SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT[1]

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. **Sector overview**. Public sector enterprises (PSEs) contribute about 10% of the gross domestic product (GDP) of Pakistan in value-added terms. Despite the federal government's divestment of 168 PSEs during two waves of privatization in the 1990s and 2000s, it still has equity in more than 200 PSEs in various sectors. PSEs provide both private and public goods. PSEs are monopoly suppliers in some sectors, and can be sources of unfair competition to private companies in others. The financial performance of PSEs is heterogeneous, but poor on aggregate. PSE government shareholdings do not yield substantial financial returns. Losses are particularly a problem in the highly indebted energy sector PSEs and a few large PSEs in other sectors (e.g., aviation and steel milling).

2. **Sector performance**. The government has partial equity participation in a small number of profitable PSEs—mostly banks and insurance companies. These are listed on the Karachi Stock Exchange. The government also has majority shareholdings in some PSEs that are not listed. A third group of PSEs is fully owned by the government. Most of the large loss-making PSEs are fully owned by the government, including most PSEs in the electricity sector and Pakistan Steel Mills. Some are partly owned by private sector shareholders, like Pakistan International Airways. The underlying reasons for the aggregate poor performance are weak management and governance, political influence in PSE management, low labor productivity and quickly deteriorating capital equipment, soft budget constraints, tariffs below cost recovery levels, and inappropriate sector regulation.[2] Investments over the last decades have been insufficient to ensure competitiveness and good quality service provision.[3] Apart from the substantial fiscal drain, distortions in product and factor markets dominated by PSEs hamper economic growth.

3. **Magnitude of fiscal drain**. PSEs are imposing high net costs on the government. Fiscal transfers to PSEs are estimated at several hundred billion Pakistan rupees, of which most are subsidies (PRs512 billion in FY2012, of which PRs464 billion for the power sector). In FY2013, the government released transfers of PRs344.1 billion for PSEs in the energy sector, PRs1.6 billion as equity injection for Pakistan International Airways, and PRs13.5 billion for PSEs in other sectors such as steel, stone, paper, and packaging.[4] PSEs have accumulated a debt stock of PRs573 billion as of December 2013. These figures do not fully reflect sovereign guarantees, asset depreciation, and other non-cash support such as waiver of interest and fees.

4. **Public sector enterprise corporate governance**. Listed PSEs are expected to comply with the Karachi Stock Exchange corporate governance requirements issued by the Securities

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1 This summary is focused on management of public sector enterprises and is based on J. Speakman. 2012. SOE Reform: Time for Serious Corporate Governance. *World Bank Policy Paper Series on Pakistan.* PK04/12. Washington, DC: World Bank; S. Aftab and S. Shaikh. 2013. Reforming State-owned Enterprises. *Pakistan Policy Note*. No. 4. Washington, DC: World Bank.

2 For example, the estimated loss of Pakistan Steel Mills in FY2011 was PRs22 billion, but other private companies in this sector reported profits.

3 Government equity injections in PSEs totaled PRs10.3 billion in FY2012 and PRs23.2 billion in FY2013. Government of Pakistan, Finance Division. 2014. *Federal Medium Term Budget Estimates for Service Delivery 2014−17.* Islamabad.

4 Government of Pakistan, Finance Division. 2013. *Year Book 2012−2013*. Islamabad.

and Exchange Commission of Pakistan (SECP) in 2012.[5] In March 2013, the SECP issued the Public Sector Companies (Corporate Governance) Rules, which are binding for all listed and unlisted PSEs.[6] These rules follow international good practice and demand independent directors, separation of the chairperson and chief executive, performance evaluation of board members, and rules for internal and external audit. The majority of PSEs that are not listed do not yet comply with these rules; reforms are necessary to improve PSE governance.

5. **Government as shareholder**. The Finance Division of the Ministry of Finance (MOF) is the ultimate shareholder in PSEs.[7] Within the Finance Division, the Corporate Finance Wing (CFW) is responsible for all financial and corporate matters related to PSEs, but its role has been limited to representation on the boards of PSEs, and administering subsidies and guarantees for PSEs. Line ministries, which are also represented on the boards of most PSEs, have been very influential in PSE operations through (i) sector policies, (ii) appointment of the board (through the prime minister) and the chief executive officer (before the SECP rules were issued), and (iii) other indirect channels (managerial capture). Requests for subsidies for PSEs involve the board of directors and the respective line ministry, but CFW processes the request for the finance minister's approval. This gives the CFW an opportunity to exercise stringent controls. However, the CFW has limited information and technical capacity to analyze and scrutinize the justification of requests, and thus to implement its legal mandate. In FY2014, the CFW started an overall assessment of the financial performance of PSEs. The first report is expected to be published by December 2014.

