Charter of the Economy

Agenda for Economic Reforms in Pakistan

Hafiz A. Pasha

FRIEDRICH EBERT STIFTUNG

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Hafiz A. Pasha

Author
Dr. Hafiz A. Pasha

Responsible:
Dr. Jochen Hippler | Country Director
Abdullah Dayo | Programme Coordinator
Friedrich-Ebert-Stiftung (FES), Pakistan Office

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1st Floor, 66-W, Junaid Plaza, Jinnah Avenue, Blue Area,
P.O Box 1289, Islamabad, Pakistan

Phone: +92 51 2803391-4
Fax: +92 51 2803395
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Facebook: Friedrich-Ebert-Stiftung, Pakistan
Twitter: @FES_PAK

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Preface

The need for economic reform

Pakistan has suffered severely from the Corona pandemic, as have most other countries. But Pakistan has also suffered from chronic economic crisis, even before the pandemic, for many years. Low growth rates, high levels of debt, inflation, low productivity and poor competitiveness have, among other factors, contributed to widespread poverty and slow development in Pakistan. Solving the key problems of Pakistan and its vibrant society, therefore, requires to overcome the economic calamities Pakistan has been facing for too long.

Economic variables are not just a matter for the economists, but for all Pakistanis, rich and poor. The future of the country, and of all its citizens, will depend on overcoming the economic crisis, which has been aggravated by the pandemic. Talk about turning the economy around is nothing new, but up to now has resulted in little success. Balance of payment figures, the rate of economic growth, tax policies and other economic topics have been discussed time and again, and with good reason – but all this talk has not solved the economic problems of Pakistan, and much less the problems of the common people. Pakistan, with all its resources and opportunities, cannot afford to continue to muddle through economically any longer, but needs a better, a functioning, and a prosperous economy. And the country needs it very soon. Most people would strongly support this view. In my view, Pakistan also requires a political consensus on economic policy. Freeing the country from its economic calamities should not be a matter of party affiliation, but a common task for all political actors who want to see Pakistan flourish. There is a dire need for a functioning economic strategy, and for continuity in its implementation, if Pakistan's economy is to be dynamized.

We are very glad the eminent economist Dr. Hafiz Pasha has undertaken the task to develop a "Charter of the Economy". This charter hopefully will contribute to develop a consensus on economic reform, which is so much needed. Dr. Pasha's "Charter of the Economy" is based on deep and serious research, and at the same time provides a wealth of recommendations for economic reform, both on the strategic and the level of details.

Developing a program and a strategy for progressive economic reform faces many hurdles. Many economists have focused on just one of a few variables, like foreign debt, balance of payments, or inflation. While these and other factors obviously are highly relevant, the danger arises that many other crucial factors get out of view. For instance, economic reform cannot ignore the need for infrastructure, for a functioning taxation system, or for quality education. And what too many economists, both in Europe and in Pakistan, have too often ignored, is the factor of Governance in the economy. Without good Governance in economic policy, but also in areas like law and law enforcement, in education and other fields, economic reform will hardly work. Reform has to include and integrate different aspects of society and statehood to make economic success possible.

Dr Hafiz Pasha is highly aware of these interconnections. He is an economist who is not losing sight of society, which the economy should serve and facilitate. Dr Pasha's "Charter of the Economy" is a wide-ranging program for economic reform in Pakistan. To overcome the crisis of the economy he insists that reform has to focus on key economic variables, but also has to actively deal with so many other fields, from education to population control.

We sincerely hope that this book, the "Charter of the Economy", will be taken up by economists, bureaucrats, journalists and by parliamentarians and their leadership of all parties in Pakistan. Hopefully, it will be a constructive contribution to enhance the awareness of economic reform, and to demonstrate how a progressive and workable reform should look like. May it be of good use to Pakistan and help build a new economic consensus.

Dr. Jochen Hippler
Country Director,
Friedrich Ebert Stiftung (FES)
Islamabad

Abdullah Dayo
Programme Coordinator,
Friedrich Ebert Stiftung (FES)
Islamabad

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Introduction

The economy of Pakistan has been mired till recently in a state of “stagflation.” The GDP growth rate was still relatively low at below 4 percent in 2020-21, while the rate of inflation is up, especially of food prices. The successive attacks of COVID-19 since February 2020 have affected lives and livelihoods in a big way. The levels of unemployment and incidence of poverty have never been so high, at 15 percent and 38 percent of the population, respectively.

The silver lining is the success in stabilizing the economy by bringing down the current account deficit from the peak level three years ago. The fundamental reason for this success is a decline in the import bill due to quantum depreciation of the rupee and more recently because of the jump in home remittances. However, exports have shown little buoyancy and imports have jumped up once again recently. Pakistan is back in the IMF Program which requires implementation in the short run of perhaps the toughest set of reforms ever.

The budgetary position remains weak with the fiscal deficit rising to between 7 percent and 9 percent of the GDP. The earlier buoyancy shown by tax revenues has gone away and the tax-to-GDP ratio has fallen. Debt servicing has grown rapidly, and development spending has had to be severely curtailed. Government debt now stands at almost 78 percent of the GDP, way above the limit of 60 percent of the GDP imposed by the Fiscal Responsibility and Debt Limitation Act, 2005.

There is a dire need for a Charter of the Economy, with a broad-based political consensus and civil society support. It will identify the wide-ranging reforms and policies for raising economic growth, tackling inequality, creating jobs, reducing poverty, improving food security, and promoting human development.

This report on the Charter of the Economy, prepared with the support of the Friedrich Ebert Stiftung (FES) Foundation, attempts to initiate the process of accomplishing this task. Thanks are due to the FES, a German foundation, which supports Social Democracy. This is also the guiding vision of the report in line with the fundamental Principles of Policy in the Constitution of Pakistan. A careful attempt is made to identify the nature of problems or constraints before solutions and reforms are proposed.

A schematic representation of the areas covered in the Charter of the Economy for achieving higher, sustainable, and inclusive growth are given in the enclosed chart. The key economic targets to be attained by 2024-25 are highlighted in the first part.

The Charter then focuses on the institutional and policy environment for achieving the targets. Part two is on improving governance. Part three is on Strengthening the Federation and Part four on exercise of the prime fiscal instrument.

Thereafter, there are parts of the Charter on raising the level of investment, improving the balance of payments and on the sectoral policies for accelerating the rate of growth.

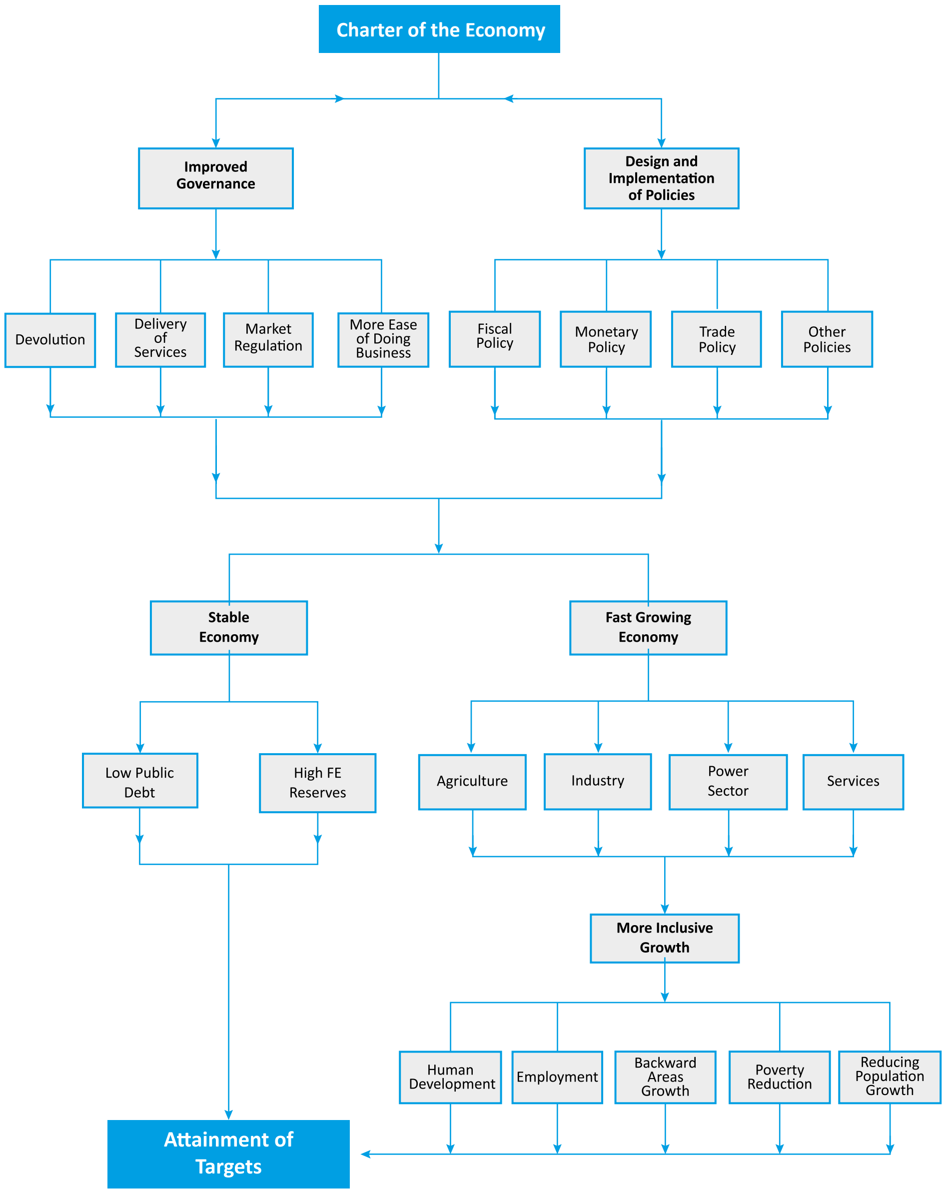
The strategies for achieving inclusive growth are then highlighted in the parts on striving for balanced regional development, focusing on human development, providing more employment opportunities, and achieving more poverty alleviation and social protection.

With all humility, the author wishes to state that this is only the first effort at preparing a comprehensive agenda of reforms. Subsequent discussions and collective effort will refine the agenda for change leading to faster, sustainable, and more inclusive development.

The author would like to acknowledge the research support of Hafsa Tanveer, Sana Iqbal, Alina Pasha, and Rizwan Ullah Khan.

Dr. Hafiz A. Pasha
Professor Emeritus, BNU
and former Federal Minister
of Commerce, Planning and Finance

The Key Elements of the Charter of the Economy



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SUMMARY OF RECOMMENDATIONS

Part-I: Targets in the Charter of the Economy

1. Targets

The Charter of the Economy includes the following ambitious targets which are feasible given the implementation of the wide-ranging reforms, and improvements in governance with institutional strengthening, included in the Report.

Targets* in the Charter of the Economy	2020-21	2024-25
Macroeconomic		
• GDP Growth Rate (%)	3.9	6.0
• Level of Investment (% of GDP)	13.6	17.5
• Unemployment Rate (%)	13.0	6.0
• Rate of Inflation (%)	8.9	6.0
Public Finances *(% of GDP)*		
• Revenues	14.6	18.4
• Expenditure	22.1	23.4
• Budget Deficit	-7.5	-5.0
• Primary Deficit (-) / Surplus (+)	-1.1	0.5
• Government Debt	77.3	70.0
Balance of Payments *($ billion)*		
• Current Account	-1.8	-9.5
• Financial Account	8.2	11.5
• BOP Surplus	5.6	2.5
• Foreign Exchange Reserves	17.3	24.8
• Import Cover (months)	3.5	3.6

*The disaggregated targets are given in the respective Chapters.

The lifeline of the economy consists of tax revenues, exports, savings, and investment.

Part-II: Improving Governance

2. 'Good' Economic Governance

'Good' economic governance requires protection of larger public interest, ensuring national sovereignty, financial discipline, consistency, and effective delivery of services. Pakistan currently has a low country rating in economic governance by the World Bank. Recommendations include the following:

2.1.	Effective role of Constitutional fora like the National Economic Council and the Council of Common Interests with regular meetings and presentation of annual report to the Parliament. The Planning Commission should be the Secretariat for these fora.
2.2.	Parliamentary Committees must act as the 'entry points' for all legislation and for accountability of Ministries.
2.3	A new framework of planning needs to be developed which is more consistent with the Federal structure. 'Top-down' planning should be replaced by 'bottom-up planning'. Regional plans may be prepared by Provincial Governments. These should be aggregated along with the Federal plan. The Planning Commission should prepare a Macroeconomic Framework which is consistent with the realization of these plans.
2.4.	Many improvements are required in the economic information system and statistics. This will require quarterly GDP series by sector; annual estimation of Provincial GDPs; development of SDGs database at the district level and more frequent Economic Censuses and Surveys.
2.5.	The autonomy of the Pakistan Bureau of Statistics must be adequately ensured through an empowered Statistical Council, with adequate representation from the private sector, civil society, and academia. The technical capacity of the PBS also needs to be augmented.

3. Voice, Transparency and Accountability

Pakistan is ranked poorly both in the Voice and Accountability Index of the World Bank and in the Corruptions Perceptions Index of the Transparency International.

Reforms needed include the following:

3.1.	Perception of NAB as an unbiased agency needs to be improved. It should be required to present an Annual Report to the Parliament. Amendments to the NAB Ordinance need to be finalized and presented to the Parliament.
3.2.	There is need for establishment of an Information Commission as per the provisions of the Right to Information Act, 2010. This Commission must play the appropriate role in facilitating greater public access, especially to Government financial transactions.
3.3	There is need for greater accountability and transparency in the budgetary process. This includes the placing on the MOF website the latest financial report of each SOE, annual report with the budget documents on 'Revenue foregone due to Tax Exemptions and Concessions,' statement by FBR on the expected revenue from each taxation proposal in the Finance Act.

4. Strengthening Regulatory Agencies

There are many regulatory agencies in Pakistan including the SBP, SECP, CCP and NEPRA. There are many noticeable failures in regulation ranging from the skewed distribution of credit by commercial banks, underdeveloped stock market with low capitalization, failure to apprehend and punish monopolies and cartels, buildup of large stock of circular debt in the power sector and so on. Recommendations include the following:

4.1.	The SBP may revert to the preparation of an Annual Credit Plan. Any commercial bank violating the targets and minimum sectoral credit levels should be subject to tax penalties.
4.2.	The SBP must set ceiling on the domestic bank borrowing by the Government corresponding to the amount envisaged in the Annual Federal Budget plus a safety margin for emergencies.
4.3	NEPRA must ensure that in presence of excess capacity the merit order of generation plants is strictly observed, determination and implementation in time of price adjustments and timely payment of subsidies to prevent the exponential growth in circular debt.

5. Ease of Doing Business

Pakistan's ranking in the international Ease of doing Business Index has improved to the 108th position out of 190 countries in 2020. But many substantial improvements are still required as follows:

5.1.	Transition to a digital economy. The internet access of households to be raised from 33 percent currently. Government agencies must take the lead in digitalization of tax, non-taxes and energy tariffs, submission and finalization of bids, computerization of land records, etc.
5.2.	Pakistan's income tax system requires withholding tax agents to collect taxes at source and remit to the FBR. Companies may be given 0.3 percent of the revenues as costs of collection.
5.3	Reduction in small withholding taxes.

Part-III: Strengthening the Federation

6. Implementing the 18th Amendment

There is need for full implementation of the 18th Amendment as follows:

6.1.	Small Divisions can be merged with larger Divisions in the Federal Government. This will bring down the number of divisions by over a dozen.
6.2.	Vertical Federal programs related to functions in Federal Legislative List-II should be financed jointly by the Federal and Provincial Governments. This includes Federal spending on health, higher education, and population planning.
6.3.	Management of Regulatory Functions is in FLL-II. Therefore, all Boards of Regulatory Agencies must have representation of each Province. The Annual Report of each Agency should be reported to the CCI.
6.4.	Labor-related functions have been transferred to Provincial Governments in the 18th Amendment. Therefore, the EOBI and revenues of the Workers' Welfare Fund (WWF) may be transferred to these Governments with an appropriate sharing formula, like collection.

7. Consensus on the 10th NFC Award

The 7th NFC Award had a tenure up to 2014-15. However, it continues to be operative because of failure of 8th and 9th NFCs to achieve consensus on an Award. The 10th NFC has recently been constituted. Progress may be facilitated by the following:

7.1.	The methodology of National Resource Picture and initial allocation to funds to priority functions used by the 5th NFC should be adopted by the 10th NFC.
7.2.	The poverty / backwardness criteria may be based not on the percentage incidence of poverty but on the number of poor.
7.3.	Items (d) to (h) in the TOR of the NFC should be included in the Award. There is significant scope as per the Constitution for sharing common functions and the 10th NFC may specify the cost-sharing formula among the Federating Units in different functions.
7.4.	2.5 percent of the divisible pool of revenues may be retained for distribution in proportion to the revenues generated from taxation proposals by the Provincial Governments in a particular year.

8. Devolving to Local Governments

The Article 140A in the 18th Amendment has recognized local government as the third tier of Government to be adequately endowed with political, administrative, and financial authority and responsibility. Recommendations for successful devolution to these governments are as follows:

8.1.	The 'subsidiarity' principle should be adopted in the allocation of functions to local governments.
8.2.	From the viewpoint of effective role, the ideal form may be 'two-tiered' local government with the top tier having the capacity to deliver services and collect revenues while the lower tier is small enough to ensure peoples' participation in the choice of services and accountability in the delivery of services.
8.3.	The allocation of taxes to local governments should be motivated by the need to link taxation to benefits, thereby increasing the willingness to pay taxes. As such, the property tax and the local rate should be allocated to local governments. Collection responsibility should rest with the top tier of local government.

8.4.	There is need for setting up a Municipal Development Fund to finance lumpy investments in mega cities, as is the case in India today. This will enable the flotation of tax-free municipal bonds. Ability to service this debt is high in Metropolitan Corporations due to high income levels of resident population.
8.5.	Provincial transfers to local Governments should be based on PFC Awards using similar methodology and criteria as the NFC Awards.
8.6.	Minimum representation of special interests like women, peasants, workers, youth, minorities, and technocrats should be ensured in local councils. Ideally, 33 percent representation should be given to women.

Part-IV: Mobilizing Resources, Reducing Expenditure and Containing Government Debt

9. Federal Tax Reforms

There is a dire need for progressive tax reforms given the high level of income and wealth inequality in the country. The top quintile has seven times the income of the bottom quintile. Over 16 percent of residential property and 22 percent of the farm area is owned by the top 1 percent.

The tax breaks and concessions to the rich segments of the population add up to Rs 1275 billion, equivalent to 2.7 percent of the GDP. This has implied a low Federal tax-to-GDP ratio of 10.8 percent. These tax privileges must be withdrawn first as part of the tax reforms process.

The proposed progressive direct tax reforms include the following:

9.1.	Taxation of comprehensive income and not bloc wise income.
9.2.	More progressive personal income tax by reducing slabs from 12 to 6.
9.3.	More progressive corporate income tax with higher tax rate, if pre-tax rate of return on equity exceeds 20 percent.
9.4.	Long-term capital gains exemption to be withdrawn on property and shares.

9.5.	Higher withholding tax rates on electricity bills of domestic and commercial consumers, who are not filing income tax returns.
9.6.	Withdrawal of small withholding taxes.
9.7.	The fiscal incentives on investment like the tax credit on BMR and accelerated depreciation allowance retained to stimulate more investment.

Indirect tax reforms in the second phase of the reform process include the following:

9.8.	Transition to a national integrated VAT on goods and services.
9.9.	Introduction of import duty and sales tax on services on the 'reverse charge' principle.

The target is to raise the federal tax-to-GDP ratio to 13 percent of the GDP by 2024-25.

10. Provincial Tax Reforms

The Provincial Governments have access under the Constitutional allocation of fiscal powers to large tax bases like agriculture and the services sectors, but the Provincial tax-to-GDP ratio is only 1 percent of the GDP.

The proposed tax reforms include the following:

10.1.	Levy of agricultural income tax with progressive PIT tax rates (in Rupees per acre) by size of farm holding.
10.2.	Assessment of the Gross Annual Rental Value (GARV) of a property for payment of the urban immoveable property tax to be equivalent to 2.5 percent of the capital value determined from recent valuation of property values at the locality level in cities by FBR.
10.3.	Merger of sales tax on services and goods. Withdrawal of the federal excise duty on financial services. Merger of the entertainment tax with the sales tax on services.

The target is to raise the Provincial tax-to-GDP ratio from 1 to 2 percent of the GDP.

11. Rightsizing the Federal Government

Devolution of functions to Provincial Governments after the 18th Amendment has not led to a significant contraction in the Federal Government. The employment in the Secretariat, autonomous bodies and attached departments is almost 1 million. There are 40 Divisions and 33 Ministries. The State-Owned Enterprises (SOEs) imposed a big net burden of Rs 525 billion on the Federal Budget in 2020-21.

The recommendations include the following:

11.1.	Undertaking exercise on 'zero-base' budgeting of attached departments and autonomous bodies.
11.2.	Privatization of SOEs as per the recent Triage Report of MOF, highlighted in Chapter 14, with the exclusion of the electricity and gas distribution companies.

12. Limiting the Increase in Government Debt

Government debt stands today at almost 78 percent of the GDP, well above the level of 60 percent of the GDP imposed by the Fiscal Responsibility and Debt Limitation Act.

The recommendations for reducing this ratio are as follows:

12.1.	Utilization annually of the scope for 'Seigniorage' up to 1 percent of the GDP.
12.2.	External borrowing to be limited to external financing requirements and preferably in the form of long-term and concessional borrowing.
12.3.	Tenure of government domestic borrowing to be linked to the rate of inflation, that is, borrowing on a 'long-term' basis when inflation rate is 'low' and the opposite otherwise.
12.4.	A strong binding limitation be placed on the extent of Government guaranteed borrowing by SOEs.

Part-V: Raising the Level of Investment

13. Raising and Prioritizing Development Spending

The overall level of public development spending has declined from 4 percent of the GDP in 2017-18 to 2.6 percent of the GDP in 2019-20. The Federal PSDP is ‘spread too thin’ currently, with as many as 1023 projects and a throw-forward of costs of projects over eight times the annual allocation, leading thereby to big cost overruns.

The recommendations are as follows:

13.1.	Impact on growth is the greatest of investments in hydel-power, irrigation, power generation, transmission, and distribution. The priority ought to shift to these growth-inducing sectors which also stimulate private investment. Similarly, Provincial ADPs ought to be oriented more towards the productive sectors and social services.
13.2.	A limit of maximum share of 15 percent be imposed on sectoral allocations to new projects.
13.3.	The Federal PSDP should focus more on trunk infrastructure projects and less on projects the benefits of which are limited to a region. The latter should be implemented largely through the Provincial ADPs.
13.4.	The scope for public-private partnership in infrastructure projects should be carefully examined. Lessons could be learned from the Indian experience with PPPs.

14. Privatizing State-Owned Enterprises

There are 204 SOEs in Pakistan. Two-thirds are commercial in nature and spread over sectors like energy, transport, oil and gas and financial services. Total assets are Rs 17.1 trillion and total sales approaching Rs 4 trillion. Net losses of the SOEs aggregate annually to over Rs 200 billion.

Recommendations for privatization are as follows:

14.1.	Appropriate criteria need to be applied to assess the case for privatization of a particular SOE. Eight such criteria have been identified in the Report. The criteria have been applied on 15 major SOEs, of which ten qualify for privatization.

14.2.	The Ministry of Finance has recently prepared a Triage report on SOEs. 44 units have been recommended for privatization and one for liquidation. The power sector DISCOs have been included in the list for privatization. The DISCOs are natural monopolies and privatization can only be considered when a market for electricity sales develops through widespread wheeling practices.
14.3	Sale of shares of highly profitable SOEs like OGDCL and PPL be avoided. Their annual dividend exceeds the saving in interest payment on the debt to be retired with the proceeds.

15. Promoting Private Investment

Private investment has followed a cyclical path in line with the rate of GDP growth. It has now fallen in terms of fixed investment to 10 percent of the GDP from the peak of 15 percent of GDP. The two largest sectors of private investment currently are agriculture and housing. 15 percent of private investment is in the manufacturing sector. Foreign investment is down to below one-third of its historical peak. Various constraints exist today to private investment.

The steps for promoting such investment are as follows:

15.1.	Creation of a favorable business environment with economic and political stability consistency and continuity of economic policies, presence of adequate infrastructure, greater ease of doing business and relatively high levels of post-tax corporate profitability.
15.2.	Excessive borrowing by the Government and the SOEs has 'crowded-out' private sector borrowing from the banking system. Appropriate regulatory steps will have to be taken by the SBP.
15.3.	Very importantly, the fiscal incentives for investment embodied in Section 22, 23 and 63B of the ITO must be retained and strengthened. They relate to depreciation allowances and tax credits for BMR.
15.4	Maximum fiscal incentives including duty-free import of machinery and ten-year income tax holiday may be given to export-oriented units and/or FDI located in Special Economic Zones or Special Technology Zones.

Part-VI: Improving the Balance of Payments

16. Promoting Exports

Pakistan's exports performed well from 2000 to 2010 and kept pace with the growth in world trade. Since then, they have fallen behind, due to loss of competitiveness in the presence of falling international prices and an overvalued exchange rate. The target is for exports to grow annually by 8 percent and reach almost $34 billion by 2024-25. Recommended steps for promoting exports are as follows:

16.1.	The exchange rate may adjust fully not only to the difference between the domestic and the global rate of inflation but also to any fall in dollar prices of exports.
16.2.	The Trade Development Authority of Pakistan may identify constraints and take steps for promoting emerging and nascent exports with more incentives and support and development of critical infrastructure.
16.3.	The electricity tariff for exports should be 40 percent less than the standard rate and coverage extended to more export industries.
16.4.	There is need for more '*quid pro quo*' in the FTA with China. Currently, exports by China to Pakistan are over six times the exports of Pakistan to China.
16.5.	The sales tax refund system should be replaced by automatic cash payment by commercial banks at the time of export receipts.

17. Containing Imports

Imports have risen to almost 18 percent of the GDP in 2020-21 from 13 percent in 1999-2000. Consequently, the trade deficit reached a peak of 11 percent of the GDP in 2017-18. Containing imports has become essential to restrict the size of the current account deficit in coming years. The level of imports will need to be restricted such that the current account deficit remains below 3 percent of the GDP up to 2024-25. Recommended measures are as follows:

17.1.	Ad hoc regulatory or additional import duties on over 700 items with rates up to 80 percent should be withdrawn and transition made to a transparent import tariff structure with five slabs from zero to 30 percent, with some statutory tariff peaks.

17.2. Imports of services to be subject to an import tariff of 5 percent and the normal sales tax rate of 17 percent, with collection on the 'reverse charge' basis.

17.3. In the event of a big jump in the current account deficit different instruments for import regulation are proposed in the report. This will be required in 2021-22 given the peak level of imports in June 2021 of $6.3 billion.

18. Managing the Balance of Payments

The balance of payments of Pakistan was fragile earlier due to a large current account deficit and now due to smaller inflows into the financial account. The total external debt is $122 billion. There is likely to be some pressure on the balance of payments in 2021-22 due to the upsurge in imports and big increase in external debt repayments.

18.1. The proposed external financing strategy may rely to the extent of 40 percent on concessional financing by multilateral and bilateral sources. Commercial loans and flotation of Euro/Sukuk bonds are targeted to generate 25 percent and other sources 15 percent. Private sources could provide 20 percent of the financing.

19. Operating in the IMF Program

The IMF Program which remained suspended for one year after the first attack of COVID-19 has become operational once again, effectively in the period of the sixth quarterly review. The performance criteria and the agenda of reforms are perhaps the toughest ever.

19.1. Contingency planning is needed in the event the IMF program is terminated or if Pakistan decides to withdraw from the Program. The plan will include cut back in non-essential imports by raising of customs tariffs, seeking rollover of debt repayment from bilateral donors and commercial banks, higher interest rates on bonds and foreign exchange deposits, and tighter regulation of financial transfers from Pakistan.

Part-VII: Accelerating Economic Growth

20. Agriculture

This is the first of the five chapters focusing on achieving faster GDP growth and raising it to 6 percent by 2024-25.

The growth rate of the agricultural sector has fallen sharply to an average of less than 2 percent since 2014-15. Given its strong backward and forward linkages this has affected the overall GDP growth. Numerous reforms and projects have already been proposed in the earlier chapters. These include top priority to expanding the irrigation system, higher research and development of improved seed varieties, appropriate procurement and support pricing policy, increased protection through higher import tariffs and so on.

This Chapter highlights the contours of each policy as follows:

20.1	The recommended import tariff is 5 percent on cotton, wheat, pulses, and vegetables. The duty on palm oil should be changed from specific to an ad-valorem rate of 15 percent and the duty on sugar imports to be fixed at 10 percent.
20.2.	The procurement and support pricing policy to be changed. A support price to be reintroduced on cotton and withdrawn on sugarcane. The level set should correspond to the landed cost of imports.
20.3.	The fertilizer prices have gone up by over 30 percent since 2018 and impacted adversely on the profitability of farmers. All taxes on domestic and imported fertilizer must be withdrawn. The price of natural gas as feedstock for fertilizer should be reduced and correspondingly enhanced for large domestic consumers.
20.4.	Higher development allocations for earlier completion of small hydel projects and the Daimer-Basha and Mohmand Dams.
20.5.	The '*abiana*' levy needs to be raised substantially to ensure more efficient use of scarce water.
20.6.	Adequate fiscal incentives and support for development of improved seed varieties by the private sector.

21. The Manufacturing Sector

The manufacturing sector has seen a big downward slide in its growth rate from 8 percent to an average of 4 percent. Earlier chapters have identified various proposals for restoring the buoyancy of the sector. In addition, the following measures are suggested to take the growth rate back to 8 percent by 2024-25.

21.1.	The manufacturing sector carries a disproportionate tax burden. Following the review of the exemptions and reduced rates in the different Schedules of the Sales Tax Act, the standard rate should be brought down to 15 percent.
21.2.	Given the large excess capacity for power generation, the time has come for reducing the industrial power tariff. Increased production by the sector will generate more tax revenues than the revenue loss due to the tariff reduction.
21.3.	There is need to emphasize the backward linkage of manufacturing with agriculture. The risk is that unless the cotton crop is restored the future of the textile sector and Pakistan's exports is problematic. Already, this year with a 36 percent fall in output of cotton, shortages have emerged, and prices of textile products have gone up sharply.
21.4	The number of SMEs in the manufacturing sector is 1.9 million with employment of 6.2 million and share in manufactured exports of over 25 percent. However, only 2.4 percent of the total private sector credit goes to these SMEs. Measures to support these SMEs include higher exemption limit on sales tax, simplification of the income tax system, setting up a Credit Guarantee Scheme for SMEs by the SBP and higher income tax deductibility to banks against bad loans.

22. The Construction Sector

The construction sector is relatively labor-intensive and employs many daily wage workers. It has strong backward linkages. Pre-dominantly activities in the sector relate to house building and execution of development projects. Currently, there is a shortage of over 5 million housing units. Over 1 million households with 8 or more persons live in one room housing units.

Following the COVID-19, major steps have been taken to revive the sector, including tax breaks, tax amnesty to builders under new projects and greater access to subsidized housing finance. The following recommendations are given below for boosting further construction activity:

22.1.	Cement is subject to an excise duty of Rs 1.50 per kg. This should be converted into the standard sales tax with input tax invoicing provision.
22.2.	Introduction of a tax deductibility provision in the ITO for personal housing loan repayments up to Rs 20,000 per month.
22.3.	The Metropolitan Building Authorities must be strengthened and held accountable for ensuring minimum building standards and no illegal acquisition of public land.
22.4	The focus in low cost-housing should be on home improvement rather than on construction of new housing units. Even 3 marla housing units are beyond the reach of low-income families, even in the presence of subsidized credit. Small loans for home improvement should be extended through microfinance institutions.

The objectives are to ensure construction of 1 million housing units annually and increasing development spending to 4 percent of the GDP by 2024-25.

23. The Power Sector

The power sector has made a transition from severe electricity shortages to excess capacity for power generation of over 16 percent. Bulk of the increase has been in thermal power, using gas and coal as the power source. The constraints faced now are growing reliance on imported fuel, large system losses both in transmission / distribution and billing, high tariffs and elastic demand for electricity, and mushroom growth in circular debt.

The recommendations, especially for increasing the output of the sector, are as follows:

23.1.	Contrary to the agreement with the IMF, the optimal pricing policy is to reduce power tariffs, especially to industry, in the present of substantial excess capacity.
23.2.	NEPRA must ensure that in the presence of excess capacity the merit order of generation plants is strictly adhered to. Henceforth, the focus may be on renewable energy projects.
23.3.	The share of power transmission and distribution projects in the Federal PSDP allocations must increase from 6 percent currently to at least 10 percent as to reduce losses quickly and expand coverage.

24. Services Sectors

The six services sectors collectively account for 62 percent of the GDP. The long-run growth rate has been 5 percent. Three sectors, viz., wholesale and retail trade, transport and communications and private services are largely informal in nature. Service activities have strong backward and forward linkages with the commodity-producing sectors.

The recommended reforms in these sectors include the following:

24.1.	There is need for tackling monopolistic behavior by wholesale intermediaries in agricultural items. A public agency like PASSCO should play a bigger role in agricultural markets and maintain reserve stocks.
24.2.	Double taxation of the telecom sector should be ended. The presumptive income tax on mobile cards needs to be withdrawn and only the Provincial sales tax on services levied. However, the Budget of 2021-22 has levied another tax of 75 paisas on mobile phone calls of above 5 minutes. These taxes are regressive in nature.
24.3.	Within the transport sector, the pricing policy on fuel should be altered such that the price of motor spirit is significantly higher than the price of HSD oil.

Part-VIII: Striving for Balanced Regional Development

25. Developing Backward Areas

The Constitution has emphasized in Article 37(a) on the need to promote, with special care, the educational and economic interests of backward areas. Overall, despite the fiscal equalization embodied in the 7^{th} NFC Award, inter-provincial income inequality has increased after 2009-10 and Balochistan has fallen further behind.

An attempt has been made for the first time to quantify the HDI within each Province at the level of Divisions and the standard of living at the district level.

Recommendations for achieving more balanced regional development are as follows:

25.1.	PBS to undertake estimation of Provincial GRPs by sector and by expenditure with the assistance of Provincial Statistics Bureaus. This will facilitate the transition from *'top-down'* to '*bottom-up*' planning both at the Provincial and Federal levels.

25.2.	The research quoted in the report has led to identification of economic production sectors where a particular Province has a comparative advantage with respect to the rest of the country. The development strategy of the Provincial Government must focus on sectors in which it has the comparative advantage.
25.3.	Both Federal PSDP and Provincial ADPs must allocate higher share of resources to the identified backward areas. The PFCs must ensure this in the horizontal sharing formula at the local level.
25.4.	The policy on regional income tax holidays should be: • 5 years in divisions/ districts at low level of development • 10 years in divisions/ districts at extremely low level of development.

Part-IX: Focusing on Human Development

26. Education and Health

Education

The HDI focuses on the health and education status of the target population. Pakistan has the lowest HDI ranking among the five major South Asian countries. The primary reason is the extremely low education index, which reflects the relatively low level of public spending on education at 2.2 percent of the GDP of Pakistan, compared to the average of 3.3 percent of the GDP of the other South Asian countries. In terms of spending by level of education, the share of college/university education is relatively high at 22 percent, compared to the average of 18 percent in the other South Asian countries.

The education-employment link is of fundamental importance. Today, the fastest growth in entrants into the labor force is of college/university graduates but their absorption rate is the lowest with the unemployment rate at over 16 percent.

Clearly, the recommendations are as follows:

26.1.	The Article 25A of the Constitution commits to provide free and full access to school education. The priority needs to be fully restored for school education and simultaneously there is need for consolidation of higher education. A moratorium should be imposed on new higher education institutions and efforts made to ensure full faculty presence at universities.

26.2.	Over 18,000 public schools have been closed. Reasons for their closure must be identified, with restoration wherever possible. The coverage of schools for girls and in rural areas must be expanded rapidly.
26.3.	The emphasis should also be on technical and vocational education in relevant market-based skills in partnership with the private sector with link to micro-credit.
26.4.	The objective must be to increase the public outlay on education annually to at least 2.5 percent of the GDP by 2024-25.

Health

Pakistan also performs poorly in health, with lowest life expectancy among South Asian countries. The total public outlay on health is barely 1 percent of the GDP and almost 52 percent is devoted to spending on hospitals and clinics. Fortunately, the share of spending on preventive measures has increased from 18 percent to 29 percent and on medical education from 13 percent to 18 percent. The coverage of health services has not improved much during the decade. There are fewer nurses in the country than doctors and there is only one lady health worker in 10,000 population.

Recommendations are as follows:

26.5.	A major step forward is the expansion of health insurance coverage, especially by Khyber-Pakhtunkhwa Government. A similar facility must be extended in the other Provinces. This has been announced in the Federal budget of 2021-22 and may be implemented forthwith.
26.6.	Today, over 1.2 million children in Pakistan do not get immunized. A conditional cash transfer scheme for child immunization should be introduced as part of the EHSAAS program.
26.7.	Private medical services have been given access to subsidized credit and duty-free import of medical equipment after the first COVID-19 attack. This facility should continue. The pace of vaccinations must be greatly accelerated.
26.8.	The Lady Health Workers are the closest equivalent to the 'bare foot doctor', especially in the rural areas. Their number should be expanded with proper work status, remuneration and access to training.

Part-X: Providing more Employment Opportunities

27. Employment Strategy

The labor force of Pakistan is close to 71 million. Following the COVID-19 attack the number of unemployed has increased from 5 million to almost 10 million, implying that the unemployment rate has crossed 14 percent, reaching the highest ever. The highest rate of unemployment is among female workers and workers with degree or post-graduate qualifications. The target is to bring down the 'open' unemployment rate to 6 percent by 2024-25. Recommendations for achieving this target are as follows:

27.1. Incrementally, the focus will need to create jobs in manufacturing, construction, and services, rather than in the public sector and agriculture. In rural areas, the focus will have to be on 'off-farm' job creation.

27.2. There is a dire need for absorbing the 'youth bulge'. Currently, there are 5 million male and 7 million female 'idle' youth. There is a big risk thereof of increase in crime and fundamentalism. Expansion of technical and vocational training with access to micro credit must be a key component of the absorption strategy. 60 percent of the 'idle' youth are in rural areas. There is need to launch food for work and rural employment guarantee programs. Also, the development of information technology and rapid digitization will provide more employment opportunities for educated youth.

28. Labor Laws and Conventions

Pakistan is a signatory to many International Labor Conventions in line with the Constitution. However, the incidence of 'decent work', as defined by the ILO, remains very low. Almost 43 percent of workers do not get even the minimum wage. There are over 3 million bonded workers and two million child workers. Over 60 percent of workers put in more than 40 hours a week. Women get 38 percent less remuneration for the same work. Recommendations for enhancing the incidence of decent work are as follows:

28.1. The adherence to Labor Conventions must be demonstrated by Provincial Governments, which have responsibility in this area, in the translation of these Conventions into relevant laws and ensuring adherence to these laws. The three major 'missing' laws are on the following:

- Equal Remuneration Law
- Elimination of Discrimination in Employment Law
- Prohibition of Child Labor Law

28.2. The Provincial Labor Departments are among the weakest line departments. There is need for setting up a system of District Labor Officers. Further, more labor court benches should be set up at least at the Division level in each Province.

Part-XI: Achieving more Poverty Alleviation and Social Protection

29. Meeting the SDGs

The SDGs are the United Nations Goals, Targets, and Indicators. Pakistan is a signatory to the SDGs. There are 17 Goals and as many as 169 targets. There is need to focus on some targets, based on application of relevant criteria. Perhaps, the most important target is to reduce poverty by half by 2030 from the level prevailing in 2015. Pakistan is performing poorly in virtually all the indicators. A SDGs Score Card prepared by Professor Geoffrey Sachs places Pakistan at 134th out of 180 countries.

Recommendations on the SDGs are as follows:

29.1. The Federal Planning Commission should be the focal point nationally on the SDGs with the role of the Secretariat to the Parliamentary Committee on the SDGs. The first task should be to design an information system on the selected indicators and construct a database on these indicators ideally at the district level.

29.2. The Planning Commission, along with the SDG units, must conceive of and design projects related to achievement of the key targets and market these projects for financial support by multilateral and bilateral donors.

30. Expanding Social Protection

The incidence of poverty in Pakistan was relatively high at 38 percent in 2014-15. It is estimated that due to growth and low inflation it had declined to below 27 percent by the end of 2017-18. Following the first attack of COVID-19 it is estimated that it has risen to over 36 percent, indicating that more than 19 million people have fallen below the poverty line. This is due not only due to higher unemployment but also because of the much faster inflation in food prices.

Recommendations to tackle the rising poverty are as follows:

30.1.	The EHSAAS Program did a very efficient job of targeting cash transfers to 17 million beneficiaries in the immediate aftermath of the first COVID-19 attack. Apparently, the number of beneficiaries is to be reduced by half. This must be avoided, and the coverage remain at 17 million given the intensity of the third COVID-19 attack. Also, there has been relative under coverage in Balochistan.
30.2.	There is need to expand the social security program. The coverage of private employees and self-employed is extremely low compared to government employees. The Workers Welfare Fund must be reverted to the Provincial Governments as per the 18th Amendment. These funds should be used by these governments to expand the coverage of pensions and for other labor related initiatives. Self-employed and expatriate workers may be welcomed into the pension schemes subject to regular contributions.
30.3.	The consumer subsidies need to be targeted. Access to food subsidy in the form of lower prices at the USC outlets should be restricted only to certified beneficiaries of the EHSAAS program. Also, the lowest electricity and gas tariffs should be available to only these beneficiaries.
30.4	The middle class has shrunk from 43 percent in 2001-02 to 30 percent of the population currently, due to high unemployment rate of highly educated workers and higher inflation in housing rents and services. Relief measures recommended include raising of the income tax exemption limit from Rs 600,000 to Rs 1,200.000; tax deductibility of monthly housing loan payments up to Rs 20,000 and larger access to credit for investments in the digital economy.

31. Restraining Population Growth

Implementation of the above-mentioned reforms and initiatives will not yield full results if the high rate of population growth continues in the country. Estimates are that the population could exceed 400 million by 2050.

Already, the increasing population pressure has substantially reduced the access to water, farmland, schools, hospital beds, nutrition, and jobs.

31.1	Expenditure on population planning is only 0.5% of total Provincial expenditure. This may be raised to at least 3%.
31.2	There is need for engagement of religious leaders, as was done in Bangladesh, to endorse and advocate the national narrative on family planning.
31.3	Inputs for achieving population control will include expansion of number of LHWs, cheap contraceptives, civil society campaigns, and conditional cash transfers.

PART-I

TARGETS IN
THE CHARTER OF THE ECONOMY

Chapter 1:

Economic Trends and Targets

The objective of this chapter is to highlight first the trends over the last five years in the key macroeconomic variables of the economy of Pakistan. This will identify the major structural problems which will need to be addressed in the Charter of the Economy. Attainable targets following removal of constraints are set in the second section.

1.1. Economic Trends

GDP Growth

The average GDP growth between 2014-15 and 2019-20 has been only 3.4 percent. It rises to 4.3 percent if the year, 2019-20, is excluded because of the large negative impact of COVID-19. It is only in 2017-18 when there was relatively high growth of 5.5 percent, as shown in Table 1.1.

Pakistan had been successful in achieving 6 percent or more GDP growth rate in the decades of 60s, 80s and for some years in the first decade of this century. If Pakistan is to achieve the status of a well-performing emerging economy and simultaneously reduce unemployment and poverty, then the GDP growth rate will have to be restored to 6 percent or more in coming years.

Table 1.1: Key Macroeconomic Indicators of the Economy, 2015-16 to 2020-21

	2015-16	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**
GDP Growth Rate (%)	**4.6**	**5.2**	**5.5**	**2.1**	**-0.5**	**3.9**
Agriculture	0.2	2.2	4.0	0.6	3.3	2.8
Manufacturing	5.6	4.5	4.6	-0.7	-7.4	8.7
Services	5.7	6.5	6.3	3.8	-0.6	4.4
Level of Fixed Investment (*% of GDP*)	**14.1**	**14.6**	**15.7**	**14.0**	**13.7**	**13.6**
Public Investment	3.8	4.5	5.2	3.6	3.2	3.8
Private Investment	10.3	10.1	10.5	10.4	10.6	9.8
Level of Savings (*% of GDP*)	**13.9**	**12.0**	**11.3**	**10.8**	**13.6**	**15.3**
Employment (*million*)	57.42	59.35	61.71	62.41	60.46	61.90

Unemployment Rate (%)*	*8.5*	*8.2*	*8.0*	*10.0*	*15.0*	*13.0*
Rate of Inflation (*CPI, %*)	**2.9**	**4.2**	**3.9**	**7.3****	**10.7**	**8.9**
Food Prices	2.1	3.8	1.8	4.6	15.0	12.8
Non-Food Prices	3.4	4.4	5.4	9.2	8.2	6.7

* '*True*' unemployment rate, including underemployment and worker discouragement effects.
** The base year was changed to 2015-16 from July 2019 onwards.
Sources: *PES, SBP*, *MOF, PBS, CPI, PBS, LFS*

Both agriculture and industrial sectors have performed poorly. There have even been years when the growth rate was negative or near zero. The agricultural sector grew by only 0.2 percent in 2015-16. Over the last five years the sector has averaged a growth rate of only 1.9 percent. Historically, a GDP growth rate of 6 percent has required agricultural growth of 4 percent or more.

The manufacturing sector witnessed a decline in output of 0.7 percent in 2018-19 and of 7.4 percent in 2019-20, after COVID-19. The last time there was negative growth of the sector was as far back as 2008-09. The sector will have to play the role of the leading sector once again in the process of growth. From the average growth rate of 3.1 percent in the last five years, excluding 2019-20, the growth rate will have to rise to 7 to 8 percent if the GDP growth rate of 6 percent is to be attained.

Level of Investment

The level of fixed investment reached a peak of 15.7 percent of the GDP in 2017-18, which facilitated attainment of the GDP growth rate of 5.5 percent. However, over the last four years the average is 14.6 percent of the GDP. During the 80s when the GDP growth rate reached 6.5 percent the level of investment almost reached 19 percent of the GDP. This rate will have to be attained once again.

There has been a decline in the level of public investment from above 5 percent of the GDP to below 4 percent of GDP in the last four years. Infrastructure constraints to growth have emerged in the form of limited water availability and high energy costs. There is need for lumpy investments in large hydro-electricity projects and for improving and expanding the power transmission and distribution system. As such, the public investment program will have to be raised to over 5 percent of the GDP with much stronger prioritization of projects.

The level of private investment has remained almost unchanged at 10 percent of the GDP since 2015-16, as shown in Table 1.1. There is currently a relatively high rate of capacity utilization and the resulting absence of excess capacity to bolster rapidly the rate of growth of output. Further, there is need for state-of-the art investments to move up the value chain and diversify the export base. As such, the level of private investment will have to rise to 12.5 percent of the GDP.

Level of Savings

Higher savings are a pre-requisite for raising the level of investment, otherwise there is the risk that the trade deficit could rise to an unsustainable level. Therefore, raising the level of savings by reduction in government deficits, higher home remittances and large corporate and household savings must get the highest priority.

The trend in the national rate of savings is given in Table 1.2. The rate of overall savings in Pakistan is low relative to the rate in countries like India, Sri Lanka, and Bangladesh, where it ranges from 25 percent to 30 percent.

Table 1.2: The Rate of Net Savings by Source (% of GDP)

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
1. Total National Saving	13.9	12.0	11.3	10.8	13.6	15.3
2. Foreign Saving	6.1	5.5	5.3	6.7	6.8	8.2
3. Domestic Saving	7.8	6.5	6.0	4.1	6.8	7.1

Source: *PES*

The last year, 2020-21, has witnessed a jump in the national savings from 13.6 percent to 15.3 percent. This is due primarily to the big jump in home remittance. Within domestic savings, the contribution by household savings, corporate savings and public savings is presented in Table 1.3 up to 2018-19. Data has not yet become fully available for the last two years.

Table 1.3: Distribution of Domestic Savings (% of GDP)

	2015-16	2016-17	2017-18	2018-19
Total Domestic Saving	**7.8**	**6.5**	**6.0**	**4.1**
Public Saving	-0.9	-0.8	-1.8	-4.7
Corporate Saving	0.5	0.6	0.6	0.5
Household Saving	8.2	6.7	7.2	8.3

Source: *Estimated*

The rate of net domestic savings has shown a declining tendency. This is due primarily to larger public net dissaving. The gap between revenue and current expenditure reached a peak in 2018-19. Corporate savings in the form of retained profits have remained largely unchanged as a percentage of the GDP.

There has been some recovery in household savings, but they remain low. There was a rise in 2018-19 due to the peaking of rates of return on National Savings Schemes.

Overall, the savings rate of Pakistan will need to be significantly augmented if the rate of investment is to be raised. In particular, the gap between revenues and current expenditure will need to be reduced in the Federal and Provincial budgets. Also, stronger incentives may be given to companies to raise their retained profits by raising the advance tax on dividends. Similarly, the rates of return on National Savings Schemes should continue to be relatively attractive. These should provide real returns in relation to the rate of inflation and the yield curve should be steeper to encourage long-term savings.

Employment

Between 2014-15 and 2017-18, 1.4 million jobs have been added annually, when the labor force is increasing currently by over 1.6 million. The 'true' unemployment, rate, inclusive of underemployment and the 'discouraged worker' effect, is higher than 8 percent. The impact of COVID-19 had been to raise the unemployment rate to almost 15 percent in 2019-20. Process of reabsorption of laid off workers is currently proceeding at only a moderate pace.

The annual rate of expansion of the labor force will approach 2 million in the next few years and accordingly this many jobs will have to be generated annually. This again can only be ensured if the GDP growth rate approaches 6 percent.

There are also three dimensions to the labor absorption problem. First, the level of agricultural employment has been falling and this is leading to more rural-urban migration, which is growing by almost 4 percent per annum. Consequently, more off-farm jobs and urban employment will need to be created to reduce pressure on the cities.

Second, bulk of the increase, almost 70 percent, in jobs outside agriculture are being provided in the informal sector. There is a visible gap in meeting the standards of 'decent work' in this sector.

Third, there are over 5 million 'idle' male youth. A special program must be launched to productively engage these youth, otherwise there is the heightened risk of more crime and a reversion to fundamentalism.

Rate of Inflation

The rate of inflation remained exceptionally low at an average of 3.7 percent from 2015-16 to 2017-18. This was the consequence of a relatively modest rate of monetary expansion of 12.5 percent annually and the maintenance of an artificially overvalued exchange rate, as shown in Table 1.3. Further, food prices also rose moderately on average during these three years by less than 4.5 percent.

The year, 2019-20, witnessed a big upsurge in the rate of inflation to almost 11 percent. Due to shortages and hoarding, food prices rose by 15 percent. A large part of the inflation was due a 24 percent depreciation of the rupee to contain the size of the current account deficit.

The inflation rate has come down in 2020-21 to below 9 percent, but food prices have risen faster by almost 13 percent. The cumulative inflation in food prices of over 29 percent since 2017-18 has had a disproportionately adverse impact on relatively poor households.

The primary reason for the relatively high rate of inflation in 2019-20 is due to the high rate of monetary expansion of 17.5 percent caused by the high level of domestic borrowing to finance the large budget deficit. Also, during the period of lockdowns after COVID-19, supply shortages had emerged in many items.

There is need to ensure in coming years that the rate of inflation remains anchored in the relatively low range of 6 to 7 percent. This will require a focus on managing supplies of essential commodities, better local regulation of markets, policy of avoiding significant under valuation of the rupee and limiting the rate of monetary expansion to a low double-digit rate.

Public Finances

The financial position of the Federal and Provincial Governments has substantially deteriorated in the last five years as shown in Table 1.4. The primary manifestation of the worsening in public finances is the virtual explosion in the absolute size of the budget by three times since 2014-15. In 2015-16, the consolidated fiscal deficit was 4.7 percent of the GDP which reached an all-time peak of 8.9 percent of the GDP in 2018-19. It has since declined to 8.1 percent of the GDP in 2019-20 and to 7.5 percent in 2020-21.

There are two fundamental reasons for the big increase in the fiscal deficit. First, the tax-to-GDP of Pakistan remains low. It had improved significantly to 13 percent of the GDP by 2017-18 on the back of withdrawal of exemptions, enhancements especially in withholding tax rates and some improvement in the quality of tax administration. However, it has fallen sharply thereafter to 11.7 percent of the GDP.

Table 1.4: Trend in Public Finances of Pakistan (% of GDP)

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21*
Total Revenue	**15.0**	**15.5**	**15.2**	**12.7**	**15.0**	**14.6**
Tax Revenue	12.4	12.5	3.0	11.6	11.4	11.7
Non-Tax Revenue	2.6	3.0	2.2	1.1	3.7	2.9
Total Expenditure	**19.6**	**21.3**	**21.8**	**21.6**	**23.1**	**22.1**
Current Expenditure	**15.9**	**16.3**	**17.0**	**18.4**	**20.4**	**19.3**
Debt Servicing	4.3	4.2	4.4	5.4	6.3	6.4

Defense	2.6	2.8	3.0	3.0	2.9	2.7
Others	9.0	9.3	9.6	10.0	11.2	10.2
Development Expenditure	**4.7**	**5.0**	**4.8**	**3.2**	**2.7**	**2.8**
Budget Deficit	**-4.6**	**-5.8**	**-6.6**	**-8.9**	**-8.1**	**-7.5**
Primary Deficit / Surplus	**-0.3**	**-1.6**	**-2.2**	**-3.5**	**-1.8**	**-1.1**
Central Government Debt	**61.3**	**61.4**	**66.5**	**77.7**	**79.7**	**77.3**

* Likely
Source: *MOF, Fiscal Operations: SBP*

Enhancement in Government revenues is one of the fundamental prerequisites for a realistic Charter of the Economy. There is need not only for substantially higher public outlays on economic infrastructure and human development but also for simultaneously reducing the size of the budget deficit to contain aggregate demand pressures in the economy and rise in Government debt. An ambitious but feasible target is to raise the tax-to-GDP ratio to 15 percent of the GDP, with the primary focus on reducing tax expenditure, and making the tax system more broad-based and progressive.

The target for the size of the budget deficit should be a maximum of 4.5 percent of the GDP with the primary deficit transformed into a surplus. This will require improved public debt management to contain the growth of debt servicing, which has gone up by 2 percent of the GDP in five years due to the big hike in interest rates after 2018 to March 2019. Other expenditure, especially on the current side, will also need to be cutback. This will require significant downsizing of Government Ministries / Divisions, economy in non-salary operating costs, transition to a contributory system of pensions and reduction in contingent liabilities of State-owned enterprises.

Balance of Payments

Managing the external balance of payments of Pakistan is of fundamental importance for ensuring the sustainability of the growth process in the economy. Acceleration of GDP growth leads to an increase in the demand for imports as it can only be achieved by larger imports of machinery, raw materials, and intermediate goods. Therefore, high growth is required in exports to keep the balance of trade at a manageable level. In effect, high growth must also be in the form of export-led growth.

This was achieved last in the first decade of the current millennium. Exports increased by almost 125 percent to $19.3 billion by 2009-10 with an annual growth rate of 8 percent, as shown in Table 1.3. Thereafter, exports have performed poorly with an annual increase of only 1.5 percent up to 2019-20. Efforts must be to achieve the high growth rate of 8 percent like in the previous decade.

Remittances have played a fundamental role in reducing the size of the current deficit. They have increased at the rate of 4 percent annually and now are even larger than exports of goods. During the current year, they have shown spectacular growth of 29 percent in the first ten months, despite the return of migrant workers after COVID-19. This may be attributable to less expenditure on travel, need for more support to families in Pakistan and to the shift in inflows from the hundi market to official banking channels.

The first ten months of 2020-21 have witnessed for the first time after the first half of 2010-11 a current account surplus, with the magnitude of $0.8 billion. This is, of course, due to the phenomenal growth in remittances and limited growth in imports. The current account deficit has returned in December 2020 due particularly to larger imports of agricultural items, transport equipment and some intermediate inputs. The expectation now is that in the full year of 2020-21 there will be a small current account deficit.

A new problem has emerged. While the current account deficit position has greatly improved the financial account of the balance of payments has worsened. It was in surplus last year of $10 billion in the first ten months, but it has now been reduced to $2.8 billion as shown in Table 1.5. Historically, financial account surpluses have not only enabled financing of the current account deficit but have also enabled a buildup of reserves of as much as $4.8 billion in 2019-20.

The reasons for the big deterioration in the financial account are, first, a 38 percent decline in foreign direct investment. Second, the net inflow of assistance to the Government has decreased by 45 percent despite the deferment of debt repayment to the G-20 as a special relief measure after COVID-19. The IMF earlier also gave a loan of $1.4 billion from the Rapid Financing facility to minimize the negative impact of a fall in exports after COVID-19.

Table 1.5: Trend in the Balance of Payments of Pakistan ($ billion)

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Current Account Surplus (+)/ Deficit (-)	**-5.0**	**-12.8**	**-19.2**	**-13.4**	**-3.0**	**-1.8**
Exports*	22.0	22.0	24.8	24.3	22.5	25.6
Imports	41.1	48.0	55.7	51.9	42.4	53.8
Balance of Trade	***-19.1***	***-26.0***	***-30.9***	***-27.6***	***-19.9***	***-28.2***
Remittances	19.9	19.3	19.9	21.7	23.1	29.4
Financial Acct Surplus (+)/Deficit (-)	**6.9**	**9.9**	**13.6**	**11.8**	**7.7**	**8.2**
Foreign Direct Investment	2.4	2.4	2.8	1.4	2.5	1.8
Portfolio Investment	-0.3	0.3	2.2	-1.3	-0.4	2.8
Net Government Borrowing	3.4	5.0	4.9	4.2	5.8	5.7

Others**	1.4	2.2	3.7	7.5	-0.2	-2.1
Balance of Payments	**2.7**	**-1.9**	**-6.1**	**-1.5**	**5.3**	**5.6**
Foreign Exchange Reserves	**18.1**	**16.1**	**9.8**	**7.3**	**12.1**	**17.3**
Exchange rate* (Rs / $)**	**104.23**	**104.70**	**109.84**	**136.09**	**155.16**	**156.16**
Real Effective Exchange Rate (2010 = 100) | (end year)	**117.34**	**121.01**	**107.48**	**90.97**	**93.04**	**99.85**

* of goods | ** inflows / outflows of SBP, Commercial Banks and others | *** Average of year
Source: *SBP*

A primary area of concern is that with the external debt approaching $120 billion, annual debt repayment has risen exponentially and trebled from $4 billion in 2015-16 to an anticipated $12 billion in 2020-21. As loans mature, especially those from international commercial banks, the debt repayment obligations will continue to rise rapidly. This will mean that Pakistan's external financing needs could exceed $16 billion to $20 billion annually in coming years.

The current perception is that the foreign exchange reserves are relatively high. They stand at over $17 billion, enough to provide import cover for more than three months. But they include $4.7 billion of other Central Bank deposits and swap funds with the SBP, and the short-term borrowing of $4.6 billion from the foreign currency deposits of the commercial banks. As such, the inherent position of reserves remains fragile. The rupee has started gradually in value since March 2020.

1.2. Targets

Based on the above the key targets identified are as follows for the Charter of the Economy from 2020-21 to 2024-25.

Growth
• Increase in GDP growth rate from almost 4 percent in 2020-21 to 6 percent in 2024-25.
• Increase in the growth rate of the agricultural sector from 2.8 percent in 2020-21 to 4 percent in 2024-25.
• Increase in the growth rate of the industrial sector below 4 percent in 2020-21 to 8 percent in 2024-25.
INVESTMENT
• Rise in the overall rate of investment from under 14 percent of the GDP in 2020-21 to 17.5 percent of the GDP in 2024-25.

- Rise in the rate of private investment from under 10 percent of the GDP in 2020-21 to 12.5 percent of the GDP in 2024-25.
- Rise in the rate of public investment from under 4 percent of the GDP in 2020-21 to 5 percent of the GDP in 2024-25.

Employment

- Annual increase in number employed by 1.7 million in 2021-22 to 2.2 million in 2024-25, with special focus on absorption of `idle' youth and improvement in `decent work' conditions.

Rate of Inflation

- Bringing down the rate of inflation from 9 percent in 2020-21 to 6 percent by 2024-25.

The resulting macroeconomic projections are given in Table 1.6.

Table 1.6: Projection of Key Macroeconomic Variables, 2020-21 to 2024-25

	2020-21	2021-22	2022-23	2023-24	2024-25
GDP Growth Rate (%)	**3.9**	**4.5**	**5.0**	**5.5**	**6.0**
Agriculture	2.8	3.0	3.3	3.6	4.0
Industry	3.8	5.0	6.0	7.0	8.0
Services	4.4	4.8	5.2	5.6	6.0
Level of Investment (*% of GDP*)	**13.6**	**14.6**	**15.6**	**16.5**	**17.5**
Public Investment (*% of GDP*)	3.8	4.1	4.4	4.7	5.0
Private Investment (*% of GDP*)	9.8	10.5	11.2	11.8	12.5
Unemployment Rate (%)	13.0	10.4	8.7	7.3	6.0
Rate of Inflation (%)					
Overall CPI (*%*)	8.9	12.0	8.0	7.0	6.0
Food Inflation (*%*)	12.8	15.0	10.0	8.0	6.0

Source: *Estimated*

Public Finances

- Raising the tax-to-GDP ratio from 11.7 percent of the GDP in 2020-21 & to 15 percent of the GDP in 2024-25.
- Maintaining the current expenditure to GDP ratio at 19.3 percent of the GDP from 2020-21 to 19.4 percent up to 2024-25.
- Raising the level of development expenditure from 2.8 percent of the GDP in 2020-21to 4 percent of the GDP by 2024-25.

- Bringing down the budget deficit from 7.5 percent of the GDP in 2020-21 to 5 percent of the GDP by 2024-25.
- Generating a Primary Surplus from 2023-24 onwards.
- Reducing the Government Debt from 77.3 percent of the GDP in 2021-22 to 70 percent of the GDP in 2024-25

The projections are given in Table 1.7.

Table 1.7: Projection of Public Finances of Pakistan, 2020-21 to 2024-25 (% of GDP)

	2020-21	2021-22	2022-23	2023-24	2024-25
Total Revenue	**14.6**	**15.7**	**16.4**	**17.5**	**18.4**
Tax Revenue	11.7	12.4	13.0	14.1	15.0
Non-Tax Revenue	2.9	3.3	3.4	3.4	3.4
Total Expenditure	**22.1**	**22.7**	**23.0**	**23.2**	**23.4**
Current Expenditure	***19.3***	***19.4***	***19.4***	***19.4***	***19.4***
Debt Servicing	6.4	6.1	5.8	5.7	5.5
Defense	2.7	2.9	3.0	3.0	3.1
Other	10.2	10.4	10.6	10.7	10.8
Development Expenditure	**2.8**	**3.3**	**3.6**	**3.8**	**4.0**
Budget Deficit	**-7.5**	**-7.0**	**-6.6**	**-5.7**	**-5.0**
Primary Deficit/Surplus	**-1.1**	**-1.0**	**-0.2**	**0.1**	**0.5**
Government Debt	**77.3**	**76.6**	**75.0**	**73.0**	**70.0**

Source: *Estimated*

Balance of Payments

- Targeting growth annually in exports of 8 percent from 2021-22 to 2024-25.
- Limiting the current account deficit to below 3 percent of the GDP annually throughout the period, 2021-22 to 2024-25.
- Achieving a financial account surplus of 2 to 3 percent of the GDP annually from 2021-22 to 2024-25 in the balance of payments.
- Ensuring that foreign exchange reserves remain high enough to provide import cover of at least three months throughout.

The resulting projections from 2020-21 to 2024-25 are presented in Table 1.8.

Table 1.8: Projection of the Balance of Payments of Pakistan, 2020-21 to 2024-25						($ billion)
	2019-20	**2020-21**	**2021-22**	**2022-23**	**2023-24**	**2024-25**
Current Account	**-3.0**	**-1.8**	**-6.5**	**-7.5**	**-8.0**	**-9.5**
Exports of Goods	22.5	25.6	26.8	28.9	31.2	33.7
Imports of Goods	42.4	53.8	60.2	63.8	67.6	71.6
Balance of Trade	***-19.9***	***-28.2***	***-33.4***	***-34.9***	***-36.4***	***-37.9***
Remittances	23.1	29.4	30.9	32.4	34.4	35.0
Others*	-6.2	-6.0	-4.0	-5.0	-6.0	-6.6
Financial Account	**7.7**	**8.2**	**7.5**	**8.5**	**9.5**	**11.5**
Others	**0.6**	**-0.8**	**0.5**	**0.5**	**0.5**	**0.5**
Balance of Payments	**5.3**	**5.6**	**1.5**	**1.5**	**2.0**	**2.5**
Reserves	**12.1**	**17.3**	**18.8**	**20.3**	**22.3**	**24.8**
Reserve Cover (*Months of Imports)*	**3.4**	**3.5**	**3.3**	**3.3**	**3.4**	**3.6**
Source: *Estimated*						

The Charter of the Economy will focus on the realization of the projections in Tables 1.6 to 1.8.

1.3. Focusing on Inflation

One Of the major negative economic factors which is impacting heavily on the lives of the people is the high prevailing rate of inflation. The rate of inflation in the overall consumer Price Index (CPI) was close to 10 percent in April 2020-21.

Pakistan has experienced varying rates of inflation in different periods over the last fifteen years. Inflation was high during the period, 2007-08 to 2011-12, when it was double digit each year and averaged an annual rate of almost 13 percent. Thereafter, we have seen a period of relative price stability up to 2018-19 with the rate of inflation down to only 5.5 percent. However, double-digit inflation returned in 2019-20 and the first ten months of 2020-21 have witnessed an average monthly inflation rate of over 9 percent.

There is need to determine the contribution of different factors to inflation in Pakistan. It is particularly important of focus on the level of basic food prices because they have a disproportionately bigger impact on the lower income groups.

There are both basic demand and supply-side factors which contribute to inflation. This includes generally recognized factors like the rate of monetary expansion and the level of availability of basic goods and services. However, not enough emphasis has been placed on the impact of imported inflation on domestic prices.

Imports today constitute 17 percent of the GDP. There have been times when they were above 20 percent of the GDP. Pakistan imports many basic food items like spices, tea, palm oil, pulses, and milk food. Now we are also importing large quantities of wheat and sugar. Other consumer goods include medicine, plastic products and paper and stationery.

There are some intermediate and raw materials which also impact on the domestic price level. This includes crude oil, petroleum products, fertilizer, cotton, synthetic textiles, iron and steel, etc.

Therefore, it is not surprising that there is a strong link between the rise in import prices and the domestic price level in Pakistan. This is shown visually in Table 1.9. The much higher rate of inflation between 2007-08 and 2011-12 is clearly due to much bigger rate of increase in import prices compared to the more recent period, when cumulatively there was no change in import prices, especially due to lower international price of oil.

Table 1.9: The Average Rate of Inflation and Rate of Change in Determinants of Inflation (%)

Period	Rate of Inflation	Rate of Change in Import Prices	Rate of Monetary Expansion*	Growth Rate of GDP
2007-08 to 2011-12	12.8	20.1	14.5	3.1
2011-12 to 2018-19	5.4	0.0	13.1	4.1
Difference	7.4	20.1	1.4	1.1

Source: *SBP*

What explains the faster rate of increase in import prices? This is examined in Table 1.10. The faster rise is due to faster rise in international prices in the first period and a somewhat more rapid rate of devaluation of the rupee. In fact, the rupee remained almost nominally stable between 2013-14 and 2017-18. Also, international price of oil fell sharply in 2015-16.

Table 1.10: Rate of Change in Import Prices due to Rise in International Prices and the Fall in the Value of the Rupee (%)

Period	Rate of Change in US$ Dollar Prices	Rate of Devaluation of Rupee	Rate of Change in Import Prices
2007-08 to 2011-12	5.0	7.8	12.8
2011-12 to 2018-19	-0.5	5.9	5.4

Source: *SBP*

Econometric analysis has been undertaken from 1990-91 onwards to determine the contribution of different factors to inflation in Pakistan. The results are shown in Chart 1.1.

Chart 1.1: Impact of Different Variables on the Rate of Inflation	
A 1% Change in	**Change in Rate of Inflation in percentage points**
• Money Supply [a]	0.696
• GDP (Real)	-1.443
• Level of Import Prices in (Rs)	0.172
• Inflationary Expectations	0.337
[a] lagged by one year	
Source: *Estimated*	

Therefore, improvement on the supply-side in terms of production has a big impact in the containment of inflation. Faster expansion in money supply puts pressure on the price level. As highlighted above, import price changes matter, and so do inflationary expectations, measured by the rate of inflation in the previous year.

An analysis has also been undertaken of the determinants in the rate of change food prices. The results are given in Chart 1.2 below. Food prices move in line with changes in factors what impact on the overall rate of inflation. On top of this, faster growth in agricultural production limits inflation in food prices while a higher procurement price for wheat inevitably raises the overall food price index.

Chart 1.2: Impact of Changes in Different Variables on the Rate of Inflation in Food Prices	
A 1% Change in	Change in Food Price Inflation in percentage points
• Overall Rate of Inflation	1.125
• Level of Agricultural Production	-0.300
• Procurement Price of Wheat	0.213
Source: *Estimated*	

The impact of the first attack of COVID-19 was that by July 2020, there was a big deflationary impact on international prices, especially of oil. In Pakistan, this was neutralized by the precipitate drop in the value of the rupee.

There has been a big recovery in global prices by June 2021. For example, the price of oil has gone up by almost $40 per barrel. The impact on domestic prices has been limited by a big reduction in the Petroleum Levy.

Based on the elasticities in Charts 1.1 and 1.2 and projected values of the determinants projections have been made of the rate of inflation, overall and for food prices, up to 2024-25. These are shown in table 1.11.

Table 1.11: Projections of Overall Inflation and in Food Prices (%)		
Years	**Overall Rate of Inflation**	**Rate of Inflation in Food Prices**
2020-21	8.9	12.8
2021-22	12.0	15.0
2022-23	8.0	10.0
2023-24	7.0	8.0
2024-25	6.0	6.0

These projections reveal that there is a risk that the inflation rate may remain relatively high in 2021-22. This will be the case if global prices continue to increase, and the process of devaluation of the rupee continues.

The policy scenario for the next four years is as follows:

i) The rate of monetary expansion each year will be in the range of 12 percent to 14 percent. This will require reduction in the budget deficit to target levels mentioned above.

ii) Interest rates, electricity and gas tariffs, tax rates especially of indirect taxes are not enhanced substantially. to provide a stimulus to economic growth and limit the rate of inflation.

iii) Agricultural production reaches a growth rate of 4 percent due to more import tariff protection, appropriate procurement, support price also for cotton and little increase in fertilizer prices.

Overall, based on this mix of policies, it should be possible to bring the rate of inflation down to single digit by 2022-23.

The Annual Plan of the Planning Commission for 2021-22 contains some unrealistic targets which have been approved by the National Economic Council. The rate of inflation is projected at 8 percent. This is low given the likelihood of high imported inflation. Also, the current account is estimated at only $2.3 billion in 2021-22, even lower than 1 percent of the GDP. This is highly unlikely.

PART-II

IMPROVING GOVERNANCE

Chapter 2:

Towards ‘Good’ Economic Governance

There is a dire need for ‘good’ economic governance today. The economy is mired in a low growth path and high inflation. Successive attacks of COVID-19 have shaken the foundations of the economy and led to quantum increases in unemployment and poverty which the various relief packages have been able to ameliorate only partially. Now Pakistan has gone back to an IMF Program which asks perhaps for the most comprehensive and tough reforms ever. These reforms will need to be implemented quickly as soon as the attacks of COVID-19 subside.

Various authors have identified different characteristics of ‘good’ economic governance, including financial discipline, consistency, credibility, ability to manage crisis, integrity, transparency, effective delivery of services, protection of public interest and national sovereignty.

The objective of this chapter is to make specific proposals for improvement in the quality of economic governance in the country. The chapter commences with identification of relatively weak areas of governance as per the Country Policy and Institutional Assessment undertaken by the World Bank for selected countries, including Pakistan.

2.1. Pakistan’s Rating in Economic Governance

The World Bank has identified 21 areas of economic governance. Each area is rated from 1 to 6, with 6 representing the best rating. The CPIA ratings of Pakistan are listed below in Chart 9.1. The average rating of the selected countries is close to 3.5.

Pakistan does not do so well in the ratings. Out of the 21 areas, the performance is average in 10 areas and relatively poor in as many as 11 areas.

A comparison is made with Sri Lanka. Pakistan’s average rating is 12 percent below that of Sri Lanka. Similarly, it is over 25 percent below the average rating of Vietnam.

The ratings are exceptionally low in two areas – fiscal policy and gender equity. The best indicator of failure of fiscal policy is the high level of Government debt. It stands today at 78 percent of the GDP whereas according to the Fiscal Responsibility and Debt Limitation Act of 2005, it should be below 60 percent of the GDP. The fiscal deficit annually should be in the range of 3 percent to 4 percent of the GDP whereas in recent years it has been between 7 percent to 9 percent of the GDP.

Today, Pakistan is ranked amongst the lowest countries in the world in the Gender Inequality Index of the UNDP. This is also not surprising given the absence of policies, laws and projects for improving access to education for girls and for improving working conditions of women.

