Public Debt Management and Way Forward

PRIME-Business Recorder
National Debt Conference

Conference Proceedings and Selected Papers

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Public Debt Management and Way Forward

PRIME is an economic policy think tank working for an open, free and prosperous Pakistan by creating and expanding a constituency for protective function of the state and freedom of the market.

This report is a product of the PRIME-Business Recorder National Debt Conference held in Islamabad on October 25, 2014. Supported by Friedrich Naumann Foundation for Freedom, the objective behind the conference was to initiate an open and informed dialogue on the status of public debt in Pakistan and its consequences for the country's future.

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Foreword

Rising Public Debt: Issues and Roadmap

Pakistan's public debt has risen from Rs. 3 Trillion in 2000-01 to Rs. 15.41 Trillion in 2013-14. Pakistan's debt servicing stood at 76 percent of Pakistan's foreign exchange reserves, 28 percent of its export earnings and 46.6% of total revenue in 2013-14. This volume delineates critical issues related to public debt in Pakistan and identifies a possible roadmap. It contains both conference report and selected papers on public debt, thus making this as an important resource for discussions on national debt.

About 68 percent of public debt in Pakistan is expensive domestic debt, and 90 percent of debt servicing takes place to retire domestic debt. The reasons for this sharp increase in public debt, as explained by Sakib Sherani, are mainly rooted in the management of the economy including exchange rate correction, insufficient tax reforms, lack of power sector reforms, weak debt management, booking of past unpaid bills, and sharp fall in net external transfers. According to Dr. Kaiser Bengali, there has been a sharp increase in programme loans in Pakistan over a few decades which has only added to increasing liability, contrary to project loans which add up to the assets of the economy.

During the last seven-ten years, the external debt in Pakistan has escalated to $ 66.5 billion from $40.5 billion. All efforts of the current government have been to generate foreign exchange which is adding to external debt stock. IMF has loaned out an amount of $ 6.6 billion during the last three years, for BOP support, however it is uncertain that how this debt will help us in improving productivity.

In 2012, government accounted for 90 percent of all incremental borrowing. Since then it has reduced, and government is taking 70% of commercial banks credit which still narrows down the room for private borrowers. As per Juvaria Jafri, increased public debt must be regarded as a hindrance to economic freedom, which is a mean to macroeconomic growth and stability.

Roadmap

A weak fiscal framework impacts public debt, growth and investment, inflation, balance of payments, and public sector delivery. This calls on a need of a debt reduction strategy, which would be mainly focused on reducing twin deficits in Pakistan through higher economic growth, improving fiscal rev-

enue, low cost borrowing and implementing the Fiscal Responsibility and Debt Limitation Act 2005.

Debt is a useful instrument for development but returns on projects ought to be at least one percent higher than the net cost of borrowing otherwise it will just add on to liabilities of the country. Program loans for budgetary support have deepened the economic crisis and must be minimized.

According to former central bank governor Syed Salim Raza, government debt has to be diversified across maturities and investors in the capital market instead of commercial banks. Government must improve the management of public funds with a proper disclosure of money and investment in organisations like EOBI so that these markets can towards mutual funds, stock market, etc.

Retail sector will get more active when large scale savers start investing in public securities. Government bond portfolio is the easiest to start with because there is no risk – so that's a benefit. This area needs to be encouraged by the central bank and finance ministry to ask banks to play a developmental role on this front.

By finally appointing a Director General (Debt), as recommended in our conference, the government has not only fulfilled its constitutional obligations but has also initiated the capacity building of the finance ministry to manage the debt. A Debt Management Office (DMO), able and empowered to structure and manage government debt is critical for the sustained viability of the government debt market. The DMO must work to reduce debt servicing costs, have well-structured, well-distributed government debt portfolio, and develop capital markets. Among other things, DMO should establish long-term benchmark profile; issue PIB/T-Bills timetables regularly; respond quickly to interest rate movements and test new ideas.

The problems of debt management are not insurmountable; however the government should remain open to critical feedback from independent economists and must consider alternatives. I hope that this volume serves as a springboard of a continuous dialogue on debt for constructive criticism and workable solutions.

Ali Salman
March, 2015

Note

This report is a product of the PRIME-Business Recorder National Debt Conference held in Islamabad on October 25, 2014. Supported by Friedrich Naumann Foundation for Freedom, the objective behind the conference was to initiate an open and informed dialogue on the status of public debt in Pakistan and its consequences for the country's future.

The conference provided an excellent opportunity for all stakeholders to share their thoughts on the subject. Though public debt is essentially a political economic issue, the dialogue in that conference took place in a non-partisan environment.

It is the government which is ultimately responsible for decisions on debt. However, instead of making the forum as an accountability instrument or a charge sheet against any government, participants presented a cogent analysis, and precise policy recommendations and alternatives.

This report, therefore, serves as a resource paper on the subject of public debt. Based on the presentations and the papers discussed at the conference, this note is to duly acknowledge all the speakers for their content reproduced in this report.

Lastly, while all efforts have been made to acknowledge each speaker for the key policy issues and recommendations presented by them, detailed citations have been intentionally avoided for the purpose of clarity.

List of speakers
(In alphabetical order)

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Executive Summary

It is a long held economic wisdom that increased level of public debt poses significant risks for a country's political and economic freedom. The former is risked when the government has to borrow money from other countries and multilateral agencies on the terms prescribed by the lenders. The latter is curtailed as more debt is followed by more debt servicing, which is often financed by taxation or by further debts, or by money printing.

Pakistan's public debt is increasingly becoming unsustainable. According to central bank data, the public debt to GDP ratio stood at 64.7 percent as of June 2014, with the stock of public debt having risen by 2.5 times in the last eight years. Debt servicing to revenue currently stands around 59.50 percent -- far exceeding the government's own sustainability benchmark of 30 percent. Another way to look at it is that the average interest rate on public debt is now 7 percent per year, which is almost double the average GDP growth rate of around 3 percent in the last six years.

While debt can be a useful instrument for growth and development, it can be equally harmful if it is taken excessively to fund current expenditure – as has been the case in Pakistan. Clearly, there is no room for business-as usual policy as high level of debt is a major source of macroeconomic stability, poor economic growth, and contributes towards higher level of poverty and unemployment.

The reasons behind Pakistan's rising public debt can be classified into two broad categories; macroeconomic factors, and governance factors. At the one end, Pakistan's failure to reform its tax system is causing its fiscal deficit to bloat to unmanageable levels. At the other end, large external accounts deficits have added pressures to take external loans. In addition, sharp depreciation of currency has also added to the pile of debt.

Aside from these macroeconomic indicators, poor economic governance is also to be blamed for Pakistan's increasing stock of debt. These include the lack of political will on the part of successive governments to reform the country's power sector, public sector enterprises, as well government institutions and overall bureaucracy. Moreover, program loans taken for

budgetary support from multilateral agencies have also deepened the economic crisis as they don't generate an economic activity from which the government could earn revenue.

In addition, the mismanagement of debt is also one of the reasons behind rising debt levels in Pakistan. The mismanagement largely stems from the absence of a single debt management office that is tasked with the responsibility of efficient debt management. Moreover, since the country's debt capital market is underdeveloped, the number of buyers of government debt is limited which also results in higher cost of debt for the government. Excessive reliance on banks for government financing also means that little credit is left for the private sector, which therefore is crowded out of the market. The crowding out does only hampers GDP growth but also results in lesser revenue collection by the government.

In the backdrop of these problems, therefore, there is a need to reduce the twin deficits of external and fiscal account. The strategy for the former includes increasing exports and attracting foreign investment. The latter has to be achieved by implementing reforms in taxation on urgent basis. The need to reform public sector enterprises and the power sector is also important to reduce fiscal deficits.

Moreover, in order to support fiscal objectives, deepen and diversify financial markets, Pakistan also needs to develop its debt capital market to broaden the distribution to new groups of investors, and to increase trading and liquidity. However, as a precondition to the debt capital market a professional debt management office, empowered to structure and manage government debt is critical for the sustained viability of the government debt market.

Lastly, the country's political leadership must take economy seriously and the government must bring a strong economic team that has the full support of the political leadership.

Conference Proceedings

Overview

The rising level of public debt in Pakistan is one of the biggest challenges for the country. Contracting debt, per se, is not harmful as long as it is taken for projects with some foreseeable return on investments. The use of borrowed money to improve governance, as long as it is used to improve efficiency of services can also be justifiable. However, more often than not, the purpose of fresh debt is not clarified, which leads to loss of public confidence in country's financial management.

With borrowings being pushed beyond the carrying capacity of the country's economy, a host of problems of have emerged in the last many years. At the one end, unsustainable debt has created problems relating to equity and lower finances for developmental spending. And at the other end, it has undermined growth, stoked inflationary pressures, and discouraged investment.

It is important to add, as Juvaria Jafri pointed out at the conference, that beyond its impact on macroeconomic variables, rising level debt public debt should also been seen as a hindrance to economic freedom, "which may be regarded not just as a means to macroeconomic growth and stability, but also as in end in itself". "Economic freedom tends to be inhibited when the full consequences of rising public debt, whether from external or domestic sources, is misunderstood."[1] Moreover, left unchecked the public debt borrowed for expansionary fiscal policy runs the risk of abuse by policymakers whose objectives are not necessarily aligned with those of the public.

[1] *Jafria, J (2014), "Insidious Debt and Elusive Freedom: Normative Issues with Public Borrowing", Presented at the National Debt Conference, Islamabad, 25th October 2014, p.8*

Recent trends in public debt

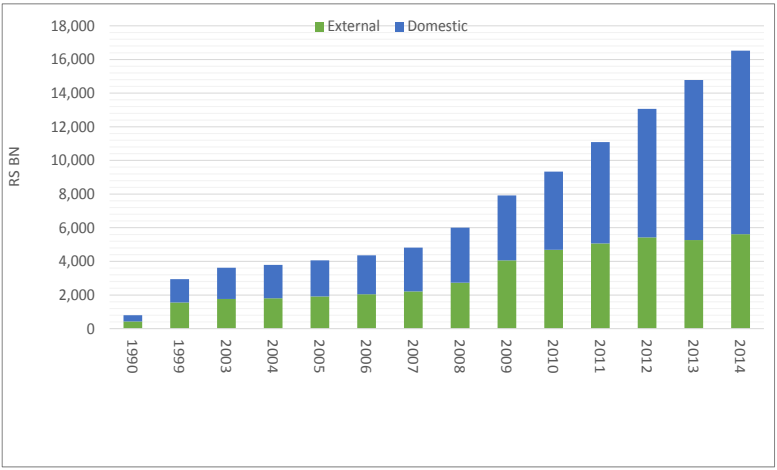
While Pakistan hasn't necessarily had the classical Keynesian expansionary fiscal policy to bail out the economy from slowdown or a recession, weak fiscal performance year after year has given birth to unsustainable level of public debt, with sharp increases visible since 2007-08. As per the State Bank of Pakistan (SBP), the public debt to GDP ratio stood at 64.7 percent as of June 2014.[2] The stock of public debt, which was Rs. 6.1 trillion in 2007, was Rs.16.45 trillion by the end of June, 2014, suggesting a spike by 2.5 times in about eight years.

Moreover, the expensive domestic debt, which was 54 percent of total public debt is now more than 68.6 percent, a growth rate of 27 percent over the last eight years. The ratio of debt servicing to revenue, as per 2014-15 budget, stands at 59.50 percent, which is far higher than the government's own benchmark of debt sustainability of 30 percent. Another worrisome factor is that the average interest rate on public debts is now 7 percent per year, which is almost double the average growth rate of the country, averaging around 3 percent over last six years. The implication is straightforward: the country's public debt has become unsustainable.

Recent trends in public debt														
	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
a) Debt Payable (Rs)	1,576	1,728	1,715	1,852	1,979	2,152	2,322	2,601	3,266	3,852	4,651	6,014	7,638	9,521
Debt payable ($)	27.5	27.8	29.9	30.6	31.2	32.1	33.9	36.4	40.7	46.4	50.0	54.6	53.2	47.9
Exc. Rate (E.O.P)	52.5	63.4	60.1	57.7	57.9	59.7	60.2	60.4	68.3	81.4	85.5	86.0	94.5	99.1
b) Foreign Debt (Rs)	1,442	1,761	1,795	1,766	1,810	1,913	2,041	2,201	2,778	3,776	4,270	4,694	5,030	4,747
c) Total Debt (a + b)	3,018	3,489	3,510	3,618	3,789	4,065	4,363	4,802	6,044	7,629	8,921	10,709	12,668	14,268
GDP (mp)	3,826	4,163	4,402	4,823	5,641	6,500	7,623	8,673	10,243	12,724	14,837	18,063	20,091	22,909
Total Revenue	513	553	624	721	806	900	1,095	1,298	1,499	1,851	2,078	2,261	2,566	2,969
Total Debt as % of:														
- GDP	78.9	83.8	79.8	75.0	67.2	62.5	57.2	55.4	59.0	60.0	60.1	59.3	63.0	62.3
- Revenue	588	631	563	502	470	452	398	370	403	412	429	474	494	481
Source: Dr Ashfaque Hasan's presentaion														

[2] SBP (2014), Pakistan's Debt and Liabilities-Summary, Available at http://www.sbp.org.pk/ecodata/Summary.pdf, Accessed on Feb 24, 2015

Trend in external and domestic debt



Source: Sakib Sherani presentation (based on SBP data)

While external debt remains a relatively smaller component of the total debt profile, it is increasingly even difficult to service it. According to calculations by Dr. Ashfaque external debt servicing as a percentage of exports rose from 16 percent in the fiscal year 2008 to 27.6 percent in 2014.[3] Likewise, annual external debt servicing as a percentage of the central bank's forex reserves increased to 76.3 percent in the fiscal year 2014 from 35.3 percent in 2008.

[3]*Khan, A (2014), "Public Debt Management: An Overview and Way Forward", Presented at the National Debt Conference, Islamabad, 25th October 2014*

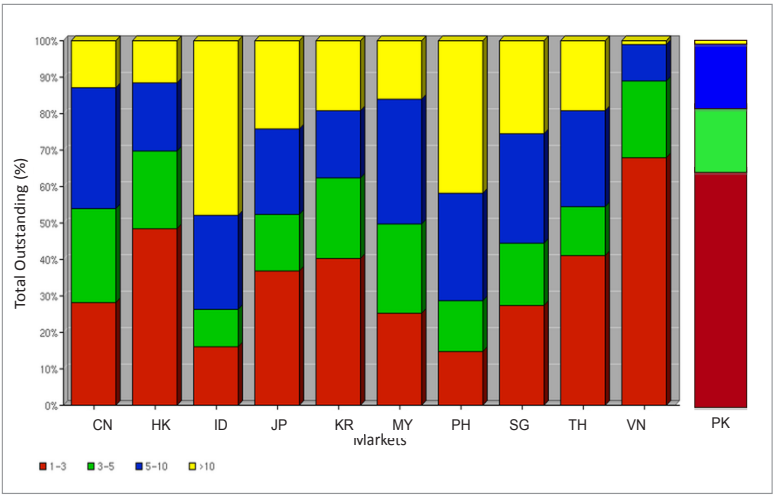
External debt servicing			
	Debt Servicing		
	$ (bn)	As % of Exports	As % of SBP Forex reserves
FY05	2.79	19.4	28.5
FY06	2.82	17.1	26.2
FY07	2.77	16.3	20.8
FY08	3.03	15.9	35.3
FY09	4.62	26.1	50.7
FY10	4.54	23.5	35
FY11	3.87	15.6	26.2
FY12	4.42	18.7	40.9
FY13	6.41	26.2	106.7
FY14	6.94	27.6	76.3
Source: Dr Ashfaque Hasan's presentaion			

Even within the domestic profile, the situation appears troublesome. Increased reliance on domestic financing of debt has not only signalled a decreasing international credibility but has also displaced the private sector from the lending markets.

