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**Fiscal strategy for growth and
employment in Pakistan:
An alternative consideration**

**A case study prepared within the framework
of the ILO's Global Employment Agenda**

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Preface

In Pakistan, commitment to the IMF/World Bank reform agenda since 1999 has been associated with both attainment of price stability and reduction of the balance of payments deficit. Yet, private investment and GDP growth have remained sluggish whilst unemployment has sharply increased, from less than 4 per cent in the 1980s to 7.8 per cent by 2001. Emphasis on fiscal contraction appears to have been achieved by squeezing out development and investment expenditures. This does not bode well for setting the economy on a path to sustainable long-run economic growth and to the goal of full, productive, remunerative employment that ultimately holds the key to eliminating poverty.

The paper explores Pakistan's fiscal stance in recent years and presents empirical evidence showing that fiscal deficits in Pakistan since 1980 did not appear to have had any detrimental impact on private investment and GDP growth, nor were they necessarily associated with tangible increases in inflation. Furthermore, the study critically finds evidence of private investment – which must ultimately serve as the longer term driver of growth and employment – being *crowded-in* by public investment expenditure in Pakistan. The importance of maintaining broader macroeconomic stability in the longer run notwithstanding, there is a strong case for a prudent degree of fiscal pump-priming, or carefully managed deficit *expansion*, in the short term, in order to provide the impetus to rekindle private investment, growth and employment.

Moreover, despite Pakistani policymakers' reluctance to engage in expansionary policy measures due to a lack of feasible financing options, the paper finds that exogenous events, in particular those of September 11th, 2001, have allowed the Pakistani Government to elicit increased concessionary external funding and an important rescheduling of foreign debt, whilst remittances and foreign reserves have simultaneously rocketed, implying that space should have been created to finance a 1-1.5 per cent of GDP increase in the fiscal deficit in the short-term, to provide the counter-cyclical stimulus that is so crucially required. If carefully managed, such action could encourage economic activity without undermining broader stability, but this would also require a shift in focus of macroeconomic policy towards growth-induced productive employment-generating concerns, or else the opportunity presented by such space is unlikely to be fully exploited.

This case study was conducted in the context of the Employment Analysis and Research Unit's development of an alternative macroeconomic policy framework that incorporates employment as its central objective, as advocated in the ILO's Global Employment Agenda. Other papers in this series of studies include Employment Paper 2003/48, *Macroeconomic stability, Growth and employment – Issues and considerations beyond the Washington Consensus*, and Employment Paper 2003/53, *Avoiding the stabilization trap: Towards a macroeconomic policy framework for growth, employment and poverty reduction*.

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1. Introduction

Within the framework of the ILO's Global Employment Agenda, a sound macroeconomic policy that is able to deliver sustainable long-run economic growth is, by association, deemed central to the core goals of achieving full, productive and remunerative employment and eliminating poverty. In essence, effective macroeconomic management is directly seen to pave the way for growth-induced employment generation and poverty reduction. This study looks at the case of Pakistan, examining one particular aspect of its macroeconomic framework, namely its fiscal policy stance. Bound by the reform programme of the International Financial Institutions (IFIs), Pakistan's policymakers have adopted numerous fiscal austerity measures since 1999 to satisfy rigid IMF conditionalities. Consequently, low rates of inflation and control of the balance of payments have prevailed, whilst investment and GDP growth have remained stagnant over a prolonged period. Focusing on Pakistan's fiscal deficit and the concurrent developments in the macroeconomy between 1999 and 2002, this paper makes an attempt to ascertain whether there is a case for relaxation of IMF conditionality and adoption of more expansionary fiscal policy (or a 'fiscal tonic') to pursue greater development and productive investment expenditure in order to boost employment through fostering growth. The remainder of this paper is structured as follows. Section 2 discusses the reform agenda of the IFIs and conditionality, as applicable to Pakistan. Section 3 raises some important precursors to our analysis of the fiscal deficit, pertaining to its definition, measurement and interpretation. Sections 4 and 5 analyse Pakistan's fiscal stance and the relationship between the fiscal deficit and various key macroeconomic indicators. Section 6 discusses the implications of our analysis, identifying a fiscal space within which a degree of deficit expansion could be permitted under certain conditions, and section 7 concludes.

2. The IFI Reform Agenda

The 1980s and 1990s represented the hey-days of the Washington Consensus approach to macroeconomic policy as successive developing countries turned to the IFIs for reform assistance in an attempt to redress large and often crippling external and internal macroeconomic imbalances. Such imbalances may be easily identified as follows in national accounting terms, through manipulation of the simple identity:

$$Y = C + I + G + X - M \quad (1)$$

i.e. National Income (Y) comprises consumption (C), investment (I), government expenditure (G), exports (X) and imports (M). Letting $(C + I + G) = A$ (domestic demand), and rearranging:

$$(X - M) = (Y - A) \quad (2)$$

The left hand side of the equation represents the external balance of an economy; imports exceeding exports implies a trade deficit on the current account of the balance of payments. If the right hand side term is negative, then the domestic economy is suffering from over-absorption. If we denote savings, $S = Y - C - G$, then from (2) we may derive:

$$(X - M) = (S - I) \quad (3)$$

The right-hand side of equation (3) now represents the investment-savings gap. Specifically, internal imbalance occurs where investment (I) exceeds savings (S), and in the *public* sector this is reflected in a budget deficit. IFI-devised reform programmes initially operate in the short run to restore internal and external equilibrium and lower inflation by curtailing demand. This is achieved through IMF-determined stabilization programmes, which impose *conditionality* on the recipient government, requiring **exchange rate devaluation, fiscal policy adjustment** (to establish fiscal discipline), and **contractionary monetary/credit policies**. However, such austere policy measures will not be sustainable in the long run without complementary supply side policies to improve the underlying structural features of the economy. Hence, in tandem with stabilization, associated World Bank structural adjustment programmes are also often pursued. These are focused on curtailing the role of the state and liberalising the economy in a manner to ‘get prices right’, such that the relative prices of goods and services may float and adjust to optimal equilibrium levels, reflecting scarcity of resources. Components of structural adjustment programmes include **trade liberalization policies** (to reduce imports and boost exports, removing price distortions resulting from misallocation of resources between sectors); **removal of subsidies and tax reform** (to increase the flexibility of the supply side); **public sector reform** through labour market policy (to increase labour market flexibility) and privatisation of state-owned enterprises; and **financial liberalisation policies** (removing ceilings on interest rates, relaxing barriers to entry and eliminating financial repression, in order to enhance the mobilisation of domestic savings and improve monetary management). In essence, structural adjustment policies are viewed as highly complementary to short-run stabilization measures in the economic reform process and the combined programmes aim to promote long-run growth and economic efficiency through creating an environment of macroeconomic stability. Within the framework, the centrality of stability to growth is founded on the premise that its achievement will reduce perceived country risk, thereby encouraging domestic and foreign investment, facilitating long-term capital accumulation and enterprise development.

Evidence of the success of the Washington Consensus approach in setting troubled developing economies on the path to sustainable long-run economic growth has emerged, however, as a critical sticking point, with a growing body of literature arguing little correlation between isolated macroeconomic reform and growth, both at the individual country and global levels, attaching more importance to institutions, governance and structural constraints. As Ahmed (1998) observes, a critical danger of implementing IFI conditionalities is that they may increase the cost of investment and reduce the cost of imports of final goods in the country¹. This would have an adverse impact on the growth of GDP and create inflationary conditions. In reality, many countries that have adhered to the IFI reform agenda over the 1980s and 1990s have succeeded in achieving price stability and curtailing their external/internal imbalances, but have subsequently been plagued with poor growth and private investment, high unemployment and rising poverty (e.g. the experience of Egypt in the 1990s), all highlighting the dangers of a “stabilization trap”.

In the light of widespread disillusionment with the Washington Consensus in the 1990s, the IFIs have in recent years shifted towards what Stiglitz first described in 1998 as a ‘post-Washington Consensus’, embracing poverty reduction as a central objective and over-arching theme. The Washington Consensus programmes were rapidly replaced by Poverty Reduction Strategy Papers (PRSPs), but as several authors (e.g. Mosley, 2001; Muqtada, 2003) are now accentuating, despite their re-aligned ‘raison d’être’, the inherent macro-advocacy of PRSPs,

¹ For instance, initial devaluation will make raw material and machinery imports more expensive, thus potentially increasing the cost of investment, whilst trade liberalisation measures that aim to reduce tariffs and quotas could reduce the prices of imported final goods relative to domestically produced goods.

as reflected in conditionality, remains the same. The IFIs' neo-liberal agenda still focuses on getting prices right through freeing up the market mechanism, albeit with greater recognition of the need for good governance, participation, social equity, and individual country 'ownership' of the programmes. The fundamental problem with this approach is that its implicit economic foundations, relying purely on market forces for automatic adjustment in the context of a perceived fixed long-run aggregate supply schedule, could produce a market equilibrium at substantially less than full employment. Where excess capacity exists, expansion of productive employment will be central to boosting economic growth; and pro-cyclical, contractionary policies will provide no leeway for this necessary expansion. The importance of stability notwithstanding, there may at times be a need for counter-cyclical, 'Keynesian' demand-management policies to be implemented in the short-run as a stimulus to reflate a flagging economy. Such reasoning, combined with the goal of attaining full employment in productive, decent work, is intrinsically promoted in the macro-policy guidelines delineated in the Global Employment Agenda².

IFI Conditionality and Pakistan

The Government of Pakistan (GoP) first adhered to a structural adjustment programme in 1981, and has subsequently submitted to the IFI reform agenda at various stages over the following two decades. The Stand-By Arrangement (SBA) agreed with the IMF in November 2000 marked a return to this agenda following a lull of over 18 months. The renewed relationship has been highly demanding on the GoP, with recent loans contingent on a high level of conditionality. The requirements of the November 2000 SBA consisted of 18 performance criteria, 9 of which were quantitative, the remaining 9, structural; 3 indicative targets and 10 (structural) benchmarks. The latter two categories are less binding than the performance criteria, with a higher in-built tolerance for deviation from targets. The crucial 9 quarterly performance criteria consisted of moving ceilings or floors on the following variables³:

Ceilings:

- Net domestic assets of the State Bank of Pakistan (SBP);
- Overall Budget Deficit;
- Net government borrowing from the banking system;
- Banking system credit to seven major public enterprises;
- Budgetary arrears to the Water and Power Development Authority (WAPDA);
- Short-term public and publicly guaranteed external debt;
- New non-concessional medium- and long-term public and publicly guaranteed external debt, with a subceiling on debt with an initial maturity of over one year and up to and including five years;
- Accumulation of external payments arrears.

Floors:

- Net foreign assets of the SBP;
- Cumulative revenue of the Central Board of Revenue (CBR).

² Core element 4 of the Global Employment Agenda recalls the conclusions drawn at the Global Employment Forum (2001) that "monetary and fiscal policy must play a role in counteracting the risks of recession in the short term", seeking appropriate macroeconomic policies to best increase demand in the interest of employment.

³ Extrapolated from IMF (2000).

The criterion that is often held to be the most significant, and is indeed the focus of our analysis in this study, is the overall budget deficit target, which the IMF staunchly believes should be reduced in the short- to medium-term to (and maintained at) under 4 per cent of GDP. This criterion emanates from the opinion that higher fiscal deficits are inherently inflationary, crowd-out private investment and generate internal and external imbalances, thereby posing a serious threat to macroeconomic stability. Whether or not this view is at all justified for present-day Pakistan is precisely what we proceed to assess.

