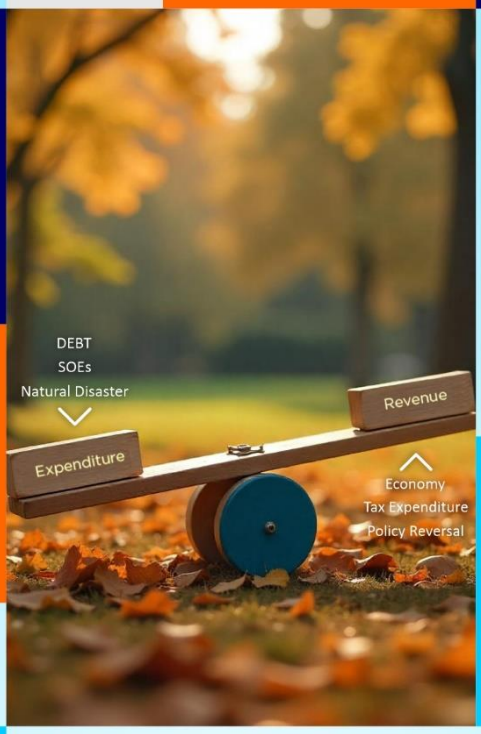
FISCAL RISK STATEMENT

March 2025



FOREWORD

The Fiscal Risk Statement (FRS) provides a structured framework for identifying, quantifying, and managing risks that could impact Pakistan's fiscal stability. It systematically evaluates fiscal risks arising from revenue shortfalls, debt vulnerabilities, and commodity price shocks. Using a rigorous methodology, it also analyzes quantitative assessment of macroeconomic and fiscal risks and contingent liabilities stemming from State-Owned Enterprises, Public-Private Partnerships, and disasters triggered by natural hazards and climate change.

The refinement of the Statement of Fiscal Risks supports the formulation of proactive government interventions in the annual budget, focusing on minimizing and managing fiscal risks in a sustainable manner. The FRS serves as a key instrument in fiscal policy formulation, providing an early warning system to identify risks that may lead to deviations from budgetary forecasts. Through a systematic evaluation of potential fiscal pressures, it enhances transparency, accountability, and risk-informed decision-making, reinforcing the government's commitment to fiscal prudence. I am confident that it will be a valuable resource for all those interested in the outlook of the economy. The Government of Pakistan (GoP) has taken various measures to address these challenges, including the implementation of key economic reforms to contain fiscal deficit, hence increasing investment in key sectors to embark on a path of economic growth.

The successful preparation of the FRS would not have been possible without the invaluable contributions and support of various institutions and individuals. I would like to express my sincere appreciation to the Asian Development Bank for their vital support in developing this report. In particular, I wish to acknowledge the technical assistance provided by Dr. Wasim Shahid, FRM Specialist at ADB, whose expertise has been instrumental in the preparation of the FRS. My heartfelt thanks go to Dr. S. M. Naeem Nawaz, Director (Fiscal), whose deep expertise in fiscal risk analysis has been crucial in preparing the FRS. I greatly appreciate the contributions of Dr. Naseem Faraz, Director-General of MFPU, for her dedication and efforts throughout this process. Finally, I would like to express my deepest gratitude to Dr. Imtiaz Ahmad, Economic Adviser, whose leadership, dedication, and efforts were fundamental in bringing this important work to fruition.

Imdad Ullah Bosal
Secretary Finance

EXECUTIVE SUMMARY

OVERVIEW

The Fiscal Risk Statement (FRS) aims to improve the STATEMENT OF FISCAL RISKS in the ANNUAL BUDGET STATEMENT by identifying and quantifying fiscal risks. It focuses on macroeconomic, revenue, debt, climate, and State-Owned Enterprise (SOE) risks, as well as contingent liabilities from commodity financing and Public-Private Partnerships (PPPs). The FRS informs government interventions to minimize these risks, ensuring fiscal stability and better decision-making. By evaluating potential deviations from budget forecasts, it improves transparency and accountability in public finance. It considers medium-term baseline fiscal projections and compares them with different risk scenarios to assess possible fiscal risks.

BASELINE PROJECTIONS

Assuming continued stability and the absence of major shocks, real GDP growth is expected to accelerate to 4.5% in FY2026 and reach 5.7% by FY2028, with nominal GDP projected at Rs. 132 trillion in FY2026 and Rs. 167.7 trillion by FY2028. Inflation is anticipated to decrease from 7.2% in FY2025 to 6.5% in FY2028, driven by lower global commodity prices and improved agricultural productivity. Exports and remittances are projected to rise, with the current account deficit remaining sustainable at 0.9% of GDP by FY2028.

Pakistan's medium-term fiscal framework assumes a gradual economic recovery following the crises of FY2023 and FY2024, with improvements in key fiscal indicators. Interest rates are declining, inflation has dropped to single digits, and GDP growth is projected to return to historical averages. FBR revenue is expected to rise to Rs. 20,572 billion by FY2028, driven by improved tax compliance and favorable macroeconomic conditions. Non-tax revenues will grow, with significant contributions from the petroleum levy and State Bank profits. Total federal expenditures are projected to increase moderately, focusing on controlling primary spending. Interest payments will decrease, while allocations for defense, grants, and subsidies are projected to remain constant as percentage of GDP. Development expenditure will slowly grow, maintaining fiscal consolidation efforts and reducing the overall federal fiscal deficit to 3.7% of GDP by FY2028.

FISCAL RISK ANALYSIS

The baseline medium-term macroeconomic and fiscal framework provides point projections without accounting for risks that might lead to deviations. Evaluating these fiscal risks involves applying probability limits to key projections, considering potential shocks to economic growth, inflation, interest rates, revenue performance, and expenditure trends. If these risks materialize, they could significantly impact the fiscal outlook, widening the fiscal deficit, increasing borrowing needs, and compromising debt sustainability.

Real GDP growth is expected to increase from 3.1% in FY2025 to 5.7% in FY2028, but risks related to structural and cyclical factors could lead to lower-than-expected growth. Inflation is projected to stabilize around 6.5%, but unexpected changes in demand, energy tariffs, or global commodity prices could cause divergence. Interest rates, projected to average 11.5% for domestic

debt in FY2026-28, could rise due to unforeseen inflationary pressures or a decline in the country's credit rating, increasing debt servicing costs.

Federal gross revenues are projected to reach 14.8% of GDP in FY2026-28, but revenue risks pose significant concerns. Tax revenues are expected to reach 12% of GDP in FY26-2028, but economic slowdowns, delays in tax administration reforms, or a shrinking tax base could lead to shortfalls. Non-tax revenues, including State Bank of Pakistan profits, are assumed to remain stable at 2.8% of GDP, but losses in the SBP's balance sheet could reduce transfers and widen the fiscal gap.

Interest payments, projected to decrease from 7.4% of GDP in FY2025 to 4.7% in FY2028, are subject to risks related to inflation, exchange rate fluctuations, and credit risk perceptions. SOEs pose significant fiscal risks, with potential losses requiring increased government support. As of FY2024, SOEs' outstanding stock of loans totaled Rs. 9,196 billion.

SCENARIO ANALYSIS

Alternative scenarios introduce potential risks that could undermine fiscal sustainability. Analyzing these scenarios helps policymakers prepare for adverse shocks and develop mitigation strategies, ensuring fiscal sustainability under various conditions. The baseline serves as a benchmark to assess the fiscal strain each risk scenario might impose.

Macroeconomic Risks

The baseline scenario for Pakistan's economy assumes stable growth, but several macroeconomic risks could disrupt fiscal stability. A key concern is lower-than-expected real GDP growth, which could fall 1.5 percentage points below the projected 5.1% average growth rate, potentially aligning closer to the lower 3.5% growth rates observed over the past decade. Reduced GDP growth would limit tax revenues and increase fiscal deficits, with a projected increase in the overall fiscal deficit by Rs. 42.1 billion in FY2026 and Rs. 312.4 billion cumulatively from FY2026-28. If all government expenditure categories remain delinked from GDP, the fiscal deficit would rise by Rs. 92.8 billion in FY2026 and Rs. 713.4 billion over FY2026-28. This scenario would also cause the public debt-to-GDP ratio to rise, further worsening fiscal indicators.

Risk Management: The government's strategy for managing macroeconomic fiscal risks involves sector-specific taxation, such as temporary surcharges on sectors that perform well during downturns. It plans to formalize this by developing a sector-specific, state-dependent marginal tax framework. In the medium term, the government aims to establish an expenditure framework emphasizing restraint during periods of low growth, scaling back non-essential projects, and enhancing fiscal reserves through better management of contingency funds. In the long term, the government will focus on structural reforms, including economic diversification and investment in human capital, to reduce reliance on vulnerable sectors.

Revenue Related Risks

Revenue risks are a significant concern for Pakistan's fiscal stability, as several scenarios could result in revenue performance falling short of projections. The baseline growth is expected to be

driven by administrative measures and tax rate increases rather than broadening the tax base. Risks to revenue performance include non-tax revenue shortfalls and challenges in closing the tax gap.

In an alternative scenario, tax revenue growth aligns with economic activity, assuming constant tax buoyancy, leading to a shortfall of Rs. 1,170 billion in FY2026 and a cumulative Rs. 5,254 billion by FY2026-28 from the baseline. This would result in a fiscal deficit higher than the baseline, with an increase of Rs. 516 billion in FY2026 and a cumulative Rs. 2,539 billion by FY2026-28. Another scenario assumes a 30% reduction in the State Bank of Pakistan's (SBP) surplus profit, leading to an increased fiscal deficit of Rs. 412 billion in FY2026 and Rs. 1,522 billion over FY2026-28. In a scenario where petroleum levy collections fall 20% below the baseline projections, the fiscal deficit would increase by Rs. 248 billion in FY2026 and Rs. 895 billion in FY2026-28, compared to the baseline, further exacerbating fiscal imbalances unless compensated by other revenue sources.

Risk Management: To address revenue-related fiscal risks, the government will separate tax policy from tax collection, broaden the tax base, improve administration, and prioritize essential expenditures. In the medium term, efforts will focus on simplifying the tax code, enhancing compliance, and leveraging technology to reduce tax evasion. In the long term, the government plans to develop alternative non-tax revenue sources, such as asset leasing and Public-Private Partnerships, to establish a more stable financial foundation.

Debt Related Fiscal Risks

As of December 2024, Pakistan's total debt is Rs. 67,034 billion, with Rs. 49,883 billion in domestic debt and Rs. 36,512 billion in external debt and liabilities. The debt portfolio faces various risks due to potential deviations in interest rates and exchange rates from baseline projections.

A risk scenario assumes domestic interest rates rise by 200 basis points, and foreign rates by 100 basis points. This would increase debt servicing costs, leading to a higher fiscal deficit by Rs. 617 billion in FY2026 and Rs. 3,025 billion cumulatively in FY2026-28. Similarly, a 10% depreciation of the exchange rate increases the cost of servicing external debt, resulting in an additional Rs. 49 billion in the fiscal deficit in FY2026 and Rs. 171 billion in FY2026-28.

In another scenario, a higher reliance on floating-rate debt, leading to greater exposure to interest rate fluctuations. It could increase costs by Rs. 67.3 billion in FY2027 and Rs. 108.6 billion in FY2028. A scenario assumes that the government evenly spreads FY2029 debt maturity over FY2026-2029, adding Rs. 2.6 trillion to the fiscal deficit annually, though it will alleviate FY2029's burden.

Risk Management: The government will reduce fiscal risk by altering the composition of its debt, increasing the proportion of longer-term, fixed-rate instruments. It will adhere to fiscal deficit limits under the Fiscal Responsibility and Debt Limitation Act, 2005 while regularly conducting debt sustainability analyses. To lower debt servicing costs, the government plans to tap into concessional climate loans and green bonds. In the long term, the government aims to boost exports, which will help stabilize the exchange rate and reduce exposure to currency risk from external debt. Additionally, uncertainty surrounding domestic debt servicing will be minimized by improving coordination between monetary and fiscal policies.

State-Owned Enterprises Related Fiscal Risks

SOEs present significant fiscal risks due to their inefficiencies and Public Sector Obligations (PSOs), which reduce their profitability and dividends to the government. In 2026, SOEs are projected to pay a dividend of Rs. 116.1 billion (baseline), but this may drop to Rs. 89.7 billion in an alternative scenario, reflecting a decline of 6.1%. This reduction would increase the fiscal deficit by Rs. 137 billion cumulatively over FY2026-28, or 0.07% of GDP.

The government's obligation to support 17 major loss-making SOEs exacerbates the fiscal burden, potentially leading to a larger deficit and increased public debt. In a scenario where government support to loss-making SOEs is determined by detailed workings at the SOE level, a fiscal burden of Rs. 1,980 billion for FY2026 and cumulatively Rs. 6,726 billion for FY2026-28, about 1.5% of GDP, would result. The net fiscal risk—calculated as the difference between this burden and projected government support (Rs. 1,452 billion for FY2026 and Rs. 4,932 billion for FY2026-28)—is estimated at Rs. 528 billion for FY2026 and Rs. 1,988 billion for FY2026-28.

In another scenario, with SOEs' total debt at Rs. 9,196 billion in FY2024 and a 40% probability of default, the government's potential fiscal liability could reach Rs. 736 billion annually, adding Rs. 2,468 billion (0.4% of GDP) to the fiscal deficit over FY2026-28. The transition to green energy sources also carries a risk for SOEs, as an estimated 3.6% annual decline in electricity consumption would reduce SOE revenues by Rs. 196 billion in FY2026 and Rs. 604.6 billion cumulatively over FY2026-28, increasing the fiscal deficit by Rs. 196 billion for FY2026 and Rs. 675 billion (0.1% of GDP) over FY2026-28.

Risk Management: The government plans to privatize certain loss-making SOEs and reform others to enhance efficiency. Key actions include aligning the Public Sector Obligations framework with the State-Owned Enterprises (Governance and Operations) Act 2023, tendering PSOs to reduce costs, and implementing clear dividend policies to mitigate fiscal risks.

Climate Change Related Fiscal Risks

Pakistan faces significant fiscal risks from climate change, including reduced agricultural productivity, water availability, and energy supply, leading to lower tax revenues and higher expenditures, threatening long-term economic growth, and increasing reliance on external borrowing.

The FRS presents two scenarios for Pakistan's climate trajectory. Substantial green investments with international support targeting a stringent mitigation approach (RCP 2.6), requiring $196 billion by 2030, with $58.8 billion from Pakistan's government. This investment is expected to moderately impact the fiscal balance, increasing the federal fiscal deficit by Rs. 363 billion in FY2026 but boosting economic activity in the medium term.

In the other scenario, green investments are not prioritized, and climate change follows a worst-case path (RCP 8.5). This scenario predicts a severe reduction in GDP growth by 0.7% annually, resulting in a higher fiscal deficit of Rs. 3 billion in FY2026 and Rs. 20 billion cumulatively for FY2026-28, compared to the baseline.

Risk Management: To address climate-related fiscal risks, the government will implement green taxes, establish environmental regulations, and invest in green infrastructure. In the medium term, it will leverage international climate finance for adaptation and mitigation projects. The government also plans to encourage private sector investments in climate-resilient technologies and reform subsidies framework to prioritize renewable energy.

Natural Disasters Related Fiscal Risks

Natural disasters present significant fiscal risks to Pakistan due to its vulnerability to climate-related events such as floods, earthquakes, and extreme weather. The 2022 floods caused damages of USD 14.91 billion and economic losses of USD 15.23 billion, leading to increased costs for emergency relief, infrastructure reconstruction, and social protection. As the probability and severity of natural disasters rise due to climate change, fiscal costs are expected to grow.

In the baseline scenario, which assumes the absence of a dedicated natural disaster fund, the projected fiscal burden for FY2026 is Rs. 4,778 billion, contingent on the occurrence of a disaster within that year. Should a natural disaster transpire in FY2027, the fiscal impact is anticipated to rise to Rs. 6,504 billion, further escalating to Rs. 8,677 billion by FY2028. This scenario would place significant strain on the fiscal balance, necessitating substantial external financing and exacerbating fiscal vulnerabilities. In contrast, a scenario incorporating the establishment of a dedicated natural disaster fund yields markedly different outcomes. Under this framework, the fiscal burden for FY2026 is projected at Rs. 614 billion, with a subsequent decline to Rs. 342 billion by FY2028. The presence of a dedicated fund mitigates the exposure to unforeseen financial shocks, fostering greater predictability and sustainability in fiscal planning.

Risk Management: The government is focusing on developing disaster-resilient infrastructure, promoting climate-adapted agricultural practices, and strengthening early warning systems. The government plans to allocate contingency funds to a dedicated natural disaster fund by enhancing the management of the "Provision for Emergency and Others" category in the federal budget and improving fiscal planning through climate risk assessments. Over time, it will implement insurance mechanisms and establish a risk transfer strategy to reduce the fiscal impact of natural disasters.

Other Fiscal Risks

Public Private Partnership and Fiscal Risk:

From FY2026 to FY2028, Pakistan's government will face direct liabilities of Rs. 120.6 billion due to Public-Private Partnership projects, including Rs. 40 billion for the Kharian-Rawalpindi Motorway, Rs. 78.2 billion for the M6 Motorway, and Rs. 2.6 billion for the Sialkot-Kharian Motorway, in the form of Viability Gap Funding (VGF). Additionally, there is a contingent liability of Rs. 87 billion, with a 50% probability of materialization, resulting in an additional Rs. 14.5 billion annually. Moreover, there is a projected fiscal impact of implicit liabilities due to potential natural disasters. Increase in fiscal deficit under this scenario, compared to the baseline, is projected at Rs. 52 billion in FY2026, Rs. 110 billion in FY2027, and Rs. 115 billion in FY2028.

Risk Management: The government will strengthen the Risk Management Unit (RMU) to oversee PPP implementation, ensuring transparency and accountability. It will enhance its PPP framework by improving legal structures for project selection, procurement, and risk allocation.

Long-term strategies include comprehensive feasibility studies, optimizing risk allocation, and incorporating contingent liabilities into the PPP budget.

Commodity Financing Operations and Fiscal Risk:

There is significant fiscal risk from the Federal Government's guarantees to provincial governments and Public Sector Enterprises (PASCO and TCP) for commodity financing operations. As of December 2024, these guarantees amount to Rs. 310 billion for provincial governments and Rs. 852 billion for PSEs. With a 20% probability of provincial governments not paying debt and a 25% probability of PSE for the same, the Federal Government may need to intervene, resulting in Rs. 31 billion in annual liabilities for provincial guarantees and Rs. 106.5 billion for PSE guarantees. This could elevate the fiscal burden, with the federal fiscal deficit projected to rise by Rs. 138 billion in FY2026, Rs. 301 billion in FY2027, and Rs. 353 billion in FY2028, beyond the baseline scenario.

Risk Management: To mitigate commodity-related fiscal risks, the government is reducing exposure by incorporating PSEs guarantees into the overall stock of guarantees and gradually decreasing exposure to provincial governments. Strategic priorities, such as food security, will take precedence over non-essential guarantees. Strengthening PSEs management through governance reforms and performance monitoring is also a key focus.

Global Commodity Price Shock and Fiscal Risk:

The FRS projects significant fiscal challenges from a 20% increase in global oil prices, leading to a reduction in the petroleum levy and an increase in energy subsidies. Assuming this oil price shock in FY2026, the Federal Government would decrease the petroleum levy, resulting in a loss of Rs. 248 billion in non-tax revenues for FY2026 and Rs. 806 billion over FY2026-28. Concurrently, the government would increase subsidies by 20%, leading to a rise in current expenditures by Rs. 238 billion in FY2026 and Rs. 924 billion over FY2026-28. This combination of reduced revenues and increased expenditures would cause the fiscal deficit to increase by Rs. 487 billion in FY2026 and a cumulative Rs. 1,730 billion through FY2026-28, straining the country's fiscal position.

Risk Management: The government will optimize subsidy allocation by prioritizing green energy and exploring alternative revenue sources to offset deficits caused by global commodity price shocks. It will also implement tax reforms and improve revenue collection to reduce overreliance on volatile sources.

Circular Debt and Fiscal Risk:

As of December 2024, the combined circular debt of the power and gas sectors stands at Rs. 4.7 trillion, representing 6% of total government debt. The FRS assumes a scenario where the government caps circular debt in FY2025 at the FY2024 level and integrates it into the broader public debt model from FY2026 onwards. This action will raise the debt-to-GDP ratio by 4 percentage points in FY2025, with debt servicing payments projected to increase by Rs. 937 billion annually from FY2026 to FY2028. The fiscal deficit is expected to rise by Rs. 937 billion in FY2026, accumulating to Rs. 3,142 billion in FY2026-28. Managing this debt will require budget allocations for servicing, potential bailouts, and sector reforms.

Risk Management: To address circular debt, the government will cap the existing stock and gradually reduce it. Tariff adjustments in the power and gas sectors have been made to reflect operational costs. Governance reforms and technology investments will reduce SOEs' inefficiencies, and the government may consider consolidating circular debt into public debt for a more favorable repayment strategy.

Tax Expenditure and Fiscal Risk: In FY2023, tax expenditures were estimated at Rs. 3,879.2 billion, accounting for 4.6% of GDP and 54.2% of FBR revenue. The last scenario outlines the fiscal implications of a 10% increase in tax expenditures due to expanded tax exemptions, extending to previously taxable activities. The fiscal impact is significant, as increased tax expenditures reduce FBR revenues. In FY2026, FBR revenues are projected to be Rs. 763 billion less than the baseline, with a cumulative reduction of Rs. 6,083 billion over FY2026-28. This results in a higher fiscal deficit, with borrowing requirements and debt servicing costs rising. The fiscal deficit is estimated to increase by Rs. 337 billion in FY2026, accumulating to Rs. 2,859 billion in FY2026-28.

Risk Management: The government will establish a robust mechanism for granting tax exemptions through the Tax Policy Unit (TPU), ensuring alignment with national priorities. The TPU will conduct cost-benefit analyses to prevent increases in fiscal burden and implement a comprehensive tax expenditure framework with regular reporting and evaluation to ensure tax exemptions achieve their intended objectives without undermining fiscal sustainability.

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1. INTRODUCTION

The Fiscal Risk Statement (FRS) provides a comprehensive and systematic framework designed to improve the STATEMENT OF FISCAL RISKS, which will be incorporated into the Annual Budget Statement (ABS). Before this, the fiscal risk estimates outlined in the FRS play a crucial role in the development of the Medium-Term National Macroeconomic and Fiscal Framework (MTNMFF). The FRS quantifies fiscal risks from a wide range of sources, including macroeconomic, revenue, debt, climate-related risks, and those linked to State-Owned Enterprises (SOEs). It also addresses contingent liabilities arising from commodity financing operations and Public-Private Partnership projects. The aim of refining the STATEMENT OF FISCAL RISKS is to propose effective government interventions in the annual budget that will minimize and manage these fiscal risks in a sustainable and proactive manner.

The Fiscal Risk Statement plays a critical role in fiscal policy by identifying and assessing potential risks leading to deviations from budgetary forecasts. By systematically evaluating these risks, the FRS helps ensure fiscal stability and informs decision-makers about the possible challenges and uncertainties that could affect government finances. It serves to enhance transparency, accountability, and effective risk management in public finance.

The FRS is crucial for understanding the potential trajectories of fiscal deficits and public debt under various scenarios related to the multiple sources of fiscal risks. By examining different environmental, domestic, and global economic conditions, the FRS offers a detailed outlook on potential fiscal risks and highlights the importance of strategic management in mitigating these challenges. It should be noted at the outset that, in alignment with the Medium-Term National Macro Fiscal Framework, the FRS addresses only the risk trajectories over the medium term. This includes a focus on the upcoming fiscal year and the two subsequent years, while giving relatively less emphasis to long-term risks.

There are various potential sources of fiscal risks, with some being more substantial than others. This Fiscal Risk Statement focuses on the most significant and reasonably identifiable and quantifiable risks. Specifically, it addresses fiscal risks stemming from macroeconomic fluctuations, uncertainties in government revenue and expenditure, concerns related to debt interest and maturity, medium-term impacts of climate change and natural disasters, financial instability within State-Owned Enterprises, challenges associated with Public-Private Partnerships, commodity price shocks and commodity financing risks, emerging circular debt pressures, and revenue losses resulting from tax expenditures.

The Fiscal Risk Statement begins by presenting the baseline forecasts for macroeconomic and fiscal variables over the medium term. These projections are integral to the Medium-Term National Macro Fiscal Framework. This section is crucial for fiscal risk analysis, as an inaccurate or biased baseline projection can undermine the government's understanding of its exposure to fiscal risks.

The baseline projections are meticulously developed using a well-defined methodology and detailed data gathered from various government ministries and departments. These projections are aligned with the forecasts of both government agencies and international institutions. These

baseline projections are then assessed against a range of fiscal risk scenarios, which account for shocks arising from the macroeconomic environment, revenue fluctuations, spending variations, natural disasters, climate-related events, commodity financing operations, and issues within State-Owned enterprises. The discrepancies between the baseline projections for the primary and overall fiscal deficit and those estimated under the various scenarios highlight the potential fiscal risks to which the government is exposed.

The Fiscal Risk Statement is organized into several sections: Section Two outlines the legal framework for preparing the STATEMENT OF FISCAL RISKS; Section Three defines key concepts within this FRS; Section Four provides an overview of the macroeconomic, fiscal, and debt models used for projecting indicators; Section Five presents the baseline macroeconomic and fiscal projections; Section Six highlights the primary sources of fiscal risk and the government's exposure; Section Seven details the scenarios used to identify fiscal risks; and Section Eight offers an in-depth fiscal risk analysis under various scenarios, beginning with the identification of fiscal risks in the baseline scenario.

2. LEGAL FRAMEWORK

The STATEMENT OF FISCAL RISKS is prepared under Section 4, Sub-Section 3 (b) of the Public Finance Management Act, 2019. This Act mandates the inclusion of a STATEMENT OF FISCAL RISKS in the Annual Budget Statement. The Statement is crucial for identifying potential fiscal risks that could cause significant deviations in fiscal indicators from the projections outlined in the Medium-Term Budgetary Statement, as required by Section 5 of the Fiscal Responsibility and Debt Limitation (FRDL) Act, 2005.

Section 3 of the Public Finance Management Act, 2019 requires the Federal Government to approve the Budget Strategy Paper containing quantified macroeconomic and fiscal projections for the medium-term. The FRS aims to identify the risks associated with this medium-term projection. The FRS offers a comprehensive medium-term analysis of various fiscal risks, focusing on climate change, natural disasters, State-Owned Enterprises, Public-Private Partnerships, contingent liabilities, and traditional risks such as macroeconomic uncertainties, revenue shortfalls, and debt-related issues.

The FRS will be instrumental in preparing the Medium-Term National Macro Fiscal Framework (MTNMFF), as mandated by Section 7A of the Fiscal Responsibility and Debt Limitation (Amendment) Act, 2022. The MTNMFF encompasses comprehensive macroeconomic and fiscal projections, focusing on revenues, expenditures, and primary balance for the upcoming year and the subsequent two years.

3. KEY CONCEPTS AND DEFINITIONS

3.1 Fiscal Risk

Fiscal risk refers to the potential difference between actual fiscal outcomes and budgetary forecasts resulting from unforeseen events, uncertainties, or inadequate budgeting practices. These risks can arise from various sources, including macroeconomic shocks, natural disasters, changes in

government policies, financial troubles in State-Owned Enterprises and Public-Private Partnerships, or a lack of awareness about certain risks by the government. The inherent unpredictability of both macroeconomic factors and specific events creates significant challenges for achieving stable and predictable fiscal outcomes.

3.2 Potential Impact on Fiscal Policy

The impact of fiscal risk on fiscal policy can be significant and complex. One primary concern is revenue volatility. Economic downturns, fluctuations in commodity prices, or changes in economic activity can lead to substantial deviations from expected tax and non-tax revenues. Additionally, variations in dividends from State-Owned Enterprises or royalties from natural resources can affect overall revenue. On the expenditure side, unexpected events, such as natural disasters or emergencies, can require considerable unplanned spending for relief and reconstruction efforts. Economic shocks or policy changes may also increase the demand for social safety nets and welfare programs, further straining the government budget.

Debt sustainability is a critical factor influenced by fiscal risks. Changes in interest rates or exchange rates can increase the costs associated with servicing public debt. Additionally, unplanned expenditures or revenue shortfalls may require governments to borrow more, potentially leading to higher debt levels and increased fiscal vulnerability. Contingent liabilities, such as financial difficulties within State-Owned Enterprises or guarantees from Public-Private Partnerships and commodity financing operations, can result in unexpected fiscal burdens if these projects do not perform as anticipated. Furthermore, macroeconomic instability, characterized by fluctuating economic growth rates, inflation, and interest rates, can exacerbate fiscal risks, which, in turn, impact fiscal planning and overall economic performance.

3.3 Managing Fiscal Risk

Effectively managing fiscal risks is essential for ensuring fiscal stability and sustainability. Governments can improve the accuracy of budget forecasts by using robust forecasting models that include risk assessments and scenario analyses. Establishing contingency reserves or fiscal buffers can help address unexpected expenses or revenue shortfalls. Strengthening institutional frameworks for monitoring and managing fiscal risks, diversifying revenue sources to lessen reliance on volatile revenues, and improving transparency and reporting are essential measures. By understanding and proactively addressing fiscal risks, policymakers can promote greater fiscal stability and sustainability, which facilitates better long-term economic planning and helps maintain investor confidence and policy credibility.

The FRS offers a comprehensive overview of fiscal sustainability analysis. It begins by outlining the need to finalize the baseline scenario, which should align with the medium-term projections specified in the Medium-Term Fiscal Framework (MTFF). The FRS then provides a detailed analysis of fiscal risks under alternative scenarios, as baseline projections typically overlook these risks.

