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Inflation, Economic Growth and Government Expenditure of Pakistan: 1980-2010.

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Abstract

This study is going to explore the relationship among the rate of inflation, economic growth and government expenditure in case of Pakistan. In this study, the government expenditure has been disaggregated in to the government current expenditure and the government development expenditure. This investigation is made by using the time series data during the period 1980-2010. The econometrics tools like Augmented Dickey Fuller (ADF) unit root test, ARDL, Johansen cointegration and Granger-causality test are used to investigate such relationship. The results derived by applying these econometrics tools show that there is a long term relationship between rate of inflation, economic growth and government expenditure, it means the government expenditures yield positive externalities and linkages. In the short run, the rate of inflation does not affect the economic growth but government expenditures do so. The causality test results show that there is unidirectional causality between rate of inflation and economic growth and; economic growth and government expenditure.

Key words: **Inflation; economic growth; government expenditure; ARDL;**

1. Introduction

In the past few years in the economic history of Pakistan, the pace of economic growth is gradually decreasing but the size of government expenditure is gradually increasing. According the Handbook of Statistics on Pakistan Economy, 2010 published by State Bank of Pakistan (SBP), in 2009 the size of government expenditure increases to 9.41% from the previous year, but the GDP increases with 3.63% from

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previous year. The condition is consider to be more worse, if we see the stat of 2008, the size of government expenditure increases to 40.76% from the previous year and GDP increases to 7.19%. The Table 1 shows the percentage change in the economic growth and government expenditure, the economic growth of Pakistan:

Table 1 GDP and Government Expenditure: Pakistan 1980 to 2010

Year	GDP		Government Expenditure	
	In Million Rs.	%age change	In Million Rs.	%age change
1980	1,265,370	7.327%	58,588	19.215%
1985	1,747,956	8.708%	119,832	15.408%
1990	2,295,202	4.589%	222,419	3.612%
1995	2,905,705	4.133%	421,736	15.767%
2000	3,562,020	4.868%	741,439	8.080%
2005	4,593,230	8.958%	1,001,006	11.407%
2009	5,767,536	3.632%	2,101,456	9.411%

In 2001 and 2003, the government was able to cut the government expenditure from the previous year by -4.502% and -9.288% respectively, the negative sign shows the reduction of expenditure from the previous year. In 2003 and 2004, the percentage change in GDP is greater than the government expenditure, i.e. the change in GDP is 4.726% and 7.483% respectively; and the change in the government expenditure is -9.288% and 4.335% respectively. As the government expenditure increases, there is need of more finances to meet such expenditures. Therefore, the government knocks at the door of international financial institutions like IMF, World Bank, Asian Development Bank; or borrows from the central bank like SBP; or imposes more taxes on the general public to meet their expenditure. In the previous literature, the ultimate effect of such loans or borrowings or imposing of such taxes had a serious negative impact on the economic growth of the country. According to Landau, 1985 the borrowing from the central bank, tend to increase the money supply, which is major reason of increasing the inflation and causes the uncertainty in the economy. The borrowing from the general public causes the interest rate to increase and reduces the further investment in the country. The enforcement of more taxes causes the distortion in the economy and reduces the output and growth.

The aim of this study is to complement the empirical investigation of inflation in Pakistan. More specifically:

- To measure the relationship between the rate of inflation and economic growth variable;
- To measure the relationship between the economic growth variable and aggregated government expenditure;
- To measure the relationship between economic growth variable, the rate of inflation and dis-aggregated government expenditure, i.e. government current expenditure and the government development expenditure; and
- To examine the direction of causal relationship among the inflation, economic growth and government expenditure.

The rest of paper is divided in the different sections: Section 2 reviews the literature. The methodology and model are explained in the Section 3. The Section 4 explains the analysis. In last, the Section 5 gives some conclusion and Section 6 gives some recommendations to the policy makers.

2. Literature Review

The previous literatures have found the negative relationship between the inflation and growth regime (De