REFORMS FOR
A BRIGHTER
FUTURE
TIME TO DECIDE

PRELIMINARY DRAFT FOR
CONSULTATIONS AND DISCUSSION

DISCUSSION NOTE 7

RATIONALIZING GOVERNMENT EXPENDITURES

Prioritizing Spending to Support Macroeconomic Sustainability, Investment in People, and Climate-Resilience

WORLD BANK GROUP

Prioritizing Spending to Support Macroeconomic Sustainability, Investment in People, and Climate-resilience

Pakistan's large fiscal deficit has been an important driver of recent macroeconomic instability. Containing the fiscal deficit without negatively impacting development and the poor will be a critical challenge as Pakistan seeks to restore fiscal and macroeconomic sustainability over coming years. Reducing expenditures that do little to support economic growth and development must play a central role. While rationalizing fiscal spending is important for immediately narrowing the deficit, it will also gradually create space for more public investment over time, including in human capital and climate adaptation, to preserve and expand the productive capacity of the economy. Measures that are immediately implementable for rationalizing fiscal expenditures include:

1. **Reducing poorly targeted energy and commodity subsidies,**
2. **Implementing the Treasury Single Account (TSA),** and
3. **Imposing temporary austerity measures.**

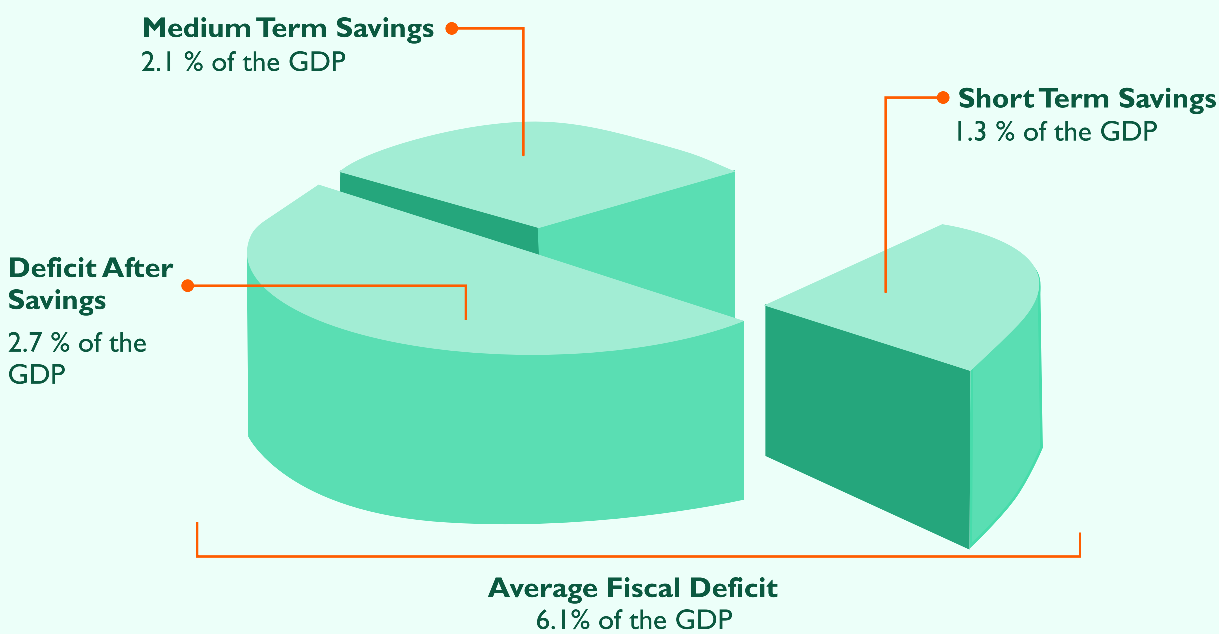
Medium-term measures include:

1. **Reducing federal recurrent and development spending in areas that are provincial constitutional responsibilities,**
2. **Reducing the fiscal drain from poorly performing State-Owned Enterprises (SOEs),** and
3. **Improving the quality of development project spending.**

Potential Gains From Expenditure reforms

- Pakistan could achieve **PKR850 billion** potential savings from short-term expenditure
- Pakistan could achieve **PKR1,380 billion** potential savings from medium-term expenditure measures
- These savings, combined, would be sufficient to finance **more than half** of Pakistan's average deficit of 6.1 percent of GDP over the past decade.

