

ISLAMIC REPUBLIC OF PAKISTAN

LEVELING THE PLAYING FIELD

Systematic Country Diagnostic

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South Asia

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Glossary

| | |
|--------|---|
| ACD | Additional Custom Duties |
| AD | Aviation Division |
| BISP | Benazir Income Support Program |
| BORs | Board of Revenues |
| BRT | Bus Rapid Transit |
| CAD | Current Account Deficit |
| CBN | Cost of Basic Needs |
| CCI | Council of Common Interests |
| CCT | Conditional Cash Transfer |
| CDMP | Circular Debt Management Plan |
| CDNS | Central Directorate of National Savings |
| CGT | Capital Gains Tax |
| CPEC | China-Pakistan Economic Corridor |
| CPF | Country Partnership Framework |
| CPI | Consumer Price Index |
| DFI | Development Finance Institutions |
| DISCOs | Distribution Companies |
| DMO | Debt Management Office |
| DPCO | Debt Policy Coordination Office |
| EAD | Economic Affairs Division |
| EDL | Essential Drugs List |
| EF | External Finance |
| EFF | Extended Fund Facility |
| EFS | Export Finance Scheme |
| EOBI | Employees Old-Age Benefits Institution |
| EU | European Union |
| FATA | Federally Administrated Tribal Areas |
| FATF | Financial Action Task Force |
| FBR | Federal Board of Revenue |
| FEI | Food Energy Intake |
| FFC | Federal Flood Commission |
| FLFP | Female Labor Force Participation |
| FRDLA | Fiscal Responsibility and Debt Limitation Act |
| FWO | Frontier Works Organization |
| GBV | Gender Based Violence |
| GCI | Global Competitiveness Index |
| GDP | Gross Domestic Product |
| GENCOs | Generation Companies |
| GST | General Sales Tax |
| GSTS | General Sales Tax on Services |
| GVCs | Global Value Chains |
| HCI | Human Capital Index |
| HOI | Human Opportunity Index |
| HIES | Household Integrated Economic Survey |
| ICT | Information and Communications Technology |
| IPP | Independent Power Producer |

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| IMF | International Monetary Fund |
| IRSA | Indus River System Authority |
| INDC | Intended Nationally Determined Contribution |
| KAIRP | Katchi Abadi Improvement and Regularization Program |
| KP | Khyber Pakhtunkhwa |
| LAR-MIS | Land Administration and Revenue Management Information System |
| LFS | Labor Force Survey |
| LG | Local Governments |
| LLC | Limited Liability Company |
| LNG | Liquified Natural Gas |
| LRMIS | Land Record Management Information System |
| LTFF | Long-Term Financing Facility |
| MC | Market Committees |
| MENA | Middle East and North Africa |
| MIS | Management Information System |
| MTDS | Medium Term Debt Strategy |
| MoE | Ministry of Energy |
| MoF | Ministry of Finance |
| NADRA | National Database and Registration Authority |
| NCL | National Construction Limited |
| NEPRA | National Electric Power Regulatory Authority |
| NFC | National Finance Commission |
| NFC-MC | National Finance Commission Monitoring Committee |
| NHA | National Highway Authority |
| NIFMIS | National Integrated Financial Management Information System |
| NLC | National Logistics Cell |
| NOC | No-Objection Certificate |
| NRA | National Regulatory Agency |
| NSER | National Socio-Economic Registry |
| NWP | National Water Policy |
| NTN | National Tax Number |
| OD | Open Defecation |
| OPP | Orangi Pilot Project |
| PBM | Pakistan Bait-ul-Maal |
| PBS | Pakistan Bureau of Statistics |
| PCAA | Pakistan Civil Aviation Authority |
| PCRWR | Pakistan Council of Research in Water Resources |
| PDHS | Pakistan Demographic and Health Survey |
| PFM | Public Financial Management |
| PIA | Pakistan International Airlines |
| PIHS | Pakistan Integrated Household Survey |
| PIT | Personal Income Tax |
| PMT | Proxy Means Testing |
| PPP | Public-Private Partnership |
| PR | Pakistan Railways |
| PRSP | Poverty Reduction Strategy Paper |
| PSC | Public Sector Companies |
| PSDP | Public Sector Development Program |

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| PSLM | Pakistan Social and Living Standards Measurement |
| RECP | Resource Efficient and Cleaner Production |
| REER | Real Effective Exchange Rate |
| SBP | State Bank of Pakistan |
| SCD | Systematic Country Diagnostic |
| SDGs | Sustainable Development Goals |
| SECP | Securities and Exchange Commission of Pakistan |
| SLIC | State Life Insurance Corporation |
| SMEs | Small and Medium Enterprises |
| SOEs | State-Owned Enterprises |
| SRO | Statutory Regulatory Order |
| SSA | Sub-Saharan Africa |
| T&D | Transmission and Distribution |
| TFP | Total Factor Productivity |
| TSA | Treasury Single Account |
| UIPT | Urban Immovable Property Tax |
| WAPDA | Water and Power Development Authority |
| WASH | Water Sanitation and Hygiene |
| WBG | World Bank Group |
| WDI | World Development Indicators |
| WeT | Waseela-e-Taleem |
| WEF | World Economic Forum |
| WGI | World Governance Indicators |
| WHO | World Health Organization |

KEY MESSAGES

Since the turn of the century, Pakistan has made good progress on poverty reduction, but has faced recurrent macroeconomic crises and is lagging in human capital development. Despite experiencing short spells of faster growth, Pakistan has been unable to achieve sustained economic growth and has repeatedly faced macroeconomic crises. Moreover, Pakistan's growth cycles tend to be consumption driven with investment and exports not contributing substantively to growth. On the human development front, the country is yet to achieve basic goals in health and education, with stark implications in terms of productivity growth and socioeconomic inclusion. But these shortcomings notwithstanding, Pakistan has made good progress on poverty reduction and approximately 46 million Pakistanis escaped poverty in the period 2001–15.

Currently, Pakistan is stuck in a development trap. *The thesis put forward in this SCD is that in Pakistan, the development of the key markets that regulate the allocation of productive factors (markets for land, capital and labor) has been stunted by an insider-outsider model of development.* In which, insiders that—for reasons of historical legacy—controlled higher original endowments of land, physical and human capital, did not have the incentives to support policies that could have addressed existing factor market imperfections because this could have diluted their economic, social and political power, and their grip over (state) resources. On the other hand, citizens who would have benefited from such reforms (outsiders) lacked the power (resources and political representation) to bargain for change. Essentially, in this framework, constraints to Pakistan's growth and prospects of poverty reduction – namely, low investment, weak fiscal management, and slow and unequal progress on human capital accumulation and (growth enhancing) structural transformation—can be ascribed to the lack of support for reforms that could have addressed inefficiencies in the land, capital and labor markets.

Change is necessary to bring Pakistan out of this trap. Pakistan's insider-outsider model lacks the potential to bring the country out of its low middle-income development trap. Consumption-led growth, with limited capital accumulation, declining productivity growth, and limited labor reallocation toward more productive sectors, will be insufficient to move Pakistan out of its structural boom-bust cycles. Moreover, without addressing the existing inequality of opportunities and systematic socioeconomic discrimination affecting women in Pakistan, the prospects for sustaining poverty reduction and increasing shared prosperity moving forward are limited. These challenges are further exacerbated as the country grapples with the socio-economic consequences of the COVID-19 pandemic.

This SCD identifies two priorities for Pakistan to achieve this: increasing competitiveness and promoting equity and inclusion. Policies aimed at *leveling the playing field*, i.e., policies that change (directly or indirectly) the distribution of power in the policy arena, are needed to address the distortions associated with the insider-outsider dynamics. Actions aimed at leveling the playing field can be summarized under two complementary pillars: one involves tackling issues around competitiveness (mainly macroeconomic instability, the poor business environment, and lack of competition) and the other requires addressing constraints around equity and inclusion (specifically low agriculture sector productivity, limited financial inclusion, poor livability of cities, barriers faced by women, and inefficiencies in public spending). The theme of institutional strengthening will be cross-cutting across each of the two pillars. These priorities remain key to Pakistan's development as the country addresses and recovers from the challenges brought about by the COVID-19 pandemic.

SUMMARY

This Systematic Country Diagnostic (SCD)—the first to be conducted in Pakistan—is aimed at informing Pakistan’s ongoing structural reform process and providing an analytical base for the World Bank Group’s (WBG) engagement moving forward. It presents a timely and evidence-based assessment of the constraints that the country needs to address, and the opportunities that it can embrace, to sustainably accelerate progress toward the goals of ending extreme poverty and promoting shared prosperity. The SCD, while focusing on developments in the past two decades, builds on the extensive analytical work conducted under the “Pakistan@100 – Shaping the Future” study and reflects inputs from the WBG’s previous and ongoing stakeholder consultations. This SCD was completed before the COVID-19 pandemic struck, and the analysis presented in the report primarily uses data released up till end-February 2020.

Whenever relevant, socio-economic developments associated with the COVID-19 pandemic are discussed based on available information. While more in-depth assessment of the macroeconomic and poverty impact will be prepared once new data become available, the structural challenges and priorities for reform identified in the SCD remain valid.

Existing trends in growth and human capital development restrict Pakistan’s ability to sustainably reduce poverty and increase shared prosperity over the long term

Over the past two decades, Pakistan has struggled to sustain economic growth, with short spells of faster growth regularly followed by crises. On average, Pakistan’s real per capita GDP growth rate between 2000 and 2018 was only 2.1 percent, substantially below the performance of other countries in the region. Pakistan’s growth is fueled by consumption, which on average has accounted for more than 90 percent of total GDP since 2001. This growth in consumption has been driven mainly by population growth and remittances. As a result, Pakistan’s short-lived high growth cycles are propelled by increases in consumption at a pace greater than the increase in the supply of goods and services, prompting higher imports, which in turn leads to unsustainable current account deficits. Most recently, this occurred in 2018 and the authorities’ entered into a 39-month, US\$6 billion Extended Fund Facility (EFF) arrangement with the IMF in July 2019 to address the country’s fiscal and external imbalances. Prior to the onset of the COVID-19 pandemic, Pakistan’s economy was gradually recovering from this crisis. However, the pandemic and its related containment measures led to a collapse in economic activity post-March 2020. As a result, real GDP growth in FY20 is estimated to have contracted for the first time since 1961. With fears of a second wave in the latter part of 2020, uncertainty weighs heavily on next year’s growth outlook.

Declining levels of private investment and low productivity growth limit Pakistan’s growth prospects to between 2.5 and 3.0 percent a year. Private investment as a percentage of GDP has declined over the past two decades, from an average of 11.7 percent in the 2000s to around 10.0 percent over the past nine years. Net foreign direct investment has been ever lower, averaging 0.8 percent of GDP over the last decade and concentrated in select sectors (telecoms, oil and gas, and financial sector). As a result, the rate at which the stock of capital per worker grows—capital deepening—has been declining in Pakistan. Lack of capital deepening is associated with a slowdown in labor productivity in Pakistan, which has grown at an average rate of 1.5 percent annually since 2000, compared with growth rates of 5.0 percent in India and 4.4 percent in Bangladesh over the past two decades. In addition, growth of total factor productivity

(TFP)—the efficiency with which capital and labor are used to produce goods and services—in Pakistan is also on a declining trend.

Pakistan’s exports are low and contribute little to overall growth. In 2018, Pakistan’s exports as a share of GDP were only 9.6 percent, compared with an average of 24.7 of GDP for lower middle-income countries and 18.4 percent of GDP for South Asia. During the period 2003–17, the country’s exports of goods increased, on average, by only 4.3 percent annually. In the same period, Vietnam’s exports grew by an average 18.4 percent per year. Overall, Pakistan’s main export destinations and top export products are highly concentrated, primarily in cotton, with agricultural-based products mainly going to regional destinations. In FY20, the COVID-19 pandemic related disruptions in trade flows adversely impacted Pakistan’s already struggling exports. Moreover, with an uncertain global growth outlook—Pakistan’s exports will face a hostile environment in the near-term.

Pakistan has experienced a slow and “gendered” structural transformation. Agriculture, which contributes only 20 percent of GDP, employs 40 percent of the total labor force—on a par with services, which contributes 57 percent of GDP. Barriers to women’s socioeconomic inclusion, limited human capital endowments, and constraints to private sector development have muted structural transformation and labor productivity growth. Expansion of job opportunities in the service and industry sectors has mostly benefited male workers, who were able to take advantage of employment opportunities originating in urban areas and outside the agriculture sector. On the other hand, women—whose mobility, education and labor force participation are traditionally constrained by cultural norms—have been mostly unable to take advantage of job opportunities in more dynamic sectors of the economy.

Job creation outside the agriculture sector has been accompanied by urbanization and an expansion of the informal sector. Employment opportunities in services and industry are being generated mostly in urban centers, which have attracted an increasing number of male migrants from rural areas. Underlying migration trends have made Pakistan one of the most urbanized countries in South Asia. Expansion of off-farm employment opportunities has gone hand in hand with the expansion of the informal sector, which has compensated for anemic formal private sector growth. According to Labor Force Survey (LFS) data, of the 15.7 million jobs generated outside the agriculture sector over the period 2001–17, three out of four jobs were generated in the informal sector. In 2017, four out of five individuals working in the private sector were either working as own account workers, or working as employees or employers in micro-enterprises. Lacking any form of social protection, workers in the informal sector are likely to have been affected the most by the COVID-19 crisis.

Increased employment opportunities outside the agriculture sector have been the major driver of poverty reduction. In 2015, according to the latest available household survey data, 24.3 percent of Pakistan’s population was living below the national poverty line, down from 64.3 percent in 2001. In fact, Pakistan is the most successful South Asian country in transforming GDP growth into poverty reduction, and one of the most successful among lower middle-income countries. The observed progress in poverty reduction is largely accounted by the expansion of male off-farm economic opportunities in the informal sector and the increase in out-migration and associated remittances. However, while Pakistan almost eradicated extreme poverty in 2001–15, about one-third of Pakistanis still live below the minimum living standard typical of a lower middle-income country.

Education has been an important enabler of socioeconomic mobility. As job opportunities increased in the off-farm informal sector, individuals with higher human capital were best placed to take advantage of them, and to do so in a more productive way. As those with higher human capital endowments were gradually able to escape poverty, so the profile of the poor became much more homogeneous over time. Compared with 2001, present-day poverty is increasingly concentrated among workers in the agriculture sector and among individuals with no education.

Growing inequality poses a challenge to the sustainability of poverty reduction moving forward. During the period 2001–15, welfare levels improved for all Pakistanis in absolute terms leading to poverty reduction. However, opportunities for socioeconomic mobility were not equally distributed. Relatively more well-off segments of the population, which could rely on higher human and/or physical capital endowments, benefited the most from the economic opportunities created by growth. As a result, inequality widened, and shared prosperity declined over time. These patterns suggest that Pakistan’s progress in poverty reduction might be running out of steam and that, unless closer attention is devoted to addressing structural inequalities and barriers to socioeconomic mobility, the gains achieved over the past two decades could be at stake. With lockdown measures having severely affected the off-farm sectors (providing livelihoods to the poorer and most vulnerable segments of the population) and in consideration of the overall slump in internal demand, poverty is expected to increase for the first time in the last two decades.

Pakistan has still to achieve basic developmental goals in health and education, with stark implications for productivity growth and socioeconomic inclusion. While its young population could become its most important asset, human capital development in Pakistan lags far behind. Pakistan ranks 134th out of 157 countries on the Human Capital Index. It has the highest rate of under-five child mortality in South Asia and the fifth highest among lower middle-income countries. At the current rate of progress, Pakistan is expected to miss the Sustainable Development Goal (SDG3) of bringing under-five child mortality below 25 per 1,000 live births by 2030. Moreover, at 37.6 percent, the incidence of stunting among children under five in Pakistan remains worryingly high. With regards to education, Pakistan has an estimated out-of-school population of 20 to 25 million and education outcomes in the country lag significantly compared with regional peers.

The COVID-19 pandemic is expected to exacerbate Pakistan’s human capital challenges. The disruption of education services will disproportionately affect disadvantaged and hard-to-reach children, including girls and young women. On the health front, diversion of resources towards the fight of the pandemic, mobility restrictions and fear of contagion has significantly reduced access and demand of prenatal and postnatal services, and disrupted immunization efforts.

Inequality in access and low quality of public service provision in health and education has led to a growing role for the private sector in these sectors. Across districts, access to education and health services is lower in poorer districts, reinforcing the transmission of poverty and monetary deprivation over time. Limited physical access is further aggravated by the poor quality of service provision at existing facilities. Key issues in the health sector include unavailability of medical practitioners (doctors, nurses and midwives) and/or lack of inputs (equipment, drugs and supplies). In the education sector, poor maintenance of school facilities and issues related to teachers’ preparedness, qualifications, instructional quality and attendance are pervasive, especially in the public sector. Underperformance of the public sector provision of health and education has led to the private sector playing an increasingly important

role in the delivery of health and education services, but these are highly heterogeneous in terms of their cost and quality, and often exacerbate existing inequalities in public sector provision.

Growing risks to macroeconomic stability, social cohesion and environment sustainability endanger Pakistan's future growth

Pakistan's macroeconomic sustainability is threatened by periodic twin deficits, a growing debt burden and an erosion of external buffers. Pakistan's economic policies in the past have led to large fiscal and current account deficits (twin deficits). An uncoordinated intergovernmental fiscal architecture has resulted in a structural fiscal deficit and poses challenges to fiscal consolidation efforts between the federal and provincial governments. Financial support to state-owned enterprises (SOEs), which amounted to around 2.0 percent of GDP in FY19, is a major driver of the fiscal deficit. On the external side, an overvalued exchange rate that subsidized imports, and made exports more expensive and uncompetitive in international markets, resulting in large growing and trade deficits. In turn, this has contributed to declining foreign reserves, an erosion of external buffers and increased external borrowing. While the recent adoption of a market-based exchange rate and other demand-management policies have helped mitigate some of these issues, public and publicly guaranteed debt has witnessed a rapid increase in the past decade and stood at 88.8 percent of GDP at end-FY19. Liabilities accumulated by provincial governments against commodity operations, circular debt in the power sector and growing debt of SOEs also add to the Government's fiscal risks. It is with these weak fundamentals that Pakistan entered the COVID-19 pandemic, which is expected to compound macroeconomic pressures in the near-term.

Inequality of opportunity, particularly for women, and limited socioeconomic mobility poses serious risks to social cohesion in Pakistan. Opportunities to engage in, and benefit from, the development process are not equally distributed, and inter-generational mobility in education is low, with Pakistan ranking among the worst performing countries in both absolute and relative mobility. Girls and women in Pakistan are denied equal opportunities, even before they are born. Despite several initiatives to safeguard the interests of women by successive governments, Pakistan ranks 143rd out of 144 countries on the World Economic Forum's Global Gender Gap Index. Women are under-represented in the economic life of society and, with one of lowest female labor force participation rates in the developing world at 25 percent in FY17, Pakistan is failing to tap the economic potential of half its population. The COVID-19 crisis is expected to exacerbate pre-existing inequalities, particularly in terms of education opportunities though the depth and scope of these effects remains to be assessed.

There are growing concerns about environmental sustainability in Pakistan. The country's development model has failed to address the environmental challenges related to the unsustainable use of natural resources. High rates of population growth, the wasteful use of water in agriculture, rapid urbanization, and Pakistan's vulnerability to climate change raise risks for the depletion of water resources, increased air and water pollution, and a greater incidence of natural disasters. Poor water and air quality are also severely challenging the livability of Pakistan's major cities. The total cost of air, water and industrial pollution and occupational safety is estimated at 9.0 percent of GDP for 2016. Pakistan is ranked fifth on the Global Climate Risk Index of countries most affected by climate change between 1999 and 2018 and the country is increasingly vulnerable to natural hazards, particularly floods, cyclones and droughts. In the absence of adaptation measures and fundamental changes to Pakistan's growth model, climate change will compound existing environmental and development challenges.

An “insider-outsider” model of development has led to Pakistan being stuck on a path of stagnating growth and declining shared-prosperity

The fragility of Pakistan’s institutions—namely, the rules of the game governing interactions between citizens and the State—is the result of elite capture. As discussed in the World Development Report 2006 “Equity and Development”, institutions are not built in a vacuum but reflect self-reinforcing power asymmetries present in the economic, political and socio-cultural spheres. In Pakistan, the power of the elite(s) is rooted in the overlap of self-reinforcing asymmetries in the distribution of economic power (through the concentration of land and capital), social power (through the control of religious/sectarian or ethnic/kinship groups) and political power (through the control of state institutions and resources). The forces of elite capture noted in Pakistan@100: Shaping the Future¹ led to an “insider-outsider” model of development in which weak and captured institutions serve the narrow interests of the few (insiders), while they fail to provide universal opportunities for socioeconomic development to the many (outsiders). In fact, the provision of opportunities is mediated within a system of client-patron relations, which allows the elite(s) to maintain their hold on political power and economic resources. This perpetuates extractive institutions and power asymmetries in a vicious circle over time, while undermining the legitimacy and effectiveness of Pakistan’s formal institutions.