4. BRIEF DESCRIPTION OF MACROECONOMIC AND FISCAL MODEL

The baseline projections provide a thorough analysis of Pakistan's macroeconomic and fiscal landscape.

4.1 Macroeconomic Model

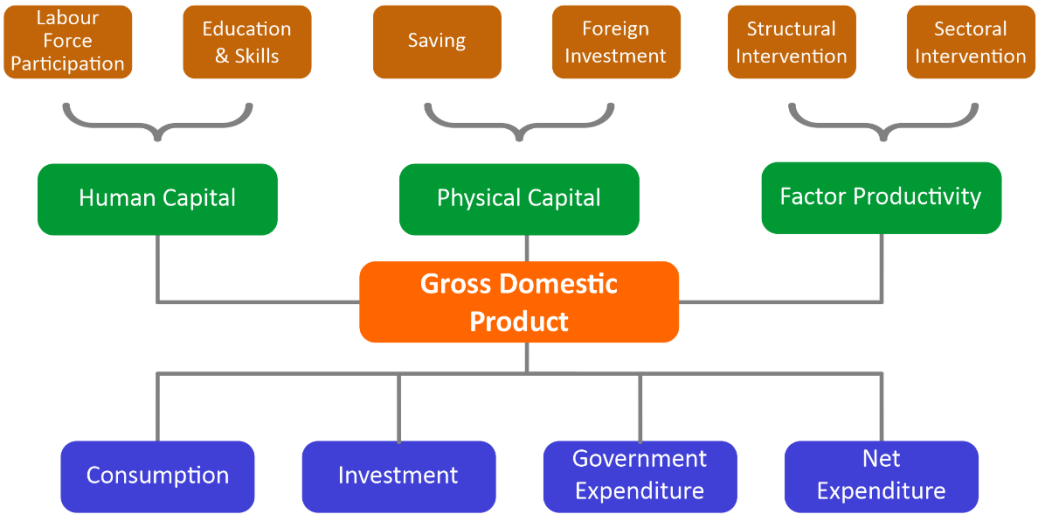
The baseline economic growth projections are based on three distinct methodologies. The first methodology utilizes a structural model of Pakistan's economy, integrating theoretical foundations, empirical data, estimated equations, and a macroeconomic accounting framework. Structural GDP growth forecasts are derived from potential GDP estimates and output gap projections. The Solow-Swan Growth Model is employed to estimate long-term potential real GDP growth, incorporating factors such as labor, capital, and technological progress (total factor productivity). The forecast for potential output is contingent on expected trends in the marginal propensity to invest. Certain influencing factors, such as the growth of gross fixed capital formation, are treated as exogenous, while others are considered as a fixed percentage of total gross value added.

Long-term GDP growth forecasts necessitate key assumptions. Population growth is projected to remain at 2.5%, consistent with historical demographic trends. Labor share and participation rates are assumed to be constant at 60%, reflecting the current labor market structure. Other key parameters, such as depreciation (4%), human capital index growth (0.7%), and total factor productivity (0.9%), are set based on historical averages and recent macroeconomic data.

The output gap forecast incorporates discretionary fiscal expenditures, tax policy changes, monetary policy stance, and foreign demand indicators. Medium-term forecasts from the World Economic Outlook (WEO) and Composite Leading Indicators (CLI) are utilized to predict business cycle turning points. Once potential GDP and the output gap are estimated, they are combined to derive real GDP growth projections.

While supply-side models effectively generate GDP forecasts, demand-side factors must also be considered. The output gap is primarily estimated from demand-side indicators, which are integrated with supply-driven potential output to refine real GDP growth projections. Additionally, demand-side components play crucial roles beyond GDP forecasting. Net exports impact customs duties, import-related general sales tax, and exchange rates, while investment drives capital accumulation and potential output. Government expenditure projections help assess fiscal risk, while household consumption is typically modeled as a residual component.

MACROECONOMIC FRAMEWORK



The second methodology employs monthly indicators to analyze economic activity from short- to long-term perspectives. The Monthly Economic Indicator (MEI) acts as a proxy for annual GDP growth, aggregating data from indicators that are strongly correlated with constant-price GDP. The three primary indicators used in this method are Composite Leading Indicators (CLI), large-scale manufacturing (LSM) growth, and seasonally adjusted money supply (M2). These indicators, when weighted appropriately, provide early signals of GDP fluctuations, enabling forecasts based on their current and expected values.

The third methodology estimates GDP through a sectoral framework, projecting subsector performance in Agriculture, Industry, and Services. Agricultural sector projections primarily rely on major crop data, while livestock and minor crop value additions are estimated using 3 to 5-year historical trends. Industrial sector projections utilize high-frequency LSM data, while fixed investment, Public Sector Development Program (PSDP) spending, and cement dispatches are used to estimate construction sector growth. The services sector lacks direct high-frequency indicators, except for credit disbursement data. Projections for Wholesale & Retail Trade and Transportation rely on the performance of the commodity-producing sector and import trends, which signal overall service sector growth.

After deriving real GDP growth forecasts from these three methods, a consensus forecast is formed by averaging the results while incorporating expert judgment.

Nominal GDP projections serve as the foundation for fiscal analysis since many fiscal risk variables—such as the fiscal deficit and public debt—are expressed as a percentage of GDP. Tax revenues and government expenditures also depend on nominal GDP trends. Nominal GDP is projected by combining real GDP forecasts with GDP deflator estimates. The GDP deflator

growth rate is forecasted using an Autoregressive Distributed Lag (ARDL) model, with the Consumer Price Index (CPI) serving as an early signal.

Exchange rate projections employ two approaches: one based on equilibrium exchange rate fundamentals and another on recent trends and expectations. In the long run, exchange rates tend to converge to equilibrium paths dictated by economic fundamentals. The final exchange rate forecast is derived by averaging both methods and incorporating expert judgment.

Interest rate projections follow a modified Taylor rule, incorporating the output gap, inflation gap, exchange rate, and lagged interest rates. The resulting forecasts are adjusted for recent policy trends and the monetary policy stance communicated by the State Bank of Pakistan (SBP) to generate a consensus forecast. Adjustments for maturity and liquidity risks on different debt instruments allow these projections to estimate future debt servicing costs on the expenditure side and the SBP surplus profits on the revenue side of the government budget.

4.2 Fiscal Model

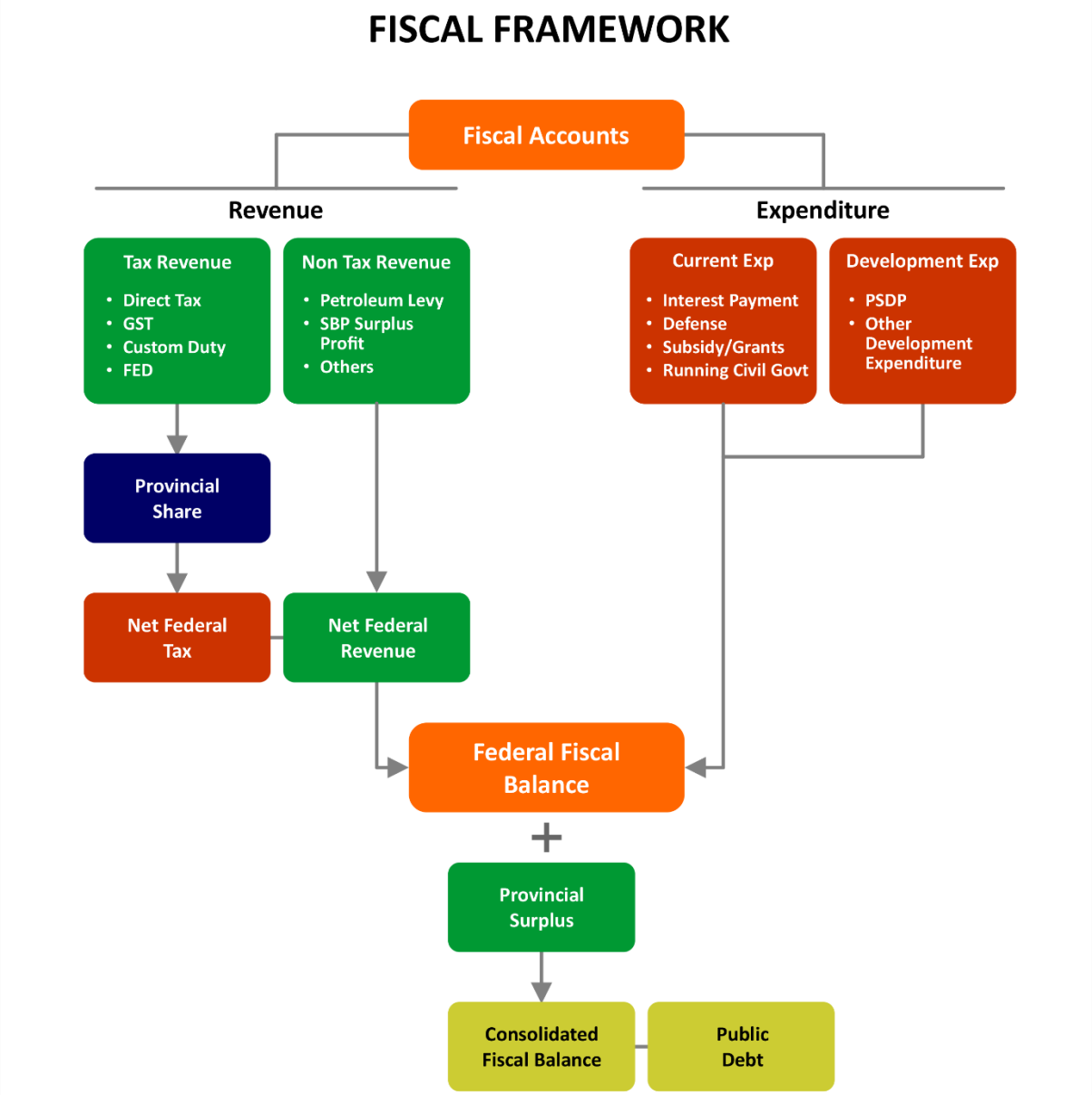
Fiscal projections in the baseline scenario rely on key economic indicators, including non-agricultural value-added, large-scale manufacturing, and imports. Long-term fiscal sustainability is assessed through direct and indirect tax revenues and expenditures. Revenue streams—such as income tax, customs duties, sales tax, and excise duty—are forecasted using econometric models and a tax buoyancy approach.

Tax buoyancy parameters are estimated using historical data from 2001 to 2024, as earlier data exhibited time-varying trends. These estimates align with the Federal Board of Revenue's (FBR) methodology in "Evidence-Based Forecasting of Revenues." Once robust buoyancy estimates are obtained, tax projections leverage tax base forecasts from the macroeconomic framework to provide reliable revenue predictions.

Non-tax revenues, a critical component of the fiscal balance, include the SBP profit and the petroleum levy (PL). Unlike tax revenues, non-tax revenues lack a unified model and are forecasted separately. SBP profit depends on domestic interest rates and market liquidity, while PL estimates are linked to diesel and petrol demand within policy constraints; both are projected using their determinants in respective models. Other non-tax revenue streams—such as royalties on oil and gas, Gas Infrastructure Development Cess, and Windfall Levy on crude oil—are projected using historical trends.

On the expenditure side, projections cover current expenditures, including interest payments (domestic and foreign), defense, pensions, civil government operations, subsidies, and grants. These forecasts use econometric models based on historical data, with a particular focus on markup payments and development expenditures. The Public Sector Development Program (PSDP) and development grants to provinces follow historical trends.

The Fiscal Risk Statement assesses fiscal risk by measuring deviations in the fiscal deficit across alternative scenarios compared to the baseline. Once revenue and expenditure forecasts are finalized, overall and primary fiscal balances are estimated using established accounting identities.



4.3 Debt Model

The debt forecasting model is designed to project the future stock of public debt by considering various debt instruments, their respective terms, and associated fiscal parameters. This model integrates the characteristics of various external borrowing instruments, including multilateral and bilateral loans, commercial loans, international bonds, and domestic instruments such as Treasury Bills, Pakistan Investment Bonds (PIBs), and Government Ijara Sukuk (GIS). National saving schemes are also included in domestic debt. The projections take into account each instrument's grace periods, maturity periods, and interest rates. Additionally, the model considers the currency in which the debt is denominated, as well as exchange rates and the type of interest (fixed or floating).

The Fiscal Risk Tool supporting this FRS employs a set of equations and identities to project future paths of public debt. External debt is assumed to be determined by the previous levels of gross external debt, new debt issuances, and external debt maturities. In this context, external debt

is considered exogenous, as its trajectory is outlined by the Economic Affairs Division, which operates independently of the model. This trajectory is influenced by several factors, including the risk of default, debt rating, agreements with friendly and other countries, the availability of development funding from donors, and, to some extent, the government's decisions regarding debt composition. Similarly, existing domestic debt maturities are assumed to be rolled over, and interest payments on fixed-rate instruments are predetermined. Therefore, domestic debt issuance is seen as residual and endogenously determined within the debt model; it is calculated by subtracting interest payments on external debt and newly issued external debt from the sum of interest payments on domestic debt, external debt maturities, and the primary fiscal balance.

After combining macroeconomic, fiscal, and debt modules, fiscal deficit, primary fiscal deficit, domestic debt, external debt, debt servicing, and other indicators are projected over the medium term. These projections form the basis of the fiscal risk assessment. The baseline medium-term paths of fiscal indicators are compared to the paths under different scenario assumptions to identify fiscal risks associated with potential shocks.

5. BASELINE PROJECTIONS

The baseline scenario outlines a strategy for fiscal consolidation that highlights the need for the government to improve its fiscal balance and control debt accumulation. Provincial governments are expected to maintain an overall fiscal surplus, aligning with the current fiscal strategy. By keeping key macroeconomic variables and fiscal parameters at their historical levels, this scenario serves as a reference point for understanding the potential impact of future policy changes and external shocks. The projections generated in this scenario provide a foundation for more dynamic analyses that incorporate varying degrees of shocks, such as climate change, commodity price volatility, and other external factors.

The baseline scenario assumes a stable macroeconomic environment characterized by moderate economic growth that gradually increases over time, along with stable revenues and expenditures growth. Interest rate, the main determinant of interest payments, is assumed to remain at the lower end of the double-digit range, due to single digit inflation rate and projected low SBP policy rate. Natural disasters, while included in scenario analysis, are not considered in the baseline projections, as the government does not have a dedicated natural disaster fund from which allocations can be projected under the baseline.

MEDIUM TERM MACROECONOMIC FRAMEWORK

Pakistan's Economic Performance in FY2025:

Economic Growth:

In FY2024, Pakistan's economic growth rebounded to 2.5%, a significant recovery from the negative growth of 0.2% in FY2023, which was marked by a complex and challenging environment. The successful completion of the IMF Stand-By Arrangement (SBA), coupled with bilateral assistance, restored market confidence. This led to a deceleration in inflationary pressures, an increase in foreign exchange reserves, and stabilization of the exchange rate. The economy

continued to show improvement in Q1-FY2025, building on the stabilization achieved in FY2024, despite lower growth in the agriculture and industrial sectors.

During Q1 of FY2025, GDP growth was estimated at 0.92%, compared to 2.30% in the same period last year. However, there are signs of improvement in economic activity from Q2 onwards, driven by an easing of monetary policy (a reduction in the policy rate from 17.5% to 12%), which is expected to facilitate an expansion in credit to the private sector, particularly an increase in credit demand for working capital (Rs 1,693 billion in Q2 against a retirement of Rs 219 billion in Q1 FY2025). Additionally, increased PSDP spending (8.3%, Jul-Dec FY2025), a rise in company incorporations (16.5%, Jul-Jan FY2025), an increase in oil sales (4.0%, Jul-Jan FY2025), and a significant rise in machinery imports (16%, Jul-Dec FY2025), primarily for the power generation, textile, construction & mining, and agriculture sectors, indicate an expansion and scaling up of production capacity.

Figure 1: Growth in GDP and Sectors (Q1: FY2025)

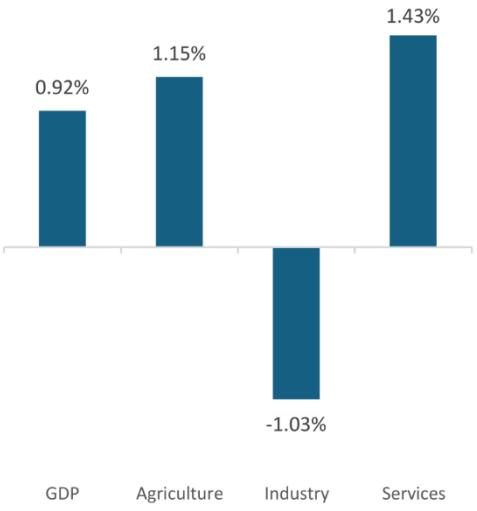
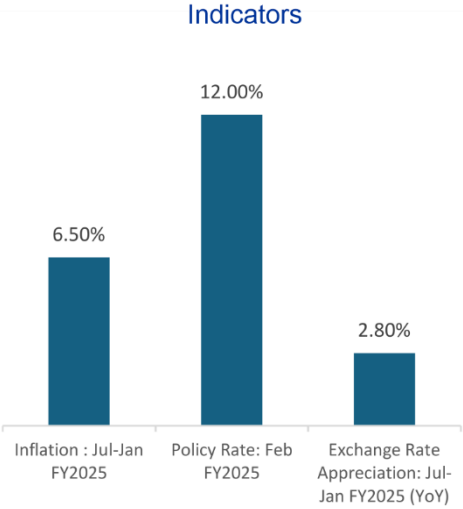


Figure 2: Other Macroeconomic Indicators



The agriculture sector grew by 1.15% in Q1 FY2025, compared to 8.09% in the same period last year. The growth in important crops contracted by 11.19% in Q1 due to the high base effect from the previous fiscal year. Other crops witnessed a growth of 2.08% in Q1, compared to -2.08% last year, while livestock increased by 4.89%. Forestry and fishing maintained their normal growth tendencies, with modest growth of 0.78% and 0.82%, respectively. The FCA set the production target for wheat for Rabi 2024-25 at 27.9 million tonnes on an area of 9.3 million hectares. However, the sown area registered at 9.0 million hectares (97% of the target), and unfavorable weather patterns pose risks for achieving the desired yield.

Agriculture credit disbursement reached Rs 1483.6 billion during Jul-Jan FY2025, an increase of 16.0% compared to Rs 1279.4 billion during the same period last year. This positive trend is expected to persist in FY2025. Agricultural machinery imports also saw a significant rise of 42.3%, amounting to $45.3 million, highlighting a growing emphasis on mechanization and efficiency improvements. For the Rabi 2024-25 season, urea offtake during Oct-Dec 2024 was 2,003 thousand tonnes (18% higher than Oct-Dec 2023), while DAP offtake was 690 thousand tonnes

(19.5% higher than Oct-Dec 2023). The increase in fertilizer offtake is likely due to the Kissan Card package and other provincial government initiatives.

In Q1-FY2025, the industrial sector contracted by 1.03%, showing improvement compared to a substantial contraction of 4.43% in the same period last year. This recovery was largely attributed to growth in manufacturing, as well as electricity, gas, and water supply. However, downside risks persist in the mining and quarrying sector, which declined by 6.49%, and construction, which contracted significantly by 14.91%.

During Jul-Dec FY2025, the LSM sector declined by 1.87%, compared to a contraction of 0.98% during the same period last year. Despite the contraction, high-weight sectors such as textiles, wearing apparel, pharmaceuticals, beverages, and automobiles displayed renewed vitality, highlighting the sector's resilience and potential for recovery. The textile sector, the largest in LSM, witnessed a growth of 2.1% in Jul-Dec FY2025, compared to -10.96% last year. This turnaround was underpinned by improved macroeconomic conditions, a decline in inflation, exchange rate stability, and a reduced policy rate that lowered borrowing costs and stimulated investment.

The automobile industry demonstrated a remarkable recovery during Jul-Jan FY2025. Total vehicle production surged by 28.9%, while sales grew by 29.1% compared to the same period in FY2024. Production of cars increased by 45.8%, trucks and buses by 122.6%, and jeeps and pick-ups by 76.3%, while tractor production showed a decline of 30.0%.

Total cement dispatches reached 26.8 million tonnes in Jul-Jan FY2025, marking a 1.7% decline from the same period last year, reflecting weak local demand amid subdued construction activity and rising input costs.

In Q1 of FY2025, the services sector grew by 1.43% compared to the same period last fiscal year. Moderate growth was observed due to a slowdown in wholesale & retail trade and transport & storage sectors. Trade volume in services (encompassing both exports and imports) grew by 8.3% in Jul-Dec FY2025, supported by expansion in the Information & Communication sector, a cornerstone of Pakistan's transition toward a digital economy. Furthermore, remittance inflows saw a notable surge of 31.7% during Jul-Jan FY2025, enhancing household incomes and stimulating consumer spending across retail businesses and other private services. As the economic recovery deepens, the other private services sector is expected to improve further.

Inflation

CPI inflation during Jul-Jan FY2025 was recorded at 6.5%, compared to 28.7% during the same period last year. Several factors, including fiscal consolidation, a high policy rate, and easing global inflationary pressures, contributed to this decline. Notably, inflation declined substantially to 2.4% in January 2025, down from 28.3% in January 2024.

Fiscal and Monetary Sectors

A substantial increase in revenues compared to expenditures improved fiscal indicators during Jul-Dec FY2025. The fiscal deficit reduced to 1.2% of GDP (Rs 1,537.9 billion) in Jul-Dec FY2025 from 2.3% of GDP (Rs 2,407.8 billion) last year. Furthermore, the primary surplus continued to

improve, reaching Rs 3,603.7 billion (2.9% of GDP) during Jul-Dec FY2024, up from Rs 1,812.2 billion (1.7% of GDP) last year.

At the start of FY2025, the SBP initiated monetary policy normalization, and by January 2025, the policy rate had been reduced by a cumulative 1000 basis points to 12%. This adjustment is expected to stimulate economic activity, enhance business confidence, and support sustainable economic recovery in FY2025 and beyond.

External Sector

Exports during Jul-Jan FY2025 increased by 10.0% to $19.6 billion, compared to $17.8 billion last year. Imports during Jul-Jan FY2025 increased by 7.0% to $33.0 billion, compared to $30.9 billion last year. Remittances during Jul-Jan FY2025 increased by 31.7% to $20.8 billion, compared to $15.8 billion last year. The current account posted a surplus of $1.2 billion during Jul-Dec FY2025, compared to a deficit of $1.4 billion last year. FDI increased by 20.0% to $1,329 million in Jul-Dec FY2025, compared to $1,108 million last year. The KSE-100 index reached an all-time high of 117,587 points, reflecting market and business confidence among investors.

Pakistan's foreign exchange reserves experienced notable improvement during FY2025, reaching $15.9 billion (SBP: $11.3 billion & Banks: $4.6 billion), sufficient to cover over two months of imports.

BASELINE MACROECONOMIC PROJECTIONS

Economic Growth

Anticipating sustained positive momentum in domestic economic activities, the economy is projected to grow at 3.1% during FY2025. Assuming continued stability and the absence of major shocks, real GDP growth is expected to accelerate to 4.5% in FY2026 and reach 5.7% by FY2028.

Figure 3: Real GDP Growth (%): Actual and Projected

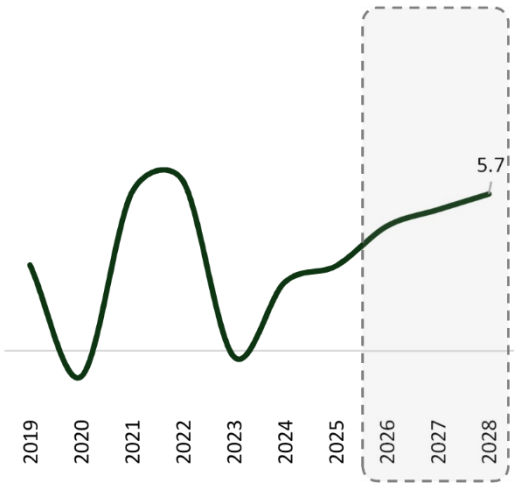
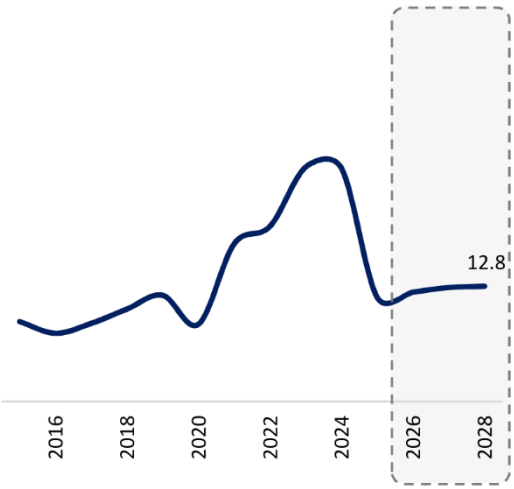


Figure 4: Nominal GDP Growth (%): Actual and Projected



The real GDP growth is expected to be driven by the agriculture sector, which is projected to grow by 1.3% in FY2025, supported by a 3.8% growth in livestock and a 4.2% growth in the other crops sector. The sector's growth is anticipated to further improve, reaching 4.7% by FY2028, with moderate increases across sub-sectors such as crops and livestock.

The industrial sector is projected to grow by 2.9% in FY2025, underpinned by a 2.8% growth in the manufacturing sector, a 3.8% growth in slaughtering, and a 4.5% growth in the construction sector. Despite the industrial sector's poor performance in recent years, there is excess capacity that will boost economic activity in the medium term. Macroeconomic stability, coupled with lower interest rates, will particularly contribute to higher growth. The industrial sector's growth rate is projected to increase from 5.3% in FY2026 to 6.8% by FY2028.

The services sector is projected to grow by 3.9% in FY2025, driven by a 3.8% growth in wholesale & retail trade, a 2.8% growth in transport & storage, a 5.5% growth in finance and insurance, a 5.8% growth in information & communication, and a 5.0% growth in other private services. The improvement in commodity-producing sectors, along with increased production and consumption, is expected to stimulate demand for these key service industries.

A combination of robust real GDP growth and a lower inflation rate is projected to result in moderate growth of nominal GDP, reaching 12.1% in FY2026 and 12.8% in FY2028. Nominal GDP, which serves as the basis for all fiscal indicators, is projected to reach Rs. 132 trillion in FY2026 and Rs. 167.7 trillion in FY2028.

Table-1: Medium-Term Macroeconomic Framework

	Actual	Projected			
	2023-24	2024-25	2025-26	2026-27	2027-28
Economic Growth					
GDP at Basic Prices (Const Price) (%)	2.5	3.1	4.5	5.1	5.7
LSM (%)	1.0	1.1	5.0	6.4	7.2
Inflation (Average)	23.4	7.2	7.0	6.8	6.5
GDP at Market Prices (Rs Billion)	105,616	117,785	132,034	148,689	167,669
Growth in Nominal GDP	25.8	11.5	12.1	12.6	12.8
Investment as % of GDP					
Gross Fixed Capital Formation (GFCF)	11.2	12.3	13.0	13.8	14.2
▪ Private	9.0	9.3	10.2	10.6	10.9
▪ Public & General Govt	2.3	3.0	3.1	3.2	3.3
External Sector ($ Million)					
Current Account	-1,695	-136	-2,973	-3,793	-4,873
CA as % of GDP	-0.5	-0.03	-0.7	-0.8	-0.9
Exports (goods)	30,967	32,987	36,121	39,553	44,892
Imports (goods)	53,056	58,981	66,250	73,231	81,628
Exports (Services)	7,870	8,569	9,863	10,948	12,098
Imports (Services)	10,692	11,549	13,859	15,245	16,465
Workers Remittances	30,251	35,238	37,003	40,082	42,102
Saving & Investment (% of GDP)					
Gross Saving	12.5	14.0	14.0	14.6	14.9
Investment	12.9	14.0	14.7	15.4	15.8

Inflation

Inflation is projected at 7.2% during FY2025. With developments at both external and domestic levels, inflation is expected to reduce to 7.0% over the medium term. The declining trend of global commodity prices will ease inflationary pressures over the medium term. According to the World Bank price forecast, global commodity prices are expected to decline further in 2025 and 2026. Additionally, a projected increase in agricultural productivity will ensure a stable domestic food supply, reducing dependency on imports and preventing food shortages, thereby helping to control food prices. A stable exchange rate is also expected in the medium term, driven by an increase in remittances, exports, and FDI, along with better inflows from multilateral and bilateral partners.

