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LOCATING THE BUDGET DEFICIT IN CONTEXT: The Case of Pakistan*

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The budget deficit, presently around 8 per cent of the GDP, is unequivocally believed to be the most serious economic problem facing Pakistan's economy. It is held responsible for causing inflation, lowering growth, crowding out private investment, and for resulting in a huge current account deficit. Consequently, the IMF, World Bank and government officials, without exception agree, that the budget deficit should be 'eliminated'. This paper presents arguments which contest these claims and shows how the budget deficit has not caused all, or in fact any, of the problems attributed to it. In fact, a counter argument is presented in support of the positive and contributory role played by public expenditure. Furthermore, the political and institutional theory literature which explains the persistence of budget deficits due to extra-economic factors is examined and, subsequently, related to Pakistan. The central theme of this paper is that ahistorical institution-free abstractions regarding the budget deficit (or for that matter any economic or political concept) are redundant: the specific context of fiscal policy and budgetary deficits is all important.

Introduction

The fiscal deficit is the primary cause of all major ills of the economy. Consequently, any effort aimed at rehabilitating the economy would have the elimination of fiscal deficit as the number one item in its agenda.[1]

Much of what is written and said about the damage done by federal budget deficits is sheer nonsense, no matter how often repeated.[2]

The two quotes above, one from an economic advisor to a third world

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government which has been closely following the covenants of an IMF determined structural adjustment programme, and the other, from an academic who has been saying much the same for the last fifty years, perhaps epitomise the differences in perception regarding the role played by budget deficits in the economy of a country. While it is more than likely that the different schools of thought may even agree about the importance of budget deficits in the functioning of the economy, both would attribute substantially different outcomes of the *role* the budget deficit is expected to play. For the orthodox neoclassical view, and what has now become Conventional Wisdom for a very large proportion of individuals and their governments, a high and/or growing budget deficit is the mother of all evils, and is "the primary cause of all major ills of the economy", and must subsequently, be eliminated. This view has become the accepted view, and at times one feels, is the only view, thanks mainly to the hugely increased and involved role played by the IMF and the World Bank in the running of the economies of the underdeveloped countries. The acceptance and adherence of the stabilization and structural adjustment programme manufactured by the these two organizations, has identified the evil budget deficit as the main cause, or one of the essential causes, for the ills of the economy. There is a minority view, usually not heard in the clamour of the orthodox view, which argues that budget deficits can even be good for the economy and may, at times, need to be increased further, rather than "eliminated".

A third, more recent, growth in the literature regarding budget deficits, has been in the area of public choice and is referred to as the political economy, or institutionalist, arena in which issues regarding the budget deficit are debated. The status, not only of the economy, but political participation and the role of politics and political parties, along with historical and institutional peculiarities and constraints, collectively help in providing the lens through which the deficit is examined. The budget deficit is, then, perceived to be not just an abstract number, a quantity, but rather, a *relationship* dependent on numerous factors which are economic, political, as well as institutional.[3]

The purpose of this paper is to examine the role the budget deficit continues to play in the specific context of Pakistan. It has been identified as the single most important cause for the ills of the Pakistani economy and it is indeed quite impossible to find any opinion, whatsoever, which detracts from this perception. From government officials, to academics, to journalists and other opinion makers, the view is consistent: the budget deficit must be "eliminated". We will examine the conventional views regarding the ills caused by the budget deficit and see how applicable they have been to the case of Pakistan. We also examine the institutional

[3] This paper does not examine the Ricardian approach to budget deficits, under which deficit policy is a matter of indifference – see Barro, (1989); (1990). The paper also does not involve itself in the extensive debate over the measurement of the deficit – for this see Eisner, (1989); (1993); Buiter, (1990). It also does not look at the rent-seeking/clientelism literature which deals with public policy – see Roy, (1994).

settings which determine budget deficits, and see their contextual relation in Pakistan. The arguments developed in this paper revolve around the question which forms the core of this article: Does the budget deficit matter in the context of Pakistan? The answer is a definite 'yes', but for reasons that differ sharply from those purported by Conventional Wisdom.

Does the Budget Deficit Matter?

The IMF and the World Bank are in agreement on one point, that dealing with budget deficits is one of the most "vexing problems" for a majority of the underdeveloped countries, and hence fiscal policy is now an essential component of adjustment programmes, where fiscal "discipline" and "restraint" are viewed as prerequisites for macroeconomic stabilization. Many observers argue that the fiscal deficit is a useful indicator for overall economic performance and have found "a significant statistical relationship between the deficit and many, though not all, macroeconomic performance variables" [Easterly and Schmidt-Hebbel, (1991), p.2).