3. Fiscal Deficit Definition and Measurement

Before engaging in our analysis of Pakistan's fiscal deficit and its impact on the macro-economy, it is perhaps helpful to first clarify exactly how we define the deficit and what it measures, as well as acknowledging any potential pitfalls that may impact upon policy prescription. Fiscal deficits may be measured in a number of ways; the most common measure is usually referred to as the **conventional deficit** (or surplus), which represents the gap between total revenue receipts and total expenditure. Alternatively, the **primary deficit** measures the difference between total revenue and *non-interest* total expenditure; whilst the **revenue deficit** is calculated by subtracting *recurrent* expenditures from revenues. As Blejer and Cheasty (1991) assert, correct measurement of the public sector's net requirements is fundamental to deriving fiscal policies to address economic problems, thus a clear need emerges to understand the mechanics, implications and potential shortfalls of the chosen deficit measure. Our study assesses Pakistan's **overall fiscal deficit**, which, in essence, is the conventional deficit of the consolidated federal and provincial governments⁴. Any references to 'the deficit' henceforth implicitly denote this measure (unless otherwise stated).

The usefulness of this conventional measure lies in its broad coverage of public sector operations and its simplicity in accounting terms; however it remains weighted by certain conceptual difficulties. Jha (2001) specifically alludes to the fact that different categories of taxation and expenditure will have different effects on aggregate demand (for instance investment expenditure on infrastructure will create productive capacity which expenditure on general administration or subsidies will not); a stand-alone measure of the conventional deficit does not account for this. Similarly, different financing sources will have different effects on the macroeconomy (which we address in section 4); using the conventional measure as an indicator for policy prescription without taking this into consideration may lead to misguided conclusions. Furthermore, tax revenues are not independent of expenditures, again not considered in the conventional deficit measure; and ambiguities with respect to revenue and expenditure flows in the treatment of arrears (for instance when foreign debt is rescheduled) can affect the accuracy of the conventional measure as a true indicator of the deficit. Finally, Easterly (1998) draws attention to the fact that conventional measures do not actually capture the changes in government assets or *implicit* liabilities (merely explicit ones), hence the conventional measure fails to capture the public sector's *net worth* (which, admittedly, would be very difficult to quantify). If a government pledged to undertake fiscal adjustment that ultimately left its net worth unchanged⁵, then this adjustment would be merely illusory. All of these inherent deficiencies of the conventional fiscal deficit measure should serve as a caveat for interpreting it out of a broader context, as a stand-alone indicator of an economy's fiscal stance, casting aspersions on the wisdom of rigid deficit-targeting demands,

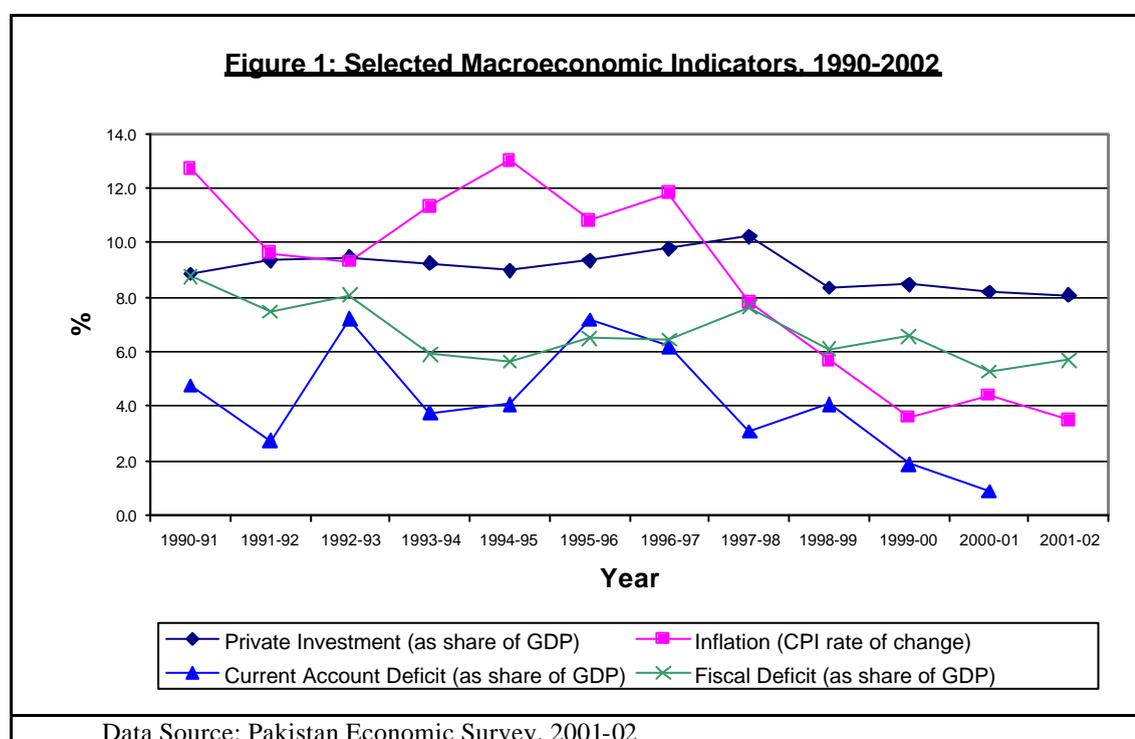
⁴ This is the most standard budgetary measure used and serves as the key target variable with respect to IMF fiscal conditionality.

⁵ For example, if a government is bound to lowering its debt accumulation, it may do so by lowering its asset accumulation or increasing its implicit/hidden liabilities by an equal amount.

as practiced by the IMF. Nonetheless, it is still likely to be the most useful tool in gauging the short-term financial impact of government imbalances (Blejer and Cheasty, op. cit.). Bearing such considerations in mind, we now turn to an assessment of recent trends in Pakistan's fiscal deficit and concurrent developments in the macroeconomy as a whole.

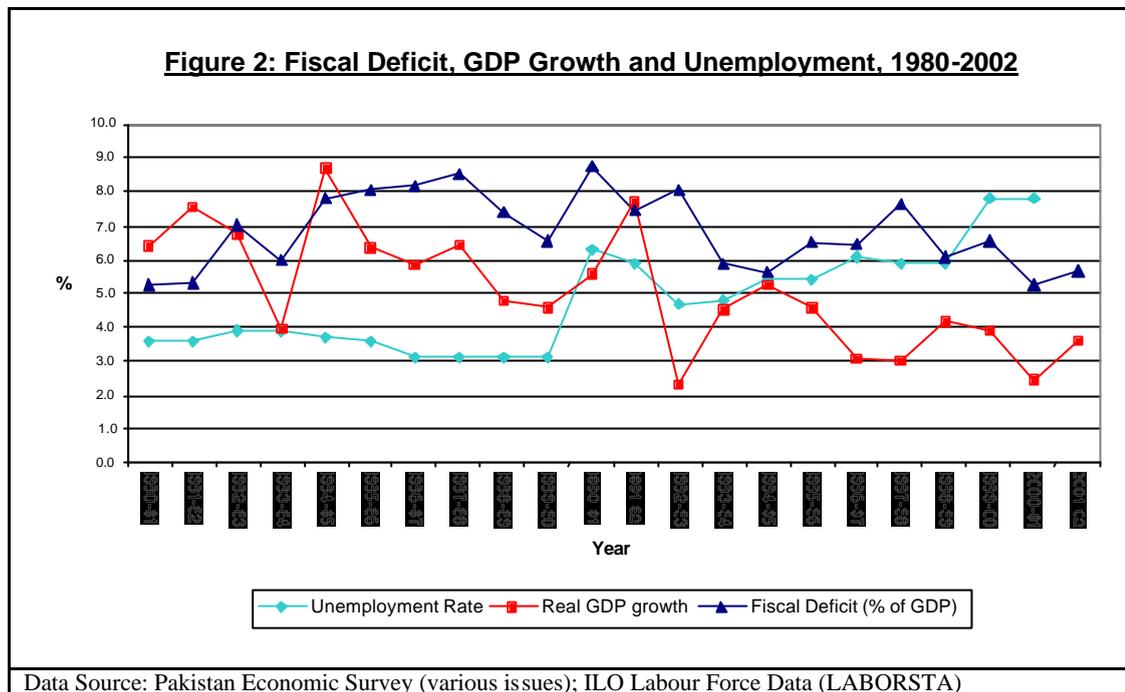
4. Fiscal Deficit, Macroeconomic Policies and Performance

In order to critically assess the fiscal stance adopted by General Musharraf's government since 1999, it is necessary to place it in the context of the policies that successive democratically elected and caretaker governments pursued over the course of the preceding decade and the related developments witnessed in the macroeconomy as a whole. The 1990s were characterised by flirtation with IFI policies aimed at economic liberalization, stabilisation and structural adjustment, in view of large macroeconomic imbalances, on the external account, but even more so domestically.



As Figure 1 shows, the overall fiscal deficit stood at nearly 9 per cent of GDP in 1990-91 (averaging nearly 7 per cent of GDP over the decade), with the balance of payments persistently in deficit, oscillating between 2.8 per cent and 7.2 per cent of GDP. Concurrently, inflation rates ranged from around 10-13 per cent for the earlier part of the decade, levels deemed by the IFIs to be too high to be conducive to stability. The fiscal difficulties of the 1990s were attributable to many factors, including continued unsuccessful revenue generation (despite reform attempts) combined with a traditionally high government proclivity to spend (see Table A1, Appendix), the inherited legacy of financial repression from previous decades, which had resulted in poor banking practices and the build-up of non-performing loans in banks' portfolios (Cashin et al., 1999), and a large accumulation of (particularly non-bank) public debt, exacting an ever increasing servicing requirement on the budget. With the IMF providing concessional finance on the main proviso that the GoP bring the fiscal deficit under control, towards a targeted level of 4 per cent, successive governments

began to implement a range of fiscal austerity measures, tax and tariff reforms and financial liberalisation policies (which included increasing real interest rates and relaxing exchange controls), albeit with limited success, as we shall discuss in more detail below.

