The Political Economy of Debt

Public Debt in South Asia: Lessons from Three Countries

• Kshitiz Dahal • Paras Kharel

Nepal's Public Debt: Concerns and Drivers

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From Borrowing to Sustainability: Understanding Pakistan's Debt Landscape

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The Political Economy of Sri Lanka's Debt

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About the Organization

South Asia Watch on Trade, Economics and Environment (SAWTEE) is a non-government organization registered in Nepal with a vision of ensuring fair, equitable, inclusive, and sustainable growth and development in South Asia. Established in 1999, SAWTEE has been actively engaged in research, advocacy, capacity building, sensitization and alliance building in issues of trade, economics, and environment. SAWTEE team is comprised of highly skilled and experienced professionals who are passionate about contributing to informed and inclusive policy-making. Researchers at SAWTEE have provided inputs to regional and global organizations, besides the Government of Nepal and the Nepali private sector.

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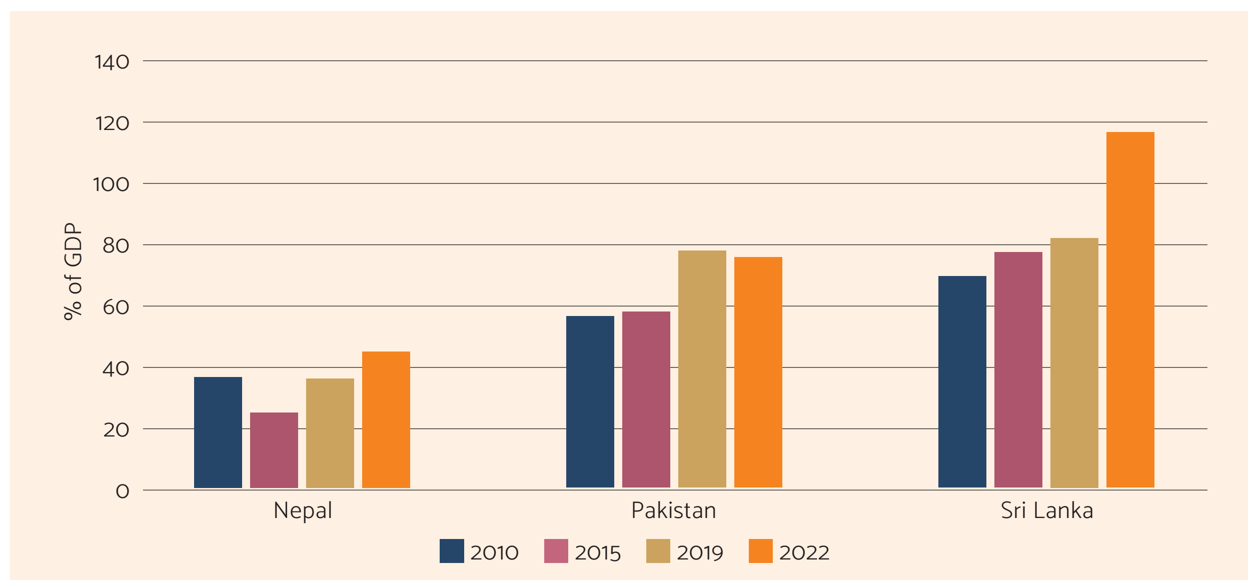
Soaring public debt, especially in the wake of the COVID-19 pandemic, has been in the cross-hairs of public debate. South Asia is at the epicenter of the debate. Sri Lanka defaulted for the first time on its sovereign loan and Pakistan is facing severe difficulties in financing its increasing public debt stock. Another South Asian nation, Nepal, while not known for its debt issues, with a relatively modest debt stock, has seen some concern over its precipitously rising public debt. Against this background, three country studies (covering Nepal, Pakistan, and Sri Lanka) were conducted to assess the state of public debt in these three South Asian nations and to identify what political-economic factors turned their debt sour.[1]

State of Public Debt

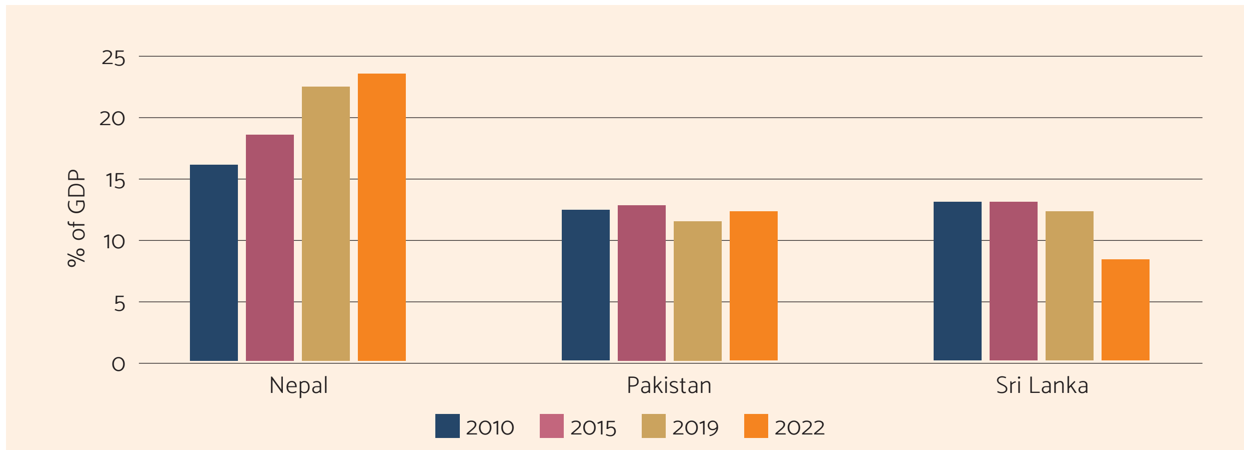
A good starting point is to present the state of public debt in each country. Although government debt has generally seen a significant increase over the years, there is a considerable variation among the countries in their debt-to-GDP ratio (Figure 1). Likewise, notable differences are seen in government revenue and expenditure patterns. Nepal's government revenue (as a percentage of GDP) is substantially superior to that of Pakistan and Sri Lanka. Still, Nepal's government expenditure (as a percentage of GDP) is also significantly higher than that of Pakistan and Sri Lanka (Figure 2 and Figure 3). Another notable trend is that Pakistan and Sri Lanka have seen a decline in their revenue-to-GDP ratio even as they ascended the growth and development ladder (Figure 2). Likewise, the countries also show variations in their stock of debt service obligations (Figure 4), but Pakistan and Sri Lanka have more extensive debt service obligations compared to Nepal and show some similarities in terms of other characteristics of debt service (Figures 5 and 6).

Figure 1 General Government Gross Debt (% of GDP)



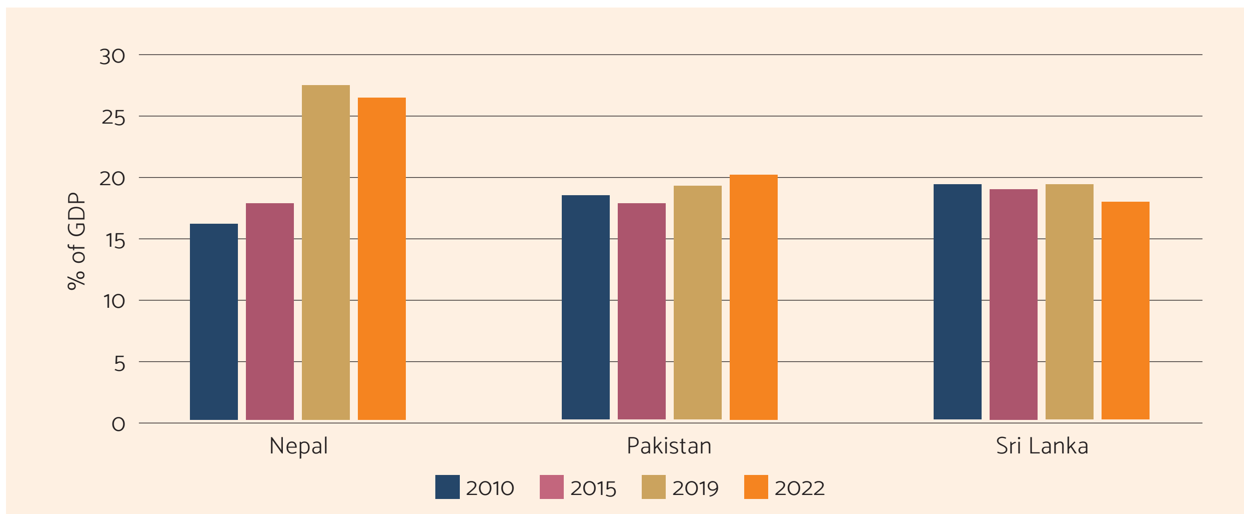
Source: World Economic Outlook (October 2023), IMF Data Mapper, accessed on 7 November 2023

Figure 2 General Government Revenue (% of GDP)



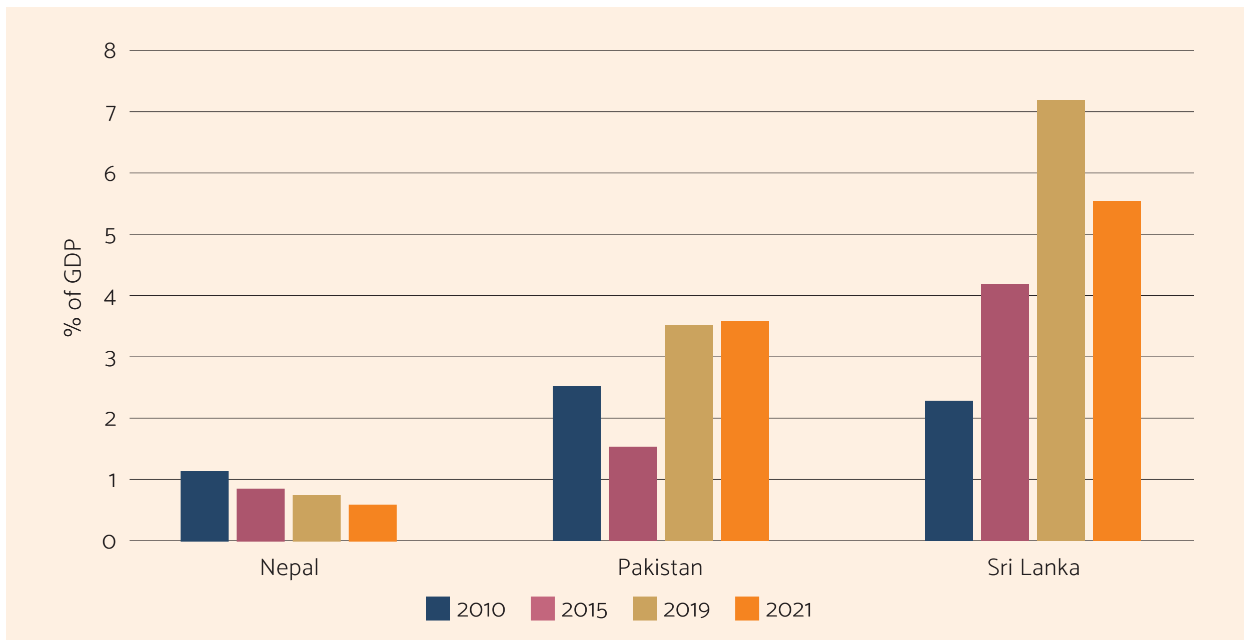
Source: Fiscal Monitor (October 2023), IMF Data Mapper, accessed on 7 November 2023

Figure 3 General Government Expenditure (% of GDP)



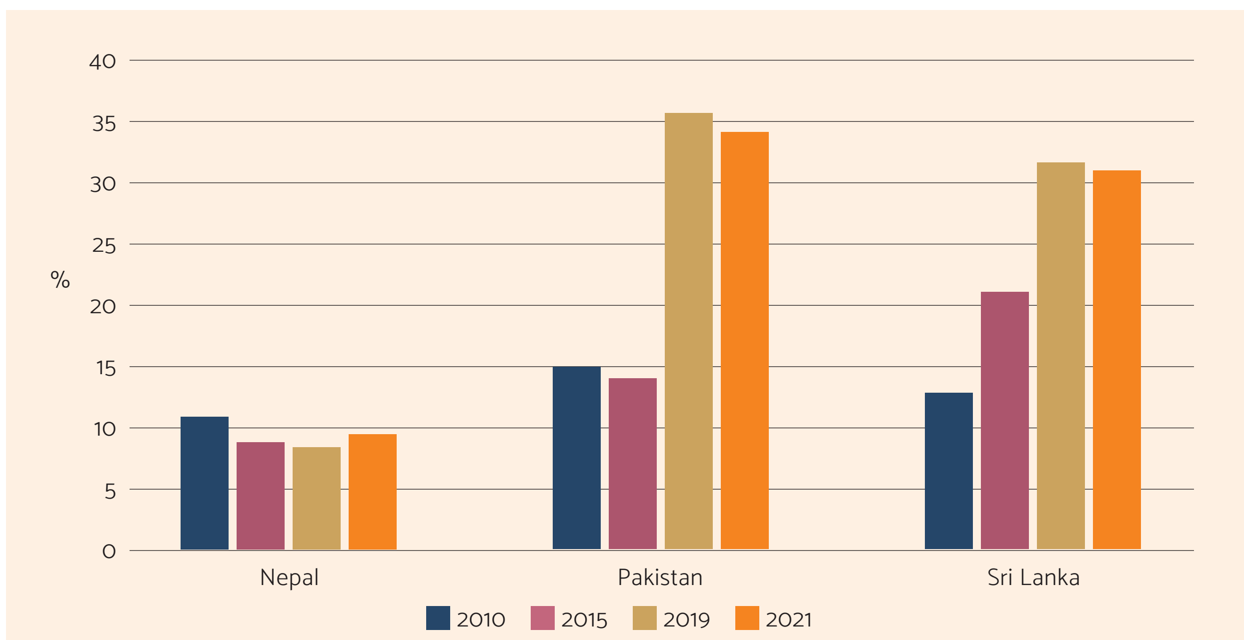
Source: Fiscal Monitor (October 2023), IMF Data Mapper, accessed on 7 November 2023

Figure 4 Total Debt Service (% of GNI)



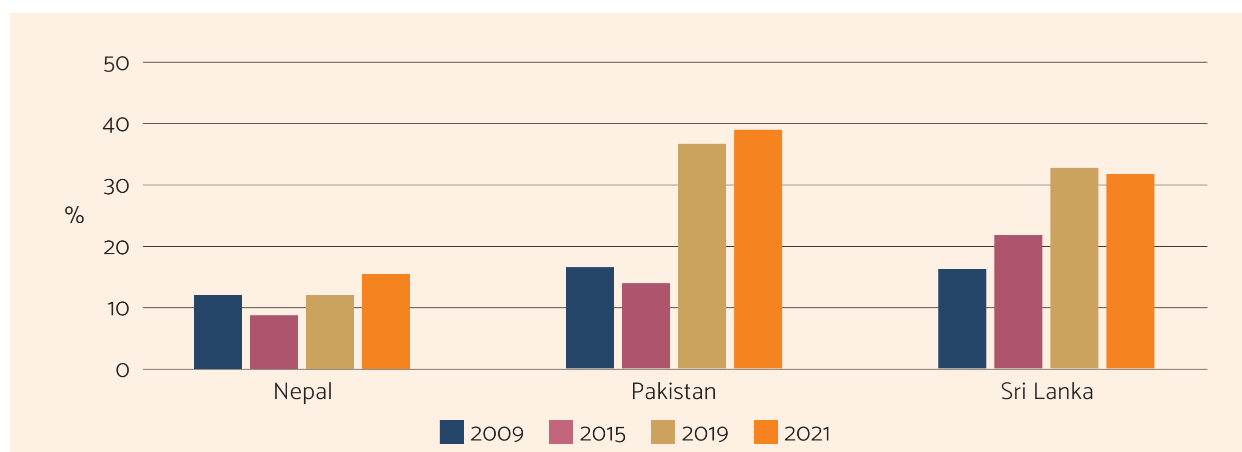
Source: World Development Indicators, accessed on 7 November 2023

Figure 5 Total Debt Service (% of exports of goods, services, and primary income)



Source: World Development Indicators (WDI), accessed on 7 November 2023

Figure 6 External Debt Service (% of exports of goods and services)



Source: Computed using debt service and exports data obtained from WDI, accessed on 7 November 2023

The case of Sri Lanka garnered much media coverage as it defaulted on its sovereign debt for the first time in April 2022. It may have come as a surprise to many, as Sri Lanka was seen as an economic success model in South Asia and was widely lauded for its extraordinary social achievements despite a 26-year-long civil war. However, the Sri Lanka study points out that its decades-long structural weaknesses meant that the recipe for a debt disaster was always there. In particular, Sri Lanka ran a persistent budget deficit to "fulfill election pledges and maintain popularity" by relying on foreign loans to finance public investments and social welfare. Sri Lanka's general government gross debt rose from 68.7 percent of GDP in 2010 to more than its GDP in 2021 (102.7 percent of GDP), and climbed to 115.5 percent of GDP in 2022[2]. Even when the debt was skyrocketing, Sri Lanka did not make necessary adjustments and instead opted for counter-intuitive tax-cuts in 2019 (as a fulfillment of an election pledge). This, coupled with the impact of COVID-19 (primarily a grinding halt to tourist inflows, an essential source of Sri Lankan foreign exchange) and policy measures such as a ban on the import of chemical fertilizer (which precipitated a decline in agricultural production and exports) hastened Sri Lanka's debt default.

Unlike Sri Lanka, Pakistan has not defaulted on its sovereign loans. Still, its severe debt distress is evident in its rapid depletion of foreign exchange reserves (covering less than a month of imports at one point) and its scrambling for International Monetary Fund (IMF) bailouts. Pakistan's debt story comes as less of a surprise—Pakistan has received bailout loans from the IMF for 30 of the last 42 years. However, the debt crisis seems to have deepened as it has seen its debt level skyrocket in the last few years. Pakistan's public debt and liabilities increased by 77 percent in less than four years (2018–2022)[3] and stood at 91.0 percent of GDP (at the end of FY 2022/2023)[4,5]. While COVID-19, the Russia-Ukraine war, and devastating floods[6] contributed to the crisis, the Pakistan study points out that the main issue is structural. A long history of taking excessive debts to finance development projects (in some cases, without adequate preparation and evaluation), a large public

enterprise sector (state-owned enterprises) that pose a significant fiscal burden, and a large web of contingent liabilities mean Pakistan has been running a persistent sizeable fiscal deficit–averaging at around 6.3 percent of GDP between 2000 and 2019.

Nepal's case is somewhat peculiar as it boasts a relatively low level of public debt and has been consistently found to have a low level of debt distress in debt sustainability analyses. However, it has seen a precipitous rise in its public debt—its public debt stock rose from 25.7 percent of GDP in fiscal year (FY) 2014/15 to 41.5 percent of GDP in 2021/22.[7] While its South Asian peers are trying to emerge from the debt crisis, Nepal is grappling with a different question: is Nepal veering towards unsustainable debt accumulation even when the debt level itself is not yet at a crisis-inducing level? At its core, this entails answering a seemingly simple question: is the public debt stock becoming large enough that servicing it will constrain the fiscal space for growth-and-development-inducing expenditure? However, answering it is not always easy. There is no magic debt sustainability indicator, and despite many attempts by economists to assess when debt becomes counterproductive to growth, there is no consensus on a debt-to-GDP ratio that could be termed unsustainable. But, against the evidence of a meteoric rise in its debt stock, coupled with a low rate of return on public investments and a myriad of issues in public finance administration[8], one can reasonably conclude that not all is well with Nepal's seemingly low level of public debt.

It is important to note that countries experiencing acute debt distress–Sri Lanka and Pakistan–face issues in servicing their foreign debt, even if external and domestic loans are of comparable volumes. This suggests that in the case of developing countries, a distinction needs to be made when analyzing domestic debt versus external debt. A persistent current account deficit is a significant contributor to external debt servicing difficulties. Imports increased persistently due to increasing purchasing power (due to a rise in GDP per capita) and, in the case of Sri Lanka, a rapid widening of the middle class, but exports failed to show significant improvements.[9] However, the current account deficit, as well as the resource gap, had to be financed somehow—and short-term political expediency meant that foreign loans were aggressively used for these purposes, resulting in a vicious cycle of persistent twin deficits (current account deficit and budget deficit), gradually sliding towards unsustainable levels of debt accumulation. Nepal also suffers from an extremely low level of exports (exports of goods and services amounted to 6.8 percent of GDP in 2022[10]), but its risks related to servicing foreign loans are limited because of abnormally high remittance inflows (personal remittances received amounted to 22.8 percent of GDP in 2022[11]) and the majority of its loan being concessional. However, Nepal risks treading a similar path of unsustainable foreign debt accumulation if remittances decrease and sources of concessional loans dry up as it climbs up the income ladder propped up by remittance-fueled growth based on increased private consumption.

Fiscal Mismanagement

Investigations into the state of public debt by individual country studies generate important insights. First, a key observation of the studies is that fiscal mismanagement due to political expediency is at the heart of these countries' public debt woes. The political expediency favored persistent

deficits to support extravagant expenditures in the form of social transfers, subsidies, and public infrastructure projects of questionable returns. For instance, the Sri Lanka study points out that the government favored a chronic budget deficit to cater to the ever-increasing consumption demands of the rising middle class, which had become the most critical voting bloc, through fiscally imprudent policies such as low taxes and energy subsidies. Likewise, the government propped up persistent budget deficits in Pakistan through politically convenient measures such as untargeted energy subsidies and uninterrupted fiscal support to state-owned enterprises (SOEs).

Furthermore, much of the increasing government expenditure was financed through foreign loans procured at higher interest rates. Likewise, in the case of Nepal, the government favored nontargeted social welfare spending to garner votes, increased government spending, and maintained persistent deficits to appease the rising development ambitions of citizens. In short, political expediency dictated that short-term gains be prioritized over long-term growth prospects. Consequently, the lack of adequate reforms in public finance administration, often due to the tendency of these reforms to be politically unpopular in the short run, contributed deeply to public debt woes.

Changing Borrowing Landscape

Another important insight generated by these individual country studies is that the foreign borrowing landscape changes as a country climbs the income ladder, which could gradually lead the nation toward unsustainable debt accumulation. As a country moves up from low-income to middle-income status, new avenues of foreign capital open. However, some of these new foreign capital sources, such as international sovereign bonds (ISBs) or foreign loans obtained from commercial lenders abroad, are much more expensive because of higher interest rates and lower maturity periods[12] than official development assistance (ODA) loans to which these countries are accustomed. But the ascent along the income ladder also translates into an even higher aspiration for increased living standards, and often, it is politically expedient to keep borrowing from these foreign commercial lenders. For instance, when Sri Lanka upgraded to a middle-income country and entered the international capital market in 2007, its share of non-concessional loans was less than 20 percent. However, as the country's income increased, so did its borrowings in the form of ISBs, and the share of non-concessional loans increased to more than 50 percent of its total loans, a trend that has been persistent since 2012. The ISBs, and not the loans from China (more on Chinese loans later), are widely believed to be behind Sri Lanka's debt woes. In the case of Pakistan, multilateral creditors, the largest source of external debt in the 1990s, have declined, with bilateral creditors (mostly Chinese loans) and commercial creditors increasing their shares. Nepal's external borrowing remains largely concessionary. However, against its impending LDC graduation (in 2026) and a recent upgradation to lower-middle income status (FY 2021), Nepal would be wise to learn from its South Asian peers and, hence, tread a cautious path, accompanied by institutional reforms, to navigate the future of external borrowing with less concessionality (including possible borrowings from international capital markets).

Geopolitics: Myth and Reality

Another significant contribution of these individual country studies is that they shed light on the emerging geopolitics surrounding foreign loans, with some observers accusing China of engaging in debt trap diplomacy—burdening developing countries with unsustainable debt. While evidence suggests that foreign loans from China did add to the debt burden in Sri Lanka and Pakistan (Chinese loans, often at higher rates than concessional loans, became an increasing feature of these countries), deeper analysis does not support the debt trap narrative. For instance, the Sri Lanka study points out that when Sri Lanka defaulted, only 20 percent of Sri Lanka's foreign debt stock was owed to China, compared to 36 percent owed to the international capital market. Moreover, debt repayment to China accounted for 20 percent of Sri Lanka's total debt servicing compared to almost 50 percent in the case of international sovereign bonds. Furthermore, Chinese debt had lower interest rates than international capital market borrowings. In addition, leasing the Hambantota port to China Merchant Port Company in 2017 was separate from the loans taken to build the port. Sri Lanka continued to service the loan even after the lease—which goes against the narrative of Sri Lanka handing over the port to China due to the failure to pay its loan. Nonetheless, the preponderance of Chinese loans did cause some issues in debt restructuring. When the Sri Lankan government defaulted on its debt and entered into negotiations with the IMF for a bailout, the IMF required it to receive financing assurances from major creditors, whereby the latter had to indicate their willingness to be in arrears and restructure the debt. A delay in getting financing assurances from China came under criticism from the United States and India.[13]

Similarly, the Pakistan study points out that Pakistan's total outstanding debt to China is relatively modest compared to Pakistan's debt to multilateral institutions. Furthermore, China has been proactive in rescheduling Pakistan's loans and has shown willingness to work with other creditors to address Pakistan's debt problems. Finally, the study asserts that the terms of Chinese loans under the China-Pakistan Economic Corridor (CPEC) are largely concessionary and often better than those offered by some other lenders.

In the case of Nepal, borrowings from China, while increasing, are so paltry (3.4 percent of total foreign loans as of FY 2021/22) that it does not warrant a debt-trap narrative. The biggest issue with loans from China, rather than its volume and interest rates, seems to be non-transparency.

Importance of Country Contexts

Besides some common themes surrounding the public debt woes of three South Asian countries, we also see certain peculiarities of each country playing an outsized role in their respective public debt issues, which suggests that country contexts play an essential role in the public debt state of a country. In the case of Sri Lanka, its exceptionally low government revenue contributed significantly to its debt distress. While a narrow revenue band, dominated by import-based and indirect taxation and the inability to expand inland revenue, is also observed in some other South Asian countries, Sri Lanka's tax collection is significantly dismal (Sri Lanka's tax revenue stood at 7.7 percent of GDP in 2021).[14] Furthermore, in contrast to the standard expectation that higher development status will

result in a superior revenue collection, Sri Lanka's revenue collection saw a decline. For instance, revenue and grants as a proportion of GDP declined from 17.3 percent in 2005 to 13.5 percent in 2018, which deteriorated further to 9.1 percent in 2020 and 8.7 percent in 2021 due to tax cuts in November 2019.[15] Besides the inconsistent tax policy, providing large tax concessions and weak institutional capacity in inland tax revenue collection and compliance contribute to the abnormally low government revenue. The World Bank indicates that tax revenues above 15% of a country's GDP are a healthy standard for poverty reduction and economic growth.

In the case of Pakistan, its extensive public enterprises sector[16] remains a significant contributor to the government's persistent fiscal deficit. Many SOEs operate at a persistent loss. The financially distressed SOEs receive regular support from the government in the form of allocation of funds from the government budget. In addition, the government also provides subsidies to SOEs, most notably to provide electricity to consumers at a concessional tariff rate. Hence, budgetary support for SOEs represents a substantial drain on the government coffers. Furthermore, SOEs also borrow directly from banks, which are sources of contingent liabilities for the government.

Nepal witnessed a sustained structural jump in government spending after implementing its newfound federal structure.[17] For instance, the federal government's budget deficit-to-GDP ratio increased significantly from 6.0 percent in FY 2016/17 to 9.0 percent in FY 2017/18.[18] The direct expenditure of the federal government has not subsided even after the devolution of powers and functions to sub-national governments. Moreover, issues in implementing federalism, primarily the duplication of expenditures by the federal and sub-national governments, owing to the lack of clarity on each government's jurisdiction, have contributed to increased government expenditure.

Concluding Remarks

In conclusion, these three studies offer insights into how three South Asian countries (Sri Lanka, Pakistan, and Nepal), with vastly different levels of debt, face different debt issues. Sri Lanka faces the starkest crisis, defaulting on its debts while struggling to emerge from the crisis. Pakistan, while not yet defaulted, is in arrears and scrambling for bailouts. Nepal has seen a meteoric rise in its public debt level in a short period, but the increase in public debt is believed to have minimal impact on its current growth and growth prospects. However, amidst this divergence lies a common source of ailment—fiscal mismanagement for short-term political expediency aided by weak public finance administration. Moreover, the public debt crises unfolding in Sri Lanka and Pakistan show the enormous pain on ordinary citizens inflicted by a debt crisis, for instance, scarcity of food, a long queue at the oil station, and a conspicuous decline in living standards. It also demonstrates the challenges in emerging out of a debt crisis once it happens, for instance, the IMF conditions force the negotiating states to abruptly alter many of their priorities.

Furthermore, the debt restructuring negotiations show that countries will have to make hard choices and cut social spending on sectors that cause adverse impacts on general welfare. For countries like Nepal that have largely unfinished development agendas and are already facing significant resource gaps to meet targets under the Sustainable Development Goals, the cases of

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Sri Lanka and Pakistan illustrate the importance of treading a sustainable path in public finance. Hence, countries not currently experiencing debt distress must make gradual reforms rather than be forced later to make abrupt, painful changes.

As South Asian nations rise on the development ladder, managing debt becomes paramount for a secure future. Several key reforms can enhance debt sustainability across countries like Sri Lanka, Pakistan, and Nepal. Each nation faces unique challenges requiring specific solutions. Sri Lanka needs to boost government revenue through comprehensive tax reforms, reduced exemptions, and strengthened tax collection. Pakistan must tackle the fiscal burden of state-owned enterprises (SOEs) by restructuring and improving their efficiency. Nepal, witnessing a post-federalization spending surge, requires streamlined expenditures, clear jurisdictional responsibilities between federal and sub-national governments, and enhanced fiscal discipline. Beyond these specific solutions, shared values pave the way for a sustainable fiscal future. Transparency, good governance, and prudent financial management practices are universally important. Implementing these principles across South Asia will ensure a more stable and prosperous path for all.

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2 The data has been obtained from World Economic Outlook (October 2023), IMF Data Mapper.

3 As per the Pakistan Study report.

4 The gross public debt rose by 27.7% to reach 74.3% of GDP in FY23 compared to 73.9% of GDP in FY22 as per the State Bank of Pakistan (https://www.sbp.org.pk/reports/annual/aarFY23/Chapter-05.pdf).

5 As per the data obtained from the State Bank of Pakistan (https://www.sbp.org.pk/ecodata/Summary.pdf).

6 Rajvanshi, Astha. “Why a $3 Billion IMF Loan Isn’t Enough to Save Pakistan’s Economy.” Time, July 11, 2023. https://time.com/6293769/imf-loan-pakistan/.

7 As per data obtained from Public Debt Management Office, Government of Nepal.

8 For instance, the Nepal Study points out that “projects that have not undergone the necessary preparations are included in the budget, projects which were not included at the start of the budget are forcefully included during the implementation phase, a mammoth proportion of capital expenditure is spent only at the end of the fiscal year, and there is a major abuse of budget head change and source change”.

9 As per the Sri Lanka Study report, Sri Lanka’s exports as a share of GDP declined from 39% in 2000 to 17% in 2015.

10 Data obtained from the World Development Indicator.

11 Data obtained from World Development Indicator.

12 For instance, ISBs attracted an effective interest rate of 6.61% compared to 0.72% for loans from Japan, and 1.35% for loans from the World Bank. Likewise, ISBs had a maturity period of 8 years compared to 25 years for ADB loans and 34 years for loans procured from Japan. See https://publicfinance.lk/en/topics/cost-of-bilateral-and-multilateral-loans-1642565346.

13 The Sri Lanka Study report.

14 Derived from the Sri Lanka Study report.

15 Compiled from Central Bank of Sri Lanka Annual Reports by the Sri Lanka study.

16 According to the Pakistan Study report, non-financial state owned-enterprises held assets worth 44% of GDP, but only employed 0.7% of the formally employed labor force.

17 Nepal adopted a federal structure of governance–three tiers of government (federal, 7 provincial governments, and 753 local governments)–through a new Constitution in 2015. The implementation of federalism commenced in FY 2017/18 through the first intergovernmental transfers to sub-national governments.

18 As per the Nepal Study report.

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Kshitiz Dahal & Paras Kharel

About the Organization

South Asia Watch on Trade, Economics and Environment (SAWTEE) is a non-government organization registered in Nepal with a vision of ensuring fair, equitable, inclusive, and sustainable growth and development in South Asia. Established in 1999, SAWTEE has been actively engaged in research, advocacy, capacity building, sensitization and alliance building in issues of trade, economics, and environment. SAWTEE team is comprised of highly skilled and experienced professionals who are passionate about contributing to informed and inclusive policy-making. Researchers at SAWTEE have provided inputs to regional and global organizations, besides the Government of Nepal and the Nepali private sector.

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Introduction

Background

If assessed against most prescriptions and standards[1], Nepal's public debt level is within the appropriate threshold. Nepal's public debt, at 41.47 percent of GDP (FY 2021/22)—external debt representing 21.14 percent of GDP and internal debt representing 20.33 percent of GDP—indicates a low risk of debt distress. Furthermore, Nepal's external debt is largely of a concessionary nature, marked by low interest rates and long maturity periods. Thus, a routine assessment may suggest no cause for concern regarding Nepal's public debt position. However, analytical reports and media accounts have started to allude that the government may be digressing from the optimal path of debt accumulation, necessitating a deeper look into the trends, patterns, and drivers of Nepal's public debt.

The rapidly rising public debt portfolio–for instance, the government debt rose steadily from a low of about 25 percent of GDP in FY 2014/15 to 41.5 percent of GDP in FY 2021/22—has been an increasing cause of concern in public debates. Moreover, Nepal's official development assistance (ODA) receipts show an increasing concentration of loans in comparison to grants—for instance, in FY 2020, loans consisted of approximately 86.31 percent of total ODA. Furthermore, there are some structural shifts–the implementation of federalism is significantly increasing public expenditure, Nepal's transition from the low-income category to the lower-middle-income country (LMIC) category, and Nepal's impending graduation from the least developed country (LDC) status—that risk pushing Nepal down the current path of rapidly accumulating public debt.

Against this background, the study undertakes a deep analysis of Nepal's fiscal policy, particularly the public debt scenario, with the aim of proposing measures to ensure debt accumulation remains sustainable, as well as preparing Nepal for a new landscape that will occur as it transitions into the lower-middle-income category, reducing the concessionality of foreign loans, and its impending graduation from the LDC status. Such an in-depth analysis of Nepal's fiscal policy can assist policymakers, development partners, and civil society actors to gain a deeper understanding of the country's public debt scenario and create the necessary awareness for implementing good public debt practices.

Research Questions

This study assesses the public debt scenario of Nepal. Uncovering the political and economic drivers of Nepal's public debt accumulation trends constitutes the core of the study. The study attempts to answer the following key research questions:

[1] Section 2 discusses the optimal debt metrics described in the literature.

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- What does the trend and pattern of Nepal's public debt indicate about potential debt distress?
- How does Nepal compare with other comparator countries in the levels, trends, and patterns of public debt?
- Is Nepal veering towards a trajectory of accumulating more public debt than what is necessary or optimal?
- What are the political-economic drivers of public debt accumulation?

Methodology and Data

The research questions have been answered with the help of a literature review, analysis of secondary data, and in-depth qualitative interviews.

- **Desk research:** The desk research consisted of a literature review and data analysis. The literature review included, among other things, reviewing and assessing relevant literature on Nepal's debt situation, the political economy framework of government debt, international practices, and lessons. Data analysis constituted an in-depth analysis of secondary data to uncover the trends and patterns of Nepal's external and internal debt scenario. Data sources include the Public Debt Management Office (PDMO), Ministry of Finance (Budget Speeches, Economic Survey, Development Cooperation Report, Consolidated Financial Statement from the Financial Comptroller General Office), Auditor General Nepal., Auditor General Nepal, National Statistics Office (NSO), Nepal Rastra Bank, International Monetary Fund (IMF), and World Bank's World Development Indicators (WDI).
- **Key informant interviews (KIIs):** KIIs with former policymakers, academicians, and other experts were conducted to uncover political and economic nuances of Nepal's public debt scenario that cannot be simply captured using secondary data and a literature review (see Annex Table A.1 for the list of those interviewed).

Nepal's Public Debt: An Overview

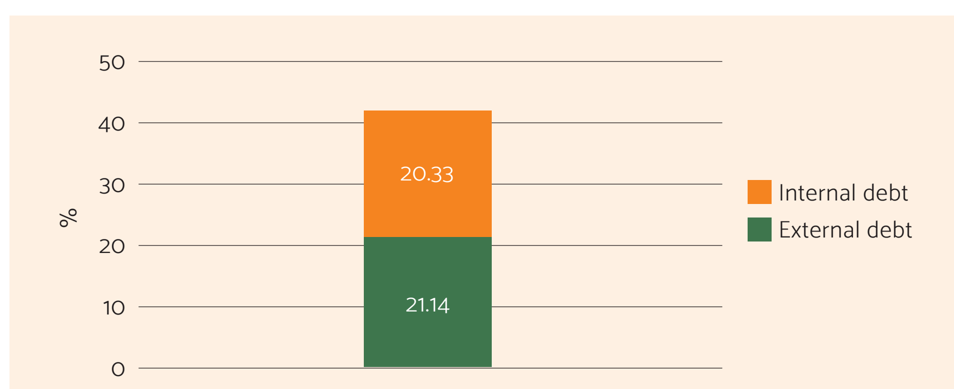
Nepal's public debt stood at 41.5 percent of GDP in FY 2021/22 (Figure 1). The current volume of Nepal's public debt, if assessed against most prescriptions and standards, indicates a low risk of debt distress.[2] Comparison with some comparator countries and country groups also indicates a relatively low level of public debt stock (Figure 2).[3]

[2] For instance, see World Bank and IMF (2020).

[3] Comparison, in this case, is regarding the general gross government debt, which IMF defines as "Gross debt consists of all liabilities that require payments or payments of interest and/or principal by the debtor to the creditor at a date or dates in the future. This includes debt liabilities in the form of SDRs, currency and deposits, debt securities, loans, insurance, pensions and standardized guarantee schemes, and other accounts payable."

Nepal's internal (domestic) debt was 20.3 percent of GDP in FY 2021/22 (Figure 1). Nepal's internal debt broadly comprises two types of debt instruments: short-term treasury bills and medium-to-long-term treasury bonds. Treasury bills are issued for a term of less than a year: 28, 91, 182, or 364 days. Treasury bills represent about 35 percent of Nepal's total domestic debt liability (Figure 3); 364-day bills constitute the highest component of treasury bills (about 43 percent of total outstanding treasury bills). Treasury bonds are issued for terms of about 4–12 years and comprise of development, citizen savings, and foreign employment saving bonds.[4, 5] Development bonds represent the biggest component of the government's domestic debt (about 64 percent), with citizen savings bonds representing only 0.96 percent and foreign employment saving bonds a meager 0.02 percent (Figure 3). Internal debt is predominantly owned by commercial banks (around 76 percent as of November 2022).[6]

Figure 1 Nepal's Public Debt Stock (% of GDP) in FY 2021/22



Source: Public Debt Management Office (PDMO) (PDMO, 2022)

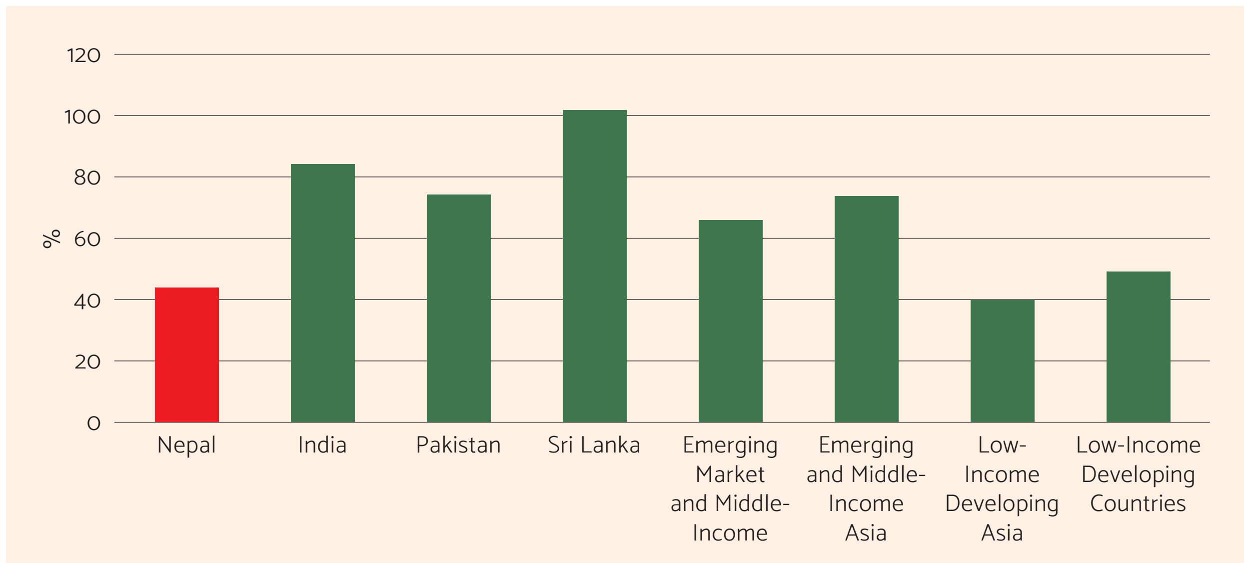
Nepal's external (foreign) debt stood at 21.1 percent of GDP in FY 2021/22 (Figure 1). Furthermore, Nepal's external debt is largely of concessionary nature, marked by low interest rates and long maturity periods. A large proportion of external debt is owed to multilateral institutions—out of the total external debt liability of NRs. 934.7 billion in FY 2021/22, debt owed to multilateral institutions represented about 87.2 percent of total external debt and bilateral debt constituted about 12.8 percent of total external loans (Figure 4). World Bank's International Development Association (IDA) and the Asian Development Bank (ADB) represented the bulk (92.2 percent) of total outstanding debts owed to multilateral institutions (57.0 percent and 35.2 percent, respectively), and Japan, India, and China represented the bulk (91.8 percent) of total outstanding debts sourced bilaterally (37.2 percent, 27.7 percent, and 26.9 percent, respectively) (Figure 4).

