



MCB Bank Limited

Treasury & FX Group

Quid Pro Quo

Issue # 31

Economic report

March 7th, 2007

The Deficit Saga: Part 2

As a sequel to our previous report, this paper begins with a summary of arguments presented in The Deficit Saga: Part 1. Next, it will present a detailed picture of the current arrangement of Pakistan's government expenditure while highlighting the major weaknesses present in the structure of spending. In the wake of these limitations and the prevailing economic ambience it will explore the areas that require a greater focus from the government and deserve increased proportions of fiscal spending.

Focusing particularly on the need to increase government spending in the employment of idle resources within the economy, this report argues against the perceived negative nature of fiscal deficits.

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Blast from the Past

In the last Quid Pro Quo, The Deficit Saga: Part I, we outlined the basic principles of fiscal expenditure and the ensuing fiscal deficit, while exploring the different attitudes presented within economic literature with regards to the economic consequences of the deficit.

Generally economists view high fiscal spending critically, as it results in increasing prices via stimulation of demand. Additionally when increase in fiscal spending is not met by an equivalent increase in revenues it results in fiscal deficits that are viewed as inherently negative since policy action to finance the deficit results in either building further inflationary pressures or raising interest rates or both. The former results when the government resorts to finance its deficit by borrowing from the central bank via printing more money while hike in interest rates result when the government chooses to finance the deficit by issuing bonds and thereby reduces the bond prices. Additionally the higher demand for credit created by the government in the financial markets tends to crowd out private investments.

However we developed a significantly different view with regards to fiscal expenditure and deficit in part one of the paper: that is, in order to assess their impact, it is most important to first identify the elements of the fiscal expenditure. For example if the government expenditure is meant to deal with a severe recession, to help self defense or focuses on public investment like infrastructure, education, basic research or public health then most economists would agree that the resulting deficit is bearable, beneficial and even necessary. In contrast if the deficit results from wasteful expenditure or current consumption then it is best to resort to cuts in government spending to balance the budget. Hence what is most important is that the government must spend money in a productive manner.

Next we drew the case of emerging economies like ours. In these economies the economic output is substantially behind the optimal output (defined as the output level beyond which the GDP growth becomes inflationary), and therefore it is best to direct fiscal expenditure in tapping the unutilized resources. In this manner increased government expenditure will actually generate higher incomes and subsequently higher savings and higher tax revenues. As long as expenditure is increased along these lines, the resulting fiscal deficits are not bad per se.

On the basis of this argument, it was clearly developed in the first part of the paper that Pakistan's fiscal deficit is in itself not bad, given that the spending is concentrated on employing the idle resources. This will increase incomes and the overall economic activity; in turn it will also result in an increase in tax revenues and subsequently will relax the pressures of rising fiscal deficits. Therefore the best way to evaluate the deficit

is not by looking at the absolute numbers; rather by examining the constituents of government expenditure.

In this part of the paper we will be discussing the current elements of Pakistan's fiscal expenditure and how it must be reformed in the upcoming budgets so that it results in enhancing economic activity enough that it overshadows the negative impacts of fiscal deficits.

Dissecting the Present Picture


Table 1 gives a detailed picture of the elements of the fiscal expenditure and their respective shares in the total expenditure for the past three fiscal years. The last column gives the budgetary estimates of the share of these constituents to total government expenditure for the current fiscal year.