Moreover, the maturity profile of recent increases in domestic debt is such that almost Rs5 trillion will be required to be refinanced within a year. Against a total of Rs1.367 trillion worth of PIBs issued during December 2000 to December 2013 – i.e. 13 years -- about Rs2.143 trillion worth of PIBs had been issued during January 2014 to September 2014, i.e. in nine months alone. As a consequence Pakistan is the only country in the region after Vietnam with 60 percent plus of government securities in the maturity profile of 1-3 years.

	Share of Domestic Debt (%) of Public Debt
FY05	53%
FY06	53.30%
FY07	54.20%
FY08	54.10%
FY09	50.50%
FY10	52.30%
FY11	56.30%
FY12	60.40%
FY13	66.40%
FY14	68.40%
Source: Dr Ashfaque Hasan's presentaion	

Govt. Securities Maturity Profile - LCY



Source: Syed Salim Raza's presentation based on ADB Bonds online, September 2014

Lastly, considering that debt-to-GDP is an insufficient indicator to evaluate debt sustainability in isolation, a comparative analysis of Pakistan's financial depth with countries in the region and elsewhere is warranted. However, even that analysis reveals that Pakistan faces clear constraints. The table below shows that deposits to GDP ratio in Pakistan

is the lowest in the region, so is private credit and domestic savings as a percentage of GDP. These indicators reflect the overall weaknesses in the macroeconomic environment and the financial sector that are needed to be turned around to be able to better manage the public debt.

Key debt sustainability indicators							
%	UK	US	TH	MY	IND	PK	BD
Govt Debt/GDP	93	102	44	55	66	66	32
Deposits/GDP	164	80	100	147	62	31	52
Debt S/Tax Revenue	7	10	6	9	25	40	20
Private Credit/GDP	158	48	82	115	44	15	48
Investment/GDP	18	17	27	27	35	14	28
Domestic Savings/GDP	11	18	31	35	30	12	30
Tax/GDP	42	33	17	16	18	9.5	9
Source: Syed Salim Raza's presentation based on Economy Watch, Helgi Analysis, ADB, World Bank data							

Key recommendations

While the ensuing chapter will shed light on the causes and consequences of rising public debt in Pakistan, the key learning from this chapter is that increased level of public debt poses significant risks for the country's political and economic freedom. National sovereignty is risked when the government has to borrow money from other countries and multilateral agencies on their terms. Economic freedom is curtailed as more debt is followed by more debt servicing, which is often financed by taxation or simply by more debts, or by money printing, which is inflationary in nature. Ergo, there is no room for business-as usual policy

Causes & consequences: the macro view

The reasons behind the rise in Pakistan's public debt are many; so are its consequences. This chapter looks at the both from different angles, along with the recommendations put forward by the speakers at the National Debt Conference.

While at its heart, rising public debt is an issue that lies squarely at the centre of political economy, the discussion on Pakistan's debt can be divided along two major lines: the macroeconomic factors, and the institutional factors, both of which are closely embedded with the political economy of the country. Following the argument presented by Dr Kaiser Bengali at the conference,[4] this chapter also talks about how the different types of debt taken from multilateral institutions inadvertently makes debt unsustainable.

However, the increase in debt due to mismanagement of debt – along with the recommendations to improve debt management - is discussed separately in the next chapter.

Causes of public debt

What causes debt to rise in Pakistan? As mentioned above, there are many factors that are simultaneously into play. These include the "incapacity of successive governments to reduce the fiscal deficit significantly, unproductive use of debt and motionless growth in real revenues,"[5] according to Kishwar Khan.

[4] *Bengali K & Hafeez M, (2014), "Debt Composition: Consequences for Economic Development", Presented at the National Debt Conference, Islamabad, 25th October 2014, (See Appendix for complete paper)*

[5] *Khan, K (2014), "Debt and Economic Growth- the case of Pakistan", unpublished, p.3 (See Appendix for complete paper)*

However, the debt problem cannot be isolated from broader issues of economic strategy and management – especially policies regarding savings, exports, revenue, expenditure, etc -- and also institutional weaknesses and the underpinnings of the country's political economy. The former is briefly discussed in the immediate subsection, followed by a discussion on the latter. The details of how the types of multilateral debt stoke borrowing pressures are highlighted at the end of this section.

Weak macroeconomic factors

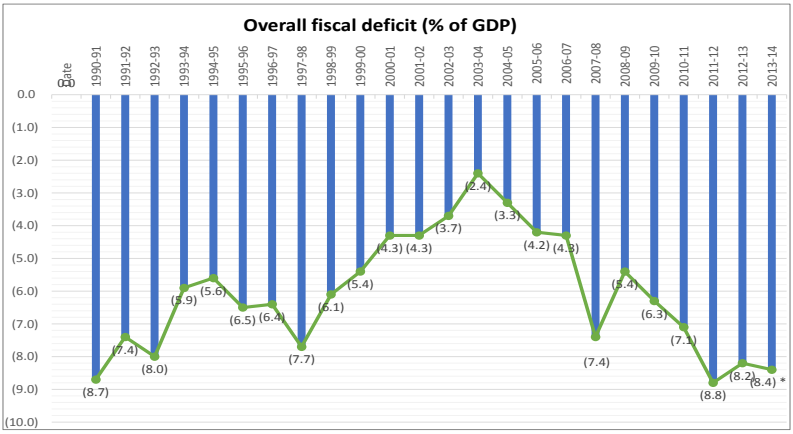
Rising level of public debt in Pakistan is largely contributed by factors like stagnant government revenues that – along with the failure to roll out power sector reforms amongst other public sector reforms - has led to fiscal imbalances, which in turn increase the need to borrow from domestic or external sources. Higher current account deficits also create borrowing pressures from external sources so as to balance the balance-of-payment account.

The graphs below show the trends in fiscal and current account deficits, where the worsening of twin deficits after FY04 onwards is quite visible. Over the same period, total debt has risen from Rs3.7 trillion in FY04 to Rs16.45 trillion by the end of fiscal year June 2014 - a growth of 4 times over ten years.[6]

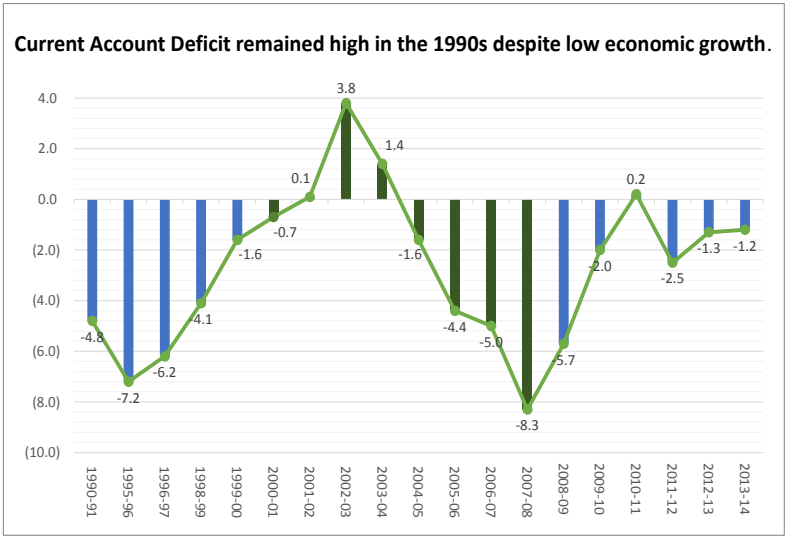
Likewise, weak non-debt creating inflows – such as grants, foreign direct investments and portfolio investments, privatisations proceeds, amid a persistently weak current account led to higher external borrowings to build forex reserves. According to central bank data,[7] external debt rose from $33 billion in FY04 to $56 billion by June 2014.

[6] *SBP (2014), "Pakistan's Debt and Liabilities-Summary", Available at http://www.sbp.org.pk/ecodata/Summary.pdf, Accessed on Feb 24, 2015*

[7] *SBP (2014), "Pakistan's External Debt/Liabilities (Archives)", Available at http://www.sbp.org.pk/ecodata/pakdebt_arch.xls, Accessed on Feb 24, 2015*



Source: Dr. Ashfaque Hasan's presenation based on MoF data

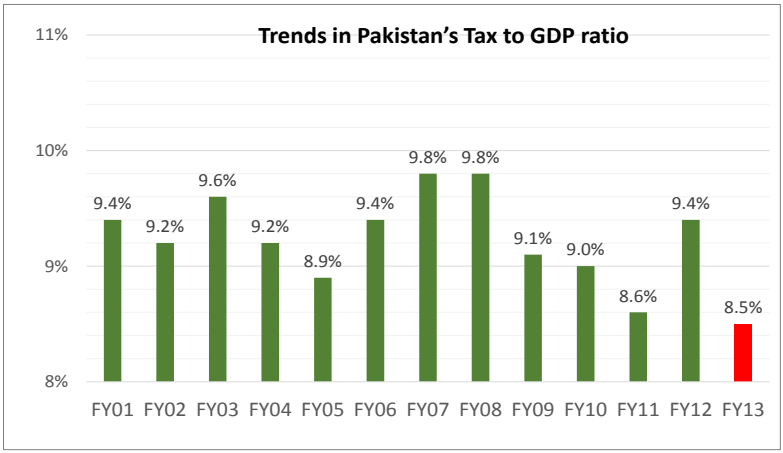


Source: Dr. Ashfaque Hasan's presenation based on SBP data

While weak external account situation can be attributed to gas and power shortages, terrorism and law & order issues amongst a host of governance problems that negatively affect export as well as foreign investments, the single biggest reason behind rising fiscal imbalance is an insufficient tax collection. According to an empirical study by Dr Haider

Mahmood[8] fiscal reforms hold the key to ensure debt sustainability.

The same was echoed by Mr. Sakib Sherani at the conference. According to his calculations, had Pakistan's tax-to-GDP ratio been increased to 12 percent in FY05, public debt in 2014 would have been Rs13.05 trillion as of FY14 instead of the actual Rs16.3 trillion and as a consequence the debt- to-GDP ratio would have been 51.4 percent today instead of 64.3 percent. That would have given a lot of fiscal space.



Source: Sakib Sherani presentation (based on FBR data)

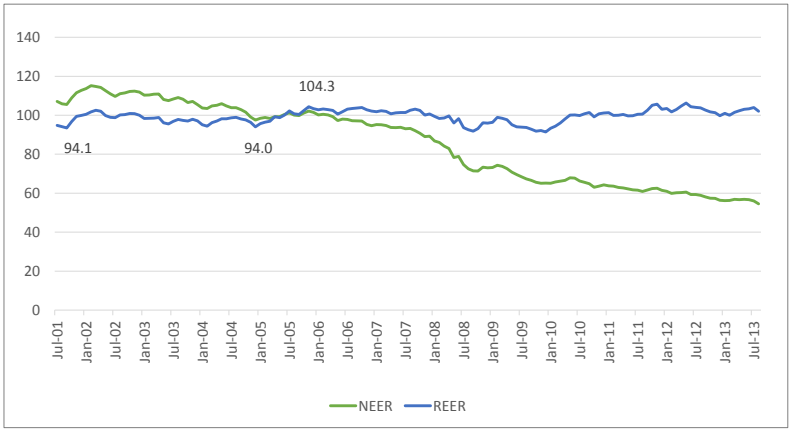
Lastly, the sharp depreciation in exchange rate between 2008 and 2013 also added to the external stock of debt. Put simply, assume if the total stock of external debt is $1 billion, it would equal Rs60 billion at PKR-USD parity of 60. Now if the exchange rate weakens to PKR 70 per USD, then the same $1 billion of external debt would rise to Rs70 billion.

The same happened to Pakistan in recent years. Following the years of persistent over valuation between 2001 and 2008, the exchange rate correction in 2008 onwards was a big hit to the external debt stock and its servicing. According to Sakib Sherani's calculations,[9] the exchange rate depreciation accounted for about a quarter of the incremental public debt between 2007 and 2011.

[8] *Mahmood, H (2014), "Public Debt and Fiscal Policy", Presented at the National Debt Conference, Islamabad, 25th October 2014*

[9] *Sherani, S (2014), "Pakistan's Public Debt Trajectory: Causes and Consequences", Presented at the National Debt Conference, Islamabad, 25th October 2014*

Trend in real and nominal exchange rate



Source: Sakib Sherani presentation (based on SBP data)

Economic governance factors[10]

In what can be construed as a rather unconventional lens of analysis, one of the biggest reasons behind Pakistan's rising debt problem is the mismanagement and bad governance on multiple fronts. This mal-governance is rooted in lack of political will to reform the country's power sector, public sector enterprises, as well government institutions and overall bureaucracy.

At the one end, fears of political backlash have prevented successive governments to raise power tariffs that has resulted in higher blanket subsidies, which in turn has added to fiscal imbalances. At the other end, the hesitance to restructure or reform or otherwise privatise public sector entities has also added to the fiscal deficit. Meanwhile, the impact of development spending by the government on GDP growth has tapered off during the years on account institutional weakening and inefficient bureaucracy.

According to Sakib Sherani's calculations, power sector losses between 2008 and 2012 alone amounted to Rs2151 billion – and contributed to about 21 percent of the incremental public debt between 2007 and 2011.

[10] *This subsection draws mostly from Sakib Sherani's presentation*

Rising losses of power sector				
Rs (bn)	Tariff	Capital Injections	Total	As % GDP
2008	133	0	133	1.3
2009	110	301	411	3.2
2010	171	125	296	2
2011	335	120	455	2.5
2012	464	391	855	4.1
Total	**1,214**	**937**	**2,151**	**2.6**
Source: Sakib Sherani's calculations based on MoF				

Sherani's analysis also reveals the state's institutional weakening. He argues that ten years ago it used to take Rs21.5 billion of development spending to provide 1 percent of GDP growth. But by 2013, it took Rs115.3 billion of development spending for the same 1 percent of GDP growth. The drop in capital efficiency is attributed to mismanagement of public funds, including corruption, and increasing weaknesses in governance.

Efficiency of govt. development spending				
	Development spending (total)	Real spending	GDP growth (%)	Capital efficiency
Year	(A)	(B)	(C)	(B/C)
2004	161	161	7.5	21.5
2005	227.7	206.4	9	22.9
2006	365.1	306.3	5.8	52.8
2007	433.7	338.8	5.5	61.6
2008	451.9	320.5	5	64.1
2009	480.3	302	0.4	755
2010	517.9	304.4	2.6	117.1
2011	506.1	273.9	3.7	74
2012	731.9	371.9	4.4	84.5
2013	851.4	415	3.6	115.3
Source: Sakib Sherani's calculations based on MoF				

Likewise, the failure to reform PSEs has been keeping the fiscal account under pressure. These loss making inefficient PSEs have been incurring costs to the government and to the economy as a whole, with annual fiscal transfers to PSEs estimated at several hundred billion rupees,[11] which includes both subsidies and debt injections to keep the PSEs running. As of 31 December 2013, PSEs had accumulated a debt stock of PRs573 billion, which does not include sovereign guarantees, asset depreciation, and other non-cash support such as waivers on interest and fees.

