

Chapter 1

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Performance Profit Comparison - Year



PAKISTAN FEDERAL PUBLIC EXPENDITURE REVIEW 2023

Reducing Pakistan's Persistent Fiscal Deficits



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PAKISTAN FEDERAL PUBLIC EXPENDITURE REVIEW

Chapter 1: Reducing Pakistan's Persistent Fiscal Deficits

2023



TABLE OF CONTENTS

Preface	i
Abbreviations	iii
Chapter 1: Pakistan’s Persistent Fiscal Deficits	1
1.1 Introduction	1
1.2 Recent macroeconomic developments and outlook	1
1.3 Pakistan’s development experience since 2000	3
1.4 Persistent budget deficits and their effects on the Pakistan economy	4
1.5 Drivers of Persistent Fiscal Deficits	10
1.5.1 Rigid expenditures and low revenue collections	10
1.5.2 A challenging intergovernmental framework	13
1.5.3 Fragmented Institutions.....	15
1.5.4 Non-budgetary shocks	17
1.6 Objective and Structure of the Report	19
1.6.1 Chapters of the PER	20
1.6.2 Policy recommendations and federal fiscal savings	22
Annex	25
References.....	28

List of Figures, Tables and Boxes

FIGURES

Figure 1.1: Human Development Index (HDI) trend for South Asian countries, 1990-2021	3
Figure 1.2: Pakistan: Government Budget Balances.....	4
Figure 1.3: South Asia: General Government Budget Balances.....	4
Figure 1.4: Contributions to Real GDP Growth.....	6
Figure 1.5: Pakistan’s Twin Deficits	6
Figure 1.6: Pakistan: Public and Publicly Guaranteed Debt.....	7
Figure 1.7: South Asia: Public and Publicly Guaranteed Debt	7
Figure 1.8: Fiscal deficit and debt – peer comparison for FY19.....	7
Figure 1.9: Government Borrowing from Banks, FY11–21	7
Figure 1.10: Credit to the Private Sector	8
Figure 1.11: Private investment, selected years.....	8
Figure 1.12: Average annual real GDP per capita growth, 2000-2021	8
Figure 1.13: Federal government spending, by rigidity	11
Figure 1.14: Federal government spending, economic classification.....	11
Figure 1.15: Total and Tax Revenues, Average 2013–22	12
Figure 1.16: Pakistan: Total and tax revenue	12
Figure 1.17: Federal and provincial government shares of fiscal revenues	15
Figure 1.18: Federal and provincial government shares of fiscal expenditures	15
Figure 1.19: Consolidated (total) fiscal and primary fiscal deficits, pre- and post-2010	15
Figure 1.20: Key Drivers of Pakistan’s Public and Publicly Guaranteed Debt.....	18
Figure B1.1: Public investment, percent deviation from baseline values (percent).....	9
Figure B1.2: Private investment, percent deviation from baseline values (percent)	9
Figure B1.3: Real GDP per capita, percent deviation from baseline values	10
Figure B.2.1: Statutory top personal income tax rates.....	12
Figure B.2.2: Corporate income tax rates.....	12

TABLES

Table 1.1: Pakistan – Trends in Poverty Incidence and Human Development Indicators	3
Table 1.2: Key Fiscal Indicators, Pakistan FY2010 to FY2022.....	5
Table 1.3: Recommended Fiscal Consolidation Measures	23
Table A.1.1: Key Past Recommendations for Rationalizing Overall Fiscal Expenditures	25
Table A.1.2: Key Past Recommendations for Debt Management	25
Table A.1.3: Key Past Recommendations for Reducing the Fiscal Impact of State-Owned Enterprises.....	26
Table A.1.4: Key Past Recommendations for Enhancing Revenue Collections.....	26

BOXES

Box 1.1: Growth Dividends from Fiscal Consolidation.....	9
Box 1.2: High tax rates and Laffer Curve Effects.....	12
Box 1.3: Pakistan’s fiscal federalism structure	13
Box 1.4: The fiscal impact of the COVID pandemic on Pakistan	19

Preface

The Pakistan Federal Public Expenditure Review (PER) 2023 was prepared by the Macroeconomics, Trade, and Investment Global Practice under the guidance of Najy Benhassine (Country Director, Pakistan), Mathew Verghis (Regional Director, Equitable Growth, Finance and Institutions), Shabih Ali Mohib (Practice Manager, Macroeconomics, Trade, and Investment) and Tobias Akhtar Haque (Lead Country Economist and Program Leader, Equitable Growth, Finance and Institutions).

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Abbreviations

BISP	Benazir Income Support Programme
CDNS	Directorate for National Savings
DMO	Debt Management Office
DPCO	Debt Policy Coordination Office
DPOs	Development Policy Operations
DSA	Debt Sustainability Analysis
EAD	Economic Affairs Division
EF	External Finance
FBR	Federal Board of Revenue
FRDLA	Fiscal Responsibility and Debt Limitation Act
GDP	Gross Domestic Product
GFNs	Gross Financing Needs
GST	Goods and Services Tax
HDI	Human Development Index
IDA	International Development Association
MTDS	Medium-Term Debt Strategy
MTFF	Medium-Term Fiscal Framework
NFC	National Finance Commission
NTC	National Tax Council
PASSCO	Pakistan Agricultural Storage & Services Corporation
PP	percentage points
PPG	Public and publicly guaranteed
PER	Public Expenditure Review
RISE	Resilient Institutions for Sustainable Economy
SBP	State Bank of Pakistan
SDFP	Sustainable Development Finance Policy
SJMS	Sarhad Journal of Management Sciences
SOEs	State Owned Enterprises
UNDP	United Nations Development Programme

Chapter 1: Pakistan's Persistent Fiscal Deficits

1.1 Introduction

Pakistan's fiscal deficit has been persistently large and growing. In FY22, the general government deficit was the largest in more than 22 years. Moreover, the deficit has been growing over time, with its post-2010 annual average larger than its pre-2010 average by 50 percent. The recurrent budget shortfall has led to a rapid accumulation of public debt. Accordingly, both the deficit and debt levels are in breach of the fiscal rules stipulated by the Fiscal Responsibility and Debt Limitation Act (FRDLA).¹ Rationalizing and reducing Pakistan's fiscal deficit is therefore critical to regaining fiscal and debt sustainability.

The high levels of fiscal deficits and public debt have adverse effects on the economy. High deficits and debt contribute to macroeconomic volatility, financial sector stress, and weigh on public and private investment and thus on long-term economic growth. Recent economy-wide shocks, such as the COVID pandemic and the devastating floods, have also exacerbated the fiscal shortfall by increasing spending needs, while shrinking tax bases. These disasters also highlight the dire need for fiscal space to adequately respond to shocks. Therefore, this Federal Public Expenditure Review (PER) focuses on providing policy options for fiscal consolidation to regain fiscal and debt sustainability.

To provide context for this PER report, this chapter documents the emergence and consequences of Pakistan's fiscal woes and points to their key structural determinants. The chapter comprises five sections. It first provides a concise overview of the recent economic developments. Next, the country's successful development experience over the past two decades is briefly highlighted, while emphasizing the importance of continued physical and human capital investment. The chapter then discusses Pakistan's persistent fiscal deficits, the growing debt stock and their consequent detrimental effects on the economy. The fourth section outlines the key factors that drive the persistence of budget shortfalls, namely the rigidity of expenditures, the low revenue collections, and other macroeconomic and institutional factors. The final section of the chapter lays out the objective and the scope of the PER report and introduces each of the four topical chapters and their relevance to addressing Pakistan's fiscal deficits.

1.2 Recent macroeconomic developments and outlook

Economic activity is estimated to have sharply declined over July–December 2022 (H1 FY23). The devastating floods, along with difficulties in securing quality fertilizers and animal feed, have reduced agricultural output and labor opportunities for low-income workers. Similarly, dwindling foreign reserves, import restrictions, flood impacts, high fuel costs, policy uncertainty, and the slowdown in domestic and global demand have affected industry and service sector activity, with large-scale manufacturing output contracting by an average of 3.7 percent over H1 FY23. With the destruction of infrastructure and disrupted access to schools, medical facilities, and sanitation systems, the floods have negatively impacted health and education outcomes especially for rural areas, potentially affecting long-term human capital accumulation.

¹ The FRDLA stipulates a fiscal deficit ceiling of 3.5 percent of GDP and debt ceiling of 60 percent of GDP. However, the fiscal deficit has consistently exceeded 3.5 percent of GDP since FY06, and the Public and Publicly Guaranteed Debt-to-GDP ratio has exceeded 60 percent since FY16.

Pakistan's external account weakened in H1 FY23 as foreign reserves fell significantly. With import controls, the trade deficit contracted by nearly 32 percent y-o-y in H1 FY23. Official remittance inflows also fell by 11.1 percent, partly due to the exchange rate cap that made informal non-banking channels preferable. Any decline in overall remittances would reduce households' capacity to cope with economic shocks, adding pressure on poverty. Overall, the current account deficit shrank to US\$3.7 billion in H1 FY23 from US\$9.1 billion in H1 FY22. With weaker sentiment and lower foreign exchange inflows, the financial account saw the largest half-year deficit in 12 years. Reserves therefore declined from US\$11.1 billion at the end-FY22 to US\$4.8 billion at end-February 2023, equivalent to 0.8 months of total imports. With the release of the exchange rate cap in early 2023, the official exchange rate has fallen by more than 20 percent against the U.S. dollar as of end-February from end-June 2022.

Headline consumer price inflation rose to a multi-decade high of an average of 25.0 percent y-o-y in H1 FY23, up from 9.8 percent in H1 FY22. This reflects the weaker exchange rate, surging global commodity prices, lower domestic fuel and electricity subsidies, and flood-related disruptions. As food constitutes half of their expenditure, the real purchasing power of poor households has fallen significantly with higher food prices, putting poverty gains at risk. The real interest rate remains negative despite the policy rate being raised by a cumulative 625 bps to 20.0 percent since July 2022.

The overall fiscal deficit widened significantly reaching PKR1,683 billion in H1 FY23, 23.0 percent larger than in H1 FY22. This was driven by higher interest payments as interest rates rose and the currency weakened, leading debt servicing costs to jump by 77.1 percent to PKR2,573 billion. Reflecting fiscal consolidation efforts, non-interest expenditure rose by only 8.2 percent with reduced spending on subsidies and grants. Meanwhile, revenue increased by 18.8 percent, supported by higher revenue from direct taxes and hikes in the petroleum development levy. Consequently, the primary balance reached a surplus of PKR890 billion – significantly higher than the surplus of PKR81 billion for H1 FY22.

Real GDP growth is expected to slow sharply in FY23, reflecting corrective tighter fiscal policy, flood impacts, high inflation, high energy prices and import controls. Agricultural output is expected to contract for the first time in more than 20 years due to the floods. Industry output is also expected to shrink with supply chain disruptions, weakened confidence, and higher borrowing costs and fuel prices. The lower activity is expected to spill over to the wholesale and transportation services sectors, weighing on services output growth. Output growth is expected to gradually recover in FY24 and FY25 but remain below potential as low foreign reserves and import controls continue to curtail growth. In the absence of higher social spending, the lower middle-income poverty rate is expected to increase in FY23. Given poor households' dependency on agriculture, small-scale manufacturing, and construction activity, they remain vulnerable to economic and climate shocks. The macroeconomic outlook is predicated on the completion of the IMF-EFF program, sound macroeconomic policy, continued structural reforms, and adequate external financing.

Key risks to the outlook are the non-completion of the IMF program due to policy slippages and non-materialization of expected financing. Additional risks include political instability, deterioration of domestic security and external economic conditions, and financial sector risks associated with revaluation losses, liquidity shortages, and high sovereign exposure. Health and education outcomes are also at risk as the high inflation and reduced incomes could lead poor households to lower school attendance and food intake.