Table 1: Federal Government Expenditure

	FY04 RE	FY05 RE	FY06 BE	FY06 RE	Excess/shortfall over		
					FY05 RE	FY06 BE	FY07 BE
I. Revenue expenditure (A+B)	773.2	866.8	961.1	1072.2	23.7	11.6	1115.9
A. Current expenditure	714.0	784.7	826.5	918.8	17.1	11.2	879.8
(i) General public service	448.4	469.0	503.1	563.7	20.2	12.0	504.3
Debt servicing	317.7	274.7	301.4	304.8	10.9	1.1	295.8
(ii) Defence affairs and services	180.5	216.3	223.5	241.1	11.5	7.9	250.2
(iii) Public order and safety affairs	14.0	17.5	18.7	20.4	16.0	8.8	22.5
(iv) Economic affairs	54.8	62.2	56.4	67.6	8.7	19.7	74.7
(v) Environment protection	0.1	0.1	0.1	0.1	8.1	0.0	0.2
(vi) Housing & comm. amenities	0.9	0.9	0.9	0.9	2.9	3.2	1.0
(vii) Health services	2.8	3.3	4.1	4.4	33.0	5.6	4.7
(viii) Rec., culture & religion	2.0	2.2	2.3	2.4	8.8	5.8	2.7
(ix) Education affairs and services	9.6	12.3	16.6	16.7	35.7	0.6	18.8
(x) Social protection	0.7	0.9	0.6	1.5	77.6	146.1	0.7
B. Development expenditure	59.1	82.1	134.6	153.4	86.9	14.0	236.2
II. Capital disbursements (A+B)	125.3	119.7	132.6	124.1	3.7	-6.3	137.8
A. Current expenditure	65.0	52.7	36.4	38.5	-27.0	5.8	24.6
B. Development expenditure	60.4	66.9	96.4	85.6	27.9	-11.2	113.2
III. Estimated adjustments in PSDP	-	14.6	-	-	-	-	0.0
Total expenditure (I+II)	898.5	1001.0	1093.6	1196.4	19.5	10.2	1253.8

Source: Annual Budget Statement, GoP.
 BE: Budget estimates, RE: Revised estimates.
 Note: The Federal budget for FY05 has been prepared according to new accounting model that is different from the previous system. The exact correspondence between historical data available on old classification system and estimates developed on the new system is not technically feasible.

Source: SBP Annual Report FY 05-06



There are some important deductions that can be drawn from this picture. Payments for debt servicing have contributed a large amount towards total fiscal expenditure in the given years. Though it has decreased significantly from 35% in FY04 to 25.5% in FY06, it still stands at a large number as the current fiscal year's budget estimates that 23.5% of the total expenditure will constitute debt servicing spending. This essentially means that the public debt remains a large burden on the budget and the balance of payments, with the interest bill alone still absorbing around one third of tax revenue.

The expenditure on defense affairs and services has increased substantially in absolute terms while its contribution towards total expenditure has hovered around the 20% level. This is a large number when especially seen relative to the expenditure allocated towards the education affairs and services and the healthcare services.


Over the years the expenditure on education services has increased by an insignificant amount as its share in total expenditure increased from 1.06% in FY04 to 1.4% in FY06. This is certainly an extremely small number. The healthcare services also failed to get any significant portion of the expenditure as during these years only around 0.33% (on an average) of the expenditure was allocated towards this sector.

Igniting the Inactive

The picture presented above has invited considerable criticism from all circles. Since a bigger fraction of the government expenditure goes towards debt repayments and defense expenditure, its limited resources prevent it from allocating appropriate amount towards education and healthcare sectors. Subsequently the government is generally accused of spending money in a wasteful manner, failing to reduce the high incidence of poverty and in turn incurring a high fiscal deficit.

However in the current political circumstances where the country faces some serious threats it may not be realistic to reduce defense spending and divert it towards education and health. Pressures from the US to combat terrorism and stresses building on the Afghan border will continue to put strain on the defense expenditures. Hence any substantial cut in the defense spending may not be a feasible choice for Pakistan.

Instead we stress for fiscal expansion to exploit opportunities and investment in productive sectors and resources. As mentioned earlier in this paper and in Part 1, fiscal spending is most productive if it focuses primarily on utilization of the idle resources within the economy. This is because mobilization of these resources will stimulate output and growth without necessarily increasing prices. As a result higher income and higher savings will be generated. A corollary of this view is that if the government expenditure expands to generate employment of unutilized and underutilized resources then an equivalent amount of savings would accrue in private hands. This shall result in an



increase in tax revenues and in this fashion the fiscal deficit will finance itself. Thus it is clear that as long as the government increases its spending in employment of inactive resources, the subsequent deficit is in fact beneficial in the medium and long term.

