

Causes of deficit: the financing in pakistan



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The aim of any government is to fulfill the socioeconomic responsibilities in order to break the vicious cycle of poverty and also uplift the economic conditions. In Pakistan it has been practiced that the aggregate of tax collection and no tax collection revenues are not ample to meet the government expenditure. To fulfill the gap between the spending and revenues so the economist used the perception of deficit financing.

The government borrowing from banking and non banking sector and printing new currency is called deficit financing. Deficit financing shows the difference between projected expenditure and projected spending. To fill the gap of government borrows from 1) state bank of the country 2) borrow from commercial banks 3) borrows from non financial sector such as saving centers, insurance companies 4) the last source is printing new notes known as deficit financing.

Deficit financing is a situation where government spends more money than its revenue collection. Deficit financing is used for different purposes the main purpose of deficit financing is used to end the recession when the economic activity slow down in order to retrieve the economy in the better situation. In the third world countries like Pakistan the deficit financing becomes the requirement due to bad governance, insufficient spending policies, corruption, tax evasion, and insufficient tax collection.

In the west the phrase Deficit Financing is used to explain the intentionally create a difference between public revenues and expenditures or the budget deficit. This gap or difference can be filled by public borrowing, commercial

banks, and central bank. The idle saving of is used to fill this gap that in turn increase the employment and output of the country.

Deficit financing is the most important tool of generating capital in developing and underdeveloped countries. In developed nation the new currency notes are used to support the public investment that in turn increases the growth rate of a country. The government used the borrowed money for the development purposes i. e. railways, roads, air services, social overhead capital, schools, hospitals etc. The deficit financing is also used to increase the economic activity of a private sector in the country.

The monetary expansion in developing countries attached with high rate of borrowing from banks and international sources to finance their budget deficit, budget deficit is the one factor that contributes in disequilibrium in the balances of payments. In developing countries governments are unable to mobilize or use their domestic resources due to inefficient tax system, in such countries the capital market are also underdeveloped and the interest rate determines institutionally. In such circumstances the supply of money increase that causes an increase in the price level.

There are different sources of financing the economic development; these resources are domestic resources and foreign resources. Domestic resources are those in which the government finances through taxation, public borrowing, and the saving of government that include the surplus and also include the deficit financing. The foreign source of finance consists of loans, grants, and private investment. The significance of both domestic and foreign resources has their own in developing countries. The most important

thing is used to execute these resources in a way that maximum benefit can be achieved for rapid development.

1. 1 Background of the problem

Pakistan is a large country with a population of 17. 50 million in 2010. The economy of Pakistan is still facing the low level of per capita income that is stranded at 699 US \$ in December 2012. In Pakistan the ratio of the budget deficit is different in different years. From last two decades the budget deficit is 5. 4% to 8. 7% of GDP. The average deficit rate was 6% in the period of 1970 and it was 7. 6% in the period of 1980. In 1990s the deficit ratio was decreased to 6. 4% of GDP due to a reduction in development expenditure. The ratio was not achieved by enhancing the tax system but due to the reduction in the development expenditure. The Pakistan tax system is still narrow and punctured due to the poor and weak tax administration.

The balance of payments deficit has become a permanent problem of Pakistan's economy. For the last fifty years Pakistan has been facing continuously from a current account deficit. The international loans are used to finance the deficit. The debt service charged more than 5% of the GDP of the country. With large budget deficit there is need of rapid growth of domestic credit. In underdeveloped countries the role of free capital markets is limited. The main source of government deficit is financed by the banking system.

Like other developing countries Pakistan is also facing a large budget deficit as the most outstanding problem. Deficit financing is also responsible for high inflation rate, decrease growth rate, and low opportunities for private

investment. Pakistan faces different rates of the budget deficit in different years. In last two decade the budget deficit ratio was 5.4% -8.7% of GDP. The ratio was 7.6% in 1980's the ratio became 7.6% in 2001- 2002. The rate of budget deficit in Pakistan has grown consistently with the passage of time. At the time of 80's the budget deficit has increased as much as faster than the early periods and touched the ratio of 8.4% in 1987-88. The rate of budget deficits has decreased to 7% but that ratio was also considered high one of the experts. Due to large budget deficit there was a high rate borrowing is used to responsible for an increase in the domestic debts since 1980-81.