There have been some developments to reform the PSEs - such as the corporate governance rules passed by the Securities Exchange Commission of Pakistan in 2013. But these remained confined to paper as the government continues to flout the rules. One such example is the appointment of an MNA, an MPA and a government official to the board of Lahore Electric Supply Corporation, in clear defiance to the PSE corporate governance rules.[12]

Types of multilateral debt[13]

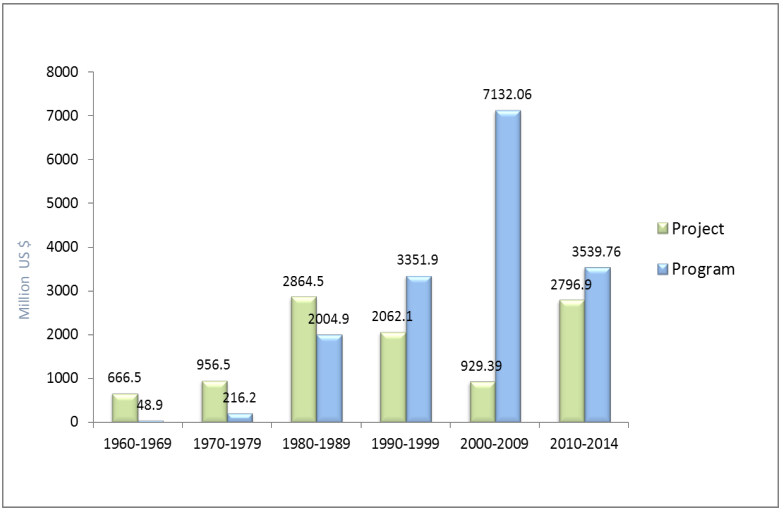
Pakistan's lending history with the World Bank and the Asian Development Bank (ADB) goes as far back as the 1960 in the case of former and 1969 in the case of latter. During this time, the World Bank has provided 310 loans totaling $26,570 million, whereas the ADB has provided 287 loans totaling $24,006. Bengali argues that while debt is not bad in itself, the composition of these multilateral loans is troublesome.

[11] *ADB, (2014), "Economic and Financial Analysis", Public Sector Enterprise Reforms Project: Report and Recommendation of the President, p.1, Available at http://www.adb.org/projects/documents/public-sector-enterprise-reforms-project-rrp, Accessed on Feb 25, 2014*

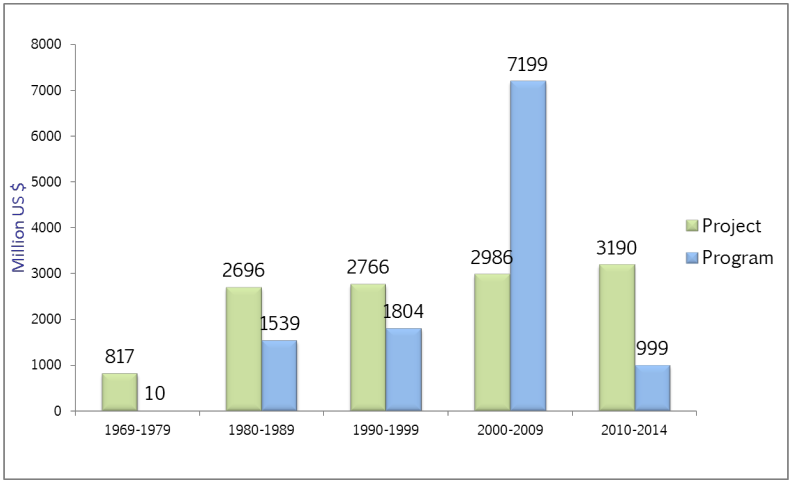
[12] *BR Research, (2015), "Lesco's noncompliant BoD appointments," Available at http://www.brecorder.com/br-research/44:miscellaneous/5101:lescos-noncompliant-bod-appointments/, Accessed on Feb 25, 2014*

[13] *This section is based on Kaiser Bengali's presentation' (See Appendix for complete paper)*

WB: Amount by Decade (Million US $)



ADB: Amount by Decade (Million US $)



He highlights – as the above graphs shows -- that the gradual shift in multilateral lending from project loans to programme loans has been making Pakistan's debt profile unsustainable.

This is because while a project loan is obtained to build economic assets which a country can use to pay off the loan and subsequently the income

from that asset becomes a part of national income, the programme loans do not build economic assets and therefore do not create any additional flow of income.

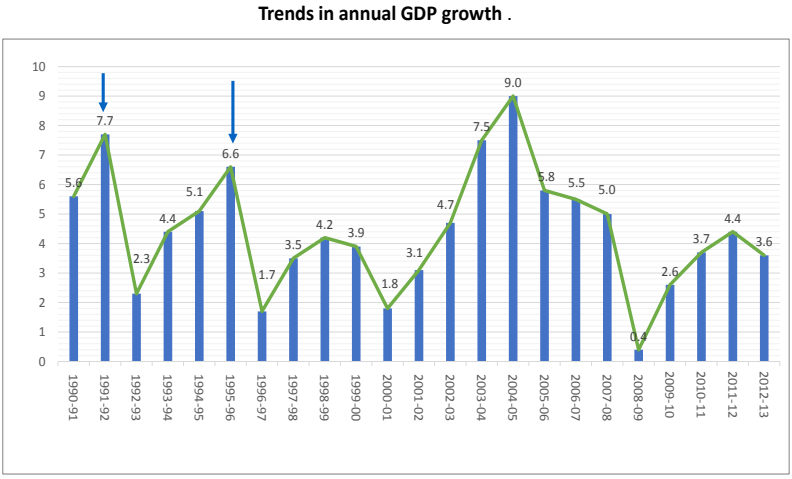
"Programme loans act as budgetary support – in fact, that is what they are referred to as – and enable governments to run high budget deficits, which are covered up through what is labeled as 'external financing'." Since this effectively means that Pakistan's national budget is not being used to provide infrastructure, these findings can be reconciled with Sherani's falling capital efficiency argument discussed in the preceding subsection.

Consequences of public debt

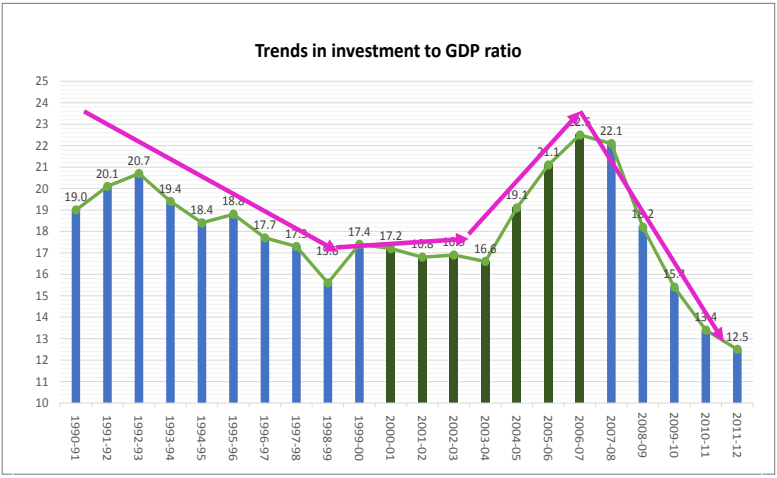
The rise in public debt to unsustainable levels can have various macroeconomic implications for an economy. According to an empirical study on Pakistan, public external debt has a significantly negative relationship with per capita GDP and investment - both in the short run and in the long run.[14] These findings echo the previous works of different academic scholars.

For instance, Levy and Chowdhury (1993) concluded that an increase in the public and publicly surefire external debt may indirectly depress the level of GNP by dispiriting capital formation and inspiring capital flight due to tax increase expectations. Cunningham (1993) found that debt burden has a negative effect on economic growth because of the impact on the productivity of labor and capital." "Fosu (1996) argued that GDP growth is negatively prejudiced via a diminishing marginal productivity of capital. It was also estimated that on average a high debt country faces about one percentage reduction in GDP growth rate annually."[15]

[14] *Khan, K (2014), "Debt and Economic Growth- the case of Pakistan", unpublished, p.3 (See Appendix for complete paper)*
[15] *Ibid*



Source: Dr. Ashfaque Hasan's presentation



Source: Dr. Ashfaque Hasan's presentation

"In another study Sawada (1994), finds that heavily indebted countries have debt overhang problems, since their current external debts are above the expected present value of the future returns."[16] The same appears to be looming in the case of Pakistan.

[16] *Ibid*

In his presentation at the conference, Ali Khizar[17] highlighted how the recent $20 billion mostly debt-based energy projects to add 15,000 MW in seven years could create pressures on external account from 2019 onwards. The argument so goes that of that $20 billion, $14 billion might be spent on machinery imports (turbines, generators, boilers etc) over the span of next 7-10 years. Add to that the fuel import estimated to cost $3.4 billion per year once the additional 15,000 MWs of plants commence operations.

Moreover, thanks to increased power supply, the manufacturing sector can be expected to rise a correspondingly, which would mean that imports (due to higher manufacturing production alone) would jump to around $15.7 billion by 2024, whereas related exports would increase to $11.2 billion. This would likely create pressures on the external account.

Other serious consequences include but not limited to lesser allocations for development spending as increasingly higher budgetary allocations are made for debt servicing, and also adding unnecessary lender influence on economic policymaking, thereby limiting the political freedom in choosing the economic possibilities of the nation.

Key recommendations

Debt can be a useful instrument for growth and development. But if it is taken excessively to finance the needs of current expenditure account and without a sense of fiscal prudence, then it can have serious consequences for the economy.

Stressing that multilateral program loans for budgetary support have deepened the economic crisis, Kaiser Bengali argues that program loans must be minimized and that foreign loans must be limited to project funding. He maintains that the returns from the investment based on project loans should be at least one percent more than the cost of borrowing.

Towing a similar line, Ali Khizar suggests that the government should concurrently design policies to diversify exports and add new avenues of exports through fiscal incentives to ensure that the above mentioned $20 billion debt-based energy projects does not add unsustainable stress on the external account after 2018.

[17] *BR Research (2014), "The dark underbelly of external loans", Available at http://www.brecorder.com/br-research/44:miscellaneous/4433:the-dark-underbelly-of-external-loans/, Accessed on Feb 25, 2015*

Echoing similar views, Dr Ashfaque Hasan along with all other speakers emphasised the need to reduce the twin deficits of external and fiscal account. The former has to be done by boosting exports – not least by way of product and market diversification -- and by attracting foreign investment flows amongst a host of other measures.

The latter has to be done mainly by undertaking wide-ranging structural reforms in taxation as poor tax collection is the single biggest reason behind fiscal deficit that has led to rising level of public debt. The need to reform public sector enterprises (where privatisation holds the key) and the power sector as a whole is also paramount to plug the gaps in fiscal account.

Lastly, the country's political leadership must take economy seriously and the government must bring a strong economic team that has the full support of the political leadership.

Debt Management: problems & solutions[18]

Aside from key macroeconomic and governance issues discussed in the previous chapter, the way debt management takes place in Pakistan is also problematic. For instance, in the mid 2000s when the interest rates were low, the government continued to borrow Treasury Bills (T-Bills), which are of shorter tenor, when in fact it could have locked loans on longer tenor Pakistan Investment Bonds (PIB) to capitalize on the low interest rates. That error in debt management had a big impact on debt servicing costs. Moreover, since the country's debt market is underdeveloped, the number of buyers of government debt is limited that results in higher cost of debt for the government.

Efficient debt management, therefore, has two ends. At the one end, there is a need to create to develop the market by changing existing regulations and by increasing the number of players in the market. At the other end, the government needs to set up a debt management office staffed by professionals instead of bureaucrats. This chapter will first discuss the former highlighting the relevant issues and proposing solutions, followed by a discussion on the latter, where it will specifically shed light on how the country's debt management office should like.

How undeveloped debt capital market hurts

The capital market for domestic debt in Pakistan is inefficient and limited. Since domestic debt is two-third of the country's total debt and accounts for about 90 percent of the interest costs, the section will mostly focus on domestic debt and how it fares in the context of the overall debt capital market in Pakistan.

[18] *This chapter is mostly based on the presentations given by Salim Raza, Shazad Dada, and Nadeem Navqi*

Govt debt by type and holding *(as of June/2014)*					
By investor (PKR Trn)				By Instrument (PKR Trn)	
1	**Banks**	**6.7**	**62%**	**T-Bills**	**4.4**
	Comm. Banks	*4.2*	*37%*	*Comm. Banks +Inst.*	*2*
	SBP	*2.4*	*25%*	*SBP*	*2.4*
2	**Institutions**	**1.5**	**13%**	**PIB (Com. Banks +Inst)**	**3.8**
3	**NSS (+P.O.)**	**2.7**	**25%**	**NSS**	**2.7**
		10.9	100%		10.9
Source: Syed Salim Raza's presentation data					

The domestic debt in Pakistan has mostly been financed by banks, as the country's debt capital markets remains underdeveloped. This has two-fold problem. At the one end, it squeezes the space for private sector lending growth by banks, which negatively affects economic growth and also puts a check on the consequent rise in tax collection by the government. The quantum of the investment resource gap and concurrent size of private sector lending can be gauged from the fact that if government securities held by commercial banks are reverted to 2007 levels (i.e. 25% of total exposure) then banks would need to offload Rs 2 trillion of government securities. At the other end, since banks are the biggest lenders to the government, there is no competition in the debt market. This leads to higher cost of debt for the government as in the absence of efficient debt capital market banks have a strong control over pricing power.

Commercial Banks Exposure										
	Govt. Securities		Commodity		PSE		Private Sector		Total	
	Rs (bn)	*% total*	Rs (bn)	*% total*	Rs (bn)	*% total*	Rs (bn)	*% total*	Rs (bn)	*%*
June '07	839	*25%*	98	*3%*	164	*5%*	2,200	*67%*	**3,031**	*100%*
June '14	4,034	*50%*	530	*6%*	540	*6%*	3,077	*38%*	**8,181**	*100%*
Source: Syed Salim Raza's presentation data										

For instance, the cost of T-Bills to the government is 1.5 percent higher than the matching tenor on bank deposits. The banking spread in Pakistan goes up to 5 percent for average T-Bill/PIB return minus the actual cost of funds. And because government debt is priced higher than what it ought to be, the lending rates for the private sector goes up accord-

ingly. In contrast, in the US, the T-Bills pay less than the matching tenor deposit rates. Historically, in the US, the 3-month T-Bill costs 4.5 percent to the government as against a 3-month dollar deposit account return of 6 percent offered by the banks. The logic behind this is simple: the government being a risk-free issuer is supposed to be price 'maker' not price 'taker' for short term paper. However, that is not the case in Pakistan due to an absence of debt capital market.[19]

Therefore, the government needs to restructure the domestic debt market by developing the debt capital market so that there are more players who can compete for government loans and lower the cost of debt. The case for developing the debt capital market is also strengthened by the fact that a developed debt capital market will help lower the cost of debt for private sector, which in turn can help trigger economic growth and a consequent increase in tax collections by the government.

