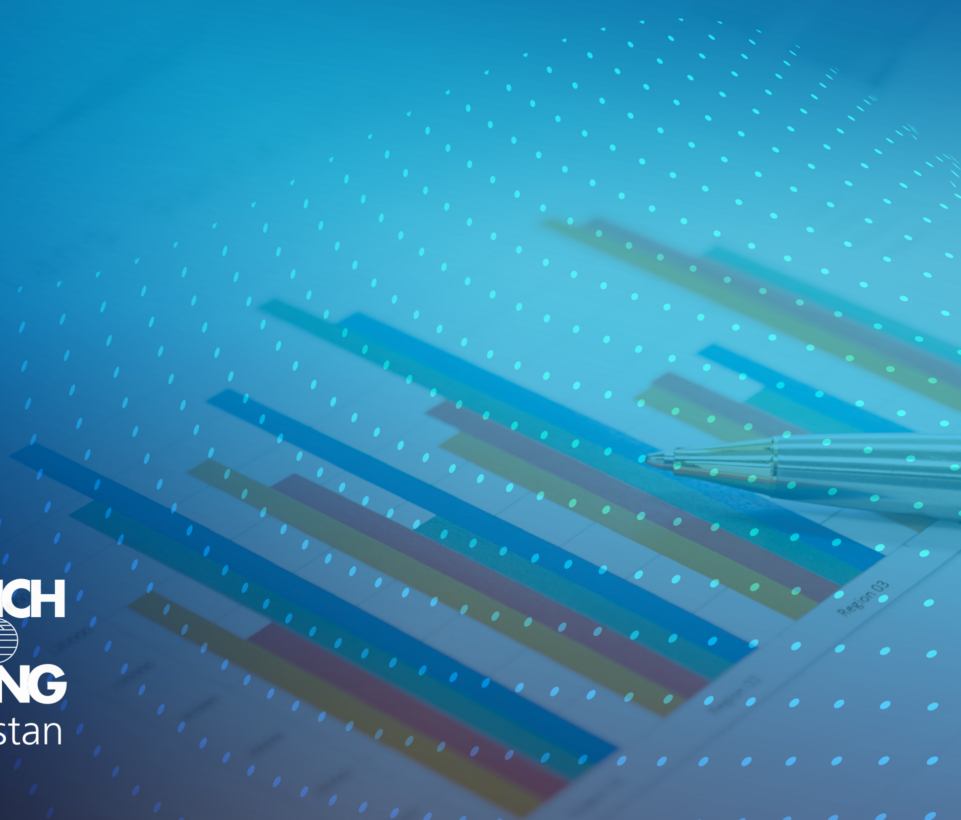
Debt and Development:
A Layman's Guide

Sajid Amin Javed and Abdus Samad Siraj



FES Pakistan

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Sajid Amin Javed

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Abstract:

This paper attempts to present the complexities of public debt in a non-technical and easy-to-understand language. It focuses on presenting key terminologies from public debt literature and the developmental impacts of public debt and borrowing. Mainly, it brings in how debt can affect development of a country. Adopting a storyline, the paper exhibits how the country ultimately converges on to a debt trap. The paper concludes with various policies that can enhance role of parliament aiding responsible borrowing. Overall, the paper aims to build and expand discourse on public debt, particularly in Pakistan. Intended audience of the paper includes parliamentarians, particularly standing committees on i) finance and revenue, ii) economic affair division, iii) parliamentary affairs, and iv) Poverty Alleviation and Social Safety Division, civil society organizations (CSOs), representative unions of workers/working class, print and electronic media and public.

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Foreword

Public debt is more than just numbers—it's a defining factor in Pakistan's economic future, shaping everything from social justice to long-term development. Its management directly affects public services, economic stability, and overall well-being.

Debt and Development: A Layman's Guide is a joint effort by Friedrich Ebert Stiftung (FES) Pakistan and the Sustainable Development Policy Institute (SDPI) to break down the complexities of public debt and its impact on governance, equity, and economic justice. At FES Pakistan, we believe that informed policymaking and active public discourse are key to responsible debt management.

This study offers a clear and accessible analysis of Pakistan's debt landscape, exploring how borrowing decisions influence everyday lives—whether through education, healthcare, or economic opportunities. By engaging policymakers, civil society, and the media, we aim to spark meaningful discussions on transparency, fiscal responsibility, and sustainable economic policies.

We hope this guide serves as an empowering resource for parliamentarians, civil society organizations, and engaged citizens, equipping them with the knowledge to advocate for fair, people-centered economic policies. We sincerely thank SDPI and the researchers for their valuable contributions and reaffirm our commitment to fostering informed dialogue for a just and sustainable future.

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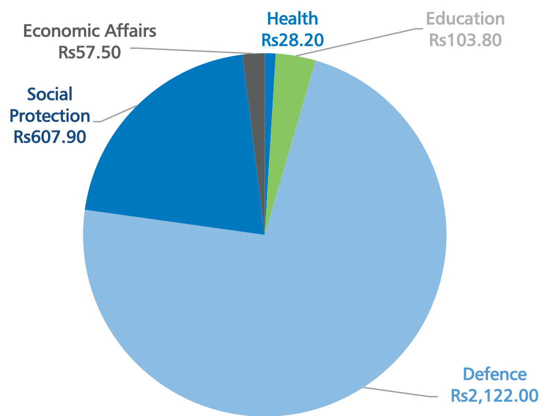
2024

1. What is public debt? Some definitions

Governments borrow when their income, known as public revenues, falls short of their spending, known as public expenditures. In other words, the gap between revenues and public expenditure is filled by borrowing, commonly known as public borrowing. Continuous and frequent borrowing leads to piling up debt of the government, known as public debt or sovereign debt.

Figure 1: Pakistan 2024/25 Budget Allocations (PKR Billion)



Source: Ministry of Finance

Governments spend most of their funds on providing public goods and services, such as defence, education, and healthcare or to financing development expenditures and investments in infrastructure, such as roads and dams. Figure 1 shows the different public expenditures (in Rs Billion) of the Government of Pakistan for 2024/25.

The funds for these public expenditures come from a handful of sources, with the single largest source being taxes, which are collected from all individuals residing within a country for 183 days and earning income through activities like jobs, businesses, and buying or selling assets, to name a few.[1] Public expenditures and revenues together are known as Public Finances.

1. Federal Board of Revenue. (n.d.). *Income tax basics*. Federal Board of Revenue, Government of Pakistan. https://fbr.gov.pk/income-tax-basics/51147/61148

Box 1

For example, take a household (economy) with a monthly income of Rs 10,000 (public revenues), and total expenditures (public expenditures) of Rs 12,000. Out of these Rs 6,000 is needed for food and Rs 6,000 for the children's education. The household now must decide whether to stay within its budget (Rs 10,000) and either cut down on food or take the children out of school. If the household does not wish to compromise on either, it must take on a debt (public debt) of Rs 2000 to meet its expenditures.

However, due to factors such as low tax collection, need for greater spending on education, the health of an increasing population, and interest payments on existing debts, public revenues are not always enough to meet all the public expenditures. Thus, the government has two options, either to cut the spending or borrow more. Governments opt for the latter. While governments do not wish to spend more money than they earn, they must do so to ensure the welfare of their people and to run a smooth economy. For example, a cut in public spending, commonly known as *austerity*, will lead to fewer and poor-quality public services, for example, hospitals and schools. Do not forget that public expenditure is a political question for any government. A government that fails to provide public services, such as new schools and hospitals, and deliver jobs will eventually begin to lose the trust of its people, leading to defeat in the next elections.

In the face of low revenues, the government must decide either to limit its spending, according to its revenues, or spend a greater amount than what was earned—the revenues. In the latter case, which is known as a budget or fiscal deficit (when public expenditures are greater than public revenues), public debt becomes a reality, since debt is needed to finance the excess expenditures. If the government decides to take on debt to fulfill its expenditures, known as debt financing.

Public debt is obtained from two main sources, the domestic borrowing, which is the funds borrowed in Rupees from local sources – such as banks or citizens– and spent locally. The second source is external borrowing, which is money borrowed in foreign currency from foreign counties, typically in US dollars. This is used to pay for international expenditures such as imports. Appendix Table 1 explains public debt, its components, and other terminologies associated with debt.

Furthermore, the debt obtained has two components: the "*principal,*" which is the total amount of exact money borrowed, and the *"interest or*

markup," which is the amount that must be paid on top of the principal, this can be thought of as the price of borrowing money. Debt acquired at a higher interest rate, thus has a higher cost of borrowing, with the government having to pay a greater sum of money than what they had originally borrowed (the principal amount). In the case of external debt, the exchange rate is also factored into the total cost of borrowing. This leads to an exchange rate risk (Box 2), with countries that have weak and falling currencies eventually paying a greater amount on their external debt.

Box 2

Exchange Rate Risk: Take a $1000 external debt obtained by Pakistan in 2016, when $1 was equal to Rs 100. While this loan is taken in a foreign currency, it would amount to Rs 100,000 in the local currency. If this loan were repaid in 2022, when the Pakistani rupee fell to Rs 200 for $1, the same $1000 loan would be equal to Rs 200,000 now. This however does not include the interest payments paid on top, which would make the total value of the loan far greater. Hence, external debt comes with the risk of a falling currency that would increase the total amount of the loan.

1.1. Public debt can either help promote economic development and a better quality of life or restrict economic development and worsen the quality of life – the outcome depends on how debt is used

Ideally, the government should minimize borrowing or completely avoid it. Resources must be generated from taxes, exports, and investment, both locally and from abroad. However, this is not possible. Even the richest of countries in the world, like the USA, Japan, and China, borrow. Public debt or simply borrowing by governments is purely a tool that is neither good nor bad, if professionally managed; rather, it is how the borrowed money is used that determines the outcome.

If the borrowed money is spent on public welfare and projects that lead to job creation, generate income, promote economic activity, and provide people with better quality of education, public debt can be beneficial for the borrowing country as a means to promoting development.

Take, for instance, public debt that is spent on building schools and hiring teachers. Eventually, these investments in education will produce higher-earning individuals who will not only have a better quality of life but will also become a source of generating greater taxes and public revenues. This

would be considered a positive return on investment, which would then help cover the cost of the debt by generating more revenue.

Similarly, if a country takes out a loan to invest in the export sector by setting up new industries, this loan will have a positive return. The new industries will firstly, create more jobs for people, giving them a source of income to improve their livelihoods. These individuals would then pay taxes on their incomes, which would contribute to the government's revenue. Secondly, the goods and services produced by these industries would result in higher exports, which would bring money into the country.

Hence, this investment would lead to new sources of revenue, which would help cover the cost of debt. Lastly, consider a government taking out loans to build new infrastructure such as roads and bridges or improve existing ones. Better infrastructure would result in increased connectivity and trade, as newly built highways could reduce transport time and costs.

These investments would also encourage the private sector to engage in new business ventures, as increased accessibility would mean that businesses can now supply to areas that were previously difficult to reach. This entire process would contribute to new job opportunities, increased incomes, and welfare of people, and, eventually, more revenues for the government. Hence, this loan would be beneficial for economic development.

On the other hand, if the debt is spent unproductively, that is, if money is spent on projects and initiatives that do not increase job opportunities or improve living standards, the loan will become a severe issue. For example, take a country that imports most of its products from abroad and only produces an extremely limited amount of goods for exports. This country would then be spending more money on its imports while it would earn less money through the sale of its locally produced goods and services to international markets through exports.

This would lead to greater foreign currency expenditures, expenses covered by foreign currency, and income from abroad. It will require debt to pay for those goods that are acquired from abroad, imports. Instead of this debt going towards job creation, promoting the local industries and economic activity, which would generate more money in the future, the money from debt would go towards buying imports, resulting in this money flowing out to foreign countries from where the imports are bought. Consequently, this loan would not generate any money in the future or benefit the citizens, and more loans would be required to pay for future imports.

Conversely, take the example of a country where the tax collected falls short and hence low public revenues, with the country requiring debt to cover public expenses. If the government of this country continues to engage in excessive spending on unnecessary expenses such as the buying of new vehicles and furniture for offices every year, these purchases will not generate any income for the government. The money spent on these will not increase public revenues and have no benefit to the overall country. This loan spending would be considered unproductive, and since public revenues have not been increased, the country will not have enough money to repay its debt and will require more loans in the future.

Another case of the unproductive spending of loans can be understood through the example of State-Owned Enterprises (SOE). Expenditure on SOEs is part of public expenditures, and these can be considered unproductive when they are not generating enough revenues, losing an increasing amount of money year after year. Firstly, as SOEs are owned by the government, any money earned (or lost) by SOEs is a source (or loss) of public revenues. Therefore, SOEs losing money means that public revenue is falling short. Secondly, if SOEs are losing money, the government must cover these losses by paying the SOEs, using a greater number of public expenditures to keep them running. To summarize, an unprofitable SOE – one that is losing money – is not only reducing the total public revenue collected but is also aiding to a rise of public expenditures, resulting in an increased and double-sided loss.

