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# Fiscal Scenario of South Asian Countries: Implications for Economic Growth and Poverty Alleviation

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**Abstract** -Sustainable economic growth and poverty alleviation are principal objectives of the developing countries. The present study present a historical picture of fiscal situation of four South Asian economies i.e. Pakistan, India, Sri Lanka and Bangladesh in descriptive manner and it also analyses its consequences for the economic growth and poverty reduction. Study reveals that confined revenues and savings coupled with rising expenditures have caused a situation of persistent fiscal deficit over the years. Coupled with that, most of the countries are also facing current account deficit. Resultantly, what is known as a 'Twin Deficit problem' has emerged. If the deficit is filled by debt then countries have to spend a considerable portion of their GDP on interest payments of the loans. The need to service debt obligations is undermining the economic performance and resulting in collapse of development planning. Because debt obligations and expenditure on debt servicing becomes a resource drain for already limited revenues and is halting economic growth and poverty reduction efforts. In view of that it is suggested that to achieve high economic growth and reduce poverty there is a need to enhanced efforts for macroeconomic stability particularly countries should focused to enhance their revenues.

**Keywords:** Fiscal Policy, Poverty, Economic growth

JEL Classification: H63, I32, O43

## Introduction

A sound fiscal position is a critical ingredient of sustainable economic growth and poverty reduction and is an essential pre-requisite for achieving macroeconomic stability. Better fiscal management helps to mobilize domestic savings, increase efficiency of resource allocation and achieve other worthwhile development goals. On the other hand, lax fiscal policy limits options open to the government for economic recovery, sustainable growth and poverty alleviation. It may lead to higher rates of interest and inflation and crowding out of private investment (Abbas, 2007, Taghavi, 2000). Theoretical models are silent on possible transmission mechanisms between fiscal policy and poverty. Similarly, empirically effectiveness of fiscal policies in reducing the poverty is not well explored. Theoretical and empirical literature covers fiscal policy issues mainly with respect to economic growth. Although, link to poverty and human development is implicitly present in supposition that overall growth shows the way to poverty alleviation. Maintaining sustainable level of debt and deficits requires idealistic economic growth, and in order to achieve the goal of poverty reduction, long term lending linked to countries' debt capability and financial support is very vital. Most of the Asian economies have relied on debt and other foreign resources to stimulate economic growth, reduce poverty and income inequality e.g. Malaysia and Thailand are considerable success stories, on the other hand in Pakistan and Bangladesh unacceptable size of domestic and foreign debt has pre-empted such opportunities (Siddiqui and Malik, 2001). This paper pinpoints the role of fiscal policy in general and public debt in particular for economic growth and poverty reduction. It is worth mentioning that public debt and other components of fiscal policy are interrelated; therefore, it is very important to keep the overall fiscal situation in balance. The objective of the study is to highlight major issues regarding the fiscal policies in the selected developing countries. This paper is divided into six different sections: the first section gives a brief introduction of the South Asian countries used within the study; secondly it deals with the issue of public expenditure and its composition. The third section offers a brief description of the resource availability in these countries, while section four highlights issues related to large public deficits. The fifth section relates to the problems of public debt, its structure and implication for overall economic performance. At the end conclusions emerging from the preceding sections are drawn. A Bird's Eye View of Selected Developing Countries

It will be useful to begin this section by giving a synoptic view in a tabular form of the state of the four South Asian economies. In this regard the economic performance, during 1990 and 2006, has been compared. Few striking facts about the relative performance of these countries over these periods are summarized are as under: Firstly, per capital GDP growth has been the highest in India and lowest in Sri Lanka. Secondly, population growth rate has falling the most in India and least in Sri Lanka. Thirdly, export/ GDP ratio has raised the most in the Bangladesh but has actually fallen in Pakistan. Fourthly, surprisingly GINI Coefficient is the highest in Sri Lanka and the least in Pakistan the least in Pakistan, revealing that Pakistan is the least unequal countries in the region and the Sri Lanka the most. Fifthly, life expectancy has raised the most in Sri Lanka and the least in Bangladesh. Sixthly, infant mortality rate is the lowest in Sri Lanka but the highest in Pakistan, although it has fallen over the years. Lastly, secondary school enrolment is the highest in Sri Lanka and the lowest in Pakistan, even lower than Bangladesh. Taken together, it can be surmised that India has gone the farthest in terms of GDP growth and the Sri Lanka the most in Human Development terms. On the other hand, Pakistan and Bangladesh compete for the least-well position in Human Development terms. Macroeconomic stability wise (in terms of inflation rate) Sri Lanka is the most vulnerable and India the least. We may now proceed with a country wise explanation of the absolute positions of each of the four countries.

Table 1. Main Indicators of selected countries

| Indicators | Years | Pakistan | Bangladesh | India | Sri Lanka |
|---|---|---|---|---|---|
| Per capital GDP growth rate | 1990 | 1.84 | 3.53 | 3.42 | 5.·20 |
| | 2006 | 4.75 | 4.78 | 7.7 | 6.18 |
| | % Change | 157.88 | 35.27 | 125.07 | 18.78 |
| Population growth rate | 1990 | 2.54 | 2.3 | 2.02 | 1.13 |
| | 2006 | 2.05 | 1.75 | 1.38 | 1·10 |
| | % Change | -19.29 | -23.91 | -31.68 | -2.65 |
| Inflation | 1990 | 9.05 | 6.13 | 8.97 | 21.5 |
| | 2006 | 7.92 | 6.77 | 5.8 | 13.69 |
| | % Change | -12.49 | 10.44 | -35.34 | -36.33 |
| Exports as % of GDP | 1990 | 15.54 | 6.12 | 7.13 | 30.18 |
| | 2006 | 15.29 | 18.97 | 22.97 | 31.62 |
| | % Change | -1.58 | 222.06 | 209.92 | 4.77 |
| GINI Coefficient (in percentage) | 1990 | 40.7 | 28.66 | 29.69 | 30.1 |
| | 2006 | 31.44 | 33.31 | 37.12 | 36.27 |
| | % Change | -22.74 | 16.22 | 25.03 | 20.51 |
| Life expectancy | 1990 | 59.1 | 54.79 | 59.13 | 71.17 |
| | 2006 | 65.21 | 63.66 | 64.47 | 74.97 |
| | % Change | 10.34 | 16.18 | 9.04 | 5.34 |
| Infant Mortality rate (per 1,000 live births) | 1990 | 100·00 | 100·00 | 100·00 | 25·60 |
| | 2006 | 77.8 | 51.6 | 57.4 | 11.18 |
| | % Change | 22.2 | -48.4 | -28.25 | -56.33 |
| Secondary school enrolment | 1990 | 25.14 | 20.18 | 44.48 | 76.83 |
| | 2006 | 30.01 | 43.77 | 54.63 | 87.18 |
| | % Change | 19.38 | 116.91 | 22.82 | 13.47 |

