# Debt Management and Financial Sustainability in the Post-18th Amendment Scenario and 7th NFC Award: Challenges and Way Forward

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## *Abstract*

*Pakistan's economic landscape is characterized by persistent fiscal deficits driven by structural and cyclical factors. The 18th Constitutional Amendment, which decentralizes fiscal responsibilities to provincial governments, has introduced both opportunities and challenges for the country's economic governance. This amendment has compounded existing issues such as low savings rates, inadequate financial sector development, and high security-related expenditures. It has also impacted debt management and fiscal sustainability, constraining federal borrowing capabilities while increasing provincial autonomy in financial matters. Consequently, Pakistan faces intensified challenges in managing public debt and ensuring financial stability. Effective public debt management is crucial for optimizing costs and risks, while the new fiscal responsibilities require robust provincial fiscal policies and enhanced coordination between federal and provincial governments. Addressing these challenges through comprehensive reforms and improved fiscal practices is essential for achieving sustainable economic growth.*

***Key words:***
*Debt Management, Fiscal Responsibility, Constitutional Amendment, Economic Governance, Public Debt*

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## *Introduction*

As a developing country, Pakistan faces numerous socio-economic challenges both domestically and internationally. It shares common traits with other developing economies, where structural and cyclical factors contribute to an overall fiscal deficit. These factors include fiscal imbalances, a low savings rate, inadequate financial sector development, limited openness, governance issues, significant security-related expenditures, and structural problems. Consequently, the economy is constantly under pressure to generate sufficient resources to cover expenditures. As a result, the government frequently resorts to domestic and international borrowing to bridge the resource-expenditure gap, leading to public debt.

Moreover, due to various internal and external factors, Pakistan has been facing many socio-economic challenges. On the external front, tensions with neighboring countries have not only restricted trade but also discouraged foreign direct investment in Pakistan. The surge in global commodity prices (wheat, soybean oil, tea, and crude oil) due to the Russia-Ukraine war has reduced financial availability. Similarly, low savings to finance investment, low revenue to support expenditure, and low export earnings to compensate for import bills are obstacles to economic growth. In addition, the depreciation of currency and political uncertainty also undermine the financial integrity of the country. All these factors have posed severe financial implications for the economy in achieving a sustainable growth path. In the wake of the 18th constitutional amendment, Pakistan has faced fiscal challenges in maintaining a reasonable surplus budget to address its financial issues.

Most countries in the world depend on foreign assistance (loans and grants) to fill their fiscal deficit and advance their development agenda. However, a radical change introduced by the 18th Amendment is the freedom, within limits, allowed to the provinces to raise domestic as well as foreign loans and issue guarantees (Tahir, 2011). Article 167 of the 1973 Constitution, related to borrowing by provincial governments, now includes a new clause to this effect, which states: "(4) A province may raise domestic or international loans, or give guarantees on the security of the Provincial Consolidated Fund within such limits as may be specified by the National Economic Council."

Debt management strategy is an essential complement to sound macroeconomic policies and the judicious choice of policy regime in achieving financial stability (Debt Policy Coordination Office, Ministry of Finance, 2010-11). Debt management is seen as a crucial factor that supports the credibility and reputation of a sovereign nation and influences the stability of debt capital markets and financial institutions holding public debt. Effective public debt management involves optimizing costs and risks within the constraints of macroeconomic policy. However, even the best debt managers cannot compensate for poor policy decisions in the long term.

Strategically, debt management is vital for securing economic benefits within a sound policy framework. Firstly, enhancing the debt structure can significantly complement fiscal consolidation efforts, ensuring a strong recovery. Secondly, such improvements, when implemented strategically, can enhance the efficiency of public debt management in the future at a relatively low cost.

