Insights for Change

Finding the Right Balance

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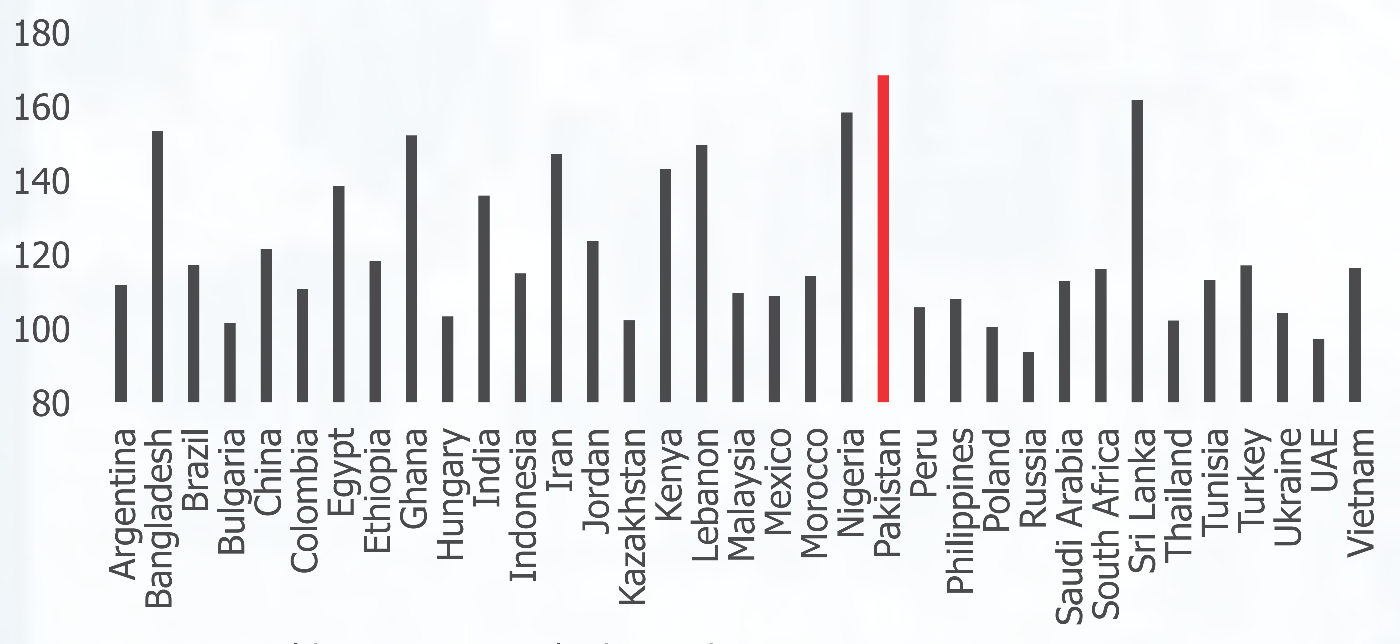
Pakistan's large budget deficit and high public debt burden often make headlines. Less well known is that our overspending—the degree to which expenditures exceed revenues—is among the highest in the world. Similarly, the share of our government's revenue that must be used to pay interest on debt is higher than in almost all other countries. Our own history shows that these imbalances can be addressed, but it will not be easy in today's environment.

If a government's spending exceeds what it raises through taxes, levies, and other receipts, it must borrow to make up the difference. If the imbalance persists for some time, its debt mounts rapidly. The interest on the debt can become a major additional expense, further exacerbating the excess of spending (which now includes interest payments) over revenue. If there is a sudden loss of income or if an urgent spending need emerges, the government may have difficulty finding creditors who are willing to lend further because they fear they might not be repaid. In this situation, the country may be forced to cut essential expenses at the worst time and by more than it would have had to if its government had not lived beyond its means in the first place.

The Government of Pakistan has spent more than its receipts year in and year out. In 2019, the last year for which comparable data for all countries are presently available, Pakistan's spending exceeded revenues by almost 70 percent, more than any other large or medium-sized developing country in the world.

