# Fiscal Policy and Economic Performance of Pakistan: Trends and Analysis

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**Abstract**
*This research is to find the impact of fiscal policy in economic growth of Pakistan. To fulfill this purpose the time series data from 1991-2021 is used. The data source is Economy Survey of Pakistan and WDI. In this analysis with respect to first Augmented Dicky Fuller unit root test is implementing for checking the stationarity of the variables. At order 1, the all variables are integrated. Secondly, the Least Square (Gauss Newton/ Marquardt Steps) is employed to recognize the Pakistan's fiscal policy has affected the country's economic condition. This finding suggests that the gross fixed capital formation, labour force participation rate, total government revenue is positively associated to the growth rate and total expenditure is negatively relate to the economic growth. This research result shows the significant the Pakistan's fiscal policy has affected the country's economic condition.*

**Keywords:** *Fiscal policy, Economic growth, Total revenue, Total expenditure, Augmented Dicky Fuller unit root test, Least Square (Gauss Newton/ Marquardt Steps)*

## Introduction

Fiscal policy and economic growth are the main topic of macroeconomics policy and its complex economic phenomenon. The rates and structure of the government's taxation, expenditure, and borrowing are the main topics of fiscal policy. The type and scope of government services, the appropriate state structure and size, and the role of government in promoting economic progress, job creation, social development, and benefit transfer, among other core policy concerns, are all covered under fiscal policy.

In essence, the notion of fiscal policy holds that any government can influence the state of the business cycle through its procedures of spending and earning. Taxes and spending are the two primary fiscal policy instruments. The policy's influence has three primary effects: it reduces inflation, boost employment and most crucially it keeps the currency value stable. An important aspect of controlling the economy is fiscal policy. A poor policy might cause the economy suffer

severe setbacks and enter recession. Stability, allocation, and distribution are the three fundamental purposes of fiscal policy. Price stability, a sustainable external balance, and economic development are employed as stabilization functions to accomplish the primary macroeconomic goals. Achieving an equitable distribution of wealth and income is ensured by the allocation function, which divides up total resources among public and private goods.

Growth in an economy is influenced by a wide range of factors. Many economists believe that the study of growth is inadequate without taking fiscal policy into account as a significant influence. Market flaws are a common occurrence, which leads to government meddling in how economies function. Prices and wages tend to be fixed in place, and automatic forces have failed to improve the economic situation, making government involvement easily justifiable. However, from Pakistan perspective, a contrary role is being played by law and order situation and terrorism (Ullah, et al, 2020).

The numerous instruments of fiscal policy, which are among the most crucial tools of economic management in attaining economic growth and eradicating issues that threaten economic stability, allow it to play a bigger role in fulfilling the many goals of the national economy. The two biggest among these are modifications to government spending and taxation. In order to promote growth, taxes are reduced and spending is increased. Government debt issuance is frequently used to finance this. Taxes may be increased and expenditure may be decreased to cool down an overheated economy (Shah,Ali & Khan,2020).

**Objectives**

The primary goal of this investigation is

1) An examination of the effects of fiscal policy on economic governance is the study's core motive.
2) The link between Pakistan's fiscal strategy and its economy.

**Research Questions**

1) What impact does fiscal policy have on economic growth?
2) How do Pakistan's fiscal policies and economic growth interact?

**Plan for the research**

Five chapters make up the structure of this work. Section 1 is introduction, Section 2 is Literature review, Section 3 is Methodology, Section 4 is Estimation and results or Section 5 is Analysis, conclusion, policy recommendations and references.

**Literature Review**

Numerous studies have looked at various fiscal regulations when discussing the fiscal policy stance and its relationship to growth. The time period, data kinds, and procedures all had a mixed effect on the results. Aggregate measurements and disaggregated metrics of fiscal policy have both been utilized in research. As well as using various taxation methods, the government uses many expenditure categories. Results also differ because of this. In this case, sample size is the key element. It should also be noted that even when the same estimating techniques and variables are used, the results might vary due to time zone differences.

