PAKISTAN FEDERAL
PUBLIC EXPENDITURE REVIEW 2023

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PAKISTAN FEDERAL PUBLIC EXPENDITURE REVIEW

Executive Summary

2023

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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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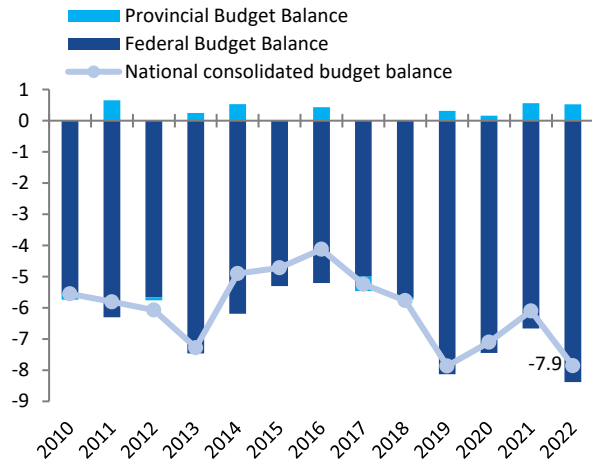
Executive Summary

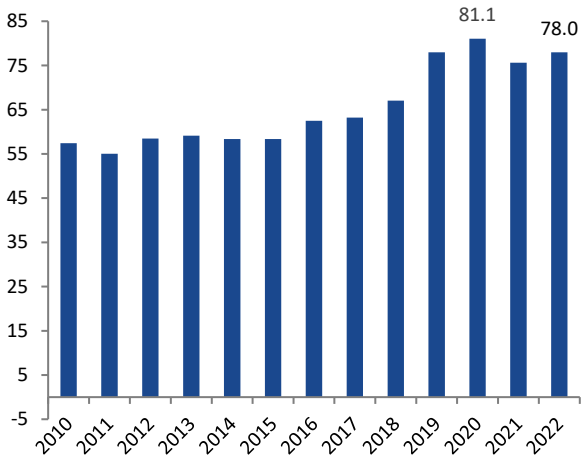
Pakistan's fiscal deficit has been persistently large and growing, posing risks to fiscal and debt sustainability. In FY22, Pakistan's general government deficit stood at 7.9 percent of GDP, matching that in FY19, to be the largest in more than 22 years (Figure ES.1). In addition to being persistently high, averaging at 6.2 percent of GDP over the past decade, the deficit has also been growing, with the post-2010 annual average being 50 percent larger than its pre-2010 average. The large recurrent budget shortfalls have led to a rapid accumulation of public debt, which reached 78.0 percent of GDP in FY22, slightly lower than the record high of 81.1 percent of GDP in FY20 (Figure ES.2). 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.

Figure ES.1: Pakistan: Government Budget Balances
(Percent of GDP)



Source: Ministry of Finance, World Bank staff calculations

Figure ES.2: Pakistan: Public & Publicly Guaranteed Debt
(Percent of GDP)



Source: Ministry of Finance, World Bank staff calculations

The high levels of fiscal deficits and public debt have adverse effects on the economy. They contribute to macroeconomic volatility, crowd out public and private investment, and thus weigh on long-term economic growth.[2] Moreover, extensive government borrowing from the domestic financial sector has led to a deep sovereign–financial sector nexus. Recent economy-wide shocks such as the COVID-19 pandemic and the devastating floods in 2022 also tend to exacerbate the fiscal shortfall by increasing spending needs, while at the same time shrinking tax bases. These disasters also highlight the dire need for sufficient fiscal space to adequately respond to economy-wide shocks.

This federal Public Expenditure Review (PER) analyzes the key drivers of Pakistan's fiscal deficits and explores how the Federal Government can regain fiscal and debt sustainability, in accordance with the

[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.

[2] 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 low, averaging at 1.8 percent, over the past 2 decades.

fiscal rules set forth in the FRDLA 2005.[3] The report builds upon previous studies, provides new and updated analysis, and suggests policy measures for fiscal consolidation that could bring the fiscal deficit under 3.5 percent of GDP and public debt below 60 percent of GDP, as stipulated by the FRDLA 2005.

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 National Finance Commission (NFC) Award[4] in 2010, which represented a major shift in the country's national fiscal architecture. While there have been three provincial PERs since 2010,[5] there has not been a federal-level PER released since then,[6] presenting a substantial knowledge gap.

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.

In light of the above, this PER examines core public finance issues at the federal level, including rationalizing federal fiscal expenditures and enhancing domestic revenue collection. The Report first provides an overview of Pakistan's macroeconomic and fiscal context and highlights the importance of fiscal and debt sustainability by examining the detrimental effects of persistently large deficits (Chapter 1). The unique drivers that contribute to the persistence of Pakistan's fiscal deficits are also identified. In addition to detailed analysis on the overall federal fiscal expenditures (Chapter 2) and the mobilization of federal domestic revenues (Chapter 5), this report also includes deep dives into two areas that drive the two largest federal expenditure categories: (i) Debt management and their impact on federal interest payments (Chapter 3), and (ii) fiscal support to State-Owned Enterprises (SOEs), which constitutes a significant portion of subsidy spending (Chapter 4). Improving SOE management also reduces contingent liabilities and fiscal risks from SOEs, which has been growing in recent years. In addition, the Report discusses the realignment of federal government spending with its constitutional mandate, which would reduce expenditures pertaining to the operating expenses of the civil government and development spending or PSDP[7]. All of these issues are the core factors behind Pakistan's recurring fiscal imbalances.[8]

[3] The PER is a World Bank core diagnostic study focused on fiscal policy and is routinely prepared for client IDA countries, typically every 5 years. The report aims to provide evidence-based policy recommendations on fiscal management to policymakers in client countries. Findings of the study are used to inform public policy dialogue and provide analytical underpinnings for structural reforms supported by World Bank lending operations. The last federal PER for Pakistan was prepared in 2010 and completed in 2011. This PER will be the first focusing on the current fiscal architecture that was reshaped by the 18th Amendment to the Constitution in 2010 and the 7th National Finance Commission (NFC) Award.

[4] The National Finance Commission Award decides the division of revenues among federating units.

[5] 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*.

[6] 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). P*akistan 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 for Results: A Review of Public Expenditure and Financial Management Practices*. Report No: 52442-PK. Washington, D.C.: World Bank.

[7] Public Sector Development Programme.

[8] 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 in this Report provides a summary of the pensions report's main findings.

The recommendations in this PER are estimated to generate fiscal savings at the federal government level of approximately 4 percentage points of GDP. The resulting fiscal consolidation can gradually free up fiscal space at the federal government level for more public investments, and reduce the crowding out of private investments, both of which will tend to drive higher long-term growth. The estimated magnitude of the 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 expanding 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.

The report analyzes the paths to fiscal and debt sustainability by posing five questions:

1. Why are recurrent fiscal deficits harmful to the economy? Why are Pakistan's fiscal deficits persistent (Chapter 1)?
2. How can federal fiscal expenditures be rationalized for fiscal savings and the efficiency of development spending be improved (Chapter 2)?
3. What are the key non-budgetary drivers of the debt shock and how can they be managed to minimize their fiscal impact and risks (Chapter 3)?
4. What is the impact of federal SOEs on the finances of the Federal Government and how can they be minimized (Chapter 4)?
5. What are the avenues through which fiscal revenue collection can be enhanced in an inclusive manner (Chapter 5)?

1. Why are recurrent fiscal deficits harmful to the economy? Why are Pakistan's fiscal deficits so persistent (Chapter 1)?

Pakistan's large and persistent fiscal deficits have contributed to macroeconomic volatility. The country's economic growth has been largely consumption-driven with low contributions from productivity-enhancing investments and exports. This has resulted in declining total factor productivity (World Bank, 2022a) limiting potential growth.[9] In periods of expansionary fiscal policy, aggregate demand tends to exceed potential growth, leading to imbalances that often results in sizeable current account deficits and high inflation (Figure ES.3).[10] 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.

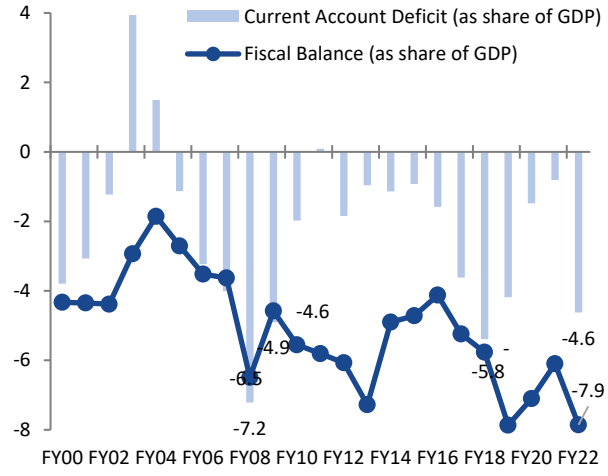
The fiscal deficit, and its financing, has led to a strong sovereign–financial sector nexus in Pakistan. The continued sizeable fiscal deficits have contributed to a buildup of public debt held by the domestic financial sector. In July 2022, more than 70 percent of all bank credit was extended to the public sector, reflecting a deep sovereign–financial sector nexus (Figure ES.4). Therefore, the health of Pakistan's

[9] 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.

[10] 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.

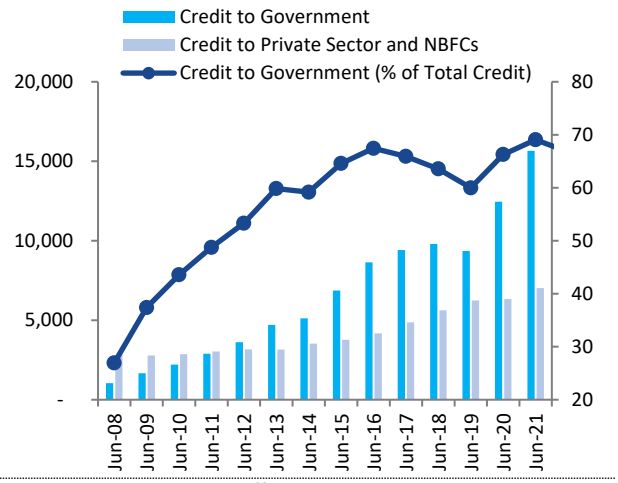
financial sector has become intertwined with the financial health of the Government, heightening risks to the financial sector in the event of a severe fiscal shock.

Figure ES.3: Pakistan's Twin Deficits
(Percent of GDP)



Source: Ministry of Finance, World Bank staff calculations

Figure ES.4: Government Borrowing from Banks
(PKR billions, Percent of Total)



Source: World Bank (2022b)[11]

The extensive government borrowing from the financial sector has crowded out private investment. Credit extended by the banking sector to the Government rose 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. The reduced access to credit contributes to low private investment and hence low productivity growth in Pakistan (World Bank, 2022b).

The large public debt stock crowds out 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, in tandem with the rapidly rising debt. The high 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. The rigidity of fiscal expenditures is also a key driver of the country's persistent deficits.

Pakistan's fiscal revenue collection is low and has been falling. Persistent low fiscal revenue is another driver of Pakistan's recurrent budget shortfall. Pakistan's total revenue collection averaged 12.8 percent of GDP over the past decade, substantially lower than the South Asian average of 19.6 percent. In addition, 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.[12]

Federal spending is also elevated by incomplete fiscal decentralization and continued outlays in provincial areas of responsibility. The 18th Constitutional Amendment transferred many fiscal

[11] World Bank (2022b). Pakistan Development Update: Financing the Real Economy. April. Islamabad: World Bank.
[12] For Pakistan, increasing tax rates may not yield more revenue, due to the existence of Laffer Curve effects. For this reason, Chapter 5 on Revenues mostly suggests base-broadening measures to enhance revenue collection.

responsibilities from the Federal Government to the provinces.[13] Notwithstanding this reassignment, the Federal Government continues to retain some devolved spending functions concurrently with the provinces. Federal spending on devolved areas has increased between FY09 – the year before the 18th amendment – and FY22 in real terms. Over the same period, the number of federal staff employed in devolved areas has remained constant. This incomplete devolution has led to spending overlaps between the federal and provincial governments, which is likely to have led to redundancies, duplication of tasks and cost, and overall higher-than-optimal expenditures at the federal level.

The 18th Amendment and 7th NFC Award together have resulted in significant vertical fiscal asymmetry. According to the 7th NFC Award, approximately three-fifths of the consolidated revenues accrue to the provinces,[14] while the Federal Government is responsible for two-thirds of total general government expenditures. In FY22, the Federal Government only retained around 46 percent of total tax revenue, despite shouldering about 67 percent of the total general government expenditure. Therefore, this post-2010 combination of lower retained revenues but with higher expenditures at the federal government level has contributed to large recurrent federal fiscal deficits.

The existing fiscal institutional arrangements are weak and fragmented and do not incentivize national fiscal discipline. Fiscal policymaking is fragmented across numerous bodies[15] resulting in institutional gaps that contribute to the unsustainable fiscal outcomes at the national level. Meanwhile, constitutionally fragmented tax bases have impacted the Government's ability to implement coherent tax policies and improve tax administration capacity. The lack of an integrated debt management function also undermines sound debt management. Together, these fragmented institutions have led to less-than-effective management of the government's finances, and consequently persistent deficits.

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 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.

Regaining fiscal and debt sustainability can result in a sustained higher growth path. Should Pakistan undertake a decisive fiscal consolidation effort to regain fiscal and debt sustainability, fiscal space will expand over time, and the federal fiscal savings from lower interest expenditures can be gradually applied

[13] 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.

[14] 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.

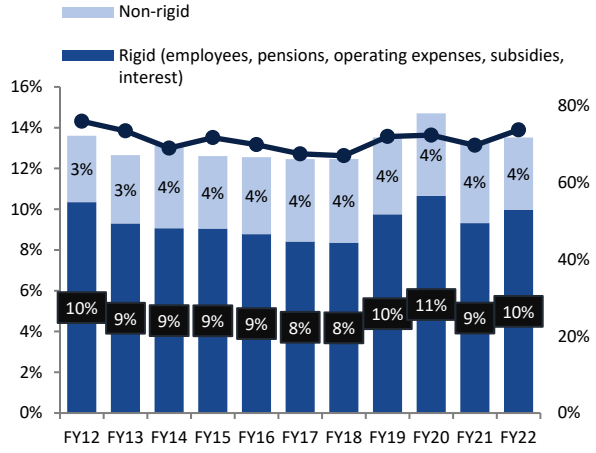
[15] Fiscal policymaking institutions at the federal level include the Finance Division, FBR, and Ministry of Planning. At the provincial level, the fiscal policymaking institutions for each province include the Finance Department, Planning Department, Revenue Authority, Board of Revenue and Excise Department. Therefore, there are at least 23 institutions involved with fiscal policymaking at the national level.

to productivity-enhancing public investment. With higher investment, the country can step up onto a higher growth path and achieve more rapid economic development. CGE simulations indicate that a sharp fiscal consolidation in the near term can lead to public investments growing by nearly 50 percent, resulting in real GDP per capita being larger by 7 percent in 2035, as compared to the no reform baseline.

2. How can federal fiscal expenditures be rationalized for fiscal savings and the efficiency of development spending be improved (Chapter 2)?

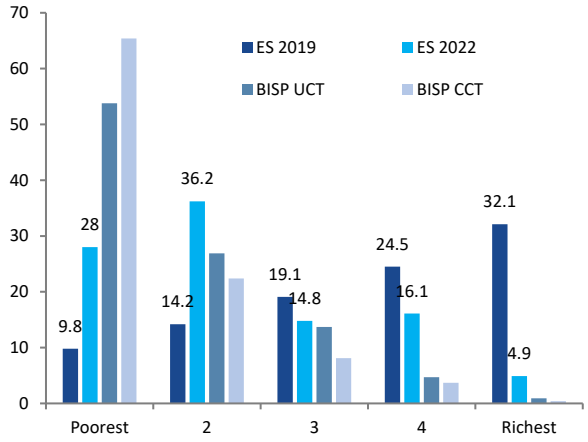
Pakistan's federal fiscal spending is particularly rigid. In FY22, combined federal and provincial expenditure stood just above PKR 13 trillion, around 19.7 percent of GDP, with the Federal Government accounting for about two-thirds at 13.5 percent of GDP. While these levels are not high by international standards, the spending pattern is strikingly rigid, with almost 70 percent of total spending per year being allocated to pre-committed areas such as interest payments, transfers and subsidies, and payments to public sector staff (Figure ES.5). These levels are higher than that of regional peers. For instance, Nepal's share of rigid federal government expenditure is less than 60 percent.

Figure ES.5: Federal government spending, by rigidity
(percent of GDP)



Source: Ministry of Finance, World Bank staff calculations

Figure ES.6: Distribution of benefits of different subsidies by quintile
(% of total benefits of a given subsidy)



Source: World Bank Staff calculations based on HIES 2018-19.

Despite its importance, public development spending is low. With a substantial share of fiscal spending being pre-committed, there is little fiscal space for public investment. Consolidated development spending in Pakistan stood at 2.5 percent of GDP in FY22, of which the Federal Government contributed about 84 percent. These levels are very modest and lower than that of regional peers; India's general government capital spending in FY21 stood at 6.7 percent of GDP. Low levels of investment have been a driving factor to Pakistan's recurrent boom–bust cycles and has contributed to low growth in productivity, potential output, and employment.

In addition to low quantities, the quality of development spending is also constrained by weak public investment management processes. Although Pakistan has a de jure comprehensive process to plan and implement development projects, there is evidence that this process is only partially implemented. Past reviews of public investment management have, among other factors, highlighted the absence of independent reviews of appraisal and selection outcomes and the inclusion of projects in the

development budget that were not approved. In addition, the authorities have struggled with implementing an integrated strategy for development spending, driven by an unclear de facto division of responsibility between federal and provincial levels, the absence of detailed sectoral strategic guiding documents, and the institutional separation between the Planning Commission and the Ministry of Finance (MoF). Cognizant of these challenges, the authorities have approved a new PFM Act in 2019, which prohibits the inclusion of unapproved projects in the budget and strengthens quality assurance and rigorous selection procedures.

Reducing energy and commodity subsidies can minimize poorly targeted and regressive spending. The Federal Government relies on poorly targeted and regressive subsidies to provide social and economic support. Electricity subsidies, mostly in the form of tariff differential subsidies, accounted for 15 percent of total subsidies released in FY22 and for 0.27 percent of GDP. Historically, these subsidies were poorly targeted and regressive, with 77 percent of the benefits accruing to middle-income and richer households the bottom 40 percent only benefited from 23 percent of total spending in 2019 (Figure ES.6). In an effort to improve targeting and reduce regressivity, a new category of protected consumers was created and the electricity tariff schedule was revamped with the support of the World Bank PACE operation. By end 2022, targeting had greatly improved with 64 percent of the subsidy benefits accruing to the bottom 40 percent and only 36 percent of the benefits accruing to the top 3 quintiles of the income distribution. Similar targeting issues also exist for other major subsidies provided by the Federal Government, including subsidies for tube-well operations and wheat. By contrast, the Benazir Income Support Programme (BISP) benefits are much better targeted, with 81 percent of BISP spending benefitting the bottom 40 percent. Reallocating spending from similar costly and inefficient subsidies, such as those on natural gas, petroleum, tube-wells, wheat and fertilizers towards a targeted transfer program such as the BISP,[16] can help to realize federal fiscal savings while simultaneously achieving improved social outcomes.

Realigning federal recurrent and development spending with constitutional mandates can decrease redundancies and duplication of tasks and costs. Despite the 18th amendment, the Federal Government maintains recurrent spending on areas that have been devolved to the provinces. Overlaps between federal and provincial recurrent spending should be eliminated from the federal budget to improve accountability, reduce duplication and waste, and realize federal fiscal savings. This should be pursued as provincial governments build their capacity to finance the delivery of devolved functions through expenditure and revenue reforms.

(i) Spending by federal ministries and autonomous institutions focused on devolved subject areas, such as those for health and education, amounted to PKR 398 billion or 0.6 percent of GDP in FY22.[17]

(ii) The Federal Government funds or co-funds vertical programs, such as the BISP, that directly provide services in the provincial domain. Federal spending on the BISP was 0.36 percent of GDP in FY22. The cost sharing of the BISP where the provinces eventually bear 90 percent of the program could yield PKR 217 billion or 0.32 percent of GDP of federal fiscal savings.

(iii) There continues to be significant federal development spending on devolved areas, which amounted to PKR 315 billion or 0.5 percent of GDP in FY22. An exclusive focus on development spending in the federal domain therefore has large savings potential for the Federal Government.

[16] www.bisp.gov.pk

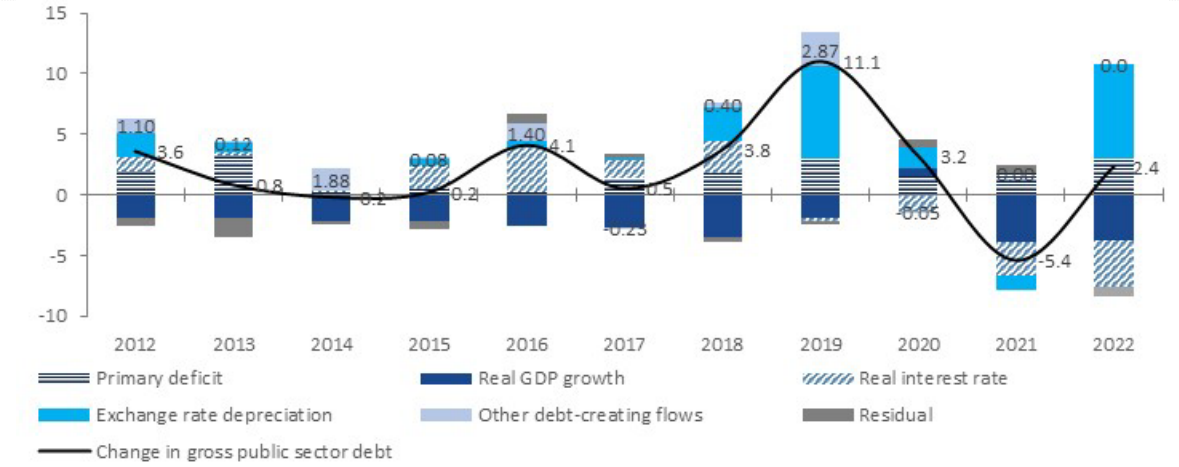
[17] The financing of specific semi-autonomous institutions, if deemed critical for service delivery, can be subsequently taken up by the provinces in line with the constitutional mandates.

3. What are the non-budgetary drivers of the debt stock and how can they be managed (Chapter 3)?

Pakistan's Public and Publicly Guaranteed Debt (PPGD) stock is high and still growing. The public debt stock, including guaranteed debt, reached 78.0 percent of GDP at the end of FY22, increasing from 58.6 percent of GDP at end-FY10. The debt levels breached Pakistan's Fiscal Responsibility and Debt Limitation Act (FRDLA) 2005,[18] which requires public debt to be at most 60 percent of GDP at the end of FY23. As a result of the large debt stock, interest payments at 4.7 percent of GDP account for over one-third of its total federal expenditure in FY22. When compared across the region for the past 10 years, the country's average public debt share was higher than the regional average.

Pakistan's high debt-to-GDP ratio makes it vulnerable to macro-fiscal shocks. The Debt Sustainability Analysis (DSA) projections show that the debt stock is expected to remain above the FRDLA threshold in the medium term under all scenarios examined. Therefore, Pakistan's fiscal authority has no margin to run large fiscal deficits as this can drive up public debt to unsustainable levels. The DSA also reveals that Pakistan's public debt stock is vulnerable to exchange rate shocks. Given Pakistan's volatile macroeconomic environment, these shocks not only drive up the public debt levels but also constrain fiscal space by increasing debt servicing costs.

Figure ES.7: Key Drivers of Pakistan's Public and Publicly Guaranteed Debt
(Change in PPGD, % of GDP)



Source: Ministry of Finance and World Bank staff calculations
Note: Contingent liabilities will be captured under "Other debt-creating flows"

Non-budgetary items such as macroeconomic developments – including interest rate increases and exchange rate depreciations – have emerged as key drivers of debt (Figure ES.7). Pakistan's debt management choices expose the country to macroeconomic risks through a comparatively high share of external borrowing and a reliance on short-term debt instruments. Between 2012 and 2022, exchange rate depreciation contributed a cumulative 22.5 percentage points (pp) of GDP to the PPG debt level, of which 15 pp occurred over two years, FY19 and FY22. Although the contribution from interest rate changes was negative over the same period – contributing to a reduction of the debt stock – this was more than offset by the revaluation losses due to exchange rate depreciations. Interest rate changes have

[18] Amended in 2017 and 2022.

contributed to debt accumulation before 2019, accounting for a cumulative increase of 11.4 pp of GDP from FY12 to FY18.

Pakistan's debt management choices are a critical non-fiscal driver of public debt. A fiscal impact model is employed to quantitatively evaluate the effects of different debt management choices on Gross Financing Needs (GFN) and the public debt-to-GDP ratio. Pakistan's overreliance on short-term domestic and external financing instruments has led to rising solvency risks due to a growing GFN. For a given fiscal and exchange rate path, the short-term financing debt strategies show higher risks in terms of GFNs compared with medium- and long-term strategies. Debt strategies with a higher share of external borrowings show higher public debt-to-GDP ratios than those where domestic funding largely predominates. The shallow domestic debt capital market of Pakistan is a critical constraint to executing a debt strategy that can extend the maturity profile of debt and lower the exchange rate risk.

The lack of an integrated debt management function undermines sound debt management in Pakistan, leading to suboptimal borrowing choices. The fragmentation has resulted in insufficient coordination among the various institutions involved, suboptimal borrowing choices, duplication of competencies, and a disconnect between debt management strategy design and implementation. The Debt Management Office (DMO) remains severely understaffed despite the recent reforms to establish a unified debt office. The lack of a centralized Debt Management Information System (DMIS) underscores how debt management operations are being recorded and managed by four institutions in three different systems (and an Excel database) that are not linked electronically. In addition, critical lagging debt management areas include: i) insufficient information sharing among the State Bank of Pakistan, the Budget Wing of the Finance Division, and the Debt Office on current and future debt transactions, and central government cash flows; ii) lack of effective cash forecasting; and iii) the unavailability of business continuity and disaster recovery plans across the entities that register debt records. The Treasury Single Account can be immediately implemented and can improve cash management and render fiscal savings of up to PKR 404 billion (0.6 percent of FY22 GDP) annually.

Contingent liabilities contribute to sudden jumps in Pakistan's debt levels due to inadequate coverage, recording, evaluation, disclosure, and appropriate accounting treatment. Over the years, the Federal Government has absorbed considerable additional expenditures that have directly driven larger-than-budgeted fiscal deficits. A part of these additional expenditures is due to the contingent liabilities that were not appropriately budgeted. The public debt management and fiscal risk analysis in Pakistan focus on the issuance, recording, and evaluation of guaranteed debt that mainly comprises sovereign guarantees issued to SOEs. A realistic assessment of contingent liability predicts a much larger fiscal risk than currently recorded and reported, which can be detrimental to public debt sustainability.

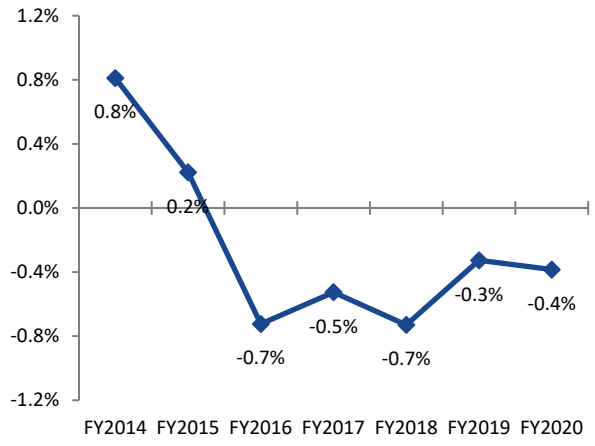
Pakistan's high public debt levels warrant significant reforms in the public debt management domain, including the establishment and staffing of a unified debt office, the development of the domestic debt market, and better management of contingent liabilities. The DSA highlights that containing fiscal deficit remains critical to bringing public debt below the FRDLA ceiling of 60 percent of GDP. However, Pakistan's public debt stock is sensitive to exchange rate and interest rate shocks and in this context, a tailored debt management strategy can help lower these macroeconomic risks and lower the public debt burden over the medium term. Implementing such a debt strategy entails reducing Pakistan's exposure to non-concessional external borrowing through concessional long-term financing and extending the maturity profile of the domestic debt portfolio. This strategy can only be implemented if anchored by a fully staffed and integrated DMO that also lays the foundation of a well-functioning domestic debt market in

coordination with financial sector regulators to facilitate the availability of domestic long-term financing. Lastly, better management of contingent liabilities can also help in reducing Pakistan's debt burden. Pakistan can benefit from a preemptive approach to systemically disclose, record, monitor, and manage debt-related contingent liabilities. Better reporting can be done through a consolidated fiscal risk report that covers key risks such as circular debt, commodity operations, and natural disasters. The contingent liabilities can be better assimilated with the PPG debt by revising the definition of PPG debt in the FRDLA to include the stock of guaranteed debt.

4. What is the impact of federal SOEs on the finances of the Federal Government and how can they be minimized (Chapter 4)?

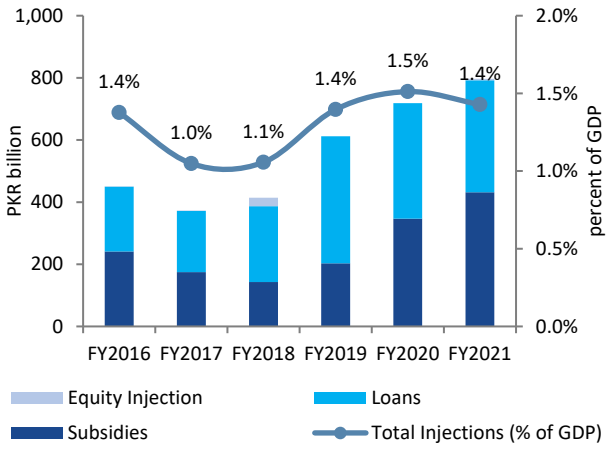
Federal SOEs impose a significant fiscal drain and pose substantial fiscal risks on the Federal Government. Federal commercial SOEs have been incurring losses since FY16, with annual losses averaging at 0.5 percent of GDP over FY16–FY20 (Figure ES.8). With the persistent losses, the accumulated SOE losses have become substantial, amounting to 3.1 percent of GDP in FY20. To cover the losses, the Federal Government has been providing direct fiscal support to the SOEs, in the form of subsidies, loans and equity injections,[19] which totaled 1.4 percent of GDP in FY21 (Figure ES.9). In addition to direct support, the Federal Government has been also issuing guarantees for SOEs to secure loans from commercial banks. Federal government exposure to SOEs, defined as the outstanding stock of guarantees and government loans to SOEs, has been rapidly increasing and stood at 9.7 percent of GDP in FY21.

Figure ES.8: Federal SOEs – Net Profit
(percent of GDP)



Source: Database of State-Owned Enterprises, Ministry of Finance.

Figure ES.9: Direct Fiscal Support to SOEs
(PKR billion, % of GDP)



Source: Database of SOEs, Ministry of Finance.

Individual SOE performance is largely dictated by sectoral performance. Although the primary reasons for SOE losses differ, they are typically related to: (i) unresolved corporate governance issues (ii) sector regulations; (iii) an underestimation of the cost of the provision of public service obligations; (iv) incomplete restructuring; and (v) insufficient current subsidies. An SOE portfolio analysis showed that individual SOE performance is influenced by sectoral policies and the level of operational autonomy by the Board of Directors and senior management. SOE losses are concentrated in the power, infrastructure,

[19] Direct equity injections have been negligible in recent years.

and transport sectors, and in aggregate, outweigh profits from profitable SOEs. Although a sizable number of commercial SOEs generated profits in FY20, they were concentrated in the oil and gas sector.

Preferential access to loan financing for SOEs is likely to crowd out financing to the private sector. Based on their financial statements, loss-making SOEs are unable to secure large loans from commercial banks without government-backed guarantees. These guarantees from the Federal Government significantly improve their risk profile, affording these SOEs preferential financing access. This access, however, creates a disparity with other firms, which will have less ready access to credit. Government guarantees to SOEs, therefore, creates distortions in the financial sector that are likely to lead to crowding out of bank financing to the private sector. Managing the level of guarantees issued is therefore necessary to mitigate such crowding out of the private sector.

A number of SOEs have a poor track record for government loan repayments.[20] Out of the stock of outstanding domestic loans to federal commercial SOEs in FY21, overdue principal and interest payments accounted for more than 30 percent, indicating a poor track record for loan repayments by SOEs. Many SOEs that are beneficiaries of government guarantees do not have a financially viable means to repay the guaranteed loans as their revenue streams are limited.

Critical corporate governance reforms, such as the implementation of the SOE Governance and Operations Law (2023), finalization of the SOE Ownership Policy and the operationalization of the SOE Oversight Unit, are still pending. The SOE Law aims to enhance the governance framework, management, and financial efficiency of SOEs, while limiting the fiscal risks stemming from their operations. The Law lays the groundwork for a gradual move toward a more centralized model, whereby a newly created SOE unit in the MoF, the Central Monitoring Unit (CMU), would assume the functions of SOE ownership and oversight. Currently, there is no policy framework to set objectives and principles for the state ownership of SOEs, which has perpetuated an ad hoc approach to the ownership and oversight functions. The state ownership policy will define the rationale for state ownership based on explicit criteria. The Federal Government has embarked on the roadmap to improve the SOE performance by identifying reform pathway for the SOEs; however, the reforms are still pending. Due to these delays, the lack of transparency and accountability is likely to continue and may result in further unanticipated fiscal risk from SOE operations.

Although the MoF has been publishing extensive data concerning federal SOEs, it is produced with considerable time lag, thus impacting evidence-based decisions. The last published report on SOE financial performance was for FY 2019. The line ministries and the MoF do not have readily available up-to-date data. Further, SOE information is not reflected in the public sector financial statements.

The fiscal burden and risks stemming from the SOEs can be reduced by managing government loans and guarantees, proper disclosure of SOE debt including explicit and implicit contingent liabilities, better reporting, and enhanced corporate governance measures. Fiscal risks emanating from government loans or guarantees can be mitigated by ensuring that SOEs, when requesting for government loans or guarantees, (i) are current on existing loan repayments, (ii) have identified revenue streams that can be designated for loan repayments, and (iii) have collateralized SOE assets for commercial loans. The Fiscal Risk Statement of the Federal Government should properly disclose SOE debt, including both explicit guaranteed debt and implicit obligations, such as non-guaranteed loans, intra-SOE debts, and unfunded pension liabilities of SOE employees. The Federal Government should also improve the

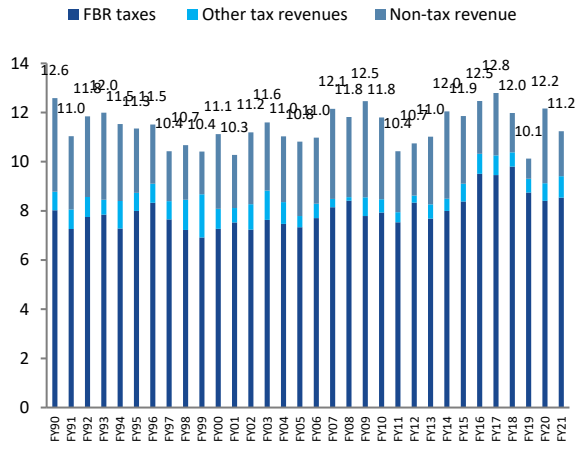
[20] Both domestic and foreign relent loans.

comprehensiveness of the Public Sector Financial Statement by incorporating into its balance sheet information, such as state holdings in SOEs and government receivables from and payables to SOEs. The Government should consider an institutionalized computerized mechanism of generating timely aggregate reports on SOEs for more effective decision-making. The Government should accelerate the implementation of the SOE Law and prioritize the finalization of the SOE ownership policy and the formulation of related rules and regulations. Finally, concrete steps need to be taken by the Federal Government to implement the reform roadmap for the key loss-making SOEs that can potentially reduce the annual fiscal outflows of approximately PKR 458 billion or 0.8 percent of GDP and would significantly contain the fiscal risk to the Federal Government.

5. What are the avenues through which fiscal revenue collection can be enhanced (Chapter 5)?

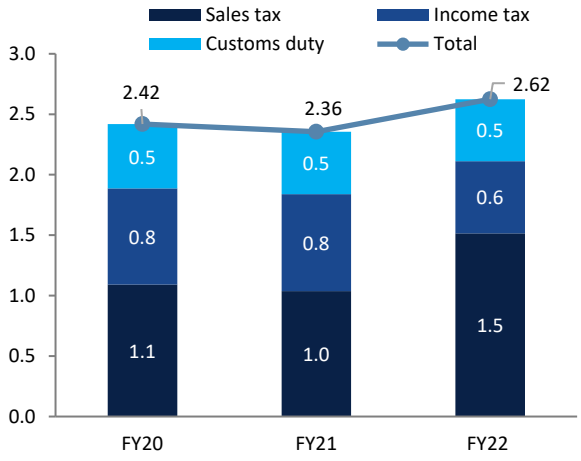
Despite various reform efforts, revenue collection has been stagnant over time and remains low in international comparison. In FY21, federal aggregate revenue stood at 11.2 percent of GDP, while tax revenue was 9.4 percent of GDP and only increased modestly over the last decade (Figure ES.10). This puts Pakistan squarely behind regional and international peers. In FY18, for instance, Pakistan's tax revenue generation was 2.8 percentage points of GDP lower than the South Asian average and 3.5 percentage points lower than the average of low- and lower-middle-income countries. Pakistan lags its peers' tax performance across revenue sources, including indirect consumption and trade taxes, as well as direct corporate and personal income taxes.

Figure ES.10: Total revenue, by source and year
(percent of GDP)



Source: Ministry of Finance, World Bank staff calculations

Figure ES.11: Cost of tax expenditures, by tax
(percent of GDP)



Source: Ministry of Finance, Tax Expenditure Statement, various years; and World Bank Staff calculations.

Pakistan's tax system is complex, has a narrow tax base, and high tax rates. The tax system has numerous special provisions, concessional rates, exemptions and, to some extent, unorthodox approaches to tax policy. Many of these policy choices were implemented to balance the provision of fiscal support to certain groups or industries with the need to maintain a minimum level of revenue collection. This has resulted in a system with many vested interests and has come at the cost of economic efficiency and the ability to sustainably raise revenue to a level that can finance Pakistan's spending needs. To raise more revenue in a sustainable manner, the tax system needs to be simplified, the tax base broadened, and the

burden on compliant taxpayers concurrently reduced. While the tax system also suffers from institutional fragmentation between the federal and the provincial level, this report, consistent with its mandate, focuses on federal tax policy only.

Tax expenditures contribute to revenue losses. Estimates show that past efforts to broaden the tax base have not resulted in tangible outcomes: in FY22, Pakistan lost a total of 2.6 percent of GDP to tax concessions, 0.2 percentage points more than in FY20 (Figure ES.11). Tax expenditures account for a substantial share of revenue potential. According to the official figures, Pakistan annually lost an average of 26, 18, and 30 percent of sales tax, income tax, and custom duty revenue potential, respectively, between FY20 and FY22.

The sales tax base is narrow with multiple exemptions, concessionary rates, and zero ratings, all contributing to low revenue efficiency. The sales tax base definition is narrow, with multiple exemptions being permitted. In addition to exemptions, the sales tax system also allows for concessionary rates below the standard 18 percent for select products and sectors. Pakistan also allows certain domestic supplies to be zero-rated under the sales tax, which further narrows the tax base. The fractionalized design of the sales tax has resulted in low revenue efficiency. A VAT gap analysis, conducted with reference to FY19 GDP, reveals that concessionary tax rates, exemptions, and zero-ratings for non-exported products cost Pakistan 15 percent of its revenue potential. In addition, estimates show that the tax exemptions induce economic distortions and place a larger burden on the production of intermediate products.

The personal income tax is complex, which allows for income shifting, and contains multiple provisions that narrow its base. Tax schedules are complex and differ significantly between salaried individuals and other taxpayers, which risks generating economic distortions and creating opportunities for tax avoidance through income shifting. Tax schedules can be simplified and harmonized, and regressive income tax holding measures removed to improve equity.

The corporate income tax (CIT) is complex and features numerous preferential schemes. CIT rates differentiate between three different regimes, with different tax rates and special provisions applying to standard companies, small firms, and small and medium-sized enterprises in the manufacturing sector. These differentiations generate incentives for firms to split or stay small. Similarly, Pakistan provides certain firms access to a simplified turnover tax regime, which is both financially lucrative for the firms and reduces incentives for them to invest in accounting, business formalization, and growth. The CIT regime also provides for various tax incentives. These include outright tax holidays, reduced rates, credits, and exemptions granted by sector, investment type, and location. Pakistan's thin-cap provisions only have limited coverage, opening opportunities for firms to reduce their tax liabilities.[21]

Federal excise duty collection on cigarettes lies below its potential. Pakistan collected 0.5 percent of GDP in federal excise duty revenue in FY21. The taxation of cigarettes was the main contributor to this and accounted for 0.19 percent of GDP, which has remained relatively steady in recent years. Cigarettes are taxed through a dual rate. A substantial revenue gain 0.4 percent of GDP could be achieved if the current rate on premium cigarettes (PKR 16.50 per cigarette) was also applied to standard cigarettes.

[21] Thin-cap provisions regulate firms that are financed by a relatively high portion of debt compared to equity. In such circumstances, interest expenditure is high, which reduces firms' tax liability. Thin-cap provisions limit the amount of interest that can be deducted in calculating the taxable profits thereby preventing companies from avoiding tax liabilities through excessive debt.

Pakistan can strengthen revenue through a concerted policy effort aimed at reducing complexities and broadening tax bases. The sales tax can be strengthened by gradually rationalizing concessions, harmonizing sales tax rates across products, removing zero-ratings for all but exported products, and limiting sales tax exemptions to only basic need items. Personal income taxation would benefit from simplifying and harmonizing personal income tax schedules. The CIT system can be simplified by harmonizing the existing concessional regimes into a single regime with a simple turnover-based eligibility threshold. As a next step, the standard regime could be harmonized to include a single rate. Tax-base broadening could be achieved by expanding thin-cap provisions, and by critically evaluating the cost-effectiveness of tax incentive schemes. Cigarette taxation can be strengthened by applying the current premium excise rate to all types of cigarettes and establishing an automatic mechanism to ensure that the rate adjusts for inflation.

6. Policy recommendations and federal fiscal savings

The estimated fiscal savings for the Federal Government derived from the fiscal 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 ES.1). Policy measures to reduce federal 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 federal SOEs, the report highlights the divesture of the largest loss-making SOEs, in accordance with the triage recommendations. Suggested reforms for enhancing domestic revenue collection include base-broadening measures, such as the reduction of goods sales tax exemptions, simplifying personal and corporate income tax schedules, and combining the tobacco excise tiers into one while 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. Table ES.2 provides the full list of PER recommendations**.**

Table ES.1: Key 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[22]
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[23]
Reduced operational spending on devolved ministries and autonomous institutions	Despite the 18th 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 institutions focused on devolved subject areas can be gradually reduced and eventually eliminated from the federal budget.[24]	398	0.59
Cost sharing by provinces on the Benazir Income Support Programme (BISP)	The Federal Government funds or co-funds vertical programs, such as the 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[25]
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**

[22] Actual electricity tariff differential subsidy spending in FY22. Estimated fiscal cost savings for FY23 is PKR 223 billion.
[23] FY22 subsidy to the Pakistan Agricultural Storage & Services Corporation (PASSCO - www.passco.gov.pk)
[24] The financing of specific semi-autonomous institutions, if deemed critical for service delivery, can be subsequently taken up by the provinces in line with the constitutional mandates.
[25] 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 one 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**

Table ES.2: PER Policy Recommendations

Topic	Area	Recommendations	Timeline	Responsible Agency
Expenditure	Realizing federal fiscal savings	Reduce spending on subsidies while compensating poorer households through the BISP Undertake a staff review in devolved ministries Devolve or identify cost sharing arrangements for federal spending in provincial areas of responsibility Stabilize interest expenditure through lower risk debt management choices	Short term	MoF
	Enhancing spending quality	Adopt IMF Government Financial Statistics definitions for international comparability Fully implement provisions under the new PFM Act and the associated updated PIM Manual Use parts of the fiscal saving to ramp up development spending and BISP spending	Medium term	MoF
	Mitigating fiscal risks	Invest in cash management, forecasting and budgeting to limit the crowding-out of development spending Integrate fiscal risk planning and debt management functions in the Ministry of Finance	Long term	MoF
Debt	Debt Management	Establishment of an integrated Debt Management Office as envisioned under the FRDLA 2022 and complete staffing of the (DMO).	Short term	Finance Division
		Publication of annual rolling MTDS, annual borrowing plans, annual debt review, and semi-annual debt bulletins by the DMO.	Short term	DMO-Finance Division

		Establish cash forecasting capability and monitoring of performance in the Budget Wing of the Finance Division. There should be timely communication of the cash forecast to the DMO to optimize borrowing decisions and avoid over-borrowing. Adopt the Treasury Single Account (TSA)	Short term	Budget Wing-Finance Division
		Implement debt management training policies that allow constant monitoring of the costs and risks of the debt strategy.	Short term	DMO-Finance Division
		Installation of a Debt Management Information System (DMIS) at the DMO that links all debt databases. Publish national accounts data on a quarterly basis to enhance macroeconomic monitoring.	Medium term	DMO-Finance Division
		Development of domestic debt capital market to increase the maturity profile of domestic debt stock.	Medium to long term	DMO- Finance Division in collaboration with SBP and SECP
	Contingent Liabilities	Analyze and appropriately disclose implicit contingent obligations such as circular debt settlements, commodity operations, and natural disasters through a fiscal risk statement.	Short term	Macro-Fiscal Policy Unit (MFPU)- Finance Division
		Strengthen the DMO middle office function to properly evaluate and award guarantees.	Short to medium term	DMO-Finance Division
		Revise definition of public debt in FRDLA to include guarantees.	Short to medium term	DMO-Finance Division
SOEs	Reducing the fiscal impact of SOEs	Define a stringent process for SOE financing requests Non-electricity subsidy (food security and essential items) should be based on unit cost of production and measured through performance contracts Enforcement of SOE loan agreements should be strengthened.	Short term Medium term Medium term	MoF MoF, Utility Stores MoF, EAD, Line Ministries, SOEs
	Contain fiscal exposure from SOE support	Protect guarantees issuance for commercial loans through collateralizing SOE assets. Mandate credit risk rating for borrowing SOEs.	Medium term	MoF

		Regularly report guarantees for commodity financing operations in the Public Debt Bulletin and governed by FRDLA Adequately disclose fiscal risk statements regarding SOE obligations including explicit and implicit obligations. Institutionalize and computerize the generation of aggregate SOE reports for effective decision making Develop monitoring procedures for implicit obligation Improve comprehensiveness of public sector financial statements by incorporating state holdings in SOEs, as well as government receivables from and payables to SOEs Develop reform plan for NHA to reduce fiscal impact and contain fiscal exposure Ensure that all commercial SOEs fully adopt IFRS and that adequate disclosures are made particularly on currency and interest rate risk on foreign re-lent loans		NHA SOEs
	Undertake Triage	Assess the restructuring cost and allocate a multi-year budget to implement reforms planned through the 2021 triage exercise Develop a reform roadmap to improve performance and reduce fiscal impact for the entities which government plans to retain and restructure Pursue options for divesture, where possible Government may consider the possibility of converting overdue CDLs to equity shares where possible, to improve balance sheet for companies planned to be privatized	Medium to Long term	MoF, Line Ministries, Privatization Commission and SOEs
	Corporate Governance	Accelerate the promulgation of the SOE bill and prioritize the SOE ownership policy and the formulation of related rules and regulations. Strengthen the capacity of central monitoring unit as a central coordinating and oversight agency. Institutionalize performance monitoring for SOEs.	Short to Medium term	MoF

		Auditor General of Pakistan (AGP) should explicitly define financial reporting framework and accounting convention for agencies/autonomous bodies functioning as commercial SOEs, such as Pakistan Railways		AGP
Revenue	Sales Tax	Unify the rate structure and eliminate zero ratings on domestically sold products.	Short term	MoF
		Reduce sales tax exemptions while concurrently lowering the overall rate.	Medium term	MoF
		Unify and align the sales tax registration threshold with the CIT threshold and harmonize the provincial and federal sales tax systems.	Long term	MoF
	Personal income tax	Unify and simplify personal income tax schedules.	Short term	MoF
		Reduce the time dependence of capital gain tax liability.	Medium term	MoF
		Establish a simple two-type income system that only differentiates between labor and capital	Long term	MoF
	Corporate income tax	Create a unified and simplified concessional tax regime for small companies.	Short term	MoF
		Unify the standard rate regime, expand thin-cap provisions and rationalize tax incentives.	Medium term	MoF
		Resolve inconsistencies between the turnover and alternative tax regimes.	Long term	MoF
	Federal Excise Duty on Cigarettes	Create an automated mechanism to adjust excise rates for inflation.	Short term	MoF
		Roll out an effective digitized stamp system.	Medium term	MoF
		Unify the tax system to increase its revenue potential.	Long term	MoF

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Chapter 1

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

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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 (**T**able 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]

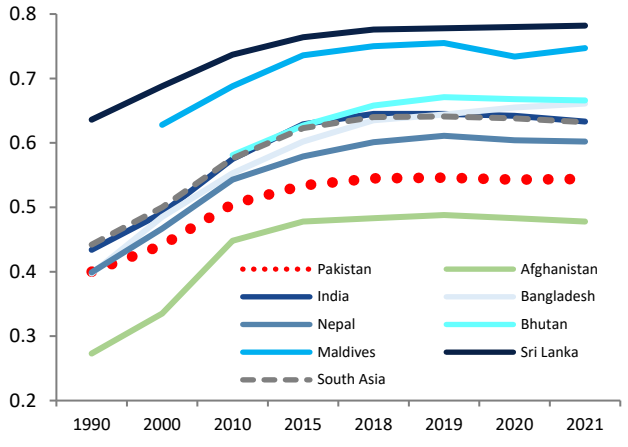
Table 1.1: Pakistan – Trends in Poverty Incidence and Human Development Indicators

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)

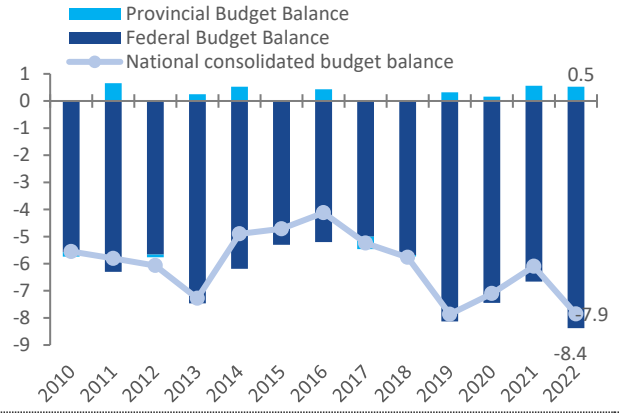
[2] World Bank (2020). *Islamic Republic of Pakistan: Leveling the Playing Field. Systematic Country Diagnostic.* September.
[3] The regressions in human development from 2019 to 2021 are largely on account of the effects of the COVID-19 pandemic.
[4] World Economic Forum (2019). *The Global Competitiveness Report 2019.* Geneva: World Economic Forum.

growth,[5] and a World Bank study[6] 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

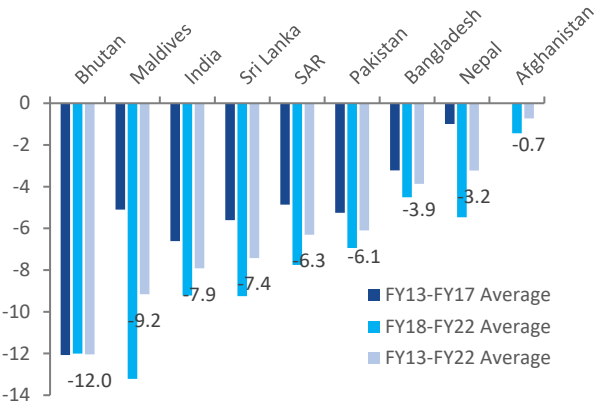
Pakistan's fiscal deficits have been large, persistent, and growing. In FY22, Pakistan's general government fiscal deficit (excluding grants)[7] stood at 7.9 percent of GDP in FY22, matching the FY19 deficit to be the highest for at least the last 22 years[8] (Figure 1.2 and Table 1.2). The deficit has 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 government[10] 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 revenue[1]	**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:

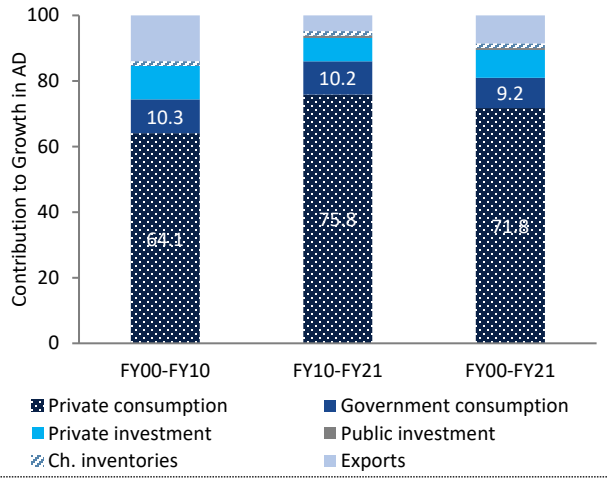
1. From FY21 onwards, the Ministry of Finance has included revenue from Gas Infrastructure Development Cess, natural gas development surcharge, and petroleum levy in non-tax revenue. For consistency of analysis across years, these taxes have been included in tax revenue.

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.

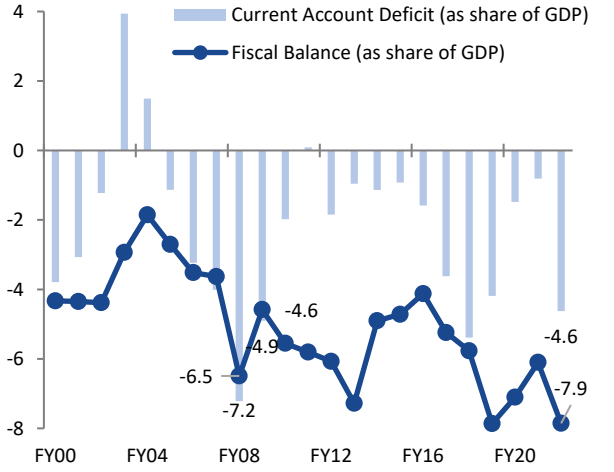
[10] The general government defined as the Federal Government and the provincial governments combined.

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)



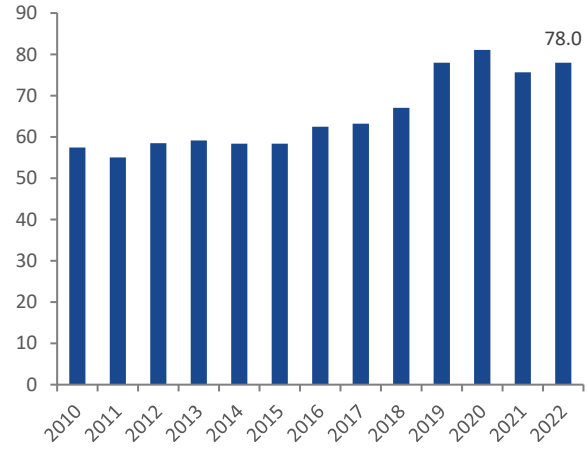
Source: Ministry of Finance, World Bank staff calculations

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]

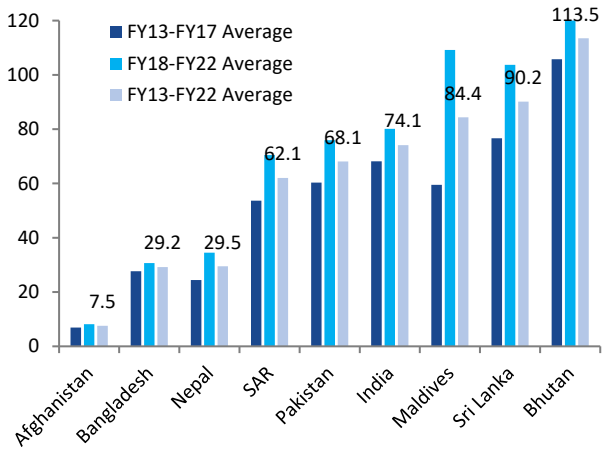
[11] World Bank (2022a). *From Swimming in Sand to High and Sustainable Growth: A Roadmap to Reduce Distortions in the Allocation of Resources and Talent in the Pakistani Economy*. Islamabad: World Bank.
[12] Pakistan's current deficit was 4.6 percent of FDP in FY22, the largest in four years. Similarly, 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

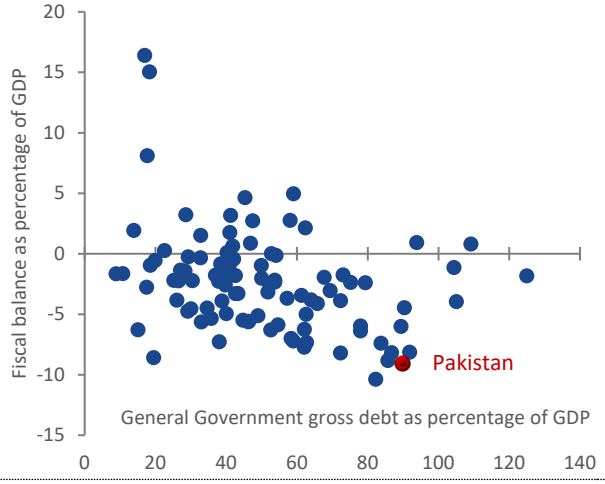
Figure 1.7: South Asia: Public and Publicly Guaranteed Debt
(Percent of GDP)



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

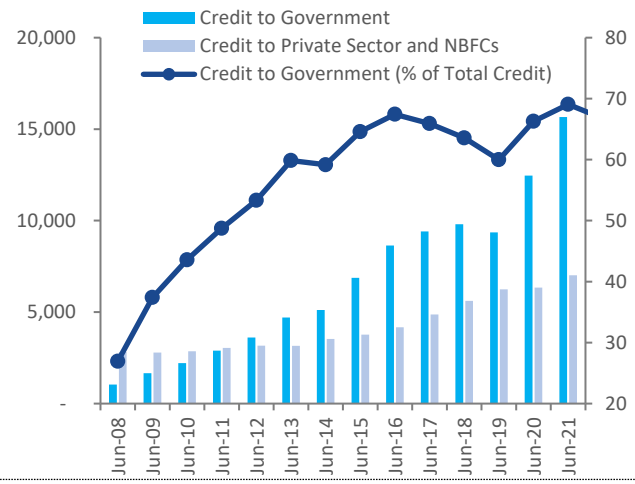
The fiscal deficit and its financing have led to a strong sovereign-financial sector nexus in Pakistan. The continued sizeable fiscal deficits have contributed to a buildup of public debt held by the domestic financial sector. In July 2022, more than 70 percent of all bank credit was extended to the 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)



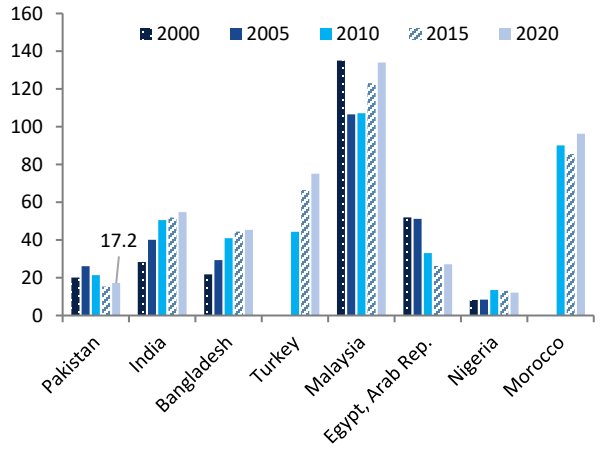
Source: World Bank (2022b)[14]

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.

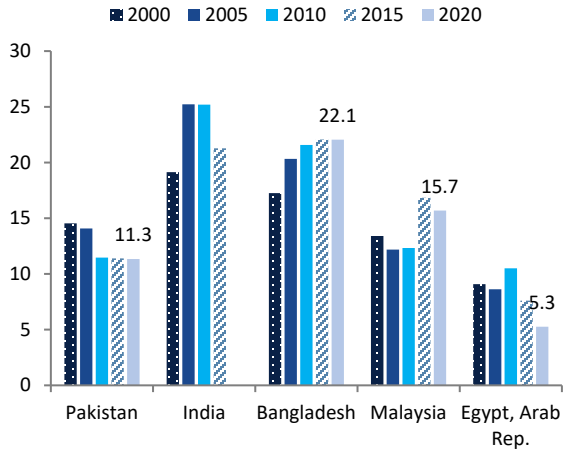
commodity operations, and lending to SOEs, has increased by more than 400 percent over FY11–21. The increased exposure to the public sector has contributed to the crowding out of credit to the private sector, which has fallen to 17.2 percent in 2020, one of the lowest among emerging economies (Figure 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)



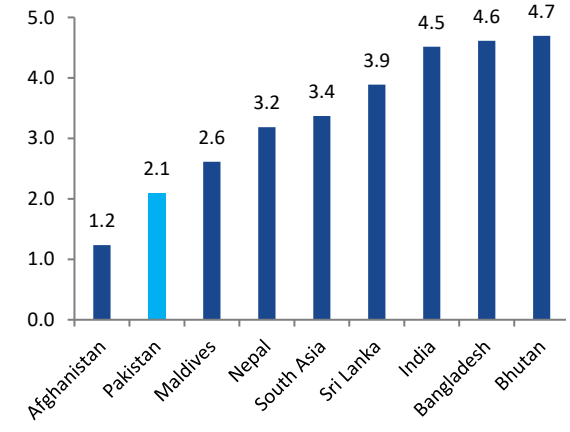
Source: World Development Indicators (WDI) and World Bank (2022b)

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 stymy 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).

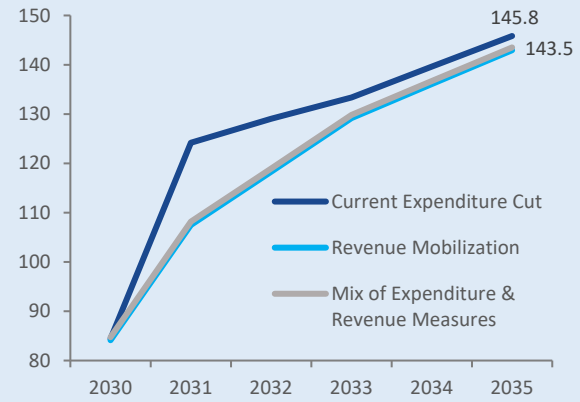
Box 1.1: Growth Dividends from Fiscal Consolidation

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.