In the period of 90's the severe situation faced by the State Bank of Pakistan to control inflation within the targeted limit and make sure the macroeconomic stability. In the fiscal year of 1998 and 2003 the rate of inflation was 4.6% that were relatively lesser the best rate. In early 1973 and 1980 the inflation rate was two digit figures that were 14.3%. The rate of inflation controlled in the period of 1980 that was 7.2% per annum but unfortunately the rate of inflation again grown to 10% per annum. The high rate of inflation also caused due to excess money supply, fiscal imbalances, and deficit finance sources.

1.2 Problem Formulation

Chaudhary and Hamid (2001) Pakistan are facing severe obstacles of generating public revenue. The persistent failure in attainment of public revenue leads the public sector to depend on public borrowing. The result is that the public debt goes to increase the rate of 90% of GDP and the rate of budget deficit increase to 8% of GDP. The figure of budget deficit lead to

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double digit inflation (ref). These imbalances adversely affect the economy. These problems all are interconnected with each other in order to decrease the public revenues that in turn create the hindrance to meet the needs of the public expenditures. In this regard the efforts are made to improve the taxation system that is not based on the scientific approach, that's why the to attain the target of achieving the projected target failed continuously. The result is that it is not only used to meet the demands of development projects because at that time it not able to meet the demand of the current expenditure. In Pakistan the less than 1% population is taxpayer. According to the economic survey of (1998-99) Pakistan has experienced the sustainable growth rate more than three decades till 1990. Pakistan's economy grew at the rate of 6% per annum more than three decades but the situation became adverse in 1990. The collection of tax also became very adverse at a satisfactory level.

The other developing nations like Pakistan at the age of early growth need to get higher revenue than the developed nations. Due to the obstacles that prevail in getting the higher growth rate this could lead to the unsustainability to survive. According to the economic survey of 1998-99 the growth rate of Pakistan goes to down at 4. 5% per annum, the ratio was about 6% in the last 3 decades and same ratio was 3% for few years.

The deficit finance is the result of failure in an increase in the public sector to increase their savings. The trend shows that the efforts made in collecting taxes do not meet the demand of the public. It is important to note that Pakistan is not attaining the targeting revenue through tax. According to world development report (1979, 1991 and 1997) the rate of tax collecting in <https://assignbuster.com/causes-of-deficit-the-financing-in-pakistan/>

the other developing countries is 25%. In the period of 1998-99 the tax shortfall was approximately 20%; it shows that there is need of detailed study of the tax reform system.

The economic crises over in 2008, Pakistan have enjoyed greater economic activity. The policy maker in Pakistan's fights a battle against the crisis hit in 2008-2009. The sudden increase in the oil prices also causes the alarming situation for the deficit in foreign debt and also decrease the value of the rupee. Pakistan made efforts to seek the international monetary fund after the allies of China, USA, and Saudi Arabia to refuse to provide the funds to the country in October 2008. Pakistan has provided the US\$ 1 billion loan for 23 months. Pakistan asked the IMF to raise their loan from US\$47. 6 billion to US\$ 12. 1 billion in February 2009. In August 2009 the IMF increases the time span to 25 months and increase the grant to US\$11. 3 billion to meet their financial needs.

1. 3 Previous Studies

Ishfaq and Chaudhary (1999)The debt history of Pakistan started in 1984-85, when the surplus revenues turned into a deficit. The fiscal deficit and debt converted into multiple rates. The total deficit rate was Rs 89. 2 billion in 1990-91 that rate was increased to 66% in 1997-98 and approximately to Rs 148 billion. The domestic debt was increased to 185 percent the amount increased Rs 448 billion to Rs 1280 billion and foreign debt increased to 156 percent the amount was Rs 272 billion to Rs 697 billion in the same time period.