Pakistan is currently stuck in a development trap. *The thesis posited in this SCD is that the development of the key markets that regulate the allocation of productive factors (markets for land, capital and labor) has been stunted by elite capture.* More specifically, elites that—for reasons of historical legacy—controlled higher original endowments of land, physical and human capital (insiders), did not have the incentives to support policies that could have addressed factor market imperfections because this could have diluted their economic, social and political power, and their grip over (state) resources. On the other hand, citizens who would have benefited from such reforms (outsiders) lacked the power (resources and political representation) to bargain for change. As a result, by maintaining underdeveloped markets, the insiders have been able to extract resources from the state, which has further exacerbated inefficiencies and inequalities in the allocation and accumulation of productive factors. In this framework, the constraints that inhibit sustainable growth and challenge prospects of poverty reduction and shared prosperity can be ascribed to the lack of support for reforms that could have addressed inefficiencies in factor markets.

Inequality in the distribution of land has been at the root of Pakistan’s system of elite capture and of its reproduction over time. Despite three major land reforms during Pakistan’s history, the level of inequality in land distribution observed today remains very similar to the one that prevailed during British colonial rule. This inequality in land distribution and the associated landlord-tenancy institutions are at the heart of the development of Pakistan’s elite capture system. By providing patronage and public goods to their tenants, big landlords were able to secure political power and to preclude the development of effective policies for the “anonymous” provision of welfare by the State. Over time, through their influence on economic policies and collusion with other economic elites for the control of state resources, inequality in assets was perpetuated (if not expanded) and the clientelistic equilibrium reproduced.

Inefficiencies in Pakistan’s land management system create additional costs for investments. Land--recording institutions in Pakistan, despite multiplying, have been unable to keep pace with population

¹ (World Bank, 2019)

growth and urbanization. Over time, fragmented and incomplete land records have created ample opportunities for rent accumulation and clientelism by the elite, reducing incentives for efficiency and equity enhancing reforms. This has contributed to a lack of tenure security, and generated opportunities for insiders and barriers for outsiders, depressing overall investments. As records do not provide comprehensive coverage, land-rights related litigation is widespread. Since access to justice reflects economic and political inequalities, the lack of security in property rights has a differential impact on insiders and outsiders. For the former, it provides opportunities for rent extraction through deliberate fraud and the manipulation of land records; for the latter, it adds to projects' riskiness and overall cost.

These dynamics in Pakistan's land market have prevented an inclusive and efficient process of urbanization, which has ultimately contributed to the spread of informality. Service provision in urban areas is closely linked to the capacity of municipalities to raise revenues, to plan for cities' development, and to secure budget allocations from provincial budgets. In all three aspects, insiders' interest in maintaining their privileges, compounded by the weakness of the land management system, has contributed to the poor livability of Pakistani cities. It is estimated that the current housing shortage in Pakistan is about 10 million units, with about half in urban areas, where private sector developers, on average, supply only half of the formal housing units that would be required by population growth. This leaves the remaining half of housing demand to be produced through informal procedures without infrastructure, titling or planning. Over time, cities' development has witnessed a proliferation of high-end (gated) communities catering to the needs of insiders—*islands of efficiency* in which inhabitants pay private developers for service provision, rather than paying taxes to municipalities—along with a proliferation of under-served and environmentally unsafe informal settlements, in which outsiders pay private providers or middlemen to access services not provided by public providers (water tankers, illegal electricity connections, etc.). This expansion of informality in housing has also given rise to informality in businesses.

Capital accumulation in Pakistan has been shaped by the history of economic policies supported by the elite. In a perfectly competitive market, capital would flow to the most profitable investment projects, leading to productivity-led growth. However, in Pakistan, the elite (insiders) through their control of economic policies—including trade policies (import tariff protection), tax policies (tax expenditures), subsidies (subsidized credit) and direct intervention in input and output markets (price controls, licensing schemes, SOEs)—have distorted the allocation of capital in favor of sectors dominated by them, with significant negative distributional and efficiency implications. In the agriculture sector, state intervention has contributed to increasing the advantage of big landowners (insiders) at the expense of small farmers (outsiders), to environmentally unsustainable practices and, ultimately, to the sector's sluggish growth (productivity) performance. Similarly, in the industry sector, the State's intervention through tax and trade policies has created barriers to entry for new/smaller businesses (outsiders), shielded larger companies (insiders) from competition, and negatively affected exports and productivity growth.

Direct state intervention in key sectors of the economy through SOEs and market regulation has distorted the allocation of resources to the advantage of insiders. The Federal Government owns 206 SOEs with a combined output of 10.9 percent of GDP that employ fewer than half a million people. SOEs enjoy a dominant position in key sectors of the economy, such as energy (from upstream oil and gas exploration activities to downstream transmission and distribution of power), insurance (State Life Insurance Corporation), and road construction and transport (Pakistan International Airways and Pakistan Railways enjoy near monopolies in their segments). Entry into such sectors, particularly for firms not

enjoying political connections (outsiders), has been considerably impeded, as SOEs receive favorable treatment by regulators, preferential access to finance, and preferential access to government contracts. Similarly, the regulatory framework and institutional set-up regarding the establishment and operation of primary agricultural produce have contributed to strengthening the monopsonist power of licensed traders/middlemen, and expanded the scope of patronage by political and landed elites to the detriment of small farmers, and of a competitive development of marketing services and infrastructure.

The distortive impact of economic policies and the consequent economic advantage of insiders over outsiders have been reinforced by capital allocation through financial institutions. The Government's growing financing needs and policy-induced differential returns (and riskiness) of investments have contributed to distorting the allocation of commercial banks' credit in favor of insiders. Credit to the public sector in Pakistan has increased dramatically in recent years, both as a percentage of total credit extended by the banking sector and in absolute terms. In addition, limited private sector credit is primarily being intermediated to the corporate sector (which receives close to 71 percent of private sector credit), leaving other critical segments, such as SMEs, consumers, agriculture, etc., underserved. Even within the corporate sector, lending is significantly concentrated: 20 business groups in the country account for 30 percent of the banking sectors private sector lending portfolio and a mere 0.4 percent of bank borrowers account for 65 percent of all bank loans.

Pakistan's elites had little interest in supporting human capital accumulation, and investments in public education and health service provision have traditionally not been high on the policy agenda. In the absence of well-functioning credit markets, public sector provision of health and education is necessary for human capital accumulation, and so is public support for collecting and redistributing resources toward these sectors. In Pakistan, support for public investments in health and education was limited by the fact that elites have traditionally opted out of public service providers.

The quality of public provision of health and education services has been hampered by political patronage. Historically, subdued demand for skilled labor in the private sector has strengthened the monopsonistic power of the state with respect to the employment of educated professionals, increasing the scope for patronage. Political interference in the appointment of bureaucrats, teachers and doctors has a detrimental impact on performance, as clientelism and patronage reduce politicians' authority to monitor and effectively sanction service providers. Poor performance and absenteeism of teachers and medical practitioners (doctor, nurses, etc.) have traditionally been very high in Pakistan, reflecting the underlying incentives of service providers and the lack of electoral competition, particularly in rural areas.

A clientelist relationship between voters (outsiders) and politicians (insiders) has also prevented the full realization of efficiency gains from labor mobility. Labor mobility—particularly of less educated and poorer workers—has also been negatively affected by patronage in access to jobs and social protection (insurance and safety nets). First, the limited development of pensions and other forms of social insurance outside the public sector has increased the value of public versus private sector jobs and expanded the scope of clientelism. Second, until the recent modernization of safety nets with the introduction of BISP, the political discretionality in the allocation of (scarce) safety net resources, as well as the importance of social groupings (caste, kinship and *biradris*) in the allocation of labor market opportunities, has limited the scope for domestic migration, possibly explaining the low rate of inter-provincial labor mobility.

Pathways for a better future require a *leveling of the playing field*

Change is necessary to bring Pakistan out of its low middle-income development trap. The insider-outsider model is running out of steam and cannot continue indefinitely going forward. Consumption-led growth, with limited capital accumulation, declining productivity growth, an increasing debt burden, a heavy public footprint in the economy and limited labor reallocation toward more productive sectors, will be insufficient to move Pakistan out of its structural boom-bust cycles. Moreover, without addressing the existing inequality of opportunities and systematic socioeconomic discrimination affecting women in Pakistan, the prospects for sustaining poverty reduction and increasing shared prosperity moving forward are limited. These challenges are further exacerbated as the country grapples with the socio-economic consequences of the COVID-19 pandemic. There is a need to create opportunities for the renewal of the social contract allowing for greater inclusion, increased accountability, amplified voice and heightened citizen engagement. However, changing the underlying incentives that have shaped Pakistan's policies and institutions will not be easy, as shown by several failed attempts to reform in the past.

Fortunately, internal and external forces of changes are already at play. First, a technological revolution is underway. Not only has technology brought new players into the business arena operating in non-traditional/non-captured spaces but, if properly leveraged, technology can provide solutions for improving the performance of public and private institutions, as well as improving accountability and transparency. Second, Pakistan is urbanizing. As population growth and domestic migration bring more people to live and work closer to each other, the demand for formal (functioning) institutions, as opposed to informal relations-based institutions (moving from deals to rules), will increase. Lastly, recent changes in Pakistan's Constitution—notably the 18th Amendment—if properly supported through stronger institutions, can create the necessary foundations for greater political stability, coordination and, ultimately, for greater commitment to deliver in the interests of all Pakistani citizens. Equally important are the incentives for change coming from transnational rules. The country is facing a different authorizing environment on the international arena, which translates into a more coherent push toward the necessary structural reforms. Taken together, internal and external drivers of change create an enabling environment for elite bargains and help to expand the set of implementable policies.

This SCD identifies two priorities for Pakistan if it is to escape from its development trap: increasing competitiveness and promoting equity and inclusion. Policies aimed at *leveling the playing field*, i.e., policies that change (directly or indirectly) the distribution of power in the policy arena, are needed to address the distortions associated with insider-outsider dynamics. Actions aimed at leveling the playing field can be articulated under two complementary pillars: one involves tackling issues around competitiveness, and the other requires addressing constraints around equity and inclusion. The theme of institutional strengthening will be cross-cutting across each of the two pillars. Such priorities remain key to Pakistan's development as the country works towards addressing the challenges brought about by the COVID-19 pandemic.

i. Increase Competitiveness

Increasing the competitiveness of Pakistan's economic system is a key priority to unleashing the growth potential of the private sector – particularly as the country recovers from the COVID-19 pandemic. Increasing competitiveness will require: (i) supporting macroeconomic stability; (ii) improving the

business environment; and (iii) supporting competition. By tackling the constraints to competitiveness, the proposed interventions are also expected to address underlying distortions that form the basis of Pakistan's insider-outsider model.

Supporting macroeconomic stability through reforms in fiscal and debt management, and continued maintenance of a market-determined exchange rate. Frequent cycles of macroeconomic instability have dampened private investment in Pakistan. A weak fiscal architecture and poor budgetary planning add to Pakistan's fiscal weaknesses. Strengthening the institutional framework underlying fiscal management, with each tier of government working toward achieving common national objectives, is a pre-requisite to supporting macroeconomic stability. Similarly, debt management in Pakistan faces challenges related to fragmentation, lack of coherent planning and data availability. Addressing these gaps in debt management will help mitigate the long-term impact of the risks posed by Pakistan's growing debt levels on the economy. The COVID-19 pandemic has elevated Pakistan's fiscal and debt concerns, reinforcing the need for fiscal coordination and institutional strengthening. In the past, an overvalued exchange rate has adversely impacted Pakistan's economy and led to a decline in its export competitiveness, contributing to Pakistan's external imbalances. While some steps have been taken to improve fiscal discipline and debt management including legislation on budget management and the consolidation of debt functions, these are still nascent and need to be continued with sustained actions that are implemented to ensure greater transparency and arresting the ballooning public debt. Pakistan has recently transitioned to a market-determined exchange rate which, together with other structural reforms to improve exports, will help boost export competitiveness. Strengthening the institutional commitment to maintain such a regime, despite adverse macroeconomic conditions such as those created by the COVID-19 pandemic, will be important going forward.

Improving the business environment through regulatory reform. Over the past two years, the Government's commitment toward reforming the regulatory environment has led to an improvement in Pakistan's ranking on the WBG's Doing Business Report 2020, from 147 out of 190 countries to 108. But despite this recent progress, Pakistan's investment climate still fares poorly compared with regional and global comparators. Regulatory delivery and governance have become more fragmented following the 18th Amendment and devolution, as investors with operations across the country need to comply with five distinct regulatory regimes that are administered with limited coordination, often with overlapping jurisdictions. The multiplicity of regulations, their fragmentation across different levels of government, together with their ad hoc and mostly manual administration, exposes the system to rent-seeking behavior, which has served as a major deterrent to private investment in the country. Some important processes have been recently digitized as part of the ease of doing business reforms, however, the bulk of licensing and regulations are still paper based and need to be urgently digitized end-to-end. Continued commitment to these reforms will be critical in supporting the economic recovery post-COVID-19.

Strengthening institutions for interprovincial coordination on tax policy and reducing distortionary exemptions to create an enabling business climate. A complex and opaque tax policy regime increases disproportionately the cost of compliance for smaller businesses, discouraging the entry of new firms. The GST regime has fragmented Pakistan into five competing tax jurisdictions, creating high compliance costs for businesses. Businesses operating across the country need to submit 60 tax returns annually and sales tax refunds take an average time of 18 months. This fragmented nature of the tax base has resulted in double taxation, exporting of taxes to other provinces, tax evasion, and consequently extremely high costs of compliance for businesses, especially SMEs with a small capital base. Moreover, weak tax policy

formulation has led to large and distortionary exemptions, reducing the Government's tax collections while creating adverse incentives.

Improving energy sector performance, as well as providing transport and logistics infrastructure to support private sector growth and investments. The quality of infrastructure in Pakistan remains relatively poor. According to the WEF Global Competitiveness Index (GCI), Pakistan ranks 105th out of 140 countries in terms of the quality of its overall infrastructure. While the infrastructure investments that are being undertaken by the Government under the umbrella of the China-Pakistan Economic Corridor (CPEC) are an important step in bridging infrastructure gaps, it is estimated that Pakistan needs to ramp up its investment in infrastructure to over US\$30 billion (10 percent of GDP) annually if it is to sustain growth. To this end, given existing fiscal constraints, the Government needs to leverage resources from the private sector through public-private partnerships as well as advance capital market development. Moreover, infrastructure development needs to respond to growing environmental sustainability challenges, particularly with regards to water services. As outlined in Pakistan's Intended Nationally Determined Contributions (INDC), national adaptation priorities include the building of climate-resilient infrastructure with a focus on water-related and transport infrastructure. Pakistan also fares poorly with regards to digital infrastructure and the government needs to reduce barriers to internet usage, affordability and access across the country. In the energy sector, reducing the cost of electricity production (which in FY19 was about US\$ cents 9.2/kWh compared with an average of US\$ cents 4-8/kWh in neighboring countries), and reducing losses in transmission and distribution, while increasing the share of domestic low carbon sources of energy (hydro, solar and wind) in the total energy mix, will be crucial in stimulating investment and addressing the growing circular debt in the sector. The COVID-19 pandemic is expected to have added as much as US\$1.6 billion to the circular debt and reinforced the need for urgent reforms in the energy sector.

Supporting the development of an efficient and transparent market for land to unleash efficiency gains from urbanization. Province-wide digitization efforts are underway. In Punjab, the Record of Rights has been fully digitized while progress is ongoing in the remaining provinces. However, all provinces continue manual updating of the Record of Rights in the village and district offices of the board of revenues. Records for Urban Immovable Property Tax (UIPT) collection are mostly in digital form but suffer from coverage issues. Moving forward, Pakistan should adopt a policy and program for completion of comprehensive digitalization, standardization and integration of land records in all provinces by 2030.

Pakistan should reduce the anti-export bias of trade policy and promote green competitiveness. To facilitate integration into global value chains, countries have made efforts to reduce trade costs. Pakistan has not. Rather, trade policies have reverted to protectionism. In recent years, to reduce the trade deficit and/or increase revenues, import duties, including import tariffs and other taxes on imports, regulatory and additional customs duties (RD, ACD), have been increased, sheltering incumbent firms from international competition and encouraging them to sell domestically. The Government has already started undertaking corrective measures to reduce the anti-export bias of the national tariff policy. In the first instance, the Cabinet has adopted the National Tariff Policy (NTP), transferring responsibility for trade tariff setting from the Federal Board of Revenue (FBR) to the Ministry of Commerce, and simplifying and rationalizing the tariff structure. This is a very significant step toward making tariff policy a trade promotion instrument rather than a revenue-generating measure. Moreover, competitiveness gains could be achieved through a more coordinated support to green investments, particularly with respect to firms'

adoption of resource efficient and cleaner production technologies and practices. Creating an enabling environment for exports will critical to economic recovery post-COVID-19.

Improving SOEs' performance to facilitate competition in sectors where the State has a footprint. Market liberalization reforms in the 2000s and early 2010s reduced the State's footprint in the financial and telecommunications sectors and boosting competition and growth in these sectors. While progress on the privatization agenda has stalled in recent years due to political constraints, competition gains could still be achieved by strengthening the performance of SOEs through better governance. As a first step, SOEs should be fully compliant with the Securities and Exchange Commission of Pakistan's (SECP) 2013 Rules on Corporate Governance (CG) for Public Sector Companies. Moreover, the State's ownership and oversight function of SOEs is currently exercised under a decentralized institutional arrangement. The Government should develop an SOE ownership policy, which should lay down the principles and objectives of state ownership, and its role in the corporate governance of SOEs.

ii. Promote Equity and Inclusion

Promoting equity and inclusion is a key priority to sustain poverty reduction moving forward and to counter the negative impact of the COVID-19 crisis. Addressing barriers to inclusion and socioeconomic mobility, the proposed interventions can also contribute toward easing power imbalances that form the basis of Pakistan's insider-outsider model and, in the long run, improve contestability of the policy arena. Promoting equity and inclusion will require: (i) improving productivity in the agriculture sector; (ii) strengthening financial inclusion; (iii) making cities work for the poor; (iv) supporting women's socioeconomic empowerment; and (v) improving the efficiency and equity of spending on poverty reduction.

Unlocking growth in agriculture and its potential for boosting inclusion requires catering to the needs of small farmers and women as well as addressing environmental sustainability constraints. Agricultural production in Pakistan is increasingly dominated by farmers operating on less than 5 acres of land, with poor farmers operating on an average 5.5 acres of land. Over the past 15 years, the agriculture sector has been absorbing most of the increase in female labor force participation. While location and household characteristics contribute to making small farmers a highly heterogeneous group, some key constraints are common to all small farmers, notably: limited crop diversification, limited market access, low security of tenure, poor access to credit and limited ability to adapt to climate change and water scarcity. Such constraints are particularly binding for women small farmers, whose participation in non-subsistence/market activities faces cultural barriers that expose them to the risk of exploitation and further reduce the profitability of their businesses. In addition, adoption of climate smart technologies is key to improving productivity, and to addressing growing water scarcity constraints and climate change risks in the sector.

Deepening financial inclusion is key to supporting productivity growth of businesses operated by the poorest segments of Pakistan's population and to promoting greater resilience to shocks moving forward. Financial intermediation in Pakistan is bank-centric and focused on select market segments. Only 39 percent of credit in the rural and agricultural economy comes from formal channels, with 90 percent of SMEs relying on internal funds or informal channels for financing and only 11 percent of women having access to formal financial services by 2015. While Pakistan has taken some important steps in

implementing reforms and policies to promote financial inclusion in the country, progress is limited. Most importantly, Pakistan has yet to leverage the potential of digital finance, which has the potential to significantly enhance financial inclusion, particularly for women, by lowering costs, using data to ascertain creditworthiness of borrowers, and intermediating retail-level savings to small borrowers.

Tailoring of social protection interventions to the needs of the working poor in urban centers should become a priority to support labor mobility and to mitigate the welfare impact of shocks. The poor livability of Pakistan's urban centers affects the poorest segments of the population the most. Congested housing conditions and poor access to water and sanitation not only impact lives of millions of people on a daily basis, but have also contributed to the highest incidence of contagion in urban centers during the COVID-19 emergency. Moreover, as demonstrated in recent lockdowns, the predominance of informal sector jobs in urban centers have exposed workers, particularly poorest and most vulnerable ones, to the direst consequences of the crisis due to the lack of job security and of any form of social insurance. Addressing housing, access to services and protection challenges of the most vulnerable urban dwellers will not only promote greater mobility but also a more inclusive development of Pakistan cities.

Addressing supply-side constraints to girls' education and promoting socioeconomic inclusion of women through investments, particularly in the services sector. Prevailing social norms do not support women's involvement in economic activity outside their homes. Women tend to be employed in agriculture and home-based manufacturing activities, the low earning potential of which reinforces the low demand for girls' education, particularly in rural areas. The lack of girl-friendly schools further entrenches households' unwillingness to send girls to school. To address this, the Government should focus on supply-side interventions to increase the availability of female teachers and upgrade/maintain the quality of existing school facilities (functioning/separate toilets for girls, access to safe drinking water, the presence of boundary walls). In terms of employment, the growing labor demand in new sectors such as ICT and financial services can expand the range of socially acceptable options for women, as no gender-specific stigma is associated with women's employment in these sectors. However, harnessing the potential of the service sector's expansion in urban areas to increase female labor force participation requires addressing women's physical mobility and personal safety constraints.

