ABSTRACT: Fiscal Policy is one of economic stabilization policy, which helps to promote the economic growth of country, as Pakistan is facing fiscal deficit from its independence with exception of three years and tax to GDP ratio is low. Pakistan is also facing trade deficit due to all these reasons, we have tried to investigate the effect of Fiscal Policy stance at economic growth of Pakistan in world inflation perspective. To capture the effect of world inflation we have taken into account the trade share of Pakistan with our trading countries. Accordingly, this paper investigates the effect of world inflation at short and economic growth of Pakistan. The data set of 40 years (1973-2013) years is taken from World Development Indicators (WDI) and Economic Survey of Pakistan. Since the expected length of data is substantial, we have applied Vector Error Correction model, Variance Decomposition Analysis, Impulse Response Function, Granger Causality Test and Johansen Co integration technique to find out long run and short run relationship. Break points are a highly likely feature of the long run time series. Variables are Gross domestic product, Trade deficit, Total investment, Worker remittances, Tax revenue, Total expenditure and World inflation. The results try to draw the attention of the policy makers towards the issue that during the period of trade, they should be well aware of the inflationary situation of the trading country.

Key Words: GDP, Fiscal Policy, Trade deficit, Johansen cointegration, Breaks points, Granger Causality, World inflation.

1. INTRODUCTION

The fiscal policy is one of the economic stabilization policy which helps to promote the economic growth of the Country. Pakistan is facing fiscal deficit from its independence with exception of three years. Pakistan is facing Trade Deficit, Balance of Payments deficit and Tax to GDP ratio is low due to all these reasons, we have tried to investigate the effect of Fiscal Policy stance at economic growth of Pakistan in world inflation perspective to capture the effect of world inflation. We have taken into account the trade share of Pakistan with other trading countries of the world. Fiscal Policy means the procedure to be followed in making government expenditures in obtaining government revenue. In simple words, we can say that by fiscal policy, we mean shaping of public taxation and government expenditure. Government revenue raising and its spending activities are called Fiscal Policy. According to Barro [4], “A balanced increase in productive expenditures and distortionary taxes has strong impact on economic growth but the effect is uncertain”. We can say that an increase in productive expenditures, which are being financed by non-distortionary taxes has a positive effect on per capita income, but this effect is ambiguous, similarly an increase in current expenditure financed by non-distortionary taxes affects the per capita GDP but this effect is neutral. A Keynesian economist has designed his economic model to argue that government should clearly formulate its short term and long term fiscal intension by government. It states that government should clearly formulate its short term and long term fiscal intension.

1.1 Objectives

Following are the objectives of the paper:

1. To estimate the elasticity of substitution between labour and capital in banking sector of Pakistan.
2. To find the type of returns to scale that is applicable in banking sector of Pakistan.

2. LITERATURE REVIEW

According to Barro [4], a balanced increase in productive expenditures and distortionary taxes has uncertain impact on economic growth. An increase in productive expenditures, which are being financed by non-distortionary taxes has positive effect on per capita income similarly; increase current expenditure financed by non-distortionary taxes has neutral effect on per capita GDP.

Amin [3] studied the Cameron fiscal policy and economic growth in Kenya by using the data set for 33 years from 1961 to 1994 from different government and financial institution because in Cameron the official data is not available and they developed a VAR model for fiscal and government intervention. They used dummy variable for economic variables, investment data and government figures.

Yasin [35] studied the effect of debt crisis of Pakistan and optimal fiscal policy. They have used 1989-1990 as the base year supply side is catered by using 18 industries out of which 17 sectors are domestic and one is for cross border transactions. They used the household information from HIES 1991, income distributed in four groups on the basis of income and expenditure level. The demand side is gauged by 10 commodities needed for consumption. But was unable to apply CGE model because it need full information of parameters which were not available so they assumed CES specification for agriculture and services they have applied the Cobb Douglas Production Function. They have applied conventional models of fiscal policy and compare the figures of debt and fiscal stimulus.