Source: World Development Indicators; Poverty Network database; World Development Bank

## (a) Bangladesh

As per the gradation of the IMF, Bangladesh had a GDP of only USD 225 billion in 2008, ranking 48th among the countries of the world (IMF, 2009). The colonial economic system was disturbed by the partition of British India in 1947. In the colonial economic system East Bengal (presently Bangladesh) was kept as a producer of rice and jute for the urban population of Calcutta. After partition, regarding the development of industrial infrastructure and to modernize the agriculture in view of the population explosion, East Pakistan has had to build from a scratch. Although the cultivated area and irrigation facilities were extended by the central government of Pakistan but the incidence of rural poverty has increased during 1947-71.

This was because of the increasing rural population; the improvements did not able to keep pace. Bangladesh emerged as an independent state in 1971, and it slowly resumed the process of economic growth, although it was badly shattered by a famine in early 1970s. Bangladesh showed a steady economic growth over the years, recovering only gradually from the dismal growth performance during 1970s and 1980s, when per capita GDP growth rate was on average only 0.8%. The slow economic growth in comparison with population growth resulted in accelerating poverty in Bangladesh. However, since the mid 1980s there have been encouraging signs of growth. But it was only during 1990's that economic fundamentals were based on surer foundations. Economic policies aimed on reinstating budgetary discipline, liberalizing the trade policies, privatizing public enterprises, and encouraging the private enterprises and investment to some extent paid dividends.

However, public corruption is severely hurting the efforts to achieve macroeconomic goals. Over the years, increasing poverty is the single most important challenge facing Bangladesh, notwithstanding the isolated but heroic efforts of the civil society, led by the Grameen Bank played important role in Bangladesh fight against poverty. It is estimated that approximately half of the population in Bangladesh lives in absolute poverty. Similarly, according to the World Bank's estimates approximately 10-15 percent of the population is facing serious nutritional threat, similarly it is also estimated the food security for 45 percent

[1]For detailed literature see Barro (1979), Krueger (1987), Sachs (1990), Fosu (1996, 1999)Easterly (2001), Pattillo, Poirson and Ricci (2004), Lora and Olivera (2007)

[1]Poverty alleviation is the principal objective of developing countries. Reliability and availability of data is major constraint for research. Poverty has numerous dimensions and indicators e.g. income poverty, child mortality, illiteracy, inaccessible markets and vulnerability to economic shocks etc. (this dimension is known as 'Human development dimension'). In contrast to human development dimensions of poverty, absolute poverty describes poverty in terms of provision of minimum physical needs, enabling them to engage in economic activity. The most commonly used standard for measurement of income or consumption related poverty is calculating poverty line (based on some minimum acceptable level of consumption) and estimating proportion of population below that line.

of the Bangladesh's population is at stake (World development Report, 2007 and ESCAP, UN 2010). The economic and social challenges facing Bangladesh are daunting indeed.

## (b)India

With a GDP of approximately USD 1 trillion in 2008, at least in the South Asian region, it is the most diverse economy, it is therefore better able to absorb internal as well external shocks (IMF 2009). Since independence in 1947, the Indian economic policies have tended towards state intervention in financial and labour markets, protectionism, importsubstituted industrialization, huge public sector, central planning and business regulations. During the period of 1947-90, the India's low average growth rate referred as the 'Hindu rate of growth', held up India's emergence as an economic powerhouse. The collapse of Soviet Union (India's major trading partner) coupled with sharp spike in oil prices in the aftermath of first Gulf War caused a severe balance-of-payments crisis in India. In 1990, it forced India to obtain a bailout loan from the IMF amounting to USD1.8 billion: which demanded reforms in various sectors. In response, during 1990s economic reforms were initiated by the Indian government. Success of these reforms has motivated Indian government to introduce another cycle of reforms. Consequently, in 2005 various other reforms were introduced in industry, trade, investment, capital and financial sectors. This has opened up almost all areas of economy to domestic as well as foreign private investment. Apparently, at least, these reforms have had a remarkable uplifting effect on the economy. Whatever the causative factors and there is a sharp divergence of opinion about them, the fact is that India has emerged as one of the fastest growing economies of the developing world. Economic growth in India has been accompanied by increases in literacy rates and life expectancy and food security; however, poverty still remains a major concern. Although during 1970-97, the proportion of population living below the poverty line has declined from 50 percent to 35 percent. Still in the terms of absolute number of poor, these efforts are not sufficient, due to increase in population. And there are also huge disparities among rural-urban poverty in India. In 2004 by using USD 1.25 per day approximately 36% of the urban population and 44% of rural population, is living below the poverty line (World development Report, 2007 and ESCAP, UN 2010).

## (c)Pakistan

Pakistan has a per capita income of USD 1,085 per annum in purchasing power terms; but it also has a population of 160.9 million, which is relatively young (Economic Survey 2009-10). This is both an opportunity to progress if the manpower is harnessed with scientific knowledge and skills, but it would be a net burden if this is not done. Unfortunately, the latter seems to have been the case over the years, which has resulted in a less than optimal human capital formation. Partly due to this and also because of the external shocks and lack of political stability over the years, the economy has suffered economic setbacks. A lack of fiscal discipline has been among the causes of its economic social and political discontent. In 2000, substantial macroeconomic reforms were launched that resulted in improving GDP growth, enabling Pakistan to grow at 6-8% range during 2004-06; and in reducing the burden of public debt. In 2005, by the World Bank, Pakistan was named 'top reformer' in the region and firmly placed it in the league of the world's top ten reformers.