[4] The information on maturity period of development bonds is derived from the Medium-term Debt Management Strategy (FY 2021/22–2023/24), 2021.

[5] Another type of government bond, the National Saving Bond, which is akin to Citizen Savings Bond, has not been issued since FY 2013/14. Likewise, another type of treasury bond, the special bond, has not been issued in recent years.

[6] Nepal Rastra Bank (secondary market), other financial intermediaries (development banks, finance companies), insurance companies, other institutional depositors own most of the rest of the domestic debt; the ownership of bonds by the public and market makers is negligible.

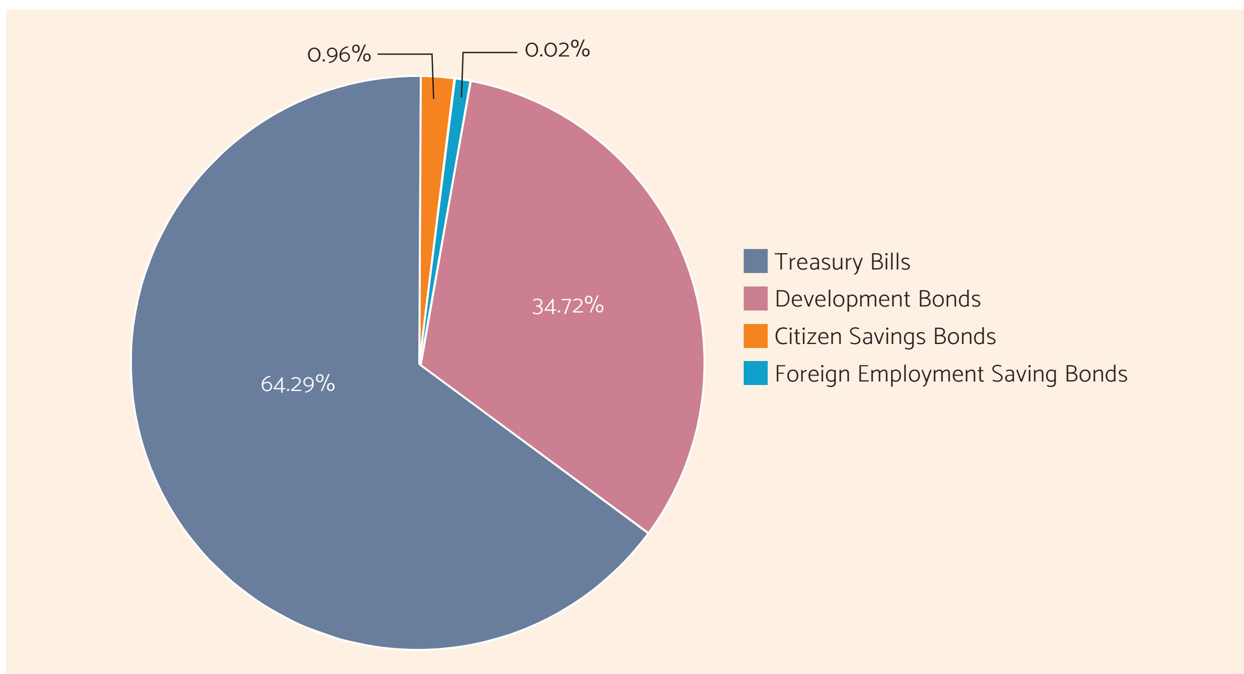
Figure 2 Gross Debt Positions (% of GDP), 2021



Note: Gross debt positions refers to "all liabilities that require future payment of interest and/or principal by the debtor to the creditor. This includes debt liabilities in the form of special drawing rights, currency, and deposits; debt securities; loans; insurance, pension, and standardized guarantees schemes; and other account payable."

Source: Fiscal Monitor (April 2023), IMF

Figure 3 Composition of Domestic Debt Instruments of the Government of Nepal



The data is as of November 2022.

Source: Government Securities and Open Market Operation Statistics (November 2022), Nepal Rastra Bank (NRB)

Besides the official public debt stock, contingent liabilities[7] are sources of potential fiscal responsibilities for the government. However, in Nepal's case, contingent liabilities that are not included in the official public debt figures seem limited, but the data on contingent liabilities is not complete. Nepal's sub-national governments have not yet assumed any debts and hence do not represent any contingent liabilities for the government. The outstanding debt of non-financial state-owned enterprises (SOE), which amounts to about 6.5 percent of GDP (at the end of FY 2019/20), primarily includes loans from the central government and, thus, is already accounted for as part of the government debt stock (World Bank and IMF 2022; World Bank 2021).[8] Likewise, the government has provided loan guarantees totaling NPR 24 billion (0.6 percent of GDP) to an SOE (Nepal Airlines Corporation) for the purchase of airplanes, which has also been included in the official debt stock (World Bank and IMF 2022; PDMO 2022). While the debt statistics concerning SOEs are not complete and the government is currently undertaking reforms to improve debt statistics (including that of SOEs), the liabilities of SOEs that are not covered by public debt appear limited (World Bank and IMF 2022). Lastly, contingent liabilities could arise from public-private partnerships (PPP) projects (most of which are hydropower projects). As the World Bank outlines, "The realization of government revenue guarantees to private contractors, cost overruns, exchange rate risks, and the government's obligation to compensate investors if projects are terminated prematurely" could incur significant fiscal obligations (World Bank 2021). While Nepal has invested approximately 12.7 percent of its GDP in PPP projects, the government has not made the details of the PPP projects public, and therefore the extent of the government's fiscal commitments and contingent liabilities are not known (World Bank 2021).

Figure 4 Nepal's External Debt, by Source

The values in the figure are in NRs. billion. The data is for FY 2021/22.

Source: Author, using data from PDMO (2022)

7 Contingent liabilities could be described as the obligation for the government to make payments if certain conditions occur in the future. Examples would be if an SOE defaults on its loans or sub-national governments default on their debts. The fiscal obligation in the case of contingent liabilities could be legal obligations or an implicit understanding that the government would step in and assume fiscal responsibilities if some event occurs.

8 SOEs are not allowed to borrow externally without government's consent and their debt includes on-lending from the Ministry of Finance (MoF) and other domestic borrowings that they are allowed to partake in without the MoF's approval (IMF 2023).

Assessment of the Sustainability of Nepal's Public Debt

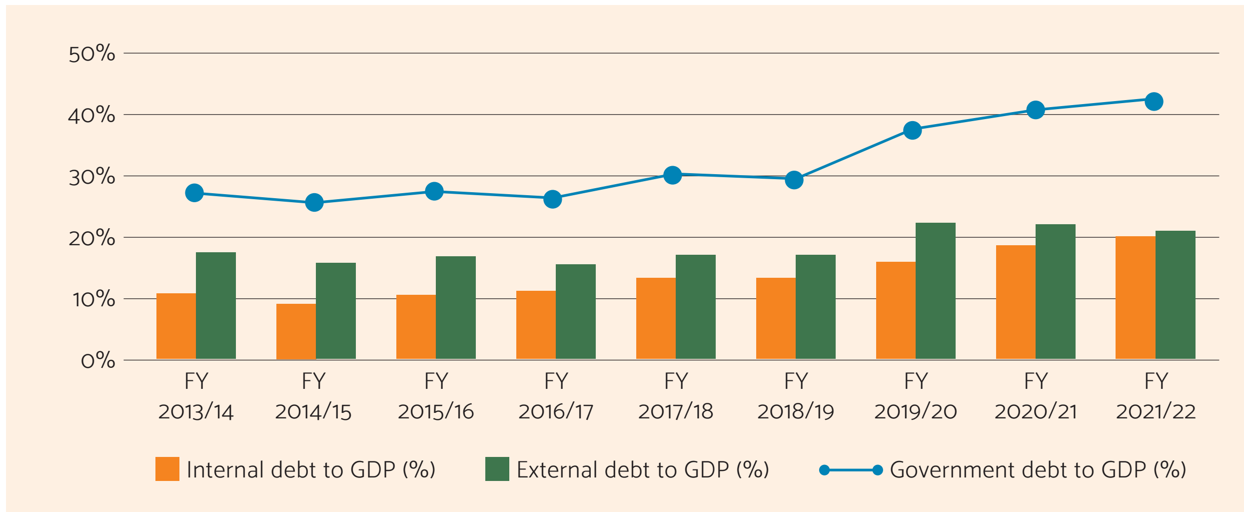
Although Nepal's public debt holdings are lower than that of many comparator countries, its precipitous rise has been a recent source of concern in the public debate. While the debt-sustainability assessment (World Bank and IMF 2020) had indicated a low risk of debt distress (for both external debt and overall debt), the recent rise in public debt, somewhat necessitated by COVID-19, greatly surpasses the projections made by this assessment. For instance, the World Bank and IMF (2020) projected that Nepal's public debt would reach around 46 percent of GDP in FY 2039/40, however, the county's current debt-to-GDP ratio is already approaching that figure. Moreover, the debt-to-GDP ratio has exceeded the periodic targets under the Sustainable Development Goals, as well as the final 2030 target of 35 percent (Kharel 2022). Against this backdrop, this section first presents some common indicators of public debt sustainability. It then examines the findings of the World Bank-IMF debt sustainability assessment for Nepal. Finally, the section looks into the public debt literature for insights into whether Nepal is veering towards an unsustainable path of debt accumulation and presents an assessment of the sustainability of Nepal's public debt.

Indicators of the Sustainability of Nepal's Public Debt

While the current stock of Nepal's public debt may indicate a low risk of debt distress, there has been a sharp rise in the debt, which could increase the risk of debt distress in the medium to long term. The public debt has risen from 28.5 percent of GDP in FY 2013/14 to 41.5 percent in FY 2021/22 (Figure 5). Both the internal and external debt have witnessed a rise in the period FY 2013/14–2021/22, but the rise in internal debt has been steeper—the external debt rose from 17.9 percent of GDP to 21.1 percent of GDP and the internal debt rose from 10.7 percent of GDP to 20.4 percent of GDP (Figure 5).

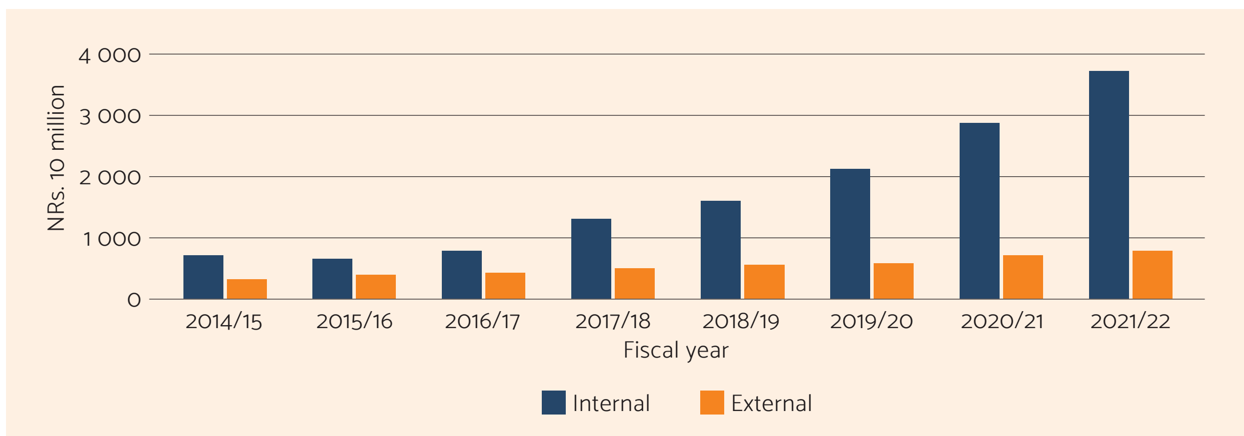
Interest payments have risen significantly since 2016/17 (Figure 6). The change is greater for internal debt (Figure 7). While a significant portion of external debt has a higher maturity period and low interest rates, the interest rates on internal debts are dependent on the vagaries of the market and hence show significant fluctuations. Consequently, interest payments on internal debt have increased more dramatically against a major rise in interest rates (Figure 8). Moreover, interest payment as a percentage of GDP has risen over the years (Figure 9). However, despite a rise in interest payments, the debt service-to-GDP ratio had not seen a notable rise in the past few years (Figure 10). But the debt servicing payments are projected to increase significantly starting in FY 2022/23 (Figure 11). More importantly, the projected debt servicing payments for the fiscal year FY 2023/24–NRs. 307.5 billion–represent 17.6 percent of the total projected government expenditure, which has surpassed the share of projected capital expenditure in the budget—17.3 percent—for the first time in the recent history of the country. The rapidly increasing debt financing obligations may pose a significant concern for debt sustainability.

Figure 5 Growth Trend of Nepal's Public Debt



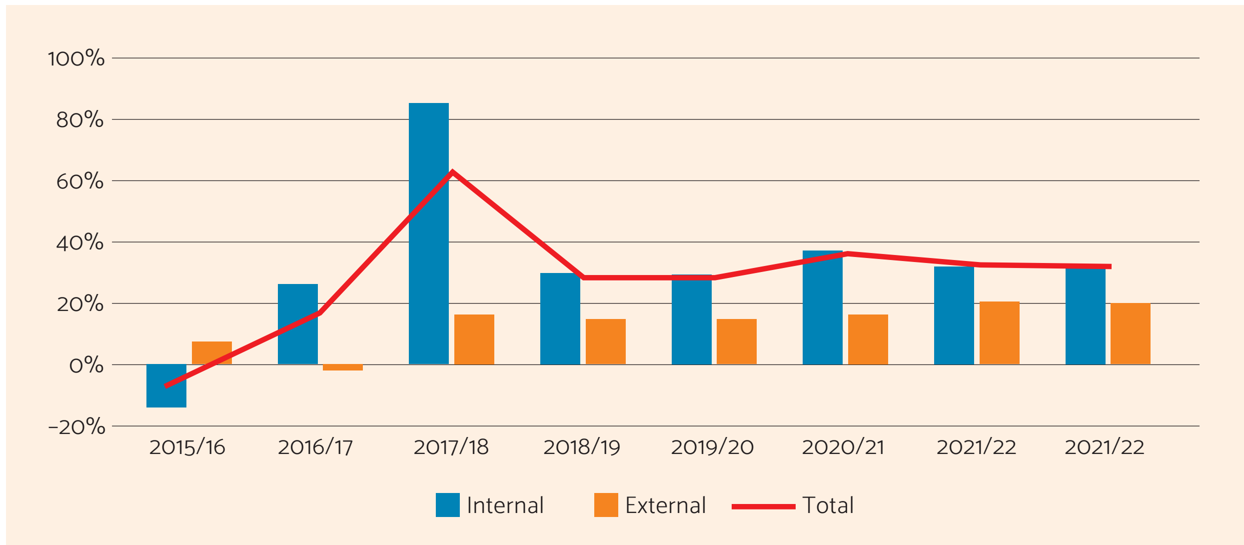
Source: PDMO (2022)

Figure 6 Interest Payment Trend



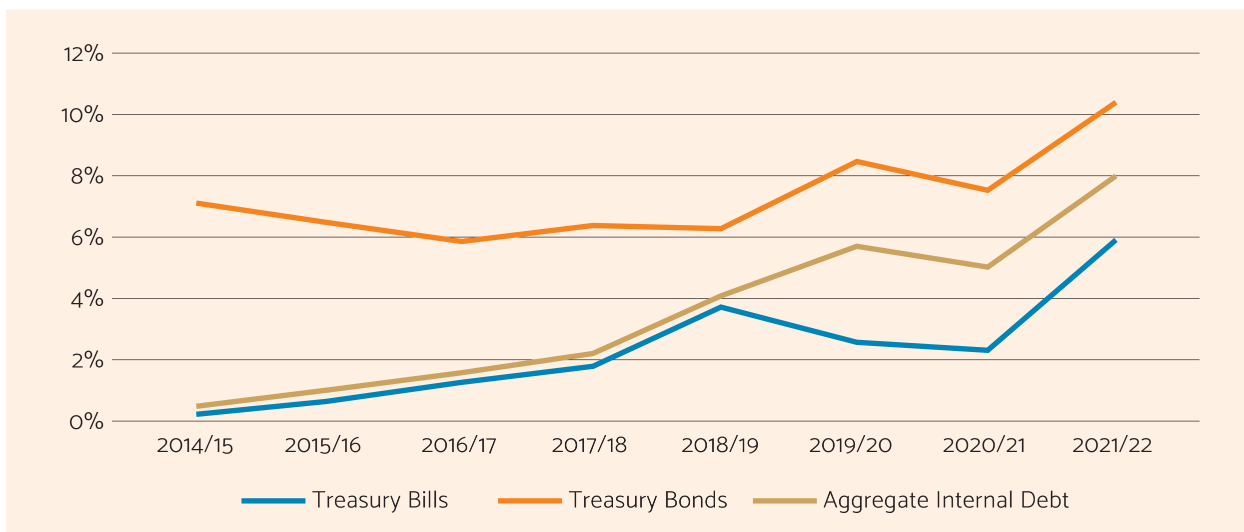
Source: PDMO (2022)

Figure 7 Annual Percent Increase in Interest Payments



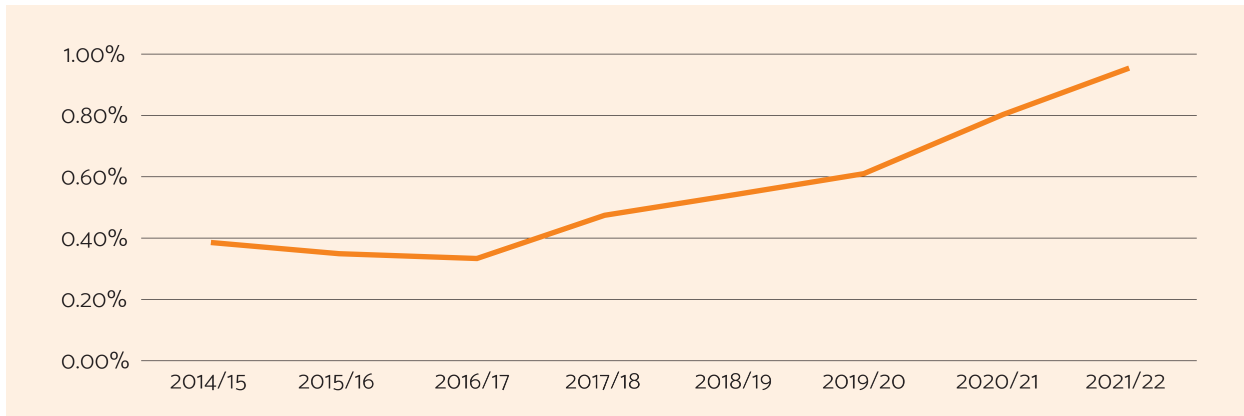
Source: PDMO (2022)

Figure 8 Average Interest Rates on Internal Public Debt



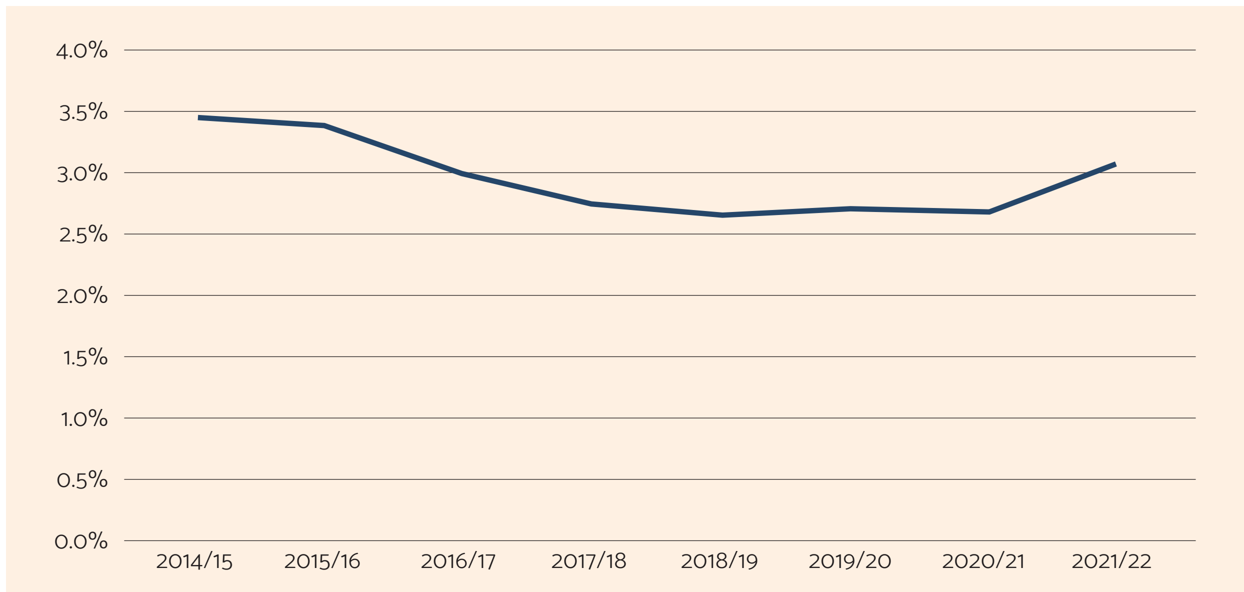
Source: PDMO (2022)

Figure 9 Nepal's Interest Payment to GDP Ratio (%)



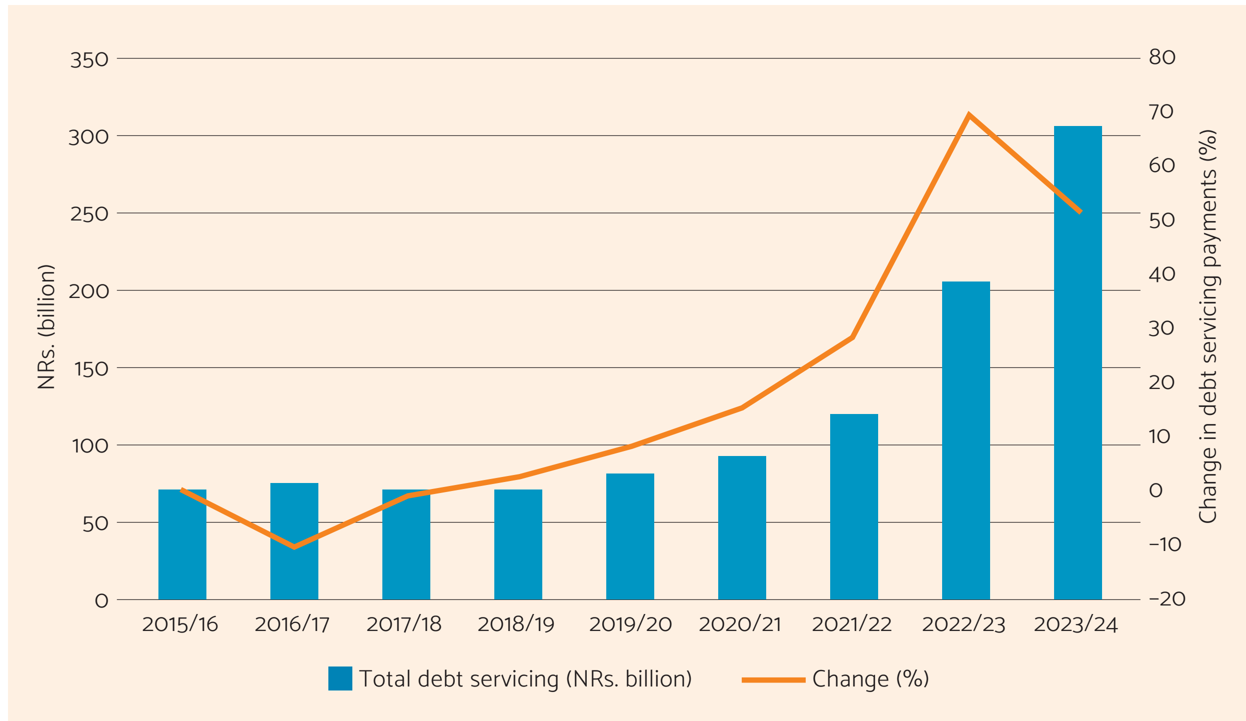
Source: Author using debt data from PDMO (2022) and GDP data from National Statistics Office (NSO)

Figure 10 Nepal's Debt Service-to-GDP Ratio (%)



Source: PDMO (2022)

Figure 11 Nepal's Debt Service Payments

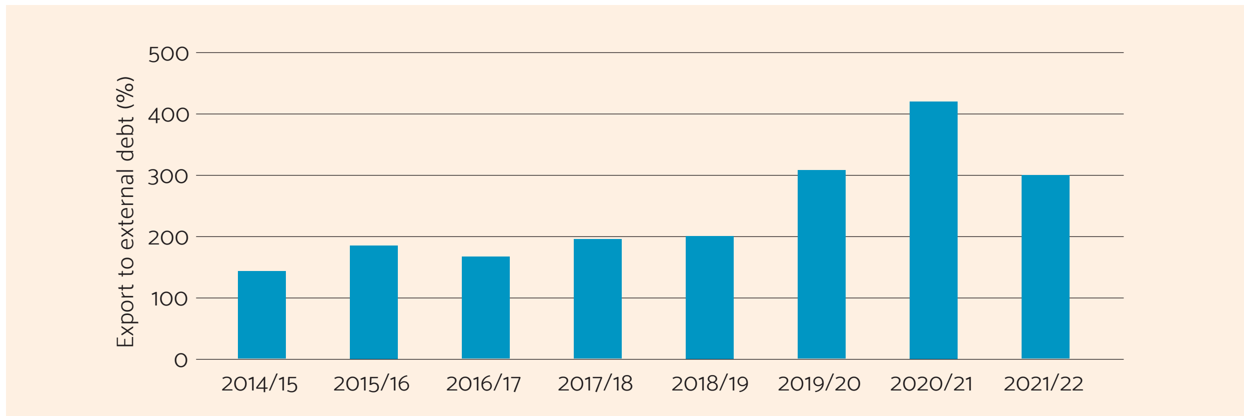


The values for FY 2022/23 and FY 2023/24 are projections derived from the budget speech for FY 2023/24

Source: PDMO (2022) for FY 2014/15–FY 2021/22; MoF (2023) for FY 2022/23–FY 2023/24

While there is a cause for concern regarding the rate of increase, most of the available indicators indicate a low level of debt distress. However, it is worth noting that financing external debt requires adequate foreign exchange earnings. One source of foreign exchange income is exports of goods and services. However, since Nepal's exports of goods and services remain small, exports are not adequate to sustainably finance Nepal's rising public debt (Figure 12 and Figure 13). This is a significant source of vulnerability for Nepal's ability to service its foreign debt holdings. Currently, Nepal's strong debt repayment position is due to high remittance inflows, which account for about 21 percent of its GDP (Figure 14). A significant increase in remittances began in the early 2000s after the 9th periodic plan (1997–2002) promoted labor migration as a means of combating poverty and unemployment. Currently, Nepal's primary source of external financing is remittances, which outnumber the combined total of all other sources of external financing—exports of goods and services, ODA receipts, and FDI inflows (Figure 15). The persistently high remittance inflows have provided Nepal with the foreign currency wherewithal to pay its external debt, given that other sources of external financing are inadequate to sustainably generate the required foreign exchange to meet its debt obligations. However, this makes Nepal vulnerable to any shocks that would impact its remittance flows.

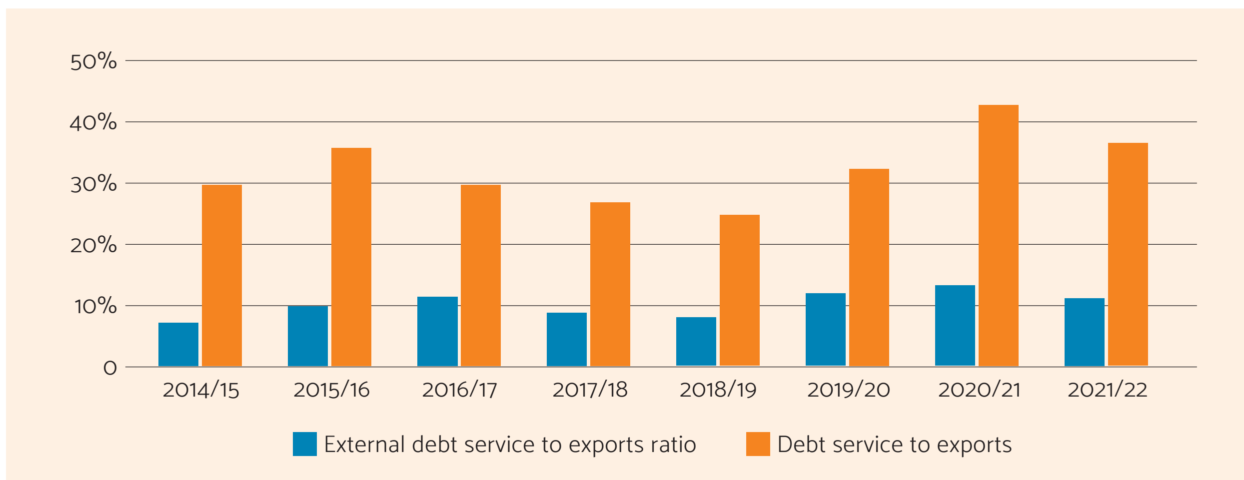
Figure 12 Nepal's External Debt to Exports Ratio



Note: *The exports include exports of goods and services*

Source: Author, using public debt data from PDMO (2022) and exports data from NRB

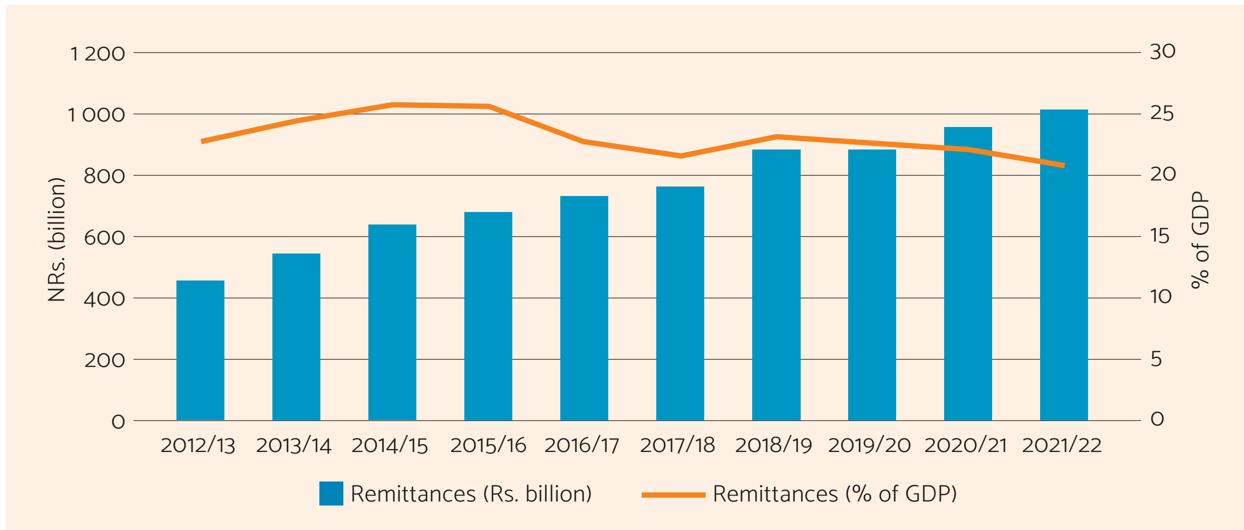
Figure 13 Nepal's Debt Servicing to Exports Ratio



Note: *The exports include exports of goods and services*

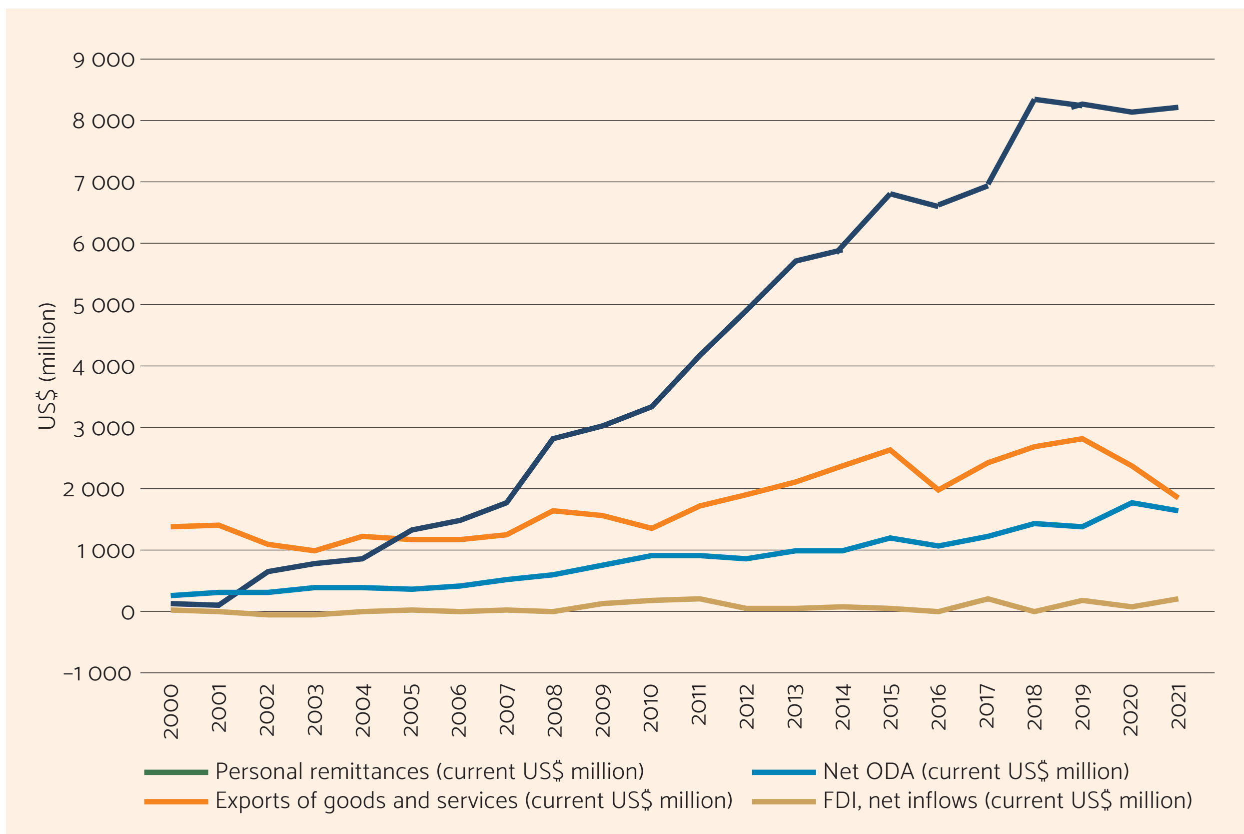
Source: Author, using public debt data from PDMO (2022) and exports data from NRB

Figure 14 Nepal's Remittance Inflows in the Last 10 Years



Source: Author, using remittances data from NRB and GDP data from National Statistics Office (NSO)

Figure 15 Nepal's Sources of External Financing



Source: Data obtained from the World Development Indicators (WDI), World Bank

World Bank-IMF Debt Sustainability Analysis

A joint World Bank and IMF debt sustainability analysis (World Bank and IMF 2022) assessed that Nepal is at a low risk of public external debt distress and overall debt distress. However, despite the low risk of debt distress, the assessment indicates some areas of concern. For instance, the assessment finds that two external debt indicators–external debt to exports ratio and debt service to exports ratio—breach the sustainability threshold, which would mean a "moderate risk of debt distress" had it not been for the evaluation of other favorable indicators and unusually high remittance levels. Consequently, the assessment highlights that despite a low debt distress risk, Nepal's "external debt is most vulnerable to shocks to exports" (World Bank and IMF 2022). Furthermore, the assessment finds that Nepal's public debt is most vulnerable to growth shocks—for instance, shocks associated with rolling back COVID-19 forbearance measures as well as climate shocks pose a risk to the low debt-distress assessment. The risk posed by these shocks can be mitigated by enhancing domestic productivity and encouraging competitiveness through scaling up quality investment in infrastructure, through encouraging diversification of export products, and through enhancing monitoring of risks posed by contingent liabilities (World Bank and IMF 2022).

Prudent Debt Target and Debt Sustainability: Evidence from the Literature

In order to evaluate whether Nepal's debt accumulation is sustainable or not, it is necessary to define an optimal level of debt accumulation. The optimal debt accumulation may be thought of as a threshold, which if exceeded, has a net negative effect on growth.[9] While the optimal debt varies according to the country context, there is a substantial literature on optimal debt, albeit without a consensus on what the magic number is. According to a seminal study on optimal debt by Carmen Reinhart and Kenneth Rogoff (Reinhart and Rogoff 2010), public debt exceeding 90 percent of GDP adversely affects economic growth.[10] However, other studies have found the optimal threshold to be at a much lower level (Table 1). For instance, Égert (2013) finds the general threshold beyond which debt has a negative association with growth to be about 50 percent of GDP, but a negative effect could occur with debt levels as low as 20 percent of GDP. Furthermore, some studies find the debt threshold to be lower for countries with lower level of development. For instance, Caner, Grennes, and Koehler-Geib (2010) find the debt threshold for developing economies to be 64 percent of GDP compared to 77 percent of GDP for the entire sample and the negative impact of debt exceeding the threshold is also higher for developing economies.

[9] An optimal debt accumulation, however, may not be stationary. For instance, an increase in growth prospects could mean a higher debt threshold, whereas lower growth prospects occurring from sudden shocks to the economy could mean a lower debt threshold.

[10] Reinhart and Rogoff (2010), while arousing significant interest in the relationship between debt and growth, has also been a subject of significant criticism.

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Table 1 Optimal Debt Threshold as per Empirical Studies

Research Paper	Region /Country Covered	Optimal Debt Threshold
Reinhart and Rogoff (2010), American Economic Review	44 developed and developing countries	90% of GDP
Mehmet Caner, Thomas Grennes and Fritzi Koehler-Geib (2010), World Bank Conference on Debt Management	74 developing countries and 35 developed countries	77% of GDP for developed countries; 64% of GDP for emerging and developing markets
Checherita-Westphal and Rother (2012), European Economic Review	12 European countries	90–100% of GDP, but negative effect may start already at 70–80% of GDP
Cordella, Ricci, and Ruiz-Arranz (2010), IMF Staff Papers	79 developing countries	In countries with good policies and institutions, evidence of debt overhang (negative marginal relation between debt and growth) can be found above the 'debt overhang' threshold of about 20-25 percent of GDP and below the 'debt irrelevance' threshold of about 70–80 percent of GDP. In countries with bad policies and institutions, the thresholds seem to be much lower.
Cecchetti, Mohanty, and Zampolli (2011), Bank for International Settlements Working Papers	18 OECD countries	85% of GDP
Presbitero (2012), The European Journal of Development Research	92 low- and middle-income countries	Public debt has a negative impact on output growth up to a threshold of 90 percent of GDP; beyond this threshold, the effect on output growth becomes irrelevant.
Law, Ng, Kutan, and Law (2021), Economic Modelling	71 developing countries	51.65% of GDP ("Debt has a negative and statistically significant impact on economic growth at a high level of public debt but an insignificant effect at a low level of public debt")
Égert (2013), OECD Economics Department Working Paper	20 advanced economies	General threshold is at about 50%, but a negative association may occur at debt levels as low as 20% of GDP.