1.3 Pakistan's development experience since 2000

Pakistan has been making progress in terms of economic development, poverty reduction, and human development. Growing at an annual average of 2.2 percent over the fiscal years 2000–22 (FY00–22), Pakistan's real GDP per capita has increased by more than 60 percent, with the country achieving lower-middle income country status in 2009. More importantly, the country has been successful at transforming economic growth into poverty reduction over a sustained period of time. The poverty headcount has declined by more than around two-thirds from 64.3 percent in 2001 to 21.9 percent by FY19. Therefore, Pakistan is the most successful South Asian country for poverty reduction, and also one of the most successful among lower middle-income countries.² Moreover, the country has also made steady improvements in human development (Table 1.1). Between 2000 and 2019, Pakistan's life expectancy at birth increased by 4.5 years (7.2 percent) and mean years of schooling increased by 1.9 years (57.6 percent), implying a nearly 25 percent increase in the value of the Human Development Index.³

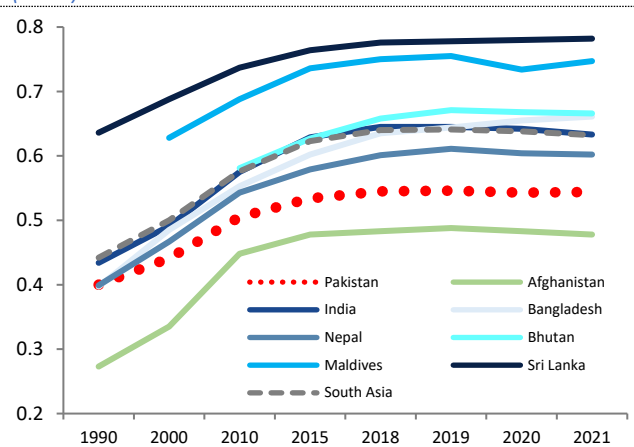
Table 1.1: Pakistan – Trends in Poverty Incidence and Human Development Indicators

Year	Poverty Headcount (percent)*	Life Expectancy at Birth (years)	Mean Years of Schooling (years)	HDI Value
2000	64.3**	62.8	3.3	0.441
2010	36.8	65.3	4.7	0.505
2015	24.3	66.6	5.1	0.534
2019	21.9	67.3	5.2	0.546
2021	..	66.1	4.5	0.544

Source: UNDP (2022). Human Development Report 2020. Briefing note for countries on the 2020 Human Development Report – Pakistan.
Notes: * Based on national poverty line; ** Poverty headcount for 2001.

Despite these successes, Pakistan's human development has been growing more slowly than regional peers. While the country has made improvements in human development, other South Asian countries have seen stronger progress, implying that Pakistan has fallen behind relative to the rest of the region (Figure 1.1). In addition to the need for more human capital investment, Pakistan also has considerable infrastructure needs. The 2019 Global Competitiveness Report ranks Pakistan 105 out of 141 countries in terms of infrastructure quality, lower than regional comparators such as India and Sri Lanka.⁴ Empirical research has shown that the infrastructure gap is a fundamental constraint to

Figure 1.1: Human Development Index (HDI) trend for South Asian countries, 1990–2021 (index)



Source: UNDP Human Development Report (various years)

² World Bank (2020). *Islamic Republic of Pakistan: Leveling the Playing Field. Systematic Country Diagnostic*. September.

³ The regressions in human development from 2019 to 2021 are largely on account of the effects of the COVID-19 pandemic.

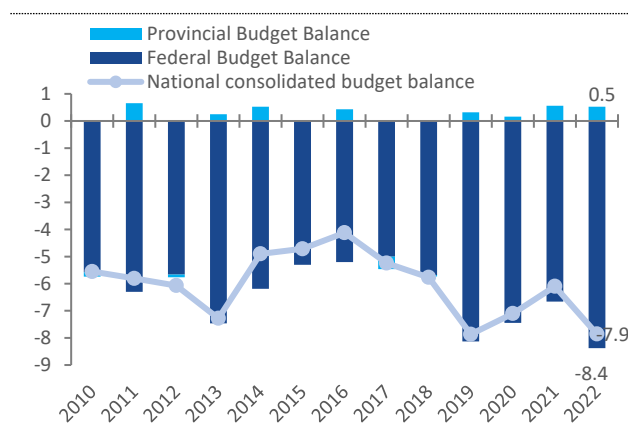
⁴ World Economic Forum (2019). *The Global Competitiveness Report 2019*. Geneva: World Economic Forum.

growth,⁵ and a World Bank study⁶ estimated Pakistan’s infrastructure gap to be substantial and recommends infrastructure spending to be raised to at least 4.5 percent of GDP for sustained economic growth. Therefore, Pakistan needs to invest more in both human and physical capital for sustained productivity-led growth. However, due to large and persistent government fiscal deficits and high public debt, there is little fiscal space for the Government to undertake the required physical and human capital investment. Therefore, reducing the government fiscal deficit to regain fiscal and debt sustainability, and gradually expanding the fiscal space required for growth-enhancing investments is critical for the country’s sustainable long-term economic development.

1.4 Persistent budget deficits and their effects on the Pakistan economy

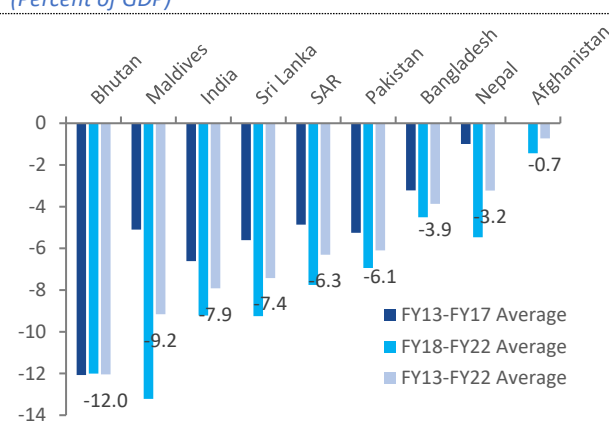
Pakistan’s fiscal deficits have been large, persistent, and growing. In FY22, Pakistan’s general government fiscal deficit (excluding grants)⁷ stood at 7.9 percent of GDP in FY22, matching the FY19 deficit to be the highest for at least the last 22 years⁸ (Figure 1.2 and Table 1.2). The deficit has been persistently high, averaging 6.1 percent of GDP over the past decade, a notch below the South Asia regional average of 6.3 percent (Figure 1.3).⁹ In addition, the country’s fiscal deficit has been growing, with the post-2010 annual average significantly larger than its pre-2010 average.

Figure 1.2: Pakistan: Government Budget Balances (Percent of GDP)



Source: Ministry of Finance, World Bank staff calculations

Figure 1.3: South Asia: General Government Budget Balances (Percent of GDP)



Source: Ministry of Finance, World Bank staff calculations

The federal government fiscal deficit is the key driver of the national fiscal deficit. Over FY10-22, the Federal Government consistently ran a deficit every year, averaging at 6.1 percent of GDP. In contrast,

⁵ See Muhammad Javid (2019). "Public and Private Infrastructure Investment and Economic Growth in Pakistan: An Aggregate and Disaggregate Analysis," Sustainability, MDPI, Open Access Journal, vol. 11(12), pages 1-1, June; Mehar, M.A. (2020). Infrastructure Development and Public-Private Partnerships: Measuring Impact of Urban Transport Infrastructure.

⁶ Loayza, Norman and Tomoko Wada (2012). *Public Infrastructure Trends and Gaps in Pakistan*. World Bank Policy Paper Series on Pakistan; No. PK 10/12. Washington, DC. © World Bank.

⁷ Grants that averaged 0.1 percentage point of GDP over FY13-FY22.

⁸ In 2022, Pakistan released official national account statistics were rebased from a base year of 2005-06 to 2015-16. However, base year 2015-16 national accounts data for the years prior to FY2000 have yet to be published. Therefore, GDP data at the 2015-16 base is currently not available for the years prior to FY2000, which implies that official deficit-to-GDP shares prior to FY2000 are also not available.

⁹ In line with the COVID pandemic and the more recent commodity price shocks, fiscal deficits have risen across the oil importing region.

the provinces typically contributed small fiscal balances with the annual aggregated provincial budget balance averaging at a surplus of 0.2 percent of GDP over the same time period. Therefore, the federal government budget shortfall is overwhelmingly the key driver of the general government¹⁰ fiscal deficit.

Table 1.2: Key Fiscal Indicators, Pakistan FY2010 to FY2022

(Percent of GDP unless otherwise noted)

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Revenue and Grants	12.7	11.2	11.5	12.0	13.5	12.8	13.7	14.0	13.4	11.3	13.3	12.4	12.1
Total revenue	12.4	11.0	11.4	11.8	12.8	12.7	13.6	13.9	13.3	11.2	13.2	12.4	12.0
Tax revenue¹	8.8	8.3	9.1	8.9	9.2	9.8	11.2	11.2	11.4	10.2	10.0	10.3	10.4
Federal	8.5	7.9	8.6	8.3	8.5	9.1	10.3	10.3	10.4	9.3	9.1	9.4	9.5
Direct taxes	3.2	2.9	3.2	2.9	3.1	3.3	3.6	3.8	3.9	3.3	3.2	3.1	3.4
Sales tax on goods	3.1	3.1	3.6	3.3	3.5	3.5	4.0	3.7	3.8	3.3	3.4	3.6	3.8
Customs duties	1.0	0.9	1.0	1.0	0.9	1.0	1.2	1.4	1.6	1.6	1.3	1.4	1.5
Federal Excise Duty	0.7	0.7	0.5	0.5	0.5	0.5	0.6	0.6	0.5	0.5	0.5	0.5	0.5
Other taxes	0.5	0.4	0.3	0.6	0.5	0.7	0.8	0.8	0.6	0.6	0.7	0.9	0.3
Provincial	0.3	0.3	0.5	0.6	0.7	0.7	0.9	0.9	1.0	0.9	0.9	0.9	0.9
Non-tax revenue	3.6	2.7	2.3	3.0	3.7	3.0	2.4	2.7	1.9	1.0	3.2	2.0	1.6
Federal	3.2	2.4	2.1	2.7	3.5	2.7	2.1	2.5	1.6	0.8	3.0	1.8	1.4
Provincial	0.4	0.3	0.2	0.3	0.2	0.2	0.3	0.2	0.4	0.2	0.2	0.3	0.2
Grants	0.3	0.2	0.2	0.1	0.7	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	18.0	16.8	17.4	19.1	17.7	17.4	17.7	19.1	19.1	19.1	20.3	18.5	19.9
Current expenditure	14.3	14.1	13.8	14.5	14.1	14.3	14.3	14.6	14.9	16.2	17.9	16.3	17.2
Federal	10.5	10.2	9.6	10.2	10.0	9.8	9.6	9.8	9.7	10.9	12.7	11.2	12.5
Interest	3.8	3.4	3.9	3.9	4.1	4.2	3.9	3.8	3.8	4.8	5.5	4.9	4.8
Superannuation allowances & pension	0.4	0.5	0.6	0.7	0.6	0.6	0.7	0.9	0.9	0.9	0.9	0.8	0.8
Transfers (other than provinces) ²	1.5	1.1	1.0	0.9	1.0	0.9	1.1	1.0	1.0	1.0	1.8	1.5	1.7
Defense	2.2	2.2	2.2	2.1	2.2	2.3	2.3	2.5	2.6	2.6	2.6	2.4	2.1
Others ³	2.5	2.9	1.7	2.5	2.1	1.8	1.6	1.6	1.4	1.6	1.9	1.7	3.1
Provinces	3.7	4.0	4.3	4.3	4.1	4.5	4.7	4.9	5.3	5.3	5.3	5.1	4.7
Development expenditure & net lending	3.9	2.5	3.3	4.5	4.4	3.7	4.0	4.7	4.1	2.8	2.5	2.4	2.5
Federal	2.4	1.3	1.6	3.0	2.8	2.1	2.2	2.3	1.9	1.6	1.2	1.0	0.7
Provincial	1.5	1.2	1.7	1.5	1.5	1.6	1.8	2.4	2.2	1.2	1.3	1.4	1.8
Statistical discrepancy	-0.2	0.2	0.3	0.1	-0.8	-0.6	-0.6	-0.2	0.0	0.1	-0.2	-0.2	0.2
Overall balance (excluding grants)	-5.6	-5.8	-6.1	-7.3	-4.9	-4.7	-4.1	-5.2	-5.8	-7.9	-7.1	-6.1	-7.9
Overall balance (including grants)	-5.3	-5.6	-5.9	-7.2	-4.2	-4.6	-4.0	-5.2	-5.7	-7.8	-7.0	-6.0	-7.8
Financing	-5.6	-5.8	-6.1	-7.3	-4.9	-4.7	-4.1	-5.2	-5.8	-7.9	-7.1	-6.1	-7.9
External	1.1	0.5	0.6	0.0	1.8	0.6	1.1	1.5	2.0	1.0	1.9	2.4	1.8
Domestic	4.4	5.3	5.5	7.3	3.1	4.1	3.0	3.7	3.8	6.9	5.2	3.7	6.1
Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public and publicly guaranteed debt	57.4	55.0	58.5	59.1	58.4	58.4	62.5	63.2	67.1	78.0	81.1	75.6	78.0
Memorandum items													
Primary balance (excluding grants)	-1.7	-2.4	-2.1	-3.3	-0.9	-0.5	-0.3	-1.4	-1.9	-3.1	-1.6	-1.2	-3.1
Primary balance (including grants)	-1.4	-2.2	-2.0	-3.2	-0.2	-0.4	-0.2	-1.4	-1.8	-3.0	-1.5	-1.1	-3.0
GDP (PKR billion)	16733	20570	22563	25195	28328	30888	32725	35553	39190	43798	47540	55796	66950

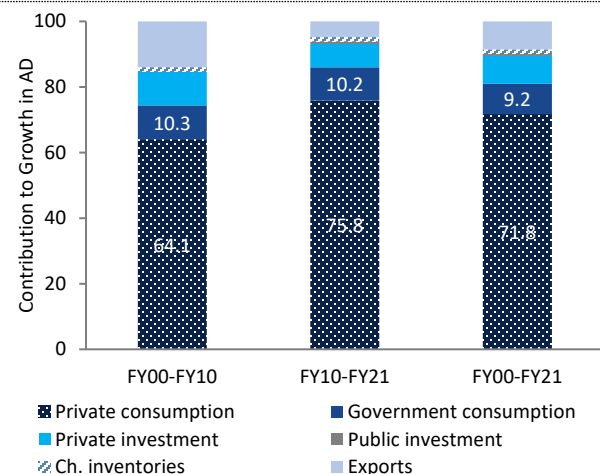
Source: Ministry of Finance, World Bank Staff calculations

Notes:

1. From FY21 onwards, the Ministry of Finance has included revenue from Gas Infrastructure Development Cess, natural gas development surcharge, and petroleum levy in non-tax revenue. For consistency of analysis across years, these taxes have been included in tax revenue.
2. For FY20 onwards, this includes the Ehsaas Program
3. This includes other object classifications including operating expenses of the Federal Government, civil and military salary, subsidies, and repairs and maintenance.

