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PAKISTAN:
Country Development Landscape

Working Paper
January 12, 2014

THE WORLD BANK

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Abstract

This Country Development Landscape (CDL) is an analytical input for the preparation of the World Bank Group (WBG) Country Partnership Strategy (CPS). It assesses the country's most recent performance, and benchmarks it to regional peers and global comparators; identifies the most critical development constraints and challenges; summarizes the Government's vision for the future and its FY 2014-18 development program; identifies some of the most promising opportunities; and weighs their scenarios and trade-offs for eliminating poverty and increasing shared prosperity in Pakistan.

This CDL benefits from most recent Bank's analytical work for Pakistan. It follows the interim guidelines for the new country Partnership Strategy—CPS—and includes findings from the following major recent reports: (i) Poverty Assessment (FY 2012) and updates (FY 2013 and FY 2014); (ii) Private Sector Development Task Force (FY 2011); (iii) Investment Climate Assessment (FY 2011) and Enterprise Survey (FY 2012); (iv) Country Economic Memorandum on Job-enhancing Growth (FY 2013); (v) Policy Notes for new Government (FY 2013); (vi) Doing Business Reports (annual); (viii) multiple provincial reports (including Public Expenditure Reviews for Punjab and KPK and PEFAs for Punjab, KPK and Sindh); (ix) several IFC studies; and (x) multiple regional flagship reports. However, the CDL is a self-standing informative report.

PAKISTAN:

Country Development Landscape

Abbreviations and Acronyms

BISP	Benazir Income Support Program
CDL	Country Development Landscape
CO_2	Carbon Dioxide
CPI	Consumer Price Index (CPI)
CPS	Country Partnership Strategy
DISCOs	Distribution Companies
EMBI+	Emerging Markets Bond Index Plus
EU	European Union
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FY	Fiscal Year
GDP	Gross Domestic Product
GENCOs	Generation Companies
GFS	Government Finance Statistics
GHG	Greenhouse gas emissions
GSP+	Generalized Scheme of Preferences Enhanced Preferences
HDI	Human Development Index
IBIS	Indus Basin Irrigation System
ICOR	Investment-capital ratio
ICT	Information and Communication Technology
IFC	International Finance Corporation
IMF	International Monetary Fund
ISO	International Organization for Standardization
KPK	Khyber Pakhtunkhwa
MAMS	Maquette for MDG Simulations
MDG	Millennium Development Goals
MW	Mega Watts
NADRA	National Database and Registration Authority
NATO	North Atlantic Treaty Organization
NEC	National Economic Council
NEPRA	National Electric and Power Regulatory Authority
NFC	National Finance Commission
NPL	Non Performing Loans
ODA	Official Development Assistance
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PKR	Pakistani Rupee
PML-N	Pakistan Muslim League—Nawaz
SAARC	South Asian Association for Regional Cooperation
SAR	South Asia Region
SEZ	Special Economic Zones
SMEDA	Small and Medium Enterprise Development Authority
SMEs	Small and Medium Enterprises
SOEs	State Owned Enterprises
SRO	Special Regulatory Order
TDS	Tariff Differential Subsidy
TFP	Total Factor Productivity
TVET	Technical and Vocational Education and Training
UNDP	United Nations Development Programme
US	United States
WBG	World Bank Group
WEF	World Economic Forum

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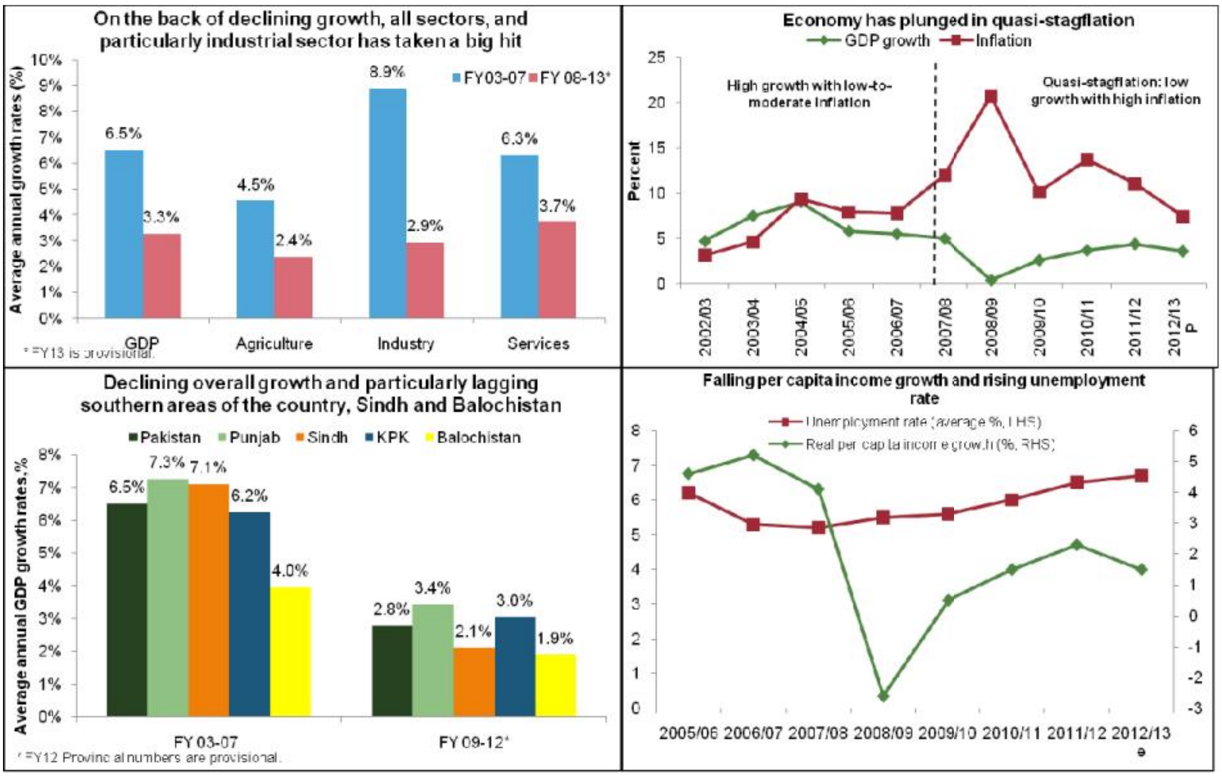
A Country in Transition

Five Factors that Shape Pakistan Nowadays

1. Pakistan's economy is not performing well and over a long-term declining trend. The country's present economic slump is the deepest in half a century. One has to go back to 1963–73 to find a boom–bust episode comparable to that of 2004–13. Indeed, its rebound from the global financial crisis has been slow and it is facing the prospects of a second balance of payments crisis in less than five years. Its recovery from the 2008-09 global financial crisis has been the weakest in South Asia Region (SAR), featuring a unique double-dip growth pattern (Figure 1). Pressing short-term macroeconomic imbalances were barely improving when two floods hit the country in 2010 and 2011, the fourth and fifth natural disasters in five years. Despite some recovery of exports and strong dynamism in remittances, borderline stagflation continues—modest growth with double-digit inflation rates—compounded by, until recently, unsustainable macroeconomic policies and domestic and international armed conflicts that keep investment depressed. As a result, Pakistan's current GDP growth rates (average of 3.5 percent in the last 4 years) are below output potential and half its level of five decades ago—markedly diverging from its main neighboring competitors, China and India. The country has no choice but to regain macroeconomic stability and recreate a proper business climate for attracting private investment and raising physical capital.

Figure 1 **Quasi-Stagflation and Unemployment**



Source: World Bank 2013, Punjab Public Expenditure Review; Pakistan Economic Surveys (various years); SBP; IMF Article IV Sept 2013.

e is estimate. Base years for national GDP and sectoral growth numbers are 1999-00 for FY 2003-05; and 2005-06 for FY 2006-13. Provincial GDP base year is 1999-00.

2. The country's most pressing medium-term challenge is to optimize its population bulge. Population is projected to almost double from 180 million to over 350 million by 2050, mostly unskilled working age youth not ready for high quality productive jobs. With one of the highest fertility rates worldwide, Pakistan's labor force is increasing faster (3.5 percent a year) than the SAR average (3.1 percent). Its youth workforce, including share of women, is rising even faster at 4.3 percent a year, well above the regional average of 2.7 percent. These patterns of population growth are expected to last for at least 10 more years. Such a bulge could either be a major political and social burden or an extraordinary dividend to propel growth. Informality of more than 70 percent of total employment puts Pakistan among the countries with the highest ratios. Rapid urban population growth combined with informality can be both a symptom of lower productivity and a cause, as excess supply of labor often leads to low-skilled jobs, and low pay, thus creating a vicious cycle. To reap this population dividend, Pakistan should invest more on human capital and improve productivity, thus creating not only more but better quality—more productive—jobs.

3. The devolution process marks a turning point in intergovernmental relations. The 7th Award and the 18th Constitutional Amendment agreed in 2009 and 2010 respectively shape the new federal, provincial and local development agendas, as a reaction to overlapping responsibilities and ensuing poor service delivery. A total of 43 departments of 18 ministries were abolished and transferred to the provinces, including food and agriculture, primary and secondary education, health, environment, youth affairs and woman development. A new redistribution formula added rate of change in poverty (10.3% weight), provincial tax effort (5% weight), and inverse of population density (2.7% weight) to previous single criterion—population (82% weight)—and shifted additional revenue sharing in favor of the provinces from 46.3 percent to 57.5 percent of the divisible pool of federally collected taxes. Taxing powers of the provinces have been expanded, including sales tax on services; and internal and external borrowing by provinces has been permitted subject to limitations imposed by the National Economic Council. Similarly, the share of provincial governments in total public investment (development) program has risen. However, expected results are still far from their goals. Not only devolution arrangements have created significant fiscal unbalances (see below), but provincial governments have struggled with limited management capacity, which has negatively affected service delivery and development outcomes. With new local governments coming in the next few months, Pakistan needs to rebalance its intergovernmental fiscal relations and upgrade its provincial and local governments' implementation and service delivery capacity.

4. A more frequent number of recent natural disasters has caused huge losses and set back to the country's development efforts. Floods in 2010 and 2011 recorded damage amounting to US$ 10 billion and US$ 3.7 billion, respectively; while the earthquake in 2005 resulted in 73,000 fatalities and US$ 5 billion in losses. The country has also had its share of droughts and cyclones in recent years. In a country, where close to three quarters of the population lies below the vulnerability threshold (2 times the poverty line) a minor shock can quickly destroy capital assets and revert vulnerable families into poverty. Pakistan needs concerted efforts for disaster risk reduction and mitigation to preserve its poverty and shared prosperity gains.

5. Pakistan's security environment and law and order situation remains volatile, with continuous uncertainty over emerging geopolitical scenario in the region. Most recent Bank

estimates show the annual costs of security conflict in Pakistan at no less than 2 percent of GDP, with deep implications over the country's efforts at attracting private and foreign investment. The negative correlation between violence and growth is well established. Pakistan's violence (measured by deaths per capita) is much higher than expected for its income level. Pakistan ranks second (after Iraq) of 158 countries on the 2012 Global Terrorism Index. Violence is correlated with poverty as well as growth: provinces with the highest conflict intensity (Khyber Pakhtunkhwa and Sindh, in particular) have higher poverty rates. Pakistan must ponder the implications of the post-2014 withdrawal of NATO forces from Afghanistan and possible spillovers of that conflict, as well as minimize tensions with India that could negatively impact its huge potential regional trade and transit opportunities.

Recent Trends in Poverty and Shared Prosperity

6. The overarching goals of the World Bank Group Pakistan CPS (FY 2014-18) are to help the country accelerate poverty reduction and boost shared prosperity. Hence, a detailed picture of recent trends in both outcomes is quintessential, before engaging into a more elaborated review of its development landscape.

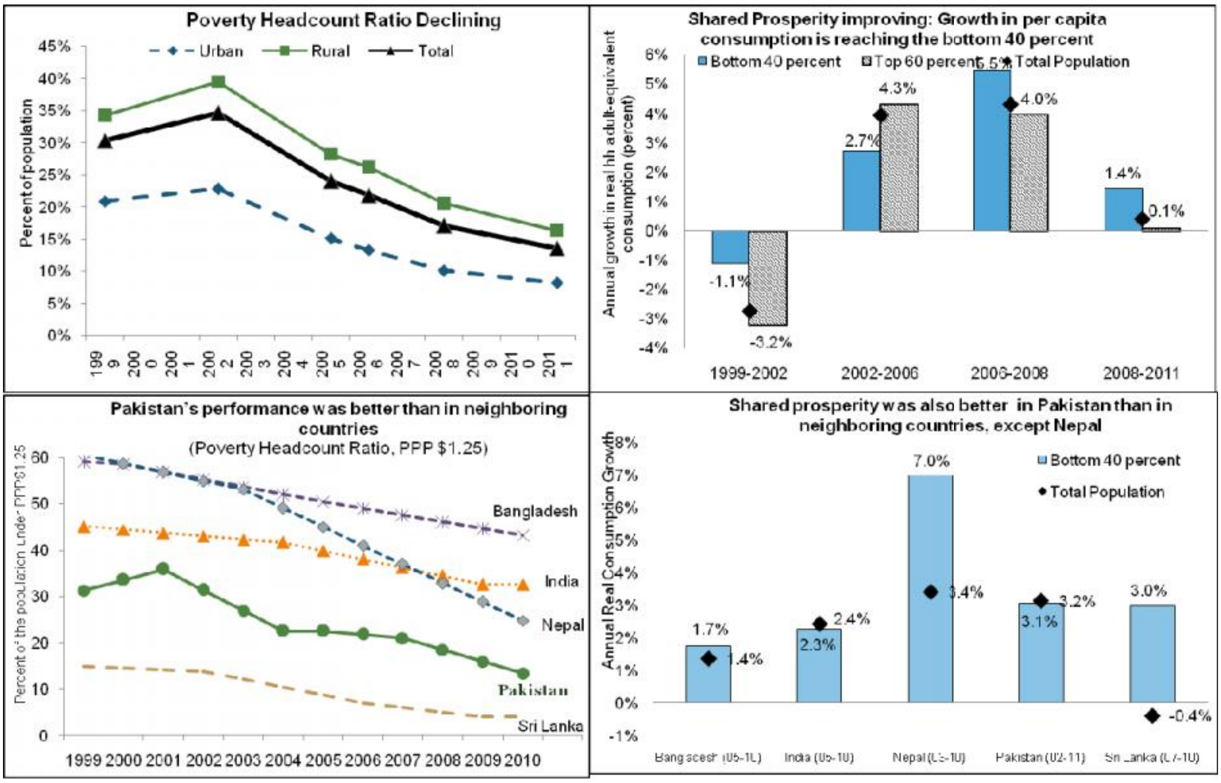
7. Pakistan has made impressive progress in reducing absolute poverty and improving shared prosperity during the last two decades. In the last decade, Pakistan's national poverty rate fell by one percentage point per year, which though, average by international standards remains impressive. The country has already achieved the first Millennium Development Goal (MDG) by more than halving the proportion of people whose income is less than US$ 1.25 a day between 1991 and 2011. The percentage of population below the national poverty rate has fallen from 34.7 percent in FY 2002 to an estimated 13.6 percent in FY 2011. The poverty reduction has been led by rural areas, where poverty has decreased by 23.2 percentage points (versus 14.7 percent in urban areas) between FY 2002 and FY 2011. Despite these gains, a huge concentration of the nation's poor (four out of five) still lives in rural areas and requires upmost attention. However, poverty reduction in urban areas is also relevant as Pakistan is rapidly becoming an urbanized country with an emerging middle class and the economy shifting toward non-farm and service-oriented activities requiring a labor force with new skills; but also with growing slums and informal low-paid jobs (Figure 2).

8. Pakistan's impressive progress against poverty is also reflected in broadly shared prosperity. Real per capita consumption of the bottom 40 percent of the population—a measure of shared prosperity—grew 5.5 percent in FY 2006-08. Such growth in per capita consumption for the bottom 40 percent exceeded that of the top 60 percent that grew by 4 percent. However, progress slowed down to 1.4 percent in FY 2009-11 due to the end-decade floods, conflict, global slowdown and the twin-macro crisis. Overall, the improvement in living standards for the bottom 40 percent remains impressive even by regional standards: Between 2002-2011, shared prosperity in Pakistan was higher than in all SAR countries, except for Nepal.

9. Growth in Pakistan is broadly inclusive. Growth incidence analysis confirms the pro-poor characteristic of Pakistan's growth, which reinforces its importance for the country. The national Gini coefficient fell between FY 1999 and FY 2011, from 0.34 to 0.29; the lowest levels of consumption inequality in SAR. However, important variations occurred during the

booming-bust periods of the decade: the Gini coefficient grew a little from 0.31 to 0.35 during the rapid economic expansion of FY 2002 to FY 2006 (in fact, the contribution of inequality to growth was negative at minus 1 percent per annum in such years); but gradually declined to 0.29 by FY 2011. Inequality is broad as it has fallen consistently with the national pattern in each province.

Figure 2 **Poverty Reduction and Shared Prosperity**



Source: World Bank staff calculations using Pakistan HIES/PSLMS data.

10. Poverty remains widespread but convergent among all provinces. Overall, more than 21 million Pakistanis still live in poverty. Punjab has about 57 percent of the poor, followed by Sindh (23 percent), KPK (14 percent) and Balochistan (6 percent). Poverty rates do not vary significantly across provinces, except for Balochistan during years that appear as outliers (FY 2006 and FY 2008). Indeed, a sizeable portion of residents in Balochistan are nomadic in conflict areas whose characteristics are hard to collect. So, in FY 2011, whereas Balochistan had a poverty rate of around 17 percent, all other provinces converged at around 13 percent. Poverty has traditionally been higher in the outlying provinces of KPK and Balochistan, and since 2002 reductions in poverty have been fastest in KPK (28.5 percentage points). Poverty reduction has also been rapid in more populous—and rural—Sindh and Punjab, falling by 24.8 and 17.8 percentage points respectively between FY 2002 and FY 2011. Pakistan's ability to reduce poverty stems from a large share of households clustered near the poverty line. Indeed, the poverty gap, which measures how far the poor are from that poverty line, features a small distance regardless of the province where a typical Pakistani poor resides.

11. Because poverty reduction has been largely driven by growth, efforts to reduce poverty and increase shared prosperity have suffered from rising GDP volatility during last

decade. The recently declining rates of consumption of the bottom 40 percent make shared prosperity gains vulnerable to frequent growth slowdowns. In the last five decades, the country has barely experienced two episodes of sustained growth in two periods (FY 1963-67 and FY 2004-07). Due to global shocks and natural disasters, per capita GDP growth volatility has doubled from 1.4 in the 1980s to close to 2.5 in the 2000s. Given the combined impact of short-lasting rapid growth episodes with increased volatility in GDP per capita, it is important to continue to develop policies that help households cope with risk due not only to shocks and natural disasters, but to illness, poor crop yields and job losses, such as the cash transfer from Benazir Income Support Program (BISP).

12. Progress against poverty and in favor of shared prosperity is not matched by progress on a range of human development indicators, where Pakistan continues to lag behind world averages. The country ranks 146 out of 186 on the UNDP's 2012 Human Development Index. At 66.3 years, life expectancy at birth is more than 4 years above the world average, and persistently high rates of malnutrition contribute to other health problems and undermine learning and productivity. At 25+ years, educational attainment is low (average 4.9 years of total schooling in 2010), and Pakistan still has more than 40 percent of its population illiterate (58 percent literacy rate for 10+ years population). Gender inequality remains high despite progress in education, health, maternal mortality and fertility. The ratio of girls to boys in schools has increased, and female participation in labor force is projected to increase from 23 to 27 by 2020, but is still low.

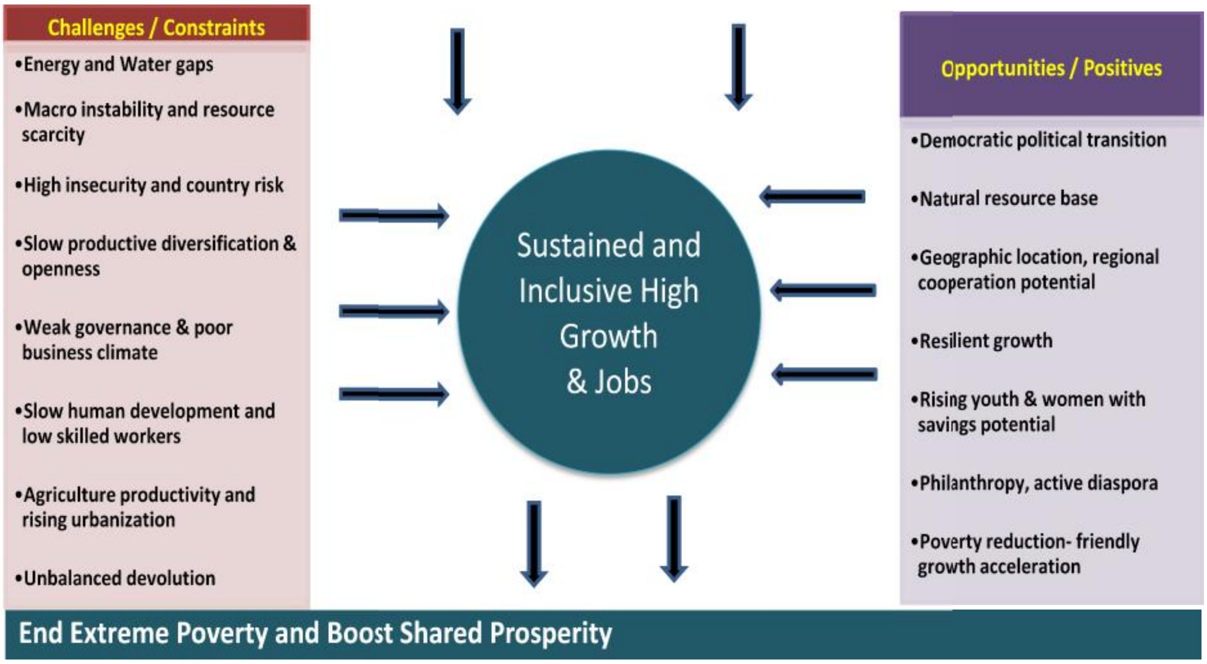
The Development Landscape of Pakistan

13. This section assesses the development landscape of Pakistan. It is divided into three parts:

   a. Global Trends Contributing to Change
   b. The Country's Positives
   c. Main Challenges/Constraints

14. Figure 3 depicts how these three components fit into the overall picture. Whereas the first section introduces major external developments shaping the country's situation, the second section reveals its assets; and finally, the third section identifies binding constraints and major development challenges.