Box 3

PIA is the national airline of Pakistan and an SOE. PIA has been losing money over the years due to factors such as safety issues, falling quality, better alternatives, and organizational issues. The SOEs losses in the first 9 months of 2023 alone amounted to Rs 75 billion. In order to keep PIA running, these losses have been paid out by the government using public revenues which largely consist of tax money and debt.

Ansari, I. (2024). *PIA incurs RS75B loss in nine months*. The Express Tribune. https://tribune.com.pk/story/2462096/pia-incurs-rs75b-loss-in-nine-months

Pakistan Steel Mill is another example of an unproductive SOE that lost a significant– nearly Rs 600 billion. Despite its losses, much like PIA, this SOE, although no longer fully operational, is funded by the government using loans and grants that come from tax-payer money.

INP. (2024). Pakistan Steel Mills losses soar to rs 600B, Urgent Action demanded. Profit by Pakistan Today. https://profit.pakistantoday.com.pk/2024/08/15/pakistan-steel-mills-losses-soar-to-rs-600b-urgent-action-demanded. &

The World Bank. (2024). Pakistan Development Update. https://thedocs.worldbank.org/en/doc/140b30353b40dbb294cca42bcb86529a-0310062024/original/ Pakistan-Development-Update-April-2024.pdf

These losses can be due to factors such as inadequate quality of services, wasteful spending (hiring more staff than is needed), or a decreasing demand for the SOE's services due to better and cheaper alternatives offered by the private sector. If, however, instead of focusing on improving the quality of SOEs and addressing the concerns, the government continues to fund these SOEs through debt – as expenditure on SOEs is greater than the SOEs revenues - the loan will not contribute to economic development or employment opportunities. Instead, it will only cover existing losses, which will continue to rise in the future, requiring more debt.

Hence, if public funds and debt are spent in an unsustainable manner - without consideration of future consequences or the country's ability to produce revenue –- during which public revenue collection remains limited, public debt transforms into a burden for the borrowing country. Such countries fall into debt distress – which is when countries struggle to repay their debt – and are forced to cut funding for essential services such as healthcare and education. They may increase taxes for their citizens, and if not solved on time, can fall into a debt trap, as explained in the following section.

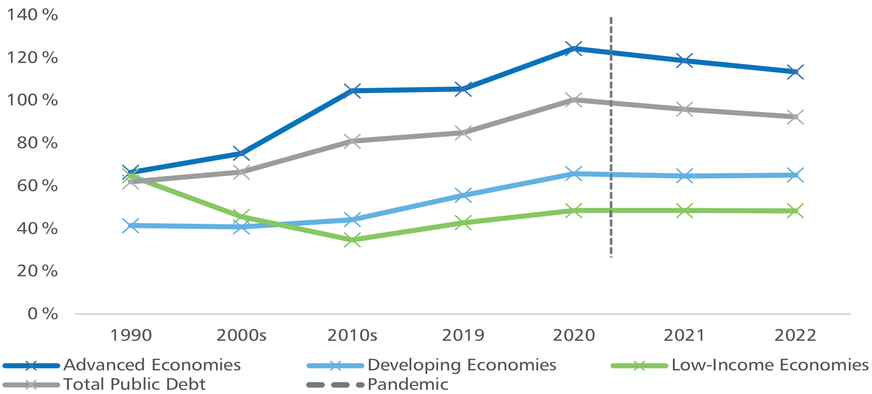
1.2. Worryingly, the debt situation is deteriorating

Global public (sovereign) debt, which is the total amount of money countries around the world owe to lenders, is rising at an increasing rate; 91 LMICs (Low and Middle-Income Countries) currently face medium to high risks of debt distress or default, when the country is unable to pay their debt as promised. As of 2023, global public debt has reached the highest level it has ever been of 92 percent of global GDP (Gross Development Potential), which is highest level of economic development a country can achieve based on their resources. This marks an increase of 300 percent since the start of the 21st century.

While *public* debt had already been on a rising trend since the 2010s for advanced, developing, and low-income (LMICs) economies alike (Figure 2), it touched its peak during the COVID-19 pandemic, reaching 100 percent of global GDP[2] (Gross Domestic Product). During this period, economies were put under great pressure, leading them to obtain large amounts of debt to meet their increasing spending requirements in response to the pandemic[3].

2. IMF. (2023). Public debt. https://www.imf.org/external/pubs/ft/ar/2023/in-focus/public-debt/
3. Ribeiro et al. (2023)

Figure 2: Global Public Debt (% of Global GDP)



Source: IMF

Despite most of the share of global public debt belonging to developed countries (70 percent), developing and low-and middle-income countries (LMICs) are increasing their debt levels at a much faster rate. This is on account of factors such as the instability caused by the COVID-19 pandemic, the Russia-Ukraine conflict, increasing living costs and inflation, and the effect of natural disasters associated with climate change[4].

Box 4

Debt Distress: When a borrower is facing difficulty in repaying their debt and requires renegotiations of the debt agreement

Debt Default: When a borrower is unable to repay their loan by the specified date. This restricts their ability to borrow in the future.

Hakura, D. (2020). Back to basics: *What is debt sustainability?* . IMF. https://www.imf.org/en/Publications/fandd/issues/2020/09/what-is-debt-sustainability-basics

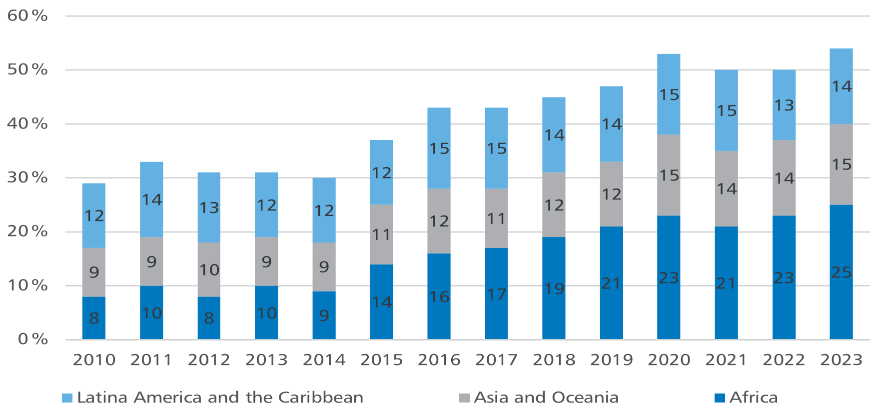
However, for the latter category of countries, their rate of borrowing is far greater than the increase in public revenues, income of citizens, known as GNP, (Gross National Income), and trade, resulting in debt becoming unsustainable. This presents a serious challenge as these countries are earning less than what is needed to pay back their debt.

4. International Debt Report 2023. World Bank; A world of debt Report 2024. UNCTAD

Moreover, slow economic recovery from the pandemic, slow and insufficient rise in revenue, and the rising cost of long-term borrowing have left developed countries facing increasing risks of default[5]. As of now, 91 LMICs suffer a middle to high risk of debt distress or default.

Currently, Africa faces the highest debt servicing cost, which is the money owed in order to keep up with debt obligations, spending 25 percent of its total revenues on interest payments in total government revenues (Figure 3) , despite having the lowest share of total public debt (Figure 2). Latin America is second on the list, followed by Asia and Oceania.

Figure 3: Share of Interest Payments in Total Revenue (%)

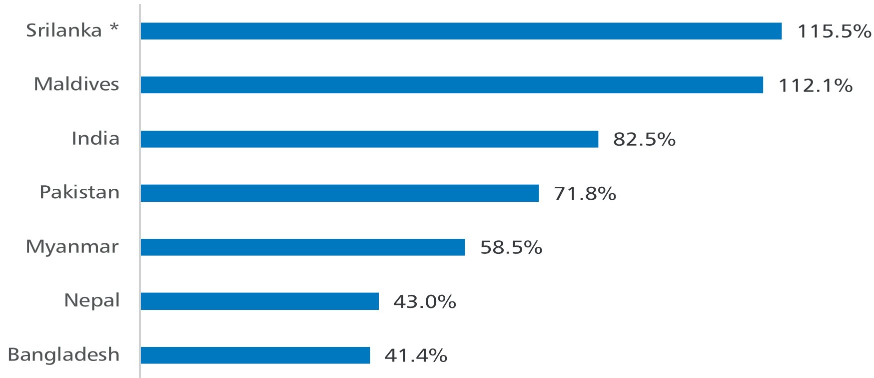


Source: UN Global Crisis Response Group – technical team calculations based on International Monetary Fund (IMF) World Economic Outlook (April 2024).

Focusing on South Asia, as of 2024, a wide range of debt levels (as a percentage of their total GDP) are observed across different countries (Figure 4). The debt to GDP ratio is the country's overall debt in comparison to how much money their economy makes overall. It can be observed that Bangladesh and Nepal have the lowest debt-to-GDP ratio (less than 50), while India and Pakistan have a comparatively higher debt-to-GDP ratio (71.8 percent and 82.5 percent, respectively). Lastly, in countries like Sri Lanka and Maldives, the debt is greater than 100 percent of their GDP.

5. Adrian et al., 2023

Figure 4: Debt to GDP Ratio in South Asia (%)



Source: IMF Data Mapper (2024)
*Note: Figure for Sri Lanka is from 2022

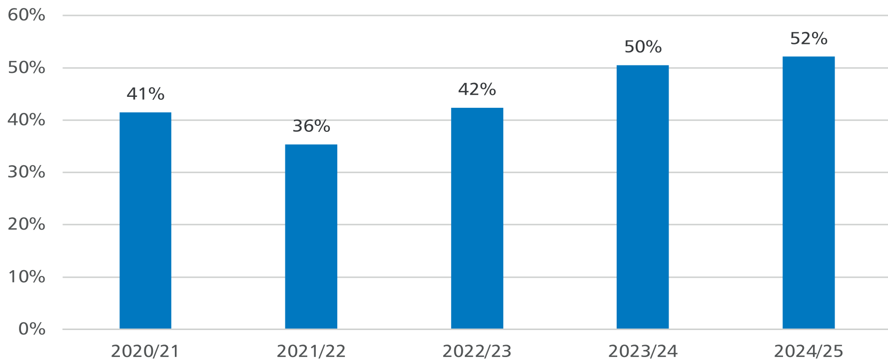
However, it is important to add here that while debt-to-GDP ratios are a good measure to keep an eye on debt levels, they do not define or show debt sustainability. Advanced Economiess such as the United States (US) and China have debt-to-GDP levels of 121 and 90.1 percent[6]. Respectively but their debt is sustainable. On the other hand, a country with a low debt ratio, such as Pakistan, can have unstable debt. Ultimately, factors such as economic growth are what determine debt sustainability.

1.3. Case of Pakistan: Public debt is simply unsustainable

In the case of Pakistan, public borrowing has been on the rise over the past decade, with public debt levels reaching an all-time high of 79.6 percent of GDP in 2020 (Figure 5). In the subsequent years, Pakistan's debt-to-GDP ratio has followed the global trend, gradually declining to 71.8 percent in 2023, with further declines expected till 2028 to 64.1 percent of GDP. However, public debt levels remain well above the 58 percent debt-to-GDP limit put in place by Pakistan's parliament[7] and above the estimated limit of 60 percent, beyond which the risk of default rises significantly[8] and above the point where economic growth is negatively affected.

6. https://www.imf.org/external/datamapper/GGXWDG_NGDP@WEO/USA/CHN
7. IMF DataMapper
8. Wahid, (2023)

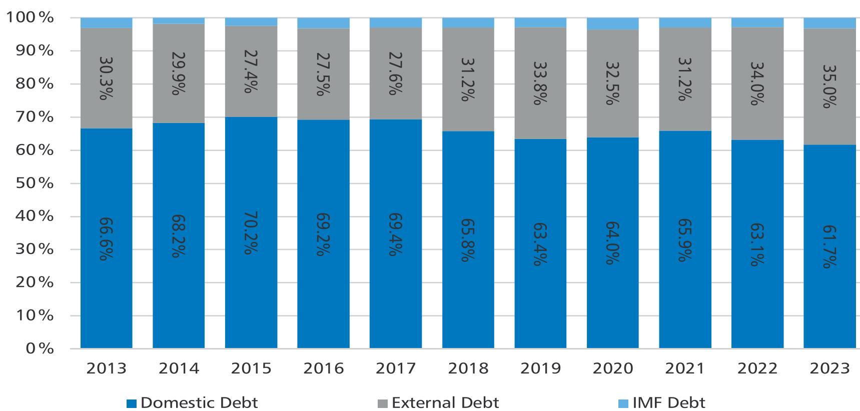
Figure 5: Debt to GDP Ratio (%)



Source: IMF
Note: 2025-2028 are forecasts

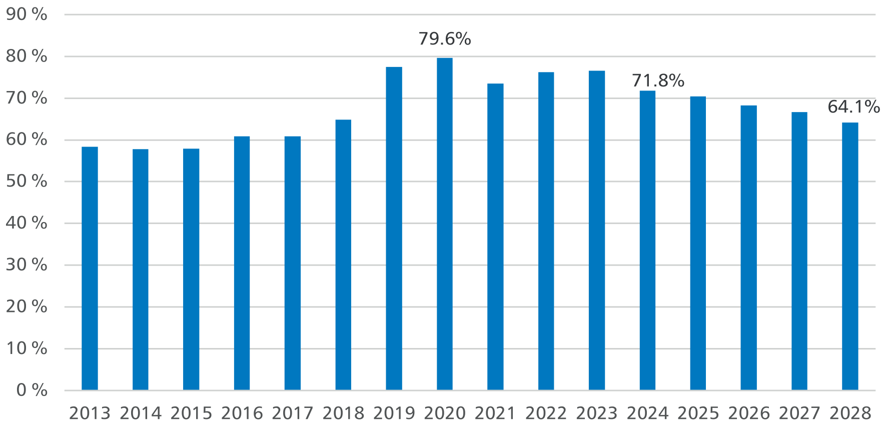
Most of Pakistan's debt (Figure 6) comes from domestic sources, sources from within the country, (61.7 percent), followed by external debt, sources from outside of the country, (35 percent) and IMF debt, money borrowed from the International Monetary Fund (3.2 percent). However, the elevated level of debt in the country comes at an inflated cost – nearly 50 percent of the country's annual budget goes towards payment of interest on previous debt (Figure 7).