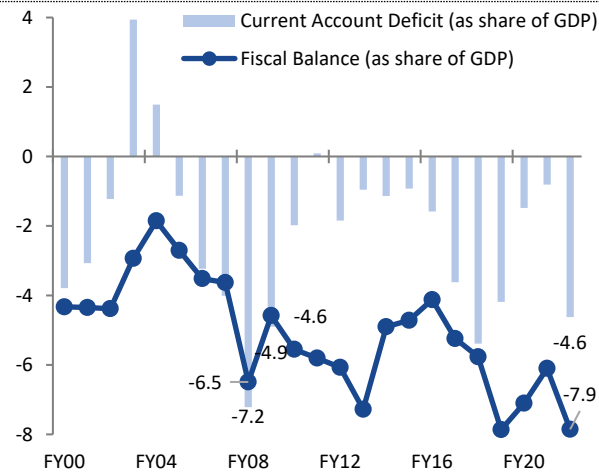
¹⁰ The general government defined as the Federal Government and the provincial governments combined.

Figure 1.4: Contributions to Real GDP Growth
(Percent of GDP)



Source: World Bank (2022a)

Figure 1.5: Pakistan’s Twin Deficits
(Percent of GDP)



Source: Ministry of Finance, World Bank staff calculations

The large fiscal deficits have contributed to the recurrent surges in the current account deficit and boom-bust cycles. Pakistan’s economic growth has been largely consumption-driven, with high contributions from private and government consumption, but low contributions from productivity-enhancing investments and exports (Figure 1.4). As a result, total factor productivity in Pakistan has been declining (World Bank, 2022a) and limiting potential growth.¹¹ In periods of strong aggregate demand that exceeds potential growth, such as the one recently seen with the post-COVID recovery, strong economic growth comes at a cost of imbalances that often results in sizeable current account deficits and high inflation.¹² Therefore, Pakistan’s fiscal and current account deficits empirically tend to move together or are correlated (Figure 1.5). Remedial cooling policy measures are ultimately required to tame the external pressures, resulting in recurrent boom-bust cycles and economic volatility that deter investment, further weighing productivity and longer-term economic development.

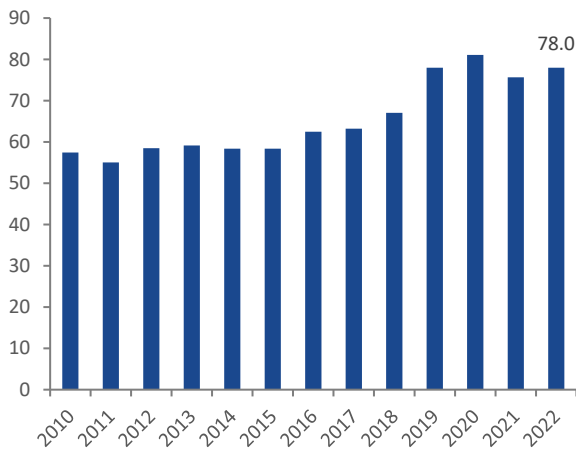
The persistence of fiscal deficits has led to a rapid accumulation of public debt. Apart from the volatile economic environment, the financing of the persistent fiscal deficits leads to other distinct but related macroeconomic challenges. Over time, the large fiscal deficits have led to a sustained increase in public and publicly guaranteed (PPG) debt, which stood at 78.0 percent of GDP at the end of FY22, after reaching an all-time high of 81.1 percent in FY22 (Figure 1.6 and Chapter 3). The PPG debt share was less than 60 percent of GDP in FY15, only 7 years ago. When compared across the region for the past 10 years, the country’s average public debt share was also higher than the regional average (Figure 1.7). Indeed, Pakistan is one of the most indebted countries in the world. Based on the FY19 debt-to-GDP ratio, Pakistan ranks in the 75th percentile of global indebtedness (Figure 1.8). As mentioned, both the deficit and debt levels are in breach of the fiscal rules stipulated by FRDLA (2005) that specifies a fiscal deficit ceiling of 3.5 percent of GDP and a debt ceiling of 60 percent of GDP.¹³

¹¹ World Bank (2022a). *From Swimming in Sand to High and Sustainable Growth: A Roadmap to Reduce Distortions in the Allocation of Resources and Talent in the Pakistani Economy*. Islamabad: World Bank.

¹² Pakistan’s current deficit was 4.6 percent of FDP in FY22, the largest in four years. Similarly, consumer price inflation for FY22 averaged 12.1 percent, sharply higher than the 8.9 percent for FY21.

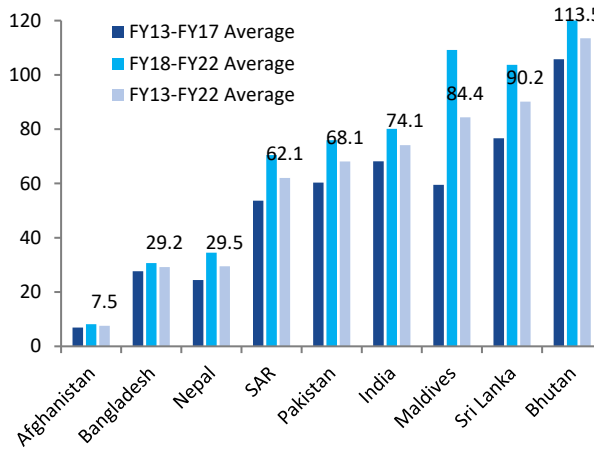
¹³ See footnote 1.

Figure 1.6: Pakistan: Public and Publicly Guaranteed Debt
(Percent of GDP)



Source: Ministry of Finance, World Bank staff calculations

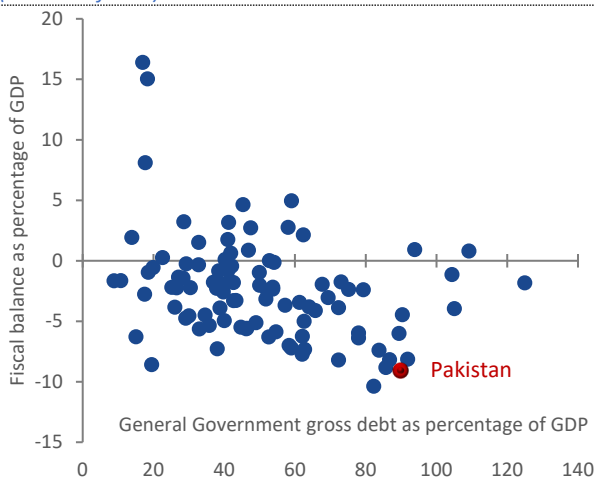
Figure 1.7: South Asia: Public and Publicly Guaranteed Debt
(Percent of GDP)



Source: World Bank MF-Mod database, World Bank staff calculations

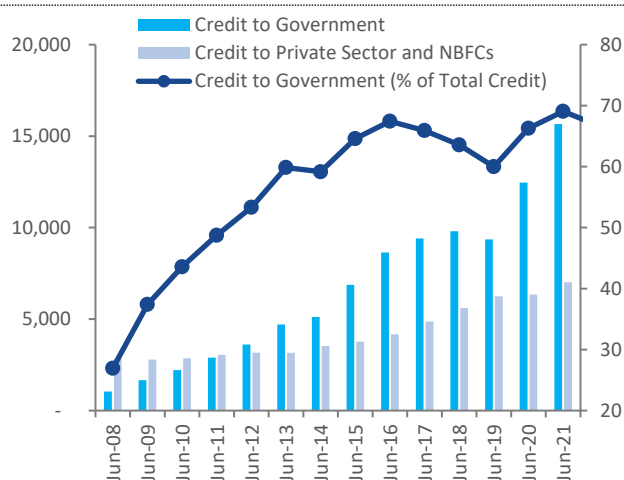
The fiscal deficit and its financing have led to a strong sovereign-financial sector nexus in Pakistan. The continued sizeable fiscal deficits have contributed to a buildup of public debt held by the domestic financial sector. In July 2022, more than 70 percent of all bank credit was extended to the public sector, reflecting a deep sovereign–financial sector nexus (Figure 1.9). Therefore, the health of Pakistan’s financial sector has become intertwined with the financial health of the Government, heightening macroeconomic risks in the event of a severe fiscal shock.

Figure 1.8: Fiscal deficit and debt – peer comparison for FY19
(Percent of GDP)



Source: Ministry of Finance, World Bank staff calculations

Figure 1.9: Government Borrowing from Banks, FY11–21
(PKR billions, percent of total)



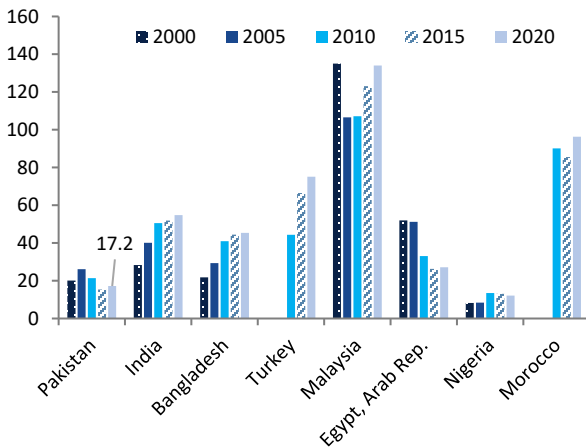
Source: World Bank (2022b)¹⁴

The extensive government borrowing from the financial sector has crowded out the private sector. Credit to the Government, which includes investments in government securities, direct lending for

¹⁴ World Bank (2022b). Pakistan Development Update: Financing the Real Economy. April. Islamabad: World Bank.

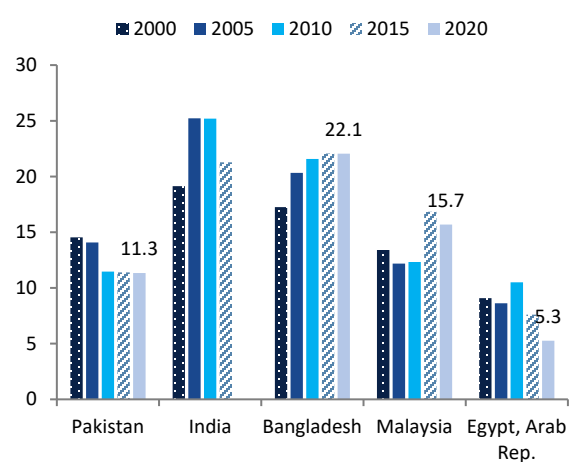
commodity operations, and lending to SOEs, has increased by more than 400 percent over FY11–21. The increased exposure to the public sector has contributed to the crowding out of credit to the private sector, which has fallen to 17.2 percent in 2020, one of the lowest among emerging economies (Figure 1.10). At the same time, the reduced access to credit is one of the contributing factors for the low levels of private investment and hence low productivity growth in Pakistan (World Bank, 2022b and Figure 1.11)

Figure 1.10: Credit to the Private Sector
(Percent of GDP)



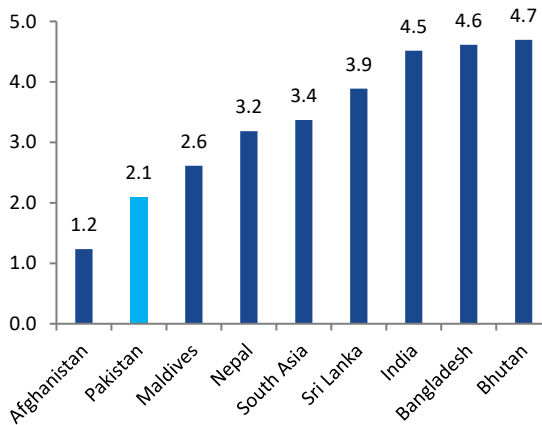
Source: World Development Indicators (WDI) and World Bank (2022b)

Figure 1.11: Private investment, selected years
(Percent of GDP)



Source: World Development Indicators (WDI) and World Bank (2022b)

Figure 1.12: Average annual real GDP per capita growth, 2000-2021
(percent)



Source: World Development Indicators
Notes: Average for Afghanistan is for the years 2003 to 2021.