A developed debt capital market can also mean that private sector funds can be potentially attracted for public investments as is being currently explored by the Asian Development Bank (Pakistan office).[20] Werner Liepach, ADB's country director Pakistan, was recently quoted as saying that his office will be exploring to tap the excess liquidity from Pakistan's Islamic financial system and also the conventional commercial finance to raising co-financing for its infrastructure projects in Pakistan. To that end, therefore, a developed debt capital market can potentially create fiscal space for the government if it can attract the former for public investments. At the same time, having commercial finance in these projects can help bring some discipline in the financing plans, because commercial financiers will not fund any public project unless they think it is not financially sustainable.[21]

Debt capital market: the way forward

In simple terms, an efficient debt capital market (DCM) is one that channels the supply of capital from savers and investors (institutional and retail alike) directly to those who need that capital i.e. the government as well as businesses. The weakness of Pakistan's DCM can be gauged by

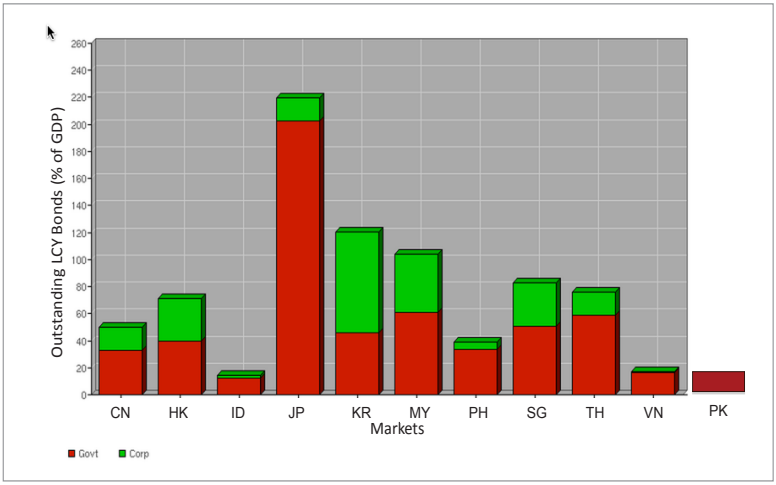
[19] *Raza S (2014), Debt Management Office: Vitalizing the Government's Debt management function in Pakistan, Presented at the National Debt Conference, Islamabad, 25th October 2014*

[20] *Business Recorder (2015), Pakistan's exchange rate is overvalued: Werner Liepach, Country Director Pakistan, ADB, Available at http://www.brecorder.com/brief-recordings/0:/1151834:pakistans-exchange-rate-is-overvalued-werner-liepach-country-director-pakistan-adb/?date=2015-02-16, Accessed on Feb 24, 2015*

[21] *Ibid*

the fact that institutional assets are only 5 percent of the country's GDP as against well over 100 percent in the developed world or 25 percent for mid-sized emerging economies.[22]

Size of LCY Bond Market in % of GDP



Source: Syed Salim Raza's presentation based on ADB Bonds online, September 2014

In order to lower the cost of government debt by means of effective distribution, Pakistan needs to develop its debt capital market. The DCM can also pave the way for private sector bond issues, which typically costs lower than bank loans with greater flexibility of financing structures. With an efficient DCM in place, the companies that enjoy ratings can migrate to the bond market, giving banks more room for mortgage and consumer financing as well as smaller corporate and SME financing.[23]

The way forward in developing Pakistan's DCM could be many. From actively promoting the entry of Pakistani bonds into global emerging market bond indices and marketing Pakistani bonds to non-resident Pakistanis to exploring unconventional distribution channels such as mobile investments along the lines of mobile banking, and allowing supermarkets and post offices to sell government bonds – these many other ideas were discussed at the PRIME-Business Recorder conference. However, given the paucity of space, and relative importance some of

[22] *Raza S (2014), Debt Management Office: Vitalizing the Government's Debt management function in Pakistan, Presented at the National Debt Conference, Islamabad, 25th October 2014*
[23] *Ibid*

the biggest problems and their solutions are discussed below.

Banking channels[24]

While banks have historically been the biggest financers of government debt, given their access to thousands of account holders in both urban and rural regions, they can also play an important role in bringing retail investors into the debt capital market.

One way to do that is through ATMs. The argument so goes that when a person can exchange money from the ATM, or pays utility bills through that, or even withdraws from personal loan account - then he/she should also be able to buy or sell government securities. While developing this system may require a bit of homework, in today's day and age of digitisation, buying and selling of government bonds through ATMs should not be a problem.

The second option is to promote banks to sell government bonds to their customers. These can take the shape of over the counter transactions for walk-in customers but also the sale and purchase of government papers via their call centres, internet banking and also mobile banking. While the central bank's regulations already allow bankers to sell sovereign papers – and some banks are indeed to trying to sell it too – the idea has not picked up as yet. The problem lies in the incentive structure of the bankers, since currently the bankers' incentives are not linked with the quantum of government securities they sell. This issue needs to be jointly sorted by the central bank and the finance ministry. And at the same time a culture of change is required from the banking sector.

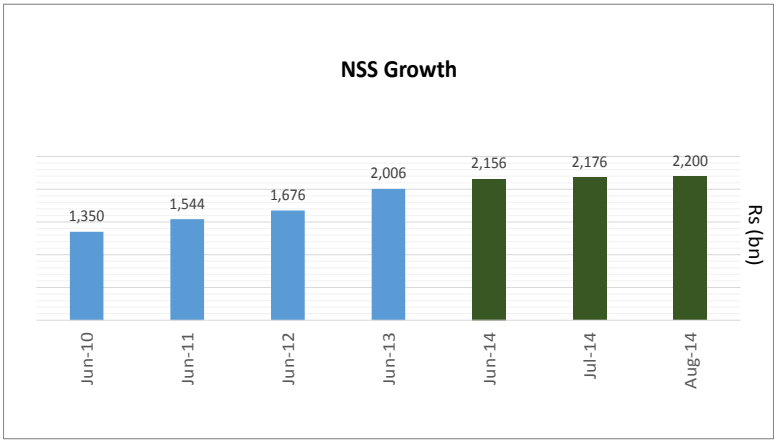
Non-banking channels[25]

The non-banking channels for buying and selling of government securities include mutual funds of asset management companies, the three bourses in Pakistan, and the public funds, and the National Savings Scheme. Of these some have an active participation in the government paper market – almost to the detriment of avenues – whereas others are yet to fully develop. Each of these are briefly discussed below.

[24] *This subsection draws heavily from Nadeem Naqvi's presentation titled: "Developing distribution channels for government debt and increasing tenor and liquidity: Implications for capital market"*
[25] *This subsection draws heavily from Shazad Dada's presentation titled: "What Restricts Development of Public (Non-Bank) Markets For Debt: A Private Bank's perspective"*

National Savings Scheme: By the end of last fiscal year, the NSS made up for about 40 percent or Rs2.2 trillion of total government bond market, which included Rs1.8 trillion in T-Bill, Rs3.3 trillion in PIBs and Rs.3 trillion in Sukuk. However, with staff strength of 3377 employees across 367 centres throughout the country, the cost of running NSS is not justified, and the inefficiency of those operations adds up to the fiscal deficit. The distribution cost of NSS is also not priced in.

Moreover, the NSS gives on tap access to primary investors. In other words, NSS is an open window where any day or any time any retail and institutional investors can go and buy government securities at whatever rate they set. And because of this open window it has lost its purpose which is to cater to the saving needs of orphan and widows. Also since the NSS is non-tradable instrument it doesn't help develop the debt capital market, as trading helps bring efficiency in the market, and prevents the yield from staling.



Source: Shazad Dada presentation based on SBP data

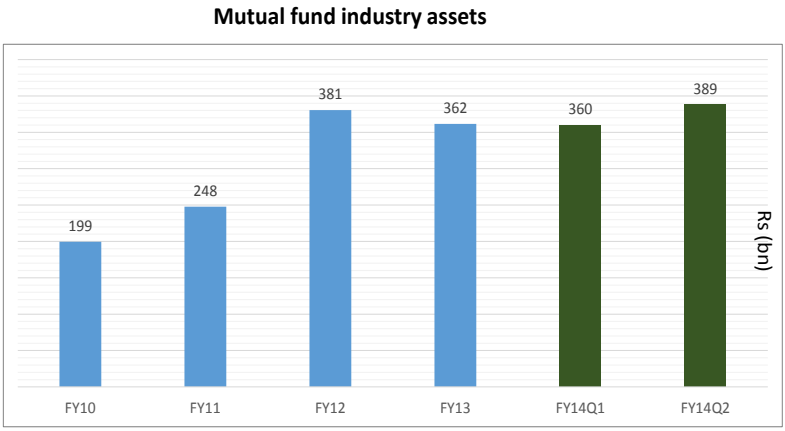
Therefore, in light of the above, the NSS rates need to be frequently with secondary market T-Bill and PIBs. The rationalisation of NSS should also include stopping institutional access to NSS, putting a maximum investment limit of Rs5 million for retail investors, and also rationalising the geographical footprint of NSS by focussing on rural and underserved areas.

Public funds: There are two types of public funds in Pakistan: unfunded and funded. Unfunded funds are postal insurance, general provided

funds to the tune of Rs150 billion. The latter type includes EOBI, Federal Employees Benevolent Fund and group insurance fund. The problem with these funds is that their performance has been very unimpressive, whereas the performance of their fund managers can be difficult to track due to lack of disclosure and transparency. Moreover, unfunded liabilities can create unplanned drawing on the budget, and hence risk adding to the growing pile of debt.

The government should ensure that the transparency and disclosure regulations applicable to the private sector mutual fund industry are also applicable to public sector funds. Moreover, public funds should also be required to publish their asset allocation criteria, benchmarks, and details of fund performance. To establish performance benchmarks it would be prudent for the government to require these public funds to hire private sector fund managers for at least 20 percent of the portfolio in each fund. Public funds should be prohibited from investing in non-transparent asset classes such as real estate, private loans. And lastly, the unfunded funds should be converted to funded entities over the medium term.

Mutual funds: Another important way of how can Pakistan increase the distribution and reduce the cost of its domestic debt is by promoting it mutual fund industry. The government securities currently held by asset management companies are worth about Rs100 billion down from its peak of Rs135-150 billion a few years ago. The decline in government debt portfolio is largely because of the way industry is taxed. The host of taxation disincentives faced by the industry include the FED and sales tax on management fees; capital gains tax and also worker welfare fund allocations. The taxation structure for the industry therefore has to be rationalised to help bring more money in the sector and then this sectors can help the budgetary pressure we have.



Source: Shazad Dada NDC presentation

Exchange trading: Platforms for government bond trading have been established at the Karachi Stock Exchange (KSE) and Islamabad Stock Exchange, and plans are underway for a similar setup at Lahore Stock Exchange. However, even a year after the launch of trading platform at the KSE, trading at that platform remains little. This is because of two reasons: a) there market lacks market makers which in part is because the existing brokers do not understand debt instruments as much as they understand equities. And b) retail investors also lack awareness about the debt instruments and how the debt capital market works.

Developing the bond trading market at the exchanges is a herculean task, but it can be achieved if a multi pronged strategy is adopted. The exchanges need to make persistent efforts to create the right incentives for brokers and market makers; the SECP needs to play its crucial role in planning and regulating the initiative, and also the central bank needs to provide its expert guidance on related affairs.

However, most importantly it is the government that needs to find a strong anchor within the Ministry of Finance – who can drive the initiatives to have market makers, to increase retail participation, and to kick start the awareness programme. Within the ministry the strongest link that is required is an efficient debt management. The ensuing section talks about same in little more detail.

Debt Management Office[26]

In light of the above discussion, a professional, empowered and independent Debt Management Office (DMO) at the Ministry of Finance is indispensible. The primary mandate of the DMO should be to reduce the cost of debt, develop sustainability, of government debt, and contribute to building the framework for broad-based debt capital markets, where the challenge would be to develop strategy and take initiatives to broaden the distribution of government debt outside banks, by fostering institutional changes in the country's debt capital markets.

The DMO should have an independent board with Finance Minister/ Finance Secretary, Governor/DG-SBP, Secretaries of EAD, Budget wing; CDNS: and key private market participants. The DMO should be staffed with professionals with relevant market experience, including in the fields of trading and strategy functions.

This would enable the DMO to properly fulfill its core responsibilities, which can be grouped into three broad classifications. The first pertains to the control of consolidated national debt database, and centralized authority for planning, structuring, execution and market intervention, for government debt. The second responsibility is to manage the controls of spectrum of debt management functions, i.e. front office (trading) – middle office (strategy, policy, risk management) – back office (settlement, accounting). And the last major responsibility is to maintain market stability, supported by regulation and oversight by Securities and Exchange Commission of Pakistan (SECP) and the State Bank of Pakistan (SBP). This would entail covering different market functionaries such as primary dealers; market-makers; trading platform; rating agencies, etc.

The DMO shall perform the following functions to help meet its responsibilities.

1. Production of annual public sector borrowing requirement alongside the budget, for parliamentary approval; where fragmentation should be avoided.

2. Establishment and institution of long-term benchmark profile

3. Issuance of time-table for TB/PIB issues.

[26] This subsection draws heavily from Salim Raza's presentation

4. Diversification of interest-rate risk, targets for fixed/floating debt, together with active use of swaps.

5. Assurance of market integrity, via SBP/SECP, by requiring regular financial appraisal of issuers/market makers, and its disclosure to investors.

6. Risk management, to ensure market stability and liquidity, while being mindful of forward-looking indicators including foreign exchange reserves; maturity 'bunching'; contingent liabilities; 'hedging' thresholds; monetary policy requirements

7. Regular market dialogue with domestic market intermediaries, and liaison with foreign rating agencies, fixed-income fund managers and investors.

Key recommendations

Economic development and financial sophistication are positively correlated. Therefore, to support fiscal objectives, deepen and diversify financial markets, and enhance contribution of finance to development, it is paramount for Pakistan to develop its debt capital market. DCM will not help reduce the overall cost of debt but it will also create lending room for banks which can be utilised by smaller cooperates and SMEs. The challenge here is to to broaden the distribution to new groups of investors, to increase trading and liquidity. However, as a precondition to the DCMs a professional DMO, able and empowered to structure and manage government debt is critical for the sustained viability of the government debt market.

Selected Papers

Debt Composition: Consequences for Economic Development

by

Dr. Kaiser Bengali
Mehnaz Hafeez

The World Bank and the Asian Development Bank are two major international development lending agencies providing financing to Pakistan. The World Bank commenced lending, with a loan for railways in 1952. The Asian Bank began providing lending in 1969, with a loan for the Industrial Development Bank.

Lending history

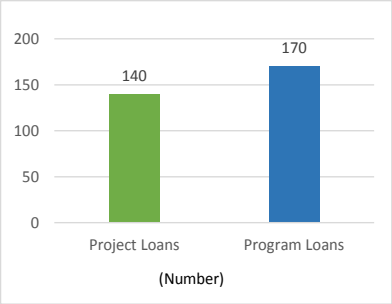
Over the 54 year period, 1960-2014, the World Bank has provided 310 loans totaling US$ 26,570. Of these, 45% of loans have been project loans and 55% have been program loans. In terms of amount, 39% of loans have been project loans and 61% have been program loans. The Asian Development Bank has over 45 years, 1969-2014, provided 287 loans totaling US$ 24,006. Of these, 54% of loans have been project loans and 46% have been program loans. In terms of amount, 52% of loans have been project loans and 48% have been program loans.