Chart 2.1: CPIA Ratings of Pakistan in Economic Governance 2018

'Poor' Rating	Average Rating	'Good' Rating
• Economic management cluster	• Building human resources	-
• Fiscal Policy*	• Business regulatory environment	
• Gender Equity*	• Debt Policy	
• Macroeconomic Management	• Efficiency of revenue mobilization	
• Policies for Social Inclusion/Equity	• Equity of Public Resource Use	
• Policy and Institutional Focus on Environmental Sustainability	• Financial Sector	
• Property-rights and Rules-based Governance	• Quality of Budgetary and Finance Management	
• Public Sector Management and Institutions	• Social Protection	
• Quality of Public Administration	• Trade Rating	
• Transparency, Accountability and Corruption in the Public Sector	• Structural Policies	
• IDA Resource Allocation Index		
[11]	[10]	[-]

**With the lowest ratings*

Source: *World Bank*

2.2. Some Successes and Failures

Despite the apparently poor quality of economic management and governance there have been some notable successes in recent years, including the following:

i) When the present Government assumed power in 2018, Pakistan had experienced the largest current account deficit in the history of the country of $20 billion in 2017-18. However, within three years it has been converted into a small deficit of less than $2 billion. Of course, this required draconian actions to curb import demand.

ii) When the previous Government came to power in 2013, the country was plagued by the highest level of power load shedding, costing the economy over 2 percent of the GDP annually. Highest priority was given to expansion in power generation capacity, either through public resources or through the CPEC. Consequently, 47 percent additional capacity had been added by 2019-20. Today, there is hardly any load shedding in most parts of the country.

iii) As opposed to the above, there have also some notable failures, as follows:

iv) Exports were at the level of $24.8 billion in 2012-13. They stagnated for the next five years and stood at the same level of $24.8 billion in 2017-18. This was primarily the consequence of the policy of maintaining an overvalued exchange rate to keep the rate of inflation artificially low. This happened at a time when even dollar prices of exports were falling due to greater competition in the global market.

v) The SBP adopted the policy of raising the policy rate massively from 6 percent in early 2018 to as high as 13.25 percent in late 2019. The motivation apparently was to attract ‘hot money’. $3 billion did come in but exited as soon as COVID-19 hit Pakistan. Meanwhile, the costs of debt servicing went up by over 30 percent in 2018-19 and contributed to the largest fiscal deficit ever, of almost 9 percent of the GDP. Private investment also collapsed.

These failures have not been followed by reprimands of the economic team at the time.

There is a need to ensure that the quality of economic governance is such that opportunities are identified quickly and fully exploited. As opposed to this institutional mechanisms and processes should exist to prevent the occurrence of big mistakes.

2.3. Presence and use of high-level Constitutional Fora

The Constitution of Pakistan has provided for two highest level Constitutional fora to act as ‘watchdogs’, discuss, approve and monitor implementation of key policies and plans and resolve disagreements among members of the Federation, that is, the Federal and Provincial Governments. These Constitutional bodies are described below.

National Economic Council

This Council has been constituted under Article 156. The Chairman of the National Economic Council (NEC), according to Article 156 of Pakistan, is the Prime Minister. The representation from a Province is by the Chief Minister and one other member. In addition, the Prime Minister may nominate four other members.

The functions of the NEC are given as:

> *‘The NEC shall review the overall condition of the country and shall, for advising the Federal and Provincial Governments, formulate financial, commercial, social and economic policies.’*

The NEC is expected to meet at least twice a year. The Council is responsible to the Parliament and must submit an annual report to each House of the Parliament.

The unfortunate reality is that it has not played the role of the supreme economic forum. For example, the decision on resumption or not of trade with India should have gone to the NEC. Also, despite the Constitutional requirement, an annual report has never been submitted by the NEC to the Parliament. Its role has largely been pre-empted by the Economic Committee of the Cabinet (ECC), which has no Provincial representation.

Council of Common Interests

The CCI has been constituted by Article 153 and consists of the Prime Minister, who will be the Chairman of the Council, the Chief Ministers and three members from the Federal Government to be nominated by the Prime Minister.

The Council shall

> *'Formulate and regulate policies in relation to matters in Part II of the Federal Legislative List and shall exercise supervision and control over related intuitions.'*

The CCI will have a permanent Secretariat and shall meet once in ninety days.

Important matters in the FLL-II include the following:

[1]	[5]
Railway	Supervision and Management of Public Debt
[2]	[6]
Oil and Gas	Census
[3]	[7]
Electricity	All Regulatory Authorities
[4]	[8]
National Planning	Inter-Provincial Matters

Clearly, any draft legislation on regulatory agencies like the SBP and NEPRA should have been cleared by the CCI before submission to the Parliament. Similarly, the Circular Debt Management Plan and the Triage Report on the SOEs should have been presented in the CCI. Unfortunately, the rare occasion when it met recently the issues related to the 2017 Census were not resolved. This should have been placed before the CCI at least a year ago.

There is a need for the Supreme Court to monitor implementation of Articles 153 and 156 related to the functioning of the CCI and the NEC.

Role of Standing Parliamentary Committees

Standing Committees have been constituted in both the National Assembly and in the Senate. These committees are effectively fora where policy issues should be initially discussed in detail and solutions proposed. Each Ministry has a relevant Committee which checks the performance of the Ministry and holds it accountable for its actions.

A strong and active committee system is an asset for any functioning democracy. It enhances accountability by making the policy and administrative functions of government more open and transparent. Committees ought to investigate public issues and bridge the gulf between people and the Parliament.

There are 34 Standing Committees in the National Assembly and 50 Committees in the Senate. From the viewpoint of economic governance, the Committees mentioned below can play important roles. It is essential that participation in the Committees from Government should be at the appropriate level. Proposed policies should be whetted by the Committees. For example, the Medium-term Budgetary Framework recently finalized by the Federal cabinet should have been placed first before the NA and Senate Finance Committees before presentation to the full Parliament, as per the requirement of the FRDL.

Economic Standing Committees	
National Assembly	Senate
• Commerce	• Poverty Alleviation & Social Safety
• Energy	• Power
• Finance & Revenue	• Finance, Revenue & Economic Affairs
• Economic Affairs	• Commerce
• Industries & Production	• Problems of Less Developed Areas
• Planning, Development & Special Initiatives	• Planning, Development & Special Initiatives
• Power	• Overseas Pakistanis & HRD
	• National Health Services
	• Devolution

There is a need for technical support to the members of committees on complex and specialized areas of policy. As such, the Pakistan Institute for Parliamentary Services (PIPS) must be adequately strengthened. The Pakistan Institute of Legislative Development and Transparency (PILDAT) should also be assigned a proper role.

2.4. Institutional Strengthening of Economic Ministries

There was a time when the Planning Commission was the premier economic institution at the Federal Level. This was the time when five-year plans and Perspective Plans were in vogue and policies were chosen within the framework of these Plans.

However, medium- and long- term plans stand largely abandoned in Pakistan. The modus operandi now is only Annual Plans containing the macroeconomic targets for the year. These plans should be results-based and focus primarily on policies, institutional changes and administrative actions that will impact on the economy during the year. Such a Plan should be placed before the NEC for approval. There should be six monthly monitoring of implementation and reporting back to the NEC.

This will require the elevation of the Planning Commission, first, as the permanent Secretariat of the NEC and the CCI. Second, it should play the role of the ultimate 'Policy Think Tank' of the Government, with the responsibility of supporting Ministries in the design of policies based on proper analysis of pros and cons of different options. The technical capacity of the Commission could be significantly enhanced by a stronger association with the Pakistan Institute of Development Economics (PIDE).

Similarly, other support agencies / parts of Ministries may be assigned a more active role in policy formulation and setting up of management information systems. This includes the strengthening of the Economic Adviser's Wing in the Ministry of Finance and the National Tariff Commission and Trade Development Authority (TDAP) attached to the Ministry of Commerce.

2.5. Implementation of Law on Conflict of Interest

There has been a growing concern about the likelihood of conflict of interest of Ministers, Advisors and Special Assistants to the Prime Minister. This has come in the public domain after the sugar, wheat flour and petrol crises.

Pakistan fortunately has a strong piece of legislation which was passed by the Parliament in 2016 and called the National Conflict of Interest Act. However, it appears that most of the provisions of the Act have not been implemented.

According to Section 3 of the Act, a Conflict of Interest and Ethics Commission should have been established with the following membership.

Membership	
Chairman	Member
• From Judge of the Supreme Court or any High Court	• A former Civil Servant of BPS-21 or above. • An Eminent Member of Civil Society.

However, this Commission has not yet been set up. This is a big violation of the Act and should be noted. Following the establishment of the Commission the Act clearly specifies how conflict of interest cases can be identified and dealt with.

Similarly, the Right to Information Act of 2017 envisaged the establishment of an Information Commission, with a Chief Information Commissioner and two Information Commissioners. This has also not happened.

2.6. A New Framework for Planning

The true spirit of the Federation is that the planning process must be 'bottom-up' and not 'top down' as has historically been the case. This will require the Provincial Governments to formulate their development strategy and fix their development priorities which should be reflected in their sectoral and project level allocations within their ADP for a particular year, based on the projected magnitude of fiscal transfers from the Federal Government.

The Federal Government should then undertake an aggregation exercise. The supporting role that the Federal Government can then play is by development of the required trunk infrastructure and filling gaps in the overall Provincial development portfolios. Thereafter, a consistent Macroeconomic Framework can be developed by the Planning Commission and become the basis for the Annual Plan to be approved by the NEC.

Also, Chapter 14 has identified the 'spreading too thin' of the PSDP. There are 1023 projects with a 'throw-forward' of costs of over Rs 7 trillion. This is over ten times the proposed development outlay in 2021-22. Inevitably, there will be big delays in completion of projects and large cost overruns.

The process of project preparation and implementation starts with the preparation of the PC-I, which is essentially cost-benefit analysis and submitted for approval to the CDWP or the ECNEC depending on the size. After completion of the project, a PC-V report is prepared on the project. This report should also be presented before the CDWP/ECNEC and an assessment made whether the benefits quantified in the PC-I are being fully realized or not. If not, then proposals should be presented on how any bottlenecks or constraints can be removed. Further, the annual PSDP document should contain a list of projects completed in the previous year.

2.7. Avoiding overoptimistic projections

Various agencies of the Federal Government, especially the Ministry of Finance, have been prone to make optimistic projections and set too ambitious targets. This is best illustrated by the divergence between estimates of the budget deficit for the forthcoming year and the actual outcome at the end of the year, as shown below.

Table 2.1: Size of the Budget Deficit			(% of GDP)
	Budget Deficit (Budgeted)	(Actual) Budget Deficit	Difference
2019-20	7.1	8.1	1.0
2018-19	4.9	8.9	4.0
2017-18	4.1	6.6	2.5
2016-17	3.8	5.8	2.0
2015-16	4.3	4.6	0.3

Source: *MOF, fiscal operations*

The year, 2018-19 witnessed an unprecedented divergence of 4 percent of the GDP between the targeted and the actual budget deficit. The consequence was an unplanned resort to massive domestic bank borrowing. It was budgeted at Rs 1 trillion in 2018-19 and turned out to be more than Rs 2.5 trillion. Consequently, the monetary expansion was 18 percent and this is one of the prime causes for the jump in the rate of inflation.

The problem with optimistic projections is that they create a false sense of complacency. Corrective action is delayed until it becomes almost too late and draconian steps have then to be taken to remedy at least partially the situation.

2.8. Improving the Economic Information System and Statistics

Formulation of appropriate policies and early identification of emerging crises hinge crucially on the development and operation of an adequate economic information system. Currently, there are major gaps in the statistical data base which need to be filled on a top priority basis. These gaps include the following:

a) ***Quarterly GDP series by sector:*** It is vital from the viewpoint of timely and responsive economic governance that the PBS should start preparing quarterly GDP series by sector. There is substantial seasonality in economic activities in Pakistan, linked partly to the crop seasons. India has had a quarterly GDP series for many years now. Examination of the Indian quarterly GDP series reveals that quarterly growth rates can vary significantly, sometimes by 3 to 5 percentage points. Therefore, preparation a of quarterly GDP time series will give an early picture of how the economy is performing.

b) ***Estimation of Provincial Gross Regional Products*:** Pakistan has devolved to the four Provincial Governments who enjoy considerable freedom in planning the development of their respective jurisdictions. Almost 57 percent of the public development spending is by the Provincial Governments today as compared to less than 30 percent two decades ago.

A fundamental prerequisite for effective regional planning is the knowledge of the size, composition by sector/expenditure and growth of the Provincial economy. Here again, India is ahead with state-wise GRP estimates since the 60s. in the context of

Pakistan a methodology for regional disaggregation of the national GDP has already been developed in the UNDP National Human Development Report of 2020. The PBS, along with the Provincial Bureaus of Statistics, must carry this process further and start preparing annual estimates of Provincial GRPs.

***c) Development of an SDG database*:** Pakistan has signed off on the targets and indicators of the SDGs. But an adequate information system does not exist for monitoring progress on different SDGs. Perhaps the biggest gap is the absence of up-to-date estimates of poverty incidence at the Provincial and district level in Pakistan. The last reliable set of estimates of multi-dimensional poverty date back to 2014-15. The data base on sample households of the Household Integrated Economic Survey (HIES) of 2018-19 should have already been used to generate more contemporary estimates of the incidence of poverty in Pakistan down to the district level.

***d) Delays in Economic Censuses*:** The last Economic Census of Establishments was undertaken as far back as 2005. Similarly, the Census of Large-Scale Manufacturing was completed fifteen years ago in 2005-06. The policy ought to have been to undertake such Censuses every ten years, that is, by 2015-16.

The value of these Censuses is substantial. They help in identifying changes in size distribution of units in different sectors and the implied changes in the tax bases. The Census of Large-Scale Manufacturing is vital from the viewpoint of determination of the input-output coefficients at the industry level. This will facilitate collection of the value added sales tax.

***e) Updating of the GDP series at constant prices*:** The conduct of the above Censuses will also facilitate changing the base year of the GDP series at constant prices. Currently, the base year is 2005-06. Earlier, it was 1999-2000. Attempts should be made by PBS to up-date the base year to 2015-16.

The above data gaps clearly highlight the big deficiencies in the economic information system in Pakistan. This has greatly handicapped the process of economic decision making in the country.

f) Improving Price Statistics: There have been observations recently on the need for improvement in the price statistics in the country as the economy approaches double-digit inflation. The following improvements are recommended:

i) For essential food items like wheat flour, sugar, pulses, vegetable ghee, etc., the format should be to show in one chart the rate of inflation at the wholesale and at the retail level. This will help in identifying at what point in the value chain there is a problem. As an example, this is shown below for the month of March 2021.

ii) The monthly publication, *Inflation Monitor*, of the SBP used to contain some useful analysis of inflationary trends. The rate of inflation in each major city/town of Pakistan was presented. However, this estimation was stopped recently. It should be resumed once again because of the big variation in the rate of inflation by location in the country.

There is a need at the end of this Section to highlight the tendency for manipulation of statistics on key economic indicators by different Economic Ministries to present a better picture of the economy than is really the case. The key indicators which are vulnerable to this manipulation are the GDP growth rate, rate of inflation and the unemployment rate.

March 2021 Wholesale and Retail Prices, Rate of Inflation

	Y to Y	M to M
Wheat Flour		
WPI	23.0	-0.1
CPI*	20.0	1.2
Sugar		
WPI	21.7	4.5
CPI	23.0	5.4

Faster MOM inflation in both items at the retail level.
Source: *PBS*

g) Autonomy of PBS: The time has come to make the PBS a truly autonomous institution with a fully operational Statistical Council, with more representation from civil society and academia. Also, the operational capacity of the Bureau needs to be substantially augmented. Hopefully, a better information system will mean better economic decision and policy making.

Chapter 3: Voice, Transparency and Accountability

The successful pursuit and conduct of economic administration and policy making hinges on the degree of responsiveness of different levels of Government and Ministries / Departments to concerns of the citizenry with regards to the role of negative factors which are affecting their daily quality of life and economic prospects. In this respect, the Government must be 'open' and in communication with elected representatives, both in the ruling party and in the opposition, and with civil society.

The issue of accountability is also related to the proper conduct of Government functions. Corruption can bias decisions and lead to misallocation of public resources and to the sacrifice of the larger public interest. Therefore, perceptions of corruption are also important not only in determining the confidence of the people in their Government but also in the motivation of foreign investors to invest in a particular country.

This Chapter is in two parts. The first part focuses more broadly on issues of voice transparency and accountability. The second part focuses more narrowly on the right to information and the type of improvements that could be implemented in the public budgetary process. Each part has its own set of recommendations.

3.1. Transparency and Accountability

Two international rankings indicate where Pakistan stands with respect to Voice, Transparency and Accountability. The first is the Voice and Accountability Index of the World Bank.

The World Bank indicator focuses on perceptions of the extent to which a country's citizens participate in selecting their government, as well as the freedom of expression, freedom of association and a free media.

The percentile rank of Pakistan is given below:

	Year	Number of Sources	Voice and Accountability Score*	Percentile Rank
Pakistan				
	2005	12	-0.98	20.67
	2014	12	-0.72	27.09
	2019	11	-0.84	23.15
**between -2.5 and +2.5*				
Source: *World Bank*				

The position of other South and East Asian countries is as follows in 2019:

Country	Percentile Rank	Country	Percentile Rank
Bangladesh	27.09	Thailand	24.14
India	57.64		
Nepal	40.39	Indonesia	52.71
Sri Lanka	43.84	Pakistan	23.15

Among the seven countries listed above, Pakistan is ranked last.

Turning to the Corruption Perceptions Index of Transparency International, Pakistan has a relatively low ranking here as well, as shown below. It is ranked 124th out of 180 Countries in 2020. However, there had been a big improvement from 146th in 2010 to 117th in 2015.

	Year	Score	Ranking
Pakistan			
	2010	23	146
	2015	30	117
	2019	32	120
	2020	31	124

The corresponding rankings of other selected countries in 2020 are given below. Out of the seven countries, Pakistan is in the sixth position here too, better than only Bangladesh.

Country	Ranking	Country	Ranking
India	86	Indonesia	102
Sri Lanka	94	Vietnam	104
Nepal	117	Thailand	104
Bangladesh	146	Pakistan	120

The problem with the low ranking of Pakistan in the Corruption Perception Index is that it plays a big role in discouraging foreign direct investment into Pakistan.

3.2. The National Accountability Bureau

The National Accountability Bureau was established by the National Accountability Ordinance of 1999. This Ordinance has since been modified somewhat in 2010.

The objective of this Ordinance is as follows:

> '*To provide for the setting up of a National Accountability Bureau so as to eradicate corruption and corruption practices and to hold accountable all those persons accused of such practices and other matters.*'

Six categories of 'holder of public office' have been identified with coverage of federal, provincial, and local elected representatives and officials. The attached departments and autonomous bodies also fall within the ambit of this Ordinance.

A person shall be appointed as Chairman, NAB, who is a retired Chief Justice or Judge of the Supreme Court, Chief Justice of a High Court, or a retired officer of the Armed Forces equivalent to the rank of Lieutenant General or is a retired Federal Government Officer in BPS 22. 12 types of corruption practices have been identified. Cases will be tried in the Accountability Courts and shall be disposed of within thirty days.

The Chairman shall have the power at any stage of the inquiry or investigation to direct that the accused be arrested. Prior to authorization or investigation against a person, he may come forward with a plea bargain and return the assets or gains acquired during the offense.

Since its inception, 457,668 complaints have been received out of which 405,212 have been disposed of. Right now, 1247 references are under trial in different courts. The Bureau has recovered Rs 363 billion directly or indirectly. Recommendations on the accountability process are as follows;

Need to Investigate why the Level of Perception of Corruption has increased**:** Pakistan's ranking in the Corruption Perception Index has worsened by seven places since 2017. This has happened despite the induction of a Government with strong commitment to reducing corruption in the country. Also, NAB has been visibly more active in recent years.

Case for Greater Press Freedom**:** The 2021 World Press Freedom Index places Pakistan at the 145th position out of 180 countries, below Nepal at 106th, Indonesia at 113th, Sri Lanka at 127th, Thailand at 137th and India at 142nd. Fortunately, Pakistan has a higher ranking than Bangladesh and Vietnam. There is a need for PEMRA to establish a body to hear the complaints of TV stations, anchor persons and journals about threats if information is released in the media.

Setting up of a Specialized TV Channel for Economic News and Debates: Pakistan has 90 TV channels today. The time has come for a channel to be introduced focusing on detailed economic news and debates on ongoing economic and social issues by well-informed economists, representatives of the private sector and civil society. It could also sometimes impart basic knowledge on economics to students and others.

Perception of Draconian Powers and Biased Selection of Cases by NAB needs to be removed: There is a strong perception that NAP is being used more for targeting politicians belonging to opposition parties. The power to arrest has been used indiscriminately without careful examination of the merits of a case.

The economy has also been affected adversely by the growing unwillingness of senior Government officials to take financial decisions or sign on to agreements or contracts. The time has come for NAB to work towards improving its image. There is a need for amendments in the NAB Ordinance to remove the draconian provisions.

3.3. Right to Information

The Constitution recognizes the right to information in Article 19A as follows:

> '*Every citizen shall have the right to have access to information in all matters of public importance subject to regulation and reasonable restrictions imposed by the laws* '

A Right to Information Act was passed by the Parliament in 2010. A new version of the Act was promulgated in 2019.

The Center for Law and Democracy has developed a system of Global Right to Information Rating. This is one of the few international rankings in which Pakistan performs well, with the 33rd position out of 123 countries in 2018. However, India is ranked 6th; Bangladesh, 29th and Sri Lanka, 4th.

The performance of Pakistan is different aspects of the right to information are as follows according to an earlier rating:

	Maximum Score	Pakistan's Score		Maximum Score	Pakistan's Score
1. Right of Access	6	4	5. Appeals	30	19
2. Scope	30	22	6. Sanctions & Protections	30	5
3. Requisition Procedure	30	7	7. Promotion Measures		3
4. Exceptions and Refusals	30	10	**TOTAL**	**150**	**70**

Therefore, there is a need for improvement in the requesting procedure, exceptions and refusals, sanctions and protections and promotion measures.

According to the Act, the 'Public Record' should be made available on acquisition and disposal of property; information on grant of approvals, licenses, and allotments; appointments and promotions.

The Act also specifies in Section 7 the types of exclusion from public access. These include matters relating to national security, record of accounts of customers of banks and financial institutions and record related to the personal privacy of any individual. Each 'public body' will designate an individual for providing information.

An important provision in the law is the establishment of an Information Commission, with three Information Commissioners. The primary function of the Information Commission shall be to receive and decide on appeals under Section 17. However, the Information Commission has not been set up by the Federal Government.

The Khyber-Pakhtunkhwa Government took the lead in 2013 in promulgating its own version of the Right to Information Act. It has 33 sections and is more operational in nature. A Provincial Information Commission has been established with a services portal for citizens.

3.4. Improving the Budgetary Process

The following improvements are proposed:

i) The Government budgeting system and the classification system of expenditure are complex. A budget manual should be made available which distinguishes, for example, between 'current expenditure on capital account' and 'development expenditure on revenue account'.

ii) The latest annual financial report of each State-owned Enterprise must be put on the website of the Ministry of Finance.

iii) The annual financial reports of DISCOs, NTDC and other power sector agencies must also be put on the website of NEPRA.

iv) The PRSP Progress Report has been delayed for 2019-20. It should be put on the website of the Federal Ministry of Finance.

v) Along with the Budget Documents, there should be an Annual Report on 'Revenue Foregone due to Tax Concessions and Exemptions'. This is the practice in India.

vi) The 'Medium-Term Budgetary Framework' should be included in the Budget-in-Brief at the time of presentation of the Federal Budget in the National Assembly. This was missing in the latest budget documents for 2021-22.

vii) All SROs (Statutory Regulatory Orders) prepared by FBR must first be whetted by the Finance Committee of the National Assembly prior to notification.

viii) The AGPR and the Public Accounts Committee of the National Assembly must increase their technical capacity to prepare more timely reviews and report to the National Assembly.

ix) Charged expenditure provisions are not voted upon by the National Assembly. However, there should be a ceiling on the annual growth in expenditure linked to the rate of inflation.

x) Practice of MNA/MPA/Senators Development Funds must cease. Allocations within these funds remain outside the public domain.

xi) The NAB must be required to submit an Annual Report to the National Assembly. The new Accountability Law must be finalized and presented.

xii) Supplementary Grants showing a growth of over 15 percent over the original allocation must be submitted to the National Assembly for fast-track approval,

xiii) Borrowing powers of Provincial Governments should continue to be restricted unless approval is obtained from the NEC.

The above proposals will greatly improve the transparency and efficacy of the budgetary process in the country.

Chapter 4: Strengthening Regulatory Agencies

The role of regulatory agencies in different areas of the national economy is vital in ensuring the larger interests of the people and preventing powerful special vested interests from taking advantage of missing or defective provisions in the laws or processes in the country.

4.1. Regulatory Agencies in Pakistan and Performance

The major regulatory agencies in Pakistan are identified in Chart 4.1 along with the laws which define their role and the regulatory process.

Chart 4.1: Major Regulatory Agencies in Pakistan

Agency	Act
• State Bank of Pakistan (SBP)	SBP Act, 1956
• Competition Commission of Pakistan (CCP)	Competition Act, 2010
• Securities and Exchange Commission of Pakistan (SECP)	SECP Act, 1997
• Oil and Gas Regulatory Authority (OGRA)	OGRA Ordinance, 2002
• National Electric Power Regulatory Authority (NEPRA)	Regulation of Generation, Transmission and Distribution of Electric Power Act, 1997
• Pakistan Standards and Quality Control Authority (PSQCA)	PSQCA Act, 1996
• Pakistan Electronic Media Regulatory Authority (PEMRA)	PEMRA (Amendment) Act, 2007
• Drug Regulatory Authority of Pakistan (DRA)	DRA Act, 2012
• Civil Aviation Authority (CAA)	Carriage by Air Act, 2012

Source: *List of Laws in Pakistan*

4.2. Pakistan's International Ranking

The World Justice project has ranked 128 countries in terms of their performance in regulatory functions in terms of the following:

- Government regulations are effectively enforced.
- Administrative proceedings are conducted without unreasonable delay.

- Due process is respected in administrative proceedings.
- The Government does not expropriate without lawful process and adequate compensation.

The performance of Pakistan is relatively poor. It is given an overall low score in Regulatory Enforcement of 0.39 out of a maximum of 1 and ranked 115th out of 128 countries. The specific ranking and score in each aspect of regulation is given below in Chart 4.2.

It may be noted that while the scores are generally low, the rating in the respect for due processes is exceptionally low. Therefore, there is a particular need to ensure that the regulatory function is performed in an objective, systematic and transparent manner.

Chart 4.2: Pakistan's Score in Different Regulatory Functions

• Effective Regulatory Enforcement	0.41
• No Improper Influence	0.49
• No Unreasonable Delay	0.38
• Respect for Due Process	0.18
• No Expropriation Without Due Compensation	0.51 Minimum = 0 Maximum = 1

4.3. Annual Reports of Regulatory Agencies

Each regulatory agency is expected to prepare an Annual Report highlighting its performance in discharging the functions attached to it. There is the problem currently that the Annual Reports are not formally submitted to the Council of Common Interests (CCI), which has been given the task of monitoring and guiding the overall performance of the regulatory function in the country under Article 153 of the Constitution.

A summary and an assessment are made below of the latest Annual Reports for 2020 by four out of the nine regulatory agencies. These four agencies are rated as performing more important functions.

State Bank of Pakistan (SBP)

The Annual Report of 2020 highlights the substantial role played by the Central Bank through special financing packages to counter the large negative effects of COVID-19. There is a need to recognize these extraordinary efforts of the SBP. By now, almost Rs 2300 billion has been routed through the various financing packages. The SBP also highlights the massive cut in the policy rate from 13.25 percent to 7 percent after COVID-19.

The report mentions efforts at building econometric models for forecasting, launching of perception surveys, ending the process of debt monetization and the effective resort to a market-based exchange rate. Other steps undertaken include facilitating flow of home remittances, improving ease of doing business and implementing the FATF Action Plan.

However, there are areas where regulatory action has been pending for a long time, including the following:

i) ***Achieving a more balanced sectoral distribution of bank credit*****:** Agriculture has not been given the due priority in access to bank advances. It was 26 percent in 1990. However, following the denationalization of banks the share has been declining rapidly and is now down to only 6 percent. The time has come for preparation of an Annual Credit Plan with sectoral distribution of loan targets. Commercial banks who do not adhere to these targets should be penalized with a higher rate of corporate income tax.

ii) ***Pre-emption of Credit by Government Guaranteed Debt*****:** The State-Owned Enterprises (SOEs) have increasingly been able to obtain more credit through Government guarantees. Between 2010 and 2019 the debt of the SOEs has increased by as much as 22 percent annually and now accounts for over 15 percent of total bank advances. This has created a 'moral hazard' problem. SOEs have less incentive to improve the efficiency of their operations given readymade access to borrowing. The result is that contingent liabilities of the Federal Government are now almost Rs 1.8 trillion. Also, SOEs are beginning to effectively 'crowd out' the share in advances of private businesses which has fallen from 70 percent to below 60 percent. Therefore, the Credit Plan annually should prescribe a limit to the growth in advances in the form of guaranteed debt.

iii) ***Ignoring the Small Borrower*****:** It is truly a sad reflection that the small borrowers are ignored in Pakistan. SMEs who are playing a major role in exports and employment have access to only 6 percent of bank advances. Personal loans, including those for housing, have an even smaller share. The irony is that small depositors and savers contribute to over 40 percent of the deposits. A major announcement has been made in the Federal budget to increase substantially the access to credit of small borrowers, small farmers, and low-cost housing. There will be need to monitor the success of this initiative.

iv) ***Broadening Access to Financial Services*****:** The SBP must attach much higher priority also to broadening access to financial services. The number of bank branches in the country needs to be increased, especially in the rural areas. Further, there should be greater impetus for digitalization of bank transactions and expansion of credit to less developed areas.

v) ***Controlling the Over-reliance on Domestic Bank Borrowing*****:** The SBP has generally shown little concern on the excessive reliance of the Federal Ministry of Finance on domestic bank borrowing to finance the budget deficit. For example, in a normal year like 2018-19, the level of bank borrowing was 240 percent of the budgeted level. This led to runaway monetary expansion with M2 increasing by 18 percent. This was one of the major factors responsible for the double-digit inflation during the year.

Competition Commission of Pakistan (CCP)

The Competitive Commission of Pakistan Act of 2010 has the following stated objective:

> '*An Act to provide for free competition in all spheres of commercial and economic activity to enhance economic efficiency and to protect consumers from anti-competitive behavior*'

The market position of an undertaking, according to the Act, shall be presumed to be dominant if its share of the relevant market exceeds 40 percent. Also, malpractices are defined as those which prevent or restrict or distort competition in a market.

The latest Annual Report of the CCP is for 2018. This is a demonstration of the somewhat low-key role of this Commission. The report reviews the ten years of the CCP. The first area where action has been taken over the decade is 'Abuse of Dominant Position'. Such behavior has been identified in the aviation industry, stock market, steel, fertilizer and real estate. Total penalties imposed were Rs 8.7 billion.

The second area relates to the halting of anti-competitive agreements relating to cartelization. 141 orders have been issued by the CCP over the ten years. Rs 17 billion of penalties have been imposed on banks, telecom, power, textile industry and cement. Other areas include elimination of deceptive practices, approvals for mergers and acquisitions and exemptions. In addition to the sectors already mentioned this has involved action by CCP in sectors like petroleum, pharmaceuticals, oil and gas, automobiles and FMCGs.

The 10 years Annual Report clearly indicates that many of the activities outside the agricultural sector are vulnerable to anti-competitive practices of different types. There are, however, also other unresolved issues as follows:

Coverage of Natural Monopolies: Many of the SOEs operate effectively as natural monopolies. Perhaps the best example is power and gas distribution. The CCP must also have the mandate to look at the performance, especially in terms of pricing behavior of natural state monopolies.

Controlling Practices which confer higher Profits and raise Prices: The view taken of competition is essentially behavior only of domestic players. The focus should also be on competition from imports. The issue is the level of tariff protection and other mechanisms for limiting imports.

A prime example is the automobile sector. Higher import duties have led to high prices and exceptionally high profits of automobile manufacturers rather than to higher tax revenues. Other forms of malpractices like transfer pricing by MNCs and under invoicing of imports are pervasive in the country. Investigation of these malpractices must also come under the purview of the CCP.

Securities and Exchange Commission of Pakistan (SECP)

The SECP was established as per the Act of 1997 for the beneficial regulation of the capital markets and superintendence and control of corporate entities. The SECP states in its Vision Statement that it works towards a modern and efficient corporate sector and capital market, based on sound regulatory principles, that provide impetus for high economic growth and faster social harmony in the country.

According to the Annual Report of 2020, SECP was able to simplify the IPO regulations, introduce categorization of brokers, revamp margin of finance product and introduce a '*Sahulut Account*' for risk investors. Also, fees for mutual funds and insurance companies have been reduced. Importance has also been attached to the process of digitization. SECP was also represented in the Sugar Enquiry Commission. However, the stock market crashed by almost 45 percent after COVID-19, but has since recovered.

There are issues related to the value of market capitalization of the stock market of Pakistan. First, it is small in relation to the GDP as compared to other countries at a similar stage of development. This ratio is currently 17 percent in Pakistan as compared to 78 percent in India, 19 percent in Sri Lanka and 31 percent in Bangladesh. Consequently, it has played a limited role in the mobilization of funds for investment in the country. Even prior to COVID-19 only two IPOs were floated in the market in 2018-19.

Second, the 530 companies listed in the stock market have a paid-up capital of Rs 1391 billion, which is only 24 percent of the value of fixed assets This indicates that private investment in the country is financed more by debt from the banking system and through retained earnings rather than through flotation of equity. SECP must find ways to broaden the capital market. There are also some allegations of '*insider trading*'.

The Income Tax Ordinance provides an incentive to buyers of new shares in the market in the form of a tax credit. However, there is also a need for encouraging flotation of IPOs by new corporate entities. One proposal is for dividends paid to be exempt from income tax for the first five years after the IPO.

National Electric Power Regulatory Authority (NEPRA)

NEPRA is the regulator of the power sector, which is at the epicenter of the structural problems faced by the economy today. The stated objective of NEPRA is to develop and pursue a regulatory framework for safe, reliable, affordable, and market-driven environment for provision of electric power to consumers in Pakistan.

The Annual Report contains the usual details of the number of new licenses granted, complaints received and how handled, internal organization developments and events held. However, the main in-depth report is the report on the State of the Industry (SOI), which has been issued for 2020.

The SOE reports clearly highlights the structural and policy issues in the power sector including the high cost of electricity, large and growing circular debt of Rs 2.3 trillion, wrong utilization policy of generation plants and non-observance of the merit-order of plants, sub-optimal distribution of cheap and more efficient fuel, over taxation of fuel and power, transmission constraints, load shedding policy of distribution companies, higher transmission and billing losses, delays in payment of subsidies, lack of market reforms and wheeling and so on and on.

The SOEs is truly a chronicle of failure of NEPRA to make the power sector work properly to the benefit of the over 33 million electricity consumers in the country. There are apparently three major reasons for this failure. First, the ability of NEPRA has been greatly limited and frustrated by an interfering and recalcitrant Ministry of Power. Second, there have been serious conflict of interest issues with the leadership in the Ministry and elsewhere in the senior echelons of Government.

Third, NEPRA has been unable to reconcile competing vested interests like the IPPs and the NTDC. Fourth, the technical and policy related issues have sometimes been beyond the capacity of NEPRA. Fifth, and perhaps the most difficult problem is the lock-in effect of the pricing formula in the 1994 Power Policy guaranteeing a minimum rate of return to IPPs in the form of capacity charges.

There is now pressure from the IMF as part of the on-going EFF for big increases in power tariffs to ensure that the outstanding stock of circular debt does not increase. The contradiction in this policy is that after a long time Pakistan has almost 20 percent excess capacity for power generation. Surely, this should have been the time when a policy of reduction in tariffs was implemented to spread the fixed costs over a larger output and sales.

There is a need for quantification of price elasticities of demand for electricity in Pakistan to determine the appropriate policy. Time series estimation has been rendered difficult by the intervening period of load shedding. However, most studies in countries like Pakistan reveal that the price elasticities are in the following ranges:

Type of Consumers	Elasticity
Agriculture	-1.1 to -0.9
Domestic	-0.8 to -0.6
Industrial	-0.2 to- 0.4

In the case of agriculture, enhancement in tariff will lead to an almost proportionate loss in quantity demanded. Consequently, there will be little increase in revenues and the agricultural sector will suffer a significant loss of output. Similarly, the rise in tariffs will have both direct and indirect effects on domestic consumer demand and not lead to major gains in revenues.

The policy on industrial tariffs is of fundamental importance. A rise in tariffs would lead to some reduction in output. This in turn will reduce revenues from the manufacturing sector which contributes to 70 percent of FBR revenues. In net terms the overall revenues from the sector will decline.

Therefore, NEPRA should be pushing for lower electricity tariffs especially in the industrial sector which will contribute to faster growth and lower inflation. This will justify the big expansion in capacity in the last five years for electricity generation.

4.4. Strengthening Regulation

- **Regulatory Agencies should be more autonomous and stronger**: For example, the SBP should be able to set limits on domestic bank borrowing by the Government. However, it should aim for the inflation target set by the NEC.

  Other regulatory agencies should be distanced more from concerned Ministries. This must be the case especially with NEPRA and OGRA.

  The CCP should be endowed with stronger legal powers. An up-to-date information system should be set up to quickly detect violations of a competitive market. CCP should also examine the pricing policy of SOEs which are natural monopolies.

- **Appointment of Members of Boards**: should not be by Ministries but by a confirmation process in a Select Committee of the Senate of Pakistan. Serving civil servants should not be members of Regulatory Boards.

- **Annual Reports:** of all Federal Regulatory Agencies must be presented in the CCI, which in turn should present a report to the Parliament. CCI meetings must be held on a quarterly basis as highlighted elsewhere.

- **Provincial representatives**: All Boards of Regulatory Agencies must have representation from each Province.

- ***Improvement in the image of NAB:*** As highlighted above there is a strong perception of a biased role. This perception must change. The amended NAB act should also be placed before the National Assembly.

The performance of Provincial and local regulatory agencies also needs to be substantially improved, especially in the areas of environment protection, land and building regulations and operation of wholesale and retail markets of essential food items.

Chapter 5: Facilitating Ease of Doing Business

One of the key factors in influencing the effective functioning of markets, especially of fast-moving consumer goods, is that firms operating on the supply side and consumers on the demand side face low transaction costs.

The World Bank has tried to establish a relationship between the magnitude of the cost of these transactions with measures of ease of doing business. A comprehensive Easy of Doing Business Index has been developed for 190 countries. There are other factors also that have affected the operations of markets and production processes in the Pakistani setting. They are identified in this Chapter.

5.1. Pakistan's Ranking in the Ease of Doing Business Index

The country rankings for 2020 have been released along with rankings in specific transactions. Pakistan's rankings in 2015 and 2020 respectively are shown in Table 5.1.

Table 5.1: Pakistan's Ranking in Ease of Doing Business Index

	Pakistan 2015	Pakistan 2020	India 2020	Bangladesh 2020
Overall	128	108	63	168
Dealing with Construction Permits	125	112	27	135
Enforcing Contracts	161	156	163	189
Getting Credit	131	119	25	119
Getting Electricity	146	123	22	176
Paying Taxes	172	161	115	151
Protecting Minority Investors	21	28	13	72
Registering Property	114	151	154	184
Resolving Insolvency	28	58	52	154
Starting a Business	116	72	136	131
Trading Across Borders	108	111	68	176

The good news is that Pakistan has significantly improved its ranking from 128th in 2015 to 108th in 2020. Now Pakistan is ahead of Bangladesh with a low ranking of 168th, but behind India, which is 63rd out of the 190 countries.

Pakistan has enhanced its ranking in six out of the ten indicators of ease of doing business. However, it has slipped in four indicators, indicated below:

	Ranking	
	From	To
• Protecting Minority Investors	21	28
• Registering Property	114	151
• Resolving Insolvency	28	58
• Trading across Borders	108	111

Despite the fall, Pakistan still has a relatively high ranking in protecting minority investors and resolving insolvency. The big fall is in registering property and some fall in trading across borders.

Two areas where there is an improvement, but the rankings remain low are as follows:

	Latest Ranking
• Enforcing Contracts	156
• Paying Taxes	161

Paying taxes is one of the most frequent transactions of companies and other entities. The basic problem is the large number of taxes and other levies by the Federal, Provincial, and local Governments.

The Board of Investment is reporting regularly on steps being taken to facilitate business operations in the country. This is an appropriate step as foreign investors are likely to focus on a country's ranking in ease of doing business.

There are some important areas of business operations and transactions that are more country-specific in character and have not been included in the World Bank's index.

5.2. Companies acting as Withholding Tax Agents

Both financial and non-financial companies act as withholding tax agents with deductions at the source on many transactions. These include the following:

Withholding Taxes Collected by Companies

Section	Description
149	Tax on Salary Income
150	Dividend Payments
150A	Return on Investment in Sukuk
151(1)(b)	Interest income and bank transactions
152	Payment to Non-Residents
153	Sale of FMCG, Services and payment for Execution of Contracts, Royalty, etc.
231	Cash Withdrawal, Sale of Motor Vehicles
235	Electricity Bills
236	Telephone Bills

Source: *FBR*

Collections on the above heads constitute over 50 percent of the total revenue from the Federal income tax. Frequently, the number of transactions runs into the thousands.

Consequently, many of the companies keep almost fully dedicated staff for collecting the withholding tax on the transactions and remitting the amount collected to the FBR.

There are two solutions to this big problem. First, the scope for reducing the number of withholding taxes should be examined. Second, in view of the costs incurred by the withholding tax agents and the saving thereby to FBR, a system may be set for payment against the costs of collection. The first proposal is examined in Chapter 5.

The cost of running the Federal Board of Revenue was Rs 27.7 billion in 2019-20. This is equivalent to 0.7 percent of total revenues. The 7th National Finance Commission has allowed the Federal Government to deduct 1 percent of the revenues in the divisible pool of FBR taxes as the cost of collecting revenues.

Therefore, FBR is saving 0.3 percent of the revenue due to the delegation of tax collection of many withholding taxes to companies. A logical recommendation is that a withholding tax agent should be compensated to the extent of 0.3 percent of the tax collection. This should help in the recovery of the costs incurred in performing the function of a withholding tax agent. The total amount of compensation would be in the range of Rs 3 to 4 billion. It would also provide an incentive for companies to act as more effective withholding tax agents.

5.3. Liquidity Impact of delayed Tax Refunds

The business operations of exporting units have been adversely affected by the delayed refunding of sales tax and import duty on inputs in the 'zero rating' regime. This has significantly impacted the liquidity position and constrained production for exports.

The fluctuation in the magnitude of tax refunds year-to-year is given in Table 5.2. The refunds have been as low as 1 percent to 2 percent of exports in some years. FBR has used them as a way of coming closer to achieving the revenue targets for a particular year. Currently, almost Rs 200 billion of refunds are held up despite the setting up of the FASTER system. However, the payment against claims for recent refunds has improved.

The proposal, which is presented in the Chapter on Promoting Exports, is that the refund should automatically be paid at the time of export receipt by the banking system at predetermined rates by export item to the exporters.

Table 5.2: Refunds of Sales Tax			(Rs in Billion)
	Value of Manufactured* Exports	Sales Tax Refund	Refund as % of Exports
2019-20	2138	93	4.3
2018-19	1802	21	1.2
2017-18	1429	71	5.0
2016-17	1299	26	2.0

**Textiles, Sports Goods, Leather Manufactures, etc.*

5.4. Ending Taxation on Movement of Goods

The Government of Sindh has levied a so-called Infrastructure fee on entry into or exit from the Province of goods. This is increasing the costs of exporting and importing to production and marketing entities in the rest of Pakistan.

This fee can be interpreted as a violation of the spirit of the Federation which implies unrestricted and free movement of goods among Federating Units. This matter should be taken up by the Council of Common Interests and resolved.

Other proposals for greater ease of doing business are as follows:

The process of enforcement of contracts: can be managed better through the establishment of formally recognized fora for purposes of acting as an Alternate Dispute Resolution Mechanism within the legal system. A maximum time may be specified for resolution of the issue related to enforcing of a contract.

Quicker Access to electricity: Prior to 2015-16 there was a severe shortage of electricity generation capacity and high levels of power load shedding. Now there is large excess capacity and new consumers should be welcomed. A digital application system should be put in place by the DISCOs.

Paying Taxes should be simplified: Efforts are being made to reduce the number of returns to be filed. It would be a big breakthrough if the same return is used for paying the sales tax on goods and services. This will not only help in reducing compliance costs but would also enable detection of more tax evasion. Further, the payment of advance income tax by small private companies and AOP may be shifted from monthly to quarterly filing. Also, tax and non-tax payments should be digitized.

Problems of Access to other Infrastructure: Today many of the industrial estates are in a rundown condition, especially in the economic hub of Karachi. Roads are broken and water supply and availability of gas are limited. This has contributed to raising costs of operations of industrial units.

Reimbursement of costs of Withholding tax agents in tax collection: This proposal has been described above.

Improvement in the System of Sales Tax Refunds to Exporters: This proposal has also been described above.

Non levy on Inter-Provincial movement of goods: This infrastructure fee levied by the Government of Sindh should be withdrawn.

5.5. Developing the Digital Economy

A revolutionary change in the conduct of business and other transactions lies in facilitating the growth of the digital economy and achieving inclusive digitalization. There are five priorities if Pakistan is to strengthen the transition to a digital economy.

The first priority is to develop and increase the availability of affordable high-speed internet. The latest estimates of the spread of information and communications technology (ICT) is by the PSLM Survey of 2019-20 undertaken by the PBS. The estimates of coverage are given in Table 5.3.

Table 5.3: Household Ownership of Computer, Mobile Phone and Internet

	Computer (%)	Mobile Phone (%)	Internet (%)
Punjab	13	94	34
Sindh	10	91	32
Khyber-Pakhtunkhwa	12	95	33
Balochistan	6	92	21
Pakistan	12	93	33

Source: *PSLM Survey, 2019-20, PBS*

While the majority of households own one or more mobile phones, the ownership of computer is very limited at 12 percent and the access to internet is only 33 percent. A transition will also have to be made from mobile broadband, such as using smart phones, to fixed broadband needed for data-intensive applications.

The second priority is expanding the use of digital payments. The World Bank Global Finder data shows that only 10 percent of financial account holders in Pakistan access their accounts using mobile phone or internet. Government agencies can help by using digital payments in their interaction with citizens and businesses, such as payment of taxes and charges for services and transfer of pensions.

The third priority is reducing barriers to e-commerce. The major constraint currently is that making products reach their destinations is expensive and unreliable. Also, e-commerce shipments face unpredictable customs procedures.

The fourth area is to promote trust in digital transactions. This requires steps from data privacy to cyber security to consumer protection. There will be a need for a comprehensive data protection law.

The fifth priority is for the Federal and Provincial Governments to lead by example and become digital themselves. This requires the setting-up of digital services platforms that support businesses and reduce transaction times and costs. Applications could include online licensing, approval of performance of specific functions following competitive bids, land sales transactions based on computerized land records, payment of taxes, etc.

The benefit of digital transactions is not only greater ease in doing business, but the absence of human contact will minimize the likelihood of the seeking of bribes and their payment. This will greatly reduce the level of corruption in the country.

PART-III

STRENGTHENING THE FEDERATION

Chapter 6:

Implementing the 18^{th} Amendment

The passage of the 18^{th} Amendment by the National Assembly in 2010 is a major milestone in the history of Constitution making in Pakistan. The primary objective of the 18^{th} Amendment was the strengthening of the Federation by the devolution of more functions and fiscal powers to sub-national levels of Government. Bringing the provision of services closer to the people was likely to increase accountability and link tax payments more closely to services received. This was likely to be a big step towards achieving greater **'Unity in Diversity'** in the country.

6.1. Design of the 18^{th} Amendment

Chart 6.1: The Federal Legislative List-II

S. No.	FLL-II List
1.	Railway
2.	Mineral oil and natural gas declared the Federal law to be dangerously inflammable
3.	Major ports, delimitation and constitution and power of port authorities therein
4.	Development of Industries
5.	Electricity
6.	All Regulatory authorities established under a Federal law
7.	National planning and national economic coordination including coordination of scientific and technical research
8.	Supervision and management of public debt
9.	Census
10.	Extension of Police force jurisdiction to another province
11.	Legal, medical, and other professions
12.	Standards in institutions for higher education and research, scientific and technical institutions
13.	Inter-Provincial matters and coordination

One of the key areas of focus in the 18^{th} Amendment to the Constitution was on the Federal List of functions in the Federal Legislative List-I and the Concurrent List. In the latter list there was joint responsibility of both the Federal and Provincial Governments. The Concurrent List was withdrawn and replaced by the Federal Legislative List with much fewer functions. Consequently, the excluded functions were transferred to the Provincial Governments. Functions not mentioned in either Federal Legislative Lists automatically have become the responsibilities of sub-national Governments.

The list of functions in the FLL-II is given in Chart 6.1. A comparison is made with the original Concurrent list in Chart 6.2. The functions which are in both lists are the joint responsibility of both the Federal and Provincial Governments. They include the railway, ports, higher education, regulation of various professions, and inter-Provincial matters and coordination.

The functions which were in the Concurrent list but not in FLL-2 include laws and administration of justice, health, environmental pollution and ecology, population planning, social welfare, labor-related issues, lower levels of education, Islamic education, film censorship and collection of fees. Therefore, many key functions stand devolved to Provincial Governments.

Chart 6.2: Areas of Coverage of the Old Concurrent List and the New Federal Legislative List-II

Common Functions	Functions only in the Concurrent List	Functions only in the FLL-II
[A]	[B]	[C]
• Electricity	• Laws and	• Railway
• Transportation (Ports)	• Administration of Justice	• Development of Industries
• Higher Education	• Health	• Regulatory Agencies established under a Federal Law
• Regulation of Professions	• Environmental Pollution and Ecology	• National Planning and National Economic Coordination
• Extension of Police Force to other Provinces	• Population Planning	
• Inter-Provincial Matters and Coordination	• Social Welfare	
	• Labor-Related Issues	
	• Lower Levels of Education	
	• Islamic Education, Zakat	
	• Film Censorship	
	• Collection of Fees	

[A] Contamination of Functions by Coordination between Federal and Provincial Governments

[B] Functions now fully delegated to the Provinces

[C] New Functions for Coordination between Federal and Provincial Governments

Some new functions were added to FLL-2 which were not in the Concurrent list. These include railway, development of industries, management of regulatory agencies under a Federal law and national planning and national economic coordination.

A major step forward was the recognition of local bodies as a legitimate third tier of Government in the form of Local Governments. Article 140A was inserted which states:

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(1) Each Province shall, by law, establish a local government system and devolve political, administrative, and financial responsibilities and authority to the elected representatives of the local governments.

(2) Elections to the local government shall be held by the Election Commission of Pakistan

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The fiscal powers of the Federal Government, as stated in FLL-I, include the following:

- Duties of customs including export duties
- Duties of excise, including duties on salt, but not on alcoholic liquors, opium, and other narcotics
- Taxes on income other than agricultural income
- Taxes on corporations
- Taxes on the sales and purchases of goods imported, exported, produced, manufactured, or consumed except the sales tax on services
- Taxes on the capital value of assets, not including taxes on immoveable property
- Taxes on mineral oil, natural gas and minerals for use in generation of nuclear energy
- Taxes and duties on the production capacity of any plant, machinery, undertaking, establishment, or installation
- Terminal taxes on goods or passengers carried by railway, sea or air, taxes on their fares and freight.

Article 160 describes of the functions and composition of the National Finance Commission and the list of shared taxes. Sub-Article 3(A) states that

> *‘**The share of Provinces in each Award of the NFC shall not be less than the share given to the Provinces in the previous Award”**.*

Two Constitutional bodies are included. The first is the Council of Common Interests (CCI) and the National Economic Council (NEC). Their composition and role have been described in the previous chapter.

6.2. Status of Implementation

A decade has already elapsed since the enactment of the 18th Amendment. This is the appropriate time for review of implementation of the various provisions in the Amendment.

First, given the devolution of functions, has the Federal Government contracted in terms of the number of Divisions? Prior to the Amendment, there were 50 Divisions. By 2011-12, the number had come down to 32. Many of the Divisions performing Social Welfare and other functions like Labor and Manpower, Livestock and Dairy Development, Local Government and Rural Development, Minorities, Population Welfare and so on were closed down.

There has, however, been a 'Division Creep' in subsequent years. There are now 40 Divisions. A list of these Divisions is given in Chart 6.3.

Chart 6.3: Ministries / Divisions[1] of the Federal Government

[33 MINISTRIES; 40 DIVISONS]

- Aviation*
- Cabinet*
- Establishment Division*
- National Security Division*
- Poverty Alleviation and Social Safety*
- Climate Change
- Commerce
- Communications
- Defense
- Defense Production
- Economic Affairs
- Power**
- Petroleum**
- Federal Education and Professional Training***
- National Heritage and Culture***
- Finance****
- Revenue****
- Foreign Affairs
- Housing and Works
- Human Rights
- Industries and Production
- Information and Broadcasting
- Information Technology and Telecommunication
- Interior
- Inter-Provincial Coordination
- Kashmir and Gilgit Baltistan
- Law and Justice
- Maritime Affairs
- Narcotics Control
- National Food Security
- Overseas Pakistan and HRD
- Parliamentary Affairs
- Planning, Development & Special Initiatives
- Privatization
- Railway
- Religious Affairs and Inter-Faith Harmony
- Science and Technology
- States and Fronter Regions
- Water Resources

*Under Cabinet Secretariat | **Under Ministry of Energy
***Under Ministry of Federal Education, Professional Training National Heritage and Culture
****Under Ministry of Finance

[1]All other Divisions have separate Ministry.
Source: *Cabinet Secretariat, GOP*

The trend in the current expenditure of the Federal Governments on staff salaries, including basic pay and allowances, pensions and operating costs is given in Table 6.1. The estimates for 2009-10 are prior to the 18th Amendment. It is indeed surprising that there has been such a rapid increase in pay and allowances, even after the initial downsizing of the Federal Government. This is due to the policy of granting big increases in salaries. In one year, they were raised by as much as 50 percent. Also, the outlay on pensions has been going up annually by 15 percent. It appears that the 18th Amendment has not stopped big increases in the cost of running the Federal Government. The Budget for 2021-22 has included another increase in allowances.

Table 6.1: Estimates of Cost of Running the Civil Administration (Rs in Billion)

	2009-10	2014-15	2020-21(R.E)
Pay and Allowances	92.6	175.9 (16.0)	295.8 (10.5)
Pensions	20.8	52.1 (23.0)	111.2 (15.2)
Operating Costs	114.8	137.7 (4.5)	192.2 (4.2)
TOTAL COST	228.2	365.7 (9.4)*	599.2 (8.8)

* Annual Growth Rate
Source: *MOF*

Turning to the Provincial Governments, a case study has been undertaken of the Government of Sindh. The equivalent of Divisions at the Federal Level is Departments at the Provincial level. In the case of Sindh, the number of departments was 34 just prior to the 18th Amendment. Over the last decade the number has increased to 48. A big part of the proliferation, as shown in Chart 6.4, is due to departments with focus on social welfare. These include new departments for empowerment of persons with disabilities, human rights, *katchi abadis*, minorities affairs, rehabilitation, social welfare, special initiatives, women development and so on.

Chart 6.4: Departments in Sindh Government

• Agricultural Supply & Prices	• Home	• Planning and Development
• Auqaf, Religious Affairs, Zakat & Ushr	• Human Rights**	• Population Welfare
• Board of Revenue	• Industries & Commerce	• Provincial Assembly of Sindh
• Chief Minister’s Secretariat	• Information & Archives	• Provincial Mohtasib**
• College Education**	• Information Science & Technology	• Public Health Engineering & RD

• Cooperation	• Inter-Provincial Coordination	• Rehabilitation**
• Culture, Tourism & Antiquities	• Investment**	• School Education**
• Empower of Persons with Disabilities	• Irrigation	• Services General & Coordination
• Energy	• Katchi Abadis**	• Social Welfare**
• Environment	• Labor & Human Resources	• Special Initiatives**
• Excise, Taxation & Narcotics	• Law & Parliamentary Affairs	• Sports and Youth Affairs**
• Finance	• Livestock & Fisheries	• Transport & Mass Transit
• Food	• Local Government & HTP	• Universities and Board**
• Forest	• Mines and Mineral Development	• Women Development**
• Governor's Secretariat	• Minorities Affairs**	• Works and Services
• Health	• Ombudsman for Protection against Women Harassment at Workplace**	• Other Development

***Set up after 2010.*

Source: *Provincial Budget*

Current expenditure by the four Provincial Governments combined has shown rapid growth after the 18th Amendment. Annual growth rate of salaries and operating costs has exceeded 15 percent per annum. They are currently four times the level in 2009-10.

Further, in the performance of the regulatory function, there would be a joint responsibility according to the 18th Amendment. However, many of the regulatory agencies do not have Provincial representation in the Boards. This includes the SBP, SECP, CCP, NEPRA and OGRA.

There has also been an overlap in the exercise of fiscal powers despite their clear demarcation by FLL-I. In particular, the Federal Government has continued to levy an excise duty on some services. Also, there has been a 'race to the bottom' in the Provincial sales tax on services with the tax rate being brought down the attract the mobile tax base.

The biggest failure has been the reluctance of Provincial Governments to devolve functions and finances to Local Governments. Consequently, municipal services are not being adequately provided especially in Metropolitan cities, like Karachi and Lahore. Issues with setting up of effective Local Governments are discussed in Chapter 8.

6.3. Achieving more Devolution

Merger of Federal Divisions: Division Creep' process needs to be reversed. Small Divisions need to be merged to enable the realization of some economies of scale, promote greater integration of functions and save both salary and operating costs, Chart 6.5 presents the distribution of the Divisions by the size of the budget for salaries and operational costs. The smallest ten Divisions are shown first and the largest three Divisions at the bottom.

There exists considerable scope for merger of Divisions, especially the small Divisions, as shown below:

Merger of Division		With Division
Defense Production	→	Defense
Revenue	→	Finance
National Heritage	→	Education
Aviation Railway Maritime Affairs	→	Communication
Industries and Production	→	Commerce
Human Rights	→	Law and Justice
Overseas Pakistanis	→	Foreign Affairs
Housing & Works	→	Establishment
Narcotics	→	Interior

Chart 6.5: Expenditure for Budget Estimates 2020-21 for Divisions by Size

Sr. #	Divisions	Staff Salaries	Other Expenditure	Total
				(Rs in million)
1.	Power Division, Climate Change Division, Water Resource Division, Kashmir Affairs & Gilgit Baltistan Division, Maritime Affairs Division	1,337	2,118	3,455
2.	Religious Affairs & Inter-Faith Harmony, Human Rights Division, Inter-Provincial Coordination Division, National Heritage & Culture Division, Overseas Pakistanis & Human Resource Development Division	1,511	5,446	6,957

3.	Economic Affairs Division, States & Frontier Regions Division, Parliamentary Affairs Division, Housing & Works Division, Information Technology & Telecommunication Division	1,659	18,958	20,653
4.	Establishment Division, Information & Broadcasting Division, Aviation Division, Science & Technology Division, Industries & Production Division	2,465	43,470	45,935
5.	Law & Justice Division, Petroleum Division, Narcotics Control Division, National Food Security & Research Division, Commerce Division	2,050	61,468	63,518
6.	Foreign Affairs Division, National Health Services, Regulations & Coordination Division, Revenue Division, Communications Division, Privatization Division	2,755	145,900	148,655
7.	Cabinet Division, Federal Education & Professional Training Division, Interior Division, Poverty Alleviation & Social Safety Division, Defense Division	5,718	1,791,207	1,796,925
8.	Finance Division, National Security Division, Defense Production Division	2,590	1,324,234	1,326,824

Shown in Descending Order of Size of Division

This will enable a major reduction in the number of Divisions and generate significant savings in both salary and operating costs. Two steps can be taken to facilitate these changes, as follows:

i) The surplus staff may be assigned to vacant posts in the entire Government system, both Federal and Provincial.

ii) The perception is that the reduction in number of Divisions will reduce the number of slots available to officers in BPS-21 and PBS-22. This can be tackled by upgrading some senior positions in Provincial Governments.

Vertical Programs: A decision was taken earlier by the CCI that vertical programs should be financed on a 50:50 basis by Federal and Provincial Governments. As such, projects in population and health in the Federal PSDP should be funded jointly. Similarly, the expenditure on higher education should also be shared.

Sharing of Project Costs: As a more general principle, development projects by both Federal and Provincial Governments in sectors which are included in FLL-II should be jointly funded. This will include the Railway, Ports and Electricity. This will imply sharing with Provincial Governments by location of projects. However, trunk infrastructure projects which provide benefits at the national level should be the sole responsibility for funding and execution by the Federal Government. A good example of a trunk infrastructure project is the upgrading of Pakistan Railway's existing Main Line (ML-1) at the cost of Rs 1184 billion, largely with Chinese assistance.

Zero Base Budgeting: There a large number, over 200, of Autonomous Bodies and Attached Departments at the Federal level. A list is given in Chart 6.6., of major entities. There is a need for careful review of the budgets of these institutions which add up to over Rs 376 billion. Some of them may be subjected to 'Zero Base Budgeting', whereby an assessment can be made of their contribution to development and performance of the economy, determine their scope for self-financing and for economy in expenditure.

Chart 6.6: List of Major Autonomous Bodies and Attached Departments,2017-18

(Rs in Billion)

•	Airports Security Force	7.3	•	Inland Revenue	13.9
•	Meteorology Department	1.3	•	Federal Lodges	0.1
•	Federal Public Services Commission	0.7			
•	Board of Investment	0.3	•	Press Information Department	0.7
•	PM Inspection Commission	0.1	•	Passport Organization	3.0
•	PAEC	10.3	•	Civil Armed Forces	83.7
•	Survey of Pakistan	1.3	•	Frontier Constabulary	10.3
•	Federal Educational Institutions in Cantonments	6.2	•	Pakistan Coast Guards	2.2
•	Geological Survey of Pakistan	0.6	•	Pakistan Rangers	23.3
•	Controller General of Accounts	6.0	•	Council of Islamic Ideology	0.1
•	Pakistan Mint	0.7	•	National Accountability Bureau	4.4
•	National Savings Directorate	3.5	•	National Assembly	4.6
•	Higher Education Commission	59.1	•	Senate	3.2
•	Federal Board of Revenue	4.4	•	Pakistan Post Office Department	19.6
•	Customs	8.2	•	Pakistan Railways	97.1
		TOTAL 376.2			

Management of Regulatory Function: The FLL-II includes all Regulatory authorities under a Federal Law. As such the boards should have one member from each Provincial Government. This will include regulatory agencies like the SBP, SECP, CCP, OGRA and NEPRA.

Transfer of Labor Functions: The labor-related functions in the Concurrent List have not been included in the FLL-II. As such, management of EOBI and revenues from WWF and

WPPF must be transferred to Provincial Governments and shared on the basis of collection. The labor-related functions also need to be performed more effectively by Provincial Governments and proposals for strengthening of the Labor Departments are included in Chapter 28.

Withdrawal of Federal Taxes on Services: Prior to the 18th Amendment, FBR had levied an excise duty on services. According to Table II on Excisable Services in the Excise Duty Act of 2005 there are 15 excisable services including banking, franchise services, services provided by stockbrokers, insurance companies, etc. Wherever the Federal excise duty is being collected it should be withdrawn and replaced by the Provincial Sales tax in Services.

Withdrawal of Infrastructure Cess: As highlighted earlier, The Sindh Government passed legislation on the Sindh Development and Maintenance of Infrastructure Cess Act in 2017. This consolidates the law relating to the levy of a cess on goods entering or leaving the Province of Sindh from or outside the country, for development and maintenance of infrastructure of the Province. The rate of the cess ranges from 1.10 percent to 1.15 percent of the total value of goods as assessed by Customs Authorities plus 1 paisa per kilometer. More recently, the Government of Punjab has also introduced such a cess.

This cess is an impediment to the free inter-Provincial movement of goods within one country. It should be withdrawn following a decision by the CCI.

'Race to the Bottom': The Provincial Governments have been reducing the standard tax rate on the sales tax on services. Currently, the tax rate is 13 percent in Sindh, 16 percent in Punjab and 17 percent in the other two Provinces. This has resulted in movement of the tax base to the jurisdiction with a lower rate. Consequently, Sindh has a disproportionately large share of 43 percent in relation to the size of the service economy in the Province. Clearly, there is need for deliberations by the CCI to resolve the issue of shifting tax base and ensuring the same tax rate across Provinces.

Borrowing Powers of Provinces: The 18th Amendment allows Provinces to access the capital market with bonds subject to approval by the NEC. However, no such borrowing has been undertaken by the provinces. As opposed to this, the States of India regularly engage in borrowing.

There is need for the NEC to recognize that there should be a provision to allow Provincial borrowing in urgent and high priority cases. One such case is that of the program of development of services in the metropolitan city of Karachi, which is the economic hub of the country but is confronted with a large-scale breakdown of basic services like water supply, sanitation, mass transit, etc.

A joint Development Program of Rs 1100 billion was announced by the Federal Government and the Government of Sindh. However, progress has been very slow because of paucity of funds. This is the ideal case for flotation of bonds by the Government of Sindh. Faster growth of the city will add enough additional revenues to the Provincial Government for interest and debt repayment on the bonds.

Local Government Elections: The Election Commission must ensure that the pre-announced dates for local Government elections are adhered to. This should lead to the formation and functioning of such Governments throughout the country. This will fulfil one of the most important components of the vision of the architects of the 18th Amendment for true devolution of the governance process in the country. God willing, Pakistan will achieve '**Unity in Diversity'**.

Chapter 7: Progressing on the 10th NFC Award

The Article 160 of the Constitution of Pakistan provides for the setting up a National Finance Commission (NFC) once every five years to make recommendations to the President on the following:

a) The distribution between the Federation and the Provinces of the net proceeds of pre-specified federal taxes.

b) The making of grants in aid by the Federal Government to the Provincial Governments.

c) The exercise of borrowing powers.

d) Any other matter relating to finance referred to the Commission by the President.

7.1. The 7th NFC Award

There have been five Awards since the promulgation of the Constitution in 1973. Table 7.1 presents the evolution of the Provincial shares in different Federal taxes in the different Awards. It is evident from the Table that the largest share given to the Provinces was in the last Award given by the 7th NFC. Table 7.2 gives the criteria for horizontal sharing among the Provinces. Up to the 7th NFC Award, the only criterion used was the share of population.

Table 7.1: Provincial Share in Divisible Pool Taxes in Different Awards

Divisible Pool Taxes	1st NFC 1974	4th NFC 1991	5th NFC 1997	PO [c] 2006	7th NFC 2009
Income Tax and Corporation Tax[a]	80	80	37.5	41.50 -46.25	56.0 - 57.5
• Other Direct Taxes	-	-	37.5	41.50 - 46.25	56.0 - 57.5
Sales Tax	80	80	37.5	41.50 -46.25	56.0 - 57.5
Central Excise Dutyb	-	-	37.5	41.50 - 46.25	56.0 - 57.5
• Tobacco	-	80			
• Sugar	-	80			
Import Duties	-	-	37.5	41.50 -46.25	56.0 - 57.5
Export Duties					
• Cotton	80	80	-	-	

[a] Excluding taxes on income consisting of remuneration paid out of federal consolidated fund.
[b] Excluding Central Excise Duty on Natural Gas | c Presidential Order.
Source: *SPDC (2014)*

The 7th NFC Award introduced four criteria, with the dominant criteria being population share. Two criteria namely poverty incidence and inverse of population density, were added to promote fiscal equalization, leading to a higher share than population to the two relatively backward Provinces, Balochistan and Khyber-Pakhtunkhwa. One criterion was included to reflect the contribution by a Province to Federal tax revenues.

Table 7.2: Criteria Used in Horizontal Distribution of Divisible Pool Taxes (%)

Divisible Pool Taxes	1st NFC 1974	4th NFC 1991	5th NFC 1997	PO 2006*	7th NFC 2010
Population	100.0	100.0	100.0	100.0	82.0
Poverty / Backwardness	-	-	-	-	10.3
Revenue Collection / Generation	-	-	-	-	5.0
Inverse Population density	-	-	-	-	2.7

**Other than 1/6th of sales tax on goods collected and distributed in lieu of Octroi / Zila Tax.*

Source: *NFC Secretariat [2010]*

Other features of the 7th NFC Award include the following:

i) Provinces have been given the choice to levy and collect GST on services themselves or ask FBR to collect it on their behalf. The expectation is that there will be no Federal excise duties on services.

ii) The magnitude of straight transfers has been raised. These transfers include the gas development surcharge (GDS), excise duty on gas and royalty on gas and oil. The distribution will be on the share in collection.

iii) Special grants have been given, first, to Sindh in lieu of the octroi/zila tax, second arrears to Khyber-Pakhtunkhwa of hydro-electricity profits and, third, arrears of the GD to Balochistan.

iv) The costs of collection of divisible pool taxes have been reduced from 5 percent to 1 percent.

v) A special transfer of 1 percent of the divisible pool (net) to Khyber-Pakhtunkhwa to provide resources for the War on Terror.

vi) In recognition of the special needs of Balochistan, Rs 83 billion was to be given to the Province in the first year, 2010-11, of the Award. Any shortfall in future was to be met by the Federal Government.

The weights in the horizontal distribution of the four criteria were as follows:

Horizontal Distribution Criteria	
	Percentage (%)
a. Population	82.0
b. Poverty / Backwardness	10.3
c. Revenue Collection / Generations	5.0
d. Inverse Population Density	2.7
TOTAL	**100.0**

Based on the magnitudes of the Provinces in the different criteria, the final percentage share of each Province emerged as follows:

Province Percentage Share	
	Share (%)
Punjab	51.74
Sindh	24.55
Khyber Pakhtunkhwa	14.62
Baluchistan	9.09
	100.00

The duration of the 7th NFC Award was expected to be from 2010-11 to 2014-15. However, the successor 8th and 9th NFCs were unable to come to arrive at a consensus on a new Award. Consequently, the 7th NFC Award has remained in operation for ten years now. 2021-22 will be the twelfth year.

The resulting ratios of share in transfers to share in population of each Province are given in Table 7.3. The transfers include both divisible pool and straight transfers. The latter have gone mostly to Sindh and Baluchistan but constitute only 3 percent of total transfers.

Table 7.3: Ratio Between Share in Transfers and Share of Population – (%)

Province	1990-91	1997-98	2009-10	7th NFC Award	
				2014-15	2019-20
Punjab	0.953	0.884	0.882	0.855	0.898
Sindh	1.030	1.026	1.069	1.109	1.052
Khyber-Pakhtunkhwa	0.948	1.328	1.099	1.087	0.920*
Balochistan	1.453	2.264	1.565	1.683	1.918
Pakistan	1.000	1.000	1.000	1.000	1.000

**After the merger of FATA*

Source: *SPDC*

The most favorable ratio of over one is observed in the case of Baluchistan. It reached a peak of over 1.9 in 2019-20. The other two Provinces, Sindh and Khyber-Pakhtunkhwa also have ratios above one. However, after the merger of FATA, the share of Khyber-Pakhtunkhwa has fallen below one. Punjab has had the lowest ratio, close to 0.9.

The share of Federal revenues, tax plus non-tax, preempted by transfers to Provincial Governments is given in Table 7.4. In the last year, 2009-10, of the Presidential Order of 2006 this share was 32 percent. It jumped to 42 percent in the first year after the 7th NFC Award.

Table 7.4 also includes the contribution of transfers to total Provincial revenues. The share of transfers is significantly above 80 percent. This highlights the strong vertical link between the Federation and the Federating units in Pakistan.

Table 7.4: Growth in Revenue Transfers to Provincial Governments (Rs in Billion)

	1990-91	1997-98	2009-10	7th NFC Award	
				2014-15	2019-20
Total Federal Revenues	448	868	1974	3663	5782
Revenue Transfers to Provincial Governments	171	257	633	1539	2504
Transfers as % Federal Revenues	38.2	29.6	32.1	42.0	43.3
Total Provincial Revenues	212	314	756	1821	3020
Transfers as % of Provincial Revenues	80.7	81.8	83.7	84.5	82.9

Source: *SPDC; MOF, Fiscal Operations*

One of the principal objectives behind the relatively liberal dispensation in favor of the Provinces by the 7th NFC was to promote human development, especially since most of the social services are in the domain of Provincial Governments. Therefore, a relevant question is whether the share of education, health, water supply, etc. has increased in the total expenditure by Provincial Governments. In the case of all four Provinces, the overall level of public expenditure of social services has in fact, increased to almost 3 percent of the GDP. The biggest increase in share of the budget is in Baluchistan from 26 percent in 2009-10 to 38 percent in 2018-19. In the latter year, the largest share of expenditure on social sectors was in Khyber-Pakhtunkhwa at 47 percent.

The fundamental question is whether the 7th NFC Award has led to a faster rate of expansion in the coverage of social services, given the increase in expenditure? Unfortunately, the outcome here has been disappointing.

A five-indicator index (primary, middle and secondary education, immunization, drinking water) has been constructed to measure the combined coverage of different social services. There are two major findings as follows:

i) The annual rate of increase nationally of the index is larger between 2004-05 to 2008-09, the pre-7th NFC period, than from 2008-09 to 2018-19.

ii) The highest index value of coverage of social services in 2018-19 is in Punjab. However, the biggest increase in the index value has been registered in Khyber-Pakhtunkhwa and smallest increase in Sindh.

