REFORMS FOR
A BRIGHTER
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TIME TO DECIDE

PRELIMINARY DRAFT FOR
CONSULTATIONS AND DISCUSSION

DISCUSSION NOTE 3

TRANSFORMING PAKISTAN'S PRIVATE SECTOR

Facilitating a Dynamic, Productive, and Environmentally Sustainable Economy

WORLD BANK GROUP

Facilitating a Dynamic, Productive, and Environmentally Sustainable Economy

Pakistan's current consumption-driven, import-intensive growth model is unsustainable. Red tape imposes a heavy compliance burden on firms, a large state presence in the economy distorts markets and competition, while heavy trade protections benefit large incumbent firms at the cost of new firms and exporters. As a result, productivity and investment is low and declining, economic growth is slowing, formal sector employment opportunities are scarce, progress with poverty reduction is inadequate, and the economy is subject to periodic macroeconomic crises. A comprehensive program of reforms is required to unleash the productive potential of Pakistan's private sector, including through increasing competition and outward orientation. This reform program should include measures to:

1. Improve firms' access to finance by limiting government borrowing from the domestic financial sector;
2. Simplify the business environment through coordinated federal and provincial regulatory reform and digitalization processes;
3. Reduce the heavy state presence in the economy through a program of SOE reform and selective divestment;
4. Rationalize trade tariffs to reduce disincentives to exporting; and
5. Ensure the rigorous maintenance of a flexible and market-determined exchange rate.

Potential From Transforming Pakistan's Private Sector:

US$88 billion
Export potential

US$2.8 billion
Foreign Direct Investment Potential

7-8% GDP growth
With investment increased to 25 percent of GDP

The Problem

Pakistan's private sector and export performance

Higher private investment and improved export performance are critical to improving living standards. Pakistan's recent growth has been driven by unsustainable booms in consumption, underpinned by fiscal expansions aligned with the political cycle. This has led to high fiscal and current account deficits and periodic macroeconomic crises, with little improvements in economy-wide productivity. Higher private sector investment can help Pakistan escape this cycle, generating new and higher paying jobs for Pakistan's young and growing population, and the revenues required to fill critical public service deficits, including in health and education. In many countries, exports have provided a critical foundation for increased private investment, allowing firms to access a much larger global market for products that Pakistan can produce efficiently, generating critical foreign exchange to finance the import of products that are costly to produce domestically, and providing economy-wide improvements in productivity through exporting firms' exposure to international innovations and competition (see Box 1).

Private investment in Pakistan is low and declining. Pakistan has very low rates of private investment relative to regional and comparator countries (around one-third of the South Asia average). Private investment declined from an average of 13.7 percent of GDP in the 2000s to around 10 percent in FY21.

Foreign direct investment (FDI) has also remained minimal, at around 0.6 percent in FY21, before declining to negligible levels amid recent macroeconomic instability and political uncertainty. This represents a major lost opportunity when FDI performance is compared against regional peers and estimated FDI potential of around US$2.8 billion per year (Figure 2).

Figure 1: Private Investment As % GDP

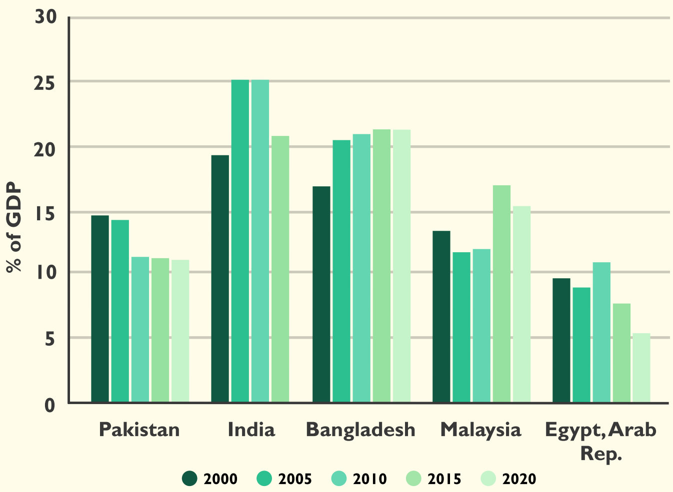
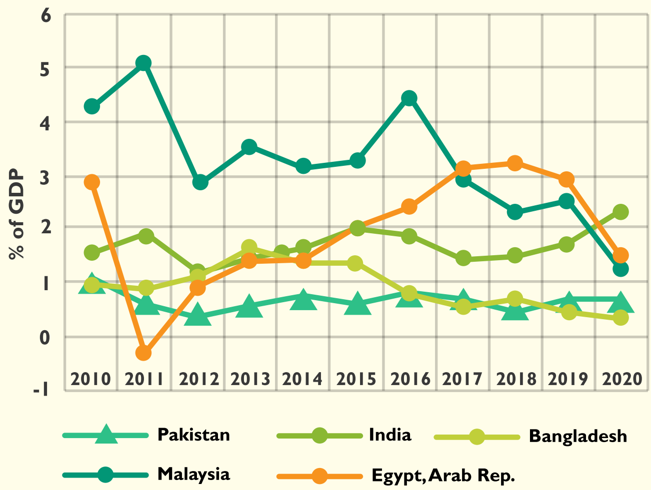