As cited in Faridi (2011) constructed research on the impact of fiscal decentralization on economic expansion. The fiscal decentralization is the process through which local or provincial governments are given control or delegation of power over the economic operations within a province or state. This piece of work defines the various fiscal variables. Fiscal decentralization increases public sector efficiency and promote economic conditions. The findings of this study demonstrate that the variables related to fiscal decentralization have a favorable furthermore; it has a considerable effect on economic growth. This report recommends giving provincial and municipal governments more autonomy and authority in budgetary matters based on empirical findings. Financial independence would undoubtedly increase resources, boost confidence, and increase accountability inside the federating unit. Additionally, fiscal decentralization would lesson provincial reliance on the federal government and speed up local growth and process. Economic growth would be expedited and federal government focus on the national issue would be increased. In nutshell, the lack of provincial capacity building mechanisms and federal intervention in provincial issues would no longer cause economic losses.

Then there is another further part of the literature that has especially investigated the effects of fiscal policies on growth in the economy. For instance, Kazmi, Imran, and Saleem (2019) investigate the outcome of Pakistan fiscal policies and economic expansion shot along its long term. To fulfill this purpose, they use data from annual time series for the years 1980 through 2014. Firstly, apply the ADR unit root to verify each of the variables are stationary. This result approves that the growth rate of domestic product, physical capital, labor force, total revenue from the government , total government spending and the fiscal deficit has no short-term relationship, only commitments to long run partnerships. The literature on fiscal policy that is highlighted in this study emphasizes the significance of these variables in the process of long-term growth. If these factors are ignored, the growth process will not be complete. Particularly when taken together, these variables possess a substantial long-term influence on expansion.

While studying the fiscal policy aftermath on economy growth Malik (2013) investigated the direct and indirect effects of Pakistan's fiscal policy on the country's private investment. This study's findings suggested that since the effect of fiscal policy in aggregate and disaggregated forms do not coincide, it is preferable to investigate fiscal policy in disaggregated form. Private investment is impacted differently by various type of expenses and revenues, and this connection is typically non-linear. The sole exception is current spending, which in the majority of cases continued to be unproductive. Additionally, results from regressing expenditures in a disaggregated form suggest that present spending are unproductive while development expenditures are productive. However, once they reach a certain level, development expenses also stop being productive. Direct taxes and private investment have an inverted U- or bell-shaped relationship with respect to revenue, whereas indirect taxes and private investment have a U-shaped relationship. After a certain point, non-tax revenues start to cause distortion as well. The fact that there is relationship that is not linear between various fiscal policy instruments or private investment emphases how crucial it is for various fiscal policy instruments to have certain threshold values in order to promote private investment.

As an approach of to ascertain the effect of fiscal policy on economic progress the attention is also drawn toward fiscal policy's effect on sectoral growth of the counter. In this illustration

Ajmair, Khan, and Bashir (2022) investigate how Pakistan's fiscal strategy has affected sectoral growth. In this research, three models were estimated, with gross domestic product per capita, the entire debt service, commodity and service external balance, and the national GDP serving as independent variables and the dependent variables being agriculture, industry, and services. Except for total det services, which had a positive and considerable influence on the agriculture sector, all fiscal policy-related factors had positive but minor effects on the industry. The industrial sector is positively and significantly impacted by GDP per capita, inflation, and total debt service, whereas the external balance of goods and services and gross national expenditure have an adverse and considerable influence on this field. All independent variables showed adverse and significant association with the services sector, with the exception of total debt services, which had a positive and substantial relationship with the sector of the economy. The agriculture, industrial, and commercial areas respective error-correcting terms are all negative, indicating that the system has remained stable and has reaches equilibrium.

Another study graph examined the link between fiscal policies and economic expansion. In this contrast Farooq and Yasmin (2017) analyze the link between fiscal policy uncertainty and economic expansion, taking into account the Pakistani financial development industry's well-informed suggestions. According to the findings, Pakistan's economic growth has been considerably slowed down by the country's unstable fiscal policy, which is a result of erratic government spending, uncertain revenue collection, and unpredictability in the budget, But the importance of financial development metrics like the ratio of liquid liabilities and loans to the private sector helped to mitigate the damage. Promoting financial advancement is important because it can help to a strong economy by minimizing the negative effects of unsure fiscal policy. Another compelling reason has been the lack of good governance which is countering the smooth fiscal policy and Foreign Direct Investment (Jan, Ali & Khan, 2019). A pattern found in entire SAARC region and moreso in Pakistan is an impediment of corruption which curtails the fiscal policy (Ghalib, Ali & Shah, 2019).