Figure 6: Public Debt Composition of Pakistan (% of total)



Source: State Bank of Pakistan

Figure 7: Share of Interest Payments in Total Revenue



Source: Ministry of Finance

In the year 2024, Rs 9.7 trillion was allocated towards interest payments[9] out of total government revenues of Rs. 18 trillion. When we add the remaining expenditures of the government into the equation, such as defence, public services, and development budget, the expenditure of the government becomes far greater than its revenues which leads to a budget deficit, with government spendings exceeding the revenue collected in a period of time. Because of a budget deficit, the government has no option but to borrow more debt to repay the previous debt. This leads to a vicious cycle of debt trap, as explained by the proceedings above.

9. https://www.finance.gov.pk/budget/Budget_2024_25/Budget_in_Brief.pdf

2. Why Public Debt Matters – Debt and Development

2.1. A small loan used unproductively can lead to a debt trap, depleting the country's funds for public services and development

To understand this, consider you are the head of a family who owns a shop and are in debt. Every month, half of your income goes to repay the debt, hardly covering initial costs. Not paying the installment adds to it further. Missing just three consecutive installments would result in default, jeopardizing not only your shop but also your home and livelihood. As a major share of your income goes to debts, you are not able to purchase goods to sell at the shop—your income will fall, making it even more difficult to pay debt. (see appendix for illustration)

You then borrow from another lender to pay the first lender. The extra lending comes at a higher cost because the lender knows that you are at risk of default. As there is a cost of risk, markup, the amount added to the cost of your product to determine the selling price, inflates further. You pay the first lender, but now it is time to pay the second lender. You take your children out of school and cut the expenditures on health, education, and food—the development expenditure of the household. Despite all this, you are hardly making a portion of markup payments. Principal debt stays there. Your shop closes as you are not able to purchase goods anymore. Since now you need more debt, you will cut more on household routine expenditures.

Let us now take this story to a country level. Your shop represents an economy, and your debt is the government's debt, that is, the public debt, and the income from the shop is tax revenue of the government. Suppose your children are the people of the country, and health and education expenditures are the total development spending. (see appendix for illustration)

As noted already, countries with higher public debt allocate a major share of their income to pay debt and markup. They end up cutting development

expenditures as tax revenues continue to fall short, even for paying the markup on debt. They take more debts at an even higher markup. Debt continues to pile up, and the country falls into a debt trap-as more debts to pay past debt. As a result, the economy slows down— the economy does not produce new jobs, incomes, or opportunities for livelihoods— as the government is not left with any money, the spending capacity, to cater to economic activity. It makes the trap more intensive as poverty and unemployment rise. Tax revenues further decrease. Take the story one step up.

Box 5

Note: One significant way in which public debt differs from private (or household debt) is the one obtaining the debt is usually not the one paying. For example, if you take out a loan to buy a car, it is your responsibility to repay that loan to the bank. However, for public debt, one government borrows and when the time comes to repay the debt, the tenure of that has already ended, leaving the new in place to pay the debt. Hence, the debt obtained by the PPP government was repaid by the PML-N government. The new debt obtained the PML-N government was then paid off by the PTI government..

When you replace debt with foreign debt—debt obtained in foreign currencies such as the dollar--and tax revenues with exports, which are the main source of foreign currency revenue for a country, you get the same story for external debts. If a significant portion of a country's debt is foreign, the economy also becomes exposed to exchange rate risks such as those mentioned in Box 2, where a weak falling currency means that even though the value of debt in US dollars remains the same, the borrowing country's debt in local currency increases, leading to an overall increase in the debt payment.

2.2. Loan conditionalities on external debt and debt retirement policies contribute to higher inflation and a poor quality of public services

When a country reaches the level where it is obtaining new debt at higher costs to repay its previous debt, such as in the example given in the previous section, it begins to exhaust the sources from which debt can be taken. In simpler terms, if a country is having trouble repaying its debt due to factors such as a financial, economic, or natural crisis and is therefore unable to generate sufficient revenues, lenders, both domestic and international, will

become reluctant to give this country more debt.

Moreover, when a country is facing a crisis, such as that observed in Sri Lanka in 2022 when the country's economy collapsed, leading to food and fuel shortages[10], or in Pakistan in 2023 when the country began facing a risk of defaulting on its debt due to flooding and declining foreign reserves, which is the countries savings in a foreign currency[11], immediate funding is needed to ensure the welfare and survival of the people. In such cases, the country is left with limited options and turns to the lender of last resort, the IMF, for timely financing.

The IMF is one of the International Financial Institutes (IFIs) that function as independent international organizations that offer policy and financial support to countries that are in crisis and require money. Financial assistance from the IMF comes in the form of an IMF program, under which a loan is given to a borrowing country under certain restrictions and requirements. These requirements are in the form of fiscal and monetary policy changes, which in simpler terms is the changes in policy that target

Box 6

Foreign reserves of a country are the amount of foreign exchange or currency (US Dollars) that a country holds. By selling exports or receiving remittances, a country increases its foreign reserves as it is receiving US dollars (or other foreign currencies). Foreign reserves are then spent on buying imports or repaying external debt, as it is paying these in US dollars (or a foreign currency). If a country does not have enough foreign reserves due to reasons such as not exporting its products, it will be unable to pay for imports or its external debt.

Box 7

Sri Lanka defaulted on its debt in 2022, that is, failed to repay its loans on time. The country had a debt-to-GDP ratio of 117.5 percent. The default led to an economic crisis with a shortage of money (foreign reserves) in the country to purchase necessities such as fuel and food. The country defaulted due to reasons including low government revenues versus high expenditures which was worsened when the government announced tax cuts –exemptions from paying tax – which led to even lower revenues. The COVID-19 pandemic also led to declining tourism, an industry which Sri Lanka relied on for revenues.

UNDP. (2022). The sovereign debt crisis in Sri Lanka: Causes, policy response and prospects. https://www.undp.org/publications/sovereign-debt-crisis-sri-lanka-causes-policy-response-and-prospects

10. Ministry of Finance. (2024). *Budget in brief 2024-25*. https://www.finance.gov.pk/budget/Budget_2024_25/Budget_in_Brief.pdf
11. Salikuddin, T. (2022). *Five things to know about Sri Lanka's crisis*. United States Institute of Peace. https://www.usip.org/publications/2022/07/five-things-know-about-sri-lankas-crisis

government spending and money management, that need to be made by the borrowing country to increase revenues and cut unnecessary expenditures while addressing the structural issues in the economy that led to this country requiring debt by the IMF.

Moreover, these policy changes are set in place to ensure that when the time comes to repay the IMF loan, the country has the capacity and funds to return the loan with interest and hence minimize its risk of default, that is, failure to repay the loan by the agreed date. Additionally, these policy reforms are set in place to ensure that the country does not fall into a vulnerable position again in the future, where it requires funding from the lender as a last resort.

Box 8

Fiscal (Policy): Refers to decisions related to the management of public finances, taxation, and public spending. It is policy of the government.

Monetary (Policy): Refers to the changes in money supply and interest rate to manage inflation, unemployment, and an economy. It is the policy of central bank - The State Bank of Pakistan.

The requirements of the IMF program are classified into two categories: priors and conditions. Priors are the conditions[12] that must be met by the borrowing country **before** a loan is given. These set the base to ensure that the borrowing country is in a position to manage its finances and return the loan when the time comes. On the other hand, conditions are the requirements set out in different stages that the country must meet while the loan is **being** given out.

Box 9

Note: An IMF program is not only a loan given out to a country, but it also acts as a character certificate for that country. This is because every IMF program has a list of priors and conditionalities that must be met which ensures that the country improves its finances and can repay its loan back on time. Hence, with these guarantees in place, other lenders then also become more willing to give loans to the country as well, due to the changes in policy. For example, you take a loan from a family member on the condition that you will get a job. Getting a job ensures that you earn money each month which will be used to repay the loan. Seeing that you have a job, banks will then also become more willing to give you loans.

These requirements include short-term goals and long-term goals - as the loan is given in installments, meeting the conditions of the IMF programs ensures the next round of installments. In cases where a country is highly

12. Bretton Woods Project. (2024). *Pakistan's debt crisis fuelled by more IMF loans*. https://www.brettonwoodsproject.org/2024/07/pakistans-debt-crisis-fuelled-by-more-imf-loans/

indebted, foreign nations also require IMF priors to be met before they lend money to the former country.

When a country finds itself in need of funds from the IMF, it first makes a formal request to the IMF, after which the borrowing country's government and the IMF discuss the country's debt requirements and economic challenges. Based on this discussion, the conditionalities of the loan - that is, the policy changes that must be made - are set and agreed upon. This forms a "letter of intent," which outlines the agreement, and a "memorandum of agreement," which contains all details. Both these documents, along with recommendations by the IMF staff on whether the country will be able to achieve the conditions in the agreement, are presented to the IMF's executive board. Once this board approves the loan, financing is given to the borrowing country along with strict monitoring from the IMF to ensure if and how the policy changes are being implemented[13].

While priors, conditionalities, and any other policies associated with loan repayments are set in place to bring about reforms and ensure the long-term welfare of a country, they can lead to various unintended consequences. The conditions and their consequences include:

Box 10 Types of IMF programs

i. Stand-By Arrangement (SBA): This is one of the major types of IMF programs that target emerging and advanced economies. These are given to address short-term financial issues (such as balance of payments – current and financial account – crisis or due floods. It is provided over a period of 1 to 3 years, maximum, and repayment of debt is within 3 to 5 years.

ii. Standby Credit Facility (SCF): This is a version of the SBA given out to low-income countries. The repayment of loans is due in 8 years and a flexibility window of an additional 4 years is given.

iii. Extended Fund Facility (EFF): This type of program is for developing and advanced economies that are facing long-term financial and economic issues. EFFs are provided for 3 three years but can be extended if the country needs additional finances. The loans must be repaid within 4 to 10 years.

iv. Extended Credit Facility (ECF): The ECF is simply the EFF for low-income countries and is provided for a period of 3 years that can be extended up to 5 years along with a grace period of an additional 5 years. The final loan repayment is due in 10 years.

13. International Monetary Fund. (2023). *IMF conditionality*. https://www.imf.org/en/About/Factsheets/Sheets/2023/IMF-Conditionality

v. Rapid Financing Instrument (RFI): This is an urgent loan program for countries that require immediate financing due to crisis such as natural disasters, war and conflict or rapid increases in prices due to reasons such as shortages, or urgent balance of payment crisis. The loan must be repaid within 3 years and 3 months to 5 years. A crucial point to note is that the RFI (or RCF) does not come with a standard list of priors or conditionalities and the loan is given in one instalment rather than over a period of years. Instead, the borrowing country must only present their plan to address the issue that led them to take the loan, which must be agreed upon by the IMF. The remaining process of obtaining this loan remains the same.

vi. Rapid Credit Facility (RCF): The RCF is a version of the RFI intended for low-income countries with repayment due in 10 years and an additional repayment grace period of 5 years.

vii. Flexible Credit Line (FCL): The FCL is a loan given to countries that have a temporary shortage of finances but otherwise have strong economic policies and performance. Hence, this program does not have nationalities attached to it. The program is given out over 1 to 2 years which is renewable. Repayments of loan is due over 3 to 5 years.

viii. Precautionary and Liquidity Line (PLL): The PLL is similar to the FCL ad is given to countries that have strong economic policies but face economic issues or problems preventing them from using the FCL.

ix. Catastrophe Containment and Relief Trust (CCRT): The CCRT is financial assistance given in the form of a grant – a payment that does not have to be repaid unlike a loan – to countries facing a crisis or disaster like COVID-19. This is given out as a debt relief measure to countries that are struggling due to the aforementioned reasons.

