STATE-OWNED ENTERPRISES IN PAKISTAN: FOOTPRINT, PERFORMANCE, FISCAL RISKS, AND GOVERNANCE[1]

SOEs in Pakistan—and the Middle East, North Africa, and Central Asia region more broadly—are prominent, yet their role and contribution to the economy is ambiguous. They are used for a range of purposes, including the supply of basic goods and services, advancing strategic interests, addressing market inefficiencies, and meeting social objectives. They are also involved in a wide range of activities that are often carried out by private firms in other regions, and often act as an employer of first and last resort. While Pakistan has recently embarked on a reform process, it will be important to follow through with its plans to improve the performance, governance, and economic contribution of SOEs.

A. Introduction

1. **In comparison with most Middle East, North Africa, and Central Asia (ME&CA) countries, SOEs in Pakistan hold sizable assets, yet their share of employment in the economy is relatively low**. The total assets of non-financial SOEs in the country stood at 44 percent of GDP in 2019 (up from 31 percent of GDP in 2015), whereas the sector employed only 0.7 percent of total formal employment. Based on a comprehensive report published by the Ministry of Finance in 2021, as of end-June 2019 there were 213 federal-level SOEs operating in various economic sectors, out of which 67 were commercial non-financial federal SOEs, excluding health and education institutions and non-commercial operations.

2. **Recently, the authorities embarked on a reform process—with the support of the IMF and World Bank—to improve the performance and governance of the SOE sector**. Consistent with international trends, Pakistan witnessed an active privatization drive in the 1990s and 2000s, that subsequently slowed, with only 5 transactions taking place over the past decade compared to 167 transactions completed over the 1991-2010 period.[2] A triage exercise to examine the functions and financial performance of individual SOEs was undertaken in 2020 to identify the SOEs that should be privatized, as opposed to those that should be only restructured or retained by the federal government. The authorities are planning to establish a Central Monitoring Unit with a central database and analysis of all the SOEs, as part of a broader reform to strengthen their corporate governance framework and limit fiscal risks stemming from their operations.

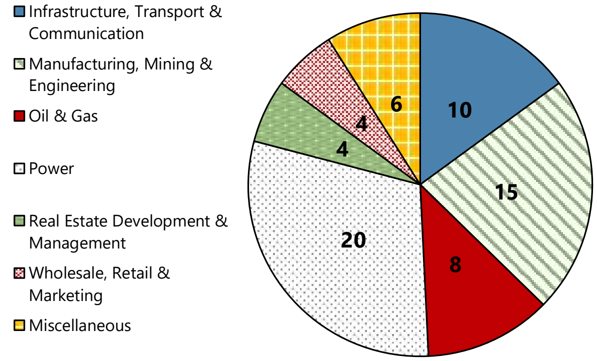
[1] Prepared by Tannous Kass-Hanna (MCD). The analysis draws on the recently published MCD Departmental Paper "State-Owned Enterprises in Middle East, North Africa, and Central Asia: Size, Role, Performance, and Challenges"

[2] http://privatisation.gov.pk/Detail/NTU0ZjE1NGQtNmYzNC00NWZjLWIxZTEtYWMzMzliYzFhNzk4

B. Footprint and Performance

3. The SOE footprint in the power and oil and gas sectors is particularly large. Out of 67 non-financial commercial SOEs, 28 are in the power or oil and gas sectors, while an additional 15 are in the manufacturing sector.

