



Review Article

## Impact of Government Expenditures, Foreign Direct Investment and Budget Deficits on Economic Growth in Pakistan

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### Abstract

This research has investigated the impact of trade openness, foreign direct investment, budget deficit, and government consumption expenditures on the economic growth of the Pakistan economy based on data from 1986 to 2024. The research makes an effort that, in the short run, especially during economic downturns, deficits can improve welfare by increasing demand and supporting vulnerable populations. In the long run, however, constant and poorly managed deficits can weaken welfare by debt accumulation, inflation, and reduced investment. The regression results show that trade openness, foreign direct investment, and government final consumption expenditures have enhanced the growth of the Pakistan economy. On the other hand, the budget deficit has negatively affected the economic growth of the economy. The study has recommended that Governments should run deficits during recessions and surpluses during booms. Borrowed funds must be properly utilized for investments, research, and development. Finally, there should be a stable economic and political environment for more trade and to attract foreign direct investment.

Keywords: Government expenditures, Foreign direct investment, Budget deficits, Economic growth, Pakistan.

## Introduction

In many developing countries, rapid monetary expansion—often driven by heavy government borrowing from both domestic banking systems and international sources—plays a central role in creating balance of payments imbalances. Governments in these economies frequently rely on deficit financing because they struggle to mobilize sufficient domestic revenue. This difficulty stems from factors such as a limited tax base, weak tax administration, and rigid or outdated tax structures (Tanzi, 1982). In addition, capital markets in these countries tend to be shallow and underdeveloped, restricting access to non-bank sources of financing. Interest rates, which are often set administratively rather than determined by market forces, can further encourage credit growth and contribute to an overall expansion of the money supply. When this monetary growth occurs in an environment where production capacity is constrained, the excess liquidity tends to push up domestic prices and increase demand for imported goods, thereby worsening external sector pressures (Yousaf, 1988).

Pakistan, similar to many other emerging economies, has long faced the challenge of persistent and widening fiscal deficits, which remain a major macroeconomic concern. These deficits are frequently cited as a source of high inflation, subdued economic growth, current account imbalances, and the crowding out of private investment and consumption (Chaudhary & Abe, 1999). Over the past two decades, Pakistan's budget deficit

has fluctuated between roughly 5.4 percent and 8.7 percent of GDP. Historical trends reveal that the deficit averaged about 6 percent of GDP in the 1970s and increased to 7.6 percent in the 1980s. By 2001–02, it had once again surpassed 7 percent of GDP. Although successive governments adopted various revenue-enhancing strategies and cut back on development spending in an attempt to stabilize fiscal conditions, these measures proved insufficient to achieve long-term deficit sustainability.

Budget Deficit is a situation where in a fiscal year, governments total expenditures are exceeded to its revenue. Welfare; welfare is also explained with the word of good its means doing goods for the individuals and the society too. In which we focused on the indicators like income levels, provide the education and access of health care, employment and also poverty rates. Budget deficit occurs when a government's spending more than it can earn in the revenue in a specific time period. Large budget deficit are profound more implications for the nation welfare, in which including inflation, increases public debt, reduction of public investment and spending, and also long-term economic instability and feasibility (Barro, 1974).

The debate over the welfare effects of budget deficits is rooted in different schools of economic thought:

Keynesian economics views budget deficits as a useful counter-cyclical tool. During economic downturns, increased government spending (even if deficit-financed) can boost aggregate demand, reduce unemployment, and raise overall welfare. Classical and neoclassical theories, on the other hand, emphasize balanced budgets and the dangers of fiscal irresponsibility. These models suggest that budget deficits may distort capital markets, reduce savings, and lead to long-term economic inefficiencies (Keynes, 1936).

### ***Problem Statement***

As a developing economy, Pakistan faces the chances of risks due to the weaker institutions in external borrowing. In Pakistan, we face many problems that damage our economy, like political instability, corruption, and inflation. Considering the significance, we focus on factors such as trade openness, foreign direct investment, and budget deficits affecting the growth of the economy.

### ***Research Questions:***

1. What is the relationship between the budget deficit and welfare outcomes of an economy?
2. How does trade openness affect the economic growth of an economy?
3. What is the impact of foreign direct investment on economic growth?
4. In which way, government consumption expenditures affect the growth of the economy?

