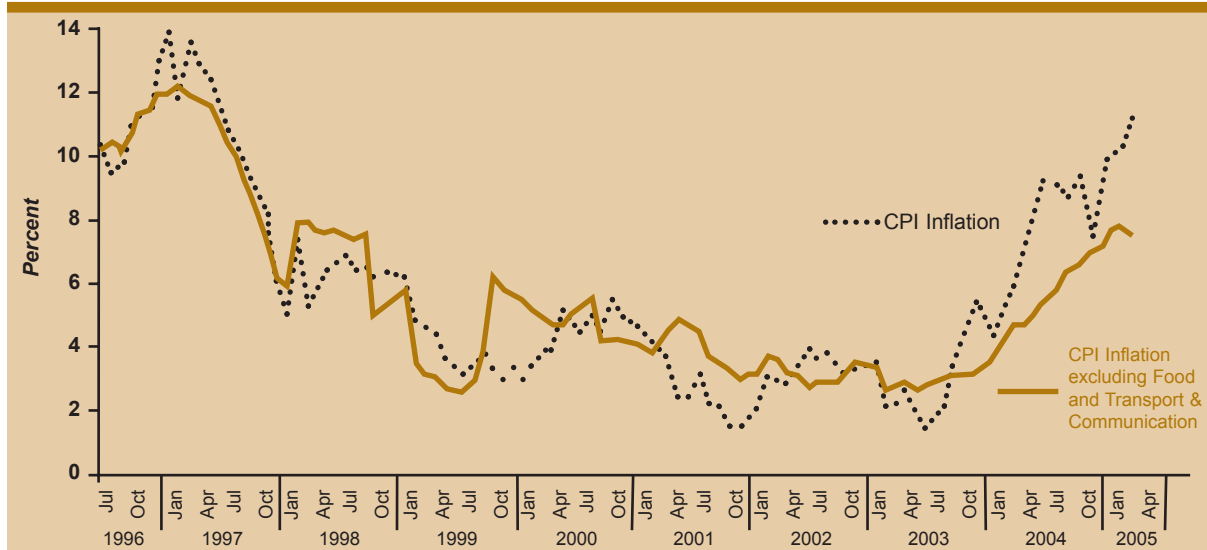
**CHART 9**  
**TREND IN UNEMPLOYMENT RATE**



Source: Pakistan Economic Survey (various issues)

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**CHART 10**  
**CPI INFLATION (12-MONTH CHANGES)**



Source: Based on data from SBP Annual Report (various issues)

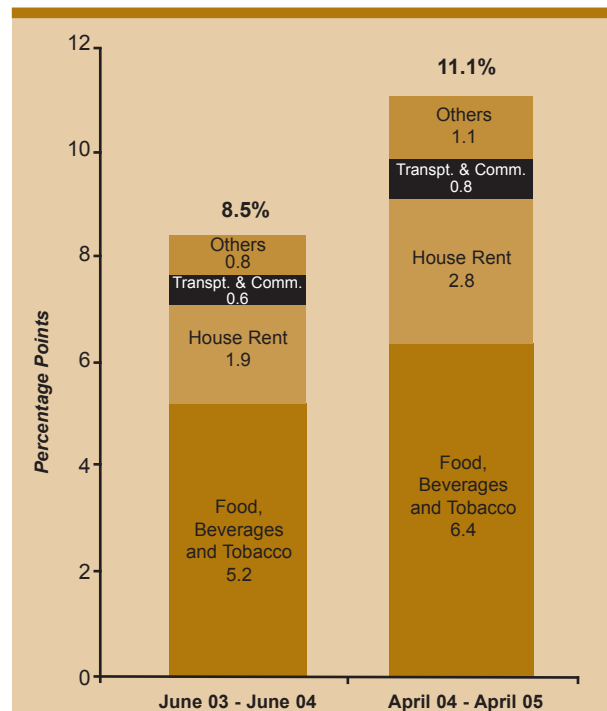
percent in 2001-02 to 7.7 percent in 2003-04. Thus, the high GDP growth recorded over the period is making a dent into unemployment, but it should be noted that the unemployment rate still remains far above the average rate of 3.4 percent that prevailed in the 1980s.

### Inflation

Following a generally declining trend since about the mid-1990s, inflation has picked up sharply since last year, reaching double-digit levels in April on the basis of 12-month changes in consumer prices (Chart 10). The chart also demonstrates that the rise in inflation has not just been restricted to increases in food and transport and communications prices (which include the price of oil). A measure of CPI inflation that excludes these two components (also graphed in Chart 10) still shows a doubling from about 4 percent to 8 percent over the past year.

The contributions to inflation of the different components of the CPI are shown in Chart 11. Of the 8.5 percent rise in consumer prices from June 2003 to June

**CHART 11**  
**CONTRIBUTIONS OF COMPONENTS TO 12-MONTH CPI INFLATION**



Source: SPDC estimates based on data from SBP Annual Report (various issues)

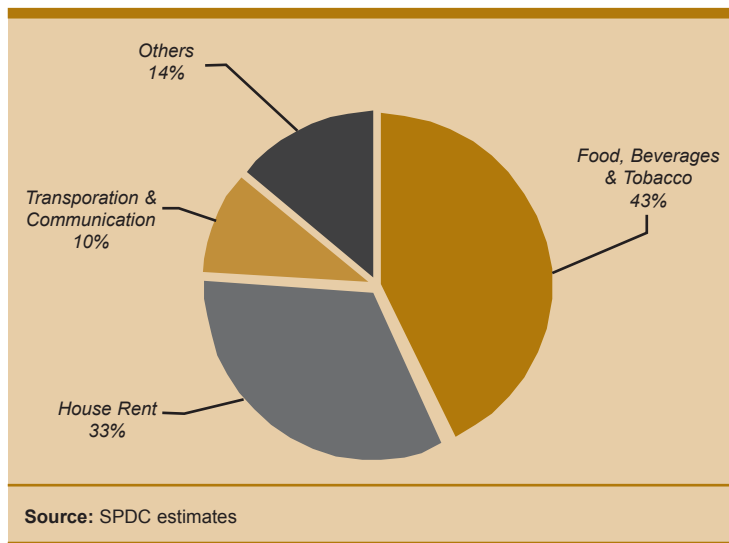
2004, 5.2 percentage points (or 63 percent) was accounted for by rises in food prices and another 1.9 percentage points by increases in the house rent component. Between April 2004 and April 2005, food price increases continued to be a heavy contributor to inflation, adding 6.4 percentage points to CPI inflation, but the house rent component and other components also added significantly, 2.8 percentage points and 1.1 percentage points, respectively.

Chart 12 displays the proportion of the change in CPI inflation between FY2004 and FY2005 that can be accounted for by the different components. Together, food prices and transportation and communications prices account for a little over a half of the increase in inflation in FY2005. In other words, nearly half of the rise in inflation from the previous year is accounted for by an increase in the house rent and other components. This suggests that demand-side pressures to inflation have now built up significantly in addition to supply-side pressures that work through volatile oil and food prices.

This merits further investigation. According to macroeconomic theory, one of the key determinants of fundamental inflationary pressures in the economy is the output gap, the deviation of actual output from potential output. If the output gap is positive--that is, the actual output of the economy is above the level that can be sustained in the long run--there is a tendency for inflation to increase due to capacity constraints, overtime shifts, bottlenecks, running down of inventories, etc. On the other hand, if there is spare capacity and actual output is below potential, there is a tendency for the rate of inflation to decline. This does not, of course, mean that higher growth rates lead to higher inflation necessarily. If actual growth is high, but the productive capacity of the economy is keeping pace and the extra output being demanded is being produced easily, there should be no pressure on inflation to increase. Or, if actual growth is high relative to potential growth, but the economy had been mired in a recessionary situation where the actual *level* of output to begin with was much lower than the *level* of potential output, then actual output growing faster is just a catching up process and should not lead to higher inflation.

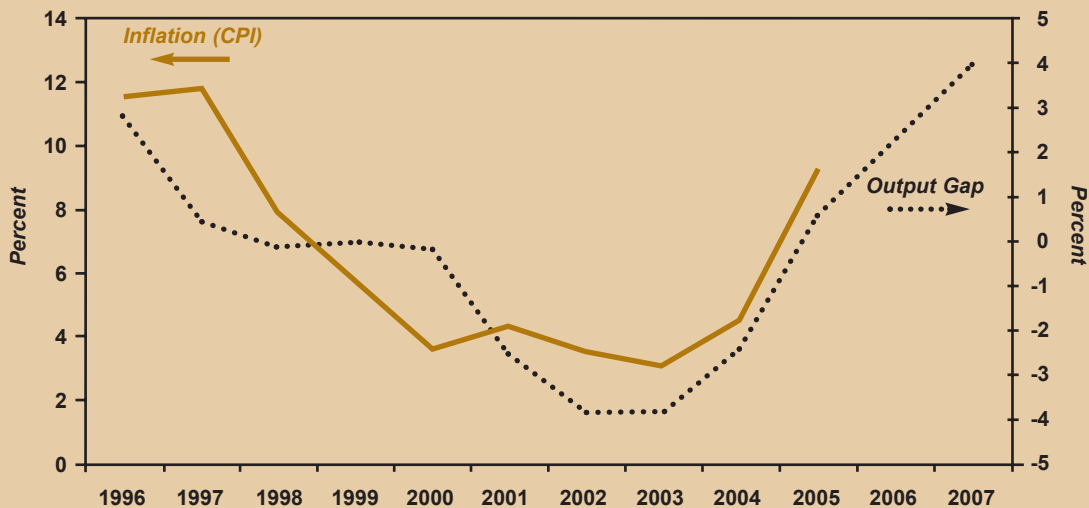
So what does the output gap situation of Pakistan look like, and what implications does this have for inflation? Based on the estimates of potential output that we obtained earlier (which we again emphasize are meant to be illustrative only), since the mid-1990s, Pakistan's output gap has generally been falling and inflation has shown a tendency to fall with it (Chart 13). In 2003, the output gap turned around and started to rise, and it is about the same time that inflation also turned around and started to pick up. However, the output gap was still negative

**CHART 12**  
**CONTRIBUTION SHARES OF INCREASE IN**  
**CPI INFLATION FROM 2004 TO 2005**





**CHART 13**  
**RELATIONSHIP BETWEEN OUTPUT GAP\* AND INFLATION**



\*Output Gap is percent deviation of actual output from potential output. Potential output is computed from a statistical filter (Hodrick Prescott Filter). Growth of 7% is assumed in 2006 and 2007 in working the projections of output gap for these years.