Source: Literature review by authors

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Studies also suggest that factors such as the level of exports, government effectiveness, and vulnerability to shocks determine the debt sustainability threshold. For instance, Fournier and Bétin (2018) find export-to-GDP ratio and the perception of government effectiveness to be key drivers of variations in debt limits. Furthermore, even the assessment of low debt distress of Nepal by World Bank and IMF (2020) warns that the debts may be unsustainable in the medium-to-long term if followed by export shocks, economic growth shocks, and risks related to contingent liabilities. Moreover, even if there may be no statistically significant relationship between public debt and growth, research has shown that there is a "statistically significant threshold effect in the case of countries with rising debt-to-GDP ratios," implying that debt trajectory may be more important than the level of debt (Fall and Fournier 2015).

Summing Up the Sustainability Assessment

Applying the findings of the literature to Nepal's context, one can infer that the steep rise in public debt in Nepal risks pushing it into growth-impeding or unsustainable territory. Nepal's government's strategy (Medium-term Debt Management Strategy (FY 2021/22–2023/24)) also targets keeping the debt-to-GDP ratio below 50 percent in the medium term (MoF 2021). Thus, it is appropriate to say that the government has set a prudent debt target; however, the possibility of meeting the target may be fraught with uncertainties given that political drivers such as the implementation of federalism and rising social expenditure, without concomitant institutional reforms, have resulted in the precipitous accrual of public debts. Furthermore, the low quality of public spending caused by factors such as delays in completing large infrastructure projects, ad-hoc selection of development projects, and non-targeted social expenditures (perceived as wasteful) implies a sub-optimal return on the incurred debt. Furthermore, a major concern in Nepal is that the increased government spending, significantly financed through increasing public debt, is of a haphazard nature rather than contributing to the productivity and capital of the country.[11] This also indicates that unsustainability can kick in at lower levels of debt. Historical evidence also suggests that default can occur at ratios of debt to Gross National Product (GNP) that are far lower than what is considered sustainable—for instance, "more than half of all defaults" in the case of middle-income countries in the period 1970–2008 occurred at debt to GNP levels below 60 percent, and 20 percent of the defaults occurred at levels below 40 percent of GNP (Reinhart and Rogoff 2009). Hence, while Nepal's public debt may not be unsustainable at the present moment, its precipitously rising public debt coupled with low exports, sub-optimal government effectiveness, and potential vulnerability to shocks may be driving public debt towards a moderately unsustainable trajectory.

[11] This point was stressed by all the experts during our in-depth interviews. This is also the theme of media accounts. For instance, see: https://ekantipur.com/opinion/2022/09/09/166268645869575700.html

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Structural Drivers of Nepal's Public Debt

This section assesses the primary drivers of the steep rise in Nepal's public debt stock. The assessment focuses on structural patterns and excludes transient drivers such as earthquakes and COVID-19, which had a notable impact on driving up public expenditure but whose impacts have diminished or become insignificant.[12]

Ambitious Growth and Development Plans Without the Necessary State Capacity

There is nothing wrong with having ambitious growth and development plans. If grounded in realistic aspirations and accompanied by concrete actions, a high level of economic growth can transform the living standards of a large segment of the population within a relatively short period of time, as shown by the economic transformations of Japan, China, and four Asian tiger economies. Nepal has had lofty growth and development plans since the inception of its development planning, but its latest development plan (the fifteenth plan), prepared against the backdrop of the introduction of a new constitution and the subsequent elections leading to the formation of a government with a two-thirds parliamentary majority, has been especially ambitious.[13] Nepal's latest periodic development (fifteenth five-year development plan) was designed to have three separate stages. The first stage aimed to create a robust foundation for a highly ambitious long-term vision, which meant massive investment in physical infrastructure development spanning transportation, energy, information and communication, irrigation, and more (NPC 2020). Additionally, the fifteenth plan set a high target for economic growth—average GDP (producer's price) growth rate of 10.1 percent per annum over the five-year period of the plan (FY 2019/20–2023/24). Likewise, the plan envisioned significant improvements in a wide array of socio-economic areas, including poverty reduction, human capital development, employment creation, and more importantly, infrastructure development. Accordingly, the plan projected a significant role of public investment and a notable increase in public expenditure to achieve its goals—for instance, the target for the total government budget as a share of GDP for FY 2023/24 was 43.3 percent compared to 34.9 percent witnessed in FY 2018/19 (NPC 2020). Consequently, partly after the promulgation of the new constitution in 2015, successive governments have presented an inflated budget (i.e., annual projection of expenditure and receipts), and sought increased amounts of loans to meet the widening deficit, which has contributed to the rise in public debt in recent years.[14]

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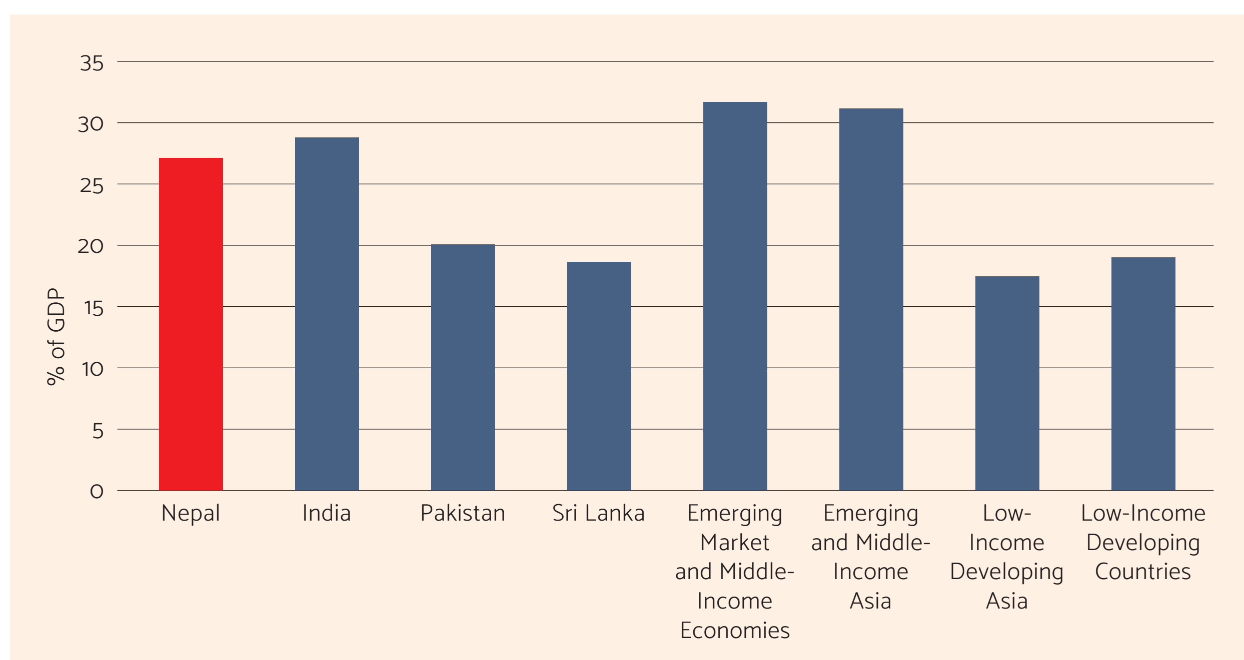
[12] For instance, external debt increased by about 5 percent of GDP in FY 2019/20, partially due to development partners' support in tackling COVID-19 impacts (World Bank and IMF 2022).

[13] This point was emphasized in one of the interviews of experts that was carried out by the study.

[14] Ibid.

A comparison of Nepal's government expenditure (as a percent of GDP) with comparator countries and country groups also shows that the government expenditure is high. While the government expenditure (as a percentage of GDP) is slightly lower than that of India, it is much higher than that of other comparator countries such as Pakistan and Sri Lanka, and is significantly higher than the average seen in low-income developing countries (Figure 16).

Figure 16 General Government Expenditure (% of GDP), 2022

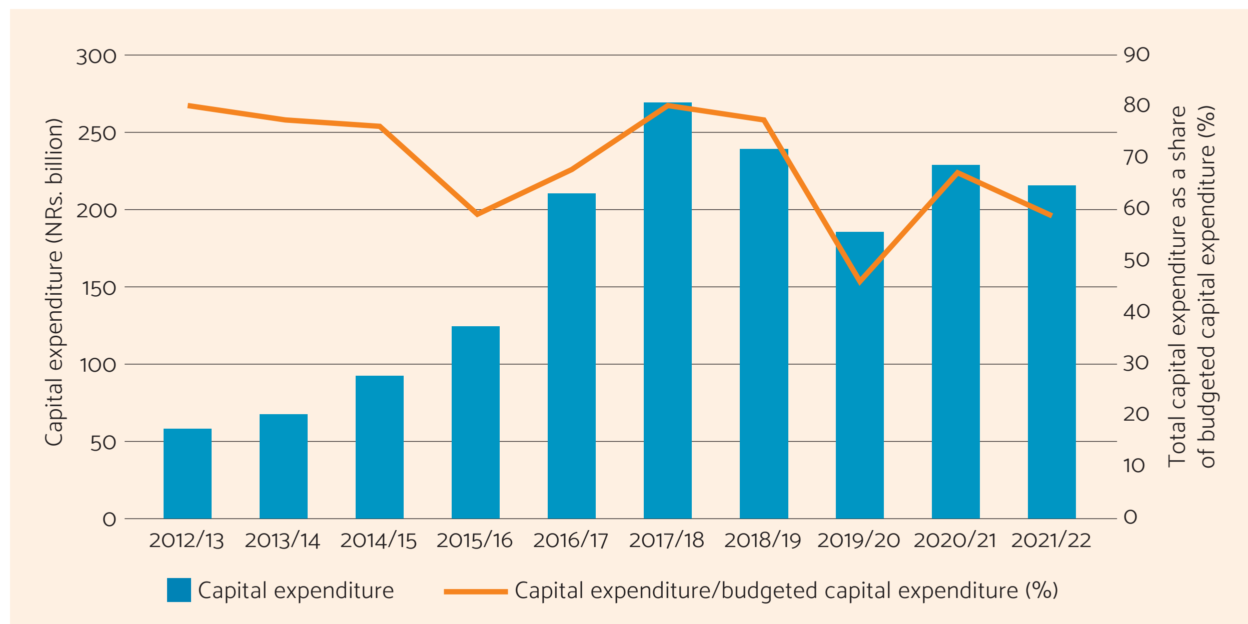


Source: Fiscal Monitor (April 2023), IMF

The presence of ambitious growth and development targets, coupled with significant aspirations of people, who suffered for many years marked by insurgency and transition, has led to intense political pressure for increased government spending to realize these goals. However, limited state capacity has resulted in issues such as weak project selection and execution, ineffective implementation of plans and policies, the poor state of capital budget expenditure, and the slow pace of reforms, which have reduced the efficacy of government spending. As a result, ambitious targets are not realized, and in addition, wasteful expenditures are added to the public debt without yielding significant benefits. For instance, capital expenditure has not increased in recent years and the actual spending under the capital expenditure heading is significantly below the budgeted capital expenditure, which reflects a poor capacity to execute capital expenditure (Figure 17). Likewise, the government acknowledges that the practice in public finance so far has been to allocate scant budget for a large number of projects and programs rather than allocating adequate

budget for projects and programs of high returns (MoF 2023b).[15] Viewed from this lens, Nepal's public debt, no matter what the figure shows, is already non-optimal—the precipitous rise in public debt has added to the stock of debt, thus shrinking its fiscal space to handle future crises, without generating significant positive benefits in the form of potential future economic gains.

Figure 17 Trends of Capital Expenditure in Nepal



Source: Compiled from FCGO (2018), FCGO (2021), and FCGO (2023)

Federalism as a Driver of Public Expenditure

Nepal adopted a new Constitution in 2015, which radically transformed its governance structure from a unitary system to a federal structure. The implementation of federalism has been followed by a rapid rise in public expenditure. After the federal government started making intergovernmental transfers to the newly created sub-national governments (seven provincial governments and 753 local governments) starting in FY 2017/18, there has been a sustained increase in the recurrent expenditure of the federal government,[16] which has been a major catalyst for driving up the public expenditure in the post-federalism era (Figure 18).[17] More importantly, a distinct break is seen in

[15] Paragraph 30 of the budget speech of FY 2023/24.

[16] While the intergovernmental transfers to the provincial and local governments are recorded as the recurrent expenditure of the federal government, the intergovernmental transfers fund both the recurrent and capital expenditure of the subnational governments. Hence, these intergovernmental transfers are not solely recurrent expenditures.

[17] Nepal's statistical authority–the Central Bureau of Statistics (now National Statistics Office)—rebased its national account statistics in 2021, thus publishing new figures for GDP. Hence, the computations involving GDP in this report will slightly differ from earlier publications.

the public expenditure after the inception of inter-governmental transfers in 2017/18 (Figure 18).[18] More specifically, the federal government's budget deficit-to-GDP ratio increased significantly from 6.0 percent in FY 2016/17 to 9.0 percent in FY 2017/18. The rise in the budget deficit is even more stark if we compare it with the budget deficit of FY 2015/16–3.2 percent of GDP—which reflects pre-federalism government expenditure before the surge created by post-earthquake reconstruction expenditure (Figure 19). Hence, the structural rise in public expenditure, and consequently the budget deficit, establishes the implementation of federalism as a major driver of the rise in public debt.

In Nepal, a feature of federalism that has a bearing on public debt accumulation is that the direct expenditure of the federal government (federal government's expenditure excluding intergovernmental transfers) has not seen a substantial decrease after the implementation of federalism (Figure 20).[19] Moreover, the federal government's recurrent expenditure shows a slightly increasing trend and the capital expenditure shows a slightly decreasing trend after the implementation of federalism (Figure 21). Given that duplication of expenditures by the federal government and sub-national governments has been reported,[20] due to the lack of clarity on the jurisdiction of each level of government on certain concurrent functions, the increased federal expenditure—and expenditure of subnational governments for that matter—can be streamlined.

Furthermore, some flaws have been reported in the implementation of federalism in Nepal that have consequences for increased public expenditure, and consequently the public debt. Besides the duplication of expenditure in areas of concurrent functions, Nepal's fiscal federalism is characterized by a large vertical fiscal gap—devoid of the ability to raise substantial revenues on their own, sub-national governments have a high dependence on inter-governmental transfers from the federal government—which poses fiscal risks such as the federal government bearing the ultimate responsibility in the case of subnational deficits and therefore creating a deficit bias in subnational governments (World Bank 2021). In addition, the large vertical imbalance may constrain the subnational government's ability to undertake transformative infrastructure projects and other important forms of capital expenditure. As a result, the public debt accumulation is primarily used to fulfill recurrent expenditures, making the public debt accumulation a low-yield phenomenon.

[18] The public expenditure in FY 2016/17 also saw a major rise compared to the preceding year as the devastating earthquake of 2015 necessitated a major outlay from the treasury for recovery and reconstruction.

[19] This point is also emphasized by World Bank (2021).

[20] For instance, see World Bank (2021).

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Figure 18 Federal Government Spending Before and After Federalism

Figure 18(a) Total Federal Government Expenditure

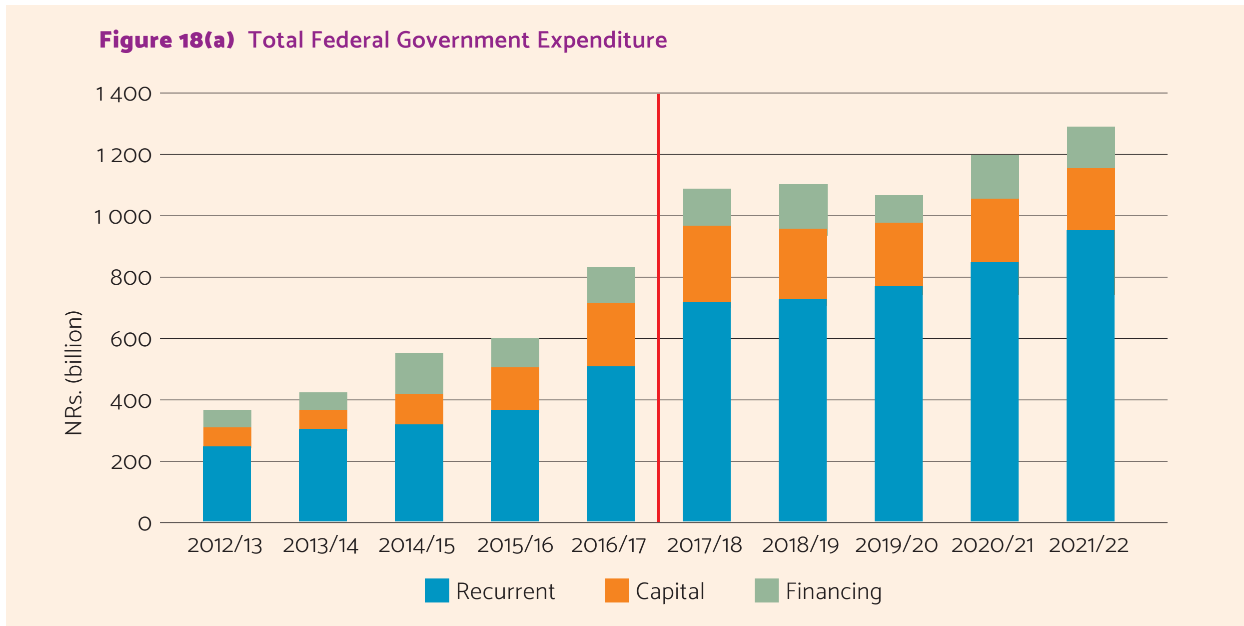
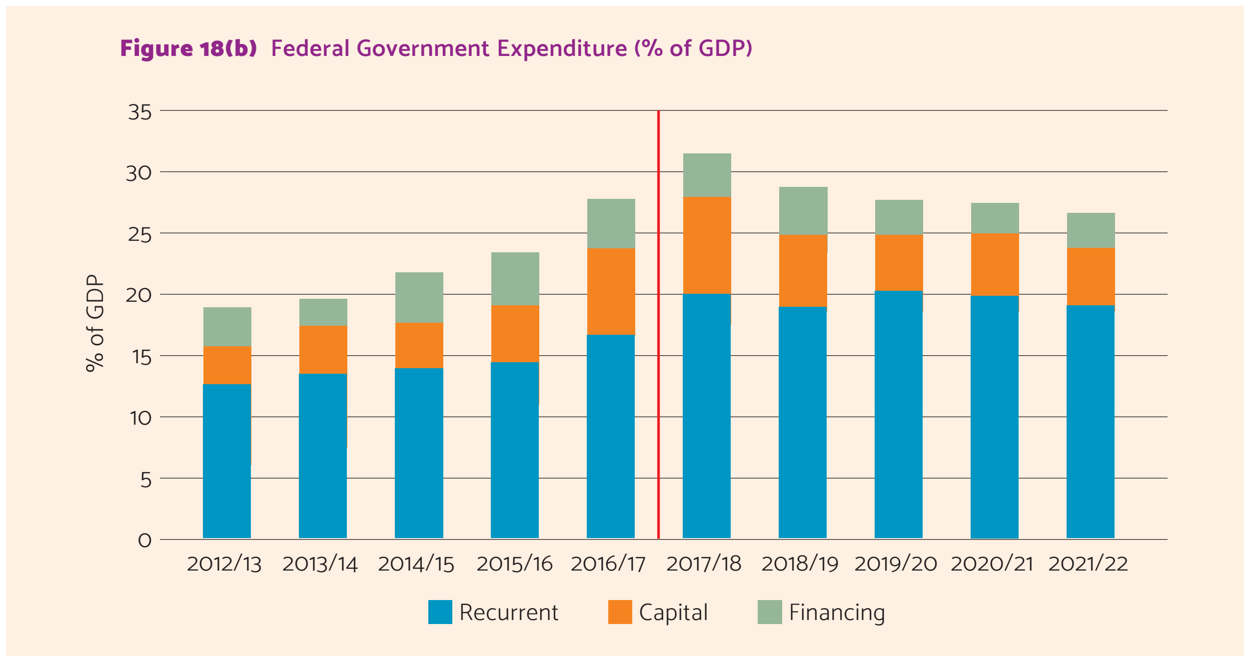
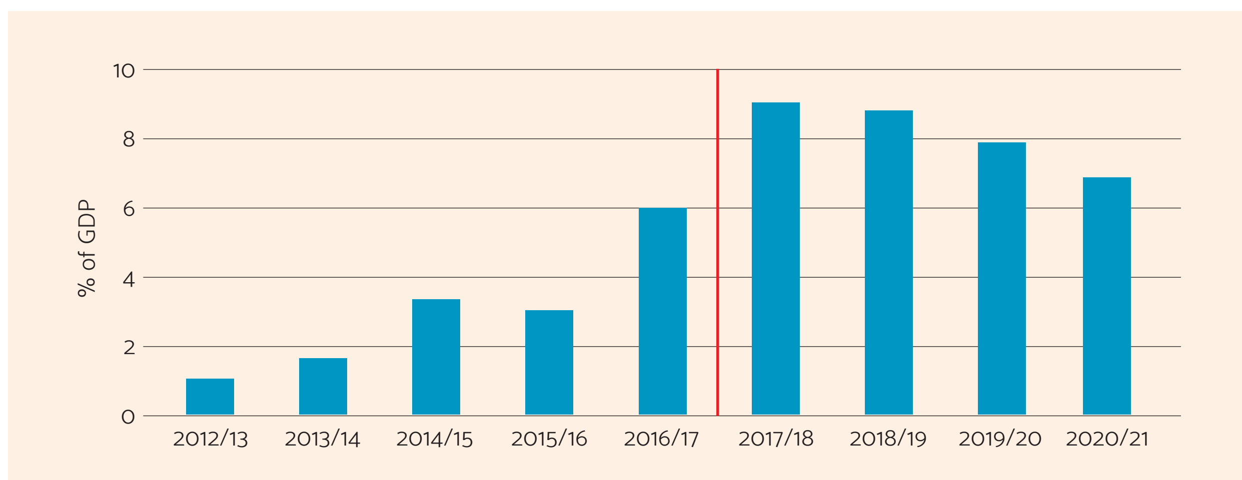


Figure 18(b) Federal Government Expenditure (% of GDP)



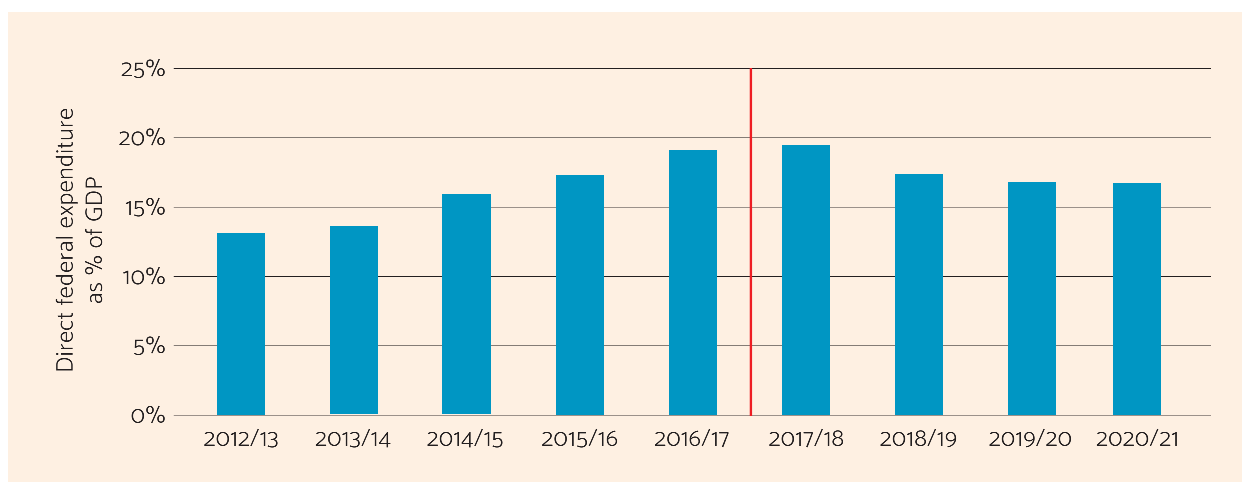
Source: Based on data obtained from Nepal Economic Survey (MoF, 2023c) and Financial Comptroller General Office (FCGO)

Figure 19 Budget Deficit Trends



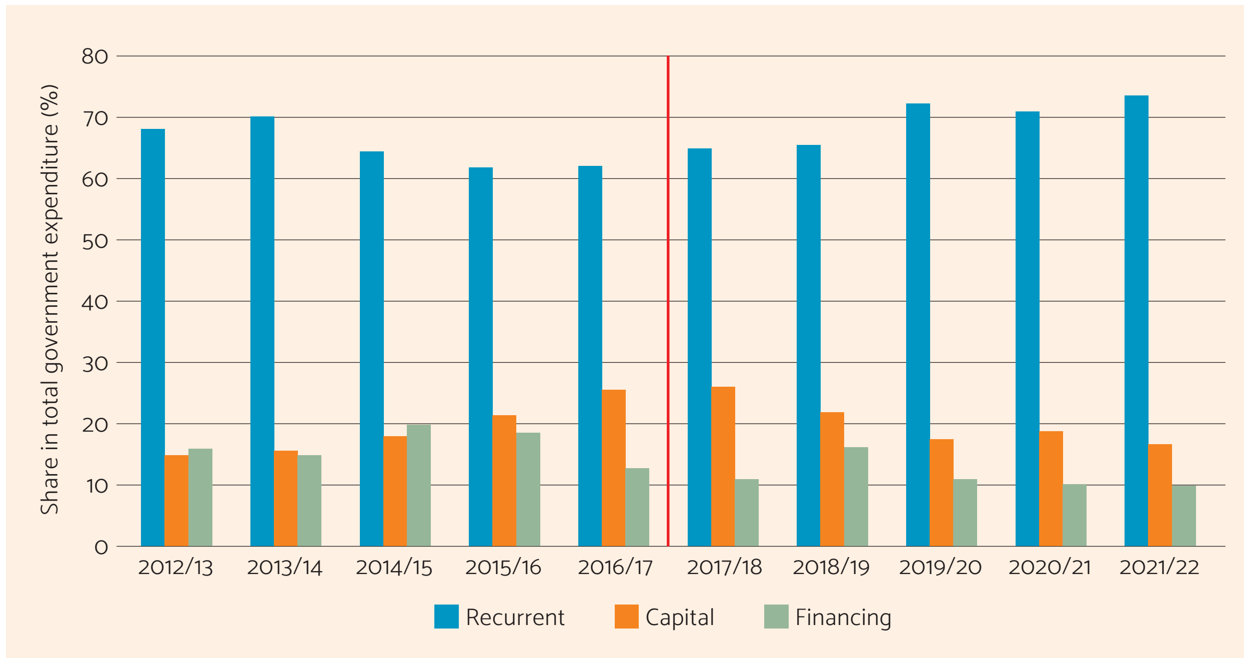
Source: Based on data obtained from Nepal Economic Survey (MoF, 2022) and FCGO

Figure 20 Direct Federal Expenditure (excluding inter-governmental transfers)



Source: Based on data obtained from Nepal Economic Survey (MoF, 2022) and FCGO

Figure 21 Trends in Recurrent, Capital, and Debt Financing Expenditure

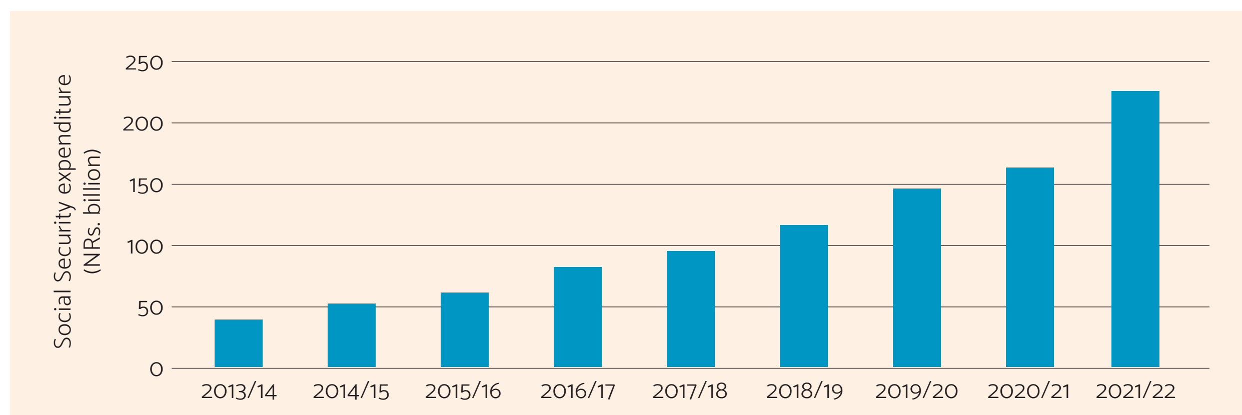


Source: Compilations from FCGO (2018), FCGO (2021), and FCGO (2023)

Rise in Social Spending

An exponential rise in the government's social security expenditure has been another major driver of Nepal's increased public expenditure. The Nepalese government provides social protections in the form of social-security allowances, pensions, scholarships, gratuity, and health benefits, among others. Over the last decade, social security expenditure has seen a meteoric rise (Figure 22), significantly adding to the government's expenditure, and hence to the public debt accumulation.

Figure 22 Trends in Social Security Expenditure



Source: Economic Survey (MoF 2023c)

Table 2 Social Security Allowances and Amounts in Nepal

Beneficiary Group	Monthly Allowance (NRs.)
Senior citizens (68 years and above)	4 000
Senior citizens (residents of Kamali district or belonging to the Dalit group (66 years and above)	2 660
Single women (60 years and above)	2 660
Widow	2 660
Complete disabled	3 990
Severe disability	2 128
Endangered indigenous tribes	3 990
Children	532

Note: *The data is as of the end of FY 2022/23*

Source: Department of National ID and Civil Registration; Economic Survey

Social security allowances constitute an important component of the government's social security expenditure. The government provides social security allowances under multiple headings (Table 2). Over the past few years, the social security allowance has increased substantially, largely due to a significant increase in the old-age allowance as well as a reduction in the minimum age at which one can receive the pension. Furthermore, social security allowances, particularly the old-age allowance, have also been criticized for having electoral motivations.[21] Observations indicate

[21] For instance, see The Kathmandu Post (2022) and Shrestha (2022).

that political parties have been using the old age allowance as a tool to increase their votes in the elections.[22] For example, the two major parties in Nepal, the Nepali Congress and the Communist Party of Nepal (Unified Marxist-Leninist) (CPN-UML), proposed many handouts in the months preceding the 2022 parliamentary election. This includes increasing the generosity of the old-age pension scheme, with the Nepali Congress proposing reducing the qualification age and the CPN-UML proposing increasing the allowances for all social security transfers (The Kathmandu Post 2022). However, increasing non-targeted social security expenditures will have a significant impact on the national treasury, without necessarily having a significant beneficial impact on the recipients.[23] In addition, as Nepal's population is rapidly aging (NPC 2017), haphazard allocations of non-targeted old-age pensions will have a significant impact on public finances. For these reasons, reforming the social security system is important for better managing Nepal's increasing public debt accumulation.

Changing Landscape of the Official Development Assistance Receipts

Loans Replacing Grants in the ODA Mix

It is important to note that loans have significantly outpaced grants in Nepal's official development assistance (ODA) mix since FY 2017/18 (Figure 23 and Figure 24). For instance, at its recent peak in FY 2013/14, grants constituted 66.4 percent of total ODA receipts, while loans represented 17.9 percent and technical assistance (TA) represented 15.7 percent of total ODA receipts (Figure 24). Since then, the grants component has seen a gradual decline, and the loan component, after surpassing grants in FY 2017/18, now constitutes a significant 67 percent of total ODA receipts compared to 21.5 percent for grants and 11.4 percent for TA (Figure 24).

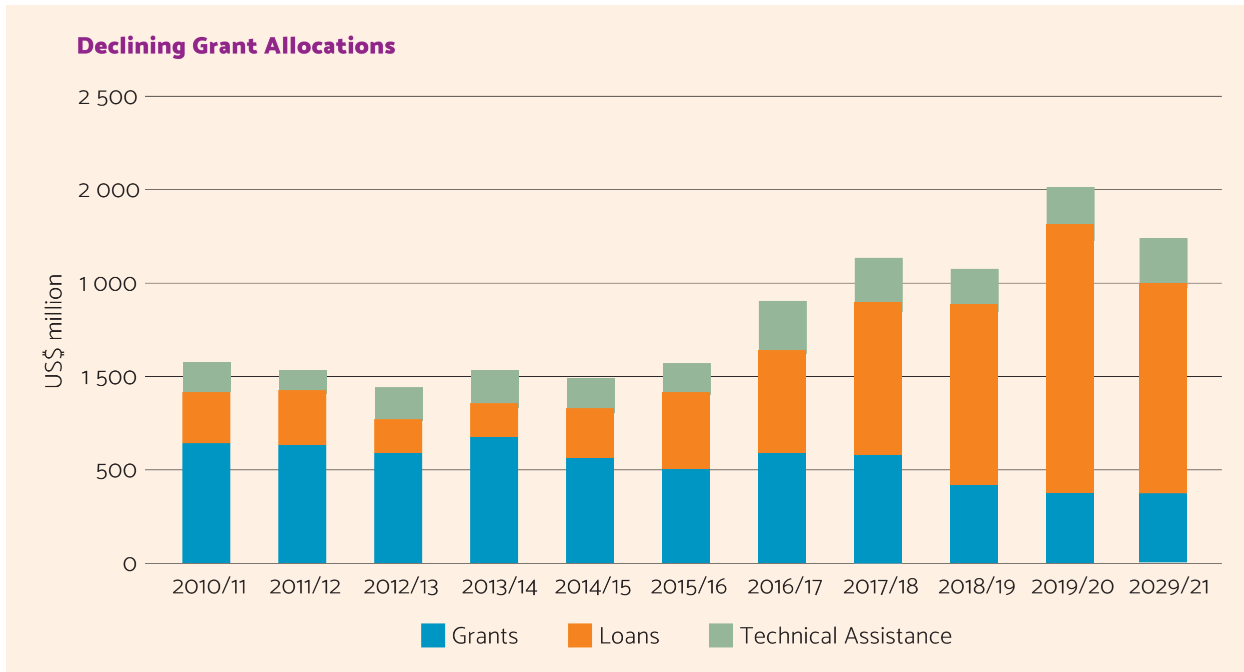
This trend is an outcome of a gradual shift towards multilateral institutions for the majority of the external ODA. Furthermore, ironically, the shift is a result of Nepal's excellent debt repayment capacity. For instance, the Asian Development Bank specifies in its concessional assistance policy that the proportion of grants is determined by the debt-distress classification (ADB 2016). Similarly, the World Bank uses debt distress as a criterion for determining eligibility for grants (World Bank 2023). The increasing dominance of loans in ODA receipts has contributed to Nepal's increasing external debt.

Nepal's current external loans, which are primarily sourced from the World Bank's IDA and ADB, have low interest rates and long maturity periods. However, since Nepal has recently graduated from the low-income category to the lower-middle-income country (LMIC) category, and is graduating from the LDC group in 2026, a possible reduction in the concessionality of Nepal's external loans may impact the sustainability of its external debts (Pandey, Kharel, Dahal, Singh, and Aryal 2022).

[22] For instance, see The Kathmandu Post (2022) and Shrestha (2022).

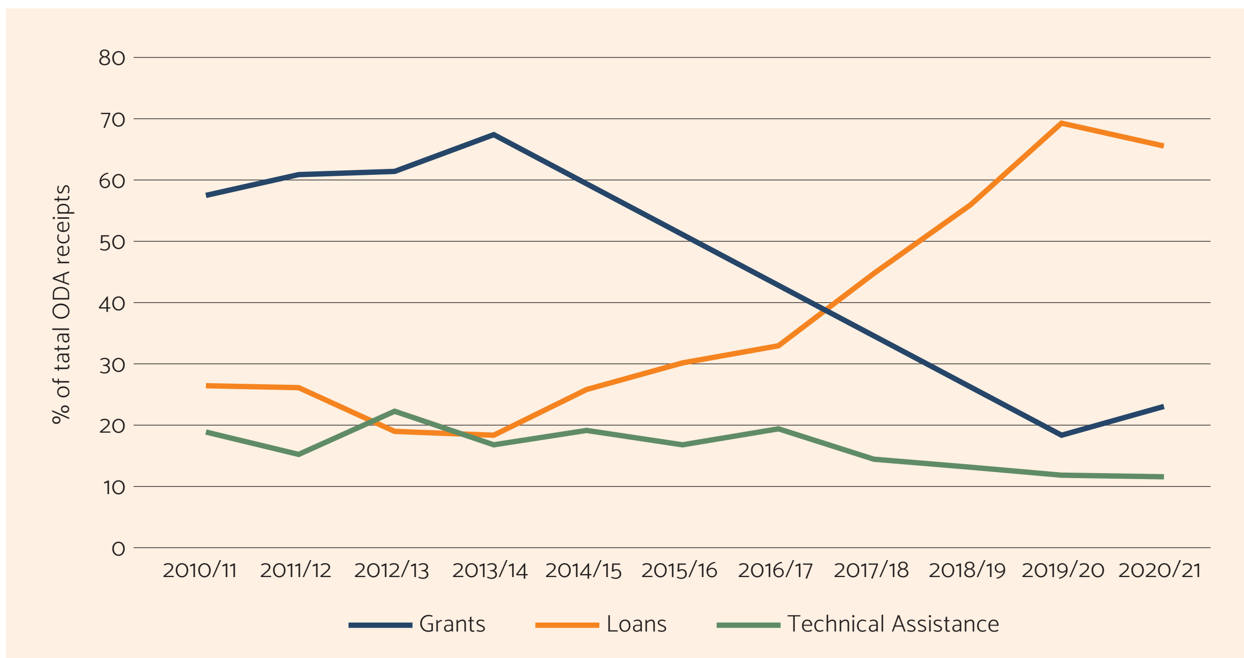
[23] For instance, see Ojha (2019) for a media account of how beneficiaries are not happy with the amount of increase in the old-age pension.

Figure 23 Decreasing Grant Allocations in Nepal's ODA Receipts



Source: Data obtained from different editions of Development Cooperation Report, Ministry of Finance

Figure 24 Changing Share of Loans and Grants in Nepal's ODA Receipts



Source: Based on compilations from different editions of Development Cooperation Report, Ministry of Finance

LDC Graduation and Income-level Graduation

Nepal is poised to graduate from the least developed countries (LDC) category[24] in 2026. While the increasing concentration of loans in the ODA receipts has been adding to the debt burden, Nepal's impending graduation from the LDC category and more particularly, Nepal's concomitant rise in per capita income, could potentially add to the debt burden by reducing the grant receipts and by reducing the loan concessionality.

LDC Graduation May Have a Modest Impact on Nepal's ODA Scenario

Considering that developed countries have committed to prioritizing development assistance to LDCs–for example, providing the equivalent of 0.15–0.20 percent of their gross national income (GNI) as ODAs to LDCs[25]—and that a fixed share of ODA will be provided as grants rather than loans to LDCs, the development cooperation landscape could be expected to change adversely for the graduating LDCs (WTO 2020). However, given that those commitments are mostly not realized, and most bilateral and multilateral donors do not use LDC status as a criterion in their ODA allocations, LDC graduation has not resulted in development assistance falling as expected, and thus LDC graduation, in practice, is expected to have a modest impact on ODA scenario post-graduation for the graduating countries (WTO 2020). However, some impacts on development cooperation are expected. For instance, a few countries have changed their development cooperation approach for non-LDCs. A few of the ODA providers—Japan, the Republic of Korea, and Germany—use LDC status as a deciding factor for their ODA policies–graduating countries will likely face higher interest rates and shorter repayment periods in the case of loans received from Japan and the Republic of Korea, while Germany will gradually shift from grants to loans for non-LDCs (Tavares 2021; UNDP 2022). Japan provides very generous loan terms to low-income countries that are LDCs–0.01 percent (Pandey, Kharel, Dahal, Singh, and Aryal 2022). Japan's loan to Nepal represents 4.8 percent of Nepal's total external debt stock. Since Nepal's LDC graduation will also be followed by a change in the income category, Nepal is expected to face higher interest rates on its loans from Japan after it graduates from the LDC category—interest rates that are about 25–60 basis points higher for non-LDC lower-middle income countries, according to their terms and conditions in 2019 (WTO 2020). The loans from the Republic of Korea are expected to incur higher interest rates after graduation; however, the impact will most likely be limited given that such loans represent only about 0.6 percent of Nepal's total external debt stock. Furthermore, while the modality is not clear, China prioritizes LDCs in their development cooperation (Pandey, Kharel, Dahal, Singh, and Aryal 2022). Moreover, LDC graduation will likely curtail the UN system budget and access to other

[24] Since 1971, the United Nations has categorized countries that have low levels of income and face immense structural barriers to their development prospects into the LDC category. These countries are accorded special and differential treatment in several areas. See Pandey, Kharel, Dahal, Singh, and Aryal (2022) for more information about the LDC category as well as the impact that graduation will have on Nepal.