Given existing fiscal constraints, improving efficiency and equity in spending is of paramount importance. With the 18th Amendment, responsibility for hitherto federal functions, including responsibility for education, health, the environment and agriculture, was transferred to the provinces and, together with that, much of the responsibility for the allocation of the Poverty Reduction Strategy Paper (PRSP) budget. However, inefficiencies in the devolution process have muted the pro-poor potential of this change. Improving the functional allocation of spending, better allocating responsibilities between the center and the provinces, and improving the targeting and transparency of spending on subsidies can help address some of these issues and help the country navigate the COVID-19 crisis. However, strengthening of data systems to develop a culture of evidence-based policymaking and accountability is key to achieving gains in efficiency and equity

Prioritizing and sequencing among suggested reforms will help pave the way forward

Based on the evidence presented thus far, the SCD identifies a set of priorities to sustain poverty reduction and boost shared prosperity. The SCD provides a framework to prioritize and sequence the reforms that will be required to move Pakistan onto a more sustainable and inclusive development path.

The SCD identifies four priority areas of reform: macroeconomic stabilization, energy sector reform, public governance and water management. Reforms in these three areas are prerequisites for successful implementation of structural reforms and policies in other areas. A stable macroeconomic environment is a prerequisite to support effectiveness of policies aimed at promoting investments and productivity growth. Similarly, energy sector inefficiencies need to be addressed to enable private sector competitiveness, as well as to curb their growing fiscal burden. Weak public governance, compounded by a deficit of accountability and transparency, has contributed to maintaining the status quo. Unless constraints to the public governance environment are addressed, reform efforts might not be effective. Lastly, the improvement and modernization of water management systems are critical to address the environmental challenges and water insecurity risks that undermine the sustainability of Pakistan's development. Such reform priorities directly address key structural constraints identified in the SCD and are expected to remain valid and possibly become even more urgent as the country navigates through the consequences of the COVID-19 crisis.

Structural reforms to improve macroeconomic stability should focus on institutional reforms to improve fiscal and debt management and empowering the central bank to act independently. In all these areas, key actions should focus on strengthening of institutions that can then plan and execute policies more effectively. A Macro-Fiscal Policy Unit should be established in the Ministry of Finance to provide sound, evidence-based policy advice and analytics, and to constrain the annual budget with a sustainable medium-term fiscal and budget framework, whereas the National Finance Commission Monitoring Committee (NFC-MC) should be tasked to form a national consensus on fiscal policy decisions that are binding on the federating units. The Government has begun consolidating mandates for public debt management into an integrated Debt Management Office (DMO) that implements a coherent and sustainable medium-term debt management strategy. The State Bank of Pakistan (SBP) Act should be amended to ensure the full operational independence of the SBP to conduct monetary policy, with price stability as its primary objective and maintain a market-determined exchange rate. Stronger institutions with clear mandates will reduce the room for use of discretionary powers by any individual/stakeholder and increase co-ordination and commitment from different tiers of government.

Reforms in Pakistan's energy sector should focus on implementation of the recently approved circular debt reduction plan, reducing the cost of generation, and improving transmission and distribution. The circular debt in the energy sector (recorded at 4.2 percent of GDP at end-June 2019) poses a significant fiscal risk to the Government. Under the current EFF, the Government will implement a circular debt reduction plan. These efforts should be supported by other reforms aimed at strengthening the National Electric Power Regulatory Authority (NEPRA), improving co-ordination and planning functions in the sector, reducing the high cost of electricity generation and losses in electricity transmission and distribution, and the elimination of unbudgeted subsidies to the sector. The Government should also rebalance the future energy-mix to reduce its dependence on expensive fossil fuels and to increase the contribution of indigenous, clean and green resources, particularly through private sector investments. Recently, the government has committed to increasing the share of domestic low carbon sources of energy (hydro, solar and wind) in the total energy mix to almost 70 percent by 2030.

Improving public sector governance in Pakistan entails reforms aimed at strengthening the 18th Amendment institutional framework, improving administrative efficiency, and strengthening transparency and accountability. The 18th Amendment has been an important first step toward addressing underlying fragility in Pakistan's state architecture. The next step should be to outline clear

and mutually agreed upon principles for the division of responsibilities and coordination between federating units. The key devolution organs, (the National Finance Commission [NFC] Secretariat, the Council of Common Interests [CCI], and the Council of Ministers) should be strengthened to effectively support devolution and the NFC formula be revisited to better align resource allocation with the achievement of development goals. The decentralization process should be completed through the establishment of elected local government authorities with fiscal decentralization to improve service delivery and increase accountability. Strengthening public administration is another important area of reform. Lastly, transparency in government processes, budget allocations and actual expenditures should be increased, and grievance redressal systems strengthened to develop social accountability.

Improving water management is key to ensuring Pakistan’s water security and the sustainability of development in the future. Pakistan is failing to make the best use of its water endowment. Extensive and unproductive water use in agriculture, coupled with poor water supply and sanitation add to the water security challenges already posed by population growth and climate change. Improved water-demand management, increased water-use efficiency, and enhanced economic productivity of water are key priorities for Pakistan’s development. While addressing some of these challenges requires sector-specific interventions, a more efficient management of water resources requires structural reforms aimed at strengthening monitoring and planning capacity at different levels of government. Efforts should be aimed at improving hydrometeorological monitoring, and data management and analysis, and at strengthening the capacity of institutions entrusted with these tasks. In addition, planning should be improved through the establishment of transparent and multi-stakeholder processes for water resources planning and allocation, both between provinces (basin-scale) and between sectors within each province. Lastly, given the growing problems of groundwater depletion in some areas, and waterlogging and salinization in others, efficiency and sustainability gains could be achieved through conjunctive planning and management of surface water and groundwater.

In addition to the four top priorities discussed above, additional areas for reform have been selected under each of the two pillars of increasing competitiveness and promoting equity and inclusion. These reforms have been selected on criteria that assess their ability to: (i) disrupt the insider/outside dynamics of Pakistan’s development model; (ii) have an impact on the twin goals; (iii) provides capacity to unlock wider positive change; (iv) can be implemented within five years; and (v) offer complementarity (the degree to which proposed interventions would have influence across different domains, such as growth, inequality and sustainability, and/or would magnify the positive impact of other interventions). This prioritization exercise identifies the following areas for reform (details of reform priorities are provided in Annex 1).

(i) Pillar 1: Increase Competitiveness

- Reforms in land management
- Improvements in tax policy and administration
- Simplification of the business regulatory environment
- Reduction of the anti-export bias in trade policy and promote green competitiveness

(ii) Pillar 2: Promote Equity and Inclusion

- Higher productivity and environmental sustainability of the agriculture sector
- Increased efficiency and equity of spending on poverty reduction

- Support for women's socioeconomic inclusion

Though reforms in some areas are likely to be met with strong resistance from the insiders, efforts should be devoted to raising awareness, improving transparency and mobilizing a wider coalition for change. Reforms in tax policy and administration, land management and agriculture remain difficult from a political-economy perspective. However, they are also a precondition to achieving effectiveness of other growth- and inclusion-related interventions. A conducive environment for these fundamental reforms can be created through greater awareness and mobilization of a wide set of stakeholders (civil society, media, etc.). Commitment problems could be also eased through greater transparency of the reform effort and support by international actors. Effective use of data and management information systems (MIS) can also be vital in enabling reforms and easing political-economy constraints, as in the case of improving the efficiency and equity of spending on poverty reduction. Meanwhile, reforms in certain areas (e.g., trade policy and business regulation) are low-hanging fruit for the Government that could be addressed with less political opposition. Benefits from these reforms will also begin to materialize more quickly and the Government can use this progress to build stronger momentum for change.

CONTEXT

Pakistan is a relatively newly established and populous country, one that is ethnically and culturally diverse with a large diaspora. The Islamic Republic of Pakistan (Pakistan) has a population of over 212 million as of 2018, making it the fifth most populous country in the world, the 33rd largest country in terms of surface area, and the 43rd largest economy in the world, with a per capita GDP of only US\$1,482 in 2018 (US\$5,567 in PPP), which ranked 132nd in the world.² Pakistan today comprises four provinces and one federal capital territory.³ Pakistan is a multi-ethnic country, with a mixture of six major ethnicities and numerous small ethnic groups. The three largest ethnic groups are Punjabi, Pashtun and Sindhi. Over 70 languages are listed as being spoken in Pakistan, although five main languages—Punjabi, Pashto, Sindhi, Saraiki and Urdu—are spoken by more than 10 million people each. According to the Ministry of Overseas Pakistanis and Human Resource Development, about 8.8 million Pakistanis live abroad, with the vast majority—over 4.7 million—residing in the Middle East. The second-largest community of overseas Pakistanis, at around 1.2 million, lives in the United Kingdom. According to the United Nations Department of Economic and Social Affairs, Pakistan has the sixth-largest diaspora in the world. In FY19,⁴ overseas Pakistanis sent remittances amounting to US\$22 billion (7.7 percent of GDP), according to the State Bank of Pakistan (SBP).

Over the past two decades, Pakistan has made significant progress toward security, democratic consolidation, and devolution. Since 2001, Pakistan has suffered a dramatic increase in violence, peaking in 2009 when the army intensified operations to control a militant insurgency from the Federally Administered Tribal Areas (FATA) in the North. After having paid a tremendous cost in terms of lives and resources,⁵ over the past five years the country has managed to successfully reduce the incidence of violence and achieve, in 2018, a political settlement with the 25th Amendment to the Constitution that integrates the former FATA—now Merged Areas—into the province of Khyber Pakhtunkhwa (KP). Since Independence, the country has had military and civilian governments in office for equal number of years. Since 2008, there have been three successive civilian governments led by separate political parties, indicating democracy is taking stronger root in the country.⁶ In recent years, the country has also made substantial progress toward devolving power to its provinces, settling—through the 18th Amendment to the Constitution, passed in 2010—the long-lasting struggle between supporters of a centralized state and supporters of a federal state. As part of the 18th Amendment, education, health, business regulations, standard setting on public services, land assets, and social protection services were moved from the Federal Government to the provinces. The 18th Amendment also provided provinces with the autonomy to decide on how they would structure local governments. The country is in the process of establishing intergovernmental institutions for collaborative management of the federation.

² World Development Indicators (accessed May 15, 2020).

³ The Federally Administered Tribal Areas (FATA) was a semi-autonomous tribal region in northwestern Pakistan that existed from 1947 until being merged with the neighboring province of Khyber Pakhtunkhwa (KP) in 2018.

⁴ The fiscal year in Pakistan runs from July 1 to June 30.

⁵ It is estimated that between 2001 and 2011 conflict claimed the lives of 35,000 people.

⁶ According to the ‘two-turnover test’ (Huntington, 1991), democratic consolidation is achieved when election winners (party or group) are peacefully changed in two consecutive elections after a transition.

While Pakistan has made good progress on poverty reduction, it has been characterized by recurrent macroeconomic crises and a poor record on human capital development. Over the past two decades, Pakistan has struggled to sustain growth, with short spells of faster growth regularly followed by a crisis. General macroeconomic instability has therefore given rise to repeated boom-bust economic cycles. As a result, on average, Pakistan's real per capita Gross Domestic Product (GDP) growth rate between 2000 and 2018 was only 2.1 percent, substantially below the performance of other countries in the region. Meanwhile, Pakistan has still to achieve basic developmental goals in health and education, with stark implications in terms of productivity growth and socioeconomic inclusion. While its young population could become Pakistan's most important asset, human capital development lags far behind its peers, with Pakistan ranking 134th out of 157 countries on the Human Capital Index (HCI). But these shortcomings notwithstanding, Pakistan has made good progress on poverty reduction: approximately 46 million Pakistanis escaped poverty in the period 2001–15⁷. From a poverty headcount of 64.3 percent in 2001, by 2015 poverty had more than halved, falling to 24.3 percent. In fact, Pakistan is the most successful South Asian country in transforming GDP growth into poverty reduction, and also one of the most successful among lower middle-income countries.

Before the COVID-19 emergency struck, the country was once again emerging from a macroeconomic crisis. The country entered into a 39-month, US\$6 billion Extended Fund Facility (EFF) arrangement with the IMF in July 2019 to address the latest boom-bust cycle.⁸ The focus of the government's latest adjustment program was to stabilize the economy by correcting the structural twin fiscal and current account deficits (CAD). In the first 9-months of FY20, the government was moving toward macroeconomic stabilization with the narrowing of the external and fiscal imbalances.

The COVID-19 pandemic has disrupted economic and social activity in Pakistan. As of August 2020, the country has registered almost 300 thousand verified cases and more than 6 thousand deaths due to COVID-19. To curtail the spread of the pandemic, the government took decisive steps at the pandemic's onset. A lockdown, which entailed closure of schools, markets and restaurants, a ban on religious/social gatherings, prohibition of movement across provinces and suspension of air travel and inter-city public transport was imposed at the end of March and remained in effect, with varying degree of enforcement, till the end of May. Currently, while all activities – with the notable exception of schools - have been allowed to reopen in observance of SOPs, localized (smart) lockdowns continue to be used to contain the spread of the pandemic, particularly in urban areas. The closure of all non-essential businesses and disruptions in global and domestic supply chains during the lockdown significantly affected the services and manufacturing sectors – which collectively account for nearly 80 percent of the total GDP. As a result, real GDP growth is expected to have contracted between 2.6 and 3.3 percent of GDP in FY20⁹.

In response to the pandemic, the government announced a fiscal stimulus package. The government's package of approximately US\$7.5 billion was targeted at supporting the health sector in combatting the

⁷ Estimates based on WDI population series which reflects latest 2017 Population Census and inter-census population growth rate.

⁸ Since becoming a member in 1950, Pakistan has had 22 IMF-supported economic bailout packages, 19 of which were provided after 1973. Based on available data, only two programs have been completed since 1988 (International Monetary Fund, 2002).

⁹ World Bank estimates. As per provisional estimates published by the Pakistan Bureau of Statistics, the economy is projected to have contracted by 0.4 percent in FY20.

disease, augmenting social welfare measures to support the poor and vulnerable households whose livelihoods have been impacted by the economic slowdown, and providing businesses and industries with the resources to protect their productive assets during the economic downturn. Federal and provincial authorities also introduced measures in the education sector to support continuity in education delivery¹⁰. Pakistan has also requested debt service suspension under the Debt Service Suspension Initiative (DSSI) and will use the fiscal space created through this initiative for additional social, health or economic spending. Additionally, the State Bank of Pakistan (SBP) announced multiple measures to provide liquidity support to firms affected by the pandemic¹¹.

While the lower demand for imports helped narrow the current account deficit, the government’s fiscal position worsened due to the pandemic. The disruption in international trade flows and low domestic demand led to imports contracting by -18.2 percent (Y-o-Y) in FY20. This helped narrow the CAD to around 1.1 percent of GDP (compared to 4.8 percent in FY19). However, efforts for fiscal consolidation very adversely impacted by the pandemic. Before COVID-19, the consolidated fiscal deficit was projected at 7.1 percent of GDP¹² but with an increase in COVID-19 related expenditures and subdued growth in tax revenues due to the collapse in economic activity, the fiscal deficit expanded to 8.1 percent of GDP in FY20. In the power sector, reduced demand, by 75 percent for commercial users and by 60 percent for industrial users, and the lower than expected recovery of receivables is expected to have added US\$1.6 billion to the circular debt. Due to the limited capacity to increase revenue collection from a contracting economy, the government has had to rely on external sources of financing to meet its financing gap.

The objective of this Systematic Country Diagnostic (SCD) is to inform ongoing structural reform process and to provide the analytical base for WBG engagement moving forward. This SCD—the first being conducted in Pakistan—presents a timely and evidence-based assessment of the constraints the country needs to address, and the opportunities it can embrace to accelerate progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable way. Spurring poverty reduction and inclusive growth are central themes of the SCD analysis, with concerted attention on issues of sustainability. The Pakistan SCD builds on the extensive analytical work and consultations conducted under the “Pakistan@100 – Shaping the Future” study, and it reflects inputs from ongoing stakeholder consultations (see Annex 2). As the World Bank Group (WBG) and the Government of Pakistan start working on the new Country Partnership Framework (CPF), this SCD suggests priorities for achieving a more sustained, sustainable and inclusive development process moving forward.

¹⁰ The Federal Government introduced the Teleschool initiative that broadcasts classes for Grades 1-12 through the state-owned Pakistan Television Network. In higher education, where possible, universities shifted to online modes of instruction.

¹¹ These include payment holidays on loan repayments (micro-finance and conventional), relaxation in the criteria for restructuring/rescheduling of loans, discounted refinancing schemes for firms providing medical equipment, and relaxation in collateral requirements and banks’ exposure limits for SME lending. To preserve employment, SBP has also introduced the “Refinance Scheme for Payment of Wages and Salaries to Workers”, directing commercial banks to provide refinancing at zero percent.

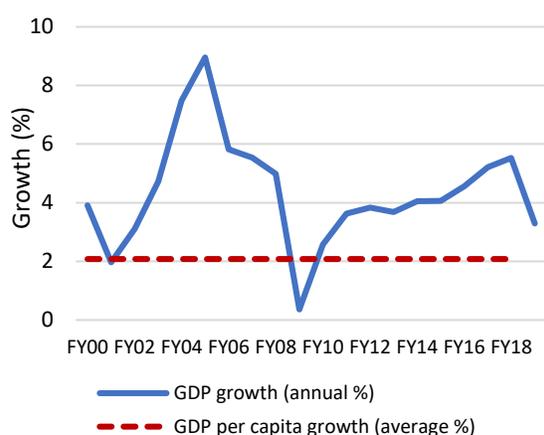
¹² Budget in Brief FY20, Ministry of Finance.

HOW DOES PAKISTAN FARE? THE GROWTH, POVERTY REDUCTION AND HUMAN CAPITAL STORY

Growth and Productivity Dynamics

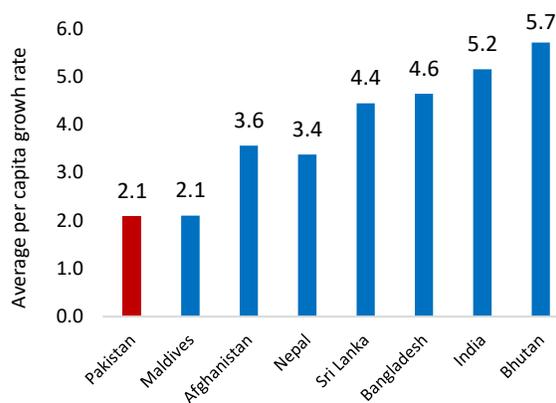
Over the past two decades, Pakistan’s growth has been low and volatile. Over the past two decades, Pakistan has not been able to sustain growth, with short spells of faster growth regularly followed by a crisis (Figure 1). On average, Pakistan’s real per capita GDP growth rate between 2000 and 2018 was only 2.1 percent, substantially below the performance of other countries in the region (Figure 2).

Figure 1: GDP growth, real terms



Source: World Bank staff elaboration on WDI and PBS data.

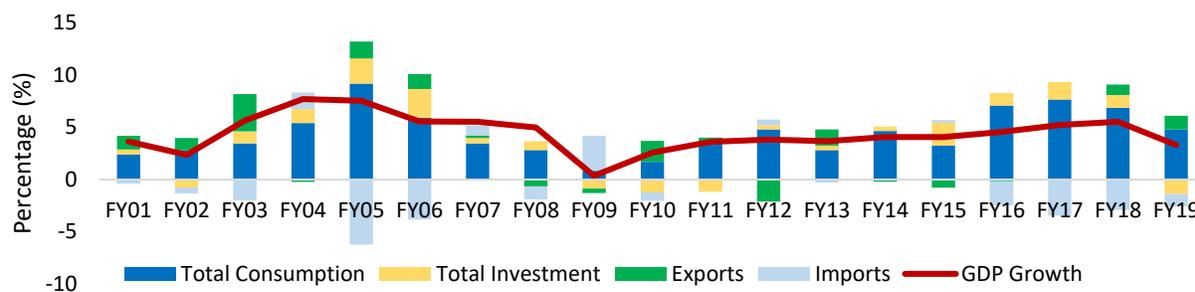
Figure 2: Average real per capita GDP growth (2000–18) in South Asian countries



Note: For Afghanistan, data are available from 2003 onward.
Source: World Bank staff elaboration on WDI data.

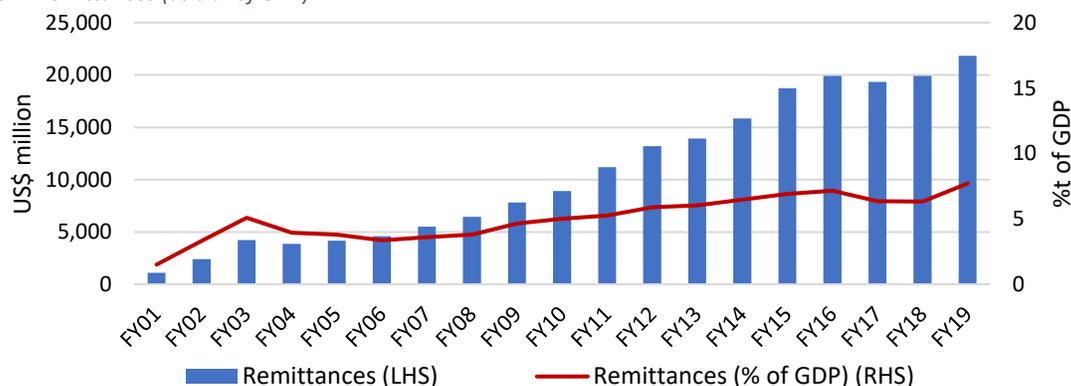
Pakistan’s growth is fueled by consumption. Consumption on average has accounted for more than 90 percent of total GDP and has been the main driver of demand-side growth since 2001 (Figure 3). Consumption has been driven mainly by population growth and remittances. Between 2000 and 2019, the population grew at a rate of 2.4 percent per year, whereas the working age population grew at an average rate of 2.8 percent per year in the same period. This has led to a gradual decline in the dependency ratio and an increase in household incomes, stimulating higher consumption. Remittances are an important source of consumption (Nabi, 2010) and amount to almost 8 percent of GDP. They increased fivefold between 2003 (US\$4.2 billion) and 2019 (US\$21.8 billion) (Figure 4). Pakistan’s short-lived demand growth cycles are propelled by increases in consumption at a pace greater than the increase in the supply of goods and services, prompting higher imports, which leads to unsustainable current account deficits.

