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- Schemenner, R.W., Huber, J.C. and Cook, R.L. (1987), "Geographic Differences and the Location of New Manufacturing Facilities," Journal of Urban Economics, Vol. 21, No. 1, pp. 83-104.

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FISCAL POLICY AND ECONOMIC GROWTH IN PAKISTAN

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ABSTRACT

This study investigates the role of fiscal policy in enhancing economic growth of Pakistan by using annual time series data during the period from 1982 to 2010. Ordinary least square procedure has been applied. Fiscal deficit is included as a proxy of fiscal policy. Moreover government expenditure and government revenue has been considered. Revenue account is disaggregated into federal and provincial level whereas expenditure is broken down into current and development expenditures. Empirically it is found that only the federal and provincial non-tax revenues have positive significant impact on economic growth. On the other hand, federal tax revenue has significantly negative impact on economic growth. Conversely, development expenditure play significant role in enhancing economic growth whereas current expenditures are insignificant and have no impact in increasing the growth. It is recommended that the government should focus more on non-tax sources and should increase the percentage of non-tax revenue in total revenue. Further the government should cut their non-development expenditure and must increase the size of budget for development expenditure in order to increase the speed of economic growth.

KEYWORDS

Economic Growth, Fiscal Policy.

INTRODUCTION

The probably answer of the question to an economist that how you can measure the economic performance of any country, the economists probably talked you about the fiscal policy as being an important economic growth predictor. This pure principle that expenditure, revenue and other portions of fiscal policy like fiscal deficit may have an important role in managing growth performance in addition to durable affects has been uttered in the framework of growth model for some decades previously Easterly and Rebelo (1993).

In Pakistan, the *GDP* growth rate was remain 6.5% in 1980s, 4.6%, in 1990s and in 2000s it was increase to 5%. Same as the fiscal deficit in 1980s and 1990s remain 7.1% and 6.9% respectively and in 2000s it was reduced to 4.4% of *GDP*. On the contrary, the averages of tax revenue and non tax revenue for the last decade were 10.46% and 3.79% respectively but it was recorded in 1980s as 13.8% and 3.5% and in 1990s as 13.4% and 3.7% respectively as a percentage of *GDP.* Wheras the average of current expendtiure in 1980s was 17.6%, in 1990s it was 19.4% and in 2000s it was reduced to 15.1%. likewise the average of development expenditure in 1980s,1990s and in 2000s was 7.3%, 4.7%, and 3.65% respectively[1].

In this research study, the impact of fiscal policy in managing and improving economic growth will be examined. The tools of fiscal policy that is government expenditure and government revenue are considered. The expenditure account is further divided into current expenditure and development expenditure. The past studies that were conducted to exmaine the performance of fiscal policy with econmic growth have a weak aspect that is those researches never divided revenue account in such a way just like consider in this study that is revenue account is further disaggregate into federal and provincial level to assess their impact on economic growth.

LITERATURE REVIEW

Researchers and authors develop many theories that highlight the tools of fiscal policy and show relationship between fiscal policy and economic growth.

THEORETICAL BACKGROUND

The level of income (output) and employment in an economy is composed of a number of components, such as, consumption, investment and government expenditure. The level of income in an economy is, therefore, derived from the total of the various purchasing components. In algebraically terms[2]

AD= C+ I + G (2.1.1)

Where *AD* represents *GDP*, *C* is expenditure on consumption, *I* mean investment expenses and *G* is the expenditures by government.

According to Keynesian theory of income and employment, when government expenditure increases, the aggregate expenditure also increases so the curve of aggregate demand shift upward (expansion policy) and when government expenditure decreases, the aggregate expenditure decreases, the aggregate demand curve shift downward (contraction policy). To fill the deflationary gap, expansion policy is used and to cover the inflationary gap, contraction policy is adopted to achieve full employment or equilibrium level in an economy.