The budget deficit is held responsible for high inflation, low growth, the current account deficit, and the crowding out of private investment and consumption. The relationship between deficits and other macroeconomic variables are said to depend on how the deficits are financed: "money creation leads to inflation. Domestic borrowing leads to a credit squeeze – through higher interest rates or, when interest rates are fixed, through credit allocation and ever more stringent financial repression – and the crowding out of private investment and consumption. External borrowing leads to a current account deficit and appreciation of the real exchange rate and sometimes to a balance of payments crisis (if foreign resources are run down) or an external debt crisis (if debt is too high)" [Easterly and Schmidt-Hebbel, (1993), p. 213]. Researchers also find "strong evidence" from empirical studies examining the role of underdeveloped countries which support the claims made above.[4]

While the theoretical and academic discussion on what constitutes the neoclassical or orthodox paradigm has been discussed for many years – see Bernheim (1989), and Eisner (1989), for some of the important theoretical assumptions – given the nature of the ideology of the institutions of the World Bank and the IMF [see Zaman, (1993); Zaidi, (1994)], our concern in this paper deals with how this Conventional Wisdom is translated into policy. The result of the acceptance of this neoclassical paradigm has been incorporated into practice as follows: "The International Monetary Fund lectures finance ministries and heads of central banks... as

[4] For a more detailed, albeit repetitive, view also see Chhibber and Khalizadeh-Shirazi, (1991); Edwards and Tabellini, (1991); Faini and de Melo, (1991); Haque and Montiel, (1991); Thorne and Dastgheib, (1992).

follows: public sector deficits, and especially increases in public sector deficits are bad always and everywhere, regardless of circumstances, and discretionary spending cuts and/or tax increases should be implemented to reduce these deficits always and everywhere regardless of circumstances" [Buiter, (1990), p. 25]. This view has increasingly become part of the programme of policy makers in all underdeveloped countries which have had recourse to IMF adjustment loans, and thus, fiscal policy in general, and a redaction in the budget deficit in particular, have become possibly the most important cornerstones to be incorporated into adjustment programmes.

Despite the generally held view that deficits are always bad and should always be reduced, there is a small school of academics which continues to argue that the nature and consequence of budget deficits depend on specific circumstances. Tobin (1987) argues that fiscal deficits may actually even be economically *desirable* in particular contexts, and what matters most is appropriate public policy. Buiter (1990) shares these views and argues that "optimal or merely sensible, budgetary policy is bound to be characterized by systematic, predictable and sometimes persistent departures from budget balance" (p. 42). Eisner, too, a leading proponent of the minority Keynesian view regarding budget deficits, argues that budget deficits do matter and their effects can be substantial, but "the current size of the federal deficit is not 'our number one economic problem', if indeed it is a problem at all" [Eisner, (1989), p. 74]. He cities data from the US – "the worlds largest debtor nation" – and shows that despite a large and growing deficit in the 1980s, inflation, thought to be one of the key victims of large budget deficits, has declined sharply. In fact, he argues, that "the time-series relation between deficits and inflation in the United States has generally been negative; larger deficits have come with less inflation and smaller deficits with more inflation" [Eisner, (1993), p. 104]. What is more surprising, and something which contradicts Conventional Wisdom is the relationship between the deficit and growth: empirical evidence shows how US deficits "have over the last several decades proved stimulatory to the economy" [Eisner, (1989), p. 81] – the greater the deficit between 1955-83, the greater was the next year's increase in GNP, and the less the deficit, the less was the subsequent increase in GNP. Not only are budget deficits seen to be related to the growth of GNP as a whole, but also positively to consumption and investment. There is evidence that "deficits have not crowded out investment [but] there has rather been crowding in" (*ibid,* p.83).

It is not surprising then, that the monetarists/neoclassicals, exemplified in real politics with respect to the third world by the IMF and world Bank, and Keynesians, would have such disparaging views regarding the consequences of budget deficits. Both cite abundant empirical evidence to stake their claims and propose policy. Before we examine the case of Pakistan, and see where the budget deficit fits in with the rest of the economy, we briefly examine the findings of the public choice/ political economy view of the budget deficit.