The large public debt stock crowds out development expenditure and public investment.

In part due to the large public debt stock, debt servicing costs constitute a large share of fiscal expenditures and have been increasing over time, together with the rapid accumulation of debt. Spending on interest payments stood at 4.7 percent of GDP in FY22 and accounted for 35 percent of total federal spending in FY22 (Chapters 3 and 4). The large interest expenditures, together with government salaries, pensions, and government operating expenses, imply that more than 70 percent of total federal spending is pre-committed and largely rigid, leaving little fiscal space for growth-enhancing development expenditure and public investments, such as infrastructure development. Indeed, Section 2.2.2 (in Chapter 2) presents evidence showing that interest payments crowd out development expenditure, which itself is small and declining: in FY22, the federal government only spent 1.15 percent of GDP on development projects. Therefore, the persistent fiscal deficit and its financing can stymie long-term economic growth due to inadequate public and private investment. This is especially the case when the deficit was not used to finance public capital expenditures.

Regaining fiscal and debt sustainability can result in a sustained higher growth path. Partly due to the consumption-driven pattern of economic growth and the recurrent spells of economic volatility, Pakistan’s growth of real GDP per capita has been relatively low, averaging at 2.1 percent, over the past 2 decades. This pace is considerably slower than most other countries in the region (Figure 1.12). Should Pakistan undertake a decisive fiscal consolidation effort to regain fiscal and debt sustainability by narrowing the deficit to 3.5 percent of GDP and reducing the debt stock to 60 percent of GDP as per the FRDLA ceilings, then fiscal space will expand over time, and the savings from lower interest expenditures can be gradually applied to productivity-enhancing public investment. With reduced crowding out and improved macro-fiscal stability, private investment is also likely to strengthen. With higher investment, the country can step up onto a higher growth path and achieve more rapid economic development (Box 1.1).

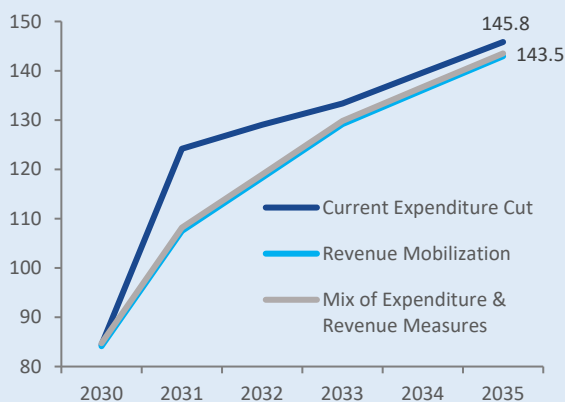
Box 1.1: Growth Dividends from Fiscal Consolidation

Fiscal consolidation can lead to stronger economic growth and higher level of output in the long term. Pakistan’s large fiscal deficits and high public debt are contributing factors to the country’s low public and private investment rates. There are economic growth enhancing benefits to be reaped in the longer term from fiscal consolidation through at least three related channels:

1. Lower fiscal and macroeconomic volatility reduces economic uncertainty and provides a more conducive environment for doing business and private investment.
2. With smaller fiscal deficits, a lower debt stock, and less government borrowing, there will be a greater availability of domestic financing to the private sector, encouraging more private investment.
3. With sustained fiscal consolidation, debt servicing costs will also decline and the gradually expanding fiscal space could be used for more public investment.

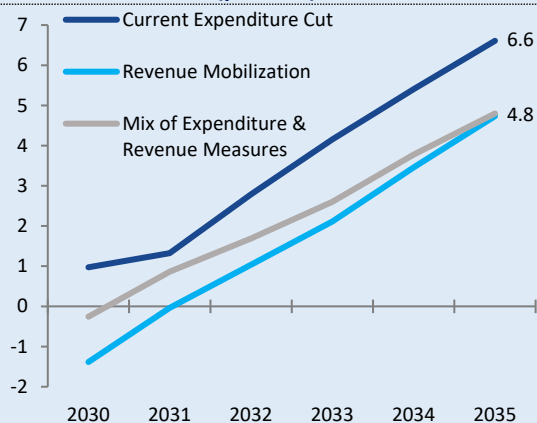
To simulate the growth effects from channels 2 and 3 through higher private and public investment, respectively, we assume the Government undertakes a sharp fiscal consolidation to bring the overall fiscal deficit to 3.5 percent of GDP by FY25, in line with the FRDLA deficit threshold. Fiscal consolidation is implemented by cutting current fiscal expenditure, raising more domestic revenues, or a combination of the two. Thereafter, with the fiscal deficit held constant at 3.5 percent of GDP, any and all fiscal savings from the smaller deficit relative to the baseline is applied to public debt principal repayments, which will shrink the stock of public debt and associated debt servicing costs. When the debt stock falls below 60 percent of GDP, which is the FRDLA threshold for public debt, all subsequent fiscal savings thereafter are channeled to increasing public investment to support economic growth.

Figure B1.1: Public investment, percent deviation from baseline values (percent)



Source: World Bank staff simulations

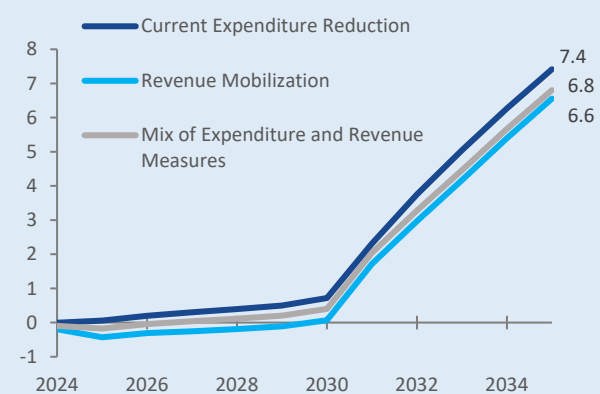
Figure B1.2: Private investment, percent deviation from baseline values (percent)



Source: World Bank staff simulations

Irrespective of the mode of fiscal consolidation, the simulations show that the public debt stock will decline just below 60 percent of GDP by FY29. Moreover, the results show that with the fiscal savings being applied to public investment, public investment will increase to nearly 150 percent of the corresponding baseline values by 2035, for all three modes of fiscal consolidation (Figure B1.1). At the same time, due to reduced crowding out, private investment will also rise by 4.8 to 6.6 percent higher than their corresponding baseline values by 2035 (Figure B1.2). With both higher public and private investments from 2029, (real GDP and) real GDP per capita could gradually increase and, by 2035, could be between 6.6 percent to 7.4 percent larger than their corresponding baseline real GDP per capita values, depending on the method of fiscal consolidation (Figure B1.3).^{1,2}

Figure B1.3: Real GDP per capita, percent deviation from baseline values (percent)



Source: World Bank staff simulations

¹ The above simulations illustrate the second and third channels of growth effects from fiscal consolidation. Accounting for the first channel of reduced macro volatility would tend to further increase the overall long-term economic growth benefits from fiscal consolidation.

² The public investment fiscal multiplier assumed for this simulation was based on estimates from Haque, N., H. Mukhtar, N. Ishtiq and J. Gray (2020). Doing Development Better. Pakistan Institute of Development Economics.

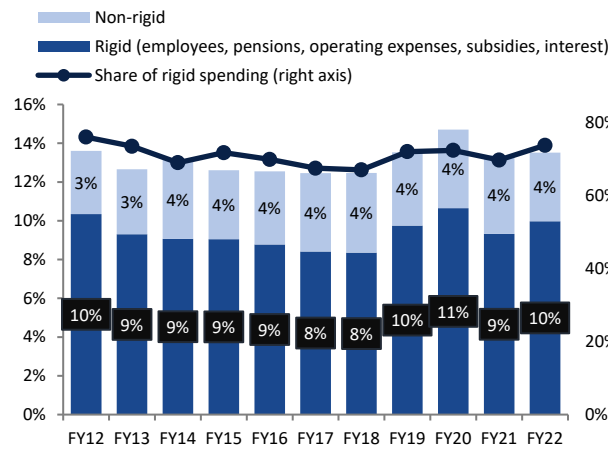
1.5 Drivers of Persistent Fiscal Deficits

Apart from being large, Pakistan’s federal fiscal deficits have also been persistent. A few key drivers of the country’s persistent federal budget shortfalls include rigid fiscal expenditures, low revenue collections, and macroeconomic and institutional factors, such as the intergovernmental framework and the fragmentation of fiscal institutions.

1.5.1 Rigid expenditures and low revenue collections

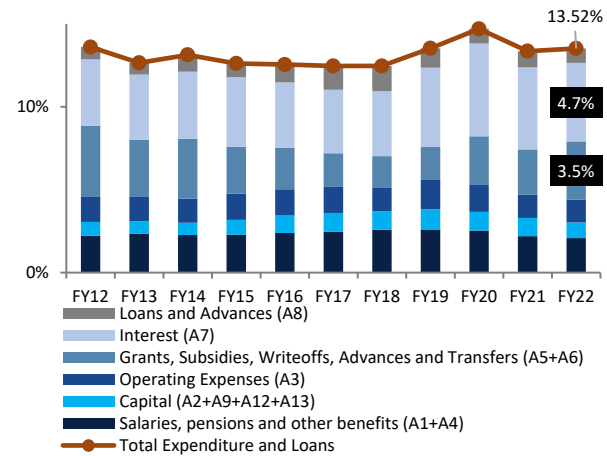
Federal government spending is largely rigid, providing little scope for fiscal consolidation by reducing discretionary expenditures. One of the factors driving the persistence of large fiscal deficits is the rigidity of federal government expenditures. The federal government expenditure, standing at 13.5 percent of GDP in FY22, is not high by international comparison. However, more than 70 percent of total expenditures were allocated to pre-committed areas, such as interest payments, salaries, pensions, subsidies, and government operating expenses (Figure 1.13). With such a high share of pre-committed expenditures, and the correspondingly low share of discretionary expenditures, opportunities for fiscal consolidation through expenditure reduction is limited, barring deep fiscal reforms.

Figure 1.13: Federal government spending, by rigidity (percent of GDP)



Source: Reproduced from Chapter 2; World Bank Staff calculations based on PIFRA data.

Figure 1.14: Federal government spending, economic classification (percent of GDP)



Source: World Bank Staff calculations based on PIFRA data.

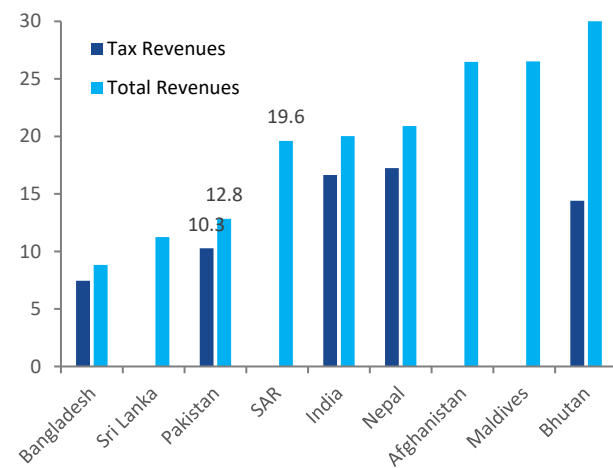
Interest payments, transfers and subsidies, and payments to public sector staff constitute the three largest spending categories of federal fiscal expenditures. Standing at 35 percent of total federal spending (4.7 percent of GDP) is debt servicing expenditure on interest payments for the public debt stock, which is rigid and non-discretionary, and the largest spending category (Figure 1.14). Given the large stock of public debt plus the high and still increasing domestic and external interest rates, interest payments have been ballooning and will constitute an even larger share of federal fiscal expenditures in FY23. Subsidies, grants, and other transfers to individuals, subnational governments, or publicly owned entities is the second largest spending category, accounting for 26 percent of total spending in FY22 (3.5 percent of GDP). Spending on public sector staff, including on salaries and pensions, is Pakistan’s third spending driver, accounting for 15 percent total spending in FY22 (nearly 3 percent of GDP).¹⁵

Pakistan’s fiscal revenue collection is low and has been falling. Persistent low fiscal revenue is another driver of Pakistan’s persistent fiscal deficit. Pakistan’s total revenue collection averaged 12.8 percent of GDP over the past decade, substantially lower than the South Asia regional average of 19.6 percent (Figure 1.15). In addition, the country’s total revenue collection has been falling over time, with the FY18-22 average at 12.5 percent of GDP, down from the FY13-17 average of 13.2 percent. Tax revenue collection, which averaged at 10.3 percent of GDP over the past decade, is also low, but has increased modestly over the past decade (Figure 1.16). For Pakistan, increasing tax rates may not yield more revenue collection, due to the existence of Laffer Curve effects. (Box 1.2).¹⁶

¹⁵ Chapter 2 on Expenditures discusses each of these spending categories in detail and suggests avenues to rationalize them.