Figure 5: CPI Inflation (%): Actual and Projected

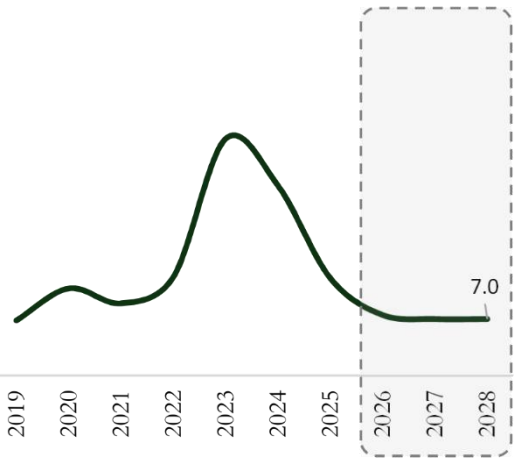
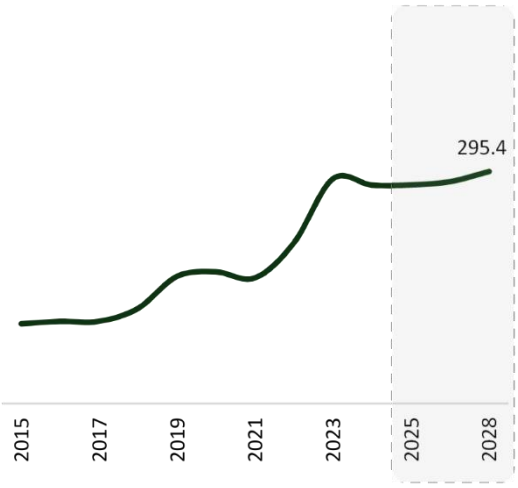


Figure 6: Exchange Rate (Rs/$): Actual and Projected



External Sector

In FY2028, exports (goods & services combined) are projected to reach $57.0 billion, up from a projected $46 billion in FY2026 and $42 billion in FY2025. Imports (goods & services combined) are projected to reach $98.1 billion, up from $80 billion in FY2026 and $70 billion in FY2025. With a better economic outlook in remittance source countries, a stable exchange rate, a decline in global inflation, remittances are expected to reach $42.1 billion by FY2028, up from more than $32 billion in FY2025. Consequently, the current account deficit is projected to be at a sustainable level of 0.9% of GDP over the medium term.

Pakistan's external sector indicates positive developments during H1 of FY2025. In the coming months, it is projected that exports will benefit from increased domestic economic activity, exchange rate stability, and favorable growth trends in main export destinations, as evidenced by the Composite Leading Indicator position of Pakistan's main export markets, which is hovering around the potential level of 100 in 2024. The world trade volume for goods and services is projected to grow by 3.4% in 2025, presenting opportunities for Pakistan's export sectors, particularly textiles and agriculture. For FY2025, exports (goods & services) are projected to reach

$41.6 billion, imports (goods & services) $70.5 billion, and remittances $35.2 billion. Consequently, the current account deficit is expected to be $0.14 billion (0.03% of GDP). With the anticipated decline in energy prices, particularly oil, the import bill will reduce, alleviating external sector pressures on the economy.

Global Economic Outlook

The macroeconomic outlook for Pakistan is closely aligned with the global economic outlook. After facing unprecedented challenges in recent years, the global economy is beginning to experience some relief as cyclical imbalances ease, bringing economic activity closer to potential output in major economies. Global GDP growth is projected to remain stable at 3.3% in both 2025 and 2026, with a notable shift in sectoral dynamics contributing to a decline in global inflation, which is expected to decrease to 4.2% in 2025 and 3.5% in 2026 from 5.7% in 2024. Global rebalancing is tending to boost activity in the services sector in both advanced and emerging markets. Manufacturing production is increasingly shifting towards emerging market economies, as advanced economies lose competitiveness.

Monetary policy rates of major central banks are anticipated to decline further, albeit at varying speeds, reflecting differences in growth and inflation projections. Meanwhile, fiscal policy is expected to tighten in 2025-26, particularly in advanced economies such as the United States, and to a lesser extent in emerging markets and developing economies.

The global economic outlook holds considerable implications for Pakistan's economy. The receding global inflationary pressures are likely to promote stability in domestic prices for food and energy.

In September 2024, Pakistan signed a new 37-month IMF Extended Fund Facility (EFF) program worth $7 billion, focusing on prudent policies and reforms to ensure sustained and inclusive growth. This program is anchored on sound policies and reforms to support the economic recovery process, continuation of prudent policies to address deep structural challenges, and creating conditions for stronger, more inclusive, and resilient growth.

BASELINE MEDIUM TERM FISCAL FRAMEWORK

Pakistan's economy faced significant economic and debt crises in FY2023 and FY2024, leading to a deterioration in economic, social, and fiscal indicators. Interest payments surged dramatically, driven by the SBP policy rate peaking at 22%. Despite these challenges, the FBR's revenue collection remained resilient, supported by improved policy compliance and higher inflation. The medium-term outlook is stable, with gradual improvements in economic and fiscal indicators. The interest rate has decreased, nearing single digits, and the exchange rate has stabilized amid a reduced current account deficit. Fiscal consolidation is underway, inflation has dropped to single digits from over 30% two years ago, and GDP growth is expected to return to its historical average.

Over the medium term, the outlook for economic and fiscal indicators is stable, with gradual improvements expected. The interest rate has declined, reaching at the lower end of the double-digit range, the exchange rate has stabilized amid an improved current account balance, fiscal

consolidation is progressing, inflation has dropped to single digits from over 30% two years ago, and GDP growth is anticipated to return to its historical average.

FBR revenues are projected to grow steadily, reaching Rs. 20,572 billion by FY2028 from Rs. 15,270 billion in FY2026. This growth assumes improvements in macroeconomic indicators, such as nominal GDP, large-scale manufacturing (LSM), and imports, alongside continued efforts by the FBR to broaden the tax base, enhance compliance, and leverage digitalization efforts. Non-tax revenue is projected to increase from Rs. 3,841 billion in FY2026 to Rs. 4,606 billion by FY2028. Gross Federal Revenue receipts are anticipated to grow from Rs. 19,111 billion in FY2026 to Rs. 25,178 billion in FY2028. Transfers to provinces are projected to rise from Rs. 8,780 billion in FY2026 to Rs. 11,839 billion in FY2028. Consequently, net federal revenue receipts are projected to grow from Rs. 10,331 billion in FY2026 to Rs. 13,340 billion in FY2028.

On the expenditure side, the fiscal position will benefit from lower interest rates, significantly reducing interest payments, which are the largest component of expenditures. Total Federal Expenditures are projected to increase moderately from Rs. 17,553 billion in FY2026 to Rs. 19,574 billion by FY2028. This projection assumes the government's commitment to rationalizing expenditures while prioritizing critical areas such as social protection, infrastructure development, and climate resilience.

Table 2: Medium Term Fiscal Framework (Rs. Billion)

	Actual	B.E.	Projection		
	FY2024	**FY2025**	**FY2026**	**FY2027**	**FY2028**
FBR Revenue	9,311	12,970	15,270	18,064	20,572
Non-Tax Revenue	3,050	4,845	3,841	4,119	4,606
Gross Federal Revenue Receipts	12,361	17,815	19,111	22,183	25,178
Transfer to Provinces	5,264	7,438	8,780	10,387	11,839
Net Federal Revenue Receipts	7,098	10,377	10,331	11,796	13,340
Total Expenditure	14,823	18,877	17,553	18,153	19,574
Federal Fiscal Balance	-7,725	-8,500	-7,222	-6,357	-6,235
As % of GDP	**-7.3**	**-6.8**	**-5.5**	**-4.3**	**-3.7**
Federal Primary Balance	435	1,275	885	1,594	1,690
As % of GDP	0.4	1.0	0.7	1.1	1.0
Provincial Surplus	518	1,217	1,360	1,437	1,677
As % of GDP	0.5	1.0	1.0	1.0	1.0
Overall Fiscal Balance	-7,207	-7,283	-5,862	-4,920	-4,558
As % of GDP	**-6.8**	**-5.9**	**-4.4**	**-3.3**	**-2.7**
Overall Primary Balance	953	2,492	2,245	3,031	3,367
As % of GDP	**0.9**	**2.0**	**1.7**	**2.0**	**2.0**
Memo: GDP	105,616	124,150	132,034	148,689	167,669

Improved revenue mobilization and expenditure consolidation are expected to result in a significant narrowing of the federal fiscal deficit over the medium term, reducing from 5.5% of

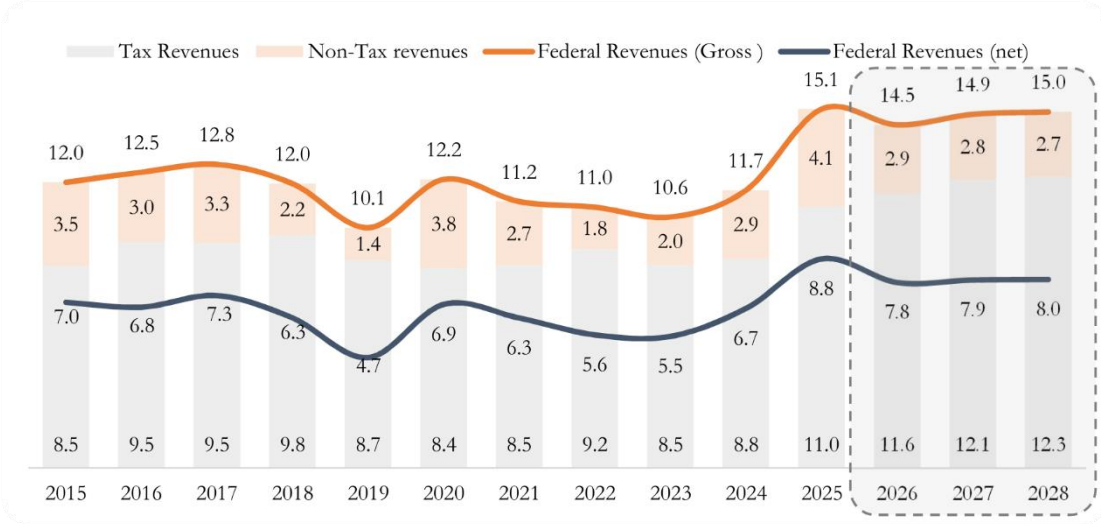
GDP (Rs. 7,222 billion) in FY2026 to 3.7% of GDP (Rs. 6,235 billion) by FY2028. The government intends to achieve primary fiscal consolidation, with the federal primary balance expected to remain in surplus at 0.7% of GDP in FY2026 and 1.0% in FY2027 and FY2028. This is contingent on the government's ability to generate resources for debt servicing smoothly.

Provincial surpluses, an integral part of the fiscal strategy, are projected to remain steady at 1.0% of GDP over the medium term, assuming effective fiscal management at the sub-national level continues. This surplus will contribute to the overall fiscal consolidation effort, enabling a reduction in the overall fiscal deficit to 2.7% in FY2028.

MEDIUM TERM TAX REVENUE PROJECTIONS

Medium-term projections indicate an increase in both tax and non-tax revenues, both in nominal terms and as a percentage of GDP. Tax revenues are expected to grow faster than economic activity, assuming continued improvements in policy compliance and gradual expansion of the tax base. Non-tax revenue is also projected to increase due to robust SBP profits and higher petroleum levy collections. However, with decreased interest rates, SBP profits will stabilize in nominal terms, causing non-tax revenue as a percentage of GDP to converge to its historical norm.

Figure 7: FBR Revenues (% of GDP): Actual and Projected



Tax revenue projections for FY2026 to FY2028 reflect improved economic activity and increased tax compliance, with the assumption that tax elasticity will exceed tax buoyancy. Direct taxes are expected to grow steadily, increasing from Rs. 6,570.3 billion in FY2026 to Rs. 8,725.2 billion in FY2028, mainly driven by increased economic activity, as income tax rates have already increased and there is limited room for further expansion of the tax base.

Indirect taxes are projected to grow substantially due to available room for tax base expansion and improved economic activity. Indirect taxes are projected to rise from Rs. 8,699.7 billion in FY2026 to Rs. 11,846.9 billion in FY2028. Within this category, sales tax is the largest contributor, expected to grow from Rs. 5,733.4 billion in FY2026 to Rs. 7,764.5 billion in FY2028, assumed to be driven by increased LSM, enhanced enforcement, and improvements in the digitalization of tax systems.

Customs Duty and Federal Excise Duty are also set to increase, reflecting improved imports and higher consumption of excisable goods, inducing higher domestic production as reflected in LSM.

Table 3: FBR Tax Collections (Rs. Billion)					
	Actual	**B.E.**	**Projection**		
	FY2024	**FY2025**	**FY2026**	**FY2027**	**FY2028**
FBR Revenues	**9,311.0**	**12,970.0**	**15,270.0**	**18,064.0**	**20,572.1**
Direct Taxes	4,530.7	5,512.0	6,570.3	7,628.7	8,725.2
Sales tax/VAT (Goods)	3,098.8	4,919.0	5,733.4	6,860.2	7,764.5
Custom duty	1,104.1	1,591.0	1,846.5	2,220.5	2,516.2
Federal Excise duty	577.5	948.0	1,119.7	1,354.6	1,566.1

MEDIUM-TERM NON-TAX REVENUE PROJECTIONS

Non-tax revenue collections are projected to remain a vital component of the fiscal framework, with an emphasis on optimizing existing sources. The petroleum levy is expected to gradually increase from Rs. 1,242.0 billion in FY2026 to Rs. 1,513.0 billion in FY2028, reflecting adjustments aligned with global energy market dynamics and domestic consumption trends. Receipts from the State Bank of Pakistan's surplus profits show significant fluctuations, peaking at Rs. 1,373.4 billion in FY2026 before stabilizing at Rs. 1,676.7 billion in FY2028. Overall, non-tax revenues are projected to increase from Rs. 3,841.4 billion in FY2026 to Rs. 4,606.2 billion in FY2028, maintaining a significant weight in the overall fiscal balance.

Table 4: Non-Tax Revenue Collections (Rs. Billion)					
	Actual FY2024	B.E. FY2025	Projection		
			FY2026	FY2027	FY2028
Petroleum Levy	1,019.2	1,281.0	1,242.0	1,274.1	1,513.0
Natural Gas Development Surcharge	30.5	25.6	29.4	33.9	38.6
Gas Infrastructure Development Cess	2.9	2.5	3.0	3.6	4.0
Petroleum levy on LPG	3.5	3.5	4.0	4.7	5.5
Receipts from Civil Administration and Other Functions / ICT Administration	21.6	50.7	59.0	64.0	72.0
Surplus Profit (SBP)	972.2	2,500.0	1,373.4	1,519.6	1,676.7
Surplus Profit (PTA)	42.3	33.8	39.2	45.5	53.7
Royalties on Oil/Gas / Windfall levy against crude oil	193.1	190.5	223.6	261.7	307.5
Mark-up (Provinces, PSEs, and others)	444.7	294.3	285.5	279.8	271.4
Other non-tax revenues	320.5	463.5	582.2	632.3	663.9
Non-Tax Revenues	**3,050.5**	**4,845.4**	**3,841.4**	**4,119.0**	**4,606.2**

MEDIUM-TERM FEDERAL EXPENDITURE PROJECTIONS

In line with contained interest payments and the government's intention to control primary spending, total expenditures are projected to remain consistent with macroeconomic conditions. Total expenditure is projected to rise from Rs. 17,552.6 billion in FY2026 to Rs. 19,574.2 billion in FY2028.

Current expenditures are expected to dominate the budget, growing from Rs. 16,085.6 billion in FY2026 to Rs. 17,794.9 billion in FY2028. Interest payments alone represent a significant share, peaking at Rs. 8,106.5 billion in FY2026 before stabilizing at Rs. 7,925.0 billion in FY2028. However, in real terms and as a percentage of GDP, interest payments are projected to decline significantly. Pensions are projected to rise from Rs. 1,185.0 billion in FY2026 to Rs. 1,571.0 billion in FY2028.

Figure 8: Federal Expenditure (% of GDP): Actual and Projected

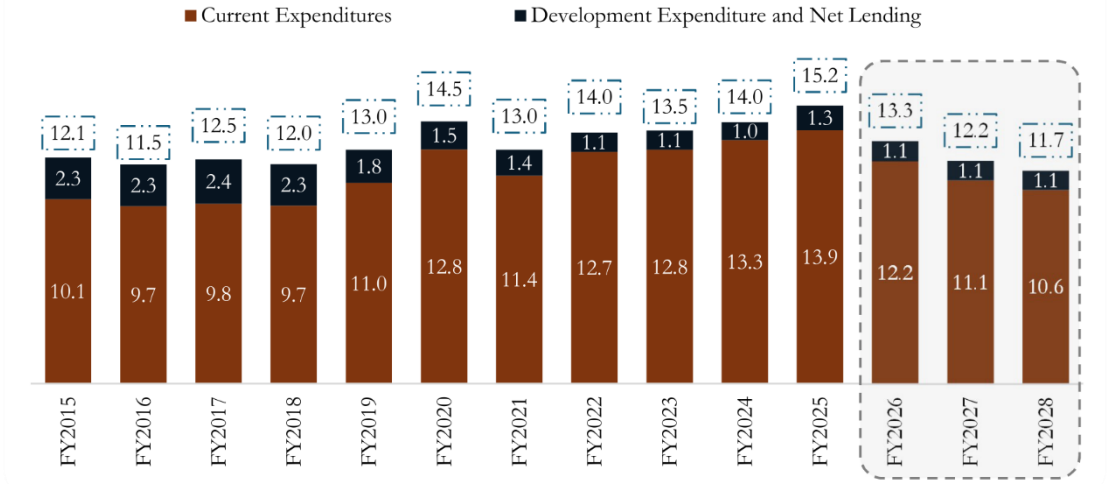
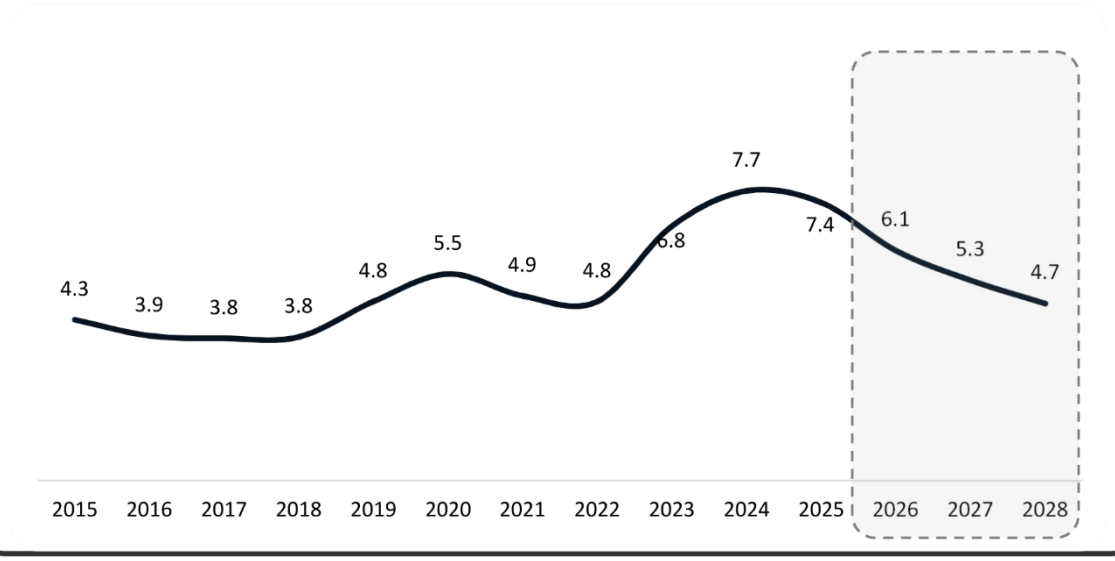


Figure 9: Interest Payment (% of GDP)



Key budget allocations include defense spending, projected to increase from Rs. 2,281.0 billion in FY2026 to Rs. 2,889.6 billion in FY2028, and Grants projected to increase to Rs. 2,511.2 billion in FY2028 from Rs. 2,077.0 billion in FY2026, while subsidies are projected to remain capped at Rs. 1,359.0 billion in FY2028. Grants and subsidies are projected based on historical trends, assuming that past trends will continue into the future.

Development expenditure and net lending are projected to rise from Rs. 1,467.0 billion (including PSDP of Rs. 1,200 billion) in FY2026 to Rs. 1,779.2 billion (including Rs. 1,450.3 billion PSDP) in FY2028. These allocations are consistent with economic activity based on past trends.

Table 5: Indicative Budget Spending Levels (Rs. Billion)

	Actual FY2024	B.E. FY2025	Projection		
			FY2026	FY2027	FY2028
a) Current Expenditures	14,073.1	17,203.1	16,085.6	16,553.9	17,794.9
Interest Payments	8,159.8	9,775.0	8,106.5	7,951.2	7,925.0
Pension	807.8	1,014.0	1,185.0	1,367.0	1,571.0
Defence	1,858.8	2,122.0	2,281.0	2,452.0	2,889.6
Grants	1,395.3	1,776.7	2,077.0	2,227.0	2,511.2
Subsidies	1,067.4	1,363.4	1,191.0	1,205.0	1,359.0
Running of Civil Government	784.0	839.0	915.0	980.0	1,120.0
Emergency and Others	0.0	313.0	330.1	371.7	419.2
b) Development expenditure and Net Lending	1,030.9	1,674.0	1,467.0	1,599.0	1,779.2
Federal (PSDP)	732.2	1,400.0	1,200.0	1,300.0	1,450.3
Net Lending and others	298.7	274.0	267.0	299.0	328.9
c) Statistical Discrepancy	-281.0				
Total Expenditure	**14,823.0**	**18,877.1**	**17,552.6**	**18,152.9**	**19,574.2**

6. FISCAL RISKS

This Fiscal Risk Statement evaluates fiscal risks by measuring the deviation of the fiscal deficit under various scenarios in comparison to a baseline scenario. Key indicators of the country's fiscal health and its exposure to fiscal risks include the overall fiscal balance, the primary fiscal balance, and public debt. The overall fiscal balance indicates the government's ability to finance its expenditures sustainably. Persistent deficits can signal vulnerabilities, such as increasing borrowing costs, declining investor confidence, and potential macroeconomic instability. The primary fiscal balance, which excludes interest payments on existing debt, is particularly important for assessing a government's ability to stabilize its debt levels and manage outstanding debt over time. A consistent primary deficit suggests that a country may have difficulty controlling its debt trajectory, making it more vulnerable to adverse events, such as economic downturns or rising interest rates.

Public debt is crucial for assessing fiscal risk, as high levels of debt limit fiscal flexibility and increase vulnerability to fluctuations in financial markets. Excessive debt can lead to higher borrowing costs, downgrades in credit ratings, and difficulties in refinancing obligations, especially during

times of crisis. Additionally, rising costs associated with debt servicing can crowd out vital public spending, restricting the government's ability to respond to economic shocks. Effective fiscal management involves maintaining a prudent fiscal balance and achieving a primary surplus when needed, ensuring medium- to long-term debt sustainability, and reducing risks to macroeconomic stability.

6.1 Sources of Fiscal Risks and Exposure

Fiscal risks arise from macroeconomic shocks, contingent liabilities, and policy inefficiencies, which threaten fiscal sustainability. Economic downturns and exchange rate volatility can decrease revenue and increase spending pressures. Similarly, higher-than-expected interest rates can lead to increased debt-servicing costs. In the past, revenue growth from the Federal Board of Revenue has been attributed to increased tax rates and administrative measures. However, future revenue gains may slow without implementing structural tax reforms.

Contingent liabilities, such as bailouts for State-Owned Enterprises and government guarantees provided to some Public Sector Enterprises (PSEs) and provincial governments, pose additional fiscal risks if they materialize. Climate change and natural disasters can also disrupt economic activity, reducing revenue and increasing emergency spending and reconstruction costs. Fluctuations in commodity prices further strain public finances by increasing the demand for subsidies. Policy inconsistency and delays in structural reforms can escalate these risks, underscoring the necessity for structural reforms, sound fiscal management, and risk mitigation strategies to ensure long-term sustainability.

SOURCE OF FISCAL RISKS

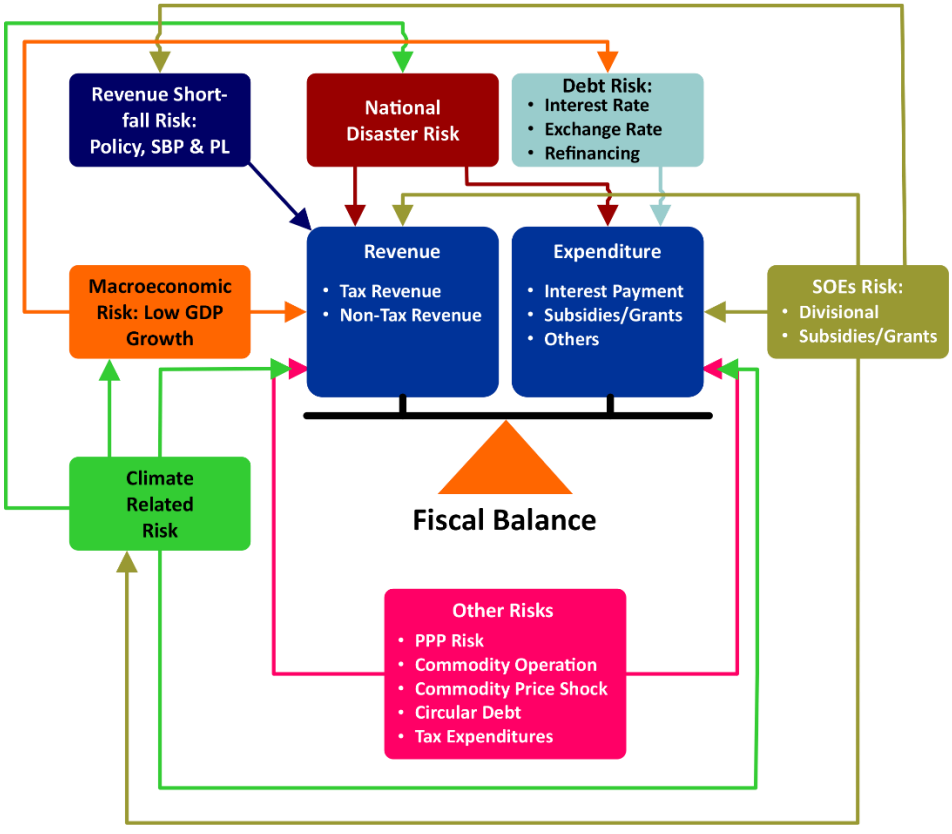


Table 6 summarizes the various types and sources of risks and highlights risk exposure. A detailed discussion of these sources and their exposure follows the table.

Table 6: Types and Sources of Fiscal Risks and Risk Exposure	
Types and Sources of Fiscal Risk	**Risk Exposure**
Macroeconomic Risks	
GDP Growth	Revenue vulnerability to lower-than-expected GDP growth while spending remains rigid, putting fiscal sustainability at risk.
Exchange Rate	Setting the economy to achieve higher-than-potential growth exposes it to exchange rate depreciation, puts a burden on external debt through debt servicing, and increases demand for debt, leading to a high current account deficit.
Inflation	Higher than expected inflation rate leading to higher interest rate.
Revenue Risks	
Tax Rates and Administrative Measures	FBR revenue growth is expected to slow down as the tax gap due to administrative measures and tax rate increases is exploited without major reform initiatives concerning the tax base
Non-tax revenue	The recent performance of non-tax revenues mainly relied on SBP profit and petroleum levy. Though the higher SBP profit compensates for the extra debt servicing payments, there is a risk of the primary fiscal balance reduction, putting additional pressure on debt. SOEs' dividends are also at risk, contributing less to non-tax revenues.
Debt-Related Fiscal Risks	
Interest rate and Currency Depreciation	Fixed-interest debt is just 30% of the total, carrying a high interest rate. Higher-than-expected inflation due to higher aggregate demand, commodity prices, or exchange rate depreciation leads to a higher domestic interest rate, causing debt servicing to increase. Exchange rate depreciation directly affects external debt servicing.
Maturity and Refinancing	The maturity risk due to the low average time to maturity (3 years for domestic debt and 6 years for external debt) puts the government at risk of refinancing. Although the maturity profile is improving, exposure remains in the medium term. Moreover, the yield curve's slope may get steeper as the government focuses more on debt with long maturity.
SOE-Related Fiscal Risk	
Dividend	SOE dividends have decreased in real terms in the last seven years, increasing the government's fiscal burden. A further decrease in dividends will increase the government's borrowing requirement and associated debt servicing.
Government support to loss-making SOEs	Loss-making commercial SOEs need continuous government support through subsidies, grants, and equity injections, which are increasing over time due to non-payment of arrears related to public sector obligations (PSOs).
Stock of Debt and Guarantees	The government is explicitly exposed to SOEs' stock of guaranteed debt and implicitly to its stock of non-guaranteed debt.

Climate and Natural Disaster Related Fiscal Risks	
Climate Change	Climate change has raised the average temperature and precipitation pattern, affecting economic activity and imports, affecting revenues and current account balances. There is also a fiscal burden due to adaptation and mitigation investment strategies. The energy transition will also result in revenue loss for DISCOs.
Natural Disasters	Natural disasters, both climate-related (floods, droughts) and others like earthquakes, have become frequent and increasingly severe. Disasters disrupt economic activity, lowering revenues while at the same time increasing government response costs in terms of subsidies, grants, and social protection. There is also a higher demand for development funds needed to reconstruct damaged public and private assets.
Other Fiscal Risks	
Public Private Partnership Guarantees	There are explicit, direct and contingent, and implicit guarantees to PPP capital stock. Guarantees for minimum revenue assurance, viability gap funds, and damages due to natural disasters create fiscal risks for the government.
Guarantees to Provincial governments and PSEs (CCL)	Risks arise from federal government guarantees to provincial governments and PSEs (PASCO and TCP) for commodity financing operations in the form of cash credit limit (CCL). Materialization of these contingent liabilities put the government fiscal accounts under strain.
Commodity Price Fluctuations	Subsidy to petroleum in the form of less PL collection and direct subsidy on petroleum products for non-transfer of energy price hikes to consumers. Any additional subsidies that may be required due to high inflation, particularly in food prices.
Circular Debt	Circular debt in the Power and Gas sectors reached Rs. 2.4 trillion and Rs. 2.3 trillion, respectively, in December 2024. There is no clear roadmap to retire this debt. Less room is available for tariff adjustment, and the government has no fiscal space.
SBP BOP deposits and Swap Line	State Bank of Pakistan is exposed to BOP deposits and a Swap line with China worth USD 3.7 billion and USD 4.18 billion, respectively. Exposure to these components will affect SBP's profit and no-tax revenue.
Tax Expenditure	In 2022-23 tax expenditures were estimated at Rs. 3,879.2 billion. There is no proper mechanism for tax expenditure; an increase will increase fiscal burden and fiscal deficit.
Policy Risk	
Time inconsistency and lack of reforms	Policy reversals cannot be overlooked, particularly in the face of external or internal shocks that create challenging environments. There have been delays in designing a roadmap to retire circular debt and reform the power and gas sectors. There have also been delays in privatizing SOEs, and there is no explicit mechanism for reducing PSOs, putting SOEs at permanent risk of remaining inefficient.