In a VAR framework, Castro and Cos (2008) calculates the consequences of exogenous fiscal policy shocks in Spain. It is discovered that government expenditure expansionary shocks increase production in the near phrase, but at the expense of greater inflation, larger national deficiency, and decreased production over the long and medium terms. Levy hikes are proven to slow profit-making growth over the longer term, increasing the stability of the national treasury only momentarily. As of the middle of the 1990s, the analyzing Spain's budgetary policy using these data leading to the conclusion that the trend of merger doesn't appear to have turned more countercyclical during that time involved expenses in terms of a rise in production.

In order to determine the influence of fiscal policy on economy Ocran (2011) suggested the impact of fiscal policy on the South African economic activity as it relates to an expansion of governance spending, levy income, and the budget deficit. The findings imply that many effects of fiscal consolidation tools on production and mortgage rates. The influence of output related fiscal policy seems to be relatively small but durable, whereas the reaction from interest rates is often both ephemeral and significant. Thus, in days following of the most recent economic collapse worldwide, the discussion on the impact of fiscal policy in promoting progress appears to have gained fresh relevance. The study's crucial observation is that proposed policy initiatives

would temporarily cost money by way of longer maturity. Similarly,, AVCI and TONUS (2022) studied the impact fiscal policy's effects on inclusive growth in Turkey. Use five different criteria to determine whether Turkish economic development is inclusive in this case. After determining that growth is inclusive, in this research utilized the derived indices as a measure of inclusive growth and investigated the effects of fiscal policies on taxes, social transfers, education, and health on inclusive growth. The ARDL is imply on the annual data for the2006 to 2018. These finding suggest the indirect taxes had a negative impact on two indices, whereas social transfers had a positive impact on the inclusive growth index. Public spending on health and education had a declining impact on these indices.

Another direction is cited during the research which is the effectives of fiscal policy contribution from institution and external debt. In this regard Canh (2018) analyze the budgetary growth consequences in developing nations under the dynamic of debt levels are not linear. In this study author uses panel data from 20 emerging economies from 2002 to 2014 for this purpose and applies GMM estimators for an imbalanced panel data policy. The various effects of fiscal policy on economic development, such as positive benefits in low levels of debts and unfavorable consequences in repeater level of debt, may help to explain the system underpinning this non-liner relationship. This research also uncovers compelling evidence that the foreign debt affects economic development in nonlinear ways.

Nuru and Gereziher (2022) explored the unequal impacts of fiscal policy, namely government expenditure, on economic condition for the South African economy during the sample duration of 2004Q2 to 2018Q1. Using a nonlinear ARDL, the asymmetric effects of government spending on economic growth over the short and long terms are examined. The results demonstrate that the impact of government expenditure on economy is more negatively than positively skewed. Real effective exchange rate is shown to have a favorable or considerable impact on economic growth, both in the short and long terms. In contrast, the inflation rate has adverse and compelling effect on economy both immediately and over the long run.

In different research paper raised the question about whether the macroeconomic policies are adopted by government so Garrison and Lee (1995) determine the influence of macroeconomic factors on economic development between 1960 and 1987 is examined in this research. The idea that nations with macroeconomic policies that produce high inflation, sizable budget deficits, and high levels of government consumer expenditure have slow rates of growth in per capita production is not supported by any data, according to our research. However, there is scant support for the idea that high marginal tax rates harm economic development. Furthermore, in this research find compelling evidence that nations with high rates of economic growth are those that attain low variability' of production growth and increase their international commerce.

Easterly and Rebelo (1993) The empirical patterns between fiscal policy variables, development levels, and growth rates are discussed in this study. We use recently created public investment series, recent cross-section data, and historical data. Key findings are that the size of the global economy, determined by the number of people living there has an impact on fiscal policy, spending on communication and transportation generally correlates with growth and the

consequences of levy are challenging to measure empirically. While income taxes are only important in substantial economies, low-income nations rely largely on international trade taxes.
Studies on the topic have often emphasized cross-country data. Only a few exceptions have examined the national situation. In terms of Pakistan, there is relatively little study on the specific issue because the majority of studies are centered on local wealth, debt, or institutional contributions, among other things. Additionally, there are several ways to gauge progress. Depending on how growth is defined, what variables are employed, and what a country's policy priorities are, several growth measuring techniques are used.