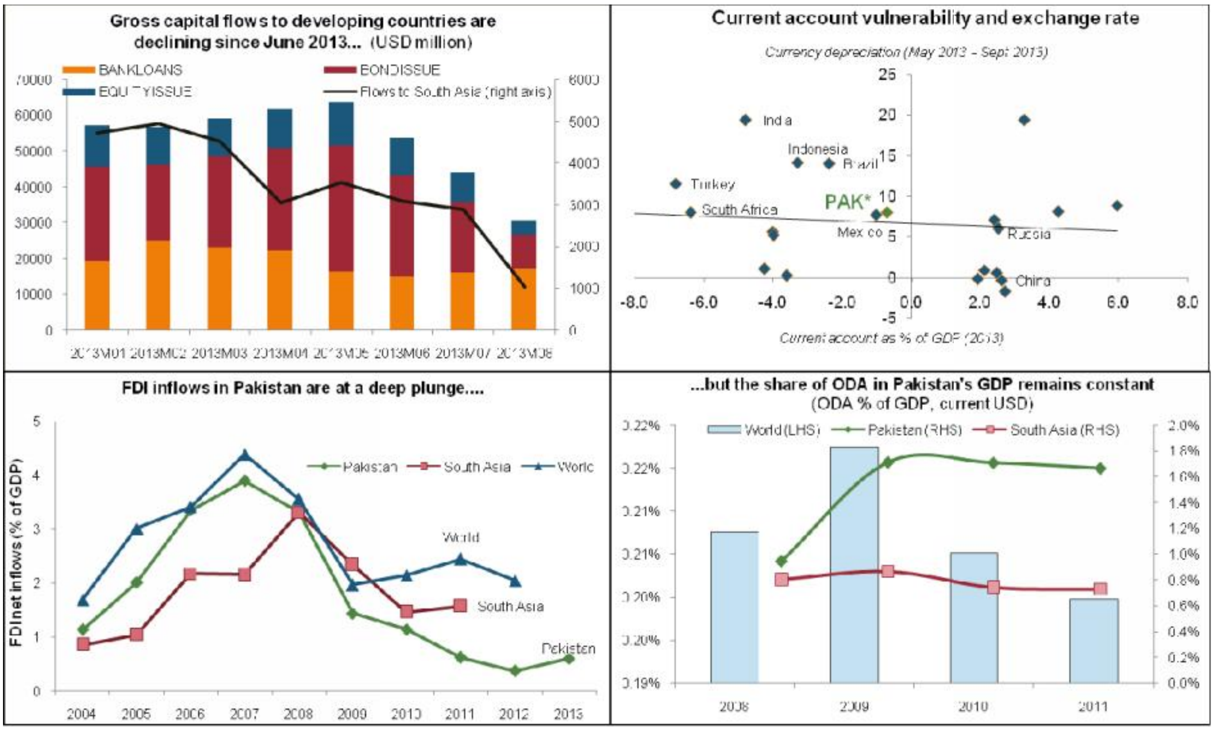
Figure 3 **Pakistan's Development Landscape: The Diagnostic Framework**



Global Trends Contributing to Change

15. A series of external developments are shaping the external environment surrounding Pakistan's development prospects (Figure 3). In particular, five factors have played major roles: (i) Private capital and official development assistance (ODA) inflows; (ii) transfers of innovations; (iii) global markets recovery; (iv) rising citizens' voices worldwide; and (v) climate change and natural disasters.

Figure 4 **Global Trend and Pakistan's Performance**



Source: WDI; World Bank DEC Global Prospects Data; IMF WEO; and World Bank staff calculations.

16. Private capitals in emerging markets have markedly declined and dwarfed ODA remains significant but stagnant in Pakistan. Global portfolio rebalancing is putting pressures on private capitals in emerging markets. Markets like Pakistan, affected by its so-called structural weaknesses—including conflict and security—have become less attractive. This movement accentuated in 2013. Gross capital inflows to SAR countries—either equity, bonds or commercial bank loans—dramatically declined from US$ 4.6 billion to US$ 1.2 billion between January and August 2013. Ensuing currency adjustments, as a function not only of diverging countries' vulnerabilities but also of central bank interventions followed. While the Pakistani rupee depreciated 5 percent in FY 2013, it has slumped by about 10 percent in the first six months of FY 2014. Global rebalancing has also contributed to what seems to be another structural decline in FDI flows to the region. Pakistan's FDI inflows dramatically fell from 4 percent of GDP in FY 2007 to 0.5 percent of GDP in FY 2013. In contrast, whereas the global share of ODA in World GDP has fallen since 2009, its share in Pakistan GDP remains high, essentially constant at about 1.8 percent during the last four years.

17. Transfers of worldwide innovations are elusive, thus limiting their key contribution to foster productivity, quality job creation and businesses knowledge sharing. Barely 2 percent of Pakistani manufactured exports have high-technology base, against an average 6 percent in SAR and 14 percent worldwide. The WB Enterprise Survey (2010) found that only 6 percent of surveyed Pakistani firms had introduced a new product in the last three years; whereas in highly innovating countries, like Chile, 70 percent did so. Mobile phone penetration, a common indicator of technology sophistication lags in Pakistan at 60 percent when compared to average 81 percent worldwide, with operators in Pakistan still using an outdated '2G' technology, when most countries in the world are already applying more

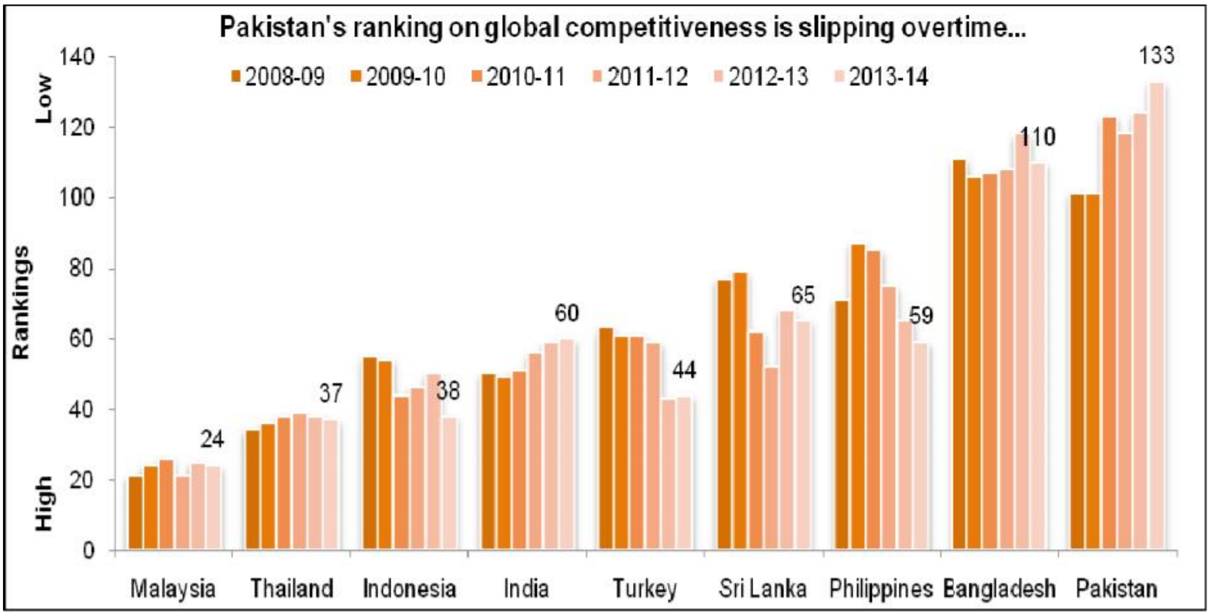
advanced '3G' or '4G' to support improved data exchange and access to information. Pakistan is ranked lower than China and India on three global innovation indexes—global innovation, global competitiveness, and innovation capacity—which reflect low levels of research activities, patent applications, and International Organization for Standardization (ISO) certifications (Table 1, Figures 5 & 6).

Table 1 **Pakistan Ranks Very Low in Different Innovation Indexes**

Country	Global Innovation Index (2013)	Global Competitiveness Innovation Pillar (2012/13) (technological readiness)	Innovation Capacity Index (2010/11)
Worst	**142**	**144**	**130**
Pakistan	137	118	102
India	66	96	88
Sri Lanka	98	89	86
Bangladesh	130	125	110
Brazil	64	48	81
South Africa	58	62	52
Thailand	57	84	--
Egypt	108	91	75
Philippines	90	79	81

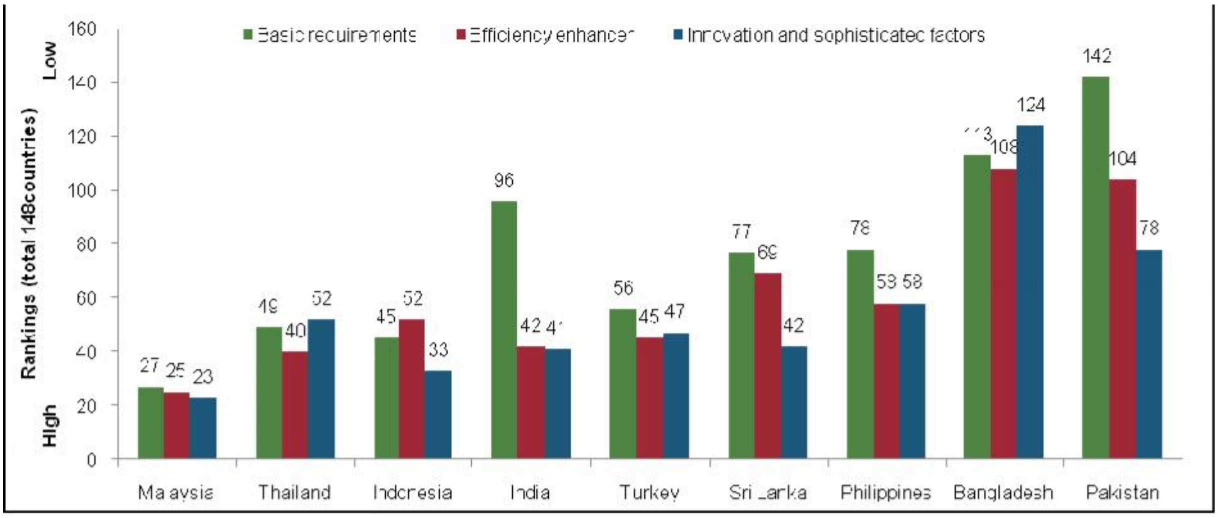
Source: Global Innovation Index; World Economic Forum; Innovation for Development Report.

Figure 5 **Pakistan's Falling Competitiveness**



Source: World Economic Forum, Global Competitiveness Report (various years)

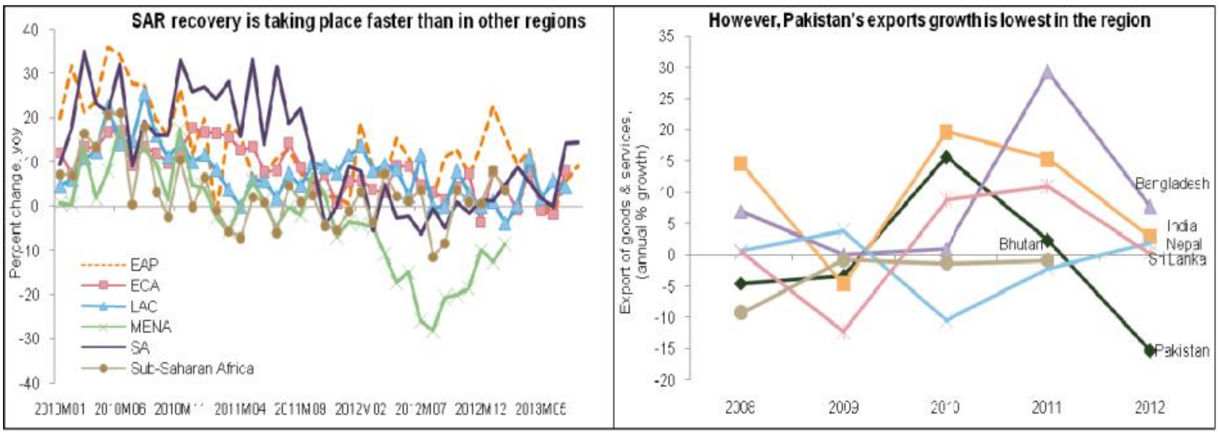
Figure 6 **Competitiveness Sub-Indexes (2013-14)**



Source: World Economic Forum, Global Competitiveness Report (various years)

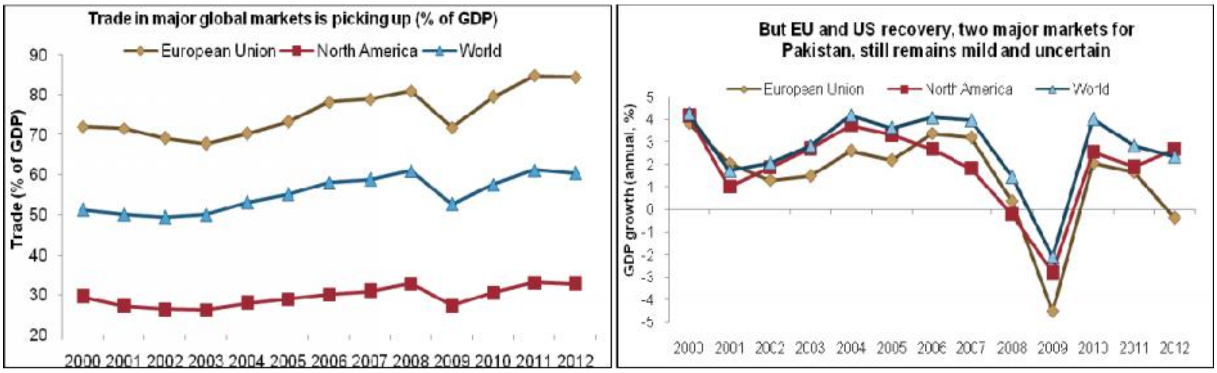
18. Weak global markets recovery is slowly taking place in main developed economies, but commodity prices are declining (Figure 7). The global economy is picking up, but emerging markets, including those in Asia are lagging. A key driver is the European Union, the world's largest trading bloc, whose recovery continues to be shackled by necessary banking sector deleveraging, fiscal consolidation and high unemployment. The US and EU economies reached positive growth rates in 2013, but the aftermath of growth recession in the US and European economies has kept global trade contracted (Figure 8). Global trade mildly increased from 3.2 percent in 2012 to an estimated 3.5 percent in 2013–still well below the average of about 7 percent between 2000 and 2005. Pakistan's trade openness ratio and share of global exports however has remained stagnant at 32 percent of GDP and 0.4 of total world exports respectively—contrary to other emerging exporters, it has failed to increase mainly because of supply constraints and slow products diversification. For its part, the effect of commodity price declines is mixed: Oil prices retreat, as risk of conflicts recedes worldwide; albeit most agricultural prices are also declining steadily, which is particularly the case of rice, but not of cotton whose prices were markedly stable during 2013.

Figure 7 **Global Market Recovery is Weak**



Source: World Bank (DEC, and WDI)

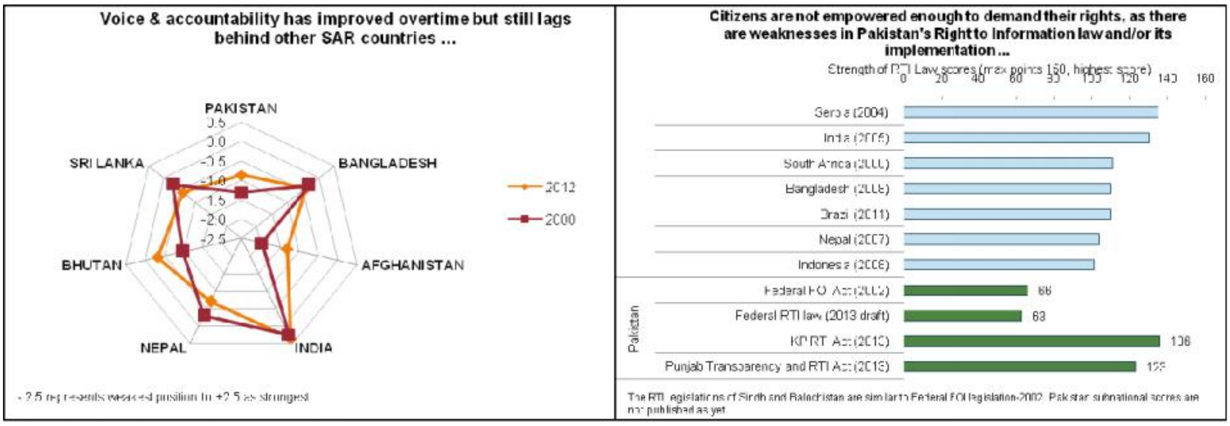
Figure 8 **Trade in Global Markets**



Source: World Bank (DEC, and WDI)

19. Voice and accountability are improving in the SAR region, but Pakistani citizens are not yet as fully empowered. The country is remarkably adapting its democratic transition to worldwide trends. According to WBG Governance Indicators, compared to a decade ago, Pakistan's rating in voice and accountability has improved from -1.5 to -1.0, but still is lowest in the SAR region, except for Afghanistan (Figure 9). Pakistan also ranks low on the rights to information legislation, which reflect low empowerment of its citizens, especially at the federal level. However, such rating has turned positive and high for KPK and Punjab, two provinces with Parliaments having recently passed right to information bills.

Figure 9 **Pakistan's Low Rating in Citizen Voice and Accountability**

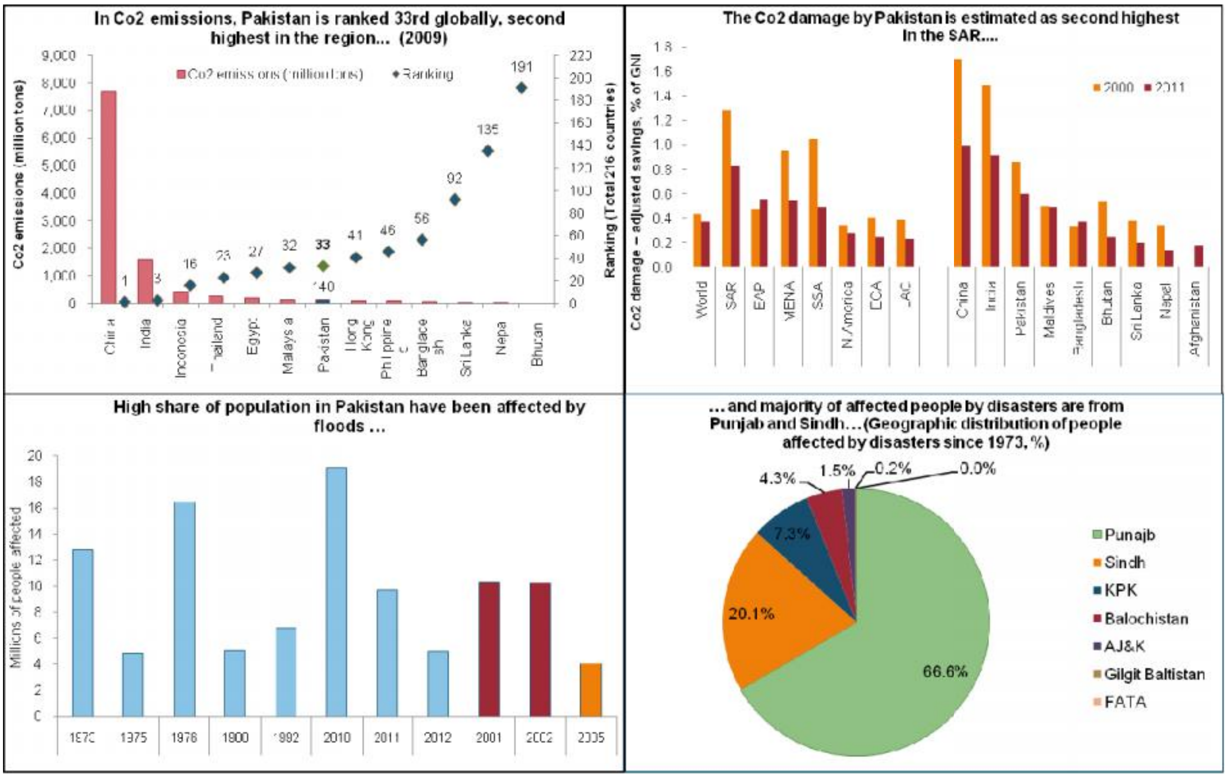


Source: WGI; and Centre for Law and Democracy.

20. Climate change is contributing to make the country more vulnerable to natural disasters. Pakistan is highly vulnerable to climate change because of its high levels of rural poverty, rising population density, heavy reliance on natural resources and an environment already under stress. While Pakistan has a relatively low-carbon economy today and small average greenhouse gas emissions, except for Karachi, both are projected to grow over the next decade. Burning of carbon-based fuels increase concentrations of carbon dioxide (CO_2), raising the rate of global warming, causing climate change and acidifying ocean waters. Greenhouse gas emissions (GHG) will likely increase especially in cities becoming rapidly dense and populated. Increasing GHG will intensify the magnitude and frequency of monsoon rains, floods and droughts. Under a conservative scenario, based on recent trends, Pakistan's mean increase in temperature at 60 ^{o}C in the next 30 years is projected to be

higher than the global warming average at 40 °C, and the highest increase in SAR; mean rainfall will increase 10-15 percent; and hot days and nights per year will increase 20 and 23 days respectively. In CO_2 emissions and CO_2-related damages, Pakistan is ranked 33rd globally, still second highest in SAR region after India (Figure 10).