Source: SPDC estimates

until last year. Now it has turned positive in FY2005 and, with forecasted growth of 7 percent in 2006 and 2007, the output gap will pick up further. On this count, inflationary pressures, unless checked appropriately will become more severe.

We have also estimated an econometric equation for inflation based on determinants that are suggested by economic theory. The model incorporates the effects of the output gap as mentioned above, expectation or inertial effects through the previous year's inflation rate, pass-through from nominal exchange rate changes, the impact of the world price of imports (including oil imports), and the influence of changes in excess liquidity in the market, proxied by the lagged value of growth in the money supply-to-GDP ratio. The model fits fairly well on statistical criteria and is able to explain about two-thirds of the variation in the CPI inflation rate.

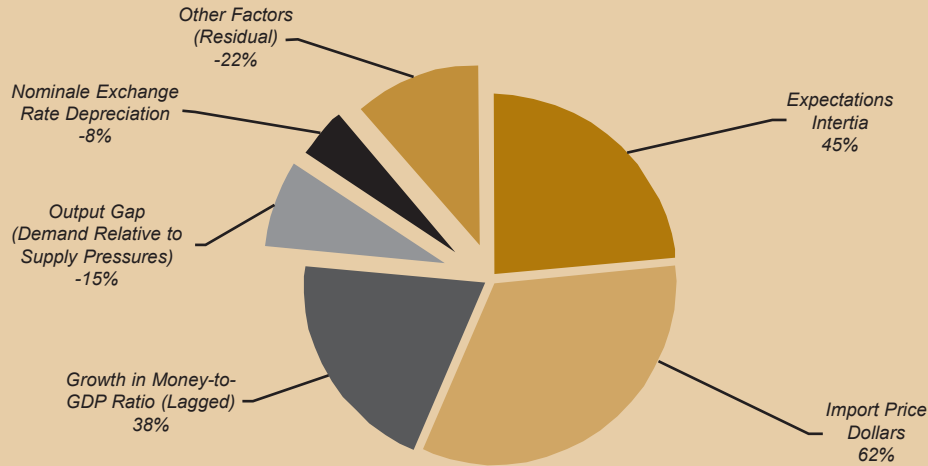
The sources of inflation based on this model for FY2004 and FY2005 are shown in

Chart 14. The contribution of the world price of imports was quite large in FY2004--the model's predicted effect on inflation from changes in world price of our imports was 62 percent of the actual inflation rate for that year. Changes in the money supply-to-GDP ratio have made less of a contribution to inflation this year than last year, but the contribution is still positive. The model also helps us to assess price pressures for next year. First, with a rise in inflation this year, the expectations effects which are quite large will only exacerbate. Second, if the rupee depreciates more, this will have some pass through effects on inflation. Third, the output gap turned positive this year with the implication that it has now become a source of inflationary pressure. These three factors will not necessarily automatically dissipate with a deceleration of food prices and world oil prices, and the now tightening stance of monetary policy needs to be maintained.

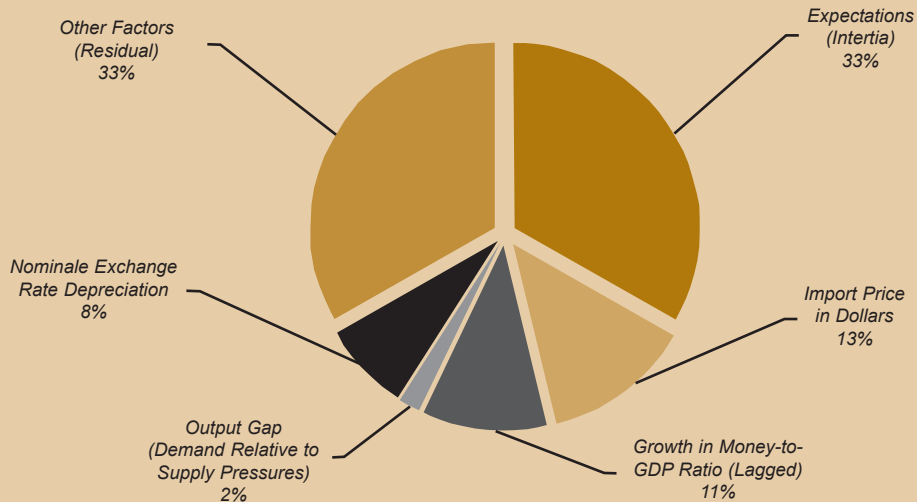
Chart 14 also shows that about a third of the inflation rate in FY2005 is not explained by

CHART 14  
SOURCES OF CPI INFLATION

(FY 2004)



(FY 2005)



Source: SPDC estimates

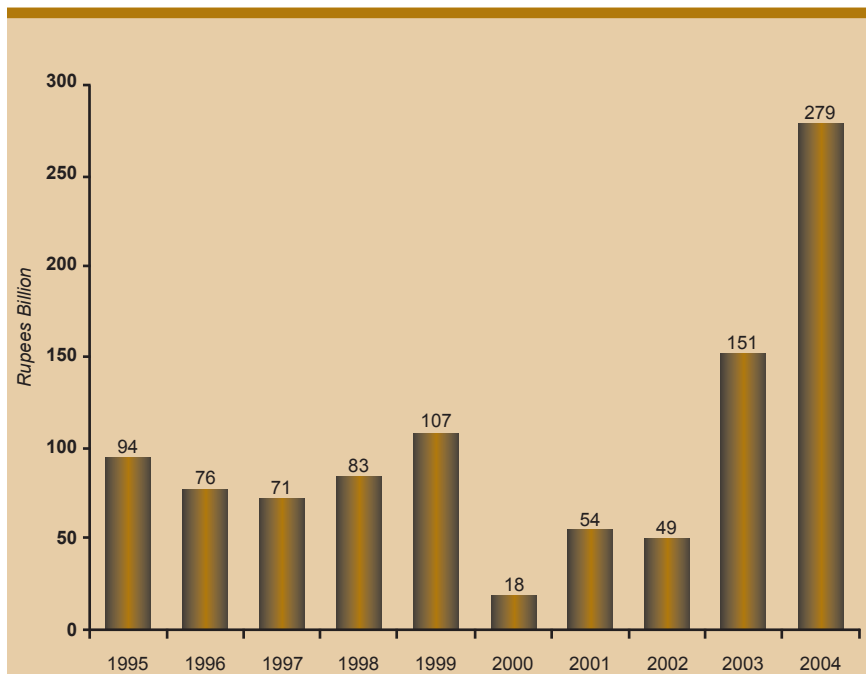
the variables in our equation but accounted for by other factors not modeled, i.e. the residual. One of these non-modeled factors might be the recent expansion of real credit to the private sector, for which we do not have consistent data for a long enough period to be able to incorporate this variable directly in our equation.

As can be seen from Chart 15, real credit to the private sector has certainly

expanded sharply over the past two years. No doubt this growth in credit has contributed to the recent strength of the economy, but the relationship between credit and growth can be tricky one. Cross-country evidence establishes a positive relationship between financial development and growth. But, this holds only up to a point. There is also evidence that once credit goes beyond the point that can be

## An Overheating Economy?

**CHART 15**  
**REAL CREDIT TO THE PRIVATE SECTOR**



Source: SPDC estimates based on data from SBP, Annual Report (various issues)

### External Sector

The trade deficit widened to \$3.4 billion during the period of July 2004 to March 2005 from its value of \$0.6 billion over the same nine months a year ago (Table 4). This reflected import growth of about 40 percent (from about \$10 billion to \$14 billion), which outpaced export growth of 15 percent (from \$9 billion to about \$10½ billion). With the deficit on the services balance also doubling, the current account during the period registered a deficit of \$1.4 billion compared to a surplus

safely supported by the banking system and the existing regulatory environment, it can have adverse effects on the economy. Of course, when credit growth becomes excessive is in the eye of the beholder and, clearly, more research needs to be done on this issue.

On balance, the above evidence appears to suggest a need for some cooling off of demand in the short run, while at the same time continuing policies and changes that would in the long run create an enabling environment for growth in the range of 7 percent to 8 percent to become sustainable.

**TABLE 4**  
**CURRENT ACCOUNT**

(US \$ Million)

	FY 2003	FY 2004	July - March	
			FY 2004	FY 2005
<b>Trade Balance</b>	<b>-444</b>	<b>-1212</b>	<b>-645</b>	<b>-3378</b>
Exports (f.o.b)	10889	12395	9175	10572
Imports (f.o.b)	-11333	-13607	-9820	-13950
<b>Services (Net)</b>	<b>-2128</b>	<b>-3585</b>	<b>-2240</b>	<b>-4238</b>
Receipts	2967	2914	2382	2660
Payments	-5095	-6499	-4622	-6898
Shipment	-951	-1241	-887	-1266
Investment Income	-2381	-2392	-1691	-1884
Others	-1763	-2866	-2044	-3748
<b>Private Unrequited Transfers (net)</b>	<b>5737</b>	<b>6110</b>	<b>4390</b>	<b>6258</b>
(Workers Remittances)	4237	3871	2875	3051
<b>Current Account Balance</b>	<b>3165</b>	<b>1313</b>	<b>1505</b>	<b>-1358</b>
<b>Trade Balance as % of GDP</b>	<b>1.3</b>	<b>3.4</b>	<b>-</b>	<b>-</b>
<b>Current Account Balance as % of GDP</b>	<b>3.8</b>	<b>1.4</b>	<b>-</b>	<b>-</b>

Source: Pakistan Economic Survey, 2004-05

of \$1.5 billion over the same months a year ago. However, the current account deficit

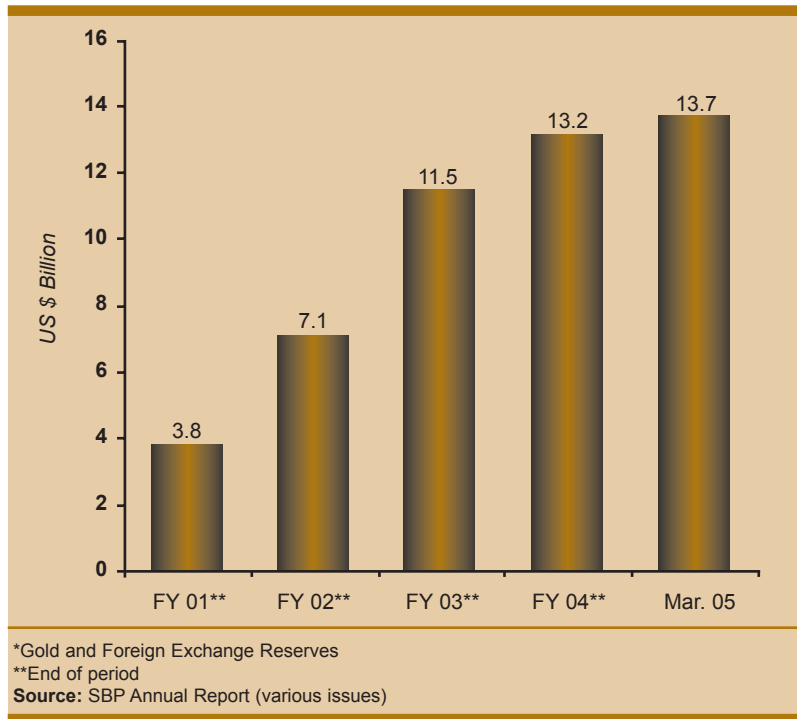
so in the near future. That said, if the current account deficit gets much worse and persists, this could have credibility effects that could jeopardize macroeconomic stability and make it's financing more difficult through an increase in the country risk premium.