Pakistan has an opportunity to do some measures for the establishment of the macroeconomic indicator rather than to go for deficit financing for generating the revenue. In the mid of the 2008 the Pakistan started registering the imbalance in the overall economy. At the end of the 2008 the Pakistan fiscal deficit was increased to \$ 5. 6 billion that exceed to \$ 8 billion. The trade deficit also increases to \$ 13 billion to \$ 18 billion. Foreign reserve has fallen to decrease to \$ 6. 5 billion. (Baig, 2011)

Pakistan forced to take the help from the IMF in order to get financing for the deficit finance of their economy. The help provided by the IMF was the package of \$6. 7 billion that was later increased to \$ 11. 3 billion in 2009. The IMF also helped Pakistan by providing bilateral and multilateral aid that also causes to increase external debt and liabilities to \$ 54 billion from \$ 41 billion in January 2008. Pakistan is also used to sovereign bonds and sindak bonds in order to use another form of deficit financing. This also creates a problem for a country to repurchase these bonds according to their specified time table or schedule because different countries have different foreign currencies. In these situation investors does not show their concern toward the investment. (Baig, 2011)

These both measures are taken by the international market that is not so enough for the needs of the Pakistan and then government compelled toward the third mode of deficit finance monetization. The Pakistani government relies on the domestic borrowing that is the cause of disparities in the debt dynamics. The domestic debt borrowing increased to 24% in the mid of 2008. Pakistan domestic debt was multiplied from Rs 2610 to Rs 4490 in the fiscal year of 2007. At the end of March 2010 Pakistan domestic debt <https://assignbuster.com/causes-of-deficit-the-financing-in-pakistan/>

was \$ 53. 2 billion which was approximately 30. 6% of GDP. All the source of the deficit finance is failing to attain the desired results and lead the economy toward the negative direction.

By the mid of 2010 Pakistan's total domestic debt reached to \$ 100 billion and there is already paid interest about \$5. 6 billion and debt servicing amounted \$ 7. 6 billion annually that was expected to cross the limit of \$ 10 billion after the fiscal year of 2010-11. (Baig, 2011)

Deficit finance works only when there are such sound policies that direct the planners that how to spend money in a way that raise debt, generate revenues and also plan some actionable ideas that directs that how to repay the debt. For the attainment of all these targets there should be a need of honest and sincere governors that Pakistan does not have. In this way we are able to increase the debt and rising the liabilities that is useful for the upcoming generation to pay off that. The money that is used to spend on the future of the Pakistani people should also be spent on the future of Pakistan that could be served as the bureaucracy, foreign visit, corruption and government functionaries.

Today the Pakistan debt situation is alarming and we have no plans that how to raise sustainable revenues and having no idea that how to accumulate the external and domestic debt. We have very few and tough choices to make serious and valuable decisions. (Baig, 2011)

Causes of Deficit Financing in Pakistan

The main causes of deficit financing in Pakistan are:

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Increase in government expenditure: The government expenditures both development and non development are increasing as time passes. The government has not been able to meet the expenditure by its revenues.

Ineffective budget deficit: There are ineffective fiscal policies implemented in Pakistan and fiscal indiscipline also result the public debt.

Fiscal deficit: The average fiscal deficit in 1990s was 7% of GDP. The public debt increased from 66% of GDP in 1980 that almost 100% by the mid of 2000. In 2004-2005 the fiscal deficit was 3.3% of GDP however; it increased to 4.2% in 2006-2007.

Low saving: The people of Pakistan are consumption oriented. Due to high consumption rate the saving ratio was lower than 16%.

Rapid population growth: The rapid population growth also a main cause to slow down the economic activity of a country. According to economic survey of 2007-2008 the population growth was 1.8%.

In underdeveloped countries the increase in money supply is one of the major causes of disequilibrium in the balance of payment with heavy government borrowing from banks and as well as from international source of finance. In such developing countries government relies on the deficit financing due to unable to use their domestic sources due to the inflexible tax structure. The capital market of such underdeveloped nations is not able to determine the interest rate and the interest rate was determined by the institutions that in case the result of excess money supply.

1. 4 Purpose Statement

The rationale of this study is used to test the theory of association that relates the dependent variables and independent variables. Here in this study the factors (exchange rate, inflation, tax, interest rate) that is affected by the deficit financing are independent variables and GDP is dependent variable. Its individuality will be statistically restricted in this study.

1. 5 Objective of Study

The following objective will be paying consideration to guide the study:

- To study the impact of deficit finance on the exchange rate
- To analyze the effect of deficit financing on the tax rates.
- To study the impact of deficit finance on the interest rate.