The fundamental question is why despite larger outlays, the progress in social indicators has not been commensurately greater. There are three possible explanations. First, within social sectors, priorities may have been altered. For example, there is evidence of far greater emphasis on curative health rather than preventive measures, including provision of safe drinking water. Second, Local Governments were far more active in pre-7th NFC period. They probably did a better job in reflecting peoples' preferences and in more effective delivery of services. Third, it is likely that the cuts in development spending, due to the constraints imposed by the IMF program, have limited the expansion in coverage of services. Fourth, the smaller Provinces may not have had sufficient institutional capacity to deliver services efficiently in the face of a rapid expansion in revenues. Issues of governance and graft in Provincial line departments have also been highlighted.

The 7th NFC Award has been subjected to criticism recently. The Award has been characterized as 'imperfect' by functionaries of the last PML (N) Government and the present PTI Government. The primary concern is that after handing over 57.5 percent of Federal Governments' revenues to the Potential Governments, the remaining revenues are only sufficient for debt servicing. To meet bulk of the needs of defense, development, pensions and running its affairs, the Federal Government has no other option but to engage in large-scale borrowing. As such, the 'natural' fiscal deficit at the Federal level is close to 8 percent of the GDP.

The extent to which net revenues receipts of the Federal Government cover its expenditure obligations are given in Table 7.5. The latest position is indeed worrying. In 2019-20, the cost of debt servicing was fully covered but only 54 percent of the defense expenditure could be financed from the revenues. Along with 46 percent of this expenditure and the entire expenditure on development and other current expenditure have been covered by borrowings.

There has been a major deterioration in the financing position since 2004-05 when debt servicing, defense expenditure and development expenditure were all financed by net revenue receipts. Clearly, at the minimum, debt servicing obligations and security needs should be covered by revenues with the Federal Government after making the mandated transfers to the Provincial Governments. The failure to meet key expenditures is attributable to the low Federal tax-to-GDP ratio of only 10.4 percent which according to the 7th NFC projections should have reached almost 14 percent of the GDP by 2014-15.

Table 7.5: Coverage of Expenditure by Net Revenues of Federal Governments						(%)
	2001-02	2004-05	2009-10	7th NFC Award		
				2014-15	2018-19	2019-20
Debt Servicing	100	100	100	100	97	100
Defense Expenditure	100	100	100	100	0	54
Development Expenditure	44	100	75	18	0	0
Other Current Expenditure	0	12	0	0	0	0
Source: *MOF, Fiscal Operations*						

7.2. The 10th NFC

The 10th NFC has recently been constituted and has held its first meeting. The terms of reference of the Commission given by the President are as follows:

a) Distribution between the Federation and the Provinces of the net proceeds of the following taxes:

   i) Taxes on income, including corporation tax, but not including taxes on income consisting of renumeration paid out of the Federal Consolidated Fund.

   ii) Taxes on the sales and purchases of goods imported, exported, produced, or consumed.

   iii) Export duties on cotton, and such other export duties as may be specified by the President.

   iv) Such duties of excise as may be specified by the President; and

   v) Such other taxes as may be specified by the President.

b) Making of grants-in-aid by the Federal Government to the Provincial Governments.

c) Exercise by the Federal Government and the Provincial Governments of the borrowing powers conferred by the Constitution.

d) Assessment and Allocation of resources to meet expenditures related to Governments of the States of Jammu and Kashmir, Gilgit-Baltistan and newly merged districts of Khyber-Pakhtunkhwa (erstwhile FATA).

e) Assessment and allocation of resources to meet expenditures made on security and natural disasters/calamities.

f) Assessment of total public debt and allocation of resources for its repayment.

g) Rationalization of subsidies given by the Federal and Provincial Governments in their budgets and agreeing on a mechanism to finance them.

h) Exploring ways to reduce losses of State-owned enterprises and agreeing on mechanism for sharing these losses between the Federal Government and the Provincial Governments.

i) Any other matter relating to finance referred to the Commission by the President.

Items (a) to (c) are the standard inclusions in the TOR. The additional items from (d) to (i) have presumably been included in the TOR given the strained financial position of the Federal Government and the need to promote some cost sharing between the two Governments. There is, however, no scope for reducing the combined Provincial share in the net Divisible Pool of Federal revenues because of the following clause inserted by the 18th Amendment to the Constitution in Article 160 (3A):

'The share of the Provinces in each Award of the National Finance Commission shall not be less than the share given in the previous Award.'

7.3. Projections for the 10th NFC

There is need to adopt the approach like that by the 5th NFC of developing a **National Resource Picture**. This involves the approach of using the National Resource Picture for making five years Government's revenue and expenditure projections. This will help in identifying the quantum of revenues that should remain with the Federal Government to cover basic expenditure needs of debt servicing and security and simultaneously cater to the expenditure of the Provincial Governments for provide coverage of basic services to the people.

A National Resource Picture has been developed which is consistent with the Public Finance targets in Chapter One. The resulting estimates are given in Table 7.6.

Table 7.6: National Resource Picture (% of GDP)

	2020-21	2021-22	2022-23	2023-24	2024-25
NATIONAL					
Tax Revenues	11.7	12.4	13.0	14.1	15.0
Non-Tax Revenues	2.9	3.3	3.4	3.4	3.4
Consolidated Budget Deficit	7.5	7.0	6.6	5.7	5.0
TOTAL	**22.1**	**22.7**	**23.0**	**23.2**	**23.4**

Source: *Projected*

The tax revenues of the Federal and Provincial Governments combined are projected to rise from 11.7 percent of the GDP to 15 percent of the GDP by 2024-25. In fact, the 7th NFC had set the target at 15 percent of the GDP to be attained by 2014-15. The expectation is that it will now be attained ten years later in 2024-25 by design and implementation of a strong agenda of tax reforms.

Non-tax revenues reached a peak in 2019-20 due to the record profits made by the SBP in the presence of high interest rates. They have fallen in 2020-21. Dividends and interest payments will start rising thereafter with improvement in functioning of State-Owned Enterprises. Also, there is the expectation of higher cost recovery in canal irrigation, highways, and other economic services.

The consolidated budget is envisaged to decline from 8.1 percent of the GDP to 5 percent of the GDP by 2024-25. This is essential to keep the costs of borrowing low and limit the impact of Government borrowing on monetary expansion and the rate of inflation. Importantly, the target is to bring down the Government Debt to GDP ratio from 78 percent in 2019-20 to 70 percent by 2024-25.

The analysis next highlights in Table 7.7 how the different components of public expenditure can be financed from the projected National Resources Picture.

The burden of debt servicing is projected to decline from 6.6 percent to 5.5 percent of the GDP along with the fall in the Government Debt to GDP ratio. Defense expenditure is expected to remain close to 3 percent of the GDP.

The big increase anticipated is in development expenditure from 2.5 percent of the GDP to 4 percent of the GDP by 2024-25. This is critical for speeding up the implementation of key projects in water resources, power generation by renewable energy and improved transmission and distribution, development of SEZs and vital inputs to promote human development and attainment of the SDGs. Higher development spending will also provide a stimulus to growth. The level of other current expenditure has been sustained for higher payment of subsidies and financing the social protection program, along with rising pensions and salaries.

Table 7.7: Projected Expenditure by Type (% of GDP)

	2020-21	2021-22	2022-23	2023-24	2024-25
National Resource Picture	**22.1**	**22.7**	**23.0**	**23.2**	**23.4**
Expenditure	**22.1**	**22.7**	**23.0**	**23.2**	**23.4**
Debt Servicing	6.4	6.1	5.8	5.7	5.5
Defense Expenditure	2.7	2.9	3.0	3.0	3.1
Development Expenditure	2.8	3.3	3.6	3.8	4.0
Other Current Expenditure	10.2	10.4	10.6	10.7	10.8

Source*: Projections.*

The implications of the National Resource Picture and the allocation to different heads on the financial position of the Federal and Provincial Governments respectively are highlighted in Tables 7.7 and 7.8. The former Table reveals that the Federal tax revenues will need to be raised from 10.4 percent of the GDP to 13.4 percent of the GDP by 2024-25.

Table 7.8: Projection of the Federal Budgetary Position					(% of GDP)
	2020-21	2021-22	2022-23	2023-24	2024-25
Total Revenues	**13.4**	**14.3**	**14.7**	**15.4**	**16.0**
Tax Revenues	10.7	11.3	11.7	12.4	13.0
Non-Tax Revenues	2.7	3.0	3.0	3.0	3.0
Transfer to Provinces	**-6.2**	**-6.6**	**-6.8**	**-7.1**	**-7.5**
Net Revenue Receipts	7.2	7.7	7.9	-8.3	-8.5
Total Expenditure	**15.0**	**15.3**	**15.4**	**15.4**	**15.4**
Current Expenditure	13.8	13.8	13.7	13.7	13.6
Development Expenditure	1.2	1.5	1.7	1.7	1.8
Budget Deficit	-7.8	-7.6	-7.5	-7.1	-6.9
Cash Surplus of Provinces	**0.3**	**0.6**	**0.9**	**1.4**	**1.9**
Consolidated Budget Deficit	-7.5	-7.0	-6.6	-5.7	-5.0
Primary Deficit (-) / Surplus (+)	-1.1	-0.9	-0.8	0.0	0.5

Source: *Estimated.*

Based on the unchanged vertical distribution formula as in the 7th NFC Award and projected straight transfers, the total transfers to the Provincial Governments are expected to rise sharply from 6 percent of the GDP to 7.7 percent of the GDP in 2024-25 based on the share in the 7th NFC Award. This will greatly improve the financial status of the Provincial Governments.

The Federal budget deficit is projected to decline from 8.4 percent of the GDP to below 7 percent of the GDP due to the rise in the level of net revenue receipts and some savings from current expenditure. Consequently, an overall primary surplus situation will be reached in 2023-24. Further, by 2023-24, net revenue receipts of the Federal Government will begin to cover the combined expenditure on debt servicing and security.

According to Table 7.9, Provincial Governments are expected to raise their own tax-to-GDP ratio from 1 percent to 2 percent of the GDP. This will primarily involve development of direct taxes like the agricultural income tax, the urban immoveable property tax, and the sales tax on services. This will make the overall national tax system more progressive.

The Provincial Governments may be able to raise their level of spending especially in promoting human development and providing more inputs to agricultural development.

Table 7.9: Projection of the Provincial Budgetary Position					
	2020-21	2021-22	2022-23	2023-24	2024-25
Provincial Revenues	**7.4**	**8.0**	**8.5**	**9.2**	**9.9**
Federal Transfers	6.2	6.6	6.8	7.1	7.5
Own-Tax Revenues	1.0	1.1	1.3	1.7	2.0
Non-Tax Revenues	0.2	0.3	0.4	0.4	0.4
Provincial Expenditure	7.1	7.4	7.6	7.8	8.0
Provincial Cash Surplus (+)	0.3	0.6	0.9	1.4	1.9
Source: *Projections.*					

The horizontal sharing implications of continuing with the same formula as given by the 7th NFC are highlighted. The up-dated share of each Province in the four criteria are presented in Table 7.10. Given the weights, the overall share of each Province is derived. According to Table 7.11 the share of Punjab falls further by 4.22 percentage points and that of Sindh marginally by 0.21 percentage point. There is a big increase in the share of Khyber-Pakhtunkhwa due primarily to the merger of FATA which has increased the share of the Province in the national population. Similarly, the share of Baluchistan rises due to faster population growth.

Table 7.10: Magnitude of the Criteria and Horizontal Shares of Provinces with the same sharing formula as in the 7th NFC Award Latest Estimates (%)					
Province	Population	Inverse Population Density	Revenue Collection	Poverty	Overall Horizontal Share
Weight	**82.0**	**2.7**	**5.0**	**10.3**	
Punjab	53.46	5.21	38.01	15.83	47.52
Sindh	23.28	8.22	55.89	21.73	24.34
Khyber-Pakhtunkhwa	17.26	8.00	4.51	26.53	17.32
Baluchistan	6.00	78.57	1.49	35.91	10.82
PAKISTAN	100.00	100.00	100.00	100.00	100.00
Source: *Diverse*					

Table 7.11: Change in the Horizontal Share of Provinces (%)			
Province	Share in 7th NFC Award	Potential Share in 10th NFC*	Extent of Change in Share
Punjab	51.74	47.52	-4.22
Sindh	24.55	24.34	-0.21
Khyber-Pakhtunkhwa	14.62	17.32	2.70
Baluchistan	9.09	10.82	1.73
TOTAL	**100.00**	**100.00**	**100.00**
**With unchanged horizontal sharing formula*			
Source: *Estimated*			

The big fall in the share of Punjab may mitigate against the process of arriving at a consensus on the 10th NFC Award. The largest Province had already accepted a significant drop in its share in relation to its population share in the 7th NFC Award.

The recommendations given below include proposals for changing the horizontal sharing formula to accommodate a somewhat larger share for Punjab.

7.4. Arriving at a Consensus

The recommendations given below are likely to facilitate the finalization of the Award by the 10th NFC.

i) The **vertical share** of the Provincial Governments will, of course, remain unchanged at 57.5 percent as in the last Award.

ii) The **cost of collection of divisible pool taxes** should continue at 1 percent of the revenues.

iii) There is a case for withdrawing the initial share of 1 percent to Khyber-Pakhtunkhwa for the War on Terror. First, the situation has improved, and there are fewer acts of terror. Second, the internally displaced persons from FATA are now part of the population of the Province and the horizontal share has been adjusted accordingly.

iv) The **horizontal sharing formula** could be modified in the following ways:

   a) Instead of the shares according to the Population Census of 2017 being used, reliance may be placed on the shares in the Population Census of 1998. This practice of taking the previous Census shares have been adopted by the Indian Finance Commission in its 15th Award. The motivation is to prevent a motivation for expansion in population and encourage population planning. In Pakistan's case, it will protect somewhat the shares of the two larger Provinces who have shown a lower population growth rate from 1998 to 2017.

   b) Another option is to take the 2017 population shares but increase the weight of population in the horizontal sharing of formula.

   c) Another option is for the poverty / backwardness criteria to be based not on the incidence of poverty as percentage of the population but on the number of poor.

v) There is need to incorporate in the Award items (d) to (h) in the TOR of the 10th NFC to the extent possible. This is feasible since the projections indicate that if the projected size of transfers to the Provincial Governments is realized then they will have significant a cash surplus. The surplus is projected at 0.6 percent of the GDP in 2021-22 rising to 1.9 percent of the GDP by 2024-25.

vi) From the viewpoint of rewarding and stimulating greater fiscal effort of the 2.5 percent of the divisible pool may be distributed on the basis of revenues generated from taxation proposals by the Provincial Governments in a particular year.

The **options for cost sharing** include the following:

i) Sharing in costs of performance of common functions listed in the Federal Legislative Cost-II of the Constitution. This will imply that the budget for higher education, population planning, and health currently being financed by the Federal Government may be shared on a 50: 50 basis, with the Provincial Governments.

ii) The function of Social Welfare is neither in FLL-I or FLL-II. This implies that this is a function to be discharged by the Provincial Governments. However, the EHSAAS / BISP programs are being run exclusively by the Federal Government. As such, there is a case for gradual transfer of such programs to Provincial Governments. However, it will be essential to ensure horizontal equity and there should not be significant differences in social protection programs among the Provinces.

iii) The Federal PSDP should focus on trunk infrastructure projects which cover more than one Province in terms of the benefits received. As such, relatively small projects in sectors like highways, water resources and power transmission and distribution which are intra-Provincial in nature may be partly or fully financed through the Provincial ADPs.

The above cost-sharing arrangements could evolve and expand during the tenure of the next NFC Award.

The time has come for a new NFC Award to reflect the changing dynamics of the political and development process in the country. This will greatly strengthen the Federation of Pakistan.

Chapter 8:

Devolving to Local Governments

Local governments were first recognized as the third tier of government in the 18th Amendment to the Constitution by insertion of Article 140A which states:

1) Each Province shall, by law, establish a local government system and devolve political, administrative, and financial responsibility and authority to the elected representatives of local governments.

2) Elections to the local governments shall be held by the Election Commission of Pakistan.

The first section of the Chapter briefly describes the history of local government in Pakistan. This is followed by sections on alternate structures of local governments, functions performed, representation of special interests, fiscal powers, and transfers from Provincial Governments. Proposals are put forward in the last section on strengthening the role of local governments in Pakistan.

8.1. History of Local Governments

The first post-Independence initiative for local government was the 'basic democracy' system by the Government of Field Marshal Ayub Khan in 1959. This consisted of urban and rural local councils directly elected by the people that would be engaged in local governance and in implementing grassroots development.

The second major initiative was undertaken by the General Ziaul Haq Government in 1979 by promulgation of Local Government Ordinances and local bodies were established in all four Provinces in 1979 and 1980. This structure of local government largely continued till the implementation of the ambitious Devolution Plan for 2001 by the General Musharraf Government.

These three Governments were all military governments. The impetus for local governments was provided by two motives. First, this was seen as an exercise in gaining legitimacy by allowing elections, albeit at the local level only. Second, this was an attempt to by-pass and weaken Provincial Governments as larger sources of potential dissent.

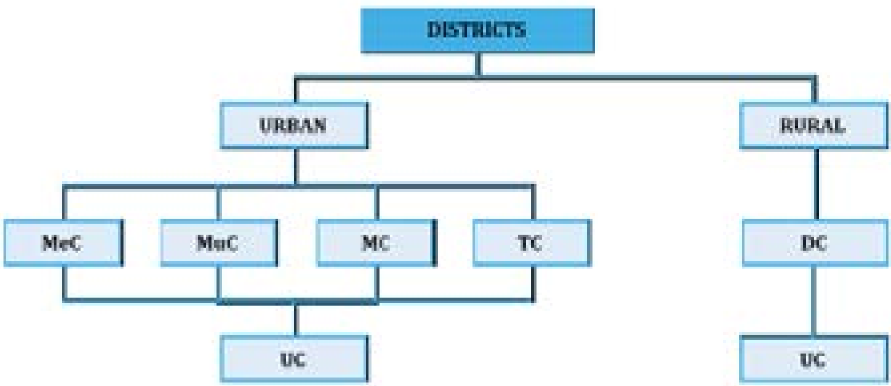
The incorporation of local governments by the passage of the 18th Amendment, with Article 140A, is the first attempt in a democratic system to recognize the need for and role of a legitimate third Government in a Federation with four Provincial Governments in Pakistan.

The Provincial Governments have proceeded to enact laws with passage through the Provincial Assemblies. The Government of Balochistan was the first Provincial Government to enact a Local Government Act in 2010. This was followed in 2013 by the other three Provincial Governments. Amendments have since been made in the original Acts.

8.2. Structure of Local Governments

The different experiments with local government in Pakistan have included different structures based on a single-tier level, as in Basic Democracy, or on two or more tiers in other cases. They have either been based on the district being the top tier or on a horizontal demarcation between urban and rural areas within a district.

Figure 8.1: Structure of Local Government, 1979



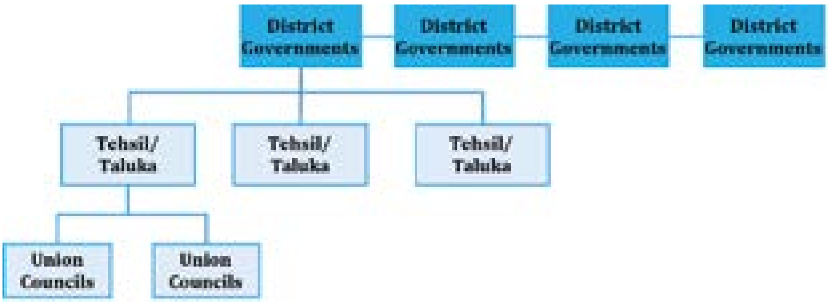
Where:

MeC = Metropolitan Corporation, Municipal Corporation
MC = Municipal Committee
TC = Town Committee
DC = District Council
UC = Union Council

The local government system of 1979 was based on the structure shown in Figure 8.1. There was a horizontal split within a district of urban and rural areas. Urban areas had municipal bodies based on the size of the settlement. The largest being the Metropolitan Corporation, followed by Municipal Corporation, Municipal Committee and Town Committee. Rural areas of a district had a District Council. Both urban and rural areas had Union Councils as the lower tier of local government.

The design and structure of local governments in the Devolution Plan of 2001 is shown in Figure 8.2. There was no distinction between urban and rural areas. The top tier of local government were the District Governments, followed at the next level by Tehsils/Talukas. The lowest tier was of Union Councils, with representation from a cluster of villages.

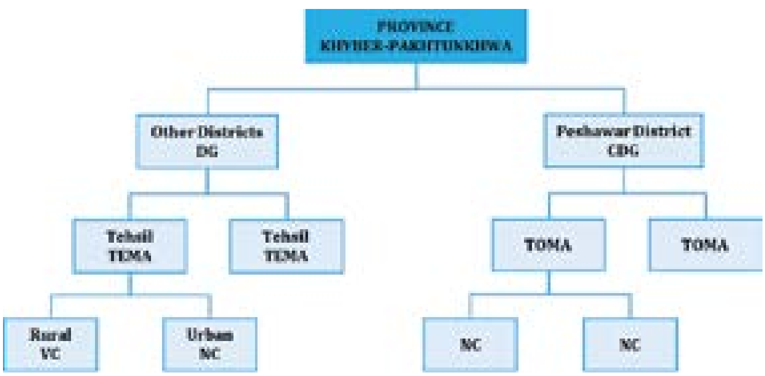
Figure 8.2: Structure of Local Government in the Devolution Plan, 2001



The local government enactments after the 18th Amendment have essentially followed the 1979 model in the three Provinces of Sindh Punjab and Balochistan. The Province of Khyber-Pakhtunkhwa has implemented a different design of local Government as shown in Figure 8.3.

The Khyber-Pakhtunkhwa model is an ingenious combination of the earlier structures. There are district governments as in 2001 but primacy has been given to the largest city, Peshawar, as in the 1979 case by having a City District Government in the city. The next level consists of Tehsil or Town Municipal Administrations and the third tier of village or Neighborhood councils, not Union Councils. Therefore, the third tier is at an even lower level. The structure is shown in Figure 8.3.

Figure 8.3: Structure of Local Government in the Khyber-Pakhtunkhwa



DG = District Government, CDG = City District Government, TEMA = Tehsil Municipal Administration, TOMA = Town Municipal Administration, VC = Village Council, NC = Neighbourhood Councils.

Based on the above structures, a number of local government issues can be identified:

i) Should the highest tier of local government be at the district level as a whole or split between the rural and areas of a district?

ii) Should there be two or three tiers of local governments, with the second tier at the tehsil / taluka level?

iii) Should the lower tier be at the Union Council level, consisting of a cluster of villages or at the neighborhood council or village council level?

Clearly the answer must be left to the preference of respective Provincial Governments. However, from an efficiency and representation point of view, the highest tier of local government should have the requisite capacity for delivery of services and be large enough to enjoy some economies of scale. The electorate should be diverse enough to allow for the representation through quotas of special interest groups. It should also have sufficient capacity for raising revenues.

The primary purpose of the lower tier of local government should be to faster community participation in revealing preferences for services and acting as a mechanism for accountability in the provision of local services. Therefore, either a Union Council or Village/Neighborhood Council could perform these functions. However, the latter will probably imply greater community participation. The case for an intermediate tier of local government is not so strong.

The number of local units in each Province is given in Table 8.1. The Table indicates that are currently almost ten thousand local government entities today in Pakistan. The largest number is in Punjab followed by Khyber-Pakhtunkhwa. The number in the latter Province is relatively large due to the presence of Village Councils.

Table 8.1: Number of Local Units in Provinces (Based on the structure)

	Punjab	Sindh	Khyber-Pakhtunkhwa	Balochistan	Pakistan
Districts / MCs*	327	52	35	58	472
District Councils	36	30	35	33	134
Tehsils	73	-	-	-	73
Union Councils	4015	1497	-	635	6147
Village Councils	-	-	2996	-	2996
TOTAL	**4451**	**1579**	**3066**	**726**	**9822**

**Metropolitan Corporation, Municipal Corporations, Committees*

Source: *AERC*

8.3. Functions of Local Governments

The allocation of functions to local governments should ideally be based on the ***principle of subsidiarity***. According to this, a government function should be performed at the local government level rather than at a higher level if it can be demonstrated that it can be more efficiently performed at the lower level. This will, of course, depend on the area covered and the size of the population served. Also, the level of provision should be linked to the scope for seeking accountability by beneficiaries of the service provided.

The Chart 8.1 indicates the functions which are generally assigned to local governments in Pakistan. The most comprehensive transfer of functions was achieved in the 2001 Devolution Plan.

The size of the Budget for 2020-21 of the Karachi Metropolitan Corporation is Rs 24.9 billion ($ 161 million). This is the largest local government in the country in terms of the population covered. However, the budget of the Lahore Metropolitan Corporation is larger at Rs 58 billion.

The average budget allocation to a Municipal Corporation or Committee by the Provincial Government of Punjab in 2018-19 was Rs 66 million and to a District Council, Rs 54 million.

Chart 8.1: Functions with Local Governments

• School Education*	• Intra-District Roads
• Public Health*	• Street Lighting
• Sanitation	• Bridges and Storm Water Drains
• Disposal of Refuse	• Public Streets
• Water Supply & Drainage	• Slaughterhouses
• Civil Defense	• Building Control**
• Removal of Encroachments	• Prevention of Nuisances in Public Places

**With District Authorities in Punjab, which are extensions of the Provincial Line Departments with some degree of autonomy.*

***with the Provincial Government in Sindh and Punjab.*

There is also the unique nature of decentralization of the education and health functions in Punjab. These have been handed over to District Authorities rather than to District Councils or Municipal Corporations/Committees. This represents the process of dominance by the bureaucratic system in the Province.

8.4. Financing of Local Governments

Article 140A clearly states that each Provincial Government must devolve financial authority and responsibility to local governments. As such, the latter should have access to sufficient funds to perform the functions listed earlier.

There are two sources of finance. The first is the transfer from the Provincial Governments as per the respective Provincial Finance Commission (PFC) Awards. The second source is own-revenues generated from taxes, fees, and charges within the fiscal powers of local governments.

The fiscal powers generally available to local governments as per the latest legislation are listed in Chart 8.2. A comparison is made with the devolution of revenue sources in 2001. Also, the Chart highlights the wide variation in fiscal powers.

Chart 8.2: Local Government Revenue Assignment since 1979

	1979			2001	2013					
Tax to be levied	All Provinces			K-PK	Punjab's LG		Sindh's LG		Baluchistan's LG	
	Urban	Rural	LG	LG	Urban	Rural	Urban	Rural	Urban	Rural
Educational and health facilities fees	x	x	✓	✓	x	x	x	x	x	x
Local rate on lands assessable to land revenue	x	x	✓	✓	x	✓	x	x	x	x
Toll on roads, bridges, ferries maintained by the LG	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Water, sanitation, drainage, lighting and conservancy rates etc.	✓	✓	✓	✓	✓	✓	✓	✓	✓	x
Fee on advertisement including hoarding and billboard	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Market fees	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Tax on the transfer of immovable property	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

Property tax	x	x	✓	✓	✓	✓	✓	x	x	x
Fees for registration and certification of birth, marriage and deaths	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Collection charges for recovery of any tax on behalf of the Government	✓	✓	✓	✓	x	x	x	x	x	x
Fees on the slaughter of animals	✓	✓	x	x	✓	✓	✓	✓	✓	✓
Tax on profession trade calling and employment	✓	✓	x	x	✓	✓	✓	✓	✓	x
Tax on produce of mineral, tobacco, fruit etc.	x	✓	x	x	x	x	x	x	x	x
Surface minerals, fisheries tax	✓	x	x	x	x	x	✓	✓	✓	x

The basic case for devolution of fiscal powers is that it leads to closer link between taxation and benefits. This is the reason why in many countries the principal source of local revenue is the property tax.

There is need to examine the position regarding the property tax. It was transferred to the urban local governments in 1979 while the rural equivalent, the local rate, was also given to District Councils.

However, the current position is that it is mostly collected at the Provincial level and then transferred to local governments. This creates a serious 'moral hazard' problem. The tax remains underdeveloped because while they collect, the Provincial Governments do not retain the revenues.

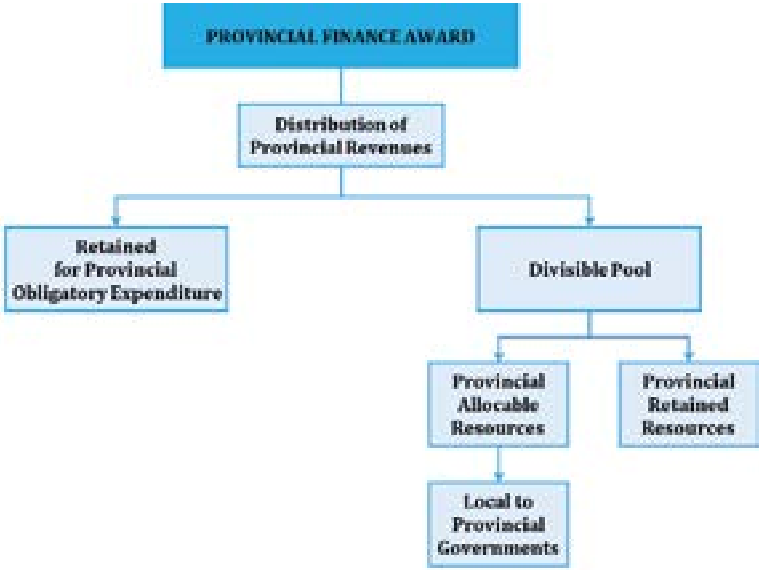
Local governments have generally been allowed to collect a wide variety of fees, although revenues generated are not every large. Other taxes which could be levied are on transfer of property, entertainment, vehicles, professions, and callings.

There is need to ensure, first, that there is no 'exporting' of the tax burden from one jurisdiction to another. This used to be the case after 1979 when District Councils were allowed to levy an export tax on agriculture produce leaving the district.

The second issue of regulation of taxes at the local level must be to ensure that there is 'no race to the bottom' by competition in reducing tax rates to attract new taxable entities and thereby improve the local economy. This is the case currently with the Provincial sales tax on services.

Turning to the Provincial Government's transfer of revenues to local governments there are governed by periodic PFC Awards. The process of distribution generally proceeds as shown in Figure 8.4.

Figure 8.4: Distribution Process of PFC Awards



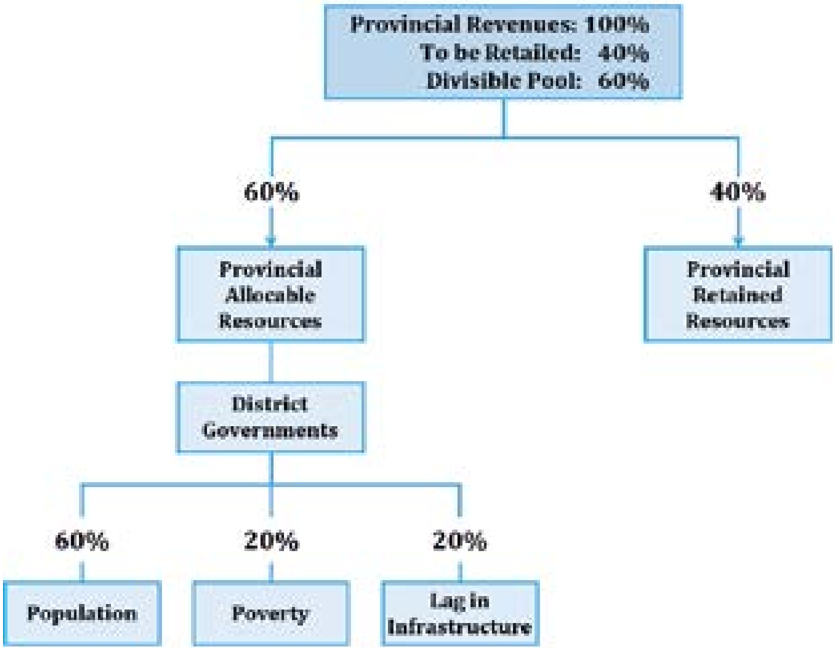
The Provincial revenues are first retained to cover obligatory expenditures like salaries and allowances, pensions, operating costs, law and order, and charged expenditure at the Provincial level. The net amount represents the divisible pool. The PFC decides, first, on the vertical share between the Provincial Government and all local governments combined. Second, the formula for horizontal sharing among local governments is also decided by the PFC.

There have been series of PFC Awards in each Province after 2001. A number of criteria have been used for horizontal sharing in different Awards as follows:

Population	Increase
Measure of Backwardness (Poverty or Others)	Increase
Tax Collection	Increase
Lag in Infrastructure	Increase

In addition, whenever necessary, transitional deficit transfers are also made.

The latest Award is by the Khyber-Pakhtunkhwa PFC for implementation from 2020-21. The salient features of the Award are as follows:



The total share of local governments of Khyber-Pakhtunkhwa in expenditure is given in Table 8.2. The proposed local share is almost 24 percent in 2020-21. It has been declining from almost 35 percent in 2018-19.

Table 8.2: Expenditure Share of Local Governments in Khyber-Pakhtunkhwa (Rs in Billion)

	Actual 2018-19	Revised Estimates 2019-20	Budget Estimates 2020-21
Salary	129.1	145.5	150
Non-Salary	10.2	18.2	17.8
Grant to Local Councils	4.0	5.8	6.3
District ADP	17.0	3.3	44.6
TOTAL	**160.3**	**172.8**	**218.7**
Total Provincial Expenditure	463.0	763.2	923.0
Share of Local Governments	34.6	22.6	23.7

Source: Khyber-Pakhtunkhwa Budget

8.5. Representation by Special Groups

The local government laws passed by the Provincial Governments have made provisions for representation for different groups, including the following:

The latest position is as follows:

% Share in Seats* of				
Women	Labor/Peasants	Youth	Minorities	Technocrats
15 – 33	0 – 5	0 – 2	1- 10	0 – 3
The largest quota is for women. It ranges from 15 percent to 33 percent, with the highest share in Sindh. Shares for the other special groups are small, and in some local governments in the country there is no representation of particular groups.				
**Range among Provinces*				

8.6. Implementing Devolution

Implementation of the Supreme Court Decision: The Supreme Court has passed a judgement on the 31st of March 2021 ordering the restoration of local governments in Punjab. This decision must be implemented forthwith. Any future dissolution of local governments must have the concurrence of the Local Government Commission in a Province.

Need for Support to Local Governments: Local governments have historically faced problems in local elections due to the lack of willingness of the political party in power at the provincial level to accepted diversity at the local level. Also, the 'overpowering' bureaucracy in the provincial line departments is frequently not willing to delegate powers to local functionaries. For example, the formation of the District Education Authority and the District Health Authority in Punjab are parallel structures to local governments in the Province and need to be dissolved.

Quoting Success Stories of Local Governments: There is need to highlight achievements of local governments to facilitate popular acceptance of their existence and role. Perhaps the best example is the rate of improvement in basic education indicators during the tenure of the Devolution from 2001 to 2008, as shown below:

	2001	2008	Annual Change	2019	Annual Change
Net Primary Enrollment Rate	42	55	1.9	62	0.6
Literacy Rate	49	56	1.0	60	0.4

The improvement was over two the three times faster between 2001 and 2008 with district governments and union councils in place under the Devolution Plan than between 2008 and 2019. There is evidence also that the presence of district governments spanning both urban and rural areas of a district have led to a reduction generally in the urban-rural gap.

***Case for Two-Tiered System for Local Government*:** There is need for the top tier of local government to have enough capacity for delivery of basic services and collection of revenues from local levies. At the other end there is need for a lower tier in the form of Union or Village/Neighborhood Council to reveal preferences for expansion of services and to exercise ground level accountability on the provision of services like teacher absenteeism, availability of medicines, supply of drinking water, etc. Therefore, the case for an intermediate tier may not be so strong.

***Allocation of Functions on the Subsidiarity Principle*:** There is need to follow the subsidiarity principle, as defined above, in the allocation of functions between Provincial and Local Governments. For example, the latter could also play a role along with the two tiers in identification and provision of subsidized credit to small farmers or in food-for-work programs.

***The Need to Link Taxation with Benefits*:** The motivation of taxpayers to pay due taxes is enhanced if they see a greater link with benefits received from the revenues. As such, the property tax and the local rate need to be in the domain of local fiscal powers. Further, collection responsibility must rest with the top tier of local government to ensure proper assessment and collection.

***Setting up of a Municipal Development Fund*:** Metropolitan areas like Karachi and Lahore frequently require lumpy investments for expansion of local services. A Municipal Development Fund may be created for flotation of tax-free Municipal Bonds to finance these investments. Countries like India have in place such funding mechanisms. Ability to service this debt is high in Metropolitan cities.

***Criteria for Horizontal Sharing of Provincial transfers*:** The criteria should be based on objective and relatively up to date measure at the district level of the incidence of poverty, level of human development or access to infrastructure and services to avoid disputes among local entities.

***Representation of Special Interests*:** There is a strong case for allocation of $1/3^{rds}$ of the seats to women in the local council of the top tier of local government. Also, there should be at least minimum representation of workers, peasants, minorities, youth, and technocrats.

***Local Share in Mineral and Natural Resource Taxes or Income*:** The local government in a district which has oil, gas or other mineral resources which are being exploited and revenues collected like the royalty or development surcharge must have a share of the revenue accruing to the Provincial Governments. This share may be decided by the PFC.

No Exporting of Tax Burden**:** There used to be an export tax on agricultural produce levied by District Councils. There should be no future levy of such taxes.

PART-IV

MOBILIZING RESOURCES, REDUCING EXPENDITURE AND CONTAINING GOVERNMENT DEBT

Chapter 9:

Agenda of Federal Tax Reforms

The objective of this chapter is to present a comprehensive agenda of reforms in the Federal tax system. The first section looks at the trend in the Federal tax to GDP ratio of Pakistan and presents estimates of the incidence of the tax system by sector and by income quintile. The second section highlights the high level of inequality in Pakistan and the large number of tax breaks and concessions enjoyed by the 'elite'. The taxation proposals in the Federal Budget of 2021-22 are listed in the third section. Based on this analysis the features of proposed reforms are identified in the last section.

9.1. Level, Composition and Growth of Tax Revenues

The major taxes with different levels of Government are given in Table 9.1. The dominant share, 91 percent, of tax revenues are collected by the Federal Government.

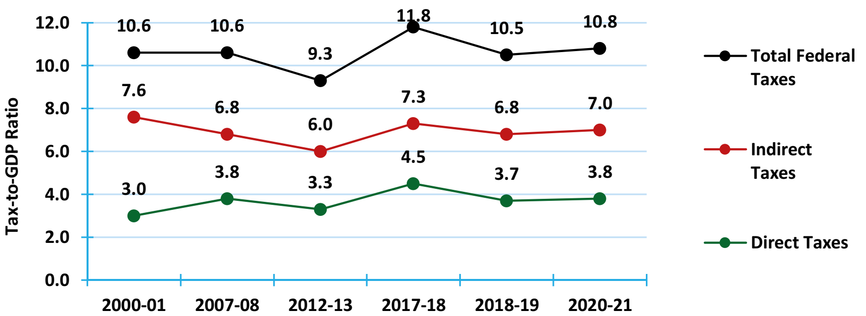
Table 9.1: Taxes of Federal and Provincial Governments

FEDERAL	PROVINCIAL
• Income Tax	• Sales Tax on Services / Electricity Duty
• Sales Tax	• Agricultural Income Tax / Land Revenue
• Import Duty	• Stamp Duty
• Excise Duty	• Urban Immoveable Property Tax
• Petroleum Levy	• Motor Vehicle Tax

The trend in the overall Federal tax-to-GDP ratio is given in Figure 9.1. The peak was attained at 11.8 percent of the GDP in 2017-18. However, it fell to 10.5 percent of the GDP in 2018-19. The year, 2019-20, has been excluded from the analysis because of the negative impact of COVID-19.

Figure 9.1: Trends in Federal Tax-to-GDP Ratio

FEDERAL TAX-TO-GDP RATIO – (%)



Source: *FBR*

Within Federal taxes, the latest share of income tax is 35 percent, with the remainder, 65 percent, being contributed by indirect taxes. The perhaps surprising finding is that the peak in collection of indirect taxes was observed as far back as 2000-01. The process of trade liberalization since then has contributed to the fall in the import duty revenues to GDP ratio. Income tax revenues have shown a rising trend reaching 4.5 percent of the GDP in 2017-18.

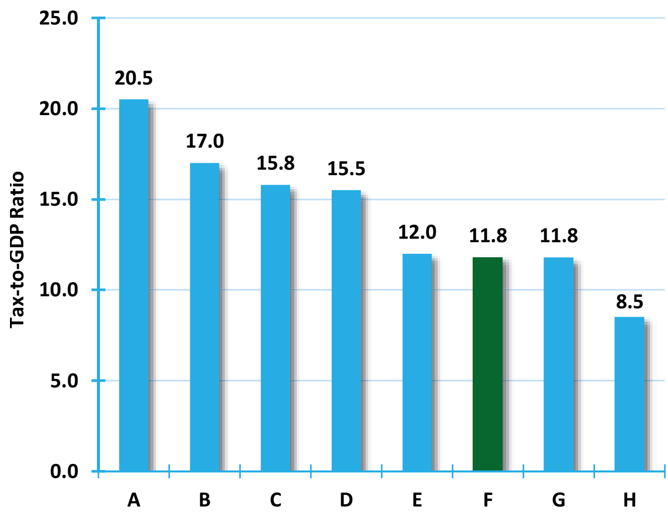
A comparison of the tax-to-GDP ratio in selected countries, especially those in South Asia, is made in Figure 9.2. Pakistan's tax-to-GDP ratio is relatively low compared to countries like China, Egypt, India, and Malaysia. However, it is higher than Sri Lanka and Bangladesh.

An effort has been to disentangle the causes of the rise in the Federal Tax-to-GDP ratio of 1.2 percent of the GDP from 2007-08 to 2017-18. It appears that the dominant part of the increase was due to a rise in tax rates. For example, the standard rate of the sales tax was increased from 12.5 percent to 17 percent. Also, the maximum rate in personal income tax was raised from 25 percent to 35 percent. Some withholding tax rates have also been enhanced. Regulatory duties have been added to import tariffs to generate more revenues.

A fundamental question relates to the distribution of the tax burden. The sectoral burden is very skewed. Almost 70 percent of revenues are contributed by industry, 26 percent by services and only 4 percent by agriculture. In effect, the tax incidence on industrial value-added is as high as 41 percent. It is below 6 percent of the value added in the other two sectors.

Figure 9.2: Tax-to-GDP Ratio in Selected Countries, 2019

TAX-TO-GDP RATIO (%)



A	CHINA
B	INDIA
C	EGYPT
D	MALAYSIA
E	INDONESIA
F	PAKISTAN
G	SRI LANKA
H	BANGLADESH

Source: *FBR*

The tax incidence in 2017-18 by income quintile of population has also been derived. The tax burden is only mildly progressive. It is 12.4 percent for the highest quintile and falls to 10 percent on the lowest quintile. As highlighted earlier the lack of more progressivity is attributable, first, to the high share, 65 percent, of indirect taxes. Second, a large part of revenues from the income tax are from withholding taxes on contracts, imports, telecom services, telephone bills, etc. This has imparted an indirect tax character to the income tax. The revenue from the personal income tax, which is progressive, is only 15 percent of the total revenues from the income tax.

A survey was undertaken a few years ago by the Institute of Public Policy (IPP) of Perceptions of Taxpayers about the tax system of Pakistan. The findings are very revealing and explain the relatively low of voluntary compliance with payment of taxes as shown in Table 9.2.

The responses highlight, first, the state capture by the elite through wide ranging exemptions and concessions and high levels of tax evasion which are either condoned by or colluded with the tax machinery. Second, willingness to pay taxes by the people at large is limited because of the perception of misuse of public funds and to no link between taxes paid and benefits received.

Table 9.2: Perception of Taxpayers of the Tax System	(IPP Survey of 1153 taxpayers)			
	Corporate Taxpayers (%)		Personal Taxpayers (%)	
	Ranking of 1st or 2nd	Ranking of 3rd to 5th	Ranking of 1st or 2nd	Ranking of 3rd to 5th
• Too many exemptions and concessions to privileged groups and sectors	32	68	42	58
• Large-scale tax evasion by the rich and powerful	50	50	54	46
• Low tax compliance because of perception of misuse of public funds by Government	40	60	34	66
• Too much corruption by Tax Officers	48	52	41	59
• Absence of a simple and friendly tax system	30	70	29	71
Source: *IPP*				

The primary objective of the tax reform agenda must be to raise the tax-to-GDP ratio to 15 percent of the GDP by 2024-25 while making the tax system markedly more progressive.

This section highlights first the extent of income and wealth inequalities in Pakistan. This is followed by identification of the tax breaks and concessions which currently the rich enjoy in Pakistan. This will indicate the key areas of reforms where tax expenditures are to be reduced and tax revenues correspondingly increased.

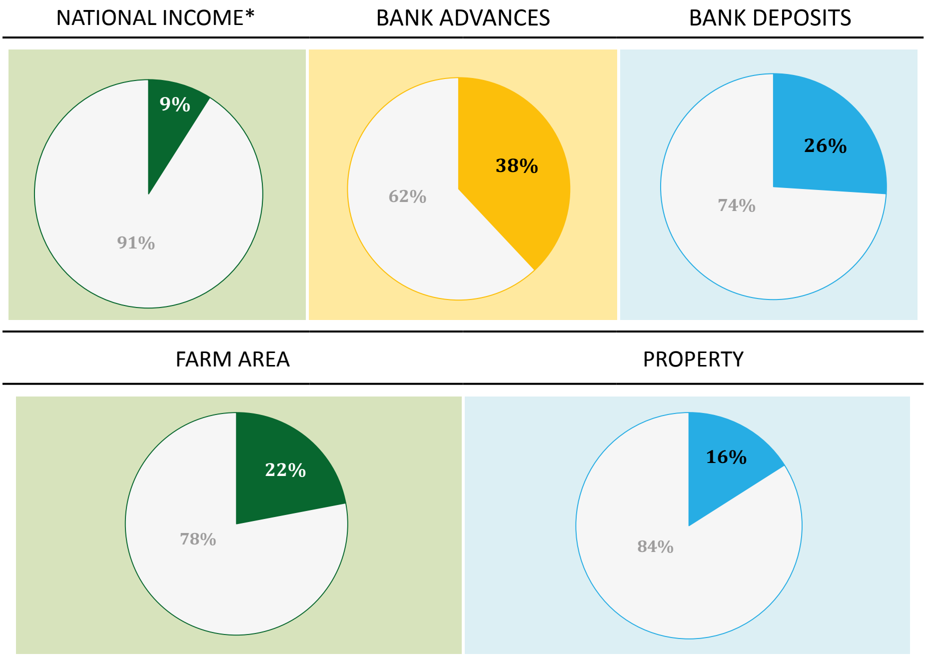
9.2. Level of Income and Wealth Inequality

A vivid manifestation of inequality in the country is the share of income accruing to and the share of assets owned by the top 1 percent of the population. This is the so-called 'elite'. The latest estimates are presented in Figure 9.3.

Almost 9 percent of the national income is pre-empted by the richest 1 percent of the population. They also own 16 percent of the wealth in the form of property owned. A striking statistic from the Agricultural Census of 2010 is that 1 percent of the largest farmers in Pakistan own as much as 22 percent of the farm area. Further, an illustration of the huge differential access to capital is that 1 percent of the largest borrowers pre-empt as much as 38 percent of the credit.

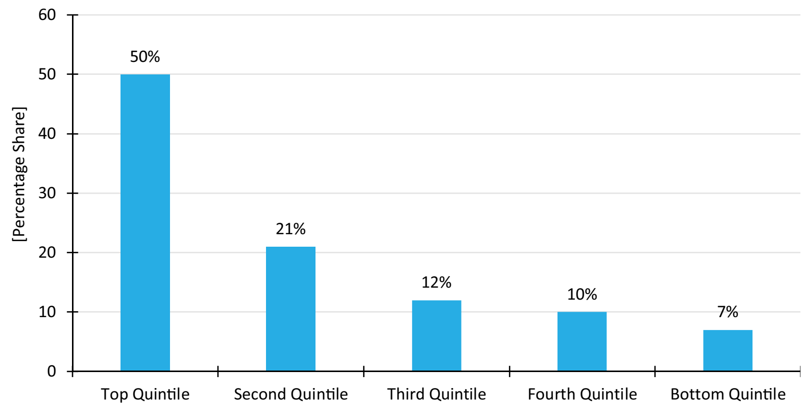
A popular measure of the extent of income inequality is the modified PALMA ratio which derives the ratio of the income share of the 20 percent of the population to the share of the bottom 20 percent of the population. It is estimated at over 7 to 1 in Pakistan, as shown in Figure 9.4, in 2018-19 after adjusting for under reporting of income. The top quintile has 50 percent of the national household income while the lowest quintile has a share of only 7 percent.

Figure 9.3: Share of the Richest 1 percent of the Population



Source: *UNDP NHDR 2020*

Figure 9.4: Share of Income by Quintile – (%)



Source: *UNDP NHDR 2020*

There is also a big variation in inequality according to the latest HIES among different sources of income, as shown below:

	Palma Ratio
• Income from home remittances from abroad by family member	15.6
• Income from property	11.2
• Income from self-employment	7.0
• Wages and Salaries	4.2
• Income from domestic remittances by a family member	2.4
AVERAGE	**7.1**

9.3. Magnitude of Tax Breaks and Concessions

The Feudal Elite

The first group is the feudal elite. They enjoy a whole range of tax privileges in direct and indirect taxes as shown in Table 9.1. The biggest tax concession is in the Provincial agricultural income tax. The tax rates are extremely low and the actual revenue in 2018-19 from the country was Rs 3 billion equivalent to 0.03 percent of agricultural value-added. The additional revenues that could be generated if the tax rates are brought close to these prevailing on non-agricultural income on the tax base in 2020-21 is Rs 105 billion. Most of the other tax expenditures are in indirect taxes adding up to Rs 90 billion. Overall, the revenue loss annually due to the tax concessions to the feudal elite add up to Rs 195 billion on a conservative basis.

Table 9.3: Tax Breaks and Concessions to the Feudal Elite (Rs in Billion)

	Tax Breaks / Concessions	Magnitude of Tax Expenditure* 2020-21
1.	Extremely low rates of agricultural income tax**	105
2.	Low rates of land revenue**	9
3.	Low sales tax rate of 2% only of fertilizer	34
4.	Lower sales tax rate on tractors of 8%	18
5.	Lower effective stamp duty on land transactions**	24
6.	Lower Petroleum Levy on LDO	5
	TOTAL	**195**

*Tax expenditure is the estimated revenue loss due to the tax break or concession.
** Provincial Taxes
Sources: *Multiple*

The Corporate Sector

Contrary perhaps to perceptions, the corporate sector, both non-financial and financial, enjoys substantial tax benefits as shown in Table 9.4. In the former case, the total tax expenditure is projected at the high level of Rs 394 billion in 2020-21. This alone is equivalent to almost 1 percent of the non-agricultural GDP.

Table 9.4: Tax Breaks and Concessions to the Corporate Sector [Non-Financial] (Rs in Billion)

	Tax Breaks / Concessions	Magnitude of Tax Expenditure* 2020-21
1.	Tax rate on Corporate Profits brought down to 29 percent from 35 percent	84
2.	Withdrawal of 'Super Tax'	12
3.	Tax Credit for Investment in BMR	59
4.	Initial Depreciation Allowance	43
5.	Lifetime Exemption from income tax to IPPs	74
6.	Lower CIT on Foreign Investment and in Backward Areas	28
7.	High level of tariff protection to some industries leading to extra-ordinary profits	11
8.	Lower sales tax rate on some industries	43
9.	Lower PIT on exports	40
	TOTAL	**394**

*Tax expenditure is the revenue loss due to tax break/concessions.
Sources: *Multiple*

This Includes the benefit of a significant reduction in the corporate income tax rate and the withdrawal of the 'super tax'. In addition, there is the tax expenditure associated with fiscal incentives given for investment, to foreign companies and for location in backward areas. The lifetime tax exemption of the IPPs implies a revenue loss of Rs 74 billion in 2020-21. Further, exporters enjoy a low PIT.

The tax concessions and benefits granted to the financial sector, primarily commercial banks, are shown in Table 9.5. The total tax expenditure is Rs 74 billion, especially due to the big reduction in the corporate income tax rate. Overall, the revenue foregone due to tax benefits to the corporate sector aggregate to Rs 468 billion.

Table 9.5: Tax Breaks and Concessions to the Corporate Sector [Financial] (Rs in Billion)

	Tax Breaks / Concessions Financial Companies	Magnitude of Tax Expenditure 2020-21
1.	Reduction in the tax rate from 44% to 29%	51
2.	Tax deductibility provision against bad debt	23
	TOTAL	**74**

Large Traders

The lowest incidence of taxes is on the wholesale and retail trade sector of Pakistan. This sector is characterized by a high degree of under taxation and tax evasion. The revenue loss estimates in this sector are given in Table 9.6. Overall, the tax expenditure, is estimated at Rs 226 billion.

Table 9.6: Tax Breaks and Concessions to Large Traders (Rs in Billion)

	Tax Breaks / Concessions and Tax Evasion	Magnitude of Tax Expenditure 2020-21
1.	Low Income Tax on Electricity Bills	50
2.	Low Withholding Income Tax on Commercial Importers	93
3.	Reduction in Tax Liabilities due to under-invoicing of imports	83
	TOTAL	**226**

High Net Worth Persons

The tax expenditure on high-net-worth persons and the likely magnitude of tax evasion is given in Table 9.7. There are multiple tax credits and concessions in the personal income tax. One of the big concessions is schedular income taxation rather than taxation of comprehensive incomes. This has greatly reduced the progressivity of the income tax system. In addition, there are many tax credits.

Table 9.7: Tax Breaks and Concessions for High-Net-Worth Persons (Rs in Billion)

	Tax Breaks / Concessions and Tax Evasion	Magnitude of Tax Expenditure 2020-21
1.	Tax credit provisions in the Income Tax Ordinance	78
2.	Schedular rather than Comprehensive Income Taxation	106
3.	Exemption from long-term Capital Gains Tax	54
4.	Low assessment of Property Tax, Income Tax and Stamp Duty on large Urban Properties	92
5.	Big Exemption from Withholding Tax on Electricity Bills	56
	TOTAL	**386**

Overall, the quantum of tax expenditure in the case of high-net-worth persons is estimated at Rs 386 billion in 2020-21.

Further, a conservative estimate of the quantum of income tax evasion is Rs 400 billion. Mechanisms will need to be identified to curb this evasion.

In summary, the total tax expenditure, primarily in direct taxes, both Federal and Provincial, is given in Table 9.8. for 2020-21. The overall magnitude is Rs 1235 billion, equivalent to 2.6 percent of the GDP.

Table 9.8: Estimated Magnitude of Tax Expenditure Due to Tax Breaks / Concessions by Type of Taxpayer 2020-21

	Tax Expenditure (Rs in Billion)
FEUDAL ELITE	**195**
CORPORATE SECTOR	**468**
Non-Financial Companies	394
Financial Companies	74
LARGE TRADERS	**226**
HIGH-NET-WORTH PERSONS	**386**
TOTAL	**1275**
% of the GDP in 2020-21	**2.7**

Therefore, there is substantial scope for raising the tax-to-GDP ratio by almost 2.7 percent of the GDP primarily by reforms in the direct tax system of the country.

9.4. Taxation Measures in 2021-22 Budget

The significant measures for increasing revenues or providing relief are listed below

Measures for Increasing Revenue

Customs Duty

- Increase in regulatory duty on import of mobile phones, non-essential luxury items.

Sales Tax

- Withdrawal of zero rating from petroleum crude oil.
- Enhancement in sales tax on RLNG from 12 percent to 17 percent.
- Taxation of sugar on the retail price.
- Excise duty on mobile phone calls above 5 minutes, at 75 paisas per call.
- Installation of point-of-sale equipment with link to the FBR system. The target is 500,000 retail sales outlets.

Income Tax

- Levy of final income tax of 1 percent on exports of services.
- Elimination of block taxation of property income, capital gains on disposal of property if gain exceeds Rs 20 million and interest income if it exceeds Rs 5 million.
- Reduction in threshold of monthly electricity bill for withholding tax on electricity consumption from 75000 to Rs 25000 from domestic users not appearing on the Active Taxpayers List.
- Taxability of profit on debt component of GP and other funds.
- Withdrawal of some personal income tax exemptions.
- Some tax credits, concessions and exemptions withdrawn from the corporate income tax.

Measures of Relief

Customs Duty

- Reduction in customs duty, additional duty, and regulatory duty on imported inputs for textiles, iron and steel pharmaceuticals, food processing; tourism, footwear, and poultry industries.
- Exemption on import of COVID-19 items and life-saving drugs.

Sales Tax

- Threshold of sales tax on cottage industry raised from Rs 3 to Rs 10 million.
- To encourage IT industry, import of plant, machinery and raw material by Special Technology Zone exempted from sales tax.
- General exemption on electric vehicles and reduced sales tax on small vehicles.

Excise Duty

- Exemption from excise duty to all industrial units in FATA and PATA.

Income Tax

- Export of IT services from Islamabad Capital Territory exempted.
- Withdrawal of 12 withholding taxes, including the tax on cash withdrawals from the banking system.
- Reduction in rate of minimum tax on turnover basis.
- Exemption of SEZ enterprises from payment of minimum tax.

- Introduction of a special tax regime for manufacturing SMEs.
- Grant of exemption from tax to various charitable and other organizations.
- Reduction in tax rate on capital gain tax on disposal of securities from 15 percent to 12.5 percent.
- Reduction in tax liability by 25 percent for women entrepreneurs.

Assessment of Taxation Proposals

The Federal Budget of 2021-22 has targeted for a big increase in FBR revenues of Rs 1200 billion, which will require a growth rate of 24 percent that has never been achieved before. The focus is on the sales tax with targeted growth rate of 30 percent.

Already, the proposals are beginning to unravel. One of the largest taxation proposals, with a yield of Rs 100 billion, has already been largely withdrawn. This is the proposed excise duty on mobile phone calls, SMS and use of internet. The only part retained is the 75 paisa tax on mobile phone calls above 5 minutes. The apparently large proposal in sales tax of charging a full 17 percent tax rate on import or domestic supply of crude oil and raising the tax rate from 12 percent to 17 percent in the case of LNG / RLNG is likely to yield very small net revenues. Revenues collected will largely be tax input invoiced away at the first stage of value-added by refineries and power generation plants. The objective of installing POS equipment in retail sales outlets will be strongly resisted by the trading community.

The only proposal in income tax with some revenue potential is the partial transition from block-wise to comprehensive taxation. However, revenue generation will be less due to limitation placed on the extent of transition to a minimum of Rs 5 million in the case of interest income and to a minimum of Rs 20 million of capital gains. Also, comprehensive income taxation has not yet brought dividend income into its ambit.

The questionable measures to generate some revenue include withdrawal of some personal income tax exemptions and fiscal incentives for investment and other concessions withdrawn from the corporate income tax. The latter will have a significant negative impact on the level of private investment.

An appropriate measure for tax base broadening is the introduction of a 1 percent final income tax on the export of services. The potential additional revenue is Rs 10 billion. Also, incentives have been given for investment in the Special Economic Zones and Special Technology Zones.

Overall, given the limited additional revenues from the taxation proposals in the Federal budget of 2021-22, an optimistic projection of FBR revenues next year is Rs 5400 billion, implying a growth rate of just under 16 percent. The emerging shortfall will be above Rs 400 billion.

A big revenue increase is proposed in the petroleum levy, which is now classified as a non-tax revenue source. The target for 2021-22 is Rs 610 billion. At present rates of levy of Rs 3to Rs 5 per liter, the likely revenue is less than Rs 100 billion. The rate will have to be enhanced to almost Rs 25 to Rs 30 per liter to achieve the target. Given the cost-push impact on inflation, the Government may find it politically difficult to achieve such a big increase in the rate of petroleum levy during 2021-22. Therefore, there could be a revenue shortfall in the petroleum levy of over Rs 300 billion.

The Chapter next presents the comprehensive agenda of direct tax reforms at the Federal level, based on the identification and quantification of tax expenditures above and the taxation proposals in the latest budget.

9.5. Income Tax Reforms

The number of individual taxpayers is close to 3 million and the number of companies paying taxes is 43,426. The personal income tax exemption limit is Rs 600,000. There are twelve slabs, and the maximum rate is 35 percent. The corporate income tax rate is 29 percent. The top 1 percent of the companies contribute 83 percent to corporate income tax revenue, while the top 5 percent of individual taxpayers contribute 78 percent to personal income tax revenue.

The types of reform needed for withdrawal of tax expenditures highlighted in the previous section and not removed in the latest budget are described below.

Transition from Block to Comprehensive income: Currently, the practice is to tax blocks of income separately. This has greatly reduced the progressivity of the tax system. Usually, the tax return contains only earned income. Unearned income in the form of interest, dividends, property income and capital gains are subject to presumptive taxation separately. For example, interest income is subject to a fixed tax of 10 percent. A preliminary step has been taken by inclusion of rental income, interest income above Rs 5 million and capital gains above Rs 20 million in total income. However, less than 1 percent of the interest income recipients have been covered.

There is need for taxation of comprehensive income by adding all types of income. This will usually imply that the marginal tax rate on unearned income becomes higher. As such, the existing presumptive taxes should be transformed into advance withholding taxes. It will lead to a fairer tax system with persons having total income of less than Rs 600,000 being able to claim a tax refund.

Rationalization of the Withholding Tax Regime: The withholding tax system within income tax contributed 67 percent to revenues in 2018-19. There are at least 70 levies in the form of advance or fixed and final taxes. The top levies are on imports, contracts and services, salaries, dividends, interest, technical fees, exports, income from property, cash withdrawal from banks and on electricity bills. Collectively, they contribute 84 percent to the total revenue from withholding taxes. An initial step has been taken in the latest budget by the withdrawal of 12 withholding taxes.

There is a strong case for reducing the number of small withholding taxes and thereby contribute to greater use of doing business. The advance tax on electricity bills should be developed as a way of taxing incomes in the informal sector. Also, the same advance tax rates should be charged from filers and non-filers, as the latter may be genuinely exempt.

Changing the Tax Credit Scheme: The tax credit scheme for individual and corporate taxpayers is as follows:

Tax Credit On	Up To
• Charitable Donations	• 30% of individual taxation income • 20% in the case of companies
• Investment in Shares and Insurance	• 20% of individual taxable income
• Investment in Health Insurance	• 5% of taxable income

The formula for determining the tax credit is as follows:

$$\textbf{Tax Credit} = \frac{A}{B} \times C$$

where A = amount of tax assessed, B = taxable income, C = amount spent for claiming the tax credit. This favors the larger taxpayer whose average tax rate is higher. As such, a fixed tax credit should be given equal to 15 percent of the amount spent for claiming the tax credit, subject to the condition that the minimum overall income tax liability is zero.

Further, a tax credit facility may be offered on repayment of housing loans up to 20 percent of income or 20,000 per month whichever is lower.

Broadening the Base of Capital Gains Tax: The capital gains tax currently applies for a holding period. If an asset is sold after the holding period, there is no capital gains tax. This is an unusual exemption and favors the privileged class which owns assets, sells them, and can hold them for long durations.

The holding period facility is as follows:

	Holding Period Exemption on Capital Gains if greater than
Property	4 years
Vacant Land	8 years
Shares	6 years

Netting out the impact of inflation and, in effect, tax real capital gains, the present system of tax for capital gains on property is as follows:

Capital Gain, A Rs	
Holding Period	Capital Gain Taxable
< 1 year	A
1 year to 4 years	¾ A
> 4 years	0

The proposal is to make all holding periods taxable as follows:

Capital Gain, A Rs	
Holding Period	Taxable
< 1 year	A
1 year to 5 years	¾ A
5 years to 10 years	½ A
Beyond 10 years	¼ A

In addition, detection of evasion can also be done via personal (domestic) electricity bills. For unclear reasons, the exemption limit of the withholding tax has been raised enormously by FBR to Rs 75000 per month of electricity bill. The proposal is as follows:

Withholding Income Tax on Domestic Electricity Bills	
Monthly Electricity Bill (Rs)	Advance / Withholding Tax Rate
Less than Rs 20,000	Exempt
Rs 20,000 to Less than Rs 40,000	5%
Rs 40,000 to less than Rs 60,000	7½%
Rs 60,000 and above	10%

Now, this withholding tax has been introduced only on persons who are not in the Active Tax payers list and have a bill above Rs 25000.

Progressive Corporate Income Tax: There are many corporate entities which are favorably placed in the market situations and enjoy a degree of monopoly power. Sometimes, higher profits are also due to access to a scarce natural resource or because of rise in prices of competing imports.

The proposal is to introduce a degree of progressivity in the corporate income tax system, as follows:

Proposed Structure of Corporate Income Tax	
Pre-Tax Net Return on Equity	Tax Rate (%) | (on Net Profits)
0% to less than 20%	29%
20% to less than 25%	29% + 10% on the profit above 20% of equity*
25% and above	29% + 20% of the profit above 25% of equity**

*For example, if the pre-tax return on equity is 24% then the effective tax rate will be 29.4%
**For example, if the pre-tax return on equity is 30% then the effective tax rate is 31%

Incentives for Filing Returns: Finally, the following incentives may be given to induce tax filing by more income earners:

i) An individual taxpayer who files a tax return for the first time to be exempt from audit for the first three years.

ii) An individual who has been an active taxpayer for at least the last three years to be exempt from audit if income declared is 20 percent higher than the previous year.

Prevention of under invoicing of imports: The approach adopted should be to introduce International Trade Prices (ITPs) on imports likely to be under invoiced. These ITPs should be based on export data of the items to other countries.

Rationalization of Tax Expenditures: The proposals for rationalization of various tax expenditure are as follows:

(i) Large pensions are subject to taxation in most countries. As such a flat rate of 10 percent may be charged on pensions amounts above 2,000,000 annually.

The tax credit to NGOs should be made available only to those NGOs operating in the fields of education, health, or social safety nets.

The Initial Depreciation Allowance and the Tax Credit on BMR should be retained as fiscal incentives for higher investment. The revenue foregone will be more than recovered by the expansion in the value added tax base due to the investment. However, the first facility has been withdrawn in the budget for 2021-22.

Reducing the Number of Slabs in the Personal Income Tax: A comparison is made below of the personal income tax system in four South Asian countries as follows:

Country	Threshold Level*	Maximum Tax Rate (%)	Number of Slabs	Level at which Maximum Rate is attained*
Pakistan	2.8	35	12	352
India	1.8	30	7	13
Sri Lanka	0.0	24	7	4
Bangladesh	1.4	30	6	16
*In relation to per capita income				

The proposal is to simplify the personal income tax system and reduce the number of slabs from 12 to 6, with the proposed maximum tax rate of 30 percent applicable on annual taxable income above Rs 15 million as compared to Rs 75 million currently.

Minimum Taxation of Rental Income: The total revenue collected from rental income taxation is Rs 20 billion, which is not even 1.5 percent of the total revenues from the income tax. The estimated rental income on property owned by households in the top two income quintiles is over Rs 780 billion. As such, the potential revenue is at least three times the actual revenue.

Therefore, to control the underreporting of rental incomes, it is proposed to introduce a minimum tax on rental incomes. The minimum rental value of a property may be set at 2½ percent of the capital value as per the Valuation Tables of FBR for neighborhoods in the cities of Pakistan.

Income Taxation of Commercial Banks: The credit extended by commercial banks to socially preferred sectors including agriculture, SMEs, housing, micro credit, and infrastructure is only 12 percent of total advances. There is need for raising the share of these sectors.

A taxation scheme is proposed as follows:

First Part	Second Part	Third Part
If the share is below 20% the corporate income tax rate will be higher at 35%	For increase in credit share to beyond 20% a tax credit of 5% of the additional credit will be made available	The provision for tax deductibility for bad loans in these sectors will be increased to 10% of total advances to these sectors

Taxing the Informal Sector: The pragmatic approach to taxing sectors which are informal in nature and income earners are prone to tax evasion due to lack of documentation is to operate a regime of presumptive taxes. Proposed new measures will replace the large number of existing small withholding taxes.

The existing income tax-to-income ratios has been derived in Table 9.9 below, based on estimates by FBR of collection from different sectors of the economy. The lowest ratios are observed in large sectors like wholesale and retail trade, transport and communications and private services.

Table 9.9: Income Tax Collection by Sector – FY 2018-19

	(Rs in Billion)		Effective Rate (%)
	Revenue	GDP Contribution	
Manufacturing	453.7	4294.8	10.6
Construction	235.7	734.1	32.1
Electricity and Gas	63.9	534.7	12.0
Mining and Quarrying	0.6	964.6	0.0
Transport and Communication	77.6	3900.5	2.0
Wholesale and Retail Trade	263.0	6803.7	3.9
Banking and Insurance	152.2	915.0	16.6
Private Services	198.1	4000.0	5.0
TOTAL	**1445.0**	**22147.4**	**5.4**

The proposed withholding tax system on electricity bills for commercial establishments, engaged in wholesale and retail trade and other services is as follows:

	Size of Monthly Electricity Bill
Exemption limit	Rs 1,000
Rs 1,001 – 5,000	5%
Rs 5,000 – 15,000	7½%
Rs 15,000 and above	10%

Some changes have been introduced in this withholding tax in the latest Budget. However, a stronger move is required.

9.6. Indirect Tax Reforms

The share of indirect taxes, inclusive of income withholding taxes, is very high in Pakistan at 82% and it has been increasing in recent years. Therefore, the focus should be more on broad-basing and reduction in tax rather than on enhancement of tax rates. The implementation of direct tax reforms described above should be followed by a reduction in the general sales tax rate to 15 percent.

The following reforms are proposed in indirect taxes.

i) Move towards a nationally integrated sales tax on goods and services with VAT features. This will lead to a closer approximation of the tax to a comprehensive value added tax. Both taxpayers of sales tax on goods and services respectively will file the same tax return. There will be one tax rate throughout the country and the same for goods and services. This fundamental reform will both widen the coverage and substantially reduce evasion.

ii) The time has come for the imposition of an import duty and sales tax on selected services. The 'reverse charge' principle can be applied to the collection of the tax.

iii) Reduction of tax evasion can be achieved by a levy of the sales tax on more goods on the manufacturer on the basis of the notified retail price. Most luxury consumer goods and consumer durables should be taxed on the retail price and paid for by the manufacturer.

iv) The excise duty is leviable on items which can be considered as harmful. As such, it should be extended on all and services which pollute the environment or lead to the depletion of natural resources that are important from the environmental point of view like wood products.

Chapter 10: Provincial Tax Reforms

10.1. The Provincial Tax System

According to the allocation of fiscal powers in the Constitution the Provincial Governments have been given taxes on the bases of exclusion and residual powers not assigned to the Federation. The two taxes partitioned out are the sales tax on services versus the tax on goods and agricultural income tax out of the overall income tax. Other major Provincial taxes are land revenue, urban immoveable property tax, motor vehicle tax, entertainment tax, electricity duty and the tax on professions, trades, and callings. The stamp duty is not charged under a fiscal statute but for documentation of transactions.

The level of and trend in Provincial tax revenues is given in Table 10.1. Following the 7th NFC Award which granted the Provinces the right to levy the sales tax on services there is a visible enhancement in the growth rate. In 2018-19, the Provincial tax-to-GDP ratio crossed 1 percent of the GDP. However, there still exists considerable potential for making Provincial taxes yield more revenues in a progressive manner.

Table 10.1: Trend in Provincial Revenues (Rs in Billion)

	2004-05	2009-10	2014-15	2018-19	2020-21 (R.E)	Share (%)
Four Provinces Combined	35	55	206	402	508	100.0
Punjab	20	30	98	193	227	44.7
Sindh	12	22	194	178	230	45.3
Khyber-Pakhtunkhwa	2	2	11	20	33	6.5
Balochistan	1	1	3	11	18	3.5
Total Revenues as % of GDP	**0.5**	**0.4**	**0.7**	**1.0**	**1.1**	

(R.E) = Revised Estimates.
Source: *MOF, Fiscal Operations*

Table 10.1 also reveals that the two bigger Provinces, Punjab, and Sindh, with higher per capita income, collect the bulk of Provincial tax revenues. Further, according to Table 10.2, the largest Provincial tax is the sales tax on services with a share of 52 percent and bulk of the revenue is from indirect taxes. Taxes like the agricultural income tax and the urban immoveable property tax currently yield only minor revenues. The focus in the Provincial tax reforms is primarily on these three taxes.

Table 10.2: Composition of Provincial* Tax Revenues (Revised Estimates – 2020-21) (Rs in Billion)				
	Punjab	Share (%)	Sindh	Share (%)
Direct Taxes	32.9	14.5	4.5	2.0
Tax on Income (Agriculture)	2.5		0.6	
Property Tax	14.4		3.6	
Land Revenue	16.0		0.3	
Indirect Taxes	192.1	84.6	218.6	95.0
Sales Tax on Services	121.0		125.0	
Stamp Duty	37.0		12.8	
Motor Vehicle Tax	12.5		10.3	
Maintenance of Infrastructure Fee	6.0		70.5	
Others	2.0	0.9	6.9	
TOTAL	**227.0**	**100.0**	**230.0**	**3.0**

*Revenues of Baluchistan and Khyber-Pakhtunkhwa are small
Source: *Provincial Budgets*

10.2. Agenda of Provincial Tax Reforms

The development of the agricultural income tax is first focused on.