Although the political economy approach to macroeconomic policy differs

amongst its constituents, there is general agreement that the nature of political regime has important repercussions on the presence of budget deficits and on the role policy plays in having to deal with steps to reduce the deficit. Roubini and Sachs (1989) show how differing institutional arrangements in the political process help to explain differing patterns of budget deficits across countries. They find that budget deficits (in industrial countries) are greatest where there are multi-party coalitions rather than majority governments. Also, "governments with large coalitions and/or short tenures are characterised by particularly large budget deficits" (p.908). The reason is that if political power is shared alternatively between political parties, "each government will be tempted to leave a legacy of high debt for its successor, whose spending priorities it is not likely to share"(p. 909). A short time-horizon and relatively rapid interchange between differing ideological partners does not bode well for restraint regarding fiscal policy.

Roubini and Sach's study shows how multiparty coalitions affect the budget deficit: "There is likely to be a fundamental *prisoners dilemma* with respect to budget costs: all of the partners of the coalition may prefer comprehensive budget cuts to a continuation of large deficits, but each coalition partner may have the incentive to protect its particular part of the budget against the austerity measures" (*ibid*, p. 924). Also, in a coalition, given the fragility of the composition of the group, even small parties are able to prevent change or veto programmes they do not approve of. Edin and Ohlsson (1991) following on the work of Roubini and Sachs, show that minority governments have a more difficult time in cutting budget deficits than do majority multiparty governments.

In their review of fiscal issues and adjustment, Faini and de Melo (1991) show how a government in power "may refrain from reforming the tax system for fear that the more efficient approaches that would result from a successful tax reform would be used by the next government to carry out spending or redistributive measures that the current government opposes. Such a situation is more likely to arrive in countries with unstable and polarized political systems. *Political stability in the sense of a strong government with a high probability of staying in power would then be a prerequisite for engaging in tax reform*" (emphasis added, p. 22). Similarly, in a model developed by Alesina and Tabellini (1989) results show that the tendency to over-borrow by a government or policy maker will be greater, the more likely it is that the government in power today will not be reelected tomorrow.

Edwards and Tebellini (1991) summarizing many of the arguments related to the political economy of fiscal policy in underdeveloped countries, argue that their central finding is that more unstable political systems tend to be associated with larger borrowing, and additionally, IMF sponsored stabilization tends to fail in those nations with more unstable politics. They show that in cases where it is unlikely that a government will be reelected, it is seen that the inflation rate is, in general, higher compared to those countries where there is a greater likelihood for governments to be reelected. Also, wherever there is the possibility of a government being replaced,

policy makers may wish to borrow in excess of the optimum, letting their successors foot the bill. A sort of collective myopia takes over in societies where political instability and polarization exists.

There is also evidence that countries that are politically more unstable tend to have larger budget deficits [Edwards and Tabellini, (1991), p.21]. Berg and Sachs [in Edwards and Tabellini, (1991)] have found that debt repayment difficulties are more pronounced in countries with a more polarised political conflict. The findings by Edwards and Tabellini (1991) show that the most important empirical implication of their study is that in countries with a weaker, more unstable and polarised political environment, it is likely that there will be greater difficulty in implementing successful fiscal adjustment programmes.

In Tabellini and Alesina (1990) and Alesina and Tabellini (1990), the authors show how differences in political institutions help to explain the variance in the debt policies pursued by different countries, or even the same country at different points in time, under different regimes. They argue "that in the presence of disagreement between current and future policy makers, public debt is used strategically by each government to influence the choices of its successors. Disagreement amongst alternating policy makers and uncertainty about who will be appointed in the future, prevent the current government from fully internalizing the cost of leaving the debt to its successor. As a result, the equilibrium stock of public debt tends to be larger than it is socially optimal" [Alesina and Tabellini, (1990), p. 404].

The discussion in this section of the paper is meant to highlight the point that the budget deficit is not a pure statistic which ought to - or can - be determined by either the IMF or other economic powers, but is dependent on numerous other factors which often negate the role of technicist and economistic prescriptions. We cannot treat the budget deficit as an abstract number devoid of historical, institutional and contextual relationships within which it is located. As Alesina and Tabellini (1990) argue, "fiscal deficits are the aggregate outcome of the political conflict between different groups of citizens" (p. 412). With this backdrop we now turn to an examination of the problem of Pakistan's budget deficit as the IMF and other mainstream observers evaluate it, and to an analysis of the actual contextual setting in which the budget deficit is located.

