PRIME ECONOMIC THINK TANK

AN ASSESSMENT OF THE FY2026–27 FEDERAL BUDGET THROUGH THE LENS OF ECONOMIC FREEDOM

PRIME PLUS

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About PRIME

Policy Research Institute of Market Economy (PRIME) is a public policy research and advocacy organization striving for an open, free, and prosperous Pakistan. PRIME was established in Islamabad in 2013 and has played a leading role in advancing ideas and policies for a free-market, open-trade, and competitive economy in Pakistan through its research and advocacy.

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Executive Summary

- The report examines the Federal Budget 2026-2027 through a lens of economic freedom, assessing if the budget promotes or restricts the ability of individuals and businesses to produce, trade and consume without arbitrary state intervention. Operating under an IMF-supported stabilisation framework further limits the use of distortionary subsidies, forcing greater reliance on market-based adjustment mechanisms. Policy response must therefore shift from reactive stabilisation to a resilience-driven framework.
- Economic freedom is defined as the fundamental ability of every individual to have control over its property and labour. In an economically free society, individuals have the right to work, produce, consume and invest in their own way.
- The index of Economic Freedom gives Pakistan a score of 48.9, "Repressed". Several scores conceal rather than reveal: Government Spending (88.5) and Tax Burden (78.2) suggest a lean, low-tax state; Pakistan is neither.
- The National Tariff Policy 2025-2030, which is positive for economic freedom, reduces customs duties over 3,125 tariff lines. In FY 26, customs revenue increased from Rs 1,588 billion to Rs 1,651 billion despite rate reduction.
- Salaried income tax relief delivers meaningful savings. Super tax has been reduced, with full withdrawal for firms deriving 80% or more of their revenue from exports. The income surcharge has been eliminated.
- The fiscal deficit narrows to 3.6% of GDP with a primary surplus of 2.0%, though it is largely on account of interest rate reduction.
- Interest payments and defence take 94% of the net federal revenue, leaving 6% for pensions, running of civil government and development combined.
- Rs 2,352.81 billion tax expenditure demonstrate preferential treatment to selected sectors funded by higher rates on the documented economy.
- Financial Freedom (60.0) is a score that most sharply contradicts the ground reality. Credit to the government sector stood at Rs 37.2 trillion in May 2026 against a RS 13.8 trillion to the private sector (SBP) A Score for a financial system where the government absorbs nearly three times more credit than the entire private sector does not reflect the reality of financial access in Pakistan.
- The report recommends lowering the tax rate by broadening the effective tax base; reducing GST to 15%, corporate tax to 25% and eliminate supertax. Reduce the government borrowing footprint through differentiated bank capital adequacy treatment; legislating the NTP’s 15% customs ceiling; and increasing transparency by replacing Petroleum Development Levy with a uniform GST rate, as frequent changes in PDL’s rate create uncertainty and reduces transparency for consumers

1 Introduction: The Budget's Promise Vs Impact

On June 12, 2026, the finance minister announced a Rs 18.77 trillion budget for FY2027. On paper, the budget was presented in the language of reforms. The income surcharge is abolished, the super tax rate is reduced with full withdrawal for firms deriving 80% or more of their revenue from exports, and the income tax rate is reduced for upper slabs. The real estate taxation is simplified by the abrogation of 7E and the reduction in stamp duty. Under the National Tariff Policy, thousands of tariff lines have been rationalised. A primary surplus of 2% and a fiscal deficit narrowed to 3.6% of GDP. By the government's own framing, this was consolidation with growth.

The top marginal personal income tax rate stays at 35%. Pakistan taxes its top earners higher than Bangladesh 30%, Malaysia 30%, and Singapore 24%.[1] For the Association of Persons (AOP), it reaches 40%, the highest in the region. However, the true inequality is not reflected in headline numbers. It all comes down to who actually pays. The Labour Force Survey 2025 states that 80.8% of the labour force is employed in the informal sector.[2] A salaried individual earning Rs 5 million faces an effective tax rate of 33.29%, with tax deducted at source leaving limited scope for tax evasion. A shopkeeper with the same income pays 0.5% in presumptive and fixed tax schemes. The budget offers limited relief to the salaried class. It does nothing to bridge this gap.

The government's greater reliance on borrowing from the banking sector is crowding out private investment. Banks are expected to finance 82.2% of the projected budget deficit by investing in government securities. Resultantly, banks lend almost Rs 2.7 to the government for every Rs 1 extended to the private sector. When faced with risk-free sovereign lending offering attractive returns, banks have little attractive returns, banks have little motivation to finance exporters or entrepreneurs. Consequently, private sector credit, once adjusted for inflation, is contracting in real terms, constraining investment, productivity and long-term economic growth.

The central question guiding this report is whether the federal budget 2026-2027 increases or decreases economic freedom in Pakistan's economy. Is it easy for a firm to access affordable credit? Does the tax system treat taxpayers fairly? Is it possible for an investor to predict what rules will be applied next year? Does the state spending facilitate private economic activity? The report uses the budget's numbers, supplemented by the Heritage Index of Economic Freedom framework.

2 What Makes an Economy Actually Free?

To access the budget from the lens of economic freedom, the concept must be clearly defined. According to the Heritage Foundation, economic freedom is the extent to which individuals and businesses can make voluntary economic decisions in an environment where labour, capital goods and services can move freely, and where government intervention is limited to providing the institutions necessary to protect property rights, enforce contracts, and uphold the rule of law.[3] Where to invest. What to produce. Whom to trade with and at what price. These decisions, when taken freely and protected by institutions, generate prosperity. When the state distorts them, whether through price restrictions, selective taxation, entry obstacles or captured financial systems, the consequences include decreased investment, lower productivity, and worse welfare. Sometimes visibly. Often in ways that are hard to trace but no less real. Three conditions make economic freedom possible.

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[1] "Worldwide Tax Summaries". Available at: https://taxsummaries.pwc.com/

[2] "Pakistan Labour Force Survey 2024 -25", Pakistan Statistical Bureau. Available at: https://www.pbs.gov.pk/wp-content/uploads/2020/07/LFS-2024-25-Annual-Report.pdf

[3] The Index of Economic Freedom", Heritage Organisation. Available at: https://economicfreedom.heritage.org/pages/about

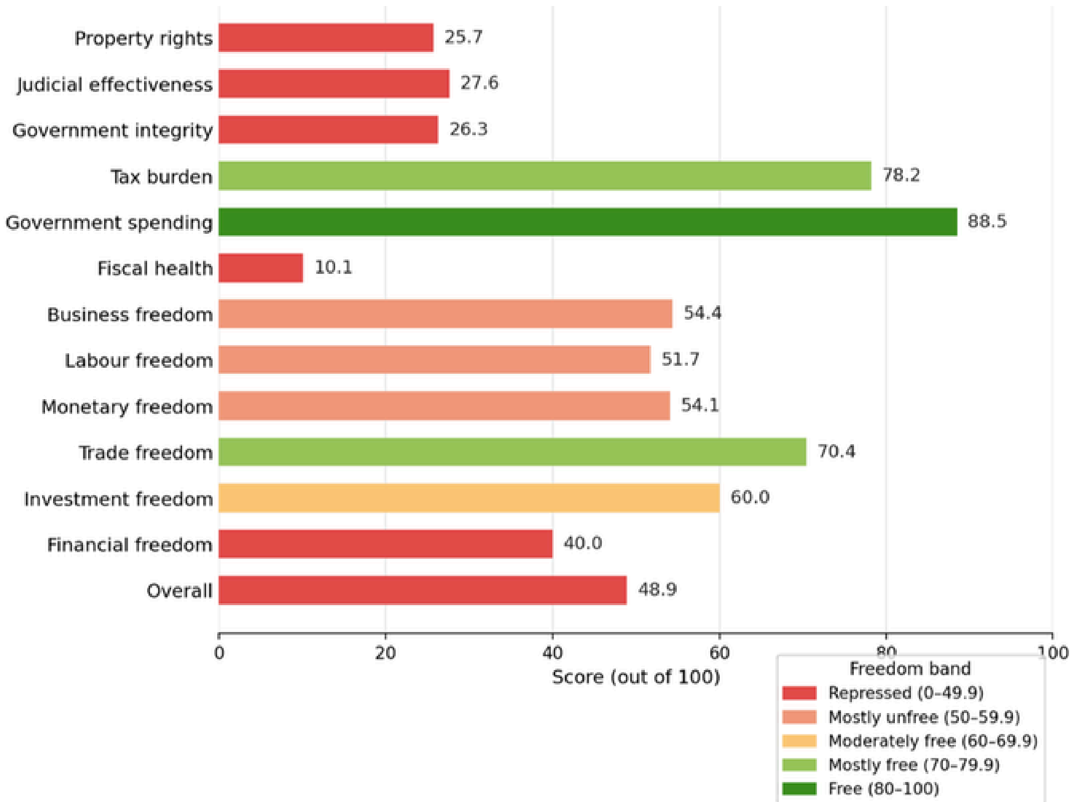
The first requisite for economic freedom is rule of law: everyone should be subjected to the same rules. A tax system that charges a salaried worker a top marginal income tax of 35%, while a shopkeeper with the same income pays only 0.5%, fails the criteria. So does a regime of Rs 2,352.81 billion tax expenditure that grants selected sectors a near-zero tax burden while the documented economy continues to bear the full weight. Generality does not necessitate the same treatment in every situation; rather, it necessitates that rules should not be designed to favour one group over another.

Stable and credible rules minimise uncertainty, allowing businesses to invest with confidence. When rules keep changing through SROs, discretionary exemptions or mid-year notices, the certainty disappears. Either capital leaves or is diverted into secure and risk-free sectors like government securities and real estate. Despite never showing up in the budget, Pakistan’s history of ad hoc policy changes acts as an implicit tax on investment.

Secure property rights, contract enforcement, and capital-efficient financial institutions are necessary for economic independence. Property rights must be safeguarded, and contracts need to be upheld. The financial institutions should direct savings towards productive private investment rather than primarily financing government borrowings. Economic freedom not only demands the absence of excessive state intervention, but also a state performing its core functions effectively.

The Heritage Foundation's Index of Economic Freedom is the most widely used quantitative framework for assessing these conditions. It evaluates 12 quantitative and qualitative factors across four pillars: Rule of Law, Government Size, Regulatory Efficiency and Open Markets. Pakistan’s score across all four pillars is presented in the figure below.

Figure 1:Index of Economic Freedom 2026: Pakistan’s Component Scores



Source: Index of Economic Freedom 2026[4]

[4] “Index of Economic Freedom 2026”, Heritage Foundation. Available at: https://economicfreedom.heritage.org/pages/country-pages/pakistan

3 Budget Through the Lens of Economic Freedom

This section examines the federal budget for FY2027 across four dimensions of economic freedom: taxation, government spending, regulatory environment and market openness. Instead of walking through the 12 variables of the Index of Economic Freedom, the analysis is organised around the questions that are central to the discussions around budget and Pakistan's economy. Where applicable, a three-year comparison of budget estimates for FY2024-2025, FY2025-2026, and FY2026-2027 is used.

3.1 Who Bears the Tax Burden?

Pakistan is scored 78.2 on the tax burden on the index of economic freedom. The reading is supported by a tax-to-GDP ratio of 10.3%, after experiencing an average of 8.7% for the last 10 years. On paper, Pakistan appears to be a lightly taxed government. It is not. It is a narrow actual base, high-rate economy in which the documented sector faces a disproportionate burden while most of the economic activity is operating under a de facto separate regime. The top marginal income rate for salaried individuals is 35%, which is comparable to Vietnam and Indonesia but higher than Bangladesh's 25%. However, the headline number does not tell the complete story. The core problem is structural; it comes down to who actually pays.