The federal government spending can be used as a tool of government financial policy through which they can make changes in taxes and government expenditure to pursue the macroeconomic goals of full employment and low inflation. These spending changes can still be considered s autonomous-the result of policy decisions and not the level of real income. These assumptions are incorporated in the government spending function in below equations[3]

G= *f* (Y, Policy) (2.1.2)

Where *G* is government spending, *Y* mean real income, *Policy* represents institutional policy decisions at all levels of government

$G = G_0$ (2.1.3)

Where *G* mean government expenditure and G_0 represents autonomous government expenditure. Both the equations show that government expenditure can only be depended on fiscal policy decisions rather than they cannot be determined by real income level in the economy.

Accoring to Lipsey and Courant (1996) the government has some target level of *GDP*, it can use its taxes and expenditures as instruments to push the economy towards that target. Suppose the economy fall in serious recession, the remedy to get out from recession is that the level of national income be increase by the government; the government can increase its expenditure or lower tax rates or both. If the economy is overheated, the government can utilize its fiscal muscles and increase the tax rates or reduce expenditures or do both things simultaneously in order to depress the level of national income.

To tax the citizens is one of the major functions the management of a country has been taken. the income collected by this exercise is then supposed to be used for many purposes, that may be include the running of administration of government itself, provision of law & order, defence of the country, and for societal improvement and infrastructure. By utilizing this revenue, they can construct road and rail network, educational centre, sanatorium, dams and other services for its people. For all these purposes, government raises revenue from those who make profits, from one source or another, within that country.[4]

[1] See Pakistan Economic Survey 2009-2010 (Economic and Social Indicators)
[2] See Agarwal, H. S (2009) pp. 1101
[3] See Farnham, P. G. (2005) pp. 356-357
[4] See Zaidi, S. A (2005) pp. 196

EMPIRICAL STUDIES

After identify the clear relationship between fiscal policy and economic growth in managing and improving the growth, we go through empirical literatures that investigate associations among them in enhancing economic growth.

Martin and Fardmanesh (1990) examined the performance amongst the key tools of fiscal policy and economic growth (*RGDP*) by means of a reduced-form model and they were taken a 76 sample size of developing and developed countries (cross-sectional data) that start from 1972 to 1981. Spending, deficits, taxes, non tax revenue and share of gross fixed capital formation in *GDP* are considered. Multiple regression analysis was used. The empirically found that taxes give the impression of negatively linked with growth; government spending and growth go in the same direction further they found that there is a strong opposite contact found between fiscal deficit and growth. As taxes look harmfully linked with the growth of gross domestic product, nevertheless, they are positively linked with rate of economic growth when their benefit is observed in reducing deficits. The other side of the findings is that the link between gross domestic product growth and government spending is cause to be harmfully opposite if they are observed with deficits. *GDP* growth is associated differently on tax share, government spending in GDP and budget deficit because this is decided by their *PCI* (low, middle and high income countries). It is recommended that a general policy should not be formulated for all countries because growth depends on country precise aspects.

Easterly and Rebelo (1993) were investigated the regularities of fiscal policy, the development level, and growth rate empirically. They work on yearly fiscal data of 100 countries starting from 1970 to 1988 by adopting the cross-section regressions made accepted by the work of Barro (1991) and annual historical data of twenty-eight countries starting from 1870 till 1988. Government revenue, grants, government expenditure, public investment, per capita income, per capita GDP growth rate, ratio of private investment to GDP, central government surplus, consolidated public surplus, primary enrollment, secondary enrollment, assassinations per million, revolutions and coups, war casualties per capita, marginal income tax rate, individual income taxes, domestic taxes, and international trade taxes are considered. Correlation and multiple regression techniques were used. They discover four things; First is that the level of development and fiscal arrangements is strongly associated with each other: low income countries and developed countries purely depend on taxes impose on international trade and taxes impose on income respectively. Secondly, the level of economy measured by its people can be affected the fiscal policy. Thirdly, communication and transport's investment is significantly connected with economic growth and lastly, empirically it is difficult to separate out the connection of taxation.

