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A Review on Fiscal and Debt Policies in Pakistan

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ABSTRACT

Pakistan has been pursuing an active albeit expansionary fiscal policy since 1970s. In the mid-1970s to early-1980s, such policy choice was manifested in externally financed development spending, primarily in the form of investment in public enterprises. Despite excessive deficit financing, Pakistan's economic performance never took off; rather, it remained on a path of truncated growth which, in turn, created structural hurdles like low productivity, poor investment climate, and higher unemployment. Likewise, deficit financing has been threatening the sustainability of fiscal framework as excessive public spending is not accompanied by corresponding enhances in domestic revenues. Consequently, these policies have caused persistence in fiscal deficit and the accumulation of public debt over time. These woes are added further by persistent deficit in external accounts and, the resultant depreciation of Pakistani Rupee, which has havocked the cost of debt-servicing over the same period. Given the history of incessant macroeconomic imbalances; currently, Pakistani economy has been trapped into a vicious circle of stagflation and low growth prospects amid unfunded losses of the State Owned Enterprises (SOEs), government guarantees to the Independent Power Producers (IPPs), unsustainable debt and huge cost of debt-servicing, sky-rocketing prices of the essential items, frequent though unsuccessful bail-outs of the IMF, low credit worthiness and negligible level of investment among others. This review is focusing on a detailed analysis of Pakistan's fiscal and debt policies, with a view to provide a framework for resolving the structural economic woes that the country has currently been faced with.

JEL Classifications: E62, H11, H50, H62, H63

Keywords: Fiscal Policy; Debt, Fiscal Deficit; Truncated Growth, Structural Economic Woes, Pakistan

1. INTRODUCTION

Fiscal policy in general is used to manage macroeconomic framework through the use of public spending and tax policies. In fact, it is aimed to steer variables like aggregate demand, inflation, employment, economic growth, debt etc. In this way, it is instrumental in stabilising the fluctuations in business cycles and regulating economic output, especially when markets have frictions (Ali, et al. 2018; Ali & Khan, 2020). For instance, during recession, governments usually lower tax rates or boost spending to increase demand and spur economic activity. Conversely, to combat inflationary pressures, governments may raise tax rates or cut spending to cool down pressures on the aggregate demand. Nevertheless, in all of its shapes, policy making and execution at fiscal level is conducted by elected and non-elected government officials. In Pakistan, fiscal policy is executed through its annual budgetary processes where allocations for spending heads and revenue targets are set at the beginning of each financial year. With regard to its history, fiscal policy in Pakistan originated in the same way as was in other developing countries where it was basically used as an instrument for industrial development. In the mid-1970s to early-1980s, Pakistan's fiscal policy was based on deficit financing which was facilitated by external aid and credits at concessional rates. Especially, it was manifested in externally financed development spending as well as investments in State Owned Enterprises (SOEs) in those years (Haque & Montiel, 1992).[1] The availability of credit at concessional rates at both the external and domestic markets though facilitated the expansion in public sector at that time but it were the beginnings of persistence in fiscal deficit as there was no corresponding increases in domestic revenues. The situation was chronic at both sides as there was no persistent growth which could raise the potentials for tax revenue; and, also, tax policy was not congruent which was largely based on preferential tax exemptions and concessions.[2] In the later years (late 1980s and 1990s), the successive governments were unable to bring fiscal deficit down as neither could they achieve significant reductions in public expenditure nor could raise domestic revenue (Khan, 2024). As a result, Pakistan has experienced debt accumulation over most of its history.

Though, in Pakistan's case, deficit financing led to the accumulation of debt but it is usually the fiscal policy which can be instrumental in managing debt in addition to its impacts on aggregate demand, growth, and inflation.[3] If we look at the global history of fiscal policy, governments usually resort to printing money or raising debt when tax revenue is not sufficient to finance public spending. Even they go for external borrowing in addition to domestic borrowing, especially when they are unable generate adequate resources domestically (Jalil, 2020). Debt by itself is not bad when it is used as an instrument for spurring economic growth; however, it is bad when there is no capacity to repay debts. In developing countries like Pakistan, we have experienced significant lack of such a capacity. In other words, repayments in such cases are usually associated with

[1] This policy was officially displayed by Bhutto's Nationalisation Policy, when all major industries, including iron and steel, heavy engineering, heavy electricals, petrochemicals, cement, and public utilities etc. were nationalised.

[2] The beneficiaries of such a tax policy were the major industrial groups who got substantial tax credits as well as the landed elite who were the main hurdle in imposing agricultural income tax.

[3] In other words, it is the fiscal imbalance which leads to the accumulation of public debt.

sustainability issues, especially when the governments are unable to repay the existent debts through their domestic resources. For instance, we have recently observed default in Sri Lanka and, similarly, the risks of default were looming on Pakistan. Alternatively, debt beyond certain limit or unsustainable debt have severe repercussions for the long-term economic development of the indebted country as it not only crowds-out private investment but also worsens the credit worthiness of the country. Moreover, in the framework of overlapping generation models, unsustainable public debt is considered to be inversely associated with the long-run economic prosperity as savings, which are supposed to be used for future generations, are spent on servicing higher public debt. As, in case of Pakistan, the existing costs of debt servicing is around 50 percent of Pakistan's total budgetary outlay, implying larger burdens for future generations as is prophesied in the famous Ricardian Equivalence. This, in other words, implies that unsustainable debt is costly not only in terms of current budgetary process but also in terms of worsening future's economic growth. In this review, the focus is on the persistence of Pakistan's fiscal deficit and its interaction with its public debt. Especially, we have two objectives. First, we want to see how persistence in fiscal deficit or budgetary support through borrowing has accumulated Pakistan's debt stock or what has caused such alarming situations with regard to debt obligations. Second, we want to review the relevant literature in this regard in order to develop some general propositions with regard to Pakistan's fiscal and debt policies. Rest of the study is organised in five sections. Section 2 overviews Pakistan's persistence in fiscal deficit and its implications on the accumulation of public debt. In Section 3, we discuss debt sustainability issues in Pakistan, with particular focus on the relevant literature on Debt Sustainability Analysis (DSA). Likewise, in Section 4, we cite the literature and discuss the response of fiscal policy to the accumulation of debt which is mainly manifested in Fiscal Reaction Function (FRF). Section 5 is with regard to the potential implications of Pakistan's fiscal deficit and debt for other macroeconomic variables. Also, in this section, we elaborate on the post Budget 2024-25 and Post Finance Bill 2024-25 scenario in order to highlight the prospective hardships that are currently faced by majority of the economic agents. Finally, in Section 6, we conclude with the purpose to provide a framework which could bring fiscal deficit and debt down to the manageable levels.