IMF. (2023). IMF lending. https://www.imf.org/en/About/Factsheets/IMF-Lending Bretton Woods Project. (2020, March 31). What types of financing does the IMF provide? https://www.brettonwoodsproject.org/2020/10/art-320868/

Condition 1: Primary Surplus

An important condition as part of an IMF program is for the government to achieve a primary surplus, with government revenues exceeding its spending. This is done by either reducing government expenditures, increasing taxes, or engaging in both these measures. The purpose of this condition is to increase government revenues so that the government has sufficient funds to repay its loans when the time comes. In the case of Pakistan, under the IMF program, a primary surplus target of 1 percent of GDP has been set

for FY (Financial Year) 2025[14]. As of the first half of FY 2024, a primary surplus of 1.8 percent has been achieved[15].

Box 11

Total Budget: Total expenditures of the government, including Current and Development Budget.

Current Budget: The expenditures of the government on the existing public sector services sectors such as providing defence, education, paying salaries of government employees, and interest payments.

Development Budget: Funds allocated for development projects such as new schools, hospitals, and infrastructure.

Budget Deficit/Surplus: When all expenditures in the budget are greater than total revenues the budget is considered to be in a deficit (fiscal deficit). When the revenues are greater than expenditures the budget is in a surplus (fiscal surplus). This includes interest payments.

Primary Surplus: This is similar to a budget surplus (or deficit) but does not include the expenditure on interest payments. When public revenues are greater than all expenditures of the government excluding interest payments, it is known as a primary surplus. By excluding the interest payments, a more detailed picture is provided of the operations of the government, which is how much the government is earning from the economy versus how much it is spending in the economy for the welfare of the people.

While reducing expenditures and promoting responsible governance is an important measure to ensure a greater availability of funds, under various circumstances, this measure can have significant consequences. Firstly, to lower expenditures, governments can cut spending on education, healthcare, and infrastructure. A reduction in spending in these

Box 12

For example, if expenditure on schools is lowered, this can mean limited schools are built, or fewer staff hired. This would result in insuffcent education for children who would then be unable to secure skilled and high-paying jobs and instead resort to low-paying jobs where they pay a low amount of taxes. Ultimately, instead of improving the government's position to repay the loan, this measure can leave the government worse off than before.

14. International Monetary Fund. (2023). *IMF lending*. https://www.imf.org/en/About/Factsheets/IMF-Lending
15. International Monetary Fund. (2024). *Pakistan: IMF reaches staff-level agreement on economic policies with Pakistan for 37-month Extended Fund Facility*. International Monetary Fund. https://www.imf.org/en/News/Articles/2024/07/12/pr-24273-pakistan-imf-reaches-agreement-on-economic-policies-for-37-month-eff

vital sectors means that the quality of life of individuals worsens, and, with poor education and healthcare, their earning ability significantly decreases.

Consequently, this results in a lower income for individuals who then pay lower taxes. On the other hand, without investments by the government in these sectors, not enough jobs will be produced, and the economy will not develop. This, once again, will result in lower taxes and government revenues.

Secondly, in order to achieve a primary surplus, governments can turn towards reducing or removing subsidies on fuel, energy, and other goods to reduce expenditures, in simpler terms the financial help given by the government to support certain industries. While such measures reduce expenditures (or increase revenues) and allow for the government to achieve a primary surplus, they can have significant consequences, which are highlighted in the following two sub-sections.

Condition 2: Removal of Energy and Fuel Subsidies and Imposition of Taxes

Another loan condition of the IMF is the removal of energy and fuel subsidies or imposing additional taxes on these commodities. Subsidies are payments by the government that can help reduce the prices of goods and services for both the producers of these goods and the consumers, making them more affordable. For example, as oil is imported into Pakistan, the price of oil in the international market could be $100 per barrel. This would mean importers buying oil at this price would then be selling it to consumers at a much higher price.

Since this may be unaffordable for many, the government can intervene and pay, for example, a subsidy of $50 per barrel. As the government is now bearing half the cost of oil, importers only pay $50 per barrel, and the closing price in the market is lower than before. Subsidies can be given out for various other commodities, including, but not limited to, electricity, natural gas, and food items such as wheat.

The power sector in Pakistan has been a focus, both due to the extent of subsidies given and because of the various issues has been plagued with. On account of multiple factors, many of which remain outside the scope of this

paper, including structural inefficiencies in how prices are set[16, 17], electricity theft and line losses[18], and a high price of inputs used (oil)[19], the production cost and price of electricity - known as tariffs - remain high.

In response, to prevent consumers from bearing the full burden of high electricity prices, the government gives out subsidies, which amounted to 2.6 percent of GDP in 2020, which was the highest amount of electricity subsidies in South Asia[20]. However, these subsidies consume a massive portion of government expenditures, contributing towards budget deficits[20].

Hence, the objective of this conditionality is to reduce the expenditure of the government. Despite this, the removal of these subsidies means that consumers must now pay a higher amount for energy and fuel. At the end of the day, households and individuals now end up spending a higher portion of their incomes on electricity and fuel, leaving them with a lower amount for their other expenditures, such as buying food or education. This directly reduces the living standards of people and worsens their welfare.

On the other hand, higher electricity costs also lead to higher inflation, with the rate at which the prices of goods and services increase overtime. Businesses and industries use electricity and (fuel) to produce their goods and services, with the former being known as inputs. Higher electricity prices mean that they must now spend more on their inputs, which leads them to charge a higher price for their goods and services to maintain their profits.

To further expand on the aforementioned statement, take the example of a mill that produces flour uses machines that use electricity to grind wheat. If electricity prices rise, it will now cost more to operate these machines. With a now higher cost and the same price of flour, the mill owners will have lower profits. Hence, to keep their profits the same after the increase in electricity prices, the mill owners will increase the price of flour for the

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16. International Monetary Fund. (2024). *IMF executive board completes second and final review of the Stand-By Arrangement for Pakistan*. https://www.imf.org/en/News/Articles/2024/04/29/pr24130-pakistan-imf-executive-board-completes-second-and-final-review-sba
17. Asian Development Bank. (2021). *Energy sector reforms and financial sustainability program (subprogram 2): Circular debt impact on power sector investment*. https://www.adb.org/sites/default/files/linked-documents/53165-002-ld-03.pdf
18. State Bank of Pakistan. (2019). Special section 1: *Why are power tariffs in Pakistan consistently high*. https://www.sbp.org.pk/reports/quarterly/fy19/Third/Special-Section-1.pdf
19. World Bank. (2018). *Power sector distortions cost Pakistan billions. World Bank*. https://www.worldbank.org/en/news/press-release/2018/12/11/power-sector-distortions-cost-pakistan-billions
20. Pakistan Economic Survey 2021-22.

consumers. This is known as supply-side inflation and contributes to the overall inflation in the economy.

In accordance with the IMF loan agreement, Pakistan has removed subsidies for the energy sector and adjusted the electricity tariffs accordingly[21]. Subsequently, to increase revenues, Pakistan has increased the petroleum levy from Rs 60 to Rs 80, which is a form of tax on petroleum products, including fuel. Through the channels mentioned above, the removal of these subsidies and increase in levies has led to a rapid increase in energy and fuel prices, with a 13.6 percent annual increase in FY 2023, which was followed by a 28.4 percent increase in FY 2024[22]. This has contributed to the elevated level of inflation in the country and has led to a significant increase in the cost of living[23]. Consequently, this has led to the welfare of the people, especially the salaried and labour class, being reduced.

Condition 3: Increase Tax Revenues

One important requirement of a loan is increasing tax revenues and broaden the total amount of money a government can tax to collect revenue, formally known as the tax base. Through higher taxes governments can ensure they earn enough money to repay the loan when the time to repay the debt arrives. Taxes can broadly be classified into two categories: Direct Taxes, which are taxes on an individual or business's earnings, such as income and profits, or Indirect Taxes, which are taxes on goods and services, including food items, electricity, and other utilities.

An increase in direct taxes means that a higher percentage of income is taken away as tax, leaving the individual (or business) with a lower final income, known as disposable income. On the other hand, an increase in indirect taxes means that consumers pay a higher price for goods and services, as indirect taxes are included in the final prices.

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21. World Bank. (2023). *Pakistan: Reforms for a brighter future – Policy Note 5: Achieving sustainable energy.* https://thedocs.worldbank.org/en/doc/79f2e3cafba128c39b2057d06ef3bd3e-0310062023/original/Pakistan-Reforms-For-A-Brighter-Future-Policy-Note-5-Achieving-Sustainable-Energy.pdf
22. International Monetary Fund. (2024). *Pakistan: IMF reaches staff-level agreement on economic policies with Pakistan for 37-month Extended Fund Facility.* https://www.imf.org/en/News/Articles/2024/07/12/pr-24273-pakistan-imf-reaches-agreement-on-economic-policies-for-37-month-eff
23. Pakistan Economic Survey 2023-24

In countries like Pakistan, where issues like tax evasion and tax avoidance are prominent within the economy, referred to as tax leakages, tax collection remains low. If the government attempts to increase tax collection through increasing direct taxes, indirect taxes, or both, taxing those who were previously avoiding or evading taxes will continue to do so. Instead, the individuals who were already paying taxes will now have to pay a higher tax percentage. This is referred to as the burden of taxation, which piles onto existing taxpayers. The latter category of individuals will be made worse off, and their quality of life and welfare will be reduced due to them paying higher taxes and receiving a lower disposable income.

While the IMF condition requires raising tax revenues through broadening the number of taxpayers (the tax base) by reducing tax exemptions and evasion[24], achieving this is a lengthy and complex process that involves reforming the tax system and strengthening the rule of law, both of which are matters of political nature. Instead, governments tend to opt for the easier option, which is increasing taxes for existing payers.

Box 13

Tax Base/Net includes those individuals, businesses, assets, and activities that are paying taxes and generating revenues.

Tax Evasion refers to the **illegal** practice of not paying taxes or paying less than what is owed through actions such as under-reporting income or hiding assets.

Tax Avoidance refers to a **legal** practice where individuals and corporations can avoid taxes using exemptions or loopholes in the tax system.

Tax Gap is the difference between the tax amount that was estimated to be collected and the amount that is actually collected. A tax gap arises due to factors associated with tax evasion.

Tax Foundation. (n.d.). What is a tax base? https://taxfoundation.org/taxedu/glossary/tax-base/

Tax Foundation. (n.d.-b). What is the Tax Gap? what drives it? https://taxfoundation.org/taxedu/glossary/tax-gap/

Tax Justice Network. (2020). Tax avoidance and tax evasion. https://taxjustice.net/topics/tax-avoidance-and-tax-evasion/

The IMF program for Pakistan has set out a target of increasing tax collection by 3 percent of GDP by the end of the program and by 1.5 percent of GDP by 2025[25]. In response, as of the 2024/25 annual budget, Pakistan has increased income taxes by 2.5 percent while sales tax was increased from 17

24. Pakistan Economic Survey 2023-24
25. International Monetary Fund. (2024). *Pakistan: IMF reaches staff-level agreement on economic policies with Pakistan for 37-month Extended Fund Facility.*. https://www.imf.org/en/News/Articles/2024/07/12/pr-24273-pakistan-imf-reaches-agreement-on-economic-policies-for-37-month-eff

percent to 18 percent in the previous year[26]. These have come as a burden for the existing taxpayers, namely the labour and salaried class, who were already faced with high energy and fuel costs alongside exceeding inflation.

Box 14

For example, there are only two individuals A and B in an economy who both earn Rs 10,000 per month. Individual A abides by the law and pays 10 percent in direct tax on income (Rs 1000) while individual B evades taxes and pays 0 in tax. The government then earns a revenue of Rs 1000 from taxes.

If the government tries to increase tax revenues by increasing the tax rate to 20 percent, individual A will now have to pay Rs 2000 in tax and will be left with a disposable income of Rs 8,000. Due to this increase this individual may have to decrease their expenditures including those on food or education. Since individual B evades taxes, they will remain unaffected by the increase in direct taxes and will enjoy a disposable income of Rs 10,000. Hence the entire burden of taxes will fall on individual A who was already paying taxes.

In the context of an economy, individual A represents all those who pay taxes and form the tax base. Individual B represents those who evade or avoid taxes.

Condition 4: Market-based Exchange Rate

The exchange rate of a country is the value of the country's currency in terms of another country's currency. For example, one US dollar is worth approximately 278 Pakistani rupees, which is the exchange rate at the time of writing. In other words, the value of the US dollar is 278 Pakistani rupees. In this case, the Pakistani rupee is considered to be weak as it has a lower value (reflected in the high exchange rate of Rs 278).

In broad terms, the exchange rate can be determined in one of two ways. Either it can be determined in the market (market-based exchange rate), that is, supply and demand of currencies determine the price. Under this mechanism, if the US dollar (or any other foreign currency) is in greater demand, it will have a higher value, and the local currency will be weaker.

