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# How Much State is Good:

## Pakistan Under Another Debt Crisis


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# Executive Summary

It is a long held economic belief that higher level of public debt breeds risk for a country's economic and political freedom. Political freedom is compromised when the government borrows money from various International Financial Institutions (IFIs) and donor countries, while the economic freedom is jeopardized when the debt is serviced through printing of money, heavy taxation or further debts.

Pakistan's public debt plight is becoming increasingly unsustainable. In actuality, the public debt to GDP ratio stands at 66.3 percent as of 2018, with the stock of total public debt rising by Rs. 1.4 trillion during the first half of the current fiscal year. Presently, the debt servicing to revenue stands at 41 percent – exceeding the government established sustainability criterion of 30 percent.

Although debt can be conducive to growth and development, it can be detrimental if not put to optimal use – as has been the case in Pakistan. For most part, twin deficits have been responsible for the mounting debt burden. In particular, the burgeoning budget deficit has been the underlying factor in excessive government borrowings. The budget deficit and consequently the public debt has been increasing owing to plethora of factors such as inefficiencies of State-owned Enterprises, excessive administrative costs (current expenditures), poorly targeted infrastructure and welfare spending etc.

To make matters worse, the debt management strategy in Pakistan lacks in many aspects. There exists poor coordination among various debt management agencies in addition to lack of long-term planning and feasibility analysis. Moreover, there is weak coordination between foreign and domestic debt. These tend to be highly interlinked however, the agencies consider domestic debt management as a secondary work. Debt management is disconnected from overall macroeconomic policies such as fiscal and monetary policies and has essentially become a part of the larger problem of governance inefficiency.

In the backdrop of these problems, there is a need to reduce the twin deficits by striving for fiscal and monetary policy stability through curbing current expenditures, undertaking tax reforms and relying on non-debt creating inflows. Furthermore, debt management strategy needs to be improved through modification of borrowing strategy to explore cheap and efficient avenues of financing. Lastly, macroeconomic environment needs to be improved through increased investments in physical and human capital and better governance so as to enhance the debt carrying capacity.

## Overview

Ever since its inception, Pakistan has relied heavily on domestic and foreign resources to counter the soaring twin deficit (fiscal and trade deficit). A sustained pattern of external accounts and public finances was never maintained: consequently, public borrowing increased, resulting in escalating public debt and increased debt-servicing burden. From 1980s onwards, the level of debt stock and subsequent debt servicing increased and continued to balloon throughout successive decades up until now.

### *Historical Debt Analysis: Causes and Trend*

In 1971, domestic debt stood at Rs. 14 billion while external and public debt lingered at Rs. 16 billion and Rs. 30 billion respectively. However, owing to the oil price hike of 1973-74, Pakistan's external account deteriorated over a five year period of 1973-78. This led to an increase in public borrowing and Pakistan witnessed a surge in external indebtedness and debt servicing liabilities. By the end of this period, domestic debt stood at Rs. 41 billion while external and public debt lingered at Rs. 71 billion and Rs. 112 billion respectively.[1] The public debt to GDP ratio hovered around 63 percent (see Figure 1).

From 1978-81, the Rupee devalued which caused the country to seek loans to support its balance of payments deficit. During 1978-88 the public borrowing increased six folds owing to staggering fiscal deficit. The growth rate of debt was 17.7 percent during this period coupled with a steadily increasing cost of borrowing. This steady rise in interest rate was a consequence of costly borrowing from non-bank sources which primarily comprised national saving schemes. By the end of 1981, domestic debt stood at Rs. 58 billion, with external and public debt it totaled to Rs. 87 billion and Rs. 145 billion respectively.[2] However, public debt to GDP ratio fell to 52 percent (see Figure 1) owing to the increase in GDP.

Moreover, Pakistan received massive amounts in foreign aid[3] because of the cold war during the 1980s. The country became the 10th largest recipient of International Monetary Fund (IMF) and World Bank (WB) loans.[4] Over this period, a major chunk of government borrowing was done at rates lower than the market rates mainly because the interest rates were pre-dominantly, administratively determined. However in 1989, World Bank's financial sector

[1] Pakistan Economic Survey 2017-18, Ministry of Finance.
[2] Ibid.
[3] Foreign aid includes both, loans and grants, for our analysis however we consider loans only.
[4] Khan, M. A., & Ahmed, A. (2007). Foreign aid—blessing or curse: Evidence from Pakistan. *The Pakistan Development Review,* 215-240.

reforms were introduced which focused on complete market-based auctioning of government borrowing. This move was criticized as it made the real cost of public borrowing explicit and undermined the subsidization of public debt by the banking sector. The adverse trade balance coupled with increased dependency on IMF and unmanageable foreign borrowings added to the debt burden. As evident from Figure 1, the percentage of debt to GDP reached 77 percent by the end of 1988. In absolute terms, public debt stood at Rs. 523 billion whereas domestic and external debt stood at approximately Rs. 290 billion and Rs. 233 billion.[5]

The situation only deteriorated from here and according to data, the 1990s were the worst years in Pakistan's debt history. Not only did Zia's regime leave the succeeding government with heavy debt but also increased the country's dependency on Structural Adjustment loans. To make matters worse, economic slowdown, stunted growth in real revenues (due to inflation) and the lack of political willingness to control the growing fiscal deficit exacerbated the debt situation. The public debt to GDP ratio increased from 82 percent in 1989 to 100 percent in 1999 (see Figure 1). In 1998, an economic embargo was imposed on Pakistan in response to the nuclear tests and political instability which lasted for six months. The actual embargo was placed on armaments trade. Consequently, no new loans were received and so the additional borrowings remained low during the period 1998-2002 By the end of 1999, domestic debt accumulated to Rs.1,389 billion while external and total public debt measured at Rs. 1,557 billion and Rs. 2,946 billion respectively.[6]

With the onset of Musharraf's era (1999-2008), a staggering amount of over $15 billion was borrowed within the first four years.[7] Moreover, the 2005 earthquake resulted in the influx of massive foreign aid and loans such as the yen-loan assistance. In 2007, the currency devaluation caused the rupee value of the debt and liabilities to increase. By the end of Musharraf's regime, total public debt stood at Rs. 6.1 trillion while domestic and external debt lingered around Rs. 3.2 and 2.8 trillion.[8] On the other hand, public debt to GDP measured at 57 percent by 2008 (see Figure 1). Although, the Paris Club loan was rescheduled on quite decent terms, but the effort of lowering debt proved to be just a mirage.

