

# Pakistan

Report no. 75521-PK

## Finding the Path to Job-Enhancing Growth

A COUNTRY ECONOMIC MEMORANDUM



THE WORLD BANK

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The Frere Hall featured on the cover is a remnant of the British era. It is located in the heart of Karachi, which is the economic hub of Pakistan. The Hall was built in honor of Sir Henry Bartle Edward Frere, who was well known for promoting the city's economic development. The staircase alludes to a journey toward achievement, prosperity, and success. The Country Economic Memorandum also presents a transformational journey toward job-enhancing growth for Pakistan.

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Currency unit: Pakistani Rupees (PRs)

\$1 = 98.50 PRs as of June 2013

## ABBREVIATIONS AND ACRONYMS

<b>Disco</b>	Power distribution company
<b>EMBI+</b>	Emerging Markets Bonds Index
<b>EU</b>	European Union
<b>FDI</b>	Foreign direct investment
<b>GDP</b>	Gross domestic product
<b>Genco</b>	Power generation company
<b>MAMS</b>	Maquette for Millennium Development Goal Simulations
<b>MDG</b>	Millennium Development Goal
<b>NADRA</b>	National Database and Registration Authority
<b>NEPRA</b>	National Electric Power and Regulatory Authority
<b>PASSCO</b>	Pakistan Agricultural Storage and Services Corporation
<b>SAM</b>	Social accounting matrix
<b>SAR</b>	Special Administrative Region
<b>SDR</b>	Special drawing right
<b>SRO</b>	Statutory regulatory order
<b>TFP</b>	Total factor productivity
<b>TVET</b>	Technical and vocational education and training
<b>WAPDA</b>	Water and Power Development Authority

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## PREFACE

*"Pakistan has struggled with a chronic fiscal problem often sacrificing growth for short term stabilization...Accelerating the economic growth rate and sustaining it at a high rate must be treated as a national priority...Implementing the growth strategy will require serious, sustained and disciplined reform over the next few years."*

**Government of Pakistan, Framework for Economic Growth**

*"Unfinished structural reforms continue to raise risks to a sustained economic revival."*

**Pakistan Business Council, Fostering Economic Growth Forum**

*"If we want to understand why countries differ dramatically in standards of living, we have to understand why countries experience such sharp divergences in long term growth rates. Even small differences in these rates, when cumulated over 40 years or more, have much greater consequences for standards of living than the kind of short-term business fluctuations that have typically occupied most of the attention of macroeconomists. To put it another way, if we can learn about policy options that have even small effects on long-term growth rates, we can contribute much more to improvements in standards of living than has been provided by the entire history of macroeconomics analysis of countercyclical (short-term stabilization) policy and fine-tuning. Economic growth is the part of macroeconomics that really matters."*

**Robert Barro and Xavier Sala-i-Martin, Economic Growth**

*"The goal is not just the creation of jobs, but the creation of jobs of acceptable quality."*

**ILO, Decent Work**

It is 2013, and Pakistan's economy has not fully recovered from the aftermath of the global financial crisis. Imbalances resulting from economic mismanagement are only making the situation worse. A careful look at medium-term options is therefore in order. The central tenet of this report is that the country has the potential to recover high growth rates and is creating jobs, formal and informal. But just having more low-productivity jobs is not enough to sustain growth acceleration in the medium term. Pakistan needs better jobs as well.

The report identifies conditions for a sustainable job-enhancing growth agenda for Pakistan. Policy must target both goals as they are closely intertwined. Higher growth rates can be achieved through productivity improvements (technology, innovation, better economic governance), but also from higher output extracted from factors—physical capital, labor, human capital, and land. But there is no single formula to guarantee success. Indeed, achieving higher growth rates depends on policymakers' capacity to address the constraints holding Pakistan back, and this is essentially a governance challenge. And to make matters more complex, high growth rates do not in themselves guarantee the rapid creation of more productive jobs. Rapid growth needs to be accompanied by a shift from low-skilled to high-skilled jobs. From jobs in rural areas to jobs in vibrant cities. From farming and self-employment to wage employment. And—to some extent—from informal to formal employment. This process is called *job-enhancing growth*.

This report finds that ensuring rapid growth and job creation in Pakistan requires a holistic agenda. Macroeconomic measures to ensure fast GDP growth, at around 7 percent, need to be complemented by microeconomic interventions to enhance labor productivity. The main contributors to growing informal employment and underemployment in Pakistan are an expanding labor force (due to strong population growth), increased participation rates (with rapidly increasing female participation), and net increases in job opportunities. However, these same factors could result in lower dependency ratios and higher saving rates, leading to more output per person and faster capital accumulation. What is holding Pakistan back today is also its biggest opportunity for success.

This report brings together the views of a large group of Pakistani and World Bank experts. The motivation for its elaboration is the genuine desire to contribute to the development agenda of Pakistan. Its ultimate goal is to disentangle the complexity of the current situation and to propose the basic ingredients for a new phase of rapid growth and job creation.

This report comes at a critical time for Pakistan: the onset of the first general elections supporting a democratic transition. As such, its main goal is to contribute to provide useful analytical inputs to the next team in charge of economic policy. And in doing so, it does not pretend to impose any possible solutions or settle long-standing debates, but rather to adventure into proposing fresh new inputs, while taking all the benefits and risks that the level of incompleteness of global knowledge about Pakistan allows. While cautioning about these risks, it hopes to open new avenues in the ongoing and prolific critical debate about jobs and growth in Pakistan.

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Most contributions and background papers supporting this report's drafting have now been disseminated through various means or are scheduled to be published on the Bank's website in the very near term. Indeed, most papers have animated the growth debate in Pakistan in the last two years. Other contributions have been presented in international forums or at the Bank's headquarters in Washington, DC. A detailed list of the pieces scheduled to be included in the new Policy Paper Series for Pakistan is in the references. They are now public documents and available from the Authors otherwise.



# Overview

Pakistan's rebound from the global financial crisis has been slow and fragile, and unless the economy changes course swiftly, it could face its second balance of payments crisis in five years. Its recovery from the 2008–09 global financial crisis has been the weakest in South Asia, with a double-dip pattern. Short-term macroeconomic imbalances were barely improving when two floods hit the country in 2010 and 2011. Despite some recovery of exports and strong remittances, borderline stagflation continues—modest growth with (until recently) double-digit inflation, compounded by unsustainable macroeconomic policies and domestic and international armed conflicts. Pakistan must now climb out of this untenable situation.

There is only one way forward: Pakistan must climb from its modest economic growth path to a much faster path. Its demographic transition is an opportunity to swiftly accelerate growth. With its high fertility, its already young population will double by 2025. The labor force has risen faster (3.7 percent a year) than the regional average (3.1 percent), a result of a larger working-age share of the population and a higher labor force participation (especially by women). The youth workforce has grown even faster, at 4.3 percent a year, well above the regional average of 2.7 percent and expected to continue at that rate for at least 10 years.

How to convert this massive demographic bulge from a political and social burden to an exceptional demographic dividend? Through rapid and inclusive job-enhancing growth that creates millions of new and better private sector jobs. The labor force is expected to expand 3.5 percent a year, as about 1.5 million young workers start seeking jobs each year. If female labor force participation rises, the pressure for new jobs will be even stronger, with net migration at less than 1 percent of the labor force.

But just creating large numbers of jobs is not enough. Creating more productive jobs—with jobs defined to include all wage work and self-employment, formal or informal—is the most reliable route for individuals and societies to move away from poverty, crime, and civil conflict. International experience shows that the key to sustaining accelerated growth is shifting the labor force from low-skilled to high-skilled jobs—in a job-enhancing process. East Asia's successful economies, and Pakistan's growth acceleration in the mid-2000s, are good examples of how this can happen.

Rapid growth and more and better jobs are attainable, but to be sustained they have to be pursued in tandem. Growth creates opportunities and incentives for people to specialize and get a better education, move from farm activities to more specialized and service-oriented nonfarm activities, and rely less on government transfers and jobs and more on competition, innovation, and private initiative. Economies also grow faster as people acquire better skills and move from less productive rural activities to more productive private urban jobs.

This report considers whether Pakistan should pursue historical growth of 4.3 percent a year, supported by piecemeal structural reforms leading to partial and unsatisfactory outcomes—or rapid growth of 7 percent, requiring comprehensive big-bang reforms.

The report is organized around three major themes:

- *The stylized facts.* What are the pluses and minuses of Pakistan's patterns of growth and job creation?(*Chapters 1–2*)
- *The diagnostics.* What is holding back Pakistan's growth?(*Chapter 3*)

- *The transformational agenda.* What are the core ingredients of job-enhancing growth? And how can analysis of the political economy identify policy tradeoffs?(*Chapters 4–5*)

The stylized facts show that Pakistan's growth and jobs record is less than stellar, but that its huge potential is not fully exploited. The report looks at why Pakistan is diverging from the rest of the world. It also looks at the main characteristics of Pakistan's declining growth—and at the redistributive potential for growth to be inclusive and job-enhancing.

The diagnostics use two strategic approaches to growth. One focuses on the accumulation of physical capital, labor, human capital, and land, financed by domestic and external savings, while enhancing their productivity. The second focuses on minimizing the binding constraints—microeconomic risks affecting domestic entrepreneurship, increased openness to external trade and foreign investment, and sound governance and business regulations. Both strategies assume that a sustained acceleration in growth is possible only with sound macroeconomic fundamentals and sustained productivity improvements, fostered by private initiative.

The transformational agenda takes advantage of the rare opportunity for Pakistan to embark on a new growth and job-enhancing trajectory. Balanced, it deals with the short-term macroeconomic imbalances, the microeconomic constraints that limit productivity and competitiveness, and the conditions for creating better private sector jobs. The agenda draws on the government's 2011 Framework for Economic Growth but expands on it with complementary policies for short-term stabilization, access to finance, export diversification, pro-poor growth, and job enhancement.

Recent developments show the failure, fragility, and high risks of a “wait and see” approach. Preliminary growth estimates for fiscal 2013 are feeble at around 3.5 percent, while inflation might rise to double digits again in the next fiscal year. With large fiscal deficits, Pakistan has little space to implement counter cyclical fiscal policy. It also faces a steep decline in domestic and foreign direct investment, a severe drain on international reserves, and an uncertain international environment that reduces the prospects for growth. But if a transformational agenda is implemented well, the incoming administration can break with the past.

## **Main features of growth and job creation**

The stylized facts of Pakistan's growth are typical of an underperforming economy. Its growth accelerations tend to be short lived—since 1961 the country has seen only three episodes of at least four years of successive GDP per capita growth above 3 percent: 1963–66, 1980–83, and 2004–07. Its long term—structural—growth trend is declining—from an average of 6–7 percent in the 1960s to 3 percent in the late 2000s. Its current growth rates are below potential (with a cyclical “output gap”) and significantly diverging from its most competitive neighbors—India and China. And the volatility of its GDP growth is average by international standards, but it has increased since the last decade, which accounts for the perceived slowdown and increased fragility of its poverty gains during the last five years.

Looking backward, perhaps the most important reason for declining long-term growth is that structural reforms have been growth-reducing rather than growth-enhancing. The declines in labor productivity and total factor productivity over the last two decades are puzzling. This

period coincided with the initial liberalization of the economy, which should have improved productivity. In the mid to late 1990s the government introduced banking and trade reforms, and in the early 2000s a large privatization program followed—involving major investments in telecommunications, roads, and power infrastructure. In other countries, such reforms substantially boosted output per worker and total factor productivity, but not in Pakistan. Why?

The answer is that structural reforms were fragmented, badly sequenced, or truncated—preventing major labor reallocations. East Asia's labor reallocations, from less productive to more productive sectors (as from agriculture to services), drove labor productivity. Reforms in India, Indonesia, Malaysia, Thailand, and Turkey produced growth-enhancing structural change. But this did not occur in Pakistan, where most of the reallocation was oriented mainly to low-productivity activities in the same sectors. Political and security uncertainty, poor implementation of structural reforms, and macroeconomic instability (and its associated fiscal stress and volatile external financing) have also held back most of Pakistan's reforms. The exception is when these reforms have had the right ingredients for success, as with the trade liberalization and banking sector reforms in the past decades.

Other findings identify important positives of Pakistan's growth and job creation—but also negatives (box 1). If Pakistan can make good use of the positives while addressing the negatives, it will have significant room not only to perform above potential (filling its output gap in the short term) but also to revert its long-term decline.

### **Box 1** Key positives and negatives of Pakistan's growth and job creation

#### *Growth positives*

- Favorable demographics: low dependency ratios.
- Favorable demographics: potential for high saving rates.
- Resilient growth due to its large informal sector and high share of remittances in national savings.
- Quiet revolution: rising educational attainment and labor force participation by girls.
- Good geography (location) and abundant natural endowments (mining and water).

#### *Growth negatives*

- Cyclical macro instability: short and faltering growth accelerations.
- High country risk and political instability: low foreign direct investment and external inflows prone to sudden stops.
- Low and falling capital accumulation: low domestic investment and crowded-out private credit.
- Low and falling total factor productivity: declining trend in long-term trend.
- Marginal contribution of land accumulation to growth: declining agricultural productivity.

#### *Job creation positives*

- Very high elasticity of poverty reduction to growth.
- High returns to labor driving poverty reduction during growth accelerations.
- Growth accelerations showing a move from unpaid work to off-farm and more productive employment.

#### *Job creation negatives*

- Labor accumulation intensive but in informal, low-skilled jobs, mainly in agriculture.
- Variable human capital accumulation combined with low enrollment in primary education and low completion rates favor growth of unskilled labor force.
- Low total factor productivity growth suggests job “churning,” moving from one low-productivity job to another.
- Stagnant external openness suggests low export competitiveness and slow diversification.
- Low contribution of structural transformation to intersectoral growth-enhancing labor shifts.

Looking forward, Pakistan's growth and job prospects will have to rely not only on filling gaps, especially the one on infrastructure that has fallen to alarmingly low levels, but on creating new job-drivers. The weak external environment is affecting manufacturing and agricultural export growth. Domestic macro-imbalances impair domestic credit expansion and the overall environment for private investment. The potential for more productive private sector jobs lies in modern urban services and more competitive (and green) manufacturing, and in more productive farm and nonfarm activities.

Each of these activities has a role. Jobs in urban services are important for trade, commerce, and construction. They are also important for networking, learning, and social mobility. Manufacturing jobs—urban or rural—are essential for accelerating the diversification of Pakistan's export basket and improving its competitiveness. More productive agricultural jobs, both in crops and livestock, also have demonstrated positive spillovers to urban development, job creation, and poverty reduction. Cross-sectoral policy reforms creating conditions for job creation in productivity-enhancing activities are needed to support the structural transformation and related increases in productivity needed to sustain accelerated growth.

### What is holding back Pakistan's growth?

The binding constraints to Pakistan's growth are numerous. Some of them are structural, with a long history; others have emerged in recent years (box 2). Emerging constraints include massive cuts in electricity access and macroeconomic instability, leading to high country risk and a sudden stop in external and domestic financing. Structural constraints include low access to domestic finance and government and market failures (micro risks) that impede investment, entrepreneurial activity, and competitiveness, blocking the transition from low-productivity to high-productivity jobs. The main government failures are ineffective taxation, large anti-export bias, cumbersome business regulations, and poor civil service. The contributing market failures are bad governance, excess business regulations, and an ineffective civil service. By holding down productivity, emerging failures prevent growth from taking off, while structural failures limit the sustainability of growth accelerations.

#### **Box 2** The binding constraints to growth

##### *Emerging constraints:*

- Poor access to electricity.
- High macro-fiscal risks.
- High country risk and sudden stop in external financial inflows.

##### *Structural constraints:*

- Low access to domestic finance.
- Slow productive diversification and high anti-export bias.
- Ineffective taxation.
- Micro risks: bad governance, excess business regulations, and poor civil service.

## Pursuing 7 percent growth—and the benefits of a bold approach to reform over a piecemeal approach

The report explores the benefits of 7 percent average annual GDP growth for fiscal 2013–22 (bold reform approach) over moving Pakistan to its historical average of 4.3 percent (piecemeal reform approach). Actual average GDP growth has been slightly below 3 percent for the last four years.

The benchmark scenario sees the economy returning in fiscal 2022 to its average historical growth rate (4.3 percent), private consumption rising 4 percent a year, unemployment falling about 3.1 percentage points, government debt increasing 0.3 percentage points of GDP, poverty declining 6.4 percentage points, and mild Millennium Development Goal progress.

In contrast, swiftly raising annual GDP growth to 7 percent assumes that broad and sustained structural reforms would improve 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.

Rapid growth, supported by higher private and government investment (with a focus on infrastructure), and enhanced total factor productivity would produce the following in comparison with the benchmark scenario:

- Welfare (and growth-inducing) gains: an extra 2.1 percentage points in annual growth of private consumption.
- Job-creation gains: an extra 7.6 percentage point drop in unemployment.
- 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.
- Poverty gains: an extra 5.5 percentage point decline in the headcount poverty rate.

In sum, a 7 percent annual growth can produce more (and implicitly better, given higher total factor productivity) jobs. The positive effects of 10 years of 7 percent growth average would spread to macroeconomic demand indicators and all the major production sectors, as well as contribute to a more substantial decline in poverty rates (pro-poor growth) and faster improvement in other Millennium Development Goal indicators (inclusive growth).

## What does faster growth and job creation require?

On the growth acceleration front, the Commission on Growth and Development (2008) identified the common characteristics of 13 economies with high and sustained growth in the postwar period.

- *They maintained macroeconomic stability.* Poor macro fundamentals (and particularly inflation) are bad for growth.
- *They let markets allocate resources.* Growth strategies were strongly market-oriented, and deregulated markets allowed price signals to function.

- *They mustered high savings and investment.* High savings and investment—on average 25 percent of GDP or more—sustain high growth.
- *They fully exploited the world economy.* Transfers of knowledge and technology were key channels for innovation and competitiveness—through FDI, education, networks, and experience.
- *They had committed, credible, and capable governments.* All the successful economies had a sound economic governance framework and a consensus supporting the growth strategy. Well-represented and effective leadership resolved the political economy challenges to reform.

On the job creation front, the *World Development Report 2013: Jobs* presented two key lessons:

- *Growth does not guarantee job enhancement.* The relationship between productivity gains and job enhancement is not mechanical. Over the medium term, employment aligns closely with the labor force's size, so growth is truly jobless in very few cases. But in the short term, dedicated job-enhancing programs can be associated with a rise or decline in employment. So, faster growth is not enough to guarantee good jobs.
- *Job challenges are diverse, so customized policies are needed.* The job challenge in an agrarian economy is not the same as in a rapidly urbanizing economy, so each country needs to prepare its own job-enhancing agenda. Pakistan's job challenges are that it is agrarian, urbanizing, and conflict-affected, and has high youth unemployment.

Pakistan's policymakers believe that faster growth alone will cover its job needs, but this report argues that it is not only the number of growth-generated jobs that matters, but also their quality. Pakistan has to create around 1.5 million jobs a year until 2020 just to keep unemployment constant (and underemployment constant), assuming labor force participation by women remains constant. Labor force growth of about 3.5 percent a year requires GDP growth of about 7 percent a year. However, Pakistan also needs good jobs.

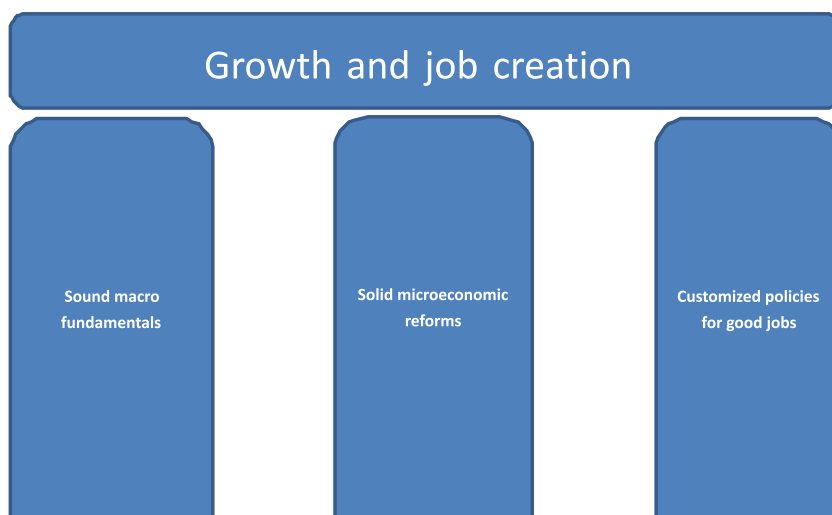
Three dimensions make jobs good. First is productivity: as more productive jobs appear, less productive ones tend to disappear. Second are living standards: they can improve as long as income rises or poverty falls, but they can deteriorate if people are trapped in volatile, low-income, and low value-added jobs. Third is social cohesion: jobs, even informal ones, can bring together people from different ethnic and social backgrounds. Private sector jobs that address all three dimensions can be considered good, but not all jobs are good. For example, jobs supported by government perks or transfers, like those in state enterprises, undermine the earnings or job opportunities of others, and some jobs in lagging industries benefit from trade restrictions.

The transformational agenda proposed here identifies three pillars that complement each other (figure 1):

- Macro-fiscal, restoring solid fundamentals.
- Microeconomic, setting priorities for structural reforms to lift the binding constraints to productivity-led growth and providing the funds to fill the infrastructure gap.
- Job enhancing, creating conditions for urban and agricultural jobs and targeting youth and female workers.



Figure 1 Three pillars of job-enhancing growth agenda



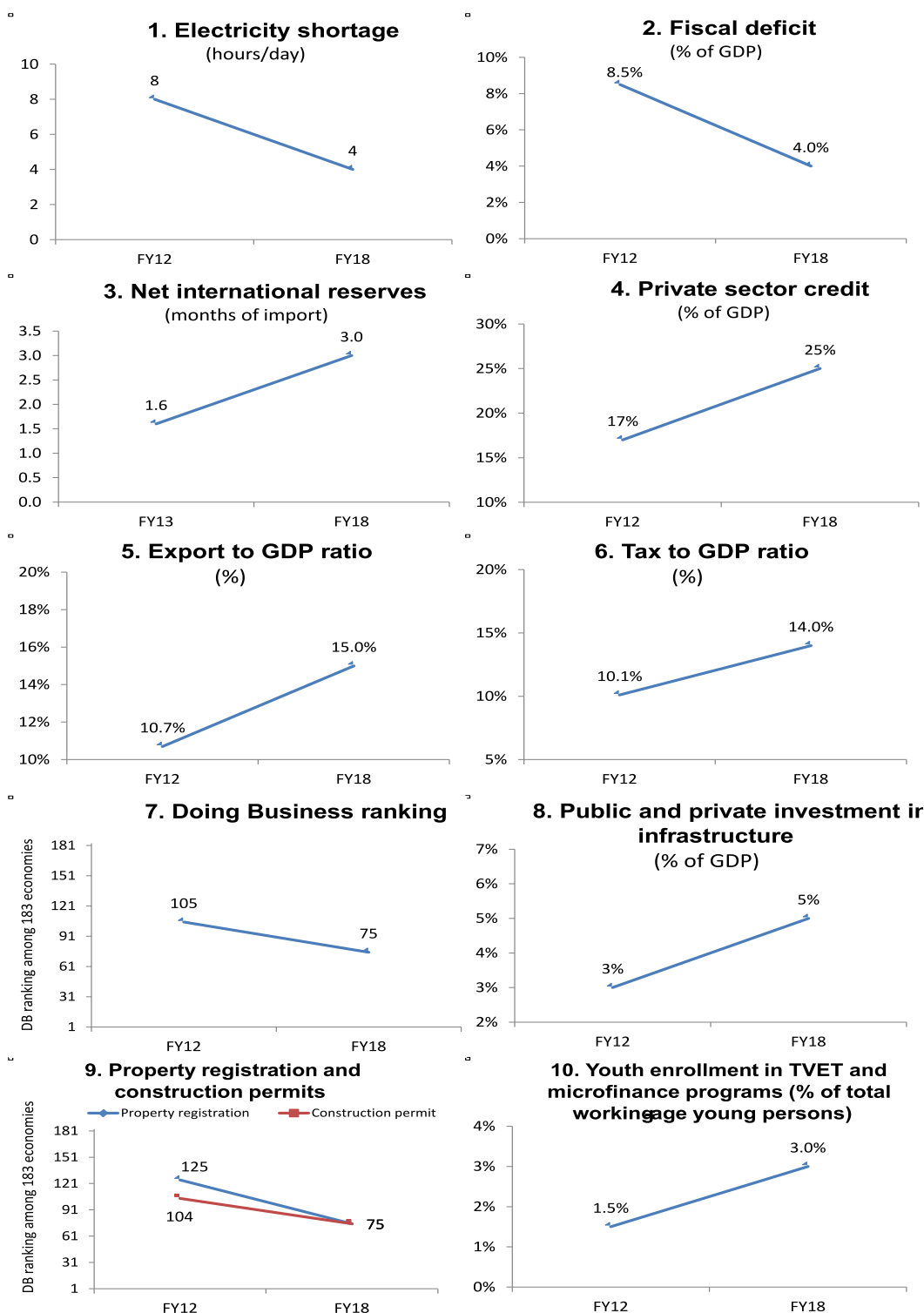
Source: Authors.

The transformational job-enhancing growth agenda should start with a national vision (figure 2). The overarching goal could be reaching 7 percent economic growth and creating 1.5 million more (and better) jobs a year by the end of fiscal 2018. Some consensus around the required measures could be endorsed (explicitly or implicitly) by the main political parties of parliament in the next administration and shared by provincial governments. The detailed job-enhancing agenda proposed here to reach this vision takes into account the international lessons and is tailored to create good jobs (see annex table 1 at the end of this overview). While a full list of the policies required can be found in the body of the report, a few selected ones, grouped around each outcome of the vision, stand out.

***To deal with the power crisis, cut average load-shedding by at least half—from eight hours a day to less than four, as in 2007***

Solving the power crisis is the top priority for growth, but the task is far from simple, and action is required on several fronts. An emergency plan of short-term policy measures could focus on improving governance, reducing subsidies, and ensuring gas supplies. A single-point lead authority could manage power sector reform and appoint professional and competent CEOs in distribution companies (Discos) and generation companies (Gencos). Along with visible reductions in power outages, a clear schedule of power tariff increases could gradually bring notified tariffs to the average minimum determined tariff. And line losses and theft could be reduced with the support of a new electricity bill. High priority should also be given to creating incentives for private investment in gas fields. Medium-term reforms would aim at wholesale energy sector reform. Besides completing the phase-out of the tariff differential subsidy, important energy and domestic gas projects could be put on a fast track (small and big dams). Discos could be made financially independent, privatized, or reorganized as corporations. And while the circular debt can be unwound over time once the system is on sounder footing, consideration can be given to taking it off the books of the energy companies and parking it for now.

**Figure 2 A vision for Pakistan in 2018:**  
targets supporting 7 percent job-enhancing growth



Source: International Monetary Fund, World Development Indicators, and Doing Business database.

***To deal with the macro-fiscal crisis, gradually achieve a sustainable fiscal deficit of 4 percent of GDP and a public debt to GDP ratio at or below 50 percent***

Solving the fiscal crisis is the key to strengthening the external position, improving the sustainability of public debt, and regaining the confidence of markets. It requires an emergency fiscal package to boost revenues, mainly by eliminating tax exemptions (except for priority medicines and food items for the poor) and zero rates, adopting austerity spending, and shifting from untargeted to targeted subsidies. If combined with a growth-oriented set of structural reforms, this would help restore prompt access to fast-disbursing budget support and international lines of credit. The medium-term focus should be on fiscal consolidation, including thorough tax policy and administration measures (see below), a reorientation of the development budget, and a rebalancing of the intergovernmental fiscal relations.

***To deal with the sudden stop in external financing, rebuild the international reserve position to at least three months of imports, twice its present level***

Restoring sound macro fundamentals and signing an International Monetary Fund program are basic steps in reactivating financial flows. Temporary exchange controls and bridge financing from a few bilateral donors—Coalition Support Funds from the United States or deferred oil payments to Saudi Arabia—would help, but not bring a permanent solution. In the medium term, reducing country risk also requires greater political and social stability, translating a potential peace dividend into perceptions of an investment-friendly country with much lower risk.

***To tackle low domestic access to finance and end the credit crunch, raise private sector credit to 25 percent of GDP, its average in the mid-2000s, and 50 percent above its present level***

Creating conditions to end the credit crunch is the immediate priority. Favoring mildly positive but low real interest rates and reducing government borrowing from scheduled banks would reduce the banks' incentives to crowd out private credit. In the medium term, the focus should be on increasing financial access and facilitating bank and nonbank credit to small and medium enterprises. New bills on collateral (allowing movable property) and on credit information (favoring the entry of credit bureaus to provide informal credit assessments) would secure lender's rights. Developing regulatory norms for micro insurance products would foster small entrepreneurs. Improving the judicial system and upgrading land records would help settle commercial disputes promptly.

***By promoting export diversification and reducing the anti-export bias, raise the export to GDP ratio to about 15 percent, its average in the early 2000s***

Pakistan already has an ambitious trade strategy paper aiming at \$95 billion in exports for 2012–15 (close to the target proposed here). In the short term, removing distortions and completing India's normalization process has promising growth potential. Removing all trade-related statutory regulatory orders (and prohibiting the issuance of new ones) would help liberalize trade. In the medium term, reducing the anti-export bias is fundamental for trade competitiveness. This requires a roadmap to simplify tariff slabs to three (0, 10, and 25 percent), thus eliminating privileges. New special economic zones could attract Indian, Chinese, and Malaysian firms—due to their growth potential. Tangible improved customs and logistics procedures at the Wagha border could deliver a visible demonstration effect. Active policy could foster supply chains in textiles, car parts, and information technologies. And to foster innovation, a minimum level of investment encouraging innovation (up to 0.5 percent of GDP) could also be agreed, following the example of emerging and developed economies.

***To deal with ineffective taxation, achieve tax revenues of 14–15 percent of GDP by 2018, up from about 10 percent today***

The federal government could make three-quarters of this effort and the provincial governments one-quarter. In the short term the focus should be on governance and in reversing the severe fall in revenue in 2013. A key measure for the Federal Board of Revenue is to appoint a well-respected Chairman and Board Members with a minimum tenure of two years. A new national tax policy committee—staffed by Federal Board of Revenue and ministry of finance professionals—could displace ad hoc with sound, well-designed tax policy. Reforming the tax code is essential for pursuing stronger audit and enforcement. In the medium term the priority would be to complete the gradual elimination of tax exemptions and zero rates and to reduce CIT and PIT ceiling rates as part of wholesale tax reform. That would require a modern and integrated information technology system, a massive taxpayer registration campaign, and risk-based audits. Converting the Federal Board of Revenue into a fully autonomous institution—reliant on its own generated revenues, staffed with high-quality professionals independent of the civil service regime, and accountable to parliament—would follow best international practices in tax administrations. The provincial governments could start their own tax reform by expanding coverage of their sales tax services.

***To overcome the “soft” regulatory barriers to the business environment, improve Pakistan's Doing Business Indicator to 75th place (up from 105th among 183 economies)***

Streamlining cumbersome business regulations requires dedicated efforts. In the short term the federal government could set up and implement a one-stop shop for business registration. In the medium term, the focus would be on commercial disputes and business regulations. New courts could be created to solve commercial disputes. A corporate rehabilitation bill could enable banks to curtail deterioration of the quality of their claims on the corporate sector, either through a court-approved restructuring or liquidation. A modern companies act could facilitate corporate transparency and protect the rights of minority shareholders.

***To initiate long-overdue civil service reform, make public payroll policy transparent and uniform***

Addressing the drag imposed on the private sector by an underperforming and overpaid public sector is essential. In the short term, the focus could be on preventing the expansion of existing (and generous) perks and promoting professional hiring practices by the new administration. This could involve creating a monitoring board attached to the Prime Minister's office. In the medium term, the focus could be on monetizing at least half the actual amount of perks, with public servants in higher grades moving faster to market comparators and protecting pay in lower categories—all while preserving high standards for hiring.

***To fill the infrastructure gap, increase public and private investment to at least 5 percent of GDP***

Fiscal consolidation should open fiscal space for public infrastructure only gradually. This concerns not only the federal but also the provincial governments, whose resources have been increased significantly. For public investment, priority could be given to increasing federal and provincial budgets for power generation, irrigation, and road operations and maintenance. For private investment, improving the regulatory framework for private-public partnerships would encourage private investment.

***To improve service delivery, privatize at least two major state enterprises, and reduce state enterprise losses by half***

Due to political sensitivity, this area requires strong governance up front. Following the strengthening of the Privatization Commission, to create a level playing field and improve services, the government should prepare a roadmap on which loss-making state enterprises can

be privatized or restructured quickly. Announcing the privatization of Pakistan International Airways and Pakistan Steel Mills could be important steps. In the medium term, the government should issue norms for effective implementation of corporate governance rules, create a Future Generations Fund with the privatization proceedings, pass a bill framing commercial activities by the state, and set hard budget constraints for state enterprise profits and losses.

***To foster urban potential for better jobs, move Pakistan's rank on Doing Business to 75th position in property registration and construction permits***

Cities should become growth-friendly clusters with green industrial parks on their periphery—which would foster firms' competition and workers' learning—and large and dense markets for goods and services. In the short term, the focus would be on governance, reducing the number of institutions delivering basic services and on revamping urban planning through strong coordination among federal, provincial, and local governments. In the medium term, the focus could be on creating business-friendly cities by revamping zoning laws, streamlining property registration and construction permit procedures, and establishing a national database for housing titles and prices.

***To create conditions for productive employment in agriculture, increase agricultural productivity by 1 percent a year and irrigated land by 10 percent***

Pakistan cannot afford to ignore agriculture while trying to diversify manufacturing and services. In the short term, the focus would be on improving governance and increasing resources for agricultural extension—streamlining the myriad institutions devoted to agricultural research and extension. Provincial governments, thanks to their fiscal space, should be the first to increase resources for agricultural research and extension. In the medium term, private investments should be encouraged in high value-added activities in agriculture. Increasing the budget for irrigation and water management by 20 percent would be instrumental in increasing the irrigated land.

***To deal with youth (and female) unemployment, mainstream the technical and vocational education and training systems to reach at least 3 percent of youth in the working-age population (about twice today's enrollment)***

Targeting youth and female unemployed and unskilled workers, as well as demobilized army members, these programs should provide either a combination of counseling, training, job-search assistance, intermediation, and subsidized internships—or micro finance skills to foster entrepreneurship. In the short term existing programs could be benchmarked to assess their potential. In the medium term, budgetary resources would be increased for existing technical and vocational education and training and micro finance programs—with the Punjab Technical and Vocational Education and Training, the Sindh Benazir Bhutto Shaheed Youth Development Program, and the Skills Development Program as the most important. 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.

***Potential synergies between federal and provincial strategies***

Pakistan's provinces have solid growth potential arising from their diverse geography, abundant natural and human resources, and international links. The provinces also have varying 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 Bin Qasim, the country's main seaport in

Sindh. 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, coal, and limestone—a solid agricultural and industrial base. Bin Qasim 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, gemstones, and oil and gas) and its geographic diversity (from high mountains in the north to the Indus plains in the south) offer great potential in mining, hydropower, and tourism. But the province relies mostly on services because of geographic constraints, including its distance from Bin Qasim.

Punjab has been the largest contributor to national income, at more than 50 percent, followed by Sindh and Khyber Pakhtunkhwa, at 10–30 percent, and Balochistan at less than 10 percent. There are no official estimates of provincial GDP and other macroeconomic variables, but unofficial World Bank estimates show that growth has also varied, with Balochistan lagging in the last decade. One of the main reasons for unbalanced growth, despite strong potential, is the country's one-size-fits-all policies, giving too much attention to the federal level and not enough to the provincial. Addressing province-specific issues and improving service delivery require thorough understanding of the different growth paths of provinces and their underlying constraints. But the lack of reliable primary data hampers research.

The preliminary framework for designing customized solutions to provincial growth constraints focuses on provincial constraints to doing business. Identifying the severity of “soft” business regulations as bigger/smaller binding constraints to growth per province informs customized solutions and potential for interprovincial collaboration. For instance, registering property takes longer in Balochistan, while enforcing contracts takes longer in Khyber Pakhtunkhwa. Access to finance is a bigger problem in Punjab, while paying taxes is a greater obstacle in Sindh. Federal and provincial strategies, while assigning areas of reform priorities, should recognize specific public sector management weaknesses affecting service delivery, public and private investment, and overall productivity.

### **The political economy of reform**

Structural reforms are rooted in a complex political economy. Clever skilled management is critical for success. Structural weaknesses in the system reflect skewed incentives, inequities across economic activities and sectors, and corruption and capture by myopic elites. Stop-and-go reforms have had mixed results, with weak and varied sustainability. Pakistan remains trapped in its inability to accelerate growth and create better jobs.

Managing the political economy first requires taking into account lessons from prior successes and failures in implementation. These could help shape future attempts in Pakistan:

- A consensus for reform is usually easier to achieve during crises, but once the crisis is over, there is little appetite to sustain the reform.
- Political leadership at the top (with a champion designing and implementing reform) is essential for vision, commitment, and credibility, but only skilled managers with persuasive negotiating capacity can move reforms through troubled political waters.
- Solid technical design makes the acceptance of reform more likely, especially if it identifies winners and losers and designs proper contingency (or compensatory) actions to minimize their opposition.
- Early gains (low-hanging fruit) provide momentum for further progress.
- Financial support from donors is secondary and not determinant. And if it forces reform with no ownership, it can even be counterproductive. Timely and qualified technical assistance, on the contrary, is valuable.



Second, policymakers need to carefully weigh policy tradeoffs between growth impacts and policy drawbacks. Based on international experience, a scorecard of the possible tradeoffs of some of the major reforms in the transformational job-enhancing growth agenda is proposed below. Selected reforms are grouped in three categories: macro-fiscal policies, energy, and other measures (figure 3). Take the elimination of tax exemptions, which can deliver the highest macro (especially fiscal and efficiency) impacts but has the downsides of political sensitivity and some fall in aggregate demand—as taxes reduce consumption. Similarly, eliminating subsidies in electricity appears to favor macro stability, efficiency, and private investment, but doing so produces some fall in aggregate demand, is politically sensitive, and risks a lack of political commitment. Finally, normalizing trade with India would have the biggest growth impact (through its effect on private investment and productivity enhancement) and no drawbacks, which makes it easier to adopt. Carefully examining such tradeoffs should help the incoming authorities make the best possible decisions.

Figure 3 Tentative scorecard for a few possible job-enhancing growth policies

(+ = positive; 0 = neutral; ? = unknown; ↓ = negative effect)

Macroeconomic measures	Growth impact			Possible drawbacks			
	Macro sustainability	Efficiency/ TFP growth	Private investment	Aggregate demand	Political stability	Takes time to implement	Lack of commitment
Reduce exemptions, simplify GST with VAT	+++	+	0	↓	↓		
Fully autonomous Board of Revenue bill	++	++	0			↓	
Modernize tax administration	+	+	0			↓	
Revise intergovernmental fiscal rules	++	+	0			↓	↓
Strengthen provincial tax agencies	++	+	0			↓	↓
Give central bank more autonomy	++	0	0			↓	

#### Scorecard for energy sector reform

(+ = positive; 0 = neutral; ? = unknown; ↓ = negative effect)

Energy sector measures	Growth impact			Possible drawbacks			
	Macro sustainability	Efficiency / TFP growth	Private investment	Aggregate demand	Political stability	Takes time to implement	Lack of commitment
Cut subsidies, increase tariffs	++	+	++	↓	↓		↓
Improve collection	+	+	++				↓
Privatize electricity distribution	++	++	++		↓	↓	
Clear circular debt arrears	?	0	++				↓
Merge ministries, rely on gas	0	+	+++				
Create central purchasing agency	+	++	+				↓
Provincialize power companies	0	?	?				

#### Scorecard for other measures

(+ = positive; 0 = neutral; ? = unknown; ↓ = negative effect)

Other possible measures	Growth impact			Possible drawbacks			
	Macro sustainability	Efficiency / TFP growth	Private investment	Aggregate demand	Political stability	Takes time to implement	Lack of commitment
PPPs in infrastructure	?	?	++			↓	↓
Trade with India	0	++	+++				
Commercial rules for SOEs	+	+	+			↓	↓
Civil service reform	0	+	0			↓	↓
Better busines regulation	0	++	+				↓

TFP is total factor productivity; GST is general sales tax; VAT is value-added tax; PPP is public-private partnership; SOE is state enterprise.