2. OVERVIEW OF PAKISTAN'S FISCAL DEFICIT AND PUBLIC DEBT

Amid recent stagflation, Pakistani economy is trapped into a scenario where the country is faced with low growth prospects, persistent macroeconomic imbalances, and enlarged vulnerabilities of a sizeable fraction of the populace. Among these, fiscal deficit is one of the fundamental causes of Pakistan's structural economic woes. Pakistan faced a fiscal deficit of around 7.6 percent of GDP for out-going fiscal year (financial year 2023-24), calling for more borrowing in the current fiscal year and enlarging the future liability. As is stated in the introduction, Pakistan has been facing fiscal deficit for most of its history. Persistence in fiscal deficit is caused by both a flawed tax system and unproductive spending behavior of the successive governments. As far as recent trends in fiscal deficit are concerned, three factors, i.e. the Covid-19 pandemic, the Russia-Ukraine conflict, and devastating floods in 2022 have contributed in this regard. Cumulatively, due to these factors, economic activities across the country stalled as a result of global

slow-down along with floods-led widespread destruction of the agriculture sector and other infrastructure. Especially, the public spending for social protection, reconstruction, and rehabilitation ballooned. Nevertheless, keeping the impacts of these shocks aside, Pakistan has been facing persistence in fiscal deficit since 1970s (Tahir, 2019). Before Bhutto's regime, fiscal deficit was for the first time aroused in 1965-66, a war year, when the defence spending more than doubled in a single year. Likewise, the next deficit did appear in another war year, i.e. 1971-72. In contrast, in Bhutto's time, fiscal deficit was mainly due to development expenditure and investment in State Owned Enterprises (SOEs).[4] For instance, in 1976-77, development expenditure increased to 11 percent of GDP compared to a tax-to-GDP ratio of only 10 percent. In other words, one percent more than the revenue was used for development. It was mostly public investment which, in fact, laid the foundations of growth in the Zia years. Similar trends continued even during Zia's regime, i.e. development expenditure was financed with fiscal deficit.[5] Furthermore, Junejo's 9 percent fiscal deficit was absorbed in a development expenditure of 7 percent and a revenue deficit of 2 percent. Since then, we have persistence in our fiscal deficit, with the exception of Musharraf Era (2001-2007) when Pakistan had got substantial amount of US Aid in return for being the front line state in War on Terror (WOT), (See Figure 1).

Both a flawed tax system and unproductive expenditure are equally attributable to persistent fiscal deficit.[6] Pakistan has one of the World's lowest tax-to-GDP ratio, hovering around 10 to 11 percent of GDP (only 9 percent for financial year 2023-24). It mainly stems from a tax system which is characterised by complexity, narrowness in base, low compliance, inefficient administration, and declining provincial tax revenues (Ahmed & Mangla, 2018). It has led to widespread discretion and corruption, with inequitable exemptions and preferential treatments, low tax registration, and massive tax evasion. The outcome is a regressive tax system (indirect taxes make up around 60 percent of total taxes).[7] For current fiscal year, the total revenue from indirect taxes is estimated at 57.5 percent of total revenue (Rs. 7,458 billion out of total of 12,970 billion). Indirect taxes combined with a corporate income of around 29 percent create anti-growth bias by shaping distortions in resource allocation. Likewise, tariff policy has strangled competition and growth, with the average effective tariff rate (11.2 percent) being the highest in the region. Moreover, 68 percent of direct taxes are derived from withholding taxes, with the share of direct taxes in total revenue decreases significantly if we exclude withholding taxes. Along with these issues, Pakistan's tax collection is costly as from around Rs. 35 billion in 2000-01, tax expenditures have been swelled to Rs. 3.9 trillion in financial year 2023-24 (Khan, 2024).[8]

Similar is the case with public expenditure, especially the current expenditure, which are increasing consistently. Over time, Pakistan has experienced spread in size

[4] For instance, in 1975-76, fiscal deficit was 10 percent of GDP. Likewise, it was percent in 1976-77.

[5] In 1978-79 fiscal deficit was percent of GDP which was fully utilized for development.

[6] See for details Khan and Khalid (2024).

[7] Total tax revenue in financial year 2023-24 was Rs. 9,252 billion, out of which Rs. 5,531 billion was coming from indirect taxes.

[8] Tax Expenditure constitutes around 54 percent of the total tax revenue for financial year 2023-24.

Fig. 1. Pakistan's Financial Year-Wise Fiscal Deficit

Source: Author's Calculation of Pakistan Economic Survey (Various issues).

with proliferation of ministries, government departments, and various agencies, which has imposed a substantial cost in terms of salaries, benefits, and pensions (PIDE, 2023). In addition, interest payments, defense spending, and subsidies has been ballooned. As is evident from table 1, which is exhibiting the budget of financial year 2024-25, of the gross revenue of Rs. 17.815 trillion, the federal government will have a net amount of Rs. 10.377 trillion after transferring Rs. 7.438 trillion to the provinces under the National Finance Commission (NFC) award. Given an allocation of Rs. 9.775 trillion to debt-servicing, it implies that almost all other heads like defense spending, pensions, running of the civil government, Public Sector Development Program (PSDP) etc. are to be financed by borrowing.[9] Likewise, there is a sizable footprint of the government in the economy, with around 212 State-Owned Enterprises (SOEs) are operating in various sectors (Government of Pakistan, 2023).[10] It not only restricts competition in the market but also puts a significant drain on the budgetary resources, with their annual losses reaches to around Rs.2 trillion for the financial year 2023-24.[11] Further, Pakistan's power sector, dominated mainly by public limited companies, is facing severe financial crisis as

[9] Around 45 percent of the total outlay would be financed through borrowing.

[10] The government's footprint in the economy exceeds 60 percent of the GDP as is estimated by PIDE.

[11] The budgetary impact of SOEs has climbed from 9.2 percent of the budget in 2000 to 46.2 percent in 2022-23 because of payments to Independent Power Producers (IPPs) (Khan, 2021).

their circular debt, the amount of money that the government owes to power producers and fuel suppliers, has reached to Rs.2.728 trillion by the end of April, 2024.[12]

The budgetary shortages are added by the external sector shortages as is shown by the persistence in current account deficit in Figure 2. The current account is persistently in deficit, again, with the exception of the beginning of Musharraf era (2001 to 2005). Alternatively, Pakistan has never been able to cope with its macroeconomic imbalances amid condensed growth performance.[13] In particular, the twin deficits cumulatively has not only led to the accumulation of public debt but they are also a significant drain on the budgetary resources as is shown by interest paid on public debt as percentage of GDP over time (see Figure 2).[14]

Table 1

Federal Budget 2024-25 at a Glance (Rupees in Billion)

Resources		Expenditure	
Tax Revenue (FBR)-Federal Consolidated Fund	12,970	A. Current	17,203
Non-Tax Revenue	4,845	Interest Payments	9,775
a) Gross Revenue Receipts	17,815	Pensions	1,014
b) Less Provincial Share	7,438	Defence Affairs and Service	2,122
I. Net Revenue Receipts (a-b)	10,377	Grants and Transfers to Provinces and others	1,777
II. Non-Bank Borrowing (NSSs and Others)-Public Account	2,662	Subsidies	1,363
		Running of Civil Government	839
III. Net External Receipts Fed Consolidated Fund	666	Provisions for Emergency and Others	313
IV. Bank Borrowing (T-Bills, PIBs, Sukuk)-Fed Consolidated Fund	5,142	B. Development and Net Lending	1,674
V. Privatisation Proceeds Fed Consolidated Fund	30	Federal PSDP	1400
Total (II+III+IV+V)	8,500	Net Lending	274
Total Resources (I to V)	18,877	Total Expenditure (A+B)	18,877

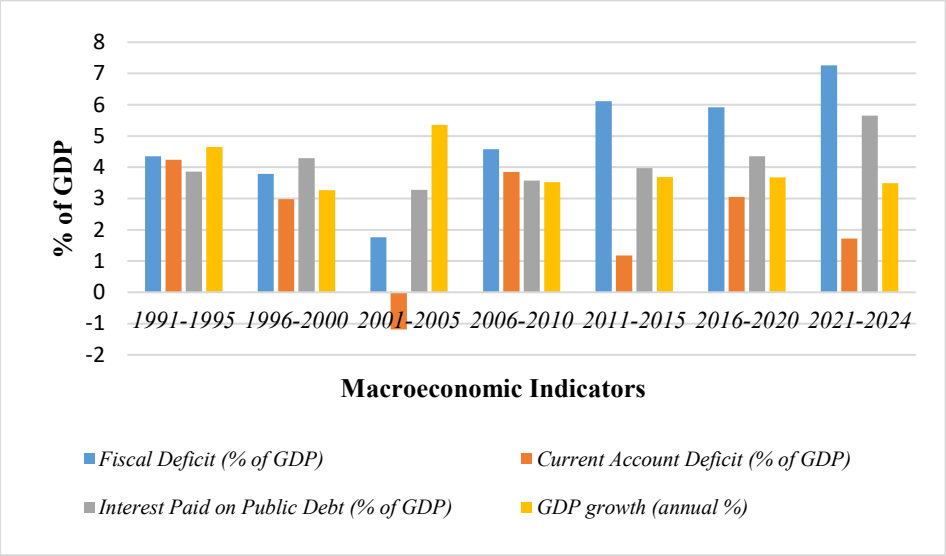
Source: Federal Budget 2024-25 in Brief, Government of Pakistan.