On the basis of this literature review following hypothesis are formed:

$H_o$: Fiscal policy has no influence on Pakistan's economic expansion.
$H_1$: Fiscal policy has influence on Pakistan's economic expansion.
$H_o$: Relationship does not exist between fiscal policy and economic growth
$H_1$: Relationship exist between fiscal policy and economic growth

This study's objective is to determine if Pakistan's fiscal policy is unyielding. However, this study concentrated on the total implacability of fiscal policy rather than the short- or long-term correlations or consequences that were largely addressed in the literature previously cited. We use the most recent statistics from Pakistan that are available to do this. Only the total income or total spending, the labor force participation rate, and gross fixed capital production are included as significant factors. In this study, there are no proxies used for real variables. This analysis employed time series data from the World Development Indicators and Economy Survey of Pakistan, which covered the years 1991 through 2021. The effects of fiscal policy on economic growth are investigated using tests such as the unit root test (ADF) and least square (Gauss Newton/Marquardt Steps) approach.

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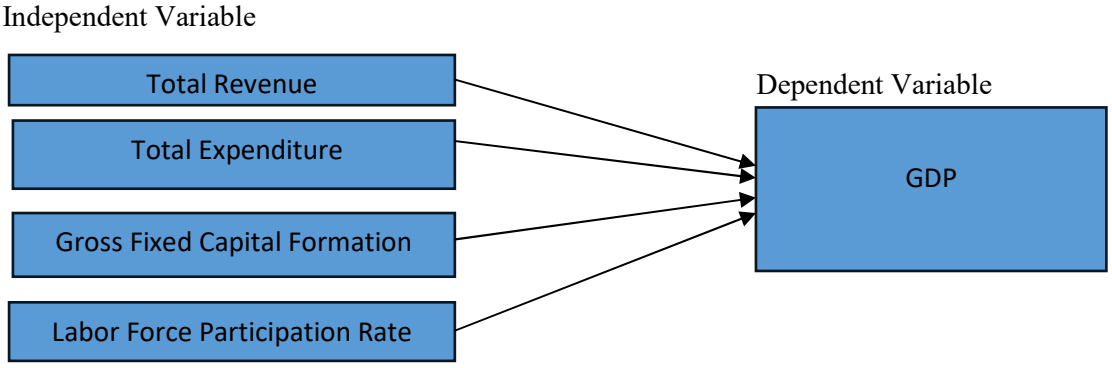
**Theoretical Framework**
Government revenue and government expenditure are two primary elements of fiscal policy. All of the government's earnings from taxes and other sources are referred to as government revenue. Taxes, customs fees, earnings from state-owned enterprises, capital gains, and foreign aid comprise the entirety of the government's income. Government spending is the amount of money used by the government for subsidize it programs operations. Government spends for the welfare of society. (Kazmi, Imran and Saleem 2019)

Numerous empirical studies have been focusing on the fiscal policy impact on Pakistan using fiscal policy variables. Fiscal measures are assessed using different fiscal policy variables like aggregate expenditures, aggregate tax revenue, and government expenditure.
This model is attained by the following equation. These studies are quantitative in nature and analyze the relationship between fiscal policy and economic growth of Pakistan for last thirty-one year 1991-2021.

**Theoretical Scheme**




In the above diagram all the independent variable are on the right side while the dependent variable is on the left side.

**Data and variable**

The study used secondary data set for Pakistan from 1991 to 2021. With a view to examining the effectiveness of fiscal policy on economic expansion of Pakistan we take GDP as dependent variable and Total tax revenue, Total expenditure, labor force participation, gross fixed capital formation as an independent variable. The major source of the data of variable which used in this study is Economy Survey of Pakistan and WDI (World Development Indicator).

**Data Source**

The Data set is assembled from Economy survey of Pakistan and world development indicators (WDI) for a time period 1991-2021.

**Description of Variables**

**Total Revenue**

The word "tax revenue" introduce to the required contributions paid to the federal government for public purposes. There are several required transfers that do not apply to fines, retribution, and the major part of social security offering. Repay and accommodation for wrongly received levy are regarded as adverse revenues.

**Total Expenditure**

Total expenditure means a sum of total recurrent, development and net lending the Government.