Agricultural Income Tax

The agricultural income tax has the potential of being a very progressive income tax given the extremely skewed distribution of farms by size in Pakistan, as shown in Table 10.3. However, development of this tax has been limited by the potential influence of landlords in the Provincial Legislatures.

Table 10.3: Distribution of Farms by Size in Pakistan		
Farm Size (Acres)	% of Farms	% of Farm Area
Under 1.0	15	1
1.0 to Under 2.5	28	7
2.5 to under 5.0	21	11
5.0 to under 12.5	25	28
12.5 to under 25.0	7	18
25.0 to under 50.0	3	12
50.0 and above	1	22
TOTAL	**100**	**100**

Source: *Agricultural Census, 2010.*

The extremely high level of inequality in farm incomes is amply demonstrated by the fact that the top 1 percent of farm owners have as much as 22 percent of the farm area and the top 4 percent own 34 percent of the farm area.

However, the agricultural income tax currently yields a paltry Rs 3 billion in the whole of Pakistan. The estimated net crop income in farms of 25 acres or more is Rs 670 billion in 2020-21. As such the incidence of the tax is currently only 0.4 percent of net income of farmers, who should be in the tax net with large farms of 25 or more acres.

Currently, the agricultural income tax in Punjab is land based, despite the presence of an income-based alternative. The tax structure is given below:

1.	Up to 12.5 acres	Exempt
2.	12.5 – 25 acres	Rs 100 per acre
3.	25 acres – 50 acres	Rs 250 per acre
4.	50 acres or more	Rs 300 per acre

According to this tax system, the revenue yield in Punjab should be Rs 2.6 billion. The actual revenue was Rs 2.0 billion. Clearly, the Board of Revenue has attached low priority to collecting revenue from the tax.

The reform of the tax should be a significant enhancement in the flat tax rates, given that the average net income per acre is at least Rs 30,000 in Punjab. However, the income per irrigated acre is approximately two times the income in barani areas. Also, the flat rates should be made more progressive.

The proposed tax system may continue to be presumptive in nature to preserve the simplicity of the system. The tax liability may be linked to farm size with an irrigated farm treated as twice the taxation size of a barani farm of the same physical size. However, the proposed tax system is more progressive as follows:

Farm Size (Acres) (Measured in equivalent barani area)	Tax Rate per
< 25	Exempt
25 – 50	Rs 500 per acre
50 – 100	Rs 1,000 per acre
100 – 150	Rs 2,500 per acre
150 and above	Rs 5,000 per acre

The estimated revenue yield is Rs 60 billion in Punjab. With a similar tax system in the other three Provinces the potential revenue is Rs 45 billion. Therefore, the estimated revenue yield from the agricultural income tax is Rs 105 billion. However, given the big jump in the PIT rates the implementation process will have to be somewhat staggered.

Urban Immoveable Property Tax

The property tax currently yields Rs 14 billion in Punjab and under Rs 6 billion in Sindh. The tax is not only progressive in nature but also the major source of revenue to local governments, although collection continues to be by the Provincial Excise and Taxation Departments. A case study is undertaken below of the property tax system in Sindh.

The tax is charged at 25 percent of the annual assessed value of lands and buildings. The determination of the Annual Rental Value is as follows:

Size of Plot x Rate x 12	Covered Area x Rate x 12
Annual Rental Value = [(a) + (b)] less 10% allowance for repairs and maintenance	

The category wise rates have been specified for each Zone / Neighborhood. Historically, these were referred to as the 'DC Rates'. The low property tax revenue is primarily due to the rates which were assessed in many cities decades ago.

Exemptions to properties are as follows:

i) Annual rental value less than Rs 864.

ii) Plot size less than 120 sq. yds.

iii) Flat with covered area less than 600 sq. ft.

iv) Property owned by a widow or orphan.

A comparison of the revenue from property tax collected by the Mumbai Municipal Corporation reveals the extent of non-exploitation of this source in Karachi. The revenue in the former city is Rs 120 billion while it is less than Rs 4 billion in Karachi.

An exercise is undertaken stepwise to assess the revenue potential of the property tax in the urban areas of Pakistan as follows:

i) Based on the PBS Household Integrated Survey of 2018-19 the total annual rent of households in Pakistan is Rs 1846 billion.

ii) The share of urban areas is 60 percent, equivalent to Rs 1107 billion.

iii) The distribution in urban areas is as follows:

Properties	%	Rent (Rs in Billion)
• Rent of Exempt Properties	9%	Rs 100 billion
• Non-Exempt Properties	99%	Rs 1007 billion
• Share (%)		
Owner-Occupied	84%	Rs 846 billion
Rented	16%	Rs 161 billion
• Rent of Commercial Properties	100%	Rs 120 billion

Assessment of the revenue-potential is based on the following tax rates and tax bases:

Properties	Tax Rate (%)	(Billion Rs)	
		Tax Base	Revenue
• Owner-Occupied	7.5%	846	63.5
• Rented	15.0%	161	24.1
• Commercial	20.0%	120	24.0
TOTAL			**116**

Therefore, the property tax could yield over Rs 115 billion, equivalent to 0.3 percent of the GDP. This is in comparison to the actual revenue of Rs 20 billion in the country.

There may be an agreement reached between the Provincial Excise and Taxation Departments and the FBR on the valuation of properties. The latter agency has carried out recently a very comprehensive and careful capital valuation of properties in different cities of Pakistan at the level of localities/neighborhoods.

The PE&T Departments should accept these valuations and apply a rate of 2 ½ percent to convert the capital value of properties into rental value. The rental value exemption may be raised to Rs 8,000 per month. The other exemptions should continue.

Sales Tax on Services

The sales tax on services is yielding significant revenues in all the four Provinces as shown in Table 10.4. The smaller Provinces are more dependent on the sales tax on services. Currently, 58 percent the tax revenues of the four Provincial Governments are generated from this tax. Also, the consumption of services is progressive in nature.

Table 10.4: Revenue from the Sales Tax on Services 2020-21 (R.E)

Punjab	13.6.6	60
Sindh	125.0	54
Khyber-Pakhtunkhwa	19.1	58
Balochistan	12.5	71
TOTAL	**293.2**	**58**

Source: *Provincial Budgets*

Unfortunately, there has been a ‘race to the bottom’ with Provinces reducing their tax rates to attract the mobile tax bases. Currently, the sales tax rate is 14 percent in Sindh, 15 percent in Khyber-Pakhtunkhwa and Balochistan and 16 percent in Punjab.

Services constitute over 57 percent of the GDP of Pakistan. However, there are large segments of each service sector in the informal part of the economy. Therefore, there is need to assess the size of the national tax base as follows:

i) The shares of the value added in the formal component of different sectors, as estimated from the PBS Labor Force Survey of 2017-18 are as follows:

Services	% Formal	Size of Tax Base – 2020-21 (Rs in Billion)
• Finance and Insurance	100	775
• Information and Telecommunication	100	954
• Hotels and Restaurants	50	563
• Private Services (excluding Education and Health)	25	652
• Wholesale and Retail Trade	10	867
TOTAL		**3811**

The largest sources of revenue from the sales tax on services are port, airport, and terminal operators; franchises: banks; insurance companies; contract execution; telecommunication; consultants; construction; labor and manpower services and restaurants.

One of the biggest and desirable tax reforms, as highlighted in the previous Chapter, is agreement among the Federal and Provincial Governments to move towards a National Integrated Sales Tax on Goods and Services with the characteristics of a value added tax.

This reform will lead to a sectorally neutral form of indirect taxation. The use of a common tax return and comprehensive input invoicing will facilitate an integrated information system on taxpayers and substantially reduce the tax evasion.

Also, double taxation in operation currently can be curtailed. The Federal Government will have to withdraw the excise duty on financial services and reduce drastically the presumptive income tax on mobile phone cards. However, more revenue can be collected from the withholding income tax on other services. Further, credit for input invoicing can take place between the two levels of Government. This system is not operating well currently.

There will be need for there to be one common tax rate on goods and services and for this rate to apply throughout the country. Conservative estimate based on a standard sales tax on services rate of 15 percent indicate that the reform could yield additional revenues equivalent to 0.5 percent of the GDP.

The additional revenues that could accrue to the Provincial Governments from the tax are of the order of Rs 222 billion, equivalent to almost 0.5 percent of the GDP.

Other Provincial Taxes

The reform proposals for other taxes are as follows:

i) The Federal and Provincial Governments should jointly support a Census of Establishments by the PBS. The last such Census was as far back as 2005. This will greatly facilitate identification of potential taxpayers in different taxes like the Provincial tax on Professions, Trades and Callings.

ii) The motor vehicle tax is flat rate in nature and varies by type of vehicle. It should be adjusted upwards periodically in line with inflation.

iii) There is a strong case for merger of the entertainment tax with the sales tax on services.

Overall, the reforms proposed above have the potential of doubling the Provincial tax-to-GDP ratio of the four Provinces combined from about 1 percent of the GDP currently to 2 percent of the GDP.

Chapter 11:

Rightsizing the Federal Government

The issue of rightsizing of the Federal Government has assumed importance after the 18th Amendment whereby functions have been transferred to the Provincial Governments. However, this process of decentralization remains incomplete. Also, in the presence of a growing budget deficit it has become necessary to economize on expenditure to the extent possible.

11.1. Growth in Federal Expenditure

The trend in the level of aggregate current and development expenditure is given in Table 11.1. Prior to the 7th NFC Award in 2010, Federal spending was growing rapidly at almost 19 percent per annum. Thereafter, the growth rate has come down, but it is still at 12 percent. In fact, the total expenditure is growing annually in real terms at 5 percent. This implies that Federal employment continues to increase.

Table 11.1: Trend in Aggregate Federal Expenditure (Rs in Billion)

	2004-05	2009-10	g (%)*	2014-15	g (%)	2018-19	g (%)	2020-21 (R.E)	g (%)*
Current Expenditure	719	1805	18.4	3070	10.6	4804	9.0	6561	15.6
as % of GDP	*10.0*	*12.1*		*11.2*		*12.5*		*13.7*	
Development Expenditure	153	432	20.8	691	9.3	795	2.8	72.6	-4.5
as % of GDP	*2.2*	*2.9*		*2.5*		*1.7*		*1.5*	
Total Expenditure	872	2237	18.8	3761	10.4	5599	9.9	7287	13.2
as % of GDP	*12.2*	*15.0*		*13.7*		*14.2*		*15.2*	

*Annual average growth rate
Source: *MOF Fiscal Operations*

The next stage in the analysis is to determine the trend in different components of current expenditure. This is shown in Table 11.2. The biggest increase is in the cost of debt servicing, which has gone up from 2.9 percent of the GDP in 2004-05 to 5.5 percent of the GDP in 2018-19. There has been a decrease in the cost of running the civil Government from 1.4 percent to 1 percent of the GDP. However, this effect has been more than neutralized by the increase in pension payments from 0.4 percent to 1 percent of the GDP. The mushrooming in pension expenditure has now become a matter of concern.

Table 11.2: Trend in Components of Federal Current Expenditure					(Rs in Billion)
	2004-05	2009-10	2014-15	2018-19	2020-21 (R.E)
CURRENT EXPENDITURE	**719**	**1805**	**3070**	**4804**	**6561****
		(18.4)*	(10.6)	(9.0)	(15.6)
Debt Servicing	210	642	1304	2090	2851
		(22.3)	(14.1)	(9.4)	(15.5)
Pensions	32	64	185	393	470
		(13.9)	(21.2)	(15.1)	(8.9)
Grants	125	332	321	469	932
		(19.5)	(-0.6)	(7.6)	(34.3)
Subsidies	37	251	328	319	430
		(38.2)	(5.4)	(-0.5)	(14.9)
Defense Services	212	375	697	1146	1295
		(11.4)	(12.4)	(9.9)	(6.1)
Running of Civil	103	141	235	387	488
Government		(6.3)	(10.2)	(10.0)	(11.6)
		(as % of GDP)			
CURRENT EXPENDITURE	**10.0**	**12.1**	**11.2**	**12.5**	**13.7**
Debt Servicing	2.9	4.3	4.8	5.5	6.0
Defense Services	3.0	2.5	2.5	3.0	2.7
Grants plus Subsidies	2.3	3.9	2.4	2.1	2.8
Running of Civil Government	1.4	1.0	0.0	1.0	1.0
Pensions	0.4	0.4	0.7	1.0	1.0

*Annual compound growth rate | ** including emergency provision of Rs 95 billion
Source: *MOF, Fiscal Operations*

There is need also to highlight the sharp drop in Federal development spending from the peak of 2.9 percent of the GDP in 2009-10 to a low of 1.7 percent of the GDP in 2018-19. Clearly, debt servicing and other current expenditure are ‘crowding out’ development spending.

The fall in development expenditure implies, first, that the potential GDP growth rate has been reduced. Also, with the large throw-forward of on-going projects this has implied delays in implementation and big cost overruns.

11.2. Employment Structure of the Federal Government

The structure of the Federal Government can be categorized in three parts, namely, the Secretariat, Attached Departments and Autonomous Bodies. There is the wrong perception that the Secretariat is where there is the major share of employment. Table 11.3 clearly shows that this is not the case. Not only is the total employment large at close to 1 million but also the share of this employment in the Secretariat is only 2 percent.

Table 11.3: Size of Employment in the Federal Government – 2019-20

	(Number of Filled Posts)		Total	Estimated Share in Employees Cost (%)
	BPS 1-16	BPS 17-22		
Secretariat	10,850	2,372	13,222	2
Attached Departments	521,024	22,583	543,607	52
Autonomous Bodies	326,143	63,154	389,297	45
Constitutional Bodies	6,727	1,526	8,253	1
TOTAL	**864,744**	**89,635**	**954,379**	**100**

Source: *Establishment Division, GOP*

The number and role of many attached departments and autonomous bodies remains largely hidden from public view. There are, for example, as many as 204 autonomous bodies with employment approaching 390,000. The total employment in attached departments is even larger at almost 544,000.

11.3. Budgetary Impact of SOEs

Many of the institutions under the umbrella of the Federal Government can be characterized as State-owned Enterprises (SOEs). There are 85 Commercial SOEs of the Federal Government operating in Pakistan today. The sectoral distribution of these SOEs is concentrated in the four sectors of power, finance, and manufacturing and mining, transport and communications. The total value of assets is as much as Rs 20.7 trillion and the annual revenue is Rs 5.5 trillion, while the employment is almost 420,000.

Units with large losses include the PIA, Railway, Zari Taraqiati Bank, Pakistan Steel Mills, and the Pakistan Post Office while these with large profits are the Oil and Gas Development Corporation, Pakistan Petroleum Ltd., National Bank of Pakistan, Pak-Arab Refinery and Pakistan State Oil.

There is need to quantify the net financial impact of these SOEs on the Federal Budget. Ideally there should be a big net inflow of dividends and repayment of debt to the Government. Unfortunately, this is not the case and there is a need to strongly focus on the extent to which the situation can be improved.

Analysis is undertaken of the net budgetary impact of SOEs from 2012-13 to 2020-21, the former with revised estimates and the latter on budget estimates. The results are presented in Table 11.3.

There is, no doubt, a significant inflow from the SOEs into the Federal budget, which includes interest payments and dividends. However, it has declined sharply from the peak level of Rs 210 billion in 2017-18 to Rs 85 billion in 2019-20. In particular, the SOE's ability to service their debt obligations has fallen by 72 percent. However, there is the expectation that the inflow will pick up substantially in 2020-21. This is highly unlikely.

Table 11.4: Budgetary Impact of SOEs, 2017-18 to 2020-21				(Rs in Billion)
	2017-18 (R.E)	2018-19 (R.E)	2019-20 (R.E)	2020-21 (B.E)
A. REVENUES FROM SOEs	**210.0**	**181.6**	**85.0**	**153.3**
• Interest Payment	130.0	121.0	36.9	93.3
• Dividends	80.0	60.6	48.1	61.0
B. COST OF SOEs	**369.5**	**487.9**	**704.2**	**708.0**
• *Contingent Liabilities*	*195.0*	*210.0*	*302.5*	*232.0*
• ***Grants to Railway & PSM***	***38.5***	***37.0***	***45.0***	***40.0***
• *Subsidies*	*108.0*	*214.8*	*317.0*	*149.0*
- WAPDA / PEPCO	81.5	189.9	211.0	129.0
- USC	4.0	6.0	43.5	3.0
- PASSCO	17.5	18.9	15.5	7.0
- TCP	5.0	-	-	-
- PETROLEUM	-	-	47.0	10.0
• *Settlement of Circular Debt*	-	-	-	*160.0*
• ***Loans***	**-**	***26.1***	***33.2***	***36.0***
- PIA	-	19.6	27.1	20.0
- Steel Mill	-	6.5	6.1	16.0
• *Others*	-	-	-	-
- Equity in CPPA-G	-	-	6.5	-
C. NET BUDGETARY IMPACT	**159.6**	**226.9**	**487.3**	**524.7**
• % of Budget Deficit	6.7	6.3	13.5	14.5
• % of GDP	0.4	0.6	1.2	1.1
Source: *MOF, Budget Documents*				

Turning to the cost of the SOEs to the Federal Budget, there are various components. These are, first, payment against contingent liabilities of guaranteed debt which SOEs are unable to service. Second, there are operating subsidies and loans to SOEs.

The total cost imposed on the Federal Budget is large as shown in Table 11.4. Contingent liabilities were Rs 195 billion in 2012-13 which have increased by 55 percent by 2019-20. Grants, subsidies, and loans aggregated to Rs 147 billion and have mushroomed to Rs 225 billion in 2019-20.

Overall, the cost imposed on the Federal Budget by SOEs was Rs 704 billion in 2019-20. An optimistic projection is that it will remain, more or less, at this level even after some retirement of circular debt.

The net negative impact has increased from Rs 160 billion in 2017-18 to Rs 487 billion, a tripling of the level in two years. This is unprecedented. In 2019-20 the net burden of the SOE was equivalent to 1.2 percent of the GDP, and almost 14 percent of the budget deficit is attributable to the SOEs.

11.4. Implementing the Rightsizing

There Is need for actions of a structural nature to both downsize the Federal Government and to reduce the burden imposed by the SOEs.

***Rationalization of Number of Divisions*:** Chapter 6 indicates that many Divisions can be merged. This will not only reduce costs but will also enable greater integration in the performance of functions.

***Privatization of SOEs*:** Chapter14 indicates the plans of the Government for privatization of 44 SOEs and liquidation of one SOE. However, the recommended privatization of DISCOs in power distribution is not justified as it will lead to the creation of many 'natural monopolies', and inter-disco tariff differentials subsidy would need to continue from the Government.

***Management of Retained SOEs*:** Many of the large SOEs with big losses are proposed to be retained on the grounds that they are delivering core services or providing basic infrastructure. This includes the Railway, PIA, National High Authority, Pakistan Post Office and 37 other smaller entities.

There is need to prepare Results-Based plans for improvement in the operations of these entities. This will involve partial retrenchment of surplus staff, reconstitution of the Board of Directors, changes in senior management, appropriate and feasible changes in pricing policies, critical new investment for reducing costs, etc. These plans should be made public by the relevant Divisions.

***Reduction in circular Debt*:** The circular debt of the power sector has risen exponentially. It now stands at Rs 2.8 trillion and is rising annually by almost Rs 500 billion. The focus must be on reducing the increase in circular debt by cutting down losses, renegotiating with IPPs on capacity charges, preserving a merit order of plants and using only those with lower fuel costs. These reforms are discussed in Chapter 23.

***Rationalization of Development Portfolio*:** Chapter 13 describes the recommended strategy for cost-sharing with Provincial Governments, projects which relate to performance of functions in FLL-II and handing over of projects neither in FLL-I nor in FLL-II. Further, The Federal PSDP should generally avoid projects which are intra-Provincial in nature and focus primarily on development of trunk infrastructure.

***Managing the Growth of Pensions*:** The emerging problem is the extremely rapid increase in pension payments to almost half a trillion Rs at the Federal level. Inclusive of corresponding payments by the Provincial Governments the pension bill has approached Rs 1 trillion, and it is doubling every six years. There is need first for an exercise of actuarial valuation of future liabilities. A mechanism will have to be found for a contribution scheme of superannuation both by the employee and by the Government. Implications of increase in the retirement age to 63 years will also need to be worked out. Also. As part of the increase of 25% increase in salary a part may be deducted monthly as the employee's contribution to a Pension Fund set up by the Government.

***Withdrawal of Vacancies*:** The Federal Government has taken the appropriate decision of cancelling 70,000 vacancies in the Secretariat, autonomous bodies and attached departments. Creation of new vacancies should be avoided for at least the next three years. In addition, there is the need to study the scope for retirement of selected employees after they have completed 25 years of and attained the right to superannuation.

***Staggering of Future Salary Increases*:** The Federal Government has recently notified the grant of a so-called Disparity Reduction Allowance (DRA) at the rate of 25 percent of the basic pay scales of 2017, which would be effective for BPS 1-19 employees from March 2021. This will be admissible to all civil employees of the Federal secretariat and attached departments. It is likely to be extended to BPS 20-22 employees from July 1 onwards. The annual cost will be close to Rs 50 billon. There will be a need to consider extension of this facility also to military personnel, which will add Rs 130 billion to the cost. In addition, a further increase of 10 percent in salaries and allowances has been announced in the Federal budget of 2021-22.

There have been mostly annual increases in salaries of Government employees, generally each time by 10 percent. However, the last such increase was in the Budget of 2018-19. It is estimated that due to these periodic increases the real salary of an employee will have increased by 23 percent between 2015-16 and 2020-21. This is more than the increase in real wages and salaries in the private sector. Clearly, following the recent increase there will be need for staggering a future salary increase to the budget of 2023-24 if the growth in the salary bill is to be restrained.

Chapter 12:

Reducing Government Debt

The management of public debt is one of the principal responsibilities of the Federal Government. An important piece of legislation, the Federal Responsibility and Debt Limitation Act (FRDL) was passed by the National Assembly in 2005. The first task is to determine the extent to which the FRDL Act has been adhered to. The Act has the definition of Government debt as domestic plus external debt minus cash balances with the banking system. Public debt has a broader coverage and includes debt owed also to the IMF.

The Chapter identifies the different types and sources of growth in the Government debt. This is followed by a statement on what should be the different components of a Debt Management Policy.

12.1. Level of Government debt in South Asian Countries

The level of Government debt in major South Asian countries is given in Table 12.1. Pakistan had the second highest Government debt to GDP ratio after Sri Lanka in 2015.

However, the biggest increase from 2015 to 2020 of over 20 percent of the GDP is observed in India, especially due to the impact of COVID-19 on the size of the Indian GDP and the budget deficit. Consequently, Pakistan has a lower Government debt to GDP ratio now than India and Sri Lanka.

Table 12.1: Evolution of General Government Debt in South Asian Countries
(% of GDP)

Countries	2015	2020
Bangladesh	33.7	39.6
India	68.8	89.3
Nepal	25.5	39.2
Pakistan	72.1	79.7
Sri Lanka	78.5	98.3

Source: *IMF*

12.2. Key Targets in the FRDL Act

This section presents the key targets in the FRDL Act and the extent to which different Governments have been able to adhere to these targets. Federal fiscal deficit was expected by the Act to be limited to 4 percent of the GDP during the three years, beginning from 2017-18. The outcome has been a Federal deficit of 6.5 percent of the GDP in 2017-18, 9.4

percent of the GDP in 2018-19 and 8.6 percent of the GDP in 2019-20. Therefore, there has been a big violation of the Act.

Further, from 2016-17 onwards the total Government debt was to be reduced to 60 percent of the GDP. It was 65 percent of the GDP in 2016-17 and will increase to 77 percent of the GDP by the end of 2020-21.

The third requirement of the Act was that from 2018-19 onwards the annual reduction in the Government Debt to GDP ratio should be 0.5 percent each year. The increase in 2019-20 was 0.4 percent of the GDP. The fourth restriction was that issuance of new guarantees should be restricted each year to below 2 percent of the GDP. The outstanding stock and increase in guarantees are given below for the last five years.

	Stock of Guaranteed Debt	Increase	%of GDP
2015-16	339	-	-
2016-17	938	599	1.9
2017-18	1004	66	0.2
2018-19	1265	261	0.7
2019-20	1890	625	1.5
2020-21 (end-March)	2410	510	1.1
Source: *MOF*			

Therefore, the limit of 2 percent of the GDP has not been violated in each of the last four years.

Overall, there is a weak record in adhering to the targets set by the FRDL Act.

12.3. The Composition of Government Debt

The shares of domestic and external debt respectively in total Government Debt are given in Table 12.2. The long-term trend has been for increase in the share of domestic debt. It has increased from 53 percent in 2008-09 to 66 percent in 2019-20.

However, the last few years have witnessed a significant increase in the share of external debt from 28 percent to almost 34 percent. This is not due to more borrowing but because of the big depreciation of the rupee, especially in 2018-19, which has increased the rupee value of the stock of external debt.

Turning to the composition of domestic debt in terms of the share of long-term debt in the form of Pakistan Investment Bonds (PIBs), short-term debt consisting of Market Treasury Bills (MTBs) and unfunded debt consisting of savings certificates issued by the National Savings Directorate, the changes in the respective shares are given in Table 12.3 for different periods for the increment in the stock of debt.

Table 12.2: Composition of Government Debt				(Rs in Billion)
	Central Government Debt			Debt as % of GDP
	Domestic	External	Total	
2008-09	3860	3452	7312	55.4
2009-10	4653	3667	8320	56.0
2010-11	6014	3988	10002	54.7
2011-12	7638	4365	12002	59.9
2012-13	9520	4336	13857	61.9
2013-14	10906	4786	15693	63.4
2014-15	12192	4770	16963	61.8
2015-16	13625	5418	19043	65.5
2016-17	14849	5919	20768	65.0
2017-18	16416	7796	24412	76.4
2018-19	20732	11055	37187	83.7
2019-20	23283	11825	35107	84.1
2020-21 (end-April)	25345	11733	37078	77.7
Share (%)				
2008-09	52.8	47.2	100.0	
2014-15	71.9	28.1	100.0	
2019-20	66.3	33.7	100.0	
2020-21	68.4	31.6	100.0	
Source: *SBP*				

Table 12.3: Composition of The Changes in Domestic Debt in Different Periods					
Period	Total Increase/ Stock (Rs in Billion)	Shares (%) of Incremental Debt			Average Rate of Inflation (%)
		Long-Term Debt	Short-Term Debt	Unfunded Debt	
2009-10 to 2013-14 (4 years)	6284	47.4	35.0	17.6	9.7
2013-14 to 2017-18 (4 years)	5510	4.6	77.9	17.5	3.8
2017-18 to 2019-20 (2 years)	6867	138.2	-48.2	10.0	8.6
2019-20 to 2020-2 (end-April)	2062	71.2	30.3	-1.5	9.1
Stock of Domestic Debt (end-April)	2545	75.6	14.4	10.0	100.0
Source: *SBP*					

Table 12.3 above has important negative implications. A basic element of optimal debt management policy is to avoid the 'the lock-in' effect of long-term debt when the rate of inflation is high and consequently yields are also high. The preference should be for short term debt at this time. Of course, there are limits to such a policy as maturity of large amounts of short-term debt could put pressure on the market and push up interest rates.

The opposite policy was followed in the period, 2013-14 to 2017-18, when the rate of inflation was exceptionally low at below 4 percent. Bulk of the incremental borrowing, almost 78 percent was in the form of Market Treasury Bills.

There was similarly a deviation from a prudent debt management policy in 2018-19 and 2019-20. Interest rates were at a peak during these two years with relatively high inflation. For inexplicable reasons, more than 100 percent of the net borrowing was in the form of PIBs and there was simultaneously a big retirement of short-term debt. The opposite policy should have been followed. The result is that the cost of servicing domestic debt increased by as much as 38 percent in 2018-19 and 27 percent in 2019-20.

12.4. Determinants of the rise in Government Debt

There are three factors which contribute to higher debt as follows:

i) Interest payments on the outstanding stock of debt

ii) Primary deficit in the Budget

iii) Increase in rupee value of outstanding external debt due to the depreciation of the rupee.

The contribution of these factors to the increase in the value of Government debt is given in Table 12.4. As expected, interest payments due are the largest source of increase in debt liabilities. Between 2011-12 and 2015-16 there was limited depreciation of the rupee and the contribution to the buildup of debt was small. This changed in the last two years.

Table 12.4: Contributory Factors to the Increase in Government Debt (Rs in Billion)

	Due to			Due to Increase in External Debt because of Rupee Depreciation
	Total Increase	Interest Payments	Primary Deficit	
2008-09 to 2011-12	4690 (100.0)	2229 (47.5)	1371 (29.2)	1090 (23.3)
2011-12 to 2015-16	7041 (100.0)	4706 (66.8)	1866 (26.5)	469 (6.7)
2015-16 to 2019-20	16064 (100.0)	7558 (47.0)	3766 (23.4)	4740 (29.6)

Source: *SBP*

A key element in the strategy for preventing rapid accumulation of debt is to manage the budgetary process in such a way that the size of the primary deficit is restricted to near zero.

The interest rate on domestic debt has a U-shaped curve, falling steadily from the peak of 15 percent in 2009-10 to a low of 8.9 percent in 2017-18, largely in line with the fall in the rate of inflation. Thereafter, it has risen to 11 percent.

The path of the effective interest rate on external debt is one of a persistent increase from 1.8 percent in 2009-10 to almost double at 3.5 percent in 2018-19. This reflects the underlying changes in the composition of external debt. Increasingly, there has been resort to commercial borrowing and flotation of bonds opposed to concessional multilateral and bilateral long-term borrowing.

12.5. Projection of the Level of Government Debt

The projection of the level of Government Debt as percentage of GDP has been derived up to 2024-25 and presented in Table 12.5, based on the macroeconomic projections in Chapter 1. The share of external borrowing in financing the budget deficit in coming years is expected to decline due to increased debt repayment.

Table 12.5: Projection of the Level of Government Debt (% of GDP)

	External Debt		Domestic Debt		Total Government of Debt*	
	Level (Rs in billion)	% of GDP	Level (Rs in billion)	% of GDP	Level (Rs in billion)	% of GDP
2020-21	12274	25.7	25644	53.8	36868	77.3
2021-22	14218	25.7	28433	51.4	42374	76.6
2022-23	16296	26.0	31257	49.8	46780	75.0
2023-24	18624	26.2	34309	48.2	51936	73.0
2024-25	20250	26.4	37563	46.6	56311	70.0

Source: *Estimated by projections in Chapter 1 and Chapter 11. * Excluding cash balances*

Therefore, subject to implementation of the recommended policies, the level of Government debt will gradually decline from 77.3 percent of the GDP in 2020-21 to 70 percent of the GDP in 2024-25. External debt is expected to rise as percent of GDP while domestic debt will decline as percentage of the GDP.

12.6. Managing the Government Debt

The following recommendations are made on the composition of public debt, tenure of borrowing, interest rates and borrowing in the domestic capital market.

Utilizing the Scope for 'Seigniorage': This is the extent of expansion in money supply, which is non-inflationary in character, which depends on the magnitude of increase in the transactions demand for money as the economy grows.

Various estimates have been made of the scope for 'seigniorage' in Pakistan. They range from 0.75 percent to 1.0 percent of the GDP. As such, it is recommended that the Federal Government limit its borrowing to this extent directly from the SBP. This will be effectively at zero cost as the interest paid will revert to the Government in the form of SBP profits.

External borrowing should be linked to External Financing Requirements: The risks associated with the portfolio of Government debt are associated with the share of external debt. Therefore, the level of external borrowing should be limited to the level of required external financing as estimated in Chapter 4.

Clearly, preference should be for relatively low cost and long-term multilateral and bilateral borrowing. If, however, there is an unanticipated increase in the requirement of external financing then there may be more borrowing from international Commercial Banks. Annually, there may also be an attempt to float Euro/Sukuk bonds of $2 to $3 billion to maintain Pakistan's presence in the international capital market.

Tenure of Government borrowing linked to the Rate of Inflation: The policy should be to avoid a 'lock-in' by floating high level of PIBs to avoid relatively high interest payment for the duration of the PIBs floated. As a rough and ready guidance, the tenure of Government borrowing may be distributed as follows:

If inflation rate high at above 8 percent:

- ***Share:*** PIBs, 35 percent; MTBs, 50percent; Government Saving Certificates, 15 percent

If inflation rate low at below 8percent:

- ***Share:*** PIBs, 50 percent; MTBs, 35 percent; Government Saving Certificates, 15 percent

PIB = Pakistan Investment Bond, MTB = Market Treasury Bill

***Steeper Yield Curve on Savings Certificates*:** Inflows into unfunded debt could be less inflationary in character if they are purchased with accumulated savings of households. This should be encouraged by 'locking in' investors into long term savings certificates of 10 to 15 years maturity with a steeper yield curve. Also, a retail market could be developed for PIBs and MTBs.

Flotation of Ijara Sukuk Bonds**:** The Government has proposed to float a large volume of Ijara Sukuk bonds in 2021-22 of Rs 1200 billion. The Federal cabinet has approved the pledging of various physical assets on these bonds. This is an Islamic instrument and should help in broadening the capital market and increase the component of non-bank borrowing.

Adherence to FRDL Act**:** The Ministry of Finance has been publishing its Fiscal Policy Statement and the Debt Policy Statement annually as per the requirements of the FRDL Act. However, the Medium-Term Debt Strategy Statement was not disseminated after the Federal Budgets of 2019-20 and 2020-21. It has recently been released for 2021-22 to 2023-24.

Preparation of Realistic Medium-term Budgetary Frameworks**:** The Medium-term Budgetary Framework (MTBF) needs to be based on realistic projection of macroeconomic indicators. For example, the MTBF of 2018-19 for 2019-20 to 2020-21 was more a statement of unbridled optimism as follows:

i) The budget deficit was expected to remain in the range of 6 percent to 7 percent of the GDP. It was high at almost 9 percent of the GDP in 2018-19 and over 8 percent of the GDP in 2019-20.

ii) The level of Government debt was expected to come down to 65 percent of the GDP by the end of June 2020. Instead, it stood at close to 80 percent of the GDP.

Limitation on Guarantees to PSEs: The Government has been successful in restricting the use of new Government guarantees to less than 2 percent of the GDP annually as per the FRDL Act. However, there is need to issue a statement annually of the quantity of loan guarantees issued to each SOE. Further, the limit must continue to be observed strictly annually to avoid the problem of 'moral hazard' behavior by the SOEs.

PART-V

RAISING THE LEVEL OF INVESTMENT

Chapter 13: Prioritizing Development Spending

Chapter 1 has highlighted the big decline in the level of development spending from 5 percent of the GDP in 2016-17 to 2.6 percent of the GDP in 2020-21. This has increased the need for better prioritization of development spending to have the maximum and far-reaching consequences on economic growth.

Therefore, the objective of this Chapter is to highlight how the PSDP of the Federal and Provincial Governments should be managed to ensure the optimal allocation of funds to different sectors of the national economy.

13.1. Level and Composition of Development Expenditure

The budgeted and actual level of development spending in the budget documents at the Federal and Provincial levels is shown in Table 13.1. During the period 2014-15 to 2019-20, the peak level of development spending was attained in the year 2016-17, at 5 percent of GDP. 46 percent of the expenditure was at the Federal level and 54 percent by the Provincial Governments. Thereafter, the level has fallen sharply to only 2.6 percent of the GDP in 2019-20.

Table 13.1: Budgeted and Actual Development Expenditure by the Federal and Provincial Governments (Rs in Billion)

	Federal PSDP		% Deviation	Actual (% of GDP)	Provincial ADPs		% Deviation	Actual (% of GDP)	Total (% of GDP)
	Budgeted	Actual			Budgeted	Actual			
2014-15	525	489	-7	1.9	650	499	-23	1.8	3.7
2015-16	700	593	-15	2.0	814	592	-27	2.0	4.0
2016-17	800	725	-9	2.3	875	852	-3	2.7	5.0
2017-18	1000	578	-42	1.7	1112	880	-21	2.6	4.3
2018-19	800	502	-37	1.3	850	509	-40	1.2	2.6
2019-20	701	468	-33	1.1	792	621	-22	1.5	2.6

Source: *MOF*

13.2. Federal Development Expenditure

Development expenditure has been squeezed by the fall in the tax-to-GDP ratio and the big increase in the share of debt servicing liabilities at the Federal level in current expenditure. The budget deficit, without the inclusion of development expenditure, was 2 percent of the GDP in 2014-15. In 2019-20, it had risen sharply to 5.5 percent of the GDP. Consequently, there had to be a big cut in actual spending compared to the allocations in the budgets of 33 percent at the Federal level and 22 percent in the case of Provincial Governments in 2019-20.

The distribution of Federal PSDP spending among economic infrastructure, social services and special region projects is given in Table 13.2. Given the allocation of functions, the Federal Government has focused on trunk infrastructure related to energy, water resources and transport. Consequently, the share of economic infrastructure has risen from 38 percent in 2009-10 to 53 percent by 2019-20. However, the Federal PSDP for 2020-21had proposed to bring this share down to 44 percent.

Table 13.2: Sectoral Spending from The Federal PSDP (Rs in Billion)

Sector	2009-10 (R.E)	Share (%)	2014-15 (R.E)*	Share (%)	2019-20 (R.E)*	Share (%)	2020-21 (B.E)	Share (%)
A. ECONOMIC INFRASTRUCTURE	**114.5**	**38.2**	**303.5**	**56.0**	**283.5**	**53.2**	**287.0**	**44.1**
A.1. Energy	35.1		108.5		70.3		63.0	
• Atomic Energy Commission	21.1		59.3		26.0		23.3	
• NTDC / PEPCO	14.0		49.2		44.3		39.7	
A.2. Transport	509		149.0		38.4		142.7	
• Railway	14.0		39.6		9.0		24.0	
• National Highway Authority	36.9		109.4		129.4		118.7	
A.3. Water Resources	28.5		46.0		74.8		81.3	
B. SOCIAL SERVICES	**49.0**	**16.3**	**53.8**	**9.9**	**44.0**	**8.2**	**56.0**	**8.6**
B.1. Higher Education Commission	18.5		25.0		28.5		29.5	
B.2. Food Security	12.0		1.0		7.4		12.0	
B.3. Health	18.5		27.8		8.1		14.5	
C. SPECIAL REGIONS	**23.7**	**7.9**	**41.2**	**7.6**	**53.4**	**10.0**	**100.4**	**15.4**

C.1. Azad Jammu & Kashmir	9.6		22.1		16.7		27.4	
C.2. Gilgit-Baltistan	5.9						25.0	
C.3. FATA	8.2		19.1		37.0		48.0	
D. OTHERS	**112.8**	**37.6**	**143.5**	**26.5**	**151.7**	**28.5**	**206.6**	**31.8**
D.1. IDPs	-		45.0		-		-	
D.2. ERRA	10.0		5.0		3.7		3.0	
D.3. SDGs / MDGs	35.0[a]		12.5		35.3		24.0	
D.4. Others	67.6		81.0		11.30		179.6	
E. TOTAL	**300.0**		**542.0**		**532.6**		**650.0**	

*Higher than actual spending
[a] COVID Responsive Program included of Rs 70 billion | [b] Special People's Works Program
Sources: *Budget Documents*

Social services are now predominantly in the Provincial Governments' domain. As such, the allocation of development funds for expansion of social services by the Federal Government has declined after 2010, following the 7th NFC Award, from 16 percent to 8 percent in 2019-20.

The regions which have a special autonomous status are Azad Jammu and Kashmir, Gilgit-Baltistan and the Federal Administered Tribal Areas (FATA). The last region was recently merged into the Province of Khyber-Pakhtunkhwa. The allocated share of the three regions combined in the Federal PSDP has gone up from 8 percent in 2009-10 to 10 percent in 2019-20. It was proposed to increase this further to 15 percent in 2020-21.

The other special allocations relate to Internally Displaced Persons (IDPs) and to the Earthquake Rehabilitation and Reconstruction Authority (ERRA), operating in Azad Jammu and Kashmir after the devastating earthquake in 2005. Now, there is a focus also on allocations to promote the Sustainable Development Goals (SDGs) of the United Nations.

There are relatively small allocations to the remaining 35 Divisions at the Federal level. Combined these allocations range from 20 percent to 28 percent of the Federal PSDP.

The priority in allocations in 2020-21 between ongoing and new projects in the major sectors of development activities is given in Table 13.3. Total cost of ongoing projects in these sectors is Rs 5923 billion. The total expenditure already incurred on these projects is Rs 2769 billion, equivalent to 47 percent of the costs. Therefore, the overall throw forward of costs of on-going projects is 53 percent of the costs. There is a wide variation in the status of completion in different sectors. 75 percent of the cost of on-going projects under implementation by the National Highway Authority has already been incurred as compared to only 22 percent in the case of the PAEC.

The normal expectation is that sectors in which the throw-forward is large, the bulk of the allocation would go to completion of on-going projects and fewer new projects would be launched. This does appear to be the case with allocations in sectors like the Atomic Energy Commission, Power, Hydel-Projects, Water Resources. However, in the case of NHA and the Railway as much as 25 percent and 17 percent of the overall allocation is to new projects.

Table 13.3: Priority of Ongoing versus New Projects in the Federal PSDP of 2020-21
(Rs in Billion)

Sector*	Cost of On-Going Projects	Throw-forward	% Not Completed	Allocation to On-Going Projects as % of Throw-forward	Cost of		% Share of New Projects in Total Allocation
					New Projects	Allocations	
NHA	1275	324	25.4	29.7	521	29.7	25.0
PAEC	1038	812	78.2	2.8	1	0.2	0.9
Railway	162	63	38.9	20.3	1215	11.2	16.6
Power	752	608	80.9	11.0	8	2.0	2.7
Hydel	1361	632	46.4	18.1	0	0.0	-
Water	1082	560	51.8	11.5	36	2.5	3.6
HEC	253	155	61.3	14.8	45	6.4	14.0
TOTAL OF ABOVE	**5923**	**3154**	**53.2**	**12.7**	**1825**	**52.0**	**12.1**

*Major sectors
Source: *Planning Commission*

Table 13.4: Number of Projects in the Federal PSDP of 2020-21

	On-Going	New	Total	Allocation (Rs in Billion)
• Higher Education Commission	113	31	144	29.4
• Water	81	3	84	81.2
• Power	72	10	82	74.4
• Housing	33	41	74	8.8
• National Highway Authority	32	25	57	118.7
• Interior	37	15	52	14.8
• Health Services	28	24	52	14.5
• Railway	22	18	40	24.0
• Food Security	24	12	36	12.0
• Finance	28	8	36	66.7
• Science and Technology	22	10	32	4.5

• Education	22	6	28	4.5
• IT and Telecom	13	15	28	6.7
• Cabinet	9	18	27	49.8
• Others	187	64	251	99.6
TOTAL	**723**	**300**	**1023**	**650.0**
Source: *Planning Commission*				

The 'spreading thin' of the development process at the Federal level is vividly demonstrated above by Table 13.4 above which indicates the number of projects in the portfolio of each Division and Corporation in 2020-21.

The total number of projects in the Federal PSDP is as many as 1023. The largest number of projects, 144, is with the Higher Education Commission even though the share in the PSDP is only 5 percent. Similarly, the Water and Power sectors combined also have a relatively large number of projects at 166. However, they have relatively large allocations.

The 'spreading thin' of the Federal PSDP into too many projects has led to a staggering of the process of completion of projects which has not only led to cost overruns but also to delays in the realization of benefits by the targeted beneficiaries. Table 13.5 highlights the extent of divergence between the planned and actual period of completion of a sample of projects as estimated by the World Bank. On average, projects take twice the planned period for actual completion. Consequently, cost overruns are very sizable, sometimes over twice the original cost estimate of a project.

The approval and implementation of new projects are sometimes dictated by the pressure to satisfy different political constituencies. This is especially the case with Special Programs.

Table 13.5: Planned versus Actual Period of Completion of Projects in Different Sectors (Months)

	Planned	Actual	Ratio
SECTORS			
Roads	23	62	2.7
Irrigation	44	84	1.9
Education	45	68	1.5
Health	32	64	2.0
LOCAL GOVERNMENT			
Federal	29	62	2.1
Provincial	36	63	1.8
ALL PROJECTS	**34**	**68**	**2.0**
Source: *World Bank*			

13.3. Provincial Development Expenditure

The sectoral allocations by each Province in the respective ADPs are given in Table 13.6.

Table 13.6: Sectoral Distribution of Development Expenditure by Provincial Governments
(Share %)

	Punjab	Sindh	Khyber-Pakhtunkhwa	Balochistan	All Four Provinces Combined
Social Services	**36.1**	**22.1**	**35.9**	**47.8**	**34.1**
Education	13.4	8.4	17.8	13.5	13.3
Health	12.8	5.7	7.6	5.6	9.5
Water Supply & Sanitation	7.7	4.0	9.5	21.3	8.5
Population Planning	2.2	4.0	1.0	7.4	2.8
Infrastructure and Production Sectors*	**63.9**	**77.9**	**64.1**	**52.2**	**65.9**
Transport and Highways	23.2	16.8	20.7	30.8	20.5
Agriculture + Irrigation	13.4	35.2	17.0	11.2	19.2
Industry	6.2	10.0	4.2	-	6.0
Others*	21.1	15.9	22.2	10.2	20.2
TOTAL	**100.0**	**100.0**	**100.0**	**100.0**	**100.2**
Level of Development Expenditure (Rs in Billion)	**242.5**	**108.3**	**113.8**	**44.6**	**509.2**
% of Gross Regional Product	**1.2**	**1.0**	**2.3**	**2.9**	**1.3**

* Including allocation to local governments

There is substantial variation in the sectoral distribution of development expenditure among the Provincial Governments in 2018-19. However, broadly speaking, they are all attaching greater priority to projects in physical infrastructure and production sectors. The share of ADP devoted to these sectors ranges from 52 percent in Balochistan to 78 percent in Sindh. Consequently, the share devoted to social sectors is smaller.

Each Province has a different top priority sector based on its development gap and needs. Punjab and Balochistan are making the largest allocations of 23 percent and 31 percent respectively to highways and transport, including mass transit. Khyber-Pakhtunkhwa is making a big allocation to the development projects of local governments and the second highest to highways. Sindh is focusing on development of its agriculture and irrigation system, with 35 percent of the allocation to the sector.

The big disappointment is that for the four Provinces the total combined ADP is only 1.3 percent of the national GDP. This is one of the fundamental reasons why the level of human development spending in Pakistan is so low, as the Provincial Governments are expected to play the primarily role in the provision of health and education.

The success in achieving a degree of fiscal equalization through the 7th NFC award is demonstrated by the higher share of ADP spending of the Gross Regional Product of the two smaller provinces, Balochistan and Khyber-Pakhtunkhwa. It is the highest in the former Province at almost 3 percent of the GRP. However, this Province has continued to show the lowest growth rate. This raises questions about the efficacy of development spending in the Province.

There will be need for higher development spending by the Provincial Governments if the regional growth rates are to be enhanced and the level of human development raised. This will require more aggressive resource mobilization from Provincial revenue sources of the type described in Chapter 10.

13.4. Changing Development Priorities

Given the resource constraints currently, too big a throw-forward and too many projects in the PSDP, some major recommendations are made below.

Development Priorities and Economic Growth: Econometric analysis has been undertaken of the determinants of the growth rate of real per capita income from 1980-81 to 2017-18. Significant variables, along with the insignificant variables, are shown below.

Significant and Insignificant Variables in the Determination of the Growth Rate of Real Per Capita Income

	Significant Positive Impact [YES / NO]
• Growth Rate of Agricultural Sector	YES
• Growth Rate of Private Investment	YES
• Growth Rate of Electricity Consumption per capita	YES
• Growth Rate of Availability of Water for Agriculture	YES
• Growth Rate of Length of Roads / Highways	NO
• Growth Rate of Number of Telephones / Mobile Phones	NO
• Growth Rate of Average Years of Schooling of Employed Workers	YES

The above results have fundamental implications on the shares of different sectors in PSDP allocations, as follows:

i) The share of allocations to the water and power sectors should be raised substantially and those of the National Highway Authority reduced over the next few years with the completion of ongoing projects. This has also become possible now following the completion of the major CPEC highway projects.

ii) The case for early completion of ongoing PEPCO/NTDC projects is strong because there has been under investment in improving and expanding the electricity transmission and distribution system. Consequently, T&D losses are as high as 20 percent. Reduction in these losses will reduce the pressure for periodic escalation in power tariffs.

iii) Pakistan is on the verge of becoming a 'water stressed' country. The lack of expansion in canal water has meant that the cropped area has remained unchanged for many years now. As such, priority must be given to the completion of small hydel projects. Further, allocations need to be substantially increased for the Daimer-Basha and Mohmand dams.

iv) Provincial Governments need to move away from transport and urban mass transit projects, as has been the case in Punjab, towards higher outlays on education and health. However, the emphasis should not be on setting up new universities but on increasing and improving the quality of high schools and vocational/training centers to improve the skill endowment of the labor force. Also, the shift should be towards greater focus on preventive health and population planning.

Priority to On-Going versus New Projects: It has been demonstrated above that in the case of some sectors in the Federal PSDP funds for the completion of on-going projects have been diverted to new projects. The examples of this diversion can be observed in two areas, namely, the, Railway and the NHA. A possible limitation that can be placed is that the allocation to new projects should not exceed 15 percent of the total sectoral allocation unless there is space left after the required allocation for timely completion of ongoing projects.

Chapter 14: Privatizing Some State-Owned Enterprises

The process of privatization has slowed down visibly during the tenure of the present Government. It has not been able to articulate a clear policy on which units should be privatized and which should not. Initially, it was proposed that a Fund be established which would focus on the restructuring of State-Owned Enterprises (SOEs) and privatization would generally not be resorted to. But such a Fund has not been set up yet.

The objective of this Chapter is to describe the SOEs as they exist today in the aftermath of different rounds of privatization since 1991. This is followed by quantification of the financial burden placed by the SOEs on the Government Budget. The last section identifies potential candidates for privatization based on the application of a consistent and relevant set of criteria.

14.1. The SOEs

There are currently 204 SOEs in Pakistan. 138 of these are commercial companies and 48 are non-commercial companies. There are 8 Development Finance Institutions (DFIs) and 10 Federal Authorities. 41 of the SOEs are in the energy sector, 35 in the transport sector, 33 in financial services, 46 play a promotional and advocacy rule and the rest are in different sectors of the economy.

The total assets of SOEs aggregated to Rs 17114 billion as of the end of 2017. Over the three years since 2014, there was a sizable increase in assets of 49 percent. The total revenues were Rs 3482 billion in 2017, with a decline of 34 percent after 2014.

The top 10 profit making SOEs and the top 10 loss making SOEs are listed in Table 14.1.

Table 14.1: Top 10 Profit Making SOEs and Top 10 Loss Making SOEs

	Profit Making SOEs	Profit – (Rs in Billion)		Loss Making SOEs	Loss – (Rs in Billion)
1.	OGDC	63.8	1.	NHA	-133.4
2.	PPL	35.7	2.	Pakistan Railway	-40.7
3.	GHPL	20.3	3.	PIA	-39.6
4.	PARCO	19.1	4.	LESCO	-37.4

5.	PSO	18.2	5.	HESCO	-27.3
6.	WAPDA	17.0	6.	PESCO	-19.4
7.	NTDC	10.6	7.	Sindh Engineering	-19.3
8.	SNGPL	8.6	8.	QESCO	-18.7
9.	GEPCO	7.5	9.	MEPCO	-17.9
10.	GENCO-II	3.7	10.	PSM	-14.9
	TOTAL	**185.4**		**TOTAL**	**-368.6**
Source: *MOF*					

The outstanding level of foreign loan guarantees is Rs798 billion, while outstanding domestic loan guarantees is Rs 1612 billion as of March 2021. Overall, the SOEs enjoy a high level of support from the Federal Government.

The number of SOEs privatized since 1991 and the sale proceeds are given in Table 14.2. They aggregate to Rs 648 billion.

Table 14.2: Number of Units Privatized by Type and the Sale Proceeds

	Number	Sale Proceeds (Rs in Billion)
Banks	7	345
Telecommunication units	4	187
Industrial Units	106	60
Energy units	48	54
Others	47	2
TOTAL	**212**	**648**

The Federal Budget documents indicate the extent of support provided to the SOEs from the Federal Consolidated Fund and the dividend and mark-up received. Chapter 11 indicates that the net support received was Rs 525 billion in 2020-21. The quantum of support has been rising at the rate of 40 percent annually.

The net transfer to SOEs in 2018-19 was Rs 522.9 billion. Therefore, there is a significant load placed by SOEs on the Federal Budget. Earlier the net transfers in 2014-15 were Rs 602.8 billion. Total financial support was Rs 783.8 billion, equivalent to 15 percent of total Federal Expenditure in 2018-19.

14.2. The Triage of SOEs

A triage of 84 SOEs was recently undertaken by the Ministry of Finance. The fundamental issue relates to whether an economic activity should be undertaken by Government by not. This has been resolved by finding the answer to two questions as follows:

a) Does the economic activity to be undertaken fall within the public policy framework of the Government?

b) Can the economic activity be performed by the private sector?

The following core functions have been identified as requiring Government involvement:

i) Ensuring food security

ii) Developing and managing large-scale infrastructure requiring substantial investments

iii) National defense and security related functions

iv) Entities that need to be established through inter-governmental arrangements

v) Supply of goods and services of national economic interest

A number of criteria were used to evaluate an SOE, as follows:

i) Is the SOE a natural monopoly? Is there an appropriate regulatory framework to ensure socially optimal and cost-effective delivery in case the function is to be performed in the private sector?

ii) Is the SOE performing a function that has significant positive externalities and is therefore less profitable for the private sector to perform?

iii) Is there an alternative delivery mechanism to achieve this objective? An assessment was undertaken of the SOEs in the triage to divide them into financially viable and financially stressed entities.

The above appraisal has led to the following categories of SOEs in Chart 14.1.

Chart 14.1: Categories of SOEs

Category 1:	**SOEs to be retained in state ownership**
Sub-category 1(a):	*SOEs which are performing core functions and are financially viable* • 25 SOEs have been identified as following in this category. The notable SOEs include PSO, PNSC and NTDC.
Sub-category 1(b):	*SOEs which are already undergoing restructuring or are to be retained and restructured* • 14 SOEs fall in this category including PIA, Pakistan Railway, WAPDA, PEPCO, Pakistan Post Office and others.
Category 2:	**SOEs to be Privatized or Liquidated**
Sub-category 2(a):	*SOEs already under privatization* • 10 SOEs are in this category and the major ones are PASMIC, SLIC, HBFC, GENCO, OGDC and PPL.
Sub-category 2(b):	*SOEs to be privatized in next phase* • 24 SOEs in this category including the power sector DISCOs, TIP, PMDC, NFC, NIC and others

Sub-category 2(c):	*SOEs which are potential privatization candidates* • 10 SOEs included consisting of ADBP, NIT, SSGC, SNGC, USC, NESPAK, PTDC and others.
Sub-category 2(d):	*SOEs under liquidation* • 1 SOE, only, the IDBP
The total number of SOEs are 84.	

According to the above categorization, out of the triage evaluation of 84 SOEs, 39 are to be retained in state ownership and 45 are to be privatized or liquidated. However, the criteria enunciated for privatization are primarily. Criteria 1, 6 and 3 out of the eight criteria in Chart 14.1.

14.3. Evaluation of the Privatization Program

As highlighted above, SOEs impose a big burden on the Federal Budget. Therefore, efforts need be made to reduce these liabilities to bring down the size of the fiscal deficit. Extent to which the liability can be reduced by privatization of SOEs, wherever justified and feasible, needs to be examined.

Criteria for Privatization

Some criteria are suggested for evaluating the case for privatization of an SOE. The criteria are presented along with the score in Chart 14.2. The maximum possible score is 10 and the minimum is 0. A SOE can be seen as a candidate for privatization if it has a score of 6 or above.

Chart 14.2: Criteria for Evaluating Case for Privatization

S. #		Score	S. #		Score
1.	**Profit-Making**		**5.**	**Outstanding Liabilities**	
	• If losses	1		• If no or small liabilities	1
	• If small profits	½		• If large liabilities	0
	• If large profits	0	**6.**	**Performance of Core Social or Economic Functions**	
2.	**Monopoly**			• If functions not performed	3
	• If in a competitive market	2		• If performed	0
	• If a monopoly	0	**7.**	**Over employment**	
3.	**Regulatory Authority**			• If large over employment	0,5

• If presence of:			• If no or small over employment	0
• Strong Regulatory Authority	1	**8.**	**If Political Opposition / Resistance from Trade Unions / Transparency Issues**	
• Weak Regulatory Authority	0			
4. Valuation of assets			• If no	0.5
• If proper and full valuation of assets available	1		• If yes	0
• If not	0			

Different weights have been assigned to different criteria, depending on their relative importance.

As an illustrative exercise, the case for privatization of a sample of major SOEs has been undertaken. The results are presented in Chart 14.3.

Chart 14.3: Case for Privatization of a Sample of SOEs

YES	Score	NO	Score
Pakistan Steel Mill	8.5	Pakistan State Oil	4.0
National Shipping Corporation	8.0	Sui Southern Gas Company	3.5
National Investment Trust	8.0	Sui Northern Gas Ltd.	3.5
SME Bank	7.5	DISCOs	3.0
Heavy Electrical Complex	7.5	Pakistan Railway	2.5
State Life Insurance Corporation	7.5		
National Power Construction Company	7.5		
Pakistan Reinsurance Company	7.0		
Pakistan International Airlines	7.0		
TOTAL	**10**	**TOTAL**	**5**
Source: *MOF*			

There are a number of SOEs the privatization of which can be contested on the basis of the criteria in Chart 14.1, as follows:

Electricity and Gas Distribution Companies**:** This includes the nine DISCOs and the two gas distribution companies, SSGCL and SNGPL. They are classic examples of regional natural monopolies. However, due to high billing and other losses, they require substantial subsidies from the Federal Government, especially if the mounting circular debt is to be brought under control. Also, the experience with the privatization of KSE has been a mixed one.

Therefore, there is not a strong case for privatization of these SOEs according to the eight criteria in Chart 14.1 and scores of individual SOEs in Chart 16.2.

***OGDCL and PPL*:** These are extremely profitable SOEs operating in an increasingly competitive environment, with the likelihood of more MNCs entering Pakistan for mineral, oil and gas exploration. The potential privatization will yield substantial revenues, 90 percent of which will have to be used for retirement of debt as per the Privatization Commission Ordinance. Therefore, the potential yield annually is close to 10 percent, equivalent to the average interest rate on domestic debt which will be saved. The dividend yield is much higher. Therefore, partial privatization through sale of shares must be avoided. This has actually been a way of generating foreign exchange receipts to bolster foreign exchange reserves.

ADBP, IDBP and USC: These SOEs are clearly performing core functions and need to be retained and restructured. ADBP can be restructured and recapitalized to focus on loans to small farmers. Similarly, IDBP can be restructured to largely extend credit to SMEs. The USC was established to offer essential food items at lower than market prices. It must remain in the public sector and target only the beneficiaries of the EHSAAS program.

There are some SOEs which are potential candidates for privatization but have not been included in the list for privatization: The prime example is

***PIA*:** PIA was identified for privatization in the previous IMF program. It passes the test for privatization as shown in Chart 14.2.

Therefore, there is need for reappraisal of SOEs with regard to retention in state ownership, privatization or liquidation by careful application of the eight criteria listed in Chart 14.1 with suitable weights.

The Privatization Commission may apply the above Criteria for Privatization to all the 204 SOEs. Those units which qualify for privatization should then be privatized on a priority basis. In fact, the Federal Budget of 2021-22 has anticipated receipts of Rs 250 billion during the year as the proceeds from privatization. implementation of the privatization process will play a significant role in reducing the burden of the Exchequer.

Chapter 15:

Promoting Private Investment

Private investment is one of the major sources of growth in the national economy. Capital outlays in production sectors not only expand the productive capacity of the economy but also create many new jobs. One of the key targets in the Charter of the Economy, identified in Chapter One, is to raise the private investment to GDP ratio from the currently depressed level of 10% of the GDP to 12.5 percent by 2024-25.

15.1. Level and Composition of Private Investment

The trend in level of private investment and total investment, including public investment, is given in Table 15.1. The two-way relationship between the level of private investment and GDP growth is clearly visible. During the period of high growth of the economy, from 2004-05 to 2007-08, the level of investment by the private sector grew rapidly and reached a peak level of over 16 percent of the GDP in 2006-07. This created the capacity for higher growth.

Table 15.1: Historical Path of Private and Public Investment (% of GDP)

Year	Private Investment	Public Investment	Total Investment	GDP Growth Rate (%)
2000-01	10.2	5.7	15.9	2.0
2004-05	13.1	4.3	17.4	9.0
2009-10	10.2	3.6	13.8	2.6
2014-15	10.4	3.7	14.1	4.1
2020-21	9.8	3.8	13.6	3.9

Source: *PES*

Thereafter, as the growth rate of the economy plummeted, the level of private investment fell sharply to below 10 percent of the GDP. There had been a modest recovery in 2017-18 when the GDP growth rate rose to above 5 percent. The last two years have witnessed a drop again. During the peak years, the share of private investment in total investment was above 70 percent. It reached a low of 67 percent in 2017-18 due particularly to the jump in public investment to above 5 percent of the GDP.

The sectoral composition of private investment is given in Table 15.2. The largest sector of private investment is agriculture, with a share approaching 30 percent in some years. However, the biggest drop that has occurred is in the level of private investment in agriculture, due particularly to a decline in the sale of tractors and in the installation of tube wells.

Table 15.2: Sectoral Composition of Private Investment							(% of GDP)
Year	Agriculture	Manufacturing	Electricity and Gas	Transport and Communication	Housing	Others	Total
1999-2000	3.6	2.2	0.1	0.7	2.5	1.9	11.0
2009-10	2.9	1.5	0.1	1.7	2.2	1.8	10.2
2020-21	2.6	1.5	0.0	1.6	2.4	1.7	9.8
Source: *PES*							

Next in size is the housing sector in terms of the level of private investment. Investment in residential property does not appear to be sensitive to the business cycle. Manufacturing has a share of 15 percent or so in private investment. The level is down to only 1.5 percent of the GDP currently. The emerging sector is transport and communications, especially in telecommunications, following the advent of the mobile phone.

Private investment has a dominant share of total investment in agriculture, manufacturing, transport and communications and housing. The public sector has played the leading role in sectors like electricity and gas, construction projects and social services.

In the manufacturing sector, the share of private investment in small enterprises, with the employment of up to 10 workers, is below 9 percent. This is primarily a reflection of less access to credit from the banking system and public services. Similarly, the share in agricultural credit of small subsistence farmers is only 6 percent.

15.2. Foreign Direct Investment

The stock of foreign investment in Pakistan is $32 billion, consisting of equity capital and reinvested earnings. The inflow was $1.8 billion in 2020-21, 30 percent less than in the previous year. The peak of FDI was observed from 2004-05 to 2006-07. It attained a peak of $5.1 billion in 2006-07, with the largest share in telecommunications.

The sectors currently of interest to foreign investors are oil and gas exploration, power, telecom, and banking. The largest inflows are from China, USA, UK, and the UAE.

Foreign investors face a lower rate of corporate income tax at 20 percent. There are no restrictions on repatriation of profits. Also, there is no law regulating transfer pricing in Pakistan. The final stage of the CPEC involves the promotion of foreign investment in the SEZs, especially by China, by the offering of attractive fiscal incentives. The objective is to place Pakistan better in global value- added chains and thereby give a fillip to exports.

15.3. Constraints to Higher Private Investment

The determinants of private investment and their impact on the growth rate of private investment have been derived by historical econometric analysis of data from 1990-91 to 2018-19. The findings are given above in Table 15.3.

Table 15.3: Determinants of Private Investment

1% Change in	Impact on growth rate of Private Investment (%)
GDP	1.052
Real Interest Rate*	-0.931
Relative Price of Capital Goods**	-0.088
Public Investment	0.262
Level of Corporate Profitability***	0.332

*The impact is with respect to 1%-point change. The real interest rate is the nominal interest rate on bank loans minus the rate of inflation.
**ratio of the unit value index of capital goods to the domestic price level.
***rate of return on equity post-tax.

Source: *Estimated*

The Table reveals that the five determinants of the growth in private investment are the growth rate of GDP, change in the real interest rate, change in the relative price of capital goods, growth in the level of public investment, especially in economic infrastructure, and the level of corporate profitability.

15.4. Reviving Private Investment

Appropriate mix of Policies: For an upsurge in private investment there is need for a combination of the following factors:

i) A favorable business environment, especially in terms of buoyancy in growth of aggregate domestic demand and exports and predictability and consistency of economic policies.

ii) An interest rate policy which does not lead to a big positive divergence between the nominal interest rate on bank lending and the rate of inflation, thereby increasing the real cost of borrowing.

iii) Higher level of public investment especially in electricity generation and distribution, in increased capacity of transport infrastructure and higher outlays on technical and vocational training of workers.

iv) An appropriate exchange rate policy which does not lead to a disproportionate increase in the cost of imported machinery.

v) Relatively high level of corporate profitability raised by the presence of a moderate tax rate on corporate profits and effective fiscal incentives to bolster new investment and in BMR. The target should be to bring down the corporate tax rate to 25 percent by 2024-25 from 29 percent currently.

vi) Appropriate fiscal incentives for investment in the export sectors and to units in the Special Economic Zones and in the Special Technology Zones.

Greater Access to Financing: There are three potential sources of financing including investment of retained profits, access to bank credit and flotation of shares in the stock market. Small investors have generally had to rely on self-financing, either through deployment of profits or by access to loans in the informal sector. Estimates of financing of private investment by the corporate sector indicate that the share of retained profits is close to 55 percent, and that of long-term borrowing from the banking system and equity are 35 percent and10 percent respectively.

Specific proposals for improved access to financing are as follows:

- SBP to target for minimum credit ratios for lending by the banking sector to the private sector. A system of tax credits may be put in place to bolster lending by the commercial banks to the private sector and SMEs especially.
- Increase in the tax deductibility provision in the Income Tax Ordinance for write-off of non-performing loans to SMEs, to small farmers and to low-cost housing.
- Introduction of an effective foreclosures law against non-performing housing loans, probably of the type existing in Sri Lanka. This has been put in place recently.
- Introduction of a Credit Guarantee Scheme by the SBP on agricultural loans in view of risk of floods, excessive rains fall or drought.
- Lower interest rates for low- cost housing through a special refinancing scheme by the SBP. Such a scheme has been put in place in 2021 with an interest rate of 5 percent.

Fiscal Incentives: The Income Tax System, as embodied in the ITO, has some fiscal incentives for promoting investment as follows:

i) Section 22 contains liberal provisions for normal depreciation, at 5 percent for building and 10 percent for plant and machinery.

ii) Section 23 provides for an initial depreciation allowance in the year of commencement of production equivalent to 25 percent of the value of plant and machinery.

iii) Section 65B is on BMR. A Tax credit is allowed equal to 10 percent of the amount so invested.

These incentives for investment were of a larger magnitude in earlier years. The higher incentives should be restored. It is important to recognize that any tax expenditure due to a fiscal incentive is likely to be more than recovered from the value added tax (GST) and other taxes on higher production. Unfortunately, some of the incentives have been withdrawn in the Federal budget of 2021-22 under IMF pressure.

iv) Special incentives have been offered for investment in renewable energy, low- cost housing projects, IPPs, LNG terminals and refineries. This list could be broadened to include investment in information technology and digital applications and oil and gas exploration.

v) The Pakistan Business Council (PBC) has made a useful suggestion that the Special Enterprise Zones (SEZs) should be seen as a vehicle for linking Pakistan to global value chains. As such, they should ideally be located near metropolitan centers with adequate infrastructure and skilled workers. A tax holiday of ten years should be given to projects in SEZs with the condition that at least 80 percent of the production is exported.

PART-VI

IMPROVING THE BALANCE OF PAYMENTS

Chapter 16: Promoting Exports

Large and growing exports, along with higher savings and tax revenues, are the pre-requisites for fast and sustained growth in the economy. Rapid growth in exports is essential to keep the current account deficit in the balance of payments under control without the need to resort to severe measures for import compression and reduction in GDP growth as Pakistan has witnessed from 2018-19 onwards.

This chapter on promoting exports first focuses on the performance of exports and the trends in the level of determinants of exports. This is followed by identification of changes in the commodity-wise composition of exports and in the country-wise and region-wise destinations of exports.

The third sector looks at the indicators of export competitiveness. Thereafter, the various instruments used for export promotion in Pakistan and elsewhere are identified. This Chapter concludes with a series of recommendations for promoting exports of Pakistan.

16.1. Growth in Exports

Econometric analysis has been undertaken of the impact of different factors on growth in the volume of exports from 1990-91 to 2018-19. The findings are presented below.

Determinants of the Growth of Exports

Due to 1% Change in	% Change in Volume of Exports	
	Short-Run	Long-Run
• Volume of World Trade	0.100	0.552
• Dollar Price Level of Exports	0.434	2.392
• Real Exchange Rate*	0.434	2.392

*Measured as the ratio of the nominal exchange rate to the domestic price level.

Clearly, the growth in exports is linked to the growth in world trade. However, on average, 1 percent growth in the volume of world trade, other things being equal, has led to a 0.55 percent growth in the volume of Pakistan's exports. This implies that Pakistan's share in world trade which was low has declined further.

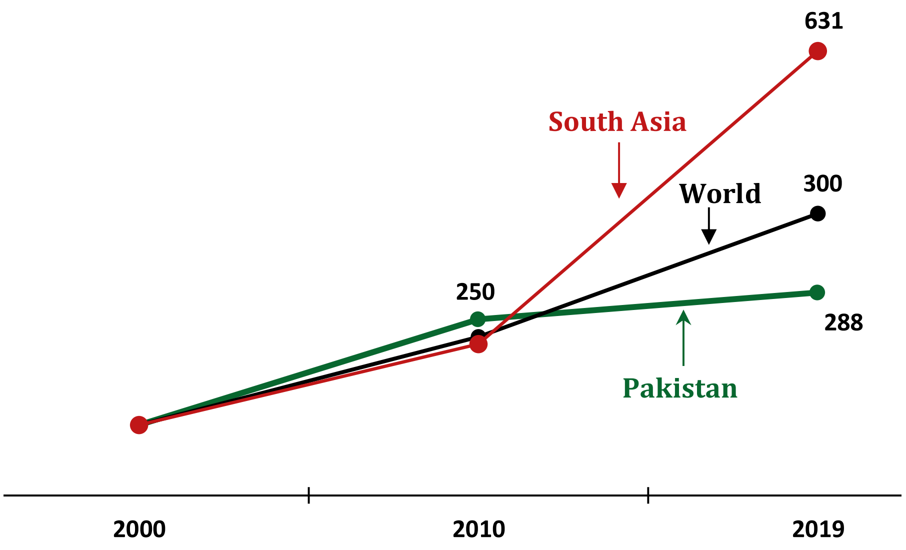
An important finding is the high level of sensitivity of Pakistan's exports to prices, both in dollars and in rupees. This has not been adequately emphasized before.

The growth in $ value of Pakistan's exports, exports of South Asian countries and world trade is shown in Figure 16.1. Pakistan's exports performed well from 2000 to 2010 and, more or less, kept pace with the rise in exports of other South Asian countries and the world economy. However, the growth in exports of the country started falling from 2011 onwards. Further, world trade has lost much of its buoyancy in the last decade.

The slowdown in export growth since 2010 has meant that on average the growth annually has been less than 2 percent, as compared to over 9 percent in the previous decade. Meanwhile, other South Asian countries, like India and Bangladesh, have continued to show robust growth with a growth rate of almost 9 percent. Today, the exports of Bangladesh are almost twice that of Pakistan and of India are thirteen times larger.

Figure 16.1: Index of Value of Exports of Pakistan, South Asia and The Global Economy

[2000 = 100]



Source: *World Bank.*

The question is what has been happening to dollar prices and the exchange rate? Both play a key role in determining the profitability of exports. The trends in these two magnitudes are given in Table 16.1.

The dollar price index of exports rose rapidly from 2000-01 and 2010-11 when world trade was witnessing a boom. However, it has fallen by almost 16 percent since then. The exchange rate has only been partially adjusted with respect to the rise in the domestic price index. Consequently, profitability in exporting has been on the decline leading to fall in investment in export sectors, especially textiles. This is one of the major reasons for the relatively slow growth in exports, especially after 2010-11.

Table 16.1: Trend in Average Dollar Price Index and The Real Exchange Rate Index (2005-06 = 100)

	Dollar Price Index	Real Exchange Rate Index	Overall Relative* Price Index
2000-01	92.9	128.5	119.3
2005-06	100.0	100.0	100.0
2010-11	138.7	77.0	106.8
2015-16	135.2	70.8	95.7
2019-20	123.3	75.5	93.0

Source: *PES; SBP*

16.2. Changes in the Composition of Exports

The change in the composition of export earnings by commodity group is given in Table 9.2. The decade of 2000 to 2010 witnessed significant product diversification away from textiles especially with faster growth in export of primary commodities and other manufactures. However, the last decade has witnessed the reversion back somewhat to textiles, the traditional backbone of Pakistan's exports.

Table 16.2: Composition of Export Earnings by Commodity Group (%)

	Share 1999-2000	Share 2009-10	Growth Rate*	Share 2019-20	Growth Rate*
Primary Commodities	10.5	17.0	13.0	16.8	3.0
Textile Manufactures	64.8	53.0	6.1	55.0	4.1
Other Manufactures	14.8	19.8	11.0	16.5	0.2
Others	9.9	10.2	8.3	13.8	7.0
TOTAL	100.0	100.0	8.1	100.0	2.5

Source: *PES*

The growth in the value of exports of the top ten export items is given in Table 16.3. These exports each contributed over $500 million to export earnings in 2018-19. Two of the exports are primary commodities, rice, fruits and vegetables. Five items belong to the textile group and three, namely sports goods, leather and products, and chemicals and pharmaceuticals belong to the other manufactures group.