1. 6 Significance of Study

Our study is about the impact of exchange rate, inflation, taxes and interest rate on deficit financing. In which we will see that how the factors are directly or indirectly affect by the deficit financing.

LITERATURE REVIEW

Mukhtar and Zakaria (2011) explain their study that, In the economic journalism, frequent models have been designed to examine the long-run association between inflation, money supply and budget deficit. However the proof from the observed literature is diverse. In 1990 De Haan and Zelhorst investigate the link between government deficit in budget and money growth in underdeveloped nations. The general conclusion of this study does not offer much sustained for the suggestion that government budget deficit causes monetary expansion and, therefore, leads to price increases. Vieira at <https://assignbuster.com/causes-of-deficit-the-financing-in-pakistan/>

(2000) examines the association between economic deficit and inflation in the case of six major European economies. The domino consequence present modest support for the proposal that the deficit in the budget was a significant causal reason for inflation in these economies over the most recent 45 years. Drivel and Ndung'u (2001), as an active error correction model of inflation for Kenya, find that money supply affect price only in the short-run. Though, the study by Catao and Terrones in 2003 shows that there is a strong positive affiliation between budget deficits and inflation among the underdeveloped countries as well as countries characterized by high inflation, but not among advanced economies with low-inflation.

In the case of Pakistan, the study conducted to inspect the part of fiscal deficit as a major determinant of inflation also give mixed results. Bilquees in (1988) discover no connection stuck between deficit in the budget and inflation. In 1998 Neyapti's experiential study based on the data set for 44 underdeveloped and less developed nations indicates that the positive involvement between the deficit in the budget and inflation is not statistically important for a number of nations as well as Pakistan. On the other hand, in comparison to these studies, in 1994 Shabbir and Ahmed locate a constructive connection linking budget deficits and inflation in Pakistan. According to their result, if there will be a 1 percent increase in budget deficit there will be 6 to 7% increase in the general price level. According to Chaudary and Ahmed in 1995 explain that if internally finance the budget deficit mainly from banking system then there will be an inflationary pressure in the long run. The outcome point to a constructive affiliation stuck between budget deficit and inflation during sharp inflation periods of the

1970s. The authors also find that money supply is not exogenous; rather, it depends on the location of global funds and fiscal deficit. Khan and Qasim in 1996 expose that the expansionary fiscal policy standpoint has been reflected in a weakening balance of payments position and has induced frequent down amendment in the rupee, which has caused the price level to increase. (Mukhtar and Zakaria, 2011)

Afreen Baig in 2011 used to examine and study the impact of deficit financing in developed countries.

The US government responded with unprecedented bank bailouts worth \$700 billion and further \$787 billion fiscal stimulus package. According to data compiled by Bloomberg, the US has spent or guaranteed bail outs worth \$11.6 trillion, only little less than the worth of their total GDP. With Interest rates lingering around zero percent and around \$300 billion already given in tax cuts - this had to be the best possible approach. The wars after 911, in Afghanistan and Iraq, forced the national debt to swell from \$5 trillion to \$13.5 trillion today. Since 1770s, the US national debt has soared higher - fueled by wars, economic recessions and accumulated budget deficits. The USA had to deficit finance their economy out on every occasion, consequentially raising the debt to about 100% of their GDP. These days, USA's GDP is \$14.3 billion dollars and a community debts of \$13.92 billion dollars. Furthermore, the USA has a trade lack of \$0.501 billion dollars and funds lack of \$1.409 billion dollars. Their supplies are a negligible \$129 billion dollars in evaluation of their nationwide failures, insufficient to back up the imbalances designed in the overall financial system. For USA, Deficit funding has not assisted generate that good incidents, to generate sufficient

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earnings, in order to get over the yearly failures or decrease their community debts. The economy shall keep warm up, unless the directing concept implemented is that of long term revenue creation and stability in the macro-economic signs with regard to their GDP.

However, since Money is the source money in the world, there is hardly any possibility of US sovereign standard.