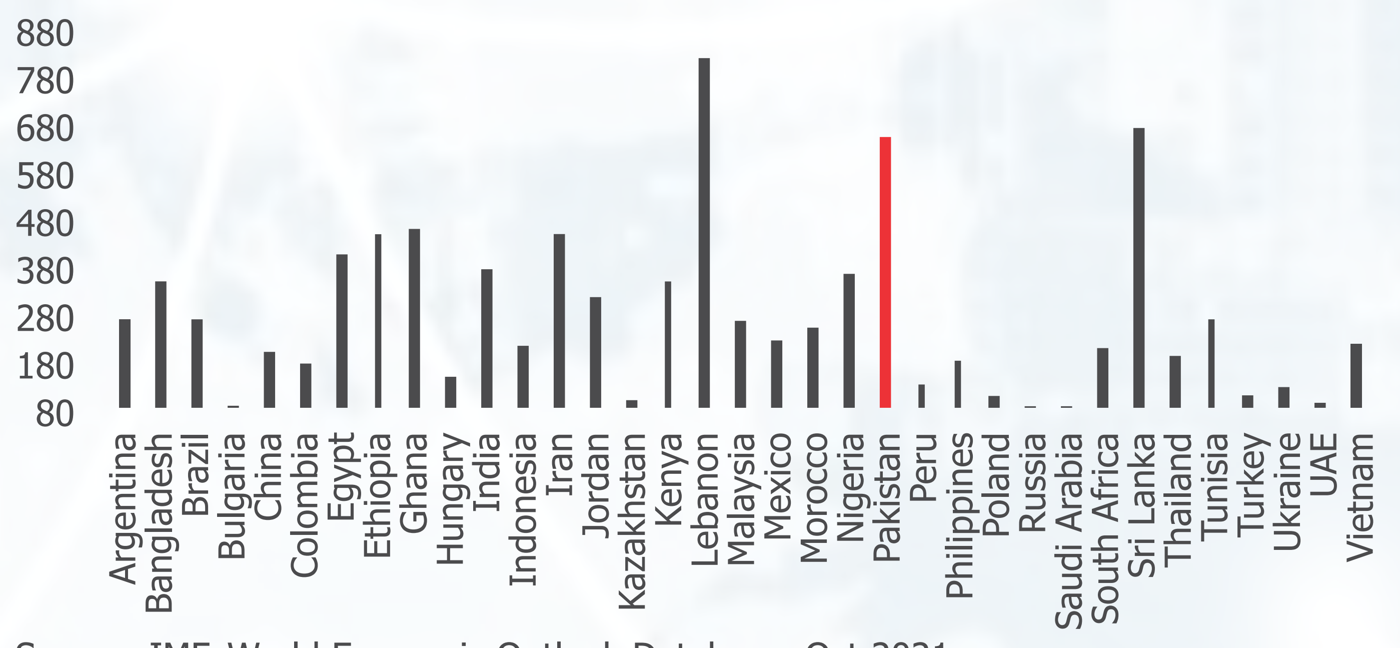
Imbalance
(Govt Expenditure/Revenue in 2019; %)



Source: IMF, World Economic Outlook Database, Oct 2021.

Persistent annual imbalances have caused debt to build up steadily. By 2019, Pakistan government debt amounted to almost seven times annual revenue receipts, one of the highest debt burdens in the world when scaled by revenue.

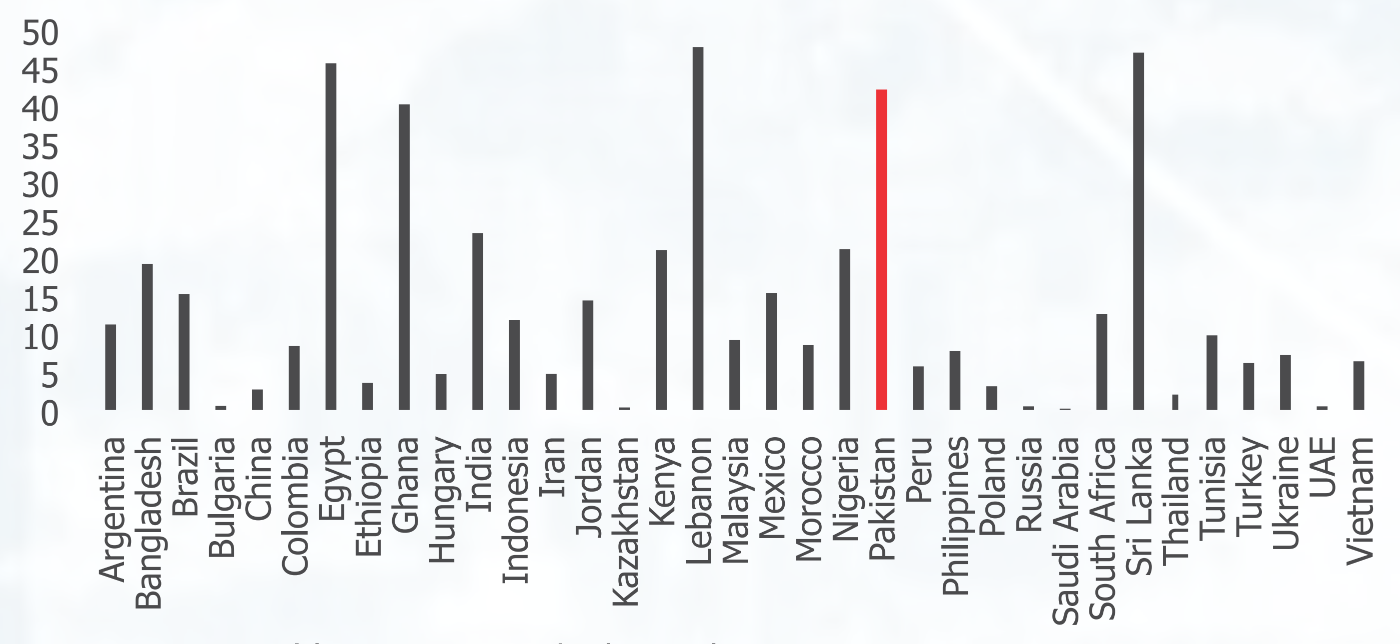
Burdened by Debt
(Govt Gross Debt/Revenue in 2019; %)