Does the Budget Deficit Matter? The Case of Pakistan

There is complete agreement over the claim that the federal budget deficit is the most important threat facing Pakistan's economy.[5] Fiscal policy has been identified as a "critical failure" in the context of Pakistan, and as one of Pakistan's key macroeconomic problems threatening price stability, balance of payments, "constraining

[5] See, for example: World Bank, (1988); (1989); (1992); (1993); Haque and Montiel (1991); Khan (1991); McCleary (1991); AERC (1992); Pasha and Akbar (1993); Pasha and Iqbal (1994); KCCI (1994).

essential government investment in economic and social infrastructure, and thereby, endangering growth prospects" [World Bank, (1992), p. 2].

The persistent reference to the "high and unsustainable" fiscal deficit by the IMF and World Bank (and other sundry commentators) – "the fiscal deficit has been perceived as a continuing problem in Pakistan" [Haque and Montiel, (1991)] – since at least the early 1980s when the first structural adjustment programme was initiated on the recommendation of the IMF, must rest on the premise that the budget deficit is responsible for most of the macroeconomic ills in the country, and thus, needs redress. The IMF, following the Conventional Wisdom which it has helped frame, would, in all likelihood, hold the deficit in Pakistan responsible for some, if not all, of the following consequences: growing inflation, crowding out of private investment, a falling growth rate, and the twin of the budget deficit, the continuing deterioration of the current account deficit. We must assume that unless it was seen as a primary cause of the problems in the economy, it would not form the central tenet of policy statements and adjustment programmes which Pakistan continuously undertakes. Let us examine some of the evidence.

Table 1 presents a brief picture of Pakistan's key macroeconomic variables since 1980. The budget deficit as a percentage of GDP is presented alongside other variables which it is supposed to affect. Let us consider growth. The "very high", "escalating" budget deficit, by all accounts according to the IMF theory of causality, should have had severe repercussions on the growth of the economy. This is clearly not the case. Pakistan has experienced very high growth rates compared to other developing countries and has averaged well over 6.5 per cent per annum in the 1980s. No mean achievement given the huge budget deficit, which has averaged 7 per cent in the same period. Surely, the numbers must give pause for thought.

The inflation rate is another key variable which should have exploded given the high budget deficit. An average of only 7 per cent inflation over a decade is quite creditable. Moreover, only 7 of the 15 years since 1980 have seen double digit inflation with a maximum of 13.9 per cent. According to estimates, Pakistan's inflation rate should have averaged in excess of 50 per cent, given the high and unsustainable budget deficit [Haque and Montiel, (1991)]. With Latin American deficits, Pakistan has continued to have South Asian rates of inflation.

The crowding-out phenomenon is a key favourite of orthodoxy and neoclassicists, what with their penchant for the private sector. The theory suggests that the government in its financing of the deficit would have pushed up interest rates to such an extent that the private sector would have found it inaffordable to invest, and thus would have been crowded out. This would have implied a growth rate of far less than the hugely impressive 15 per cent annum experienced by the private sector in the 1980s. Moreover, with the even greater "burgeoning of the budget deficit" in 1990-91 (8.7 per cent), 1991-92 (7.5) and 1992-93 (7.9), one would not have expected the 19, 30 and 13.7 per cents of growth in the private sector over the same years. Clearly, there does seem to be little truth in the claim that the private sector has been crowded