Figure 3: Contributions to GDP growth of different demand-side components



Source: World Bank staff elaboration on PBS data.

Figure 4: Remittances (as a % of GDP)



Source: World Bank staff elaboration on SBP data.

Low private investment and productivity growth limit Pakistan’s growth prospects. Private investment as a percentage of GDP has declined over the past two decades, from an average of 11.7 percent in the 2000s to around 10.0 percent over the past nine years.¹³ As a result, the rate at which the stock of capital per worker grows—capital deepening—has been declining, in sharp contrast to the developments in peer countries such as India and Bangladesh, which show an increasing rate of capital deepening. Put another way, in Pakistan, new workers joining the labor force get equipped with the same stock of capital as existing workers, while in India and Bangladesh new workers receive more equipment than existing workers (Figure 5). Lack of capital deepening is associated with a slowdown in labor productivity in Pakistan, which has grown at an average rate of 1.5 percent annually since 2000, compared with growth rates of 5.0 percent in India and 4.4 percent in Bangladesh over the past two decades. In addition, growth of total factor productivity (TFP)—the efficiency with which capital and labor are used to produce goods and services—in Pakistan is also on a declining trend (Figure 6). Overall, the low levels of private

¹³ Pakistan has also failed to attract foreign direct investments. Since 2010, net FDI inflows have averaged 0.75 percent of GDP. In addition, FDI has been largely concentrated in select sectors, i.e., oil and gas exploration, telecoms and the financial sector, which have accounted for over 60 percent of the total FDI over the past 15 years.

investment leading to no capital deepening and low productivity growth limit Pakistan’s growth potential to between 2.5 and 3.0 percent per year.

Figure 5: Trends in capital deepening

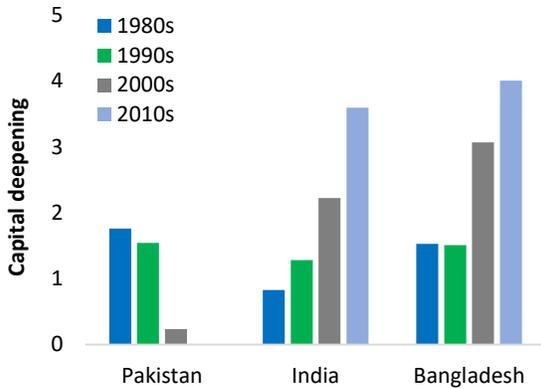
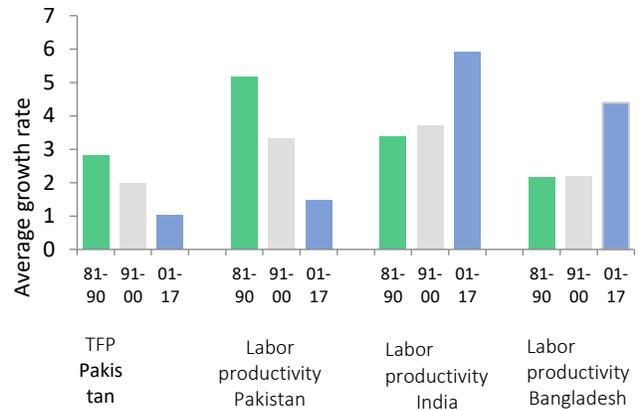


Figure 6: Trends in productivity

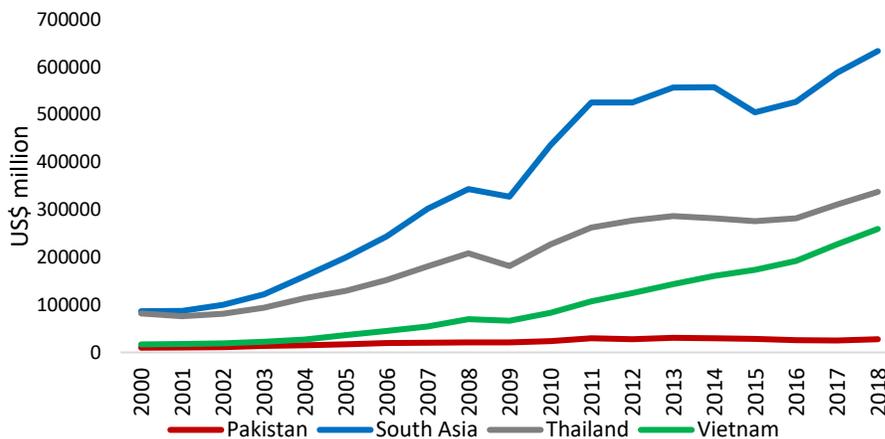


Note: Capital deepening indicates the rate of change in capital stock per labor hour.
Source: World Bank staff elaboration on the APO Productivity Database 2019.

Source: World Bank staff calculations based on the APO Productivity Database 2019.

Pakistan’s exports have not been contributing to growth. Exports are low and lack dynamism. In 2018, Pakistan’s exports as a share of GDP were only 9.6 percent, compared with an average of 24.7 of GDP for lower middle-income countries and 18.4 percent of GDP for South Asia. During the period 2003–17, the country’s exports of goods increased, on average, by only 4.3 percent annually. In the same period, Vietnam’s exports grew by an average 18.4 percent per year (Figure 7). While Vietnam’s share of world exports more than quadrupled, Pakistan’s share dropped from 0.17 percent in 2003 to 0.13 percent over the same period. Overall, Pakistan’s main export destinations and top export products are highly concentrated, primarily in cotton, with agricultural-based products mainly going to regional destinations (Box 1).

Figure 7: Pakistan's exports compared with peers (2000–18)



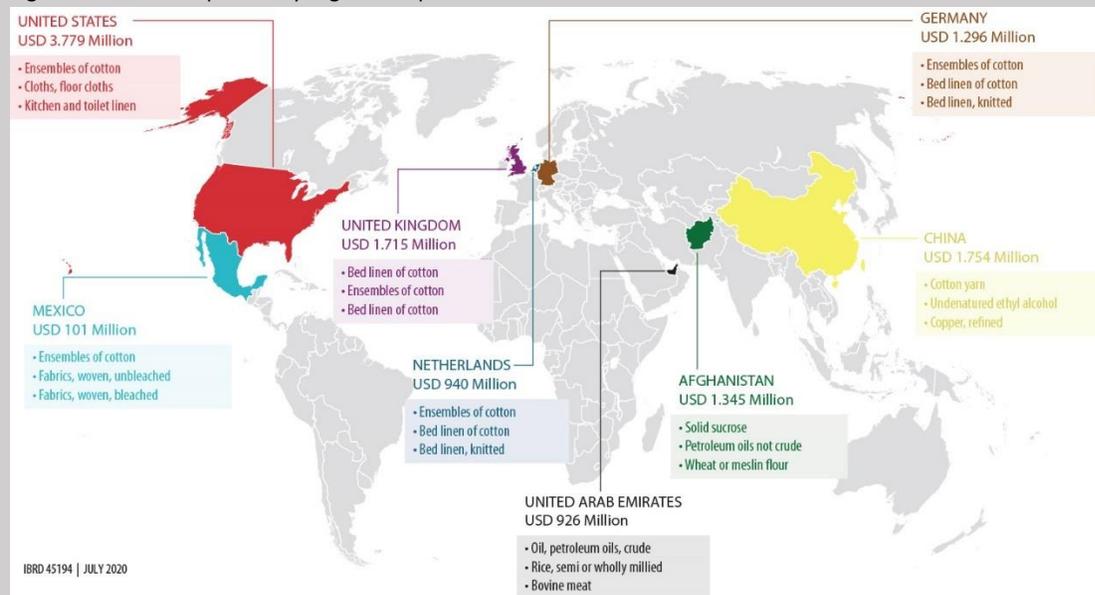
Source: World Bank staff elaboration on WDI data.

Box 1: Pakistan's export concentration: by product and region

Pakistan's export bundle is undiversified and lacks sophistication. The country's export structure has remained largely unchanged over the past two decades, with almost one-fifth being agricultural products—typically fetching prices in the bottom half of the price distribution across countries—three-fifths textiles and apparel, and the rest a combination of ICT, chemicals and metals, among other products. Lack of sophistication is particularly evident in Pakistan's textile sector, where production is primarily cotton-based, despite the global shift toward apparel made of synthetic material (Figure below). Synthetic fibers, increasingly in demand for high-performance garments such as sports uniforms or protective gear, require more technological sophistication than products with traditional fibers. However, Pakistan's textile and apparel sectors are heavily tilted toward cotton, which constitutes 84 percent of its apparel exports. In comparison, world exports of cotton apparel accounted for only 46 percent of total apparel exports in 2012.^a

Pakistan's export market base and penetration have remained stagnant over the past decade. Five markets have historically accounted for almost 70 percent of Pakistan's exports. Geographically, the European Union (EU) and the United States represent the most important destinations for these exports, with the United States absorbing 17 percent and the EU taking 34 percent in 2016/17.

Figure: Pakistan's exports – by region and product



Source: World Bank staff elaboration on WITS data.

Source: a) (Rocha & Varela, 2018).

The COVID-19 pandemic is expected to significantly slow down growth in the near term. Prior to the onset of the COVID-19 pandemic, Pakistan's economy was gradually recovering from a macroeconomic crisis with support from the IMF-EFF. Growth in FY20 was already subdued due to the implementation of contractionary fiscal and monetary policies. However, the pandemic and its related containment measures led to a collapse in economic activity post-March 2020. Disruptions in domestic distribution channels and restrictions on trade have adversely impacted supply chains in the industry and services sectors (which constitute around four-fifths of the GDP). On the demand-side, private consumption and investment are projected to fall due to uncertainty around the pandemic and weak consumer confidence. Given the poor global growth outlook, exports are projected to remain low. As a result, real GDP growth in FY20 is

estimated to have contracted¹⁴ for the first time since 1952. With fears of a second wave in the latter part of 2020, uncertainty looms on next year's growth outlook as well.

Pakistan's economy shows imbalances in its output-employment structure due to the slow process of structural transformation. Over the past two decades, the services sector has contributed, on average, 57 percent of Pakistan's GDP—a relatively large share compared with other countries at similar levels of development (Sharma, 2019). At the same time, the services sector's contribution to employment—about 40 percent—is on a par with that of agriculture, which averaged only about 20 percent in its contribution to Pakistan's GDP. The imbalance in the output-employment structure is the result of the slow pace of structural transformation. In fact, over the past two decades, the employment structure of the economy has remained remarkably stable, despite wide productivity differentials across sectors (Figure 8).¹⁵

Barriers to women's socioeconomic inclusion, limited human capital endowments and constraints to private sector development have muted structural transformation and labor productivity growth.

Women remain at the margin of Pakistan's labor market, mostly confined to employment in the agriculture sector. Structural transformation in Pakistan has had a strong gender dimension. The expansion of job opportunities in the services and industry sectors has mostly benefited male workers, who were able to take advantage of employment opportunities originating in urban areas and outside the agriculture sector (Figure 9). On the other hand, women—whose mobility, education and labor force participation are traditionally constrained by cultural norms—have been mostly unable to take advantage of job opportunities in more dynamic sectors of the economy.¹⁶ In fact, while female labor force participation has increased over the past two decades, job opportunities for women have been concentrated in agriculture, largely substituting for the departing male employment.¹⁷

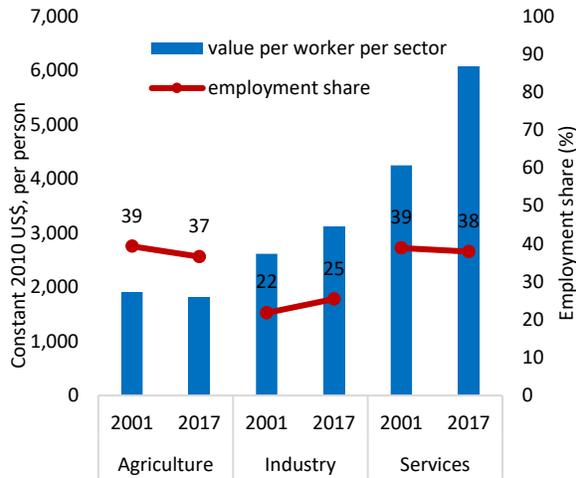
¹⁴ World Bank estimates FY20 growth between -2.6 and 3.3 percent. As per provisional estimates published by the Pakistan Bureau of Statistics, the economy is projected to have contracted by 0.4 percent in FY20.

¹⁵ Looking at value-added per worker, the services sector is the most productive sector and the one whose productivity has increased the most since 2001, followed by industry and agriculture, the latter exhibiting stagnating labor productivity growth. However, while labor has been reallocating toward the most productive sectors, the trend has reversed in recent years

¹⁶ See discussion on gender-based inequality (pp 35).

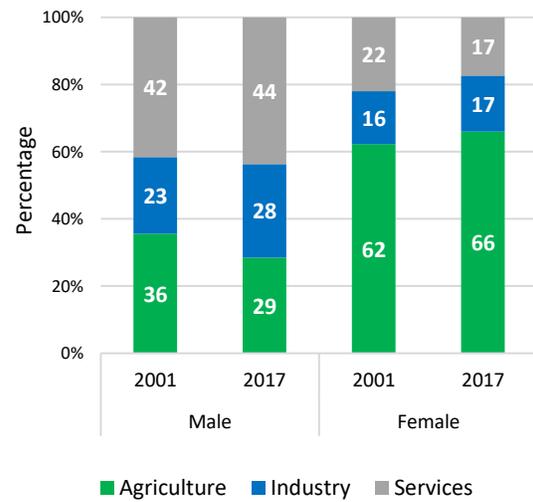
¹⁷ Between 2001 and 2017, overall female labor force participation grew from 13.3 to 22.2 percent and the agriculture sector accommodated more than two-thirds of the increase in female employment (68 percent of new female jobs were in agriculture and 63 percent of new agriculture jobs were taken up by women). Over the same period, female employment in agriculture increased by 4 percentage points, rising from 62 to 66 percent, while male employment in the sector dropped by 7 percentage points, declining from 36 to 29 percent.

Figure 8: Value-added per worker by sector



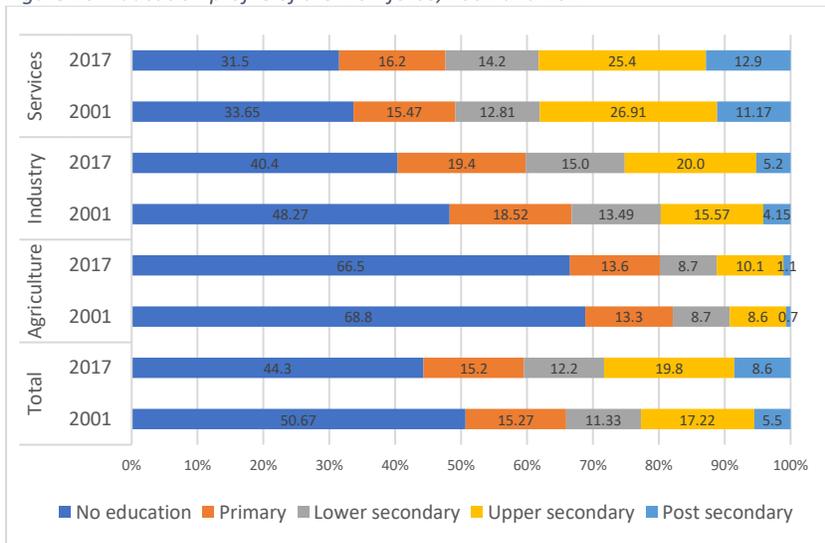
Source: World Bank staff elaboration on PBS data.

Figure 9: Employment share by sector



Source: World Bank staff elaboration on LFS data.

Figure 10: Education profile of the workforce, 2001 and 2017



Source: World Bank staff elaboration on LFS data.

Similarly, the low human capital endowment of Pakistan’s labor force constrains the potential for economic transformation. In 2017, 44 percent of Pakistan’s workforce had no formal education and only 9 percent of the workforce had post-secondary education, with only marginal improvements over time.¹⁸ The education profile across sectors matches differences in productivity, with the services sector having a relatively more educated workforce than the industry sector and, even more so, agriculture. However,

¹⁸ Corresponding figures for 2001 indicate 51 percent of the workforce with no formal education and 5.5 percent with post-secondary education.

even in the services sector, almost half the workforce has only primary education, or no formal education at all (Figure 10).

Job creation outside the agriculture sector has been accompanied by urbanization... Employment opportunities in services and industry are being generated mostly in urban centers, which have attracted an increasing number of male migrants from rural areas.¹⁹ It is estimated that one-third of the urban population increase over the past two decades has been due to migration (World Bank, 2014). Underlying migration trends have made Pakistan one of the most urbanized countries in South Asia. Urban areas in Pakistan account for more than one-third of the total population and more than 50 percent of GDP. Urbanization has been accompanied by an increase in the population density of economically active rural areas and by the emergence of “ruralopolises”,²⁰ particularly in northern Punjab and central Khyber Pakhtunkhwa (KP), which are competing to attract migrants (Box 2).

Box 2: Pakistan’s hidden urbanization

According to official estimates—which are based on administrative demarcation of metropolitan corporations, municipal corporations, municipal committees or cantonments—the urban population accounts for 36 percent of Pakistan’s total population (Census of Population, 2017).

Alternative estimates based on the actual spatial distribution of population seem to suggest a much higher level of urbanization in Pakistan. Following the U.S. Census Bureau’s longstanding density threshold for any urban area of 1,000 people per square mile, large parts of rural Pakistan—including the eastern half of Punjab province, a large area outside of Peshawar in KP province, and a triangular region connected by the cities of Karachi, Hyderabad and Thatta in Sindh province—could be regarded as urban, bringing the urbanization rate up from 60 to 65 percent.^a In recent years, a growing body of research using satellite imagery to demarcate contiguous built-up settlements, population density and sizes for specific settlements has confirmed the emergence of spatial agglomerations of various sizes across the country and increased awareness regarding the existence of hidden urbanization in Pakistan.^b In fact, irrespective of the methodology used, urbanization rates are found to be significantly above the 36 percent reflected in official estimates (see table below).

| | Agglomeration Index | Global Housing Settlement Layer (GHSL) ^c | R. Ali. Estimating Urbanization ^d |
|----------------------------------|--|---|---|
| Categories of Settlements | Binary: (a) Urban; and (b) Rural. Urban areas are defined by a minimum population density of 500 people/km ² and located within a travel time of 30 minutes within a large city with a minimum population of 50,000. | Three Categories: (a) Urban Centers; (b) Urban Clusters; and, (c) Rural. (a) An urban center consists of contiguous grid cells of 1 km ² with a density of at least 1,500 inhabitants per km ² and a minimum total population of 50,000. (b) An urban cluster consists of contiguous grid cells of 1 km ² with a density of at least 300 inhabitants per km ² and a minimum total population of 5,000. (c) A rural area consists of grid cells of 1 km ² with a density below 300 inhabitants per km ² and other grid cells outside urban clusters or centers. | Three Categories: (a) Urban; (b) Urbanizing; and, (c) Rural. (a) Urban areas include a city core with a population of 100,000 or more, and its linked built-up and surrounding areas with a minimum density of 500 persons/km ² . (b) Urbanizing areas have (i) a population density more than 250 persons/km ² , (ii) an urban core of 50,000 or more, and (iii) lie within a 75-minute distance of a city (100,000 or more). |

¹⁹ Over the past two decades, urban population has increased at a faster pace than rural population, despite higher fertility rates in the latter. According to Census data, between 1998 and 2017, the urban population increased at an annual rate of 3 percent, against 2.1 percent of rural population. Also, while the major trend up to 1998 had seen migrants largely originating in rural Punjab and KP who were moving toward economic opportunities in the urban areas of Sindh, the dominant trend over recent years involves migrants from rural areas in Punjab and KP moving to urban areas within the same provinces.