Figure: Average fiscal deficit and potential savings from short-term and medium-term expenditure reforms



The Problem

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 a 22-year high at 7.9 percent of GDP. The fiscal deficit has been growing, with the post-2010 annual average significantly larger than its pre-2010 average. 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. Deficit and debt levels are now in breach of fiscal rules under the Fiscal Responsibility and Debt Limitation Act (FRDLA). Rationalizing and reducing Pakistan's federal expenditure is critical to regaining fiscal and debt sustainability.

Figure 1: Federal Government Spending
(By Current And Development Spending)

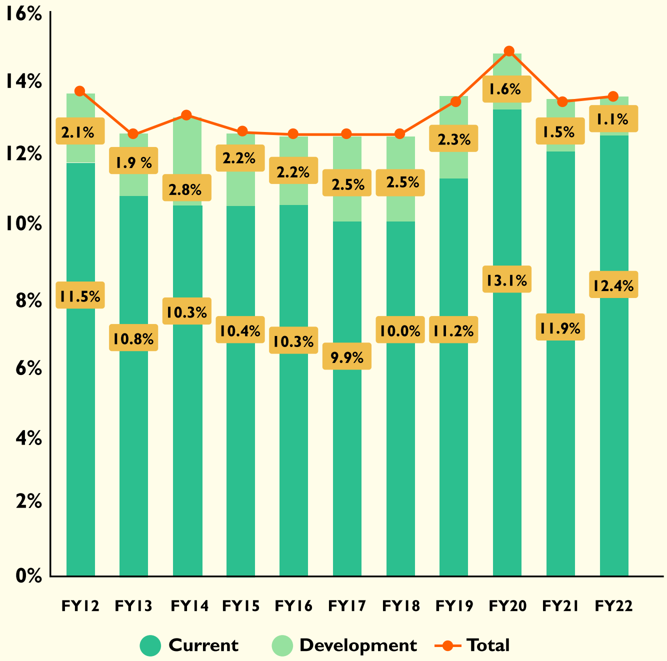
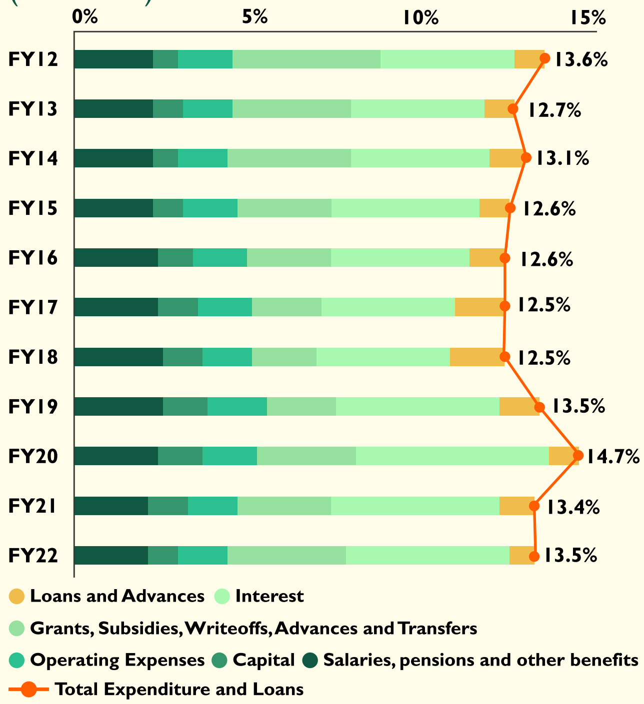


Figure 2: Federal Government Spending, Economic Classification
(% Of GDP)