However, since 2007 Pakistan's role in the war on terror has resulted in great political, economic and social instability. Concurrently, a massive capital flight from Pakistan to Gulf has occurred, and the flow of FDI has sharply declined. In addition, different agencies have lowered Pakistan's rating for foreign currency debt substantially (just above the level of default). In Pakistan Poverty in urban areas has declined until 1970, but thereafter it increased in rural areas: leading to a rise in overall poverty in Pakistan. However, during 1970-88 poverty declined in both in urban and rural areas. During 1990s, Pakistan faced sluggish economic growth, macroeconomic instability and debt crisis. Consequently, the incidence of poverty is increased from 22-26 percent in 1991 to 32-35 percent in 1999. Incidence of poverty was 34.5% in 2001, thereafter it started to decline and in 2005, it reduced to 23.9 % and in next years to 22.3 %. However, reduction in poverty in that rapid fashion is rather controversial, lot of questions have been raised on authenticity of the data of Pakistan Social and Living Standards Measurement (PSLM 2004-05).

## (d)Sri Lanka

With a GDP of approximately USD 27.4 billion in 2006, Sri Lanka is also one of the major economies of South Asia. Since becoming independent from Britain in 1948, Sri Lankan economy has been affected by political unrest and natural disasters e.g., insurrections of 1971, 1987-89, the civil war of 1983-2009 and Indian Ocean earthquake of 2004. Civil conflict in north and east of Sri Lanka has severely affected the pace of Sri Lankan economic growth. It can be seen that during 1970s its per capita GDP growth was on average 5.6% and due to civil war in 1980s it fell down to only 1.6%. However, in spite of the impacts of civil war, economic growth has improved during 1990s and per capita GDP at an average rate of 4% in 1990s and 4.9% in 2005. (De Silva, 1997 and Peebles, 2005) Moreover, notwithstanding all obstacles, Sri Lankan record in human development is world class. However what casts doubt on its long-run growth rate and even human development, are the ruling political parties' failure to implement a consistent national policy, constantly veering between right and left wing economic practices.

All this has badly affected the country's efforts for economic growth and poverty alleviation. Indeed, in 2001 pubic debt reached at 101% of GDP and GDP growth rate slipping down to -1.4% and Sri Lanka faced bankruptcy. The crisis has exposed fundamental structural imbalances and policy failures and need for bold reforms. Hence, country economic managers initiated the policies of social and economic reforms, deregulation and private sector development. As a result, after 2002, Sri Lanka has commenced a gradual

poor, according to the Asian bank's report. However, if we consider the poverty line as USD 1.25 per day per person then in 2002 approximately only 14% of population in Sri Lanka lives below the poverty line, and these figures are also lowest among the selected developing countries. It is worth mentioning here that in Sri Lanka, poverty is mainly a rural phenomenon, as approximately 7 percent in urban areas, 85 percent in rural areas, and 6 percent belongs to estate sectors are living below the poverty line (World development Report, 2007 and ESCAP, UN 2010).

## The Fiscal Characteristic of Selective South Asian Countries

### 1. Public Expenditure

In market economies government uses public expenditure as an effective instrument of public policy. There are certain sectors of economy e.g., public utilities, infrastructure, or where external economies are compelling-- herein due to one reason or the other private sector is reluctant to invest or restrained by the government to operate effectively. Public expenditure also reveals the preferences of government for public goods, and it is used to create effective demand in the market to ensure its smooth functioning. However, theoretically as well as empirically, the impact of public expenditure on private initiative to make investment and on economic growth remains a matter of debate in academic circles and public discourse. There is the view associated with the neo-classical understanding of the real world that a large size of government expenditure is a source of economic instability or stagnation (Naqvi, 2010).

However, this conventional wisdom has not been supported by empirical studies. Also, the Great Recession has shifted public policy from the unregulated role of the market to a large government role. Table 2 depicts trend of public expenditure as percentage of GDP in South Asian countries. Among the sample countries total expenditure-to-GDP ratio has been the highest in Sri Lanka, where the concern of the government regarding social welfare--- especially with respect to providing education and access to health services---has been most evident. Total expenditure-to-GDP ratio for Sri Lanka was 25.3% per annum in 1975 and it was on the average 32.5% during 1980s. However, after the 1990s, the government came to believe, or was made to believe, more and more in the efficacy of the market (mainly under the influence of market reforms), so that by 2007, the ratio has declined to 23.2%.

However, in comparison with other countries it still remains the highest. Pakistan had an average expenditure to GDP ratios. India and Bangladesh have the lowest ratios: In India, total expenditure was only 11.3% of GDP in 1970s and was on average 15.3 % during 1980s and in 2007 a mere 15.1%. In Bangladesh, the situation has been even worse: in 1995, public expenditure was 12.4% of GDP. Since then it has slightly increased to 14.3% of GDP in 2007.

Table 2. Public Expenditure (As percentage of GDP)

| Years | Pakistan | Bangladesh | India | Sri Lanka |
|---|---|---|---|---|
| **1990** | 25.9 | 12.4 | 17.3 | 28.7 |
| **1995** | 23·0 | 14.4 | 14.1 | 29.6 |
| **2000** | 18.9 | 14.5 | 15.5 | 25 |
| **2001** | 17.5 | 14.8 | 15.9 | 25.9 |
| **2002** | 18.6 | 14.9 | 16.8 | 23.8 |
| **2003** | 18.9 | 14.5 | 17.1 | 22.5 |
| **2004** | 16.4 | 14.8 | 15.8 | 22.6 |
| **2005** | 18·0 | 15·0 | 14.1 | 23.8 |
| **2006** | 18.7 | 14.7 | 14.1 | 24.2 |
| **2007** | 19.3 | 14.3 | 15.1 | 23.2 |

Source: Key indicators of Asia & Pacific; Asian Development Bank 2008

### The Composition of Public Expenditure:[1]

Not only the total size but also the composition of public expenditure is very important because different components of expenditure exercise a different impact on growth and development and social welfare, and also because changes in its composition is an important determinant of the efficiency in resource allocation.