Table 16.3: Annual Growth Rate of Major Export Items – (%)			
	1999-2000 to 2009-10	2009-10 to 2019-20	Level of Exports 2019-20 ($ million)
Rice	14.0	-0.1	2527
Fruits and Vegetables	25.4	15.9	498
Cotton Yarn	2.9	-2.0	1140
Cotton Fabrics	5.0	2.1	2115
Knitwear	6.9	5.3	3234
Bedwear	9.0	3.3	2489
Readymade Garments	5.0	7.8	2949
Sports Goods	0.7	6.2	306
Leather and Products	8.6	-0.5	906
Chemicals and Pharmaceuticals	20.0	5.6	1171
Share of Total Exports (%)	**75.5**	**73.4**	**70.0**
Source: *PES*			

The decline in the growth rate of total exports has already been highlighted. This is the case with eight out of the ten items. Two items, namely, readymade garments and sports goods have shown faster growth. Both are produced by SMEs or have links with SMEs and are more labor-intensive in nature.

The fastest growing export has been of fruits and vegetables, followed by readymade garments. Exports of rice, cotton yarn and leather goods have witnessed some decline in the last decade. Overall, the combined share of these items in total exports has declined from over 75 percent to 68 percent since 1999-2000.

This indicates the presence of some promising emerging exports which will help in further diversification of the export base of the country and contribute to less volatility in exports. Some of these items which have already reached a level of exports in 2018-19 of more than $200 million are identified below in Table 16.4.

Table 16.4: Emerging Exports of Pakistan in 2018-19			($ million)
Primary Commodities	Exports	Mineral Products	Exports
Meat	243	Salt, Sulphur, Limestone	520
		Mineral Fuels*	675
Prepared Food Stuffs		Plastics and Articles	414
Sugar**	340	Base Metals	
Beverages, Spirits & Vinegar	439	Copper	277
		TOTAL	**2908**
		Share	***12%***

*essentially by-products of the refining process, subject to big fluctuations | **artificial export surplus

These emerging exports are of a diverse nature and will need to be nurtured and developed.

16.3. Destinations of Exports

The major countries to which Pakistan exports annually more than $500 million and to different regions of the world are given in Table 16.5.

Table 16.5: Major Regions and Countries of Exports to By Pakistan					($ million)
	2009-10	Share (%)	2019-20	Share (%)	Growth Rate (%)
North America	**3560**	**18.5**	**4186**	**18.6**	**1.6**
USA	3360		3915		
Europe	**4830**	**25.1**	**8075**	**35.8**	**5.1**
UK	1027		1638		
Italy	606		752		
Spain	434		871		
Belgium	430		517		
Germany	793		1303		
Eastern Asia	**2093**	**10.9**	**2264**	**10.0**	**0.8**
China	1154		1664		
South Asia	**2827**	**14.7**	**2057**	**9.1**	**-3.2**
Afghanistan	1571		890		
Bangladesh	483		695		
Middle East	**3299**	**17.1**	**2980**	**13.2**	**-1.0**
UAE	1720		1588		
Other Regions & Countries	**2681**	13.9	**2978**	**13.2**	1.0
TOTAL	**19290**	**100.0**	**22540**	**100.0**	**1.6**

The largest regional market for exports of Pakistan is Europe, with a share currently of almost 35 percent. It has also emerged as the fastest growing destination of Pakistani exports with an annual growth rate of over 6 percent. This is due largely to the granting of GSP Plus status to Pakistan in 2014.

The largest importing country from Pakistan is the USA, with a share of 17 percent. Exports to the USA have grown at 2 percent annually. The other major importing countries are the UK, Germany, China, Afghanistan, and the UAE.

Despite the proximity and the presence of SAFTA, Pakistan's exports in the South Asian region are only 11 percent of the total. This is the consequence of similarity in factor endowments and non-tariff restrictions by India.

The real disappointment is the level of exports of Pakistan to China. Despite the FTA with China, which was further liberalized in December 2019, and access through the CPEC highway network, exports are still below $2 billion to China. Also, the pattern of trade with China is highly skewed. Exports by China to Pakistan are over $10 billion, almost 20 percent of Pakistan's total imports. These imports were almost six times the exports of Pakistan to China. In fact, Pakistan's trade deficit with one country, China, is almost 30 percent of its global trade deficit.

16.4. Assessment of Competitiveness of Exports

There is need to assess the competitiveness generally of exports of Pakistan, with respect to other South Asian countries and competitors elsewhere like Vietnam and Thailand. Various indicators of competitiveness have been identified and their magnitudes presented for a sample of countries.

The Table 16.6 reveals that Pakistan is severely handicapped with respect to its competitors. First, the electricity tariff is the highest among the five countries highlighted in Table 16.6. Fortunately, six export industries – textiles, carpets, leather, sports goods, and surgical instruments – enjoy a lower tariff of $9 per kwh. However, other exporting industries like pharmaceuticals, chemicals, petroleum refining, plastics, beverages, sugar, etc., face high tariff of almost $17 per kwh, which is more than twice the tariff in a country like Vietnam.

Second, HSD oil is the key component of transport cost to and from exporting units. The only country which has a significantly higher price is India. Third, labor productivity, according to the ILO, in Pakistan is lower than in Sri Lanka, India and Thailand.

Table 16.6: Indicators of Export Competitiveness in A Sample of Countries

Country	Electricity Tariff on Industry[a]	Price of HSD Oil[b]	Minimum Wage	Labor Productivity	Interest Rate[f]	CurrentRate of Inflation[e]
	(cents/kwh)	($ per litre)	(Monthly US$)[c]	($)[d]	(%)	(%)
SOUTH ASIA						
Bangladesh	10.6	0.767	96	10,067	4.75	5.2
India	11.5	1.257	n.a.	21,181	4.00	6.3
Pakistan	**16.8**[g]	**0.715**	**110**	**15,294**	**7.00**	**9.7**
Sri Lanka	6.8	0.558	n.a.	31,130	4.50	5,2
EAST ASIA						
Vietnam	7.7	0.620	n.a.	11,970	4.00	2.4
Thailand	12.0	0.772	218	31,204	0.50	1.3

[a] for business, as of September 2020 | [b] for businesses transportation purposes as of Mid-April 2021
[c] as of 2018 to 2020 | [d] Constant 2011 International $ in PPP | [e] of the GDP Deflator in 2019
[f] of the Central Bank | [g] for five export sectors – textiles, surgical goods, carpets, leather and sports goods
Sources: *Diverse*

Fourth, perhaps one of the biggest cost disadvantages relates to the interest rate on working capital of exports and for new investment in the export sector. Pakistan has the highest interest rate and even the rate on concessional financing is likely to be higher. Fifth, with the highest rate of inflation the rate of increase in local costs is likely to be the fastest.

The authorities need to focus on ways to tackle the problems leading to and associated with low competitiveness. Otherwise, the prospects for exports in the near term are not encouraging.

16.5. Facilities and Incentives for Export

Various export promoting polices have been adopted to boost exports such as devaluation of currency and a wide range of export incentives. Export incentives are popular and diverse in nature. In Pakistan, India and Bangladesh, export incentives are in the form of cash payments, lower income tax rate, concessional export financing, zero-rating of sales tax and export cash payments.

Table 16.7: Export Incentives and Measures in Different Countries

	India	Pakistan	Bangladesh	Thailand
• Duty Drawback/Tax Exemptions on Imported Inputs	Yes	**Yes**	Yes	Yes
• Concessional Export Finance	Yes	**Yes**	Yes	Yes
• Export Insurance and Guarantees	Yes	**Yes**	Yes	Yes
• Export Quality Management	Yes	**Yes**	Yes	Yes
• Export Processing Zones	Yes	**Yes**	Yes	Yes
• Exports Performance Requirement	Yes	**No**	Yes	Yes
• Exports Cash Payments	Yes	**No**	Yes	Yes
• Export Promotion Organizations	Yes	**Yes**	Yes	Yes

Duty-Drawback Schemes: Pakistan's duty drawback scheme is administered by The Federal Board of Revenue (FBR) and duty drawback rates set by FBR through the Input-Output Coefficients Organization. The duty drawback rates are low in Pakistan compared to India and Bangladesh. The largest part of the benefit goes to textiles exporters of clothing, followed by engineering goods and metal products.

Export Finance and Guarantees: The export finance and guarantees in India are managed by The Export Bank of India and Export Credit Guarantee Corporation of India. The export finance in India is broadly divided into pre-shipment finance and post-shipment finance. The pre-shipment credit is available up to 270 days and credit against incentives receivable from Government is covered by ECGC Guarantee up to 90 days, while post shipment credit is available up to 180 days and for exporters under the Gold Card Scheme (Exports having good record over last 5 years) up to 365 days. Commercial banks are given mandatory credit ceiling by the Reserve Bank of India. The concessional Interest rate on the export credit facility is Benchmark Prime Lending Rate (BPRL) minus 2.5 percent.

The concessional finance in Pakistan can be broadly categorized into transaction based and performance based. Transaction based Facilities (reshipment/or post-shipment) are granted by the commercial banks to the exporter with a firm Export Order/Export Letter of Credit, for a maximum period of 180 days with rollover option for further 90 days upon payment of 117 percent of the borrowed amount. Under performance-based facility, the entitlement of exporter for revolving export finance is equal to 50 percent of the realized export proceeds in the preceding financial year. The maximum tenure of the performance-based facility is 180 days, extended for another 180 days subject to showing at least 70 percent shipment of loan availed in initial 180 days.[1]

The Pakistan Export Finance Guarantee agency (PEFG) aims to provide a comprehensive range of export trade finance guarantees, including both pre-shipment and post shipment, to small, medium, and emerging exporters. These bankable guarantees are substitute for traditional repayment collateral requirements of the financing banks.

Export Processing Zones: As a policy means of achieving high export growth and competitiveness, the concept of Export Processing Zones (EPZs) has gained significance in recent years. In 1986, there were 176 zones across 47 countries. The number of export processing zones increased to over 3000 across 116 countries by 2003. Many of these export-processing zones are operating in developing countries.[2]

The standard definition applied by World Bank and UNIDO 1995 states that an EPZ is an industrial area that constitutes an enclave with exemption from payment of customs' tariffs and the commercial code in force in the host country. Therefore, the main purpose of EPZs is to compensate for anti-export-bias under the import-substitution policy regime.

The Government of India has provided special incentives for units that set up in designated EPZs or can be 100 percent Export Oriented Units (EOUs) outside EPZs. Apart from duty free environment at low cost for export production each of the zones provide essential infrastructure facilities like developed land, standard design factory buildings, roads, water supply, power, drainage, and customs clearance facilities. The EOUs are complementary to the EPZ schemes. It offers wider locational options with reference added benefits of easy sourcing of raw materials, availability of technological skills, existence of an industrial base and availability of larger area of land for the project. One of the many incentives is that EPZs and EOUs are exempted from corporate income tax for 5 years and export earnings continue to be exempt from tax even after the tax holiday is over.

1 State Bank of Pakistan, Annual Performance Review.

2 WEPZA

In Bangladesh, the industrial units located within the EPZs need to export at least 90 percent of their production, in other words they can sell 10 percent in the domestic market at maximum but upon payment of customs duties and other taxes. Import and export regulations do not apply on the Imports and exports to/from EPZs and therefore are free from import policy restrictions, tariffs and duties, and any other control list. From 1st January 2011, the industrial units located in the EPZs enjoy tax holiday of 2-years followed by 50 percent reduced rate for the 3rd and 4th years and a 25 percent reduced rate for the 5th year.

In Pakistan, the Export Processing Zones Authority (EPZA) administers export-processing zones (EPZs). The firms located in EPZs must export at least 80 percent of production from 2004-05 onwards. Among a long list of incentives for industrial units, major incentives by the EPZs in Pakistan are duty-free import of machinery, equipment and materials, freedom from national import and exchange control regulations and presumptive income tax of 1 percent.

Cash Payments: The proponents of cash payments say that these are easy to administer. The exporters availing cash incentives have luxury to reduce prices straight away and/or can also use cash payment as increased profits. Therefore, the survey of exporters regarding preferences among different kinds of export incentives, the cash incentive is preferred the most.

Bangladesh is giving cash incentives to export-oriented industries, defined as industries that have more that 80 percent export sales. The number of such sectors have reached 38 and shrimp, jute yarn and readymade textiles are the major sectors availing cash incentive. In Bangladesh, cash incentives and export subsidies granted on the FOB value of selected exports range from 5 percent to 25 percent on selected products.[3]

Impact of Export Incentives: A methodology has been developing for quantifying the impact of export incentives. This is referred to as the effective exchange rate, which is the higher exchange rate on exports (not on export inputs) that would yield the same increase in profits to the exports as is the result of the export incentives.

The effective exchange rate of the various export incentives in Pakistan on textile exports are given below:

	% equivalent exchange rate (Textile Exports)
Due to Lower Income Tax*	2.1
Concessional Export Finance	2.6
Lower Energy Cost	4.0
Zero-Rating of Sales tax on domestic sales	4.1
TOTAL	**12.8**

A similar exercise was undertaken for Bangladesh.

3 Bangladesh Board of Investment.

The incentives, imply an effective exchange rate on the country's exports of almost 26 percent.

Pakistan has the choice as to the extent to which the various incentives can be converted into a cash incentive payable along with the export receipts. The actual incentive can then be withdrawn.

Recommendations

***Need for highest priority to boosting exports*:** Pakistan is entering a period of peak external debt repayment. Consequently, external financing requirements need to be limited by reducing the size of the current account deficit to below 3 percent of the GDP each year from 2021-22 to 2024-25. This will require both the promotion of exports and the containment of imports.

***Using the exchange rate for preserving profitability*:** The exchange rate should reflect not only the rise in domestic input costs due to inflation, but exporters should also be compensated for any drop in dollar prices of exports by a corresponding adjustment in the exchange rate.

***Developing Strategy for Promotion of Emerging Exports*:** The emerging exports of Pakistan have been identified above. The Trade Development Authority of Pakistan (TDAP) must develop a detailed plan of the steps needed for promotion of each emerging export item including quality control, storage facilities, transport, etc.

***Measures for Improving Competitiveness*:** The handicaps that Pakistan faces with respect to its competitiveness need to be addressed. The concessional rate of export financing will need to be reduced further given the relatively high interest rates in Pakistan.

Lower Electricity Tariff for Exports: The coverage of the lower electricity tariff to export in selected six industries should also cover industries like chemicals, plastics, fans, cement, chemicals and pharmaceuticals, which are emerging as export industries. The percentage of the sales of electricity may be 40 percent lower than the standard rate set by NEPRA.

There is need also for changing the petroleum levy on various petroleum products. It may be reduced for High-Speed Diesel Oil and enhanced accordingly for Motor Spirit.

***Enhancing the Supply of Domestic Inputs*:** The prime exporting industry of Pakistan, textiles, has been increasingly constrained by lack of adequate supply of domestically produced cotton. The policies recommended for restoring cotton output in Chapter 21 must be implemented on a top priority basis.

***Diversification of Export Markets*:** There is need for promoting exports to countries in

Central Asia and Africa. The regional organization, ECO, must focus on the development of a regional trade agreement like SAFTA. This will help in increasing trade especially with the Central Asian Republics.

***More 'Quid Pro Quo' from China*:** The FTA with China is very imbalanced. Pakistan is importing six times as much as it is exporting to China. The duty-free list of exports to China should be expanded. Over the years, it is hoped that the establishment of SEZs will facilitate China in using the location of Pakistan as part of its global value chain.

***Transition from Payment of Sales Tax Refunds to Cash Payment with Export Receipts*:** There are delays in payment of refunds to exporters on the sales tax paid on inputs. This has created problems of liquidity for exporters as frequently in the presence of revenue shortfall refund payments are delayed.

The recommended alternative scheme is cash payment, in lieu of zero rating, at the time of export receipts by commercial banks. The rates can be set by the Input-Output Coefficients Organization (IOCO). Commercial banks can then seek reimbursement from the SBP for these payments. This will greatly facilitate exporters.

Further, one or more of the incentives may be withdrawn and instead included in the cash payment scheme based on the value of the incentive in terms of the equivalent exchange rate. If this policy is adopted then the average cash payment on exports on top of the export proceeds could exceed 12.5 percent, especially if duty drawbacks are also included in the scheme. Bangladesh has adopted the policy of giving a higher cash incentive for emerging exports. This policy should also be adopted by Pakistan.

***Fiscal Incentives for Investment*:** Units in designated export-oriented industries may be allowed duty-free imports of machinery for BMR. New units being established in SEZs or EPZs may also be granted duty exemption on import of machinery 10 year tax holiday.

Chapter 17: Containing Imports

The need for containing imports has emerged not only because Pakistan needs to achieve a degree of self-reliance as the economy develops but also because in coming years Pakistan is faced with large external debt repayment obligations. Between 2021-22 and 2023-24 the cumulative repayment is estimated at $40 billion. Therefore, the current account deficit in the balance of payments will have to be maintained at significantly below 2 percent of the GDP, to limit the external financing requirements. This will require simultaneous containment of imports and the acceleration of exports.

This chapter first highlights the historical relatively rapid growth in imports. The composition of imports is examined to see where there has been a greater upsurge in recent years. This is followed by quantification of the extent import substitution that has been achieved in the country. The existing nature of import policies is examined, especially from the viewpoint of effective protection to economic activities in the country. Proposals are then formulated for greater containment of imports.

17.1. Growth in Imports

The growth in imports is seen in relation to the growth in the GDP and in exports. A comparison is made in Table 17.1. The imports and exports to GDP ratios are shown from 1999-2000 to 2020-21.

The Table clearly demonstrates the substantial rise in the imports to GDP ratio. It has increased from 13.2 percent of the GDP in 1999-2000 to reach a peak of 20 percent of the GDP in 2017-18.

Table 17.1: Trend in The Imports, Exports and the Trade Deficit to GDP Ratios (at current prices) (% of GDP)

	Imports*	Exports*	Trade Deficit
1999-2000	13.2	12.1	-1.1
2004-05	17.8	14.3	-3.5
2009-10	19.4	14.1	-5.3
2014-15	17.0	10.6	-6.4
2017-18	20.0	9.0	-11.0
2020-21	17.9	8.5	-9.4

*Goods and services
Source: *PES*

The level of exports has plummeted from 14.3 percent of the GDP in 2004-05 to 8.5 percent of the GDP in 2020-21. The result has been mushroom growth in the trade deficit from only 1.1 percent of the GDP in 1999-2000 to an unbelievably large deficit of 11 percent of the GDP in 2017-18. The large and growing deficits have partly been financed by home remittances but there has also been resort to large and growing external borrowing to cover these deficits. It is not surprising that the external debt of Pakistan now stands at over $115 billion, equivalent to 41 percent of the GDP.

The argument can, of course, be put forward that the growth in imports has been enhanced by a rise in international prices, especially of oil. Therefore, the ratio of imports to GDP has also been derived in constant prices of 2005-06 to determine the relative growth in the volume of imports and in the real GDP. Estimates are presented in Table 17.2 along with the exports to GDP ratio.

Table 17.2: Trend in The Volume of Imports, Exports and The Trade Deficit to real GDP ratios
(At constant Prices of 2005-06) (% of GDP)

	Imports*	Exports*	Trade Deficit
1999-2000	16.5	10.1	-6.4
2004-05	19.2	13.6	-5.6
2009-10	17.2	13.7	-3.5
2014-15	13.8	10.3	-3.5
2017-18	19.3	9.6	-9.7
2020-21	20.8	11.4	-9.4

*Goods and services
Source: *PES*

The estimates in Table 17.2 reveal a similar trend as in Table 17.1, though somewhat less pronounced. Imports were at a trough of 13.8 percent of the GDP in 2014-15 but have risen since then to 20.8 percent of the GDP. Consequently, the trade deficit in volume terms has risen from 3.5 percent of the GDP to 9.4percent of the GDP in 2020-21.

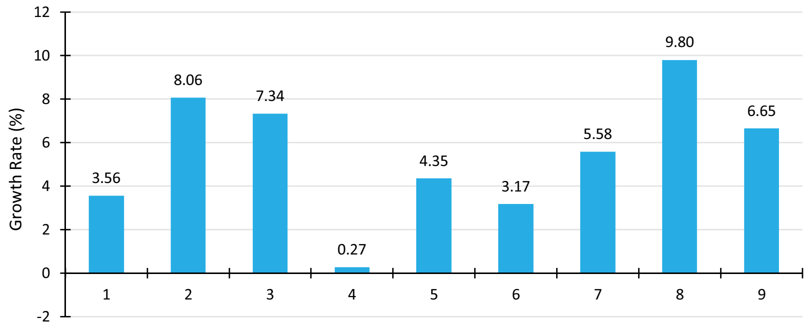
There is no doubt that Pakistan historically had a high marginal propensity to import. A comparison is made with Bangladesh and India to see if this is relatively the case. The elasticity of imports with respect to GDP growth is indeed significantly higher at 1.2 in Pakistan as compared to 0.8 in India and just under 1 in Bangladesh.

17.2. Changes in the Composition of Imports

The annual growth rates in value and volume of major imports of Pakistan from 1999-2000 to 2018-19 are shown in Charts 17.1 and 17.2.

Chart 17.1: Cumulative Growth in Volume of Imports by Groups (%)

1999- 2000 to 2019-20

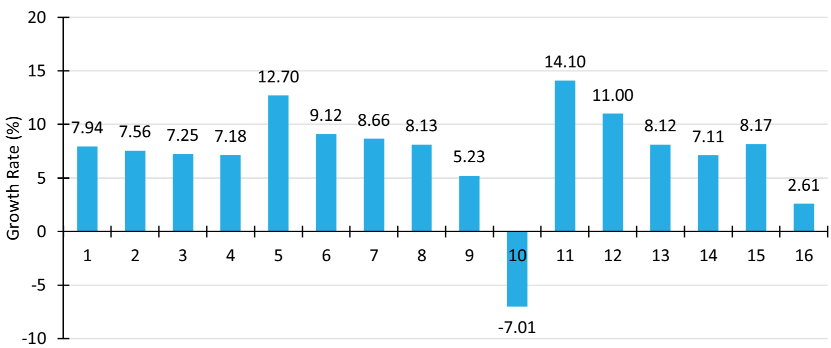


1. Food & Live Animals	2. Beverages & Tobacco	3. Crude Material inedible except Fuels
4. Mineral Fuels & Lubricants	5. Vegetables, Animals Oil and Fats	6. Chemicals
7. Other Manufactured Goods	8. Machinery & Transport Equipment	9. Miscellaneous Manufactured Articles

Source: *PES*

Chart 17.2: Cumulative Growth in Value of Imports by Various Groups (%)

1999- 2000 to 2019-20



1. Chemicals	2. Drugs & Medicines	3. Dyes and Colors	4. Chemical Fertilizer
5. Electrical Goods	6. Machinery (non-electrical)	7. Transport Equipment	8. Paper, Board and Stationery
9. Tea	10. Sugar-Refined	11. Art-Silk Yarn	12. Iron, Steel & Manufactures thereof
13. Non-Ferrous Metals	14. Petroleum & Products	15. Edible Oils	16. Miscellaneous

Source: *PES*

The five fastest and the five slowest growing groups of items are listed below as measured in US$ terms.

Categorization of Imports by Rate of Growth			
Fast Growing	(%)	Slow Growing or Falling	(%)
Art Silk Yarn	14.1*	Sugar Refined	-7.0
Electrical Goods and Machinery	12.7	Grains, pulses	2.6
Iron & Steel Manufactures	11.0	Tea	5.2
Machinery, Non-Electrical	9.2	Chemical Fertilizer	7.2
Transport Equipment	8.7	Dyes and Colors	7.3
Source: *SBP*			

The fast growth in imports of art silk yarn, iron and steel manufactures has been facilitated by duty free imports from China following the FTA. Expansion in power generation capacity since 2014-15 explains the double-digit growth in imports of electrical machinery. As inequality in income increased, there has been rapid growth in imports of vehicles. Slow growth has been registered especially in basic food items like grains, pulses, tea and sugar due to limited growth in real household consumption expenditure in the country.

Another approach has been adopted to look at the composition of imports, as shown in Table 17.3. This relates to the share of consumer, capital, and intermediate goods, respectively.

The trend would be deemed positive if there was faster growth in capital goods or intermediate goods used in the production of capital goods. This would lead to faster growth in the national economy due to the rapid expansion in productive capacity. However, Table 17.5 shows that the share of these types of goods has been fluctuating between 35 percent to 44 percent. Not only is the share of consumer goods plus intermediate goods for consumer goods higher but the direct imports share of consumer goods, especially manufactured goods, is increasing. Clearly, the import demand in the economy is tilted more towards consumer goods.

Table 17.3: Trend in the Composition of Imports of Consumer, Capital and Intermediate Goods (%)

	Consumer Goods			Capital Goods		
	Direct	Intermediate Inputs for Consumer goods	Total	Direct	Intermediate Inputs for Capital goods	Total
2004-05	10	46	56	36	8	44
2009-10	13	52	65	28	7	35
2014-15	17	48	65	27	8	35
2017-18	16	43	59	31	10	41
2019-20	18	42	60	29	11	40
Source: *PES*						

This raises the fundamental question of the degree of success achieved by Pakistan in import substitution in the agricultural and manufacturing sectors respectively. Table 17.4 quantifies the extent of success in this process in agriculture, while the estimates for manufacturing are given in Table 21.3.

Table 17.4: Extent of Import Substitution by The Agricultural Sector of Pakistan (At constant prices of 2005-06) (Rs in Billion)

	Value of Imports of Agricultural Goods	Value of Domestic Production* of Agricultural Goods	Total Domestic Consumption	Extent of Import Substitution
2004-05	89	1632	1721	94.9
2009-10	193	3748	3941	95.1
2014-15	274	8356	8630	96.8
2018-19	1331	14688	16019	91.7

* **Net of Exports of agricultural goods**
Source: *Estimated.*

The state of import substitution in the agricultural sector has greatly worsened in the current year, 2020-21. For the first time in Pakistan's history, there are large imports of three major agricultural items, viz, cotton, cereals, and sugar. The level of imports combined of these items is up by $ 2billion.

17.3. Measures for Import Containment

The basic policy instruments that are available for containing imports are import tariffs and the exchange rate. The level of import tariffs has been scaled down periodically to promote the process of trade liberalization, especially during the tenure of IMF programs.

There was a time before the mid-90s when import tariffs were set at exceptional high levels. The maximum tariff was as high as 120 percent and the principal source of FBR revenues was customs duty. Since then, the level of import tariffs has been brought down periodically as shown below.

Table 17.5 gives the schedule of import tariffs and the average trade-weighted tariff since 2007-08. The average tariff was as high as 22.5 percent in the mid-90s. The effective rate of protection, measured as the difference in value added at domestic prices versus the value added at international prices, without tariffs, was as high as 177 percent. This provided a high level of profitability to import substituting investments.

Table 17.5: Number of Import Tariff Slabs, Average Effective Tariff and the Average Level of Effective Protection to Domestic Production					
	Number of Slabs	Minimum Tariff (%)	Maximum Tariff (%)	Average Weighted Tariff (%)	Average Effect Rate of Protection (%)
Early 90s	10	0	120	22.5	177
2007-08 to 2010-11	7	0	35	7.1	65
2012-13	7	0	30	5.7	52
2014-15	6	1	25	7.0	48
2015-16	5	2	20	7.2	35
2016-17*	4	3	20	9.0	33
2019-20*	4	0	20	9.2	33

*Higher because of Regulatory Duties
Source: *FBR Customs Tariffs and Estimates*

The maximum tariff rate was brought down to 35 percent in 2007-08 and then further reduced stepwise to 20 percent by 2015-16. However, there has been an increase in the average weighted tariff from 7.1 percent in 2010-11 to 9.2 percent in 2018-19.

How did this happen in the presence of falling import tariffs? Insidiously, the previous Government took two steps to contain the growing imports. First, minimum import tariffs were introduced on various items. Second, a regime of regulatory duties was introduced. Initially, 731 items were subjected to regulatory duty vide SRO 1035(1)/2017, with duty rates ranging from 5 to 80 percent.

The resulting effective rates of duty and the extent of duty exemption by commodity group is given in Table 17.6. The effective rate varies from a low of 3.6 percent on mineral fuels and 5.9 percent on machinery to a high of 28 percent in the case of vehicles and 48 percent on ceramic products.

Almost 29 percent of the imports are duty free. This includes, first, imports from China under the RTA. Second, there are area wise and sector wise imports of machinery which are exempt from import duty. Third, import of crude oil is subject to zero duty. Fourth, raw materials and intermediate goods that are not available locally for production of exports have also been exempted to reduce the need for duty drawbacks. There is a case for levying a minimum import duty of 1 percent on all imports to cover the costs of customs valuation and clearances of consignments as is done in some other countries. This will fetch additional revenues of almost Rs 80 billion.

Table 17.6: Effective Rate of Import Duty by Commodity Group, 2019-20						(Rs in Billion)
Chapter	Description	Import Value	Dutiable Import	%	Customs Duty Revenue	Effective Rate %
87	Vehicles	290	269	93	81.5	28.0
27	Mineral Fuels	2180	1580	72	79.4	3.6
72	Iron and Steel	458	393	86	47.2	10.3
84	Machinery	725	407	56	42.5	5.9
85	Semiconductor Devices	502	210	42	42.2	8.4
15	Vegetable Oils	278	275	99	31.7	11.4
39	Plastics & Articles	321	291	91	25.5	7.9
48	Paper & Paperboard	79	73	92	15.1	19.1
73	Articles of Iron & Steel	115	71	62	13.2	11.5
09	Coffee, Tea and Spices	100	97	97	12.0	12.0
29	Organic Chemicals	354	166	47	11.9	3.4
69	Ceramic Products	24	23	96	11.5	47.9
	TOTAL OF ABOVE	5426	3855		413	7.6
	OTHERS	2074	1199		289	13.9
	TOTAL	7500	5054		702	9.4

Source: *FBR year book*

The policy must be to withdraw the regulatory duties and opt for a statutory tariff regime with somewhat higher rates. In this connection it will be useful to make a comparison of the average import tariff in major South Asian countries. This is done in Table 17.7.

Table 17.7: Import Tariffs and Tariff Equivalent of Import Restrictions					(%)
	Agriculture	Manufacturing	Total	Tariff Equivalent*	Overall Total Effective Tariff
Bangladesh	13.4	17.5	14.0	n.a.	n.a.
India	60.7	8.0	10.3	13.4	23.7
Nepal	13.8	13.7	13.7	14.6	28.3
Pakistan	8.0	10.5	10.2	7.5	17.7
Sri Lanka	30.5	17.4	19.0	6.1	25.1

*of various trade restrictions like quotas
Source: *WTO, World Tariff Profiles | World Bank*

The surprising finding is that Pakistan has the most liberal import policy among South Asian countries, especially on agricultural items. It is not surprising, therefore, that the marginal propensity to import is higher in Pakistan.

Clearly, there is a strong case for returning the import tariffs to somewhat higher levels and to withdraw simultaneously the ad hoc imposition of regulatory duties.

The recommended transition is as follows:

From	To
tariff slabs 0, 3%, 11%, 16%, 20%	***tariff slabs 0, 5%, 15%, 20%, 25%***

This will raise the average rate of effective protection from 33 percent to almost 50 percent. The containment policy on imports through larger or smaller increase in tariff hinges on the income elasticity of imports and the respective contribution to growth and production, as shown below.

Commodity Group	Income Elasticity of Demand	Recommended Increase in Import Tariff
• Non-Basic Agricultural Items	0.85	Bigger
• Crude Materials, excluding Fuel	1.88	Bigger
• Transport Equipment	1.72	Bigger
• Other Manufactured Goods	1.05	Bigger
• Chemicals	1.02	Medium
• Machinery	1.11	Smaller
• Basic Food Items	0.87	Smaller
• Mineral Fuels & Lubricants	0.75	Smaller

Therefore, four categories of goods mentioned above need the biggest absolute increase in import tariffs.

Regarding the exchange rate policy, the experience from 2015-16 to 2017-18 provides an important lesson. The exchange rate was kept almost nominally stable during these years. There was an upsurge of imports, and the current account deficit reached the highest ever level of $20 billion. Clearly, the policy must be to avoid any significant overvaluation of the rupee. The movement of the exchange rate should, of course, be market based.

The policy of raising import tariffs somewhat may be criticized by the believers in trade liberalization. However, this must be seen as a step towards achieving a degree of self-reliance. This appears to be the policy adopted by other South Asian countries who have all maintained a more restrictive trade regime.

The path to import substitution must be led by Pakistan's agriculture, especially in wheat and cotton. This should be followed by more import substitution in manufactured consumer goods. The time has come for the slogan of:

Recommendations

Based on the analysis above the derived recommendations are presented below.

***Need for containment of the current account deficit*:** Pakistan's external financing needs are rising exponentially. Over the next three years, the cumulative repayment of external debt is projected at $40 billion. Therefore, the current account deficit must be kept each year to less than 2 percent of the GDP largely by containing imports and promoting exports.

***Imposition of Ad hoc levies on Imports*:** From the viewpoint of containing imports and raising revenues from imports, many regulatory and minimum duties have been levied. These are non-transparent, subject to manipulation and with the regulatory duty rising to above 50 percent on many items has led to greater smuggling. The Customs Tariff must have for each 8- digit item of the Harmonized Code showing the statutory duty, additional and regulatory duty respectively. This will make the customs duty structure more transparent.

***Resetting of Import Tariffs*:** The level and structure of import tariffs needs to be changed to promote greater import substitution and thereby contain imports and replace the ad-hoc impositions on imports. The proposed new structure will have five slabs of 0, 5, 10, 20 and 25% respectively.

***Targeted Increase in Import Tariffs*:** The largest targeted increase in tariffs should be on agricultural items, excluding basic food items, and imported manufactured consumer goods. These are the two areas where the objective must be to achieve the maximum degree of import substitution.

***Introduction of Minimum Import Duty*:** A minimum import duty of 1 percent may be introduced to cover the costs of customs valuation and clearance. This practice has already been adopted in some countries like India.

***Prevention of Under-Invoicing by Introduction of International Trade Prices*:** The practice of significant under invoicing has been observed in many items. These items may be valued for duty purposes with International Trade Prices (ITPs), set by linking to export prices of different countries.

***Emergency Measures in the event of an upsurge in Imports*:** Many mechanisms for quick containment of imports are available as follows along with their advantages and disadvantages:

Advantages and Disadvantages of different Instruments of Import Regulation					
Measure for Restricting Imports	Scope for Differentiation of Products	Additional Revenue	Ease of Administration	Effectiveness in Reducing Imports	Inflationary Impact
Rupee Devaluation	L	H	H	L	H
Higher Import Tariffs	M	M	H	L	M
Regulatory Duties	H	M	M	L	L
Cash Margins on Imports	M	L	M	H	L
Minimum Import Prices	H	M	L	M	M
Tariff Quotas	H	L	L	H	M
H = high, M= medium, L= low					

Depending On the nature of the increase, one or more of the above measures may be adopted.

Steps may be required to limit the growth of imports in 2021-22 because of rapidly international prices. Already, the level of imports has reached the historical peak level of $6.3 billion in June 2021.

Policy on the Exchange Rate**:** The policy must be to ensure that there is no overvaluation of the rupee. The nominal change in the exchange rate should at least correspond to the difference between the domestic and the global rate of inflation.

Raising the Slogan of 'Made in Pakistan'**:** As a measure for achieving greater self-reliance and limiting imports a slogan and a campaign may be launched of:

'Made in Pakistan'

Chapter 18: Managing the Balance of Payments

The ultimate litmus test of the stability of the Pakistan economy rests on the state of the external balance of payments. This determines the level of foreign exchange reserves and the extent of change in the effective exchange rate.

The experience of Pakistan during the last two decades is that the balance of payments tends to worsen during periods of relatively high GDP growth due to the large income elasticity of demand for imports, leading to a big increase in the trade deficit and consequently in the current account of the balance of payments. Also, the economy tends to be vulnerable to high oil prices.

Pakistan has been in an IMF program in 21 out of the last 34 years. Recently, Pakistan has returned to the Extended Fund Facility which had been suspended due to COVID-19. The Program will continue till September 2022. The Fund will monitor Pakistan's performance and support policies which lead to sustainability in the honoring of the external debt repayments.

18.1. Trends in the Balance of Payments

The trends in key magnitudes of the balance of payments are presented in Table 18.1. There appears to be a cyclical pattern in the current account deficit from 2007-08 to 2019-20. The deficit was at its all-time peak as a percentage of the GDP in 2007-08. Thereafter, it declined and in 2010-11 there was a surplus. But the deficit started increasing from 2011-12 onwards and reached another peak deficit level in 2017-18. This was the largest deficit ever in absolute terms. Since 2017-18, there has again been a big improvement and 2020-21 has ended with only a small deficit of $1.8 billion on the current account.

The financial account has had to move in a counter-cyclical fashion to the current account to ensure financing of the latter, especially through higher levels of external borrowing. The all-time peak of inflows into the financial account was 2017-18 when there was also the record current account deficit.

Foreign exchange reserves have also shown considerable fluctuation. They fell to below two months of import cover in 2008-09 and Pakistan had to enter an IMF program for extra financing. The next time was in 2013-14 after yet another fall in reserves to a low level. This is the only Fund program that was successfully completed in 2016.

Following the change of Government in mid-2018 there was an extended period of deliberation as to whether Pakistan should go back to the IMF or not. Eventually, there were negotiations with the Fund and Pakistan entered yet another IMF program in mid-2019.

Table 18.1: Trend in the Balance of Payments ($ million)

	Current Account Deficit	Financial Account Surplus/ Deficit	Other Net Flows	Balance of Payments Surplus/ Deficit	IMF	Change in Reserves	Reserves
2007-08	-14,302	8,310	120	-5,872	-	-5,872	10,680
2008-09	-9,395	5,936	210	-3,249	-	-3,249	7,431
2009-10	-3,946	5,097	115	1,266	2,797	4,063	11,494
2010-11	214	2,101	177	2,492	-267	2,225	13,719
2011-12	-4,658	1,280	103	3,275	-1,155	-1,992	11,727
2012-13	-2,496	549	-45	-1,992	2,538	-4,530	7,197
2013-14	-3,134	5,553	1,439	3,858	-573	3,285	10,509
2014-15	-2,815	5,119	342	2,646	1,949	4,595	15,104
2015-16	-4,961	6,878	735	2,652	2,009	4,661	19,446
2016-17	-12,278	9,855	477	-1,946	102	-1,844	17,550
2017-18	-19,195	13,611	-577	-6,141	-86	-6,227	11,341
2018-19	-13,434	11,759	171	-1,504	-376	-1,880	9,301
2019-20	-4,449	9,313	435	5,299	-745	4,554	13,724

Source: *SBP*

18.2. Level and Composition of External Debt

The process of borrowing to finance current account deficits inevitably leads to an accumulation of external debt. The change in the level and composition of this debt over the last two decades is presented in Table 18.2.

The level of external debt and liabilities has risen from $37.9 billion in 1999-2000 to $112.8 billion in 2019-20. This represents an average annual growth rate of 5.5 percent. The GDP has increased in dollar terms annually by 5.9 percent. As such, the long-term trend is some decline in the external debt to the GDP ratio. In fact, it fell sharply from 49 percent in 1999-2000 to 36 percent in 2009-10. However, it had gone back to 45 percent by 2019-20.

The level of external debt to GDP ratio is more than twice that of India and Bangladesh. However, it is significantly lower than Sri Lanka where the ratio is 69 percent compared to 39 percent currently in Pakistan.

Table 18.2 highlights the composition of the external debt of Pakistan. Almost 78 percent is public and publicly guaranteed debt in 2019-20. This has declined from 92 percent in 1999-2000. The share of the private sector has increased from 8 percent to 10 percent and of others from zero to 12 percent.

Table 18.2: Level and Composition of External Debt and Liabilities			($ million)
	1999-2000	2009-10	2019-20
A. PUBLIC AND PUBLICLY GUARANTEED DEBT	**35,018**	**56,160**	**87,885**
1. Government Debt	27,804	44,801	70,314
2. From IMF	1,550	8,736	7,680
3. Foreign Exchange Liabilities	5,664	2,623	9,891
B. PUBLIC SECTOR ENTERPRISES	**-**	**1,465**	**4,817**
C. BANKS	**-**	**866**	**4,637**
D. PRIVATE SECTOR	**2,842**	**4,314**	**11,120**
E. LIABILITIES TO DIRECT INVESTORS-INTER COMPANY DEBT	**-**	**1,695**	**4,335**
TOTAL EXTERNAL DEBT AND LIABILITIES	**37,860**	**64,500**	**112,795**
Foreign Exchange Reserves	**989**	**14,126**	**12,501**
GDP	76,871	177,410	248128
External Debt and Liabilities as % of GDP	**49.3**	**36.4**	**45.5**
Source: *SBP*			

The level and composition of Government debt is given in Table 18.3. As of 2019-20, the largest share of 44 percent is of outstanding loans with Multilateral agencies like the World Bank and Asian Development Bank. These loans are long-term and concessional in character. Bilateral sources now have the second largest share, of 19 percent. This is primarily loans owed to China for financing of CPEC projects and is also concessional in nature.

Table 18.3: Level and Composition of Government External Debt						($ million)
	1999-2000	Share (%)	2009-10	Share (%)	2019-20	Share (%)
GOVERNMENT DEBT	**27,804**	**100.0**	**44,801**	**100.0**	**70,314**	**100.0**
1. Medium and Long Term	**27,674**	**99.5**	**43,889**	**98.0**	**68,773**	**97.8**
• Paris Club	13,048	46.9	14,942	33.4	10,924	15.5
• Multilateral	12,234	44.0	24,613	54.9	30,898	43.9
• Other Bilateral	639	2.3	1,803	4.0	13,428	19.1
• Euro / Sukuk Bonds	-	-	1,550	3.4	5,300	7.5
• Commercial Loans / Credits	1,100	4.0	-		8,068	11.5
• Others	653	2.3	981	2.3	155	0.3
2. Short Term	**130**	**0.5**	**912**	**2.0**	**1542**	**2.2**
Source: *SBP*						

The flotation of Euro/Sukuk bonds and resort to commercial borrowings from international banks, mainly Chinese, are of more recent origin. The share of the latter source is now over 11 percent. The last bond flotation in 2020-21 was in March 2021 of $2.5 billion.

The record of external borrowing annually is given in Table 18.4. It reached a peak of almost $20 billion in 2018-19. The total cumulative level of external borrowing since 2012-13 is almost $100 billion. This has been used to the extent of 52 percent for repayment of debt and the remainder largely for financing the current account deficit.

Table 18.4: Level of Gross External Borrowing ($ billion)

	Increase in External Debt	External Debt Repayment	Level of External Borrowing
2012-13	-4,579	5,552	973
2013-14	4,369	6,088	10,457
2014-15	-108	4,237	4,129
2015-16	8,785	3,970	12,755
2016-17	9,532	6,523	16,055
2017-18	11,760	6,076	17,836
2018-19	11,112	8,638	19,750
2019-20	6,446	11,345	17,791

Source: *SBP*

18.3. Managing the Balance of Payments

The two critical areas of the balance of payments are limiting the size of the current account deficit and managing the external debt average tenure in such a way that there is no rapid growth in external debt repayment.

The policies for controlling the size of the current account deficit need to simultaneously work on both fronts to regulate the level of imports and promote exports of both goods and services.

Econometric analysis of the historical trends of imports in the balance of payments reveals the quantitative impact of key variables as follows:

- 1 percent increase in the real GDP leads to a 1.26 percent growth in the volume of imports.
- 1 percent increase in the relative price of imports in relation to the domestic price level leads to a 0.20 percent fall in the volume of imports.

Similarly,

- a 1 percentage point rise in the real interest rate reduces the volume of imports by 1.5 percent.

The results of the historical analysis of exports in the balance of payments are as follows:

- 1 percent growth in the volume of world trade leads to a 0.66 percent growth in the volume of exports.
- 1 percent increase in the relative price of exports increases export volume by 1.22 percent.

These elasticities highlight the type and magnitude of policy instruments to be used. These are as follows:

Nominal Exchange Rate: The exchange rate plays a dual role in restricting imports and promoting exports. The policy will be to keep a flexible exchange rate and ensure that the trade deficit remains thereby at the target level. It is estimated that the real effective exchange rate will need to change by 3 percent to 5 percent in 2021-22 due to the big jump in imports. Thereafter, the exchange rate adjustment is expected to be smaller.

Interest Rates: The policy will be to link the policy rate of the SBP to the extent possible to the 'core' rate of inflation in the economy. As such it could rise somewhat by up to 2 percent in 2021-22 and thereafter show a decline.

The export promotion strategy has been described in Chapter 9. The primary elements of the strategy are exchange rate adjustment, cash payment against indirect taxes for 'zero rating' of exports, export refinancing by SBP at a concessionary rate and a discount on the prevailing electricity and gas tariffs.

18.4. Projection of The Current Account

The projection of the current account and the balance of payments is already presented in Table 1.8 of Chapter 1. Given the implementation of measures for export promotion, there is the expectation of some export-led growth in the economy. Exports are projected to grow annually by 8 percent from 2021-22 onwards.

There has been an upsurge in imports in 2020-21, due particularly to the peak in agricultural imports. A growth of almost 23 percent has taken place during the year. The year 2021-22, is likely to witness a growth rate of 12 percent due to the rise in international commodity prices. The conduct of effective import policies should limit the annual growth rate thereafter to 6 percent.

The saving grace for the economy in 2020-21 is the spectacular growth rate in remittances of close to 30 percent. This has led to a situation where for the first time since 2010-11 the current account has been in surplus in the first ten months of 2020-21. However, a small deficit emerged by the end of the year of $1.8 billion. Beyond 2020-21, the growth rate in remittances is expected to be a modest 5 percent only.

The bottom line is that the size of the current account deficit has been limited to $1.8 billion in 2020-21. Three years ago, it was almost $20 billion in 2017-18. Therefore, there has been a big success in controlling the deficit. It is below 1 percent of the GDP in 2020-21. The current account deficit is projected to remain below 3 percent of the GDP thereafter.

18.5. Estimation of External Financing Requirements

The external financing requirements during a particular year are the sum of the following:

(1)	(2)	(3)
Current Account Deficit	External Debt Repayment	Reserves Build-up

less the non-debt creating inflows, like foreign investment.

The projected magnitude of external financing requirements is given in Table 18.5. They are expected to be met by external borrowing of $14.1 billion in 2020-21 rising to $20.5 billion by 2024-25, with a growth rate annually of 9 percent.

The net implication of the gross external borrowing minus the external debt repayment is the increase in the external debt. As shown in Table 18.5, the total external debt of Pakistan, both public and private, is expected to rise from close to $119 billion at the end of 2020-21 to almost $ 142 billion by the end of 2024-25. The external debt to GDP ratio is expected to fall somewhat to below 38 percent of the GDP.

Table 18.5: Projection of External Financing Requirement* ($ million)

	2020-21	2021-22	2022-23	2023-24	2024-25
Current Account Deficit	1.8	6.5	7.5	8.0	9.5
External Debt Repayment	8.2	11.3	12.5	13.0	13.5
Reserve Build Up	5.6	1.5	1.5	2.0	2.5
TOTAL EXTERNAL FINANCING REQUIREMENT	**15.6**	**19.3**	**21.5**	**23.5**	**25.5**
Non-Debt Creating Inflow/ debt relief	1.5	3.0	4.0	4.5	5.0
EXTERNAL BORROWING REQUIREMENT	**14.1**	**16.3**	**17.5**	**19.0**	**20.5**
PROJECTED EXTERNAL DEBT	**118.7**	**123.7**	**128.7**	**134.7**	**141.7**
External Debt as % of GDP	38.8	38.9	38.7	38.1	37.8

Source: *SBP, IMF, Estimated* ** Excluding the Private Sector*

The financing strategy is recommended to be as follows:

	Share of Source of Borrowing (%)
PUBLIC	**80.0**
• Multilaterals[1]	27.5
• Bilaterals[2]	12.5
• Commercial Loans	15.0
• Euro / Sukuk Bonds	10.0
• Foreign Exchange Liabilities[3]	5.0
• Short-term Borrowing	5.0
• Borrowing by PSEs	5.0
PRIVATE	**20.0**
Private Sector / Banks/ Others	15.0
Direct Investors	5.0

[1]including the World Bank, ADB, IDB and the IMF

[2]Paris Club, from China and Others

[3]Swap funds, Deposits of other Central Banks

The projected level of foreign exchange reserves is given in Table 18.6.

Table 18.6: Projected Level of Foreign Exchange Reserves ($ million)

	2020-21	2021-22	2022-23	2023-24	2024-25
Level of Foreign Exchange Reserves	17.3	18.8	20.3	22.3	24.8
Months of Import Cover	3.5	3.4	3.4	3.5	3.6

Source: *Estimated*

Based on the realization of the external financing projections, the level of foreign exchange reserves could reach $25 billion by the end of 2024-25. This will be adequate to provide import cover of over 3.5 months. Pakistan should emerge as and remain an attractive location for foreign investment and lending if the BOP targets of the Charter of the Economy are adhered to.

Chapter 19: The IMF Program

The IMF Program which remained suspended for almost one year after COVID-19 has become operational once again. Effectively the Program has entered the period of the Sixth Quarterly Review up to the end of the current financial year. This implies that the Program will continue till the end of September 2022.

Meanwhile the IMF has played a supportive role. Under the Rapid Financing Facility, a loan of $1.4 billion was released on a fast-track basis to counter the negative impact of COVID-19 in June 2020. Now at the time of resumption a quarterly installment of the loan under the Extended Fund Facility has also been advanced of $500 million.

The sixth review of the Program was held in the first week of June 2021. If Pakistan had succeeded in this review, then a loan installment of $1 billion would have been received from the IMF. But the review identified a lack of implementation of many reforms, which are described below. Consequently, the Program was effectively suspended up to the 7th review due in September 2021. At this time, Pakistan's performance will be assessed in key sectors of the economy, especially after the Federal and Provincial budgets of 2021-22.

This chapter highlights the macroeconomic, fiscal and balance of payments projections for 2021-22 by the IMF and the Federal Government in the Annual Plan for 2021-22, approved by the National Economic Council. This is followed by a listing of the reforms that are to be completed next year as agreed with the IMF in the fifth review. The performance criteria and indicative targets in the Program are presented for the first and second quarter of 2021-22, followed by an assessment of the likelihood of success.

The final section explores the impact of a termination of the program by the IMF or a voluntary withdrawal from the program by Pakistan. The impact on the economy and the steps needed to avert a financial crisis in either case will also be identified.

19.1. Projections for 2021-22

The IMF expects the GDP growth rage in 2021-22 to be somewhat slower at 4 percent in 2021-22, as compared to the Government's projection of 4.8 percent. However, there is a big contradiction here. IMF's estimate of the total investment to GDP ratio is 15.5 percent of the GDP as compared to 14.4 percent of the GDP in the Annual Plan. This implies that the IMF's expectation is that private investment will be more buoyant in 2021-22. As opposed to this the Annual Plan projects a substantially larger level of public investment, financed primarily through budgetary borrowings.

Even bigger differences can be observed from Table 19.1 in the outlook for public finances in 2021-22. This is the Achilles heel of the program. The bottom line is that the IMF expects the consolidated budget deficit to be brought down to 6.3 percent of the GDP. As compared to this, the budget estimates are likely to lead to a budget deficit of 7.7 percent of the GDP, due primarily to a lower level of tax revenues by almost 2 percent of the GDP and higher development spending.

Table 19.1: Projection of Macroeconomic Variables

	IMF	Government
GDP Growth Rate *(%)*	4.0	4.8
Rate of Inflation *(%)*	8.0	8.0
Level of Investment *(% of GDP)*	**15.5**	**14.4**
Public	2.6	4.4
Private	13.0	10.0
Public Finances *(% of GDP)**		
Total Revenues	***16.4***	***15.5***
Tax Revenues	14.2	12.3
Non-Tax Revenues	2.4	3.2
Total Expenditure	***22.6***	***23.2***
Current Expenditure	19.7	19.5
Development Expenditure	2.9	3.8
Budget Deficit	***6.3***	***7.7***
Balance of Payments		
Current Account Deficit ($ million)	***-5419***	***-2216***
Exports – Growth Rate *(%)*	5.5	6.5
Imports – Growth Rate *(%)*	8.7	9.5
Remittances – Growth Rate *(%)*	6.1	7.5
Financial Account	***7533***	***5896***
Change in Reserves	***3442***	***4680***

*as in the Budgets for 2021-22.

The balance of payments projections of the Annual Plan are also somewhat more optimistic, with the current account deficit down to $2.2 billion in 2021-22 as compared to the IMF's estimate of $5.4 billion. The month of May 2021 has witnessed the return to a current account deficit in the month of over $600 million. Therefore, the IMF projection appears to be more realistic. Overall, both projections reveal that foreign exchange reserves could continue rising in 2021-22.

19.2. The Reform Agenda

The IMF program focuses strongly on taxation reforms to lead to a sizeable increase in the tax-to-GDP ratio.

The proposed tax reforms include the following:

***Corporate Income Tax*:** withdrawal of tax credits and allowances and elimination of exemptions.

***Personal Income Tax*:** The first proposal is to increase the progressivity of the tax by reducing the number of slabs from 11 to 5. Simultaneously, there will be a halving of tax credits and allowances.

***Sales Tax*:** The proposal is to eliminate non-standard preferential rates and tax exemptions on items in the different schedules of the Sales Tax Act, 1990.

A fundamental reform proposed is the integration of Federal sales tax on goods and the Provincial sales on services along with harmonization of the tax rates. Also, the petroleum levy is to be raised to Rs 30 per liter.

Economy in expenditure is to be achieved primarily by the reduction in subsidies to SOEs and restricting the increase in contingent liabilities due to larger guaranteed debt of the SOEs. A program, referred to as the triage, is the decision on each SOE as to whether it should be liquidated, privatized or exist in its present form. Further, a new law on SOEs has to be enacted.

A list of the structural benchmarks is given in Chart 19.1.

Chart 19.1: Structural Benchmarks in the IMF Program (for 2021)

		Status
Prior Action (to March 21)		
1.	Adoption of income tax reform	Yes
2.	Submission of amendments to SBP Act	No
3.	Adoption by Parliament of Amendments to NEPRA Act	Yes
4.	Rise in electricity tariff by Rs 1.95 per kwh and quarterly adjustment of Rs 1.62 per kwh	Yes
5.	Approval of by Cabinet of Circular Debt Management Plan	Yes
Structural Benchmarks		
1.	No further tax amnesties	No
2.	No further preferential treatment or exemptions	Yes
3.	Presentation of Mid-Year Review in line with the PFM Act	Yes

Monetary / Fiscal		
1.	Roll out track and trace system for tobacco products	Yes
2.	Audit of COVID-19 related expenditure	Yes
3.	Reduction in CPPA-G payables by payment of Rs 180 billion	No
4.	Finalization of the energy-cross-subsidy reform	Yes
5.	Notification of FY 2020 Q4 electricity tariff adjustment	No
6.	Adoption by Parliament of amendments to OGRA act	No

Source: *IMF*

The circular debt is to be managed, first, by a big escalation in the power tariff in the short-run of over Rs 1.90 per kwh followed by more moves in 2021. A Circular Debt Management plan has to be presented for approval by the Parliament. Also, the regulatory powers of NEPRA and OGRA are to be enhanced. In addition, the Government is expected to assume part of the PHPL debt.

Other major reforms include fundamental amendments in the State Bank Act to grant the central bank much greater economy. Emphasis has also been placed on the implementation of the 9 & 10 Actions in the FATF. Also, no tax amnesties are to be given in future.

The above set of reforms are far tougher than what was included in the initial part of the Program in mid-2019. It is significant that the primary thrust is now on fiscal policy. As per the projections, monetary and exchange rate policies are expected to take a backseat during the remaining tenure of the Program and thereafter.

The primary concern is the extreme bunching of the reforms in a very short span of time. This could exceed the administrative capacity for implementation and also be politically in- feasible for a Government which is already under severe pressure because of the rise in prices of basic food items. Also, the economy has been hit by successive COVID-19 attacks.

The merger of the goods and service sales tax and withdrawal of sales tax exemptions may be deferred to 2022-23 when the economy will hopefully have regained its growth momentum. Similarly, with high oil prices currently, doubling of the petroleum levy will not only have a regressive impact but will also trigger higher inflation.

Instead, more progressive reforms could be implemented. Conversion of the fixed and final tax regime on unearned incomes to advance tax combined with the filing of total income, earned and unearned, will make the tax system more progressive and yield significant additional revenues. Only a small attempt in this domain has been made in the Federal budget. However, tax credits and depreciation allowances on investment must be retained to promote a higher level of investment in the economy.

The Provincial Governments must be induced to develop the urban immoveable property tax. Fortunately, the FBR has completed a comprehensive market valuation of property in urban neighborhoods throughout the country. This information should be used to assess the level of property taxation on individual properties. The next major step is the development of the agricultural income tax following an improvement in the performance of the sector.

19.3. Quantitative Performance Criteria and Indicative Targets

The IMF program has included quantitative performance criteria and indicative targets, following agreement with the Government, for the end of the first and second quarters of 2021-22. Performance in relation to these targets will determine the success or failure in implementing the reform agenda.

The key targets are listed in Table 19.2. the likelihood of meeting each target is discussed below.

Table 19.2: Performance Criteria and Indicative Targets in the IMF Program for 1st and 2nd Quarters of 2021

	FY 2020-21 End-June	FY 2021-22	
		End-September	End-December
Performance Criteria			
• Floor on International Net Reserves *($ million)*	-8,676	-8,618	-7,677
• Ceiling on Net Domestic Assets of SBR *(Billion Rs)*	10,173	9,947	10,190
• Ceiling on Government Budget Primary Deficit *(Billion Rs)*	-246	130	96
• Ceiling on Government Guarantees *(Billion Rs)*	2,715	2,735	2,765
• Indicative Targets			
• Net Revenues of FBR *(Billion Rs)*	4,691	1,181	2,585
• Net Refund Arrears *(Billion Rs)*	65	0	0
• Power Sector Payment Arrears *(Billion Rs)* in Flows	354	-166	-154

Source: *IMF, Second to Fifth Review.*

i) Net international reserves are expected to decline by close to $1 billion by December 21 and remain, more or less, unchanged between June and September. The outcome will depend on the inflows of foreign assistance during a period of suspension of the Fund program, especially from the Multilateral agencies. Also, the level of imports could rise sharply in the short-run in the face of rising international prices of oil and other products.

ii) The ceiling on Government primary deficit is a very important performance criterion. Some space has been provided by setting of small primary deficits and not surpluses. However, restricting this deficit will hinge on the growth of revenues. The annual target at the Federal level is increase of 24 percent in FBR revenues. This is an ambitious target and the Federal budget has not included enough tax measures to facilitate achievement of the target.

Further, there will be need to stagger the very substantial growth in development spending to the second half of the year and to cover some of the power sector circular debt liabilities from the budget as soon as possible. The impact of the increase in salaries and pensions will also come into effect from the beginning of 2021-22.

Given the Federal and Provincial budgets of 2021-22, the current projection is of a primary deficit of significantly above 2 percent of the GDP by the end of the year. Therefore, restricting it to less than 0.3 percent of the GDP in the first quarter may be extremely difficult.

iii) Government guarantees have shown exponential growth in the presence of burgeoning losses of SOEs. They are expected to rise by almost 27 percent in 2020-21. A growth of only 1 percent in the first quarter of 2021-22 looks highly unlikely.

iv) Net revenues, as per the indicative target, of FBR are expected to show growth of almost 17 percent in the first two quarters of 2021-22. This will require vigorous implementation of the measures announced in the budget. Some of the administrative and legal improvements may take time to yield results. Also, the major move towards broad-basing of the retail sales tax will be politically and administratively difficult to implement in the short-run. Further, the enhancement in the petrol levy will inevitably be spread over the year. As such, it will be difficult to show a growth in FBR revenues of 17 percent early in 2021-22.

v) Refund arrears of FBR have fortunately been reduced sharply following the implementation of the FAST system. However, the rise in the sales tax rate on ginned cotton will increase the need for refunds to exporters. There may also still be a stock of past arrears. Here again, the likelihood for ensuring zero refund arrears by end-September 2021 is low.

vi) Transforming the flow of power sector payments arrears from positive to negative will be one of the most difficult targets to achieve. This is likely to be the case even more after the decision by the Government not to escalate power tariffs in coming months.

Overall, there is a high likelihood that the majority of the performance criteria will not be met in September 2021 at the time of the combined sixth and seventh review. How will the IMF respond? Will it give a number of waivers as it did in the previous program from 2013 to 2016?

There is a view that the attitude of the IMF may be influenced by extraneous developments. However, the country will have to pay a huge price by yielding to the regional security related demands of the largest shareholder in the board of the IMF, leading thereby to a softening of the Program.

19.4. Contingency Planning

There is need for the Government to undertake an in-depth and objective assessment of the likelihood of the performance criteria and indicative targets being met in the seventh review of September 21. Attempts may be made to devise a strategy and identify specific measures to coming close to the maximum extent to the targets.

However, there is need to prepare a fallback option and develop a home-grown strategy to meet the external obligations in the event the program is terminated by the IMF or Pakistan voluntarily withdraws from the Program, given its very high economic and political costs, especially in terms of a higher rate of inflation and unemployment.

What could be the ingredients of such a 'home grown' strategy? These are listed below.

i) The external debt repayment in 2021-22 is estimated at $14.7 billion in 2021-22. The big repayments are $4.7 billion on Chinese project loans, largely as part of the CPEC, $2.6 billion to the Multilaterals, $4.4 billion to international commercial banks, mostly Chinese, $1 billion redemption of Euro/Sukuk bond and just over $1 billion to the IMF.

   The scope for roll-over of these repayments will need to be carefully explored. The likelihood is potentially higher in the case of Chinese project loans. This could lead to a deferment of over 31 percent of the liabilities. Chinese commercial banks could also be approached for some extension of the period of repayment of loans.

ii) During the period of suspension of the IMF program and while it still exists on paper there should be a flotation of a Euro/Sukuk bonds in July 21.

iii) Efforts may also be made to secure a larger oil deferred payment facility of up to $3 billion from Saudi Arabia. Apparently, half the amount has already been committed.

iv) The return on Roshan Digital Account, especially on long-term Naya Pakistan Certificates should be enhanced.

v) The current account deficit will have to be reduced substantially to near-zero in 2021-22 in the absence of a functional IMF program, to bring down in a big way the external financing need. This will require the overall level of customs duty plus additional duty plus regulatory duty to be increased further by 20 to 30 percentage points on various non-essential imports.

The coverage of this measure should be extended to all relatively non-essential items like exotic food products, motor cars, textile products, mobile phones, some plastic materials, various other consumer durables, rubber types and paper and paper board. This will also provide an incentive for import substitution. Imports could be reduced by $5 billion, leading thereby to a virtual elimination of the current account deficit. Also, significant additional tax revenues will be generated.

vi) Exports should be encouraged by introduction of a rupee cash payment scheme at the time of export receipts as a substitute for sales tax refunds. Also, zero-rating of domestic sales may be brought back. Suitable adjustment in the exchange rate may also be undertaken.

vii) Investment related fiscal incentives may be brought back in the form of larger initial depletion/depreciation allowance and tax credit on BMR.

viii) More progressive taxation may be resorted to of the type described in Chapter 2, with the justification that Pakistan is finally moving on the path of self-reliance as a self-respecting nation. The enlightened self-interest of the elite lies in contribution to this historic objective.

The PTI had prior to taking over the reins of the Government in its election campaign indicated that one of its objectives is achieve greater self-reliance and eliminate any dependence on the IMF. The time has probably come to pursue this objective and for building a broad-based political consensus on the achievement of this great national objective.

PART-VII

ACCELERATING ECONOMIC GROWTH

Chapter 20: Revival of Agriculture

20.1. Role of Agriculture

Agriculture has historically served as the backbone of Pakistan's economy. At the time of Partition, the share of agriculture in the GDP was 53 percent. Today, it directly contributes almost 24 percent to the GDP, still higher than the contribution of industry of 19 percent to the GDP.

However, what is generally not realized is that the agricultural sector has strong forward and backward linkages. First, it provides inputs to agro-based industries like textiles, sugar, tobacco, beverages, etc. These industries account for 59 percent of the output in manufacturing. Second, it has backward linkages with industries like fertilizer, chemicals, and tractors. Third, almost 53 percent of the income generated in the wholesale and retail trade is through the sale of agricultural items. Fourth, 42 percent of the value added in the transport sector is through the movement of agricultural goods. Overall, it is estimated that 39 percent of the GDP is generated directly or indirectly by the agricultural sector. It is truly the 'primary` sector of Pakistan's economy.

Other key macroeconomic variables are also linked to the performance of the agricultural sector. 39 percent of the national employment is in this sector. Agricultural exports have a 20 percent share directly in exports and almost 34 percent indirectly. The largest share of 30 percent of private investment is in agriculture.

The above facts clearly demonstrate the central role still of agriculture in the economy of Pakistan. An increase of 1 percentage point in the growth rate of the sector can raise the GDP growth rate by almost 0.4 percentage points. On top of this, the sector makes the biggest contribution to food security and poverty alleviation.

Table 20.1 demonstrates that there has been a substantial decline in food security, as measured by the food availability per capita. The food security index has fallen by over 11 percent between 2005-06 and 2020-21. However, there was some improvement in 2020-21 due to bumper crops of wheat, rice and sugarcane.

Table 20.1: Index of Food Security (2005-06 = 100)			
	Output of Food Crops* Index	Population Index	Per Capital Food Availability Index
2005-06	100.0	100.0	100.0
2009-10	106.0	110.0	95.4
2014-15	113.4	123.8	91.6
2019-20	119.8	139.4	85.9

Source: *PES*

The tragedy is that, for many years now, it has remained a largely neglected sector. The emphasis of Governments and planners has shifted to power generation, highways, and industry. Consequently, the growth rate of the sector has plummeted badly with the inevitable negative impact on the GDP growth rate.

The buoyancy of the sector was at its peak in the three decades of the 60s, 80s and 90s. During the 60s, the Green Revolution substantially raised yields, especially of wheat and rice. The impetus to high agricultural growth of 5.4 percent annually in the 80s was provided by the *Tarbela Dam*, which increased the availability of water for agriculture by almost 10 percent. The high growth rate in the 90's, of 4.4 percent, was the result of pro-agriculture policies, especially related to the pricing of inputs and outputs. By 2000, food self-sufficiency had been attained.

During these three decades, the growth rate of agriculture ranged between 4 to 5.5 percent. Since 2000, the growth rate has plummeted to between 2.5 to 3 percent. During the last five years, it has been as low as 1.9 percent, as shown Table 20.2. In fact, since 1999-20, the average annual growth rate has been below 3 percent.

Table 20.2: Growth Rate of The Agricultural Sector		(Annual Growth Rate, %)	
	Crops	Other[c]	Agricultural Sector
1999-2000 to 2004-05	1.8	3.6[d]	2.8
2004-05 to 2009-10	0.1[a]	2.8	2.0
2009-10 to 2014-15	1.7	3.7	2.5
2014-15 to 2019-20	-0.3[b]	3.2	1.9
2020-21	2.5	3.0	2.8

[a] Negative impact of floods on crops in 2009-10.
[b] Decline in 2019-20 due to heavy monsoon rainfall and locust attack.
[c] Includes livestock, forestry and fishing.
[d] There is strong evidence that the growth rate of the livestock sector is overstated.
Source: *PBS*

The acreage and output growth of crops is given in Table 20.3.

The striking finding is that the area under cultivation of major crops has shown significant growth only in this case of rice and maize, along with their yields, with the solitary exception of maize. The biggest fall is in cotton. The area is down by 6 percent annually and the output, every year on average, by 11 percent. There is truly a 'cotton crisis' in the country today.

There is a need to understand why the performance of the agricultural sector has been poor. What are the structural factors which have held back realization of the full agricultural potential of a country with one of the finest irrigation systems in the world?

Table 20.3: Growth in Area and Output of Crops		(Annual Growth Rate, %)	
		2009-10 to 2014-15	2014-15 to 2018-19
RICE	Area	0.0	-0.7
	Output	0.1	0.7
WHEAT	Area	-0.1	-1.5
	Output	0.9	-0.6
COTTON	Area	-1.4	-5.0
	Output	1.6	-8.7
SUGARCANE	Area	3.8	-0.8
	Output	4.8	1.7
MAIZE	Area	4.0	4.6
	Output	10.4	8.1
Source: *PES*			

The first set of explanations relate to the slowdown in the increase in access to inputs, as shown in Table 20.4. First, the cropped area has remained largely unchanged since 2013-14, due to a lack of increase in availability of water. No major dam has been constructed over the last forty years. Initially, there was investment in tube wells for extraction of groundwater, but limits have been reached and the number of tube wells has remained largely unchanged since 2014-15.

Table 20.4: Growth in The Availability of Agricultural Inputs					(Annual Growth Rate, %)		
	Cropped Area	Water Availability (Canal water)	Number of Tube wells	Fertilizer Use		Credit	Annual Production of Tractors
				Urea	Total		
2000-01 to 2004-05	0.8	0.2	8.0	5.3	5.5	10.0	7.6
2004-05 to 2009-10	0.9	-0.3	2.0	4.4	3.3	2.0	9.7
2009-10 to 2014-15	-0.5	0.7	4.1	-0.9	-0.2	4.1	-8.9
2014-15 to 2020-21	0.2	-1.1	1.0	2.0	1.7	-3.0	-1.4
Source: *PES*							

Second, the use of fertilizer has shown little growth annually since 2014-15 of only 1.7 percent. The nutrient content has been characterized by the overuse of nitrogenous fertilizer. Between 2005-06 and 2012-13, the prices of fertilizer rose very sharply, by over 18 percent per annum, especially after the levy of the Gas Infrastructure Development Cess, which has withdrawn subsequently.

Third, the availability of credit has been limited. The share of agriculture is 12 percent in total advances currently. A big portion is preempted by large farmers. Fourth, the pace of mechanization has slowed down, especially in recent years due to the jump in the price of tractors following the big rupee devaluation. The use of insecticides has also not increased significantly despite frequent pest attacks.

20.2. Constraints to Growth

There are four structural factors that have contributed to the lack of realization of the full agricultural potential. The first is the extremely skewed ownership of farmland. The top 1 percent of the farmers own as much as 23 percent of the farm area. These farms are characterized by relatively low land use and cropping intensities, and wasteful use of water. At the other extreme, 43 percent of the farmers own / operate small farms of less than 2.5 acres and do not possess the resources to invest in improved seeds and technology. Pakistan today has one of the most skewed distributions of farmland, but land reform does not feature any more in policy debates as in the decade of the 70s.

The second structural impediment is the policy of providing little or no protection to domestic output of agriculture as shown in Table 20.5. According to the WTO tariff profiles, Pakistan has the lowest MFN tariff on agricultural imports, of only 8 percent, as compared to 17 percent in Bangladesh, 33 percent in India and 24 percent in Sri Lanka.

Table 20.5: Average MFN Tariffs on Imports of Agricultural Commodities in Different Countries – 2019 (%)

	Pakistan	India	Bangladesh	Sri Lanka
Animal Products	12.0	32.5	19.3	26.6
Dairy Products	20.0	35.7	24.0	39.1
Fruits and Vegetables	13.3	33.2	21.2	25.1
Tea	11.4	56.3	22.5	28.8
Cereals	11.0	37.1	16.0	24.4
Oils (Palm)	7.8	52.0	10.3	24.6
Cotton	0.0	26.0	3.5	0.0
Sugar	20.0	n.a.	n.a.	n.a.
Other Agricultural Products	6.7	29.0	11.4	13.0
Overall Average*	13.5	38.8	17.5	27.1

*Unweighted
Source: *WTO, Tariff Profiles.*

The third factor is the lack of institutional support to agriculture. Perhaps, the biggest failure is in providing research, extension, and loan services, especially to small farmers. Less than 1 percent of the agricultural value added goes to Research and Development, especially on new varieties of seeds for crops like cotton.

The fourth key factor is pricing policy on agricultural outputs. There was a time when Pakistan used to have a procurement / support price regime, to reduce risk perceptions of farmers, on wheat, rice, sugarcane, cotton (*phutti*), potato and onion. Now it is only offered for wheat and sugarcane.

The overall consequence has been not only a fall in the sectoral growth rate of agriculture but also a fundamental change in cropping patterns. The biggest change since 2004-05 is the simultaneous 14 percent increase in the area under sugarcane and 26 percent decline in the area under cotton, due to the influence of the powerful sugar lobby. Also, the area under maize has increased significantly since 2004-05 by 40 percent.

This is due to the changes in the ratio of output to input prices of different crops, as shown in Table 20.6. The biggest drop in profitability up to 2019-20 was in the case of cotton, followed by wheat. Fortunately, there was a big increase in the procurement price from Rs 1400 per maund to Rs 1800 in Punjab and Rs 2000 in Sindh for the 2020-21. This has led to a record level of wheat output of over 27 million tons.