²⁰ (Pakistan’s Runaway Urbanization: What Can be Done?, 2014).

| | | | |
|--|---|---|---|
| Available Results/ Estimates | Share of urban population: | <u>Estimates for 2015:</u> | <u>Combined estimates for Punjab, Sindh, KP, and Balochistan (1998):</u> |
| | <ul style="list-style-type: none"> (World Bank, 2009): 53.6% (Uchida & Nelson, 2010): 56.5% | Share of population in - Urban centers: 69.48% Urban clusters: 23.45% Rural: 7.07% | Share of population that is - Urban: 34.59% Urbanizing: 28.06% Rural: 37.35% |
| Source: (a) (Qadeer, 2014); (b) See (Reza, 2002); (Hasan, 2002); (Arif, 2003); (c) (EU Global Human Settlement, 2016); (d) (Reza, 2013). | | | |

... and by the expansion of the informal sector. According to Labor Force Survey (LFS) data, of the 15.7 million jobs generated outside the agriculture sector over the period 2001–17, three out of four jobs were generated in the informal sector. In 2017, the informal sector accounted for 82 percent of private sector employment outside agriculture, meaning that four out of five individuals working in the private sector are either working as own-account workers, or working as employees or employers in micro-enterprises. The predominance of informal job creation is noteworthy in two of the largest and most dynamic sectors of employment, namely construction (95 percent of the total), and wholesale and retail.²¹ In general, informal (micro) enterprises are considered to have lower productivity than small formal enterprises and, in particular, compared with the larger formal enterprises.²²

Expansion of the informal sector has contributed toward growth and poverty reduction, possibly compensating for anemic formal private sector growth. Formal private sector development in Pakistan is being hampered by several constraints, ranging from an unfavorable business environment, lack of integration with global value chains, limited competition and innovation. In this context, the expansion of the informal sector contributed to absorbing Pakistan’s growing labor force, with micro-businesses and self-employment providing livelihood opportunities to compensate for the limited labor demand in the formal sector. While no direct evidence is available to assess productivity gaps between formal and informal firms in Pakistan, available evidence suggests that informal establishments have been positively contributing to growth and resilience of Pakistan’s economy (Box 3).

Box 3: Pakistan’s informal sector: what do we know about its productivity?

In Pakistan, data that would enable a comparative analysis of performance of the formal and informal sectors are missing. The latest economic census in Pakistan was conducted from 2001 to 2003, and released in 2005, by the Pakistan Bureau of Statistics (PBS). The latest Enterprise Survey in Pakistan was conducted in 2013–16 for nonagricultural enterprises with five or more employees. However, the survey suffered low response rates, undermining the credibility of the results. On the other hand, Pakistan has frequent and good-quality household survey data, which also include information on businesses with fewer than 10 employees (micro-businesses) and the activities of the self-employed. While these data do not allow a comparative analysis of productivity in the formal and informal sectors, they still provide important insights into the dynamics of the latter.

Informal establishments grew both in number and in importance in the Pakistani economy. Between 2001 and 2015, the number of informal establishments (households engaged in self-employment and micro-enterprises with fewer than 10

²¹ In the construction sector, micro-businesses create opportunities for low-skilled workers predominantly in rural areas, mostly engaged in elementary occupations and through casual forms of employment. In wholesale and retail, micro-businesses and self-employment create opportunities for educated workers predominantly in urban areas.

²² (LaPorta & Shleifer, 2008).

employees) more than doubled. Micro-enterprises increased by 60 percent, while the number of self-employed grew by 53 percent. About four-fifths of informal establishments operate in the services sector. Informal sector growth is reflected in its increasing contribution to GDP, as measured by the informal sector's wage bill as a share of GDP (left-hand figure below). Labor productivity of informal activities has been steadily increasing over time, even during the bust cycle in the second half of 2000s. The labor productivity of both the self-employed and micro-enterprises was about three times higher in 2015 than it was in 2001 (right-hand figure below). Growth rates slowed down during the financial crisis, in particular for micro-enterprises, but remained positive. On the other hand, the economy as a whole exhibited a 3.1 percent decline in labor productivity over the period 2007–11. After the crisis, the labor productivity of micro-enterprises, and to a lesser extent that of the economy as a whole, grew faster than that of the self-employed.

Figure: Informal sector's contribution to GDP

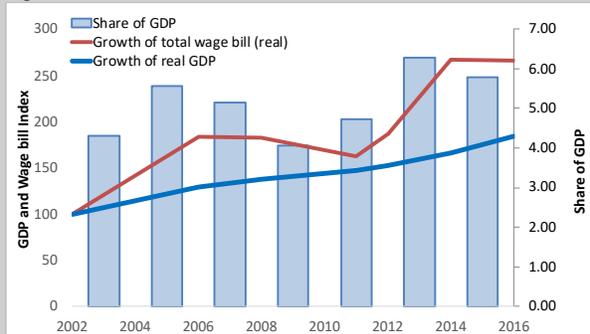
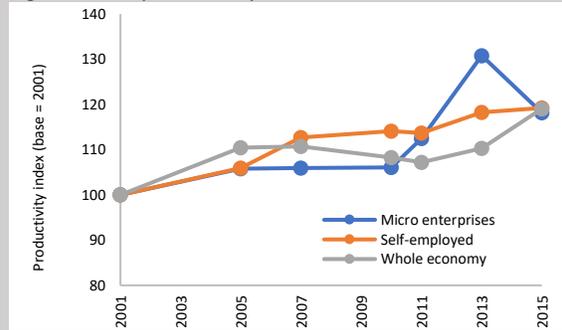


Figure: Labor productivity



There are sizeable differences in productivity within the informal sector. Overall, labor productivity for both micro-enterprises and self-employed is higher in the service sector. Large productivity differentials also persist within sectors. For example, within the services sector, micro-enterprises in the bottom 10th percentile are 12 times as large as those in the top 10th percentile. A similar pattern is observed for the self-employed (Figure below, left panel).

Productivity differences among informal establishments are associated with the level of education of their owners. For instance, the productivity of establishments whose owners have at least upper-secondary education is about 1.3 times higher than those who do not (Figure below, right panel). After taking into account differences in age, sector, location and income, differences in productivity persists and labor productivity is 10 percent higher for owners with upper-secondary education. Over time, an increase in education is associated to an increase in labor productivity: a 1-percentage point increase in the share of educated owners over time is associated with a 0.5 percent increase in labor productivity.

Figure: Dispersion in productivity across the self-employed/micro enterprises

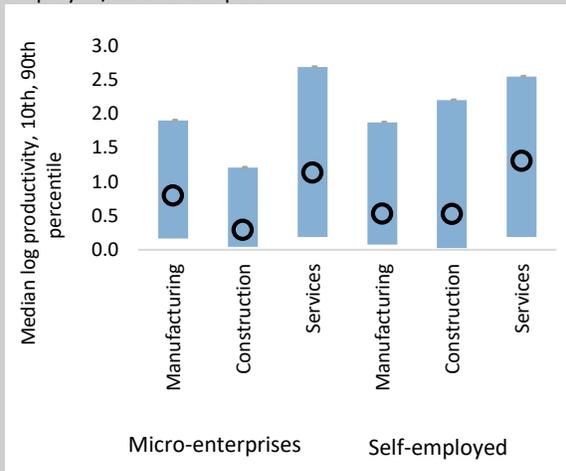
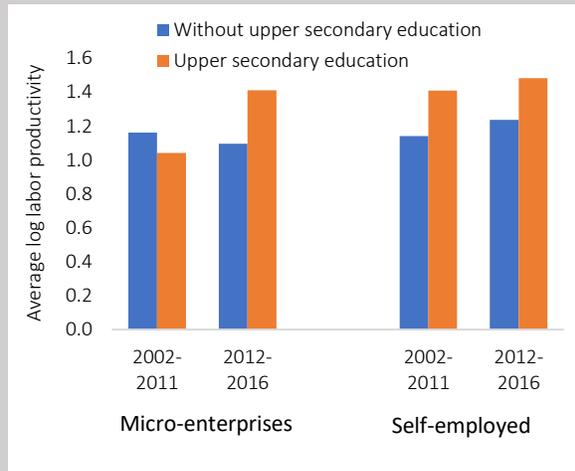


Figure: Differences in productivity by education level



Source: (Lovo & Redaelli, 2020).

The lockdown measures imposed to contain COVID-19 are expected to have weighed heavily on the informal sector. As suggested by a growing body of international evidence, urban workers employed in the informal sector and daily wage workers employed in the formal sector are likely to bear the brunt of the slowdown associated with the COVID-19 crisis. While the informal sector exhibited resilience during economic downturns in the past ²³, it's capacity to rebound in the aftermath of the current crisis remains uncertain and will require additional analysis²⁴.

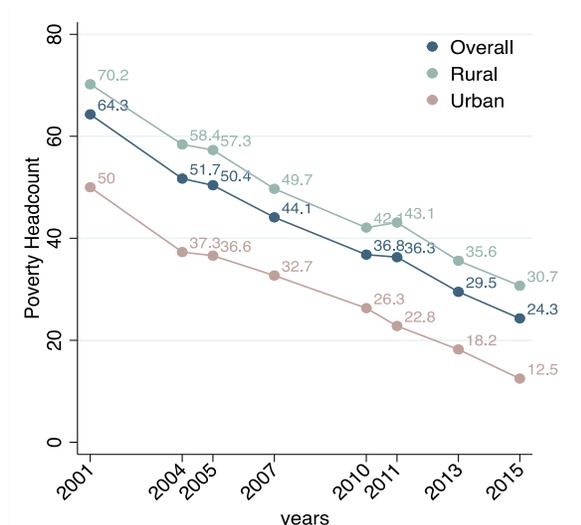
²³ (Love and Redaelli, 2020)

²⁴ See section on Data and Knowledge gaps.

Poverty and Shared Prosperity

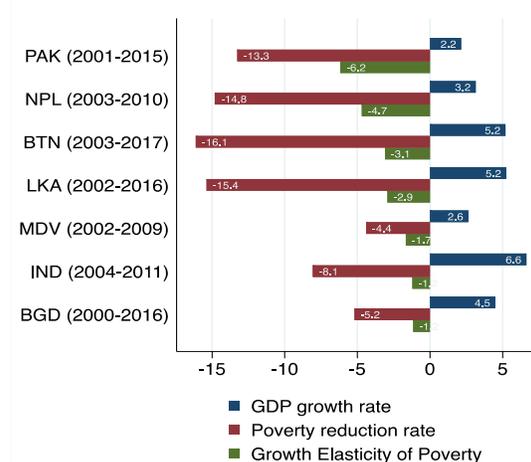
Pakistan has made huge strides in poverty reduction: approximately 46 million Pakistanis escaped poverty in the period 2001–15. In 2001, using the current national poverty line (Box 4), the poverty headcount was very high, at 64.3 percent. Fourteen years later, in 2015, poverty had more than halved, falling to 24.3 percent (Figure 11). In fact, Pakistan is the most successful South Asian country in transforming GDP growth into poverty reduction, and one of the most successful among lower middle-income countries (Figure 12). This is illustrated by Pakistan’s high poverty growth-elasticity, at 6.2. This means that a 1-percentage-point increase in GDP over the period 2001–15 was associated with a poverty decrease—as measured at the US\$1.90 international poverty line—of more than 6 percentage points.²⁵

Figure 11: Incidence of poverty: national, urban and rural



Source: World Bank staff calculations using PIHS, HIES and HIICS data.

Figure 12: GDP growth rate (annualized), poverty reduction rate (annualized) and growth elasticity of poverty



Source: World Bank staff elaboration on WDI data.

Box 4: Data and poverty estimation methodology

Poverty trends presented in this note are based on household survey data from the Household Integrated Economic Survey (HIES), which provides information on socioeconomic indicators at both the national and provincial levels, including an urban/rural breakdown. The survey has been conducted by the Pakistan Bureau of Statistics (PBS) more or less regularly since 1963, although comparability over time is limited as the survey design (instruments and sample) has changed to respond to evolving data requirements. In 1998–99, the HIES was integrated with the Pakistan Integrated Household Survey (PIHS) and it has been conducted without major revisions since 2001–02. Eight rounds of data are used for the analysis, namely 2001–02, 2004–05, 2005–06, 2007–08, 2010–11, 2011–12, 2013–14, and 2015–16. New data from the 2018–19 HIES are expected to become available in April 2020.

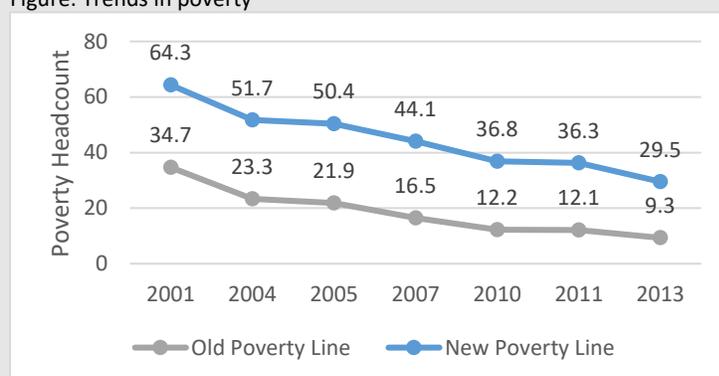
²⁵ The second-best performer in the region was Nepal, with a growth-elasticity of poverty of 4.7, followed by Bhutan and Sri Lanka (elasticity of about 3.0), the Maldives (elasticity of 1.7), and India and Bangladesh (elasticity of about 1.2). Among other countries currently defined as lower middle-income, Pakistan’s performance is surpassed only by three countries in the Europe and Central Asia region: Ukraine, the Slovak Republic and Kyrgyzstan, with elasticities of 8.2, 6.8 and 6.5, respectively.

Pakistan’s first official poverty line was set in 2001 at PKR 723.40 per adult equivalent per month. The poverty line was estimated using the Food Energy Intake (FEI) methodology and at a minimum threshold level of 2,350 kcal per day per adult equivalent. According to this poverty line, 34.7 percent of the population was registered as poor in 2001–02, a proportion that progressively declined to 9.3 percent in 2013–14.

Pakistan’s success in reducing poverty encouraged the government to raise the bar and estimate a more ambitious and inclusive poverty line reflecting the evolution of consumption patterns in the society. The new poverty line was estimated using HIES 2013–14 data and was set at PKR 3,030.32 per adult equivalent per month in 2013–14 prices. In line with international best practice, the new poverty line was estimated following the Cost of Basic Needs (CBN) method.

The new line sets a higher bar and provides a more inclusive view of those who are considered disadvantaged in Pakistan today. In absolute numbers, based on population estimates of approximately 200 million in 2013–14, the new poverty line allows 7.6 million households (59 million people) to be classified as poor. This demonstrates the government’s commitment to catering to a wider pool of low-income households through its policies and interventions. Back-casting this new poverty line to 2001–02, using the Consumer Price Index (CPI), shows that the headcount rate using this new higher line would have been 64.3 percent in 2001–02—almost double the rate seen using the old poverty line. However, the trends over time remain the same.

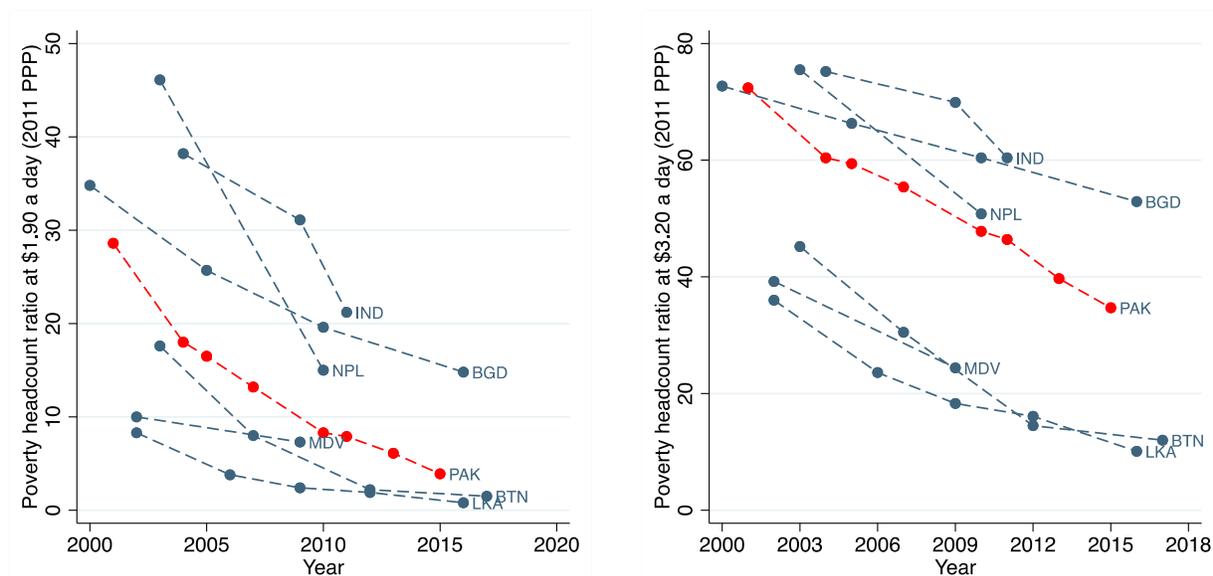
Figure: Trends in poverty



Source: (Redaelli, 2019).

While Pakistan almost eradicated extreme poverty in 2001–15, about one-third of Pakistanis still live below the minimum living standard typical of a lower middle-income country. Over the past 15 years, Pakistan has closed the gap with Bhutan and Sri Lanka with respect to the lowest international poverty line (set to US\$1.90 2011 PPP), which represents the minimum living standard for low-income countries (Figure 13, left panel). In terms of the international minimum living standard for lower middle-income countries (set to US\$3.20 2011 PPP), poverty in Pakistan stands at 34.7 percent; three times higher than the two best performers in the region (Figure 13, right panel), but nonetheless in line with lower middle-income countries’ average poverty rate of 32.9 percent.

Figure 13. Trends in poverty headcount at international poverty lines in South Asian countries, US\$1.90 a day (left panel) and US\$3.20 a day (right panel)



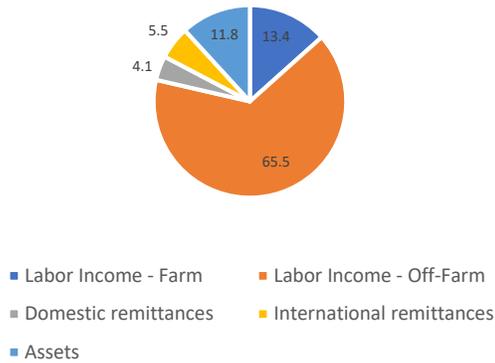
Source: World Bank staff elaboration on WDI data.

The increase in employment opportunities outside the agriculture sector was the main driver of this poverty reduction. Two self-reinforcing economic dynamics accounted for the observed progress in poverty reduction: (i) the expansion of economic opportunities outside the agriculture sector, particularly with growth in male off-farm employment in the informal sector; and (ii) the increase in out-migration and associated remittances.²⁶ The latter not only boosted consumption of recipient households but also fueled internal demand—particularly of goods and services locally produced in the informal sector—and the increase in real wages. About two-thirds of the decline in poverty between 2001 and 2015 was driven by the increase in labor incomes in the off-farm sector (Figure 14), which in real terms increased by as much as 74 percent (Figure 15).²⁷

²⁶ Figure 4.

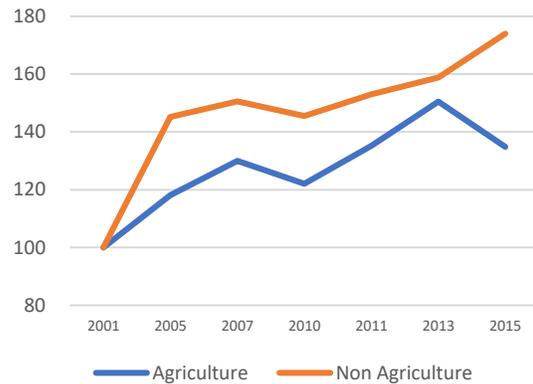
²⁷ The overall increase in income is mirrored by an increase in minimum wages in the formal sector. Between 2001 and 2015, the real value of minimum wages increased by 70 percent.

Figure 14: Drivers of poverty reduction, 2001–15



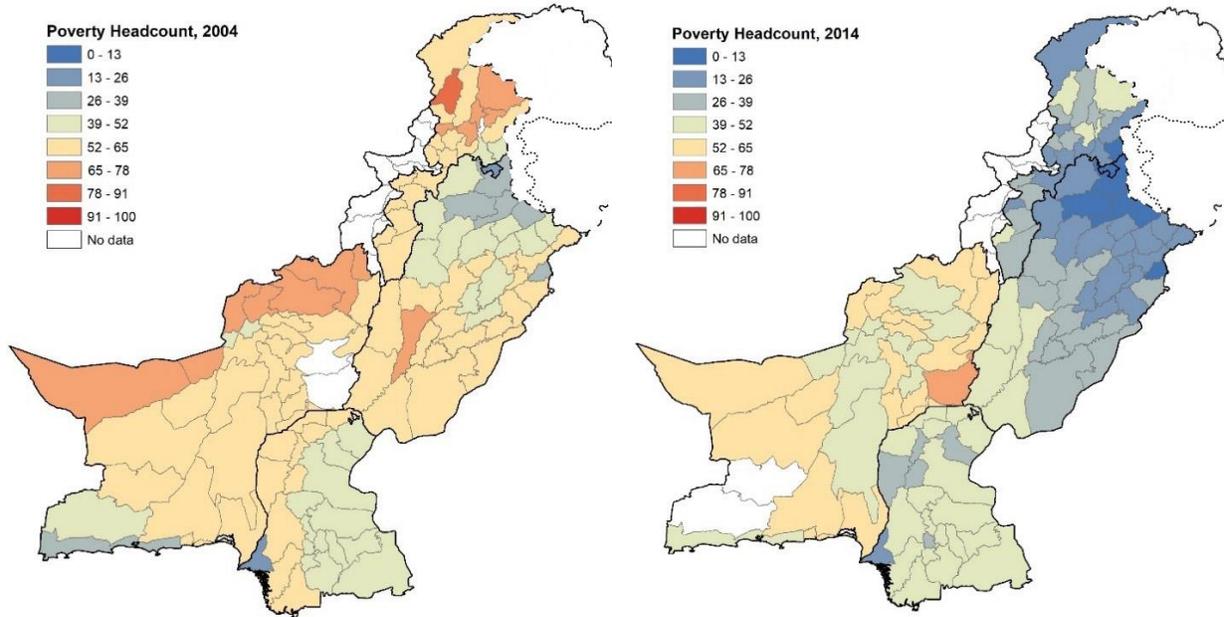
Source: World Bank staff calculations using PIHS, HIES and HIICS data.