Devarajan, Swaroop, and Zou (1996) were worked out to investigate the composition of public expenditure and economic growth with the help of twenty-year time series data of forty-three developing from 1970-1990. Five-year forward moving average of per capita real *GDP* was included as dependent variables whereas share of total government expenditure (current, development, defense, health, education, transportation an communication) in *GDP*, premium in the black market for foreign exchange, external shocks and public expenditure vector are considered as independent variables. Multiple regression technique was used. They empirically found that the non-development spending and economic growth has statistically positive and considerable relationship. Growth in per capita and capital component of public spending was oppositely related with each other. It is concluded that the usage of productive spending becomes unproductive if they are used in excess. It means that at the cost of non-development spending, the government of developing countries misallocates the public expenditures on the side of capital expenses.

Iqbal and Zahid, (1998) empirically work on the macroeconomic determinants of economic growth in the context of Pakistan by using the data of period 1959-60 to 1996-97. PCI growth, GDP growth, primary school enrolment, secondary school enrolment, other institutions enrolment, physical capital stock, budget deficit, export, import, and foreign debt are considered. Multiple regression analysis was adopted. They find that primary school enrolment increases growth. Likewise, mounting the stockpile of physical capital will positively push growth. Both the output variables of growth (*PCI* growth and *RGDP* growth) are harmfully associated with fiscal deficit. Foreign debt reduces growth. *PCI* is negatively correlated with growth. It is recommended that that primary education is a vital requirement for boosting growth so it should be provided. The experimental outcome in addition suggests that if there is need to encourage growth, the economy of Pakistan should be open. To funding the growth, Pakistani resources are most excellent option rather to give loan from foreign side and to achieve stable growth the policy makers should formulate growth friendly and lasting fiscal policies.

Kneller, Bleaney, and Gemmell (1999) examined a study to find out the contact between fiscal policy and economic growth with respect to the countries of OECD. They conduct their research on the assumption that the tools of fiscal policy that is tax collection structure and expenditure may have a significance role in the growth of an economy They take annual panel data set from 1970 to 1995 (22 OECD countries) and then convert into 5-year averages to remove business cycle impacts. They categorized the variables of fiscal into distortionary, non-distortionary taxation, and productive, unproductive expenditures, other revenues and other expenditures. Budget surplus, GDP PC growth, initial GDP per capita, investment, labor force growth and lending minus repayments are used. Multiple regression technique was used. They empirically found that, non-distortionary taxes and unproductive expenditures have zero impact on growth; productive expenditures and economic growth are positively associated, and distortionary taxes and economic growth are negatively correlated. It is suggested that with 1% of *GDP*, either increasing spending on productive side or cut in distortionary taxes can play role in enhancing the growth rate by 0.1 to 0.2 percent annually.

Kneebone and McKenzie (1999) find out the choices of Canadian policies in which Canadian government try to reduce the budget deficits at federal and provincial levels from the period of 1962 to 1996. They take 37-year data of 10 provinces and a federal government. Program spending(S), tax revenue(R), provincial unemployment rate (UR), and TS and TR as province-specific, non-linear trends derived by applying the Hodrick-Prescott filter are considered. They adopted a methodology to differentiate the discretionary and non discretionary adjustments in provincial and federal fiscal policy that suggested by Blanchard (1993). It is concluded that discretionary fiscal policies in Canada that increases deficits were expenditure oriented and those policies that decreases the deficits were due to more balance (tax enhancement and spending decreases) efforts. From 1962 to 1992, the fiscal retrenchments was made by a balance between reduce in program expenditures plus increase revenue, but from 1993-96 it is quite interesting that reduction in fiscal deficit was due to choices in discretionary policies by means of cuts in expenditures program. Thus, deduction in deficit (fiscal retrenchments) was due to a balanced policy whereas increment in deficit (fiscal expansions) was differentiated by an unbalanced method that preferably increases the expenditure. It is recommended that to reduce deficits, cuts in expenditure is good rather than to increase the revenue.