[25] For instance, the developed countries reaffirmed their commitment to achieve the target of 0.15-0.20 percent of ODA/GNI to LDCs in the 2030 Agenda for Sustainable Development as well as the Istanbul Programme of Action for the LDCs for the Decade 2011-2020. The recent Doha Programme of Action for the Least Developed Countries for the Decade 2022-2031 also encourages ODA providers to target at least 0.20 percent of gross national income for ODA to the LDCs.

dedicated technical assistance and capacity-building funding windows such as the Technology Bank, the LDC Fund (on climate change), and the Enhanced Integrated Framework (WTO 2020). Hence, LDC graduation is expected to have a modest impact on Nepal's development cooperation assistance.

Income Graduation Will Have Implications for Nepal's Favorable ODA Terms

Nepal graduated from the low-income category to the lower middle-income category in the fiscal year 2021 after surpassing the GNI per capita threshold (calculated using the World Bank Atlas Method) for the first time (Table 3). Gradually, Nepal's per capita income level is reaching a level that could have an impact on the level of concessions that it receives while borrowing from multilateral partners.

Table 3 Nepal's Graduation from Low Income Category to Lower Middle Income Category in World Bank Classification

Bank's fiscal year	FY19	FY20	FY21	FY22	FY23
Data for calendar year	2017	2018	2019	2020	2021
Low income (L)	⩽ 995	⩽ 1 025	⩽ 1 035	⩽ 1 045	⩽ 1085
Lower middle income (LM)	996–3 895	1 025–3 995	1 035–4 045	1 046–4 095	1 086–4 256
Upper middle income (UM)	3 896–12 055	3 996–12 375	4 046–12 535	4 096–12 695	4 256–13 205
High income (H)	> 12 055	> 12 375	> 12 535	> 12 695	> 13 205
Nepal's classification	L	L	LM	LM	LM

Source: World Bank[26]

Impact on World Bank's development assistance: The World Bank categorizes its development assistance to governments into two categories–the International Bank for Reconstruction and Development (IBRD) support, which lends to the governments of middle-income and some creditworthy low-income countries, and the International Development Association (IDA) support, which provides interest-free or low-interest loans (called credits) and grants to the governments

[26] https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups

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of poor countries.[27, 28] Currently, the World Bank offers its development assistance to Nepal solely through IDA credits—Nepal has been only receiving IDA credits and no IDA grants since the bank's fiscal year FY 2015, and Nepal's ODA receipts from the World Bank do not consist of any IBRD loans.[29] The IDA concessional credit terms under which Nepal has been borrowing are comprised of five different types: Regular, Blend, Small Economy, 50-year Credit, and Shorter Maturity Loan (World Bank 2023). The 'regular' category or the IDA-only non-gap category offers the most favorable lending terms, which currently include no interest charges and 38 years' amortization with a grace period of six years (World Bank 2023). However, once a country exceeds the operational cut-off for IDA eligibility[30] for two consecutive years, it is classified as a 'gap country' (World Bank 2023). Upon a positive creditworthiness assessment by IBRD, a gap country may be reclassified from regular (IDA-only) to blend status (World Bank 2016).[31]

In the case of Nepal, its GNI per capita value is rapidly approaching the operational cutoff (Table 4). Once it breaches the operational cutoff for two consecutive years, it will reach the gap status, and upon the positive assessment of creditworthiness by IBRD, it may move to the 'blend status'. This transition will result in less favorable loan conditions (Table 5). Given that Nepal is fast approaching the operational cutoff, it may make the transition to 'blend' status in a few years, which will impact the concessionality of loans it receives from the World Bank. Given that the World Bank represents the largest source of ODA for Nepal, less-favorable loan conditions will have a bearing on its public debt.

Table 4 World Bank's Operational Cutoff for IDA Loans and Nepal's GNI per Capita

Bank's fiscal year	FY19	FY20	FY21	FY22	FY23
Data for calendar year	2017	2018	2019	2020	2021
Operational cutoff (GNI per capita, US$)	1 145	1 175	1 185	1 205	1 255
GNI per capita for Nepal (US$)	970	1 110	1 220	1 180	1 220

Source: 'World Bank Country and Lending Groups' for operational cutoff and WDI for Nepal's GNI per capita

Table 5 Terms and Conditions of IDA-loans (Regular vs Blend)

[27] https://financesapp.worldbank.org/summaries/ibrd-ida/#ibrd-len/.

[28] IBRD and IDA collectively constitute the World Bank.

[29] https://financesapp.worldbank.org/summaries/ibrd-ida/#ibrd-len/countries=NP/.

[30] The operational cut-off (annually revised) for FY 2023, measured in terms of GNI per capita for the year 2021, is US$ 1,255.

[31] Theoretically, an IDA-only non-gap country may also be classified to the blend status, but this rarely occurs (World Bank 2016).

Terms and Conditions	Regular Terms	Blend Terms
Interest charge (SDR)	No interest charge	1.25% (in addition to the service and commitment charges)
Amortization period	38 years	30 years
Grace Period	6 years	5 years
Service charge (SDR)	0.75%	0.75%
Commitment Charges	0%–0.50% per annum	0%–0.50% per annum

Source: World Bank (2023)

Impact on ADB's development assistance: Developing countries receiving ADB assistance are classified into three categories:

(i) Concessional assistance-only (Group A),
(ii) Ordinary Capital Resources (OCR) blend (Group B), and
(iii) Regular OCR-only (Group C).

Group A (concessional assistance-only) represents countries needing the greatest concessionality and grants[32]; Group B (OCR blend) represents countries needing some concessionality; and Group C represents countries needing the least concessionality.[33] The criteria for determining the country classification are based on twin pillars: (i) gross national income (GNI) per capita cutoff, and (ii) creditworthiness for less-concessional regulatory ordinary capital resources (OCR) loans or market-based resources (ADB 2023). The GNI criterion uses the same cutoff for eligibility that the World Bank's IDA uses, which is revised annually (Table 4). As per ADB's graduation policy, the determination of creditworthiness is based on both quantitative scores and qualitative assessments[34] (ADB 1998), which are not made public (ADB 2023). Assessment of creditworthiness would place countries into three groups: adequate creditworthiness, limited creditworthiness, and lack of creditworthiness (ADB 2023). The twin criteria form the basis for the decision of the country classification (Table 6).

Table 6 ADB's Decision Matrix of Classification

[32] Group A consists of countries receiving support in the form of a 100 percent grant (Asian Development Fund only), those receiving a mixture of grants and loans (ADF blend) and those receiving 0 percent grant or concessional OCR lending only (COL-only).

[33] https://www.adb.org/what-we-do/public-sector-financing/lending-policies-rates.

[34] In ADB's graduation policy (ADB 1998), the second criterion for determining eligibility was named "debt repayment capacity," which has now been changed to "creditworthiness for regular ordinary capital resources (OCR) loans or market-based resources."

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Creditworthiness*	Per Capita GNI Cutoff		
	Below Per Capita GNI Cutoff	Above Per Capita GNI Cutoff	
		LDC	Others
Lack of	Concessional assistance-only (Group A)	Concessional assistance-only (Group A)	OCR Blend (Group B)
Limited	OCR Blend (Group B)	OCR Blend (Group B)	OCR Blend (Group B)
Adequate	OCR Blend (Group B)	OCR Blend (Group B)	Regular OCR-only (Group C)

*Creditworthiness for regular OCR loans or market-based resources

Source: Reproduced from ADB (2023)

Nepal is currently categorized as a 'Concessional assistance-only (Group A)' country owing to its GNI per capita being less than the cutoff value (IDA operational cutoff)[35] and its being assessed as lacking creditworthiness. Furthermore, given that Nepal's risk of debt distress is assessed as being low by the IMF-World Bank Analysis, Nepal belongs to the concessional OCR lending only (COL-only) category under Group A,[36] which means it receives no grants but only concessional loans. Even when Nepal's GNI per capita breaches the cutoff (which Nepal is fast approaching), Nepal will remain in Group A as long as it is an LDC. However, breaching the income cutoff combined with graduation from the LDC category will push Nepal into Group B (OCR blend). That will be irrespective of its level of creditworthiness. Even during the few more years in which Nepal remains an LDC, there is a theoretical possibility that Nepal will move to Group B if its creditworthiness is assessed to have improved from 'lack of creditworthiness' to 'limited'. While Nepal seems poised to breach the GNI per capita threshold in the near future, it is difficult to judge when the assessment of its creditworthiness will improve. However, it may be reasonable to expect that this may happen in a few years given that there are discussions in the policy sphere of conducting a sovereign rating of the country and gradually borrowing from foreign capital markets. Hence, in a few years, Nepal may transition from Group A to Group B, which will make its ADB borrowings dearer (Table 7).

Table 7 Terms and Conditions of ADB's Concessional-loans: Concessional-assistance Only vs OCR Blend

[35] Since Nepal is a member of the LDC category, Nepal would have been in Group A even if its GNI per capita had exceeded the cutoff value.

[36] The other categories in Group A are ADF-only (100 percent grant) and ADF blend (a mixture of grants and loans).

Terms and Condition	Group A (Concessional Assistance-only)		Group B (OCR blend)
	Project Loans	Policy-based Loans	
Interest	1% during the grace period; 1.5% during the amortization period	1% during the grace period; 1.5% during the amortization period	2% interest per year
Maturity	32 years	24 years	25 years
Grace Period	8 years	8 years	5 years
Other Features	Equal amortization; No commitment fee	Equal amortization; No commitment fee	Equal amortization; No commitment fee

Source: Lending Policies and Rates, ADB[37]

In summary, Nepal's impending transition from the LDC category, specifically its rising income level (nearing the concessional loan threshold), could impact the concessionality of its ODA receipts in a few years. This will result in higher borrowing costs from external donors, which will have an impact on the country's public debt situation.

Sub-optimal Administration of Government Expenditure: Institutional Issues

Institutional issues—weak capacity in public debt administration, lack of appropriate institutions, sub-optimal budgetary practices, inefficient and extravagant public spending, etc.—lie at the core of Nepal's rising public debt.

Non-transparent, non-scientific, and wasteful budgetary practices: Nepal's budgetary practice is filled with non-transparent and non-scientific practices. For instance, projects that have not undergone the necessary preparations are included in the budget, projects which were not included at the start of the budget are forcefully included during the implementation, a mammoth proportion of capital expenditure is spent only at the end of the fiscal year, and there is a major abuse of budget head change and source change (MoF 2019; OAG 2022). Likewise, wasteful expenditure has also been a source of the dramatically rising recurrent public expenditure (MoF 2019).

Weak capacity to mobilize government expenditure: There is a serious capacity constraint in selecting capital projects and ensuring their proper implementation (World Bank 2021; MoF 2023a). For instance, even the projects that are accorded the highest priority—the 'national pride projects'[38]—face implementation issues (MoF 2019). For instance, only three national pride projects

[37] https://www.adb.org/what-we-do/public-sector-financing/lending-policies-rates, accessed 23 June 2023.

[38] National pride projects are 24 infrastructure projects (out of which three have been completed as of January 2023) spanning irrigation, hydropower, airport, road, etc. that are prioritized by the government for their supposed transformational role in

have been completed (MoF 2023a), and progress in finishing the remaining projects has been slow—expenditures on the national priority projects are well under their allocated budgets. Further, the federal government has seriously underperformed in executing capital expenditures—for instance, only 46.2 percent of the allocated capital budget was spent in FY 2019/20, which increased to only 64.8 percent in FY 2020/21 (MoF 2022). In FY 2022/23, as per the Financial Comptroller General Office (FCGO), only 61.44 percent of the allocated capital budget was spent, with a significant spending done towards the end of the fiscal year. Moreover, the quality and effectiveness of the capital expenditure are also poor; the capital budgets allocated for development works are frequently diverted towards easy expense headings through virement[39] and source transfer (MoF 2022).

Furthermore, weak institutional capacity is also reflected in the fact that foreign loans are significantly less than what is targeted by the budget (Table 8). There are several factors contributing to the underutilization of foreign loans, including the inability or delay of fulfilling procurement and accounting standards in projects supported by foreign resources, and a lack of matching funds (provided by the government). Additionally, the inability to conduct timely agreements with international development partners (MoF 2023) contributes to the underutilization of foreign loans.

Table 8 Actual Receipt of Foreign Loan vs Budgeted Target Foreign Loan

Fiscal Year	Actual Receipt of Foreign Loan as a Share of Budgeted Target Foreign Loan
2014/15	59.09%
2015/16	74.68%
2016/17	29.64%
2017/18	43.66%
2018/19	37.31%
2019/20	54.41%
2020/21	43.70%
2021/22	43.02%
2022/23	49.08%

Source: PDMO

Lack of appropriate institutional mechanisms: Until recently, there was no institution exclusively responsible for managing public debt. Despite the government's designation of the Public Debt Management Office (PDMO) under the Ministry of Finance to manage public debt functions in 2018, it lacked the influence to reform the public debt administration. While the recent legislation—the Public Debt Management Act (2022)—provides legislative backing to PDMO and clearly delineates its duties, functions, and powers, its ability to effect reforms in public debt administration is yet to

development.

39 Virements are transfers of budgetary resources from one expenditure category to another after the budget has already been authorized by the legislature.

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be seen. Likewise, the current institutions responsible for internal control mechanisms and internal auditing have not been effective in reining in the wasteful components of recurrent expenditure (MoF 2019). Additionally, there is a lack of adequate basis and category-wise expenditure standards for recurrent expenditures, which results in excess expenditures. Furthermore, other issues such as weak project implementation resulting from inadequate coordination among the three tiers of the government, delays in fulfilling the vacancy of the chief of projects and staff, frequent transfers, and recurring changes in the political and administrative leadership of the ministry/department/project (MoF 2023) also indicate weak institutional mechanisms. Finally, as indicated by the World Bank-IMF debt sustainability analysis (World Bank and IMF 2022), the government bond market currently lacks depth and must be developed in order to facilitate greater domestic financing.

The government has recently introduced new legislation to enhance public debt management functions (see Box 1). The legislation may be able to solve some of the institutional issues, for instance through the legislative backing of a specialized institution for overseeing the issues of public debt management. However, judging from its functions, duties, and powers, the major focus of PDMO will be providing research and advisory services, thus giving it limited authority in effecting changes. Moreover, the regulations and directives that are required to complete the Act have yet to be drafted. Hence, the root causes of many of the suboptimal and wasteful public expenditures lie outside the scope of the Act, and as such, will require the government to implement major reforms in order to better manage public debt in addition to faithfully implementing the newly promulgated Act.

Box 1 Introduction of New Legislation to Enhance Public Debt Management Functions

Acknowledging the need to reform the public debt administration, the government introduced a new piece of legislation—the Public Debt Management Act (2022). The Act, which came into effect in November 2022, replaces the outdated Public Debt Act (2002) and integrates the debt-related provisions that were defined in other regulations. The Act aspires to better manage public debt administration for the rapid economic growth and economic stability of the country. The Act establishes a separate authority for managing the public debt of the country. While the government had established a dedicated office under the Ministry of Finance—the Public Debt Management Office (PDMO)—to improve public debt management function, the new Act provides legislative backing to the office and clearly delineates its duties, functions, and powers. The Act also provides a regulatory framework for public debt in the context of the federal structure introduced by the new Constitution promulgated in 2015. An important feature of this Act is that it imposes a ceiling on the stock of foreign debt–the stock of foreign debt held by the government (all three tiers of government) cannot exceed the amount equivalent to one-third of the previous fiscal year's GDP.

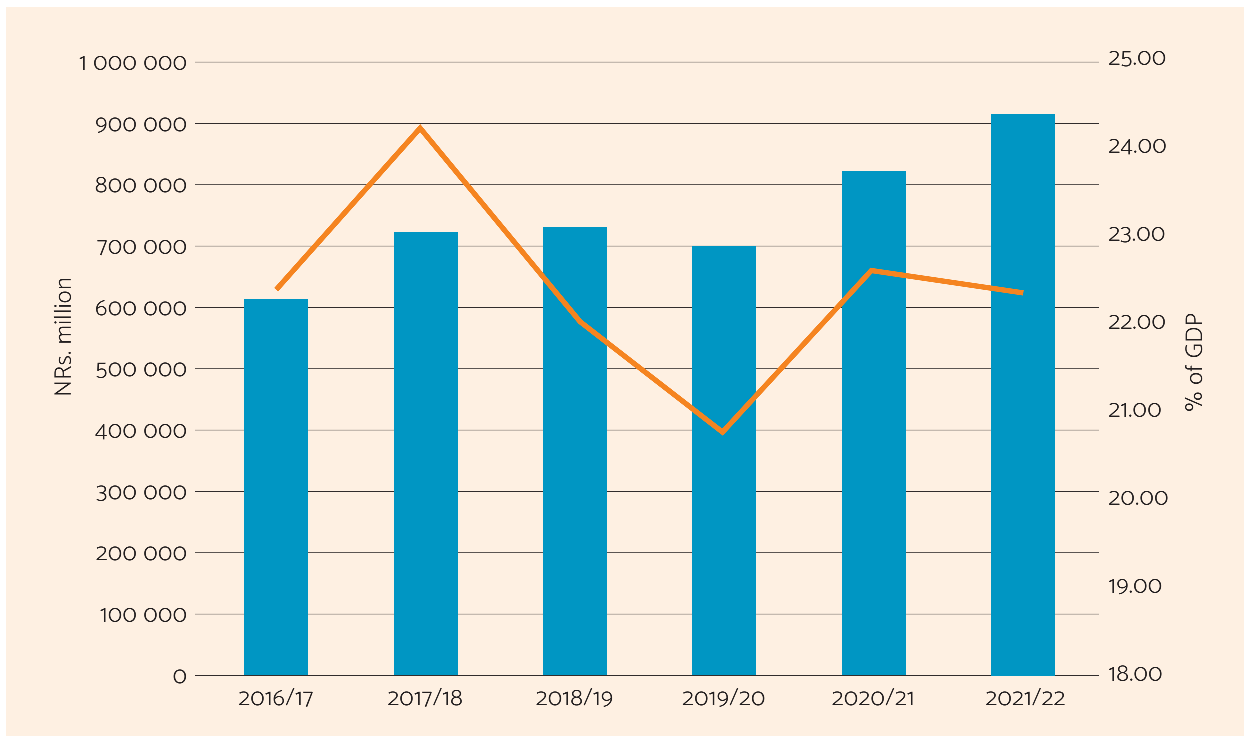
Source: Author, using the information from Public Debt Management Act (2022)

Narrow Revenue Band

On the surface, Nepal's revenue generation looks robust. In the past few years, there has been a steady rise in revenue collection and the revenue-to-GDP ratio remained high (Figure 25). Furthermore, Nepal's revenue collection is superior compared to regional peers and other country

groups (Figure 26). However, the superior revenue collection hides its unsustainable base. Nepal's revenue collection is heavily dominated by import-based taxation, making it unsustainable. For instance, import-based tax accounted for 48.1 percent of total tax revenue in FY 2020/21 and 54.3 percent of total tax revenue in FY 2021/22 (until mid-March) (MoF 2022).

Figure 25 Nepal's Revenue Trends



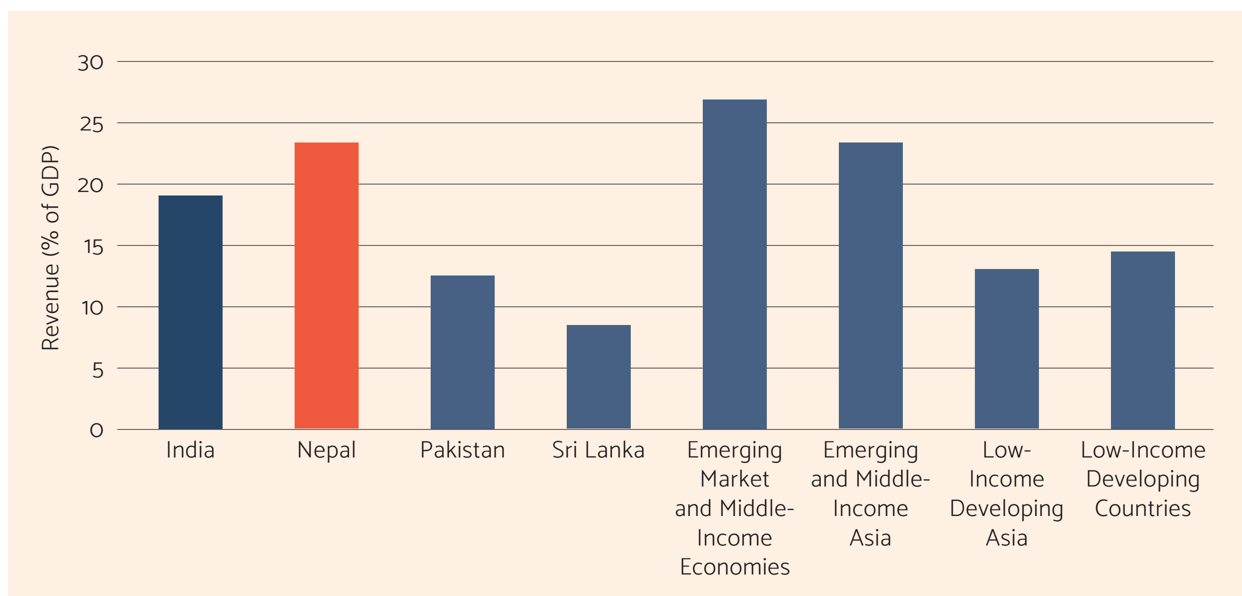
Note: GDP at basic prices is used as the denominator. The government revenue presented in this figure doesn't include grants and recovery of other irregularities that form the total government income.

Source: Based on data obtained from FCGO

The vulnerability of Nepal's revenue system was made apparent in the fiscal year 2022/23. When the government was compelled to impose import restriction measures against rapidly declining foreign exchange reserves,[40] the revenue collection suffered drastic losses. In FY 2022/23, as per Financial Comptroller General Office (FCGO), only 68.2 percent of the revenue target was realized.

Figure 26 Government Revenue (% of GDP), 2022

[40] Increased prices of imports owing to supply-chain issues and the Russia-Ukraine war coupled with a rise in imports owing to ultra-loose credit conditions due to COVID-era recovery policies, but a sluggish growth in remittances, were largely to blame for the precipitous decline in foreign reserves.



Source: Fiscal Monitor (April 2023), IMF

Likewise, the government's revenue raised from internal sources comes from a narrow base—income taxes account for only about a quarter of total tax revenue, while indirect taxes account for most of the revenue (Kharel 2022). For instance, the income tax accounted for only 26.2 percent of total tax revenue in FY 2021/22 and 50.6 percent of total inland tax revenue in FY 2021/22 (MoF 2022). Furthermore, the growth rate of the import-based tax revenue had been higher than the growth rate of internal tax revenue (MoF 2022). This points to an inability to expand the currently narrow inland tax base. Nepal's public debt holding is vulnerable due to the heavy dominance of import-based taxes coupled with a slow expansion of the internal tax base. As seen in the fiscal year 2022/23, import shocks can significantly decrease government revenue—the revenue collection was only 68.21 percent of the targeted revenue. Furthermore, the inability to expand the inland tax base implies lost opportunities for higher revenue collection as well as a risk factor in dealing with debt vulnerabilities arising from import shocks.

Conclusion

Nepal's accumulation of public debt, although seemingly benign, raises some concerns related to its unsustainability. The foremost concern is the meteoric increase in the amount of public debt accumulation in the last few years. Moreover, the growth of public debt is driven by the growth of recurrent expenditure rather than capital expenditure. Debt financing obligations are taking a precipitous rise and the debt financing payments for the fiscal year 2023/24 are expected to be higher than the allocated capital expenditure budget. Furthermore, a low capacity for executing capital expenditures, coupled with a haphazard and non-transparent selection of projects, implies a low rate of return on the accumulated public debt. This also indicates an unsustainable path of public debt accumulation even though the stock of public debt is not alarming as indicated by standard metrics. Overall, a precipitously rising volume of public debt, an alarming increase in debt financing payments, serious challenges to public finance mobilization, and concerns about the rate of return on public expenditure, coupled with a public finance execution system that lacks capacity, casts serious doubts regarding the sustainability of Nepal's public debt.

Our assessment of the political economy of Nepal's public debt finds that the major drivers of the rapid debt accumulation are overly ambitious growth and development targets without the building up of state capacity, adoption of federalism without expenditure rationalization, a rise in social security expenditure (including electorally motivated ones), change in foreign aid dynamics that favor loans over grants, and poor institutional capacity that leads to issues such as underutilization of obtained loans. It is evident that the government has shown some commitment to improving public debt management practices and adopting fiscal prudence, as reflected in the recently promulgated 'Public Debt Management Act.' However, a lack of effective budget implementation capacity in both federal and subnational governments, as well as a poor track record of implementing reforms, indicate a risky outlook. The government must mitigate the unsustainable drivers of rapidly increasing public debt accumulation in Nepal to make the accumulation of debt sustainable, and, most importantly to ensure that public debt drives what it is intended to–growth, development, and the mitigation of crises. In order to reduce dependence on public debt, more reforms are urgently required. These reforms need to strengthen the capacity of the state to manage public debt for growth and development, as well as increase and improve the utilization of alternative sources of financing, such as foreign direct investment and remittances.

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Annex A

Table A List of Persons Consulted for In-depth Interviews

S.N.	Full Name	Remarks
1	Dr. Biswo Poudel	Former Vice Chairman, National Planning Commission
2	Dr. Dilli Raj Khanal	Economist; Academic
3	Dr. Resham Thapa	Associate Professor, Central Department of Economics, Tribhuvan University
4	Mr. Deependra Bahadur Kshetry	Former Governor, Nepal Rastra Bank
5	Mr. Keshav Acharya	Former Executive Director, NRB
6	Mr. Lal Shanker Ghimire	Former Secretary, Ministry of Finance, Government of Nepal

From Borrowing to Sustainability: Understanding Pakistan's Debt Landscape

Ahsan Zia Farooqui, Dr. Faisal Bari,
Waleed Mehmood, Ali Asad Sabir

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About the Authors

Ahsan Zia Farooqui: Ahsan Zia Farooqui is a PhD student in Economics at the University of Sussex and a Doctoral Fellow at ICTD. His research focuses on revenue mobilisation and compliance with subnational tax in weak state capacity. Ahsan has worked on large-scale experimental interventions, including governance, crime and policing, and public finance.

Dr. Faisal Bari: Dr. Bari is IDEAS' Senior Research Fellow and Associate Professor of Economics at LUMS. Dr. Bari has more than 15 years of experience in research on teaching and understanding the role of government policies on human development. He is a member of the Higher Education Commission and has previously served on the board for the Punjab Education Commission.

Waleed Mehmood: Waleed Mahmood is a student in the Master of Data Science program at the University of British Columbia. He has studied economics previously, and he has one year of experience in academic research in developmental economics. His research interests lie in leveraging data science to explore innovative solutions for addressing socioeconomic challenges and informing evidence-based policymaking.

Ali Asad Sabir: Ali Asad Sabir works as a Senior Research Assistant at the Institute of Development and Economics Alternatives (IDEAS) and the Mahbub-ul-Haq Research Centre (MHRC). He has over four years of experience in conducting development research related to governance clusters. His primary areas of interest include political economy, environmental policy and planning, and urban policy planning.

Institute of Development Economics and Alternatives (IDEAS)

IDEAS, based in Lahore, Pakistan, conducts multidisciplinary public policy research to advocate for economic and political reforms, emphasizing public finance and debt management. It aims to address institutional challenges and promote sustainable development through evidence-based studies and policy engagement, contributing to Pakistan's economic stability and democratic growth.

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Executive Summary

Pakistan's current economic context is characterized by a depletion of foreign exchange reserves, which has had significant repercussions on the country's economy. The persistent trade deficit, resulting from high oil prices and a lack of economic diversification, has contributed to the devaluation of the Pakistani rupee and a decline in exports. This situation has particularly affected textile manufacturers, who account for a substantial portion of Pakistan's exports.

To address the economic challenges, Pakistan has implemented a debt management and stabilization program in collaboration with the International Monetary Fund (IMF). In order to improve debt management, the program recommends reducing government spending, increasing tax revenues, and implementing structural reforms. While progress has been made in implementing some of these measures, obstacles such as political opposition and the impact of the COVID-19 pandemic persist.

A major obstacle between the Government of Pakistan and reaching an agreement with the IMF has been the issue of circular debt in the power and gas sectors which has further exacerbated Pakistan's financial situation. A significant amount of circular debt exists in the power sector alone, which necessitates measures to reduce the fiscal deficit to meet IMF recommendations. The government's proposed Circular Debt Management Plan (CDMP) has faced criticism from the IMF due to concerns about its feasibility, lack of clarity in implementation, coordination, and potential adverse effects on vulnerable groups. Additional policy changes are necessary to mitigate the losses incurred by the power sector.

Pakistan's government debt has reached alarming levels, raising concerns about default. However, the government and central bank have taken measures to manage these challenges, and debt repayments are on track. Understanding the historical context of debt accumulation in Pakistan reveals a trend of seeking bailout loans from the IMF over the past four decades. This has resulted in a significant burden of debt passed down through generations, with debt payments surpassing government healthcare spending.

The China-Pakistan Economic Corridor (CPEC) and Public-Private Partnerships (PPPs) play a crucial role in infrastructure development in Pakistan. CPEC projects implemented under PPP mode have attracted substantial investment. However, the increasing share of PPP-related debt in Pakistan's total public debt, along with higher debt servicing costs for PPP projects compared to conventional ones, raises concerns. Converting some projects from PPP to government-to-government mode may alleviate the debt burden, but the effectiveness of such measures requires further evaluation.

The fiscal burden associated with state-owned enterprises (SOEs) present Pakistan with additional challenges. In Pakistan, many SOEs operate at a loss, resulting in poor financial performance and substantial liabilities. Providing bailouts and financial assistance to SOEs can have a positive impact on local economies by ensuring the continuity of essential services. However, bailouts also create moral hazard, distort market incentives, and crowd out private investment, thereby hindering innovation and economic growth.

Addressing the fiscal risks associated with PPPs and SOEs requires decisive policy actions. Strengthening governance frameworks, enhancing transparency and accountability, and pursuing privatization where necessary are key recommendations. The Ministry of Finance should assess and monitor fiscal risks associated with SOEs, evaluate their performance against public policy objectives, and publish audited financial statements. Additionally, a consolidated list of all SOEs as well as an ownership policy document should be published.

To improve the overall financial stability and economic growth, Pakistan needs to implement comprehensive reforms, strengthen fiscal discipline, and address the governance and operational vulnerabilities of SOEs. By taking these steps, Pakistan can mitigate fiscal risks, promote sustainable economic development, and achieve long-term stability.

Introduction

Currently, Pakistan is undergoing a multi-pronged crisis as its foreign exchange reserves stand at $13 million as of February 22, 2024 (State Bank of Pakistan, 2024). Simultaneously, Pakistan is experiencing difficulties in securing a bailout package from the International Monetary Fund (IMF). The Pakistani Rupee has witnessed a steep decline and has fallen to PKR 278.6 per dollar in February 2024 in the inter-bank market (State Bank of Pakistan, 2024). The country's inflation is at a 48-year high and foreign currency reserves cover less than a month of imports (Arif Habib Limited, 2023). According to the Consumer Price Index for February 2023, the annual inflation rate was 31.2%. Rising inflationary pressure has increased the prices of essential commodities such as wheat, onions, gas cylinders, etc. For example, the average cost of a 20kg wheat flour bag in May 2023 was Pakistani Rupee (PKR) 1,164.8[1]. This rapidly increased to an average of PKR 2,400[2] in May 2023 (Government of Pakistan, 2023). Further compounding the situation, the country is also heavily reliant on imports. In recent years, Pakistan's imports have significantly increased, while exports have largely remained stagnant, resulting in a widening trade deficit. There is little technological sophistication in Pakistan's exports, which are mainly comprised of textiles and agriculture-related goods. Pakistan's expenses are also rising. As a result of the high level of borrowing, Pakistan's total debt and liabilities reached Pakistani Rupee 59,697.7 billion (89% of the GDP) in FY22.

The composition of Pakistan's external debt has evolved over time. For instance, in the 1990s, Pakistan's external debt was primarily owed to multilateral creditors, while in recent years, bilateral creditors and commercial creditors have become more prominent. Additionally, China's and Chinese commercial banks held about 30% of Pakistan's total external debt of about $100 billion (Peshimam, 2023). However, Pakistan's external debt composition remains diverse, with a mix of multilateral creditors, bilateral creditors, and commercial creditors.

According to the World Bank, Pakistan's fiscal deficit has been a persistent problem, averaging around 6.3% of GDP between 2000 and 2019. The fiscal deficit is primarily due to circular debt[3] and contingent liabilities arising from government-backed securities provided to state-owned enterprises (SOEs). In Pakistan, SOEs have been experiencing a number of problems, which have negatively affected their performance and financial stability. The primary issue with SOEs is their poor governance and management practices, which have led to corruption, nepotism, and political interference. The SOEs are often used as political tools by the government, which has led to their inefficiency and losses. Furthermore, SOEs in Pakistan lack autonomy and accountability since they are not subject to proper monitoring and evaluation mechanisms. This has contributed to a lack of transparency and accountability in the SOEs' financial matters, which has contributed to their mounting losses and debts. Additionally, SOEs face difficulties in attracting skilled professionals

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[1] Equivalent to USD 6.59.

[2] Equivalent to USD 8.37.

[3] Circular debt occurs when one entity facing problems in its cash inflows holds back payments to its suppliers and creditors.

due to the fact that their salaries and incentives are not competitive with those offered by the private sector. The poor performance of SOEs has put a strain on the country's finances and has been a burden on taxpayers. For Pakistan to ensure its financial sustainability and contribute to its economic development, it is imperative to address the governance and management issues in state-owned enterprises, and implement reforms to improve their efficiency, transparency, and accountability.

In addition to a large SOE sector, political divisions between sub-national governments and the federal government may also contribute to debt mismanagement. For example, the political divisions between the Khyber Pakhtunkhwa government (KPK) and the federal government have had a negative impact on the debt situation in Pakistan post-April 2022. Due to the refusal of the KPK government to refund the loan provided by the federal government, there is a hidden debt situation in which the outstanding debt is not reflected in the official figures. This has undermined the transparency and accountability in the country's financial matters and has put the country's debt situation in a precarious position. The situation has also raised concerns among international lenders, such as the IMF, who have been urging Pakistan to reduce its debt burden and improve its fiscal position (Khan, 2022). Political divisions have also weakened Pakistan's negotiating position with the IMF and other international lenders, which could have negative implications for the country's economic stability. It is important for Pakistan to ensure coordination and transparency between its federal and provincial governments to manage its debt burden and maintain the confidence of international lenders.

Thus, while in Pakistan's domestic landscape, China has been cited as pushing Pakistan into a debt trap, this study argues that the problems leading to debt accumulation significantly predate the launch of the China-Pakistan Economic Corridor (CPEC) in 2013. According to the State Bank of Pakistan (SBP), Pakistan's total outstanding debt to China was around $22.9 billion as of June 2021, which is a relatively modest amount compared to Pakistan's debt to multilateral institutions such as the World Bank and the Asian Development Bank (ADB). The IMF has also noted that Pakistan's debt problem is primarily due to its chronic fiscal deficit and the lack of structural reforms. In its latest country report, the IMF stated that "Pakistan's economic challenges are primarily of a structural nature and require comprehensive reforms to address the underlying causes of the country's persistent macroeconomic imbalances and to boost its potential growth." The IMF in its seventh review also mentioned that "The China-Pakistan Economic Corridor (CPEC) could help boost Pakistan's long term development prospects." CPEC has the potential to improve Pakistan's business environment by reducing infrastructural bottlenecks, and therefore stimulate domestic and foreign investment over the long term. China has also been working with Pakistan to address its debt problem through debt rescheduling and other measures. In December 2020, China agreed to reschedule Pakistan's loans, providing a two-year extension on repayments of approximately $1.7 billion in debt. Furthermore, China has shown a willingness to work with other creditors to address Pakistan's debt problem. In June 2020, China participated in a G20 debt relief initiative for low-income countries affected by the COVID-19 pandemic, which included Pakistan.

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While it is true that China has provided significant loans to Pakistan for infrastructure development under the China-Pakistan Economic Corridor (CPEC) initiative, the debt burden is largely the result of Pakistan's own fiscal mismanagement and overreliance on borrowing. This problem predates the CPEC initiative as Pakistan has a long history of taking on excessive debt to finance its budget deficits and development projects. Furthermore, the terms of Chinese loans under CPEC are largely concessional and often better than those offered by other lenders.

Consequently, it is important to recognize that Pakistan's debt problem is multifaceted and requires a comprehensive solution that addresses the country's underlying fiscal challenges. This includes sound practices in public debt management and in the evaluation, prioritization, and implementation of public investment projects which will be essential to ensure that maximum benefit accrues. Pakistan must effectively organize the Debt Policy Coordination Office (DPCO) as a middle office responsible for updating the medium-term debt strategy (MTDS), monitoring its implementation, and coordinating credit risk management functions.

This study argues that despite a high percentage of Chinese loans in the external debt, macroeconomic policies, the political economy of SOEs, and ongoing political divisions are the primary drivers of the rising debt problem in Pakistan. There is a need to develop an understanding of how various macroeconomic factors contribute to the debt problem. In this regard, the study explores the fiscal burden of state-owned enterprises (SOEs), Public-Private Partnerships (PPPs), and Sub-National Governments (SNGs). For SOEs, the study highlights two main sources of fiscal deficit: a) the circular debt most prominently incurred in the power and gas sector and b) the hidden debt or contingent liabilities. The study also discusses the political economy of SOEs and how despite inefficiencies these SOEs continue to operate. Secondly, the study presents a unique case of how sub-national governments were able to assume independent debt from the federal government after the 18th Amendment passed, and how fiscal decentralization, accompanied by ongoing political unrest between sub-national and federal governments, may lead to an increase in hidden debt.

The rest of the study is structured as follows: **Section 2** discusses the current problems and ongoing talks with IMF. **Section 3** discusses the genesis of the current debt crisis that the country is facing, more specifically highlighting key policies of each regime that led to internal and external debt. **Section 4** discusses the role of PPPs in CPEC, the nature of debt taken by PPPs, and provides estimates of the fiscal risk of debt taken by PPPs. **Section 5** discusses the impact of the fiscal burden of SOEs, and **Section 6** discusses the unique case of Pakistan and the effects of decentralization on government debt.

Methodology of Analysis

The study used a mixed methods approach to answer research questions. The approach was deemed appropriate for this study because the factors leading to debt accumulation in Pakistan are multifaceted and cannot be truly uncovered by only using quantitative or qualitative data. Hence

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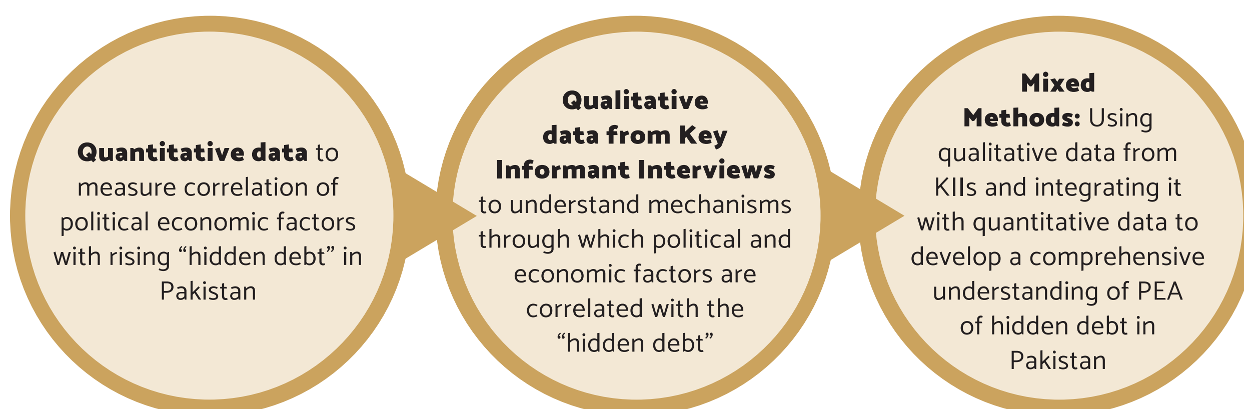
quantitative data collected through reports was buttressed through Key Informant Interviews (KII). This allowed the team to explore diverse perspectives and uncover relationships that exist between the intricate layers of the multifaceted research questions.