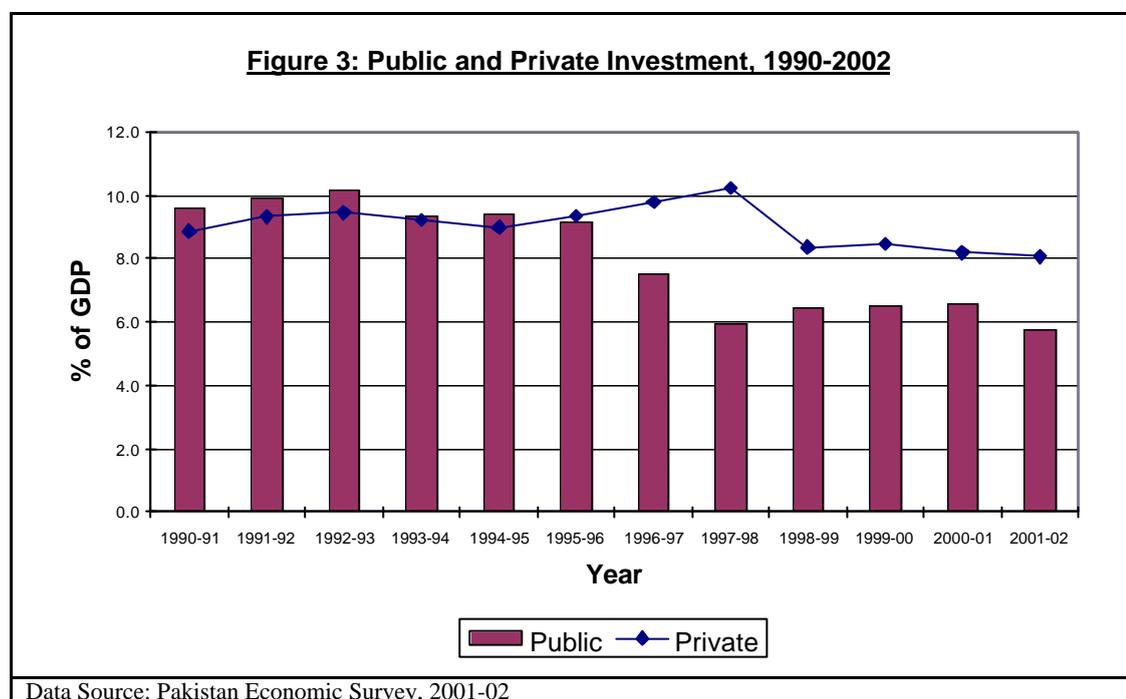


The austerity and liberalisation measures started to impact on certain target variables from 1997, as inflation fell to more tenable levels and the current account balance began to improve (although the effect on the latter was temporarily reversed in 1998 with Pakistan's nuclear test and the subsequent imposition of sanctions, which spurred the effective reversal of certain reform efforts, notably the re-instatement of exchange controls). Yet the government had not succeeded in cutting the budget deficit to the 4 per cent target level. Furthermore, throughout the decade, Pakistan witnessed a slowdown in economic growth, with average GDP growth rates of 3-4 per cent since 1992, well below 1980 averages in excess of 6 per cent (8.7 per cent in 1984-85), whilst the unemployment rate soared to over double the 1980s levels⁶ (Figure 2). Although it could be argued that the growth rates of the 1980s were driven by excessive borrowing, resulting in unsustainable macroeconomic imbalances, figure 2 shows that the pursuit of more austere and pro-cyclical policies since the 1990s has critically failed to restore conditions conducive to growth whilst aggravating unemployment. Notably, figure 3 shows that real public investment was cut from approximately 10 per cent of GDP in the earlier part of the decade to around 6 per cent by 1997 (Figure 3) to control public expenditures to meet IMF conditionality, yet reform efforts failed to significantly enhance investor confidence, as private investment remained at relatively stagnant levels of 9-10 per cent of GDP, dropping to around a wholly inadequate 8 per cent in 1998, after the nuclear test, and failing to recover thereafter⁷. Moreover, a public

⁶ Unemployment estimates do not include the 11-13% of the Pakistani labour force that is underemployed (defined as those who work less than a 35 hour week and are available for additional work), or the fact that up to a third of the labour force may be categorised as the working poor (based on current ILO estimates). Moreover, it should be noted that the Labour Force Participation Rate (LFPR) in Pakistan, to which the unemployment rate accrues, is a mere 29% of the total population, due in large part to particularly low female participation rates and a burgeoning informal sector in which employment or unemployment cannot be clearly classified.

⁷ It is also arguable that officially published statistics use an outdated industrial reference base and thus may to some degree under-report the extent of output and investment activity that is actually taking place,

and private investment correlation coefficient of +0.34 since 1990⁸ suggests the prevalence of a crowding-in (c.f. crowding-out) effect of public investment expenditure⁹; thus the containment of the state in this regard under structural adjustment, effected with a view to restoring and promoting the private sector, may well have been misguided from the outset.



It is in this broad macroeconomic setting that the Musharraf administration took control of the country and its finances in October 1999, and agreed a Stand-By Arrangement with the IMF in November 2000, marking a comprehensive return to the IFI reform agenda, following 18 months of strained GoP-IMF ties that pre-dated the military takeover (largely as a result of missed targets and broken promises (ABN Amro, 2000)). However, although the overall fiscal deficit has begun a downward trend (curtailed to under 6 per cent of GDP in 2000-01 for the first time since 1995), with inflation stabilising at about 4 per cent and the balance of payments witnessing a continued improvement, the key macroeconomic indicators of private investment and GDP growth have thus far marginally deteriorated or remained stagnant at best (see also Table A2, Appendix). Furthermore, unemployment has increased from 6 per cent in 1997 to 7.8 per cent in 2001. These trends could identify a need for a stronger focus on policies to reflate the economy to kickstart growth, generate employment and alleviate poverty¹⁰. Our central concern in this study is whether any carefully managed fiscal expansion could be tolerated to a degree, to help achieve these goals without adversely impacting on the macroeconomy as a whole, and we address this issue directly in section 5. Before doing so, however, we conduct below a more detailed exploration of Pakistan's fiscal

although investment patterns in those industrial units included in the national accounts estimates are likely to give a fairly clear indication of general trends in the economy.

⁸ Calculated using data from the Pakistan Economic Survey (2002).

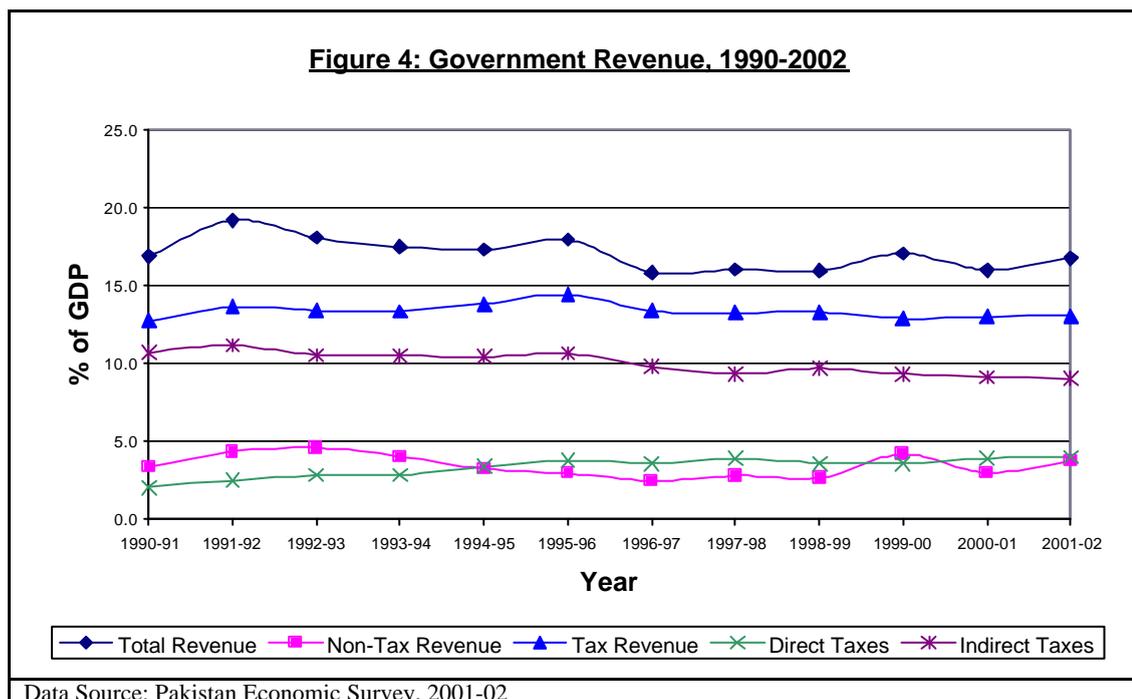
⁹ Indeed, Zaidi (1995) points to empirical work by the IMF conceding that even between 1972 and 1988, government investment in infrastructure was the "most important positive determinant" of private investment; whilst Easterly and Schmidt-Hebbel (1993) estimate that each percentage point increase in the ratio of public capital stock to output results in a 2.1 percentage point increase in the ratio of private capital stock to output in Pakistan.

¹⁰ Sustained high and labour-intensive growth will be central to creating sufficient and appropriate employment to absorb the increase in the labour force, which in the 1990s was over 1 million per annum (Table A2, Appendix), and contain unemployment.

stance and the resulting 'high' deficit with an analysis of the two sides to the budget balance, namely revenues and expenditures.

Fiscal Revenues

It has been argued by some (e.g. Ahmed, 1998; Pasha and Iqbal, 1994; Pasha 1995) that Pakistan's high budget deficits directly result more from inefficient and unsuccessful revenue generation than any other factor; in particular, they point to the persistence of inherent structural problems in the tax system. Figure 4 reveals a consistently low tax-GDP ratio of 12-14 per cent throughout the 1990s and beyond, heavily over-reliant on indirect taxes (e.g. on trade, excise, sales) that increase the regressivity of the tax system and impose a higher excess burden of taxation. Numerous exemptions and concessions (especially in the agricultural sector) coupled with widespread tax evasion and a large and unrecorded informal sector that remains outside the tax net have resulted in a narrow effective tax base, whilst tax administration remains weak and inefficient (Pasha, 1995; Ahmed, 1998; Cashin et al., 1999; GoP, 2002). Consequently, high nominal tax rates ensue, only serving to perpetuate a vicious cycle of further erosion of the tax base and even higher rates in turn. Moreover, given Pakistan's increasingly less buoyant tax system¹¹, despite these high nominal rates, revenue growth has barely kept pace with income such that the government would have struggled to fund any increase in demand for its services.



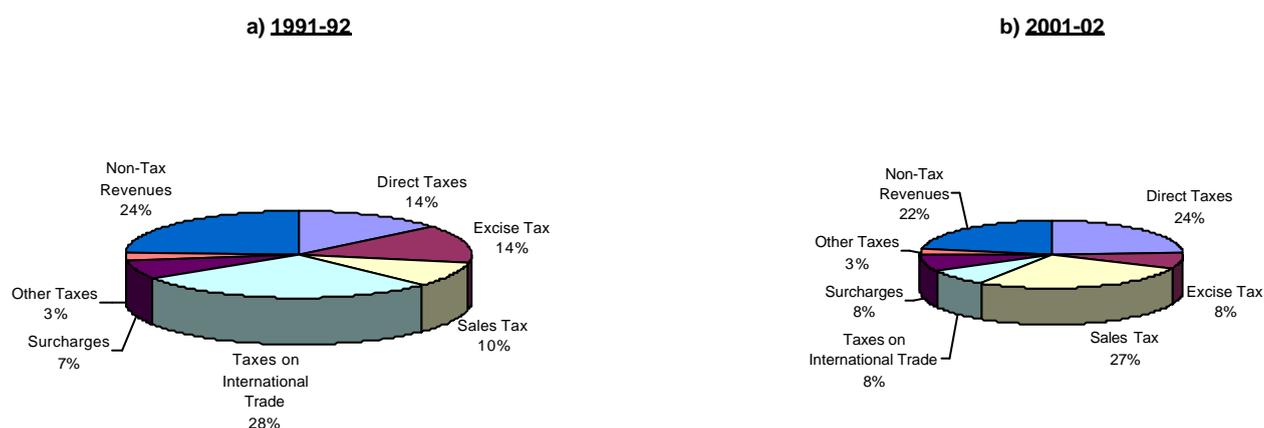
Acknowledging these long-standing structural problems, and with a strong motive to mobilise additional resources to contain the fiscal deficit, the process of reform of the tax system started in the 1990s with the establishment in 1991 of the Resource Mobilization and Tax Reforms Commission (RMTRC), charged with developing and implementing taxation reforms on the part of the GoP. Ahmed (1998) summarises the overall reform strategy in terms of general principles, specific measures and administration reforms to improve efficiency. The doctrines underlying the broad strategy include:

¹¹ Total tax-to-GDP elasticity in Pakistan has declined from just over unity in the 1980s to just under 0.9 in the 1999-2002 period (see Table A3, Appendix).

- maintaining neutrality of the tax system, such that reforms do not interfere with individual investment and consumption decisions;
- establishing horizontal and vertical equity in the tax system;
- increasing the share of direct (notably income) taxes in total taxes;
- switching from more distortionary (especially trade) taxes to less distortionary domestic indirect taxes (i.e. on sales);
- increasing the tax burden on agriculture to reduce inter-sectoral tax inequities.