6. **Redistributive effects**. Pakistan PSEs provide infrastructure services and other public and private goods that are used by all segments of the population. However, service delivery is poor in general, and economically disadvantaged groups are not able to substitute inefficient services provided by PSEs with private sector alternatives. The power sector is one example of how the inefficiency of PSEs has redistributive effects—the urban poor and small and medium-sized enterprises are affected by frequent load shedding, while wealthier groups and larger companies have the means to install alternatives sources of power.

2. Government's Sector Strategy

7. Successive governments in Pakistan have expressed concerns over the poor performance of PSEs and have vowed to revamp these entities, especially at times of increased awareness of their fiscal cost. However, efforts to improve the performance of key infrastructure PSEs have not been successful.[8] The government has not had sufficient capabilities —institutional, technical, and legal—to instill sustained improvements in PSE management. A rising number of stakeholders now favor government divestiture of most PSEs through a comprehensive reform program, because of the increasing levels of public debt and fiscal constraints. Encouraging commitments have been made since September 2013 under a new International Monetary Fund $6.7 billion extended facility.[9] In October 2013, the government

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[5] SECP. 2012. *Code of Corporate Governance 2012*. http://www.secp.gov.pk/CG/CodeOfCorporateGovernance_2012.pdf

[6] SECP. 2013. *Public Sector Companies (Corporate Governance) Rules, 2013*. http://www.secp.gov.pk/CG/SRO_180_PublicSectorCompanies_CGRules_2013.pdf

[7] Some PSEs are departmental or divisional undertakings that fall directly under the line ministry or even constitute a department, as in the case of Pakistan Railways. These undertakings are very similar to PSEs, but since they are not distinguishable entities, they are not considered PSEs. They are part of the national budget and cannot accumulate debt independently. This can be very costly to the budget.

[8] ADB. 1998. Impact Analysis of the Privatization in Pakistan. Consultant's report. Unpublished (TA 2905-PAK).

[9] International Monetary Fund. 2014. *IMF Country Report No. 14/90*. Washington, DC.

identified 68 PSEs for privatization, of which 31 PSEs are expected to be partially privatized.[10] For profitable PSEs, divestiture is expected through capital market transactions. For more problematic PSEs, ownership and management control is likely to be partially transferred to strategic private investors.[11] However, key constraints to successful and sustained PSE reform need to be urgently addressed to make the process successful and sustainable.

8. **Technical requirements of public sector enterprise reforms.** The government has initiated the identification of the policy, technical, and financial challenges and requirements of PSE reforms. The Asian Development Bank (ADB) and other development partners have provided a framework for this process. However, the Finance Division of the MOF and the Privatisation Commission lack the technical capacity to define, initiate, and sustain a PSE reform strategy that could (i) help the different government agencies coordinate responsibilities and objectives; (ii) articulate guiding principles (e.g., transparency and consistency on labor-related issues) and sequencing concerns; (iii) take into account important fiscal space trade-offs (para. 9 below); and (iv) be the basis for an effective communications strategy. In the case of the Privatisation Commission, this is in large part the result of almost a decade without any privatization activity in Pakistan, which resulted in a significant drain in the Commission's technical capacity (e.g., all senior transaction managers and legal counsels left) and an almost complete loss of senior-level institutional memory about the challenges that past privatization drives had faced and how those were overcome.

9. **Financial and policy requirements of public sector enterprise reforms.** The implementation of meaningful PSE reforms in Pakistan cannot be done without substantial adjustment costs—a challenge in the current fiscal circumstances. Adjustment costs include the labor separation costs that privatization outcomes are projected to require (e.g., voluntary separation schemes); and the costs of retiring legacy debt in key PSEs, or, in the case of power distribution companies, the costs of addressing more than PRs480 billion of receivables of doubtful realizable value (as of 30 June 2013).[12] The Privatisation Commission Fund does not have the financial resources to fund pre-transaction work at key PSEs. The rules and practices on the use of these funds also lack clarity, and the current arrangements mix funding for privatization transaction advisers with funding for the commission's general operational expenditures. This prevents the fund from becoming transparent and effective.