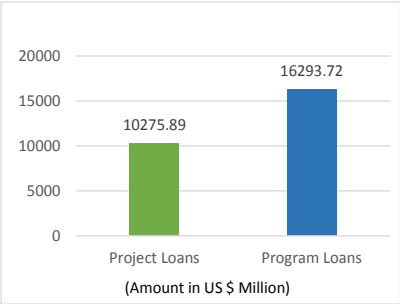
WB* (1960-2014)		
Nature of Projects	**No of Projects**	**Amount in Million $**
Project Loans	140	10275.89
Program Loans	170	16293.72
Total	310	26569.61

ADB* (1969-2014)		
Nature of Projects	**No of Projects**	**Amount in Million $**
Project Loans	156	12455.273
Program Loans	131	11551.01
Total	287	24006.283

Source: http://www.worldbank.org/en/country/pakistan/projects
http://www.adb.org/countries/pakistan/projects

WB Projects: No. and Funding (1960-2014)



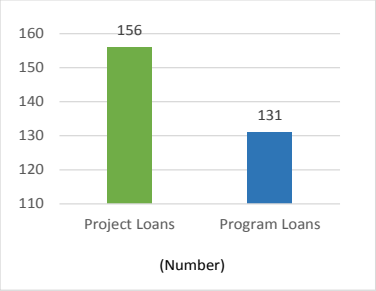


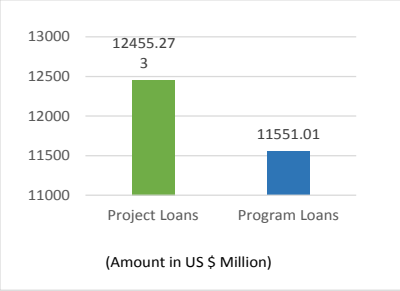
Source: http://www.worldbank.org/en/country/pakistan/projects

*WB = World Bank

*ADB = Asian Development Bank

ADB Projects: No. and Funding (1969-2014)





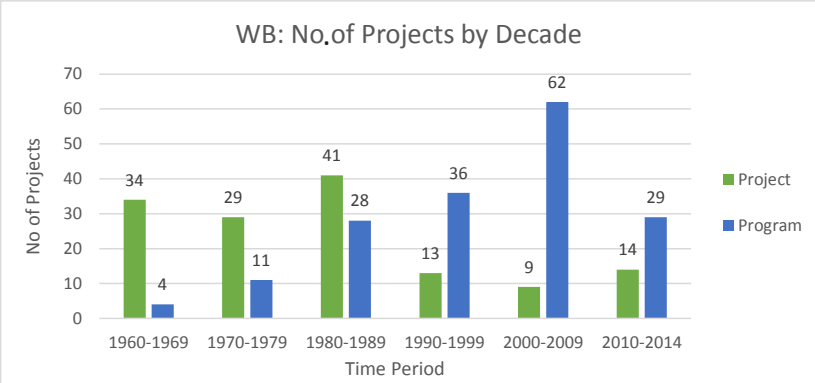
Source: http://www.adb.org/countries/pakistan/projects

The composition of loans has changed over the years. The World Bank provided 147 loans totaling US$ 6,758 over the 29 year period, 1960-1989; of which, 71% were project loans and 29% were program loans. In terms of amount, 66% were project loans and 34% were program loans. The Asian Development Bank provided 115 loans totaling US$ 5,062 over the 20 year period, 1969-1989; of which, 79% were project loans and 21% were program loans. In terms of amount, 69% were project loans and 31% were program loans. In the case of both the banks, there was a heavy bias towards project loans in terms of numbers as well as amount.

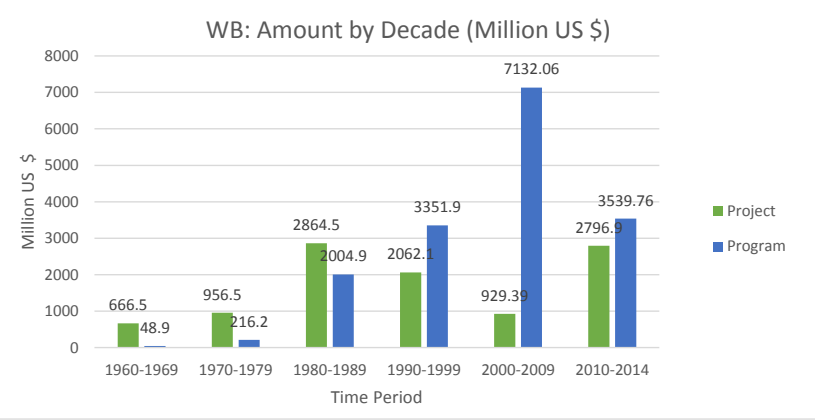
WB – No.of Projects by Decade		
Time Period	**Project**	**Program**
1960-1969	34	4
1970-1979	29	11
1980-1989	41	28
1990-1999	13	36
2000-2009	9	62
2010-2014	14	29
Total	140	170

WB – Amount by Decade(Million $)		
Time Period	**Project**	**Program**
1960-1969	666.5	48.9
1970-1979	956.5	216.2
1980-1989	2864.5	2004.9
1990-1999	2062.1	3351.9
2000-2009	929.39	7132.06
2010-2014	2796.9	3539.76
Total	10275.89	16293.72

Source: http://www.worldbank.org/en/country/pakistan/projects



Source: http://www.worldbank.org/en/country/pakistan/projects

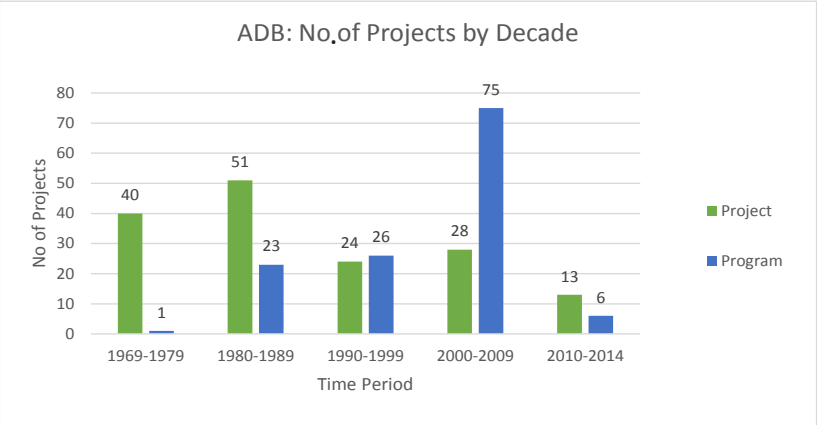


Source: http://www.worldbank.org/en/country/pakistan/projects

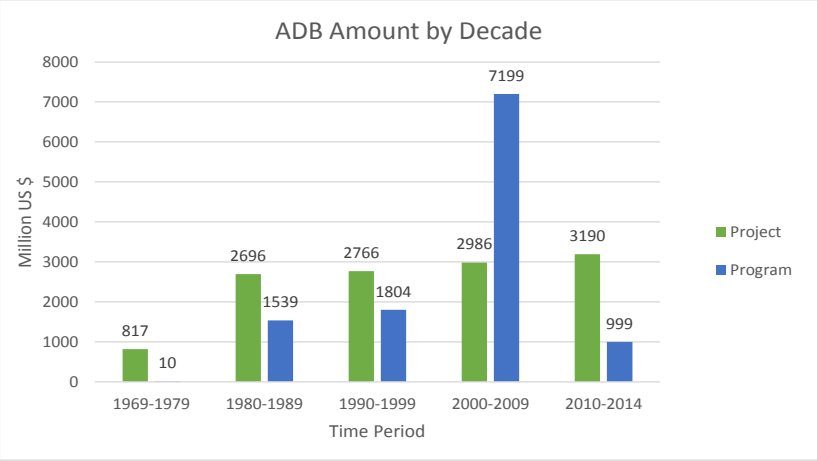
ADB – No.of Projects by Decade		
Time Period	**Project**	**Program**
1969-1979	40	1
1980-1989	51	23
1990-1999	24	26
2000-2009	28	75
2010-2014	13	6
Total	156	131

ADB – Amount by Decade(Million US $)		
Time Period	**Project**	**Program**
1969-1979	817.02	10
1980-1989	2695.75	1539.4
1990-1999	2766.363	1803.91
2000-2009	2985.7	7198.6
2010-2014	3190.44	999.1
Total	12455.27	11551.01

Source: http://www.adb.org/countries/pakistan/projects



Source: http://www.adb.org/countries/pakistan/projects



Source: http://www.adb.org/countries/pakistan/projects

The 1990s onwards saw a major shift in the composition of lending. Over the 24 year period, 1960-2014, the World Bank provided 163 loans totaling US$ 19,812; of which, 22% were project loans and 78% were program loans. In terms of amount, 29% were project loans and 71% were program loans. The Asian Development Bank provided 172 loans totaling US$ 19,044 over the 24 year period, 1960-1989; of which, 38% were project loans and 62% were program loans. In terms of amount, 47% were project loans and 53% were program loans. There has been a complete reversal, with the bias shifting heavily in favor of program financing.[1]

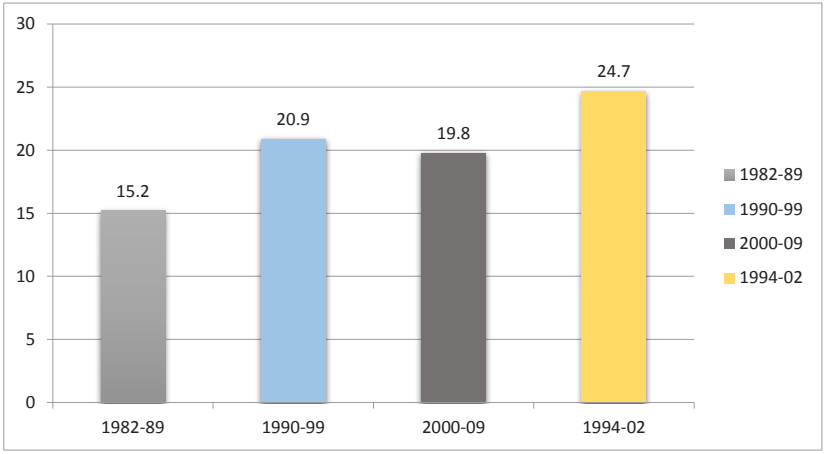
Cost of the shift

Project and Program loans have significantly differential impact on public finances and the development process. By and large, Project loans are utilized to create an economic asset, which in due course of time begins to provide a flow of additional income; and which can be used to repay the loan. Program loans do not create any economic asset and do not create any additional flow of income. As such, repayment has to be made from existing income – thus, forcing a reduction in public expenditure – or a new loan has to be contracted to repay an old loan. Program loans merely add to the debt burden.

Program loans act as budgetary support – in fact, that is what they are referred to as – and enable governments to run high budget deficits, which are covered up through what is labeled as 'external financing'. There is evidence to this effect. The average share of external financing as a percentage of total revenue receipts has risen from 15% during 1982-89 to about 20% during 1990-99 and 2000-2009. The years 1994-2002 are notable for being the period marked for externally financed fiscal profligacy. During 1994-2002, the average share of external financing as a percentage of total revenue receipts was 25%. In other words, a quarter of the budget was being financed largely through external Program loans.

[1] Asian Development Bank Project loans exceed Program loans in 2014

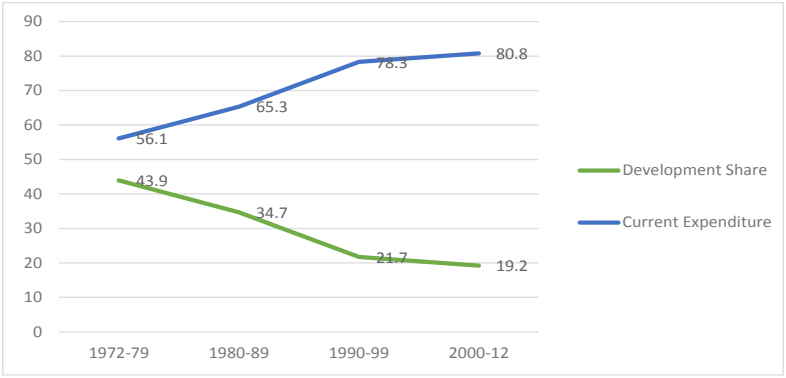
Average Share of External Financing as a Percentage of Total Revenue Receipt (%)



Source: Federal Budgets, Various Issues

The amounts received as budgetary support were used to finance current expenditure. This is evident from the fact that the share of development expenditure in total expenditure declined from 44% during 1972-79 to 35% during 1980-89 to 22% during 1990-99 and to 19% during 2000-12. During 1994-2002, the said share was even lower at 18%.

Average Shares of Current & Development Expenditure in Total Expenditure (%)



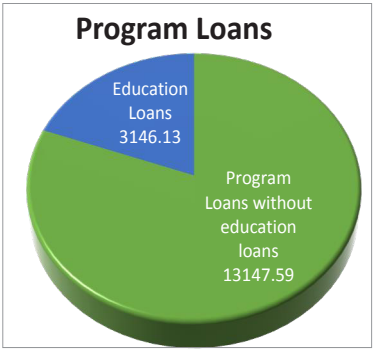
Source: Federal Budgets, Various Issues

Impact on Development

Program loans have had little developmental impact. Circumstantial evidence to this effect can be seen in the education sector.

Out of 172 Program loans totaling US$ 16,294, 28 loans totaling US$ 3,146 – one-fifth of the total amount – have been for the education sector. Yet, the performance of the education sector remains severely deficient.

WB - Program and Education Loans		
Nature of Projects	**No of Projects**	**Amount in Hundred Thousand $**
Program Loans(without education loans)	142	13147.59
Education Loans	28	3146.13
Total	170	16293.72



Source: http://www.worldbank.org/en/country/pakistan/projects

The Social Policy Development Centre in its Annual Review of 2003, titled The State of Education, reports the result of Class X tests in science subjects administered to Class X!! (Intermediate). The results are reproduced below and are self-explanatory.

Test Results				
	Average Percentage Obtained			Percentage Passing
Subjects	**MCQ***	**Theory**	**Overall**	
Mathematics	--	--	24.0	19.1
Physics	24.7	12.8	18.7	4.3
Chemistry	32.5	11.3	19.0	7.7
Biology	44.8	27.0	35.9	37.0

*MCQ = Multiple Choice Questions
Source: SPDC test results

ShahidKardar carried out two 'Teacher Management Studies' over 2004-06 in Punjab and Khyber-Pakhtunkhwa (then NWFP).[2] The study results were summarized by the Daily Times of October 10, 2014 and is reproduced here:

[2] Similar studies were also carried out in Karachi in 1996-97 and had produced similar results.

"While enrolment rates capture the extent to which children are attending school i.e., cover only the "access" aspect of education, the real indicator of the quality of services deliveredthrough educational institutions is the knowledge of students in the subjects being taught to them.

To assess learning outcomes of children, students of Grade Four and their teachers were administered a test in a recently concluded survey of a sample of government school in six representative districts of the Punjab (Rawalpindi, Faislabad, Sargodha ,Muzaffargarh, Rajanpur and Mianwali). In the 104 schools that were surveyed, student were tested in Mathematics and Urdu using an instrument designed by the national education assessment system (NEAS) for children who had completed the curriculum developed for Grade three.