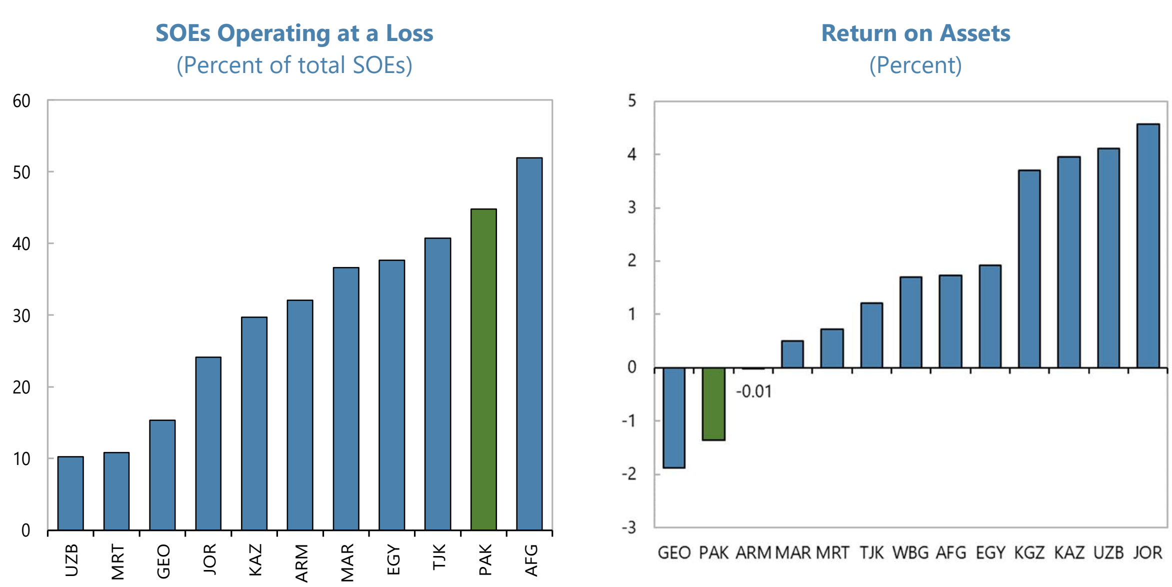
Figure 1. Portfolio of Non-Financial Commercial SOEs, FY 2019
(Number of SOEs)



Source: Finance Division, Government of Pakistan (2021).

4. The financial performance of the SOE sector in Pakistan is relatively weak when compared to ME&CA countries, despite their important role in the economy. Almost half of the SOEs operated at loss in 2019 (Figure 2), including one-third of commercial SOEs that are consistently generating losses (NHA, power sector distribution companies (DISCOs), Pakistan Railways, and Pakistan International Airlines that owns the Roosevelt Hotel in New York and the Scribe Hotel in Paris are among the major ones). Commercial SOEs recorded losses of PRs 143 billion in FY 2019. The average return on assets for SOEs in the country is among the lowest in the ME&CA region, at –1.4 percent (Figure 2.B). A recent work published by the World Bank (Melecky, 2021) estimates the liabilities of loss-making SOEs in Pakistan in the range of 14–18 percent of GDP, posing considerable potential fiscal costs.[3]

Figure 2. SOE Performance Indicators, 2019 or Latest Available



Sources: Finance Division, Government of Pakistan (2021); Ramirez Rigo and others (2021).

[3] Note that liabilities are being measured from the balance sheet, of which debt is only one component.

C. Corporate Governance

5. A survey on SOE corporate governance practices in ME&CA countries sheds light on (i) ownership policy, (ii) financial oversight, and (iii) fiscal and policy interactions with the government. During Winter 2021 staff in the IMF's Middle East and Central Asia Department conducted a survey with ME&CA countries on SOE corporate governance practices, using the World Bank Corporate Governance Toolkit (World Bank, 2014) and the OECD guidelines (OECD, 2015) as a benchmark. The responses of 16 ME&CA countries reflect stated or de jure corporate governance policies of SOEs in the region, as opposed to de facto practices which may somewhat differ.

D. Ownership Policy

6. Best international standards require the state to exercise centralized operational and fiscal oversight over all SOEs and to communicate its rationale and objectives for state ownership to market participants, and the public more broadly. Governments need to first know what they own, by establishing consolidated SOE lists with full coverage of SOEs owned at the national and subnational levels. Second, they should determine the rationales for state ownership and clearly communicate them to the public, the market, and to relevant government entities that exercise ownership rights or are otherwise involved in the implementation of the state's ownership policy. Multiple and contradictory rationales for state ownership can lead to either a very passive conduct of ownership functions, or conversely result in the state's excessive intervention in the management of the enterprise and its governance organs. Lastly, governments need to establish centralized, merit-based, and transparent board nomination processes, independent from political interference.