**Annex table 1 Toward a new vision for Pakistan: the transformational job-enhancing growth agenda**

Policy Issue	Short term (first 180 days)	Mid term (up to end-fiscal 2018)	Final outcomes (fiscal 2018)
Addressing emerging constraints			
Electricity shortages	<p><i>Focus on governance, subsidies and gas supplies</i></p> <ul style="list-style-type: none"> <li>Establish one lead authority for power sector reform implementation, monitoring, and accountability.</li> <li>Pay the Water and Power Development Authority (WAPDA) for hydropower produced, put WAPDA's hydroelectric planning and investment on a "war footing," and establish integrated resource planning for investment decisions.</li> <li>Reform the management and boards of Discos to become businesslike with professional managers and board members with proven expertise in the business.</li> <li>Enhance revenues by notifying tariffs for all Discos and consumers at no less than 85 percent of the minimum average determined tariff and by issuing court stay orders to recover fuel cost adjustments.</li> <li>Ensure timely payment of subsidies from the budget, saving on penalties and interest.</li> <li>Promulgate/amend legislation to prosecute power theft, establish special courts or tribunals to expeditiously handle theft cases, and strengthen Discos capacity to investigate and submit cases for prosecution.</li> <li>Toughen enforcement for all levels of government to pay their electricity bills.</li> <li>Enhance incentives to promote further gas exploration.</li> </ul>	<p><i>Focus on wholesale energy sector reform</i></p> <ul style="list-style-type: none"> <li>Make Discos financially independent, privatized, or corporatized.</li> <li>Accelerate WAPDA's hydropower investment program with financing from internal cash generation.</li> <li>Enhance WAPDA's access to domestic financial markets.</li> <li>Give priority to power sector's use of official foreign financing.</li> <li>Facilitate coastal imported coal thermal power plants. Conclude agreements to import electricity from Central Asia.</li> <li>Notify tariffs for all Discos and consumers at 100 percent of minimum determined tariff, thus phasing down the tariff differential subsidy.</li> <li>Assist Discos with anti-power theft campaign (cutting theft by half).</li> <li>Eliminate subsidized gas distribution and gradually introduce market conditions and price competition.</li> <li>Facilitate liquefied natural gas import terminals.</li> <li>Set up a power transmission link with India (1,000 megawatt potential).</li> </ul> <p>Create a wholesale market for power purchasing.</p>	<p>Average national power load-shedding levels cut by half (to four hours a day or less)</p>
Macro-fiscal crisis	<p><i>Focus on fiscal crisis</i></p> <ul style="list-style-type: none"> <li>Approve an austerity federal budget for fiscal 2014 (cutting power subsidies, freezing public salaries, preserving the Benazir Income Support Programme budget).</li> <li>Initiate a three-year program to eliminate key tax exemptions and zero rates.</li> <li>Increase fuel taxes and special excise taxes (cigarettes, luxury items)</li> <li>Approve expanded coverage of services subject to the general sales tax</li> <li>Stop public procurement of agricultural products (wheat and others).</li> </ul>	<p><i>Focus on tax (see below) and expenditure reform</i></p> <ul style="list-style-type: none"> <li>Shift spending mix from untargeted power and state enterprise subsidies to development spending.</li> <li>Adopt policy of public salary increases at par with inflation.</li> <li>Thoroughly review and reorient the development budget.</li> <li>Complete review of the Finance Commission award balancing federal and provincial responsibilities with revenue.</li> </ul>	<p>Sustainable fiscal deficit reaches 4 percent of GDP and public debt below 50 percent of GDP</p>
Stop in external financing	<p><i>Focus on reversing stop in external financing</i></p> <ul style="list-style-type: none"> <li>Consider emergency measures to ration foreign exchange.</li> <li>Ensure bridge financing from bilateral donors.</li> <li>Adopt initial measures required to ensure official budget support from external financing (International Monetary Fund and donors).</li> <li>Consider placing bonds in sovereign markets if country risk reaches low levels.</li> </ul>	<p><i>Focus on rebuilding a minimum cushion level of international reserves</i></p> <ul style="list-style-type: none"> <li>Effective implementation of 2–3 year agreed program of growth-oriented structural reform (with International Monetary Fund and donors).</li> <li>Engage in process to end the armed conflict.</li> <li>Adopt measures to minimize political risk and attract foreign investment.</li> <li>Improve government services in Pakistan's conflict-prone border areas.</li> </ul>	<p>Net international reserves cover no less than three months/imports</p>

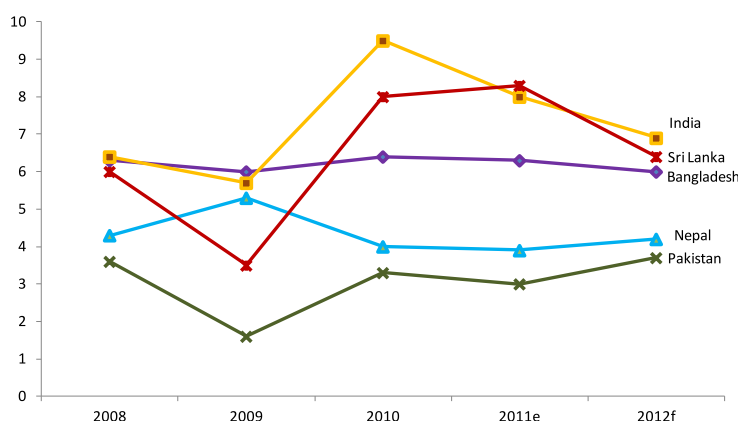
Policy Issue	Short term (first 180 days)	Mid term (up to end-fiscal 2018)	Final outcomes (fiscal 2018)
Addressing structural constraints			
Low access to finance, especially by small and medium-size enterprises	<p><i>Focus on reversing domestic credit crunch and on containing monetary financing of the deficit</i></p> <ul style="list-style-type: none"> <li>Cap government public borrowing from the banking system.</li> <li>Adopt macro policies to keep real interest rates mildly positive.</li> </ul>	<ul style="list-style-type: none"> <li><i>Focus on a more stable, efficient, and inclusive finance sector</i> Modernize payments systems by addressing gaps in the legal and regulatory framework, and undertaking initiatives to expand the use of electronic payments to enhance safety and efficiency, and to bring more users into the formal financial system.</li> <li>Pass a modern law and implement a notice filing archive to reform the collateral and registry system in support of both bank and non-bank lenders providing loans against movable property. Pass a modern credit information law, which focuses on the provision of deeper and more comprehensive credit information, fosters the entry of private credit bureaus, and provides stronger consumer protections.</li> <li>Develop a micro insurance regulatory regime for micro products.</li> <li>Develop a sound legal and regulatory framework for consolidated supervision including financial groups and conglomerates.</li> <li>Create a depositor protection scheme which will protect the vast majority of small depositors.</li> </ul>	Private sector credit rises to 25 percent of GDP
Slow diversification and high anti-export bias	<p><i>Focus on eliminating trade distortions and spearheading trade relations with India</i></p> <ul style="list-style-type: none"> <li>Approve a program to eliminate trade-related statutory regulatory orders in three years and prohibit issuing new tax and trade-related statutory regulatory orders in the fiscal 2014 federal budget.</li> <li>Grant most-favored-nation status to India.</li> </ul>	<p><i>Focus on reducing high anti-export bias and export diversification</i></p> <ul style="list-style-type: none"> <li>Approve a roadmap bringing the tariff regime down to three slabs (0 percent, 10 percent, and 25 percent) in the fiscal 2015 federal budget.</li> <li>Open at least two special economic zones dedicated to Chinese, Indian, and Malaysian firms.</li> <li>Complete overhauling of Wagha Border customs and transit procedures.</li> <li>Sign at least three new export value chains with Asian firms.</li> </ul>	Exports to GDP ratio reach 15 percent and trade flows with Asian partners double (especially China, India, and Malaysia)
Ineffective taxation system	<p><i>Focus on governance and on reversing severe fall in tax revenue (see fiscal crisis section)</i></p> <ul style="list-style-type: none"> <li>Appoint highly respected Federal Board of Revenue (FBR) Chairman and Board Members under minimum two-year tenures.</li> <li>Create a High Commission Finance/FBR on tax policy (open to outsourcing services).</li> <li>Reform tax code to strengthen enforcement of tax laws and prosecute white-collar crime of egregious tax evaders.</li> </ul>	<p><i>Focus on wholesale reform of tax policy and administration</i></p> <ul style="list-style-type: none"> <li>Complete three-year program ending tax exemptions and zero rates.</li> <li>Pass bill granting full autonomy to the FBR.</li> <li>Develop massive registration campaign of one million new taxpayers.</li> <li>Complete audit of general sales tax refunds.</li> <li>Implement risk-based audit of no less than 30 percent of large taxpayers. Complete integration of FBR information technology systems to facilitate taxpayer cross-checking, risk-based audits, reporting, and taxpayer ledger accounts.</li> </ul>	Tax ratio reaches 14–15 percent of GDP (shared effort: 3 percent federal and 1 percent provincial)
Excess business regulations	<p><i>Focus on business registration at federal level and provincial level</i></p> <ul style="list-style-type: none"> <li>Approve and implement virtual one-stop shop for corporates' registration.</li> <li>Bring SMEs into the formal sector through the provincial registration systems.</li> <li>Upgrade the FBR portal to improve taxpayer e-registration and e-filing.</li> </ul>	<p><i>Focus on business regulations</i></p> <ul style="list-style-type: none"> <li>Build capacity of existing commercial courts to settle disputes and set up alternative dispute resolution mechanisms.</li> <li>Pass corporate rehabilitation law enabling banks to curtail deterioration of the quality of their claims on the corporate sector.</li> <li>Pass a modern companies act that facilitates transparency and protects the rights of the minority shareholders.</li> </ul>	Pakistan's ranking in Doing Business improves from 105th to 75th position
Inefficient civil service	<p><i>Focus on preventing expansion of existing perks and nonprofessional hiring</i></p> <ul style="list-style-type: none"> <li>Immediately freeze public perks granted to civil service (including provinces).</li> <li>Establish competitive and transparent process for selection of senior officials on key strategic positions (for example, FBR Chairman; power Discos and Gencos, state enterprises, regulators).</li> <li>Create Monitoring Board, attached to Prime Minister's office, setting performance contracts for senior officials on key strategic positions and reviewing their performance regularly.</li> </ul>	<p><i>Focus on gradual monetization of perks and civil service reform</i></p> <ul style="list-style-type: none"> <li>Adopt measures conducive to monetize at least half of actual perks received by public servants.</li> <li>Move monetized civil service pay and benefits toward market comparators faster than grades 1–16; maintain absolute pay in lower grades.</li> <li>Strictly enforce sound selection, promotion, and transfer criteria, and introduce accredited in-service training of civil service.</li> </ul>	Public payroll policy becomes transparent and uniform

Policy Issue	Short term (first 180 days)	Mid term (up to end-fiscal 2018)	Final outcomes (fiscal 2018)
<b>Filling the gaps</b>			
Low investment in infrastructure	<p><i>Focus on reversing the rising infrastructure gap</i></p> <ul style="list-style-type: none"> <li>• Increase by at least 0.5 percent of GDP the fiscal 2014 federal development budget allocation to power generation, roads, operations and maintenance, and irrigation.</li> <li>• Review legal framework for public-private partnerships in infrastructure</li> </ul>	<p><i>Focus on provincial revenue collection to fund provincial infrastructure</i></p> <ul style="list-style-type: none"> <li>• Convince provincial governments to enforce upgraded rates, reindex the base, adjust urban property valuation tables and revamp motor vehicle tax.</li> <li>• Further increase, by 1 percent of GDP, the provincial development budget allocation to power generation, roads, operations and maintenance, and irrigation.</li> </ul>	Public and private investment in infrastructure rise to at least 5 percent of GDP
Inefficient and loss-incurring state-owned enterprises	<p><i>Focus on state enterprise governance and initial steps</i></p> <ul style="list-style-type: none"> <li>• Reinvigorate the Privatization Commission to manage privatization agenda.</li> <li>• Make the Corporate Governance Rules applicable to all PSEs and not just those in corporate form.</li> <li>• Develop a vision statement and road-map/action plan for PSE reform, including short and medium-term measures.</li> <li>• Prepare and approve state enterprise restructuring plans and announce privatization of at least two major loss making PSEs.</li> <li>• Professional appointment through a transparent process of competent PSE chairman and boards, with no political interference and full accountability.</li> <li>• Set up individual state enterprise performance contracts, to be reviewed quarterly, by a Central Monitoring unit.</li> <li>• Convert Pakistan Railways into a public corporation, with ownership separate from management and business-like board and management.</li> </ul>	<p>Focus on state enterprise restructuring, governance, and private sector participation:</p> <ul style="list-style-type: none"> <li>• Issue norms for effective implementation of corporate governance rules by PSEs.</li> <li>• Complete privatization of selected PSEs.</li> <li>• Create a Future Generations Fund with the proceeds of privatizations.</li> <li>• Pass a PSE Bill to provide the framework for how the state, as owner, governs the PSEs. The law should require PSEs to be commercially oriented, lay down obligations to provide timely financial and management information, etc. The legislation may also include hard budget constraints that incentivize the PSEs to run profitably.</li> </ul>	At least two major state enterprises are privatized and state enterprise losses are reduced by half
<b>Creating more and better private sector jobs</b>			
Growth-unfriendly cities	<p><i>Focus on city governance and planning</i></p> <ul style="list-style-type: none"> <li>• Reduce the number of institutions devoted to basic services and business regulation in big cities.</li> <li>• Approve national framework for urban planning, coordinated with sub national governments.</li> </ul>	<p><i>Focus on growth-oriented and business-friendly cities</i></p> <ul style="list-style-type: none"> <li>• Ease provincial procedures for property registration and construction permits, and pass new zoning laws.</li> <li>• Create national database for housing titles and selling prices.</li> </ul>	Urban jobs: Pakistan ranks 75th in property registration & construction permits in Doing Business
Low productivity in agriculture	<p><i>Focus on governance and resources to agriculture extension</i></p> <ul style="list-style-type: none"> <li>• Reduce the number of public institutions devoted to agricultural research and extension.</li> <li>• Eliminate the requirement for two years of testing on new seeds to facilitate new entrants from private sector. Increase by 20 percent the federal and provincial resources for agricultural research and extension.</li> </ul>	<p><i>Focus on private investment in agriculture and water irrigation</i></p> <ul style="list-style-type: none"> <li>• Approve plan to attract private investment into the agricultural sector.</li> <li>• Increase by 20 percent the provincial budget allocation to irrigation and water management.</li> </ul>	Agricultural jobs: a 1 percent annual increase in average grain yields or 10 percent rise in irrigated land
Low youth and female employment	<p><i>Focus on governance of technical and vocational education and training (TVET) programs</i></p> <ul style="list-style-type: none"> <li>• Complete the benchmarking of existing TVET programs indicating their strengths and weaknesses.</li> </ul>	<p><i>Focus on fostering TVET and entrepreneurship</i></p> <ul style="list-style-type: none"> <li>• Approve funds raising youth enrollment in TVET programs by half.</li> <li>• Expand the number of micro finance jobs targeting youth (and female) entrepreneurs and demobilized army members by half.</li> </ul>	Youth and demobilized jobs: double enrollment—to 3 percent—of youth in TVET and microfinance programs

# 1. A COUNTRY AT A TURNING POINT: MAJOR FEATURES OF GROWTH IN PAKISTAN

Pakistan must climb out of its modest economic growth slump. It has rebounded slowly from the global financial crisis, and it faces the prospect of a second balance of payments crisis in less than five years. Its economic recovery has been the weakest in South Asia, featuring a unique double-dip growth pattern (figure 1.1). Pressing short-term macroeconomic imbalances were barely improving when floods hit the country in 2010 and 2011, the fourth and fifth in five years. Despite some recovery of exports and strong dynamism in remittances, borderline stagflation—modest growth with (until recently) double-digit inflation—continues, compounded by unsustainable macroeconomic policies and civil unrest arising from domestic and international armed conflicts.

**Figure 1.1 GDP growth in Pakistan and other South Asian countries, 2008–12**  
(2005 \$)



Source: World Bank 2012b.  
e is estimate; f is forecast.

Pakistan's economic slump is the deepest in half a century (figure 1.2). One has to go back to 1963–73 to find a boom–bust episode comparable to that of 2004–12. The boom ran from 2004 to the 2008–09 global financial crisis (Calvo and Ottonello forthcoming). GDP growth averaged below 3 percent a year over the last four years, and severe fiscal and external imbalances remain. During the boom, fiscal accounts were strongly pro cyclical and began to deteriorate well before the crisis. The counter cyclical fiscal stance following the crisis has caused them to deteriorate even faster. Fiscal deficits of 6 percent or more have prevailed for four years in a row, and the deficit of –8.5 percent of GDP for fiscal 2012 is the fourth highest in Pakistan's history (and the highest in more than two decades, after the –8.8 percent of GDP for fiscal 1989).

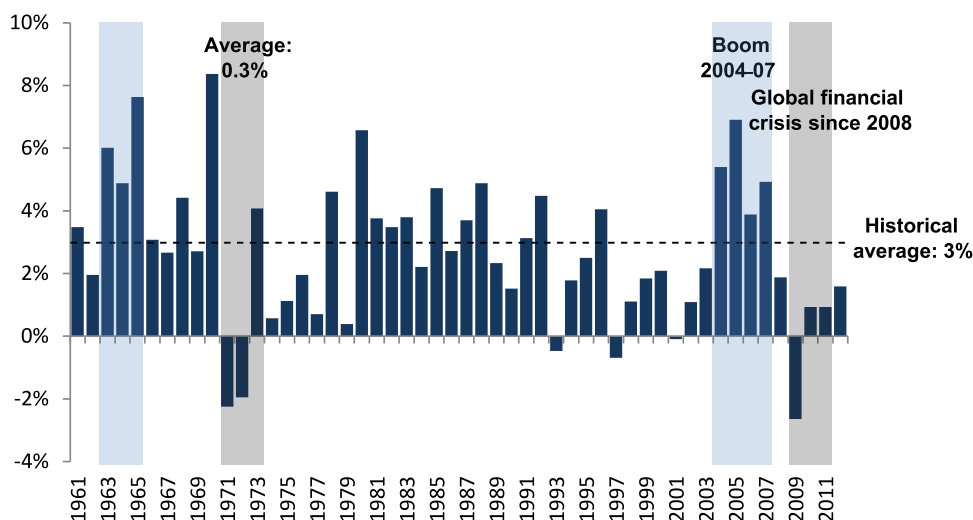
Expansionary monetary policies before the crisis led to double-digit inflation, peaking at 18 percent in 2008. Monetary tightening has lowered inflation slowly, but rates dropped to single digits only in July 2012. During fiscal 2013 several factors have shrunk international reserves: the current account deficit, declining financial inflows, sizable repayments to the International



Monetary Fund, and Central Bank intervention in the foreign exchange market to avoid rapid nominal exchange rate depreciation and its potential pass-through exacerbating inflation. With less than two months of reserve coverage of imports and another year of fiscal disarray, Pakistan's next administration has good reason to avoid another currency crisis. Indeed, macroeconomic risks are very high, and pressure is mounting on the rupee for faster depreciation.

**Figure 1.2 Pakistan: booms and busts in growth, 1961–2012**

(GDP per capita growth, percent)

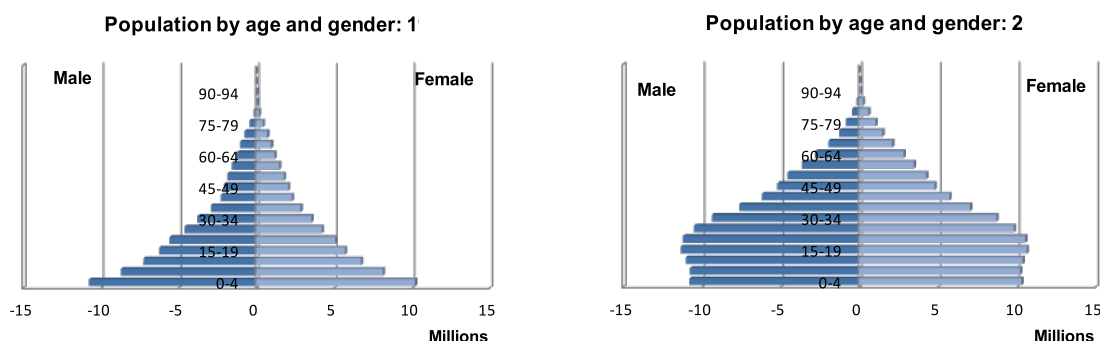


Source: Calvo and Ottonello forthcoming.

Pakistan's demographic challenge is one reason to accelerate growth (figure 1.3). With the sixth highest fertility in the world, Pakistan will double its already young population by 2025. The labor force has risen faster (3.7 percent) than the regional average (3.1 percent) as a result of a larger working-age population and rising labor force participation. The youth workforce has grown even faster, at 4.3 percent a year, well above the regional average of 2.7 percent. This phenomenon is expected to last for at least 10 more years. The only way to convert this demographic bulge from a political and social burden to a dividend is through rapid and inclusive growth that creates millions of new jobs. With no changes in participation rates, the labor force is expected to grow 2.7 percent a year as about 1.5 million young workers enter the labor market each year. If female labor force participation rises, the pressure for new jobs will be even stronger. International migration does not seem to be an important safety valve, as net migration was a negligible 0.8 percent of the labor force in 2009 (Robalino and Cho forthcoming).

Figure 1.3 Change in Pakistan's demographic structure: 1990 and 2020

(millions of people)



Source: Robalino and Cho forthcoming.

Pakistan needs to accelerate growth to bring years of armed conflict to a close—and vice versa. Most recent estimates show the annual costs of conflict at 2 percent or more of GDP (Favaro and Koehler-Geib 2009). The negative correlation between growth and violence 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 (Institute for Economics and Peace 2012). Violence is correlated with poverty as well as growth: provinces with the highest conflict intensity (Khyber Pakhtunkhwa and Sindh, in particular) have the greatest poverty (Ghani 2010).

Pakistan has many of the conditions needed to meet both the growth and demographic challenges. First, it has experienced two previous episodes of sustained rapid growth averaging 7 percent a year (fiscal 1963–67 and fiscal 2004–07). At that rate, the economy doubles in size every six to seven years, creating enough jobs for its expanding labor force. Second, it has demonstrated an extraordinary resilience to maintain moderate growth despite civil conflict, natural disasters, and a complex political transition. Third, it has many “positives”: the cohesion and legitimacy of many of its institutions and the capacity to implement national projects that transcends institutional inefficiencies, the resilience of its economy, the impressive growth of remittances from abroad in the 2000s, its natural resources and huge potential as a food and mining exporter, its strategic location, its international alliances, and the rapid growth of women in the labor force.

## Pakistan's enormous potential

Pakistan has many positive features that can help achieve its potential<sup>1</sup>. Perhaps most vital is the capacity to isolate key national projects from the inefficiencies of the rest of the system. The state is good at preventing famine, educating members of the elite, building infrastructure in some sectors, recruiting and sustaining a disciplined and efficient military, and maintaining a crude and basic level of order by suppressing or containing rebellion and ethnic and religious clashes. The state has made real progress when it focused on particular development projects, appointed good officials, gave them adequate resources, and left them in place long enough to finish the job. Examples include the crackdowns on domestic heroin production in the 1990s and creation of the National Database and Registration Authority (NADRA), a computerized registration system

<sup>1</sup> This section is based on Lieven (2012).

that supplies an ID card to every citizen. NADRA has contributed to the success of the Benazir Income Support Program for the poor, which has improved the lives of several million poor Pakistanis.

The greatest strength of the Pakistani economy is resilience. While the economy has not matched the leading Asian economies since the 1960s, it has never collapsed. Several factors cushion the economy against international shocks. It is relatively closed, and much activity is informal, featuring many small family farms. Though this contributes to massive underemployment, it also protects large parts of the population from complete immiseration. Because of the informal economy's size, the economic situation is rarely as bad as official statistics indicate. Consumer spending has held up well in recent years, despite a severely troubled economic climate.

Agriculture is still central to Pakistan's resilience, generating about 22 percent of GDP, 45 percent of jobs, and 60 percent of exports. So although ordinary Pakistanis have suffered from rising food prices in recent years and malnutrition 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—showed its strength. Pakistan has great potential as a food exporter. Pakistani agriculture, and the extensive irrigation systems that maintain it, are an important resource for the region. The growth of the Chinese, Indian, and Southeast Asian economies is creating rising demand for food, pressuring global food prices.

Another important source of economic resilience is remittances from Pakistanis working abroad. Since the 1970s remittances have not only ameliorated an unfavorable balance of payments but also improved the incomes of many poor households. Remittances totaled more than \$13 billion in fiscal 2012, an amount equivalent to about half of total exports.

Pakistan is rich in natural resources. Balochistan Province alone has an estimated \$3 trillion in mineral resources. Unexploited hydrocarbon reserves are estimated at 27 billion barrels and 280 trillion cubic feet of natural gas. Unexploited hydroelectric potential is estimated at more than 100,000 megawatts, enough to make Pakistan a regional power supplier (Speakman 2011).

Pakistan's location has created serious problems for the country, but if regional stability can be achieved, location would become an advantage. Pakistan is the only overland route between India—on course to become 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 Baluchistan's mineral wealth.

Pakistan's international alliances are a hedge against economic difficulties, but they are underused, especially alliances with China and India. Aid from the United States has sometimes been vital. Saudi Arabia has at critical times sent essential supplies of oil at delayed or reduced payment. Pakistan has yet to 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 Pakistan's most-favored-nation status with India becomes effective in early 2013. More trade with India could boost growth in Pakistan by strengthening trust between them

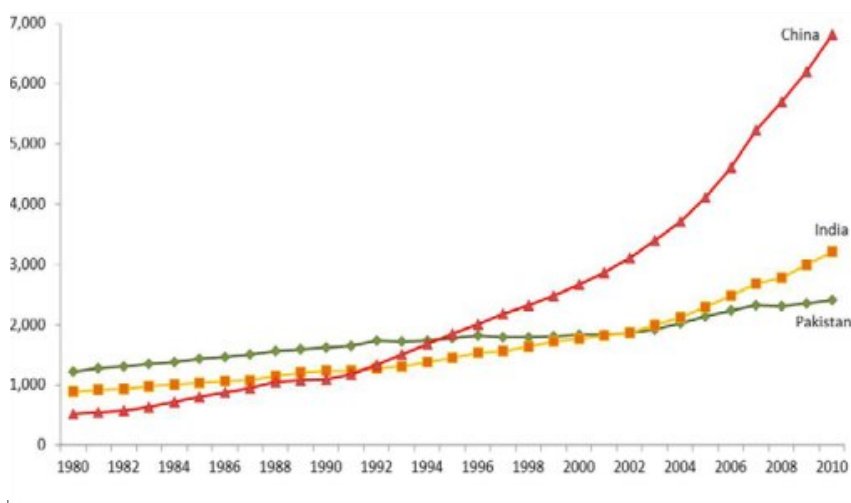
and accelerating the two economies' complementarities.

The rapid growth of female participation in politics and the labor market is another positive feature for Pakistan. 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. By 2015 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. Even without assistance from the state, women will contribute more than a percentage point a year to economic growth within five years. Moreover, women have a strong presence in the national and provincial legislatures. Pakistan is one of few countries to have a woman as the speaker of the National Assembly (Burki 2012).

## Diverging from the world's rapidly growing economies

Failing to make full use of its positive features, Pakistan is diverging from China and India, two of its main neighboring competitors. Growth was robust over half a century, at 2.5 percent per capita a year, but growth has lost momentum since the mid-1990s and lags behind that of its neighbors. And since 2008–09 average real GDP growth per capita has been only 0.2 percent. India, with similar institutional endowments (and to some extent resources) at its founding, has surpassed Pakistan in GDP per capita since the early 2000s (figure 1.4; see chapter 5). The Republic of Korea and other East Asian countries had a lower GDP per capita than Pakistan in the 1960s but have rapidly overtaken it. Thirty years ago China's income per capita was half that of Pakistan, and today it is two and a half times Pakistan's.

**Figure 1.4** Diverging GDP per capita between Pakistan and world's fast-growing economies  
(purchasing power parity, 2005 \$)



Source: World Bank 2012e.

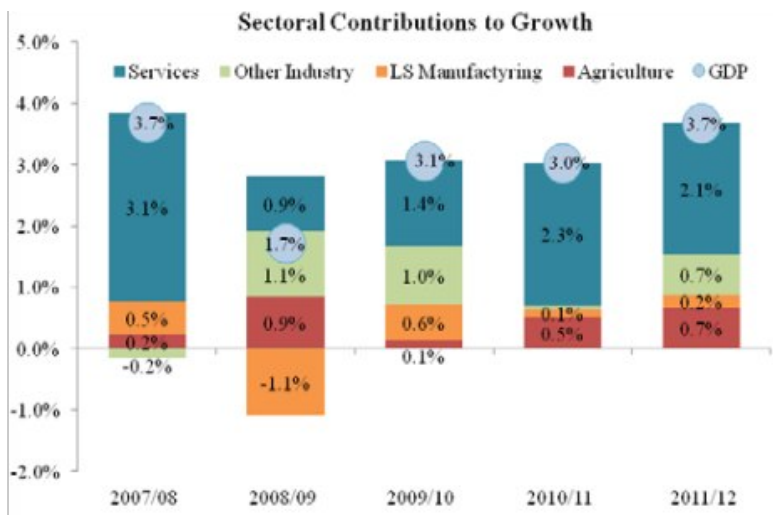
# A boom-to-bust crisis

Empirical evidence supporting the view that average growth in Pakistan over 1961–2010 was higher under military regimes (6 percent) than under democratic regimes (4.3 percent) comes with several caveats. Above-average growth in the 1960s and 1980s coincided not only with reform and economic and political stability, but also with larger aid inflows. In contrast, the democratic Bhutto and Sharif regimes of the 1970s, 1990s, and late 2000s were times of political upheaval, regional tensions, natural disasters, little structural reform, and global economic uncertainties. However, greater gains in social outcomes occurred under democratic governments, which undermined popular support to the continuity of military regimes (Khan 2007).

Pakistan's episodes of high growth tend to be short-lived, with multiple short cycles of rapid growth followed by stagnation. Besides being shorter than low-growth episodes, just a few of Pakistan's high-growth episodes can be characterized as “growth accelerations” (GDP per capita growth of more than 3 percent a year for at least four years). Since 1961 GDP per capita has grown at least 3 percent in 23 fiscal years, but in only three fiscal periods did it maintain this growth for at least four years in a row: 1963–66, 1980–83, and 2004–07.

To a large extent agriculture still drives Pakistan's growth. Although agriculture's share of GDP fell from 42 percent in 1960 to 21 percent in 2009, a high correlation still exists between real GDP and real agricultural GDP. That correlation has weakened, however, since the 2000s, as the services sector came to dominate the economy (figure 1.5). Overall the 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, marking a structural shift in the economy.

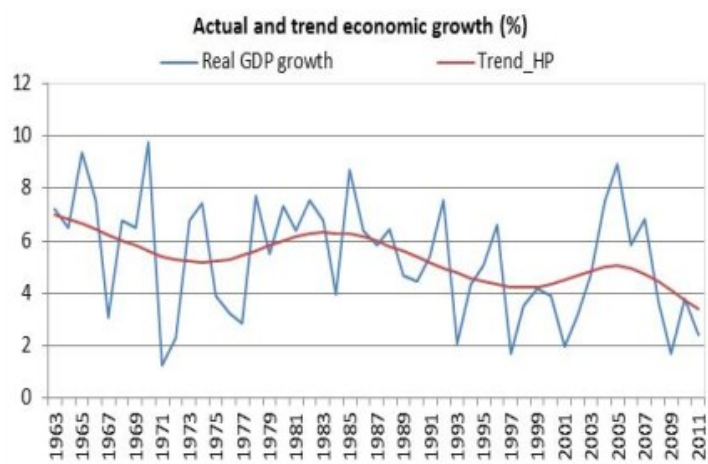
Figure 1.5 Sectoral contributions to Pakistan's growth



Source: Debowicz and others 2012b; World Bank staff calculations.

Pakistan is on a long-run declining trend in both potential and actual growth. Most disturbing is the steady fall in the economy's potential over the past 50 years, from 6.0–7.0 percent to 4.5–5.0 percent (figure 1.6). The loss of growth potential results mainly from agriculture's slowing dynamism over the past two decades compared with manufacturing and services (see chapter 5). This decline is particularly evident in Punjab, which accounts for 63 percent of agricultural output (Institute of Public Policy 2012). Recent floods, emerging constraints in power (rising load-shedding), less availability of irrigation water, and meager public investments in the sector explain Punjab's agricultural slump (Institute of Public Policy 2012).

Figure 1.6 Pakistan's declining long-term growth potential, 1961–2009



Source: Lopez-Calix, Srinivasan, and Waheed 2012.

Pakistan's GDP growth volatility of around 1.8 percent during the past four decades—measured by its standard error around trend growth—is average by international standards, but it has risen since the 2000s and is higher in per capita terms (World Bank 2011d). The recent rise partly reflects the global financial crisis and flooding. Volatility in GDP growth has been higher in manufacturing than in agriculture and services, and provincially disaggregated it has been lower in Punjab (1.9) than in the rest of Pakistan (2.2; table 1.1).

Table 1.1 GDP growth volatility is on the rise in Pakistan and Punjab Province, 1973–2011 (percent)

	Punjab	Rest of Pakistan	Pakistan
Agriculture	3.2	3.5	2.9
Industry	4.2	4.3	3.3
Services	2.2	2.2	1.9
GDP	1.9	2.2	1.8
National GDP (1980s)	n.a.	n.a.	1.4
National GDP (2000s)	n.a.	n.a.	2.5

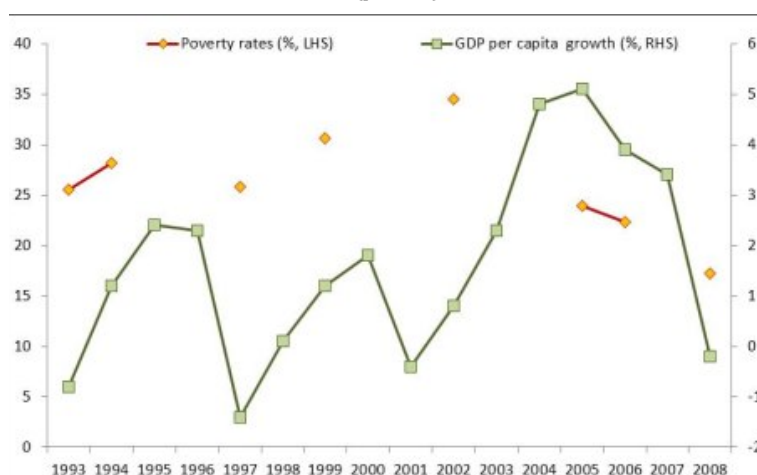
Source: Institute of Public Policy 2012; World Bank staff calculations.

Note: Volatility is measured by the standard error around trend growth rate.  
n.a. is not applicable.

## A mixed performance in inclusiveness and job-enhancing growth

Growth has been good for Pakistan's poor. Cross-country studies show economic growth as the main determinant of poverty reduction in recent decades (World Bank 2011d). Pakistan is no exception. Despite falling and increasingly volatile per capita growth, poverty declined over the last decade. Average volatility in GDP per capita growth more than doubled over the 1990s, peaking in 2005. The poverty rate broadly followed the per capita growth trend (figure 1.7). As GDP per capita rose from close to nil in 2001/02 to a peak of 5 percent in 2004/05, the share of the population below the national poverty line fell from 34.7 percent in 2001/02 to 21.9 percent in 2005/06 and 17.2 percent in 2007/08. Depth and severity of poverty also declined. The depth of poverty (the average income needed to lift a poor person out of poverty) dropped from 7.0 percent of the poverty line (PRs 79.9 per poor person in 2007/08 prices) in fiscal 2002 to 2.7 percent (PRs 30.8) in fiscal 2008 (World Bank 2011d).

**Figure 1.7 Growth in GDP per capita and declines in poverty track each other closely**  
(percent)



Source: World Bank 2011d.

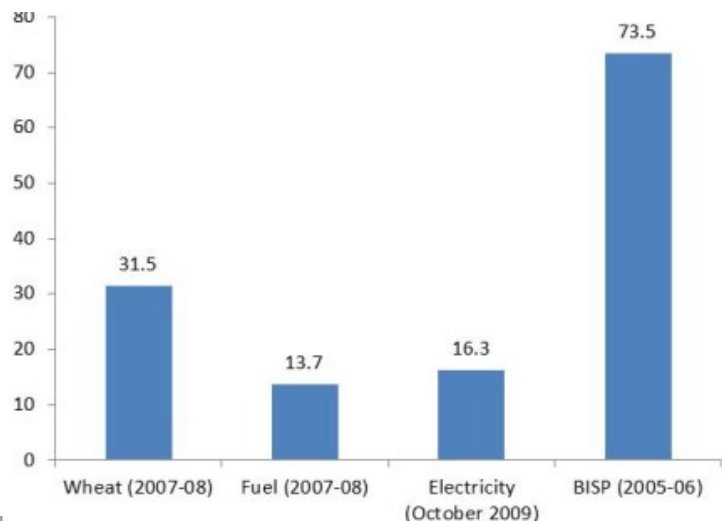
Note: Dots indicate discontinuous data.

In contrast, growth has done little to reduce inequality. Pakistan's economic expansion in the early to mid-2000s was almost distribution-neutral: both poor and rich benefitted. The Gini coefficient improved a bit during the rapid economic expansion of 2001–06 but declined after (World Bank 2011d). Thus the decline in poverty came strictly from growth; redistribution contributed little.

Social safety nets have a unique redistributive impact on the poor and vulnerable and are especially important when growth is volatile. But not all social transfers are efficient, and their size (except for energy subsidies) is small. The Benazir Income Support Programme achieves high efficiency, with an estimated 73.5 percent of the program budget reaching the poor (figure 1.8). In contrast, the wheat, fuel, and electricity subsidies show poor targeting, at 31.5 percent, 13.7 percent, and 16.3 percent. The biggest subsidies (on fuel and electricity) are the most anti poor.



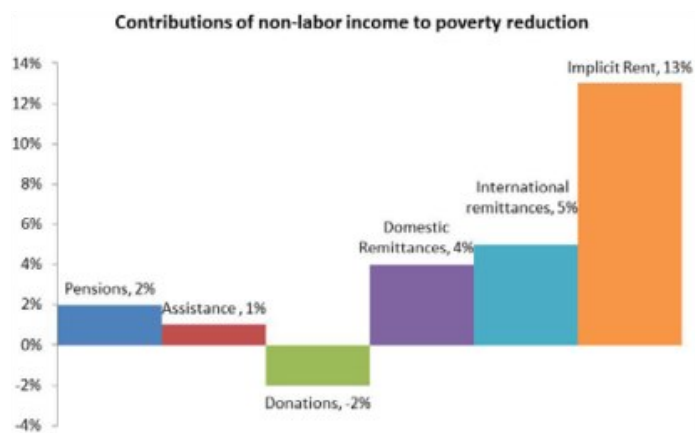
**Figure 1.8**Benefit incidence for the poor and vulnerable of four transfer programs in Pakistan  
(percent)



Source: World Bank 2011d.  
BISP is Benazir Income Support Programme.

The redistributive patterns of growth can be further disentangled by examining the contributions to poverty reduction and distributional changes over the last decade in returns to endowments as well as changes in these endowments—age, occupation, education, and geographic distribution of the labor force (figure 1.9).

**Figure 1.9** The contributors to poverty reduction in Pakistan, 2002–08  
(share of total reduction in poverty headcount rate, percent)



Source: Inchauste and Winkler 2012.

Over 2002–08 the largest contributor to poverty reduction was growth in returns to labor endowments and characteristics (farm and nonfarm labor income). Higher returns to these two variables explain 50 percent of poverty reduction. Returns were almost three times higher (37 percent) to nonfarm income than to endowments in farm income. The relative price of labor rose,

consistent with an increase in labor productivity in nonfarm activities (job-enhancing growth). Non labor income (including pensions, social assistance, donations, remittances, and implicit rents) contributed 23 percent to poverty reduction, followed by improvements in the education of the nonfarm workforce, at 10 percent. External remittances and domestic transfers (both part of non labor income) contributed 5 percent and 4 percent to poverty reduction. This result indicates that poverty reduction comes more from higher labor incomes than from social transfers, highlighting the importance of jobs for faster growth and poverty reduction. The shift in occupation from unpaid family workers toward salaried workers accounted for about 8 percent of poverty reduction. Finally, demographic changes (age, gender) and geographic factors contributed 10 percent to poverty reduction.

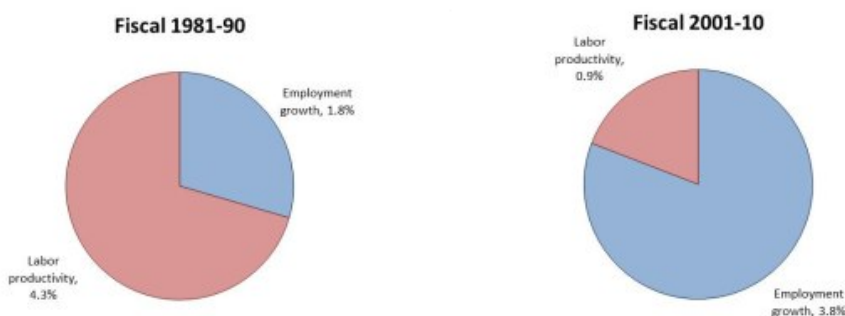
The gains in total factor productivity appear to have been short-lived—and most likely reversed in the years following the global financial crisis and Pakistan's severe balance of payments crisis of 2007/08 (see chapter 2). However, this growth decomposition analysis offers important insights into the type of (good) jobs Pakistan can generate during a booming growth period. They underline the need to spur investments that will raise productivity, to focus investment in nonfarm activities in rural areas and cities, and to support the migration from farm to nonfarm work to raise productivity and wages throughout the economy.

## 2. WHAT CONTRIBUTES TO GROWTH IN PAKISTAN?

This chapter uses a growth accounting model to show the contribution to growth of the four main factors of production—capital, labor, human capital, and land—and of the residual term, total factor productivity (TFP), which measures changes in technology and in the efficiency of input use. Employment grows when the share of working people in the total population increases, as when women shift from household chores to income-generating activities. Changes in human capital reflect the acquisition of skills.

Growth accounting quantifies the contribution of each of those factors to economic growth. In the last three decades employment (labor accumulation) grew rapidly, investment in physical capital was scarce, the human capital contribution was low, land accumulation was nil, and TFP declined. Pakistan appears to be evolving toward an economy of intensive employment of unskilled labor that struggles to boost productivity (figure 2.1). The vital question: Is this just job-creating growth—growth that does not lower unemployment—instead of job-enhancing growth?

Figure 2.1 Employment and labor productivity growth in Pakistan  
(percent)



Source: Lopez-Calix, Srinivasan and Waheed 2012.

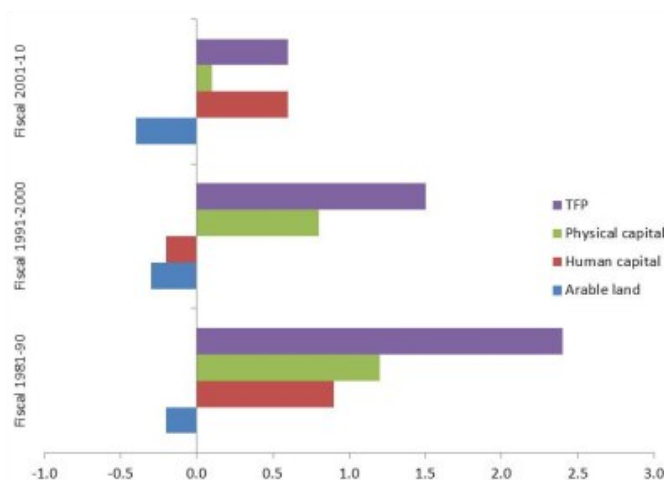
This section presents more detailed findings of the growth accounting model, followed by a factor-dedicated analysis to elucidate their evolution. The methodology first separates the individual contributions of labor productivity (output per worker) and labor accumulation (employment) to real output growth. Then it estimates the contributions of capital, human capital, land, and TFP to labor productivity. This section presents more detailed findings of the growth accounting model, followed by a factor-dedicated analysis to elucidate their evolution. The methodology first separates the individual contributions of labor productivity (output per worker) and labor accumulation (employment) to real output growth. Then it estimates the contributions of capital, human capital, land, and TFP to labor productivity.