Effective implementation of taxation reforms in Pakistan since the inception of the RMTRC has been mixed, with progress witnessed in some areas whilst others have floundered. For instance, Figure 5 shows that between 1991 and 2002, direct taxes have increased from 14 per cent of total revenues to 24 per cent, largely as a result of the successful extension of withholding and presumptive taxes within the income tax system (Pasha, 1995); and within indirect taxation, distortionary trade taxes, which lead to welfare losses (despite the appeal of their low administrative costs), have fallen significantly, whilst the share of sales tax has increased proportionately.

Figure 5: Consolidated Federal and Provincial Government Revenue



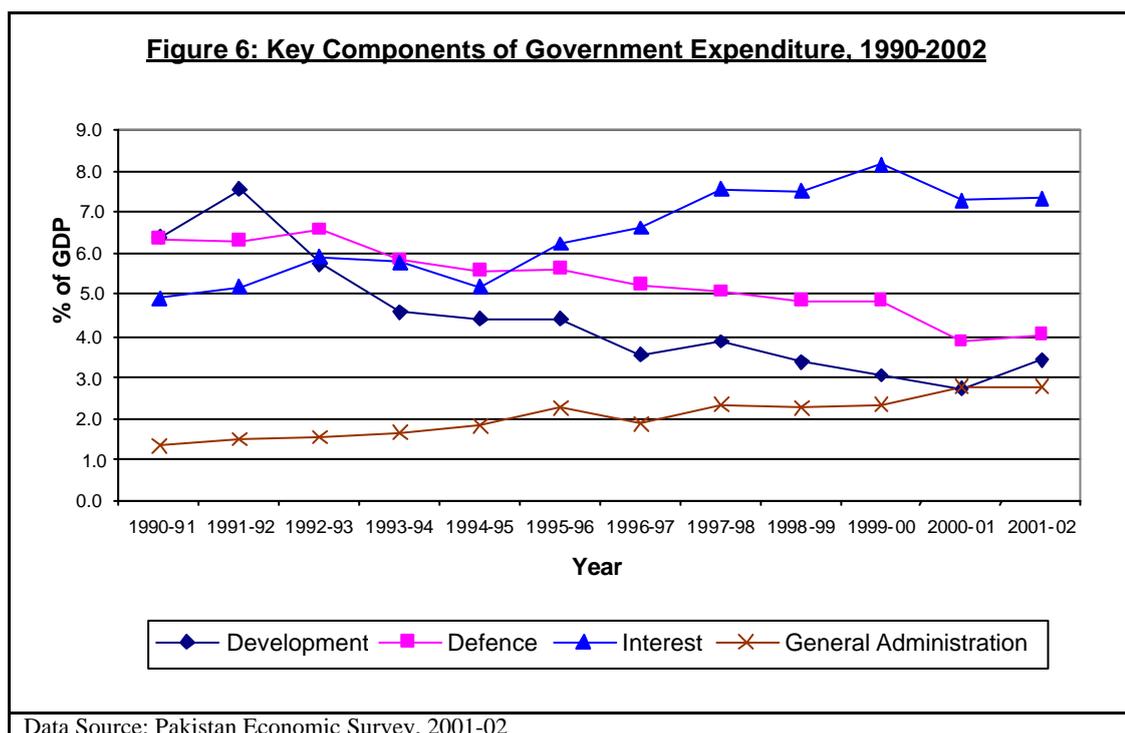
Data Source: Pakistan Economic Survey, 2001-02

Table A5 (Appendix) shows that much of the reform headway in the indirect taxation category has been made since 1999, as sales taxes have grown from under 15 per cent of total revenues in 1998-99 to nearly 28 per cent in 2000-01, with excise and international trade taxes falling markedly over the same period. Such outcomes are directly attributable to the renewed efforts of the Musharraf administration, yet the taxation reforms implemented to date have crucially failed to broaden the overall tax-GDP ratio, which remained at a mere 13 per cent in 2001-02 (Table A4, Appendix). Arguably, given the pre-existing revenue structure, where trade taxes in particular formed a large portion of government revenue (28 per cent in 1991-92, the majority of which accrues to imports), the efficiency gains resulting from trade liberalization have been too low to generate sufficient additional revenue, resulting in an effective 'fiscal squeeze' (Grunberg, 1998). Admittedly, the events of September 11th, 2001 constrained indirect tax revenues in FY02, as with nearly 40 per cent of tax revenue originating from imports, the sharp reduction in the volume of imports in the aftermath of the terrorist attacks, combined with an exchange rate appreciation, led to a contraction in the tax base. This was further compounded by an extra-ordinary customs refund/rebate policy to cushion the blow of exogenous events on exporters' liquidity (GoP, 2002). However,

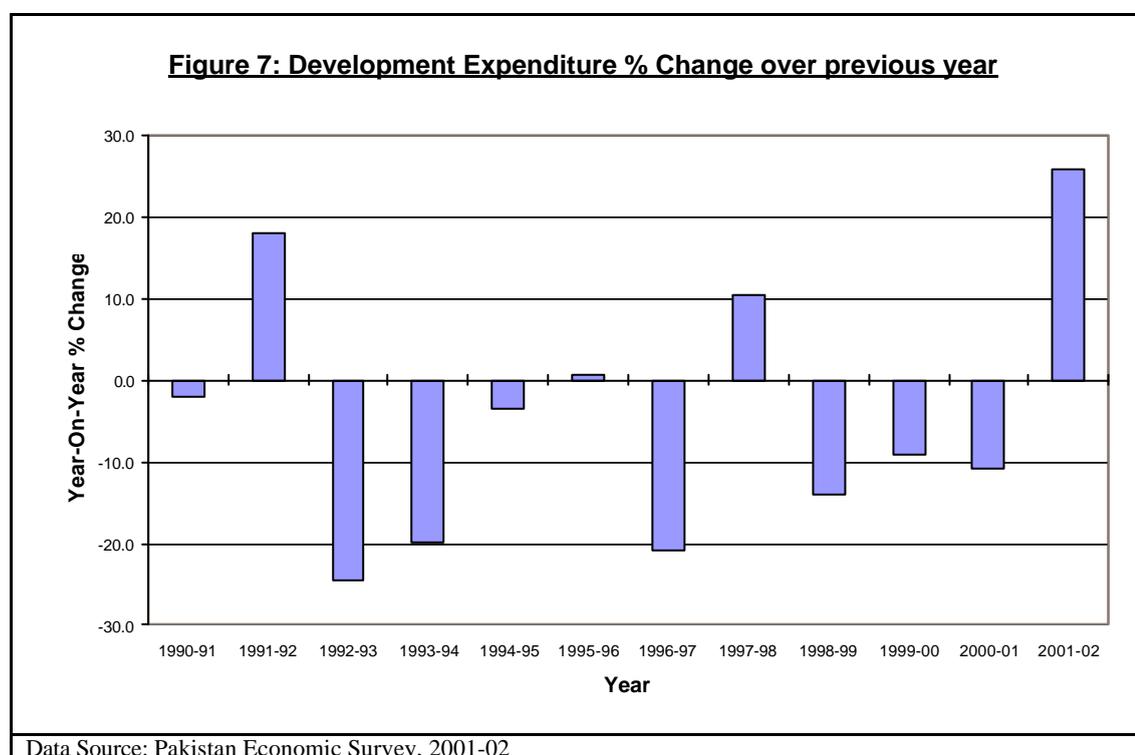
irrespective of exogenous shocks, the persistently low overall tax-GDP ratio is more generally attributable to the prevalence of other inherent structural weaknesses. Elimination of tax concessions and exemptions and widespread restructuring of agricultural sector taxation have continually been deferred from the tax reform agenda, in part because of state capture by special interest groups and strong organization and lobbying power of the potential losers from such policies (Pasha, 1995). Furthermore, tax administration reform, which is fundamental to improving collection efficiency and curbing the rent-seeking activity underpinning the eroded tax base, has been slow in coming. Indeed Pasha and Iqbal (1994) note that “[t]he unfinished task of tax reforms...requires a level of political commitment and willingness to improve the quality of tax administration which has hitherto been lacking”. Although certain progress has undoubtedly been made since 1999, in particular the launching of a tax survey and documentation drive aimed at capturing more of the informal sector within the tax net, continuity of policy will be vital to simplifying the tax system (removing irritants and reducing rates) whilst simultaneously broadening the tax base and improving administration in order to mobilise greater revenues in the future, especially in view of the inevitable ‘fiscal squeeze’ accompanying trade liberalisation-focused reform.

Fiscal Expenditures

The counterpart to the above discussion of revenues in our analysis of the fiscal deficit is, of course, expenditures. Whereas neoclassical theory and IMF wisdom may regard high government expenditure as inflationary, crowding-out private investment, it may also be deemed that government expenditure has the capacity to generate “domestic income redistribution, incremental demand for goods and services and capital formation, all of which should have a likely *net positive impact* on investment and growth, depending on the level and composition of government expenditure” (ILO, 1999: 77). Indeed we have already seen that, empirically, government investment expenditure in Pakistan has a tendency to crowd-in private investment. Clearly, though, composition is critical, as non-productive civil administration and defence spending (for example) would not yield the same investment, growth, employment and general positive welfare effects associated with infrastructural investment and development expenditures.