**Gross Fixed Capital Formation**

Pay out on new fixed assets for the economic activity as well as net transform in catalogue volume make up gross capital formation, formerly known as gross domestic investment. outbuilding expressway, rail line, and further alike framework, along with buildings edifice, health facility, residence, occupation, and the manufacturing sector, are all illustration of fixed assets. The land improvement (Barriers, waterways as well as sewers, for example) are also regarded as fixed assets. The inventory management are the equipment of strong retained by organisations as "currently in construction" and to compensate with for a while or sudden

fluctuations in output and profit. In accordance to the 1993 SNA, the capital development is sometimes defined as the net takeover of commodities.

**GDP**

Using the steady domestic currency prices, yearly expansion in gross domestic product (GDP) rate in terms of percent, the totals are computed using constant 2015 prices expressed in United States dollars. To compute, the entire value generated by every manufacturer that are considered citizens of the nation's economy is employed together through regard to applicable good and levies as well as other unrecognized allowances. It is calculated without accounting for the degradation, fatigued, and manufacturing assets depreciation and the resources from nature.

**Labor force participation**

The labor force participation rate is the comparison of persons who work in the manufacturing of services as well as goods over a specific time period whom 15 years of age or older.

**Methodology and Estimation technique**

**Methodology**

In accordance to the growth theory literature, fiscal policy has an impact on regarding the extent and percentage of expansion of output. The analytical foundation for this job is built along the production function line.. The production function is;

$Y_t = A, f(K, L)^{\alpha}$ … (1)

In equation (1) Y stands for output or growth, K denotes gross fixed capital formation, L denotes labor force and A is a measure of productivity.

Taking log on both sides of equation 1

$\text{Log } Y_t = \log A + \alpha \log K + (1-\alpha) \log L$ … (2)

Take derivative with respect to time

$$\frac{d \log Y_t}{d\,t} = \frac{d \log A}{dt} + \frac{\alpha\, d \log K}{dt} + \frac{(1-\propto) \log dt}{dt}$$

$g\,Y_t = g\,A + \alpha\, g\,K + (1-\alpha)\, g\,L$ … (3)

g A is equal to $\alpha_o$, g K is equal to $\alpha_1$ their K denotes both gross fixed capital formation and total revenue and total expenditure and g L is equal to $\alpha_2$.

$Y_t = \alpha_o + \alpha_1 K + \alpha_2 L + u_t$ … (4)

**Estimation Technique**

In this research, the influence of fiscal policy on economic progress and their relations are examined using time series data with a sample size of 31 (1991-2021). Due to its clarity and simplicity, E-views is utilized as an economic and statistical tool.

**Unit Root Test**

A unit root test utilizes an autoregressive model to assess the stationary status of a time series data. The widely recognised analysis that is trustworthy in large data samples is the improved Dickey-Fuller test, which is based on linear regression and is occasionally introduce to as a linear Pantula test. When association with time is an issue, the Augmented Dickey-Fuller (ADF) test

might be used. The ADF oversees bigger, trickier models. The most successful assess with a limited the size of the sample for the unit root of an autoregressive model were established by Denis Sargan and Alok Bhargava. If the variables are non-stationary, the Phillips-Perron test is a further investigation in unit root.

**Least Square (Gauss Newton/ Marquardt steps)**

To find the line that appropriate fits, configure of data points, the least squares approach involves minimizing the sum of squares of the offset (residual sets) of the point from the curve. When attempting to figure out the relationship between the two variables, the outcomes are statistically calculated. Regression analysis is the name for this procedure. The one of the common methods that utilizes least square is gauss newton. Gauss newton is an iterative method to solve nonlinear least square problems

**Estimation and Result**

**Table 4.1.1:** *Unit root results*

| Variables | t-Statistics | p-value | Order of Integration |
|---|---|---|---|
| GDP | -6.530345 | 0.0000 | I (1) |
| Total Revenue | -5.335506 | 0.0002 | I (1) |
| Total Expenditure | -4.654776 | 0.0009 | I (1) |
| Labor-force participation rate | -5.765844 | 0.0000 | I (1) |
| Gross fixed capital formation | -5.475974 | 0.0001 | I (1) |

At order 1, the all variables are integrated.