The federal budget for FY27 provides real but small relief to the salaried class. Income tax rates have been decreased across four slabs, and the 9% surcharge on salaried income over Rs10 million has been eliminated. [5]

Table 1: Illustrative Impact of the FY2026-2027 Income Tax Reforms on Salaried Individuals

Annual taxable income	Tax 2025-206	Tax 2026-207	Annual Savings
Rs 2.5 million	Rs 185,000	Rs 176,000	Rs 9,000
Rs 3.5 million	Rs 436,000	Rs 391,000	Rs 45,000
Rs 5 million	Rs 931,000	Rs 802,000	Rs 129,000
Rs 6.5 million	Rs 1,456,000	Rs 1,264,000	Rs 192,000

The budget FY2027 provides gradually increasing tax relief as taxable income climbs within income bands. While taxpayers earning Rs 2.5 million annually save approximately Rs 9000, the benefit increases to RS 45,000 at Rs 3.5 million, Rs 129,000 at Rs 5 million and Rs 192,000 at Rs 6.5 million. The relief is being driven by lower marginal tax rates in the middle-income band, as well as the increase in the top marginal 35% tax rate threshold from Rs 4.1 million to Rs 7 million. Although these tax measures reduce the tax burden for the salaried class, they remain limited to the recorded documented workforce whose taxes are withheld at source.

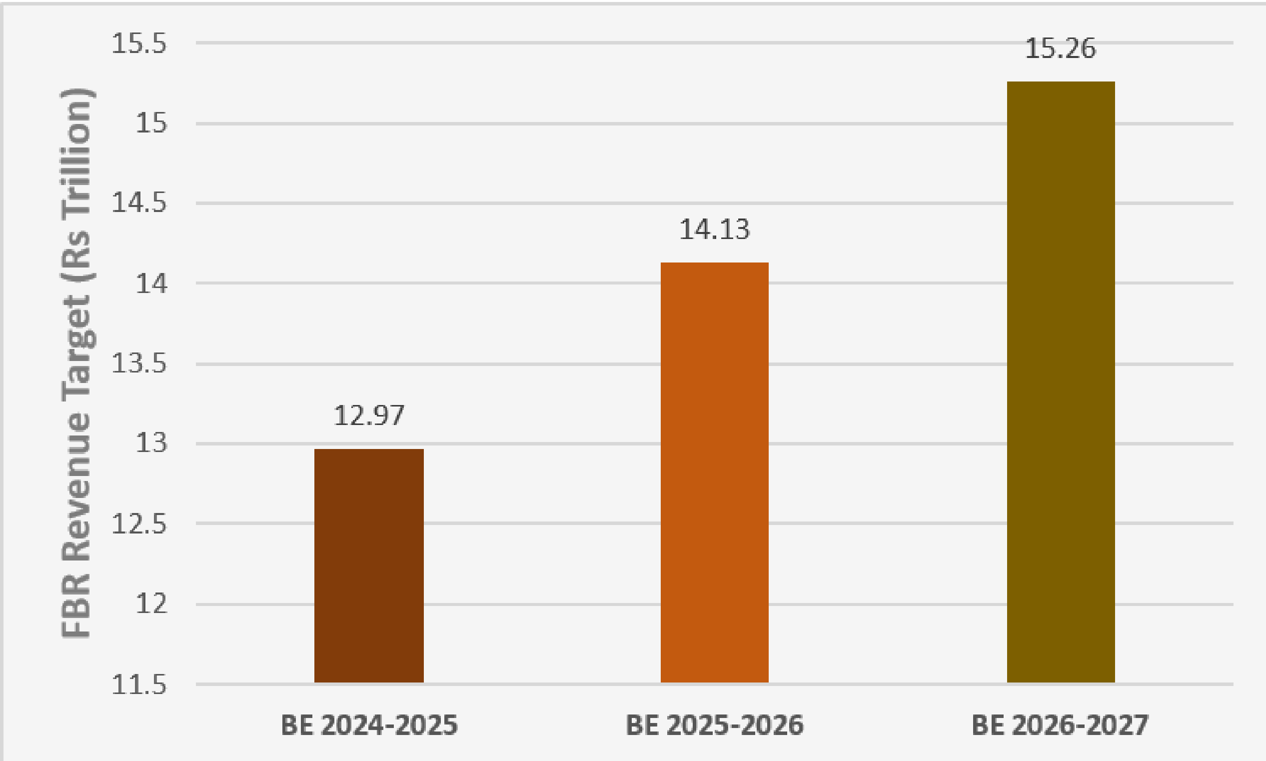
The super tax has been eliminated for income less than Rs. 500 million, and for income more than Rs 500 million, the tax rate has been reduced from 10% to 8%. Banks, Exploration and Production (E&P) companies and fertiliser companies are exempted from this relief. Moreover, there has been full withdrawal of super tax from

[5] "Finance Act 2026", FBR. Available at: https://download1.fbr.gov.pk/Docs/20266291261044366FinanceAct2026.pdf

firms deriving 80% or more of their revenue from exports. Additionally, the export development surcharge of 0.25% has also been eliminated. These are positive signals. However, the budget fails to address the structural imbalance between documented and undocumented sectors, as these reform measures operate exclusively in the formal economy. Following the Tajir Dost Scheme's failure to achieve its stated targets, under section 99B, the fixed tax targets, under section 99B, the fixed tax scheme has been introduced.[6] Intended to formalise the retail sector, this scheme offers a fixed tax rate of 1% for retailers with an annual turnover of up to Rs 200 million. Retailers are subjected to Rs 25,000 via QR code without a POS requirement. While the plan tries to streamline documentation and make compliance easier, it continues to tax annual turnover rather than actual income or profits. As an outcome, the contribution of the undocumented retail sector remains modest relative to its share in the economic activity, raising concerns about the horizontal equality within the tax system.

Then, there is the issue of tax expenditure. The FBR's tax expenditure reports note that the total federal tax expenditure for FY2025 totaled Rs 2,352.81 billion, approximately 2.7% of the GDP. Rs 579.70 billion exemption in income tax, Rs. 1,273.98 billion in sales tax exemption and Rs. 499.14 billion in customs duty exemptions.[7] Each exemption gives a significant economic freedom to its beneficiaries. Each exemption is cross-subsidised by high tax rates on the documented sectors with no exemption. One of the requisites of economic freedom established in the previous section is generality. Tax expenditure represents selected freedom, not general freedom. Rs 2,352.81 billion in differential treatment fails this test. The budget does not indicate any narrowing of this pool.

Figure 2: FBR Tax Revenue Targets



Source: Budget In Briefs, Ministry of Finance [8]

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[6] Ibid.

[7] "Tax Expenditure Report 2026", Annual Report on Federal Tax Expenditures, FBR. Available at: https://download1.fbr.gov.pk/Docs/202662414633924TaxExpenditureReport2026.pdf

[8] "Budget in Brief", Ministry of Finance. Available at: https://www.finance.gov.pk/fb_2026_27.html

The three-year FBR revenue tells its own story. The FBR revenue target has increased from Rs 12.97 trillion to Rs 15.26 trillion. But these gains come primarily from intensifying tax collection on the existing base through withholding taxation, digital enforcement and banking transaction surveillance, widening the base to include the undocumented economy. Every new withholding tax collection point is both a revenue measure and a compliance cost on the formal sector.

In a nutshell, this budget has reduced the marginal burden on the salaried class, while also lowering the super tax on businesses. The direction is correct. However, the deep structure stays unchanged. The formal economy remains over-taxed relative to the informal economy. Tax expenditure of Rs 2,352.8 billion establishes an area of selective freedom funded by the unfreedom for the rest. The index score of 78.2 reflects a statistical fiction.

3.2 What does the Government Actually Spend On?

Heritage scored Pakistan 88.5 against the government spending, implying a relatively small government. The problem isn't the size of the government, but the rigidity of its budget. Much of the government spending is pre-committed, leaving little fiscal room for productive spending. This is evident from the budget trajectory over the last three years.

Table 2:Composition of Current Federal Expenditure and Revenue

Budget Heads (Rs Billion)	BE 2024-2025	BE 2025-2026	BE 2026-2027
Interest Payments	9,775	8,207	8,054
Defence	2,122	2,550	3,000
Pension	1,014	1,055	1,169
Subsidies	1,363	1,186	1,091
Federal PSDP	1,400	1,000	1,000
Total Expenditure	18,877	17,573	18,771
Net Federal Revenue	10,377	11,072	11,751

Source: Budget in Brief in respective years, Ministry of Finance [9]

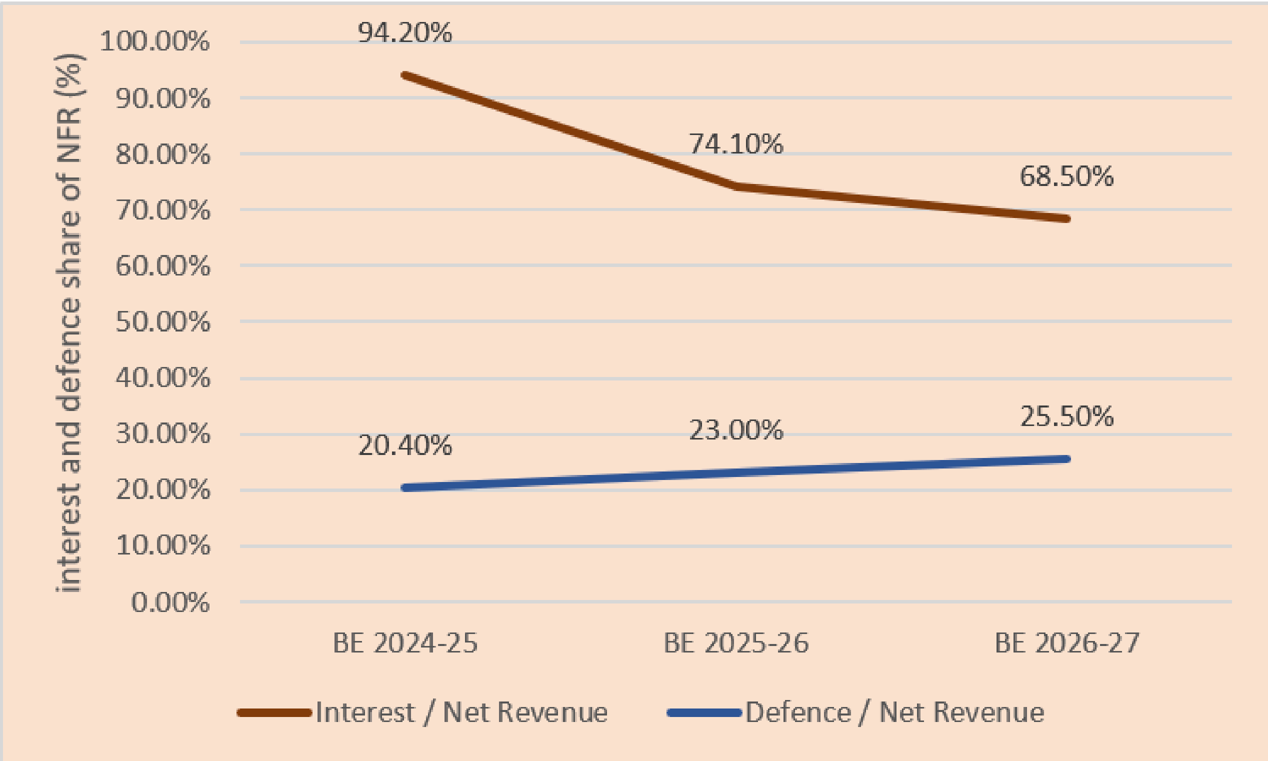
Starting with interest payments. They are decreasing in absolute terms from Rs 9,775 billion to Rs 8,054 billion from budget estimates of FY2024-2025 to FY2026-2027. The progress is real; however, the cause matters a lot here. The fall is primarily driven by the State Bank of Pakistan (SBP) 1,050 basis point rate reduction, bringing the policy rate down to 11.5% to 22%. If rates rise again, as they did in April 2026 with a rate hike to 11.5%, this pattern will reverse. The improvement is cyclical, not systemic. As a share of net federal revenue, the trajectory is striking. Out of Rs 10,377 billion in net federal revenue in FY2024-2025, Rs 9,775 were absorbed in interest payments, leaving behind nearly Rs 602 billion for all other government functions. Resultantly, it is reliant on borrowed money for carrying out other government expenditures. This single statistic captures the depth of the fiscal trap more clearly than the index score. By FY2026-2027, this statistic will have improved to 68.5%. There is an improvement; is an improvement; however, it remains extremely high by world standards. However, it reflects a significant increase in fiscal headroom, from Rs. 602 billion

[9] Ibid.5

available after interest to Rs. 3,697 billion. The breathing room mainly exists due to reduced interest rates.