In Pakistan, during 2007, administrative expenditure accounted for 46% of total expenditure, while the collective share of debt servicing and defence was approximately 38%. Consequently, the government has very little room available for expanding social sector and development expenditure: indeed, not more than 3% of total expenditure has been spent on education and health, which is lowest among the selected developing countries---which also explains why Pakistan's performance in human development terms has been dismal. A roughly similar pattern of public spending exists in India: administrative expenditure was 37%, while defence expenditure and debt servicing were 13% and 20% of total public expenditure in 2007. This scenario has contributed to a net shrinkage in the share of social spending: India has on average spent only 6% of total public expenditure on health and education, slightly higher than Pakistan but far below from other developing countries.

In sharp contrast, in Sri Lanka, administrative expenditure has been around a mere 7%, and defence spending and debt servicing 12% and 22% of total public expenditure respectively. This has left lot of room for the Sri Lankan economic managers to allocate higher amounts to development and social sectors. No wonder, therefore, that Sri Lanka's social spending has been the highest in the region. The expenditure on education and health has on average been 11% and 8% of total public expenditure, and the expenditure on subsidies and economic affairs etc. makes a major part (40%) of total public expenditure. Their achievement on the human development scale has therefore been impressively high---in some ways, it is now of the First World standards. It suggests that public expenditures plays crucial role in achieving the better health, nutrition and education facilities that make the foundation of the poverty alleviation programs.

Surprisingly, among selected countries, Bangladesh is having highest ratio of expenditure on education and health: it has allocated 17% and 7% respectively of the total public expenditure to these heads in 2004. The expenditures on public administration (22%), defence (10%) and debt servicing (15%) have been moderate as compared to India and Pakistan.

The low allocation of expenditure to development and social sectors has adversely affected economic growth in selected countries via three channels. Firstly,

## 2. Public Revenue

Reductions in social spending on health and education have stunted the development of human capital, which is a prerequisite for sustainable economic growth. Secondly, cuts in public investment, especially in infrastructure have created bottlenecks in economy and increased the cost of doing business. Thirdly, the low share of development expenditure also resulted in discouraging private investment. Whatever it is, a sharp increase in social spending is necessary to ensure a better quality of life, especially for the poor.

As mentioned earlier the public expenditure plays vital role in poverty alleviation, countries that have spent higher amounts in education and health are better able to improve the human development indicators. However, government cannot increase its public expenditure unless it has been able to generate revenues, as we discuss latter in detail the reliance on debt to finance the deficits is extremely destructive. To finance public expenditure, government collects revenue from various sources in a way that is equitable, which improves social welfare and does not distort the structure of price incentives. In most of the developing countries, the tax/GDP ratio (including tax and non-tax revenue) is low by international standards. According to the World Bank estimates in developing countries, revenue collection, on average, forms only 13% of GDP during 2004. Ineffective tax systems, an expanding shadow economy, shifting profits to low-tax jurisdictions, capital flight to tax havens, trade liberalization and tariff reductions are some of the major reasons for low revenue collection.[2] Tax revenue is the major source of total public revenue. It measures the willingness of the government and the people to bear the burden of development effort and to ensure a minimum degree of equity.

**Table 3** Tax revenue (As % of GDP)

| Countries | 2004 | 2005 | 2006 |
|---|---|---|---|
| Pakistan | 10.3 | 9.6 | 9.5 |
| India | 9.8 | 10.4 | 10.7 |
| Sri Lanka | 13.9 | 14.2 | 15.3 |
| Philippines | 12.4 | 13 | 14.3 |
| Bangladesh* | 8.5 | 8.6 | 8.7 |
| France | 22.2 | 22.4 | 22.7 |
| United Kingdom | 27.2 | 27.9 | 28.8 |
| Italy | 21.6 | 21.3 | 22.9 |
| Norway | 28·0 | 29·0 | 29.2 |

Data Source: World Development Indicators 2008, CD-ROM
* Publications of Asian development bank

Table 3 above gives a comparative picture of the tax-GDP ratios in both the developed and the developing countries. It also indicates the directions in which the developing countries must move: the tax/GDP ratios should in the long run be raised by about three times over their present level in the long run-- --from the 8.7% (Bangladesh),15.3% (Sri Lanka) range at present to the 22.7 (France), 29.2 (Norway). The difference is also a reflection of the level of social responsibility in the developing and the developed countries.

Like public expenditure, tax revenue collection has been the highest in Sri Lanka and the lowest in Bangladesh. In Sri Lanka, during 1970s, tax revenues were on average 18% of GDP, and this ratio persisted in 1980s. During the 1990s, the tax/GDP ratio started to decline and in 2007 it, for various reasons (presumably civil war and other exogenous disturbances) became only 14.2% of GDP. This is an unfortunate development and has largely been responsible for lower allocations to health and education. It is also surprising because IMF-led reforms generally require raising the tax/GDP ratio. Since 1970s, in India, the tax revenue/GDP ratio has remained in the narrow range of 6-10% of GDP but in 2007 the ratio was 9.2%. As noted above, Bangladesh has had the least tax revenue collection but over time a conscious effort has been made to raise this ratio: from a mere 5.8 % of GDP in 1990, the ratio rose to a more respectable figure of 8.7 % of GDP in 2006. This is creditable, considering all the difficulties it has faced in the last two decades or so. But a lot of ground has to be covered to reach a sustainable level of tax revenue collection.

By world standards, Pakistan has had a very narrow tax base, grossly inadequate tax-to-GDP ratio and low elasticity of tax revenue with respect to GDP growth rate. Tax revenues were on average 13.7% of GDP during 1980s, but regrettably, this ratio was reduced to 13.1 % in 1990's. This declining trend persisted and in 2006, tax revenues reached only 9.5% of GDP. Consequently, even with good growth performance, low tax collection has forced the governments to rely on loans for financing of deficit. In this the scandalous unwillingness of the affluent class, especially of the landlords, in Pakistan to contribute to the tax effort has played a large role. To increase tax revenue, during 2001, the government made a somewhat serious effort to repair this tax inadequacy. Tax reforms were introduced and Federal Board of Revenue (FBR) has since then taken numerous steps to broaden the tax base. However, unfortunately, as a percentage of GDP, these tax reforms have proved to be a failure.