7. Pakistan reports having decentralized coverage and oversight over SOEs, with an ownership policy that is not communicated to the public. While the government has visibility over all SOEs in Pakistan, their coverage and oversight are fragmented among line ministries for SOEs owned at the federal level, or among provincial governments for SOEs owned at the subnational level. However, the Finance Division within the Ministry of Finance has the financial and fiscal oversight function over all federal SOEs, particularly those with significant fiscal costs. Similarly, the selection of board members is decentralized between the cabinet, sectoral ministries, and other agencies, depending on the SOE, with legislative requirements for independent board member representation across all SOEs, and requirements of certain competencies only for a subset of SOEs. Based on the survey responses, Pakistan's rationale for state ownership is associated with the objectives of (i) supporting national economic and strategic interest, (ii) supplying specific public goods and services, (iii) performing business operations in a natural monopoly situation, and/or (iv) supporting social objectives. And although these objectives and an overall ownership policy is laid out in a document, the latter is not publicly available, and its substance is not well-communicated to the public.

E. Financial Oversight

8. **Best international practices call for regular target-setting and performance evaluation, as well as disclosure and transparency in financial reporting**. Oversight authorities should set operational and financial targets for SOEs and evaluate their performance. To support this and to enhance transparency, annual financial statements of individual SOEs should follow international accounting standards and be audited by external independent auditors, published, and reviewed by the oversight authority. More broadly, an aggregate SOE report—providing an overview of the sector, along with performance and risks assessments, financial transactions with the government, disclosure of individual SOE mandates, and ownership policy assessment—should be produced and published on a regular basis by a centralized oversight authority.

9. **Pakistan reports having systematic operational and financial oversight over SOEs, with norms to audit and make public their annual financial statements**. The relevant authorities appear to set operational and financial targets for SOEs, evaluate their performance, and make them accountable for the quality of service provided. While it is a common practice for annual financial statements to be audited by independent external audit firms and reviewed by the oversight authority, only a subset of SOEs follow international audit and accounting standards and make their financial statements publicly available on their website or the website of the relevant oversight unit. Moreover, there are often significant lags between the end of the fiscal year and completion of audits. Given the decentralized nature of oversight, there is also an absence of an aggregate SOE document evaluating the annual operational and financial performance of the sector as a whole.

F. Fiscal and Policy Interactions

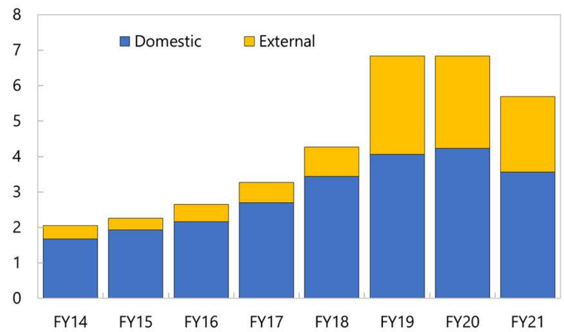
10. **Best practices call for establishing clear rules for fiscal support, maintaining competitive neutrality as well as preserving budgetary transparency and sustainability**. The authorities should strengthen the legal and institutional framework for an efficient and timely management of fiscal risks stemming from SOEs. This requires an effective legal framework and capacity building to empower the oversight authority, typically located in the Ministry of Finance, to assess, measure, and monitor SOE fiscal risks. The legal framework should also have an explicit dividend policy outlining the magnitude and conditions associated with the transfer of SOE dividends to the government budget. In its dealings with SOEs, the government should have an arms-length relationship regarding in terms of financing to maintain a level-playing field between SOEs and the private sector. For instance, SOEs should not receive budget or quasi-fiscal support when conducting their business operations. As for non-commercial SOE operations mandated by the government, public sector obligations (PSOs) should be explicitly spelled out in legislation.

11. **The government of Pakistan has room to improve its management of fiscal risks stemming from SOEs**. SOEs in Pakistan often have a mandate to undertake investment or social spending on behalf of the government to meet PSOs. Such non-commercial mandates are explicitly laid out in legislation, ensuring the obligation of the government to compensate SOEs for any losses associated with such activities. Budgetary support—in the form of transfers, subsidies, or cash

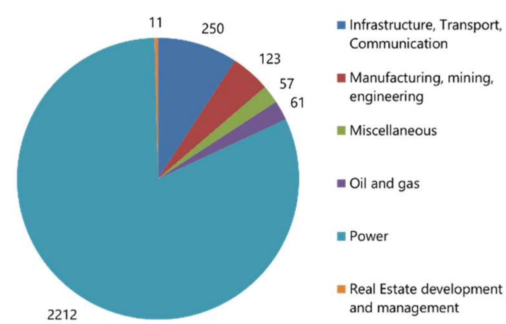
injections, as well as quasi-fiscal support—in the form of guarantees or budgetary loans—are submitted to the parliament and available in public as part of the federal budget, but documents have yet to include guarantees expected to be issued in the forthcoming year. While there are limits on government exposure to SOEs—including limits to public guarantees, SOE risk is not integrated in the overall fiscal risk management framework. For instance, beyond explicitly publicly guaranteed SOE debt—amounting to almost 6 percent of GDP in FY 2021 and mostly concentrated in the power sector (see Figures 3.a and 3.b)—SOE losses and liabilities are not included in the headline fiscal indicators.