Defence spending is moving in the opposite direction. Across two budget cycles, the defence spending has increased from Rs 2,122 billion to Rs 3,000 billion. The combined interest payments and defence share of net federal revenue tell an interesting fiscal story of this budget. The defence affairs and services as a share of the net federal revenue increased from 20.5% to 25.5%. In BE 2024-2025, interest payments and defence combined exceeded the federal revenue by 14.7%. The government wasn't even able to meet these two expenditure heads from its own revenue. In budget 2026-2027, the combined figure is 94.0%, implying that six rupees out of every hundred collected are all that remain after defence and interest payments. Six rupees for health, education, infrastructure, social protection and everything else the state is supposed to do.

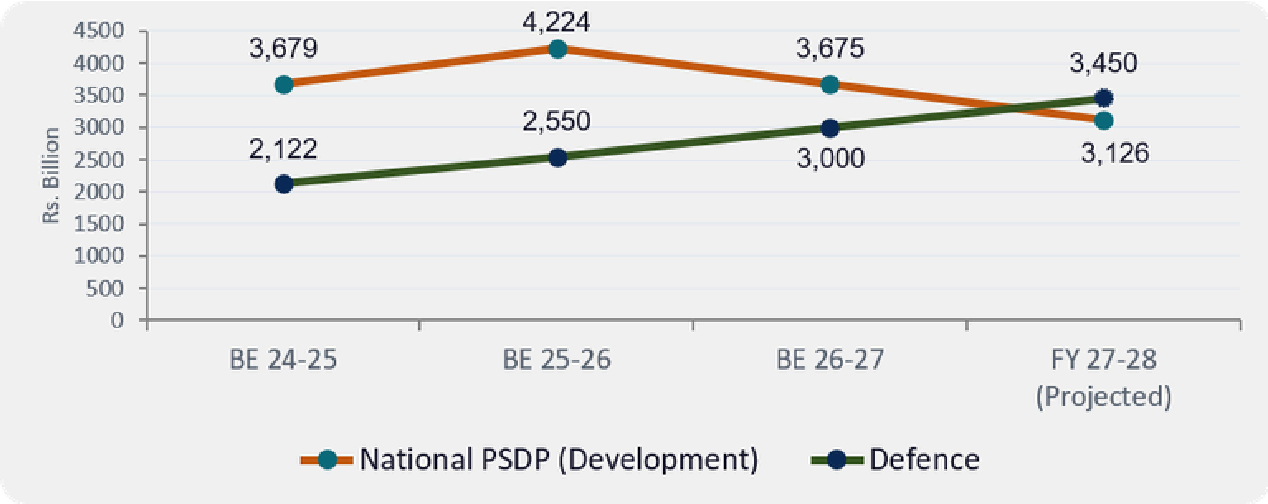
Figure 3:Interest Payments and Defence as a Share of Net Federal Revenue



Source: Budget in Brief in respective years, Ministry of Finance

Between FY2025 and FY2027, the defence budget has increased by Rs 871 billion. Over the same time, the Federal PSDP was reduced Rs 400 billion, from Rs 1,400 billion to Rs 1000 billion. Defence budget allocation has exceeded the development spending by three to one. If this trend continues, with the defence spending growing at around Rs 450 billion every year and the PSDP remaining flat at Rs 1,000 billion, the disparity will widen every year. This is a guns-vs-butter trade-off reflected in Pakistan's fiscal data as shown in the figure below.

Figure 4: Defence vs Development: The Lines Are Crossing



Source: Budget in Brief

Here, the government's spending mix also matters to how we interpret the Index's government spending score of 88.5%. The index favours low expenditure-to-GDP ratios. Pakistan's total expenditure as a percentage of GDP fell from 13.56% to 13.07%. The index interprets this as proof of a government with a limited spending footprint. However, a government that devotes 94% of its net revenue to debt and defence is not lean. It is incapable. A really limited government that invests efficiently in public goods (infrastructure, rule of law, education, and contract enforcement) lays the groundwork for private economic freedom. Pakistan's government is tiny in production capacity but not in cost.

Subsidies have fallen from Rs. 1,363 billion to Rs. 1,091 billion, a 20% drop. The index would regard this positively, and overall, it is a step in the right direction. However, the overall composition merits investigation. The power sector continues to get most subsidies. Of the Rs. 1,091 billion in BE 2026-27, about Rs. 830 billion is allocated to the electricity sector under various headings: price differential subsidies for WAPDA/PEPCO, K-Electric, AJK, Balochistan agricultural tube wells, and provisions for cyclical debt containment. The power sector receives 76% of all subsidies. This demonstrates the structural capture of fiscal resources by a power market based on sovereign-guaranteed IPP contracts with dollar-denominated profits. Meanwhile, new selective subsidies have emerged. The EFS Enhanced Plan for export refinance phasing (Rs. 88 billion), the PM Apna Ghar housing scheme (Rs. 71 billion), and a Production & Supply of Urea Fertiliser (Rs. 5.8 billion) are all new interventions, even as total subsidies decrease. Total subsidies are declining. The number of subsidised programs is not.

The government's spending on State-Owned Enterprises (SOEs) points to an interesting contradiction. Development spending allocated to SOEs increased 27.1% Y-o-Y to Rs 451 billion in budget 2026-207. Net lending to public sector enterprises stands at Rs 276 billion. These are not small fiscal commitments in a budget where 6% of net revenue remains after defence and interest. The contradiction lies in the direction. PIA was formally privatised in FY2026. The Privatisation Commission has advanced preparation for three DISCO sales i.e. FESCO, GEPCO, and LESCO. Islamabad airport was listed for privatisation. Public Private Partnership Authority (P3A) was transferred from the Planning Division to the Privatisation Division to streamline public-private partnership. But the budget simultaneously increases the financial exposure to the SOEs. A government that privatizes PIA while increasing SOEs' development spending by 27% is sending mixed signals about whether it intends to shrink or expand its economic footprint. The PIA privatisation is a genuine milestone. But one transaction that does not constitute a privatisation program. Heritage's government spending score of 88.5 does not distinguish between a government that spends on productive public goods and the one that spends on sustaining loss-making enterprises. The distinction matters for economic freedom.

Heritage gives Pakistan a 10.1 for fiscal health, the lowest possible score. Here, the trajectory is truly positive. The budget deficit fell from 5.9% of GDP (BE 2024-25) to 3.6% (BE 2026-27). A primary surplus was maintained for all three years: 2.0% (BE 2024-25), 2.4% (BE 2025-26), and 2.0% (BE 2026-27). The public debt-to-GDP ratio is dropping to around 70.4%. These are real accomplishments. But they're a bit fragile. The primary surplus is dependent on the FBR attaining a target of Rs. 15,264 billion, representing an 18% increase over estimated FY2025-26 receipts of Rs. 12,983 billion. Pakistan has already generated primary surpluses without sustaining them. The question is whether this is a tipping point or simply a temporary consolidation before the next crisis.

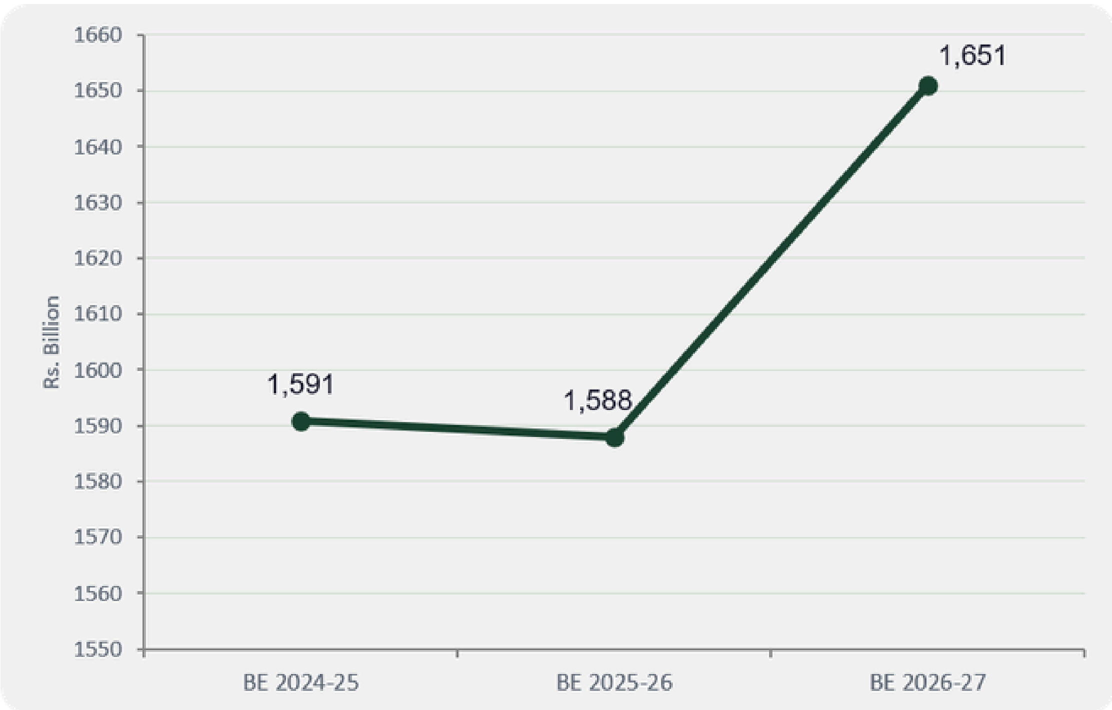
3.3 Are Markets Really Open?

This section focuses on three dimensions of market openness. They vary from the budget's most significant reform to its most harmful structural failure.

The National Tariff Policy 2025-30 represents the budget's most substantial pro-freedom measure. Average customs tax rates have been decreased for 3,125 tariff lines. Industrial input duties on 92 lines have been reduced, with rates dropping from 20% to 15%/10% and 15%/10% to 10%/5%. Additional customs tax reductions apply to 449 lines (6% to 4%), 2,107 lines (4% to 2%), and 569 lines (2% to 0%). The target maximum customs duty is 15%. This is a rule-based, incremental change. This is what economic freedom looks like in practice.

The revenue data supports the strategy. Customs revenue has been resilient over the last three years at Rs. 1,591 billion to Rs. 1,588 billion, and Rs. 1,651 billion. Lower rates appear to result in more accurate declarations and equivalent revenue. This is the Laffer curve at work in trade policy, and it supports the need for more rationalisation.

Figure 5: Custom Duty Collection and the Tariff Rationalisation



Source: Budget in Brief, Ministry of Finance

Pakistan's investment freedom score of 40.0 is quite low. It reflects a chronically low investment-to-GDP ratio and an environment in which capital is restricted. The budget includes major real estate reforms. Section 7E, which levied a presumed income tax on immovable property at around 1% of fair market value independent of actual income, has been invalidated by the Federal Constitutional Court. The advance tax on property transfers has been reduced. Stamp duty in Islamabad has been reduced from 4% to 1%. The federal excise levy on commercial property has been eliminated. These initiatives should boost property market activity and improve transaction paperwork.