According to the said report, public debt management in Pakistan is managed by a Debt Policy Coordination Office, which was established after the enactment of the Fiscal Responsibility and Debt Limitation Act, 2005, amended in 2016. The act also mandates that the central government develop a plan for debt reduction and establishes fiscal institutions, albeit with lax management, to limit the fiscal deficit and control the ratio of public debt to GDP. The medium-term debt plan, which is developed in accordance with the medium-term budgetary framework, is another crucial component of public debt management. This gives the nation's fiscal management a clear direction so that medium-term planning is done with an emphasis on the current year and carried over to the next two years. The government's policy measures to improve fiscal outcomes are demonstrated by the strategies developed. The FRDLA Act of 2005, as amended in 2016, mandates the release of an annual fiscal policy statement and a debt policy statement, which outline the general parameters of each program.

The constitutional amendment has posed fiscal challenges, including debt management and fiscal sustainability, for the federal government. In addition, the promulgation of the Fiscal Responsibility and Debt Limitation Act has further limited the space for the federal government to avail foreign assistance. However, debt management and financial sustainability have become problematic after the 18th constitutional amendment for the federal government. A comprehensive research study is required to evaluate and identify its implications for debt management and financial sustainability.

## *Statement of the Problem*

Sound debt management and financial sustainability are prerequisites for economic growth and development. Because of the 18th constitutional amendment and the 7th NFC Award in Pakistan, which granted greater financial autonomy to provinces, the country faces significant challenges regarding debt management and financial sustainability. Fiscal decentralization has weakened the financial position of the federal government to finance its current as well as development expenditures. Further, it has also posed challenges for long-term economic growth and development of the country. Therefore, comprehensive research is required to identify the short-term and long-term consequences of debt management and financial sustainability in light of the post-18th amendment and 7th NFC Award and to suggest recommendations.

## *Research Methodology*

This study has been conducted using secondary data on the 18th constitutional amendment and the 7th NFC Award from various data sources and materials available on the issue. Similarly, the data has been examined and analyzed through situation analysis, PESTEL analysis, gap analysis, and comparative analysis techniques to draw conclusions and recommendations regarding debt management and financial sustainability in Pakistan.

## *Scope*

This research paper will focus on the post-18th amendment and 7th NFC Award scenario and will identify the debt management and financial sustainability situation following these changes. The study will also highlight the implications on economic growth and development and will suggest corrective measures to make debt management sustainable.

## *Literature Review*

According to Reinhart and Rogoff (2010), public debt tends to increase following a financial crisis. Significant signs suggest that almost all economies worldwide, irrespective of their level of income, have witnessed an increase in public debt and a slowdown in economic growth. Additionally, the debt dynamics for developing countries differ from those of developed economies due to less-than-optimal development in financial markets and differences in openness to the global economy (Frankel and Romer, 1999; Levine and Rennet, 1992). In Pakistan, the issue of public debt reduces the prospects of debt management and financial sustainability due to a low growth rate. Empirical results from a time series study conducted by Arshad et al. (2014) utilized an extended Solow growth model and the Johansen co-integration technique for model testing. This study also considered the relationship between public debt and GDP growth rate using the Granger causality test. The findings indicated that external debt positively impacts growth, while internal debt has negative implications for GDP growth. Total public debt has increased manyfold over a few years, putting pressure on revenue to finance debt servicing.

Similarly, the findings of a study by Naeem (2011) confirm the issue of debt overhang, where high levels of public external debt hinder economic growth. Ayyoub et al. (2014) investigated the relationship between debt and GDP growth, the manufacturing sector, and unemployment using the Ordinary Least Squares (OLS) technique on secondary data from 1990 to 2010. Their study found a negative relationship between domestic debt and growth but a statistically significant positive relationship between GDP growth and external debt.

In conclusion, the reviewed literature indicates that Pakistan's public debt has increased substantially over the last decade. This surge is primarily attributed to fiscal mismanagement and a significant decline in foreign direct investment, grants, portfolio investments, and exports. The increase in debt arises from both cyclical factors, such as the war on terror, security-related expenditures, issues with temporarily displaced persons, and floods, as well as structural problems including low tax revenue, losses in the power sector, and public sector enterprises. Furthermore, the energy crisis, coupled with high energy prices and the high cost of doing business, has further hindered economic growth. Additionally, the depreciation of the local currency against the US Dollar has exacerbated total external debt and debt servicing obligations.