Lin and Liu (2000) investigated on whether the fiscal decentralization that takes place in mid-1980 has had any contribution to the growth process of the Chinese economy. Multiple regression technique was adopted by taking 534 sample size data from 28 of the 30 provinces from the time period of 1970 to 1993. Per capita *GDP* growth rate, rural population, total population, relative prices of farm products to nonfarm products, share of Non-SOEs' output in the total industrial output, growth rate of per capita fixed asset investment, the average retention rate of locally collected budgetary revenue, household responsibility system, fiscal capacity and fiscal decentralization was measured as the marginal retention rate of locally collected budgetary revenue are considered as variables. They empirically found that fiscal decentralization was increased the Chinese economy. Furthermore they discover that rural change, capital amassing, and non state sector enlargement were the answer in driving forces of the economic growth in China over the past 20 years. They also conclude two things. First is that institutional planning matters. More to the point fiscal decentralization, additional reforms (the family dependability system in the rural segment plus the "privatization" of the industrialized division by means of mounting the private enterprises) have been also contributing economic growth in China. Second was, as to the data situate, fiscal decentralization has move up the expansion speed in China mostly by humanizing the effectiveness of resource allotment somewhat by stir up more investment.

Dong, Taylor, and Yücel (2003) go through an empirical research to investigate the link between U.S economy growth and fiscal policy by taking monthly time series data from 1983 to 2002 of fiscal indicators into consideration. The objective is to assess unanticipated configuration shock of fiscal tools to check the link amongst spending, taxes and fiscal deficits by holding other things constant. Nonfarm employment, *GDP* deflator, federal fund rate, federal expenditure, receipts (taxes) and deficits are considered. They assess shocks to more than one variable simultaneously by adopting methodology of value at risk (VAR). They argued that if the volume of federal government increases, it will diminish the growth of economy. About United States economy three wide findings were concluded; first of all, consistent cuts in the rate of job results when government increases their expenditures or tax revenue. Next, an unreliable predictor of economy is fiscal deficits. Lastly, they conclude that the consistent predictor in fiscal policy is tax revenue.

Amanja and Morrissey (2005) were conducted a research study to assess the performance of fiscal policy in Kenya by taking time series annually data from 1964 to 2002. They categorized the fiscal data according to their attitude that are productive government spending, unproductive government spending, income tax (distortionary revenue), indirect tax (non distortionary revenue),non-tax revenue, budget deficit, real per capita income, primary and secondary enrolment (human capital), government investment, private investment, grants, real *GDP*, and nominal *GDP* are considered. Autoaggressive distributed lag (ADL), cointegration, and causality analysis techniques were used. They empirically concluded that fiscal policy matters for economic growth. Unproductive spending and non-distortionary tax revenue have no impact to growth as forecast by economic theory. Productive expenditures have negative impact on economic growth. No distortionary influence of distortional tax was found on growth. Private investment and human capital have good impact in favor of *PCI*. Conversely, in the long run economic growth and government investment go in the same direction and are positively correlated. Real *PCI* of Kenya are shaped by productive consumption spending and investment by government. Growth move strongly negatively by productive consumption expenses while enhancement in the investment by government bring economic growth and private investment positively up. It is recommended that the government of Kenya should reduce unproductive spending and increase public investment.

Gupta, Clements, Baldacci, and Mulas-Granados (2005) investigate that during 1990s, the countries that have low income, how the fiscal consolidation & spending composition associate with economic growth by analyzing 39 countries data. Per capita *RGDP* growth, budgetary balance, current spending, domestic financing, external financing, initial level of primary and secondary enrolment rates , labor force, initial level of *GDP* per capita, private investment ratio, terms of trade, public sector wages and salaries, expenditures on other goods and services, transfers and subsidies, interest payments, capital spending, tax revenue, grants and nontax revenue are used. Multiple regression and correlation techniques are used. They empirically conclude that, in industrial countries, reduction in fiscal deficit increases growth in both periods. Deficits financing from domestic sources enhance growth rates. In the short as well as in long run, high budgetary balances and economic growth are usually strongly positively related. What approach is adopted for public spending is also matters for economic growth. The countries in which spending is consider on salaries shows lower growth, at the same time as those countries that assign more part of their spending on capital and non salaries goods and services benefit from more rapidly output extension.