### Growth patterns and determinants

The findings replicate and expand on conclusions in previous growth accounting models for Pakistan over the past 30 years:

- Over the long term growth in Pakistan has been driven mainly by labor and capital accumulation rather than by productivity gains, as measured by TFP.
- Whereas labor accumulation has been on the rise, labor productivity—measured by output per worker—has been steadily declining. Pakistan has the lowest labor productivity among its regional competitors, and the gap has grown in the last two decades (Government of Pakistan 2011a).
- Capital's contribution to labor productivity growth has declined; it was almost nil in the 2000s (figure 2.2). Diminished public investment—which fell from 10 percent of GDP in the early 1980s to 3 percent at the end of the 2000s—and slowly rising private investment—up from 8 percent of GDP to 10 percent—contributed to the decline.
- TFP's contribution also declined in the 2000s to about a quarter of its level in the 1980s, at about a third of GDP growth. At 1.4 percent over the last three decades, the contribution was below the medium-term average of 2.0 in East Asia (World Bank 2006a; Lin and Monga 2010; IMF 2004).
- The contribution of human capital (proxied by years of schooling) was considerable in the 1980s, mildly negative (–0.2 percent) in the 1990s, and positive again in the 2000s.<sup>2</sup> With a rapidly growing labor supply and low enrollment in primary education, Pakistan is evolving toward an economy with an intensive supply of unskilled labor, reducing its job enhancing potential for high-value activities.
- Land's contribution (proxied by arable land) to labor productivity has been persistently negative.

**Figure 2.2 Contribution to growth**  
(percent)



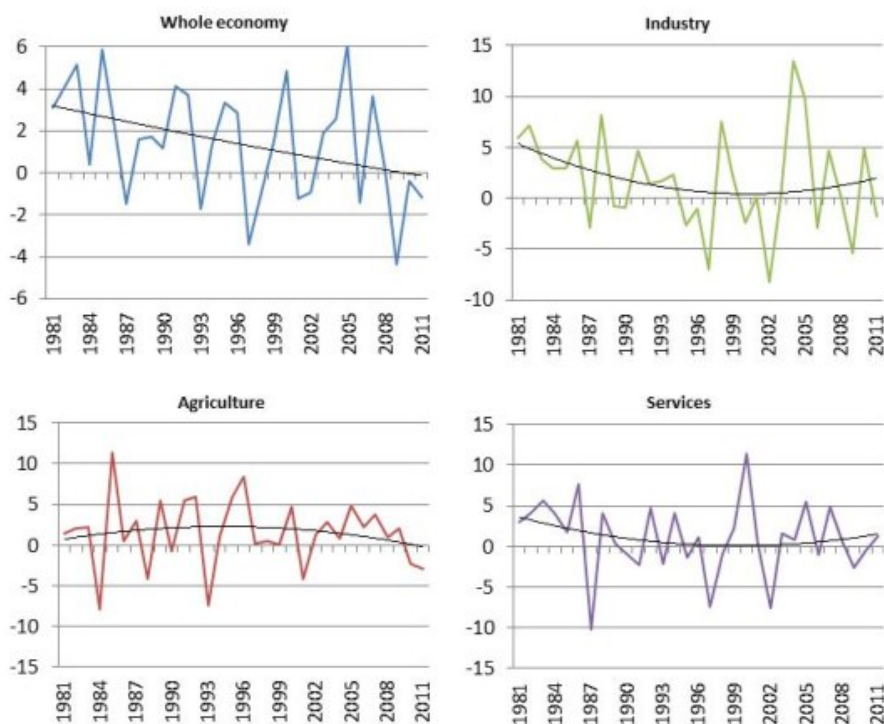
Source: Lopez-Calix, Srinivasan, and Waheed 2012.

Since the 1980s TFP's contribution to growth has declined in all sectors. TFP and physical capital contributions were particularly strong in manufacturing in the 1980s. In the 1990s only the contributions of physical capital to industry and TFP to agriculture rose; TFP's contribution to growth in other sectors declined markedly (figure 2.3). The rise in TFP in agriculture was due to the continuing gains from the green revolution (improved seeds, irrigation, and fertilizers). In

<sup>2</sup> Human capital has always been low in Pakistan. Educational enrolment at all levels is below that of its regional peers, and health spending per capita is 42 percent lower. Elite domination and ethnic factionalism contribute to the weak showing. The landed aristocracy is unwilling to tax itself to pay for mass education. High ethnic factionalism is associated with poor institutions, bloated bureaucracy, and underprovision of public goods (Easterly and Levine 2003).

the 2000s the contribution of physical capital declined sharply in all sectors, as did the contribution of TFP, except in industry. Job creation accelerated during the 2000s across all three sectors, unaccompanied by a similar rise in labor productivity. The structural transformation in Pakistan was not without jobs; instead, it tended to absorb the growing labor supply into low-skilled, low-productivity jobs rather than transfer labor from low-productivity to high-productivity sectors.

**Figure 2.3** Changes in total factor productivity's contributions to output per worker, by sector (percent)



Source: Lopez-Calix, Srinivasan, and Waheed 2012.

Perhaps the most important reason that trend growth is declining is that structural reforms in Pakistan have been growth reducing rather than growth enhancing. The declines in labor productivity and TFP over the last two decades are puzzling. This period coincided with the initial liberalization of the economy, which should have improved productivity. By the mid to late 1990s the government had introduced banking and trade reforms, and in the early 2000s a large privatization program followed—involving major investments in telecommunications, roads, and power infrastructure. In other countries such reforms substantially boosted output per worker on a sustained basis, but not in Pakistan. Why?

Because structural reforms were fragmented, badly sequenced, or truncated. In East Asia labor reallocations from less productive to more productive sectors (such as from agriculture to services) drove labor productivity. This did not occur in Pakistan, where most of the reallocation took place within sectors (World Bank 2012f). Pakistan's structural reforms have not been

growth-enhancing, as in some Latin American and African countries, because the resulting labor flows in Pakistan have been oriented mainly to low-productivity activities within the same sectors (Lopez-Calix and Verduzco 2012; McMillan and Rodrik 2011; figure 2.4). Political uncertainty, incomplete structural reforms, and macroeconomic instability (and its associated fiscal stress and volatile external financing) held Pakistan back. In contrast, reforms in India, Indonesia, Malaysia, Thailand, and Turkey led to positive, growth-enhancing structural change. This finding also has important implications for job-creating growth: Pakistan has to do more to prevent unemployment from rising.

**Figure 2.4 Within-sector changes in labor flows dominate the contribution of structural change, indicating that Pakistan's structural reforms were growth reducing**  
(percentage points a year)



Source: Lopez-Calix and Verduzco 2012.

Note: HI is high income countries, and LAC is Latin America and Caribbean.

### *Physical capital accumulation*

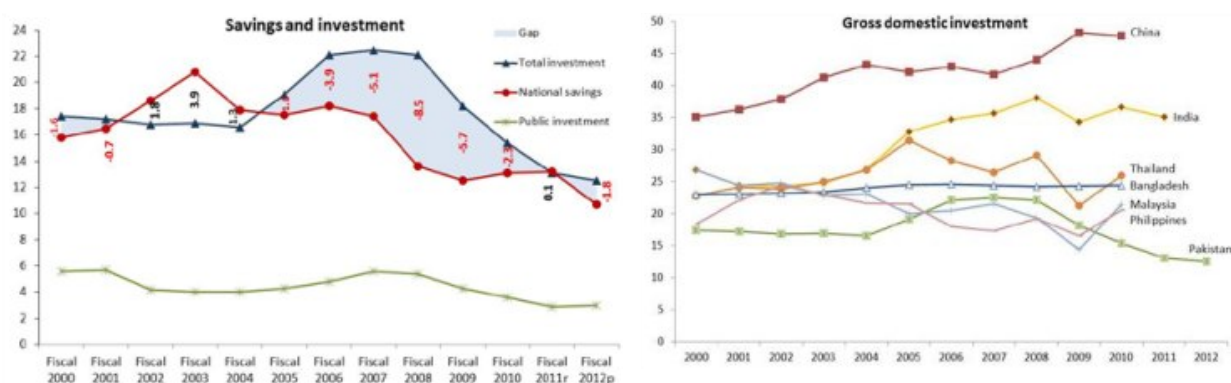
Pakistan's public infrastructure has improved over the last 50 years, but slowly, resulting in many gaps that place the country at a disadvantage to competitor countries such as Egypt, Malaysia, and Sri Lanka, where investment has been greater and progress faster. Pakistan has a low density of paved roads, dismal quality railroads and inadequate airports, and acceptable quality seaports. It has among the lowest electricity-generating capacity and the highest power losses of comparator countries. Even worse, institutional shortcomings hold electricity generation below capacity, resulting in systematic power outages and load-shedding. Access to potable water and improved sanitation is well below that in comparator countries. Only in irrigation infrastructure and telecommunications does Pakistan perform well among the comparator group. Although fixed-telephone density is relatively low, Internet penetration and mobile-phone density grew rapidly over the last decade before reaching a plateau (Techpolis 2012).

Recent stimulus plans in Brazil, China, the European Union, and India show wide variation in their policy mixes, but they all emphasize infrastructure investment to accelerate growth and employment—along with the need for adequate savings to finance it. Rather than rising, in Pakistan savings and investment rates have fallen and are on the decline.

While Pakistan's national savings and investment have always been low, since the mid-2000s they have declined well below the levels needed to accelerate growth (figure 2.5). Investment dropped from a peak of 22.5 percent of GDP in fiscal 2007 to 12.5 percent in fiscal 2012—three to four times lower than in China and India. Because investment depends on savings, reversing the decline in savings is a primary challenge. National savings rose briefly in the early 2000s on improved macroeconomic performance and a surge in remittance inflows, then declined with the consumption boom of 2005/06. Later, the savings rate fell even faster because of security concerns, political instability, declining tax revenue, and related fiscal imbalances, despite even stronger remittances. At 10.7 percent of GDP in fiscal 2012, savings were about half that in fiscal 2007 (22.3 percent of GDP) and several times lower than in India (31 percent) and China (47 percent) during the 2000s. In a remarkable shift, more than half of the current national savings are remittances, up from less than a third in the early 2000s.

Public and private investment in infrastructure is also too low to achieve rapid growth. At less than 1 percent of GDP, public investment in infrastructure has declined over the last 20 years due to fiscal constraints. At around 2 percent of GDP private investment has not filled the gap in most sectors, as it did in comparator countries. If current conditions prevail, both trend and projected growth will be lower in Pakistan than in most comparator countries—Bangladesh, Brazil, Egypt, India, Malaysia, Sri Lanka, and Turkey (Loayza and Wada 2012). If Pakistan were to bring its public investments in electricity, transport, and telecommunications sectors up to those in Malaysia, for example, growth in GDP per capita would rise 3.7 percentage points, with varying contributions from each sector (1.9 percent electricity, 0.6 percent transport, and 1.2 percent telecommunications). And as the fiscal space is small, reinvigorated private (and public) financing of infrastructure has become increasingly critical.

Figure 2.5 Saving and investment, 2000–12  
(percent of GDP)



Source: Lopez-Calix and Touqeer (forthcoming), based on Government of Pakistan (2012d), Government of India (2012), and World Bank (2012e).  
r is revised; p is projected.



## Labor

Pakistan was among the world's largest job creators in the 2000s, but the quality of new jobs was poor (Robalino and Cho forthcoming). This raises the question of whether its growth model is job creating. Of the 15 million jobs created over 2000–09, more than a third were in agriculture, even though its share declined in total employment (from 48 percent to 45 percent) and GDP (from 26 percent to 21 percent). In contrast, the share of employment rose from 32 percent to 35 percent in services, while stalling at about 20 percent in manufacturing. Despite high job growth, labor market outcomes were disappointing. Most jobs were in low-productivity sectors and provided workers little if any protection against economic shocks. Female labor participation rose but remained low, and there were large income disparities between rural and urban areas and across sectors. The fundamental reasons for this pattern of job creation are low education levels and an environment not conducive for entrepreneurship (see chapter 3).

Under the current pattern of low productivity, with mainly rural jobs created, growth of 6 percent or higher appears needed to absorb new market entrants and keep formal unemployment from rising (Robalino and Cho forthcoming). This rate would help Pakistan reap the demographic dividend as more women enter the labor force, lifting the share of the working population relative to the share of dependents. But better jobs are needed. The economy will continue creating formal or informal jobs. The goal is not formalize workers—it is to raise their productivity, even if they stay informal.

## Human capital

Rising labor demand is not the only job-enhancement challenge facing Pakistan. Other problems include the large stock of unskilled workers, high informality, and cultural factors dissuading young people from entering the labor market.

The need to raise the quality of the labor force is a longstanding problem in Pakistan. 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 Programme's Human Development Index. Gaps are particularly large in education, especially among youth<sup>3</sup>. Consider these figures:

- Workers' education in Pakistan mildly improved over the last decade, but about 40 percent of workers still have no education.
- Average educational attainment of the working-age population is low, with wide gaps between genders and across provinces. In 2009 years of schooling averaged 6.5 for men and 3.5 for women and ranged from 4.7 in Balochistan to 5.4 in Khyber Pakhtunkhwa. The average was almost 7.0 years for young men and 5.3 years for young women, showing some progress, especially among women.
- Education varies widely between urban and rural workers: 71 percent of the workforce in urban areas but only 43 percent in rural areas have a primary education or higher.
- While education is higher among youth (6.5 years) than the average (3.5 years), a third have no education. And skill levels among the educated are concerning, given that student learning evaluations are often negative.

<sup>3</sup> Indicators related to education and labor market outcomes are calculated from the latest Labor Force Survey, unless otherwise indicated.

- Literacy was only 61 percent among female youth and 79 percent among male youth, the lowest in South Asia.

In 2009 public spending was 2.7 percent of GDP on education, and 2.2 percent on health, placing Pakistan among the lowest spenders on human capital in the world. These rates remain very low.

The importance of access to education cannot be underestimated. Growth is positively influenced by higher initial schooling and life expectancy; lower fertility, inflation, and government consumption; and stronger rule of law (Barro and Sala-i-Martin 1995). Pakistan's growth in GDP per capita would remain at an estimated 1.7 percent at the current 2.3 years of schooling for men ages 25 and older but would triple if the years of schooling almost doubled to four (Cnoblach and others 2012).

The importance of growth for social outcomes cannot be underestimated. The country's progress toward the Millennium Development Goal (MDG) targets for 2015 has been slow and is unlikely to improve in the near future unless growth accelerates and public expenditure priorities change. Using SimSip, a World Bank model that allows cross-country simulations, Cnoblach and others (2012) show that:

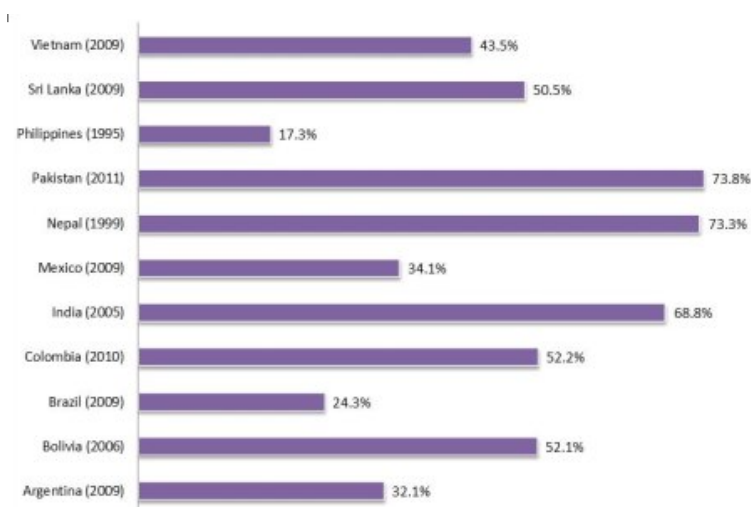
- If GDP per capita growth is 3 percent a year—the historical average—Pakistan is unlikely to meet any of the targets by 2020, except access to safe water.
- If GDP per capita growth accelerates to above 5 percent a year, progress on all MDGs would be much faster.

But growth is not enough. Federal and provincial governments need to make sectoral reforms and raise investments in human capital—particularly in health and education—if Pakistan is to achieve the MDG targets earlier and reach its long-term economic growth potential.

High informality is associated with low-skilled and low-productivity jobs. Informality of more than 70 percent of total employment puts Pakistan among countries with the highest informality worldwide (figure 2.6). Informality can be both a symptom of lower productivity and a cause, as low-skilled jobs and low pay create a vicious cycle (World Bank 2012f). At an estimated 38 percent of GDP the informal economy's size is higher than the Asian average of 30 percent (Schneider 2006).

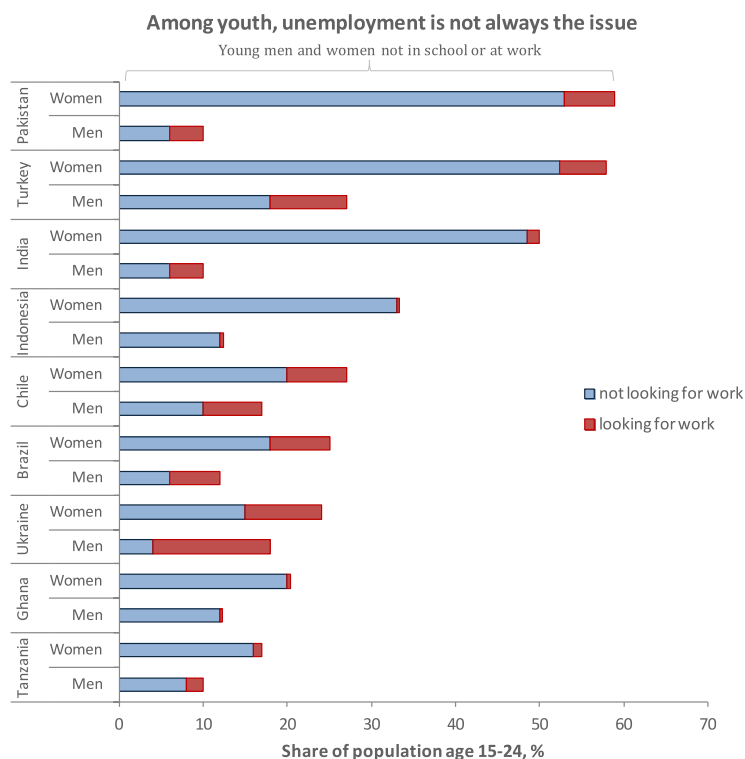
Several cultural factors shape the speed of human capital gains in Pakistan. Only 21 percent of Pakistani women, compared with 82 percent of men, participate in the labor force, well below the South Asian average of 46 percent and averages in other regions (58.4 percent in East Asia and Pacific, 52.0 percent in Europe and Central Asia, 48.9 percent in Latin America and the Caribbean, 63.8 percent in Sub-Saharan Africa, and 27 percent in the Middle East and North Africa; World Bank 2011e). At more than 50 percent, idleness—not in school or training, not employed, and not looking for work—among young Pakistani women is the highest in the world (figure 2.7). Women with a higher education are less likely to enter the labor force than women with no education, except for women in urban areas with a pre-university and above education. Marriage is associated positively with labor force participation for men and negatively for women.

**Figure 2.6 Informality in Pakistan is among the highest in the world**  
(people in informal employment as a share of total nonagricultural employment)



Source: For Pakistan, Pakistan Bureau of Statistics (2011); for all other countries, ILO (2011).

**Figure 2.7 Pakistani young women have the highest rate of idleness in the world**  
(share of population ages 15–24, percent)



Source: World Bank 2012f.

Note: The data are for 2010 for Indonesia; 2009 for Brazil, Chile, India, and Tanzania; 2008 for Pakistan; and 2005 for Ghana, Turkey, and Ukraine.

## *Land and the challenge of agricultural productivity*

Few people believe that difficult access to land is a critical constraint to growth in Pakistan, even though demand is high and supply is low. Just 1.9 percent of Pakistani entrepreneurs believe that access to land is a major obstacle to the growth of their business (down from 12.1 in 2008). Among the 35 countries covered by an investment climate assessment, Nepal and Pakistan have the lowest entrepreneur concern about access to land. This finding aligns with the small role of land holdings in productivity—perhaps because only large and medium-size landholders' income depends on land or because they are the only ones who can use it as collateral for loans (Debowicz and others 2012b).

These findings might be distorted. The growth accounting model uses arable land holdings as the variable, but the real determining factor is declining agricultural productivity, which requires a more detailed look at the sector. Agriculture remains central to Pakistan's development. About two-thirds of the population lives in rural areas and depend mainly on agriculture for their livelihoods. Agriculture contributes about 21 percent to Pakistan's GDP, although its share is declining. The sector's share in employment fell to about 40 percent in 2002, but since then it has risen to about 45 percent, mirroring the growth in its output. Agriculture contributes about 80 percent of export earnings directly and indirectly through forward links to agriculture-based industries such as textiles. Agricultural growth also affects urban growth. Agriculture is a major source of raw materials for manufacturing, contributing 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.

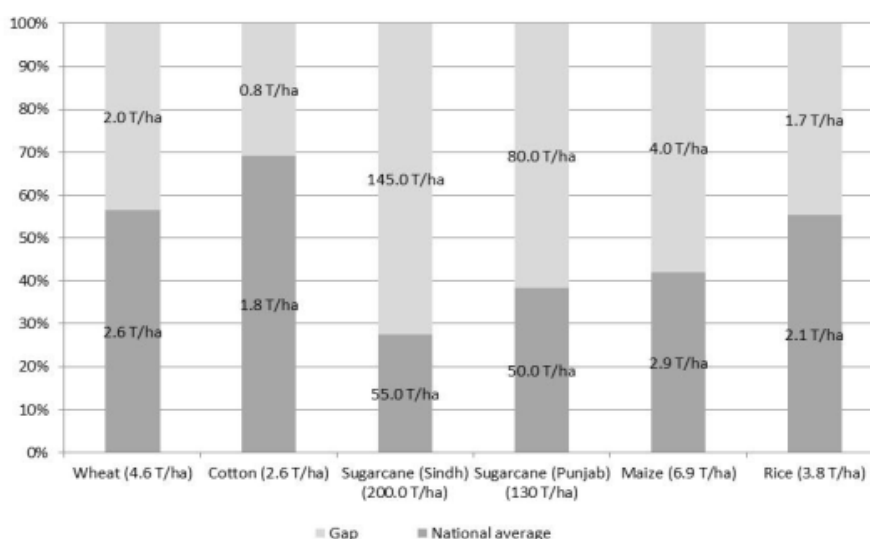
In the last two decades agriculture's focus has shifted from crops to livestock. As crops declined from 65 percent of agricultural value added in 1991/92 to 42 percent in 2011/12, livestock's share increased from 30 percent to 55 percent. Slowing growth has been particularly evident in crops, despite higher world prices during the late 2000s. Causes include inadequate investment in irrigation, slow adoption of new technologies, weak extension service, and perhaps changes in trade and price policies on agricultural investment. Fishing and forestry, the other two agricultural sub sectors, remained broadly unchanged, accounting for only 2.9 percent of agricultural value added. Livestock, cotton, wheat, sugarcane, and rice are the backbone of the rural economy and main sources of foreign exchange earnings for Pakistan. Wheat contributes about 2.7 percent of GDP, cotton 1.4 percent, rice 0.8 percent, and sugarcane 0.9 percent. Cotton accounts for about half of agricultural exports, and rice, fish, and fruits for about 16 percent.

Economy wide modeling suggests that agriculture-led growth could be poverty reducing while favoring urban growth (Debowicz and others 2012b). Targeting productivity growth in crops or livestock, or both, is more inclusive than targeting productivity growth in industry or services alone. Improving agricultural productivity by 10 percent in either or both sectors has positive income links that benefit rural nonfarm workers (poor and non poor) and urban residents (poor and non poor) by lowering the real cost of agricultural output. Improvements in crop productivity would lead to higher agricultural wages, rural nonfarm incomes, and urban household incomes than would wages obtained through similar productivity growth in industry or services. Alternatively, a livestock-focused growth strategy would tend to benefit households with large farms, but income growth would be almost as good for households that depend on agricultural wages as for nonfarm and urban poor workers. Growth led by productivity

improvements in services (mostly urban) appears to harm incomes for rural households that do not own farms, even though it boosts demand for industrial commodities and other services. Productivity improvements across all sectors have the highest impact.

Broad-based agricultural growth can improve agricultural incomes (especially for landless workers and smallholder farmers) by narrowing wide yield gaps between small farms and larger, more progressive farms and by diversifying toward high-value agricultural products. The Planning Commission (2009) estimates that average yields are far below the upper bound yields achieved by the most progressive farmer (figure 2.8). Average national yield gaps of major crops like wheat and rice are about 45 percent of those of progressive farmers. These yield gaps are even greater for some commercial crops, such as sugarcane in Sindh (73 percent). Despite great potential for improvement, yield growth declined steadily. Average annual yield growth for rice was 5.24 percent in the 1960s, 3.16 percent in the 1990s, and just 1.68 percent in the 2000s. Average annual yield growth for wheat was 2.92 percent in the 1960s, 1.99 percent in the 1990s, and 1.1 percent in the 2000s.

**Figure 2.8 Average national yields and yield gaps**  
(percentages of progressive farmer yields)



Source: Planning Commission 2009.

Note: Numbers on bars indicate yields for the national average and for the difference from progressive farmer yields.

At least four constraints affect these gaps (Ahmed and Gautam forthcoming). The first is inadequate funding of research and technology. Much of the high historical growth in yields and productivity, as during the green revolution, has resulted from technological breakthroughs following investments in agricultural research. Agricultural research and development in Pakistan, led mainly by the public sector, has been a good investment. Estimated internal rates of return have ranged from 57 percent to 65 percent. But the current agricultural research system has severe technical capacity constraints. Public investment has been on the decline—it is currently about 0.21 percent of agricultural GDP and ranks at the bottom of the region in

agricultural research and development spending as a share of agricultural GDP (Flaherty, Sharif, and Spielman 2012). Only 15 percent of agricultural research staff hold PhDs, low for the region (Beintema and others 2007). Disincentives—including limited promotion opportunities and low salaries in public research agencies—discourage qualified researchers from applying for positions.

A second constraint is inefficiencies generated by the institutional environment. The Pakistan Agricultural Research Council coordinates a large network of public national and provincial agricultural research centers, institutes, and experimental stations. Although the council conducts no agricultural research, the National Agricultural Research Center, which is under its administration, does. Since passage of the 18th amendment to the Constitution in 2010, which made the government a parliamentary system, the public agricultural system has devolved from the federal to the provincial level, but institutional functions still overlap.

A third constraint is water and the poor irrigation system. Officially, about 95 percent of Pakistan's arable land is irrigated, up from 64 percent in 1960. But in practice serious limitations in the water allocation system reduce farmers' access. Location along the canal and the *warabandi* water allocation system of administratively set rotations determine water access. Farms at the tail end of distributaries or watercourses may not receive enough water, especially if upstream farmers are illegally drawing it (Yu and others 2012). A more worrisome problem is financial sustainability. The canal irrigation management systems recover only a quarter of annual operating and maintenance costs, with the shortfall expected to rise as costs go up and water charges (*abiana*) remain low (Planning Commission 2012). Collection of assessed charges is also low, at just 60 percent. The federal government subsidizes the resulting budget gap of about PRs 5.4 billion. The current *abiana* charges, which do not reflect each crop's relative profitability, may be distorting farmer decisions. For example, irrigation charges per acre of rice and cotton are about the same, even though rice requires 60 percent more water, possibly encouraging overproduction of rice.

The fourth constraint is Pakistan's highly discretionary and deliberately complicated agricultural trade policy, with its many tariffs and para-tariffs (Valdes and others forthcoming). The policy invites lobbying for preferential treatment and risks corruption. The current formal tariffs, with statutory regulatory order (SRO) exemptions and regulatory duties, have become a de facto mechanism of concessional rates and import licensing, contravening the Uruguay Round international trade agreement. Most SROs are aimed at specific firms rather than all importers and target primarily inputs. These exemptions make the trade regime highly discretionary and uncertain. They generate uneven price impacts across final products and inputs, leading to a dispersion of effective rates of protection. Trade preferences that arise through bilateral preferential trade areas are a different case, although the risk of trade diversion rises the higher the level and dispersion of the total rate of protection, including all tariffs and taxes.

The trade regime's complexity confuses incentives in agriculture. The agricultural trade regime has six types of taxes: customs duty, regulatory duty, federal excise duty and special federal excise duty, provincial excise duty, sales tax, and withholding tax. Major crops like wheat, rice, sugar, and cotton are also implicitly taxed by the price distortions the policies introduced. Estimates of the nominal and effective rates of protection for these four products suggest that the policy-induced implicit tax on crop production depresses production, despite implicit net input

subsidies (Valdes and others forthcoming). For example basmati rice had negative effective rates of protection between 2008 and 2010: its farm income would have been 21–40 percent higher under a no-intervention regime.

Government procurement policies also affect agricultural incentives. Consider the extensive government procurement of wheat, which operates at the federal, provincial, and district levels. The government sets the procurement price and establishes expected procurement targets that provincial food departments and the Pakistan Agricultural Storage and Services Corporation (PASSCO) must meet. Provincial governments (mainly Punjab and Sindh) and PASSCO procure about 20 percent of the total wheat produced each year (Prikhodko and Zrilyi 2012). Since the 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.

The effect of these procurement policies on consumer welfare is ambiguous. They can become fiscally unsustainable and lead to perverse outcomes, such as subsidized exports. All procured wheat is bought and then sold to flour millers, with the government absorbing procurement, storage, and financing costs. Millers buy the subsidized wheat at below-market prices and then sell the flour at open market prices. This price stabilization might explain why wheat stocks have risen recently and why wheat has been exported at subsidized prices in years of high production.

## Growth accounting does not tell the whole story

Growth accounting is useful in separating the contributions of each factor of production, but it has well-known limitations. It is subject to data limitations. Measures of the stock of capital vary with the estimation method used and the assumed depreciation rates. TFP productivity is estimated as a residual and not directly as the improvement in the quality or performance of factors of production. Uncertainties in measuring output and factors of production affect this residual. An error in the estimate of capital stock or labor can substantially change the estimate of productivity growth. The estimating equation does not isolate the main relative weight of “software” factors that have contributed most to productivity growth, such as management skills or innovation. There is no way to identify whether improvements in productivity come from better capital stock, better human capital stock, firms' managerial or organizational skills, or innovation in production. The share of each production factor is assumed to be constant throughout the analysis period. This may be true for Pakistan, which has not moved from labor-intensive to capital-intensive activities over time, as have other emerging economies.

Despite such shortcomings this analysis sheds light on the critical role that factors of production and productivity have played in Pakistan's growth patterns. But it leaves unanswered the critical question of what constraints—technological or institutional—trigger (or fail to trigger) productivity and investment and ultimately promote (prevent) growth. A separate growth diagnostic model identifies the binding constraint to growth and offers some possible answers.



### 3. WHAT IS HOLDING BACK PAKISTAN?

The binding constraints to Pakistan's growth are both structural and emerging. Structural constraints include low access to finance and government and market failures that lead to insufficient investment, entrepreneurial activity, and competitiveness, blocking the transition from low-productivity to high-productivity activities (productive diversification). Emerging constraints include severe power shortages, macroeconomic instability leading to a sudden stop in external financing, and ensuing high country risk.<sup>4</sup>

The main government failures slowing the transition to productive diversification and lowering the competitiveness of Pakistani businesses are a dysfunctional tax system, ineffective civil service, large anti-export bias, and other cumbersome business regulations. The contributing market failures include weak coordination (governance) and insufficient innovation and learning externalities. Both governance constraints ("software") and infrastructure constraints ("hardware"), especially those related to the power sector, affect private investment and entrepreneurship. By slowing growth, these shortcomings limit job-enhancing development.

Two possible growth strategies can focus on accumulating factors of production, improving their private appropriability (reducing the risk of expropriation), or increasing productivity by removing constraints to their effective use. The first strategy focuses on accumulating factors that raise productivity by growing infrastructure, labor, human capital, and domestic and external savings (see the growth accounting model in chapter 2). The second minimizes microeconomic risks affecting openness to trade and foreign investment and introduces needed improvements in economic governance, business regulations, and the rule of law.

Growth strategies often include a long list of constraints and reforms, but literature on growth acceleration suggests that smaller changes that relax just a few binding constraints on growth can trigger rapid growth (Hausmann, Pritchett, and Rodrik 2004). Many structural reforms undertaken by Pakistan may have improved secondary aspects of growth dynamics without substantially easing binding constraints and sustaining high growth.

Studies have identified a wide range of binding constraints to Pakistan's growth, with no broad consensus on the most important ones<sup>5</sup>. The debate has followed the international literature, moving from exogenous to endogenous models.

Growth diagnostics applies a deductive model, as fully developed in Hausmann, Rodrik, and Velasco (2005), which initially assumes that all potential constraints on factors of production are complementary and that all matter for growth. The challenge is to identify which have the highest marginal return (are truly binding) so that policy changes can have the greatest beneficial effect on growth. There are two basic rules for identifying them. Factors of production with high shadow prices (rates of return), such as high interest rates on credit, or difficult access, such as credit and electricity, are considered binding. Changing the supply of these factors could have very large effects on growth.

<sup>4</sup> Calvo and Ottonello (forthcoming) define an external "sudden stop" as a fall in capital inflows two standard deviations below its sample mean. A domestic sudden stop uses the same criterion but applies it to real bank domestic credit flows to the private sector.

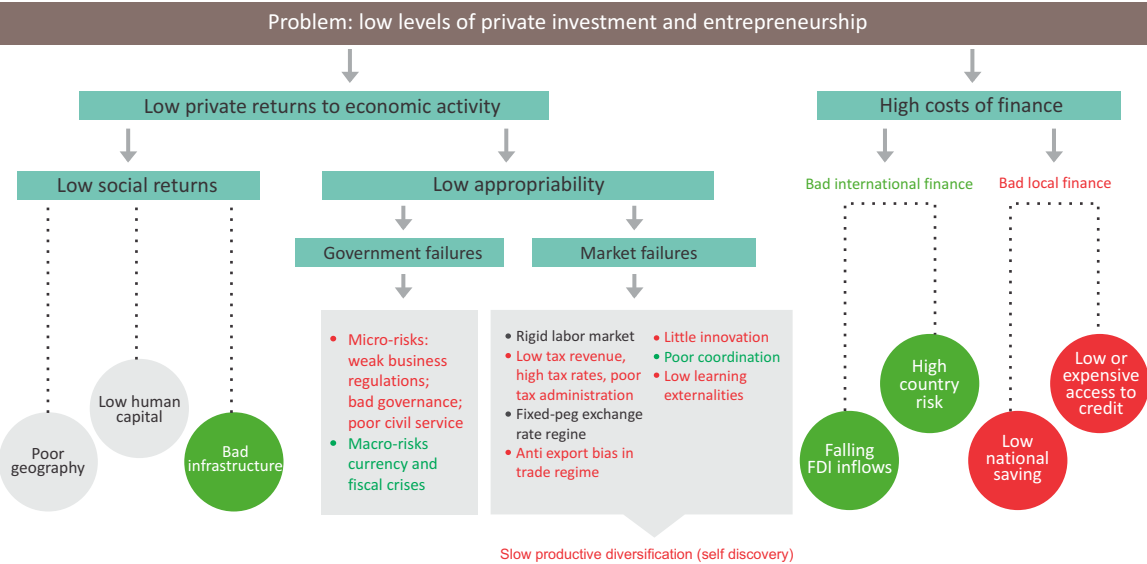
<sup>5</sup> This section is based on Lopez-Calix and Touqueer (forthcoming). A detailed list of past literature on this topic and its main findings is in the paper.

The main advantage of growth diagnostics is its selectiveness: it can reduce the number of potential binding constraints to a few actual ones, based on quantitative evidence. It applies a discriminatory procedure that can be represented by a decision tree (figure 3.1).

First, the procedure defines the potential binding constraints to investment and entrepreneurship associated with factors of production, regrouped under financing constraints (low domestic savings, poor intermediation in domestic financial markets, limited access to external financial markets, and low foreign direct investment); low social returns to factors of production (insufficient investment in complementary factors such as human capital, insufficient infrastructure, or poor geographic location); and low private appropriability due to government or market failures (high macroeconomic risks or microeconomic factors, inefficient tax structure or high tax rates, weak property rights and contract enforcement, too little product innovation or self-discovery, and large externalities). Second, the procedure determines the validity of each potential binding constraint, using a decision tree. Moving down the branches of the decision tree allows sequentially discarding nonqualifying constraints. For Pakistan the few remaining choices can be grouped as structural (deep-rooted binding constraints that have to be eased to make growth acceleration sustainable over the medium term) or emerging constraints (recent constraints that require prompt solutions to spark growth in the near term).

While the growth diagnostics approach has many advantages, it also has disadvantages. First, it is static, considering a steady-state solution to the dynamics of constraints that are binding today but might not be in the future and vice versa. Inadequate roads might not be binding today but could become so once growth accelerates. Second, it does not deal with the sequencing of reforms between structural and emerging binding constraints, or between current and future ones. And third, because of data limitations on some variables, direct measures of the shadow prices needed to assess whether a constraint is binding are difficult to find, forcing the diagnostic to rely on theory or indirect evidence.

Figure 3.1 Decision tree on all possible main constraints to growth in Pakistan



Source: Lopez-Calix and Touqeer forthcoming.

Note: In lower levels, red text represents structural binding constraints, and green text represents emerging binding constraints. Black text means nonbinding.

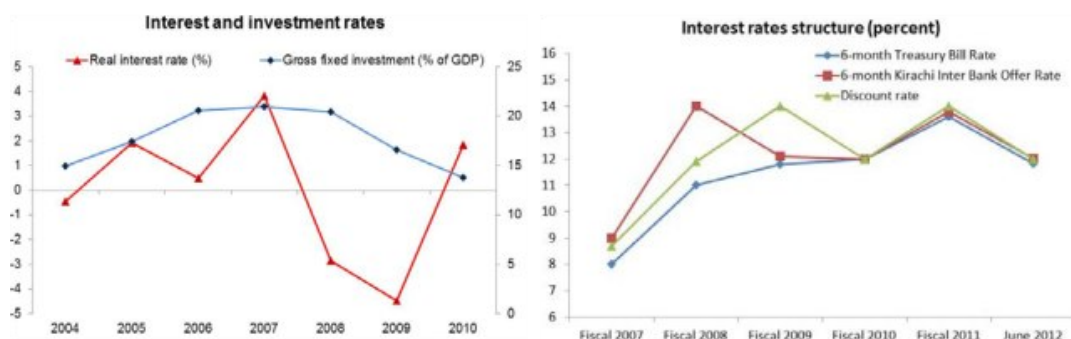
## Structural constraints

Structural constraints are deep-rooted binding constraints that have to be eased to allow for sustainable growth. The main structural constraints are low access to finance, low productive diversification and innovation, government failures in tax and trade policies, and microeconomic factors including excess business regulation and a nonperforming civil sector.

### Low access to finance

A long-standing binding constraint to growth in Pakistan is low access to finance, associated partly with high intermediation costs and private sector credit that crowded out access to finance, especially for small and medium-size enterprises and women. If high financing costs were the problem, Pakistan would have very high real interest rates, a large current account deficit, and entrepreneurs ready to invest (Rodrik 2006). That has not been the case. Domestic real interest rates have lately been mildly positive, the current account deficit has been average (below 2 percentage points of GDP) by international standards, and private investment has been falling (see figure 2.5 in chapter 2). But what really puts finance out of reach for smaller enterprises and women is weak financial intermediation, high collateral requirements, and financial illiteracy. And all this happens in a context where credit to the private sector has shrunk as risk-averse commercial (scheduled) banks have turned to purchasing government bonds at attractive short-term rates to finance high fiscal deficits (figure 3.2).

Figure 3.2 Evolution of interest rates in Pakistan



Source: Lopez-Calix and Touqeer (forthcoming), based on data from World Bank (2012e) and State Bank of Pakistan (2012a).

High intermediation costs, as evidenced by large and rising interest rate spreads, suggest that competition is weak and the administrative efficiency of commercial banks is poor (table 3.1). Pakistan's domestic interest rate spread averaged 650 basis points over a two-year period through September 2011, which is in the high range (IMF 2012a). The widening spread may be attributable to low deposits, high lending, or both. In Pakistan deposit rates are low because most deposits are held in banks for transactional purposes; personal savings are placed elsewhere, especially in rural areas, where financial illiteracy causes people to avoid banks. Lending rates are relatively high due to commercial banks' strong preference for holding government securities over riskier corporate debt or personal lending and a lack of other

borrowing alternatives, such as a well-developed capital market. This particularly affects small and medium-size businesses, as large corporations prefer retained earnings over expensive commercial bank loans to cover their financial needs.

**Table 3.1 Nominal interest rates and inflation**  
(weighted average percent)

Year	Lending rate <sup>a</sup>	Deposit rate <sup>a</sup>	Interest rate spread	Inflation, consumer prices (annual %) **
2004	5.1	1.2	3.9	4.6
2005	8.2	3.4	4.8	9.3
2006	9.9	4.7	5.2	7.9
2007	10.3	5.3	5.0	7.8
2008	12.8	7.0	5.7	12.0
2009	14.3	7.6	6.7	20.8
2010	13.2	6.8	6.4	11.7
2011	14.3	7.2	7.0	13.9

Source: Lopez-Calix and Touqeer forthcoming.

Note: All figures are of June each year, except inflation data, which are for fiscal year.

a. Excludes interbank rates from January 2011.

Further evidence that domestic financing constrains Pakistan's growth is the lack of financial depth. Pakistan is well below average in credit availability to the private sector relative to income per capita—lower than Bangladesh, India, and Sri Lanka. Credit to the private sector declined from about 28 percent of GDP in fiscal 2007 to about 16 percent of GDP in fiscal 2012. Deposit to loan ratios decreased from 66 percent in 2011 to 53 percent in 2012. Barely 8 percent of the population puts their savings in financial institutions. Pakistan has the lowest private sector credit to GDP ratio and the lowest financial depth ratio (M2/GDP) among leading emerging economies (Government of Pakistan 2011a). Only about 14 percent of the population uses financial products or services (including savings, credit, insurance, payments, and remittance services; World Bank 2009a).