Figure 15: Labor incomes growth index, base 2001 real terms



Source: World Bank staff calculations using PIHS, HIES and HIICS data.

Figure 16: Poverty map by district, 2004 and 2014



Source: Data4Pakistan, World Bank.

Poverty reduction was geographically uneven, reflecting the patterns in which off-farm informal employment opportunities grew. The pace of poverty reduction was stronger in urban areas where most of the expansion in services sector jobs was concentrated.²⁸ On the other hand, poverty reduction in rural areas was supported by employment growth in the construction sector, which absorbed most of the low-

²⁸ Poverty in urban areas declined at an annualized rate of 9 percent, compared with 6 percent in rural areas. In 2015, rural poverty was more than twice as high as poverty in urban areas²⁸ and, despite a decline in the share of rural population, rural areas still account for four out of five poor individuals—the same share as at the beginning of the century.

skilled male labor shed by the agriculture sector. The spatial evolution of poverty marks a clear north-south divide (Figure 16), with a stagnating “poverty belt” concentrated in southern Punjab, northern Sindh and across Balochistan, versus more dynamic areas in the north. Among Pakistan’s provinces, KP and Punjab have been particularly successful at consistently reducing poverty. In these two provinces, a higher incidence of international and domestic migration, as well as a higher density of productive infrastructure, has supported greater off-farm labor demand and the reallocation of labor toward more productive jobs outside agriculture in cities and in emerging “ruralopolises”.²⁹ Progress has been particularly impressive in KP, where poverty declined by 56 percentage points, allowing the province to graduate from being the poorest in 2001 to the least poor, together with Punjab, in 2015.³⁰

Education has been an important enabler of socioeconomic mobility. As job opportunities increased in the off-farm informal sector, individuals with higher human capital were best placed to take advantage of them, and to do so in a more productive way.³¹ As those with higher human capital endowments were gradually able to escape poverty, so the profile of the poor became much more homogeneous over time.

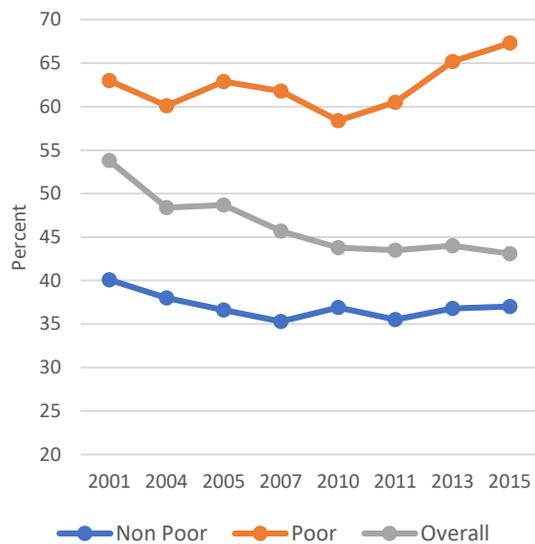
Over time, poverty has increasingly become concentrated among rural households relying on agriculture and among individuals possessing low human capital endowments. Compared with 2001, present-day poverty is increasingly concentrated among workers in the agriculture sector (particularly among share-croppers and fixed rent/contract farmers), and poor rural households are increasingly reliant on agricultural income for their livelihoods. Similarly, poverty is increasingly concentrated among individuals with no education. The share of poor individuals aged 15 and above who had never attended school increased over time, a trend that has become more pronounced in recent years and that corroborates the increasingly important role played by education in socioeconomic mobility and transition out of poverty (Figure 17).

²⁹ See Box 2.

³⁰ In 2015, the poverty headcount rate in KP was 18.0 percent, against 20.9 percent in Punjab. However, the difference between KP and Punjab’s poverty headcount is not found to be statistically significant.

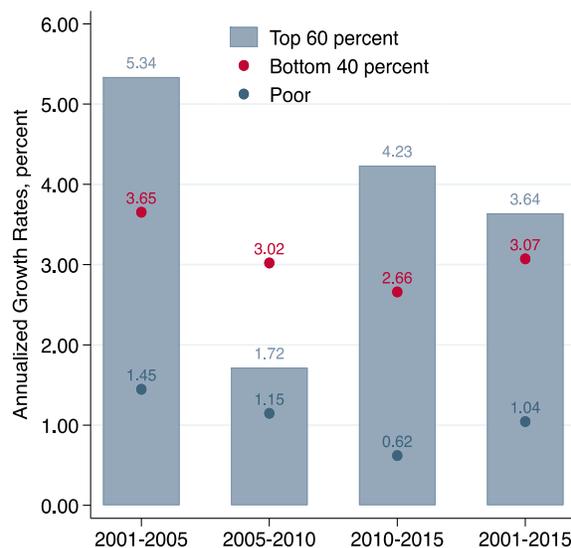
³¹ Education is positively correlated with higher likelihood of migration and higher productivity of informal businesses. Analysis based on latest wave of the LFS (2017) shows that migrants who move from rural to urban areas have significantly more years of schooling (6.1 years) than those who stay in rural areas (3.9 years) or those who move from rural to rural areas (3.4 years) (Cho & Majoka, 2020). Analysis based on latest HIICS 2015–16 also indicates that productivity of informal businesses is positively correlated with the level of education of their owners. For instance, the productivity of establishments whose owners have at least upper-secondary education is about 1.3 times higher than those who do not. Over time, an increase in education is associated with an increase in labor productivity: a 1-percentage-point increase in the share of educated owners over time is associated with a 0.5-of-percentage-point increase in labor productivity (see Box 3).

Figure 17: Share of population 15+, never attending school



Source: World Bank staff calculations using PIHS 2001 and HIICS 2015 data.

Figure 18: Trends in shared prosperity



Source: World Bank staff calculations using PIHS, HIES and HIICS data.

Growing inequality, macro-economic instability and vulnerability to shocks pose a challenge to the sustainability of poverty reduction moving forward. During the period 2001–15, welfare levels improved for all Pakistanis in absolute terms leading to poverty reduction. However, as previously discussed, opportunities for socioeconomic mobility were not equally distributed. Relatively more well-off segments of the population, which could rely on higher human and/or physical capital endowments, benefited the most from the economic opportunities created by growth. As a result, inequality widened, and shared prosperity declined over time (Figure 18).^{32,33} Addressing growing inequalities and expanding access to opportunities for socioeconomic mobility should go hand in hand with efforts to sustain growth and to build resilience to shocks. In fact, considering Pakistan’s rate of population growth, sustaining GDP growth above the 2 percent mark is a necessary (but not sufficient) condition to continue progress on poverty reduction.

Pakistan’s challenges in sustaining progress in poverty reduction emerge even more clearly as the country grapples with the socio-economic consequences of the COVID-19 pandemic. The economic contraction due to the COVID-19 crisis is likely to have a significant impact on poverty. With lockdown measures having severely affected the off-farm sectors that provide livelihoods to the poorer and most vulnerable segments of the population, and in consideration of the overall slump in internal demand, poverty is expected to increase for the first time in the last two decades. Whether or not such increase

³² Consumption inequality, as measured by the Gini coefficient, increased from 27.5 in 2001 to 30.3 in 2015. A similar picture emerges when looking at income inequality, with the Gini coefficient increasing by just over 1 percentage point, from 37.5 in 2001 to 38.7 in 2015. Similarly, the average consumption growth rate of the bottom 40 percent declined progressively, from 3.7 percent annually between 2001 and 2005 to 3.0 percent annually between 2005 and 2010, and to only 2.2 percent annually between 2010 and 2013.

³³ Interestingly, inequality declined during the 2005–10 period of economic crisis, during which consumption growth of the poorest 40 percent outpaced that of the richest. As discussed, the informal sector proved to weather the crisis relatively better compared with the rest of the economy.

will be short lived, and Pakistan will be able to return on its previous path of poverty reduction remains an open question.³⁴ What is certain is that, in order to achieve this goal, Pakistan will have to address both pre-existing and COVID-19-induced inequalities.³⁵

³⁴ See section on Data and Knowledge Gaps.

³⁵ See section on Risks to Social Cohesion.

Human Capital

Pakistan has still to achieve basic developmental goals in health and education, with stark implications for productivity growth and socioeconomic inclusion. While its young population could become Pakistan’s most important asset, human capital development lags far behind its peers, with Pakistan ranking 134th out of 157 countries on the Human Capital Index (HCI, see Box 5). This means that a Pakistani child born in 2018 is expected to attain only 39 percent of his or her full potential, given the risks of poor health and education prevalent in the country.

Box 5: The Human Capital Index

The Human Capital Index (HCI) provides an international metric to benchmark the key components of human development across countries. The HCI is designed to highlight how improvements in current health and education outcomes shape the productivity of the next generation of workers. The underlying assumption is that children born today experience over the next 18 years the educational opportunities and health risks that children in this age range currently face.

The HCI is constructed based on the aggregation of six components, each measuring a key step along the trajectory from birth to adulthood of a child born today: ^(a)

1. Probability of survival to age five;
2. Expected years of school;
3. Harmonized test scores;
4. Learning-adjusted years of school;
5. Adult survival rate; and
6. Probability of not being stunted as a child under age five.

The HCI has an intuitive interpretation: the value can be understood as the productivity of the average worker in the future, compared with the benchmark of the highest possible investments in human capital, meaning full health (zero stunting and zero child mortality) and full education (full enrolment and no drop-outs until age 18, with learning levels at the ‘advanced level’ in international assessments).

On average, considering the 157 countries for which HCI estimates are available, the majority (57 percent) of children born today will grow up to be, at best, only half as productive as their full potential. In Pakistan, future workers will only reach 39 percent of their full potential, well below global average and other countries in South Asia.

Table: Pakistan HCI and its components

| Component | Total | Boys | Girls |
|-----------------------------------|-------------|-------------|-------------|
| HCI | 0.39 | 0.39 | 0.38 |
| Probability of survival to age 5; | 0.93 | 0.92 | 0.93 |
| Expected years of school; | 8.8 | 9.5 | 8.1 |
| Harmonized test scores; | 339 | 335 | 343 |
| Learning-adjusted years of school | 4.8 | 5.1 | 4.4 |
| Adult survival rate | 0.84 | 0.82 | 0.86 |
| Not stunted rate | 0.55 | 0.52 | 0.58 |

Source: (a) See (Kraay, 2018) for a full description of HCI methodology.

Child health outcomes in Pakistan are worse than in most South Asian countries and progress along health dimensions of the HCI has been the lowest. Pakistan has the highest rate of under-five child mortality in South Asia and the fifth highest among lower middle-income countries. Starting from the highest level registered in the South Asia in 1950, Pakistan was among the top performers in reducing under-five mortality up to the 1980s. However, the decline in infant mortality slowed down (Figure 19)

after that and, in 2017, Pakistan’s under-five mortality rate stood at 75 per 1,000 live births. Among lower middle-income countries, only Mauritania, Cameroon, Côte d’Ivoire and Lesotho have higher under-five mortality rates, each of which (with the exception of Mauritania) has higher poverty rates than Pakistan (Figure 20). Should the pace of progress continue at the same rate as in the past 15 years, Pakistan is expected to miss the Sustainable Development Goal (SDG3) of bringing under-five child mortality below 25 per 1,000 live births by 2030.

Figure 19: Trend in under-five mortality rates in South Asia

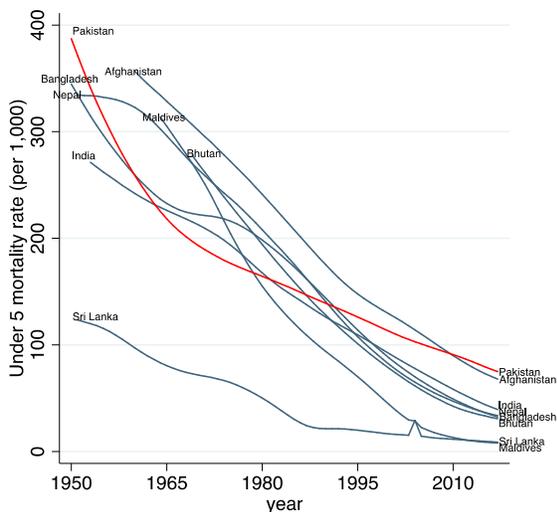
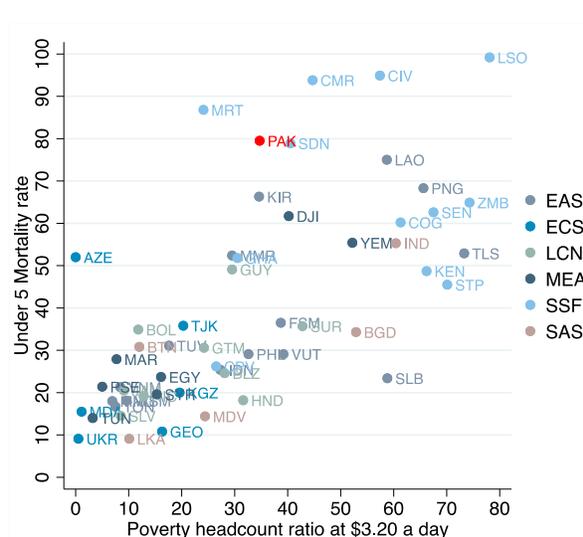


Figure 20: Under-five mortality and poverty in lower middle-income countries, latest available years



Source: World Bank staff elaboration on UNICEF data (country-specific under-five mortality rate, last update September 18, 2018) and WDI data.

At 37.6 percent, the incidence of stunting among children under five remains worryingly high.³⁶ Stunting³⁷ is defined as a child being short for his/her age, a condition that reflects the cumulative effect of chronic malnutrition. Despite progress in recent years,³⁸ Pakistan is once again among the worst performers. Malnutrition is the number one health risk factor involved. At early stages of childhood development, malnutrition plays a critical role in shaping an individual’s burden of disease, his or her potential for cognitive development, and for human capital accumulation. A growing body of research shows that improved health care and nutrition for infants can have long-lasting effects that persist throughout their lives, and that damage from childhood disease and malnutrition, in terms of lost opportunities for learning, can be difficult to undo. As highlighted by Prime Minister Imran Khan’s first address to the nation, stunting remains a fundamental development challenge in Pakistan.

With an estimated out-of-school population of 20 to 25 million, education outcomes in Pakistan lag significantly compared with regional peers, and progress over time has been slow. In 2017, 24 percent of primary school age children and 46 percent of lower secondary school age adolescents were out of

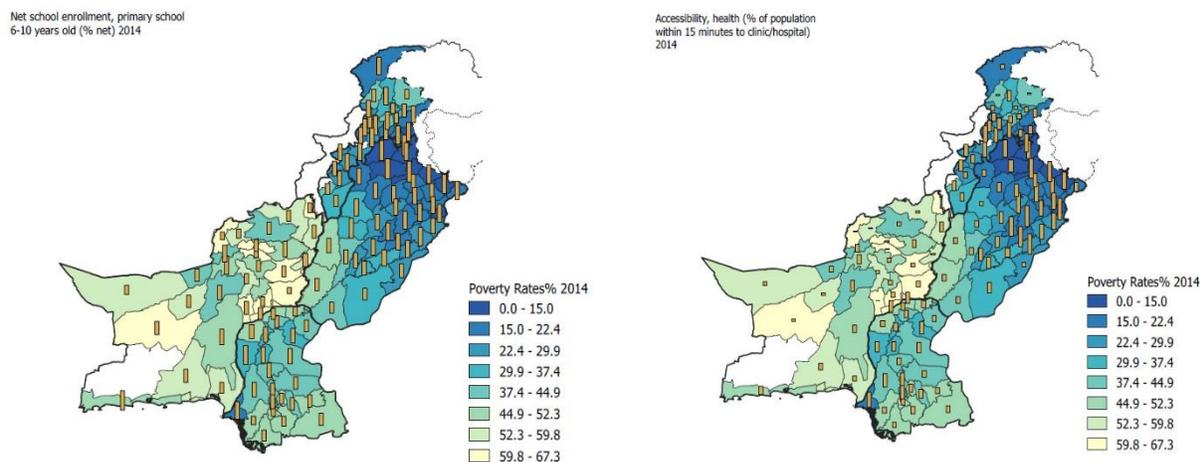
³⁶ Pakistan Demographic and Health Survey [PDHS], 2017.

³⁷ A child who is below two standard deviations from the WHO reference median for height-for-age is considered stunted.

³⁸ Stunting declined from 45 percent in 2012 to 37.6 percent in 2018.

and issues related to teachers' preparedness, qualifications, instructional quality and attendance are pervasive, especially in the public sector.⁴⁴

Figure 22: Relation between poverty and education and health outcomes



Source: Data4Pakistan, World Bank.

The private sector has been playing an increasingly important role in the delivery of health and education services, but cost and quality are heterogenous. Underperformance of the public sector provision of health and education services is at the root of the private sector's expansion. The private sector represents more than one-third of all educational institutions in Pakistan, and the number of students enrolled in private education institutions has almost tripled over the past two decades, growing from 6 million in 2000 to 21.6 million in 2016.⁴⁵ The growing importance of private sector health service provision is equally striking, with recent data showing that more than two-thirds of the population seeks care from private dispensaries/hospitals (PSLM, 2014). Private provision of health and education services is highly heterogeneous in terms of cost and quality of the services provided, as well as in terms of geographical distribution. High-quality/high-cost private education institutions and private hospitals coexist with low-quality/low-cost ones, catering to different segments of the population in terms of location (mostly along the urban/rural divide) and capacity to pay, often exacerbating existing inequalities in public sector provision.

The COVID-19 pandemic is expected to exacerbate Pakistan's human capital challenges. The closure of education institutes imposed to contain the spread of the pandemic has impacted more than 50 million students, with Tele-school initiatives only reaching a daily pool of 2 million students in the 5-15 age

⁴⁴ Underperformance of public sector teachers compared with private sector's counterparts has been widely documented and it is compounded by relatively larger class size, poor managerial capacity and limited parent engagement and supervision (Andrabi, Das, & Khwaja, 2017).

⁴⁵ According to official statistics (Pakistan Education Statistics, 2000–01 and 2016–17), private sector enrolment grew by 8.4 percent a year, against a 3.5 percent annual growth rate of enrolment in public sector institutions. In 2016–17, students enrolled in the public sector were 28.7 million, against 21.6 million in the private sector (Ministry of Federal Education and Professional Training, Government of Pakistan).

group.⁴⁶ On the health front, diversion of resources towards the fight of the pandemic, mobility restrictions and fear of contagion has significantly reduced access and demand of prenatal and postnatal services, and disrupted immunization efforts⁴⁷. The crisis is also expected to exacerbate pre-existing inequality in access with girls/women and poorest segments of the population being affected the most.

⁴⁶ The closure of education institutes was imposed on April 5, 2020 and it is currently set to continue till September 15, 2020. The closure affects all schools, colleges and universities, public and private, vocational institutions and madaris (religious institutes).

⁴⁷ Polio immunization campaigns were halted between March and July 2020 to avoid the risk of COVID-19 transmission to children caregivers and vaccinators. According to UNICEF reports, the suspension of the immunization campaign lead to a surge in cases (63) and to the introduction of the disease into new areas of the country.

WHAT ARE THE RISKS THAT CHALLENGE THE SUSTAINABILITY OF PAKISTAN'S DEVELOPMENT MODEL?

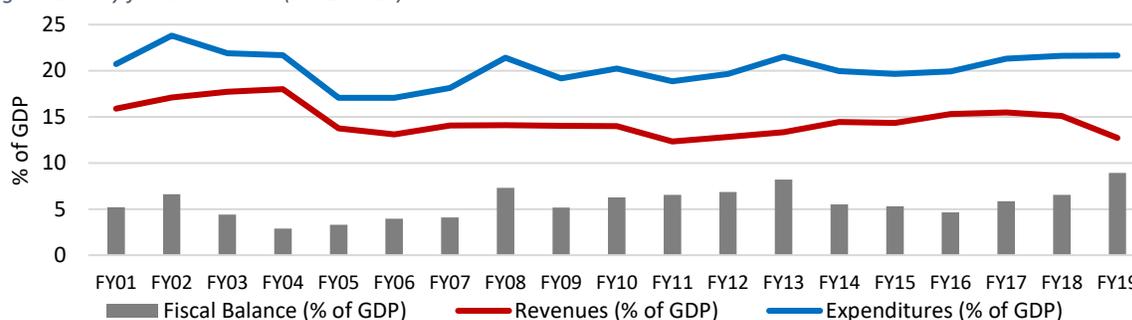
Risks to Macroeconomic Stability

Periodic twin deficits, a growing debt burden and the erosion of external buffers threaten Pakistan's macroeconomic sustainability. Pakistan's recent economic policies have led to large fiscal and current account deficits (twin deficits). These have resulted in a rapid increase in public debt and a deterioration of macroeconomic buffers, increasing Pakistan's vulnerability to external shocks. It is with these weak fundamentals that Pakistan entered the COVID-19 pandemic.