Figure 2: Foreign Direct Investment As % GDP



Source: World Development Indicators

Pakistan's export performance is weak, and the private sector increasingly inwardly oriented. As a share of GDP, Pakistan's exports fell from 16 percent in 1999 to 9 percent in 2021, an exceptionally low level among middle-income countries (Figure 1). In 2000, US$14 out of every US$10,000 worth of goods and services exported worldwide originated in Pakistan. This has fallen to only US$11 in 2021 (in contrast, Vietnam increased its export market share from US$23 to US$123 over the same period) (Figure 4). Declining export performance is generalized across sectors, with Pakistan's share of the global textile and apparel market shrinking from 2.3 percent to 1.8 percent over the past two decades. Pakistan has also made little progress in diversifying its exports. It is in the bottom half of countries in terms of the diversity of exported products, and the bottom third of countries in terms of the diversity of its export markets, with both measures showing deterioration over the past decade.

Figure 3: Exports Of Goods & Services (Percentage Of GDP, 2021)

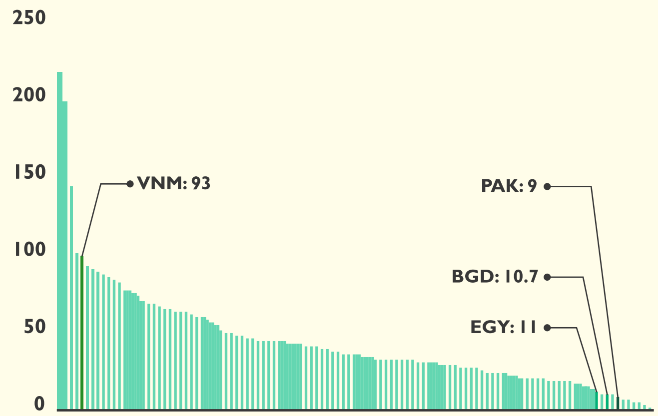
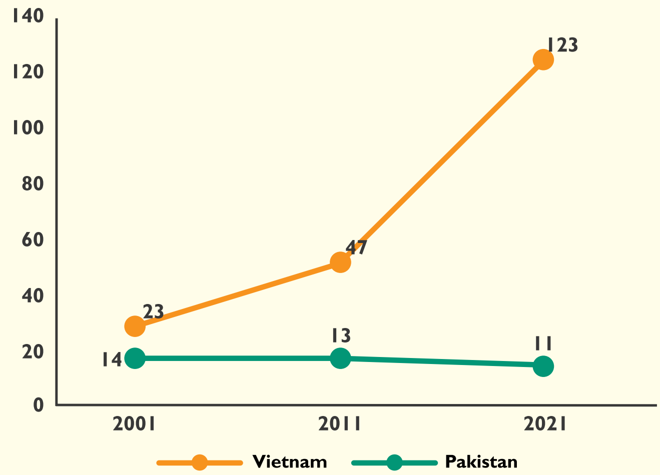


Figure 4: Global Market Shares (Exports Per $10,000 Of World's Exports)