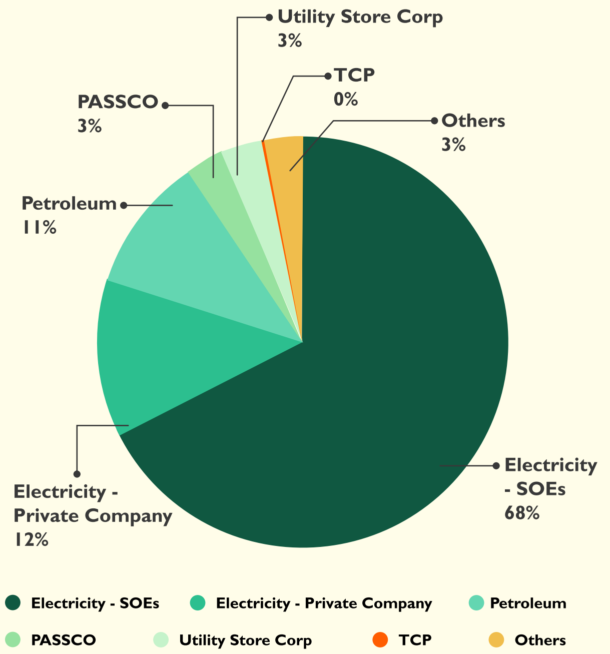
Source: World Bank Staff calculations based on PIFRA data

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. The federal government accounted for about two-thirds of expenditure (13.5 percent of GDP). While not high by international standards, spending is strikingly rigid, with almost 80 percent of total spending annually being allocated to pre-committed areas such as interest payments, transfers and subsidies, and payments to public sector staff (Figures 1 and 2). This is much higher than regional peers. For instance, Nepal's share of rigid federal government expenditure is less than 60 percent.

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 physical and human capital investment have contributed to low growth in productivity, potential output, and employment, and therefore contributed to Pakistan's recurrent boom-bust cycles. Development expenditure needs are expected to rapidly increase over coming years, as Pakistan is forced to adapt to the impacts of climate change.

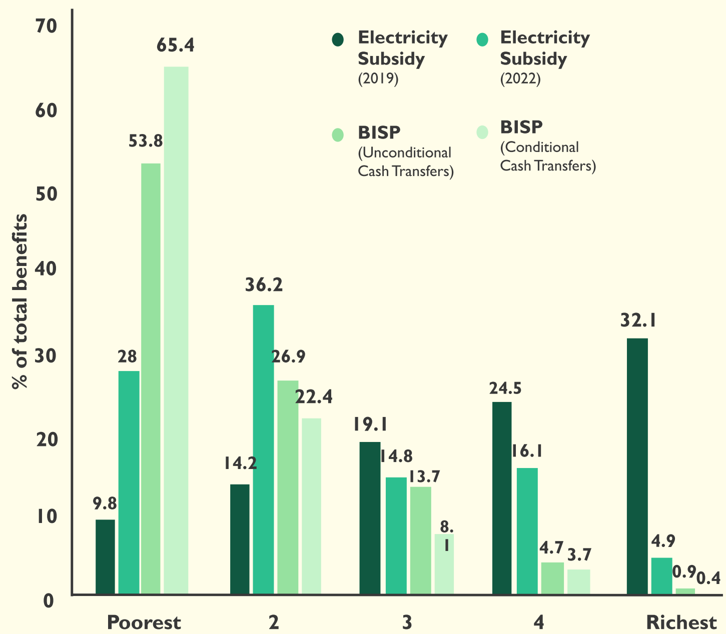
Spending on energy and commodity subsidies is distortive and wasteful. Between FY12 and FY22, subsidy spending averaged 1.1 percent of GDP and increased significantly to 1.8 percent of GDP in FY22. Over 80 percent of recurrent subsidy spending between FY13 and FY22 benefited the electricity sector (Figure 3), with a large share being tariff differential subsidies, accounting for 15 percent of total subsidies in FY22 (0.27 percent of GDP). These subsides are regressive with large shares of the benefits accruing to the non-poor: in FY19, 77 percent of the subsidy spending benefited households in the top 3 quintiles of the income distribution (Figure 4). By contrast, the bottom 40 percent only benefited from 23 percent of total spending. With recent tariff reforms, targeting had greatly improved. By FY22, 64 percent of the subsidy benefits accrued to the bottom 40 percent and only 36 percent of the benefits accrued to the top 3 quintiles of the income distribution. However, with one-third of benefits still accruing to relatively more affluent households, targeting can be further improved.