Over the past year or so, the rupee has depreciated more than 3 percent against the dollar (Chart 17). However, this development by itself is unlikely to improve our competitiveness and boost our exports relative to imports because our inflation rate has been much higher than that of our trading partners. Adjusting for this price differential, a trade-weighted real effective exchange rate (REER) that we have computed shows an appreciation, on balance, over the past year (Chart

17). However, the REER remains at a depreciated level, relative to historical averages.

The behavior of major exports is shown in Table 5. Over the nine-month period from July 2004 to March 2005, total exports grew about 15 percent compared with the same period a year earlier. This was higher than growth of 10 percent in exports recorded in FY2004 relative to FY2003. Note that exports of textiles manufactures, which last year constituted about two-thirds of total exports, increased just 2.1 percent. However this slow growth was made up by 23.4 percent growth in exports of primary commodities (led by raw cotton), 22.4 percent growth in exports of other manufactures, and 90.3 percent growth in exports of other goods. While the diversification of Pakistan's export base is a

**CHART 16**  
**INTERNATIONAL RESERVES\***

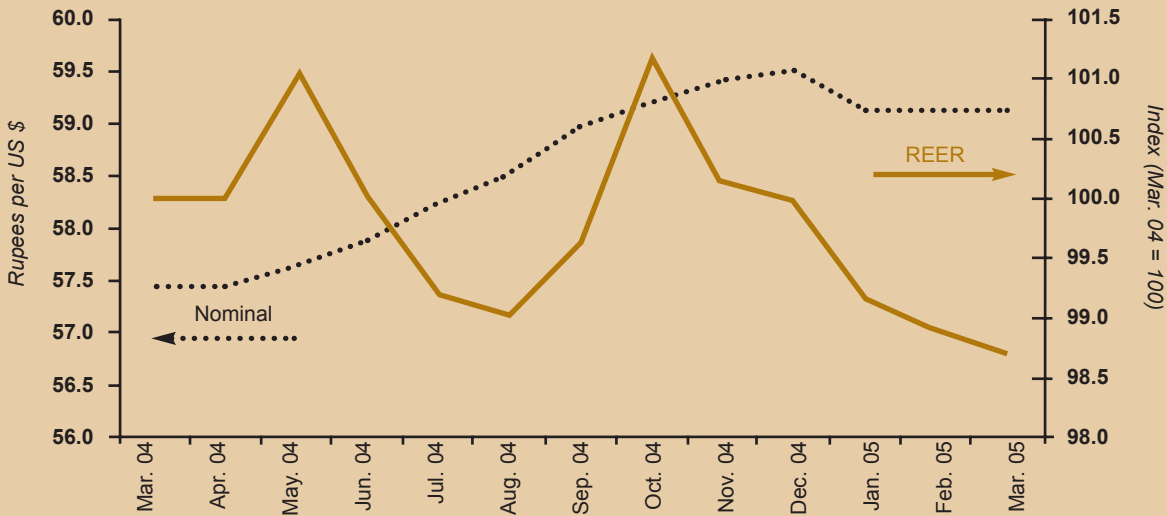


was much less than the deficit on merchandise trade and services combined (\$7.6 billion) during the July 2004 to March 2005 period because net private unrequited transfers were positive to the tune of \$6.2 billion. In particular, workers' remittances from abroad have started to increase again, rising to about \$3 billion during the period.

Even though the current account has dipped into the red, financing it is not an issue at the moment. The central bank's war chest of international reserves, graphed in Chart 16, has continued to rise and stood at nearly \$14 billion in March 2005. However, expressed in relation to imports, reserves have fallen to about 9 months of imports from 12 months of imports in FY2004. The government also has been able to tap international markets at better terms and should be able to continue to do

## An Overheating Economy?

**CHART 17  
EXCHANGE RATES**



Source: Nominal: from SBP Statistical Bulletin  
REER (Real Effective Exchange Rate):SPDC estimates  
Note: A rise in exchange rate represents a depreciation of the rupee.

welcome development, the relatively weak performance of textiles manufactures does not augur well for making inroads in the post-textile quota environment, although it is probably too early to tell just yet. One possible reason for the relatively weak performance of textiles in value terms might be that gains in export volume (quantity) are being offset by decreases in export unit values. In that case, we should see higher (and positive) growth rates of volumes compared to those of values, which does not appear to be the case generally, except for towels and ready-made garments.

Table 6 reveals that total imports rose nearly 40 percent during the July 2004 to March 2005 period, relative to their value during the same months a year ago. This came on the heels of strong import growth last year as well. Strong increases were recorded in nearly all major groups with growth of 20.8 percent in food imports (led by wheat), 54.9 percent in machinery imports (which constitute about a third of all imports), 30.9 percent in petroleum and

petroleum products, and 32.9 percent in imports of agriculture and chemical goods (including fertilizer and insecticides). Considering components within the broad groups, the increases in import volume growth are generally less pronounced than that of import value growth, reflecting increases in unit values of imports as well.

As shown in Table 7, the growth rates of imports by type of good during the July 2004 to December 2004 period from a year earlier were 30.9 percent for capital goods, 57.7 percent for raw material for capital goods, and 32.9 percent for raw material for consumer goods. Consumer goods imports have also been strong, rising 41.5 percent, but they have a share of only 10 percent. There is, thus, much to the argument that imports are of the productive kind and could lead down the road to much stronger export performance. However, it is not heartening that despite strong imports of capital goods, including machinery, the performance of private fixed investment (discussed earlier) has been rather weak.

**TABLE 5  
MAJOR EXPORTS**

	(Values in US \$ Million)																	
	FY 2003			FY 2004			Growth (%)			July-March FY 2004			July-March FY 2005			July-March Growth (%)		
	Value	% Share	Quantity	Value	% Share	Quantity	Value	% Share	Quantity	Value	% Share	Quantity	Value	% Share	Quantity	Value	% Share	Quantity
<b>Primary Commodities</b>	<b>1012</b>	<b>9.1</b>	-	<b>1017</b>	<b>8.3</b>	<b>0.5</b>	<b>8.3</b>	<b>0.5</b>	-	<b>744</b>	<b>8.4</b>	<b>8.4</b>	<b>919</b>	<b>9.0</b>	<b>23.4</b>	<b>9.0</b>	<b>9.0</b>	-
Rice	556		0.2	635		14.2		14.2	0.2	461			602		30.4			31.0
Raw cotton	49		-32.3	48		-2.7		-2.7	-32.3	35			94		171.4			190.0
Fish & Fish Preparation	135		13.7	153		13.7		13.7	10.8	115			98		-15.4			-24.0
Fruits	83		23.4	103		23.4		23.4	36.9	77			71		-7.8			-21.0
Vegetables	32		-0.6	31		-0.6		-0.6	-11.4	18			17		-5.6			-48.0
Tobacco	5		106.1	11		106.1		106.1	-	9			7		-22.2			-27.0
Wheat	130		-95.4	6		-95.4		-95.4	-96.2	6			-		-			-
Spices	16		20.0	19		20.0		20.0	17.2	15			10		-35.9			-32.0
Oil seeds, nuts and kernels	7		55.6	11		55.6		55.6	34.4	8			21		162.5			247.0
<b>Textile Manufactures</b>	<b>7264</b>	<b>65.1</b>	-	<b>8073</b>	<b>65.6</b>	<b>11.1</b>	<b>65.6</b>	<b>11.1</b>	-	<b>5850</b>	<b>65.7</b>	<b>65.7</b>	<b>5972</b>	<b>58.5</b>	<b>2.1</b>	<b>58.5</b>	<b>58.5</b>	-
Cotton Yarn	928		-3.9	1127		21.4		21.4	-3.9	848			729		-13.9			-9.0
Cotton Cloth	1346		18.3	1712		27.2		27.2	18.3	1221			1333		9.2			5.0
Knitwear	1147		27.2	1459		27.2		27.2	27.3	1031			1265		22.8			10.0
Bedwear	1329		4.1	1383		4.1		4.1	1.0	1008			910		-9.7			-1.0
Towels	375		7.7	404		7.7		7.7	1.2	277			345		24.5			32.0
Ready-made Garments	1093		-9.1	993		-9.1		-9.1	-24.3	733			754		2.9			11.0
Synthetic Textile	574		-18.0	471		-18.0		-18.0	-16.9	375			221		-41.1			-39.0
Others	472		11.2	525		11.2		11.2	-	359			415		15.6			-
<b>Other Manufactures</b>	<b>2043</b>	<b>18.3</b>	-	<b>2149</b>	<b>17.5</b>	<b>5.2</b>	<b>17.5</b>	<b>5.2</b>	-	<b>1590</b>	<b>17.9</b>	<b>17.9</b>	<b>1946</b>	<b>19.1</b>	<b>22.4</b>	<b>19.1</b>	<b>19.1</b>	-
Carpets, Rugs & Mats	221		4.8	231		4.8		4.8	-2.6	164			188		14.3			9.0
Petroleum & Petroleum Products	249		-1.8	295		18.5		18.5	-1.8	194			316		62.9			36.0
Sports Goods	335		-3.1	325		-3.1		-3.1	-	229			212		-7.6			-
Leather Tanned	235		7.2	252		7.2		7.2	4.6	177			202		14.7			11.0
Leather Manufactures	387		7.2	414		7.2		7.2	-	311			347		11.6			-
Footwear	12		-13.6	11		-13.6		-13.6	27.7	65			83		27.7			53.0
Surgical Goods & Instruments	150		-11.6	133		-11.6		-11.6	-	100			118		17.9			-
Cutlery	30		0.3	30		0.3		0.3	24.0	21			20		-4.8			-
Onyx Manufactured	12		-1.8	12		-1.8		-1.8	2.0	8			7		-12.5			-15.0
Chemicals & Pharmaceuticals	261		0.8	263		0.8		0.8	-	196			256		30.5			-
Engineering Goods	74		35.1	100		35.1		35.1	-	69			115		66.9			-
Gems & Jewelry	25		13.8	28		13.8		13.8	-	20			17		-15.0			-
Furniture	8		15.5	10		15.5		15.5	-	7			9		28.6			-
Molasses	45		3.1	47		3.1		3.1	14.5	29			56		93.1			11.0
<b>Others</b>	<b>841</b>	<b>7.5</b>	-	<b>1075</b>	<b>8.7</b>	<b>27.7</b>	<b>8.7</b>	<b>27.7</b>	-	<b>720.6</b>	<b>8.1</b>	<b>8.1</b>	<b>1371</b>	<b>13.4</b>	<b>90.3</b>	<b>13.4</b>	<b>13.4</b>	-
<b>Total</b>	<b>11160</b>	<b>100.0</b>	-	<b>12313</b>	<b>100.0</b>	<b>10.3</b>	<b>100.0</b>	<b>10.3</b>	-	<b>8905</b>	<b>100.0</b>	<b>100.0</b>	<b>10207</b>	<b>100.0</b>	<b>14.6</b>	<b>100.0</b>	<b>100.0</b>	-