### ***Objectives of the Study***

The primary objective of this study are:

1. To analyze the impact of budget deficits on economic welfare.
2. To estimate the influence of trade openness on economic growth.
3. To highlight the effect of foreign direct investment on the growth of the Pakistan economy.
4. To offer a policy for further recommendations.

### ***Hypothesis of the Study***

The major hypotheses of the study are given as:

H1: Budget deficits positively affect economic growth.

H2; Foreign direct investment and growth are positively related.

H3: Trade openness positively affects economic growth.

H4: The Higher the government spending, the higher the economic growth.

### **Significance of the Study**

We conducted research to give a good policy regarding this issue. It also offers the knowledge of how the fiscal decisions influence the social outcomes. It improves the fiscal policy formulation, and it can ensure the welfare programs are sustainable or not.

### **Literature Review**

In this section, we highlight major factors, including budget deficit, government consumption expenditures, trade openness, and foreign direct investment, to highlight the effect of these factors on other variables influencing the economic growth of developing countries.

Danziger (1983) focused on budget cuts as welfare reform in Pakistan. The regression results showed that short-term physical stability tended to increase poverty and disparity were the results of the budget cuts and economic welfare. The study suggested for improved tax collection, skills training, monitoring, and evaluations are needed for the better welfare of Pakistan. However, Al-Khedair (1996) analyzed that interest rates were increased in the short run due to the budget deficit. He has used the VAR model by selecting data from G-7 countries for the period 1964-1993. It was found that deficits decreased the trade balance. However, the budget deficit positively affected the economic growth of economies. Fatima et al. (2011) checked the effects of government fiscal deficit on investment and economic growth by using data from 1980 and 2009. It was found that fiscal deficits adversely affected the growth of the economy.

Kurantın et al. (2017) used data from 1994 to 2014 to check the effects of budget deficits on growth in the Ghanaian economy. Findings showed that continued budget deficit affected the processes of economic growth and development very adversely. The study suggested improved policies for high growth and the welfare of the economy. Rana and Wahid (2017) focused on the impact of government budget deficits on the economic growth of Bangladesh. VAR findings showed that budget deficits affected economic growth very badly. The study recommended reestablishing the rule of law, political stability in the country, restructuring the tax structure, closing tax loopholes, and harmonizing fiscal policy with monetary policy for high FDI. Minhaj and Nishat (2018) also examined the effect of the government's budget on the welfare in the Pakistan economy. The regression result showed that the higher rate of indirect taxes and development and infrastructure sources positively affected the growth and development of the economy.

Umaru et al. (2021) checked the relationship between deficits and growth by using data from 1981 to 2019. Findings showed that the growth of national output was enhanced by a persistent budget deficit in Nigeria. It was found that, government should lower the interest rate and that expansionary fiscal policy should ensure that fiscal deficits do not exceed 2.02 per cent of the gross domestic product. Mavodyo et al. (2023) have analyzed the link between budget deficits and economic growth by using data from 1975 to 2020. It was found that a 10 percent rise in the budget deficit slowed economic growth by 0.2 percentage points. Results showed that the growth-inhibiting consequences of the budget deficit in South Africa were derived by negatively influencing private and public physical capital accumulation growth, as well as a drop in gross national savings. Aggarwal and Karwasra (2024) focused on the trade openness and economic growth relationship based on data from 2000 to 2022. The results showed a positive relationship between trade openness and economic growth in the economies. Utouh and Kitole (2024) checked how foreign direct investment (FDI) affected the industrialization process in Tanzania. They used data from 1960 to 2020. It was found that industrialization has increased economic growth in the economy.

### **Data and Methodology**

We have used secondary data for this analysis. Time-series data on an annual basis for Pakistan have been used for 30 years (e.g., 1986–2024) and were taken from World Development Indicators databases. Secondary data usage offers reliability and comparability among variables. We have used data for the dependent variable of GDP and independent variables such as budget deficit, trade openness, and foreign direct investment, and government final consumption expenditures. We have used the regression technique for the analysis.