6.2 Fiscal Risks and Their Implications for Macroeconomic Stability

Fiscal risks arise from various uncertainties related to macroeconomic conditions, financial markets, and policy decisions that can affect government revenues and expenditures. If they materialize, these risks may result in larger-than-expected fiscal deficits, increased borrowing requirements, and greater vulnerabilities in debt management. This section explores the main

sources of fiscal risks, their potential impacts, and the importance of integrating risk assessment mechanisms into fiscal planning.

6.2.1 Macroeconomic Risks

Economic growth is a crucial factor in determining fiscal stability because government revenues are closely tied to GDP performance. When the GDP growth rate falls below expectations, revenue collection decreases, while government expenditures—especially social spending and subsidies—tend to remain fixed. This discrepancy leads to a higher fiscal deficit and increased borrowing requirements. Furthermore, efforts to stimulate growth beyond the economy's potential can result in external imbalances, which may cause the exchange rate to depreciate. A weaker currency raises the costs of servicing external debt and worsens financing needs, particularly when combined with a growing current account deficit.

Inflation and interest rates present significant fiscal risks. When inflation is higher than expected—whether due to global fluctuations in commodity prices or increased domestic demand—it can lead to tighter monetary policies and higher domestic interest rates. This, in turn, raises the government's borrowing costs and places additional pressure on debt servicing expenditures. Furthermore, a large portion of public debt carries variable interest rates, making debt servicing costs highly sensitive to changes in interest rates. Additionally, exchange rate volatility complicates fiscal management by raising the costs of repaying external debt, particularly if global interest rates increase, contrary to the baseline projection.

6.2.2 Revenue Risks

The sustainability of fiscal policy relies on stable and predictable revenue collection. However, several risks threaten the performance of this revenue, particularly in tax compliance and non-tax revenue sources. While administrative measures and increased tax rates have historically helped reduce the tax gap, further improvements in tax revenue will require structural reforms, such as broadening the tax base and rationalizing tax expenditures. Without significant policy initiatives, revenue growth may slow, leading to fiscal pressures.

Non-tax revenues pose a significant risk as they have historically depended heavily on profits from the State Bank of Pakistan (SBP) and petroleum levy. However, SBP profits primarily serve to offset additional debt servicing costs rather than act as a sustainable revenue source. Additionally, fluctuations in petroleum levy collections due to government interventions in fuel pricing create uncertainty in revenue projections. A decline in either of these revenue sources would weaken the primary fiscal balance, resulting in increased borrowing and higher debt accumulation.

6.2.3 Debt-Related Risks

Debt-related fiscal risks mainly arise from fluctuations in interest rates, refinancing challenges, and the composition of public debt. The government's debt portfolio includes a significant portion of high-cost, fixed-interest-rate instruments, which restricts fiscal flexibility. Rising inflation, currency depreciation, and heightened risk perceptions can lead to increased interest rates, substantially raising the cost of debt servicing. Furthermore, a large share of domestic and external debt has a short maturity profile, exposing the government to refinancing risks. Although efforts have been

made to extend the maturity of debts, the possibility of rolling over short-term debt at higher interest rates remains a significant concern.

6.2.4 State-Owned Enterprise Related Risks

State-owned enterprises put a significant fiscal burden, as their performance directly impacts public finances. While government revenues benefit from dividends paid by SOEs, these dividends have been declining in real terms over the past decade. If this trend continues, it could lead to an increased need for government borrowing, resulting in higher debt servicing costs. Additionally, 17 major loss-making commercial SOEs require ongoing financial support through subsidies, grants, and equity injections. Many of these entities, especially in the energy sector, accumulate unpaid debts, which exacerbate fiscal risks. For example, the unpaid dues of Pakistan State Oil contribute to the escalating circular debt problem, necessitating government intervention.

The government faces substantial fiscal risks due to the debts of SOEs, both guaranteed and non-guaranteed, representing a significant portion of the GDP. Many SOEs have accumulated considerable debt, and the government's obligation to cover these liabilities in the event of a default adds further pressure to fiscal resources. Additionally, circular debt in the power and gas sectors worsens the fiscal situation, as there is no clear plan in place for its resolution. The limited fiscal space to manage these debts hinders the government's ability to implement essential reforms.

Fiscal risk from SOEs mainly arises when government contingent liabilities, stemming from guarantees provided for SOE risks, materialize. The situation is further complicated by the government imposing non-commercial obligations on SOEs, known as Public Sector Obligations, without offering adequate compensation. These obligations can negatively impact SOEs' financial performance, increasing the likelihood that contingent liabilities will arise. Therefore, a thorough assessment of fiscal risk related to SOEs requires understanding these interdependencies.

Fiscal risks associated with SOEs can be categorized into two main types: Direct Liabilities, such as unfunded Public Sector Obligations that require budgetary resources, and Contingent Liabilities, which include both explicit liabilities (e.g., loan guarantees) and implicit liabilities (e.g., expectations of government bailouts).

6.2.5 Climate and Natural Disaster Risks

Climate change and natural disasters are posing increasing fiscal risks. Changes in temperature and precipitation patterns affect economic activity, agricultural output, and trade balances, leading to revenue shortfalls. Simultaneously, the government is confronted with escalating fiscal pressures due to the need for investments in adaptation and mitigation. This includes potential revenue losses for State-Owned Enterprises in the power sector as they transition to cleaner energy sources. Such transitions may lead to financial losses for these power sector SOEs, which could require government intervention.

The frequency and severity of natural disasters, such as floods, droughts, and earthquakes, have risen in recent years. These events disrupt economic activity, leading to a decrease in both tax and non-tax revenues while simultaneously increasing government spending on disaster response and the reconstruction of damaged infrastructure. Large-scale natural disasters require additional social

protection measures, grants, and subsidies, which further strain public finances. Without sufficient fiscal buffers or contingency planning, these disasters can significantly worsen fiscal imbalances.

6.2.6 Other Risks

PPP Guarantees Risk

In addition to State-Owned Enterprises and natural disasters, other contingent liabilities contribute to fiscal vulnerabilities. Public-Private Partnership projects involve both explicit and implicit liabilities, as the government may need to intervene during financial crises. There are also committed payments in the form of explicit guarantees, such as cases where user fees fall short of making a project profitable or where there are assurances of minimum revenues. Furthermore, while there are no explicit guarantees for PPP capital stock and infrastructure, the government is often expected to support struggling projects, especially during natural disasters or economic downturns.

The Public Private Partnership Authority (P3A), established under the Public Private Partnership Authority Act of 2017 (as amended), is the governing body responsible for advising and assisting federal Implementing Agencies (IAs) in executing PPP projects. The P3A's mandate is to ensure that risk-sharing mechanisms are transparent and adhere to international standards. The P3A Board is supposed to play a crucial role in approving the transaction structures of PPP projects that meet specific criteria, which may include the need for financial support through the Project Development Facility (PDF), Viability Gap Fund (VGF), or sovereign guarantees.

If a project is mandated for implementation by the Central Development Working Party (CDWP), it can be pursued on a Public-Private Partnership basis. Implementing Agencies can still undertake projects that do not meet these requirements as long as they receive administrative approval from the respective Principal Accounting Officer (PAO). The P3A has facilitated the development of various projects. Currently, the Sialkot–Kharian Motorway is under construction with a Viability Gap Fund of PKR 6.94 billion. Additionally, a sovereign guarantee has been issued to cover the operational VGF, which is valid for a 10-year debt service period following the 2-year construction phase.

The Risk Management Unit, operating under the Ministry of Finance, is responsible for assessing project risks and ensuring clear accountability for the financial exposures linked to each project. However, the mechanisms to effectively manage fiscal risks have not yet been developed, which exposes medium-term fiscal accounts to potential vulnerabilities.

Guarantees to Provincial Governments and PSEs

The guarantees provided to the provincial governments and Public Sector Enterprises present fiscal risks. The federal government backs the commodity financing operations of provinces and PSEs through cash credit limits (CCL). If provinces or PSEs fail to meet their financial obligations, the federal government would need to intervene, which could increase fiscal pressures.

SBP Liabilities Risk

The State Bank of Pakistan manages balance of payments (BOP) deposits, including loans from the IMF, and maintains a swap line with China—both carry inherent risks. If losses occur from

these liabilities, the profitability of the SBP would decline. A decrease in SBP profits directly impacts non-tax revenue, as the surplus transfers to the federal government would shrink. This would lead to widening the fiscal deficit, increasing the government's borrowing needs and debt servicing costs. Given the reliance on SBP profits as a major source of revenue, any shortfall could worsen fiscal imbalances. This situation emphasizes the need for careful external debt management and effective risk mitigation strategies.

Circular Debt Risk

Pakistan's circular debt in the power and gas sectors presents a significant fiscal risk, with no clear strategy for its repayment in the near future. The federal budget does not include specific provisions to tackle this growing liability, yet the government remains liable to repay this debt. As circular debt continues to accumulate, it increases fiscal pressure by necessitating subsidies, bailouts, or debt restructuring, which in turn strains public finances. If this issue is not addressed, the persistent burden will weaken fiscal sustainability, limit essential development spending, and raise borrowing requirements. A credible and transparent strategy is crucial for containing and eventually eliminating circular debt, ensuring long-term fiscal stability.

Commodity Price Risks

Fluctuations in global commodity prices pose significant fiscal risks, especially in the energy and food sectors. When petroleum prices rise, government revenue from the petroleum levy decreases. At the same time, the government may need to increase subsidies to stabilize fuel prices. Similarly, rising food prices require higher subsidies for the Utility Stores Corporation to help mitigate the impact of inflation on consumers. These issues contribute to fiscal imbalances, complicating budget execution.

Tax Expenditures Risk

Pakistan's high level of tax expenditure significantly undermines the Federal Board of Revenue's ability to collect taxes, ultimately reducing the overall tax-to-GDP ratio. Each year, substantial revenue is lost due to exemptions, concessions, and preferential treatments, which limit the fiscal space available for essential spending. Rising tax expenditures, along with the lack of transparency regarding the foregone amount in the federal budget—both in terms of additional revenue and targeted expenditure—harm fiscal efficiency. This situation not only hampers revenue mobilization but also contributes to a more inequitable tax system. Without reforms to rationalize tax expenditures, fiscal imbalances will continue, weakening the government's capacity to meet development and social spending needs.

Policy Risks

Time inconsistency and delays in structural reforms significantly increase fiscal risks. Policy reversals cannot be overlooked, particularly in the face of external or internal shocks that create challenging environments. The government's long-term commitment to essential reforms—such as addressing circular debt, privatizing State-Owned Enterprises, and reforming the power and gas sectors to ensure profitability and repayment of circular debt—remains uncertain, due to emerging challenges. Delays in implementing these reforms prolong fiscal vulnerabilities, keep inefficient

SOEs operational, and add to the debt burden. Furthermore, the lack of a structured mechanism to rationalize tax expenditures restricts fiscal space, worsening the overall fiscal deficit.

The fiscal risks outlined above underscore the complex challenges facing public finances. Macroeconomic shocks, revenue uncertainties, debt vulnerabilities, SOE inefficiencies, climate-related risks, and policy inconsistencies all contribute to fiscal instability. To enhance fiscal resilience, the government must adopt a proactive risk assessment approach incorporating stress testing and contingency planning into fiscal policymaking. Strengthening institutional frameworks for debt management, improving tax revenue mobilization, and implementing structural reforms in the energy and other SOE sectors are essential for ensuring long-term fiscal sustainability.

7. DESCRIPTION OF FISCAL RISK SCENARIOS

Alternative scenarios are created to evaluate how actual revenues and expenditures might deviate from budgeted or projected figures, resulting in increased fiscal deficits and public debt. These scenarios, presented in Table 7, highlight potential risks to fiscal sustainability. Fiscal risk is measured by the difference in fiscal deficits between these alternative scenarios and the baseline scenario, with adjustments made for additional interest payments on the extra borrowing needed to cover the higher deficit.

In comparison to the baseline scenario, the alternative scenarios suggest several changes: real GDP growth is assumed to be 1.5 percentage points lower, the exchange rate depreciates by 10%, and tax revenues will increase only in line with economic activity without any expansion of the tax base or additional administrative measures. Furthermore, the petroleum levy is expected to decline by 20%. The surplus profit from the State Bank of Pakistan is projected to drop by 30%. At the same time, domestic interest rates rise by 2 percentage points, and foreign interest rates increase by one percentage point. Additionally, refinancing risk continues due to high debt maturity in FY2029, which is assumed to span over four years in an alternative scenario.

For State-Owned Enterprises, dividends are expected to decline based on historical trends rather than increase, as suggested by the two-year average used in the baseline scenario. Government support for the 17 loss-making SOEs, provided through equity injections, subsidies, and grants, is projected to rise to 1.5% of GDP, up from 1.1% in the baseline. Climate-related risks may follow either the RCP2.6 or RCP8.5 scenario, while the likelihood of natural disasters is assessed based on historical data. Additionally, power sector SOEs are expected to experience a reduction in revenues due to the energy transition towards alternative energy sources.

Public-Private Partnership projects include explicit guarantees, with a 50% likelihood of realization. Implicit guarantees depend on the likelihood of natural disasters occurring. Provincial governments are supposed not to pay their commodity financing debt with a 20% probability and PSEs with 25%. In addition, commodity prices are projected to rise by 20%, tax expenditures are expected to increase by 10%, and the government is assumed to initiate a 10-year plan to clear circular debt.

Table 7: Scenarios for Fiscal Risk Analysis			
No.	**Scenario**	**Description**	**Potential Fiscal/Macroeconomic Impact**
1.	**Macroeconomic Risk**		
1A	Lower GDP growth rate	In FY 2026-28, the GDP growth rate remains 1.5 percentage points less than the baseline	Lower tax revenue combined with rigid expenditures results in a higher fiscal deficit, contributing to a higher debt-to-GDP ratio and a lower ability to meet debt obligations.
2.	**Revenue Risks**		
2A	Low performance of Tax Revenues	Administrative measures and tax rate changes without tax policy reforms exhaust potential. Therefore, taxes increase only with an increase in economic activity.	The tax-to-GDP ratio remains constant, and there is little chance of reducing the current debt burden. Expenditure rigidity may also increase the fiscal deficit and add to public debt.
2B	SBP Surplus Profit Reduction	State Bank of Pakistan's surplus profit reduced by 30%, compared to the baseline, due to SBP liabilities	Reduced non-tax revenue, straining fiscal accounts, and widening fiscal deficit, especially primary fiscal deficit.
2C	Petroleum Levy Reduction	The petroleum levy is 20% lower than that projected under the baseline due to policy inconsistency	Reduced non-tax revenue, straining fiscal accounts, and widening fiscal deficit, especially primary fiscal deficit.
3.	**Debt-related Fiscal Risks**		
3A	Higher Interest Rates	Increased interest rates (1% on external and 2% on domestic borrowings) compared to the baseline	Increased debt servicing costs could potentially reduce fiscal space and increase the fiscal deficit. The debt-to-GDP ratio would also increase.
3B	Higher Exchange Rate Depreciation	In FY 2026-28, the exchange rate depreciates by 10%, significantly higher than the baseline.	Increased external debt servicing costs and inflationary pressures lead to higher fiscal deficits and inflation.
3C	Frequent Refinancing Risk	Only one-fourth of the new domestic debt, after subtracting t-bill stock, is raised through fixed-rate debt; 50% is considered in the baseline.	The government remains exposed to refinancing risk as low inflation and low interest rate regimes end.
3D	Management of 2029 debt maturities	Early management of FY2029 huge debt maturity	Extra debt-related expenditure due to FY2029 payments
4.	**SOE-related Fiscal Risk**		
4A	Low SOE Dividend	SOE dividend decreases in real terms at 6.1% per year (historical average) rather than increasing at 10% (baseline scenario)	The government receives less in non-tax revenues, increasing fiscal deficit and debt, or increasing taxes, which will discourage economic activity.

Table 7: Scenarios for Fiscal Risk Analysis			
No.	**Scenario**	**Description**	**Potential Fiscal/Macroeconomic Impact**
4B	Increased government support to loss making SOEs	Government support to loss-making SOEs in the form of subsidies, grants, and equity injections reaches 1.5% of GDP compared to 1.1% in the baseline	SOEs require more government support, which increases their fiscal burden, resulting in increased fiscal deficits and debt. Thus, they have fewer incentives to undertake governance reforms.
4C	SOEs' inability to pay existing debt	40% probability that SOEs cannot pay debt	The government has to clear SOE debt, straining its fiscal position
4D	Energy Transition Risk	Electricity consumption decreases by 3.6% annually.	The transition to renewable energy sources negatively affects the revenues of energy-related SOEs. SOE losses increase with an increased fiscal burden in terms of subsidies/grants.
5.	**Climate-related Fiscal Risks**		
5A	RCP2.6 (Stringent climate change mitigation scenario)	Possibility to keep the increase in the global mean temperature below 2°C. Climate change mitigation expenditures are assumed to be partially contributed by the government, as envisaged in NDC 2021	Green investment will cause a fiscal burden in the short run. However, due to the improved climate and the multiplier effect of green investment, economic activity and government revenues will increase. SOEs face revenue loss due to energy transition.
5B	RCP8.5 (Unmitigated emissions scenario)	If society does not make concerted efforts to cut greenhouse gas emissions, the outcome is normally referred to as Business as Usual (BAU).	The government does not invest in climate-related projects, resulting in better fiscal outcomes in the short run. However, the loss in economic activity and, therefore, in revenues increases with every passing year, leading to more disasters in the future.
6.	**Natural Disasters Related Fiscal Risk**		
6A	Natural Disasters: Increasing Severity and Probability without a Dedicated Natural Disaster Fund	Each coming year increases the conditional probability of a natural disaster occurring and its severity. Due to probability accumulation, annual exposure to fiscal risk increases.	If the government does not allocate funds to the Natural Disaster Fund, then exposure to fiscal risk emanating from subsidies, grants, social protection, and reconstruction of damaged assets increases with each passing year.
6B	Natural Disasters: Increasing Severity and Probability with	Each coming year increases the conditional probability of natural disasters occurring and their severity, but	The government does allocate for the Natural Disaster Fund; exposure to fiscal risk emanating from natural disasters remains the same.

Table 7: Scenarios for Fiscal Risk Analysis			
No.	**Scenario**	**Description**	**Potential Fiscal/Macroeconomic Impact**
	a Dedicated Natural Disaster Fund	the annual financing requirement remains constant in real terms.	
7.	**Other Fiscal Risks**		
7A	Government Allocates Funds to Public-Private Partnership Projects	Government starts allocating funds to PPP projects from FY2026 onwards both for explicit and contingent liabilities.	Fiscal burden increases in the medium term, though long-term fiscal sustainability will increase
7B	Commodity Financing Guarantees materialize	20% (25%) probability that provincial governments (PSEs; PASCO, and TCP) could not repay their existing debt raised for commodity financing operations and guaranteed by the federal government.	The federal government pays the debt, reducing its fiscal space and increasing fiscal burden
7C	Commodity Price Hikes	Global oil prices increase by 20%; government reduces petroleum levy and increases subsidies	Government gives subsidy to consumers and reduces petroleum levy to avoid pass on of higher prices to consumers. Fiscal deficit and public debt increase.
7D	Circular Debt in Mainstream Debt Model	The government caps circular debt in FY2025 at the FY2024 level and then, from FY2026 onwards, combines it with the overall debt	Debt servicing will increase compared to the baseline that does not include circular debt repayment
7E	Increased tax expenditure	Increased tax exemptions are projected to lead to a 10% rise in tax expenditures from existing tax-paying sources, gradually occurring over a three-year period.	Revenue decreases with rigid government spending. Fiscal deficit and public debt increase

8. DETAILED FISCAL RISK ANALYSIS

8.1. Fiscal Risks in the Baseline Projections

The baseline scenario assumes a stable macroeconomic environment characterized by moderate economic growth that gradually increases over time, along with stable revenues and expenditures. In the baseline, no major natural disasters are assumed over the medium term, although they are incorporated into the scenario analysis. Additionally, State-Owned Enterprises are projected to receive government support in line with historical trends, and contingent liabilities arising from Public-Private Partnership projects or commodity financing operations are not anticipated to materialize.

The alternative scenarios contrast with this baseline by introducing potential risks that could undermine fiscal sustainability. Analyzing these scenarios allows policymakers to prepare for adverse shocks and develop mitigation strategies. This approach ensures that fiscal sustainability can be upheld under various macroeconomic conditions and governance challenges. Consequently, the baseline serves as a benchmark to assess the fiscal strain that each risk scenario might impose, aiding in long-term fiscal planning.

The baseline medium-term macroeconomic and fiscal framework provides point projections without accounting for the risks that might lead to deviations from these forecasts. To evaluate these fiscal risks, it would be beneficial to apply probability limits to key projections, taking into consideration potential shocks to economic growth, inflation, interest rates, revenue performance, and expenditure trends. If these risks materialize, they could significantly impact the fiscal outlook, potentially widening the fiscal deficit, increasing borrowing needs, and compromising debt sustainability.

The baseline projection for real GDP growth is expected to increase from 3.1% in FY2025 to 5.7% in FY2028. However, this projection comes with risks related to both structural and cyclical factors. A lower-than-expected potential growth rate—stemming from weak productivity, low investment, or external shocks—could result in persistently low potential growth. Additionally, cyclical downturns caused by global economic slowdowns, domestic policy uncertainty, or disruptions in supply chains could lead to shortfalls in output.

Inflation projections may also diverge from the baseline, which anticipates stabilization around 7.0% in the medium term. This divergence could occur due to unexpected changes in aggregate demand, adjustments in energy tariffs, or fluctuations in global commodity prices. Higher global oil prices present a dual risk: they could reduce government revenue from the petroleum levy (which is assumed to be at the maximum rate in the baseline) while increasing the likelihood of higher subsidies for fuel. Similarly, rising food prices may require greater subsidies to support vulnerable populations, putting additional pressure on government finances.

Interest rates could rise beyond projections, which currently average 11.5% for domestic debt in FY2026-28. This could be due to unforeseen inflationary pressures or a decline in the country's credit rating, leading to increased debt servicing costs. Additionally, higher exchange rate depreciation, which is assumed to be minimal (2.0%) in the baseline scenario, can occur due to external shocks or decreasing foreign exchange reserves. This depreciation raises the cost of repaying external debt, putting further pressure on fiscal resources. Furthermore, a significant portion of domestic debt has short maturities (with ATM at 3.1 years), exposing the government to refinancing risks if future interest rates exceed expectations.

Federal gross revenues, which include both tax and non-tax sources, are projected to reach 15.0% of GDP in FY2028 under the baseline scenario. However, revenue risks pose a significant concern, as tax collections are closely tied to economic performance and the successful implementation of tax policy reforms. A slowdown in economic activity (not factored into the baseline), delays in improving tax administration, or a shrinking tax base due to high tax rates could lead to revenue shortfalls; tax revenues are expected to reach 12.3% of GDP in FY2028 under the baseline.

The baseline also assumes that non-tax revenues will remain stable at 2.8% of GDP from FY 2026 to FY 2028, which includes surplus profits transferred from the State Bank of Pakistan amounting to 1.0% of GDP. However, any losses in the SBP's balance sheet, resulting from exchange rate fluctuations or its liabilities, could reduce these transfers and consequently widen the fiscal gap.

Interest payments continue to be the largest component of the budget. They are projected to decrease from 7.4% of GDP in FY2025 to 4.7% of GDP in FY2028. However, this forecast is subject to risks related to inflation, exchange rate fluctuations, and perceptions of credit risk.

State-Owned Enterprises pose a significant fiscal risk as their performance directly impacts government finances. While profitable SOEs contribute dividends to the government, those that operate at a loss often require financial support through subsidies, grants, or equity injections. The baseline assumes that SOE performance will follow historical trends, limiting subsidies and grants to a maximum of 2% of GDP. However, if future losses exceed expectations due to poor governance or external shocks, the government may need to increase its support.

Moreover, SOEs carry substantial debt, both guaranteed and non-guaranteed, which presents additional risks in the event of default. As of FY 2024, the SOEs' outstanding stock of loans stood at Rs. 9,196 billion. As the owner and guarantor of these enterprises, the government could be compelled to absorb these liabilities, thereby increasing fiscal stress.

The baseline projections do not account for the potential fiscal impact of natural disasters. While large-scale disasters tend to happen at least once a decade, smaller climate-related events occur more frequently. These events can disrupt economic activity and lead to increased government spending on subsidies and reconstruction efforts. Additionally, as years go by, the likelihood of experiencing a large natural disaster rises, increasing the government's financial exposure. Climate change worsens these risks by making extreme weather events more frequent and severe, resulting in unexpected fiscal pressures.

Other contingent liabilities that are not accounted for in the baseline include both explicit and implicit government guarantees for Public-Private Partnership projects, as well as borrowing by provincial governments and public sector enterprises. If these guarantees are invoked due to financial distress or policy failures, the federal government may need to intervene, which would increase its fiscal burden. Additionally, the government is obligated to address circular debt, which stood at Rs. 2.4 trillion in the power sector and Rs. 2.3 trillion in the gas sector as of December 2024. Although this debt is not explicitly included in the baseline fiscal framework, it remains a significant fiscal challenge.

The baseline scenario assumes that fiscal consolidation measures and tax policy reforms will continue to be implemented. However, delays or reversals in these efforts—especially in reducing tax expenditures or broadening the tax base—could further strain public finances. The fiscal framework should include a more thorough risk assessment to address these risks. This should encompass fiscal indicators under various probable scenarios and involve contingency planning to enhance resilience and ensure fiscal sustainability in the medium term. Such analyses have been conducted in this FRS, as detailed in the following sections.

8.2 Macroeconomic Risks

The baseline scenario assumes a stable trajectory for economic activity and its associated variables. However, there is a risk that the country's economic performance may not align with these projections. If this divergence occurs, fiscal outcomes may deviate from expectations, potentially jeopardizing the government's fiscal position. Macroeconomic risks include lower-than-expected real GDP growth, higher-than-projected inflation, increased currency depreciation, and global economic shocks, such as rising commodity prices. While inflation volatility and exchange rate depreciation are addressed in scenarios related to debt, global commodity price shocks are

discussed separately. Therefore, this section focuses solely on the shock related to real GDP growth within the context of macroeconomic risks.

Scenario 1A: Lower Real GDP Growth

Description of the Scenario: Under this scenario, the real GDP rate remains 1.5 percentage point lower than what is projected under the baseline in the medium term.

Justification of the Scenario:

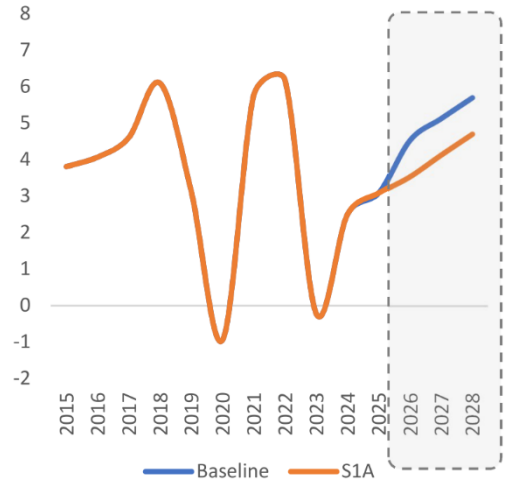
Since the early 1990s, Pakistan's growth potential has been on a declining trajectory, with each subsequent decade experiencing lower growth rates than the previous one. Historically, the average GDP growth rate for Pakistan has been around 4 to 4.5%. However, over the past decade, this potential has diminished to approximately 3.5%.

Recent significant events, such as the COVID-19 pandemic, the floods of 2022, and the looming threat of debt default, have adversely impacted the economy. Despite these challenges, the economy is beginning to show signs of stabilization, making it plausible that the growth rate could rebound to its historical average rather than continue to decline.

Under the baseline scenario, the average GDP growth rate for the FY2024-28 is projected to be 5.1%, moderately above the country's long-term average. However, due to the persistent risks of natural disasters and global economic shocks, there is a possibility that the actual growth rate may fall short of this projection. As a result, over time, the growth rate may align more closely with the lower rates observed over the past decade, averaging around 3.5%.

Figure 10: Real GDP Growth (%): Actual and Projected

Real GDP Growth Rate: Actual and Projected			
	Time Period	Growth Rate	Status
1	FY2015-2020	3.5	Actual
2	FY2021-2025	3.5	Actual
3	FY2015-2025	3.5	Actual
4	FY2026-2028	5.1	Projected (Baseline)
5	FY2026-2028	3.6	Projected (Scenario 1A)



This alternative scenario assumes that potential GDP may underperform relative to the baseline, resulting in a one-and-a-half percentage point reduction in the growth rate. Understanding this scenario is crucial, as slower economic growth can exacerbate fiscal risks and constrain the government's ability to meet its obligations.

Fiscal Implications:

Economic growth is a key determinant of fiscal health, significantly impacting both revenue collection and debt ratios. A decline in GDP growth limits the government's ability to collect taxes while concurrently increasing the fiscal deficit and public debt as ratios of GDP. In this Fiscal Risk Statement, it is assumed that the reduction in GDP growth is distributed proportionally among three sectors of the economy: agriculture, industry, and services.