[12] It comprises payment owed to Independent Power Producers (IPPs) at Rs. 1.854 trillion, payable to Generation. Companies (Gencos) at Rs.109 billion, and the volume of the loans of Rs.765 billion parked at Government Holdings Private Limited (GHPL).

[13] If we look at the data from the last three and a half decades, the rate of economic growth has been truncated for almost all of the time except the beginning of Musharraf era (2001 to 2005).

[14] The current debt to GDP ratio in Pakistan is 82 percent while Pakistan is currently paying huge interest on its debt constituting almost 7 percent of GDP, 52 percent to total budgetary outlay, and 75 percent of tax revenue.

Fig. 2. Pakistan's GDP Growth Rate, Macroeconomic Imbalances, and Interest



Source: Author's Calculation from Pakistan Economic Survey (Various Issues).

3. PAKISTAN'S DEBT SUSTAINABILITY ANALYSIS (DSA)

Debt management basically implies maintaining a delicate balance between the borrowing needs of a country to support its development process vis-à-vis the country's repayment capacity. In other words, it is extremely necessary to ensure that the optimal financing options are selected in view of the cost and risk tradeoffs. Formally, debt sustainability refers to the level of debt which permits a country to fulfill its present and upcoming debt servicing obligations without any rescheduling or accumulation of accruals. Thus, a debt is sustainable when the debt-to-GDP ratio turns down or remains unaffected with fiscal deficit, i.e. fiscal deficit should not push the debt-to-GDP ratio to move faster than the growth rate of GDP even though if it is not zero. This concept implies that borrowings are only unproductive when the capacity to repay of the indebted country is limited. The repercussions of unsustainable debt are huge, ranging from huge interest payments to lower capacity of development spending and social protection, declining credit worthiness, and even the risks of sovereign default. These repercussions are summarised in or can be gauged by the Debt Sustainability Analysis (DSA) of a country (IMF, 2002).[15] DSA is used to improve debt transparency, fiscal sustainability, and strengthen public debt management. Alternatively, by employing historical growth context and policy choices, DSA evaluate the debt sustainability in optimistic and pessimistic scenarios. DSA is theorised in the following simple equation which provides the dynamics of debt projections under various assumptions in the context of policy

[15] The IMF has developed a formal framework for conducting public and external debt sustainability analyses (DSAs) as tool to better detect, prevent, and resolve potential crises. This framework became operational in 2002.

decisions. The model is in fact the tool of the IMF which is usually based on the Public and Publically Guaranteed Debt (PPG).[16]

$$d_t = \frac{(1+r)}{(1+g)} * d_{t-1} - pb_t \text{..} (2).$$

In equation, r and g are historical real interest rate and growth rate, respectively. d and pb are showing debt and primary balance, respectively.[17] Equation 1 implies that when a country's debt-to-GDP ratio rises, it is then required to run surpluses in primary balance and promote measures that support higher long-term economic growth in order to bring it down.

There are a number of studies which have done debt-sustainability analysis for Pakistan but here I want to discuss the most recent and relevant ones. The latest analysis is done in the ministry of finance's Debt Sustainability Analysis Report (DSAR) 2022-23. The report, while keeping the average-growth rate at 4.67 percent and average inflation rate at 11.67 percent along with zero average primary balance for three years, estimates that the Public and Publicly Guaranteed (PPG) Debt to GDP ratio to be 63 percent, with guarantees of only 3.1 Percent of GDP, by the end of financial year 2025-26.[18] This in other words implies that the Public Debt-to-GDP ratio is projected to be around 60 Percent compared to the limit of 55.25 percent of the FRDL Act for financial year 2025-26. Though the projection is interesting but it would really depend on persistent fiscal consolidation in the three years along with favourable growth-interest rate differential. Likewise, Jalil (2020) has done DSA for optimistic, historical, and pessimistic scenarios.[19] In optimistic scenario (zero primary balance), with average annual growth rate of 4.5 percent, the debt-to-GDP ratio would reach to 60 percent by 2031, which is the general limit in FRDL Act. This projection is based on real interest rate of 1.5 percent which is its historical average and 2.1 percent growth rate of population. With the same assumptions with regard to real interest rate but a primary balance of -2.5 percent (historical scenario), the GDP growth must be 6.6 percent (the average of last twenty years (4.5 percent) plus population growth of 2.1 percent) to maintain the debt-to-GDP ratio at 86 Percent which is the actual debt-to-GDP ratio at the end of financial year 2019-20. The FRDL Act limit of 60 percent can be achieved by 2027 but only at a growth rate of 10 percent on average. Finally, in pessimistic scenario (when the primary balance is -4.3 percent), and a real interest rate at its historical level, the growth rate must be 8.9 percent to maintain the debt-to-GDP ratio at 86 percent, again, which is 2019-20 level. Moreover, the FRDL Act limit may be achieved by 2040 but only at a growth rate of 10 percent. The main crux of Jalil (2020) is that Pakistan has to either keep primary balance at zero level or grow sufficiently faster in order to bring the existing debt down to a sustainable level.

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[16] Public and publicly guaranteed debt servicing is the sum of principal repayments and interest actually paid in currency, goods, or services on long-term obligations of public debtors and long-term private obligations guaranteed by a public entity. In contrast, FRDLA 2005 defines "Total Public Debt" as debt owned by government (including Federal Government and Provincial Governments) serviced out of consolidated fund and debts owed to the IMF.

[17] Fiscal Deficit=Total Expenditure-Total Receipts except Borrowing. Primary Deficit=Fiscal Deficit-Interest Payments.

[18] The average is taken for three financial years 2023-24, 2024-25, 2025-26.

[19] The three scenarios are defined by the level of primary balance, with optimistic (baseline) scenario is when primary balance is zero, historical scenario is when primary balance is at historical level (-2.2percent), and the pessimistic scenario is when primary balance is at historical high level of the last 10 years (-4.3 percent).