## *Situation Analysis*

The Fiscal Responsibility and Debt Limitation (FRDL) Act 2005 defines “Total Public Debt” as debt owed by the government (including the Federal Government and Provincial Governments) serviced out of the consolidated fund and debts owed to the International Monetary Fund. In addition, as per the Fiscal Responsibility and Debt Limitation Act, 2005 (as amended from time to time), "Total Debt of the Government" means the debt of the government (including the Federal Government and the Provincial Governments) serviced out of the consolidated fund and debts owed to the IMF, less accumulated deposits of the Federal and Provincial Governments with the banking system. According to the Debt Management Office (2023), public debt has increased due to certain reasons, the most notable of which are: Economic flows that lead to changes in the total public debt stock over a given period (e.g., a fiscal year) are generally classified into two categories: (i) transactions and (ii) other economic flows. Changes in the total public debt stock due to borrowings to cover the fiscal deficit or adjust the cash balance are considered economic flows from transactions. In contrast, changes resulting from exchange rate movements fall under other economic flows. The following table depicts the composition of Pakistan’s total public debt portfolio:

**Table-1: Pakistan's Total Public Debt Summary**

| **Public Debt Statistics (Rs in billion, unless otherwise stated)** | | | | |
|---|---|---|---|---|
| | **Jun-22** | **Dec-22** | **Jun-23** | **Dec-23** |
| Domestic Debt | 14,849 | 16,416 | 20,732 | 23,283 |
| External Debt | 6,559 | 8,537 | 11,976 | 13,116 |
| **Total Public Debt** | **21,409** | **24,953** | **32,708** | **36,399** |
| **Total Debt of the Government*** | **19,635** | **23,024** | **29,521** | **33,235** |

| | | | | |
|---|---|---|---|---|
| **GDP (Nominal)** | **66,640** | **84,069** | **84,069** | **105,817** |
| **In Percentage of GDP** | | | | |
| Total Public Debt | 46.6 | - | 46.2 | - |
| Total Debt of the Government* | 66.9 | - | 68.7 | - |
| **(US$ in billion)** | | | | |
| External Public Debt (US$ in bn) | 151.1 | 146.2 | 135.5 | 151.1 |
| Domestic Debt (US$ in bn) | 88.8 | 86.6 | 84.1 | 87.8 |
| **Total Public Debt** | **240.9** | **232.8** | **219.6** | **238.9** |
| **Source: Debt Office, Ministry of Finance** | | | | |

### *External Public Debt*

According to Finance (2023-24), Pakistan's external public debt is obtained from the following major sources:

i. Loans from multilateral development partners (including the IMF) and bilateral countries constitute 53 percent and 21 percent, respectively. These loans are concessional in nature, i.e., long tenor and low interest rate.
ii. Deposits from friendly countries (China and Saudi Arabia) account for 10 percent. These loans are short-term in nature (1 year) and are obtained for balance of payments as well as budgetary support.
iii. Loans from foreign commercial banks constitute around 6 percent. These loans are mostly short-to-medium term (i.e., 1-3 years) with market-based interest rates.
iv. Government of Pakistan's international capital market transactions in the form of Eurobonds and international sukuk constitute 9 percent. These transactions represent long-term debt with market-based interest rates.
v. Other foreign inflows in terms of Naya Pakistan Certificates, non-resident investment in government securities, and Pakistan Banao Certificates, etc., constitute around 1 percent. This category falls under short-to-medium term debt with market-based interest rates.

## *PESTLE Analysis*

The PESTLE analysis determines various aspects of debt management and fiscal sustainability after the 18th Amendment in Pakistan. It is essential as this amendment has changed the financial dynamics between the federal and provincial governments. In addition, it has also raised questions about the Fiscal Responsibility & Debt Limitation Act, 2005 of the federal government. Provinces can now also raise borrowing from external sources subject to clearance from the Council of Common Interest. According to Pasha (2011), the 18th Amendment has various implications for both federal and provincial governments, which are summarized below:

### *Political Factors*

***Devolution of Power:***

The 18th Amendment has decentralized power, giving provinces more autonomy over their finances. This shift can lead to better resource allocation tailored to local needs but also requires strong provincial governance structures. There is no mechanism at the provincial level to further transfer funds to the district level to trickle down the effects of the NFC to the district level for improved governance and public delivery.