TABLE 1

	Growth Rate (%)					As % of GNP			As % of GDP				
		Investment				Investment							
	GDP	Public	Private	CPI	CAD	Public	Private	CAD	Defence Expend.	Develop. Expend.	Interest Payments	Budget Deficit	PBD
	1	2	3	4	5	6	7	8	9	10	11	12	13
1960s	6.8	14.0	20.9	3.8	–	–	–	–	–	–	–	–	–
1970s	4.8	25.3	17.0	12.3	–	9.2	7.2	–	–	–	–	–	–
1980s	6.5	10.6	15.0	7.3	21.2	8.6	7.3	3.7	6.5	7.2	3.8	7.0	–
1980-81	6.4	–1.2	13.1	13.9	–9.0	8.7	7.2	3.4	5.5	9.3	2.1	5.3	3.2
1981-82	7.6	19.8	8.0	11.1	47.9	8.9	6.7	4.6	5.7	8.2	2.4	5.3	2.9
1982-83	6.8	12.0	14.7	4.7	–66.3	8.7	6.6	1.6	6.4	8.1	3.1	7.0	3.9
1983-84	4.0	8.0	17.4	7.3	92.8	8.2	6.8	2.9	6.4	6.7	3.4	6.0	2.6
1984-85	8.7	11.4	14.0	5.7	68.5	8.2	7.0	5.0	6.7	7.0	3.4	7.8	4.4
1985-86	6.4	13.1	11.5	4.4	–26.4	8.6	7.2	3.6	6.9	7.7	3.8	8.1	4.3
1986-87	5.8	17.3	11.0	3.6	–41.8	9.2	7.3	2.0	7.2	6.3	4.2	8.2	4.0
1987-88	6.4	6.8	16.7	6.3	133.9	8.5	7.4	4.2	7.0	6.9	4.9	8.5	3.6
1988-89	4.8	16.0	23.9	10.4	15.0	8.7	8.0	4.7	6.6	6.3	5.0	7.4	2.4
1989-90	4.6	3.6	19.3	6.0	–2.2	8.0	8.6	4.5	6.8	6.5	5.4	6.5	1.1
1990-91	5.6	20.9	19.2	12.7	14.8	8.3	8.7	4.6	6.3	6.4	4.9	8.7	3.8
1991-92	7.7	22.3	30.0	9.6	–38.0	8.6	9.7	2.7	6.3	7.6	5.2	7.5	2.3
1992-93	2.3	15.3	13.7	10.6	174.0	9.0	9.9	7.1	6.5	5.7	5.9	7.9	2.0
1993-94	3.8	7.1	18.8	11.2	–45.2	8.3	9.6	3.9	6.0	4.7	6.6	5.8	–0.8
1994-95	4.7	11.58	15.5	13.2	8.6	8.3	9.3	3.6	5.5	4.8	5.7	5.6	–0.1

CAD = Current Account Deficit. PBD = Primary Budget Deficit (Col. 12 minus Col.11).
Source: Pakistan Economic Survey, 1994-95.

out due to government policies or the budget deficit. The evidence, no matter how superficial, points to utterly different conclusions. Moreover, in the period since 1988 when the deficit has been particularly high, so much so that the structural adjustment programme of 1988 emphasised the need to cut the deficit drastically, the economy behaved even more unconventially with respect to IMF theory: real per capita GDP rose by 10.4 per cent between 1988 and 1992; merchandise exports have expanded by an average of 14 per cent per annum in volume; private sector gross fixed capital formation has gradually expanded from 7.7 to 9.4 per cent of GDP; and even domestic savings rose from 10.5 to 12.2 per cent [World Bank, (1993), p. 36)]. Furthermore, even the twin deficit, of the current account, behaved quite contrary to IMF theory. With this evidence, one is forced to reexamine the questions: Does the budget deficit matter in the context of Pakistan? and , how does the IMF/ World Bank feel about this question?[6]

Given its insistence regarding repeated concern over the issue of the budget deficit, one would believe that the IMF has views over Pakistan's budget deficit consistent with its theoretical construct. Not so. The IMF/World Bank admit that "the macro consequences of fiscal deficits in Pakistan have apparently been quite dissimilar from those in other developing countries with fiscal deficits of comparable magnitude. Specifically, Pakistan has experienced neither hyperinflation nor debt rescheduling ... Growth has remained quite strong through the last two decades, inflation has not been high, and the current account deficit has averaged about 2.5 per cent of GNP, remaining largely financeable and not posing debt servicing problems for the country" [Haque and Montiel, (1991), p. 1]. These institutions, despite their insistence to lower the deficit, admit that the deficits have been "quite benign", and despite the presence of fiscal deficits "that are *very high* by international standards, the country's macroeconomic performance has been relatively good ... There is no evidence in Pakistan of the chronic acute macroeconomic crises – manifest in extended periods of negative per capita income growth, hyperinflation, and inability to service external debt – that have characterised many other developing countries with comparable fiscal performance" (*ibid* , p. 2).