For a country is exporting more and importing comparatively less, the exchange rate determined by the market, will lead the country to have a stronger local

26. International Monetary Fund. (2024). *Pakistan: IMF reaches staff-level agreement on economic policies with Pakistan for 37-month Extended Fund Facility.*. https://www.imf.org/en/News/Articles/2024/07/12/pr-24273-pakistan-imf-reaches-agreement-on-economic-policies-for-37-month-eff

currency or vice versa. This is because more people would want to obtain that country's exports and require their currency to make the purchase. Similarly, if individuals want to hold foreign currency as a form of investment and increase the demand for that currency, or if sellers attempt to artificially reduce the supply in the market, the exchange rate or price of that currency will rise. This was observed in Pakistan in 2022, when a high demand for US dollars and an artificially reduced supply by sellers were among the reasons that led to a substantial increase in the value of US dollars and a subsequent decrease in the value of the Pakistani Rupee[27].

Box 15

For instance, take a mobile phone which costs $100 in the US. If Pakistan imports this mobile phone (at an exchange rate of Rs 278 = $1) it will be worth Rs 27,800 (not including taxes or other factors). At this same exchange rate, if Pakistan exports 1 Kg of wheat at a price of 278 per Kg, this will only cost $1 in the US. At this exchange rate, Pakistan's imports are expensive, and exports are cheaper (for the foreign country

On the other if the Pakistani rupee is stronger – that is the Pakistani rupee is worth more in US dollars or US dollars are worth less in terms of Pakistani rupees – at say an exchange rate of Rs 100 for $1, the same imported phone will now be worth only Rs 10,000 while the exported 1 Kg at will cost $2.78 for the US.

To summarize, a stronger local currency means that exports are expensive and imports cheaper while a weaker currency means that imports are expensive and exports cheaper the examples above, a stronger Pakistani rupee would mean that imports are cheaper.

The second mechanism of exchange rate determination is when the government or state bank fixes the value of the local currency (fixed exchange rate), either at a specific value (for example, it is fixed at Rs 100 = $1) or between a range (value of rupee fixed between Rs. 100 to 110 = $1). If the exchange rate begins to rise and fall, the government or state bank intervenes to bring the currency back to its fixed value[28]. Any intervention, however, requires the use of a country's foreign reserves. Similarly, the government can choose to let the market determine the exchange rate but intervene if the currency becomes weaker (or stronger) beyond a certain limit.

This condition has its benefits as well as its drawbacks. In economies that largely rely on imports and does not engage in much export activities, their

27. Ernst & Young. (2024). *Pakistan increases sales tax and federal excise tax rates.*. https://www.ey.com/en_gl/technical/tax-alerts/pakistan-increases-sales-tax-and-federal-excise-tax-rates
28. The Express Tribune. (2023). *Govt cracks down on dollar smuggling*. https://tribune.com.pk/story/2434559/govt-cracks-down-on-dollar-smuggling

exchange rate tends to fall, making imports more expensive. In the case of Pakistan, which heavily relies on imported raw materials, food items, goods, and energy, a weakening, also known as deprecation, in the exchange rate leads to the price of these commodities rising. As discussed in the previous subsection, rises in the cost of inputs, in turn, lead to a rise in inflation. Hence, when a country with limited exports and a large dependence on imports moves towards a market-based exchange rate, it potentially exposes its citizens to inflation.

Despite this, a weaker currency in the exchange rate promotes exports. This works towards promoting a country's exports, as imports are discouraged due to being more expensive and exports are cheaper, increasing the demand of these products, both locally and internationally. However, to benefit from this, a country needs exports that are competitive in nature, that is, low in price and meet international quality standards.

Pakistan's exports are limited at only 10.4 percent of GDP (as opposed their neighboring countries, Bangladesh and India, having exports at 3.2 and 21.9 percent, respectively)[29], whereas imports stand at 17.7 percent of GDP[30], as of 2023, many of which are vital resources such as oil. To consolidate, a weaker currency can cause more harm than good. Balancing the pros and cons of a market-based exchange rate ultimately is the responsibility of the central bank. If the central bank allows both fundamental changes and speculative changes (Box 17) to pass on to the exchange rate, the loan condition of a market-based exchange rate may cause damage to the economy.

Box 16

Fundamental Changes: Changes in the exchange rate due to market mechanisms such as demand and supply of currency, exports, and imports.

Speculative Changes: Changes arising from speculation of the future value of a currency or through artificial hoarding of currency.

29. Stone, M., Anderson, H., & Veyrune, R. (2008). Exchange rate regimes: *Back to basics.* Finance & Development, 45(1), 42-43. International Monetary Fund. https://www.imf.org/external/pubs/ft/fandd/2008/03/pdf/basics.pdf

30. World Bank. (n.d.). Exports of goods and services (% of GDP). https://data.worldbank.org/indicator/NE.EXP.GNFS.ZS?locations=PK-BD-IN

Condition 5: Monetary Policy Changes in Response to Inflation

Monetary policy refers to the actions of a State Bank regarding changes in the interest rate and supply of money. State banks use these two variables, mainly interest rates, to alter the level of inflation, unemployment, and production in the country. If the state bank increases the interest rate, which is known as monetary policy contraction, this would result in borrowers paying a higher amount of interest payments on their loans. This action is typically taken to reduce price levels and inflation. The current IMF program in place in Pakistan requires Pakistan to keep its monetary policy tight - which implies high interest rates - to reduce inflation. Subsequently, the interest rate in Pakistan increased to an all-time high of 22 percent[31] between 2023 and 2024, while inflation stood at 30 percent[32].

While a tight monetary policy helps reduce inflation, it comes with a sacrifice. In specific, high interest rates discourage production. Businesses typically rely on loans to expand their production by buying new machinery and production sites. At a high interest rate, any business taking a loan would have to pay more in interest payment to a point where the interest payment on the loan could quite possibly be more than the money earned from investing in that loan. Therefore, high interest rates discourage the expansion and ventures of businesses. When businesses do not expand and produce more, no new jobs are created, rendering individuals with limited employment opportunities, businesses earning limited profits, and governments raising less revenue. Consequently, both the welfare of citizens and economic development suffer. Corresponding to an interest rate of 22 percent, GDP growth fell to -0.2 percent[32].

With lower production, a country's export opportunities are also limited, as the locally produced goods and services may only be enough to meet the needs of the country, leaving nothing behind to export. In more extreme cases, a country may not even produce enough to meet its own needs and must rely on imports. On the other hand, a high interest rate also means that any new domestic debt that is obtained will cost more. This acts as an increased burden on the government, which may already be struggling to repay its previous debt.

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31. World Bank. (n.d.). Imports of goods and services (% of GDP). https://data.worldbank.org/indicator/NE.IMP.GNFS.ZS?locations=PK

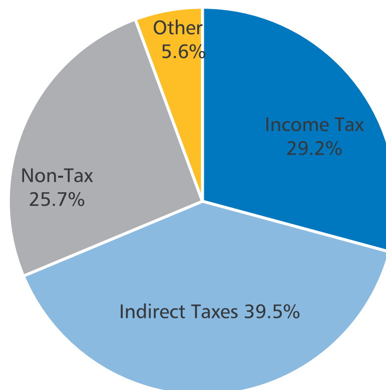
32. State Bank of Pakistan. (n.d.). https://easydata.sbp.org.pk/apex/f?p=10:120:6964613703287::NO:RP:P120_SERIES_KEY,P120_ACTION,P120_PAGE_ID:TS_GP_IR_SIRPR_AH.SBPOL0030,New,100&cs=184BA13E16E3A2C3D428D1737E289773D

3. Who pays the debt bill: Tax, debt, and developmental implications?

> **Box 17**
>
> The short answer to this question is that the people - ordinary citizens –pay the debt bill, not governments. This is because governments mainly earn their money (public revenues) through taxes that are paid by the people. The money taken from these people in the form of tax is used to repay debt. A government that has a large amount of debt to repay often increases the taxes on people who pay more out of their pockets to repay public debt

To answer the question of who pays the debt bill, we must first understand how the government earns its revenues (public revenues). Public revenues are generated through various sources (Table 1), which include tax and non-tax revenues. Tax revenues are the largest source of government revenues and include direct and indirect taxes, as shown in Figure 8. Non-tax revenues, on the other hand, come from sources such as revenue generated from government services such as issuing licenses and permits, fines, privatization of SOEs, or aid or grants received from foreign countries (which do not have to be repaid). These revenues are used to then repay the domestic debt, which is in its local currency.

Figure 8: Pakistan's Public Revenue Breakdown (2024/25)



Source: Ministry of Finance

Table 1: Sources of Government Revenues (excluding debt)

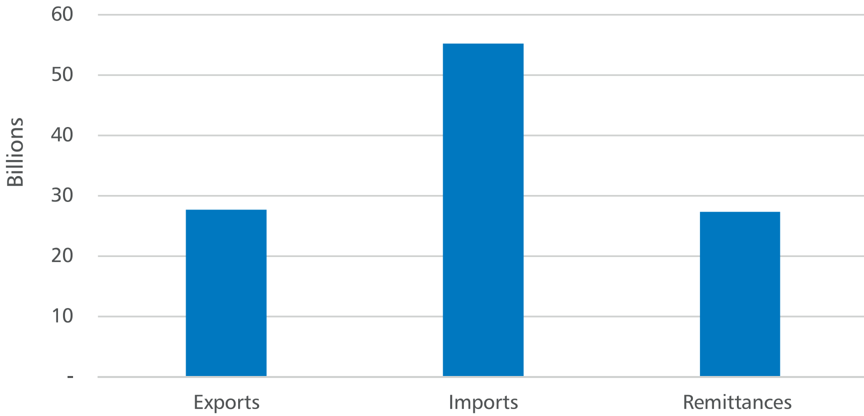
Tax Revenue	***Direct Taxes***: • Individual Income Tax • Business Income Tax (on revenues/profits) • Capital Gains Tax on assets • Withholding Tax ***Indirect Taxes:*** • Sales Tax such as General Sales Tax (GST) and Value Added Tax (VAT) • Custom Duties • Taxes on Imports • Excise Tax • Levies such as on Petroleum
Non-Tax Revenue	• Public service revenues such as issuance of licenses, permits or fines. • Government granted leases on land or resources. • Foreign Grants and Aid
Others	• Privatization of state-owned enterprise (SOEs) • FDI • Exports • Remittances

On the other side, all external debt is obtained and repaid in a foreign currency, such as the US dollar. The repayment of this debt requires that the government holds a sufficient amount of foreign currency. Governments earn foreign currencies through sources including exports, FDI, and remittances, which amounts to the governments foreign currency holding, also known as a country's 'foreign reserves.

As global trade is conducted in US dollars, a country that has a higher number of exports compared to its imports will be bringing in more dollars from the countries it exports to and increasing its foreign reserves. Conversely, a country that imports more will be spending more of its foreign reserves on purchasing those imports. Exports and imports, combined with remittances– which is money sent in a foreign currency by workers living and working abroad and is another source of reserves - make up the current account of a country, which amounted to -0.7 percent of GDP in 2023[33]. Figure 9 shows that in FY 2023 a far greater amount of foreign exchange was spent on imports than the foreign exchange earned from exports or remittances.

33. State Bank of Pakistan. (2024). Annual report FY24. https://www.sbp.org.pk/reports/annual/aarFY24/Complete.pdf

Figure 9: Exports, Imports, and Remittances FY 2023



Source: Pakistan Bureau of Statistics and SBP

When exports are greater than imports, the current account money a country earns from selling things to other countries and the money it spends on buying things from them is considered to be in a surplus, whereas when imports are greater, the current account is in a deficit. In case of a deficit, a country will be spending more dollars (reserves) on imports than what it is earning through exports. Since the spending (in terms of dollars) on imports is greater than what it is earning through exports, expenditures are greater than revenues, this country will once again require debt to meet its financing needs.

On the other hand, a government can earn foreign currencies through foreign direct investment (FDI), which is the investment made by foreign individuals and corporations into a country. FDI is a non-debt source of revenue that promotes the private sector, exports, and economic activity in a country. For example, if an international car manufacturer sets up a car manufacturing plant in Pakistan, this would be considered FDI, which would lead to new employment opportunities for the locals and may open up prospects to export cars in the future. On the other hand, foreign investors can also invest in the country, through buying local assets such as stocks, which is known as foreign portfolio investment (FPI). The earnings on these assets would be a source of reserves. Both FDI and FPI form a financial account of a country, which is in surplus when more money is flowing into the country

through these sources than flowing out. Total foreign investment in Pakistan stood at approximately $530 million in FY 2024[34].

Both tax and non-tax revenues are used to repay debts. However, since taxes make up the largest share of public revenues, debt repayments are primarily paid for by taxes. These taxes, both direct and indirect, are paid for by the citizens and businesses in the country. Hence, all debt repayments come directly from the pockets of the citizens. As discussed in the previous section, when governments raise taxes to repay their debt, the burden falls entirely on the tax paying citizens.

3.1. Low taxes and higher spending equal more borrowing, but higher taxes do not equal increased revenues

Since governments rely on taxes for their revenues, the tax level in a country has important implications for public debt. If the tax rate is low and government spending much further above the revenues, despite the citizens paying lower taxes, the country in question will have to rely on debt. As taxes alone will not cover the government's operations, given that the government wants to maintain the same level of expenditure, the public sector will have to close this gap through borrowing.