Authors in [31] studied the effect of fiscal policy and inflation volatility of using monthly data for 5 years, having 60 observations for European countries by using GARCH model they found that fiscal policy has affected inflation volatility. But a positive correlation between these two variables is due to reverse causality. They also found the effect by using panel estimation of a single equation to studied inflation variability for 15 industrial countries and
GLS method is used at OECD countries that fiscal policy has an impact on CPI inflation volatility. Author in [1] found out the fundamental determinant of fiscal policy by using Global Fiscal Model by using macroeconomic implications and changing tax policies create government debt, it also affects other countries through government spending on consumption. Author in [2] studied the effect of fiscal policy on economic growth with reference to Pakistan by using a time series data and found that low interest rate and gross capital formation are the major determinant of GDP growth in Pakistan. They have chosen four variables and found ARDL model and found that Long run relation exist in fiscal deficit and growth and expansionary and contractionary fiscal policy occurs in Pakistan.

Others [6] studied the impact of fiscal decentralization to economic growth by using the annual time series data from 1972 to 2009 and applied AR model of ordinary least square and found fiscal decentralization and revenue have positive and significant impact on economic growth. It has been recommended by the author that fiscal power should be transferred to local and provincial government to raise growth and development. Other workers [12] studied the impact of fiscal variables on economic development of Pakistan subjecting data set of 39 years using Granger causality test to determine the direction of causality. They have studied the effect of net tax revenue, population growth rate, real interest rate, CPI, government expenditure and gross capital formation they found that fiscal policy is a long run phenomenon rather than short run. In short run they can control it by interest rate and government expenditures but at the cost of inflation.

Brasovan et. al.[5], studied the correlation between the fiscal policy and economic growth a case study of Romania a data set of just 18 years has been taken they have studied the relationship between the distortionary fiscal revenues and other revenues with GDP growth rate found negative impact of distortionary and non-distortionary fiscal revenues at growth. Ahmad [1] studied the impact of fiscal variables on economic growth of Pakistan a data set of 31 years has been taken they tried to investigate the effect of productive, non-productive, distortionary and non-distortionary taxation as well as the labor force and human capital have been studied by using Auto Regressive Distributed Lag (ARDL) technique on time series data. They found a long run relationship hold among the variables but labour force as a percent of GDP is insignificant and negative.

Others [8] studied the role of fiscal decentralization, economic growth and the role of democracy in unemployment, basically it is an extended model of [4] endogenous growth model by assuming the public spending will be taken up by the government in three levels federal, state and local. Data set of 38 years has been used and the time series estimation has been done using GMM technique. The study reveals that revenue decentralization increase per capita income of country and a positive externality and expenditure decentralization is negatively related to GDP growth rate. Hence the interaction of revenue decentralization in the presence of democratic institution has positive association with growth. Elsewhere [14], studied the fiscal policy for growth and employment generation in Pakistan. They have chosen four fiscal variables they have tested four different hypotheses at government expenditure and unemployment, growth rate, unemployment, FDI with unemployment and tax revenue with unemployment a data set of 30 years has been used and Johannsen Co-integration technique has been applied. They found a positive and significant relationship between government expenditure and unemployment which is not supported by the null hypothesis. FDI has negative relationship with unemployment which is in the favor of null hypothesis. Again the inflation has been found significant but positive relationship with unemployment which is against the Philips curve.

Some others [34] found that the fiscal determinant of inflation in Pakistan by using time series data of 33 years from 1975-2008. They have used the Johannsen Cointegration technique to check the long run relationship between the variables error correction model was used to check the short run equilibrium and they found that local credit is a fiscal determinant of exchange rate is playing a vital role in determining inflation but gross domestic product has negative relationship in short run and long run.

[33] have studied the impact of budget deficit on output, inflation and balance of trade a data set of 40 years has been used a separate equation for money supply, money demand, output supply and export supply and import demand equation has been used by using ARDL and found that the budget deficit have significant effect on inflation and balance of trade and changes in money supply have affected the balance of trade so the budget deficit and balance of trade can be effected by money supply. Others [32] studied the effect of fiscal policy and inflation target in Australia and USA economy and developed a large model of 170 estimated equations small scale VAR model has been used. They found that low interest rate in USA is attached with fiscal policy. They used counter cycle fiscal policy in large scale model of USA and found that fiscal policy is linked with inflation target but an increase in fiscal policy and inflation target is not narrated despite increased volatility of macroeconomic shocks.