Fiscal and debt sustainability

Pakistan faces persistent fiscal imbalances. The average fiscal deficit between FY01 and FY19 was 5.6 percent (excluding grants), with the fiscal deficit in FY19 rising to 9.1 percent of GDP (Figure 23). The frequently elevated fiscal deficits are a result of low revenue collections (12.9 percent of GDP in FY19), and rigid current expenditures (salaries, pensions,⁴⁸ interest payments, defense, subsidies, etc.). These issues are exacerbated by an uncoordinated intergovernmental fiscal architecture that results in a structural fiscal deficit and makes achieving fiscal consolidation between the federal and provincial governments more difficult (Box 6).

Figure 23: Key fiscal indicators (FY01–FY19)



Source: World Bank staff elaboration on MoF data.

Box 6: Cross-cutting issue – Weak inter-governmental fiscal architecture

There is a misalignment of institutional responsibilities between the federal and provincial governments, which has contributed to fiscal instability and unsustainable budget deficits.

The 7th National Finance Commission (NFC) award, implemented in FY10, reduced the Federal Government's share in the divisible pool of revenue without any corresponding reduction in its expenditure mandates, resulting in a structural deficit at the federal level. In addition, the 18th Constitutional Amendment in 2010 enhanced the fiscal autonomy of provinces without establishing any mechanism to implement consolidated fiscal targets for the general government. Thus, implementing a

⁴⁸ In 2019, civil service pensions absorbed 12.3 percent of provincial general revenues in Punjab and 11.8 percent in Sindh in 2019, while civil service employees only represented 2.0 to 3.5 percent of the labor force.

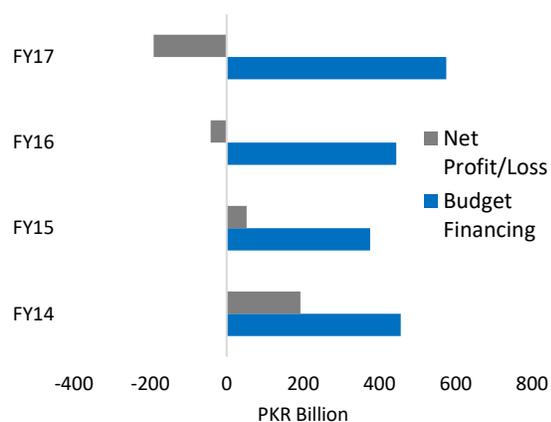
credible fiscal policy across the country is challenging, as the mandate to drive fiscal consolidation rests with the Federal Government.

By FY19, provinces received 57.5 percent of the Federal Divisible Pool, which is equivalent to 80 percent of total provincial revenues, but had no constitutional responsibility to contribute to the national fiscal goals. In FY19, the Federal Government received a 42.5 percent share of total national revenues, while undertaking 66 percent of total national expenditures.

This mismatch between expenditure responsibilities and revenue assignments contributes to persistent high general government fiscal deficits, insufficient development spending and adverse incentives for fiscal consolidation at the provincial level. Currently, there are no institutional and regulatory anchors for coordinating federating units to deliver a sustainable general government fiscal deficit.

Financial support to SOEs is a major driver of the fiscal deficit. In FY19, budget financing of SOEs amounted to almost 2.0 percent of GDP and accounted for 23 percent of the fiscal deficit. Government support to SOEs is in the form of subsidies, loans and grants, and tends to exceed the aggregate profits of SOEs (Figure 24). For the most part, subsidies received by SOEs tend to support operational costs rather than capital investments and come without any conditionality. Moreover, this support can often be a reflection of the political leverage of specific SOEs and their ministries and serves to perpetuate a situation whereby SOEs have no incentive to reduce their losses based on the certainty that the government will pay for them. This preferential access to state aid allows inefficient SOEs to remain in the market at the expense of more efficient firms, and even enables them to take a larger share of the market than they would have in the absence of these financial resources.⁴⁹ For instance, through subsidies in the energy sector, the government absorbs part of the losses incurred by electricity distribution companies (DISCOs) and alleviates public pressure on the DISCOs to improve their performance.⁵⁰

Figure 24: SOEs profit/loss vs budget financing



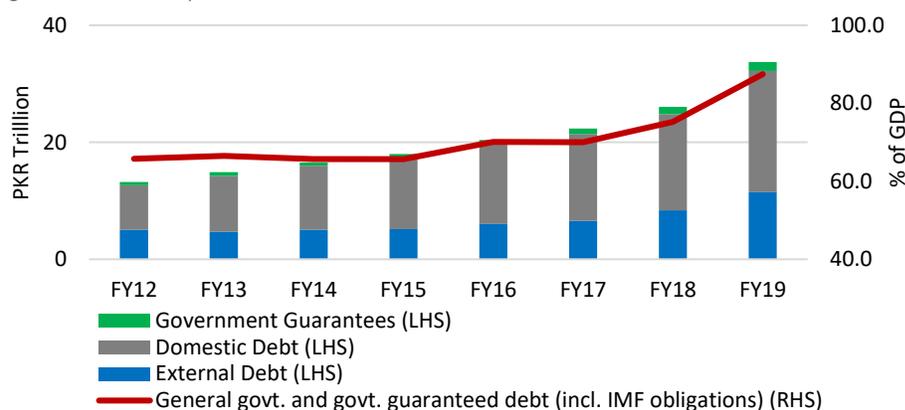
Source: World Bank staff elaboration on MoF data.

⁴⁹ See Box 14.

⁵⁰ (State Bank of Pakistan, 2019).

Consequently, due to frequent macroeconomic imbalances, the debt burden is large and growing. At end-June 2019, Pakistan’s public debt⁵¹ (including guarantees to SOEs) stood at 87.5 percent of GDP, compared with 65.8 percent in FY12 (Figure 25). In FY19 alone, the debt burden grew by 12.3 percentage points due to the large fiscal deficit, upward revaluation of the external debt stock as a result of exchange rate depreciation, and government borrowing in excess of budgetary requirements.⁵² The increase in debt levels has come from both domestic, as well as external, debt. The debt level is in breach of the Fiscal Responsibility and Debt Limitation Act (FRDLA) 2005, which stipulates a reduction of total public debt to 60 percent of GDP by end-FY18.⁵³ The public debt-to-GDP ratio is expected to remain elevated over the medium term, increasing Pakistan’s exposure to debt-related shocks.

Figure 25: Trends in public debt



Source: World Bank staff calculations based on SBP data.

Growing debt of SOEs is concerning. The stock of sovereign guarantees to SOEs has risen rapidly in recent years, reaching PKR 1.6 trillion (4.2 percent of GDP) by end-June 2019 (Figure 26). These guarantees cover 78.6 percent of SOEs’ debts, which reached over PKR 2.0 trillion or 5.3 percent of GDP in FY19. Public guarantees for SOEs pose significant fiscal risks, as they accumulate contingent liabilities⁵⁴ for the Federal Government. On top of this, SOEs also generate implicit contingent liabilities.⁵⁵ This is most pressing in

⁵¹ The public sector is defined as general government and includes public guarantees, defined as guarantees to Public Sector Enterprises.

⁵² Extra government borrowing remained in deposits with the banking system. At end-June 2019, government deposits with the banking system stood at PKR 3.2 trillion compared with deposits of PKR 1.9 trillion at end-June 2018. First Quarterly Report 2019–2020, State of Pakistan’ Economy, State Bank of Pakistan.

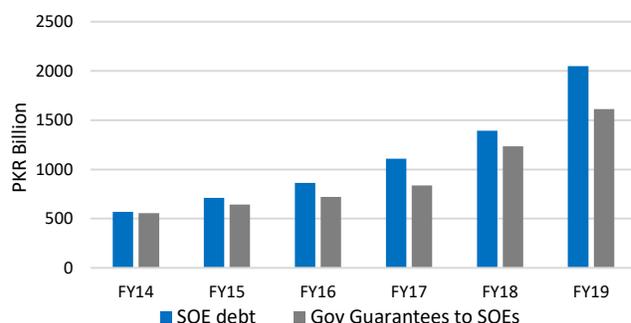
⁵³ As per the FRDLA, public debt is defined as “*debt of the government (including the Federal Government and the Provincial Governments) serviced out of the consolidated fund and debts owed to the International Monetary Fund (IMF) less accumulated deposits of the Federal and Provincial Governments with the banking system.* As per this definition, debt stood at 75.2 percent at end-June 2019. The amendment to the FRDLA also stipulates a reduction of total public debt by 0.5 percent each year from FY19–FY23 and by 0.75 percent each year from FY24–FY33 after which, public debt would be maintained at a level of 50 percent of GDP or less.

⁵⁴ Contingent liabilities are government obligations defined by a contract or a law. The Government is legally mandated to settle such an obligation when it becomes due.

⁵⁵ Implicit contingent liabilities represent a moral obligation or expected burden for the Government not in the legal sense but based on public expectations and political pressures”. Examples of implicit contingent liabilities include defaults of provincial governments and public or private entities on non-guaranteed debt and other obligations.

the power sector, where inter-enterprise arrears reached PKR 812 billion⁵⁶ (2.1 percent of GDP) by end-June 2019 (Box 7).

Figure 26: Stock of SOEs' debt and government guarantees



Source: World Bank staff calculations based on MoF and SBP data.

Box 7: Power sector circular debt

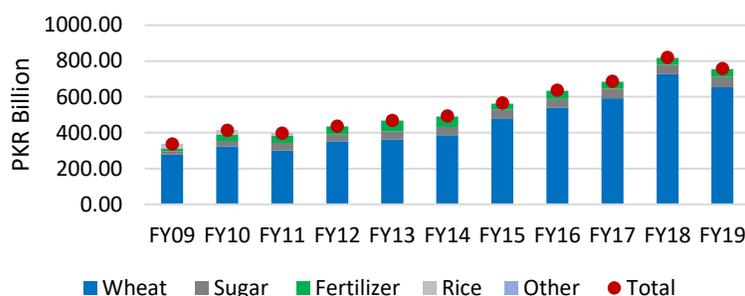
Annually, the power sector incurs substantial losses due to its heavy reliance on costly imported fossil fuels, unbudgeted subsidies, lack of timely determination and implementation of tariffs, and the poor performance of electricity distribution companies (DISCOs). As of June 2019, payables to the power generators—a measure used to estimate the sector's financial liabilities (and commonly known as circular debt)—were about PKR 812 billion. This is on top of the PKR 806 billion of power sector debt parked in the Power Holding Company (established by the government to park these liabilities off-budget). In total, these PKR 1,618 billion (4.2 percent of GDP) of payables are fiscal liabilities that the government will have to settle. Thus, the accumulation of circular debt represents a direct fiscal cost and compromises macroeconomic sustainability. Furthermore, financial liabilities in the power sector constrain investment, as they increase the risk for investors and result in under investment in transmission and distribution systems.

Liabilities accumulated by provincial governments against commodity operations add to Pakistan's fiscal risks. Every year, federal SOEs and provincial governments⁵⁷ borrow from commercial banks to finance the purchase of commodities, for example wheat, etc. They are required to subsequently retire these loans from the proceeds generated from the sale of crops (whose stock is used as a collateral in these transactions). However, with delays in subsidy payments, losses in stock during storage, release to flour mills at low rates and transportation and storage costs, these liabilities have been accumulating over the years and, at end-June 2019, they stood at PKR 756 billion compared with PKR 336 billion in FY09 (Figure 27). Borrowing against wheat procurement constitutes the bulk of these liabilities (86 percent of total). These liabilities are not part of public debt (as they are considered to be backed by the stock of the commodity purchased) but pose fiscal risks (1.7 percent of GDP in FY19) for the government if they are not repaid by the borrowing agencies.

⁵⁶ In addition to these arrears, PKR 806 billion of the power sector debt are parked in the Power Holding Company (an SOE). This is part of the government guarantees issued to SOEs.

⁵⁷ Provincial governments undertake this borrowing under a federal guarantee.

Figure 27: Liabilities against commodity operations



Source: World Bank staff calculations based on SBP data.

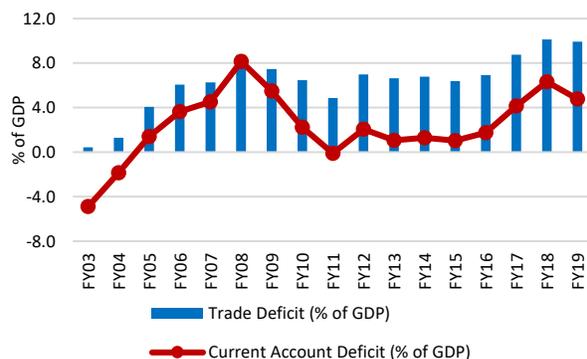
The COVID-19 pandemic has exacerbated Pakistan’s fiscal and debt concerns. To contain and deal with the health and economic costs of the pandemic, the government announced a large fiscal stimulus package that added to the government’s expenditures. On the other hand, efforts to increase revenues in FY20 suffered as the decline in private consumption and near halt in domestic activity led to a revenue shortfall. With limited options for fiscal consolidation, development expenditures were restricted. The fiscal deficit in FY20 was recorded at 8.1 percent of GDP compared to the budget estimate of 7.1 percent of GDP. The government borrowed externally to meet its financing requirements and public debt (including guaranteed debt) is expected to have crossed 90 percent of GDP by end FY20. Pakistan has also availed debt service suspension under the Debt Service Suspension Initiative (DSSI)⁵⁸. Fiscal risks posed by the circular debt in the power sector are expected to have increased by US\$1.6 billion due to the pandemic’s impact on electricity consumption and recovery of receivables.

External sustainability

Pakistan experiences recurring external imbalances. Since FY03, Pakistan’s trade and current account balances have remained largely negative, with imports exceeding exports throughout the period (Figure 28). While remittances have increased in recent years, on average they only cover less than 40 percent of the imports bill (Figure 29). Most recently, consumption-driven GDP growth during FY18 came at the cost of a high CAD of 6.1 percent of GDP, as imports of goods and services reached US\$62 billion (22 percent of GDP) compared with exports of just US\$29.6 billion (10.4 percent of GDP). In FY19, the government took various adjustment measures, as a result of which the CAD narrowed to 4.8 percent of GDP in FY19. However, this primarily resulted from a sharp contraction in imports, rather than an expansion in exports.

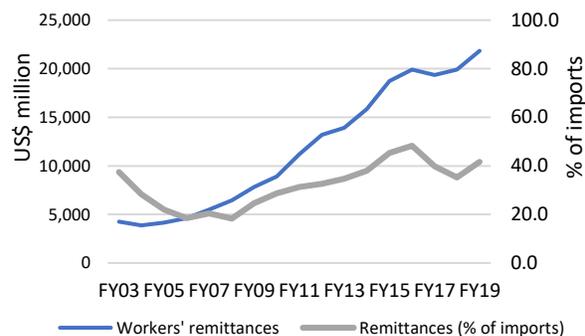
⁵⁸ Under the DSSI, Pakistan has written to its 21 bilateral creditors and signed the Memorandum of Understanding with the Paris Club to suspend payments coming due between May 1 and December 31, 2020. The DSSI is expected to provide between US\$1.9 billion and US\$2.7 billion in temporary additional fiscal space. The country has committed to use these resources toward additional social, health or economic spending.

Figure 28: Current account and trade deficits



Source: World Bank staff elaboration on SBP data.

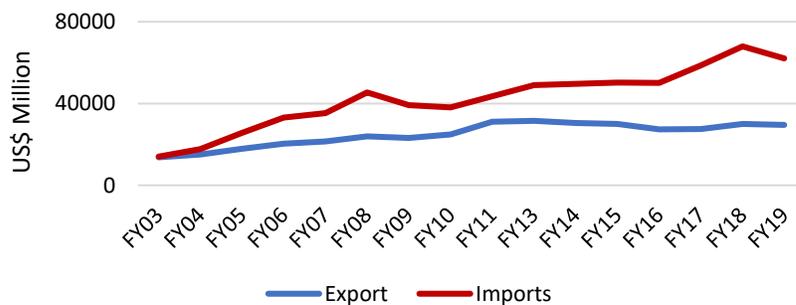
Figure 29: Remittances (as a % of imports)



Source: World Bank staff elaboration on SBP data.

Maintenance of an overvalued exchange rate has added to Pakistan’s external woes. An overvalued exchange rate subsidizes imports, while making exports more expensive and uncompetitive in international markets. This results in large and growing trade deficits. In Pakistan, the artificially propped-up exchange rate, particularly between 2013 and 2018, encouraged imports, contributing to rising domestic demand under an already expansionary fiscal policy and an accommodative monetary policy stance. As a result, during this period, Pakistan’s goods imports grew by 39 percent, whereas goods exports contracted by 5 percent. This growing imbalance due to misaligned exchange rate policies fueled a CAD of 6.1 percent of GDP in FY18 (Figure 30).⁵⁹

Figure 30: Import and export trends (FY03–FY19)



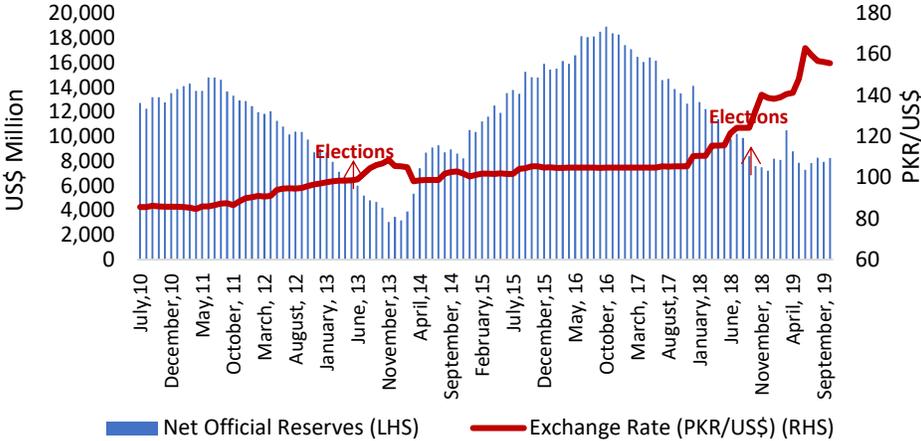
Source: World Bank staff elaboration on SBP data.

It has also led to an erosion of external buffers. The overvalued position of the Pakistani rupee between 2013 and 2018 was achieved at the cost of declining foreign reserves, the erosion of external buffers and increased external borrowing. For instance, during 2013 the PKR/US\$ exchange rate depreciated from 98.6 at end-May to 108.9 at end-November. The resulting criticism led to the then finance minister declaring that the nominal PKR/US\$ exchange rate would be brought back to May 2013 levels, which the government managed to do by April 2014 (aided by external inflows from the IMF and Saudi Arabia). From thereon, a strong rupee was integral to the then government’s economic policy (Hamid & Sarosh Mir, 2017), until external pressures forced it to depreciate in late 2017 to early 2018 (Figure 31). The potential

⁵⁹ (International Monetary Fund, 2019).

negative impact of this policy can be seen in import coverage, which fell from a high of 4.0 months in June-2016 to just 1.9 months in June-2019 and an increase in public debt levels.

Figure 31: Net official reserves and exchange rate (PKR/US\$)



Source: World Bank staff calculations based on SBP and IFS (IMF) data.

While the fall in imports helped narrow the current account deficit in FY20, exports suffered due to the pandemic. To avoid frequent external imbalances, Pakistan needs to increase its exports. The COVID-19 pandemic disrupted international trade flows that led to a decline in both imports (-18.2 percent) and exports (-7.2 percent) in FY20. However, with an uncertain global growth outlook and the pandemic related stresses weighing in on the domestic manufacturing sector – Pakistan’s exports face a hostile environment in the near-term. Export-oriented firms will need the government’s support to rebound following the protracted economic downturn period.

Risks to Social Cohesion

Inequality of opportunities and limited socioeconomic mobility

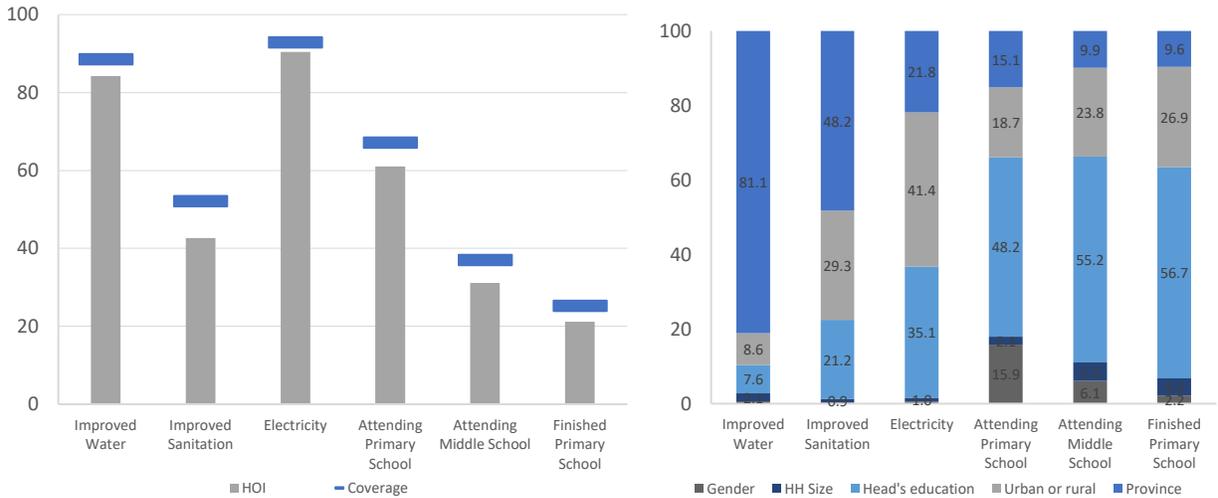
Opportunities to engage in, and benefit from, the development process are not equally distributed...