Source: Pakistan Economic Survey 2004-05, SBP Annual Report (2003-04), and SBP Third Quarterly Report 2004-05

**TABLE 6  
MAJOR IMPORTS**

(Values in US \$ Million)

	FY 2003		FY 2004		Growth (%)		July-March FY 2004		July-March FY 2005		July-March Growth (%)	
	Value	% Share	Value	% Share	Value	Quantity	Value	% Share	Value	% Share	Value	Quantity
<b>Food Group</b>	<b>978</b>	<b>8.0</b>	<b>1033</b>	<b>6.6</b>	<b>5.7</b>	-	<b>781</b>	<b>7.4</b>	<b>942</b>	<b>6.5</b>	<b>20.6</b>	-
Wheat Unmilled	29		24		-17.8	-27.0	15		56		271.5	306.0
Tea	173		193		11.5	7.2	151		175		15.7	15.0
Soyabean Oil	48		46		-4.0	2.3	40		49		21.3	-22.0
Palm Oil	539		613		13.7	5.7	466		478		2.5	2.0
Pulses	116		75		-35.2	33.7	53		83		56.8	50.0
Others	74		84		12.8		56		102		82.4	-
<b>Machinery Group</b>	<b>2942</b>	<b>24.1</b>	<b>4220</b>	<b>27.1</b>	<b>43.4</b>	-	<b>2513</b>	<b>23.9</b>	<b>3892</b>	<b>26.9</b>	<b>54.9</b>	-
Power Generating	269		278		3.5	-	205		273		32.7	-
Textile	532		598		12.4	-	419		697		66.3	-
Construction & Mining	101		102		0.2	-	73		112		53.6	-
Electrical & apparatus	217		258		19.1	-	180		228		27.0	-
Road Motor Vehicles	501		653		30.2	-	482		706		46.5	-
Others	1323		2332		76.3	-	1153		1876		62.7	-
<b>Petroleum Group</b>	<b>3066</b>	<b>25.1</b>	<b>3167</b>	<b>20.3</b>	<b>3.3</b>	-	<b>2108</b>	<b>20.1</b>	<b>2761</b>	<b>19.1</b>	<b>30.9</b>	-
Petroleum Products	1700		1401		-17.6	35.9	936		1149		22.9	8
Petroleum Crude	1367		1765		29.2	16.2	1173		1611		37.4	19
<b>Textile Group</b>	<b>222</b>	<b>1.8</b>	<b>261</b>	<b>1.7</b>	<b>17.6</b>	-	<b>194</b>	<b>1.8</b>	<b>238</b>	<b>1.6</b>	<b>22.6</b>	-
<b>Agril/Other Chemical Group</b>	<b>2161</b>	<b>17.7</b>	<b>2798</b>	<b>17.9</b>	<b>29.5</b>	-	<b>1972</b>	<b>18.8</b>	<b>2621</b>	<b>18.1</b>	<b>32.9</b>	-
Fertilizer	240		285		18.7	4.1	191		262		37.5	10.0
Insecticides	59		124		112.1	86.2	78		107		37.2	29.0
Plastic Material	421		549		30.4	18.0	387		581		50.1	33.0
Medicinal Products	222		275		23.8	8.9	201		200		-0.5	17.0
Other	1219		1565		28.3	-	1115		1471		31.9	-
<b>Metal Group</b>	<b>507</b>	<b>4.2</b>	<b>688</b>	<b>4.4</b>	<b>35.5</b>	-	<b>477</b>	<b>4.5</b>	<b>857</b>	<b>5.9</b>	<b>79.6</b>	-
Iron & Steel	402		512		27.3	15.0	351		625		78.1	84.0
other	105		176		67.2	-	126		232		83.7	-
<b>Miscellaneous/Others</b>	<b>2344</b>	<b>19.2</b>	<b>3426</b>	<b>22.0</b>	<b>46.2</b>	-	<b>2452</b>	<b>23.4</b>	<b>3158</b>	<b>21.8</b>	<b>28.8</b>	-
<b>Total</b>	<b>12220</b>	<b>100.0</b>	<b>15592</b>	<b>100.0</b>	<b>27.6</b>	-	<b>10497</b>	<b>100.0</b>	<b>14469</b>	<b>100.0</b>	<b>37.8</b>	-

Source: Pakistan Economic Survey 2004-05, SBP Annual Report (2003-04), and SBP Third Quarterly Report 2004-05

**TABLE 7**  
**IMPORTS BY ECONOMIC CATEGORIES**

(US \$ Million)

Categories	FY 2004		FY 2005		% Change (3 over 1)
	(July - December)		(July - December)		
	Value (1)	% Share (2)	Value (3)	% Share (4)	
Capital Goods	2084	32	2729	31	31
Raw Material for Capital Goods	450	7	710	8	58
Raw Material for Consumer Goods	3418	52	4542	51	33
Consumer Goods	658	10	932	10	42
Total	6611	100	8913	100	35

Source: SPDC estimates based on data from Pakistan Economic Survey 2004-05

modestly because the poverty-reducing effects of growth are partially offset by the poverty-inducing effects of increases in food prices and a fall in investment as a share of GDP.

We would prefer to let the data speak for itself about how the relationship between per capita growth and inequality

### **Poverty and Social Development**

The recent Pakistan Economic Survey enlightens us that "Readers would have to wait till December 2005 to get estimates of poverty from the Provincial level survey of the PSLM which is focusing on household consumption and expenditure.... The estimates of poverty for 2004-05 would then be available for all of us."

SPDC's large-scale ISPM model has a poverty and inequality module in it. Poverty is estimated to be a function of per capita income and income inequality; inequality, in turn, is estimated to be function of variables such as per capita income, food prices, investment-output ratio, and development expenditures as a share of GDP, etc. In principle, therefore, we have the expertise to forecast poverty for 2005 but, in practice, this requires us to take a stand on what is happening to inequality or how the relationship between per capita income and inequality has changed recently. If we take the historical relationship between per capita growth and inequality, then our model predicts poverty to have gone up because historically per capita growth has been accompanied by significant increases in income inequality. On the other hand, if we assume that the recent per capita growth is distribution-neutral, then poverty is projected to have gone down, but only

has changed and, therefore, eagerly await the new PSLM/HIES survey. Meanwhile, let's focus on social development and relate it to economic performance. There is now widespread dissatisfaction with per capita income as the sole indicator to measure the well-being of a nation in any case. The emphasis has now shifted to alternative measures of development. Social indicators, quality of life, basic needs, human development, and standard of living are the new approaches, which are being discussed and propagated by international institutions and concerned scholars. Interest in social development as a development policy objective appears to have been promoted by the observed unevenness in the economic performance of developing countries. In many cases, despite positive and high GDP growth rates, economic development has failed to reach all segments of society and the poorest have hardly reaped any of the benefits of development.

To summarize various social indicators, we constructed a Social Development Index (SDI) for Pakistan using the "Principal Component" statistical technique for the period 1960-2004. The choice of component variables for forming the composite SDI is primarily governed by the availability of consistent time series data. Individual indicators used to create the



## An Overheating Economy?

**TABLE 8  
COMPONENTS OF SDI**

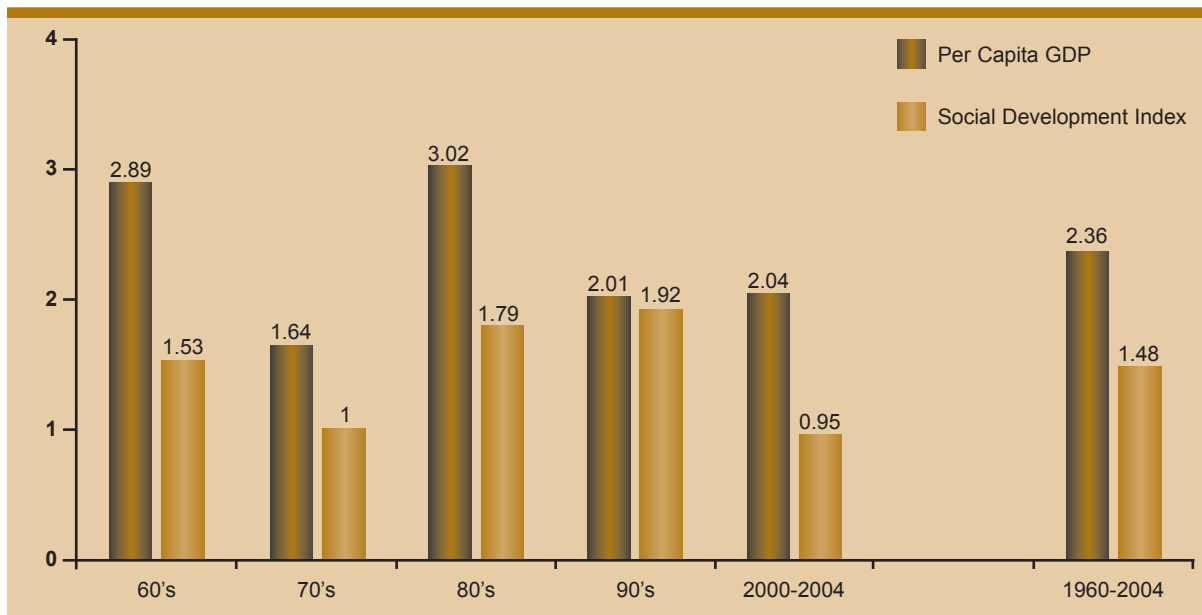
<b>Health:</b>
Physicians Per Million Population
Hospital Beds Per Million Population
Infant Survival Rate Per 1000 Live Births
<b>Education:</b>
Primary Male Enrollment Rate
Primary Female Enrollment Rate
Secondary Male Enrollment Rate
Secondary Female Enrollment Rate
Tertiary Male Enrollment Rate
Tertiary Female Enrollment Rate
<b>Consumption:</b>
Cars Per Million Population
Telephone Per Million Population
Proportion of Non-Agriculture Labor Force
Electricity Generation Per Million Population

components of the SDI represent health services, education facilities, and consumption of durable goods and energy. The constituent variables of the SDI are

listed in Table 8. All data on these variables are taken from various issues of the Pakistan Economic Surveys.