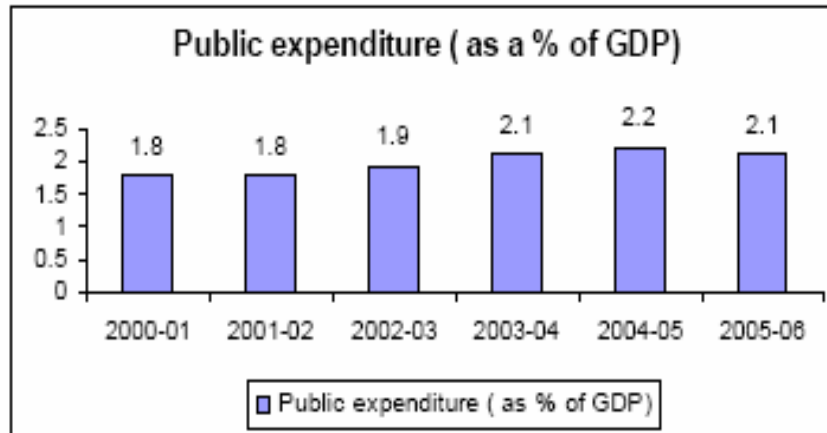
The next step therefore is to identify the inactive resources. The most important idle and underutilized resource in Pakistan and in most developing economies is certainly the labor. Though the unemployment rate in Pakistan has decreased since 2001, underemployment of labor still persists. This largely reflects the fact that most of these laborers lack the required skills which in turn is a result of lack of access to any formal training. Therefore in order to mobilize these unemployed and underemployed laborers in the most efficient manner, it is crucial to develop institutes for deliverance of formal training and education. Formal education and training enhances the skills of laborers and so is critical to increasing labor productivity and economic competitiveness. This essentially implies that the fiscal spending must allocate sizeable amount towards expenditure on education.

Evidence from both developing and developed economies clearly shows that education has a real impact on productivity at both the individual and the firm level in the medium and long terms. This is primarily because education produces human capital. In macroeconomics for over a decade emphasis has been on endogenous growth models that see human capital leading to innovations and to implementation of those innovations. Education by allowing workers to use existing capital and resources more efficiently stimulates development and diffusion of new technologies. This production and diffusion of technologies, in turn, is perceived to be a central factor in the growth of a country's output and standard of living. Hence in particular educational quality has a significant impact on labor market outcomes and subsequently per capita income. Additionally education involves issues also at the state level. This is because the level of education largely determines the organization of formal and informal institutions within the society, the governance, government policies and property rights. These societal factors interact with those at the individual and firm levels, determining economic growth. Most importantly it must be noted that education does not increase productivity in the short term only but also determines the economy's future productivity. In this way the provision of education is a key element of a policy to promote broad based and long term economic growth.

Despite this clear policy direction, the education sector in Pakistan has never been allocated its deserved share of expenditure as the education spending for the past few years has hovered around 2% of GDP (See Figure 1).



Figure 1: Public Expenditure (as a % of GDP)




Source: Ministry of Education

Public expenditure on education as a percentage of GDP is lowest in Pakistan as compared to other South Asian countries. India spends 4.1% percent of its GDP on education, Nepal 3.4%, Bangladesh 2.4% while Pakistan as seen in the chart above spends only 2.1% of its GDP on education affairs and services.¹ This reflects the low priority assigned by the government to the education sector. Public expenditure as a percentage of GDP increased only marginally from 1.8% in FY01 to 2.1% in FY04, and since then has stagnated at approximately 2.0%.

In the wake of these limitations and long term benefits generated via education, we strongly advocate for an increase in public education spending. However some may see increased spending as inflationary in nature and view the resulting deficit critically. We on the other hand stress that a fiscal deficit aimed at financing education spending is not bad per se. This is because education mobilizes inactive and underutilized laborers at almost a zero opportunity cost by increasing labor productivity. Increased labor productivity will contribute positively towards GDP, generating higher incomes and savings and subsequently higher tax revenues. In this fashion the deficit will eventually finance itself.