***Political Stability:***

Pakistan has a perpetual phenomenon of political instability, which has socio-economic implications for the country, including financial planning and debt management. Consistent policies are necessary for sustainable financial management.

***Intergovernmental Coordination:***

After the 18th Amendment, provinces can also borrow from external sources against their revenue subject to clearance from the Council of Common Interest. However, there is a lack of coordination between federal and provincial governments for effective debt management. The amendment has increased the need for clear communication and collaboration.

### *Economic Factors*

***Economic Growth:***

Financial sustainability and sound debt management are strongly correlated because sustained economic growth is essential for financial sustainability. The amendment aims to boost local economies by empowering provinces, but uneven growth across regions can pose challenges.

***Debt Levels:***

High levels of public debt can stress financial sustainability. With the post-amendment provision for borrowing from external sources, provinces need to manage their debt efficiently to avoid contributing to national debt burdens.

***Revenue Generation:***

After the 18th Amendment, provinces now have more responsibility for generating their revenue. Effective taxation policies and improved collection mechanisms are crucial for financial health. Such mechanisms would improve financial sustainability in the country.

## *Social Factors*

***Regional Disparities:***

After the 18th Amendment, health, education, and many other sectors have been transferred to provinces for better governance and public service delivery. The amendment aims to address regional inequalities, but effective implementation is key. Disparities in education, healthcare, and infrastructure can affect economic performance and financial sustainability.

***Public Awareness and Involvement:***

Increased provincial autonomy requires higher public awareness and involvement in governance. Educating citizens about fiscal policies and encouraging participation can lead to better financial management.

## *Technological Factors*

***Digital Infrastructure:***

Advanced digital infrastructure can improve financial management and transparency. Investment in technology is necessary for efficient debt management and service delivery. Moreover, accurate and timely data collection at the provincial level is crucial for informed decision-making. Implementing modern data management systems can enhance financial planning and debt tracking.

## *Legal Factors*

***Regulatory Framework:***

Post-amendment, provinces need a robust regulatory framework to manage their finances. Clear laws and regulations are essential to ensure accountability and transparency.

***Fiscal Responsibility:***

Legal provisions must enforce fiscal responsibility at the provincial level. Mechanisms for monitoring and penalizing fiscal mismanagement are crucial.

## *Environmental Factors*

***Resource Management:***

The subject of the environment has been transferred to provinces after the 18th Amendment for the sound implementation of policies at the grassroots level. Provinces must manage natural resources sustainably to ensure long-term financial health. Environmental degradation can impact economic activities and revenue generation. Adapting to climate change and investing in resilient infrastructure can safeguard economic activities and financial sustainability.

## *Gap Analysis*

The 18th Amendment, enacted with the vision of decentralizing power and granting greater autonomy to provincial governments, has reshaped the financial governance framework of our nation. Through a comprehensive gap analysis, we will measure how this significant legislative change has influenced our debt management strategies and financial stability. We will identify the areas where progress has been made, as well as the gaps that need to be addressed to ensure a robust and sustainable economic future for Pakistan.

### *Current State*

***Decentralized Financial Responsibilities:***
The 18th Amendment devolved financial powers to the provinces, increasing their responsibility for revenue generation and expenditure management.

***Debt Accumulation:***
Provincial governments have limited experience and capacity in managing debt effectively, leading to potential risks of unsustainable debt accumulation.

***Revenue Collection Challenges:***
Provinces struggle with inefficient tax collection systems and a narrow tax base, resulting in inadequate revenue generation.

***Economic Disparities:***
Significant regional economic disparities exist, affecting overall financial stability and sustainability.