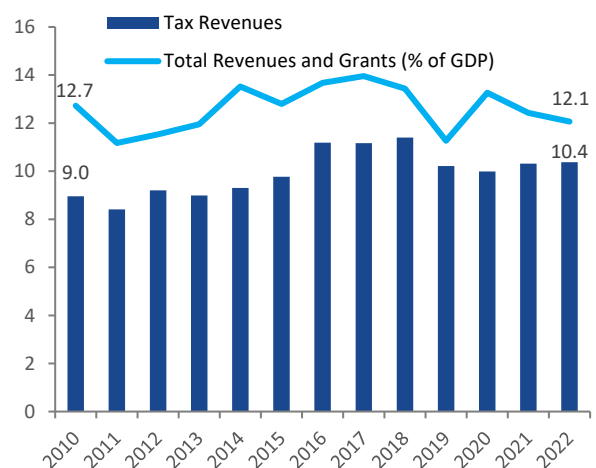
¹⁶ For this reason, Chapter 5 on Revenues mostly suggests base broadening measures to enhance revenue collection.

Figure 1.15: Total and Tax Revenues, Average 2013–22
(Percent of GDP)



Source: World Bank Macro Poverty Outlook (MPO) database

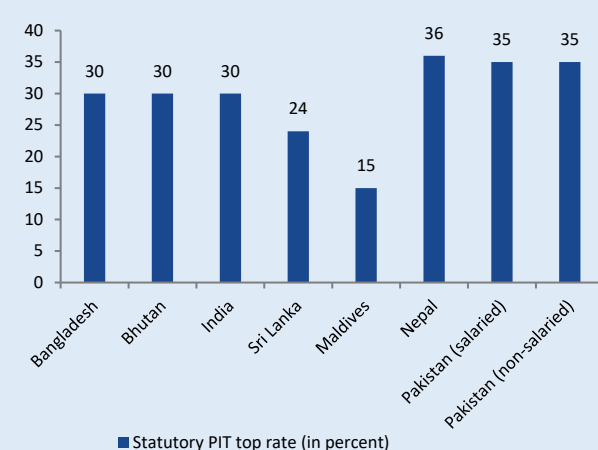
Figure 1.16: Pakistan: Total and tax revenue
(Percent of GDP)



Source: World Bank Macro Poverty Outlook (MPO) database

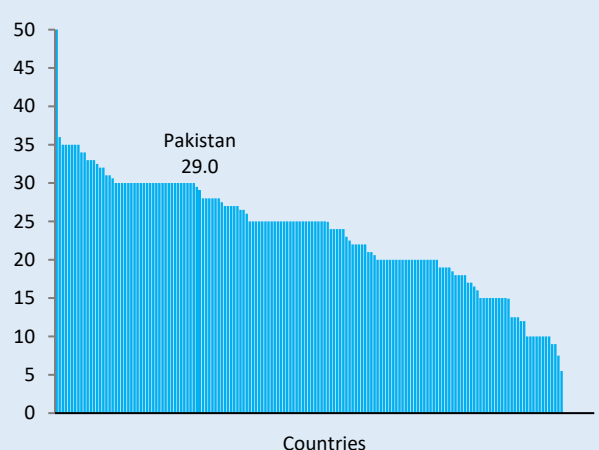
Box 1.2: High tax rates and Laffer Curve Effects

Figure B.2.1: Statutory top personal income tax rates
(percent of GDP)



Source: World Bank staff calculations

Figure B.2.2: Corporate income tax rates
(percent of GDP)



Source: KPMG data World Bank staff calculations

Pakistan’s tax rates are already among the highest in South Asia and relatively high globally, with GST tax rates on goods at 18 percent and the highest personal and corporate income tax rates at 35 and 29 percent, respectively (Figure B.2.1 and Figure B.2.2). Several studies, such as Latif et al. (2019),¹⁷ Mehmood et al. (2022)¹⁸ have found empirical evidence indicating the presence of Laffer curve effects for both direct and indirect taxes. More specifically, these studies have found that tax rates are so high that further increases tend to yield less revenue due to reduced economic activity, and/or compliance, and movement into informality. In particular, Waseem (2018)¹ found that in response to a corporate tax rate increase, Pakistani firms reported less earnings than before while others stopped reporting altogether, resulting in an overall decrease in corporate tax revenue.

¹⁷ Latif, M. I, H. Rahman, H. Ahmad, F. Ahmad, M. M. Khurshid and M. N. Shafique (2019). “Estimation of Laffer Curve: Evidence from Pakistan.” Sarhad Journal of Management Sciences (SJMS). Vol. 5, Issue 1, June.

¹⁸ Mehmood K., S. Ahmad, T. Mehmood, M. Mohsin and M. Ishfaq (2022). “Does Laffer Curve Exist in Tax Structure of Pakistan? A Threshold Regression Analysis.” Journal of Economic Impact. Vol 4, No. 1, pp.145-149.

In an effort to determine the presence of such Laffer curve effects using more recent data, we conducted an event study using quarterly data on direct tax revenue from Q1 2006 to Q3 2022, and within that time span personal and corporate income tax rates for the top brackets were increased to 35 percent in Q1 2020. Using a simple regression analysis with quarter-specific dummies, we found statistically significant decreases in direct tax revenue collected in the quarter of the tax rate increase, as well as in most of 4 quarters preceding and the 4 quarters following the tax rate increase. The result is in line with the findings of existing studies referenced above, indicating that further increases in tax rates are likely to yield lower tax revenues because taxpayers are able to relatively easily undertake means to reduce or avoid paying taxes on account of Pakistan's large informal economy and low enforcement.

Based on these Laffer curve effects, lowering tax rates while simultaneously broadening the tax base by reducing exemptions should lead to increased revenue collections while decreasing economic distortions (Section 5.4).

¹ Waseem M. (2018). "Taxes, informality and income shifting: Evidence from a recent Pakistani tax reform." *Journal of Public Economics*. Vol. 157, pp. 41-77.

1.5.2 A challenging intergovernmental framework

The decentralization initiative in 2010 has contributed to the persistence of fiscal deficits at the federal government level. The 18th Constitutional Amendment and the 7th National Finance Commission (NFC) Award¹⁹ in 2010 fundamentally changed the national fiscal architecture and led to significant fiscal asymmetry between the Federal and Provincial Governments (Box 1.3). This change contributed to the emergence of larger fiscal deficits post-2010, over and beyond the deficit-widening effects of low revenue collection and high expenditure rigidities at the Federal Government level.

Box 1.3: Pakistan's fiscal federalism structure

Pakistan is a federal republic comprising four provinces, the federal capital and two autonomous regions. Under the constitution, the federal government is primarily responsible for defense, external affairs, natural resources, energy, and the regulatory functions, whereas all the residual economic and social functions, including service delivery, are assigned to the provincial governments. The current assignment of responsibilities was implemented in 2010 under the 18th Constitutional Amendment, which attempted to enhance the fiscal autonomy of the provinces.

The tax bases are constitutionally split between federal and provincial governments. Among direct taxes, the federal government is tasked with collecting personal and corporate income tax (except for income derived from agriculture) and capital value tax (excluding immovable property) whereas among indirect taxes, it collects custom duties, federal excises, and the General Sales Tax (GST) on goods. These taxes are shared revenues, though their base and rate are set by the federal government. The following direct taxes are assigned to the provinces: urban immovable property tax (UIPT), agricultural income tax and capital gains tax (on property). In indirect taxes, provinces have the authority over GST on services, tax on professions, motor vehicle tax, and stamp duty, among others. Such division of taxing powers have led to tax arbitrage and tax evasion and an enormous tax compliance challenge for businesses.

The vertical distribution of revenue is governed by the National Finance Commission award. The 7th NFC award, implemented in 2010 following the 18th Amendment and in effect since then, altered the vertical distribution of revenue by giving provinces 57.5 percent share of the divisible pool of federal revenues.¹ The current formula for

¹⁹ The National Finance Commission Award decides the division of revenues among federating units.

provincial transfers is based on population (82 percent); poverty or backwardness (10.3 percent); revenue collection or density (5.0 percent) and inverse population density (2.7 percent).

The 7th NFC award reduced the Federal Government's share in the divisible pool of revenues without any corresponding reduction in its expenditure mandates. As a result, in FY22, for example, the Federal government retained about 40 percent of total tax revenue while federal spending constituted 67 percent of total expenditure. In the same year, provinces received 58 percent of the federal divisible pool of revenues, which was equivalent to 83 percent of the total provincial expenditure.

Provincial debt consists of external multilateral loans. Provinces largely borrow through concessional loans from multilateral banks that are officially contracted by the Federal Government on behalf of the provincial governments and (their rupee value) is on-lent to the provinces. Constitutionally, provinces are also empowered to borrow externally or domestically, subject to limits set forth by the National Economic Council. However, provinces cannot raise any loan without the consent of the Federal Government if it already has an outstanding loan to the Federal Government.² Provincial governments also borrow directly from commercial banks for state trading in agricultural commodities. While these loans are guaranteed by the Federal Government, their valuation is currently zero, as they are assumed to be backed by commodity stocks.

¹ The divisible pool of revenue includes almost the entire revenue of the Federal Board of Revenue, with deductions only for workers welfare fund contributions, federal GST on services, excise duty on natural gas, and charge for Export Development Fund.

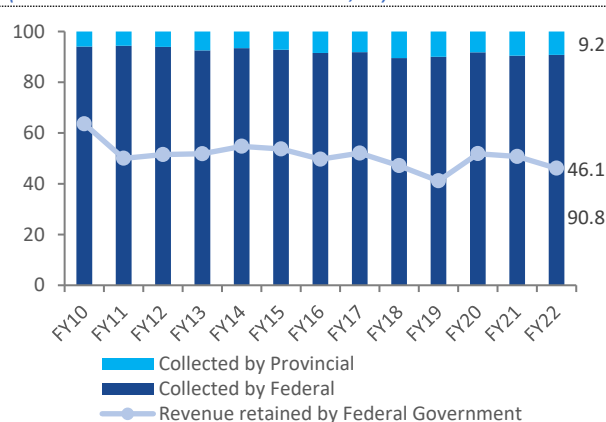
² Article 167 of the Constitution. Source: <https://www.infopakistan.pk/constitution-of-pakistan/article/167-Borrowing-by-Provincial-Government>.

Incomplete fiscal decentralization is likely to have led to spending inefficiencies. The 18th Constitutional Amendment transferred many fiscal responsibilities from the federal government to the provinces.²⁰ The Amendment explicitly specifies federal functions and assigned all residual functions to the provincial governments. Notwithstanding this reassignment, the Federal Government continues to retain some devolved spending functions concurrently with the provinces. Under the 18th Constitutional Amendment, the Federal Government is only assigned 16 core expenditure functions, but there are still 34 federal ministries. In addition, the Federal Government has also maintained a similar number of employees in devolved areas as before the 18th amendment. This incomplete fiscal decentralization is likely to have led to redundancies, duplication of tasks and costs, inefficient use of resources and higher than optimal expenditures at the federal level.²¹

²⁰ 17 subject areas were devolved to the provinces. These included: Culture, Education, Environment, Food and Agriculture, Health, Labor and Manpower, Livestock and Dairy Development, Local Government and Rural Development, Minorities' Affairs, Population Planning, Social Welfare and Special Education, Special Initiatives, Sports, Tourism, Women Development, Youth Affairs, and Zakat and Ushr. These were functions that under the Constitution could be concurrently performed by the federal and provincial governments but were mainly performed by the Federal Government.