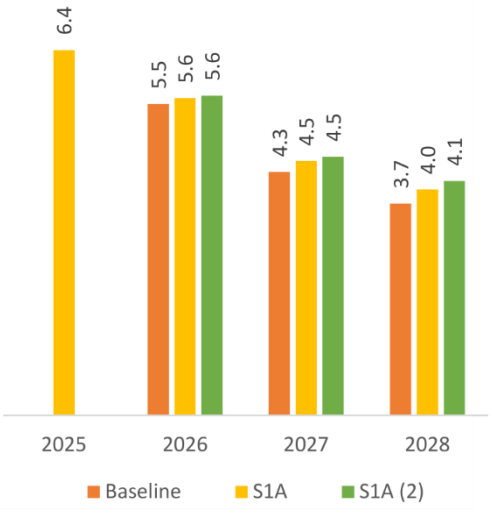
A decrease in non-agricultural GDP results in lower direct tax revenues compared to the baseline, assuming that tax buoyancy remains constant. This reduction amounts to Rs. 107 billion in FY2026 and a cumulative Rs. 775 billion in FY2026-28. Additionally, a decline in the value added by large-scale manufacturing (LSM) reduces general sales tax on domestic goods and federal excise duties, as their respective tax buoyancies also remain unchanged. Sales tax on domestic goods may decrease by Rs. 27 billion in FY2026 and Rs. 209 billion cumulatively in FY2026-28. Federal excise tax may be reduced by Rs. 13 billion in FY2026 and by Rs. 103 billion cumulatively in FY2026-28.

On the other hand, government expenditure categories evolve independently of GDP, as they are rigid and are modeled accordingly (see Section 4 for more details) except for a few categories. However, interest expenses increase in response to higher borrowing needs. As a result, the primary and overall fiscal deficits increase compared to the baseline. The overall fiscal deficit increases by Rs. 42.1 billion in FY2026 and Rs. 312.4 billion cumulatively in FY2026-28 in scenario S1A, and by Rs. 92.8 billion and Rs. 713.4 billion, respectively, in scenario S1A (2)[1]. Additionally, when GDP is lower than the baseline, the fiscal deficit and public debt to GDP ratios become higher under both alternative scenarios compared to the baseline.

Figure 11: Fiscal Deficit Projections (% of GDP): Baseline vs Growth Scenarios

FBR Revenue Projections (Rs. Billion): Baseline vs Growth Scenarios

		Direct Tax	Sales Tax on Domestic Goods	FED	Total
2026	Baseline	6570	2253	1120	9943
	S 1A	6463	2226	1106	9795
	Difference	107	27	13	148
2026-28	Baseline	22924	8173	4040	35138
	S 1A	22149	7964	3937	34051
	Difference	775	209	103	1087



[1] In scenario S1A, certain expenditure categories, such as Defence, subsidies, and grants, are linked to GDP growth. In scenario S1A (2), however, all expenditure categories are assumed to be exogenous.

Managing Fiscal Risks from Low Economic Growth:

The government's primary strategy for managing fiscal risk involves sector-specific taxation, including temporary surcharges on sectors that perform well during economic downturns, to bolster revenue. It is also considering formalizing this approach by developing a sector-specific, state-dependent marginal tax framework.

In the medium term, the government aims to manage macroeconomic risks by establishing an expenditure framework that emphasizes restraint during periods of low growth. This includes scaling back non-essential projects and enhancing fiscal reserves through more effective management of contingency funds to address unforeseen challenges.

In the long term, the government is committed to implementing structural reforms, such as diversifying the economy and investing in human capital, to foster sustainable economic growth and reduce dependency on vulnerable sectors.

8.3 Revenue Risks

Under the baseline scenario, total federal revenues—both tax and non-tax—are projected to reach 14.8% of GDP, up from 11.6% over the last decade. In FY2025, when revenues are already above 14%, the revenue-to-GDP ratio is likely to remain above 14%, even if revenue growth aligns with nominal GDP growth.

Revenue has increased over the past decade due to economic activity, and administrative and policy measures (such as increased tax rates), leading to lower tax elasticity than tax buoyancy. However, efforts to close the tax gap without broadening the tax base pose risks to revenue performance. Additionally, there are potential scenarios where non-tax revenue may not perform as projected under the baseline scenario.

Revenue Scenarios:

Scenario S2A: Low Performance of Tax Revenues

Scenario S2B: SBP Surplus Profit Reduction

Scenario S2C: Less Petroleum Levy Collection

Description of the Scenarios:

Under the scenario 2A, tax revenues are just aligned to an increase in economic activity, with tax buoyancy being constant and tax elasticity being equal to tax buoyancy. In **scenario 2B**, SBP surplus profit is expected to be 30% lower than that projected under the baseline. In **scenario 2C**, the petroleum levy is projected to be 20% lower than that projected under the baseline.

Justification of the Scenarios:

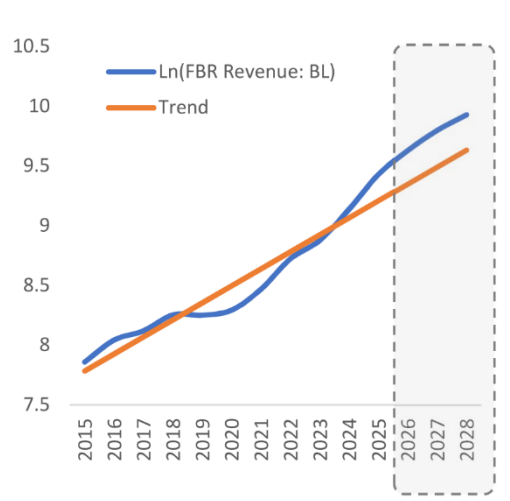
Scenario 2A: Tax buoyancy is estimated to be approximately 1 for all Federal Board of Revenue taxes for the period from 2001 leading up to FY2024. However, over the past decade, tax buoyancy has been around 1.2, indicating that 20% of the increased revenue collection can be attributed to additional measures, whether policy-related or administrative. These additional measures have

primarily involved raising tax rates rather than making serious efforts to broaden the tax base or simplify tax procedures.

FBR revenue grew at an average annual growth rate of 14.2% from FY2015 to FY2024. The baseline projection assumes a 17.1% annual average growth rate from FY2026-28. In FY2026-28, trend revenues are on average 34% less than the FBR revenues under the baseline. This casts doubt on achieving the FBR revenue target, failing which will put the fiscal balance at risk. This situation suggests that the potential for increased revenue through higher tax rates is nearly exhausted. Without efforts to expand the tax base and initiate other tax reforms, tax revenue is expected to grow only in line with economic activity, at a one-to-one rate. Nevertheless, different types of tax revenues may have different performances based on their unique tax bases and buoyancies.

Figure 12: FBR Revenues (Log): Actual and Projected vs. Trend

FBR Revenue (Rs. Billion)			
	2026	2027	2028
Baseline	15270	18064	20572
Trend	11510	13272	15304
Difference	3760	4792	5268
% Deviation	33%	36%	34%



Scenario 2B: The State Bank of Pakistan manages the balance of payments deposits and maintains a swap line with China, both of which carry risks and have implications for the federal budget. As of December 2024, the SBP's liabilities amount to USD 7.88 billion, equivalent to Rs. 2,199 billion. This figure represents double the SBP's surplus profit, excluding a one-time gain recorded in FY2024. If the SBP incurs a loss due to interventions amounting to 10% of its foreign exchange liabilities, it would lead to at least 20% reduction in the surplus profit available for transfer to the federal government.

The average annual growth rate of SBP profit transferred to the federal government has been 16.1% from FY2015 to FY2025. The baseline assumes a 15.4% growth in SBP profit in FY2026-28. Therefore, projected SBP profit is aligned with the historical trend. However, this source of revenue has been quite volatile historically. For instance, it was 314% below the trend in FY2019 and 82% above in FY2025. Therefore, deviations of SBP profit from the baseline and historical trend are very likely.

Figure 13: FBR Revenues (Log): Actual and Projected vs. Trend

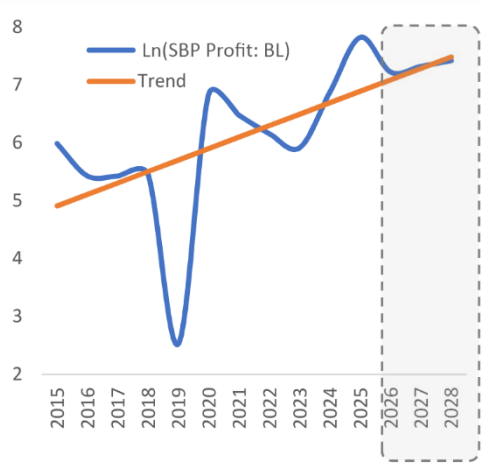
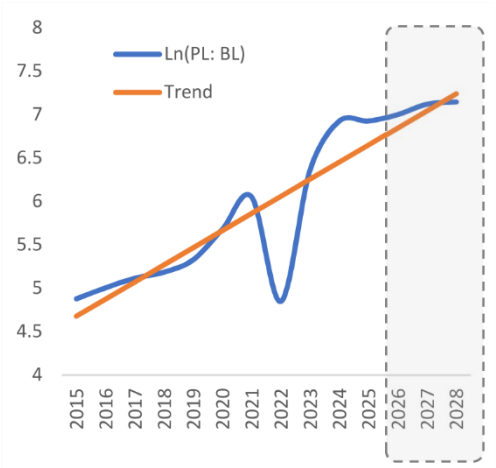


Figure 14: Petroleum Levy (Log): Actual and Projected vs. Trend



Scenario 2C: Political governments need to demonstrate their economic performance and relief measures to the public, as these are often seen as indicators of their effectiveness. Historically, governments in Pakistan have accomplished this by providing subsidies through the Utility Stores Corporation, stabilizing the exchange rate, and refraining from passing oil price increases onto consumers. In this context, the government might reduce the petroleum levy, reversing its existing policy of collecting higher non-tax revenues.

Though the average annual growth rate of the petroleum levy has been 20% from FY2015 to FY2025, this increase was mainly due to raising the rate of the petroleum levy. Under the baseline, no increase in the PL rate has been assumed. Consequently, projected PL revenues are aligned with the historical trend. However, PL was 123% below the trend in FY2022. Therefore, collecting PL less than the baseline is quite likely.

Fiscal Impact:

In all three scenarios related to revenues, the federal fiscal deficit remains higher on average by 0.2% to 0.6% of GDP compared to the baseline. Under the baseline, the federal fiscal deficit converges to 3.7% of GDP in FY2028, starting from 5.5% in FY2026. However, in the alternative scenarios related to revenues, the overall fiscal deficit remains on average 4.1% of GDP in FY2028, starting from 5.8% in FY2026.

Scenario 2A: In this scenario, tax revenues are expected to increase in line with growth in economic activity, as outlined in the baseline projections. However, the impact of other measures, such as tax rate increases, is not included, meaning that the increase in economic activity is the sole factor influencing tax revenues. In FY2024-25, approximately Rs. 2,230 billion is expected to be collected above what could be predicted through tax buoyancy. The proportionate distribution of this excess collection into different types of taxes has been used under the baseline to project taxes for the future.

Under alternative scenario 2A, the additional collections are set aside, and tax revenues are projected solely based on economic activity, using the tax buoyancies of various taxes. In this case,

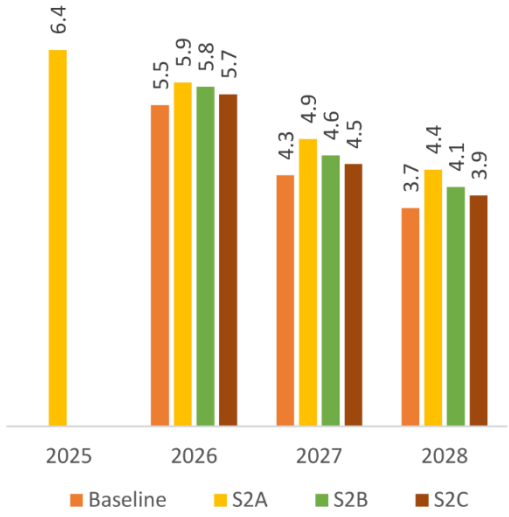
FBR revenues are projected to be Rs. 1,170 billion less than in the baseline in FY2026 and Rs. 5,254 billion cumulatively in FY2026-28.

In this scenario, tax elasticity will be equal to tax buoyancy, resulting in tax revenue growth that is approximately 3.5 percentage points lower than the baseline growth. Under the baseline scenario, tax revenues are projected to grow by 18.3%, while GDP is expected to increase by 12.5% on average over the medium term. In alternative scenario 2A, tax revenues are expected to grow at a rate close to the GDP growth rate, leading to 4.3 percentage points less revenue growth compared to the baseline.

Given the reliance of fiscal accounts on FBR revenues, this shortfall would worsen fiscal imbalances, registering an increase in the fiscal deficit above that in the baseline to the tune of Rs. 516 billion in FY2026 and a cumulative Rs. 2,539 billion in FY2026-28.

Figure 15: Fiscal Deficit Projections (% of GDP): Baseline vs Revenue Scenarios

Fiscal Deficit (Rs. Billion)			
	2026	2027	2028
Baseline	7,222	6,357	6,235
S2A	7,737	7,281	7,333
S2B	7,634	6,862	6,840
S2C	7,470	6,641	6,596
Difference			
S2A	516	924	1,099
S2B	412	505	605
S2C	248	284	362



Scenario 2B: In this scenario, losses from foreign exchange liabilities decrease the SBP's profit. A decline in SBP profits directly impacts non-tax revenue, as the surplus transferred to the federal government would decrease. SBP surplus profit transferred to the federal government under this scenario is projected to be Rs. 412 billion less than under the baseline in FY2026 and Rs. 1,371 billion less in FY2026-28.

This scenario widens the fiscal deficit, increasing the government's borrowing needs and debt servicing costs. Given the reliance on SBP profits as a significant source of non-tax revenue, this shortfall would worsen fiscal imbalances, registering an increase in the fiscal deficit above that in the baseline to the tune of Rs. 412 billion in FY2026 and a cumulative Rs. 1,522 billion in FY2026-28.

Scenario 2C: In this scenario, a decrease in the petroleum levy would negatively affect Pakistan's fiscal position, as this is a significant source of non-tax revenue for the government. Lower collection of PL would result in less non-tax revenue for the federal government under this scenario, projected to be Rs. 248 billion less than under the baseline in FY2026 and Rs. 806 billion less in FY2026-28.

Lower revenue from the petroleum levy would reduce overall collections and widen the fiscal deficit unless compensated by other sources of revenue. Given Pakistan's significant dependence on petroleum levy receipts to meet its budgetary targets, a decline in these receipts would force the government to either cut expenditures, increase borrowing, or impose additional taxes.

This Fiscal Risk Statement assumes that expenditures are fixed and acquiring additional tax revenue is unlikely. As a result, the burden would fall entirely on increased borrowing, which would strain public finances, raising debt servicing costs and potentially leading to fiscal imbalances. The fiscal deficit is projected to increase above that in the baseline by Rs. 248 billion in FY2026 and a cumulative Rs. 895 billion in FY2026-28. Furthermore, diminished collections from the petroleum levy could limit the government's ability to fund essential development and social welfare programs, ultimately affecting economic stability.

Managing Fiscal Risk from Revenue Shortfall:

To mitigate fiscal risks, the government is prioritizing immediate measures, including separating tax policy from tax collection, broadening the tax base, improving tax administration, and focusing on essential expenditures.

In the medium term, the government aims to simplify the tax code, enhance compliance, and leverage technology to reduce tax evasion. Additionally, it is exploring contingency fund management strategies to build fiscal buffers that can provide short-term relief in the event of revenue shortfalls.

In the long term, the government is committed to structural reforms designed to stimulate economic activity, improve expenditure efficiency, and reduce reliance on volatile revenue sources. A key focus will be on developing alternative non-tax revenue streams, such as asset leasing and Public-Private Partnerships, to establish a more stable financial foundation.

8.4 Debt-Related Fiscal Risks

According to the FRDLA definition, the government's total debt is Rs. 67,034 billion as of December 2024, with Rs. 49,883 billion (74.4%) classified as domestic debt. Additionally, external debt and liabilities amount to Rs. 36,512 billion. This debt portfolio comes with various fiscal risks. The baseline projections are based on a specific path of domestic and foreign interest rates for servicing new loans and existing floating-rate debt. However, the actual interest rate path may differ from the assumptions made in the baseline scenario. Furthermore, any depreciation of the exchange rate beyond what is projected will increase external debt and its servicing costs, even if foreign interest rates remain as expected.

The government has a strategic plan to convert floating-rate debt into fixed-interest rate instruments; however, this plan may not materialize due to the differing appetite of lending institutions. Lastly, a significant portion of government debt—over Rs. 10.4 trillion—will mature in FY2029, posing a major risk that has not been considered in the baseline projections.

Scenarios Related to Debt:

Scenario 3A: Higher Interest rate

Scenario 3B: Higher Exchange Rate Depreciation

Scenario 3C: Refinancing Risk

Scenario 3D: Preparation for higher debt maturity in FY2029

Scenarios Description:

Scenario 3A assumes domestic interest rates to be 200 basis points higher than the baseline, while foreign interest rates are 100 basis points higher in all three years of projection. **Scenario 3B** assumes the exchange rate depreciation to be 10% higher than the baseline over the medium term. **Scenario 3C** assumes that after subtracting the T-bill stock, only one-fourth of the new domestic debt could be raised through fixed-rate debt, while the new debt portfolio remains heavily dominated by floating-rate debt. **Scenario 3D** assumes that the government divides FY2029 debt maturity equally among four fiscal years starting from FY2026.

Justification of the Scenario:

Scenario 3A: Under the baseline scenario, the inflation rate is expected to average 7.0% over the medium term. While this projection aligns with the current state of the economy, certain risks could lead the inflation rate to diverge from this path. The historical average inflation rate (over the past four decades) in Pakistan was 8% and 10.5% in the past decade; both serve as benchmarks for future inflation trends. As a result, inflation could be at least 100 basis points higher than the baseline prediction.

The baseline scenario also anticipates that the GDP growth rate will exceed the historical average, which could contribute to a higher inflation rate than initially projected. Moreover, any increase in global commodity prices may further elevate the inflation rate. In these situations, interest rates are likely to be higher than the baseline projections. An increase in global commodity prices, along with a rise in global inflation rates, will probably lead to higher foreign interest rates, particularly on commercial loans and international bonds.

Figure 16: Inflation Rate (%): Actual and Projected vs. Historical Average

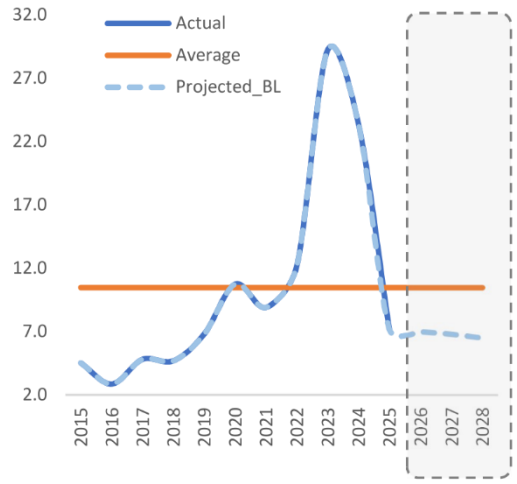
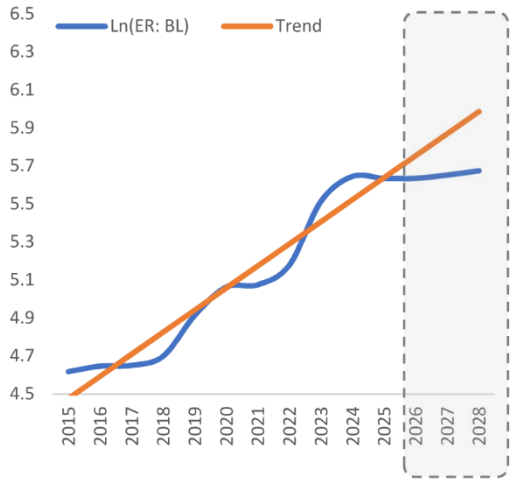


Figure 17: Exchange Rate (Rs/$): Actual and Projected vs. Trend



Scenario 3B: During FY2025, the Pakistani rupee appreciated by 1% against the USD. With a stable current account balance, the exchange rate is expected to depreciate only slightly, with an

average annual depreciation of 2% projected over the medium term. This outlook aligns with the inflation differential between Pakistan and its trading partners. However, the Pakistani economy experienced annual currency depreciation rate of 10% over the past decade. Therefore, a 10% currency depreciation in a shock scenario is not unlikely. If the past decade's trend continues, the exchange rate under the baseline may significantly deviate from the trend.

Scenario 3C: The composition of debt issuance is influenced by the needs of the government and the priorities of lending institutions, which also depend on the credit demand from the private sector. In FY2024, the domestic debt portfolio was dominated by floating-rate debt, including T-bills (76% of total debt). In the medium term, interest rates are expected to remain low compared to the recent past. As a result, the government will likely aim to increase the issuance of fixed-rate instruments. However, lending institutions may prefer floating-rate instruments because the yield curve is not steep enough to effectively absorb significant interest rate increases if inflation turns out to be higher than expected. Consequently, the government's intended composition of new debt may not be achieved.

Figure 18: Composition of Public Debt

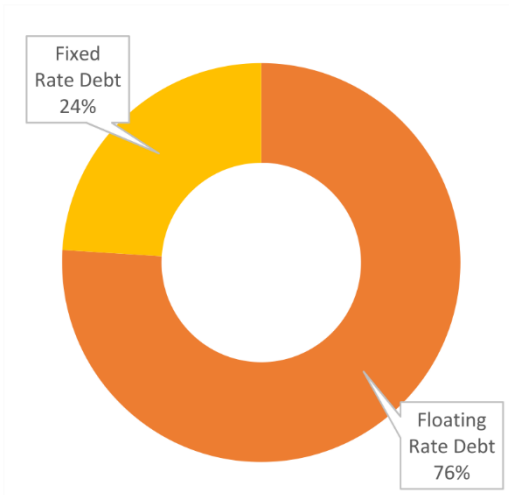
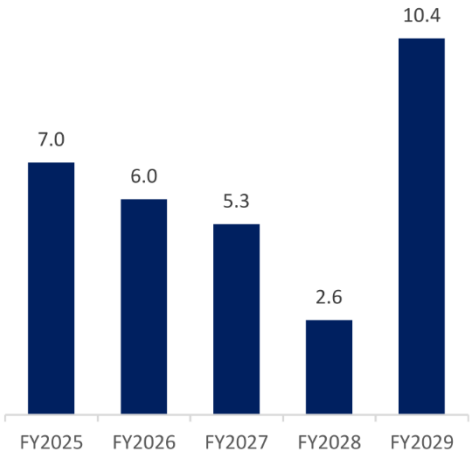


Figure 19: Debt Maturity (Rs. Trillion)



Scenario 3D: A significant portion of government debt exceeding Rs. 10 trillion (Rs. 5.4 trillion owed to the State Bank of Pakistan and the remainder to commercial banks) is due in FY2029. This will severely strain the fiscal position that year, potentially leading to a lower credit rating and an increase in market interest rates due to a rise in demand for loanable funds. To avoid such a situation, the government should consider making early arrangements to manage this challenge, although this may add extra pressure on the government's fiscal account in the medium term.

Fiscal Impact:

Scenario 3A: The government's external debt consists of multilateral, bilateral, commercial, and international bond loans. Each loan carries a specific interest rate, which is projected based on baseline assumptions. However, actual interest rates may differ from these projections; therefore, the cost of servicing new external debt will also change. The government's outstanding domestic debt is projected to be Rs. 54 trillion, while external debt is projected to be USD 88 billion at the

end of FY2025. These levels include old debt after repayments made, and new debt raised in FY2025. The future path of interest payments on outstanding debt at the end of FY2024 is given for fixed-rate instruments. However, interest payments on floating-rate debt and newly raised debt during FY2026-28 are unknown, which are projected under the baseline.

Under the baseline, interest payments are projected to be Rs. 8.11 trillion, Rs. 7.95 trillion, and Rs. 7.93 trillion for FY2026, 2027, and 2028, respectively. Actual interest rates, however, may differ from projections due to deviations in the inflation rate from the projected level. An increase in domestic and foreign interest rates by 200 and 100 basis points, respectively, will increase the interest payments to Rs. 8.72 trillion, Rs. 8.98 trillion, and Rs. 9.31 trillion, respectively, in FY2026, 2027, and 2028. The extra amount payable in debt servicing will be borrowed, resulting in a higher fiscal deficit compared to the baseline. The increase in the fiscal deficit, in excess of that under the baseline, is projected to reach Rs. 617 billion in FY2026 and Rs. 3025 billion cumulatively in FY2026-28. This will not change the primary fiscal deficit.

Figure 20: Fiscal Deficit (% of GDP): Baseline vs. Debt Related Scenarios

Fiscal Deficit (Rs. Billion)			
	2026	2027	2028
Baseline	7,222	6,357	6,235
S3A	7,839	7,385	7,614
S3B	7,270	6,427	6,286
S3D	9,822	9,266	9,447
Difference			
S3A	617	1,028	1,380
S3B	49	70	52
S3D	2,600	2,909	3,213

Scenario 3B: Pakistan's significant exposure to external debt makes exchange rate volatility a considerable risk. A 10% depreciation in the exchange rate, as modeled in this scenario, impacts fiscal indicators through two main channels. First, depreciation increases the cost of servicing external debt, as approximately a quarter of public debt—and an even larger portion when including liabilities—is denominated in foreign currency. This situation directly exposes the debt to currency depreciation, worsening the fiscal balance. External debt interest payments increase by Rs. 49 billion in FY2026 and a cumulative Rs. 171 billion in FY2026-28, due to assumed exchange rate depreciation. This will increase the fiscal deficit one-for-one, though the primary fiscal deficit will not change.

Second, currency depreciation leads to fewer imports, which can be costly. However, the rupee value of imports may not deviate from the baseline since the decrease in imports valued in foreign currency is assumed to be offset by the increase in the rupee value caused by depreciation. Consequently, the net impact of currency depreciation primarily influences external debt and its

servicing costs. The baseline projections of external debt and its servicing are converted to local currency using the exchange rate assumptions from this scenario.

Scenario 3C: This scenario does not directly affect the fiscal position if both floating-rate and fixed-rate debt experience similar changes in interest rates. However, in the long run the government will remain exposed to refinancing risk in a high inflation and high interest rate environment. For instance, 50% of the new non-T-bill domestic debt (Rs. 13.46 trillion) raised in FY2026 is planned to be through fixed-rate instruments, which amounts to Rs. 6.73 trillion. If only a quarter (Rs. 3.36 trillion) of the new debt issuance net of T-bills can be raised through fixed-interest rate instruments, then the remaining Rs. 3.36 trillion will remain exposed to interest rate risk. If the domestic interest rate is observed to be 2 percentage points higher than the baseline, then the change in debt structure in FY2026 would cost an extra Rs. 67.3 billion in FY2027 and Rs. 108.6 billion in FY2028.

Scenario 3D: The fiscal impact of this scenario is straightforward to estimate. Payments related to this situation are not included in the baseline. Therefore, a plan to make early arrangements for FY2029 in four equal yearly installments will increase the government's debt-related costs by Rs. 2.6 trillion per year. However, this additional cost must be borrowed, therefore, the actual fiscal burden is higher than the estimated yearly payments. This will lead to a higher fiscal deficit more than that in the baseline, reaching Rs. 2.6 trillion in FY2026, Rs. 2.9 trillion in FY2027, and Rs. 3.2 trillion in FY2028. However, in the long term, this approach will ease the strain on fiscal accounts starting from FY2029 and beyond. Assuming that the heavy debt maturity in FY2029 (Rs. 10.4 trillion) increases the interest rate by one percentage point, the early payment strategy would save Rs. 104 billion in FY2029 with a present value of Rs. 74 billion.

Managing Fiscal Risk from Government Debt

Recognizing the importance of fiscal risk management, the government plans to alter the composition of its debt by increasing the proportion of instruments with longer maturities and fixed rates.

In the medium term, it aims to adhere to the fiscal deficit limits set by the Fiscal Responsibility and Debt Limitation Act, while regularly conducting debt sustainability analyses to maintain vigilance. The government will also diversify its financing sources by tapping into concessional loans and green bonds to reduce debt servicing costs.

For long-term sustainability, the government is incentivizing the export sector to stabilize the exchange rate and mitigate exposure to external debt. Additionally, enhancing coordination between monetary and fiscal policies, as well as utilizing financial instruments to hedge against currency risks, are also being considered.

8.5 SOE-related Fiscal Risks

State-Owned Enterprises present significant fiscal risks due to both revenue shortfalls and expenditure pressures. When SOEs incur losses from inefficiencies or are burdened by Public Sector Obligations, their ability to generate profits decreases. This results in lower dividend transfers to the government, which diminishes non-tax revenues and weakens the fiscal position. Consequently, the government is often required to provide financial support to struggling SOEs—

especially the 17 major loss-makers—through equity injections, subsidies, and grants. These further strains public resources.

The combined effect of reduced revenues and increased expenditures heightens fiscal vulnerabilities, leading to a larger fiscal deficit and a growing debt burden. If these SOE-related fiscal risks are not addressed, they can crowd out essential public investments and raise long-term sustainability concerns for government finances.