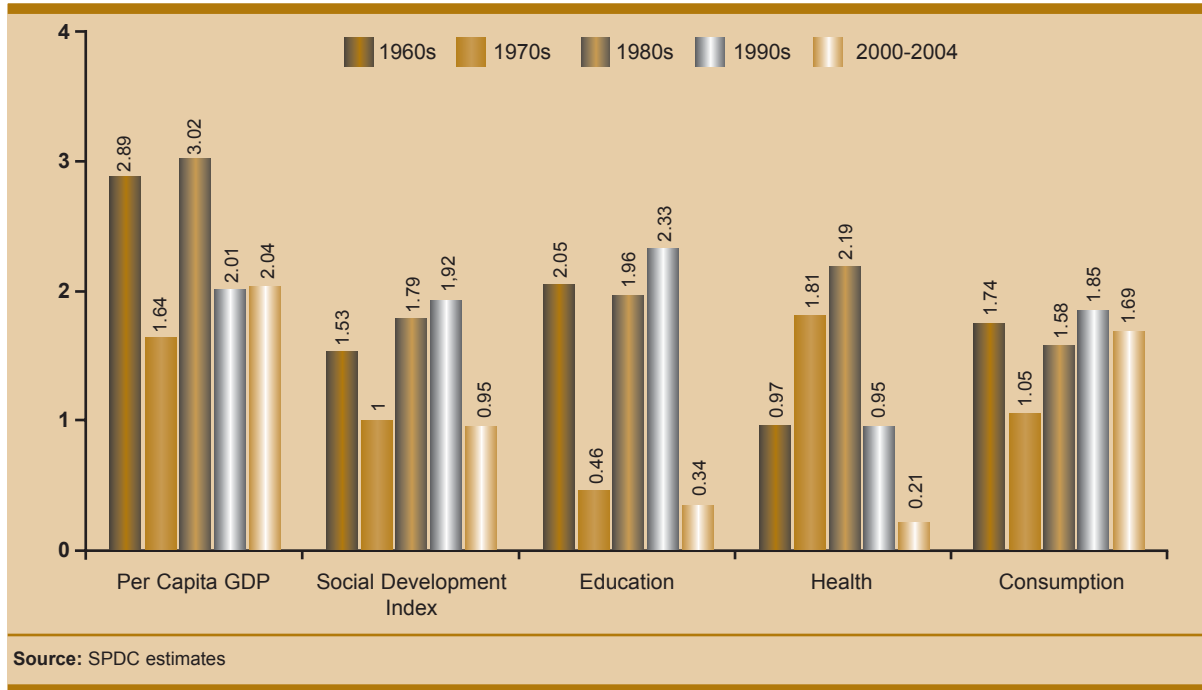
The comparison between growth in the SDI index and per capita real GDP growth is depicted in Chart 18. From the 1960s until the 1980s, changes in per capita growth and growth in social development are positively related. In particular, the 1970s period of proclaimed trickle-up policies led to slippage in per capita growth, which was also accompanied by slippage in growth of social development. This bolsters the argument that higher growth in income is a prerequisite for higher achievement in social and human development. Nevertheless, the positive relationship between growth and improvements in social development does not hold strongly in the fourth period. During the 1990s, a decrease in per capita GDP growth did not significantly affect SDI growth. This is perhaps indicative of the Social Action Programme's (SAP) success in improving access to basic public social

**CHART 18  
ECONOMIC AND SOCIAL GROWTH  
[Average Annual Growth Rates]**



Source: SPDC estimates

**CHART 19**  
**COMPONENTS OF SOCIAL DEVELOPMENT INDEX**  
*[Average Annual Growth Rates]*



services and the dynamism demonstrated by the private sector in filling the gap in demand.

The last period exhibits a completely different and rather disconcerting picture. Despite sizable gains in per capita real GDP during the 2000-2004 period, the average growth in SDI is quite low, compared with the 1980s and 1990s. The component analysis (Chart 19) clearly reveals continued solid performance in the consumption component of the SDI (which measures availability of cars, telephones, and electricity), but average growth in education and health indicators since 2000 has been visibly inglorious. However, to be fair, the year-wise growth rates in the health and education components of SDI do indicate some upward trend after 2002.

The evidence, based on the selected indicators and methodology suggest that economic growth is a pre-requisite for social development. Nevertheless, over the past

few years, the gap between economic performance and social development, especially human development as it relates to health and education, has widened, which needs to be redressed on an urgent basis.

## FISCAL ANALYSIS

Unencumbered by IMF pressures for fiscal restraint, the Federal Budget 2005-06 turns the stance of fiscal policy significantly more expansionary. This has both positive and negative aspects. The substantial increases in development expenditures, which can potentially help alleviate poverty and foster social and human development are to be lauded. Also to be commended, in principle, are the tax incentives being provided to exporters in an attempt to broaden the source of growth to include exports.

## An Overheating Economy?

But the widening gap between total expenditures and total revenues, leading to an increase in the budget deficit, may not be wise in an economy which is experiencing double-digit inflation and is showing signs of overheating. Adjusted for the business cycle, the budget is even more expansionary than it might appear at first. More efforts should be made to finance the requisite increase in development expenditures through some expenditure switching and through more targeted measures to increase tax revenues and expand the tax base. Moreover, the experience from last year suggests that the Public Sector Development Programme (PSDP) needs considerable improvement to more effectively channel and utilize the expenditures. Otherwise, the government's intentions underlying the increased allocation of development expenditures may not have the desired results in addressing the problems of poverty, inequality, and lack of social development more generally.

### Budget Deficit

The revised fiscal deficit of Rs. 246 billion for FY2005 is Rs. 33 billion (or 15½ percent) more than budgeted, as reported in Table 9. Moreover, in FY2006, the budget deficit is slated to increase further by nearly 20 percent from this revised estimate. As a share of GDP, the revised budget deficit of 3.8 percent of GDP is projected to increase to 4 percent of GDP in FY2006, if we assume economic growth of 7 percent and inflation of 6 percent for that year. To the extent that the deficit is being fueled by the projected increase of nearly 35 percent in development expenditures, it should be expected to spur growth further. But note that development expenditures start off from a low base, with their share in total expenditure being just 20 percent. Moreover, even though current expenditures are expected to rise only 5.3 percent from the revised estimates for FY2005, the revised estimates of these expenditures were 12.4 percent higher than budgeted for that year. Compared to budgeted values for FY2005, the budget for FY2006 implies an increase in current

**TABLE 9  
THE FEDERAL BUDGET**

(Rs. Billion)

Categories	FY 2005		Growth (%) (2 over 1)	FY 2006	
	Budgeted (1)	Revised (2)		Budgeted (3)	Growth (%) (3 over 2)
Current Expenditures	700.8	784.7	12.0	826.5	5.3
Minus Repayment of Foreign Loans	51.1	54.3	6.2	65.3	20.4
Current Expenditures (excluding Repayments of Foreign Debt)	649.7	730.4	12.4	761.2	4.2
Plus Development Expenditures	202.0	202.0	0.0	272.0	34.7
Minus Net Revenue Receipts	557.2	630.0	13.1	643.1	2.1
Minus Self-Financing of PSDP by Provinces	33.1	38.4	16.0	41.0	6.7
Minus Recovery of Loans from Provinces	13.2	28.7	116.5	14.4	-49.6
Minus Provincial Surplus	31.6	6.2	-80.5	33.5	442.5
Minus Net Lending to others	3.6	-16.9	-565.8	6.2	-136.5
<b>FISCAL DEFICIT</b>	<b>213.0</b>	<b>246.0</b>	<b>15.5</b>	<b>295.0</b>	<b>19.9</b>
<b>FISCAL DEFICIT as % of GDP</b>	<b>3.3</b>	<b>3.8</b>	<b>-</b>	<b>4.0p</b>	<b>-</b>

Source: Federal Budget in Brief 2005-06

p = Projected

**TABLE 10  
FISCAL DEFICIT FINANCING**

(Rs. Billion)

Heads	2004-05		Growth (%) (2 over 1)	2005-06 Budgeted (3)	Growth (%) (3 over 2)
	Budgeted (1)	Revised (2)			
<b>FINANCING OF THE DEFICIT</b>	<b>213.1</b>	<b>246.0</b>	<b>15.5</b>	<b>295.0</b>	<b>19.9</b>
Non-Bank Borrowings	74.7	13.3	-82.2	55.4	315.3
Share (%)	35.1	5.4	-	18.8	-
Net External Resources	78.2	141.9	81.5	121.6	-14.3
Share (%)	36.7	57.7	-	41.2	-
Bank Borrowings	45.1	80.8	78.9	98.0	21.4
Share (%)	21.2	32.8	-	33.2	-
Privatization Proceeds	15.0	10.0	-33.3	20.0	100.0
Share (%)	7.0	4.1	-	6.8	-

Source: Federal Budget in Brief 2005-06

expenditures of about \$125 billion, while the increase in development expenditures is \$70 billion. Net revenue receipts, on the other hand, increase relatively less from their budgeted amount by about \$85 billion.

The financing of the budget deficit is shown in Table 10. The dependence on external sources to finance the budget deficit has increased in recent years, with a share in financing of more than 55 percent in the revised estimates for FY2005. In FY2006, this dependence is expected to go down some, but remain over 40 percent. Another important source of financing for the deficit is bank borrowing. In FY2005, such borrowing was budgeted to finance Rs. 45 billion of the deficit, but ended up financing more than Rs 80 billion and again is expected to finance Rs. 98 billion of the deficit in FY2006. This is an alarming trend in the prevailing inflationary environment.