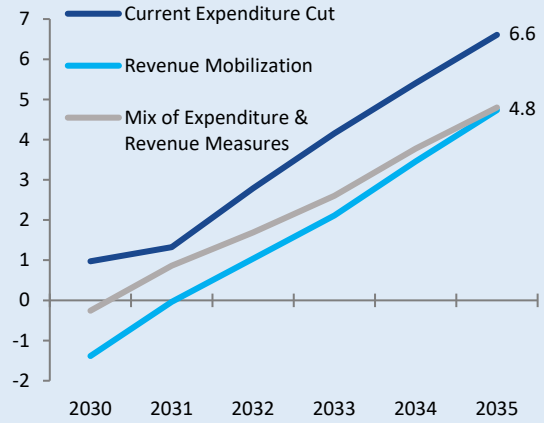
To simulate the growth effects from channels 2 and 3 through higher private and public investment, respectively, we assume the Government undertakes a sharp fiscal consolidation to bring the overall fiscal deficit to 3.5 percent of GDP by FY25, in line with the FRDLA deficit threshold. Fiscal consolidation 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)

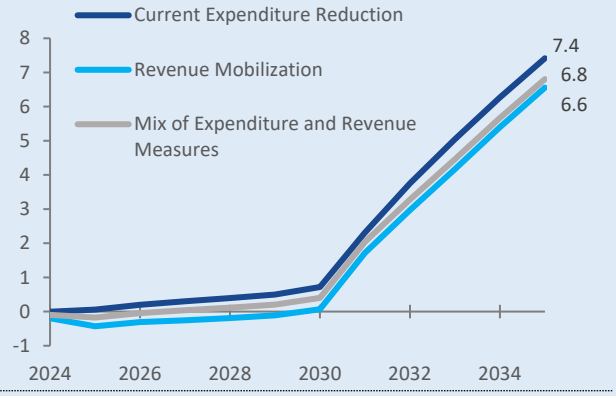


Source: World Bank staff simulations

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.

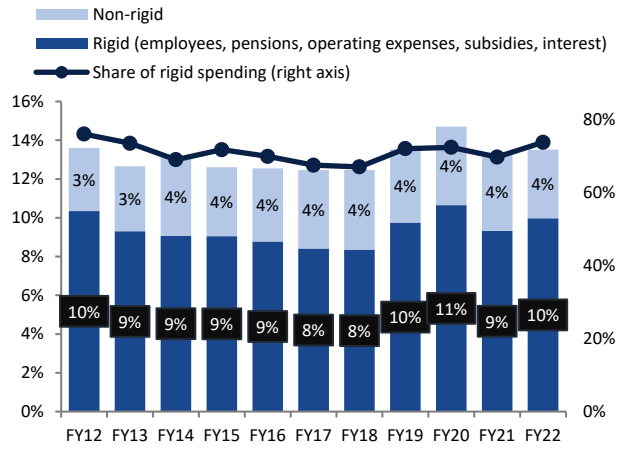
1.5 Drivers of Persistent Fiscal Deficits

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

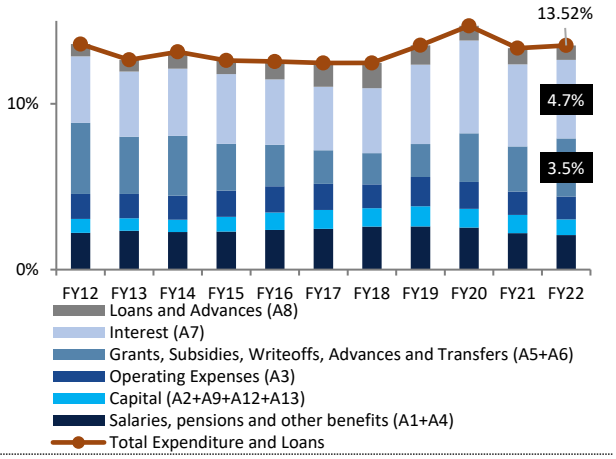
Federal government spending is largely rigid, providing little scope for fiscal consolidation by reducing discretionary expenditures. One of the factors driving the persistence of large fiscal deficits is the rigidity of federal government expenditures. The federal government expenditure, standing at 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)



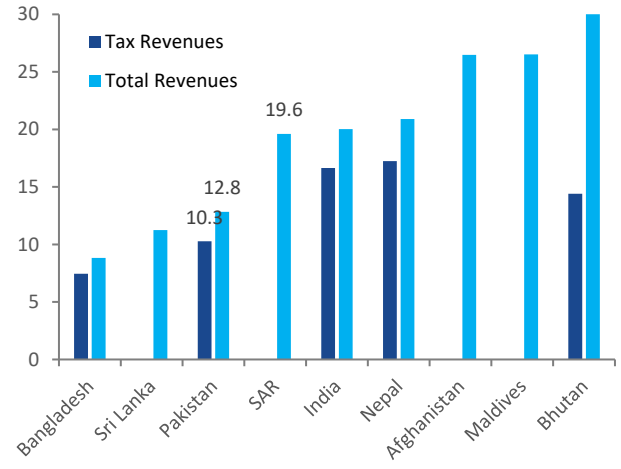
Source: World Bank Staff calculations based on PIFRA data.

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]

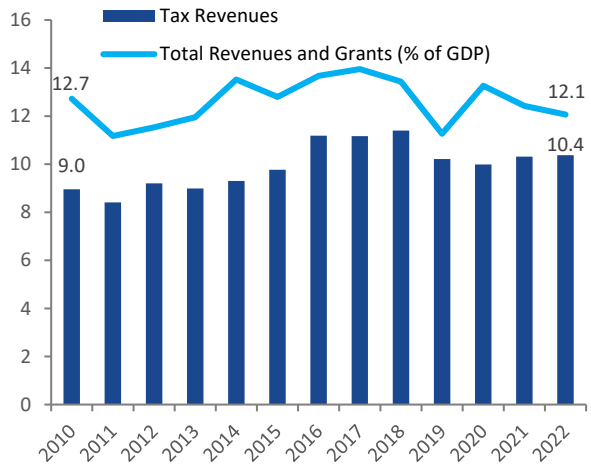
[15] Chapter 2 on Expenditures discusses each of these spending categories in detail and suggests avenues to rationalize them.
[16] For this reason, Chapter 5 on Revenues mostly suggests base broadening measures to enhance revenue collection.

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



Source: World Bank Macro Poverty Outlook (MPO) database

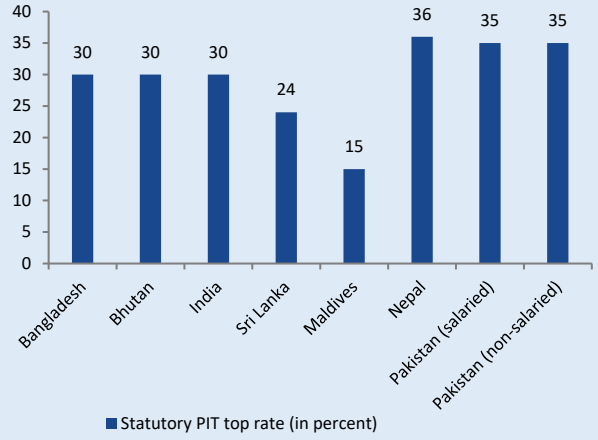
Figure 1.16: Pakistan: Total and tax revenue
(Percent of GDP)



Source: World Bank Macro Poverty Outlook (MPO) database

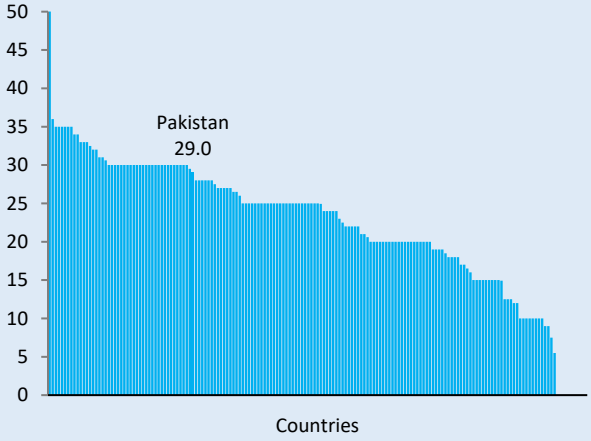
Box 1.2: High tax rates and Laffer Curve Effects

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) Award[19] 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.

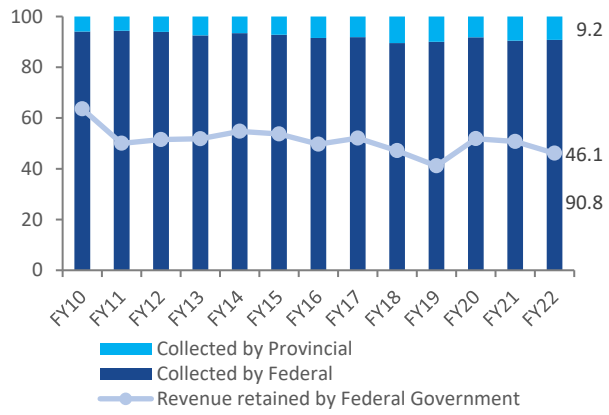
Provincial debt consists of external multilateral loans. Provinces largely borrow through concessional loans from multilateral banks that are officially contracted by the Federal Government on behalf of the provincial governments and (their rupee value) is on-lent to the provinces. Constitutionally, 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]

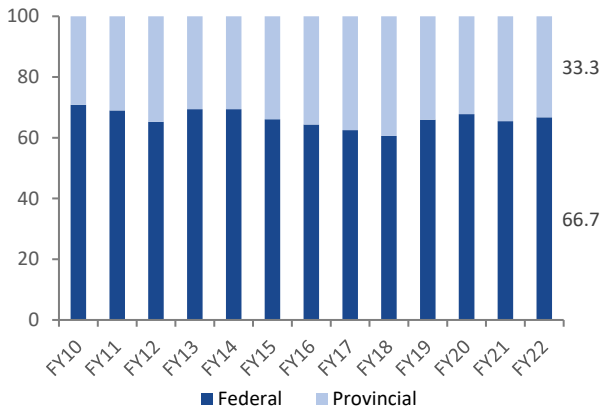
[20] 17 subject areas were devolved to the provinces. These included: Culture, Education, Environment, Food and Agriculture, Health, Labor and Manpower, Livestock and Dairy Development, Local Government and Rural Development, Minorities' Affairs, Population Planning, Social Welfare and Special Education, 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

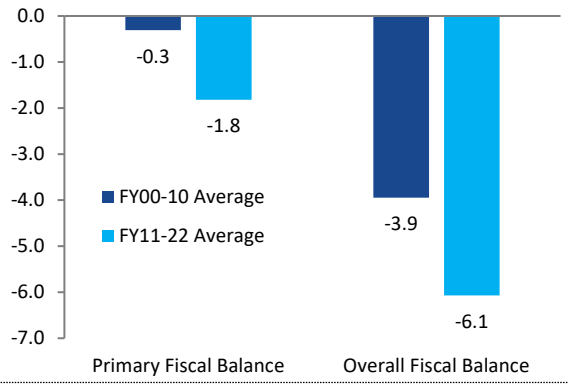
Figure 1.18: Federal and provincial government shares of fiscal expenditures
(Share in consolidated expenditures, %)



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.

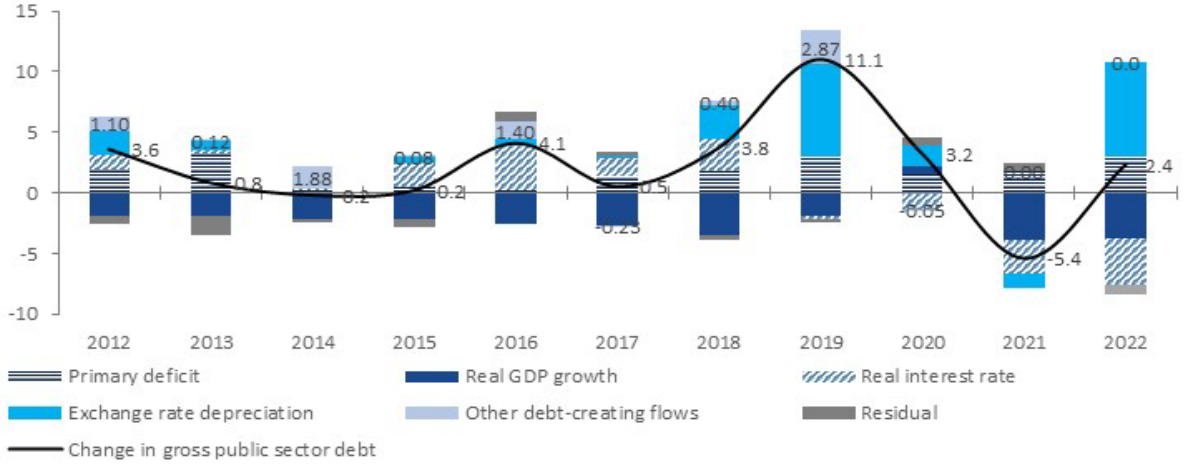
[30] These reports are published by different entities such as, the Ministry of Economic Affairs, the DMO, SBP, and the Ministry of Finance. There are several reports available such as Statistical Bulletins by SBP; Risk Reports, Debt Policy Statements, Medium Term Debt Strategies, and Fiscal Policy Statements 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 expenditures[34] 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 divesture 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 18th 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 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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Chapter 2

PAKISTAN FEDERAL PUBLIC EXPENDITURE REVIEW 2023

Towards Inclusive and Productive Federal Expenditure

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PUBLIC EXPENDITURE REVIEW

Chapter 2. Towards Inclusive and Productive Federal Expenditure

2023

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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

APL	Attock Petroleum Limited
BISP	Benazir Income Support Program
CPPA	Central Power Purchasing Agency
CCI	Council of Common Interests
GDP	Gross Domestic Product
IMF	International Monetary Fund
MFPU	Macro Fiscal Policy Unit
NCHD	National Commission for Human Development
PACE	Program for Affordable and Clean Energy
PASSCO	Pakistan Agricultural Storage and Services Corporation
PHPL	Power Holding Private Limited
PIFRA	Project to Improve Financial Reporting and Auditing
PRIDE	Punjab Resource Improvement and Digital Effectiveness
PSDP	Public Sector Development Program
PSO	Pakistan State Oil
QESCO	Quetta Electric Supply Company
SEED	Sustainable Energy and Economic Development
SOE	State-owned Enterprises

Chapter 2: Towards Inclusive and Productive Federal Expenditure

2.1 Introduction

Expenditure policy is a key tool used by policymakers in Pakistan to support the economy and to redistribute resources. Expenditure policy provides a powerful tool to steer economic developments. Pakistan has used this lever extensively in recent years, for instance, by subsidizing exports to address external account deficits or by providing transfers to state-owned enterprises. At the same time, expenditure policy is also extensively used to redistribute resources to socially disadvantaged groups and to selected other beneficiaries. Redistribution occurs, for instance, by providing subsidies on fuel, electricity and other production and consumer goods.

Pakistan's current approach to expenditure policy risks foregoing opportunities to leverage public spending to support of long-run growth. This chapter shows that Pakistan relies heavily on liability-financed expenditure to meet recurrent spending obligations and to achieve short-run policy objectives. Considering this expenditure allocation, spending does not result in a significant growth dividend, and instead risks perpetuating a cycle of increasing debt and rising debt service expenditure. This, in turn, diminishes the ability of expenditure to steer economic developments, as discretionary spending areas are increasingly crowded out by interest spending. Pakistan's Federal Government has already entered this vicious cycle, with interest expenditure accounting for the largest share of federal spending.

This chapter provides a roadmap for Pakistan to escape this vicious cycle. The analysis focuses on federal-level spending and proceeds in three parts. Section 2 provides a stylized overview of federal expenditure patterns and highlights that spending is rigid and volatile, and there is little space to effectively use spending as a policy tool for growth without further worsening fiscal and debt sustainability. Section 3 reviews Pakistan's policies in key expenditure areas – debt servicing, development spending, subsidies, and the allocation of staff and responsibilities to service delivery areas – to identify options for policy reform. The discussion on subsidies in this chapter focuses on federal consumer-focused subsidies, whereas the federal government's support to state-owned enterprises is discussed in the State-owned Enterprises (SOE) chapter of this report. Section 4 provides a policy roadmap to realize federal fiscal savings as a priority before enhancing the quality of spending and mitigating fiscal risks. The data used for this chapter is outlined in Box 2.1

This chapter adds to existing work on expenditure policy in four dimensions. First, it uses detailed cost-center level spending data to comprehensively characterize federal government spending. Second, using higher-frequency data, this chapter provides novel evidence on the interaction between recurrent and development spending and is the first, to the extent of the authors' knowledge, to provide quantitative evidence on crowding-out effects between expenditure categories. Third, it summarizes results from a novel fiscal incidence analysis that allows a comparison of fiscal and social impacts of key subsidy schemes. Fourth, the chapter uses its expenditure data to take stock of the devolution of expenditure since the 18th amendment. These pieces of analysis jointly identify concrete and quantifiable avenues to generate fiscal savings.

Box 2.1: Data Sources

The analysis in this report is based on detailed expenditure data from Pakistan's PIFRA ("Project to Improve Financial Reporting and Auditing") system. The data provides cost center-level figures on budgeted, revised, and actual expenditure by economic and functional classifications and covers fiscal years 2008 to 2022.

For each year, figures in the data have been reconciled with the Government of Pakistan's Annual Budget Statement. The PIFRA system reports gross figures, which are inclusive of principal repayments and rollover payments for debt. To align these with the reporting in headline statistics, which treat principal repayments as below the line, the gross figures have been adjusted by removing the economic classification category "Principal Repayment of Loans."

In addition, this chapter uses supplementary data sources. These include figures on staffing for FY09 and FY22, extracted from the Government of Pakistan's public financial management system. In addition, various public data sources were used, such as the debt bulletin. Regression analyses in this chapter are based on quarterly expenditure data available from the Ministry of Finance at a less detailed level of disaggregation than the PIFRA data.

2.2 An overview of federal expenditure patterns

2.2.1 Federal expenditure is driven by predetermined commitments

Pakistan's average spending levels are not exceptionally high. In FY22, combined federal and provincial expenditure stood just above PKR 13 trillion (approximately USD 58 billion), or about 19.7 percent of GDP. The Federal Government accounted for about two-thirds of this (13.5 percent of GDP). These spending levels are low in international comparison. Figure 2.1 uses data for 2019 and compares Pakistan's general and federal government spending to its global peers. The figure highlights that general government spending in 2019 corresponded to the international average when considering Pakistan's per-capita income levels.

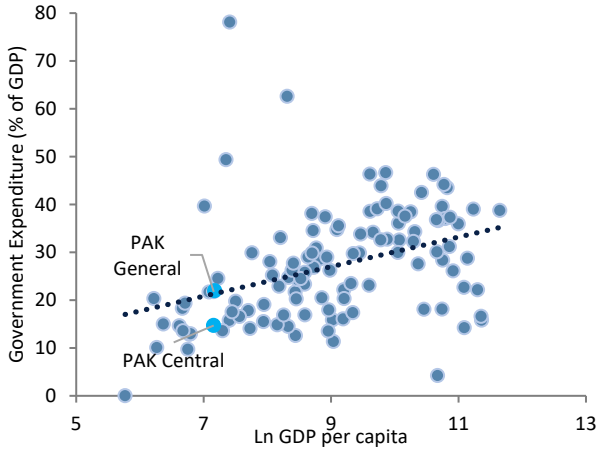
Federal-level spending is concentrated on interest payments, transfers and subsidies, and payments to public sector staff. Interest to service the country's significant public debt burden is the primary driver of federal spending (Figure 2.2).[1] Over the last ten years, interest spending averaged 4.3 percent of GDP per year and has increased from FY19 onwards, standing at 4.7 percent of GDP or 35 percent of total federal spending in FY22. Subsidies, grants, and other transfers to individuals, subnational governments, or publicly owned entities are Pakistan's second largest spending category, accounting for 3.5 percent of GDP and 26 percent of total spending in FY22. Since FY19, spending in this category has increased by about 1.5 percentage points of GDP, driven in large part by an increase in social assistance spending during the COVID-19 pandemic. Spending on public sector staff, including on salaries and pensions (Box 2.2), is Pakistan's third spending driver, accounting for between 2 and 3 percent of GDP per year and 15 percent of total spending in FY22.

Operating expenses of the Federal Government are another important federal spending category, but there is a notable lack of transparency on what is captured in these. In FY22, the Federal Government spent 1.4 percent of GDP (approximately 10 percent of total spending) on operating expenses (Figure 2.2).

[1] Pakistan treats principal repayments on public debt as below-the-line. As a result, payments to service principal are not included in the expenditure analysis.

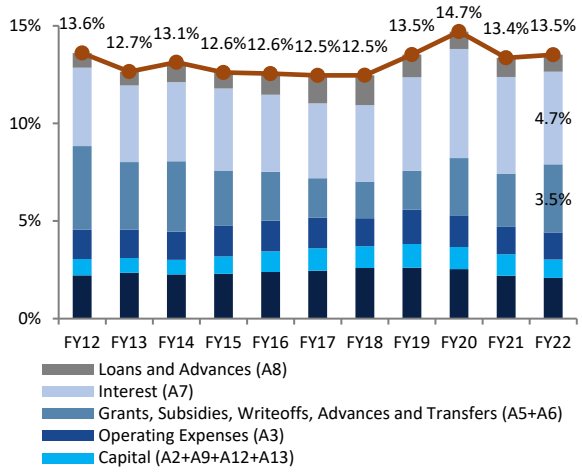
This spending has decreased significantly since the 18th amendment. In FY09, for instance, operating expenses amounted to 3 percent of GDP, but have decreased consistently thereafter and have ranged between 1.4 and 1.6 percent of GDP between FY11 and FY22. While Pakistan thus has realized significant savings, there remains a notable lack of transparency on what goods and services are procured to meet operating expenses. Specifically, in FY22, standard operating expenses such as fuel and power, leases, and motor vehicles only accounted for 15 percent of all operating expense spending. The remainder was booked under a general category, with spending on the unspecified "other goods and services" sub-category consistently accounting for over 70 percent of all operating expense spending in the last ten years.

Figure 2.1: Government expenditure in international comparison (% of GDP)



Source: World Bank staff calculations based on data from the Word Development Indicators.

Figure 2.2: Federal government spending, economic classification (% of GDP)



Source: World Bank Staff calculations based on PIFRA data.

Box 2.2: Pension Reform in Pakistan

Fiscal costs for Pakistan's civil servants' pension schemes have dramatically grown over the past several years, which, if not constrained, will threaten other development priorities. These costs grew from about 4.5 percent of provincial fiscal revenues in Sindh and 6.7 percent in Punjab in 2012 to about 12 percent of provincial revenues in 2019.[1] Ahmed et al. (2021)[2] tallied budget estimates, finding that provincial pension expenditures went from 1.6 percent of GDP in 2016–2017 to 2.2 percent of GDP in 2020–2021. The State Bank of Pakistan noted in 2021 that overall pension spending as a share of tax revenue reached 18.7 percent as of FY20.[3]

Actuarial projections undertaken by the World Bank in 2019 along with assessments by external actuarial consultants point to growing civil service pension (and salary) costs over the coming years.[4] For example, fiscal costs of the Punjab[5] and Sindh Civil Service Pension schemes are projected to almost double as a proportion of fiscal revenues by 2060, if pension benefits increase in line with wages. The reasons for such growing costs include ad hoc indexation that has been much higher than inflation, historical growth in civil service headcount, and liberalization of the eligibility requirements for benefits such as survivorship benefits.

There are means of containing such projected cost growth. Projections suggest that the most important measure would be to adopt automatic indexation determined by the growth in the consumer price index up to a cap. Other so-called parametric reforms include establishment of a minimum retirement age to receive benefits (which is being considered or has been adopted), adopting an actuarially fair adjustment factor for those retiring prior to age 60, circumscribing dependents eligible for survivorship (Family Pension) benefits and replacing post-

retirement allowances for health needs with health insurance contributions. Reducing the permitted amount of commutation and revising the commutation factors is another means of deferring costs in a fair manner.

The equity of benefits between workers could be improved. The distribution between (pensionable) basic salaries and allowances varies greatly, and the level of total income replacement (replacement rate) provided by pensions also varies. This can only be remedied by more comprehensive review of compensation. Further, pensions are calculated based on the final basic salary before retirement, which creates strong incentives for preretirement promotion, while also leaving retirees vulnerable to being disproportionately impacted by inflation and wage adjustments near retirement. Gradually moving from the determination of pensions based on final basic salary to using a multi-year average that is indexed or "valorized" to the average growth in basic salaries could improve equity and reduce retirement risks.

Legal and institutional reforms are also needed. For example, provincial authorities have recognized the need to embody civil service pension provisions in revised laws that can replace evolving regulations and annual budget rules. There is also a need to establish the institutional mechanisms to support proof-of-life certification. Although the retire benefit accounting and disbursement systems have been improved in recent years, payroll management systems also need to be established and strengthened to track employment, wages, accrued pension rights, and other compensation.

Authorities at both the federal and provincial level have been considering or have enacted reforms to moderate pension costs. The Federal Finance Ministry early in 2020 constituted a Pay and Pension Commission to review the existing compensation and pension system of the federal and provincial governments. Moreover, the authorities in Punjab, Sindh, and Khyber Pakhtunkhwa are actively considering parametric reform measures and, in some cases, have enacted reforms. Key measures common across the provinces are: (i) setting a minimum of age 55 for retirement with 25 years of service, thereby replacing eligibility with 25 years of service at any age; (ii) circumscribing dependents eligible for survivorship Family Pension benefits; and (iii) reducing permitted commutation from 35 percent of benefits to 25 percent.

Some provinces are also considering the introduction of a contributory defined-contribution scheme to replace the current non-contributory defined-benefit scheme for new entrants. Introducing such a scheme will not reduce fiscal costs but, on the contrary, will increase them over more than three decades. This will impact the stock and composition of the Government debt. This is because the provincial authorities will need to budget for the employer contributions and possibly employee contributions on behalf of affected employees. The projected costs of such contributions would grow to become an important part of the budget as the proportion of employees covered by such a scheme grows. Only after about 25–30 years would the Government be able to realize a reduction in fiscal costs as the funds set aside for contributions begin to pay for covered employees.

Most of the design, financing, and institutional parameters for a contributory defined-contribution scheme will need further study and consideration prior to their introduction. Design parameters to consider include the contribution rate, retirement eligibility conditions, and payout phase design. It will also be important to consider the design for disability and survivorship benefits under a defined-contribution architecture. A key fiscal concern is how the authorities aim to finance decades of contributions as well as how might the introduction of a contributory scheme impact public debt and other securities markets. There are also key questions about who bears the responsibility for investment risks and custodial risks and what is the regulatory and supervisory framework to protect workers. Lastly, supporting infrastructure will be needed for information systems, clearing and settlement, payments, and communications.

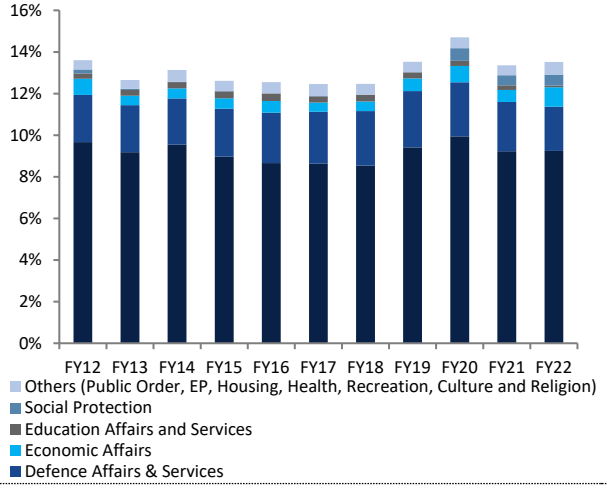
Enactment of additional parametric reforms will be essential for containing pension costs and improving equity. The authorities have recognized the nature of the challenges and the options to address them. Both parametric reforms and the potential establishment of a defined-contribution scheme for new entrants should be guided by further actuarial projections and a clear assessment of the fiscal implications and institutional needs.

[1] World Bank (2020). Pakistan: Assessment of Civil Service Pensions, February 5, 2020.
[2] Ahmed, V., Amin, S., Bakhtiar, U., Javed, A. (2021). 'Government Pension and Fiscal Sustainability in Khyber Pakhtunkhwa,' Sustainable Energy and Economic Development (SEED) Programme: Islamabad.
[3] State Bank of Pakistan (2021). State Bank of Pakistan First Quarterly Report 2020-21, Special Section: Public Pension Expenditures in Pakistan – The Need for Reforms.
[4] In 2020, the World Bank also made PROST projections for civil servant schemes in KPK and Balochistan.
[5] Punjab is currently undertaking a number of pension reforms with the support of the World Bank Punjab Resource Improvement and Digital Effectiveness (PRIDE) Program.

Considering a functional spending classification, Pakistan's Federal Government primarily spends on general public services and defense. Spending on general public services includes the financing of the executive, legislative, and judicial organs, including the Cabinet Secretariat and the Ministry of Finance. It also involves transfers and public debt transactions, including interest payments. The defense sector is the second largest recipient of public funds. Defense spending has been steady over the last ten years and has absorbed 2.12 percent of GDP or 16 percent of total spending in FY22 (Figure 2.3).[2]

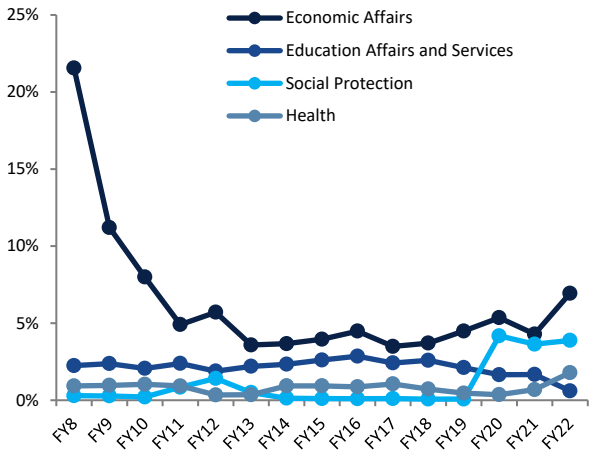
Spending on traditional service delivery sectors, including on economic affairs, health, education, and social protection is comparatively low. Together, these sectors accounted for 1.8 percent of GDP in FY22. Much of this consists of economic affairs spending, which encompasses direct subsidies, including for the agricultural sector. The low levels of service delivery spending today reflect substantial shifts in budget allocations since the passage of the 18th amendment in FY10, which transferred most spending responsibility for service delivery to the provinces. Prior to this, the Federal Government played a significant role in spending on economic affairs, which accounted for 22 percent of total federal government spending in FY08 (Figure 2.4). About half of this, 10 percent of total spending, was administered by the Ministry of Economic Affairs. Today, economic affairs spending accounts for only 7 percent of federal government expenditure. Although spending on health and education has remained constant at low levels, social protection spending has increased substantially during the COVID-19 crisis and in FY22, stood at 0.5 percent of GDP.

Figure 2.3: Federal government spending, functional classification (% of GDP)



Source: World Bank Staff calculations based on PIFRA data.

Figure 2.4: Federal government spending, functional classification for select sectors (% of total federal government spending)

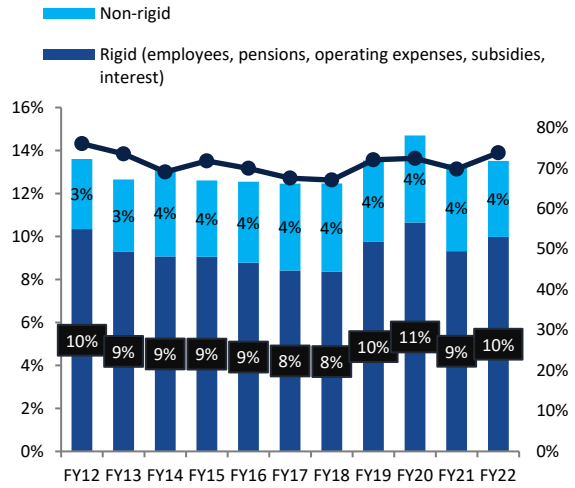


Source: World Bank Staff calculations based on PIFRA data.

[2] In addition to the published defense budget figures the military also undertakes contingent off-budget spending.

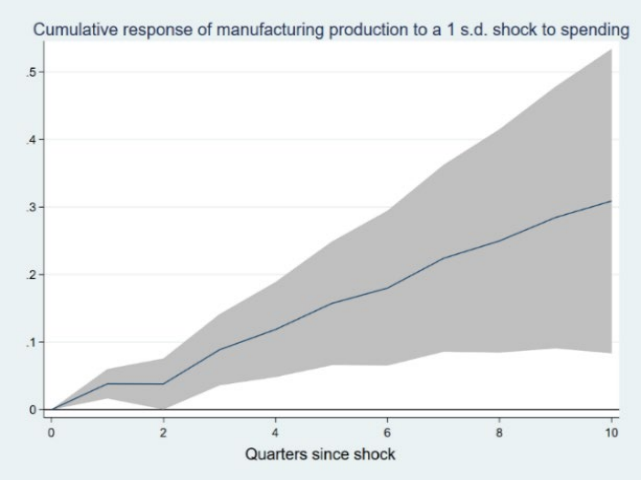
Pakistan's federal spending patterns are rigid. Over the last ten years, almost 80 percent of total spending per year was allocated to pre-committed areas such as interest payments, salaries, pensions, subsidies, and government operating expenses (Figure 2.5). These levels are higher than that of regional peers. For instance, using the above definition of rigid expenditure, Nepal's federal government allocates less than 60 percent of total expenditure to rigid areas.

Figure 2.5: Federal government spending, by rigidity (% of GDP)



Source: World Bank Staff calculations based on PIFRA data.

Figure 2.6: The impact of federal government spending on large-scale manufacturing output



Source: World Bank Staff calculations based on data from the Pakistan Bureau of Statistics and quarterly expenditure data. Notes: The figure shows the cumulative impulse response function of a one-standard-deviation shock to total government spending on an index of large-scale manufacturing output from a structural VAR estimation. The VAR included six lags of manufacturing output and total government expenditure using quarterly data and, following Blanchard and Perotti (2002), assumes that government spending cannot affect output contemporaneously. All variables have been detrended and account for seasonality. The shaded area represents 90 percent confidence intervals.

2.2.2 The extent to which federal spending stimulates growth is limited

The impact of public spending on economic output is positive but modest in magnitude. Figure 2.6 shows the cumulative impact of a 1-standard deviation – approximately PKR 65 billion – shock to total federal government expenditure on output of large-scale manufacturing enterprises.[3] The estimates highlight that spending shocks positively affect output: increasing public spending raises manufacturing output by about 0.2 percent (compared to the output level in Q4 FY18) within 1.5 years after the shocks. The estimated total cumulative increase in manufacturing output due to the shock converges to 0.4 percent. Back-of-the-envelope calculations based on these estimates imply that one additional PKR of government spending triggers a PKR 0.54 increase of GDP.[4] While not directly comparable due to different data used,

[3] These estimates were obtained using a structural vector autoregression. Manufacturing output is measured using the Pakistan Bureau of Statistics' index of large-scale manufacturing production. This index has been normalized for this analysis to the fourth quarter of FY18, which can be used as a reference point when interpreting results.

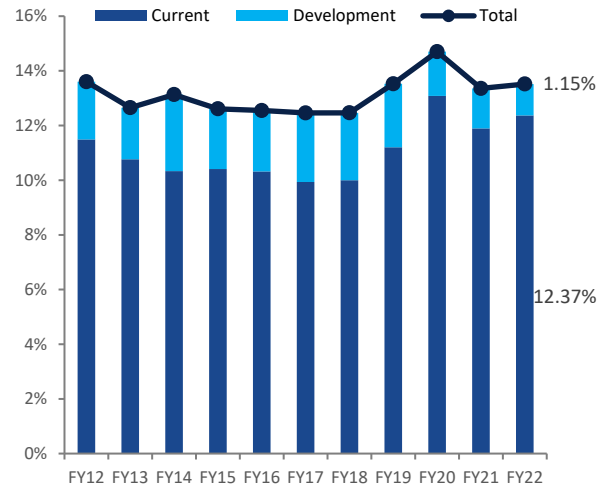
[4] Large-scale manufacturing output in FY18 was PKR 3,163 billion. The annual distribution of the manufacturing index suggests that 25.8 percent of this – PKR 816 billion – accrued in the last quarter. This implies that a one-standard-deviation shock to expenditure of PKR results in a large-scale manufacturing output increase of PKR 3.3 billion, a multiplier of 0.05. Assuming that the response of large-scale manufacturing is like that of GDP, the implied multiplier is 0.54.

Ilzetzki, Mendoza and Vegh (2013) estimate a benchmark long-run fiscal multiplier of 0.66 for higher income countries.[5]

The above result is driven exclusively by current spending, whereas the growth impact of development spending is statistically indistinguishable from zero. This is consistent with the results of a study by the Pakistan Institute of Development Economics, which suggests that the growth impact of public capital spending in Pakistan is only 33 percent of the impact in the highest performing country in the sample.[6] The study also highlights that spending efficiency has declined over recent decades.

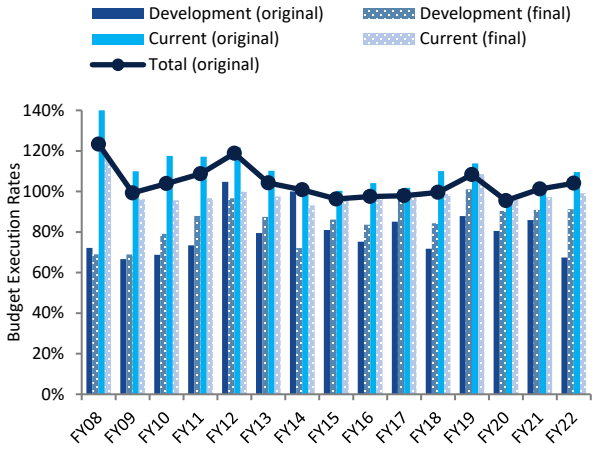
A potential explanation for low observed fiscal multipliers is that development spending is low. Unlike other countries, Pakistan does not distinguish spending between recurrent and capital spending but instead uses a classification of current and development spending. Development spending in this context encompasses expenditure on projects and programs that focus on the social, infrastructure, competitiveness, and climate change functional areas.[7] Thus, although development spending is not directly equivalent to capital spending in other countries, it broadly corresponds to the overarching objective of enhancing the productive capacity of Pakistan's economy. Despite the critical growth focus, development spending is small and declining. In FY22, the Federal Government only spent 1.15 percent of GDP (9.3 percent of total spending) on development projects, almost one percentage point less than ten years prior (Figure 2.7).

Figure 2.7: Federal government spending, by current and development spending (% of GDP)



Source: World Bank Staff calculations based on PIFRA data.

Figure 2.8: Federal government budget execution rates (actual spending as % of original budget)



Source: World Bank Staff calculations based on PIFRA data.

Pakistan's Federal Government achieves high budget execution rates, but these mask significant mid-year budget reallocations from development to current spending. Total budget execution rates in reference to the original budget averaged 104 percent between FY08 and FY22 and have remained stable

[5] Ilzetzki, E., Mendoza, E. G., & Végh, C. A. (2013). How big (small?) are fiscal multipliers? *Journal of Monetary Economics*. 60(2), 239-254.

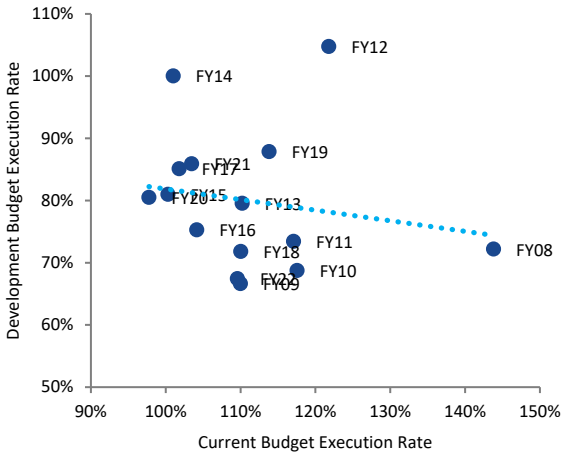
[6] Ul Haque et al. 2020. Doing Development Better. Pakistan Institute of Development Economics, Islamabad.

[7] The Public Finance Management Act 2019 specifies that development spending should "create material assets," but the scope of programs included in development spending go significantly beyond infrastructure development and include, for instance, the Benazir Income Support Program, a cash transfer.

and close to 100 percent in recent years (Figure 2.8).[8] The aggregate number does, however, mask substantial heterogeneity between development and current spending. Budget execution rates for current spending averaged 111 percent between FY08 and FY22, whereas the corresponding figure for development spending was only 81 percent. Budget execution rates between development and current spending correlate negatively with each other, suggesting that anticipated overruns in current spending are compensated for by reducing development spending (Figure 2.9).[9] Although budget execution rates calculated in reference to the final budget show lower levels of reallocation especially in more recent years, the final budget figures already incorporate mid-year adjustments.

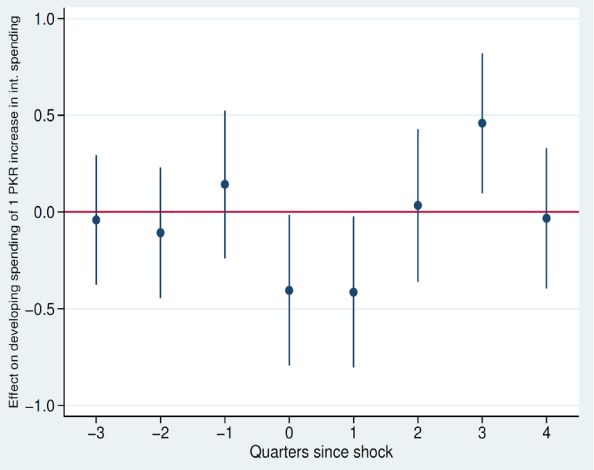
There is evidence that interest payments crowd out development expenditure. Figure 2.10 shows the impact of a 1-PKR increase in interest expenditure on development expenditure.[10] The figure shows substantial evidence of a crowd-out of development spending in response to interest rate shocks: a 1-PKR increase in interest spending reduces development spending by about 0.5 PKR in the period of the shock and in the subsequent period. These estimates are statistically significant at the 5-percent level. Expenditure recovers two periods after the shock and there is some evidence of incomplete catch-up spending in period 3, with development spending exceeding the trend by about 0.5 PKR. Notably, a similar pattern does not exist for current expenditure, which is not affected by interest payment shocks due to its rigidity. The model also highlights, as expected, no deviation from the trend of development spending before the shock.

Figure 2.9: Current vs. development budget execution rates for different years



Source: World Bank Staff calculations based on PIFRA data.

Figure 2.10: The impact of interest payment shocks on development spending



Source: World Bank Staff calculations based on quarterly expenditure data.

Crowding-out is enabled by weak cash management practices. In Pakistan, the Ministry of Finance releases cash to budgeted items on a quarterly basis. The cash forecasting needed for this process is done on a manual and ad-hoc basis and does not incorporate realistic revenue and expenditure forecasts.

[8] The most recent exception is FY19, when a shift in debt profiling led to a discrete jump in interest expenditure. See next section for a more detailed discussion.

[9] Similar scatterplots can also be generated for (i) the calculation of execution rates with regard to the revised budget (unlike the original budget data used in the figure) and (ii) interest spending budget execution rates.

[10] The estimates were obtained from a time series regression in which de-trended and de-seasonalized quarterly expenditure was regressed on contemporaneous de-trended and de-seasonalized interest expenditure as well as three leads and four lags. The model results are robust to changes in the lag and lead structure.

Instead, interest payment budgets are especially unreliable, with annual deviations from budget averaging 8 percent of budgeted amounts between FY12 and FY22. This regularly results in reduced cash releases to the Planning Commission for development projects, especially when revenue realizations fall behind expectations or when pressing current expenditure needs take priority for the release of scarce cash.

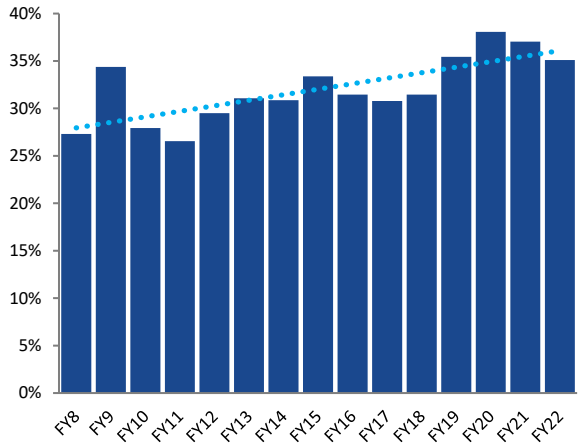
Taken together, the descriptive analysis of federal expenditure highlights that a substantial share of spending is pre-committed, resulting in little space for fiscal policy to support and stimulate the economy. Addressing this challenge hinges on a three-pronged strategy. First, Pakistan needs to make space for development spending by realizing saving opportunities. A substantial share of these savings should be used for deficit reduction, with the aim of reducing Pakistan's large debt stock. Second, to improve the quality of spending, some of the savings could be reprioritized towards areas with higher impacts on growth – which can support fiscal sustainability – and poverty reduction, including development spending and well-targeted social support. This should be coupled with reforms to improve the impact of this type of spending. Finally, Pakistan should invest in fiscal risk mitigation to sustainably reduce the volatility of spending. The next section will analyze four key spending areas in turn – interest payment, development spending, subsidies, and service delivery in devolved areas – to map out the key priorities of such a transition.

2.3 An analysis of policy levers driving expenditure outcomes

2.3.1 Interest Spending: Volatility is driven by debt management choices

Interest payments account for a large share of aggregate expenditure. In FY22, interest spending accounted for 35 percent of total federal spending and has been increasing over time (Figure 2.11). The share of interest payments in total current spending has also increased persistently over the last 20 years and currently stands at about 38 percent.

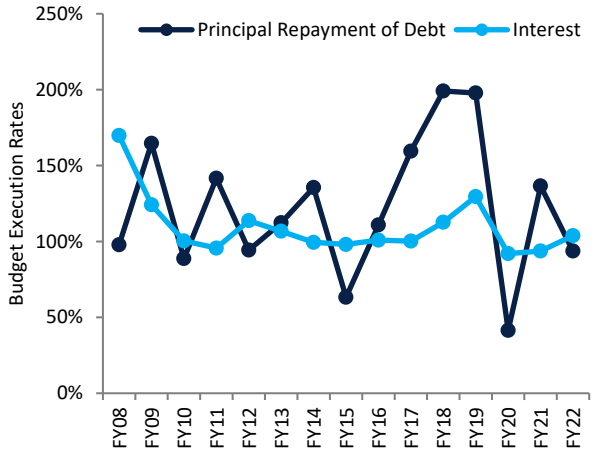
Figure 2.11: Interest payments (% of total federal expenditure)



Source: World Bank Staff calculations based on PIFRA data.

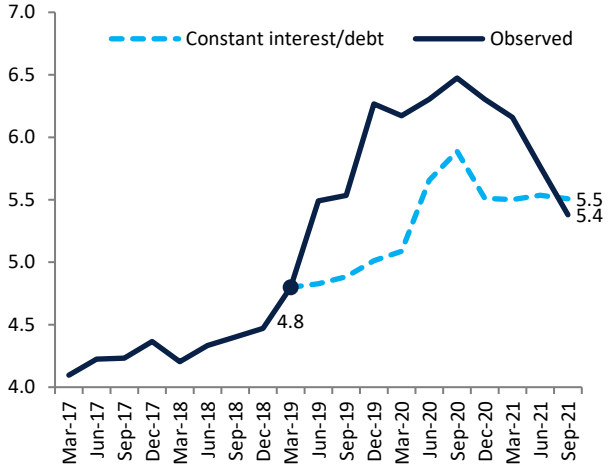
Budget figures for debt service, including interest payments and principal repayments, are a weak predictor of actual spending on debt service. Between FY08 and FY22, Pakistan's annual debt repayments exceeded the amount budgeted for principal repayments by an average of 22.5 percent per year (Figure 2.12). Excess debt repayments occur frequently, reaching up to twice the budgeted amount, and are indicative of shortcomings in financial planning. Similarly, interest payments exceeded budgeted figures by an average of 9.4 percent over this period. Although budget credibility for interest payments had improved until FY17, interest payments significantly exceeded budgeted amounts in FY18 and FY19. Importantly, although mis-estimations may account for year-to-year variation in budget execution rates, budget execution rates for interest and principal payments experience a clear systematic underestimation: Foreign debt service expenditure varies because of exchange rate fluctuations and depends on the policy rate announcements by the SBP.

Figure 2.12: Budget execution rates for principal repayment and interest (actual as % of budget)



Source: World Bank Staff calculations based on PIFRA data.

Figure 2.13: Observed and counterfactual interest payments (% of GDP)

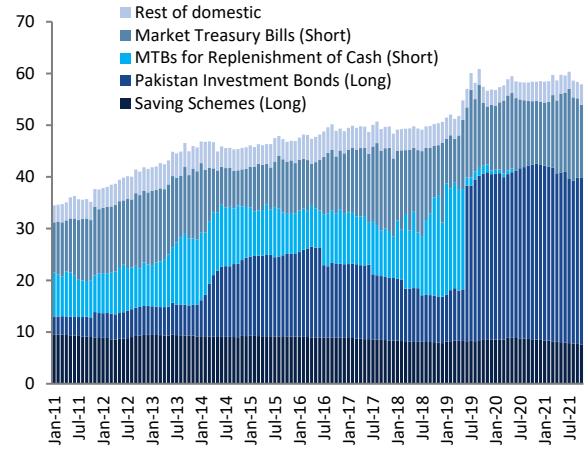


Source: World Bank staff calculations based on data from the State Bank of Pakistan and the PIFRA data.
Notes: The calculations assume that the debt stock in each quarter affects the interest payments four quarters later, whereas changes to the debt costs impact interest payments immediately.

Interest expenditure is driven to a large extent by variations in the cost of debt, rather than historic fiscal deficits. Conceptually, increases in interest spending can be driven by two factors: a larger stock of debt that needs to be serviced or higher debt servicing costs. Figure 2.13 compares the evolution of observed interest payments between December 2018 and September 2020 – a period of strong interest payment growth – to a counterfactual which assumes that debt servicing costs, proxied by the interest payment to total debt ratio, remains unchanged from March 2019. As a result, only the stock of debt and not its servicing cost is allowed to vary. The figure highlights that nearly the entire initial increase in interest payments between March 2019 and March 2020 was driven by increased debt servicing costs, rather than an increase in the aggregate debt stock. Starting in March 2020, the debt burden also started to increase, following a rising deficit. This highlights that interest payments, rather than being a by-product of past fiscal profligacy, are themselves a driver of the deficit.

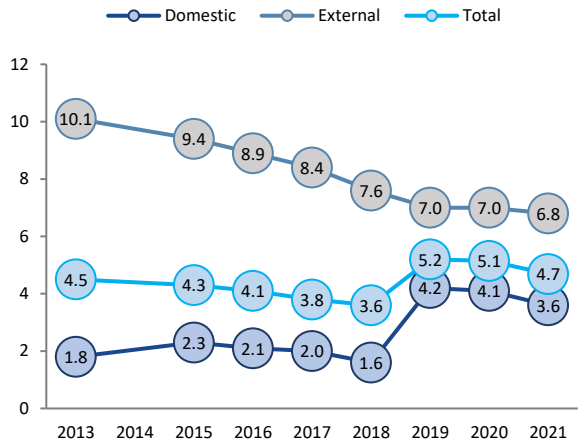
Interest rates incurred by the loan portfolio increase when debt management shifts the debt composition towards higher-cost sources. Pakistan's debt servicing costs are directly influenced by endogenous policy choices and exogenous macro-economic developments. In terms of endogenous policy choices, interest rates depend on the debt's maturity structure, whether its interest rates are floating or flexible, and whether the debt is denoted in domestic or foreign currency. The rise in debt servicing costs between March 2019 and March 2020 was a direct result of a policy choice, as the State Bank of Pakistan (as part of an IMF-supported program) ended the practice of financing the budget deficit through the purchase of short-term Market Treasury Bills (Figure 2.14). Although this monetization of the deficit had in the past contributed to macro-fiscal imbalances, the shift also meant that public debt was discretely shifted toward the longer-term and higher-cost Pakistan Investment Bonds (Figure 2.15 and Figure 2.16).

Figure 2.14: Domestic debt stock, by instrument (% of GDP)



Source: World Bank Staff calculations based on data from the State Bank of Pakistan.

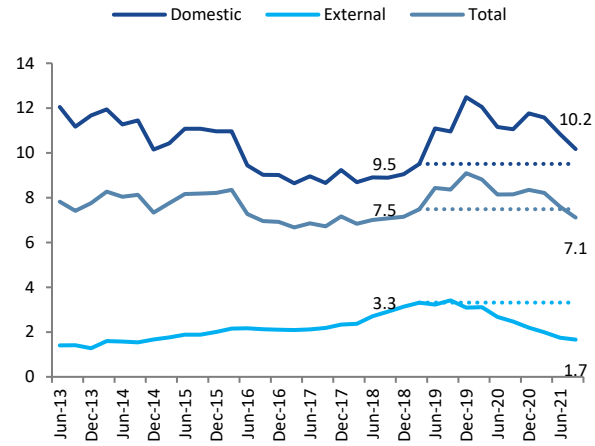
Figure 2.15: Average time to maturity of the debt stock (in years)



Source: World Bank Staff calculations based on Debt Management Risk Reports.

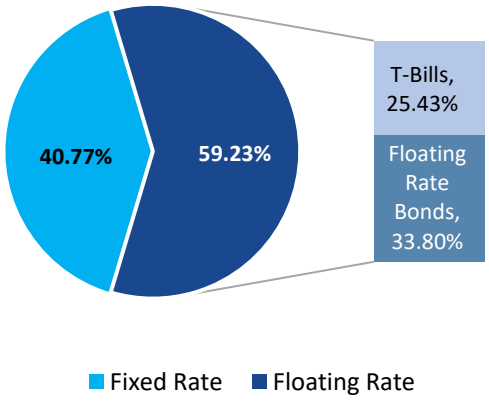
Pakistan's reliance on shorter-term and flexible interest rate debt means that interest rates are susceptible to changes in inflation expectations, raising fiscal risks and inducing interest volatility. Prior to March 2019, most debt was held in short-term Market Treasury Bills with 6-month maturity. Although this instrument has lower interest rates, it is subject to substantial roll-over risks, which frequently contributed to stark jumps in debt servicing costs when inflation expectations changed. Despite moving to a longer maturity structure, Pakistan continues to be susceptible to exogenous changes in inflation expectations because many of the recently issued Pakistan Investment Bonds have a floating rate structure (Figure 2.17).

Figure 2.16: Ratio of interest payments to debt (in %)



Source: World Bank Staff calculations based on PIFRA data and data from the Ministry of Finance.

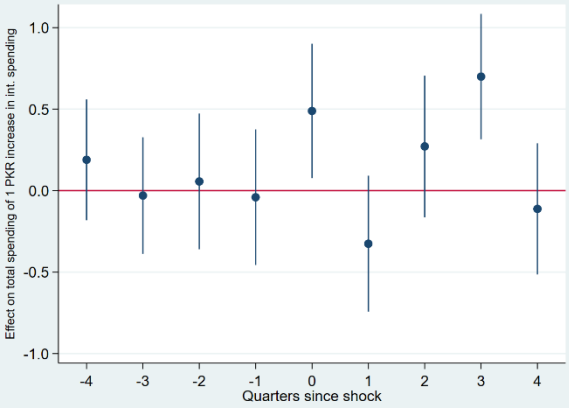
Figure 2.17: Fixed and floating rate debt in FY21 (in % of total domestic debt)



Source: World Bank Staff calculations based on data from the Public Debt Bulletin and the Debt Policy Coordination Office.

Such interest volatility can induce spending cycles. Figure 2.18 presents the results from an econometric model that estimates the impact of a 1-PKR shock to interest payments, occurring in period 0, on total spending. The figure shows that prior to the shock, in periods -4 to -1, total expenditure is stable and does not differ significantly from its long-term trend. By contrast, the simulated shock induces a spending cycle, leading to a temporary aggregate expenditure increase of 0.5 PKR on account of higher interest spending. Although total expenditure temporarily returns to trend in the period after the shock, increased financing needs from the shock increase interest payments in subsequent quarters, leading to further positive deviations from trend multiple quarters after the shock.

Figure 2.18: The impact of interest spending shocks on total expenditure



Source: World Bank Staff calculations based on quarterly expenditure data.

Taken together, this discussion highlights that Pakistan's reliance on short-term debt instruments drives interest spending volatility, which in turn undermines productive fiscal spending. The discussion in this section has uncovered two mechanisms of debt management-induced volatility: First, public debt managers have actively shifted maturities in March 2019 (and at other points in history), thus moving the debt portfolio from the short to the long end of the yield curve. Second, debt management in Pakistan prioritizes debt instruments that are susceptible to changes in inflation expectations and are seemingly not appropriately hedging against interest rate and rollover risks. Considering Pakistan's macroeconomically volatile environment, this choice induces substantial interest rate volatility. Although these policy choices may minimize short-term borrowing costs, a reliance on them has direct fiscal and real sector implications because shocks to debt servicing costs result in a crowd-out of development spending and induce aggregate expenditure volatility while also increasing fiscal risks.

2.3.2 Public Development Spending: Improved procedures can enhance development impact

2.3.2.1 Weak development project performance undermines public investment

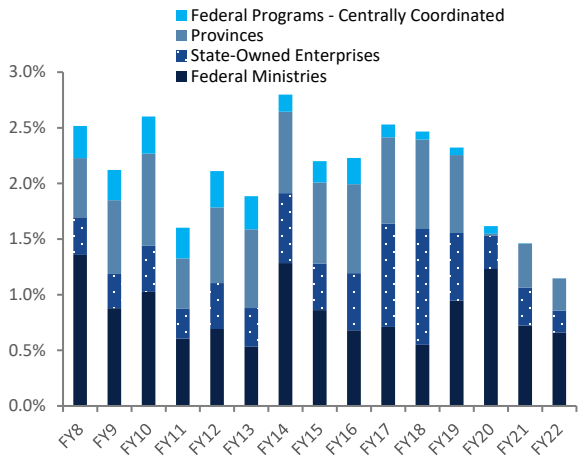
Low levels of public and private investment are a bottleneck to growth in Pakistan. At only 12 percent of GDP in FY22, Pakistan's fixed capital formation rates are lower than that of peers. Low investment expenditure underlies the boom–bust growth cycle that has trapped the country's economy over the last decades and has contributed to low growth in productivity, potential output, and employment. Evidence suggests that unlocking the country's growth potential will require increasing investment by about 10 percentage points of GDP in the medium term.[11] Public development spending is critical to meet this end as it can boost productivity directly, for instance through the provision of infrastructure, and can help crowd in additional investments from the private sector.[12]

[11] World Bank. 2019. Pakistan at 100: Shaping the Future. World Bank, Washington, DC.

[12] See, for instance, https://blogs.worldbank.org/endpovertyinsouthasia/improving-pakistan-s-public-and-private-investment. To date, there is evidence that the crowding-in effect of public investment in Pakistan has been limited (e.g. Bint-e-Ajaz, Maryam, and Nazima Ellahi. "Public-Private Investment and Economic Growth in Pakistan: An Empirical Analysis." The Pakistan Development Review, vol. 51, no. 4, 2012, pp. 61–77.)

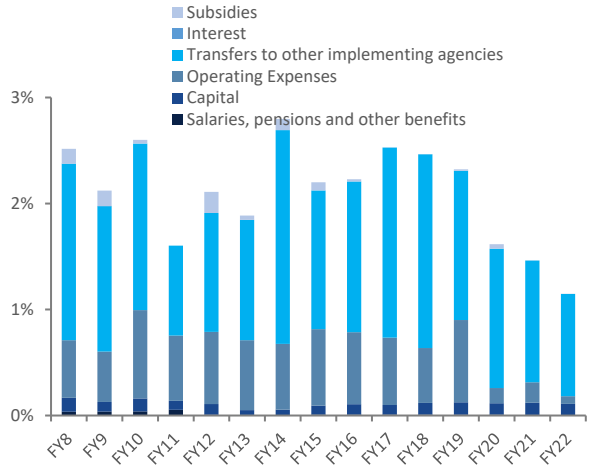
Despite its importance, public development spending is low. Federal development spending averaged 2.1 percent of GDP between FY08 and FY22 and has declined consistently over this period, standing at only 1.15 percent of GDP at the end of FY22 (Figure 2.19). At the general government level, development spending stood at 2.5 percent of GDP in FY22, of which the Federal Government contributed about 84 percent. While Pakistan's classification of spending into current and development spending does not correspond directly to the classification of spending into current and capital used in other countries, these levels are nevertheless low and lower than that of regional peers. For instance, India's general government capital spending in FY21 stood at 6.7 percent of GDP, 67 percent of which was delivered by the states. In Nepal, capital spending stood at 5.5 percent of GDP in FY21.

Figure 2.19: Federal government development spending, by implementing agency (in % of GDP)



Source: World Bank Staff calculations based on PIFRA data.

Figure 2.20: Federal government development spending, economic classification (in % of GDP)



Source: World Bank Staff calculations based on PIFRA data.

Federal development spending is executed through four types of agencies. In FY22, about two-thirds of development spending was undertaken by federal ministries, which accounted for 0.7 percent of GDP in spending. In addition to spending through ministries, the Federal Government also channels development spending through independent corporations such as the National Highway Authority or the Water and Power Development Authority. Spending through such state-owned enterprises accounted for 0.2 percent of GDP in FY22, or about 18 percent of total development spending. The third component of development spending is executed through provincial governments, with the Federal Government providing a loan or grant transfer, which is then used by the provinces for development projects. This implementation modality accounted for 0.3 percent of GDP in FY22, but has been more important prior to the pandemic, averaging 0.8 percent of GDP between FY10 and FY19. Finally, a small share of development spending is executed directly by the Cabinet and Prime Minister's Office for priority programs.