Figure 10 Climate Change and Increasing Vulnerability



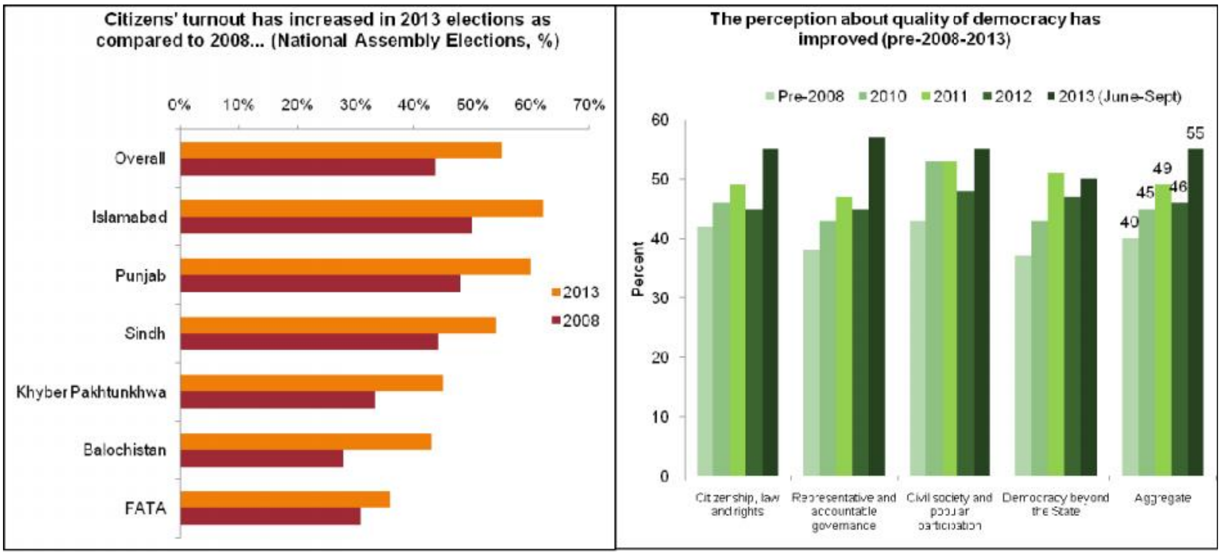
The Country's Positives

21. In order to optimize prospects for performing above potential and achieving full potential in medium term, Pakistan should make good use of at least seven positives. These are: (i) democratic transition; (ii) rich natural resource base; (iii) geographic location with potential regional cooperation; (iv) resilient growth; (v) rising youth and gender labor force; (vi) generous philanthropy from diaspora; and (vii) pro-poor growth accelerations.

22. Pakistan has the window of opportunity offered by the orderly democratic political transition that brought a new Government with a strong mandate to reform and change trajectory for Pakistan (Figure 11). On May 11, 2013 86.2 million registered Pakistanis cast their vote, with the highest voter turnout in the country's 66-year existence (56 percent). The new government led by the Pakistan Muslim League–Nawaz (PML-N) had a clear majority at the center which provides a strong mandate for reform. At the provincial level PML-N retained its mandate to govern Punjab, the biggest province. It also got favorable numbers in Balochistan and chose to become a partner in the coalition there. The two opposition parties–Pakistan Tehreek-e-Insaf won mandate in Khyber Pakhtunkhwa and the Pakistan People's Party managed to maintain its foothold in Sindh provincial assembly. A strong mandate is important as the country's last decade has shining examples to show that solid commitment to isolate important national initiatives from the inefficiencies of the system has borne results. Examples include privatization of the banking sector; deregulation of the

telecom sector; and creation of the National Database and Registration Authority (NADRA), a computerized registration system that supplies an identification card to every citizen. NADRA has contributed to the success of the Benazir Income Support Program (BISP), which has improved the lives of several million poor Pakistanis. The initial steps of the new government have been promising, bringing a new development vision 2025 for Pakistan, supported by a strong program.

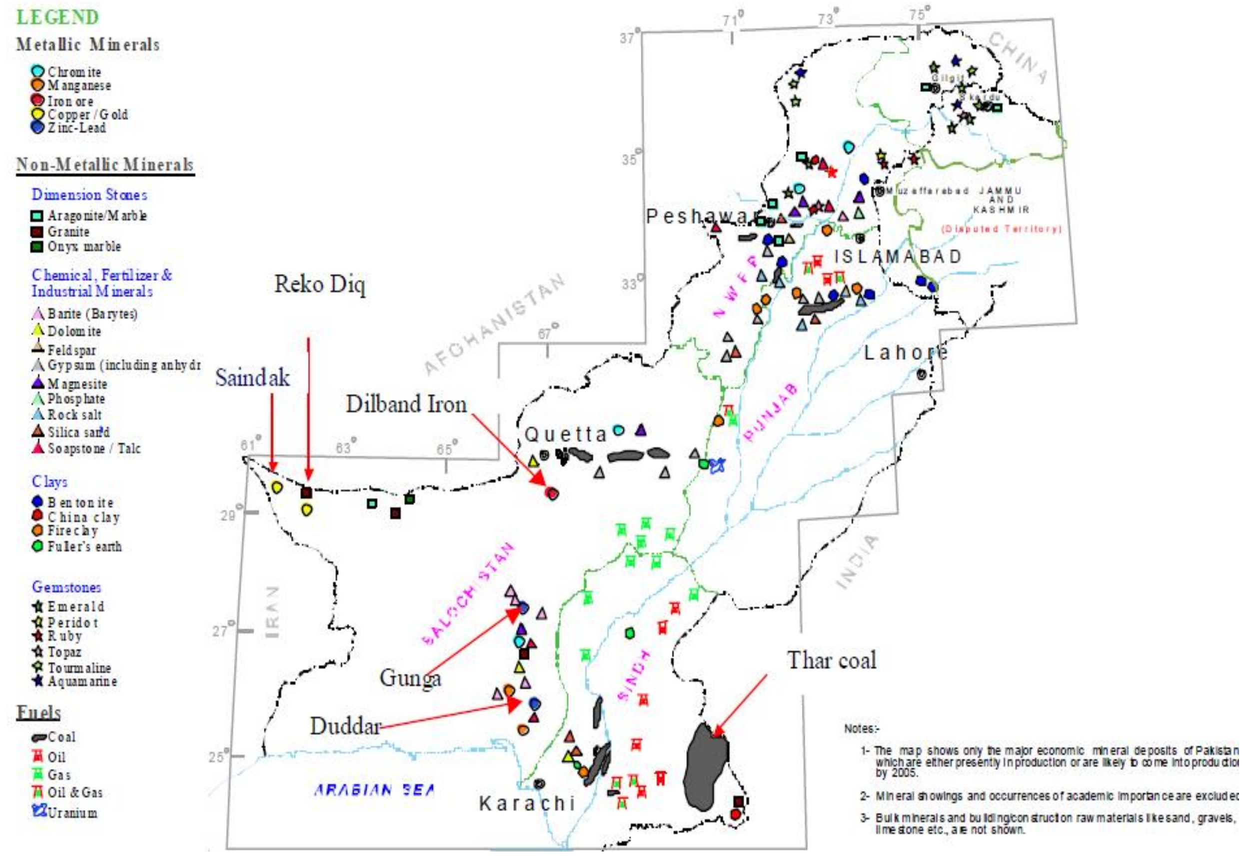
Figure 11 **Democratic Political Transition in Pakistan**



Source: Election Commission of Pakistan; PILDAT (2013). Assessment of the quality of democracy in Pakistan.

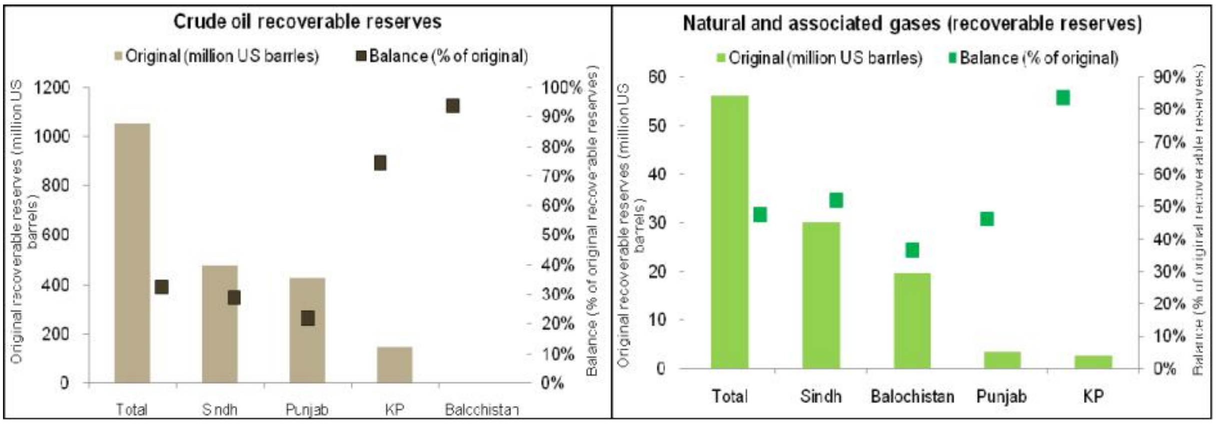
23. Pakistan's rich natural resource base and strategic geographic location can contribute to achieving its potential (Figure 12, Table 2). On the one natural resource front, Balochistan alone has an estimated US$ 3 trillion in mineral resources. Unexploited hydrocarbon reserves are estimated at 27 billion barrels and 280 trillion cubic feet of natural gas (Figure 13). Unexploited hydroelectric potential is estimated at more than 100,000 megawatts, enough to make Pakistan a regional power supplier. On the geographic location front, Pakistan's position as an economic center can improve if regional stability can be achieved, especially after the pullout of the US troops from Afghanistan. Pakistan is the only overland route between India—one of the great economies globally—and the energy-rich countries of Central Asia and the Persian Gulf. It is also China's most direct overland route to the Arabian Sea and the Persian Gulf. Dedicated rail freight corridors from Karachi to Lahore and from Lahore to Islamabad have immense potential to reduce logistic costs. Gwadar's underutilized port opens connections to Afghanistan, China, and the rest of Central Asia and is a logical channel for exports of Balochistan's mineral wealth.

Figure 12 Pakistan's Rich Natural Resource Base



Source: Ministry of Petroleum and Natural Resources, and Geological Survey of Pakistan..

Figure 13 Natural Resource Reserves



Government of Pakistan (2012), Energy Yearbook 2012; Public Bureau of Statistics (2007). Census of Mining and Quarrying 2005/06; and Bank staff calculations.

Table 2 **Metallic Mineral Resources**

Metallic mineral resources	Ore reserves (estimates in billion tones)	Location
Gypsum and Anhydrite	5.6000	Balochistan, Sindh, Punjab
Granite	4.14	
Iron Ore	0.6000	Balochistan
Copper	0.5000	Balochistan
Marble and onyx	0.1602	
Fire Clay	0.1000	Punjab, Sindh
Aluminum	0.0740	Balochistan and Punjab
Lead/Zinc Ore	0.0460	Balochistan
Clays	0.0340	KP, Punjab, Sindh
Barite	0.0300	Balochistan, KP
Phosphate	0.0220	KP
Magnesite	0.0120	KP, Balochistan
Sulphur	0.0008	Balochistan
Soap Stone	0.0006	KP
Flourite	0.0001	Balochistan

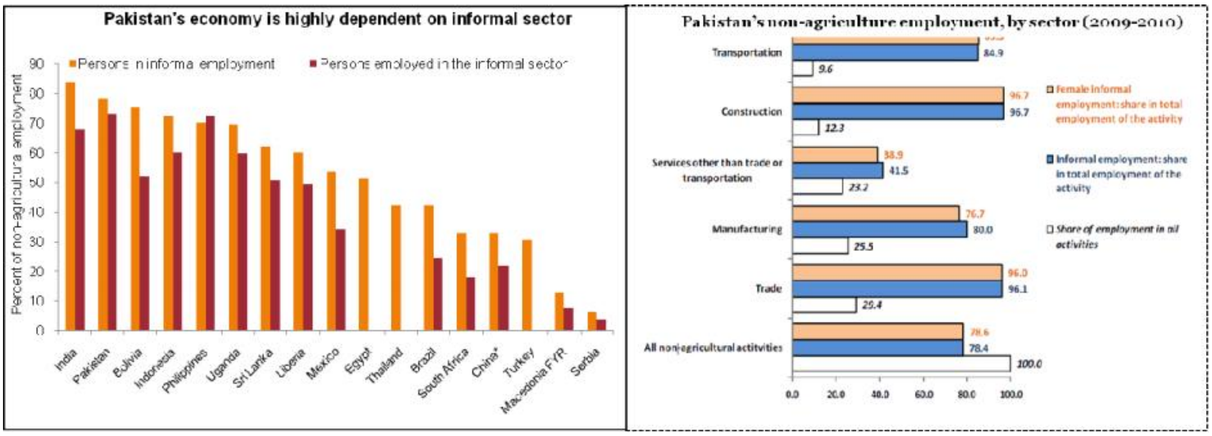
Government of Pakistan (2012), Energy Yearbook 2012; Public Bureau of Statistics (2007). Census of Mining and Quarrying 2005/06; and Bank staff calculations.

24. Pakistan's regional cooperation can be a solid support for growth acceleration in times of economic difficulties, especially 'looking East' with China and India. Saudi Arabia and United Arab Emirates have at critical times sent essential supplies of oil at delayed or reduced payment. However, Pakistan has yet to fully benefit from economic relations with China, whose immense financial reserves and status as the world's second largest economy offer tremendous potential for Pakistan; and with India, once most-favored-nation status (or non-discriminatory access) becomes granted. More joint investments with China and India could boost growth in Pakistan by strengthening integrated value chain production processes and benefitting from the economies' complementarities.

25. Pakistan's economy is extremely resilient. While its growth performance has not matched that of leading Asian economies, it has never collapsed. Three factors cushion the economy against international shocks; agriculture, rising urbanization contributing to the "tertiarization" of the economy as it shifts into services; and remittances. Despite a declining trend in terms of its share of GDP, agriculture still generates about 21 percent of GDP and 45 percent of jobs. Its intra- and inter-sectoral linkages, however, makes its actual economic impact more significant. Agriculture contributes to about 80 percent of export earnings directly and indirectly through forward links to agriculture-based industries such as textiles. Bank estimates also show that agriculture growth is poverty reducing while favoring urban growth. As a major source of raw materials for manufacturing, agriculture contributes to more than 50 percent of basic inputs. And on the demand side, the sector is a large market for products such as fertilizers, pesticides, machinery, and equipment. Furthermore, although ordinary Pakistanis have suffered from double digit increases in food prices in recent years and malnutrition still is a serious problem among the poor, there is no risk of nationwide food shortages or famine. Agriculture's surprisingly rapid recovery from the

floods of 2010 and 2011—especially cotton, sugarcane, and rice—proved its resilience. Pakistan has great potential as a food exporter. The growth of the Chinese, Indian, and Southeast Asian economies is creating rising demand for food, pressuring global food prices. Informality is another reason for the economy's resilience (Figure 14). Much activity is informal, even agriculture features many small family farms and though this contributes to massive underemployment, it also protects large parts of the population from complete immiseration. The same is happening with urban informal employment growing fast in cities. Because of the informal economy's large size (above 70 percent), the economic situation is rarely as bad as official statistics indicate.

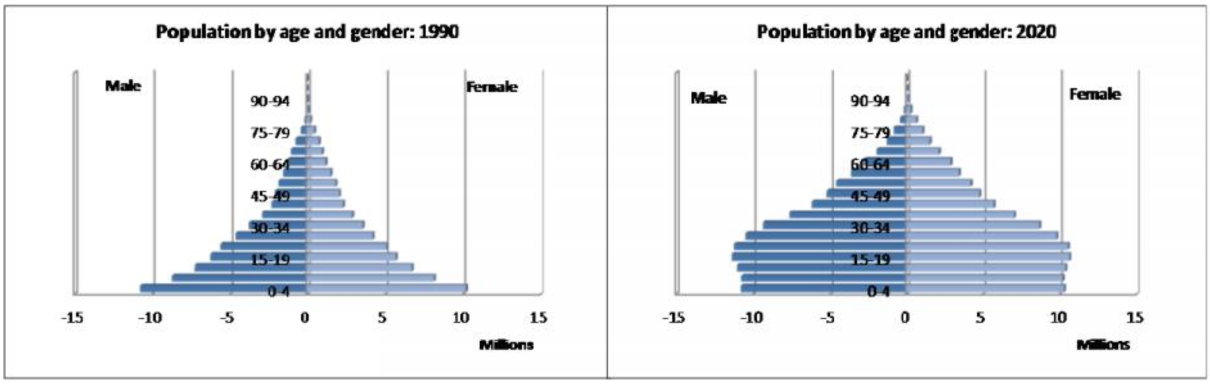
Figure 14 **Resilient Growth Supported by High Informal Sector**



Source: Labor Force Surveys; ILO (2012). Statistical update on employment in the informal economy.

26. Pakistan's quiet revolution is the rapid growth of youth female participation in the labor market (Figure 15). Women have made extraordinary progress in the last decade. Female literacy has improved, albeit from a low base. There are now more women than men in colleges and universities. In a country still featuring the highest rate of young women unemployed not actively looking for a job worldwide (above 50 percent), if female labor force participation rises from 23 to 27 percent as expected, the pressure for new jobs will be even stronger. Every three years, a million well educated and trained women will join the workforce, and many will take jobs in the economy's modern sector or add to family income through part-time work.

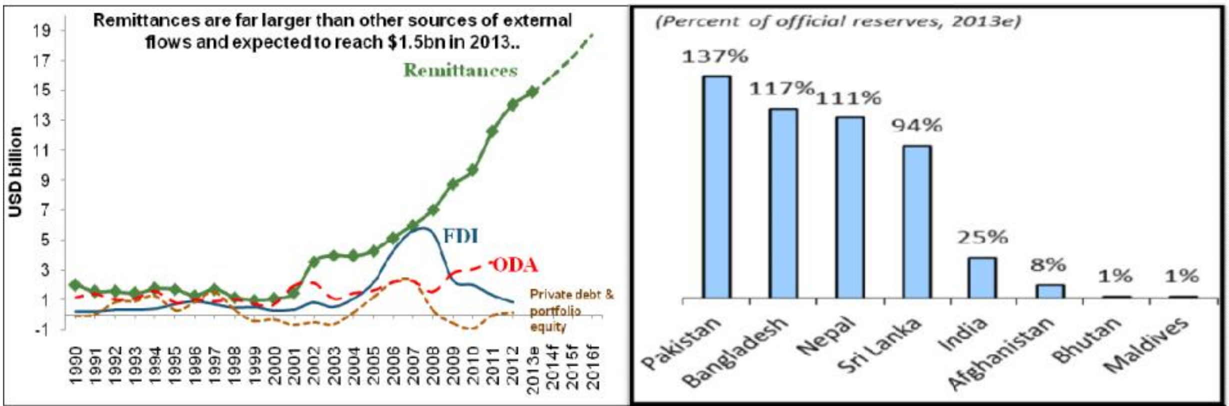
Figure 15 **Growing Youth and Females in Working Age Population**



Source: Robalino and Cho 2013; World Bank 2012. World Development Report.

27. Pakistan's strong and dynamic remittance inflows are a blessing. International migration, often considered an important safety valve for countries in economic difficulties, represents a negligible 0.8 percent of Pakistan's labor force, thus making little contribution to diminish demographic pressure on employment opportunities. But the impact of workers' remittances is far more significant (Figure 16). Remittances not only ameliorate an unfavorable balance of payments but improve the incomes of many poor households. On the macro side, remittances totaled almost US$ 14 billion in FY 2013, an amount equivalent to about half of total exports. On the micro side, remittances raised consumption among the rural poor and extreme poor, helped to reduce income inequality, and contributed to housing improvements, primary school enrolment, and investments by small businesses. In 2007-08, about 72 percent of total remittances went rural and 28 percent went urban, except for Sindh. Provinces receiving the highest shares of remittances were Punjab and KPK, while Balochistan had less than 1 percent of total remittances. Remittances tend to concentrate: five districts alone—Gujranwala, Faisalabad, Rawalpindi, Lahore and Karachi—received more than two-thirds of urban remittances; while Gujarat, Sialkot and Mandi Bahauddin received about a quarter of total rural remittances.

Figure 16 Remittances—A Ray of Hope



The Pakistani Diaspora is Large

- There are about 5.7 million people who were born in Pakistan but are now living outside the country.
- Pakistan's diaspora is the sixth largest in the world.
- The top five destinations in 2013 are:
  - Saudi Arabia (1.3 million migrants).
  - India (1.1 million migrants).
  - UAE (1.0 million migrants).
  - United Kingdom (0.5 million migrants).
  - USA (0.3 million migrants).

Remittances in Pakistan Continue to be Steady

- Remittances expanded right through the international financial crisis that started in 2008.
- They also rose through the turbulent times in Pakistan during the 2007-2012 period (unlike FDI and private debt and portfolio equity that were adversely affected).
- Within South Asia, Pakistan is the third largest recipient of remittances, and they are equivalent to about 6 percent of GDP.
- The Pakistan Remittance Initiative is playing a positive role in promoting remittances into Pakistan.

Source: World Development Indicators and World Bank Development Prospects Group ; Remittance Prices Worldwide, World Bank.; Ratha and Mohapatra 2011; IMF and World Bank staff estimates.

28. Pakistan's growth accelerations tend to be highly pro-poor. Poverty reduction in Pakistan, as in most countries, is aligned closely with its growth in per capita income. While there are poverty data concerns (see Annexure 1), when comparing the elasticity of poverty reduction with respect to growth across countries in the last two decades, Pakistan had high elasticity at -2.16, well above the mean and toward the upper end of the distribution of developing countries, indicating a much stronger proportional reduction in poverty for the improvement in GDP. Hence, Pakistan does well converting high growth into poverty reduction, and its impact would be even higher had it keep it for longer periods.

Main Challenges/Constraints to Development

29. Pakistan's main development challenges are of a dual nature. Some of them have emerged in recent years, but many others are structural, as they have a long history and play a central role in growth, human capital and service delivery; and through their contribution to jobs, poverty reduction and shared prosperity as well. According to the government, the most visible emerging challenges constraining development in Pakistan are the three 'Es': Electricity, i.e. massive shortages in electricity supply; Economy, i.e. macroeconomic instability; and Extremism, i.e. its ensuing high insecurity-cum-country risk. However, long standing structural problems prevail as well and require outmost attention.

30. In general, Pakistan's growth has been driven mainly by labor and capital accumulation rather than by productivity gains, as measured by labor productivity and Total Factor Productivity (TFP). Bank estimates show that whereas labor accumulation (growth of labor force) has been on the rise in recent decades, capital's accumulation has declined and its contribution to labor productivity growth was almost nil in the 2000s. Public investment dramatically fell from 10 percent of GDP in early 1980s to 3 percent at the end of the 2000s, only partly offset by rising private investment—up from 8 percent to 10 percent of GDP. Labor productivity—measured by output per worker—has steadily declined; while TFP's contribution to growth has reached in 2000s about a quarter of its level in 1980s. Finally, the contribution of human capital (proxied by years of schooling) has been mixed: considerable in 1980s, mildly negative in 1990s, and positive again in 2000s.