### Revenues

Table 11 provides a comparison of budgeted and revised figures of gross revenue receipts and their components. The table indicates that gross revenue receipts were 10 percent higher than the budgeted figure for FY2005. However, this largely reflects an increase of \$107 billion (or 71 percent) relative to target in non-tax

**TABLE 11  
TARGET AND ACTUAL  
FEDERAL RECEIPTS**

(Rs. Billion)

	2001-02	2002-03*	2003-04*	2004-05**
<b>Gross Revenue Receipts</b>				
Target	643.8	674.9	728.4	796.3
Actual	618.9	703.3	769.9	875.3
Actual as % of Target	96.1	104.2	105.7	109.9
<b>Tax Revenues (CBR)</b>				
Target	457.7	460.6	510.0	580.0
Actual	404.1	460.6	518.9	590.0
Actual as % of Target	88.3	100.0	101.7	101.7
<b>Direct Taxes</b>				
Target	149.8	148.4	161.1	181.9
Actual	142.5	151.9	165.3	182.7
Actual as % of Target	95.1	102.4	102.6	100.4
<b>Indirect Taxes</b>				
Target	307.9	312.2	348.9	398.1
Actual	261.6	308.7	353.6	407.3
Actual as % of Target	85.0	98.9	101.3	102.3
<b>Import Duties</b>				
Target	69.6	56.5	78.1	103.2
Actual	47.8	68.8	89.9	113.9
Actual as % of Target	68.7	121.8	115.1	110.4
<b>Federal Excise</b>				
Target	53.1	50.0	47.7	45.7
Actual	47.2	44.8	44.6	54.4
Actual as % of Target	88.9	89.6	93.5	119.0
<b>Sales Tax</b>				
Target	185.2	205.7	223.1	249.2
Actual	166.6	195.1	219.1	239.0
Actual as % of Target	89.9	94.8	98.2	95.9
<b>Surcharges</b>				
Target	47.0	60.5	61.1	65.3
Actual	54.9	66.9	64.4	27.1
Actual as % of Target	116.7	110.5	105.3	41.6
<b>Non-Tax Revenues</b>				
Target	139.1	153.8	157.2	151.0
Actual	159.9	175.8	186.6	258.2
Actual as % of Target	115.0	114.3	118.7	170.9

Sources: Targets and Revised Estimates are from Federal Budget in Brief (various issues)  
Actuals are from SBP Annual Report (various issues) and SBP Website

Note: Non-Tax Revenues for 2003-04 & 2004-05 also includes Workers' Profit Participation Tax, Foreign Travel Tax and Airport Tax.

\* Revised Estimates for Surcharges and Non Tax Revenue, otherwise Actuals  
\*\* All Revised Estimates

## An Overheating Economy?

**TABLE 12**  
**CBR TAX COLLECTIONS**

(Rs. Billion)

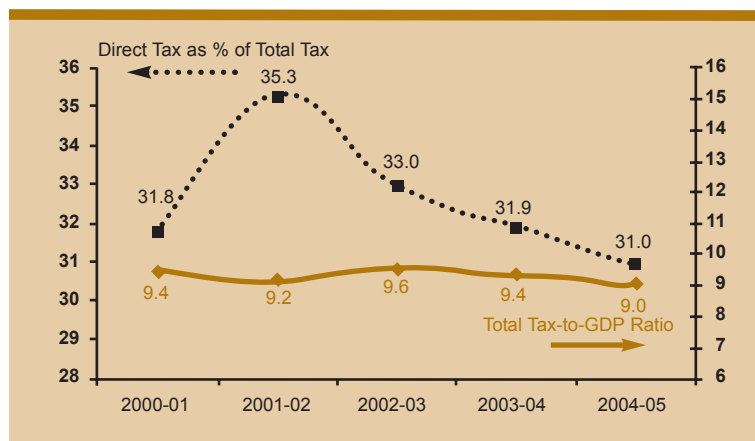
	ACTUAL				Revised	Budgeted
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
<b>TAX REVENUES</b>	<b>392</b>	<b>404</b>	<b>461</b>	<b>519</b>	<b>590</b>	<b>690</b>
Growth (%)	13.0	3.0	14.0	12.7	13.7	16.9
<b>Direct Taxes</b>	<b>125</b>	<b>143</b>	<b>152</b>	<b>165</b>	<b>183</b>	<b>215</b>
Growth (%)	10.3	14.4	6.6	8.8	10.5	17.9
<b>Indirect Taxes</b>	<b>268</b>	<b>262</b>	<b>309</b>	<b>354</b>	<b>407</b>	<b>475</b>
Growth (%)	14.3	-2.3	18.0	14.5	15.2	16.5
<b>Customs</b>	<b>65</b>	<b>48</b>	<b>69</b>	<b>90</b>	<b>114</b>	<b>121</b>
Growth (%)	5.5	-26.5	43.9	30.7	26.7	6.4
<b>Federal Excise</b>	<b>49</b>	<b>47</b>	<b>45</b>	<b>45</b>	<b>54</b>	<b>59</b>
Growth (%)	-12.0	-3.9	-5.1	-0.4	22.0	9.2
<b>Sales Tax</b>	<b>154</b>	<b>167</b>	<b>195</b>	<b>219</b>	<b>239</b>	<b>294</b>
Growth (%)	31.6	8.5	17.1	12.3	9.1	23.0

Source: SBP website and Federal Budget in Brief 2004-05

revenues. According to the revised estimates, CBR tax revenue was Rs. 10 billion (or 1.7 percent) higher than the target. Collection from surcharges amounted to only about 42 percent of the budgeted amount, largely because of the shortfall in the petroleum development levy resulting from an increase in international oil prices. The sales tax target was again missed by a significant amount, as in recent years.

CBR tax collections for FY2006 are analyzed in Table 12. Revised figures indicate that CBR tax collections rose nearly 14 percent in FY2005 over the previous year and are projected to increase about 17 percent in FY2006. Considering the composition of taxes, revenues from indirect taxes, which constitute about 70 percent of total tax revenues, increased 15 percent in FY 2004; whereas direct taxes, which constitute about 30 percent of total tax revenues, increased relatively less, by 10 percent. Thus, the share of direct taxes in total taxes, depicted in Chart 20 has fallen in recent years. This has made a tax system, which already lacks enough tax progressivity, even less progressive (Note that progressivity measures the extent to which the rich bear a greater burden of taxes as a share of their income than the poor do). The projected growth of nearly 18 percent in direct tax revenue in FY2006 versus 16½ percent in indirect tax revenue

**CHART 20**  
**TAX SHARES**



Source: SPDC estimates based on data from Pakistan Economic Survey 2004-05, SBP website and Federal Budget in Brief 2005-06

**TABLE 13  
GROWTH IN CUSTOM DUTIES**

	Growth in B.E (FY 2005 over FY 2004)	Growth in R.E (FY 2005 over FY 2004)	Growth in R.E (FY 2006 over FY 2005)
Chemical & Chemical Products	27%	27%	6%
Dyes, Colors, Paints & Varnishes	27%	27%	6%
Iron, Steel & Manufactures	27%	27%	6%
Machinery	27%	16%	6%
Metals (Other than Gold)	27%	27%	6%
Minerals, Fuel Oils (POL)	27%	27%	6%
Rubber & Rubber Products	27%	27%	6%
Plastic Resins etc.	27%	27%	6%
Vehicles	27%	2%	6%
Wood Pulp & Papers	27%	27%	6%
Yarn & Fabrics	27%	27%	6%
Medical & Photographic Equip.	27%	27%	6%
Other Items	30%	35%	26%
<b>Gross Collection</b>	<b>28%</b>	<b>28%</b>	<b>16%</b>
<b>Less: Refund / Rebates</b>	<b>11%</b>	<b>11%</b>	<b>6%</b>
<b>CUSTOM DUTIES (Net)</b>	<b>32%</b>	<b>32%</b>	<b>17%</b>

B.E. Budget Estimate, R.E. Revised Estimate

Source: SPDC estimates based on Explanatory Memorandum on Federal Receipts (various issues)

**TABLE 14  
NON-TAX REVENUE**

(Rs. Billion)

	Revised Estimates				ACGR* (%)
	FY 2002	FY 2003	FY 2004	FY 2005	
<b>Interest</b>	<b>54.2</b>	<b>54.0</b>	<b>67.3</b>	<b>61.1</b>	<b>4.1</b>
Provinces	29.5	28.0	26.4	24.3	-6.3
Local Bodies	19.6	10.7	12.4	13.1	-12.7
Financial Insitutions	5.4	4.2	5.4	5.3	-0.9
Non- Financial Institutions	18.8	29.8	29.8	25.6	10.9
WAPDA	16.4	26.5	27.6	23.6	12.9
Other Autonm. Bodies/Corp.	2.4	3.2	2.1	2.0	-5.7
Govt. Servants, Commercial Deptt., AJK & Others	3.9	3.5	4.7	6.9	20.8
Less: Estimated Shortfall	-23.0	-22.2	-11.4	-14.0	-15.3
<b>Dividends &amp; Returns</b>	<b>26.5</b>	<b>27.7</b>	<b>33.4</b>	<b>57.5</b>	<b>29.5</b>
<b>Defence</b>	<b>26.0</b>	<b>56.3</b>	<b>42.9</b>	<b>61.4</b>	<b>33.1</b>
Effective & Non-Effective	2.5	2.5	2.5	2.9	4.9
Receipts from UN and Misc. Receipts	23.5	53.8	40.4	58.5	35.5
<b>Miscellaneous and Others</b>	<b>58.0</b>	<b>37.8</b>	<b>43.0</b>	<b>78.2</b>	<b>10.5</b>
<b>TOTAL NON-TAX REVENUE**</b>	<b>165</b>	<b>176</b>	<b>187</b>	<b>258</b>	<b>16.2</b>

Source: SPDC estimates based on Explanatory Memorandum on Federal Receipts (various issues)

Note: \*Annual cumulative growth rate

\*\*Non-Tax Revenue for 2003-04 & 2004-05 also includes Workers' Profit Participation Tax, Foreign Travel Tax and Airport Tax

will make only a minor adjustment to the composition of taxes.

Moreover, the overall tax-to-GDP ratio, also depicted in Chart 20, has also fallen slightly in recent years and, at less than 10 percent, remains very low even by developing country standards. Better tax performance is needed if the increase in development expenditures projected in the FY2006 Budget is to be sustained without adding to concerns about the budget deficit.

According to revised data, revenues from custom duties increased 32 percent in FY2005 over FY2004, reflecting a surge of imports last year (Table 13). However, it seems rather strange that even for revised data 10 out of 13 items display exactly the same rate of growth of 27 percent. This raises some questions about the plausibility of the data.

