INSTITUTE OF STRATEGIC STUDIES

web: www.issi.org.pk
phone: +92-920-4423, 24
fax: +92-920-4658

Issue Brief

(Views expressed in the brief are those of the author, and do not represent those of ISSI)

How Mounting Fiscal Deficit is Hampering Pakistan's Economic Growth

August 30, 2017

Written by: Mian Ahmad Naeem Salik, Research Fellow *Edited by: Najam Rafique*

The problem of Fiscal Deficit is one of the major causes for the stunting of economic growth in many developing countries around the world. These countries' inability to deal with its crippling deficit leads to debt financing, which leads to an inability to mobilise domestic resources, a relatively narrow tax base, and an inflexible tax structure. Like most developing countries, a large and growing fiscal deficit in Pakistan is one of its major outstanding economic problems. It is held responsible for high inflation, low growth, a current account deficit and crowding out of private investment and consumption. Pakistan in the year 2017 is at the crossroads between an economic growth spurt or stagnation. The country budget deficit had blown up to Rs1.375 trillion, or 4.1 per cent of the GDP during the Fiscal Year 2017 (FY 2017).[1] This poses a serious threat to the economic stability of the country with projected economic growth to reach 5 per cent by the end of the year, helped by improving global economic conditions, rising investment related to the China-Pakistan Economic Corridor (CPEC) and the recovering agriculture sector.

Escalating fiscal deficit is the major catalyst, as government borrowing remains disproportionately high, power sector circular debt being restructured, tax collections falling short of target and continue to remain at around 50 per cent of the tax capacity, and development budget disbursements short of the original targets.[2] The government finds itself in a bind over which route to follow in order to alleviate the financial crunch it finds itself under. The remedy often used is to borrow the money either from the public, termed as public debt, or from multinational organisations like International Monetary Fund

1 Imran Ali Kundi, "Budget deficit surges to Rs1.24 trillion," Nation, May 06, 2017, http://nation.com.pk/business/06-May-2017/budget-deficit-surges-to-rs124-trillion

2 Mohiuddin Aazim, "Can a stable monetary policy cover up fiscal 'indiscipline'?" Dawn, June 31, 2017, https://www.dawn.com/news/1348724

(IMF), under their various Structural Adjustment Programmes (SAPs). All debts liable on the government, like all other debts, come in with their own interest rates, which are serviced by the government through some of the policy tools like increasing the amount of tax collected by increasing tax rates, simulating economic growth leading to increased tax generation, or printing of money by the central banks, also called debt monetisation. Depending on the magnitude of government's borrowing requirement, financing of its deficit has a significant impact on the economy, as both domestic and foreign debt are directly related to fiscal deficit.

Amid political turmoil the country's internal and external accounts appear to be entering uncertain territory. At the heart of problem lay the inability of the government to push through critical structural reforms, coupled with bloating current account deficit, which according to the State Bank (SBP) is a major challenge facing the country's economy. Current account deficit widened to $12.12 billion and recorded a decade-high growth in the last fiscal year. The growing current account deficit neutralised the positive impact of about $19 billion remittances sent by overseas Pakistanis. For the first time in more than a decade, remittances declined on a year-on-year basis in FY2016-17.[3] When facing fiscal deficits, the Pakistani government is confronted with the choice between different sources of financing its deficit - the government can finance the deficit through domestic and external sources. Domestic source of financing fiscal deficit can be divided into two components, printing new money or issuance of interest-bearing debt to both bank and non-bank institutions, and secondly, borrow money from international financial markets.

Prudent fiscal management requires a right balancing between the two sources of funding fiscal deficit. With a widened fiscal deficit outlook due to a shortfall in revenue collection, the IMF has already raised concerns over challenges in the fiscal, energy and external sectors. The deterioration in fiscal and external accounts and declining foreign exchange reserves seems to be pushing Pakistan in the direction of institutional support of the IMF, and its SAPs.[4] The aim of the SAPs is to power growth in the developing world to bring it up to speed with the rest of the world. But so far, the packages have not materialised into sizable gains. The process of restructuring has faced many problems and can be termed as partial reform syndrome, meaning that the high growth rate remains elusive, and there is an increasing rate of poverty with difficulty in reforming the fiscal policy, coupled with long-term

[3] Khaleeq Kiani, "Fiscal deficit widens as IMF warns of challenges ahead," Dawn, April 06, 2017, https://www.dawn.com/news/1325215

[4] Business, "Current account deficit poses biggest challenge to economy: SBP," the News, August 24, 2017, https://www.thenews.com.pk/print/225481-Current-account-deficit-poses-biggest-challenge-to-economy-SBP

sustainability cost of these reforms.[5] The government has not been able to create sustainable sources of foreign inflows. Thus, when exports and remittances are declining and trade deficit widening, the stability of forex reserves would depend on the international prices of oil as the current account deficit expands.

Pakistan has the potential to revitalise its economic trajectory if it sets its priorities straight, and if it is to succeed in promoting sustained and equitable economic growth it has to focus on the following objectives:

- Upgrading human capital resources through the continued expansion of educational and health services, which can lead to increased efficiency of Pakistan's workforce, and ultimately lead to an increase in the country's GDP.

- Reduction in fiscal and foreign trade deficits through policies designed to promote privatisation of state-owned industries (SOEs) and the expansion of export markets. This is mainly due to the inefficient working of the SOEs, which are causing annual cost for the economy, as the state is forced to provide them with bailout packages.

- Preserving the country's natural resources, particularly water supplies, which are being wasted and need to be saved.

- Providing protection to low-income groups by designing policies in a way that does not adversely affect them, for instance, the expansion of tax base.

If all of these objectives can be fulfilled, and the integration of CPEC projects into the economy over the next decades goes smoothly, there may still be light at the end of the tunnel to keep the country on path of sustained economic growth.

[5] Rana Ejaz Ali Khan, Muhammad Atif Nawaz, and Altaf Hussain, "Impact Evaluation of Structural Adjustment Program: A Case of Pakistan", European Journal of Economics, Finance and Administrative Sciences, 2011: 52-63.