When the time for debt repayment comes, this will result in an added expenditure on the already burdened expenditures that cannot be covered by the current low tax rate. This now larger budget gap will once again require more debt financing, resulting in a debt cycle or trap. This debt will ultimately be repaid for the citizens. Referring back to the example in Box 2, where spending (public expenditures) was high and income was less (lower taxes), the individual in question was left with the option of either reducing expenditures or obtaining debt.

Alternatively, even if the tax rate is set to an adequate amount, low tax collection in a country will result in the same cycle. This can occur due to two major reasons. Firstly, if there are a large amount of tax exemptions or incentives being granted, it will cause leakages in revenues. While tax exemptions are given to encourage economic activity in important sectors, they can also cause significant revenue shortfalls. Evidence from global literature shows that in the case of tax incentives for corporations, the

34. https://www.sbp.org.pk/ecodata/NetinflowSummary.pdf

greater the extent of these incentives, the lower the total tax collected[35]. For Pakistan, such exemptions have cost the country **Rs 3.9 trillion** in lost revenue[36] (approximately 22 percent of the 2024/25 budget).

Conversely, if tax evasion and avoidance are prominent in an economy, these will contribute to higher public sector revenue losses. These two factors result in a narrow tax base and are significant contributors to a country's persistent budget and subsequent borrowing. Individuals and corporations both can be involved in tax evasion. Table 2 shows the tax gap in Pakistan, which amounts to **Rs 1961 billion**, with corporate income taxes having the single largest share.

Box 18

In Pakistan, businesses such as importers of livestock, meat, and vegetables[37], among others, face a 0 percent sales tax. Similarly, income from agriculture is taxed at a lower rate than income from other sectors[38].

Moreover, if only taxes are increased, without any thought of increasing the tax base, the same individuals that were paying taxes before will have to bear a greater brunt of tax, while others continue to evade and avoid taxation. Consequently, revenues will not be increased by the government's desired amount. Additionally, a higher tax rate does not necessarily result in greater revenue generation, rather, it increases the amount of tax evasion as the perceived benefits of tax evasion go up with the tax rate. If the authorities responsible for tax collection are ill-equipped, such that they may lack authority or technology, or the rule of law is weak, tax evasion will be easier and more widespread. In this case, increasing the tax rate has a much greater chance of motivating tax evasion[39].

35. State Bank of Pakistan. (n.d.). *Net inflow summary*. https://www.sbp.org.pk/ecodata/NetinflowSummary.pdf
36. Kronfol, H., & Steenbergen, V. (2022). *Evaluating the costs and benefits of corporate tax incentives: Methodological approaches and policy considerations*. World Bank. https://documents1.worldbank.org/curated/en/180341583476704729/pdf/Evaluating-the-Costs-and-Benefits-of-Corporate-Tax-Incentives-Methodological-Approaches-and-Policy-Considerations.pdf?
37. Rana, S. (2023). *Annual tax exemptions hit record Rs3.9 trillion*. The Express Tribune. https://tribune.com.pk/story/2471112/annual-tax-exemptions-hit-record-rs39tr
38. Government of Pakistan. (1990). *The Sales Tax Act, 1990: Section 13 and the Sixth Schedule*. Ministry of Law and Justice.
39. Wattoo, K. S., & Ahmad, W. (2023). *Tax amnesty scheme: A relief for the business community. Dawn*. https://www.dawn.com/news/1847215

Table 2: Pakistan's Tax Gap (Rs. billion)[40]

Tax	Gross Tax Collectable	Tax Collection	Gross Tax Gap
Salaried Class	153	125	28
AOP and non-salaried	1300	545	755
Corporate Income	2833	1655	1178

3.2. Tax justice can help lower borrowing and reduce inequalities.

Tax justice refers to the concept of everyone in an economy paying their fair share of taxes as per their payment ability. Under a just system, those who have a greater earning capacity pay a greater amount of taxes so that the burden of taxes is equal regardless of their income level. While we have already established that higher tax rates alone are simply not enough to fix budget deficits and limit dependence on borrowing, a highly indebted government is inevitably forced to raise taxes. This can either be due to the government's independent decisions or as part of one of the conditions on the debt it has acquired.

However, like in the case of Pakistan, if the tax base is narrow and the tax and public finance system is weak, the tax hikes will fall short of their intended goal. Instead, the increase in taxes will fall entirely on the shoulders of the existing taxpayers. This has several consequences. A sizeable portion of these taxpayers fall among the salaried and labour class, who are already working hard to earn income and now have to bear the entire weight of rising taxes. As income taxes reduce an individual's income for spending (disposable income), income taxpayers are left worse off.

Oppositely, a hike in sales tax makes goods and services more expensive for individuals. As Pakistan relies on GST for most of its revenues (Figure 9), an increase in this tax impacts the poor and low-wage earners far more than other income groups, as the former spend a greater portion of their income on the consumption of goods and services.

40. Richupan, S. (1987). 6 *Determinants of Income Tax Evasion Role of Tax Rates, Shape of Tax Schedules, and Other Factors*. In Supply-Side Tax Policy. USA: International Monetary Fund. https://doi.org/10.5089/9780939934911.071.ch006

Upon factoring in a rise in utility prices as well (as part of the loan condition), an economy now faces higher price levels, or inflation, along with a lower spendable income. These factors then combine to push people into poverty. Estimates from 2023 showed that nearly 10 million people become exposed to the risk of falling below the poverty line due to high inflation and poor economic conditions during this period[41].

While the poverty rate was estimated to remain the same in 2024 as the previous year (40 percent)[41], a significant hike in both direct and indirect taxes[42] in the second half of the year and a 28.5 percent increase in utility and fuel prices[43] since 2023 will without a doubt expose a greater portion of the population to poverty than previously estimated.

Unfortunately, when tax evasion and avoidance is prominent, the situation worsens in the form of inequalities. The richest individuals in society and large corporations are typically the ones engaged in the evasion of avoidance of taxes and have little to no contribution in the government's tax collection efforts. Hence, even if taxes systems are progressive with increasing taxes, these groups remain unaffected. Once again, the burden of taxation falls upon existing taxpayers, belonging to low-and-middle-income groups or small and medium-sized businesses (SMEs), who are left indirectly paying for the government's debt alone. This fosters inequalities in the economy as "the rich get richer, and the poor get poorer."

This brings us to the importance of tax justice and its implications for debt repayments. If the government focuses on the principles of tax justice and targets its efforts on widening the tax base by introducing tax reforms and strict penalties instead of solely increasing taxes, there will be two key benefits. Firstly, the public sector will be able to generate a greater amount of revenue as a larger portion of the population will be paying their share of taxes. This will help reduce the dependence on debt and pay for existing debt by bridging the gap between revenues and expenditures. Take an example of the tax gap shown in Table 3. If this tax gap is closed through

41. https://thedocs.worldbank.org/en/doc/140b30353b40dbb294cca42bcb86529a-0310062024/original/Pakistan-Development-Update-April-2024.pdf

42. World Bank. (2024). P*akistan development update, April 2024: Fiscal impact of federal state-owned enterprises*. https://thedocs.worldbank.org/en/doc/140b30353b40dbb294cca42bcb86529a-0310062024/original/Pakistan-Development-Update-April-2024.pdf

43. Ernst & Young. (2024). *Pakistan's 2024 finance bill proposes indirect individual & corporate tax changes*. Ernst & Young. https://globaltaxnews.ey.com/news/2024-1196-pakistans-2024-finance-bill-proposes-indirect-individual-corporate-tax-changes

enhanced tracking and tracing of income along with strict enforcement, the public sector can generate an additional revenue of Rs 1961 billion.

Secondly, given that taxes are progressive in nature, those with higher incomes will pay more rather than escape the tax net. This will result in the burden of tax payment, and, in turn, the burden of debt repayment being spread across the population more evenly. In specific, all citizens will be able to contribute equally instead of just one strained segment paying everyone's share, while the government will be able to generate more money as a larger portion of society will be brought into the tax net.

4. Policies for improved management of debt and public finances

Sound debt management and fiscal policies are at the heart of achieving debt justice and sustainability, ensuring that the burden of borrowing does not exceed a country's paying capacity or cause harm to its public services and future development. In this regard, two institutions have a key role to play. Firstly, the parliament of Pakistan must fulfill its oversight role over the government and its fiscal decisions. Secondly, the government must work towards improving its management of public finance and introduce policies and reforms that target areas such as tax and revenue collection, among others. This section suggests various policies and recommendations that can help Pakistan achieve more sustainable and responsible management of its public debt.

4.1. Strengthening parliamentary oversight for public debt management

Having discussed the serious implications that public debt can have on an economy and its citizens, policies aimed at improving debt and fiscal management become ever more important. The elected law-making bodies in a country lie at the forefront of creating these policies and overseeing debt, which include the parliament at the national and provincial levels and the senate.

Box 20 highlights some of the key pieces of legislation that govern debt at the national level, with similar legislation existing at the provincial level. The constitution of Pakistan empowers the parliament to be the sole authority in determining the country's borrowing limits. Additionally, the Fiscal Responsibility and Debt Limitation Act, 2005 (FRDL) remains the primary framework for debt management in Pakistan.

However, due to factors such as a lack of an enforcement mechanism and penalties within the act, the targets of the FRDL Act have not been met. This includes achieving a 60 percent GDP ratio by 2016/17, as the ratio currently

Box 19

Article 166 of the Constitution, 1973:

"Federation extends to borrowing upon the security of the Federal Consolidated Fund within such limits, if any, as may from time to time be fixed by Act of Majlis-e-Shoora (Parliament), and to the giving of guarantees within such limits, if any, as may be so fixed."

For more information visit: https://na.gov.pk/uploads/documents/1333523681_951.pdf

Fiscal Responsibility and Debt Limitation Act, 2005:

i. Budget deficits to be a maximum of 4 percent of GDP for 3 years starting from financial 2017/18, beyond which deficits must be kept under 3.5 percent of GDP.

ii. Debt to GDP ratio to be brought under 60 percent within two years starting from 2016/17.

iii. Debt to be limited to 50 percent of GDP (or less) through a 0.5 percent reduction in debt each year from 2018/19 to 2023/24, followed by an annual 0.75 percent reduction from 2023/24 to 2032/33.

Government of Pakistan. (2022). *Fiscal responsibility and debt limitation act, 2005 (amended 2022).* Ministry of Finance. https://www.finance.gov.pk/publications/frdla2005_amended_2022.pdf

stands at 71.8 percent[44]. Moreover, despite there being a consensus on the reduction of debt in Pakistan[45], the parliament has yet to exercise its role of limiting debt. This is evident through the parliament's approval of the annual budget each year. Each year, the country's budget is in a deficit and hence requires additional borrowing to meet all expenditures. When the parliament approves this budget, it ends up giving its silent approval on increasing the debt stock as well.

Hence, the parliament needs to address the gap that currently exists by increasing its oversight and exercising its constitutional rights to limit Pakistan's excessive borrowing. To achieve this, the parliament can:

i. Improving understanding of public debt

Members of legislative bodies, both at the national and provincial levels, can greatly benefit from a deeper understanding of public debt. For this purpose, the parliaments can arrange for special sessions where public debt experts

44. Pakistan Economic Survey 2023-24

45. https://www.nation.com.pk/17-May-2024/prime-minister-for-all-out-efforts-to-deal-with-mounting-pakistan-debt

and academia can brief the members on Pakistan's debt structure, borrowing needs, and future consequences. Similarly, short training programs on debt matters can be held to improve debt literacy, especially at the provincial level, where debt understanding remains limited.

ii. Observing public debt through an SDG lens

Reframing debt within the context of the Sustainable Development Goals (SDGs) can boost engagement and outreach to the Parliament and its members. To achieve this, the parliament can collaborate with the SDGs units at the Federal Planning Commission of Pakistan and provincial planning departments. Through this partnership, a series of sessions can be organized for parliamentarians from various parties to show how debt impacts Pakistan's progress on the SDGs and affects the daily lives of citizens. These awareness sessions on debt justice and the parliamentary role in this issue can strengthen parliamentary oversight of public borrowing.

iii. Establish effective enforcement mechanisms, financial oversight, and reporting systems

The current legislation in place, such as the FRDL Act, 2005, needs to be enhanced by introducing penalties for missing the established debt and fiscal target. Without these, the government has no compulsion to limit its debt and can continue to borrow as per its prerogative. Additionally, in order to increase oversight, the parliament must demand reporting on public finance through Public Expenditure and Financial Accountability (PEFA) and Public Investment Management Assessment (PIMA).