(Baig, 2011) Similarly, the Economy of UK has not been that perfect, and decades of lack funding, including the present trance of relief and quantitative reducing, value around £1. 122 billion dollars and interest prices cut as low as 0. 5%, in previous times two decades several weeks, from 4. 5% in 2008 has not provided a substitute design for long-lasting financial development and durability. Today, UK - the globe's 5th biggest financial system, has a GDP of around \$2. 15 billion dollars and a public debt of \$9. 12 billion dollars. Furthermore, they have a business lack of \$123 billion dollars and a fund deficit of \$312 billion dollars, accented by their pitiable international supplies of \$53 billion dollars. UK's external debt as the amount of their GDP has rocketed to 424% and the perspective to 2011 is as perturbing, as throughout the economic downturn period of 2007-2010, even after the various ways of deficit financing

Despite whatever upgrades the financial experts predict, most of the Western economies keep warm up, are vulnerable to the tiniest sign of financial recession and the recovery begins flagging in any case, despite all efforts at lack reducing. The only reason for this warming up is that they have become amongst the globe's maximum struggling with debt countries,

due to years of lack funding, with their income creation not adequate to back up their development on their own. Most of these Western financial systems have become disaster-prone, unless they create resolute attempts to lower their debt to GDP rate, and further create sure you bring about equilibrium in their significant financial signs, even if they cannot accomplish budget surplus. (Baig, 2011)

China providers - however, has been in a fairly good position, mainly due to its balanced macro-economic signs and sensible guidelines. Genuine and identified cost-effective changes of late 70's set the stage for balance in an investment, industrial, local consumption, exports and income generation. Today, China providers - an economic system with a GDP of above \$5 billion money has a limited group cost-effective financial debt of merely \$347 billion money dollars, a positive business excess of \$190 billion money dollars, and a little budget absence of \$109 billion money dollars. Extremely, China providers also maintain the planet's biggest collected sovereign funds, foreign resources of \$2. 648 billion money. These encouraging set of macro-economic indicators enabled China providers to prevent international results of financial issues easily, however providing its local consumption, in wake up of low business goals. Lack financing worked for China providers - it shored up on extra group spending, as its group financial circumstances remained continuous throughout. The stimulus measures or absence financing, wishes to increase China's group cost-effective financial debt hardly by 3% of their GDP, without creating any problem. (Baig, 2011)

China's projects to get over the repercussions of financial issues are much more commendable and more sensible, than any other country in the world.

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While most nations spend huge on bailing out financial institutions and financial companies to improve indirect resources for trading markets, China providers have offered direct employment and money activity in the trading markets. China providers released upon the most sensible of absence financing. (Baig, 2011)

The government will be able to fund only 5% of its resources absence with international loans, throwing the rest of the economy problem on family sources of financing, helping the possibility of continuous excellent bolstering, excellent prices and low economic growth during economical period 2012.

As a result of the cancellation of the \$11.3 billion money dollars Globally Financial Finance (IMF) bailout program, which activated other worldwide loan providers to delay their financing as well, the government will be remaining with less than \$526 million (Rs46 billion) in net external financing during the economical period completing May 30, 2012.

This amount is just 5.3% of the resources absence, approximated at Rs856 billion money dollars - or 4% of the complete size of the marketplace - during the next economic period. Many professionals have regarded the concentrate on good at best.

The rest of the Rs810 billion money dollars will have to be raised for the family market, for which the government is likely to turn to two sources, neither of which is delicious from the economical perspective. The first is credit from professional banking organizations, which drives out lending towards the personal market and reduces economical growth. The second

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choice is to power the main financial institution to simply make money, which is the single biggest cause of bolstering in the country. (The Express Tribune, May 26th, 2011)

The government credit for funding of financial lack has improved the attention transaction to 58.5 percent of the complete net approximated income during the present financial season, official documents revealed. The government has reserved Rs 699 billion dollars in the present financial season budget for attention transaction, which has now been improved to Rs 727 billion dollars due to credit by the government for funding of financial lack and great attention rate by the Condition Financial institution of Pakistan to acquire the blowing up.