## 3. Public Deficit:

Public deficits can arise for a variety of reasons: either when liabilities exceed assets, or if expenditures exceed incomes or if imports exceed exports, or if losses exceed profits. To meet any of these situations the government must indulge in some kind of deficit financing. It may be of interest here to distinguish between a fiscal deficit and a current account deficit.

### Fiscal Deficit:

When the governments' total expenditure exceeds total revenue then a fiscal deficit emerges. Fiscal deficits have

attracted greater attention all over the world after the Second World War, to meet the inadequacy of effective demand that held back economy growth during the Great Depression. However, for more than one reason, it has become a permanent feature in the developing countries for financing economic growth and employment creation. Heavy doses of fiscal deficit have also created problems of macroeconomic instability.[3] The general belief held by the government, especially those under the IMF vigilance, is that reducing fiscal deficit will always result in better economic conditions. However, experience suggests that this need not necessarily be so. If a reduction in fiscal deficit is achieved by reduced expenditure especially by reducing development expenditure, rather by an expansion in revenue collection, then the long-run impact of a reduction in fiscal deficit may indeed be negative for economic growth, which may impede generation of public revenues for financing government expenditure.

Table 4: Fiscal Imbalances (As percentage of GDP)

| Years | Pakistan | Bangladesh | India | Sri Lanka |
|---|---|---|---|---|
| **1990** | -6.5 | -5.7 | -6.6 | -7.9 |
| **1995** | -5.6 | -2.2 | -4.2 | -8.8 |
| **2000** | -5.4 | -4.5 | -5.7 | -9.3 |
| **2001** | -3.3 | -4.1 | -6.2 | -10.2 |
| **2002** | -2.4 | -3.7 | -5.9 | -8.2 |
| **2003** | | -3.4 | -4.5 | -7.3 |
| **2004** | -1.8 | -3.4 | -4 | -7.5 |
| **2005** | -4.2 | -3.7 | -4.1 | -7 |
| **2006** | -3.7 | -3.3 | -3.4 | -7 |
| **2007** | -4 | -3.3 | -3.1 | -6.9 |

Source: Key indicators of Asia & Pacific; Asian Development Bank 2008

It can be seen from the table that fiscal deficits are the general rule rather the exception. Even if the sunshine of fiscal surplus ever dawns, it lasts only for a short time. In Sri Lanka, fiscal deficits have been the most severe in comparison with other countries. During the 1970s, fiscal deficit was on average -7.5% of GDP and increased to - 11.1 % of GDP in 1980s. However, since 1990 fiscal deficit has started to decline mostly under the pressure of the IMF and was -6.9 % of GDP in 2007. The main causes of these deficits have been: (a) huge defence expenditure incurred to fight the Civil war, and (b) large debt servicing liabilities. It is hoped that with the ending of the Civil War the defence expenditure will be reduced and the country will enjoy better fiscal situation.

Pakistan, India and Bangladesh have also faced fiscal deficits over the years, yet the problem has been somewhat less acute, though not less alarming, than in Sri Lanka. In Pakistan, during the 1970s, the fiscal deficit remained, on average, 8.0% of its GDP; but that was because of the very severe shocks caused by the 1971 war (which culminated in the separation of East Pakistan and the emergence of Bangladesh as an independent nation) and by its aftermath. The cumulative fiscal effect of these cataclysmic events was a severe resource crunch in government and a sharp rise in government expenditure. Later on, during 1980s, fiscal deficit was reduced to 7.1 % of GDP. During the 1990s, government has tried its level best to bring fiscal deficits down to 4% of the GDP, as part of its obligations under the IMF's structural adjustment program; but it succeeded only to bring it down to 6.9% of GDP. In 2003 it became only 1.2% of GDP, but after that it starts rising once again.

In India, fiscal deficit was as high as 6.6 % of GDP in 1990, but thereafter India has been able to bring down it to only 3.1% of GDP in 2007. The main factor behind this reduction in fiscal deficit is reduction in the public expenditure from 17.3% of GDP in 1990 to 14.1 % of GDP in 2006. The revenues remained almost stagnant 10.7% of GDP in 1990 and 10.6% of GDP in 2006. Contrary to that trend, Bangladesh has achieved the reduction in fiscal deficit by means of greater revenues. During 1990, the fiscal deficit there was 5.7 % of GDP that was reduced to 3.3% of GDP in 2007. During the same period revenues increased from 6.8% of GDP to 10.6 % of GDP and expenditures from 12.4 % of GDP to 14.3% of GDP. Sachs (1990) concludes that higher deficits tend to weaken macroeconomic stability. It further argues that if accumulated debt caused by deficit financing is serviced by higher taxes, then high rates of taxation are likely to undermine economic growth by creating distortions in the economy, including barriers to trade (via trade taxes), capital flight, tax evasion and reduced work effort. The conclusion is that deficit crisis should be understood as a crisis of state insolvency and the fiscal burden of debt servicing is enormously adverse for economic growth.

## Current Account Deficit:

When a country's total imports of goods, services and transfers exceed exports of goods, services and receipts, then current account deficit emerges. Achieving current account balance becomes very critical for those developing countries that also face a fiscal deficit. If there is surplus in current account, it can help to finance the deficit in fiscal account, without resorting to deficit financing or public borrowing. However, if the fiscal deficit is accompanied by the current account deficit --- the "twin deficit problem"-- then the fiscal situation needs to be fixed urgently. If not, then these deficits quickly become unsustainable, the real interest rates rises and results in crowding out of private and public investment. Since country's overall financing constraint becomes binding, as fiscal deficits feeds the current account deficits then it becomes a part of the public debt problem. None of this can be allowed to last for long and remedial action becomes necessary. Table 5 presents a comparative picture of current account imbalances in Pakistan, India, Sri Lanka, and Bangladesh. It reveals that all these countries have had to face current account deficits. Once like fiscal deficits current account deficits also have been the rule rather than the exception. There have been brief periods of reprieve:

[1]For detailed discussion see Siddiqui (2006)

Table 5: Current Account Imbalances (As percentage of GDP)

| Years | Pakistan | Bangladesh | India | Sri Lanka |
|---|---|---|---|---|
| 1980 | -3.66 | -3.88 | -0.97 | -16.28 |
| 1985 | -3.43 | -2.11 | -1.8 | -7·00 |
| 1990 | -4.15 | -1.32 | -2.22 | -3.71 |
| 1995 | -5.52 | -2.17 | -1.56 | -5.91 |
| 2000 | -0.11 | -0.65 | -1·00 | -6.39 |
| 2001 | 2.6 | -1.14 | 0.29 | -1.37 |
| 2002 | 5.33 | 1.56 | 1.39 | -1.43 |
| 2003 | 4.29 | 0.25 | 1.46 | -0.39 |
| 2004 | -0.83 | -0.49 | 0.11 | -3.23 |
| 2005 | -3.3 | -0.29 | -0.97 | -2.76 |
| 2006 | -5.36 | 1.93 | -1.03 | -4.95 |

Data Source: World Development Indicators 2008, CD-ROM

Pakistan also enjoyed a surplus in 2001, 2002 and 2003; but this period ended very soon and since 2004, the deficit situation has again reared its head. In 2006 its current account deficit was -5.4 % of GDP and the highest among the selected countries. It has been caused mainly by the rising prices of crude oil, commodities, increasing prices of exports, higher domestic inflation and electricity crisis etc. India was also able to get out of the deficit in 2001, but it once again fell into a deficit situation in 2005. However, it has succeeded to cap the deficit around -1 % of GDP. In Sri Lanka, the current account deficit was -16.3 % of GDP in 1980, but it could reduce it. In 2006 current account deficit became only -4.9 % of GDP, though relatively higher than the previous year figure of -2.8 % of GDP. As for Bangladesh, the current account deficit has remained under control and in 2006 it enjoyed a surplus of 1.9 % of GDP. It should be obvious that in these countries the problem of twin deficits is a real one and has to be faced on an urgent basis by a combination of domestic resource mobilization and export expansion (together with efficient and creative import substitution in areas where long-run comparative advantage either exists or can be created).

## 4. Public Debt

Public debt refers to borrowing by a government from inside or outside the geographical boundaries of a country over a period covering its entire history. There is a small distinction to be made between public debt and deficit of a country. Debt is referred as a stock variable while deficit is a flow variable. Accumulation of deficit over the years adds to the stock of debt of the country. It can be concisely expressed by the following equations.[4]

Let $G_t$ = *Government Revenue* $T_t$ = *Tax Revenue* Then

*Primary Deficit* = $G_t - T_t$

If $D_{t-1}$ is last year's debt, and $r$ is the rate of interest, then

*Total Deficit* = $G_t - rD_{t-1} - T_t$

Finally, one can calculate this year's debt:

$$D_t = (1 + r)D_{t-1} + G_t - T_t$$

1 Discussion is based on the data maintained by Asian Development Bank

Public debt is an extremely vital source for bridging the government-financing gaps. If it is utilized in an effective manner then it can increase economic growth and is helpful in achieving the social and development objectives. However, it should be kept in mind that public debt is a doubled-edged sword; excessive reliance on public debt entails unacceptable macroeconomic risks and can impede economic growth and development. Public debt can be classified into two parts external debt and domestic debt and as pointed earlier both have problems of their own.

Table 6 Domestic Debt (% of GDP)

| Years | Pakistan | Bangladesh | India | Sri Lanka |
|---|---|---|---|---|
| 1970's | 9·0 | 5·0 | 2·0 | 1.6 |
| 1980's | 10.3 | 7.3 | 2.1 | 2.2 |
| 1990's | 14·0 | 11.3 | 4.2 | 4.2 |
| 2000 | 9.3 | 15.9 | 5.5 | 6·0 |
| 2001 | 7.7 | 17.9 | 8.5 | 14.4 |
| 2002 | 13.5 | 20.7 | 7.9 | 15.9 |
| 2003 | 14.1 | 23 | 7.4 | 16.2 |
| 2004 | 9.7 | 22.2 | 6.2 | 16.9 |
| 2005 | 9.6 | 19.6 | 7.8 | 15.4 |
| 2006 | 8.7 | 18·0 | 6.3 | 14.9 |

Source: International Financial Statistics, 2009 CD-ROM

The availability of data for domestic debt has been a major issue for all developing countries. Therefore, the information about government securities is usually used as proxy for domestic debt5. Table 6 shows the trends of domestic debt for Pakistan, Sri Lanka, India and Bangladesh. During 1970s, 1980s and 1990s Pakistan had the highest domestic debt/GDP ratio. However, in spite of high growth in government's domestic borrowings during last three decades, growth in domestic debt started to decrease at the beginning of the 21st century. During 2006, it reduced to 8.7 % of GDP in comparison with average 14% in the 1990s. The improvement in fiscal discipline, privatization of public sector enterprises coupled with the rescheduling of external liabilities all helped in reducing the growth in domestic debt.

During 1970s and the 1980s, the Indian domestic debt was well below 8% of GDP but for wrong reasons---- because the growth rate of the economy was rather poor. During 1990s due to economic reforms, Indian economic growth rate has accelerated. To finance a high rate of economic growth Indian domestic debt burden also increased during 1990s to 11.3 % of GDP and to 22.2 % in 2004. However, it declined to 18.0% of GDP in 2006, perhaps due to better financial discipline. In Bangladesh, domestic debt was on average below 6.0% during 1975-2000. This might be ascribed to its lackluster economic growth. However, it increased to 16.9 % in 2004 and was 14.9% of GDP in 2006. Surprisingly, in Sri Lanka, domestic debt has been the lowest among selected countries over the years. It remained below 9% of GDP until 2006.