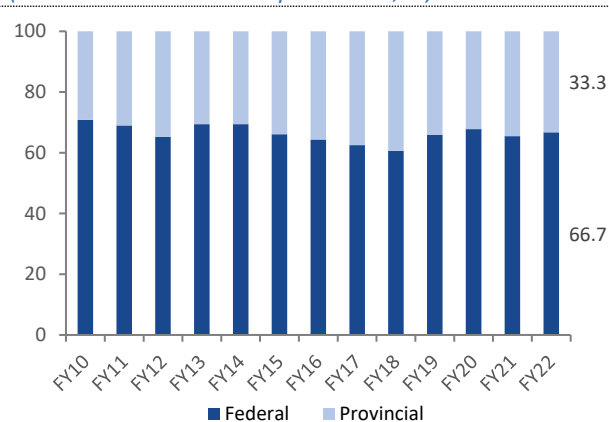
²¹ Chapter 2 on Expenditure provides suggestions for completing the current partial devolvement.

Figure 1.17: Federal and provincial government shares of fiscal revenues
(Share in consolidated revenues, %)



Source: Ministry of Finance and World Bank staff calculations

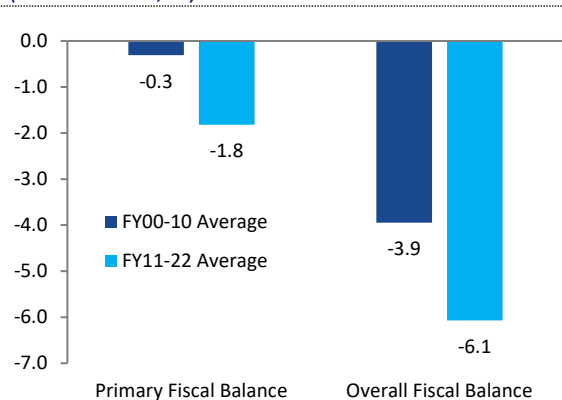
Figure 1.18: Federal and provincial government shares of fiscal expenditures
(Share in consolidated expenditures, %)



Source: Ministry of Finance and World Bank staff calculations

The 18th Amendment and 7th NFC Award resulted in significant vertical fiscal asymmetry. According to the 7th NFC Award, approximately three-fifths of the consolidated revenues accrue to the provinces,²² while the Federal Government assumes responsibilities for two-thirds of total general government expenditures. More specifically in FY22, the Federal Government only retained around 46 percent of total tax revenue, despite collecting about 91 percent of it (Figure 1.17). In the same year, federal spending constituted about 67 percent of the total expenditure of the general government, despite the transfer of core social service delivery functions to provinces post the 18th Constitutional Amendment in 2010 (Figure 1.18). Therefore, this post-2010 combination of lower (retained) revenues but with higher expenditures at the Federal Government level has contributed to larger (total) fiscal and primary fiscal deficits (Figure 1.19).

Figure 1.19: Consolidated (total) fiscal and primary fiscal deficits, pre- and post-2010
(Share in GDP, %)



Source: Ministry of Finance and World Bank staff calculations

1.5.3 Fragmented Institutions

The existing fiscal institutional arrangements are weak and fragmented and do not incentivize national fiscal discipline. The country’s existing fiscal institutions and intergovernmental coordination arrangements have constrained the effective management of the government’s finances. Fiscal policymaking is fragmented across numerous bodies,²³ resulting in institutional gaps that contribute to

²² 7th NFC Award sets vertical share of provinces in federal divisible pool at 57.5 percent up from 46.5 percent in the previous award. As per the 18th Constitutional Amendment, the share of the provinces in subsequent awards cannot be less than their share in the previous award.

²³ Fiscal policymaking institutions at the federal level include the Finance Division, FBR, and Ministry of Planning. At the provincial level, the fiscal policymaking institutions for each province include the Finance Department, Planning Department, Revenue

the lack of focus on achieving sustainable fiscal outcomes at the national level. These flaws also result in incoherence between the objectives of the federal government spending and its development goals, leading to inefficient or mis-directed spending and increases in fiscal risks.

The fiscal responsibility framework lacks safeguards against violations of fiscal rules set in the Fiscal Responsibility and Debt Limitation Act (2022). With the lack of a national MTFF to anchor federal and provincial budgets, there is little coordination on fiscal management between the Federal Government and the Provinces to systematically achieve sustainable national fiscal targets.²⁴ This results in incremental budgeting and a lack of coherence between the objectives of the federal and provincial governments, contributing to sizable recurrent fiscal deficits. The federal Finance Division is mandated with formulating a coherent medium-term fiscal framework and undertaking fiscal risk analysis, but only has limited in-house fiscal policy function and capacity. Meanwhile, the preparation of the federal government's annual budget is also bifurcated, with recurrent and capital outlays being determined separately by the Finance Division and the Planning Division, respectively, resulting in a high probability of mis-coordination.

Constitutionally fragmented tax bases have impacted the Government's ability to implement coherent tax policies and improve tax administration capacity. On the revenue front, the sales tax base is fragmented between tax on goods and on services, the former being legislated and administered by the Federal Government, and the latter being under the purview of the provinces. This renders tax policy on the sales tax difficult to legislate, implement, and reform. This fragmentation also encourages businesses in the country to remain informal, as it exacerbates administrative hurdles they face: A national firm providing services in all five jurisdictions will have to file 60 monthly tax returns per year.²⁵ Similarly, the income tax base is fragmented between agriculture income (provincial tax base) and non-agriculture tax (federal tax base).²⁶ With agriculture income being taxed at relatively lower rates, the tax rate differentials between agriculture and non-agriculture income create incentives for tax avoidance and evasion through within-country transfer pricing, resulting in lower direct tax collections. In addition, the lack of adequate data sharing protocols between the federal and provincial tax agencies hinders enforcement, creating even more opportunities for tax avoidance, especially in income taxation. In terms of institutions, there is inherent mis-coordination in the tax system as the Ministry of Finance does not set tax policy. Instead, the tax policy function rests with the tax administrator—Federal Board of Revenue (FBR).

The lack of an integrated debt management function undermines sound debt management in Pakistan. Debt management in Pakistan has been facing three main challenges. First, there is significant fragmentation in debt-management functions between different offices in the Ministry of Finance and other agencies,²⁷ which operate independently with no single entity empowered to, and/or tasked with, implementing a coherent debt-management strategy in Pakistan. The Debt Management Office (DMO)²⁸—established through amendments to the FRDLA 2005—only plays a coordinating and advisory

Authority, Board of Revenue and Excise Department. Therefore, there are at least 23 institutions involved with fiscal policymaking at the national level.

²⁴ Reform of the federal and provincial fiscal responsibility laws to support the preparation of a national Medium-Term Fiscal Framework (MTFF) is in progress and supported by the World Bank Resilient Institutions for Sustainable Economy (RISE) Development Policy Operations (DPOs) and IDA SDFP PPAs.

²⁵ There has been significant progress made on the harmonization of the Goods and Services Tax (GST), which is support by the RISE DPOs.

²⁶ Moreover, as discussed above, taxes collected by the Federal Government are shared with the provinces as per the 7th NFC award.

²⁷ These include the Budget Wing in the Ministry of Finance, the Central Directorate for National Savings (CDNS), the Economic Affairs Division (EAD), and the External Finance (EF) Wing.

²⁸ Formerly known as the Debt Policy Coordination Office (DPCO).

function.²⁹ Second, there is lack of a coherent medium-term debt-management strategy. In fact, while the DMO prepares a Medium-Term Debt Strategy (MTDS), it does not have the authority to enforce its implementation. The current MTDS is also dated, as it was prepared in 2019 and has not been updated since. As a result, the debt-management authorities have relied excessively on short-term domestic borrowing to finance the fiscal deficits. This has increased the Government's exposure to debt rollovers and the consequent liquidity risks of debt. Third, availability of debt data in Pakistan is fragmented and not reconciled between different data sources. Until recently, there is limited consolidation of debt data that investors and creditors can easily have access to, and that policymakers can base policy decisions on. Information on public debt is fragmented across several documents, often with overlapping or incomplete information.³⁰ Moreover, detailed information on fiscal risks and contingent liabilities, such as guarantees to SOEs, commodity operations liabilities, and provincial debt stocks is either highly aggregated or not disclosed at all, such as in the case of commodity operations debt.

1.5.4 Non-budgetary shocks

Non-budgetary shocks have been key drivers of the debt stock and in turn, the fiscal deficit. As discussed in detail in Chapter 3, the debt stock is susceptible to non-budgetary "below-the-line" drivers such as macroeconomic outturns and formal recognition and/or realization of contingent liabilities. More specifically, macroeconomic variables such as real GDP growth, the real interest rate, and exchange rate depreciation have been having substantial impact on the level of the debt stock. For example, the Rupee depreciated 23.1 percent against the U.S. dollar in FY22, which led to the debt stock increasing by 7.8 percentage points of GDP. This was more than double the increase due to the primary deficit. Over the past decade, real GDP growth, including the recent GDP rebasing, has played a significant role in reducing the debt stock as a share of GDP (Figure 1.20). Compared to the primary deficit that cumulatively added 18.5 percentage points (pp) to the debt stock as a share of GDP from FY12 to FY22, real GDP growth cumulative decreased the debt stock of GDP by 25.6 pp over the same time period.³¹ In contrast, the exchange rate depreciation and real interest rate increased the debt stock of GDP cumulatively by 22.6 and 3.3 percentage points, respectively, over the past decade.³²

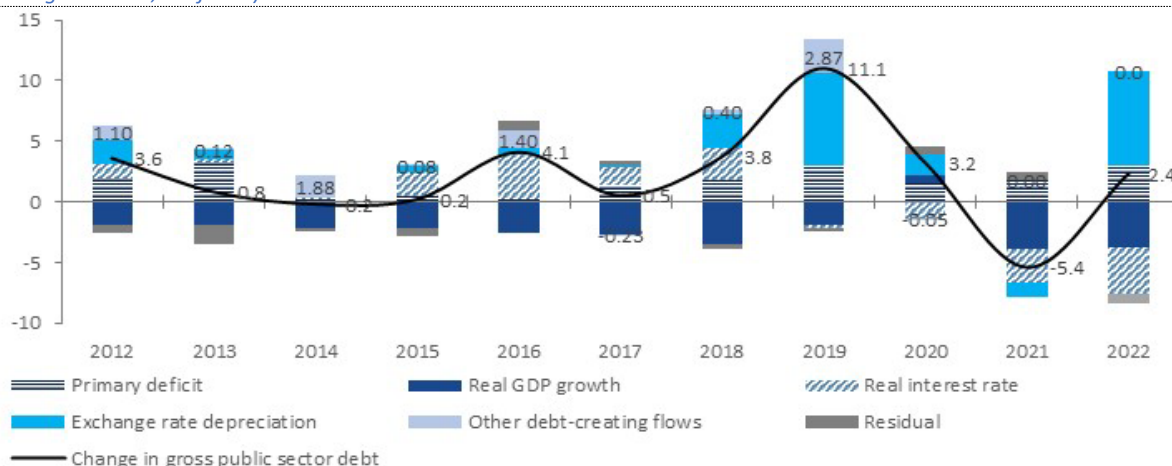
²⁹ The DMO/DPCO focuses on advising on a debt reduction path; providing policy advice; monitoring the costs of borrowing; and preparing the debt policy statement. It does prepare a medium-term debt strategy (MDTS) but due to fragmentation issues and lack of implementation authority, the strategy is not properly followed. Recently additional functions have been assigned to the DMO/DPCO. These have been effectively implemented and codified through amendments to the FRDLA 2005.

³⁰ These reports are published by different entities such as, the Ministry of Economic Affairs, the DMO, SBP, and the Ministry of Finance. There are several reports available such as Statistical Bulletins by SBP; Risk Reports, Debt Policy Statements, Medium Term Debt Strategies, and Fiscal Policy Statements by DMO, as well as some provincial debt bulletins.

³¹ As discussed above, the "high" economic growth rate historically has been without matching increases in the potential growth of the economy. This has led to recurrent economic imbalances in the external sector and is therefore not sustainable in the long-term.

³² While the debt increasing effects of the real interest rate has been minimal because monetary policy has been largely accommodative over the past decade, the loose monetary stance has contributed to significant external imbalances, which has consequently contributed to significant exchange rate depreciations that have led to substantial increases in the debt stock. Chapter 3 on Debt and Debt Management discusses in detail other "below the line" drivers of the debt stock.

Figure 1.20: Key Drivers of Pakistan’s Public and Publicly Guaranteed Debt
(Change in PPGD, % of GDP)



Source: Ministry of Finance and World Bank staff calculations

Contingent liabilities contribute to below-the-line PPG debt accumulation and future deficits. The build-up in public debt can also partially be attributed to continued federal government support to State Owned Enterprises (SOEs), which contribute to non-budgetary below-the-line PPG debt accumulation principally through the issuance of guarantees. The total stock of sovereign guarantees to SOEs are sizable and reached 4.5 percent of GDP at end-FY22. Such increases in explicit contingent liabilities contributed 7.6 pp of GDP to the debt stock over the past decade.³³ However, there are also implicit contingent liabilities that have not been formally accounted for. Such liabilities are estimated to be even larger than explicit liabilities and is around 7.0 percent of GDP in FY22. Changes in the debt stock in turn affect the fiscal balances over the medium-term through the future stream of interest expenditures associated with the debt stock. Therefore, these non-budgetary factors have been indirectly driving the persistence of future deficit levels by increasing the size of the debt stock.