The performance of the students in the tests was so poor that it was heart rending, highlighting the low quality of instruction in public schools. Since the tests were meant to assess the familiarity of students with concepts that they had supposedly been exposed to in grade Three it was alarming that the vast majority of the students, 76 per cent, were unable to score even 30 per cent in Maths. Of the 595 students tested in Maths only six per cent were able to score more than 50 per cent.

The students maintained that they were unfamiliar with a large proportion of the concepts covered in the test that had ostensibly been designed on the basis of the curriculum and textbooks of Grade Three. The performance of students in the Urdu test was relatively better. Around 42 per cent of the 619 students who sat the Urdu test did not pass (Pass marks were a mere 30 per cent) and 28 per cent scored more than 50 per cent marks.

In view of the difficulties experienced by students in attempting the tests it was decided to administer the same tests to teachers to access their knowledge of the concepts they were required to pass on to students. It was highly disturbing to discover that in excess of 18 per cent of the teachers were unable to score even 50 per cent in the same Math test, While a mere 31 per cent managed to get more than 75 per cent despite reliance on textbooks and collaboration with other colleagues in some instances."

The Annual Status of Education Report also reports performance measurement of Class 5 students for the years 2011 to 2013, shows the following.

In 2011, 53% of rural students and 41% of urban students could not read sentences in Urdu/Sindhi/Pashto. With respect to English, 59% of rural students and 33% of urban students could not read sentences. And with

respect to Arithmetic, 63% of rural students and 50% of urban students could not perform Division sums.

		Ability to read sentences(Urdu/Sindhi/Pashto)	Ability to read sentences(English)	Ability to perform Division
2011	Rural	47.4	40.6	37.3
	Urban	59.2	66.5	50.0
2012	Rural	50.9	48.0	43.8
	Urban	59.6	60.1	52.8
2013	Rural	49.8	43.3	43.2
	Urban	55.2	59.2	51.1

Source: ASER- Annual Status of Education Report

In 2013, 50% of rural students and 45% of urban students could not read sentences in Urdu/Sindhi/Pashto. With respect to English, 57% of rural students and 41% of urban students could not read sentences. And with respect to Arithmetic, 57% of rural students and 49% of urban students could not perform Division sums. The performance level in languages of urban students appears to have declined over 2011.

Similarly, the Asian Development Bank provided a US$ 330 million loan titled "Access to Justice Program" in December 2001. Other than better white-washed court houses, better furniture and better stationery, no visible improvement in dispensation of justice is visible.

Conclusion

Program loans for budgetary support have deepened the economic crisis and must be minimized. External creditors and donors must limit assistance to project funding. Pakistan' finance managers too need to learn to 'kick' the budgetary support addiction. That is how the first three decades of the county recorded impressive and meaningful growth and development as compared to mere growth rates in the last three decades.

Appendix 1:

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988	FY 1989	
Tax Revenue			39933	47370	56360	52681	58207	62241	89018	91249	
Surcharges										15009	
Non-Tax Revenue			10958	12546	16832	25095	35508	40013	32221	37251	
Capital Receipts (Net)			11811	18656	21701	25080	40213	35087	31365	26043	
External Resources			12400	14863	14539	14294	19962	23081	27282	45739	
Total Receipts			75103	93436	109433	117151	153892	160423	179888	215292	
Share of External Resources In Total Receipts (%)			16.5	15.9	13.3	12.2	13.0	14.4	15.2	21.2	15.2
	FY 1990	FY 1991	FY 1992	FY 1993	FY 1994	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	
Tax Revenue	106715	120600	143027	161651	183234	225000	262500	286000	297617	307950	
Surcharges	11050	13309	16347	12841	24979	21526	25091	24974	46930	73225	
Non-Tax Revenue	43336	50361	63499	75358	83929	77841	94331	77729	104619	120680	
Capital Receipts (Net)	45185	40351	30460	31971	35568	23832	33648	10740	22753	53417	
External Resources	39703	39315	57401	61582	87845	105690	110128	142643	141976	200082	
Total Receipts	245990	263938	310735	343405	415556	453891	525698	542088	613896	755356	
Share of External Resources In Total Receipts (%)	16.1	14.9	18.5	17.9	21.1	23.3	20.9	26.3	23.1	26.5	20.9
	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	
Tax Revenue	351600	406500	414200	458900	580108	626289	715712	839598	1005569	1180462	
Surcharges	36682	33000	53902	66882							
Non-Tax Revenue	131120	118450	164697	175794	180875	249017	306992	374445	393349	603141	
Capital Receipts (Net)	30854	94433	66866	100763	116127	79838	31731	63887	105485	69159	
External Resources	191301	221122	304026	169009	144820	197640	233914	276570	275406	367433	
Total Receipts	741559	873504	1003692	971348	1021930	1152784	1288349	1554500	1779809	2220195	
Share of External Resources in Total Receipts (%)	25.8	25.3	30.3	17.4	14.2	17.1	18.2	17.8	15.5	16.5	19.8

	FY 1994	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002		
Tax Revenue	183234	225000	262500	286000	297617	307950	351600	406500	414200		
Surcharges	24979	21526	25091	24974	46930	73225	36682	33000	53902		
Non-Tax Revenue	83929	77841	94331	77729	104619	120680	131120	118450	164697		
Capital Receipts (Net)	35568	23832	33648	10740	22753	53417	30854	94433	66866		
External Resources	87845	105690	110128	142643	141976	200082	191301	221122	304026		
Total Receipts	415556	453891	525698	542088	613896	755356	741559	873504	1003692		
Share of External Resources In Total Receipts (%)	21.1	23.3	20.9	26.3	23.1	26.5	25.8	25.3	30.3	24.7	24.7

Appendix 2

Rs. In billions

Fiscal Year	Current Expenditure	Share (%)	Development Expenditure	Share (%)	Total
1972-73	7.3	62.9	4.3	37.1	11.6
1973-74	10.9	64.1	6.1	35.9	17.0
1974-75	14.5	57.3	10.8	42.7	25.3
1975-76	14.9	50.5	14.6	49.5	29.5
1976-77	16.2	48.8	17	51.2	33.2
1977-78	20.1	52.8	18	47.2	38.1
1978-79	26.1	56.4	20.2	43.6	46.3

Rs. In billions

Fiscal Year	Current Expenditure	Share (%)	Development Expenditure	Share (%)	Total
1979-80	28.9	56.9	21.9	43.1	50.8
1980-81	31.8	54.6	26.4	45.4	58.2
1981-82	38.1	58.5	27	41.5	65.1
1982-83	51	64.3	28.3	35.7	79.3
1983-84	64.3	68.8	29.1	31.2	93.4
1984-85	70.8	67.7	33.8	32.3	104.6
1985-86	87.5	69.6	38.2	30.4	125.7
1986-87	105.6	70.4	44.5	29.6	150.1
1987-88	120.6	70.7	49.9	29.3	170.5
1988-89	135	70.9	55.3	29.1	190.3

Rs. In billions

Fiscal Year	Current Expenditure	Share (%)	Development Expenditure	Share (%)	Total
1989-90	159.8	74.4	55	25.6	214.8
1990-91	171.6	73.1	63	26.9	234.6
1991-92	198.9	71.5	79.1	28.5	278
1992-93	235.2	77.1	69.9	22.9	305.1
1993-94	272.2	78.6	74.1	21.4	346.3
1994-95	294.6	78.2	81.9	21.8	376.5
1995-96	353.2	80.2	87.2	19.8	440.4
1996-97	398.2	82.4	85.2	17.6	483.4
1997-98	456.6	83.7	89.1	16.3	545.7
1998-99	478.4	83.9	92.1	16.1	570.5

Rs. In billions

Fiscal Year	Current Expenditure	Share (%)	Development Expenditure	Share (%)	Total
1999-00	565.4	84.9	100.6	15.1	666
2000-01	579.7	85.0	102.1	15.0	681.8
2001-02	648.6	83.9	124.7	16.1	773.3
2002-03	673.3	83.7	131.6	16.3	804.9
2003-04	714	82.2	154.4	17.8	868.4
2004-05	784.7	79.5	202	20.5	986.7
2005-06	918.8	74.5	313.7	25.5	1232.5
2006-07	1,033.50	72.4	394.5	27.6	1428
2007-08	1,516.30	75.4	495	24.6	2011.3
2008-09	1,649.20	77.5	477.8	22.5	2127

Rs. In billions					
Fiscal Year	**Current Expenditure**	**Share (%)**	**Development Expenditure**	**Share (%)**	**Total**
1993-94	272.2	78.6	74.1	21.39763	346.3
1994-95	294.6	78.2	81.9	21.75299	376.5
1995-96	353.2	80.2	87.2	19.80018	440.4
1996-97	398.2	82.4	85.2	17.62516	483.4
1997-98	456.6	83.7	89.1	16.32765	545.7
1998-99	478.4	83.9	92.1	16.14373	570.5
1999-00	565.4	84.9	100.6	15.10511	666.0
2000-01	579.7	85.0	102.1	14.97507	681.8
2001-02	648.6	**83.9**	124.7	16.1257	773.3

Insidious Debt and Elusive Freedom: Normative Issues with Public Borrowing

by

Juvaria Jafri[1]

Introduction

The objective of this essay is to discuss, in a normative context, how policies that involve rising public debt may be questioned on the grounds that they limit economic freedom. Excess debt accumulation is of course an important policy concern in both developing and advanced economies because it is associated with issues such as low growth and high inflation. In fact, the case against high public debt is supported by so many arguments that it might seem odd that governments in both advanced and developing countries, particularly in the last decade or so, have continued to not only hold but also grow their debt burdens. It is hence relevant to consider the counter arguments, that is, the case for increasing public debt. This is rooted in the social liberal need for redistributive justice, and is especially noteworthy when considering the moral basis against public debt. The objective of this essay is to show how the redistributive purpose of public debt is prone to be overcome by governments that take on odious debt, practice financial repression, use the inflation tax, and compromise national sovereignty.

Public debt or government borrowing is a form of state intervention so the arguments for and against tend to rely on the differing perceptions of the role of the state. These are central to the development of classical, and subsequently, social liberal thought in the 18th century where the importance of individual freedom vis-a-vis social justice was debated by several political philosophers as well as economists including Adam Smith, Jean-Baptise Say, Thomas Malthus, and David Ricardo.

Classical liberalism is based on ideas of individual liberty and limited

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government. This eventually came to be known as distinct from social liberalism, which advocates a balance between individual liberty and social justice. This is the basis for government intervention. In relatively more recent times, among the more influential proponents of government intervention has been J.M Keynes who proposed expansionary fiscal policy as a way out of a high-unemployment equilibrium.[2]

The Keynesian view may be held partially responsible for the high levels of debt in both advanced and developing economies today. It also reflects the short-term aspect of what Elmendorf and Mankiw (1999) refer to as the conventional view of debt where a rise in debt results in an increased demand for output.

The long term aspect of the same view holds that debt results in reduced public savings and a consequent drop in the capital stock (Elmendorf and Mankiw, 1999).

Positive and normative approaches

The above description is an extremely brief synopsis of the implications of public debt from the standpoint of the tradition that is known as positive economics. This branch of the subject seeks to be objective and restricts itself to the description and explanation of economic phenomena. In the context of public debt the positive approach considers how and why public debt affects macroeconomic variables such as consumption, savings, investment, and so on.

A different approach is that of the tradition known as normative economics, which is subjective and value based. Given this approach and the context of public debt, it is pertinent to consider what ought to be done from the perspective of the policy maker responsible for intervening in the economy on behalf of the state.

Both positive and normative approaches are relevant to discussions on economic freedom, and this apparent in the existing literature. For instance, the literature on the former tends to regard economic freedom as an independent variable that shares a positive relationship with macroeconomic variables such as economic growth (Doucouliagos & Ulubasoglu, 2006), and foreign direct investment (Bengoa and Sanchez-Robles, 2003).

[2] In "The General Theory of Employment, Interest and Money" which was first published in 1936.

The normative literature tends to see economic freedom as an extension of individual freedom and hence draws heavily upon classical liberal thought, including the works of John Locke and Adam Smith.[3] In this context, economic freedom is regarded as having intrinsic value; so it may be regarded not just as a means towards the achievement of ends such as higher growth or investment, but as an end unto itself. More recently, arguments made by Knut Wicksell in the eighteenth century and developed by James Buchanan after 1948[4] and Amartya Sen also emphasize the importance of economic freedom as something that holds its own inherent value.

Buchanan (1989) describes the contribution of Wicksell as a challenge to the "orthodoxy of public finance theory". According to Wicksell, cited in Buchanan (1989); ... "whether the benefits of the proposed activity to the individual citizens would be greater than its cost to them, no one can judge this better than the individuals themselves." Building on this, it is argued that there is a lack of consent, when debt burdens arising from the deficit financing and the welfare state are planned so that they are borne by generations separate from those that incurred the debt (Buchanan, 1989).

Amartya Sen is in recent times, perhaps one of the most influential proponents of the intrinsic value of freedom, based on his critique of dominant approaches have tended to equate development to per capita, food security to food availability; and seen poverty only as income deprivation (Vizard, 2001). His emphasis is not on economic freedom; rather it is focused on political and civil freedoms which tend to be compromised through approaches that are evaluated based on market outcomes. Nevertheless, his work is extremely relevant to the concept of economic freedom because it gives prominence to human ends and also because it has facilitated a paradigm shift particularly in the area of development economics.

Measurement through indices

Since the 1990's a number of attempts have been made to quantify economic freedom through the construction of indices (Gwartney and Lawson, 2003). These have tended to be based on measurements of what are

[3] John Tomasi presents a "The Moral Case for Economic Liberty in http://www.heritage.org/index/book/chapter-3

[4] Wicksell's influence on Buchanan is the topic of the latter's lecture to the memory of Alfred Nobel, December 8, 1986. This is available online at http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1986/buchanan-lecture.html

considered to be fundamentals of economic freedom. Some instances include personal choice, voluntary exchange, freedom to compete, and protection of person and property.[5]

Among the most widely used indices measuring economic freedom are the Economic Freedom of the World Index or EFW, and the Index of Economic Freedom or IEF. Gwartney and Lawson note that both of these have been updated on an annual basis since 1996 and 1995 respectively (2003). The EFW is prepared by the Fraser Institute the IEW is prepared by the Heritage Foundation/WSJ.

Economic freedom and public debt

Neither of these indices includes a measure of public debt, although measurements of variables that have been known to share a close relationship with public debt have been included in the EFW and the IEF both. These include:

Size of Government: Expenditures, Taxes, and Enterprises

This is the first of the five areas that the EFW index measures, and focuses on government consumption, transfers and subsidies. Because it does not explicitly measure the occurrence or size of budget deficits which may arise from government intervention, it is at best an indirect indicator of the extent to which economic freedom is compromised from public debt. A similar measure is used by the IEF. This is discussed later in this section and attempts to draw a more explicit linkage between economic freedom, budget deficits, and government spending.

Sound Money

This is the third of five areas that the EFW is comprised of. It highlights the issue of inflation which reduces economic freedom by distorting relative prices, changing the terms of contracts and constraining future planning (Gwartney and Lawson, 2003). The occurrence of inflation is directly attributable to the government when intra-temporal budgetary deficits are addressed through seigniorage.