### ii. External Debt

If domestic savings are not sufficient to meet requirements of investment then a country has to rely on foreign savings and borrowing from external sources. External debt comes

in the form of unilateral borrowing, multilateral borrowing, and borrowing from a consortium or donor agencies etc. Foreign borrowing allows the country to consume and invest beyond the limits of domestic production and is helpful for economic growth. Financing development related projects with the help of foreign lenders could help the country to build its production capacity and smooth the progress of economic growth. Particularly, external borrowing enables a country to finance capital formation not only by using domestic savings but also foreign capital surplus. Indeed, much of the fast growth witnessed throughout the developing world during the 1950's to 1970's can be safely attributed to the easy availability of foreign aid, most of which carried very low interest rates or was in the form of grants. However, an addiction to foreign aid can, as it has, slow down efforts to achieve self-reliance and undercut efforts to rise domestic saving and investment and severe debt service obligations could hamper the long-term growth potential of a country. Pakistan, India, Sri Lanka and Bangladesh present examples of both phases of external borrowings in relation to growth, the incapacity to achieve self-reliance etc. In order to analyze the debt carrying capacity different indictors have been used; stock measures of the external debt burdens are generally expressed in terms of ratios to GDP.[6] Similarly, the problem of indebtedness also depends very importantly on the composition of debt obligations (i.e. short term and long-term obligations) and level of foreign exchange reserves. For lack of comparable data, the following discussion focuses on only two indicators---i.e., external debt as percentage of GDP and external debt as foreign exchange earnings.

### (i) External Debt as percentage of GDP

It can be seen that external debt as percentage of GDP has been the lowest in India among the selected countries. During the 1970's and the 1980's the ratio was on average 13% and 17% respectively; however, in the 1990's, it accelerated to 28% .As a result of successful economic reforms India has been able to control the external debt to GDP ratio. As a result, in 2006, external debt has once again reduced to only 16.8% of GDP. During the 1980's, external debt was on average 74% of GDP and in 1990's it slightly reduced to 66% of GDP.

In Bangladesh, external debt was on average 32% of GDP in 1980's and it increased to 40% of GDP in 1990's. However, the situation started to improve on the eve of the 21st century and in 2005 external debt reduced to 31% of GDP. Sri Lanka also has had a similar trend. External debt as percentage of GDP has been on average 34%, 60% and 65% of GDP during 1970's, 1980's and 1990's respectively. After the 1990's, however, debt-GDP ratio started to decline and in 2006 it reduced to only 42% of GDP.

Table 7 External Debt (% of GDP)

| Years | Pakistan | Bangladesh | India | Sri Lanka |
|---|---|---|---|---|
| 1970's | 48.75 | 13.19 | 34.28 | 18.75 |
| 1980's | 42.93 | 17.21 | 59.96 | 32.39 |
| 1990's | 50.55 | 27.97 | 64.54 | 40.13 |
| 2000 | 44.33 | 21.53 | 56.07 | 33.37 |
| 2001 | 43.78 | 20.59 | 55.45 | 32.48 |
| 2002 | 46.45 | 20.68 | 58.9 | 35.88 |
| 2003 | 42.93 | 18.75 | 57.22 | 36.23 |
| 2004 | 36.27 | 17.87 | 55.27 | 35.52 |
| 2005 | 30.29 | 15.28 | 47.89 | 31.53 |
| 2006 | 28.31 | 16.79 | 42.45 | 22.533 |

Source: World Development Indicators, World Bank

In Pakistan, during 1970s, external debt was on average 49 % of GDP, external debt as percentage of GDP has declined in first half of 1980s, and increased in later half. On average during 1980s external debt remained on average 43 % of GDP. Rising trend, which started in 1988, persisted in 1990s and during that period external debt obligations increased much more than the growth of the GDP. It went up to 55% of GDP in 1999; but, on average, during 1990, debt has been 51% of GDP. At the beginning of year 2000, the economy of Pakistan experienced a turnaround: as GDP growth got acceleration and most of the macroeconomic indicators showed significant improvement. Good growth performance accompanied with debt relief after participating in war on terrorism. Pakistan was able to made external debt sustainable and it reduced to 28.3% of GDP in 2006. It indicates that external debt grew much slower than GDP growth rate.[7]

(ii) External Debt as Percentage of Exports Debt as percentage of exports is another very important indicator of the severity of external debt obligations; it reveals a country's capacity to repay external debt. In Pakistan, the situation has been disturbing:taking 1970s as a starting point, external debt has been on average 482% of exports. Situation slightly improved in 1980s and continued to improve during 1990s with debt are on average 309% of total exports. However, the improvement became dramatic after 2001: in 2006, external debt was 185 % of exports. It is worth mentioning here that external debt as a percentage of exports have improved at a slower rate than external debt as percentage of foreign exchange earnings, reflecting the fact that its export performance has not been satisfactory.

In India, debt as percentage of exports was 288% of exports in 1980s and ratio remained same during 1990s. However, due to the dramatic growth in Indian software exports, this ratio started to decline and was only 73% in 2006. This bespeaks a dramatic turnaround. On the other hand, Bangladesh's debt carrying capacity has been severely limited. During the 1970s, external debt was 353% of exports; this ratio went up to 628% during 1980. However, in 1990s debt as percentage of exports started to decline and on average it has remained around 442% of exports. But, in 2006 debt, debt was only 175% of exports showing considerable improvement in debt carrying capacity of Bangladesh.

In Sri Lanka, debt as percentage of exports has been quite moderate—the corresponding figures being 106% and 223% and in 2006, the ratio was only 134% of exports.

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[2]Martens (2007)
[3]Uzair(2004)
[4]Wikipedia (an online encyclopaedia)
[5]The data on government securities are generally used as a proxy for domestic debt. Actual data for overall can be higher.