Table 2
Summary of the Studies on Debt Sustainability Analysis (DSA) in Pakistan

Study Name	Assumptions	Findings	Reasons	Risks
SAR (2022-23)	g =4.67% *CPI* = 11.67% *PB* = 0	$\frac{PPG}{GDP} = 63\%$ in 2026 *PPG* = 3.1% of GDP	Fiscal Consolidation and Favorable Growth-Interest Rate Differential	Exchange rate shocks, the combined macro-fiscal and contingent liability shocks, gross financing needs and liquidity risks
Jalil (2020)	r = 1.5% $\frac{Debt}{GDP} = 86\% *$	$\frac{Debt}{GDP} = 60\%$ in 2031 when *pb* = 0% & g = 4.5% $\frac{Debt}{GDP} = 60\%$ in 2027 when *pb* = -2.5% & g = 6.6% $\frac{Debt}{GDP} = 60\%$ in 2040 when *pb* = -4.3% & g = 10%	Fiscal Consolidation and Favorable Growth-Interest Rate Differential	The larger the deficit in primary balance, the larger the debt-to-GDP ratio or the higher the growth needed to maintain the current debt-to-GDP ratio
Wajid, et al. (2023)	r = 2.7% $\frac{Debt}{GDP} = 86\% *$	$\frac{Debt}{GDP} = 60\%$ in 2030 when *pb* = 0% & g = 4.5% (g>r) $\frac{Debt}{GDP} = 60\%$ in 2030 when *pb* = -3.5% & g = 10% (g>r)	Fiscal Consolidation and Sustainable Growth Rate	External Shocks to growth Rate such as Covid-19, Russia-Ukraine, and Floods etc.
Mahmood, et al. (2009)	Actual real interest rate and growth rates decade-wise	Both the public debt and external debt was unsustainable in 1970s, 1980s,and 1990s. Sustainability Improves (2001-005) & Worsen Again (2005-2010)	Persistence in Fiscal Deficit and CAD, Stagnant Tax-to-GDP Ratio & truncated Economic Growth	Still No Reforms, Gloomy Growth Prospects, Non-Favorable External Accounts

Notes:g =Average growth rate, r = Average Real Interest Rate, PB = Average Primary Balance, CPI =Average Inflation Rate.

*Initial Value (At the end of financial year 2019-20).

Wajid, et al. (2023) is another study which did DSA for Pakistan. This analysis is based on data from 1976 to 2021 and, accordingly, the historical average of real interest rate of 2.7%. On the basis of this set up and historical GDP growth rate of 4.5 Percent, the debt-to-GDP ratio is estimated to drop from the current 86 percent (again, the 2019-20 level) to 64 percent by 2030 if the government can maintain zero primary balance. The FRDL Act limit of 60 percent can only be attained if the annual growth rate of GDP is more than the historical average of 4.5 Percent while the real interest is below its historical level. In contrast, in pessimistic scenario, with all real interest rate and primary balance at their historical levels (real interest rate at 2.7 percent and primary balance at -3.5 percent), a growth rate of 10 percent is required to bring the debt-to-GDP ratio down to

the FRDL Act level. In a slightly different approach, Mahmood et al. (2009) had looked at a decade-wise debt sustainability from 1970s to 2000s. On the basis of decade-wise actual real interest and growth rates, the study shows that both the public and external debt have never been sustainable in Pakistan with the exception of the beginning era of Musharraf regime (2001-2005). Alternatively, both the public debt and external debt were unsustainable throughout the decades of 1970s, 1980s, and 1990s. Whereas the debt situation improved in the first half of 2000s (the beginning of Musharraf era with significant US Aid received by Pakistan) and, then, started to worsen in the second half of 2000s. In addition to these studies, there are many studies which did the DSA for Pakistan but the results are more or less the same, showing unsustainability of the debt, especially if the situation remains the same. In other words, a higher and sustainable growth is needed to come out of the existing debt-trap. The summary of DSA in Pakistan is summarised in proposition 1.

Proposition 1: *Debt sustainability improves in lowering the deficit in primary balance and/or raising economic growth. Alternatively, debt sustainability requires a two-fold strategy. First, gradually reduce deficit in primary balance. Second, rapid growth, especially a rate which is higher than the real interest rate, is of upmost importance for debt sustainability and resolving the existing structural economic woes in Pakistan.*

4. PAKISTAN'S FISCAL RESPONSE TO PUBLIC DEBT AND OUTPUT GAP

In addition to DSA, debt sustainability can also be gauged from Fiscal Reaction Function (FRF) which shows the fiscal response of a country to the accumulation of debt. It is captured by variations in primary balance which are caused by fluctuations in output gap and debt levels. FRF implies that, for debt sustainability, increase in primary surplus is needed to offset the increase in debt as the debt levels increase. An extended form of FRF is given by the following equation:

$$pb_t = a_0 + a_1 pb_{t-1} + a_2 d_{t-1} + a_3 og_t + a_n X_{tn} + \varepsilon_t \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (2)$$

$$pd_t - pd_{t-1} = r_t pd_{t-1} + G_t - R_t \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (3)$$

Where pb_t denotes the primary balance-to-GDP ratio at time *t*; similarly, d_{t-1} shows the previous period's debt-to-GDP ratio, og_t represents the output gap at time *t*, and $\boldsymbol{\varepsilon_t}$ is used for the error term. *X* is the set of control variables like oil prices, Current Account Deficit (CAD), Dummies for external shocks and other domestic characteristics of the indebted country. The signs of the coefficients α_1 and α_2 should be expected to be positive if we presume persistence in primary balance and if the country is responsive to an upsurge in its debt by controlling its fiscal policy. Alternatively, a statistically significant and positive lagged public debt coefficient indicates sustainable public debt. In contrast, if this coefficient is negative and significant, it implies the fiscal policy is not responsive to the accumulation of public debt.[20] Likewise, a significant positive and negative $\boldsymbol{\alpha_3}$ implies that fiscal policy is counter-cyclical or pro-cyclical, respectively.

[20] In other words, the budget of the government does not change with the increased debt.

Like DSA, FRF is estimated in a number of studies for Pakistan.[21] Khalid et al. (2007), while taking output gap and inflation as policy objectives, tries to capture the response of Pakistan's fiscal policy to the state of economy. In endogenous setting with inflation, output gap and fiscal deficit as variables, the study identifies the transmission mechanism of fiscal policy and, thereby, estimates FRF. The study finds that fiscal response in terms of fiscal deficit is pro-cyclical in boom; while in recessionary periods, it is insignificant. Government expenditures reflect anti-cyclical response in the recessionary periods but are insignificant in boom. In comparison, tax policy is pro-cyclical for both recession and boom. Likewise, Wajid, et al. (2023) estimates proper FRF by using data from 1976 to 2021. The study finds that Fiscal policy is not responsive to the accumulation of public debt as is shown by the insignificant coefficient of lagged public debt. Likewise, external debt is unsustainable as is shown by the negative and significant coefficient of lagged external debt. This result is justified by two explanations. First, around 62 percent of Pakistan's total debt is domestic debt and, usually, governments are a bit risk takers vis-à-vis domestic debt.[22] Second, most of external debt, especially the debt of multi-lateral creditors, involve conditionalities with respect to budgetary policies such as primary balance or tax policy etc. In Pakistan's case around 45.3 percent of the external debt is those of the multi-lateral donors which involve strict conditionalities with regard to primary balance, containing the circular debt, governance of the SOEs, and tax policy etc. However, these conditionalities are not sufficiently enough to maintain the sustainability of external debt. Wajid, et al. (2023) further elaborates that fiscal policy is persistent in its behavior as is shown by the significant coefficients of lagged primary balance in cases of both total public debt and external debt. Furthermore, the coefficient of output gap is insignificant for both the total public and external debts though the sign of the coefficient is positive in both cases. This in other words implies that fiscal policy is counter-cyclical and, thereby, offers weak evidence in support of the assertion that fiscal policy is not being used as a stabilisation tool.

Mehak & Hyder (2019) finds something which are in Sharpe contrast to Wajid, et al. (2023). Alternatively, Mehak & Hyder (2019) finds that external debt is sustainable to a larger extent while the total debt is not sustainable. This, in other words, suggests implies that conditionalities associated with external debt are helpful in roads towards achieving sustainability to external debt. The study overall suggests that that fiscal deficit needs to be contained with the mobilisation of domestic resources and the observance of austerity. Mansoor, et al. (2020) shows that Pakistan just entered into a phase of unsustainable debt burden as its FRF exhibits the weak significant negative relationship between primary balance and external debt to GDP ratio. Moreover, macroeconomic policies are ineffective in making the external debt of Pakistan sustainable. In nutshell, these studies are summarised in proposition 2.