As loans and foreign aid started to flow in due to the 2010 floods, Pakistan's debt situation further aggravated. By the end of 2013, total public debt reached Rs. 14.3 trillion in contrast to the domestic and external debt, which hovered at

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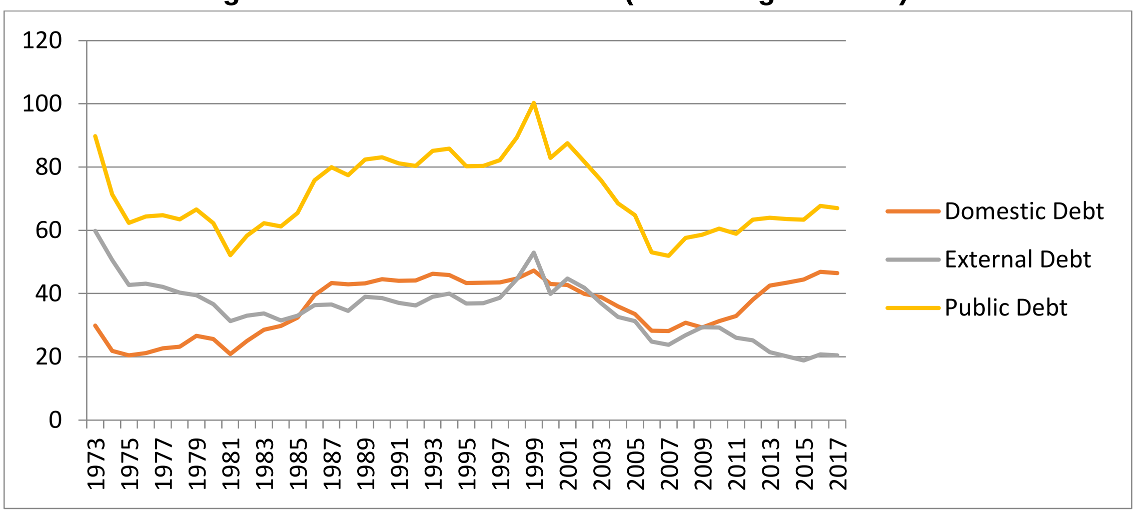
[5] Pakistan Economic Survey 2017-18, Ministry of Finance.
[6] Ibid.
[7] Naeem, T. (2007). Musharraf's Economic Deception. Date accessed: October 25, 2018. Retrieved: https://teeth.com.pk/blog/2007/12/05/musharraf%E2%80%99s-economic-deception-part-1/
[8] Ibid.

Rs. 9.5 trillion and Rs. 4.7 trillion respectively.[9] Moreover, public debt to GDP reached to 63 percent (see Figure 1). By the end of 2018, total public debt is expected to reach Rs. 22.8 trillion, on the other hand, domestic and external debt to Rs. 15.4 trillion and Rs. 7.3 trillion respectively.[10] Currently, public debt to GDP ratio stands at 72 percent[11] owing to circular debt, CPEC and debt servicing.

Figure 1 depicts the trends in public debt for the period 1973-2017. As evident, public borrowing remained high throughout the period under consideration. Noticeably, the increase in domestic, external and public debt as a percentage of GDP was relatively sharper in the 90s decade.

**Figure 1: Trend of Public Debt (Percentage of GDP)**




Source: Pakistan Economic Survey (2017-18) and Author's Calculations.

[9] Ibid.
[10] Pakistan Economic Survey 2017-18, Ministry of Finance.
[11] Debt and Liabilities Report 2018, State Bank of Pakistan.

## Analysis of Government Size and Debt

Generally, size of the government can be assessed in terms of number of employees and fiscal indicators such as total expenditure and revenues.

### *Number of Employees*

With respect to number of employees, between 2001 and 2011, the actual and sanctioned strength of government employees depicted a mixed trend. Precisely, in the first seven years from 2001-08, the actual and sanctioned strength of federal government employees remained low at 0.12 and 0.41 percent respectively. However in the subsequent years, the actual strength increased to 0.63 percent and the sanctioned strength to 1.86 percent.[12] This slow growth in actual strength between 2001 and 2007 can be attributed to the austerity measures undertaken by the government which included the ban on further recruitment of government employees. However, in the years preceding 2011, the employment situation improved as the actual and sanctioned employee strength rose to 5.81 percent and 6.07 percent[13] mainly due to increased awareness of public sector employment opportunities, favorable job conditions and restructuring of public sector organizations (see Figure 2).

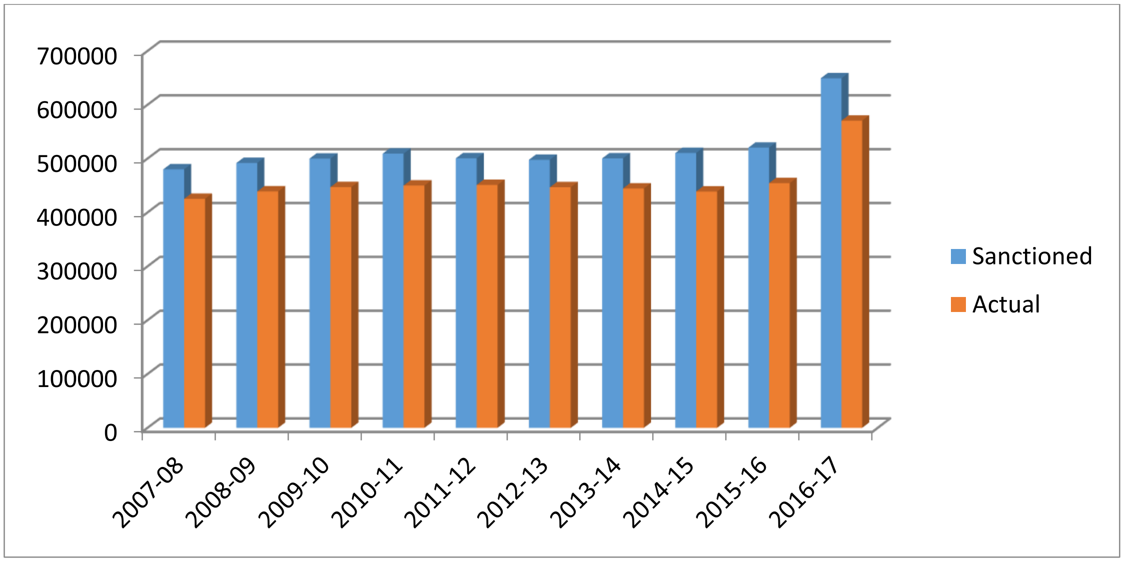
In 2012, the size of government with respect to actual and sanctioned strength was 446,816 and 497,846 while in 2013 it was 444,521 and 500,382[14], exhibiting a decrease of 0.51 percent in the actual strength and an increase of 0.51 percent in the sanctioned strength. In the year 2014, a fall of 1.26 percent was observed in actual employee strength as a result of ban on new entrants in government sector, retirement and death cases. In absolute terms, size of federal government stood at 438,921 and 510,455[15] with respect to actual and sanctioned strength (see Figure 2).