The question is, what kind of investment would these reforms attract? The budget's investment facilitation still relies on sector-specific incentives: SEZ concessions, the Prime Minister's Apna Ghar housing initiative (Rs. 71 billion), and electric vehicle subsidies. Each result in an area of incentivised activity while leaving the overall investment climate unchanged. These are selected actions, not broad investment opportunities. SIFC was established as a supranational governance structure to address institutional investment limits. After two years of operation, its approach has been "quite transactional" rather than structural. This results in inconsistency rather than a level playing field. Investment freedom necessitates predictability and generalisation. SIFC, by design, provides neither.

The combination of bank lending suggests a quite different story. Credit to the government sector totalled Rs. 37.2 trillion in May 2026, compared to Rs. 13.8 trillion granted to the private sector. For every rupee that flows to enterprises, the government receives around Rs. 2.7.

The banking system's preference for sovereign lending is quite rational. At the SBP policy rate of 11.5%, government paper provides comparable returns with zero default risk, no credit evaluation cost, and favourable regulatory treatment for capital sufficiency. Why would a bank lend to a small or medium-sized business or an exporter when the sovereign provides the same risk-free return? The incentive structure directs national savings toward government borrowing and away from productive investment. This does not constitute a market failure. It is a market responding appropriately to a distorted incentive structure caused by the government's borrowing requirements.

Figure 6: Credit to Non-Government Sector

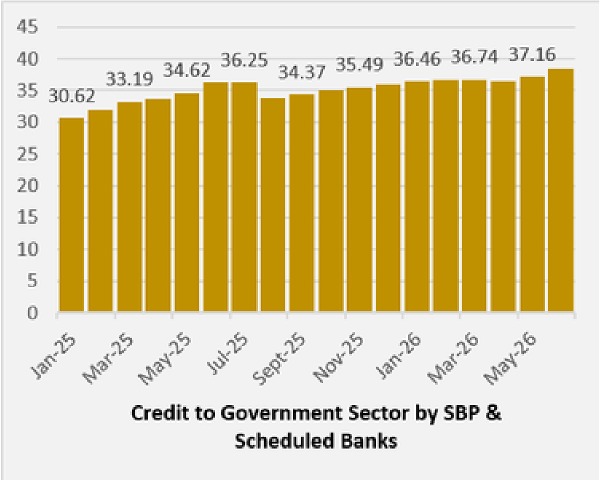
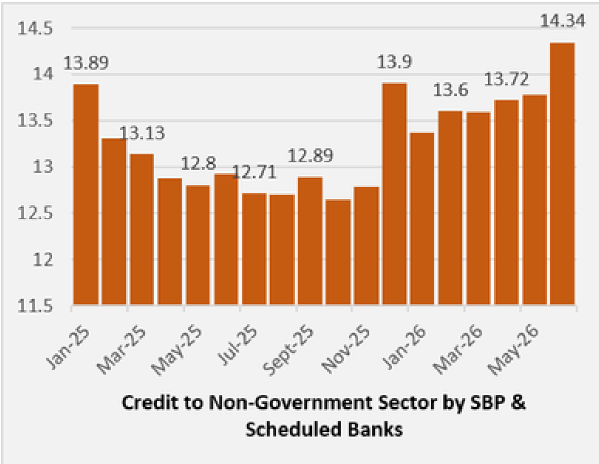


Figure 7: Credit to Government Sector



The three-year trajectory puts this into context. In BE 2024-25, the government's interest payments of Rs. 9,775 billion compared to net revenue of Rs. 10,377 billion indicated that the country was borrowing heavily to meet even its basic responsibilities. The entire banking sector was dragged into financing the deficit. The rate-cutting cycle has lowered the intensity. The structure survives. Until the fiscal deficit is reduced enough to significantly cut government borrowing from the banking system, private sector lending will remain crowded out.

A financial freedom score of 60 for a system in which the government absorbs three times more bank credit than the entire private sector does not accurately reflect Pakistan's financial access reality.

3.4 Does the Regulatory Environment Enable or Obstruct?

Starting a business in Pakistan can take one day. Closing one is punishing: tax returns must be filed for five years after discontinuance, with fines for noncompliance even if income is zero. The FY2026-27 Finance Bill introduces significant compliance costs, including extended banking transaction monitoring, digital reporting requirements, and documentation standards linked to the Active Taxpayers List. Each increases the expense of formality relative to informality. When documentation is more costly than the undocumented sector, people end up choosing informality. A countersignal exists. The Asaan Karobar Act revisions and regulatory guillotine process are intended to simplify registration and minimise the regulatory burden. However, the Finance Bill's compliance provisions go against the claimed goal of formalisation.

The budget contains no significant labour market reforms. The minimum salary has been raised by 10% to Rs. 40,700 per month (Finance Act 2026). With 81% of the workforce informal, formal labour market regulation affects just a small proportion of actual employment connections. Labour freedom in the informal economy is great by default, not on purpose. Workers have no minimum wage, no contract rights, and no social insurance. Heritage represents a statistical average over a labour market that is divided between strict formal restrictions and nearly complete informal deregulation. The score of 51.7 represents neither reality accurately.

3.5 Budget Adjacent Measures

Pakistan receives low rankings from the Index in the following areas: property rights (27.6), judicial effectiveness (25.7), and government integrity (26.3). The budget has limited direct influence here. In terms of property rights, the elimination of the 7E and the reduction in transaction taxes should improve paperwork and shift property transactions to market-based valuation. The overall direction is positive; however, a single budget cannot change underlying institutional scores.

In terms of government integrity, Rs 2,352.81 billion in tax expenditures equates to Rs 2,352.81 billion in discretionary decisions on who is eligible for exemptions. Every exemption represents a rent-seeking opportunity. The system's framework produces veto points for reform even when broad agreement exists, as proven by the sugar deregulation case: total agreement across the federal government, industry, and farmers, but rejected by one province.[10]

4 Pakistan’s Structural Reality: Missing Points in the Index of Economic Freedom

The index of Economic Freedom provides a good starting point but doesn’t complete the picture. Four components of Pakistan’s economy distort the index scoring in a way that is critical for accurate assessment of economic freedom in the country.

4.1 The Dual Economy

The overall economy of Pakistan is divided into two categories: formal and informal. Approximately 19.2% of the workforce is employed in the formal economy, documented sectors. It is taxed at source, subjected to regulations and bears the entire cost of compliance. The informal economy, accounting for 80.8% of the labour force, operates under a de facto independent framework with limited taxation, negligible taxation, and without any formal contract enforcement.11 The share of the labour force employed in the informal economy increased from 72.5% in

[10] Salman, Ali, “Does Pakistan have the Will to Liberalize?”, 9th July, 2026. Available at: https://www.youtube.com/watch?v=Ek_4wH3bd9Q

[11] “Pakistan Labour Force Survey 2024 -25”, PBS. Available at: https://www.pbs.gov.pk/wp-content/uploads/2020/07/LFS-2024-25-Annual-Report.pdf

2020-2021 to 80.8% in 2024-2025. The index averages across the divide capture neither reality.[12] A tax burden score of 78.2 doesn't reflect the 29% effective rate faced by a salaried individual or the 1% paid by the shopkeeper at equivalent income. A labour freedom of 51.7 describes neither the rigid formal labour code nor the near-total deregulation of the informal economy. The index score for Pakistan across all the components represents a statistical midpoint between economies that function by fundamentally different rules. The midpoint represents neither's experience.

4.2 Tax Expenditure as Selective Freedom

The Rs 2,352.81 billions of tax expenditure, 2.7% of the GDP, provides margins of high economic freedom for specific sectors and activities. The exemptions of Rs. 1,273.98 billion in sales tax exemption alone are larger than the entire federal PSDP allocation of RS 1000 billion. Properly conceptualised economic freedom requires generality: the same laws for everyone. However, tax expenditures are the reverse case, giving near-zero effective rates for certain sectors, while the rest are cross-subsidised with higher rates. Each exemption represents a policy judgement regarding who receives the freedom and who does not. The index fails to represent this selective treatment.

4.3 The Spending Quality of the Government

The index scores Pakistan an 88.5 on government spending because total expenditure relative to GDP is low. The score indicates the size. It does not assess the composition or comparability. In the earlier section of the report established that 94% of the net revenue is spent on interest payments and defence combined. The remaining 6% and the net financing cover all that the state is required to do to support economic activity. A government that spends nearly nothing on public service is not lean in any way.

This points to a larger issue of how economic freedom is measured. The index approach inherently views government spending as a cost to be minimised. However, economic freedom necessitates the functioning of institutions. The first pillar of the heritage framework, the rule of law, depends on courts, regulators, and enforcement agencies that cost money to operate. A state cannot enforce contracts, maintain roads, provide reliable electricity or educate the labour does not create freedom through minimal spending. It creates a vacuum. Just Price liberalization doesn't work without the rule of law as the basis.[13] Heritage's Government Spending score of 88.5 rewards the absence of spending without considering whether that absence promotes or weakens economic freedom.

5 Scorecard: Federal Budget vs Economic Freedom

The table on the next page presents the report's directional assessment for each dimension of economic freedom based on the analysis done in the earlier two sections. The scores of the index of economic freedom are included as a reference column.

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[12] Salman, Ali. "Pakistan's lost economic freedom", Express Tribune 9 feburary,2026. Available at: https://tribune.com.pk/story/2591528/pakistans-lost-economic-freedom

[13] Ibid.11

Table 3:Federal Budget 2026-2027 Scorecard

Dimension	Heritage Score (2026)	Budget Direction	Key Driver
Tax Burden	78.2	Weakens Economic Freedom	Salaried relief and super tax reduction positive. Top rates unchanged. Base not broadened. Rs. 2,352.81 billion in tax expenditures untouched. PDL increased. The overall tax burden remains unchanged.
Government Spending	88.5	Limited or Mixed Impact	Expenditure-to-GDP declining. But composition unchanged: interest + defence = 94% of net revenue. Score measures size, not capability.
Fiscal Health	10.1	Strengthens Economic Freedom	Deficit narrowing to 3.6%. Primary surplus at 2.0%. Debt-to-GDP declining. Real but fragile progress, dependent on FBR meeting the ambitious target.
Property Rights	27.6	No direct effect	
Judicial Effectiveness	25.7	No direct effect	
Government Integrity	26.3	No direct effect	
Business Freedom	54.4	Limited or Mixed Impact	Additional documentation and WHT requirement increase compliance costs, while digitalisation improves administrative efficiency. Overall impact is mixed.
Labour Freedom	51.7	Limited or Mixed Impact	No major reform. Minimum wage raised by 10%. While this may improve worker's incomes, it could also increase unemployment or informality if productivity fails to keep a pace.
Monetary Freedom	54.1	Weakens Economic Freedom	Inflation back in double digits (10.9-11.7%). PDL increased.
Trade Freedom	70.4	Strengthens Economic Freedom	NTP 2025-30 is the strongest pro-freedom reform. 3,125 tariff lines reduced. Revenue holding despite rate cuts.
Investment Freedom	40	Limited or Mixed Impact	Real estate reforms positive. But continued reliance on sector-specific incentives and SIFC's transactional approach. The general investment climate is unreformed.
Financial Freedom	60	Weakens Economic Freedom	Credit ratio 2.7:1, government to private sector. Crowding out structural.

Red – Weakens Economic Freedom, Orange – Limited or Mixed Impact, Green – Strengthens Economic Freedom, Grey – No Direct Effect

Overall Assessment: The budget increases economic freedom in specific areas including fiscal consolidation, trade policy, property transactions and tax relief. These are actual gains. However, the underlying architecture of economic unfreedom in the country remains unchanged. The pre-committed expenditure base, restrictive financial system, the dual economy and the fragmented fiscal federalism. The direction of the budget is relatively positive. However, the pace is simply too slow to lift Pakistan out of the "repressed" category of the index of economic freedom.