31. Productivity shortfalls also show up in sectoral terms. Growth accounting findings also identify TFP's declining contribution to growth in all three sectors—agriculture, manufacturing and service. In the 1980s and 1990s, TFP and physical capital contributions were particularly strong in manufacturing, while only TFP contribution to agriculture rose. Such productivity hike was due to continuing gains from the green revolution (improved seeds, irrigation, and fertilizers). In contrast, during 2000s only job creation accelerated across all three sectors, unaccompanied by a similar rise in physical capital, labor productivity, and TFP. Hence, it is interesting to notice that the structural transformation in Pakistan is not without job creation; instead, it tends to absorb the growing labor supply into low-skilled, low-productivity jobs rather than transfer labor from low-productivity to high-productivity sectors. While this finding is further explored later in this paper, still it leaves unanswered the critical question of what constraints trigger (or fail to trigger) productivity and investment and ultimately accelerate (prevent) Pakistan's development. These can be grouped as follows: (i) weak growth fundamentals; (ii) limited inclusive quality jobs basics; and (iii) unbalanced devolution.

Weak Growth Fundamentals

32. Bank analytical work using growth diagnostic methodology finds two groups of binding constraints: emerging and structural (Box 1). Emerging constraints include massive cuts in electricity access and macroeconomic instability leading to high country risk and a sudden decline in external and domestic financing. These emerging constraints are nothing else than the three 'Es' that the Government has identified as top priorities of the administration: Energy, Economy and Extremism. But structural constraints also matter. These block the transition from low-productivity to high-productivity jobs and include

government and market failures (micro risks) that impede investment, entrepreneurial activity, and competitiveness. By holding down TFP productivity, these failures limit job-enhancing growth.

Box 1 Binding Constraints to Growth

Emerging constraints:

1. Infrastructure gaps, urgently in power and, in the medium term, in water.
2. High macroeconomic instability—stagflation--derived from chronic resource scarcity.
3. High insecurity and country risk leading to sudden "stop"of capital inflows and private investment.

Structural constraints:

1. Slow productive diversification and stagnant openness.
2. Weak governance.
3. Poor business climate

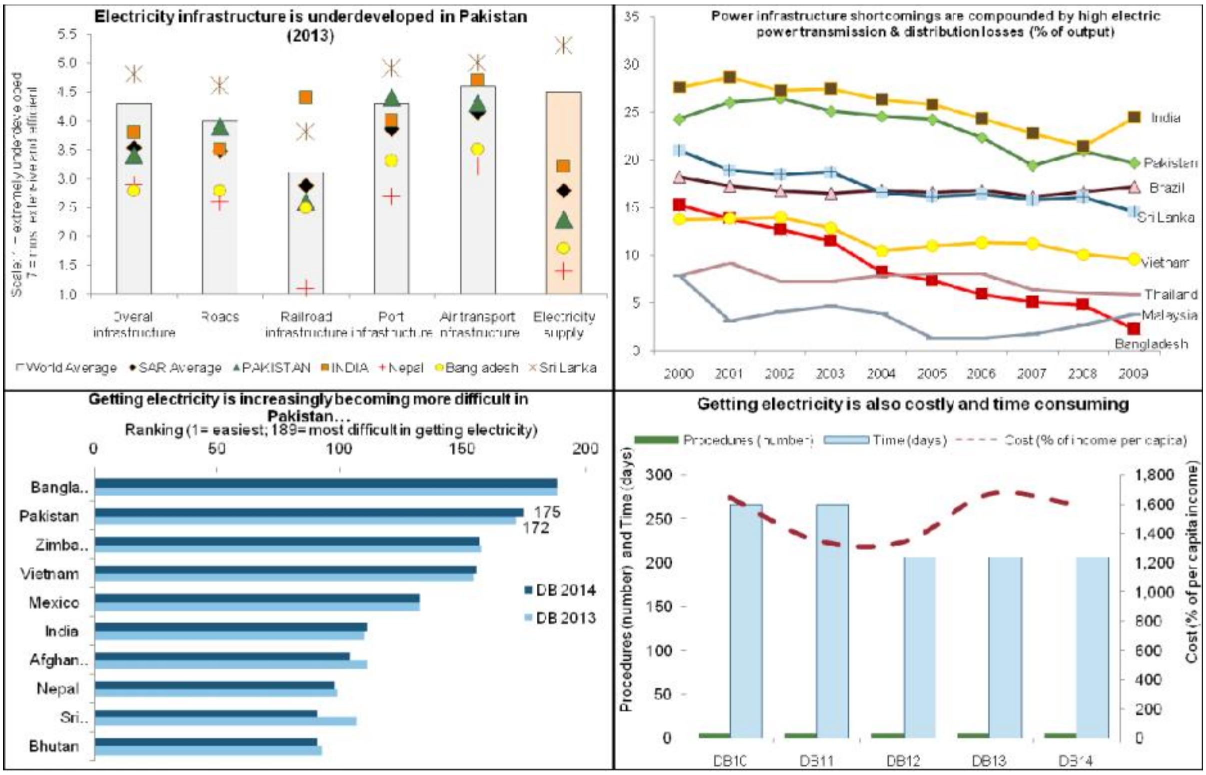
Infrastructure Gaps–Power and Water

33. Pakistan's public infrastructure has improved over the last 50 years, but slowly, resulting in many gaps that place the country at a disadvantage to competitor countries. The overall quality of infrastructure is mixed. Pakistan has among the lowest electricity-generating capacity, the highest power losses of comparator countries, and severe institutional shortcomings that hold electricity supply below capacity, resulting in widespread power outages and load-shedding. Access to potable water and improved sanitation is well below comparator countries. The country has a low density of paved roads, dismal quality railroads and inadequate airports, but acceptable quality seaports. Only in telecommunications does Pakistan perform well among the comparator group. At close to 1 and 2 percent of GDP each, public and private investment in infrastructure are about half the level of key comparator fast growing countries (Thailand, Malaysia, Turkey to name a few), and well below the minimum required to reignite and sustain high growth.

34. Power supply scarcity is dramatic. The most important emerging constraint holding back Pakistan's growth is shortage of power (Figure 17). Pakistan ranks 166 of 183 economies on the ease of getting electricity, worse than the average for South Asia. Insufficient energy supply is holding back economic growth by no less than 2 percent a year; and subsidies (including one-off arrears payments) peaked at US$ 6 billion a year (2.8 percent of GDP in FY 2013), 80% of which go to the non-poor, amount broadly equivalent to federal expenditure in health and education combined. The power sector features a demand-supply gap growing due not only to rising demand and high system losses, but also to declining generation capacity. As a result, average load shedding/power outages that crossed 6000 MW in 2009 surpassed 8000 MW in 2012; averaging 8-10 hours a day. Shortfalls are massive and spread out nationwide, and appear more accentuated in Punjab and Sindh. On the supply side, seasonal reductions in the availability of hydropower, reductions in domestic gas resources, the country's generation mix excessively reliance on expensive imported fuels and forced outages due to poor sector management and degraded maintenance capacity are all responsible for the declining generation capacity. The circular debt—as the Government fails to adjust energy prices to reflect supply costs—has only accentuated the crisis. On the demand side, system—theft and collection—losses are three times those of comparable

countries. Overall, getting electricity in Pakistan is very difficult, costly and time consuming. Government cannot handle required investment and management skills alone and private investment has to urgently come in as the private sector itself mainly suffers the acute power shortages.

Figure 17 **Large Energy Shortfalls**



Source: WDI; Doing Business; World Economic Forum 2013, Global Competitiveness Report 2012-13.

35. While reliable power supply is the most pressing binding growth constraint at present, water supply is the one in the future (Figure 18). Water is the lifeblood of Pakistan, contributing far beyond hydropower generation. Water resources support irrigated agriculture, and by the same token the development of major cities, industry, and growth centers. Pakistan has the world's largest contiguous water system–the Indus Basin Irrigation System (IBIS), considered as the backbone of the country's economy and the sole source of water supply supporting life and livelihoods. About 80 percent of cropped area is irrigated and agriculture consumes about 90 percent of available water resources. Water faces four major issues:

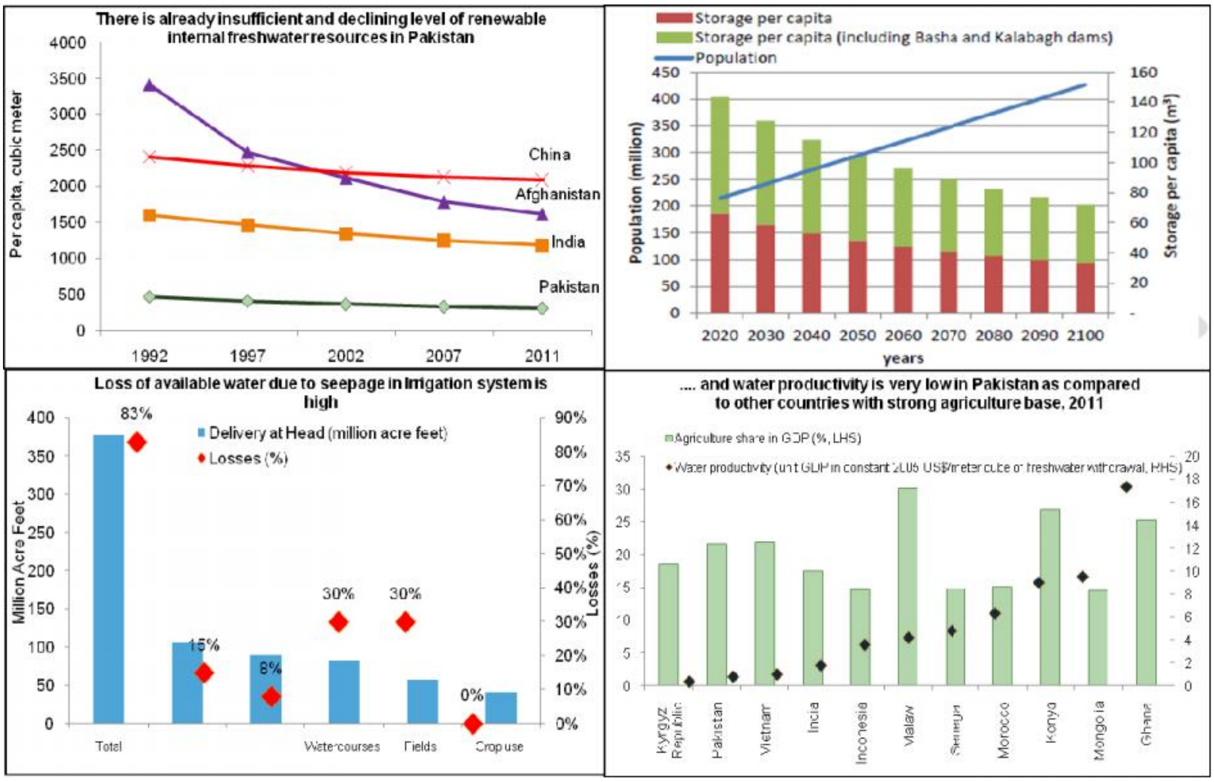
i. Pakistan has low water storage (and hydropower) development in relation to its geographical potential. Total storage is about 10 percent of total inflows in the system; its three large hydropower dams (Tarbela, Raised Mangla, and Chashma) in the Indus basin are running on low live storage capacity; and over 40 percent of the Indus River water is lost each year.

ii. There is a shift occurring between surface and groundwater irrigation, mainly caused by declining per capita water availability (due to population growth). With a growing demand and supply gap, water availability is projected to decline to 'water insecure' level of about 800 m^3 per capita by 2025. The water table of groundwater varies among the four provinces of Pakistan—it is shallow in Sindh and Balochistan—and its easy drawing down is leading to fast depletion of underground water table in both provinces.

iii. Water productivity is very low in Pakistan as compared with other countries with strong agriculture base: Crop (wheat, rice and cotton) yields showed low growth last decade.

iv. Climate change is another concern as its seasonal fluctuation affects the supply of water and causes huge losses to the economy. The Indus basin depends heavily on snow and glacial melt water, making it extremely susceptible to climate change-induced glacier melt and snowmelt. With ongoing increase in temperature, Himalayan glaciers, have been retreating over the past century. There is evidence of earlier melting and inflows into Indus, during *Rabi* period (October to March), while these decrease during *Kharif* period (April to September); thus posing risk of water security for agriculture sector. Variability of monsoon rainfall has also produced multiple episodes of floods and droughts during last decade.

Figure 18 **Water Scarcity**

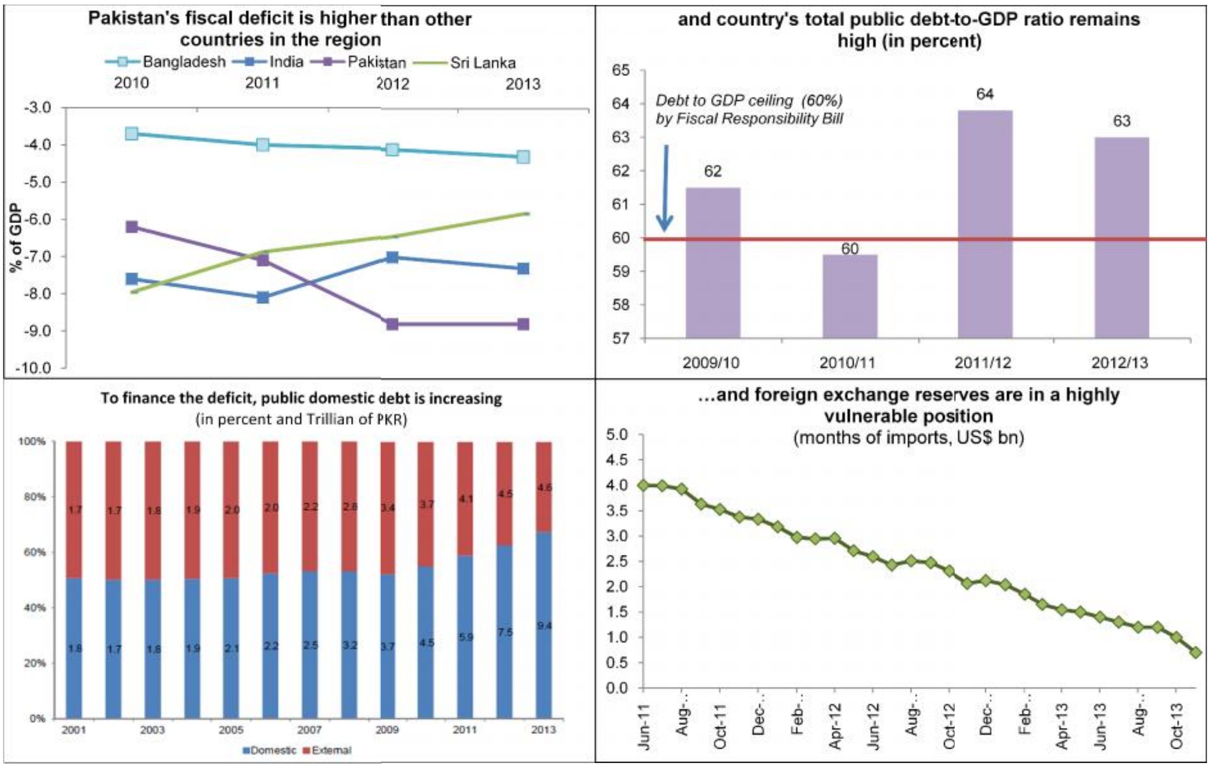


Source: WDI; Yu and others (2012 draft), Climate Risks on Water and Agriculture in the Indus Basin of Pakistan; Planning Commission(2005), Medium-Term Development Framework, 2005-2010.

36. In sum, since early 2000s, Pakistan has become a water stressed country (in terms of approaching the minimum threshold of required per capita cubic meters); and this ratio will likely decrease by more than 10 percent by 2025 due to a combination of population increase and climate change in South Asia. How these challenges are managed in anticipation to such date will have a profound impact on Pakistan's future growth and well-being of its citizens.

37. High macroeconomic instability derives from chronic scarce national savings. The symptoms of Pakistan's macroeconomic instability are its weak fundamentals: domestic and external imbalances. Domestically, the challenge is to achieve fiscal consolidation after three consecutive years of high fiscal deficit ranging between 7 and 8.8 percent of GDP. Externally, the challenge is to revert the dramatic fall in international reserves from 2.6 months of imports in June 2012 to 0.8 months of imports by end 2013; which poses the real risk of becoming the second full fledged balance of payments crisis in the last five years. At present, Pakistan is the country with the lowest level of international reserves worldwide (Figure 19). Macro instability has turned investment and saving conditions more difficult. Pakistan's investment rate plummeted from an average 22 percent of GDP in FY 2006-08 to an average 14.8 percent of GDP in FY 2010-13. Investment efficiency was also suboptimal: Pakistan features an investment-capital ratio (ICOR) of 4.1[1]. A long-standing domestic financing gap is explained by chronically scarce aggregate—public and private—savings. Low public savings is the outcome of one of the lowest tax-to-GDP ratios worldwide. Low private savings rates result from crowded out access to private credit by high public sector deficits and poor access to finance—specially by youth, women and microenterprises. Such domestic savings gap leads the country to an excessive reliance on official external flows.

Figure 19 **Macroeconomic Instability**



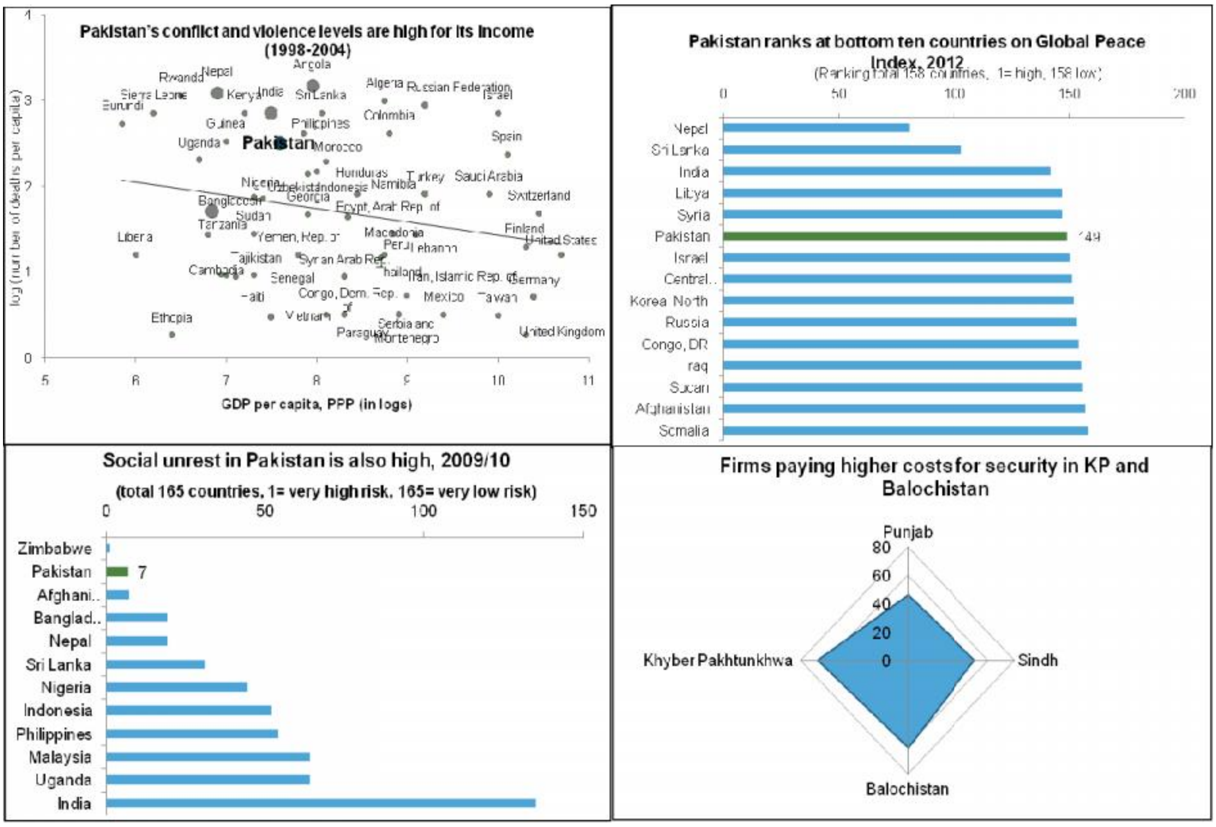
Source: World Bank staff calculations based on State Bank of Pakistan data; WB and IMF 2013. R is revised.

38. Country risk perception has improved significantly since last elections. EMBI+ spread peaked at above 1000 basis points last March 2013, but it has steadily declined to around 600+ basis points following the arrival of the present administration. This is remarkable as Pakistan still ranks among the bottom ten countries on the Global Peace index

[1] The ICOR measures investment efficiency. A higher ICOR requires more investment for unit of output. Pakistan's historic ICOR has been around 4 percent; which is above the benchmark of 3 for a developing country. Had Pakistan an ICOR of 3, it would require a lower investment ratio of 18-21 percent of GDP, to reach GDP growth rates of 6-7 percent.

and social unrest in Pakistan is also rated at the highest level among 165 countries, after Zimbawe and Afghanistan, with KPK, Balochistan and Sindh being the provinces, in that order, paying higher costs for insecurity (Figure 20). Reasons for insecurity vary. Domestically, the growth slowdown bias and potential social unrest that might result from the ongoing stabilization program may complicate reform success and prompt recovery of high growth rates. Externally, the ongoing retreat of about half of US troops (from estimated 60,000 to 34,000) by February 2014, has increased the perception of rising security risks as renewed conflict in Afghanistan could lead to political destabilization in Pakistan. In sum, the investors' confidence gap still impacts FDI. At present, Pakistan has the lowest ratio of FDI to GDP of all emerging countries: FDI peaked above 3 percent of GDP (well above other South Asia countries) in FY 2007-08, but has dramatically fallen to 0.6 percent of GDP in FY 2013. Besides improving energy supply and regaining macro stability, improving security conditions and lowering the country risk is the last 'E' needed to reverse the sudden fall of external capital inflows, help rebuild the external position, and attract badly needed FDI as another pre-requirement for increasing investment and implementing growth-oriented reforms. But sustained growth also requires dealing with structural longstanding problems.