Adverse economy-wide shocks have recently also become significant factors for both higher fiscal deficits and debt. Economy-wide shocks such as the COVID-19 pandemic (Box 1.4) and the more recent devastating floods, have resulted in sharp spending shocks, as public relief and recovery efforts are critical in mitigating the economic fallout from such disasters. As the same time, revenue bases tend to shrink in such instances due to the decline in economy activity. Therefore, fiscal deficits tend to increase significantly in times of crisis. These disasters have underscored the critical need for governments to have sufficient fiscal space, not only to meet development challenges, but also to adequately respond to shocks. The need for Pakistan to regain fiscal sustainability and, in due course, enlarge its fiscal space has therefore become even more urgent and pressing.

³³ Increases in contingent liabilities show as “Other debt-creating flows” in Figure 1.18.

Box 1.4: The fiscal impact of the COVID pandemic on Pakistan

Economic effects associated with the COVID pandemic exacerbated the fiscal and debt risks. Tax revenues in FY20 declined modestly to 10.5 percent of GDP from 10.2 percent of GDP in FY19, in line with lower economic activity amid the lockdown and other social restrictions, and larger tax expenditures³⁴ to help mitigate the adverse economic effects of the COVID-19 induced crisis. Fiscal expenditures rose to 20.3 percent of GDP mainly due to a COVID-related fiscal stimulus package of approximately 2.9 percent of GDP. This included the launching of the “Ehsaas” program at the national level, with the largest component being the Benazir Income Support Programme (BISP), the national social protection program. Consequently, the BISP expenditures more than doubled to PKR246.1 billion in FY20 from PKR116.3 billion in FY19. However, the overall fiscal deficit, excluding grants, shrank from 7.9 percent of GDP in FY19 to 7.1 percent of GDP in FY20, predominantly due to large non-tax revenues.³⁵ Nonetheless, public debt, including guaranteed debt, increased to 81.1 percent of GDP by end-FY20 from 78.0 percent at end-FY19.³⁶ With the higher debt, debt overhang has become more severe, leaving even less fiscal space and more crowding out of development expenditure.

1.6 Objective and Structure of the Report

The objective of this federal-level PER is to provide policy options to the Government for fiscal consolidation to regain fiscal and debt sustainability, in accordance with the FRDLA 2005. Pakistan's large and persistent fiscal deficits have led to a rapidly growing stock of public debt, resulting in deficit and debt levels that are in breach of the ceilings stipulated by FRDLA. Moreover, the high deficits and debt levels have detrimental effects on the economy and pose high risks for sustained economic development. Therefore, this Report provides policy recommendations for fiscal consolidation that could in total generate fiscal savings for the federal government of approximately 4 percentage points of GDP, contributing to lower deficit and debt levels, and thereby regaining fiscal and debt sustainability, as per the FRDLA. The estimated magnitude of federal fiscal savings represents a lower bound as it does not account for the second order fiscal and economic growth dividends associated with reduced distortions, improved compliance, and broader tax bases. Apart from reducing fiscal vulnerabilities, these reforms are also expected to support macroeconomic stability, reduce uncertainty, improve the investment climate and thereby provide a more conducive environment for investment and sustained economic growth.

This is the first PER report since 2010. This Report is the first federal-level PER since the implementation of the 18th Constitutional Amendment and the 7th NFC award in 2010, which represented a major shift in the country's national fiscal architecture. While there has been three provincial PERs since 2010,³⁷ there has not been a federal-level PER released since then,³⁸ presenting a substantial knowledge gap.

³⁴ In the last quarter of FY20, the government announced exemption of duty and tax on food supplies and medical supplies. In addition, taxes on the construction sector were reduced, with an aim to boost the economy.

³⁵ Non-tax revenues rose from 1.0 percent of GDP in FY19 to 3.2 percent of GDP in FY20, because of renewal fees for 4G spectrum licenses from telecommunications companies, and a high volume of transfers from the State Bank of Pakistan due to higher interest rates. As a result, total revenue increased to 13.2 percent of GDP in FY20 from 11.2 percent of GDP in FY19, despite lower tax revenues.

³⁵ Total revenues rose to 15.2 percent of GDP due to atypically higher non-tax revenues, as the central bank and the telecommunication authority transferred large profits.

³⁶ The public debt-to-GDP ratio rose partly due to the contraction of GDP in FY20.

³⁷ World Bank (2012). Pakistan – Khyber Pakhtunkhwa Public Expenditure Review; World Bank (2013). Pakistan Punjab Social Sector Public Expenditure Review; World Bank (2017). Pakistan Sindh: Public Expenditure Review.

³⁸ There were three national PERs based on the fiscal architecture prior to the 18th Constitutional Amendment and the 7th NFC award in 2010: World Bank (1998). Pakistan Public Expenditure Review: Reform Issues and Options. Report No. 18432-PAK. Washington, D.C.: World Bank; World Bank (2004). Pakistan Public Expenditure Management: Strategic Issues and Reform Agenda. Report No: 25665-PK. Washington, D.C.: World Bank; World Bank (2011). Pakistan: From Raising Spending to Spending

The federal government fiscal deficit is the key driver of the national fiscal deficit. While the provinces together have been typically running small fiscal surplus over FY10-22, the Federal Government has been consistently running large budget deficits, such that there is a persistent overall significant budget shortfall at the general government level. Therefore, this report focuses on reducing the federal government budget shortfall as it is overwhelmingly the dominant contributor to the national fiscal deficit.

This PER discusses core public finance issues at the federal level, including rationalizing fiscal expenditures and enhancing domestic revenue collection. In addition to detailed analysis on overall federal fiscal expenditure and the mobilization of federal domestic revenues, this report includes deep dives into two areas that drive the two largest federal expenditure components: (1) Debt management and their impact on federal interest payments (Mark-up Payments) that constituted 4.8 percent of GDP in FY22, and (2) Fiscal support to State-Owned Enterprises (SOEs) that constitutes a significant portion of Subsidies that accounted for 2.3 percent of FY22 GDP. Improving the management of SOEs also tends to reduce contingent liabilities and fiscal risks from SOEs, which has been growing in recent years. In addition, the PER includes a detailed analysis on the realignment of federal government spending to the federal constitutional mandate that would impact expenditure categories on “Running of Civil Government” and “PSDP.”³⁹ These issues are the core factors behind Pakistan's recurring fiscal imbalances.⁴⁰

1.6.1 Chapters of the PER

Apart from this macro-fiscal context chapter, this federal PER comprises four topical chapters on Expenditure; Debt and Debt Management; State-Owned Enterprises; and Tax Revenues.

Chapter 2: Towards Inclusive and Productive Federal Expenditures

The Expenditure chapter focuses on analyzing the expenditures of the Federal Government, with a view to identify options for federal fiscal savings and development spending efficiency improvements. The chapter begins by documenting that Pakistan's Federal Government barely has any space to conduct spending-based fiscal policy. Instead, most expenditure is pre-committed to interest payments, commitments to public sector staff, and subsidies. This results in a situation where public spending – much of which is deficit financed - does not result in significant growth dividends and thus perpetuates a cycle of increasing debt and rising debt service costs that gradually crowd out any remaining discretionary spending.

The chapter focuses on four broad areas for fiscal savings and efficiency improvements. First, it examines the drivers and impact of debt servicing costs, documents that high volatility in interest payments are driven by debt management choices, and provides evidence that this volatility crowds-out growth-focused development spending. Second, the chapter reviews development spending performance and links weak project performance to the public investment management processes. Third, it reviews Pakistan's subsidy landscape, summarizes the social and fiscal impact of subsidies, and proposes options to improve their targeting. Finally, the chapter compares functional federal spending allocations with the

for Results: A Review of Public Expenditure and Financial Management Practices. Report No: 52442-PK. Washington, D.C.: World Bank.

³⁹ Public Sector Development Programme.

⁴⁰ This PER does not discuss in detail federal expenditures on Pensions and Defense. Pension spending has been analyzed in detailed in World Bank (2020). *Pakistan: Assessment of Civil Service Pensions*, February 5, 2020. Box 2.2 on pension reform provides a summary of the Pensions report's main findings.

federal level's constitutional mandates and finds that there are substantial saving opportunities for the federal government from improved expenditure realignments. The chapter closes with a policy roadmap. Table Annex 1 presents a few key recommendations on the rationalizing of federal expenditures from previous World Bank analytical reports, highlighting their implementation where relevant.

Chapter 3: Debt Diagnostics, Management and Sustainability

This chapter focuses on debt management and sustainability and presents the findings of an updated Debt Sustainability Analysis (DSA). A review of the public debt profile shows that Pakistan's public debt is large and growing. While domestically issued debt accounts for two-thirds of the debt stock and that domestic rollover risks have declined as the maturity profile of its domestic debt has lengthened, the share of external commercial debt has also increased, implying higher overall exchange rate, interest rate, and rollover risks for the external debt stock. The chapter also undertakes an updated Debt Sustainability Analysis (DSA) that shows that the debt stock is expected to remain above the FRDLA threshold in the medium term under all scenarios examined. In addition, because of its high level, the debt stock is vulnerable to macro-fiscal shocks such as exchange rate depreciations.

The chapter also identifies key non-budgetary factors of debt accumulation—which include macroeconomic and institutional factors and contingent liabilities—and examines their effects on the debt stock. The chapter also runs simulations to determine optimal borrowing mixes. Simulation results show that for a given fiscal and exchange rate path, the medium- and long-term financing debt strategies show lower risks in terms of gross financing needs (GFNs) than short-term ones. Due to lower exchange rate costs, debt strategies with a higher share of domestic borrowings show lower public debt-to-GDP ratios than those where external funding largely predominates. A recent World Bank debt management assessment showed improvements in areas of debt management, such as debt reporting. However, the assessment also revealed continued long-standing challenges, such as insufficient staffing at the debt management office and weak cash management (Table A.1.2). The latter is likely due to over borrowing and a larger-than-necessary debt stock. Lastly, the chapter discusses the large and growing stock of contingent liabilities in Pakistan and highlights that such liabilities is a source of significant fiscal risk that require proper disclosure, recording, monitoring, and management. The chapter concludes with a series of immediate and medium-term policy measures to improve debt management.

Chapter 4: Reducing the fiscal Impact of State-Owned Enterprises (SOEs)

This chapter examines the financial performance of SOEs and focuses on reducing the fiscal drain of federal commercial SOEs on the finances of the Federal Government. The chapter begins with a brief introduction to the SOE landscape in Pakistan. Next, the chapter reviews the financial performance of SOEs and shows that collectively they have been making net losses since FY16, with losses concentrated in the power and transportation sectors. The chapter then shows that there is substantial direct fiscal support, in the form of loans, grants, and subsidies, from the Federal Government to the SOEs. Such support accounted for more than 20 percent of the fiscal deficit in recent years. The chapter proceeds to discuss fiscal risks stemming from SOEs and highlights that outstanding loan guarantees issued to SOEs by the Federal Government stands at 4.5 percent of GDP in FY22, which is even larger than the annual direct support to SOEs. The chapter concludes with suggested policy recommendations to reduce both the fiscal drain and fiscal risks accruing from SOEs, which would support the required fiscal consolidation. The recommendation in this chapter builds upon the key findings of previous studies (Table A.1.3).

Chapter 5: Enabling a Modern and Efficient Tax System

The Revenue chapter reviews tax policy in Pakistan to propose options for tax base broadening and deficit reduction through federal revenue increases.⁴¹ It begins by documenting that tax collection has been stagnant over the past two decades and remains significantly below regional and global peers. The chapter then shows that this is driven by two factors. On the one hand, Pakistan's economic structure naturally limits its ability to collect revenue. On the other hand, however, revenue collection is also constrained by policy choices. For instance, tax expenditures – 2.6 percent of GDP in FY22 – impose large fiscal costs.