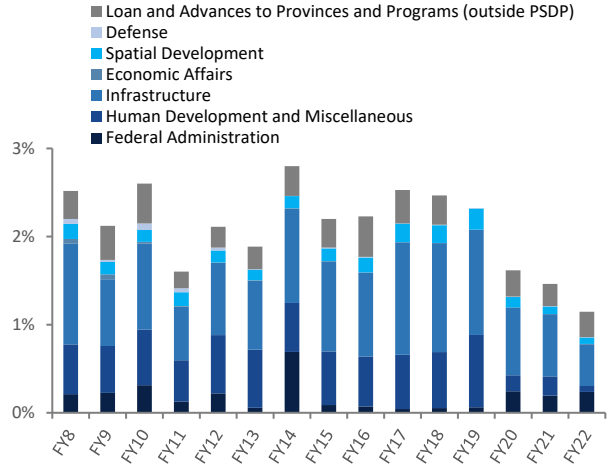
Due to a lack of transparency, the true composition of development spending cannot be assessed. A superficial overview of the development expenditure data suggests that actual spending on non-financial assets is low: in FY22, for instance, Pakistan only spent 0.1 percent of GDP on physical assets, civil works, repair and maintenance, and project pre-investment analyses. However, Pakistan's fiscal data system classifies most development spending as loans and advances, grants, or transfers to other agencies originating from the Ministry of Finance.[13] This category accounted for 1 percent of GDP or about 91

[13] More recently, and not yet reflected in the data used for this report, this responsibility has been transferred to the newly created Planning Division.

percent of total development spending in FY22 (Figure 2.20). These transfers are then executed by the receiving implementing agencies, who do not report the composition of spending in a harmonized economic or functional classification back to the Ministry of Finance. As a result, the current system is unable to trace the economic areas that the development expenditure resources were used for and the extent to which development spending encompasses expenses and physical asset acquisition.

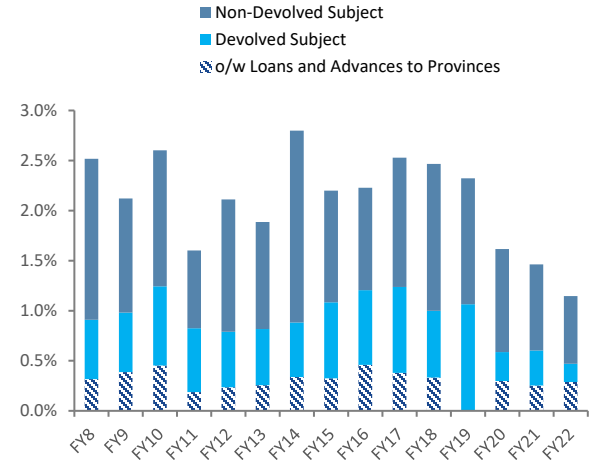
Most development spending is undertaken by infrastructure-focused spending agencies. In FY22, 0.5 percent of GDP of development spending, 45 percent of the total, was undertaken by agencies who are primarily tasked with providing infrastructure (Figure 2.21). Among these, the National Highway Authority and the Water and Power Development Authority were the largest executers of development expenditure, with a combined spending of 0.3 percent of GDP in FY22. In addition, Pakistan classifies select programs relating to human development and social sectors as development expenditure. Most prominently, the Benazir Income Support Program (BISP) was classified as development expenditure until FY19 and has been classified as current spending since then.[14] In FY22, most development spending in the human development area was undertaken by the Higher Education Commission, whose spending amounted to 0.04 percent of GDP.

Figure 2.21: Federal development spending, functional classification (in % of GDP)



Source: World Bank Staff calculations based on PIFRA data.

Figure 2.22: Federal development spending, by devolution status (in % of GDP)



Source: World Bank Staff calculations based on PIFRA data.

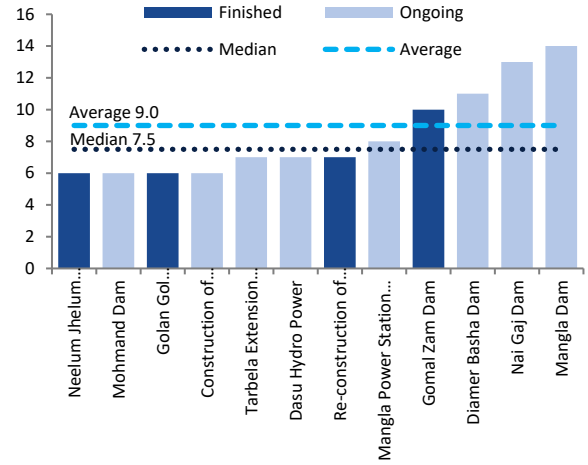
A large share of federal development spending covers functional areas that are provincial responsibilities. Federal development spending responsibilities after the 18th amendment are relatively narrow, encompassing primarily inter-state highways, energy, federal administration, air and water-based transport, telecommunications, railways, and development spending in select regions. Despite the relatively narrow mandate, the Federal Government continues to finance development spending in devolved areas. Classifying spending agencies based on whether their primary mandate is a federal or devolved subject highlights that in FY22, 0.7 percent of GDP was spent on exclusive federal areas, whereas 0.5 percent of GDP was development spending by agencies whose primary task falls into the provincial domain (Figure 2.22). Among the latter, 0.3 percent of GDP consisted of direct loans and advances to provinces for development spending outside the federal Public Sector Development Program (PSDP).[15]

[14] This explains the decrease in Human Development and Miscellaneous expenditure from FY20 onwards in Figure 2.11.
[15] It is also worth noting while the official data labels much of the transfers to provinces as loans, many of them take the form of grants which are not repaid and later classified as loan write-offs by the Federal Government.

This figure suggests that an exclusive focus on development spending in the federal domain has large savings potential for the Federal Government.

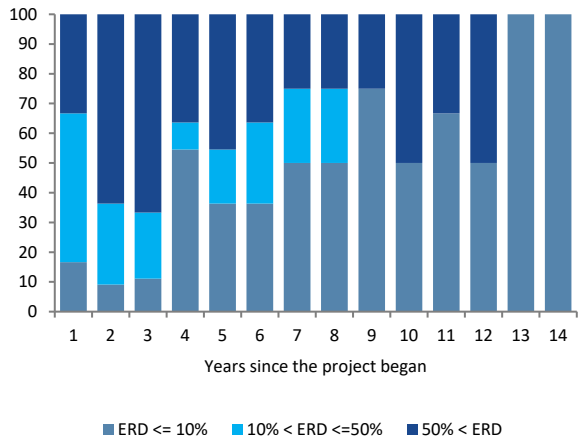
Development projects are subject to delays and spending irregularities. To assess project performance, a sample of 12 hydropower projects were compiled and analyzed for this report. These projects were initiated between FY08 and FY21 and can be tracked from their beginning to the latest active date. They represent 4.2 percent of total development spending and 50 percent of total spending on hydro projects for this period. Their analysis highlights that the time taken for completion is long: the average age of hydro projects is 9 years, and a quarter of all projects are older than ten years and have yet to be completed (Figure 2.23). This contrasts with the Planning Commission's stated target for completing development projects within five years of initiation and exceeds the global average of hydro project duration of 8.6 years[16]. Spending patterns are also irregular, with many projects significantly underspending their allocated budget in the early years (Figure 2.24). This indicates that projects may not be ready for implementation after approval. A second factor contributing to spending irregularities is that cash releases for projects often fall below the budgeted amounts, which contributes to budget under-execution and project delays. Finally, limited availability of qualified staff and legal challenges related to land acquisition can also delay hydropower projects.

Figure 2.23: Age of hydropower projects active between FY10 and FY22



Source: World Bank Staff calculations based on PIFRA data.

Figure 2.24: Budget execution rate (ERD), in absolute value (% of active projects)



Source: World Bank Staff calculations based on PIFRA data.

2.3.2.2 Planning and implementation challenges can be traced back to the public investment management process

De jure, Pakistan has a comprehensive process for the selection and implementation of development projects. Development spending in Pakistan is administered primarily through the PSDP which is administered by the Planning Commission. According to the regulatory framework, the PSDP should be guided by two documents. First, consecutive five-year plans should lay out priorities and provide broad guidance to planning and implementing agencies. Second, the Planning Commission's Manual for Development Projects guides project preparation, appraisal, selection, and prioritization. Once projects are approved, they should be included in the PSDP and implemented, subject to the allocation of budget.

[16] Ansar, A., Flyvbjerg, B., Budzier, A., & Lunn, D. (2014). Should we build more large dams? The actual costs of hydropower megaproject development. Energy policy, 69, 43-56.

The responsibilities for the planning, implementation, and monitoring of a project rest with the line ministry, with oversight by the Planning Commission's project wing. The manual also requires an evaluation within 4 to 5 years of project completion.

In practice, the envisioned public investment management process is only partially implemented. A review by the Pakistan Institute of Development Studies[17] highlights three procedural challenges: First, compliance with the procedures outlined in the project manual is limited, and the sequencing of steps is often not followed in practice. Second, the appraisal process is not independently reviewed. Third, and as a result, many projects are included in the PSDP without having been approved and without having completed the preparation and selection steps. According to the study, 79 percent of active development projects in FY19 were unapproved.

In addition to procedural challenges, the absence of technical and strategic guidance documents also complicates the effective prioritization of projects. The public investment management process is centered around five-year plans that, after being prepared by the Planning Commission, can help select those projects with the highest potential impact on growth and other development objectives. In practice, however, the most recent five-year plan was approved in 2015 and expired in 2018.[18] A subsequent five-year plan remains pending and political priorities have shifted towards the implementation of projects under the China–Pakistan Economic Corridor, which has taken the role of a de-facto plan. At the same time, the guidance provided by five-year plans and the high-level "Vision 2025" is too abstract to guide project selection. Although line ministries prepare annual plans, these take a mostly retrospective approach, summarizing current projects under implementation instead of providing a forward-looking vision that could be used to effectively prioritize specific development projects.

The institutional separation between the Planning Commission and the Ministry of Finance can undermine the maintenance of development projects. In Pakistan, current spending is managed by the Ministry of Finance, whereas development spending falls under the responsibility of the Planning Commissions. As also highlighted in previous Public Expenditure Reviews, this institutional separation means that current cost implications for repair and maintenance and potential cost overruns are insufficiently considered during the planning phase.[19] However, the separation between the institutions has anecdotally contributing to safeguarding development spending, as the Planning Commission has a clear mandate to support growth, whereas the Ministry of Finance may prioritize deficit reduction over development needs.

The public investment management process has limited built-in opportunities for learning and improvements. Development projects are monitored by implementing agencies that submit monthly and quarterly progress reports. Although this data is currently not independently reviewed and the Planning Commission conducts neither ex-post evaluations nor systematic project performance reviews, it is

[17] Ul Haque, N., Mukhtar, H., Ishtiaq & N., Gray, J.(2020). Doing Development Better. Pakistan Institute of Development Economics, Islamabad.
[18] See https://www.pc.gov.pk/web/yearplan.
[19] This is partially driven by weak outer year estimates for fiscal and economic variables in the Medium-Term Budget Framework, which makes it difficult to estimate accurate budget ceilings and select worthwhile projects. A stark example of this is the Tarbela dam project, whose implementation was scheduled from 1968 to 1976 but was delayed to 1984. The planning had included a contingency of 7.5 percent of total project size to account for, among other factors, inflation. As Ansar et al. (2014) document, this estimate was not realistic, as inflation equaled 380 percent on a cumulative basis over the project period, leading to large cost overruns. Ansar et al. also documents that the likely benefit–cost ratio of the Diamer Bhasha Dam would have been below 1 if accurate macro projections had been used.

developing a monitoring and evaluation framework that, when approved, could strengthen project oversight and learning.

The new Public Financial Management Act, approved in 2019, initiated a reform process that intends to alleviate some of these challenges. A key improvement of the new act is that it prohibits the practice of including unapproved projects in the budget and the PSDP. It also introduces a requirement for feasibility studies and assigns the Planning Commission with a legal mandate to undertake project evaluations. The new act emphasizes that development expenditure should be based on well-defined plans and has elevated the project preparation manual to the status of a legally binding document, making compliance with it mandatory. It also defines criteria to classify development projects and mandates the notification of thresholds for cost–benefit analyses, project risk assessment, and different quality assurance procedures. Finally, it contains provisions that require the assignment of adequate budgetary resources for asset maintenance and operation.

Implementation of these provisions is on-going. Although unapproved projects are no longer included in the PSDP and budgetary provisions for operation and maintenance have been improved, no thresholds for further analyses and risk assessments have to date been notified. In addition, no formal guidelines to assess the adequacy of maintenance budgets have been developed and project plans and classification are still lacking.

Pakistan has also updated its project preparation manual in 2021. The manual outlines a rigorous process for project preparation and selection. It also contains important provisions that incorporate climate change considerations into project designs. As such, it requires an evaluation of the project's contribution to climate change mitigation and adaptation as part of the standardized project preparation checklist. It further requires a climate change analysis as part of the environmental and social impact assessment. However, there are still no detailed sectoral guidelines available that outline the technical parameters of project preparation.

2.3.3 Subsidies: Improving targeting can generate savings and enhance spending efficiency

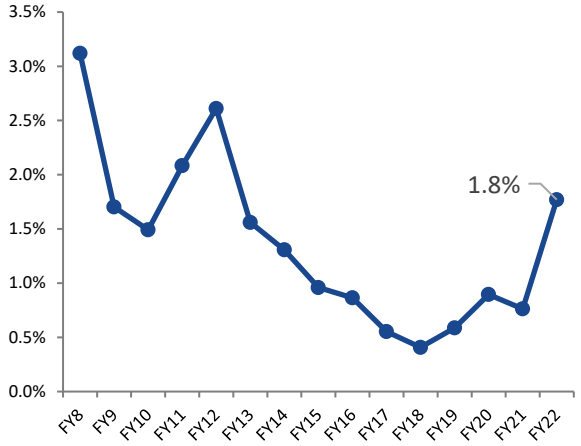
2.3.3.1 Subsidies are a costly and underbudgeted expenditure source

Between FY12 and FY22, subsidy spending averaged 1.12 percent of GDP and has increased significantly in the more recent years (Figure 2.25)**.** Subsidy spending is also consistently under-budgeted: on average, Pakistan's federal government spent 64 percent more on subsidies than envisioned in the original budget. This is driven by two factors: over-optimistic projections that underestimate subsidy demand and unbudgeted one-off subsidies that arise on an ad-hoc basis.

Electricity subsidies account for most subsidy spending. Over 80 percent of recurrent subsidy spending between FY13 and FY22 benefited the electricity sector and was executed through transfers to public and private utility companies (Figure 2.26). A substantial portion of electricity subsidies are tariff differential subsidies, which accounted for 15 percent of total subsidies released in FY22 and for 0.27 percent of GDP (Figure 2.27). They accrue when cost-recovery tariffs determined by the regulator exceed notified tariffs by the Government. The tariff schedule is undergoing frequent revisions (Box 2.3) and is generally progressive, with marginal tariffs increasing with the amount of electricity consumed. A subsidy arises as some consumers pay tariffs that lie below the cost-recovery tariff. The electricity subsidy is not paid directly to consumers but is instead transferred from the Ministry of Finance to the power market operator, the Central Power Purchasing Agency (CPPA). The CPPA purchases power from the generators

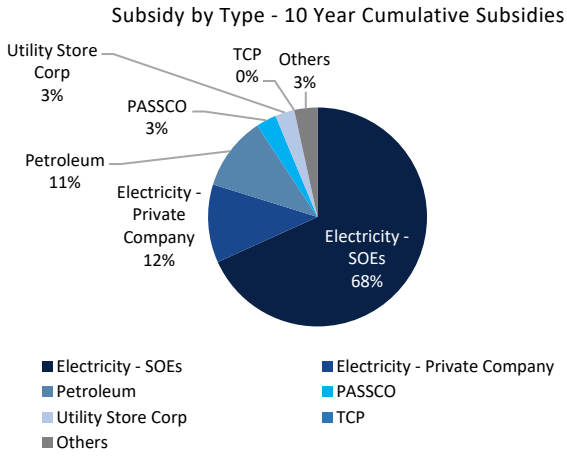
at cost recovery tariffs on behalf of distribution companies (DISCOs), who then resell power to consumers at government-notified tariffs. The CPPA is compensated for the resulting loss through a fiscal transfer, which constitutes the government's subsidy payment.

Figure 2.25: Expenditure on subsidies (% of GDP)



Source: World Bank Staff calculations based on PIFRA data.

Figure 2.26: Cumulative spending on subsidies between FY13 and FY22, by type (% of total spending)



Source: Subsidies Table, Federal Budget in Brief, Ministry of Finance.

The modality of channeling consumer-facing subsidies through SOEs has generated persistent SOE losses as a by-product. The losses of all SOEs in Pakistan have averaged 0.5 percent of GDP annually since 2016, and SOEs in the power sector alone have accumulated losses of 0.3 percent of GDP in FY20. These losses result from inefficiencies in the administration of subsidies and the regulation of prices, which are discussed – together with suggestions on the sector's reform – in Chapter 4 on SOEs.

Federal subsidies on electricity supply to agricultural tube-wells are another type of tariff differential subsidies. Tube-well users in Pakistan benefit from a flat electricity tariff that does not differentiate by usage or firm size and lies below the cost-recovery tariff, resulting in a blanket tariff-differential subsidy. Expenditure on this is estimated at approximately 0.03 percent of GDP in FY22. Half of this amount is earmarked for the Quetta Electric Supply Company (QESCO), which distributes electricity to tube-well users in Balochistan, with the remaining part largely distributed among tube-well users in Punjab. Together, these two provinces account for 96 percent of the total electricity consumption by tube-wells. Weak collection performance exacerbates the fiscal cost of this subsidy, as only a small share of billed amounts was paid by farmers to QESCO. The federal and provincial government have also not been paying their contributions regularly in recent years, making this less of a fiscal drain and more of a gradually accruing contingent liability.

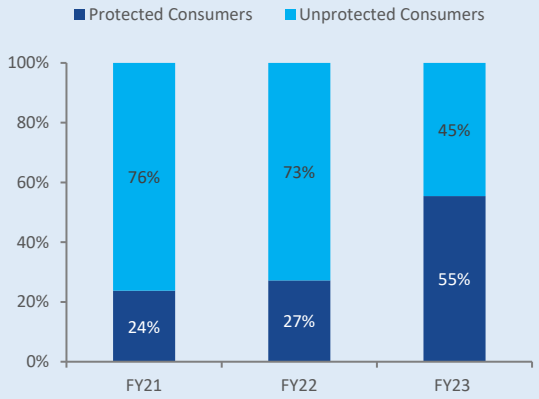
Box 2.3: Reforms to the tariff structure supported under the World Bank's Program for Affordable and Clean Energy (PACE)

Prior to FY21, Pakistan's residential tariff schedule featured six slabs and an increasing block tariff, requiring users to pay stepwise higher marginal costs for electricity consumed based on the total level of consumption. Average tariffs for residential consumption under 300 kWh per month were below the cost-recovery tariff and thus subsidized. However, due to the increasing block tariff structure, all consumers benefited from the lower rates on their initial consumption, even though additional consumption beyond 300 kWh per month was not subsidized. This feature made the subsidies very regressive, where a total of 97 percent of residential consumers benefited

from the subsidies, with 32 percent of subsidy spending benefiting the richest quintile of households, whereas only 10 percent reached the poorest quintile.

With support under the Program for Affordable and Clean Energy (PACE) DPC, the government has taken steps to rectify this situation by adopting a phased approach in subsidy rationalization reforms. The initial phase has involved the creation of a new category of protected consumers that consume up to 200 kWh/month for six consecutive months[20], who will be protected from increases in tariffs that occur as part of the government's annual tariff rebasing exercise (but will be subject to quarterly price adjustments and adjustments due to fuel prices). These reforms transformed the former six-slab schedule to a twelve-slab schedule.

Figure B3.1: Distribution of electricity subsidy benefits, by protection status (% of total benefit)

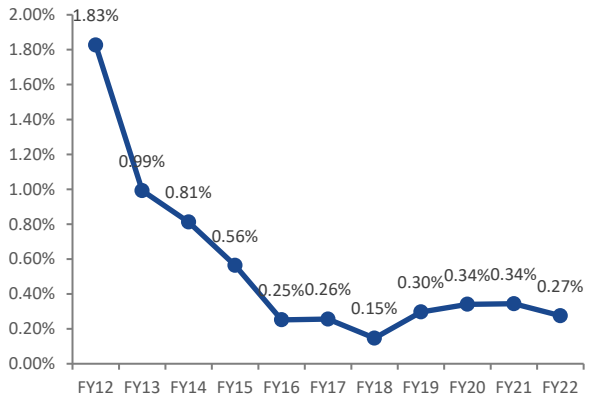


Source: World Bank Staff calculations.

As part of the second phase of the tariff reforms, the authorities notified a progressive increase in tariff across non-protected consumers in June 2022 to reduce the subsidy provided to these consumers. The authorities also notified the results of the annual rebasing for FY23, which will result in a higher percentage of the subsidy going to protected consumers (an increase from 24 percent in FY21 to 55 percent in FY23, Figure B2.1 and B2.2). This would mark an important change compared to previous fiscal years.

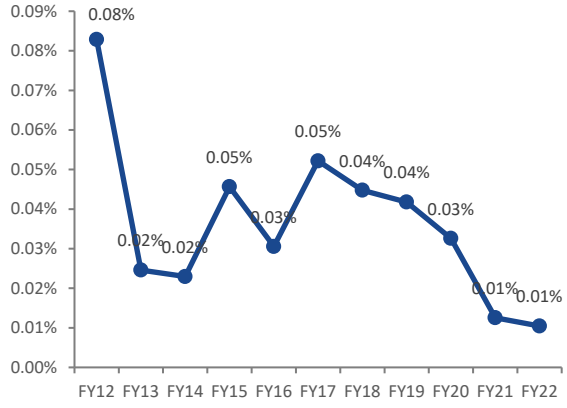
Wheat subsidies are another important federal expenditure. Pakistan's wheat market is heavily regulated through the interventions of the Pakistan Agricultural Storage and Services Corporation (PASSCO). PASSCO purchases wheat stocks from farmers at minimum support prices, which tends to be above market prices, and then sells at the retail price. A subsidy to PASSCO arises as the difference between the sales price recovery and the costs accruing to PASSCO, with the latter including the minimum support prices plus incidentals, including mark-ups, transportation, and bagging of wheat (Figure 2.28). In FY22, federal expenditure on wheat subsidies was 0.01 percent of GDP.

Figure 2.27: Expenditure on the tariff differential subsidy (% of GDP)



Source: World Bank Staff calculations based on data from Budget in Brief, Ministry of Finance.

Figure 2.28: Transfers to PASSCO on account of wheat operations (% of GDP)



Source: World Bank Staff calculations based on data from Budget in Brief, Ministry of Finance.

[20] The protected consumers correspond to the bottom two quintiles.

In addition to recurrent subsidies, Pakistan has substantial expenditure on irregularly occurring one-off subsidies. Total one-off subsidies accounted for 0.72 percent of GDP in FY21 (Table 2.1). This was a substantial increase compared to FY21, driven by expenditure on a temporary petroleum subsidy. In the past, one-off subsidies have focused on the clearance of accrued debt in the utilities sector and relief efforts to address the COVID pandemic.

Table 2.1: One-off subsidy expenditure (% of GDP)

Subsidy	FY20	FY21	FY22
Electricity: Power Holding Private Limited (PHPL) Settlement of Power sector payables		0.08%	
Electricity: Tariff Differential to AJK (settlement of arrears)		0.07%	
Electricity: Bill Deferment COVID-19	0.02%		
Electricity: Zero-rated industrial subsidy		0.05%	
Electricity: Industrial Support Package – K-Electric	0.02%		
Electricity: Prime Minister Package – Tariff Differential			0.12%
Electricity: Subsidy to Coal Power Plants			0.15%
Petroleum: LNG Sector for lower tariff	0.05%	0.02%	
Petroleum: PSO, APL liabilities and others	0.05%	0.00%	
Petroleum: LNG to Domestic Consumers			0.05%
Petroleum: Price Differential Claims			0.37%
Utility Stores Corporation: Sale of Essentials	0.06%		
Utility Stores Corporation: COVID-19 Stimulus Package	0.02%		
Utility Stores Corporation: Prime Minister Package			0.02%
Metro Bus Subsidy		0.00%	
Naya Pakistan Housing Authority		0.01%	
Fertilizer: White Fly pesticide		0.00%	
Prime Ministers fiscal package		0.02%	
Prime Ministers package for rabi crops		0.00%	
ZTBL Agri loans to Farmers		0.01%	
Ehsaas Ration Subsidy			0.00%
Total	**0.23%**	**0.26%**	**0.72%**

Source: World Bank Staff calculations based on data from Budget in Brief, Ministry of Finance.

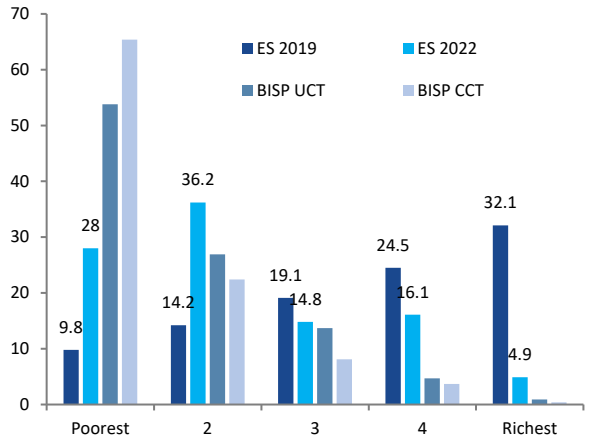
2.3.3.2 The current subsidy structure does not efficiently support the poor and generates adverse side-effects

Tariff-differential electricity subsidies benefit the poor but also richer households. The reason for introducing subsidies to domestic electricity consumers was to support poor and vulnerable households by providing them with electricity tariffs that lie below cost recovery. A fiscal incidence analysis shows that this has been successful.[21] In FY19, electricity subsidies to domestic consumers reduced poverty by 2.3 percentage points and decreased inequality, measured through the Gini coefficient, by 0.2 Gini points.

[21] Amjad, B., Carrasco, H. and Meyer, M. 2022. The Effects of Fiscal Policy on Inequality and Poverty in Pakistan. World Bank Working Paper.

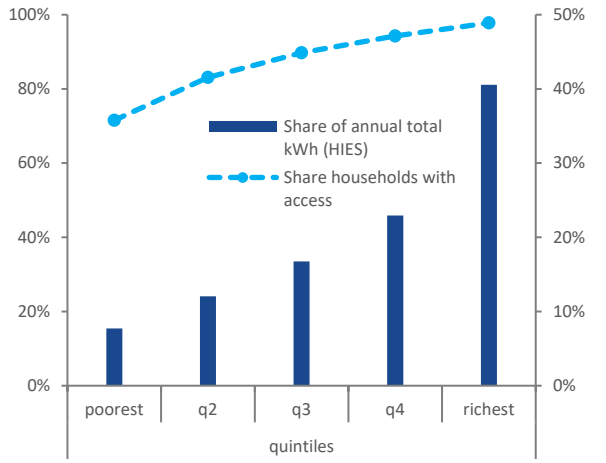
However, most of these benefits also accrue to richer households. In FY19, 76 percent of tariff differential subsidy spending benefited households in the top 3 quintiles of the income distribution (Figure 2.29). In contrast, the bottom 40 percent only benefited from 24 percent of total spending. This is because richer households more often have electricity connections – 98 percent of households in the top 20 percent of the income distribution versus 72 percent in the bottom 20 percent. Richer households also consume greater shares of total kilowatt-hours (kWh) produced – for example, in FY19, the top 20 percent of households accounted for approximately two-fifths of all kWh consumed, representing about 20.2 billion kWh in FY19, while the bottom 20 percent accounted for 8 percent of the total, representing about 3.85 billion kWh in FY19 (Figure 2.30). In an effort to improve targeting and reduce regressivity, a new category of protected consumers was established and the electricity tariff schedule was revamped with the support of the World Bank PACE operation. By end 2022, targeting had greatly improved with 64 percent of the subsidy benefits accruing to the bottom 40 percent and only 36 percent of the benefits accruing to the top 3 quintiles of the income distribution.

Figure 2.29: Distribution of benefits of different subsidy schemes, by quintile (% of total benefits of a given subsidy)



Source: World Bank Staff calculations.

Figure 2.30: Electricity consumption by quintile (% of total consumption)



Source: World Bank Staff calculations based on HIES 2018-19 and NEPRA data.

Electricity subsidies also cause adverse environmental impacts. According to the International Energy Agency, Pakistan generates about 70 percent of its electricity from high-carbon sources, predominantly gas and, to a smaller extent, coal and oil.[22] As these energy sources generate significant externalities through greenhouse gas emission and air pollution, a strong policy argument exists to increase their prices above generation costs to entice consumers to internalize these externalities when making electricity consumption decisions. By contrast, electricity subsidies in Pakistan act as an effective carbon subsidy, encouraging the consumption of electricity and thus the combustion of environmentally harmful fossil fuels. Subsidies on electricity for tube-wells also incentivize inefficient irrigation practices and the cultivation of water-intensive crops in a water-starved economy, thus contributing to groundwater depletion.

The benefits of wheat subsidies only accrue to landowning farmers. Although an absence of data in the household survey makes a quantitative analysis of the social impact of wheat subsidies difficult, the design

[22] Based on 2019 data.

of the program suggests that non-land-owning households, who tend to be poorer, are unlikely to benefit from it. As PASSCO only procures wheat directly from landowning farmers, anecdotal evidence suggests that other farmers tend to avail of intermediate traders to sell their wheat and, as a result, tend to sell the wheat at a value below PASSCO's support price. For instance, 78 percent of wheat produced in Punjab today and traded through PASSCO is produced by large landowners. This contrasts with the subsidy's original objective, which was to incentivize the rural poor to grow wheat for import substitution, to provide urban consumers with subsidized flour, and to stabilize wheat market prices.

Through its BISP, Pakistan has established a social assistance program which is significantly more efficient at targeting the poor than its current portfolio of subsidies. In FY22, Pakistan's Federal Government spent 0.36 percent of GDP on the BISP, making it the largest contributor to the federal government's social assistance program. Estimates for FY19 suggest that the BISP has reduced poverty by 1.45 percentage points and inequality by 0.48 Gini points.[23] It is important to note that focusing only on poverty reduction understates the BISP's true contribution to social welfare because, designed as a relief program, its primary focus is to provide support to households below the poverty line, thus increasing their income (without necessarily lifting many households out of poverty). The efficiency with which the BISP achieves this is highlighted by the distributional impact results: most of the benefits of the BISP program accrue to the poor, as 81 percent of spending benefits the bottom 40 percent.

Transitioning from general subsidies to targeted social transfers presents an opportunity for Pakistan. Reallocating spending from costly and comparatively inefficient subsidies—such as the ones on electricity and tube-wells—towards a targeted transfer program that could be housed under the BISP can help Pakistan realize fiscal savings while simultaneously achieving improved social outcomes.

2.3.4 Constitutional Alignment: Generating federal fiscal savings by aligning federal spending with its core mandates

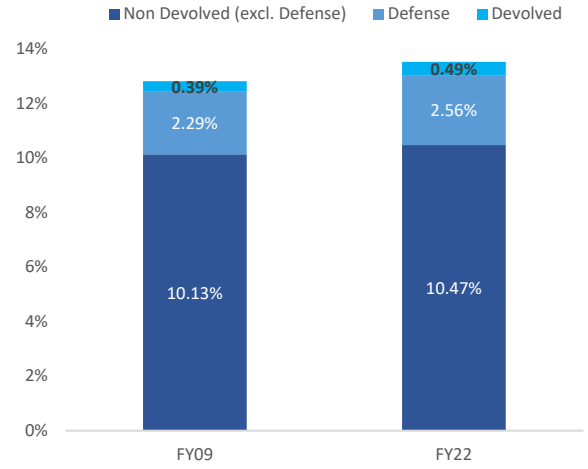
In 2010, Pakistan passed the 18th amendment, which devolved a large share of resources and spending responsibilities to provincial governments. The amendment restructured the country's constitution by deleting the list of concurrent responsibilities, replacing it with a list of federal responsibilities that are limited to natural resources, electricity, and regulatory functions, and delegating all remaining service delivery responsibilities, including for key economic and social services, to the provinces. As a result, the Federal Government was relieved of its responsibility in agriculture, rural development, social services, education, health, and social protection, among others. The constitutional amendment also affected resource distribution as it stipulated that the provincial share of the federal divisible pool – comprising, among others, taxes collected by FBR, federal GST on services, and excise duty on natural gas – could not fall below 57.5 percent.

In response to the 18th amendment, the Federal Government abolished and subsequently reestablished 17 ministries. The devolved ministries include the ministries of health, education, food and agriculture, social welfare, and labor. Many, but not all, of these ministries were reestablished in subsequent years, often with a changed name to better reflect the narrower federal responsibilities. For instance, the ministry of health was reestablished as the Ministry of National Health Services, Regulation and Coordination in 2013.

[23] Amjad, B., Carrasco, H. and Meyer, M. (2022). The Effects of Fiscal Policy on Inequality and Poverty in Pakistan. World Bank Working Paper. These estimates focus on the conditional and unconditional cash transfer programs. The BISP also incorporates a variety of smaller projects whose distributional impact could not be estimated.

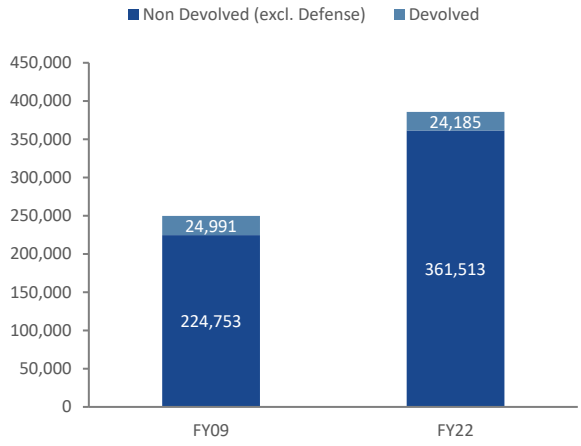
Despite the substantial devolution of resources, the allocation of spending across levels of government has not adjusted to align it with the updated constitutional mandates. Figure 2.31 shows spending by ministry, distinguishing between ministries in devolved and non-devolved areas. Federal spending in devolved areas has increased slightly between FY09 – the fiscal year before the 18th amendment was enacted – and FY22, from 0.4 to 0.5 percent of GDP. Over the same period, spending on non-devolved areas has increased from 10.1 to 10.5 percent of GDP.

Figure 2.31: Spending by ministries' devolution status (% of GDP)



Source: World Bank Staff calculations based on PIFRA data.

Figure 2.32: Employees by ministries' devolution status, excluding defense (number of employees)



Source: World Bank Staff calculations based on data extracted from the SAP employee database.

Notes: The figures show spending and staffing at the ministry level, classifying ministries as devolved when their main subject area of focus is not on the constitution's federal list.

The Federal Government has also struggled with devolving and reassigning personnel from devolved subject areas. In FY09, there were approximately 25,000 federal employees engaged in subject areas that would be devolved with the 18th amendment. This figure has remained approximately constant since then, with almost the same number of staff employed by ministries in devolved subject areas today (Figure 2.32). Employee-related spending and spending per staff has also remained similar across the two periods, with devolved ministries spending 0.07 percent of GDP on staff in FY09, compared with 0.05 percent of GDP in FY22. This finding is consistent with anecdotal evidence that points to resistance from the bureaucracy in devolving staff and authority.[24]

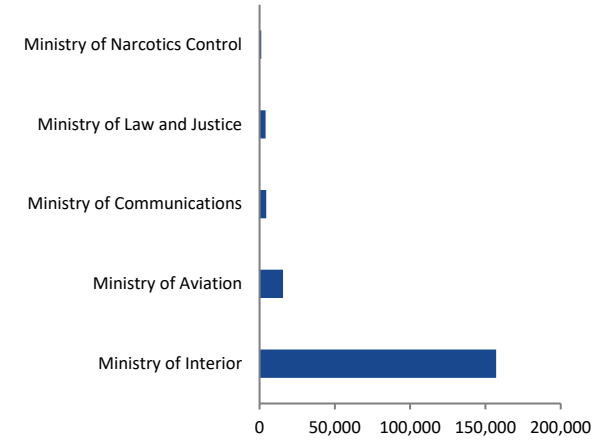
The large increase in non-devolved employees between FY09 and FY22 is also partially driven by federal support to provincial service delivery. Between FY09 and FY22, staffing in non-devolved areas increased by 137,000 employees (61 percent) on a net basis. Just above one-third of the increase was driven by grade-6 civil servants.[25] In terms of functional assignment, staffing for the Ministry of Interior increased substantially and accounts for most of the increase (Figure 2.33). Additional staff hired was predominantly non-military security personnel, such as the Rangers in Sindh and the Balochistan Frontier Corps. These

[24] See, for instance, Rana, M. A. (2020). "Decentralization Experience in Pakistan: The 18th Constitutional Amendment." *Asian Journal of Management Cases*, 17(1), 61–84, who attributes implementation challenges to "covert and overt opposition from the federal bureaucracy, which is characteristically averse to any transfer of resources and authority".

[25] Grades 7, 8, 1, and 2 are the next four contributors, with grade 7 contributing 10 percent to the increase and the others each contributing between 3 and 4 percent to the total staffing increase.

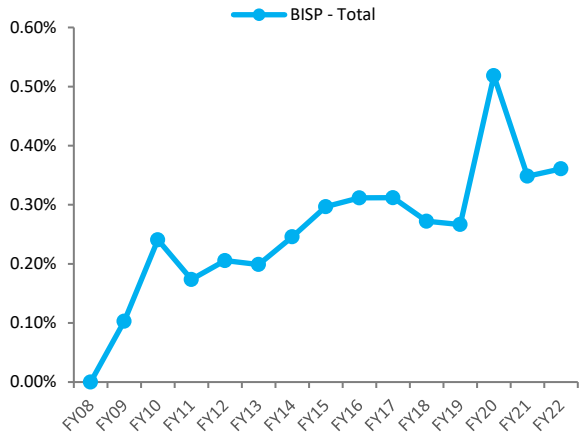
outfits were initially created as special border guard units but are increasingly assigned domestic security functions at the provincial level, even though policing responsibilities have been devolved after the 18th amendment.[26] While on provincial assignment, their salary continues to be paid at the federal level, whereas provinces pay 30 percent of salaries as a special allowance for provincial requisition.

Figure 2.33: Increase in employees between FY09 and FY22, top 5 (number of employees)



Source: World Bank Staff calculations based on data extracted from the SOE employee database

Figure 2.34: Federal Spending on BISP (% of GDP)



Source: World Bank Staff calculations based on PIFRA data.

The Federal Government also continues to engage on devolved subjects through semi-autonomous institutions that are involved in devolved service delivery areas, as well as vertical programs that directly provide services in the provincial domain. The most prominent among vertical programs is the BISP program, a social protection program organized by the Poverty Alleviation and Social Safety Division. Federal spending on the BISP has increased consistently since its inception in FY09, peaking at 0.52 percent of GDP during the COVID-19 pandemic in FY20 (Figure 2.34). In addition to BISP, the Federal Government maintains multiple public health programs, for instance to eradicate polio, even though public health falls within the provincial domain.

2.4 Policy Discussion

This chapter has identified opportunities to realize fiscal savings, especially at the federal government level, while simultaneously ensuring that expenditure can better support inclusive growth. The policy recommendations propose a three-phased approach. The immediate priority is the *realization of federal fiscal savings* through a subsidy rationalization program that buffers adverse social impacts and through a refocusing of federal spending on federal mandates. In the medium term, Pakistan could combine parts of these savings with expenditure management reforms to enhance the *quality of spending*. The longer-term priority will then be the *mitigation of fiscal risks* through debt management and budgeting reforms. Where quantifiable, these efforts could generate fiscal savings at the federal government level of about 1.69 percent of GDP (Table 2.2).

[26] Such arrangements are consistent with articles 146 and 147 of the constitution, enabling provinces and the federal level to confer and entrust powers.

Table 2.2: Rationalizing Federal Fiscal Expenditures

Reform	Federal Fiscal Savings Potential per Year	
	Billions of PKR in FY22	% of FY22 GDP
Eliminate electricity tariff differential subsidies to achieve full cost recovery	167	0.25 [27]
Tube-well subsidies	20	0.03
Rationalization of wheat subsidy	7	0.01 [28]
Reduced operational spending on devolved ministries and autonomous institutions	398	0.59
Cost sharing by provinces on BISP	217	0.32 [29]
Refocusing federal development spending on federal mandates	315	0.49
Total	**1,124**	**1.69**

2.4.1 Immediate Priority: Realizing federal fiscal savings

Reducing spending on subsidies: This chapter has shown that electricity subsidies are costly, have adverse environmental impacts, and do not efficiently target their intended beneficiaries. Considering these findings, Pakistan could consider gradually phasing them out. The introduction of protected residential consumers is a good initial step, allowing the authorities to generate fiscal savings while leaving the welfare of the bottom 40 percent unaffected. In the medium term, Pakistan could fully align the whole tariff schedule with costs and compensate poorer households through the BISP program (Section 4.2). A rationalization could also involve wheat subsidies and spending on one-off subsidies that could jointly generate around 0.26 percent of GDP in savings.

Realizing federal fiscal savings through improved alignment of expenditure with constitutional responsibilities: Despite the 18th amendment, the Federal Government maintains recurrent spending on areas that have been devolved to the provinces. Overlaps between federal and provincial recurrent spending should be eliminated from the federal budget to improve accountability, reduce duplication and waste, and realize federal fiscal savings. This should be pursued as provincial governments build their capacity to finance the delivery of devolved functions through expenditure and revenue reforms.

1. ***Staff in devolved ministries:*** Taking the constitutional division of responsibilities as given, the Government should initiate a working group that identifies clear terms of references for each ministry and division in a devolved area, with the goal to refocus their work on exclusively federal mandates. Based on these terms of references, the Ministry of Finance could then issue a notification to these ministries asking them to undertake a zero-based budgeting [30] exercise that ensures that only staff contributing to federal responsibilities are retained at the federal level. This can be complemented by the institution of an intergovernmental staff rotation that moves technical staff from federal to provincial ministries, as envisioned in 2011 by the implementation commission. This exercise, together with the reduction of the operating expenses of devolved ministries, could save as much as 0.5 percent of GDP at the federal level annually in the medium term.

[27] Actual electricity tariff differential subsidy spending in FY22. Estimated fiscal cost savings for FY23 is PKR 223 billion.
[28] FY22 subsidy to the Pakistan Agricultural Storage & Services Corporation (PASSCO - www.passco.gov.pk)
[29] Assuming provinces cover 90 percent of FY22 BISP expenditure in the medium-term.
[30] Zero-based budgeting requires starting from a situation of no funding allocation to each spending unit and including as well as approving a justification for each included spending item. It is the opposite of incremental budgeting, which uses previous budget allocations as a baseline.

2. ***Semi-autonomous institutions, vertical programs, and federal staff contributing to devolved functions:*** A devolution of semi-autonomous bodies and vertical programs through which the Federal Government provides services in provincial areas of responsibility could also generate cost savings at the federal level.[31] A central question is how costs for the BISP should be shared, considering that it is a federal program that falls within the provincial domain. A potential solution involves an agreement within the Council of Common Interest (CCI) for a unified social protection program for Pakistan, maintained by the Federal Government and to which the provinces contribute in proportion to the recipients in their areas. This would enable the Federal Government to deduct cost contributions directly from the NFC award. The provinces would have the option to opt out of this agreement, which would preclude recipients in these provinces from becoming BISP beneficiaries. A phased approach where provinces agree to finance 90 percent of BISP expenditure over time (Box 2.4) could generate federal fiscal savings of 0.3 percent of GDP in the medium-term.
3. ***PSDP:*** Spending under the federal PSDP encompasses many areas that go beyond a strict federal mandate. Pakistan could generate fiscal savings of 0.5 percent of GDP at the federal level by focusing only on capital spending in function areas under the mandate of the Federal Government.

Stabilizing interest expenditure: Debt management in Pakistan currently prioritizes the lowering of direct short-term borrowing costs over the mitigation of risks to interest spending over the medium term. This can contribute to higher fiscal costs, both directly because higher interest rates will lead to a direct increase in expenditure needs, and indirectly because crowding-out development spending can adversely impact growth and thus the tax base. Immediate steps to address this include the following:

1. Pakistan could consider transitioning towards longer-term debt instruments with fixed interest rates. While this may lead to a short-term increase in borrowing costs, it would reduce medium-term expenditure volatility and lower borrowing costs over the longer-term.
2. If Pakistan is unable to access financing with long tenor and fixed interest rates at reasonable costs, it could also explore the use of hedging instruments provided by financial institutions that use options to insure Pakistan against macro shocks.

Box 2.4: Provincial Cost-Sharing of the BISP Program

Federal government expenditures on BISP cash transfer programs amounted to 0.36 percent of GDP in FY22. The support includes regular unconditional cash transfers to 8.5 million families across the country and also Conditional Cash Transfers to a subset of these 8.5 million families that are linked to incentivizing the uptake of education and health services. BISP was the first safety net authority setup in 2008 and, since then, has been instrumental in providing regular support to targeted beneficiaries and also responded to catastrophic shocks due to COVID-19 and climactic impacts. With the 18th amendment devolution of Social Protection to the provinces, the provinces are also in the process of setting up their own institutional setups, all of which are in nascent stages. In the absence of fully functional or developed safety net systems and programs at the provincial level, it is imperative that the BISP continues to function as the main safety net program. However, in order to be fiscally sustainable, the provinces should bear more of the fiscal burden of the BISP program.

Ideally, if the social protection institutional setup in a province is sufficiently adaptive to cater to the regular protective requirements of the population, the provinces should take on the complete responsibility of funding and managing all safety net initiatives within its domain. Some provinces may be more advanced than others in structuring social protection programs and can take over the delivery of such programs sooner from the Federal

[31] The financing of specific semi-autonomous institutions, if deemed critical for service delivery, can be subsequently taken up by the provinces in line with the constitutional mandates.

Government. For others, BISP may need to continue with its institutional setup for a longer period. Having said this, meanwhile, all provinces should at least take on some fiscal responsibility through cost sharing of federal safety net programs that are providing support to their population. This can be done in a phased manner and agreed upon through the institutional setup of CCI. An example of this collaboration was seen during the 2010 flood response where around 50 percent of the costs for cash transfer support was borne by the provinces. A cost sharing arrangement for the BISP where provinces bear progressively larger shares over time can immediately ease the federal fiscal burden of the program, while ensuring the poor and vulnerable households remain protected as social protection delivery systems gradually become fully established at sub-national level.

In parallel, during this transition period, the Federal Government can also offer grant-based incentives to encourage the lagging provinces to develop or establish their own delivery mechanisms and programs. The basis for this incentive can vary from grants against establishment of delivery mechanisms to matching grants against programs once they are transitioned to the provinces.

2.4.2 Medium-Term Priority: Enhancing the quality of spending

Improving development project preparation, selection, and implementation: Reforms to enhance the ability of development spending to support growth are key to enhancing spending quality:

1. ***Strategies:*** The regular formulation of overall and sectoral growth strategies is critical to identify priority areas for public investment and to provide guidance for project selection.
2. ***Project Preparation:*** To enhance project selection, Pakistan could consider introducing an independent third-party review of project design and appraisal documents. Fully implementing an updated monitoring and evaluation framework, currently under preparation by the Planning Commission, will also be critical to undertake ex-post evaluations of project performance and ensure that past experiences inform project preparation.
3. ***Project Selection and Prioritization:*** Project selection and prioritization should be based on a rigorous cost–benefit analysis and a quantitative scoring procedure that measures project returns and alignment with both federal priorities and federal mandates. The scores and results of the cost–benefit analysis should be made publicly available. In addition, Pakistan could consider introducing and publishing annual cut-off scores based on funds available for new development projects and allowing only those projects above the cut-off score for approval. Institutionally, this process could be initiated by the Planning Commission and agreed upon in the National Economic Council.
4. ***Planning:*** Pakistan could also benefit from a consolidation of the current and development budget planning process. This would involve the establishment of an integrated budget system that provides consistent budget ceilings for both types of spending. Such a reform would also require a new division of responsibility between the Finance Division and the Planning Commission. As part of this reform, Pakistan could also consider allocating responsibility to line ministries to prepare, select, and implement smaller projects independently.
5. ***Transparency:*** As discussed in this chapter, the current fiscal reporting does not disaggregate development spending by economic or functional classifications and instead classifies most development spending as loans and advances to implementing agencies. This should be rectified by ensuring that expenditure under the PSDP is coded consistently with current spending categorizations and that final expenditures are published and disseminated, as a prerequisite to undertake independent reviews of the PSDP portfolio for ex-post evaluations and to mitigate risks of resource misappropriation in development spending.

Use fiscal savings to ramp up development spending in federal areas and BISP: Parts of the federal fiscal savings could be invested in expanding development and social protection spending to support growth and to buffer the impact of expenditure rationalization on the poor. This would also help reverse the continued trend of declining development spending allocations and fill infrastructure gaps. Increased spending on the BISP, could, for instance, be used to remit electricity subsidies directly to consumers, which would open new avenues to better target subsidies and reduce leakages, and further alleviate political concerns surrounding subsidy rationalization. Such reforms would be conditional on improved BISP systems that minimize exclusion errors and ensure that as many beneficiary households as possible are covered by the program.

2.4.3 Longer-Term Priority: Mitigating Fiscal Risks

Enhancing accounting and cash management to limit development spending crowd-out: Interest spending crowds out development spending in Pakistan because interest and other current expenditures are systematically underestimated and, when realized, are prioritized for cash release over development spending. This can be addresses through a three-pronged strategy:

1. Pakistan could consider adopting accrual accounting, which would ensure that future interest payment liabilities are accounted and budgeted for when they are assumed, and not when they are realized.
2. Capacity building efforts could focus on strengthening liability and cash management forecasting capacity in the Finance Division. Key to this is a transparent and automated process for cash management forecasting that adequately captures (i) risks related to market-dependent interest rate changes and (ii) revenue forecasts.
3. The ongoing adoption of a treasury single account will be critical to ensure that available cash is adequately accounted for and to prevent cash shortfalls that facilitate development spending crowd-out.

Incorporating macro-fiscal stability considerations into debt management: Reducing fiscal risks associated with Pakistan's debt burden will hinge on redefining the objective of debt management to seek a cost-risk strategy that is optimal in the medium- to long-term. On an institutional level, Pakistan could consider enabling a closer coordination between the Finance Division's new Macro-Fiscal Policy Unit, tasked with identifying and monitoring fiscal risks, and the debt management division, including the potential inclusion of officers tasked with minimizing fiscal risks into the debt management decision making process.

Strengthening budget planning, forecasting, and transparency: This chapter has highlighted that although Pakistan's effectively executes its budget on an aggregate level, it tends to overspend on current spending and underspend on development spending. This is partially driven by optimistic revenue and macro forecasts that underpin the budget. Therefore, execution rates could be improved by:

1. Strengthening the predictive power of forecasts by building the capacity of the Macro-Fiscal Policy Unit will be critical to overcome this challenge.
2. Pakistan could also consider amending the Public Finance Act to start publishing and discussing the projections from the Medium-Term Fiscal Framework in the National Assembly biannually, as currently mandated, once as part of the budget process, and another time as part of a mid-year budget review.

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Chapter 3

PAKISTAN FEDERAL PUBLIC EXPENDITURE REVIEW 2023

Debt Diagnostics, Management and Sustainability

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PUBLIC EXPENDITURE REVIEW

Chapter 3. Debt Diagnostics, Management and Sustainability

2023

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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

ADB	Development Bank
ATM	Average Time to Maturity
BW	Budget Wing
CD	Circular Debt
CDNS	Central Directorate of National Savings
DeMPA	Debt Management and Performance Assessment
DISCOs	Electricity Distribution Companies
DMFAS	Debt Management and Financial Analysis System
DMO	Debt Management Office
DPCO	Debt Policy and Coordination Office
DPOs	Development Policy Operations
DSA	Debt Sustainability Analysis
DSC	Defense Savings Certificate
EAD	Economic Affairs Division
EF	External Finance
EFF	Extended Fund Facility
FRDLA	Fiscal Responsibility and Debt Limitation Act
FRS	Fiscal Risk Statement
FX	Exchange Rate
GDP	Gross Domestic Product
GFN	Gross Financing Needs
GG	General Government
MAC	Market Access Country
MoF	Ministry of Finance
MRTBs	Market-Related Treasury Bills
MTBs	Market Treasury Bill
MTDS	Medium-Term Debt Strategy
NPBs	National Prize Bonds
NSS	National Saving Schemes
PFM	Public Financial Management
PIBs	Pakistan Investment Bonds
PP	Percentage Points
PPBs	Premium Prize Bonds
PPG	Public and Public Guaranteed
PPGD	Public and Publicly Guaranteed Debt
PPP	public–private partnerships
RIC	Regular Income Certificates
RISE	Resilient Institutions for Economy
SBP	State Bank of Pakistan
SOEs	State-Owned Enterprises
SSC	Special Saving Certificates
TSA	Treasury Single Account
UFG	Unaccounted-for Gas Losses

Chapter 3: Debt Diagnostics, Management and Sustainability

3.1 Introduction

Interest payments are Pakistan's primary expenditure driver and a key source of persistent high fiscal deficits. In FY22, Pakistan spent over one-third of its total federal expenditure (4.7 percent of GDP) on interest payments to service its public debt stock. In contrast to other expenditure items, interest payments are non-discretionary; they are contractual and determined by past fiscal policy choices and must be met for the country to avoid falling short on its debt service obligations. In Pakistan, the large interest payments are a direct result of the rapid build-up of public debt over the past decade, which increased public and public guaranteed (PPG) debt from 58.6 percent of GDP in FY10 to 78.0 percent of GDP in FY22. These debt shares breach the fiscal rules stipulated by the Fiscal Responsibility and Debt Limitation Act (FRDLA), which specifies a debt ceiling of 60 percent of GDP.[1] Debt and interest dynamics are mutually reinforcing, with higher interest payments having the tendency to increase public debt stocks and vice versa.

Both budgetary and non-budgetary items drive debt levels and corollary interest payments. On the one hand, debt can increase "above-the-line" when budgetary expenditure exceeds revenue. Pakistan has persistently registered large fiscal deficits that averaged 6.0 percent of GDP over FY10–FY22, which has contributed to the rapid debt build-up. Thus, addressing the budgetary or above-the-line drivers of debt and interest payments requires rationalizing expenditure (Chapter 3) and enhancing revenue collection (Chapter 5). On the other hand, public debt can also increase due to non-budgetary or "below-the-line" factors, such as changes in interest and exchange rates. Similarly, the formal recognition and/or realization of contingent liabilities can lead to discrete jumps in the debt stock without any associated expenditures.

This chapter identifies policy options to address the non-budgetary "below-the-line" debt build-up dynamics. It will present how these factors historically have affected the public debt stock and their potential in driving debt dynamics in the future. The analysis focuses on avenues to regain debt sustainability and is therefore guided by the goal of complying with FRDLA debt stock ceiling of at or below 60 percent of GDP. After Section 2 provides an overview of Pakistan's historical drivers of public debt, Section 3 presents the debt sustainability analysis. There are three channels of non-budgetary "below-the-line" debt accumulation: macroeconomic factors, institutional factors and contingent liabilities, each of which is detailed in the three following sections. Section 4 discusses macroeconomic factors and examines their effects on debt exposure through simulations with alternative borrowing mixes. Section 5 describes Pakistan's institutional debt management setup and proposes options to strengthen decision-making for optimal debt management. Section 6 examines the accumulation of contingent liabilities and

[1] As per the FRDL Act (2005), the ceilings for the fiscal deficit and debt are 3.5 percent and 60 percent of GDP, respectively. Despite the fiscal rules, the fiscal deficit has consistently exceeded 3.5 percent of GDP since FY06 and the PPG-debt-to-GDP ratio has surpassed the 60 percent threshold since FY12. The FRDLA was amended in 2017 to address this challenge. As per the amendments, the total public debt was to be reduced to 60 percent of the GDP beginning from FY17. The FRDLA has been in June 2022, however, the debt to GDP ceiling has remained at 60 percent.

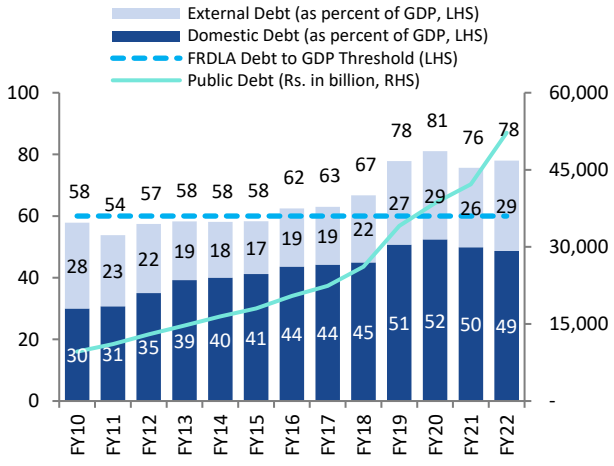
provides policy recommendations to minimize their fiscal impact. Section 7 proposes a policy roadmap based on the preceding analysis.

This chapter adds significantly to the discussion on public debt sustainability and public debt management in Pakistan. It first provides an updated public debt sustainability analysis by projecting PPG debt for the next five years and identifies the potential effects of various macroeconomic and fiscal drivers on debt buildup. The analysis is cutting edge, incorporating stochastic simulations to project debt ratios under different scenarios and thereby allowing for a wide range of possibilities. The analysis reveals the main debt vulnerabilities in the face of macroeconomic shocks. The chapter also presents alternative financing strategies that compares their potential for reducing financing needs, the debt burden, and liquidity risks. On the institutional front, based on the recently conducted Debt Management and Performance Assessment Report (DeMPA), the chapter outlines recent improvements and continued challenges in Pakistan's public debt management system, and a path for future reforms to optimize debt management decision-making in Pakistan. Finally, as noted, contingent liabilities are a key driver of PPG debt in Pakistan, and by analyzing recently available data, the chapter discusses the country's sizeable stock of contingent liabilities and how it accentuates vulnerabilities and risks for public debt. These contingent liabilities are a source of significant fiscal risk due to inadequate formal recognition, recording, disclosure, monitoring, evaluation, and mitigation measures.

3.2 Evolution and Composition of Public Debt

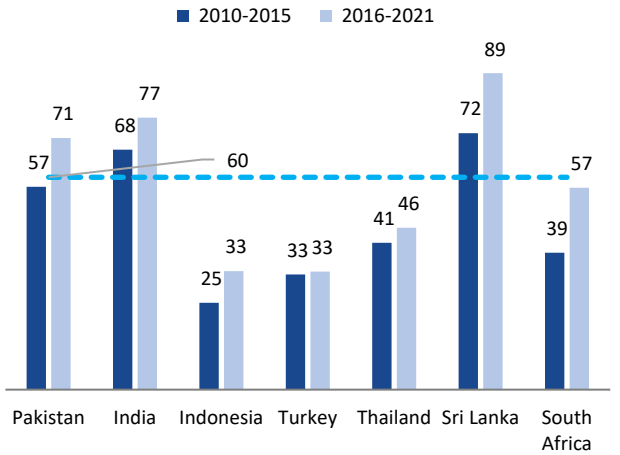
Pakistan's Public and Publicly Guaranteed Debt (PPGD) stock is high and still growing. The public debt stock, including guaranteed debt, reached 78.0 percent of GDP at the end of FY22, increasing from 58.6 percent of GDP at end-FY10 (Figure 3.1). These debt levels breach Pakistan's Fiscal Responsibility and Debt Limitation Act (FRDLA) 2005 (amended in 2017 and 2022), which requires public debt to be at most 60 percent of GDP at the end of FY23. Pakistan's general government debt has grown sharply compared to economic peers, including Indonesia, South Africa, Thailand and Turkey (Figure 3.2).

Figure 3.1: Pakistan's Public and Publicly Guaranteed Debt



Source: World Bank Staff calculations.

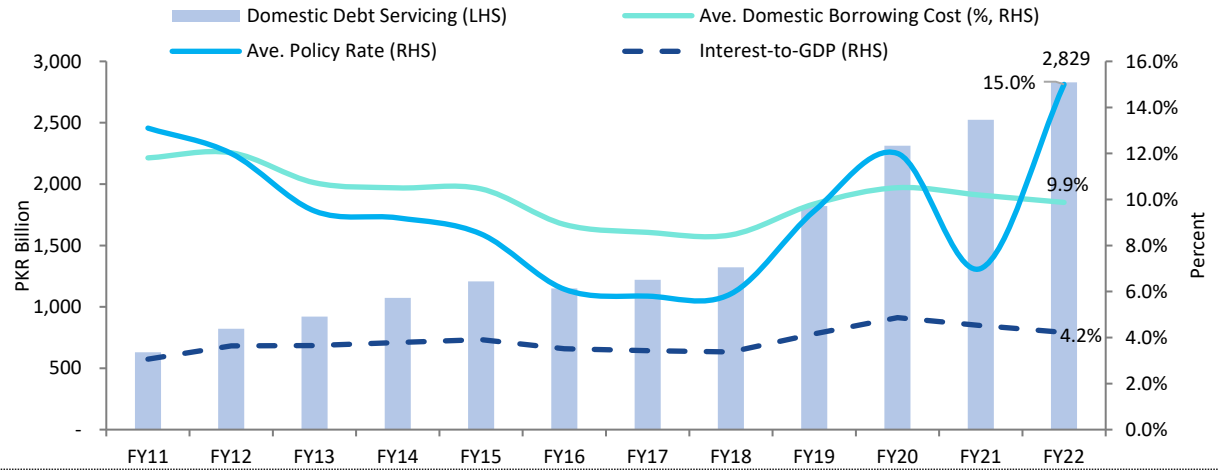
Figure 3.2: General Government Debt to GDP
(Average annual GG debt, as a percent of GDP)



Source: IMF WEO April 2022 and World Bank Staff calculations.

The growing debt stock imposes high fiscal costs and exposes the country to debt vulnerabilities. Annual fiscal gross financing needs (GFN) are high, averaging 27 percent of GDP over the last decade, exceeding the emerging market threshold of 15 percent. GFN also accounted for 200 percent of revenues annually over the last decade, implying that Pakistan relied on market access and continued borrowing in both domestic and external markets to service its debt. Debt servicing reached 4.7 percent of GDP, of which domestic debt servicing accounted for the lion's share (Figure 3.3).[2] The high level of interest expenditure therefore not only reduces fiscal space but also exposes Pakistan to macroeconomic shocks and heightens its vulnerability to debt crises.

Figure 3.3: Domestic Debt Servicing
(PKR billions, percent of GDP)



Source: World Bank Staff calculations.
Note: Average domestic borrowing cost is calculated by dividing annual domestic interest expenditures (reported in fiscal accounts) with average debt stock of the corresponding and previous fiscal year.