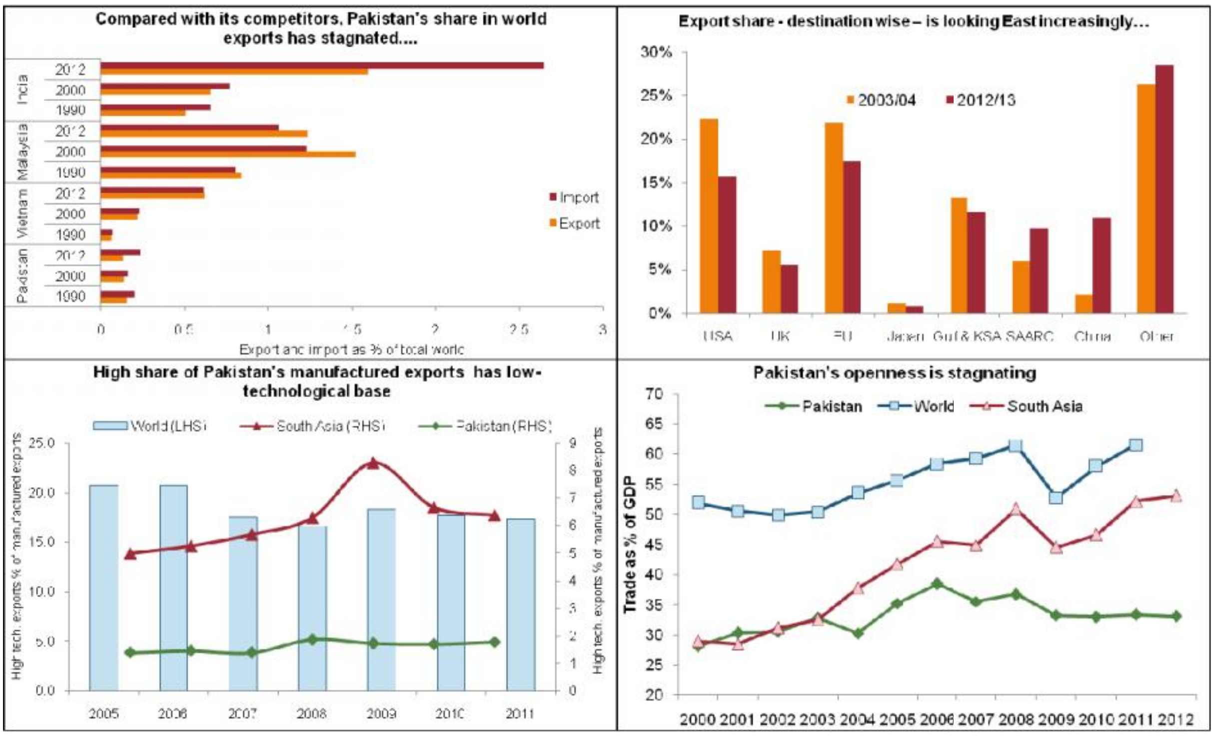
Figure 20 **High Insecurity**



Source: LaFree and Dugan 2008; Enterprise Survey 2007; EIU; The Guardian.

39. Productive diversification is the process by which an economy shifts from producing low-productivity, low-skilled goods to producing high-productivity, high-skilled goods by technology and learning from fast-growing countries and introducing niche products. Several indicators point to Pakistan's slow productive diversification. Countries with lower export concentration, and higher export sophistication/connectedness and openness have a higher probability of accelerated growth.

Figure 21 Slow Productive Diversification and Openness



Source: WDI; UNCTAD; State Bank of Pakistan; Federal Board of Revenue; and World Bank staff calculations

- The Herfindahl Index of export concentration (by product or market) shows that over the last decade Pakistan's diversification by products remained largely unchanged while concentration declined in some markets. Pakistan's improvement reflects the decline in U.S. and European market shares of Pakistan's exports and the small rise in exports to Brazil, China, India, the Russian Federation, and Gulf Corporation Council countries (Figure 21). And once bilateral relations with India normalize, Pakistan is expected to trade more with not only India but also China and South Asian countries.

- Pakistan's export sophistication/connectedness is below average for its per capita GDP and its export basket is stagnating, contrary to its main competitors: China, India, the Philippines, and Thailand that have substantially improved their export sophistication indexes. Connectedness identifies whether a country's export products are in a dense product space which offers multiple (and close) opportunities for their structural transformation (high value added), or in a thin and unconnected product space which lacks opportunities for transforming products into new high-value products (low value added).

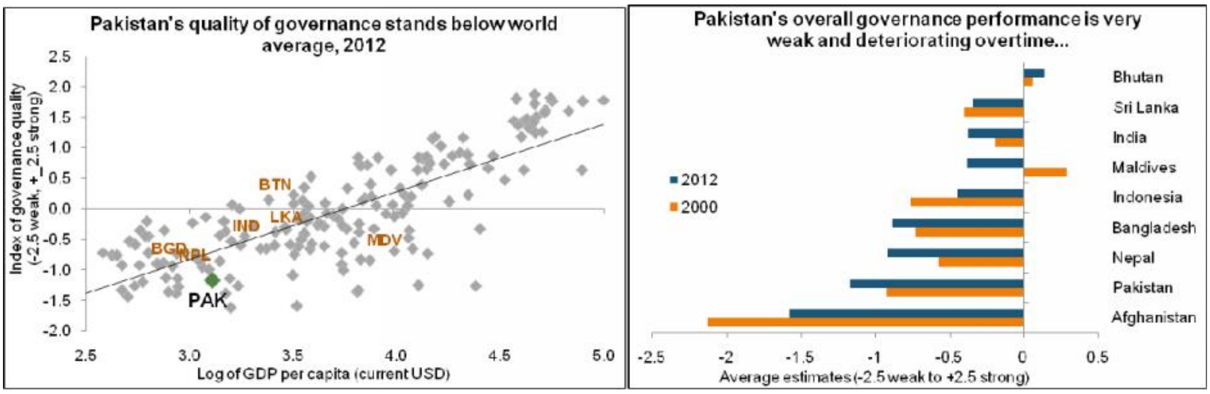
- Pakistan's openness ratios are stagnant in terms of its world exports' share, or low and declining in terms of its trade-to-GDP ratio over the last decade.

40. Overall, many Pakistani industries remain heavily protected and plagued by inefficiencies. The country still specializes in low-value added goods requiring low skills and wages—mainly textiles, leather, carpets, sport and surgical goods—and faces many difficulties moving into new high-value products. Slow productive diversification is a direct

result of its arbitrary tariffs and other protectionist instruments that multiplied in the aftermath of the 2008 global financial crisis when its trade regime was made deliberately more complex and protected through a myriad of Customs duty exemptions and ad hoc tariffs through Special Regulatory Orders (SROs). These 'distortionary taxes' affect existing and potential export activities by shifting price incentives (and profitability) in favor of import-substituting production for domestic market rather than international markets, and encourage production of low value-added products, thus impeding diversification and competitiveness.

41. Weak governance has strong distributional and security-related implications. Pakistan ranks among the weakest performing countries on governance indicators worldwide (Figure 22). Among South Asian countries, Pakistan is second lowest (after Afghanistan). Of six governance indicators Pakistan ranks lowest in the region (where scores are already low) on political stability and below average on all other indicators except regulatory quality (Table 3). The corruption index of Transparency International also signals a low, but mildly improving ranking: Pakistan fell to 139th of 183 countries in the FY 2012 perception of corruption index, but such index improved by around 10 points in FY 2013. Province-wise indicators show Balochistan and Sindh with the highest number of firms identifying corruption as a major constraint. On government effectiveness, Sindh and Punjab provincial government show higher effectiveness, measured by their lowest ratios (11 and 14) of low- to high-skilled positions.

Figure 22 Weak Governance



Source: WGI 2013; WDI ; and Bank staff calculations

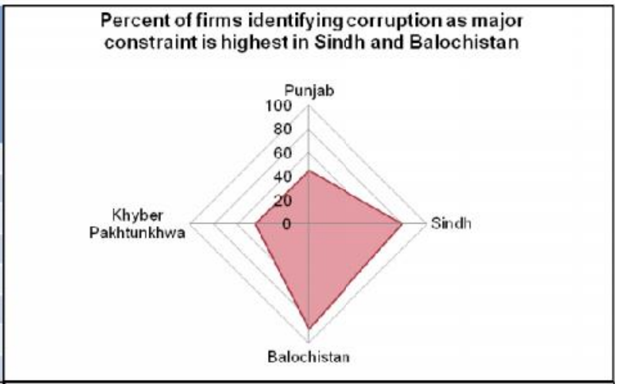
Table 3 2012 Governance Scores

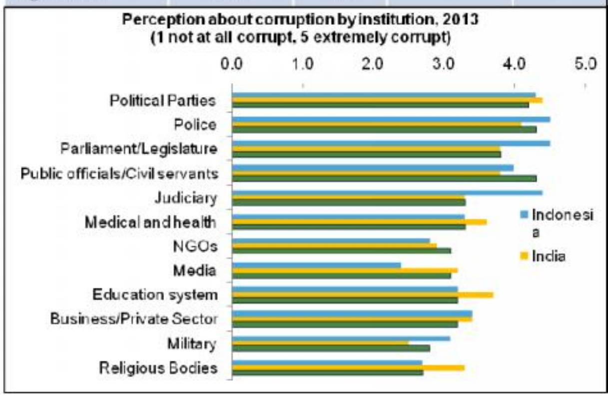
Country	2012 Governance scores (-2.5 weak to +2.5 strong)						Average
	Rule of Law	Control of Corruption	Political stability	Voice and Accountability	Government Effectiveness	Regulatory Quality	
Afghanistan	-1.72	-1.46	-2.09	-1.18	-1.23	-1.65	**-1.55**
Bangladesh	-0.97	-1.41	-1.84	-0.60	-0.86	-1.03	**-1.12**
Bhutan	0.36	0.75	1.30	-1.03	0.28	-0.43	**0.21**
India	0.16	-0.40	-0.99	0.39	-0.08	-0.24	**-0.19**
Nepal	-0.84	-0.63	-2.11	-1.19	-0.84	-0.50	**-1.02**
Pakistan	-0.91	-1.06	-2.68	-0.87	-0.79	-0.73	**-1.17**
Sri Lanka	0.15	-0.37	-1.19	-0.21	-0.29	-0.35	**-0.38**

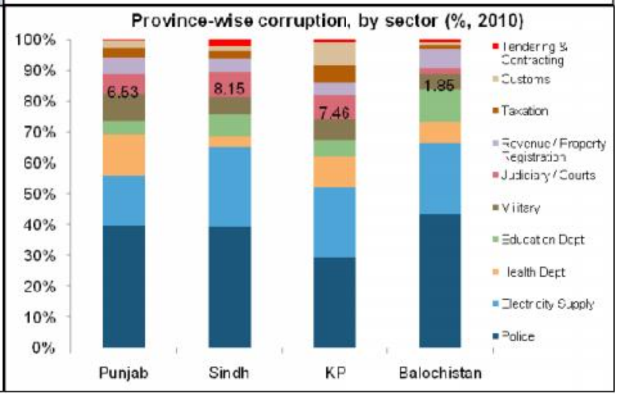
Source: WGI 2013; WDI ; and Bank staff calculations. Weak Governance (Corruption)

Figure 23 Corruption

Countries	Corruption Perception Index 2012		Corruption Perception Index 2001	
	Ranking (total 183 countries)	Score (0-100)	Rankings (total 91 countries)	Score (0-100)
Bhutan	33	63	–	–
Sri Lanka	79	40	--	--
India	94	36	71	27
Indonesia	118	32	88	19
Nepal	139	27	--	--
Pakistan	139	27	79	23
Bangladesh	144	26	91	4
Afghanistan	174	8	–	–







Source: Global Corruption Barometer 2013; Transparency International Pakistan; Enterprise Survey 2007; and Bank staff calculations

42. Poor business climate critically affects private investment and shapes growth prospects. On the Doing Business indicators, Pakistan shows low scores. Out of 189 countries, those indicators with lowest scores are: getting electricity (175), paying taxes (166), enforcing contracts (158), registering property (135), issuing construction permits (109) and starting a business (105). Pakistan's ratings on the WEF Global Competitiveness Index are even worse. Dealing with these indicators is the subject of federal and/or provincial intervention. For instance, working on the energy sector, facilitating payment of taxes or obtaining business registration are federal responsibilities. However, obtaining utility connections is easier in Khyber Pakhtunkhwa and Punjab than in Sindh and Balochistan. Similarly, enforcing contracts or obtaining building permits or licenses for site development are rather provincial subjects, whose compliance also varies per type of procedure. Enforcing contracts takes longer in Khyber Pakhtunkhwa (six years on average) and costs more in Punjab (43 percent of the claim's value). And there are different building permit fees and charges for processing and validating building plans. As except in the provincial capitals, most work is done manually, and documents must be submitted in person, the entrepreneurs must travel to main cities to complete paperwork, adding time and cost. Private access to finance also remains restricted, particularly for small and medium-size enterprises and for female entrepreneurs. Access to finance is a greater problem in Punjab and Khyber Pakhtunkhwa than in the other two provinces, because of the rapid growth in the nonagricultural informal sector over the last decade.

Limited Inclusive Quality Jobs Basics

43. High growth per se is not enough for ensuring sustainable development. Investments in human capital and sectoral reforms leading to quality jobs also lead to inclusion. The previous section was about creating conditions for improving TFP productivity and, by the same token, reinvigorating investment conditions. This section is devoted to inclusive job creation basics, i.e. demand conditions for quality jobs (jobs of higher labor productivity). As discussed earlier, Pakistan has the lowest labor productivity among its regional competitors. Low labor productivity is often not only related to chronic demand for low-skilled jobs but to growing labor supply of low quality human capital, except in high growth episodes. Pakistan is no exception to this and its key challenges for generating quality jobs are discussed in Box 2.

Box 2 Key Challenges for Generating Quality Jobs in Pakistan

Inclusive quality job basics: factors that prevent to increase inter-sectoral productivity through enhancement of labor productivity (and income) shifts.

- *Stagnant external openness and protectionism,* as evidence above showed that agricultural and manufacturing firms have slow diversification, and benefit from high anti-export bias.
- *Weak human capital accumulation cum rapid labor accumulation* (demographic bulge) leading to low enrollment in primary education and low completion rates, which favors growth of unskilled youth labor force, prevents workers' skills upgrade and promotes job 'churning,' i.e. workers moving from one low-productivity job to another, both in agriculture and urban service-led informal jobs.
- *Lack of sustained growth accelerations,* as evidence shows that high returns to labor endowment (wage) drive poverty reduction during Pakistan's growth spurs, as workers move from unpaid work to off-farm and more productive employment.
- *Weak sectoral drivers of quality job creation*: agricultural productivity (especially small landholders), competitive manufacturing and modern service-led oriented non-informal job creation in urban centers.
- *Low access to finance as a major determinant of investment oportunities.*

44. Weak human capital affects job opportunities, i.e. inclusion. While human development indicators have improved in the last decade, they still lag behind countries at a similar income level and many of Pakistan's neighbors. Pakistan ranks 145 of 187 countries on the United Nations Development Program's Human Development Index. Gaps are particularly large in human capital, especially among youth and women, with wide gaps between genders, urban and rural areas, and across provinces: (i) Literacy is only 61 percent among female youth and 79 percent among male youth, the lowest in South Asia; (ii) educational enrolment at all levels is below its regional peers (21 percent, 14 percent and 65 percent in primary, secondary and tertiary respectively); (iii) years of schooling average 6.5 for men and 3.5 for women; (iv) about 71 percent of the workforce is in urban areas but only 43 percent in rural areas have a primary education or higher; (v) while education is higher among youth (6.5 years) than the average (3.5 years), a third have no education; and (vi) last but not least, in FY 2012, public spending was 1.7 percent of GDP on education, and 0.9 percent on health, placing Pakistan among the lowest spenders on human capital in the world. Political economy reasons seem to explain such underperformance: elite resistance to tax itself to pay for mass education and ethnic factionalism associated with poor institutions and under provision of public goods. The importance of progress in the MDGs for raising human capital cannot also be underestimated. The country's progress toward the MDG

targets for 2015 has been slow and is unlikely to improve in the near future unless growth accelerates and public expenditure priorities change, and service delivery improves.

45. Lack of sustained high-growth episodes do not appear favoring the creation of quality (and better paid) jobs. Despite human capital shortcomings, growth of labor productivity in booming years suggests that job transitions from farming to off-farm agriculture employment or, following migration to the cities, from unpaid family work to either manufacturing or wage (non-informal) service-led employment lead to increases in productivity. Indeed, between FY 2002 and FY 2008, a period of high growth for Pakistan, Bank estimates show that the largest contributor to poverty reduction was the growth in labor income (wages), consistent with an increase in productivity. Other key findings show that (i) returns on non-farm income were almost three times higher than returns on traditional farm income; and (ii) labor earnings out of agriculture also increased relative to earnings in agriculture, which provided an incentive for the reallocation of labor toward more productive non-agricultural activities. Hence, during growth spurs, workers migrate from family or low-productivity jobs in agriculture to slightly more productive jobs in the manufacturing/construction and service sectors, both in rural and urban areas. Evidence also shows that these gains reverse during growth busts.

46. Low agricultural productivity requires fixing of the causes of its structural decline, including trade policy distortions that affect its productivity. As the service sector has come to dominate the economy, the overall shares of agriculture, industry, and services in total output have changed from an average of 39 percent, 23 percent, and 38 percent in the 1970s to 21 percent, 26 percent, and 54 percent in the 2000s respectively, representing a structural shift in the economy. However, agriculture still contributes about 80 percent of export earnings directly and indirectly through its forward links to agriculture-based industries such as textiles, contributing more than 50 percent of their basic inputs. Agricultural growth also affects urban growth. And on the demand side, the sector is a large market for products such as fertilizers, pesticides, machinery, and equipment. But agriculture has also gone through another structural shift: in the last two decades, its focus has shifted from crops to livestock. As crops declined from 65 percent of agricultural value added in FY 1992 to 42 percent in FY 2012, livestock's share increased from 30 percent to 55 percent. Causes of agricultural decline include inadequate investment in irrigation, slow adoption of new technologies, and weak extension services, all of them affecting productivity. Furthermore, Pakistan's highly protectionist agricultural trade policy does not promote competition. Major crops like wheat, rice, sugar, and cotton are implicitly taxed by the various price distortions and procurement policies introduced. Since government partly controls domestic wheat prices and substantial procurement volumes, as well as Pakistan's international wheat trade, there is very little price transmission from world markets to domestic markets.

47. Competitive manufacturing and modern service-led urban jobs should be favored among rising urbanization. Cities' development is crucial to Pakistan's jobs future prospects. Pakistan's potential for fast growth also relies on rising productivity of urban services and manufacturing jobs in an economy that is handicapped by high informality, weak connectedness and slow diversification. Pakistan's urbanization has been the fastest in South Asia, making it the most urban country in South Asia. By 2030 cities are likely to house about 50 percent of Pakistan's population. More than half of Pakistan's urban population is already living in eight urban agglomerations—Karachi, Lahore, Faisalabad, Rawalpindi,

Multan, Hyderabad, Gujranwala, and Peshawar. These large cities have grown at around 3 percent a year over 2000-05. The number of Pakistani cities with more than 1 million people is projected to increase from 9 today to 17 in 2020. The macroeconomic effect of some Pakistan's cities might be well above those of other developing countries but its urbanization process pales compared with East Asian and Latin American countries. Karachi handles almost 95 percent of Pakistan's foreign trade and contributes about 20 percent of Pakistan's GDP and 30 percent to Pakistan's manufacturing sector. One way of doing this is by reducing 'transport' costs—moving goods, people, and ideas—urbanization facilitates agglomerations, which enable highly productive jobs. Another is by tackling its weak governance that affects economic activity. Dealing with the bad externalities associated with urbanization, such as congestion, pollution, and crime is also needed. Hence, for Pakistan's cities to favor quality jobs creation, they would need to address both, the business-friendly climate, and the connectedness, environment and life conditions of their jobs as well, so as to attract and retain both investors and highly skilled high-income earners.

Unbalanced Devolution

48. The provincial development agenda also needs customized solutions. Besides addressing structural fiscal imbalances created by the 18th Amendment, provinces face long-standing development challenges. One of the main reasons for unbalanced provincial development, despite strong potential, has been the country's one-size-fits-all policies, which has arisen from too much attention to federal level and not enough to provinces. Addressing province-specific issues and improving service delivery require thorough understanding of differential growth path of provinces and their underlying factors and growth constraints (Box 3).