Figure 1 Proposed Mixed Methods Approach



Quantitative Evaluation

The study also estimated the fiscal burden of hidden debt/contingent liabilities for PPPs, SOEs, and sub-national governments. The details of the quantitative evaluation are provided below:

- **Fiscal risk of debt taken by PPPs**
  - The report uses Drape et. al. (2022) methodology for the local context of Pakistan to estimate fiscal risks from PPP projects in Pakistan. The report uses the World Bank's PPI data and Drape et. al. (2022) calculations to estimate the probability of financial distress of PPP projects in Pakistan on a range of factors. This study used regression analysis to estimate fiscal risk or approximate losses due to early termination of PPP projects using the World Bank's Private Participation in Infrastructure (PPI) for the years 1990 to 2020. The variables considered were the probability that a project is financially distressed, the contract period, whether a project was greenfield or brownfield, sector, levels of direct and indirect government support, multilateral support, sub-national government contract, and physical investment.

This study used the same methodology but restricted the analysis to Pakistan only. The following measures were constructed to summarize the fiscal burden of SOEs using descriptive statistics:

- **Debt statistics**
  - Statistics on external and domestic debt from publicly available reports on the Ministry of Finance, State Bank of Pakistan, and Department of Debt websites. Statistics from the previous 10 years i.e., 2012-2021. Some of the reports that were used are:
    - Annual Debt Review and Debt Bulletin from the Finance Department focusing on statistics on the sector-wise composition of debt stock.
    - Debt policy statement from the Ministry of Finance.

- **State-owned enterprises (SOE)**
  - Statistics on the profitability of SOEs were reported from the following reports:
    - Federal Footprint SOEs Annual Report.

- **Fiscal risk of debt taken by sub-national governments**
  - Pakistan presents a unique case in South Asia where sub-national governments can directly raise debt. The study also estimated the inherent risks of the political economy of sub-national governments which may impact debt taken by sub-national governments.

- **Indicators related to decentralization impacting the hidden debt:**
  - These include indicators of *legislative fractionalization and political division* in the government, which are expected to be positively related to the hidden debt. To measure fractionalization, an index available from the *Database of Political Institutions* or DBPI (Beck et al., 1999) that consists of the probability that two randomly selected deputies in the legislature belong to two different parties was used. The *political division* index, also available from DBPI under the name "political cohesion," was based on the criteria proposed by Roubini and Sachs (1989). In presidential systems, the *political division* index equals 0 when the same party controls the executive and legislature and equals 1 otherwise. In parliamentary systems, the index equals 0 when there is a one-party majority government, equals 1 when the government is a coalition with two parties, equals 2 if a coalition government with three or more parties, and equals 3 if there is a minority government.
  - *Decentralization* may also be viewed as another determinant of hidden debt with effects like fractionalization. For this purpose, the decentralization index available from DBPI was utilized. It takes a value of 2 for countries where there are both executive and legislative elections at sub-national levels of government and a value of 1 for countries where there is only one of those two types of elections. It is equal to 0 for all other countries.
  - The impact of these two measures was estimated on the net change in public debt, adjusted for the declared budget deficit and reserve money expansion using the same methodology by Esfahani and Kim (2002). This indicator was referred to as the net extra-budgetary debt assumption by the government (NEBDA). This indicator was constructed using IMF's *Government Financial Statistics* and *International Financial Statistics and the World Bank's World Development Indicator 2000 (WDI) CD-Rom*.

Qualitative Evaluation

Since the study design needed to be flexible and adaptive to deal with complex and fluid situations, the evaluation framework needed to accommodate the significance of lesson learning, iterations, and unexpected outcomes, both positive and negative. Despite the fact that the quantitative evaluation on which the study was based remains largely valid, it is difficult to anticipate all the various ways through which political and economic factors can be uncovered. Therefore, the study complemented quantitative methods by also using qualitative evaluation.

Qualitative research was conducted by analyzing the content of key informant interviews (KII) to gain triangulation for our primary outcomes. Where the quantitative data will help in measuring the correlations, KIIs helped to capture the narrative and experience of economists, politicians, and technocrats qualitatively and identify patterns and relationships that exist between various factors.

Qualitative data sources:

Primary evidence through KIIs[4] was generated from the following personnel who had expertise in finance, budget, planning, and debt strategy:

- Associate Professors in Economics, Lahore University of Management Sciences, Pakistan
- Ex-Deputy Chairman, Planning Commission of Pakistan
- Serving government officer from Debt Management Office
- Independent researchers from the IMF focusing on the macroeconomic framework of Pakistan

The Current Context of Pakistan

Depletion of Foreign Exchange Reserves and Its Impact

The root cause of Pakistan's dollar crisis is a balance of payments deficit that has been exacerbated by several factors. Firstly, Pakistan has been running a large trade deficit for many years (since 2003), which means that it imports more goods than it exports. This has been driven by a combination of high oil prices and a lack of diversification in its economy. Pakistan needs to buy a substantial amount of oil from other countries and when global prices for oil went up following the Russia-Ukraine War, the government had to use more of its own money to pay for the imported oil. Pakistan's exports of goods have declined from $17.742bn (July–January FY 2022) to $16.429bn (July–January FY 2023). Trade deficits shrank by 32.7% (July–January FY 2024). The imports narrowed down by 32.7% during July to January of the current fiscal year 2023–24. The reduction in the trade deficit was primarily attributed to a 14.14% decline in imports, while the exports increased during the same period from 7.87% to $17.8 billion dollars, compared to $16.4 billion dollars in the same period of the last fiscal year.

[4] The final list below was based on the availability and willingness to talk to researchers on this study.

Secondly, the Pakistani rupee lost value very quickly, making it one of the worst-performing currencies in Asia. The rupee hit a historic low of Rs276.58 against the US dollar on February 3, 2023, but gradually recovered to Rs259.99 by February 24, 2023, marking a 6% gain, due to import restrictions, and rose to Rs278.86 by February 24, 2024. The rupee's resurgence was short-lived as it is expected to face renewed challenges in the April–June quarter due to persistently weak external sector fundamentals that are unlikely to provide sustained support to the local currency. Rupee depreciation led to expensive imports, exacerbating Pakistan's dollar shortage crisis. Exporters believe the instability of the exchange rate is one of the main causes of the decline in exports.

Thirdly, debt servicing is a major burden on the forex reserve. The decline in remittances from $17.988 billion (July–January FY 2022) to $16 billion (July–January FY 2023) has also had a negative impact on the country's forex reserves. Fourthly, as reported by Bloomberg, a consistent and substantial outflow of dollars to Afghanistan (estimated to be approximately $5 million) has exacerbated Pakistan's dollar shortage (Eltaf Najafizada, 2023). This outflow can be attributed to the freezing of Afghanistan's reserves by the United States following the Taliban's takeover in the summer of 2021. Pakistan had previously received significant inflows of dollars from Afghanistan over the years, primarily as a result of U.S. economic assistance.

Pakistan's dollar shortage problem has led to banks refusing to issue new letters of credit for importers, which is impacting an economy already struggling with high inflation and weak growth. Economic and political instability in Pakistan is having a major impact on the population, with many struggling to afford necessities. Furthermore, textile manufacturers are being hit hard by the crisis, with many shutting down and thousands of jobs being lost. Textile manufacturers are responsible for around 60% of Pakistan's exports. They have been adversely impacted by energy shortages, damage to cotton crops during floods, and recent tax increases. A combination of these factors has resulted in the closure of approximately 30 percent of the power looms in Faisalabad, the center of the textile industry, resulting in the loss of thousands of jobs. In February 2023, the government enacted a supplementary bill to increase the goods and services tax from 17% to 18%, with the aim of generating additional revenue of Rs170 billion ($639 million) for the fiscal year until July (NA passes Finance Supplementary Bill 2023, 2023).

IMF and Pakistan's Debt Management and Stabilization Program

Pakistan will require new and larger bailout support from the IMF to continue to service its old external debts. Pakistan is currently in talks with the IMF regarding a debt management and stabilization program. The negotiations have been ongoing since 2019 when Pakistan received a $6 billion bailout package from the IMF.

The talks aim to address Pakistan's high levels of debt, which have been exacerbated by the COVID-19 pandemic. Pakistan's total public debt as of February 2024 is around $271 billion dollars, and the country's GDP per capita stood at $1,223 dollars in 2023. The IMF has recommended several measures to improve debt management such as reducing government spending, increasing tax revenues, and implementing structural reforms to improve economic efficiency. In February 2023,

the IMF and Pakistan reached a staff-level agreement on a new 39-month Extended Fund Facility (EFF) program worth $6 billion. Pakistan seeks to negotiate a new loan of at least $6 billion and also negotiate EEF where talks were expected to start in March or April 2024. The program is aimed at supporting Pakistan's economic recovery and achieving sustainable and inclusive growth.

As part of the EFF program, Pakistan has agreed to implement a number of structural reforms. These reforms include improvements in tax administration, energy sector reforms, and measures to strengthen the social safety net. In addition, the program includes measures to improve debt management, including strengthening the capacity of the Debt Management Office and improving transparency in public debt management.

Pakistan has made progress in implementing some of these reforms, including approving a new Electricity Policy and establishing a National Single Window to streamline trade procedures. However, there are some challenges to implementing these reforms. The IMF insists on trading off short-term losses to gain long-term stability (Dawn Report, 2023). Since some of the costly reforms outlive politicians' tenures in office, there is little incentive for them to adhere to the program in Pakistan (Kiani, 2023). Inflation, austerity, and additional taxes in the short term are unpopular measures that risk eroding the political capital of the current government that entered with a one-year mandate (Noor, 2023). Political expedience, therefore, incentivizes the government towards discontinuing even those reforms that align with the local context as a policy imperative, often putting it at odds with the IMF (Kiani, 2023).

The IMF has become increasingly politicized in Pakistan, partly as a consequence of the government externalizing the burden of its failures to the IMF. Initially, the previous government in 2023 anticipated avoiding dealings with the IMF by securing agreements with bilateral lenders. However, options for bilateral agreements disappeared when potential lenders linked their financing to the IMF's technical review of Pakistan's economy. Hence, the government ran into the peril of losing its political capital very quickly if it was unable to arrange finance that could save the country from an imminent default (Butt, 2023).

Circular Debt, Circular Debt Management Plan, and IMF

Apart from foreign exchange reserve depletion and economic crisis, Pakistan faces a large fiscal deficit primarily driven by circular debt in the energy sector in Pakistan. Circular debt occurs when one entity facing problems in its cash inflows holds back payments to its suppliers and creditors. Thus, problems in the cash inflow of one entity cascade to other segments of the payment chain. At present, the circular debt of the power sector liabilities stands at Rs. 4.17 trillion and it is increasing by Rs. 1.29 trillion annually. Adding to the circular debt is another 1.4 trillion rupees that belong to the gas sector (Javed, 2023). The current circular debt balance is equivalent to 5.6% of the country's gross domestic product (GDP) and represents 6.8% of Pakistan's general government debt.

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Reducing circular debt has been at the core of IMF demands to curb the fiscal deficit. The IMF has recommended that Pakistan reduce its fiscal deficit (the difference between government spending and revenue) to around 3.8% of GDP by 2023. To curb the circular debt issue, the current government proposed a Circular Debt Management Plan (CDMP) which included recovering Fuel Price Adjustment (FPA) charges deferred last summer to collect Rs.20 billion.

Under the plan, the government would increase the electricity price by Rs7.91 per unit in four quarterly adjustments: February–March 2023, March–May, June–August, and September–November to meet the IMF's tough conditions. Pakistan's power regulator, National Electric Power Regulatory Authority (NEPRA), has jacked up the electricity tariff by Rs.4.96 per unit for the ongoing fiscal year (FY24) in line with the conditions of the IMF. Earlier in March 2023, the federal government also withdrew the electricity subsidy of Rs.65 billion given to exporters and farmers. The subsidy of Rs.12.13 per unit of electricity given to the export sector will be withdrawn. Moreover, it is also expected that Rs.250 billion will be recovered from electricity consumers by June 2023. Under the Circular Debt Management Plan, the government would impose a surcharge of Rs.3.39 per unit. The government will charge Rs.3.21 per unit from now onwards, Rs0.69 per unit from March–May, and increase again to Rs.1.64 per unit from June onwards to August 2023. From September–November, the government will hike the power tariff by Rs.1.98 per unit.

However, during the second day of technical-level talks, the IMF termed the revised circular debt management plan (CDMP) as unrealistic, which they believe is based on certain incorrect assumptions, lacks clarity in implementation, lacks coordination, and may negatively impact vulnerable groups. So, the government will have to bring more changes in its policy prescription to reduce the losses of the cash-bleeding power sector.

Projection of the Level of Government Debt

Table 1 Projection of the Level of Government Debt (% of GDP)

	External Debt		Domestic Debt		Total Government of Debt	
	Level (Rs. in billion)	% of GDP	Level (Rs. in billion)	% of GDP	Level (Rs. in billion)	% of GDP
2022–2023	16 296	26	31 257	49.8	46 780	75
2023–2024	18 624	26.2	34 309	48.2	51 936	73
2024–2025	20 250	26.4	37 563	46.6	56 311	70

Source: *Charter of the Economy: Agenda for Economic Reforms in Pakistan*

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In Table 1, the projected level of Government Debt as a percentage of Pakistan's GDP has been projected up to 2024-25. This projection is based on many economic trends (including but not limited to rates of inflation, GDP growth, unemployment, levels of savings, etc.) that have been discussed in the book *Charter of the Economy* written by Hafeez Pasha. Based on his recommended policies, including the utilization of Seigniorage[5] and linking the tenure of Government borrowing to the rate of inflation, the level of Government debt will decline to 70 percent of the GDP in 2024-25. External debt as a percent of GDP is expected to rise while domestic debt as a percent of GDP will decline.

Technically, Pakistan has not defaulted on its debt because it hasn't missed—or even delayed—any payments to its creditors. However, it certainly has fallen into arrears. For example, in March 2023, the International Air Transport Association complained that Pakistan was second among the top five markets that have restricted or stopped foreign airlines from repatriating their ticket sales revenues of nearly $290 million to their home countries (Gul, 2023). However, the government and the central bank are taking measures to overcome these challenges. All debt repayments are on track and it is expected that the country's foreign exchange reserves will increase in the second half of the fiscal year 2023. Given these circumstances, it is important to understand the dynamics of the ever-ballooning debt situation in Pakistan. Pakistan's foreign exchange reserves, held by the central bank, have surprisingly increased for the second consecutive week, hitting a five-and-a-half-month high at $8.22 billion, according to data released by the State Bank of Pakistan (SBP) in January 2024.

History of Debt Accumulation in Pakistan

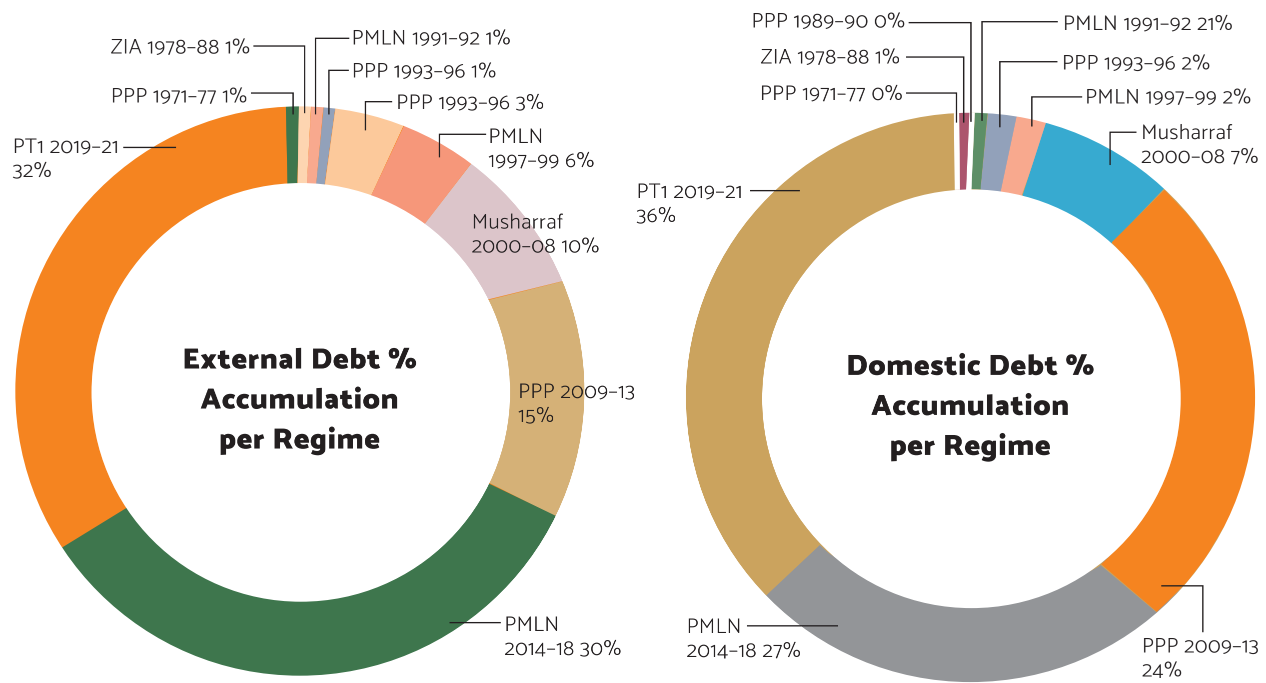
In the 1970s, Pakistan's government borrowed money to cope with the impact of high oil prices. Since then, the people have been burdened with a large external debt. To manage this debt crisis, the country has continuously obtained bailout loans from the IMF for 30 of the last 42 years. This has given the IMF enormous power over Pakistan's development through the economic conditions it has imposed on the country. As a result of these loans, debt has been passed down generations, with government debt payments averaging 17% of government revenue between 1990 and 2011, more than public healthcare expenditures.

Pakistan has also been excluded from the IMF and World Bank's Heavily Indebted Poor Countries debt relief scheme despite being impoverished and heavily indebted since canceling debt would cost lenders more than in smaller countries. The lending and grants have also been used to prop up various military governments in Pakistan supported by the Western world, in return for their support during the Cold War, Pakistan's support for Afghan fighters against Soviet occupation, and during the 'war on terror.' Pakistan has also received much 'aid' in the form of loans that have caused environmental harm and suffering among local communities (Husasin, 2005). The country faces huge development challenges, and its debt burden increased after the disastrous floods in 2010 and the impacts of the

[5] Seigniorage is the difference between the face value of money–both paper bills and coins—and what it costs to produce it.

global financial crisis. Pakistan's external debt increased from $37.9 billion at end of June 2000, to $55.9 billion by the end of June 2010, and stood at $59.5 billion at the end of March 2011 with $8 billion being more bailout loans from IMF between 2008 and 2010 (Ministry of Finance, 2011) (Debt Justice, 2022).

Figure 2 Debt and External Accumulation as Percent of GDP by Regime



Source: Islam, W., Ahmed, J., & Faraz, N. (2023). *To borrow or not to borrow: Empirical evidence from the public debt sustainability of Pakistan* (No. 1354). ADBI Working Paper.

Since then, every government in Pakistan has significantly increased the country's public debt, regardless of whether it was a military dictatorship or civilian government. From 2000 to 2008, public debt increased by 100%, from Rs.3.1 trillion to Rs.6.1 trillion (Rana, 2023). In five years, from 2008 to 2013, public debt increased by 130% to Rs.14.3 trillion, and from 2013 to 2018, it increased by 76% to Rs.25 trillion. The government led by Prime Minister Imran Khan from 2018–2022 promised to reduce the debt burden to Rs.20 trillion, but in less than four years, public debt increased by 77% to Rs.44.3 trillion. As of 2023, Pakistan's total debt and liabilities exceed Rs.77.7 trillion, with Rs.12 trillion added in the past 4 years.

Therefore, from a historical standpoint, Pakistani public debt is a result of a variety of factors, including higher expenditures than revenues, a model of economic growth financed by foreign savings, and currency depreciation against foreign currencies.

CPEC and Public-Private Partnerships

The use of public-private partnerships (PPPs) in the China-Pakistan Economic Corridor (CPEC) has been a key strategy for infrastructure development in Pakistan. According to the Pakistan Ministry of Planning, Development and Reform, as of December 2020, 23 CPEC projects were being implemented under PPP mode. These projects were primarily in the energy and transportation sectors, with a total investment of over $14 billion dollars.

The use of PPPs in the CPEC has had both positive and negative impacts on Pakistan's debt. On the positive side, PPPs have allowed for efficient allocation of resources and risk sharing between the public and private sectors. However, PPPs have also contributed to the accumulation of debt in Pakistan. As a result of the reliance on PPPs, the Pakistani government has had to provide guarantees and subsidies to the private sector, which has increased the government's debt obligations. Additionally, the terms of some PPP contracts have been criticized for being too favorable to the private sector, with the government bearing a disproportionate share of the risks.

In the energy sector, PPPs have been used to develop power plants, transmission lines, and distribution networks. For example, one of the largest energy projects under CPEC is the Port Qasim Coal-fired Power Plant, which is a joint venture between China Power International Holding (CPIH) and the Pakistani private sector firm, Hub Power Company (Hubco). The project has a total capacity of 1,320 MW and was constructed for $2 billion dollars.

In the transportation sector, PPPs have been used for the development of highways, ports, and railway lines. For example, the Karakoram Highway (KKH) Upgradation Project, a joint venture between China Road and Bridge Corporation (CRBC) and the Pakistani National Highway Authority (NHA), is a major infrastructure project under CPEC. The project involves the upgradation of the KKH, a 1,300 km road that connects Pakistan and China, at a cost of $1.3 billion dollars. In September 2021, the Pakistani government signed a Memorandum of Understanding (MoU) with the Asian Infrastructure Investment Bank (AIIB) to finance PPP projects under CPEC. The MoU outlines for the AIIB to provide financing for PPP projects in Pakistan, and for the two countries to work together to promote sustainable infrastructure development.

The move to convert some projects from PPP to government-to-government may help to reduce the burden of debt servicing because PPP projects are likely to put less pressure on government regarding financing and traditional government procurement processes (World Bank, 2022). However, it remains to be seen how effective these measures will be in mitigating the impact of PPPs on Pakistan's debt.

Nature of Chinese Loans

According to the SBP data, the nature of Chinese loans to Pakistan for CPEC projects have been primarily in the form of concessional loans and preferential buyer's credits. Concessional loans have lower interest rates than the market rate and longer repayment periods than commercial

loans. The interest rates for these loans are typically below 3%, and the repayment period can be as long as 20-25 years. According to a report by the Center for Global Development, about two-thirds of China's loans to Pakistan for CPEC projects are concessional loans.

Preferential buyer's credits are another form of Chinese loans provided to Pakistan for CPEC projects. These are typically loans provided by Chinese banks to Pakistani companies for purchasing Chinese goods and services. The interest rates for these loans are typically higher than concessional loans, ranging from 4–6%, and the repayment period is typically shorter, ranging from 5–15 years.

The repayment schedules for Chinese loans to Pakistan have also been a point of negotiation between the two countries. In 2019, it was reported that China had agreed to extend the repayment period for some CPEC loans to 30 years, which is longer than the typical 15–20-year repayment period for commercial loans (Khaliq, 2023). The extension of the repayment period is intended to reduce the financial burden on Pakistan and improve the sustainability of the CPEC projects.

However, it should be noted that the exact terms of Chinese loans to Pakistan for CPEC projects are not always transparent and publicly available. The lack of transparency has led to unsustainable debt levels for Pakistan and limits the country's ability to manage its finances effectively.

Evaluating the Fiscal Burden of PPPs in Pakistan

While well-structured PPPs can unleash efficiency gains in infrastructure provision, PPPs can also create liabilities for governments, among them contingent liabilities such as liabilities triggered by a specific event. Providing infrastructure through PPPs is preferred to public provision if the efficiency gains offset the higher cost of private financing and the public liabilities that PPPs may create. This section assesses the fiscal risks from contingent liabilities assumed by Pakistan's governments through their current stock of PPPs in infrastructure.

The fiscal risks from early termination over the remainder of the PPP contract period range between $864 million and $1.6 billion in Pakistan. Early termination can occur primarily due to financial difficulties due to economic challenges, such as budget constraints or the inability to secure funding. Changes in laws, regulations, or government policies that significantly impact the project's feasibility or profitability can prompt the termination of the contract. Unforeseen circumstances beyond the control of the parties involved, such as natural disasters or political instability, may also necessitate the early termination of the project. About 37 to 50 percent of the fiscal risks from early termination of active projects are due to early termination risks during the 2020–2024 period. The fiscal risks for the entire lifetime of the PPP portfolio in Pakistan range between 0.27 and 0.51 percent. These estimates give an idea of the resources needed in case of early termination of the PPP portfolio relative to the size of the economy.

Pakistan faces the most significant fiscal challenge from the early termination of PPPs in South Asia, largely because of its low revenue mobilization capacity. The revenue mobilization capacity of South Asian governments varies greatly, which determines their ability to absorb the fiscal costs

associated with the early termination of PPPs in infrastructure. The Government of Pakistan's revenues represent 15.6 of GDP in comparison to the Government of Bangladesh's revenues which represent only 9.6 percent of GDP and the Government of India's revenues which account for 20.5 percent of GDP. Pakistan's fiscal risks represent just below 3.3 percent of the government's annual revenues. Even though Bangladesh's fiscal risks are low compared to the size of its economy, they are significant compared to annual government revenues. This poses a significant fiscal challenge to the country because only the revenues of a single year are available to absorb the costs of early termination of PPPs.

The deep macroeconomic crisis of 2020 had a notable impact on the fiscal risks associated with the premature termination of PPPs, especially in 2021. In Pakistan, the fiscal risks during 2020-2021 reached up to 4 percent of government revenues. These estimates fail to fully capture the actual effect of the crisis, as they assume government revenues remain constant despite the contraction expected in such a significant economic downturn.

The fiscal risks from the current infrastructure PPP programs in Pakistan are not negligible. Under a severely adverse scenario, the fiscal risks from early termination in 2020-2021 amount to 2.9-4.0 percent of Pakistan's government revenues. The number of PPP projects in South Asia is quite large, particularly in Pakistan, which has as many active projects as it does in the pipeline (30). Such an expansion of the PPP program can lead to a significant increase in fiscal risks. Therefore, an important agenda in Pakistan is improving the design and management of infrastructure PPPs to mitigate the corresponding fiscal risks while ensuring financially responsible and timely implementation of infrastructure projects to address the infrastructure deficit.

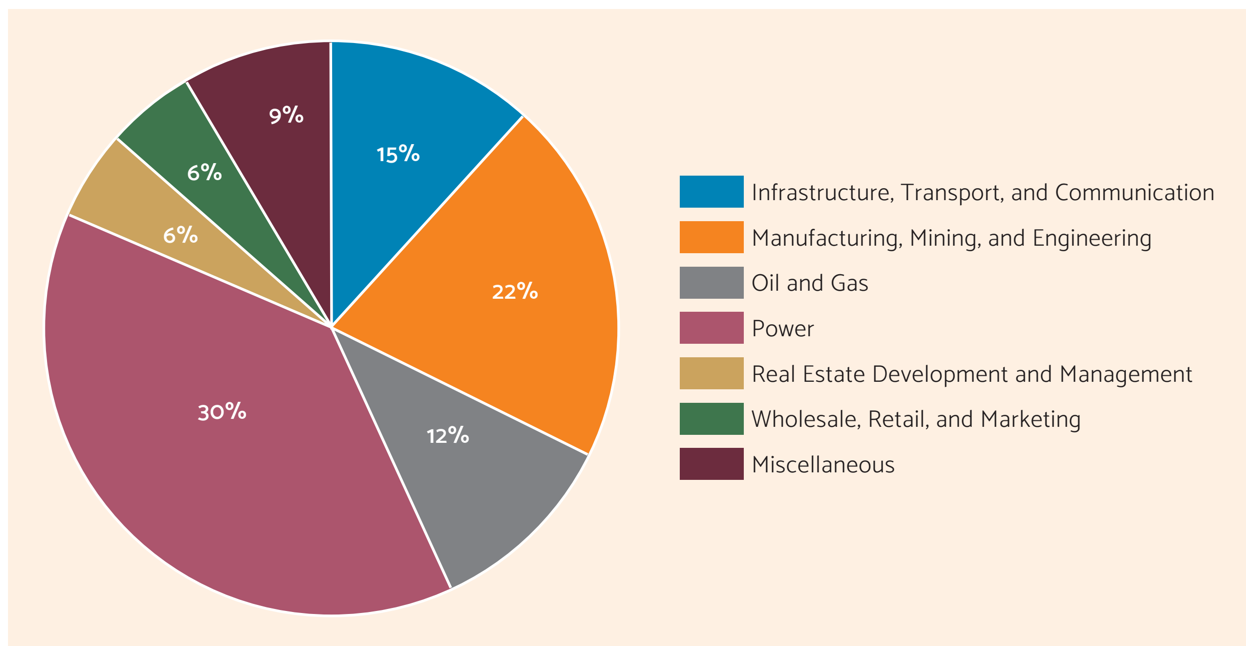
Policy Recommendations to Reduce Fiscal Risks from Early Termination of PPP Contracts

- The government needs to develop its capacity to prepare, procure, and manage PPP projects effectively to achieve the expected efficiency gains and contain fiscal risks from contingent liabilities. Following good practices in PPP preparation, procurement, and management can help governments take advantage of PPPs at acceptable levels of risk.
- To understand the fiscal implications of PPPs, the Ministry of Finance or central budget authority should approve the long-term financial implications of the project, including its budgetary, accounting, and reporting treatment.
- Given the complexity, magnitude, and long-term nature of PPP projects, the procuring authority should conduct a thorough due diligence process and rigorous assessments to evaluate the viability of infrastructure projects before choosing to procure them through PPP.
- The first step in a sound PPP preparation is identifying potential infrastructure projects that could be procured through PPP. Feasibility studies should be conducted to inform the structure of the PPP project, including assessing and allocating risks and sounding out the market to determine its appetite and capacity. These measures can reduce the likelihood of early termination.

Evaluating the Fiscal Burden of State-owned Enterprises

Compared to many countries in the Middle East, North Africa, and Central Asia (ME&CA) region, Pakistan's state-owned enterprises (SOEs) possess a significant amount of assets, but they do not employ many people in the economy, according to the International Monetary Fund's 2021 report (Rigo et. al, 2021). As of 2019, non-financial SOEs held assets worth 44% of Pakistan's GDP, a rise from 31% in 2015, but the sector's contribution to formal employment was only 0.7%. In a detailed report issued by the Ministry of Finance in 2021, it was revealed that 213 SOEs were working at the federal level, including 67 commercial non-financial SOEs, excluding non-commercial operations as well as health and education institutions.

Figure 3 Portfolio of Non-Financial Commercial SOEs, FY 2019



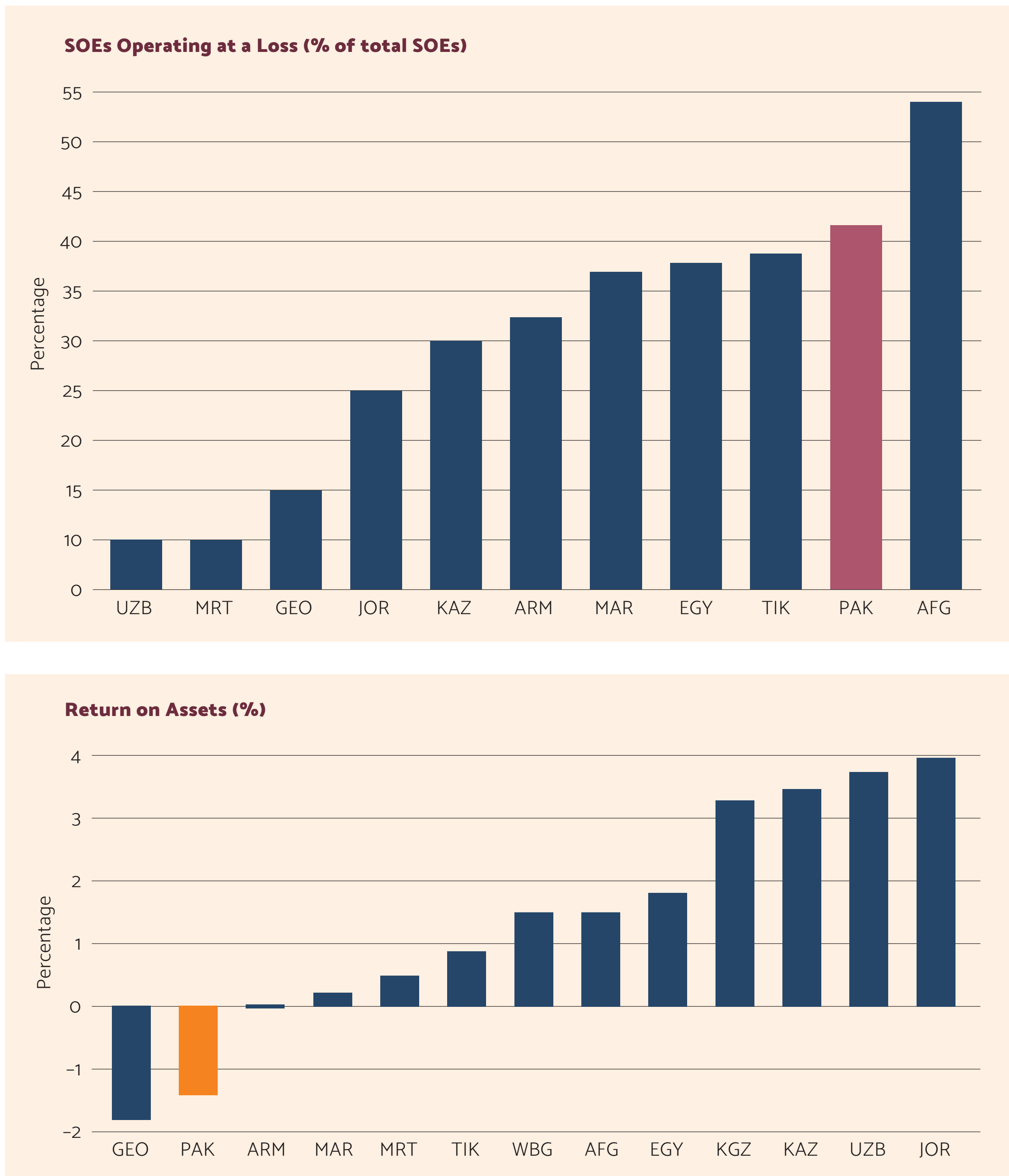
Source: *Finance Division, Government of Pakistan (2021)*

The SOE footprint in the power and oil and gas sectors is particularly large. Out of 67 non-financial commercial SOEs, 42% are in the power or oil and gas sectors, while an additional 22% are in the manufacturing sector (Figure 3).

Financial Performance of the SOE Sector in Pakistan

Despite their critical role in the economy, the financial performance of the SOE sector in Pakistan is relatively weak when compared to ME&CA countries. Almost half of the SOEs operated at a loss in 2019 (Figure 4), including one-third of commercial SOEs that are consistently generating losses such as NHA, power sector distribution companies (DISCOs), Pakistan Railways, and Pakistan

Figure 4 SOE Performance Indicators, 2019



Source: *Finance Division, Government of Pakistan (2021); Ramirez Rigo and others (2021)*

International Airlines that owns the Roosevelt Hotel in New York and the Scribe Hotel in Paris are among the major ones (International Monetary Fund, 2022). Commercial SOEs recorded losses of Rs. 143 billion in FY 2019 (Ministry of Finance, 2021). The average return on assets for SOEs in the country is among the lowest in the ME&CA region, at –1.4 percent (Figure 4). A recent publication by the World Bank (Melecky, 2021) estimates that the liabilities of state owned enterprises range between 14-18 percent of the GDP, and of this estimate, the debt is only one component posing considerable potential fiscal costs.

Channels of the Bailout to SOEs in Pakistan and their Impact on Local Economies

State-owned enterprises in Pakistan can receive bailout support through various channels, including:

- *Government budget allocations:* The government can allocate funds from its budget to support SOEs in financial distress. These funds can be used for debt servicing, operational expenses, or capital investments.
- *Privatization:* SOEs that are not performing well can be sold to private investors, which can provide a much-needed injection of capital and expertise to turn the company around. While it may look feasible, it can fall victim to corrupt practices.
- *Loans from government-owned banks:* SOEs can also receive loans from banks that are owned by the government, such as the National Bank of Pakistan or the Bank of Punjab. These loans may have lower interest rates and more favorable repayment terms than loans from private banks.
- *International financial institutions:* Pakistan can also seek support from international financial institutions such as the International Monetary Fund or the World Bank, which can provide loans or other financial assistance to SOEs.
- *Corporate restructuring:* SOEs can also be restructured to improve their efficiency and profitability. This can include measures such as downsizing, outsourcing, and improving management practices.

The impact of bailouts on local economies in Pakistan can vary depending on the specific circumstances of each case. Here are some potential ways that bailouts can impact local economies:

- *Job creation and preservation:* Bailouts can help SOEs maintain or create jobs, which can have a positive impact on local economies. In some cases, SOEs are major employers in a particular region or industry, and their failure could lead to significant job losses.
- *Improved services:* If SOEs provide essential services such as electricity, water, or transportation, a bailout can help ensure that these services continue to be provided at a reasonable cost. This can benefit both consumers and businesses in the local economy.

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- *Fiscal impact:* Bailouts can have an impact on government finances, as they typically involve the use of taxpayer money. If the bailout is successful in turning around the SOE, it could ultimately result in a positive impact on the government's budget. However, if the SOE continues to struggle, the government may need to provide additional support in the future.
- *Market distortion:* Bailouts can also create market distortions by providing an advantage to the SOE over private sector competitors. This can make it more difficult for private sector firms to compete on a level playing field, potentially leading to reduced investment and economic growth in the long run.

While bailouts of state-owned enterprises can provide short-term relief for distressed companies, they can also have negative impacts on the economy of Pakistan in the long run. Here are some potential key negative impacts of bailing out SOEs in Pakistan:

- *Moral hazard:* Bailouts can create moral hazard by encouraging SOEs to take on excessive risks, knowing that the government will be there to bail them out if they fail. This can lead to inefficiencies and mismanagement within SOEs, as well as a greater burden on taxpayers. For example, PIA is a government-owned airline that has struggled financially for many years. In 2020, the government announced a bailout package of PKR 54 billion (approximately USD 335 million) for the airline. However, this bailout has been criticized for creating moral hazard and political interference, as well as diverting resources from other important priorities such as education and healthcare.
- *Fiscal burden:* Bailouts can put a strain on government finances, diverting resources from other important priorities such as education, healthcare, and infrastructure. They can also lead to higher taxes or government debt, which can have negative effects on the overall economy.
- *Inefficient allocation of resources:* Bailouts can distort market incentives, by allowing inefficient SOEs to continue operating at the expense of more efficient private sector firms. This can lead to an inefficient allocation of resources, reducing overall economic growth. PSM is a government-owned steel producer that has faced financial difficulties for many years. In 2019, the government announced a bailout package of PKR 17 billion (approximately USD 105 million) for the company.
- *Political interference:* Bailouts can also lead to political interference in the operations of SOEs. This can create further inefficiencies and mismanagement, reducing the SOE's ability to compete effectively in the market. Pakistan Railways is a government-owned railway company that has also struggled financially for many years. In 2018, the government announced a bailout package of PKR 11 billion (approximately USD68 million) for the company.

- *Crowding out of private investment:* By providing support to SOEs, bailouts can crowd out private investment, making it more difficult for private firms to compete in the market. This can have negative effects on innovation, productivity, and economic growth. One example of crowding out of private investment as a negative impact of bailing out SOEs in Pakistan can be seen in the energy sector. In recent years, the government has provided significant bailouts to state-owned power companies such as Pakistan State Oil (PSO) and Pakistan Electric Power Company (PEPCO). However, these bailouts have been criticized for crowding out private investment in the energy sector. Private sector energy companies have had difficulty competing with the subsidized prices offered by SOEs, leading to a decrease in private investment in the sector. This has resulted in reduced innovation, productivity, and overall economic growth in the energy sector. Furthermore, bailouts to SOEs in the energy sector have also led to inefficiencies and mismanagement. For example, PEPCO has faced criticism for its inability to recover electricity bills from consumers, resulting in huge financial losses for the company. This inefficiency not only diverts resources from other important priorities but also discourages private investment in the sector.

The government's support for SOEs has diverted resources from other critical social and developmental priorities, such as education. By providing loans to inefficient state-owned enterprises, the government deprives the education sector of resources that are crucial for the country's long-term economic growth and development. This will negatively impact the educational progress of Pakistan, resulting in a lack of quality education for many children and young adults. Additionally, this can further exacerbate existing inequalities in the education system, creating a gap between those who can afford private education and those who cannot. It is therefore imperative that the Pakistani Government reassesses its lending policies and prioritizes investments in the education sector in order to ensure the country's long-term prosperity.