Another notable aspect of the budget is the build-up of non-tax revenues, from about Rs 165 billion in FY2002 to Rs. 258 billion in FY2005 (Table 14), representing an annual cumulative growth rate of 16 percent. Items with a major share in non-tax receipts are

**TABLE 15  
BUDGETED AND ACTUAL  
FEDERAL EXPENDITURES**

(Rs. Billion)

	2001-02	2002-03*	2003-04*	2004-05*
<b>Current Expenditures</b>				
Budget Estimates	621.7	608.0	645.2	700.8
Actual	650.4	673.3	714.0	784.7
Actual as % of B.E.	104.6	110.7	110.7	112.0
<b>Defence</b>				
Budget Estimates	131.6	146.0	160.3	193.9
Actual	149.3	160.1	180.5	216.3
Actual as % of B.E.	113.4	109.7	112.7	111.5
<b>Debt Servicing</b>				
Budget Estimates	329.2	289.7	256.0	265.3
Actual	318.7	257.4	317.7	274.7
Actual as % of B.E.	96.8	88.9	124.1	103.5
<b>Subsidies</b>				
Budget Estimates	20.7	20.8	-	59.5
Actual	25.5	49.8	-	51.4
Actual as % of B.E.	123.1	239.4	-	86.3
<b>Other Current Expenditures</b>				
Budget Estimates	140.2	151.4	229.0	182.0
Actual	156.9	205.9	215.8	242.3
Actual as % of B.E.	111.9	136.0	94.2	133.2
<b>Public Sector Development Program (PSDP)</b>				
Budget Estimates	130.0	134.0	160.0	202.0
Actual	126.3	131.6	154.4	202.0
Actual as % of B.E.	97.1	98.2	96.5	100.0
<b>Federal Current Expenditure + PSDP</b>				
Budget Estimates	751.7	742.0	805.2	902.8
Actual	776.6	804.9	868.4	986.7
Actual as % of B.E.	103.3	108.5	107.8	109.3

Source: SBP Annual Report and Federal Budget in Brief (various issues)

Note: Subsidy figures are not available for 2003-04

\* Revised Estimates

interest receipts, dividends from non-financial institutions (OGDC and PTCL being the main contributors), and defence earnings. Defence earnings have registered an annual cumulative growth rate of 33 percent since FY2002, largely being driven by receipts from the U.N. and miscellaneous receipts, which appear to have been bolstered by Pakistan's role as an ally against the war on terrorism. The main concern about the recent surge in non-tax revenues is whether this can be relied upon as a source of revenue on a sustained basis.

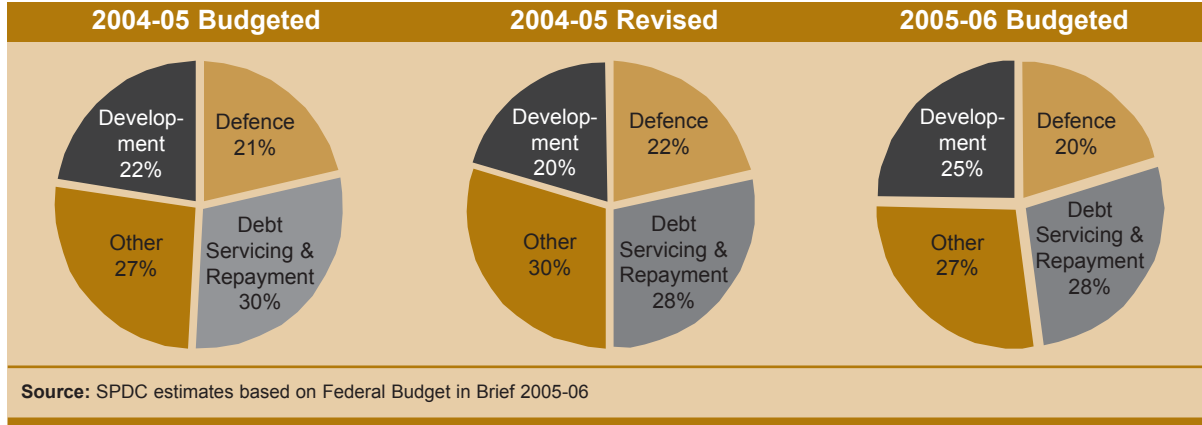
### Current and Development Expenditures

Table 15 provides a comparison of budgeted and actual federal expenditures. In the current expenditures category, there was overspending of 12 percent in FY2005 relative to the target level. Debt servicing was over the budgeted amount by 3.5 percent, an improvement over FY2004 when the target was overshoot by 24 percent. Defence spending increased 12 percent in FY2005 relative to the budgeted amount for the year and the category "Other Current Expenditures" exceeded its target by 33 percent. On a positive note, the development expenditures target was fulfilled for the first time in at least 5 years. That said, it seems as though the extra fiscal space created by higher-than-expected GDP growth went towards extra current expenditures rather than extra development expenditures.

One should not feel too complacent about development expenditures in any case because their relative share is very low to begin with. As shown in Chart 21, the share of development expenditures in total expenditure was budgeted to be just 22 percent in FY2005 and the revised

estimates indicate that the actual share turned out to be even a bit less at 20 percent. On the other hand, defence expenditure and debt servicing and repayment account for about half of total expenditure. It is imperative to shift the composition of expenditures more toward development expenditures to combat poverty and create an enabling environment for social development, and the projected increase of the share of development expenditures in total spending to 25 percent implied by the Budget FY2006 is a welcome development.

**CHART 21  
COMPOSITION OF EXPENDITURE**



Estimated current expenditures in the new FY2006 Budget and a comparison of these with the previous year's figures are reported in Table 16. The total of these expenditures is expected to grow a bit more

than 5 percent over the next year. This is a relatively restrained growth rate but follows higher-than-budgeted spending in FY2005, as noted above. Note that the growth rate of spending on transfer payments,

**TABLE 16  
CURRENT EXPENDITURE**

(Rs. Billion)

Heads	FY 2005			FY 2006	
	Budgeted (1)	Revised (2)	Growth (%) (2 over 1)	Budgeted (3)	Growth (%) (3 over 2)
General Public Service	423.8	469.0	10.7	503.1	7.3
Executive & Legislative Organs, Financial	349.5	342.5	-2.0	399.4	16.6
Interest on Domestic Debt	170.2	180.1	5.8	190.2	5.6
Interest on Foreign Debt	44.0	40.4	-8.3	45.8	13.4
Repayment of Foreign Debt	51.1	54.3	6.2	65.3	20.4
Pensions	42.5	42.5	0.0	43.4	2.1
Others	41.7	25.3	-39.4	54.6	116.3
Foreign Economic Aid	0.1	0.1	0.0	0.1	26.7
Transfer Payments	65.4	118.5	81.2	79.8	-32.7
General Services	1.7	1.1	-33.7	1.3	11.5
Basic Research	0.6	0.8	46.8	0.9	10.7
R&D General Public Services	2.5	2.5	0.7	2.9	16.9
Admn. Of General Public Service	0.4	1.2	190.5	0.5	-61.8
General Public Services not defined elsewhere	3.7	2.2	-40.3	18.3	732.7
Defence Affairs & Services	193.9	216.3	11.5	223.5	3.3
Public Order and Safety Affairs	15.1	17.5	16.4	18.7	6.7
Economic Affairs	48.8	62.2	27.5	56.4	-9.2
Environment Protection	0.1	0.1	0.0	0.1	8.1
Housing and Community Amenities	0.8	0.9	4.1	0.9	-0.3
Health Affairs and Services	3.3	3.3	0.8	4.1	25.9
Recreational, Cultural and Religion	2.2	2.2	2.2	2.3	2.9
Education Affairs and Services	12.2	12.3	1.0	16.6	34.9
Social Protection	0.5	0.9	60.1	0.6	-27.8
<b>Total</b>	<b>700.8</b>	<b>784.7</b>	<b>12.0</b>	<b>826.5</b>	<b>5.3</b>

Source: Federal Budget in Brief 2005-06



**TABLE 17  
SUBSIDIES**

(Rs. Billion)

	2004-05				2005-06	
	Budget	Share (%)	Revised	Share (%)	Budget	Share (%)
Subsidies for WAPDA	17.1	29	22.0	43	24.0	33
Subsidies for KESC	13.0	22	9.7	19	9.6	13
Others	29.4	49	19.7	38	38.8	54
Of Which:						
Inter Disco Tariff Differential	19.6	33	0.0	0	21.0	29
<b>TOTAL SUBSIDIES</b>	<b>59.5</b>	<b>100</b>	<b>51.4</b>	<b>100</b>	<b>72.3</b>	<b>100</b>

Source: Federal Budget in Brief 2005-06

Administration of General Public Service, and Social Protection are projected to be significantly negative. This might perhaps be due to the tremendous overspending on these items relative to budgeted amounts in FY2005, although the original budgeted amounts on some of these items, such as only Rs. 0.5 billion for Social Protection, might be considered small. Current expenditures on education and health, however, are slated to receive a boost of 35 percent and 26 percent, respectively, in FY2006.

Total subsidies in FY2006 are projected to be about Rs. 72 billion, as against the revised estimates of roughly Rs. 51 billion in FY2005 (Table 17). The table reveals that WAPDA and KESC continue to be the main recipients of federal subsidies, with their combined share of 62 percent according to revised FY2005 figures. Budget estimates for FY2006 project this share to be dropping to 46 percent. However, if the contribution to unbundled WAPDA power distribution companies (DISCO) of 29 percent of all subsidies is included, total subsidies to the power sector continue to be hefty.

As mentioned above, development expenditure in FY2005 was commendably on target with 100 percent utilization of the budgeted Rs. 202 billion expenditures in this

category. Moreover, the FY2006 Budget has projected an increase in development expenditures to Rs. 272 billion, which represents a 35 percent increase. A comparison of targeted and revised expenditures in different categories of development expenditures for FY2005, presented in Table 18, reveals some interesting features. While the overall utilization rate was exactly 100 percent, the category-wise decomposition indicates that Divisions such as Finance, Interior, and the Cabinet utilized substantially more than their budgeted amounts. This came at the expense of Social Development categories such as the Education, Women Development, and Labour/Manpower Divisions, whose allocated budgets were underutilized by 40 percent, 87 percent, and 25 percent, respectively.

Amid reports that the development spending was largely backloaded into the fourth quarter, this raises concerns about the appropriate channeling and proper utilization of the development expenditures budget. Thus, together with the projected increase in development expenditures for FY2006 that the government has already announced, it also needs to improve delivery and appropriate use of these funds.