Figure 3: Cumulative Spending on Subsidies between FY13 and FY22, by type
(% Of Total Spending)



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

Figure 4: 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.

Weak management of SOEs is a major drain on fiscal resources. The federal SOE portfolio has been incurring net losses since FY16 that average around 0.5 percent of GDP annually, with the top 14 loss making SOEs incurring an annual fiscal cost of 0.8 percent of GDP (PKR 458 billion).[1] As a result, federal annual fiscal support to the SOEs, in the form of equity injections, subsidies and loans, has been substantial and growing, reaching 1.4 percent of GDP in FY21. In addition, many government loans to SOEs are overdue and not being serviced. The stock of outstanding government domestic loans to SOEs stood at 3.5 percent of GDP in FY21, of which nearly a third was overdue. Contingent liabilities, in the form of loan guarantees provided by the federal government for SOEs to contract commercial loans, have been rapidly rising, reaching almost 4.5 percent of GDP at end-FY21. Information on tax and dividend arrears is not readily available but taxes and dividends from SOEs averaged just 0.4 percent of GDP over the FY16-FY21, significantly lower than government direct transfers to the SOEs (1.3 percent of GDP).

[1] Excluding health and education institutions, the federal SOE portfolio comprises 207 enterprises, of which 87 are commercial enterprises operating in various economic sectors, and 47 are non-commercial enterprises. Punjab has 224 SOEs (including 49 PSCs) and KP has 121 SOEs (including 6 PSCs). No information is available regarding the SOE portfolios of Sindh and Balochistan.

Recommendations

The following immediate measures should be implemented to reduce fiscal expenditures

1. Reduce energy and commodity subsidies. Reallocating spending from costly, inefficient, and regressive subsidies, such as those on natural gas, petroleum, tube-wells, wheat, and fertilizers towards a targeted transfer program such as the Benazir Income Support Programme (BISP), can help to realize fiscal savings, reduce excessive consumption of imported fuels, and improve social outcomes. Targeted transfers prioritize public resources towards those who are most in need while providing a boost to purchasing power that allows households to choose the highest value goods and services relevant to improving their welfare.

2. Adopt the TSA. The adoption of the TSA can improve the effectiveness the Government's cash management practices. 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. By proper accounting and use of these idle cash balances, the amount of required sovereign borrowing can be reduced, generating interest cost savings of up to PKR 424 billion annually.[2]

3. Impose temporary austerity measures, while protecting maintenance expenditures. The temporary imposition of stringent review requirements over staff and operational costs, as well as development spending, can generate immediate cost savings. The government could consider setting a recurrent expenditure reduction target of 10 percent and implement a government-wide hiring freeze, wage freezes for the mid to upper echelons, and conservative salary increases (if any) for the lower echelons. These should be complemented by other measures, such as the halting vehicle purchases and limiting allowances for representation, meetings, travel and petrol usage for all staff. Concurrently, the government could conduct review of PSDP development expenditure and cancel all projects that have not undergone proper project preparation, selection and prioritization and delay previously vetted projects that are unlikely to bring significant benefits to the poor. Such a consolidation of development expenditure could target a 20 percent reduction in near-term development spending.[3]

Immediate reforms for fiscal expenditure reduction:	Annual Fiscal Savings Potential Billions of PKR
Eliminate spending on subsidies for:	
Electricity tariff-differential	**167**[a]
Tube-wells	**20**[a]
Minimum support price for wheat (Subsidies to PASSCO)	**8**[a]
Fertilizers (Subsidies to farmers plus subsidies for urea manufacturing)	**41**[a]
Gas (to LNG sector for subsidized gas supply to industry)	**81**[b]
TSA interest cost savings	**424**
Austerity measures over government staff and operational costs (10 percent of FY22 "Running of Civil Government" costs)	**55**[c]
Consolidation of PSDP allocations (20 percent of FY22 Federal PSDP expenditure)	**80**[c]
Total	**876 (1.3 percent of FY22 GDP)**

Source: Controller General of Accounts and Ministry of Finance. Notes: [a]PIFRA data; [b]FY22 Revised Budget; [c]Fiscal Operations 2021-22 data

[2] This assumes that new government borrowings incur interest rates that are equivalent to the policy rate, currently at 21 percent at the time of writing.