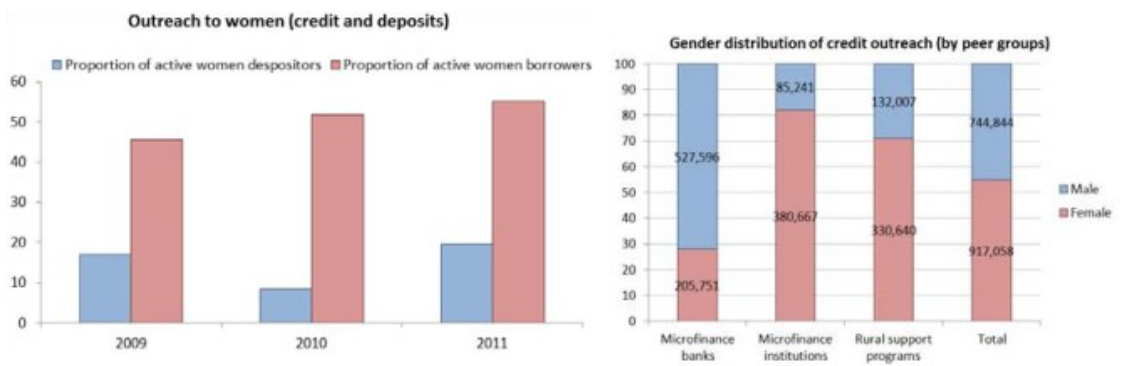
The lack of clarity regarding depositor protection is an obstacle to attracting depositors and could undermine the system's stability by provoking runs on banks in the event of distress, leaving small depositors uncovered. Many people are averse to formal borrowing, especially in poor and rural households. About 3 percent of poor households borrow from financial institutions, and only 15 percent of farmers have access to credit through the financial system. About half the population uses informal financial mechanisms (including shopkeepers, moneylenders, *hawala/hundi*, and money transfers). The remaining 36 percent do not engage in either formal or informal financial transactions. Such high financial exclusion not only exposes individuals and businesses to the risks of fluctuating income, but also raises their operating costs and depresses future investments.

Micro, small, and medium-size enterprises find it hardest to get credit. As the growth engine of Pakistan's economy, these enterprises make up about 90 percent of private enterprises in the industrial sector, employ 78 percent of the nonagriculture labor force, and contribute more than

30 percent to GDP. Yet lending to these firms, at 16 percent of total lending, is below demand. Reasons include the 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; 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. By preventing small entrepreneurs from financing high-return investment projects, credit constraints reduce the efficiency of resource allocation and slow job-enhancing growth. Cultural factors such as poverty, financial illiteracy, and religious beliefs also restrict access to finance.

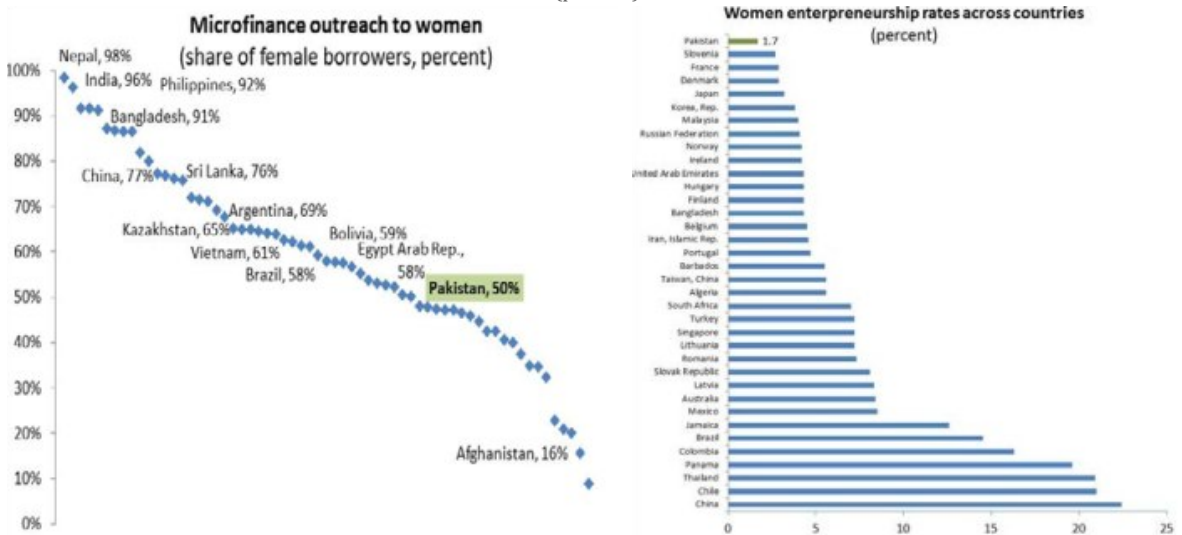
Women are also underserved. Women run mostly small businesses and cottage industries, and access to credit is important for setting up and running their businesses. Although the proportion of women borrowers has risen and women constitute a majority of borrowers in microfinance institutions and rural 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 (figure 3.3). 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 a good match for microfinance-based jobs. The Pakistan Microfinance Network (2011) 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. Women still rely on informal finance, which tends to be expensive and limited in quantity. The share of female entrepreneurs remains abysmally low (figure 3.4).

Figure 3.3 Credit outreach by gender  
(percent)



Source: Pakistan Microfinance Network 2011.

Figure 3.4 Women entrepreneurs and microfinance outreach, 2011  
(percent)



Source: Lopez-Calix and Touqeer (forthcoming), based on Microfinance Information Exchange and Global Entrepreneurship Monitor databases.

Note: Data relate to countries with at least five microfinance institution reports.

### Slow productive diversification

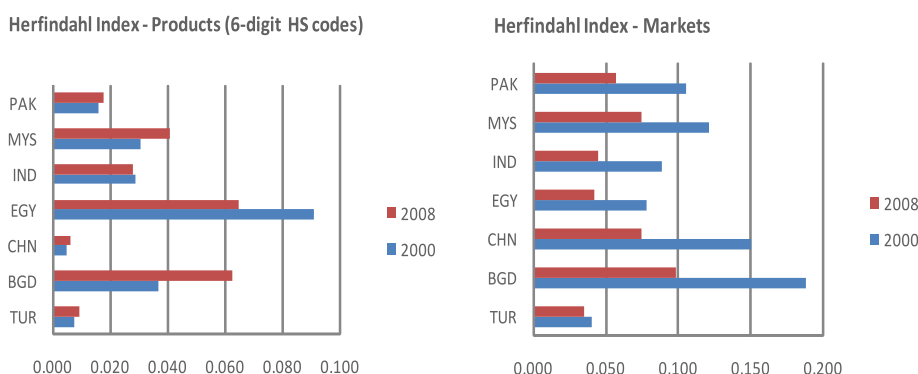
A second long-standing binding constraint to Pakistan's growth is a combination of government and market failures that stifle competitiveness and lead to low productive diversification (an economy's shift from producing low-productivity, low-skilled goods to producing high-productivity, high-skilled goods by learning from fast-growing countries and identifying niche products). Structural transformation requires a business-friendly environment and protected property rights to reduce the risk of expropriation (appropriability rights).

Pakistan's near-stagnant trade performance, with a low and falling trade to GDP ratio over the last decade, is yet another symptom of poor productive diversification. Unlike fast-growing economies, Pakistan's trade regime has never been guided by an overarching export-led strategy. Exports and imports as a percentage of GDP have changed little over the past three decades (Government of Pakistan 2011a). Export growth was lower than in the rest of South Asia and the large emerging economies, and as a result Pakistan's world market export shares declined—while those of Malaysia, Mexico, and Thailand doubled and those of China tripled. Pakistan's exports are based on a few labor-intensive light manufacturing products (textiles, footwear, leather), which accounted for 65 percent of exports in fiscal 2009. And Pakistan is under exporting to fast-growing economies like China and India. With most exports going to U.S. and European markets, Pakistan's exports are more vulnerable to the recent economic downturn and adverse shocks in those western countries. There are signs of export dynamism, with substantial churning of firms, but it seems to be losing steam, as declining trends in firm entry and exit show (Reis and Taglioni forthcoming).

*Five indicators of productive diversification.* While diversifying export products and markets could help Pakistan reduce its vulnerability to external shocks (price- and partner-specific) and

contribute to growth, multiple indicators show little diversification to date (Reis and Taglioni forthcoming). The Herfindahl Index of export concentration (by product or market) shows an inverted U-shaped relationship between growth and diversification: as countries develop, they diversify production until they reach relatively high GDP per capita, and then become more specialized (Imbs and Wacziarg 2003). Analysis at the six-digit Harmonized System level shows that Pakistan's exports are more diversified in products than in markets and that over the last decade diversification by products remained largely unchanged while concentration declined in some markets (figure 3.5). In 2008 Pakistan's export diversification by product (Herfindahl Index of less than 0.02) was better than India's, Malaysia's, Egypt's, and Bangladesh's but worse than China's and Turkey's. By markets, Pakistan's export diversification (Herfindahl Index around 0.05) was better than in 2000, but still lagged all competitor countries except China, Malaysia and Bangladesh. 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, and the Russian Federation. Pakistan now trades more with Gulf Corporation Council countries. And once bilateral relations with India normalize, Pakistan is expected to trade more with not only India but also China and South Asian countries.

**Figure 3.5 Export diversification by product and market, 2000 and 2008**  
(Herfindahl Index)



Source: Reis and Taglioni forthcoming.

Note: A value of 0 equals perfect diversification and 1 equals no diversification.

Analysis is at the six-digit Harmonized System level.

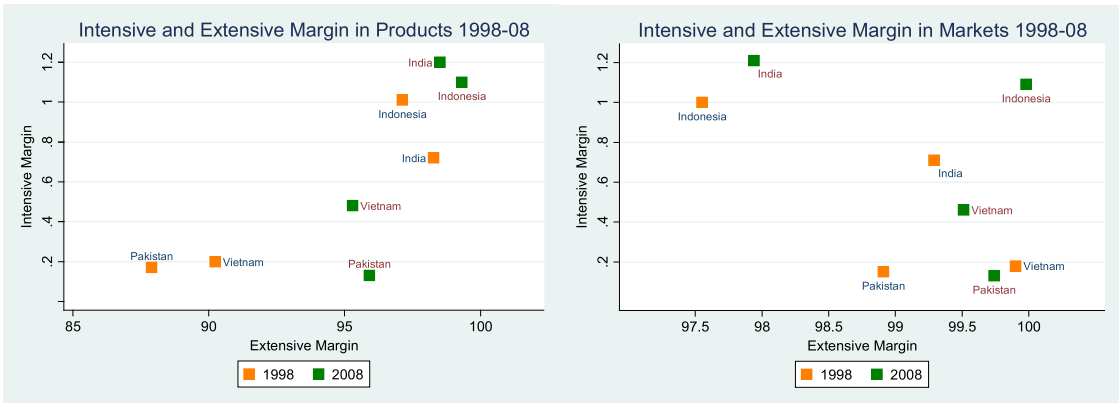
Analysis of intensive and extensive margins in export products and markets yields broadly similar findings. Pakistan is moving to new products and markets but slowly and from a low base (figure 3.6; Reis and Taglioni forthcoming). Pakistan's share of exports of products that the rest of the world also exports (intensive margin) diminished slightly over 1998–2008, but it appears to be moving to more globally strategic exports (extensive margin). Its competitors, except India, Indonesia, and Vietnam, have grown their export share in existing markets (intensive margin) rather than adding new markets (extensive margin).

A third indicator of diversification is the share of high-tech products (engineering and other high value added) in exports. The share of high-tech exports in total exports was less than 2 percent in 2008, almost unchanged since 1980s, while the share of low-tech exports rose from 54 percent in 1982 to about 65 percent in 2008. Meanwhile, Pakistan's competitors grew the share of high



value-added products in their exports (Reis and Taglioni forthcoming).

**Figure 3.6 Intensive and extensive margins in products and markets, Pakistan and selected competitor countries, 1998 and 2008**



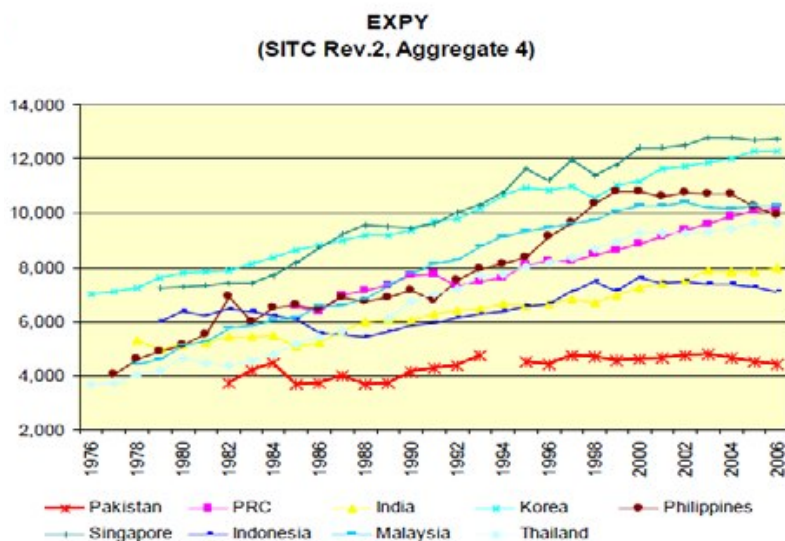
Source: Reis and Taglioni forthcoming.

A fourth indicator is export sophistication (a close proxy for productive diversification). Countries with higher export sophistication relative to their income have a higher probability of accelerated growth (Hausmann, Hwang, and Rodrik 2006)<sup>6</sup>. Export sophistication is an aggregate index of the ratio of each export good in a country's export basket to its total exports multiplied by the weighted average income per capita in countries that produce a similar good. Pakistan's export sophistication is below average for its per capita GDP and is stagnating (Reis and Taglioni forthcoming). Over the past 40 years its main competitors have raised the sophistication of their export basket; Pakistan's improved only between 1982 and the mid-1990s, followed by stagnation (figure 3.7). India, with a comparable GDP per capita, has a more sophisticated export package, and China, the Philippines, and Thailand have substantially improved their export sophistication.

A final measure of productive diversification is export connectedness ("open forest"; Hausmann 2011). This measure identifies whether a country's export products are in a dense product space (high value), which offers multiple opportunities for structural transformation, or in a thin and unconnected product space (low value), which lacks opportunities for transforming products into new high-value products. Pakistan still specializes in low-wage goods requiring low skills and faces many difficulties moving into high-value products. Over the past 40 years Pakistan has barely moved into denser, more connected product spaces, as have many other countries. Three competitor countries—Indonesia, the Philippines, and Thailand—also started off with low connectedness but gradually made it to better export connectedness.

<sup>6</sup> Felipe (2010) estimates that growth rises about half a percentage point on average for each 10 percent rise in export sophistication.

Figure 3.7 Export sophistication of Pakistan and selected countries



Source: Hausmann 2011.

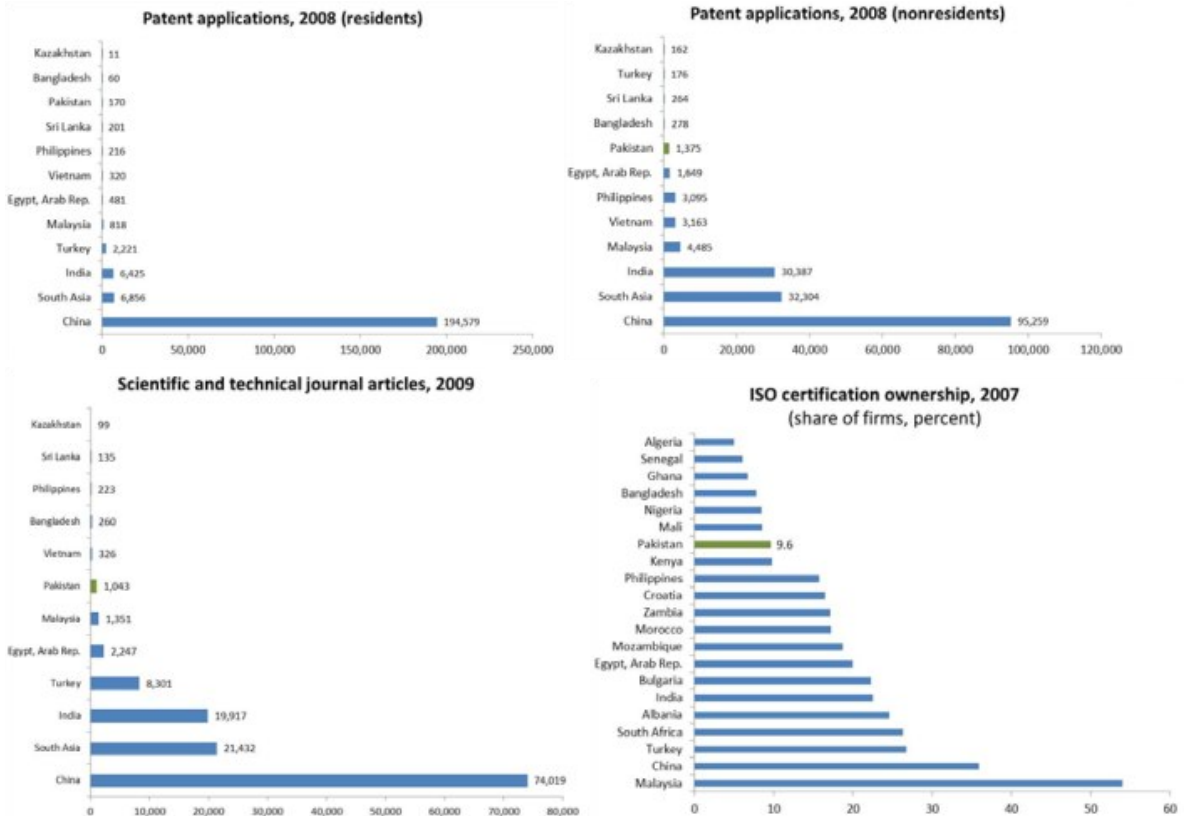
All five indicators of productive diversification show that low, slowly changing productive diversification (and competitiveness) is at the root of Pakistan's growth and export under performance. Only the Herfindahl Index shows any glimmers of good performance. A primary challenge is developing new products with higher technological content. The first step is to identify what factors prevent productive diversification. Both market and government failures play a role.

*Market failures.* Market failures partly explain Pakistan's slow productive diversification. Innovation (creative destruction) is a critical link between entrepreneurship and growth (Schumpeter 1934). Some externalities in exchanging and accumulating knowledge may be harmful to innovation and by extension to total factor productivity and growth (Romer 1986, 1990). These market failures are categorized in two ways: innovation exchange and learning externalities.

Innovation fosters productivity, job growth, and knowledge sharing. Pakistani firms' poor showing on export sophistication and productive diversification is directly related to low innovation exchange (Hausmann 2011). Pakistan is ranked lower than China and India on three global innovation indexes—global innovation, global competitiveness, and innovation capacity (Speakman and others 2012)—as reflected in low research activities, patent applications, and International Organization for Standardization certifications (figure 3.8). Pakistan lacks incentives for entrepreneurs to invest in new activities (Government of Pakistan 2011a). The World Bank's 2010 Enterprise Survey finds that only 6 percent of surveyed Pakistani firms had introduced a new product in the last three years; in Chile, 70 percent did so.

However, because Pakistan is ranked above Bangladesh, which has developed a successful export-led strategy while Pakistan has not, it is important to look at another dimension of competitiveness: firms' efforts to upgrade their workers' learning skills.

Figure 3.8 Pakistan's performance in innovation



Source: Lopez-Calix and Touqeer (forthcoming), based on World Bank (2012e).

Note: International Organization for Standardization 2007 for all countries except India, 2006; Turkey, 2005; China, 2003; and the Philippines, 2003.

It is difficult to hire people with the necessary skills and experience to implement a new technology, so entrepreneurs are often required to provide their own basic training. Yet less than 5 percent of manufacturing firms in Pakistan provide employee training, considerably lower than in competitor countries, including Bangladesh, Egypt, India, the Philippines, Sri Lanka, and Turkey (World Bank 2009b). This learning gap discourages private investment in new activities.

### Government failures: a dysfunctional tax system and an anti-export bias

Two government failures in particular are binding constraints to productive diversification: a dysfunctional tax system, resulting in low tax revenues, and a strong anti-export bias in the trade regime.

*Inefficient, expensive, and cumbersome taxes.* An efficient tax system generates adequate revenue to fund public investments and services and keeps the tax burden low on important business activities, facilitating tax compliance. Pakistan has a narrow tax base with multiple exemptions and a high corporate income tax rate. The tax system's narrow coverage and administrative shortcomings have led to vast tax evasion. In 2010 Pakistan had the lowest value-added tax gross compliance ratio (28 percent), as well as the lowest productivity rates for the value-added tax (0.23) and corporate income tax (0.08) in the world (USAID 2011)

Expensive direct taxes affect Pakistani firms' competitiveness and profitability. High corporate taxes also lead to extensive informality and tax evasion and discourage enterprises (that pay taxes) from hiring skilled labor and becoming more productive. The government gradually reduced corporate income tax rates from 66 percent for banking, 55 percent for private companies, and 44 percent for public companies in the 1990s to a uniform 35 percent on taxable profits in 2005. But this rate is still high by international and regional standards. Because of weak compliance and numerous exemptions and loopholes, the effective rate is higher than the nominal rate for most manufacturing firms. In contrast, Pakistan's top marginal personal income tax rate of 20 percent, which affects skilled professionals, is among the world's lowest. In theory, this should make hiring professionals or permanent staff less expensive for firms.

Cumbersome payment procedures are another binding constraint reported by firms. *Doing Business 2012* ranks Pakistan 158 of 183 countries in ease of paying taxes, down from 116 in 2011 (World Bank 2012a). Preparing, filing, and paying taxes takes three times longer than the Organisation for Economic Co-operation and Development average, despite the recent introduction of e-filing. Large and medium-size firms report being severely constrained by shortcomings in tax administration (World Bank 2007, 2010b). PwC UK and World Bank Group (2012) also report that paying taxes in Pakistan is cumbersome, noting that Pakistan recently raised the profit tax for small firms.

*Anti-export bias.* Pakistan is one of the most protected economies in the world. Its trade regime shows a high anti-export bias, creating barriers to export competitiveness and diversification (box 3.1). Tariffs and other protectionist instruments act as taxes on existing and potential export activities by shifting price incentives in favor of import-substituting production and by boosting the cost of imported inputs. This raises the profitability of production for domestic rather than international markets, reducing incentives for diversification. Pakistan began a comprehensive and politically challenging trade liberalization program during late 1990s and early 2000s, reducing the maximum tariff to a still high 25 percent, which encouraged illegal imports from Afghanistan and India (World Bank 2004b). When the current account deficit ballooned during the 2008 global financial crisis, the trade regime was made deliberately more complex, creating a high anti-export bias. This anti-export bias encourages the production of low value-added products, impeding competitiveness and productive diversification into high value-added products. Most industries remain heavily protected and plagued by inefficiencies.

### Box 3.1 How high and escalating tariffs create an anti-export bias

High and escalating tariffs protect domestic industries and create strong disincentives to export through several channels:

- Duties on imports of final goods raise their domestic relative prices, thereby increasing the profitability of import substitutes instead of exports, which are sold at world prices. This diverts resources from exports to inefficient production for the domestic market.
- With import demand curtailed by high protection, import-related (ex ante) demand for foreign exchange is also curtailed, allowing the country to maintain a lower exchange rate (a lower domestic currency price for foreign currency) than otherwise. Export proceeds, expressed in domestic currency, would thus be lower than without protection.
- Escalating tariffs—lower tariffs on imports of raw materials and intermediates and higher tariffs on more processed products—raises the effective protection rate for import substitutes above the nominal protection rate.
- Exporters, who sell in competitive world markets, cannot pass on to buyers the higher production costs resulting from import duties and other protective measures.
  - o Duty and tax rebate systems, as in Pakistan, are generally not efficient enough to reimburse exporters quickly.
  - o Enclave arrangements, such as bonded-warehouses and export processing zones, provide speedy duty-free access to imported inputs, but they serve only limited activities and cannot substitute for broader and deeper trade liberalization.

Pakistan's overall trade restrictiveness index is high and rising, placing the country in the 88th percentile of economies with restrictive trade policies.<sup>7</sup> The index ranges from 0 (no restrictiveness) for Singapore and Hong Kong SAR, China, to 16 in the Islamic Republic of Iran, with Pakistan at 9.9 in 2010, up from 9.0 in 2004.

Pakistan's tariff structure, with its many rates and exemptions, is a complex, nontransparent system that leads to substantial deviation between applied and official tariffs and considerable tariff dispersion. On most-favored-nation statutory terms, there are currently 17 ad valorem tariffs, ranging from 0 to 150 percent, with most product line items (about 40 percent) at or below 5 percent. The highest tariffs are on transportation and certain agricultural products. However, Pakistan effectively applies more than 40 tariff rates, once statutory regulatory orders are included. More than half of product-line items have effective tariffs at less than 5 percent. And about 2 percent of tariff lines have high administrative costs, are prone to corruption, and have “nuisance taxes” (taxes between 0 and 2 percent) that create further dispersion. These complex tariffs greatly affect imports and contribute to anti-export bias: a 1 percent rise in tariff complexity leads to a 13.2 percent decline in export growth (Reis and others forthcoming). The high effective rates of protection on low value-added (manufactured) activities also raise incentives to produce low value-added goods and reduce incentives for new high value-added exports.

<sup>7</sup> The overall trade restrictiveness index, a measure of the anti-export bias of the trade regime, calculates a uniform tariff that, if imposed on imports instead of the existing heterogeneous structure of protection, would leave aggregate imports at their current level. It is a rigorous way to compare weighted average tariffs of countries, with weights reflecting the importance of each good in total imports and the responsiveness of each import to the relative tariff. For details see Anderson and Neary (1994, 1996, 2003) and Reis and Taglioni (forthcoming).

## Microeconomic factors

Pakistan's Framework for Economic Growth (2011a) identifies microeconomic factors related to bad economic governance as major constraints to growth. These consist of overarching regulatory and institutional obstacles that limit firms' ability to boost productivity, scale, and profitability, including poor governance, impediments to doing business, and weak civil service performance. Confronting such factors would enable the software needed to expand the hardware of growth (physical infrastructure) and make it more productive. Micro risks are multidimensional, and not all components are of equal weight.

*Poor governance.* Poor governance is a binding constraint to growth in Pakistan, with strong distributional and security-related implications. Pakistan ranks among the weakest performing countries on governance indicators worldwide. 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 3.2). Indexes for 2012, including the corruption index of Transparency International and the rule of law index of the World Justice Project, signal a deeper deterioration: Pakistan fell to 139th of 176 countries in the perception of corruption index and to 90th of 97 countries in the rule of law. Bad economic governance translates into cumbersome procedures and inefficient civil service as well.

**Table 3.2 Comparative scores on six governance indicators, 2011**

Region or country	Governance scores						Average
	Rule of law	Control of corruption	Political stability	Voice and accountability	Government effectiveness	Regulatory quality	
East Asia	0.13	0.00	0.37	0.08	-0.06	-0.17	0.06
Latin America	0.05	0.24	0.25	0.39	0.22	0.18	0.22
Middle East and North Africa	-0.17	-0.26	-0.65	-0.90	-0.15	-0.15	-0.38
Sub-Saharan Africa	-0.71	-0.59	-0.54	-0.60	-0.75	-0.67	-0.64
South Asia	-0.62	-0.65	-1.17	-0.50	-0.47	-0.71	-0.69
Afghanistan	-1.94	-1.55	-2.51	-1.49	-1.46	-1.54	-1.75
Bangladesh	-0.72	-1.00	-1.50	-0.31	-0.85	-0.81	-0.87
Bhutan	0.13	0.74	0.87	-0.48	0.62	-1.17	0.12
India	-0.08	-0.56	-1.20	0.41	-0.03	-0.34	-0.30
Nepal	-0.99	-0.77	-1.55	-0.53	-0.79	-0.72	-0.89
Pakistan	-0.90	-1.00	-2.70	-0.83	-0.82	-0.61	-1.14
Sri Lanka	-0.07	-0.42	-0.54	-0.53	-0.08	-0.09	-0.29

Source: Lopez-Calix and Touqeer (forthcoming), based on World Governance Indicators data for 2011.

Note: Scores range from -2.5 (weak) to 2.5 (strong).

*Impediments to doing business.* Cumberse regulatory barriers to businesses have a deep and varied effect on growth. Their influence depends on firm size, formality, market structure, type of industry, and location. *Doing Business 2012* captures data on the formal regulatory requirements faced by firms, while the 2007 and 2010 Enterprise Surveys provide statistics on firms' perceptions of regulation enforcement. Analysis of the obstacles suggests the need for more focused policy efforts in getting electricity, paying taxes, enforcing contracts, registering property, obtaining construction permits, starting businesses, and trading across barriers (Kularatne and Lopez-Calix 2012).

In general, the business environment in Pakistan is better than in most South Asian economies, except the Maldives and Sri Lanka. Of 183 economies Pakistan ranks 105 on the overall Doing Business index for 2012. But this position reflects a deterioration since 2011, when Pakistan ranked 96. And differences across provinces are substantial. Among other findings:

- Pakistan ranks 166 of 183 economies on the ease of getting electricity; the median for South Asia is 118. Pakistan's firms suffer the greatest financial losses in South Asia due to power interruptions, with small firms bearing the highest losses. The *Global Competitiveness Report 2011–12* ranks Pakistan 126 of 142 countries for the quality of electricity supply (World Economic Forum 2012). The 2007 Enterprise Survey finds that electricity is the greatest obstacle for 60 percent of small firms and 36 percent of large firms (World Bank 2007).
- Pakistan ranks 158 of 183 economies on the ease of paying taxes. On average, firms make 47 tax payments a year and spend 560 hours a year (about 14 weeks) filing, preparing, and paying taxes—about double the South Asian average. The cost of paying taxes in Pakistan is slightly below the South Asian average of 18.6 percent of profits, but once labor taxes and other taxes and contributions are accounted for, Pakistan's cost rises to 35.3 percent of profits in 2012. The 2007 Enterprise Survey ranks tax administration and rates as 8 on a list of 13 perceived obstacles (World Bank 2007).
- Pakistan ranks 154 of 183 economies on the ease of enforcing contracts. *Doing Business 2012* finds that enforcing a contract takes an average of 46 procedures and 976 days in Pakistan, double the time it does in Organisation for Economic Co-operation and Development countries and up 96 days since 2004 (World Bank 2012a).
- Registering property in Pakistan requires six procedures, takes 50 days, and costs 7.7 percent of the property value. These indicators have not changed since 2005. Archaic filing systems, low accountability, and work overload affect this indicator.
- Pakistan is 104 of 183 economies on the ease of dealing with construction permits. The median for South Asia is 123 days. In Pakistan it involves 11 procedures, takes 222 days, and costs 262.5 percent of income per capita.
- Starting a business in Pakistan requires 10 procedures and takes 21 days, which is 3 fewer days than the South Asian median and 8 fewer than in India. The cost is marginal, but the number of procedures is higher than the median for the region (7).
- Exporting a standard container of goods requires seven documents, takes 21 days, and costs \$660. The time and cost to export have declined considerably since 2006, from 31 days and \$996. Pakistan outperforms South Asia but still falls short of the Organisation for Economic Co-operation and Development averages.

Corruption is another primary constraint affecting market development in Pakistan. In 2012 Pakistan scored 2.1 on Transparency International's Corruption Perception Index, down from 2.5 in 2011, and lagging behind Bangladesh (2.7), Mexico (3.0), India (3.1), and Brazil (3.8).<sup>8</sup> Corruption is perceived as a serious and growing obstacle to the investment climate (World Bank 2009b). With so much regulatory excess, bribing government officials to get things done is common in Pakistan.

Excess regulation prevents positive coordination externalities among government institutions. Coordination failures arise when new projects or industries exhibit economies of scale and inputs are missing (Rodrik 1996). For large-scale private investments to make sense,

<sup>8</sup> The Corruption Perception Index scores 183 countries and territories from 0 (highly corrupt) to 10 (very clean) based on perceived levels of public sector corruption.

complementary public investments are needed in such areas as irrigation, logistics, transport networks, and electricity. Excess paperwork in developing public projects leads to a lack of critical inputs or an inefficient mix of inputs, and bureaucratic steps slow project implementation and reduce the investment's profitability. The government acknowledges that infrastructure facilities need to be better organized to maximize returns. Public investment weaknesses include inadequate attention to maintenance, investment priorities other than economic efficiency, little attention to completion and efficient use of infrastructure, and undue emphasis on brick and mortar projects (Government of Pakistan 2011a).

*Weak civil service performance.* Weak civil service performance, yet another reason for poor coordination externalities, is also a major binding constraint to economic growth in Pakistan. By international standards, the public sector in Pakistan is small: 3.3 million people, less than 2 percent of the population. The average for low-income countries is 2.3 percent. But according to the *Global Competitiveness Report 2011–12*, Pakistan ranks near the bottom on the quality of public institutions: 107 of 147 countries (World Economic Forum 2012).

Since 1973 the government has made several attempts to reform the civil service's structure and incentives. Pakistan's National Commission for Governance Reform (2008) presented a detailed agenda. And the 2009 Poverty Reduction Strategy Paper, highlighting the civil service's role as the backbone of the country's governance, proposed enhancing the talent pool and professionalism of the civil service (Government of Pakistan 2009). The 2011 Framework for Economic Growth also placed reform of public sector management at the center of institution building to solve the software growth problems (Government of Pakistan 2011a). Most of the government and market failures discussed earlier in this chapter are related to corruption, poor government management, and other civil service-related issues. A more detailed look at these productivity-reducing constraints shows considerable challenges ahead.

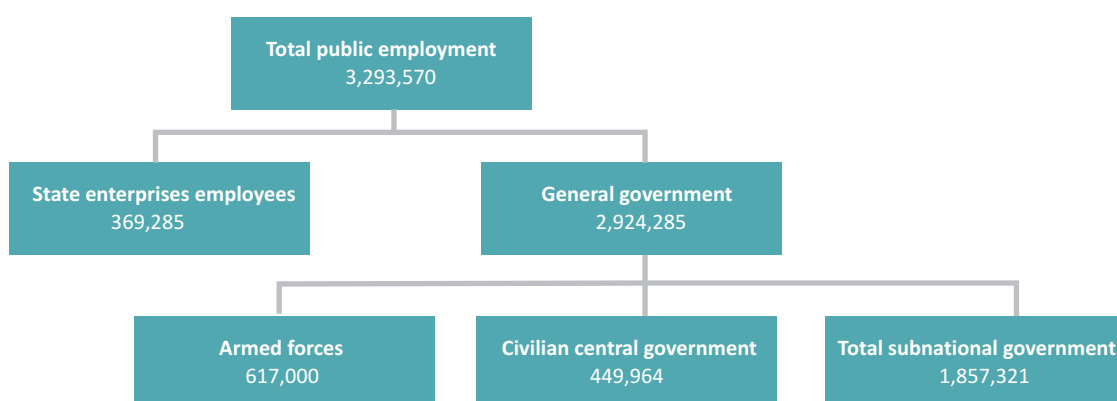
At the provincial level the civil service's excessive size (and rapid growth) is the most pressing issue. Provincial governments hire more than half (56 percent) of public employees, and public employment at the provincial level is growing. More than four times as many civil servants work at the provincial level as at the federal level (figure 3.9). With the transfer of most state functions and responsibilities from the center to the provinces under the 18th amendment to the Constitution, the situation is likely to worsen (Pasha 2012 and Shah 2012). Most additional resources (fiscal space) shifted to the provinces have been diverted to public salaries rather than provincial investment in basic infrastructure or social needs (Mukhtar 2012). Overall about 95 percent of public employment is in the lower grades (BS1–16). The ratio of low- to high-skilled public sector positions (BS1–16/BS17–22) is higher for the federal government, at 21, than for the provinces, where it ranges from 11 in Sindh to 15 in Balochistan and Khyber Pakhtunkhwa (figure 3.10). Qualifications of civil servants are thus lower on average at the federal than at the provincial level.

Estimating public sector labor productivity is extremely complex and subject to data gaps and irregularities that adversely affect the results. In 2005 labor productivity in Pakistan's public sector (2000 PPP \$9,509) was roughly estimated at less than half the worldwide average (2000 PPP \$20,251; Lopez-Calix and Verduzco 2012). And there is no reason to believe that this ratio has improved—it could even have declined.



But public sector remuneration is not correspondingly low. While the wage bill is at about 4 percent of GDP—average by international standards and similar to that in Bangladesh, China, and India (World Bank 2004b)—numerous perks and extra cash payments greatly increase the base pay. These perks reduce productivity, not only by requiring more bureaucracy to manage them but also by encouraging rent-seeking (Government of Pakistan 2011a). Perks such as transportation, housing, land, and membership in clubs and boards are assigned on a discretionary basis, especially at the highest salary levels. This practice encourages rent-seeking and corruption and has introduced distortions in civil service pay at the highest (BS21 and BS22) levels. Over 1994–2011 the average ratio of total salary to cash payments more than doubled, from 1.8 to about 3.7 (World Bank 2004a; Bilquees 2006; Government of Pakistan 2011a). While the 2001 reforms lowered the ratio to less than 1.5 for both categories, by 2006 they had risen again, as allowances multiplied more than fivefold. Restructuring the civil service system would create well-needed fiscal space to change the mix of high- to low-skilled public servants while generating incentives for higher productivity.

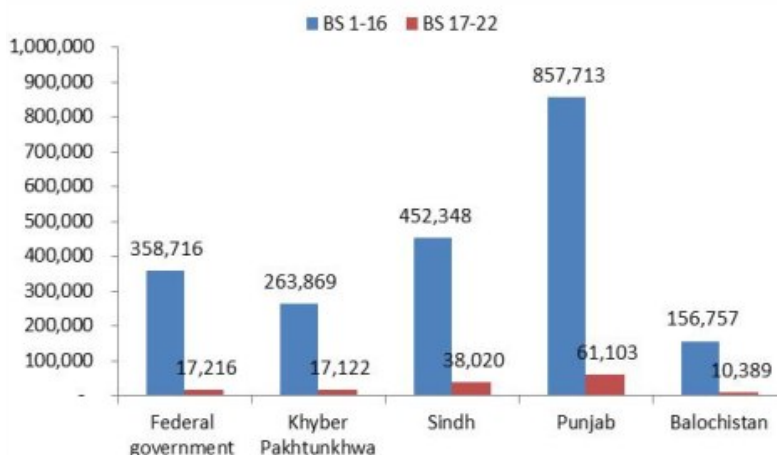
**Figure 3.9 Public sector employment in Pakistan**



*Source:* For state enterprise employee data, Government of Pakistan (2012b); for armed forces data, “Pakistan Military Strength 2012,” [www.defence.pk/forums/strategic-geopolitical-issues/163022-pakistan-military-strength-2012-a.html](http://www.defence.pk/forums/strategic-geopolitical-issues/163022-pakistan-military-strength-2012-a.html); for civilian central government data, Government of Pakistan (2012c); for total sub national government data, National Commission for Governance Reform (2008).

*Note:* All figures are for 2011, except for sub national government. The sub national government employment data are for 2007/08 and are likely to have increased.

Figure 3.10 Size and composition of civil service, by pay scale, 2008



Source: Pakistan National Commission for Governance Reform 2008.

Note: Some 162,000 civilians paid out of the defense budget are not included in the federal government.

## Emerging constraints

Three constraints to growth have recently emerged in Pakistan: massive electricity shortages, high macroeconomic risks, and high country risk, leading to a sudden stop in financial inflows and crunch in domestic credit.

### Poor access to electricity

Rising power shortages are threatening the competitiveness of Pakistan's businesses, its fiscal discipline, and its economic growth potential. By mid-2012, power outages reached an alarming average of 8–10 hours a day, up from 3 in 2007.<sup>9</sup> The direct cost of the power crisis to the economy is conservatively estimated at PRs 380 billion a year—no less than 2 percent of GDP (Government of Pakistan 2012d). For firms, the direct costs in 2008 were estimated at 400,000 jobs, \$1 billion in exports, and PRs 210 billion in business losses (2–3 percent of industry's GDP; Institute of Public Policy 2009). The losses are certainly higher today. Textile industries and small firms bear the highest losses. Manufacturing firms identify access to electricity as their main obstacle to growth (World Bank 2009b, 2010a). These direct costs do not take into account indirect costs such as risk mitigation, firm closures, lower investments, or moving to another country, all of which hurt Pakistan's long-term growth potential.

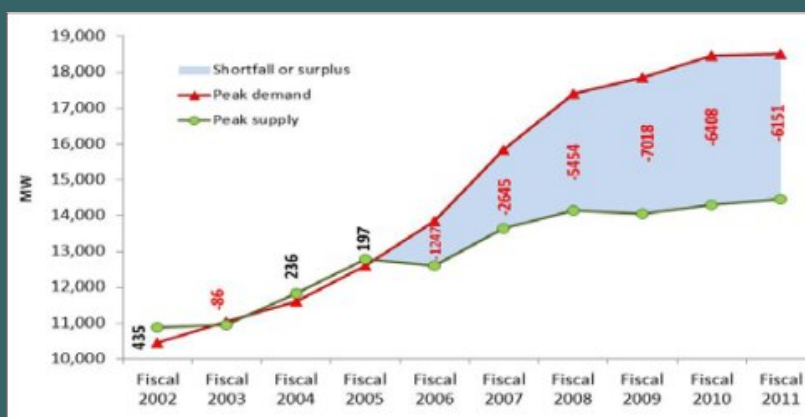
The country's estimated electricity deficit is 20 percent, the second largest in South Asia. Power load-shedding is rising because of inefficiencies in the system, which prevent supply from meeting demand. The worsening shortages are due mainly to demand growth, technical losses, financial factors, governance issues, and changes in power sources (box 3.2).

<sup>9</sup> World Bank estimates based on electricity shortfall data from the National Transmission and Despatch Company.

### Box 3.2 Main reasons for electricity load-shedding in Pakistan

Power supply in Pakistan has not kept pace with rising demand over the last decade, a trend expected to continue over the next few years. Although electricity consumption is low by international standards, expanding the electricity network led to a 59 percent rise in total consumption. Punjab has the biggest share of consumption (62 percent), followed by Sindh (20 percent), Khyber Pakhtunkhwa (12 percent), and Balochistan (6 percent). On the supply side, electricity generation rose only 39 percent over fiscal 2001–11. As a result, Pakistan went from a surplus of 435 megawatts in fiscal 2002 to a deficit of 6,151 megawatts in fiscal 2011 (see figure).

**Pakistan's power gap, fiscal 2002–11**  
(megawatts)



Source: Government of Pakistan 2011b; State Bank of Pakistan 2012b.