When considering the opportunity cost of the support provided to SOEs by the Pakistan Government, the educational sector is one of great importance. The estimate given by the Higher Education Commission in the Fiscal Years FY17-18 and FY18–19 were PKR 62.18 billion and PKR 65 billion, respectively. The support provided to SOEs was PKR 459 billion and PKR 285 billion in FY17–18 and FY 18–19, respectively. As some of this funding is given to SOEs that are operating at a loss, it raises the question of how efficiently the budget is being allocated. Since the spending is not in the education sector, which is a viable path towards poverty alleviation, the allocation of the Federal Budget can be considered inefficient.

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Table 2 State-Owned Enterprises (SOEs) Year-on-year Financing

Year	Foreign Loans (Rs. million)	Domestic Loans (Rs. million)	Subsidies (Rs. million)	Total Support by GoP (Rs. million)	Higher Education Commission Estimated Expenditure (Rs. million)
2014–2015	41 404	168 199	302 099	511 702	43 000
2015–2016	54 600	167 514	240 971	463 085	51 000
2016–2017	187 166	205 118	175 330	567 614	58 000
2017–2018	111 351	204 258	143 372	458 981	62 183
2018–2019	154 529	93 444	37 000	284 973	65 000
2019–2020	–	–	–	–	59 100
2020–2021	–	–	–	–	64 100
2021–2022	–	–	–	–	66 250

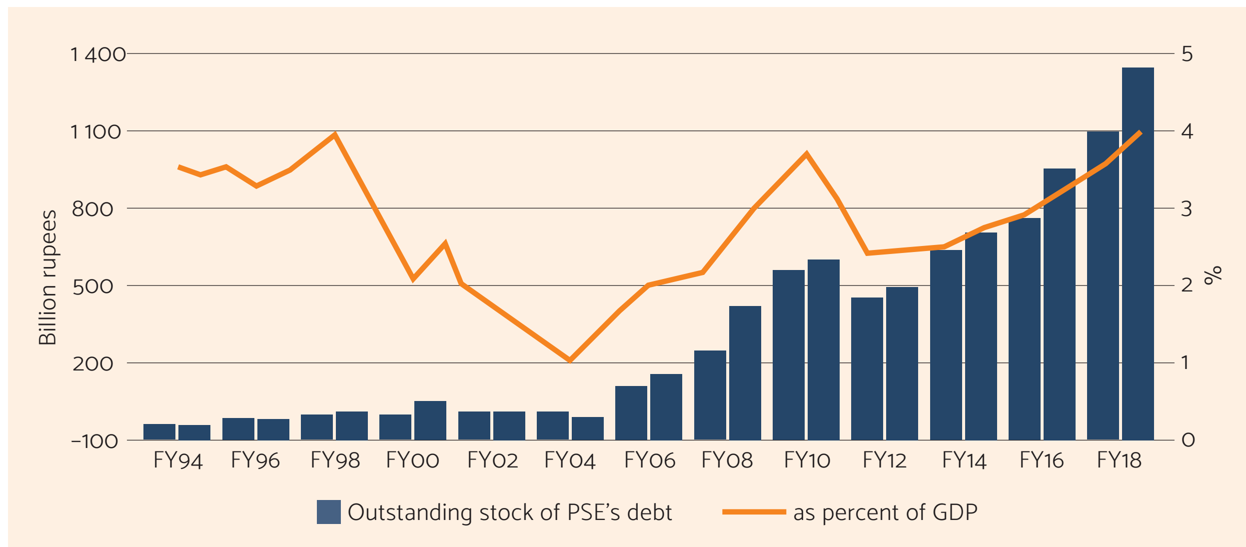
Source: *State-Owned Entities (SOEs) Reports and Federal Budget by the Ministry of Finance, Pakistan*

The next section details the fiscal burden of SOEs, and financial risks associated with SOEs that exacerbate the negative impact of the bailouts. There are two main sources of fiscal burden of SOEs: (a) circular debt most predominant in the power sector and, (b) contingent liabilities creating hidden debt.

Fiscal Burden of SOEs

In the absence of decisive policy actions such as performance-based management, transparency and accountability, corporate governance, and privatization, problems in financially constrained SOEs have been exacerbated, leading to heavy debt accumulation by these entities as shown in Figure 5. This section examines on a macro level, the financial position of the SOE sector as a whole and provides perspectives on determining the actual fiscal burden these enterprises incur. In particular, this section highlights the role of sectoral policies and overall business conditions in SOEs operating in various sectors that have hampered the financial performance of associated SOEs. In the Economic Survey of Pakistan, the government reported that out of the total Public Sector Development Program (PSDP) allocation of PKR 1.32 trillion (approximately USD 8.3 billion) for the fiscal year 2020–21, PKR 1.06 trillion (approximately USD 6.7 billion) was allocated to infrastructure development projects, including roads, energy, and transportation. In addition, the report provided information about how these funds were utilized by a number of SOEs, including the National Highway Authority (NHA) for road projects and various power sector entities for energy projects.

Figure 5 Stock of SOEs Debt



Data source: Ministry of Finance and Pakistan Bureau of Statistics

The government provides details of its support to SOEs in an annual publication, "Federal Footprint – SOE Annual Report." According to this document, the federal government provides support mechanisms which includes subsidies, loans, and grants to SOEs. Guarantees are also included since these represent contingent liabilities of the government. However, to assess the overall impact of SOEs' financial health on the fiscal accounts, one must understand the nature and objective of this support and account for the revenue stream generated by the government from the operational activities of SOEs (Ministry of Finance, 2021).

First, as shown in Table 3, subsidies are the largest item on the government's books. The bulk of these subsidies are energy-related and represent the government's policy decision to provide electricity to consumers at a below-market price. Technically, this expense comprises the difference between the NEPRA-determined power tariff and the tariff notified by the government. It is important to highlight here that end-consumers, not the SOEs, are the beneficiaries of the subsidy (thus, it is not surprising to see that K-Electric, which is the only generation and distribution company in the private sector, was the recipient of one-third of total energy-related subsidies during the past three years).

This is because: (i) subsidies represent the government's effort to unify the electricity tariff across the country despite a wide disparity in DISCOs' efficiency levels; and, (ii) these also shield consumers from the impact of high input costs and inefficiencies across the energy value-chain. As shown in Figure 6, for household consumers who consume up to 200 units of electricity, the government notifies the tariff at a level which is even lower than what NEPRA determines for the most efficient DISCOs. Certainly, political considerations make it hard for the federal government to pass on the impact of prevalent inefficiencies in the power sector value-chain to end-consumers (State Bank of Pakistan, 2017).

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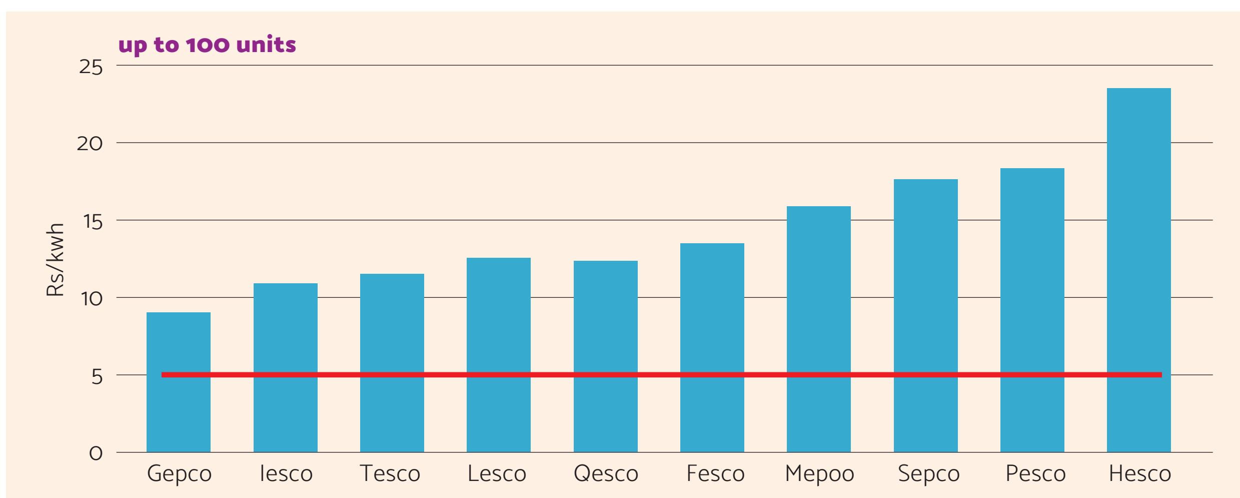
Table 3 Annual Fiscal Expense on SOEs

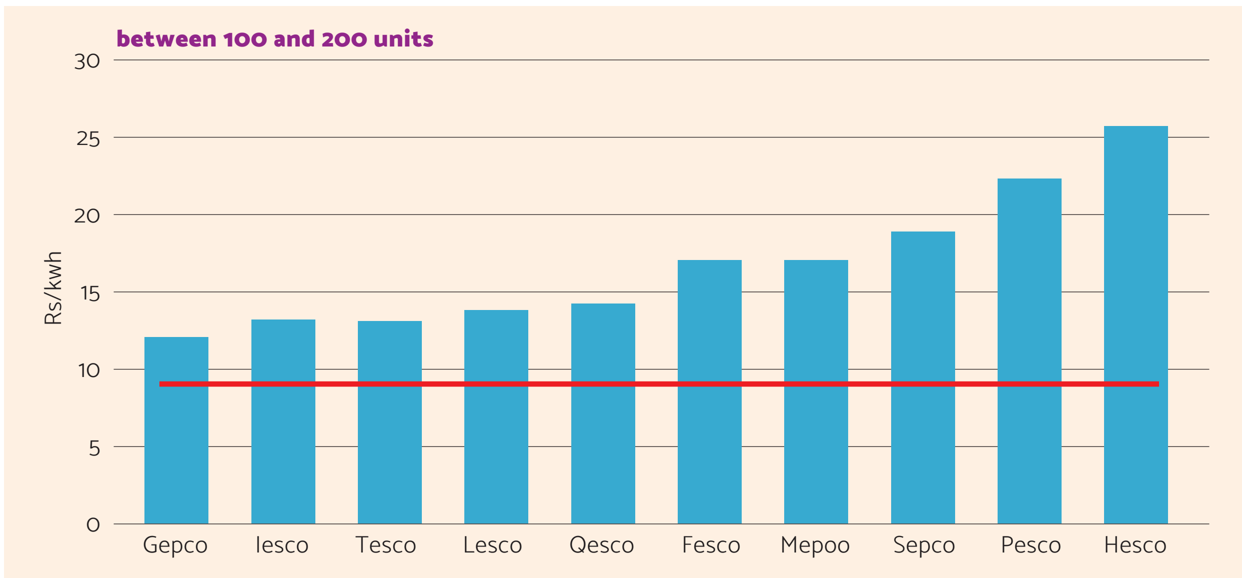
	FY13	FY14	FY15	FY16
A Loans	80.4	150.5	110.3	181.3
o/w Energy sector	*29.6*	*57.5*	*29.0*	*80.2*
B Guarantees	123.6	99.7	154.8	128.5
o/w Energy sector	103.1	57.0	96.0*	114.2
C Subsidies	281.2	271.8	229.3	223.1
o/w Energy sector	260.0	228.0	221.0	171.2
D Grants to Pakistan Railway	35.4	33.5	37.0	37.0
E Total support (A+B+C+D)	520.6	555.5	531.4	569.9
F Fiscal expenses (A+C+D)	397.0	455.8	376.3	441.4
as % of GDP	*1.8*	*1.8*	*1.4*	*1.5*
G Total income/revenues	75.8	133.0	88.3	146.3
as % of GDP	*0.3*	*0.5*	*0.3*	*0.5*
Mark-income	12.3	67.0	14.2	57.7
Dividend income	63.5	65.9	74.1	88.5
H Net expenditures (F-G)	321.2	322.8	324.0	295.1
as % of GDP	*1.4*	*1.3*	*1.2*	*1.0*
as % of FBR Revenue	*15.7*	*13.6*	*11.5*	*8.7*

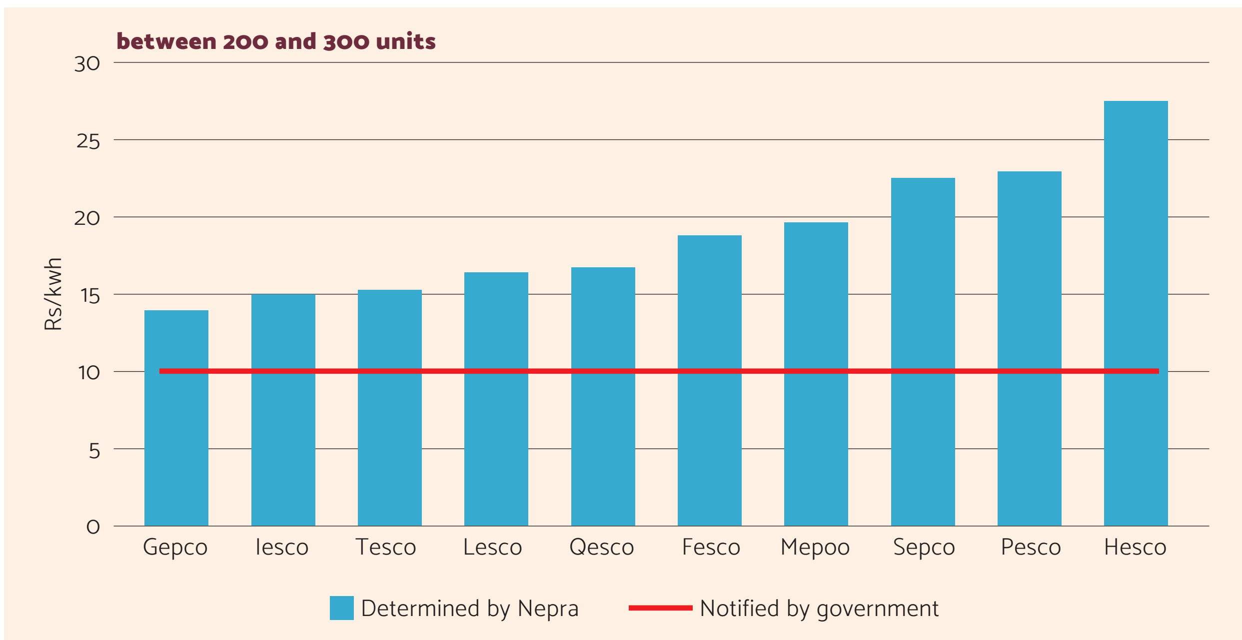
*Since decomposition of guarantees was not available for the year, this number was calculated by subtracting guarantees to PIA from total guarantess (for other years, this amount was almost equal to guarantees to the energy sector).

Data source: Federal Footprint SOE Annual Report, 2015-16, 2013-14, MoF, PBS

Figure 6 Difference between Tariff Determined by NEPRA and GoP Notified Tariffs for Different Consumer Slabs



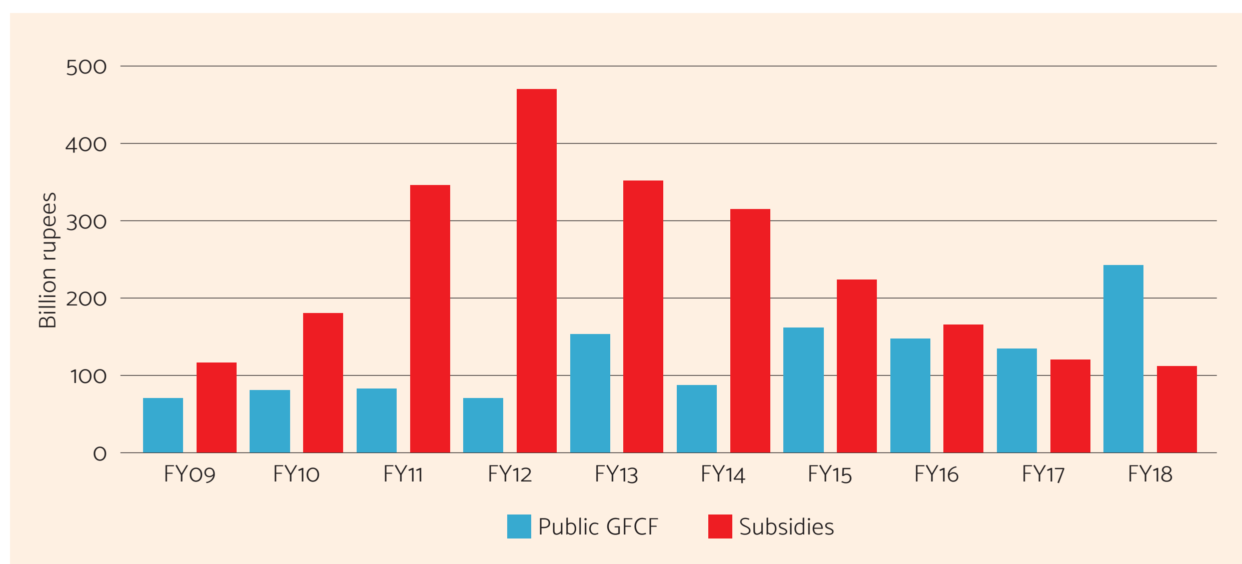




Data source: SRO 01 (I)/2019, Ministry of Energy, Government of Pakistan

This practice of allowing untargeted subsidies has two negative fallouts. First, the unintended consequence of implementing a unified tariff across the country is that it feeds into inefficiency. The second fallout is that over the past decade, subsidies have eaten up the bulk of financial resources as shown below in Figure 7, leaving fewer resources for capacity expansion and upgrades (State Bank of Pakistan, 2017).

Figure 7 Comparison of Fiscal Expenses on Energy: Subsidy vs GFCF



Data source: Ministry of Finance and Pakistan Bureau of Statistics

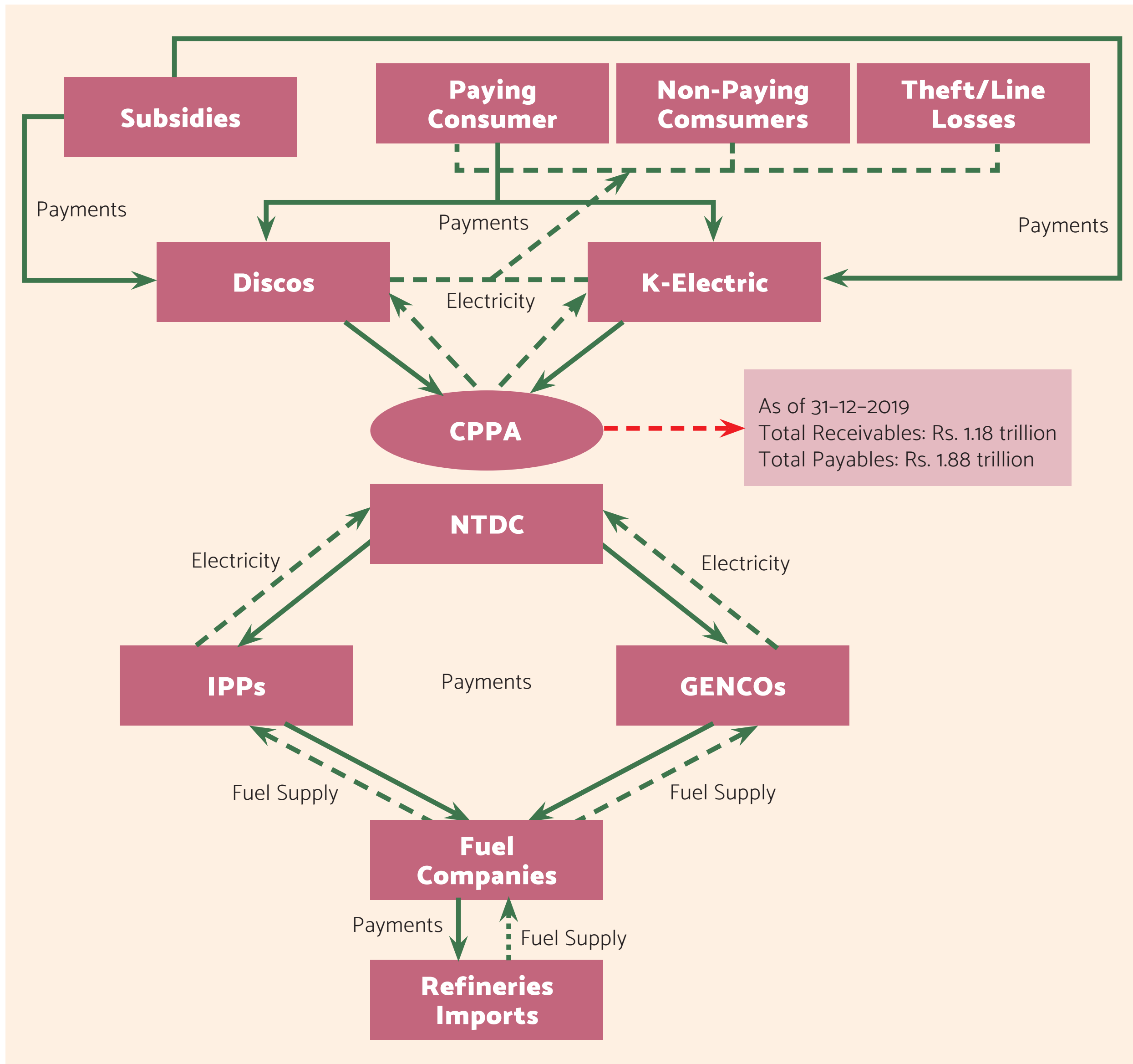
As far as loans to SOEs are concerned, the bulk of loans to SOEs is PSDP spending by the government in strategically critical sectors like roads, energy, and transport. Specifically, the government's development expenditures in these sectors comprise loans to the relevant entities. Importantly, the markup that the federal government charges on development loans to SOEs are slightly higher when compared with the SOEs' cost of borrowing from commercial banks (State Bank of Pakistan, 2017).

It is important to recall here that the federal government encourages SOEs to borrow directly from commercial banks to finance their CAPEX and working capital needs. However, the disaggregated data showed that nearly half of these guarantees (46.5 percent) merely represented cash flow constraints in the energy sector stemming from circular debt. At the end of December 2018, banks' exposure to Power Holding Private Limited (on whose books the bulk of the circular debt is parked) increased to Rs. 516.5 billion (Aftab). More details on circular debt and SOEs in the power sector are discussed below.

SOEs and the Problem of "Circular Debt" in Pakistan

As discussed previously, circular debt occurs when one entity facing problems in its cash inflows holds back payments to its suppliers and creditors. Thus, problems in the cash inflow of one entity cascade down to other segments of the payment chain. In Pakistan, the energy sector and most recently the gas sector has faced this issue for several years. Figure 8 details the payments and supply chain within the energy sector of Pakistan and explains the origins of circular debt in SOEs of the power sector mainly.

Figure 8 Circular Debt – Payments and Supply Chain



Circular debt is a problem in Pakistan's power sector caused by shortfalls in payments from distribution companies to the Central Power Purchasing Agency, which in turn causes delays in payments to power generation companies and other suppliers. The circular debt has now reached around Rs4 trillion, including a new element from the gas sector. The reduction of energy subsidies has been proposed as a solution to reduce circular debt, but this could have an impact on the welfare of poor households, so subsidies should be channeled to them through targeted programs. The high-capacity charges and fuel costs, along with inefficiencies and losses, are also contributing to the circular debt. The way capacity charges are structured may bring more financial problems than benefits.

SOEs and Contingent Liabilities in Pakistan

SOEs are a source of contingent liabilities for central or subnational governments. Contingent liabilities (CLs) are off-budget activities that appear on the government balance sheet only when an event happens. These generally relate to government guarantees, which may be explicit or implicit. The explicit liabilities are the guarantees issued to sub-national governments and public or private sector entities against their borrowing. While these explicit government guarantees are issued by law or contract, implicit guarantees could be in the form of moral obligations like rehabilitation expenses in post-natural disasters or support to troubled banks and/or public sector enterprises (PSEs) during crises. They can be explicit when they are formalized by a legal contract or an explicit commitment, or implicit when there is an expectation that the government may step in and help the firm even if there is no legal obligation. A debt guarantee granted to an SOE is a typical example of an explicit contingent liability. Sometimes explicit contingent liabilities directly assumed by SOEs (for instance, public-private partnership contracts) are also implicit contingent liabilities for the government.

Figure 9 Evolution of Guaranteed SOE Debt (Percent of GDP)

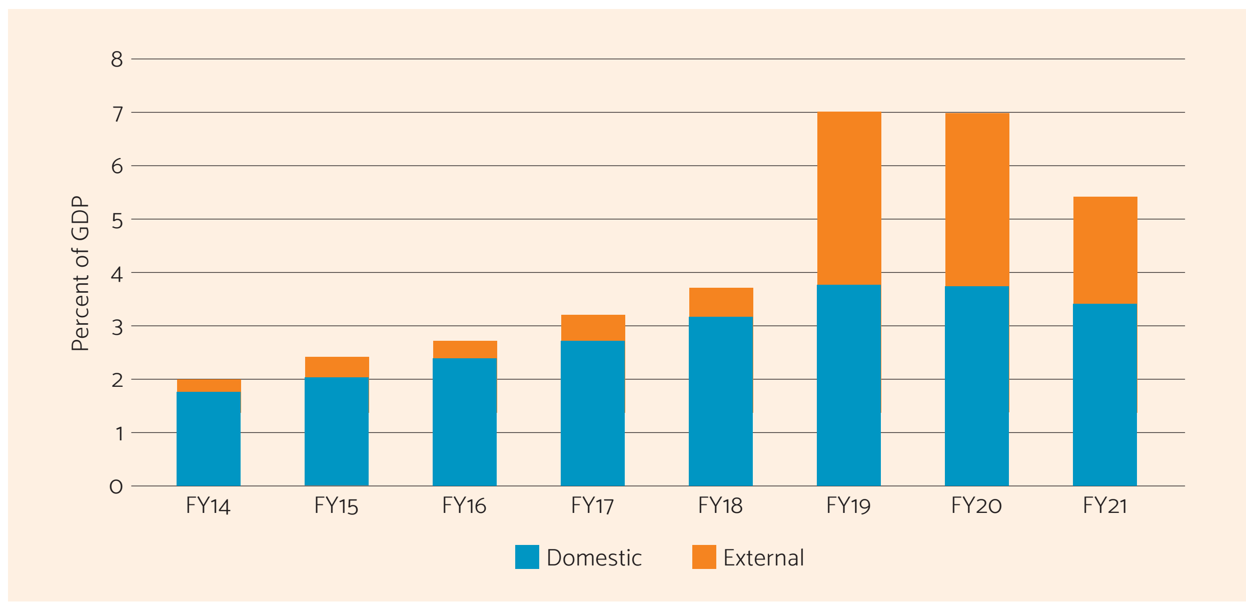
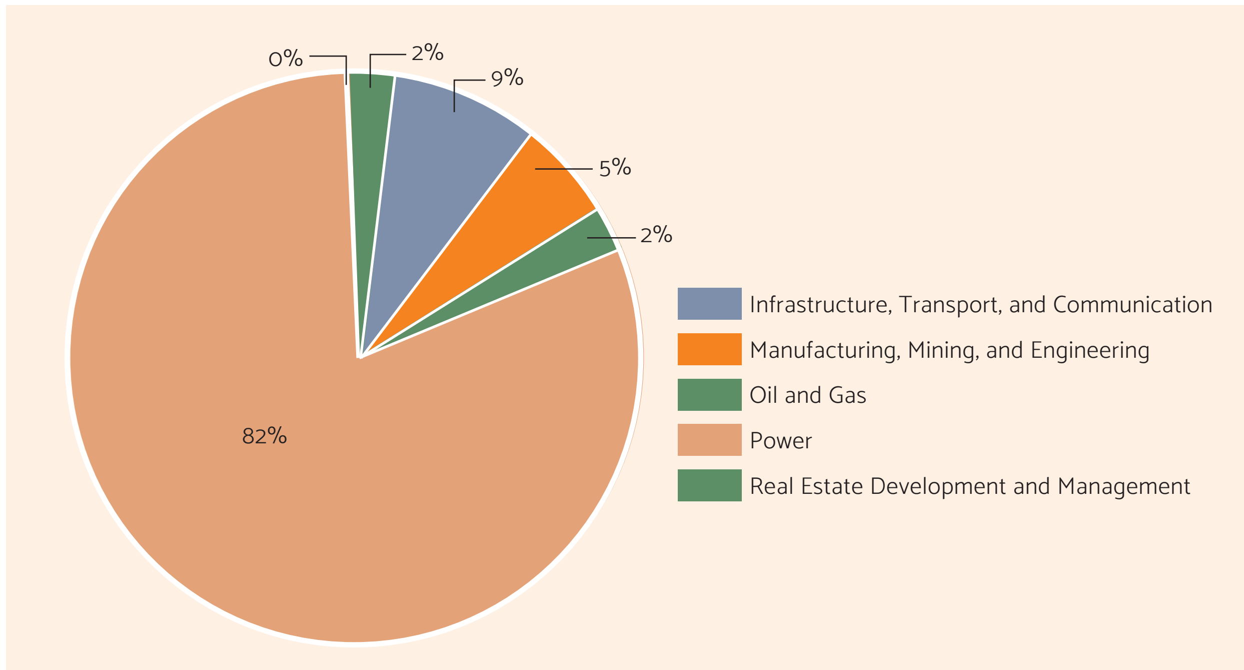


Figure 10 Composition of Issues Guarantees to SOEs



Sources (for Figure 9 and Figure 10): IMF. 2021. State-Owned Enterprises in Pakistan: Footprint, Performance, Fiscal Risks, and Governance. IMF, U.S.

Note: Beginning FY 2019 reporting is on issued guarantees only.

SOEs in Pakistan are often mandated to undertake investment or social spending on behalf of the government to meet PSOs. Such non-commercial mandates are explicitly laid out in legislation, ensuring the government's obligation to compensate SOEs for any losses associated with such activities. Nevertheless, this creates a moral hazard and increases the default risk, as guarantees usually cover losses on default. The entity-wise detail suggests that loss-making entities regularly rely on government guarantees for their day-to-day operations. Budgetary support—in the form of transfers, subsidies, or cash injections, as well as quasi-fiscal support—in the form of guarantees or budgetary loans–are submitted to the parliament and publicly available as part of the federal budget. But the documents currently do not incorporate details about anticipated guarantees made by the government to support certain financial transactions or obligations. These are anticipated to be issued in the forthcoming year.

The main risk associated with CLs is the fiscal cost after their occurrence. Once realized, these could result in an additional burden on government resources and can lead to a higher debt/GDP ratio. Bova et al (2016) show that CLs—mainly government support to financial institutions—emerged as a drain on fiscal resources in advanced and emerging economies during 1990-2014. Their estimates show an average cost of 6.1 percent of GDP, while the median cost was 2.3 percent of GDP. Another significant finding was that CLs usually occur during crisis periods. For instance, emerging market economies during the Asian Crisis of 1997-98 and advanced economies during the Global Financial Crisis of 2008.

While there are limits on government exposure to SOEs—including limits to public guarantees, SOE risk is not integrated into the overall financial risk management framework. For instance, beyond publicly guaranteed SOE debt–amounting to almost 6 percent of GDP in FY 2021 and mostly concentrated in the power sector (see Figures 9 and 10)—SOE losses and liabilities are not included in the headline fiscal indicators.

Political and Economic Causes of Financial Distress of SOEs

Governance and the financial and operational vulnerabilities of SOEs exacerbate fiscal risks and raise their potential fiscal costs. SOEs continuously experience external shocks of different sizes and lengths. As of 2008, the accumulated losses and liabilities of Pakistan Steel Mills (PSM) were Rs. 26 billion, which has now swelled to Rs. 415 billion – an increase of over 1,000 percent in eight years (Naveed, 2022). The government's cumulative financial support to PSM up until June 2020 amounted to Rs. 92 billion. This figure encompasses government bailouts extended to the organization. Additionally, the period since 2012 brings the total government funding allocated to PSM over the past two decades to exceed Rs. 130 billion. The total debt of Pakistan Steel stands at Rs. 230 billion (Suleri, 2020). The government has also injected Rs. 85 billion in bail-out packages during the last eight years. Although these shocks can result from macroeconomic factors (for example, a slowdown in private consumption with cross-cutting effects) or from market-specific factors (for example, a decrease in the relative price of the product sold by the SOE), this section discusses reasons rooted in poor corporate governance and political factors that create inefficiencies in these SOEs resulting in massive losses.

- **Decentralized coverage and oversight over SOEs:**
  Pakistan reports having decentralized coverage and oversight over SOEs, with an ownership policy that is not communicated to the public. Key informant interviews revealed that while the government has visibility over all SOEs in Pakistan, their coverage and oversight are fragmented among ministry lines for SOEs owned at the federal level, or among provincial governments for SOEs owned at the subnational level (Salman, 2017). However, the Finance Division within the Ministry of Finance has the financial and fiscal oversight function for all federal SOEs, particularly those with significant fiscal costs. Similarly, the selection of board members is decentralized between the cabinet, sectoral ministries, and other agencies and is dependent on the SOE. There are legislative requirements for independent board member representation across all SOEs, and specific requirements of certain competencies only for a subset of SOEs (Salman, 2017). Pakistan's rationale for state ownership is associated with the objectives of (i) supporting national economic and strategic interest; (ii) supplying specific public goods and services; (iii) performing business operations in a natural monopoly situation; and (iv) supporting social objectives. Although these objectives and an overall ownership policy are laid out in a document, the latter is not publicly available, and its substance is not well-communicated to the public (Naveed, 2022).

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- **Lack of transparency**

  Pakistan reports having systematic operational and financial oversight over SOEs, with norms to audit and make public their annual financial statements. The relevant authorities appear to set operational and financial targets for SOEs, evaluate their performance, and hold them accountable for the quality of service provided. While it is common practice for annual financial statements to be audited by independent external audit firms and reviewed by the oversight authority, only a subset of SOEs follow international audit and accounting standards and make their financial statements publicly available on their website or the website of the relevant oversight unit (Iftikhar, 2015). Moreover, there are often significant lags between the end of the fiscal year and the completion of audits. Given the decentralized nature of oversight, there is also an absence of an aggregate SOE document evaluating the annual operational and financial performance of the sector (Smith, 2001).

- **Inefficient governance framework**

  Corporate governance offers a framework that clearly identifies the roles and responsibilities of stakeholders responsible for the governance and management of any organization. SOEs in Pakistan are operating under different governance frameworks which include (a) Companies Ordinance 1984; (b) Corporations; and in some cases (c) as an attached department of a certain ministry, as in the case of Pakistan Railways (Iftikhar, 2015).

  Most of these legal and governance frameworks do not fulfill modern commercial requirements. Due to such outdated governance frameworks, SOEs cannot compete with their domestic and international counterparts (IMF, 2022).

  Let's take the example of Pakistan International Airways, which is operating under the Pakistan International Airlines Corporation Act of 1956. The 1956 Act requires that the chairman of the board of PIA should also be its Chief Executive Officer. Though the government has issued Public Sector Companies (Corporate Governance) Rules 2013, there are still certain SOEs (such as PIA, National Highway Authority, WAPDA, Port Qassim Authority, and Pakistan National Shipping Corporations) that are operating under special legal arrangements. This heterogeneity in the SOE governance structure is creating unpredictability and inconsistency in the management of SOEs (Iftikhar, 2015). Iftikhar (2015) noted that "weak corporate governance will continue to pose challenges in terms of transparency, lack of clarity of roles, political interference and ineffective oversight by the BoDs [Board of Directors] that create difficulties for the SOEs to operate efficiently and vibrantly" (Noor, 2022).

- **Poor regulatory structure**

  The independence of regulatory bodies, which regulate SOE functions, plays a significant role in the efficient functioning of such enterprises. Instead of politicizing policies, independent regulators design policies and regulations that are business-friendly and help improve the performance of different organizations (Iftikhar, 2015). In Pakistan, the independence of regulatory bodies is still in its infancy. The flawed institutional design

does not allow any independence and autonomy for the regulators. Though some independent regulators were established in the 1990s and 2000s, successive governments have remained hesitant to provide complete autonomy and independence to these regulators which affects transparency and incentivizes corruption in these organizations. In an unanticipated move on December 19, 2016, the Government of Pakistan stripped the autonomy of five regulatory bodies including the Pakistan Telecommunication Authority (PTA), Oil and Gas Regulatory Authority (OGRA), National Electric Power Regulatory Authority (NEPRA), and Public Procurement Regulatory Authority (PPRA). Previously, these regulatory bodies were under the administrative control of the Prime Minister or the Cabinet Division, but now the administrative control of these bodies has been transferred to the relevant ministries (Zulfiqar, 2022).

This move will likely result in the concentration of power in the center and will circumvent the rights promised to the provinces under the 18th Amendment. By amending the Rules of the Business, the parent ministries will directly interfere in the internal affairs of the regulatory bodies which will affect the effectiveness of such platforms. The very purpose behind the existence of these regulatory bodies is to provide protection to consumers and investors against unfriendly government policies. However, this new type of arrangement will erode the confidence of investors and consumers. It should be understood that if the regulatory structure of the SOEs remains inefficient and centralized then the performance of SOEs will continue to deteriorate.

- **Political interference**

Key informant interviews revealed that SOEs in Pakistan are perceived as tools to achieve the political objectives of the government, and in some cases, the interests of the individual politicians. The politics of clientelism gave importance to the idea of keeping SOEs within traditional models instead of promoting the culture of well-governed entities. This general model has allowed the political governments to influence the service delivery and employment process. Conflict of interest and abuse of position is inevitable in this case. It is quite possible that the Chairman Board of Directors (BoDs) might influence the voting process of the BoDs for his or her own compensation without taking care of the mandate of the company and the rights of shareholders (Cheema, 2021).

Historically, Pakistani politicians have often implemented populist policies to gain support from the public, including subsidies for energy-related products such as electricity, natural gas, and fuel. These subsidies often provide immediate relief to consumers, particularly those in low-income households. Pakistani politicians have also used energy-related subsidies to maintain patronage networks and political support. For example, subsidies for fuel and energy have been used to win over the support of voters, fuel political mileage, and gain the support of powerful interest groups such as transport unions and the agriculture sector. Pakistan gave more than $2 billion in subsidies to the oil and power sectors from April to June in 2022 (Shahzad, 2022). The Ministry of Finance disbursed a subsidy of Rs. 200 billion to the financially strained power sector, aiming to address the growing issue of circular debt. There has been a lack of fiscal discipline in Pakistan, with

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governments often overspending on social and economic programs. Subsidies for energy-related products have been one of the areas where overspending has been particularly acute. Lastly, corruption has been a persistent problem in Pakistan, and the energy sector is no exception. Subsidies for energy-related products have often been misused or diverted by corrupt officials, resulting in high levels of waste and inefficiency.

Policy Recommendations to Reduce Fiscal Risks from SOEs

- The performance of SOEs cannot be improved under the current governance structure which solely relies on the public service department. There is a need to introduce modern practices of corporate governance in the SOEs. These practices are proven to be more effective in ensuring accountability, transparency, and clarification of the roles and responsibilities of key stakeholders of these SOEs. In early 2021, the Pakistani government submitted to the parliament an SOE Governance and Operations Act that aims to enhance the governance framework, management, and financial efficiency of SOEs in the country and limit the financial risks stemming from their operations. An immediate priority of the authorities should be the passage of the SOE Governance and Operations Act. Some additional actions that should be considered in the short and medium term to help strengthen SOE corporate governance and contribute to improving performance are:
  - A consolidated list of all SOEs—owned by the federal government, provincial governments, or other SOEs—should be produced and published on an annual basis to provide a comprehensive picture of the SOE sector in Pakistan.
  - Publish the ownership policy document, to communicate the ownership objectives, financial and public policy targets, reporting guidelines, and guidelines for boards of directors to the market and the public.
  - SOE performance should be assessed on an annual (or quarterly) basis, supported by timely audited annual financial statements following the best international standards. This should include an evaluation against public policy and individual SOE objectives as well as private sector comparators.
- The Ministry of Finance should be empowered by strengthening the legal and institutional framework, as well as by building its capacity to assess and monitor fiscal risks stemming from SOEs. Faced with capacity constraints, the initial focus could be on the sectors generating the most fiscal risk in Pakistan, namely the power and transport sectors.
- Greater transparency and disclosure of SOE debt including both explicitly and implicitly guaranteed debt are warranted to adequately monitor and reduce fiscal risks.
- The Government of Pakistan should incorporate into its balance sheet information such as the state holdings in SOEs, as well as the government's receivables from and payables to SOEs.
- The government should condition financial support to a commitment by the SOE to improve its corporate governance practices and audit procedures as well as enhance reporting, disclosure, and transparency.

- SOE board composition requirements should be improved to support objective and independent decision-making while avoiding potential conflicts of interest.
- Beyond the legal reforms to the institutional framework in Pakistan, attention and commitment should be placed on the implementation of corporate governance standards.