Based on these stylized facts, the chapter reviews tax policy for Pakistan's four main taxes: sales, personal, and corporate income tax and excise.⁴² It shows quantitatively that sales tax exemptions and concessions – which are highly prevalent in Pakistan – not only impose high fiscal costs but also lead to economic distortions that can reduce growth. The chapter also documents that Pakistan's personal income tax system acts like a de-facto sales tax system by imposing withholding taxes on non-income transactions, and that revenue enhancement potential from a widening of the salaried personal income tax base exists. With regards to corporate income taxes, the chapter argues that the system's complexity provides opportunities for tax avoidance and that many tax incentives are unlikely to yield the desired economic benefits. Finally, the chapter highlights that tobacco taxation enforcement could benefit from investment in digital administration technologies. The chapter closes with a detailed roadmap aimed at reducing the complexity of the system, refocusing each tax on its core base, and broadening the applicable bases, that builds upon previous key recommendations (Table A.1.4).

1.6.2 Policy recommendations and federal fiscal savings

The estimated fiscal savings for the federal government derived from the consolidation measures recommended in this PER is approximately 4 percent of FY22 GDP. The Report proposes avenues for fiscal consolidation that include reforms on both fiscal expenditure rationalization and domestic revenue mobilization (Table 1.3). Policy measures to reduce fiscal expenditure include the rollback or elimination of subsidies, and the realignment of federal spending with federal constitution mandates. The Report recommends the immediate adoption of a Treasury Single Account to reduce borrowing needs, the debt stock and associated interest payments. To reduce the fiscal drain of SOEs, the Report highlights the divestiture of the largest loss-making SOEs, in accordance with the triage recommendations. Suggested reforms for enhancing domestic revenue collection include simplifying personal and corporate income tax schedules, and combining the tobacco excise tiers into one and then applying the premium rate. The estimated federal fiscal savings represents a lower bound as it does not account for the second-order fiscal and economic growth dividends associated with reduced distortions, improved compliance and broader tax bases.

⁴¹ The chapter focuses mainly on tax revenue, which constitutes the lion's share of total revenues. Federal non-tax revenue only accounted for 15.8 percent of federal total revenue in FY22.

⁴² Given that the focus of this chapter is on federal fiscal revenues, potential major revenue items such as agricultural and property taxation and sales tax on services have not been included in the analysis.

Table 1.3: Recommended Fiscal Consolidation Measures

Reforms for Fiscal Expenditure Rationalization	Description	Federal Fiscal Savings Potential per Year	
		Billions of PKR	% of FY22 GDP
Reduce regressive subsidy spending			
Electricity subsidies	Eliminate electricity tariff differential subsidies to achieve full cost recovery	167	0.25 ⁴³
Tube-well subsidies	Remove or reduce as they are distortionary and incentivize overconsumption	20	0.03
Subsidies for wheat support price	Regressive subsidy, with benefits accruing to mostly large landowners	7	0.01 ⁴⁴
Reduced operational spending on devolved ministries and autonomous bodies	Despite the 18 th Amendment, the Federal Government maintains recurrent spending on areas that have been devolved to the provinces. The rationalization of overlaps between federal and provincial recurrent spending provides opportunities for federal fiscal savings. Spending on federal ministries and autonomous bodies focused on devolved subject areas can be gradually reduced and eventually eliminated. If pertinent for service delivery at the provincial level, provinces can provide the financing for these institutions.	398	0.59
Cost sharing by provinces on Benazir Income Support Programme (BISP)	The federal government funds or co-funds vertical programs, such as BISP, that directly provide services in the provincial domain. The cost sharing of BISP where the provinces eventually bear 90 percent of program costs could yield significant federal fiscal savings.	217	0.32 ⁴⁵
Refocusing federal development spending on federal mandates	There continues to be significant federal development spending on devolved areas. A refocusing of federal development spending on federal domains therefore has large savings potential for the federal government.	315	0.47
Total		1,124	1.68

Reforms for reducing debt servicing costs and the fiscal impact of SOEs	Description	Federal Fiscal Savings Potential per Year	
		Billions of PKR	% of FY22 GDP
Adoption of the Treasury Single Account (TSA)	The TSA is ready for implementation. It will enable proper monitoring and accounting of the Government's available cash balances and reduce public borrowing needs.	404	0.60
Implementation of the recommendations of the 2021 triage exercise	Divest loss making SOEs, especially those in sectors where there is no clear rationale for government involvement	458	0.68
Total		862	1.29

⁴³ Actual electricity tariff differential subsidy spending in FY22. Estimated fiscal cost savings for FY23 is PKR 223 billion.

⁴⁴ FY22 subsidy to the Pakistan Agricultural Storage & Services Corporation (PASSCO - www.passco.gov.pk)

⁴⁵ Assuming provinces cover 90 percent of FY22 BISP expenditure in the medium-term.

Reforms for enhancing revenue collections	Description	Federal Fiscal Savings Potential per Year	
		Billions of PKR	% of FY22 GDP
Goods sales tax	Remove concession rates, limiting zero ratings, limit exemptions	402	0.6
Increase cigarette excises	Collapse the two tiers into a single tier and levy the premium excise tax rate, applied on an ad-valorem basis to allow automatic indexation to inflation.	268	0.4
Total		670	1.00
Total for PER		2,656	3.97

Annex

Table A.1.1: Key Past Recommendations for Rationalizing Overall Fiscal Expenditures

Generate savings through reallocation of public funds either by shifting resources from low-priority to high-priority sectors, functions, and uses, by assigning functions to the levels of government that is best suited for their implementation or by moving away from a “build, neglect, and rebuild” culture to a “build and maintain” philosophy. Savings could also be mobilized through more efficient implementation of the Government’s on-going activities (World Bank, 2011).

Reduce expenditure needs by privatization of activities outside the proper domain of the public sector and permitting and facilitating the private sector to undertake such investment and activities that to date have remained in the public sector domain (World Bank, 2011).

Implement an integrated medium-term approach to planning and budgeting for improved public expenditure management and better integrated and coordinated national fiscal policymaking. The medium-term expenditure framework (MTEF) is a strategic policy and budgetary framework within which federal line ministries and provincial governments are given greater responsibility for resource allocation decisions, subject to medium-term resource constraints. The framework will require relevant decisionmakers to balance what is affordable in aggregate and align the budget allocations with the policy priorities of the country (World Bank, 1998).⁴⁶ The formation and implementation of the MTEF, as known as the medium-term fiscal framework (MTFF), has been included as a series of policy reforms supported by the World Bank’s series on Resilient Institutions for Sustainable Economy (RISE) Development Policy Operations.

Table A.1.2: Key Past Recommendations for Debt Management

Consolidate all mandates for public debt management into an integrated Debt Management Office (DMO) that is responsible for managing all aspects of domestic and external debt and issuance of guarantees, implementing a medium-term debt-management strategy and publishing semi-annual comprehensive debt reports with detailed data on key debt indicators, subnational debt, guaranteed debt, and collateralized debt (e.g., debt undertaken by provincial governments for commodity operations), as well as fiscal risks. These issues have been undertaken by the Second Resilient Institutions for Sustainable Economy (RISE-II) Development Policy Operation.

Strengthen cash management institutions and strengthen cash forecasting. This should also improve coordination between cash- and debt-management arrangements in the Ministry of Finance.

The development of domestic capital markets is important to mobilize long-term financing and to lower the rollover and exchange-rate risks posed to Pakistan’s debt portfolio. However, there is a need for DMO to active relation with the market through provision of information and understating market needs and provision of adequate liquidity. The role of the capital markets regulator is critical for the regulatory environment.

Debt-related contingent liabilities are a significant source of sudden jumps in Pakistan’s PPG debt. Pakistan would greatly benefit from a preemptive approach to systemically disclose, record, monitor, and manage debt-related contingent liabilities. In this context, the role of a proactive debt back and middle office in parallel with the macro-fiscal unit is critical.

⁴⁶ World Bank (1998). Pakistan Public Expenditure Review: Reform Issues and Options. Report No. 18432-PAK. Washington, D.C.: World Bank.

Table A.1.3: Key Past Recommendations for Reducing the Fiscal Impact of State-Owned Enterprises

Privatization of SOEs	Divest government stakes in selected SOEs. Classify SOEs by relevance of their activities to the SOE ownership policy's criteria for government ownership and by financial performance. Use the classification to identify which SOEs to keep in the public sector, or privatize, or close.
	Prepare partial divestment or privatization transactions for SOEs in commercial sectors, especially where SOEs have dominant positions in the market.
	Strengthening the regulatory framework. The government must ensure that the core infrastructure regulatory authorities are credible, effective, and autonomous. This will greatly improve the marketability of public sector utilities.
	Removal of labor-related impediments to privatization. The problem of surplus labor, a major hurdle to privatization of large public enterprises, should be tackled through attractive voluntary separation schemes within overall budgetary constraints. Labor unions should be brought on board in the process of privatization through consultations.
	Further strengthening of the Privatization Commission. The capacity of the PC needs to be further strengthened: it needs to be provided with adequate financial resources and allowed greater flexibility to engage professionally competent staff.
	Credibility of the privatization process should be ensured by maximizing transparency and avoiding the governance problems that sometimes detracted from earlier privatization efforts. Judicial procedures need to be streamlined to settle legal issues in a timely manner.
Corporate Governance	Compliance with existing Corporate Governance rules. Amend the Corporate Governance Rules to exclude public officials from SOE Boards and senior management positions and make the publication of annual financial statements and external audit reports mandatory for all SOEs.
	SOE ownership policy. Adopt an SOE law to streamline the regulations governing different sets of SOEs and safeguard the principles for government ownership of SOEs.
	Central Entity for SOE portfolio management. Designate a central ownership entity with a strong mandate to oversee the financial performance of the SOE portfolio, or the broader performance, including operational aspects.
	Enhanced oversight for issuance of guarantees. Issuance of guarantees to SOEs should be contingent upon publication of the previous year's audited financial accounts and detailed plans to achieve financial stability.
	Making financial support conditional on improved financial performance. To improve SOE financial performance, replace budget financing of SOEs' operational losses with subsidies that are tied to the unit costs of public service obligations, which should be specified in annual performance agreements with measurable indicators. Alternatively, allow SOEs to charge user fees that enable cost recovery and compensate low-income consumers with social assistance.

Table A.1.4: Key Past Recommendations for Enhancing Revenue Collections

Tax Policy
Focus reforms on expanding the tax base and removing discretion. Convert the GST into a VAT to expand the base to untaxed sectors (World Bank, 2011).
Increase revenue productivity of direct taxes, by reduce exemptions, preferential treatments to some sectors, and withholding taxes. Favorable treatment of small companies relative to corporations should also be reconsidered due to the anti-corporation bias that discourages enterprises growing in size and benefiting from economies of scale and scope (World Bank, 2011).
Eliminate low-yielding minor taxes that impose significant compliance costs for taxpayers (World Bank, 2020).

Update property valuation tables annually to reflect market values (World Bank, 2011). This reform, both for the Federal and Provincial District Collectorate valuation tables, have been completed with support from the World Bank RISE-I and RISE-II DPOs.

Tax Administration

Improve general tax administration, making the system taxpayer-friendly, more efficient, and better able to leverage modern technology to enforce compliance (identification of non-filers, track-and-trace in high-risk sectors, risk-based audits) (World Bank, 2019). Implement a single electronic tax payment system with end-to-end processing without need for direct interaction between the taxpayer and collector. Expand e-registration, e-filing, and e-payment mechanisms (World Bank, 2020). Implement systems to enable automatic tax refunds that remit directly into taxpayer accounts (World Bank, 2011).

Enhance tax enforcement. Formulate and implement action plans to improve tax enforcement and tax audits. Increase the use of risk-based audits (World Bank, 2011).

Separate tax policy and tax administration functions. The tax policy function should be separate from the tax administration function, a reform already being planned, and tax administration would benefit from increased autonomy (World Bank, 2019).

Strengthen the Federal Tax Ombudsman. The Federal Tax Ombudsman was established in 2000, tasked with addressing tax administration complaints, but significant strengthening may be necessary for this office to be able to fulfill its functions (World Bank, 2019).

Establish a permanent National Tax Council (NTC) comprising the Federal Government and provinces. The NTC is a high-level constitutional body tasked with resolving all inter-governmental taxation issues. The NTC advises the National Finance Commission Monitoring Committee (NFC-MC) on measures to harmonize, streamline, and resolve all taxation issues (World Bank, 2019 and 2020). This reform has been completed with support of the World Bank RISE-I development policy operation.

Simplify and harmonize the tax code. The tax code should be simplified and made more uniform across the five tax jurisdictions, supporting federal–provincial harmonization and integration and reducing costs associated with tax compliance (World Bank, 2019). Harmonize the GST by agreeing to common taxation principles, supply and use rules, common definitions, and a single positive rate (World Bank, 2020). Harmonization of the GST is currently being implemented with support of the World Bank RISE-II development policy operation.

Improve documentation of economic transactions, ownership of assets, and sources of income, by expanding efforts to ensure auditing of more businesses. Better documentation will enable the government to implement existing tax laws more effectively as well as to broaden the tax base in the future (World Bank, 2011).

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