During 2015, actual strength of government employees rose by 3.55 percent while sanctioned strength witnessed an increase of 1.94 percent. In terms of absolute numbers, government size hovered around 454,517 and 520,382[16] with respect to actual and sanctioned strength. In 2016, the actual and sanctioned strength observed a growth of 25 percent and 24 percent respectively. The federal government's size increased to 570,553 and 649,176[17] in terms of actual and sanctioned strength. Figure 2 depicts the trend of actual and sanctioned strength of employees. Apparently, there is a growing trend over

[12] Annual Statistical Bulletin of Federal Government Employees 2010-11.
[13] Ibid.
[14] Annual Statistical Bulletin of Federal Government Employees 2012-13.
[15] Annual Statistical Bulletin of Federal Government Employees 2014-15.
[16] Annual Statistical Bulletin of Federal Government Employees 2015-16.
[17] Annual Statistical Bulletin of Federal Government Employees 2016-17.

the last ten years in the actual and sanctioned employee strength, indicating an increase in the administrative costs. Since the revenues have not increased proportionately over the years (see Figure 3), the government borrowing (debt) has increased to finance the rising administrative costs (non-development expenditures).

**Figure 2: Trend of Actual and Sanctioned Strength of Employees**



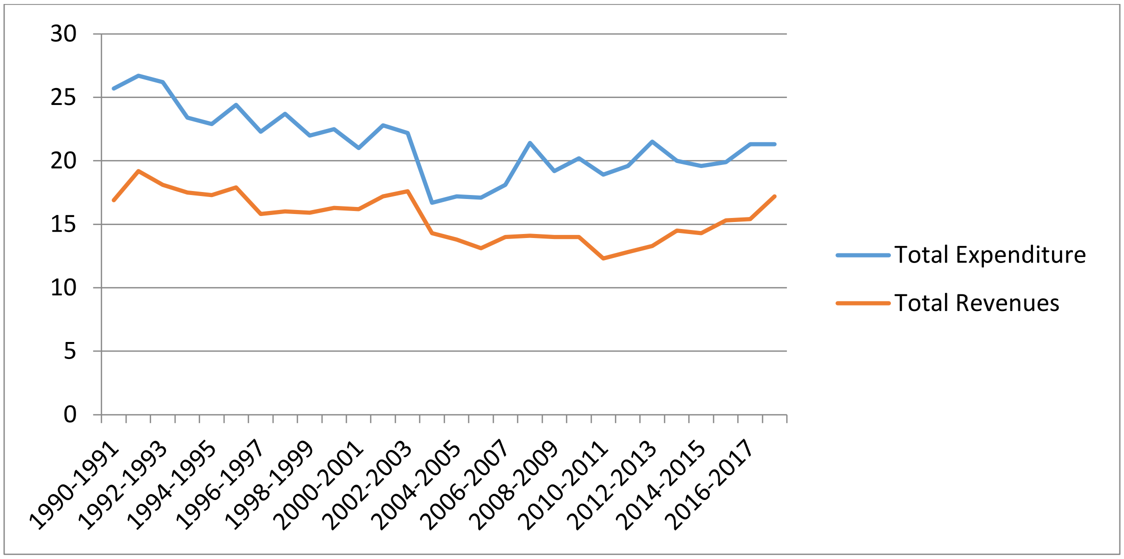

Source: Annual Statistical Bulletin of Federal Government Employees 2016-17.

## *Revenues and Expenditures*

Ever since Pakistan's inception its expenditures, for most part, exceeded its revenues. Thus, the prevalence of high fiscal deficit over several decades contributed significantly to raising public debt. The borrowings from internal and external sources increased to fill the resource gap. Over the years, Pakistan's revenue generating capacity failed to improve (see Figure 3) leading to deterioration of the debt repayment ability.

Figure 3 depicts the trend of government revenues and expenditures for the period 1990-2017. As evident, the expenditures remained higher than the revenues throughout the period under consideration. While remaining high throughout the period, fiscal deficit was minimum during 2002-03. The reason being, during the FY03, development expenses were cut down significantly. Another obvious notion from Figure 3 is, greater the size of government in terms of revenues and expenditures, greater the fiscal deficit and consequently public debt (see Figure 1).

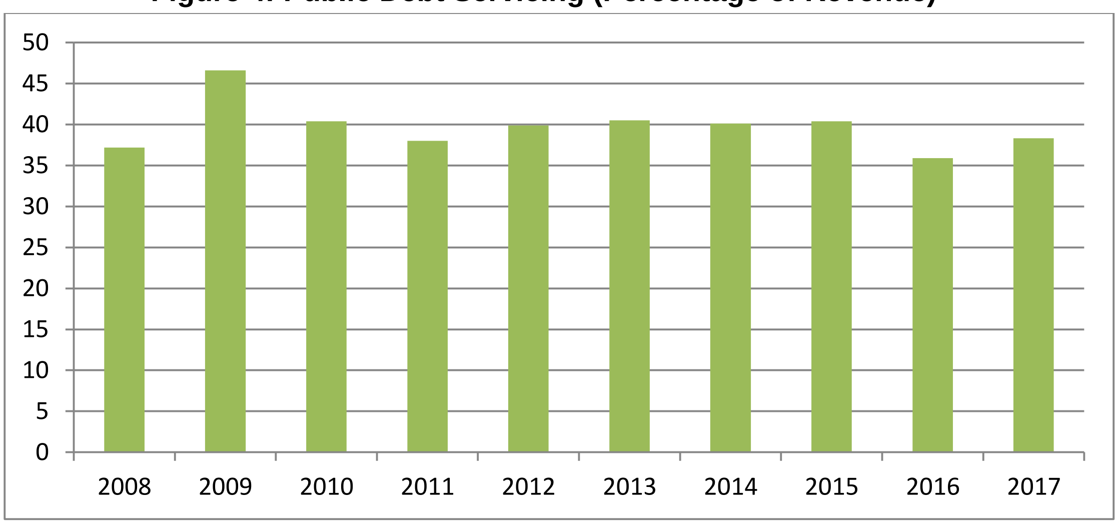
**Figure 3: Fiscal Indicators (Percentage of GDP)**




Source: Pakistan Economic Survey (Various Issues).