3. ADB Sector Experience and Assistance Program

10. ADB conducted an impact analysis of privatization in Pakistan from 1997 to 1998 (footnote 8). It has supported economic transformation programs, and is supporting the strengthening of social protection at the federal level and enhancing various public sector management programs at the provincial level. ADB leads the multi-donor sustainable energy sector reform program, which includes restructuring of some PSEs in the energy sector.[13]

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[10] Government of Pakistan, Privatisation Commission. Broad-Based Privatisation Programme of the Government. http://www.privatisation.gov.pk/Policy%20and%20Objectives/Privatisation%20Programme.htm

[11] Actions on these 31 PSEs are listed as International Monetary Fund program conditions. Eleven of them—in oil and gas, banking, insurance, and power sectors—have been identified for block sales privatization. In 17 PSEs—mainly in the energy sector—increased private sector participation is expected to improve the value of the government's residual shareholding. Three PSEs in oil and gas are marked for restructuring, followed by privatization in segments.

[12] Government of Pakistan, Ministry of Finance. 2014. *Pakistan Economic Survey 2013−14.* Islamabad.

[13] ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan to the Islamic Republic of Pakistan for Subprogram 1 of the Sustainable Energy Sector Reform Program*. Manila.

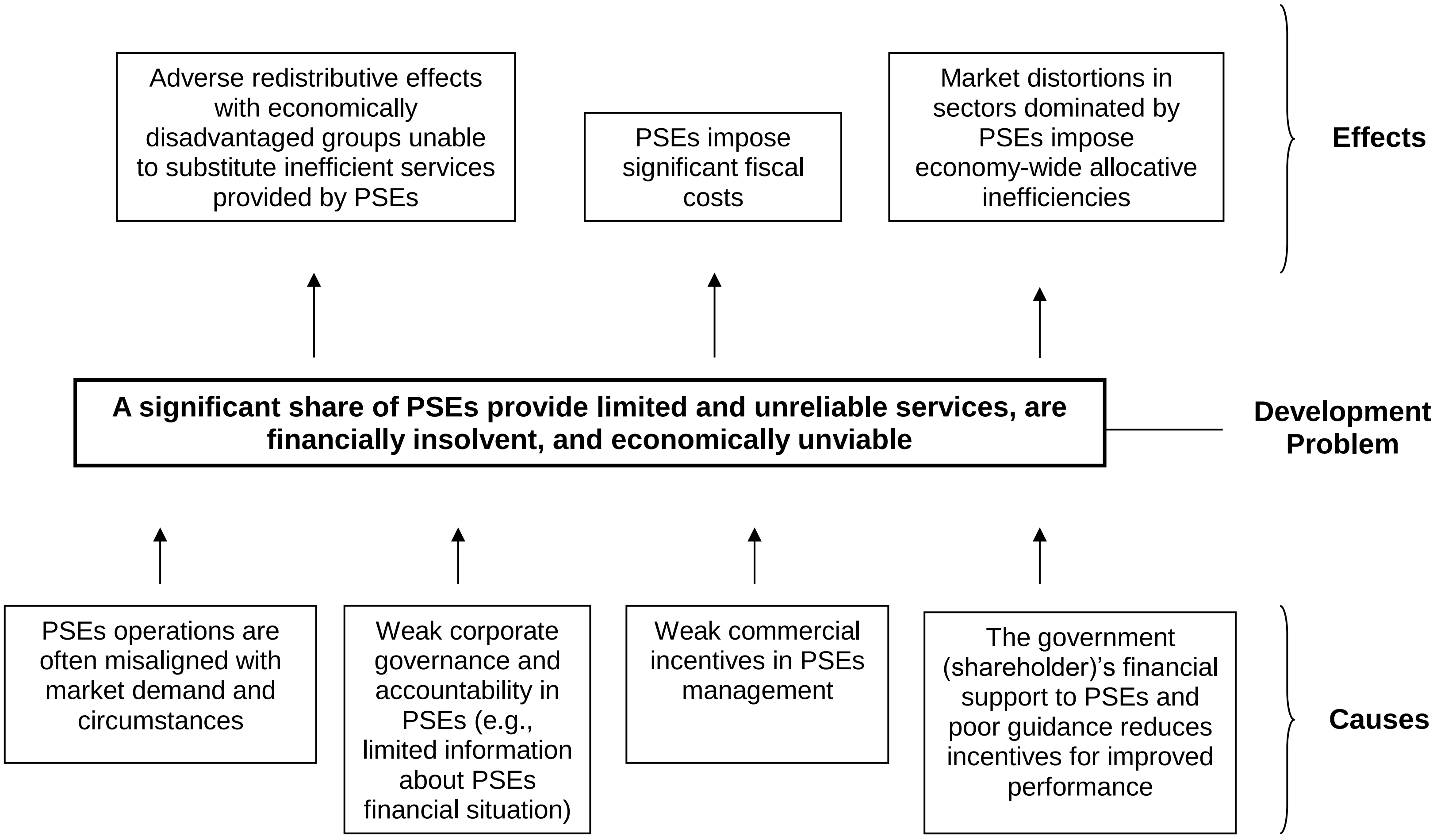
11. Experiences from privatization and restructuring programs are mixed both internationally and in Pakistan. International experience suggests that privatization in natural monopoly industries with network infrastructures or of enterprises that provide universal essential services (e.g., water supply) can be difficult. Industries with potential for competition and well-developed financial markets are seen as preconditions for successful privatization. The government should also have the capacity to regulate the sector to guarantee competitive prices and quality provision of services. Privatization should have transparent processes, regular communications, broad representation on boards managing the process, and a set of rules that makes it impossible to reverse the process.