There are four main reasons for the power gap:

- *Bad mix of power sources.* Pakistan gets its electricity from oil (35 percent), hydropower (34 percent), gas (27 percent), nuclear (6 percent), and coal (0.1 percent). This mix, while similar to that in other low-income countries, differs from that in other South Asian countries, which rely more on coal and less on oil and gas. The mix poses several problems, including seasonal shortages of gas; irregular availability and fluctuating prices of imported oil; insufficient and aging hydropower infrastructure, with seasonal shortages of water supply.
- *Technical losses.* Huge transmission and distribution losses lower installed capacity of 22 gigawatts to actual capacity of 18 gigawatts, straining the sector's financial sustainability. Technical problems include overloading, aging and under-maintained infrastructure, insufficient fuel and other inputs, and underinvestment in the transmission and distribution system. Distribution losses arise from theft, faulty metering, poor transmission technology, and low rates of bill collection. Losses are higher than in all competitor countries except India.

- *Fiscal deficits.* Misalignment of tariffs with the supply cost and the high transmission and distribution losses results in financial deficits. Federal subsidies for the power sector in fiscal 2012—more than PRs 500 billion (2.4 percent of GDP and 20 percent of total tax revenues)—overran the budget by PRs 353 billion. That included accumulated arrears equivalent to 1.9 percent of GDP in fiscal 2012. Financial deficits are met through government subsidies, short-term borrowing by companies, and accumulation of receivables and payables. The subsidies are fiscally unsustainable, highly regressive (not pro-poor), and favor the nonindustrial sector (tariffs are higher for industries than for consumers). Energy shortages are estimated to reduce growth by 2 percent annually (Beaconhouse University 2010).
- *Governance issues.* According to a 2009 investment climate assessment, about 84 percent of firms in Pakistan applying for a new electricity connection had to make informal payments—the highest among competitor countries India, Bangladesh, Egypt, Vietnam, Sri Lanka, Turkey, and Brazil (World Bank 2009b). Corruption reflects weak governance at power generation and distribution companies. The government's interference in operational decisionmaking also inhibits commercial operation based on cost-effectiveness and maximizing profit. Improving services requires restructuring, hiring competent managers, separating power policies from management, applying the recommendations of technical and financial audits, and strengthening the regulatory body through a new legal framework.

*Source:* Lopez-Calix and Touqeer (forthcoming), based on Loayza and Wada (2012), IMF (2012a), Government of Pakistan (2012d), State Bank of Pakistan (2012b), and World Bank (2009a).

## *Macroeconomic risks—currency and fiscal crises*

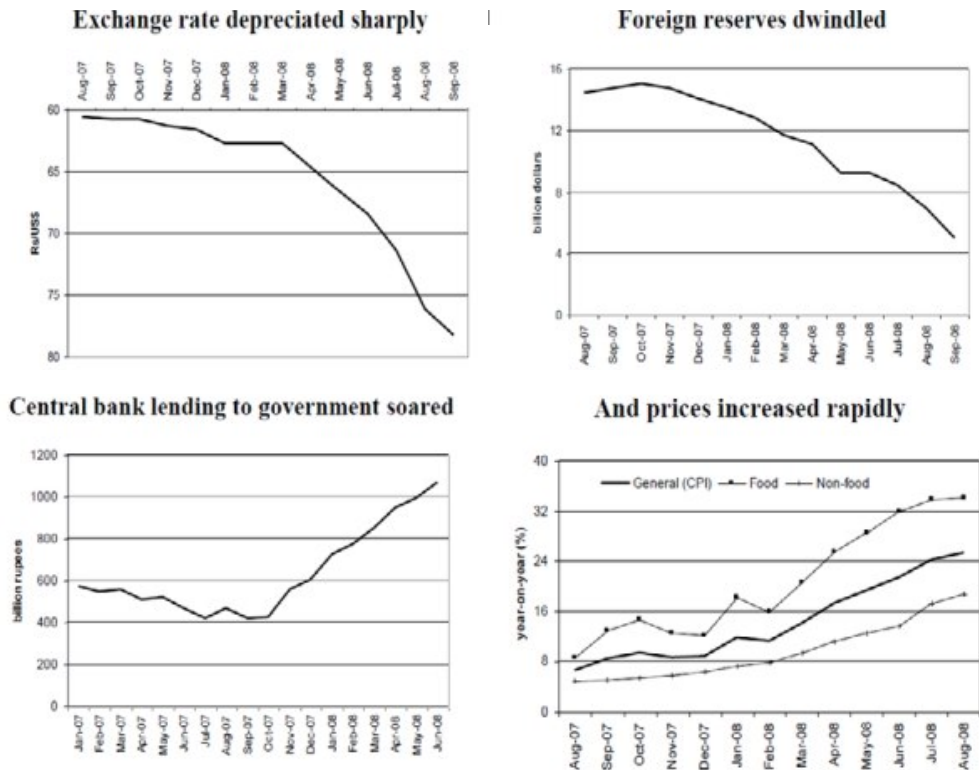
Underlying all growth success stories is a stable macroeconomic policy environment with solid fundamentals. Often a growth-enabling environment combines fiscal solvency, low and stable inflation, and an exchange rate regime that avoids both systematic currency misalignment and excessive volatility, helping prevent external imbalances. In 2006 the World Bank suggested four policy goals to support sustained growth in Pakistan (World Bank 2006a):

- Maintain a low fiscal deficit (3.0–3.5 percent of GDP), consistent with a higher tax to GDP ratio and greater expenditures in sound public investment and the social sectors.
- Reduce the debt burden as a share of revenues as well as GDP.
- Make price stability (inflation at single digits) the primary goal of monetary policy.
- Maintain positive real interest rates to encourage savings and discourage low-quality lending.

Pakistan has not fully adopted this policy mix, and high macroeconomic risks are emerging as a major binding constraint to growth. Double-digit inflation has accompanied most of the current fiscal crisis. International reserves are depleted as both external inflows (due to domestic and external causes) and domestic credit (due to the fiscal crisis) stop suddenly. The only bright spot in this dismal picture is a moderate current account deficit (projected to fall below 1 percent in fiscal 2013) and a persistently rising and positive inflow of remittances.

In fiscal 2009 Pakistan experienced a convergence of multiple shocks (figure 3.11). Starting in mid-2007, greater political uncertainty, the global financial crisis, and huge hikes in the international prices of oil and food were the first blows. These factors would not have been so devastating without preexisting weak domestic and external balances. An externally financed consumption-led boom had become the economy's main engine, with current account deficits rising from 4 percent of GDP in the mid-2000s to 8.4 percent in 2007–08, when the terms of trade shock led to fiscal collapse. Macroeconomic imbalances reached dramatic levels: economic growth plunged from 5.8 percent in fiscal 2008 to 1.7 percent in fiscal 2009. Inflation reached double digits in January 2008 and peaked at 25 percent in March 2008. The exchange rate fell from 63 PRs to the dollar in March 2008 to 77 in September 2008. And net international reserves fell below five weeks of imports in September 2008.

Figure 3.11 A convergence of multiple shocks in 2008/09

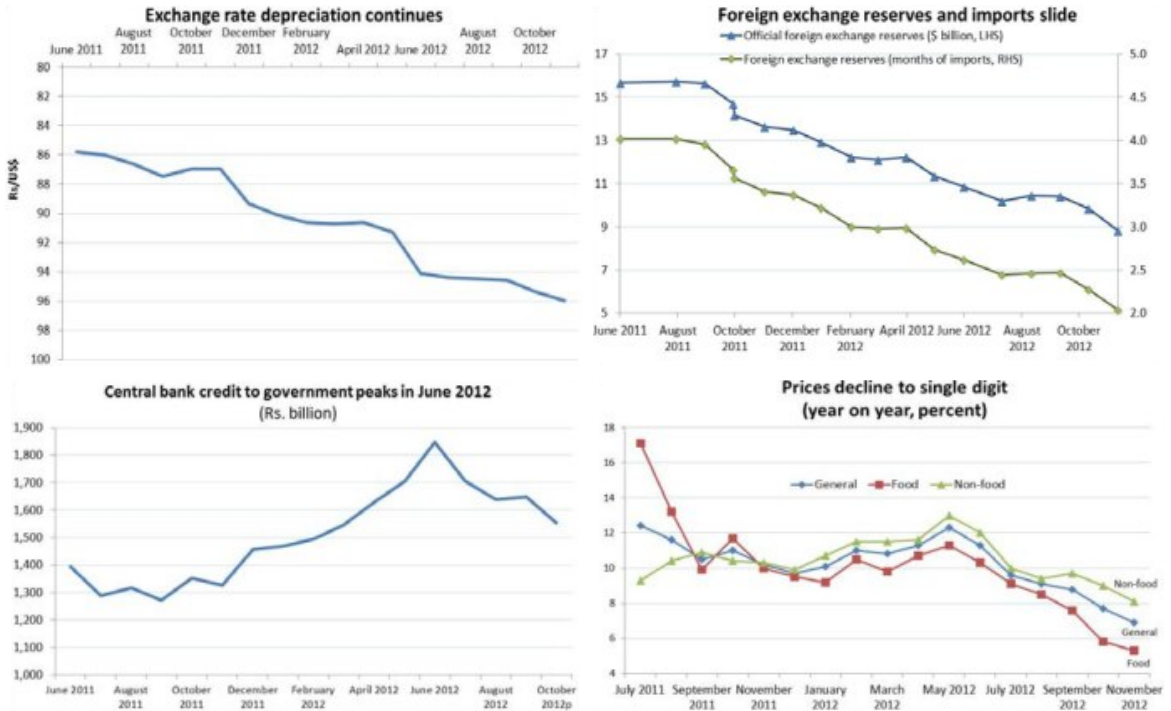


Source: Favaro and Koehler-Geib 2009.

Since fiscal 2012 Pakistan has shown signs of another convergence of shocks. Even after the closing of an International Monetary Fund program that went off-track in June 2011 and was suspended in March 2012, Pakistan continued to implement a counter cyclical policy mix, leading to predictably deteriorating fiscal balances and, to a lesser extent, monetary balances (figure 3.12). By the end of fiscal 2012 the fiscal deficit was 8.5 percent of GDP, with the government publicly acknowledging its inability to contain subsidies to power and state enterprises because of governance weaknesses. Even as the tax to GDP ratio recovered somewhat to around 10 percent of GDP, public investment bottomed out at 2.6 percent of GDP in fiscal 2011, down from 3.6 percent in 2005–06, before partly recovering to 3.1 percent in fiscal 2012.

With limited external financing of the budget, accommodating monetary policy led to soaring central bank lending to the government, keeping inflation at double digits for almost four years before dropping to single digits in July 2012. Real interest rates have become marginally positive, but massive purchases of government bonds by risk-averse commercial banks continue to crowd out domestic credit. Dynamic exports and strong inflows of remittances kept the current account deficit from exceeding an estimated 2 percent of GDP. Large oil price hikes and EU financial and economic turmoil have made matters worse, raising import costs and lowering demand for Pakistan's exports. And the ruling government coalition failed to include comprehensive fiscal consolidation in its 2013 budget, fearing to tackle politically sensitive measures that would risk the next election. By December 2012 international reserves were at 2 months of imports.

Figure 3.12 Macroeconomic imbalances in fiscal 2012



Source: State Bank of Pakistan 2012a; World Bank staff calculations.  
p is provisional.

### High country risk and a sudden stop in external financial inflows and domestic credit

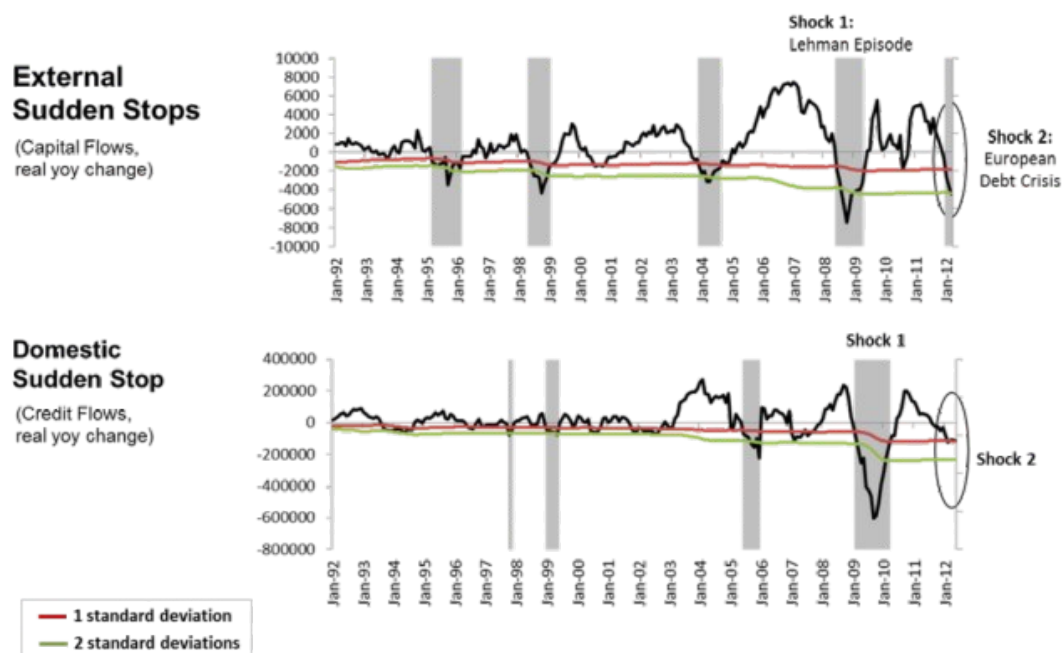
A third emerging constraint to growth in Pakistan, closely related to the previous two, is the high cost and low access to international and domestic finance. Country risk has risen close to 2008/09 levels because of the long domestic armed conflict, political instability in anticipation of elections, and the combination of bad economic fundamentals and the global financial risk associated with Europe's recession.

Following elections in 2002 Pakistan reduced its country risk by strengthening its democratic credentials and showing commitment to serious reforms. Domestic and foreign investment rose, social indicators improved with higher income per capita, and the economy emerged as one of the fastest growing in South Asia, with average growth of more than 6 percent over 2004–06. Future growth prospects looked promising. But these hopes were dashed as insecurity and political instability grew and the global financial crisis erupted in 2008. The spread on the Emerging Markets Bond Index moved from 400 basis points in January 2008 to a peak of 2,135 basis points in December 2008. It took more than a year for the newly elected government to reduce the risk, which remained low until 2010.

After the end of 2010 country risk rose again, reaching almost 1,500 basis points in December 2011, and then falling to about 750 by May 2013. Coupled with a downgrade of Pakistan's sovereign bond rating in 2012, external finance has become too expensive for Pakistan. The high country risk and the new wave of financial turmoil in Europe resulted in another sudden stop in external and domestic financial credit flows (figure 3.13).



Figure 3.13 Sudden stop in external and domestic credit, 1992–2002



Source: Calvo and Ottonello (forthcoming), based on International Monetary Fund data.

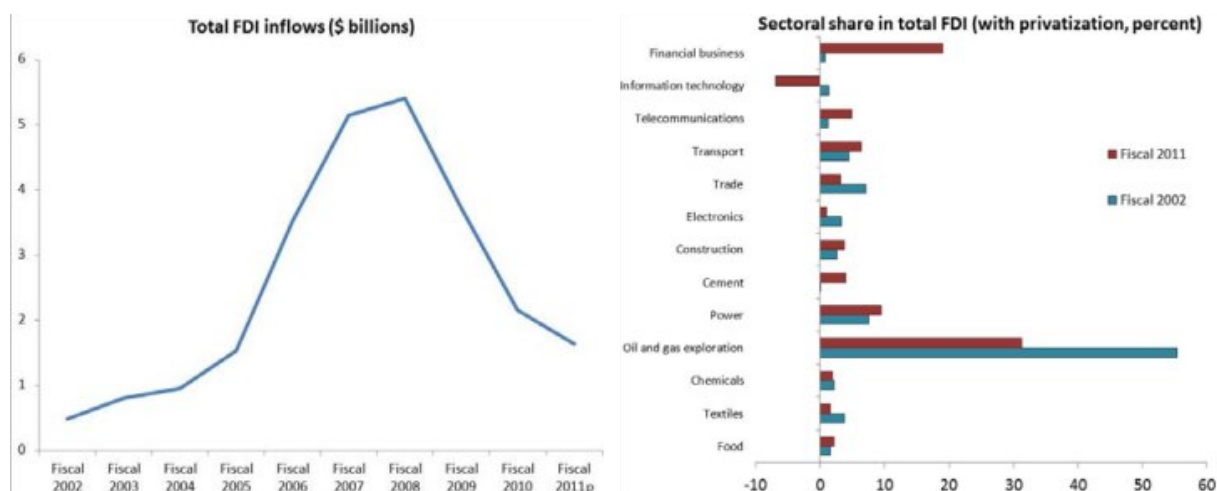
Note: Capital flows are proxied using monthly data on imports, exports, and international reserves. Credit flows use bank credit to the private sector.

Without significant external inflows, Pakistan international reserves are declining. And as commercial bank financing has been diverted to well-remunerated public bonds issued to finance the large fiscal deficits, credit to the private sector has slowed to a trickle. The credit crunch has particularly affected small and medium enterprises and women. The central bank, initially afraid to float the currency under double-digit inflation, has been forced to intervene in the foreign exchange market. Reserve losses have been larger as the country halved its net international reserves from 3.9 months of imports in June 2011 to 2 months in December 2012. The rupee has depreciated almost 10 percent, and pressure is mounting for further depreciation.

Foreign direct investment (FDI) inflows plunged from \$5 billion in fiscal 2008 to less than \$1.7 billion in fiscal 2011 and \$876 million in fiscal 2012 (IMF 2012c). Only the financial, power, transport, and construction sectors have been spared the enormous drops in FDI. Trade, electronics, textiles, information technology, and oil and gas exploration (from 55 percent of FDI in fiscal 2002 to 31 percent in fiscal 2011) have all declined (figure 3.14). One of the main reasons was reduced privatization receipts, which went from 44 percent of FDI inflows in 2006 to no privatization over fiscal 2009–11. The share of FDI in total foreign private investment (FDI plus portfolio investment) fell from 98 percent in fiscal 2003 to 82 percent in fiscal 2011.



**Figure 3.14 Total foreign direct investment inflows and sectoral share, fiscal 2002–11**



p is provisional.

*Note:* Sectoral foreign direct investment figures for fiscal 2002 include privatization proceeds.

*Source:* Lopez-Calix and Touqeer forthcoming.

Amid this high volatility, political unrest and natural disasters have further boosted macroeconomic risk. The estimated annual cost of armed conflict is equivalent to a 2 percent loss of GDP (Favaro and Koehler-Geib 2009), while the estimated annual effects on growth of the July 2010 and August 2011 floods were about 2.1 percent of GDP (from an estimated rate of 4.5 percent) and 0.4 percent of GDP (from an estimated rate of 4.2 percent; ADB 2008; Lin and Monga 2010; World Bank 2011b). Dealing with country risk is a major challenge as Pakistan tries to recover solid fundamentals.

## 4. A TRANSFORMATIONAL JOB-ENHANCING GROWTH AGENDA

Pakistan has not implemented an effective growth strategy recently, but not for want of sound proposals. The 2009 Poverty Reduction Strategy Paper and the 2011 Framework for Economic Growth, both comprehensive, have not been fully developed (Government of Pakistan 2009, 2011a). The transition to the second democratic government in June 2013 presents a rare opportunity for Pakistan to embark on a renewed job-enhancing growth path. The agenda should be balanced, dealing with short-term macroeconomic concerns, microeconomic constraints to growth that limit productivity and competitiveness, and job enhancement. This agenda complements the Framework for Economic Growth, which has a deliberately narrow focus, by expanding complementary policies.

The status quo is a high-risk option for Pakistan, as growth will not accelerate under current trends and policies, and new entrants to the job market will not be fully absorbed. The mild recovery since 2009—stimulated by good agricultural yields and a more dynamic services sector—initially suggested that Pakistan might enter a new boom. But recent developments show the limits of this “wait and see” approach. Preliminary estimates for fiscal 2013 show feeble growth of 3.3–3.7 percent, while inflation is expected to rise in the second half of the year. And the country already faces severe external shocks, including declining foreign direct investment (FDI), a massive drain on international reserves, and an uncertain international environment.

The proposed job-enhancing growth agenda aims for prudent macroeconomic policies, large increases in savings and investment, extensive infrastructure investment, private sector participation, public sector modernization, consolidation of decentralization, fiscally sustainable extension of social and youth employment programs, and implementation of new trade agreements with China, India, and other key partners. This chapter presents the agenda's core elements—the macroeconomic and microeconomic foundations needed to generate momentum for Pakistan's accelerated job-enhancing growth. It explores growth acceleration under two scenarios: a (more likely) return to the historical average GDP growth rate of around 4.5 percent and a (more ambitious) rise to the 7 percent growth rate that this report considers necessary to absorb the population bulge. It details the complementarities between the Framework for Economic Growth and this report as well as possible synergies between the federal and provincial growth strategies. Finally, the chapter explores lessons from the political economy of past structural reforms in Pakistan.

The proposed agenda is rooted in international experience. On growth acceleration, the Commission on Growth and Development published a report in 2008 on the common characteristics of 13 successful economies with high and sustained growth in the postwar period:

- *They fully exploited the world economy.* The 13 successful economies made the most of the global economy, benefiting from transfers of knowledge and technological know-how—two key channels for innovation and competitiveness—through FDI, education, networks, and experience. This lesson is critical for Pakistan, whose position in world trade has barely changed over the past three decades.

- *They let markets allocate resources.* Growth strategies were strongly market-oriented, and markets were deregulated to allow price signals to function.
- *They let markets allocate resources.* Growth strategies were strongly market-oriented, and markets were deregulated to allow price signals to function.
- *They mustered high savings and investment.* High savings and investment—on average 25 percent of GDP or above—appear to be necessary for sustaining high growth, especially in low- and middle-income economies. Pakistan's investment rate has been well below 25 percent over the last four decades—and below 18 percent since the 1980s—and national savings (especially the tax ratio) are among the lowest worldwide. As a result, Pakistan has relied excessively on foreign borrowing (Government of Pakistan 2010a).
- *They maintained macroeconomic stability.* Ample empirical evidence shows that growth is negatively associated with inflation and that causation runs from macroeconomic policy to growth (Fisher 1993). Among the 13 successful growth stories, only China and the Republic of Korea had double-digit inflation rates, due to overheating and despite extensive state-managed indexation. Pakistan's double-digit inflation rates between 2007 and mid-2012 were due to external shocks and expansionary macroeconomic policies.
- *They had committed, credible, and capable governments.* All the successful economies had a sound economic governance framework, consensus built around the strategy, and well-represented and effective leadership capable of collective action to resolve the political economy challenges posed by reforms.

On job enhancement *World Development Report 2013: Jobs* drew two key lessons (World Bank 2012f):

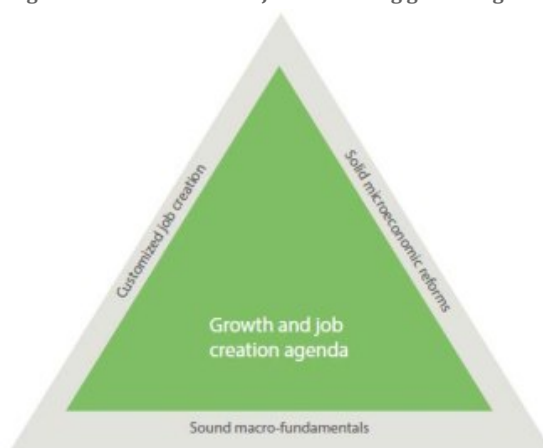
- Growth alone does not guarantee job enhancement—not even job creation. In fact, the opposite is possible. Over the medium term, a common empirical finding is that employment—formal and informal—aligns closely with the labor force's size. But in the short term, because economies grow as high-productivity jobs are created and some low-productivity jobs disappear, the relationship between productivity gains and job enhancement may not be unidirectional. However, job-enhancing policies and dedicated employment programs can be associated with increases in employment (see chapter 5 for an explanation of why growth acceleration is not enough for defining a job strategy).
- Job challenges vary, so customized policies are needed. Each country needs to prepare its own job-enhancing agenda. For example, the job challenge is not the same in an agrarian economy as in a rapidly urbanizing economy. Of eight possible types of job challenges (World Bank 2012f), Pakistan has features of four: agrarian (most people engage in agriculture and live in rural areas); conflict-affected (social cohesion is a major aspiration, and large population segments are engaged in military/security activities); urbanizing (Pakistan's urbanization is the fastest in South Asia—see chapter 5—but only applies to some extent, as it implies that productivity in agriculture has risen enough to allow many to work in cities in higher value-added exports and activities, which is not the case); and high youth unemployment (a youth bulge puts downward pressure on employment and earnings, and education and training systems are not developing the skills needed for the private sector).

The job-enhancing agenda proposed for Pakistan is tailored to these characteristics.

## Core ingredients of the job-enhancing growth agenda

The proposed agenda identifies three complementary axes: macro-fiscal, correcting fundamentals; microeconomic, setting priorities for structural reforms to solve the binding constraints to economic (productivity) growth (box 4.1) and factor gaps; and job enhancing, targeting low-skilled rural and urban youth, who are prone to violence, and female employment (figure 4.1). Thus while restoring macroeconomic fundamentals and easing microeconomic growth-related constraints are necessary for accelerated growth, programs are also needed to address specific job challenges (see chapter 5 for a selection of bad ideas).

Figure 4.1 The axes of the job-enhancing growth agenda



Source: Authors.

### Box 4.1 The binding constraints to growth and the main factor gaps

#### *Emerging constraints*

- Poor access to electricity.
- High macro-fiscal risks.
- High country risk and sudden stops in external financial inflows (including foreign direct investment) and domestic flows.

#### *Structural constraints*

- Low access to domestic finance.
- Slow productive diversification and high anti-export bias.
- Dysfunctional tax system.
- Micro risks: bad governance, impediments to doing business, and weak civil service performance.

#### *Factor gaps*

- Low investment in infrastructure.
- Inefficient and loss-incurring state enterprises.

## *Correcting fundamentals: mitigating the macro-fiscal risks*

Fiscal consolidation would advance growth mainly through a decline in sovereign risk premiums, which would lower borrowing costs for the government, reduce domestic real interest rates, and make domestic credit more available. Coupled with lower security-related spending if conflict diminishes, such measures would expand fiscal space and development spending.

Pakistan already has sound legislation for the main fiscal targets needed to restore its fundamentals, but compliance has been weak. The Fiscal Responsibility and Debt Limitation Law directs the federal government to take all appropriate measures to instill fiscal discipline and reduce public debt to prudent limits.<sup>10</sup> If the law's main goals are preserved and combined with the basic policy measures suggested in the Framework for Economic Growth and the 2012 Medium-Term Macroeconomic Framework (Government of Pakistan 2012e), possible main macro-fiscal targets for fiscal 2014–18 are:

- Growth averaging 7 percent a year over the medium term.
- Per capita income rising from \$1,372 in 2012 to \$2,250 in 2018.<sup>11</sup>
- Public debt shrinking from 62 percent of GDP in 2012 to 50 percent by 2015.
- Target fiscal deficit at 3.7 percent of GDP by 2015.
- Inflation at or below 8 percent a year over the period.

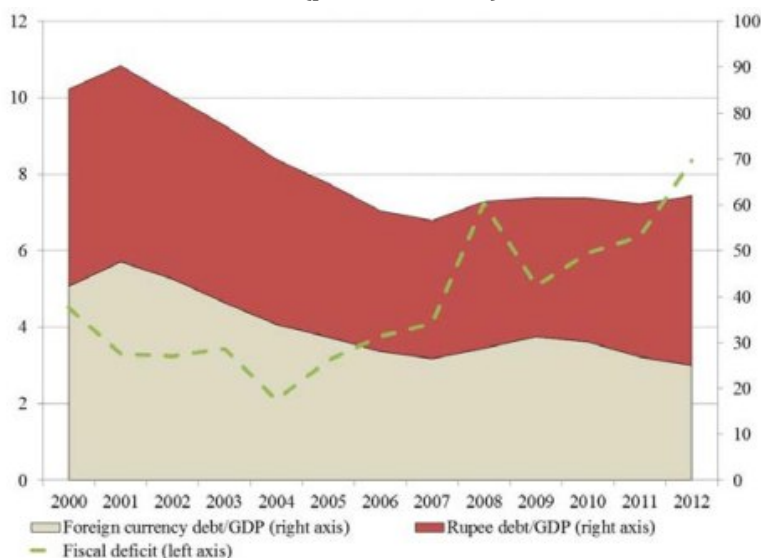
This list may be broadened to include other targets in the law for social expenditures and higher revenue mobilization at federal and provincial levels. As social welfare functions are decentralized, careful revenue and expenditure planning should take place in consultation with provincial governments.

The government has to put public debt on a sustainable path. Pakistan's public debt trajectory improved considerably in the early 2000s, but progress has slowed. After an unprecedented 90 percent of GDP in fiscal 2001, public debt dropped to 57 percent in fiscal 2007, only to reverse course again (figure 4.2).

<sup>10</sup> The Fiscal Responsibility and Debt Limitation Law defines several rules for sound fiscal and debt management: eliminating the revenue deficit (the gap between overall revenue and recurrent expenditure) by June 30, 2008, and thereafter maintaining a revenue surplus; ensuring that for the 10 fiscal years beginning July 1, 2003 the total public debt does not exceed 60 percent of GDP and thereafter maintaining it below that level; ensuring that for the 10 fiscal years beginning July 1, 2003 the total public debt is reduced by no less than 2.5 percent of GDP a year; maintaining social and poverty-alleviation expenditures at least at 4.5 percent of GDP; doubling budgetary allocation for education and health from the 2005 level of 2.5 percent of GDP by the end of fiscal 2013; and not issuing new guarantees, including those for rupee lending, bonds, rates of return, output purchase agreements, and all other claims and commitments, for any amount exceeding 2 percent of estimated GDP in any fiscal year; renewal of existing guarantees shall be considered as issuing of new guarantees.

<sup>11</sup> Pakistan took almost 20 years to double its nominal dollar GDP per capita from fiscal 1985 to fiscal 2004, but it took only 7 years from fiscal 2004 to fiscal 2011 because of higher average growth in the 2000s (despite the slowdown at the end of the decade), declining population growth rate, and appreciating rupee in nominal terms to the U.S. dollar. Estimates are available on request.

**Figure 4.2 Government debt and fiscal deficit, fiscal 2000–12**  
(percent of GDP)



Source: World Bank staff calculations.

Multiple factors contributed to the initial turnaround: high growth over fiscal 2004–07, improved macroeconomic fundamentals, and reprofiling from the Paris Club.<sup>12</sup> In June 2005 the government passed the fiscal responsibility law to lock in these gains, but compliance weakened after the global financial crisis. Fiscal 2008 was destabilizing, with turmoil in financial markets and a sharp escalation in international commodity prices. Domestic politics also prevented the government from taking immediate remedial actions. Since then the fiscal outlook has deteriorated considerably, mainly from massive energy subsidies and weakening revenue mobilization. Pakistan's debt to GDP ratio appeared to be holding steady until fiscal 2011 (see figure 4.2), thanks largely to declining external debt inflows and large repayments related to the International Monetary Fund program.<sup>13</sup> But the record deficit of 8.5 percent of GDP in 2012, the highest since fiscal 1989, aggravated the situation.

To better understand the factors driving this trajectory, a decomposition exercise for fiscal years 2000–12 identified changes in the debt ratio attributable to the primary fiscal balance, real GDP growth, real interest rate, real exchange rate, privatization receipts, and unidentified factors (table 4.1; Refaqt and Ashraf 2012).<sup>14</sup> Debt rose during fiscal years 2000 and 2001 and then declined 6.4 percentage points of GDP over fiscal years 2002–05 and 4.1 percentage points over fiscal years 2006 and 2007. The debt ratio then rose 1.1 percentage point of GDP over fiscal years 2008–12.

<sup>12</sup> In January 1999, under the Paris Club agreement, principal and interest payments due on public and publicly guaranteed debt up to the end of 2000 were agreed to be rescheduled with official development assistance (soft loans) over 20 years with a 10-year grace period and other loans such as export credits from bilateral donors were rescheduled over 18 years with a 3-year grace period. This relief amounted to \$3.3 billion. In January 2001 the debt restructuring exercise in Paris Club loans was repeated, resulting in relief of \$1.8 billion.

<sup>13</sup> A 23-month stand-by arrangement in an amount equivalent to special drawing right (SDR) 5.17 billion (about \$7.61 billion) was originally approved on November 24, 2008. On August 7, 2009 the arrangement was augmented to SDR 7.24 billion (about \$10.66 billion). The program went off-track and was cancelled before being fully disbursed. Total purchases reached SDR 4.94 billion (about \$8.08 billion).

<sup>14</sup> Estimates, including technical calculation of composite interest rates used in the next section, are available on request.

In fiscal years 2000 and 2001 the debt to GDP ratio rose despite an improved primary surplus, mainly because of a decline in real GDP growth. In fiscal years 2002–05 and fiscal years 2006 and 2007 real GDP growth of 4.2 and 3.4 percentage points of GDP was the main factor underlying the reduction in public debt, though real exchange rate appreciation of 1.8 and 1.4 percentage points of GDP also contributed. In fiscal years 2008–12 a primary deficit played a major role in increasing the public debt ratio. The effect of the real interest rate gradually weakened, becoming marginally positive during the last two sub periods.

Hence, real GDP growth has been the dominant factor reducing the debt ratio, and the primary balance was the dominant factor raising the debt ratio. This points to the importance of growth accelerating substantially to lower the debt to GDP ratio over the next few years, while fiscal consolidation is needed to generate positive primary surpluses.

**Table 4.1 Factors explaining Pakistan's public debt to GDP path**  
(changes in government debt to GDP, percentage points of GDP)

	Fiscal 2000-01	Fiscal 2002-05	Fiscal 2006-07	Fiscal 2008-12
Changes in government debt / GDP	2.0	-6.4	-4.0	1.1
Underlying factors:				
Primary balance <sup>a</sup>	-2.1	-1.1	0.3	2.1
Real GDP growth	-2.5	-4.2	-3.4	-1.9
Real interest rate	3.0	1.4	0.4	0.1
Real exchange rate	3.6	-1.8	-1.4	-1.1
Privatization	0.0	-0.3	-1.0	0.0
Other factors	0.0	-0.3	1.2	1.8

Source: Ministry of Finance; State Bank of Pakistan; World Bank staff calculations.

Note: The table shows the average annual impact of each factor on the debt to GDP ratio in each period.

a. Revenue minus noninterest expenditures (negative denotes surplus).

The eventual government's goal to quickly reduce the fiscal deficit to 3.7 percent of GDP by fiscal 2015 might appear as too ambitious and entail daunting challenges for managing not only the political economy of severe cuts in public finances but also the social impact of potential stagflation. In fact, fiscal consolidation is usually followed by a brief episode of slower growth, especially in the first year, which is expected to be quickly offset by more than 6 percent growth in later years. So, the size of adjustment matters and how quickly. And how the fiscal space is created will have deep implications for growth recovery (discussed in the section on policy scenarios).

A summary example of the fiscal arithmetic involved follows. Since the fiscal deficit is simply the difference between government investment (annual capital expenditure) and government savings (revenue minus current spending), this goal would require raising government savings to 1 percent of GDP (about 4 percentage points above its present level). Reducing government debt to 50 percent of GDP by fiscal 2015 would require raising the primary deficit from an average of -1 percent of GDP over the last decade to a surplus of at least 2 percent of GDP over fiscal 2013–15 (Refaqat and Ashraf 2012).<sup>15</sup> Growth slower than 6 percent or higher positive real interest rates would call for an even greater fiscal effort.

<sup>15</sup> This calculation assumes a linear reduction in the debt ratio from 62 percent in fiscal 2012 to 50 percent in fiscal 2015, a real interest rate of 1 percent, and real GDP growth of 6 percent a year. Once the goal of 50 percent is reached, under certain assumptions, Pakistan could run primary deficits of close to 2 percent of GDP and maintain the 50 percent debt ratio.



### *Mitigating macro-fiscal risks*

The initial focus should be on solving the fiscal crisis. This requires comprehensive stabilization of the sort associated with an International Monetary Fund program. Such a program should aim at rebuilding the credibility of the government's growth program and regaining the confidence of external markets. Short-term expenditure measures could send a clear message of fiscal consolidation for economic growth. The government could publish credible austerity measures to gradually approach the fiscal deficit of 4 percent of GDP and bring public debt to about 50 percent of GDP on or before fiscal 2018 by:

- Adopting effective measures to raise the tax ratio to 14–15 percent of GDP (see below).
- Holding public wages constant in real terms.
- Gradually phasing down untargeted power subsidies and reorienting them to targeted subsidies.
- Strengthening well-targeted social spending (including the Benazir Income Support Programme) at a minimum of 1 percent of GDP in fiscal 2014 and raising it to at least 1.5 percent of GDP in fiscal years 2015 and 2016.
- Completing a thorough review of the development budget.

### *Strengthening the microeconomic reforms*

From a microeconomic perspective, the logical option is to address the binding constraints to growth identified above. This approach has the virtues of focus, selectivity, and simplicity, without the need for comprehensive reform. Narrowing the scope of reforms to the emerging constraints with pressing negative effects would suffice initially (see box 4.1). Pakistan could start with measures to regain macroeconomic stability, expand access to electricity, and lower country risk to reverse the sudden stop in financing. As this would lead to some acceleration of growth in the short term, parallel policies could attack the structural constraints to growth by easing access to finance, reducing the anti-export bias, improving the tax system, simplifying business regulations (software constraints), and strengthening economic governance and civil service. This would bring sustainability to growth acceleration. Further, the federal strategy would need to coordinate with provincial growth strategies—especially important after the 18th amendment's devolution process (see below). And bad policies should not be allowed, so a tentative and non exhaustive list of bad policies is also identified (see chapter 5). The next sections depict a detailed agenda of actions tackling each binding emerging and structural constraint and filling the gaps in infrastructure and state enterprises.

### *Addressing other emerging constraints*

*Increasing access to electricity.* The Government of Pakistan has prepared a summary proposal to improve power sector performance. The proposal includes sustainable tariffs covering all prudently incurred costs, measures to bring costs under control and enhance generation capacity, and actions to strengthen commercially oriented governance at the sector and corporate levels (ADB and World Bank 2012).



Power load-shedding averaged 8 hours a day nationwide in fiscal year 2012. Electricity subsidies, which are highly regressive, take 15–17 percent of government revenues and cost no less than 2 percent of GDP a year. A gradual reduction of power load-shedding would require developing an emergency plan focused on solid governance by establishing a single point lead authority for power sector reform, businesslike management and boards of DISCOs. This would also mean to complete the transition of decision making authority and accountability from the government to the boards of public sector companies. Leading distribution companies and the National Transmission and Dispatch Company are well advanced in this transition. Their management teams must be given full operational authority, with board endorsement where needed. Performance review and accountability frameworks are also important next steps. In parallel, a sustainable and predictable tariff regime that includes all prudently incurred costs, closing the gap between a technically determined tariff by the power regulator and the effectively notified tariffs by the government (the difference being the so-called tariff differential subsidy) and more gas- and hydro-generated power supply are also needed. All this would help eliminate one of the most important consequences of the power crisis: the circular debt. More specifically:

- As perceived improvements in load-shedding are visible, notified tariffs could be raised to no less than 85 percent of the average minimum determined tariffs while still maintaining the uniform tariff policy. Notified tariffs were 16 percent lower than the lowest determined tariffs by the end of 2012.
- As the National Electric Power and Regulatory Authority (NEPRA) tariff does not include all costs, it needs to include generation losses and expenses resulting from changes in the fuel mix. Delays in NEPRA tariff determinations and government notifications also need to be eliminated, as do late payments to independent power producers, which incur penalties.
- Once the system is put on sounder footing, the existing circular debt needs to be isolated, and after net-offs, write-offs, and rescheduling of this debt stock among sector companies, the residual stock could be parked off the energy companies by the government.

Reducing high losses and theft, changing the power generation fuel mix, and constraining demand can help bring costs under control. About a quarter of purchased electricity is lost in distribution, so reducing losses could lower power costs. Public sector generation plants use about a third more gas and furnace oil than Pakistan's independent power producers to generate a kilowatt-hour of electricity, largely because fuel inputs are off specifications.

- A baseline of primary performance indicators for generation and distribution companies should be the first step in reducing losses, followed by improved transparency through network wide metering, increases in collections, and disconnections for nonpayment. Legislation, strongly enforced, should criminalize theft. Supplying more domestic gas to power generators can greatly reduce costs. Gas shortages force gas-fired power plants to use diesel, adding to costs. And gas and oil need to be directed to the most efficient plants. Adjustments to the rules for operating hydroelectric plants could expand hydro power capacity.
- Demand can be partly constrained by expediting efforts already underway: enacting an energy conservation law, distributing compact fluorescent lamps, and installing time-of

-day meters at large commercial and residential customers.

Unblocking stalled projects, soliciting independent power producers, and rehabilitating and replacing public sector plants can expand generation capacity. For instance, of the nominal installed capacity of 23,412 megawatts in June 2011, only 19,218 were available for generation and only 14,300 were used in fiscal 2011 because of gas shortages and inadequate funds to purchase fuel oil. Peak demand was more than 19,000 megawatts. Primary steps to expand capacity include:

- Enhancing incentives to further gas exploration.
- Rehabilitating and replace the largest public sector plants (Guddu, Jamshoro, and Muzaffargarh) in the medium term. If these plants had the efficiency of independent power producers, fuel costs would have been PRs 97 billion lower in fiscal 2012.
- Making progress on tapping Pakistan's large hydro power and coal resources, expected to be available toward the end of the decade.
- Rapidly unblocking and expediting stalled generation projects in the public sector (Jamshoro rehabilitation, Chichoki Mallian, and Nandipur), using liquefied natural gas to support the base load.
- Making Discos financially independent, privatized, or reorganized as corporations.
- Set a wholesale market for power purchasing by allowing direct contracting between generators and large customers.

*Reducing country risk and sudden stops in external financing.* Progress in regaining fiscal consolidation and implementing growth-oriented structural reform, especially if supported by an International Monetary Fund program and other donors, would improve Pakistan's country rating. But to raise its rating, the country also needs to improve security and political stability. The end of conflict would bring multiple peace dividends, fueling output expansion and taking Pakistan off the list of conflict-affected countries. Strengthening political stability would ease the concerns of risk-averse investors about continually changing business rules. The recent agreement with Afghanistan and normalization of trade relations with India could yield interesting prospects.