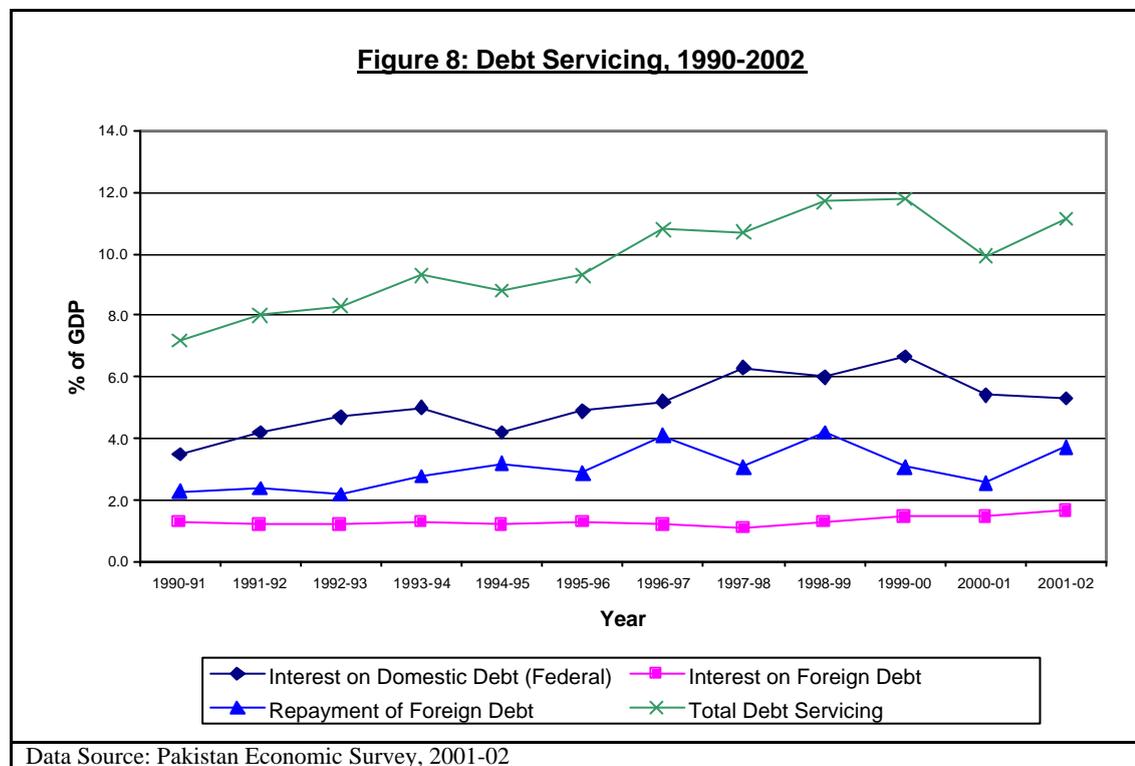


Total expenditure in the National Accounts is divided into current and development expenditures (see Table A6, Appendix). Throughout the 1990s, defence and interest payments have constituted the lion's share of current and total expenditures, whilst development expenditures have flagged. Simultaneously, expenditures on general administration have assumed an increasingly more significant share. Figure 6 depicts spending on these four components as a percentage of GDP. In an attempt to control the budget deficit to meet IMF conditionalities, successive governments in the 1990s, faced with rising interest payments on outstanding debt, consistently cut defence and development expenditures as a percentage of GDP. Development expenditure has suffered in particular, since defence reductions have been limited due to the intrinsic political power of the military, which has historically maintained an overt policing role even during periods of democratic rule (Zaidi, 1995). Indeed, in terms of magnitudes, expenditure on defence has been higher than that on development in every year since 1992. Herein lies a large part of the problem with imposed conditionalities that have been derived out of a fuller political and economic context: in a country such as Pakistan, where revenue mobilisation is poor and a large part of the military's budget is effectively untouchable (although the downward trend in defence spending as a share of GDP since 1992 is a positive start), reductions in the deficit will tend to be sought through cuts in development expenditures such as health and education, and even productive investment in infrastructure. Such measures are bound to impact negatively on growth in the long run. Moreover, the relative reduction of these components after 1995 still failed to curtail the deficit, as interest payments soared on rapidly accumulating debt and general administration expenditures continued to creep upwards, instigating further cuts in development spending. Figure 7 shows the year-on-year percentage change of the share of development expenditure in GDP since 1990.



The graph reveals that development expenditure has been cut in real terms in 8 out of the past 12 years, and these reductions have exceeded 10 per cent on five occasions, including during the year 2000-01, when the Musharraf administration renewed its commitment to IMF conditionality to reduce the fiscal deficit. Modified budget estimates for the year 2001-02 point to a 26 per cent improvement in the development expenditure-GDP ratio, however a

decade of erosion of this measure means that despite this ‘significant’ increase, development expenditure will still only amount to a mere 3.4 per cent of GDP, compared to 4 per cent for defence and 7.3 per cent for interest payment expenditures¹². Re-asserting the complementarities between development and investment expenditures and private investment (and consequently GDP growth and employment), this does not bode particularly well for the long-term.



The high share of interest payments in total fiscal expenditure is attributable to rapid accumulation of non-concessionary debt in the mid-late 1990s. Figure 8 shows that whilst interest payments on foreign debt have remained at a fairly constant level since 1990, it is interest on domestic debt as a share of GDP that has exhibited a marked upward trend. Indeed, domestic non-bank debt was the principal source of deficit financing in the mid-late 1990s, but its corollary is of course higher domestic interest rates and a greater servicing drain on the budget, leaving fewer resources available for productive investment and development purposes.

Our analysis thus far has identified a clear need not only for greater revenue mobilisation, but also for increased public sector development/productive investment expenditures in Pakistan, which in turn would encourage greater private investment, boosting long-run growth and employment. The external balance and the great ‘ill’ of inflation have been shown to be under control, whilst a need has been identified for a stimulus to kickstart growth in the dwindling economy. Given that institutional and political economy constraints have rendered a decade of taxation reform incapable of mobilising higher revenues for much needed development and investment expenditure, a rigid pro-cyclical conditionality that

¹² Furthermore, it is worth noting that the final development share of total expenditure for 2001-02 is in reality less than that reported in Table A6 (Appendix), as a range of extra-ordinary one-off current expenditure items were not incorporated in those estimates. These include various contingent liabilities, most notably a Rs. 30 billion debt-equity swap to bail out the Karachi Electricity Supply Company (KESC), as well as additional unbudgeted defence expenditure to the tune of Rs. 17 billion, resulting from the escalating military tensions and standoff with India.

requires the fiscal deficit to be reduced to under 4 per cent of GDP has arguably further exacerbated the sense of economic stagnation.

5. Deficits and Indicators: Weak Links

In this section we attempt to ascertain whether there are grounds for any temporary deficit expansion within a reasonable space, as a means of providing the necessary stimulus to growth, but without forsaking the greater stability of the macroeconomy. To this end, we estimate the direct effects of the fiscal deficit on the key indicators of private investment and GDP growth, as well as addressing the association between the budget deficit and the other ‘stability’ indicators of inflation and the balance of payments. For the first two relationships, the Ordinary Least Squares (OLS) technique was used to regress each of these key indicators in turn against fiscal deficits and other appropriate independent/explanatory variables as derived from economic theory and existing empirical studies. Simple bivariate graphical correlations were then derived for the associations between the stability variables¹³. Aggregate time series data since 1980 were used, primarily from various editions of the Pakistan Economic Survey, with some data extracted from the State Bank of Pakistan’s Annual Reports and the Statistical Yearbook of Pakistan. Although concerted efforts were undertaken to establish consistency in generating the data series that were analysed, it is perhaps appropriate at this point to proffer a couple of caveats regarding the quality and reliability of Pakistani economic data. In particular, there is a tendency for discrepancies to appear in published statistics as later surveys are released, whilst measurement definitions and techniques are often unstandardised across different statistical departments and may further be subject to change over time, sometimes resulting in alternative estimates of the same indicator being published in any one source. Consequently, it is not unlikely that certain magnitudes may in fact be under- or over-stated, and any such data errors would filter through to our resulting regression estimates; considering this possibility alongside the fairly simple statistical procedure conducted, we do not propose that the coefficients generated should serve as *definitive* descriptive or predictive functions, merely that they provide a useful indication of the direction and general strength of the relationships concerned.

The first relationship we examine is between the fiscal deficit and private investment. The model employed is based on that of Khan and Iqbal (1991), whereby real private investment is specified to depend upon real GDP, the fiscal deficit, inflation and the availability of bank credit to the private sector¹⁴, i.e.

$$\text{RPRINV} = f(\text{GDP}, \text{BUDDEF}, \text{CPI}, \text{CRED})$$

The regression results are reported in Table 1. The high R^2 and Adjusted R^2 values are indicative of a strong goodness of fit of the model to the data; however the only statistically significant coefficients (derived from the t-statistic values) accrue to GDP, which appears to be positively correlated with private investment, and bank credit to the private sector, which carries a marginally negative partial correlation coefficient. Both are significant at the 1 per cent level. The fiscal deficit itself is not a statistically significant variable in the model,

¹³ Various other authors have focused in-depth on the questions as to whether budget deficits are inherently inflationary (e.g. Darrat (2000); Shabbir and Ahmed (1994)) or exacerbate external imbalances (e.g. Piersanti (2000)). Needless to say the relationships are often far from clear-cut.

¹⁴ Supply and demand for credit will be intermediated by the interest rate, which itself is not determined by free market forces in a developing country such as Pakistan (and hence does not reflect the true opportunity cost of investment), rather it is managed.

though we should be wary of conflating statistical with economic significance: the relatively small sample size (22 years) is likely to restrict statistically significant outcomes, in the same way that a very large sample would nearly always produce statistically significant differences. Interestingly, the (albeit weak) partial correlation coefficient for the fiscal deficit shows a positive relationship with private investment, suggesting that since 1980, higher fiscal deficits would appear to have been better associated with a ‘Keynesian’ crowding-in rather than a ‘neoclassical’ crowding-out of private investment. Needless to say, such a result is far from exclusive; Auer (2000) finds in his study on European employment revival, focusing on Austria, Denmark, Ireland and the Netherlands, that the public sector does not appear to have crowded-out private consumption or investment, whilst Bahmani-Oskooee (1999) even presents long-run empirical evidence of real federal deficits crowding-in real investment in the US.

Table 1: OLS Regression on Private Investment

| Dependent Variable | Explanatory Variables | B coefficients | Std. Error | t |
|--------------------|-----------------------|----------------|------------|--------|
| RPRINV | (Constant) | -44.049 | 6.572 | -6.703 |
| | GDP | 0.194 | 0.027 | 7.073 |
| | BUDDEF | 0.147 | 0.767 | 0.192 |
| | CPI | 0.121 | 0.072 | 1.670 |
| | CRED | -0.100 | 0.026 | -3.189 |

Where: **RPRINV** = Real Private Investment (bn. PKR, measured at constant 1980-81 prices); **GDP** = Real GDP (bn. PKR, measured at constant 1980-81 cost); **BUDDEF** = Overall Fiscal Deficit (% of GDP, +ve values denote deficit); **CPI** = Consumer Price Index (1980 = 100); **CRED** = Bank Credit to Private Sector (bn. PKR).

| R | R Square | Adjusted R Square | Durbin-Watson |
|-------|----------|-------------------|---------------|
| 0.984 | 0.969 | 0.961 | 1.913 |

Data Source: Pakistan Economic Survey (various issues); Statistical Yearbook of Pakistan (1997).

The relationship between the fiscal deficit and GDP growth, which we examine next, is estimated within a straightforward model that also includes, as independent variables, the growth of Gross Domestic Fixed Capital Formation (GDFCF), the growth of the labour force and, in order to capture the external sector, a measure of trade policy, calculated as the total sum of the value of exports and imports as a proportion of GDP¹⁵, i.e.

$$GGDP = f(GGDFCF, GL, XMGDP, BUDDEF)$$

The results are presented in Table 2. The model displays a reasonable fit to the data, with an R^2 value of 0.637. Whilst the growth of labour force variable turns out to be weak and statistically insignificant, investment (GDFCF) growth carries a positive partial correlation coefficient which is significant at the 1 per cent level. This result, when combined with our previously identified evidence of a positive correlation between public and private investment, reinforces our contention that containment of public investment in an attempt to meet fiscal deficit targets is detrimental to growth. The budget deficit itself, though not

¹⁵ See also Ahmed (1994), who regresses the GDP growth rate against the rate of growth of physical capital, growth of labour, a trade policy measure and a dummy variable to capture the impact of economic liberalisation since 1978, using data from 1974-1992.

statistically significant up to the 10 per cent level, is positively correlated with GDP growth over the sample range¹⁶.

Table 2: OLS Regression on GDP growth

| Dependent Variable | Explanatory Variables | B coefficients | Std. Error | t |
|--------------------|-----------------------|----------------|------------|--------|
| GGDP | (Constant) | 11.082 | 4.856 | 2.282 |
| | GGDFCF | 0.196 | 0.044 | 4.423 |
| | GL | 0.041 | 0.157 | 0.262 |
| | XMGDP | -0.273 | 0.127 | -2.155 |
| | BUDDEF | 0.383 | 0.231 | 1.654 |

Where: **GGDP** = Real GDP growth (% change, measured at constant 1980-81 cost); **GGDFCF** = Growth in Real GDFCF (% change, measured at constant 1908-81 cost); **GL** = Labour Force growth (% change); **XMGDP** = Measure of Trade Policy ((X+M)/GDP); **BUDDEF** = Overall Fiscal Deficit (% of GDP, +ve values denote deficit).

| R | R Square | Adjusted R Square | Durbin-Watson |
|-------|----------|-------------------|---------------|
| 0.798 | 0.637 | 0.552 | 2.806 |

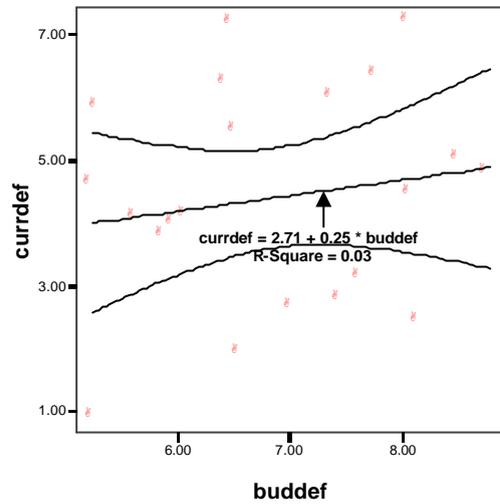
Data Source: Pakistan Economic Survey (various issues).