Source: World Development Indicators

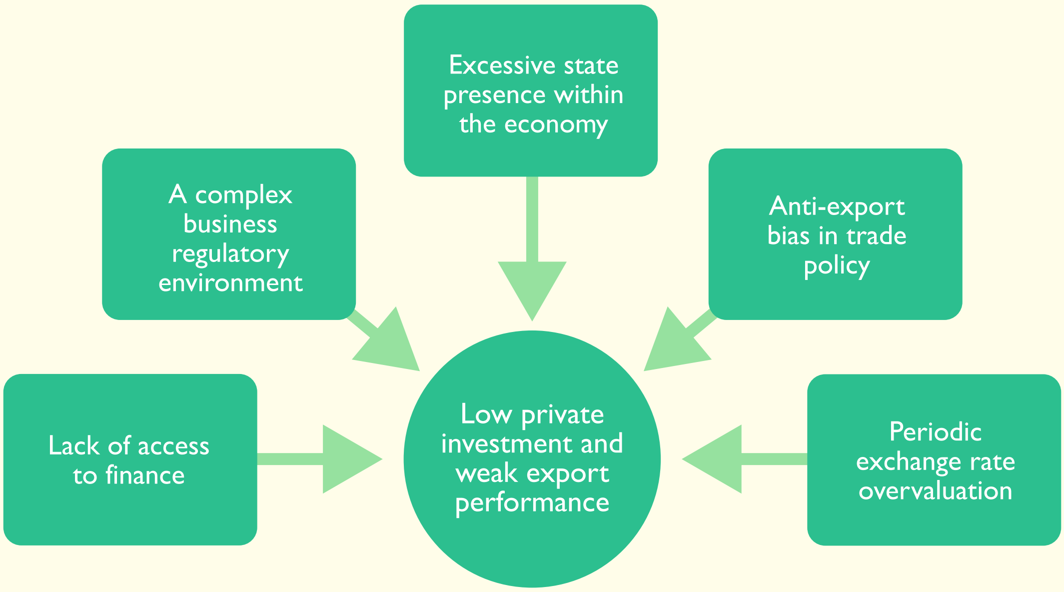
Box: Why is exporting associated with higher productivity?

Evidence for Pakistan and the world suggests trade and productivity are closely linked. Firm-level analysis shows that Pakistani exporters are substantially more productive than comparable domestic-oriented firms (similarly, foreign-owned firms are more productive than domestic-owned ones). The productivity premium for exporters holds across sectors, and it is explained both by selection into the export markets (it is firms that are most productive in the first place that get to export) and by learning from exporting (firms' productivity grows as they export more systematically). Indeed, in Pakistan, systematic exporters are, on average, 23 percent more productive than new exporters, suggesting a virtuous circle where productivity drives export participation, and exposure to the export market further improves productivity.

Drivers of poor private sector and export performance

Low private investment and weak export performance largely reflect distortions and resource misallocations arising from current policies. Existing policy settings constrain access to finance, impose high regulatory compliance costs, and disincentivize exports. Private firms are subject to unfair competition from state-owned entities undertaking commercial operations and receive little support when seeking to access new overseas markets.

Figure 5: Constraints To Private Sector Investment And Exports



Source: Author

Firms lack access to finance. Pakistan's financial sector is failing to effectively deliver on its critical intermediation role of channeling savings into productive investment. Credit to the private sector has dropped from a high of 29 percent of GDP in 2008 to 13.8 percent in 2022, below half the SAR average and significantly lower than Pakistan's aspirational peers. Access to credit is also highly uneven with 56 percent of outstanding credit to the private sector held by the corporate and manufacturing sector, compared to just 5.4 percent to small and medium enterprises (SMEs), which make up the vast majority of firms in Pakistan. In the recent 2022 Business Enterprise Survey, firms cited lack of access to finance as the second most important constraint to doing business (medium-sized firms employing 20-99 employees cited lack of access to finance as the most important constraint).[1] While the microfinance sector has 9.2 million active borrowers, it accounts for only four percent of lending and the balance sheets of micro-finance institutions have been heavily impacted by the COVID-19 crisis and 2022 floods. The most important constraint to private sector credit is high levels of government borrowing from commercial banks, which crowds out the private sector (73.4 percent of all bank lending is now to government, up from 43 percent in 2010). In the presence of a dominant and theoretically 'risk-free' borrower, the banking sector has few incentives to design innovative financial products and institute robust risk management practices to extend finance to underserved sectors. Additional constraints include: i) a weak insolvency and creditor-right regime, providing banks with limited options for recourse in the case of defaults; ii) low domestic savings driven by limited financial inclusion and low financial literacy; iii) uncoordinated and ineffective development financing programs, with a diverse array of development finance instruments (ranging from direct allocation of funding in the fiscal budget, to public ownership of financial institutions to the very expensive provision of subsidies and guarantees) showing very limited impact in real terms.