Scenarios Related to SOEs:

Three scenarios have been assumed related to SOEs:
Scenario 4A: Lower SOE dividend paid to the government
Scenario 4B: Increased support of the government to loss-making SOEs
Scenario 4C: SOEs' inability to repay existing debt
Scenario 4D: Energy transition risk

Scenarios Description: Contrary to the baseline, **Scenario 4A** assumes a declining annual real dividend by 6.1% transferred by SOEs to the government. **Scenario 4B** assumes approximately two times higher government support to SOEs over and above what is given in budget books and considered under the baseline. **Scenario 4C** assumes that there is a 40% probability that SOEs cannot repay their existing debt. Finally, **Scenario 4D** assumes that on-grid electricity consumption decreases annually by 3.6%.

Justification of the Scenarios:

Scenario 4A: The baseline scenario predicts that the dividends from SOEs will grow in real terms at a rate based on the average growth from the last two years, which is 10%. However, there is a risk in relying on just two years of performance, as this could be influenced by specific accounting practices or temporary windfall gains. In fact, over the past eight years, the average real growth in dividends has been -6.1%. Therefore, it is likely that dividends will follow this historical trend over the next three years. Hence, it is more likely that the actual dividends of SOEs may remain below what is predicted under the baseline.

Figure 21: SOEs (Real) Dividend to Government (Log): Actual, Projected and Trend

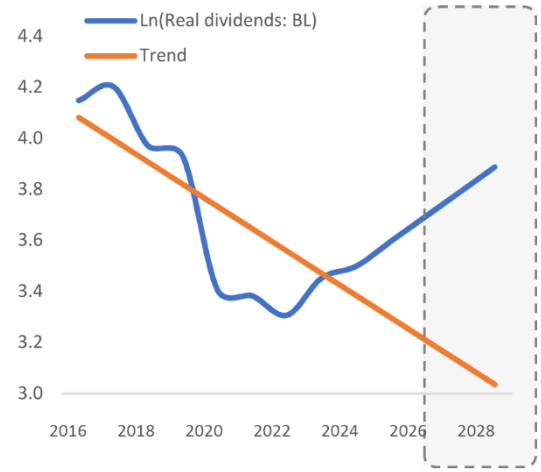
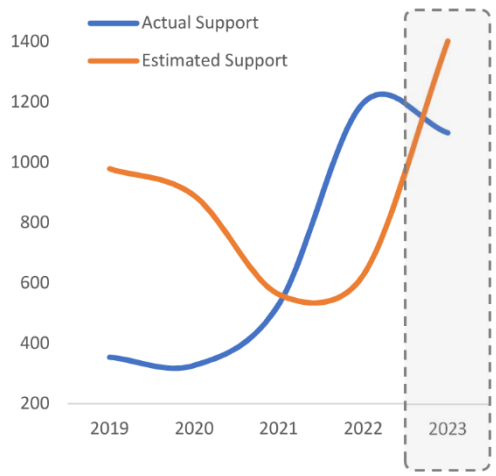


Figure 22: Government's Support to Loss Making SOEs (Rs. Billion) Actual vs. Benchmark



Scenario 4B: There are seventeen SOEs that have been experiencing major losses and require frequent financial support from the government. This support is provided in the form of equity injections, grants, and subsidies. The growth rate of this support has varied significantly, ranging from a decrease of 40% in one instance to an increase of 126% in another, with an average growth rate of 22% over the past decade. Trend analysis indicates an average annual increase of Rs. 84 billion in government support. However, a more detailed analysis suggests that SOEs have been incurring losses amounting to an average of Rs. 226 billion each year. Government support to SOEs remained Rs. 4,533 billion from FY2019-2023, though the estimated fiscal burden put by loss-making SOEs stands at Rs. 6,016 billion during the same period. In this situation, the government did not record one-fourth of its actual liabilities in its budget, accumulating additional liabilities and exposing itself to significant fiscal risk.

Scenario 4C: State-Owned Enterprises had an outstanding debt of Rs. 9,196 billion at the end of FY2024, including guarantees issued, cash development loans (CDL), foreign relent loans, bank loans, accrued interest, and other loans. This includes both government-guaranteed and non-guaranteed debt. The FRS does not distinguish between these categories, as the federal government ultimately bears the liability. While explicit guarantees differ in nature, the government implicitly backs all SOE debt, if it wants SOEs to remain operational. Financial health and risk exposure vary across SOEs, affecting default probabilities. Considering individual SOE risks and debt types, the FRS assumes a weighted average probability of 40% that SOEs will not be able to pay their outstanding debt.

Figure 23: Outstanding Debt of SOEs on June 2024 (Total: Rs. 9.2 Trillion)

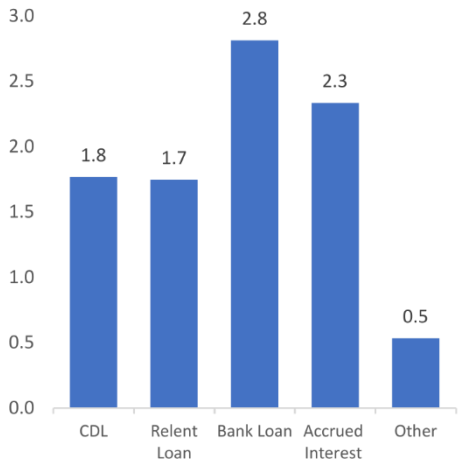
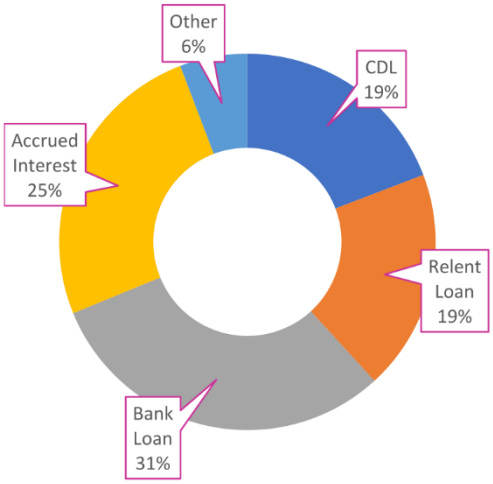


Figure 24: SOE Debt Composition (%)



Scenario 4D: In the first half of the last decade, electricity consumption grew at an average annual rate of 6.1%, coinciding with GDP growth of 4.3%. In contrast, during the second half of the decade, electricity consumption demand slowed to just 1.1%, while GDP growth dropped to 2.7%. This suggests that a decline of 1.3 percentage points in GDP growth resulted in a 5 -percentage point decrease in on-grid electricity consumption.

In the last two years (FY2022-2024), electricity consumption has actually reduced by an average of 5.9% despite an average GDP growth of 1.1%. Consequently, electricity consumption will likely continue to decrease annually by approximately 3.6%—a percentage consistent with recent history.

Figure 25: GDP and Electricity Consumption Growth (%)

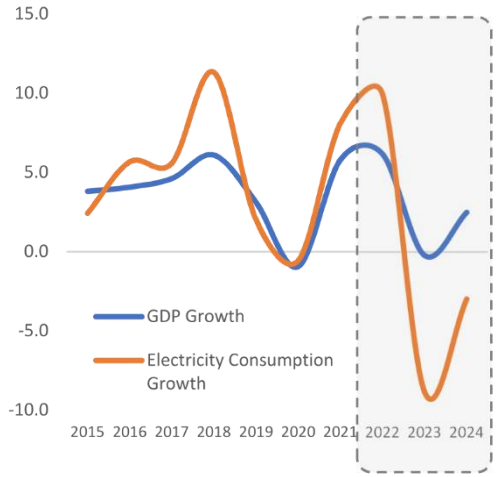
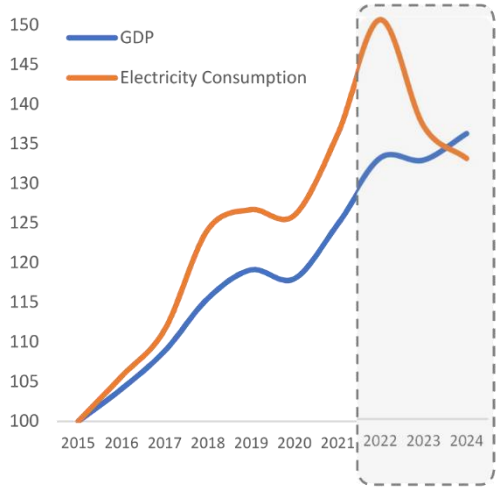


Figure 26: GDP and Electricity Consumption Standardized (2015=100)



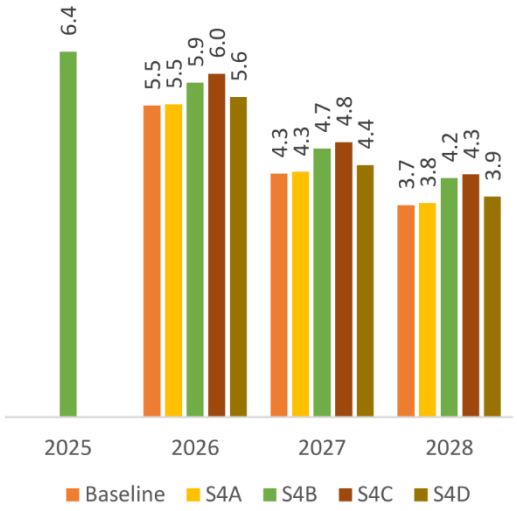
Fiscal Impact Estimation:

Scenario 4A: The fiscal impact of this scenario is estimated through several steps. First, the dividends from State-Owned Enterprises are converted into real values using the GDP deflator over the past eight years. The average growth rate is found to be -6.1%. In scenario 4A, it is assumed that the real dividend will grow at the average rate observed over the last eight years, contrary to the baseline where the dividend grows at 10%, consistent with the last two years' growth. The future real values of these dividends are then multiplied by the projected GDP deflator to obtain nominal values. The dividend is projected to be Rs. 89.7 billion (compared to Rs. 116.1 billion under the baseline) in FY2026 and Rs. 288.2 billion (compared to Rs. 414.1 billion in the baseline) cumulatively in FY2026-28.

The dividends in this scenario are subtracted from those in the baseline scenario, and the resulting difference is considered a fiscal risk as this part of non-tax revenue would hardly materialize. This fiscal risk is estimated to be Rs. 26.4 billion for FY2026 and Rs. 125.9 billion cumulatively for FY2026-28. This amount is deducted from non-tax revenues, leading to an increase in the fiscal deficit, which in turn raises borrowing requirements and adds to interest costs. The fiscal deficit in this scenario is found to be Rs. 137 billion higher than the baseline cumulatively in FY2026-28. The extra fiscal deficit generated above the baseline is considered a fiscal risk.

Figure 27: Fiscal Deficit (% of GDP): Baseline vs. SOEs Related Scenarios

Fiscal Deficit (Rs. Billion)			
	2026	2027	2028
Baseline	7,222	6,357	6,235
S4A	7,248	6,401	6,301
S4B	7,750	7,014	7,037
S4C	7,957	7,180	7,144
S4D	7,417	6,582	6,488
Difference			
S4A	26	44	66
S4B	528	657	803
S4C	736	823	909
S4D	196	225	254



Scenario 4B: There are 17 loss-making State-Owned Enterprises, which need continuous support from the government. The fiscal burden is estimated from support to these loss-making SOEs using a comprehensive methodology conducted at SOE level to estimate SOE-related fiscal risks in Pakistan. The annual fiscal burden, at SOE level, is estimated as:

Annual Fiscal Burden = Change in Net Trade Payables + Change in unpaid interest on borrowing and delayed payments + Change in Unfunded employees terminal benefits + Issuance of new debt [2]

The required support is projected to be Rs. 1980 billion for FY2026 and a cumulative Rs. 6,726 billion in FY2026-28, approximately 1.5% of GDP. On the other hand, government support provided to SOEs in the form of subsidies, grants, equity injections, loans, and guarantees, extracted from budget documents, is found to be 1.1% of GDP over the past five years. Assuming this ratio prevails over the medium term, government support is projected to be Rs. 1452 billion for FY2026 and Rs. 4932 billion for FY2026-28.

Net fiscal risk is estimated to be the difference between the projected annual fiscal burden estimated at SOE level and the baseline government support. It is found to be Rs. 528 billion for FY2026 and Rs. 1794 billion for FY2026-28.

Scenario 4C: SOEs have a total outstanding debt of Rs. 9,196 billion. Assuming the average maturity of the debt is five years, this debt must be repaid at 20% annually, which amounts to approximately Rs. 1,839 billion each year. However, due to the fiscal risks associated with SOEs, there is an assumed 40% chance that they may be unable to meet their debt obligations, exposing the government to 40% of SOE debt. This translates to the government paying 40% of the annual debt maturity, which equates to an expected value of Rs. 736 billion per year.

It is important to note that the baseline projection does not account for this potential risk. If such a situation arises, it could further increase the fiscal burden, as the government would need to

[2] *Net Trade Payables = Trade Payables – Trade Receivables + Customer Security Deposits - Inventories - Cash holdings and bank deposits*

borrow this amount, resulting in interest payments due in subsequent fiscal years. This contingent liability poses a significant fiscal risk, as government support for SOE debt repayments could strain public finances, increasing the fiscal deficit and crowding out essential development expenditures. The increase in the federal fiscal deficit is estimated at Rs. 736 billion in FY2026 and Rs. 2468 billion in FY2026-28 (0.4% of cumulative GDP).

Scenario 4D: In this scenario, electricity consumption growth is considered to be -3.6% annually. Using this growth rate, medium-term on-grid electricity demand (in GWh) is projected to decrease by 11,910 GWh cumulatively in FY2026-28. This reduced electricity demand is multiplied by the price per GWh, adjusted for inflation, to estimate the revenue loss for power sector SOEs. It is found to be Rs. 196 billion in FY2026 and Rs. 604.6 billion for FY2026-28.

This revenue loss increases the demand for borrowing and the resulting interest payments. Therefore, the federal fiscal deficit increases by Rs. 196 billion compared to the baseline in FY2026 and Rs. 675 billion cumulatively for FY2026-28.

Managing Fiscal Risk from SOEs

To address these risks, the government is committed to privatizing certain loss-making SOEs and reforming the governance structures of others to enhance efficiency. Key measures include improving the PSO framework in accordance with the SOE Act of 2023, tendering PSOs to reduce costs, and implementing clear dividend policies.

8.6 Climate-related Fiscal Risks

Pakistan faces significant climate-related fiscal risks due to its susceptibility to extreme weather events such as floods, droughts, and heat waves. These disasters impose substantial costs on public finances, requiring emergency relief efforts, rehabilitation, and infrastructure reconstruction. Additionally, climate change negatively impacts agricultural productivity, water availability, and energy supply, leading to revenue losses and increased government expenditures on subsidies and social protection programs.

The rising frequency of climate-related disasters also heightens contingent liabilities, as the government frequently provides financial assistance to affected communities and businesses. Furthermore, climate change may hinder Pakistan's economic growth potential, which in turn reduces the tax base and increases reliance on external borrowing.

A comprehensive fiscal impact analysis of climate change involves evaluating its effects on government revenues, expenditures, and debt sustainability. Climate-related disruptions can lead to a decline in both tax and non-tax revenues, especially from sectors such as agriculture and energy. At the same time, these disruptions increase spending on adaptation measures, disaster response, and health care. As a result, the fiscal deficit may widen, and debt could accumulate more quickly, necessitating adjustments to the fiscal framework.

Integrating dynamic modeling and risk assessments can enhance revenue and expenditure projections, contributing to fiscal sustainability. Additionally, implementing mitigation strategies—such as creating fiscal buffers, investing in climate-resilient infrastructure, and developing

insurance mechanisms—will be crucial for managing these risks and strengthening Pakistan's fiscal resilience against climate change.

This Fiscal Risk Statement presents two scenarios. The first scenario assumes strict adherence to the Paris Agreement, with the government making green investments supported by the international community. If other countries engage in similar green investment initiatives, climate change is expected to follow the Representative Concentration Pathway (RCP) 2.6. The second scenario assumes that the government does not pursue green investment projects, leading to the expectation that RCP 8.5 will prevail. This would have severe negative effects on economic activity.

Scenarios Related to Climate Change

Scenario 5A: RCP 2.6 (Stringent Climate Change Mitigation Scenario)

Scenario 5B: RCP 8.5 (Severe Climate Change Scenario)

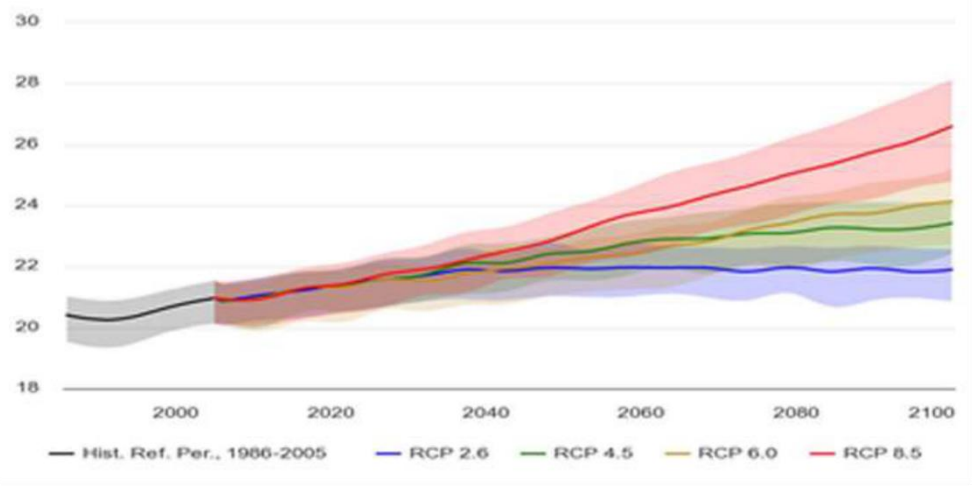
Scenarios Description: In **scenario 5A**, the government heavily invests in green projects with the international community's support so that climate change follows RCP 2.6. Under **scenario 5B**, the government and the private sector do not invest in climate change mitigation, and the international community does not support green investment as well. Climate change follows RCP 8.5, which is the worst scenario in terms of temperature rise and changes in precipitation patterns.

Justification of the Scenarios:

Scenario 5A: To achieve the RCP 2.6 target, Pakistan needs to invest USD 196 billion by 2030 to mitigate greenhouse gas emissions. Pakistan requires USD 58.8 billion to invest, while the international community will contribute the remainder. The total investment is to be spread over five years, which amounts to an annual requirement of USD 11.76 billion. Importantly, not all of this funding will come from the government; both the government and the private sector will invest in green energy solutions.

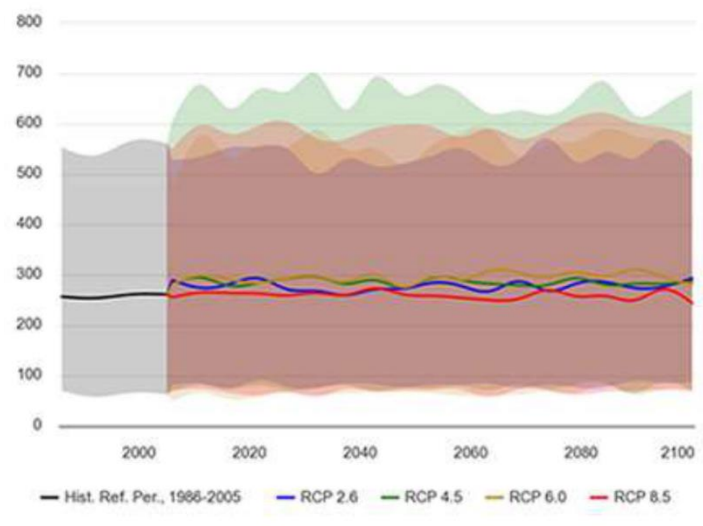
Scenario 5B: While RCP 8.5 is unlikely given the current global trend towards green energy, it is important to consider its implications. Even if governments fail to invest in climate change mitigation, the private sector actively invests in solar energy to lower energy costs, which also reduces greenhouse gas emissions. However, this scenario serves as a benchmark for the worst potential outcomes of climate change. Therefore, estimating the fiscal impact under this least likely scenario is valuable.

Figure 28: Annual Mean Temperature Projections for Pakistan



Source: World Bank Group, Climate Change Knowledge Portal

Figure 29: Precipitation Projections for Pakistan



Source: World Bank Group, Climate Change Knowledge Portal

Fiscal Impact Estimation:

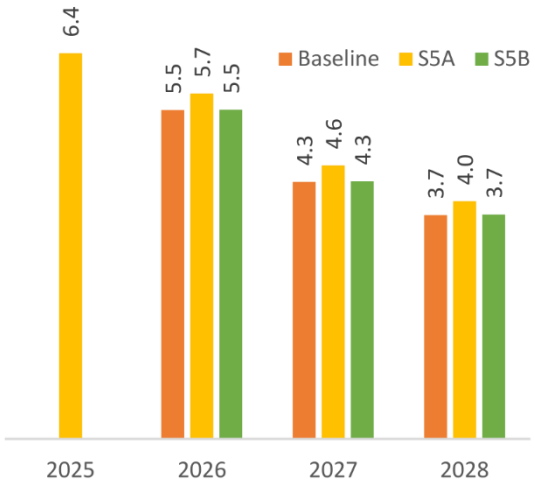
Scenario 5A: This scenario impacts fiscal balance through two main channels. First, the RCP 2.6 scenario has a positive effect on economic activity compared to other climate change scenarios like RCP 4.5 and RCP 8.5. However, since the baseline scenario does not account for the effects of climate change on GDP growth, even the RCP 2.6 scenario is associated with a negative effect on GDP under this alternative scenario. The RCP 2.6 decreases Pakistan's annual real GDP growth by 0.006% for FY2026-28. This reduction in economic activity leads to a negligible decrease in revenues, as green investments do not foster a growth-friendly climate in the short to medium term. Therefore, it is important to consider the negative effects of climate change in this context.

Second, the government needs to invest 20% (in proportion to government size in GDP) of 30% of USD 196 billion (with 80% coming from the private sector) to reduce greenhouse gas emissions, which is added to government expenditure directly increasing fiscal balance. However, this investment activity creates a multiplier effect (assumed to be threefold on the domestic component of investment, which is estimated at 50%) on economic activity, leading to an increase in revenue. The increase in economic activity is projected to be Rs. 103 billion in FY2026 and Rs. 286 billion cumulatively in FY2026-28.

While this scenario has huge long-term benefits that outweigh the costs, the medium-term impact on the fiscal deficit is also moderate. The federal fiscal deficit increases by Rs. 363 billion in FY2026 and Rs. 1,174 billion cumulatively in FY2026-28.

Figure 30: Fiscal Deficit (% of GDP): Baseline vs. Climate-Related Scenarios

Fiscal Deficit (Rs. Billion)			
	2026	2027	2028
Baseline	7,222	6,357	6,235
S5A	7,584	6,770	6,632
S5B	7,225	6,364	6,244
Difference			
Baseline			
S5A	363	413	398
S5B	3	7	10



Scenario 5B: Under this scenario, where the government does not invest in green energy, the negative impact primarily arises from the detrimental effects of climate change on GDP growth potential. The RCP 8.5 scenario results in a reduction of annual GDP growth by 0.7% in FY2026-28. This decrease in economic activity compared to the baseline limits revenue potential, which, in turn, places strain on the fiscal account. This reduction in economic activity leads to a decrease in revenues reaching Rs. 1910.4 billion in FY2026 compared to Rs. 1911.1 billion under the baseline; these values for FY2026-28 are Rs. 6,665.9 billion and Rs. 6,670.9 billion, respectively. The federal fiscal deficit increases by Rs. 3 billion in FY2026 and Rs. 20 billion cumulatively in FY2026-28.

Additionally, this scenario increases both the frequency and severity of climate-related natural disasters. A detailed analysis of these natural disaster scenarios is provided in the following subsection. It is important to note that this scenario doubles both the probability and severity of climate-related natural disasters. The fiscal impact of these changes is estimated as the additional costs incurred by the government due to the RCP 8.5 scenario compared to the baseline scenario.

Managing Fiscal Risk from Climate Change

To mitigate these risks, Pakistan is adopting proactive strategies, including the implementation of green taxes through appropriate carbon pricing, establishing environmental regulations, and

investing in green infrastructure. In the medium term, the government will leverage international climate finance mechanisms to support adaptation and mitigation projects. Additionally, it is encouraging private sector investment in climate-resilient technologies through tax incentives. Reforming the subsidy framework to prioritize renewable energy and enhancing fiscal planning through climate risk assessments are also key priorities on the government's agenda.

8.7 Natural Disasters Related Fiscal Risks

Natural disasters present a significant fiscal risk to Pakistan, largely due to its vulnerability to floods, earthquakes, and climate-related events. The country often experiences extreme weather patterns, such as the devastating floods of 2022, which resulted in damages of USD 14.91 billion and economic losses of USD 15.23 billion. These disasters strain public finances by increasing the demand for emergency relief, infrastructure reconstruction, and social protection spending while simultaneously diminishing revenue due to disrupted economic activities.

Pakistan's limited fiscal space, high debt burden, and reliance on external financing further exacerbate these risks. Therefore, it is crucial to strengthen disaster resilience through improved fiscal planning, insurance mechanisms, and climate adaptation strategies.

Scenarios Related to Natural Disaster

Scenario 6A: Natural Disasters: Increasing Severity and Probability without a Dedicated Natural Disaster Fund

Scenario 6B: Natural Disasters: Increasing Severity and Probability with a Dedicated Natural Disaster Fund

Scenarios Description: In **Scenario 6A**, the government has no dedicated natural disaster fund. On the other hand, the severity of a major natural disaster is increasing with each passing year, while probability accumulates over time until the next disaster occurs. In **Scenario 6B**, the government allocates a budget each year to a dedicated natural disaster fund. The severity of major natural disasters is increasing, while probability accumulates over time until the next disaster occurs. However, the government's exposure remains the same.

Justification of Scenarios:

Scenario 6A: Natural disasters related to climate change frequently occur in Pakistan, varying in scale and likelihood. Past data indicates that the severity of these disasters has been increasing over time. Currently, the Government of Pakistan does not have a dedicated fund for natural disasters. As a result, each year that passes without a major disaster raises the probability of one occurring in the following year. Consequently, the government's exposure to the fiscal burden associated with disaster response gradually increases as the time between significant disasters lengthens.

Scenario 6B: Natural disasters, including climate change-related ones, occur frequently in Pakistan. These disasters vary in scale and likelihood of occurrence. Historical data indicates that the severity of these disasters has been increasing over time. The Government of Pakistan is assumed to allocate funds to a dedicated natural disaster fund responsibly. Each year without a natural disaster increases the cumulative probability of one occurring the following year. However,

the government's exposure to the fiscal burden associated with disasters remains constant because of the dedicated fund.

Table 8: Natural Disasters and their Consequences in Terms of Human Life and Damages

Disaster Type	Disaster Subtype	Events Count	Total Deaths	Total Affected	Total Damages ('000 US$)
Drought	Drought	2	220	6,880,912	247,000
Earthquake	Ground Movement	30	75,124	7,420,276	5,345,500
Epidemic	Bacterial disease	2	105	10,028	
	Parasitic disease	1	0	5,000	
	Viral disease	4	130	59,066	
	Infectious disease (General)	5	131	371	
Extreme Temperature	Cold Wave	3	18		
	Heat Wave	**13**	**2,741**	**80,574**	**18,000**
Flood	Flash Flood	**28**	**3,630**	**22,114,353**	**10,184,118**
	Riverine Flood	**42**	**6,329**	**34,967,357**	**9,727,030**
	Flood (General)	**39**	**5,059**	**43,694,593**	**16,510,230**
Mass Movement	Avalanche	13	580	4,460	
	Landslide	9	222	29,707	18,000
	Mudslide	2	16	12	
	Rockfall	1	13		
Storm	Convective Storm	**18**	**514**	**1,019,806**	
	Tropical cyclone	**5**	**1,106**	**2,189,940**	**1,710,936**
	Storm (General)	7	223	3,123	

Source: EM-DAT, *The International Disaster Database*

Fiscal Impact Estimation: The floods of 2022 have been selected as the benchmark for estimating the fiscal impact of natural disasters since they provide the most recent evidence. The fiscal cost is categorized into five areas: infrastructure and asset damage costs, disaster response costs, subsidies for disrupted economic activity, increased social protection, and losses for State-Owned Enterprises due to natural disasters. In the budget for FY2023-24, the federal government allocated Rs. 18 billion for disaster response costs, Rs. 96 billion for subsidies related to disrupted economic activity, and Rs. 50 billion for social protection. Moreover, the damage to infrastructure has been estimated at USD 15 billion in the 2022 floods (Pakistan Floods 2022: Post Disaster Need Assessment 2023).

Scenario 6A: The damages of 2022 floods have been converted to Pak Rupees, and then adjusted for severity factor (found from increasing damages over time), probability of occurrence of major, moderate, and minor natural disasters, and inflation to project the expected value of damages for the medium term. These damages have been estimated at Rs. 4,674 billion in FY2026, assuming that a major disaster occurs in FY2026 after the floods in FY2023. In this case, there will be less fiscal burden in FY2027, as all the burden of disaster is borne in FY2026. However, it will increase over time as probability accumulates. If a major disaster does not happen in FY2026 but occurs in FY2027, then the expected loss is even higher due to increased probability, severity, and inflation. The projected fiscal burden is Rs. 5,796 billion in FY2027 (if a major disaster does not occur up to FY2026) and Rs. 7,239 billion in FY2028 (if a disaster does not occur up to FY2027).