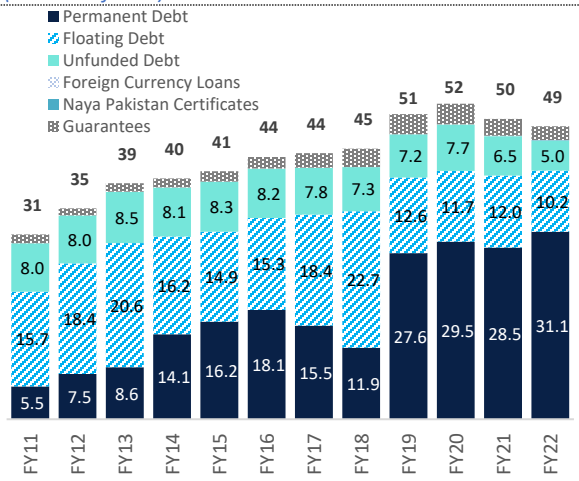
3.2.1 Debt Composition and Implications

Domestically issued debt accounts for about two-thirds of Pakistan's debt stock, but the domestic market is limited. Domestic debt has gradually increased over the last ten years, from 31 percent of GDP in FY11 to 49 percent in FY22. Domestic debt is issued in three main categories that vary by maturity (Box 3.1). Of these, permanent debt – which has maturities of greater than one year – represented 64 percent of total domestic PPG debt at the end of FY22. Floating debt, with maturities below one year, accounted for 21 percent, and unfunded debt that could be drawn at any time, for another 10 percent. A significant share of the permanent and floating debt, which form the bulk of the domestic debt, is held by the domestic banking system. Thus, the government has become increasingly reliant on the domestic banking system to meet its funding requirements in recent years, increasing the bank exposure to sovereign debt risk. At present, approximately 70 percent of all the outstanding credit of the banking system is to the government. However, banks' short-term maturity deposit base hampers their ability to provide longer-term financing.[3] The development of domestic debt capital market remains critical in diversifying the investor base, which can help in maximizing long-term domestic borrowing potential.

[2] IMF debt sustainability benchmark for emerging markets with access to international capital markets.
[3] Pakistan at 100: Growth and Investment Policy Note.

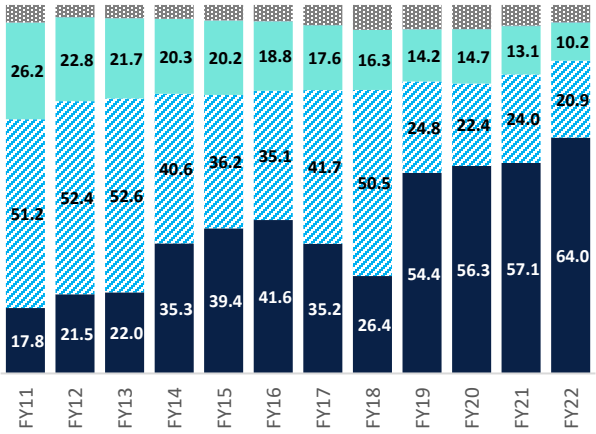
Over time, roll-over risks have declined as Pakistan lengthened the maturity profile of its domestic debt, including by reclassifying debt held at the central bank. Permanent debt, medium-and long-term debt, grew to 31 percent of GDP at the end of FY22, from 6 percent in FY11.[4] In particular, Pakistan Investment Bonds (PIBs) rose from 3 percent of GDP in FY11 to 32 percent in FY22, representing 54 percent of the total domestic debt in FY22. Floating debt, short-term debt, fell from 16 percent of GDP in FY11 to 10 percent in FY22, and unfunded debt dropped from 8 percent in FY11 to 5 percent of GDP in FY22 (Figure 3.4 and Figure 3.5).[5] At the end of FY19, the Government reclassified the existing stock of central bank borrowing from short-term to long-term debt (1 to 10 years), which mechanically increased the maturity profile and reduced rollover risks.[6]

Figure 3.4: Domestic Public and Publicly Guaranteed Debt
(Percent of GDP)



Source: World Bank Staff calculations.

Figure 3.5: Domestic Debt Composition
(Percent)



Source: World Bank Staff calculations.

Box 3.1: Pakistan's Domestic Debt Structure

Domestic debt can be divided into floating, permanent, and unfunded debt:

1. Floating debt is short-term borrowing (up to one year), primarily at market rates.

Market Treasury Bill (MTBs):[7] Issued under the Public Debt Act 1944, this category includes MTBs, also called zero-coupon bills (issued at a discount), which are generally used by the Government to borrow from the banking and non-banking sectors with tenors of 3, 6, and 12 months. Alternatively, these are called Treasury bills (T-bills), which are negotiable debt instruments issued by the State Bank of Pakistan (SBP) on behalf of the Government of Pakistan. These bills are scripless, traded freely in the secondary market, easily transferable, and redeemable only at maturity. T-bills are usually sold through auctions on a discount basis with a yield equal to the difference between the purchase price and the maturity value.

Market-related treasury bills (MRTBs):[8] These are treasury bills of 6-month tenor through which the Government borrows from SBP at the weighted average rate of a 6-month T-bill decided in the latest primary auction.

[4] Permanent debt mainly includes Pakistan Investment Bonds (PIBs), Ijara Sukuk, and prize bonds.
[5] Floating debt comprises a market treasury bill with one year of maturity.
[6] State Bank of Pakistan annual report FY20.
[7] https://www.sbp.org.pk/dmmd/Guidelines/MTB.pdf
[8] https://www.sbp.org.pk/m_policy/mp-learn-3.asp

2. Permanent debt[9] represents government borrowing using instruments of more than one-year maturity and includes Pakistan investment bonds (PIBs), Sukuks, National Saving Bonds (Prize Bonds), and Market Loans:

PIBs:[10] Issued by the Government of Pakistan under the Public Debt Act 1944, a PIB is a conventional fixed coupon bond, bearing bond classification of principal plus semi-annual coupon payments, issued for tenors of 3, 5, 10, and 20 years. The pricing is based on market-determined yields. PIBs are scripless, traded freely in the secondary market, and easily transferable.

PIB Float:[11] Recently, the Government introduced 10 years of conventional PIBs with floating rate coupon bonds (PIB-F "floaters") under Pakistan Investment Bonds Rules, 2000. The coupon rate on the floating rate PIBs will be equal to the benchmark rate plus/minus a margin decided in the auction. The Benchmark rate would be the weighted average yield of the 6-month Market Treasury Bills (MTBs) as determined in the latest successful 6-month MTB auction held prior to the floating rate PIB auction and/or the start of the coupon period. The coupon will be paid and reset semi-annually following this procedure. These are not redeemable before maturity, scripless, easily tradable in the secondary market, and transferable.

Government of Pakistan Ijara Sukuk:[12] A Sukuk is an Islamic borrowing instrument with a floating rate and semi-annual coupon payments; the pricing is based on market-determined yields. The yields are called semi-annual rentals, linked to the weighted average yield of six-month T-bills. These are issued for 3 years of maturity. The Sukuks are also scripless, freely traded in the secondary market, redeemable at maturity, and easily transferable.

National Saving Bonds (Prize Bonds): No formal definition is available for national prize bonds; however, some features are defined on the State Bank and CDNS websites. They are of two categories: national prize (bearer) and premium prize bonds (registered).

National Prize Bonds (NPBs) (bearer):[13] These are issued for unlimited tenors without any maturity. As the name suggests, these are unregistered savings bonds issued by the Central Directorate of National Savings (CDNS) and are cashable on demand. NPBs are bearer instruments, and whoever is holding the prize bond is the instrument's owner and can claim the prize money. There is no limit to investment in these bonds. The draws for each denomination of prize bonds are held quarterly.

Premium Prize Bonds (PPBs):[14] The CDNS initiated a new registered prize bonds scheme called "Premium Prize Bonds (Registered)," parallel to the national prize bonds scheme. Contrary to the national prize bonds NPB (bearer), the PPBs is a registered prize bond issued in the name of a registered investor. PPBs are issued for unlimited tenors without any maturity. The draws for each denomination of bonds are held quarterly. The investor gets a six-monthly profit on investment at a rate notified by the Government of Pakistan from time to time and in addition to the eligibility of prize money in quarterly draws.

Market loans: To meet financing requirements, the government used to invite applications for subscriptions by indicating the amount of credit required and the cost they would be willing to pay. As the Federal Government has stopped this practice since FY92 and provincial governments since FY98, with ongoing maturities and no new additions, the outstanding balance has stagnated at a fixed payable amount for a long time.

3. Unfunded debt refers to mobilization from national saving schemes (NSS) instruments that are cashable on demand. Of the three most popular instruments offered by the CDNS), the most popular is the Defense Savings Certificate (DSC), Special Saving Certificates (SSC), and Accounts and Regular Income Certificates (RIC).

[9] https://www.sbp.org.pk/m_policy/mp-learn-3.asp
[10] https://www.finance.gov.pk/publications/PIB_Guide.pdf
[11] https://www.sbp.org.pk/dmmd/2018/C9.htm#:~:text=The%20floating%20rate%20PIBs%20will%20be%20issued%20at%20face%20value,over%2Funder%20the%20benchmark%20rate.
[12] https://www.finance.gov.pk/publications/Sukuk_Guide.pdf
[13] https://www.sbp.org.pk/sbp_bsc/PrizeBond/NationalPrizeBonds-FAQs.pdf
[14] https://www.sbp.org.pk/sbp_bsc/PrizeBond/premium/FAQs.pdf

Since FY20, the government has been increasing the debt issuances of Pakistan Investment Bonds at a floating rate, increasing the interest rate risk. In recent years, the Government has been increasing the target of the floating rate debt issuances (Figure 3.6), while fixed rate debt issuances targets have remained constant (Figure 3.7). In addition, the level of acceptance of bids for floating-rate instruments averaged 56% compared to 36% for fixed-rate instruments in government auctions. This financing strategy doubled the stock of floating-debt bonds. The floating-rate debt stock grew from PKR 5,784 billion in FY19 (28 percent of total domestic debt) to PKR 12,954 billion in FY22 (42 percent of total domestic debt). Meanwhile, the fixed-rate bond stock grew from PKR 9,447 billion in FY19 to PKR 11,279 billion in FY22.

Increasing the floating-rate bonds debt stock has raised the interest burden in recent years. Although fixed-rates instrument yields were marginally higher than the average yield of the previous five years (9 percent compared to 11 percent on average from FY20), fixing the interest rates would have reduced interest costs in the future, particularly considering the prevailing trend of generalized interest rate hikes. If all debt issuances at a floating rate within the last five years had been issued at a fixed rate, the interest payment would have been reduced by almost PKR 200 billion from FY20 to FY22.[15] This represents an average reduction of 30% per year of the interest paid on floating-rate bonds.

Figure 3.6: Floating-Rate Bond Issuances
Face value (PKR Billions)

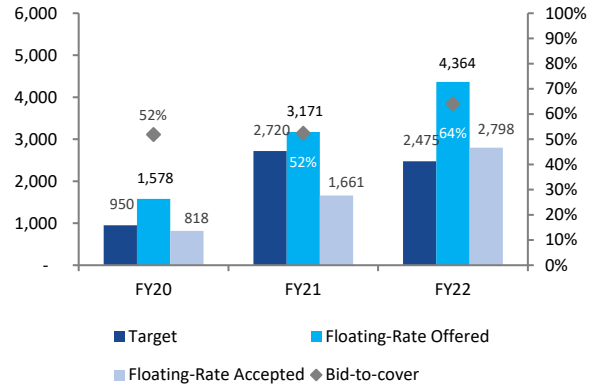
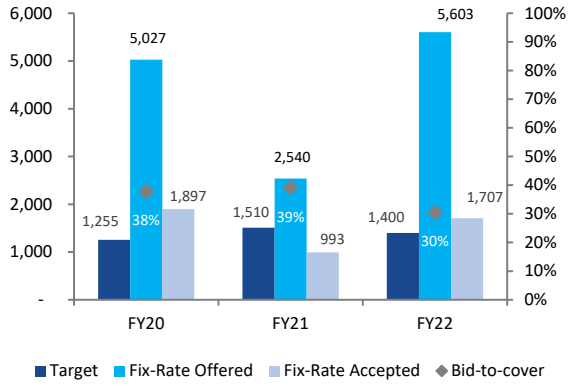


Figure 3.7: Fixed-Rate Bond Issuances
Face value (PKR Billions)



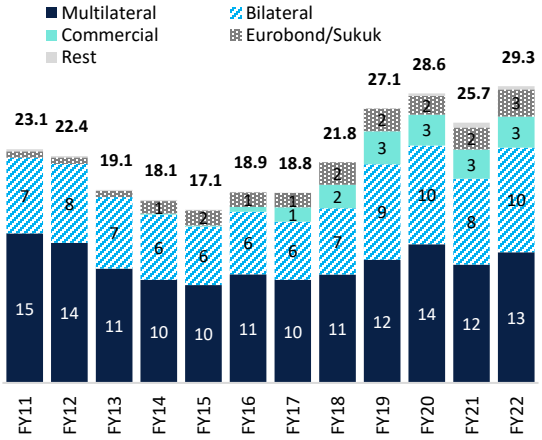
Source: SBP and the World Bank staff calculations.

Public external debt has increased in the last years, increasing the currency risk. After a downward trend, external debt grew from 19 percent of GDP in FY17 to 29 percent of GDP in FY22. Almost 90 percent of public external debt was concessional being held by official multilateral creditors over the last ten years, helping reduce interest rate and refinancing risks due to the lower interest rates and longer maturities. More recently, however, the Government has started borrowing from bilateral and commercial creditors at floating rates and short-term maturities, at one year or less. These creditors only partially compensate for the associated refinancing and rollover risks through lower interest rates, compared with the international issuances.[16]The key issue remains that these commercial and bilateral loans are primarily mobilized to support the foreign exchange reserves and the creditors show hesitancy to refinance and rollover these loans as country's foreign exchange reserves remain low coupled with increases in the

[15] Debt issuance decisions are not arbitrary decisions that depend on the public officer but on several factors, such as market condition, market appetite, and future outlook. The exercise presents a hypothetical scenario where all floating-rates bonds issuances would have been issued at fixed rates, maintaining the same amount and maturity. The average yield of an equivalent fixed-rate bond of the same period and maturity was used as the interest rate to calculate the interest payments.
[16] The interest rate of China Safe deposit is Libor 12 months + 1%, and the Saudi Arabia loan includes a fixed 3.8 interest rate.

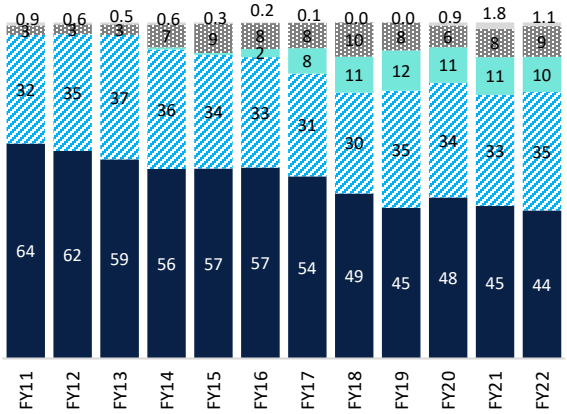
country's credit risk. In addition, Pakistan has returned to the international Islamic bond market with the issuance of new Sukuks. As a result of this practice, borrowing from multilaterals agencies has declined from 64 percent of the total public external debt (15 percent of GDP) in FY11 to 44 percent (13 percent of GDP) in FY22 (Figure 3.8 & Figure 3.9). Concurrently, the commercial debt stock increased from 0.5 percent of GDP in end-June 2016 to 3.1 percent of GDP in end-June 2022, heightening interest rate and rollover risks.[17]

Figure 3.8: External Public and Publicly Guaranteed Debt (percent of GDP)[18]



Source: World Bank Staff calculations.

Figure 3.9: External Public and Publicly Guaranteed Debt Composition (percent of total)



Source: World Bank Staff calculations.

Disbursements from multilateral and bilateral creditors accounted for half of the total external financing in FY22. More than three-quarters of total disbursements were obtained for balance of payments or budgetary support. Multilateral agencies disbursed USD 5.8 billion during the year, of which the main creditors were the Asian Development Bank (ADB), the Islamic Development Bank (IDB), World Bank, and IMF. Bilateral sources contributed USD 3.6 billion, of which USD 3 billion correspond to Saudi Arabia's time deposits, which were utilized toward budgetary support. In addition, the IMF disbursed USD 1.0 billion under the 6th review of the IMF Extended Fund Facility (EFF) program. One-third of the disbursement came from commercial banks (USD 5 billion), which were mostly taken to refinance existing loans. Finally, the Government raised USD 1 billion through Sukuk under the "Trust Certificate Issuance Program" and USD 1 billion through multi-tranche tap issuance of 5-, 10- and 30-year Eurobonds in FY22.

In line with the Government's objectives, the main funding source is the medium-to-long-term domestic debt instrument in FY22. During FY22, the Government issued Treasury Bills for an amount of PKR 17.9 trillion and repaid PKR 17.8 trillion, increasing the short-term domestic debt stock by PKR 0.1 trillion. Furthermore, the Government had highest gross issuances of Shariah Compliant Securities for a total of PKR 1.6 trillion. Pakistan Investment Bonds, which are medium-to-long-term domestic debt instruments, were the main sources of net financing (PKR 3.3 trillion). In addition, the Government repaid PKR 569 billion to the State Bank of Pakistan (SBP).[19]

[17] The new borrowing in commercial loans between FY17-FY20 was primarily meant for balance of payment support with a bullet repayment, a maturity of 2-3 years and a floating interest rate linked to LIBOR.

[18] The rest category includes Non-resident's investments in GS (Local Currency Securities (PIBs and TBills), Pakistan Banao Certificates (PBC), Naya Pakistan Certificates (NPC), Military debt, and Saudi fund for development (SFD).

[19] The government continue reducing the debt owed by the SBP. From July 2019 to June 2022, the debt retirement against SBP stood at PKR2.3 trillion.

Eurobond and Sukuk's short-term repayments are low; however, financing risks are elevated because the international reserves position has recently deteriorated. Total Eurobond and Sukuk global bonds debt stock is USD 8.8 billion in FY21, of which only USD 1 billion is due in the CY2022 (Table 3.1). In the following three years, the Government will face amortization payments of USD 1.5 billion. Even though this amount comes across to be manageable in terms of refinancing, refinancing risks are heightened with the current scarce availability of international reserves and high exchange rate volatility.

Table 3.1: Pakistan Sovereign Bonds

Issuer Name	Issue Date	Maturity Date	Nominal Amount US$ million	Coupon (percent)	Original maturity (years)
International Sukuk	05-Dec-17	05-Dec-22	1,000	5.625	5
International Sukuk	31-Jan-22	31-Jan-29	1,000	7.95	7
Eurobond	15-Apr-14	15-Apr-24	1,000	8.25	10
Eurobond	30-Sep-15	30-Sep-25	500	8.25	10
Eurobond	08-Apr-21	08-Apr-26	1,300	6	5
Eurobond	05-Dec-17	05-Dec-27	1,500	6.875	10
Eurobond	08-Apr-21	08-Apr-31	1,400	7.375	10
Eurobond	30-Mar-06	31-Mar-36	300	7.875	30
Eurobond	08-Apr-21	08-Apr-51	800	8.875	30

Source: Bloomberg

3.2.2 Drivers of Debt

Persistent primary deficits contribute to debt accumulation. Primary deficits averaged 1.9 percent of GDP between FY10 and FY22 and reached 2.4 percent on average during FY19–FY22 (Figure 3.10). The fiscal slippage in recent years has contributed to the high level of public debt in Pakistan, increasing solvency and liquidity risks.

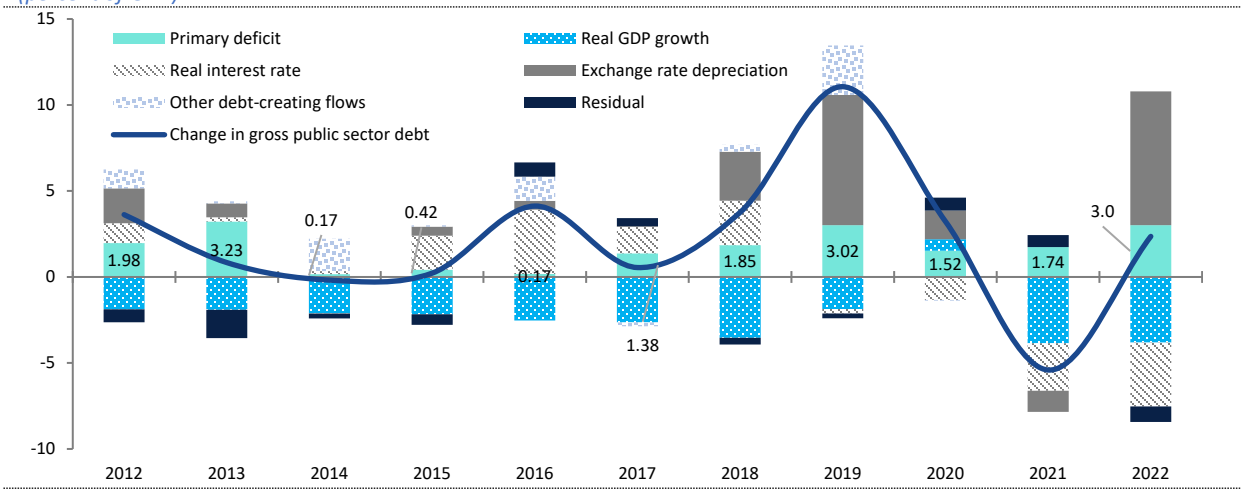
In recent years, non-budgetary items such as macroeconomic developments – including interest rate increases and exchange rate depreciations – have emerged as key drivers of debt. Pakistan's debt management choices expose the country to macroeconomic risks through a comparatively high share of external borrowing and a reliance on short-term debt instruments. Between 2012 and 2022, exchange rate depreciation contributed a cumulative 22.5 percentage points (pp) of GDP to the PPG debt level, of which 15 pp occurred over two years, FY19 and FY22. Although the contribution from interest rate changes was negative over the same period – contributing to a reduction of the debt stock – this was more than offset by the revaluation losses due to exchange rate depreciations. Interest rate changes have contributed to debt accumulation before 2019, accounting for a cumulative increase of 11.4 pp of GDP from FY12 to FY18.

The build-up in public debt can also partially be attributed to continued fiscal support to State Owned Enterprises (SOEs), which contribute to non-budgetary below-the-line PPG debt accumulation principally through the issuance of guarantees. The Federal Government has a network of 207 SOEs, including subsidiaries, trusts, and funds – most of which are incurring heavy losses and are a major source of fiscal drain for the Federal Government. On top of the financing received by the SOEs through grants and subsidies, commercial borrowing by SOEs is also guaranteed by the Federal Government. The total stock of sovereign guarantees to SOEs reached 4.5 percent of GDP at end-FY22, with more than 80 percent

of it accrued by the power sector. In addition, the Federal Government borrows for below-the-line commodity procurement (Box 3.2 and Section 4).

Figure 3.10: Key Drivers of the PPGD in Pakistan

(percent of GDP)



Source: World Bank Staff calculations.

Box 3.2: SOE Debt

Power and Gas Sector Circular Debt[20]

Annually, the power sector incurs substantial losses due to heavy reliance on costly imported fossil fuels, unbudgeted subsidies, lack of timely determination and implementation of tariffs, and the poor performance of electricity distribution companies (DISCOs). As of June 2022, payables to the power generators, a measure used to estimate the sector's financial liabilities (commonly known as circular debt or CD), were approximately PKR 1,453 billion. This is on top of the PKR 800 billion (1.2 percent of GDP) of power sector debt parked in the Power Holding Company (established by the government to park these liabilities off-budget). In total, PKR 2,253 billion (3.4 percent of GDP) of payables are fiscal liabilities that the government will have to settle, either through the recovery of outstanding bill payments from electricity consumers or through budgetary support. Thus, CD accumulation represents a direct fiscal cost and compromises macroeconomic sustainability. Furthermore, financial liabilities in the power sector constrain investment as they increase the risk for investors and result in under-investment in transmission and distribution systems.

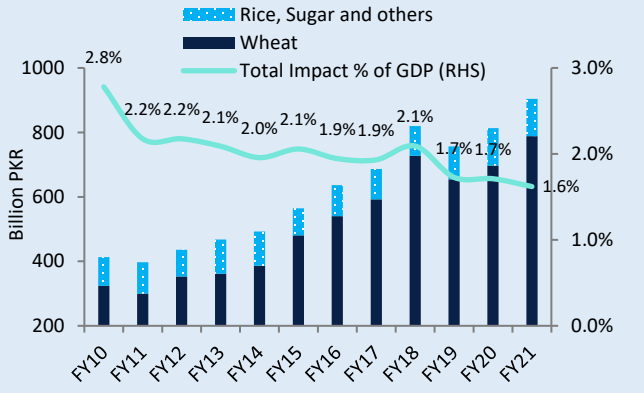
Gas: The gas sector circular debt primarily originates from operations of two State Owned Enterprises (SOEs), Sui Northern Gas Pipelines Limited and Sui Southern Gas Company Limited. On other side, the main drivers of the accumulation of CD stock in the gas sector are delayed sales price adjustments, uncovered subsidies (especially for export and zero-rated industries), high, unaccounted-for gas losses (UFG), delayed sales price adjustments (since September 2020), and collection shortfalls. By end-March 2022, a substantial CD stock of about PKR 720 billion (1.1 percent of GDP) has also amassed in the gas sector.

[20] Source: Pakistan: Seventh, and Eighth Reviews of the Extended Arrangement under the IMF-Extended Fund Facility.

Commodity financing (off-balance sheet)

Provincial and federal government departments' liabilities against commodity operations also add to Pakistan's fiscal risks. Every year, federal SOEs and provincial governments' food departments borrow from commercial banks to finance the purchase of commodities such as wheat and rice.[21] They are required to subsequently retire these loans from the proceeds generated from the sale of crops (whose stock is used as collateral in these transactions). However, with delays in subsidy payments, losses in stock during storage, release to flour mills at low rates, and transportation and storage costs, these liabilities have been accumulating over the years, and by end-June 2022, they stood at PKR 1,134 billion compared to with PKR 413 billion in FY10. The exposure against commodity operations has been 1.9 percent of GDP since FY2010 and stands at 1.7 percent of GDP at end-FY2022 (Figure B.3.1). Borrowing against wheat procurement constitutes the bulk of these liabilities (87 percent of the total). These liabilities are not part of public debt (as they are considered to be backed by the stock of the commodity purchased) but pose fiscal risks for the government if they are not repaid by the borrowing agencies.

Figure B.3.1: Government Commodity Financing



Source: State Bank of Pakistan and world bank staff calculations

3.3 Debt Sustainability Analysis (DSA) - Fiscal and External Determinants of Pakistan's Debt Trajectory

Fiscal consolidation remains key to Pakistan reducing its high levels of debt. The preceding section showed that the fiscal deficit and macro factors were key in the accumulation of debt. Using a standard market access country (MAC) DSA methodology, this section quantifies key contributors to Pakistan's future debt path and assesses options for consolidation. Simulations show that the debt trajectory is sensitive to both fiscal and macroeconomic factors, btu highlights that fiscal consolidation to pivotal to regaining debt sustainability and meet debt levels consistent with the FRDLA.

3.3.1 Business-As-Usual Scenario (BAU)[22]

The BAU scenario projects that PPG debt will remain above the FRDLA 2005 limit over the forecast horizon. The BAU scenario assumes that the IMF-EFF will stay on track with a moderate recovery in growth and fiscal consolidation (Table 3.2). It assumes that Pakistan will continue to use domestic and external borrowing sources to manage the level of gross financing needs (Figure 3.11). It is projected that 60 percent of gross financing needs would be covered by domestic debt (Figure 3.12). Based on these assumptions, the BAU scenario projects that PPG debt is projected to fall from 78.0 percent in FY22 to

[21] Provincial governments undertake this borrowing under a federal guarantee.

[22] Pakistan's public debt was assessed as sustainable in the last public and external debt sustainability analysis in the 2022 Article IV, but the high macroeconomic volatility experienced at end-FY22 highlighted the macroeconomic risks described in the report. According to the IMF report, due to a stronger exchange rate path, higher growth outturn, and the fiscal adjustment efforts in the context of the EFF program, the public debt and gross financing need to GDP were projected to decline over the medium term. However, the report emphasized debt sustainability risk under macroeconomic shocks, which comes from the higher public debt level and the higher gross financing needs.

74.4 percent in FY27 (Figure 3.13), remaining above the FRDLA threshold of 60 percent of GDP. A significant part of this reduction – 5.5 percentage points of GDP – is expected to occur in FY23, with high inflation reducing the domestic value of liabilities (Figure 3.14).

Table 3.2: Medium-Term Outlook for FY22–FY26 under BAU Scenario

MACROECONOMIC VARIABLES	Currency	Units	FY23	FY24	FY25	FY26	FY27
GDP (Nominal)	PKR	Billions	84,260	95,249	106,584	117,968	128,955
Real GDP	PKR	Billions	39,558	40,837	42,312	43,973	45,780
Real GDP growth rate	%	Annual % change	2.0	3.2	3.6	3.9	4.1
Inflation Average (YoY)	%	Annual % change	23.3	9.50	8.0	6.5	5.0
Revenues	PKR	Billions	9,474	11,327	12,919	14,876	16,588
Primary Expenditures	PKR	Billions	11,856	13,316	14,919	16,526	18,110
Primary Balance-to-GDP (excluding grants)	%	% GDP	-2.8	-2.1	-1.9	-1.4	-1.2

Figure 3.11: Gross Financing Needs under BAU Scenario
(percent of GDP)

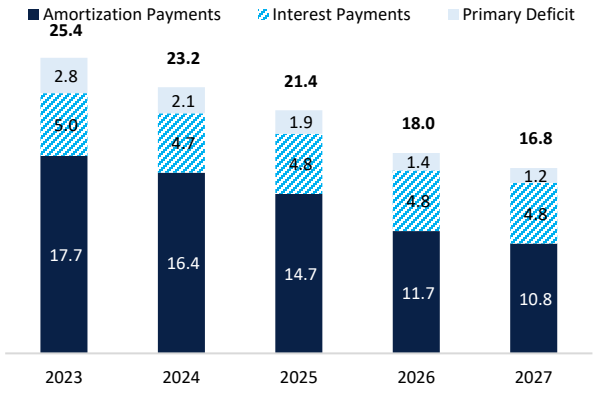
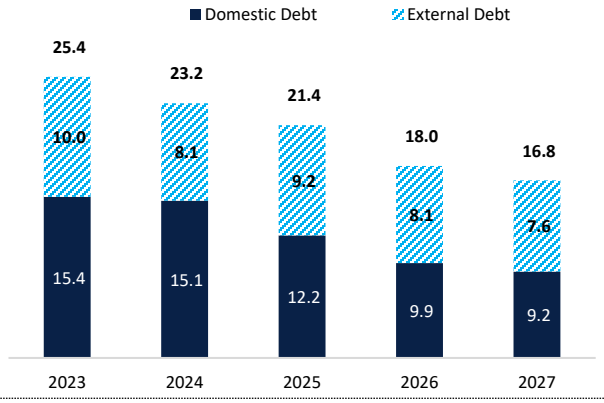


Figure 3.12: Borrowing Plan under BAU Scenario
(percent of GDP)



Source: World Bank Staff calculations

Figure 3.13: PPG debt
(percent of GDP)

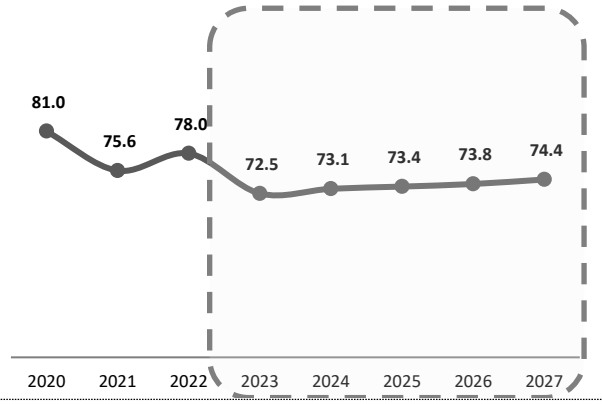
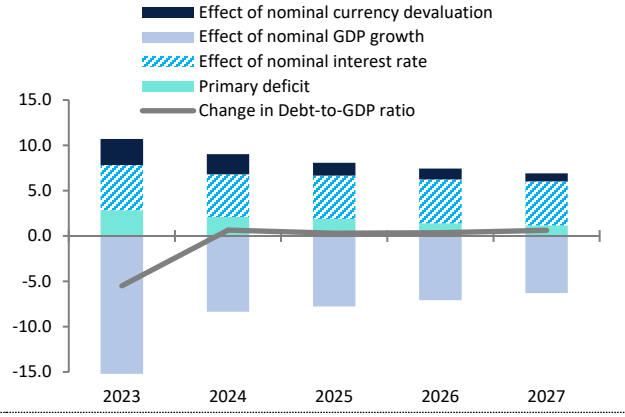


Figure 3.14: Public Debt Dynamics
(percent of GDP)



Source: World Bank Staff calculations.

Figure 3.15: Fan Chart: PPG Debt[23]
(percent of GDP; Percentiles)

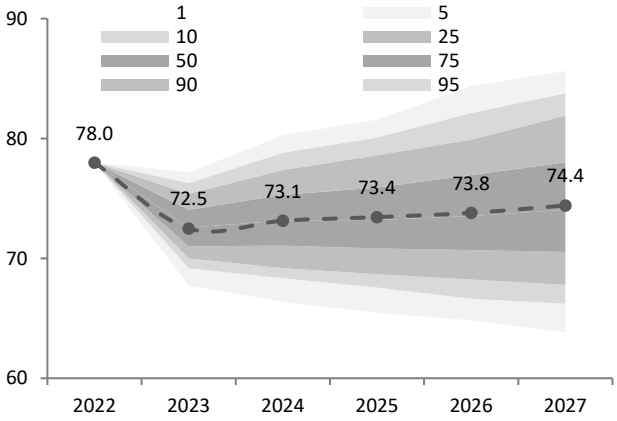
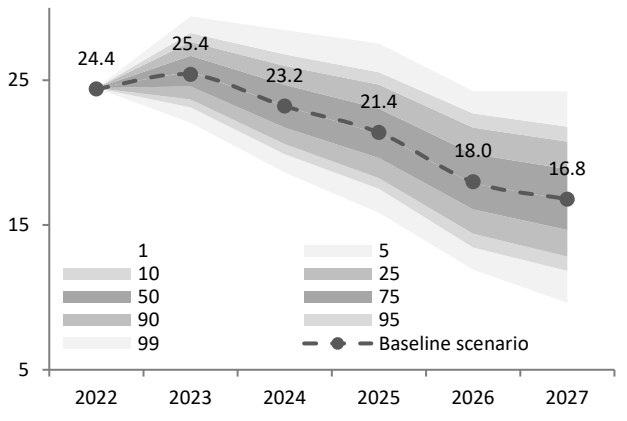


Figure 3.16: Fan Chart: GFNs
(percent of GDP; Percentiles)



Source: World Bank Staff calculations.

PPG debt is projected to remain above the FRDLA limit in the medium-term. Although the projected debt path under the BAU scenario is subject to significant uncertainty, the PPG debt is expected to remain above the FRDLA threshold of 60 percent of GDP with a high degree of confidence. To understand the uncertainty underlying these projections, Figure 3.15 presents a range of possible paths for the PPG debt, constructed by applying shocks to various debt determinants that were calibrated using historical variances.[24] The chart shows that even in the most favorable scenario, PPG debt would remain above 60 percent of GDP. In addition, the simulations also highlight that under adverse circumstances, PPG debt could reach up to 89.3 percent of GDP by FY27 in the BAU scenario (Figure 3.15). However, the probabilistic approach also shows that there is a 20 percent probability of experiencing good events that would push the PPGD below 70 percent of the GDP. In addition, every one of the simulations of the GFNs result in a decreasing path, on which the most extreme one project GFN-to-GDP ratios at the same level as FY22 in the medium-term, 24.2 percent (Figure 3.16). The following alternative scenarios will help to understand the types of shocks that could generate the debt path included in the fan chart.

3.3.2 Sensitivity of the Debt Level to the Fiscal Deficit

This section estimates the sensitivity of the debt trajectory to policy interventions that affect the fiscal deficit. It does so through two types of scenarios: i) a constant primary balance or non-fiscal adjustment scenario, where the primary deficit will be equal to 3.1% from FY23 to FY27 and ii) a fiscal consolidation scenario that calculates the impacts of an ambitious fiscal consolidation path. The ambitious scenario assumes a permanent 4.5 percent of GDP increase in revenue from FY23 to FY27, which would allow Pakistan to run a balanced overall budget by FY27.

[23] The fan chart shows the distribution of possible outcomes. The darkest color corresponds to the high frequency debt levels and lighter ones are those with lower frequency debt levels.

[24] The fan chart presents the possible evolution of the debt-to-GDP ratio. A standard fan chart combines a line chart of historical data for a variable with a possible range of forecasted values and a line showing a most likely outcome for the forecasted value. Historical values from FY11 to FY22 are used to calibrate the persistent shocks on i) real GDP growth, ii) inflation, iii) exchange rate, iv) primary expenditures, and v) revenues; and to compute sample means and the variance-covariance matrix. A total of 2000 shocks for each variable each year are added to the variable expected path producing 2000 projection debt paths. As it is assumed that the distribution of the variables is jointly normal, the alternative paths are centered around the variable's expected path. Then, these paths are sorted by percentile and used to build the fan chart.

Fiscal slippage continues to pose a risk to debt sustainability over the forecast horizon. If the fiscal deficit remains unchanged from FY22 onwards, this implies that the primary deficit over the projection horizon (from FY23 to FY27) will remain constant at the FY22 level, and PPG debt would rise to 80.4 percent of GDP in FY27 as a result of the persistent deficits with higher borrowing requirements (Figure 3.17).

Figure 3.17: PPG Debt
(percent of GDP)

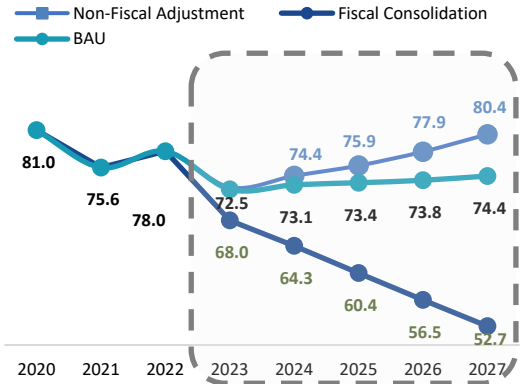
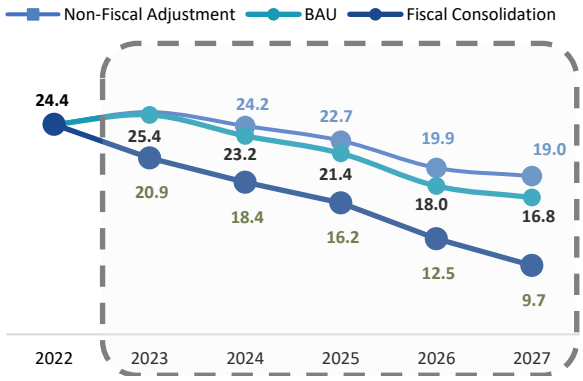


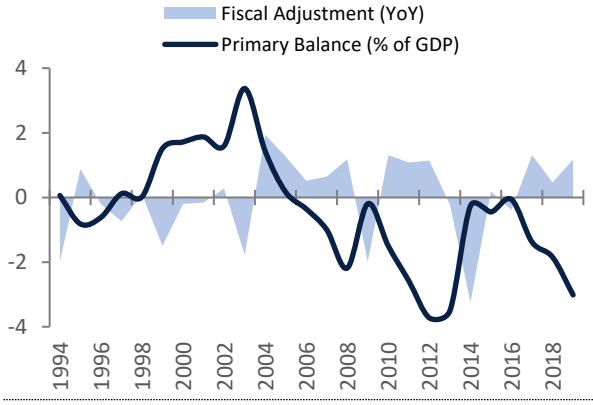
Figure 3.18: GFNs
(percent of GDP)



Source: World Bank Staff calculations.

By contrast, ambitious fiscal consolidation can help Pakistan reduce the deficit to levels that are compliant with the FRDLA. Under the ambitious fiscal consolidation scenario, the PPG debt would fall from 78.0 percent of GDP in FY22 to 52.7 percent in FY27, well below Pakistan's FRDLA limit. This would also reduce the gross borrowing requirements over the medium-term, from 24.5 percent of GDP in FY22 to 9.7 percent in FY27 (Figure 3.18). The policy measures to achieve this are, however, highly ambitious, and were not even achieved between FY13 and FY14, when notable reductions in energy subsidies and tax reforms reduced the primary deficit from 3.5 to 0.2 percent of GDP (Figure 3.21).

Figure 3.19: Primary Fiscal Balance



Source: WEO April 2022 and World Bank Staff calculations.

3.3.3 Sensitivity of the Debt Level to Macro Shocks

This section compares the sensitivity of the debt trajectory to macroeconomic shocks. It considers two shocks. The first shock, the exchange rate shock, considers an increase of 30 percent in the exchange rate level against the USD from FY23 to FY27. The second shock, the interest rate shock, simulates a 300 bps increase in interest rates across the new debt instruments. Since the interest rate increase applies only to new financing, the effective nominal interest rate would only increase from 7.8 percent (on average) in the BAU scenario to 9.5 percent.[25]

[25] The unavailability of granular instrument level data prevents the accurate application of the interest rate increase on the appropriate portion of the existing debt.

Pakistan's PPGD is extremely sensitive to an exchange rate or interest rate shock. Under the exchange rate (FX) depreciation scenario, the PPGD-to-GDP ratio is projected to reach 81.9 percent of GDP in FY27 (Figure 3.20). The depreciation shock affects both external and domestic debt. External debt, when measured in local currency terms, is directly affected by the valuation effect, and increases when depreciation occurs. Domestic debt will increase as a result of higher gross borrowing requirements. Although an exchange rate depreciation would increase debt levels, it would barely impact the GFNs in the short and medium terms. This is because more than 70 percent of external debt is owed to multilateral and bilateral creditors at low interest rates and longer maturities. As a result, interest payment obligations in foreign currency in the short and medium term are unlikely to increase (Figure 3.21).

Figure 3.20: PPG Debt
(Percent of GDP)

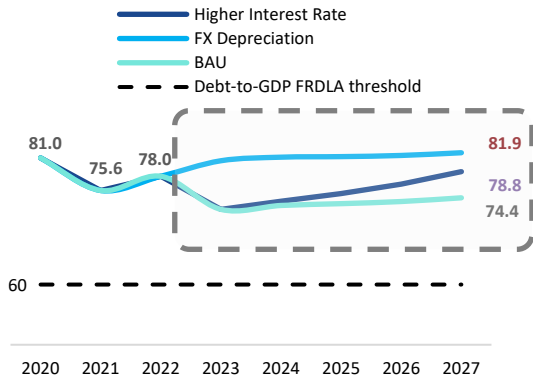
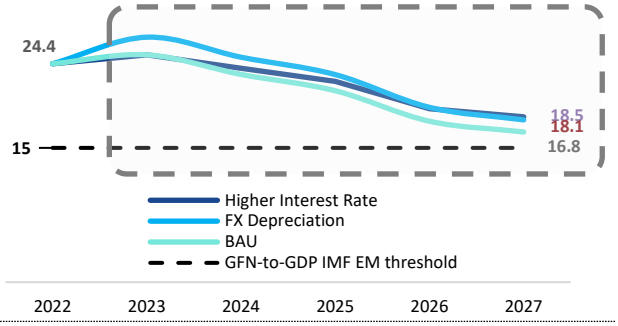


Figure 3.21: GFNs
(Percent of GDP)



Source: World Bank Staff calculations

An interest rate shock would have a more gradual impact on the debt trajectory. The immediate impact of an interest rate increase would be modest, with PPG debt still decreasing from 78.0 percent of GDP in FY22 to 72.5 percent in FY23 as high inflation would keep real interest rates negative even after the shock. Over the medium term, however, PPG debt would increase to 78.8 percent of GDP by FY27, as the slowing inflation assumed in the BAU scenario (Table 3.2) turns interest rates positive (Figure 3.20). Such an interest rate shock would increase GFNs by about 1.7 pp of GDP compared to the BAU scenario by FY27 and would lead to an increase in interest payments up to 6.5 percent of GDP in FY27 (Figure 3.21).

Taken together, these simulations highlight Pakistan's vulnerability to macro shocks and the criticality of fiscal consolidation. This section has shown that Pakistan's debt levels are very vulnerable to exchange rate depreciations and to a failure to contain the fiscal deficit. This implies that reducing the exposure to foreign currency-denominated debt will be key. The simulations also show that there is substantial scope to reduce the debt levels to FRDLA compliance through fiscal consolidation. The final observation is that Pakistan has a brief window of opportunity during the high inflation period to stabilize its economy through interest rate tightening without fundamentally impacting the debt stock, provided that interest rate increases are reversed in the near term. The next section explores alternative medium-term debt management strategies that could reduce the total financing cost and dissipate refinancing risks.

3.4 The Impact of Debt Management Choices on the Debt Trajectory

Recognizing the impact of macro shocks on the debt level, this section explores the role of debt management in determining Pakistan's fiscal trajectories. Debt management is defined as the process

of setting and implementing a strategy to raise the required amount of funding at the lowest cost over the medium and long term. To this end, it focuses on the role of debt management in determining the financing mix between shorter- and longer-term debt, and between domestic and external sources. The section first provides an overview of recent reform initiatives to address challenges in Pakistan's debt management structure before using a fiscal impact model to quantitatively evaluate the impact of different debt management choices on GFNs and PPG debt. The section also covers a counterfactual analysis of the Medium-Term Debt Strategy to simulate various scenarios with potential savings due to lower GFNs.

3.4.1 Performance against the Medium-Term Debt Strategy

In 2019, Pakistan approved a new Medium-Term Debt Strategy (MTDS).[26] The MTDS is guided by the following objectives: i) lengthening the maturity profile of domestic debt; ii) improving the redemption profile to reduce the refinancing risk; iii) encouraging transparency; iv) diversifying instruments and the investor base; v) increasing the issuance of shariah-compliant instruments and Pakistan's presence in international markets; vi) maximizing the available concessional external financing from bilateral and multilateral creditors; vii) facilitating investment by non-residents, and; viii) maintaining adequate cash buffers.

The MTDS was enacted by an amendment to the Fiscal Responsibility and Debt Limitations Act that was enacted in June 2022. The new amendment seeks to strengthen debt management by converting the former Debt Policy and Coordination Office into a full-fledged Debt Management Office (DMO). The DMO will have as its main objective the continued updating and implementation of a medium-term debt management strategy that is aligned with the Medium-Term Budgetary Framework.[27]

The implementation of the MTDS focused on the issuance of various new instruments to further develop the domestic securities market, attract a more diversified investor base, and diversify investment and financing opportunities. Implementation actions included the issuance of 5-Year Sukuk with fixed-rate rental payments in July 2020, whose auction included a re-opening mechanism to increase its liquidity and make it more similar to conventional debt. The authorities also started to issue 3-, 5-, and 10-year floating rate bonds with quarterly coupon payments from October 2020, which was complemented by 2-year floating rate bonds in November 2020. The interest rate on these instruments is reset on a fortnightly basis.

Despite these efforts, changing market conditions have induced a return to short-term borrowing more recently. Global financial uncertainty has led to an increase in short-term borrowing for external debt over the last two years (mainly with bilateral creditors) and domestic debt (increasing the treasury bill financing and reducing medium-term financing). For instance, bids for 10-year floating rate bonds were low and rejected by authorities, leading them to rely predominantly on shorter-maturity issuances.

Performance indicators included in the 2019 MTDS show a mixed picture. The MTDS defined indicative targets for the duration of its validity (FY20–FY23) to assess currency and refinancing risks. According to these, the increase on short-term borrowing for external and domestic financing led to an increase in the

[26] Medium Term Debt Strategy (MTDS) 2019/20 - 2022/23.
https://www.finance.gov.pk/dpco/RiskReportOnDebtManagement_End_June_2019.pdf
[27] The rolling MTFF provides the context under which the federal fiscal targets will be set for the medium-term horizon in with the budget cycle. The MTFF incorporates the country's policy choices and priorities given Pakistan's medium-term growth potential, resources availability, and fiscal sustainability constraint.

refinancing and currency risks in FY22 in comparison to previous years (Table 3.3). By contrast, concentration risks decreased due to the issuance of the Sukuk.

Table 3.3: Indicative Benchmarks

Risk Exposure	Indicators	Indicative Benchmarks	FY20		FY21		FY22	
			Targe	Actual	Target	Actual	Target	Actual
Currency Risk	Share of External Debt in Total Public Debt (% of total)	40% (Max)	-	36	-	34	-	37
Refinancing Risk	ATM of Domestic Debt (Years)	3.5 (Min)	4	4.1	4	3.6	4	3.6
	ATM of External Debt (Years)	6.5 (Min)	7	7	7	6.8	7	6.2
	Gross Financing Needs (% of GDP)	35% (Max)	32	31	30	28	27	26
Concentration risk	Share of Shariah-Compliant Instruments in Government Securities (%)	-	2	2	5	3.9	7.5	8.6
Interest Rate Risk	Share of Fixed Rate Debt in Government Securities (%)	25% (Min)	30	34	30	30	30	26

Source: Debt Policy Coordination Office, Ministry of Finance

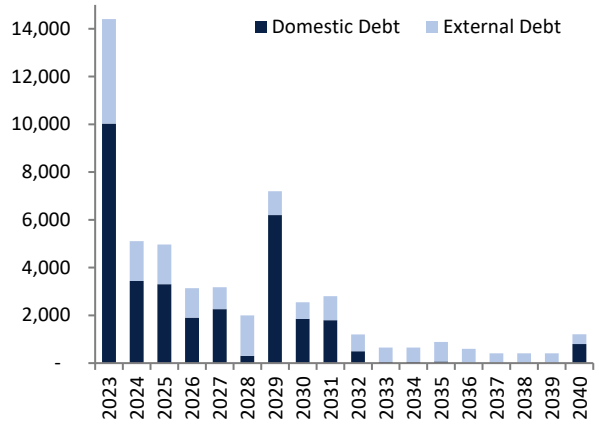
3.4.2 Simulation of different financing strategies on debt levels and GFN

This section presents three alternative financing strategies that have the potential to reduce financing needs, reduce the debt burden and mitigate liquidity risks. These are compared to a BAU scenario. The strategies are the following:

1. **BAU:** The BAU scenario maintains the current financing mix with significant participation of short-term financing in the borrowing plan.
2. **Strategy 1: Long-Term External:** From FY23 to FY27, this scenario simulates the impact of transitioning all short-term external financing to long-term bilateral and multilateral financing.
3. **Strategy 2: Long-Term Domestic:** From FY23 to FY27, this scenario simulates a reduction of short-term domestic financing by replacing the issuance of 1-year bonds assumed under the BAU scenario with 10-year bonds.
4. **Strategy 3: External to Domestic:** From FY23 to FY27, this scenario combines a reduction of the reliance on foreign borrowing with the extension of the domestic financing maturities. On this strategy, 74 percent of GFN would be covered by domestic debt, compared with the 60 percent assumed in BAU scenario. The strategy assumes that external sources would finance external amortization and interest payments — 50 percent of which would be from multilateral organizations, 30 percent from the international markets, and 20 percent from external commercial loans. Domestic debt services plus the primary deficit (which represents more than 70 percent of the total GFNs) would be financed with medium- and long-term domestic bond issuances. The three scenarios preserve the fiscal and macroeconomic assumptions in the BAU scenario.

Under the BAU scenario, the average time to maturity (ATM) is expected to decrease. As of end-June 2022, 30 percent of the amortization payments are due in FY23 (Figure 3.22). The BAU scenario incorporates this and assumes that it would be met primarily through domestic and external short-term financing. This implies that the ATM[28] of domestic and external debt would decrease from 3.6 to 2.2 years and from 6.2 to 6.0 years by FY27, respectively.

Figure 3.22: Maturity Profile of Public Debt under BAU
(PKR billion)



Source: Debt Policy Coordination Office, Ministry of Finance

Long-Term External Strategy: Extending maturities of external debt would substantially reduce refinancing and exchange rate risks. Shifting all external borrowing to longer maturities assumes that bilateral and multilateral lenders would agree to absorb the additional borrowing and thus finance about 30 percent of GFNs. The main fiscal implication of this scenario is that it would reduce short-term external amortization payments and thus annual GFNs, which would decrease from an average of 20.9 percent of GDP from FY23 to FY27 under the BAU scenario to 18.2 percent. It would also reduce rollover risks and extend the average time to maturity of the external debt stock to 7.7 years. At the same time, it would reduce the average time to maturity of domestic debt to 1.8 years by FY27.[29] Although this strategy would reduce the GFNs, it would barely affect the level of PPG debt, which would stabilize at 73 percent of GDP in the projected horizon (0.2 percent less than the BAU scenario).

Long-Term Domestic Strategy: Extending domestic maturities reduces refinancing risks. The absence of domestic short-term amortization payments would reduce the GFNs from 25.4 percent in FY23 to 11.7 percent in FY27. As the net financing needs—GFNs less amortization payments—remain unchanged, the PPGD-to-GDP would continue at the same level as the BAU scenario.[30] Extending the maturity profile of the domestic debt would increase the average time to maturity to 4.9 years in FY27.

Implementing the borrowing mix in the third strategy reduces refinancing needs and increases the average times to maturity for domestic debt. It would reduce the GFNs from an average of 20.9 percent of GDP from FY23 to FY27 to 9.2 percent of GDP in the medium term. As a result of lower interest rates and the lack of short-term amortization payments, GFNs are estimated to be reduced by 7.2 percentage points per year on average (Figure 3.24). However, the PPGD continues to be stable at 74.5 percent of GDP (Figure 3.23). The borrowing mix presented in this strategy remains at the same level as the ATM of the external debt and increases the ATM for the domestic debt to 4.7 years in FY27.

[28] ATM is the average time – weighted by loan size – until the debt instruments mature.
[29] The ATM reduction is generated by a lower proportion financed by medium-term domestic borrowings, given the lower financial needs.
[30] In 2022, the Pakistan government experience an inverted yield curve in the domestic bonds. This implies that bonds with short-term maturities have higher interest rate than longer ones. The simulations assume a partial normalization in the financial conditions in the medium-term. A greater compression in short-term securities is assumed, generating a flat yield curve.

Figure 3.23: PPG Debt
(percent of GDP)

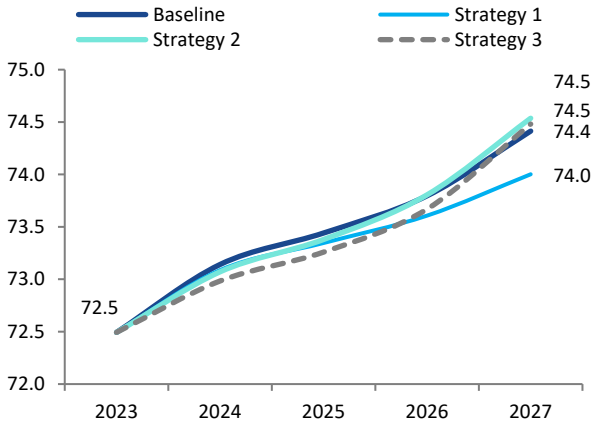
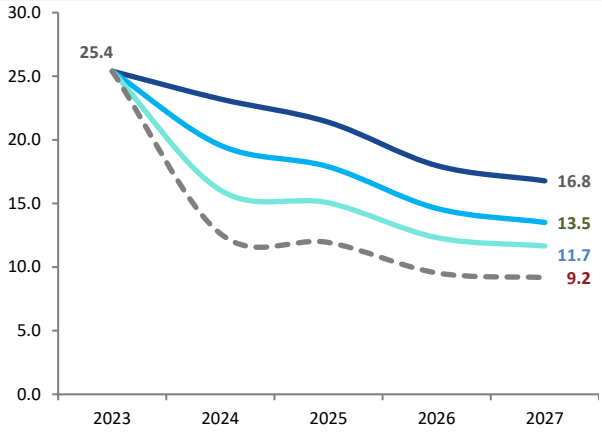


Figure 3.24: GFNs
(percent of GDP)



Source: World Bank staff calculations

Extending domestic maturities results in the lowest debt risk relative to the other strategies.[31] Strategy 2 (Long-Term Domestic) shows the lowest risk when all strategies are tested to the shocks developed in the previous section. Although Strategy 2 has slightly higher ratios of PPGD-to-GDP and GFN-to-GDP than other strategies, the deviation produced by the negative effect of shocks would be lower (measured as a risk in the x-axis). This strategy reduces the exposure to foreign currency, reducing the risk caused by unexpected devaluations, which results in the most extreme shock in terms of public debt levels. Figure 3.25 and Figure 3.26 below illustrate the performance of the four strategies based on two cost-risk indicators and the maturity profile of each strategy.

Figure 3.25: PPG Debt (% of GDP) As at end of 2027

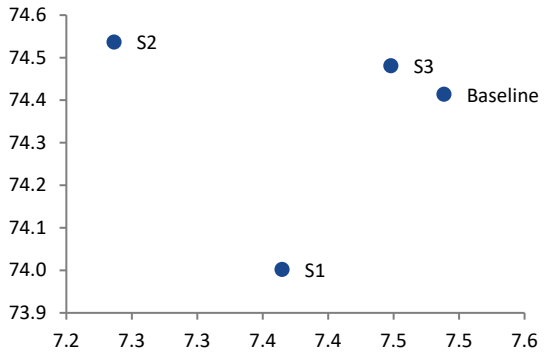
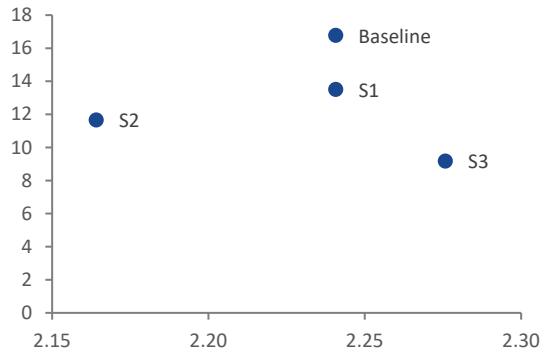


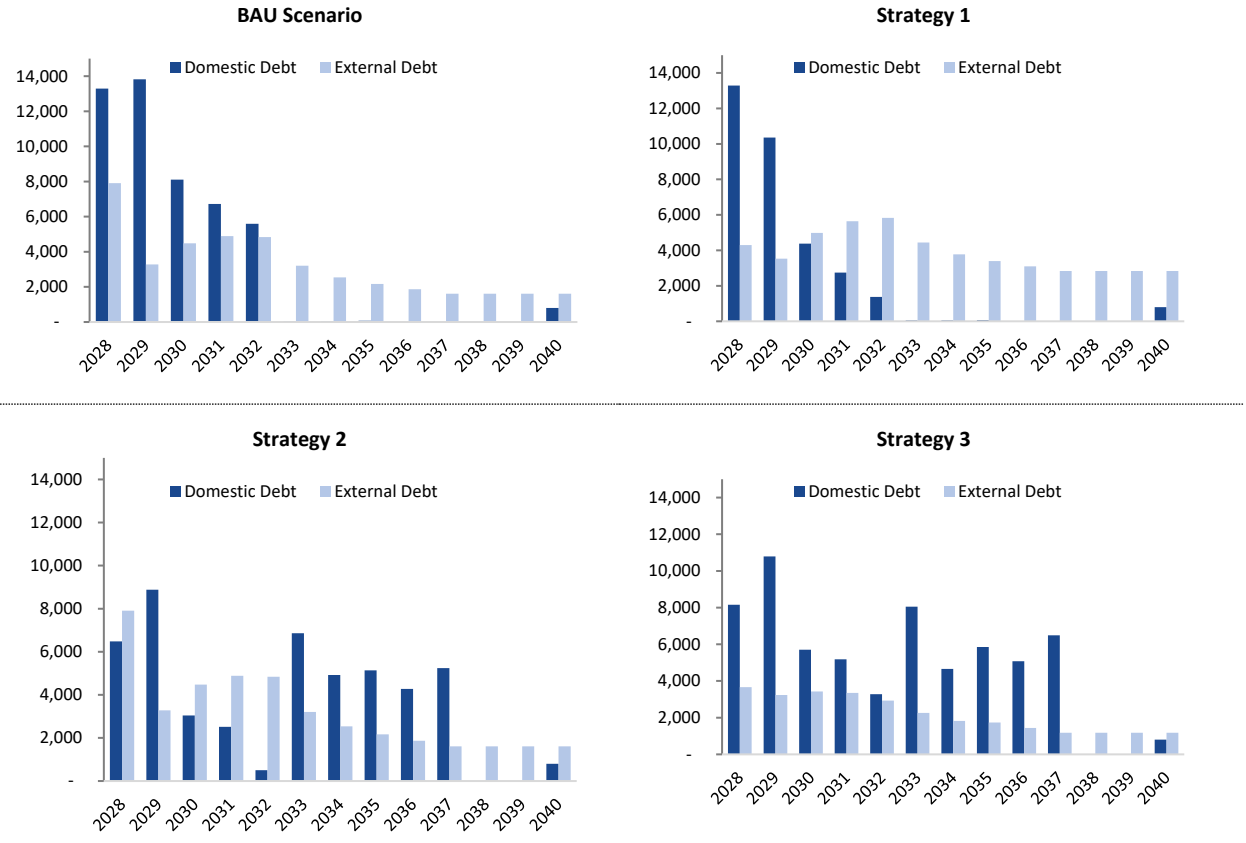
Figure 3.26: GFN (% of GDP) As at end of 2027



Source: World Bank staff calculations. "S" represents each strategy.

[31] Each strategy was tested with the sensitivity scenarios developed in the previous section (constant primary balance, exchange rate depreciation, and interest rate shock). The measure of cost is simply the value of the given performance indicator obtained in the last projected year (FY27) by combining the strategies and the BAU outlook. The measure of risk is the change in the value of the given performance indicator in the fifth year of the projection when it moves from the BAU to the adverse shock.

Figure 3.27: Maturity Profile of Public Debt
(PKR billion)



Source: World Bank staff calculations

Source: World Bank staff calculations

3.4.3 Counterfactual Analysis of the MTDS

A tailored debt management strategy can help in reducing liquidity risks that Pakistan faces over the medium term. Pakistan's liquidity risks emanate from sizeable fiscal deficits and short- to medium-term domestic and external debt maturities as discussed in the earlier part of the analysis. In this context, the following analysis aims to explain the trade-offs between short- and long-term financing and domestic and external financing. To this end, 15 debt management strategies were developed using the historical average of interest rates and a zero primary balance path. These strategies were tested with fiscal and exchange rate shocks (Figure 3.28). The 15 strategies cover a wide range of debt instruments, encompassing short-, medium-, and long-term domestic and external financing instruments and are developed for the medium-term projection horizon from FY23 to FY27 (Table 3.4). The financing mix of these strategies is explained in detail in Annex 3.6.

