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The optimal level

According to Vision 2025, the fiscal deficit should be less than four percent of the GDP to achieve macroeconomic stability – which is a prerequisite for sustained and inclusive growth.

Pakistan, however, is struggling to control the fiscal deficit despite various commitments by the government to improve revenues. The fiscal deficit of 4.6 percent was recorded in FY 2016 – which was higher than the target of 4.3 percent set for the year. More recently, according to the State Bank of Pakistan's The State of Pakistan's Economy - Second Quarterly Report 2016-2017, the decline in revenue collection has led the fiscal deficit to widen by 0.7 percent of GDP in H1-FY 2017 (2.4 percent of the GDP) as compared to the last year (1.7 percent of the GDP).

Senator Ishaq Dar, the finance minister, said at the end of Article-IV Consultations with the IMF that the project's fiscal deficit will be 4.1 percent of GDP as compared to budged limit of 3.8 percent of GDP for the current financial year. On the other hand, the IMF has cautioned for "strong efforts with respect to fiscal consolidation and the implementation of key structural reforms, and vigilance in managing the country's external position".

What is the level of fiscal deficit that can be maintained without jeopardising economic growth? What is threshold level of fiscal deficit? To identify the threshold level of fiscal deficit in Pakistan, a study was conducted.

This study revisits the relationship between fiscal deficit and economic growth in Pakistan to explore whether there exists a threshold level of fiscal deficit which can act as a benchmark for policymakers who aim to promote growth through fiscal expansion. It assumes that a fiscal deficit below the threshold level can be instrumental in promoting economic growth. Meanwhile, if the deficit exceeds the threshold level, it can hamper economic growth.

The threshold of the budget deficit is linked with numerous factors, including intergenerational distributive effects of deficits. These effects include the change in debt burden, the composition of taxes and spending, macroeconomic indicators, national debt levels and the expected impact of certain political and procedural aspects of the budget process. Imposing restrictions by fixing fiscal deficit level helps to force elected representative to act within constraints.

At least 5.57 percent of the GDP fiscal deficit is the threshold level for Pakistan. This implies that macroeconomic policy needs to keep the fiscal deficit below the threshold level to avoid its adverse consequences for economic growth. This finding is consistent with other developing countries. For example, five percent of the GDP for Nigeria and for Gambia, it is six percent of the GDP. During a period of high growth, the budget deficit is below the threshold level while during low-growth periods, the budget deficit is higher than the threshold level. During the recovery period, fiscal deficit reflects a declining trend. Another study done at PIDE also reveals that the fiscal deficit at the current level may boost economic growth, but a very high level may adversely impacted growth. This signifies that Pakistan would need to keep fiscal deficit in check and keep on practicing fiscal prudence.

By projecting fiscal deficit of 4.1 percent of the GDP – which is well below the threshold level – the government can achieve the objective of macroeconomic stability. This is fundamental and a prerequisite for sustained and inclusive growth by allowing further fiscal expansion. It may be tempting to argue that running a fiscal deficit below the threshold level is desirable as fiscal expansion within acceptable limits would fuel economic growth. It can stimulate domestic production and consequently make private investors more optimistic about the future course of the economy. This results in more investment – the so-called "crowding in" effect.

However, the benefits of such a policy will only be realised if public spending is targeted through long-term investments that yield adequate returns on infrastructure, education, health and other development projects. Such public investments may also improve the marginal productivity of private capital. This implies that if public capital is complementary to private capital, investment in public capital will crowd in private investment and reinforce the process of economic growth. A strong economy can, in turn, help fiscal consolidation, promote macroeconomic stability, improve investor confidence and sustain robust growth momentum.

It is necessary to keep deficit in check. However, in light of the threshold, the government is doing fine. It is necessary to increase spending on projects which facilitate private sector investment. We need higher growth to engage the youth in the productive sector. In the upcoming budget, the government can use some leverage to generate demand by opting expansionary fiscal policy.

The threshold level of fiscal deficit does not imply that it is the optimal level of deficit which ensures inter-temporal solvency conditions. It merely indicates a fiscal deficit that may be targeted by policymakers as a benchmark beyond which fiscal expansion would hamper economic growth. The threshold level may be conditioned by the composition of deficit financing. Future research may focus on how the threshold level of fiscal deficit depends on different financing options including public borrowing and seigniorage.

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