Fiscal Decentralization and Debt Taken by Sub-national Governments

In Pakistan, the subnational governments (SNGs) have a significant degree of independence when borrowing money. The country's constitution permits provinces to borrow funds from both domestic and international sources if the provincial legislature has not imposed any restrictions. Provinces may also issue guarantees within the limits set by the legislature. Additionally, SNGs borrow money from commercial banks, including state-owned banks, primarily to finance the purchase of commodities such as wheat and sugar. Although limited official data is available, according to the public debt bulletin 2021–22, the external public debt amounted to $89 million dollars and sub-national government debt amounted to $11 million dollars as of June 2022 (Ministry of Finance, 2022).

The relatively low level of subnational debt in Pakistan is in part due to the existence of a hard-budget constraint: prior to the passage of the 18th constitutional amendment of 2010, provinces were not authorized to raise new loans if they still held outstanding debt to the federal government. However, since 2010, provinces have been allowed to borrow money within certain limits set by the National Economic Council, which is made up of provincial policymakers. As a result, it is possible that provinces may begin to borrow more now. In fact, in FY 2017, the National Economic Council increased the borrowing limit for provinces from 0.5 percent of GDP to 0.85 percent of GDP, equivalent to approximately PRs 323 billion (Ministry of Finance, 2018).

Nonetheless, the bulk of provincial debt consists of foreign multilateral/bilateral loans contracted by the federal government, rather than domestic borrowing. Most of this debt is highly concessionary, with long maturities and fixed interest rates (Figure 11, Panel A). Although provincial governments decide on the interest rate and disbursement mode of each loan, the choice of currency is made by the Economic Affairs division of the federal government (Manoel, 2012). Because most of the debt is denominated in foreign currency, primarily in US dollars, provinces are exposed to exchange rate risks (Figure 11, Panel B). In the event of a significant depreciation of the Pakistani rupee to the US dollar, increases in outstanding debt stock and debt servicing costs could cause fiscal stress to provinces, which rely solely on foreign exchange management by the federal government to mitigate such risks (Manoel et al. 2012). A 25.5 percent currency depreciation in FY 2019 illustrates this risk. According to Pakistan Economic Survey, the outstanding debt balance from multilateral and bilateral sources stood at $2.9 billion in 2021–22. Notably, the IMF disbursed approximately $1 billion as part of the Extended Fund Facility, while the Development Bank (IDB) contributed $0.8 billion. Furthermore, an additional $3 billion was received in the form of time deposits from Saudi Arabia (Ministry of Finance, 2022).

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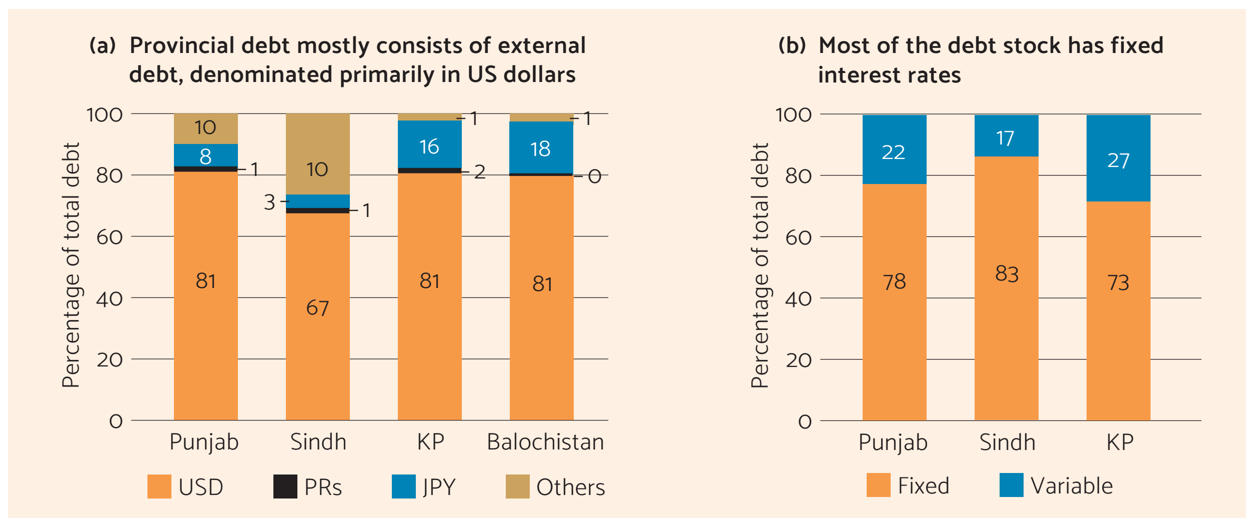
Figure 11 Composition, Currency Denomination, and Interest Rates Structure of Provincial Debt, Pakistan 2019



Data sources: Subnational debt bulletins and Government of Balochistan 2019.
Note: Data are as of end-June 2019. KP = Khyber Pakhtunkhwa. JPY = Japanese Yen; PRs = Pakistan Rupee; USD = US dollars.

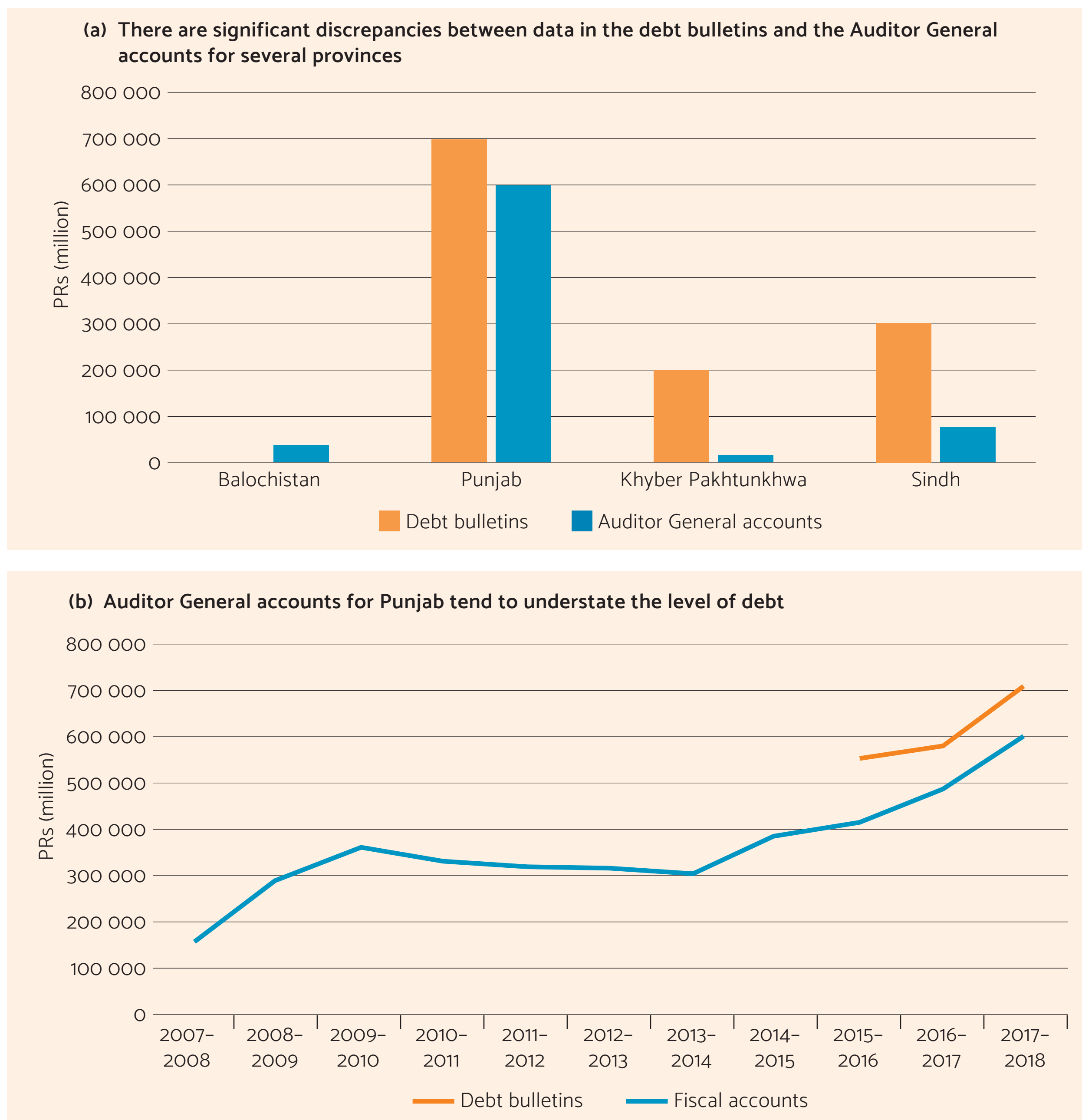
Poor Recording of Debt Taken by Sub-national Government

Poor recording of debt, guarantees, and contingent liabilities increases the exposure to future fiscal shocks. There is no unified, centrally audited time series of provinces' debt levels on an individual basis (published by each province's Finance Department) or on an aggregate basis (published by the Ministry of Finance or the State Bank of Pakistan). Instead, there are two different sources of provincial debt data. The first source is debt bulletins published by all provinces except Balochistan. However, debt information varies in coverage and does not allow for long-term series analysis. Punjab's Finance Department publishes the most comprehensive information, offering a compositional analysis of debt by origin, currency, creditor, and risk, but it has done so only since December 2016, thus limiting the opportunity for time series analysis. Khyber Pakhtunkhwa and Sindh publish a single debt bulletin on their Finance Department websites outlining the composition, currency, and creditor of the most recent debt stock. Budget documents for Sindh have more detailed information, but only as far back as FY 2015. Balochistan occasionally publishes debt data in a white paper on the budget (available for FY 2020, FY 2015, and FY 2010), the most recent being the debt report for 2021 (Buzdar, 2021).

A second source of debt information is each province's internal finance account, maintained by the province's Auditor General (AG). These accounts are sent to the AG of Pakistan but are not centrally audited or publicly available (Melecky, 2021). For this report, we have obtained these records for all Pakistani provinces, ranging from FY 2008 to FY 2018. In general, these provincial debt accounts are constructed based on historical balances, to which payments and receipts to the province's account at the State Bank of Pakistan are added. There are some differences among provinces in how the debt data are accounted for in these reports. For instance, the reports for Sindh do not indicate any buildup of debt stock due to commodity financing, while those for Punjab do.

However, their classification of debt over a 10-year period is generally consistent. Unfortunately, detailed analysis has proven futile due to several issues with the data quality. First, the AG accounts data are inconsistent with data published in the debt bulletins (Figure 12, Panel A). Figure 12, Panel B compares figures for Punjab from the two sources and highlights that while the trajectories are comparable, the AG public debt accounts show a lower level of indebtedness. Similar patterns are observed for Sindh and Khyber Pakhtunkhwa, while the debt levels are similar for Balochistan.

Figure 12 Discrepancies and Understatements in the Accounting for Provincial Debt, Pakistan



Sources: Subnational debt bulletin and Auditor General public debt account for Punjab

Political Economy of Sub-national Governments and Its Impact on Hidden Debt

Fiscal decentralization is another institutional feature identified in the literature as a determinant of public expenditure and borrowing, but its role has proven more controversial. According to some, decentralized fiscal systems can contribute to improved macroeconomic governance since they require greater clarity regarding the role of various players and greater transparency regarding the rules that govern their interactions to ensure fair play (Shah, 1998). Others believe that as long as there is a chance that the national government will come to the rescue, sub-national governments have the incentive to generate excess liabilities (Prud'homme, 1995; Tanzi, 1996). The national government itself may find it attractive to improve its fiscal situation by delegating tasks directly to some projects. Even though it may provide funding for the tasks, the developmental project administrators are likely to demand more and use indebtedness as a way of keeping pressure on the central government. When these administrators occasionally find it difficult to service such debts, the central government may be pressed to bail them out and assume the liabilities. In this sense, decentralization can lead to higher hidden and exposed public debts.

For example, the federal government in Pakistan often provides financial support to provinces through a system called "federal transfers." However, these transfers are often subject to political divisions and disputes between the federal and provincial governments. For instance, in 2015, the federal government in Pakistan announced a financial package of Rs. 341 billion for the province of Sindh. However, the Sindh government rejected the package and demanded greater control over the funds. As a result, the federal government decided to bypass the provincial government and directly allocate the funds to various development projects in the province. This type of political division and lack of coordination between the federal and provincial governments often results in hidden debts, where the provincial governments may incur debts through unofficial channels to finance their own projects or initiatives. This can lead to a lack of transparency and accountability in the country's borrowing and debt situation.

The study used regression analysis to estimate how these kinds of *fractionalization and political divisions* between federal and sub-national governments can lead to future fiscal risks. Estimates suggest that both elements raise Net Extra Budgetary Debt Assumption (NEBDA). Fractionalization and political divisions tend to raise government expenditure and increase debt. Theoretical and empirical analyses show that controlling for other factors, the higher demand for spending translates into larger hidden public debt. Similarly, elections also have a positive effect on *hidden debt as a ratio of GDP*, though their impact may be shorter. As the estimates for the transitory factors indicate, the rate at which hidden debt is revealed rises in election years and possibly in the year immediately following. This suggests that incumbent politicians tend to incur hidden expenditures during election years, which they turn into extra-budgetary debt at the end of those years or soon after.

Policy Recommendations to Reduce Fiscal Risks from Fiscal Decentralization

- Political instability is one of the major reasons behind fiscal risks in Pakistan. Therefore, efforts should be made to promote political stability and reduce political polarization. This can be achieved by encouraging political dialogue, strengthening democratic institutions, and increasing transparency and accountability.
- The government should adopt fiscal responsibility measures to ensure sustainable public finances. This includes measures such as reducing wasteful expenditure, increasing revenue collection, and improving public debt management.
- Legal fractionalization can lead to regulatory gaps and inconsistencies, which increase fiscal risk. Therefore, the government should take measures to strengthen legal frameworks and promote consistency in laws and regulations. This could involve harmonizing laws across different regions, strengthening the judiciary, and improving contract enforcement mechanisms.
- Pakistan's regional fragmentation is a significant contributor to fiscal risk. Therefore, promoting regional integration can help reduce fiscal risks by creating a larger and more unified market, reducing trade barriers, and promoting economic growth.
- Transparency and accountability are critical for reducing fiscal risk. Therefore, measures should be taken to enhance transparency in public finances, such as publishing detailed budgetary information and conducting regular audits. Additionally, measures should be taken to hold public officials accountable for mismanagement of public finances. Sub-national governments should adopt accounting standards that highlight contingent liability risks when they accrue, not when they materialize, to allow for adequate budgeting and decision-making. This would require moving from the cash-based standards prevalent in Pakistan toward accrual accounting.
- The intergovernmental fiscal framework must address the tension between providing incentives and insurance to the subnational governments. On the one hand, higher reliance on central transfers can weaken accountability and impose a soft budget constraint, leading to inefficient spending and fiscal unsustainability. A soft budget constraint and central government support are then needed to prevent a large fiscal adjustment that can negatively affect the local economy.

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Conclusion

Pakistan is currently grappling with a severe economic crisis, political instability, and a daunting debt burden. The sources of the debt crisis are deeply intertwined with these challenges, making it a critical issue that demands immediate attention. The complex and multifaceted nature of the crisis stems from domestic and external factors. These factors include ineffective tax collection systems, mismanagement of state-owned enterprises, weak export competitiveness, excessive reliance on external borrowings, and vulnerability to external economic shocks. While Public-Private Partnerships (PPPs) have been instrumental in driving infrastructure development in Pakistan, they have also created additional liabilities for the government, including contingent liabilities. These factors were further aggravated by the COVID-19 pandemic, which dealt a severe blow to Pakistan's economy, exacerbating its debt burden, and pushing the country closer to the edge.

Pakistan stands at a critical juncture where bold and decisive structural reforms are necessary to address the debt crisis, alleviate the economic challenges, and restore stability. The government must focus on enhancing its fiscal position, bolstering its revenue mobilization capacity, and improving public financial management. By embracing fiscal discipline and recalibrating economic policies, Pakistan has the potential to achieve substantial fiscal consolidation, as demonstrated in FY20 and FY21, when it successfully reduced the public debt-to-GDP ratio during the COVID-19 shock. However, recent setbacks, such as high commodity prices, extended fiscal stimulus, and soaring inflation, have revealed the underlying vulnerabilities. This emphasizes the urgent need for sustained fiscal discipline and responsible economic management. Consequently, the design and management of PPPs require urgent improvement to mitigate the associated financial risks. Considering the significant impact they have on Pakistan's debt dynamics, it is imperative to ensure the financially responsible and timely implementation of infrastructure projects. Neglecting this aspect could further exacerbate the already dire debt situation and impede the country's ability to recover from the economic crisis.

Resolving the debt crisis requires a comprehensive approach that extends beyond mere fiscal adjustments. Pakistan must embark on a transformative journey that includes effective tax reforms to enhance revenue collection, robust governance and management of state-owned enterprises, and a renewed focus on export diversification and competitiveness. Controlling spending and strengthening debt sustainability should be prioritized in the budget strategy, allowing for increased allocations to social and infrastructure expenditures. Additionally, it is crucial to fortify social safety nets, ensuring protection for vulnerable segments of society and fostering inclusive growth, thereby addressing the deep-rooted social and economic disparities that fuel political unrest.

It is essential for Pakistan to take decisive actions to tackle the challenges head-on. Institutionalizing the establishment of a central Debt Management Office, as envisioned in the Medium-term Debt Management Strategy, becomes more critical. Simultaneously, the amendments to the Fiscal Responsibility and Debt Limitations Act passed by the National Assembly in June 2022 must be implemented with the utmost seriousness. Monitoring cash forecasts through the recently established Treasury and Cash Management Unit and Cash Forecasting Unit in the Federal Treasury Office in Islamabad provides a glimmer of hope for effective debt management. These measures, coupled with strong political will and prudent decision-making, can steer Pakistan towards a path of sustainable debt management, economic stability, and political resilience in the face of ongoing crises.

Achieving sustainable economic growth and overcoming the debt crisis in Pakistan demands a concerted effort from a wide range of stakeholders. The government, policymakers, development partners, and civil society must collaborate to address the root causes of the crisis and facilitate inclusive and sustainable economic growth. International cooperation and support, including debt relief and technical assistance, can play a pivotal role in bolstering Pakistan's efforts to navigate its current economic and political challenges. The interconnected nature of the crises necessitates a holistic approach that considers the interdependencies between economic policies, political stability, and social development. This is necessary to forge a path toward long-term stability and prosperity.

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The Political Economy of Sri Lanka's Debt

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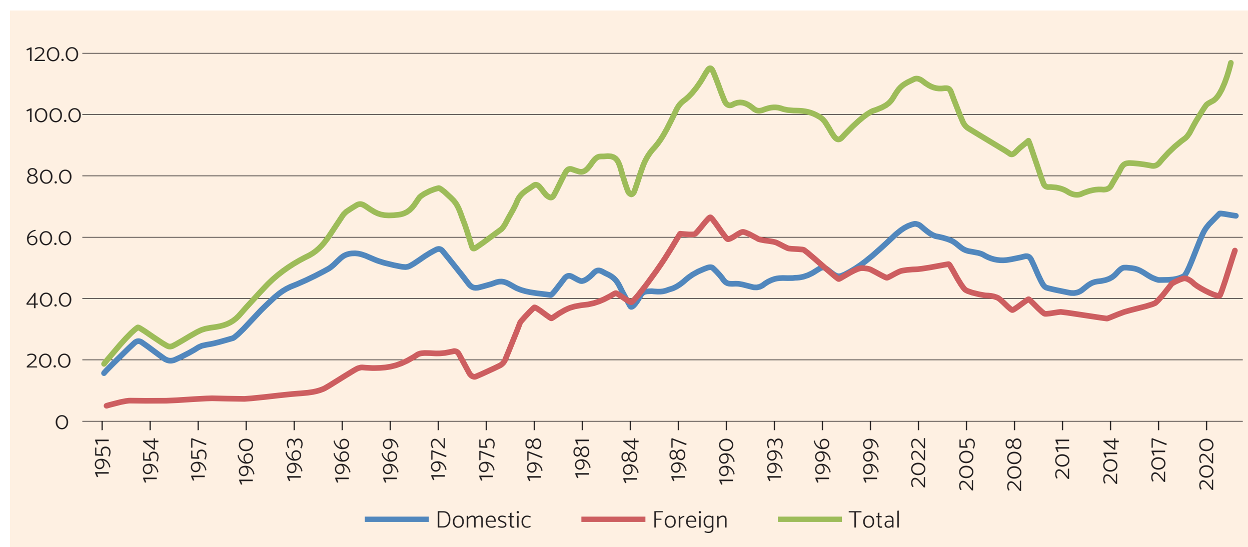
The Unravelling of Sri Lanka

Sri Lanka's ongoing economic crisis has its roots in decades-long structural economic weaknesses. These problems were compounded by severe public financial mismanagement leading up to the first-ever sovereign default in April 2022. The economic crisis and the subsequent people's protests received significant international media attention. However, most media reports incorrectly attributed Sri Lanka's economic woes to the COVID-19 pandemic, the war in Ukraine, or the "Chinese debt trap." These explanations glossed over the serious, long-standing issues of governance and public finance in Sri Lanka. A significant shift in the dynamics of foreign debt, without addressing the structural weaknesses in the economy, resulted in the country encountering severe balance of payments crises and shortages of foreign exchange.

This study will first establish both the long-term and short-term causes of the current economic crisis, focusing primarily on Sri Lanka's unsustainable borrowing patterns and perennial tax problems. It will also explore the timeline of specific policy decisions and events that led to the sovereign default. A detailed examination of these events and subsequent decisions will demonstrate how the economic crisis could have been mitigated. The study will then analyze both the geopolitical and local political economy factors that led to Sri Lanka's unsustainable borrowing patterns. This will be followed by a political economy analysis of the current tax reforms and the demand for government accountability. Using this analysis, this study will outline recommendations concerning Sri Lanka's reform agenda.

Debt Distress

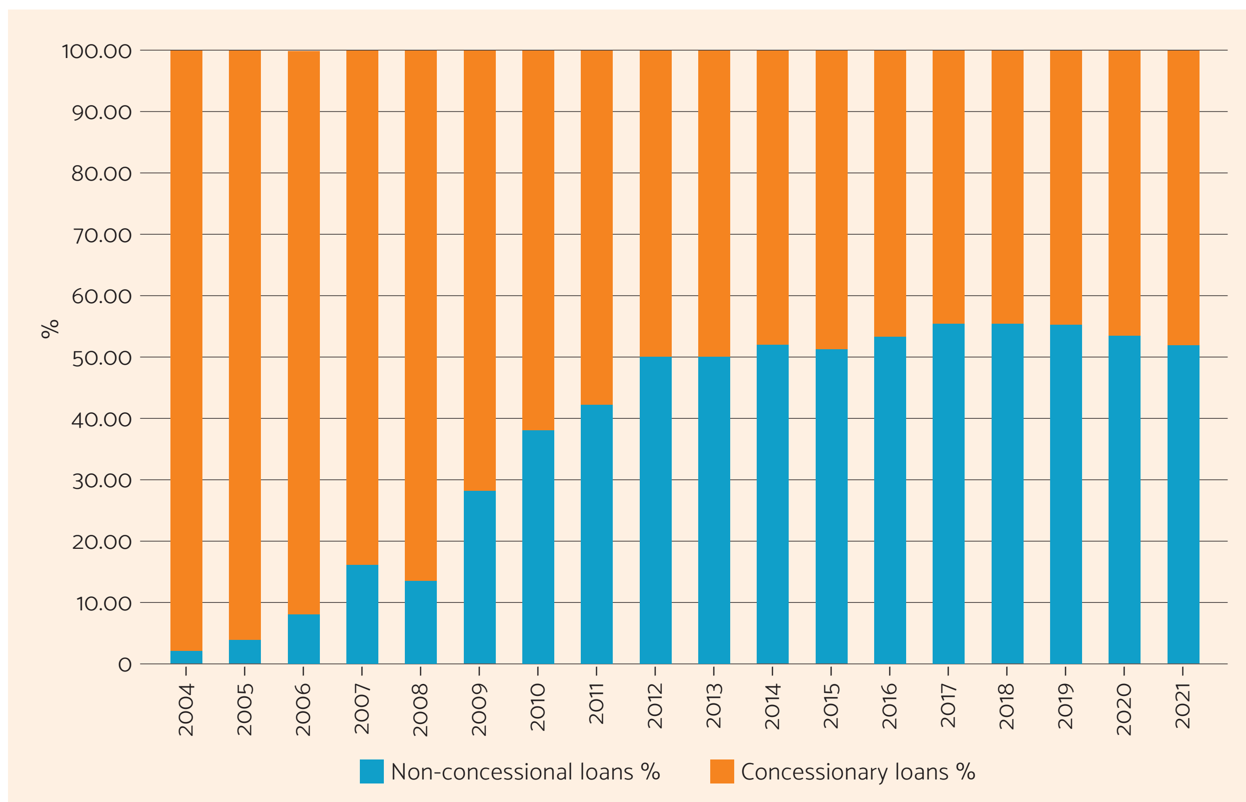
Figure 1 Public Debt in Sri Lanka



Source: CBSL Annual Reports, multiple years

Throughout the post-independence period, Sri Lankan governments have consistently run budget deficits in an effort to fulfill election pledges and maintain popularity.[1] This has resulted in a substantial stock of public debt. The country's public investments and welfare were largely driven by foreign loans obtained on concessionary terms. Since the country was upgraded to middle-income status in the mid-2000s, this trend has shifted. As the concessionary loans from traditional multilateral lenders declined, Sri Lanka increasingly relied on foreign commercial loans to finance its infrastructure-led development programs. After entering the international capital markets in 2007, Sri Lanka began borrowing at commercial interest rates with short maturity periods, primarily in the form of International Sovereign Bonds (ISBs). In addition to these borrowings, China also became a major lender to Sri Lanka, providing loans for large-scale public investment projects which helped maintain the government's popularity. This chapter will explore both the geopolitical and local political economy that led to Sri Lanka's unsustainable borrowing patterns. Further compounding these borrowing practices, Sri Lanka also failed to grow its sources of export earnings, relying heavily on foreign remittances, tourism, and the garment industry. However, a fundamental weakness in the economy that has had a direct effect on its sovereign default is the low level of government revenue.

Figure 2 Foreign Debt Dynamics in Sri Lanka



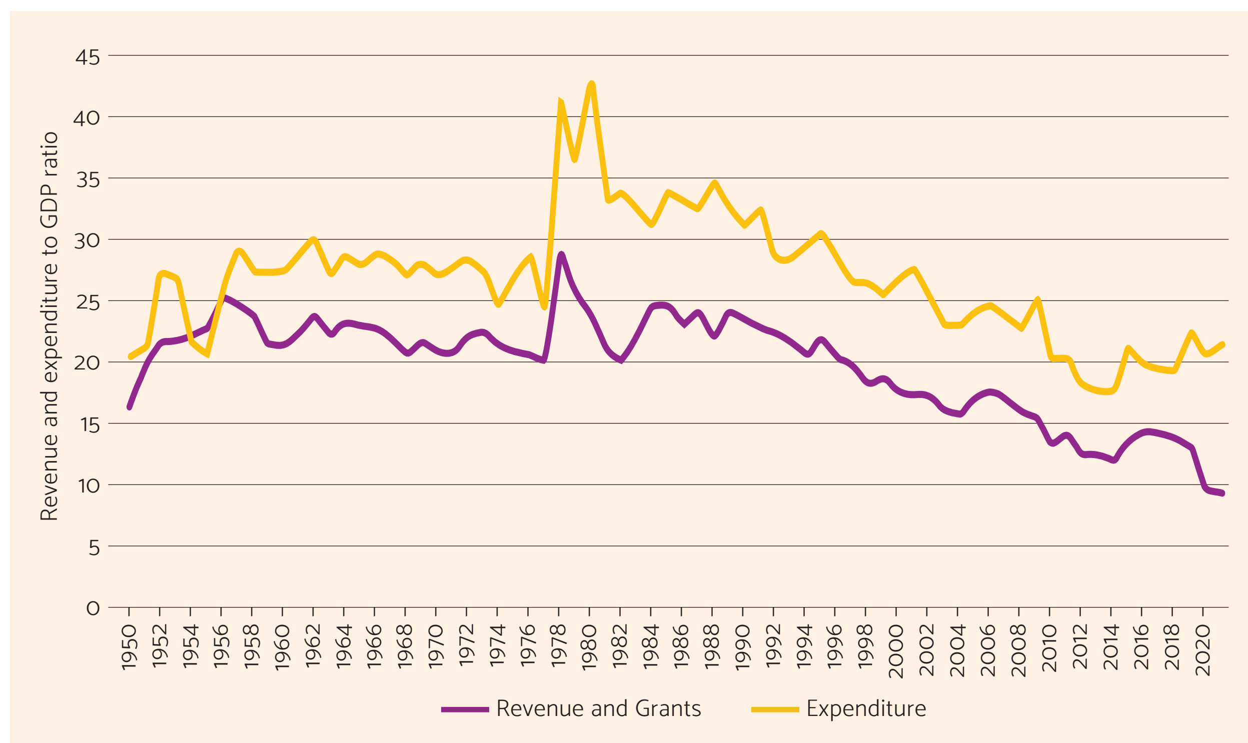
Source: Author compiled based on CBSL Data

[1] Moramudali and Panduwawala (2022). Evolution of Chinese Lending to Sri Lanka Since the mid-2000s – Separating Myth from Reality.

The Perennial Tax Issue

Despite the 26-year-long civil war that ended in 2009, Sri Lanka maintained higher social indicators than its South Asian neighbors. This was due in large part to a robust welfare system financed by a healthy revenue base. However, since the 1980s Sri Lanka's revenue has been declining, leading to a mismatch with its high development indicators.[2] The issue of government revenue is twofold. First, the overall reduction in tax-to-GDP ratio over the past three decades, and second, the alarming reliance on indirect taxation, which accounts for an estimated 80–82% of tax revenue. This has resulted in a highly inequitable tax system. Sri Lanka's predicament is extremely unusual as its higher development status should have resulted in higher government revenue.

Figure 3 Government Revenue and Expenditures as a % of GDP



Source: CBSL Annual Reports (multiple years)

In part, Sri Lanka's declining tax ratio is due to a heavy reliance on other indirect forms of taxation, such as border taxes, which make Sri Lanka's tax system extremely inequitable. This, coupled with the systemic issue of providing tax concessions and inconsistent tax policy, has adversely impacted the state's ability to raise revenue. In 2020, over 50% of Sri Lanka's revenue came from the border,

[2] The Political Economy of Long-Term Revenue Decline in Sri Lanka.

while income taxes only accounted for 22% of tax revenue.[3] One reason for this is the slow growth in the number of individual income taxpayers. The total number of registered individual income taxpayers has marginally increased from 210,399 in 2009 to 281,105 in 2019. This is a low number of tax payers relative to the country's population. In 2019, the total registered individual tax payers was only 1.3% of the total estimated population in Sri Lanka. Furthermore, income tax rates remain lower than many peer countries even after upward income tax rate revisions in 2017 and a maximum individual income rate in 2019 of 24%.[4] This regressive tax system cannot keep up with public spending needs.

A major reason for Sri Lanka's reliance on indirect taxation is its ease of administration. Even indirect taxation compliance levels on VAT sales tax which is a more efficient indirect tax in relation to import taxes, has been weak. Frequent changes made to the VAT legislation have prevented consistent implementation and the Inland Revenue Department (IRD) lacks capacity to monitor compliance. Despite the IRD being one of the oldest in the South Asian region, it has not developed sufficient capacity to improve compliance and collections in an increasingly complex economy. The income tax system continues to rely on self-assessments by taxpayers. Due to the populist election promises made during the 2019 presidential election, the few automated methods of collecting taxes from employers and banks were eliminated. Consequently, at the onset of the pandemic, tax administration became more difficult. With tax revenue contracting 29.9% from 2019[5], the government had no means of compensating businesses and workers as lockdowns deprived people of livelihoods.

Following 1977, the economic growth model was dependent on attracting foreign direct investment (FDI) to establish industries in new sectors. As a result, the Greater Colombo Economic Commission (GCEC) was established, which had discretionary powers to award tax concessions to investors. As this body's mandate expanded, domestic firms also received tax concessions on investments made towards export industries. This meant that growing sections of the economy, even those owned by domestic firms, did not fall within the tax base for prolonged periods of time. In the 2000s, further legislation expanded the government's discretion to provide tax exemptions as investment incentives.[6] As a result, some of the largest FDIs in the last decade, including port terminals, hotels, and the port city development, have received extraordinary and decades-long tax exemptions. Consequently, even though they contribute to gross domestic product and benefit from government services, they add little in terms of direct tax revenue to the Treasury.

Successive tax reform commissions have made recommendations such as implementing consistent tax policy and providing more independence to the revenue collecting agencies vis-a-vis the political authorities, while also improving cooperation among these agencies. Sri Lanka's revenue collection is hampered by the disjointed operation of its revenue departments which are under the

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[3] Taxation in Sri Lanka: Issues and Challenges.

[4] Ibid.

[5] Ministry of Finance Annual Report, 2020.

[6] Inland Revenue Department, June 2016. http://www.ird.gov.lk/en/publications/Income%20Tax_Documents/IR_Act_No_10[E]_2006_(Consolidation_2015).pdf.

purview of the Treasury but operate in a siloed manner. The revenue departments do not have an overall coherent strategy for revenue collection, and communication between the departments is minimal.

In the 2019 presidential election, election pledges focused on reducing taxes and substituting imports instead of addressing structural weaknesses. Following this landslide victory in the presidential election, Gotabaya Rajapaksa delivered on his campaign promises and reduced taxes. As a result of these politically motivated policy decisions, tax revenue and credit ratings were further downgraded, resulting in an increase in debt stock and a weakening of the exchange rate. This resulted in Sri Lanka's debt becoming unsustainable and the country's subsequent default on its debt obligations.

The Road to Default

In the short term, the now infamous tax cuts of the Gotabaya Rajapakse government in November 2019 can be considered the first domino in Sri Lanka's default. The major reversal in tax policy (see Table 1) saw Sri Lanka's tax revenue drop to 8.4% of GDP in 2020 and 7.7% in 2021.[7] Tax revenue was reduced by more than Rs. 500 billion; the highest fall in tax revenue recorded in Sri Lankan history. As a result of the reversal of the fiscal consolidation policies, an economic program supported by the International Monetary Fund (IMF) was left incomplete. The tax cuts led to a sovereign credit downgrade amid the COVID-19 pandemic in April 2020. Credit rating agencies specifically cited the tax cuts as exacerbating an already precarious foreign debt situation. This led to Sri Lanka losing access to international capital markets and thus being unable to roll over its commercial debt.

In the lead up to Sri Lanka's default on foreign debt, there were calls both from domestic and foreign sources urging for a pre-emptive default and to enter into negotiations with the IMF. These calls went unheeded, further deepening the crisis. Due to the government's insistence on continuing to service foreign debt, there was a shortage of foreign exchange, which impacted its ability to import essential items.[8] The Central Bank Governor Ajith Nivard Cabral was especially insistent that Sri Lanka would be pursuing a "homegrown" solution to its economic issues. Several short-sighted policy decisions and reversals compounded this precarious situation as the government treated the problem as a short-term liquidity issue rather than a medium to long-term issue of solvency.[9] One such policy decision was the ban on the import of chemical fertilizer. This was reportedly an attempt by the authorities to stem the country's foreign currency outflow but was masked as a drive towards organic farming. In May 2021, President Rajapaksa announced an almost overnight switch to organic fertilizer. This had a disastrous impact on the country's agricultural sector.[10] This policy was eventually reversed. Another key policy decision that exacerbated the situation was the

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7 https://www.treasury.gov.lk/ and http://www.ird.gov.lk/en/sitepages/default.aspx

8 Sri Lanka has foreign lenders' interests 'at heart': central bank – Nikkei Asia

9 Sri Lanka's problem linked to insolvency, not liquidity: Harsha | EconomyNext

10 In Sri Lanka, Organic Farming Went Catastrophically Wrong – Foreign Policy

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Table 1 Major Tax Reforms in 2019/2020

Type of Tax	Tax Changes
Personal Income Tax	• Highest tax rate was reduced to 18% from 24% • Six band structure of 4, 8, 12, 16, 20, and 24% was replaced with a three band structure of 6, 12, 18% • Income tax exemptions were granted to profit, or income generated through agriculture, Information Technology (IT) and enabling services and few other sources.
Corporate Income Tax	• Standard tax rate was reduced from 28% to 24% • Income tax rate applicable for manufacturing industry was reduced to 18% from 28%
Pay As You Earn (PAYE) tax	The tax was abolished, and an Advanced Personal Income Tax scheme was introduced
Withholding Tax (WHT)	WHT removed on interest, rent, and other services
Economic Service Charge (ESC)	Abolished
Value Added Tax (VAT)	• VAT rate was reduced to 8% from 15% • Threshold for registration of VAT increased to Rs. 300 million per annum from Rs. 12 million per annum.
Ports and Airports Development Levy (PAL)	Standard rate was raised to 10% from 7.5%
Nation Building Tax (NBT)	Abolished
Debt Repayment Levy (DRL)	Abolished
Telecommunication Levy	Reduced to 11.25% from 15%

Source: Ministry of Finance and Inland Revenue Department

fixing of the foreign exchange rate. This led to a loss of foreign remittances as migrant workers used informal channels which offered a higher exchange rate than official channels.[11] However, the policy decision that proved to be the final nail in the coffin for Sri Lanka was the repayment of an ISB of USD 500 million in January 2022. As the government was forced to utilize its foreign reserves to keep servicing its debt, its official reserves drastically depleted with its usable reserves dipping to USD 50 million by May 2022. While official data showed reserves at USD 1,827 million in April 2022, a majority of it was a Chinese Yuan swap that could not be used for debt servicing.[12]

[11] Explainer: Why does Sri Lanka want migrant workers to remit funds via banking channels? | Reuters

[12] Sri Lanka foreign reserves drop to US$1.8bn in April | EconomyNext

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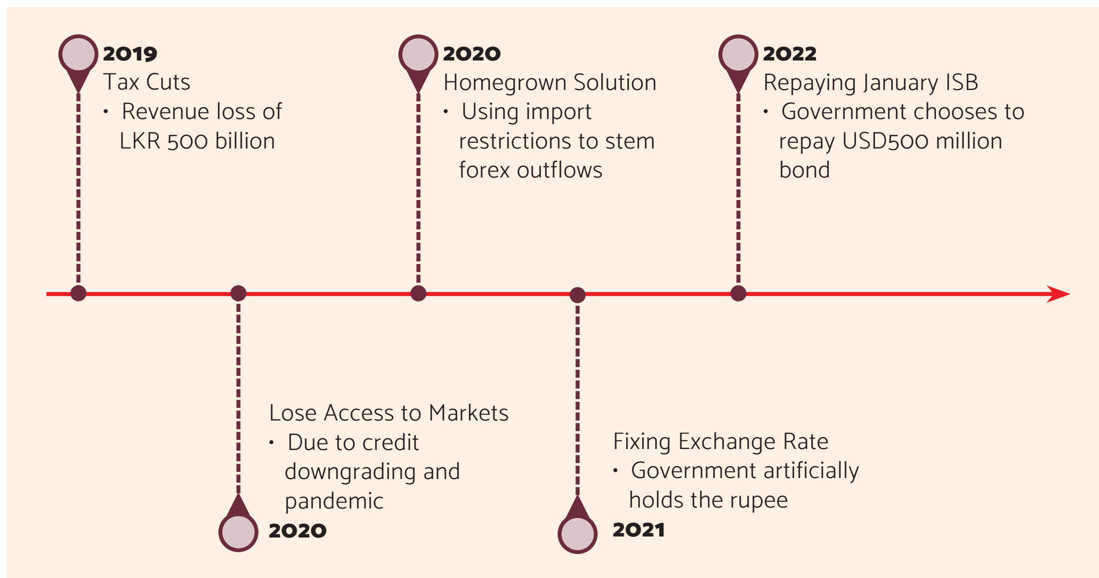
Infographic 1 Timeline of Key Policy Decisions and Events Leading to the Sovereign Default



Political Crisis and Popular Protests

Acute consequences of the crisis were felt by the population in the form of high inflation, daily scheduled power cuts, and severe shortages of fuel, cooking gas, and pharmaceuticals due to import restrictions. The crisis eventually led to political and social unrest culminating in an unprecedented people's protest that became known as the "Aragalaya" (Sinhala for the struggle). The rallying call of the protestors and the accompanying online campaign was #GoHomeGota. The central demand of the protests was the resignation of the President and by extension the government riddled with his family members, including his brother, Mahinda Rajapaksa, the Prime Minister.[13] The "occupy" style movement known as GotaGoGama ("Gota Go Gama Village") was established by groups of protesters at the beachfront park Galle Face Green as a symbol of peaceful civil disobedience. The protests were considered unique as they were mostly non-partisan and saw many protestors from the middle class. Protests continued across the island as the refusal of the President and the Prime Minister to step down led to a political stalemate. On May 9th pro-government supporters attacked the GotaGoGama protest site leading to an immediate nation-wide backlash. The escalation of violence led to five fatalities including one Member of Parliament from the ruling party (Aljazeera, 2022). Approximately 30 properties belonging to or associated with government politicians were attacked and torched (Sunday Times, 2022). This led to the resignation of the Prime Minister and the appointment of Ranil Wickremasinghe, a political opponent and previous Prime Minister. While there were sections of the population that were appeased by this move, the lack of improvement in the economic situation led to a continuation of the protests. Prompted by a crippling fuel crisis, a massive number of protestors descended on Colombo on July 9th, storming

[13] Hemachandra, 2023

the Presidential Secretariat, the Presidential Palace, and the Official Residence of the Prime Minister. After fleeing the country, the President resigned and Wickremasinghe was appointed president.[14] The government under Wickremasinghe consisted of members of Parliament from the Rajapaksa government. The protests were, however, quelled as Wickremasinghe imposed curfews and clamped down on protestors, resulting in the dramatic shrinking of civic space.[15]

The Politics of Debt

Global Debt Crisis

Post COVID-19 economic dynamics were especially volatile in developing countries which were severely affected by the increase in trade costs, contraction of economies, and reduction of trade. This was further exacerbated by the Russia-Ukraine war which resulted in severe supply chain shocks. Additionally, the United States Federal Reserve raised interest rates aggressively in order to curtail inflation caused by massive deficit financing (often referred to as money printing), as a result of the COVID-19 pandemic. This severely affected many developing countries as the US government securities became the preferable option for global investors. This led to capital flowing back to the US from emerging markets and made it more difficult for emerging and frontier markets to obtain foreign currency-denominated debt from international capital markets.