Table 3.4: Hypothetical Debt Strategies

	Domestic Financing				External Financing			
Strategies	Short-Term	Medium-Term	Long-Term	Mix	Concessional Loans	BAU Disbursement	Short-Term	Medium-Term
1	✓							
2		✓						
3			✓					
4				✓				
5	✓				✓			
6		✓			✓			
7			✓		✓			
8				✓	✓			
9	✓					✓		
10		✓				✓		
11			✓			✓		
12				✓		✓		
13							✓	
14								✓
15					✓			

Fiscal consolidation remains critical for debt sustainability. As it is discussed in the previous section, a higher primary deficit will increase the level of public debt, increasing the solvency and liquidity risks. In addition, strategies with higher shares of external debt present a higher risk of external shocks. Even though the increase in short-term external financing was necessary to finance the recent high levels of public sector financing needs and the current account deficit, reducing reliance on short-term external financing is essential to diminish public debt vulnerabilities.

Under any fiscal path depicted by the primary balance, strategies with a longer-term domestic and external financing mix yield lower refinancing risks. Domestic and external strategies with short-term financing (Strategies 1, 5, 9) show higher refinancing risk due to higher GFN-to-GDP ratios. Conversely, strategies with medium-term (Strategies 2, 6, 10) and longer-term (Strategies 3, 7, 11) financing all show lower refinancing risks as measured by lower GFN-to-GDP ratios.[32] This is a critical result that underpins the urgent need for development of domestic debt capital market, which can help in extending the maturity profile of the PPGD as well as lower the risk of exchange rate shocks.

The development of the domestic debt capital market is critical for the implementation of a tailored debt strategy that can lower the macroeconomic risks posed to Pakistan's PPGD stock. A deep and well-functioning domestic debt market can provide an avenue for Pakistan to mobilize long-term domestic financing and lower its reliance on short-term external and domestic financing. It can also help in reducing overreliance on the domestic banking sector for meeting financing needs. The development of the domestic debt capital market is one of the critical objectives of the current MTDS also. However, the absence of an empowered and properly staffed integrated debt office remains a bottleneck in the implementation of this objective.[33] In addition, liquidity in the primary and secondary debt markets

[32] Strategies with medium- and long-term financing would result in similar levels of costs (PPGD-to-GDP) and risks (GFN-to-GDP ratios). Given the projection horizon of the analysis is only up to FY27, both types of strategies have no maturities during the analyzed period (from FY23 to FY27). A long-term analysis would modify these results, increasing the refinancing risks on the medium-term strategies.

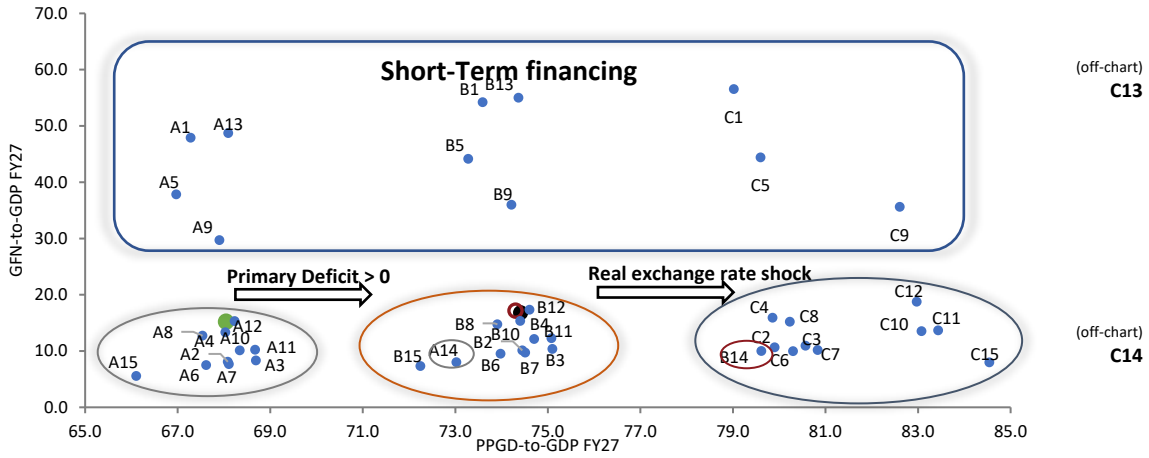
[33] Fragmentation in debt management function is discussed in detail in section 3.5.

intertwined with an investor base and appropriate regulatory and legal framework is crucial for the development of both the primary- and secondary-market government debt securities in Pakistan.

Maximizing the long-term external concessional financing is crucial for reducing refinancing risk and the cost of borrowing. The domestic debt strategies result in similar PPGD-to-GDP and GFN-to-GDP ratios at end-2027 due to marginal interest rate differential in short-term and long-term interest rates.[34] While medium-term external financing (Strategy 14) would produce a higher PPGD-to-GDP ratio due to higher interest rates, the strategy focused on concessional long-term external financing (Strategy 15) would produce the lowest PPGD-to-GDP due to the long maturities and the low-interest rates (Figure 3.28). Therefore, maximizing long-term external concessional financing is crucial to reduce the refinancing risk and the cost of borrowing.

The analysis in this section underpins that while fiscal consolidation remains critical in lowering debt sustainability risks, tailored debt management can help in lowering macroeconomic risks. Given a fiscal and exchange rate path, the short-term financing strategies show higher risks in terms of GFNs compared with medium- and long-term strategies. In addition, running a higher deficit would increase the cost of the public debt, measured as the PPGD-to-GDP ratio, in all the strategies. Strategies with a higher share of external borrowings show higher PPGD-to-GDP ratios compared to those where domestic funding largely predominates. Figure 3.28

Figure 3.28: PPG Debt and GFN
(percent of GDP)



Source: World Bank staff calculations. Each strategy is calculated with three scenarios. The "A" scenarios include the strategies with zero primary deficit from FY24 to FY27. The "B" scenarios include a primary deficit of 1.6 percent of GDP from FY24 to FY27 (historical average from FY14 to FY22). The "C" scenarios include the historical primary deficit plus a real exchange rate shock of 30 percent. The dark dot (located behind the red dot) is the BAU scenario developed in the previous section. The green dot is the BAU scenario with zero primary balance. The red dot is the BAU scenario with the historical primary balance.

[34] The primary debt issuance yields for Pakistan Investment Bonds from FY14 to FY22 were 9.2% for the 1-year maturity, 9.8% for the 5-year, and 10.3% for the 10-year PIBs.

3.5 Institutional Factors affecting Debt Management

The lack of an integrated debt management function undermines sound debt management in Pakistan, leading to suboptimal borrowing choices. This section outlines these fragmentations and the recent reforms that were undertaken to address them. Lastly, this section covers the institutional gaps identified by the recently conducted Debt Management Performance Assessment (DeMPA) assessment.

3.5.1 Fragmentation in Public Debt Management and Recent Reforms

Until recently, debt management responsibilities were extremely fragmented and complex in Pakistan. This has resulted in insufficient coordination among the various institutions involved, suboptimal borrowing choices, duplication of competencies, and a disconnect between debt management strategy design and implementation. Further, while information on debt was publicly available in several documents, debt information was scattered, making it extremely challenging for a comprehensive overview of the public debt portfolio and any adjustments needed.

Figure 3.29 reflects the fragmentation of debt management functions in Pakistan. Through several debt management reforms, including those supported by the Resilient Institutions for Sustainable Economy (RISE) World Bank Development Policy Operations (DPOs), the authorities have taken important steps towards centralizing decision-making, establishing a Debt Management Office (DMO), initiating a semi-annual debt bulletin, publishing a debt management strategy, and limiting State Owned Enterprise (SOE) guarantees to those enterprises that have published audited financial accounts.

Figure 3.29: Debt Management Responsibilities, by Function

Front Office functions	Middle office functions	Back office functions
• Economic Affairs Division (EAD)-for bilateral and multilateral projects • External Finance (EF) Wing, Ministry of Finance (MoF)-for budget support and commercial external borrowing • Budget Wing (BW), Ministry of Finance, Debt Policy and Coordination Office (DPCO) for wholesale domestic debt • Budget Wing (BW) through Central Directorate of National Savings (CDNS) for retail domestic debt	• DPCO for strategy design and reporting • EAD for reporting on disbursement information	• EAD for external debt recording in Debt Management and Financial Analysis System (DMFAS) • State Bank of Pakistan (SBP) – for wholesale domestic debt recording in in-house systems. • CDNS-for retail domestic recording partially electronic

Source: Technical Assistance on Institutional Framework and Debt Reporting, 2020 report prepared jointly by the World Bank and IMF

Over the last few years, Pakistan has embarked on debt management reforms that seek to reduce the fragmentation of decision-making, improve the institutional setup, and enhance debt reporting. To address institutional fragmentation, the Government is in the process of transforming the DPCO into a fully integrated Debt Management Office (DMO) under the World Bank's RISE DPO series. The DMO will be responsible for devising and implementing all aspects of domestic and external debt management and issuance of guarantees. The DMO will have integrated decision-making responsibility and enforcement authority for domestic wholesale and retail market issuance (from Budget Wing of Finance Division), external borrowings from the market, and bilateral and multilateral institutions (from the External Finance Wing of Finance Division), and project loan terms for bilateral and multilateral project loans (from the Economic Affairs Division), and the mandate to issue guarantees. To provide an overarching objective, the Federal Finance Division has made amendments to the Fiscal Responsibility and Debt Limitation Act (FRDLA), which will be followed by the issuance of detailed rules for the DMO. The DMO will be publishing

an updated Medium-Term Debt Management Strategy (MTDS), which will be linked with the updated macro-fiscal outlook, and to strengthen transparency, it has begun the publication of semi-annual debt bulletins that includes comprehensive and consolidated debt data in a user-friendly format. In addition to debt stock and flow indicators that are already being published in the debt bulletin, it includes the breakdown of government debt between the federal and the subnational levels, guaranteed debt, collateralized debt, and domestic debt securities by tenors and creditors.

3.5.2 The Debt Management Performance Assessment (DeMPA)

The World Bank over February-March 2022 conducted the Debt Management Performance Assessment (DeMPA) in Pakistan. The DeMPA is a comprehensive methodology developed by the World Bank to evaluate the entire spectrum of debt management and related activities, broken down into five broad areas and 35 debt policy indicators (DPI). Each indicator is evaluated according to a scoring methodology that is consistently applied across countries and the outcome is a report aiming at not only evaluating debt management practices at a specific point in time but also its evolution over the years via comparison with past scores.[35] This section discusses key gaps in debt management identified by the DeMPA and possible ways forward to address these gaps.

The latest assessment reveals significant improvement compared to the 2010 assessment. Areas that saw an improvement in performance comprise the managerial structure for central government borrowing and debt-related transactions and debt reporting in terms of content and timeliness and reporting to the legislature. The audit frequency for financial and compliance audits improved, as did coordination with monetary policy given the limits introduced on government borrowing from the central bank. Notable improvement is recognized in domestic borrowing related to the publication of a borrowing calendar for wholesale securities and the publication of issuance results. The use of legal advisors in external borrowing now meets minimum requirements. Finally, the registry system covers wholesale and retail domestic debt as the Central Directorate of National Savings (CDNS) has completed digitization of retail debt.

However, there are the longstanding challenges that mask improvements in some critical areas. Core areas that continue to fall short of meeting the benchmark include preparation and publication of debt sustainability analysis; insufficient information sharing between the State Bank of Pakistan (central bank), the Budget Wing of the Finance Division, and the DMO on current and future debt transactions and central government cash flows; lack of effective cash forecasting; and the unavailability of business continuity and disaster recovery plans across the entities that register debt records. The adoption of the Treasury Single Account (TSA) can improve the effectiveness the Government's cash management practices. The TSA is ready for implementation and its rollout can be rapid. It will enable proper monitoring and accounting of the Government's available cash balances and reduce public borrowing needs. In June 2022, total federal government deposits at commercial banks amounted to PKR2,020 billion, which could reap interest cost savings of up to PKR 404 billion annually.[36]

[35] A score *D* indicates that the minimum requirements have not been met and signals a performance deficiency requiring priority corrective action. A *C* score indicates that the minimum requirements are met, although there is plenty of room for further improvements. A score *B* goes beyond minimum requirements, but does not indicate yet sound practices, which are achieved only with a score *A*. A complete description of the methodology can be found on https://www.worldbank.org/en/programs/debt-toolkit/dempa

[36] This assumes that new government borrowings incur interest rates that are equivalent to the policy rate, currently at 20 percent at the time of writing.

The assessment highlights important risks in areas of the DMO staffing and debt management information systems. The degree of commitment to address audit outcomes regressed compared to the previous DeMPA. The severe understaffing of the DMO, which presents a key operational risk, is highlighted in a newly introduced indicator on staffing and HR issues related to the key debt management entity. The lack of a centralized Debt Management Information System (DMIS) underscores how debt management operations are being recorded and managed by four institutions in three different systems (and an Excel database) that are not linked electronically. Reporting and cost–risk analyses thus require manual consolidation by the DMO. This is inefficient and significantly increases the risk of human error.

The assessment provides insights on key areas to prioritize in the next phase of debt management reforms. For example, the adoption of the Fiscal Responsibility and Debt Limitation Act (FRDLA) 2021 amendment and additional legal provisions for debt management to include borrowing purposes, the definition of debt instruments, and debt management objectives in the DMO rules would strengthen the legal framework. The DMO rules would also support the hiring of staff to strengthen DMO capacity. The centralization of debt information into one debt management information system is crucial to reduce operational risks. Building the capacity to develop and publish debt sustainability analyses and fiscal risk statements is needed, particularly given the risks of contingent liabilities in Pakistan. Retaining dedicated legal counsel with expertise in contracts and financial transactions is also recommended for debt management as Pakistan increases its borrowings from the international capital market. Debt reporting can be further enhanced. To this end, enhancing investor relations functions should be an important part of Pakistan's communication strategy.

3.6 The Sources and Impacts of Contingent Liabilities

This section explores contingent liabilities as a driver of PPG debt in Pakistan and a significant fiscal sustainability risk due to inadequate coverage, recording, evaluation, disclosure, and appropriate accounting treatment. Over the years, the Federal Government has absorbed considerable additional expenditures defined as "excess expenditures" in the Federal Public Financial Management (PFM) Law, which has directly driven larger-than-budgeted fiscal deficits.[37]A part of these excess expenditures is due to the contingent liabilities that were not appropriately budgeted. The public debt management and fiscal risk analysis in Pakistan focuses on the issuance, recording, and evaluation of guaranteed debt that mainly comprises sovereign guarantees issued to SOEs. The analysis in this section highlights that a realist assessment of contingent liability predicts a much larger fiscal risk than currently recorded and reported. Therefore, there is an urgent need to review and update the legal framework and methodology to record, report, evaluate, and budget contingent liabilities in Pakistan.

3.6.1 Coverage, Reporting, and Key Drivers of Contingent Liabilities

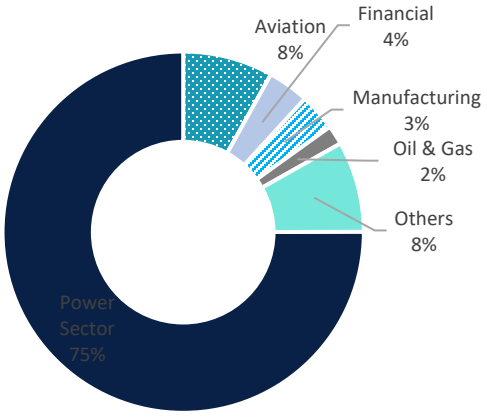
Currently, the Finance Division only considers guarantees issued to SOEs as contingent liabilities. In the FRDLA 2022, guarantees are defined as follows: *"guarantee" means a contingent financial liability undertaken by the Government to pay the financial liability of a third party in the event when the third-party defaults on that financial liability.* The DMO publishes the Statement on Contingent Liabilities, although coverage is limited to guarantees**.**[38] The report aims to demonstrate compliance with the FRDLA that establishes an annual ceiling of 2 percent of GDP on new government guarantees and 10 percent of

[37] Pakistan Public Expenditure and Financial Accountability (PEFA) Assessment 2019
[38] https://www.finance.gov.pk/budget/Statement_of_Contingent_Liabilities_Sep_2021.pdf and State-Owned Enterprises Triage: Reforms and Way Forward https://www.finance.gov.pk/publications/SOEs_Triage_03032021.pdf.

GDP on stock of guaranteed debt. The report also presents the outstanding guaranteed amounts and breakdown by sector, beneficiary, type of interest rate and currency. However, coverage is incomplete as government guarantees related to commodities, such as corn and rice, are not included and pose fiscal risks.

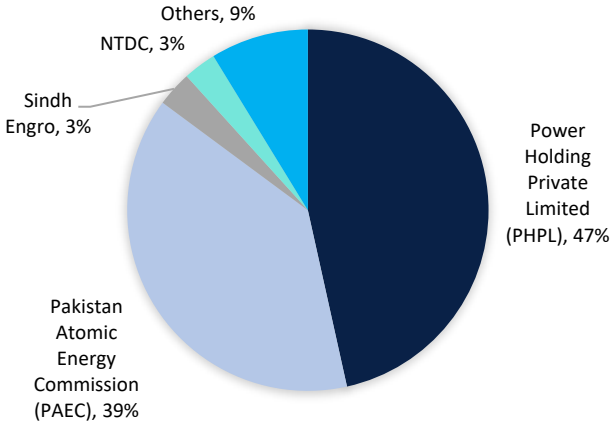
Additional information on sovereign guarantees is reported to Parliament as part of the Annual Budget Statement, in a dedicated section on contingent liabilities. It notably includes outstanding and new guarantees issued over the reported period, and outstanding stocks of guarantees issued against commodities operations undertaken by SOEs and subnational governments. In addition, budget documents provide detailed figures of the current year's pension liabilities. However, the Finance Division does not account for implicit contingent liabilities and other fiscal risks including potential bailout packages, expected change in policies, and legal cases against the Government.

Figure 3.30: Outstanding Guarantees to SOEs (excl. commodity operations) – end-June 2022
(percent of GDP)



Source: Public Debt Bulletin FY2022, Debt policy coordination office, Ministry of Finance

Figure 3.31: Distribution of Power Sector Guarantees, by SOE, FY 2021
(percent share)



Source: Public Debt Bulletin (July–December 2021), Debt policy coordination office, Ministry of Finance

Therefore, under the current reporting framework, guarantees issued to SOEs are a sole source of contingent liabilities to the Federal Government. The outstanding stock of guarantees issued to SOEs has nearly doubled over the last decade, reaching over 4.5 percent of GDP by FY22.[39] These guarantees are a form of quasi-fiscal or off-budget government support. The Government issues guarantee on behalf of SOEs to improve the viability of projects or activities undertaken with significant social and economic benefits. Any creditor against the guarantee to the entity has full recourse to the Government. Most of the guarantees are issued to SOEs in the power or transport sectors, such as the Electricity Distribution Companies (DISCOs) and Pakistan International Airlines Corporation Limited (PIACL), which collectively account for 92 percent of the total outstanding guarantees (Figure 3.30). Power sector guarantees make up two third of the total SOE guarantees issued in FY22—3.4 percent of GDP (Figure 3.31)**.** The Power Holding Private Limited (PHPL) accounts for 47 percent of power sector guarantees (1.7 percent of GDP).[40] In addition, almost two thirds of SOE guarantees are issued for floating rating loans that expose

[39] This guaranteed amount excludes guarantees issued to Trading Corporation of Pakistan (TCP) and Pakistan Agriculture Storage and Services Corporation (PASSCO) due to their nature of operations. These SOEs are discussed in later paragraphs.
[40] Federal Footprint: State-Owned Enterprises Annual Report FY2019

the guaranteed portfolio to sizeable market risk exposure due to the prevailing domestic and international interest rate environment (Table 3.5).

Table 3.5: Stock of Government Guarantees (Sector-wise and Interest rate type)

	FY2020		FY2021		FY2022	
	PKR billion	USD billion	PKR billion	USD billion	PKR billion	USD billion
Power Sector	1,961	11.7	1,999	12.7	2,238	10.9
Aviation	204	1.2	210	1.3	241	1.2
Financial	66	0.4	66	0.4	110	0.5
Manufacturing	45	0.3	45	0.3	99	0.5
Oil & Gas	60	0.4	50	0.3	52	0.3
Others	8	0.1	37	0.2	243	1.2
Total Stock	**2,344**	**14.1**	**2,407**	**15.2**	**2,983**	**14.6**
Floating Rate	1,724	10.3	1,649	10.5	1,628	7.9
Fixed Rate	620	3.7	757	4.8	1,355	6.7
Total Stock	**2,344**	**14.0**	**2,406**	**15.3**	**2,983**	**14.6**

Source: Public Debt Bulletin & Annual Debt Review (2021-22), Ministry of Finance

3.6.2 Analyzing Fiscal Risk of Contingent Liabilities and Way Forward

The coverage of contingent liabilities is broadened in this section to provide a more precise assessment of the fiscal risks of contingent liabilities and their implications for PPGD. The Federal Government's contingent liabilities can be categorized according to those emanating from a) guarantees; b) public–private partnerships (PPP) liabilities; c) commodity financing guarantees issued by the Federal Government; and d) natural disasters. In addition to these items, federal pensions and provincial governments' contingent liabilities can also fall on the federal balance sheet. However, this section focuses on the federal portfolio, and federal pensions are not categorized as contingent liability. For convenience, contingent liabilities are aggregated in two broad buckets for this analysis; i) explicit obligations, which cover guarantees to SOEs and PPPs and SOE losses, and ii) implicit obligations that cover remaining liabilities.

Implicit liabilities are large and almost one-and-half times larger than the explicit liabilities, and they pose a significant fiscal risk. In total, Pakistan's contingent liabilities are estimated at 11.6 percent of GDP at the end of FY2022 (Table 3.6). While the explicit liabilities are largely accounted for and disclosed by the Federal Government, the stock of implicit liabilities, which stands at almost one-and-half times larger than explicit liabilities, is largely unbudgeted and not appropriately disclosed. The FD does not carry out a periodical fiscal risk assessment for contingent liabilities, and there is a lack of transparency on capturing the full extent of these contingent liabilities in the official documents. Some of these liabilities materialize over the years, resulting in annual fiscal outflows. This analysis uses the framework of the fiscal risk matrix to categorize and analyze the different types of explicit and implicit contingent liabilities.[41]

[41] Debt and Fiscal Risk toolkit, The World Bank

Table 3.6: Fiscal Risk Matrix FY2022

(Percent of GDP)

Obligation type	Contingent Liability	Potential Impact FY2022*		
		Percent of GDP*	PKR billion	USD billion
Explicit Obligation	Guarantees – SOEs (Power sector)	3.3	2,238	10.9
	Guarantees – SOEs (Aviation, Financial and other sectors)	1.1	745	3.6
	Federal Public–Private Partnership (PPP) Projects – guarantee against Viability Gap Fund (VGF) payments	0.1	67	0.3
	Pakistan Railways losses	0.1	47	0.2
	Total Explicit Obligations	**4.6**	**3,097**	**15.1**
Implicit Obligation	Guarantees – SOEs and Provinces against commodity financing operations	1.7	1,134	5.5
	Power sector circular debt (non-guaranteed)	2.2	1,500	7.3
	Gas sector circular debt (non-guaranteed)	1.1	720	3.5
	WAPDA Green Eurobond	0.2	110	0.5
	Government to Government (G2G) Guaranteed loan under CPEC – given to National Highway Authority (NHA)***	1.3	859	4.2
	Natural disasters (historical estimate range is 0.5 to 0.8 percent of GDP)^	0.5	335	1.6
	Total Implicit Obligations	**7.0**	**4,658**	**22.8**
Grand Total		**11.6**	**7,755**	**37.9**

***FY2022 GDP at MVA, Pakistan Bureau of Statistics**
****Exchange rate Mark to market revaluation exchange rates. State Bank of Pakistan (SBP)**
***** USD 4.2 billion of CPEC realized Highway Projects**
^ the estimate of natural disasters is based on the historical minimum estimate of 0.5 percent of GDP
CPEC = China–Pakistan Economic Corridor
Source: Economic Survey of Pakistan 2021–22, Ministry of Finance; Federal Public Sector Development Program (PSDP) FY2021–22, Ministry of Planning, Development and Special Initiatives; Budget, in brief, Ministry of Finance; State Bank of Pakistan; Case Study on China–Pakistan Economic Corridor (CPEC), Asian Development Bank; Fiscal Disaster Risk Assessment Options for Consideration, Pakistan, The World Bank; author estimate.

Contingent liabilities are a significant fiscal risk and there is a need to curtail these liabilities by active management. The FRLDA 2022 partly addresses this risk by imposing a limit on the issuance of new government guarantees, including rollovers of existing guarantees, to 2 percent of GDP per annum and 10 percent of GDP limit on guarantees stock. The federal authorities have always complied with this fiscal rule to date. The FRDLA's definition of government guarantees is comprehensive. A major objective of the fiscal rule on guarantees is to constrain the financial obligations of the Federal Government that arise when there are call-ups of federal guarantees on debt. Call-ups of guarantees are not recorded on the Federal Government's budgetary accounts until they occur. One-off guarantees on a debt instrument, such as a federal government guarantee on SOE's debt, are *off*-balance sheet items, whereas some guarantees are *on* balance sheet.[42] However, since the federal government accounting system is largely cash-based (Javed and Zhuquan, 2018), there is no published government balance sheet.[43]

However, the PPG debt rule in the FRDLA only applies to the General Government (GG) and does not cover the guarantees or liabilities. In an ideal scenario, the institutional coverage of public debt should

[42] Other guarantees, notably those in the form of financial derivatives and provisions for calls under standardized guarantee schemes are liabilities recorded *on* the balance sheet (see Figure 7.2, IMF, 2014).
[43] Governments whose accounting system is accruals based necessarily prepare a balance sheet of assets and liabilities. Accrual accounting, an important topic, is outside the scope of this report.

be the same as that of the fiscal deficit.[44] However, the cash-based accounting system and inadequate recording of provincial expenditures, notably commodity financing, implies that government guarantees are not included in the public debt in Pakistan. Therefore, the FRDLA 2022 debt stock ceiling of 60 percent of GDP also excludes guarantees. The FRDLA 2022 imposes a flow limit of 2 percent of GDP on issuance of new guarantees and 10 percent of GDP on stock of guarantees. However, these additional limits are high in the context of prudent debt management and sustainability. As a first best, there is a need to converge to the standard application of the Government Finance Statistics (GFS), which is a long-term solution given the institutional fragmentation in Pakistan. In the short term, Pakistan can amend the FRDLA to change the GG (net) debt concept to include the stock of guaranteed debt or lower the limit on the issuance of new guarantees to zero. This can partly help in mitigating the solvency risk posed to Pakistan.

There is no regular report disclosing financial indicators and fiscal risks arising from SOEs. The FD published an SOE overview in March 2021, in the context of the IMF Extended Fund Facility (2019–2022).[45] The report acknowledges that some SOEs are structurally loss-makers and underscores the need to implement a privatization program. However, the report has limited coverage, and it does not present financial ratios or debt indicators.[46] While the Federal Government publishes a Fiscal Risk Statement (FRS), it is not comprehensive. The FRS contains information on guarantees and some fragmented information on SOEs. However, there is no assessment of other sources of fiscal risks such as Public–Private Partnerships, subnational governments, judiciary decisions, and off-balance sheet settlements.

3.7 Conclusions and Policy Recommendations

Pakistan's Public and Publicly Guaranteed Debt (PPGD) stock is high and still growing, requiring significant policy and institutional adjustments to lower the risks. The PPGD is already in breach of the FDRLA limit, which imposes high fiscal costs and exposes the country to debt vulnerabilities. The debt dynamics projections show that the PPG debt-to-GDP ratio is expected to remain above the FDRLA limits in all the scenarios. Vulnerabilities and risks associated with Pakistan's public debt are further accentuated by the fragmentation in Pakistan's public debt management and fiscal risks posed by a sizeable stock of contingent liabilities. Although fiscal consolidation remains a prerequisite to reducing public debt accumulation in Pakistan, the analysis in this chapter provides important policy recommendations focusing on debt management that can help in better managing the public debt portfolio and lower financing risks and costs. The policy recommendations of this chapter anchor around i) better debt management and deepening domestic capital markets, and ii) better contingent liability management

1. **Pakistan's high public debt levels warrant significant reforms in the public debt management domain and the development of domestic capital markets.** There is an urgent need to empower the recently established DMO so that it can design a tailored medium-term debt strategy linked to Pakistan's macro-fiscal realities and provide technical oversight on sovereign guarantees. The current fragmentation in debt management function has also led to limited consolidation of debt data that citizens, investors, and creditors can access and on which policymakers can base their decisions. The analysis in this chapter highlights that Pakistan can lower its liquidity and solvency risks by pursuing a strategy to both increasing the share of domestic debt and lengthening its maturity profile. This

[44] This ideal is met in the EU's fiscal rules: both the gross debt and the consolidated fiscal balance are at the level of "General Government" (as defined in GFS-equivalent).
[45] State Owned Enterprises (SOEs) Triage: Reforms and Way forward, March 2021, Ministry of Finance.
[46] Listed SOEs do publish financial indicators, but they represent around 20 percent of total SOEs and there is no consolidation process within the MoF.

strategy cannot be implemented in the absence of a well-developed capital market which is essential to extend the tenors of domestic debt issuances in Pakistan.

In this context, debt management reforms can be prioritized on the following timeline;

- **Short Term:** The FD should immediately notify the rules of the newly established DMO and complete the recruitment process to empower the debt office. The DMO rules should cover borrowing purposes, the definition of borrowing instruments, and debt management objectives.
- **Short Term**: The DMO should continue with the publication of the MTDS, which is to be updated on a rolling basis and linked with the national macro-fiscal framework. For the continued improvement of debt transparency, the DMO should also continue publishing semi-annual debt bulletins. The bulletin should include guaranteed debt, for its proper tracking and monitoring. Continued publication of the debt bulletin will help establish it as the primary and comprehensive source for all debt information. This will also increase debt transparency and build accountability for debt-related outcomes. Retaining dedicated legal counsel with expertise in contracts and financial transactions is recommended for debt management as Pakistan increases its borrowings in capital markets.
- **Short Term:** Publish the annual borrowing plan at the beginning of the fiscal year, consistent with the MTDS and its fulfillment during the fiscal year semi-annually. The publication of financing needs and sources, objectives, and targets for the fiscal year enhances transparency and predictability and improves the Government's reputation. In addition, publishing the public debt flows of amortization and interest payments of the existing debt contributes to the same objective. Debt reporting can be further enhanced by strengthening investor relations functions and making it an important part of the DMO's communication strategy. The investor relations function can help in supplying information on debt and debt management to external users – International Financial Institutions (IFIs), credit rating agencies, Parliament, and the public.
- **Short Term**: There is an urgent need to establish cash forecasting capability and monitoring of performance in the Budget Wing of the Finance Division. The TSA can be immediately implemented and can improve cash management and render fiscal savings of up to PKR 404 billion (0.6 percent of FY22 GDP) annually. The cash forecast should be communicated in a timely manner to the DMO to optimize borrowing decisions and avoid over-borrowing. The Government does not earn a market-based return on its cash holdings at the SBP and necessary legal amendments should be made to revisit this arrangement.

- **Medium Term:** Implement debt management training policies that allow constant monitoring of the costs and risks of the debt strategy. Debt management analysis requires quantifying risks and modeling stress scenarios based on potential economic and financial shocks. Therefore, solid human resources and a sound debt recording system are essential.
- **Medium Term**: Currently debt management operations are recorded and managed by four institutions in three different systems (and an Excel database) that are not linked electronically. Therefore, the debt data is not recorded in a single DMIS to adequately plan and manage the debt operations of the DMO. The debt recording systems are not linked with each other. There is an urgent need for the installation of a DMIS at the DMO that links all debt databases.
- **Medium Term:** The maturity profile of the external PPGD can be extended by replacing short-term external debt for medium- and long-term sources. This can be partly achieved through the maximization of the sources of concessional financing. However, this recommendation is heavily

intertwined with fiscal consolidation and the development of domestic capital markets discussed below.

- **Medium Term:** The FD should send clear signals of fiscal consolidation to improve external bond yields and recover the capacity to borrow in the international markets at better conditions. Fiscal consolidation is crucial to ensure debt sustainability, and would improve market confidence, reducing the risk premia on the government bond yields. The bond yield recovery would allow Pakistan to return to the external bond market, increasing the financing sources for the public and private sectors. The FD should also consider the annual publication of the debt sustainability analysis.
- **Medium and long term:** To reduce domestic refinancing risk, the development of domestic capital markets is critical. Currently, domestic debt is mainly sourced from the banking system. This has impacted both the tenure and average cost of domestic debt, leading to a high rollover risk. Capital markets development is also important to transfer expensive short-term external financing to long-term domestic financing that will also help in reducing exchange rate risk. For domestic capital markets development, it's important to:
  - Maintain regular meetings with the capital market participants and find a balance between the needs of the Government and the market.
  - Ensure secondary market liquidity and increase the investor base through new debt instruments that are in line with private sector demand without increasing the costs and risks of public debt, and
  - Regulatory policies are crucial to boosting the local capital markets.

2. **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 following reforms should be prioritized.
   - **Analyzing and appropriately disclosing implicit contingent obligations such as circular debt settlements, commodity operations, and natural disasters.** This will help policymakers determine its volume, likelihood of materialization, and its fiscal impact. Resultantly, management of the contingent risks will ensure that there are fewer fiscal overruns, reducing fiscal risks. The Government already recognizes most of the explicit contingent liabilities; however, careful consideration is needed where the overall stock of guarantees has been increasing unchecked and to record and report these guarantees. There is an urgent need to begin publishing a detailed Fiscal Risk Statement (FRS) that includes major explicit and implicit contingent liabilities.
   - **Strengthening the middle office function of the DMO is critical for better managing the stock and flow of government guarantees.** The establishment of a Middle office function in DMO is critical for debt management strategy design and risk assessment, including evaluating and reporting guarantees and on-lending.
   - **The PPG debt definition should be revised in the FRDLA to include the stock of guaranteed debt.** The amended FRDLA imposes a limit on the stock of government guarantees. However, as per the PPG debt definition, the FRDLA guarantees are not covered in the PPG debt stock, and the PPG debt stock limit of 60 percent of GDP stipulated in the FRDLA excludes the guaranteed stock. Therefore, the PPG debt definition should be revised to include guaranteed debt and liabilities.

Annex 3.1: Annex: Debt Sustainability Analysis (DSA) and Medium-term Debt Management Strategy (MTDS) Model

A DSA framework was developed to determine the public debt dynamics. Public debt depends on four variables: i) the existing public debt stock, which results from past borrowing decisions; ii) the cost of borrowing, measured by the average interest rate of the existing debt; iii) the exchange rate, the valuation effect of currency depreciation on foreign liabilities; and iv) the primary balance, which reflect the current fiscal decision in terms of revenues and expenditures. The following equation determines the public debt dynamics:

$$D_t = D_{t-1}^{dom}\left(1 + i_t^{dom}\right) + D_{t-1}^{ext}(1 + i_t^{ext}) + PD_t$$

where D denotes the total public debt stock at the end of year t; D_{t-1}^{dom} is the domestic public debt stock at the end of the previous year; D_{t-1}^{ext} is the external public debt stock at the end of the previous year; i_t^{dom} and i_t^{ext} are the average interest rate paid on the inherited debt stock for the domestic and external debt; and PD_t is the primary deficit.

Mathematical steps allow us to divide the public debt-to-GDP dynamics into four main effects: i) interest rate effect; ii) valuation effect, including the valuation effect of the interest rates; iii) the GDP growth effect; and iv) the fiscal effect, the additional spending or saving due to fiscal decision.

$$\Delta d \approx \frac{i^{dom} d_{t-1}^{dom}}{(1+g)(1+\pi)} + \frac{i^{ext} d_{t-1}^{ext}}{(1+g)(1+\pi)} - \frac{\pi + g + \pi g}{(1+g)(1+\pi)} d_{t-1} + \frac{\left(\Delta e_{ext}/e_{ext}\,(1 + i^{ext})\right) d_{t-1}^{ext}}{(1+g)(1+\pi)} + \frac{PD}{GDP_t}$$

where d_{t-1} is the public debt-to-GDP ratio, g is the real GDP growth rate, π is the GDP deflator and e_{ext} is the exchange rate.

The DSA model projects the fiscal and debt variables. The projection of these variables generates future gross borrowing requirements, which is the sum of the primary deficit, interest, and principal payments of the existing debt. The future gross borrowing requirements are covered with new debt borrowing. The model is calibrated to equal the new debt with the gross borrowing requirements. Different assumptions are made to build the new instruments, such as assumptions on interest rates, maturities, grace periods, and currency. As the new instruments produce new interest and principal payments, the total gross borrowing requirements result from the sum of the primary deficit, the existing debt's interest, amortization, and the interest and the new debt's interest and amortization payments. The following equation resumes the gross borrowing requirements dynamics:

$$GBR_t = PD_t + Ip_t^{Old} + Ip_t^{New} + Amort_t^{Old} + Amort_t^{New}$$

where Ip_t^{Old} and $Amort_t^{Old}$ denotes the interest and amortization payments of the old debt, inherent debt, and Ip_t^{Old} and $Amort_t^{Old}$ denotes those of the new debt.

As the report aims to assess the medium-term public debt dynamics, it is assumed that the new financing does not produce interest or amortization payments in the same fiscal year it was issued. Analyzing the annual borrowing plan requires much more detailed data since it is necessary to know the cash flows as frequently as possible. This type of analysis is beyond the scope of this paper.

A debt management strategy is defined as the process of setting and implementing a strategy to raise the required amount of funding at the lowest cost over the medium and long term. The model was adapted to incorporate several strategies, thus analyzing the performance of the public debt dynamics using the same macroeconomic context. Comparing strategies with the same macroeconomic context allows us to infer that the changes in the key performance indicator, such as public debt-to-GDP and gross borrowing requirements-to-GDP, were directly produced by the strategies due to changes in interest rates, maturity profile, grace period, and currency composition of the new debt.

Annex 3.2: Debt Sustainability Analysis (DSA) Scenarios Tables

Table 3A.1: Business-as-Usual

PKR billions	2023	2024	2025	2026	2027
Revenues	9,474	11,327	12,919	14,876	16,588
Primary Expenditures	11,856	13,316	14,919	16,526	18,110
Primary Balance	**-2,383**	**-1,989**	**-2,001**	**-1,650**	**-1,522**
Interest Payments	4,215	4,496	5,106	5,699	6,241
Fiscal Balance	**-6,598**	**-6,485**	**-7,106**	**-7,349**	**-7,763**
Grants	146	13	0	0	0
Amortization Payments	14,946	15,631	15,684	13,859	13,873
Gross Financing Needs	**21,398**	**22,103**	**22,790**	**21,208**	**21,636**
Gross Borrowing	**21,398**	**22,103**	**22,790**	**21,208**	**21,636**
Domestic Borrowing	12,990	14,370	13,007	11,673	11,848
External Borrowing	8,408	7,734	9,783	9,535	9,788
PPG Debt	**61,082**	**69,666**	**78,277**	**87,057**	**95,961**
Domestic Debt	35,525	39,701	42,648	45,664	48,497
External Debt	25,558	29,965	35,629	41,393	47,463

% of GDP	2023	2024	2025	2026	2027
Revenues	11.2	11.9	12.1	12.6	12.9
Primary Expenditures	14.1	14.0	14.0	14.0	14.0
Primary Balance	**-2.8**	**-2.1**	**-1.9**	**-1.4**	**-1.2**
Interest Payments	5.0	4.7	4.8	4.8	4.8
Fiscal Balance	**-7.8**	**-6.8**	**-6.7**	**-6.2**	**-6.0**
Grants	0.2	0.0	0.0	0.0	0.0
Amortization Payments	17.7	16.4	14.7	11.7	10.8
Gross Financing Needs	**25.4**	**23.2**	**21.4**	**18.0**	**16.8**
Gross Borrowing	**25.4**	**23.2**	**21.4**	**18.0**	**16.8**
Domestic Borrowing	15.4	15.1	12.2	9.9	9.2
External Borrowing	10.0	8.1	9.2	8.1	7.6
PPG Debt	**72.5**	**73.1**	**73.4**	**73.8**	**74.4**
Domestic Debt	42.2	41.7	40.0	38.7	37.6

External Debt	30.3	31.5	33.4	35.1	36.8
GDP (PKR billions)	*84,260*	*95,249*	*106,584*	*117,968*	*128,955*

Table 3A.2: Depreciation Shock Scenario

PKR billions	2023	2024	2025	2026	2027
Revenues	9,474	11,327	12,919	14,876	16,588
Primary Expenditures	11,856	13,316	14,919	16,526	18,110
Primary Balance	**-2,383**	**-1,989**	**-2,001**	**-1,650**	**-1,522**
Interest Payments	4,404	4,697	5,344	5,969	6,525
Fiscal Balance	**-6,786**	**-6,686**	**-7,345**	**-7,619**	**-8,047**
Grants	146	13	0	0	0
Amortization Payments	16,420	17,262	17,371	15,419	15,331
Gross Financing Needs	**23,060**	**23,936**	**24,716**	**23,038**	**23,377**
Gross Borrowing	**23,060**	**23,936**	**24,716**	**23,038**	**23,377**
Domestic Borrowing	12,130	13,882	11,998	10,643	10,653
External Borrowing	10,930	10,054	12,718	12,396	12,724
PPG Debt	**67,890**	**77,308**	**86,608**	**96,087**	**105,617**
Domestic Debt	34,665	38,353	40,290	42,277	43,915
External Debt	33,225	38,955	46,318	53,810	61,702

% of GDP	2023	2024	2025	2026	2027
Revenues	11.2	11.9	12.1	12.6	12.9
Primary Expenditures	14.1	14.0	14.0	14.0	14.0
Primary Balance	**-2.8**	**-2.1**	**-1.9**	**-1.4**	**-1.2**
Interest Payments	5.2	4.9	5.0	5.1	5.1
Fiscal Balance	**-8.1**	**-7.0**	**-6.9**	**-6.5**	**-6.2**
Grants	0.2	0.0	0.0	0.0	0.0
Amortization Payments	19.5	18.1	16.3	13.1	11.9
Gross Financing Needs	**27.4**	**25.1**	**23.2**	**19.5**	**18.1**
Gross Borrowing	**27.4**	**25.1**	**23.2**	**19.5**	**18.1**
Domestic Borrowing	14.4	14.6	11.3	9.0	8.3
External Borrowing	13.0	10.6	11.9	10.5	9.9
PPG Debt	**80.6**	**81.2**	**81.3**	**81.5**	**81.9**
Domestic Debt	41.1	40.3	37.8	35.8	34.1
External Debt	39.4	40.9	43.5	45.6	47.8
GDP (PKR billions)	*84,260*	*95,249*	*106,584*	*117,968*	*128,955*

Table 3A.3: Constant Primary Balance Scenario

PKR billions	2023	2024	2025	2026	2027
Revenues	9,474	11,327	12,919	14,876	16,588
Primary Expenditures	12,103	14,279	16,223	18,533	20,586
Primary Balance	**-2,629**	**-2,953**	**-3,304**	**-3,657**	**-3,998**
Interest Payments	4,215	4,517	5,210	5,923	6,655
Fiscal Balance	**-6,844**	**-7,470**	**-8,514**	**-9,580**	**-10,652**
Grants	146	13	0	0	0
Amortization Payments	14,946	15,631	15,684	13,859	13,873
Gross Financing Needs	**21,644**	**23,088**	**24,198**	**23,439**	**24,525**
Gross Borrowing	**21,644**	**23,088**	**24,198**	**23,439**	**24,525**
Domestic Borrowing	13,236	15,354	14,415	13,904	14,737
External Borrowing	8,408	7,734	9,783	9,535	9,788
PPG Debt	**61,329**	**70,897**	**80,915**	**91,926**	**103,720**
Domestic Debt	35,771	40,931	45,286	50,534	56,257
External Debt	25,558	29,965	35,629	41,393	47,463

% of GDP	2023	2024	2025	2026	2027
Revenues	11.2	11.9	12.1	12.6	12.9
Primary Expenditures	14.4	15.0	15.2	15.7	16.0
Primary Balance	**-3.1**	**-3.1**	**-3.1**	**-3.1**	**-3.1**
Interest Payments	5.0	4.7	4.9	5.0	5.2
Fiscal Balance	**-8.1**	**-7.8**	**-8.0**	**-8.1**	**-8.3**
Grants	0.2	0.0	0.0	0.0	0.0
Amortization Payments	17.7	16.4	14.7	11.7	10.8
Gross Financing Needs	**25.7**	**24.2**	**22.7**	**19.9**	**19.0**
Gross Borrowing	**25.7**	**24.2**	**22.7**	**19.9**	**19.0**
Domestic Borrowing	15.7	16.1	13.5	11.8	11.4
External Borrowing	10.0	8.1	9.2	8.1	7.6
PPG Debt	**72.8**	**74.4**	**75.9**	**77.9**	**80.4**
Domestic Debt	42.5	43.0	42.5	42.8	43.6
External Debt	30.3	31.5	33.4	35.1	36.8
GDP (PKR billions)	*84,260*	*95,249*	*106,584*	*117,968*	*128,955*

Table 3A.4: Higher Interest Rates Scenario

PKR billions	2023	2024	2025	2026	2027
Revenues	9,474	11,327	12,919	14,876	16,588
Primary Expenditures	11,856	13,316	14,919	16,526	18,110
Primary Balance	**-2,383**	**-1,989**	**-2,001**	**-1,650**	**-1,522**
Interest Payments	4,215	5,159	6,223	7,345	8,425
Fiscal Balance	**-6,598**	**-7,148**	**-8,224**	**-8,996**	**-9,947**
Grants	146	13	0	0	0
Amortization Payments	14,946	15,631	15,684	13,859	13,873
Gross Financing Needs	**21,398**	**22,766**	**23,907**	**22,854**	**23,820**
Gross Borrowing	**21,398**	**22,766**	**23,907**	**22,854**	**23,820**
Domestic Borrowing	12,990	15,033	14,124	13,319	14,033
External Borrowing	8,408	7,734	9,783	9,535	9,788
PPG Debt	**61,082**	**70,329**	**80,057**	**90,483**	**101,572**
Domestic Debt	35,525	40,363	44,428	49,091	54,109
External Debt	25,558	29,965	35,629	41,393	47,463

% of GDP	2023	2024	2025	2026	2027
Revenues	11.2	11.9	12.1	12.6	12.9
Primary Expenditures	14.1	14.0	14.0	14.0	14.0
Primary Balance	**-2.8**	**-2.1**	**-1.9**	**-1.4**	**-1.2**
Interest Payments	5.0	5.4	5.8	6.2	6.5
Fiscal Balance	**-7.8**	**-7.5**	**-7.7**	**-7.6**	**-7.7**
Grants	0.2	0.0	0.0	0.0	0.0
Amortization Payments	17.7	16.4	14.7	11.7	10.8
Gross Financing Needs	**25.4**	**23.9**	**22.4**	**19.4**	**18.5**
Gross Borrowing	**25.4**	**23.9**	**22.4**	**19.4**	**18.5**
Domestic Borrowing	15.4	15.8	13.3	11.3	10.9
External Borrowing	10.0	8.1	9.2	8.1	7.6
PPG Debt	**72.5**	**73.8**	**75.1**	**76.7**	**78.8**
Domestic Debt	42.2	42.4	41.7	41.6	42.0
External Debt	30.3	31.5	33.4	35.1	36.8
GDP (PKR billions)	*84,260*	*95,249*	*106,584*	*117,968*	*128,955*

Table 3A.5: Budget Consolidation Scenario

PKR billions	2023	2024	2025	2026	2027
Revenues	13,266	15,613	17,715	20,184	22,391
Primary Expenditures	11,856	13,316	14,919	16,526	18,110
Primary Balance	**1,409**	**2,297**	**2,795**	**3,658**	**4,281**
Interest Payments	4,215	4,174	4,392	4,517	4,467
Fiscal Balance	**-2,806**	**-1,877**	**-1,596**	**-858**	**-186**
Grants	146	13	0	0	0
Amortization Payments	14,946	15,631	15,684	13,859	12,303
Gross Financing Needs	**17,606**	**17,495**	**17,280**	**14,717**	**12,489**
Gross Borrowing	**17,606**	**17,495**	**17,280**	**14,717**	**12,489**
Domestic Borrowing	9,198	9,761	7,497	5,182	2,701
External Borrowing	8,408	7,734	9,783	9,535	9,788
PPG Debt	**57,291**	**61,266**	**64,366**	**66,655**	**67,983**
Domestic Debt	31,733	31,301	28,737	25,263	20,520
External Debt	25,558	29,965	35,629	41,393	47,463

% of GDP	2023	2024	2025	2026	2027
Revenues	15.7	16.4	16.6	17.1	17.4
Primary Expenditures	14.1	14.0	14.0	14.0	14.0
Primary Balance	**1.7**	**2.4**	**2.6**	**3.1**	**3.3**
Interest Payments	5.0	4.4	4.1	3.8	3.5
Fiscal Balance	**-3.3**	**-2.0**	**-1.5**	**-0.7**	**-0.1**
Grants	0.2	0.0	0.0	0.0	0.0
Amortization Payments	17.7	16.4	14.7	11.7	9.5
Gross Financing Needs	**20.9**	**18.4**	**16.2**	**12.5**	**9.7**
Gross Borrowing	**20.9**	**18.4**	**16.2**	**12.5**	**9.7**
Domestic Borrowing	10.9	10.2	7.0	4.4	2.1
External Borrowing	10.0	8.1	9.2	8.1	7.6
PPG Debt	**68.0**	**64.3**	**60.4**	**56.5**	**52.7**
Domestic Debt	37.7	32.9	27.0	21.4	15.9
External Debt	30.3	31.5	33.4	35.1	36.8
GDP (PKR billions)	*84,260*	*95,249*	*106,584*	*117,968*	*128,955*

Table 3A.6: Debt Strategies

Strategies	Domestic Financing				External Financing			
	Short-Term	Medium-Term	Long-Term	Mix	Concessional Loans	BAU Disbursement	Short-Term	Medium-Term
1	✓							
2		✓						
3			✓					
4				✓				
5	✓				✓			
6		✓			✓			
7			✓		✓			
8				✓	✓			
9	✓					✓		
10		✓				✓		
11			✓			✓		
12				✓		✓		
13							✓	
14								✓
15					✓			

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Chapter 4

PAKISTAN FEDERAL PUBLIC EXPENDITURE REVIEW 2023

Reducing the Fiscal Impact of State-Owned Enterprises

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PUBLIC EXPENDITURE REVIEW

Chapter 4. Reducing the Fiscal Impact of State-Owned Enterprises

2023

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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

CDL	Cash Development Loan
CF	Corporate Finance
CG	Corporate Governance
CMU	Central Monitoring Unit
DISCOs	Electricity Distribution Companies
ERC	Exchange Rate Coverage
FRDLA	Fiscal Responsibility and Debt Limitation Act
FY	Fiscal Year
GDP	Gross Domestic Product
GENCO	Electricity Generation Companies
GoP	Government of Pakistan
HR	Human Resources
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LNG	Liquified Natural Gas
ME&CA	Middle East and Central Asia
MoF	Ministry of Finance
NBP	National Bank of Pakistan
NEPRA	National Electric Power Regulatory Authority
NHA	National Highway Authority
NTDC	National Transmission and Dispatch Company
OECD	Organisation of Economic Co-operation and Development
PASSCO	Pakistan Agriculture Storage and Services Corporation
PER	Public Expenditure Review
PHPL	Power Holding Private Limited
PIACL	Pakistan International Airlines Corporation Limited
PKR	Pakistani Rupee
PSC	Public Sector Company
PSML	Pakistan Steel Mills Corporation Limited
PSX	Pakistan Stock Exchange
ROA	Return on Assets
ROE	Return on Equity
SAIFI	System Average Interruption Frequency Index
SECP	Securities and Exchange Commission of Pakistan
SLIC	State Life Insurance Corporation
SOE	State-Owned Enterprise
TCP	Trading Corporation of Pakistan
TDS	Tariff Differential Subsidy
WAPDA	Water and Power Development Authority

Chapter 4: Reducing the Fiscal Impact of State-Owned Enterprises

4.1 Introduction

Pakistan's state-owned enterprises (SOEs) play a vital role in the country's socio-economic development as they provide essential goods and services. However, the overall performance of SOEs in Pakistan has remained below par; over one-third of all commercial SOEs incur losses in any given year, a trend that has been persistent since FY13. SOE performance has further deteriorated in recent years, as the aggregate losses of the loss-making SOEs significantly exceeds the aggregate profits of profit-making ones. Thus, the Federal Government has been incurring losses on its investment in SOEs since 2016. The annual aggregate loss averaged 0.5 percent of gross domestic product (GDP) over FY16-20, while the accumulated stock of losses reached 3.1 percent of GDP in FY20.

This chapter analyzes the financial performance of federally owned commercial SOEs[1] and their impact on the fiscal position of the Federal Government. Further, it explains factors underlying losses in key sectors. The chapter also discusses the fiscal transactions between the Government and the SOEs, including the annual flows and cumulative stocks of each instrument used as a form of support to the SOEs (subsidies, grants, loans, equity injections, and guarantees).

This chapter draws upon multiple data sources to provide an overview of the key fiscal issues related to federal commercial SOEs in Pakistan. Although constrained by the lack of latest published financial information on SOEs, the analysis was conducted based on information from various alternative sources, including annual audit reports and Ministry of Finance (MoF) data for the elaboration of this chapter. The timely availability of this systematic information and absence of a central database on SOEs are highlighted as a significant aspect to improve the transparency and disclosure dimension of SOEs. For this chapter, the financial performance of SOEs is assessed using provisional SOE data for FY20, whereas the annual fiscal cost and exposure are assessed using fiscal data for FY21 and FY22. While, quality and consistency checks were conducted, the finalized published FY20 SOE data could still differ from the provisional version.

The main objective of this chapter is to inform the Government, the World Bank, and relevant stakeholders about the fiscal impact of the SOE portfolio. In addition, the chapter attempts to estimate the current fiscal risk of the SOEs in the form of explicit obligations. It proposes ways to reduce fiscal costs and manage fiscal risk, for example, by strengthening the SOE legal and regulatory framework, institutionalizing an oversight and monitoring function, enforcing SOE performance and loan contracts, strengthening the fiscal risk management framework, corporatizing large commercial SOEs, and implementing the Government's SOE reform plan (Ministry of Finance, 2021).

[1] Commercial SOEs represent 95 percent of the federal SOE portfolio.

4.2 The Portfolio of Federal State-Owned Enterprises

Pakistan has a legacy portfolio of SOEs that remain an important pillar of the economy. Excluding health and education institutions, the federal SOE portfolio comprises 207 enterprises,[2] of which 87 are commercial enterprises operating in various economic sectors, and 47 are non-commercial enterprises, with the primary objective of undertaking welfare activities (Figure 4.1 and Figure 4.2).[3]

Figure 4.1: Number of Commercial SOEs by Sector

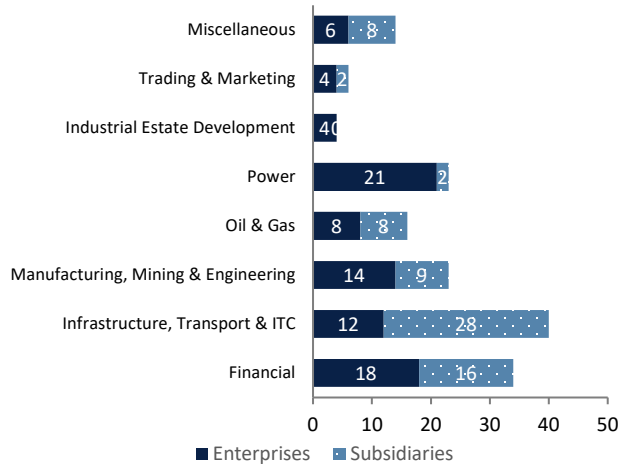
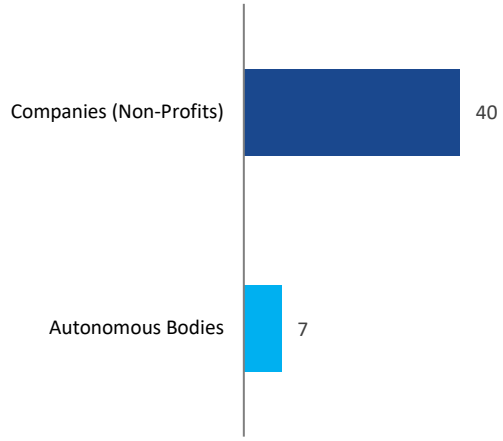


Figure 4.2: Non-Commercial SOEs



Source: Database of SOEs, Ministry of Finance.
Note: ITC = Information and communication technology

This chapter focuses on federal commercial SOEs[4] and therefore excludes analysis on minority interests, educational and training institutes, healthcare facilities, security agencies, regulatory bodies, and other public sector-associated companies that have non-commercial mandates. Federal commercial SOEs have a combined output of 12 percent of GDP and combined assets of 48 percent of GDP in FY20.[5] The commercial enterprises are mainly concentrated in the energy, financial, manufacturing, and transportation sectors, with ten of them listed on the Pakistan Stock Exchange (PSX) and adhering to all listing regulations.[6] These SOEs includes natural monopolies[7], such as Pakistan Railways and the National Transmission and Dispatch Company (NTDC), and providers of services not offered by the private sector, such as SOEs that provide access to finance in rural areas. There are also SOEs in sectors, such as manufacturing, for which the rationale for state presence is not clear.

[2] "Federal Footprint: State Owned Enterprises Annual Report 2018-19: Volume I – Commercial SOEs."
[3] The remaining entities are subsidiaries of SOEs, with a few commercial SOEs having non-commercial subsidiaries.
[4] The Pakistan Industrial Development Corporation is a commercial SOE that owns 8 subsidiaries registered as non-profit companies. These subsidiaries act as facilitators (for example, for capacity-building and training institutes) for industrial development in Pakistan.
[5] However, their share of employment in the economy is relatively low, that is, less than one percent of the total formal employment.
[6] The SOE count from the government publication captures most of the large-sized institutions. It explicitly excludes security firms, educational institutes, and regulatory bodies.
[7] "Natural Monopoly" is characterized by steeply declining long-run average and marginal-cost curves such that there is room for only one firm to fully exploit available economies of scale and supply the market. "Competition for-the-market: Advocacy & Enforcement in Concessions – Background note by the secretariat", OCED

An SOE can be formed by the Government either as a limited liability company through the Companies Act or as an autonomous body under a special enactment of the Parliament.[8] Of the 207 SOEs, 179 are Public Sector Companies (PSCs), and therefore, have been incorporated under the Companies Act of 2017. Another 21 SOEs have been created by special enactment, and the remaining seven are foreign incorporated subsidiaries. The Companies Act of 2017 defines PSCs as having: (i) direct or indirect control by the Government; (ii) ownership/voting rights of over 50 percent; and (iii) ownership that can be through an agency of government or a statutory body having the power to elect, nominate, or appoint a majority of its directors. The definition applies to all PSCs and non-profit companies under Section 42 of the Companies Act 2017. In contrast, there are also SOEs that are created through a special enactment or a legislation, such as the National Bank of Pakistan, the Pakistan Television Corporation, and the Water and Power Development Authority (WAPDA). These SOEs have different powers and business mandates that originate from the associated legislation.

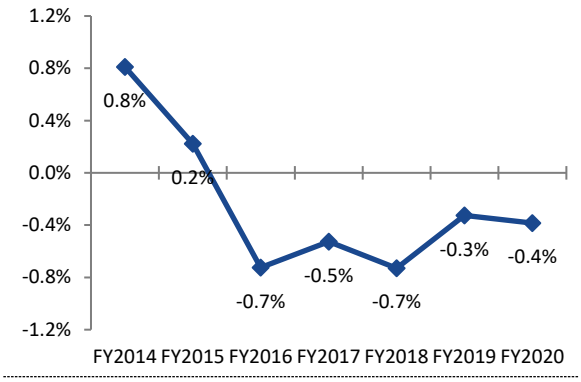
SOEs are active in the strategic and commercial sectors, and some operate as natural monopolies. Some of the largest SOEs in Pakistan are active in the energy and transport sectors. These include enterprises active in the oil and gas sector and power sector. The power sector includes four Electricity Generation Companies (GENCOs), 10 Electricity Distribution Companies (DISCOs), the NTDC, and the WAPDA. The transport companies include seaports and airports authorities, the National Highway Authority (NHA), the Pakistan Railways, and the Pakistan International Airlines Corporation Limited (PIACL). The Government holds control over natural monopolies through regulators and various sectoral legislation. This allows for government intervention, such as the right to make rules, issue guidelines, control utility tariffs, subsidize products and services, and take other actions related to other political or strategic interests.

Several federal SOEs also operate in the commercial sectors, such as manufacturing, trade, and services. A few of these are engaged in defense-related sectors that could be defined as strategic. Most operate in market sectors alongside private firms. For example, the Pakistan Steel Mills Corporation Limited (PSML) is one of the largest SOEs in the industrial sector. It is also among the SOEs with the highest losses. Other manufacturing SOEs operate in sectors such as fertilizers and plastics. The SOEs in the service sector include engineering consultancy firms, construction companies, and even hotel operators.

4.3 Financial Performance

Pakistan's federal commercial SOEs have been making losses since FY16. The aggregate profitability of federal commercial SOEs has deteriorated since FY14, when aggregate profit was at 0.8 percent of GDP, to a loss of 0.4 percent of GDP in FY20 (Figure 4.3).

Figure 4.3: Federal SOEs – Net Profit (% of GDP)



Source: Database of State-Owned Enterprises, Ministry of Finance.

The profitability of Pakistan's federal SOEs are the lowest in the South Asia Region.[9] The extensive presence of SOEs across the economy is not unique to Pakistan: SOEs characteristically participate in a large number of economic activities across other countries in South Asia. In addition, SOE presence in the energy

[8] These definitions are consistent with international practices. Definitions, OECD Corporate Governance of State-owned Enterprises Guidelines, (OECD, 2015).

[9] The regional average excludes India due to the lack of data.

and financial sectors is common to all South Asian countries. However, Pakistan's federal SOEs stand out because they are the least profitable in the region, with net losses of 0.3 percent of GDP in 2019 (Figure 4.4). One contributing factor to poor profitability is the low revenues in relation to costs, as well as when compared across the region (Figure 4.5).