Proposition 2: *The studies on FRF shows that debt has entered into unsustainable phase in Pakistan. Fiscal Policy, which is persistent in its nature, is not responsive to both the public and external debts. Though conditionalities associated with multilateral debt are helpful in roads towards sustainability of the external debt but the government's behavior towards the domestic debt exhibits too much risk-taking. Fiscal policy must provide active*

[21] A snapshot of these studies is given in Table 3.

[22] Domestic debt is usually easily controllable through printing money or allowing inflation in the domestic economy.

response to the debt management, especially in situations where the shocks are exogenous, FP should have acyclicality in its usage.

Table 3

Studies on Fiscal Reaction Function (FRF) in Pakistan

Study Name	Variables (Data)	Findings	Conclusion
Mehak and Hyder (2019)	DV=pb_t; EV= d_{t-1}; og_t *X*= IMF programmes, Rescheduling, Regime Data Range 1973-2018	$\alpha_{2=0.100}$** $\alpha_{3=0.372}$**	PD is not Sustainable ED is Sustainable to a Larger Extent
Wajid, et al. (2023)	DV=pb_t; EV=pb_{t-1}; d_{t-1}; og_t *X*= CAB, Oil Prices, Dummies for COVID, Regime, Election Year etc. Data Range 1976-2021	PD $\alpha_{1=1.01}$*** $\alpha_{2=0.287}$ $\alpha_{3=0.0123}$ ED $\alpha_{1=0.653}$*** $\alpha_{2=-0.093}$** $\alpha_{3=0.0458}$	FP is not Responsive to both PD and ED FP is Persistent FP is Anti-cyclical
Mansoor, et al. (2020)	DV=pb_t; EV= pb_{t-1}; d_{t-1}; og_t *X*= GDP per capita, TO, GR Data Range 1980-2019	ED $\alpha_{1=0.071}$ $\alpha_{2=-0.177}$*** $\alpha_{3=0.304}$*	FP is not Responsive to ED FP is not Persistent FP is Pro-Cyclical
Khalid, et al. (2007)	DV Fiscal Deficit EV Output Gap and Inflation Data Range 1965-2006	Coefficients when FD is DV $\alpha_{3=0.155}$ (GMM) $\alpha_{3=0.084}$ (VAR) $\alpha_{3=0.1843}$ (OLS, Boom) $\alpha_{3=-0.002}$ (OLS, Recession)	FD Pro-Cyclical FP in Boom Insignificant FP in Recession GE Anti-Cyclical FP in Recession Insignificant FP in Boom TP Pro-Cyclical in both Boom and Recession

Notes:DV=Dependent Variable, EV, Explanatory Variable, FP=Fiscal Policy, FD=Fiscal Deficit, GE=Government Expenditure, TP=Tax Policy, PD=Public Debt, ED=External Debt, CAB=Current Account Balance, GR=Government Revenue, TO=Trade Openness

**Significant at 5 percent, ***Significant at 1 percent

5. DISCUSSION IN LIGHT OF DSA AND FRF AMID 24TH IMF PROGRAMME

In this section, keeping the discussion of DSA and FRF in background, we highlight what does literature offer with regard to the implications of debt and persistence in fiscal deficit for Pakistan's current structural economic woes. Second, we elaborate on the current scenario, especially the post Budget 2024-25 and Finance Bill 2024-25 situation.

5.1 Persistence in Fiscal Deficit, Debt and Macroeconomic Outlook

Public Debt might have a variety of implications for macroeconomic aggregates. On one hand, we have beneficial effects of debt on investment and economic growth, especially when debt is used as investment in infrastructure or human capital development (Siddiqui et al., 2022; Salman and Ali, 2022). On the other hand, we have a 'Debt Overhang Effects', leading to obstruction in investments in projects that might be deemed as essential for future development, especially when, due to existing debt, the capacity for more albeit productive borrowing is handicapped (Chaudhary et al., 1996; Akram, 2011; Jalil, 2020; Ali et al., 2023).[23] Likewise, we might have 'Crowding-Out Effects' where higher debt or debt-servicing might swap private investment.[24] Furthermore, along with its implications for aggregate investment and aggregate productivity, public debt might be inflationary, especially the domestic debt, leading to more severe dynamic implications for the future's development of the indebted country.[25] In Pakistan, we have contrasting literature where some studies such as Salman and Ali (2022) finds beneficial effects of debt for economic growth while others such as Akram (2011), Ali et al. (2023), Chaudhary et al. (1996) conclude that higher debt or deficit financing have detrimental effects on employment, aggregate productivity, economic growth, and inflation in the country. However, despite ample literature, this relationship is not that simple as it involves a bunch of threshold conditions. For instance, debt, especially external debt at concessional rates, might lead to enhancement of public infrastructure and investment in State Owned Enterprises (SOEs) as is discussed in details by Haque and Montiel (1992)[26] in case of Pakistan. In particular, if such deficit financing is accompanied by corresponding increases in domestic revenues, then it might provide a sound basis for economic development as we have experienced in case of 'Asian Tigers'. However, public investment through debt or deficit financing might create hurdles if it is invested in inefficient projects such as Pakistan's investment in 1970s, and early 1980s, in the SOEs. Also, in case of Pakistan, deficit financing has never been accompanied by enhances in domestic revenues which, in turn, has threatened the sustainability of fiscal deficit (Chaudhary, et al. 1996).[27] Alternatively, a spendthrift behavior of the public sector combined with persistence in fiscal deficits in 1970s, 1980s and 1990s has cumulatively contributed to Pakistan's higher indebtedness over its history. These woes are added by unfunded losses of the SOEs during the same period and govt. guarantees given to Independent Power Producers (IPPs) in 1994. Likewise, current account deficit and the consequent of depreciation of the Rupee have havocked the costs of debt-servicing over the same period.

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[23] Debt overhang is the condition of an organisation or a country that has existing debt so great that it cannot easily borrow more money, even when that new borrowing is actually a good investment that would more than pay for itself.

[24] For instance, higher interest rate or investment in government securities reduces the availability of credit to private investors.

[25] Domestic Debt is usually serviced with printing money which might create inflation, reducing private savings.

[26] Haque & Montiel (1992) finds that, in the 1970s after first oil price shock, Pakistan pursued fiscal expansion where economic policies preached economic equality with greater role for the public sector, external financing at concessional rates primality from middle eastern countries leading to current account surplus. This led a fiscal deficit of around 7.5percent in the 1970s.

[27] Chaudhary, et al. (1996) finds that, in 1980s, Pakistan's sustainable fiscal deficit was 4.2percent of GNP while the actual deficit was 6.5 percent. Likewise, in early 1990s, the sustainable level of deficit was 5.4 percent of GNP against the actual deficit of 7.4 percent.