Table 20.6: Ratio of Output to Input Prices of Different Crops (2017-18 = 100)

	2017-18	2018-19	2019-20	2020-21
Wheat	100.0	84.2	79.5	99.4
Cotton	100.0	97.8	75.1	114.5
Rice	100.0	95.6	103.1	102.7
Sugar Cane	100.0	84.2	83.2	82.1
Maize	100.0	104.1	99.3	97.2
Minor Crops	100.0	85.2	93.2	95.6

Source: *PBS | WPI | PES*

Based on all the above factors which have contributed to the plight of agriculture, there is now a true indicator of the state of collapse of agriculture. *For the first time in Pakistan's history, we have seen imports simultaneously of three major agricultural items in 2020-21. These are 3 million tons of wheat, 0.5 million tons of sugar and as much as 6 million bales of cotton. The combined import bill will approach $3.5 billion. Export competitiveness of textile manufacturers will also be adversely affected.*

It is truly unfortunate that Pakistan which was once a net agricultural exporter has now become a net agricultural importer of as much as $3.5 billion. Sensible and prudent pro-agricultural policies could have avoided this situation.

There is a need to identify the set of reforms and policies to restore the buoyancy of agriculture. Otherwise, consequences will be high inflation in food prices and less food security, big rural-urban migration due to the lack of agricultural absorption of the incremental rural labor force, rising pressure on the balance of payments because of larger agricultural imports and greater poverty.

Successful implementation of the reforms proposed in the next section can lead to early gains in agricultural productivity. The '*yield gap*' of Pakistan is large. The wheat yield in the country is only 47 percent of the yield of the largest global producer, while it is 51 percent in the case of rice and 32 percent only in cotton.

20.3. Strategy for Promoting Agriculture

Based on the above description of the plight of agriculture in Pakistan, there is a dire need for agricultural revival. Reforms and measures are recommended below for early and effective implementation. The target as identified in Chapter 1 is to raise the growth rate of the agricultural sector from under 2 percent to 4 percent by 2024-25.

Providing More Effective Protection

The agricultural sector has been receiving little protection from imports. There is a need for a proper tariff wall to insulate the farming population and enable the realization of a moderate level of income per acre.

The tariff policy on agriculture imports is recommended to be changed as follows:

Items with Import Tariff currently of	New Import Tariff
0%	0% or 5%
3%	5%
11%	15%
20%	25%

The new recommended tariff is 5 percent on cotton, wheat, pulses, vegetables. Two important other changes are, first, reduction in the import duty on sugar from 20 percent to 15 percent and transition, in the case of palm oil, from a specific to ad- valorem tariff of 15 percent.

Changing the Domestic Price Regime

Currently there is only a procurement price of wheat and a support price for sugarcane. A support price should also be given to cotton once again, corresponding to the landed cost of cotton import. The support price for sugarcane should be withdrawn henceforth, given that the water requirement per acre of this crop is three times that of cotton. A minimum price may be also guaranteed for different vegetables, given that the prices of vegetables are characterized by violent seasonal fluctuations.

Improving the Terms of Trade

The above section of the Chapter has demonstrated that the terms of trade between output and input prices have generally worsened since 2015 with some recent improvement. The prices of urea, DAP, pesticides, cotton seed and tractors have risen at a much faster rate, by 38, 25, 24, and 26 percent, respectively. Output prices have generally gone up by 2 to 10 percent, with the notable exception of wheat in 2020-21.

The key issue is the pricing of fertilizer. There continues to be a relatively low price of natural gas as a feedstock into fertilizer production and the sales tax on fertilizer is 2 percent. The tax should be withdrawn. Imported fertilizer should be exempted from all taxes. In addition, the relative price should be shifted towards DAP.

Greater Investment in Agriculture

The Provincial Governments have not allocated an adequate share of their development funds to agriculture. For example, the Government of Punjab allocated only 8 percent of its ADP to agriculture in 2019-20. There is a need for investment in small hydel projects, lining, and desalination of canals and in a bigger network of rural roads for marketing of produce.

The Federal Government must ensure the timely completion of the Daimer-Basha and Mohmand Dams. The big enhancement in availability of water will give a big push to agriculture, as it did in the early 80's after the commissioning of the Tarbela Dam. There is also a need for a subsidy on drip irrigation equipment. It is reassuring to note that a increase has been made in the Federal PSDP of 2021-22 for water resources development.

More and Better Targeting of Agricultural Credit

The share of agricultural credit has actually declined since 2014-15 in total private sector credit. The share of small and subsistence farmers is below 25 percent in total agricultural credit.

Commercial banks may be given some incentives to compensate for the higher transaction cost and risk of agricultural lending. First, a tax credit be given of 5 percent on the increase in the quantum of agricultural credit during the financial year. Second, the tax deductibility provision against bad loans in the Income Tax Ordinance may be increased in the case of small agricultural loans. Third, a Credit Guarantee Scheme should be set up by the SBP.

Taxing More Large Farms

There are 92,919 farms in Pakistan with farm size of 50 acres or more, according to the Agricultural Census of 2010. The combined net income of these farms is estimated at over Rs 800 billion, with an average annual income per farm of over Rs 8.5 million. However, the national revenue from the agricultural income is hardly Rs 3 billion.

These large farms are characterized by less efficient use of land in the presence of large net incomes. The share of cultivated area in total farm area is only 48 percent as compared to over 90 percent in the case of small farms. Therefore, not only from an equity but also from an efficiency point of view, there is a strong case for a progressive agricultural income tax with high tax rates. The revenues generated should be earmarked for financing development projects in the agricultural sector.

Proper Pricing of Water

Pakistan is perilously close to being declared a '*water short'* country. Pricing of irrigation water has assumed importance from the viewpoint of promoting economy in the use of water. However, the current rates of *Abiana* are extremely low. They cover only 8 percent of the O&M and replacement costs of the irrigation system. They will need to be raised substantially to prevent profligacy in the use of water.

Higher Investment in Research and Development

The existing institutional structure for R&D and agricultural extension has failed. The allocation of funds should be at least 1 percent of the value added in agriculture. Tax concessions may be given for private sector participation in the development of better seeds, especially in the case of cotton, more robust varieties of different crops and optimal mix of inputs.

Within the public sector, the time has probably come for handing over the R&D and agricultural extension function to the government-owned Agricultural Universities in Pakistan. This will ensure that the findings and outcomes of R&D are more quickly and efficiently transmitted to farmers.

Overall, the agricultural sector must be given the highest priority in the Charter of the Economy if Pakistan is to achieve faster and more inclusive growth.

Chapter 21: Manufacturing Sector

The manufacturing sector plays a leading role in accelerating the pace of economic growth in Pakistan. For example, the GDP growth rate reached a peak in 2004-05 of over 9 percent. More than half of this was due directly or indirectly to the extremely high growth rate of the manufacturing sector of over 18 percent. Also, when the manufacturing sector performs poorly the GDP growth rate tends to be low. During 2018-19 and 2019-20 output of the sector fell by 8 percent. Consequently, the GDP growth rate in the former year was only 2.1 percent and actually negative by 0.5 percent in the latter year.

Given the importance of the manufacturing sector in the process of growth, one of the key targets in the Charter of the Economy is to raise the growth rate of the sector to 8 percent by 2024-25. This will contribute to the achievement of the target GDP growth rate of 6 percent.

21.1. Characteristics of The Sector

The manufacturing sector consists of three sub-sectors, viz., large-scale manufacturing, small-scale manufacturing and slaughtering. The combined contribution to the GDP is 12.5 percent, with individual shares of 9.5 percent, 2 percent and 1 percent respectively.

The growth rate of the manufacturing sector has been systematically on the decline since 2004-05, as shown in Table 21.1 below. This continuing fall in the sectoral growth rate can be considered as one of the major structural problems that the country faces today. Fortunately the year, 2020-21, has witnessed a recovery by the sector with a growth rate approaching 9 percent, due to the depressed output in 2019-20 after COVID-19.

Table 21.1: Average Annual Growth Rate of The Manufacturing Sector (%)

	Large-Scale	Small-Scale	Slaughtering	Total
1999-2000 to 2004-05	12.0	7.5	3.9	10.9
2004-05 to 2009-10	4.0	8.5	3.5	4.3
2009-10 to 2014-15	3.2	8.3	3.5	3.8
2014-15 to 2019-20	0.7	6.8	3.6	1.7
2020-21 (up to April)	9.3	8.3	3.9	8.7

Source: *PES*

The growth rate of the major industries in large-scale manufacturing is given in Table 21.2. The pattern of growth in each industry is, more or less, the same as the sector, with the notable exceptions of cement industry which attained a peak growth rate from 2004-05 to 2009-10 and the sugar industry which reached a double-digit rate between 2009-10 to 2014-15.

Table 21.2: Growth Rate of Major Industries

	Cotton Yarn	Cotton Cloth	Fertilizer	Vegetable Ghee	Sugar	Cement	Cigarettes
1999-2000 to 2004-05	6.6	16.6	5.7	9.0	6.3	12.3	6.2
2004-05 to 2009-10	4.3	1.8	2.0	0.7	2.9	14.0	1.7
2009-10 to 2014-15	3.8	0.5	2.0	2.0	11.1	0.8	-0.7
2014-15 to 2019-20	-0.2	-0.4	3.8	4.4	1.7	4.9	-1.4
2020-21 (up to April)	10.3	10.0	7.4	-2.8	16.5	25.4	19.8

Source: *PES*

According to the Census of Manufacturing of 2005-06, the share in the value of output of large-scale units of intermediate material inputs was close to 60 percent. The share of electricity and gas costs was estimated at 6 percent. According to more recent estimates, while the former share has remained, more or less, unchanged, the former share has increased to 11 percent.

The small-scale manufacturing sector has a level of value-added equivalent to 30 percent of the large- scale sector. Given its widespread presence and informal nature it is difficult to derive its annual growth rate. The PBS assumes it to be close to 7 percent, which is clearly biased upwards. However, its share in sectoral employment is over two-thirds, given its relatively labor-intensive nature. Bulk of the employment is in units of textiles and apparel, leather, food and beverages and metal products.

Pakistan had historically followed a policy largely of import substitution in the industrial sector. Table 21.3 highlights the extent of import substitution in the use of manufactured goods in the country. The research findings are very revealing. Already, by 2000-01, the extent of import substitution achieved was as high as 70 percent. However, even after eighteen more years, it has remained unchanged at 71 percent. Clearly, industry has not acquired greater ability to contend with the competition from imported manufactured goods.

Table 21.3: Extent of Import Substitution in The Use of Manufactured Goods (Rs in Billion at constant prices of 2005-06)						
	Import of Manufacturing Goods	Domestically Manufactured Output	Export of Manufacturing Goods	Domestic Use of Manufactured Goods	% Import Substitution	% of Exports
	[1]	[2]	[3]	[4]	([2] – [3]) / ([1] + [2] – [3])	[3] / [2]
2000-01	865	2479	422	2922	70.4	17.0
2005-06	1572	4235	826	4981	68.4	19.5
2009-10	1472	4465	825	5112	71.2	18.5
2014-15	1280	4883	762	5401	76.3	15.6
2017-18	2196	6337	949	7584	71.0	15.0
Source: *SBP | PBS*						

Analysis has also been undertaken in Table 21.3 of the share of exports in the domestic production of manufactured goods. The estimates are that the share has declined from a peak of 20 percent in 2005-06 to 15 percent in 2018-19. This is yet another indicator of the disappointing performance by the sector.

The manufacturing sector continues to have strong forward and backward linkages with agriculture. Over 60 percent of the sector value added is by agro-based industries including textiles, sugar, cigarettes and vegetable ghee. Also, 34 percent of the sectoral value added is by consumer goods industries, 60 percent by intermediate goods industries and only 6 percent by units engaged in the manufacture of capital goods. Bulk of the machinery is imported.

21.2. Constraints to Growth

The long-term fall in the growth rate of the manufacturing sector is attributable to a number of factors described below.

Premature Reduction in Level of Effective Protection

Pakistan has been undergoing a process of trade liberalization since the late 90s. the maximum tariff has been scaled down from 60 percent to 20 percent as shown in Table 21.4. Frequently, there has been a very big decline in the level of effective protection from 112 percent on average in 1997-98 to only 33 percent in 2018-19. This is primarily due to pressure to scale down import tariffs in the various IMF Programs with Pakistan. Consequently, this has reduced profitability and retarded investment in the sector.

Table 21.4: The Import Tariff Structure				
	Number of Slabs	Minimum Tariff (%)	Maximum Tariff (%)	Average Effective Rate of Protection*
1997-98	8	0	60	112
2007-08	7	0	35	65
2013-14	7	0	30	52
2018-19	4	0	20	33

*% difference in value-added at domestic prices compared to the value-added at world prices.
Source: *FBR*

The path of investment in the manufacturing sector is given in Table 21.5. The long-term growth rate is only 1 percent after 2000-01. With this sluggish path of new investment or balancing modernization and replacement (BMR), it is not surprising that the industrial sector has become less competitive. Also, the rate of capacity utilization has been rising. Consequently, there is only limited capacity available in the short-run for boosting output in a big way.

Table 21.5: Growth of Investment, Capital Stock and Output of The Manufacturing Sector (Valued at constant prices of 2005-06) Annual Growth Rate (%)				
	Investment	Capital Stock	Output	Capacity Utilization
1999-2000 to 2004-05	7.0	4.5	10.2	5.7
2004-05 to 2009-10	-7.3	4.2	4.1	-0.1
2009-10 to 2014-15	0.5	0.9	3.7	3.2
2014-15 to 2019-20	4.5	1.7	2.8	1.1
2020-21	1.2	-3.2	9.0	-
Long-Term Growth Rate (%)	***0.9***	***3.0***	***5.2***	***2.8***

Source: *PBS*

Excessive Tax Burden

The large-scale manufacturing sector has been the favorite target for taxation because of the domination of corporate entities and generally documented transactions. Further, much of the imported duty revenue is collected from manufactured goods imported, like petroleum products.

Consequently, the distribution of tax revenues, both Federal and Provincial, is very biased. 67 percent of the revenue is from the industrial sector, 30 percent from services and 3 percent only from agriculture. The tax burden on industry is very high at almost five times as on the economy as a whole.

The sales tax rate on manufacturing was initially set at 12½ percent of value-added in the late 90s. Subsequently, it was raised to 15 percent. It now stands at 17 percent. Similarly, the share of dutiable imports of manufactured goods has been increased. Further, very high rates of excise duties have been applied on a number of goods like cigarettes.

High Power Tariffs

Industry has been placed at a competitive disadvantage due to the very high-power tariffs in Pakistan. Currently, the average tariff per kwh is equivalent to 16 cents. This compares with 6.7 cents in Sri Lanka, 7.4 cents in Indonesia, 7.7 cents in Vietnam, 10.2 cents in Turkey, 10.6 cents in Malaysia, 10.6 cents also in Bangladesh and 11.4 cents in India. More recently, a special concession has been made for five export industries, especially textiles, of a reduced tariff of 9 cents per kwh.

21.3. Reviving Industry

There is a need for a strong set of reforms and major policies described below for industrial revival. This will enable realization of the target growth rate of 7 percent to 8 percent by 2024-25.

Enhancing the Level of Effective Protection

As highlighted above, Pakistan has moved too prematurely towards trade liberalization. A comparison with other countries confirms this finding. The average MFN tariff and the Trade Restrictive Index is given for a number of countries in Table 21.6. The latter includes the impact of non-tariff measures and trade agreements on imports.

Therefore, there is a need for providing more tariff protection to industry. As indicated in the chapter on Agriculture there is need to change the tariff structure by raising the maximum tariff. As such, four slabs are recommended of 0 percent, 5 percent, 15 percent and 25 percent respectively.

Table 21.6: The Average MFN Tariff and The Trade Restrictiveness Index* on Manufactured Goods of Selected Countries – (%)

	Average MFN Tariff	Trade Restrictiveness Index
Egypt	13.4	32.6
India	14.1	13.4
Malaysia	5.3	25.9
Bangladesh	13.4	16.8
Pakistan	11.9	7.5

*including the tariff equivalent of non-tariff measures and trade agreements
Source: *WTO, Tariff Profiles | World Bank*

Rationalizing the Sales Tax Rates on Domestic Production

There is need for reviewing the inclusion of items in the Sales Tax Schedules in the Sales Tax Act of 1990 with a viewpoint to rationalizing the tax rates and broad-basing the coverage by withdrawal of exemptions. The following Schedules need to be reviewed:

Third Schedule:	Items subject to tax on retail price
Sixth Schedule:	Goods supply or imports exempt from sales tax
Eight Schedule:	Items subject to special reduced rates
Nineth Schedule:	Items subject to fixed taxes
Tenth Schedule:	Items taxed on production capacity

The Third Schedule violates the allocation of fiscal powers according to the Constitution. Sales taxes on services, including wholesale and retail trade, are in the Provincial domain. Therefore, the Third Schedule should be withdrawn, implying a reduction in the tax rate on some industries.

Wherever possible exemptions and reduced rates should be withdrawn. The only exceptions should be basic food and other essential items. Also, the value added tax nature of the tax should be preserved and fixed taxes generally avoided. Overall, the target should be to reduce the standard rate to 15 percent from 17 percent, while achieving higher level of revenues by withdrawing exemptions, lower tax rates and fixed taxes wherever possible.

Access to Credit

The manufacturing sector has fortunately received relatively large share of credit from commercial banks. However, the access of the over 3 million SMEs has remained very limited at only 6 percent of total private sector credit. There is a case for creating a specialized Development Financial Institution (DFI) for SMEs, as defined by the SBP, and offering special tax incentives to commercial banks to lend to SMEs. The Federal Budget of 2021-22 has provided some tax relief and greater access to credit.

There is also need to ensure that interest rates are not high. For example, during 2018-19 and the earlier part of 2019-20, the policy rate was raised to a very high level of 13.25 percent, with the corresponding enhancement in the interest rates on bank advances. This is one of the reasons for the big fall in the level of private investment of 12 percent. The interest rate policy must maintain a link with the rate of core inflation which is currently close to 7 percent.

Exchange Rate Policy

Exports from 2013-14 onwards to 2017-18 have been adversely impacted by the policy of maintaining an overvalued exchange rate. The Real Effective Exchange Rate (REER) Index reached a peak value of 121.1 in June 2017, with the base year of 2010. The policy ought to be avoid any overvaluation or undervaluation of the rupee. The rupee is once again somewhat overvalued currently.

Free Trade with China

The FTA with China was extended to a larger number of items under Phase-II in 2019. China has offered to eliminate tariffs on 313 most priority tariff lines of Pakistan's export interest. This list includes textiles and garments, sea food, meat, prepared foods, leather, chemicals, plastics, footwear, etc. Pakistan has put 25 percent of the tariff lines on the protected list and a number of safeguard measures have been instituted.

Table 21.7: Imports from and Exports to China

	Imports from China		Exports to China		Trade Deficit with China	% of Total Deficit
	Level	Share of Total Imports (%)	Level	Share of Total Exports (%)		
2009-10	4411	12.7	1154	6.0	-3257	
2014-15	10395	22.7	2170	9.2	-8225	
2019-20	9956	23.4	1661	7.4	-8295	42.2
Annual Growth Rate (%)	8.1		3.6		9.3	

Source: *SBP*

China has emerged as by far the largest exporter to Pakistan, with a share of over 23 percent in the country's imports. Items imported from China include the following in 2019-20:

HS Code	Commodity	Import from China, 2019-20 ($ million)
29	Organic Chemicals	827
31	Fertilizers	332
32	Tanning or Dying Extracts	204
38	Miscellaneous Chemical Products	209
39	Plastics and Articles Thereof	431
48	Paper and Paper Board	167
54	Man-made Filaments	501
55	Man-made Stable Fibers	221

72	Iron and Steel	701
84	Nuclear Reactors, Boilers, Machinery and Appliances	2299
85	Electrical Machinery and Equipment thereof	3198
	TOTAL	**9090**

The imports primarily consist of intermediate and capital goods. Many of the imports are currently non-competitive in nature. But this has reduced the likelihood of greater diversification of Pakistani industry. There is also evidence of significant under-invoicing of imports from China.

The share of the large Chinese market in Pakistan's exports is only 7 percent even after the FTA. Exports to the USA, UK and the EU countries remain larger. Consequently, the trade deficit with respect to China is very large at almost $8.3 billion in 2019-20, equivalent to 42 percent of the global trade deficit of the country.

The time has come for a review of the costs and benefits of the FTA with China. There is need also to determine if the safeguards are being properly applied. Ultimately, Pakistan may need to ask for a greater *quid pro quo* from China for continuation of the FTA.

Pricing of Energy

The estimated average tariff paid in 2019-20 for electricity per kwh, including the taxes and levies, was (13.68 cents) Rs 21.89 per kwh. This includes the lower rate of 9 cents per kwh charged on the five export sectors. The flexibility in bringing about a tariff reduction is limited by the massive stock of circular debt and its rapid rate of increase.

However, the Government has introduced an appropriate incentive scheme after COVID-19 for reducing the marginal cost of electricity. Any consumption of electricity beyond the last year's level will enjoy a 25 percent to 50 percent discount depending upon the size of the unit. This scheme is operational up to March 31st, 2021. It should be made a lasting incentive especially since higher industrial production will lead to a big increase in tax revenues.

Higher Agricultural Growth

As highlighted earlier, 60 percent of the manufacturing sector has forward or backward linkages with agriculture. Therefore, a rise in the growth rate of the agricultural sector is a necessary pre-condition for faster growth of the manufacturing sector.

The Chapter has highlighted the big loss of momentum in the growth of the manufacturing sector over the last fifteen years, with consequential impact on the GDP growth. There is need for implementation of the abovementioned reforms and policies if the target of 8 percent growth in the Charter of the Economy by the manufacturing sector is to be met by 2024-25.

21.4. Supporting the SMEs

Small and medium enterprises (SMEs) have been identified as production units with employment up to 10 workers, as per the Factories Act. However, the SBP has multiple criteria for identifying an SME. The number of employees should not exceed 250; the value of assets should be less than Rs 100 million and sales turnover up to Rs 300 million. The SBP definition covers a much larger number of establishments in the category of SMEs.

The focus here is on SME sector in manufacturing. According to the Labor Force Survey by the PBS of 2017-18, the total employment in the manufacturing sector was 9.9 million. It is estimated that 63 percent of this employment, over 6.2 million, is in SMEs. The value-added by these SMEs is Rs 755 billion as of 2020-21, equivalent to 1.6 percent of the GDP.

However, these estimates are biased downwards. The last Economic Census was conducted in 2005. This census reported the total number of SMEs, as per the PBS definition, at over 2.9 million. The number of SMEs in the manufacturing sector was almost 0.5 million, with average employment per unit of 3.3 workers. As such, there are probably 1.9 million SMEs currently in the manufacturing sector and the overall number in the country is close to 5 million.

The Economic Census also indicated that within the manufacturing sector, the largest share of 43 percent was in textiles wearing apparel and leather industries. Other major industries, with large number of SMEs, are food, beverages and tobacco, manufacture of fabricated metal products and handicrafts.

These SMEs in the manufacturing sector have a strong export orientation and contribute, either directly or indirectly, to almost 25 percent of Pakistan's manufactured exports. Therefore, supporting their operations will strengthen the country's capacity for export.

The commercial banking system has provided only limited support to SMEs. The total outstanding credit to SMEs in the country is Rs 444 billion as of March 2021. The share of manufacturing SMEs is 40 percent. The share of SMEs in total private sector credit is only 6.6 percent, despite their major contribution to non-agricultural employment and significant share in exports. The total number of SME borrowers is just over 300,000. Therefore, only 5 percent of the SMEs in the country currently have access to credit.

The performance of SMEs has been adversely affected by the successive attacks of COVID-19. According to NEPRA, electricity consumption by industrial units fell by over 10 percent in 2019-20. SMEs, in particular, have faced serious problems of lack of liquidity, delayed payments, supply chain disruptions and high default risk on loans.

The SBP announced a number of financing packages to reduce the negative impact on production and employment after the first COVID-19 attack. Unfortunately, there has been a bias in primarily supporting large-scale units. Only 10,406 SMEs have benefited from the Loan Extension and Restructuring Package and even fewer, 2,603, from the Rozgar Risk-Sharing Scheme. The electricity DISCOs offered a deferment of payment of electricity bills. This benefited over 300,000 SMEs, but the benefit was much smaller in magnitude.

There has been recovery in exports in 2020-21. Exports largely by SMEs like carpets, surgical instruments, sports goods, leather products, etc., have, however, shown combined growth of only 6 percent over the pre-COVID-19 level. Domestically oriented SMEs have made even less progress.

Steps to Support SMEs

The recovery and growth of the large number of SMEs will require various steps to support their operations, especially in the presence of COVID-19 attacks, including the following:

i) The budget of 2021-22 has announced that the threshold level for payment of sales tax has been raised from Rs 3 million to Rs 10 million. This is still by SBP standards, whereby SMEs can have turnover up to Rs 300 million. Therefore, the exemption limit must be substantially higher.

   The withholding tax on electricity consumption by industrial and commercial consumers has been revised in the Federal budget. The exemption limit of this tax is up to a monthly electricity bill of Rs 500. There is need for different tax slabs for industrial and commercial consumers as the average net income per kwh varies greatly between these two categories of consumers. It is much higher for commercial consumers. Therefore, the exemption limit for industrial consumers may be raised to Rs 5000. This will be the appropriate level for SMEs in the manufacturing sector.

ii) Further, as a major attempt at simplification of the income tax system, industrial SMEs who pay less than Rs 10,000 as the annual withholding tax, the amount paid may be treated as the final discharge of the income tax liability. This will save SMEs from harassment by the tax collector. Of course, if an SME wants to claim a refund it will have to file a return.

iii) The Budget Speech of 2021-22 includes the provision of interest-free loans of Rs 0.5 million, especially to SMEs. This is a welcome move and will encourage modernization of plant and machinery and as the economy expands and investment in additional capacity especially in the export sectors.

However, there is built-in reticence on the part of commercial banks on leading to because of the relatively higher transaction costs and greater lending risks. This can be mitigated in two ways. A credit guarantee scheme should be put in place by the SBP. Also, the Income Tax Ordinance has a provision for tax deductibility of bad debt of SMEs up to 5 percent of advances. This should be raised to 10 percent.

Finally, there is need to recognize that SMEs can act as the primary growth driver and be a big source of employment. The performance of South Korean SMEs amply illustrates this potential.

Chapter 22: The Construction Sector

22.1. Characteristics of The Sector

The construction sector has a share of 2.5 percent in the GDP of Pakistan. It relates primarily to the activities associated with the implementation of investment in public and private projects, especially to the building of housing units and development projects.

One of the key features of the construction sector is its labor-intensive nature. It has a higher share in employment than in value added. According to the latest Labor Force Survey of the PBS in 2017-18, the share of the sector in national employment is 8 percent, with employment of 4.7 million. This is more than three times its share in value added.

The other special characteristic of the sector is its strong backward linkage with a number of industries and services. This includes the building materials industry of cement and bricks, basic metal and non-metallic products, wood and wood products, rubber and plastic products, glass plates and chests, paints, etc.

Turning to the housing sector, there are an estimated 34 million housing units in Pakistan today. The average annual rate of construction is close to 750,000 housing units, predominantly on the basis of self-financing. 74 percent of the housing units in urban areas and 90 percent in rural areas are owner-occupied.

There are large disparities in housing consumption among households. The PALMA ratio of the share in housing rents between the top 20 percent and the bottom 20 percent of households is as high as 11.5. It has shown a rising trend since 2001-02. Today, 55 percent of the households in the bottom two quintiles have families of 7 or more persons living in housing units with only one or two rooms. The magnitude of the housing shortage is 13 percent of the existing housing stock, equivalent to 4.4 million housing units.

The construction sector is characterized by a strong business cycle. Construction activity rose at the fastest rate during 2004-05 to 2007-08 when the GDP growth rate was relatively high. There was a slump from 2008-09 to 2013-14. Between 2015-16 and 2017-18 there has been some recovery in business activities. Overall, a 1 percent GDP growth leads to a 1.6 percent increase in construction activity.

22.2. Constraints of the Sector

The level of fixed capital formation in the public and private sector combined is low in Pakistan. It had attained a peak rate of over 17 percent of the GDP over 15 years age, which has fallen to 13 percent of the GDP in 2018-19.

The declining level of public development spending from 5 percent of the GDP over a decade ago to 3.5 percent of the GDP currently is primarily due to efforts at trying to control the size of the budget deficit. The mix of public investment is shifting from highways as CPEC proceeds to the next stage involving greater focus on power generation and distribution. This implies less construction activity.

Investment in housing constitutes 18 percent of private investment. Currently, it is even below 2.5 percent of the GDP. As highlighted earlier, housing investment closely follows the business cycle. Consequently, the housing shortage, based on a housing standard of three persons per room, has risen exponentially and reached 4.4 million housing units on average with two rooms each.

Rising Cost of Construction

The cost of inputs into construction activities has been rising relatively rapidly. Between 2005-06 and 2013-14, the price index of construction inputs doubled. In 2018-19, the rise in the cost of construction was over 12 percent. The annual rate of inflation between 2007-08 and 2019-20 in construction inputs is given in Table 22.1. It has averaged 6 percent to almost 12 percent for different inputs.

Table 22.1: Annual Growth Rate in Prices of Construction Inputs, 2007-08 to 2019-20

Construction Material	Annual Growth Rate (%)	Construction Material	Annual Growth Rate (%)
Wood	7.7	Steel Products	6.3
Bricks	8.0	Glass Sheets	11.1
Cement	7.3	Paints	11.5
Ceramics & Sanitary	8.4	Pipe Fittings	8.7

Source: *PES*

Limited Access to Housing Finance

The share of housing finance in total advances of commercial banks has been extremely low at 1.5 percent. This is one of the principal constraints to the expansion of the housing stock in the country.

Latest estimates are that the quantum of outstanding loans is only 0.25 percent of the GDP. This compares with 11 percent in India, 8 percent in Sri Lanka and 3 percent in Bangladesh.

Conventional commercial banks only account for 53 percent of the credit for housing. The remainder, 47 percent is by the HBFC and Islamic Banks. The former has a high ratio of above 20 percent of non-performing loans. The total number of borrowers of housing loans is only 58,620.

The loan size distribution is also very skewed. Loans below Rs 1 million have a share of only 7 percent in housing credit. Bulk, over 74 percent is in relatively large loans of Rs 5 million or more.

Informal Nature of Construction Activity

Almost 86 percent of construction employment is in the informal sector. This has had two negative implications. First, there has been little absorption of improvements in construction technology and equipment. Imports of construction machinery are only 1 percent of total machinery imports. Second, a large proportion of construction workers are in the nature of daily wage earners with little access to decent work. There is also a relatively high incidence of injuries. It is 18 percent of all injuries to workers in the economy.

Slack Building Controls and Poor Residential Services

The large cities like Karachi and Lahore have building and land acquisition activities which are not effectively controlled by the Government Building Authorities. The consequence is the high incidence of squatter settlements and large-scale illegal occupation of land. The access to services like tap water, sewerage and solid waste disposal is very limited.

22.3. Magnitude of Housing Shortage

The final results of the Population and Housing Census of 2017 have been released recently by the PBS. The key indicators of the housing situation in Pakistan at the Provincial level from the findings of the Census are given in Table 22.2 below.

Table 22.2: Key Indicators of Housing by Province

	Total Number of Housing Units (million)	Persons per Housing Unit (number)	Percentage Owner-Occupied
Pakistan	**29.0**	**6.51**	**82.2**
Punjab	17.0	6.47	84.5
Sindh	6.5	7.35	77.1
Khyber-Pakhtunkhwa	3.8	8.02	83.0
Balochistan	1.7	7.23	84.4

Source: *Population Census, 2017*

There were 29 million housing units in Pakistan in 2017, excluding FATA and Islamabad. The number of persons per housing unit varied significantly among the Provinces. It was the highest in Khyber-Pakhtunkhwa at 8.02 and the lowest at 6.47 in Punjab. This reflected not only the variation in household size but also the difference in the extent of overcrowding. Home ownership rates were at 82 percent for the country as a whole.

The quantification of the housing shortage requires data on the distribution of housing units by number of residents and number of rooms. This information has now become available from the Housing Census.

Most studies have assumed that a housing unit is overcrowded if it has more than 3.5 persons living in a room as the housing standard. This has been used to determine the housing shortage in Pakistan in 2017, according to the Population Census.

The number of overcrowded housing units is given in Table 22.3. The Table indicates that as many 10.4 million, out of the total of 29 million, housing units are characterized by overcrowding. This is equivalent to 36 percent of the housing units. The total population of the country which was living in overcrowded conditions in 2017 is 87 million, equivalent to 44 percent of the population. As estimate has been made of the number of additional rooms required in the overcrowded units to eliminate the congestion. The number is 12.3 million. This is equivalent to 15.5 percent of the total number of rooms in the housing units of Pakistan in 2017, implying a shortage of almost 5 million housing units.

Table 22.3: Number of Overcrowded Housing Units (000)

Persons per Unit	Number of Rooms in Housing Unit			
	1	2	3	4
4	1558	-	-	-
5	1555	-	-	-
6	1353	-	-	-
7	970	-	-	-
8	624	911	-	-
9	362	598	-	-
10	456	971	1048	-
TOTAL	**6878**	**2480**	**1048**	**TOTAL**

Source: *Housing Census, 2017*

22.4. Housing Finance

One important finding is that the addition of only one room to the existing housing units can remove the overcrowding in existing 3.1 million units. Therefore, the appropriate strategy, which will be much more cost effective will be to extend housing finance in the form of relatively small loans at concessional interest rates for home improvement rather than focus on loans for entirely new housing units.

The current focus is only on housing construction. The *Mera Pakistan Mera Ghar* low-cost housing finance schemes of the NAPHDA are in three tiers as shown in Chart 22.1.

The average share of income devoted to rent, imputed or cash payment is 14 percent in the first quintile, in urban areas with a current average household income of Rs 29238 as per the HIES. Therefore, the level of affordability for housing is Rs 4093 per month. The corresponding estimate for households in the second quintile is Rs 5437 per month. Therefore, the housing schemes of NAPHDA are out of the reach of the low- income groups as they require over 20 percent up-front self-financing of the cost and monthly loan repayment of Rs 6600 per month even on the smallest housing units in Tier 1 projects. Clearly, the projects of NAPHDA are likely to be catering primarily for households in the middle and upper middle-income category, largely in the third- and fourth-income quintiles.

Chart 22.1: Features of the Low-Cost Housing Schemes of National Pakistan Housing Development Authority (NAPHDA)

Parameter	Tier-1 – NAPHDA Projects	Tier-2 – Non-NAPHDA Projects	Tier-3 – Non-NAPHDA Projects
Size of Units	a) House up to 125 sq yds (5 Marla) with maximum covered area of 850 sq ft b) Flat/apartment with maximum covered area of 850 sq ft	a) House up to 125 sq yds (5 Marla) b) Flat/apartment with maximum covered area of 1,250 sq ft	a) House up to 250 sq yds (10 Marla) b) Flat/apartment with maximum covered area of 2,000 sq ft
Subsidized Profit Rate	First 6 Years = 3%	First 5 years = 5%	First 5 years = 7%
	Next 5 years = 5%	Next 5 ears = 7%	Next 5 years = 9%
	For period exceeding 10 years = 1-year KIBOR + 2.5%	For period exceeding 10 years = 1-year KIBOR + 4%	For period exceeding 10 years = 1-year KIBOR + 4%
Maximum Price of Units	PKR 3.5 million	No Limit	No Limit
	Market value of a single residential unit at the time of approval of financing		

Maximum Financing Range	PKR 2.7 million		PKR 6 million		PKR 10 million	
Financing Tenor	Minimum 5 years and maximum 20 years financing tenor, depending upon choice of customers.					
Approximate monthly payments*						
Financing Amount	Rs. 1 million	Rs. 2 million	Rs. 4 million	Rs. 6 million	Rs. 8 million	Rs. 10 million
Total Monthly Payment	Rs. 6,600/-	Rs. 13,200/-	Rs. 25,398/-	Rs. 39,597/-	Rs. 62,024/-	Rs. 77,530/-
(Monthly payments mentioned above are of first five years, based on 20 years financing period) | (Monthly payment includes unit price and rent)						

Therefore, the recommended strategy for reducing the housing shortage in the country by provision of low-cost housing should be as follows:

i) The emphasis must shift from construction of new housing units to improvement of existing housing units.

ii) Microfinance Institutions may start a credit line of housing finance with a ceiling on the size of the loan of Rs 200,000 to an individual borrower.

iii) Commercial banks should act as largely wholesalers of credit for housing finance to microfinance institutions.

iv) The SBP has introduced a requirement that commercial banks must extend at least 5 percent of their private sector credit in the form of housing loans. A penalty may be imposed if this target is not met. However, as an incentive and for hedging against greater risk, a 2½ percent tax credit may be extended to commercial banks on the amount of additional housing loans during a particular year.

v) A foreclosure law has been put in place. Special courts may be established for settlement of cases within six months.

22.5. Promoting Construction Activity

In the aftermath of COVID-19, the PTI implemented a strong package of reforms and incentives to activate the housing sector. The logic was its potential for labor absorption, especially of workers in the informal sector who had lost jobs in the shutdown after the pandemic. Further, it was anticipated that jobs would be generated not only directly but also indirectly because of the big backward linkages of construction activities. Construction of 1 million housing units annually is part of the election manifesto of the PTI Government.

The incentives include, first, tax amnesty on investment in land and housing projects to developers. Second, taxes on land and buildings have been reduced. More importantly, the focus has been on expansion of credit, especially for low-cost housing. The Government has launched a Naya Pakistan housing program with access to relatively small loans at an interest rate of 5 percent.

Over nine months since the launch of the above program, there are indications that it has stimulated construction activity, although the evidence is not conclusive. The domestic consumption of cement has increased by 22 percent. However, a big part of this increase may be due to resumption of development work on public sector projects after COVID-19.

The growth sales in other construction inputs is not so striking. Sales of glass plates and sheets have actually fallen by 35 percent while the production of steel products is down by 26 percent. Clearly, the growth in construction activity, especially in housing, is linked to buoyancy in the economy. It is not surprising that despite the concessional terms of housing finance loans, they have increased by only 18 percent up to March 202I.

The policy should be to extend the above-mentioned incentives up to June 2022, by which time the economy ought to have gathered enough momentum leading to stronger demand for housing.

Reduction in Taxes

Currently, the cement industry is subject to an excise duty of Rs 1.50 per Kg. This is equivalent to 12.4 percent of the retail price. The effective rate is higher because of the cascading of the taxes on inputs like natural gas. There is a strong case for transition to a value added tax on the industry at the standard rate of 17 percent.

Tax Deductibility of Housing Loan Payments

Most countries have tax deductibility provisions for household loan repayments in the personal income tax. This is not the case currently in Pakistan. It is proposed that such a facility is also included in the Income Tax Ordinance up to a maximum limit of Rs 20,000 per month. This will increase the demand for households by middle income households.

Corporatization of the Sector

A fiscal incentive may be granted to construction companies employing more than 100 workers in the form of a tax credit of 5 percent on the wage bill against their income tax liability.

Land Allocation

All housing projects by builders must devote at least 20 percent of the land for small housing units located on plots of up to 8 Marla in size. This requirement must be fulfilled also by the Defence Housing Authority in the eight major cities of Pakistan.

Effective Building Control

The Metropolitan Building Authorities will need to be greatly strengthened to ensure minimum building standards and no illegal acquisition of public land.

The objective should be to ensure that over 1 million housing units are constructed annually. In addition, it has already been proposed that the Public Sector Development Program be raised to 4 percent of the GDP by 2024-25. This will give a big boost to construction activity in the country and create many more employment opportunities for both unskilled and skilled workers. The level of housing outstanding loans should reach 2 percent of the GDP as compared to only 0.5 percent of the GDP currently by 2024-25.

Chapter 23: The Power Sector

The power sector must play a central and strategic role in providing uninterrupted and moderately priced electricity to the production sector of the economy and to households.

23.1. Characteristics of the Sector

The power sector directly through the generation and distribution of electricity contributes almost 1.5 percent to the GDP of Pakistan. Table 23.1 shows the evolution of generation capacity, the actual production of electricity and the rate of capacity utilization.

Table 23.1: Generation Capacity, Electricity Generated and Level of Capacity Utilization

	Installed Capacity (MW)	Annual Increase (MW)	Generation (Gwh)	Index of Capacity Utilization
1990-91	8776		41082	100.0
1994-95	12100	831	53545	94.9
1999-2000	17399	1060	65748	80.7
2004-05	19378	396	85738	94.5
2009-10	20922	309	95608	97.6
2014-15	23795	575	107408	96.4
2019-20	38619	5571	134746	70.1*

* Over 5500 MW of excess capacity
Source: *PES*

The expansion of generation capacity has proceeded in cycles. Power outages were at their peak in the late 80's. The 1994 Power Policy provided a number of big incentives to Independent Power Producers (IPPs), including a guaranteed rate of return and various tax breaks. Consequently, there was a strong investment response in power generation and annually between 1994-95 and 1999-2000 over 5000 MW were added.

The surplus capacity for electricity generation was one of the key factors which contributed to relatively fast growth during the Musharraf Era. However, over the 10-year period, from 1999-2000 to 2009-10, there was only a minor expansion in generation capacity. Consequently, power outages returned in a big way. The incidence of these outages peaked in 2014-15 and cost the economy annually over 2 percent of the GDP. For example, the cost of electricity not supplied to industry reached the high value of Rs 46 per kwh.

One of the major priorities of the PML-(N) Government was rapid growth in electricity generation capacity. The Punjab Government invested in two major plants with capacity each of 1000 MW. New IPPs also entered the sector. Under the umbrella of CPEC, a number of Chinese power plants have also been installed with coal as the fuel source. There has been visible success in expansion of capacity. By 2019-20, the capacity has increased by over 14800 MW. The rate of capacity utilization is down to 70 percent and the incidence of power outages has been virtually eliminated except occasionally in summer time.

The distribution of capacity and actual generation by source are given in the Table 23.2 and Table 23.3, respectively. The fastest growth in recent years has been in thermal, nuclear and renewable energy. The distribution of generation is 65 percent by thermal power, 26 percent by hydro-electricity and 9 percent by nuclear and renewable energy. The largest fuel source for thermal power is gas/RLNG, with a share of 56 percent, followed by coal.

Table 23.2: Power Generation Capacity by Source (MW)

	Hydel	g (%)	Thermal	g (%)	Nuclear + Renewable	g (%)	Total Capacity	g (%)
2000-01	4867		12169		462		17498	
2004-05	6499	7.2	12423	0.5	462	0.0	19384	2.6
2009-10	6481	-0.1	13978	2.4	787	10.6	20922	1.5
2014-15	7030	1.6	15541	2.1	1188	8.2	23759	2.5
2019-20	9874	6.8	25244	9.7	3514	21.6	38619	9.7

Source: *PES*

Table 23.3: Power Generation by Source (Gwh)

	Hydel	g (%)	Thermal	g (%)	Nuclear + Renewable	g (%)	Total Generation	g (%)
2000-01	17194		48926		1997		68117	
2004-05	25671	10.0	57162	3.9	2795	8.4	85378	5.6
2009-10	28093	1.8	64371	2.4	2894	0.7	95608	2.3
2014-15	32474	2.9	67886	1.1	6606	16.5	107408	2.3
2019-20	9874	6.8	25244	9.7	3514	21.6	38619	9.7

Source: *PES*

The pattern of consumption of electricity is given in Table 23.4. There is relative dominance of domestic consumers in consumption of electricity in Pakistan, with a share of 49 percent. Next is industry with a share of 26 percent, followed by commercial and other consumers, mostly agricultural and government, with shares of 8 percent and 17 percent respectively. There was negative growth in electricity consumption in 2019-20 due to the COVID-19 attack.

Table 23.4: Electricity Consumption by Type of Consumer Electricity Consumption by Type of Consumer – (Gwh)										
	Households	g (%)	Commercial	g (%)	Industrial	g (%)	Other	g (%)	Total	g (%)
2000-01	22765		2774		14349		8697		48555	
2004-05	27601	4.8	4080	9.6	18591	6.5	11055	6.0	61327	5.8
2009-10	34272	4.3	5605	6.4	19823	1.3	14648	5.6	74348	3.9
2014-15	41450	3.5	6512	3.0	24979	4.6	12877	2.6	85818	2.9
2019-20	55132	5.7	7874	3.8	25647	0.5	23417	12.0	112070	5.3
Source: *PES*										

The power tariffs by type of customer are characterized by significant variation and with different rates of increase since 2009-10, as shown in Table 23.5. There is a sharp progressivity in domestic tariffs as the level of monthly consumption increases but the rate of increase is regressive in nature. The latest increase of Rs 1.95 per kwh was the same for all consumer. Tariff rates are relatively high and comparable for commercial and industrial consumers with variation by peak or off-peak use. Agricultural tariffs are relatively low.

Table 23.5: Level of Tariffs and Average Rate of Annual Increase (01 – 1 – 2019 to 12 – 2 – 2021)			
Residential	Level* (Rs per Kwh)		ACGR (%)
	(01-1-2019)	12-2-2019	
≤ 50	2.00	3.95	8.1
≤ 100	5.79	7.74	6.6
≤ 200	8.11	10.06	6.0
≤ 300	10.20	12.15	5.7
301 – 700	17.60	19.55	6.9
> 700	20.70	22.65	6.8
Commercial (< 5 kw, Peak)	18.00	19.95	6.4
Industrial	18.78 – 18.84	20.79 – 21.9	8.4
Agricultural	5.35	7.30	4.0
*Date of last two increases **Source:** *PES and NEPRA*			

There has been a single-digit rate of increase in tariffs annually from 2010 to 2019. The highest rate of increase is of 8.1 percent annually for the smallest domestic consumers and almost 7 percent for big domestic consumers. Agricultural tariffs have increased annually by about 4 percent. The tariff schedule is the same for all distribution companies, the DISCOs.

23.2. Constraints to Growth

The power sector faces serious impediments to utilization of existing capacity as described below.

Growing Reliance on Imported Fuel

There is a big increase in the use of imported fuel for power generation. This is due, first, to decline in available gas reserves in the country, especially at Sui. Second, the expansion of thermal capacity has increased the level of imports of coal and LNG, as shown in Table 23.6. This has created problems of timely availability and price fluctuations, which was demonstrated recently in the import of LNG.

Table 23.6: Import Share in Generation of Different Fuels – (%)

	2001-02	2018-19
Petroleum Products	55	58
Natural Gas / LNG	00	21
Coal	24	76

Source: *NEPRA State of Industry Report*

Large System Losses

The power sector of Pakistan is characterized by high losses as compared to international standards. These losses are of two types, namely, transmission and distribution losses and billing losses. The trend in the magnitude of losses is given in Table 23.7.

Table 23.7: Magnitude of Transmission and Distribution and Extent of Non-Recovery of Billing – (%)

	2014-15	2019-20
Transmission and Distribution Losses	***20.1***	***15.2***
Billing Losses	***10.7***	***10.8***
By Type of Consumer:	24	76
Domestic	12.4	13.8
Commercial	2.5	0.3
Industrial	4.2	3.5

Source: *NEPRA State of Industry Report*

Transmission and distribution losses are high, though they have come down from 20 percent to 15 percent in the last five years. This is attributable to an outdated system of feeders and to high level of electricity theft. They are high in relation to other countries where it generally ranges from 7 percent to 10 percent.

Billing losses have remained virtually unchanged at close to 11 percent, with the highest incidence in the case of domestic consumers. Overall, for the system as a whole, for every 1 Gwh of electricity purchased by a DISCO the revenue effectively collected is on 0.756 Gwh. This has fundamentally affected the financial viability of the power sector.

There is also a large variation in the extent of losses among the nine DISCOs and K-Electric as shown in Table 23.8. Consequently, with the same national tariff for all DISCOs this has implied substantial regional cross-subsidies.

Table 23.8: T&D and Billing Losses in Discos and K-Electric				(%)
	Billing Losses of DISCOs		Transmission & Distribution Losses	
	2018-19	2019-20	2018-19	2019-20
PESCO	11.38	12.35	35.62	38.69
TESCO	32.09	31.84	11.97	16.19
IESCO	12.39	9.73	8.86	8.69
LESCO	2.32	5.52	13.17	12.40
FESCO	0.72	5.82	9.81	9.62
MEPCO	0.65	7.06	15.79	15.23
HESCO	25.53	26.81	29.49	28.82
SEPCO	36.72	43.46	36.97	36.27
QUESCO	7267	50.75	23.56	26.68
Overall DISCOs	9.75	11.23	17.61	17.90
K-Electric	7.28	7.86	18.94	19.73
Source: *NEPRA State of Industry Report*				

High Tariffs and Elastic Demand

The relatively high tariffs in Pakistan are shown in Table 23.9. Pakistan has the highest industrial tariff among the countries covered in the table. As opposed to this it has the lowest average domestic tariff.

Table 23.9: Power Tariffs in Selected Countries (as of June 20) (cents per kwh)			
	Business	Domestic	Ratio of Domestic to Business
Sri Lanka	6.7	7.6	1.134
Indonesia	7.4	10.5	1.419
Vietnam	7.7	8.1	1.052
Nepal	7.9	7.1	0.986
Turkey	10.2	9.9	0.971
China	10.4	8.4	0.808
Malaysia	10.6	6.0	0.566
Bangladesh	10.6	6.6	0.622
India	11.4	8.1	0.698
Philippines	11.6	18.2	1.568
Thailand	12.5	12.7	1.016
Pakistan	**16.0**	**5.9**	**0.369**
Source: *www.globalpetrolprices.com*			

The responsiveness of electricity demand to changes in the level of tariffs over time has been difficult to quantify because of the presence of power outages. However, now with excess capacity, it is possible to get a handle on the price elasticity of demand. The World Bank's Enterprise Survey has been used to quantify the price elasticity of industry. It is estimated at -0.57 in Pakistan. Other studies have estimated the industrial price elasticity at -0.46 and that of agriculture at -0.79. Similarly, the domestic elasticity is -0.85.

As mentioned earlier, a price increase of Rs 1.95 per Kwh in the base electricity tariff has recently been announced. This is equivalent to an escalation of almost 15 percent on the overall average tariff. It is likely that the consumption of electricity will fall significantly. Consequently, the rise in revenues is likely to be limited.

Mushroom Growth in Circular Debt

The circular debt of the power sector has grown exponentially at the annual rate of 29 percent since 2015-16, as shown in Table 23.10. At the end of 2019-20 it was Rs 2150 billion. This is drastically affecting operations in the power sector.

There are two primary sources of circular debt. The first is payment due to power generation companies, especially to the IPPs in the form of capacity charges. This stands at Rs 994 billion and has grown annually at the rate of 37 percent.

Table 23.10: Sources of and Magnitude of Circular Debt (Rs in Billion)

	2015-16	2016-17	2017-18	2018-19	2019-20
Due for Payments to Power Generation Companies	223.7	288.1	441.4	694.3	994.0
Change		**64.4**	**153.3**	**252.9**	**299.7**
Energy Payable Swap by GOP through loan by Commercial Banks to Power Holding (Pvt) Ltd.	368	439.0	582.9	805.8	1003.3
Change		**71**	**143.9**	**222.9**	**197.5**
Others	97.4	90.9	102.4	153.1	188.1
Change		**-6.5**	**11.5**	**50.7**	**35.0**
Total	689.1	818.0	1126.4	1653.2	2185.4
Change		**128.9**	**308.4**	**526.8**	**532.2**

Source: *NEPRA State of Industry Report*

The second source is energy payable swap by GOP through loan by commercial banks to Power Holding (Pvt) Ltd. This has exceeded 1 trillion Rs and stands at Rs 1003 billion. The annual growth rate is 25 percent.

Efforts will have to be made by the Federal Government to retire a large part of the circular debt on a top priority basis. Otherwise, the risk is disruption in operations of the sector due to serious liquidity constraints at different points in the value chain of the power sector. This represents a classic case of breakdown of governance.

23.3. Sustaining the power sector

Incentives for Higher Consumption

Currently, almost 30 percent of the generation capacity is not being used. There is, therefore, a strong case for providing incentives for higher consumption by all types of consumers, in relation to the base level of consumption in the corresponding period of the previous year. The design of the incentive scheme could be as follows:

% Increase over Base Level	% Discount in the Tariff on Incremental Consumption
0 – 20%	15%
20% or More	30%

Further, the differential between the peak and off-peak tariffs should be reduced. This scheme should come into effect from the 1st of July 2021.

There is a case especially for bringing down industrial tariff. The resulting increase in output will lead to higher tax revenues than the loss in revenues from the tariff. This could be almost three times the direct revenue loss.

Adhering to the Merit Order of Power Generation

There is wide variation in the fuel cost per Kwh, depending upon the fuel source and the efficiency in power generation. The distribution of plants by fuel cost per Kwh is given in Table 23.11. The cost ranges from less than 1 Rs to above 30 Rs per Kwh. Given the spare capacity, if the 100 most efficient plants are used then the saving in fuel cost could exceed 20 percent. This will lead to a corresponding reduction in the fuel adjustment charge.

Table 23.11: Merit Order of Plants

Fuel Cost (Rs / Kwh)	Number of Plants	Cumulative Number
0.77 – 5.00	4	4
5.01 – 10.00	34	38
10.01 – 12.50	27	65
12.51 – 15.00	22	87
15.01 – 17.50	19	106
17.51 – 20.00	8	114
20.01 – 30.00	13	127
30.01 and above	3	130
TOTAL	**130**	

Source: *NEPRA State of Industry Report*

Removing Cascading of Tariffs

There is a substantial cascading on tariffs by the levy of charges unrelated to power generation and the sales tax. On a typical bill, the cascading could be as much as 5 percent or more. These levies include the TV Fee, E-Duty, Neelum–Jhelum surcharge, etc. They should be excluded from the billing. Instead, the Income Support Levy could be reintroduced in the personal income tax and revenue earmarked as required.

Policy on Power Tariffs

Pakistan has relatively low domestic electricity tariffs compared to industrial tariffs. In future tariff increases, the policy ought to be of increasing the tariff more for domestic consumers with monthly billing of above 500 Kwh. This will impact only the top two quintiles of households.

Further, the tariff increase should be relatively large for big industrial consumers, in the category above 5 KW and commercial consumers. It should be significantly less for small industrial consumers. Also, the increase should be minimal for agricultural consumers and for small domestic consumers.

Change in Intra-Sectoral Development Priorities

Table 23.12: Share of NTDC and Pepco in Federal PSDP (Rs in Billion)

	Allocation	Share of PSDP (%)
2018-19	63.8	6.4
2019-20	33.6	5.0
2020-21	39.6	6.1
2021-22	69.5	7.7

Source: *NEPRA State of Industry Report*

There has been an overemphasis on investment in mostly new thermal generation capacity and much less priority given to the improvement and expansion of the transmission and distribution system. This is reflected in the low share in PSDP allocations to NTDC/PEPCOs, as shown in Table 23.12. The share has remained low at below 7 percent. However, in the latest PSDP for 2021-22 there is an increase in allocation of 76 percent. It is essential that all on-going projects are implemented on a priority basis.

There is need to ensure that in future at least 10 percent of the annual PSDP is allocated to transmission and distribution projects and the funds allocated are fully used.

Shift towards Renewable Energy

The target must be to increase the share of renewable energy, hydel and otherwise, from under 30 percent currently to over 50 percent in the next ten years. Both hydel, solar and other projects with renewable energy must be given priority. Within hydro-electricity both large projects like the Daimer-Basha and Mohmand Dams and small hydel projects need to be implemented as quickly as possible. The shift towards renewable energy will not only be cost effective but will reduce the reliance on imported fuels.

Provincial Governments role in the Power Sector

There is a proposal for merging DISCOs within a Province and charging power tariffs at the Provincial level. However, this will discriminate against the two smaller and less developed Provinces, which will require substantially higher tariffs due to larger system losses. As such, this proposal is a non-starter unless this is reflected in a future NFC Award.

Management of the Circular Debt

The root causes of the large and fast-growing circular debt are the high system losses which lead to lower revenues and the high-capacity charges of the IPPs. Clearly, the institutional capacity of DISCOs must be developed to reduce billing losses and electricity theft.

There is a proposal for privatizing the DISCOs on the grounds that there will be a stronger motivation for reducing losses. However, the K-Electric experience is a mixed one, with losses remaining relatively high. However, wheeling arrangements by IPPs may be allowed so as to create a wholesale market for electricity.

The Federal Government must make payments against subsidies committed on time so as to avoid the buildup of arrears and liquidity issues in the value chain. Also, the time has come to convert the guaranteed debt with the Power Holding Company (Ltd) into public debt and ensuring the payment of interest from budgetary sources. This has effectively been done in the Federal budget of 2021-22 and provision has been made of additional payments of Rs 254 billion to the IPPs and PHPL.

The Government has also been in a process of negotiations with the IPPs with the agreement on payment of dues subject to a ceiling being placed on future capacity charges. Apparently, there has already been some success in the negotiations.

There is no doubt that the implementation of the above measures specially to ensure adequate and economic supply of electricity is central to expediting the growth process of the economy. The power sector reforms must remain high on the agenda of reforms in the Charter of the Economy, if it is not to remain the ‘black hole’ of the economy.

Chapter 24: The Services Sectors

The six services sectors collectively contribute almost 62 percent to the value added in the national economy. Therefore, they have a vital role to play in the growth process of the economy.

24.1. The Services Sectors

Characteristics of the Service Sectors

The six services sectors are listed in Table 24.1 along with their share in the GDP and their long-run growth rates. The three relatively large sectors are wholesale and retail trade; transport, storage and communications and private services. The fastest growth has been observed in government services, private services and finance and insurance.

Table 24.1: Size and Growth Rate of Services Sectors (%)

	Share of GDP 2020-21 (%)	Growth Rate 2020-21 (%)	Long-Run Growth Rate from 1999-2000 to 2020-21 (%)
Wholesale and Retail Trade	18.8	8.4	4.4
Transport, Storage and Communications	12.2	-0.6	3.4
Finance and Insurance	3.7	7.8	5.3
Housing Services	7.0	4.0	3.7
General Government Services	8.2	2.2	5.7
Other Private Services	11.8	4.6	6.0
TOTAL	**61.7**	**4.4**	**4.4**

Source: *PES*

One of the key characteristics of the services sectors is the variation in the shares of informal versus formal activities. The former includes small enterprises with employment of up to 10 workers and the self-employed. The share of informal employment is given in Table 24.2. Overall, the share in economic activities of the informal service economy is as high as 72 percent. This is especially the case in wholesale and retail trade and transport, storage and communications. Consequently, there are limits to the amount of tax revenues that can be generated from these sectors. Also, almost 17 million workers are employed in the informal sector. The prospects of 'decent work' are limited for these workers.

Table 24.2: Informal Versus Formal Sector Employment in The Services Sectors 2017-18 (%)

	Employment (million)	Share of Informal Sector	Share of Formal Sector
Wholesale and Retail Trade	9.2	96.7	3.3
Transport, Storage and Communications	3.8	81.6	18.4
General Government Service and Private Services	9.1	48.4	51.6
Other Services	1.2	25.0	75.0
TOTAL	**23.3**	**72.0**	**28.0**

Source: *PLS, PBS*

Another key feature of the services sectors is the extent of the link with the commodity producing sectors in the economy. In effect, there are two types of sectors, as shown below:

Types of Sectors	
Linked*	Not Linked
Wholesale and Retail Trade	Housing Services
Transport, Storage and Communications	General Government Services
Finance and Insurance	Private Services

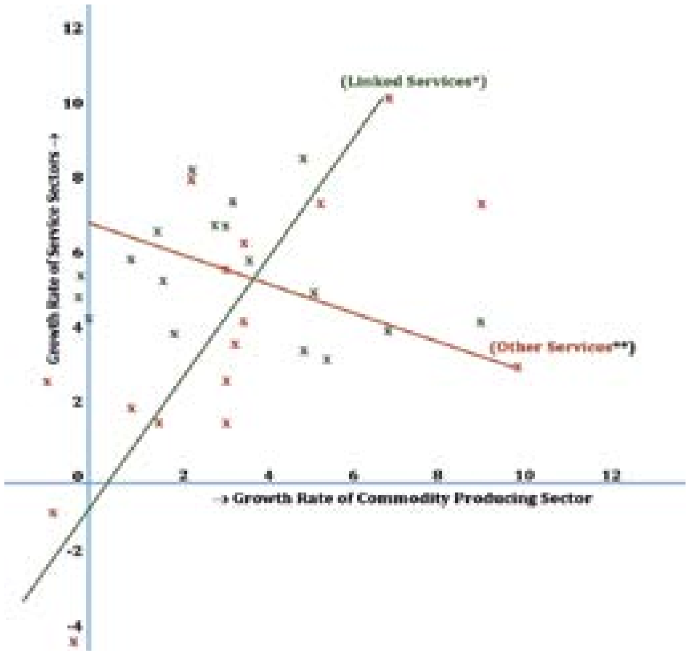
*with growth in Commodity producing sectors.

There is a relationship between the growth rate of the commodity-producing sectors, agriculture and industry, and the growth rate of the linked services sectors listed above.

The annual growth rates of the two types of service sectors are plotted with respect to the growth rate of the commodity-producing sector from 2000-01 to 2019-20 in Figure 24.1. The upward sloping line clearly indicates the positive relationship between the growth rate of the commodity-producing sector and that of the linked sectors. Therefore, the latter sectors are pro-cyclical in character. In fact, a 1 percentage point growth rate in the commodity-producing sector leads to an over 1 percentage point growth rate in the linked service sectors.

The basic message is that efforts at raising the growth rate of the agricultural and manufacturing sectors will have a favorable impact on the growth of some of the large services sectors like wholesale and retail trade and transport, storage and communications. Figure 24.1 also indicates the counter-cyclical nature of the autonomous service sectors.

Figure 24.1: Relationship between The Commodity Producing Sectors and Services Sectors



*Wholesale and Retail Trade, Transport and Communications and Banking and Insurance.
**Housing, Public Admin & Defence and Community, Social Services and Personal Services.

24.2. Wholesale and Retail Trade

Characteristics of Sector

There are two critical determinants of the value added generated in the sector. The first is the share of output marketed of agricultural commodities. This can range from approximately 70 percent in the case of wheat and milk to almost 90 percent in the case of other food crops and livestock products. Second, the trading margins can range from 10 percent to over 40 percent.

Overall, PBS has derived that the largest contribution to value added in the sector is through trading in domestically manufactured goods with a share of over 58 percent. The contribution of agriculture is 24 percent and 18 percent by imports respectively.

The Census of Establishments by PBS reveals the extreme concentration of trade in small units. Almost 96 percent of the employment is in establishments with one to five workers only.

Constraints to Growth

Clearly, the growth in trading activities hinges primarily on the increase in output in the agricultural and manufacturing sectors. Further, the dominance of very small establishments precludes the access to credit, use of digital technology for transactions and greater vulnerability of employment to the down swing in the business cycle.

Recommended Reforms and Policies

Tackling Monopolies: The trade in agricultural commodities, especially fruits and vegetables, is dominated by the *Aarthi*, the wholesaler. This tends to reduce the price received by the grower and raise the prices to retailers and eventually the consumers. As such, there is a case for a wider role in procurement by Government agencies like PASSCO. This will also eliminate the seasonal 'cobweb' in vegetable prices.

Taxing the Wholesale and Retail Trade Sector: The small size of the bulk of establishments and the lack of documentation of transactions greatly limits the tax potential of the sector, despite the fact that is the largest sector in the economy.

Given the sectors' informal nature, it is the ideal candidate for levy of a simple presumptive/ withholding tax. This is in the form of a presumptive income tax added to the electricity bills. Based on the net income per kwh of electricity consumed, the proposal is to change the existing tax system to the following:

Electricity Consumption/Bill (kwh per month)	PIT on the Electricity Bill
1 – 200	0%
200 – 400	5%
400 – 600	7½%
600 – 1000	10%
> 1000	15%

This will be treated as the fixed tax. However, the tax payer can file a return under the normal personal income tax system and claim a refund.

24.3. Transport, storage, and communications

The income generated in this sector is primarily from road transport, with a share of over 74 percent. The newly emerging and fast-growing sub-sector is telecommunications with a share approaching 14 percent. The remaining value-added share of 12 percent is contributed collectively by pipelines, railway, water transport, air transport and storage.

Table 24.2 has already demonstrated that over 84 percent of the sector is in the informal economy. The determinants of growth in the road transport sector are presented in Table 24.3. The growth rate has been declining since 2004-05. This is a reflection not only of a decline in the growth rate in the volume of goods transported but also a fall in the rate of expansion of the road network and in the rate of increase of vehicles on road.

Table 24.3: Growth in Value Added in The Road Transport Sector and in Roads and Vehicles Growth Rate (%)

	Value Added	Length of High type Roads	Vehicles on Road		
			Trucks	Buses	Cars
1999-2000 to 2004-05	3.6	3.0	3.4	4.2	7.9
2004-05 to 2009-10	4.8	2.0	5.6	3.7	12.0
2009-10 to 2014-15	3.9	0.9	4.6	3.7	13.6
2014-15 to 2019-20	2.3	1.6	3.6	2.8	10.7

Source: *PES*

Constraints to Growth

As identified above, the rate of physical expansion in the road network has been low. However, with the upgrading of the main national highway network under CPEC there is the likelihood of faster expansion in inter-city road traffic.

Further, there are serious pricing issues. Most of the vehicles are imported, either in CKD or CBU form. The large devaluation of the rupee since June 2018 has raised serious affordability issues.

Recommended Reforms and Policies

The first set of recommendations relate to the pricing and taxation issues in the transport and communications sector.

Double taxation of Telecom: There is double taxation of mobile cards in the form income tax and the provincial sales tax on services. The majority of mobile phone owners who have annual incomes below Rs 600,000 and should, therefore, be exempt from the income tax. As such, this tax should be withdrawn. The provincial sales on services may continue to be levied on mobile phone cards. The over taxation issue has been further magnified by the introduction of an excise duty of 75 paisas on mobile phone calls exceeding five minutes.

The Pricing of Petroleum Products: The level currently of the prices in selected countries of Motor Spirit and HSD Oil is given in Table 24.4. In dollars, prices in Pakistan appear to be low. However, if adjustment is made for differences in purchasing power parity then the prices in Pakistan are not far from the average. Also, Pakistan has a lower price for Motor

Spirit than for HSD oil. Four out of the six countries have a lower price for HSD oil than for Motor Spirit. This is the proper pricing policy as HSD oil is used mostly for transporting basic goods while a large part of the consumption of Motor Spirit is in cars owned by the top income quintile of the population.

Therefore, the recommended policy is to keep a Rs 10 higher Petroleum Levy on Motor Spirit than on HSD oil. Also, the cascading of the sales tax on the Petroleum Levy must be avoided.

Table 24.4: Current Prices in Selected Countries of Motor Spirit and HSD Oil – ($)

	Gasoline (Motor Sprit) (litre / US$) [1]	Diesel (HSD Oil) (litre / US$) [2]	Ratio [2] / [1]
Malaysia	0.476 (1.225)*	0.520 (1.338)	1.092
Pakistan	0.700 (2.670)	0.726 (2.768)	1.037
Sri Lanka	0.828 (2.934)	0.535 (1.896)	0.646
Turkey	1.033 (3.182)	0.945 (2.911)	0.914
Bangladesh	1.053 (2818)	0.769 (2.057)	0.730
India	1.233 (4.109)	1.117 (3.722)	0.905

*in Purchasing Parity Dollars (PPP)
Source: *www.globalpetrolprices.com*

24.4. Finance and Insurance

Characteristics of the Sector

The Finance and Insurance sector is predominantly in the formal sector of the economy. It is, however, still a relatively small sector with the share of GDP of 3 percent. But it has been one of the fastest growing sectors. Banking services account for over 90 percent of the value added in the sector. Currently there are 25 commercial banks operating in Pakistan.

Indicators of the size of the banking sector are presented in Table 24.5. Deposits have grown at double-digit rates, although the growth rate has been declining. The growth rate of advances is in the form of a U-shaped curve with a recovery in the growth rate in recent years. Today, the number of branches is close to 15000, implying that there is one branch available for a population of 14,666 persons.

Table 24.5: Deposits, Advances and Number of Bank Branches							(Rs in Billion)
	Deposits	Growth Rate (%)	Advances	Growth Rate (%)	Ratio of Advances to Deposits	Number of Bank Branches	Growth Rate (%)
2001-02	1428		970		68.0	7890	
2004-05	2377	17.0	1759	19.8	74.0	6803	-4.9
2009-10	4661	13.5	3308	12.6	71.0	9007	5.6
2014-15	9141	13.4	4576	6.5	50.1	11705	10.9
2020-21 (March)	17435	10.8	8536	10.4	49.0	14985	4.1
Source: *SBP*							

The important trend to note is the change in the ratio of bank advances to deposits. SBP specifies the maximum level as a regulatory measure. The worrying development is the decline in this ratio from the peak of 74 percent in 2004-05 to 49 percent in 2020-21. The basic reason for this is that there has been much faster growth in bank investments, mostly in Government securities, as shown in Table 24.6.

Table 24.6: Growth in Different Types of Assets of The Banking System								
	Investment*	g (%)	Advances	g (%)	Other Assets	g (%)	Total	g (%)
2005	729		1801		1094		3624	
2010	1861	18.7	3233	11.7	1687	8.7	6781	12.5
2015	5812	22.7	4576	6.9	2015	3.6	12403	12.0
2021 *(end March)*	12503	13.3	8536	10.8	3399	5.8	24438	11.8
Long-Term Growth Rate		**18.0**		**7.5**		**5.5**		**9.2**
Source: *SBP*								

There is, therefore, evidence of a degree of 'crowding-out' of private borrowers from the banking system. The growth rate in investments at 18 percent has been much higher than the growth rate in advances of below 18 percent. As budget deficits have increased, the Government has accessed the banking system much more via SBP with relatively high returns on Market Treasury Bills (MTBs) and Pakistan Investment Bonds (PIBs)

The sectoral distribution of advances to the private sector by banks is also very skewed, as shown in Table 24.7. Almost 63 percent of the outstanding loans are to the manufacturing sector, with a share of only 11 percent in the GDP. Risk aversion of the banking system has led to a strong preference for large corporate clients. Consequently, while there 2.9 million borrowers, only 10,000 of the largest borrowers account for 72 percent of advances.

Table 24.7: Sectoral Distribution of Bank Advances to Private Sector (as of December 2020) (Rs in Billion)		
	Stock of Advances	% Share
Agriculture	292	5.3
Manufacturing and Mining	3453	62.9
Electricity and Gas	532	9.7
Construction	145	2.6
Wholesale and Retail Trade	460	8.4
Transportation	119	2.2
Communication	148	2.7
Personal Services	341	6.2
TOTAL	**5490**	**100.0**
Source: *SBP*		

Currently, there are no binding constraints to development of finance and insurance in Pakistan. Levels of profitability are high. From 2015 to 2019, the average return on equity of banks has been over 14.5 percent.

Recommendations

There is a dire need for reducing the ‘crowding out` of credit to the private sector and of diversification of credit to more sectors beyond manufacturing and to smaller borrowers.

Taxation of the Banking Sector: The corporate income tax rate on commercial banks was 60 percent in the early 90s. This was drastically brought down to 35 percent in the Musharraf Era. Currently, the tax rate is 29 percent and there is a supertax of 4 percent.

There is a case for raising the tax rate to 40 percent with a supertax of 5 percent, in view of the low risk in investing in Government securities and shares, which now constitute over 44 percent of the assets of the banking system.

However, fiscal incentives may be offered as follows:

i) If the growth rate of bank advances to the private sector of a particular commercial bank exceeds the growth rate of bank deposits then it is entitled to a tax credit of 5 percent on the additional advances above the growth rate of deposits.

   For example, if deposits grew by 12 percent and the total advances rise from 200 billion to 235 billion, then the amount liable for a tax credit is Rs 11 billion. With the tax credit at 5 percent, the reduction in tax liability is Rs 0.55 billion.

ii) If the growth rate in advances to SMEs, as defined by the SBP, is higher than the growth rate in advances then the additional amount will receive a tax credit of 10 percent. For example, if advances grew by 15 percent and total advances to SMEs grew from Rs 15 billion to Rs 25 billion, then the amount liable for tax credit is Rs 7.75 billion. With the tax credit at 10 percent, the reduction in tax liability is Rs 0.775 billion.

A particular bank can enjoy both tax credits if it alters its lending policies in the desired directions.

24.5. General Government Services

Characteristics of Sector

This sector covers the compensation of employees of the Federal, Provincial and Local Governments. The growth of the sector is presented in Table 24.8. The total size of the sector is Rs 3.4 trillion as of 2019-20.

Federal Government employee's compensation is estimated at Rs 1159 billion in 2019-20 according to the Budget Documents. Therefore, the estimate is that the magnitude of Provincial and Local Governments combined is much larger at Rs 2265 billion. This implies that 34 percent of the wage bill is at the Federal level and 66 percent with lower levels of Government.

Table 24.8: Level and Growth of Compensation of Government Employees* (Rs in Billion)

	at Current Prices	Growth rate (%)	at Constant Prices	Growth rate (%)
1999-2000	232		314.3	
2004-05	361	8.9	385.6	4.1
2009-10	778	15.3	499.0	5.2
2014-15	1818	17.0	758.7	8.4
2020-21	3670	11.7	1070.8	5.7

*This constitutes of the value added of the sector
Source: *PBS*

The annual growth rate, both in current and in constant prices, peaked during the period, 2009-10 to 2014-15. This was the period after the 7th NFC Award, when there was a large increase in fiscal transfers to the Provincial Governments.

The level of employment is estimated at close to 1.5 million at the Federal level and approximately 3 million in the lower levels of Government. The average remuneration per employee is derived at 38,000 Rs per month. It has been growing annually in real terms by 3 to 4 percent.