### **Addressing structural constraints**

*Increasing access to domestic finance.* A dynamic private sector requires prompt access to credit. In the short term creating conditions to end the credit crunch is the immediate priority. Favoring mildly positive but low real interest rates and reducing government borrowing from scheduled banks would reduce the banks' incentives to crowd out private credit. In the medium term possible measures could aim to expand credit by small and medium-size enterprises and improve the soundness of financial markets and people's perception about the banking sector. Policy measures involve both the public and private sectors:

- Reform the collateral system. Passing a new collateral law and registry is essential to help lenders (including banks and nonbanks) secure loans against movable property, guarantee their rights, and enforce their secured contracts more quickly and with lower costs while building foundations for increased access to financial services for households and firms. Replacing the current registry-based system would allow firms of all sizes to better exploit their productive assets in securing credit. Expanding the

leasing and trade finance industry would make finance available to firms without collateral. An intrafirm collateral system could also be established, along with an Internet-based archive of security interests for movable and immovable collateral.

- Reform the credit information system. A modern credit information law would allow for the entry of private credit bureaus, making it easy for banks and nonbanks to conduct more informed credit assessments of borrowers and enabling them to grant credit to new customers.
- Deepen the State Bank of Pakistan's financial inclusion program to enhance access of small and medium-size firms to financial services. This would involve creating a Financial Monitoring Unit at State Bank of Pakistan with well-integrated databases to monitor access to credit. The need for greater transparency applies to non listed companies and requires expanding credit information on small business borrowers outside capital markets.
- Develop a wider range of micro finance products, especially targeting small and medium-size firms and women through micro finance, Islamic financing, and remittance receivers. The goal is to expand access to credit by fostering competition among banks and reducing the borrowing spread. Possible avenues include creating a micro finance fund.
- Develop a new depositor protection regime and improve financial literacy. The government should pass legislation creating a new depositor protection scheme that will protect most small depositors. In addition, and supported by technology improvements, the banking sector needs to raise awareness of the benefits of financial services through media campaigns and accelerated expansion of branchless mobile banking accounts.
- Develop insurance protection regulation. This is critical for a country affected by frequent catastrophic events and with one of the world's lowest insurance coverage rates (0.7 percent of GDP). Insurance should cover key micro finance products dealing with livestock, crops, and livelihoods.

*Boosting productive diversification.* Pakistan's outlook for structural transformation is gloomy. The government's Vision 2030 discusses Pakistan's potential as an investment destination for global production (Government of Pakistan 2007). The document acknowledges the need to expand knowledge and innovation to drive future growth. It identifies manufacturing, machinery, electronics, automobiles, pharmaceuticals, and chemicals as priority sectors for diversification. But the strategy lacks policy specificity for achieving these ambitious goals.

Pakistan needs to establish the institutional architecture to guide structural transformation. It must respond systematically to opportunities by identifying which sectors are easiest to enter and which have strategic value. Also vital is high-level political support for an economic transformation policy, to provide coordination, oversight, and monitoring of the agencies entrusted with carrying out the policies. Institutions that can balance discipline and incentives by safeguarding against capture, rent-seeking, and corruption are necessary. A focus area could include removing the anti-export bias and spurring innovation.

Removing the anti-export bias would facilitate better integration of Pakistan into the global economy and foster competitiveness. This would create a level playing field for domestic firms by promoting domestic competition and improving international competitiveness. Accelerating

implementation of preferential trade agreements and reducing trade costs are also important to integrate Pakistan into the global economy. Specific policy recommendations would include:

- Immediately freeze the issuance of distortive trade- and general sales tax-related statutory regulatory orders (SROs), and pass a clear schedule in fiscal 2014 to eliminate them over the next three years.
- Reduce effective tariffs to a few slabs (ideally three, 0–10–25), while reducing tariff peaks to a maximum tariff of 25 percent.
- Streamline special tariff regimes for selected industries, such as automobiles and pharmaceuticals.
- Following the expected completion of the phase-out of the negative list with India in 2014 and granting it most-favored-nation status, consolidate the opening of the Wagha border with India (demonstration effect) and comply with other trade commitments, especially regarding non tariff barriers, standards, norms, and visa exchanges.
- Unilaterally upgrade the quality and reliability of logistics services by improving port performance, accelerating the unified customs system, strengthening the trucking industry's legal framework, and developing land transport links to neighboring countries—a crucial step in becoming a regional hub for logistics.
- Assign budget priority to implementing the bill creating special economic zones, and foster value chains (especially with China, India, and Malaysia).

To remove trade distortions, agricultural trade policy reforms would include the following:

- Move toward low and uniform agricultural tariffs. Uniform tariffs would not preclude the occasional, prudent use of transparent contingency measures, such as safeguards, antidumping, and countervailing duties.
- Given the volatility and political sensitivity of international wheat and sugar prices, and their related high subsidies, evaluate the feasibility of their replacement by a price band, with price floors and ceilings. The policy would have to be identified as a lone exception to tariff uniformity, based on transparent, pre-established rules. The price band could be based on moving averages of border prices. Price bands based on domestic prices would fall into the category of a variable levy, in contravention of World Trade Organization rules.
- Consider eliminating the fertilizer subsidy, which is a basic driver of effective rates of protection and comes at a high fiscal cost. Before any radical changes are made, the subsidy's cost-effectiveness should be evaluated, taking into account the opportunity costs and the possible effect on yields, farm income (especially of small farmers), use of other inputs, and fertilizer use across various products.

Spurring innovation should start by establishing a dedicated institutional framework for innovation, strengthen the innovation system, encourage firm-level innovation, and support knowledge creation and dissemination. The agenda needs to consider the interactions among the three principal actors in an innovation system—firms, government, and knowledge providers—on fiscal policy, government procurement policies, infrastructure for innovation, small business entrepreneurship, technology and business model acquisition, education, venture capital and commercialization, attitudes toward risk, encouragement of patents, protection of intellectual property, university–industry links, and incubators and technological

parks.

In the short term Pakistan's innovation policy needs to focus on firms and actions with the greatest return. Firms must learn to focus on upgrading capabilities. Equally important is establishing a dedicated institutional framework with the medium-term goal of devoting at least 0.5 percent of GDP to innovation (the international benchmark is 2 percent). International experience also suggests the following components:

- Install a cabinet-level head to design, monitor, and implement the policy.
- Adopt coordination mechanisms, including an interagency coordinating body, perhaps through performance contracts with implementing agencies.
- Establish and maintain a public-private dialogue on this policy at the highest levels.
- After the broad policy outlines are agreed on, submit enabling legislation.

*Reforming complex, ineffective, and expensive taxation.* Drastic changes are needed across the board to rationalize taxation, overhaul the Federal Board of Revenue (FBR), and achieve reliable computer-supported tax registration and payments, with simplified, user-friendly, time- and cost-saving paperless procedures. This would require radically simplifying the tax system, improving tax compliance and enforcement, and eliminating most preferential treatments, tax exemptions, and zero-rate regimes.

Tax measures should aim to collect at least 4 percent of GDP in the next four years: 3 percentage points from federal tax reforms and 1 percentage point from provincial reforms. FBR performance has also been marred by extremely short tenure of key officials, political appointments in key posts, and corruption charges. The following suggested measures are far from exhaustive:

- Announce a revamped FBR strategy that commits to a gradual move to a very small number of major taxes over the medium term: essentially income tax, sales tax, and customs duties (see below).
- Gradually eliminate most sales tax exemptions, zero rates, and special excise duties. To support this measure with total transparency, publish an annual tax expenditure annex from the fiscal 2014 budget onwards, clearly identifying the next year's removal of remaining exemptions and zero ratings and their expected fiscal impact.
- Create a joint FBR-Ministry of Finance National Tax Policy Agency staffed with solid professionals and charged with producing sound revenue forecasts and analyses of alternative tax policy proposals.
- Expand the coverage of goods affected by the general sales tax on services by provinces.

Major changes in tax administration are needed to enhance perceptions about the FBR's independence and capacity to manage user-friendly tax registration, collection, audit, and enforcement:

- Submit a bill to Parliament granting full autonomy to the FBR. The new FBR would not be required to follow civil service rules for its staff, so that staff tenure stability, performance monitoring, and merit-based promotions could be strengthened

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- Revamp the information technology system into a fully functional integrated system supportive of the conversion of FBR into simple and effective paperless management. The new system should be able to use the National Database and Registration Authority's (NADRA) database as well as other databases (if possible those from the banking system) to facilitate cross-checking and detect tax evasion.
- Revise and revamp tax registration mechanisms to increase the number of taxpayers by 1 million by fiscal year 2018. Supported by new technology, the FBR should find new taxpayers in property and vehicle owner registration, air travel records, utility bills, clubs memberships, credit card use, and hotel stays.
- Revise the tax code to strengthen the registration, e-filing, audit, and enforcement powers of the FBR.
- Upgrade the FBR e-portal to correct inconsistencies, facilitate reconciliation, expand e-registration, e-filing, and e-payments, thus reducing transaction costs (and bribes).
- Complete and fully implement the taxpayer ledger as a key tool for effective tax enforcement. Supported by the information technology system, full registration of taxpayers' debits and credits would allow an effective mechanism to identify and pursue tax evasion and fraud.
- Strengthen the use of parametric audits by Large Taxpayer Units, with cases selected through rigorous, centralized risk-based criteria and quantitative performance contracts for tax officers.
- Complete the audit of the general sales tax refunds, closing the loopholes that lead to presumed overpayments.

*Reducing the micro risks of cumbersome business regulations and civil service inefficiency.* Six directions for less cumbersome regulations could improve the business environment (most of the following actions involve provincial governments):

- Reduce the burden of paying business taxes (see above).
- Ease procedures for starting a business by approving a one-stop shop for registering new entrepreneurs, nonresident companies, and investors. The one-stop shop would integrate all legal formalities required by the FBR, the Securities and Exchange Commission of Pakistan, and other departments. Making online registration services and Internet stations more available would facilitate e-services, as only 10.5 percent of the population has access to the Internet.
- Improve contract enforcement by streamlining filing and court procedures; reducing legal (and court) fees; creating additional courts, mainly for commercial disputes; and expanding court capacities in infrastructure and human resources.
- Simplify subnational property registration by computerizing land records, reducing the number of fees, streamlining and consolidating procedures for land registration and transfers.
- Ease subnational procedures for construction permits. Make inspections more efficient and uniform—moving from random inspections to risk-based inspections at critical steps in construction—and eliminate overlapping agencies that administer bylaws and



- preside over inspections and approvals
- Ease trade across borders by reducing and streamlining documentation requirements, strengthening inland clearance facilities, upgrading electronic data interchange systems, and improving inland transportation, especially railways.

For the civil service, first steps could be making payroll policy transparent and converting public institutions into performance-based entities (supported by the proper incentives) rather than downsizing staff:

- Continue converting non wage allowances (housing, cars) into their monetary equivalent to fully monetize salaries in anticipation of a plan to rationalize the public payroll (almost impossible with current wage distortions).
- Introduce results-oriented management in the public sector by defining incentives to convert a few institutions on a pilot basis.

### *Filling the gaps*

Two additional growth-enhancing policies focus on infrastructure gaps and state enterprises.

*Narrowing infrastructure gaps and ensuring financing.* Total public and private investment in infrastructure should grow to at least 5 percent of GDP over the next five years to achieve the sustained high growth needed to generate sufficient employment to meet labor market supply. On the one hand, public investment in infrastructure should grow to at least 2 percent of GDP, which would still be well back from its average of 5 percent over the previous decade. Three priorities are power generation, water irrigation, and roads operations and maintenance, where investment has declined severely. For roads, raising tolls to eliminate the financing gap in the roads maintenance account of the National Highway Authority is a priority. On a less pressing schedule, taking care of contingent liabilities in the pension scheme of railroads and ports is also an important precondition for greater private sector participation. In agriculture, fully implementing water measurement and pricing policies would advance irrigation reforms, especially in Punjab and Sindh.

On the other hand, private investment in infrastructure needs to grow to at least 3 percent of GDP just to recover its average for the 2000s and get close to the ratio in successful developing economies. A larger private sector role in administration and funding is also essential to improve quality in every sector, especially in electricity, ports, and railroads. Expanding the private sector's role in software and investment financing is especially critical. The contrast between the electricity and telecommunication sectors over the last decade is revealing. The electricity sector is a patchwork of inadequate public and private sector initiatives, with equivocal incentives and burdensome regulations. The telecommunications sector is driven mainly by the private sector, with streamlined regulations and strong competition—a good model for all infrastructure.

*Restructuring or privatizing state-owned enterprises.* The fundamental changes needed to reform state-owned enterprises normally take time, but the window of opportunity at the beginning of the next administration for a policy agenda will be narrow—possibly reduced to the first 24 months. This requires solid governance actions up front. Three state enterprises are already under restructuring: Pakistan International Airlines, Pakistan Steel Mill, and Pakistan Railways.

Their restructuring plans include partial privatization through initial or secondary offering of shares at the Karachi Stock Exchange. The following recommendations focus on broad reforms at the federal level, but they will become relevant at the provincial level as well as more responsibility is devolved to the provinces.

- Establish a reinvigorated Privatization Commission to manage the privatization agenda. Nominating and appointing professional boards is also suitable. The boards should be in charge of close monitoring to track financial and managerial performance, select the enterprise chair and directors, observe directors' performance, and negotiate performance and financial targets. Managerial performance needs to be monitored as much as financial performance.
- Consider privatizing at least two major state enterprises or restructuring. This might involve conducting technical, financial, and operational audits of all companies listed on the exchange. These audits should be followed by drawing up and implementing performance contracts to determine whether to privatize (totally or partially), restructure, or close firms.
- Issue new norms to effectively implement the recently promulgated (March 8, 2013) Corporate Governance Rules for state enterprises. Good corporate governance begins with selecting and empowering an independent board of directors that does not include current civil servants or ministers on the board—a common practice in Pakistan. Other important governance reforms include accountable management, a voice for key stakeholders (consumers, workers, others), board-level committees such as an audit committee, widely disseminated disclosure of financial and managerial performance, strong management information systems and allied internal controls, and external and internal audit functions with appropriate lines of communication.
- Finally, Pakistan could consider transferring state enterprise ownership from line ministries to a centralized ownership model, which can take various forms, such as an advisory/coordinating body (Norway, Sweden, New Zealand, India, South Africa), ownership agencies (France, Indonesia, China), or holding/investment companies (Malaysia, Singapore, Gulf countries).

### *Customizing policies for more and better jobs*

Improving labor market outcomes and job policies requires dealing with four key challenges: the economy is urbanizing, is agrarian, has rapid growth in youth and female participation, and is affected by conflict. Improving the education and skills of the labor force is often considered a precondition to improving labor market outcomes. But the root cause of skill shortages or mismatches might lie not with the education and training system but with false signals generated by market distortions and institutional failures elsewhere in the economy. A similar argument applies to encouraging entrepreneurship: building managerial capacity may not be enough to realize productivity gains and employment expansion; removing obstacles to firm and business growth is a prerequisite (World Bank 2012f). The relevant question for a job-enhancing growth agenda then becomes which comes first, skills or jobs?

The answer is private jobs—not public sector-generated jobs. If a civil service career pays well, with generous perks, as in Pakistan, young people may prepare themselves for such jobs, even if



the wait is long. But these are not the jobs that Pakistan needs. Productivity growth is associated with entrepreneurship, technology adoption, and finance, and these are often related to functioning cities (to profit from skills related to agglomeration effects and social networking), integrated value chains (to profit from skills derived from contact with global trade, innovation, and production clusters), and more productive agriculture (that also benefits from knowledge spillovers), even though self-employment and low-skilled jobs are prevalent in rural areas. Employment generation increases the demand for education and skills. The main role of policies is to ensure that signals are adequately transmitted and provide incentives to continue skill accumulation by youth, women, and demobilized Pakistanis.

*Creating conditions for urban jobs.* The initial focus should be on reducing the myriad institutions devoted to basic services by cities. Other measures would help develop job-friendly cities and urban jobs in the private sector:

- Develop a new framework of urban planning. Good skills and jobs attained through global integration are impeded by negative spillovers from rapid urbanization. Starting with major cities like Karachi and Lahore, careful urban planning can mitigate these externalities and must be coordinated with sub national governments.
- Revamp zoning laws. Zoning laws determine how land is used in cities—what combination of housing, businesses, public spaces, and community infrastructure can be built in neighborhoods—and what construction standards should be. Pakistan's zoning law is obsolete, allowing mostly for single family housing and, to a lesser extent, commercial use, and building regulations are stringent. A new bill should encourage multiple-use zoning, with more flexible regulations that allow for high-rise buildings (Government of Pakistan 2011a).
- Simplify property registration and construction permits (see above). For instance, obtaining a construction permit involves 11 procedures, takes 222 days, and costs 262.5 percent of income per capita.
- Develop an urban rental market. A prerequisite would be centralizing all transfers of land and housing titles in a national database and setting up a clearinghouse on housing demand and supply, from the district to the national level, with assistance from Federal Bureau of Statistics, NADRA, and the FBR.

*Creating conditions for rural jobs.* Policy actions are needed to encourage diversification and productivity in agriculture, which ultimately will lead to more and better rural jobs in the private sector:

- Overhaul the national agricultural research and extension system to make it more efficient and effective. The roles of the Pakistan Agricultural Research Council and the National Agricultural Research Centre need to be adjusted to exploit their comparative advantage as federal institutions—building capacity, facilitating federal funding, and sharing knowledge across provinces. If primary research activities are shifting from the federal to the provincial level, and if the focus is moving from policy coordination to fundamental research, staffing and performance incentives need to reflect these objectives. This may require moving personnel from the center to provincial institutions or increasing the share of scientific research staff.

- Increase spending on agricultural research and development, whether for the provincial research centers or for the capacity building of scientific research staff. The determination of the additional spending should depend on the prior implementation of institutional reforms.
- Reform the water management system. Institutional reforms are needed to complete the devolution of authority to the relevant scale, clarify the roles and mandates of each authority, and allocate sufficient resources and capacity building to allow each authority to fulfill its mandate. Reform should also tackle the water allocation system, its financial sustainability, and the distortions of the current *Abiana* (irrigation cost per acre) system.

*Jobs for youth and women.* With the great number of new entrants to the labor market, raising job opportunities for youth and women working in low-productivity jobs or not yet employed entails improving the skills and employability of the existing workforce and of new entrants. The initial focus should be on benchmarking the existing technical and vocational education and training (TVET) programs to assess their strengths, weaknesses, and potential. Meeting the enormous job challenge requires improved governance and financing mechanisms to align TVET programs with the needs of job-seekers and employers, especially in the private sector. Mainstream actions should focus on improving skills and fostering entrepreneurship through microfinance, especially for small and medium-size entrepreneurs. Key policies are to:

- On the demand side, expand resources to the TVET system, focused especially on new entrants (for whom payoffs are biggest); encourage private sector involvement; and establish autonomous public training institutions.
- On the supply side, approve a new system for allocating training vouchers directly to individuals, enabling them to choose their TVET providers and obtain more relevant training.
- Support the creation of urban micro enterprises. Expanding urban self-employment and entrepreneurship is critical when formal wage employment is limited. Micro enterprises—formal or informal—create most urban jobs. International evidence suggests that entrepreneurship programs tailored to particular groups—combinations of business skills training, access to finance, advisory services, and micro franchises—effectively address the main constraints to job enhancement. These packages should also expand access to systems that protect workers' income and guarantee basic standards in working conditions. Jobs that move the country up the export ladder should be encouraged.
- Foster jobs for demobilized army members—the peace dividend. Efforts should be made to integrate demobilized army members with the minimum skills for enrollment into existing TVET programs.

## Policy scenarios for job-enhancing growth

This section explores the use of fiscal policy to accelerate growth, employment, and human development in Pakistan over 2013–22. It simulates the effects of alternative policies in creating the fiscal space needed to raise public investment. It also explores the potential effects of these policies on growth and employment indicators and the country's progress toward the Millennium Development Goals (MDGs).

The simulations are based on Kinnunen and Lofgren (forthcoming), who use the Maquette for MDG simulations (MAMS)—a computable general equilibrium model developed at the World Bank—to analyze growth strategies. MAMS offers a comprehensive picture of the economy and of households, government, and the rest of the world, drawing on basic features of standard economics. Its framework relies on the comprehensive social accounting matrix (SAM) prepared by Debowicz and others (2012), disaggregated into 30 sectors, 21 private and 9 public.<sup>16</sup> The database consists of a detailed dataset for the simulation base year (2008) including the SAM, extended with a data set on factors of production (including different types of labor and capital), population, and school enrollment; indicators for selected MDGs and the education system; elasticities for production, consumption, trade, and human development relationships; and other projections required to calibrate the MAMS baseline simulation. MAMS is well suited to assess a development strategy's effect on the economy, as it is distinguished from SAM by its additional coverage of employment and human development indicators and their interaction with other aspects of economic policy and performance.

The analysis includes a base scenario, a set of fiscal policy simulations that explore alternative sources and use of fiscal space and their impact; and a high-growth scenario that permits a comparison between two sanguine growth recoveries: a piecemeal reform effort that brings the economy back to its average growth rate of 4.3 percent and a bold reform scenario that brings the economy into a high-growth (7 percent) path, as required by the government's strategy starting in 2013. The analysis is summarized in the following two sections; Annex 4.1 provides additional detail.

### *The base scenario*

The base scenario, which serves as a benchmark, returns Pakistan's economy to its historical growth rate of 4.3 percent—on average—up to 2022.<sup>17</sup> Drawing on the current trend and projections, the base annual GDP growth rate also assumes growth of 4–5 percent for all aggregate sectors (agriculture, industry, private services, and government services). Among the final demand categories (private and government consumption and investment), growth ranges from 4 percent to 6 percent.

Under the base scenario, employment growth is sufficient to generate 2022 unemployment rate that is 3 percentage points lower than in 2012. Government domestic revenues rise modestly by around 3.4 percent of GDP as the net result of tax increases—direct, indirect, and customs tariffs—to finance mainly a rise in current spending (1.2 percent of GDP), including transfers (unchanged) and a mild increase in public investment (0.2 percent of GDP). Domestic government debt rises (by 0.6 percent of GDP), and foreign government debt declines (by 0.3 percent of GDP). The total public debt to GDP ratio remains largely unchanged at around 61.6 percent of GDP. Private consumption grows without major distributional changes, but national headcount poverty declines about 6.4 percentage points. Other MDG indicators also improve slightly as a result of greater human

<sup>16</sup> A SAM is a square matrix with identical row and column accounts providing a comprehensive representation of payments flows in the economy (typically a country) during a set period (typically one year). Cell entries represent payments from its column account to its row account. In a SAM without errors, row and column totals are equal. SAMs appear with widely varying degrees of disaggregation. The payments flows are expressed in current local currency or some transformation thereof, such as percent of GDP at market prices in the same year.

<sup>17</sup> All results from simulated scenarios are in Kinnunen and Lofgren (forthcoming) and available on request.

development services, higher real household consumption, and improved government infrastructure (see annex 4.1 for details on the base and alternative scenarios).

The fiscal policy scenarios emphasize the importance of how fiscal space is created to finance infrastructure investment—and how it is used. They also underscore the necessity of selecting good quality infrastructure projects (with high productivity effects). And they warn of the tradeoff in using the created fiscal space to finance transfer programs instead of infrastructure investments. Transfers generate immediate welfare gains but with weaker medium-term effects on growth and job enhancement unless they are designed to raise productivity (for example, through improvements in health, nutrition, and education). Note that in all scenarios the changes in economic growth and other indicators are modest, reflecting the relatively small (and thus more feasible) assumed fiscal space created.

### *The high-growth scenario*

This scenario explores 7 percent average annual growth in GDP for 2013–22. A change this large—swiftly raising annual GDP growth from 4.3 percent to 7 percent—assumes broad structural reforms that would improve the investment climate, economic governance, and private savings and investment in physical and human capital.

Achieving such rapid GDP growth also assumes a minimum rise in investment from 14 percent of GDP to 18 percent (assuming a 70–30 split between private and public investment) supported by higher private and government savings, and a rise in annual TFP (productivity) growth from 1–2 percent to 3–4 percent. Compared with the base scenario, the results for more rapid GDP growth, higher private and government investment (with a focus on infrastructure), and enhanced TFP include the following:

- Welfare gains: a 2–3 percentage point rise in annual growth for private consumption, much higher than under previous shocks.
- Job creation gains: a marked drop in unemployment of an extra 7.6 percentage points over the base scenario.
- Debt reduction and fiscal space gains: assuming no rise in government borrowing over the base scenario, the total government debt in 2022 would fall by an extra 9.9 percent of GDP. This decline is due to the larger fiscal space generated from higher growth and to major shifts in the government budget from consumption to public investment in infrastructure.
- Gains in Poverty reduction: among MDG indicators in 2022, poverty would decline an additional 5.5 percentage points. Improvements in other indicators would be much stronger than under any of the policy shocks and base scenario considered.

This scenario shows that rapid and equitable growth may lead to job enhancement in Pakistan. A combination of major growth in savings, investment, and productivity can achieve this. By 2022 the positive effects of 10 years of 7 percent growth would spread to the macroeconomic demand indicators as well as the major production sectors. Poverty would decline and other MDG indicators would improve (inclusive growth).

## Complementing Pakistan's Framework for Economic Growth

The Framework for Economic Growth identifies low productivity as the greatest challenge to growth in Pakistan and focuses on how to raise productivity (Government of Pakistan 2011a). It includes a diagnostic, a vision, and five priority development themes.

The diagnostic notes five obstacles to growth:

- Underdeveloped markets do not channel scarce savings into the most productive uses.
- Hardware public investment in infrastructure projects is declining, is of low quality, and relies too much on foreign aid.
- Excess public spending in nonpriority areas leaves little fiscal space for public investment and leads to high fiscal deficits; financing the deficits through borrowing crowds out private investment.
- There are no incentives encouraging investment in software (innovation and technology) to improve human capital and productivity.
- Software obstacles, including outdated market and labor regulations (contract enforcement, property rights) are the major constraint to productivity gains and growth.

The vision rightly notes that the private sector should drive growth in an open market that rewards efficiency, innovation, and entrepreneurship, and that the government should facilitate growth by enforcing laws, providing public goods, protecting public interests and individual rights, and operating with transparency and accountability.

The five priority development themes are (figure 4.3):

- *Innovation and competitiveness.* Pakistan ranks lowest in innovation policy among regional economies. It needs a knowledge-driven innovation policy, guided by a quasi-public autonomous body that can design and implement an “Innovation Buzz” strategy and an “Opportunity Pakistan” global campaign to promote a new “enterprise image.” Incubators and clustering of innovators should be promoted.
- *Domestic markets.* Pakistan ranks low globally on domestic commerce-related indicators: business sophistication, goods markets efficiency, and property rights protection. A simplified tax system, updated commercial laws, deregulation of land zoning for domestic commerce, new business norms that protect contract enforcement, and land reforms (including reliable and efficient land titling) are needed.
- *New role for cities.* Cities in Pakistan are unable to meet the needs of a rapidly growing population. The Framework for Economic Growth views cities as suburban clusters with appended industrial parks. Supported by new zoning laws, housing construction, and community development, these cities can become dynamic centers for retail, distribution, transport, leisure, entertainment, and other services.
- *Connectivity.* While Pakistan's basic infrastructure is similar to India's and average by regional standards, it lags in transport (road, air, and railways) and information and communication technology-related connectivity. Poor transport sector performance costs the economy 4–6 percent of GDP a year, and its information and communication technology score (1.53 out of 100) is the lowest among 25 resource-driven economies.

The framework proposes moving gradually toward e-government (especially on taxes, customs, and trade-related proceedings) and fostering private sector participation in building and monitoring transport infrastructure.

- *Youth development.* A third of Pakistanis are 10–24 years old. Policy is needed to address shortcomings affecting this age group: illiteracy, low skills, limited job opportunities, and cultural factors that impede their job search, including religious conventions and gender bias.

Figure 4.3 Core themes of the Framework for Economic Growth



Source: Government of Pakistan 2011a.

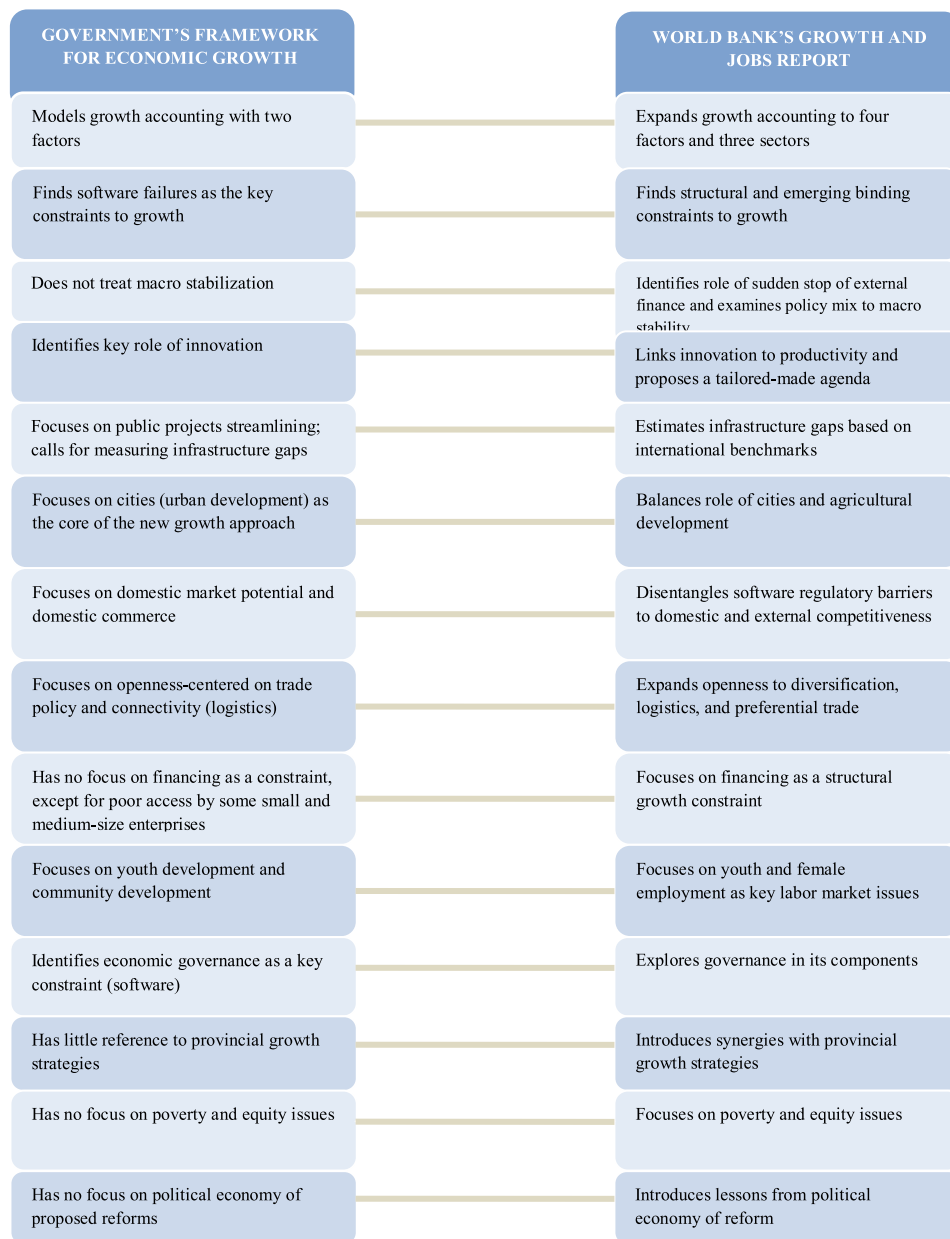
The Framework for Economic Growth's new paradigm also favors endogenous, inward-oriented growth focusing on solid governance—as an all across the board requirement for wholesale reform—and a market-driven reallocation of resources. Despite a chapter on openness and trade policy, the framework emphasizes raising productivity through domestic market openness, competition, change, and innovation. It prioritizes five strategic dimensions: growth of software (physical and human capital productivity) rather than hardware (physical infrastructure); private rather than public investment; internal rather than external competitiveness, favoring incentives for entrepreneurship over eliminating anti-export bias and protectionism; urban rather than rural development; development of services rather than agriculture and industry; and enhanced quality (efficiency) rather than quantity of public investment and service delivery to optimize scarce fiscal resources.

Pakistan national growth strategy's main virtue is also its major shortcoming: its simplified (but well-focused) framework makes it incomplete. It is silent on two primary ingredients of growth acceleration that the country seriously lacks: higher savings and investment (the low revenue mobilization and investment gaps twin challenges) and the right policy mix for recovering macroeconomic stability (see chapter 5). It also overlooks how agriculture, with its strong links to nonfarm jobs in urban and rural areas, can strengthen urban development. And it fails to even mention major challenges like the link between job enhancement and the redistributive patterns of growth (how growth affects poverty and social indicators), the federal strategy's potential

interaction with provincial growth strategies, and the lessons of the political economy of past structural reforms in Pakistan.

This report complements the government's work on a new growth strategy that could accelerate Pakistan's GDP growth to around 7 percent a year (figure 4.4). In doing so, this report not only deals with some difficult tradeoffs (see chapter 5) but also expands growth-related debate to new areas.

**Figure 4.4 How a job-enhancing growth agenda complements Pakistan's Framework for Economic Growth**



Source: Authors' elaboration based on Government of Pakistan 2011a.



## Potential synergies between federal and provincial strategies

Pakistan's provinces have solid growth potential arising from their diverse geography, abundant natural and human resources, and important international links. The provinces have international connections with China, South Asia, Central Asia, and the Middle East. Punjab and Sindh share a long international border with India on the east, and Sindh has sea connections with the Middle East and elsewhere. Khyber Pakhtunkhwa and Balochistan share international borders with Afghanistan and the Islamic Republic of Iran, and Khyber Pakhtunkhwa provides a direct land-route to China and the north (for details on provincial growth and performance, see annex 4.2).

### *How the 18th amendment has affected the provincial development agenda*

From the perspective of growth and jobs, the provinces have affected the development agenda through four main channels that point to increased accountability but decreased fiscal space for investment:

- *Increased provincial dependence on fiscal transfers.* The Seventh Award agreed on in 2010 substantially raised the share of the provinces in the divisible pool of federally collected taxes—from 46.3 percent to 57.5 percent. Hence, provinces are now less motivated to collect more tax revenue on their own. Provinces are now also allowed to borrow.
- *Misallocation of scarce provincial fiscal space.* While additional revenue has been captured by wage increases in provinces, more than 38,000 federal employees were declared redundant. Most resisted transfers and remain on the public payroll. Overall the federal government was left with enough to barely cover its fixed expenditure (defense, wages, pensions, debt service), while wage increases at the provincial level shrank the fiscal space for social and basic infrastructure investment.
- *Reallocation of divisible resources.* New criteria were introduced to the redistribution formula, including poverty, tax collection, geographic size, and population, in an attempt to cater to the needs of the two smaller provinces.
- *Increased decentralization and accountability of service delivery.* While abolishing 17 ministries and transferring their functions to the provinces, including agriculture, education, and health, service delivery in essential areas has moved closer to the people. This decision raises expectations on provincial accountability and will test provincial capacity to exercise responsibilities in delivering public services.

### *Identifying the drivers of economic growth and the constraints to business growth at the provincial level*

A traditional approach in exploring growth potential at the provincial level is to identify the drivers of growth in each province. Disparities in the endowments of physical and human resources require different policies to realize the development potential of each jurisdiction. Ikram (2013) recently developed such an approach for the four provinces (box 4.2). Once stock is taken of the assets of each province, the relevant question is how to realize the potential.

## Box 4.2 Potential growth-generating assets (drivers of growth) at the provincial level

### Balochistan

- *Strategic location and coastline.* Balochistan's strategic location and 750-kilometer coastline can help it act as a hub for trade among resource-rich Middle Eastern and Central Asian countries, Pakistan, and Iran. By developing Gwadar Port, a cost-effective alternative to Karachi Port, the province has potential for expanding its manufacturing (for example, import-intensive textile industries), fisheries, and tourism sectors.
- *Minerals.* Balochistan's copper deposits, the world's largest, have barely been exploited. The province also has extensive deposits of gold, marble, granite, onyx, and other minerals. To expand its manufacturing sector, Balochistan can rely in part on integrating mineral development with the rest of its economy.
- *Energy resources.* Balochistan has been the major producer of Pakistan's natural gas for more than 50 years and has the potential to produce more by exploiting many of its unexplored geographical structures. Its topographic and climatic conditions provide the prospects for generating large amounts of wind power (about 20,000 megawatts) and solar power (national and provincial potential estimate of 1.2 million megawatts).
- *Agriculture.* Agriculture (including livestock) contributes about 30 percent of Balochistan's GDP and employs nearly two-thirds of its labor force. The province's rangeland supports a large livestock sector that, appropriately developed, could substantially increase the production of meat, leather, wool, and dairy products.

### Punjab

- *Agriculture.* Agriculture contributes 27 percent of Punjab's GDP and employs 40 percent of its labor force. Wheat and rice are major crops, but the province could benefit enormously by moving toward high-value, more labor-intensive products, such as fruits and vegetables.
- *Nonfarm sector.* The nonfarm sector includes manufacturing, construction, wholesale and retail trade, transport, and other services, which combined contribute more than two-thirds of Punjab's GDP. These areas are largely in the private sector, especially small and medium-size enterprises. Almost 90 percent of Punjab's labor force works for private firms, the majority of which employ fewer than 10 employees.
- *Location.* Punjab is Pakistan's only province with both domestic and international cost-effective trade opportunities—through direct geographic links to all other provinces of Pakistan, as well as India.

### Khyber Pakhtunkhwa (KP)

- *Minerals.* KP's key indigenous mineral resources include gemstone, marble, granite, and other construction materials that provide for its manufacturing base. The construction industry generates a considerable amount of employment and has vertical and horizontal links with other industries, such as cement, glass, bricklaying, wood and metal working, furniture, plumbing, and electricity. It also has potential for meeting international demand—especially for the reconstruction of Afghanistan.
- *Agriculture.* KP has potential for expanding its agriculture beyond cereal production (which accounts for three-quarters of land use) to horticulture to accelerate growth and reduce poverty. Livestock

contributes more to provincial GDP than do crops, and it has potential to grow quite rapidly with increasing demand. Further, KP is home to 40 percent of Pakistan's forests and 2.1 million hectares of rangelands, both of which are resources for high-value products.

- *Hydel power resources.* KP has comparative advantage in producing hydel electricity due to its abundant water resources. The province's potential is many times the 4,000 megawatts it currently generates and sells to the Water and Power Development Authority for sale to consumers.
- *Location.* Being landlocked does not restrict KPs international trade potential, as the province has cost-effective trade possibilities with Central Asian countries and Afghanistan.
- *Tourism.* KP has the potential to attract tourism, as it has ancient Buddhist monasteries, Gandhara sculptures, and museums. The province also has scenic sites, high mountain ranges, Alpine valleys, and rivers and streams.

## Sindh

- *Coastline/seaport.* Sindh is a home to Pakistan's first seaport (Bin Qasim Port), which has provided international trade links for the whole country, as well as Afghanistan. The port has helped the province strengthen its industrial base by establishing many import-based and export industries.
- *Agriculture, forestry, and fishing.* Sindh's main economic areas are agriculture and livestock, forestry, and fishing, which employ 70 percent of the province's rural population.
- *Manufacturing and services.* Sindh's industrial and services sectors employ a third and two-thirds of its urban labor force, respectively. Total urban population makes up half the province's population.

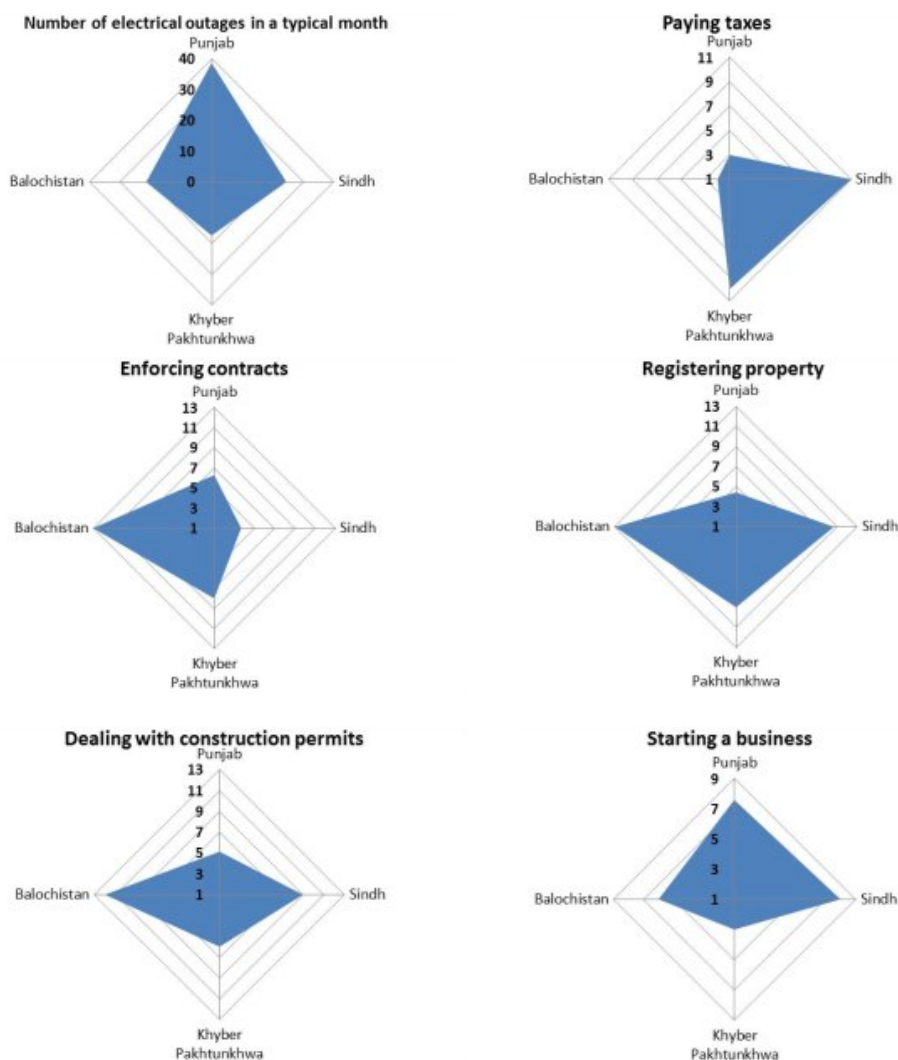
Source: Ikram 2013.

A possible complementary approach is to look at the main constraints to business growth at the provincial level.<sup>18</sup> International surveys—especially World Bank (2010a)—help identify the specific constraints in each province and their effect on the business environment at the provincial level. Provinces with better performance can provide horizontal support to lagging provinces, fostering learning and horizontal cooperation.