***Governance and Transparency:***
Varying levels of governance and transparency across provinces, with some lacking robust financial management systems.

***Coordination Issues:***
Poor coordination between federal and provincial governments on fiscal policies and debt management.

***Infrastructure and Technology:***
Limited digital infrastructure and data management systems at the provincial level hinder efficient financial management.

### *Desired Future State*

***Effective Debt Management:***
Provinces have robust systems and capacities for managing debt, ensuring it remains within sustainable limits.

***Efficient Revenue Generation:***
Enhanced and efficient tax collection mechanisms, a broader tax base, and innovative revenue generation strategies.

***Economic Equitability:***
Reduced regional economic disparities, with more balanced economic growth across provinces.

***Strong Governance and Transparency:***
High levels of governance and transparency in financial management across all provinces.

***Seamless Coordination:***
Effective and seamless coordination between federal and provincial governments on fiscal policies and debt management.

***Advanced Infrastructure and Technology:***
Advanced digital infrastructure and data management systems in place to support efficient financial management.

***GAP Analysis***

***Debt Management Capacity***

- **Gap:** Limited provincial experience and capacity in debt management.
- **Actions Needed:** Capacity-building programs, training in debt management, and establishing debt management offices at the provincial level.

***Revenue Generation***

- **Gap:** Inefficient tax systems and a narrow tax base.
- **Actions Needed:** Reform tax policies, improve tax collection systems, and explore alternative revenue sources.

***Economic Disparities***

- **Gap:** Significant regional economic disparities.
- **Actions Needed:** Targeted economic development programs, infrastructure investments, and incentives for industries to establish in less developed regions.

***Governance and Transparency***

- **Gap:** Inconsistent levels of governance and transparency.

- **Actions Needed:** Implement standard financial management frameworks, enhance accountability measures, and promote transparency initiatives.

*Intergovernmental Coordination*

- **Gap:** Poor coordination between federal and provincial governments.
- **Actions Needed:** Establish intergovernmental fiscal councils, conduct regular joint planning sessions, and synchronize fiscal policies.

*Infrastructure and Technology*

- **Gap:** Inadequate digital infrastructure and data management regarding debt management.
- **Actions Needed:** Invest in modern digital infrastructure, implement integrated financial management information systems (IFMIS), and promote e-governance.

## *Comparative Analysis*

The debt-to-GDP ratio is usually used to measure the trend of public debt. Pakistan has shown a 75% debt-to-GDP ratio during the current financial year, 2023-24. Similarly, Bangladesh and Sri Lanka (before default) recorded 32% and 105%, respectively. It is pertinent to mention here that economic sustainability depends on many other economic indicators, not only on the debt-to-GDP ratio of a country. For instance, Japan, Greece, Italy, and Singapore are some of the countries with the highest debt-to-GDP ratios, but they have sustainable economic indicators. In this regard, the IMF describes the usability of debt ratios as: “Debt ratios should be considered in conjunction with key economic and financial variables, in particular expected growth and interest rates, which determine their trend in medium-term scenarios” (IMF, 2003).

## *Issues and Challenges*

Overall, while the 18th Amendment offers significant potential benefits in terms of fiscal federalism and provincial autonomy, it also poses challenges for federal debt management and requires robust financial planning and reforms to ensure long-term financial sustainability. The federal government has faced revenue shortages due to changes in the revenue-sharing formula, which has resulted in a high domestic and external debt burden. This has made debt management and financial sustainability at risk. Similarly, provinces now have more resources and are empowered to borrow to increase their resources without any restrictions from the federal government. Such imbalances will also deteriorate debt management as well as the financial sustainability of the federal government. However, Shah (September, 2012) has summarized the following major issues and challenges:

***Revenue Generation Potential:***

The provinces have the potential to raise additional revenues through various taxes, including capital value taxes on property, estate, inheritance taxes, and environmental taxes. These areas are currently underexploited or unexploited.