The complete approximated net income available with the government is Rs 1,242 billion dollars after Rs 993 billion dollar transfers to the regions against attention transaction of Rs 727 billion dollars during 2010-11. The Fund Ministry also acknowledged that community industry lack plays a role in inflationary pressure and shows dangerous for financial commitment and growth by increasing household investment and forcing up prices. The problem with the Condition Financial institution of Pakistan of funding the government financial lack is a negative aspect of the macroeconomic situation and deteriorates its ability to engage in a sound monetary plan. The reason behind this is that the funding of the lack takes up funds in the personal and banking industry which would otherwise be used for the financial commitment. The funding of the lack forced the Central Financial institution of Pakistan to keep prices great which get smaller credit to the personal industry and ultimately undermines financial commitment.

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According to Fund Ministry after several decades from 2000 forward the country's community financial debt reduced and brought under a degree of management, the trend since 2008 has been towards improved indebtedness. This is true both for household financial debt, which had carried the main part of the problem of funding the community industry lack, and two exterior financial debts, in which the inevitable options to credit up to 9 billion dollars from the IMF to address the 2008 economic crisis, has left a heritage of substantial exterior financial debt repayment obligations for the coming 3-4 decades. This problem substantially reduces room for manoeuvring in community industry funding. This all happened because of a failure by the government to implement the financial plan as on the one side it was able to mobilize resources by bringing casual areas in the tax net while however it was not ready to manage investments. (31 May 2011 BUSINESS RECORDER WWW. FOREXPK . COM)

Gaber in 2010 explain the financial plan symbolizes strong instrument which through community expenditure and taxation can have an impact on the combination need for goods and solutions in the economic system. The budget lack plan, excessive community financial commitment upon collecting community earnings, is started because of the economic growth impact. Through the household and organization choices that modify the money supply or level of taxation, there is oblique impact of the combination need bend. But with public expenditure involved from the government, there is a direct impact on the aggregate need bends. If we assume that the government made a buy of some community good, for example flat lands, it will improve the combination need. But is the amount of change the same as

the preliminary community expenditure? Therefore, we are faced with two macroeconomic results. The first, multiplier impact indicates that the movement in the combination need will be bigger than they buy, but the second one - "crowding out" indicates that the combination need modify will be smaller than the preliminary community financial commitment that can be seen the latter.

However, improved need leads to with bigger engagement of the workforce and higher earnings of the organization. That kind of modern impact is relocated to the worker wages and other organization earned, which results to improve of consumption of different goods and solutions. So the state need for planes increases the need for other company's products in the economic system. Because an increase in the combination need is bigger than the preliminary government financial commitment, it is said that the government investing has growing impact on the aggregate demand. This implies that there is a review between the greater aggregate demand and the earnings which consistently leads towards greater need, then again to greater earnings etc. All these results imply that the total impact on demand goods and solutions will be bigger in respect to kick off point of the government financial commitment.

Also, that could start response from the financial commitment side as a reply to the increased need of goods and solutions. That would mean an additional investment in the plain organization for new plant, equipment and so on. In this case, the higher government investing produces greater financial commitment products need. This is known as financial commitment decrease. (Gaber, 2010)

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Multiplier effect could be obtained from the individual investing multiplier where the marginal propensity to consume (MPC) is the essential factor – the aspect of the extra income that the family takes in instead of preserving it. The multiplier = $1 + MPC + MPC^2 + MPC^3 + \dots = 1 / (1 - MPC)$. It shows the need for products and

services created upon 1 European of government financial commitment. The multiplier reasoning indicates to any part of the GDP, and not only to the government financial commitment, as customer investing, financial commitment and net trade. So, if it acquires decrease in the net trade of some nation, for example, in the amount of 1 million European, the decrease in nations products will put stress on the national Income and therefore will decrease the household customer investing. With $MPC = 4$, the net trade decrease of 1 thousand European will mean shrinkage in the aggregate need from 4 thousand European. (Gaber, 2010)

This is only the first device of the financial plan, public financial commitment, but there is another – taxation, which also can have effects on nationwide income. That can be seen through the personal income tax. Decrease in this tax will improve the household income that the individuals take home. One aspect is stored and the other is consumed. Because of taking changes, there is action in the aggregate demand bend to the right. Reverse, tax improve will decrease investing and move the combination need bend to the left³. Therefore, the multiplier and frequenting out effect is also regular for the second instrument of the financial plan. When the