Hence, fiscal deficit and public debt are correlated and their causality has considerably increased over the years. Consequently, the country is faced with mounting burden of debt servicing. Each year, debt servicing liability accounts for a major portion of the Federal budget.[18] In order to analyze a country's debt servicing capability, it is imperative to compare the debt service to its repayment capacity over a period.

**Figure 4: Public Debt Servicing (Percentage of Revenue)**



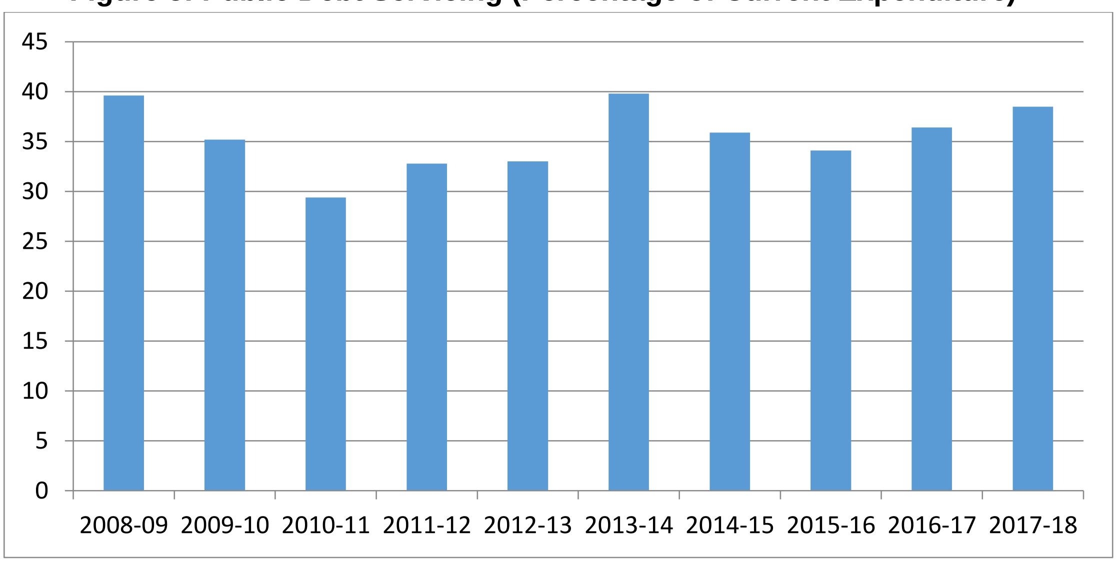

Source: Budget Wing and Debt Policy Coordination Office, Ministry of Finance.

[18] Ishfaq and Chaudhary (1999). Fiscal Deficits and Debt Dimensions of Pakistan. *The Pakistan Development Review.* 38(4).

Figure 4 shows the debt servicing as a percentage of revenue for the period 2008-2017. Apparently, debt servicing exceeds the 35 percent mark throughout the period under review, with the highest (46 percent) being in 2009. Thus, debt servicing liabilities consume a significant fraction of the total revenues.

In addition to revenues, a major part of current expenditure constitutes debt servicing. Current expenditure comprises of expenditure on defense and general public services. The latter entails pensions, grants and annuities as well as markup payments on domestic and foreign debt. Figure 5 portrays public debt servicing as a percentage of current expenditure for the past 10 years and as evident, debt servicing accounts for approximately 33 to 40 percent of the current expenditures. In other words, Rs. 2.22 trillion is allocated for debt servicing in the FY 2018-19 leaving lesser resources for socioeconomic development. This is evident from that fact that only Rs. 25 billion and Rs 46.23 billion has been allocated for health and education under the PSDP, leaving the social sector a low priority area.[19]

**Figure 5: Public Debt Servicing (Percentage of Current Expenditure)**




Source: Budget Wing and Debt Policy Coordination Office, Ministry of Finance.

[19] Here is all you want to know about budget 2018-19. *The News.* Date accessed: November 2, 2018. Retrieved: https://www.thenews.com.pk/latest/310231-here-is-all-you-want-to-know-about-budget-2018-19

## Outflows of Government Spending

The major outflows of government spending in Pakistan are in the form of subsidies/guarantees to loss-making State-owned Enterprises (SOEs), administrative costs, infrastructure and welfare spending.[20]

### *Losses of State-owned Enterprises*

SOEs in Pakistan are engaged in the provision of important infrastructure and related services such as construction and transport. Unfortunately, they are a burden on the national exchequer as each year government provides substantial amounts in guarantees to keep them operational and cover their mounting losses. Top three loss-making SOEs include Pakistan International Airlines (PIA), Pakistan Railways and Pakistan Steel Mills (PSM) which are being operated inefficiently (see Table 1). For instance, during the last four years, PIA accumulated losses of over Rs. 146 billion, forcing it to abandon some of its important routes. The airline suffers from overstaffing whereby, on average, 700 employees are hired per aircraft thus surpassing the world average of 70 to 80 employees per aircraft.[21] On the other hand, despite recent improvement in its services, Pakistan Railways suffered a loss of almost Rs. 26 billion in 2016. On the same lines, PSM has been accumulating losses in spite of massive injections by the government to clear its liabilities.

This routine of losses is being financed through guarantees (contingent liabilities) and bailout funds by the government. However, a major drawback related with contingent liabilities is the fiscal cost. Over the years, these liabilities have constrained the government resources leading to a higher debt to GDP ratio. Table 2 reveals the total debt accrued by the three major loss-making SOEs and as evident through statistics, is on the rise.

**Table 1: Top Three Loss-making SOEs**

| Net Losses (Rs. in Billion) | | | |
|---|---|---|---|
| **Years** | **Railway** | **PIA** | **Pakistan Steel Mills** |
| 2012-13 | 30.5 | 45.1 | 28.4 |
| 2013-14 | 32.5 | 30.7 | 25.8 |
| 2014-15 | 27.2 | 32.1 | 25.7 |

Source: State-Owned Entities Performance Review 2014-15, Ministry of Finance.

[20] Handbook of Statistics on Pakistan Economy 2015.
[21] PIA overstaffing 2016. Dawn. Date accessed: November 2, 2018. Retrieved: https://www.dawn.com/news/1240650

**Table 2: Total Outstanding Debt of SOEs**

| (Rs. in Billion) | | | |
|---|---|---|---|
| **Years** | **PIA** | **PSM** | **Railways** |
| 2012-13 | 48.3 | 25 | 83.0 |
| 2013-14 | 61.1 | 36 | 76.2 |
| 2014-15 | 67.6 | 39.7 | 81.3 |
| 2015-16 | 78.7 | 42.3 | - |

Source: SOE Performance Review, Ministry of Finance and State Bank of Pakistan Annual Report 2016-17.