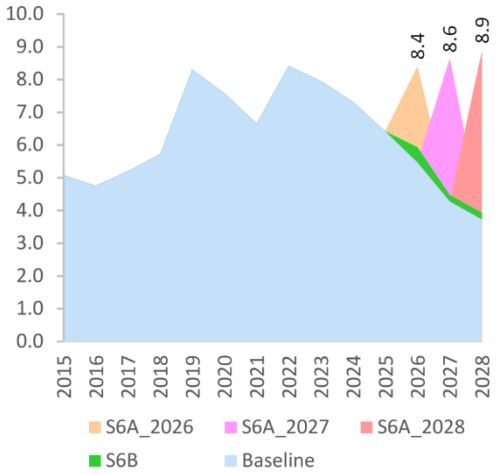
Disaster response costs, subsidies for disrupted economic activity, and increased social protection are projected in a similar way, though these are also adjusted for population growth. Disaster response costs are projected to be Rs. 8.4 billion in FY2026, Rs. 11.4 billion for FY2027, and Rs. 14.8 billion for FY2028. Subsidies for disrupted economic activity are projected at Rs. 45.1 billion for FY2026, Rs. 60.8 billion for FY2027, and Rs. 79.1 billion for FY2028. Increased social protection is projected at Rs. 21.6 billion for FY2026, Rs. 29.6 billion for FY2027, and Rs. 38.9 billion for FY2028. Each year's fiscal cost is estimated given that a major disaster did not occur after 2022-23 up to the previous fiscal year.

For projection of SOE losses due to natural disaster, a trend model has been fitted to the losses incurred by non-commercial State-Owned Enterprises from FY2016 to FY2023 after adjusting by the GDP deflator, considering the trend as the normal pattern of losses. Deviations from this trend indicate events that either increase or decrease losses. The largest deviation from the trend was observed in FY2023, coinciding with the floods that year. The actual SOE loss in that year was Rs. 55.3 billion in real terms against a trend (normal) value of Rs. 22.4 billion. The difference, assumed due to floods, has been found to be Rs. 32.9 billion in real terms and Rs. 67.5 billion in nominal terms. This, along with the severity factor, probability of occurrence of disaster, and inflation, is used to project future values of SOEs losses due to natural disasters. The increase in SOEs loss due to natural disasters is projected at Rs. 29.4 billion for FY2026, Rs. 38.7 billion for FY2027, and Rs. 49.1 billion for FY2028.

Cumulatively, the losses across all five categories total Rs. 4,778 billion for FY2026. In the absence of a disaster in FY2026, the projected loss is expected to rise to Rs. 5,936 billion in FY2027, assuming a disaster occurs in that year. For FY2028, the estimated loss is projected to reach Rs. 7,421 billion. As these extra expenditures result in a higher fiscal deficit and consequent higher demand for borrowing, the effect on the fiscal deficit is even higher. The projected federal fiscal deficit under this scenario, in excess of that in the baseline scenario, has been found to be Rs. 4,778 billion for FY2026, Rs. 6,504 billion for FY2027, and Rs. 8,677 billion for FY2028.

Figure 31: Fiscal Deficit (% of GDP): Baseline vs. Natural Disaster Related Scenarios

Fiscal Deficit (Rs. Billion)			
	2026	2027	2028
Baseline	7,222	6,357	6,235
S6A_2026	12,000	6,754	6,631
S6A_2027	7,222	12,861	6,774
S6A_2028	7,222	6,357	14,911
S6B	7,835	6,651	6,576
Difference from Baseline			
S6A_2026	4,778	397	397
S6A_2027	0.0	6,504	540
S6A_2028	0.0	0.0	8,677
S6B	614	295	342



Scenario 6B: As in this scenario, the government has a dedicated natural disaster fund, so the government's exposure does not increase each year in the absence of a natural disaster. The procedure used to estimate the fiscal burden of potential natural disasters while considering a dedicated natural disaster fund is similar to the method employed in Scenario 6A, except that the government exposure does not increase. However, factors such as severity, inflation, and population growth compound over time, increasing the demand for allocations to the natural disaster fund.

This scenario also takes into account all five categories of fiscal burden associated with natural disasters: costs for infrastructure and asset damage, disaster response costs, subsidies for disrupted economic activities, increased social protection, and losses from State-Owned Enterprises due to natural disasters. As each category is multiplied by marginal instead of conditional probability, the projected fiscal burden of the government is lower. Under this scenario, the government must allocate Rs. 613.8 billion to the natural disaster fund in FY2026, Rs. 221.6 billion in FY2027, and Rs. 240.5 billion in FY2028. The projected federal fiscal deficit under this scenario, in excess of that in the baseline scenario, has been found to be Rs. 614[3] billion for FY2026, Rs. 295 billion for FY2027, and Rs. 342 billion for FY2028.

It is important to note that the government still faces fiscal risk, even with a dedicated natural disaster fund, as this potential burden is not captured in the baseline scenario. However, this fiscal risk is significantly lower than those without a disaster fund.

Managing Fiscal Risk from Natural Disasters

To manage and mitigate fiscal risks, the government is prioritizing investments in disaster-resilient infrastructure, incentivizing climate-adapted agricultural practices, and strengthening early warning systems. Additionally, the government plans to enhance the role of the budget item "Provision for

[3] The higher payment in the first year is due to the delayed allocation of three years' worth of payments that were not allocated following the 2022 floods.

Emergency and Others" by allocating these funds to a natural disaster fund, which can be accessed when needed. Long-term intended measures of the government include leveraging insurance mechanisms, establishing a risk transfer strategy, and improving budget execution capacity, all aimed at reducing the fiscal impact of natural disasters.

8.8 Other Fiscal Risks

Fiscal Risk from Public Private Partnership Projects

Scenario 7A: Government Allocates Funds to PPP Projects

Scenario Description: From FY2026 to FY2028, the government pays its committed liabilities to PPP projects.

Justification of Scenario: From FY2026 to FY2028, the government will assume direct liabilities amounting to Rs 120.6 billion related to Public-Private Partnership projects. This includes Rs 40 billion for the Kharian-Rawalpindi Motorway, Rs 78.2 billion for the M6 Motorway, and Rs 2.6 billion for the Sialkot-Kharian Motorway, all in the form of Viability Gap Funding (VGF). Additionally, there is a contingent liability of Rs 87 billion, with an assumption that 50% of this amount will materialize.

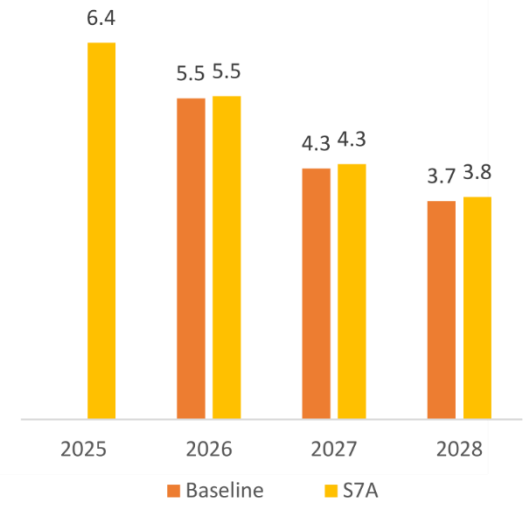
Fiscal Impact Estimation: Direct or explicit liabilities are derived from project-level agreements of PPP projects. The government has direct liabilities of paying Rs 2.6 billion in Viability Gap Funding to the Sialkot-Kharian Motorway. Additionally, there are VGF payments of Rs 40 billion to the Kharian-Rawalpindi Motorway and Rs 78.2 billion to the M6 Motorway, although these projects are still in the pipeline. These direct liabilities amount to Rs 120.6 billion over FY2026-28, with Rs 10.9 billion in FY2026, Rs 59.9 billion in FY2027, and Rs 49.9 billion in FY2028.

Furthermore, there are contingent liabilities against the Sialkot-Kharian Motorway as a payment against termination risk worth Rs 87 billion, equally divided among FY2026-28. These payments are considered with a 50% probability, amounting to Rs 14.5 billion each year. This scenario also assumes a 50% chance that these amounts would be renegotiated, which is possible as per the agreements of the PPP projects, potentially leading to a two-fold increase. In this case, the direct liabilities would increase to Rs 241.2 billion over FY2026-28.

A natural disaster scenario model based on scenario 6B is used to estimate the implicit guarantees related to disasters. This model assumes a 50% probability that a natural disaster will damage the infrastructure of the PPP project. Key variables, including the probability of occurrence, severity factors, and other parameters, are extracted from scenario 6B. The projected federal fiscal deficit due to such implicit liabilities, in excess of the baseline scenario, is estimated to be Rs 52 billion for FY2026, Rs 110 billion for FY2027, and Rs 115 billion for FY2028.

Figure 32: Fiscal Deficit (% of GDP): Baseline vs. PPP-Related Scenario

Fiscal Deficit (Rs. Billion)			
	2026	2027	2028
Baseline	7,222	6,357	6,235
S7A	7,274	6,467	6,350
Difference			
S7A	52	110	115



Managing Fiscal Risk from PPP Projects

To mitigate fiscal risks, the government will strengthen the capacity of the Risk Management Unit to oversee PPP project implementation, ensuring transparency and accountability. Additionally, it will enhance its PPP framework by improving its legal structure for project selection, procurement, and risk allocation.

Over time, the government plans to improve the fiscal risk framework by conducting comprehensive feasibility studies, optimizing risk allocation, incorporating explicit contingent liabilities into the PPP budget, establishing contingency reserves, and utilizing insurance and guarantees from multilateral institutions.

Fiscal Risk from Commodity Financing Operations

Scenario 7B: Commodity Financing Guarantees materialize

Scenario Description: This scenario assumes a 20% probability that provincial governments will be unable to repay their existing debt raised for commodity financing operations, which is guaranteed by the federal government. Additionally, there is a 25% probability that Public Sector Enterprises, specifically PASCO and TCP, will be unable to meet their debt obligations.

Justification of the Scenario: As of December 2024, the total stock of guarantees provided to provincial governments for commodity financing operations, specifically in the form of cash credit limits, amounts to Rs 310 billion. Additionally, guarantees for PSEs, including the Pakistan Agricultural Storage and Services Corporation (PASCO) and the Trading Corporation of Pakistan (TCP), stand at Rs 852 billion. Although these guarantees are included in the overall stock of guarantees and do not require separate treatment, this Fiscal Risk Statement categorizes them as part of commodity operation guarantees, as they are not counted within the stock of guarantees for State-Owned Enterprises in this report.

These guarantees are primarily extended to provincial governments to facilitate better borrowing terms from banks and to support PSEs. The provincial governments and PSEs are responsible for

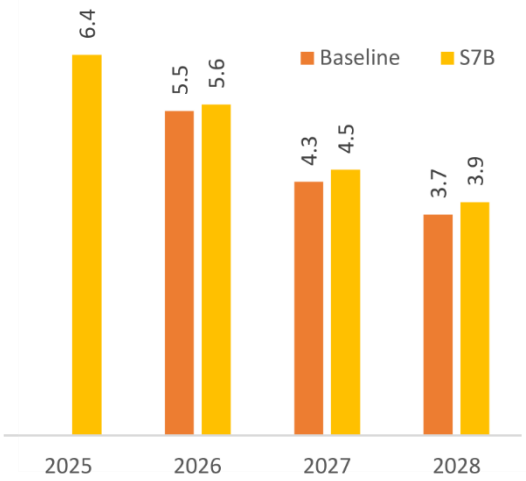
repaying these debts. While it is highly unlikely that provincial governments will default on their loans, there is a risk that the debts of PSEs may not be aligned with the available commodity stocks of PASCO and TCP due to inefficiencies in commodity operations. Consequently, the federal government may be obligated to cover these debts if provincial governments and/or PSEs encounter challenges in their fiscal accounts.

Fiscal Impact Estimation: As of December 2024, the federal government guarantees outstanding debts for provincial governments related to commodity financing operations, totaling Rs 310 billion. With an average maturity of two years for this debt, the provinces will need to repay 50% of the total amount annually, which equates to approximately Rs 155 billion each year.

Similarly, the federal government guarantees outstanding debts for PASCO and TCP related to commodity financing operations, totaling Rs 852 billion. With an average maturity of two years for this debt, the provinces will need to repay 50% of the total amount annually, equating to Rs 426 billion each year.

Figure 33: Fiscal Deficit (% of GDP): Baseline vs. Commodity Financing Operation Related Scenario

Fiscal Deficit (Rs. Billion)			
	2026	2027	2028
Baseline	7,222	6,357	6,235
S7B	7,359	6,658	6,588
Difference			
S7B	138	301	353



However, this Fiscal Risk Statement considers a 20% probability that the provinces and a 25% probability that PSEs may fail to meet their debt obligations, necessitating federal intervention. If this occurs, the federal government might have to cover 20% of the annual debt repayment of provincial guarantees, amounting to Rs 31 billion, and 25% of the annual debt repayment of PSE guarantees, amounting to Rs 106.5 billion each year. The baseline projection does not consider this risk, which could further elevate the fiscal burden, as the government would need to borrow this amount, incurring interest payments in subsequent fiscal years.

This contingent liability poses a significant fiscal risk, as the materialization of these liabilities could strain public finances, increase the fiscal deficit, and limit funding for essential development projects. The projected federal fiscal deficit due to such implicit liabilities, in excess of the baseline scenario, is estimated to be Rs 138 billion for FY2026, Rs 301 billion for FY2027, and Rs 353 billion for FY2028.

Managing Fiscal Risk from Government Guarantees and PSEs Management

To mitigate fiscal risks, the government is reducing exposure by incorporating PSEs guarantees into the overall stock of guarantees and gradually decreasing its guarantees exposure to provincial governments. It is also narrowing its focus to strategic priorities, such as food security, while limiting guarantees for non-essential operations. Additionally, enhancing the management and efficiency of PSEs through governance reforms, performance monitoring, and capacity building is a key priority to reduce fiscal burdens. Over time, the government's strategies will include strengthening oversight through a comprehensive risk assessment framework and developing contingency plans for potential defaults.

Fiscal Risk from Global Commodity Price Shocks

Scenario 7C: Commodity Price Hike

Description of the Scenario: Under this scenario, a 20% increase in global oil prices prompts the federal government to reduce the petroleum levy and increase subsidies.

Justification of the Scenario: In February 2025, Brent crude was trading at approximately USD 75 per barrel, compared to around USD 91 in April 2024, reflecting a 21% increase. As a hypothetical scenario, it can be assumed that oil prices might increase by 20% in FY2026 (this is one-fourth of the shock observed in FY2022). While this scenario is possible, it is less likely to occur.

It is important to note that this situation differs from the 2C scenario, where the petroleum levy was reduced, as that reduction was not a result of global oil price increases. The key distinction in the source of the petroleum levy reduction is that an increased subsidy typically accompanies a reduction due to rising global oil prices.

When global oil prices hiked in FY2022, the petroleum levy was 123% below the trend. A similar shock in the future, though less severe by one-fourth, may cause a deviation of PL collection from the baseline scenario by 30%. Moreover, in response to the global price hike, the government increased subsidies by 81% from the trend, which is assumed to be the normal path of subsidies. Therefore, it is likely that a global oil price shock, one-fourth in severity to that observed in FY2022, may cause the government to increase subsidies by 20%.

Figure 34: Petroleum Levy (Log): Actual and Projected vs. Trend

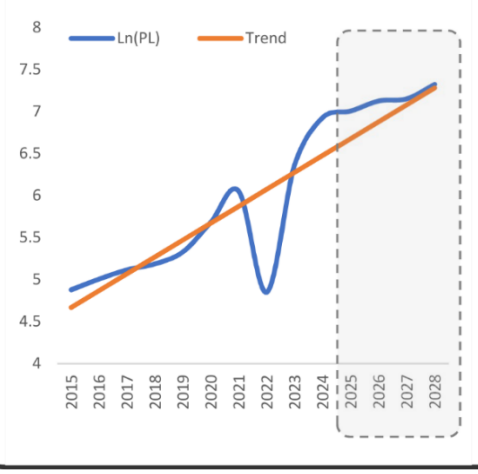
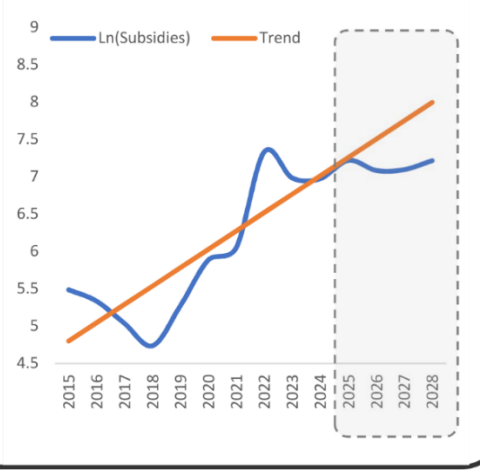


Figure 35: Subsidies (Log): Actual and Projected vs. Trend

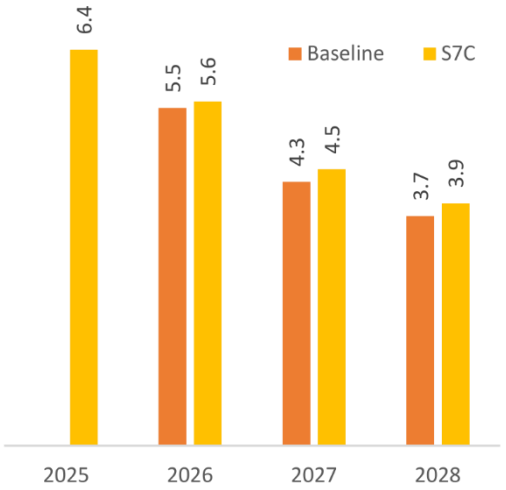


Fiscal Impact: A global increase in oil prices would prompt the government to reduce the petroleum levy and increase energy-related subsidies. Lowering the petroleum levy would decrease tax revenues, while higher subsidies would raise the government's current expenditures, negatively impacting the country's fiscal position.

Under this scenario, the lower collection of the petroleum levy would result in non-tax revenues being Rs 248 billion less than the baseline in FY2026 and Rs 806 billion less in FY2026-28. Similarly, increased subsidies would result in higher current expenditures by the federal government, projected to be Rs 238 billion more than the baseline in FY2026 and Rs 924 billion more in FY2026-28. Consequently, the fiscal deficit is projected to increase above the baseline by Rs 487 billion in FY2026 and by a cumulative Rs 1,730 billion in FY2026-28.

Figure 36: Fiscal Deficit (% of GDP): Baseline vs. Commodity Price Hike Scenario

Fiscal Deficit (Rs. Billion)			
	2026	2027	2028
Baseline	7,222	6,357	6,235
S7C	7,708	6,911	6,925
Difference			
S7C	487	554	690



As a result, the government would be forced to either cut spending, increase borrowing, or impose additional taxes. This situation would either suffocate the economy or strain public finances, raising debt servicing costs, and potentially lead to fiscal imbalances. Furthermore, reduced

collections from the petroleum levy and increased subsidies could limit the government's ability to fund essential development and social welfare programs, ultimately affecting economic stability.

Managing Fiscal Risk from Global Commodity Price Shock

To manage fiscal risk, the government will optimize subsidy allocation by prioritizing green energy and exploring alternative revenue sources to offset deficits in such situations. Additionally, implementing tax reforms and improving revenue collection from other sources will reduce overreliance on volatile revenue streams.

Fiscal Risk from Circular Debt

Scenario 7D: Circular Debt in Mainstream Debt Model

Scenario Description: In FY2025, the government caps circular debt at the FY2024 level and then combines it with the government's overall debt from FY2026 onwards.

Justification of the Scenario: As of December 2024, the government's outstanding circular debt stands at Rs. 2.4 trillion for the power sector and Rs. 2.3 trillion for the gas sector. Circular debt represents 6% of the government's combined public debt and circular debt. This ongoing issue poses a significant fiscal challenge for the government. Since the government is required to address this debt, developing a roadmap to manage its resolution by incorporating it into the overall public debt is a reasonable approach to maintaining fiscal discipline. Although, according to the Fiscal Responsibility and Debt Limitation Act, circular debt is not classified as public debt, it can nonetheless be integrated with public debt in the overall debt management model.

Figure 37: Debt and Other Liabilities (Rs. Trillion) December 2024

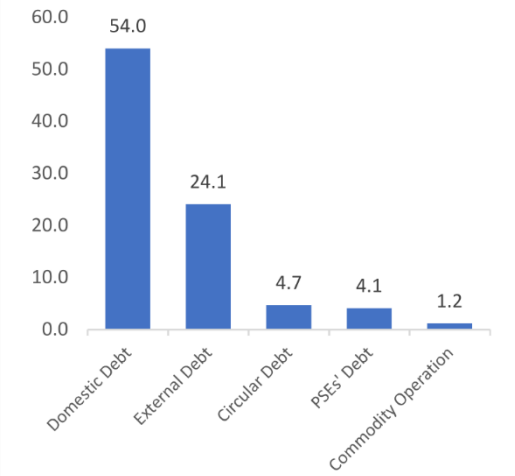
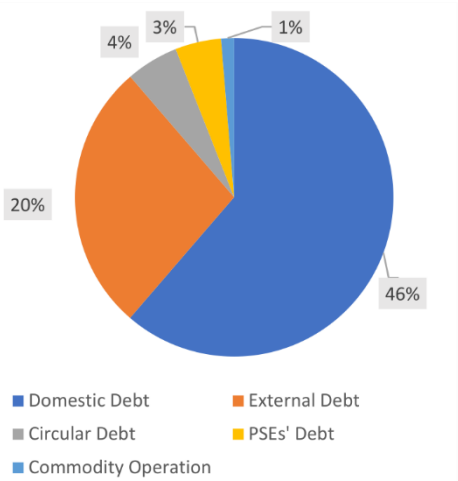


Figure 38: Debt and Other Liabilities (% of GDP) December 2024

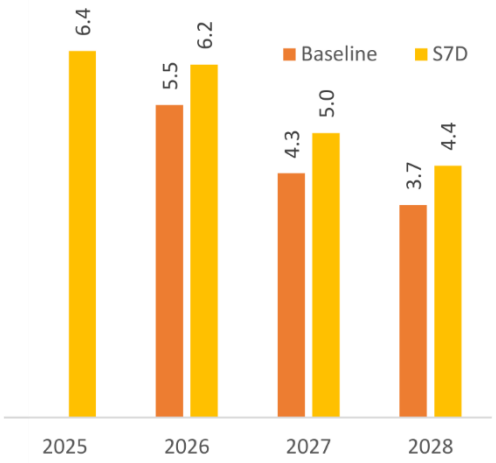


Fiscal Impact Estimation: Addressing the circular debt in the power and gas sectors over ten years will significantly strain fiscal accounts. This approach will necessitate ongoing budget allocations for debt servicing, possible bailouts, and implementing sector reforms. The government has already raised electricity and gas tariffs, leaving limited space for further adjustments. Increased energy prices may also lead to higher inflation, requiring additional social safety measures and further burdening public finances.

Under this scenario, the Fiscal Risk Statement considers circular debt alongside the government's debt, as defined by the FRDLA in the debt model. Consequently, this elevates the debt-to-GDP ratio by 4 percentage points in FY2025 and increases government payments by Rs 937 billion each year starting from FY2026 up to FY2031. The fiscal deficit is projected to increase above the baseline by Rs 937 billion in FY2026 and by a cumulative Rs 3,142 billion in FY2026-28.

Figure 39: Fiscal Deficit (% of GDP): Baseline vs. Circular Debt Related Scenario

Fiscal Deficit (Rs. Billion)			
	2026	2027	2028
Baseline	7221.6	6356.9	6234.6
S7D	8,158	7,405	7,392
Difference			
S7D	937	1,048	1,158



Managing Fiscal Risk from Circular Debt in Gas and Power Sectors

To reduce fiscal risks, the government intends to cap the existing circular debt stock and gradually work to pay it off. Tariff adjustments in the power and gas sectors have already been implemented to reflect operational costs. In the medium term, the government is committed to implementing governance reforms in these sectors, along with investing in technology to reduce inefficiencies. The government may also consider consolidating circular debt into public debt to adopt a more suitable repayment strategy on favorable terms.

Fiscal Risk from Tax Expenditure

Scenario 7E: Increase in Tax Expenditure

Scenario Description: The government increases tax exemptions, which result in a 10% increase in tax expenditures from existing tax-paying sources.

Justification of Scenario: The tax expenditure estimate for FY2022-23 is Rs 3,879.2 billion, which represents 4.61% of GDP and 54.2% of FBR revenue. This is 73.21% higher than the Rs 2,239.63 billion estimated for FY2021-22. Given this trend, it is likely that tax expenditures could increase by up to 10% in the medium term, potentially extending exemptions to activities that were previously subject to taxation.

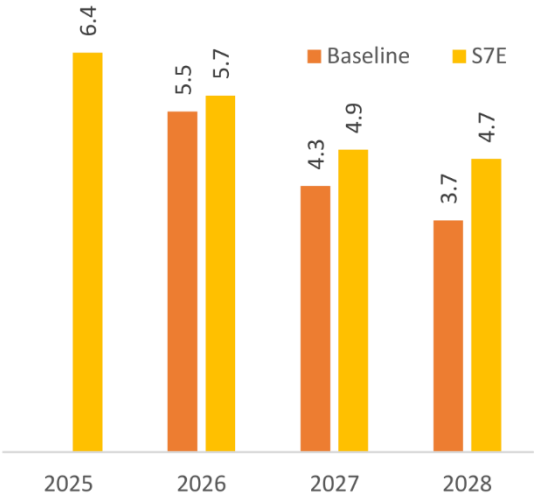
Fiscal Impact Estimation: The fiscal impact of increasing tax expenditures is estimated by deducting 5% of the tax expenditure of FY2025 from the FBR revenues projected under the baseline for FY2026, and 2.5% more for FY2027 and FY2028. In this case, FBR revenues are

projected to be Rs 763 billion less than the baseline in FY2026 and Rs 6,083 billion cumulatively in FY2026-28.

Additionally, government expenditures are presumed to be rigid in the medium term. This situation leads to a higher fiscal deficit, increasing the borrowing requirement and, consequently, the debt servicing costs. The fiscal deficit is projected to increase above the baseline by Rs 337 billion in FY2026 and by a cumulative Rs 2,859 billion in FY2026-28.

Figure 40: Fiscal Deficit (% of GDP): Baseline vs. Tax Expenditure Related Scenario

Fiscal Deficit (Rs. Billion)			
	2026	2027	2028
Baseline	7221.6	6356.9	6234.6
S7E	7,559	7,219	7,895
Difference			
S7E	337	862	1,660



Managing Fiscal Risk from Tax Exemptions

To mitigate fiscal risks associated with increased tax expenditures, the government will establish a robust mechanism for granting tax exemptions through the Tax Policy Unit, with clear criteria to ensure alignment with national priorities. The TPU will also work to align tax exemptions with government expenditure reductions by conducting thorough cost-benefit analyses to prevent any increase in fiscal burdens. Additionally, the unit will implement a comprehensive tax expenditure framework, including regular reporting and evaluation, to ensure that tax exemptions achieve their intended objectives without undermining fiscal sustainability.

APPENDIX

FISCAL RISK MANAGEMENT FRAMEWORK

The following strategies outline the broader fiscal risk mitigation framework upon which the government has based its approach. Some of these strategies are being implemented promptly, while others are planned for the medium term. Additionally, certain actions will take a longer period to implement and represent long-term goals for the government's commitment to managing fiscal risk.

Managing Fiscal Risk from Low Economic Growth

1. Strengthening Fiscal Buffers:

The government shall enhance fiscal reserves during periods of robust economic growth to create a buffer for downturns. Establishing contingency funds to address unexpected revenue shortfalls or expenditure pressures in the event of lower-than-expected GDP growth is essential. In Pakistan, the federal government currently allocates contingency funds under the "Provision for Emergency and Others" category, with plans to improve its management over time.

2. Sector-Specific Taxation:

Not all sectors perform equally during low-growth periods. Some sectors may thrive even in adverse economic conditions. For example, the banking sector of Pakistan performed well during the crisis years of FY2022-24, despite an overall economic slowdown. Temporary surcharges or windfall taxes shall be considered for sectors that perform well despite the slowdown. This approach has been implemented in the past two years with some specific taxes on banks, which can be further improved by designing an appropriate mechanism to impose taxes on windfall gains effectively.

3. Expenditure Management:

It is appropriate to link government spending to GDP performance, with increased expenditure during periods of economic growth and restraint during downturns. However, social protection and other benefits, such as subsidies, are more critical during low-growth scenarios. This scenario planning can include contingency plans to respond quickly to adverse growth scenarios. For instance, non-essential expenditures, such as non-critical infrastructure projects or discretionary spending, can be delayed or scaled back. The government can also limit operational costs, such as travel, training, and administrative expenses, during low-growth years. Addition of a contingency clause in the Public Financial Management Act can categorize planned expenditures in the budget as "rigid" or "flexible", which can be invoked at the time of reappropriation of funds. This will also increase budget credibility.

4. Structural Reforms for Economic Growth:

In the long run, the governments shall focus on structural reforms to achieve sustainable economic growth. This includes diversifying the economy to reduce reliance on a few sub-sectors. For example, in addition to focusing on agriculture, private investments shall be encouraged in industry and the expansion of the manufacturing base. Promoting human capital development and

investment in technology is crucial. Reforms can be implemented to attract investment and stimulate private sector growth. Foreign Direct Investment shall be particularly targeted at sectors that generate higher incomes and employment opportunities.

Managing Fiscal Risk from Revenue Shortfall

1. Enhance Revenue Mobilization:

Improving the tax system to enhance revenue mobilization is imperative. This shall be achieved by broadening the tax base rather than solely focusing on increasing tax rates, which has its limitations. Government shall reduce reliance on volatile revenue sources by expanding the tax base and improving compliance. For example, a significant portion of revenues in Pakistan is collected on imports, which are inherently volatile due to their linkage with the exchange rate management. It is crucial to bring informal sectors and under-taxed activities into the tax net. Simplifying the tax code and enhancing the capacity of tax authorities are essential steps in this direction. Additionally, efforts shall be made to improve taxpayer services and education to foster a culture of voluntary compliance.