The scope of these tools is to analyse the effectiveness of the management of public finances by the government. This would be achieved through detailed reporting on government finances, auditing of revenues and expenditures, and budget execution reports presented to the parliament annually. Since major public sector projects require funding through debt, PIMA would allow for better management and oversight of public investments and expenditures by tracking where and how public funds are being spent.

iv. Form committees solely focused on debt

The parliament of Pakistan can form committees consisting of up to 10 members from different political parties to address the issue of public debt. These committees would be the focal point of the debate on debt and would

work towards introducing legislation on debt management. The focus of legislation should be on strengthening existing borrowing laws, introducing and enforcing strict borrowing limits, ensuring transparency in debt matters, increasing revenues, promoting responsible government spending, and aligning Pakistan's borrowing with its broader social and developmental objectives.

v. Learn from global success stories and best practices

Alongside improving debt literacy, the parliament can learn from the experiences of similar countries that have effectively addressed their debt challenges. This learning process could involve examining the legislative policies implemented by these nations. Pakistan could also engage with these countries by organizing legislative workshops in parliament, where the representatives from these countries can share their best practices with the assembly members. For instance, Brazil has had remarkable success in improving its debt management and aligning its borrowing goals with development and growth objectives[46].

4.2. Fiscal and policy reforms for improved debt and public finance management

Effective debt and public finance management is crucial for ensuring economic stability and sustainable development. This section deals with essential fiscal and policy reforms that target tax justice, financial governance and accountability, and alternative sources of revenue that limit dependence on debt. These reforms can help Pakistan navigate its debt challenges and promote long-term fiscal health.

i Tax reforms based on principles of tax justice

Due to reasons discussed in previous sections, the government must focus on broadening the tax base rather than simply increasing taxes. As taxation is essentially a political issue, the focus must lie on effective advocacy of tax issues, which involves having the right narrative and cooperation between the key stakeholders, including parliament, tax authorities, and technical

46. The Nation. (2024). *Prime minister for all-out efforts to deal with mounting Pakistan debt*.. https://www.nation.com.pk/17-May-2024/prime-minister-for-all-out-efforts-to-deal-with-mounting-pakistan-debt

experts. A clear and simple message for the government and relevant parties is required, as strong collaborations are the backbone of successful policy reform.

Advocacy further includes raising awareness of taxation issues among both the public and policymakers to enable a fair and equitable tax system. Educating policymakers enhances their understanding of the complexities and consequences of tax policies, enabling them to create legislation that promotes fairness, reduces inequality, and targets tax evasion and avoidance. Well-informed citizens are equally as important as they can hold governments and corporations accountable, demand transparency, and support progressive tax reforms. Increased public awareness can drive the implementation of tax policies aligned with the principles of tax justice.

Furthermore, a deeper understanding of the tax system's challenges is also necessary to identify what works and what doesn't. For example, despite high tax rates, revenue has not increased by much, as higher taxes simply result in greater tax evasion. Therefore, it is important to focus on more than just tax rates.

The issue of evasion arises due to the current tax system's weakness in tracking, tracing, and penalizing tax evasion, along with limitations in data collection. Tax justice reform can only be achieved by engaging tax collection authorities and incorporating their capabilities into policies. Policies that target tax justice but cannot be implemented by the tax authorities due to their limitations are ineffective. Hence, reforms must target strategies that improve upon the authorities' revenue collection capacity. These can include introducing state-of-the-art technologies and data management processes that allow for better record-keeping and income verification identification.

Secondly, policies aimed at improving reporting and transparency, coupled with a strong monitoring system, can significantly advance tax fairness. If laws and policies empower tax authorities to demand greater disclosure of corporate tax practices, such as public reporting of profits, revenues, and tax payments, both tax authorities and the public can hold companies accountable for their tax contributions.

Similarly, a higher rate will not have much effectiveness due to the presence of tax loopholes. It is essential to look beyond tax rates and pinpoint existing loopholes that undermine the goal of fair taxation. For instance, companies registered abroad or in tax havens can avoid paying taxes in the countries

where they operate. This loophole enables large multinational firms to pay little or no tax on their corporate earnings. Implementing a minimum global tax rate can promote tax equality and fairness by requiring corporations to pay a baseline amount in income tax, regardless of their location.

ii. Fiscal consolidation to realign government expenditures

Fiscal consolidation refers to the reduction of excessive and non-essential government spending, which is crucial for addressing fiscal deficits, reducing debt, and promoting long-term economic stability.

One potential avenue is limiting untargeted subsidies to unproductive sectors and redirecting financial resources toward areas that generate greater revenues and benefits for society through targeted subsidies. For example, in the case of export subsidies, it is the larger scale firms that benefit from these, while SMEs often lack the relevant knowledge or resources to obtain the subsidies. Instead, for sectors the government wishes to promote, targeted subsidies can be given.

Box 20

Untargeted Subsidies: A subsidy that anyone can obtain. For example, under a subsidy for wheat, all producers can obtain the subsidy.

Targeted Subsidies: A subsidy that can only be obtained if the recipient fulfills a certain criterion. For example, for an agricultural subsidy, only those earning below a certain income level can obtain the subsidy.

To effectively achieve fiscal consolidation, it is essential to prioritize government expenditure on welfare projects and sectors that yield positive returns, such as infrastructure, health, and education. Investing in infrastructure not only facilitates economic growth by improving transportation and communication networks but also creates jobs and enhances productivity across various industries. In the case of subsidies, for example. The return on these must be analyzed to determine whether their benefits exceed their cost by generating a higher return on investment.

Another area of focus can be unproductive state-owned enterprises (SOEs). These place a significant burden on public funds, as it takes more to run them than the revenues they generate. Their resources can be better allocated elsewhere. To reduce fiscal burdens, it is essential to consider either full or semi-privatization of these entities. This approach can enhance operational efficiency, attract private investment, and ultimately lead to better service

delivery while freeing up public funds for critical social and economic initiatives.

iii. Alternative sources of funds

Pakistan must look to increase its non-debt sources of revenues and foreign exchange. The export market of the country is one such source. A focus on export-oriented growth is vital for Pakistan, as it can increase the foreign revenues coming into the country.

Improving exports firstly requires enhancing the quality of local products and minimizing the costs associated with production, such as electricity. Secondly, significant investments in human capital are needed, such as Improving education and skill development to ensure that the workforce is well-equipped, which enables innovation and productivity. This is not only applicable to the export sector but to all sectors of the economy.

In addition to human capital investments, promoting an environment that encourages private sector investment is crucial for the economy as a whole. By improving the business environment in the country, the government can create a more attractive landscape for both domestic and foreign direct investment (FDI). This will allow for additional revenue streams that reduce dependence on debt as expanding business will generate greater tax revenues that can be reinvested into public services and infrastructure.

Conclusion

This paper establishes the implications of public debt for an economy and the individuals within. It establishes linkages between public debt, taxation, and development, placing these in the context of debt and tax justice.

In a nutshell, when a government engages in excessive borrowing, it threatens the well-being of its citizens, as a large public debt stock demands large debt servicing costs. These costs eat away a country's development budget and the funding for the provision and improvement of essential public goods ranging from health and education to infrastructure. This results in reduced productivity and economic slowdowns, where economies no longer produce a sufficient number of jobs, leading to higher unemployment, poverty, and a poor quality of life. With low productivity and higher unemployment, there is a lower number of workers who are earning less, leading to a lower sum of taxes being collected.

As taxes are the primary source of revenues, if a country has low revenues and excessive spending, its debt payments pile up and require more debt to be paid off, with the new debt coming at a higher cost. These new loans also come with stricter conditions that inevitably contribute to higher taxes, inflation, and, ultimately, poverty while resulting in a debt trap. Low public revenues arise from low tax rates or issues like tax evasion, loopholes, and excessive tax incentives. With such weaknesses present in the tax system, simply raising taxes does not improve revenues and only places a greater burden on taxpayers. Moreover, as taxes pay for debt, the burden of debt repayment also falls on the shoulders of these taxpayers.

To prevent a country from falling deeper into a debt trap, parliamentary interventions and oversight are needed. For this purpose, parliamentarians at the provincial level must begin by improving upon their knowledge and understanding of public debt through special briefings from experts, short trainings, and global best practices. Parliament needs to form committees with representation from major political parties that solely focus on the debate on debt alongside drafting legislation and policies. These would strengthen existing laws while also introducing newer legislation that improves debt and fiscal reporting and enforces strict borrowing limits.

On the financial front, the government must focus on tax justice principles and work towards reforming the tax system. As the debate on taxation is inherently a political issue, it requires concise and targeted advocacy that involves I) having specific and attainable goals based on the capabilities of tax authorities, II) taking on board all relevant stakeholders, including the parliament, tax collection bodies, and taxpayers, III) works towards addressing weaknesses in the tax system such as tax evasion and tax loopholes and lastly, IV) enhances the capacity of tax authorities through investments in improving data collection, resources, and technologies that improve tracking and tracing.

Other efforts of the government must be focused on fiscal consolidation measures to reduce excessive and unproductive spending. On the other hand, alternative sources of revenues must be explored, such as through investments in the export sector and improvement in the business environment to attract FDI and reduce dependence on debt.

At the end of the day, the path towards sustainable debt and fiscal spending requires a commitment from all the stakeholders in the country and an informed citizenry that advocates fairness.

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Appendix

Table A.1 – Definitions of Key Terms

Term	Definition
Public Debt/Sovereign Debt	The total amount of money borrowed by a government to finance its past and current budget deficits. Includes debt borrowed from local and international lenders
Private Debt	Debt owed by private individuals or businesses, rather than by the government. This is not included in public debt
Domestic Debt	Public debt obtained by a government in its own currency, from domestic lenders such as citizens, banks, and financial institutions.
External Debt	Debt that a country owes to foreign creditors, including loans, bonds, or other financial obligations. This debt is borrowed in foreign currencies.
Consolidated Debt	The total amount of debt owed by all branches of government, including local, state, and federal levels.
Principal	The original amount of money borrowed or invested, excluding any interest or fees. For example, if $1000 is borrowed, then this sum is the principal amount.
Interest	The additional amount that must be paid on top of the principal amount. This is the cost borrowing money and is expressed as a percentage of the principal, paid periodically to lenders. The interest rate in an economy is determined by the State or Central Bank of the country. A higher interest rate means a greater cost to be paid on loans.
Simple Interest	This type of interest is paid only on the principal amount for every year of the loan. On a $1000 loan with 10% annual interest, $100 (10%*$1000) must be paid every year as interest till the original amount ($1000) is paid off.

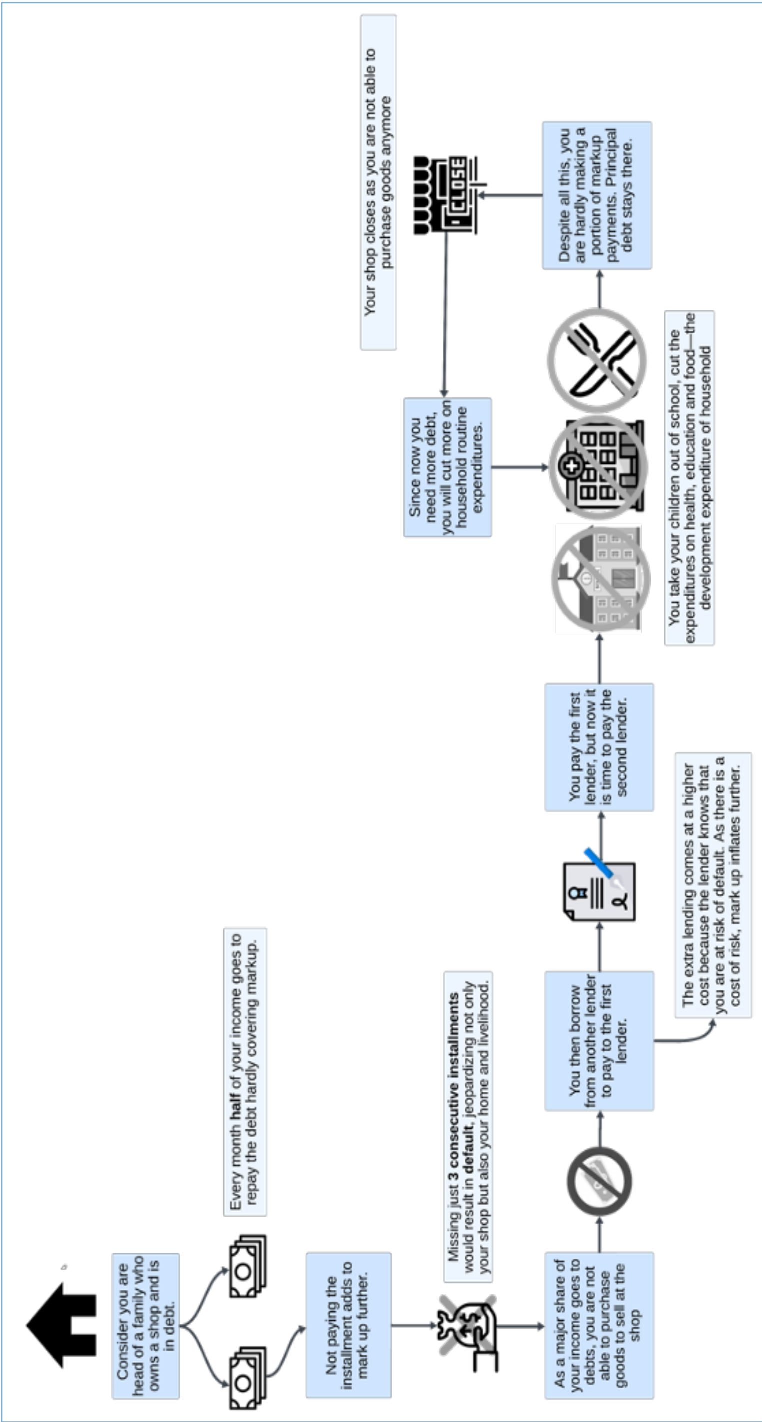
Compound Interest	This type of interest is charged on the sum of the principal and all previous interest payments. Hence, each year the interest payments increase. With a 10% yearly compounding interest on a 1-year loan: 1st Year Interest Payment: $100 (10%*$1000) 2nd Year Interest Payment: $110 (10%* $1000 principal + $100 interest from previous year) 3rd year Interest Payment: $121 (10% * $1000 principal + $100 + $110 interest from previous years)
Interest Rate	The amount of interest rate set by the Central/State Bank which determines the interest charged on debt
Borrowers	Governments, individuals, banks, or entities that borrow money.
Creditors/Lenders	Individuals, banks, or entities that lend money. This includes domestic lenders such as citizens and local banks and international lenders such as foreign banks, countries, and lending agencies such as the International Monetary Fund (IMF), The World Bank and Asian Development Bank
Lender of Last Resort	An institution such as the IMF that provides loans to a government that does enough money to meet its expenditures including debt repayments and does not have any other sources of funding.
Debt Financing	The method of raising funds by borrowing money, typically through loans or issuing bonds, to fund investments or expenditures
Bonds/Treasury Bills	An instrument that issued by governments (or corporations in the case of bonds) to raise funds. These are sold to investors (lenders) such as individuals, corporations, or banks with the promise to: Pay interest at specified intervals (annually/quarterly/monthly) known as the yield of the bond. Pay the principal amount at a specified date, known as the maturity of the bond.
Debt Servicing	The process of paying back the principal and interest on a debt over time.