3. DATA AND METHODOLOGICAL ISSUES

3.1 Data

The data set of 40 years has been taken from 1973 to 2013 from world development indicators (WDI) and Economic Survey various issues of Pakistan.

| GDP = β0 + β1 (TRDF) + β2 (TEXP) + β3 (TINV) + β4 (TAX) + β5 (WINF) + β6 (TEXP) + µ |
| GDP = Natural Logarithm of Gross Domestic Product in (Current US$). |
| TRDF = Trade Deficit to GDP Ratio (Exter |
| TEXP = Total Expenditure to GDP Ratio (Sum of Development, Military and Government Final Consumption Expenditure). |
| TINV = Total Investment to GDP Ratio. |
| TAX = Tax to GDP Ratio. |
| WINF = Natural Logarithm of Worker Remittances (Personal Remittances) in (Current US$). |

\[ \Delta \text{GDP} = \beta_1 \Delta \text{TRDF} + \beta_2 \Delta \text{TEXP} + \beta_3 \Delta \text{TINV} + \beta_4 \Delta \text{TAX} + \beta_5 \Delta \text{WINF} + \beta_6 \Delta \text{TEXP} + \mu \]

\[ \Delta \text{GDP} = \beta_0 + \beta_1 \Delta \text{TRDF} + \beta_2 \Delta \text{TEXP} + \beta_3 \Delta \text{TINV} + \beta_4 \Delta \text{TAX} + \beta_5 \Delta \text{WINF} + \beta_6 \Delta \text{TEXP} + \mu \]

\[ \Delta \text{GDP} = \beta_0 + \beta_1 \Delta \text{TRDF} + \beta_2 \Delta \text{TEXP} + \beta_3 \Delta \text{TINV} + \beta_4 \Delta \text{TAX} + \beta_5 \Delta \text{WINF} + \beta_6 \Delta \text{TEXP} + \mu \]

\[ \Delta \text{GDP} = \beta_0 + \beta_1 \Delta \text{TRDF} + \beta_2 \Delta \text{TEXP} + \beta_3 \Delta \text{TINV} + \beta_4 \Delta \text{TAX} + \beta_5 \Delta \text{WINF} + \beta_6 \Delta \text{TEXP} + \mu \]

\[ \Delta \text{GDP} = \beta_0 + \beta_1 \Delta \text{TRDF} + \beta_2 \Delta \text{TEXP} + \beta_3 \Delta \text{TINV} + \beta_4 \Delta \text{TAX} + \beta_5 \Delta \text{WINF} + \beta_6 \Delta \text{TEXP} + \mu \]

\[ \Delta \text{GDP} = \beta_0 + \beta_1 \Delta \text{TRDF} + \beta_2 \Delta \text{TEXP} + \beta_3 \Delta \text{TINV} + \beta_4 \Delta \text{TAX} + \beta_5 \Delta \text{WINF} + \beta_6 \Delta \text{TEXP} + \mu \]
We applied the Vector Error Correction model (VECM) due to cointegration between the variables. Coefficient of cointegrating term is 0.2638 implying that model is 26% deviated from the equilibrium and after the time period of 2.5 years they will again come back towards the equilibrium. The coefficient of TINV, TAX and TRDF are significant and negative. This shows that the responsible in affecting the fiscal policy stance and economic growth of Pakistan. But the coefficient of worker remittance, TEXP and WINF are insignificant WR is positive means that it is affecting the fiscal policy stance positively in short run and TEXP is negative, which means that it is negatively affecting the fiscal policy stance of Pakistan. Here world inflation is showing the negative sign which mean that it is affecting our policy stance negative in short run. 

For finding the robustness of long run slopes, we apply two versions of OLS, i.e. fully modified OLS (FMOLS) and dynamic OLS (DOLS). In recent empirical literature, it is customary to check robustness of the slope using these techniques ([15], 16, 18, 9, 20) and [21]). Results in Table 3 show that long run slope parameters are quite robust and remain positive and statistically significant.

**REFERENCES**