6 Recommendations: What Will a Freedom-Enhancing Budget Look Like?

The following recommendations are based on the report's analysis. These are the minimum interventions required to shift Pakistan's category from repressed towards a functioning economy.

1. **Protect and Expand the NTP tariff reforms:** Uniformly apply the 15% maximum customs tariff cap to prevent SRO's from overriding it. Publish annual NTP compliance report that detects deviations. Lock in lower tariffs through bilateral agreements with Central Asia, ASEAN, and GCC, making reversal diplomatically costly.

2. **Reduce the government's borrowing footprint in the banking sector:** SBP has already attempted to lengthen the maturity of profile public debt by increasing the issuance of Pakistan Investment Bonds (PIBs), the banking system continues to favour sovereign paper over private lending. A more substantial solution would be to implement differential prudential treatment, such as imposing small positive risk weights to sovereign holdings beyond a certain threshold, to limit excessive concentration in government securities and increase incentive for private sector borrowing.

3. **Replace PDL with a uniform Sales Tax Rate:** Replace Petroleum Development Levy with a uniform GST on petroleum products. A transparent, rule-based tax would improve economic freedom by making fuel taxation more predictable, reducing discretionary changes in tax rates, strengthening parliamentary oversight, and allowing consumers and businesses to make decisions under a stable and transparent tax regime.

4. **Broaden the Effective Tax base by lowering Tax rates:** The path to a competitive tax regime involves rate reduction. Reduce GST from 18% to 15% over two fiscal years. Instead of keeping the super tax of 8% for income over Rs 500 million, eliminate it entirely. Reduce the corporate rate from 29% to 25%, bringing Pakistan in line with its regional competitors.

7 Conclusion

The Federal Budget FY2026-2027 includes improvements. The National Tariff Policy 2025-2030 is a step in the right direction. Salaried Tax relief, super tax rate reduction with complete elimination for firms deriving 80% or more of their revenue from exports and real estate reforms improve incentive for documentation and taxation. Fiscal consolidation is underway with budget targeting a fiscal deficit of 3.6% of GDP with alongside a primary surplus of 2.0%. However, the structural foundations of economic unfreedom remain deep rooted in Pakistan's policy framework. Interest payment and defence account about 94% of the net federal revenue, leaving little space for productive public investment. The Banking system remains heavily oriented towards financing the government rather than the productive private sector, and more than four-fifths of the country's workforce continues to operate outside the formal economy. Pakistan's overall score of 48.9 (Repressed) in the index of economic freedom captures this reality partially. Component scores of government spending, financial freedom and tax burden presents a picture of a lean low-tax and financially open economy that is inconsistent with Pakistan's institutional realities. The reforms Pakistan need are well understood. Expanding economic freedom requires a tax system based on generality, a predictability and institutions that enforce contracts and channel finance towards productive investment. The budget moves in the direction but only incremental.

According to the Economic Survey of Pakistan, in FY2026, the economy grew by 3.70%.[14] However, the economy missed the 4.2% growth target, continuing the pattern of missing the annual growth target for the fourth consecutive year. This is not an isolated outcome. Over FY2022-2026, the country's real GDP growth averaged 3.22% per annum. The Labour Survey reports that between 2020-2021 and 2024-2025, the working-age population increased by approximately 19.8million, while the unemployment rate increased by 6.3% to 6.9%.[15] This indicates that currently the job creation in Pakistan is insufficient to absorb the increasing labour force. Therefore, the country's long-term challenge is not to merely restore economic development, but to sustain the growth at the rate that outpaces population growth and generates enough job opportunities. Without increased private investment, improved productivity, and more efficient resource allocation, the economy is likely to remain trapped in a cycle of slow growth, restricted job creation and stagnating living standards.

[14] "Economic Survey of Pakistan 2025-2026", PBS. Available at: https://www.finance.gov.pk/survey/chapter_26/Complete_PES2025_26.pdf

[15] Ibid.,16

What’s the score? So far, only 1 down!

Khalil Ahmad

As the caption of this writeup shows, finally and ultimately after so many deadlines, delays, and hitches, the PIA was handed over to a private consortium. That’s the score that the government has achieved in ages.

As part of the sale agreement, the new management will spend Rs.80 billion to improve the functioning of PIA, and an amount of Rs.10 billion will be paid to the government. It has also met 40 conditions before formal handover took place.

With the start of this month, there was an uproar in the newspapers that Pakistan Railways' revenue has risen 24.19% to Rs. 115 billion.

Let it be clear that it is revenue, not the profit. No doubt, it is an improvement. However, as an analyst, Dawn notes that “PR is still at a loss, owing to multiple factors, including a lack of capacity to compete with road transportation.” And no doubt, there are chronic flaws gnawing at the PR that may suck the life out of this achievement if the positive developments do not sustain their pace.

It may also be noted that despite the proposed joint plans regarding the PSM by the Sindh and federal governments, Pakistan Steel Mills' losses skyrocketed 1,355% to Rs.245.9 billion, as reported by the Auditor-General of Pakistan.

The process for the sale of Fesco, Gepco, and Iesco is progressing, but we know there are so many slips between the lips and the cup.

The bad news! Under the two heads that we keep a tab on, **non-development spending** and **liberalisation and deregulation**, during the previous three months, no development was reported.

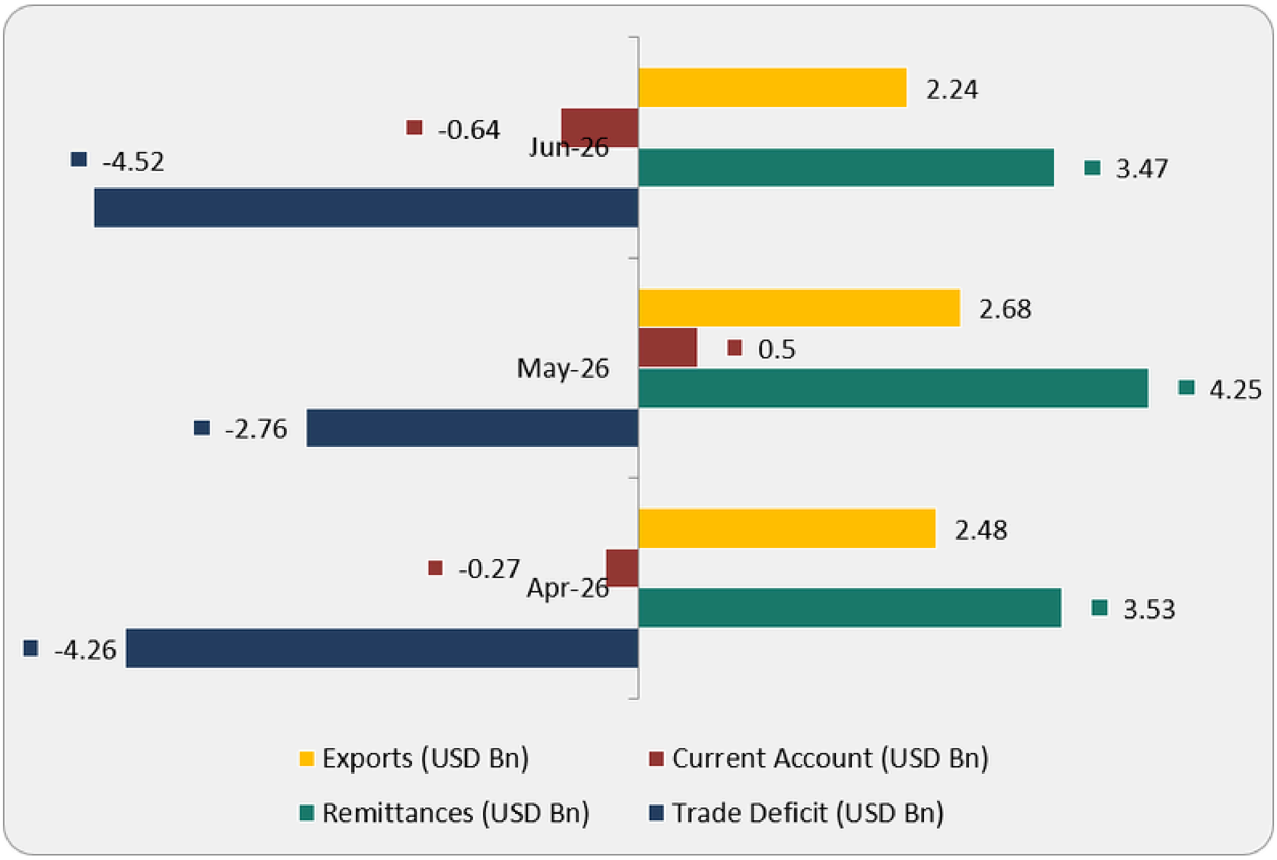
Two pieces of good news: Islamabad airport is up for sale, and an authority, the Public Private Partnership Authority (P3A), is being transferred from the administrative control of the Planning, Development, and Special Initiatives Division to the Privatization Division, and as stated, the purpose is greater utilization of expertise of private partnerships.

What relevant information was reported in various newspapers regarding the incumbent government’s efforts to limit its footprint in the economy from April 10 to July 10, 2026, has briefly been arranged with issues and entities collated together.

July 13, 2026

Macroeconomic Analysis

Figure 8: External Sector of Pakistan

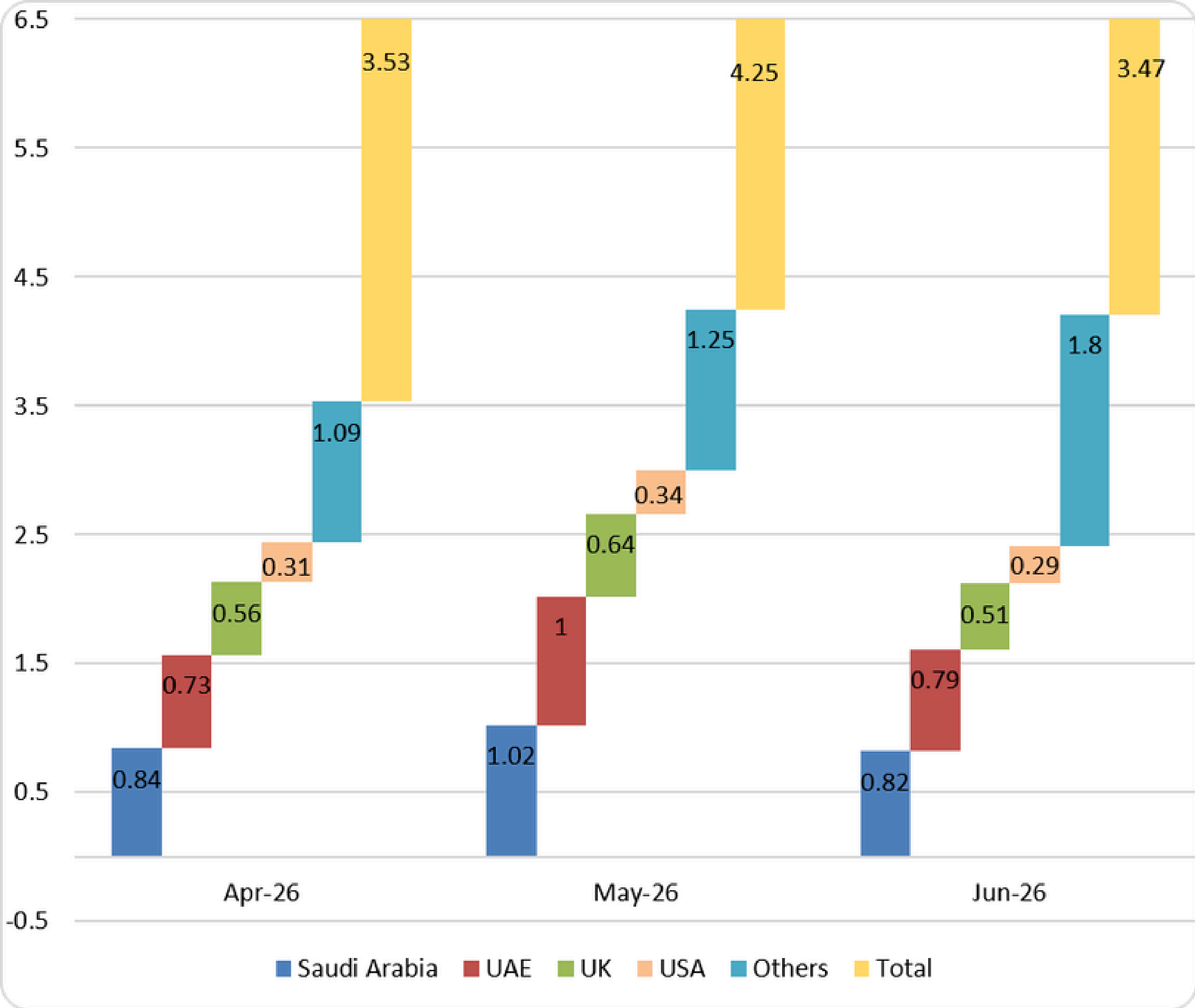


Source: PBS[16]

