Inflation and government strategy
By
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Inflation remains in double digits three years after the demise of the Musharraf regime; and yet blame continues to be laid at his doorstep. Initially, the two major political parties that emerged victorious after the February 2008 elections - PPP and their then allies PML (N) at the Centre - were legitimately convinced that the flawed policies of the Musharraf era accounted for double digit inflation in 2008; especially his decision to maintain the domestic price of oil and products in 2007/February 2008, a time when they rose to the unprecedented level of over 140 dollars per barrel internationally.

MQM and JUI (F), the government's erstwhile partners in the Centre, did not openly blame Musharraf era policies for inflationary pressures. However, these two parties are now openly blaming the PPP-led government for the rise in inflation today: a legitimate accusation against a government that has been in power for two months short of three years. The PPP is, therefore, increasingly isolated in its stance that Musharraf era policies are the main contributory factor to high inflation at the present moment in time.

One major reason for inflation as far as basic economic theory is concerned is a burgeoning budget deficit. In other words, when the government spends more than it earns, it is compelled to borrow from the banking sector, which crowds out private sector borrowing, considered the engine of growth in terms of propelling the Gross Domestic Product growth rate as well as value-added tax revenue. Additionally, the Pakistan government opted to reduce development as opposed to non-development expenditure, not associated with productivity, which further fuelled inflation as too few goods/output are chasing too much money.

In November of 2008, the PPP government opted to go on the International Monetary Fund (IMF) Programme. A major objective of the programme as acknowledged by the government in the letter of intent (LoI) it submitted to the IMF board as a prerequisite for the approval of the release of the first tranche was to reduce the budget deficit from 7.4 percent to 4.2 percent by 2008-09. The methodology was also agreed and the LoI noted that the deficit target would be achieved by the government through increasing "tax revenue by 0.6 percentage points of GDP, and reducing non-interest current expenditure by about 1.5 percentage points of GDP mainly through elimination of oil subsidies by December 2008 and electricity subsidies by June 2009. At the same time domestically financed development spending will be reduced by about one percentage point of GDP through better project prioritisation." The question is what has the government achieved with respect to these specific performance criteria agreed with the IMF?
Tax revenue remains hostage to four negative elements that have repeatedly been identified by several former Finance Ministers including Shaukat Tarin: (i) the inability of the government, be it led by a dictator or a democratically elected President or the Prime Minister, to end exemptions on the income of rich landlords, (ii) inability to bring other wealthy non-income tax payees into the tax net whether they bank/own assets in this country or abroad, (iii) heavier reliance on value-added tax as a source of revenue which would, definitely, be compromised during recession, and last but not least (iv) heavy leakage from the Federal Board of Revenue due to corruption estimated at over 500 billion rupees per annum. It is no wonder that tax as a percentage of GDP did not rise during the past three years.

However, the government did remove subsidies substantially, the pain of which, as expected, is being felt more by the lower income groups. Thus oil and electricity subsidies, though not yet eliminated as agreed initially with the IMF, are on the decline and the government has committed to increasing electricity tariffs by 2 percent each month till the end of the current fiscal year at least. Increased electricity rates have raised prices across the board as the price of a critical factor of production has risen; increasing price of oil and products in line with the international price (which incidentally does not take account of the Rs 20 to 30 tax that the government collects on each litre sold) has led to skyrocketing transport prices further eroding the value of each rupee earned.

Two factors have compromised the government's commitment to slash subsidies and needless to add will continue to compromise it. First, the government's rather generous though misguided policy of raising support prices of key farm products coupled with its even more ill advised policy of purchasing quantities in excess of domestic demand. For example, wheat support price was raised, which led to an output in excess of domestic demand; wheat procurement by the government, federal and provincial, led to surplus purchase of 2 million tons - an excess that was not exported at a time when domestic price, the price at which the government procured the wheat, was lower than the international price. Today a large portion of the surplus wheat has been destroyed due to the rains/floods

and the rest is lying unused as the government grapples with a dilemma of its own making: to export at a price which would not imply a loss of revenue before the next crop comes into the market in two months time.

Secondly, the government's decision to reverse the increase in the oil prices would reduce its revenue collection, which without a commensurate decline in expenditure would further fuel the deficit and consequently inflation would rise.
Interest expenditure has risen dramatically this year due to heavy reliance on borrowing, however, eliminating non-interest current expenditure by 1.5 percentage points of GDP, as committed to the IMF, did not take effect either. General public services budgetary outlay increased from 11.4 billion rupees in 2009-10 to 58.4 billion rupees in 2010-11 budgets largely due to 50 percent rise in government salaries.

The only commitment that the present government made to the IMF that it has fulfilled is slashing domestically financed development expenditure. In the current year, the Finance Ministry directed the Panning Commission to reduce development expenditure earmarked in the budget by 50 percent and there are reports that the ministry has now indicated that a decline of 75 percent is required.

Inflation is, of course, also a function of smuggling activity across our eastern and western borders, the cartelization even with respect to essential commodities like sugar, and failure to check prices in the retail and wholesale markets that account for periodic hoarding and windfall profits.

This article does not explore these factors for the simple reason that given that the present government opted for the IMF programme with its associated conditions, combating inflation was to be mainly through reducing the fiscal deficit. That unfortunately has clearly not happened.

To conclude, the solution out of the current economic impasse and rising prices is available - the issue, as always, is one of government commitment and ability.

Anjum Ibrahim, “Inflation and government strategy,” *Business recorder*. 10-01-2011.
Keywords: Economics, Political parties, Political issues, Economic policy, Politics, Inflation, Legitimately, Finance, Elections, International monetary fund, Income, Electricity, Inflation, Eliminating, Budget, Gen Musharraf, GDP,PMLN, PPP, MQM, IMF