Despite this huge fiscal deficit, the institutions which insist on cutting down the deficit admit that "inflation performance in Pakistan appears to have been remarkably good ... At the same time economic growth has been robust" (*ibid*, p.3), and real

[6] Before anyone uses the 1992-93 data from Table 1 and scores a point arguing that finally, with a 7.9 per cent deficit, the IMF predicted scenario of disaster has hit Pakistan's economy, it is best to put things in perspective. The World Bank (1993) report has explained this as follows: "The economy was severely affected by the 1992 floods, the worst in 50 years, which hit the country in August/September. There was extensive damage to crops and livestock, 15 per cent of cotton and rice was lost, and 10 per cent of sugarcane was ruined. Subsequently, there was a loss of exports from cotton and rice, an increase in the import of wheat, relief items, fertilizers and reconstruction material and equipment. On the revenue side, there was a loss of Rs10 billion due to exemption from loan repayment, relief packages, and flood effectees were given exemptions from a number of taxes. There was also an additional expenditure of Rs13 billion on reconstruction and relief goods " [World Bank, (1993), p.9].

GNP per capita between 1972-87 has shown a cumulative increase of more than 60 per cent. Additionally, even the crowding out argument seems to have been rejected, albeit reluctantly, where the IMF/World Bank admit that public and private investment seems to be positively correlated and "the infrastructural build up that results from government investment appears to facilitate private investment" [Haque and Montiel, (1991), p. 39].

A recent study conducted by the IMF on determinants of private investment in Pakistan [Sakr, (1993)], argues that aggregate government investment has a significant positive impact on private investment implying "that the crowding out effect was not strong enough to balance the crowding in effect in the period covered [1972-1988] and is consistent with the view, inter alia, as to the importance of upgrading the country's roads and transportation networks, and improving the drainage system" (p. 16). This government investment in infrastructure was "estimated to be *the most important positive determinant*" of private investment in the period covered. The investment in infrastructure is expected to continue to play a "*significant* crowding-in effect" (emphasis added, *ibid*, p. 17) in the future.

Our own observations regarding the effect and impact of the budget deficit on key macroeconomic variables question the orthodoxy with respect to Pakistan, as do the observations and findings of the Fund staff and Fund sponsored studies which themselves, undoubtably, question the claim that the budget deficit is the "primary cause of all major ills of the economy". While the monetarist neoclassical assumptions and predictions regarding the behaviour of the budget deficit are clearly spurious, if not outrightly rejected, the Keynesian interpretations where public spending causes an increase in aggregate demand and, subsequently, growth, given the less- than-full-capacity of the economy, seem somewhat closer to reality. The greater the public expenditure, the greater the rate of growth of GDP and the greater the private investment. Also, since there is no crowding out through the mechanism of the interest rate as predicted by theory, one is led to believe that there are ample loanable funds available at a given interest rate – Easterly and Schmidt-Hebbel (1993), in their review of developing countries found that private investment does not respond much to interest rates. As has been argued extensively elsewhere [Zaidi, (1994a)], the evidence suggests that Pakistan's economy is in far better shape than the IMF/World Bank believes. Whether this is due to the huge under-reported nonformal economy or to any other factor, is open to debate. In fact, it is interesting to note that if, indeed, it is true that Pakistan's GDP is underreported by as much as 40 per cent [see Zaidi, (1994a)], then, the size of the budget deficit as a percentage of the true GDP would be much less than the reported official figure of 8 per cent and the present figure may actually even be "sustainable".[7] Although this is a

[7] Also see Roy, 1994 (p.175), who examines the impact of India's black economy on the disposable fiscal surplus.

debatable and controversial point which is not conclusive, it may, nevertheless, be the key to answering the question as to why the deficit has proven to be "benign", and has not disrupted the positive trends in the economy as it should have. Given the nature and robustness of the economy, a fact conceded to even by the IMF, it seems to be quite clear that in the conventional orthodox framework, *the budget deficit in Pakistan does not matter*.[8, 9]

But, does the Budget Deficit Matter? The Case of Pakistan

Having just argued that the budget deficit, in the conventional orthodox neoclassical framework, does not matter with regard to Pakistan, we will now argue that it is possibly the most important statistic around which debate *ought* to take place. We argue, as do the IMF and World Bank, that the budget deficit should be the variable around which discussion should take place, but for very different reasons.

The obsession which policy makers in Pakistan have with the budget deficit distracts attention from the really important issues. The focus should not be on asking the question: "how high is the budget deficit, and is it sustainable?", but the real concern regarding the deficit should revolve around the issue of spending and redistribution. It is more important to ask the questions: "What use is being made of public money? Who is funding government expenditure, i.e., who is being taxed? How is public expenditure managed?", and so on.