12. The impact assessment of the previous Pakistan privatization program (footnote 8) concluded that it had been a success overall. Of the 95 PSEs privatized from 1991 to 1996, 32% performed better after privatization, 39% performed at the same level, and 29% performed worse. Past privatization efforts in Pakistan's financial sector have been successful, in contrast to those in the main infrastructure sectors. Privatization proceeds (total of 4.3% of GDP) had significant macroeconomic impacts. Recommendations to the government included (i) to develop a comprehensive public awareness program, and (ii) to gain access to a constant source of advice on utility sector reform and regulatory matters. Experience suggests that without a strategically planned and paced restructuring and privatization program, vested interests and lawsuits can stifle reform efforts. Recent political commitments are yet to be framed in a comprehensive and time-bound strategy for restructuring, governance improvements, and privatization of PSEs, as well as for sector-specific reforms.

13. ADB will provide technical support to the government's PSE reform program through the project. Technical assistance and expert advice will be crucial for the strategic restructuring work that many PSEs require before further divestiture can take place. The technical advice leverages government investments in PSEs and their reform before and during privatization. The pre-transaction technical advice is expected to reduce the necessary adjustment costs during and after privatization. For 2015, a policy-based programmatic assistance of $400 million in support of PSE reforms is in the pipeline of ADB's country operations business plan.[14] This assistance could leverage the technical assistance to be provided under the project, and partly finance the government's adjustment costs.

[14] ADB. 2014. *Country Operations Business Plan: Pakistan, 2014–2016*. Manila. Project preparatory technical assistance for $500,000 is being processed to prepare the policy-based programmatic assistance loan.

Problem Tree for Public Sector Management



PSE = public sector enterprise.

Sector Results Framework (Public Sector Management, 2015–2019)

Country Sector Outcomes		Country Sector Outputs		ADB Sector Operations	
Outcomes with ADB Contribution	**Indicators with Targets and Baselines**	**Outputs with ADB Contribution**	**Indicators with Incremental Targets**	**Planned and Ongoing ADB Interventions**	**Main Outputs Expected from ADB Interventions**
Enabling environment for private sector development that reduces the cost of doing business	Independent investment climate and World Bank *Doing Business* surveys show substantial improvement in Pakistan's business environment by June 2018 Improvement in Pakistan's standing on the Global Competitiveness Index as measured by a higher rank by 2018, from the rank of 133 in 148 countries for 2012–2013	Successful privatization and restructuring of selected PSEs	Government divested from at least 4 fiscally costly PSEs[a] by 2019 Effective restructuring of at least 3 fiscally costly PSEs[a] by 2019	**Planned target subsectors** Reforms of state-owned enterprises **Pipeline projects with estimated amounts** Public Sector Enterprise Reforms Project ($20 million) Public Sector Enterprises Reforms Program ($400 million) Enhancing Public-Private Partnerships in Pakistan (Provincial Support) ($100 million) **Ongoing projects with approved amounts** Sustainable Energy Sector Reform Program ($1.2 billion)	**Planned target subsectors** Reforms of state-owned enterprises **Pipeline projects** Strengthened privatization program Corporate governance, structure, and management capacity improved in selected PSEs Governance and regulatory regimes enhanced in selected sectors dominated by PSEs **Ongoing projects** Improvement in collection rate of DISCOs from 86% in 2012 to 94% of total billing by 2017 Aging of government receivables reduced from 410 days (provincial) and 180 days (federal) to 90 days by June 2015
Increased private sector investment in industry and other key sectors of the economy to support higher GDP and employment	Private investment as a share of total investments in the power sector increased from 19% in 2012 to 23% by June 2018				

ADB = Asian Development Bank, DISCO = distribution companies, GDP = gross domestic product, PSE = public sector enterprise.
[a] For the purpose of the project, fiscally costly PSEs are those that impose direct and indirect fiscal costs to the federal budget of at least 0.05% of GDP per annum.
Source: Asian Development Bank.