As a result of these factors, a number of emerging and frontier markets faced severe balance of payment (BOP) issues.[16] In October 2022, a UNDP report indicated that 53 countries in the Global South were in debt stress, and some with a serious risk of sovereign default.[17] By that time, Sri Lanka had declared sovereign default. Zambia and Suriname had already defaulted on their foreign debt in 2021.

Although Sri Lanka and Ghana declared sovereign default in 2022, most countries in the Global South started experiencing serious difficulties in repaying foreign loans in 2020, due to the shock form the global COVID-19 pandemic. Against that backdrop, the World Bank and IMF initiated the Debt Service Suspension Initiative (DSSI). Under this initiative, foreign debt repayments of many low-income countries were suspended in 2020 and 2021 (World Bank, 2022). As the DSSI came to an end in 2021, major global creditors developed a common framework to provide long-term debt relief to countries in debt stress which goes beyond DSSI (IMF, 2022). This framework is referred to as the G20 Common Framework and is expected to support low-income countries to reduce debt distress. However, research shows that the G20 Common Framework has not met this objective (Brautigam and Huang, 2022).

14 Sri Lanka political dynasty ends as Rajapaksa quits – BBC News.
15 Sri Lankan President continues crackdown on activists and protesters, including use of anti-terror law - Civicus Monitor.
16 Trouble is coming for emerging markets beyond Sri Lanka I Financial Times and Debt Relief For A Green And Inclusive Recovery
17 Avoiding 'Too Little Too Late' on International Debt Relief: Development Futures Series Working Papers. UNDP Global Policy Network (October 2022).

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The Poster Child of Debt Traps: Geopolitics of Sri Lanka's Debt

Sri Lanka's foreign lending has been subject to many controversies during the last decade in light of the rapid increase in Chinese lending to Sri Lanka. There were many global discussions about the Chinese debt trap,[18] of which Sri Lanka was frequently cited as a victim. While this myth has mostly been debunked,[19] Chinese loans once again became a controversy amid Sri Lanka's debt restructuring efforts.

Table 2 Foreign Debt by Creditor

	2000	2006	2011	2016	2017	2018	2019	2020	2021	end-May 2022
World Bank	24%	22%	13%	10%	10%	9%	9%	9%	10%	10%
ADB	21%	25%	16%	13%	13%	13%	12%	13%	15%	15%
Japan	32%	28%	22%	11%	10%	10%	9%	10%	9%	8%
India	0.2%	1%	2%	3%	3%	3%	2%	2%	2%	4%
China	0.4%	1%	9%	16%	15%	17%	17%	18%	20%	19%
Other Bilateral Lenders	19%	14%	7%	4%	4%	4%	4%	4%	3%	3%
ISBs	–	–	14%	28%	29%	35%	40%	38%	36%	36%
Foreign Held Domestic Bonds	–	–	11%	6%	6%	3%	2%	0.2%	0.1%	0.1%
Others	4%	8%	6%	8%	10%	7%	6%	5%	4%	4%

Source: Author calculations based on External Resources Department and CBSL data

[18] South Asia Diary: Is Sri Lanka China's debt trap diplomacy victim? I World Latest English News and Experts say Sri Lanka walked into China's debt trap diplomacy I Latest English News I WION. See also: Remarks by Vice President Pence on the Administration's Policy Toward China – The White House. China's Debt-Trap Diplomacy by Brahma Chellaney – Project Syndicate. There Is No Chinese 'Debt Trap' – The Atlantic and Is Sri Lanka Really a Victim of China's 'Debt Trap'? – The Diplomat

[19] There Is No Chinese 'Debt Trap' – The Atlantic and Is Sri Lanka Really a Victim of China's 'Debt Trap'? – The Diplomat

Sri Lanka's reliance on Chinese loans increased in the post-2000 era when the Sri Lankan government adopted a public infrastructure-driven growth strategy. Given that the country had a persistent budget deficit, financing for large-scale public infrastructure had to come through borrowing. However, by this time Sri Lanka had been upgraded to a middle-income country, and as a result had limited access to concessionary loans from multilateral institutions. A limited number of multilateral loans were available, but they could not be channeled towards the development of infrastructure with political objectives.

Chinese loans thus became a viable alternative that served both the economic and political needs of the Sri Lankan government. Sri Lanka was seen as a potential market for exports of Chinese state-owned enterprises (SOEs) which are often financed through loans provided by Chinese state banks such as EXIM and China Development Bank (CDB). In 2004, Sri Lanka obtained a loan from China EXIM Bank to construct the country's first coal power plant to meet the increasing demand for electricity. This was followed by a series of other large-scale infrastructure projects including expressways, a port, and an airport.

This was also the time Mahinda Rajapaksa became President for the first time. He won the election marginally and his coalition government had a marginal majority in the parliament. Therefore, Rajapaksa needed to gain public support and he made many populist promises, including large-scale infrastructure development, in his 2005 presidential manifesto. Given the narrow margin of his victory and the hung parliament, delivering on major promises were crucial for his popularity and the survival of his government.[20] During his first presidential term, the government launched an aggressive campaign against the Liberation Tigers of Tamil Eelam (LTTE) in an effort to end the ongoing civil war. Rajapaksa took on a mission to defeat the LTTE[21] which also required substantial public support. Thus, the government initiated many large-scale infrastructure projects including Hambantota Port, Expressways, and the Mattala Airport.[22]

When the war ended in 2009, Rajapaksa ran for election for a second term. While he was at the peak of his popularity due to defeating the LTTE, his government needed to deliver more promises to ensure his re-election. Against that backdrop, Rajapaksa pledged to expand public infrastructure-driven growth including infrastructure development in the Northern and Eastern provinces that were affected by the nearly three decades long conflict. Continuing infrastructure development was a major part of the Rajapaksa manifesto in 2010, and the expansion of Hambantota Port and the expressway network were key highlights. After securing a victory by a large margin, the

[20] Moramudali and Panduwawala (2022). Evolution of Chinese Lending to Sri Lanka Since the mid-2000s – Separating Myth from Reality.

[21] The Liberation Tigers of Tamil Eelam (LTTE), commonly known as the Tamil Tigers, was a separatist militant organization fighting for an independent homeland for Sri Lanka's Tamil minority in Northern Sri Lanka.

[22] Moramudali and Panduwawala (2022) and Mahinda Chinthana: Vision for a New Sri Lanka, Department of National Planning (2006). This was accessed through the Finance Ministry library.

Rajapaksa-led government continued debt-fueled infrastructure development to maintain economic growth. As public infrastructure expanded, the notion of Chinese debt driven growth and the Chinese debt trap started to develop domestically and internationally.[23]

Table 3 Major Project Loans from China during 2005–2014

Project Name	Agreement Date	Principal Repayment Starting Year	Loan Amount ($ million)	Loan Period (Years)	Interest Rate (%)
Puttalam Coal Power Project – Preferential Buyer's Credit	2005-08-30	2012	300	21	2
Puttalam Coal Power Project – Buyer's Credit Facility	2006-09-08	2015	153	18	USD LIBOR 6 month + 1
Hambantota Port Development Project – Phase I	2007-10-30	2013	307	17	6.3
Bunkering Facility & Tank Farm Project at Hambantota	2009-08-06	2014	65	15	6.5
Colombo Katunayake Expressway (CKE)	2009-08-06	2013	248	16	6.3
Puttalam Coal Power Project – Phase II	2009-12-25	2014	891	20	2
Mattala Hambantota International Airport Project	2010-03-05	2016	191	20	2

[23] International narrative was led by Brahma Chellaney, Professor of Strategic Studies at the New Delhi-based Center for Policy Research and one of his articles about Chinese debt trap can be accessed in China's Debt-Trap Diplomacy by Brahma Chellaney – Project Syndicate.

Project Name	Agreement Date	Principal Repayment Starting Year	Loan Amount ($ million)	Loan Period (Years)	Interest Rate (%)
Northern Road Rehabilitation Project	2010-09-09	2015	302	15	USD LIBOR 6 month + 2. 4
Southern Expressway Extension Project – Phase 1	2011-02-17	2017	74	15	USD LIBOR 6 month + 2.4
Southern Expressway Extension Project – Phase 2	2011-02-17	2016	55	15	USD LIBOR 6 month + 2.4
Improvement and Rehabilitation of Priority Roads	2011-03-31	2014	500	15	USD LIBOR 6 month + 2.9
Hambantota Port Development Project – Phase 2	2012-09-17	2022	156	22	2
Hambantota Port Development Project – Phase 2	2012-09-17	2018	600	19	2
Southern Railway Line Extension Project – Phase 1	2013-02-19	2020	200	19	2
Hambantota Port Development Phase I for Ancillary Work and Supply of Equipment Project	2013-04-24	2018	147	20	2
Southern Railway Line Extension Project – Phase 2	2013-05-28	2021	83	21	2
Improvement and Rehabilitation of Priority Roads Project 3 – Phase I	2014-03-11	2017	300	15	USD LIBOR 6 month + 2.95

Project Name	Agreement Date	Principal Repayment Starting Year	Loan Amount ($ million)	Loan Period (Years)	Interest Rate (%)
Construction of Outer Circular Highway Project – Phase 3	2014-09-16	2020	494	20	2
Extension of Southern Expressway – Section 4	2014-09-16	2020	2020	20	2
Hambantota Road and Infrastructure Development Project	2014-09-16	2020	251	20	2
Extension of Southern Expressway – Phase 3	2014-12-23	2020	684	21	2

Source: Author constructed based on data obtained through information requests from Ministry of Finance, Sri Lanka

The development of the Chinese debt trap narrative stemmed from three key factors. Firstly, China wasn't a major lender to Sri Lanka during the period of 1980-2000. Therefore, the increase of Chinese presence was distinctly visible. Secondly, projects financed by Chinese loans and FDI such as the Puttalam Coal Power Plant, Hambantota Port, Mattala Airport, and Hambantota cricket stadium caught public attention. The infrastructure drive was used to showcase the government's ability to develop the country and was prominently featured in the media.[24] This media narrative gave credence to the idea that Sri Lanka's infrastructure development was mostly financed through Chinese loans. The narrative ultimately backfired in the lead-up to the 2015 presidential election as the main opposition highlighted these projects when raising concerns regarding Chinese influence on Sri Lanka's sovereignty. Thirdly, the rise of Chinese lending became a geopolitical concern, largely due to reporting in international media and especially in the Indian media.[25] Given Sri Lanka's proximity to India and its close bilateral ties, increasing Chinese economic presence in terms of

[24] State media channels and newspapers gave big publicity to Rajapaksa's development projects. Some selected links are: https://www.youtube.com/watch?v=uG6YDzhXXfA and The New Tank Farm Complex and Bunkering Terminal declared open by the President Mahinda Rajapaksa.

[25] See Abeysekara et el. for comprehensive analysis of India-Sri Lanka trade. Can be accessed in Handbook on the India-Sri Lanka Free Trade Agreement.

both loans and investment was seen as a threat. After Sri Lanka's economic liberalization in 1977, China's influence in the country was minimal, while India had a substantial economic and political presence. India was Sri Lanka's major trading partner during its post-liberalization era. Additionally, India played a key role in Sri Lanka's civil war, intervening several times, including sending the Indian Peace Keeping Force to fight the LTTE. Sri Lanka's interactions with China were minimal and went almost unnoticed during this era. Thus, the increase of China's economic presence, including its investments in strategic places in Colombo, raised concerns for India.

By 2017, the notion that Sri Lanka was a victim of a Chinese "debt trap" was a popular narrative.[26] The narrative spread faster when Sri Lanka leased the Hambantota Port to China Merchant Port Company for 99 years in 2017. In the same year, the New York Times published an article titled "How China Got Sri Lanka to Cough Up a Port" claiming that Sri Lanka handed over Hambantota Port to China because the country was unable to repay the loans obtained to build the port.[27] This narrative was also used by some U.S. politicians to justify anti-China rhetoric. For example, in 2018, US Vice President Mike Pence accused China of pursuing debt trap diplomacy, citing the Hambantota port deal.[28] In reality, the lease of the port and the loans taken to build the port are separate and Sri Lanka continued to service those loans after the lease. In spite of the fact that the port deal was neither a debt-to-equity swap nor an asset seizure, the narrative thrived.

Sri Lanka's debt problem goes beyond Chinese loans. It is true that Chinese loans had many issues including a lack of transparency and attachment to unsolicited bids,[29] but these loans themselves were not the primary driver of the sovereign default. When Sri Lanka defaulted in April 2022, only 20% of Sri Lanka's foreign debt stock was owed to China. Debt repayments to China also only accounted for 20% of the country's debt servicing.[30] In contrast, the largest share of foreign debt stock was in international capital market borrowings (International Sovereign Bonds or ISBs) which accounted for 36% of the foreign debt stock and almost 50% of the government's foreign debt repayments in 2021. Additionally, research shows that Chinese loans had lower interest rates than international capital market borrowings.[31] Therefore, the issues regarding Chinese lending were not necessarily about interest rates or the amount of debt, but rather about transparency in Sri Lankan government processes.[32]

[26] There Is No Chinese 'Debt Trap' – The Atlantic.

[27] How China Got Sri Lanka to Cough Up a Port – The New York Times.

[28] Remarks by Vice President Pence on the Administration's Policy Toward China – The White House.

[29] The Lure of Chinese Loans.

[30] Evolution of Chinese Lending to Sri Lanka (2022) Evolution of Chinese Lending to Sri Lanka Since the mid-2000s – Separating Myth from Reality.

[31] Ibid.

[32] China's Overseas Lending (2021) Horn et al and can be accessed here: China's overseas lending – ScienceDirect,

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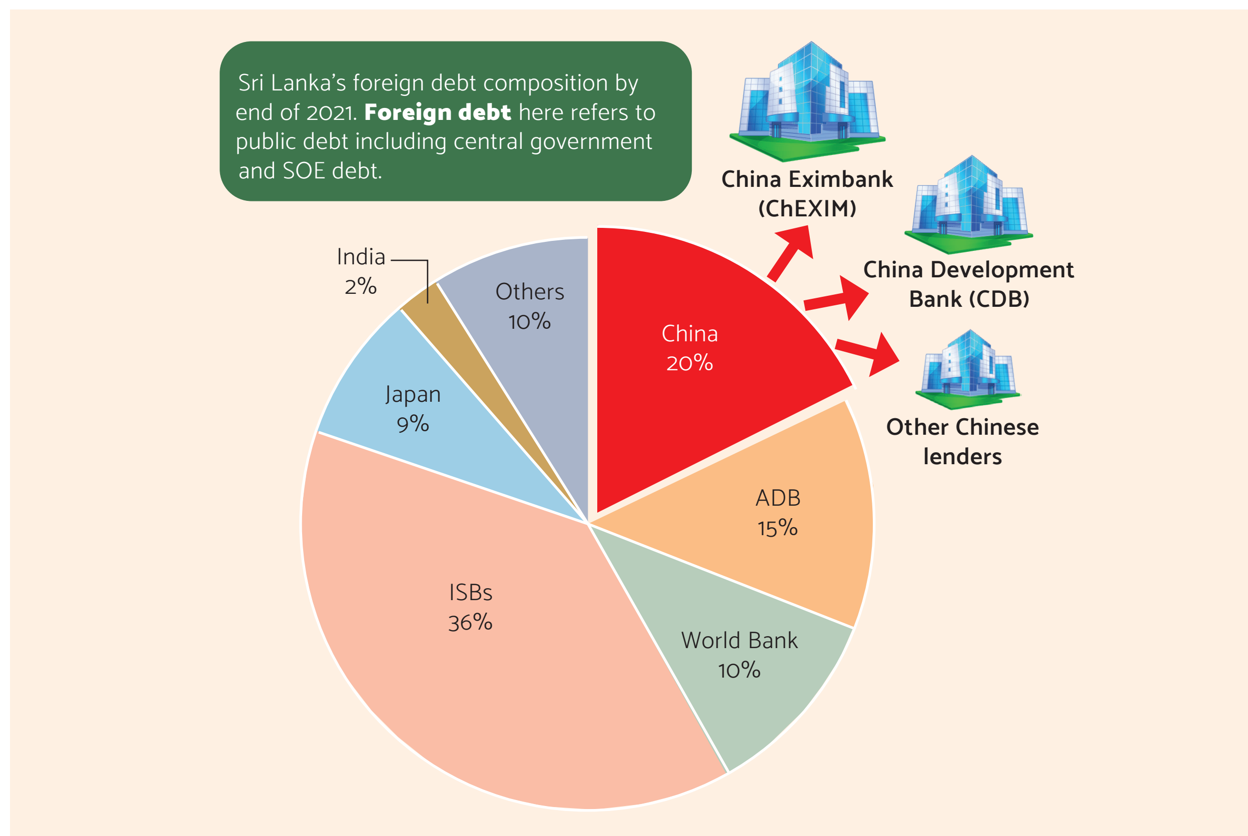
Debt Restructuring

After Sri Lanka declared sovereign default in 2022, its debt problem once again became a global concern. Soon after declaring sovereign default, Sri Lanka announced that it sought to enter an IMF program and began negotiations to initiate the process of restructuring sovereign debt. Sri Lanka authorities reached a staff-level agreement with the IMF in October 2022. However, entering an IMF program requires the approval of the IMF Executive Board which in turn requires certain financing assurances from major creditors. Sri Lanka's creditors had to indicate that they were willing to be in arrears and to restructure debt in order to achieve debt sustainability. This is when China became the deciding factor, thereby becoming a geopolitical concern. China EXIM Bank provided financing assurances to Sri Lanka pertaining to debt restructuring in January 2023.[33] However, the delay in providing it was criticized by the United States and India.

Figure 4 China's Role in Sri Lanka's Foreign Debt



Source: External Resource Department (ERD)

[33] See https://www.fmprc.gov.cn/mfa_eng/xwfw_665399/s2510_665401/2511_665403/202302/t20230203_11019466.html

As outlined before, China was Sri Lanka's largest bilateral creditor, accounting for almost 20% of Sri Lanka's foreign debt at the time of sovereign default. Thus, having concrete financing assurances about debt restructuring from China was essential for Sri Lanka to obtain IMF Executive Board approval. However, China was not only slow to provide financing assurances to Sri Lanka, but also reluctant. Chinese officials kept demanding Multilateral Development Banks (MDBs) to be included in the debt restructuring and kept delaying providing financing assurances.[34] This position was made clear at the Foreign Ministry Spokesperson Mao Ning's Regular Press Conference on February 3, 2023: "China calls on all other creditors of Sri Lanka, especially multilateral creditors, to take synchronized, similar steps and give effective, strong support to Sri Lanka to help the country emerge from its default status at an early date and eventually work out an arrangement for Sri Lanka to achieve medium- and long-term debt sustainability. China also calls on the IMF to take into full consideration the urgency of the situation in Sri Lanka and provide loan support as soon as possible to relieve the country's liquidity strain."[35]

This caused a tug of war between China and other creditors, including the United States, which insisted that China provide Sri Lanka with financing assurances. China eventually provided financing assurances to Sri Lanka in March 2023[36] based on which the IMF executive board approved funding to Sri Lanka on 20 March 2023. However, the nature of China's participation in the debt restructuring process remains to be seen.

Local Political Economy: Middle Class Consumption and the Welfare State

The root causes of Sri Lanka's debt problem lie with the country living beyond its means while failing to address structural weaknesses for decades. Since independence, successive governments in Sri Lanka have pursued policies that promoted a welfare state. Attempts to deviate from such welfarist policies were strongly resisted, thus governments were reluctant to cut back on welfare spending due to the fear of losing elections.[37] Welfare spending gradually declined after economic liberalization in 1977.[38]

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34 During Chinese Foreign Ministry Press Briefings, China insisted the need of multilateral institutions such as World Bank and IMF also providing debt relief. See more : Foreign Ministry Spokesperson Wang Wenbin's Regular Press Conference on February 14, 2023. See also : Foreign Ministry Spokesperson Mao Ning's Regular Press Conference on February 2, 2023. See also: https://www.fmprc.gov.cn/mfa_eng/xwfw_665399/s2510_665401/2511_665403/202302/t20230202_11018861.html

35 See full transcript of the press conference here: https://www.fmprc.gov.cn/mfa_eng/xwfw_665399/s2510_665401/2511_665403/202302/t20230203_11019466.html

36 Chinese foreign ministry confirmed on 8 March that EXIM Bank provided financing assurances in line with IMF parameters. See full transcript here : Foreign Ministry Spokesperson Mao Ning's Regular Press Conference on March 8, 2023.

37 See Abeysinghe (2019) can be accessed here: https://gamanicoreafoundation.lk/wp-content/uploads/2021/01/SL-Welfate-state-Nov-11-2019.

38 Sri Lanka's welfare policy shift after liberalization is analyzed in detail here in the article 'Stabilisation and Adjustment: Sri Lankan Experience, 1977-1993'. It can be accessed here : Stabilisation and Adjustment: Sri Lankan Experience, 1977–1993. Further reference was used: Changes in the living standards of the poor in Sri Lanka during a period of macroeconomic restructuring – ScienceDirect.

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For most of Sri Lanka's post-independence, it has been a twin deficit country, running both a current account and a budget deficit. The former refers to a country spending more foreign currency than it earns, and the latter refers to the government spending more than it earns. Having a twin deficit became more problematic after Sri Lanka's transition to a middle-income country in 1997. Along with Sri Lanka's upgrade to middle-income status, the country's middle class expanded substantially, becoming a key voter bloc. From 1990–2015, Sri Lanka's GDP per capita soared from USD 472 to 3,842.[39] While the per capita income grew rapidly, government revenue as a share of GDP declined substantially. This is very contrary to the global norms of development which suggest that when a country upgrades from a low-income country to a middle-income country, its government revenue as a share of GDP increases. On the other hand, increasing per capita income resulted in an increase of purchasing power parity (PPP) which refers to the ability to buy goods and services.[40] As the population's ability to purchase goods and services expanded due to economic growth, private consumption also started to increase. Such an increase of private consumption largely came from the country's growing middle-class. It was supported by the state by providing employment, investment in public infrastructure, low taxes, and energy subsidies (fuel and electricity being provided at a lower price than the cost).[41] The growth in private consumption helped Sri Lanka to boost economic growth in the short term while ignoring the need to address long-standing structural weaknesses. This growth model was mutually beneficial for both the government and the growing middle class, which had become the determining voting bloc in Sri Lanka. The growing middle class continued to benefit through low taxes and energy subsidies which allowed them to increase their consumption. As a result, most middle-class individuals could fulfill their aspirations of constructing a house and owning a vehicle, most of which were funded through loans. The government also benefited from this expansion because it allowed them to retain their popularity.

While this short-term economic growth benefited the growing middle class and the government, this growth strategy further exacerbated the country's economic woes and structural weaknesses. As Sri Lanka continued to have a high budget deficit and current account deficit, increasing government spending was financed through loans. Given the persistent current account deficit, Sri Lanka was compelled to obtain foreign loans, most of which were obtained from international capital markets and China. Therefore, increased consumption by the expanding middle class was facilitated using foreign loans which were used to bridge the external finance gap as well as the budget deficit. The government policy of heavily intervening in the foreign exchange market, coupled with high import tariffs led to a deterioration of export performances. Sri Lanka's exports as a share of GDP dropped to 17% in 2015 from 39% in 2000.[42] There were limited incentives and support for individuals and businesses to engage in export related businesses.

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[39] Special Statistical Appendix

[40] Consumption patterns in Sri Lanka: a decomposition analysis

[41] Who does Sri Lanka's fuel subsidy really benefit? – The Island.

[42] World Bank data accessed here: Exports of goods and services (% of GDP) – Sri Lanka.

On the other hand, due to the overvalued exchange rate and the maintenance of low interest rates, imports became affordable. This resulted in the growing middle class shifting consumption habits by purchasing items such as imported household items, mobile phones, and vehicles.[43] Low interest rates allowed people and businesses to obtain loans at low cost which were used to import items such as vehicles, household items, mobile phones, or construct houses. Therefore, low interest rates and controlled exchange rate policies led to further deterioration of the account deficit, which then forced the government to obtain more foreign loans. Conversely, low taxes provided more incentives to middle-class individuals with fixed income to stretch their limits in terms of obtaining loans, most of which were used to purchase vehicles and construct houses or purchase houses at inflated prices. Data shows that during 2005 to 2019, Sri Lanka's motor car population increased from 361,000 to 875,000.[44] Parallel to this, fuel consumption also increased. The growth strategy was ultimately responsible for the crisis that threatened the economic security of the middle class, which had previously benefited from this ill-advised strategy.

Reform, Recover, Restore

Lack of accountability was a major theme during the people's protests, but Sri Lanka's current reform agenda does not prioritize governance reforms. On 20th March 2023, the International Monetary Fund's Board approved a USD 3 billion program under the Extended Fund Facility (EFF) to support Sri Lanka's recovery and reform agenda.[45] The initial disbursement is expected to catalyze much-needed bridge financing from multilateral lenders. The program includes reforms for revenue-based fiscal consolidation, strengthening social safety nets, cost-recovery-based energy pricing, restoring public debt sustainability, tackling inflation, ensuring financial sector stability, and addressing corruption.[46] The main focus of public debate around the IMF program has been the proposed tax reforms and fears of austerity measures. In order for the reform agenda to succeed, the government must be able to restore the trust in public institutions that has been severely damaged by the current economic crisis.

Sri Lanka's Fiscal Social Contract

Since August 2022 Sri Lanka has embarked on ambitious tax reforms as a prerequisite for the IMF's EFF. These reforms will have to address many of Sri Lanka's perennial revenue issues including changing the direct to indirect tax ratio. Rationalizing the structural problem of tax concessions will also be essential for any longer-term efforts in building public finances that can keep up with Sri Lanka's future developmental and public investment needs. In response to the Wickremasinghe government's tax reforms, there has been a severe backlash, raising serious doubts as to how successful the four-year EFF will be.

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[43] Increase of vehicle imports were incentivized through low interest rates.

[44] Data regarding Sri Lanka's total vehicle population can be accessed here – https://dmt.gov.lk/images/PDF/statistics/TOTAL_VEHICLE_POPULATION_2010-2022.pdf

[45] IMF Executive Board Approves US$3 Billion Under the New Extended Fund Facility (EFF) Arrangement for Sri Lanka.

[46] Ibid.

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Sri Lanka currently has a weak fiscal social contract which needs to be addressed if the reform agenda is to succeed. A crucial aspect that needs to change is government expenditure patterns. Sometimes this entails earmarking revenue for specific expenditures such as social spending.[47] This may prove to be a crucial factor in whether or not Sri Lanka creates a new fiscal social contract through their tax reform process. Sri Lanka's decades-long revenue problem reduced social spending and drastically affected the quality of public services.[48] This is in direct contrast to Sri Lanka's reputation as a model welfare state in the 1950s to 1980s. Sri Lanka's pre-reform tax regime was not reliant on income taxes and decades of low-income taxes have created a culture of receiving free public goods such as healthcare and education as well as a plethora of subsidies without the burden of taxation.[49] One major criticism that was already levied is the increase in defense spending in the 2023 national budget. This is part of a trend of inefficient overspending on defense that has continued despite the end of Sri Lanka's civil war in 2009. This manner of government spending is in contradiction to the needs of the wider polity and can negatively impact trust in public institutions. Strengthening Sri Lanka's fiscal social contracts would thus require tax reforms to be accompanied by expenditure reforms reflective of the needs of citizen-taxpayers especially in relation to social spending.

Public Debate on Tax Reform

As this study highlighted initially, Sri Lanka's poor tax collection has been one of the major structural weaknesses of the economy, thus addressing the concerns pertaining to taxation remains vital to achieving debt sustainability, stabilizing the economy, and maintaining long-term equitable growth. After the political turmoil that led to the resignation of Gotabaya Rajapaksa, Sri Lanka initiated the process of carrying out long-delayed economic reforms along with a request to obtain a much-needed bailout package from the IMF. One such reform was the tax reforms that aimed to increase the country's low government revenue, which is one of the major causes of the economic crisis.

While tax reforms have been in discussion for a few months, the government announced tax increases for the first time on 31 May 2022.[50] However, there were many ambiguities about these changes, and legislations pertaining to much-needed tax reforms were gazetted later. Firstly, the government increased the VAT rate to 12% from 8% and later it was increased further up to 15%.[51] Parallel to this, the VAT threshold of Rs. 300 million per annum (Rs. 75 million per quarter) was reduced to Rs. 80 million per annum (Rs. 20 million per quarter) with effect from 1 October 2022 to capture more businesses into the tax net. Income tax changes were proposed after VAT changes. The Inland Revenue Amendment Act (IR Amendment Act), which suggested a series of tax

47 Taxing Africa – Coercion, Reform and Development

48 The Political Economy of Long-Term Revenue Decline in Sri Lanka

49 The Incidence of Taxes and Spending in Sri Lanka I The Distributional Impact of Taxes and Transfers: Evidence From Eight Developing Countries and The Politics of Economic Reform – Groundviews.

50 Crisis-hit Sri Lanka hikes tax rates to maximise govt revenues I Reuters.

51 See gazette: http://documents.gov.lk/files/egz/2022/8/2295-08_E.pdf

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changes, was gazetted in October 2022.[52] Most of these changes aimed to revise the tax reductions and exemptions implemented by the Gotabaya Rajapaksa government in 2019 and early 2020. These proposed income tax changes included increasing personal income tax rates from 18% to 36%, reintroducing Withhold Tax (WHT), increasing corporate taxes up to 30%, and reducing the personal income tax-free threshold from Rs. 3 million to Rs. 1.2 million per year.

Proposed tax changes were a difficult pill to swallow for the business community as well as for many professionals whose tax burden was significantly increased due to upward tax revisions. Opposition parties that criticized Gotabaya Rajapaksa for tax cuts also vehemently criticized tax increases. Interestingly, opposition to tax increases came from parties across different ideologies. Samagi Jana Balawegaya (SJB), which is seen as a party that stands with IMF policies, criticized tax increases claiming that they adversely affect exporters and professionals.[53] Leftist parties Janatha Vimukthi Peramuna (JVP) and Frontline Socialist Party (FSP) both criticized tax increases despite the progressive nature of tax reforms. The JVP claimed that under a government led by them, the tax-free threshold should increase to Rs. 200,000 from Rs. 100,000 and the maximum tax rate should be 24%.[54] JVP leader Anura Kumara Dissanayake also claimed that the tax revisions were causing the increased migration of professionals and thus needed to be reversed. It was evident that these pledges were given to capture the votes of middle-class households who had become the deterministic voting bloc in Sri Lanka's election since the early 2000s.

It was clear that opposition to personal income tax reforms came from middle and upper-middle-class fixed earners who had previously benefited from low-income tax rates. Such households mostly consisted of doctors, engineers, academics, banking and finance professionals, and IT professionals. In response to tax changes, a number of fundamental rights (FR) petitions were filed in the Supreme Court (SC) claiming that tax changes affect FR. Petitioners included businessmen, professionals, and university lecturers.[55] Petitions claimed that tax changes are unfair and violate the fundamental rights of taxpayers. The SC took its time and provided its ruling which stated that the IR Amendment bill (the proposed tax legislation) is in line with the constitution. The SC ruling, delivered in November 2022, stated that the proposed tax system is manifestly unreasonable or manifestly discriminatory and tax revisions are consistent with the constitution.[56] After the bill was cleared by the SC, the Inland Revenue (Amendment) Act came into force from 19 December 2022.[57]

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[52] Inland Revenue Amendment Bill which proposed income tax changes can be accessed here: http://documents.gov.lk/files/bill/2022/10/282-2022_E.pdf

[53] SJB expressed serious concerns over tax reforms, and two major economists in the party Dr. Harsha De Silva and Eran Wickremeratne were amongst leading critics of personal income tax changes that affected the middle-class. See more : Harsha asks govt. not to impose steep tax on professional incomes lest it should worsen brain drain – The Island and New tax rates unfeasible with 45% below poverty: Harsha | Daily FT

[54] See more: Sri Lanka's leading leftist alliance NPP promises tax cuts for the rich | EconomyNext.

[55] Supreme Court determination can be accessed here: http://www.supremecourt.lk/images/documents/sd_64_71_2022.pdf

[56] Supreme court determination – chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/http://www.supremecourt.lk/images/documents/sd_64_71_2022.pdf

[57] News – Inland Revenue (Amendment) Act comes into force from today (Dec. 19)

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Although the tax revisions were implemented, resistance to tax revisions continues. Most of the resistance came from professional groups, who formed a united alliance to oppose the tax reforms. This alliance, named the Professional Trade Union Alliance (PTUA) included doctors, engineers, academics, and many others who claimed that the tax burden is unbearable, and it will significantly increase brain drain.[58] The main trade union that represents doctors, the Government Medical Officers Association (GMOA), submitted a letter to the President, signed by a majority of doctors, requesting to reduce taxes.[59] Many other trade unions also initiated trade union action.[60] The Federation of University Teachers Association (FUTA) also signed a petition and submitted it to the government and proposed to increase the tax-free threshold up to Rs. 250,000 and reduce the tax rates.[61]

On 25 January 2023, which is the government payday, most of the government employees who were affected by tax increases wore black to work and decorated office premises with black flags.[62] This included university lecturers, doctors, engineers, CBSL officials, and many others. However, the government insisted that tax revisions are an essential part of essential economic reforms and a prerequisite to obtaining the approval of the IMF Executive Board for the bailout package requested by Sri Lanka. As the government dismissed the trade union demands, PTUA put forward an alternative set of tax reform proposals and engaged in an island-wide strike demanding to implement their proposals. This island-wide strike took place on 15 March 2023 with the participation of doctors, engineers, academics, petroleum workers, port workers, some banking and finance professionals, and many other professionals.[63] In response to the strike, the government offered to continue discussions with the trade unions regarding tax reforms and submit viable alternative tax reform proposals to the IMF.

> "(The) *President is of the view that through a constructive consultation process, we should be able to submit a viable proposal to the IMF at its first Review Meeting which will be held in a few months and the President will be meeting the GMOA and other Trade Unions for further discussions in due course*" – President's letter to the GMOA on 15 March.[64]

While some trade unions temporarily called off the strike action (while maintaining other trade union action), some unions continued to be engaged in strike action. In the following week, a meeting was arranged between trade union representatives and IMF representatives regarding the tax reforms.[65]

58 Key Informant Interviews with representatives of PTUA.

59 GMOA against Govt. Tax policy.

60 Sri Lanka unions stage strike to protest against IMF bailout plan | News | Al Jazeera.

61 Key Informant Interviews with a representative of FUTA. We had also obtained the document which consisted of a set of alternative tax proposals advocated by FUTA.

62 Sri Lanka central bank workers protest tax hike as governor defends painful measures | EconomyNext

63 Trade Unions decide to call off strike action on Thursday – NewsWire.

64 Information is based on KII conducted with trade union representatives engaged in the strike.

65 Sri Lankan trade unions in high-level talks with the IMF – World Socialist Web Site.

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Table 4 Tax Revisions and Proposals by Professionals

	Status Quo After Tax Reforms	Proposals by PTUA
Tax free allowance	Rs. 100,000 per month	Rs. 200,000 per month
Tax rates	6%, 12%, 18%, 24%, 30%, 36%	4%, 8%, 12%, 16%, 20%, 24%
Tax slabs	Rs. 500,000	Rs. 600,000

Source: Inland Revenue Department and PTUA

While the discussions continued, the government did not revise the tax changes and as the government stood firm, the momentum of professional trade union action was lost. It is important to note that the resistance to tax reforms stemmed only from middle and upper-middle-class groups who were brought into the tax net via the new reforms. As the personal income tax applied only to those who earn more than Rs. 100,000 per month, approximately 80% of income earners were exempted from personal income tax. Therefore, it can be inferred that the majority of the population would not be concerned about income tax revisions. Furthermore, discussions regarding these income tax changes also made the class division more apparent as the majority of the population held the sentiment that those who earn more than Rs. 100,000 are wealthy enough to pay taxes.

Accountability and Public Goods

Opposition to tax reforms did not merely focus on the increase of the tax burden. As the personal income tax burden increased, the demand for accountability also increased. As noted, during the people's protests, a major public demand was "accountability" as many people believed that it was large-scale corruption that caused the economic crisis.[66] As tax reforms were implemented, those who are reluctant to pay tax often cited lack of accountability as a concern to pay taxes. There were also concerns raised about the large public sector, loss-making SOEs, and lack of quality in public infrastructure.

> "*The government should focus on reforming the state sector, including both the central government and the provincial sector, to ensure cost efficiency, productivity, and efficacy. Hence, it requires a thorough assessment of the current situation by consulting the relevant professionals and stakeholders. Immediately introduce KPI for all the ministries, departments, and officials. Use the achievement of KPIs for the promotion and service extensions of all executive officers of the government*" – Extract from PTUA Proposals 2023[67]

[66] The aftermath of Sri Lanka's economic crash.

[67] We obtained the set of proposals from PUTA during KIIs with their representatives.

Tax reforms sparked a significant interest amongst taxpayers about accountability and the quality of public goods. Up to this point of time, the importance of accountability as well as the quality of public goods were not seen as essential factors of governance. As the tax burden increased, people began to question the return on their tax payments. This is a feature seen in some contexts where tax reforms have taken place which links increased taxation with increased governance. There is, however, no guarantee of greater reciprocity by the government, nor is it assured that citizens will continue to organize to demand greater accountability from their government. Both factors would have to be maintained in order to fix Sri Lanka's fiscal contract and bring about lasting governance reforms. On the other hand, as the tax burden increased, people's disposable income decreased and that compelled them to use public goods more. For example, some people who used personal vehicles were compelled to use public transport, the quality of which has significantly deteriorated over the last three decades. As a result, this led to segments of the population demanding higher quality public services.

Conclusion and Recommendations

The current economic crisis in Sri Lanka is a crisis of mismanagement caused by short-sighted policy decisions that exacerbated long-standing weaknesses in its economic foundations, most notably its low government revenue and unsustainable debt. While China is their largest bilateral creditor, the country's first sovereign default was fueled by the inability to service its debt to international capital markets. China's role in Sri Lanka's debt restructuring process, however, should not be underestimated. Sri Lanka's debt accumulation was a result of financing its chronic budget deficit with politically convenient decisions to cater to the consumption demands of the rising middle class. These borrowing patterns became unsustainable especially because of Sri Lanka's unique issue of low government revenue.

A holistic approach is required to address Sri Lanka's long-standing structural weaknesses, which includes improving governance structures and strengthening state capacity. For Sri Lanka to sustain the ongoing IMF program and get out of the middle-income trap, the country needs to increase tax revenue, expand trade, attract investments, and practice fiscal discipline. Achieving all those targets requires ensuring central bank independence, a strong public service, limited political influence on public administration, and enhanced state capacity. However, such reforms and changes must be accompanied by public support for the reform agenda. The ongoing tax reform debate does not show a strategy nor a willingness by the government to clearly communicate and engage with its citizens. The debate is dominated by business interests and the middle class but has brought to the forefront a much-needed discussion on transparency, accountability, and social spending. However, a weak fiscal social contract threatens to derail its current reform agenda which could delay economic recovery. A successful reform agenda would correct institutional weaknesses, focus on governance structures and communicate effectively with its populace. Anything short of this could lead to the further unraveling of Sri Lanka.

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