[3] However, maintenance spending for infrastructure should be protected to prevent deterioration of growth-enhancing assets and higher future repair or replacement costs.

4. Reduce the fiscal drain of SOEs. The fiscal drain stemming from SOEs can be reduced by (i) discontinuing subsidies to SOEs that do not provide a public good benefit (ii) enforcing all SOE loan agreements and establishing stringent processes and criteria for evaluating SOE loan requests, including reviews of assets that can be collateralized for repayment capacity (iii) implementing the recommendations of the 2021 triage exercise (a Ministry of Finance review, which assigned SOEs to categories for retention, privatization, or liquidation), and preparing for the divestment of major loss making SOEs, especially those with no clear rationale for government involvement, (iv) pursuing opportunities for private participation across the SOE portfolio through management or concession contracts; and (v) strengthening SOE governance through implementation of the new SOE law and improving financial management and performance, including by strengthening the capacity of the SOE Central Monitoring Unit and institutionalizing SOE performance monitoring.

Medium-Term measures for rationalizing fiscal expenditures

5. Realign federal recurrent and development spending with constitutional mandates. 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 in the following areas should be eliminated from the federal budget to improve accountability, reduce duplication, and realize fiscal savings.

- Spending on federal ministries focused on devolved subject areas, such as those for health and education, amounted to PKR 328 billion (0.5 percent of GDP) in FY22.
- Federal spending on devolved subjects through semi-autonomous bodies that focus on devolved service delivery areas, such as the Higher Education Commission (HEC) and the National Commission for Human Development (NCHD). Spending on the HEC was PKR 70 billion in FY22. Therefore, a gradual or phased elimination of the financing for devolved ministries and semi-autonomous programs bodies from the federal government budget, could eventually result in federal fiscal savings of 0.6 percent of GDP annually.[4]
- Federal government spending on vertical programs, such BISP, that directly provide services in the provincial domain. Federal spending on BISP was approximate PKR 240 billion in FY22. The cost sharing of BISP, where the provinces eventually bear 90 percent of the program, could yield PKR 217 billion (0.3 percent of GDP) of federal fiscal savings annually.[5]
- Federal development spending on devolved areas, which amount to PKR 315 billion in FY22. An exclusive focus on development spending in the federal constitutionally mandated domain has large savings potential for the federal government.

Medium-term reforms for fiscal expenditure rationalization	Annual Fiscal Savings Potential Billions of PKR
Reduced operational spending on devolved ministries	**328**
Devolution of the HEC	**70**
Cost sharing by provinces on BISP	**217**
Refocusing federal development spending on federal mandates	**315**
Triage of top 14 loss making SOEs	**458**
Total	**1,388 (2.1 percent of FY22 GDP)**

Source: World Bank Pakistan Federal Public Expenditure Review 2023

[4] The financing of semi-autonomous institutions, such as the HEC, can be subsequently taken up by the provinces in line with the constitutional mandates.
[5] In order to protect access to essential social services in lower-capacity provinces, a phased devolution approach with appropriate safeguards and remedial actions should be planned and adopted.

6. Reform pensions to reduce pension costs. Fiscal costs for Pakistan's civil servants' pension schemes have dramatically grown. A recent study[6] found that provincial pension expenditures grew from 1.6 percent of GDP in 2016-2017 to 2.2 percent of GDP in 2020-2021. Estimates indicate that overall pension spending as a share of tax revenue reached 18.7 percent as of FY20.[7] Measures to constrain the growth of pensions spending include automatic indexation to inflation subject to a cap, instituting a minimum retirement age to receive benefits, and limiting dependents eligible for survivorship benefits.