Figures 9 and 10 show the simple bivariate associations between the fiscal deficit and, respectively, inflation and the current account deficit on the balance of payments. In both cases, the scatterplots show little evidence of any definitive relationship, though the fitted trendlines suggest a positive association between the fiscal deficit and the current account deficit (in line with the ‘twin deficits’ theory¹⁷), but a seemingly *negative* association with inflation. This outcome somewhat neuters the implied conventional stance that a fiscal deficit in excess of the 4 per cent target level is likely to be inherently – and problematically – inflationary. Even if the fiscal deficit was to exhibit inflationary tendencies, for example through a greater recourse to money creation financing, there would be little cause for alarm at current or even slightly higher inflation rates as, given the prolonged period of low growth in Pakistan, a reflationary impetus may well be necessary.

¹⁶ In addition, it may be noticed that the measure of trade policy is statistically significant (at the 5% level), but appears to be slightly negatively associated with GDP growth since 1980. However other studies, such as that of Ahmed (1994), have found a significant positive relationship between the variables. This is an area that requires further exploration, but is not the focus of this present study.

¹⁷ The ‘twin deficits’ phenomenon: whereby large and persistent budget deficits are seen to occur in tandem with current account deficits. Piersanti (2000) finds strong evidence of current account deficits being associated with expected future budget deficits for OECD countries between 1970 and 1997.

Figure 9 : Scatterplot – Fiscal Deficit and Current Account Deficit



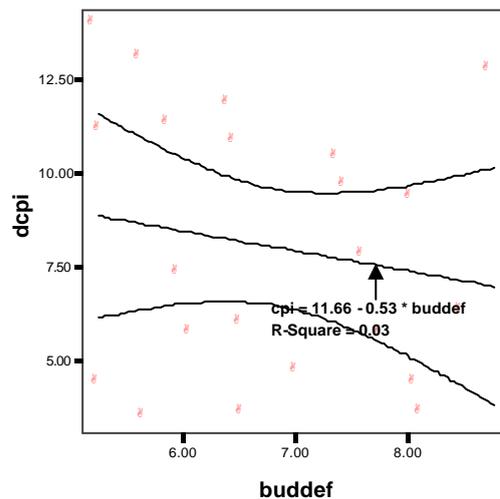
Notes:

1) Linear Regression with 95.00% Mean Prediction Interval

2) buddef = Overall Fiscal Deficit (% of GDP, +ve value denotes deficit); currdef = Current Account Deficit (% of GDP, +ve value denotes deficit)

Data Source: Pakistan Economic Review (various issues)

Figure 10 : Scatterplot – Fiscal Deficit and Inflation



Notes:

1) Linear Regression with 95.00% Mean Prediction Interval

2) buddef = Overall Fiscal Deficit (% of GDP, +ve value denotes deficit); dcpi = inflation (% change in the Consumer Price Index)

Data Source: Pakistan Economic Review (various issues)

6. Implications: Towards a Fiscal Space

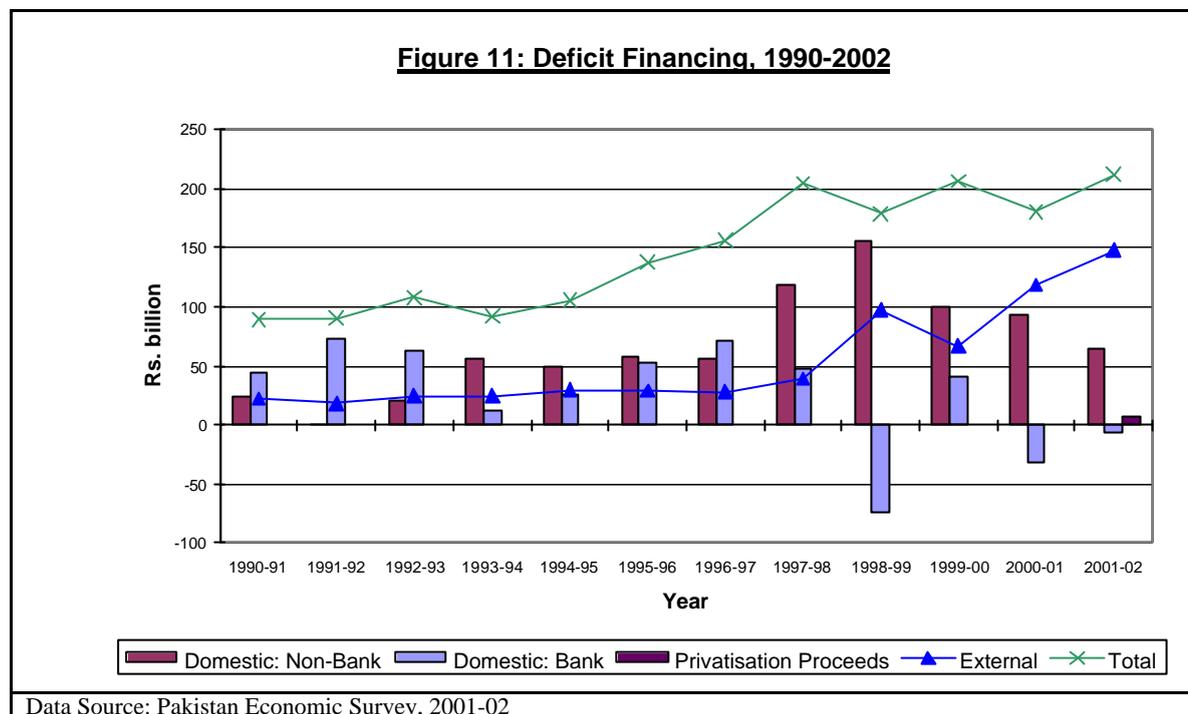
The above analysis offers little support for conventional IMF wisdom. The empirical relationships that we have established are weak at best, and their directions often undermine neoclassical theoretical predictions. Fiscal deficits in Pakistan since 1980 appear neither to have any detrimental impact on the key macro-economic indicators of investment and GDP growth, nor to be necessarily associated with inflation. In actual fact, when this evidence is considered in conjunction with our acknowledged need for greater government expenditure for development and employment-generating purposes, in the context of low levels of inflation, external balance and stagnant private investment and GDP growth, a case emerges for a degree of fiscal pump-priming, or carefully managed deficit *expansion*, to be tolerated, in order to provide the impetus to rekindle investment, employment and growth¹⁸. Duly recognising the importance of maintaining macroeconomic stability, it is proposed that any expansion should take place only in the short term, within a stipulated fiscal 'space', and should consist solely of directly productive investment/development expenditures¹⁹. In response to the persistence of a large negative output gap (the difference between actual and potential output) in the economy, and the limited capacity of interest rate cuts alone to spur investment to close this gap, the Economics Department of ABN Amro Bank, Pakistan (ABN Amro, 2002a) suggests tolerance of up to a 1.5 percent of GDP increase in the fiscal deficit for an interim period of up to two years. In the present milieu, we contend that such a fiscal space is both tenable and preferable to a rigid fiscal target. However, the real problem with any deficit expansion lies with whether and how it could actually be financed. The three broad options available for deficit financing are domestic bank, domestic non-bank, and external sources. In the former scenario, where the fiscal deficit is financed through money creation, the effect is likely to be highly inflationary²⁰; whilst the latter two options would imply a further accumulation of debt, thereby exacting a greater debt servicing requirement in the future. Private sector debt will tend to entail higher interest rates than official bilateral or multilateral debt, and where perceived risk is high, these rates are likely to be further inflated. In a developing country such as Pakistan, characterised by under-developed institutions, a lack of depth and maturity of financial markets, and rampant corruption, cost-effective financing options are likely to be severely limited. Indeed, policymakers in Pakistan, besides being tied down by IMF conditionality, have recently argued that they were reluctant to engage in expansionary policy measures due to a lack of financing options - further accumulation of debt at high rates of interest would have led to untenable debt repayments, whilst domestic bank financing would have created destabilizing inflationary consequences. Figure 11 disaggregates the financing of the fiscal deficit since 1990. As we have already seen, accumulation of non-concessionary debt in the mid-late 1990s has resulted in the presently excessively high share of interest payments in fiscal expenditure. With the military takeover in 1999, both domestic and external debt financing of the deficit initially fell significantly, as the government was forced to return to bank financing, but the IMF agreement signed in November 2000 marked a turnaround in the availability of external resources. Yet in reality, the government remained fundamentally constrained: net foreign assets as a proportion of broad money were a mere 1.86 per cent at end-June 2001, indicative

¹⁸ Auer (2000) recalls that such a fiscal stimulus was successfully adopted by the Danish government during the recession of the early 1990s, whereby a public spending boost and tax cut helped return the economy to a sustained growth path.

¹⁹ These should also include expenditure on *maintenance* of existing infrastructure, which has a tendency to be neglected once initial investments have been made, due to a lack of deployable resources.

²⁰ Indeed, Easterly and Schmidt-Hebbel (1993) estimate that a percentage point increase in the deficit, financed through seignorage, boosts inflation by 18% in Pakistan.

of severe limitations on feasible external public borrowing options other than financing from IFI sources, which, of course, is conditional upon a reduction of the fiscal deficit - hence a conflict of interests would ensue if expansion were to be pursued.



Nonetheless, exogenous events, in particular September 11th 2001 and Pakistan's subsequent support for the War on Terror, have eased the flow of concessionary resources, including an inflow of approximately \$777m in grants alone by March 2002 (World Bank, 2002a). Revised estimates of total external grants in 2001-02, at Rs. 83.5bn (2.24 per cent of GDP), are nearly double the original budget estimates of Rs. 46bn. Furthermore, heightened bank security has led to a significant increase in repatriation of flight capital and a doubling of remittances through official channels, thereby practically eliminating the kerb exchange market premium over official interbank rates. This in turn has allowed the State Bank of Pakistan to substantially increase its reserves²¹. Concurrently, a rescheduling agreement in December 2001 has reduced the net present value of Paris Club debt by some \$2.7bn (ibid.), thereby keeping foreign debt servicing disproportionately low relative to domestic debt servicing (see Figure 8). Indeed, revised estimates of total debt rescheduling for 2001-02, at over Rs. 65bn (1.76 per cent of GDP), equate to three times the original budget estimates, whilst total external resources were 15.7 per cent higher than budgeted. This would imply that, in theory, some fiscal space should have been created since 2001 – albeit through unanticipated concessions reflecting an accidental consequence of circumstances, rather than through any long-term upward paradigm shift in external financing availability or improvement in fundamentals – in which the fiscal deficit could have been expanded by an additional 1-1.5 per cent of GDP (as suggested in ABN Amro (2002a)) to meet development and productive employment-generating goals, without having any particular adverse effects on key macro-economic indicators, as supported by our earlier empirical analysis. A critical caveat, however, relates to the management of any such expansionary policy measures. Upward trends in general administration expenditures, along with persistent contingent

²¹ Total liquid foreign exchange reserves, that is, the sum of reserves with the SBP and with other banks, grew from barely \$2bn at end FY00 to \$6.5bn by end FY02, rising even further to \$9.5bn thereafter (State Bank of Pakistan Economic Data, available online at <http://www.sbp.org.pk/Ecodata/Ecodatamain.htm>).

liabilities and greater defence requirements resulting from increased regional tensions are all exerting pressure on Pakistan's budgetary policymakers, yet it would be imprudent and self-defeating to use any fiscal space in non-directly productive investment/development activities.