The business environment is complex and discourages foreign investment. Regulatory bottlenecks and onerous and discretionary regulatory enforcement discourage businesses from entering the formal economy and impose substantial compliance costs. It also compounds regulatory risks to investment creating incentives to avoid and evade compliance. Dealing with business regulations (registrations, licenses, permits, certificates, standards, and inspections) in Pakistan is complex, costly, and overlaps across the federal, provincial, and municipal boundaries. Over 40 federal, provincial, and local agencies in Pakistan regulate investment and business activities in an uncoordinated manner. The passage of 18th Amendment to the Constitution of Pakistan in April 2010 that aimed to devolve power from the center to provinces has further complicated the regulatory environment, creating five regulatory markets – four provinces and the capital territory – in the presence of long-standing federal-provincial coordination challenges. FDI is deterred by a lack of consistency between the legal framework for investment. The Foreign Private Investment Act of 1976 stipulates that foreign investment is subject to Government's clearance and would be allowed if it meets the development priorities of the Government or if the activity does not exist in the country, violating the principle of National Treatment. Challenges to repatriating profits, as reported by existing multinational firms in Pakistan, coupled with a relatively limited network of free trade agreements are also deterrents to greater FDI inflows.

The state plays a large and intrusive role within the economy. The federal government owns more than 200 State-Owned Enterprises (SOEs), while provincial governments own many more. Total assets of SOEs and other state entities are very significant, with the value of SOE assets estimated at around 48 percent of GDP. Many SOEs and other state entities are engaged in commercial activities, crowding out private sector activity competing on uneven terms, due to their preferential access to finance, subsidies, and in-kind benefits (such as subsidized or fixed price inputs). SOEs' preferential access to loan financing crowds out financing to the private sector, undermining private investment. Subsidies to SOEs and other state entities in the energy, food, and trade sectors are highly distortive, impeding efficiency and competition across entire value chains (see Discussion Notes 4 and 5).

Protectionist tariff policies disincentivize exports. Protectionist trade policies, initially intended to facilitate import substitution, are instead disincentivizing exports, worsening Pakistan's trade position. Import tariffs benefit firms selling to the local market by protecting them from import competition (a one percent increase in tariffs on a given output increases markups obtained by selling in the domestic market by 4 percent). Protectionist trade policies therefore act as an implicit export tax, discouraging domestic or foreign investment in exporting firms. In addition, when import duties are applied on intermediates, raw materials and capital equipment, and duty drawback schemes for exporters do not work efficiently, they increase production

[1] Firms reported financing only one percent of fixed asset purchases through bank loans, compared to 12 percent for South Asia, and 13 percent for middle income countries.

costs, harming economy-wide productivity. Costly tax expenditures are incurred as various exemptions are granted on import duties for inward oriented firms under the 5th Schedule of the Tariff Code.[2]

Pakistan's recent history of exchange rate intervention and manipulation has also harmed export performance. A weaker real exchange rates boosts export competitiveness as it reduces the dollar-value of domestic value added. When instead, the exchange rate is artificially kept overvalued, the export sector is negatively affected, and its structure is tilted towards low value-added activities. Evidence for Pakistan shows that, on average, a real depreciation of the PKR by 10 percent increases exports by 5 percent.

Recommendations

1. **Addressing constraints to private investment and export growth will require development and implementation of a bold reform agenda.** Highest priority reforms are summarized in the following figure.

Figure 5: Constraints To Private Sector Investment And Exports

Lack of access to finance	A complex business regulatory environment	Excessive state presence in the economy	Anti-export bias in trade policy	Periodic exchange rate overvaluation
• Constrain fiscal deficits • Strengthen insolvency and creditor rights regimes • Reform development finance • Develop capital markets	• Reform the Investment Act • Pursue simplification and digitalization through coordinated provincial and federal processes	• Implement the triage process • Divest SOEs operating in purely commercial sectors • Improve SOE governance and financial management	• Implement a long-term tariff rationalization strategy • Phase out regulatory and additional customs duties • Reform export support schemes	• Maintain a market-determined and flexible exchange rate

Source: Author

2. **A range of reforms are required to strengthen private sector access to finance.** Government should: i) reduce the fiscal deficit and government's increasing monopolization of domestic financial sector resources, encouraging stronger flows to the private sector (see Discussion Notes 6 and 7); ii) increase outreach, investor awareness, and financial literacy to equip businesses and households with the information required to access the financial sector and the products offered by it; iii) pursue financial inclusion policies to tap into the informal savings of the population, particularly by leveraging newly developed digital channels; iv) address legal, policy, and institutional hurdles that currently limit the development of the market for credit information (including data sharing, data privacy, integration of platforms etc.); v) enhance the effectiveness of the court system in resolving credit-related disputes and insolvency proceedings; vi) strengthen the supervisory and crisis management framework; and vii) strengthen banks' capital base to provide space for enhanced lending to riskier segments. Over the longer-term, the government should: i) develop capital markets through promoting listing for large companies with significant debt requirements and reducing tax driven distortions between asset classes; and ii) consolidate and harmonize development financing instruments and institutions based on a review of their mandates, governance, and rules of engagement.