**Gross Domestic Product:**

The GDP is dependent variable which is integrated at I (1). The probability value is 0.0000 which means that the GDP is significant at 5% level and t-statistics which is -6.530345 show that its statistically significant (t-statistics is an absolute measure). The Durbin-Watson value is 1.8012869 means there is no autocorrelation.

**Total Revenue**

Total Revenue is one of the independent variables which is integrated at difference 1. The probability value is 0.002 which means its significant at 5% level. The t-statistics is -5.335506 which shows that the variable is also statistically significant. The Durbin-Watson value is 1.727564 that were is equivalent to 2 stating autocorrelation between variables.

**Total Expenditure**

Total Expenditure is an explanatory variable which is stationary at order 1. The p-value is 0.0009 that is below 0.005 so its notable at 5% level. The t-statistics value is -4.654776 which means total expenditure is statistically significant. Durbin-Watson value is 1.705222 so there is no autocorrelation.

**Labor Force Participation**

Labor force participation is an independent variable which is integrated at I (1). The t-statistics value is -5.765844 which means this variable is statistically significant and the p-value is 0.0000 which also show that this variable is significant at 5% level. The Durbin-Watson value is 1.962223 so there is no autocorrelation as well.

**Gross Capital Fixed Formation**

Gross Fixed Capital Formation is also one of the explanatory variables which is integrated at difference 1 as well. The p-value is 0.0001 which that the gross fixed capital formation is also significant at 5% level. The t-statistics is -5.475974 which also show that this variable is statistically significant (t- value is an absolute measure). Durbin-Watson value is 2.047769 which shows no autocorrelation.

**Table 4.2.1:** *Least Square (Gauss Newton/ Marquardt Steps)*

| Variables | Coefficients | Std. Error | t-statistic |
|---|---|---|---|
| Labor Force | 0.758329 | 0.609981 | 1.243200* |
| Gross Fixed Capital Formation | 0.310974 | 0.305254 | 1.018736* |
| Total revenue | 0.59687 | 0.367721 | 1.623161* |
| Total expenditure | -0.44546 | 0.229973 | -1.93703* |

* Indicates at 10% level of significance.

The above result shows that growth rate is positively related to the labor force participation rate, the labor force participation 0.758329 increase growth rate is also increase because the more labor force participate, the output will increase and eventually there will be economic growth. The gross fixed capital formation 0.310974 increase growth rate is increase due to increase in marginal productivity than increase in growth rate. Total revenue is positively related to the growth rate which is 0.59687 so there is increased in total revenue then growth rate is also increase because it promotes new investment which eventually cause economic growth to increase and the total expenditure is shows negative relation -0.04456 decreased than there is increase in growth rate because the bottom line of the budget shows that the more money is spent than is brought in, resulting a cycle of debt. The all the variable is approximately 10 (t-value is absolute measure) appear it statistically significance. The standard error of all the variables is less than 1 which indicates that this model is better. The Durbin-Watson value is 1.84076 which determine that there is no auto-correlation.

**Conclusion**

This research analysis the impact of fiscal policy on economic progress of Pakistan, this empirical study is based on time series data for Pakistan from 1990 to 2010. The data is collected from Economy survey of Pakistan and WDI. This research acquires the Least Square (Gauss Newton/ Marquardt steps) to establish the impact of fiscal policy on economic growth of Pakistan. This finding suggests that the gross fixed capital formation, labor force participation rate, Total government revenue is positively associated to the growth rate or total expenditure is negatively

related to economic growth. This study result shows the significant effect of fiscal policy on Pakistan's economic growth.

The literature on fiscal policy emphasis the importance of these variables in the mechanism of long-term growth, Even though these factors are ignored, the growth process will not be complete. Overall, the above factors have a very strong effect on economic growth.

**Recommendations**

- As per empirical results, the government should increase tax collections to boost Pakistan's economy. However, direct tax burden is already heavier on the public; revenues should be increased by imposing them rather than indirect taxes.
- Physical stock of capital should also grow rapidly as consequently worrisome to our economic system, also ground association approve our findings. As Pakistan is a developing nation so capital accumulation is necessary for long-term economic growth.
- To achieve higher economic growth, the labor force participation rate should also increase rapidly.
- Unemployment is not entirely unusual in Pakistan; therefore, the government should employ workers so that the economy can thrive.

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