### *Administrative Costs*

The current expenditures have witnessed an increase over the years (see Figure 6). Essentially, current expenditures comprise of mark-up on government borrowing, defense, running of civil government, pension, grants and subsidies. One of the major outlays of current expenditure is the administrative cost (running of civil government) which consists of salary, non-salary and other benefits.

From Table 3 it is apparent that the administrative expenditure has increased over the past five years. Since such an expense falls under the category of current or non-development expenditure, it has been partially responsible for the increased total current expenditures. Figure 6 compares the trend of current expenditures and payments made to public employees. As evident, both depict increasing trend thus adding to the fiscal deficit. The fiscal deficit in turn is financed through domestic borrowing hence exacerbating the domestic debt burden.[22]

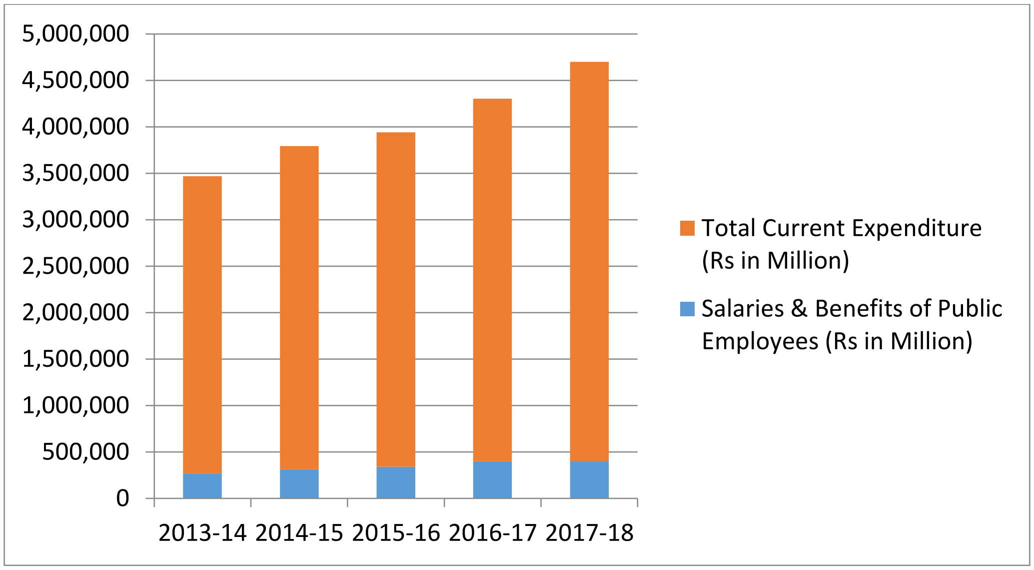
**Table 3: Public Administrative Expenditure**

| (Rs. in Million) | |
|---|---|
| **Years** | **Salaries & Benefits of Public Employees** |
| 2013-14 | 271,349 |
| 2014-15 | 313,294 |
| 2015-16 | 340,072 |
| 2016-17 | 398,822 |
| 2017-18 | 402,076 |

Source: Federal Budget (Various Issues), Ministry of Finance.

[22] Public Debt Chapter, Pakistan Economic Survey 2017-18, Ministry of Finance.

**Figure 6: Payments to Public Employees and Total Current Expenditure**




Source: Federal Budget (Various Issues), Ministry of Finance.

### *Infrastructure Spending*

Infrastructure spending essentially falls under the category of development expenditure. To finance development expenditure, government obtains loans and grants from foreign sources. Table 4 depicts the external loans and grants availed by the government for the purpose of capital and development expenditures. Apparently, these have increased in the years under review. The spending on roads, highways and bridges increased till 2016 after which a sharp decline has been observed (see Figure 7). This is mainly due to an increased spending on infrastructure under the China-Pakistan Economic Corridor (CPEC) starting in 2013. However recently, the extent has slowed down.

It is important to note that the spending under CPEC is being financed through external resources also, precisely, the Chinese loans worth $58 billion. These loans will have to be repaid starting 2025. Although the government propagates the multi-billion dollar initiative to be beneficial for the economy in terms of growth, employment generation and modernization of infrastructure and that the country would be able to payback the Chinese loans, however, this notion may not necessarily match with the ground reality as the current external debt which is Rs. 7,795.8 billion[23], is likely to double by 2025 owing to the debt servicing on existing loans and further borrowings for infrastructure under the CPEC.

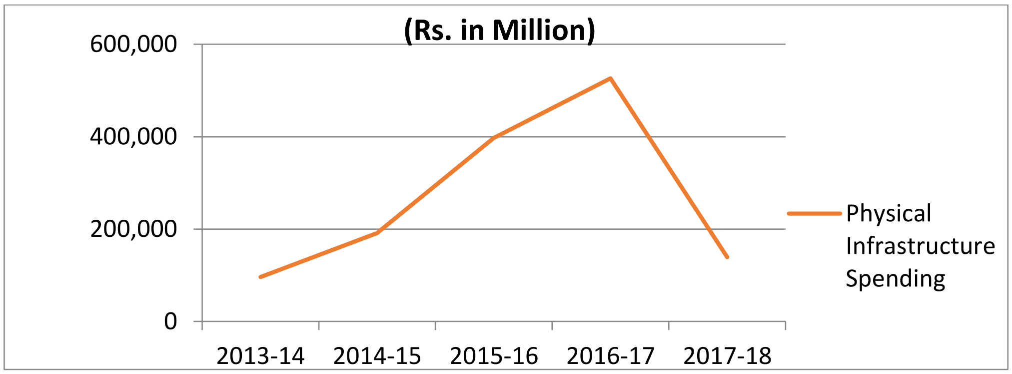
[23] Debt and Liabilities Report 2018, State Bank of Pakistan.

**Table 4: External Resources for Development Expenditures**

| (Rs. in Million) | |
|---|---|
| **Years** | **External Loans & Grants** |
| 2013-14 | 714,112 |
| 2014-15 | 692,687 |
| 2015-16 | 859,689 |
| 2016-17 | 996,287 |
| 2017-18 | 1,229,754 |

Source: Federal Budget (Various Issues). Ministry of Finance.

**Figure 7: Physical Infrastructure Spending**




Source: Pakistan Economic Survey 2017-18, Ministry of Finance.