A counter-argument may also be made that this proposed strategy focuses purely on demand management, is too short-termist in nature and could undermine the government's credibility, whilst undoing the strides taken in recent years towards establishing internal and external stability, particularly given the fragile state of the economy and its heightened susceptibility to exogenous shocks. However, the essence of this counter-cyclical policy prescription is targeted, prudent fiscal pump-priming that would merely rekindle, not destabilize the economy if contained in the short-run and within an identified space, as has already been created by recent surges in resource availability. In fact this action may well be *necessary* to regenerate the depressed economy and instil investor confidence, since interest rates cuts alone have failed to stimulate activity and autonomous government expenditures, most notably on investment, have been shown to encourage private investment. Moreover, in view of the fragility and vulnerability of the Pakistani economy, there is a clear need to strengthen institutions and infrastructure, and this undeniably requires government investment.

7. Conclusions

In this study, we have explored the rationale behind the reform programmes and associated conditionality of the IFIs, identifying critical conceptual and practical problems with their pro-cyclical policy prescriptions, not least of which has been a notable failure of adherence to these programmes to alleviate poverty and generate sustainable long-run growth in practice. Pakistan's commitment to reform since 1999 has been associated with attainment of price stability and control of the balance of payments, yet investment and GDP growth have remained sluggish, with interest rate cuts failing to stimulate activity. Tight fiscal policy is promoted primarily because of the perceived inflationary effects of fiscal expansion. 'Fetishism', or obsession with bringing certain indicators, notably inflation and the fiscal deficit, into line for the sake of stability outside a broader contextual perspective, has been achieved by squeezing out development and other investment expenditures, to the detriment of productivity-enhancing employment generation and growth. In the 1980s, average GDP growth was 6.2 per cent, whilst inflation averaged 7.3 per cent, as opposed to the 3-4 per cent since 1999, indicating that a little more inflation – though we recognise the importance of maintaining broad long run stability – may well be tolerable if it stimulates growth. Our empirical analysis shows that the direct relationship of the conventional measure of the fiscal deficit to various key macroeconomic variables in Pakistan since 1980 has been weak, with little evidence of any particularly harmful effects. Hence, in the current depressed economic setting, we argue that there is a case for short-term expansion of the deficit, specifically for productive investment and development expenditure purposes. Exogenous events, in particular those of September 11th, 2001, have allowed the GoP to elicit increased concessionary external funding and an important rescheduling of foreign debt, implying that space should have been created to finance a 1-1.5 per cent of GDP increase in the fiscal deficit, to provide the counter-cyclical stimulus that is so crucially required. However, as long as Pakistan's macroeconomic policy is bound by rigid conditionality over (growth-induced) productive employment-generating concerns, the opportunity presented by such space may not be fully exploited, if indeed at all. In the short run, investor-confidence needs to be restored, as private investment surely holds the key to creating employment and alleviating poverty. Certain autonomous public expenditures have crowded-in private

investment in Pakistan in recent years, but unless growth-induced productive employment generation is made central to macroeconomic policy, perhaps greater development expenditure may only realistically be achieved through a reorganisation of spending within the budget at the cost of other current expenditures (e.g. greater cuts in defence and recurrent/general administration expenditures), in tandem with a concerted continuation of reform efforts to improve tax collection and broaden the tax base. Even in this regard, it is more than likely that political obstacles will continue to obtain.

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Appendix: Tables

Table A1: Fiscal Indicators as Percentage of GDP (MP), 1990-2002

| Year | GDP Real Growth | Overall Fiscal Deficit | Expenditure | | | Revenue | | | | |
|------------------|-----------------|------------------------|-------------|---------|-------------------|---------------|-----------|------------|--------------|----------------------|
| | | | Total | Current | PSDP ¹ | Total Revenue | Total Tax | Direct Tax | Indirect Tax | Non-Tax ² |
| 1990-91 | 5.4 | 8.8 | 25.7 | 19.3 | 6.4 | 16.9 | 12.7 | 2.0 | 10.7 | 4.2 |
| 1991-92 | 7.6 | 7.5 | 26.7 | 19.1 | 7.6 | 19.2 | 13.7 | 2.5 | 11.2 | 5.5 |
| 1992-93 | 2.1 | 8.1 | 26.2 | 20.5 | 5.7 | 18.1 | 13.4 | 2.8 | 10.6 | 4.7 |
| 1993-94 | 4.4 | 5.9 | 23.4 | 18.8 | 4.6 | 17.5 | 13.4 | 2.9 | 10.5 | 4.1 |
| 1994-95 | 5.1 | 5.6 | 22.9 | 18.5 | 4.4 | 17.3 | 13.8 | 3.4 | 10.4 | 3.5 |
| 1995-96 | 6.6 | 6.5 | 24.4 | 20.0 | 4.4 | 17.9 | 14.4 | 3.8 | 10.6 | 3.5 |
| 1996-97 | 1.7 | 6.4 | 22.3 | 18.8 | 3.5 | 15.8 | 13.4 | 3.6 | 9.8 | 2.5 |
| 1997-98 | 3.5 | 7.7 | 23.7 | 19.8 | 3.9 | 16.0 | 13.2 | 3.9 | 9.3 | 2.8 |
| 1998-99 | 4.2 | 6.1 | 22.0 | 18.6 | 3.4 | 15.9 | 13.3 | 3.6 | 9.7 | 2.7 |
| 1999-00 | 3.9 | 6.5 | 23.6 | 20.4 | 3.0 | 17.1 | 12.9 | 3.6 | 9.3 | 4.2 |
| 2000-01 | 2.4 | 5.3 | 21.3 | 19.0 | 2.7 | 16.0 | 13.0 | 3.9 | 9.1 | 3.0 |
| 2001-02 (M.B.E.) | 3.6 | 5.7 | 22.5 | 18.9 | 3.4 | 16.8 | 13.1 | 4.0 | 9.1 | 3.7 |

Notes:

1 PSDP: Public Sector Development Program. Source: Finance Division, (Budget Wing)

2 Figures up to 95-96 include surplus of autonomous bodies.

M.B.E: Modified Budget Estimates.

Source: Pakistan Economic Survey (2002)

Table A2: Selected Indicators, 1995-2002

| | | 1995-96 | 1996-97 | 1997-98 | 1998-99 | 1999-00 | 2000-01 | 2001-02 |
|--------------------------------|-------------------|---------|---------|---------|---------|---------|---------|---------|
| Real GDP (fc) Growth | <i>(% change)</i> | 4.6 | 3.1 | 3.0 | 4.2 | 3.9 | 2.5 | 3.6 |
| Inflation | <i>(% change)</i> | 10.8 | 11.8 | 7.8 | 5.7 | 3.6 | 4.4 | 3.5 |
| Real Investment Growth | <i>(% change)</i> | | | | | | | |
| Total | | 5.2 | -3.9 | -3.7 | -4.5 | 5.0 | 0.9 | -3.1 |
| Private | | 8.8 | 7.9 | 7.7 | -14.9 | 5.4 | -0.8 | 1.9 |
| Public | | 4.2 | -10.7 | -31.7 | 23.5 | 7.1 | 4.8 | -17.5 |
| General Govt. | | -1.9 | -24.4 | 7.3 | 1.0 | 0.8 | 0.5 | 4.5 |
| Real Consumption Growth | <i>(% change)</i> | | | | | | | |
| Private | | 7.1 | 4.2 | 1.6 | 7.4 | 0.4 | 2.1 | 3.4 |
| General Govt. Current | | 6.8 | -8.4 | 6.8 | -6.9 | 7.5 | -5.3 | 18.2 |
| Overall Fiscal Deficit | <i>(% of GDP)</i> | 6.5 | 6.4 | 7.6 | 6.1 | 6.6 | 5.3 | 5.7 |
| Imports | <i>(% of GDP)</i> | 18.7 | 19.1 | 16.3 | 16.1 | 16.8 | 18.4 | |
| Exports | <i>(% of GDP)</i> | 13.8 | 13.4 | 13.9 | 13.3 | 14.0 | 15.7 | |
| Trade Balance | <i>(% of GDP)</i> | -4.9 | -5.7 | -2.4 | -2.8 | -2.8 | -2.6 | |
| Current Account Balance | <i>(% of GDP)</i> | -7.2 | -6.2 | -3.1 | -4.1 | -1.9 | -0.9 | |
| Population | <i>(millions)</i> | 123.9 | 126.9 | 130.0 | 133.0 | 136.0 | 139.1 | 142.1 |
| Labour Force | <i>(millions)</i> | 34.4 | 37.3 | 39.2 | 40.1 | 40.4 | 41.3 | |
| Employed | <i>(millions)</i> | 32.6 | 35.1 | 36.9 | 37.7 | 37.3 | 38.1 | |
| Unemployed | <i>(millions)</i> | 1.9 | 2.3 | 2.3 | 2.4 | 3.2 | 3.2 | |
| Unemployment rate | <i>(%)</i> | 5.4 | 6.1 | 5.9 | 5.9 | 7.8 | 7.8 | |

Source: Pakistan Economic Survey (2002); ILO Labour Force Data (LABORSTA)

Table A3: Average Tax-to-GDP Elasticities

| | 1980-1990 | 1990-1999 | 1999-2002 | 1980-2002 |
|---------------------------|------------------|------------------|------------------|------------------|
| Average Elasticity | 1.054 | 0.960 | 0.896 | 0.991 |

Notes:

Tax-to-GDP elasticity calculated as:

$\% \text{ Change in total tax revenue} / \% \text{ Change in GDP}$

Values cited are averages of yearly estimates for each reference period.