2. Improve Tax Administration:

Strengthening tax collection mechanisms and leveraging technology to reduce evasion are vital for mobilizing revenue. Digital tools can enhance tax administration, reduce leakages, lower administrative costs, and increase transparency. For instance, implementing e-filing systems and real-time data analytics can help identify and address tax evasion more effectively. Additionally, enforcement mechanisms shall be strengthened to reduce tax avoidance, including conducting targeted audits for sectors with historically low compliance rates. Regular training and capacity-building programs for tax officials can further enhance the efficiency of tax administration.

3. Prioritize Expenditures:

If a revenue shortfall is anticipated to be temporary, the government can review and prioritize essential expenditures, delaying or scaling back non-critical projects. With limited fiscal space, resources can be allocated to programs and development projects that offer the highest economic and social returns, as well as the highest impact and efficiency. This approach ensures that critical services and investments are maintained while non-essential spending is deferred until fiscal conditions improve. While this is a common approach to managing difficult situations, establishing a proper framework to prioritize actions in the event of lower-than-expected revenue will enhance prudence.

4. Build Fiscal Buffers:

To address temporary revenue shortfalls, the government plans to maintain or increase contingency reserves. These funds can be utilized when revenues fall short of expectations, providing short-term relief. However, continuous reliance on contingency funds undermines their purpose. It is important to establish clear guidelines for the use and replenishment of these reserves to ensure their sustainability and effectiveness in mitigating fiscal risks.

5. Expansion of Economic Activity:

In the long run, higher tax collection is achievable through increased economic activity. The government shall implement structural reforms to attract investment and boost private sector growth. This includes improving the business environment, enhancing infrastructure, and ensuring regulatory stability. Sectors like Small and Medium Enterprises (SMEs) shall be given time bound tax incentives to flourish, eventually enhancing their contribution to tax revenues as economic activity increases and they are gradually brought into the tax net. Additionally, fostering innovation and entrepreneurship can create new sources of revenue and drive long-term economic growth.

6. Focus on Expenditure Efficiency:

In the long run, improving expenditure efficiency shall accompany enhanced revenue mobilization. This not only results in better fiscal outcomes but also increases the incentive for taxpayers to comply. Measures to increase expenditure efficiency include conducting regular expenditure reviews, implementing performance-based budgeting, and adopting best practices in public financial management. By ensuring that public funds are used effectively and efficiently, the government can achieve better value for money and strengthen fiscal discipline.

Non-tax Revenues:

7. SBP Profits:

The profit of the State Bank of Pakistan is beyond the control of the fiscal branch of the government, as it depends on interest rates and market liquidity conditions. SBP profit can be accounted for separately from fiscal accounts, as it is earned by a monetary institution. Fiscal management will shift toward reduced reliance on SBP profits, whose volatility typically distorts the loanable funds market. Establishing a robust financial buffer, such as a reserve fund, can smooth out SBP profits over time. This fund can be built up during periods of high profitability and drawn upon during times of lower profits or losses, ensuring a more stable contribution to fiscal accounts.

8. Petroleum Levy Transparency:

The government shall establish a transparent formula for petroleum products, including the petroleum levy. Committing to planned petroleum levy rates and communicating any changes to the public and parliament can help maintain political support even at the times of oil price hikes. Higher global oil prices increase the import bill, which can be managed by rationing demand through higher prices. By lowering the petroleum levy during periods of high oil prices, consumption inadvertently rises above optimal levels. Therefore, the government plans to maintain transparency and consistency in petroleum levy rates for effective fiscal management and building public trust.

9. Asset Leasing:

The government plans to generate income by leasing out government-owned land, buildings, or other assets through proper auctions. This approach not only provides a source of non-tax revenue but also ensures that public assets are utilized efficiently. Additionally, the government shall

explore Public-Private Partnerships to leverage private sector expertise and investment in managing and developing public assets.

Managing Fiscal Risk from Government Debt

1. Debt Sustainability Analysis:

Regularly conducting debt sustainability analysis is crucial to ensure that debt levels remain manageable even under adverse economic conditions. This involves assessing the debt burden relative to the country's economic growth, revenue generation, and expenditure patterns to identify potential risks and take preemptive measures. Debt sustainability assessment shall be supplemented by the government's adherence to the debt and guarantees limits, as well as fiscal deficit limits, set in the Fiscal Risk and Debt Limitation Act, 2005 and the Public Financial Management Act, 2019. The Budget Strategy Paper may accompany debt sustainability analysis to highlight debt projections and scenarios alongside economic and fiscal projections.

2. Diversify Financing Sources:

To reduce reliance on high-cost borrowing, it is important to explore alternative financing options. This includes seeking concessional loans, issuing green bonds, and tapping into other innovative financial instruments. Diversifying financing sources shall help lower borrowing costs and spread risk. This approach is particularly beneficial for reducing external debt servicing costs, as Pakistan has a significant amount of commercial debt, which carries high interest costs and currency risks. Concessional loans for climate-related projects can reduce the high debt servicing costs of external debt while addressing climate-related issues.

3. Extend Maturities:

Refinancing high-cost debt or extending maturities can alleviate short-term repayment pressures. Refinancing short-term debt with longer maturities can significantly reduce refinancing risks. By spreading out repayment obligations over a longer period, the government plans to manage its debt more effectively and avoid the pressure of large, lump-sum repayments. Currently, only one-quarter of Pakistan's domestic debt has a fixed rate and long-term maturity. In the medium term, Pakistan is expected to observe lower interest rates compared to the last two years. This is an opportune time to substitute some portion of floating-rate debt with fixed-rate long-term maturity debt. Although this depends on the appetite of lending institutions for such instruments, the government shall gradually increase the weight of fixed-rate long-term maturity instruments in the overall debt portfolio.

4. Monetary-Fiscal Coordination:

Close coordination between fiscal and monetary authorities is essential for achieving macroeconomic stability. Aligning fiscal policies with monetary policies can enhance their overall effectiveness, ensuring that fiscal measures support currency stability and economic growth. The Federal Government allocates the highest expenditure for debt servicing. Any change in interest rates by the State Bank of Pakistan has significant fiscal implications. Therefore, monetary and fiscal coordination can improve budget forecasting, especially for domestic debt servicing. For a

period, the SBP can adopt an instrument rule for setting interest rates, which is more transparent and easily understandable in a country like Pakistan.

5. Hedge Currency Risk:

Utilizing financial instruments to hedge against exchange rate volatility is crucial for managing foreign currency-denominated debt. This can include forward contracts, options, and swaps to protect against adverse currency movements.

6. Foreign Exchange Reserves:

Maintaining adequate foreign exchange reserves is essential for buffering against external shocks and stabilizing the currency. Reserves provide a safety net that can be used to manage exchange rate volatility and support the balance of payments. Ensuring a minimum level of reserves shall be achieved by mandating the SBP to maintain a critical level of foreign exchange reserves.

7. Currency Composition:

A significant portion of Pakistan's debt is denominated in foreign currency, which carries exchange rate risk. Increasing the proportion of debt issued in local currency can reduce exposure to exchange rate fluctuations. This strategy involves shifting the debt portfolio towards local currency borrowing, thereby mitigating the risks associated with foreign currency debt. Although this may be costly, raising more domestic debt with fixed-rate long-term maturity instruments can reduce exchange rate risk exposure.

8. Export Promotion:

Pakistan has faced a substantial trade deficit for many decades. Implementing policies to increase exports is vital for enhancing external sector stability. This shall be achieved by providing incentives for export-oriented industries, improving trade logistics, and negotiating favorable trade agreements. A strong export sector can generate foreign exchange and reduce the trade deficit. Pakistan can increase IT exports, which requires government incentives and special focus, such as short training courses. Increased exports are the only long-term solution for exchange rate stability. Moreover, debt composition can be changed, as suggested in the last paragraph, only if current account balance is maintained.

Managing Fiscal Risk from SOEs

Managing SOEs fiscal risks is essential to ensure their financial stability and responsible management. The following are specific strategies to support this goal:

1. Public Service Obligation (PSO) Framework:

The fiscal risk assessment of State-Owned Enterprises confirms that a significant portion of the fiscal challenge is associated with unfunded Public Service Obligations (PSOs). PSOs are specific services or activities that typical governments consider essential for the welfare of their citizens, such as the availability of basic utilities like electricity and gas.

The State-Owned Enterprises (Governance and Operations) Act, 2023 restricts the Federal Government from directing a commercial SOEs to perform a public service obligation that diverges from its primary objective, unless it is documented in a manner consistent with the PSO

framework in the SOE Act. The framework requires that PSOs be identified, quantified, and funded. The PSO cost is the difference between the cost of service delivery (including a profit margin) less any user pays charges that are received by the SOE.

Tendering PSOs: The Government plans to consider competitively tendering Public Service Obligations. Tendering PSOs is a mechanism used to efficiently allocate and manage the provision of essential public services while promoting competition and transparency. Some advantages include:

- Efficient allocation of essential services to providers who can offer them at a lower cost.
- Creation of competition among service providers, driving innovation, higher quality services, and cost-effective delivery.
- Transparency in the selection process, reducing the potential for corruption or favoritism.
- Accountability for meeting specified performance standards and objectives, enhancing service quality.
- Enforcement of service quality standards in contracts with private sector providers.

Key Considerations for Tendering PSOs:

- Clear and well-defined objectives for the PSO to guide the process and evaluation criteria.
- Transparency in the process with clearly stated rules, procedures, and evaluation criteria.
- Performance metrics and standards to ensure the quality and effectiveness of the PSO.
- Subsidy structure outlining the financial support provided to the winning bidder.
- Regulatory oversight to monitor and enforce compliance with PSO agreements.
- Flexibility in PSO contracts to allow for adjustments over time.

Funding Options for PSOs:

- **Service Fund:** Establish a fund aimed at providing essential utilities to underserved communities, funded by contributions from power generation and distribution companies.
- **Government Budget:** Allocate funds to cover subsidies.
- **Carbon Credits:** Explore carbon credits in renewable energy systems, with earnings credited to the Service Fund or used for subsidies.
- **Lower Rate of Return:** Fund part of the PSO through the government agreeing to a lower rate of return or dividend.

2. Dividend Policies:

The Companies Act, 2017 requires companies to pay dividends only out of profits, ensuring that dividend payments do not materially prejudice the company's ability to pay its creditors. Clear dividend policies can balance the need to generate returns for the Government with SOEs' capital requirements.

3. Robust Governance Framework:

Enhancing the governance framework of SOEs through the appointment of independent and highly qualified board members is pivotal. The SOE Act requires that the majority of the Board comprise independent members with the necessary skills, competence, knowledge, and experience to promote diversity and expertise, reduce conflicts of interest, and enhance decision-making quality.

4. Transparency and Accountability:

Fostering a culture of transparency through regular disclosure of financial information and SOE performance is crucial. The SOE Act mandates the establishment of a Central Monitoring Unit (CMU) within the Finance Division to maintain an electronic database of SOEs' financial and operational performance and independent directors. The CMU has already taken a step forward in enhancing transparency by providing clearer information related to SOEs.

5. Risk Management:

Enterprise risk management shall be a core focus, with an emphasis on fostering a culture of risk awareness. SOEs shall develop comprehensive risk assessment frameworks, implement risk management strategies, and present risk registers to the respective Boards quarterly. Contingency plans for financial and operational crises should be formulated, outlining actions, timeframes, and responsible persons.

6. Performance-Based Incentives:

Introduce performance-based incentives for SOE management and boards. Executive compensation can be linked to key performance indicators (KPIs) that align with corporate objectives, vision, and mission.

7. Legal and Regulatory Framework:

A clear and robust legal and regulatory framework governing SOEs is essential. The SOE Act emphasizes quantifiable performance, responsible governance, board composition, transparency, and accountability. The legislation should be regularly reviewed and updated to adapt to changing circumstances and best practices.

8. Capacity Building:

Invest in the capacity building of SOE directors, management, and staff to enhance financial management skills, risk assessment capabilities, and corporate governance practices.

9. Devolving Responsibility to Provinces:

Review the possibility of devolving responsibility for electricity distribution to provinces, especially for Distribution Companies (DISCOs) experiencing significant technical and commercial losses.

10. Third-Party Access:

Consider designating existing gas and power distribution companies as infrastructure companies to allow any company to utilize the network for transporting gas or electricity and engage in retail operations.

11. Tariff Framework:

Implement a tariff framework that allows entities to autonomously determine their prices and promptly pass them on to consumers. Safeguards should include post-period audits, development of service delivery benchmarks, and utilization of digital technology for routine calculations.

12. Promote Competition:

Promote competition in the power sector before considering privatization. Improve SOE corporate governance and strengthen regulatory oversight to address the reasons for poor performance.

13. Debt Management:

Formulate a debt management strategy for previous liabilities on SOE balance sheets. Set limits on debt-to-equity ratios and establish a stringent approval framework for significant debt issuance. Effective debt management should align with the national debt management strategy and involve a thorough evaluation of investment risks and benefits.

14. SOE Transformation:

The objective of SOE transformation is to enhance their efficiency, competitiveness, and overall performance. This involves increasing transparency, enhancing corporate governance, and implementing transparent financial reporting, clear procurement processes, and robust anti-corruption measures. The transformation process includes assessment and analysis, policy formulation, corporate governance reform, transparency and accountability, stakeholder engagement, financial restructuring, operational improvement, contracting out, privatization, and monitoring and evaluation.

Managing Fiscal Risk from Climate Change

In response to the increasing impacts of climate change, it is crucial for Pakistan to adopt a proactive and structured approach to managing climate-related fiscal risks. The following strategies outline a comprehensive framework for mitigating these risks and ensuring a resilient and sustainable economic future.

1. Implement Green Taxes:

The government shall introduce environmental taxes or levies on carbon emissions, plastic use, and other pollutants to discourage harmful activities and fund climate initiatives. The objective shall be to generate revenue while incentivizing environmentally friendly practices.

2. Improve Fiscal Planning and Risk Assessment:

Conduct climate risk assessments and incorporate their findings into fiscal planning and budgeting processes to better anticipate and manage climate-related fiscal risks. The objective shall be to integrate climate considerations into fiscal policies and budgeting.

3. Promote Green and Sustainable Investments:

Invest in renewable energy, energy efficiency, and sustainable water management to reduce vulnerability to climate change. Moreover, it is necessary to fund projects that restore natural

ecosystems, such as mangroves and wetlands, which act as natural barriers against disasters. The government shall **s**upport farmers in adopting climate-resilient practices and technologies.

4. Leverage International Support:

Climate resilience shall be strengthened by accessing international climate finance mechanisms, such as the Green Climate Fund (GCF) or the Global Environment Facility (GEF), to support adaptation and mitigation projects. Additionally, the government shall seek technical assistance from international organizations to build capacity in disaster risk management and climate adaptation. Given Pakistan's substantial debt portfolio, the government can also explore debt-for-climate swaps as a way to reduce debt burdens while financing climate resilience initiatives.

5. Encourage Private Investment in Green Technologies:

The government alone cannot shoulder all the necessary investments to reduce greenhouse gas emissions. It is crucial to mobilize private sector resources for climate action. The government offers tax incentives or subsidies to encourage private investment in green technologies and climate-resilient projects. These types of projects are well-justified in receiving tax exemptions to foster greater private sector participation and investment.

6. Enhance Climate Literacy and Community Engagement:

The government can effectively combat climate change only through raising public awareness on the issue. Therefore, the government plans to launch awareness campaigns and engage communities in climate action. The government shall fund public awareness initiatives to educate citizens about climate risks and disaster preparedness. Furthermore, the federal government, in collaboration with provincial governments, plans to integrate climate change and disaster risk reduction into school curricula. Additionally, the government shall actively involve local communities in disaster risk reduction planning and implementation, working together with NGOs operating in this sector.

7. Reform Subsidies Framework:

Historically, the government has provided subsidies or, at times, offered relaxations in levies on petroleum products. The government shall redesign its subsidy framework by redirecting financial support towards more sustainable practices. Specifically, subsidies will be shifted from fossil fuels to renewable energy initiatives and climate resilience projects, promoting long-term environmental sustainability.

8. Promote Renewable Energy and Energy Efficiency:

The primary contributor to climate change is the use of fossil fuels, which increases carbon emissions. The government shall take steps to reduce reliance on fossil fuels and lower greenhouse gas emissions. To achieve this, the government shall invest in, or incentivize the private sector to invest in, renewable energy sources such as solar, wind, and hydroelectric power. Additionally, there shall be a focus on implementing energy efficiency programs that reduce energy consumption and minimize emissions, fostering a more sustainable energy future.

9. Enhance Budget Execution and Troubleshoot Bottlenecks:

The government shall enhance the implementation and monitoring of climate and SDG-related projects. The Climate Finance Unit at the Ministry of Finance (MOF) and the Sustainable Finance Bureau (SFB) at the Ministry of Planning, Development, and Special Initiatives (MOPDSI) can play a crucial role in aligning investment needs with climate-resilient projects. Additionally, the government shall improve data management, conduct regular performance audits, and strengthen the institutional framework to ensure effective project implementation.

Managing Fiscal Risk from Natural Disasters

In the face of escalating climate impacts, the government intends transition from ad-hoc budgeting responses to a more robust, proactive approach towards climate-related fiscal risks. The following strategies provide a framework for managing and mitigating these risks, ensuring a more resilient, sustainable, and inclusive economic future.

1. Establishment of a Dedicated Natural Disaster Fund:

The government plans to establish and maintain a dedicated natural disaster fund to ensure a timely and efficient response during times of disaster, without putting undue strain on the fiscal balance. This fund would provide a financial safety net, enabling the government to address the immediate needs of disaster relief, recovery, and reconstruction without relying on emergency borrowing or reallocating funds from other critical sectors. By setting aside resources specifically for natural disasters, the government will better manage the fiscal impact of such events, ensuring that public finances remain stable while safeguarding the resilience of affected communities.

The Federal Government allocates contingency funds under the "Provision for Emergency and Others" category, management of which can be improved. The government shall improve this by ensuring that any unspent allocated amounts are preserved for future disasters, if not utilized in the current year. This necessitates proper fund management and investment in highly liquid assets to ensure availability of funds when needed.

2. Invest in Climate-Resilient Infrastructure:

A major fiscal risk from climate change arises from the damage to infrastructure caused by climate-related natural disasters. While in the past governments have developed a strategy to fund the reconstruction of damaged infrastructure, this approach is not fiscally sustainable in the long term. Therefore, the government shall focus on building public infrastructure and regulating private construction to ensure resilience against climate impacts. Mega infrastructure projects are planned to be funded through public private partnerships. Priority shall be given to investments in infrastructure that can withstand extreme weather events, such as flood defenses, resilient roads, and climate-proof buildings. Additionally, the government shall implement and enforce green building standards to ensure that new constructions are energy-efficient and resilient to climate-related challenges.

3. Develop a Risk Transfer and Risk Retention Strategy:

The government shall expand its financial strategies to manage disaster expenditures more effectively, by implementing a range of risk-layering instruments, including direct budgetary

allocations, contingent disaster facilities, solidarity funds, and comprehensive insurance mechanisms. Additionally, the government plans to offer incentives to encourage the uptake of disaster insurance among households, businesses, and the agricultural sector. Establishing a risk retention mechanism, such as a solidarity fund, would support livelihood recovery and infrastructure reconstruction. Furthermore, the government plans to tap into funding sources like unspent contingent budgets, contributions from donor agencies, and private sector support through Corporate Social Responsibility (CSR) initiatives.

Managing Fiscal Risk from PPP Projects

1. Enhance Capacity of RMU:

The government shall enhance the capacity of Pakistan's existing Risk Management Unit for PPP projects by investing in specialized training, technology, and data analytics tools. The RMU shall be equipped with the latest risk assessment models and software to better identify, quantify, and manage risks in real time.

Strengthening the RMU's capacity to conduct thorough risk analyses, particularly in sectors with complex challenges like infrastructure and climate resilience, will help the government make more informed decisions. Additionally, the RMU shall foster greater collaboration with external experts, including sector-specific consultants and financial institutions, to stay updated on global best practices and emerging risks. Regular workshops, scenario planning exercises, and knowledge-sharing sessions with private sector partners will further ensure that the RMU is proactive in managing and mitigating risks, ultimately safeguarding the fiscal health of the government.

2. Thorough Risk Assessment and Allocation:

The government shall conduct a comprehensive risk assessment, before entering any Public-Private Partnership agreement, to identify potential fiscal risks, such as cost overruns, revenue shortfalls, or delays. It is crucial that risks are clearly allocated between the public and private sectors based on each party's capacity to manage them. The government shall avoid assuming excessive risks, such as guaranteeing revenue streams for projects or bearing the cost of unforeseen circumstances. A well-defined contract that specifies risk-sharing mechanisms, such as performance bonds or insurance, can help minimize the government's exposure to financial risks, ensuring that the private sector has a strong incentive to meet deadlines and deliver quality outcomes.

3. Establishing Clear Payment Mechanisms and Monitoring:

For successful PPP projects, the government shall establish transparent and reliable payment mechanisms that are closely linked to project performance. Instead of committing to open-ended financial guarantees, payment schedules shall be performance-based, meaning that the government only pays when agreed-upon milestones are met. Additionally, robust monitoring and evaluation systems shall be in place to track progress and costs in real time. This allows for early detection of potential issues and ensures that public funds are not released prematurely. Regular audits, performance reviews, and independent assessments can provide transparency and help prevent any fiscal risk from escalating into a major liability.

4. Creating Contingency Plans for Implicit Guarantees:

Even with the best planning, unexpected issues can arise in PPP projects, such as economic downturns, natural disasters, or sudden regulatory changes. To mitigate these risks, the government shall create contingency plans that include reserve funds specifically allocated for PPP projects. These funds can be used to cover unforeseen costs or to stabilize projects in case of financial difficulties. It's essential that these reserves are adequately sized and are kept separate from the regular fiscal budget to ensure they can be accessed quickly if needed. Establishing this financial cushion would reduce the government's need to rely on emergency borrowing or drastic budget cuts during a crisis, helping to maintain fiscal stability.

5. Equitable Risk Sharing and Force Majeure Clauses:

To minimize fiscal risks, it is essential that the government ensures equitable risk-sharing in PPP contracts, where both parties—the public and private sectors—assume the risks they are best equipped to manage. The private sector should bear the risks associated with construction delays and operational inefficiencies, while the government shall handle risks tied to regulatory changes or public policy shifts. Additionally, the inclusion of force majeure clauses in contracts is crucial to protect both parties from unforeseeable events, such as natural disasters, political instability, or economic crises. These clauses shall clearly outline the process for managing such events, including how liabilities will be addressed and whether financial compensation or project timelines will be adjusted.

Managing Fiscal Risk from Government Guarantees for Commodity Financing Operations

1. Gradually Reducing the Size of Guarantees:

The government shall implement a gradual reduction strategy for the size of guarantees it provides to provincial governments and PSEs like PASCO and TCP. This can be achieved by encouraging PSEs to diversify their funding sources and improve their creditworthiness through operational efficiencies and revenue generation. Over time, the government can set a ceiling on the total amount of debt guarantees, ensuring that only essential and high-priority guarantees, particularly those related to strategic sectors, are provided. Additionally, a clear timeline and phased reduction targets can be established, gradually shifting responsibility for debt servicing to the respective PSEs, reducing the fiscal burden on the government.

2. Implementing Governance Reforms in PSEs:

Strengthening governance structures within PSEs is critical for reducing fiscal risks associated with government guarantees. The government shall mandate comprehensive governance reforms that focus on improving financial management, transparency, and accountability in PSEs. This includes appointing independent boards with expertise in finance and risk management, implementing robust internal audit systems, and enhancing the management of state assets. Additionally, establishing clear performance metrics and monitoring systems can ensure that these enterprises operate efficiently and meet their financial obligations, reducing the likelihood of default that would trigger government guarantees.

3. Linking Guarantees to Strategic Food Security Concerns:

The government shall prioritize linking guarantees solely to strategic and critical sectors, such as food security, where guarantees are essential for ensuring national stability. Specifically, guarantees for PSEs involved in food procurement and distribution, like PASCO, shall be tied directly to maintaining adequate food stocks and preventing shortages. By narrowing the scope of guarantees to only these critical areas, the government can reduce its exposure to non-essential financial risks while ensuring that fiscal resources are allocated to areas that directly contribute to national security. Furthermore, risk management frameworks shall be implemented for guarantees, including regular assessments of the financial health and operational risks of the entities receiving guarantees, to ensure that these guarantees remain sustainable and are only provided when absolutely necessary.

4. Improving Efficiency of Storage and Inventory Management:

PSEs involved in commodity operations, such as PASCO, shall focus on enhancing the efficiency of their storage and inventory management systems to prevent losses and ensure that food commodities are properly stored. The government shall encourage PSEs to invest in modern storage facilities that are well-equipped with climate control and pest management systems to preserve the quality and quantity of stored commodities. Additionally, adopting advanced inventory management software can help optimize stock levels, reduce wastage, and prevent overstocking, which could lead to financial losses. Regular audits and inspections shall also be conducted to identify inefficiencies and potential risks early, enabling corrective measures to be taken promptly. By improving storage practices, PSEs can reduce operating costs, increase the shelf life of stored commodities, and minimize the need for emergency government support due to avoidable losses.

Managing Fiscal Risk from Circular Debt in the Gas and Power Sectors

1. Capping the Existing Stock of Circular Debt and Integrating it with Government Debt:
A practical strategy to reduce fiscal risk is for the government to cap the existing stock of circular debt in the power and gas sectors. This would set a clear limit on the accumulation of debt, preventing further financial strain. To effectively manage this capped debt, the government could consider integrating the circular debt into the overall national debt, thus providing more control over its repayment terms and reducing the fiscal pressure on these sectors. This would allow the government to set more favorable repayment schedules for the circular debt, thus enabling a long-term, sustainable approach to gradually reduce its burden without immediate fiscal shocks.

2. Allowing SOEs to Adjust Tariffs to Reflect Cost Increases:

To prevent further accumulation of circular debt, the government shall empower State-Owned Enterprises in the power and gas sectors to make tariff adjustments that reflect rising costs, such as inflation, fuel price changes, and operational expenses. By allowing these entities to revise tariffs in line with their cost structures, SOEs would be able to generate sufficient revenue to cover operational expenses and reduce losses due to tariff differentials. This approach would help SOEs operate on a financially sustainable basis and prevent the need for ongoing government subsidies or debt accumulation.

3. Minimizing Subsidies in the Power and Gas Sectors:

To address the root cause of circular debt accumulation, the government shall focus on reducing subsidies in the power and gas sectors. While subsidies are often used to shield consumers from high costs, they can inadvertently exacerbate circular debt by allowing SOEs to operate at a loss. A more sustainable approach would be to target subsidies towards vulnerable segments of the population and gradually phase out blanket subsidies, ensuring that SOEs can cover their operational costs without relying on government bailouts. This would help to prevent the further buildup of circular debt and allow for more market-driven pricing in these sectors.

4. Implementing Governance Reforms in SOEs to Reduce Losses:

A critical step in addressing circular debt is to implement robust governance reforms in the SOEs within the power and gas sectors. The government shall focus on reducing inefficiencies, such as line losses, theft, and poor financial management, which contribute significantly to the accumulation of circular debt. This can be achieved by enhancing transparency, improving internal controls, and introducing performance-based management systems. Additionally, SOEs shall adopt modern technologies for energy distribution, monitoring, and reporting, to reduce technical and commercial losses. Strengthening the governance framework would ensure that SOEs operate more efficiently, reducing operational deficits and the need for government support to manage circular debt.

Managing Fiscal Risk from Tax Exemptions

1. Design a Robust Mechanism for Granting Tax Exemptions:

To reduce fiscal risk arising from growing tax expenditures, the government shall design a clear and transparent mechanism for granting tax exemptions. This mechanism shall include a thorough cost-benefit analysis for each proposed exemption, ensuring that only those which provide clear and tangible benefits to the economy or society are granted. The process shall be systematic, with well-defined criteria and a clear assessment of the long-term fiscal impact.

2. Require Parliamentary Approval for Tax Exemptions:

To prevent an ad hoc approach to granting tax exemptions, the government shall require parliamentary approval for all new or extended exemptions. This would ensure that tax exemptions are subject to scrutiny and debate, allowing for greater transparency and accountability in their approval. By involving parliament in the decision-making process, the government can align tax policy with broader fiscal and economic goals and reduce the risk of politically motivated or unsustainable exemptions that could strain public finances.

3. Align Tax Exemptions with Government Expenditure Reductions:

To ensure tax exemptions are justifiable and fiscally sustainable, the government shall align them with corresponding reductions in government expenditure for the activities that the exemptions aim to support. For example, if tax exemptions are granted to encourage investments in certain sectors, the government could reduce related subsidies or spending in those sectors. This alignment would ensure that tax exemptions do not result in an overall increase in the fiscal deficit, making them more targeted and reducing the fiscal risks associated with rising tax expenditures.

4. Implement a Comprehensive Tax Expenditure Framework:

To improve transparency and manage fiscal risks effectively, the government shall implement a comprehensive tax expenditure framework. This framework would involve systematically tracking and reporting all tax exemptions, deductions, and credits, including their fiscal costs and economic impacts. It would also require regular evaluations of tax exemptions to assess their effectiveness in achieving policy objectives. By establishing a comprehensive framework, the government can monitor the cumulative impact of tax expenditures on the budget and ensure that they do not exceed fiscally sustainable limits.