## *Welfare Spending*

As far as welfare spending is concerned, Social Safety Net Programme (SSNP) is an ongoing project of the government which aims to support the vulnerable and the poor segments of the society through redistribution of economic resources. It includes both budgetary and non-budgetary programmes. The budgetary programme includes the Social Security and Welfare Spending which encompasses the Benazir Income Support Programme and Pakistan Bait-ul-Mal. Overall, the spending on social security and welfare shows an increasing trend between 2014 and 2017 after which there was a decline (see Table 5).

**Table 5: Welfare Spending**

| Years | Social Security and Welfare (Rs. in Billion) |
|---|---|
| 2013-14 | 29.7 |
| 2014-15 | 155.72 |
| 2015-16 | 173.53 |
| 2016-17 | 259.75 |
| 2017-18 | 111.74 |

Note: Social Security and Welfare includes the expenditure of BISP and PBM.
Source: Pakistan Economic Survey 2017-18, Ministry of Finance.

With the fiscal deficit at 4.1 percent[24] of GDP as of 2018, increasing expenditure on social safety programmes could further exacerbate the financial difficulties and debt burden of the government. This could partially explain as to why the welfare spending witnessed a decline after 2016 as the government tried to curtail current expenditure to cope with the soaring fiscal deficit. However, cutting down funds for social safety programmes might not be the most rational decision on government's part. This is because currently, there is no private sector solution available for catering to the needs of the poor and vulnerable groups at an extensive scale.

Though reducing fiscal deficit is crucial but the solution does not lie in curtailing welfare expenditures. There are various ways through which the government can raise revenues for welfare spending instead of relying on domestic borrowing. These include, but are not limited to, reducing SOE losses, reforming energy prices, increasing tax-to-GDP ratio, facilitating public-private partnership and improving economic governance to boost growth. Out of all these, public-private partnership has the greatest scope of generating fiscal space for welfare spending. For instance, substituting public investment and delivery of social services by private sector investment and delivery of social services can generate fiscal space for government's social welfare spending.

[24] Pakistan Economic Survey 2017-18, Ministry of Finance.

## Dynamics of Public Debt Servicing

### *External Debt*

Over the years, the trend of external loans and grants from multilateral agencies have remained mixed. Table 6 gives break up of foreign loans and grants received by federal government from multilateral agencies. These comprise of project loans and grants, programmes loans and other loans and grants. The project loans and grants availed from specialized international financial institutions are essentially used for purchasing project equipments, supplies and services. While programme loans are accrued for budgetary support and are linked to the achievement of specific goals. Other loans comprise of loans from Islamic Development Bank and are generated through Sukuk bonds, sovereign bonds etc. which are received through non-traditional sources for budgetary support and external account balance.

**Table 6: External Loans and Grants from Major Agencies**

| (Rs. in Billion) | | | | | |
|---|---|---|---|---|---|
| **Years** | **ADB** | **IBRD** | **IDA** | **IDB** | **IFAD** |
| 2013-14 | 86.3 | 74.6 | 80.8 | 68.3 | 1.4 |
| 2014-15 | 85.0 | 11.5 | 139.3 | 133.6 | 2.2 |
| 2015-16 | 133.9 | 14.0 | 179.5 | 114.6 | 2.4 |
| 2016-17 | 167.2 | 13.6 | 69.2 | 65.9 | 2.1 |
| 2017-18 | 102.7 | 25.9 | 69.7 | 146.3 | 1.8 |

Note: ADB denotes Asian Development Bank
IBRD denotes International Bank for Reconstruction and Development
IDA denotes International Development Association
IDB denotes Islamic Development Bank
IFAD denotes International Fund for Agriculture Development
Source: Federal Budget 2017-18, Ministry of Finance.

**Table 7: Public External Debt Servicing**

| (Rs. in Billion) | |
|---|---|
| **Years** | **External Debt Repayment** |
| 2014-15 | 64.1 |
| 2015-16 | 76.6 |
| 2016-17 | 84.6 |
| 2017-18 | 73.5 |

Source: Budget Wing and Debt Policy Coordination Office Staff Calculations, Ministry of Finance.

Each year the government repays part of the accumulated external debt, in this regard, Table 7 shows the external debt servicing from 2014 to 2017. The external debt servicing increased up until 2016. On average, the external debt repayment obligations of Pakistan are not more than $5.5 billion[25] per annum up until 2023. Keeping in view the track record of the country, the external debt repayments should not pose any serious concerns as the country has successfully met higher repayment obligations even with much lower foreign exchange reserves.

### *Domestic Debt*

As far as domestic debt is concerned, it comprises of permanent debt (medium and long- term), floating debt (short-term) and unfunded debt. Permanent debt encompasses market loans, federal government bonds and prize bonds. On the other hand, floating debt consists of Market Treasury Bills (MTBs), MTBs for replenishment of cash and outright sale of MRTBs to banks while unfunded debt includes GP Fund, postal life insurance and saving schemes.[26] Between 2013 and 2017, borrowings from deposit money banks and other financial institutions increased while borrowings from State Bank remained mixed: fluctuating during alternate years. Apparently, government accrues bulk of its domestic debt from commercial banks and State Bank of Pakistan (see Table 8).

**Table 8: Major Lenders of Domestic Debt**

| (Rs. in Billion) | | | |
|---|---|---|---|
| **Years** | **State Bank of Pakistan** | **Deposit Money Banks** | **Other Financial Institutions** |
| 2013 | 2322.3 | 3829.2 | 419.2 |
| 2014 | 2936.5 | 4034.7 | 551.8 |
| 2015 | 2325.7 | 5681.2 | 604.1 |
| 2016 | 2050.3 | 7036.7 | 659.2 |
| 2017 | 2521.5 | 7676.0 | 713.6 |

Source: Statistics & Data Warehouse Department, State Bank of Pakistan.

**Table 9: Public Domestic Debt Servicing**

| (Rs. in Billion) | |
|---|---|
| **Years** | **Domestic Debt Repayment** |
| 2013-14 | 855 |
| 2014-15 | 910.5 |
| 2015-16 | 1002.9 |
| 2016-17 | 1009.9 |
| 2017-18 | 678 |

Source: Budget Wing and Debt Policy Coordination Office Staff Calculations, Ministry of Finance.

25 Pakistan Economic Survey 2017-18, Ministry of Finance.
26 Ibid.

Each year the government repays part of the accumulated domestic debt. Since the volume of domestic debt is considerably larger than the external debt in the total public debt portfolio, the debt servicing is also relatively larger. Table 9 depicts the debt servicing on domestic debt which increased between 2013 and 2016 however, it witnessed a decline in 2017 owing to the budgetary constraints.