Freedom to Trade Internationally

This is the fourth EFW measure and is based on the contention that vol-

[5] These are specifically associated with the Economic Freedom of the World (EFW) index which along with the Heritage/WSJ Index of Economic Freedom is one of the two most widely used measures of economic freedom.

untary exchange benefits all those involved. When the country holds foreign debt the issue of economic freedom tends to acquire an additional dimension; this extends beyond the matter of the protectionist-influenced trade restrictions of various sorts that exist in virtually every country. Sjaastad (1983, cited in Reisen 1989) notes that the debt servicing becomes problematic as the largest share debt is owed by governments whereas countries' export earnings and most of their foreign assets are usually in private hands. So, governments tend to use measures that often "depress private savings, exports, and growth, instead of pursuing policies that promote them" (Reisen, 1989).

Regulation

This is the fifth area and contains a component that focuses on the domestic credit market and the extent to which freedom of exchange is possible. This relates to public debt in the context of financial repression, which according to Reinhart, Kirkegaard, and Sbrancia (2011) has historically been applied to reduce debt-GDP ratios, and has been resurgent in recent times given large public debt increases in advanced economies. Financial repression, which refers to government led market manipulation to push down debt financing costs, may appear in a number of forms, either explicitly or implicitly. Some instances include caps on interest rates, regulation of international capital movements, and heavy government involvement in the banking sector.

Government Spending

This component is from the Limited Government category of the IEF. The authors of this index note that "excessive government spending that causes chronic budget deficits and the accumulation of sovereign debt is one of the most serious drags on economic dynamism" (Miller, Holmes, and Kim, 2013).

Monetary Freedom

This is included in the IEF under Regulatory Efficiency. It measures the extent to which inflation and price controls distort market activity. Like the measure of Sound Money in the EFW, it is related to public debt when seigniorage is used to plug deficits.

Trade Freedom

This component is from the Open Markets category of the IEF and seeks to assess the extent to which trade barriers hinder the import and export

of goods and services. Like the EFW measure related to international trade, this relates to issues that arise when debt servicing results in reliance on private sector foreign currency earnings.

Investment Freedom

This is also a component of the IEF Open Markets category and measures the extent to which foreign and domestic investment capital is controlled through the presence of constraints foreign exchange restrictions, labour regulations, corruption, red tape, poor infrastructure, and political instability. Like Trade Freedom, it relates to external debt and its servicing and repayment.

Financial Freedom

This is also a component of the IEF Open Markets category and is addressed in a similar manner through the Regulation measure of the EFW. Because it too measures government involvement in the financial sector it reflects the extent to which a government may use financially repressive policies that distort market activity and limit the freedom of exchange.

The Benevolent Planner Problem

Based on the above, it may be noted that although existing measures of economic freedom capture the impact of public debt, this is so only a limited extent. The political economy of public finance indicates that there is a basis for raising the emphasis on public debt as a hindrance to economic freedom. There are a number of problems that are associated with high public debt, whether it is raised externally or locally.

National sovereignty

Very often, when countries accept external aid, there is a dramatic erosion of domestic authority. The issue of national sovereignty is highlighted by the deterioration of the state (Plank, 1993). In such circumstances, donors, foreign consultants, and non-governmental organisations assume responsibilities previously reserved for the state, and frequently apply conditionalities that must be incorporated, or form the core of government policy. As mentioned earlier, external debt is complicated by the fact that much of the foreign debt is owed by the public sector, whereas export earnings and an important part of foreign assets are owned by the private sector

Odious Debt

Kremer and Jayachandran (2002) note that one of the two arguments[6] in favour of sovereign debt relief is that some debts may be considered illegitimate because they were undertaken under dubious circumstances or with doubtful intent. This is the doctrine of "odious debt" which olds that new regimes should not be responsible for debts incurred by old ones, particularly when rulers in the past are known to have been corrupt and/or inclined to make poor decisions on how loans should be utilized. The argument extended here is analogous to one extended by individuals who do not feel entitled to repay what has been borrowed illegitimately in their name. Similarly, in corporate law, companies are not compelled to honour contracts negotiated by an executive without authority.

The historical precedent for this view was set in the early 20th century when the United States argued that neither Cuba nor the United States should be responsible for debt incurred by the colonial Spanish government (Ginsburg and Ulen, 2007). More recently, a similar discussion was held in the Iraqi context when the Saddam Hussein regime was overthrown by a US led coalition. Another instance of such an argument was presented in Pakistan in August 2014 during anti-government protests lead by the Pakistan Tehreek-e-Insaaf party, when party leader Imran Khan p-urged the IMF and World Bank not to lend to the Nawaz Sharif government on the basis that they were elected through poll rigging and that the people should not be liable for their loans.

Inflation taxation

As Sargent and Wallace (1981) point out, fiscal dominance results in inflation even when monetary policy is tight. This is so because a finite amount of demand for government bonds ensures that there will be discrepancies between the interest on government bonds and the rate of economic growth, resulting in rising price levels.

Strategic Deficit Bias

The issue of strategic deficit bias has been highlighted by Alesina and Tabellini (1990), who use econometric techniques to show how outgoing governments might use debt strategically to constrain incoming regimes. Such a contention assumes that the interests of the policymaker

[6] The other rationale is that some countries are simply too poor to repay off their debt "at least without inflicting great harm on their people" (Kremer and Jayachandran, 2002)

are not aligned with those of the public. Strategic debt bias has inflationary consequences as incumbent regimes are prone to plug deficits through seigniorage.

Intergenerational equity

Among the earliest critiques of public finance theory is the one that emphasizes intergenerational equity. There is an issue of consent when debt burdens arising from deficit financing and the welfare state are planned so that they are borne by generations separate from those that incurred the debt. Rising debt has various implications for future generations. Among these are more inflation and less fiscal stability. Calmfors (2011) notes that the value judgment behind what might be considered an equitable distribution of welfare across generations is based on a commonly accepted view; that every generation should be responsible for its own costs.

Financial repression

Financial repression is when governments manipulate markets to hold down the cost of financing debt. One of the goals of a financially repressive policy is to keep nominal interests rates artificially low, and very often this creates what has been called a 'home biasii', where countries look to a captive domestic market to finance public debt (Reinhart et. al, 2011). This may be achieved through directed lending to the government by domestic institutions (such as pension funds or banks), and also explicit/ implicit interest rate caps, regulation of international capital movements, and tighter connection between government and banks; explicitly through public ownership or moral suasion.

Calmfors (2011) provides some reasons for the excessive accumulation of debt. This provides a useful context in which to place the arguments discussed earlier in this paper.

Explanations for excessive government debt accumulation

Explanation	Related issues	Discussion
Insufficient understanding.	Issues of national sovereignty	A flawed understanding of the requirements of future policy, particularly of the need for future primary surpluses is likely to result in excessive debt accumulation. More specifically, it is possible that policymakers and the public are overoptimistic and overconfident about the macroeconomic environment, and about the impact of potential future shocks. This is especially relevant given external debts where countries leave their repayment schedules exposed to foreign currency fluctuations which have exogenous causes.
Politicians acting in their own interest.	Strategic debt bias and financial repression	An inadequate degree of fiscal transparency or poor knowledge about the functioning of the economy might cause voters to overlook rent seeking behaviour from politicians. Particularly, procyclical policies might be used when the public expects higher government spending and lower taxes during better times. Also, governments are inclined towards the ends of their terms to spend more to increase chances of re-election, and also to constrain future regimes in case their re-election bid is unsuccessful. Even within a democratic framework then, regimes are hampered in their fiscal policy.

Shortsightedness.	Intergenerational inequity	In addition to rent-seeking behaviour, when the interests of politicians are not aligned with those of voters it is likely that they will make decisions based on the assumption that the future burden of current deficits will be passed on to other players if the profligate regime is not re-elected. In an extension of this situation, the issue of intergenerational inequity arises, based on the premise that each generation should only be responsible for its own costs, and not those of preceding generations.
Time inconsistency.	Inflation taxation	The issue of time inconsistency arises because of the expectation that the policymaker will not follow the plan that is announced initially. Because of this tendency, private sector behaviour will be based on expectations of what policy will actually be followed. So even though a government has induced low expectations of inflation through policy, later on it will be inclined to inflate to reduce unemployment as doing so now involves a lower cost than previously.

Common pool problems.	Disproportionate private sector burden from external debt	Common pool problems arise because government spending is directed towards specific groups even though the source of revenues is general. There is thus an issue of clearly defined rights regarding entitlement and this might cause overspending and excess debt. An instance of such a situation is when groups contest the imposition of a necessary fiscal adjustment in the hope that it gets passed onto another group. In the case of external debt, as noted earlier, much of the foreign debt is owed by the public sector, whereas export earnings and an important part of foreign assets are owned by the private sector.

Adapted from Calmfors (2011).

Conclusions

From this discussion it may be contended that the issue of excessive public debt accumulation should be considered beyond the context of its impact on other macroeconomic variables such as economic growth and inflation. Rather, there is basis to regard public debt as a hindrance to economic freedom, which may be regarded not just as a means to macroeconomic growth and stability, but also as in end in itself. Economic freedom tends to be inhibited when the full consequences of rising public, whether from external or domestic sources, is misunderstood. This is likely to occur when the assumption of the 'benevolent planner' behind does not apply. This paper has attempted to highlight some of the key issues that arise from such a flawed perception.

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Debt and Economic Growth: The case of Pakistan

by

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1. Introduction

At the beginning of the 21st century, heavy indebtedness is one of the major challenges for economic managers in Pakistan. Government can finance its budget and development efforts by borrowing or taxing the output. However, taxes tend to falsify the structure of relative prices; borrowing, if pushed beyond the carrying capacity of the economy, creates problems relating to equity, and it can cause a transfer of resources that tends to undermine growth.

As far as the relationship between external debt and economic growth is concerned, a reasonable level of borrowing is likely to enhance economic growth through capital accumulation and productivity growth (Chowdhuary, 2001). At the early stage of development, countries have small stocks of capital and they have limited investment opportunities. External borrowing for productive investment creates macroeconomic stability (Burnside, 2000). External debt has also been considered as capital invasion, having positive effect on domestic savings, investment and economic growth; it implies that foreign savings complement domestic savings to gratify for investment demand (Eaton, 1993). High level of accumulated debt has an adverse effect on the rate of investment and economic growth. Most broad validation of the adverse effect of debt is "debt overhang" effect (Krugman, 1988; Sachs, 1990; Karagol, 2002). The other channel through which debt obligations affect economic growth is known as "crowding out" effect (Karagol, 2002; Diaz-Alejandro, 1981).

However, various authors like Pattillo (2002) and (2004) remained unable to find evidence of a significant crowding out effect, while others (i.e. Chowdhury, 2004; Clements, 2003; Elbadawi, 1997) found that both

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debt burden and debt service obligations have reduced the investment and economic performance. By protecting bank balance sheets and profitability domestic debt can crowd in risky private sector investment (Barajas, 1999; 2000).

As such, investments are more proficient when compared with the investment associated with low risk. Most important concern about domestic debt is crowding out effect on private investment. When governments borrow domestically, they use domestic private savings, otherwise that may have been on hand for private sector lending. In turn, smaller residual pool of loanable funds become available in market to elevate the cost of capital for private borrowers. It results in dropping private investment demand, and therefore capital accumulation, growth, and welfare (Diamond, 1965). Domestic debt is also viewed as more expensive in comparison to concessionary external financing (Burguet, 1998). Consequently, interest load of domestic debt may absorb important government revenues and thus crowd out pro-poor and growth enhancing expenditures. High-yielding government domestic debt held by banks can make them self-satisfied about costs and decrease their efforts to mobilize deposits and fund private sector projects (Hauner, 2006).

This paper reviews literature, which explores the linkage between public debt and economic growth in Pakistan.

2. Literature Review

A number of studies have been done on the debt-economic growth relationship over the last two decades. Particularly, in the context of worldwide recession period of 1980-1983, which affected all the countries after the second oil crisis in 1979. Due to low goods prices, high real rates of interest and slow growth in the industrial countries, some debtor countries experienced debt-returning problems. Therefore, the period since 1982 has been portrayed as a period of debt overhang.

Levy and Chowdhury (1993) concluded that an increase in the public and publicly surefire external debt may indirectly depress the level of GNP by dispiriting capital formation and inspiring capital flight due to tax increase expectations. Cunningham (1993) found that debt burden has a negative effect on economic growth because of the impact on the productivity of labor and capital. In another study Sawada (1994), finds that heavily indebted countries (HICs) have debt overhang problems. Since their current external debts are above the expected present value

of the future returns.

Fosu (1996) argued that GDP growth is negatively prejudiced via a diminishing marginal productivity of capital. It was also estimated that on average a high debt country faces about one percentage reductions in GDP growth rate annually. Latter on Fosu (1999) concludes that negative relationship between economic growth and debt might be due to a poor performance of recipient country. Chowdhury (2001), Siddiqui and Malik (2001), Easterly (1999, 2001 and 2002), and Sen (2007), came to the same conclusion that external debt negatively affects economic growth.

Smyth and Hsing (1995), found that in early 1980s debt ratio increased but it was below 38.4, and debt-bank rolling stirred the economic growth. On the other hand, during 1986-1993, debt ratio increased from 40.7 percent to 50.9 percent. This ratio is above the (38.4) optimal debt ratio and it is expected to adversely affect the economic growth. In another comprehensive study, Patillo (2002), indicated that on average, external debt is 'growth-enhanced' up to about 160% of export to debt level, and 'growth-reducing' thereafter (i.e. the debt overhang range).

Blavy (2006) found that the threshold level of debt is 21% of GDP, below that level, debt is positively associated with productivity, but the constant for the "above threshold debt" becomes negative and significant. The total effect of high debt is significantly negative.

Cohen (1993) found that the level of debt does not explain the slowdown of investment in highly indebted developing countries. Warner (1992) suggests that the reasons behind the decline of investment in many of the heavily indebted countries are declining exports prices, high world interest rates, and lethargic growth.

Metwally (1994) found that capital invasions have a significant impact on the growth in Algeria, Egypt and Morocco. In a study on Kenyan economy, Maureen (2001) found that current debt streams stimulate investments while past debt accumulation dispirits the investment. Anwar (2002) concluded that if exports remain constant, then the depreciation directly increases the foreign debt in rupee and results in dramatic increase in debt service burden, lower economic growth and higher poverty level.

From the review of literature, it can be broadly guessed that divergent opinions exist on practically every aspect of the relationship of debt with key economic variables. Firstly, most of the studies on the subject fo-

cused on the relationship between external debt and economic growth, while neglecting the domestic debt entirely or mentioning it only partially. Unlike domestic debt, external debt is more difficult to service and repay. However, this is true only when the level of domestic debt is moderate, and not true when it is large and growing. Secondly, most of these studies have been conducted by using panel data. There are very limited studies on Pakistan on the impact of public debt on economic growth. This study will try to fill this gap and present meaningful results.

3. Assessing the Situation of Public Debt in Pakistan

In Pakistan, limited revenues and savings coupled with rising expenditures caused situation of persistent fiscal deficit over the years. The following significant points can be identified regarding public debt scenario in Pakistan:

- Firstly, incapacity of successive governments to reduce the fiscal deficit significantly, unproductive use of debt and motionless growth in real revenues intensified the debt problem in Pakistan.
- Secondly, rising public debt in Pakistan is largely contributed by factors like stagnant government revenues and high real cost of borrowing. Resultantly, sharp fluctuation in real cost of borrowing, dynamics of the growth in public debt also changed over time.
- Thirdly, debt problem cannot be isolated from broader issues of economic strategy and management especially policies regarding savings, exports, revenue, expenditure, etc.
- Lastly, due to rising expenditure on debt servicing, governments have always reduced development expenditure instead of reducing the current expenditure.