Box 3 Challenges of Devolution Process

The 18th Constitutional Amendment has brought forward the need for customized provincial solutions focused on the main challenges of the devolution process:

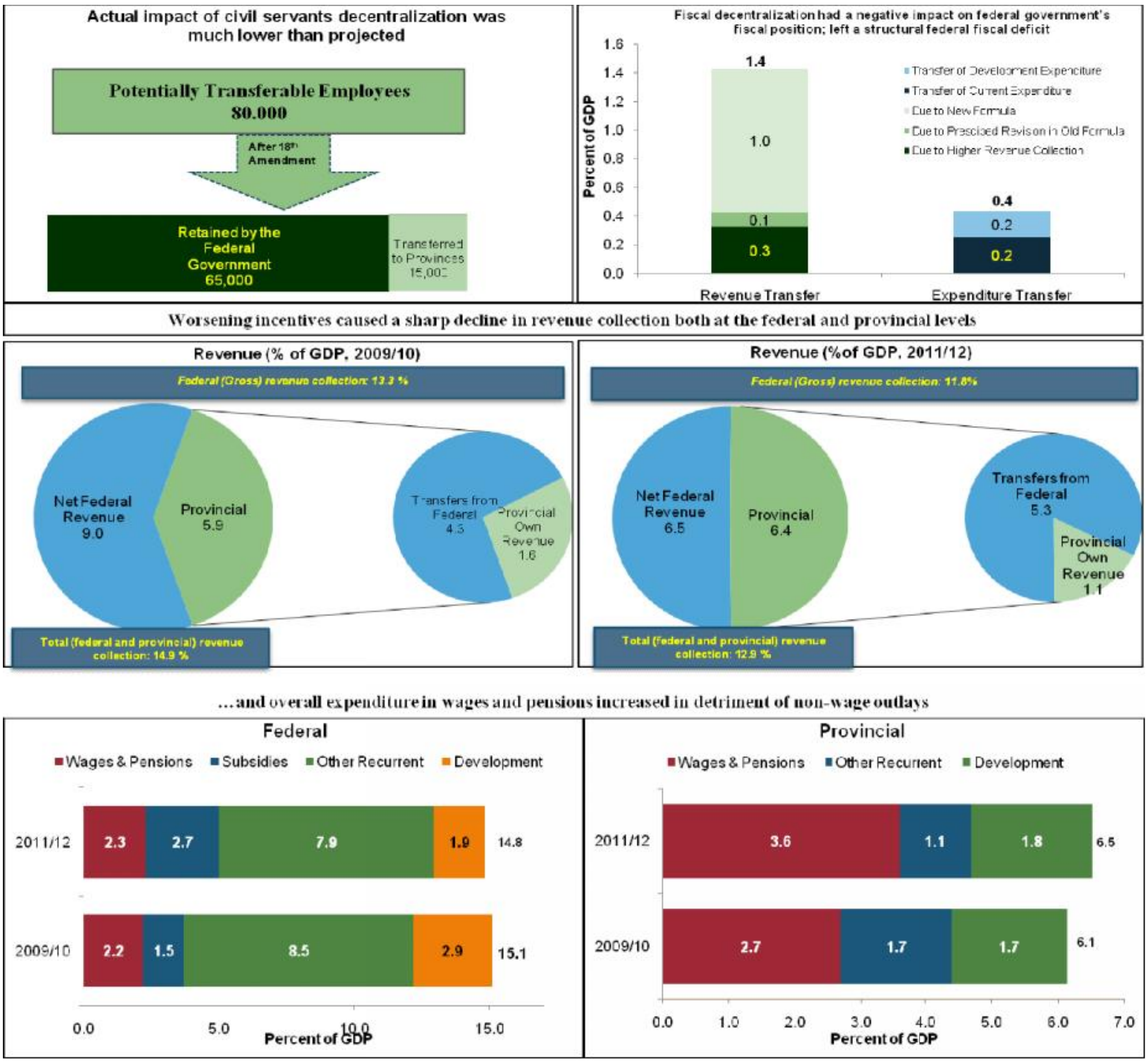
- One country but multiple economies.
- Asymmetric growth patterns but convergent poverty trends.
- Diverse human development gaps.
- New structural fiscal imbalances generated by the devolution process.

49. Provinces have different distributions of the factors of production and physical and human resource endowments. Balochistan is the largest province (covering 43.6 percent of the land area), but it contains only 5 percent of the national population, owing mainly to the difficult terrain. Punjab is the second largest province, with a 55 percent share in national population, followed by Sindh (24 percent) and Khyber Pakhtunkhwa (16 percent). Punjab has a large agricultural and industrial base (mostly small industries) and better connectivity with other provinces, especially with Sindh, through Bin Qasim, the country's main seaport. Balochistan has abundant natural resources, including natural gas and mineral reserves, and the newly developed seaport of Gwadar. Sindh also has mineral reserves—including gas, oil, limestone, and coal—a sound agricultural base, and a strong industrial base. Home to Pakistan's main seaport, Sindh provides opportunities for international trade and trade links for the country's landlocked provinces and neighboring countries. Khyber Pakhtunkhwa's abundant natural resources (water, forests, minerals and gemstones, and oil and gas) and its geographic diversity (from high mountains in north to the Indus plains in south) offer great

potential in mining, hydropower, and tourism. But the province relies mostly on services because of geographic constraints, including its distance from the country's main port.

50. Growth patterns do not converge and each province faces different challenges. Unfortunately, official provincial statistics is one area where significant gaps on macroeconomic and social variables exist. Based on unofficial estimates, Punjab is the largest contributor to national income, at more than 50 percent, followed by Sindh and Khyber Pakhtunkhwa, at 30 and 10 percent, and Balochistan at less than 10 percent. World Bank estimates also show that growth performance varies, with Balochistan lagging in the last decade as an outlier and GDP in Punjab and Sindh tracking national GDP more closely than GDP in the other two provinces: Simple correlation analysis confirms that GDP growth rates for Punjab and Sindh are almost equally highly correlated with national GDP, whereas Balochistan's is negatively related with national GDP and all provinces except for a weak positive correlation with Sindh; and among provinces the highest correlation is between Khyber Pakhtunkhwa and Punjab, which reflects some degree of integration between the two provincial economies. Balochistan also exhibits the highest GDP volatility in the last decade.

Figure 24 Unbalanced Devolution



Source: Finance Department, Government of Pakistan; and Bank staff calculations

51. The main reason for divergent provincial growth patterns is the economic structure of provincial economies. Since 1970s, the four provinces have shifted from relying on agriculture to more on services and manufacturing. The shift was most pronounced in Khyber Pakhtunkhwa and Punjab, followed by Sindh. Balochistan's economy has been the slowest to transition out of agriculture, which still accounted for 34 percent of provincial GDP in fiscal 2011. Because of its high dependence on agriculture productivity (livestock and crops), fluctuations in water availability may have affected its GDP growth. Geographic barriers (difficult terrain) and recent armed conflict, especially spillovers from conflict in neighboring Khyber Pakhtunkhwa, may also explain its low and declining GDP. Estimates of labor productivity at the provincial level suggest that Sindh has the most productive workers, followed by Khyber Pakhtunkhwa and Punjab. Balochistan has the least productive workers, with productivity about a quarter less than in Khyber Pakhtunkhwa and Punjab and more than a third less than in Sindh.

52. Not only is productivity low and declining, but the labor supply is growing rapidly, and important inter-provincial (as well as rural-urban) migration seems to be taking place. The shares of Balochistan and Khyber Pakhtunkhwa in total population are projected to rise by 2020, while Sindh's share is expected to decline, and Punjab's will be about the same. In the last decade, the share of uneducated workers has been declining in Balochistan and Khyber Pakhtunkhwa; it has been almost stagnant in Punjab, and has been rising in Sindh since 2007.

53. Provincial poverty trends, instead, converge. While poverty fell among all provinces between FY 1999 and FY 2008, the pace was volatile. Poverty fell in Khyber Pakhtunkhwa, Punjab, and Sindh, but was extremely variable in Balochistan—46 percent in FY 2008, about 29 percentage points higher than in other provinces, which makes such result suspicious. Sindh experienced some volatility as well, though the trend remained downward. The volatility in Balochistan and Sindh appears to reflect the pattern of growth of their agriculture, while worker remittances might have helped stabilized gains in poverty reduction in Punjab and Khyber Pakhtunkhwa. Khyber Pakhtunkhwa and Balochistan also underperformed other provinces in income inequality, recording a rise in income inequality of 0.03 points in its Gini index over fiscal FY 2002 to FY 2008, which is above Punjab (0.02). Only Sindh saw its Gini index decline over the same period.

54. Provinces also feature different human development—gender and rural-urban—gaps. In FY 2011,

- Education: Literacy was highest in Punjab (60 percent) and Sindh (59 percent), followed by Khyber Pakhtunkhwa (50 percent) and Balochistan (41 percent). Gender gaps were highest in Balochistan and Khyber Pakhtunkhwa; while Sindh and Balochistan had high rural-urban gaps.
- Health: Punjab performed best on health indicators, with 86 percent immunization coverage, followed by Khyber Pakhtunkhwa at 77 percent and Sindh at 75 percent; again, Balochistan lagged at 56 percent. Gender gaps are smaller in health than in education, but rural areas continue to underperform. The rural-urban gap was especially large in Balochistan, at 39 percentage points, followed by Sindh at 18 percentage points and Khyber Pakhtunkhwa at 4 percentage points. There was no gap in Punjab.

- Safe drinking water. Disparities were also large in access to safe drinking water and improved sanitation. Punjab performed lowest, with 24 percent of the population having access to safe drinking water, though its rural areas had slightly better access than rural areas in Sindh. Next lowest was Khyber Pakhtunkhwa, with the highest rural-urban disparity of 66 percentage points. Sindh recorded the second highest rural-urban coverage of 59 percent of its population and Balochistan was above 80 percent regarding urban coverage but below 30 percent regarding rural coverage.
- Sanitation. Only 31 percent of Balochistan's rural population had access to improved sanitation—and rural areas in Sindh, Khyber Pakhtunkhwa, and Punjab followed with coverage below 40 percent.

55. The 18th Amendment has created new 'structural fiscal imbalances' leaving the sub-national reform agenda unfinished and impacting on service delivery. Between pre- and post-decentralization—FY 2010 and FY 2012—some preliminary results show at least six types of federal/provincial 'structural fiscal imbalances':

i. *'Structural' federal fiscal deficit gap*. By substantially raising the share of the provinces in the divisible pool of federally collected taxes—from 46.3 percent to 57.5 percent, the federal government has been left with a 'structural deficit': enough money to barely cover its fixed outlays: defense, wages, pensions and debt service, and little or no money to fully cover federal subsidies and public investment;

ii. *Provincial revenue gap*. By increasing dependence on fiscal transfers, provinces have little incentives to generate own revenue; so, their share of own-generated revenue has fallen from 1.6 percent of GDP to 1.1 percent of GDP;

iii. *Wage-Non-wage provincial expenditure gap*. Additional provincial revenue generated by transfers almost exclusively financed wage hikes, so as to level them with federal wages, for a cost of about 0.9 percent of GDP. This was in detriment of non-wage expenditure that felt from 3.4 percent of GDP to 2.7 percent of GDP;

iv. *Civil servants bulge*. Projected transfer of civil servants to the provinces partly aborted: from the 65,000 federal employees originally scheduled to be transferred to provincial governments under devolved functions, barely 15,000 actually made it. The vast rest, supposed to be declared redundant, remains on the federal public payroll;

v. *Provincial fiscal mismanagement gap:* Out of 32 sub-national PEFA indicators that measure Public Financial Management (PFM) performance, close to a third have deteriorated while less than one-fifth have improved in Sindh and Punjab; and

vi. *Provincial outcomes gap*: Expected provincial social outcomes are yet to materialize, with exception of primary education enrolment, other key education and health indicators show little or no progress. The need to customize provincial budget allocations to most urgent needs is particularly important. For instance, Punjab stands ahead of KPK and Sindh in terms of education and health indicators. But all provinces lag well behind Balochistan in terms of access to piped water. Literacy gender gaps are highest in Balochistan and Khyber Pakhtunkhwa. No health gender gaps appear in Punjab. Urban-rural gaps are very high countrywide in access to sanitation, but worst in Balochistan and Sindh.

Opportunities: Prospects and Policy Options

56. Pakistan is at a turning point. The Government has set up an ambitious agenda whose implementation aims to recover its rapid growth (with rates close to 7 percent). This is the target set in the Government's Program and the Vision 2025 for Pakistan.

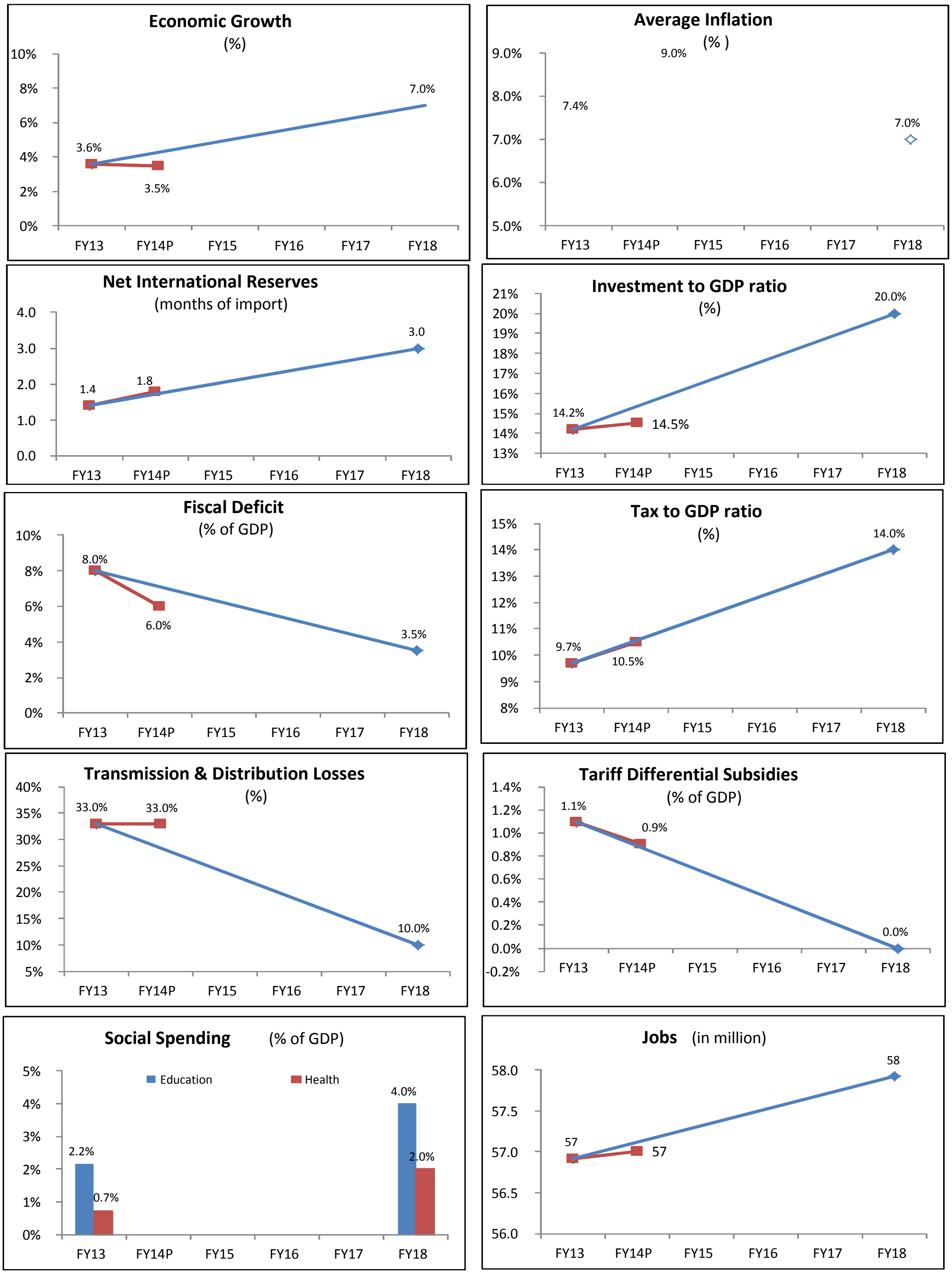
The Government's Agenda and the Vision for Pakistan 2025

57. The new PML-N Government led by Nawaz Sharif is an urban-based party with its stronghold in Punjab province, significant participation in Balochistan province and secured Parliamentary seats in other provinces. The party draws its strength mainly from the mercantile class and big business. In the elections, it also gained support from younger educated urban groups and made inroads into lower income groups. During his prior two terms in office, Mr. Sharif prioritized economic development. His biggest achievements were on privatization, financial reform, trade liberalization and de-regulation of the economy, and infrastructure development. During the large-scale privatization program more than 110 enterprises were privatized. Financial sector reform resulted in banking sector expansion. Trade openness increased under his regimes and infrastructure development led to a network expansion of highways and motorways. PML-N, however, also implemented populist projects, and some degree of fiscal indiscipline pushing the country to the brink of a major financial crisis at the end of its last tenure.

58. The new Government's Vision 2025 will be structured around 7 pillars. These are: (i) ensuring energy security; (ii) shifting from exogenous to endogenous sources of financing (domestic taxes, domestic savings and remittances); (iii) filling gaps in infrastructure (power, coal, urban infrastructure, regional connectivity and railroads); (iv) promoting private sector development (SMEs, entrepreneurship, youth entrepreneurial skills); (v) improving governance and service delivery with institutional reform and devolution; (vi) building human capital; and (vii) accelerating productive diversification. The Vision is based on a comprehensive diagnosis of Pakistan's economic challenges addressing: high and unsustainable fiscal and balance of payments deficits; heavy burden of domestic and external debt; poorly performing public sector enterprises and rising subsidies and contingent liabilities; declining government outlays in such critical areas as education, health and skill development; crippling energy shortages; and very little investment in the economy's infrastructure.

59. The Vision 2025 is supported by an economic agenda with ambitious targets set for 2017-18 (Figure 25). Supported by an IMF Program signed on September 4, 2013, initial steps include an upfront increase in energy tariffs both for industrial and commercial consumers (50 percent) and for residential consumers, adoption of a new energy policy, and elimination of then existing stock of circular debt. The IMF program is expected to be on track for a second review on March 2014. Details on the Government's program contained in the five year plan and the IMF program are in Box 4.

Figure 25 The Government's Program 2013-14 to 2017-18



Source: World Bank staff elaboration, P is provisional

Box 4 **The Government's Program 2013-14 to 2017-18**

Overall goals: The government envisages (i) stabilizing the economy, bringing inflation down to the 6–7 percent range, and (ii) accelerate growth targets to 6–7 percent by 2017-18 or earlier. This implies the following:

Stabilization (or preventing a balance of payment crisis)

- *Moving to fiscal consolidation.* The ultimate goal is to reduce the fiscal deficit from 8.0 percent of GDP in 2012-13 to 3.5-4 percent in 2016-17. This require: (i) tax policy measures to increase revenues over 1 percent of GDP annually, to reach a tax-to-GDP ratio of 14-15 percent by FY 2018; (ii) no increase in tax rates, but elimination of tax expenditure—exemption and zero rates under SROs; (iii) reduce corporate tax rates to ensure regional equity and encourage foreign investment; (iv) rationalize Sales tax by ensuring standard rate for all items and broadening the scope of GST; (v) increase provincial revenue; (vi) impose austerity in expenditure management based on significant reductions in ministries' nonwage current expenditures; (vii) rationalize social outlays while strengthening safety net (BISP); (viii) reduce power subsidies and losses from SOEs; and (ix) carry on active public debt management.

- *Rebuilding the external position and tightening monetary policy*. The ultimate goal is to rebuild the level of international reserves up to a comfortable level (3 months of imports). Main measures involve: (i) scale back monetary accommodation of fiscal deficits by limiting government borrowing; (ii) set up policy rates to keep positive real interest rates; (iii) strengthen the central bank's independence; (iv) rebuild external position by repurchasing reserves to cushion against major shocks; and (v) make solid steps to eliminate money laundering and whitening of black money.

Major growth-enhancing reforms

- *Comprehensive power sector reform.* Reducing power subsidies; restructuring boards of power distribution and generation companies; making new investments; strengthening the power sector regulator; and expanding alternative sources of energy. This includes: (i) transmission & distribution losses to be brought down to 10 percent (from 33 percent actually); (ii) ensure collection of 100 percent of billed amount of electricity; (iii) preserve power subsidies only to lifeline users below 200 units; (iv) privatization of generation companies; (v) corporatization and privatization of DISCOS; (vi) rationalization of energy tariffs in line with international prices; (vi) tariffs to be determined and notified by the National Electric and Power Regulatory Authority (NEPRA); (vii) tariff rationalization in gas sector; (viii) wellhead pricing for oil and gas exploration and production companies; and (ix) set up a wholesale market for energy, where energy-surplus provinces can sell to provinces in deficit.

- *Reforming SOEs.* Privatizing or restructuring—the latter requiring professional chief executives and board members with a corporate structure in line with corporate governance rules. A list of 31 companies has been selected.

- *Increasing openness and normalizing trade relations with neighbors.* The ultimate goal is to return to a simple and transparent framework trade regime with 4 slabs and a maximum tariff of 25 percent with few exceptions. Policies include**:** (i) Gradually simplifying tariffs; (ii) phasing out trade-distortive statutory regulatory orders (SROs) on 4,000 products; (iii) 'trade not aid' policy; (iv) strengthen regional cooperation forums, like SAARC; (v) ensure preferential trade agreements (e.g. Malaysia, China); and (vi) obtain GSP+ preferential access (zero percent duty) to 75 line items in Pakistani exports with European Union.

Role of the Private Sector

60. Pakistan's private sector role is critical for the economy. Contrary to other developing economies, where 50 percent of firms are large, in Pakistan, only 8 percent of firms are large compared with 54 percent in Sri Lanka, 46 per cent in Thailand, and 52 percent in Indonesia.

About 70 percent of firms are classified as small, and most of them do not aspire to expand in scale, given the costs associated with formalization of businesses, which also explains the predominant informality and low registration of firms as taxpayers. Despite these features, about 90 percent of Pakistan's GDP originates in the private sector.

61. Under these conditions, the fall of Pakistan's competitiveness ranking worldwide has been steady and severe. The WEF provides yearly benchmarks for Pakistan's competitiveness against other countries on three basic dimensions of competitiveness: (a) basic requirements (institutions, infrastructure, macro stability, social spending), (b) efficiency enhancers (training, efficient markets, labor and financial markets); and (c) innovation factors. These three indices underscore Pakistan's low and falling position both in the global and regional rankings across all dimensions during the last decade, and particularly at the 'basic' dimensions of competitiveness.

62. Pakistan's private sector struggles to riddle with rules and regulations that create arbitrary obstructions in doing business. A detailed account of Pakistan's ranking in Doing Business indexes was already described earlier. These rules and regulations explain why Pakistan struggles with diversification, openness and competitiveness. When examining the tax and trade regime—full of a myriad of special exemptions through SROs—it is not hard to realize that most of the private sector, and manufacturing in particular, has relied on government subsidies while the move toward risk taking and innovating and learning processes and products has been missing. Bank's 2007 investment climate survey found that less than 5 percent of firms had provided training to their employees. Existing barriers are also a source of creative rent-creation, informal payments and kickback: the same survey found that firms had made payments to government officials for an amount close to 35 per cent of the value of their enterprises' sales in order to 'resolve bureaucratic issues.' Already in FY 2011, Doing Business estimated that firms spend on average 560 hours preparing, filing and paying taxes, which is double the South Asian average of 285 hours.

63. Pakistani private sector is also affected by low access to finance. Pakistan has the lowest private sector credit-to GDP ratio among emerging economies—17 percent in FY 2012. This also poses a major challenge for promoting entrepreneurship. Part of the reasons of this is the ongoing crowding-out of private sector credit by public sector borrowing discussed earlier. But poor microeconomic conditions are also a reason. Micro, small, and medium-size enterprises find it hardest to get credit. As the growth engines of Pakistan's economy, these enterprises make up about 90 percent of private enterprises in the industrial sector, employ 78 percent of the non-agriculture labor force, and contribute more than 30 percent to GDP. Yet lending to these firms, at 16 percent of total lending, is well below potential demand. Reasons include high number of nonperforming loans in total loans (while the national average is 15.5 percent, the average for smaller firms is 40.3 percent); lack of an enabling legal and regulatory environment allowing for movable goods to be used as collateral; and poor administrative capacity within small and medium-size enterprises. Financial market imperfections—information asymmetries, transaction costs, contract enforcement costs—are particularly binding for smaller enterprises, which lack collateral, credit histories, and connections. Cultural factors such as poverty, financial illiteracy, and religious beliefs also restrict access to finance. By preventing small entrepreneurs from financing high risk, high-return investment projects, credit constraints reduce the efficiency of resource allocation and slow job-enhancing growth.