Castro and hernandez de Cos (2008) was conduct a research study in the case of Spain regarding the economic results of fiscal policy on economic issues by taking quarterly records on public spending, taxes (net), *RGDP*, deflator of gross domestic product, primary budget balance, public revenues net of transfers, public investment, sum of public consumption and real rate of interest charged on 3-year government bonds comprising from 1980 to 2004. They estimated the shocks of fiscal exogenous policy on major macroeconomic variables with the help of value at risk (VAR) methodology. They empirically concluded that output and expansionary shocks of spending are go together in the same direction in the short run at the cost of government deficits and inflation that is higher and lower output in the intermediate and lengthy run. Increment in the economic activity occurred if tax size increases in the intermediate run whereas non-permanent expansion in public budget balance required. Spot the conclusion in Spain from the 1990s by implementations of this analysis of fiscal policy is that in growth of productivity, the techniques of consolidation not appear that they have any costs involved but it positively contribute in *GDP* growth in some periods.

MODELING FRAMEWORK

After reviewing the past literature on fiscal policy and economic growth, the following models are developed to investigate the role of fiscal policy in enhancing the growth:

$$LGDP = \alpha_0 + \alpha_1 FD + \mu_t \quad (3.1)$$

$$LGDP = \beta_0 + \beta_1 FTXR + \beta_2 FNTXR + \beta_3 PTXR + \beta_4 PNTXR + \varepsilon_t \quad (3.2)$$

$$LGDP = \gamma_0 + \gamma_1 CE + \gamma_2 DE + \kappa_t \quad (3.3)$$

Expenditures, revenues and fiscal deficit are included in the regression model as independent variables whereas log of gross domestic product is included as dependent variable, *LGDP* represents log of real gross domestic product that represent the value (in monetary) of the entire finished commodities and services produced within a country by taking a base year (Siddiqui, 2001), *CE* represents current expenditures which included all those expenditures that are consumed on services within a year. *DE* represents development expenditures that are spend on durable items that yields services over a long time, for example expenditures on construction of dams, radar stations, and infrastructure (Rosen, 2009). Similarly *FTXR* means federal tax revenue, *FNTXR* represent federal non tax revenue. *PTXR* means provincial tax revenue, *PNTXR* means provincial non tax revenue, and *FD* representing fiscal deficit. Annually time series data from 1982 to 2010 has been gathered from secondary sources as under:

- Statistical Supplement of Economic survey of Pakistan
- Federal Board of Revenue of Pakistan (FBR)

ESTIMATION AND RESULTS

TABLE 1: DETERMINANT OF ECONOMIC GROWTH

Variables	Coefficients	t-stat.	P-Value
Constant	2.13	29.39	0.00
FD	0.33	10.28	0.00
Adj. R^2	0.80	F-Stat.	105.75
D.W	1.62	Prob.	0.00

Source: Author's Estimations

Table 1 shows the output of statistical test. Where *FD* (used as a proxy of fiscal policy[5]) has significant and positive impact on the economic growth. The coefficient value of *FD* shows that if there is an increase in the *FD*, there will be an increase in economic growth by 0.33 times. Cochran Orcutt iterative procedure[6] was adopted to correct the autocorrelation and the *p-value* and *F-stats*. of serial correlation *LM* test are 0.22 and 1.60 respectively.

After evaluating the affect of fiscal deficit on growth, they are further divided and analyzed as government revenue and expenditure in the following section:

TABLE 2 DETERMINANT OF ECONOMIC GROWTH

Variables	Coefficients	t-stat.	P-Value	VIF
Constant	6.78	62.90	0.00	-
FTXR	-1.35	-1.08	0.28	4.11
PTXR	-71.36	-3.65	0.00	2.35
FNTXR	4.57	2.74	0.01	3.41
PNTXR	28.66	4.04	0.00	2.22
Adj. R^2	0.79		F-Stat.	27.22
D.W	1.01		Prob.	0.00

Source: Author's Estimations

[5] See Ali, Irum and Ali (2008)

[6] See Cochrane and Orcutt (1949)

Table 2 shows the output of ordinary least square *(OLS)* procedure. In above analysis, the *PTXR*, *PNTXR* and *FNTXR* are significant whereas the federal tax revenue is insignificant. The *DW* is 1.01 and the *p-value* and *F-stats*. of serial correlation *LM* test are 0.28 and 1.34 respectively.