Figure 4.4: South Asia, SOE Profitability in 2019
(% of GDP)

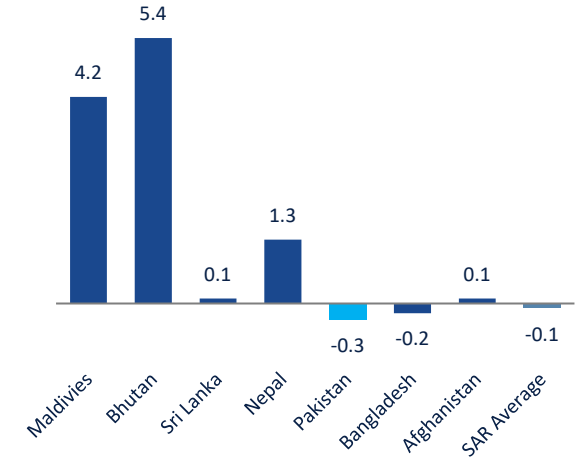
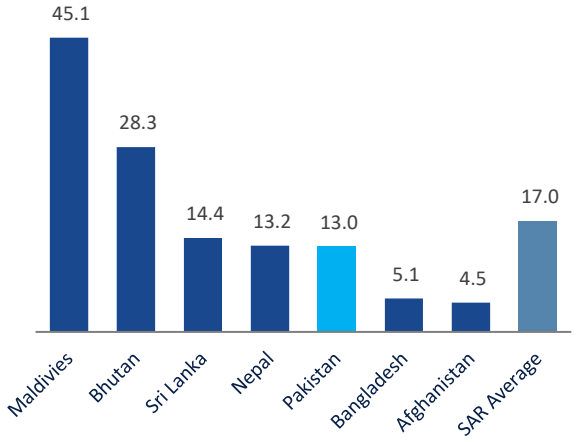


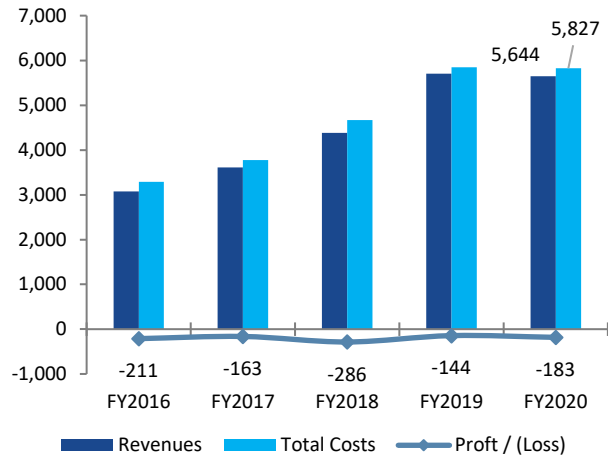
Figure 4.5: South Asia, SOE Revenues in 2019
(% of GDP)



Source: Dall'Olio, Goodwin, Martinez, Orlowski, Patino-Pena, Ratsimbazafy, and Sanchez-Navarro. The authors used ORBIS to build a global database of firms with state participation (World Bank, Global SOE database).
Notes: SAR= South Asia Region; includes state-owned corporations at the central government level only

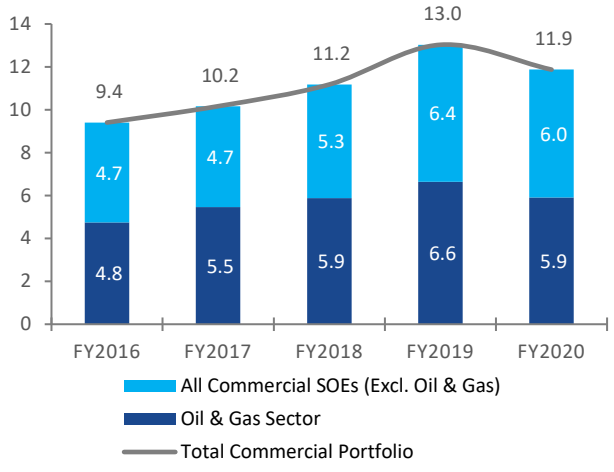
The federal SOE portfolio places a strain on public finances. In light of persistent losses, federal commercial SOEs require government support, and consequently are placing a drain on the finances of the Federal Government. Financial support to underperforming SOEs is a major driver of the fiscal deficit, as well as a source of substantial fiscal risks. Such support via various financial instruments, such as domestic and foreign loans, subsidies, and grants accounted for 18 percent of the FY22 consolidated fiscal deficit. Even in years when SOEs posted an aggregate profit, such as in FY2015, government support to SOEs accounted for more than 25 percent of the fiscal deficit.

Figure 4.6: Aggregate SOE Revenues, Costs, and Profits/(Losses) (PKR billion)



Source: Database of SOEs, Ministry of Finance.

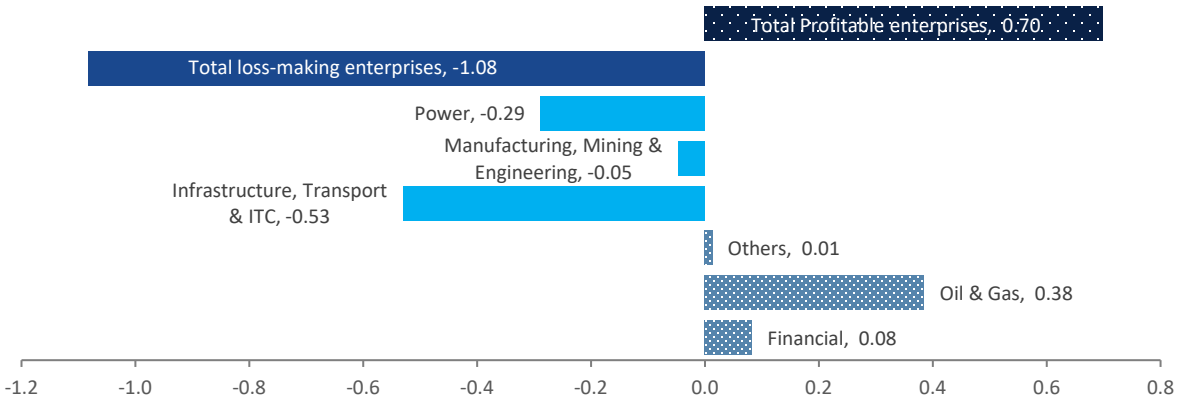
Figure 4.7: Revenues of Commercial SOEs (% of GDP)



Source: Database of SOEs, Ministry of Finance.

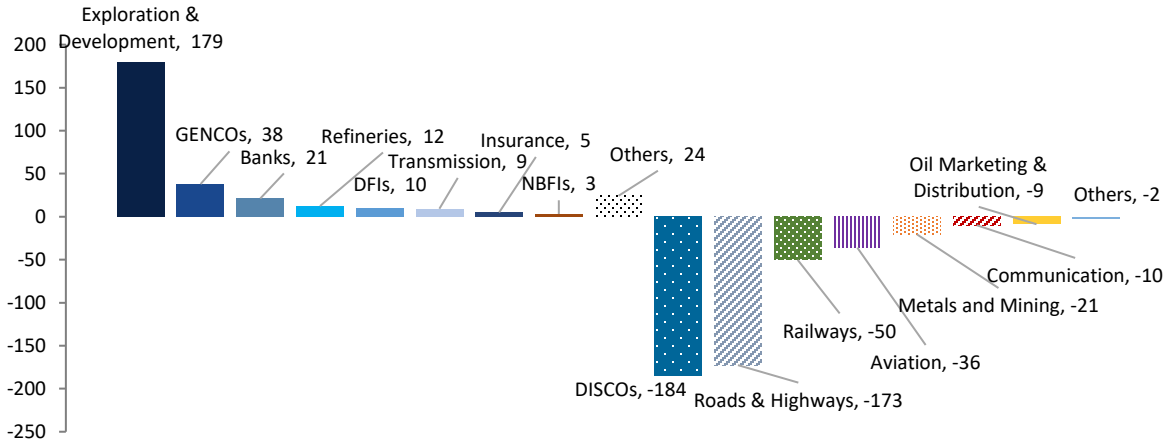
Operational costs increased together with revenues, impacting profitability. Revenues of federal commercial SOEs has risen in recent years, standing at 11.9 percent of GDP in FY20 (Figure 4.6). However, higher costs have offset the financial contribution of higher revenues by more than half. The oil and gas sector has been the most profitable, accounting for nearly 50 percent of the SOE portfolio revenues (Figure 4.7). The variation in the portfolio revenues is largely driven by fluctuations in revenues from the oil and gas sector, which in turn is primarily attributable to volatility in the prices of gas and liquified petroleum gas. Higher international crude oil prices tend to have a positive impact on the sales revenues and profit margins in the oil and gas sector, but adversely affect the power sector in Pakistan, where the regulated oil and gas prices have a cascade effect on the regulated electricity prices.

Figure 4.8: Profit/Loss by Sector, FY 2020 (% of GDP)



Source: Database of SOEs, Ministry of Finance.

Figure 4.9: Profit/Loss by Sub-sectors in FY 2020 (PKR billion)



Source: FY 2020 SOE database, Ministry of Finance.
Note: DFI = Development Financial Institutions, DISCOs = Electricity Distribution Companies; GENCO = Electricity Generation Companies; and NBFI = Non-Banking Financial Institutions.

Individual SOE performance is largely dictated by sectoral performance. Although the primary reasons for SOE losses tend to differ, they are usually related to: (i) sector regulations; (ii) an underestimation of the cost of the provision of public service obligations; (iii) incomplete restructuring; (iv) insufficient current

subsidies; and (v) unresolved corporate governance issues.[10] A SOE portfolio analysis showed that individual SOE performance is influenced by sectoral policies and the level of operational autonomy by the Board of Directors and senior management. Overall SOE losses, amounting to 1.1 percent of GDP in FY20, are concentrated in the power, infrastructure, and transport sectors, and in aggregate outweigh profits from profitable SOEs (Figure 4.8 and Figure 4.9). Although a sizable number of commercial SOEs generated profits in FY20, they were concentrated in the oil and gas sector.

Table 4.1: Top Profit-Making Commercial SOEs in FY2020

	SOE Name	Profit FY2020 (% of GDP)
1	Oil & Gas Development Company Limited	0.21
2	Pakistan Petroleum Limited	0.10
3	National Bank of Pakistan	0.06
4	Government Holdings Pvt. Limited	0.06
5	National Power Parks Management Company Ltd.	0.06
	Combined profit of the 5 SOEs	**0.49**
	Share of combined profits of profit-making commercial SOEs	**70.0***

Source: Database of SOEs, Ministry of Finance.
Note: * Computed as 0.49/0.70*100

Table 4.2: Top Loss-Making Commercial SOEs in FY2020

	SOE Name	Loss FY2020 (% of GDP)
1	National Highway Authority (NHA)	0.36
2	Quetta Electric Supply Company	0.23
3	Pakistan Railways	0.11
4	Pakistan International Airlines Corp. Ltd.	0.08
5	Sukkur Electric Supply Company	0.05
6.	Pakistan Steel Mills Corporation (Private) Limited	0.04
7	Hyderabad Electric Supply Company Limited	0.04
	Combined losses of the 7 SOEs	**0.91**
	Share of combined losses of loss-making commercial SOEs	**84.2***

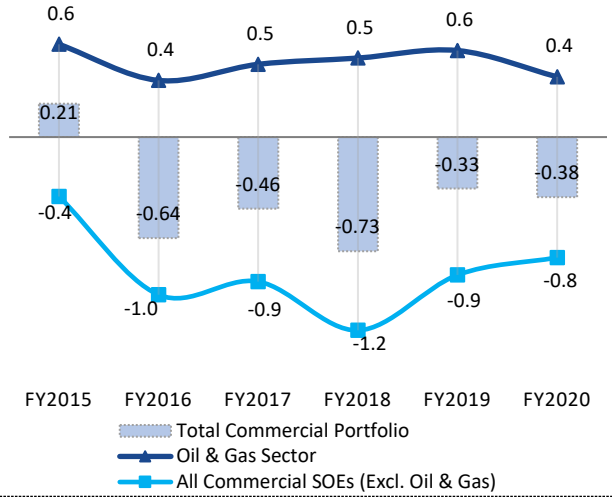
Source: Database of SOEs, Ministry of Finance.
Note: * Computed as 0.91/1.08*100

The profits and losses of federal SOEs are concentrated among a few enterprises. The significant profit-making SOEs (profits of at least 0.04 percent of GDP each) comprise five companies, which together constitute 70 percent of the total combined profit of profit-making federal SOEs in FY20 (Table 4.1). Similarly, the major loss-making SOEs (losses of at least 0.04 percent of GDP each) consist of only seven companies, which together account for 84 percent of the combined total losses of loss-making SOEs in FY20 (Table 4.2). These companies are concentrated in the power and transport sectors, which include the roads and highways, railways, and aviation sub-sectors. The two sectors represent 72 percent of total SOE employment and over 60 percent of total commercial SOE assets. Because of the high concentration, the profitability of each enterprise has a significant impact on the net profitability of the overall SOE portfolio. In addition, for each (profit or loss) category, the enterprises tend to be from the same sector, highlighting the likely dominance of sectoral policies on SOE profitability.

The oil and gas sector accounts for a large share of federal SOE profits. Profits in the oil and gas sector amounted to 0.4 percent of GDP in FY20, compared with the combined loss of all other commercial SOEs of 0.8 percent of GDP (Figure 4.10). Additionally, five out of eight companies in the oil and gas sector are listed on the Pakistan Stock Exchange (PSX) (Table 4.3)[11].

[10] Governance issues include the inability of company management to create linkages between performance and incentives.
[11] Pakistan Stock Exchange (PSX) Data Portal.

Figure 4.10: Net Profit of Commercial SOEs
(% of GDP)



Source: Database of SOEs, Ministry of Finance.

Table 4.3: State-Owned Enterprises in the Oil and Gas Sector Listed on the Stock Market

Listed Company	Free Float (%)
Oil and Gas Development Company Limited	15.0%
Pakistan Petroleum Limited	24.5%
Sui Northern Gas Pipelines Limited	45.0%
Sui Southern Gas Company Limited	38.1%
Pakistan State Oil Company Limited	45.0%

Source: Data Portal, Pakistan Stock Exchange

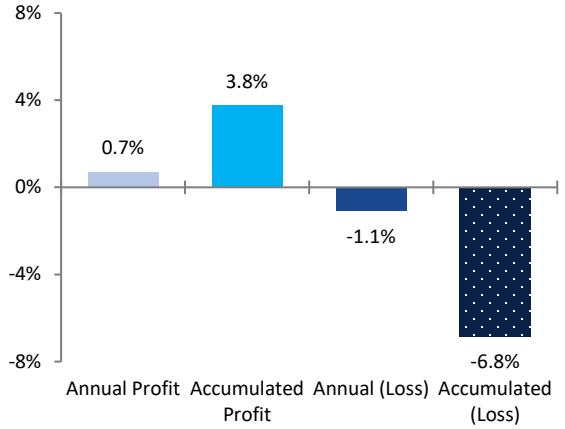
Even the profitable SOEs can face liquidity challenges due to large receivable balances owed by other poor performing SOEs. These intra-SOE receivables and payables tend to create liquidity issues. For example, the state-owned oil, gas, and liquified natural gas (LNG) supply companies provide fuel to public and private power generators, who then sell electricity and gas to state-owned utilities. However, they are running a payment shortfall (known as circular debt[12]) of PKR 1,452 billion (2.1 percent of GDP) and there is also a "gas sector circular debt" (created mainly due to shortage of payments for imported LNG) amounting to PKR 1,402 billion (2.1 percent of GDP) as of FY22.[13] These intra-SOE debts create explicit and implicit government obligations, particularly when the Government has insufficient fiscal space to settle such accounts.

The accumulated losses from federal commercial SOEs have become substantial. At the end of FY20, accumulated losses of loss-making federal commercial SOEs stood at 6.8 percent of GDP, compared with accumulated profits of 3.8 percent of GDP (Figure 4.11). With the annual losses consistently exceeding profits since FY16, the stock of net losses of the federal commercial SOE portfolio has been growing, amounting to 3.1 percent of GDP in FY20, after reaching a high of 3.5 percent of GDP in FY19 (Figure 4.12). As discussed, the bulk of losses have been accruing from a few SOEs, such as the DISCOs, PIACL, Pakistan Railways, and the NHA, and the Government has been supporting their operations and capital investments through subsidies, grants, and loans. The Government has also been issuing guarantees to assist these SOEs with their commercial loans, further increasing government exposure and fiscal risk. In general, the accumulation of losses makes it difficult for the Government to undertake reforms in loss-making SOEs to turn them around in the absence of large investments. The magnitude of the accumulated losses also makes privatization efforts challenging (Box 4.1), as potential investors will tend to avoid taking on investments with substantial existing losses.

[12] The circular debt is the payment shortfall created primarily because of non-collection of bills, transmission and distribution losses, as well as delays in charging periodical tariff adjustments, which creates liquidity issues to pay the electricity generators.
[13] Ministry of Energy's strategic unit on gas sector reforms.

Figure 4.11: Commercial profit-making and loss-making SOEs, FY2020

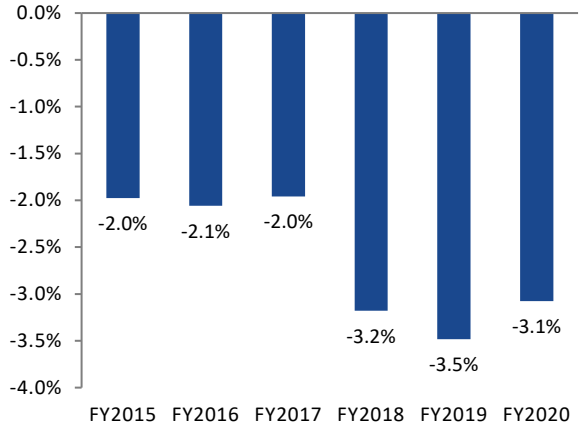
(% of GDP)



Source: Database of SOEs, Ministry of Finance.

Figure 4.12: Aggregate net profits of commercial SOEs

(% Of GDP)



Source: Database of SOEs, Ministry of Finance.

Box 4.1: Lessons from the Privatization Experience in Pakistan

The nationalization of major sub-sectors of the economy, except textile and sugar industries, led to enormous growth in the public sector. With its socialist agenda during the 1971–1977 period, the political government, under the Economic Reforms Order 1972, nationalized banks, insurance, investment, shipping, oil and gas, petroleum-marketing companies, cement, steel, vegetable oil units, export trade in cotton and rice, flour mills, rise husking, and cotton ginning units. In 1977, these SOEs accounted for 11 percent of GDP and 52 percent of the gross domestic investment and contributed 23 percent of tax revenues.

Pakistan espoused the policy of deregulation, liberalization, and privatization in 1989. The broad objectives of privatization include fostering competition and integration with the global economy, deepening the capital markets, attracting foreign direct and private investment, freeing up public sector resources and reducing fiscal deficit, to utilize privatization proceeds for debt retirement and poverty reduction. Recognizing the growing financial losses, mismanagement, and leakages, the military government then promulgated the State-Owned Company Management Transfer Order in 1978 to support divestment and the sales of SOEs to back former owners.[14] The privatization program commenced in 1989, but only gained momentum starting 2000, with measures to remove a number of structural bottlenecks. These included: (a) the enactment of the privatization Commission Ordinance 2000 to institutionalize the Privatization Commission, initially established as a sub-branch of the Ministry of Finance, and to provide legal cover to the privatization process; (b) reforming the macroeconomic environment; (c) establishing regulatory frameworks;[15] (d) adopting a more liberal foreign investment policy; (e) the enactment of Economic Reforms Protection Act; (f) establishing a high-powered Cabinet Committee on Privatization; and (g) strengthening the Board of the Privatization Commission. The privatization in Pakistan can be divided into three distinct phases: 1989–1999 (political governments), 2000–2008 (military and quasi-military governments), and 2009–to-date (political government). In the first phase, 104 units were sold for

[14] Concurrently, the Government enforced the Protection of Rights in Industrial Property Order in 1979 invalidating the Economic Reform Order 1972 that laid the foundation of nationalization in 1972. The Divestment Committee, later replaced by the National Divestment Authority so established could not make a major headway.

[15] Regulatory agencies for electricity (NEPRA), oil and gas (OGRA), telecommunications (PTA), electronic media (PEMRA), power sector (PPIB), and Competition Commission of Pakistan were set up and existing regulators such as the State Bank of Pakistan and the Securities Exchange Commission of Pakistan were strengthened.

Rs 59.3 billion, 54 SOEs were privatized for Rs 416.8 billion during the second, while 14 entities have been sold/privatized for Rs 173 billion since 2009.[16]

Key determinants of successful privatization in Pakistan included: (i) strong political commitment; (ii) an effective legal framework complemented with supportive policies and investment protection; (iii) building a coalition for change; (iv) transparency throughout the privatization process; (v) a communication strategy to disseminate the direct and indirect benefits of privatization, while addressing key fears and concerns of the citizenry; and (vi) measures to mitigate social costs, including the displacement of labor. The military government in 1999 demonstrated a strong political commitment to privatization as part of broader economic reforms in the country under the IMF's Poverty Reduction and Growth Facility and Paris Club Debt Restructuring in 2001. It established the necessary legal and regulatory framework, adopted policies to incentivize domestic and foreign private investors, and built a coalition for change with concerned stakeholders. The Government also sought necessary financial support from the multilaterals where needed—such as in clearing the balance sheets of the banks before privatization and payment of severance packages—and ensured transparency in all privatization transactions. In addition, the adverse social effects of the privatization initiative were mitigated by taking respective trade unions on board by negotiating an acceptable severance benefits package. Concomitantly, the Government demonstrated the advantages of privatization to the general public by lowering the fiscal deficit and debt trajectory that increased the market and public confidence, albeit privatization proceeds were not the only factor in this.

The key success stories in privatization include those for the telecom and banking sectors. The banking sector included the divestment/privatization of four of the five publicly owned banks, Habib Bank Limited[17], United Bank Limited[18], Muslim Commercial Bank and Allied Bank, and Bankers Equity Limited. Similarly, with privatization of firms in the telecom sector, teledensity[19] increased from 2.8 percent in 2001 to 89.5 percent in 2022, with the number of cellular subscribers growing from 2.4 million in FY2003 to 195 million. Revenues also increased from PKR19.8 billion in FY2003 to PKR644 billion in FY2021, while the industry contributed over PKR228 billion to national revenues for various taxes in FY2021 and attracted huge foreign direct investment.[20]

Key factors leading to unsuccessful privatization efforts include economic volatility, judicial activism, litigation, weak political commitment, and perception of corruption post 2007. *First,* ideologue in some of the mainstream political parties did not support privatization, and preferred the Government-approved Benazir Employees Stock Option Scheme (BESOS) offering 12 percent shares to the employees of 80 SOEs in 2009.[21] *Second,* the general perception of privatization was negative among civil society because of elite capture, resultant unemployment, and social unrest despite a stringent legal framework for privatization. *Third,* judicial decisions in the Pakistan Steel Mills privatization[22] and Reko Diq mining contract[23] cases badly hurt Pakistan's image as an untrustworthy country where international contracts are not honored. *Fourth,* Pakistan's failure in international arbitration in critical cases[24] deterred the key decision makers of the Government for further privatization or seeking foreign investment in the sector. Aversion to foreign investment was mainly due to the signing of generous bilateral investment treaties that maximized risk by accepting the jurisdiction of neoliberal investment forums without

[16] Privatization Commission of Pakistan, http://www.privatisation.gov.pk/Detail/NTU0ZjE1NGQtNmYzNC00NWZjLWIxZTEtYWMzMzliYzFhNzk4
[17] Aga Khan Fund for Economic Development
[18] Best way and Al Ayaan Groups
[19] Availability of both landline and cellular phones per 100 persons in a specified geographical area
[20] https://www.pta.gov.pk/en/telecom-indicators accessed on 14 August, 2022
[21] The Supreme Court of Pakistan declared BESOS unconstitutional since it was in breach of Article 154 of the Constitution in October 2020.
[22] The Supreme Court of Pakistan declared the privatization of Pakistan Steel Mills null and void in 2006."
[23] The Supreme Court of Pakistan declared in 2013 that "the Chagai Hills Exploration Joint Venture Agreement dated 23.07.1993 is held to have been executed contrary to the provisions of the Mineral Development Act, 1948, the Mining Concession Rules, 1970 framed thereunder, the Contract Act, 1872, the Transfer of Property Act, 1882, etc., and is even otherwise not valid, therefore, the same is declared to be illegal, void and non est."
[24] Reko Diq and Karakey Rental Power

consideration or limiting the state's exposure. Invocation of sovereign guarantees by the independent power producers for non-payment of dues by the government quite frequently posed yet another challenge. *Fifth,* the incorporation of Sarmaya-e-Pakistan Limited (SPL) in 2019, a holding company, mandated to take management control of all SOEs and revamp or privatize them further delayed the process. However, the SPL never took off.

In addition to the above, efforts to privatize power sector distribution companies remained unsuccessful because of resistance from trade unions and vested interests, fear of private sector monopolies, circular debt, and management issues. The Government sold 73 percent of its shares in the Karachi Electric Supply Company (K-Electric) in 2005 to a conglomerate that guaranteed professional management, new investment, technology, and employment benefits (Box 4.2). However, even after privatization, tariff hikes, local security and city planning issues, regulatory bottlenecks, and segmented load shedding resulted in public demonstrations against K-Electric. Questions were raised regarding the benefits of further privatization of distribution companies in their current state. The Government made another attempt to privatize distribution companies in 2012 but had to pause due to labor unions strikes. A third attempt was made in 2015 to privatize FESCO, LESCO, and IESCO[25] but the Senate of Pakistan opposed it and suggested privatizing the loss-making entities first before privatizing profitable entities.[26]

In the absence of a competitive electricity market in Pakistan, an effective regulatory regime, and contract enforcement, the privatization of DISCOs[27] may not reap its full benefit. SOEs in the power sector presently are state monopolies. There is also organizational resistance to privatization because of the potential loss of rent-seeking opportunities. Non-resolution of the circular debt, gap between cash inflows from DISCOs and outflows to power suppliers on a sustainable basis has also undermined the privatization process**.** The reasons are: weak governance, political appointees in the boards and the regulator, government directives, technical, operational, and commercial inefficiencies and leakages, a tariff-determination framework and tariff-differential subsidy regime, and lack of sufficient incentives for the DISCOs to improve their financial and operating performance as they are regularly bailed out by the government.

For privatization programs to proceed successfully, it is important to:

1. take necessary measures for political and macroeconomic stability and signal strong political commitment to the privatization agenda;
2. build a broad-based coalition of change underlining the structural challenges in the economy and the need for privatization;
3. revamp the Privatization Commission with able professionals who can prepare a financial model for each entity to be privatized;
4. ensure that privatization would promote efficiency and competition in the relevant sub-sector of the economy rather than resulting in private-sector monopolies and cartelization that would require strengthening the regulatory bodies to protect the general public. The Competition Commission of Pakistan will need to be equipped with powers such that an appeal against its decisions will only be entertained after depositing the penalty amount;
5. ensure necessary safeguards to make the entire privatization process more transparent to avoid a repeat of the observations made by the Supreme Court of Pakistan;
6. further strengthen parliamentary oversight of privatization by constituting a Special Joint Committee of the Parliament reviewing the process;

[25] FESCO - Faisalabad Electric Supply Company, LESCO - Lahore Electricity Supply Company, IESCO - Islamabad Electric Supply Company

[26] https://senate.gov.pk/en/news_content.php?id=4401, https://www.thenews.com.pk/print/13989-senate-opposes-indiscriminate-privatisation

[27] Ten electricity distribution companies (DISCOs) were formed as part of the unbundling of Water and Power Development Authority (WAPDA) in 1998. They buy electricity from Central Power Purchasing Agency Guarantee Limited (CPPA-G) and sell it to their respective area customers. All companies are owned by the Government of Pakistan except for K-Electric, which was privatized in 2005.

7. guarantee the necessary safeguards to mitigate social impact and costs (the displacement of workers would add to the already high unemployment rate) of privatization as done in cases of successful privatization;
8. make public offering of SOEs shares, which is the easiest way to gradually move toward divestment and ultimately privatization or awarding management concessionaire. This model worked successfully in the banking and telecommunication sector.
9. (a) restructure power sector entities (DISCOs), especially loss-making DISCOs, in terms of financial health and rationalizing human resource; (b) award a management concessionaire to the private sector while ensuring that it does not lead to concentration of assets in few hands thus creating private sector monopolies; (c) gradual divestment of government shares by the public offering of shares of DISCOs while safeguarding procedural and process transparency; and (d) finally, phase out government shares. This will require an effective regulatory framework to promote efficiency, investment to improve service delivery, and competition.
10. re-enact and enforce laws for punitive actions against the Pakistan Electricity Act, 1910; both India and Bangladesh legislated new laws in 2003 and 2012, respectively, to deal with the power sector.

The National Assembly has passed the Inter-Governmental Commercial Transactions[28] Act, 2022 on 15 August, 2022 whereby the Government can offer shares of SOEs to foreign governments. It may possibly lead to litigation and raise questions about transparency and full disclosure and may slow down the process further.

Box 4.2: The K-Electric Privatization Experience

Since its privatization in 2005, K-Electric (formerly KESC) has experienced significant improvements in its performance and profitability. Prior to privatization, the company faced financial losses and relied on annual operational subsidies from the Government. Following privatization, K-Electric made substantial investments and achieved profitability in 2012 after 17 years of losses. This privatization has resulted in savings of PKR 900 billion for consumers and the government. Targeted investment across the power value chain have led to significant improvements in generation efficiency and a reduction in transmission and distribution losses.

The new management then implemented work force optimization processes and invested over USD 4.4 billion across the value chain, resulting in improved operational efficiency. Aggregate Technical and Commercial (AT&C) losses decreased from 43 percent in 2009 to 21 percent in 2023, and Transmission and Distribution (T&D) losses decreased from 35 percent in 2009 to 15.3 percent in 2023. The company prioritized digitization and customer centricity, leading to transparent billing system, improved customer service and digital connectivity for over 1 million of its 3.5 million customers.

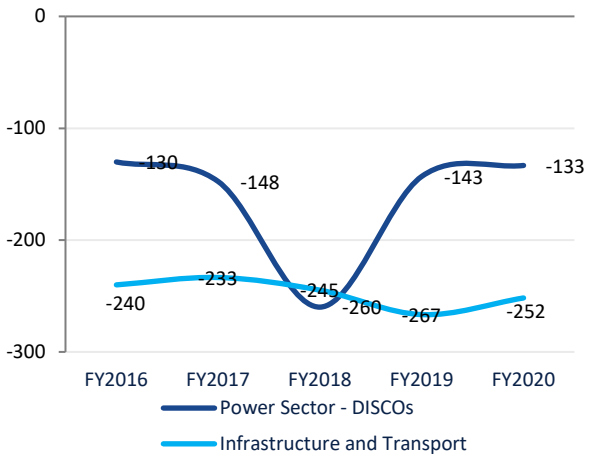
Despite these operational improvements, K-Electric faced challenges over FY2017-23. The lack of a cost reflective Multi Year Tariff (MYT) significantly impacted the company's financial performance. Additionally, high generation costs due to the non-supply of indigenous gas, accumulation of receivables from government entities, and delays in regulatory approvals posed further challenges. As a result, K-Electric's average return on equity remained below other private industry players in the power generation segment, and the company was unable to pay dividends since privatization.

To improve further privatization efforts in energy sector, it is recommended to ensure equitable terms and conditions for investors and the government, maintain consistency in regulatory and policy regimes, and establish a viable tariff setting. Capacity building of regulators and the establishment of a privatization ecosystem are also crucial, along with mechanisms to expedite the approval process for critical items in the sector.

Source: K-Electric

[28] "commercial transaction" is to include sale, purchase, investment, divestment, procurement, licensing & lease, joint ventures, assignments, concessions, services contracts, management contracts or such other mode of business transactions arising out of a Government to Government agreement or a commercial agreement. The jurisdiction of the Courts has been barred.

Figure 4.13: Net Profit – Power, Infrastructure and Transport SOEs
(PKR Billion)



Source: Database of SOEs, Ministry of Finance.

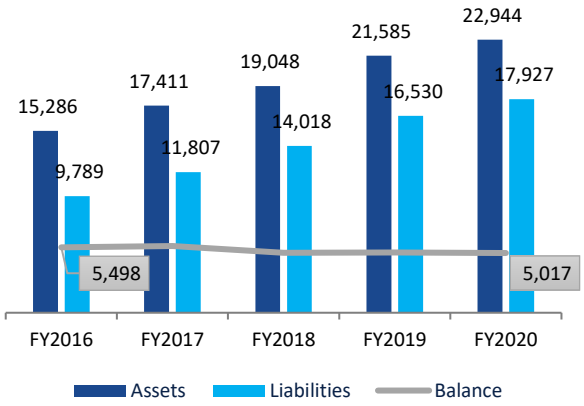
Delays in adjustments to tariffs set by the Government is a major factor for SOEs losses in the power sector. Power sector SOEs, with losses of 0.3 percent of GDP in FY20, face challenges to their financial performance due to sectoral characteristics, such as their dependence on imported fuels, rigid government administered tariffs, under-payment of consumer electricity bills, electricity theft, and transmission and distributional losses. More broadly, these challenges can be categorized into (i) delays in tariff adjustments; and (ii) inefficient operations of the electricity distribution network. In FY18, the 10 DISCOs reported an increase in losses by over 60 percent because the tariff was not adjusted (Figure 4.13).[29] Moreover, subsidy funding for the tariff differential can be delayed, leading to cashflow shortfalls and electricity supply disruptions among the DISCOs. As part of the tariff reform strategy, the Government has categorized residential electricity consumers into those who consume less and need to be subsidized ("protected" category) and those who are not eligible for subsidy ("unprotected" category). In addition, newer consumption slabs have been introduced to implement a progressive residential tariff based on consumption.[30]

Consistently failed reforms in the transport and infrastructure sectors have resulted in poor operating margins, high debt-servicing costs, as well as an annual bailout to save these SOEs from default. SOEs in the transport and infrastructure sectors have consistently reported losses amounting to 0.5 percent of GDP in FY20. The key loss-making entities in the transport and infrastructure sector are: (i) Pakistan Railways,[31] (ii) PIACL and (iii) the NHA, a federal authority responsible for constructing roads across the country. The Government considers the NHA as an operational arm for implementing road and highway infrastructure projects. In many cases, it undertakes development projects based on national priorities, rather than economic feasibility. For example, the NHA has been directed to undertake sizeable reconstruction of the roads and highways damaged by the 2022 floods, which affected the provinces of Sindh, Balochistan, and Khyber Pakhtunkhwa.[32] The NHA is not able to finance development projects from its own resources, nor generate sufficient funds from the tolls (regulated by the Government) to repay its loans.[33] Furthermore, the NHA's profitability is impacted by high debt service cost as the foreign re-lent and government development funds are treated as loans/liabilities owed by NHA in the Government and NHA financial statements.

[29] Tariff adjustments can take the form of changes in the base tariff, monthly fuel price adjustments, quarterly adjustments and/or annual adjustments.
[30] Policy guidelines for re-targeting subsidies in future, Ministry of Energy https://nepra.org.pk/Admission%20Notices/2021/07%20July/Policy%20guidelines%20of%20MoE.PDF
[31] Where losses are picked up by the Government through an annual grant and hence, the Railways do not have accumulated losses.
[32] Press release: 27 July 2022, National Highway Authority (NHA) https://nha.gov.pk/uploads/topics/16589804588548.pdf
[33] The MoF recognizes the need to manage the fiscal risk emanating from the NHA and plans to improve its operational performance.

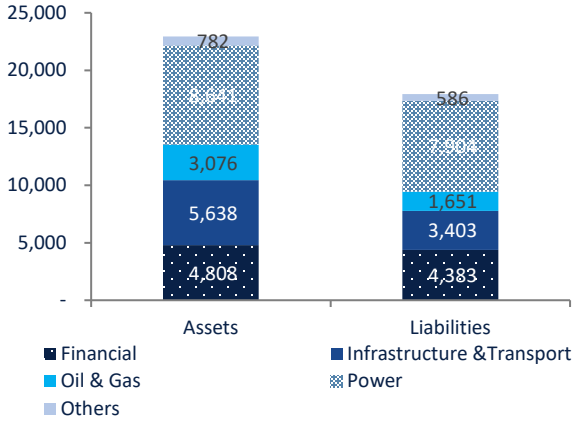
The aggregate balance sheet of the SOE portfolio remained positive over FY16-20, although liabilities have been growing faster than assets (Figure 4.14). Energy sector SOEs have the largest asset base, with 51 percent of total SOE assets in FY20. However, they also have the largest liabilities (47 percent of the total), followed by the infrastructure and transport sector, with 33.5 percent of total assets and 20 percent of the liabilities. They are followed by the financial SOEs, with 28.6 percent of total assets and 26 percent of the liabilities (Figure 4.15).

Figure 4.14: SOE Aggregate Assets and Liabilities
(PKR billion)



Source: Database of SOEs, Ministry of Finance.

Figure 4.15: Assets and Liabilities by Sector in FY2020
(PKR billion)



Source: Database of SOEs, Ministry of Finance.

Commercial SOEs have a combined asset base of PKR 22,944 billion (48 percent of GDP) in FY20, accounting for over 99 percent of the total SOE assets. The commercial SOE assets have grown by an average of 10 percent in the past 5 years, with assets in the power sector seeing the highest growth. However, this growth in power sector assets is partly attributable to the accumulation of receivables, that is, the non-payment of electricity bills, rather than capital infrastructure. Table 4.4 shows the 10 SOEs with the highest asset bases.

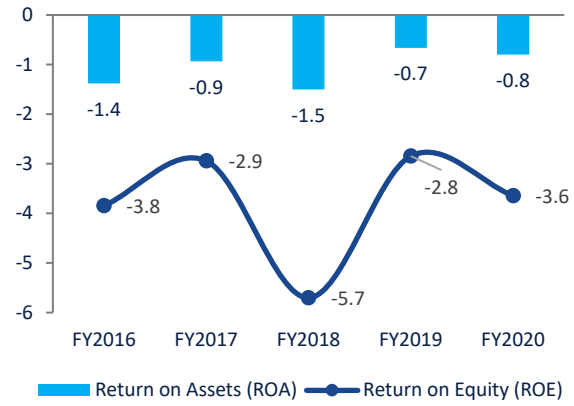
Table 4.4: Top 10 SOEs by Net Assets, FY 2020

No	Name of SOEs	Incorporation type	Net assets (% of GDP)
1	NHA	Special Enactment	4.46
2	Water and Power Development Authority	Special Enactment	3.12
3	Oil and Gas Development Company Limited	Companies Act	1.45
4	Pakistan Petroleum Limited	Companies Act	0.72
5	Pakistan Railways	Special Enactment	0.61
6	National Bank of Pakistan	Special Enactment	0.56
7	National Power Parks Management Company	Companies Act	0.35
8	National Transmission and Dispatch Company	Companies Act	0.34
9	Pakistan Steel Mills Corporation (Private) Limited	Companies Act	0.34
10	Karachi Port Trust	Special Enactment	0.32

Source: Database of SOEs, Ministry of Finance.

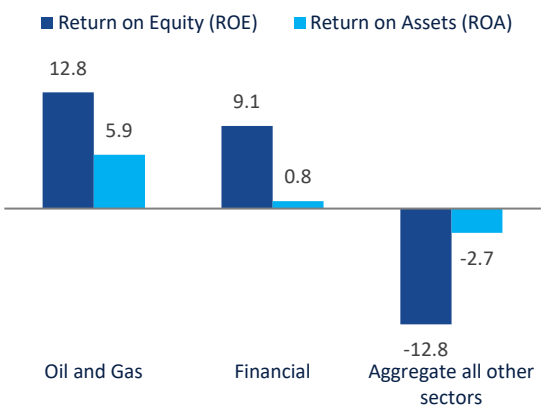
Returns on equity and on assets similarly show the poor profitability of the federal commercial SOE portfolio. The SOE portfolio also performs poorly based other common metrics of profitability. The return on equity (ROE) measures how effectively the company management has used investor funds, whereas the return on assets (ROA) considers how well management is using both equity and debt. The total commercial portfolio has consistently generated negative returns on both equity and assets since FY16 (Figure 4.16). Only the oil and gas and the financial sectors saw positive ROEs and ROAs in FY20 (Figure 4.17). Returns on the rest of the SOE portfolio are predominantly due to negative returns in the power, transport, and infrastructure sectors, despite the high asset base in these sectors.

Figure 4.16: Average Return on Equity and Return on Assets (%)



Source: Database of SOEs, Ministry of Finance.

Figure 4.17: Profitability Ratios by Major Sectors FY2020 (%)

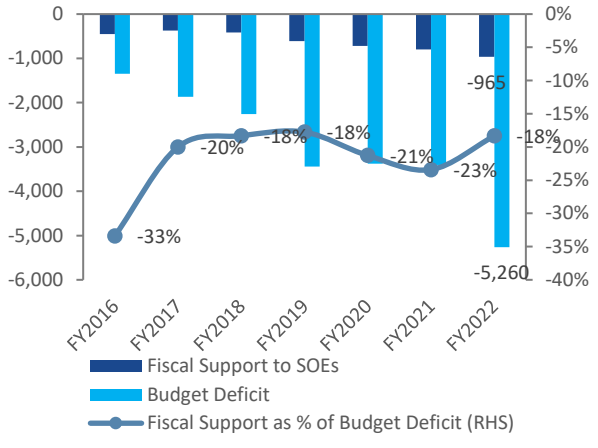


Source: Database of SOEs, Ministry of Finance.

4.4 Fiscal Costs and Risks from SOEs

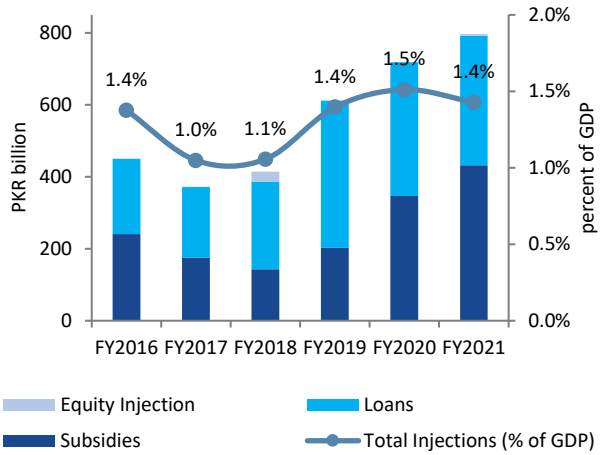
4.4.1 Fiscal costs

Figure 4.18: Fiscal Support to SOEs vs Fiscal Deficit
(PKR billion, % of budget deficit)



Source: Database of SOEs, Ministry of Finance.

Figure 4.19: Direct Fiscal Support to SOEs
(PKR billion, % of GDP)



Source: Database of SOEs, Ministry of Finance.

Direct government support to federal commercial SOEs has been growing in recent years. Direct government support to SOEs in the form of subsidies, loans, and equity investments accounted for 18

percent of the budget deficit in FY22 (Figure 4.18) and 1.4 percent of GDP in FY21 (Figure 4.19). Such direct support was for various reasons, such as providing price support, bailouts from creditors, subsidized service, divestment, or undertaking new development projects. Subsidies are typically for current activities, including those for specific public service obligations. Grants and loans are approved annually by the Federal Government for operational support and capital investment. Direct equity injections have been negligible in recent years.

Direct support to SOEs have been exceeding their financial contributions. Net inflows from federal commercial SOEs to the federal government budget were negative, averaging 0.9 percent of GDP over FY16–21 (Table 4.5). Revenues remitted by the SOEs in the form of taxes and dividends, which averaged 0.4 percent of GDP over the period, was significantly lower than government direct transfers to the SOEs, which averaged 1.3 percent.

Table 4.5: Transactions between the Government and Federal Commercial SOEs

(PKR billion)

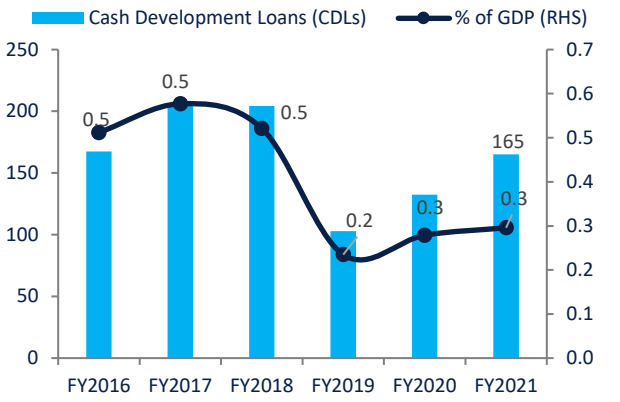
	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
Fiscal Outflows to SOEs						
Subsidies and Grants*	241	175	143	203	347	432
Equity Injection	1	2	27	-	-	5
Domestic Loans	168	205	204	103	133	165
*Foreign Re-lent Loans***	41	-9	39	306	239	195
Total Outflows	**451**	**373**	**414**	**612**	**719**	**797**
Total Outflows (% of GDP)	**1.4**	**1.0**	**1.1**	**1.4**	**1.5**	**1.4**
Fiscal Inflows from SOEs						
Dividend Payments	63	70	57	60	41	44
Corporate Tax – Aggregate	77	108	127	154	135	Not available
Interest on Domestic Loans	Not available	Not available	Not available	Not available	23	16
*Interest on Foreign Re-lent Loans****	Not available	Not available	Not available	Not available	22	10
Total Inflows	**141**	**177**	**184**	**214**	**220**	**70**
Total Inflows (% of GDP)	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**	**0.1**
Net Inflows (% of GDP)	**-0.9**	**-0.6**	**-0.6**	**-0.9**	**-1.0**	**-1.3**

Source: Database of SOEs, Ministry of Finance; State Bank of Pakistan; and Author's estimate.
Note: The interest inflows are based on the actual recovery of interest from SOEs. The total interest accrued is much higher.
*The payments made to Pakistan Railways are classified as grants in the annual budget. These have been presented together with subsidies due to the nature of the transaction.
**Foreign re-lent loans are estimated based on changes in annual stock (includes any loan repayments made during the years).
***Exchange Rate Coverage (ERC) fee has not been included here.

Government domestic loans to federal SOEs were substantial, averaging 0.4 percent of GDP annually and accounting for about a third of direct support over FY16–21 (Figure 4.20). The loans supported SOEs with cash to pay short-term liabilities and/or undertake new development projects. The loans were typically issued as Cash Development Loans (CDLs). CDLs are concessional loans with long tenures. However, SOEs have not been current on their payments on the loans, and only 4 percent of the overdue interest was received in FY21.

Figure 4.20: Domestic Loans Disbursement

(PKR billion, % of GDP)

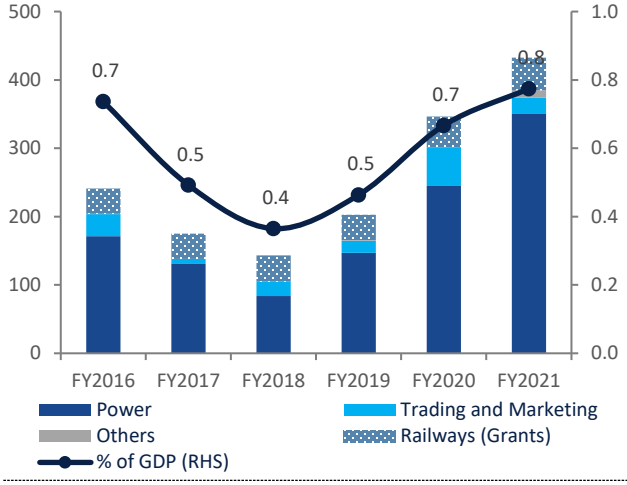


Source: Database of SOEs, Ministry of Finance.

Foreign loans contracted by the Government are re-lent to SOEs, primarily to undertake infrastructure projects. The issuance of re-lent loans has averaged 0.3 percent of GDP annually since FY16. The original contractual obligation for the repayment of principal and interest lies with the Federal Government, whereas the terms for foreign relending to SOEs change in accordance with policy directives periodically issued by the Ministry of Economic Affairs.[34] For instance, the NTDC currently has outstanding foreign re-lent loans amounting to PKR 101 billion, from various international development agencies for undertaking various high-voltage transmission line projects.

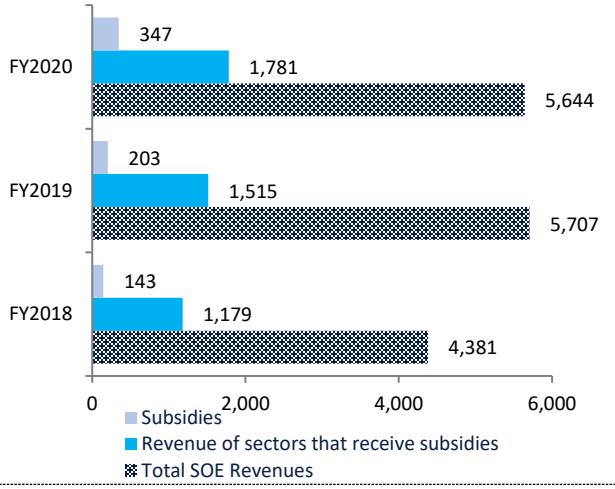
Subsidies and grants are the dominant forms of government direct support to the SOEs. Government subsidies and grants to SOEs averaged 0.6 percent of GDP, accounting for nearly half of government direct support to SOEs over FY16–21 (Figure 4.21). Subsidies to SOEs have been rising since FY18. Government subsidies constituted 19.4 percent of revenue for sectors that receive subsidies and accounted for 6.1 percent of total SOE revenues (Figure 4.22). In FY22, subsidies surged to 1.8 percent of GDP, with over 75 percent of all subsidies going to electricity DISCOs (see Figure 4.25 and Figure 4.26). Most subsidies were for SOEs in the power (DISCOs) and trading sectors (food security) to compensate them for their public service obligations, that is, for providing services at below-market prices. Subsidies are paid to DISCOs largely to account for the tariff differential subsidy (TDS), that is, the difference between the tariffs approved by the National Electric Power Regulatory Authority (NEPRA) and the tariffs set by the Government to be charged to consumers. The subsidies in the trade and marketing sector are provided to the Trading Corporation of Pakistan (TCP), utility stores corporation, and the Pakistan Agriculture Storage and Services Corporation (PASSCO) to ensure food security and subsidizing essential food items during the Islamic month of Ramadan. In contrast, Pakistan Railways received annual grants around 0.1 percent of GDP to cover the recurrent operational losses.[35]

Figure 4.21: Subsidies and grants to SOEs by sector
(PKR billion, % of GDP)



Source: Database of SOEs, Ministry of Finance.

Figure 4.22: Share of Subsidies in Revenues of SOEs
(PKR billion)



Source: Database of SOEs, Ministry of Finance.

[34] Office Memorandum, Policy for Relending of Foreign loans 2020, Ministry of Economic Affairs. The re-lending mark-up rates are usually higher relative to the original mark-up liability of the Government. This is because the repayment of such loans is denominated in PKRs, and an Exchange Rate Coverage (ERC) fee is charged on these loans to cover the exchange rate risk to the Government.

[35] The Railways operate on cash-based accounting, whereby the losses are not accrued on the balance sheet. Instead, they are paid for annually by the Government as grants.

4.4.2 Fiscal risks

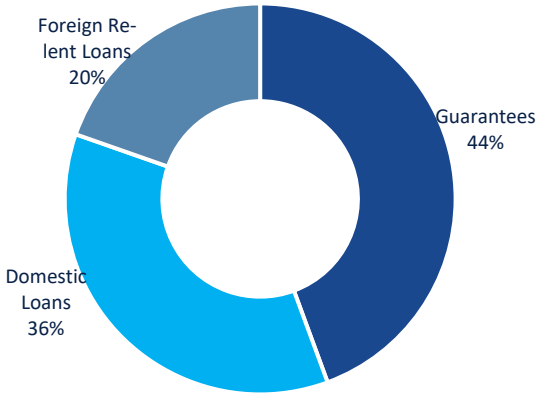
Fiscal risk arising from fiscal exposure to federal commercial SOEs has been rapidly increasing and has become substantial in FY21, at nearly 10 percent of GDP.[36] The combined fiscal exposure against domestic and foreign loans and guarantees[37] has been increasing rapidly with annual growth averaging 42.9 percent over FY16–21 (Table 4.6). However, the MoF may require detailed risk assessments of key SOEs to have an accurate assessment of the risk undertaken by the Government on account of contingent exposure that may arise from guarantees. The available data show that guarantees constituted the bulk of fiscal exposure, at 44.4 percent of total exposure in FY21, while CDLs and foreign loans accounted for 36.0 percent and 19.6 percent of exposure, respectively (Figure 4.23).

Table 4.6: Fiscal Exposure of the Government against SOE Support
(PKR billions)

	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
Outstanding Loans and Guarantees						
Guarantees	721	937	1,236	1,969	2,344	2,407
Domestic – CDLs	Not available	Not available	Not available	Not available	1,733	1,951
Foreign Re-lent Loans	294	285	325	631	870	1,065
Total Exposure	**1,015**	**1,222**	**1,561**	**2,600**	**4,946**	**5,422**
Total Exposure (% of GDP)	**3.1**	**3.4**	**4.0**	**5.9**	**10.4**	**9.7**

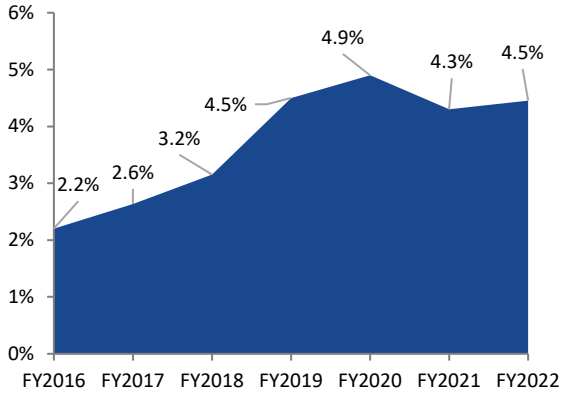
Source: Pakistan's External debt and liabilities, State Bank of Pakistan; Debt Bulletin FY22, Ministry of Finance; Details of CDLs obtained from the Ministry of Finance.

Figure 4.23: Explicit Fiscal Exposure by Type FY2021
(% share)



Source: Pakistan's External debt and liabilities, State Bank of Pakistan; Debt Bulletin FY2022, Ministry of Finance; Details of CDLs obtained from the Ministry of Finance.

Figure 4.24: Outstanding Guarantees to SOEs
(% share)



Source: Public Debt Bulletin FY2021, Ministry of Finance.

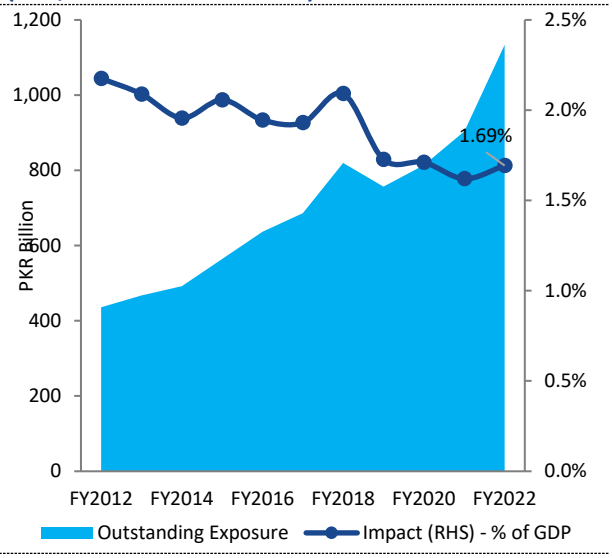
[36] Federal government fiscal exposure to SOEs comprises the stock of outstanding domestic and foreign loans and guarantees to SOEs. These instruments are included because they can negatively impact the federal government's balance sheet if the loans are not repaid and need to be written off or if guarantees become realized turning into an explicit fiscal outflow. Fiscal support in the form of subsidies, grants, and equity injections are not included in fiscal exposure as these instruments are not assets on the balance sheet of the Federal Government because they are not expected to be repaid.

[37] Guarantees, when not realized, are not explicit fiscal outflows; rather, they are an assurance on behalf of SOEs for them to borrow from commercial banks, and the Government assumes the repayment liability if the SOEs do not repay the loan. For the purposes of this report, only guarantees, where the government has a contractual or contingent obligation for repayment, is considered as fiscal exposure.

The stock of outstanding government guarantees to SOEs has more than doubled since FY16. Government guarantees are aimed at supporting the SOEs to borrow money, usually on favorable terms, from commercial banks. In addition, government guarantees can be preconditions for the approval of concessional loans for SOEs from bilateral or multilateral agencies. Over 75 percent of the stock of guarantees is against the power sector for financing the circular debt. The stock of outstanding guarantees from the Federal Government to federal commercial SOEs has increased from 2.2 percent of GDP in FY16 to 4.5 percent of GDP in FY22 (Figure 4.24). Annual issuance of total new government guarantees[38] has been averaging 0.8 percent of GDP over the FY16–21 period and below the ceiling of 2 percent of GDP stipulated by the Fiscal Responsibility and Debt Limitation Act 2005 (FRDLA). In addition, the FRDLA Amendment Act of 2022 mandates that the stock of outstanding government guarantees be capped at 10 percent of GDP.[39] The stock of outstanding guarantees, currently at 4.5 percent of GDP, is below the regulatory threshold.

Guarantees for commodity financing operations[40] should be included in the stock of outstanding guarantees governed by the FRDLA. Commodity financing is typically secured through an asset or commodity hypothecation along with a government guarantee.[41] Government guarantees issued to the SOEs, such as TCP and PASSCO, for such commodity operations stood at 1.7 percent of GDP in FY22, slightly lower than the annual average of 1.9 percent of GDP since FY12 (Figure 4.25). Guaranteed loans against commodity financing operations are a source of fiscal exposure and risk and should be included in the guarantees reported in the Public Debt Bulletin of the MoF and governed by the FRDLA.[42] The stock of all outstanding guarantees would increase to 6.2 percent of GDP, more than a third higher, if commodity operations guarantees are fully accounted for.[43]

Figure 4.25: Commodity financing (PKR, billions and % of GDP)



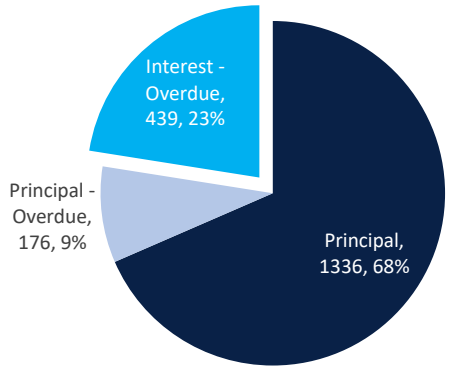
Source: Ministry of Finance

Preferential access to loan financing for SOEs is likely to crowd out financing to the private sector. Based on their financial statements, loss-making SOEs are unable to secure large loans from commercial banks without government-backed guarantees. These guarantees significantly improve their risk profile, affording these SOEs preferential financing access. This access, however, creates a disparity with other

[38] Any rollover of existing guarantees will count as a new guarantee.
[39] FRDLA Amendment Act of 2022, https://finance.gov.pk/publications/frdla2005_amended_2022.pdf. The Act also mentions that guarantees will be rated at risk-weighted values for the purpose of measuring the utilization of the limit. However, the risk-weighted method has not been clarified in the Act.
[40] Commodity Operations refers to operations for off-loading commodities (such as wheat) every season, where the SOEs and other provincial agencies procure commodities for consumption and reserves. The SOEs include the Trading Corporation of Pakistan (TCP) and the Pakistan Agriculture Storage and Services Corporation (PASSCO).
[41] Annex-V – Contingent Liabilities, Economic Survey of Pakistan 2016–17, Ministry of Finance.
[42] In addition, these guaranteed backed loans should be retired every season when the commodities are offloaded or added to strategic reserves. However, this is not the case and these loans continues for various other reasons, such as holding strategic commodity reserves, price stabilization objectives of various commodities, and volumes.
[43] In FY2022, commodity guarantees amounted to 1.7 percent of GDP, while other guarantees added to 4.5 percent of GDP, leading total guarantees to be 6.2 percent of GDP.

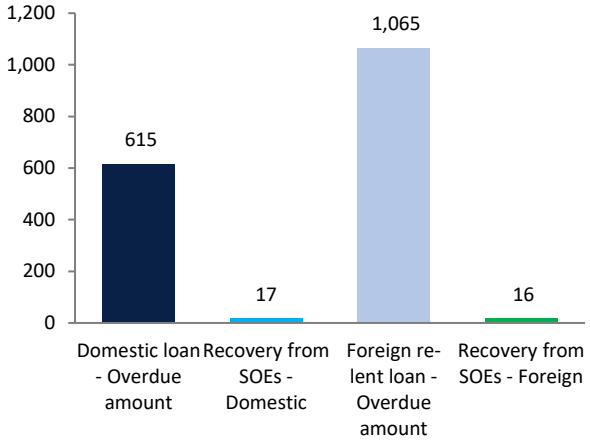
firms, which will have less ready access to credit. Government guarantees to SOEs, therefore, creates distortions in the financial sector that are likely to crowd out bank financing to the private sector.

Figure 4.26: Domestic Loans, Outstanding Amount as of FY2021 (PKR billion, % share)



Source: Details of CDLs, Ministry of Finance.

Figure 4.27: Loan Recovery from SOEs (PKR billion)



Source: Details of CDLs, Ministry of Finance; Foreign loan details, Economic Affairs Division.

Guarantees to SOEs should be issued only if the SOEs have an identified revenue stream that can be pre-committed for loan repayment. Out of the stock of outstanding domestic loans to federal commercial SOEs in FY21, overdue principal and interest payments accounted for more than 30 percent (Figure 4.26), indicating a poor track record for loan repayments by SOEs. In the same year, SOEs only paid PKR 17 billion, equivalent to 2.8 percent of the total overdue domestic loan amount of PKR 612 billion. Similarly, SOEs only repaid PKR 16 billion, or 1.5 percent of the stock of overdue foreign re-lent loans (Figure 4.27). Many SOEs are the beneficiaries of government guarantees but do not have a financially viable means to repay the guaranteed loans. For example, the NHA accounts for nearly 75 percent of the total domestic loans and is unable to generate sufficiently large revenues to cover the repayment of domestic loans.[44] In view of the poor loan repayment track record of SOEs and to minimize contingent liabilities and hence fiscal risks to the Federal Government, guarantees should only be issued if SOEs have an identified pathway for the timely repayment of the loans.