[2] According to the latest data available, these exemptions reached 168.7 billion PKR in FY22, more than three times as much as the exemptions due to export-related duty remission schemes (51 billion PKR) or Preferential Trade Agreements (46 billion PKR).

3. **Critical reforms are needed to radically simplify the business environment.** Firstly, Pakistan should immediately revise the Investment Act to align it with the new Investment Policy, addressing unnecessary constraints to foreign investment, and clearly signaling commitment to investment reforms. Revised legislation should mandate establishment of an investor grievance redressal system through which investors' grievances with the state can be addressed before they become legal disputes or limit further investment. Formal and informal constraints to the repatriation of profits should be removed. Secondly, government should establish a National Regulatory Delivery Office reporting directly to the prime minister, in line with international good practices. This office would consolidate and lead efforts (including under the Pakistan Regulatory Modernization Initiative) to ease of investing and doing business in Pakistan, for both domestic and foreign investors. The office would ensure a risk-based approach to regulatory delivery for targeted and effective enforcement minimizing the cost of compliance for businesses. Thirdly, equivalent offices with similar mandates should be established at the provincial level (Provincial Regulatory Delivery Units). The usefulness of such an approach has been demonstrated in Punjab where a Doing Business Reform Unit within the provincial Ministry of Planning and Development has worked effectively to drive substantial regulatory reforms. Across the board, business climate reform initiatives should maximize the use of digital solutions and involve strong links to the private sector. Pakistan should establish a national business portal which can integrate federal and provincial regulatory agencies into an online interface for business licensing, and for receiving, reviewing, and processing regulatory approvals efficiently without unnecessary face-to-face interactions. The portal should also facilitate ongoing compliance with business regulation including inspections, gather feedback from the private sector on the quality of regulations and associated administrative procedures, and provide an online complaint registration and management system. While progressing critical reforms, Pakistan should seek to offer stability in the regulatory and tax environment over time, to provide certainty to investors.

4. **Drastic measures are needed to reduce the presence of the state in the economy.** Firstly, government should pursue a program of ambitious SOE reforms based on the 2020-2021 triage exercise. Government should quickly divest viable SOEs operating in commercial sectors. For other SOEs, government should curtail subsidies that are not associated with the provision of public goods, and phase out preferential access to financing, bailouts, guarantees, and loans, while introducing private participation, enhanced performance monitoring, and strengthened governance practices. These reforms combined should improve commercial discipline and curtail unfair competition with the private sector (further details on a potential SOE reform roadmap are included in Discussion Note 7). Secondly, government should curtail distortionary and costly subsidy schemes in energy and agriculture, allowing improved allocation of resources and improvements in productivity and sustainability (see Discussion Notes 4 and 5). Finally, government should review state asset holdings, allowing the private sector to take on management of assets that are not critical to the provision of core public goods (especially state controlled commercial operations).

5. **Trade policies should be comprehensively overhauled to eliminate the current anti-export bias.** Government should: i) design and implement a long-term tariff rationalization strategy; ii) gradually reduce import duties and tariff cascading, identifying potentially affected sectors and providing time-bound support to displaced workers; iii) phase out regulatory and additional customs duties; iv) digitalize and automate duty remission schemes for exporters, relying on trust-based systems and risk-based audits, and time-bound approval processes; v) gradually phase out import duty exemptions under the Fifth Schedule of the Tariff Code, to level the playing field, and reduce tax expenditures; and vi) equip the National Tariff Board to make evidence-based policy decisions, building capacity in the National Tariff Commission.

6. **Pakistan should maintain a flexible, market-determined exchange rate.** Avoidance of further exchange rate intervention or manipulation is critical to ensure that the exchange rate reflects market fundamentals and does not present an additional artificial constraint to exports.

5. **As a conducive broader policy environment is established, government could also consider options to improve support to export development.** Existing export financing schemes should be reformed to focus on long-term financing and supporting new exporters, with subsidy eligibility and amount subject to rigorous cost-benefit analysis. Trade portals should be consolidated under the Pakistan Single Window, complying with the WTO Trade Facilitation Agreement. Government should consider pursuing double taxation agreements to reduce the tax burden on exports of modern services.

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 third of 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 Tobias Haque (Lead Country Economist), Gonzalo Varela (Lead Country Economist), Fahad Hasan (Financial Sector Specialist), Rafay Khan (Economist), Qurat ul Ain Hadi (Financial Management Specialist), and Amjad Bashir (Senior Operations Officer). Please send feedback or comments to Tobias Haque (Task-Team Leader, **thaque2@worldbank.org**) and Puteri Watson (Task-Team Leader, **pwatson2@worldbank.org**).