Fig. 3. Pakistan's Debt-to GDP Ratio in Comparison with FRDL Act. Limit

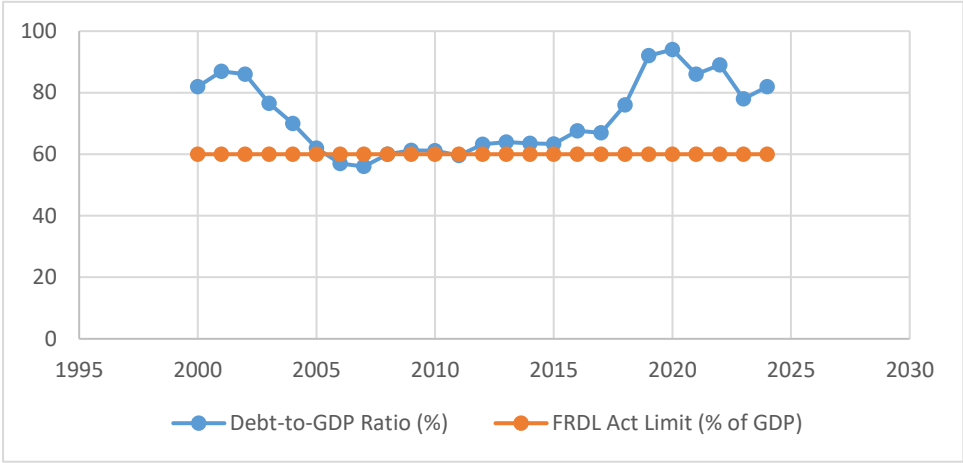
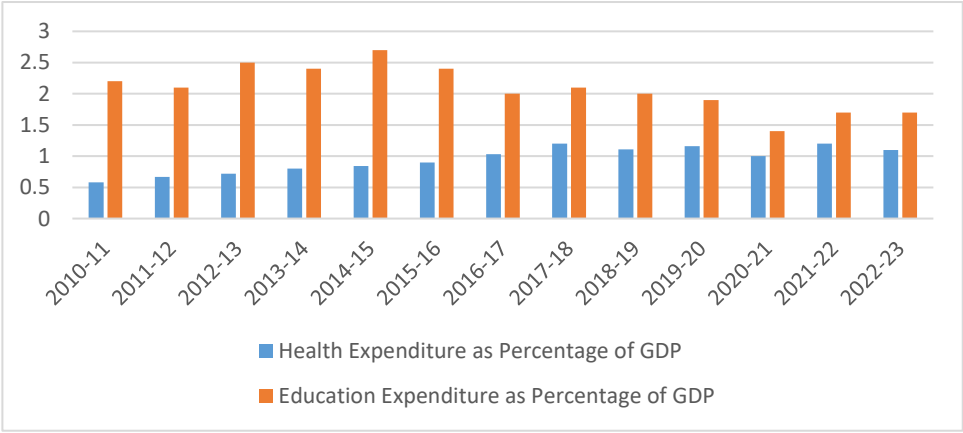


Fig. 4. Health and Education Expenditures as Percentage of GDP



(Hassan, 1999).[28]This discussion,in short, leads to the conclusion that fiscal deficit and debt needs a proper mix of expenditure measures and tax policy that passes some efficiency criteria to overcome the indebtedness (Yasin, 2001). Moreover, to protect the masses from the worst effects of indebtedness, this mix should be persistency changing as is predicted in the famous Ricardian Equivalence.[29]

Pakistan's borrowing, especially for budgetary support, and the ever worsening balance of payments situation have caused public debt to surge, with domestic debt reaches to Rs. 46.21 trillion and external debt reaches to around 21.61 trillion as of May, 2024, both amounting roughly 82 percent of the country's GDP. Since 2000, Pakistan's debt-to-GDP ratio has been more than 60 percent (the FRDL Act. Limit) for most of the time as is shown in Figure 3. So, fiscal indiscipline is not only upsetting our budgetary process; but it is also escalating our risks of default on external front with rising public

[28] During this periods, Pakistan have been on the brink of prospective debt default several times.

[29] Today's Debt is future's taxation.

debt. Such a higher indebtedness and, the consequent fiscal deficit, has created structural bottlenecks which have kept Pakistan in low development trajectory (Wahid, 2023). Due to higher costs of debt-servicing, Pakistan has not been able to spend much on the provision of social services which is restricting fiscal policy oriented growth in the country (Khan, 2022). Pakistan has been cumulatively spending less than 5 percent of GDP on health and education, putting serious dents on the development of human capital (see figure 4). Human capital, being an important ingredient in the growth process, is very essential for overall development of the economy as well as trickle down in terms of poverty reduction. Consequently, the growth performance has been truncated for most of the history of Pakistan (see Figure 2). Even, the growth prospects are not very bright in the near future, with the World Bank's estimated growth rates of 2.2 percent and 2.5 percent for financial years 2024-25 and 2025-26, respectively. The sluggish performance would cause more unemployment, with 31 percent of Pakistan's youth are already unemployed as is recently estimated by a PIDE study. Likewise, it would intensify poverty, with 40.1 percent of the populace is under the lower-middle-income poverty line ($3.2 per day).

5.2. Post Budget 2024-25 and Finance Bill 2024-25 Scenario

Pakistan is on the eve of 24th IMF program amid structural problems like low growth prospects, persistent macroeconomic imbalances, and sky-rocketing prices of essential items and utilities. In final review of the 23rd Stand-By Arrangement (SBA), the IMF's Executive Board reiterated on policy measures such as fiscal adjustment and debt sustainability, buffering external shocks through market-determined exchange rate, proactive monetary policy, along with structural reforms like energy sector viability, governance of State Owned Enterprises (SOEs), and climate resilience. Accordingly, the government presented the IMF's guided budget on June 12, 2024 for financial year 2024-25. The main crux of the budget is to keep primary balance in surplus which forces the government to create avenues for additional revenue. Again, the cited reasons on which both the Pakistani authorities and IMF agree are Pakistan's persistent fiscal deficit due to higher debt-servicing, growing circular debt of the power sector, and losses of the SOEs. These are added by current account deficit amidst poor exports performance and dwindling reserves. To cope with circular debt, the IMF has directed the government to raise the tariff rates of electricity along with raising Petroleum Development Levy (PDL).[30] This, along with the increase in General Sales Tax (GST) on certain items, have significant implications for prices of the essential items and utilities. Second, on the direction of IMF, the government has substantially changed the income tax slabs, effective from July 01, 2024, which have adverse impacts on individuals, especially the salaried class. This sub-section focuses specifically on the potential impacts of such IMF led conditionalities on the lives of common people and salaried class.

Pakistan's power sector, though essential for economic development, is in severe financial crisis as its circular debt has become a monster. As of April 30, 2024, the total circular debt has reached to Rs. 2.728 trillion, including payment owed to Independent Power Producers (IPPs) at Rs. 1.854 trillion, payable to Generation Companies (Gencos)

[30] PDL is a fixed fee or tax that companies pay to the government on petroleum products.

at Rs.109 billion, and the volume of the loans of Rs.765 billion parked at Government Holdings Private Limited (GHPL). As a condition to the proposed 24th program, the IMF wants to contain the circular debt to Rs.2.310 trillion by the end of current financial year. To cope with this conditionality, the government has decided to pass on more than Rs.700 billion additional burden to consumers during the current fiscal year. Accordingly, the government has significantly increased the power tariffs from July 01, 2024, ranging from Rs.7 to Rs.12, depending upon the usage. On average, the increase for protected consumers stands at 46 percent compared to an average increase of 23.13 percent for non-protected consumers.[31] This would increase the electricity bill of protected consumers with 200 consumption units to Rs.4836.[32] Likewise, the bill of non-protected consumers with 200 consumption units would surge to Rs.9030. Furthermore, the electricity bill for consumption units of 300, 500, and 700 would jump to Rs.15051, Rs.29880, Rs.44268, respectively, as is shown in Table 4, excluding the fixed capacity charges (Khan, 2024).[33] Similar would be the case for agricultural, industrial, commercial, and other consumers. The Finance Bill 2024 has also raised the PDL up to Rs.80 per litre on petroleum products to collect Rs.1.28 trillion. The rise in tariffs and PDL would have severe implications for inflation in the country as power prices have a cumulative impact up to 30 percent on inflation in Pakistan, with most affected are the prices of daily consumption products. The standards of living of majority of the population would be adversely affected, 40 percent of which are below the poverty line and are currently faced with around 24.5 percent inflation rate.[34]

Similarly, as stated earlier, Pakistan's 24th financing arrangement with IMF also entails another conditionality of keeping the primary balance in surplus. This has led the government to create additional avenues for revenue. Along with soaring energy prices, the government approved new income tax slabs in Finance Bill 2024 which would significantly increase the effective rates of taxation across the board. As can be seen from Table 5, tax rates on the upper slabs for salaried and non-salaried incomes are raised to 35 percent and 45 percent, respectively. This is added by a wide-spread imposition of General Sales Tax (GST) (18 percent-25 percent), Federal Excise Duty (FED), and Custom Duties (CD). If we incorporate the cumulative incidence of all Indirect Taxes, the effective rates for upper slabs reach to 40.38 Percent and 47.37 percent for salaried and non-salaried incomes, respectively (see Figure 5).[35]

[31] Protected Consumers are those who are protected through government subsidies for consuming less 200 units per month consecutively for six months.