Table 1 again provides a very brief overview of what we feel is the central issue regarding the budget deficit. The contrast in the patterns of defence expenditure and development expenditure are the key concerns regarding the budget deficit and public spending. In fact, Pakistan might well be the only underdeveloped country where defence spending outweighs development expenditure. Since 1980, as the table shows, there has been a relative increase in defence expenditure as a share of GDP compared to a relative decrease in development spending. Moreover, since 1985 defence spending has increased 150 per cent, compared to an 89 per cent increase in development expenditure. Ironically, prior to 1985-86 when there was

[8] The IMF believes that the deficit has not behaved in Pakistan as it should have, because: (i) There was a very high rate of growth of real output (6 per cent per annum) which permitted a fairly rapid expansion of both interest bearing and non-interest bearing debt without recource to inflationary finance (ii) The equilibrium deficit is quite high – 5.5 per cent of GNP despite a low inflation rate, because of a very high underlying rate of growth of real output (iii) The government of Pakistan was able to borrow, both domestically and externally, at rates below the marginal cost of funds in the international private capital markets – see Haque and Montiel, (1991).

[9] Also, throughout the 1980s the budget deficit was not monetized and external funds and non-bank borrowing were the main sources of funds used to finance the deficit, and thus also, inflation remained low. It was only after 1990-91 that bank borrowing contributed a very large share to the financing of the budget deficit, thus possibly causing inflationary pressures. However, after 1993-94, bank borrowing has returned to the low, pre-1990 level. I am grateful to Hafiz A. Pasha for explaining this point.

a military government in power and Pakistan was under martial law for most of this period, defence expenditure was considerably less than development expenditure. Following the advent of democracy in Pakistan in the last ten years, defence spending has been higher than development expenditure in seven of those years. There are two possible explanations for this pattern: according to one view, during military rule, not only was the military making direct use of the military (defence) budget, but also, due to its status as "the government" and due to various privileges, it acquired a large share in the civilian side of the economy. Thus, in real terms, defence expenditure was just a small share of the extent to which the military really had access to and thus subsequently, benefitted [Zaidi, (1988); (1991)]. This also explains why the Primary Budget Deficit (PBD) (Table 1) was higher in the 1980-86 period (average 3.6) compared to the 1986-95 period (2.0).

A second explanation for this trend is that in the post-martial law period, while the military has not been *in government*, there is little disagreement that the military continues to be *in power*. Furthermore, given democracy's inability to deal with political problems in Pakistan, the military has had to play a more involved and overt policing role. Ergo, a high share to defence expenditure – and a smaller residual share to development – under democracy [see Zaidi, (1992); (1994a); (1994b)]. Given Pakistan's political history and structure and the newly found policing role of the military, it is unlikely that any real cut in military expenditure will take place in the near future, possibly resulting in a clearer trade off between defence and development expenditures. Nevertheless, one can simulate models which would statistically examine such an effect. Mehar (1992), has shown that a one-time decrease of a mere Rs5 billion from defence expenditure in 1991-92 (when it was about Rs80 billion), would have resulted in a fall in net domestic borrowing and in the budget deficit in subsequent years, upto at least, the year 2000 AD.

Thus, if the budget deficit is "the number one problem of Pakistan's economy" as most observers believe, it is for reasons regarding the role and distribution of public expenditure, and is not dependent on the fetish and fixation with an abstract, arbitrary, badly calculated, statistic. The question of governance, or how public money is utilised, allocated, managed, and siphoned-off, is of critical importance. With corruption at all levels of government rampant and where political power is bought and sold, as has been the case in different provincial and national governments over the last few years, it is clear that the tax payer's money continues to be used to buy-off opposition and acts as a bribe to keep dissent in tow, possibly resulting in greater and poor use of public expenditure.[10] Unquestionably, the specific context of fiscal policy and budgetary deficits are all important.[11]

[10] A sample of any issue of the *Herald, Newsline* or *The Friday Times* since the 1988 elections would give ample flavour of the nature and extent of misappropriation by government dignitaries of public money.

[11] The rent seeking and clientelist nature of a state like Pakistan, helps explain reasons and repercussions of the misuse of public funds and its consequences on the budget deficit – see Roy, (1994).

Contextuality

The arguments presented above, with those in a previous section in which the political economy framework of macroeconomics was discussed, seem to show that it is improbable that the budget deficit in Pakistan can, or will, be cut substantially. Nevertheless, the IMF/World Bank are insistent on eliminating the budget deficit and intend to bring it down to a "manageable" size, somewhere close to around 4 per cent of GDP. The arguments regarding the institutional and political rigidities notwithstanding, it would be worth our while to examine the possibilities and repercussions of budget cuts and/or increases in revenue.