Data Source: Pakistan Economic Survey (various issues)

Table A4: Summary of Public Finance
Consolidated Federal and Provincial Governments

| (Rs Million) | | | | |
|--------------------------------------|-----------|-----------|-------------------|--------------------|
| Fiscal Year/ Item | 1998-99 | 1999-00 | 2000-01 (P.A.) | 2001-2 (M.B.E.) |
| Total Revenues (I+II) | 468,601 | 536,832 | 546,400 | 625,400 |
| Federal | 429,691 | 495,865 | 507,300 | 581,900 |
| Provincial | 38,910 | 40,967 | 39,100 | 43,500 |
| I) Tax Revenues | 390,726 | 405,824 | 444,800 | 486,000 |
| Federal | 375,078 | 387,050 | 425,400 | 464,600 |
| Provincial | 15,648 | 18,774 | 19,400 | 21,400 |
| II) Non-Tax Revenues | 77,875 | 131,008 | 101,600 | 139,400 |
| Federal | 54,613 | 108,815 | 81,900 | 117,300 |
| Provincial | 23,262 | 22,193 | 19,700 | 22,100 |
| Total Expenditures (a+b+c) | 647,778 | 743,632 | 726,900 | 837,600 |
| a) Current | 547,279 | 642,935 | 650,700 | 705,500 |
| Federal | 424,443 | 485,550 | 500,800 | 535,400 |
| Provincial | 122,836 | 157,385 | 149,900 | 170,100 |
| b) Development (PSDP) | 98,286 | 95,589 | 92,500 | 127,000 |
| c) Net Lending to PSE's | 2,213 | 5,108 | -16,300 | 5,100 |
| Overall Deficit | -179,177 | -206,800 | -180,500 | -212,200 |
| Financing (net) | 179,177 | 206,800 | 180,500 | 212,200 |
| External (Net) | 97,070 | 66,869 | 118,800 | 148,000 |
| Domestic (i+ii+iii) | 82,108 | 139,931 | 61,600 | 64,200 |
| i) Non-Bank | 155,919 | 99,969 | 93,900 | 64,700 |
| ii) Bank | -73,811 | 39,962 | -32,300 | -7,000 |
| iii) Privatization Proceeds | - | - | - | 6,500 |
| Memorandum Item | | | | |
| GDP (mp) | 2,938,379 | 3,147,167 | 3,416,252 | 3,726,611 |
| (As percent of GDP at Market Prices) | | | | |
| Total Revenue | 15.95 | 17.06 | 15.99 | 16.78 |
| Tax Revenue | 13.20 | 12.89 | 13.02 | 13.04 |
| Non-Tax Revenue | 2.65 | 4.16 | 2.97 | 3.80 |
| Expenditure | 22.05 | 23.63 | 21.28 | 22.48 |
| Current | 18.63 | 20.30 | 19.05 | 18.93 |
| Development¹ | 3.42 | 3.30 | 2.42 | 3.60 |
| Overall Deficit | 6.10 | 6.57 | 5.28 | 5.69 |

Notes:

1 From 1998-99 onward, also includes lending to PSEs

M.B.E. Modified Budget Estimates

P.A. Provisional Actual

Source: Pakistan Economic Survey (2002)

Table A5: Consolidated Federal and Provincial Governments Revenues

| | | (Rs million) | | | |
|--|---------|--------------|-------------------|---------------------|--|
| Fiscal Year/ Item | 1998-99 | 1999-2000 | 2000-01 (P.A.) | 2001-02 (M.B.E.) | |
| Total Revenue (I+II) | 468,601 | 536,832 | 546,400 | 625,400 | |
| Federal | 429,691 | 495,865 | 507,300 | 581,900 | |
| Provincial | 38,910 | 40,967 | 39,100 | 43,500 | |
| I. Tax Revenues (A+B) | 390,726 | 405,824 | 444,800 | 486,100 | |
| Federal | 375,078 | 387,050 | 425,400 | 464,600 | |
| Provincial | 15,648 | 18,774 | 19,400 | 21,500 | |
| A. Direct Taxes (1+2) | 105,588 | 112,553 | 133,312 | 148,727 | |
| 1. Federal | 103,476 | 109,481 | 127,400 | 146,500 | |
| 2. Provincial | 2,112 | 3,072 | 5,912 | 2,227 | |
| B. Indirect Taxes (3+4+5+6+7) | 285,138 | 293,271 | 311,488 | 337,373 | |
| 3. Excise Duty | 62,691 | 57,958 | 50,495 | 49,812 | |
| Federal | 60,572 | 56,624 | 49,200 | 47,100 | |
| Provincial | 2,119 | 1,334 | 1,295 | 2,712 | |
| 4 Sales Tax¹ | 68,680 | 116,767 | 152,800 | 170,100 | |
| 5. Taxes on Interna- tional Trade | 78,654 | 63,916 | 64,509 | 50,500 | |
| 6. Surcharges¹ | 61,927 | 38,912 | 30,500 | 49,000 | |
| 6.1 Gas | 9,855 | 25,403 | 12,600 | 15,000 | |
| 6.2 Petroleum | 52,072 | 13,509 | 17,900 | 34,000 | |
| 7. Other Taxes² | 13,186 | 15,718 | 13,184 | 17,960 | |
| 7.1 Stamp Duties | 5,287 | 6,397 | 5,098 | 6,581 | |
| 7.2 Motor Vehicle Taxes | 2,368 | 2,803 | 3,100 | 3,269 | |
| 7.3 Foreign Travel Tax¹ | 1,769 | 1,350 | 184 | - | |
| 7.4 Others | 3,762 | 5,168 | 4,802 | 8,110 | |
| II. Non-Tax Revenues | 77,875 | 131,008 | 101,812 | 139,599 | |
| Federal | 54,613 | 108,815 | 81,900 | 117,300 | |
| Provincial | 23,262 | 22,193 | 19,700 | 22,100 | |
| (As Percentage of Total Revenue) | | | | | |
| Tax Revenues | 83.38 | 75.60 | 81.41 | 77.73 | |
| Direct Taxes | 22.53 | 20.97 | 24.40 | 23.78 | |
| Indirect Taxes | 60.85 | 54.63 | 57.01 | 53.95 | |
| Excise Tax | 13.38 | 10.80 | 9.24 | 7.96 | |
| Sales Tax | 14.66 | 21.75 | 27.96 | 27.20 | |
| Taxes on Interna- tional Trade | 16.78 | 11.91 | 11.81 | 8.07 | |
| Surcharges | 13.22 | 7.25 | 5.58 | 7.83 | |
| Other Taxes | 2.81 | 2.93 | 2.41 | 2.87 | |
| Non-Tax Revenues | 16.62 | 24.40 | 18.63 | 22.32 | |

Notes:

1 Revenues under these heads are exclusively Federal.

2 Mainly includes Provincial Revenues.

M.B.E. Modified Budget Estimates.

P.A. Provisional Actual

Source: Pakistan Economic Survey (2002)

Table A6: Consolidated Federal and Provincial Governments Expenditures

| | (Rs million) | | | |
|--|--|---------|-------------------|--------------------|
| Fiscal Year/ Item | 1998-99 | 1999-00 | 2000-01 (P.A.) | 2001-02 (M.B.E) |
| Current Expenditure | 547,279 | 655,015 | 650,700 | 705,500 |
| Federal | 424,443 | 492,734 | 500,800 | 535,400 |
| Provincial | 122,836 | 162,281 | 149,900 | 170,100 |
| Defence | 143,471 | 152,794 | 131,200 | 149,600 |
| Interest | 220,100 | 256,799 | 249,452 | 272,710 |
| Federal | 213,259 | 252,004 | 234,700 | 257,000 |
| Provincial | 6,841 | 4,795 | 14,752 | 15,710 |
| Current Subsidies | 15,035 | 28,929 | 23,112 | 24,816 |
| Federal | 9,533 | 20,390 | 14,700 | 15,700 |
| Provincial | 5,502 | 8,539 | 8,412 | 9,116 |
| Gen. Administration¹ | 66,950 | 73,228 | 94,052 | 102,700 |
| Federal | 26,650 | 28,620 | 45,900 | 52,000 |
| Provincial | 40,300 | 44,608 | 48,152 | 52,360 |
| All Others² | 101,723 | 143,265 | 152,884 | 155,674 |
| Grants | - | - | 24,000 | 19,600 |
| Development Expenditure³ | 98,286 | 95,589 | 92,500 | 127,000 |
| Net Lending to PSEs | 2,213 | 5,108 | -16,300 | 5,100 |
| Total Expenditure | 647,778 | 755,712 | 726,900 | 837,600 |
| | (As Percentage of Total Expenditure) | | | |
| Current Expenditure | 84.5 | 86.7 | 89.5 | 84.2 |
| Defence | 22.1 | 20.2 | 18.0 | 17.9 |
| Interest | 34.0 | 34.0 | 34.3 | 32.6 |
| Current Subsidies | 2.3 | 3.8 | 3.2 | 3.0 |
| General Administration | 10.3 | 9.7 | 12.9 | 12.3 |
| All Others | 15.7 | 19.0 | 21.0 | 18.6 |
| Development Expenditure | 15.5 | 13.3 | 10.5 | 15.8 |
| Total Expenditure | 100.0 | 100.0 | 100.0 | 100.0 |
| | (Percentage Growth over Preceding Period) | | | |
| Current Expenditure | 3.28 | 19.69 | -0.66 | 8.42 |
| Defence | 5.37 | 6.50 | -14.13 | 14.02 |
| Interest | 8.77 | 16.67 | -2.86 | 9.32 |
| Current Subsidies | 70.08 | 92.41 | -20.11 | 7.37 |
| General Administration | 8.98 | 9.38 | 28.44 | 9.19 |
| All Others | -58.71 | 40.84 | 6.71 | 1.82 |
| Development Expenditure | -5.58 | -2.74 | -3.23 | 37.30 |
| Total Expenditure | 2.17 | 16.66 | -3.81 | 15.23 |

Notes:

1 Includes Law & Order.

2 Includes mainly Provincial Expenditures.

3 Includes net lending

M.B.E. Modified Budget Estimates

P.A. Provisional Actual

Source: Pakistan Economic Survey (2002)

Table A7: Pakistan: Net External Program Financing FY 2001/02 and FY 2002/03

| | Cumulative from July 1, 2001 | | | | Cumulative from July 1, 2002 | | | |
|--|------------------------------|---------------|---------------|--------------|------------------------------|--------------|--------------|--------------|
| | Sep. 2001 | Dec. 2001 | Mar. 2002 | Jun. 2002 | Sep. 2002 | Dec. 2002 | Mar. 2003 | Jun. 2003 |
| | Act. | Act. | Act. | Act. | Proj. | Proj. | Proj. | Proj. |
| Program financing (a+b+c+d+e+f-g+h) | -160.5 | -180.2 | -479.4 | 170.0 | 447.5 | 597.4 | 689.1 | 795.5 |
| a. World Bank | 0.0 | 95.0 | 95.0 | 697.5 | 185.0 | 215.0 | 400.0 | 550.0 |
| b. AsDB loans | 0.0 | 150.0 | 150.0 | 185.0 | 235.0 | 385.0 | 455.0 | 455.0 |
| c. Other multilaterals | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| d. Bilateral loans | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| e. Commercial bank borrowing | 207.0 | 469.0 | 660.3 | 822.7 | 100.0 | 200.0 | 300.0 | 400.0 |
| <i>Of which: IDB</i> | 106.0 | 176.0 | 267.3 | 329.7 | 100.0 | 200.0 | 300.0 | 400.0 |
| f. Privatisation receipts | 0.0 | 0.0 | 0.0 | 117.0 | 50.0 | 100.0 | 150.0 | 200.0 |
| g. Amortization Due | 650.3 | 1392.7 | 2155.0 | 2861.7 | 393.0 | 790.9 | 1346.2 | 1734.0 |
| Multilateral creditors | 122.4 | 258.4 | 376.2 | 499.2 | 130.7 | 270.6 | 400.6 | 526.1 |
| Bilateral creditors | 193.6 | 324.5 | 484.2 | 646.9 | 184.9 | 302.0 | 467.3 | 567.9 |
| Commercial creditors | 317.9 | 772.2 | 1236.4 | 1633.0 | 49.5 | 169.7 | 397.7 | 538.1 |
| Other (Military) | 16.4 | 37.6 | 58.2 | 82.6 | 27.9 | 48.6 | 80.6 | 101.9 |
| h. Debt service rescheduled/arrears | 282.8 | 498.5 | 770.3 | 1209.5 | 270.5 | 488.3 | 730.3 | 924.5 |
| Multilateral creditors | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Bilateral Creditors | 267.6 | 460.4 | 717.4 | 1127.9 | 245.9 | 440.3 | 656.6 | 827.4 |
| Commercial creditors | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other (Military) | 15.2 | 38.1 | 52.9 | 81.6 | 24.6 | 48.0 | 73.7 | 97.1 |

Source: Pakistan Letter of Intent, Memorandum of Economic and Financial Policy and Technical Memorandum of Understanding, October 16th 2002 (IMF)