Constraints to Growth

The budgetary position of the Federal and Provincial Governments since 2018-19 has substantially worsened when the consolidated budget deficit approached the peak level of 9 percent of the GDP. Consequently, there were no salary awards in the budget of 2018-19 and 2019-20. However, given the cumulative inflation of 26 percent from July 2018 to January 2021, Federal employees recently launched an agitation for increase in salaries. The Federal Government was compelled to announce an additional ad-hoc allowance of 25 percent.

The Federal and Provincial Budgets of 2021-22 included increase in salaries and pensions, generally of 10 percent. This will imply higher growth of the General Government Services sector in 2021-22.

24.6. Private Services

The last services sector is private services.

Characteristics of Sector

The private services sector includes the services listed in Table 24.9. The largest share is of business-related services, including IT services. This is followed by private sector involvement in provision of health and education services. Smaller services include recreation and sports activities.

Table 24.9: Share of Different Private Services

	% of Sectoral Value Added
Business Related Activities	63.3
Private Education	4.7
Private Health	9.0
NGOs	2.8
Recreation, Culture and Sport	7.6
Other Services	11.4
Domestic Staff	1.2
TOTAL	**100.0**

Source: *PBS*

The sector demonstrated high growth from 1999-2000 to 2004-05 as shown in Table 24.10. Since then the growth rate has been relatively low.

Table 24.10: Growth Rate of Private Service Sector		
	Value Added at Constant Prices	Growth Rate (%)
1999-2000	414	
2004-05	730	11.3
2009-10	832	2.6
2014-15	1050	4.6
2020-21	134	6.3
Source: *PBS*		

Constraints to Growth

Infrastructure Availability: Business services growth has been limited by the availability of office, adequate supply of electricity and gas, and IT infrastructure. Large companies have preferred to have their own in-house facilities and services. Similarly, the development of private education and health services has also been constrained by lack of availability of land and infrastructure in middle to upper income areas of large cities. Increasingly, there is also the issue of affordability of these services.

Financing of NGOs: Pakistan has one of the highest levels of philanthropy. However, this occurs more in the form of charity at the personal level in the form of Zakat contributions. As such NGOs are not always able to achieve a large enough and sustainable level of financing. Despite this constraint, there is the need to recognize the nationwide efforts of the Edhi Foundation and more recently the Akhuwat Foundation.

Proposed Reforms and Policies

Allocation of Land and Infrastructure: Building Authorities must ensure that in the planning and development of new residential blocks, adequate provision is made for land to provide educational, health and other services at moderate prices.

Tax Issues: Charitable contributions by corporate entities enjoy tax deductibility provision according to the ITO. This provision should be increased for officially recognized NGOs. Issues of taxation of income generated through investment or from economic activities by NGOs also need to be resolved.

Overall, this Chapter has comprehensively covered the various services in the national economy with a description of their characteristics, constraints to growth and the agenda of proposed reforms and policies to accelerate their growth.

PART-VIII

STRIVING FOR BALANCED REGIONAL DEVELOPMENT

Chapter 25: Developing Backward Areas

One of the key indicators of a successful Federation is the presence of a Constitutional and fiscal framework which reduces inequalities among the federating units in the standard of living of the people.

Article 37(a) of the Constitution clearly states:

> *"Promote, with special care, the educational and economic interests of backward classes or areas"*

Therefore, developing backward areas and reducing inter-regional inequality have to be the key focus areas of the Charter of the Economy.

25.1. Size and Growth of Provincial Economies

Pakistan does not have official estimates of the Gross Regional Product of each Province. This has greatly hindered regional planning. Fortunately, some research institutions like the SPDC, IPP and BCPR have made estimates of the Provincial Gross Regional Products (GRPs) for different years.

The latest estimates of the GRPs for 2018-19 at constant factor cost of 2005-06 are given below in Table 25.1. the GRPs indicate the level of economic activity and the overall value added. The GRIs also include the inflow of remittances and are, therefore, a comprehensive measure of the total Provincial income.

Table 25.1: Estimates of The GRPS for 2018-19 (At constant 2005-06 prices) (Rs in Billion)

	Size of the GRP	Share (%)	Size of the GRI*	Share (%)
Punjab**	6825	54.2	7833	55.4
Sindh	3693	29.4	3746	26.5
Khyber-Pakhtunkhwa	1489	11.8	1937	13.7
Balochistan	573	4.6	623	4.4
Pakistan	**12580**	**100.0**	**14139**	**100.0**

*Including net inflow of domestic remittances and remittances from abroad | **Including Islamabad
Source: *Estimated.*

Table 25.1 indicates that two Provinces, Punjab and Khyber-Pakhtunkhwa have a higher share in the Gross National Income than in the Gross Domestic Product. Bulk of the remittances, both foreign and domestic, flow into these Provinces.

The estimated per capita income in 2018-19 of each Province at current prices is given in Table 25.2.

Table 25.2: Per Capita Income of The Provinces, 2018-19

	Gross Regional Income at Current Prices	Population	Per Capita	Income	% Deviation from Average Per Capita Income
	(Rs in Billion)	(Million)	(Rs)	($)	(%)
Punjab*	22452	114.48	196121	1441	0.5
Sindh	10739	49.03	219029	1609	12.2
Khyber-Pakhtunkhwa**	5552	31.37	176984	1300	-9.3
Balochistan	1783	12.78	139514	1025	-28.5
Pakistan	**40526**	**207.66**	**195155**	**1434**	

*Including Islamabad | **Excluding the Merged Districts
Source: *Estimated.*

The Province of Sindh has the highest per capita income, which is over 12 percent above the national average. The Province of Balochistan has the lowest per capita income, which is substantially below the national average by almost 29 percent. Punjab has a per capita income very close to the national per capita income. Khyber-Pakhtunkhwa has a per capita income also 9 percent below the national average.

The growth rates of the Provincial Economies from 1999-2000 to 2018-19 are given in Table 25.3. The highest average GRP growth rate is of Khyber-Pakhtunkhwa of just over 5 percent from 1999-2000 to 2018-19. It achieved the highest growth rate of 5.6 percent between 2004-05 and 2009-10.

Table 25.3: Provincial GRP Growth Rates (at constant 2005-06 prices) (%)

	1999-2000 to 2004-05	2004-05 to 2009-10	2009-10 to 2015-16	2015-16 to 2018-19*	Average Long-Run Growth Rate
Punjab	4.6	3.5	3.9	4.3	4.0
Sindh	5.4	4.4	3.3	3.3	4.1
Khyber-Pakhtunkhwa	4.6	5.6	4.8	5.2	5.0
Balochistan	4.2	0.6	2.9	3.6	2.7
Pakistan	**4.8**	**3.9**	**3.8**	**4.1**	**4.1**

*2019-20 excluded because of the impact of COVID-19
Source: *Estimated.*

Sindh has had a long-run growth rate of 4.1 percent, the same as the growth rate of the national economy. It enjoyed relative buoyancy between 1999-2000 and 2004-05. However, the growth rate of the economy has faltered after 2009-10 and has come down to 3.3 percent.

Punjab has seen less fluctuation in its growth rate over the years. Overall, for the last nineteen years Punjab has managed an average annual growth rate of 4 percent. The Province of Balochistan has unfortunately been the straggler. It has had a growth rate of only 2.7 percent, which was as low as 0.6 percent between 2004-05 and 2009-10. With a higher population growth rate, Balochistan is the only Province which has seen a long-term decline in real per capita income. The Federal Government and Constitutional bodies like the National Economic Council (NEC) and the Council of Common Interests (CCI) will have to accord the highest priority to facilitating the growth process in Balochistan.

25.2. Sectoral Composition of Provincial Economies

There are large differences in the sectoral composition of the Provincial economies as shown in Table 25.4. Punjab and Balochistan have the larger share of the economy devoted to agriculture as compared to the other two Provinces. Punjab is by far the largest producer of major crops in the country while Baluchistan specializes in minor crops. Despite the substantial presence of small-scale manufacturing units, overall, the share of industry In Punjab is low, especially in sub-sectors like mining and quarrying, and electricity production and distribution and gas distribution.

Table 25.4: Sectoral Composition of the Provincial Economie
(Rs in Billion Value Added at 2005-06 prices)

	Punjab	Share (%) of Economy	Sindh	Share (%) of Economy	Khyber-Pakhtunkhwa	Share (%) of Economy	Balochistan	Share (%) of Economy
Agriculture	1474	21.6	502	13.6	225	15.1	156	27.2
Industry	998	14.6	1016	27.5	328	22.0	141	24.6
Services	4353	63.8	2175	58.9	936	62.9	276	48.2
Total GRP	**6825**	**100.0**	**3693**	**100.0**	**1489**	**100.0**	**573**	**100.0**

Source: *Estimated.*

Sindh, as expected, has the highest share among the Provinces of industrial value added and a relatively low share in agriculture. Sub-sectors like large-scale manufacturing and banking and insurance play a big role in Sindh's economy.

Khyber-Pakhtunkhwa's economy is concentrated in service activities, especially transport and wholesale and retail trade. It has a big share in electricity generation due to the presence of the Tarbela Dam. Balochistan has a relatively underdeveloped service sector. However, it generates a relatively large portion of its value added from the mining and quarrying sector, especially natural gas.

There is need to identify sub-sectors where a particular Province has a locational and comparative advantage. This is measured by the Location Quotient, LQ, for a particular sector in a Province. LQ is the ratio of share of national value added in a particular sector in the Province divided by the overall share of the Provincial Economy in the national GDP. A ratio above unity implies comparative advantage in the sub-sector of the Province.

The sub-sectors of comparative advantage in each Province are given below:

Punjab**:** important (major crops); cotton ginning; livestock (especially milk production); large-scale and small-scale manufacturing slaughtering; construction; transport and communications; finance and insurance; public administration and defense; and economic, social and community services.

Sindh**:** cotton ginning; livestock; fisheries; mining and quarrying; large-scale manufacturing; wholesale and retail trade; finance and insurance, ownership of dwellings.

Khyber-Pakhtunkhwa**:** livestock; forestry; slaughtering, construction; electricity and gas; transport and communications; economic, social and community services; ownership of dwellings.

Balochistan**:** minor crops; fishing; forestry; mining and quarrying; electricity and gas; wholesale and retail trade; public administration and defense.

Clearly, the development strategy of Provincial Government must be to focus more on sub-sectors where it has a comparative advantage in the national context.

25.3. The Gross Regional Product by Expenditure

The GRP by expenditure of each Province has been estimated for the first time. The resulting estimates for 2018-19 are presented in Table 25.5. On the bases of these estimates, key economic ratios are derived for each Province and given in Table 25.6. the derived ratios are extremely revealing and have never been highlighted before.

The overall investment to GDP ratio is, in fact, higher in the two smaller Provinces. Khyber-Pakhtunkhwa has a higher level of private investment due to relatively large inflow of remittances, a large part of which goes into the housing sector. The higher level of investment in Balochistan is sustained by larger public investment financed primarily through NFC transfers and more recently due to CPEC.

A striking finding is the distribution of domestic saving. Sindh and Punjab do all the saving while the economies of Khyber-Pakhtunkhwa and Balochistan are characterized by dissaving. Similarly, the only Province with a trade surplus, in both domestic and international trade, is Sindh. The three other Provinces carry large trade deficits.

There is need to recognize the extra ordinary contribution of Sindh to national development. This is primarily the consequence of its large contribution to national tax revenues which are transferred to other Provinces via the fiscal equalization formula embodied in the 7th NFC Award.

Table 25.5: Estimates of Provincial GRP by Expenditure, 2018-19 (at constant prices of 2005-06, Rs in Billion)

	Punjab	Sindh	Khyber-Pakhtunkhwa	Balochistan	Pakistan
Household Consumption Expenditure	6164	2499	1375	462	10501
Government Consumption Expenditure	759	492	265	163	1679
Private Investment	742	395	169	56	1361
Public Investment	227	138	62	33	460
Change in Inventories	114	63	25	10	213
Net Trade Deficit	-814	426	-328	-117	-883
GRP at Market Prices	**7192**	**4013**	**1568**	**607**	**13380**
Net Taxes	367	320	79	34	800
GRP at Factor Cost	**6825**	**3693**	**1489**	**573**	**12580**
Net Factor Income from Abroad	**1008**	**53**	**448**	**50**	**1559**
Gross Regional Income	**7833**	**3746**	**1937**	**623**	**14139**

Source: *Estimated.*

Table 25.6: Key Economic Ratios of The Provinces, 2018-19 (% of GRP at Market Prices)

	Fixed Investment			Total Savings	Trade Deficit (-)/ Trade Surplus (+)
	Private	Public	Total		
Punjab	10.3	3.2	13.5	2.2	-11.3
Sindh	9.8	3.4	13.2	23.9	10.6
Khyber-Pakhtunkhwa	10.8	4.0	14.8	-6.1	-20.9
Balochistan	9.2	5.4	14.6	-4.6	-19.3
Pakistan	**10.2**	**3.4**	**13.6**	**7.0**	

Source: *Estimated*

25.4. Level of Human Development of the Provinces

The UNDP National Human Development Report for Pakistan of 2020 has estimated the Human Development Index (HDI) for each Province and separately for urban and rural areas. The HDIs are presented in Table 25.7.

The Province with the highest HDI is Sindh followed closely by Punjab. Balochistan has a relatively low HDI, which is 17 percent below the national average. The fastest growth in HDI has been witnessed in Khyber-Pakhtunkhwa.

Table 25.7: Human Development Index by Province and for Urban and Rural Areas

	2006-07	2018-19	Annual Growth Rate (%)
PUNJAB	**0.527**	**0.572**	**0.68**
Urban	0.600	0.631	0.42
Rural	0.488	0.539	0.83
Ratio	***1.230***	***1.717***	
SINDH	**0.529**	**0.574**	**0.68**
Urban	0.599	0.645	0.62
Rural	0.447	0.485*	0.68
Ratio	***1.340***	***1.330***	
KHYBER-PAKHTUNKHWA	**0.491**	**0.546**	**0.88**
Urban	0.563	0.612	0.70
Rural	0.476	0.532	0.93
Ratio	***1.183***	***1.150***	
BALOCHISTAN	**0.470**	**0.473**	**0.05**
Urban	0.568	0.548	-0.30
Rural	0.435	0.440*	0.09
Ratio	***1.305***	***1.245***	
PAKISTAN	**0.529**	**0.570**	**0.62**
Urban	0.606	0.641	0.47
Rural	0.483	0.527	0.73
Ratio	***1.254***	***1.216***	

*low level of human development. Source: UNDP, NHDR, 2020.

The rural areas of each Province are characterized by a significantly lower HDI than the urban areas. The rural HDI is the highest in Punjab followed by Khyber-Pakhtunkhwa. Sindh has a surprisingly low rural HDI. Consequently, the inequality in HDI between urban and rural areas is the highest in Sindh.

The highest urban HDI is in Sindh as expected, followed by Punjab. One positive trend is the gap between the urban and rural HDI is narrowing in all the Provinces. However, there are still two pockets of low HDI. These are rural areas of Sindh and Balochistan.

The magnitude of sub-indices of income, health, and education within the HDI are presented in Table 25.8 for 2018-19. The health sub-index has generally relatively large values, while the education sub-index has relatively low values.

Sindh has the highest value in the income index among the Provinces. Khyber-Pakhtunkhwa performs the best in the health sub-index. Punjab's education system is more developed than the other three provinces.

The largest urban-rural gap in HDI is in education sub-index. It is as high as 85 percent in Sindh and 71 percent in Balochistan. Overall, the largest difference between the urban and the rural HDI is observed in Sindh.

Table 25.8: Income, Health and Education Sub-Indices of HDI by Province, 2018-19

	SUB-INDEX			
	Income	Health	Education	HDI
PUNJAB	**0.563**	**0.598**	**0.556**	**0.572**
Urban	0.591	0.638	0.665	0.631
Rural	0.546	0.588	0.488*	0.539
Ratio	***1.062***	***1.085***	***1.363***	***1.171***
SINDH	**0.593**	**0.660**	**0.484***	**0.574**
Urban	0.626	0.698	0.613	0.645
Rural	0.547	0.630	0.331*	0.485*
Ratio	***1.144***	***1.108***	***1.852***	***1.330***
KHYBER-PAKHTUNKHWA	**0.529**	**0.701**	**0.438***	**0.546**
Urban	0.559	0.753	0.545	0.612
Rural	0.523	0.692	0.416*	0.532
Ratio	***1.068***	***1.088***	***1.310***	***1.150***
BALOCHISTAN	**0.518**	**0.631**	**0.324***	**0.473**
Urban	0.541	0.658	0.461*	0.548
Rural	0.507	0.625	0.269*	0.440*
Ratio	***1.067***	***1.053***	***1.714***	***1.245***
PAKISTAN	**0.564**	**0.648**	**0.506**	**0.570**
Urban	0.606	0.691	0.630	0.641
Rural	0.534	0.637	0.430*	0.527
Ratio	***1.135***	***1.085***	***1.465***	***1.216***

*Pockets of low HDI
Source: *UNDP, NHDR, 2020*

25.5. Trend in Inter-Provincial Inequality

The trend in inter-provincial inequality is a key determinant of the state of the Federation of Pakistan. The 7th NFC Award took a major step forward by building in significant fiscal equalization in the horizontal sharing formula among the Provinces.

The Pashum Index has been used to quantify the extent of inter-Provincial inequality in per capita income and the HDI. . The estimates are presented in the Table 25.9.

Table 25.9: Magnitude of Inter-Provincial Inequality in Income and the HDI

	Pashum Index* – (%)	
	Income	HDI
2006-07	16.2	5.1
2018-19	22.9	5.3

* Presented in HDR 2020

The worrying finding is that inter-Provincial inequality has increased according to both measures. The principal reason is the falling behind of Balochistan. Therefore, the pre-requisite for any reduction in coming years in inequality is faster growth of the Province of Balochistan.

25.6. Inequality within Provinces

The magnitude of the HDI at the division level has been quantified for 2018-19 in each Province. The HDI estimates are presented in Table 25.10.

Table 25.10: HDI of the Divisions of Pakistan by Province, 2018-19

Province/Division	HDI	Type	Province/Division	HDI	Type
ISLAMABAD	**0.885**	VH			
PUNJAB			**KHYBER-PAKHTUNKHWA**		
Rawalpindi	0.754	VH	Peshawar	0.647	H
Lahore	0.726	VH	Hazara	0.575	M
Gujranwala	0.623	H	Mardan	0.527	M
Faisalabad	0.587	M	Malakand	0.508	M
Sargodha	0.549	M	Kohat	0.491	L
Multan	0.494	L	Bannu	0.481	L
Dera Ghazi Khan	0.419	L	Dera Ismail Khan	0.413	L
Bahawalpur	0.406	L	Waziristan	0.410	L
SINDH			**BALOCHISTAN**		
Karachi	0.884	VH	Makran	0.609	H
Hyderabad	0.515	M	Quetta	0.547	M

Shaheed Benazirabad	0.472	L	Rakshan	0.478	L
Sukkur	0.465	L	Kalat	0.471	L
Mirpurkhas	0.389	VL	Sibi	0.446	L
Larkana	0.361	VL	Nasirabad	0.336	VL
Banbhore	0.342	VL	Zhob	0.287	VL
HUMAN DEVELOPMENT INDEX					
Very High (VH): HDI ≥ 0.7	High (H): 0.6 ≤ HDI < 0.7		Medium (M): 0.5 ≤ HDI < 0.6		
Low (L): 0.4 ≤ HDI < 0.5			Very Low (VL): HDI < 0.4		
Source: *Estimated*					

Punjab has two divisions with a high level of human development. These are Rawalpindi and Lahore divisions. An unexpected finding is the higher ranking of Rawalpindi. This is probably due to the externalities of proximity to the capital city, Islamabad, which has the highest HDI in Pakistan. Three divisions of Punjab have a low HDI, namely, Multan, Dera Ghazi Khan, and Bahawalpur. This confirms the big North-South divide in Punjab. All three of the low HDI divisions are in South Punjab.

Sindh has a big spread in the HDI values among the divisions. It ranges from a high HDI, as expected, in Karachi to very low HDIs in three divisions – Mirpur Khas, Larkana and Banbore.

Khyber-Pakhtunkhwa is also characterized by a North-South divide. Peshawar has a high HDI while the southern divisions, namely, Kohat, Bannu, Dera Ismail Khan and Waziristan all have low HDI values.

Balochistan has widespread low or very low level of human development. Only two divisions, namely, Makran and Quetta, have either higher or medium HDI. In fact, the two divisions with the lowest HDI values among the divisions of Pakistan are in Balochistan. These are Zhob and Nasirabad.

A similar analysis of inequality among divisions in a Province has also been undertaken. The greatest intra-provincial inequality is observed in Sindh, followed by Balochistan and Punjab. The province of Khyber-Pakhtunkhwa is characterized by the lowest level of regional inequality.

25.7. Development Ranking of Districts

The PSLM Survey of 2019-20 at the district level in Pakistan has undertaken a Situation Analysis of each district. This analysis is based on 16 indicators, including the following:

	Number of Indicators	Weights (%)
Education	5	30
Health	3	30
Living Standards	5	30
Information Community and Technology	3	10
TOTAL	**16**	**100**

The groupwise weights are also given above. The overall development score of a district can range from 0 to 100. The districts are categorized as follows:

		Development Score
A.	Very Highly Developed	≥ 80.5
B.	Highly Developed	68.4 – 80.4
C.	Middle Level of Development	56.3 – 68.3
D.	Low-Middle Level of Development	44.2 – 56.2
E.	Low Level of Development	32.1 to 44.1
F.	Very Low Level of Development	≤ 32

The distribution of districts by level, A to F, in a Province is given Table 25.11, along with the overall development score of the Province.

Table 25.11: Distribution of Districts by Level of Development and the Overall Development Score by Province

Category of District	PROVINCE			
	Punjab	Sindh	Khyber-Pakhtunkhwa	Balochistan
A	-	-	-	-
B	15	6	3	-
C	18	4	11	2
D	3	14	11	11
E	-	4	5	12
F	-	1	2	3
TOTAL	**36**	**29**	**32**	**28**
Average Development Score of Districts	**68.9**	**55.4**	**53.7**	**43.0**

Source: *PSLM Survey, PBS, 2019-20*

The results indicate that Punjab has taken over from Sindh as the most developed province of Pakistan with the highest average district development score. Khyber-Pakhtunkhwa has come closer to Sindh. Balochistan remains a relatively underdeveloped Province with a score 38 percent below that of Punjab.

The very backward districts in each Province in category E and F are highlighted in Chart 25.1. Punjab has a relatively balanced pattern of regional development with no districts in these two categories.

Chart 25.1: Districts at Low and Very Low Level of Development by Province

Province	Districts
Punjab	-
Sindh	Sujawal, Tando Mohammad Khan, Badin, Umerkot, Tharparkar
Khyber-Pakhtunkhwa	Kohistan, Bajaur, Mohmand, Torghar, North Waziristan, South Waziristan, Tank
Balochistan	Sheerani, Kila Saifullah, Killa Abdullah, Ziarat, Harnai, Dera Bugti, Nasirabad, Jaffarabad, Shaheed Sikanderabad, Washuk, Awaran, Khuzdar, Sohbatpur

Source: *PSLM Survey, 2019-20, PBS*

The above districts must get the highest priority in development allocations by the Federal Government and the Provincial Governments.

25.8. Regional Distribution of Development Projects

The objective of this analysis is to determine if the allocations in the Federal PSDP are focused more on development of the relatively under-developed areas in the country. If yes, then this will contribute significantly to reducing inequality in the country.

A case study has been undertaken of project allocations by the National Highway Authority (NHA). This agency receives the largest allocation from the Federal PSDP. The allocation of Rs 113.7 billion out of the Federal PSDP of Rs 900 billion for 2021-22 is to the NHA.

The portfolio of projects being implemented include 48 on-going and 15 new projects with the total cost of Rs 1979 billion. There are two types of projects. The first are trunk infrastructure projects which are inter-provincial in nature. The second type are smaller intra-provincial highway projects linking two locations within a province.

A priori, there is the expectation that the allocation for intra-provincial projects would be the highest to Balochistan. This is the largest province in terms of geographical area, with a share of over 40 percent. However, it has less than 12 percent of the network of highways and roads in the country.

Analysis of projects in the NHA portfolio of 2021-22 reveals the distributions of on-going and new projects shown separately in Table 25.12. The major share goes to trunk infrastructure in the form of CPEC projects or upgrading of the National Highway.

Table 25.12: Regional Distribution of On-Going and New Projects of NHA (Rs in Billion)

Type of Project / Location	On-going Projects			New Projects		
	Number of Projects	Cost	Share (%)	Number of Projects	Cost	Share (%)
INTER-PROVINCIAL*	**14**	**1029.8**	**61.6**	**4**	**175.5**	**56.8**
INTTRA-PROVINCIAL	**34**	**639.7**	**38.4**	**11**	**133.7**	**43.2**
Punjab	10	170.9	10.2	2	2.6	0.8
Sindh	2	61.1	3.6	1	0.1	-
Khyber-Pakhtunkhwa	10	241.4	14.4	4	34.8	11.3
Balochistan	8	99.6	6.0	3	46.3	15.0
Others**	4	66.7	4.2	1	49.9	16.1
TOTAL	**48**	**1669.5**	**100.0**	**15**	**309.2**	**100.0**

* mostly the CPEC projects and the National Highway | ** Islamabad, Gilgit-Baltistan, Azad Jammu and Kashmir
Source: *Planning Commission, Federal PSDP, 2021-22.*

Within intra-provincial projects, the province of Khyber-Pakhtunkhwa appears to be getting the highest priority in allocations to on-going projects. Balochistan has projects under execution with a share of only 6 percent in total allocation of NHA. Similarly, Sindh is also receiving low priority with a share below 4 percent.

The priority in allocations to new projects in Balochistan is significantly higher with a share of 15 percent. Here again, Sindh and Punjab are neglected. The largest new project is being executed in Gilgit-Baltistan.

The regional distribution of projects should also be derived by the Planning Commission for all other sectors. The results should be placed before the Council of Common Interests (CCI), which is chaired by the Prime Minister and the four Chief Ministers are members.

25.9. Fiscal Indicators of Provinces

Following the estimation of the Gross Regional Product of each Province, it has become possible to derive the revenues and expenditure ratios with respect to the GRP of each Province. The estimates and presented in Table 25.13.

Table 25.13: Revenues and Expenditure as % of the GRP of Provincial Governments, 2018-19 (% of GRP)					
	Punjab	Sindh	Khyber-Pakhtunkhwa	Balochistan	Four Provinces Combined
Total Revenues	**6.3**	**6.6**	**10.0**	**13.8**	**7.2**
Own Revenue	1.0	1.5	1.0	0.0	1.2
Federal Transfers	5.3	5.1	8.9	12.9	6.0
Total Expenditure	**6.1**	**6.1**	**9.7**	**12.9**	**6.8**
Current	5.0	5.2	7.3	10.7	5.6
Development	1.1	0.9	2.4	2.2	1.2
Cash Surplus / Deficit	**0.2**	**0.4**	**0.1**	**0.9**	**0.4**
Source: *Fiscal Operations, MOF*					

The highest own revenue to GRP ratio is observed in the case of Sindh of 1.5 percent. As expected, the fiscal transfers from the Federal Government are the highest to Khyber-Pakhtunkhwa and Balochistan at 8.9 percent and 12.9 percent respectively of the GRPs.

Consequently, the Expenditure-to-GDP ratios are also significantly higher for the two smaller Provincial Governments. It is closer to 6 percent of the GRP for Punjab and Sindh and rises to almost 10 percent of the GRP in the case of Khyber-Pakhtunkhwa and 13 percent of the GRP in Balochistan.

Table 25.14 highlights the spending on health and education by the Provincial Governments as a percentage of their respective GDPs. In line with the overall level of spending, the expenditure is higher in Khyber-Pakhtunkhwa and Balochistan.

Table 25.14: Expenditure on Education and Health as % of GRP by Province, 2018-19 (% of GRP)					
	Education (Billion Rs)	% of GRP	Health (Billion Rs)	% of GRP	Total (% of GRP)
Punjab	371.8	1.7	218.9	1.0	2.7
Sindh	162.0	1.3	98.1	0.8	2.1
Khyber-Pakhtunkhwa	152.7	3.1	55.7	1.1	4.2
Balochistan	55.3	2.9	21.9	1.1	4.0
Federal	125.6	0.3	27.1	0.1	0.4
Pakistan	**867.4**	**2.1**	**421.7**	**1.0**	**3.1**
Source: *PRSP Progress Reports*					

The fundamental question which arises is why with a higher level of spending there is a divergence in the performance of the two smaller Provinces? Why has Khyber-Pakhtunkhwa shown the fastest growth in its HDI among the four Provinces but why has Baluchistan demonstrated the slowest growth?

An attempt is made to answer this question by looking at the efficiency of spending in Table 25.13. the efficiency is measured as the elasticity of growth in the education or health sub-indices of the HDI with respect to the growth in real spending between 2006-07 and 2018-19.

There is a large inter-Provincial variation in the elasticity. The education elasticity is the highest in Punjab in education with the lowest growth rate in real education spending. Next is Khyber-Pakhtunkhwa, followed by Baluchistan and Sindh. The ranking of the elasticities is different in health. The best performance is by Sindh, followed by Khyber-Pakhtunkhwa and Punjab. It is negative in Balochistan.

Table 25.15: Elasticity of Education and Health Sub-Index of HDI with Respect to Growth in Real Spending

	EDUCATION		
	Growth Rate in Real Expenditure (%)	Growth Rate in Sub Index (%)	Elasticity
Punjab	5.61	1.32	0.235
Sindh	8.08	0.21	0.026
Khyber-Pakhtunkhwa	9.05	0.95	0.105
Balochistan	8.84	0.59	0.067
		HEALTH	
Punjab	10.9	0.31	0.028
Sindh	12.1	1.56	0.129
Khyber-Pakhtunkhwa	10.4	0.94	0.090
Balochistan	10.7	-0.48	-0.045

The magnitude of the elasticities reveals a relatively good performance in Khyber-Pakhtunkhwa but not in Balochistan. This leads to the conclusion that Balochistan may have pursued the wrong priorities in social sector spending and / or there has been a relative lack of institutional capacity in the delivery of services and / or large leakages in expenditure.

Based on the extensive analysis above of regional development in Pakistan recommendations are given below for a faster and more balanced development in the country.

25.10. Achieving balanced Regional Development

***Development of Annual Gross Regional Product Estimates*: Following the passage of the 18th Amendment and the 7th NFC Award which gave greater autonomy and resources to the Provincial Governments, they should have embarked on planning with an appropriate growth strategy. Unfortunately, there are no official estimates of the size, growth, and composition of each Provincial Economy.

The Pakistan Bureau of Statistics and the Provincial Bureaus of Statistics must be assigned the task of preparing for the respective Province the annual estimates of GRP by sector. The required information system can first be identified and developed. At a later stage, the GRP estimates by expenditure can also begin to be prepared.

The annual estimates of the GRP must be made available on nine months data to facilitate the process of budget making for the next fiscal year. This will enable the identification of appropriate interventions in the Provincial Budget.

India has had a long tradition of making annual GRP estimates at the level of States. The methodology used for making these estimates should be examined to determine its replicability in the Pakistani context.

***Replacement of 'Top-Down' Planning by 'Bottom-Up' Planning*:** In the true spirit of the Federation the annual exercise must first be completed by the Provincial Governments. The required macroeconomic envelope to support the regional plans can then be prepared by the Federal Planning Commission. The overall Macroeconomic Plan with the regional dimensions can then be presented to the National Economic Council. The NEC has the Prime Minister as the Chairman. At the Provincial level, the Planning and Development Department must undertake assessment of the growth potential at the Division level within the Province and the identify constraints which need to be removed for realization of this potential.

***Provincial Development Strategy and Priorities must be aligned with locational and comparative advantages of the Province*:** The Section 25.2 has already identified sectors and sub-sectors where a particular Province has a comparative and locational advantage. As an illustration the development priorities for Baluchistan, the relatively backward Province, are derived.

Balochistan has comparative advantage in some sub-sectors within agriculture. These are minor crops (especially vegetables and fruits), fishing and forestry. The ADP should focus on identification of projects, possibly in partnership with the Federal Government or the private sector, which will provide appropriate policies and inputs for faster development of these sub-sectors. Further, mining and quarrying and, electricity and gas are other sub-sectors where Balochistan has substantial development potential and should be focused on.

***Focus of Federal PSDP on Reducing Backwardness*:** The Federal PSDP constitutes about 42 percent the public development spending in the country. The portfolio of projects consists both of trunk infrastructure of an inter-provincial nature and of projects which are more location-specific with benefits accruing to a region within a particular province.

The three PSDP sectors with the largest outlays are highways, water resources and electricity transmission and distribution. A case study has been undertaken to identify the regional distribution of on-going and new projects of the National Highway Authority.

	Share of Cost of Intra-Provincial Highway Projects (%)
Punjab Projects	26.4
Sindh Projects	9.3
Khyber-Pakhtunkhwa Projects	42,1
Baluchistan Projects	22.2
TOTAL	**100**

As highlighted above it comes as a surprise that Balochistan, with the biggest geographical area and a relatively underdeveloped road network has received lower priority in the allocation of development expenditure by the NHA than Punjab and Khyber-Pakhtunkhwa.

A similar problem in the case of the water resources sector. A large part of the development spending is targeted towards Khyber-Pakhtunkhwa and large hydel projects. Balochistan again is the must water-short Province and needs a portfolio of relatively small projects. Fortunately, the collection of electricity transmission and distribution projects are focused more on improving the system in Balochistan in PESCO and QESCO, currently with higher losses, and on trunk infrastructure through NTDC.

***Provincial ADP allocations must accord due priority to social services where the level of human development is relatively low*:** The proposed distribution of ADP spending by type in 2020-21 Budget at the Provincial level is given in Table 25.16.

Table 25.16: Shares in ADP Allocations in 2020-21 (%)

	Social Services	Infrastructure	Production Sectors	Others*	Total
Punjab	29.0	23.1	5.2	42.7	100.0
Sindh	32.8	26.5	6.2	34.5	100.0
Khyber-Pakhtunkhwa	26.8	26.0	9.2	38.6	100.0
Baluchistan	25.8	44.4	6.0	23.8	100.0
TOTAL					

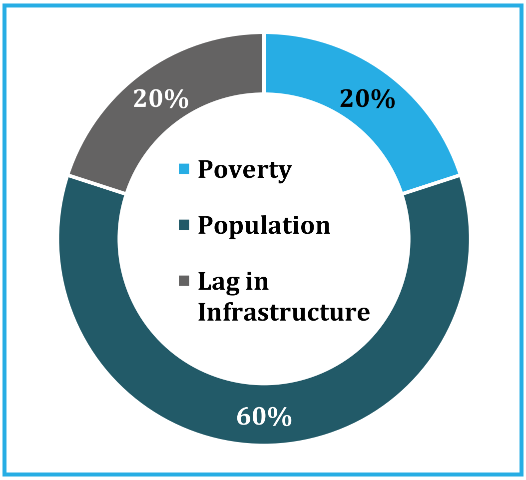
*Includes allocations for special initiatives, Planning and Development Department, Lump Sum Allocations to Local Government, New Projects, etc.
Source: *Provincial ADPs*

It is interesting that the largest sectoral allocation in the ADP of Punjab is to education. In Sindh it is to health. Both Khyber-Pakhtunkhwa and Baluchistan are giving more to roads. However, Balochistan is allocating only 8 percent of its ADP to education despite the very low education sub-HDI. The allocation by the other Provinces ranges from 12 to 15 percent.

Need for an Explicit Share of ADP to Backward Areas: Section 25.5 has identified the relatively backward regions within each Province. There is clearly need for diversion of more public resources to the development of these regions.

From the viewpoint of ensuring transparency and due recognition the ADP should be presented by Division or if possible, down to the project level and not in lump sum form. This will enable public identification of whether more allocations are being diverted to the relatively backward areas.

The Government of Khyber-Pakhtunkhwa has developed an appropriate formula for distribution of funds among districts as follows:



Similar horizontal sharing formula may be adopted by other Provinces.

Enhancements in Institutional Capacity: Section 25,7 has demonstrated the large variation in the rate of translation of growth in spending to improvement in the HDI. This implies that there is need for adequate institutional capacity for delivery and O&M of projects. Also, proper systems of accounting and procurement must be put in place for minimizing leakages.

Differentiated System of Fiscal Incentives: Income tax holidays have typically been offered for private investment in backward areas. There is need for differentiating the period of tax holiday by level of backwardness and focusing more directly the incentives to these areas within Provinces as follows:

		Very Low HDI Divisions	Tax Holiday of
Very Low HDI:	•	Mirpurkhas; Larkana, Banbhore, Nasirabad; Zhob	Ten Years
Low HDI:	•	Multan, D.G. Khan, Bahawalpur, Shaheed Benazirabad, Sukkur, Bannu, D.I. Khan, Waziristan, Sibi, Kalat, Rakshan	Five Years

Need for Limiting Transfer of Financial Resources from Backward to Developed Areas: A truly negative phenomenon is the reverse flow of bank deposits in the two smaller Provinces to the more developed Provinces as shown below:

REVERSE FLOW OF BANK ADVANCES
(*Rs in Billion*)

	Deposits			Advances		
	June 2018	June 2019	Change	June 2018	June 2019	Change
Punjab	5505 (51.1)	6193 (51.4)	688	3219 (58.5)*	3335 (46.8)	116
Sindh	3976 (36.9)	4457 (37.0)	79	3102 (78.0)	3650 (81.8)	548
Khyber-Pakhtunkhwa	1000 (9.3)	1079 (9.0)	18	72 (7.2)	108 (10.0)	36
Balochistan	300 (2.8)	318 (2.6)	18	16 (5.3)	26 (0.4)	10
TOTAL	**10781** **(100.0)**	**12047** **(100.0)**	**1266**	**6409** **(59.4)**	**7119**	**710**

*Ratio of Advances to Deposits
Source: *SBP*

For example, the deposits in bank branches within Baluchistan as of June 2019 are Rs 318 billion. However, the outstanding credit is only Rs 26 billion. The Banks must devote more effort to developing the credit market in the two relatively underdeveloped region. A special incentive can be given annually for increase in bank advances in Baluchistan and Khyber-Pakhtunkhwa.

The strengthening of the Federation of Pakistan will require a special focus on faster development in Balochistan. It is imperative that regional inequality is reduced in Pakistan.

PART-IX

FOCUSING ON HUMAN DEVELOPMENT

Chapter 26:

Higher and More Effective Spending on Education and Health

The level of human development is not only a critical factor in determining the level of labor productivity and, thereby, economic growth but also in ensuring that the benefits of growth are equitably distributed leading thereby to a lower incidence of poverty in the population.

The UNDP has developed a Human Development Index (HDI). This index has three components – per capita income, level of education and the level of health. This chapter focuses especially on the education and health indices. Initially, a comparison is made of Pakistan with other South Asian countries and the trend in the magnitude of HDI.

26.1. Level and Trend in the HDI

The latest magnitude of the HDI in 2019 and the key HDI indicators are given in Table 26.1 for South Asian countries. The unfortunate finding is that Pakistan has the lowest HDI among the five major South Asian countries. The level in each indicator is also the lowest, with the solitary exception of per capita income where Pakistan does better than Bangladesh and Nepal.

Table 26.1: Human Development Index Ranking Among South Asian Countries, 2019

Country	Level of HDI	HDI Value (2019)	Rank*	Life Expectancy at Birth (SDG 3)	Expected Years of Schooling (SDG 4.3)	Mean Years of Schooling (SDG 4.6)	GNI per Capita (PPP $) (SDG 8.5)
Sri Lanka	High	0.782	72	77.0	14.1	10.6	12,707
India	Medium	0.651	131	69.7	12.2	6.5	6,681
Bangladesh	Medium	0.632	133	72.6	11.6	6.2	4,976
Nepal	Medium	0.602	142	70.8	12.8	5.0	3,457
Pakistan	**Medium**	**0.557**	**154**	**67.3**	**8.3**	**5.2**	**5,005**

*Out of 189 countries
Source: *UNDP, Global HDR*

From the average for the other four South Asian countries, the extent of deviation in an indicator by Pakistan has been derived. The level of Pakistan is the lowest in expected years of schooling at 35 percent, while the smallest difference is 7 percent is in the case of life expectancy. This clearly highlights the fact that Pakistan will have to attach the highest priority to education if it is to catch up with the rest of South Asia.

Table 26.2: Trend in HDI of Pakistan		
Year	HDI	ACGR (%)
1990	0.402	-
2000	0.447	1.06
2010	0.512	1.36
2014	0.530	0.86
2019	0.557	0.99
Source: *UNDP, GHDR*		

Table 26.2 above gives the trend in the HDI of Pakistan from 1990 onwards, when it was first constructed by UNDP. The fastest growth rate was from 2000 to 2010. There are two possible explanations for higher growth during this decade. First, the GDP growth rate was higher especially in the Musharraf era. Second, the provision of social services was largely devolved to district Governments. This probably led to a better reflection in expenditures of people's preferences and to greater efficiency in the provision of services.

Table 26.3 highlights the variation in the HDI by location from 2006-07 to 2018-19. This has been done for the first time for Pakistan in the 2020 National HDR of UNDP. Two important conclusions emerge from the Table. First, there is a big gap of almost 20 percent between the urban HDI and the rural HDI. Fortunately, this gap has narrowed somewhat since 2006. However, this will be a need for greater focus on service provision in rural areas.

Second, there is significant variation both in the level and rate of change in the HDI of the Provinces of Pakistan. On the positive side, Khyber-Pakhtunkhwa, a relatively backward Province, has shown the fastest growth in the HDI. However, Baluchistan has a HDI over 20 percent lower than that of Sindh, which has the highest HDI. It has also shown little improvement in the HDI.

Table 26.3: Trend in the Level of HDI by Location and by Province			
	2006-08	2018-19	Annual Growth Rate (%)
Urban	0.606	0.641	0.47
Rural	0.483	0.527	0.73
Ratio	0.797	0.822	-
By Province			
Punjab	0.527	0.472	0.68
Sindh	0.529	0.574	0.68
Khyber-Pakhtunkhwa	0.491	0.546	0.88
Balochistan	0.470	0.473	0.05
Ratio*	1.125	1.213	-

*HDI of highest Province divided by HDI of the lowest Province.
Source: *UNDP, NHDR 2020*

There is a need to see if the South Asian country rankings in human development reflect differences in the level of public spending on education and health. This is attempted below in Table 26.4. Nepal presents an interesting case. Despite being classified as a Least Developed Country (LDC), it has managed to raise its HDI by the highest level of spending an education at over 5 percent of the GDP and on health at 1.5 percent of GDP. Pakistan has close to the average spending level but does not do as well in the HDI.

Table 26.4: Public Spending on Education and Health as % of GDP in South Asian Countries

Country	HDI	Spending on Education	Spending on Health
Sri Lanka	0.782	2.1	1.1
India	0.645	3.8	1.0
Bangladesh	0.632	2.2	0.9
Nepal	0.602	5.1	1.5
Pakistan	**0.557**	**2.2**	**1.1**

Source: *World Bank, WDI.*

26.2. Education

The Education System

The distribution of education sector public spending is given in Table 26.5 for South Asian countries. It appears that perhaps somewhat prematurely the share of colleges and universities in public education expenditure has increased in Pakistan. It stands at over 22 percent as compared to 11 percent in Nepal, 15 percent in Bangladesh and 21 percent in the more developed Sri Lanka. Therefore, there appears to be a case for increasing the shares of primary and secondary levels of education, especially if the imbalance in coverage by location and gender is to be reduced.

Table 26.5: Distribution of Education Sector Spending by Government in South Asian Countries

Country	Share of Expenditure (%)				
	Primary	Secondary	College/ University	Other	Total
Sri Lanka	29.9	45.7	20.7	3.7	100.0
India	28.4	41.4	28.5	1.7	100.0
Bangladesh	44.6	39.1	14.7	1.6	100.0
Nepal	53.8	33.3	10.8	2.1	100.0
Pakistan	**36.5**	**37.5**	**22.2**	**3.8**	**100.0**

Source: *World Bank, WDI.*

A long-term comparison is made in Table 26.6 of the evolution of public expenditure at constant prices of 2005-06 on different levels of education in Pakistan.

Table 26.6: Annual Growth Rate of Real Public Expenditure on Different Levels of Education in Pakistan – (%)			
	2001-02 to 2009-10	2009-10 to 2018-19	2001-02 to 2018-19
Primary	4.2	9.4	7.0
Secondary	11.8	7.4	9.5
Colleges & Universities	25.3	5.1	15.8
Teacher Training	4.2	7.5	5.5
TOTAL	6.6	8.3	7.5
Source: *PRSP data base*			

Some key conclusions emerge from the Table. First, 2009-10 was the last year before the 7th NFC Award. This Award allocated substantially higher resources to the Provincial Governments, with the primary responsibility of delivering education and health services. It is not surprising that after the Award the growth rate of education expenditure in real terms has been higher at 8.3 percent, as compared to 6.6 percent prior to the Award.

Second, as already identified, the country has prematurely seen a very rapid expansion in colleges and universities. The growth rate of expenditure was by far the highest at 25 percent between 2001-02 and 2009-10. Apparently, this was at the cost of basic primary education where the growth rate in expenditure was only 4 percent. The period after 2009-10 has rightly seen higher growth rates in spending on primary and secondary education as compared to college/university education.

The impact of education expenditures on outcomes in terms of the enrollment rates is given in Table 26.7. The analysis has been conducted from 2007-08 to 2018-19.

Table 26.7: Trend in Key Education Indicators – (%)					
	2007-08	2013-14	Change	2018-19	Change
• Literacy Rate (%) |*(Age > 10 years)*	56	58	2	60	2
• Youth Literacy Rate (%) | *(Age 15-24 years)*	n.a.	71	-	72	1
• Adult Literacy (%) | *(Age > 15 years)*	n.a.	55	-	56	1
• GER Primary (%)	91	90	1	96	5
• NER Primary (%)	55	62	7	66	4
• GER Middle (%)	53	59	6	63	4
• NER Middle (%)	18	35	17	38	3
• GER Matric (%)	50	57	7	57	0
• NER Matric (%)	11	24	13	27	3
• GER Matric (%)	-	-	-	-	-
Source: *PSLSMS, PBS*					

The worrying finding is that despite faster growth in real education spending after 2009-10, the impact on enrollment rate has been lower. The Net Enrollment Rate increased by 7, 17 and 13 percent by level of education in the earlier period. However, the rate of improvement declined to 4, 3 and 3 percent respectively in the latter period. This reinforces concerns about the efficiency of public education spending in recent years.

A third piece of evidence is the substitution of public institutions by private institutions in enrollment. As shown above in Table 26.8 above the share of enrollment in the latter institutions has expanded rapidly.

Table 26.8: Share of Private Institutions in Enrollment – (%)

	2009-10	2017-18
Primary	31.8	36.3
Middle	33.3	35.6
High	31.0	31.5
Degree Colleges	13.0	24.6
Universities	14.4	19.6

Source: *AEPAM*

This has exacerbated the risk of a 'dual' education system with significantly higher quality in private schools versus public schools. This tends to become the root cause of lifetime income inequality. Also, there is evidence of profiteering through high fees by owners of private institutions.

The bottom line is the consequential impact on the unit cost of public education. This is examined first by relating the growth in inputs of the teachers and schools compared with the growth in output in the form of enrollments. This analysis is undertaken in Table 26.9.

Table 26.9: Annual Growth Rate in Public Education Inputs and Outputs by Level of Education 2009-10 to 2017-18 Growth Rate (%)

	Growth in Inputs (Number)		Composite Input* (i)	Growth in Enrollment (ii)	Difference Between (ii) and (i)
	Schools	Teachers			
Primary	-1.8	0.8	-0.8	1.0	1.8
Middle	0.8	1.5	1.2	1.7	0.5
Secondary	3.4	3.6	3.5	3.4	-0.1
Colleges	5.6	6.8	6.3	5.4	-1.1
Universities	5.2	-2.4	0.6	6.5	5.9

*weight of teachers is 0.6 and that of schools is 0.4
Source: *AEPAM, Pakistan Education Statistics*

There are some important findings from Table 26.9. First, the number of public primary schools has contracted between 2009-10 and 2017-18 by 13 percent. The number of schools closed is 18,042. There is a need for investigation of the causes of these closures as to whether it is due to shortage of teachers, competition from private schools or other factors. Availability of financial resources is apparently not the constraint as the total public outlay on primary schools has increased significantly in real terms over the period.

Second, despite the big increase of 52 percent in the number of public universities and degree granting institutions the number of teachers has declined by 18 percent. This implies that new universities have been established without adequate faculty. Clearly, this must have affected adversely the quality of education imparted.

Third, the difference between the growth rate of outputs and inputs is small, except in universities where some economies of scale have been realized. There is a negative difference in the case of secondary and college education. Overall, the response to expansion in institutions and teachers has not been strong. In particular, the rapid expansion in colleges has been accompanied by a significantly less increase in enrollment. Perhaps college education with a terminal Intermediate qualification is considered as incomplete higher education and thereby facing lower demand in the labor market. The preference is therefore for degree colleges or universities.

The next analysis focuses on the education-employment link in the Pakistani context. It highlights the extent to which the planning of rate of growth in enrollments in different levels of education should consider the level of demand for different types of workers in the country. The public and private returns to education are dependent upon early absorption in employment after completion of education and adequate remuneration which reflects the skills acquired.

The growth rate by level of education of the labor force, employment and the rate of unemployment is given in Table 26.10.

Table 26.10: Growth Rate of Labor Force, Employment and Rate of Unemployment by Level of Education 2009-10 to 2017-18 (%)

	Annual Growth Rate			
	Enrollment	Labor Force	Employment	Unemployment Rate -2017-18
Primary + Middle	0.5	0.4	2.2	4.5
Secondary	3.5	3.3	2.9	6.4
College-Intermediate	5.9	5.1	4.5	11.6
Degree + Post-Graduate	5.7	7.0	5.8	16.5
Source: *LFS, PBS*				

There is a strong correlation between the rate of increase in enrollment and in the rate of entry into the labor force. It is the highest for degree holders. The rate of entry into the labor force and the rate of acquisition of jobs varies between workers with different levels of education. Consequently, the unemployment rate varies by level of education of workers. It is by far the highest for the most educated workers at above 16 percent, as compared, for example, to 6.4 percent for workers with secondary education.

These findings have the fundamental implication from the labor market perspective that the rate of expansion of the capacity of higher education system in the country should be reduced given the present stage of development of Pakistan. The labor market is currently able to absorb a higher percentage of the output from primary and secondary schools.

26.3. Education Policy

Before the recommendations are laid out, it is necessary to quote Article 25A of the Constitution of Pakistan, which states:

> *'The State shall provide free and compulsory education to all children of age five to sixteen years in such a manner as may be determined by law.'*

This Article has fundamental implications for education policy.

Emphasis on Primary and Secondary Education: The most important goal of Education Policy must be to facilitate near 100 percent net enrollment of boys and girls in primary, middle, and secondary education. Currently, the NERs are substantially lower. Therefore, there is a need for a substantial increase in school enrollments by 2024-25.

Consolidation of Higher Education: There has been a big increase since 2009-10 in the numbers of public colleges and universities. There is a need for imposing a temporary moratorium on the establishment of new higher education institutions. Instead, the emphasis should be on ensuring the presence of adequate faculty in each institution.

Expanding Coverage and Improving Quality of Schools: There has been a big contraction in the number of public primary schools. There is a need to determine if there is consequently a 'gap' in the access to education. All such gaps should be filled. Adequate coverage will need to be provided especially for girls and in relatively remote areas.

Policy on Cost Recovery: It is clear from Article 25A that public primary and secondary education should be free. In the case of higher education, a policy of equal sharing of the O&M cost may be adopted between the students and the Government. A scholarship fund may be established for poor but deserving students.

Raising the Level of Government Spending on Education: The financial projections in Chapter 1 indicate that with mobilization of more tax revenues there will be some 'fiscal space' for expansion of the level of public education spending from 2 percent to 2.5 percent of the GDP by 2024-25. The shares of different levels of education in public expenditure as proposed as follows:

	2019-20 – (%)	2024-25 – (%)
Primary	36.5	40
Middle/Secondary	37.5	40
College/University	22.2	15
Teacher Training / Technical and Vocational Education	3.8	5
TOTAL	**100**	**100**

The share of current and development spending should be 85:15 as compared to 90:10, with development expenditure mostly at lower levels of education.

Greater Priority to Technical and Vocational Education and Teacher Training: There is a need for expansion of the capacity of public technical and vocational education in the country in partnership wherever possible with the private sector to focus on skills for which there is market demand. Training of teachers must be given higher priority. This will include training not only at the time of entry but also in-service.

Improved Governance of the Education Sector: The education sector faces serious problems today of teacher absenteeism, lack of adequate teaching materials and basic school infrastructure. The focus will need to be on monitoring the performance of teachers by digital technology if possible.

The basic lesson learned from the faster growth in the HDI index of Pakistan in the Musharraf era is that local governments are the appropriate level of Government for managing the public school system. As such, following the establishment of local governments after elections the basic education function should be handed over to local governments.

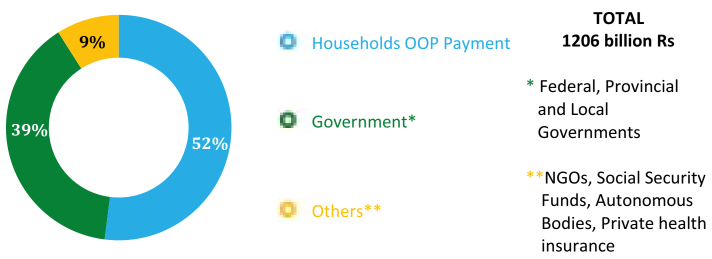
26.4. Health

The Health System

The distribution of total health expenditure in Pakistan has been extracted from the latest publication of the National Health Accounts of 2017-18, prepared by the PBS. Figure 26.1 reveals that the largest share of 52 percent is of out-of-pocket expenses by households, aggregating to as much as Rs 627 billion. This highlights the very limited coverage of public health services and health insurance in the country.

Figure 26.1: Distribution of Total Health Expenditure

2017-18



Source: *NHA, PBS*

The expenditure on provision of health services by all three levels of government has a share of 39 percent. The underdeveloped nature of the health sector is highlighted by the only 9 percent share of social security funds, private health insurance and NGOs. However, the announcement in the Federal Budget of 2021-22 of a nationwide health insurance scheme is very welcome. A health *('sehat')* card scheme has already been operating in Khyber-Pakhtunkhwa and will be introduced shortly in Punjab.

The trend and distribution of public sector spending on health is given in Table 26.11. Total Government spending has increased from Rs 94 billion in 2009-10 to Rs 422 billion by 2018-19, with an annual growth rate of almost 17 percent. Since health is primarily the responsibility of Provincial government, the growth has been facilitated by the jump in transfers following the 7th NFC Award of 2010.

The largest share in government expenditure on health is on curative services of hospitals and clinics. However, the share has declined from 69 percent in 2009-10 to 51 percent in 2018-19. As required, the priority is shifting to preventive health measures, with the share rising to 29 percent. Other health services, especially training institutions, have also seen an increase in share to 18 percent.

Table 26.11: Health Public Sector Spending by Type (Rs in Billion)

	General Hospitals and Clinics	Share (%)	Mother & Child Health	Share (%)	Health Preventive Measures	Share (%)	Others	Share (%)	Total
2009-10	65	69.1	-	-	19	20.2	10	10.6	94
2014-15	168	72.7	1	-	19	5.9	43	18.6	231
2018-19	217	51.4	9	2.1	121	28.6	74	17.5	422

Source: *MOF, PRSP progress reports.*

A worrying development is the declining share on expansion of coverage of public health services. The share of capital expenditure has declined from 30 percent in 2009-10 to only 14 percent in 2018-19. Clearly, budgetary allocations to the health sector will have to increase even more rapidly, if the coverage is to be improved in the presence of the fast-growing population of the country.

Table 26.12 tracks the availability of medical and health facilities and personnel over the last fifteen years. The lack of adequate expansion is clearly demonstrated by the decline in the number of hospital beds from 6.5 per 10,000 population in 2005 to 6 per 10,000 population in 2020. The limited facilities available were acutely manifested after the first COVID-19 attack. Ad hoc arrangements had to be made and the SBP introduced a concessionary financing scheme for expansion of the required facilities. There was large-scale import of ventilators from China.

Table 26.12: Availability of Medical and Health Facilities and Personnel

	Hospital Beds	Dispensaries	Maternity & Child Centers	Doctors	Nurses
2005	101,490	4,632	907	118,113	51,270
	(6.5)*	(3.0**	(0.6)**	(7.6)*	(3.3)*
2010	104,137	4,842	909	144,901	73,224
	(5.9)	(2.8)	(0.5)	(8.3)	(4.2)
2015	119,548	5,695	733	184,711	94,766
	(6.0)	(2.9)	(0.4)	(9.4)	(4.8)
2020	133,707	5,743	752	245,987	116,659
	(6.0)	(2.6)	(0.3)	(11.0)	(5.3)

*per 10,000 population | **per 100,000 population
Source: *PES*

Along with a decline in availability of hospital beds, there has also been a reduction in population coverage by dispensaries and maternity and child centers. Perhaps the most unexpected finding is that there are over twice as many doctors as nurses in Pakistan. This vividly highlights the shortage of medical training facilities in the country.

Trend in Health Indicators

The trend in some health and related services indicators is presented in Table 26.13. Progress is visible in the percentage of children fully immunized, but 24 percent of the children in the country still do not get fully protection. Over a twelve-year period, infant mortality has declined by less than 10 percent. Pakistan today has the highest infant mortality rate in South Asia. It is over double the level in other South Asian countries. As highlighted earlier, Pakistan also has the lowest life expectancy.

The crisis in the availability of safe drinking water, through piped tap, has also been highlighted by Table 26.13. access to tap water, which was already low, has declined further from 36 percent to only 18 percent.

Table 26.13: Trend in Health Indicators in Pakistan			
	2007-08	2013-14	2018-19
% of Children fully Immunized (%)	**51**	**76**	**76**
Male	52	77	76
Female	50	76	75
Infant Mortality	**66**	**65**	**60**
Male	78	70	62
Female	61	61	58
Source of Drinking Water (Piped)	**36**	**26**	**18**
Type of Toilet	**66**	**74**	**80**
Source: *PBS*			

There are also large differences regionally in the health indicators. For example, the percentage of children fully immunized ranges from a high of 84 percent in Punjab to only 42 percent in Balochistan. The corresponding magnitudes for Sindh and Khyber-Pakhtunkhwa are 73 percent and 68 percent respectively. The coverage is 84 percent in urban areas of the country and 73 percent in the rural areas.

The latest Household Integrated Economic Survey of 2018-19 by the PBS also reveals that the incidence of health expenditures is higher on poor households, in the first quintile. They are also constrained from access to hospitals at times of serious illness. Clearly, the universal insurance coverage against catastrophic illness must have the highest priority in Pakistan.

26.5. The COVID-19 Pandemic

The COVID-19 pandemic is the worst in the last century. Virtually all countries of the world have been hit. Pakistan has been through three attacks since the last week of February 2020. The peaks and troughs in weekly number of cases is presented in Table 26.14. Currently the fourth attack is approaching a peak.

Table 26.14: Peaks and Troughs of COVID-19 Attack in Pakistan		
Period	Peak / Troughs	Weekly Cases
1st Week of June 2020	[Peak]	40,287
1st Week of September 2020	[Peak]	2,972
1st Week of December 2020	[Peak]	21,865
1st Week of February 2021	[Trough]	8,497
2nd Week of April 2021	[Peak]	39,858
3rd Week of June 2021	[Trough]	6,674

However, the NCOC has warned of the likelihood of the fourth attack being the worst attack because of the spread of the DELTA-variant and asked people to continue taking major precautions. The Government has imposed a near complete lockdown in the city of Karachi.

Table 26.15 makes a comparison of the incidence of COVID-19 in the different countries of Asia as of the end of the third week of June 2021.

According to Table 26.15, Pakistan has been fortunate in having the lowest incidence of confirmed cases among the major South Asian countries. The GDP impact also has been the smallest. However, there is no scope for complacency.

There is need for the widespread use of vaccines. Here Pakistan performs poorly. Only 2.3 percent of the population of Pakistan has been fully vaccinated as of the 25th of July 2021, as compared to 4 percent in India and Bangladesh. Also, 9.1percent of the population has been partly vaccinated as compared to over 20 percent in India. There will need for procurement of larger number of vaccines to build up stocks and avoid localized shortages.

Table 26.15: Cumulative Incidence of COVID-19 Cases and Deaths per Million Population in South Asian Countries (Per million population)

Countries	Confirmed Cases	Deaths
India	21,698	288
Nepal	21,962	313
Sri Lanka	12,167	139
Bangladesh	5,481	87
Pakistan	4,324	100

Source: *WHO*

26.6. Health Policy

Emerging Constraints in the Health Sector: The analysis above has clearly demonstrated that public health facilities and services are not keeping pace with the increase in the country's population. The level of health spending is low and the share of development expenditure on expansion of services is very low and declining. At the minimum, the Provincial Governments will need to raise their health sector allocations sufficiently to ensure that the overall level of spending rises to 1.5 percent of the GDP and almost half is for the expansion of services, especially in the rural areas.

Changing Priorities in Spending**:** Bulk of the spending is on curative health. The priority has to be shifted towards preventive health. Almost one-fourth of the children are not fully immunized. Polio continues to exist in Pakistan. Infant mortality remains high because of lack of awareness of pregnant women on necessary safeguards.

Regularizing the Services of Lady Health Workers**:** The closest functionaries to 'barefoot doctors' are the LHWs, especially in the rural areas. They must be mobilized to achieve higher coverage of vaccinations, education of women on family planning and caring of infants.

This employment should be transferred to the Provincial governments and their services regularized with proper remuneration.

Need for more vigorous COVID-19 vaccination campaign**:** It has been demonstrated above that Pakistan has the lowest coverage of full vaccines in the population among South Asian countries. This campaign for vaccination must be accelerated, with a target of coverage of 40 percent of the population by end-December 2021.

Achieving Comprehensive Health Insurance Coverage**:** Major steps have been proposed to provide health insurance in the budgets of the Federal and Punjab Governments. There is a case for a national scheme of health insurance. This will not only ensure uniformity in coverage but also reduce the cost of the premium due to the larger pooling of risk. There is need, however, to ensure that there is no problem of 'moral hazard' or leakages.

Introducing Generic medicines**:** India has been focusing on generic medicines. It is now the world's largest maker of generic drugs. Pakistan should also promote the use of generic drugs for infections like fever, bacterial fever, diarrhea, etc. This will reduce the monopoly power of multinational pharmaceutical firms and bring down drug prices, which have gone up sharply since 2018.

PART-X

PROVIDING MORE EMPLOYMENT OPPORTUNITIES

Chapter 27:

Designing an Employment Strategy

The provision of productive, remunerative, and decent employment is one of the fundamental pre-requisites for achieving inclusive growth and tackling poverty in the country. This has been recognized as one of the prime objectives in the development plans prepared by the Planning Commission.

Achievement of near full employment is even more a challenge in Pakistan because, first, the high rate of population growth and the 'youth bulge', which implies many entrants into the labor force annually. Second, the growth rate of the economy has faltered at below 4.5 percent on average. This has limited the growth in labor demand in the various sectors of the economy. Therefore, the design of an employment strategy must be linked to the strategy described in earlier Chapters on revival of growth in agriculture, industry and the various service sectors of the national economy.

27.1. The Labor Force and Employment Trends

The labor force of Pakistan is estimated at 70.7 million currently. On average it has been growing annually at the rate of 2.6 percent. In effect, the number of new entrants annually into the labor force is over 1.8 million. The effective labor force participation rate of population aged 10 years and above is 45.3 percent.

The shares of the rural and urban labor force are 65 percent and 35 percent respectively. The urban labor force is expanding relatively rapidly at 3.2 percent per annum due to the growing pressure of rural-urban migration of workers. The gender distribution is almost 76 percent male and 24 percent female workers. However, the number of female workers is growing rapidly at 4.3 percent annually.

Table 27.1: Distribution of the Labor Force by Level of Education (%)

	2007-08	2017-18*	Annual Growth Rate (%)
Illiterate	**46.2**	**40.1**	**0.9**
Literate	53.8	59.9	3.4
No formal education	0.5	2.1	16.7
Pre-Matric	29.6	29.4	2.3
Matric	12.6	13.1	2.7

Intermediate	5.2	6.2	4.1
Degree & Post-Graduate	5.9	9.1	6.7
TOTAL	**100.0**	**100.0**	**2.5**
Average Years of Education	**5.0**	**5.7**	

*The last Labor Force Survey by the PBS was in 2017-18.
Source: *LFS, PBS*

The education level distribution of the labor force is presented in Table 27.1. The share of illiterate workers is high at 40 percent in 2017-18. However, it has declined from over 46 percent in 2007-08. The good news is that the number of workers with degree education is expanding rapidly by almost 7 percent per annum. However, they still constitute only 9 percent of the labor force. Overall, the average education level (in years of schooling) has gone up from 5 years in 2007-08 to 5.7 years in 2017-18.

The level of employment is estimated at 65.2 million in 2019-20 prior to the COVID-19 attack. This implies that the unemployment level had approached 5.5 million, implying an unemployment rate of 9 percent. Earlier, the last Labor Force Survey by the PBS in 2017-18 had estimated the unemployment rate at 5.8 percent. This corresponds to the 'open' unemployment rate.

There was substantial variation in the 'open' unemployment rate among different types of workers in 2017-18. It was 5.1 percent in the case of male workers while it was 8.3 percent in the case of female workers. It was at the peak of over 10 percent for young workers aged up to 24 years. A perhaps surprising and worrying finding is that the rate of unemployment was higher for highly educated workers in 2017-18 as shown in Table 27.2 at over 16 percent. A decade ago, it was only 5 percent. The absorption of educated workers appears to hinge on the growth rate of the GDP. The year 2007-08 was preceded by four years of high growth of 6.6 percent annually. However, 2017-18 was a year of some recovery from four years of low growth of only 4.8 percent. Clearly, it is essential for the formal sector of the economy to expand rapidly for the relatively fast increase in jobs for educated workers entering the labor force.

Table 27.2: Unemployment Rate by Level of Education of Worker (%)

	2007-08	2017-18
Illiterate	**5.2**	**3.2**
Literate	4.9	7.5
No formal education	4.3	4.4
Pre-Matric	4.9	4.5
Matric	6.5	6.4
Intermediate	7.0	11.5
Degree & Post-Graduate	4.9	16.3
OVERALL	**5.2**	**5.8**

Source: *LFS, PBS*

The focus only on the 'open' unemployment rate tends to significantly understate the overall level of unemployment in the economy. This should also include underemployment in terms of number of hours worked, mismatch between the level of skills of a worker and the nature of work and workers who give up search for a job in depressed labor market conditions. Inclusion of these types of unemployment raises the overall unemployment rate by almost 2 percentage points. Therefore, the overall unemployment rate was close to 8 percent in 2017-18 and almost 10 percent in 2019-20, even prior to the COVID-19 spread in Pakistan.

A crucial determinant of the state of the labor market is the trend in real wages. This is important for determining if the incidence of poverty among the lower echelon of workers is rising or falling. The rate of change annually in wages for different categories for workers is given in Table 27.3.

The positive finding is that real wages have grown between 2008-09 and 2017-18. Real wages have tended to grow faster for more skilled workers. The ratio of remuneration between the top and bottom occupational category of workers is 4.5:1. The corresponding growth in overall labor productivity at the national level is 2.3 percent. Therefore, the growth rate in real wages has been higher than the growth rate in labor productivity. This implies that the share of labor in the national income has increased. Estimates are that this share was 38 percent in 2017-18. Despite the rise it is still low relative to other countries at a similar stage of development where the labor share is above 46 percent.

Table 27.3: Annual Rate of Change in Nominal and Real Wages for Different Types of Workers (%)

	Annual Growth Rate from 2008-09* to 2017-18	
	Nominal Wages	Real Wages
By Level of Skill and Status		
Senior Managers	12.4	5.7
Professionals	8.0	1.3
Technician & Associate Professionals	11.0	4.3
Clerks	10.4	3.7
Service and Sales Workers	9.9	3.2
Skilled Agricultural Workers	11.5	4.8
Craft and Related Trades Workers	10.0	3.3
Plant and Machine Operators	10.0	3.3
Elementary (Unskilled) Occupations	9.8	3.1
OVERALL	**10.0**	**3.3**

*first year when wage data was collected in the LFS
Source: *LFS, PBS*

Labor market conditions have deteriorated after 2017-18 due to the big decline in the GDP growth rate, even prior to COVID-19. The rise in unemployment rate has already been highlighted. The more recent trend in wages is highlighted in Table 27.4 for particular categories of workers on whom PBS collects data on wages on a weekly basis. Between June 2018 and January 2020, real wages of skilled workers have fallen significantly while that of unskilled workers have remained unchanged.

There is need to focus on the impact on employment in the immediate aftermath of the first spread of COVID-19 in Pakistan after February 2020. The loss of employment has been severe with estimated layoffs of almost 5.2 million workers, thereby raising the unemployment rate further to over 15 percent by mid-2020. The expectation is that half these workers will return to jobs by the end of 2021. It is inevitable that real wages have fallen, leading thereby to a big increase in the incidence of poverty to over 37 percent as compared to 28 percent in 2017-18.

Table 27.4: Growth in Wages Between June 2018 and January 2020 (%)

	Nominal Wages	Real Wages
Carpenter	10.4	-7.4
Mason	14.5	-3.3
Plumber	11.8	-6.0
Electrician	9.5	-8.3
Laborer	17.9	0.1

Source: *PBS, SPI*

27.2. Growth Pattern of Employment

There have been visible changes in the pattern of employment over the last decade or so on. The sectoral distribution of employment has changed significantly between 2009-10 and 2017-18 as shown in Table 27.5. The share of employment in agriculture is expected to decline as development proceeds. This is what has happened in Pakistan and the share of agriculture in total employment has declined from 45 percent to 39 percent.

Table 27.5: Changes in the Sectoral Distribution of Employment (Share %)

Sector	2009-10	2013-14	2017-18
Agriculture	45.0	43.5	38.5
Manufacturing	13.2	14.2	16.1
Construction	6.7	7.3	7.6
Wholesale and Retail Trade	16.3	14.6	14.9
Transport and Communications	5.2	5.5	6.2
Community, Social and Private Services	11.2	13.1	14.7
Others	2.4	1.8	2.0
TOTAL	**100.0**	**100.0**	**100.0**
Employment (Million)	**51.9**	**56.5**	**61.7**

Source: *PBS, LFS*

The employment growth sectors have been manufacturing, construction, transport and communications and community, social and private services. The total increase in employment is close to 10 million. Almost 3 million of this increase is in the manufacturing sector, over 3 million in the community, social and private services sector, 1.3 million in construction and over 1.1 million in transport and communications.

What types of workers have seen the greatest improvement in their employment prospects? Table 27.6 gives the growth rate of employment of different occupations. A priori, there is the expectation that high level managers, technical personnel and professionals would see the greatest increase in demand in the growth process.

However, workers in high level occupations saw a decline in the share in employment between 2010-11 and 2017-18. Clearly, the economy is yet to rise sufficiently in terms of technological sophistication and corporatization. Consequently, the fastest growth in employment is observed from 2003-04 to 2017-18 in the case of workers in medium level occupations, including skilled agricultural workers, clerical support workers and service and sales workers. The faster growth of employment is also observed in the case of employees versus the self-employed.

Table 27.6: Distribution of Informal and Formal Employment Within Sectors (%)

	Years	Informal	Formal	Total	Average Wage (Rs/ Month)
Manufacturing	2003-04	59.7	40.3	100.0	
	2017-18	62.6	37.4	100.0	16890
Construction	2003-04	91.7	8.3	100.0	
	2017-18	93.6	6.4	100.0	16402
Wholesale & Retail Trade	2003-04	93.5	6.5	100.0	
	2017-18	96.7	3.3	100.0	14007
Transport & Communications	2003-04	79.2	20.8	100.0	
	2017-18	81.6	18.4	100.0	19300
Government & Private Services	2003-04	49.2	50.8	100.0	
	2017-18	48.4	51.6	100.0	29633
Others	2003-04	37.5	62.5	100.0	
	2017-18	25.0	75.0	100.0	12077
TOTAL*	2003-04	70.2	29.8	100.0	
	2017-18	72.0	28.0	100.0	18754

*Excluding Agriculture
Source: *PBS, LFS*

The link between employment creation and poverty alleviation is strongest for workers who are in the informal sector, either as self-employed or employees in SMEs. The distribution of workers in each economic sector by formal or informal status is given in Table 27.6. Fortunately, the growth process has operated from 2003-04 to 2017-18 in favor of informal sector workers. The sectors which have the largest share of these workers are the sectors which have seen the fastest growth in employment like manufacturing, construction, transport and communications and wholesale and retail trade. This has, no doubt, contributed to a faster process of poverty alleviation in the country.