Pakistan's increasing debt servicing requirements during 1990s has wielded significant strain on fiscal management. To meet the commitments for external borrowings, Pakistan had to reduce size of the budget deficit to less than 5 % of GDP during 1990s. Revenue generation efforts were only partially successful, and Pakistan remained unable to generate adequate revenues to meet expenditures. Debt explosion coupled with higher fiscal and current account deficits resurfaced during 2008, and is more like a threatening syndrome for economic management that depicts that Pakistan has wasted the opportunity for sustainable growth. In the following section, this aspect will be explored in detail.

3.1. Data and Methodology

Akram (2011) has applied the framework developed by Cunningham to estimate the relationship between growth and debt. This section is based on the results drawn by Akram. Following the analogy of the inclusion of exports in production function, Cunningham (1993) introduced debt burden into the production function. This is because debt burden has important implications for the capital and labor productivity. A debt-inclusive production function can be written in the following form:

$$Y = A(K, L, Debt)$$

Where Y, K, L, debt and A are the measure of GDP, capital stock, labour force, public debt and other constant factors, respectively.

According to the Presbitero (2005), keeping in view the importance of investment, it is better to unscramble the analysis of public debt and economic growth in a two -step relationship: firstly, the direct links between public debt and economic growth are explored, and secondly, the relationship between public debt and investment is analyzed.

3.2. Estimation Methodology

To empirically test, the relationship between public debt and economic growth, time series data of Pakistan for the period of 1972-2009 has been used.

For the time series, in order to guard against spurious regression, the first step is to see whether the series is stationary or non-stationary; this is required to ensure that unit root tests are used. The time-series method used has the problem of settling at the very outset the issue of the stationarity of the data. The results of unit root test reveal that the model is a mixture of I(0) and I(I) variables, so most appropriate method for estimation in these circumstances is Autoregressive Distributed Lags Model (ARDL) Cointegration technique proposed by Pesran et. al (2001).

4. Growth Equation Results

The selection of maximum lag length is very important for F-test. We have only 36 observations with six parameters and the observations in the study are annual. For such short observations, as suggested by Pesran (2001), we have selected a maximum lag length of 2. According to the results, the F-statistic is greater than the upper bound critical val-

ues. It depicts that there exists a cointegrating relationship among the variables. After the existence of cointegration among the variables, the next step in the ARDL approach that determine the long-run coefficients for equation A. Schwarz Bayesian criterion (SBC) of the lag selection is utilized for finding out the optimal length for the long-run coefficients of Eq. (A).[i]

Table 1: Bound F Test Results for Pakistan

Lag length	F- Statistic value	Bound critical values		Significance level
		I(0)	I(1)	
2	6.188	3.15	4.43	1%
		2.45	3.61	5%
		2.12	3.23	10%

Table 2: Long Run Estimation Results (1,1,0,0,1,2)

Variable	Coefficient	Std. Error	t-Statistic
Constant	0.798221	0.190963	4.179970
KT(-1)	0.095112*	0.046206	2.058433
OP	0.089862*	0.046123	1.948336
ED_Y	-0.160239*	0.025842	-6.200679
DS_X(-1)	-0.004322	0.014070	-0.307201
DD_Y(-2)	-0.014205	0.014709	-0.965728
R-squared		0.995511	
Adjusted R-squared		0.994341	
F-statistic		850.1940	
Prob(F-statistic)		0.000000	
Serial Correlation LM test		1.845262	
P value of LM test		**0.1715**	

Note: *and ** represent significance at 5% and 10 % level, respectively

4.1 Long run Relationships

The above results show a negative relationship between external debt indicators and economic growth. We find that the negative relationship between per capita GDP in Pakistan and external debt as a percentage of GDP is significant. Debt servicing as a percentage of exports has insignificant relationship in Pakistan. It reveals that in Pakistan, The crowding out effect of external debt is not significant debt while overhang hypothesis seem to be significant. The effects of domestic debt are negative and insignificant relationship with per capita GDP. Domestic debt has both positive and negative effects on economic growth. However, according to (Del, 2003) macroeconomic stability and financial markets liberalization is a necessary condition for the domination of positive effects. The conventional wisdom is that investment enhances economic growth. Openness has positive and significant relationship with per capita GDP, and it supports the conventional wisdom that globalization and free trade promotes economic growth; Naqvi (2010) supported it. Diagnostic tests' results suggest a high value of R^2, revealing that overall goodness of fit of the model is satisfactory considering the number of variables. The F-Statistic measuring joint significance of all the regressors in the model is also statistically significant. There exists no serial correlation according to correlation LM test.

4.2 Short run Relationships

After the estimation of long run coefficients, the analysis of Error correction and estimation of short run coefficients is the final step in ARDL approach. According to the relevant theory, if there is cointegration among the variables then in the short-run error correction will also happen.

Table 3 showed that the existence of a stable long-run relationship among the variables is further confirmed by the significant error correction term (Bannerjee et al., 1998). Speed of adjustment represented by the coefficient of the error correction term. That is following a disturbance in the unrestricted model how quickly the variables returned backs to their long-run values. The results suggest that following a shock, approximately 72%, adjustment towards the long-run equilibrium is completed after one year.

Table 3: Error correction representation of the selected ARDL model

Variable	Coefficient	Std. Error	t-Statistic
Constant	0.00093	0.00429	0.21749
D(KT)	0.01339	0.05677	0.23577
D(KT(-1))	0.128012*	0.04776	2.68044
D(OP)	0.044413	0.032878	1.350842
D(ED_Y)	-0.18442*	0.03267	-5.64514
D(DS_X)	-0.01240**	0.00830	-1.49378
D(DS_X(-1))	-0.02656*	0.00668	-3.97391
D(DD_Y)	0.02269	0.01386	1.63723

Note: *, and ** denote significance at 5% and 10 % level, respectively

According to the results, the external debt as percentage of GDP has a negative and significant relationship in the short run. Debt servicing as a percentage of exports also has a negative and significant relationship in the short run with per capita GDP. On the other hand, domestic debt does not has a significant effect on per capita GDP in the short run. Similar to the long run investment that has a positive and significant effect on per capita GDP in the short run as well. On the other hand, openness has insignificant relationship with per capita GDP in the short run.

5. Investment Equation Results

In the following table, it is showed that F-statistics value was within the bound limits at 10% level of significance. So, these results are uncertain and from the results of error correction model the existence of the cointegration was determined. Long run relationship is determined and long run coefficients are estimated for equation **B**, after determination of cointegration among the variables. The optimal length of the long-run coefficients is found by using the lag selection criterion of SBC. Table 7 summarized the long-run results of investment equation.

Table 4: Bound F-test results

Lag length	F- Statistic value	Bound critical values		Significance level
		I(0)	I(1)	
2	**2.18**	3.15	4.43	**1%**
		2.45	3.61	**5%**
		2.12	3.23	**10%**

The above table showed that in the long-run external debt as percentage of GDP has a significant and negative relationship with investment and debt servicing as percentage of exports has a negative but significant relationship with investment. Combined results of the debt serving and impacts of public external debt show that in Pakistan, debt overhang is the major channel curtailing investment and per capita GDP. The domestic debt also seems to have a negative and significant relationship with investment. It is also evident from the results that per capita GDP has a positive and significant relationship with investment.

Table 5: Long Run Estimation Results (1,0,1,1,1,2)

Variable	Coefficient	Std. Error	t-Statistic
INF	0.082148*	0.022979	3.574845
ED_Y(-1)	-0.164481*	0.073332	-2.242953
DS_X(-1)	-0.010207	0.038837	-0.262823
DD_Y(-1)	-0.095909*	0.048019	-1.997317
YT(-2)	0.080666**	0.04478	1.801379
Constant	2.117185	0.666954	3.174409
R-squared		0.645456	
Adjusted R-squared		0.552966	
F-statistic		6.978675	
Prob (F-statistic)		0.000254	
Serial Correlation LM test		2.004280	
P value of LM test		0.1597	

Note:*, ** and *** denote significance at 1%, 5% and 10 % level, respectively

The short run coefficients of the model are estimated and results are presented in table 8.

Table 6: Error correction representation of the selected ARDL model (1,0,1,1,1,2)

Variable	Coefficient	Std. Error	t-Statistic
Constant	-0.02953	0.01504	-1.96324
D(KT(-1))	0.247017	0.15417	1.602239
D(INF)	0.034109	0.021647	1.575683
D(ED_Y)	-0.41422*	0.203461	-2.03586
D(ED_Y(-1))	-0.24726*	0.124859	-1.98033
D(DS_X)	-0.05105	0.036778	-1.38795
D(DS_X(-1))	-0.02393	0.027757	-0.86224
D(DD_Y)	0.033382	0.033803	0.987534
D(DD_Y(-1))	-0.04228	0.050002	-0.84557
D(YT)	-0.47572	0.560392	-0.8489
D(YT(-1))	0.538052*	0.285887	1.882046
D(YT(-2))	0.992588**	0.561617	1.767375
ECTK(-1)	-0.85042*	0.265804	-3.19944
R-squared		0.74623	
Adjusted R-squared		0.555902	
F-statistic		3.920766	
Prob(F-statistic)		0.006235	

Note: * And ** denote significance at 5% and 10 % level, respectively

The results suggest that following a shock, after one year, about 85% adjustment back towards the long-run equilibrium is completed.

From the above results, it can be concluded that debt variables have an insignificant relationship in the short run but a significant one in the long-run.

6. Conclusions and Recommendations

In Pakistan, both in the short run and in the long run, public external debt has a negative and significant relationship with per capita GDP and investment. Therefore, the results strongly confirm the existence of "Debt Overhang effects". On the *other* side, only in the short run, debt servicing has a negative and significant relationship with per capita GDP. However, from this evidence, we cannot infer the existence of the "crowding out effect" because debt servicing does not seem to significantly affect investment. Domestic debt has a negative and significant relationship with investment, suggesting that it has tended to crowd out private investment. However, domestic debt does not have significant relationship with per capita GDP; and that investment has a positive and significant relationship with per capita GDP.

Policy Implications

- This review of literature shows that openness is growth enhancing. However, efforts to accelerate economic growth through trade and openness, should be supplemented by pro-poor policies.
- Heavy reliance on external debt should be discouraged. Public external debt almost always results in deteriorating economic growth process, partly because it also adversely affects investment.
- Policy makers should not use domestic debt to finance the fiscal deficit rather efforts should be made to enhance revenue or reduce the current expenditure.

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(Endnotes)

[i]Per Capita GDP is denoted by Y, and the data was acquired from World Development Indicators (WDI), World Bank

Investment is denoted by K, and data was acquired from WDI

External debt is denoted by ED_Y, and data was acquired from Global Development Finance GDF (World Bank)

Domestic debt is denoted by DD_Y, and data was acquired from International financial statistics (IFS) of IMF.

Debt serving is denoted by DS_X, and data was acquired from GDF

Openness is denoted by OP, and the data was acquired from WDI

The data of export, import, and openness was acquired from WDI

Inflation is denoted by If and data was acquired from WDI

Method part

The basic equation showing the relationship between the economic growth and public debt can be represented by the following equation:

$$\Delta k_i\ t=\alpha+\gamma_i\ 1k_i\ (t\text{-}i)+\gamma_i\ 2inf_i\ (t\text{-}1)+\gamma_i\ 3yt_i\ (t\text{-}i)+\gamma_i\ 4[(ed_i\ y)]_i\ (t\text{-}1)+\gamma_i\ 5[(ds_i\ x)]_i\ (t\text{-}i)$$

…… Equation B.

α is an intercept, ε_t represent the error. Similarly, $\gamma_1 \ldots \gamma_6$ represents the coefficients in the long run. τ, β, ω, φ, π, σ, and θ are the dynamic coefficients for the short run. Inf, k, y, and op denote inflation, per capita GDP, and investment openness, respectively.

The domestic debt dd_y, external debt ed_y, debt servicing ds_x are used as percentage of GDP are used in the analysis and are the major indicators of the public debt. The long run and short run relationships have been derived from the above mentioned equations.

Speakers' Testimonials

"Excellent efforts to bring together economists to discuss Pakistan's growing debt burden." **Dr. Ashfaque Hassan Khan**, Dean, School of Social Sciences & Humanities, National University of Science & Technology.

"PRIME-Business Recorder National Debt Conference was a timely and relevant forum organized under the aegis of PRIME Institute, where useful deliberations were made for debt management options by leading economists of the country. I hope this dialogue can be sustained in future to serve as an effective source of information on debt policy decisions." **Rana Assad Amin,** Advisor Finance Division, Government of Pakistan.

"Debt management is critically important for the economy and the National Debt Conference organized by PRIME, first of its kind, is a very useful contribution to throwing light on various aspects of Pakistan's debt." **Dr. Kaiser Bengali**, Consultant for Economic Affairs, Government of Balochistan.

"The first National Debt Conference organised by PRIME and Business Recorder was truly path-breaking. For the first time, an issue that should be at the top of the policy-makers radar, but unfortunately is not, was brought to the public attention and into mainstream public debate via this initiative. This should be an annual feature." **Sakib Sherani**, CEO, Macroeconomic Insights (Pvt) Ltd.

"National Debt in Pakistan is a creeping problem. Debt growth has historically surpassed growth in Tax revenues, and lack of commercial distribution channels for public borrowings has made Government borrowing more expensive than the cost paid by prime private borrowers. This conference was important in drawing attention to ways in which debt growth can be reduced, debt management by Government made more efficient, and national savings applied more effectively for investment and growth." **Syed Salim Raza**, Former Governor, State Bank of Pakistan.

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Public Debt Management and Way Forward
PRIME-Business Recorder
National Debt Conference

Conference Proceedings and Selected Papers

Current report is a product of the PRIME-Business Recorder National Debt Conference held in Islamabad on October 25, 2014. Supported by Friedrich Naumann Foundation for Freedom, the objective behind the conference was to initiate an open and informed dialogue on the status of public debt in Pakistan and its consequences for the country's future.

State-Led Pilferage: The Case of Electricity Provision in Pakistan

This study analyzes the state led provision of electricity in Pakistan. It examines different aspects of the debate over public provision of this utility, process of tariff determination and the substantial costs associated with the entire system. It is authored by Shahid Mehmood.

Conditional Cash Transfers: Safety Net or Welfare Trap?

This study proposed that government may take short-term measures to achieve poverty alleviation but poverty cannot be eradicated by cash transfers, conditional or unconditional. The long-term and permanent solutions are required through which human capital is enhanced like vocational trainings and educational programmes so that the allocated budget can be utilized in the best possible manner. It is authored by Fizza Behzad.

Export Development Fund

"Export Development Fund: A Critical Analysis and Roadmap for Restructuring", highlights various factors which have led to misallocation and misappropriation of funds instead of boosting exports. It is authored by Sara Javed.

State Coercion and the Fledgling Enterprises in Sharaqpur Bazaar

This study demonstrates that by simplifying regulations, decreasing corruption, debottlenecking procedures, lowering tax rates and making it easier for them to own their business premises, a lot more businesses can be brought into the formal sector, than coercion, penalties, punitive taxes, heavy fines and demolition of buildings with earthmoving machinery can collectively bring because no amount of coercion can outsmart the acumen and ambition of an entrepreneur. It is authored by Asad Ullah.

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