Table 8 External Debt (% of Exports)

| Years | Pakistan | Bangladesh | India | Sri Lanka |
|---|---|---|---|---|
| 1970's | 482.14 | 206.39 | 106.07 | 353.55 |
| 1980's | 357.54 | 288.13 | 223.01 | 627.91 |
| 1990's | 308.82 | 289.25 | 193.83 | 441.82 |
| 2000 | 329.78 | 162.78 | 143.72 | 238.72 |
| 2001 | 298.62 | 161.54 | 148.53 | 211.16 |
| 2002 | 305.11 | 142.94 | 163.22 | 251.31 |
| 2003 | 256.8 | 127.17 | 159.23 | 254.86 |
| 2004 | 231.54 | 98.21 | 152.21 | 229.65 |
| 2005 | 193.09 | 75.18 | 142.91 | 190.15 |
| 2006 | 185.14 | 134.24 | 73.07 | 174.73 |

Source: World Development Indicators, World Bank

### iii. Debt Servicing:

The main problem with external borrowing is that eventually it has to be repaid in one form or other, which entails a real transfer of resources from the borrowing country to the donor country or organization. This transfer, if too large in relation to the growth of the domestic economy and the net addition to the country's exporting capabilities, may cause a diminution in the long-term growth potentials and impose a burden on the balance of payments. Public policy, therefore, must balance the pros and cons of external borrowing. Public debt repayments consist of two elements; for external debt servicing payments to foreigners in the form of interest payments and the eventual repayment of the principal amount. This causes problems mostly in connection with the external debt. Unlike the domestic debt where the monetary authorities have control over their own Currency and therefore only interest payments matter; both interest payments and the repayment of the principal amount have to be settled in terms of foreign exchange. Therefore, payment of the principal amount and interest payment for external debt both have to be considered for analyzing debt servicing of external debt. However, to understand the burden of public debt the analysis of the annual revenues pre-empted by debt servicing, whether foreign or domestic, is very crucial. Table 9 shows the large size of external debt servicing among selected countries. As discussed earlier, in Pakistan debt servicing has been a major part of government expenditure. During the 1970s, debt servicing was on average 30% of GDP. This ratio rose to 35% of GDP in the 1980s.[8] During the 1990s, debt servicing was on average 32% of exports. However, after the debt relief granted on the eve of Pakistan participating in the war against terrorism, all the indicators of external debt servicing started to improve. As a cumulative of the debt relief and other factors, debt servicing by 2006 had declined to only 12% of exports. However, the reduction in the debt servicing liabilities does not tell a complete picture of government liabilities on this count. Contingent liabilities, which might arise in near future, must also be taken into account (so far they have been excluded) in computing the official public debt figures.[9]

Table 9 External Debt Servicing (% of Exports)

| Years | Pakistan | Bangladesh | India | Sri Lanka |
|---|---|---|---|---|
| 1970's | 29.54 | 15.44 | 14.55 | 21.8 |
| 1980's | 35.7 | 25.91 | 20.88 | 31.03 |
| 1990's | 30.85 | 30.69 | 12.17 | 19.97 |
| 2000 | 28.71 | 17.85 | 12.39 | 12.14 |
| 2001 | 28.26 | 19.23 | 12.82 | 9.35 |
| 2002 | 26.23 | 21.09 | 12.09 | 10.71 |
| 2003 | 22.1 | 23.27 | 9.27 | 9.12 |
| 2004 | 27.75 | 15.2 | 10.58 | 7.65 |
| 2005 | 14.09 | 14.86 | 5.7 | 8.09 |
| 2006 | 11.77 | 8.53 | 11.24 | 5.83 |

Source : World Development Indicators, World Bank

In Bangladesh, debt servicing was 21%, 31% and 19% during 1970s, 1980s and 1990s respectively. A decreasing trend persisted in first decade of 21st century and in 2006 debt servicing was a mere 6% of exports. Similarly, in Sri Lanka debt servicing which was 15% of exports in the 1970s increased in 1980s to 21%. However, thereafter, debt as percentage of exports started to decline. In 1990, it was on average 11% and was further reduced to 6 % of exports in 2005. In India, debt servicing was 15% of exports during 1970's and this ratio increased to 25% in 1980's and to 30% in 1990's. But thereafter due to overall better economic performance and particularly in exports, India has been able to reduce the debt servicing as percentage of exports and it become only 8.5% in 2006. The overall picture is one that calls for constant vigilance in planning sound public debt policies.

It can be summarised that the funds needed to service debt obligation undermines the economic performance and resulting in collapse of development planning. Because debt obligations and expenditure on debt servicing become a resource drain for already limited revenues and is halting economic growth and poverty reduction efforts. Pakistan's performance during decade of 1990s is a typical example of this situation, during 1990s Pakistan is facing severe fiscal deficit, elevated public debt and near to the ground economic growth and rising incidence of poverty. Developing countries with higher incidence of public debt have to cope up with the same situation.

## 4. Concluding Remarks

Initially all four countries were poor and underdeveloped; so to stimulate economic growth, adequate revenues had to be generated. However over the years these countries have faced a financial crunch, inadequate resource mobilization and rising expenditures have made the situation of fiscal deficit worse. Similarly, the balance of payments has remained far from satisfactory and most of the countries

[6]Hassan (1999)
[7] Khan (2006)
[8]The decade of 1980s can be divided into two halves: the period of 1980-85(when Afghan War was in its full swing); and from 1985 onwards. In the first half of the 1980s, Western countries granted loans on concessional basis and provided relief on debt servicing. As a result, debt servicing was on average 32% of exports. In the latter half, debt servicing as a percentage of exports increased up to 40 %.

have faced current account deficit. The persistence of twin deficit has resulted in the creation of large domestic and external public debt that has prevented these countries from earmarking enough resources for development and social spending. The need to service debt obligation periodically has undermined efforts at long term economic development planning.

In order to stimulate economic growth, curtail the incidence of poverty and improve the indicators of human development, these countries require tremendous amount of resources to finance development and social expenditures. Given the downward rigidity of current expenditure, and crucial importance of the development expenditure, the only way would be to mobilize additional resources by generating higher level of tax and non-tax revenues. Therefore, there is an urgent need for implementing tax reforms. To this end, these countries have to bring under-taxed and un-taxed sectors in the tax net. Above all, sincere efforts should be made for curbing smuggling, corruption, tax evasion and the increasing size of the shadow economy. In addition, the tendency to acquire both external and internal debt to finance deficit without comprehensive analysis needs to be restricted. In this context, it is especially necessary that resort to domestic debt should not be regarded as a risk-free option. The fact is that domestic debt increases inflation. It is therefore necessary that bank and non-bank borrowings through domestic sources for budgetary

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