Table 27.7: Growth Rate of Employment by Occupation (%)

	2003-04 to 2010-11	2010-11 to 2017-18	Share in Employment in 2017-18
High level [a]	3.6	-5.0	11.3
Medium Level [b]	4.2	3.7	49.3
Low Level [c]	3.0	2.4	39.4

[a] Managers, Professionals plus Technical Personnel and Associate Professionals
[b] Clerical Support Workers, Service and Sales Workers and Skilled Agricultural Workers
[c] Craft and Related Traders Workers, Plan/Machine Operators and Assemblers and Elementary Occupations
Source: *PBS, LFS*

Table 27.8: Employment Elasticity with respect to Output Growth in Different Sectors (%)

	2009-10 to 2013-14			2013-14 to 2017-18		
	Employment Growth Rate	Value Added Growth Rate	e	Employment Growth Rate	Value Added Growth Rate	e
Agriculture	1.3	2.7	0.48	-0.8	2.0	-0.40
Manufacturing	3.9	3.4	1.15	5.3	4.6	1.15
Construction	4.2	0.5	8.40	3.2	7.1	0.45
Wholesale and Retail Trade	-0.6	2.8	-0.21	2.7	5.2	0.52
Transport and Communications	3.4	3.8	0.89	5.2	4.0	1.30
Community, Social and Private Services	6.0	7.3	0.82	5.1	7.4	0.73
TOTAL	**2.1**	**3.7**	**0.56**	**2.2**	**4.7**	**0.47**

Source: *PBS, LFS*

The employment elasticity with respect to output is surprisingly low in agriculture. It was negative in the period, 2013-14 to 2017-18. The trend is for a shift to off-farm rural employment or migration to the urban areas. Therefore, the case for higher investment must now be made more for food security and export promotion.

The high employment elasticities are observed more in sectors like manufacturing, construction, transport and communications. It is also relatively high in the community, social and private services. This has been due largely to the rapid expansion in the number of government employees after 2009-10. This is no longer possible given the acute financial constraint faced now by the public sector.

Therefore, fiscal, monetary, trade and investment policies must target the manufacturing, construction and the transport and communications sectors as the leading sectors for generating employment. This is already evident in the high priority attached to the construction sector.

27.3. Providing more Employment

The Employment Target

Chapter 1 has given targets for the level of employment and the resultant unemployment rate. These are replicated in Table 27.9. The target is to reduce the 'open' unemployment rate from 15 percent in 2019-20 to a modest 6.5 percent by 2024-25. The question is what strategy will help in achieving this ambitious target?

Table 27.9: Targets for Level of Employment and Reduction in The Unemployment Rate up to 2024-25

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Labor Force (million)	68.8	70.5	72.2	73.8	75.8	78.0
Employment (million)	58.5	63.0	64.4	67.1	69.8	72.9
Unemployment Rate (%)	15.0	10.6	10.0	9.0	8.0	6.4

Source: *Estimates*

Sectoral Growth Strategy

The first element of the strategy is determination of the sectoral composition of GDP and individual sectoral growth rates which will create the targeted level of demand for labor. This requires quantification of the sectoral employment to output growth elasticities. Estimates of these elasticities from 2007-08 to 2017-18 are given in Table 27.10.

Table 27.10: Sectoral Employment to Output Elasticities, 2007-08 to 2017-18			
	Annual Growth Rate of Value Added (%)	Annual Growth Rate of Employment (%)	Employment-to-Output Elasticity
Agriculture	2.3	0.8	0.348
Manufacturing	3.0	4.4	1.467
Construction	3.7	4.2	1.135
Wholesale and Retail Trade	2.5	2.5	1.000
Transport and Communications	3.8	3.5	0.921
Community, Social and Personal Services	7.1	3.0	0.422
Others	3.0	0.7	0.233
TOTAL	**3.6**	**2.3**	**0.638**
Source: *PBS, LFS and PES*			

There are large differences in the sectoral elasticities. It is very low at 0.35 in the case of agriculture. As development proceeds, the labor force in agriculture typically shifts to other sectors of the economy as highlighted above.

The elasticities are above one in two sectors of the economy – manufacturing and construction. They are close to one in the case of wholesale and retail trade and transport and communications. These sectors will have to play a leading role in creating employment in the economy over the next five years.

The required employment to output elasticity from 2020-21 to 2024-25 is 0.70, as compared to 0.64 between 2007-08 and 2017-18. The GDP is expected on average to grow annually by 5.1 percent and employment by 3.6 percent. This is achievable with the sectoral growth rates of 6 percent to 8 percent in manufacturing and construction sectors and from 5 percent to 6 percent in the wholesale and retail trade and transport and communication sectors. The incentives given to investment in housing and construction activities must continue.

Employment of Educated Workers

The issue relates to the composition of incremental employment. Table 27.11 has demonstrated that the highest rates of unemployment are observed in the case of the most educated workers. This structural problem will have to be tackled both on the supply and demand side. This will require a fundamental change in the education policy on the expansion of enrollment at different levels of education. The historical pattern of growth in enrollment is given in Table 27.11.

The fastest expansion in enrollment has been in universities at 7.5 percent per annum. It is not surprising that workers with degree or post-graduate qualifications have had difficulty in finding jobs in a labor market where the growth in employment annually is 2.5 percent.

Table 27.11: Growth in Enrollment at Different Levels of Education			(Million)
	2007-08	2017-18	Annual Growth Rate (%)
Primary Stage	18.360	22.931	2.2
Middle Stage	5.427	7.362	3.0
High Stage	2.434	3.861	4.6
Technical and Vocational	0.256	0.433	5.2
College	1.344	2.292	5.3
Universities	0.741	1.575	7.5
Source: *PES*			

The number of universities has increased from 124 in 2007-08 to 211 in 2018-19. A comparison can be made with Bangladesh. It has 40 percent fewer universities with 22 percent less population. India has four and half times the number of universities with over six times the population. The time has come to impose a moratorium on new public universities.

The priority must shift in a decisive way towards secondary education. At the stage of development that Pakistan is in, the demand is increasing more for workers with middle level of skills. Also, the coverage of technical and vocational institutions is limited, and it should be greatly expanded. As an incentive a worker with a diploma from such institutions should get preferential access to credit.

Focus on the demand side for workers with higher educational qualifications will require adequate expansion in the large-scale manufacturing sector, banking, and professional private services. With the revolution in information technology more opportunities will emerge for trained graduates as digitalization of the economy proceeds further and more expansion takes place in the export of IT services.

Absorbing the 'Youth Bulge'

One other important dimension of the employment strategy is productive absorption of the 'youth bulge'. Estimates are that in 2019-20 prior to COVID-19 there were 5 million 'idle' male youth and 7 million female 'idle' youth, who were either unemployed or not engaged in acquiring further education. Especially in the case of idle male youth there is the risk of move towards crime or fundamentalism. As such, the employment strategy will need to ensure that there are special programs for absorption of youth into economic activities.

The first type of interventions will be to impart marketable skills to youth. This will require as highlighted above an expansion in enrollment in Vocational and Technical Institutions. Also, there will be need for arranging more internships in productive establishments. Tax credits may be offered to employers for providing job opportunities to youth in their enterprises.

The second and potentially large component of a Youth Program is the provision of credit to eligible youth at subsidized rate for relatively small loans. The Kamyab Jawan Program of the government is potentially an important and strategic initiative. It will need to be upscaled based on an initial pilot project.

A Rural Employment Guarantee Program of employment for 100 days annually may also be offered in the off-peak season for rehabilitation of rural roads, lining of canals, construction and maintenance of schools and rural health centers. This Program could be run by the Union Councils.

Chapter 28:

Labor Conventions and Laws

There is a need to first highlight the articles in the 1973 Constitution of Pakistan relating to labor rights, as follows:

Articles	1973 Constitutions
Article 11:	Prohibits all forms of slavery, forced labor and child labor.
Article 17:	Provides for the fundamental right to exercise the freedom of association and the right to form unions.
Article 18:	Supports the right of its citizens to enter upon any lawful profession and to conduct any lawful trade or business.
Article 25:	Lays down the right to equality before the law and prohibition of discrimination on the grounds of sex alone.
Article 37(e):	Makes provision for securing just and humane conditions of work, especially for women and children.

Pakistan also has a history of Labor Policy announcements by different Governments. There have been seven Labor Policy statements in 1949, 1955, 1959, 1969, 1972, 2002 and 2010 respectively.

The most radical Policy was the one announced by the first PPP Government of Mr. Zulfiqar Ali Bhutto in 1972. This policy sought to fundamentally enhance the rights of workers, improve their access to benefits and change the nature of the relationship between employers and their workers. The 2002 Labor Policy focused especially on removing gender discrimination in wages. The Seventh Labor Policy of 2010 was more oriented towards increasing labor productivity.

Pakistan has ratified a number of international Labor Conventions. This is part of the agreement, for example, with the European Union for access to duty free exports under GSP+. Implementation of Conventions has become more essential after the recent threat to withdraw GSP+ from Pakistan.

The responsibility rests with the Provincial Governments for implementing these Conventions following the transfer of the labor function under the 18th Amendment. These Conventions must be converted into the appropriate laws and passed by the Provincial Assemblies. Thereafter, it is the role of the Provincial Labor Departments to ensure the full implementation of these laws.

28.1. Implementation of Conventions

Forced Labor Convention

The objective of this Convention is to eliminate the use of forced or compulsory labor in all its forms. Forced or compulsory labor is all work or service which is exacted from a person under the menace of a penalty and for which the person has not offered himself voluntarily.

Exceptions include the following:

[A]	[B]	[C]	[D]
Compulsory military service	Work or service as part of normal civic obligations	Work or service during an emergency	Community service

The competent authority in a country will not allow forced labor for private gain. Also, the authority shall issue complete and precise regulations governing the use of forced labor.

The Annual Report that a member makes, who has ratified the Convention, shall contain information on the extent of recourse to forced labor and the purposes for which it has been used.

Numerous laws have been promulgated in Pakistan against forced or bonded labor. For example, in Punjab there are the following laws:

	Laws	Last Updated
1.	The Bonded Labor System (Abolition) Act of 1992	1st of June 2018
2.	The Usurious Loans Ordinance of 1959	6th of December 2003
3.	The Protection of Tenancy rights Act of 1950	6th of December 2003

In Pakistan the most prevalent form is debt bondage. Economic sectors with incidence of bonded labor are brick kilns, agriculture, domestic service, construction, and mining. Work is usually in hazardous conditions and there is frequently sexual abuse of female workers.

The Australian based Global Slavery Index estimates that in Pakistan 3 million workers remain stuck in debt bondage. The highest incidence is in brick kilns and tenant operated farms. Farms of more than 50 acres in size are operated partly or fully by tenants who have large unpaid debt with the landlord.

Abolition of Forced Labor Convention

This follows the 1930 Convention, described above. It contains proposals consistent with the UN Universal Declaration of Human Rights. It seeks to suppress the following forms of forced labor:

a. As a means of political coercion or education
b. Mobilizing labor for economic development
c. As a means of labor discipline
d. As punishment for having participated in strikes
e. As a means of racial, social or religious discrimination

This type of forced labor is seldom the case in Pakistan.

Freedom of Association and Right to Organize Convention

The Convention adopts proposals concerning freedom of association and right to organize as a means of improving conditions of labor and as essential to sustained progress. It states in Article 2 that workers and employers have the right to establish and join organizations of their choosing without previous authorization. Such organizations cannot be dissolved or suspended by administrative authority. However, these organizations will respect the law of the land.

The extent to which this Convention applies to the armed forces and the police shall be determined by national laws or regulations.

Right to Organize and Collective Bargaining Convention

This Convention shall apply particularly to the following:

a) Make the employment of a worker subject to the condition that he will not join a union or shall relinquish trade union membership.

b) Cause the dismissal of a worker by reason of union membership.

The laws which govern industrial relations and collective bargaining in Pakistan are as follows:

	Laws	Last Updated
1.	The Industrial Relations Act of 2010	6th of June 2014
2.	The Industrial Dispute Ordinance of 1967	6th of June 2003
3.	The Industrial and Commercial Employment Ordinance of 1968	28th of February 2012

Trade unions are relatively infrequent in Pakistan. The trade union density, as defined by the ILO, is only 5.6 percent, as compared to 12.8 percent in India, 15.3 percent in Sri Lanka and almost 50 percent in China. According to the National Industrial Relations Commission (NIRC) there are 7096 trade unions in the country with a total membership of 1.4 million. One of the reasons for the low density is the limited size of the formal sector. However, even within the formal sector only 16 percent of the workers are members of trade unions. On top of the Unions are Federations, with a combination of four or more trade unions. The three large Federations are PWF, MLF and NLF.

Equal Remuneration Convention

This Convention adopts proposals about the principle of equal remuneration for men and women workers for work of equal value.

The term *remuneration* includes the basic or minimum wage or salary and any other emoluments in cash or in kind.

This principle of equal remuneration shall be applied by means of the following:

[A]	[B]	[C]	[D]
National laws or regulations	Legally established or recognized machinery for wage determination	Collective agreements between employers and workers	A combination of these various means

Pakistan has historically no law against gender discrimination in the payment of wages for identical work. The only legal provision is *The Minimum Wage Ordinance* of 1970, last updated on the 6th of June 2003, which says that there will be no discrimination in the payment of the minimum wage. However, the Khyber-Pakhtunkhwa Payment of Wages Act of 2013 does specify that there should be equal pay for equal work.

Pakistan currently has one of the largest gender pay gap. On average, the difference between male and female remuneration in the same occupation is as large as 50 percent, according to the Labor Force Survey of 2017-18. It has increased from 43 percent in 2013-14. The wage differential is higher in the lower occupations.

However, there is need to control for the length of labor inputs. Only 6 percent of male workers work part-time (less than 35 hours a week) as compared to 41 percent in the case of female workers. Therefore, after adjustment for time input the gender pay gap stands at close to 30 percent.

The passage of an Equal Remuneration Law must have the highest priority.

Discrimination (Employment and Occupation) Convention

This Convention focuses on the elimination of discrimination in the field of employment and occupation. For purposes of this Convention, the term discrimination includes:

a) Any distinction, exclusion or preference made on the basis of race, color, sex, religion, political opinion, national extraction, or social origin, which has the effect of nullifying or impairing equality of opportunity or treatment in employment or occupation.

b) Such other distinction, exclusion or preference which has the effect of nullifying or impairing equality of opportunity or treatment in employment or occupation as may be determined by the Member concerned after consultation with representative employers' and worker's organizations, where such exist, and with other appropriate bodies.

Any distinction, exclusion, or preference in respect of a particular job based on the inherent requirements thereof shall not be deemed to be discrimination.

For the propose of this Convention the terms employment and occupation include access to vocational training, access to employment and to particular occupations, and terms and conditions of employment.

Each Member for which this Convention is in force undertakes, by methods appropriate to national conditions and practice:

a) to seek the cooperation of employer's and worker's organizations and other appropriate bodies in promoting the acceptance and observance of the policy;

b) to enact such legislation and to promote such educational programs as may be calculated to secure the acceptance and observance of the policy;

c) to repeal any statutory provisions and modify any administrative instructions or practices which are inconsistent with the policy;

d) to pursue the policy in respect of employment under the direct control of a national authority;

e) to ensure observance of the policy in the activities of vocational guidance, vocational training, and placement services under the direction of a national authority;

f) to indicate in its annual reports on the application of the Convention the action taken in pursuance of the policy and the results secured by such action.

Any measures affecting an individual who is justifiably suspected of, or engaged in, activities prejudicial to the security of the State shall not be deemed to be discrimination, provided that the individual concerned shall have the right of appeal to a competent body established in accordance with national practice.

There is need also for passage of Law on Elimination of Discrimination in Employment.

Minimum age Convention

This Convention aims at total abolition of child labor. Each member commits to a national policy designed to progressively raise the minimum age for admission to employment to a level consistent with the fullest physical and mental development of young persons.

The minimum age for wage in the Convention is at least 15 years.

Members whose economy and administrative facilities are insufficiently developed may, after consultation with the organizations of employers and workers concerned, where such exist, initially limit the scope of application of this Convention.

Each Member which avails itself of the above provisions shall specify, in a declaration appended to its ratification, the branches of economic activity or types of undertakings to which it will apply the provisions of the Convention.

The provisions of the Convention shall be applicable as a minimum to the following: mining and quarrying; manufacturing; construction; electricity, gas, and water; sanitary services; transport, storage, and communication; and plantations and other agricultural undertakings mainly producing for commercial purposes, excluding family and small-scale holdings producing for local consumption and not regularly employing hired workers.

This Convention does not apply to work done by children and young persons in schools for general, vocational, or technical education or in other training institutions, or to work done by persons at least 14 years of age in undertakings, where such work is carried out in accordance with conditions prescribed by the competent authority, after consultation with the organizations of employers and workers concerned, where such exist, and is an integral part of:

[A]	[B]
a course of education or training for which a school or training institution is primarily responsible	a program of training mainly or entirely in an undertaking, which program has been approved by the competent authority

Punjab has promulgated a specific law on child labor as follows:

The Prohibition of Child Labor at Brick Kilns Act, 2016

However, there is no general law against the employment of children below the age of 15 years.

According to the latest Labor Force Survey of 2017-18 there are 2.9 million child workers aged 10 to 14 years. This includes 1.7 male children and 1.2 million female children. Fortunately, the number of child workers is declining and has fallen by 8 percent since 2013-14.

Overall, there is need for legislation by the Provincial Governments on the following labor-related laws:

Equal Remuneration Law	Elimination of Discrimination in Employment Law	Prohibition of Child Labor Law

28.2. Improving Implementation of Labor Laws

The fundamental problem has been effective implementation of existing laws especially from the viewpoint of institutional capacity. The Provincial Governments have Labor Departments, which primarily perform inspection functions of enterprises. Unfortunately, these Departments lack capacity. For example, the Labor Department in Sindh has a budget of only 0.08 percent of the total budget of all Provincial Departments. The recommendations are as follows:

- There should be a Labor Officer (in BPS-19) in each district of a Province with supporting staff. The Provincial headquarters should possess enough legal capacity to frame improvements in laws for submission to the Provincial Assembly after Provincial cabinet approval. Also, there is need for development of a comprehensive Labor Information Management System (LIMS).
- Labor courts have been established to resolve disputes and complaints. There is need to ensure enough benches of these Courts. The policy should be to have at least one Labor Court in each Division of Province. The labor courts should be required to give judgement within 30 days of the lodging of a case.
- The process of registration of trade unions should be facilitated and made easier. Efforts should be made to promote the formation of industry level trade unions, to act as a counter to the existing powerful Employer Associations at the industry level. The requirement for appointment as a Collective Bargaining Agent (CBA) of at least one third of the employment should be relaxed.

28.3. Workers' Benefits and Programs

There is need for providing more benefits to workers and launching special support programs as follows:

- There should be the requirement of a Group Insurance Scheme to cover death or injury of workers.
- The EOBI covers 8.7 million persons currently, and old age benefits are being given to only 640,000 persons. The total value of benefits was Rs 10.7 billion few years ago. The insurance payment was Rs 11 billion by employers. The minimum pension is Rs 8500 per month.

  The coverage of social security is very limited. The Provincial Governments may consider establishment of a pension scheme for workers in the Province. Following the transfer of the labor function to the Provincial Governments, revenues from the Workers' Welfare Fund (WWF) should be used to finance the pension schemes at the Provincial level rather than accrue to the Federal Consolidated Fund.
- The Worker's Profit Participation Fund (WPPF) revenues should also no longer accrue to the Federal Consolidated Fund. It may be made a profit-sharing scheme at the enterprise level.
- There is need for establishing the following special programs:
  - » A conditional cash transfer program through the EHSAAS Program for mothers to send their child to school rather than to work.
  - » A special financing scheme to facilitate the establishment of female putting out systems in proximity to cities.
  - » Special line of credit for women entrepreneurs.

28.4. Fiscal Incentives for Employment

Two special fiscal incentives are already in place for promoting employment, as follows:

SPECIAL FISCAL INCENTIVES	
INCENTIVE – I	INCENTIVE – II
For relatively new enterprises, a special incentive has been provided under Section 64B of the Income Tax Ordinance (ITO) for employment generation. For every 50 jobs created, a 2 percent tax credit is admissible	For hiring of graduates, a tax credit has been offered under Section 64C of the ITO, equivalent to the effective tax rate applied on the graduate's salary

Two more fiscal incentives are proposed especially for promoting female employment, as follows:

SPECIAL FISCAL INCENTIVES FOR FEMALE EMPLOYMENT	
INCENTIVE – I	INCENTIVE – II
During a particular tax year, a 10 percent tax credit on the additional wage bill of female employees	The income tax exemption limit be enhanced for female professionals from Rs 600,000 per annum to Rs 1,200,000 per annum and maximum rate of 20%

28.5. Improvement in the Quality of Labor Statistics

The prime responsibility for Labor Force Surveys (LFS) is with the Pakistan Bureau of Statistics. There is need for greater cooperation with the Provincial Bureaus.

Labor Force Surveys have not been carried out infrequently, despite the rapid changes in the labor market conditions in the country. The last survey was three years ago in 2017-18 and earlier in 2014-15. These Surveys should be undertaken once every two years.

The Labor Force Surveys should distinguish carefully between different types of labor inputs, for example, between unpaid family labor and participation in the augmented labor force. Also, the sectoral and occupational classifications must be more disaggregated.

An attempt must be made to quantify the 'true' rate of unemployment as defined in Chapter 27 of the Report. Information should also be given on effective hourly wage rates and on membership of trade unions.

Overall, the recommendations in this chapter of the report aim to fulfill the vision of a Social Democracy in the Constitution of Pakistan by giving due recognition to the labor rights of the people of Pakistan.

PART-XI

ACHIEVING MORE POVERTY ALLEVIATION AND SOCIAL PROTECTION

Chapter 29:

Achieving the Sustainable Development Goals

The Sustainable Development Goals (SDGs) have been set by the United Nations with the consent of all member countries. There are 17 Goals ranging from No Poverty to Partnerships for Achieving the Goals. The SDGs are a successor to the Millennium Development Goals. The latter covered the period from 2000 to 2015 while the former is for 2015 to 2030.

The MDGs and the SDGs both focus on achievement of a relatively high rate of economic and inclusive growth by individual countries. The objectives are to eliminate poverty and hunger, achieve good health, quality education, gender equality and so on. Most of these objectives are to be met by Provincial Governments after the 18^{th} Amendment. The co-ordination role is with the Federal Government.

Performance by countries on the MDGs was mixed. Many of the targets were not met at the global level. One of the big reasons for lack of success in meeting various targets was that the global partnership for development was not very effective. Developed countries had made a commitment for providing assistance of 0.7 percent of their GDP to developing countries to support the attainment of the MDGs but the actual flow was only 0.3 percent of the GDP.

Pakistan has made a commitment to achieving the SDGs. The Planning Commission has been made the national focal point for monitoring progress on the SDGs. A High-Level Parliamentary Committee in the National Assembly has been established on the SDGs. At the Provincial level, SDG units have been set up create a database on the targets and indicators and monitor progress.

29.1. The SDG Goals and Targets

The 17 SDGs and the key targets with each SDG are identified below, out of the total of 169 targets, 25 have been identified as key targets. The Criteria used for selection of the sub-set of targets is, first, the target is essential for achieving sustainable and inclusive growth; second, is already embedded as a target in national planning; third, there is greater scope for achievement of the target with co-operation from multilateral agencies; fourth, where regular data on trends is available and where achievement of the target has popular appeal. The targets chosen are identified below.

CHART 29.1: SELECTED SDG TARGETS

SDG 1: NO POVERTY

Target 1.2:	Reduce by 2030 the proportion of population living below the national poverty line by half
Target 1.3:	Achieve by 2030 achieve through appropriate social protection systems and measures substantial coverage of the poor and vulnerable

SDG 2: ZERO HUNGER

Target 2.2:	By 2030 end all forms of under nutrition
Target 2.3:	By 2030 double the agricultural productivity of small farmers

SDG 3: GOOD HEALTH AND WELL-BEING

Target 3.1:	By 2030, reduce the maternal mortality ratio to less than 70 per 100,000 live births
Target 3.2:	Reduce by 2030 neonatal mortality to as low as 12 per 1000 live births and under 5 mortality to as low as 25 per 100 live births.

SDG 4: QUALITY EDUCATION

Target 4.1:	By 2030, ensure that all girls and boys complete primary and secondary education

SDG 5: GENDER EQUALITY

Target 5.1:	End all forms of discrimination against all women and girls everywhere

SDG 6: CLEAN WATER AND SANITATION

Target 6.1:	By 2030, ensure universal access to safe drinking water to all

SDG 7: AFFORDABLE AND CLEAN ENERGY

Target 7.1:	Ensure universal access to affordable, reliable and modern energy services

SDG 8: DECENT WORK AND ECONOMIC GROWTH

Target 8.1:	Achieve at least 7% growth in GDP
Target 8.5:	Achieve decent work for all women and men
Target 8.6:	Substantially reduce the proportion of youth not in employment, education or training

SDG 9: INDUSTRY, INNOVATION AND INFRASTRUCTURE

Target 9.2:	Double industry's share in GDP and employment

SDG 10: REDUCED INEQUALITIES

Target 10.1:	By 2030 progressively achieve and sustain income growth of the bottom 40% of the population at a rate higher than the national average

SDG 11: SUSTAINABLE CITIES AND COMMUNITIES

Target 11.1:	Ensure access to adequate, safe and affordable housing and upgrade slums

SDG 12: RESPONSIBLE CONSUMPTION AND PRODUCTION

Target 12.1:	Achieve the sustainable management and efficient use of natural resources

SDG 13: CLIMATE ACTION

Target 13.1:	Strengthen resilience and adaptive capacity to climate-related hazards and natural disasters

SDG 14: LIFE BELOW ATER

Target 14.1:	By 2025, prevent and significantly reduce marine pollution of all kinds

SDG 15: LIFE ON LAND

Target 15.1:	By 2020, ensure the conservation, restoration and sustainable use of fresh water ecosystems, in particular, forests, wetlands, mountains and dry lands

SDG 16: PEACE, JUSTICE AND STRONG INSTITUTIONS	
Target 16.1:	Significantly reduce all forms of violence
Target 16.2:	End abuse, exploitation, trafficking and all forms of violence against children

SDG 17: PARTNERSHIPS FOR THE GOALS	
Target 17.1:	Strengthen domestic tax and other revenue collection, including thorough international support
Target 17.2:	Developed countries to implement fully their official development assistance commitments of 0.7% of GNI
Target 17.3:	Promote a universal, rules-based, open, non-discriminatory and equitable multilateral trading system

The above SDGs and selected checklist of targets are useful to the Federal and Provincial Governments as they can act as prime objectives of policies and determinants of allocation of public resources.

29.2. Pakistan's Progress on the SDGS

There is need to review Pakistan's progress in achievement of the various targets, especially from 2015 onwards. There is, of course, the need to highlight separately how the progress has been severely hampered and taken back by the pandemic, COVID-19.

Poverty Reduction (Target 1.2)**:** SPDC [2018] has estimated that the incidence of poverty was 38 percent in 2015, based on a poverty line corresponding to the cost of meeting minimum basic needs. It is estimated that it has fallen to 34.1 percent by 2019, prior to COVID-19.

Level of Social Protection (Target 1.3)**:** The Asian Development Bank has ranked Pakistan low among Asian countries in the Social Protection Index.

Incidence of Malnutrition (Target 2.2)**:** The Pakistan Social and Living Standards Measurement Survey by the PBS indicates that 16 percent of the population suffers from malnutrition and in addition another 2 percent have severe malnutrition in 2018-19.

Agricultural productivity of Farmers (Target 2.3)**:** Agricultural productivity has increased per worker by only 3 percent between 2015 and 2019. The target is to double it by 2030.

Infant Mortality (Target 3.2)**:** The neo-natal mortality was 46 per 1000 live births in 2014 which has declined somewhat to 41 by 2019. The target is to reduce the incidence to only 12 by 2030.

Net Enrollment (Target 4.1)**:** The progress in net enrollment rates by gender at the national level is give below:

	Boys – (%)		Girls – (%)	
	2014-15	2018-19	2014-15	2018-19
Primary	72	68	62	63
Middle	39	40	34	36
High	29	29	24	26

The improvement rate in the NER is low. In fact, it has apparently actually fallen at the primary level for boys. The target of 100 percent net enrollment at the primary and secondary level of boys and girls by 2030 seems to be very elusive.

Gender equality (Target 5.1)**:** Pakistan is ranked very low in terms of gender equality. The Global Human Development Report of UNDP of 2020 ranks Pakistan at the 135th position among 189 countries.

Access to Safe Drinking Water (Target 6.1)**:** Here again, there has been a fall in coverage of households with tap water from 27 percent in 2014-15 to only 18 percent in 2018-19.

Access to Electricity (Target 7.1)**:** Pakistan does relatively well with 91 percent of the households having access to electricity. However, there are emerging issues of affordability due to the big hikes in electricity tariffs.

Achieve 7 percent GDP Growth**:** There has been a modest revival in the GDP growth rate to 5.5 percent in 2017-18 from 4 percent in 2013-14. However, it fell back to 1.9 percent in 2018-19 even prior to COVID-19. A near 4% growth rate was achieved in 2020-21 partly because of the low base effect of the fall in the GDP after the first COVID-19 attack.

'Decent' Work for all Workers (Target 8.5)**:** The absence of 'decent' work in Pakistan is highlighted by the presence of 2 million bonded workers and 3 million child workers. Only 47 percent of the workers receive the minimum wage and 73 percent of the workers put in more than 40 hours a week. The incidence of work-related disease or injury is high at 4 percent. Pakistan has a long way to go before it can provide 'decent' work to most workers.

Reduction in Number of 'Idle' Youth (Target 9.2)**:** Pakistan in 2018-19 had as many as 5 million 'idle' male youth and almost 7 million 'idle' female youth.

Higher Income Growth of Bottom 40 percent (Target 10.1)**:** Between 2015-16 and 2018-19, the real per capita income growth rate of the bottom 40 percent was 1 percent as compared to only 0.4 percent for the whole population, according to the Household Integrated Economic Surveys conducted by the PBS. Inequality fell somewhat.

Adequate and Affordable Housing (Target 11.1)**:** There is an acute shortage of housing in the country. According to the LSSMS Survey of the PBS, 28 percent of the households live in housing units with only one room as of 2018-19. Also, only 33 percent of the housing units have 'pucca' (RCC/RBC) roofs.

Other Environmental Indicators (SDG 12 to 15)**:** The Yale University Environmental Performance Index of 2020 ranks Pakistan at 142nd out of 180 countries. The ranking is especially low in air quality, sanitation and drinking water and wastewater treatment. Relatively high ranking has been obtained in marine protected areas, tree cover loss, grass land loss, wet land loss and fish stock status.

Overall, the performance of Pakistan is behind in the extent to which the targets have been achieved by 2019 because the rate of improvement is very slow or there has actually been some worsening.

The relative lack of progress by Pakistan up to 2020 in achieving the SDGs has also been highlighted in the Global SDGs Progress Report 2020 prepared by a team led by Professor Jeffrey Sachs. Pakistan is ranked 134th out of 166 countries.

Pakistan has the lowest ranking among South Asian Countries as shown below:

Countries	Score*	Ranking
Bangladesh	63.5	109
India	61.9	117
Nepal	65.9	96
Pakistan	56.2	134
Sri Lanka	66.9	94

*The maximum score is 100.

The lack of progress on the SDGs has been further hampered by the large negative impact of successive waves of COVID-19 on the national economy which has rendered it even more difficult to achieve the SDG targets by 2030. The five SDGs that have been most affected are as follows:

SDG 1	SDG 2	SDG 3	SDG 8	SDG 10
No Poverty	Zero Hunger	Health and Well-being	Decent Work and Economic Growth	Reduced Inequalities

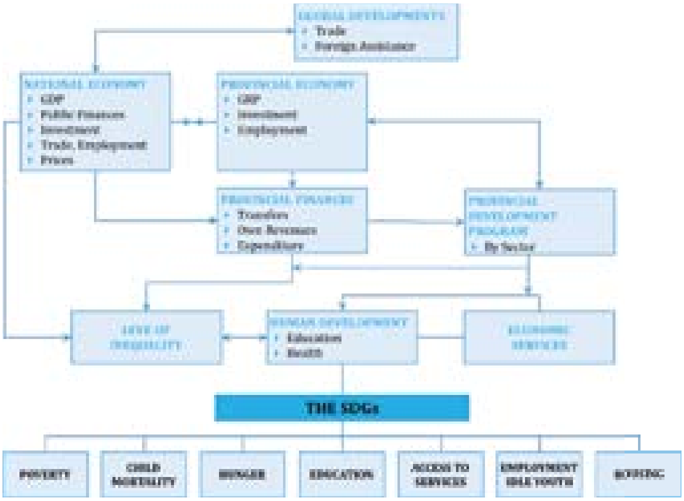
A recent report by the UN on Financing for Sustainable Development has expressed the concern that COVID-19 could push achievement of the SDGs much beyond 2030. The terminal year may need to be extended to 2035 or even 2040.

29.3. Planning for the SDGs

Achievement of the SDGs will require planning jointly by the Federal and Provincial Governments in Pakistan. The latter are responsible for the provision of basic social services like education, health, water supply and sanitation. The focus of the Federal Government is on macroeconomic policies and the overall growth of the economy, provision of trunk economic infrastructure and for providing more social protection to the poor.

The Provincial Government of Punjab, through its planning and Development Department, has undertaken a major exercise in planning for the achievement of the SDGs. This has involved the development of a National Macroeconomic Framework with a Regional Dimension of the Provincial Economy. The Framework is presented in Figure 29.1.

Figure 29.1: The Planning Framework for The SDGs



Following the construction of a large database, a Macro-Econometric Model has been constructed for projection of the variables linked to the achievement of the SDG targets. This Model has 120 equations and projects the outcome up to 2030 of achievement of SDG targets with different scenarios.

Based on the insights gained from this planning exercise by the Government of Punjab the following recommendations are made for increasing the ability to achieve the key SDG targets.

29.4. Achieving the SDGs

Identification of the Key Elements in the SDG Planning Exercise: A particular Provincial Planning and Development Department will need to first identify the following:

i) The nature of the link between the regional economy and the national economy.

ii) Sectors in which the Province has a comparative advantage in the national context and measures required to harness fully the potential of these sectors.

iii) Determination of the potential for resource mobilization from provincial revenue sources and the required size of transfers from the Federal Government.

iv) Prioritization of the sectoral composition of the Annual Development Program at the Provincial level and needed public investments at the Federal level.

v) Required level of private investment to achieve SDG goals related to the rate of economic growth and employment creation, and incentives to be provided for achieving this level of investment and exploring opportunities for public- private partnerships.

Required Level of Resource Mobilization: The required growth rate in real transfers and own revenues in the context of Punjab are highlighted below:

	Historical*Real Growth Rate (%)	Required Real Growth Rate (%)
Federal Transfers	2.1	10.0
Own-Provincial Revenues	6.5	12.5
*Since 2015-16.		

Required Changes in Sectoral Development Allocations: Major changes are required in sectoral allocations within the Federal PSDP, and the Punjab ADP as shown in Table 29.1.

Table 29.1: Changing the Sectoral Allocation Shares in the Federal PSDP and in the Provincial ADP of Punjab for Greater Progress on the SDGs (%)

	FEDERAL PSDP		PROVINCIAL PSDP	
	Actual (2018-19)	Scenario for Achieving SDGs	Actual (2018-19)	Scenario for Achieving SDGs
Agriculture	1	-	4	7
Industry	3	5	4	6
Irrigation	14	25	8	11
Hydro-Electricity				
Energy	13	15	2	4
Transport and Communications	28	20	27	16
Education	6	7	13	24
Health	2	3	13	17
Regional	12	13	-	-
Water Supply & Sanitation	9	9	9	10
Others	2	3	20	5
TOTAL	**100**	**100**	**100**	**100**

The big change required at the Federal level is a large increase in the shares of irrigation, hydel and power transmission and distribution projects, with a reduction in the share of highway projects. The Provincial ADP will have to be oriented more towards education, health, and productive sectors, away from transport, building and construction and urban projects.

***Development of Data Base and Monitoring Systems*:** Ideally the data base should be developed at the district level by the Provincial Bureaus of Statistics. Monitoring system on the extent of progress on SDG targets should be the responsibility of the Planning and Development Departments and the SDG units. Similarly, the Planning Commission should prepare a national report on progress in attainment of SDGs.

***Mobilization of External Resources*:** The Economic Affairs Division should have the prime responsibility for raising funding for SDGs with the relevant Federal Divisions and Provincial Departments. Some examples are as follows:

- Support from a Multilateral Source for development of the Provincial Revenue Base.
- Support from a Multilateral or Bilateral source for development of the Technical and Vocational Training Capacity in collaboration with the Private Sector.
- Support for development and marketing of new seed varieties, drip irrigation and other agricultural innovations.
- Support for projects for environmental protection and managing climate change.

Overall, the SDGs targets are extremely ambitious, especially after COVID-19, but they have the great merit of providing a useful framework for Federal and Provincial Planning. They also ensure that the focus will always be on improving the lives of the people.

Chapter 30:

Expanding Social Protection

The primary focus of the Charter of the Economy must be to achieve high, sustainable and inclusive growth. However, there is likely to be a section of the population which remains marginalized and does not benefit directly from the process of growth. As such there will always be the need for a comprehensive program of social protection to reach out to these people and reduce thereby the incidence of poverty.

Tackling poverty has emerged as an even greater priority after the large-scale negative impact of COVID-19. The first part of the Chapter provides a quantitative estimate of the impact. This is followed by the review of existing social protection initiatives by the Federal and Provincial Governments respectively. A series of recommendations are then made for expanding and diversifying the measures for poverty alleviation.

30.1. Trend in the Incidence of Poverty

The incidence of poverty has generally been derived by adopting the cost of basic needs approach. Households whose income is less than the cost of meeting the basic needs of household members are classified as poor. The cost of basic needs is derived as the cost of providing a minimum level of nutrition to an adult equivalent.

Data on a large stratified random sample nationally of households is obtained through the Household Integrated Economic Survey (HIES) undertaken periodically by the Pakistan Bureau of Statistics. The last HIES was in 2018-19. The Social Policy and Development Centre has derived a consistent time series of the incidence of poverty from the various HIES. The resulting estimates are presented in Table 30.1.

Table 30.1: Incidence Of Poverty in the Rural and Urban Areas of Pakistan 2001-02 to 2015-16 (% of Population)

	2001-02	2004-05	2010-11	2014-15
Rural Areas	35	31	39	41
Urban Areas	30	28	34	32
Pakistan	33	30	38	38

Source: *SPDC*

There was some decline in the level of poverty from 2001-02 to 2004-05 due to the fast growth in the economy, although income inequality increased significantly during these years. From 2004-05 onwards, the incidence of poverty rose sharply due to the big fall in the GDP growth rate and relatively higher inflation in food prices. From 2010-11 onwards up to 2014-15, the level of poverty remained largely unchanged due some improvement in the growth process.

An econometric approach has been adopted to estimate the level of poverty after 2015-16. The findings are as follows:

- A 1 percent rise in the GDP growth rate reduces the incidence of poverty by 1.33 percent.
- A 1 percent increase in the difference between the rate of inflation in food prices and the overall CPI raises the incidence of poverty by 2.69 percent.
- A 1 percent increase in real pro-poor expenditure reduces poverty by 0.12 percent.
- A 1 percent increase in the level of inequality, as measured by the PALMA ratio, raises poverty by 1.32 percent.

Based on these elasticities, the estimated incidence of poverty after 2015-16 is given in Table 30.2.

Table 30.2: Estimated Incidence of Poverty in Pakistan, 2015-16 to 2020-21 (% of Population)

	2015-16	2017-18	2018-19	2019-20*	2020-21
Pakistan	34.6	26.7	26.9	36.8	32.5

* In the immediate aftermath of COVID-19
Source: *Estimated*

There was a significant reduction in the incidence of poverty from 2014-15 to 2017-18 due to relatively fast growth, stability in food prices and some decline in income inequality.

There has been a quantum jump in the incidence of poverty following the COVID-19 attack. It had initially gone up by almost 10 percentage points which means that over 21 million more people fell below the poverty line in 2019-20. Due to the smart lockdown and restriction on certain activities the impact has been greater in the urban areas, especially in the large cities. Almost 10million urban residents had become poor due to loss of jobs and/or the quantum jump in food prices.

Clearly, there was need to expand substantially the interventions to support indigent households. Efforts of the Government and the SBP must be acknowledged. The following measures were taken:

i) The Ehsaas/BISP Program was upscaled and through an appropriate and transparent mechanism cash transfers have been made to almost 15 million beneficiaries of Rs 12000 each.

ii) The operations of the Utility Stores Corporation (USC) were expanded to provide greater access to subsidized basic food items. The subsidy given to USC in 2019-20 rose to Rs 44 billion as compared to the original budgeted amount of Rs 5 billion.

iii) Option of deferment of payment of electricity bills was given to SMEs.

iv) The SBP organized special schemes for deferment of the repayment component of loans, special loan facility for payment of the wage bill, investment in health facilities and lower interest rate on fixed investment.

Overall, these interventions have provided a temporary cushion to the affected households. However, 2020-21 continued to create pressures on household income and expenditures. Only some of those who lost jobs got back to employment and the cost of living has been affected by the big increase in food prices of 16 percent. Currently, it is estimated that almost 33 percent of the population is below the poverty line.

30.2. The Existing Social Protection Programs

Social protection programs are essentially of four types:

Social Insurance: This includes the payment of pensions to workers who have retired and during the working lifetime had relatively low wages. It also includes various forms of insurance including health coverage and insurance against crop failure to small farmers.

Social Assistance: This primarily consists of cash transfers to target households, identified by some criteria. The transfers may be conditional or unconditional in nature.

Labor Market Programs: These initiatives include training, apprenticeship, placement in productive enterprises, food for work, microcredit, etc.

Consumer Subsidies: In the Pakistani context this primarily includes two interventions. The first is the lower tariff to very small domestic consumers of electricity and gas. The second is subsidized price of basic food items in outlets of the USC. This intervention is not targeted and available to all households.

There are social protection initiatives both by the Federal and the Provincial Governments. Social welfare is not mentioned as a function either in the FLL-I or in the FLL-II. Therefore, the presumption is that it would be primarily the responsibility of Provincial Governments. However, in Pakistan up to now the Federal Government has taken the lead in launching anti-poverty interventions. The first major program was the Benazir Income Support Program (BISP), which was launched by the PPP Government in 2009-10. The merit of this program is that it provides for equal treatment of households in all the four Provinces.

Federal Programs: The outlays on different social programs by the Federal Government from 2010-11 to 2018-19 are presented in Table 30.3. In overall terms the outlay has increased from Rs 171 billion in 2010-11 to Rs 518 billion in 2018-19. This is equivalent to an increase from 0.9 percent of the GDP to 1.4 percent of the GDP.

The large interventions are in the domain of social insurance, social assistance, and subsidies. Social insurance includes Federal pensions to employees who at the time of retirement were in BPS 1-11. It is estimated that their share in total pension payments is almost 50 percent. The pensions by EOBI are to retiring workers from private contributing enterprises. The pension has recently been raised from Rs 6500 to Rs 8500 per month. The Government and EOBI pensions had a share of 36 percent in 2018-19 in the total Federal outlay on social protection.

Table 30.3: Outlays on Social Protection by the Federal Government (Rs in Billion)

	2010-11	Share (%)	2014-15	Share (%)	2018-19	Share (%)
A. SOCIAL INSURANCE	**54.9**	**32.1**	**121.8**	**32.5**	**187.0**	**36.0**
Pensions	46.4		110.0		171.0	
EOBI	8.5		11.8		16.0	
B. SOCIAL ASSISTANCE	**36.4**	**21.3**	**138.3**	**37.0**	**128.4**	**24.7**
BISP	35.0		91.8		118.7	
Bait-ul-Maal	1.4		2.0		5.0	
Internally/Temporarily Displaced Persons	-		45.0		4.7	
C. LABOR MARKET/INCOME GENERATION PROGRAMS	**28.7**	**16.8**	**14.9**	**4.0**	**-**	**0.0**
Youth Program	-		7.0		-	
PPAF/Micro Credit	3.0		7.9		-	
National Internship Program	2.9		-		-	
People's Works Program	22.8		-		-	
D. SUBSIDIES	**51.1**	**29.8**	**87.0**	**23.2**	**179.4**	**34.6**
Lower Price of Electricity/ Gas	45.2		78.1		169.6	
USC	1.6		4.1		1.5	
PASCO	1.4		4.8		7.3	
TCP	2.9		-		1.0	
E. MDGs/SDGs Community Development Program	-		**12.5**	**3.3**	**24.0**	**4.7**
TOTAL	**171.1**	**100.0**	**375.0**	**100.0**	**518.8**	**100.0**
% of GDP	**0.9**		**1.4**		**1.4**	

Source: *Diverse*

Social assistance consists largely of unconditional cash transfers from the Ehsaas Program/ BISP. These transfers have more than tripled since 2010-11. The Bait-ul-Maal is an Islamic intervention with committees at the local level. However, the amount allocated to it is small. A special program of support was launched in 2014-15 for internally displaced persons especially after the launch of *Zarbe-Azb* in 2015 to drastically curb terrorism. The focus was especially on FATA due to the temporary migration of people to Khyber-Pakhtunkhwa.

The weak area currently is labor market and income generation programs especially for youth and unemployed workers in the informal sector. There was a sizeable Peoples' Works Program in 2010-11 but it has since been abandoned.

The biggest form of subsidy is to small domestic consumers of electricity and gas. The cost has multiplied from Rs 45 billion in 2010-11 to Rs 170 billion by 2018-19. Other smaller subsidies are by USC and PASSCO, mostly for food items.

The fifth category of social protection is the earlier MDGs and now SDGs Community Development Program. This consists of interventions at the political constituency level and the expenditure is on the provision of municipal services.

Overall, the three largest Federal programs are BISP, pensions and consumer subsidy. Together they account for 88 percent of the total Federal expenditure on social protection. Social insurance, social assistance and consumer subsidies had shares of 36 percent, 25 percent, and 35 percent respectively in 2018-19.

Provincial Programs: The Provincial Governments have entered the area of social protection with some innovative programs. Of course, their outlay on pensions has traditionally been larger than the Federal Government because of larger employment. The estimated cost of pensions for low grade employees of the four Provincial Governments combined has approached Rs 250 billion in 2019-20. This is almost 50 percent more than the outlay on pensions to such employees by the Federal Government.

Beyond pensions, the Government of Khyber-Pakhtunkhwa has launched a sizeable health insurance scheme. The target is to cover 7.1 million families in 2020-21. The services provided are secondary and tertiary care. The coverage per family is Rs 1,000,000. A Citizen Budget is published annually by each Provincial Government which highlights the benefits of Provincial expenditure.

The Government of Punjab has some relatively small initiatives. A Health Insurance Scheme is being launched with the initial cost of Rs 4 billion. A Punjab Social Protection Authority has been set up. On-going programs include Special Education, Empowerment of the Kissan through Digital and Financial Inclusion, Punjab Education Endowment Fund with scholarships for poor deserving students and subsidy on wheat, sugar and a Ramzan package. The total outlay budgeted for these programs in 2020-21 is Rs 34 billion.

The Government of Sindh has put in place a People's Support Program of Rs 20 billion for cash transfers. In addition, there is a Sindh Minorities Program for medical treatment and construction of places of worship.

Overall, there has been an increase at the national level in the outlay and diversity of social protection programs. Recommendations are given below for further development of initiatives to tackle poverty, which had risen by over 21 million after COVID-19.

30.3. Strategy for Poverty Reduction

Various criteria need to be applied in the design and execution of programs of social protection as follows:

- Targeting efficiency
- Extent of program coverage
- Degree of ease of access of potential beneficiaries
- Percentage of program expenditure devoted to benefits and not to overhead costs
- Adequacy of support
- Income equivalence of transfer
- Absence of negative incentive effects like 'moral hazard`.
- Sustainable and adequate financing

Based on the above criteria, a number of recommendations are made.

Increase in Coverage of the BISP/EHSAAS Program: At its peak in the immediate aftermath of COVID-19, cash transfers were made to almost 15 million beneficiaries. Apparently, the coverage will now be reduced to 7 million. The target should be raised to 12 million as poverty continues to be high.

The coverage has not been in line with the incidence in different parts of the country. The coverage has been relatively high in Sind and low in Balochistan. There is need for better penetration in the latter Province given the low population density.

Move to Conditional Cash Transfers: A part of the cash transfers could be made conditional to immunization of the child, adoption of family planning, sending the girl child to school or avoiding child labor.

Rationalizing the Pensions: The spread of basic pay among Government employees is large. A BPS-22 employee gets more than seven times the basic pay of a BPS-1 employee. As such in future pensions increases a proportionately larger increase may be given to employees who retired from BPS-I to BPS-II.

Further, given the extremely rapid increase in the cost of pensions to both the Federal and the Provincial Governments, there is a case of increasing the retirement age from 60 to 63 years. The Government of Khyber-Pakhtunkhwa has already proposed this move.

The coverage of pensions of private sector employees and self-employed is very limited. The EOBI may consider launching a contribution-based scheme for self-employed workers. Also, such a scheme could also be launched for Pakistani expatriate workers.

More Labor Market Programs: This has been identified as the weak component of social protection in Pakistan today. It must be given much higher priority if the over 5 million male youth and 7 million female youth are to be productively absorbed.

The priority must be to expand the capacity of Vocational and Technical Training Institutions to impart market-related skills. A diploma holder from one of these accredited institutions may also be considered as eligible for a small project loan. Further, Food for Work or Employment Guarantee Schemes may be launched through Union Councils in rural areas.

Targeting Consumer Subsidies: The price subsidy on electricity and gas should be restricted to families who offer themselves for Poverty Scorecard Assessment or are already a BISP beneficiary. Further, the access to the Utility Stores Corporation outlets may be restricted by the introduction of a Food Stamp Scheme for beneficiaries of the BISP. This will lead to much better targeting of the food subsidy by the USC. Simultaneously, the number of USC outlets should be substantially increased.

Expansion of Microfinance: Small loans need to be made available to workers in the informal sector at this time given the adverse impact on livelihoods due to smart lockdowns and closures. A tax credit scheme may be introduced for commercial banks and other financial institutions of 10 percent of the increase in lending to PPAF and Microfinance Institutions.

Housing Finance for Home Improvements: The emphasis of the Naya Housing Scheme of the Government is on the construction of new low-cost housing units on 3 to 5 Marla plots. There are serious issues of affordability of loan repayment by low-income families even in the presence of an interest rate subsidy. There are over 6 million housing units in Pakistan with only one room. Therefore, as highlighted earlier a more appropriate strategy may be to give small loans for home improvement like the construction of an additional room or improving the quality of construction. This scheme could be run by large NGOs or Microfinance Institutions.

In conclusion, the success of the Charter of the Economy will be determined by the extent to both fast and inclusive growth are achieved in the next few years. If the key targets are achieved by 2024-25 then the incidence of poverty could decline by 30 percent and over 20 million people taken out of poverty.

30.4. Protecting the Middle Class

The middle class has generally been defined as the class of people who are between the 'upper' class and the 'working' class on the basis generally of income or expenditure. These people are sometimes referred to also as the 'bourgeoisie'. They possess either or both of two characteristics. First, they are generally persons with higher education often employed as professionals or managers. Second, they may be endowed with entrepreneurial qualities and own small trading or production establishments. A large and expanding middle class is the sign of a rapidly growing economy.

The middle class can also play an effective role in promoting social and political change, as has been the case in many countries. They are frequently instrumental in ensuring accountability for efficient and honest delivery of services and act as a counter to elite capture of state resources. They are also more inclined to promote the formulation and implementation of progressive policies.

The simplest approach to identifying the middle class is to look at the characteristics of the people in the third and fourth quintile of population based on income or expenditure. This is made possible in the Pakistani context by the Housing Integrated Economic Survey (HIES) conducted periodically by the Pakistan Bureau of Statistics (PBS).

Based on adjustment for some understatement of income especially at the upper end of the income distribution, the spread of per capita incomes among the three classes has been determined for the latest survey year, 2018-19. Accordingly, the per capita income of the middle class is 166 percent of the per capita income of the lower class (bottom two quintiles) and 41 percent of the income of the upper class (top quintile). This demonstrates the high level of income inequality in Pakistan.

Three periods can be identified regarding the progress of the middle class since 2001-02. During the Musharraf era up to 2007-08, incomes grew relatively fast, but income inequality increased sharply. Consequently the per capita income of the middle class rose in real terms annually by 4 percent, while the national per capita income grew faster at 5 percent.

The tenure of the PPP government for the next five years saw both slow growth in the economy and unchanged inequality. The per capita income of the middle class grew by just over 2 percent annually. The middle class saw per capita income growth of over 3 percent in the tenure of the PML(N) government.

Turning to the question as to whether to the size of the middle class is expanding or contracting with respect to the total population, a different approach needs to be adopted. The middle class is now defined to include households with per capita expenditure in the range of 25 percent below and 25 percent above the median per capita expenditure. The results are very revealing. In 2001-02, 43 percent of the population was in the middle class. By 2015-16, the share had fallen to 38 percent. By 2018-19, the share of the middle class has fallen further to 35 percent. Therefore, the presence of the middle class is shrinking as part of the population of the country. Given the impact of COVID-19, the size of the middle class is now estimated at 31 percent of the population.

The next question of interest is how large the middle class is in relation to an international standard for a family to qualify as part of the middle class. The standard used is that the per capita expenditure per day should range from $5 to $25 in purchasing power parity (PPP) terms. For the latest year, almost 26 percent of the population falls in the middle class, with the PPP $ being over three times the nominal US$ in the case of Pakistan. Therefore, almost 9.5 million families of the country form part of the global middle class. For example, Pakistan's middle class is 5 percent of the middle class of Asia and the Pacific. The combined purchasing power annually is estimated at Rs 1650 billion. This implies a relatively large market for housing, consumer durables and FMCGs.

There is need also to identify the distribution of the middle class within the country. Estimates are that 58 percent of the middle class is in the cities and towns of Pakistan and 42 percent in the rural areas, 57 percent of the middle-class lives in Punjab; 23 percent in Sindh; 16 percent in Khyber-Pakhtunkhwa and 4 percent in Balochistan. The share in home remittances of the middle class is 31 percent. Over 62 percent of the remittances accrue to the upper class.

Wealth inequality is more pronounced than income inequality. Perhaps the best indicator of wealth is the ownership of property. The middle class owns 28 percent of the property in the country. This share has also been declining. Bulk of the property, almost two thirds, is with the upper class.

Based on the above findings, there is need to explain why the middle class of Pakistan is shrinking and why their incomes are growing very slowly. The first reason is the adverse development in the labor market during the last few years, regarding employment opportunities for educated workers, a large segment of which is in the middle class. There has been an exponential increase in the unemployment rate of such workers. It was 5 percent in 2007-08 and has risen to 16 percent by 2018-19. Consequently, almost one in six workers in the labor force, with a graduate or post-graduate degree, is without a job. This is a tragic waste of the human capital in the country. After COVID-19, and the fall especially in large-scale manufacturing, the unemployment rate of the educated is now above 20 percent.

Second, the middle class is being squeezed by rising costs of living, especially of housing utilities, transport and education and health services. The expansion in the number of housing units with two to four rooms between 2010-11 and 2018-19 has been only 14 percent. This compares with an increase of over 21 percent for the upper class of housing units with five or more rooms. Also, rents, especially in metropolitan cities, have risen 25 percentage points more than the cumulative rise in the overall consumer price index since 2007-08. Simultaneously, the electricity tariff for monthly domestic consumption of 300 to 700 kwh per month has gone up to almost four times. It is not surprising that the average savings rate for the middle class is down to only 3 percent from 6 percent eight years ago.

However, middle income workers, with annual income from Rs 400,000 to Rs 1,000,000 per annum remain the backbone of our personal income tax system. The majority are salaried taxpayers. They account for over 90 percent of tax return filers and contribute over 46 percent to the tax revenue.

There has also been a rapid growth in the demand for consumer durables like motorcycles, refrigerators, TV sets, etc., of 4 to 6 percent per annum in the last seven years. This has been facilitated by the arrival of relatively cheap Chinese makes in the market and somewhat improved consumer financing. Mobile phones have, of course, filtered down even to the lower class.

The Federal and Provincial Budgets of 2021-22 include the announcement of over 25 percent increase in the minimum wage throughout the country. Government employees have also received a significant increase in their allowances.

30.5. Relief to the Middle Class

There is a dire need to provide relief also to the middle class, including the following:

i) The exemption limit in the personal income tax should be raised once again to Rs 1,200,000 from Rs 600,000 currently. This was included in the Federal Budget of 2018-19 but withdrawn subsequently by the new Government.

ii) The NPHDA is developing housing schemes on plots of up to 8 Marlas. An incentive should be provided to middle class families to buy these housing units by offering tax deductibility of up to Rs 20,000 per month from the loan repayments.

iii) The Budget speech included a special loan scheme of interest free loans for the low-income group. This facility should also be made available to low middle- income families with incomes less than Rs 48,000 per month.

iv) The other chapters have already emphasized the need for development of the digital economy. This will provide more employment to young graduates and post-graduates who are potential entrants into the middle class. The focus should be on exports of IT services.

Chapter 31: Restraining Population Growth

The last chapter of this report on Charter of the Economy is on Restricting Population Growth. This is a conscious decision. The large number of reforms and programs proposed in the previous chapters will either fail or meet with limited success unless the population growth rate comes down significantly.

Projections by various international agencies are that if the population growth rate of the country remains unchanged then the pressure of population on resources will be virtually unmanageable. UNDESA projects that by 2050 the population could nearly double from the present level to 403 million. Visualizing this scenario is scary.

This chapter tracks through the historical growth of population in Pakistan and compares this growth with the rate of increase in population in other South Asian and Islamic countries. The extent of population pressure already is quantified with the use of different indicators. The mechanisms and programs for population control are then identified, followed by recommendations.

31.1. Trend of Population Growth

The size of population enumerated by different Censuses after the creation of Pakistan is presented in Table 31.1. The population growth rate reached a peak of 3.8 percent between 1961 and 1972. This was due to the in-migration of population from the Eastern wing of the country prior to its separation in 1971. Thereafter, the population growth rate has come down from 2.8 percent to 2.4 percent in the last inter-Census period of 1998 to 2017, but it remains high.

The growth rate of rural population has also been coming down from 1972 onwards. It is down to 1.4 percent between 1998 and 2017. This has implied a higher rate of rural-urban migration and the urban population growth rate is high at close to 4 percent. By 2017, the share of urban population had approached 44 percent.

Table 31.1: Rural, Urban and Total Population of Pakistan (Annual Growth Rate, 1951 to 2017) (Million)							
	Rural Population	g(%)*	Urban Population	g(%)	Extent of Urbanization (%)	Total Population	g(%)
1951	27. 8	-	6.0	-	17.7	33.8	-
1961	33.3	1.8	9.7	4.8	22.6	43.0	2.4
1972	48.7	3.5	16.6	4.9	25.4	65.3	3.8
1981	60.4	2.4	23.8	4.0	28.3	84.2	2.8
1998	89.3	2.3	43.0	3.5	32.5	132.3	2.6
2017	117.2	1.4	90.5	3.9	43.6	207.7	2.4

*Annual compound growth rate
Source: *UN | PBS*

A comparison of demographic indicators in selected South Asian and Islamic countries is made in Table 31.2. Pakistan's population growth rate has apparently come down somewhat to 2.1 percent by 2021, but it is still the highest among the nine countries.

The total fertility rate is also the highest at 3.3 children. It is as low as 2.0 in Bangladesh and 1.8 in Nepal. It is important to observe that it is also low in Islamic countries like Malaysia, Iran, and Indonesia at between 1.9 and 2.2. Clearly, these Islamic countries have been able to overcome any resistance from religious leaders and the clergy on the resort to measures of population control.

Table 31.2: Demographic Indicators in Selected South Asian and Islamic Countries			
	Population (2021)	Population Growth Rate (%)	Total Fertility Rate per Women (No. of Children)
SOUTH ASIA			
Bangladesh	166.3	1.1	2.0
India	1393.4	1.0	2.2
Nepal	29.7	1.8	1.8
Pakistan	225.2	2.1	3.3
Sri Lanka	21.5	0.5	2.2
OTHER ISLAMIC COUNTRIES			
Egypt	104.3	2.0	3.2
Indonesia	276.4	----	2.2
Iran	85.0	1.4	2.1
Malaysia	32.8	1.3	1.9

Source: *UN*

Pakistan needs to fix a target of reduction in the total fertility rate down to 2.2 children, as in India and Sri Lanka currently. This will enable a substantial reduction in the population growth rate annually to between 1.1 and 1.5 percent. if this is achieved by the next Population Census, the projected population of Pakistan in 2050 will come down from 403 million to 333 million, a potential reduction of 70 million.

31.2. Impact of the Population Pressure

The impact of rapid population growth is evident on the availability of natural resources and access to basic services, as shown below:

i) The availability of agricultural land for crop cultivation has declined from 2.5 hectares to 0.2 hectares per capita of rural population between 1961 and 2017. Consequently, farm sizes are becoming smaller from one generation to the other. Yields have not risen sufficiently, and this is putting pressure on the real incomes of small farmers.

ii) The availability of water per capita has declined by as much as 49 percent between 1990-91 and 2020-21. Pakistan has already been declared a *'water short'* country and is on the way to becoming a *'water-stressed'* country.

iii) The access to basic services is declining. In the case of hospital beds access improved between 1961 and 1998. However, the number of persons served per hospital bed has increased from 1440 in 1998 to 1566 in 2020.

iv) The population served per primary school has increased from 1998 onwards by 36 percent. Access to middle / high schools has also started declining in recent years.

v) The rate of expansion in the road network has also not kept pace with population growth.

vi) There is evidence of increasing food insecurity in the two lower income quintiles of population. Between 2013-14 and 2018-19, the HIES reveals that real food expenditure per adult equivalent has declined. Food prices are rising faster due to the above-mentioned constraints to higher agricultural output.

vii) The unemployment rate has consistently been rising since 1961. It was only 1.7 percent then. By 1981 it had increased to 3.1 percent and reached 5.8 percent in 2018. The growth in number of entrants into the labor force has risen at a faster rate than the increase in number of jobs in the economy. This problem has been exacerbated by the 'youth bulge'.

viii) The fast growth in urban population has put enormous pressure on municipal services in megacities, especially Karachi. Today, Karachi has huge problems of water availability, solid waste disposal, traffic congestion and so on. In terms of quality-of-life Karachi is ranked in 2020 by Mercer at 201 out of 231 cities in the world.

Therefore, there is irrefutable evidence that fast population growth is putting severe pressure on natural resources, services, and jobs. Keeping pace will require big increases in public and private investment, which have not been forthcoming.

31.3. Population Planning and Control

The rate of population growth varies among the different regions of Pakistan is shown in Table 31.3. the estimates do not adjust for any under-enumeration during a Census.

The two less developed provinces have shown faster population growth between 1998 and 2017. In the case of Khyber-Pakhtunkhwa, it is partly due to the large influx of refugees from Afghanistan. The biggest decline in the population growth rate is observed in Punjab, followed by Sindh. It is likely that a larger proportion of married couples are attempting voluntarily to achieve same family size control, given relatively higher incomes and education.

Table 31.3: Population Growth Rate in Different Regions of Pakistan (In the last two Inter-Census Periods) Annual Growth Rate (%)

	1981 to 1998	1998 to 2017
Punjab	2.60	2.11
Sindh	2.76	2.38
Khyber-Pakhtunkhwa	2.78	2.85
Balochistan	2.40	3.32
FATA	2.21	2.38
Islamabad Capital Territory	5.12	4.81
Pakistan	**2.66**	**2.37**

Public sector interventions for population control are currently very limited as indicated by expenditure on population planning in Table 31.4. the expenditures are very small and aggregate to only 0.5 percent of the total combined expenditure of the four Provincial Governments.

Table 31.4: Expenditure on Population Planning, 2018-19 (Rs in Billion)

Provincial Governments	Expenditure on Population Planning			Percentage of Total Expenditure
	Current	Development	Total on Population Planning	
Punjab	4.3	1.2	5.5	0.4
Sindh	3.9	0.3	4.2	0.5
Khyber-Pakhtunkhwa	1.2	-	1.2	0.2
Balochistan	0.8	2.6	3.4	1.4
TOTAL	10.2	4.1	14.3-	0.5

Source: *MOF*

The consequence is that the coverage of reproductive health services is limited. According to the PSLM survey, 68 percent of the deliveries are assisted by skilled health personnel. This compares with 81 percent in India and 100 percent in Sri Lanka.

The contraceptive prevalence rate is very low at 37 percent, as compared to 48 percent in Bangladesh, 57 percent in India and 67 percent in Sri Lanka. Only 52 percent of the demand for family planning is satisfied by modern methods.

Infant mortality remains high at 67 per 1000 live births. This creates pressure for more children to achieve the desired family size. Also, the demand for children is higher in low-income families as child labor is seen as a potential source of income.

31.4. Population Policy

***Engagement of Religious Leaders*:** The Governments, both Federal and Provincial, need to act resolutely to engage religious leaders to endorse and advocate the national narrative on family planning. There should be learning from the experience of Bangladesh.

***Higher Priority to Family Planning*:** The Provincial Governments will need to increase the outlay on population planning and raise allocation for this purpose to at least 3 percent of the budgeted expenditure. This will involve the expansion of coverage and provision of integrated family planning services at all healthcare posts. Post-pregnancy family planning should be introduced in all clinics. Women must be given access at very low prices to modern methods of contraception.

***Expansion of Lady Health Workers*:** As emphasized earlier the number of Lady Health Workers needs to be doubled on a priority basis. Their role will be also to provide counselling and family planning services. Their employment status needs to be regularized and they should be absorbed in the appropriate BPS. The pre-dominant majority of LHWs must operate in the rural areas and suitable logistical arrangements made for this purpose.

***Civil Society Campaigns*:** The corporate sector in its role of social responsibility, academia, non-governmental organizations, and youth should participate more aggressively in family planning campaigns. In particular, the media must convey public messages on optimal family size and control.

***Conditional Cash Transfers*:** The EHSAAS program should include conditional cash transfers to women who do not get their child to work and or adequately space births.

In conclusion, we quote the Federal Planning Minister who said recently, *‘With such a phenomenal impact in such a short duration on key development outcomes, we should make population growth reduction as one of our top national priorities’*

on

World Population Day.

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List of Acronyms

ADB	Asian Development Bank
ADBP	Agricultural Development Bank of Pakistan
ADP	Annual Development Program
AML	Anti- Money Laundering
BCPR	Beaconhouse Centre for Policy Research
BISP	Benazir Income Support Program
BMR	Balancing, Modernization and Replacement
BPRL	Benchmark Prime Lending Rate
BPS	Basic Pay Scale
CBA	Collective Bargaining Agent
CCI	Council of Common Interests
CPEC	China-Pakistan Economic Corridor
CPI	Consumer Price Index
CPPA-G	Central Power Purchasing Agency – Government
DAP	Di Ammonium Phosphate
DC Rate	Deputy Commissioner Rate
DC	District Council
DEDO	Duty Exemption and Drawback Office
DFI	Development Financial Institution
DFIA	Duty Free Import Authorization
DFIS	Development Finance Institutions
DIP&S	Department of Investment Promotion and Supplies
DISCOs	Power Distribution Companies
DRA	Disparity Reduction Allowance
ECGC	Export Credit Guarantee Corporation
ECGS	Export Credit Guarantee Scheme
EDF	Export Development Fund
EO	Export Obligation
EOBI	Employees Old Age Benefits Institution
EOUS	Export Oriented Units
EPCG	Export Promotion Capital Goods
EPZA	Export Processing Zones Authority
EPZs	Export Processing Zones
ERRA	Earthquake Rehabilitation and Reconstruction Authority
FATA	Federally Administrative Tribal Area
FATF	Financial Action Task Force

FBR	Federal Board of Revenue
FESCO	Faisalabad Electric Supply Co. Ltd.
FLL-I	Federal Legislative List-I
FLL-II	Federal Legislative List-II
FRDL	Federal Responsibility and Debt Limitation
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GDS	Gas Development Surcharge
GENCO-II	Power Generation Companies
GEPCO	Gujranwala Electric Power Company
GER	Gross Enrollment Rate
GHDR	Global Human Development Report
GHPL	Government Holding Private Ltd.
GNI	Gross National Income
GRI	Gross Regional Income
GRPs	Gross Regional Products
GST	General Sales Tax
HBFC	House Building Finance Corporation
HEC	Higher Education Commission
HESCO	Hyderabad Electric Supply Co. Ltd.
HIES	Household Integrated Economic Survey
HRD	Human Resource Development
HSD	High-Speed Diesel
ICT	Islamabad Capital Territory
IDB	Islamic Development Bank
IDBP	Industrial Development Bank of Pakistan
IDPs	Internally Displaced Persons
IESCO	Islamabad Electricity Supply Company
ILO	International Labor Organization
IMF	International Monetary Fund
IOCO	Input-Output Coefficients Organization
IPP	Independent Power Producer
IPP	Institute of Public Policy
IPPs	Independent Power Producers
IT	Information Technology
ITO	Income Tax Ordinance
ITO	Income Tax Ordinance
ITPs	International Trade Prices
K-Electric	Karachi Electric

KSE	Karachi Stock Exchange
KWH	Kilowatt Hour
LDC	Least Developed Country
LESCO	Lahore Electric Supply Company
LFS	Labor Force Survey
LHW	Lady Health Worker
LIMS	Labor Information Management System
LNG	Liquid Natural Gas
LQ	Location Quotient
LSSMS	Living Standards and Social Measurement Survey
MC	Municipal Committee
MDGs	Millennium Development Goals
MEPCO	Multan Electric Power Company
MFN	Most Favored Nation
MLF	Mahajir Labor Federation
MMC	Metropolitan Corporation, Municipal Corporation
MNCs	Multinational Companies
MOF	Ministry of Finance
MTBF	The Medium-term Budgetary Framework
MTBs	Market Treasury Bills
MW	Mega Watt
NAPHDA	Naya Pakistan Housing Development Authority
NEC	National Economic Council
NEPRA	National Electric Power Regulatory Authority
NER	Net Enrollment Rate
NESPAK	National Engineering Services of Pakistan
NFC	National Finance Commission
NFC	National Finance Commission
NHA	National Highway Authority
NIC	National Insurance Corporation
NIRC	National Industrial Relations Commission
NIT	National Investment Trust
NLF	National Labor Federation
NPPMC	National Power Parks Management Company
NTDC	National Transmission and Dispatch Company Limited
O&M	Operation and Maintenance
OGDC	Oil and Gas Development Corporation
OGRA	Oil and Gas Regulatory Authority
PAEC	Pakistan's Atomic Energy Commission

PARCO	Pak Arab Refinery
PASMIC	Pakistan Steel mills Corporation
PASSCO	Pakistan Agricultural Storage and Supplies Corporation
PBC	Pakistan Business Council
PBS	Pakistan's Bureau of Statistics
PE&T	Provincial Excise and Taxation Department
PEFG	Pakistan Export Finance Guarantee
PEPCO	Pakistan Engineering Co. Lt.
PES	Pakistan Economic Survey
PESCO	Peshawar Electric Supply Company
PFC	Provincial Finance Commission
PHPL	Power Holding Private Limited
PIA	Pakistan International Airline
PIB	Pakistan Investment Bond
PIT	Presumptive Income Tax
PML(N)	Pakistan Muslim League (Nawaz)
PNSC	Pakistan National Shipping Corporation
PO	Presidential Order
PPAF	Pakistan Poverty Alleviation Fund
PMDC	Pakistan Mineral Development Corporation
PPL	Pakistan Petroleum Limited
PPP	Public-Private Partnerships
PSDP	Public Sector Development Program
PSM	Pakistan Steel Mill
PSO	Pakistan State Oil
PTDC	Pakistan Tourism Development Corporation
PTI	Pakistan Tehreek Insaaf
PWF	Pakistan Workers Federation
QESCO	Quetta Electric Supply Company
QUESCO	Quetta Electric Supply Company
R&D	Rural and Development
RBC	Reinforced Brick Construction
RCC	Reinforced Cement Construction
REER	Real Effective Exchange Rate
RLNG	Liquefied Natural Gas
RTA	Regional Trade Agreement
SAFTA	South Asian Free Trade Agreement
SBC	Sadharan Bima Corporation
SBP	State Bank of Pakistan

SDGs	Sustainable Development Goals
SECP	Securities and Exchange Commission of Pakistan
SEPCO	Sukkur Electric Power Company
SEZs	Special Enterprise Zones
SFIS	Served from India Scheme
SION	Standard Input-Output Norms
SLIC	State Life Insurance Corporation
SMEs	Small-Medium Enterprises
SNGPL	Sui Northern Gas Pipelines Limited
SOEs	State Owned Enterprises
SPDC	Social Policy and Development Centre
SPI	Sensitive Price Index
SSGC	Sui Southern Gas Company
TC	Town Committee
TCP	Trading Corporation of Pakistan
TDAP	Trade Development Authority of Pakistan
TESCO	Tribal Areas Electric Supply Company
TIP	Telephone Industries of Pakistan
UAE	United Arab Emirates
UC	Union Council
UNDESA	United Nations Department for Economic and Social Affairs
UNDP	United Nations Development Program
UNIDO	United Nations Industrial Development Organization
USA	Untied State of America
USC	Utility Stores Corporation
WAPDA	Water and Power Development Authority
WPI	Wholesale Price Index
WPPF	Worker’s Profit Participation Fund
WTO	World Trade Organization
WWF	Workers’ Welfare Fund

About the Author

Dr. Hafiz A. Pasha is Professor Emeritus at Beaconhouse National University, Lahore. He has served as Assistant Secretary General of the United Nations. He has been the Federal Minister for Commerce, Planning and Finance in three Governments of Pakistan. Earlier, he served as Vice Chancellor of the University of Karachi, Dean of IBA and Director of the Applied Economics Research Centre. He has received a number of international and national awards.

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1st Floor, 66-W, Junaid Plaza, Jinnah Avenue
Blue Area, Islamabad, Pakistan

Responsible:
Dr. Jochen Hippler
Country Director
Abdullah Dayo
Programme Coordinator

Phone: +92 51 2803391-4
E-mail: info@fes-pakistan.org
Website: http://pakistan.fes.de

To order publication:
info@fes-pakistan.org

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