TABLE 3 DETERMINANT OF ECONOMIC GROWTH

Variables	Coefficients	t-stat.	P-Value	VIF
Constant	0.24	112.52	0.00	-
CE	0.07	0.76	0.45	1.37
DE	0.37	2.81	0.01	1.37
Adj. R^2	0.20		F-Stat.	4.21
D.W	2.49		Prob.	0.03

Source: Author's Estimations

The above table 3 shows determinant of economic growth. The p-value of current expenditures is above 0.05 that is 0.45 that indicates that the current expenditures are insignificant in the regression model and have no contribution in boosting economy. Whereas the p-value of development expenditure is below 0.05 that is 0.01 so the *DE* is significance in the model. If the budget size of *DE will increase*, they will boost the gross domestic product by 0.37. Cochran Orcutt iterative procedure was adopted to correct the autocorrelation and the *p-value* and *F-stats*. of serial correlation *LM* test are 0.23 and 1.54 respectively.

CONCLUSION AND RECOMMENDATIONS

This research study investigates the role of fiscal policy in managing economic growth in the frame of Pakistan by taking the annual time series data from the period from 1982 to 2010. Ordinary least square (OLS) procedure has been applied. Government revenue and expenditure account are considered. Revenue account is disaggregated into federal and provincial level whereas expenditures are broken down into current and development expenditures. The result shows that federal tax revenue and provincial tax revenue are negatively contributed to economic growth. This may be happened for two possible causes; one reason is our tax administration is extremely corrupted and most of the time they are involved with and support the tax liable persons not to pay the tax amount for the sake of themselves and illegally take money and hide the income data of tax payers. Secondly, the agriculture sector is free from tax because the big fishes who are involved with agriculture sector are really clever and fully trained not to pay tax and hide income accounts from the tax department and also benefited from gigantic political control. Even above 80% parliament members are from the feudal class or are the supporter of this group[7]. When we move on expenditure side of fiscal policy, the non-development expenditure is not significant for the reason that the government not appropriately spends money on this side. Only development expenditure found significantly contributed in economic growth. Hence, it is imperative to cautiously spend the resources on current expenditure and spend as much as possible on development projects to increase the speed of economic growth of Pakistan.

At last after analyzing the empirical results, are that there is a strong relation exist between economic growth and fiscal policy therefore the policy makers of Pakistan should formulate their polices after carefully considering fiscal policy variables.

The tax structure of Pakistan is based on 1973 Constitution in which they outline the taxes and duties in federal legislative list[8], the federal and provincial government can collect from assessee only from these ways. After analyzing the results, the tax system of both federal and provincial government must be restructure to make them positively correlated with the economy because they are oppositely contributed in the growth as concluded by our study's results. Both sources of revenue (taxes and non-taxes) must be positively contributed in managing economic growth of Pakistan because Pakistan is not financial so strong that they not only rely on just non-tax source. The fiscal policy makers must have to rethink about the structure of taxes imposed on assessee when they are formulating and implementing fiscal policy. There is an urgent need to make a large part of non tax revenue in collecting total revenue. In contrast, government should focus more on development expenditures like spending on dams, roads, ports etc. The advantages from this type of spending are long term and growth oriented. On the other hand, government should avoid much spending on current expenditures. The current expenditure are of two types; necessary current expenditure like pensions, salaries, law and order, defence etc should not reduce because these are necessary to our economy and sustainability but un-necessary current expenditure like purchasing of bullet-proof vehicles for ministers personal use, un-necessary movements of ministers convoy from one place to another should reduce because those visits require VVIP protocols for security purpose at the expense of taxpayers, the royal expenses of our ministers etc because amount spend on these types of expenditures will have no significant affects on economic growth. Expenditures on non-development projects should be reduced and their amount should be spend on long term projects as they were empirically identified as growth oriented in this study.

AREA FOR FURTHER STUDY

In this paper the governments expenditures are not disaggregate into federal and provincial level so the new study will be conducted and more deeply recommendations and suggestions will be drawn with respect to fiscal policy and economic growth of Pakistan if they are divided as described.

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[7] See Zaidi, S. A.(2005) pp. 217

[8] See Zaidi, S. A.(2005) pp. 197-198

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