The top binding constraints to business growth identified at the national level are access to electricity, access to finance, taxation, and regulatory constraints (enforcing contracts, registering firms, obtaining construction permits). These constraints differ in intensity at the provincial level (figure 4.5):

<sup>18</sup> The discussion in this section has benefited from Kularatne and Lopez-Calix (2012), Lopez-Calix and Touqeer (2013), and World Bank (2009b).

Figure 4.5 Business constraints at subnational level



Source: Lopez-Calix and Touqeer (forthcoming), based on World Bank (2007b, 2010a).

Note: All constraints are a simple average of the rankings of 13 major cities, grouped by province, in Pakistan; a higher ranking implies a more severe constraint. Electricity constraint shows average numbers.

- *Getting electricity.* Pakistan ranks 166 of 183 economies on ease of getting electricity, which is worse than the average for South Asia. The situation in all provinces has worsened recently, but it takes longest to get a connection in Balochistan, followed by Sindh and Khyber Pakhtunkhwa. The electricity shortage's effect on productivity is most acute in Punjab.
- *Access to finance.* Private sector access to finance remains restricted, particularly for small and medium-size enterprises and 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.

Balochistan also has many small enterprises, and the 2012 Balochistan development strategy singles out access to finance as a critical constraint to entrepreneurship (World Bank forthcoming a).

- *Taxation.* Pakistan ranks 158 of 183 economies in ease of paying taxes. By number of payments it is less cumbersome to pay taxes in the federal capital, Islamabad (35 payments), than in other parts of the country. Among the provinces, paying taxes is a greater obstacle to doing business in Sindh and Khyber Pakhtunkhwa than in the other two provinces.
- *Enforcing contracts.* Pakistan ranks 154 of 183 economies on enforcing contracts, due mainly to inefficiency. Among provinces, it takes longer in Khyber Pakhtunkhwa (six years on average) than in the other provinces, and costs more in Punjab (42.8 percent of the claim's value). Of the three steps in contract enforcement, judgment takes longest in all provinces, particularly in Khyber Pakhtunkhwa and Balochistan.
- *Registering property.* Pakistan ranks 126 of 183 countries in registering property. Regulations differ across the provinces, implying that procedures, time, and cost vary. It takes longer to transfer a property title in Balochistan (52 days) than in Punjab (30 days). And registering it costs more in Balochistan due to higher stamp duty rates (5 percent of property value) than in Punjab (2 percent of property value).
- *Obtaining construction permits.* Pakistan is 104 of 183 economies on the ease of dealing with construction permits. The time and cost involved in getting the permits varies at the subnational level, as building permits, utility connections, and licenses for site development are governed at the local level. Obtaining approvals and utility connections is easier in Khyber Pakhtunkhwa and Punjab than in Sindh and Balochistan. It takes much longer in Sindh to get electricity and water connections. And there are different building permit fees and charges for processing and validating building plans.
- *Starting a business.* Nationwide, the cost for starting business is 11.2 percent of income per capita, lower than the South Asian average but higher than the Organisation for Economic Co-operation and Development average. Among provinces, registration times differ due to varying levels of efficiency, despite the same regulatory framework and similar number of procedures. For example, in Sindh it takes 22 days (on average) to start up a business, while in Khyber Pakhtunkhwa it is swifter. Among different procedures, the registration for tax and labor (social security, employees' old age benefits, labor department) takes longer. Except in the provincial capitals, most work is done manually, and documents must be submitted in person, despite the fact that the proper offices have no presence in many areas. Entrepreneurs must travel to the main cities to complete registration, adding time and cost. As a result, registration costs are very high in Balochistan and in some cities of Punjab (Sialkot and Sheikhupura) and Sindh (Hyderabad).

This list of constraints is not exhaustive. Other challenges, such as those related to rapid urbanization, environmental deterioration, and neglect of tourism, are specific to certain provinces. For example, in Punjab and Sindh greater rural-urban migration is placing pressure on urban infrastructure and employment needs. Sindh suffers from air and water pollution, affecting coastal and marine ecosystems, forests, and biodiversity. Sindh has also neglected the tourism potential of its cultural heritage sites because of inadequate funding and conservation regulation. Khyber Pakhtunkhwa faces natural disasters and security concerns, which also affect the province's tourism potential. The federal strategy includes urbanization under its main pillar of building creative cities, but it does not mention the environment- and tourism-related issues

that are important to growth and job enhancement in Khyber Pakhtunkhwa and Sindh.

These binding constraints to growth demonstrate that collaboration is required between federal and provincial strategies, along with a tentative division of labor among them. At both levels, strategies identify governance, regulations, and institutional constraints, as well as other obstacles to investment, but this analysis is only a starting point for setting provincial priorities. Both federal and provincial strategies concede that low infrastructure and human capital need priority attention to improve overall productivity.

## Lessons from past reform efforts

Structural reforms such as those proposed in this report are rooted in complex political economy issues. Pakistan continues to lag in structural transformation largely because of lingering political economy constraints. Structural weaknesses embedded in the system reflect skewed incentives, inequities across economic activities and sectors, and corruption and capture by myopic elites. Stop-and-go reforms have had mixed results, few of them sustainable. Pakistan remains trapped in its own inability to accelerate and maintain growth and create jobs.

Pakistan has comprehensive attempts and proposals for structural reform prepared by skilled professionals educated at the best Western universities and with experience in international organizations or multinational companies. But only 2 of 12 International Monetary Fund programs, spanning 22 years, were completed successfully (IEO 2002). So if the goals, diagnostics, and strategies have been clearly identified, and capable policymakers are available, why is Pakistan still lagging? A possible explanation could be external circumstances. Tough reforms have often been undertaken during a crisis or when a non elected government wanted to justify its assumption of power. Governments elected by popular vote have found it more difficult to introduce and sustain growth-enhancing reforms.

But this explanation falls short when considering several underlying factors that also appear to be at play. Based on case studies, this final section explores these underlying factors from two angles: policy and institutional constraints. Analysis of policy constraints addresses reform program design, relationships with donors, and political and governance issues affecting ownership of proposed measures. Analysis of institutional constraints addresses program implementation, coordination issues, and overall surveillance.

Depending on data availability, the case studies differ in their treatment of five possible dimensions: proper identification of winners and losers, realistic assessment of the capacity for collective action (for or against reform), risk of elite capture (often among winners) of reform, consensus on a shared medium-term vision that goes beyond a particular administration, and institutional capacity to implement reform.

### *Banking sector reform*

The successful banking sector reform of the late 1990s and early 2000s, following the financial recession of the 1990s, yielded impressive results. In less than a decade the private sector went from owning 20 percent of banking assets to owning 80 percent. Financial deepening increased. Interest rates were liberalized, and microfinance expanded. Success stemmed from a combination of bold policy decisions and institutional change (Husain forthcoming a).

Policy steps included a clear plan for privatization, deregulation, and liberalization; the transfer of power from the Pakistan Banking Council to the State Bank of Pakistan, whose autonomy was strengthened; a ban on trade union activities and establishment of collective bargaining agents in individual banks; merit-based appointments of independent directors; stable macroeconomic conditions; and privatization of the three largest state banks. These steps helped make the reforms irreversible.

Institutional factors included the unwavering commitment of the political leadership (including an active champion for reform), intensive use of human resources and mid-managerial skills, regular consultations with primary stakeholders to foster a sense of ownership of the reforms, clear assignment of responsibilities for each part of the reform, and continuous monitoring and communication about reform outputs and outcomes. Donors were also important, mainly for delivering timely financing and technical assistance.

### *Civil service reform*

Multiple attempts at civil service reform over several decades have failed in Pakistan. The civil service is dysfunctional and inefficient, failing to perform the main functions of the state—basic services, law and order, infrastructure—to acceptable standards. Corruption, nepotism, and favoritism are rampant, and people without political connections or the resources to pay bribes are deprived of state services. Several factors can explain this failure (Husain forthcoming b).

In 2006 a National Commission for Government Reform, with mixed private and public sector representation, was tasked with developing a plan to reform the structure of federal, provincial, and local governments; modernize human resources policies for the civil service; and reengineer business processes and procedures. After two years of intensive research and consultations with stakeholders, the commission released a comprehensive report in May 2008. But a new government had come to power in the interim that had no ownership of the report shelved it. Instead of gradually adopting the report's main recommendations, the new political leadership made several decisions that violated the basic principle performance-based compensation.

What happened? At least five factors help explain the failure. First, the new authorities' failure to clearly endorse the plan indicated that a highly centralized, personalized decisionmaking process remained entrenched. The strongman template inherited from years of military rule concentrated decisionmaking over personnel in the federal and provincial governments' chief executives, and they were generally opposed to the reform.

Second, because incumbents in the civil service felt threatened by the reforms, they supported inaction. The proposed performance evaluations and results orientation would upset their equilibrium.

Third, reform had few allies with any influence. Pakistan's vibrant civil society had many complaints against government responsiveness, but they had no vehicle to effect change.

Fourth, political leaders, whatever their origins or party, preferred to staff key positions with loyal civil servants rather than on the basis of merit and competence.



Fifth, design could not prevent time inconsistency between costs and gains—the costs would come early and be incurred by the current regime, while the benefits (in savings and efficiency) would accrue much later, under a new government. For example, the reform called for freezing new recruitment to grades 1–16, which account for 85 percent of the wage bill, to free resources to augment the salaries of higher grade officers and professionals, who were underpaid. Politicians were unwilling to alienate most of the civil servants (also voters) for the sake of a minority of higher grade civil servants. The cozy alliance between the political leaders and lower graded civil servants was so strong that any change became unlikely.

### *Social protection reform*

The Benazir Income Support Programme, a successful cash transfer program established in June 2008 by the Benazir government, emerged from technical work done for the 2006 National Social Protection Strategy prepared by the previous government. In its initial rollout, the program was flawed: the women receiving cash transfers were drawn from heavily politicized beneficiary lists submitted by parliamentarians. But the program quickly found the technical support needed to refine its targeting tools at the National Database Registration Authority, and targeting improved. The program is viewed as a best practice worldwide, offering several lessons (Gazdar forthcoming).

Several factors contributed to its success. Strong political leaders sought cross-political support for the program in Parliament and support from civil society. The program had two goals, which helped to establish support: to compensate vulnerable populations affected by the 2007/08 global economic and financial crisis and to create fiscal space for other vital government activities (initially the program was intended to replace excessive and regressive subsidies, but that did not happen). Despite the flawed initial selection of beneficiaries, the program targeted the right population: women. The program also had a clear design, which was subject to correction under a scorecard-based selection procedure. Transparency in the program's beneficiaries and simplicity in its disbursement also facilitated its adoption. Complex partnerships with provincial governments and non governmental and private organizations through subcontracting arrangements made the program more efficient. And secondary aspects of reform were introduced gradually, with sensitivity to “losers,” especially in downsizing provincial social programs that became less relevant.

### *Greater openness to trade*

The reopening of trade relations between India and Pakistan in 2012 culminated several decades of effort. The economic justifications had been evident for years, but political obstacles impeded progress. Informal trade is estimated to be as large as formal trade (\$2 billion), despite being burdened by the additional transaction costs of moving commodities through a third country. Success was based on changing attitudes (Husain forthcoming c).

A confidence-building process acknowledging mutual economic interests erased the long-standing “trust deficit” in political relations between India and Pakistan. India now appears more interested in improving relations with its neighbor, while Pakistan is seeking to build peaceful political alliances region wide. The policy change in both countries from import-substitution policies to trade liberalization has also been influential. India has engaged in further

liberalization following its 2012 growth slowdown, and Pakistan is eagerly looking for ways to accelerate growth through trade after three years of mediocre economic performance. South Asia is the least integrated region in the world. Both countries are at the forefront of efforts to reinvigorate regional trade. Several accords have been signed, but the political economy for trade reform is much more complex than for other reforms.

There are institutional winners and losers in the reopening of trade between India and Pakistan (table 4.2). Not all actors carry similar weight, but the variety and interest of the actors involved shows the complexity of designing and adopting structural reform.

**Table 4.2 Winners and losers in the reopening of trade between India and Pakistan**

Winner or loser	Attitude to reform	Net benefit/cost from supporting/opposing reform	Level of influence	Ability to generate political action
Government of Pakistan	Positive	Benefits >	Very high	High
Government of Punjab	Positive	Benefits >	High	High
Major political parties	Positive	Benefits >	Very high	High
Military	Neutral	Unclear	Very high	High
Big business	Positive	Benefits >	High	High
Chambers, federations, and councils of business	Positive	Benefits >	High	High
Auto manufacturers, part suppliers	Negative	Costs >	Medium	Low
Domestic pharmaceutical industry	Negative	Costs >	Medium	Low
Textile industry	Mixed	Unclear	High	Moderate
Commercial importers	Positive	Benefits >	Low	Low
Media	Neutral	Unclear	Very high	High
Exporters	Positive	Benefits >	Low	Low
Raw material supporters	Positive	Benefits >	Low	Low
Academia	Positive	Benefits >	Low	Low
Public	Neutral/ mixed	Unclear	Very high	High
Logistics industry	Positive	Benefits >	Low	Low
Retailers and wholesalers	Positive	Benefits >	High	High

Source: Husain forthcoming c.

### *Lessons from the case studies*

These case studies suggest several lessons from prior successes and failures in the political economy of structural reform that may help shape future attempts in Pakistan:

- For external conditions, consensus for reform appears easier to achieve during crises. But sustainability is often a challenge. In Pakistan, once the crisis is over there is little appetite to sustain the reform, which is left incomplete (Husain 2012).
- Political leadership at the top (with a champion designing and implementing reform) is essential for commitment and credibility. But the vision and political decisions need to be complemented by skilled managerial and persuasive negotiating capacity to move reform through troubled waters. All successful reforms in Pakistan featured not only strong support from leaders, essential for reaching cross-political support, but also from highly respected professionals with strong deal-making political skills. The failed civil service reform demonstrates what happens when such support fades between administrations.
- Solid technical design makes acceptance of reform more likely, especially if it correctly identifies winners and losers and, for the losers, designs proper contingency actions to

minimize their opposition. The Benazir Income Support Programme's key to success was its major redesign, which was praised by most political forces and gained it acceptance, even though that initial design came from the prior administration.

- Early gains can provide momentum for further progress. Banking sector reform and the Benazir Income Support Programme are examples, as is the ongoing trade normalization with India, where small confidence-building steps increase trust between the two countries.
- Financial support from donors is secondary—and not determinant. It can even be counterproductive if it forces reform with no ownership. But it may prove useful when complemented by solid institutional ownership, timely advice, and technical assistance on demand.

## Annex 4.1 Base simulation tradeoffs and high-growth alternative fiscal policy scenarios

The fiscal policy scenarios simulate the effect of raising government spending on infrastructure with alternative means of creating the necessary fiscal space. They use alternative assumptions regarding the source of the additional revenues, the use of the resources, and the economic strength of the productivity gains (or losses) associated with the additional investment in infrastructure. Although several simulations are performed, six main scenarios are examined here: (table 4.1.1)<sup>19</sup>

- *inv-og*: 75 percent less growth in government consumption in areas not related to human development or infrastructure with the new fiscal space shifted to infrastructure investment (this scenario is later referred as the slowdown in wasteful government spending).
- *inv-tx*: Higher domestic taxes to finance the same amount of infrastructure investment as in *inv-og*.
- *inv-sb*: Elimination of the electricity subsidy, with the fiscal space transferred to infrastructure investment.
- *trn-og*: 75 percent less growth in government consumption, other than wages, with the fiscal space used for additional cash transfers to low-income households (such as under the Benazir Income Support Programme).
- *inv-tx-*: Higher domestic taxes to finance the same increase in fiscal space as in *inv-og*, combined with a 50 percent decline in the elasticity of total factor productivity (TFP) to higher infrastructure capital stocks over base levels (using fiscal space generated with taxation for poor-quality public investments).
- *inv-ogsb+*: Same changes in spending policy as in *inv-og* and *inv-sb*, with the fiscal space used for infrastructure investment and a 50 percent increase in the elasticity of TFP to higher infrastructure capital stock over base levels (using fiscal space for high-quality public investments).

<sup>19</sup> Three additional simulations were also performed: *inv-og+* and *inv-og-*, which are the same as *inv-og* but with an additional 50 percent rise or fall in TFP; and *inv-tx+*, which is same as *inv-tx* but with an additional 50 percent rise in TFP.

**Table 4.1.1 Different scenarios for real growth, government spending,  
and the Millennium Development Goals in Pakistan**

<b>Section I : Real macro indicators by simulation (% annual growth, 2013-22)</b>									
<b>Indicators</b>	<b>2012 <sup>a</sup></b>	<b>base</b>	<b>inv-og</b>	<b>inv-tx</b>	<b>inv-sb</b>	<b>trn-og</b>	<b>inv-tx-</b>	<b>inv-ogsb+</b>	<b>hi-grw</b>
Absorption	12,273.1	4.2	4.4	4.3	4.3	4.3	3.9	5.0	6.7
Consumption - private	9,885.2	4.0	4.2	3.9	3.9	4.2	3.5	4.5	6.1
Consumption - government	783.4	6.0	3.8	6.2	6.1	3.6	6.2	4.0	6.2
Fixed investment - private	1,179.8	4.5	4.9	4.0	4.4	4.8	3.1	5.6	9.5
Fixed investment - government	424.7	5.0	9.0	9.4	8.6	4.4	9.4	12.4	11.6
GDP at factor cost	10,858.4	4.3	4.5	4.4	4.4	4.3	3.9	5.1	7.0
Unemployment rate (%) <sup>b</sup>	15.7	12.6	11.7	13.8	13.2	12.0	15.7	10.6	5.0
Foreign government debt	25.7	25.4	25.1	25.5	25.3	25.3	26.3	24.2	20.2
Domestic government debt	35.6	36.2	35.5	36.0	35.8	36.2	37.6	33.5	31.5
<b>Section II : Government receipts and spending in 2012 and by simulation in 2022 (% of nominal GDP)</b>									
		<b>2022</b>							
<b>Indicators</b>	<b>2012</b>	<b>base</b>	<b>inv-og</b>	<b>inv-tx</b>	<b>inv-sb</b>	<b>trn-og</b>	<b>inv-tx-</b>	<b>inv-ogsb+</b>	<b>hi-grw</b>
<b>Receipts</b>									
Direct taxes	3.5	4.7	4.7	5.5	4.6	4.8	5.7	4.6	4.8
Import tariffs	1.0	1.3	1.4	1.3	1.3	1.3	1.3	1.4	1.4
Other indirect taxes	4.2	6.1	6.2	7.5	7.6	6.1	7.7	7.7	6.3
Foreign transfers	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.3	0.3
Factor income	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Domestic borrowing	5.8	3.3	3.3	3.3	3.3	3.3	3.4	3.2	3.6
Foreign borrowing	0.9	1.1	1.0	1.1	1.1	1.1	1.1	1.0	0.8
<b>Total</b>	<b>15.9</b>	<b>17.3</b>	<b>17.3</b>	<b>19.5</b>	<b>18.7</b>	<b>17.4</b>	<b>20.0</b>	<b>18.7</b>	<b>17.6</b>
<b>Spending <sup>c</sup></b>									
Consumption	6.8	8.0	6.4	8.2	8.1	6.3	8.5	6.3	6.8
Fixed investment	3.7	3.9	5.6	5.9	5.3	3.7	6.1	7.1	5.6
<i>Human development</i>	3.2	3.8	3.7	3.8	3.7	3.8	3.9	3.6	3.1
<i>Infrastructure</i>	2.5	2.5	4.5	4.6	4.0	2.5	4.8	6.1	4.4
<i>Other consumption and investment</i>	4.9	5.7	3.7	5.7	5.6	3.8	5.9	3.6	4.9
Domestic transfers	4.5	4.5	4.5	4.5	4.5	6.5	4.5	4.5	4.5
Domestic interest payments	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Foreign interest payments	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.6
<b>Total</b>	<b>15.9</b>	<b>17.3</b>	<b>17.3</b>	<b>19.5</b>	<b>18.7</b>	<b>17.4</b>	<b>20.0</b>	<b>18.7</b>	<b>17.6</b>
<b>Section III : MDG and education indicators in 2012 and by simulation in 2022</b>									
<b>Indicators</b>	<b>2012</b>	<b>base</b>	<b>inv-og</b>	<b>inv-tx</b>	<b>inv-sb</b>	<b>trn-og</b>	<b>inv-tx-</b>	<b>inv-ogsb+</b>	<b>hi-grw</b>
MDG 1: Headcount poverty (%)	15.0	8.6	7.9	9.0	8.5	7.4	10.8	6.7	3.1
MDG 2: Primary net completion rate (%)	48.0	59.5	62.3	61.7	61.6	59.9	60.9	65.0	66.7
MDG 4: Under-five mortality rate (%)	85.5	74.8	72.4	73.1	73.2	74.3	73.9	70.4	68.6
MDG 7: Water access (%)	93.2	96.9	97.5	97.4	97.3	97.0	97.2	98.0	98.3
MDG 7: Sanitation access (%)	49.5	57.4	59.2	58.7	58.7	57.7	58.2	60.9	62.2

Source: Kinnunen and Lofgren forthcoming.

Note: Definitions of simulation scenarios.

*inv-og*: 75 percent reduction in growth in other government consumption + fiscal space used for infrastructure investment

*inv-tx*: same increase in infrastructure investment as *inv-og*+, financing from domestic taxes

*inv-sb*: elimination of electricity subsidy + fiscal space used for infrastructure investment

*trn-og*: same reduction in growth for other government as *inv-og*+, fiscal space used for transfers to low-income households

*inv-tx-*: same as *inv-tx*, except for 50 percent decrease in elasticity of total factor productivity (TFP) with respect to increase in infrastructure capital stocks over base levels.

*inv-ogsb+*: same changes in spending policy as *inv-og* and *inv-sb*+ fiscal space used for infrastructure investment + 50 percent increase in elasticity of TFP to increases in infrastructure capital stocks over base levels.

*hi-grw*: high GDP growth of an average 7 percent driven by increased savings, investment, and TFP growth.

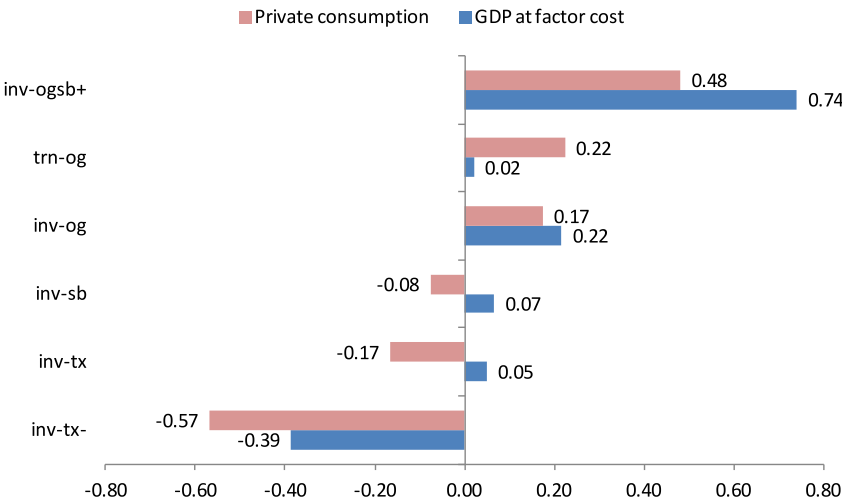
a. Unless otherwise noted, data are in 2008 rupees.

b. The 2012 and simulation columns show the 2012 rate and simulation-specific 2022 rate, respectively.

c. Government final demand may be split into consumption and fixed investment or by function (here broadly into human development, infrastructure, and other.)

The largest medium-term gains in welfare and growth occur when the government curbs wasteful current spending (spending without identified positive impacts on productivity, welfare, or human development) and when the additional public infrastructure investments are of high quality (figure 4.1.1). But the effects are more ambiguous (improvement in some indicators and deterioration in others) if the fiscal space is created through higher taxes or reduced energy subsidies because the greater fiscal space for government infrastructure spending is accompanied by a decline (at least initially) in private consumption. No matter the magnitudes, the exercise shows that policymakers face tradeoffs. Finally, using the new fiscal space for good productive investment has a greater effect on growth than using it for cash transfers to low-income households.

**Figure 4.1.1 GDP and private consumption: real growth deviations from base**  
(percentage points)



Source: Kinnunen and Lofgren forthcoming.

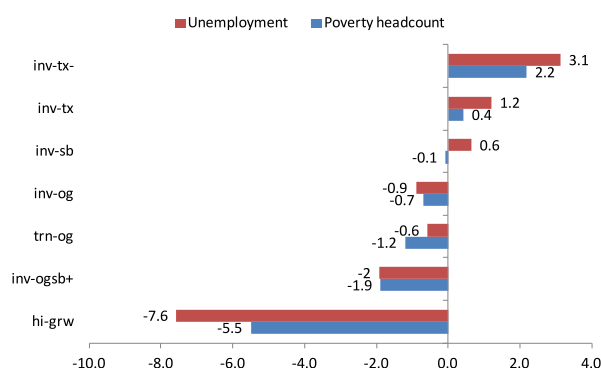
The next examples illustrate the effects of policy shocks (see figure 4.1.1 on GDP and private consumption, figure 4.1.2 on poverty and unemployment, and table 4.1.1 on MDG outcomes). The results are presented as the relative deviations from the 2022 base scenario:

- If reduced growth in wasteful government consumption (*inv-og*) finances additional infrastructure, GDP rises 0.22 percentage point and consumption growth 0.17 percentage point. Growth gains are modest and do reduce unemployment, which declines 0.8 percentage point over the base, while the poverty rate falls 0.7 percentage point.
- If a strong rise in domestic taxes (*inv-tx*), equivalent to 5.3 percentage points of GDP by 2022 (over their 2012 level) finances strictly the additional infrastructure investment, the effect on GDP growth over the base is marginally positive (0.05 percentage point). This result shows that raising taxes alone is no guarantee of faster growth because private consumption falls (–0.17 percentage point) after higher taxes. Unemployment

risers 1.2 percentage points and poverty 0.40 percentage point (see figure 4.1.2). However, thanks to the improved infrastructure (facilitating access to and production of health and education services), other MDG indicators improve, albeit marginally, over the base scenario. These tradeoffs reflect the opportunity costs of tax-based financing.

- If the expanded infrastructure is financed by eliminating the electricity subsidy (*inv-sb*)—treated like a negative tax on the heat and energy sector—GDP growth rises marginally over the baseline by 0.07 percentage point while consumption falls 0.08 percentage point. And while unemployment increases 0.6 percentage point, poverty falls an extra 0.1 percentage point. This shock is similar to the tax increase, by redistributing resources from the private sector to the government, even though it reduces distortions in the price system. Unlike in the tax increase case (*inv-tx*), eliminating the subsidy results in strong positive MDG improvements across the board, avoiding any tradeoff between poverty reduction and improved social outcomes.
- If wasteful government spending slows and the new fiscal space goes exclusively to per capita cash transfers (*trn-og*), and none to infrastructure, private consumption rises 0.22 percentage point over the base scenario, but the overall effect on growth is nil (0.02 percentage point). Unemployment falls 0.6 percentage point, and poverty drops an extra 1.2 percentage point over the baseline. Without the productivity gains arising from good infrastructure expansion, medium-term gains in growth and unemployment from cash transfers are weaker.
- If the tax-based financing of infrastructure investment is accompanied by a decrease in TFP (*inv-tx-*), the poor-quality investments have a negative effect on GDP growth (–0.39 percentage point) and consumption (–0.57 percentage point). Unemployment rises 3.1 percentage points and poverty 2.2 percentage points over the baseline. This is the worst case scenario: expensive taxes coupled with bad public investment. This scenario strongly emphasizes the need to ensure that fiscal space is not just created but properly used.
- Conversely, if the productivity gains from additional infrastructure are strong (*inv-ogsb+*) because the elasticity of TFP to infrastructure services doubles as a result of high-quality investments, GDP growth rises 0.74 percentage point, propelled by consumption increases of 0.48 percentage point. Unemployment falls 2.0 percentage points, and the 2022 poverty rate falls 1.9 percentage points over the baseline. All MDG indicators improve much more than in any other scenario. This is the best case scenario.

Figure 4.1.2 Scenarios for poverty and unemployment in 2012 and 2022: deviations from base (percentage points)



Source: Kinnunen and Lofgren forthcoming.

Note: The poverty headcount base is 8.6 percent and the unemployment base is 12.6 percent.



## Annex 4.2 Potential and recent performance of provincial development

The provinces' growth strategies will also affect strategies at the federal level. The 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.<sup>20</sup> 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 (UNDP 2011), 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 the north to the Indus plains in the 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.

Each province also has different challenges. Punjab has been the largest contributor to national income, at more than 50 percent, followed by Sindh and Khyber Pakhtunkhwa, at 10–30 percent, and Balochistan at less than 10 percent. There are no official estimates of provincial GDP and other macroeconomic variables (Ikram 2009). Unofficial World Bank estimates show that growth has also varied, with Balochistan lagging in the last decade. One of the main reasons for such unbalanced growth, despite strong potential, is the country's one-size-fits-all policies, which arise from too much attention to the federal level and not enough to the provinces. Addressing province-specific issues and improving service delivery require thorough understanding of the differential growth path of provinces and their underlying factors and growth constraints, but research is severely hampered by the lack of reliable primary data.

This annex offers a preliminary framework for designing customized solutions to provincial growth constraints.<sup>21</sup> Although since fiscal 2006 all four provinces have suffered from declining growth trends, low productivity, and weak social outcomes, some of their main binding constraints to growth differ. The framework brings together data on provincial GDP, poverty, and social infrastructure. It focuses strictly on provincial constraints to investment and suggests a customized policy agenda for provincial growth and job enhancement.

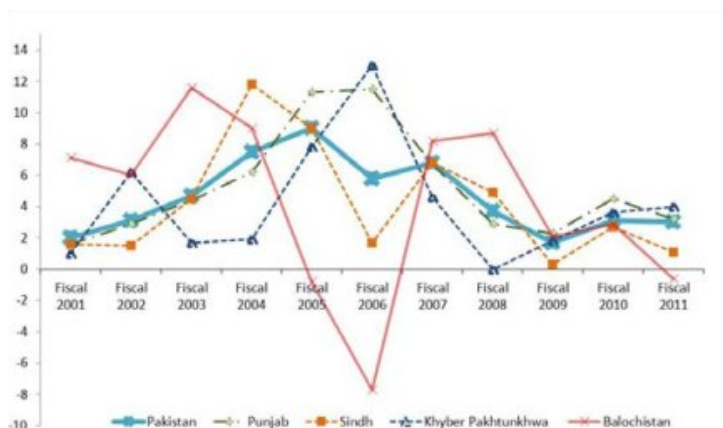
### *Provincial growth performance*

There is high growth volatility across provinces and incomes vary widely. But GDP in the provinces broadly follows the falling national trend, from 9 percent in fiscal 2005 to 3 percent in fiscal 2011. Declines were highest in Punjab, at 8.1 percentage points, followed by Sindh at 7.9 percentage points and Khyber Pakhtunkhwa at 3.8 percentage points. Balochistan recorded a 0.2 percentage point rise (figure 4.2.1).

<sup>20</sup>Population estimates in this paragraph are for 2011, based on Government of Pakistan (2012d) data.

108 <sup>21</sup>This section is based on Lopez-Calix and Touqueer (2013).

**Figure 4.2.1 Provincial GDP growth rate, fiscal 2001–11**  
(percent, at fiscal 2000 prices)



Source: World Bank forthcoming; Bengali and Sadaqat 2006.

GDP in Punjab and Sindh track 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 over fiscal 2001–11, whereas Balochistan's is negatively related with national GDP (table 4.2.1). Among provinces the highest correlation is between Khyber Pakhtunkhwa and Punjab, followed by Punjab and Sindh. Balochistan is positively correlated only with Sindh and highly negatively correlated with Khyber Pakhtunkhwa. These findings confirm that Balochistan's growth appears as an outlier and lags behind the other provinces significantly. Its share in national GDP has been small (at or below 10 percent) over the last three decades, in marked contrast to Punjab's share that has risen to almost 55 percent (figure 4.2.2).<sup>22</sup>

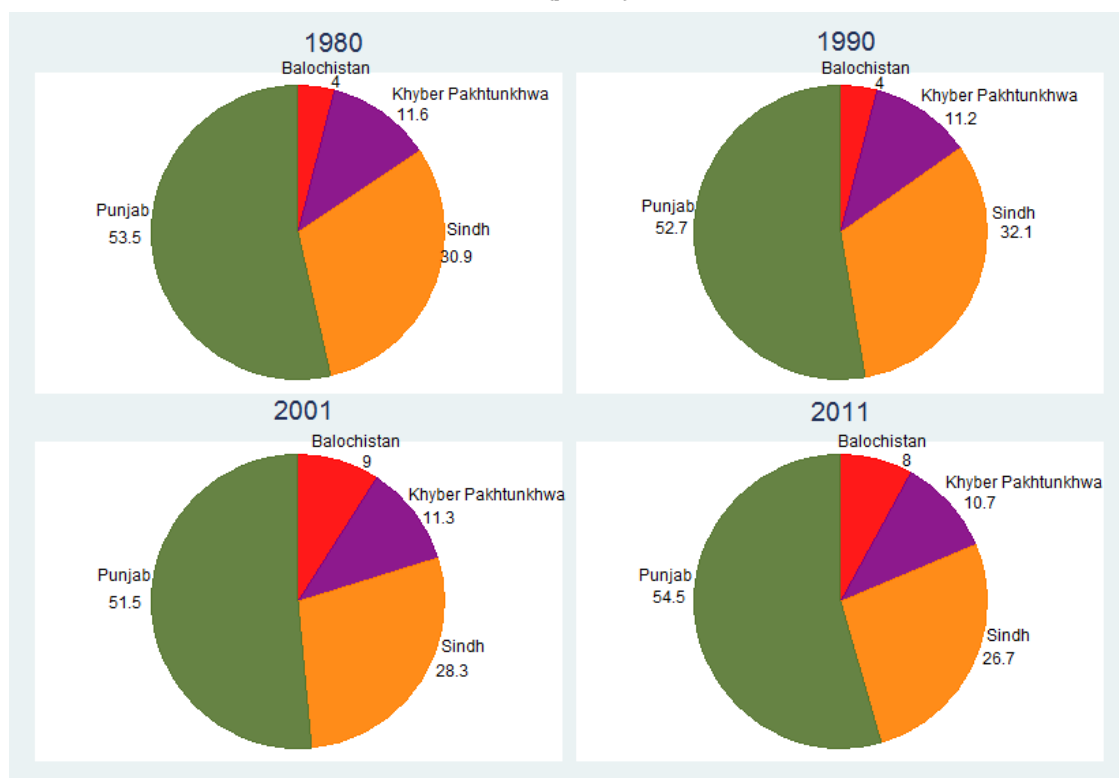
**Table 4.2.1 Correlation between provincial GDP growth rates, fiscal 2001–11**

	Pakistan	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan
Pakistan	1.000	-	-	-	-
Punjab	0.832	1.000	-	-	-
Sindh	0.848	0.455	1.000	-	-
Khyber Pakhtunkhwa	0.421	0.797	-0.080	1.000	-
Balochistan	-0.084	-0.561	0.338	-0.794	1.000

Source: World Bank staff calculations.

<sup>22</sup> Calculation of provincial GDP is not without controversy. For example, the production and distribution of natural gas does not compensate the producer province (Balochistan) for the full value it generates, but it overstates the province's already lowest GDP.

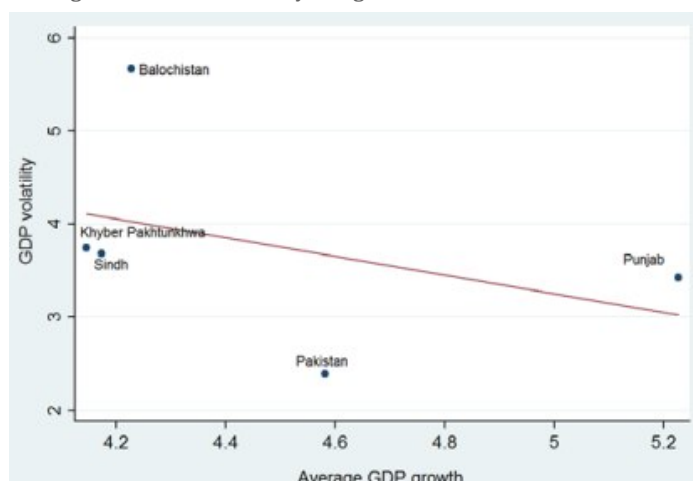
Figure 4.2.2 Provincial shares in national GDP, various years  
(percent)



Source: World Bank staff calculations.

Volatility (measured by the standard error around trend growth) in provincial GDP differs as well, pointing to structural variations (figure 4.2.3). During fiscal 2001–11 Balochistan recorded the same average growth as Sindh, but its growth fluctuations were exceptionally high, with three episodes of negative growth. Punjab recorded higher and less volatile growth over the period (see figure 4.2.2).

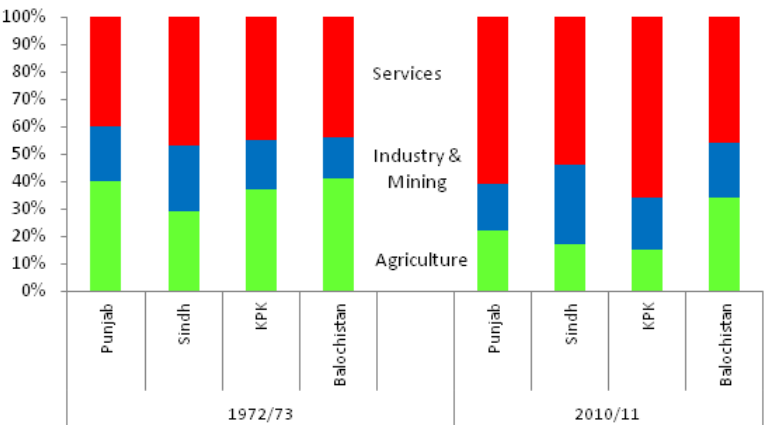
Figure 4.2.3 GDP volatility and growth rate, fiscal 2001–11



Source: World Bank staff calculations.

The main reason for the differences in growth volatility has been the economic structure of provincial economies. Since fiscal 1973 the four provinces have shifted from relying on agriculture to relying more on services and manufacturing (figure 4.2.4). 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 accounted for 34 percent of provincial GDP in fiscal 2011. Because of a 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.

**Figure 4.2.4 Structure of provincial GDP, fiscal 1973 and 2011**  
(percent of provincial GDP)

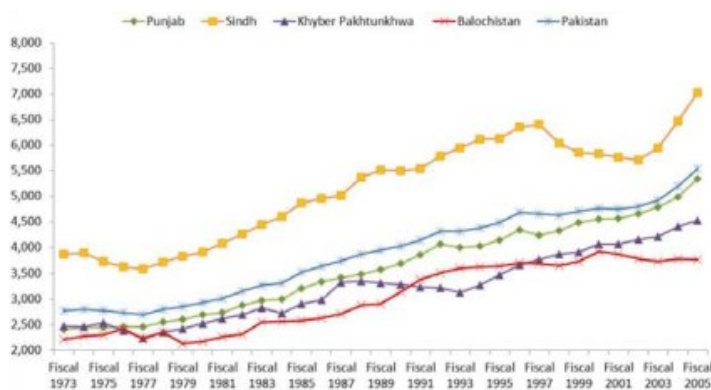


Source: World Bank forthcoming a; Bengali and Sadaqat 2006.

Corresponding to different growth rates, provincial incomes per capita also vary, with no sign of convergence, except for Khyber Pakhtunkhwa and Punjab (figure 4.2.5). Provincial GDP per capita followed a rising trend over fiscal 1981–2005, with Sindh leading, followed by Punjab, Khyber Pakhtunkhwa, and Balochistan. After the mid-1990s, however, Balochistan's GDP per capita started to diverge from the others. Its estimated PRs 3,700 per capita in fiscal 2005 (in fiscal 1981 prices) was about 0.7 times lower than the national average and almost half of that of Sindh (PRs 6,900). With average annual growth of 2.1 percent, Balochistan was about 0.04 percentage point lower than Sindh, 0.10 percentage point lower than Khyber Pakhtunkhwa, and 0.60 percentage point lower than Punjab. Balochistan's weaker growth performance prevents its income per capita from converging with that of the other provinces.

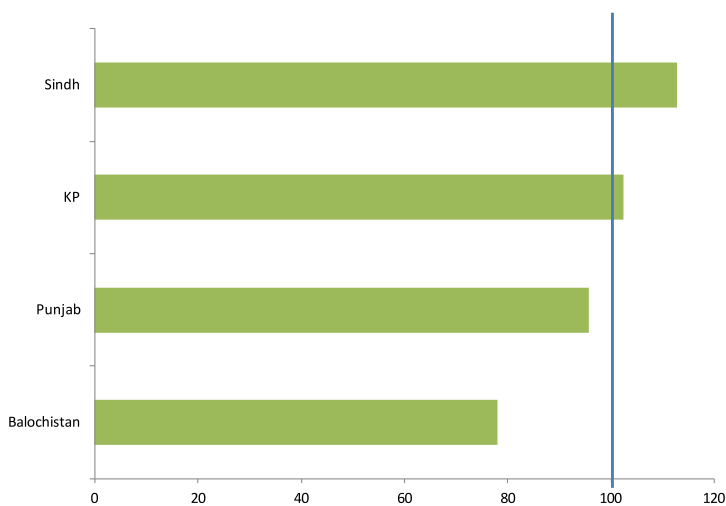
Falling labor productivity and rapidly growing population have accompanied the declining growth trend in the provinces. Nationally, growth accounting analysis points to declining labor productivity (see chapter 2). Estimates of labor productivity at the provincial level suggest that Sindh has the most 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 (figure 4.2.6).

Figure 4.2.5 Provincial GDP per capita, fiscal 1973–2005



Source: World Bank 2008.