**TABLE 18**  
**TARGETED AND ACTUAL**  
**DEVELOPMENT EXPENDITURE**  
(Rs. Billion)

Ministries / Divisions / Corporations	FY 2004-05		Growth (%)
	Original	Revised	
<b>FEDERAL</b>	<b>148.0</b>	<b>148.0</b>	<b>0.0</b>
Infrastructure Development	73.0	72.7	-0.4
Water/Power Div.	20.8	21.4	3.1
WAPDA (Power)	14.2	14.2	0.0
Pakistan Atomic Energy Comm.	4.8	4.1	-14.1
Pak Nuclear Regulatory Auth.	0.0	0.0	-
Petroleum & Natural Resource Dev	0.5	1.1	102.1
Commu. Division/Ports-Shipp	23.4	22.4	-4.0
Railways Division	9.3	9.4	1.5
<b>Social Development</b>	<b>50.2</b>	<b>50.4</b>	<b>0.5</b>
Finance Div.	7.6	9.3	22.3
Special Programmes	8.8	9.4	6.8
Education Division	3.4	2.0	-39.6
HEC	9.1	9.1	0.0
Health Division	6.0	5.6	-7.4
Popul. Welfare Div	2.6	2.6	0.2
Women Dev. Div	1.3	0.2	-86.7
Social Welf/Sp Edu Div	0.0	0.6	-
Labour/Manpower	0.1	0.1	-24.8
KA/NA Division/SAFRON	11.2	11.5	2.4
<b>Others</b>	<b>24.9</b>	<b>24.9</b>	<b>0.1</b>
IT/Telecom Division	2.7	2.4	-11.1
Science/Tech Research	1.9	1.7	-10.7
Culture/Sports/Youth/Tourism	0.6	0.6	-2.8
Works Division	0.9	1.0	8.5
Defence Division	1.0	1.1	9.3
Food/Agri/Livestock	7.3	7.1	-3.1
Local Govt/RD Division	0.3	0.3	0.0
Environment	0.4	0.4	5.3
Industries/Production	0.4	0.4	-8.2
Interior Division	4.9	5.7	16.5
Law/Justice/Human Rights	2.4	2.4	0.2
Establishment Division	0.0	0.0	-8.0
Cabinet Division	0.4	0.7	48.4
Information and Broadcasting	0.5	0.4	-14.3
Narcotics Control Div.	0.2	0.2	-1.4
Planning/Dev Division	0.7	0.5	-33.0
Statistics Division	0.1	0.0	-23.6
M/o Foreign Affairs	0.2	0.1	-66.7
Commerce Division	0.0	0.0	0.0
<b>PROVINCIES</b>	<b>54.0</b>	<b>54.0</b>	<b>0.0</b>
<b>TOTAL DEVELOPMENT OUTLAY</b>	<b>202.0</b>	<b>202.0</b>	<b>0.0</b>

Source: Public Sector Development Program 2004-05 & 2005-06

### **Intergovernmental Relations and Regional Development**

Table 19 highlights the transfers made by provincial governments to the federal government on account of interest payments, recovery of federal loans, self financing of PSDP, and the provincial surplus. Among these four heads, interest payments and loan repayments are physically transferred to the federal government, while the other two, though not physically transferred, add up to total resources that contribute to reducing the federal deficit. The total provincial transfers as a share of the divisible pool are projected to decrease from 44 percent in FY2004 to about 39 percent in FY2006, but the latter figure is still a high share that restrains the provinces in their ability to provide basic social services including education, health, and public health.

Inequality generally and regional inequality particularly is an important outcome of government economic policies in last two decades. Limited transfers of funds from the federal to provincial governments on the basis of population are causing inequality. Moreover, skewed distribution of federal government PSDP and non-PSDP expenditures are aggravating this situation. There are two relevant issues in the allocation of development expenditures. First out of total PSDP allocation, what is the fraction that each province gets? Second, what percentage of provincial Allocation of the Divisible Pool (ADP) is financed by federal assistance?

**TABLE 19**  
**PROVINCIAL TRANSFERS TO FEDERAL GOVERNMENT**

(Rs. Billion)

	2003-04 Revised	2004-05 Revised	2005-06 Budget
Interest Receipts from Provinces	26.4	24.3	22.6
Recovery of Loans from Provinces	17.3	28.7	14.4
Self Financing of PSDP by Provinces	34.8	38.4	41.0
Provincial Surplus	14.3	6.2	33.5
<b>Total Provincial Transfers</b>	<b>92.8</b>	<b>97.6</b>	<b>111.5</b>
Fiscal Deficit	173.9	246.0	295.0
<b>Total Provincial Transfers as % of Fiscal Deficit</b>	<b>53.4</b>	<b>39.7</b>	<b>37.8</b>
Divisible Pool Transfers*	211.4	245.3	284.3
<b>Total Provincial Transfers as % of Divisible Pool</b>	<b>43.9</b>	<b>39.8</b>	<b>39.2</b>

\* Including Straight Transfers

Source: SPDC estimates based on Federal Budget in Brief and Explanatory Memorandum on Federal Receipts (various issues)

The analysis of federal assistance in provincial ADPs (Table 20) shows that both southern provinces Balochistan and Sindh have got reasonable shares in FY2006. However, this trend should continue and be further enhanced in years to come to narrow the regional inequality gap of North and South. For example, the table shows that in FY2005, the federal contribution was highest for Balochistan (45 percent of provincial ADP) and in FY2006 it is estimated to be 43.5 percent of provincial ADP. In contrast, for other three provinces, federal assistance has been increased by more than 10 percentage points in FY2006.

The Table also reveals how the total federal assistance to provinces is distributed among them. The highest share of federal assistance is allocated to Punjab and NWFP in both fiscal years (41 percent and 23 percent, respectively, in FY2005, and 42 percent and 27 percent, respectively, in FY2006). On the other hand, Balochistan's share is reduced from 20 percent of total federal assistance to 11 percent whereas Sindh's share is increased from 17 percent in FY2005 to 20 percent in FY2006. Federal funds for development programs should be allocated with both population composition and provincial poverty levels in mind. Given

the fact that Sindh and Balochistan are the two most deprived provinces in terms of poverty incidence, meticulous attention is needed in order to correct the growing North-South divide.

## CONCLUSIONS

The growth performance of Pakistan's economy in FY2005 has been impressive and the environment of macroeconomic stability that the government has promoted has contributed to this, no doubt. Real GDP accelerated further and unlike last year which showed rather disappointing growth in the agricultural sector, the growth has become much more balanced. There is some evidence of increases in productivity and employment as well.

However, some of the growth can be attributed to transient factors, such as the role of good weather in generating a bumper cotton crop. While efforts to increase the country's long-run sustainable rate of economic growth should continue, there are signs that the economy is now overheating. Thus, in the short run at least, there is some need to cool off demand. Further

**TABLE 20**  
**FINANCING OF PROVINCIAL DEVELOPMENT PROGRAMME**

	Punjab	Sindh	NWFP	Balochistan	Total
<b><u>FY 2005 (REVISED ESTIMATES)</u></b>					
<b><i>Province wise composition of ADP Financing</i></b>					
ADP	100.0	100.0	100.0	100.0	100.0
Provincial Contribution	75.7	76.1	65.1	54.7	71.1
Federal Assistance	24.3	23.9	34.9	45.3	28.9
<b><i>Financing as Percentage of Four-Province-Combined ADP</i></b>					
ADP	48.5	19.9	19.1	12.5	100.0
Provincial Contribution	51.6	21.3	17.4	9.6	100.0
Federal Assistance	40.8	16.5	23.0	19.6	100.0
	Punjab	Sindh	NWFP	Balochistan	Total
<b><u>FY 2006 (BUDGET ESTIMATES)</u></b>					
<b><i>Province wise composition of ADP Financing</i></b>					
ADP	100.0	100.0	100.0	100.0	100.0
Provincial Contribution	65.3	62.0	49.3	56.5	60.3
Federal Assistance	34.7	38.0	50.7	43.5	39.7
<b><i>Financing as Percentage of Four-Province-Combined ADP</i></b>					
ADP	47.7	20.8	21.3	10.3	100.0
Provincial Contribution	51.6	21.3	17.4	9.6	100.0
Federal Assistance	41.7	19.9	27.2	11.2	100.0

Source: SPDC estimates based on Explanatory Memorandum on Federal Receipts 2005-06

accelerating demand by an excessive amount in a developing economy that is overheating can be a recipe for a boom-bust cycle that ends in crisis.

The rise in inflation to double digits is a matter of concern. Although much of it can be attributed to supply-side factors which have increased food prices and world oil prices, there is evidence of demand side pressures as well. It is imperative that the now tighter stance of monetary policy that the central bank has adopted should continue for a while and even become tighter to abate inflationary pressures. There is strong evidence from all over the world that if inflation gets beyond a certain point and stays there for a while, it can have very deleterious effects on economic

growth. Moreover, it also increases poverty and inequality. Bank credit to the private sector, having done its job of spurring demand, should also be reined in to prevent household debt from reaching unsustainable proportions.

Higher growth than its trading partners is also widening Pakistan's trade deficit and has turned a current account surplus into a deficit. The current account deficit is not a source of pressure yet, but this trend should not be allowed to continue. Therefore, the effort to target exports and make them an important mechanism, over time, for sustaining the high growth should continue and intensify.

Along with the emphasis on growth, there is also a need for a more concerted

## *An Overheating Economy?*

effort on direct interventions to help alleviate poverty, reduce inequality, and foster social development more generally. The budget is rather silent on the specifics of how to directly tackle poverty and income inequality. The proposed increase in development expenditures of 35 percent in the federal budget for FY2006 is, of course, much needed--and this trend should continue. At the same time, though, for these increases in development expenditures to be an effective tool for aiding social and human development, there is a need to reform the mechanisms for the appropriate channeling and utilization of the funds under the PSDP. Moreover, the ability of the provinces to provide social services is restrained by the substantial reverse flow of resources back to the federal government.

Along with development expenditures, other government expenditures are also budgeted to rise and revenue receipts, in particular tax revenues, are not projected to keep pace. This will result in further

widening of the federal government deficit, which might not prove too wise in an overheating economy. The expansionary stance of fiscal policy puts pressure on the central bank and makes its job of controlling inflation more difficult.

In our view, increasing development expenditures by a meaningful amount is critical and cannot be compromised. But greater effort is needed to finance these increases through expenditure switching and more tax revenues to prevent expanding budget deficits from fueling inflationary pressures further. Pakistan's ratio of taxes to GDP at less than 10 percent is low even by developing country standards and the fraction of the working population that file tax returns is trivial. The tax system should also be made more pro-poor by rendering it more progressive, e.g. by changing the composition of taxes toward direct taxes from indirect taxes, so the rich bear a greater burden of taxes.





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