Apart from labor, Pakistan has other idle assets in the form of rich natural mineral resources, fertile land and abundant river waters. In order to utilize at least some of these valuable resources we additionally advocate for increased fiscal spending in the development of mega projects involving exploration and absorption of these resources in the very short term. Consider the example of coal reserves in Pakistan.





Despite having one of the largest coal reserves in the world located in the Tharparker region, the country still imports considerable amount of coal for various purposes. This is because the government has failed to develop these reserves significantly. Currently Pakistan has 185 billion tons of proven coal reserves and it produces only a very small percentage every year. As a result Pakistan's coal power generation is hardly 5% of total power production as compared to regional averages of above 50 % (in India's case it is above 70%). It is primarily the imports of furnace oil that accounts for a large proportion of power production and represents a significant portion of our import bill. This means that if the government develops its coal reserves by a significant amount every year, it will trim its coal as well as oil import bill tremendously since it has been estimated that by using only 2% of the existing coal reserves, we can generate around 20,000 megawatts for almost 40 years.² Acknowledging that projects for development of coal reserves would mean tremendous direct costs and hence a higher fiscal deficit, we would argue that the benefits generated off this project are tremendous and the resulting fiscal deficit is acceptable. Besides reducing our import bill, project for development of coal will generate several job opportunities allowing absorption of labor from adjoining impoverished areas, once again at a near zero opportunity cost. Most importantly the coal production will contribute significantly to the national output igniting the virtuous flow of higher income, higher savings and higher tax revenues which will finance the deficit.


Besides employment of unutilized resources, we also support government spending on physical infrastructure like roads, ports and dams. This in fact provides additional support to the productivity levels in the economy and increases the rate of employment by absorbing labor.

Going Forward.....

Fiscal expenditures are the key instruments by which the government seeks to achieve its economic and social goals. Through their impact on the allocation of resources, the distribution of income, and on aggregate demand, fiscal expenditure policies play a potentially major role in sustaining sound macroeconomic performance and promoting economic development. However the extent to which fiscal expenditure generates macroeconomic stability and economic growth depends on a set of issues, the most important being the nature of expenditure.

As developed through the course of this paper, increased fiscal spending aimed at employing idle resources is beneficial and in these circumstances the government can afford a high deficit. This is because via employment of the inactive resources the government will generate higher output and therefore higher incomes and savings which

² Dr Akram Shiekh; Chairman, Planning Commission



will bring about an increase in tax revenues; the deficit thus will finance itself with a small lag. This kind of public spending is thus sustainable and controllable.

Secondly fiscal expenditure policy must account for technical efficiency which requires the policy makers to see whether public expenditures are planned and implemented in an efficient manner. It will also require a focus on public sector management issues, such as the budgeting process, oversight and evaluation of spending.

Lastly it must be noted that increasing fiscal expenditure can be a futile effort on part of the government if the expenditures are not distributed optimally with respect to social and economic goals. It is also important to measure the extent to which public spending in particular areas is the most efficient manner of accomplishing government goals versus alternatives such as regulation or reliance on the private sector.



Economic Snapshot

Fiscal year 06														
	Units	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan
<u>Inflation</u>														
Headline Inflation	%	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64
Core inflation	%	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.30
Food inflation	%	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7
Non-food inflation	%	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.64	8.64	8.64
6 month	%	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81
12 month	%	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00
<u>External Sector</u>														
Export	MIn US\$	1,257	1,292	1,536	1,450	1,527	1,533	1334	1392	1392	1288	1448	1536	1227
Import	MIn US\$	2,037	1,854	2,269	1,656	2,330	2,685	2383	2267	2172	2162	2139	2365	2100
Trade balance	MIn US\$	(780)	(562)	(733)	(206)	(803)	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)
Remittances	MIn US\$	391	339	444	401	507	464	376	435	422	410	448	475	391
Forex reserves	MIn US\$	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212



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