- Textile exports increased 10.8% MoM and 7.1% YoY in May to $1.64bn. Food group fell 30.2% YoY. Rice exports decreased to 17.2%. Fruits and vegetables exports declined 59% and 67% Y-o-Y respectively.
- The current account swung from a deficit of $0.27 billion in April to a deficit of $0.64 billion in June, before recovering to $0.5 billion in May.
- Policy Note: Pakistan's external stability rests on labour export, not goods export. Diversify exports beyond textiles and rice by promoting value-added sectors such as pharmaceuticals, engineering goods, and processed foods. Improve competitiveness through market-based industrial energy pricing and expanded trade agreements. Build earned reserves through sustained current account surpluses rather than borrowed inflows. The buffer remittances provide should buy time for structural reform, not substitute for it.

[16] https://www.pbs.gov.pk/monthly-summary-on-foreign-trade-statistics-for-march-2026/

Figure 9: Workers' Remittances in Pakistan

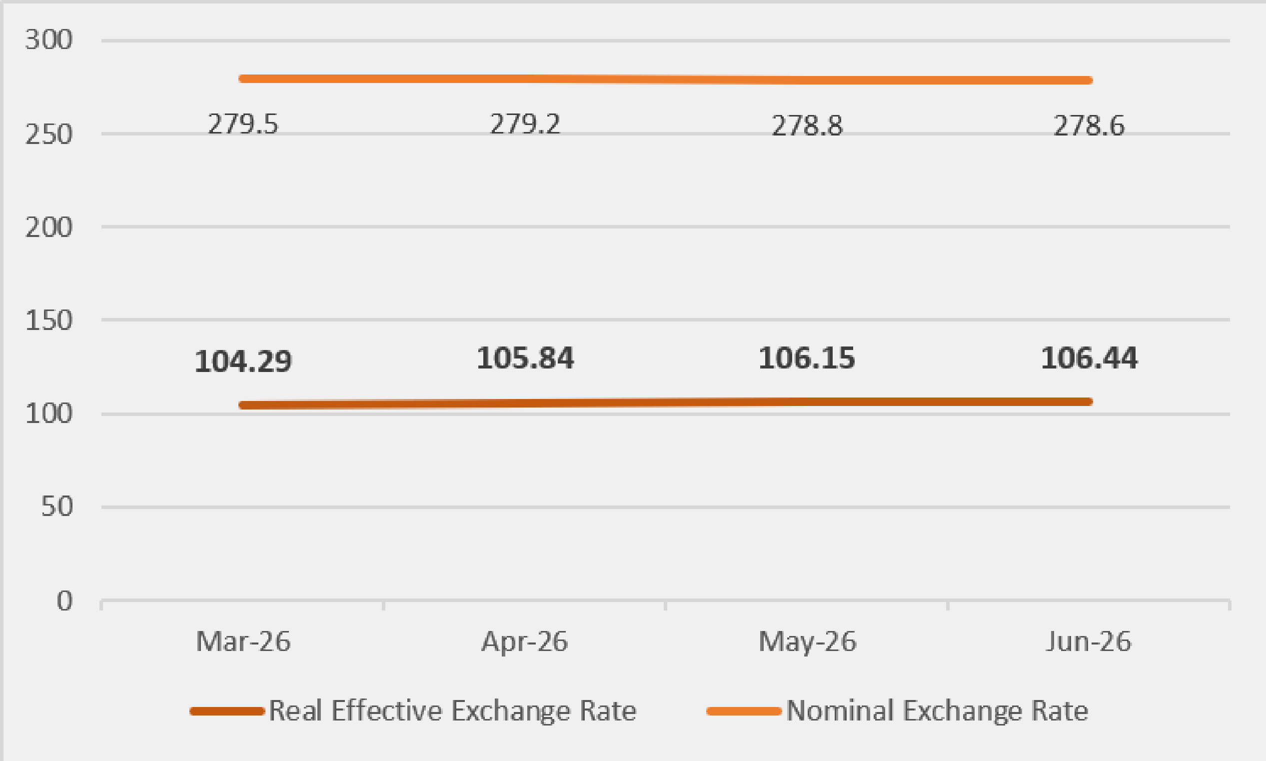


Source: SBP[17]

- The decline in June remittances was driven by lower inflows from all major source markets, particularly Saudi Arabia (US$1.03bn to US$0.83bn) and the UAE (US$1.01bn to US$0.79bn), indicating that May's exceptional performance was largely seasonal.
- Policy Note: While maintaining and expanding remittance inflows should remain a priority through stronger diaspora engagement, improved digital payment channels, premium banking products, and bilateral labour agreements, remittances cannot substitute for a competitive export sector. There is a need to diversify overseas employment markets beyond the GCC while simultaneously strengthening export competitiveness through productivity gains, lower trade costs, and a stable policy environment.

[17] https://easydata.sbp.org.pk/apex/f?p=10:211:::NO:RP:P211_DATASET_TYPE_CODE,P211_PAGE_ID:TS_GP_BOP_WR_M,210&cs=1F743692A58FE97CD791417EFAE146503

Figure 10: Real Effective Exchange Rate of Pakistan March - June

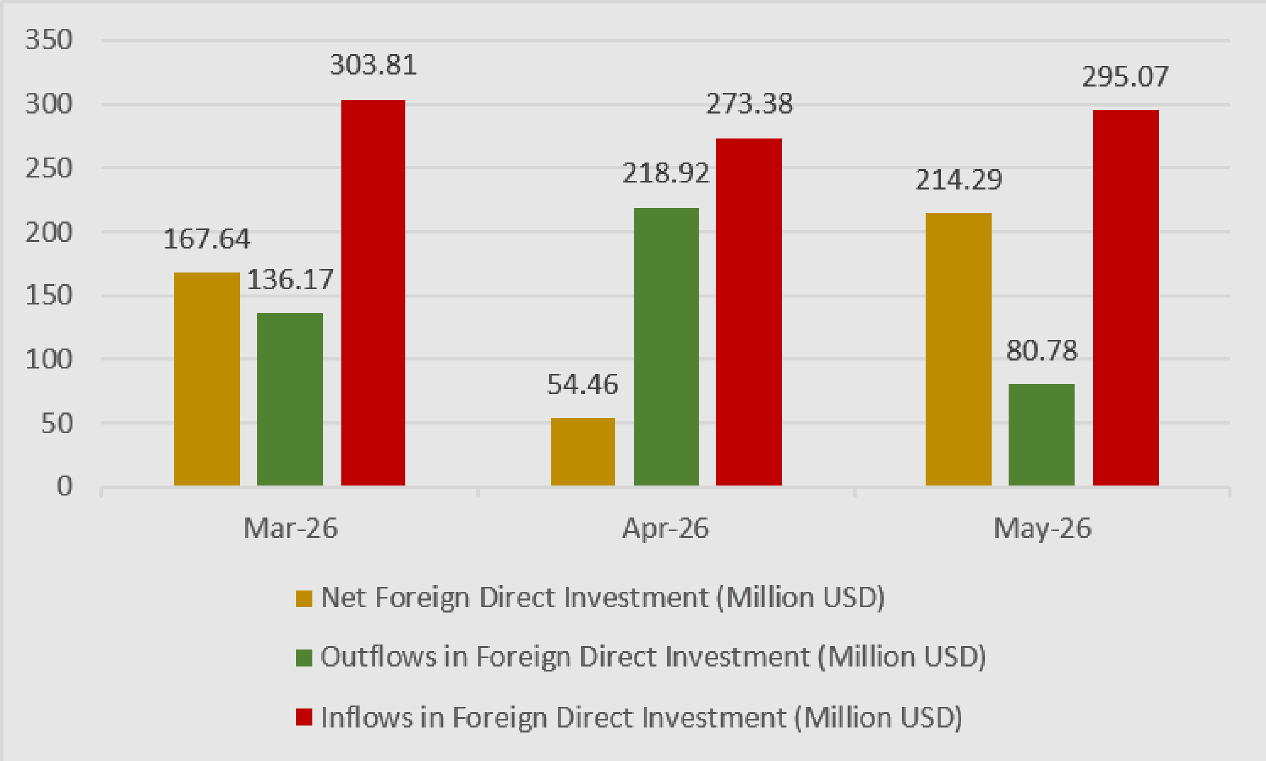


Source: SBP[18]

- REER increased from 104.29 in March to 106.44 in June, while NEER stayed flat at 38.02 to 38.14. This implies that nominal exchange rate is not moving, but Pakistan's exports are becoming more expensive than its major trading partners.
- This erodes export competitiveness without any visible change in exchange rate.
- Policy Note: Greater exchange rate flexibility would allow the exchange rate to adjust more readily to changing economic conditions, helping preserve external competitiveness, but may increase imported inflation. Maintaining exchange rate stability while inflation remains elevated risks eroding export competitiveness. The most sustainable solution is to reduce domestic inflation and strengthen productivity, allowing external competitiveness to improve without relying solely on exchange rate adjustments.