The econometric model is given as in the following.

$$LGDPGR_t = \beta_0 + \beta_1 BDEF_t + \beta_2 TOPEN_t + \beta_3 FDINV_t + \beta_4 GFCEXP_t + \mu_t \tag{1}$$

Where:

LGDPG<sub>t</sub> = Log of Gross Domestic Product growth % of GDP

BDEF<sub>t</sub> = Budget deficit

TOPEN<sub>t</sub> = Exports of goods and services(% of gdp) and Imports of goods and services (% of GDP)

FDINV<sub>t</sub> = Foreign direct investment inflow(% of GDP)

GFCEXP<sub>t</sub> = Government final consumption expenditures % of GDP

μ<sub>t</sub> = Error term

### Results and Discussion

In this section, we explain the summary statistics of important factors as given in Table 1. We also highlight the regression results as given in Table 2.

Table 1. Summary statistics of the variables used in the analysis.

Variables	Mean	Std.dev	Minimum	Maximum
GDPPC	125168.9	24230.91	88586.98	168259.3
TOPN	30.8631	4.5172	21.4599	38.4993
FDINV	0.8708	0.6322	0.3096	3.0357
BDEF	-5.7360	1.1245	-7.7	-3.3
GGFCEXP	88.9832	3.7902	82.6007	96.3896

On average, GDP per capita is 125168.p percent in Pakistan. It is found that trade openness is 30.8631 percent on average, and its standard deviation is 4.5172 percent. Data also indicates that foreign direct investment is 0.8708 percent, and it ranges from 0.3096 to 3.0357. Moreover, the mean of the budget deficit is 5.7360 percent in the economy. Finally, general government final consumption expenditures are 88.9832 percent of Pakistan.

Table 2. Dependent variable is Log GDP - regression results.

Variables	Coefficients, Standard Error and T statistics
TOPN	0.0151 ** 0.0019 (2.73)
FDINV	0.0286 *** 0.0162 (1.77)
BDEF	0.0138 ** 0.0091 (1.52)
GGFCEXP	0.0172 * 0.0018 (9.50)
C	3.6081 0.1795

	(20.10)
R-square	0.80
Adjusted R-square	0.78
F-Statistics	34.70
Prob	0.0000

t- values are in parentheses; \*\*  $p < 0.05$ , \*  $p < 0.1$  and \*\*\*  $p < 0.01$ .

Trade openness is a very important factor for the high growth of economies. It tends to increase production, investment, and growth. The result shows that a one percent increase in trade openness results in increased growth by 0.0151 percent in Pakistan. The reason may be that more exports result in more growth. Our result is supported by Aggarwal and Karwasra (2024).

Besides trade openness, foreign direct investment also affects the economic growth of the economy. It is found that a one percent increase in foreign direct investment leads to increased growth by 0.0268 percent. The reason may be that more investment results in more income and investments, which ultimately increase growth. The result is favoured by Utouh and Kitole (2024).

Budget deficit may increase or decrease the economic growth of the developing economies. The study result shows that a one percent increase budget deficit results in a decrease in growth of 0.0138 percent in the economy. The result is favoured by Rana and Wahid (2017).

Government final consumption expenditures also affect the economic growth of the economy. A finding shows that a one percent increase in government final consumption expenditures tends to increase economic growth by 0.0172 percent in the economy.

## Conclusion and Recommendations

In this research, we have analyzed the role of trade openness, foreign direct investment, budget deficit, and government consumption expenditures in the economic growth of the Pakistan economy. We have used data from 1986 to 2024. We have highlighted that in the short run, especially during economic downturns, deficits can improve welfare by boosting demand and supporting vulnerable populations. In the long run, however, persistent and poorly managed deficits can undermine welfare through debt accumulation, inflation, and reduced investment. It is found that trade openness, foreign direct investment, and government final consumption expenditures have enhanced the growth of the Pakistan economy. However, the budget deficit has decreased the economic growth of the economy. It is suggested that Governments should run deficits during recessions and surpluses during booms. Ensure borrowed funds are used for high-return investments (infrastructure, R&D, education). There should be a stable economic and political environment for more trade and foreign direct investment. Finally, the Government must spend the budget on developmental work for more growth and development of the economy.

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