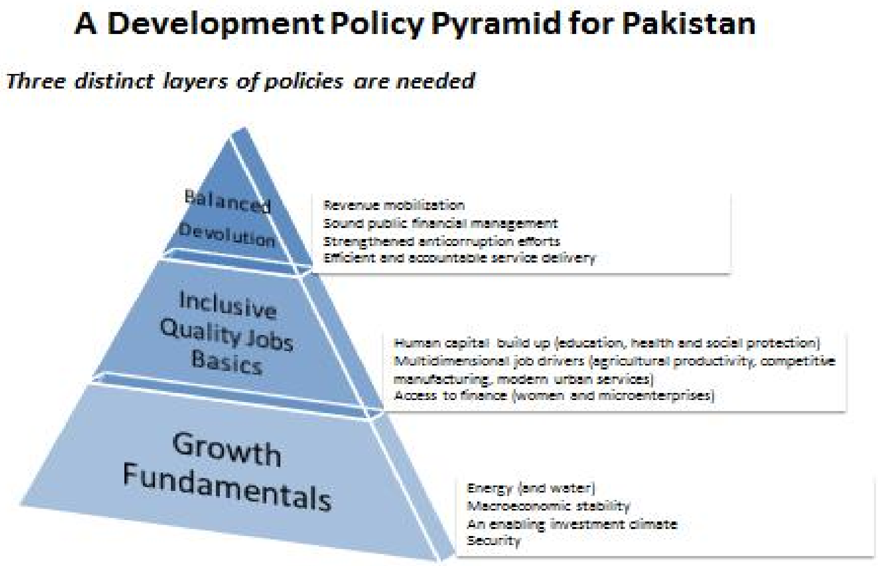
64. Women entrepreneurship is also underserved. Women run mostly small businesses and cottage industries, and their access to credit is important for setting up and running their businesses. Women tend to be better credit risks and create greater social spillovers from loans than men. And their demand for credit is high. With all these positives women entrepreneurs are good match for microfinance-based jobs. Although the proportion of women borrowers has risen and women constitute a majority of borrowers in microfinance institutions and rural support programs, women in Pakistan are well below world and regional averages as a share of total borrowers. In Pakistan women borrowers account for only 50 percent of microfinance outreach, compared with 98 percent in Nepal and 96 percent in India. The Pakistan Microfinance Network estimates the potential microfinance market at close to 27.5 million clients. Yet as of December 2011 total active borrowers (2.1 million) were less than a tenth that number. Collateral requirements, mobility problems, and complex documentation demands are the main reasons women entrepreneurs lag in access to formal finance. At 1.7 percent, the share of Pakistan's female entrepreneurs remains abysmally low, even though much higher (50 percent) when it comes to microfinance.

65. Looking at the future, a fresh compact between firms and government is needed. The new compact should change the 'business as usual rent-seeking opportunistic behavio' that has characterized the private sector and rather look for steady structural change toward diversification, production of higher value-added sectors, innovation, learning, high productivity and more investment in research and development. A higher contribution from the private sector in raising taxes and increased participation in public and private sector partnerships should also facilitate to close the financing gap in infrastructure. A more specific policy agenda is developed below.

Key Reform Options: An Agenda for Rapid and Inclusive Growth and Job Creation

66. The Government of Pakistan has the core components of a vision for a transformational job-enhancing growth agenda. The country has decided to embark on a renewed economic and social trajectory. The Government has reaffirmed that sticking to the status quo is not an option anymore, because despite Pakistan's positives, growth will not accelerate under current trends and the economy will not create the number and kind of jobs needed to meet a massive youth bulge. Recent macro developments show the high risks associated with a 'wait and see' approach. Preliminary growth estimates for fiscal 2014 are feeble at around 3-4 percentage points, while inflation attained double digits again last November. The credibility gained by the new administration in the markets, supported by an early program agreed with the IMF, is initially focused in addressing the three 'Es': a severe shortage of energy supply, a fragile economy hit by a huge drain on international reserves, and extremism in an uncertain international security environment, that is producing a steep decline in its domestic and FDI. To materialize the Government's agenda, three layers of policy actions are possible (Figure 26).

Figure 26 **Policy Agenda**



67. Pakistan's development has to rely on new growth fundamentals and inclusive quality jobs basics and a re-balanced devolution process to escape the status quo. Beyond dealing with short-term priorities, it is also critical to address the microeconomic constraints that limit firms' productivity, as well as quality job creation, and efficient service delivery through improved devolution. Pakistan faces important head-wings to adjust to the global trends that are contributing to change. One of them is the continuing weak external and regional environment that is affecting its manufacturing and agricultural export dynamism, as well as its foreign capital inflows. Growth drivers will rely on the diversification of the export basket and improved openness, which can only happen in a more competitive business environment. Job drivers will have to come from a mix of more productive farm and off-farm agricultural activities, and new manufacturing exports and services in more modern and competitive cities, not just traditional human capital activities and low skilled-jobs. Dynamic cities should be important not only for trade and commerce, but also for construction and export manufacturing, with foreign investment attracted by special economic zones. They are also a platform for networking, learning, and social mobility. The next sections focus on three key policy areas critical for putting the country on a path of sustained development

Growth Fundamentals

68. Reliable energy is the cornerstone of a strong business environment and opens fiscal space for human capital. To deal with the power crisis, the medium term outcome is to cut average load-shedding at least to half its present eight hours a day; eliminate the tariff differential subsidy (TDS) in three years, starting by adjustments to several commercial, industrial and consumer tariff (an increase of around 25-50 percent over its actual level); and reduce transmission and distribution losses to 10 percent. Medium-term reforms also aim at wholesale energy sector reform, important energy (small and big dams) and gas projects (with more domestic gas to be supplied to power generation); and GENCOs and

DISCOs made financially independent, privatized or reorganized as a corporation. Without a reliable and efficient source of energy, businesses simply cannot be competitive. And many businesses have either to invest in captive power generation capacity or face closure and possible bankruptcy. But just as significant is the inverse—the importance of the business environment in resolving the energy sector governance dysfunctions. An important goal all can agree on is to develop lower cost sources. But the amount of investment needed suggests that—without private financing and strengthening the overall macro, business, and trade environment—this will not be an easy task. An efficient energy sector is also necessary to achieve macro/fiscal consolidation and improve human capital. It clearly is not possible to make the fiscal situation sustainable without a dramatic reduction in power subsidies. This then also feeds into strengthening human capital in two ways. First, without reducing power subsidies, Pakistan will not have the fiscal space to make the increased investments in education, health, and social protection it so desperately needs. Second, reduced subsidies leading to targeted protection to the most vulnerable low power consumers is in turn creating the political space to reduce subsidies–most power subsidies go to the well off.

69. Filling broader infrastructure gaps—not only on power but on water--also requires private sector investment. In the medium term, investment in infrastructure, public and private investment combined should increase to no less than 4-5 percentage points of GDP. Fiscal consolidation should open fiscal space for public infrastructure, and this concerns not only the federal but provincial governments whose resources have been increased significantly. On the public investment side, priority should be given to projects on power generation, water irrigation (critical for agricultural productivity) and roads maintenance. On the private investment side, exploring further private and public partnerships in these sectors would also encourage private sector investment.

70. Regaining macroeconomic stability is needed not only to reduce country risk and attract investment but to preserve poverty gains. The perception of an investment-friendly country with solid macro fundamentals and much lower risk is a pre-requisite for reinvigorating private sector credit and keeping inflation low for businesses. In the medium term, as stated earlier, key objectives have been defined by the Government: bring inflation down to 7 percent; rebuild the international reserve position to at least three months of imports; consolidate fiscal deficit to 3.5-4 percentage points of GDP; supported by a tax ratio of 14 percent of GDP, and reduce power tariff differential subsidies to nil. On the external position, credit lines from international financial institutions should help address the extremely vulnerable reserve position in the near term, but this support can only fully materialize if accompanied by strong compliance with commitments made on structural reforms, particularly on energy, fiscal consolidation and privatization. Strong initial liquidity support from international finance institutions is also likely to generate a positive response from the private sector and lower Pakistan’s future needs to draw from the multilaterals. On the domestic balance, fiscal consolidation is not only the key element to create fiscal space, but to strengthen the external position, improve public debt sustainability and, through its impact on monetary policy, reduce inflation. Growth prospects can benefit from fiscal consolidation in at least two ways: It will help reduce the large country risk spread and relieve the private sector’s crowding out of credit, which constitutes a major roadblock for prompt private investment recovery. In sum, to fully grasp the benefits of regaining sound fundamentals, Box 5 describes the macroeconomic outlook under the baseline assumption of compliance with the targets of the IMF program.

Box 5 Pakistan Macroeconomic Outlook

Pakistan's economy is expected to gradually recover from stagflation. For current fiscal year, real GDP growth for 2013-14 should remain close to 3.6 percent, mainly as a result of increased power supply, enhanced investment confidence and improved macroeconomic management. In the medium term, and under a baseline scenario, high growth rates are expected to be stimulated by fiscal, monetary and structural reforms initiated by the government. Fiscal consolidation should contribute to reduce crowding-out of private investment and to create fiscal space for public investment. Tightening of monetary policy and relatively stable or declining international commodity prices will contribute to reduce inflationary pressures. As the country is expected to improve its security situation, structural reforms will spearhead productivity growth, lower country risk, attract foreign investment linked to restructuring or sale of state-owned enterprises; and foster competition in the banking, telecom and commercial sectors. Strong remittances and recovery of private sector credit would also support consumption.

Key Economic Indicators

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
							Projections		
Output and Prices (annual percentage change)									
Real GDP at factor cost	2.6	3.7	4.4	3.6	3.6	4.0	4.5	5.0	5.5
Consumer Prices (period average)	10.1	13.7	11.0	7.4	9-10	9.2	8.0	7.0	7.0
Balance of Payments (in percent of GDP unless otherwise indicated)									
Current Account Balance	(2.2)	0.1	(2.1)	(1.0)	(1.0)	(0.8)	(1.0)	(1.4)	(1.6)
Exports of goods & services	14.0	14.6	13.2	13.3	14.9	15.0	15.0	14.8	14.5
Imports of goods & services	21.5	20.4	21.6	20.5	22.5	23.1	23.3	23.3	23.3
Remittances	5.0	5.2	5.9	5.9	6.4	6.6	6.7	6.8	6.8
Gross official reserves (in months of imports of G&S) 1/	3.6	3.6	2.7	1.4	1.8	2.6	3.0	2.9	2.8
Public Finance (in percent of GDP)									
Revenues and Grants	14.3	12.6	13.1	13.3	14.3	15.0	15.7	16.0	16.1
Expenditures	20.2	19.5	21.5	21.0	20.2	19.9	19.7	19.9	20.0
of which: Current	16.7	16.5	17.8	16.0	15.8	15.2	14.5	14.4	14.4
Overall Fiscal Balance 2/	(6.2)	(7.1)	(8.8)	(8.0)	(6.1)	(5.1)	(4.2)	(4.0)	(4.0)
Total Public Debt (incl. obligation to IMF)	61.3	59.4	63.7	63.0	63.3	63.0	61.3	58.8	56.0
Memorandum									
GDP at market prices (in billions of Pakistani Rupees)	14,867	18,285	20,091	22,909	26,139	29,485	33,171	37,217	41,795

Notes:
1/ Excluding gold and foreign currency deposits of commercial banks held with the State Bank of Pakistan.
2/ Excluding grants.
Source: International Monetary Fund and WB staff

Inflation will return to single digits early on. Headline inflation rose again to double digits in 2012-13 due to hikes in administrated prices of electricity, oil, and gas, shortages of perishable food items, and exchange rate depreciation. However, projected improvements in the fiscal stance, measures to tighten monetary policy, and declining international oil prices should contribute to reduce inflationary pressures and bring average inflation down to around 7 percent by 2017-18. Structural bottlenecks in agricultural production, floods or any adverse commodity price shock pose upside risks to this outlook.

Fiscal consolidation will prevail over the medium-term. Fiscal deficit (excluding grants) is projected to decline from 8 percent of GDP in 2012-13 to 4 percent of GDP by 2017-18. The cornerstone of this outlook for this period is an improvement in FBR tax revenues by about 2.5 percentage points of GDP and compression of current expenditures by about 2 percentage points of GDP, mainly as a result of reduction in electricity subsidies. Primary balance (excluding grants) as a result is expected to turn from a deficit of 3.6 percent of GDP in 2012-13 to close to nil in 2017-18. Pakistan's public debt-to-GDP ratios are expected to decline over the medium term as a result of fiscal consolidation. Total public debt (including obligation to IMF) is projected to fall from 63 percent in 2012-13 to around 56 percent of GDP by 2017-18 over medium-term. Any delay in undertaking tax reforms, or in non-materializing nontax revenues, or in reducing power subsidies poses upside risks to this outlook.

The external position will gradually rebuild its buffer. The external current account deficit is projected to increase from 1.0 percent of GDP in 2012-13 to 1.6 percent of GDP by 2017-18 in tandem with growth acceleration. Exports are expected to regain dynamism with global trade recovery and increased market access in Europe, while imports should expand with rising consumption and investment levels. Strong remittance inflows are expected to cushion trade deficits. Lower country risk and unfolding of privatization plans are expected to attract foreign direct investment and financial inflows. As a result, foreign exchange reserves are expected to improve from 2012-13 level of 1.4 month of import coverage to close to 3 months of import coverage in 2017-18. Downside risks emanate from any external shock that diminishes workers' remittances reduces external demand for exports or raises oil prices; or from any domestic factor that delays privatization plans.

71. Reducing country risk requires further efforts, including attention to the political front. Financial markets have been generous with the new administration: the Emerging Markets Bond Index (EMBI+), which rose above 1,000 basis points in March 2013, has kept falling following the election and the signing of the IMF program. However, Pakistan has not yet reversed the latest downgrade of its sovereign bond ratings in 2012, which made its external finance expensive. Furthermore, proper sequencing of its adjustment measures is needed, as a too radical fiscal adjustment—based on important tax hikes and drastic cuts in government spending—should be avoided, as it could generate political disarray and actually worsen country risk. On the regional political front, the changing environment in Afghanistan could potentially increase security risks. Indeed, renewed internal conflict in Afghanistan could also lead to some degree of political destabilization in Pakistan. Fortunately, the economic impact of the projected retreat of about half of U.S. troops (from estimated 60,000 to 34,000) by February 2014 is small. Mainly, it means loss of localized services and jobs related to lucrative reconstruction and development contracts, which Pakistani workers and companies have enjoyed so far. Mitigating relocation and job-generating programs in this regard, most likely centered in Balochistan and Sindh, will be required.

72. Reinvigorating export diversification, including urban manufacturing, and openness would stimulate Pakistani manufacturing firms to increase productivity and regain global competitiveness. In the medium term, the goal might be to raise the export-to-GDP ratio to about 15 percent (from about 11 percent of GDP at present). Steps in the right direction are the agreed approval of a 3-year plan to remove all trade-related SROs (while adopting regulations to prevent new ones in the future); and the to-be-agreed roadmap to simplify Customs tariff slabs to 4 (between 0 and 25 percent). This is fundamental to eliminate privileges and adopt a simple and transparent trade system. Other positive growth-enhancing measures would be completing the trade normalization with India, starting with the full granting of non-discriminatory access status; eliminating nontariff barriers; tangibly improving customs procedures at the Wagha border, which would have a substantially visible demonstration effect; and actively developing supply chains, especially with entrepreneurs from China and India, supported by the creation of special economic zones (SEZ). Finally, while some businesses would surely face stronger competition, the sooner Pakistan integrates into the regional market, the faster its businesses will become competitive overall and benefit from the high growth rates of its large neighbors and from the greater availability of trade finance. Trade logistics businesses such as trucking, rail, roads, ports, trade finance, warehousing, and storage would also benefit.

73. A much improved business environment is critical to tackle low investment and low domestic access to finance, thus ending the credit crunch to the private sector. In the medium term, the government expects private investment to reach at least 20 percent of GDP. Actions on two fronts are needed: At the macroeconomic level, fiscal consolidation and monetary tightening should help bring inflation back to single digits. Favoring positive but low real interest rates and reducing government borrowing would reduce the banks' incentives to crowd out private credit. At the microeconomic level, overcoming the 'soft' regulatory barriers to the business environment may improve Pakistan's falling position in the Doing Business Indicator. Such improvement requires a customized agenda of actions by the federal and provincial governments to help streamline procedures to facilitate construction, enable contracts, and prevent corruption. At the federal level, the government

is improving power access, facilitating tax payments, setting up a One-Stop Shop for business registration. At the provincial level, it is creating new courts to solve commercial disputes—one in Punjab and another in Sindh—computerizing land registration and easing procedures for construction permits. Improving access to credit might aim to bring private sector credit up to at least 20 percent of GDP (around 25 percent above its present level). The growth of businesses and SMEs is critical not just for growth and jobs, it is also necessary for the Government to increase the tax revenues.

74. Reinvigorating the business environment also requires addressing the drag imposed on the private sector by losses-generating SOEs. There are two channels by which SOEs privatization will support growth: First, their eventual sale and savings will create fiscal space; and second, their restructuring should bring improved service delivery, especially on utilities. Heavy SOE losses and guarantees for about 2.5 percent of GDP respectively are making the fiscal situation worse. The Government has prepared a roadmap on which 31 loss making SOE's will be privatized and another 32 restructured on a short time frame. The recent approval of the new Corporate Governance Code is also a step in the right direction, but the real test is its implementation; for which norms still need to be issued.

75. Increasing agricultural productivity (especially among smallholders) is essential and helps diversify manufacturing and expand services, as well as to generate new job drivers and promote inclusion.There are two valid reasons why agriculture remains critical. First, agriculture's importance extends beyond its direct contributions to GDP through its foreign exchange earnings, its role in supplying savings and labor to other sectors; and then through its substantial links with other nonfarm activities (often services and inter-industry links), calling for an 'expanded' agricultural sector. Broad estimates of Pakistan's agriculture's GDP share that account for an 'expanded' sector vary between 3 and 5 percent of GDP over its actual share of national GDP. Second, agriculture contributes more to poverty reduction and reduction of inequalities than other sectors do—poverty remains more entrenched in rural areas, and a major share of the (poor) population still depends on farm and nonfarm rural activities.Pakistan's potential for such an upward shift in crops productivity by smallholders should come from a combination of technology innovation and extension, improved water use management (irrigation) and removal of trade distorted policies that create adverse agricultural incentives.

76. On technology innovation and extension, the institutional system needs an urgent overhaul followed by proper reallocation of human and financial resources; as about 111 public agencies are involved, in part as a result of the 18th Amendment that has contributed to institutional duplications and overlapping functions between national and provincial agricultural research councils. On water management, crop yields still rely on a financially unsustainable irrigation system. Again, its institutional reform is needed to complete the devolution of authority to the relevant scale, and provide sufficient resources and capacity building to each authority so as to fulfill its mandate. Finally, improving agricultural trade will require removing distortions in the trade regime arising from statutory regulatory orders (SROs) and subsidies in the domestic commodity markets. Food price stability is important, but it can be achieved through more cost-effective mechanisms than in use today; and food security for the most vulnerable can be supported more efficiently through well-targeted social safety net programs.

Inclusive quality jobs basics

77. The country should start by reallocating the to-be-created fiscal space toward increased education and health non-wage spending. Education reform initiatives in Punjab and Sindh have delivered on some counts, but suffer from chronic shortage of resources and need a significant lift. In addition, provinces are overspending on staff salaries rather than on non-salary priority social outlays (teaching materials) and investment.

78. Beyond increased and reallocated resources the country should address major challenges in providing access to quality education at all levels. Pakistan has the world's second highest out-of-school population (7 million)—two-thirds of them girls (though enrollment rates vary appreciably between and within provinces). National surveys of student learning suggest that achievement is also very low—a sizable share of school leavers do not achieve even minimum mastery of mathematics, reading, and language, as defined by the government. The main contributing factors include poor teacher quality and accountability, inadequate and inefficient funding, and weak management and governance. With the management and financing of social services decentralized to the provinces, national and provincial standards need to be set and coordinated, and their achievements monitored to address inequities. Developing a system to set standards in hiring, track performance, and monitor learning outcomes should be the cornerstone of quality service delivery. The federal government should play this role and coordinate and facilitate the provision of 'education for all'.

79. The country should also address its major health and nutrition challenges. These include persistent inequities in health and nutrition outcomes and poor quality service varying by economic status, gender, and region; poor governance and weak and centralized management; and programmatic shortcomings in reducing fertility and improving nutrition—areas with cross-cutting impacts on human development and economic growth. In this regard, the devolution of most federal responsibilities for health and population welfare to the provinces provides opportunities for more responsive and accountable governance, but they also pose severe challenges. Special attention is required to ensure appropriate institutional arrangements to house federal functions, a clear delineation of responsibilities, and the building of capacities and structures at all levels. Actions to improve health sector performance include improving health services targeting the poor; strengthening health sector management and accountability with a greater focus on monitoring and information (in a context of devolution and contracting); and expanding family planning and nutrition services.

80. Protecting vulnerable populations makes a huge difference not only for the targeted poor but also for the outlook on shared prosperity prospects. Supporting the pro-poor targeted BISP is a priority. Whereas Pakistan spends about 3 percent of GDP in untargeted subsidies, the BISP spends barely about a 10th of that figure, with more inclusive results. The BISP has an efficient and modern system for targeted cash transfers to the poor, and its database can be expanded to integrate other social programs under a targeted approach. Future efforts are needed to consolidate these gains through a coherent social protection framework across provinces, while replacing expensive universal subsidies (power, wheat) with more targeted (and conditional) cash transfer interventions. This requires an increase

in social protection spending, accompanied by a review of other less well targeted social programs.

81. Better management of natural disasters is also needed for protecting vulnerable populations and preserving human capital. Pakistan is a disaster-prone country whose profile, when combined with rapid population growth and urbanization, significantly increases the vulnerability of human and physical capital, and poverty gains. The major challenges in managing natural disasters are threefold: preparedness, well executed emergency response, and strong dedicated institutions and data systems to oversee mid-long term rehabilitation. It will also be critical to mainstream disaster risk reduction in urban planning, factory design, and other infrastructure.