[32] A one-time exemption is given to protected consumers only for three months.

[33] These are estimated after incorporating 18 percent GST, Quarterly Adjustments, Fuel Costs Adjustments (FCAs).

[34] The annual inflation, as indicated by CPI, stood at 24.5 percent for out-going fiscal year (2023-24), with food inflation of 24.2 percent and 23.7 percent in urban and rural areas, respectively and non-food inflation of 25.7 percent and 23.8 percent, again, in urban and rural areas, respectively.

[35] There are some non-adjustable withholding taxes as well as other taxes on the purchase of property, new cars etc. which are not incorporated in this analysis due to the non-availability of concrete data. So, the effective rates are still underestimated. Also, this analysis is only based on individuals who are on taxpayers list, so tax evasion or tax cheating is out of our analysis.

Table 4

Pakistan Post-Budget 2024-25 Power Tariff Rates

Consumptions in Units	New Tariff Rates in Rs. (% Increase in Tariff)	Approximate Effective Tariff Rates in Rs.*	Expected Bill of Upper Limit in Rs.***
Protected Consumers			
1≤Units Consumed≥100	11.69 (51%)	20.42	2,042
101≤Units Consumed≥200	14.16 (41%)	24.18	4,836
Non-Protected Consumers			
1≤Units Consumed≥100	23.59 (43%)	37.38	3,738
101≤Units Consumed≥200	30.10 (31%)	45.15	9,030
201≤Units Consumed≥300	34.26 (26%)	50.17	15,051
301≤Units Consumed≥400	39.15 (22%)	56.73	22,692
401≤Units Consumed≥500	41.36 (18%)	59.76	29,880
501≤Units Consumed≥600	42.78 (17%)	61.70	37,020
601≤Units Consumed≥700	43.92 (16%)	63.24	44,268
701≤Units Consumed	48.84 (14%)	69.27	69,270**
Other Consumers			
Commercial Consumers		68.7	68,700**
Industrial Consumers		51	51,000**
Agricultural Consumers		36	36,000**

Source: Author's calculation based on *The Nation* (www.nation.com.pk) and current IESCO Bills.
Notes:* These are estimated after 18 percent GST, Quarterly Adjustments, Fuel Cost Adjustments (FCAs). and Other Taxes.

**Bills are calculated for 1,000 Units.

*** The bills don't include fixed capacity charges which are charged at Rs. Rs 200-1000 per kilowatt capacity to general consumers with more than 300 consumption units, Rs. Rs.400 per kilowatt to agricultural consumers, Rs. 400 Rs.500 per kilowatt to industrial, commercial and general services consumers.

A detailed analysis of the effective tax rates in post budget 2024-25 scenario is given in Table 6 which indicates that the effective tax rates for the lowest decile of income is 19.98 percent even though there is no direct tax on this category. The average effective tax rates for other nine deciles of incomes are 33.1 percent and 39.8 percent for salaried and non-salaried incomes, respectively. So, the tax payers are being overburdened amid a cumulative federal spending of less than 5 percent of GDP on health and education which matter much to common tax payers.

Table 5

New Tax Slabs as of Finance Bill 2024-25

Salaried Income		Other than Salaried Income (for individuals and associations of persons [AOPs])	
Income Range (in Rs.)	Tax Rate (in %)	Income Range (in Rs.)	Tax Rate (in %)
Income≤600,000	0%	Income≤600,000	0%
600,000≤Income≥1,200,000	5% of the amount exceeding Rs600,000	600,000≤Income≥1,200,000	15% of the amount exceeding Rs600,000
1,200,000≤Income≥2,200,000	Rs 30,000 + 15% of the amount exceeding 1,200,000	1,200,000≤Income≥1,600,000	Rs90,000 + 20% of the amount exceeding 1,200,000
2,200,000≤Income≥3,200,000	Rs 180,000 + 25% of the amount exceeding Rs2,200,000	1,600,000≤Income≥3,200,000	Rs170,000 + 30% of the amount exceeding Rs1,600,000
3,200,000≥Income≥4,100,000	Rs430,000 +30% of the amount exceeding Rs3,200,000	3,200,000≥Income≥5,600,000	Rs650,000 +40% of the amount exceeding Rs3,200,000
Income≥4,100,000	Rs700,000 + 35% of the amount exceeding Rs4,100,000	Income≥5,600,000	Rs1,610,000 + 45% of the amount exceeding Rs5,600,000

Source: Finance Bill 2024-25, Government of Pakistan.

Fig. 5. Effective Tax Rates in Pakistan

Source: Author's Calculation from Federal Budget 2024-25 and Finance Bill 2024-25.

Table 6

Post Budget and Finance Bill (2024-25) Effective Tax Rates and their Impact

Gross Income (in Rs.)	Disposable Salaried Income Per Month (in Rs.)	Disposable Non-Salaried Income Per Month(in Rs.)	Effective Direct Tax Rate (%) for Salaried Income	Effective Direct Tax Rate (%) for Non-Salaried Income	Incidence of All Indirect Taxes (%)**	Effective Tax Rate (%) for Salaried Income*	Effective Tax Rate (%) for Non-Salaried Income*
50,000	50,000	50,000	0	0	22.96	19.9752	19.9752
100,000	97,500	92,500	2.5	7.5	22.66	22.2142	27.2142
150,000	139,950	132,450	6.7	11.7	22.63	26.3881	31.3881
200,000	180,800	165,800	9.6	17.1	22.22	28.9314	36.4314
250,000	218,250	200,750	12.7	19.7	21.95	31.7965	38.7965
300,000	254,100	232,500	15.3	22.5	21.61	34.1007	41.3007
350,000	288,750	262,500	17.5	25	21.42	36.1354	43.6354
400,000	321,200	292,400	19.7	26.9	21.21	38.1527	45.3527
450,000	353,700	322,650	21.4	28.3	20.77	39.4699	46.3699
500,000	386,000	351,000	22.8	29.8	20.2	40.374	47.374

Source: Author's Calculation from Federal Budget (2024-25) and Finance Bill (2024-25).

Notes:*A generalise national saving rate of 13 percent is applied in order to calculate the net incidence of indirect taxes on expenditure only.

**For Incidence of Indirect Taxes, the rates of Iffat and Khan (2022) are inflated by 1% in order to account for the increase in Sales Tax Rate from 17 percent to 18 percent-25 percent and Federal Excise Duty in February 2023 and March, 2023, respectively.