## Consequences of Public Debt

The rise in public debt to unsustainable levels can have serious implications for an economy. This is evident from the fact that over the years, high levels of domestic and foreign debt have deteriorated various socio-economic indicators of Pakistan. Some of the major implications are discussed below:

### *Lowers Growth and Investment*

According to an empirical study on Pakistan, public external debt has a significantly negative relationship with GDP per capita and investment - both in the short- and long-run.[27] These findings are in line with previous works of different academic scholars. For instance, Cunningham (1993) postulated debt burden to have a negative effect on economic growth by affecting the productivity of labor and capital. Similarly, 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. In another study Sawada (1994) found heavily indebted countries to have debt overhang problems mainly because their current external debts exceed the expected present value of the future returns.[28] The same appears to be looming in the case of Pakistan.

### *External Account Imbalances*

The $20 billion energy projects could potentially create pressures on external account starting 2019 onwards. The argument so goes that of that $20 billion, $14 billion might be spent on machinery imports such as turbines, generators, boilers etc. over the span of next 7 to 10 years. In addition to that, the fuel imports are 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 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 deteriorate the external account balance.

### *National Sovereignty at Stake*

Rising public debt also undermines the national sovereignty. Very often, when countries accept external aid, there is a dramatic erosion of domestic authority. In such circumstances, donors, foreign consultants, and non-governmental

[27] Khan (2014).
[28] Ibid.

organizations assume responsibilities previously reserved for the state, and frequently apply conditionalities that must be incorporated, or form the core of government policy. This is the reason many are skeptical about the IMF bailout packages that Pakistan has contracted in the past and is about to contract in the near future as they believe it shifts the priorities of the national government towards matters not requiring immediate attention.

### *Less Social Sector Spending*

Another serious consequence of rising public debt includes lesser allocations for social sector spending as increasingly higher budgetary allocations are made for debt servicing. Since investment in social sector is not directly productive, allocations for education and healthcare provision remain largely neglected in the budgeting process and fiscal considerations. This decelerates human capital development, with an indirect adverse impact on growth and productivity of new investment in physical capital. This has also been the case in Pakistan where the government spending on health and education has always remained dismal mainly due to the distorted priorities such as increased non-development/current expenditures that has contributed to rising public debt. Specifically, the estimated debt servicing on both domestic and foreign debt will consume 39 percent of the total revenue during 2018-19.[29] It is obvious that if more than one-third of the total revenue is being spent on interest payments and loan repayment then social sector spending is likely to decrease, let alone remain constant.

### *Increase in Taxation*

Rising debt burden also results in increase in taxation as the government has to meet the extra burden of interest costs and principal repayments. The increase in taxation results in increase in inflation as firms have to maintain their profits and viability. This rising inflation, increase in taxes and higher cost of debt significantly affects all areas of the economy, implying more and more taxes that are levied on the general public. This is evident from the fact that over the years, number and rates of taxes levied have increased in Pakistan as the state is making efforts to generate revenues to finance debt servicing.[30]

### *Crowding Out of Private Investment*

Public borrowing from domestic financial sources crowds out private sector investment as the required rate of return of private investors and lending institutions goes higher due to increased risks associated with default, thereby

[29] Anwar (2018).
[30] Khan (2018).

making the personal financing, housing and auto loans more expensive. Various studies have supported the crowding out hypothesis in case of Pakistan, see for instance, Shahid *et al.* (2016) and Zaheer *et al.* (2017).

### *Rising Unemployment*

The rising public debt is also giving birth to ‘discouraged worker’ effect in the country whereby individuals are getting out of the job market after remaining unemployed for considerable period. The capacity of the economy to generate new jobs is also being undermined by the escalating debt situation as it is hindering growth and investment prospects of the country.

## Debt Management Policy

The prime responsibility for managing debt lies with the Ministry of Finance. Its subsections such as the Economic Affairs Divisions (EAD) and Finance Division (FD) maintain the record of all the relevant information regarding debt. Specifically, the EAD tracks debt servicing, aid flows and allocation of funds received in grants, aids and borrowings. In contrast, the FD is liable for formulating the debt policy. Its Export Finance Wing plays a crucial role in formulating medium to long-term policies taking into account the nexus between debt-related variables such as borrowings and debt servicing. The State Bank of Pakistan also keeps record of debt-related data whereas the Central Directorate of National Savings maintains information on the public domestic debt accrued through National Savings Scheme.[31]

### *SWOT Analysis of Debt Management Policy*

It is pertinent to look at the strengths, weaknesses, opportunities and threats of the debt management strategy that is being pursued for the past several years.

### *Strengths*

The Medium Term Debt Management strategy made some positive developments, for instance:

- A reduction of over 150 basis points was attained in the average cost of gross public debt during the past years.
- An increase of Rs. 3.02 trillion was observed in the long-term domestic debt portfolio over the past four years.
- Despite the rise in the absolute stock of public debt, interest cost has remained constant over the last two years.
- Resultantly, government's interest expenditure as a percentage of its revenue witnessed a decline since 2012. Thus, not only the cost of debt portfolio decreased but the risk indicators have experienced an improvement over the medium term.

### *Weaknesses*

Debt management in Pakistan lacks in many aspects, for instance:

- There exists poor coordination among various debt management agencies. Consequently, agencies report differing figures for the same

[31] Ahmad, E. (2011). A Qualitative Analysis of Pakistan's External and Internal Debt. *The Lahore Journal of Economics.* 16.

- debt-related variables, adding to the confusion of the researchers and public alike.
- There is lack of long-term planning and feasibility analysis. These are given the least priority when it comes to policymaking and implementation.
- There is weak coordination between foreign and domestic debt. These tend to be highly interlinked however, the agencies consider domestic debt management as a secondary work while primarily focusing on ways to service foreign debt and minimize the default risk.
- National agencies tend to follow the harsh conditionalities imposed by international donor agencies without taking into account the ground realities.
- Vested interests and political motives overshadow the socioeconomic considerations.
- Debt management is disconnected from overall macroeconomic policies such as fiscal and monetary policies.
- Debt management has essentially become a part of the larger problem of governance inefficiency. The old patterns of governance coupled with lack of prudent approach to fiscal and debt management continue to be followed.