4.4.3 Fiscal Impact of the top loss-making SOEs identified in SOE Triage, Ministry of Finance

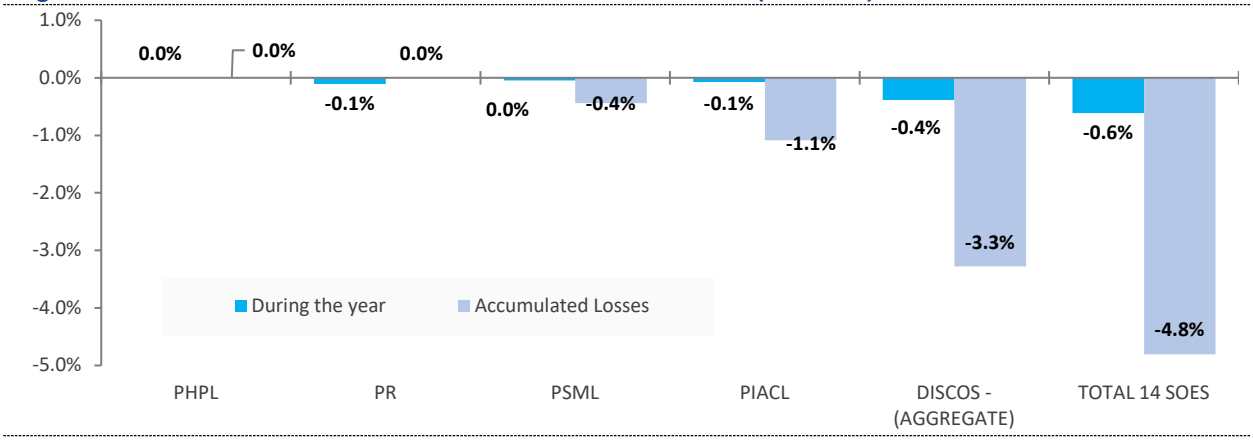
The MoF has embarked on a reform process with the support of the IMF, the World Bank, and the Asian Development Bank—to improve the performance and governance of the SOE sector. A triage exercise to examine the functions and financial performance of individual SOEs was undertaken in 2020–21 to identify the SOEs that should be privatized, restructured, and retained by the Federal Government.[45]

As noted, SOEs with the largest losses are predominantly from the transport and power sectors. The top loss-making federal commercial SOEs are either planned to be privatized or retained and restructured

[44] Cash Development Loans (CDLs) data, Ministry of Finance
[45] Government of Pakistan (2021). "State-Owned Enterprises Triage: Reforms and Way Forward 2021." Ministry of Finance.

in the Triage exercise, except for NHA.[46] These top loss-making SOEs cover 55 percent of the total annual SOE losses in FY 2020 and together incurred an annual loss of 0.6 percent of GDP in FY20 and accumulated losses amounting to 4.8 percent of GDP (Figure 4.28). The losses, mostly in the power and transport sectors, have been persistent, and therefore have significant fiscal implications for the Federal Government. These SOEs include the ten electricity DISCOs, which account for the majority of the losses and fiscal support to SOEs. PSML has closed its operations but has yet to shut down and causes an annual fiscal drain in the form of grants and loans. The losses of the Pakistan Railways are covered by annual government grants. Lastly, the PHPL has benefited from substantial guarantees. Given their share of the fiscal impact, identifying channels to address the losses in these 14 SOEs can significantly alleviate pressures on the Federal Government budget.

Figure 4.28: Current and Accumulated Losses of 14 SOEs in FY2020 (% of GDP)



Source: Database of SOEs, Ministry of Finance.
Note: DISCOs= electricity distribution companies; PHPL= Power Holding Private Limited; PIACL= Pakistan International Airlines Corporation Limited; PSML= Pakistan Steel Mill Corporation Limited; PR= Pakistan Railways. PR does not follow the IFRS for preparing its financial data. Thus, there are no reported accumulated losses because of annual grants received against losses. FY21 data was not included due to unavailability of the annual audited financial statements.

The fiscal impact of SOEs is categorized into two groups (Table 4.7):

1. **Annual Fiscal Cost to the Government:** Annual direct budgetary outflows include annual subsidies, grants, equity injections, and domestic CDLs.[47] The annual fiscal outflows from the Federal Government to the 14 SOEs amounted to 0.8 percent of GDP in FY21, more than half of total government support to SOEs. The power sector accounts for three-fourths of the fiscal cost in the form of subsidies.
2. **Government Fiscal Exposure:** Fiscal exposure comprises the stock of liabilities due to the Government, including outstanding government guarantees (Local + Foreign currencies), CDLs,

[46] MoF excludes NHA from Triage exercise. The Government considers the NHA as an operational arm for implementing road and highway infrastructure projects. However, the NHA has the highest fiscal exposure among all SOEs, accounting for over 75 percent of the total outstanding loans, equivalent to 2.6 percent of GDP in FY21. It reported a loss of PKR 173 billion in FY20 (0.4 percent of GDP), and accumulated losses of 1.7 percent of GDP as of FY20. This exposure can be managed if the NHA is able to generate sufficient toll revenues to repay the loans, or at least to cover the interest costs. However, since the toll tax rate and the entity's business plan are set by the Government, the NHA has not been able to collect sufficient toll revenues and therefore has a large overdue interest payment liability.

[47] CDLs are provided to the NHA to carry out the Public Sector Development Plan (PSDP) projects. Although CDLs are typically issued for development work, they have been issued for working capital support in some instances.

and foreign loans (includes multilateral project loans). The total outstanding exposure of the 14 loss-making SOEs is 2.7 percent of GDP — mostly in the form of guarantees.

The Government has not yet developed an implementation plan to undertake Triage: Even after two years, the Government has not yet developed a plan to execute Triage outcomes. As noted in Table 4.7, the delay would continue to cause an annual outflow of approximately 0.8 percent of GDP and would increase fiscal risk for the Government. Conversely, implementation of the Triage could potentially result in 0.8 percent of GDP of annual fiscal savings.

Table 4.7: Fiscal Impact of top 14 loss-making SOEs identified for Reform in Triage, FY 2021

SOE		Annual Fiscal Cost		Fiscal Exposure**		
		Grants/ Subsidies	Loans disbursed*	Outstanding Loans	Outstanding Guarantees	Triage Outcome
Electricity DISCOs[48]	PKR Billion	350	-	69.4	-	Privatize in medium term
	% of GDP	0.6	-	0.12	-	
Pakistan International Airlines Corporation	PKR Billion	-	19	89	241	Retain and Restructure
	% of GDP	-	0.03	0.2	0.4	
Pakistan Steel Mills Corporation (Private) Limited	PKR Billion	-	38	128	-	Immediate Privatization
	% of GDP	-	0.07	0.2	-	
Pakistan Railways	PKR Billion	48	-	32	-	Retain and Restructure
	% of GDP	0.1	-	0.06	-	
Power Holding Private Limited	PKR Billion	-	-	-	930	Retain and Restructure
	% of GDP	-	-	-	1.7	
Total for 14 SOEs	PKR Billion	458		1,489		
	% of GDP	0.8		2.7		

Source: Details of CDLs, Ministry of Finance; Foreign loan details, Economic Affairs Division.
Note: Outstanding guarantees data from the Public Debt Bulletin of FY2021, Debt Wing, Ministry of Finance.
*Includes domestic loans only. **Exposure includes domestic and foreign re-lend loans.

4.5 Recommendations

Aligned with the analysis and findings discussed above, this section presents policy recommendations to reduce losses and improve the financial viability of federal commercial SOEs, and to better manage the adverse fiscal impact and risks stemming from SOEs onto the finances of the Federal Government. To address longstanding issues related to corporate governance of SOEs (Box 4.3), a few high-level recommendations for improving governance framework are also included.

[48] Electricity DISCOs include following 10 SOEs: Islamabad Electric Supply Company (IESCO), Lahore Electric Supply Company (LESCO), Faisalabad Electric Supply Company (FESCO), Gujranwala Electric Power Company (GEPCO), Multan Electric Power Company (MEPCO), Peshawar Electric Supply Company (PESCO), Tribal Electric Supply Company (TESCO), Sukkur Electric Power Company (SEPCO), Hyderabad Electric Supply Company (HESCO), and Quetta Electric Supply Company (QESCO).

A. Reducing the fiscal impact of SOEs. As part of its consolidation efforts, the Federal Government should consider reducing or eliminating the longstanding practice of covering SOE operating losses with transfers from the federal budget. It can do so by taking the following actions:

- With the Government's direct fiscal support to the 14 largest loss-making SOEs at 0.8 percent and support to all SOEs reaching 1.4 percent of GDP in FY21, the Government should subject all SOE financing requests to a more stringent review process, including submission of independently audited financial statements and credible business plans to reduce losses.
- Subsidies for electricity tariff differentials, that is, the difference between the tariffs that consumers face and the cost recovery tariff, should be revisited. The TDS is not an efficient instrument for reducing poverty as it is poorly targeted with most of the benefits accruing to the richer households (Chapter 2, Section 2.3). The Government should instead consider alternative means of supporting the poor, such as disbursements through the Benazir Income Support Programme (BISP), which are much better targeted.
- Other (non-electricity) subsidies to SOEs for ensuring food security and subsidizing the essential food items during month of Ramadan should be proportionate to the unit costs of providing the subsidized goods or service, with legally enforceable quantitative and qualitative indicators in SOEs' performance contracts. The conditions for the provision of such subsidies should be defined in the subsidiary legislation under the SOE Law.
- The enforcement of SOE loan agreements should be strengthened. Outstanding government domestic loans to SOEs stood at 3.5 percent of GDP in FY21, of which nearly a third was overdue. Loss-making SOEs may lack the means and intention to repay Government loans because there are no available funding streams and/or no direct consequences for not doing so. Loan repayment should be added as a key performance indicator for the Board of Directors. This will achieve the dual objectives of encouraging internal financial discipline and limiting requests for new loans.

B. Contain fiscal exposure from SOE support. The growing fiscal risk from the SOEs in the form of explicit and implicit obligations can be contained using the following measures:

- Given that the stock of guarantees has been increasing, it is recommended that further rules and regulations that are in line with international best practices be considered. Such rules could include requiring collateralizing SOE assets for commercial loans to limit government exposure through guarantees.
- The Government should consider measures to mitigate the credit risk arising from SOEs. One suggestion would be to mandate credit risk ratings for borrowing SOEs, which should be evaluated prior to the issuance of new CDLs by the Government. Similarly, new CDLs should not be considered for SOEs that are not current on their payments for existing loans and debt service charges.
- Guarantees for commodity financing operations should be regularly reported in the Public Debt Bulletin of the MoF and governed by the FRDLA.
- All commercial SOEs should follow the International Financial Reporting Standards (IFRS). The policy for fiscal risk management arising from the currency and interest rate fluctuations on the foreign re-lent to SOEs may be adapted. It should be regularly monitored and reported in the statement of the Federal Government fiscal risk assessment.

- Transparency regarding SOE debt should be improved. The fiscal risk statement of the Federal Government should have proper disclosure of SOE debt, including both explicitly guaranteed debt and implicit obligations. This is warranted to adequately monitor and manage fiscal risks.
- The Government should consider an institutionalized and computerized mechanism of generating timely aggregate reports on SOEs for more effective decision making. The comprehensiveness of these reports should also be improved following OECD guidelines. The reports should provide portfolio-level information and entity-level exposure and performance information to the decision makers. Further, it is essential to set up a centralized SOE database within the MoF.
- Mandate disclosures and develop monitoring procedures for implicit obligations to the Federal Government such as non-guaranteed loans, intra-SOE debts, and unfunded pension liabilities of SOE employees. For instance, some DISCOs have significant pension liabilities with inadequate pension funds.
- The Federal Government should improve the comprehensiveness of the Public Sector Financial Statement by incorporating into its balance sheet information such as the state holdings in SOEs, as well as the government's receivables from and payables to SOEs.
- The Government should develop a reform plan to reduce fiscal impact and contain fiscal exposure in the NHA. This can be done by implementing good management practices to generate profit, such as development of the business plan, costing of public service obligation, reclassification of domestic loans and prudent financial management practices, and improving accountability.

C. Undertake Triage. The Ministry of Finance (2021)[49] details the outcome of a government-led triage exercise that identifies the federal SOEs that should be retained and those that should be privatized or liquidated. The report classifies federal SOEs based on two main criteria: whether they are "strategic/essential," and whether they are financially viable. Strategic/essential SOEs that are not financially viable will need to be restructured, whereas the non-essential SOEs could be sold or liquidated. To undertake triage, the Government should:

a. Assess the restructuring cost and allocate a multi-year budget for the implementation of the Triage.
b. Develop a reform roadmap to improve performance and reduce the fiscal impact for the entities that will be retained and restructured.
c. Restructure and resize the SOEs by closing insolvent SOEs and restructuring inefficient but economically viable SOEs. Assess the possibility of divestment, where possible.
d. To improve the financial profile of SOEs earmarked for divestment, the Government may consider debt-to-equity swaps and convert long overdue CDLs into equity shares. As noted, certain SOEs are defaulting on principal and accrued interest payments to the Government. The debt-to-equity swap will improve the SOEs' financial standing and is a suggested option for the SOEs being planned for privatization under Triage, such as PSML.

D. Corporate Governance. Accelerate compliance with the SOE Law (2023) by prioritizing the finalization of the SOE ownership policy and the formulation of related rules and regulations. With the growing fiscal exposure of SOEs, the Government should accelerate the implementation of the SOE Law. It should also finalize and disseminate a state ownership policy to define the rationale for state ownership based on explicit criteria. These priority actions would in turn lay the ground for other important measures, such as the allocation of subsidies in line with these objectives and the state-aid rules; the incorporation of large public sector enterprises into corporates; the SOE dividend policy and criteria/rules set for preferential

[49] Ministry of Finance (2021). *State-Owned Enterprises Triage: Reforms and Way Forward.* Finance Division. March.

treatment, if any (tax, procurement, access to finance) for borrowing and competitive selection of board members of SOEs; the hiring of professional and independent board directors; and the development and utilization of an SOE performance monitoring and evaluation system.

Strengthen the capacity of the Central Monitoring Unit (CMU) as a central coordinating agency. To strengthen SOE oversight and ensure a clear separation of SOE ownership and regulatory functions, the Government should consider transferring the SOE oversight function from line ministries to the CMU. In order to fulfill the ambitious state-ownership coordinating role provided by the SOE Law, the recently established CMU needs to strengthen its capacity and acquire the economic, financial, and managerial resources and expertise to perform its tasks effectively. Developing the relevant tools and the pool of experts needed to monitor SOEs effectively will require technical assistance, training, as well as the exchange of international best practices.

Institutionalize performance monitoring for SOEs. SOE performance should be assessed on a quarterly basis. It should be supported by timely quarterly financial statements following international best-practice standards. This should include an evaluation against public policy and individual SOE objectives, as well as private sector comparators.

Define a financial reporting framework for SOEs created by special enactment. The Auditor General of Pakistan should define a financial reporting framework for SOEs created by special enactment. The application of accounting standards by SOEs differs, making it difficult to compare financial information across SOEs and over time. While PSCs[50] and some authorities, such as WAPDA, are applying IFRSs, others follow the cash basis of accounting (Pakistan Railways, Pakistan Post Office).

Box 4.3: Cooperate Governance of SOEs in Pakistan

SOE governance practices for Middle Eastern and Central Asian (ME&CA) countries indicated the potential for Pakistan to better align its corporate governance standards to high performers in the region, as well as to international best standards (IMF 2021)[51]. The assessment provided a comparison of the legal and institutional framework vis-à-vis the guidelines of the Organisation for Economic Co-operation and Development (OECD). Pakistan's overall corporate governance index is at par with the median ME&CA country, indicating that Pakistan has room to improve its governance measures, especially in the areas of financial oversight and fiscal and policy interactions.

The regulatory framework for SOEs has been progressively improving since 2013. The Corporate Governance (CG) Rules of 2013, issued by the Securities and Exchange Commission of Pakistan (SECP), initially applied only to Public Sector Companies (PSCs)[52]. However, an amendment in 2017 extended the applicability of the CG Rules to other SOEs, including the federal authorities.

Recently, the authorities embarked on a reform process—with the support of the IMF, the World Bank and the Asian Development Bank—to improve the performance and governance of the SOE sector. A triage exercise to examine the functions and financial performance of individual SOEs was undertaken in 2020–21. It sought to identify the SOEs that should be privatized, restructured or retained by the Federal Government.[53] In February

[50] PSCs are required to prepare financial statements as per IFRS as required by Companies Act 2017
[51] State-Owned Enterprises in Middle East, North Africa and Central Asia: Size, Costs, and Challenges 2021, International Monetary Fund (IMF)
[52] PSCs are state-owned enterprises registered under the Companies Act, 2017. The definition of a PSC is consistent with the international definition of a SOE, as mentioned in the OECD Corporate Governance of State-owned Enterprises Guidelines of 2015.
[53] Government of Pakistan (2021). "State-Owned Enterprises Triage: Reforms and Way Forward 2021." Ministry of Finance.

2023, the Government promulgated a new SOE Governance and Operations Law that defines the SOE governance framework.

Ownership and Oversight Function

The ownership model in place is fragmented, with blurred roles between line ministries and regulatory authorities in various sectors. Legal ownership of SOEs lies with the Government of Pakistan. However, in practice, the line ministries exercise the ownership and oversight function of the SOEs in their respective sectors, often by appointing their officials to the SOEs' Boards of Directors—despite regulatory requirements that mandate the appointment of independent board members.[54] This arrangement gives rise to conflicts of interest between, on one hand, line ministries' policy and regulatory functions, and on the other hand, their interests as *de facto* owners of the SOEs in their respective sectors. In some instances, the line ministry assumes the combined roles of regulator, owner, and main customer of a SOE. For example, the Ministry of Communications and the NHA; or the Ministry of Housing and Works and the National Construction Limited; or the Ministry of Energy and the power sector companies.

The SOE Governance and Operations Law (2023) aims to enhance the governance framework, management, and financial efficiency of SOEs, while limiting the fiscal risks stemming from their operations. The SOE Law lays the groundwork for a gradual move toward a more centralized model, whereby a newly created SOE unit in the Ministry of Finance (MoF), the Central Monitoring Unit (CMU), would assume the functions of SOE ownership and oversight. With respect to the selection of SOE board members, the Law proposes a "nomination committee" headed by the minister of the line ministry in charge of the SOE along with four other members.[55] Under this new model, the majority of the SOE board members would be independent directors, while the governance functions of the SOE would be separated from its management. Moreover, the SOE Law intends to separate the regulatory and policy-making functions of the Government with regard to its SOEs. The reforms proposed by the Law are also expected to strengthen the board's oversight of SOE operations, thus strengthening internal and external controls, as well as the reporting and disclosure standards. In this regard, the new SOE Law improves the financial reporting framework. The Law also requires the disclosure of non-financial information (for example, details of a Public Service Obligation Agreement) and the aggregate reporting on an annual basis, at a minimum. Under the new SOE Law, the board of each SOE will be expected to adopt a three-year business plan every financial year, including laying out targets, a strategic direction, and operational and financial performance measures. This business plan mandated by the new SOE Law is envisaged to serve as the performance agreement between the Government and the SOE.

Although the oversight of SOE performance has also improved, there is still no policy framework to set objectives and principles for the state ownership of SOEs. The absence of an ownership policy framework has perpetuated an *ad hoc* approach to the ownership and oversight functions, as opposed to a portfolio-based one. With regard to ownership policy reforms, SOEs will have to set company mandates through a publicly available statement of corporate intent. An ownership policy document, currently in draft form, will clarify the processes for developing a strategy, negotiating performance agreements, and determining the respective roles of all involved institutions.

Managing SOE Aggregate Reporting and Public Sector Financial Statements

Albeit with a considerable time lag, the MoF has been publishing extensive data concerning federal SOEs, which is essential for evidence-based decisions. The oversight functions of the Ministry of Finance have improved, with the publication of the "Federal Footprint—SOE Annual Report," which assesses the SOE portfolio risks in a more structured and transparent manner. The MoF has also compiled annual reports on SOEs covering financial indicators, board composition, and the workforce since FY 2012/13. However, these reports have been completed

[54] Sub-section 2, Section 3, *Public Sector Companies (Corporate Governance) Rules 2013* issued by the Securities and Exchange Commission of Pakistan (SECP) in 2013 and amended in 2017.
[55] These would include the secretary of the division in charge; the finance secretary or his/her nominee; and two private sector experts with at least 20 years of experience.

with a time lag of one to two years, which is too late to inform the annual budget process. The last SOE aggregate report was compiled and published for FY 2019.

The SOE-related fiscal information is scattered across multiple departments within the MoF and the Ministry of Economic Affairs. The line ministries and the MoF do not have readily available up-to-date data. The information on guarantees to SOEs is with the Debt Management Office at the MoF, whereas the SOE subsidies, domestic loans, equity, and dividend information is with the Corporate Finance (CF) Wing of the MoF. Further, the corporate tax information from financial statements is collected by the recently notified CMU at the MoF. Details of fiscal inflows, outflows, and outstanding fiscal exposure at the SOE level and aggregates should be compiled at regular intervals for reporting purposes. This would support better assessment of fiscal risks emanating from the SOE operations.

SOE information is not reflected in the public sector financial statements. Although aggregate reporting and public sector financial statements serve distinct purposes, they can complement each other to improve public reporting on SOEs. Aggregate reports draw on existing SOE financial statements. As such, they provide a useful summary of the financial situation of the sector. Moreover, aggregate reports can be extended to capture key information regarding the SOE's compliance with corporate governance; environmental, social and sustainability practices; fiscal risks; and the economic actions taken by the Government to manage and monitor the SOE portfolio. Such information can enrich the disclosures and explanatory notes to the public sector financial statements. In this context, the SOE information should be included in public sector financial statements.

Financial Accountability, Controls, and Transparency

Corporate governance of SOEs is weak, which may partly explain the performance of the SOE portfolio, which displays low productivity and efficiency levels.[56] Various governance assessments of the SOEs noted that internal audit functions lack capacity, and application of accounting and auditing standards are weak. In addition, financial reporting is riddled with numerous accounting exemptions that may have a significant bearing on the evaluation of the actual financial performance of the overall SOE sector. The timely availability and publication of the audited financial statements of the non-publicly listed SOEs remains a challenge. Although PSCs are expected to comply with IFRS, other SOEs such as agencies and autonomous bodies, including Pakistan Railways, have no defined financial reporting framework. The SOE Law provides a timeline for compliance with IFRS accounting standards. Finally, performance target-setting and evaluation seem to be lacking. This is due to the absence of an efficient performance monitoring system. These shortcomings have in turn brought about unanticipated fiscal risks from SOE operations.

[56] The IMF technical assistance was conducted in early 2020 in collaboration with the World Bank and the Asian Development Bank.

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Chapter 5

PAKISTAN FEDERAL PUBLIC EXPENDITURE REVIEW 2023

Enabling a Modern and Efficient Tax System

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PUBLIC EXPENDITURE REVIEW

Chapter 5: Enabling a Modern and Efficient Tax System

2023

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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

AMT	Alternative Minimum Tax
AMTI	AMT income
BISP	Benazir Income Support Programme
CIT	Corporate income tax
DPO	Development Policy Operation
FBR	Federal Board of Revenue
GDP	Gross Domestic Product
IMF	International Monetary Fund
LPG	Liquefied petroleum gas
PDL	Petroleum Development Levy
R&D	Research and Development
SBP	State Bank of Pakistan
SME	Small and medium-sized enterprises
SRO	Statutory Regulatory Orders
VAT	Value Added Tax

Chapter 5: Enabling a Modern and Efficient Tax System

5.1 Introduction

Pakistan's revenue collection is low by international standards. In FY21, the Federal Government only collected 12.4 percent of GDP in total and 11.2 percent of GDP in tax revenue, two percentage points less than the South Asian average for the same year. As federal revenues consistently fall short of expenditures, thus driving persistent budget deficits, strengthening tax revenue generation is key for Pakistan to return to a path of fiscal sustainability.

This chapter asks how tax expansion can be achieved and managed in an inclusive and economically efficient manner. Pakistan's tax system is complex with various special provisions, concessional rates, and unorthodox approaches to tax policy. Many of these policy choices were implemented to balance the provision of fiscal support to certain groups or industries – small manufacturing businesses, sugar producers, and many others – with the need to maintain a minimum level of revenue collection. This has resulted in a system with many vested interests and has come at the cost of economic efficiency and the ability to sustainably raise revenue to a level that can finance Pakistan's spending needs. There is no silver bullet to resolve this situation. Instead, policy makers will need to make hard choices by reducing exemptions, softening the blow through time-bound transition arrangements, and communicating clearly that a fiscally sustainable Pakistan is in the national and the public's interest.

In addition to the federal revenue sources discussed in this chapter, Pakistan also has the potential to increase collection from provincial sources, which highlighted in the literature. Pakistan's provinces are assigned three significant sources of revenue: sales tax on services (Box 5.5), agricultural income taxation and property taxation. The World Bank's and the IMF's respective tax policy reviews[1] have analyzed agricultural income taxation, and have highlighted the resulting fractionalization of the tax base[2] and the exceptionally low revenue performance,[3] despite the agricultural sector's substantial contribution to GDP. As a potential remedy, the reports suggest the introduction of a presumptive tax on agriculture based on land holding and productivity characteristics. Property taxation, which is a shared responsibility between provincial, district and town governments, has also been shown to suffer from low collection rates, driven by outdated valuation tables[4] that understate current market values and/or the potential income from property, especially for self-occupied property[5]. More recent academic literature on provincial property taxation has also highlighted the potential of appropriately incentivizing property tax collectors in raising revenue.[6]

[1] World Bank (2018). *Pakistan Tax System – Tax Policy Review*. IMF (2019). *Redesigning Pakistan's Tax System*. Fiscal Affairs Department Technical Report.
[2] The FBR estimates that the fractionalization of the tax base costs the Federal Government more than PKR 69 billion in foregone revenues in 2020. See Federal Bureau of Revenue (2020). *Tax Expenditure Report 2020*.
[3] Nasim, A. (2012). "Agricultural Income Taxation: Estimation of the Revenue Potential in Punjab." Pakistan Development Review. 51:4 Part II (Winter) pp. 321-337.
[4] With the support of the World Bank Resilient Institutions for a Sustainable Economy development policy operations, federal and provincial property valuations were recently adjusted higher to better reflect market valuations.
[5] World Bank (2017): "Annual Report 2016---17. Sindh Annex 6 – Property Tax Study", *Multi Donor Trust Fund for Accelerating Growth and Reforms*; World Bank (2018). *Pakistan Tax System – Tax Policy Review*.
[6] Khan, A. Q., Khwaja, A. I., & Olken, B. A. (2019). Making moves matter: Experimental evidence on incentivizing bureaucrats through performance-based postings. *American Economic Review*, 109 (1), 237-270. Khan, A. Q., Khwaja, A. I., & Olken, B. A.

The analysis presented here complements a rich literature of past policy reports and technical assistance (Box 5.1)**.** Although some results from previous work will be repeated here for completeness, the chapter adds to existing work in two ways. First, it provides novel quantitative assessments of key tax policy design aspects, which sheds light on possible new ways to enhance tax revenue collection and improve economic efficiency. For instance, existing work has thus far not assessed the fiscal cost of sales tax exemptions by sector, and empirical evidence on the economic distortions created by such exemptions is currently limited. This chapter fills this gap by employing the VAT gap analysis methodology that provides evidence on revenue potential, the sector-specific cost of tax expenditures, and the impact of tax exemptions on the distribution of the tax burden along the value chain. The chapter also provides novel evidence on excise duty potential for cigarettes and the distributional impact of key taxes. Second, the chapter provides a comprehensive comparison of Pakistan's tax code for the federal level's four main taxes (sales tax on goods, excise duty on cigarettes, and personal and corporate income taxes) with international practice, thus highlighting hitherto unexplored opportunities for tax strengthening.

The recommendations in this chapter focus on reducing the complexity of Pakistan's tax system, broadening its base and concurrently reducing the burden on compliant taxpayers. The estimated revenue impacts of the proposed measures amount to around 1.0 percent of GDP.[7]

- **Sales tax** recommendations emphasize the importance of gradually rationalizing concessions, including by harmonizing sales tax rates across products, removing zero-ratings for all but exported products, and limiting sales tax exemptions to only basic need items. This could raise 0.6 percent of GDP in additional revenue. This base broadening could allow Pakistan to lower its comparatively high standard sales tax rate. The impact of removing exemptions on poorer households could be compensated by allocating some of the additional revenue to the Ehsaas program. Institutional sales tax reforms could include making the issuance of tax concessions the prerogative of the parliament.
- **Personal income tax** recommendations highlight opportunities to close avoidance loopholes by harmonizing the tax schedules between salaried and non-salaried individuals and simplifying the tax schedules, such as by reducing the number of tax brackets. This simplification should be accompanied by the elimination of regressive income tax withholding on non-income transactions, such as telecom bills.
- **Corporate income tax (CIT)** recommendations suggest first harmonizing the existing concessional regimes into a single regime with a simple turnover-based eligibility threshold. As a next step, the standard regime could be harmonized to include a single rate. Tax-base broadening could be achieved by expanding thin-cap provisions, and by critically evaluating the cost-effectiveness of tax incentive schemes.[8]
- **Federal excise duty** reforms focus on the taxation of cigarettes and suggest instituting a uniform rate for all brands and an automatic mechanism to ensure that the rate adjusts for inflation. This, in combination with strengthened enforcement to close the collection gap through the effective roll-out of a digitized stamp system, could raise 0.4 percent of GDP in additional revenue. Recommendations also focus on tax enforcement.

(2016). Tax farming redux: Experimental evidence on performance pay for tax collectors. *The Quarterly Journal of Economics*, 131(1), 219-271.

[7] For some of the proposed revenue measures, the data available was insufficient to estimate a precise revenue gain. This applies to the recommendations on corporate income tax, capital gains tax, and on potential revenue gains from improved tax enforcement on sales and excise taxes. The potential revenue gains from these are likely to be sizable based on international experience but a precise number could not be estimated due to data limitations.

[8] Due to a lack of available data on the universe of firm incomes, the revenue impact of this reform could not be estimated.

Box 5.1: Reform recommendations from previous World Bank and IMF analytical work

Previous analytical work has identified an opportunity to enhance revenue collection, while concurrently improving the economic efficiency of the tax system. To this end, recommendations have prioritized an expansion of the tax base, coupled with a simplification of provisions and the elimination of costly and ineffective tax exemptions and incentives, over a further increase in tax rates. The table below provides a non-exhaustive summary of the recommendations:

World Bank	IMF
Overall	
Expand the tax base, simplify the tax system, and publish tax expenditure statements.	
Sales Tax	
Eliminate exemptions and zero rates. Consider reintroducing a broad-based and unified VAT system that consistently incorporates all goods and services traded.	Move toward a broad-base tax with a single standard rate by (i) eliminating zero-ratings on domestically sold goods, (ii) eliminating concessional rates, and (iii) limiting exemptions to a small group of basic food and medicine items.
Personal Income Tax	
Limit withholding taxes to the informal and undocumented sectors, while freeing formal taxpayers from the obligation of distortionary withholding. Apply a single rule to all capital gains and limit concessions and exemptions, especially those benefiting richer taxpayers.	Reduce the number of rates and brackets to increase tax progressiveness and reduce compliance costs. Harmonize the taxation of capital gains with the taxation of property income. Eliminate the (regressive) deduction of voluntary payments for pensions.
Corporate Income Tax	
Gradually reduce the standard CIT rate from 30 percent to 25 percent. The use of turnover taxation can help reduce tax evasion.	Simplify the system and limit exemptions by (i) reviewing all credits and incentive schemes and eliminating non-beneficial ones, (ii) repealing distortionary minimum taxes, (iii) redefining small businesses for tax purposes and implementing a comprehensive asset test to limit opportunities for tax planning, and (iv) replacing the thin cap rule with an earning stripping approach to protect the tax base.
Other Federal Taxes	
Customs: Enhance the revenue management system by focusing on risk profiling; strengthen pre- and post-clearance facilities; and include more traders into the domestic tax net by linking audits and registries between customs and inland revenue.	Excise: Limit excise to products with negative externalities, equalize rates on domestic and foreign cigarettes and un-manufactured tobacco, and increase excise on petrol derivatives or the petrol levy to reduce environmental externalities. Customs: Reduce tariff rates in general, starting a phase-out of tariffs on capital goods, intermediate products, and raw materials.

Sources: World Bank (2004). Pakistan Public Expenditure Management. Report No: 25665-PK. Washington, D.C.: World Bank.
World Bank (2011). Pakistan: From Raising Spending to Spending for Results: A Review of Public Expenditure and Financial Management Practices. Report No: 52442-PK. Washington, D.C.: World Bank (unpublished mimeo)
World Bank (2018). Pakistan Tax System – Tax Policy Review.
IMF (2019). Redesigning Pakistan's Tax System. Fiscal Affairs Department Technical Report.

The analysis in this chapter proceeds in three parts. Section 2 provides a stylized overview of Pakistan's tax system and revenue performance. Section 3 provides an analytical deep dive into the design of the sales, personal income tax, and CITs, analyzing their base and rate structure and the availability of

concessional provisions. Section 4 provides a policy roadmap that aims at enhancing revenue and economic efficiency while reducing the impact on those adversely affected by reforms. Consistent with the theme of this report, this chapter focuses on the three main federal taxes, including sales tax as well as personal and CITs. Where possible, the report also provides estimates on potential revenue gains. A detailed analysis of production and trade-related taxes is available in World Bank (2022).[9]

5.2 Overview of the Tax System

5.2.1 Structure of the tax system and reform dynamics

Pakistan's tax code contains provisions for direct and indirect taxation. The legal framework for direct taxation is based on the 2001 Income Tax Ordinance, which differentiates between a large variety of income sources (Table 5.1). The personal income tax schedule is progressive, with marginal tax rates ranging between 2.5 and 35 percent on taxable income above a tax-free allowance of PKR 600,000 for salaried individuals[10] and PKR 400,000 for all others, at the time of writing. Corporate profits are taxed at a standard 29 percent rate, reduced from 35 percent in 2021, with various preferential tax schemes available depending on firm size and other characteristics. Dividend taxes are withheld at source at a rate between 7.5 and 25 percent, and interest income is taxed through a withholding scheme that levies a 15 percent rate. The income tax ordinance also contains multiple provisions for tax withholding, including on salaries, trade, cash withdrawals, electricity and mobile phone bills, and others. In addition, Pakistan has an advance tax regime that requires taxpayers whose income in the previous year exceeds PKR 1 million to remit estimated tax payments on a quarterly basis.

Indirect taxes are levied on sales, imports, and production. The sales tax is Pakistan's main indirect tax source that is levied on registered firms' imports and sales. Sales tax on goods is collected at the federal level, whereas sales tax on services is collected by the provinces.[11] Registration requirements differ by sector and are complex. Pakistan also maintains a tax regime for non-registered taxpayers, whose sales tax revenue is collected through their electricity bills. The standard sales tax rate is 18 percent, with multiple exemptions and concessional rates for products and sectors. Exports and some domestically traded goods are zero-rated. Imports are also taxed through import duties whose rates vary by product. The production and import of select items, including tobacco, cigarettes, cement, and certain oils, are taxed through excise duties.

Pakistan also collects significant revenue from non-tax sources and through levies collected by line ministries. In FY21, Pakistan collected 2.7 percent of GDP through levies imposed by government agencies and through non-tax revenue. Two sources were especially important. First, collections from the Petroleum Development Levy (PDL) provide a steady source of revenue and accounted for 0.8 percent of GDP in FY21. The PDL is collected by the Ministry of Energy and is levied on petrol, diesel, kerosene, LPG, and fuel production inputs. At the time of writing, the PDL rates stood at PKR 37.50 per liter on petrol, PKR 7.50 on diesel, and PKR 10 on kerosene, with a commitment by the authorities under an IMF-supported program to continue raising rates on petrol and diesel by PKR 5 per month until taxes on both reach PKR 50 per liter.[12] Second, the Government receives revenue through profit transfers from the State

[9] World Bank 2022. *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*. Pakistan's Country Economic Memorandum 2022. Islamabad: The World Bank.
[10] Defined as individuals for whom more than 75 percent of earnings are derived from salary.
[11] This chapter will focus on the sales tax on goods, considering the report's focus on federally collected revenue and expenditure.
[12] https://www.dawn.com/news/1712678.

Bank of Pakistan (SBP). These transfers are volatile, reaching for instance from a low of 0.03 percent of GDP in FY19 up to 2 percent of GDP in FY20. Most revenue by the central bank is earned from lending operations to the sovereign[13]. Profit transfers are expected to decline after an IMF-supported moratorium on the purchase of government securities by the SBP.

Table 5.1: Overview of main taxes (not exhaustive)

Tax	Tax base	Marginal rate	Revenue as share of GDP, FY21 (%)
Direct taxes			
Corporate income tax	Corporate earnings (paid on-demand, voluntarily, or through advance taxation)	29 percent.	1.6[14]
Personal income tax	Withholding on income from salaried individuals	2.5 to 35 percent, distributed in 12 slabs based on earnings.	0.27
Dividend taxes	Withholding on dividend earnings	7.5, 15, and 25 percent, depending on who distributes the dividends.	0.11
Interest income	Withholding on income earned from loans and deposits	15 percent.	0.24
Other withholding taxes	Withholding on various transactions (partially creditable against income tax liability)	Varies by type of transaction.	1.6
Indirect taxes			
Federal Sales Tax	Sales of goods (input tax credit available for both goods and services)	18 percent.	3.57
Federal Excise Tax	Production and import of excisable items, including tobacco, cigarettes, selected petroleum products, aerated water, cement, natural gases, air conditioners, imported motor vehicles, and air travel services.	Varies by product.	0.5
Import duties	Import of goods and services	Varies by product.	1.37

Source: World Bank staff elaborations, based on Pakistani Tax Law.

The authorities have undertaken continuous efforts to modernize tax policy and administration, but efforts have so far produced limited results. Reforms were supported by international development partners, including the World Bank and the IMF, and can be categorized into five phases (Box 5.2). Reform efforts were designed to be comprehensive, targeting tax policy and administration in parallel, with a clear vision of simplifying the tax regime and compliance procedures, broadening the tax base, and enhancing enforcement. The implementation of this vision has, however, been uneven and inconsistent.

[13] https://www.sbp.org.pk/reports/annual/arFY21/Vol-1/Chapter-8.pdf

[14] There is no formal definition of CIT revenue in the data provided by the FBR. For the purpose of this exposition, it is defined as all voluntary payments plus advance taxes minus voluntary capital gains taxes plus withholding taxes on corporate transactions (e.g., imports). All figures are gross revenue, including refunds, as refund data does not distinguish between personal and corporate taxpayers.

Box 5.2: Tax policy priorities since 2000

Phase-I: 2000

In FY00, the authorities launched the "Tax Survey and Registration Scheme" to broaden the tax base. As part of this, authorities initiated a survey of taxpayers in prosperous urban areas and a campaign to issue new national tax numbers as a unique ID for all taxes. The authorities also established a computerized process to select up to 20 percent of all tax returns for audits. The tax survey and registration drive brought approximately 25,000 new taxpayers into the sales tax net and added over 100,000 direct taxpayers.[15] At the same time, national tax numbers were issued to 90 percent of taxpayers.

Phase-II-2001-2005

The period from FY01 to FY05 witnessed significant tax policy reform efforts, including the promulgation of a new income tax ordinance and the inclusion of agricultural income in the tax net (with jurisdiction assigned to the provinces). The authorities also eliminated sales tax exemptions on all fertilizers and other commodities. This was complemented by continued improvements to tax administration procedures, including the updating of taxpayer databases, the registration of new taxpayers, and functional and personnel reforms within the Federal Board of Revenue.

Phase-III: 2009-2012

The IMF's stand-by arrangement, in place between 2008 and 2011, supported a transformation of the sales tax into a value-added tax with a simplified rate schedule. On the tax administration side, the authorities continued to improve their systems through the adoption of an integrated IT system in 2009 and the preparation of risk-based compliance strategies.

Phase-IV: 2013-2016

Between 2013 and 2016, Pakistan, with support from various World Bank DPOs, eliminated exemptions and concessions embedded in Statutory Regulatory Orders and in the law.[16] Reforms also focused on eliminating the power of the executive to grant preferential tax treatment through SROs, with the goal of further moving the sales tax towards an integrated VAT. Tax administration measures focused on improving the national data warehouse.

Phase-V: 2019-2022

Tax policy reform discussions centered around the removal of sales tax exemptions and preferential rates, except for basic food and medicines, and a harmonization of the sales tax across provinces and between the federal and provincial level. However, to date, the authorities have not reached an agreement with the provinces on a concrete plan to harmonize the sales tax regimes.

The Government has also rationalized 12 withholding lines under the income tax and has added federal excise duties on select products while increasing the rate on others, including cigarettes, sugary drinks, and cement.

Phase-VI: Recent tax developments

On January 13, 2022, the National Assembly passed a supplementary finance act that focused on enhancing revenue mobilization by broadening the tax base and improving tax administration. Selected measures included an additional sales tax on imported mobile devices exceeding USD 200 in value, the elimination of some GST exemptions, an increase of federal excise duty on imported and locally manufactured vehicles and the introduction of advance taxes on dividends paid to non-real estate investment trust investors.

On June 29, a new budget and finance bill was approved by the parliament, which aimed to boost revenue collection through progressive measures in line with the objectives of the ongoing IMF program. Key income tax measures included a reduction of income tax slabs that increased the tax burden on higher earners as well

[15] IMF, 2001. Letter of Intent of the Government of Pakistan and Memorandum on Economic and Financial Policies.
[16] SROs refer to all kinds of government regulations carried out by FBR and different ministries through delegated powers. For FBR, SROs include concessionary and procedural regulations on inland revenue services (income tax, sales tax, federal excises) and customs.

as the introduction of a "super tax" on incomes exceeding PKR 150 million and an additional "poverty alleviation tax" of 10 percent on individuals and firms in select sectors with income above PKR 300 million. The bill introduced a super tax to raise the CIT rate on banking companies from 35 percent to 45 percent and additional taxes for banks generating income from holding government securities. In addition, withholding tax (WHT) rates were expanded, for instance on electronic payments made outside the country (1 percent for filers, 2 percent for non-filers) and on electricity bills (fixed amounts between PKR 3,000 and PKR 10,000). Income taxes for real estate holdings were also expanded. Finally, the Government also announced a gradual increase in PDL rates.

5.2.2 Revenue performance

Despite various reform efforts, revenue collection has been stagnant over time and remains low in international comparison. In FY21, federal aggregate revenue stood at 11.2 percent of GDP (Figure 5.1). Tax revenue stood at 9.4 percent of GDP in the same year, primarily collected by the FBR, and has also only increased modestly over the last decade. This puts Pakistan squarely behind regional and international peers. In FY18, for instance, Pakistan's tax revenue generation was 2.8 percentage points of GDP lower than the South Asian average and 3.5 percentage points lower than the average of low and lower-middle income countries (Figure 5.2). Pakistan lags behind its peers' tax performance across revenue sources, including indirect consumption and trade taxes, as well as direct corporate and personal income taxes.

Figure 5.1: Total revenue, by source and year (% of GDP)

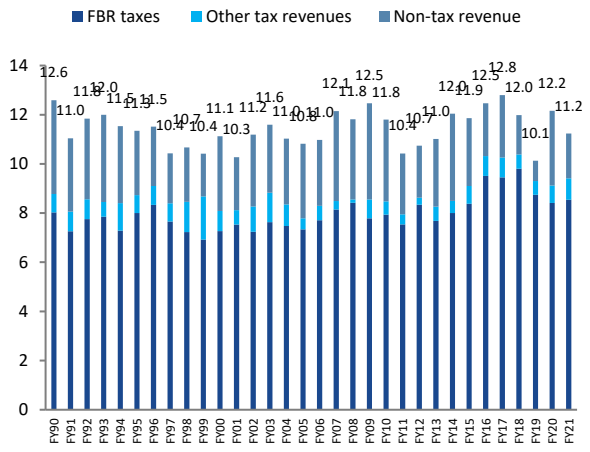
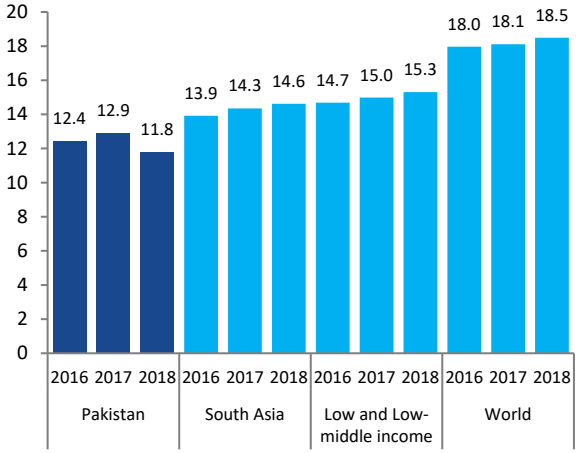


Figure 5.2: Tax revenue in international comparison (% of GDP)



Source: FBR Yearbook, IMF Government Finance Statistics and World Bank Staff calculations.

Tax revenue collection is balanced between direct and indirect sources. Direct taxes include all forms of income taxes and accounted for 3.1 percent of GDP in FY21, 0.5 percentage points lower than the sales tax revenue collection in the same year (Figure 5.3). The proportion of sales and direct taxes in total tax revenue have remained markedly constant over time, and both have acted as the central drivers of nominal tax revenue growth. Customs are the third most important tax revenue source, accounting for 1.3 percent of GDP in FY21, whereas excise duties only accounted for 0.5 percent of GDP. In FY21, 3.8 percent of GDP (or 44 percent of total tax revenue) was collected at the border through custom duties, sales tax, and withholding of corporate and personal income tax on imports (Figure 5.4).

Figure 5.3: FBR-collected tax revenue, by source and year (% of GDP)

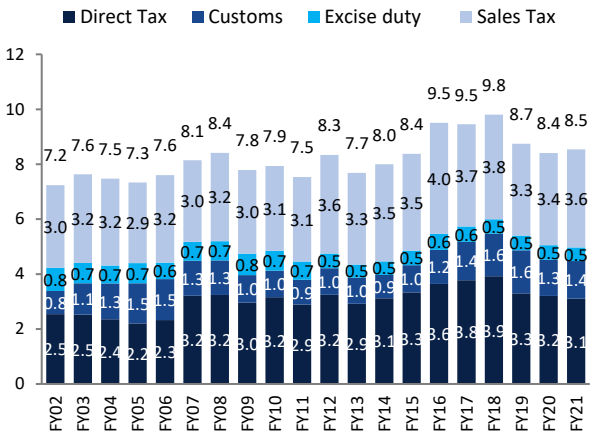
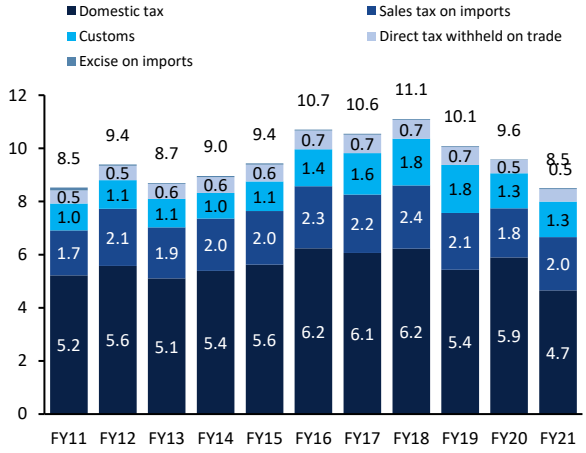


Figure 5.4: FBR-collected tax revenue, by origin and year (% of GDP)



Source: FBR Yearbook, IMF Government Finance Statistics and World Bank Staff calculations.

Figure 5.5: Tax revenue prediction, total tax revenue (actual vs. predicted)

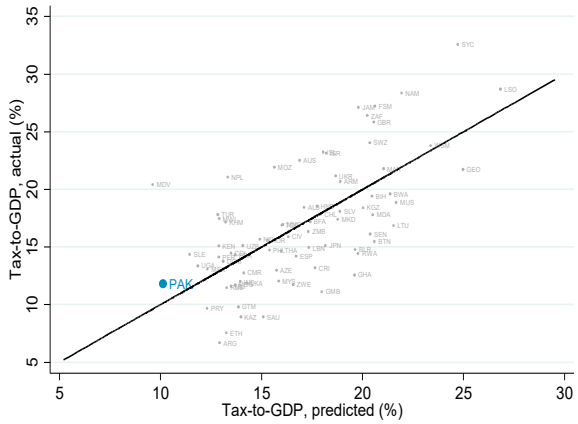
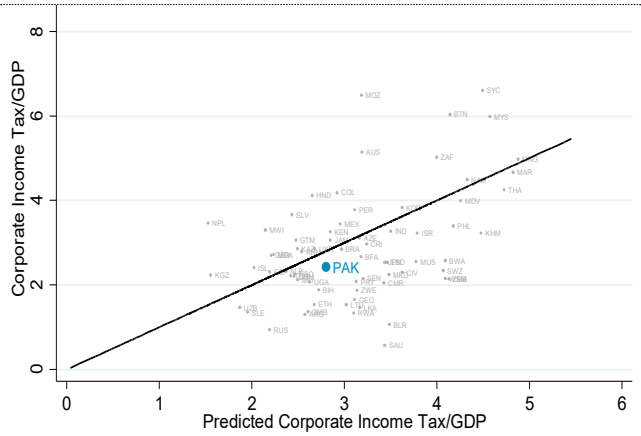


Figure 5.6: Tax revenue prediction, corporate income tax revenue



Source: Authors' elaboration based on Le, Moreno-Dodson and Bayraktar (2012).
Note: Predictor variables include [1] Agri: share of agricultural value added in GDP, [2] Trade: trade share (imports plus exports) as percentage of GDP, [3] Pop: annual population growth of those 15–64 years old, [4] Corrup: control of corruption index from the World Governance indicators, [5] Locked: dummy variable taking the value 1 if the country is land locked and 0 otherwise, [6] Remit: Personal remittances received (as percent of GDP), [7] Region fixed effects, [8] Year fixed effects. Data was obtained from the IMF's Government Finance Statistics, World Development Indicators, World Governance Indicators, and World Bank TCdata360.

Weak revenue performance is at least partially driven by fundamental characteristics of Pakistan's economy. A regression approach that estimates a country's expected tax-to-GDP ratio based on macroeconomic, demographic, and institutional characteristics highlights that Pakistan in FY20 collected marginally more total tax revenue than would be expected given its fundamentals (Figure 5.5). The analysis does, however, also highlight that Pakistan has among the lowest predicted tax revenue in the sample. The aggregate figure masks differences between tax types: whereas Pakistan collects close to its potential in indirect taxes, corporate income taxation falls below its potential by approximately 0.5 percentage points of GDP (Figure 5.6).

In addition to fundamental characteristics, tax expenditures also contribute to revenue losses. As mandated by a new public finance act passed in 2019, the FBR has instituted a tax expenditure analysis

that provides estimates of revenue losses as part of the annual budget presentation to parliament. Tax expenditures are estimated using tax return data that is not publicly available, relying on a revenue-foregone methodology that compares actual tax collection under concessions with a benchmark concession-free system on an ex-post basis. The estimates show that past efforts to broaden the tax base have not resulted in tangible outcomes: in FY22, Pakistan lost a total of 2.6 percent of GDP to tax concessions, 0.2 percentage points more than in FY20 (Figure 5.7). Tax expenditures accounts for a substantial share of revenue potential. According to the official figures, Pakistan lost an average of 26, 18, and 30 percent of sales tax, income tax, and custom duty revenue potential per year between FY20 and FY22 (Figure 5.8).

Figure 5.7: Tax potential, by revenue and expenditure (% of total potential)

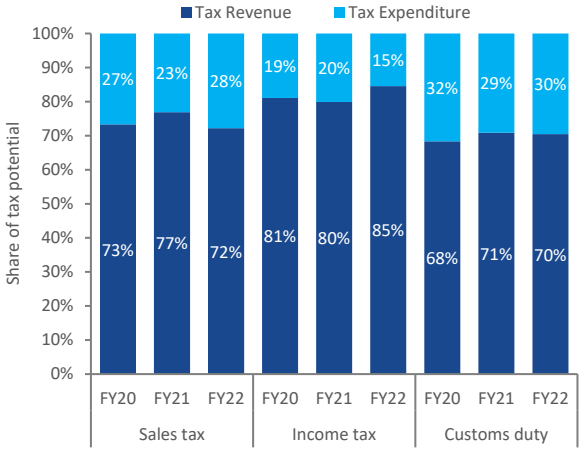
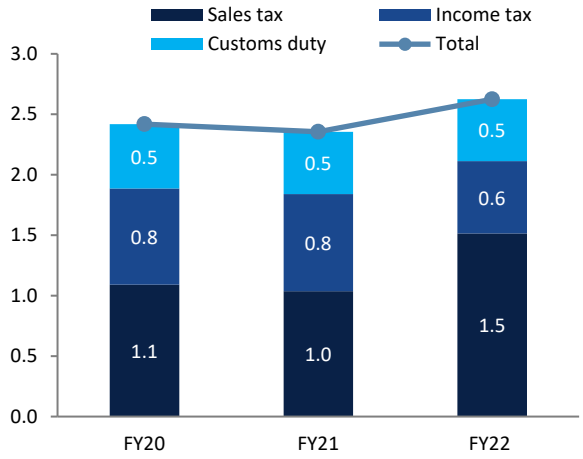


Figure 5.8: Cost of tax expenditures, by tax (% of GDP)



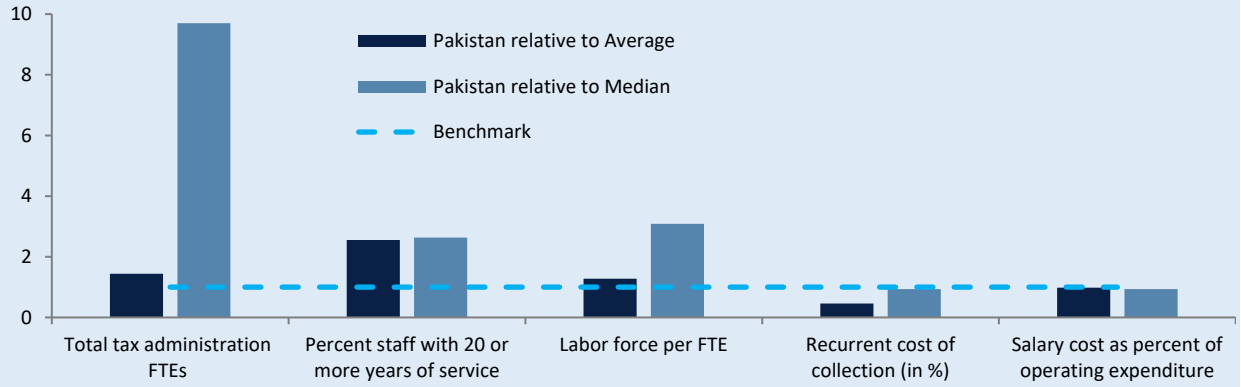
Source: Ministry of Finance, Tax Expenditure Statement, various years; and World Bank Staff calculations.

Box 5.3: Tax administration performance

Pakistan's tax administration is under-resourced. Figure B3.1 below compares resources available to the FBR with those in the average and median country around the world. A value greater than 1 implies that Pakistan has more of a given factor than the average or median country. The figure illustrates three facts. First, Pakistan's tax administration has more staff than in the average or median country, exceeding full time employees (FTEs) in these by a factor 1.4 and 9.7, respectively. This staff is also more experienced than in other countries. Second, considering the size of Pakistan's labor force as a proxy for tax administration workload, Pakistan has 1.3 and 3.1 more potential taxpayers per full-time employee than the average and median country. Third, Pakistan's recurrent cost of collection (expressed as a share of revenue) is lower than in other countries. Taken together, these factors highlight that even though Pakistan's tax administration has many staff, it has less resources available than tax administrations in other countries of comparable size.

Expanding the FBR's resource and staff envelope may raise revenue collection. Figures B3.2 and B3.4 link two tax administration inputs metrics (operating costs and worker-to-tax administration staff ratios) to revenue collection (an output metric). The figures highlight that tax administrations with a higher operating budget and lower taxpayer to tax administration employee ratios tend to collect more revenue. The figures also highlight that Pakistan, shown as the red dot in the figures, collects less revenue than other countries with similar inputs. These factors imply that there is potential to raise revenue collections by (i) investing in tax administration inputs and (ii) raising the efficiency of FBR to ensure that more revenue with a constant input mix can be collected.

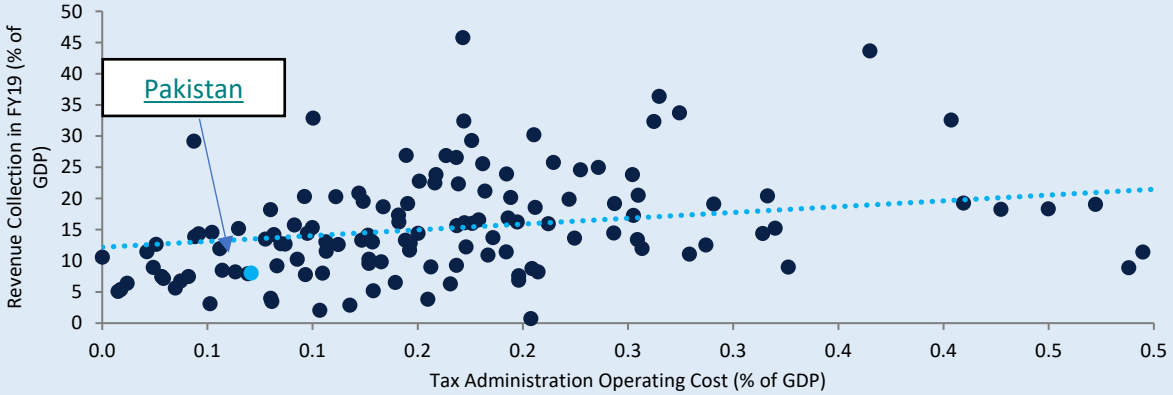
Figure B3.1: Tax administration resources in international comparison.



Source: World Bank staff calculations based on data from the International Survey on Revenue Administration Database (data.rafit.org).

Past tax administration reforms have focused on the legislative framework and the digitization of tax administration operations. Past reforms include a restructuring of FBR along functional lines, a modified oversight structure that moved the tax administration under the oversight of a Cabinet Committee on Finance and Revenue and the approval of a previously nonexistent human resource management policy framework, including a rationalization plan for nonessential FBR staff. Investments in tax administration have included the establishment of Large and Medium Taxpayer Units and investments into IT infrastructure and business process automation. With regards to digitization, the FBR has established databases for reporting and audit purposes, an online tax registration system and a self-assessment system for filing tax returns. It has also integrated retail, restaurants, and textile retail point of sale systems with its own to ensure data exchange.

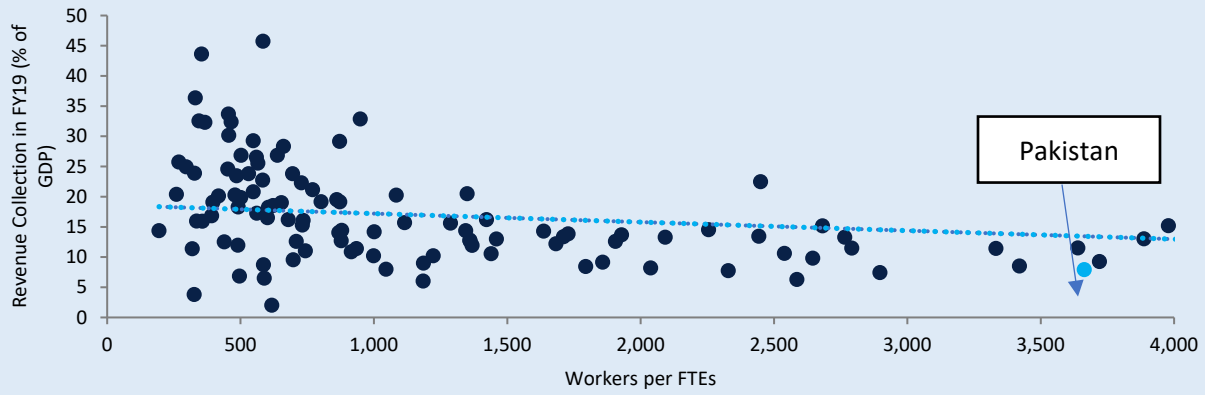
Figure B3.2: Revenue collection vs. operating costs



Source: World Bank staff calculations based on data from the International Survey on Revenue Administration Database (data.rafit.org).

Going forward, priority investment areas include data exchange and staff incentives. Although initial steps toward establishing tax enforcement databases have been taken, the FBR would benefit from an integrated data system that combines provincial and federal data on a real-time basis. This could be complemented by a fully automated system without human interface for taxpayers that automatically processes tax returns and refunds, thus fostering accountability and preventing moral hazard between tax administrators and taxpayers. Equally important is a focus on investing in FBR's human resources by identifying and hiring qualified staff, effectively managing performance, and providing incentives for performance. Setting up a dedicated and well-trained revenue cadre could be a potential avenue to this end.

Figure B3.3: Revenue collection vs. taxpayer to staff ratios.



Source: World Bank staff calculations based on data from the International Survey on Revenue Administration Database (data.rafit.org).

5.3 Discussion of Specific Taxes

5.3.1 Indirect Taxes

5.3.1.1 Sales Tax

Resident businesses in the manufacturing, importing, services, distribution, wholesale, and retail sectors that supply taxable transactions are required to register for and charge sales tax on their supplies. Manufacturers and retailers with taxable turnover below PKR 5 million during the past twelve months are exempted from the registration and payment of sales tax. Since 2021, cottage industries with an annual turnover exceeding PKR 10 million are required to register for the sales tax which, in nominal terms, is comparable to value added tax (VAT) thresholds in other countries. All firms registered for the sales tax and remitting tax payments on their sales are eligible for credit on sales tax paid on inputs, making the sales tax a de jure VAT. Sales tax collection has increased modestly over the last twenty years, from 3 percent of GDP in FY02 to 3.6 percent of GDP in FY21 (Figure 5.9). This increase was aligned with the overall increase in revenue, with the sales tax accounting for just above one-third of total tax revenue (Figure 5.10).

Figure 5.9: Goods sales tax revenue (% of GDP)

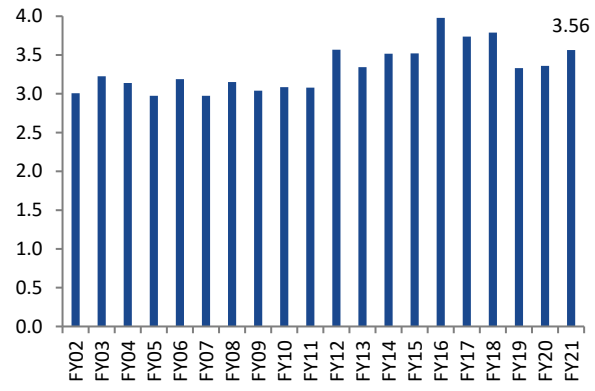
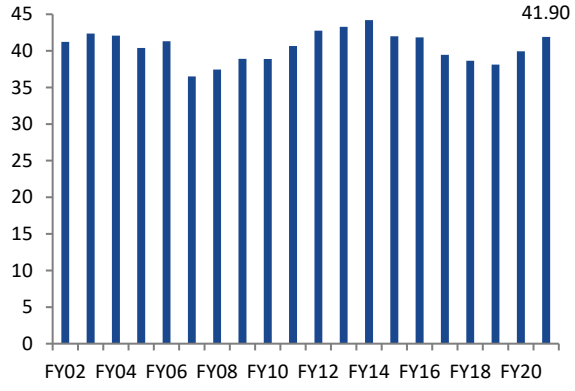


Figure 5.10: Goods sales tax revenue (% of total tax revenue)



Source: FBR revenue division yearbook 2020-21.