***Borrowing Powers:***

Pursuant to the 18th Constitutional Amendment, the provinces can obtain both internal and external borrowing, subject to limitations imposed by the National Economic Council. Previously, provinces required federal government approval for such actions as long as they owed debt to the federal government.

***Fiscal Decentralization:***

The amendment has shifted almost all direct public services to provincial responsibility, devolving 17 central government ministries to the provinces. This shift includes expenditure decentralization and a more limited decentralization of taxing powers, most notably for VAT on services, which is a potentially buoyant source of revenue.

***Federal Deficit and Provincial Surplus:***

With the transition arrangements in place, the federal deficit is expected to increase by about 3%, while the provinces are projected to be in surplus by the same amount. This shift in financial responsibilities highlights the need for federal government reform through privatization, tax reform, and restructuring federal departments to manage the increased deficit.

***Structural Transformation:***

By FY2015, the governance structure in Pakistan was expected to transform significantly, moving from centralized federal power to centralization at the provincial level. This shift implies that provinces will assume a dominant role in policymaking and service delivery for economic and social services.

***Implications for Governance:***

The amendment is anticipated to enhance responsive, responsible, fair, and accountable governance by empowering provincial governments. However, this also necessitates effective management and oversight to ensure financial sustainability and prevent mismanagement at the provincial level.

## *Conclusions*

To conclude the discussion, it is imperative to mention here that the 18th Constitutional Amendment has had an intense impact on debt management and financial sustainability in Pakistan. According to Shaikh (December, 2010), by decentralizing fiscal responsibilities and granting greater autonomy to provincial governments, it has introduced both opportunities and challenges for economic governance. The government's strategy to manage debt sustainably includes commitments to running primary budget surpluses, maintaining low and stable inflation, and promoting long-term economic growth. These efforts are complemented by an exchange rate regime grounded in economic fundamentals.

Fiscal discipline is reinforced by strong revenue generation and streamlined spending, which are essential for sustaining manageable debt levels. Consequently, with a reduced fiscal deficit, public debt is expected to steadily decrease. Additionally, the government's initiatives to improve the maturity structure of debt and expand the base of debt instruments are pivotal in meeting financing requirements more efficiently.

Hence, the 18th Amendment and the 7th NFC Award have decentralized fiscal responsibilities, presenting both opportunities and challenges. Addressing these challenges through enhanced coordination, capacity building, effective debt management, and sustainable economic practices will ensure financial stability and growth for Pakistan. Overall, the 18th Amendment has laid the foundation for a more decentralized and potentially resilient fiscal framework. However, its success in enhancing financial sustainability hinges on the effective implementation of these strategies, continuous fiscal discipline, and the provinces' capacity to manage their finances autonomously. As such, the amendment presents a transformative step towards better debt management and financial stability in Pakistan, provided that the associated challenges are adeptly navigated.

## *Recommendations*

To improve debt management and ensure financial sustainability in the future post-18th Amendment, the following recommendations are proposed:

I. A new fiscal responsibility law should be enacted by each province in which limits for fiscal deficits/surpluses, revenue mobilization, and expenditure on development should be imposed.

II. If the allocation for provinces from the divisible pool rises or provinces make an extra tax effort, the incremental resources should be used for development projects.

III. Provinces should be encouraged to generate budgetary surpluses in order to offset the deficit of the federal government.
IV. The federal and provincial governments will have to formulate their budgets within the parameters approved by the National Economic Council (NEC) of the federal government.
V. The power of the provincial governments to borrow from domestic capital markets or financial institutions needs to be reviewed to manage the total public debt of the country.
VI. Provinces should be encouraged to enhance their own revenues through taxes transferred in pursuance of the 18th Constitutional Amendment in order to reduce dependency on federal government borrowing from other sources.
VII. Enhance the capacity of provincial governments through training and development programs. Implement effective governance structures to ensure accountability and transparency.
VIII. Establish mechanisms for regular communication and coordination between federal and provincial governments. Joint fiscal planning and debt management strategies can be beneficial.
IX. Encourage provinces to diversify their economies to reduce dependence on a few sectors. This can enhance economic resilience and revenue stability.

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