[18] https://easydata.sbp.org.pk/apex/f?p=10:211:11968943018556::NO:RP:P211_DATASET_TYPE_CODE,P211_PAGE_ID:TS_GP_ER_REERNEER_M,210&cs=17DB4772A01D723201E2C27E035A5541A

Figure 11: Foreign Direct Investment in Pakistan Mar-May

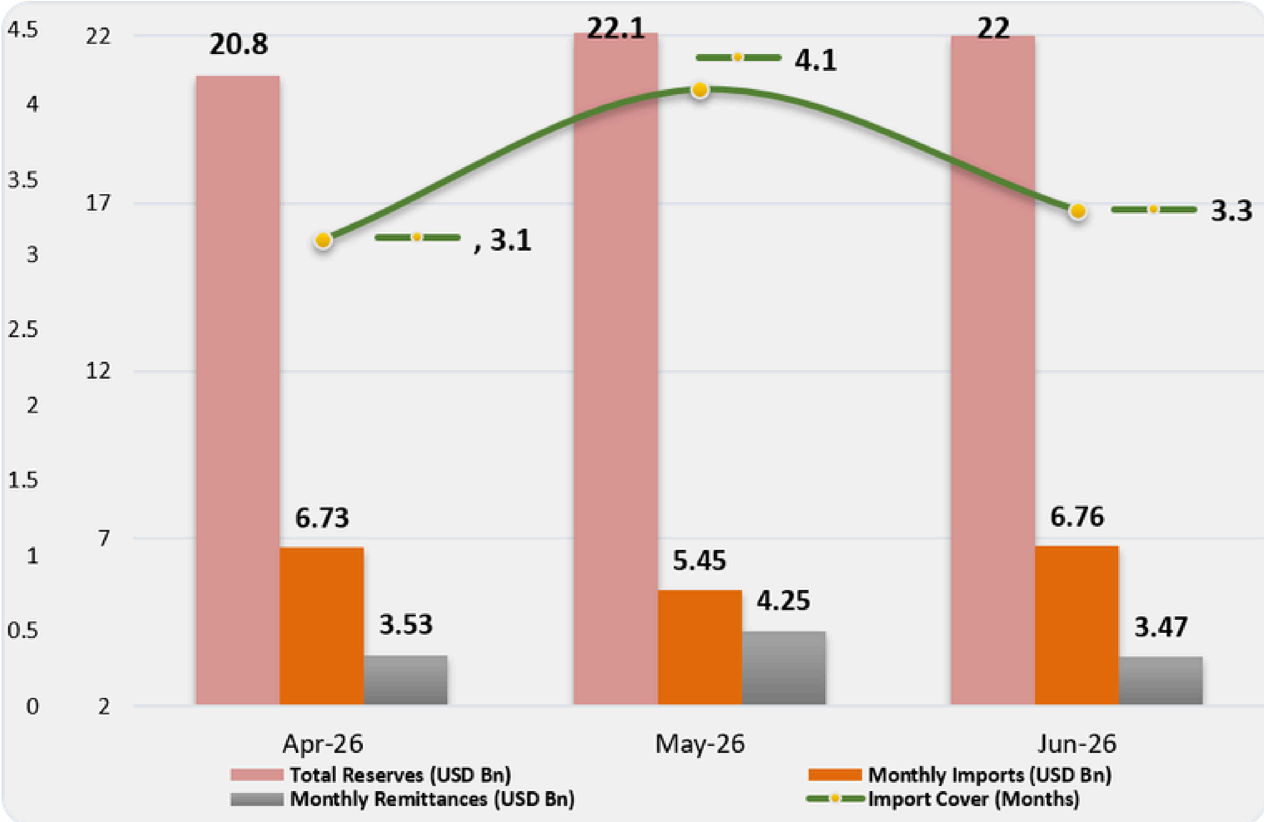


Source: SBP[19]

- Gross inflows held steady at $273-303mn, but an annualised $1.5-2bn is negligible. FDI remains concentrated in CPEC-linked flows, creating sovereign concentration risk.
- April outflows of $218.92mn nearly matched inflows, likely reflecting profit repatriation amid geopolitical uncertainty.
- Policy Note: Investment responds to predictability more than to concessions. Tax holidays and SEZ incentives have not moved the needle because the underlying investment climate, regulatory uncertainty, energy costs, contract enforcement, and intellectual property protection remain unattractive relative to regional peers. Corporate tax rationalisation, regulatory simplification, and transparent dispute-resolution mechanisms are prerequisites for attracting diversified FDI beyond CPEC.

[19] https://easydata.sbp.org.pk/apex/f?p=10:211:::NO:RP:P211_DATASET_TYPE_CODE,P211_PAGE_ID:TS_GP_FI_FIPK_M,210&cs=1EEC988B2E32EA2F5343C1705B38CBE3D

Figure 12: Total Liquid Foreign Reserves of Pakistan & Import Cover

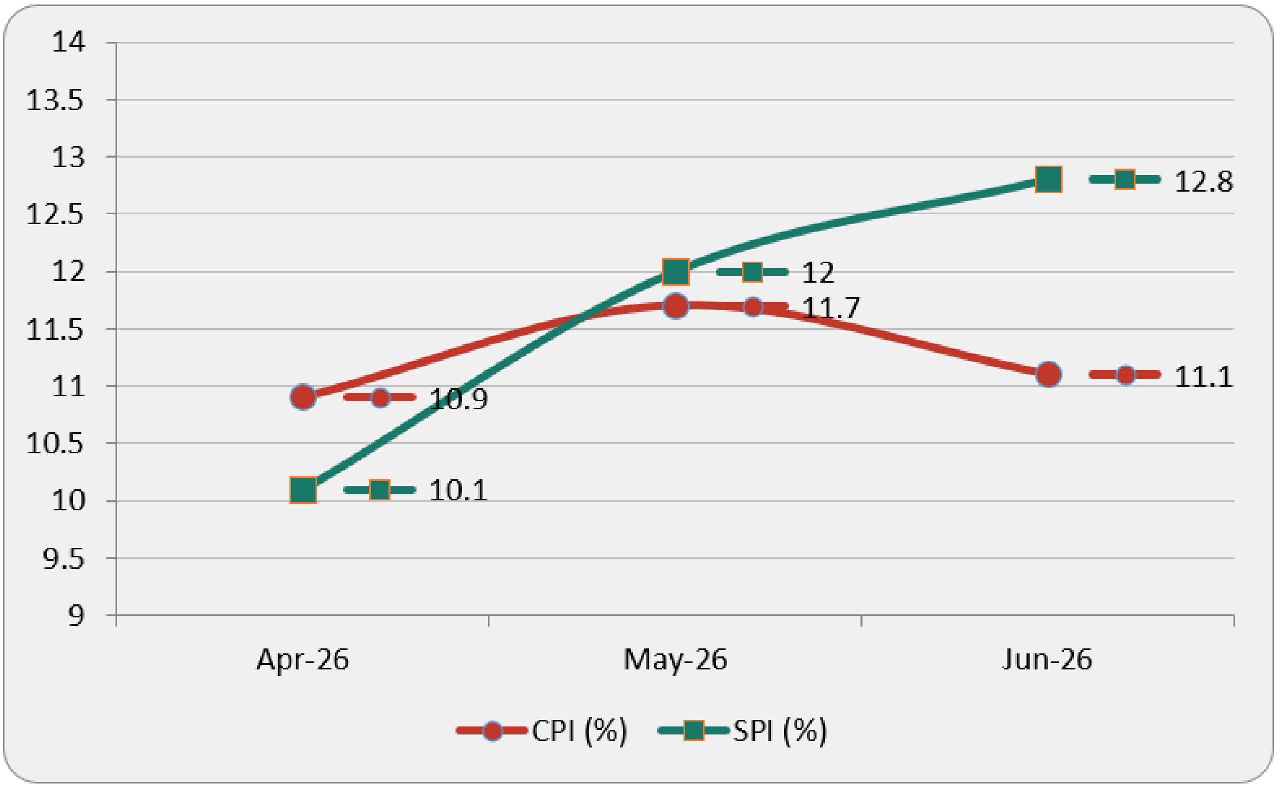


Source: SBP[20]

- Total reserves remained stable at $20.8-22.0bn, but adequacy fluctuated significantly with the import bill. Import cover dropped to 3.1 months in April when imports hit $6.73bn, recovered to 4.1 months when imports compressed in May, and fell again to 3.3 months as June imports surged to $6.76bn.
- Remittances ($3.47-4.25bn) consistently exceeded monthly FDI inflows by a factor of 15-20x, underscoring how narrow Pakistan's external inflow sources are. Reserves are sustained by remittances and IMF disbursements, not by export earnings or investment inflows.
- Policy note: Build earned reserves through export competitiveness and sustained current account surpluses. Re-profile bilateral deposits into long-term arrangements to ease rollover pressure. Diversify external inflows beyond remittances and multilateral borrowing. At 3.1-3.3 months import cover, one missed rollover or external shock compresses the buffer to critical levels.

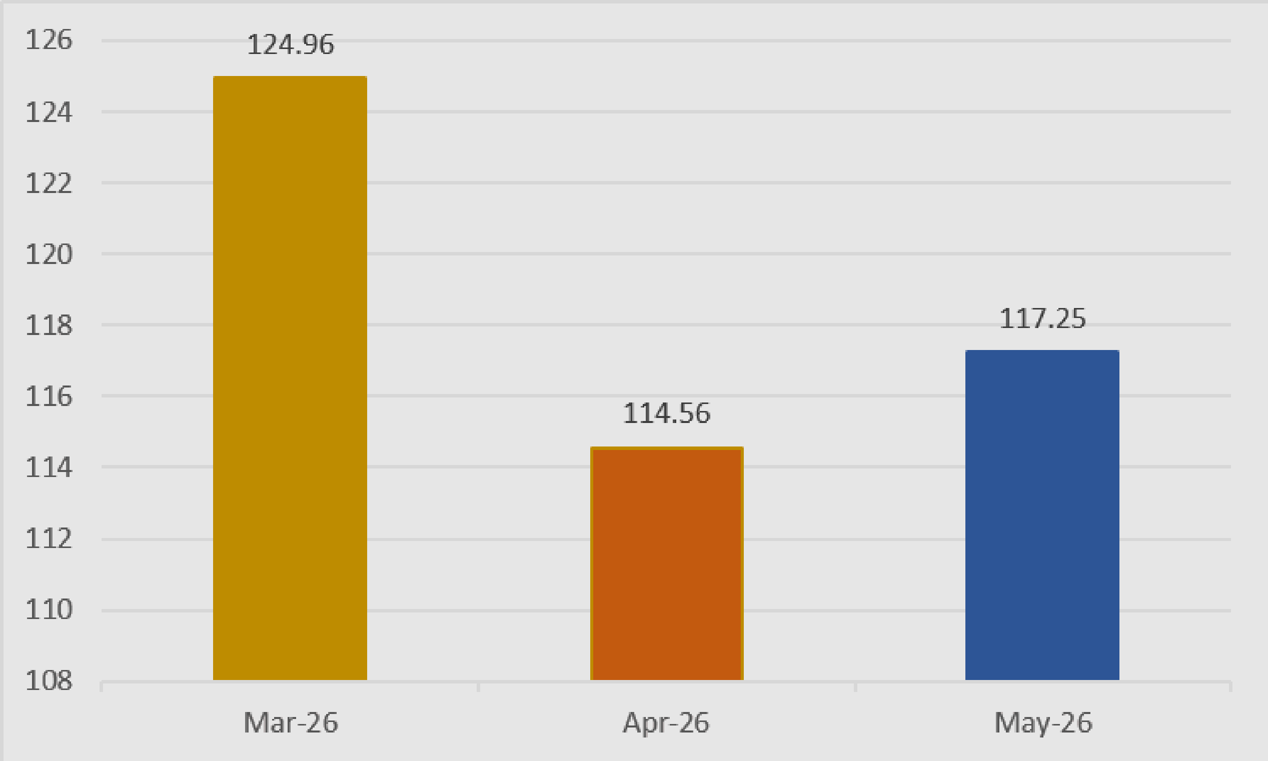
[20] https://www.sbp.org.pk/ecodata/forex.pdf

Figure 13: CPI & SPI April-June



- CPI surged from 7.3% in March to 11.1% in June, reversing the disinflation gains of 2025. The acceleration was broad-based: housing & utilities increased 15.50% Y-o-Y, transport and food group recorded an increase of 25.72% and 9.83% Y-o-Y, respectively. Core inflation at 8.7% signals the shock has embedded into sticky categories.
- SPI, which tracks weekly prices of essential goods, increased from 10.1% to 12.8% between April and June. CPI eased slightly to 11.1% in June, but SPI kept increasing.
- The SBP raised policy by 100bps to 11.5% in April, the first hike since June 2023, and held in June. Double-digit inflation is expected to persist for the next few months.
- Policy Note: Coordinate fiscal and monetary policy. Allow energy prices to adjust through a transparent mechanism. Accompany with targeted social protection for the bottom two income quintiles through BISP. Broad-based price controls are fiscally expensive, distortionary, and regressive.