There is a huge literature which has examined the consequences of expenditure cuts – particularly IMF-supported structural adjustment programme cuts – in underdeveloped countries (for an extensive review see Zaidi, (1994a). The empirical evidence from scores of countries is largely consistent: the main victims of "successful" reductions in budget deficits are health, education, social welfare, etc; defence spending suffers far fewer reductions than social expenditure and investments. As Reed (1992) argues, "draconian cutbacks in government expenditure have frequently led to dramatic and often extended reduction in public investment in infrastructure" (p. 36).

If the IMF/World Bank believe, as they do, that the budget deficit must be cut, everywhere, always, regardless of specific circumstances, then one must ask how these cuts are to be made. Banalities regarding better government, more privatization, greater fiscal effort, extending the tax base, and so on, are all very well, but do they help address the difficult question of how the deficit is to be reduced? The answer is a probable 'no'. Even the IMF recognises that close to 70 per cent of the current budget in Pakistan is "virtually untouchable", and that no government, given political and institutional realities (contextuality?), has been able to impose an agricultural income tax despite the fact that this sector accounts for 25 per cent of GDP [Khan, (1991)]. The inherent weaknesses in the tax structure and the impediments to an expansion on the revenue side have been elaborated at length [AERC, (1992); World Bank, (1993); Pasha and Iqbal, (1994)]. Thus the IMF's obsession to reduce the budget deficit does not bode well for a developmentalist scenario in Pakistan. As has been argued in this paper, and even accepted by the IMF, if public investment plays a positive and contributory role in the overall growth rate of the economy, a cut in the deficit, with the military's budget "untouchable", is likely to fall on the development side with cuts in investment, in infrastructure, and in human capital. These cuts would be of a more critical nature at a time when the overall growth rate is below its historically high levels, and in fact, what may be required to boost growth, is *more* expenditure from the government, rather than less.

It is worth examining the conclusions reached through the political economy school's approach to budget deficits and relating them to Pakistan. The salient features discussed in an earlier section can be summarised as follows: governments

with short tenures are characterised by particularly large budget deficits; those governments which feel they will not be reelected tend to over-borrow, and the inflation rate is higher in such countries as well; strong and stable governments are better at stabilization programmes; and, most importantly, more unstable political systems tend to be associated with larger borrowing. In Pakistan's case, it seems that under a "strong" martial law government, the budget deficit was particularly high, and the PBD averaged 4.3 per cent of GDP over the period 1977-86,[12] which was substantially higher than under weak democratic governments which followed (1986-95 average: 2.0); since May 1988, while there have been ten governments in office in Pakistan, the view that there is a strong link between short tenures and high deficits does not seem to hold; the highly specific political factors which have determined the political process in Pakistan since 1988, have also played a prominent role in creating substantial uncertainty about a government's reelectability – however, over-borrowing and resulting large deficits do not seem to have taken place; and, while there can be little disagreement over the fact that since the revival of democracy in 1988, Pakistan is characterised by highly unstable political system, excessive borrowing and larger deficits have not necessarily been the result. Curiously, the political economy school's conclusions, as those of the IMF/World Bank do not seem to hold in the context of Pakistan. Again, the specific context of Pakistan's economy and political and institutional structure, may give specific reasons as to why this is the case.[13]

Essentially then, given the specific context of Pakistan's budget deficit, it may actually be futile and counter-productive to initiate cuts in the budget deficit. We argue that instead, it may be fruitful to *increase* public expenditure as long as the money is spent in a productive manner (howsoever defined) and not on wasteful nonproductive sectors like defence. If public investment in education, health, and infrastructure is to be increased rather than "eliminated", continued large nominal deficits may well be in order and, possibly, even large real deficits as well. Since a great deal of growth, development and prosperity in Pakistan has been largely dependent on the role the public sector has played in helping and complementing the private sector, better management and use of public funds may help promote further growth and subsequent development. The key to Pakistan's future economic success lies in reallocating and redirecting public expenditure, and possibly even increasing it, and certainly not in its reduction or elimination.

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[12] For data prior to 1980-81, see Mehar, (1992).

[13] We realise immediately that much more substantive rigorous work is needed to study these relationships before conclusive claims are made, and our arguments are at best illustrative, and quite tentative, but nevertheless, interesting.

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