The sales tax base definition is narrow, as Pakistan allows for multiple exemptions, which are granted with or without links to other legislation or designated economic zones. Examples of exempt items include pesticide production inputs registered under the Agriculture Pesticides Ordinance (1971), plant, machinery, equipment, and raw materials supplied for special technology zones, and certain types of electric and internal combustion engine vehicles.

In addition to exemptions, the sales tax system also allows for concessionary rates for select products and sectors. Pakistan's standard goods sales tax rate is 18 percent.[17] However, the sales tax act's 8th schedule allows for multiple reduced rates, for instance for locally manufactured electric vehicles (subject to a rate of just 1 percent) and locally manufactured cars up to 1000cc (12.5 percent). Certain domestic supplies in five export-oriented sectors (textile, leather, footwear, surgical goods, and sport goods) are also granted reduced rates. The fact that beneficiary sectors are both relatively easy to tax and mostly do not qualify as merit or basic goods suggest that exemptions and zero-ratings were motivated by the desire to provide a fiscal transfer to certain sectors. This interpretation is corroborated by the fact that an additional sales tax of 3 percent is levied on commercial imports, acting as protectionary measure for domestic industries.

The 5th schedule of the sales tax rate allows for a broad list of zero-rated products, consisting of both exported and—in contrast to international practice—domestically sold goods. The provision of zero-ratings for domestically sold goods violates the destination principle of VATs, which emphasizes that only exported items should be zero-rated. Examples of zero-rated items in Pakistan include select food items and milk. In addition to products mentioned in the 5th schedule of the sales tax act, zero-ratings are also available for local supply of inputs, plant, and machinery to registered exporters under an export facilitation scheme introduced in 2021, and for the supply to exporters in export processing zones.

Figure 5.11: C- Efficiency in international comparison

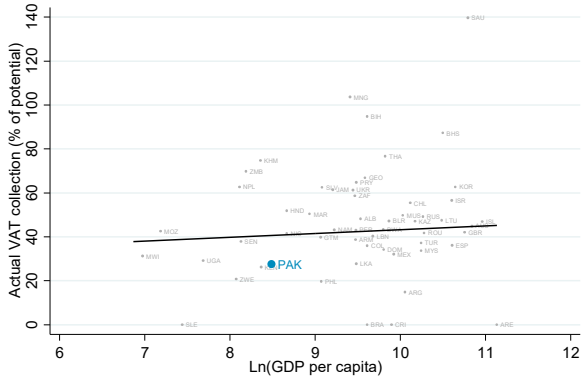
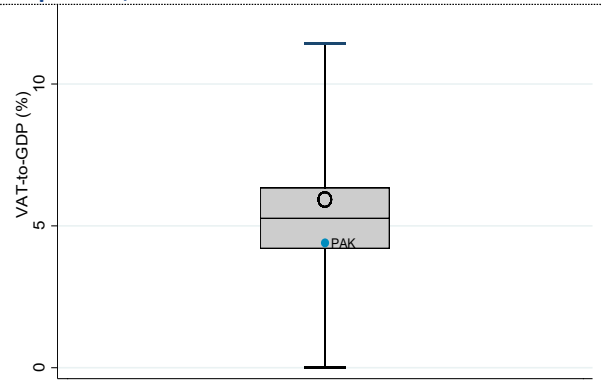


Figure 5.12: Sales tax revenue in comparison with countries that have a sales tax rate between 16 and 18 percent, 2019



Source: Data from KPMG, World Development Indicators and World Bank Staff calculations.
Notes on the left-hand-side box plot: The bar in box highlights median revenue collection in the sample and the circle shows the mean. The upper and lower ends of the box visualize the third and first quartile. The whiskers show the upper and lower limit of the range of collections. In 2019, the reference year for this graph, Pakistan's sales tax rate was 17 percent.

The fractionalized design of the sales tax has resulted in low revenue efficiency. One way to benchmark the effectiveness of a sales tax system in an internationally comparable manner is by calculating C-efficiency. This is defined as the proportion of actual to potential collection, where the latter is the

[17] Provinces service sales tax rates range from 13 to 16 percent.

statutory sales tax rate multiplied by aggregate final consumption expenditure in the economy. This calculation highlights that Pakistan's sales tax is comparatively inefficient: in FY20, its C-efficiency lay below 30 percent, significantly below the level expected considering its per capita income (Figure 5.11). This result is even more striking when considering that Pakistan has a relatively high standard sales tax rate, but 75 percent of comparator countries—which had sales tax rates between 16 and 18 percent in FY19—achieve higher collection rates (Figure 5.12).

Figure 5.13: Sales tax revenue, by origin (% of total revenue)

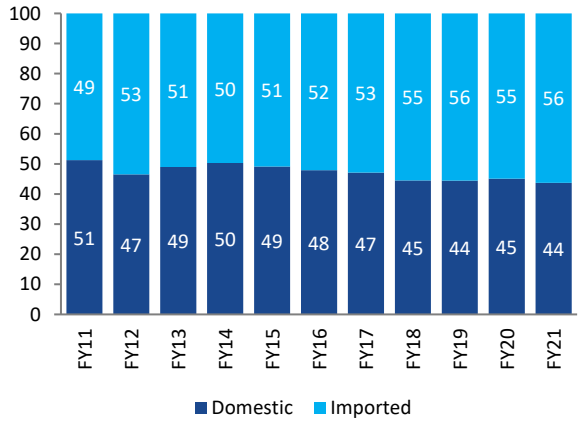
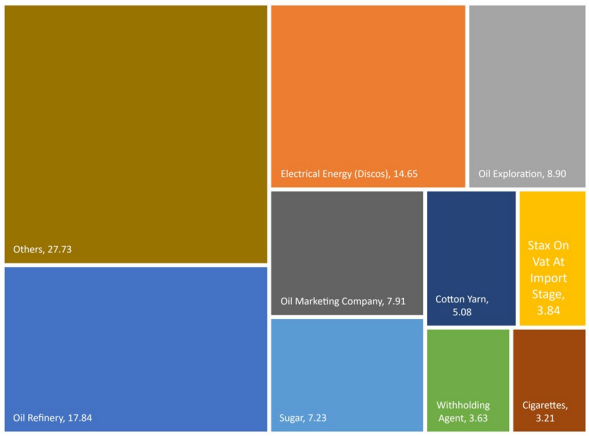


Figure 5.14: Domestic sales tax revenue, by sector (FY21, % of total revenue)



Source: FBR Yearbook and World Bank Staff calculations.

The narrow base definition has also contributed to a concentration on imports and select sectors. In FY21, Pakistan collected 56 percent of total sales tax revenue at the border (Figure 5.13). This share has grown over time, with sales tax on imports accounting for the majority of sales tax revenue growth over the last ten years.[18] The sales tax base is concentrated not only by origin, but also by product. Refined oil, oil exploration, oil marketing, and electrical energy jointly account for 49 percent of domestic sales tax revenue, and petroleum products account for 23 percent of imported sales tax revenue (Figure 5.14).

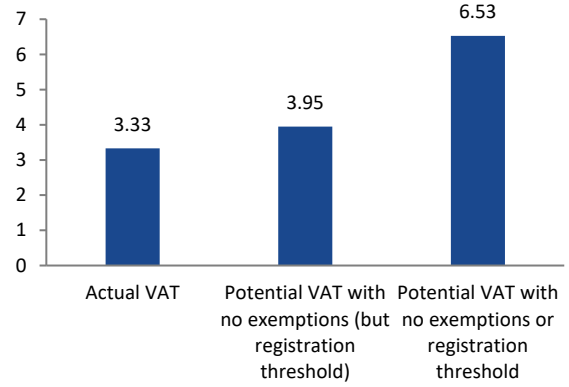
A VAT gap analysis, conducted with reference to FY19 GDP and using parameters of the FY19 tax system, reveals that concessionary tax rates, exemptions, and zero-ratings for non-exported products cost Pakistan 15 percent of its revenue potential. In FY19, had Pakistan not allowed for any concessionary rates, exemptions, or zero-ratings, and had it registered all firms in the tax net, it would have had a total sales tax revenue potential of 6.53 percent of GDP (Figure 5.15). Similarly, when considering that only a subset of firms is required to register for the sales tax, its potential in FY19 stood at 3.95 percent of GDP in the absence of concessions on tax rates and tax exemptions. The manufacturing sector accounted for 37 percent of this potential, followed by the livestock sector, mining and quarrying, and the crop sector. By contrast, Pakistan collected 3.33 percent of GDP in FY19, about 51 percent of its total sales tax potential and 85 percent of its registered sales tax potential. Tax losses from exemptions and other concessionary rates accrued primarily in the petroleum sector, in which collection losses amounted to PKR 284 billion, followed by chemicals, oils and fats, and machinery.

These results are broadly consistent with the Government's published tax expenditure figures, which highlight that most revenue losses are driven by exemptions and concessionary rates. Due to differences

[18] In addition to tax policy factors discussed in this chapter, this trend can also be explained by a continuous currency depreciation.

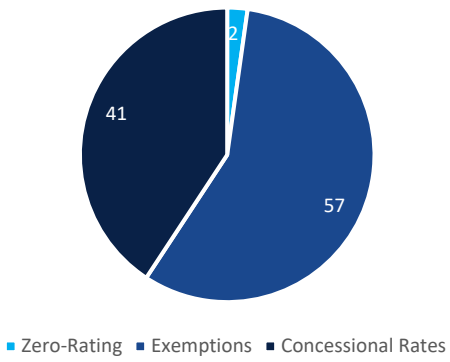
in methodology, estimates of the sales tax gap differ slightly between the Government's estimate published in the annual budget documents and the estimates derived from the sales tax gap analysis. According to government figures, Pakistan lost between 23 and 28 percent of potential revenue in the last three years, slightly above the estimate of 15 percent obtained for FY19 in this report's analysis. The government figures also highlight that 57 percent of total losses are caused by exemptions, whereas concession rates account for most of the remaining losses (Figure 5.16). By contrast, zero-ratings for domestic supplies only play a minor role.

Figure 5.15: Potential compared to actual sales tax collection in FY19 (% of GDP)



Source: World Bank Staff calculations based on the IMF VAT gap analysis methodology.

Figure 5.16: Cost of different sales tax exemptions in FY20 (% of total sales tax expenditure)

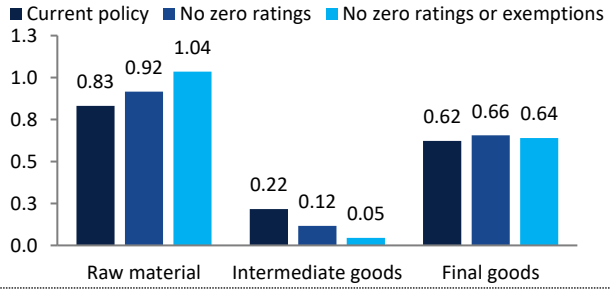


Source: Ministry of Finance, Tax Expenditure Statement; and World Bank Staff calculations.

In addition to revenue losses, concessionary rates and exemptions also contribute substantially to factor misallocation by redistributing the sales tax burden along the production chain. Sales tax exemptions have two effects on taxpayers. First, they relieve producers of exempt items from the obligation to remit sales tax. Second, unless exemptions are sequentially applied through the production chain, they also preclude producers at later stages of the value chain from claiming input tax credit for exempt items. Sales tax exemptions on raw materials thus do not, ceteris paribus, cause a revenue loss, but rather increase the tax obligation for producers of intermediate goods and thus generate a cascading effect. This changes relative prices across the production chain and contributes to factor misallocation.

In Pakistan, concessionary rates and exemptions place an exceptional burden on the production of intermediate goods. Zero-ratings are primarily applied on raw and final products, whereas exemptions primarily benefit raw and intermediate products. Considering these characteristics, the domestic sales tax potential in Pakistan's current system was 0.83 percent of GDP for raw materials, 0.22 percent of GDP for intermediates and 0.62 percent of GDP for final goods (Figure 5.17).[19] Removing zero ratings would increase the revenue potential for raw materials and final goods, but approximately halve the revenue potential of intermediates.

Figure 5.17: Sales tax revenue potential by production stage, baseline, and reform scenarios (% of GDP)



Source: World Bank Staff calculations based on the IMF VAT gap analysis methodology.
Notes: The classification into raw materials, intermediate goods and final goods follows the UN TRAINS classification and its adaption by the World Bank for Pakistan.

[19] The sum of these figures is lower than the total potential because it excludes the sales tax potential of imports.

This indicates that, in the current system, zero-ratings redistribute a substantial share of the sales tax burden from raw materials to intermediates.[20] Taken together, concessionary rates and exemptions thus place a large burden on producers of intermediates and risk distorting competitive neutrality along the value chain.

As is typical for indirect taxes, Pakistan's sales tax imposes an equal burden on richer and poorer households. A fiscal incidence analysis[21] highlights that the sales tax is neither progressive nor regressive: while a 34 percent of all sales tax revenue is paid by the top 20 percent of households in the income distribution, the Kakwani index[22] of the sales tax—a measure that increases with the tax' progressiveness—is only 0.02.[23] Due to its neutral redistributive properties, the indirect tax imposes a substantial burden on the poor: all else being equal, poverty in Pakistan would be 4 percentage points lower in the absence of the sales tax.

5.3.1.2 Federal Excise Duty on Cigarettes

The taxation of cigarettes is an effective tool to achieve dual policy objectives. Cigarette taxation typically attempts to achieve a dual policy objective by raising revenue and discouraging smoking to improve health outcomes. This dual objective can be achieved because cigarette consumption has a low short-term elasticity of demand that allows for the realization of revenue, but a high long-run elasticity. Similarly, although cigarette taxation is typically regressive, it also generates larger health benefits for poorer consumers, which can outweigh the regressive impact of the tax.[24] As such, cigarette taxation can act as a stop gap measure to fill short-term revenue needs and concurrently realize longer-term health benefits.

In Pakistan, cigarettes are taxed through the federal excise duty. Pakistan collected 0.5 percent of GDP in federal excise duty revenue in FY21. The taxation of domestic cigarettes was the main contributor to this and accounted for 0.19 percent of GDP, which has remained steady in recent years (Figure 5.18). By contrast, the taxation of imported cigarettes is negligible. Cigarettes are taxed through a dual rate, with cigarettes that have a final market price of less than PKR 6.7 liable for a tax of PKR 5.05 per cigarette, and those sold above this price, for a tax of PKR 16.5. The system was reformed in FY22, when the number of tiers was reduced from three to two and the tax rates on both tiers were increased. The tax rates for both tiers were increased again in FY23.

[20] Similarly, removing tax exemptions in addition to zero-ratings would marginally lower the revenue potential of final goods, emphasizing that exemptions on intermediates redistributed some burden to final goods. More importantly, however, removing exemptions would further lower the revenue potential on intermediates. This highlights that the benefit accruing to producers of intermediate products from being able to claim input tax credit on raw material inputs outweighs the increase in tax burden from the removal of exemptions for them.

[21] Amjad, B., Carrasco, H. and Meyer, M. (2022). The Effects of Fiscal Policy on Inequality and Poverty in Pakistan. World Bank Working Paper.

[22] The progressivity of a tax is measured by the Kakwani index, which is calculated as the difference between the concentration coefficient of a tax and the Gini coefficient of a reference income. A positive Kakwani index means a tax is progressive, and a negative one means it is regressive. A Kakwani Index close to 0 means neutral.

[23] A larger discrepancy between contribution to revenue and incidence arises because of significantly higher incomes and consumption levels at the top of the distribution.

[24] See (i) World Bank. Tobacco tax reform at the crossroads of health and development: technical report of the World Bank Group global tobacco control program (Vol. 2): Main report. Washington, D.C.: World Bank Group and (ii) Fuchs, A., González Icaza, F. and Paz, D. 2019. "Distributional Effects of Tobacco Taxation: A Comparative Analysis." Policy Research Working Paper; No. 8805. World Bank, Washington, DC.

Federal excise duty collection on cigarettes lies below its potential. The tax potential analysis highlights that the reform undertaken in FY23 raised revenue potential by 0.5 percent of GDP (Figure 5.19). The analysis also highlights that Pakistan's tax potential in FY19 (under the previous three-tier system) was 0.23 percent of GDP, which exceeds actual collection by about 0.04 percentage points. This points to potential enforcement gaps that can be filled. As discussed further below, a further simplification to a single tier and applying the current premium excise rate of PKR 16.50 per cigarette to all would raise to the tobacco excise revenue potential to 1.09 percent of GDP.

Figure 5.18: Federal excise duty revenue, by source (in % of GDP)

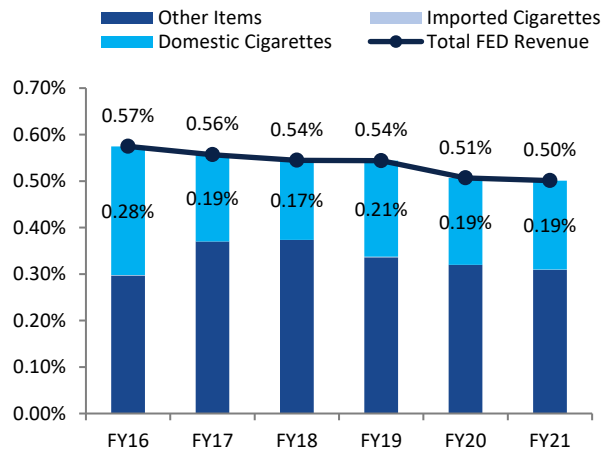
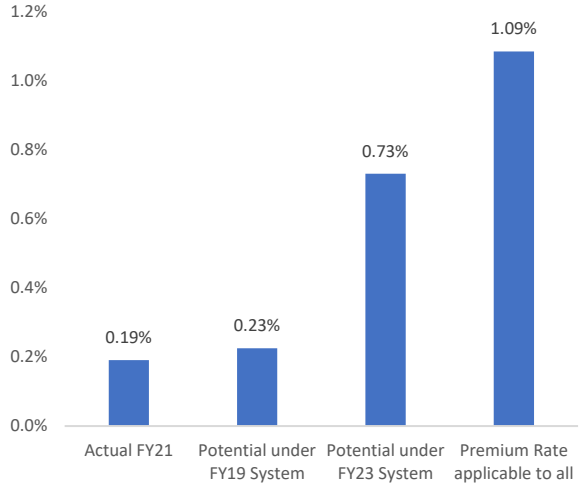


Figure 5.19: Tobacco excise revenue potential under alternative scenarios (in % of FY21 GDP)



Source: FBR Yearbook and World Bank Staff calculations.
Note: In the righ-hand-side figure the middle two bars show revenue potential before and after the FY19 reform to cigarette taxation.

Although Pakistan's choice of applying a nominal specific rate on cigarettes is consistent with international practice, a regular update to account for inflation is needed. Cigarette taxation can be applied on an ad-valorem basis or through a specific nominal tax, with countries approximately equally likely to adopt either system (Figure 5.20). Pakistan has opted for a specific nominal tax, which allows it to adequately address the health objective of the tax and safeguard revenue from cigarette price fluctuations while not requiring the estimation of ex-factory cigarette prices. However, nominal taxes must be adjusted over time to account for inflation. Pakistan currently does not have an automated system for tax rate adjustments in place as any inflation adjustment of cigarette duty rates requires a vote by parliament.

Revenue collection could be increased by harmonizing the system to a single unified rate. Pakistan's cigarette taxation system differs from international practice by applying a dual rate structure (Figure 5.21). This reduces revenue potential and enables tax evasion by allowing producers to apply the cheaper rate on premium cigarettes. A substantial revenue gain could be achieved if the current rate on premium cigarettes (PKR16.50 per cigarette) was also applied to standard cigarettes. In this case, tobacco excise revenue potential would increase to about 1.09 percent of GDP, which could – if accompanied by appropriate enforcement measures – increase total excise revenue by a factor 2.5.[25]

[25] Total federal excise revenue collection was 0.5 percent of GDP in FY21. The transition to a single tier with an excise tax of PKR 16.50 per cigarette will raise total federal excise potential to 1.39 percent of GDP, ceteris paribus.

Figure 5.20: Number of countries that have adopted different types of excise designs

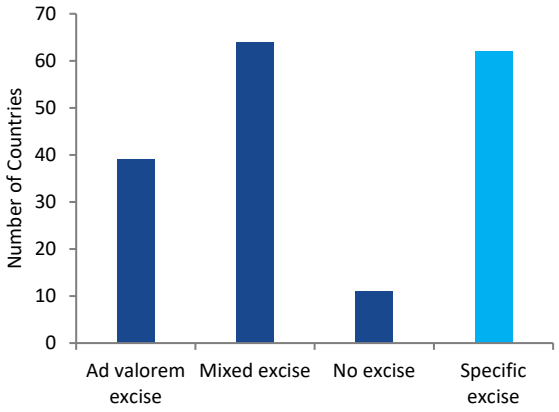
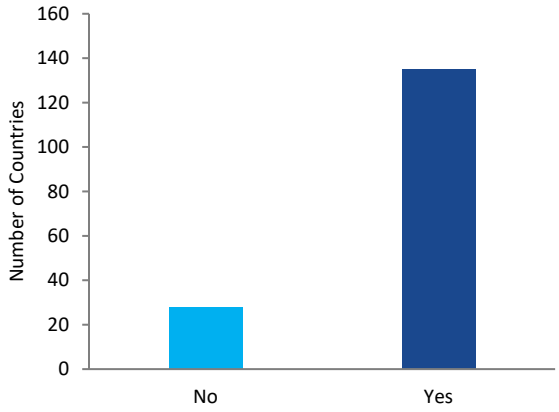


Figure 5.21: Number of countries that have a single ("yes") or multiple ("no") excise rate on tobacco



Source: WHO Tobacco Tax Design Database and World Bank Staff calculations.

Pakistan's envisioned track and trace system presents a good opportunity to strengthen excise duty administration. Pakistan has embarked on establishing a track and trace system for excise duty enforcement, which involves the application of stamps on cigarette packages to signal that the duty was paid. This system is eventually planned to evolve into a technology-based tracking system that would allow the FBR to enforce taxation throughout the value chain. In practice, the system has been met with legal and practical challenges involving, for instance, court challenges to resolve the question of whether producers should be liable for the cost of applying stamps. In practice, most cigarettes sold do not include an excise stamp. There is also anecdotal evidence that stamps are prone to falling off and that stamps for standard cigarettes are applied to premium packages. There are two pathways to alleviating these challenges. First, Pakistan could adopt QR codes that are printed directly on the packages instead of physical stamps. This would reduce the cost of stamp application and could facilitate enforcement. Second, Pakistan could offer cash incentives to consumers—possibly paid directly through mobile phone—to report cigarettes sold with no or incorrect excise stamps.

5.3.2 Direct Taxes

Direct revenue depends overwhelmingly on withholding and advance taxes. In FY21, the country collected a total of 3.1 percent of GDP in direct tax revenue (Figure 5.22). Approximately 1.6 percent of GDP was collected through a total of 52 withholding schemes on non-income transactions, including the purchase of airline tickets, electricity bills, car registration, exports, and imports. The contribution of most withholding schemes is small, averaging just 0.04 percent of GDP each in FY21. The most important withholding line was income tax withholding on imports (Figure 5.23) and payment on contracts for the delivery of goods and services (0.39 and 0.49 percent of GDP in FY21, respectively). Advance taxes contributed a further 0.74 percent of GDP and are collected based on historical incomes and on un-realized capital gains on a quarterly basis. Despite the high share of withholding and advance taxes, refunds play a relatively minor role in the direct tax system, accounting for only 5 percent of total direct tax revenue in FY21. This is consistent with anecdotal evidence that income taxes withheld through non-income transactions are rarely credited in final tax returns and refunded in even fewer cases. As a result, direct tax collection through withholding on non-income sources acts as a de-facto sales tax on select transactions, which induces economic production distortions typically not associated with an income-based direct tax.

Figure 5.22: Direct tax, by source (in % of GDP)

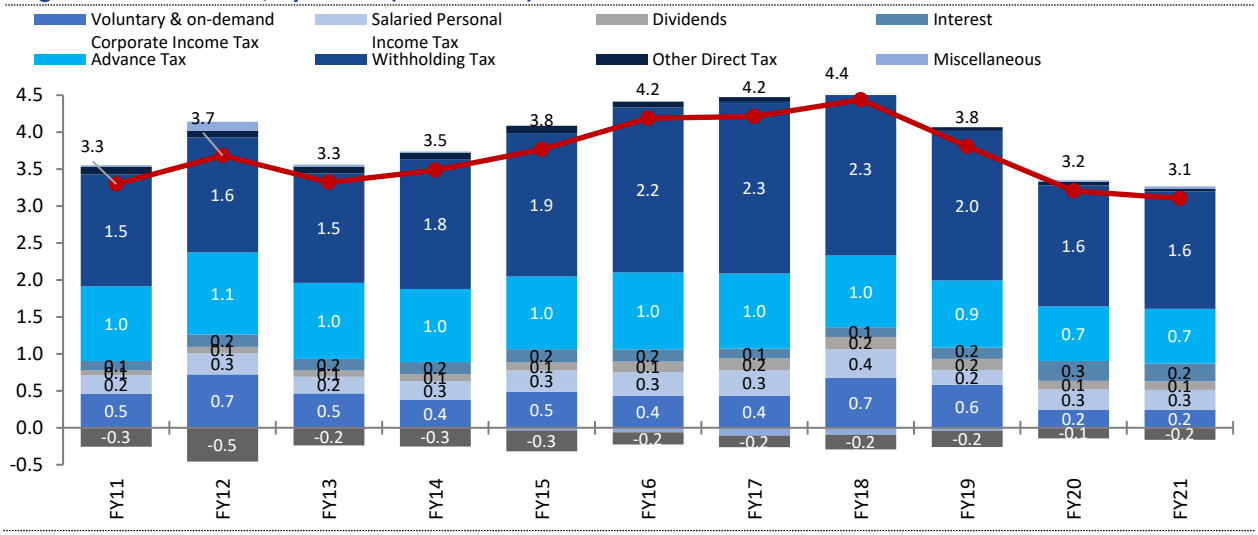
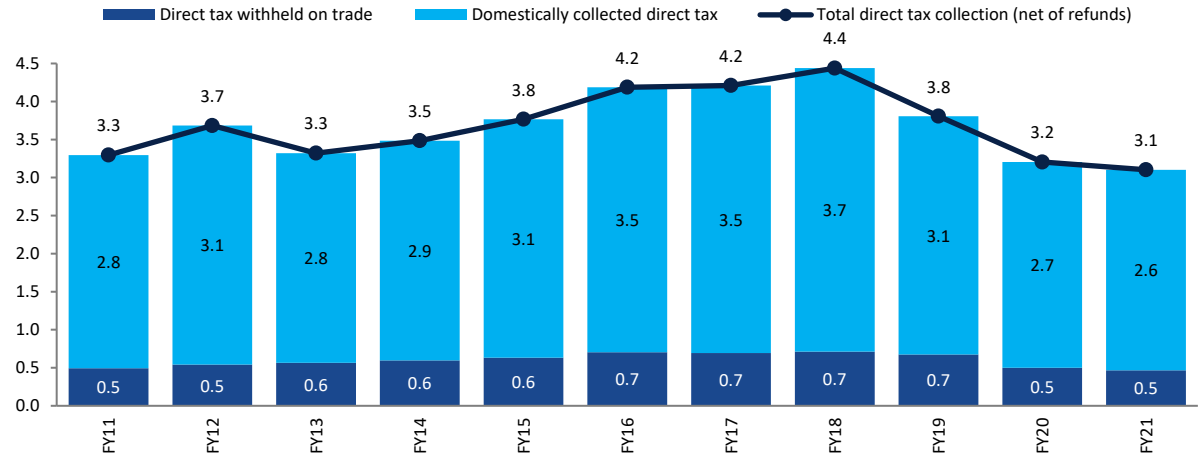


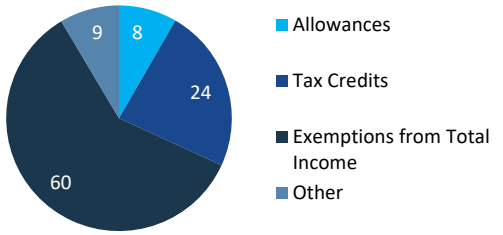
Figure 5.23: Direct tax, by origin (in % of GDP)



Source: FBR Yearbook and World Bank Staff calculations.

Income tax collection is constrained by tax expenditures. Pakistan lost an annual average of 0.7 percent of GDP to income tax exemptions over the last three years. Most of these losses are caused by exempting certain types of incomes or select groups of taxpayers from a tax obligation, which accounts for 60 percent of all tax expenditures (Figure 5.24). Tax credits that are provided to encourage certain behaviors, such as investments, accounted for 24 percent of tax expenditures, whereas allowances, for instance for interest deductions or education expenses, accounted for 8 percent.

Figure 5.24: Cost of different income tax exemptions in FY20 (% of total income tax expenditure)



Source: Ministry of Finance, Tax Expenditure Statement; and World Bank Staff calculations.

5.3.2.1 Personal Income Tax

Pakistan's personal income tax base definition is comprehensive. The personal income tax system recognizes five different types of income: salary, property income, business income, capital gains, and income from other sources.[26] The definition of taxable salary is likewise broad, including direct compensation for work in addition to leave pay, overtime pay, bonuses (monetary and non-monetary), commissions, fees, gratuities, work condition supplements, and allowances.[27] Pakistan taxes the worldwide income of its residents, whereas non-residents are only taxed based on income sourced from Pakistan.

Personal income tax collection at source only plays a minor role but has grown considerably in recent years. Personal income tax—defined as income tax collected through salary withholding—accounted for only 0.27 percent of GDP in FY21. This tax base has, however, experienced significant growth in recent years, accounting for 10 percent of total nominal direct tax revenue growth between FY15 and FY20. Pakistan also applies a 15-percent WHT to earnings from dividends, interest, royalty, and fee for technical services derived from Pakistani sources. Collections through such WHTs on interest and dividends stood at 0.24 and 0.11 percent of GDP in FY21.

The personal income tax differentiates between salaried and non-salaried individuals. Tax-free allowances and tax brackets and rates differ significantly between salaried individuals and other taxpayers. At the time of writing, the exemption threshold for salaried individuals is PKR600,000 and the highest marginal tax rate of 35 percent kicks in for salary exceeding PKR 12 million. By contrast, non-salaried individuals' tax-free allowance is PKR 400,000, with the highest marginal tax rate applied on all income above PKR 6 million.

The differentiation between salaried and non-salaried individuals risks two unintended consequences. First, it generates economic distortions by providing an incentive to shift occupations and income towards salaried sectors, without consideration of production efficiency. Second, the differentiation creates opportunities for tax avoidance through income shifting as, for example, the wealthy can create a company and extract income in terms of salary to benefit from lower marginal tax rates.

Figure 5.25: Personal income tax schedule

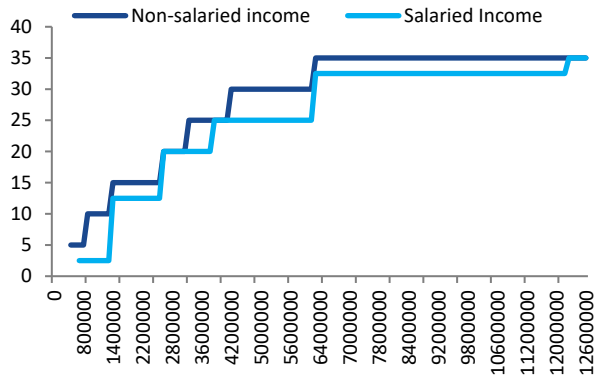
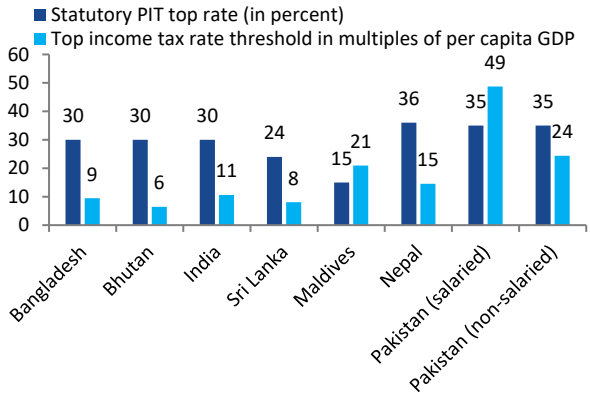


Figure 5.26: Statutory top personal income tax rate and threshold in international comparison



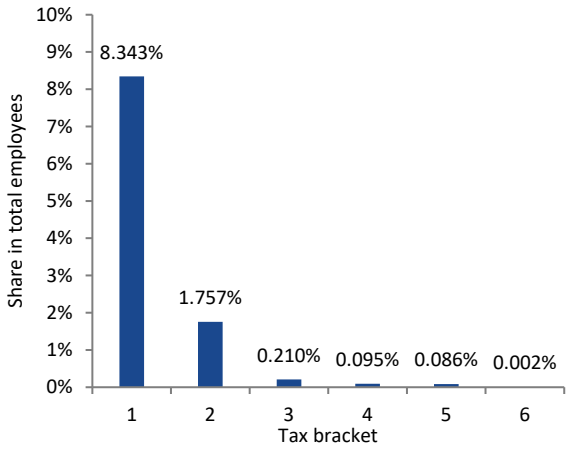
Source: World Bank staff elaborations.

[26] Income from other sources comprises, inter alia, income from dividends, royalties, profit on debt (interest), ground rent, sub-lease of land or building, lease of building inclusive of plant or machinery, prize money, and winnings.
[27] Certain deductions, exemptions, and credits are available, for instance for medical expenses and mortgage interest payments.

The personal income tax schedule is also complex within taxpayer categories, raising compliance and administration costs. The tax schedule for salaried and non-salaried individuals contains 6 and 7 brackets, (Figure 5.25). The number of tax brackets not only raises compliance costs by making the system complex, but also provides ample opportunity for income shifting toward lower brackets to optimize tax liabilities.

The threshold for the top income tax bracket for salaried individuals is very high and is likely to only capture a very limited number of taxpayers. Salaried taxpayers are only required to pay the top income tax rate of 35 percent for income exceeding PKR12 million, or approximately 49 times the per capita GDP (Figure 5.26). This figure is significantly higher than in Pakistan's peer countries and results in a low coverage of the top income tax brackets. In Pakistan's current system, about 10.5 percent of all salaried individuals earn sufficient income to have a positive income tax liability. Almost all fall into the first and second brackets of the income tax schedule, for which modest marginal tax rates of 2.5 and 12.5 percent are applied. By contrast, only 0.002 percent of all salaried individuals have sufficient income to qualify for a marginal rate of 35 percent (Figure 5.27).

Figure 5.27: Share of total employees by income tax bracket



Source: World Bank staff calculations, based on Pakistan Bureau of Statistics LFS Data, 2019.
Note: Employees are defined as respondents who report (i) a regular monthly salary with a contract and (ii) employment by an employer that maintains written records.

The reliance on income tax withholding on non-income-generating transactions undermines the redistributive properties of the personal income tax. An analysis of the fiscal incidence[28] highlights stark differences between the redistributive impacts of different WHTs. On the one hand, with a Kakwani index of 0.52, withholding on salaries is highly progressive and reduces inequality by 0.05 Gini points. The richest 20 percent of households pay 82 percent of all revenue collected through the WHT on salaries and the contribution of the poorest households is negligible, so that the imposition of the WHT on salaries neither increases nor decreases poverty. On the other hand, income tax withholding on telecommunication bills, a non-income-generating transaction, acts like a regressive sales tax, as it marginally increases inequality and has a Kakwani index of -0.25. Taken together, these results highlight that Pakistan's reliance on non-salary withholding for personal income tax reduces the ability of a traditionally progressive tax instrument to redistributive income.[29]

Like salary taxation, the current regime of taxing capital gains is very complex. The system features multiple rates that are determined based on the size of the gains and the holding period. The tax schedule

[28] Amjad, B., Carrasco, H. and Meyer, M. 2022. "The Effects of Fiscal Policy on Inequality and Poverty in Pakistan." World Bank Working Paper.
[29] Other reasons for not employing withholding taxes for revenue collection include:
1. Many withholding lines collect an insignificant amount of revenue and is a burden for withholding agent;
2. An excessive use of withholding taxes is equivalent to shifting the tax collection responsibility onto withholding agents, who have to bear the collection cost. This extensive practice tends to deteriorate the business climate;
3. There are certification issues as to whether the withholding agent remitted the full collection;
4. Excessive withholding has consequences for business cash flows, such as the case when collecting withholding.

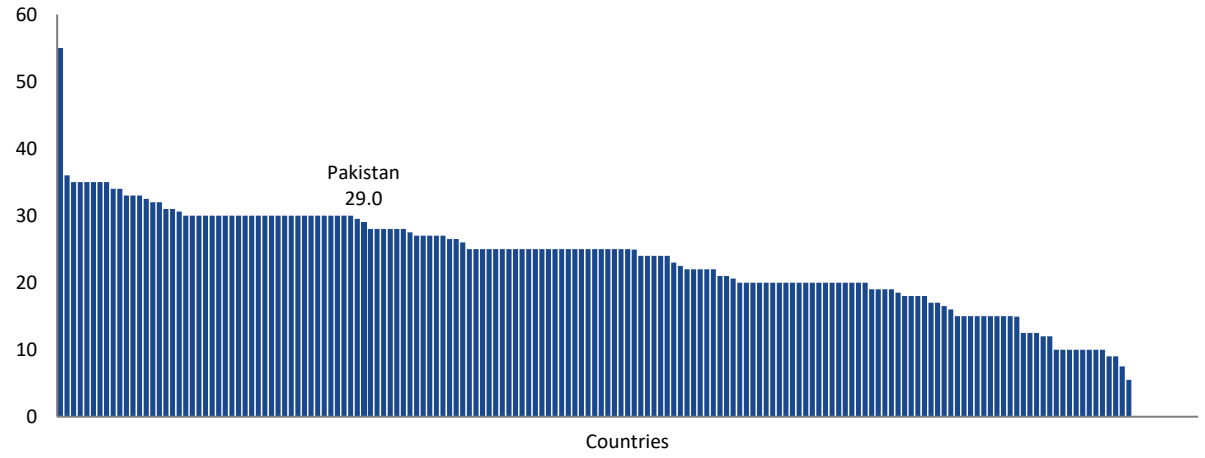
is progressive, with rates ranging from 3.5 percent on gains up to PKR 5 million to 15 percent on gains exceeding PKR 15 million. The rate decreases with the holding period of the asset and is set at 0 for holding periods exceeding 4 years. This risks distorting asset allocation by giving potential sellers an incentive to hold assets for an extended amount of time to minimize their tax liability, even when market condition would encourage an earlier sale. The progressive schedule also provides strong incentives for sellers and buyers to collude on under-reporting of asset values to reduce applicable tax rates. It is for these reasons that most countries opt for a flat capital gains schedule or, if systems are more advanced, decide to tie capital gain taxation into the progressive salary tax schedule.

5.3.2.2 Corporate Income Tax

The definition of the CIT base is consistent with international practice. CIT is levied on revenues minus costs of goods sold, depreciation, interest expenses, and overheads. Companies are allowed to carry forward losses for six years.[30] Pakistan taxes the global corporate income of resident companies and has introduced key anti-avoidance provisions, governing transfer pricing, foreign debt interest expense, and foreign-controlled companies. Pakistan has also signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

Pakistan's thin-cap provisions only have limited coverage, opening opportunities for firms to reduce their tax liabilities. Thin-cap provisions regulate firms that are financed by a relatively high portion of debt compared to equity. In such circumstances, interest expenditure is high, which reduces firms' tax liability. Thin-cap provisions limit the amount of interest that can be deducted in calculating the taxable profits to prevent companies from avoiding tax liabilities through excessive debt, for instance by defining a maximum debt-equity ratio and disallowing tax deductions on interest paid on debt exceeding this ratio. Pakistan's thin-cap provisions are limited as they only apply when the foreign debt to foreign equity ratio of a company exceeds 3:1, in which case interest paid on debt above this ratio is not eligible for a deduction. The lack of thin cap provision, especially on domestic loans, creates options for transfer pricing and an incentive for over-leveraging.

Figure 5.28: Corporate income tax rate in international comparison



Source: KPMG data and World Bank staff calculations.

[30] Resident companies in the hotel business (classified as an 'industrial undertaking') are allowed to carry forward losses for up to eight years.

CIT rates differentiate between three different regimes. Different tax rates and special provisions apply to standard companies, small firms, and small and medium-sized enterprises (SMEs) in the manufacturing sector:

- **Standard regime:** All firms not eligible for a preferential scheme are subject to a 29-percent flat tax rate. This rate is high by international standards and places Pakistan in the top 30 percent globally (Figure 5.28).[31] A higher standard rate of 35 percent is applied to the banking sector, with "super taxes" applied on an ad-hoc basis to fill revenue needs.[32] Firms in the standard regime are also subject to two special provisions. First, the minimum tax scheme requires firms to pay either the standard tax liability on net income or 1.25 percent of turnover, whatever is larger. Second, the alternate corporate tax requires firms to pay at least 17 percent of accounting income in corporate taxes. In summary, firms either pay the standard rate multiplied by revenue minus deductions, 1.25 percent of turnover or 17 percent of accounting profits, whichever is larger.
- **Small companies:** These are defined by a complex list of factors, including equity, number of employees, and turnover.[33] Many of the thresholds are comparatively high and encompass what would typically be considered a medium-sized company in other countries. Small companies benefit from a reduced CIT rate of 21 percent.
- **SME in the manufacturing sector:** The tax regime for manufacturing SMEs is distinct from that for small companies. Manufacturing firms whose turnover does not exceed PKR 250 million are eligible for this scheme. A qualified company can elect to either be taxed on a progressive scale based on its taxable income or to be taxed on turnover, also on a progressive scale (Table 5.2). Firms in this regime are not subject to the minimum tax and, if they opt for the turnover tax, are not subject to audit.

Table 5.2: SME tax categories and options

Categories	Normal Tax Regime	Final Tax Regime
Category 1: Annual turnover below or at PKR 100 million.	7.5% of the taxable income.	0.25% of the gross turnover.
Category 2: Annual turnover above PKR100 million but capped at PKR250 million.	15% of the taxable income.	0.5% of the gross turnover.

These systems generate incentives for firms to split or stay small. The objective of special tax regimes for smaller companies is to encourage formalization and corporatization through the reduction of compliance costs. At the same time, the generosity of the special regimes encourages firms to comply with their requirements, which generates economic distortions if firms adjust their scale to benefit from the beneficial schemes. This is especially relevant for the small firm regime, where caps on the number of employees risk incentivizing firms to stop hiring or rely on informal labor instead, and where caps on equity may lead firms to rely on debt financing instead, inducing financing risks and, in the absence of thin-cap provisions, reducing tax liability. Firms also have an incentive to split to comply with the requirements, especially in the SME scheme for manufacturing firms, where smaller firms benefit from a substantial reduction in applicable tax rates.

[31] The rate was lowered from 35 percent previously, which was the third highest corporate income tax rate in the world.
[32] In June 2022, the Government imposed a 10 percent super tax on banks.
[33] A small company is defined for tax purpose as one that: (1) is registered on or after 1 July 2005, (2) has a paid-up capital plus undistributed reserves not exceeding PKR 50 million; (3) has no more than 250 employees; (4) has an annual turnover not exceeding PKR 250 million; and (5) is not formed by splitting up or the reconstituting a business already in existence (PWC, 2021).

The unequal treatment of firms distorts competition. The CIT system provides substantial implicit fiscal transfers to select sectors and firms, with applicable tax rates ranging between 7.5 percent of income for small manufacturing firms to 45 percent for firms in the banking sector. The unequal application of CIT system distorts the neutrality principle of taxes and generates an uneven playing field for firms, with potentially adverse impacts on competition-induced growth.

Provisions for turnover tax reduce incentives to invest in accounting and tax administration. Firms with inadequate accounting practices are taxed on turnover under the minimum tax scheme. In addition, back of the envelope calculations suggest that the final tax regime under the manufacturing SME regime is a dominant choice for almost all firms. For instance, for category 1 firms with a 30 percent profit margin, the turnover tax would result in a tax liability of 0.25 percent, compared with 2.25 percent under the normal tax regime, which is only attractive for firms with profit margins at 3 percent or lower (Table 5.3). With most firms likely to opt in to the turnover tax regime, and due to the rule that SME's under this regime are not audited, they are disincentivized from investing in better book-keeping, a potential constraint to both firm growth and revenue potential. The reliance on turnover taxes also risks discouraging FBR from investments into the effective administration of a profit-based income tax. Finally, the minimum tax exposes genuine loss-making firms to tax liabilities, potentially worsening their situation because there is no provision to transfer to a profit-based tax instead.

Table 5.3: Tax liabilities under the normal and final tax regime, category 1

Scenarios	Turnover	Profit	Normal tax regime (7.5% on profit)	Final tax regime (0.25% on turnover)
1. **Standard case:** 30 percent profit margin	100	30	2.25	0.25
2. **Break-even case:** 3 percent profit margin	100	3.3	0.25	0.25

There is evidence that the minimum tax yields enforcement benefits. Turnover taxes provide fewer opportunities for tax evasion as they do not require audited estimates of costs. Thus, while they may be less desirable from an economic efficiency perspective, turnover taxes can yield enforcement benefits. Estimates for Pakistan suggest that the minimum tax scheme has reduced evasion by between 60 to 70 percent of corporate profits, and that switching to a full turnover scheme could raise corporate tax revenue by 74 percent without reducing after-tax profits. [34]

Pakistan's CIT regime also provides for various tax incentives. They include outright tax holidays, reduced rates, credits, and exemptions granted by sector, investment type, and location. Many tax holidays run for a long time. For instance, profits derived from an electric power generation project are exempt from tax without a sunset period, new deep-conversion refineries enjoy a 20-year tax holiday, and 10-year income tax holiday are awarded to certain transmission line projects and to enterprises set up in special economic zones. In addition to outright tax holidays, the income tax code allows for generous reductions of tax liabilities, for instance up to 90 percent for low-income housing projects and the provision of a reduced 20 percent tax rate (and tax exemption for dividends) for select builders and developers. Reduced minimum tax rates are also available for certain industries, such as sugar, cement, edible oils, and fertilizer. To attract investment, a tax credit of 25 percent of the amount invested is available to a green

[34] Best, M. C., Brockmeyer, A., Kleven, H. J., Spinnewijn, J. and Waseem, M. 2015. "Production versus revenue efficiency with limited tax capacity: theory and evidence from Pakistan." *Journal of Political Economy* Vol. 123 No.6: 1311-55.

field industrial undertaking. Such incentives are an additional provision in the income tax to conduct implicit fiscal transfers to select industries while undermining the tax base at the same time. They also generate complex incentives through their interaction with the alternate corporate and minimum tax regimes.

5.4 Policy Recommendations

Pakistan's tax system needs a well-structured overhaul that simplifies its provisions, closes loopholes, and ensures an equitable distribution of the tax burden. Despite the development of strategies and proclaimed intentions over the last two decades, successful outcomes remain to be attained. Instead of a complete system overhaul, which may be infeasible from a political economy perspective, a carefully prioritized approach that bundles reforms with compensation mechanisms, stakeholder consultations, and continued investments in taxpayer services may be more promising. In the long run, reforms should aim to create (i) a simple CIT regime with a single, simplified provision for smaller companies, (ii) a simplified personal income tax system focused on taxing income only at source and (iii) a non-distortionary comprehensive sales tax system. The following roadmap outlines key step towards this goal.[35]

Box 5.4: The political economy of tax reform in Pakistan

Tax policy reform is at risk of being influenced by a diverse set of stakeholders whose priority is not the restoration of fiscal sustainability in Pakistan. Pakistan's current tax system provides preferential treatment to a range of economic and political interest groups through concessions, exemptions, and other policy measures. Table B4.1 provides an overview of the main stakeholders and their motivation to influence tax reform and tax administration. It argues that tax policy is influenced by a negotiation within the public sector on the one hand—between federal and provincial governments and the bureaucracy—and on the other hand, between the public and the private sector, including businesses, traders, elites, associations, broader civil society, and media. Elites exert influence and resist reform through a variety of channels, including by mobilizing their political connections, threatening to obstruct businesses, or staging public protests. In doing so, they create a system in which narrow interests determine policy and undermine the interest of the public. It also creates a situation in which policy outcomes are significantly more responsive to the preferences and priorities of the wealthy than the bottom 40 percent.

Overcoming the challenging political economy requires convincing those that are set to lose from tax reforms that a more stable Pakistan is central to their own interests. Dercon (2022)[36] argues that meaningful reform, and therefore growth, is contingent on a country's elites' acceptance that growth is in their self-interest. For Pakistan, this requires highlighting to the elites that currently oppose tax reform that their personal costs associated with Pakistan's boom–bust growth cycle outweigh their benefits from narrow preferential tax treatment, and that they (and their businesses) are set to gain more from a stable and fast-growing Pakistan with an equitable and efficient tax system than under the status quo. Public pressure on elites through transparency can also help, for instance through the publication of detailed beneficiary reports that highlight which firms and beneficiary owners take advantage of certain tax incentives.

The Government itself may be reluctant to undertake reforms that impose short-term transition costs in exchange for longer-term revenue gains. An example of this is the WHT regime on non-income transaction which, as discussed in this chapter, is prevalent in Pakistan. This system, while economically distortionary and limited in

[35] The introduction of new types of taxes, specifically the wealth, inheritance, and gift taxes, should be deferred. While it is tempting to introduce such instruments to tax richer segments of the wealth distribution, such taxes have not feature in the authorities' recent reform agendas. With the segregated databases across federal and provincial levels (and more so, the property tax is under the purview of provincial governments by Constitution), the introduction of new taxes on net wealth and/or inheritance tends to be unrealistic and cloud over other more critical reform actions.

[36] Dercon, S. 2022. *Gambling on Development: Why Some Countries Win and Others Lose*. London: Hurst and Company.

revenue potential, provides an assured stream of revenues to the tax administration, and thus enables them to meet their (narrowly defined) revenue target. Similarly, anecdotal evidence suggests that obtaining refunds for either income tax withheld or for excessively paid sales tax is difficult in Pakistan, as FBR uses the collected revenues to meet their revenue targets. Overcoming this short-term inertia, for instance by redefining FBR's annual targets to include tax system efficiency measures, or by separating the tax administration from the tax policy function, is instrumental for meaningful tax reform.

Table B.4.1. Stakeholders Influencing Tax Policy

Stakeholders	Motivation	Influence	Example actions taken by stakeholder that prevent reform
Political Elites • Executive/Cabinet • Parliament • Political Parties • Finance Ministers • Cabinet Committees • Standing Committees	• Raising tax revenues to finance public policies • Attracting foreign direct investment • Consolidating power and narrow political interests • Political survival through reelection while maintaining public image as a reformist • Patronizing political and economic allies • Deepening rent-seeking opportunities • Fundraising for election campaign financing	Very strong	• Politization of tax system through higher-level appointments of political allies in revenue authorities • Backing off from tax reforms opposed by lobbies and associations • Designing complicated tax laws to make their enforcement non-transparent and require judicial interpretations • Ideological battles at Cabinet level that slow down reform
Sub-national governments • Provincial Governments • Local Governments	• Securing large share of the divisible pool to meet increasing expenditure needs • Quest for more political, financial, and administrative autonomy	Very strong post 18th Amendment	• Negotiating revenue compensation mechanisms to offset potential revenue losses • Undermining fiscal reforms by resorting to ad hoc fees for additional, off-budget revenue generation • Opposing own-source revenue reforms that could alleviate fiscal pressure on federal level
Bureaucracy • Revenue Authorities • Ministry of Finance	• Maintaining discretionary powers for rent-seeking • Networking for promotion • Protecting interests of ruling coalition, their financiers, and lobbies/businesses	Strong	• Creation of informal rules • Cumbersome administrative requirements facilitating rent-seeking • Hiring and staffing policies that encourage high staff turn-over, often under political influence
Economic Elites • Industry • MNCs • Exporters • Service Sectors	• Business benefits through lower taxation and compliance costs, e.g., through exemptions	Strong	• Lobbying and networking for exemptions, incentives, special regimes (zero-rated sectors) and informal benefits through

• Traders/Retailers • Landlords/Agribusiness • Business Associations • Chambers of Commerce and Industry • Trade Unions	• Avoid audits • Improve business environment • Prompt refund payments		business associations (APTMA, APSMA, Fertilizer, Cement) • Financing political campaigns • Leveraging promises of job creation and investment to obtain preferential tax treatment • Staging public protests to influence tax negotiation outcomes or against tax reforms
Civil Society • Media • Civil Society Organizations • Tax Professionals	• Equitable and fair tax system • Promoting transparency in tax administration • Advocating transparency in governments expenditure	Moderate	• Complete monopoly of some media houses over the ways and means of influencing public opinion gives them unmatched access and intrusion into the policymaking process by exerting pressure on the political structures
Development Partners • IMF • World Bank Group • Asian Development Bank • FCDO • USAID	• Increasing tax revenues for financing national development priorities and fiscal stability • Promoting equity, efficiency, and fairness in tax system	Strong	• Foreign capital inflows from development partners lower tax effort

5.4.1 Sales Tax

<u>Immediate Priority:</u> Unifying the rate structure and eliminating zero-ratings on domestically sold products.

- As outlined in this chapter, Pakistan's sales tax on goods is complex and highly distortionary. Rectifying this could initially involve unifying the rate structure by removing concessional rates through the elimination of the 8th schedule of the sales tax act and applying the standard rate on all goods subject to reduced rates.
- This could be complemented by limiting the list of goods subject to zero-rating exclusively to exports. All domestically sold goods mentioned in the 5th schedule of the sales tax act could initially be moved to the exempt list under the 6th schedule before exemptions are gradually rationalized (see medium-term priority).

<u>Medium-Term Priority:</u> Reduction of sales tax exemptions while concurrently lowering the overall rate.

- In the medium-term, Pakistan could strive to reduce the items included in the 6th schedule of the sales tax act, limiting exemptions only to those considered as basic food, basic public health services, and selected financial transactions.
- To buffer the social impacts of such exemption removal and prevent an increase in poverty, some of the savings could be used to increase BISP transfers to targeted households.
- A broadened tax base could also be leveraged to lower the currently high sales tax rate to garner support for the reforms.

<u>Long-Term Priority:</u> Unifying and aligning the sales tax registration threshold with the CIT threshold and harmonizing the provincial and federal sales tax systems.

- A simplification of the sales tax system could involve a unification of the registration threshold for all industries, in close coordination with an updated threshold for the small companies' concessional CIT (see recommendations in section 4.3).
- A unification of provincial sales tax on services and federal sales tax on goods is also critical, but beyond the scope of this chapter (Box 5.5).

Box 5.5: Challenges and options for sales tax harmonization in Pakistan

Under Pakistan's constitution, the Federal Government is tasked with collecting federal sales tax on goods, while provinces levy sales tax on services. This leads to fragmentation with regard to legislation and administration and has resulted in five different sales tax regimes and multiple taxing authorities. Such segregation breaks down the flow in tax administration processes and risks posing additional challenges to FBR and provincial tax authorities, including:

- Increased complexity in managing refunds for cross state transactions.
- Increased compliance cost and reduced enforcement effectiveness: Complications in dealing with proportioning the same inputs produced for exempts and non-exempts when transactions transverse provinces; non-uniform definition of taxable supplies (especially when businesses are engaged in both services and manufacturing or trading).
- Heightened risk of double taxation when the definition of goods and services are not consistent across jurisdictions.

Such challenges are not uncommon in federal systems, which typically choose one of three approaches to address policy interdependencies:

1. **Ideal case:** Completely harmonizing the base, rates, and administration at the central level, in combination with an agreed-upon formula for revenue allocation (example: Australia). In Pakistan, this would simplify and minimize the administration and compliance costs in taxing inter-provincial supplies but would require a constitutional change.
2. **Realistic case:** Harmonizing the base while allowing rates to vary across provinces (example: the EU). This is a compromise that preserves some subnational autonomy but increases compliance costs and entails a risk of leakage for inter-state supplies (e.g., through carousel VAT evasion) when compared to the ideal case.
3. **Current case:** Co-existence of multiple bases and rates that erode tax bases and discourage inter-provincial trade.

To move towards the second or first approach, the following steps will be critical:

I. Creating a joint Federal-Provincial Review Committee (this has been instituted with the National Tax Committee).
II. Determining transitional policy actions, including specifying intergovernmental compensation mechanisms, institutional and procedural preparation of policy and administration reviews, and setting reform milestones.
III. Harmonizing federal and provincial sales tax base definitions, regimes, place of supply rules, administrative procedures, tax interpretation, and audit and enforcement activities.
IV. Concurrence of and operationalizing information exchange.

5.4.2 Personal Income Tax

Immediate Priority: Unifying and simplifying the personal income tax schedule.

- Pakistan's tax system features some low-hanging fruits to enhance equity and increase personal income tax collection. The authorities could consider merging the tax schedules for salaried and non-salaried taxpayers and simplifying the tax schedule by reducing the number of brackets. This would equalize tax treatment across income sources, reduce economic distortions, and reduce opportunities for tax planning.
- These measures to simplify the tax schedule could be combined with a gradual reduction of withholding lines on non-salary transactions, thus reducing the tax burden, enhancing equity, and improving economic efficiency.

Medium-term Priority: Reducing the time-dependence of capital gain tax liability. Pakistan's current system reduces taxable capital gains to zero after 4 years of asset holding, encouraging investments in relatively unproductive assets, including real estate, and opening tax avoidance opportunities. Redesigning this system will require a careful balance that provides some tapering of tax rates to discourage speculation for short-term gains, while preventing lock-in effects into non-productive assets as experienced under the current system. One option could involve a two-tier system, where assets held for one year or less would be subject to the standard capital gain tax rate, and a separate concessional rate applies to a subset of assets, such as property, that is held for a longer time and for which public policy wants to decrease the incentive for speculation.

Long-term Priority: Calibrating the taxation of capital and labor income. Over the longer-term, Pakistan could consider establishing a dual income tax regime that only differentiates income by two sources: labor and capital. A distinction between these two sources adequately considers that capital should be taxed for redistributive purposes, but that lower taxation than for labor income can encourage savings and investments. Under such a system, labor would be subject to the progressive schedule outlined above, whereas any other income from capital would be subject to the two-tier structure mentioned previously. A standard rate for 15 percent for capital gains would be appropriate.

5.4.3 Corporate Income Tax

Immediate Priority: Creating a unified and simplified concessional tax regime for small companies.

- The current co-existence of two concessional CIT regimes for manufacturing SMEs and other small companies is ineffective and inefficient. Instead, Pakistan could consider creating a unified concessional tax system for small enterprises that replaces the existing structure. Eligibility for this system should only be based on annual turnover, and the threshold should be equivalent to the sales tax registration threshold. All firms above the threshold would be required to comply with the normal CIT regime.
- Firms below the threshold could benefit from a simplified tax regime that reduces compliance costs, for instance through a single turnover tax that encompasses both sales and income tax liabilities and simplified book-keeping requirements. The tax rate in the turnover scheme would need to be calibrated in such a way that firms' tax liability is a continuous function of turnover at the registration threshold to minimize any tax-induced incentives for firms to remain small. In such a system, firms would only gain a compliance and not a tax advantage.

Medium-term Priority: Unifying the standard rate regime, expanding thin-cap provisions and rationalizing tax incentives.

- To enhance economic efficiency, reduce misallocation, and improve equity, Pakistan should consider establishing a single tax rate for all sectors, including abolishing "super taxes" for the banking sector.
- A simplification of the CIT regime would also involve a close look at tax incentives by conducting a rigorous cost–benefit analysis of each incentive scheme, abolishing those tax incentives that provide few positive externalities to the wider economy, and switching towards well-targeted incentives that reduce investment costs for firms.[37] To garner political support for a rationalization of tax exemptions, this reform could be designed in a revenue-neutral manner by lowering the CIT rate.
- To ensure policy consistency, Pakistan should also consider eliminating the legal authorization for the executive to grant tax exemptions or concessions through Statutory Regulatory Orders (SROs) without prior National Assembly approval.
- In terms of transparency, Pakistan could consider enforcing and capacitating sectoral ministries to prepare their own estimates of revenue loss from tax expenditure provisions in their domain as part of the annual budget proposal to involve them in evaluating trade-offs between tax expenditures and sectoral budget allocations.
- Finally, Pakistan could consider expanding thin-cap provisions to all firms and all forms of debt.

Long-term Priority: Resolving inconsistencies between the turnover and alternative tax regimes. The alternate corporate tax and the minimum tax deserve a comprehensive review to align them with a reformed rate, regime, and incentive structure. Initially instituted to stabilize CIT collection in the light of enforcement loopholes and various tax incentives, it is worth experimenting with a gradual reduction of these alternative regimes as the tax system matures. One option could involve removing the minimum tax regime while uniformly applying the alternate corporate tax across all sectors and firm sizes.[38] This would enable the FBR to directly compare the tax liabilities calculated under alternative and standard regime and form a basis for a more comprehensive reform of the system. During the transition phase, firms would still be taxed on the larger of the alternate or standard tax liability but could be allowed to carry any difference forward into future tax cycles by using the provisions for loss-carry-forward.

5.4.4 Federal Excise Duty on Cigarettes

Immediate Priority: Creating an automated mechanism to adjust excise rates for inflation. Pakistan taxes cigarettes through nominal specific rates. Although this approach is consistent with international practice, inflation risks eroding the tax base over time when nominal taxes are not adjusted upwards. Adjusting cigarette tax rates currently requires a vote of the parliament. To safeguard against an inflation-induced tax base erosion Pakistan could consider introducing an annual automatic adjustment mechanism that updates cigarette tax rates in line with inflation.

[37] Pakistan's existing investment tax credit granted to greenfield industrial undertakings is a good example of a cost-efficient tax incentive. Other types of cost-effective tax incentives would include those granted as income tax exemptions or credit for R&D, technology acquirements, national workers training, etc.

[38] The practice in the USA is illustrative. There, the alternative minimum tax (AMT) is based on the calculated AMT income (AMTI). The AMTI in turn is computed by adjusting regular taxable income with adding back certain tax preference items. In addition, the net operating losses may reduce AMT by up to 90 percent, compared to a potential full reduction for regular tax purposes.

Medium-term Priority: Rolling out an effective digitized stamp system. While Pakistan has taken initial steps towards establishing a track and trace system, implementation challenges remain. These should be overcome as quickly as possible to allow for a uniform enforcement of the excise duty. To overcome practical challenges with the application of stamps, Pakistan could consider adopting QR codes that link directly to a verifiable database within the FBR. This could be complemented by offering cash incentives to consumers and retail sellers to report cigarette packages sold without or with incorrect QR codes imprinted on them.

Long-term Priority: Unifying the tax system to increase its revenue potential. Pakistan's system of dual taxation for cigarettes based on their final retail price opens evasion opportunities and differs from international practice. Pakistan could consider applying a single rate to all cigarettes independent of their price. This would not only raise revenue but would also align the taxation of cigarettes with the WHO's recommended practice.

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