### *Opportunities*

Over the years, some opportunities have been created while numerous have been lost in terms of improving debt portfolio and its management, for instance:

- Following the debt crisis of early 1990s, government took couple of initiatives to articulate debt reduction and management strategies. In this regard, it set up a debt policy coordinating office in the Ministry of Finance in order to disseminate the debt management issues across relevant agencies and offer financial and economic advice where required.
- Opportunities to improve the debt management by acquiring management autonomy from the bureaucratic mindset in the public departments have never been availed.
- The opportunity to develop a debt market for long-term investment has not been exploited.
- The Fiscal Responsibility and Debt Limitation (FRDL) Act of 2005 was unable to deliver owing to the weak accountability measures on the demand and supply side which should have been the part of the law

- Due to the vested political interests and corruption, the previously acquired debt has not been used for development and welfare purposes. Thus, the opportunity to gain confidence of potential lenders has been lost.
- Pakistan has missed twice the deadline to submit its commitments under the Open Government Partnership (OGP) which is a multilateral initiative to promote transparency by bringing the government and citizens together.
- The opportunity to privatize State-owned Enterprises and reform Public Sector Enterprises is yet to be availed in order to minimize budget deficit and consequently, the debt burden.

### *Threats*

There are several socioeconomic threats associated with poor debt management, for instance:

- Debt burden is likely to have poverty implications as inflation could erode the purchasing power thus adversely affecting the poor segments of the society.
- Lack of prudent approach to debt management is likely to restrain growth as the high debt servicing costs result in reduced development expenditures.
- Rising debt burden is expected to depress the investment climate as uncertainties rise.
- The external debt servicing that falls due every year amount to $6 billion on average and is likely to consume a major chunk of foreign exchange earnings leaving behind meagre amount for imports.
- Improper management of debt is projected to enhance the likelihood of sovereign bankruptcy.
- Increasing public debt is likely to exert downward pressure on exchange rate, encourage capital outflow and result in sub-optimal tax collections.

## Concluding Remarks and the Way Forward

Over the years, serious concerns have been raised regarding hasty borrowings from domestic and foreign entities and its manifestation in the form of debt overhang and the consequences for the economy. The present policy brief provides an overview of the trend and causes of public debt from 1973 onwards. It examines the nexus between government size and debt and also discusses the major outflows of government spending in the form of losses of state-owned enterprises, administrative expenses, infrastructure and welfare spending which are partially responsible for the soaring debt. Lastly, an attempt has been made to analyze the dynamics of public debt servicing (both, public domestic and external debt) and conduct a SWOT analysis of the debt management strategy.

The analysis reveals rising budget deficit to be a major contributor in escalating public debt. The factors responsible for persistent budget deficit include losses of SOEs, rising non-development expenditure (in particular administrative costs), and spending on infrastructure and welfare. Not only do these widen the budget deficit but also compel government to borrow. Consequently, domestic debt tends to be significantly larger than the external debt and therefore the servicing on domestic debt exceeds that of external debt. Although as per the Medium Term Debt Management Strategy, improvements have been observed in terms of reduction in average cost of gross public debt, non-increasing interest costs and risk indicators however, there are major weaknesses plaguing the current debt management policy that overshadows any positive developments. For instance, there is lack of long-term planning and feasibility analysis as well as poor communication among various debt management agencies. Furthermore, the debt management policy is disconnected from macroeconomic policies such as fiscal and monetary policies.

The worsening debt situation has serious implications for the economy. The debt burden is depressing the investment climate and dampening the growth prospects. It is also exerting a downward pressure on exchange rate and is contributing in dismal tax collection.

### *The Way Forward*

The ability of core economic institutions such as Ministry of Finance, Planning Commission, and State Bank of Pakistan etc. has been undermined by the weak economic leadership. Consequently, the ability to formulate sound and robust economic policies and engage with international financial institutions has deteriorated. In this regard, there are certain policy recommendations which can plausibly ease the debt burden and improve the debt management strategy:

***Achieve Fiscal stability:*** In order to balance the fiscal budget, government needs to curb non-development outlays including the subsidies and grants that are being given to the loss-making SOEs and undertake tax reforms to enhance tax revenues and improve tax administration. This would ensure a smaller budget deficit and would suppress the borrowing needs.

- ***Strive for Monetary Stability:*** Government should refrain from relying heavily on State Bank of Pakistan for its borrowing requirements as it complicates the monetary policy management. Instead, in order to ensure monetary stability, it should focus on non-debt creating inflows such grants, portfolio investment, privatization proceeds and FDI to sustain its borrowing needs.
- ***Modify Borrowing Strategy:*** Government needs to explore cheap and efficient avenues of financing and ensure effective utilization of borrowed funds. Moreover, reliance on short-term money market borrowing needs to be reduced through development of domestic capital markets for long-term government securities which would also assist in altering the composition of domestic debt.
- ***Independent Debt Management Office:*** Given the lack of coordination between various debt management agencies, there is need to establish a proper Debt Management Office (DMO) that is able to execute its function of managing debt in a cohesive manner. The DMO should comprise of independent board with representatives from various agencies such as Finance Ministry, State Bank of Pakistan and other private-sector stakeholders.
- ***Enhance Macroeconomic Environment:*** In order to enhance the debt carrying capacity, macroeconomic environment needs to be improved through increased investments in physical and human capital, better governance, opening of trade through reduction in tariffs and barriers and improved efficiency of public and private sectors through reduced corruption and increased automation etc.
- ***Route for External Balance:*** The external account imbalance needs to be reduced to minimize the external borrowing needs. This can be achieved through restoring external competitiveness by addressing exporters' problems. Efforts should be made to curb the cost of doing business by providing energy at competitive rates, ensuring a competitive exchange rate and refraining from unfair taxation.
- ***Undertake Civil Service Reforms:*** In order to curb administrative expenses and ensure placement of efficient individuals, civil service reforms should be undertaken on priority basis. A blanket ban on creation of new job positions in public organizations should be enacted for at least one year. There is need

- for visionary and independent civil servants who are free from bureaucratic and political pressures to undertake debt management responsibilities.
- ***Privatization:*** The major loss-making SOEs (PIA, Railways and Pakistan Steel Mills) should be privatized so as to ensure improved quality, reduced unit costs, increased output and fund generation to reduce public debt.
- ***Efficient Resource Mobilization:*** Efforts should be made to efficiently allocate and enact constraints to utilize the borrowed funds for more productive purposes such as development expenditures so that it can be an avenue for net investments which could enhance exports and reduce trade deficit. Moreover, debt servicing expenses should be reduced through enhanced negotiations with donor countries and agencies.
- ***Trade Liberalization:*** Since trade openness is growth enhancing in the context of Pakistan[32], efforts should be made to enhance exports through establishing Export Processing Zones (EPZs), streamlining export procedures and rationalizing the energy and petroleum prices. This would assist in reducing trade deficit and thus the reliance on external debt.

[32] Akram, N. (2011). Impact of Public Debt on Economic Growth of Pakistan. *The Pakistan Development Review.* 50(4).

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