Figure 3. Publicly Guaranteed SOE Debt

Evolution of Guaranteed SOE Debt[1]
(Percent of GDP)



Composition of Issued Guarantees to SOEs
(PRs billion, FY 2021)

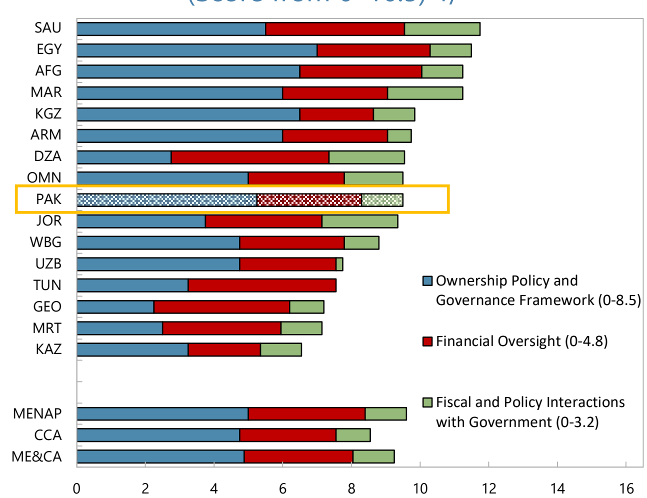


Sources: Pakistani authorities; and IMF staff calculations.
1/ Beginning FY 2019 reporting is on issued guarantees.

G. SOE Corporate Governance Index

12. Pakistan's overall corporate governance index is comparable to the median ME&CA country, indicating that there is room to better align its corporate governance standards to high performers in the region and to international best standards. A composite index of SOE governance practices is constructed for cross-country comparison in the ME&CA region (see Figure 4). While the index covers survey responses from country authorities (de jure policies on ownership policy, financial oversight, and fiscal and policy interactions), it does not reflect the de facto policies. This snapshot of stated policies in

Figure 4. SOE Corporate Governance Index
(Score from 0–16.5) 1/



Source: Ramirez Rigo and others (2021).
1/ Higher values denote closer adherence to OECD guidelines and greater fiscal transparency. See Annex 8 in Ramirez Rigo and others (2021) for a full description of the methodology.

place in late-2020 helps provide a rough comparison of the legal and institutional framework vis-à-vis OECD guidelines. Pakistan scores 9.5 out of a maximum of 16.5, which is weak when compared to the maximum score in the ME&CA region of 11.8. However, this is comparable to the median country in the region, particularly the median MENAP country that also scores 9.5. This suggests that Pakistan has room to improve its governance measures, especially in the areas of financial oversight and fiscal and policy interactions.

13. **Consistent with survey results, an IMF technical assistance mission in early 2020 noted that the corporate governance of SOEs in Pakistan was weak, which may explain—at least in part—the performance of the SOE portfolio, displaying low productivity and efficiency levels**.[4] The IMF TA mission observed that the ownership model in place in 2020 was fragmented, with blurred roles between line ministries and regulatory authorities in various sectors while a marginal role was played by the Ministry of Finance. For instance, it was observed that the Ministry of Energy has the final say on power tariff adjustments, the regulator of the aviation sector owns the civil aviation infrastructure, and the regulator of the financial sector is the majority shareholder of a systemic state bank. Contrary to de jure policies as reported by the authorities in the survey, political interference in the selection of members of SOE boards seems to be prevalent. Moreover, the mission observed that internal audit functions lack capacity, accounting and auditing standards are weak, and financial reporting is riddled with numerous accounting exemptions that may have a significant bearing on the evaluation of the actual financial performance of the overall SOE sector. Finally, performance target setting, and evaluation seem to be lacking due to the absence of an efficient performance monitoring system. These shortcomings have in turn brought about unanticipated fiscal risks from SOE operations.