Source: IMF, World Economic Outlook Database, Oct 2021.

Meanwhile, as debt has increased, so has the interest that has to be paid—to over 40 percent of the government's revenue. That share is close to the highest among all developing countries worldwide.

The Interest Legacy of Debt
(Net Interest Spending/Revenue in 2019; %)



Source: IMF, World Economic Outlook Database, Oct 2021.

With almost half of the government's resources devoted to paying for past spending (via interest on borrowing), the large interest bill severely limits what is left over to spend on essential needs such as schools, hospitals, and security. It also raises the specter of deep cuts to the already meager amounts allocated for these essentials if financing tightens in the future. Reducing this ratio must take priority.

How much lower should the interest-revenue ratio be? Experience from other countries suggests that it is rare to sustain a ratio above 25 percent for an extended period. Indeed, in the decade preceding the global pandemic, only four developing countries other than Pakistan (Egypt, Ghana, Lebanon, and Sri Lanka) reached or exceeded 40 percent. None of the other 30+ countries ever even reached 30 percent, and only 3 others went beyond 25 percent, and that too only for a single year during 2010-2020.

Can a large reduction in the interest bill relative to revenue be achieved? It is surely a difficult and painful task, but we need not look elsewhere to see that it can be done. Pakistan was able to reduce its interest bill from 45 percent of revenue in 2000 to 21 percent in 2006.

Our Interest History
(Net Interest Expenditure/Revenue; %)

Source: IMF, World Economic Outlook Database, Oct 2021.

How did we do it?

(1) Almost the entire drop in the ratio—22.5 of the 24 percentage points—came from an increase in government revenue, which more than doubled in six years. Adjusting for inflation, the revenue increase was about 50 percent, or about 7 percent annually in real terms. Money flowing into Pakistan in the aftermath of 9/11 boosted economic activity and, as a by-product, revenue collection.

(2) The government managed to prevent any increase in the interest bill, thanks to debt relief from external creditors and lower interest rates on domestic debt. Even though the level of debt rose by 40 percent, the effective interest rate dropped from 8 percent to 5.5 percent, keeping the amount of interest paid flat. Official foreign creditors (via the Paris Club) agreed to substantial delays in both interest and principal repayments. Lower interest rates on domestic debt were made possible by the achievement of low inflation (3-4 percent until 2005).

(3) Non-interest spending was also contained early on. The excess of total spending (including interest) over revenue was cut from 30 percent in 2000 to under 1 percent in 2003. For that one year, the government managed to live within its means.

There is no "right" combination of particular revenue enhancements, expenditure restraints, and—eventually—interest rate cuts that is going to work magic for Pakistan this time around. A careful study of what worked twenty years ago could be instructive, but today's solutions will need to fit today's realities. Geopolitical and geoeconomic realities have changed dramatically, so the same level of external debt relief and financing is unlikely to materialize. Whether public support for painful spending cuts and revenue increases can be won and then sustained over several years also remains to be seen. Inflation is presently very high, so the prospect of substantially lower interest rates seems distant at best, especially as central banks of major countries start raising their own interest rates.

Success in achieving the right balance will hinge on distributing the burden of adjustment fairly and on those that can shoulder it. The task will be challenging, but we have to learn to live within our means. Our future depends on it.

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About the Author

The author was formerly with the International Monetary Fund, where he served as Deputy Director of the European, Middle East & Central Asia, Western Hemisphere, and Strategy, Policy & Review departments. While on leave from the IMF in 1995-96, he founded the Economics Department at ABN-AMRO Bank Pakistan and its Economic Bulletin and Economy Watch publications.

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