Proposition 3: *Deficit financing couldn't put Pakistani economy on the path of sustainable economic growth; instead, it caused a consumption led though truncated growth performance combined with excessive spending of the public sector. As a by-product, it triggered debt accumulation with successive but mostly unsuccessful bailouts of the IMF. Currently, the consequences are low growth prospects in the near future and persistence in macroeconomic imbalances, with sky-rocketing prices of the essential items and utilities.*

6. CONCLUSION AND THE WAY FORWARD

This study is motivated by the gloomy pictures of Pakistani economy amid persistent stagflation in recent years. Second, recently the government of Pakistan has launched a growth-targeted program, i.e. 'Uraan Pakistan' which includes fiscal sustainability as a necessary ingredient for the realisation of the embedded objectives of the program. Given this scenario, we conclude by finding from the existing literature and recent trends that public debt is not sustainable in Pakistan. Second, fiscal response to the accumulation of debt and output gap which is captured by primary balance, through FRF, is not sufficient to discharge Pakistani economy out of the vicious circle of truncated growth and IMF bailouts. Third, such spendthrift behavior of the government through borrowings is not sustainable in the long-run. Here, we elaborate on why such inefficient behavior is not sustainable? The minimum wage in Pakistan, as of Budget 2024-25, is Rs.37000 while, in practice, majority of the unskilled labour force in the informal sector is earning less than this amount. Moreover, the lowest decile of populace by income is liable to 19.98 poercent incidence of indirect taxes and paying an electricity bill of more than Rs.2000 if they are protected and consuming less than 100 units of electricity. So,

the lowest decile of income group is paying more than 25 percent of its earning in taxes and electricity bills. Is it sustainable in a country with 40 percent of the population is still living under the poverty line? I would say no and Pakistan has to initiate structural reforms to come out of the vicious circle of persistent macroeconomic imbalances and low growth trajectory. Yes, we need more revenue but revenue must be augmented by measures like removing preferential tax credits and exemptions, enhancing tax base and registration by simplifying the mechanism, introducing agricultural income tax, harmonising the sales tax regime etc. For instance, tax expenditure which also includes the revenue foregone due to various exemptions and concessions in tax laws constitutes to be around Rs.3.9 trillion for outgoing fiscal year (2023-24) amounting around 54 percent of tax revenue. The exemptions are mostly awarded to the elite section of the society. The United Nation Development Programme (UNDP) in its National Human Development Reports (NHDR), 2020, has estimated that around Rs.2.6 trillion are spent each year on the privileges and benefits enjoyed by the powerful interest groups in Pakistan. So, this behavior of stated-created and state-fed elite has to be culminated in order to come out of the current economic despairs.

Second, raising power tariffs is not the only solution to circular debt; rather other aspects such as renegotiating contracts with IPPs vis-à-vis fixed capacity charges, reducing generation cost, removing transmission and distribution losses[36], and competitive practices in the energy market are the alternative that would provide durable solution to the problem of circular debt. Moreover, why is always there a free lunch in Pakistan when it comes to the utilities enjoyed by state officials? Alternatively, monetisation of such usage could be the alternative in order to remove distortions in the power sector. Third, why do we inject money to inefficient SOEs as their annual losses reaches to more than Rs.2 trillion?[37] In other words, is it always necessary for state to sell airline tickets, steel or even utilities when private sector is more than able to do the jobs efficiently compared to the public sector. We postulate that efficiency must be the sole criterion for running the SOEs. In this regard, reforms like corporate governance, market-based induction of CEOs, joint ownership structure, and privatisation of irremediable SOEs must be initiated to have a permanent solution to the inefficient footprint of the state in the economy.

Finally, we need investment and a sustainable exports led growth which can upscale our revenue potentials along with coping with our external sector shortages. We have been an investment deficient country, with investment-to-GDP ratio remaining below 20 percent over the last four decades. In particular, private investment has remained around 10 percent of GDP which is roughly half of regional peers and only one-third of more dynamic emerging markets in Asia. Likewise, FDI has been averaged around 0.8 percent of GDP since 2010. A crucial feature of our current FDI is that 95 percent of it is driven by market-seeking motive, with negligible shares of those of the efficiency-seeking and natural resources based. This, in other words, suggests that we need to enhance our

[36] Transmission and distribution losses stands at around 30 percent of the generation on average for all distribution companies.

[37] Estimates indicate that in the past decade, the top 23 loss-making enterprises, including Pakistan International Airlines (PIA) and Pakistan Railways, have incurred losses totaling $20 billion.

skills and productivity to augment efficiency-seeking and natural resources based FDI in Pakistan.[38] According to World Investment Report 2023, Pakistan received $1.3 billion of FDI in 2022, while neighboring China and India attracted $189 billion and $49 billion worth of FDI, respectively. Bangladesh, a country smaller than Pakistan in terms of size and population, was able to secure inflows of $3.48 billion in 2022. These statistics underscore the need for Pakistan to review its approach towards FDI in which China's experience can serve as an example. In this regard, reforms that can guarantee external sector liquidity, maintain market-determined exchange rate, improve our sovereign credit rating, and mobilise domestic revenues are of upmost importance. Likewise, market must be opened to global firms by providing them with level-playing field in terms of regulatory procedures, clearly-defined tax and trade policies, and investment-friendly infrastructure. With regard to exports, we have been stagnant over the last two decades, with worsening competitiveness of our exports vis-à-vis our competitors. Pakistan's share in global trade dropped from 0.15 percent in 2005 to 0.13 percent in 2022 while, during the same period, Bangladesh's share in world exports increased from 0.06 percent to 0.19 percent, India's from 0.61 percent to 1.65 percent, and Vietnam's from 0.14 percent to 1.17 percent. Similarly, Pakistan's exports lack product diversification, with high concentration in resource-based items such as cotton, rice, hides and skins etc., dominated largely by textiles products and rice. With regard to market diversification, our main trading partners are only three, e.g. the United States, Europe, and China, though we sell much of our rice to the Middle East. Moreover, our firms struggle in terms of value-addition and in upscaling their sizes. All these obstacles call for structural reforms that can promote our exports; enlarge our product and market diversification; encourage value addition in exports; and enhance the scope of our exporters. The cost of doing business needs serious attention in this regard amidst tough competition from Bangladesh, India, and Vietnam. Internal security, productivity-oriented or growth-oriented incentives mechanism, rationalising energy prices, and enabling regulatory environment should be the priority areas in order to reduce the costs of doing business in the country. As stated earlier, to encourage technological upgradation and enhance the size of businesses, we need to accommodate global firms, especially for joint-ventures. In addition, rationalising tariff structure from the perspectives of anti-export bias and creating competition in the market might boost exports along with a thriving private sector.

Most of the reforms which are highlighted above are presumed to remove distortions only in the economic markets though their success largely depends on reforms in the political market. Alternatively, political will or reforms for removing distortions in the political market are central to the success of economic reforms. In particular, economic viability of the country needs to be the fundamental theme of political discourse. We need reforms in the political market that can enhance the accountability of our political elite, on one hand, and solve the problems of collective action and free riding

[38] According to World Investment Report 2023, Pakistan received $1.3 billion of FDI in 2022, while neighboring China and India attracted $189 billion and $49 billion worth of FDI, respectively. Bangladesh, a country smaller than Pakistan in terms of size and population, was able to secure inflows of $3.48 billion in 2022. These statistics underscore the need for Pakistan to review its approach towards FDI in which China's experience can serve as an example.

with regard to unbridled subsidies, Statutory Regulatory Orders (SROs) and several other forms of regulatory abuse, on the other. Likewise, rationalisation of public expenditure along with a transparent, fair and progressive tax system is essentially needed to bring down the fiscal deficit to limits. Specifically, the political elite must think like Mancur Olson's stationary bandit instead of roving bandit where its interests are more encompassing in pursuing growth-geared policies. They must focus on the share of wealth created by economic agents as taxes, as a revenue maximising state would do, and that this option is more profitable to them than grabbing the extant wealth and fleeing.

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