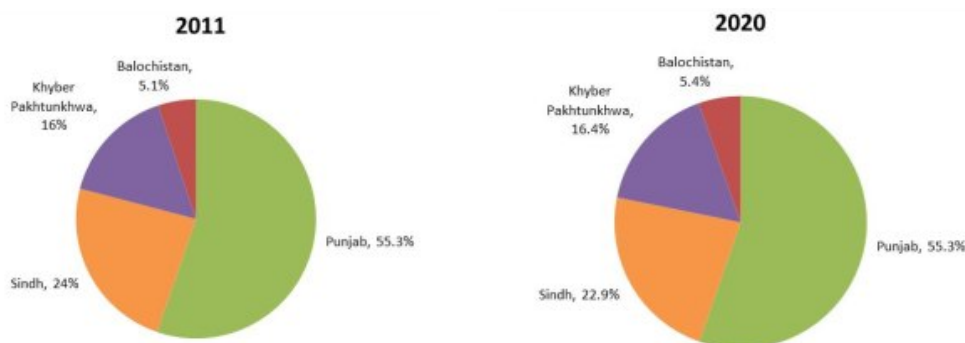
Figure 4.2.6 Provincial labor productivity as a share of national average, fiscal 2005 (percent)



Source: World Bank 2008.

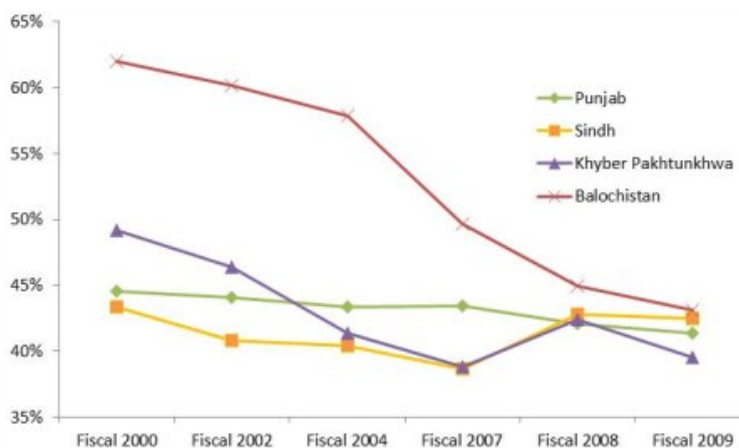
Not only is productivity low, but the labor supply is growing rapidly and important inter-provincial (as well as rural-urban) migration seems to be taking place. The shares of Balochistan and Khyber Pakhtunkhwa in total population are projected to rise by 2020, while Sindh's share is expected to decline, and Punjab's will be about the same (figure 4.2.7). All provinces have made some recent progress in improving labor force quality. The share of uneducated workers has been declining in Balochistan and Khyber Pakhtunkhwa; in Punjab it has been almost stagnant for nearly a decade, and in Sindh it has been rising since 2007 (figure 4.2.8).

**Figure 4.2.7 Provincial share in total population, 2011 and 2020**  
(percent)



Source: World Bank staff calculations, based on data from Government of Pakistan (2012d) and National Institute of Population Studies.

**Figure 4.2.8 The share of uneducated workers, by province, fiscal 2000–09**  
(percent)

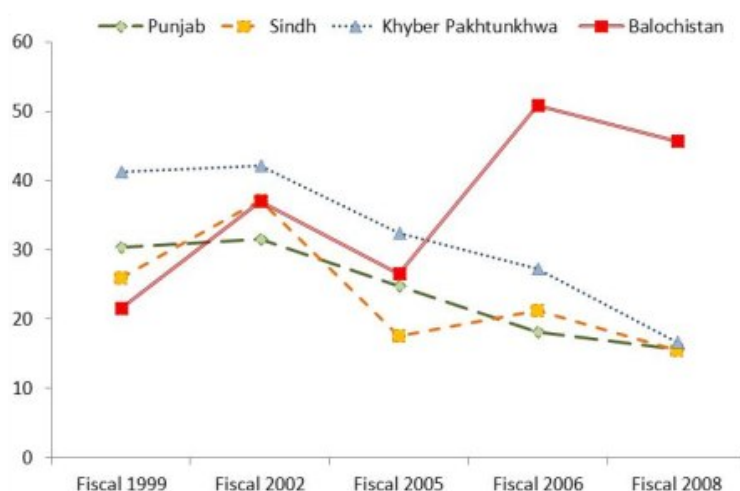


Source: Robalino and Cho forthcoming.

### *Provincial performance on poverty, inequality, and social indicators*

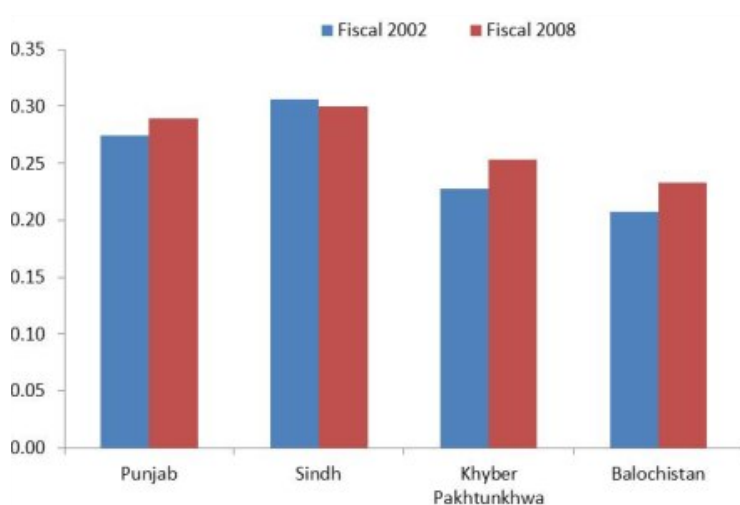
Efforts to reduce poverty and income inequality have had mixed results. While poverty fell between fiscal 1999 and 2008, the pace was slow. Poverty fell in Khyber Pakhtunkhwa, Punjab, and Sindh, but was extremely high and variable in Balochistan—46 percent in fiscal 2008, about 29–30 percentage points higher than in the other provinces (figure 4.2.9). Sindh experienced some volatility as well, though the trend remained downward. The volatility in Balochistan and Sindh appears to reflect the growth of agricultural GDP (World Bank forthcoming a), while worker remittances might have stabilized poverty reduction in Punjab and Khyber Pakhtunkhwa (Lopez-Calix and Touqeer forthcoming). Balochistan also underperformed other provinces in income equality, recording a rise in income inequality of 0.03 points in its Gini index over fiscal 2002–08, which is similar to Khyber Pakhtunkhwa (0.03) and above Punjab (0.02). Only Sindh saw its Gini index decline over fiscal 2002–08 (figure 4.2.10).

**Figure 4.2.9 Poverty headcount by province, fiscal 1999–2008**  
(percent of population)



Source: World Bank 2011d.

**Figure 4.2.10 Inequality by province, fiscal 2002 and 2008**  
(Gini coefficients)



Source: World Bank 2011d.

Note: The Gini index varies from zero (denoting complete equality) to 1 (complete inequality).

The provinces also differ on social outcomes, and gender and rural-urban gaps are evident in all provinces.

- In 2011 literacy was highest in Punjab (60 percent) and Sindh (59 percent), followed by Khyber Pakhtunkhwa (50 percent) and Balochistan (41 percent). Punjab and Sindh had higher rural-urban disparities than gender disparities. Gender disparities were highest in Balochistan, which also had high rural-urban disparities. Khyber Pakhtunkhwa had high gender disparities but low rural-urban disparities.



- Punjab performed best on the 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 disparities 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.
- Gaps 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 gap of 66 percentage points. Sindh recorded the second highest rural-urban gap of 59 percentage points due to the lowest availability of safe drinking water in its rural areas.
- Only 31 percent of Balochistan's population had access to improved sanitation—and only 16 percent in rural areas. Rural areas in Sindh, Khyber Pakhtunkhwa, and Punjab followed.

## 5. ANSWERS TO SIX DIFFICULT QUESTIONS

This final chapter attempts to answer difficult questions about the growth and job-enhancing challenges in Pakistan:

- What explains the divergence in long-term growth between Pakistan and India?
- Why should Pakistan's development strategy focus on growth and jobs together?
- Should the job-enhancing growth strategy have an urban focus?
- With industry relying on an export-led strategy to move from stagnation and with the rising demand for services associated with cities, should Pakistan also focus on agricultural extension?
- How much stabilization and structural reform are needed during the sudden stop of financing inflows?
- What policies should Pakistan definitely avoid to accelerate growth and job enhancement?

### What explains the divergence in long-term growth between Pakistan and India?

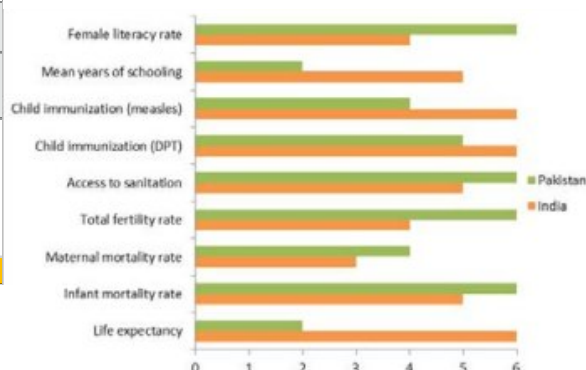
Not until the last two decades did India post higher GDP growth than Pakistan.<sup>23</sup> And not until the 1990s did GDP per capita rates also start to diverge. By the 1990s and the 2000s India's GDP growth was 50 percent higher than Pakistan's (5.6 percent and 7.4 percent for India against 4.0 percent and 4.6 percent for Pakistan) and its GDP per capita growth rates were more than double Pakistan's (table 5.1). Yet both countries lag equally in social indicators compared with the region (figure 5.1).

**Table 5.1 Average growth rates in Pakistan and India, 1961–2010 (percent)**

Years	Pakistan		India	
	GDP (annual %)	GDP per capita (annual %)	GDP (annual %)	GDP per capita (annual %)
1961-69	6.8	4.1	6.7	4.4
1970-79	4.8	1.8	2.9	0.6
1980-89	6.9	3.4	5.7	3.3
1990-99	4.0	1.3	5.6	3.6
2000-10	4.6	2.7	7.4	5.7
1961-2010	5.4	2.6	5.7	3.6

Source: World Bank 2012e.

**Figure 5.1 Rankings of Pakistan and India on social indicators among main six South Asian countries, 2009**



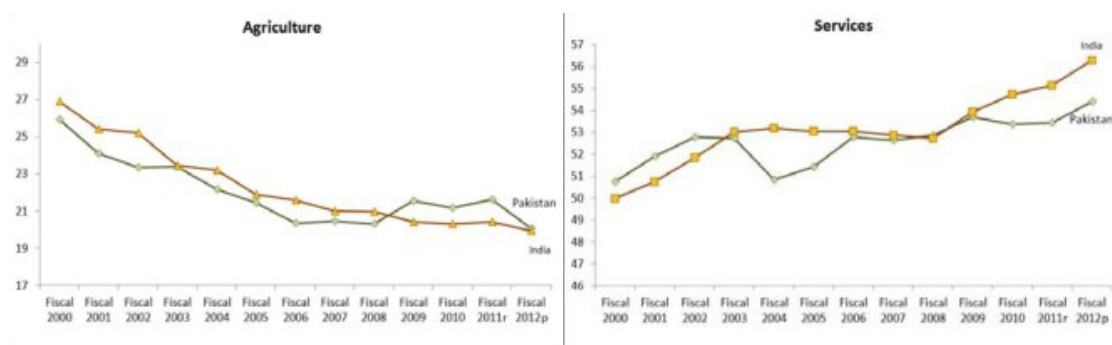
Source: World Bank 2012e; Dreze and Sen 2011.

Note: Highest rankings means worst positions compared to Bangladesh, Bhutan, Nepal and Sri Lanka

<sup>23</sup> This section is based on Lopez-Calix and Touqeer (forthcoming).

There are three main reasons for the divergence in growth. First is the strength of India's inter- and intrasectoral shifts. India decreased its reliance on a volatile agriculture sector and increased its dependence on services (figure 5.2). The share of agricultural output in India's GDP dropped from 32 percent in fiscal 1991 to 20 percent in fiscal 2012, while the share of services rose from 50 percent to 56 percent (Government of India 2012). Something similar occurred in Pakistan, but the intersectoral labor shift toward high-skilled labor activities was much milder. Further, important agricultural reforms in India also supported the movement of labor from farm to nonfarm activities. Reforms focused on irrigation facilities, agriculture credit, market development, research and extension services, and agricultural inputs. These reforms also reduced farmers' dependence on weather conditions and improved agricultural productivity (Acharya 1998). Pakistan failed to comprehensively reform its agriculture sector, which remains constrained by weak markets, production inefficiencies, land ownership problems, adverse weather conditions, and water shortages. Most important, the Agricultural Produce Markets Act of 1939 gives the government control over agricultural markets, which are heavily regulated and fail to meet the needs of domestic commerce or to benefit small farmers.

**Figure 5.2 Sectoral shares in GDP in Pakistan and India, fiscal 2000–12**  
(percent of GDP)



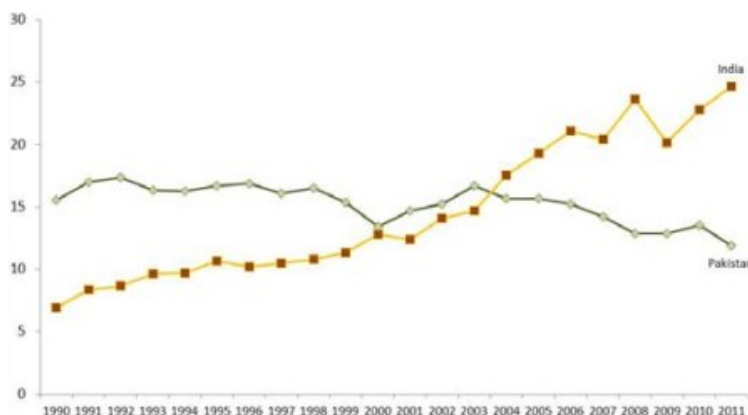
Source: Government of Pakistan 2012d; Government of India 2012; World Bank staff calculations.  
r is revised; p is provisional.

Second, capital accumulation and productivity have played important but unequal roles in each economy over the past 50 years. In India the contributions to growth of both factors rose over 1980–2012 compared with 1960–80 (from 1.0 percent to 1.4 percent for capital accumulation and from 0.1 percent to 2.6 percent for productivity). But capital's contribution declined in Pakistan (from 2.4 percent to 1.0 percent), and while productivity's rose (from 0.9 percent to 1.4 percent; World Bank 2012c), it was on a declining trend in the 2000s as India grew strongly over 1980–2012; its aggregate total factor productivity (TFP) growth of 2.6 percent was the highest in the region. In contrast, Pakistan's economy has experienced a long-term decline in productivity. And capital accumulation, the main driver of growth in the 1960s, has dwindled in importance, reflecting reduced fiscal space, falling foreign direct investment, and crowding out of the financial sector (Khan 2006).

Third (perhaps explaining the first two) is India's sustained policy shift toward trade liberalization and export-led growth, supported by steady development of the industrial and

services sectors. India's policy shift began in the 1980s, supported by political economy factors favoring change, including pressure from industrialists to relax controls and improved export performance and remittance accumulation (Panagariya 2003). The systemic structural reforms of the 1990s led to large increases in India's share of exports (figure 5.3). Pakistan's exports, less diversified, experienced a downward shift.

**Figure 5.3 Export of goods and services by Pakistan and India, 1990–2011**  
(percent of GDP)



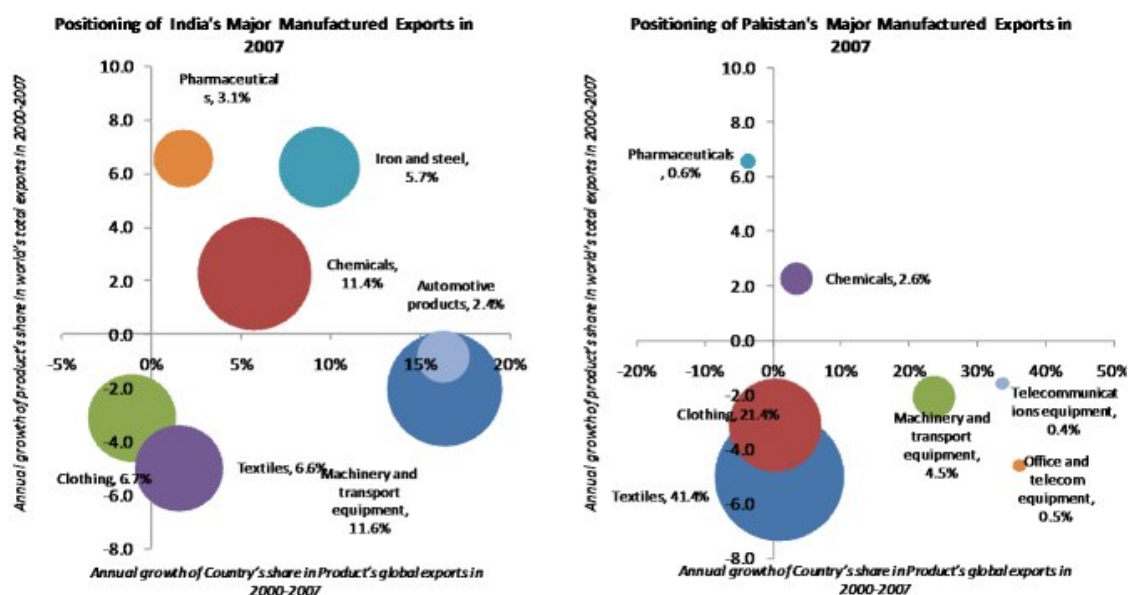
Source: World Bank 2012e.

The main components of India's successful strategy are well known (Panagariya 2003; World Bank 2004b; Hausmann and Klinger 2008; Srinivasan and Archana 2009; Lopez-Calix, 2012). The result has been a well-diversified and competitive tradables sector, with export market penetration four times greater than Pakistan's:

- *Export incentives.* India offered tax incentives to targeted export industries, reduced interest rates, and assured continuity of preferential export-import policies for at least three years (Joshi and Little 1994).
- *Import liberalization.* India liberalized imports of capital and intermediate goods. Although some high tariffs remain, average industrial tariffs declined. Relaxing internal controls also facilitated enterprise growth. But important opaque non tariff barriers remain.
- *Macroeconomic policies.* In the past decade India's broadly prudent economic policies (with a healthy current account balance and positive capital inflows) have supported industrial and export growth and attracted foreign direct investment. In contrast, the deteriorating macroeconomic situation in Pakistan since the late 2000s has not been conducive to attracting foreign direct investment or diversifying exports.
- *Flexible exchange rate policy.* India has actively led its exchange rate to move with market fundamentals, rather than attempting to keep it fixed at a certain rate, which would have raised the cost of exports. This policy has supported exports at difficult periods of severe external shocks—especially during the aftermath of the 2008 global financial crisis. While Pakistan turned to inward, protective policies (see chapter 3), India's deliberate devaluation of the rupee complemented its tariff reductions and other export-promotion policies, thus preserving dynamic exports.

Pakistan's export positioning in world markets is not very encouraging. Comparing the growth of a given manufactured good in world exports with the corresponding growth in Pakistan's exports reveals Pakistan's lack of international competitiveness. Pakistan has a minuscule share of its exports (only 2.6 percent) in the competitive (upper right-hand) quadrant of figure 5.4. And manufacturing exports are dominated by textiles (41.4 percent), whose world demand is falling. In contrast, India exports a much greater variety of manufactured products, with several of its exports—pharmaceuticals, chemicals, iron and steel, and automotive parts—in the competitive quadrant.

Figure 5.4 Competitiveness and performance of India's and Pakistan's exports, 2000–07 (percent)



Source: Sanchez-Triana, Nabi, and Dezfuli(2012), based on Nabi (2010).

## Why should Pakistan's development strategy focus on growth and jobs together?

Pakistan's policymakers believe that simply accelerating growth will be enough to meet its job and development needs.<sup>24</sup> But this is far from guaranteed. Creating more and better quality jobs usually occurs only in a growing economy. Pakistan needs to create around 1.5 million jobs a year until 2020, just to keep the current unemployment rate constant. And simple arithmetic shows that given a 0.5 constant elasticity of employment to GDP growth, a 1 percentage point rise in GDP leads to a 0.5 percentage point rise in employment (Government of Pakistan 2011a; Robalino and Cho forthcoming). Thus, for an annual labor force growth rate of about 3.5 percent, GDP growth needs to be 7 percent a year. But even if high growth rates are welcome, these are not enough to solve the country's development challenges.

High growth rates do not prevent short-term fluctuations in employment—formal or informal. Over the medium term employment is determined by the size of the labor force, but over the short term there can be large fluctuations around the trend. In addition, it is not only the number of growth-generated jobs that matters; quality is also important.

<sup>24</sup> This section is based on World Bank (2012f).

Jobs are not just a by-product of economic growth. Jobs can be transformational, for three reasons. First is productivity: as more productive jobs appear and less productive ones disappear, efficiency rises. This is what makes them growth-enhancing. But in Pakistan, under a long-term decline in TFP, structural transformation has produced growth-reducing jobs (see chapter 2). Second are living standards: they can improve as long as income rises or poverty falls through steady and well remunerated employment, but living standards can deteriorate if people are trapped in low-income, low value-added, volatile jobs, as in Pakistan. Third is social cohesion: it can result from jobs, even informal jobs, that bring together people from different ethnic and social backgrounds.

Jobs that address all three dimensions can be transformational. But often this is far from the case, and with growth come tradeoffs in its job-enhancing impact. For example, jobs with high pay and benefits may be coveted by individuals, but they are less valuable to society if they are supported by government transfers or restrictive regulations, undermining the earnings or job opportunities of others. This is the case with jobs created by state enterprises, which often generate losses. Conversely, some jobs are intrinsically bad, like those that are underpaid. This is the case under typical forms of disguised underemployment in lagging industries that benefit from trade-restrictive measures. Policymakers have to look at different options to identify which transformational jobs most benefit their development priorities.

The following suggestions show possible types of good jobs within each of the three dimensions:

- *Productivity.* Jobs that are connected to global markets, located in functional cities, and are environmentally benign.
- *Living standards.* Jobs for the poor and women, even though they do not provide high-enough wages.
- *Social cohesion.* Jobs that give a sense of fairness, link to networks, or shape social identity.

### Should Pakistan's job-enhancing growth strategy have an urban focus?

The Pakistan government's Framework for Economic Growth identifies the need for policies to transform cities into engines of growth (Government of Pakistan 2011a).<sup>25</sup> Rising shares of services and, to some extent, manufacturing in a fast-growing economy are associated with the positive externalities of urbanization as the economy grows in sophistication through high productivity jobs and connectedness. In a virtuous circle, it is possible to link urbanization, agglomerations, high productivity jobs, and green manufacturing growth to infrastructure services.

But urbanization and agglomerations are not the same. Urbanization is a physical concept while agglomeration is economic. People may take advantage of agglomerations without living in cities when other ways to connect and exchange information are available (such as telecommunications and the Internet). But face-to-face exchange of information is also important, allowing labor and production to learn from each other and apply technological

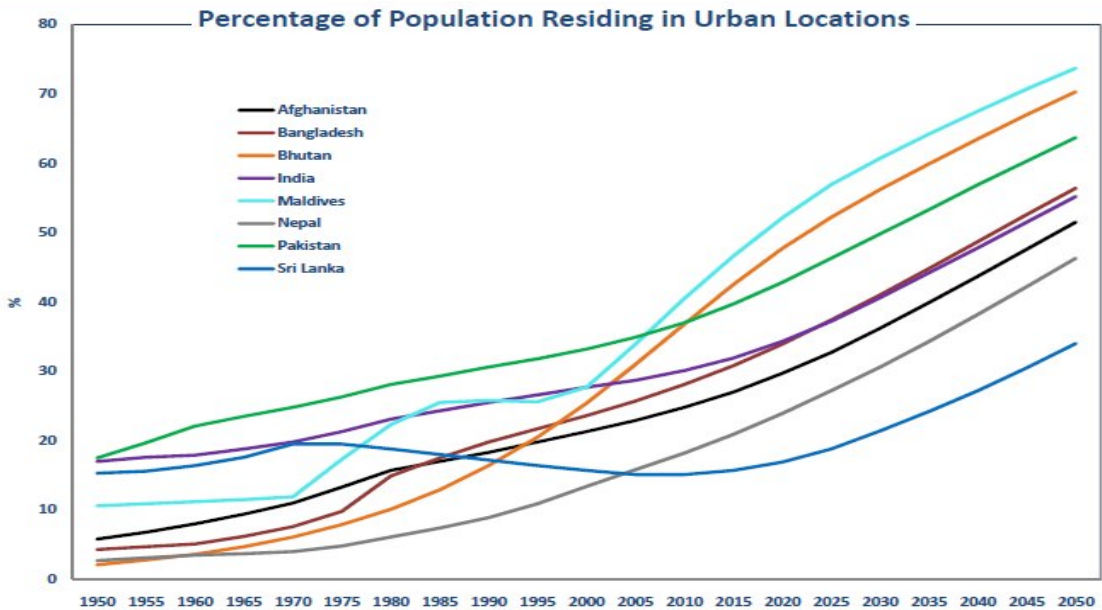
<sup>25</sup> This section is based in in Biller and Sanchez-Triana (forthcoming) and Yuen (2012). The literature on cities is vast and recent. Fujita and Thisse (2002) and Florida (2002) are a few examples of good reviews. For applications to Pakistan, see Haque and Nayab (2007).

advances. By reducing transport costs—moving goods, people, and ideas—urbanization facilitates agglomerations, which enable highly productive jobs and economic growth. Agglomeration economies also help create international cities, concentrating manufacturing production and further facilitating services growth. And as cities catalyze agglomerations, and agglomerations attract migrants, cities are also important engines of employment and income gains. Most Pakistani men (61 percent) cite economic reasons as the main factors for migration (Arif and Hamid 2009). The average income of working men and women improves considerably after migrating to cities. Income data also reveal that gender differentials in incomes for urban areas are lower in urban areas than in rural areas.

But the benefits of agglomeration economies should not be oversold. While Pakistan is the most urban country in South Asia, its urbanization process pales compared with that in East Asian and Latin American countries. Cities like Karachi suffer from the bad externalities associated with urbanization, such as congestion, pollution, and crime. Pakistan seems to have reached its agglomeration potential without generating enough high-productivity jobs.

Pakistan's urbanization has been the fastest in South Asia, rising from 17 percent in 1951 to 33 percent in 1998 and 37 percent in 2010 (figure 5.5). By 2030 cities are likely to house about half of Pakistan's population, compared with 40 percent of India's. 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, a rate projected to continue for the next eight to nine years (Government of Pakistan 2011a). By 2015 Karachi's population could exceed 15 million, Lahore's 8 million, and Faisalabad's 3 million. The number of cities with more than 1 million people is projected to increase from 9 today to 17 in 2020 (Yuen 2012).

Figure 5.5 Urban population growth in selected South Asian countries, 1950–2050



Source: World Bank 2011f



City development is crucial to Pakistan's growth future prospects. The macroeconomic effect of Pakistan's cities might be well above those of other developing countries. In 2011 nonagricultural activities in Pakistan generated up to 78 percent of GDP—but not all of it from cities. In 2008 cities contributed 58 percent to India's GDP, while Latin America's 10 largest cities contributed more than 30 percent to national GDP, and China's 10 largest cities created about 20 percent of the country's GDP. Karachi, Pakistan's largest city, handles almost 95 percent of Pakistan's foreign trade and contributes about 20 percent to Pakistan's GDP and 30 percent to Pakistan's manufacturing sector (Yuen 2012).

But Pakistan's large cities face many challenges. An estimated 35–50 percent of urban dwellers live in of them *katchi abadis* (informal settlements). In Karachi 89 percent of them live below the poverty line. In absolute numbers Pakistan's major cities have an estimated 1.2 million street children (Government of Pakistan 1998, 2011a).

For Pakistan's cities to become more functional and improve their economic performance, they would need not only to raise economic growth but also to address quality of life. A good urban environment is a precondition for a good quality of urban life, critical for attracting and retaining people and businesses. The world's leading cities aim to be the best performing city, offering a better quality of life and attracting and retaining highly skilled, high-income earners. Major challenges facing Pakistani cities include inadequate land supply; expensive construction costs; a high housing gap, forcing many people to live in slums; unclear regulations for land and property market transactions; a substantial urban infrastructure gap; and outmoded planning.

**With industry relying on an export-led strategy to move from stagnation and with the rising demand for services associated with cities, should Pakistan also focus on agricultural extension?**

Pakistan cannot afford to ignore agriculture while trying to diversify manufacturing and expand services.<sup>26</sup> For growth to be high, inclusive, and job-enhancing, a dynamic agriculture sector also must play an important role.

Agriculture's direct contributions to the economy are measured through its share of GDP, its foreign exchange earnings, and its role in supplying savings and labor to other sectors. Agriculture also has strong links with other sectors. Its links to nonfarm activities (often services) and its inter industry links need to be consolidated to determine its real size and importance to the overall economy. Broad estimates of the GDP share of this “expanded” agriculture sector vary an additional 3–5 percentage points of GDP over its actual share of national GDP (Valdes and Foster 2010).

But agriculture's importance extends beyond its direct contributions to GDP (Valdes and Foster 2010). It also contributes more to reducing poverty 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. Despite a drop in national poverty, rural poverty has fallen more slowly than urban poverty, with poverty in rural areas twice that in urban areas. About half the rural poor are in nonfarm activities, and there is a close negative relationship between land ownership and rural poverty. Many of the rural poor are landless or own only small amounts of land. There is almost no poverty among farm households with more than a hectare of land. The highly unequal distribution of land exacerbates rural poverty. The Gini coefficient of land holdings in Pakistan, about 0.66, remained fairly constant over 1970–2000 (World Bank 2007a).

<sup>26</sup> This section is based largely on Ahmed and Gautam (forthcoming).

When the 63 percent of households that were landless in 2000 are accounted for, the Gini coefficient rises to 0.86, higher than that of other South Asian countries.

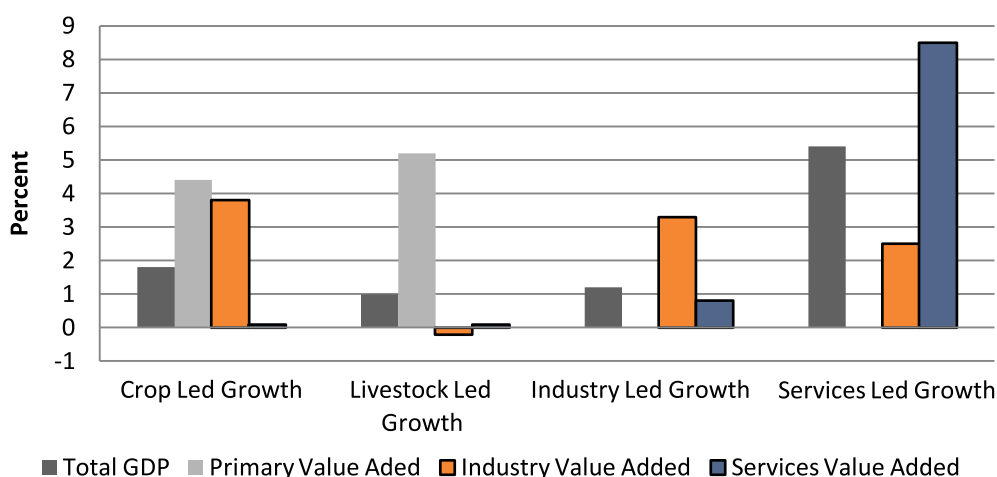
Pakistan's rural poverty and land rights regime impede rapid agricultural growth and job enhancement. Land is rarely bought and sold, solidifying the status quo of unequal land distribution. Land rental markets are highly inefficient. The low rate of land transactions is due largely to high transaction costs and prices in excess of the discounted value of potential agricultural earnings from the land (World Bank 2007a). Since the landless do not have access to credit—with land being the most commonly accepted collateral for formal loans—they are unable to generate financing to acquire land.

Pakistan's rapid population growth is expected to contribute to a steady rise in small farms, as land is divided into smaller plots for successive generations. In 1973 the average farm size was 5.3 hectares, and there were 1.1 million small (less than 2 hectare) farms. By 2000 the average farm size had shrunk to 3.1 hectares, and the number of small farms had more than tripled (Headey and others 2010; Hazell and others 2012). The evidence on the effect of declining farm sizes on land productivity is mixed. Some evidence suggests a negative but insignificant correlation between farm size and productivity (Kiani 2008). Small and large farms are more productive than medium farms. Small farms are associated with higher intensity and irrigation and large farms with capital-intensive production. Despite small farms' potentially higher productivity (higher output per cultivated unit of land)—perhaps through better access to technology and more intensive cultivation—the impact in household incomes may be limited by the restricted scope for diversification and little access to resources (Malik 2008).

Simulation analysis comparing the economic impacts of historical TFP growth with the impacts of more accelerated TFP growth suggests that agriculture-led growth can reduce poverty more than can non agriculture-led growth. Expanding the rural nonfarm sector helps create jobs and reduce poverty. The rural nonfarm sector tends to produce services for local markets. So if the local economy is growing slowly, this will be reflected in the nonfarm sector. Five counterfactual scenarios can test the sensitivity of Pakistan's economy to rapid growth through accelerated TFP growth in four broad sectors: crops, livestock, industry, and services (Debowicz and others 2012). In the first four scenarios TFPs rise 10 percent individually. So the first scenario increases TFP of crops only, the second of livestock only, the third of industry only, and the fourth of services only. The fifth scenario increases the productivity of all sectors simultaneously. The main results are:

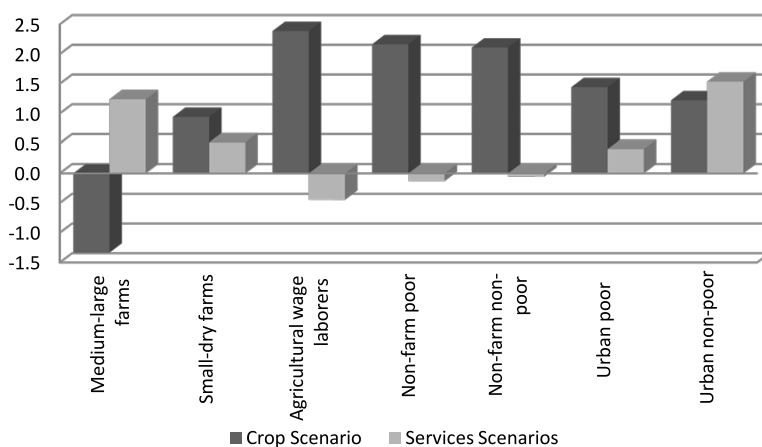
- TFP growth of 10 percent in services would lead to GDP growth of 5.4 percent; in crops, 1.8 percent; and in livestock, 1.0 percent (figure 5.6). The opposite occurs with poverty reduction. GDP growth originating in crop and livestock sectors tends to be more inclusive, though it does not generate faster growth than does an approach that targets services. GDP growth and poverty reduction from TFP improvements in industry are lower than those in services and agriculture.
- Because of the resulting decline in food prices, higher productivity growth for major crops results in larger per capita income growth for the urban poor, rural nonfarm households (poor or not), and rural wage laborers than does growth led by productivity improvements in services (figure 5.7). This suggests that investment strategies that focus on non agriculture services, while ignoring the positive spillover effects on rural nonfarm and urban populations of productivity gains from major agricultural crops, are less pro-poor.

**Figure 5.6 Growth in GDP and value added by broad sector due to total factor productivity improvements of 10 percent in sectors**



Source: Debowicz and others 2012.

**Figure 5.7 Distributional impacts on per capita incomes of GDP growth of 1 percent originating from the crop sector versus services sector**



Source: Ahmed and Gautam (forthcoming), based on the results of Debowicz and others (2012).

## How much stabilization and structural reform are needed during the sudden stop of financing inflows?

Managing macroeconomic policies during a sudden stop in inflows of external financing is like sailing a ship during a storm: the primary concern is to maintain stability until the storm ends.<sup>27</sup> This involves policy in the short- and medium terms. In the short term severe cuts in government spending to cover debt amortization may generate political disarray that could seriously worsen policy credibility and raise rather than lower Emerging Markets Bonds Index (EMBI+) spreads

<sup>27</sup> This section is based on Calvo and Ottonello (forthcoming).

measuring country risk. Coming elections would likely heighten the credibility problem of such adjustment, especially with the likelihood that short-run fiscal austerity will slow growth, thus worsening the fiscal deficit and aggravating debt rollover difficulties. Pakistan is unlikely to prevent high inflation or a balance of payments crisis in the short run unless it gets credit lines from international financial institutions large enough to solve the debt rollover problem during the first years of the new administration. These credit lines will come with strong conditionality to ensure a sustainable fiscal stance and higher policy credibility.

### *Policies in the short term*

Fiscal deficits and inflation are closely linked in Pakistan. Analysts have not only attributed the rise in inflation to the fiscal imbalances, but they have also argued that fiscal adjustment would be a main policy tool to reduce inflation (see, for example, IMF 2012a). A drastic fiscal adjustment might not be the sole instrument to reduce inflation by 5 percentage points in the short term, for two reasons. First, the fiscal adjustment needed to reduce inflation is probably too high. The fiscal deficit would need to contract by about 3.6 percent of GDP, which if no other measures are considered would translate into a 23.6 percent reduction in primary expenditure. If feasible, such a reduction in government spending would almost certainly increase social tension and political instability. Second, the rise in inflation that Pakistan felt after the global financial crisis was related largely to the currency depreciation typically observed during financial crises in emerging markets. And the inflationary spike was transitory. When output recovered, inflation returned to its precrisis level: since July 2012, inflation has been in the single digits.

The sudden stop and virtual lack of access to international credit markets and official external financing might make current policy unsustainable in the medium term. The decline in international reserves since June 2011 risks becoming a full-fledged balance of payments crisis if left untreated. The rise in the fiscal deficit alone cannot explain the acceleration in credit to the government: excluding one-off registration of power liabilities, the fiscal deficit in fiscal 2012 has been broadly similar to that of fiscal 2011. But due to the lack of access to external borrowing, and associated problems in rolling over outstanding debt, the share of financing of fiscal deficits by banks has risen from 33 percent in fiscal 2011 to 53 percent in fiscal 2012. And bank financing of fiscal deficits can explain only a minor fraction of the contraction in international reserves. More than three-quarters of the rise in bank credit to the government is linked to problems in rolling over or repaying external debt.

Trying to fix rollover problems through fiscal austerity alone could be counterproductive. Debt rollover problems are also rooted in credibility factors unlikely to be remedied by measures that increase social tension and political instability. Serious consideration should be given to extending loans from multilateral institutions that allow Pakistan to rollover its external debt, even if the private sector is reluctant to follow suit. Given that some degree of fiscal consolidation to ensure debt sustainability is not hard to achieve in the medium term, strong liquidity support from international financial institutions is likely to generate a positive response from the private sector and lower Pakistan's need to draw from the multilaterals.

Another reason for multilateral institutions to extend loans would allow Pakistan to rollover or repay its external debt is the positive effect that domestic bank financing of fiscal deficits can have on bank credit to the private sector. Under a sudden stop, credit to the public sector is likely to crowd out credit to the private sector, slowing recovery of output and employment. Empirical findings show that a statistically significant crowding-out effect occurs when domestic credit flows to the public sector rise.

A fiscal adjustment is unavoidable, however, and except for the intricacies of power subsidies, fiscal consolidation does not appear too hard to achieve in the medium term. Two real interest rate scenarios are analyzed: one with a positive rate of about 4 percent (the average EMBI+ yield) and another with a negative rate of about -4.4 percent (as in IMF 2012).

The paths of the ratio of public debt to GDP differ dramatically in these two scenarios: the ratio decreases in the negative interest rate scenario and increases without bound in the emerging markets real interest rate scenario. So, unless real interest rates are negative—a highly unrealistic scenario—under the current primary fiscal balance, the public debt to GDP ratio would take an increasing and boundless path. Strengthening the primary fiscal balance (by raising revenues or phasing out energy subsidies or wasteful spending, for example) is necessary to avoid an explosive path of public debt.

Strengthening the fiscal balance is likely to help Pakistan's economy in at least two additional ways. First, it would help build up international reserves. Reinforcing the international liquidity position may lower the still extraordinarily high interest rate spread, as measured by the EMBI+. Second, a stronger fiscal position can make it more likely for Pakistan to obtain sizable external credit lines. Additional external financing would help to relieve the private sector's costly crowding out of credit, which likely constitutes a major roadblock for output and employment recovery.

### **What policies should Pakistan definitely avoid to accelerate growth and job enhancement?**

Bad ideas tend to infiltrate growth strategy debates. The World Bank (2008a) provides a simple account of policies that often sound promising but ultimately lead to high costs and become hard to eliminate. A list measuring their status (or risk of introduction) in Pakistan is presented below.

- *Subsidizing energy (except for very limited subsidies for highly vulnerable sections of the population).* Pakistan spends more than 2 percent of GDP in untargeted and regressive power subsidies—the main reason for the fiscal disarray. They should be gradually phased down, with special provisions for protecting low-income consumers.
- *Imposing price controls to stem inflation.* Pakistan has direct price controls on energy (fuels and power), water, and wheat. Prices are adjusted regularly, and adjustments should continue until full cost recovery is reached.
- *Reducing fiscal deficits by cutting infrastructure investments (or other social spending that yields large social returns in the long run).* The government acknowledges that some public investment has been of bad quality and has streamlined its investment program. But the current level is so low, and the infrastructure gap so large, that reversing its declining trend while promoting quality is desirable.
- *Allowing the exchange rate to appreciate excessively before the economy is ready for the transition to higher productivity industry.* Despite double-digit inflation, Pakistan has not let its currency appreciate significantly in real terms. But strong remittance inflows could be exerting pressure on the rupee to appreciate.
- *Providing open-ended protection of specific sectors, industries, and firms.* Such protection is a major obstacle to competitiveness. If support is provided, it should be temporary. Pakistan has not recovered from the “protectionist move” that deepened existing privileges to industry and agricultural businesses. Removing this protectionism is a major challenge for the next administration.

- *Dealing with unemployment by relying on the civil service as an employer of last resort.* This is distinct from public works programs that provide a valuable safety net. Pakistan appears to be facing this risk, especially in provincial governments and even more so if military service is included. A peace dividend would favor programs for the training and transitioning of former soldiers into productive activities.
- *Underpaying civil servants relative to what the market would provide for comparable skills and promoting with seniority instead of performance.* Pakistan suffers this acute problem at both ends of its civil service categories. Unifying perks and moving into performance-based promotions would mitigate this risk—an initial step into civil service reform.
- *Resisting urbanization, underinvesting in urban infrastructure, and ignoring environmental issues that are an “unaffordable luxury.”* This is a serious risk already facing provincial governments, which are shifting the resources gained from devolution into wages rather than into urban infrastructure needs.

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