82. Managing rapid urbanization can unlock cities' potential, with special attention to the creation of modern jobs for youth and female, and to the environment. Cities should become growth-friendly clusters with appended green industrial parks in their periphery and large and dense markets for goods and services, which would foster firms' competition and job's learning. This should in turn help introduce new more competitive technologies, including those that meet basic environmental and social standards increasingly required for exports. Careful urban planning would imply strong coordination between the federal, provincial and local governments. Equally important is that cities be linked to each other to get the most out of agglomeration, connecting industrial clusters. This requires upgrading, extending, and rehabilitating transport infrastructure to build trade corridors (within Pakistan and between Pakistan and its neighbors). Three key measures that could be achieved during the next administration are the revamping of zoning laws, the streamlining of construction permit procedures and the establishment of a national database for housing titles and prices. Similarly, to deal directly with youth (and female) urban unemployment, the technical and vocational education and training (TVET) systems provide either a combination of counseling, training, job-search assistance, intermediation, and subsidized internships, or microfinance skills to foster entrepreneurship. These should be mainstreamed with a view to enroll a higher percentage of the youth working-age population by existing major TVET programs: The Punjab Technical and Vocational Education and Training, the Sindh Benazir Bhutto Shaheed Youth Development Program, and the Skills Development Program. This would imply not only expanding budgetary resources to them, but providing incentives for greater involvement of the private sector in program design, on-the-job training, and temporary initial placements would be critical for achieving the required job expansion rates. Finally, microfinance jobs should target formation of youth entrepreneurs. The SMEDA could be singled out to promote the growth of micro and small enterprises. And particular priority should be given to creating or expanding programs encouraging female-managed small and medium enterprises.

83. Manufacturing has a role to play in reviving growth, but given the growing labor force, and rapid urbanization, it can only do so by gaining competitiveness and diversifying. Its actual stagnant performance—in terms of GDP share—stems from its largely low-skilled labor force, prevailing informal commercial environment, poor working conditions and failure to diversify production and climb up the technology ladder. Manufacturing remains heavily concentrated on non-dynamic low value added consumer products that attract little investment. The contrast is clear: Small industrial and household companies have generally had a more stable and upward growth trend than larger companies since 2000, while large-

scale manufacturing—with only some of them capital intensive—have seen a sharp contraction since the second half of the 2000s reflecting weakening aggregate demand, deteriorating security, and power shortages. Districts with higher population density and with faster population growth have seen stronger growth in manufacturing production value, a sign that agglomeration is an essential element in its growth. Such districts tend to have better education, health infrastructure, and sanitation, than those in rural areas. By contrast, districts with low population densities—below 30 persons per square kilometer—offer few job opportunities and little to no industrial presence. Taking into consideration growing labor force and rising urbanization, Pakistan's attempt to follow in China's footsteps by engaging in low-skilled labor-intensive manufacturing, filling the gap left behind as China moves up the value chain, is insufficient. Yet, equally important is to move up the value chain which involves a raft of measures: improving skills and the commercial environment; harnessing the positive forces of agglomeration (such as focusing on infrastructure investments and facilitating trade); addressing bottlenecks in supply chains, promoting inclusive green industrial growth (taking advantage of cleaner industries), facilitating entry of women in the labor force; and ensuring that labor regulations are in place and enforced to avoid the negative externalities of agglomeration.

84. Growth in modern services also provides an alternative path for quality job creation. According to Bank's estimates, Pakistan underperforms its level of export services sophistication with respect to its income per capita. And while urbanization has made progress, the transformative potential of agglomerations not only in manufacturing but in services remains to be realized in Pakistan. Services that were historically produced primarily for domestic consumption could gradually become more productive, as they become tradable, and unbundled. These modern services include communication, insurance, finance, computer and information, royalties and license fees and are growing faster than traditional ones. These may take advantage of ICT, globalization, and economies of scale; and benefit from higher productivity growth. More limited potential also exists for traditional services (such as tourism, education, musicians, entertainment production media etc.), as they still require face-to-face contact and are affected by the cumbersome business regulations affecting the investment climate.

85. The creation of a certain type of quality jobs requires provincial customization. While focusing on broad human capital needs is a basic task, the objective and specific type of job creation needs to respond to different dimensions, given provincial varying endowments and institutional environments. From a productivity dimension, Sindh, Punjab and KPK could center their development policies on how to make cities functional spaces for productive activities (infrastructure, city governance and accountability, skill building, efficient service delivery) and on how to provide conditions for the realization of special returns, such as those potentially provided by special economic zones. And as the vast majority of their non-agricultural jobs are in microenterprises (>90 percent) and in the informal sector (>80 percent), the role of labor policies has to be adjusted so as to avoid misguided interventions that create constraints. From a social cohesion dimension, jobs that contribute to build a social network in conflict-prone situations, like those in KPK and Balochistan, are relevant. These jobs include activities dedicated to promote 'safe economic zones' or reintegration of ex-combatants, where the role of a positive social dynamism is critical for a smooth integration of young people into a productive and social life. From a living standards dimension, jobs that provide working opportunities to youth and women may lead to

fundamental changes in the population, as they may alter the community development dynamics and have a considerable poverty reduction potential, especially in rural non-agricultural activities in Sindh and Punjab.

86. Finally, a key element for inclusive job creation is access to financial services, especially by female and small entrepreneurs. Less than 14 percent of the Pakistani population has access to any financial service, microfinance reaches less than 3 percent of the population, and less than 7 percent of SMEs use formal finance for working capital or investments. Lack of financial inclusion is a drag both on growth as well as equality and poverty, and financial sector deepening and improved access to financial services would support private sector growth while reducing vulnerabilities for women, households and the poor. Although availability of financial products and services has become gradually more widespread, access to finance continues to be limited, especially on the credit front. Overall credit growth has been declining and rising Non Performing Loans (NPL) ratios have reinforced banks' risk-aversion towards the private sector. Decline in credit growth stems from underlying structural issues—weak private sector demand for credit and rising NPLs are symptoms of a risky environment, where electricity/power, security, and slow growth are the drivers. Additionally, the microfinance sector in Pakistan is amongst the most progressive and innovative globally, but outreach to the poor and underserved remains static, with less than 3 percent of the population having access to microfinance products or services. There are even more serious issues facing women borrowers, including discriminatory lending policies and practices which reinforce financial exclusion of women by lending institutions. If inclusion requires a special focus on SMEs and on women to deepen and broaden their access to a range of financial services for these key constituencies, under a Financial Inclusion Strategy two key initiatives would be to (a) strengthening creditors' rights through regulatory reforms in Secured Transactions and Credit Information, as existing public and private credit bureaus in Pakistan provide credit information on only 7 and 2 percent of the population respectively; (b) the use of movable property as collateral for commercial lending, which could facilitate access to credit by agricultural producers, women, and SMEs, as the bulk of SMEs are engaged in trade and services (51 percent and 35 percent, respectively), and also decrease the cost of finance.

Balanced devolution

87. A rebalanced devolution is the glue that will support growth acceleration and inclusive quality jobs creation, while improving social service delivery. Recent positive developments resulting from the 18th Amendment include the growing entrenchment of sub-national democratic processes, the transfer of greater responsibility for their service delivery, the exponential participation growth in electronic media (enhancing transparency and accountability), and some recent gains in corruption rankings and right to information. A sub-national agenda in this regards is multidimensional and includes four priority areas:

i. Revenue mobilization to create fiscal space.
ii. Improved public financial management and transparency.
iii. Strengthened anticorruption efforts.
iv. Improved governance for efficient and accountable service delivery.

88. Creating fiscal space by mobilizing revenue in a fair and effective manner, is not only critical for growth and macroeconomic stability, but for inclusion and efficient service delivery. As Pakistan has one of the lowest tax ratios worldwide, even when considering its income per capita, the country needs to create the additional fiscal space required for its development needs—both for infrastructure and social service. The comprehensive national tax reform agenda should be perceived as equitable in its policy design, simple so as to make it effective and taxpayer-friendly, and corruption-free in its administration. From an implementation perspective, the federal government could make about three-quarters of this effort and the provincial government about one-quarter. The present focus is on making taxation simple, on broadening the tax base, on ensuring compliance, and on modernizing the tax administration—with FBR Board steady tenure and professional hiring policies, and enhanced transparency and accountability about its results. At the federal level, on tax policy, the ongoing elimination of SROs, exemptions, and zero rates that make compliance low will enable authorities to raise more revenue with equity. Lowering personal and corporate income taxes to international averages is also being considered once revenues start to pick up. Customs tariffs are being simplified to a maximum of four slabs. On tax administration, supporting modern and integrated IT-systems, while adopting performance agreements in all major functional areas of FBR (e-registration, e-filing, ballot-audit and reporting) is needed. Creating a joint Finance-FBR Tax Policy Commission might be an important step toward more effective revenue mobilization. As provincial tax revenue relies too heavily on federal taxation (about 95 percent), while paying too little attention to self-generated collection potential, provincial revenue administrations should also develop their own results-oriented administrative model. Provincial tax reform could be stimulated by explicit arrangements linking provincial transfers to additional local revenues and include expansion of services sales tax scope, a hike in the agricultural tax, and other measures to be agreed under the incoming 8th National Finance Commission Award.

89. Improved public financial management can be a foundation for making public expenditures more transparent and service delivery more accountable. The public financial management system is fairly well developed, but not consolidated and has deteriorated at the provincial level recently. The most notable initiatives have been adopting a uniform IMF-GFS compliant chart of accounts for budgeting and accounting, separating accounting and auditing functions, introducing a pilot medium-term budgetary framework at the federal level, implementing government-wide financial management information system, enabling automated budget compilation, and establishing procurement regulatory authorities for Sindh and Punjab. Beyond keeping pace with these achievements, the next sub-national priorities are to develop an effective decentralized budget management system, improve cash management, introducing e-procurement, strengthening the complaint mechanisms at procurement agencies with data publicly available, and conducting performance audits of key public transactions. Similarly, a local government system that has the requisite administrative and financial autonomy be established.

90. Strengthened anti-corruption drives are also necessary. Pakistan should keep monitoring systemic diagnosis, focusing on key institutions (e.g. police, tax administration, etc), devising carefully deliberated strategies to address complaints, ensuring proper implementation of strategies, and reaching out to international community to make progress visible and widely supported and appreciated. As the first ingredient for fighting corruption is promoting an informed voice among citizens, Pakistan also needs to complete the

establishment of effective right-to-information regimes at federal and provincial levels. This requires passage of right-to-information legislation, followed by proper implementation and enforcement, and awareness-raising campaigns for ordinary citizens. Citizen's voice and active participation in local planning, monitoring, accountability and complaints should be promoted.

91. Quality service delivery is the ultimate outcome of devolution. The 18th Amendment requires better governance by provincial governments, which is a strong challenge for them, as it requires improving their outreach and perception about the quality of services among recipients. An additional challenge is that further accountability at the provincial level could be devolved toward the local and community level. And given fiscal imbalances in the federal budget, the level of budgetary transfers needs to be rebalanced to ensure consistency with the devolution of responsibilities. In this regard, the roles and functions of each level of government should be further clarified in the 8th NFC Award. Direct improvements can be achieved through a mix of: civil service reforms, results-based performance monitoring, and sub-national and local capacity building to monitor and ensure effective implementation. Setting upfront goals and in many cases outsourcing contracts; giving more voice to stakeholders—including electronic means; and holding officials accountable for their delivery should enable the government to regularly report on progress and then reduce excessive control or political interference.

Simulating Medium-Term Scenarios for Poverty and Vulnerability

92. What would it take for Pakistan to make a historic jump up to decrease poverty and increase shared prosperity at a high growth rate? This section compares the effects of two growth scenarios over poverty reduction and vulnerability in the medium term. Bank simulations first use a Maquette for MDG Simulations (MAMS) model and second use an approach by elasticity[2]. They explore the benefits of an accelerated 7 percent average annual GDP growth rate for FY 2013–22 (bold reform approach) over moving back Pakistan to its historical average of 4.3 percent growth rate (step wise piecemeal reform approach), which is also the one retained in the baseline for the medium term outlook. Actual average GDP growth has been slightly below 3 percent for the last four years, which implies that under present circumstances, even returning Pakistan to its historic average rate would appear as optimistic. The model also allows appraising the impact of simulations on selected MDGs compliance.

93. The realization of a bold or stepwise approach cannot be taken for granted, as these will critically depend on hard political decisions to implement structural reforms during the following years. Achieving and maintaining high rates of growth will require continued efforts to regain stability, rebuild other growth fundamentals and address key structural constraints for inclusive job creation and devolution. The ongoing structural transformation to an economy that relies more on livestock than on crops, more on competitive and modern manufacturing and services than on agriculture, and more on off-farm, increasingly urban, employment requires to be managed effectively. Social programs, especially BISP, have to be expanded and other inclusive job creation policies implemented. The increase in labor

[2] Projections using the MAMS model follow those assumptions used in the 2013 Bank's Country Economic Memorandum. Elasticity estimates for shorter periods are highly volatile and very sensitive to the starting value in each period. This becomes a problem especially in periods with high fluctuation in GDP growth as is the case for Pakistan.

productivity and TFP over the next decade is critical as they will substantially boost output per worker on a sustained basis. Reducing political uncertainty will also help Pakistan back into another boost.

94. Simulations are performed over a five-year horizon, FY 2014-18, to allow structural changes to be more visible. The high growth scenario assumes the economy returning to 7 percent average growth, supported by strong and sustained structural reforms improving the investment climate, economic governance, and private investment in physical and human capital. It also assumes a minimum rise in total investment from 14 percent of GDP to 18 percent (with a 70–30 split between private and public investment) supported by higher private and government savings—and a rise in annual total factor productivity growth from 1–2 percent to 3–4 percent per year. Instead, the baseline scenario assumes the economy returning to its average historical growth rate (4.3 percent), more moderate increases in the key variables above, including TFP, and private consumption rising 4 percent a year.

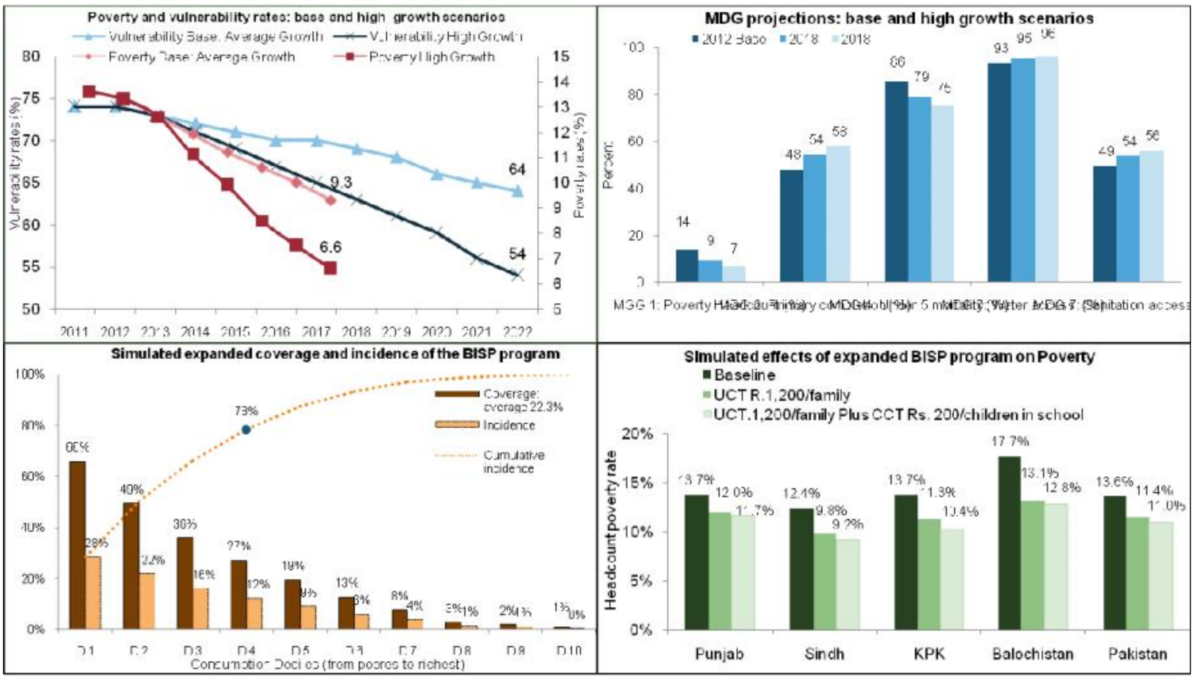
- Under the baseline scenario poverty headcount is projected to be 9.3 percent in 2018, above 6.6 percent under the high growth scenario. After taking into consideration population growth, consumption elasticity to poverty and distributional characteristics, poverty is estimated to decrease 0.7 percentage points per year under the baseline scenario (and 1 percentage point under the high case).[3]

- Higher GDP growth brings Pakistan closer to the MDG goals, especially for education and health. The effect of growth on socioeconomic indicators, including those used for the Millennium Development Goals (MDGs), was simulated using a computer general equilibrium model. As expected, higher economic growth would improve socioeconomic indicators better than under the baseline. For example, compared to base GDP growth rate, a higher growth rate would improve Net Primary Completion rates from 54 to 58 percent by 2018, and Access to Sanitation from 54 to only 56 percent.

- Higher GDP growth also more substantially reduces the size of the vulnerable population. High growth reduces population under the vulnerability threshold from 74.2 percent in 2011 to about 64.0 percent in 2018, a decline of 2 percentage points per year (versus 1 percentage point a year under the baseline).

[3] Projections using the MAMS model were remarkably close to those of the CEM over a longer time period (2012-2022), with yearly poverty reductions of 0.64 percentage points for the base scenario and 1.18 percentage points for the high growth scenario.

Figure 27 Poverty and Vulnerability Scenarios (FY 2014-18)



Note: A person is defined as vulnerable if their household per capita consumption falls below twice the poverty line.
Source: World Bank staff estimates based on PSLM household survey

95. Over a longer period, rapid growth, supported by higher private and government investment (with a focus on infrastructure), and enhanced total factor productivity consolidates the previous results. In comparison with the baseline scenario, rapid growth gives with respect to FY 2012: (i) Welfare gains: an extra 2.1 percentage points in annual growth of private consumption; (ii) Job-creation gains: an extra 7.6 percentage point drop in unemployment; (iii) Public debt and fiscal gains: an extra 9.9 percentage point of GDP decline in the total government debt in 2022 (close to 50 percent of GDP), with added fiscal space generated; and (iv) Poverty gains: an extra 5.5 percentage point decline in the headcount poverty rate. Overall, the positive effects of a sustained period of high growth would spread to macroeconomic demand indicators and all the major production sectors, as well as contribute to a more substantial decline in poverty rates and faster improvement in other MDGs (inclusive job creation growth).

96. Simulations expanding the BISP coverage also bring additional poverty reduction gains. Currently, BISP eligibility is determined by a proxy means test based on a national census carried out by the program. Potential beneficiaries are identified by applying the BISP's proxy means test to the 2011 household survey. Simulations on a transfer amount of PKR 1,200 amount increased by this Government, was simulated for each household. It shows that nearly two thirds of the Pakistan BISP benefits would accrue to the poorest 40 percent of the population, i.e. the program is pro-poor. Program targeting suffers because of implementation challenges common to all large-scale social programs, including measurement error in the targeting system, and the difficulty of reaching households lacking identity cards. Nevertheless, with 65 percent of its benefits reaching the poorest two quintiles, the Pakistan BISP targeting performance is close to many older programs such as 'Oportunidades' in Mexico, where 73 percent of benefits go to the poorest 40 percent. However, the benefit of PKR 1,200 per month, barely is 7 percent of the poverty line and

about 6.2 percent of beneficiaries' consumption, ranging from 8.5 at the lowest decile to 2 for the highest decile. Overall, the projected impact of BISP coverage expansion on the poverty rate is a positive, with a small reduction of 2.2 percentage points (from 13.6 to 11.4 percent) in the next 5 years; and this impact further increases, but mildly, with the new Conditional Cash Transfer component linked to children attending primary education under pilot test in 2013.

Annexure 1 – Pakistan: A few concerns regarding poverty data measurement gaps

While concerns have been raised about the methodology used to construct the poverty line, these are unlikely to have a major effect on poverty trends. Two main aspects of the methodology used to calculate poverty have received considerable attention. First, the poverty line is based on 1998 data, and is updated using the overall Consumer Price Index (CPI) as the deflator. Using the CPI tends to overestimate the true decline in poverty; and failing to update the poverty line doesn't account for households changing their consumption patterns in response to changes in relative prices. On the one hand, deflating the poverty line using the overall CPI slightly overestimates the decline in poverty. This is because the relative price of food increases over time and the poor tend to consume a larger share of their budget on food. In practice, in illustrative calculations for Punjab, this overestimates the decline in poverty by no less than 3 percentage points. On the other hand, when relative food prices change, households adjust, allowing them to meet their minimum caloric requirement at a lower cost in real terms. This lowers the poverty line and reduces true poverty, i.e. failing to do so tends to underestimate the true poverty gains. Because the poverty line has not been updated, however, it is hard to know how big a difference this change in consumption patterns will make.

While these concerns are legitimate, they do not fundamentally alter the direction of the declining trend in poverty reduction. The age of the poverty line and choice of CPI are each likely to have small effects on the overall poverty trend. Furthermore, the two concerns indicated above work in opposite directions and therefore partially cancel each other out. Some experts though argue that the minimum caloric intake chosen for Pakistan is too low, which affects the level of poverty more than its CPI-deflator originated bias over its time trend.

Other concerns have been raised about the quality of the sampling frame and data collection procedures in Balochistan and KPK. The sampling frame is based on the 1998 Census, meaning that households in newly constructed or settled residences are excluded. Balochistan is sparsely populated and a significant portion of the population is nomadic, which makes it difficult to collect accurate data in that province. Migration and conflict may have also have affected the accuracy of the sampling problem in Khyber Pakhtunkhwa in the last few years as well. Overall, however, there are no reasons to question the recent decline in poverty in KPK, and Balochistan's population is sufficiently small such that its large recent fluctuations in poverty do not alter the conclusion that overall poverty declined substantially in Pakistan. In short, important methodological issues should be addressed, but their eventual measurement errors are small when compared to the 17 percentage point reduction in the poverty rate observed between 1999 and 2011.