H. SOE Sector Reform

14. **In early 2021, the Pakistani government submitted to the parliament an SOE Governance and Operations Act that aims at enhancing the governance framework, management, and financial efficiency of SOEs in the country, and limit the fiscal risks stemming from their operations**. The Act lays the groundwork for a gradual move towards a more centralized model, whereby a newly created SOE unit in the Ministry of Finance would assume the functions of ownership and oversight. The oversight functions of the Ministry of Finance have already started to improve with the publication of the "Federal Footprint—SOE Annual Report" to assess SOE portfolio risks in a more structured and more transparent way. With respect to the selection of SOE board members, the Act proposes a "nomination committee" headed by the minister of the line-ministry in charge of the SOE along with four other members: the secretary of the division in charge, the finance secretary or his/her nominee, and two private sector experts with at least 20 years of experience. Under this new model, the majority of the SOE board members would be independent directors, while the governance functions of the SOE would be separated from its management.

[4] The IMF technical assistance was conducted by Pasquale Di Benedetta and Mia Pineda (both IMF Legal Department)—in collaboration with the World Bank and the Asian Development Bank.

Moreover, the Act intends to separate the regulatory and policy making functions of the state with regards to its SOEs.

15. With regards to ownership policy reforms, SOEs will have to set company mandates and strategies through a publicly available statement of corporate intent. An ownership policy document will subsequently integrate this framework and will clarify the processes for developing strategy and negotiating performance agreements as well as the respective roles of all involved institutions. The reforms proposed by the new Act are also expected to strengthen the central role of the board in its oversight of SOE operations, hence strengthening internal and external controls as well as reporting and disclosure standards. In that respect, the new Act provides a timeline for compliance with IFRS accounting standards and requires the disclosure of non-financial information (for example, details of a PSO agreement) and the aggregate reporting on an annual basis at a minimum. Under the new Act, the board of each SOE will be expected to adopt a three-year business plan every financial year, laying out targets, strategic direction, and operational and financial performance measures. This business plan mandated by the new Act is envisaged to serve as the performance agreement between the government and the SOE.

I. Policy Recommendations and Conclusions

16. Considerable fiscal cost and risks emanate from the weak performing SOE sector in Pakistan, particularly from the power sector. As of 2020, SOE corporate governance standards in Pakistan showed significant gaps against international best practices (for example, OECD guidelines) and against top performers in the region and in the world. The authorities need to retain strong political commitment to the recently introduced structural reforms aiming at restructuring and privatizing some SOEs as well as enhancing both the SOE corporate governance framework and the fiscal risk management framework.

17. An immediate priority of the authorities should be passage of the SOE Governance and Operations Act. Some additional actions that should be considered in the short- and medium-term to help strengthen SOE corporate governance and contribute to improving performance are:

- A consolidated list of all SOEs—owned by the federal government, provincial governments, or other SOEs—should be produced and published on an annual basis to provide a comprehensive picture of the SOE sector in Pakistan.

- Publish the ownership policy document, to communicate the ownership objectives, financial and public policy targets, reporting guidelines, and guidelines for boards of directors to the markets and the public.

- SOE performance should be assessed on an annual (or quarterly) basis, supported by timely audited annual financial statements following the best international standards. This should include an evaluation against public policy and individual SOE objectives as well as private sector comparators.

- The Ministry of Finance should be empowered by strengthening the legal and institutional framework, as well as by building its capacity to assess and monitor fiscal risks stemming from SOEs. Faced with capacity constraints, the initial focus could be on the sectors generating the most fiscal risk in Pakistan, namely the power and transport sectors.

- Greater transparency and disclosure of SOE debt including both explicitly and implicitly guaranteed debt are warranted to adequately monitor and reduce fiscal risks.

- The Government of Pakistan should incorporate into its balance sheet information such as the state holdings in SOEs, as well as government's receivables from and payables to SOEs.

- The government should condition financial support to a commitment by the SOE to improve its corporate governance practices and audit procedures as well as enhance reporting, disclosure, and transparency.

- SOE board composition requirements should be improved to support objective and independent decision making, while avoiding potential conflicts of interest.

- Beyond the legal reforms to the institutional framework in Pakistan, attention and commitment should be placed on the implementation corporate governance standards.

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