7. Divest or restructure SOEs (including through increased private participation), in accordance with the recommendations of the triage exercise. After identifying and addressing binding constraints to divestment/restructuring, the government should proceed rapidly with required restructurings and transactions to divest those SOEs that engage in purely commercial activities. Subsequently, private participation can be introduced where this is likely to improve incentives and capacity for commercial performance. Implementation of triage could reduce fiscal expenditures by 0.8 percent of GDP.

8. Strengthen public investment management to improve the quality of development spending. Recommendations include to fully implement the PFM Act of 2019, including the use of economic and risk analysis for development projects and to establish an M&E system for public investment projects and programs.

9. Rationalize provincial expenditures. Opportunities should also be pursued to rationalize provincial expenditures. Important opportunities include reforms to i) reduce the spiraling costs of provincial civil service pensions; ii) address provincial commodity subsidy and price support schemes that lead to high fiscal costs and the accumulation of commodity debt; iii) reduce costs of the provincial SOE portfolio, mirroring efforts underway at the federal level; and iv) optimize human resource expenditures in basic service delivery, including civil service pay reform to ensure that compensation is aligned with market norms and based on adequate qualification and performance.

[6] 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.
[7] 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.

A Roadmap for SOE Reform

1. Reduce fiscal exposure by i) instituting strict conditionalities and performance covenants for issuance of new fiscal support to SOEs; ii) enforcing loan contracts to ensure the timely recovery of overdue amounts, linking this to the performance contracts of Boards of Directors; iii) enforcing a legislated overall guaranteed limit; and iv) introducing a maximum cap on exposure as a percentage of SOE assets/liabilities.

2. Improve information on SOE performance by: i) improving the financial reporting framework and comprehensiveness of Government Financial statements; ii) defining a financial reporting framework for federal and commercial SOEs created by special enactment; iii) introducing disclosure requirement for corporate reporting for PSCs, including in relation to the adoption of sustainability standards; iv) incorporating SOE holdings onto the Government balance sheet; v) introducing a computerized database to provide portfolio-level information and entity-level exposure and performance information to the decision makers.

3. Introduce corporate governance reforms in line with the new Federal SOE Law (2023) including i) developing a state ownership policy and dividend policy; ii) ensuring competitive selection of professional and independent Boards of Directors; iv) developing a SOE performance monitoring and evaluation system; and v) transferring the SOE oversight function from line ministries to a strengthened Central Monitoring Unit.

4. Support improved commercial performance, including i) requiring SOE management to develop business plans to achieve commercial rates of return; and ii) monitor implementation through separately accounting for commercial and non-commercial activities and taking explicit account of subsidies paid to SOEs for the provision of public service obligations.

5. Pursue triage to quickly divest SOEs where there is no rationale for government ownership, through: i) identifying binding constraints to divestment/restructuring; ii) developing a reform roadmap to improve performance of the entities that will be retained and restructured; and iii) progressing transaction for those SOEs that can be quickly divested.

ABOUT THE "REFORMS FOR A BRIGHTER FUTURE" DISCUSSION NOTES:

"Reforms for a Brighter Future" is an initiative of the World Bank, aimed at fostering debate and dialogue on critical economic development policy issues facing Pakistan. Further information is available from the World Bank Pakistan website at https://www.worldbank.org/en/country/pakistan/brief/reforms-for-a-brighter-future-time-to-decide. This is the seventh in a series of eight discussion notes. These notes outline World Bank recommendations across selected policy areas where major reforms are critical for Pakistan's progress towards inclusive and sustainable development. They do not aim to be comprehensive, but rather focus on selected areas where major policy shifts will be required to improve Pakistan's current development trajectory. Feedback from consultations and dialogue will be incorporated as the notes are finalized. This note was prepared by Derek Chen (Senior Economist) with inputs from Qurat ul Ain Hadi (Financial Management Specialist). Please send feedback or comments to Tobias Haque (Task-Team Leader, thaque2@worldbank.org) and Puteri Watson (Task-Team Leader, pwatson2@worldbank.org).