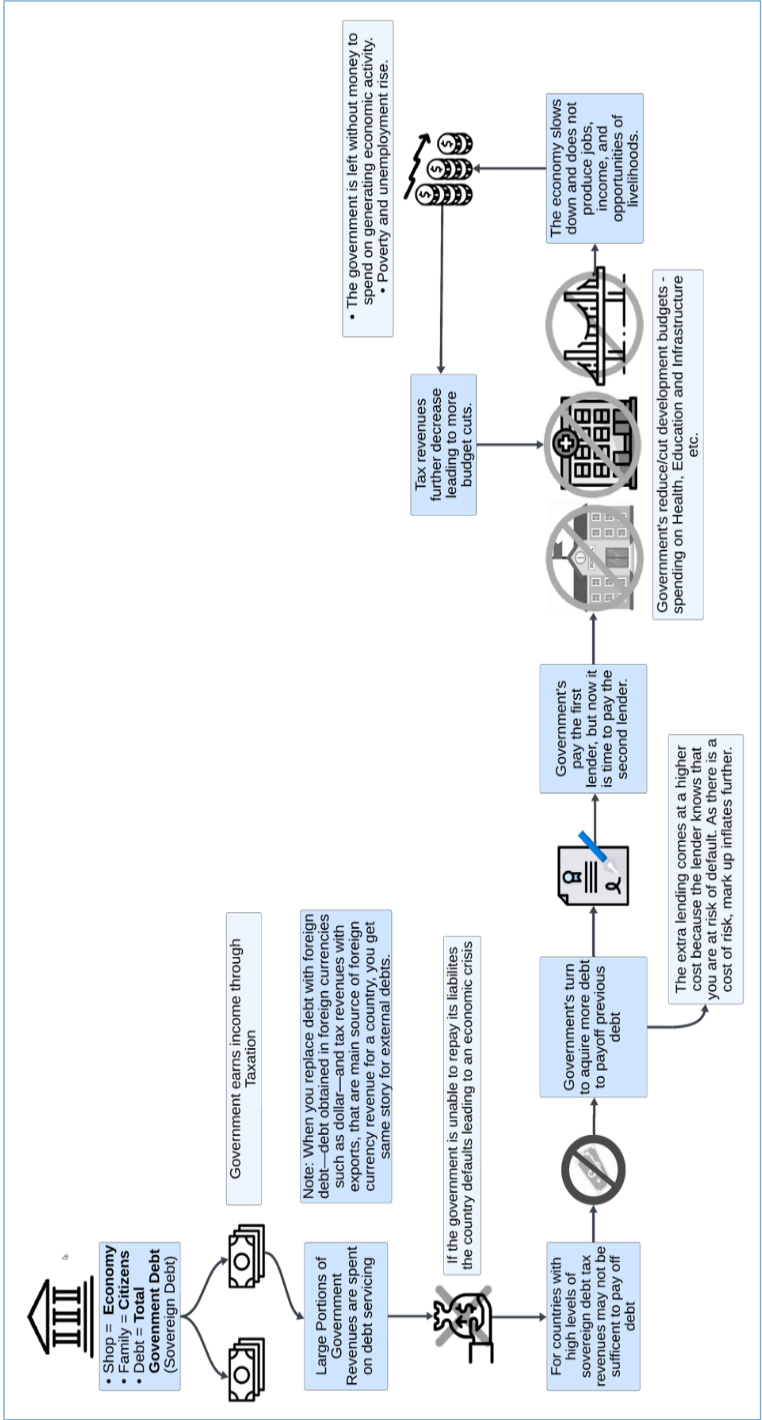
Debt distress	Occurs when a borrower struggles to meet their debt payments such as paying interest or principal amount. This situation can arise from slow economic growth, mismanagement of public finances, low government revenues or events like pandemics or floods. When in debt distress, borrowers may face the risk of default, which can lead to serious financial consequences,
(Debt) Default	The failure to repay a loan or a partial payment of the loan by the agreed date.
Credit Rating	A rating that describes how likely a borrower (government) is to repay a loan on time that is their credit worthiness. For example, a credit rating of AAA shows that the borrower is extremely likely to repay their loan on time
Credit Agencies	Agencies that determine the credit rating of a borrower (government). Provided by agencies like Moody's, S&P, and Fitch
Loan Agreement	A formal contract between a borrower and a lender outlining the terms of a loan, such as principal, interest rate, and repayment schedule.
Debt Refinancing	The process of changing the previous loan agreements with better conditions such as a lower interest rate.
Debt Renegotiation	The process of modifying the terms of an existing loan agreement to make it more manageable for the borrower, such as changing the interest rate or repayment schedules.
Debt Restructuring	A formal process in which a borrower reorganizes its debt to avoid default. This can include extending the due date of the repayment (principle + interest) or reducing the principal or interest rates.
Debt Relief	Measures aimed at reducing or cancelling the debt obligations of countries, often in response to crises or underperformance, to improve reduce the burden of debt repayments.
Debt Forgiveness	The cancellation of a borrower's debt, typically provided under specific conditions, such as economic hardship or development assistance.
Debt Rollover	The practice of repaying existing debt by taking on new debt to pay off old debt.

Debt Trap	When a government does not have enough money to repay its loan, it borrows more debt to repay its existing debt. The new debt often comes at a higher cost. When the time comes to pay the second debt, the government may need to borrow once again to repay its second debt.
Debt Ceiling	A limit put in place by the parliament or law-making body on the maximum amount of public debt that can be borrowed by the government.
Debt Transparency	Ensuring public debt data and all related information is publicly accessible and dependable which would improve accountability and governance.
Debt Sustainability	A measure of whether a country can meet its current and future debt obligations without needing refinancing or accumulating more debt.
Public Debt Management	Strategies and practices used by governments to manage their debt levels, including issuance, repayment, and monitoring.
Currency Risk	The risk on external debt that arises due to fluctuations in exchange rates. If a foreign currency becomes more expensive and the local currency loses its value, the debt payment in local currency will become greater. For example, a $1000 loan is taken by Pakistan at an exchange rate of $1 = Rs.100. Although the loan is to be repaid in dollars, the loan is equal to Rs 100,000. If the local currency (Rupees) weakens and the exchange rate depreciates (falls) to $1 = Rs.200, the amount to be repaid on the loan will rise to Rs.200,000. Due to the exchange rate, an extra Rs.100,000 must now be paid on the debt.
Debt-to-GDP Ratio	A measure comparing a country's total debt to its Gross Domestic Product (GDP), expressed as a percentage, indicating the ability to pay back debt.
Debt-to-Export Ratio	A measure comparing a country's total debt to its total exports, showing how much debt is supported by revenue from exported goods and services.
Government Revenues	The money collected by the government from taxes, fees, and other sources,

Government Expenditures	The total amount spent by the government on programs and services, including salaries of government employees, defence, education, healthcare., infrastructure, and social programs.
Budget Deficit	Occurs when government expenditures exceed revenues, requiring the government to borrow money to cover the gap.
Budget Surplus	Happens when government revenues exceed expenditures, allowing for savings, debt repayment, or investment in future projects.
Primary Deficit	The difference between total expenditures (excluding interest payments) and revenues, indicating the government is spending more than it earns from core activities.
Austerity Measures	Policies implemented by governments to reduce public debt, often involving spending cuts and tax increases, which can impact economic growth.
Fiscal Policy	Government policies regarding taxation and government spending that influence economic conditions, including public debt levels.
Monetary Policy	Central bank policies that manage the money supply and interest rates to influence economic activity and public debt.
Fiscal Space	The ability of a government to provide additional resources for public spending without harming its fiscal sustainability, that is, obtaining more debt.
Fiscal Consolidation	A policy approach aimed at reducing government deficits and debt levels, often through a combination of reducing expenditures and increasing revenues.
Debt Indicators and Measures	
Debt-to-GDP Ratio	A measure comparing total public debt to a country's Gross Domestic Product (GDP), expressed as a percentage, indicating how manageable the debt is relative to the size of the economy. GDP refers to the total value of goods and services produced in an economy in a year.
Debt to Export Ratio	A measure comparing a country's total public debt to its total exports, expressed as a percentage.
Debt Service-to-Revenue Ratio	The ratio of debt service payments (interest + principal) to government revenue, reflecting the percentage of government income required to repay debt. Government revenues consist of tax revenues and non-tax revenues.

Public Debt-to-Revenue Ratio	A measure of total public debt compared to total government revenue, indicating how much of the government's income is needed to pay off its debt.
External Debt-to-GDP Ratio	A measure of a country's external debt as a percentage of its GDP, highlighting reliance on foreign financing.
Interest Payments as a Share of Government Revenue	A measure indicating the proportion of government revenue that is used to make interest payments on public debt.
Net Present Value of Debt	The Net Present Value (NPV) of Debt shows how much the future debt payments are worth in today's money. It considers the value of money today is more valuable than the same amount in the future due to interest. For example, if $100 are kept in a savings account today with 10% interest per year, in one year's time this money will be equal to $110 (10%*$100). Hence $100 today = $110 in one year's time or vice versa.


Consider you are head of a family who owns a shop and is in debt.
Every month **half** of your income goes to repay the debt hardly covering markup.
Not paying the installment adds to mark up further.
Missing just **3 consecutive installments** would result in **default**, jeopardizing not only your shop but also your home and livelihood.
As a major share of your income goes to debts, you are not able to purchase goods to sell at the shop
You then borrow from another lender to pay to the first lender.
The extra lending comes at a higher cost because the lender knows that you are at risk of default. As there is a cost of risk, mark up inflates further.
You pay the first lender, but now it is time to pay the second lender.
You take your children out of school, cut the expenditures on health, education and food—the development expenditure of household
Despite all this, you are hardly making a portion of markup payments. Principal debt stays there.
CLOSE
Your shop closes as you are not able to purchase goods anymore
Since now you need more debt, you will cut more on household routine expenditures.


• Shop = **Economy**
• Family = **Citizens**
• Debt = **Total Govenment Debt** (Sovereign Debt)
Government earns income through Taxation
Large Portions of Government Revenues are spent on debt servicing
Note: When you replace debt with foreign debt—debt obtained in foreign currencies such as dollar—and tax revenues with exports, that are main source of foreign currency revenue for a country, you get same story for external debts.
If the government is unable to repay its liabilites the country defaults leading to an economic crisis
For countries with high levels of sovereign debt tax revenues may not be sufficent to pay off debt
Government's turn to aquire more debt to payoff previous debt
The extra lending comes at a higher cost because the lender knows that you are at risk of default. As there is a cost of risk, mark up inflates further.
Government's pay the first lender, but now it is time to pay the second lender.
Government's reduce/cut development budgets - spending on Health, Education and Infrastructure etc.
The economy slows down and does not produce jobs, income, and opportunities of livelihoods.
Tax revenues further decrease leading to more budget cuts.
• The government is left without money to spend on generating economic activity.
• Poverty and unemployment rise.

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