Figure 14: Quantum Index of Manufacturing

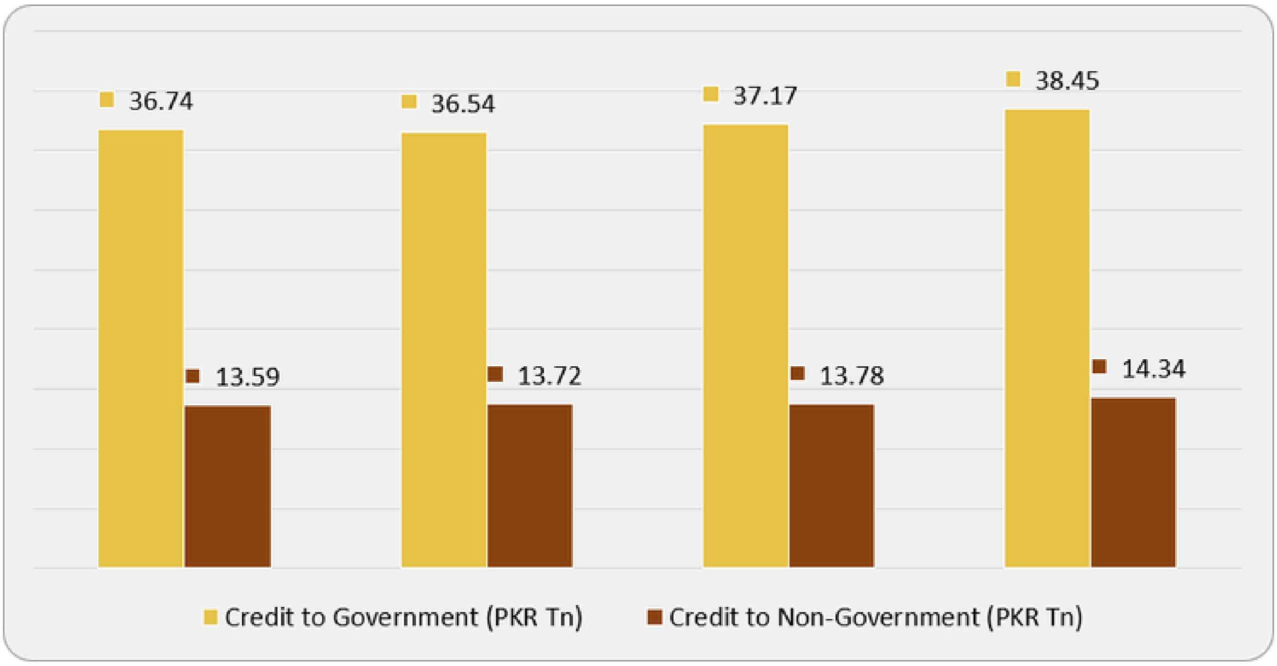


Source: PBS[21]

- QIM fell from 124.96 in March to 117.25 in May, a 6.17% decline. This reverses the positive trend from earlier in the fiscal year when QIM jumped to 144 in January, and LSMI grew 10.5% year-on-year.
- The drop reflects higher input costs, tighter monetary conditions after the increase in the policy rate, and demand compression as double-digit inflation eroded purchasing power.
- Policy Note: Structural supply-side reforms, including industrial energy pricing, regulatory simplification, and credit access, are needed to decouple manufacturing from monetary policy cycles. Reorient support toward export-generating sectors rather than domestically oriented ones whose growth depends on consumer demand cycles.

[21] https://www.pbs.gov.pk/summary-of-provisional-quantum-index-numbers-of-large-scale-manufacturing-industries-qim-for-april-2026/

Figure 15: Credit to Government & Non-Government Sector

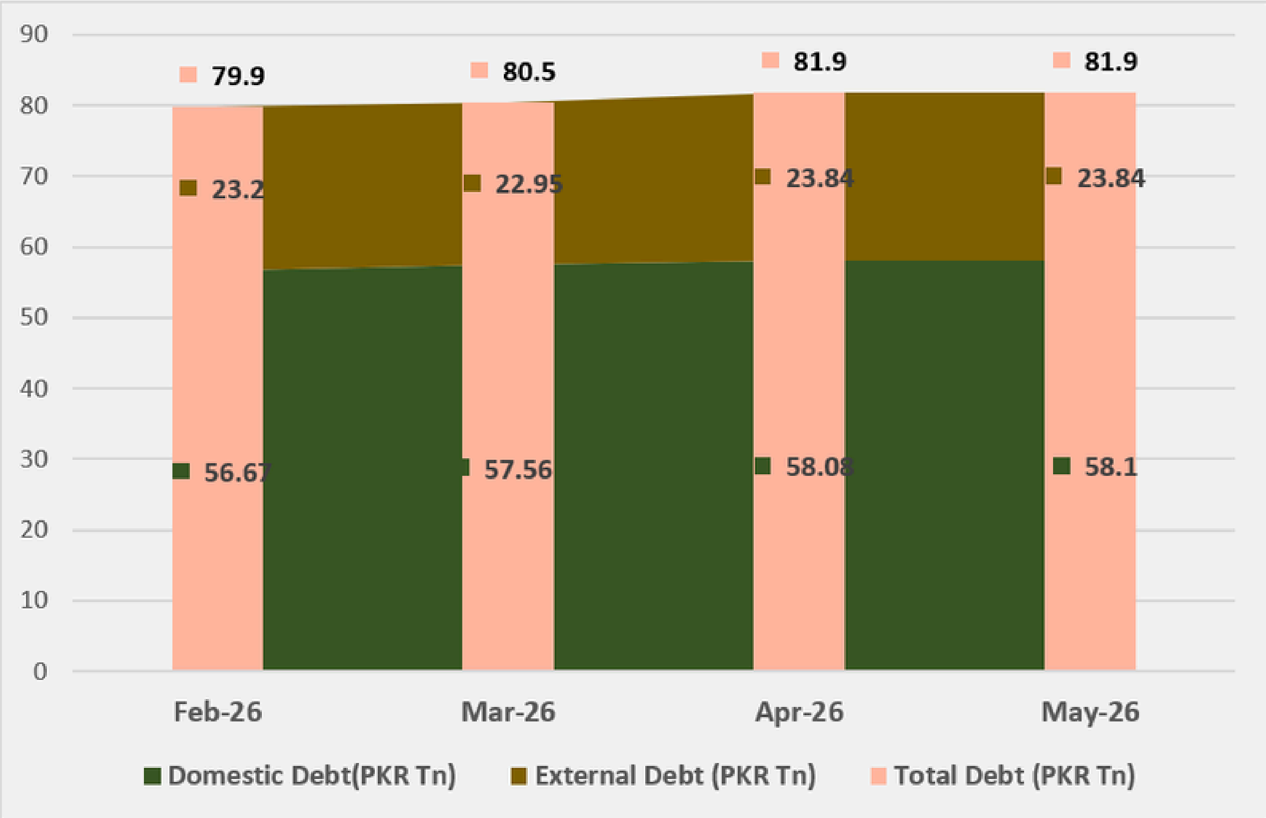


Source: SBP[22]

- Government credit fell marginally in April (PKR 36.5tn) before surging to PKR 38.45 tn, a new high. Private sector credit showed a slight increase from PKR 13.59tn to PKR 14.34. For every rupee flowing to the private sector, approximately PKR 2.7 goes to the government.
- The modest increase in private sector credit suggests lending to productive sectors remains subdued despite easing monetary conditions.
- Policy Note: Pakistan's credit allocation challenge is rooted in fiscal dominance. Sustained fiscal consolidation would reduce the government's reliance on bank financing, freeing resources for the private sector. At the same time, reforms to strengthen credit markets, including improved collateral recovery, better credit information, and support for export-oriented and SME lending, would help channel financing toward productive investment.

[22] https://easydata.sbp.org.pk/apex/f?p=10:211:9577876461653::NO:RP:P211_DATASET_TYPE_CODE,P211_PAGE_ID:TS_GP_BAM_CRLONBOR_M,210&cs=112954267502CDD3E6C490C34711DE586

Figure 16: Debt Profile of Pakistan



Source: SBP[23]

- Total debt rose from PKR 79.9trillion (Feb) to PKR 81.9trillion (May). Domestic debt reached PKR 58.1trillion and external debt totalled PKR 23.8 trillion. The increase of Rs 2 trillion in domestic debt reflects continued government reliance on bank borrowing.
- At the SBP policy rate of 11.5%, carrying costs are enormous. The April policy rate hike (100bps) will add meaningfully to debt servicing in FY27. The feedback loop is clear: high deficits require borrowing, borrowing raises servicing costs, inflation forces rate to increase, and increase in policy raises costs further.
- Policy Note: Prioritise fiscal consolidation through revenue mobilisation and expenditure rationalisation. The budget's primary surplus target of 2.0% of GDP for FY27 is in the right direction. Execution will determine whether the debt trajectory bends.

[23] https://easydata.sbp.org.pk/apex/f?p=10:211:::NO:RP:P211_DATASET_TYPE_CODE,P211_PAGE_ID:TS_GP_BAM_CENGOVTD_M,210&cs=1453DC1491BDB202E723BA5FCE7B9CD9D

Annexure

1. **Physical Size: Government Departments and Employees**
   - The government notified the transfer of the administrative control of the Public Private Partnership Authority (P3A) from the Planning, Development and Special Initiatives Division to the Privatization Division
   - Govt advances Fesco sale, Islamabad airport deal
2. **Non-Development Spending**
   - Under this head, no development reported
3. **Power Sector: Privatization of GENCOs and DISCOs**
   - Privatisation Commission approved key recommendations for submission to the Cabinet Committee on Privatisation (CCoP) regarding the privatisation of the first batch of Discos, that is, Fesco, Gepco, Iesco
   - EoIs for 3 DISCOs will be floated after approval: PC
   - Iesco, Gepco, Fesco up for sale, offer up to 100pc stakes
   - Govt launches international outreach for Discos sale
   - Govt eyes 20pc rate of return to attract buyers for three Discos
   - Govt advances Fesco sale, Islamabad airport deal
   - Govt offers 20pc returns to woo buyers
   - Privatisation board okays FESCO restructuring
   - Board also declared a consortium led by KPMG, in partnership with Bridge Factor and others
   - Pakistan extends Fesco, Gepco bid deadlines by up to a month
4. **The SOEs: Privatization of PIA, Pakistan Steel Mills, Etc.**
   - Govt aims to hand over PIA control to new buyer in April
   - CCP clears PIA acquisition by consortium
   - The transaction is part of the government's privatisation initiative
   - Arif Habib consortium forms SPV (Special Purpose Vehicle) for full PIA takeover
   - Privatisation board reviews progress on PIA first closing
   - President signs PIA Repeal Bill, completing privatisation formalities
   - Import of aircraft, parts: ST exemption solely for PIACL opposed by the Senate Standing Committee on Finance
   - PIA to be handed over to new owners this month (22-6-2026)
   - Arif Habib Consortium takes over PIA management as govt formally completes privatisation process
   - PIA says the transition marks 'bold new chapter of modernisation and global excellence' for the national flag carrier
   - Private era begins for national flag carrier
     - New management pumps Rs80bn into PIA, pays Rs10bn to govt
     - 40 conditions met before formal handover to new owners
     - PM terms handover 'milestone in economic reforms'
     - Restructured PIACL board to be headed by Fauji Fertiliser chairm
   - PSM losses skyrocket 1,355pc to Rs245.9bn: AGP
   - Railways generates record Rs115bn revenue: Abbasi
   - Railway revenue rises 24.19% year-on-year to Rs115b
   - Minister says ML-1 groundbreaking in Sept; ML-2 to be developed under PPP model
   - Railways in loss despite record revenues
5. **Liberalization and Deregulation**
   - Under this head, no development reported

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