Promoting shared prosperity goes hand-in-hand with guaranteeing equality of opportunity. This means ensuring that every child's access to basic services does not depend on factors for which they bear no responsibility, such as gender, location, or the family socioeconomic background that he or she is born into. This is important in order to level the playing field for all. The Human Opportunity Index (HOI)⁶⁰ is a useful tool that captures the availability of services—or opportunities—after adjusting for how equally they are distributed. In the case of Pakistan, basic opportunities, such as completing primary school on time, continuing studies after primary school, having safe water to drink, and access to adequate sanitation facilities and electricity at home, appear to be far from universal or equally distributed (Figure 32). Finishing primary school is the opportunity in which Pakistan performs the worst, followed by middle-school attendance and improved sanitation. Equally worrisome is that progress over time has been marginal, both in terms of basic coverage and the HOI. A child's gender and the type of household into which he or she is born⁶¹ bear significantly on the opportunities that he or she will enjoy early in life. In particular, differences in where children are born (province and urban/rural location) are more relevant for inequality of opportunities in basic infrastructure, while gender and education of the household head are the most relevant for inequality in education opportunities.

⁶⁰ The Human Opportunity Index (HOI); (Paes de Barros, Ferreira, Molinas Vega, & Saavedra Chanduvi, 2009) is one of the analytical tools developed to measure equality of opportunities. The HOI synthesizes in a single indicator how close a society is to universal coverage of a given opportunity and how equitably coverage of that opportunity is distributed. The HOI "penalizes" the extent to which different circumstance groups—that is, population groups defined by certain circumstances or attributes of an individual's environment—have different coverage rates. When coverage rates among multiple circumstance groups are equal, the penalty is zero and the HOI is equal to the opportunity's overall coverage rate. As coverage rates differ among circumstance groups, the penalty increases and the HOI decreases. Higher inequality in coverage rates leads to lower HOI.

⁶¹ Households' circumstances included in the analysis of the HOI include education of the household head, composition of the household (household size), and geographical area of residence (urban or rural area, province). Unfortunately, data do not allow to account for ethnicity, religion, or caste, which could have provided further insights on the extent of horizontal inequalities and exclusion.

Figure 32: Coverage, HOI, and contribution of circumstances to opportunities



Source: World Bank staff elaboration based on PSLM 2014 data.

...and socioeconomic mobility is low. A recent report analyzing trends in inter-generational mobility in education,⁶² ranks Pakistan among the worst performing in both absolute and relative mobility.⁶³ To illustrate this, the report looks at individuals from the 1980s generation whose parents had education levels in the bottom half of their peers. Among these, it measures the share of individuals who ended up achieving education in the top quartile. Ideally, if one's ability to obtain an education does not depend on how well-educated one's parents are, this share should be 25 percent. Pakistan ranks among the bottom 10 countries: only 9.4 percent of individuals born to parents in the bottom half make it to the top, compared with a median of 15 percent among developing economies.⁶⁴

The COVID-19 crisis is expected to exacerbate pre-existing inequalities, particularly in terms of education opportunities. The disruption of education services during the COVID-19 pandemic will disproportionately affect disadvantaged and hard-to-reach children, including girls and young women. It is expected that the pandemic will reduce both education demand and supply in at least three ways: (i) negative shocks to household incomes that will make children in poorer households less likely to attend school once they reopen; (ii) negative effects on household perceptions and attitudes towards sending children to school due to fears of contagion; and, (iii) negative impacts to the supply of education due to the permanent closure of low-fee private schools due to the crisis. The depth and scope of these effects remains to be assessed⁶⁵.

⁶² (World Bank, 2018).

⁶³ Absolute educational mobility is defined as the share of adults that are more educated than their parents, and relative mobility is defined as the correlation between individuals' education and that of their parents.

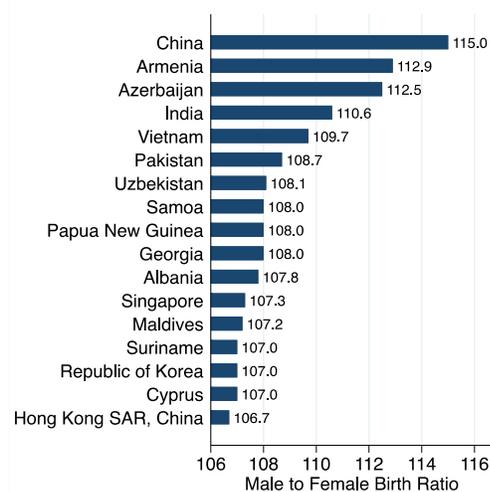
⁶⁴ Compared with other South Asian countries, Pakistan is doing marginally better than India (8.9 percent) and Bangladesh (8.6 percent), but worse than Nepal (11.4 percent), Afghanistan (12.3 percent), Sri Lanka (15.9 percent), and the Maldives (24.8 percent).

⁶⁵ See section on Data and Knowledge Gaps

Gender-based inequality

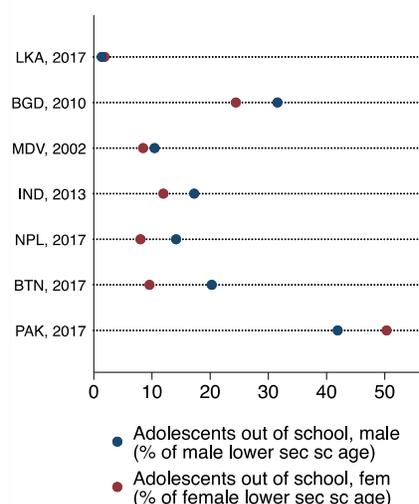
Girls and women in Pakistan are denied equal opportunities, even before they are born. With a sex ratio of 108.7,⁶⁶ Pakistan has the sixth-highest sex ratio at birth, after China (115.0), Armenia (112.9), Azerbaijan (112.5), India (110.6) and Vietnam (109.7) (Figure 33). Growing up, girls at any age are less likely to be at school than their male counterparts. Compared with other countries in the region, Pakistan has the highest rate of adolescent girls who are out of school (Figure 34). While the proportion of uneducated working age women has declined over time, female literacy remains as low as 48 percent—25 percentage points lower than male literacy.⁶⁷

Figure 33: Sex ratios at birth, 2017



Source: World Bank staff elaboration based on WDI data (Source organization: United Nations Population Division. World Population Prospects, 2017 Revision).

Figure 34: Adolescents out-of-school rates, by gender



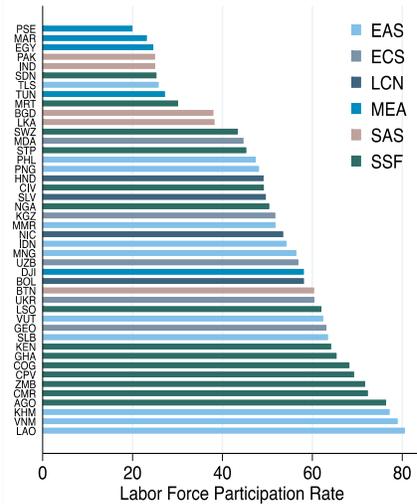
Source: World Bank staff elaboration based on WDI data.

Women are under-represented in the economic life of society. With one of lowest female labor force participation rates in the developing world, Pakistan is not tapping the economic potential of half its population. At 25 percent in 2017, the female labor force participation (FLFP) rate in Pakistan is the fourth lowest among lower middle-income countries, after Egypt (24.6 percent), Morocco (23.2 percent) and the State of Palestine (20 percent). Even including low-income countries, Pakistan sits at the bottom, following countries in the Middle East and North Africa region (except Tunisia and Djibouti) and Somalia (Figure 35, left panel). Pakistan currently has the same FLFP rate as India. But the two countries reached this level following two opposite paths. Pakistan experienced an increase of FLFP from 16.5 percent in 2000, to 22.8 percent in 2010, while India experienced a 7-percentage-point decrease, from 32 percent in 2000 to 27 percent in 2010 and then 25 percent in 2017 (Figure 35, right panel).

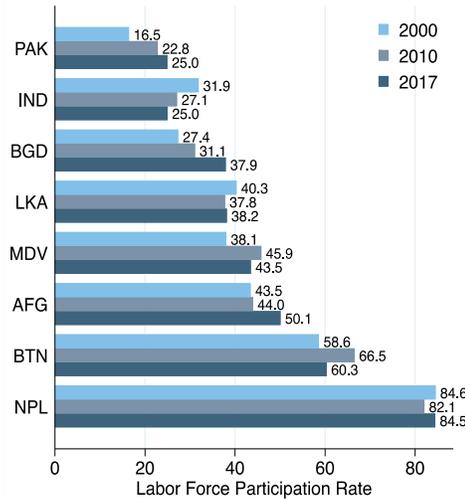
⁶⁶ The natural *sex ratio at birth* is considered to be around 105 (WHO). This means that at birth on average, for every 100 females there are 105 males.

⁶⁷ Based on PSLM 2014–15 data.

Figure 35: Female labor force participation
Lower middle-income countries, 2017



South Asian countries, various years



Source: World Bank staff elaboration based on WDI data.

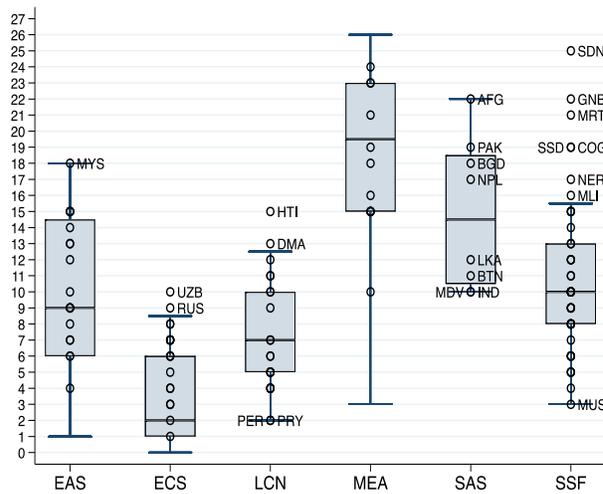
During their working lives, women’s participation in the political and economic life of Pakistan is hindered by formal laws and discriminatory norms. Gender equality and women’s participation in all spheres of public life are enshrined in the Constitution of Pakistan. Nonetheless, despite several initiatives to safeguard the interests of women by successive governments, Pakistan ranks 143rd out of 144 countries on the World Economic Forum’s Global Gender Gap Index. According to the latest data available from the Women, Business and the Law project (World Bank, various years),⁶⁸ women in Pakistan still face 19 legal restrictions that interact with their economic decisions at various stages of their working lives (Figure 36), and the country has the 16th lowest score in a sample of 126 developing countries.⁶⁹ While affirmative action has contributed to increasing the share of women legislators,⁷⁰ the female share of employment in senior- and middle-management positions remains as low as 3 percent (Figure 37). This is not only the worst outcome in South Asia, but in all 158 countries for which data are available.

⁶⁸ World Business and Law project tracks 35 different areas of law that interact with economic decisions that women make at various stages of their working lives, divided in eight indicators: Going Places, Starting a Job, Getting Paid, Getting Married, Having Children, Running a Business, Managing Assets and Getting a Pension.

⁶⁹ In South Asia, only Afghanistan has a worse score. All other countries in the first 14 worst positions are found in the Middle East and North Africa (MENA) and in Sub-Saharan Africa (SSA).

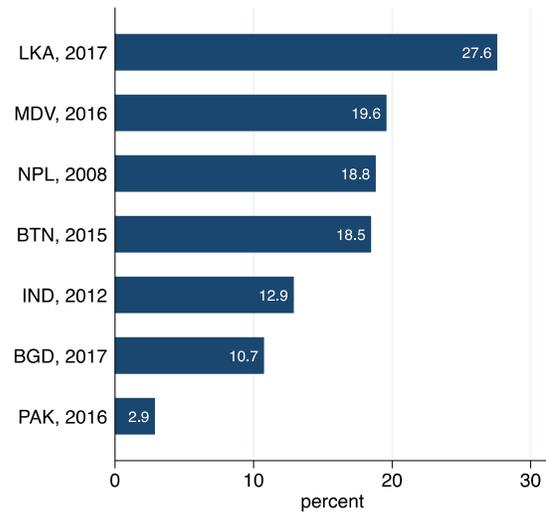
⁷⁰ The share of women in Parliament increased from less than 2 percent in 1995 to 20.2 percent after the March 2018 elections (IPU, 2019).

Figure 36: Number of legal restrictions to women's decision-making, 2018



Source: World Bank staff elaboration based on data from Women, Business and the Law (database).
 Note: The figure does not include high-income countries.

Figure 37: Female share of employment in senior and middle management



Source: World Bank staff elaboration based on WDI data.

Underlying these dismal statistics is the rigidity of the form of patriarchy that women and men experience in Pakistan. Scholars over the years have documented the existence of ‘classic patriarchy’ in South Asia (Kandiyoti, 1988). Under this form of patriarchy, men are considered not only to be superior to women in all aspects of life, but also control women throughout their life cycle: as daughters, wives, mothers, and mothers-in-law. This system provides incentives to devalue women and girls, whose agency is thereby severely limited (Solotaroff & Pande, 2014). In Pakistan, for instance, despite improvements in gender equality on socioeconomic indicators,⁷¹ women and girls remain severely restricted in their choices for mobility, education, marriage, and employment, and are exposed to gender-based violence (GBV).⁷²

⁷¹ Evidence suggests that improvements in gender equality in socioeconomic indicators may, at least in the short run, exacerbate this situation of rigid patriarchal control. (Klugman, et al., 2014) show that when endowments (such as health and education) and economic opportunities become more equitable, social norms can be particularly hard to dislodge and can impose limitations on other gender-equitable outcomes or overburden women with increased expectations of responsibilities and labor.

⁷² Data on myriad forms of violence against women and girls in Pakistan are unreliable and not up to date. However, it is known that such violence is very high. For instance, one in three ever-married women (ages 15-49 years) has experienced physical and emotional spousal violence in their lives (Pakistan Demographic and Health Survey 2012–13); other studies estimate these figures to be much higher.

Pakistan presents a complex case of state fragility. Despite relatively strong federal institutions and ongoing democratic consolidation, as seen by the recent (and third consecutive) peaceful handover of political power, this fragility is associated with a number of mutually reinforcing conflict drivers that are linked to deeper, structural factors. A narrow and entrenched political settlement, combined with the weakness of the democratic system, has enabled elites to resist structural changes that would allow for a more level playing field.

Challenges related to the exclusive distribution of power and resources feed into pre-existing fault lines marked by economic and social inequalities between groups. Intra-elite conflicts along provincial and ethnic lines have periodically arisen. The three demographically smaller provinces, namely Sindh, Balochistan and KP, have asked for a greater share of resources from the Federal Government. Recent institutional reforms, notably the 18th Amendment to the Constitution in 2010 and the 7th National Finance Commission (NFC), have significantly contributed to addressing some of the underlying causes of fragility by increasing the provinces' political and fiscal autonomy.

The exclusion of populations in parts of Pakistan's territory, similar to the case of the former Federally Administered Tribal Areas (FATA), has been a major driver of conflict. Former Federally Administered Tribal Areas are located along the North-Western border with Afghanistan. Over the years, a colonial-era body of law isolated the region from the rest of Pakistan, giving it an ambiguous constitutional status, and depriving the population of economic opportunities.⁷³ Between 2001 and 2011, conflict claimed the lives of 35,000 people—a situation that many observers have likened to a civil war.⁷⁴ In 2018, the 25th Amendment to the Constitution of Pakistan integrated the former FATA—now Merged Areas—into the province of KP. Despite representing an opportunity, the administrative transition of the former FATA and the merger with KP have added a further layer of complexity to existing dynamics. The 25th Amendment for a FATA-KP territorial merger, abolition of Article 247, and extension of judicial oversight, have created new opportunities to end the area's political, social, and economic isolation.

Pakistan's leading urban center, Karachi, grapples with different manifestations of fragility too. Home to a population of 16 million, Karachi is the fifth-fastest-growing mega-city in the world and accounts for about 35 percent of the country's GDP. It is Pakistan's main economic hub and hosts the country's only fully functional port. Karachi has experienced high levels of criminality and tensions between ethnic groups and continues to suffer from poor service delivery and weak local institutions. The presence of large-scale heterogeneity, political organization of ethnic identity, and heightened competition over urban resources have all acted as strong drivers of conflict. While heterogeneity and migration are key drivers of fragility, a headline outcome from analyzing Karachi's case is the breakdown of local government institutions.

⁷³ Historical marginalization of Federally Administered Tribal Areas is further confirmed by the lack of official development statistics for the region.

⁷⁴ (Lieven, 2011) According to government estimates, the direct and indirect cost incurred by Pakistan due to incidents of terrorism during the past 16 years amounted to US\$123.13 billion (Ministry of Finance, 2017).

Risks to Environmental Sustainability

Growing challenges to environmental sustainability pose a serious risk to the achievement of twin goals in Pakistan. Pakistan's development model has not addressed the environmental challenges related to an unsustainable use of natural resources. High rates of population growth, wasteful use of water in agriculture, rapid urbanization, and Pakistan's vulnerability to natural disasters and climate change, all raise risks to achieving inclusive growth as well as poverty reduction. Poorest segments of the population will be the most affected should environmental concerns and depletion of natural resources remain unaddressed. Higher reliance on agriculture for livelihoods, poor housing quality and employment conditions, particularly in urban areas, as well as limited capabilities to cope with shocks are all factors that expose the poorest to suffer the most from the incidence and negative consequences of natural hazards as well as of natural resources depletion.

Growth in water demand is on an unsustainable path. Water availability per capita in Pakistan varies from year to year because of climate fluctuations but has declined in recent decades because of population growth (Figure 38). Looking forward, water demand could increase by at least 50 percent over the next 30 years, significantly outstripping supply. Population and economic growth will be the dominant drivers of the demand increase, but climate change will also contribute significantly.⁷⁵ The largest increases in demand will be for irrigation, while the fastest rates of increase will be for domestic and industrial use. Current withdrawal levels are already nearing 60 percent of renewable water supply, making a large increase in water demand unsustainable, further increases in groundwater pumping notwithstanding. Stringent demand management and efficiency improvements will be critical if Pakistan is to stay within its available water resource envelope.

Water use in agriculture is inefficient. Agriculture is heavily dependent on irrigation and the sector alone accounts for more than 90 percent of water withdrawals in Pakistan, while contributing only 20 percent of GDP. Within the sector, the four major crops (wheat, rice, sugarcane and cotton) represent nearly 80 percent of all water use and generate less than 5 percent of GDP (Figure 39). Governance issues in the sector provide only weak incentives to save water. Irrigation water tariffs (*abiana*) are charged on a flat rate per hectare (Punjab) or a crop-based system (Sindh, KP and Baluchistan),⁷⁶ making farmers insensitive to water saving and efficiency. There are also concerns over the equity and reliability of water distribution.⁷⁷ Improper water use and management and deteriorating drainage infrastructure in

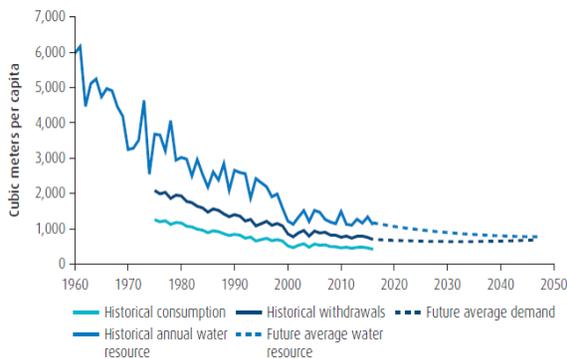
⁷⁵ According to (Young, et al., 2019) climate warming could increase water demand between 5 to 15 percent.

⁷⁶ Both systems of water pricing do not encourage saving as neither relate to actual water use (Commission, 2012).

⁷⁷ There are also concerns over the equity and reliability of water distribution. Farmers at the tail end of the canals—typically small farmers—invariably do not receive their share of water due to the poor maintenance of existing canals, water theft by farmers upstream—typically big landowners—and rent-seeking by operators (Jacoby, Mansuri, & Freeha, 2018).

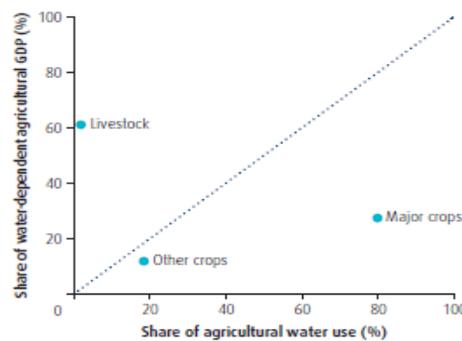
agriculture are also major causes of land degradation. An estimated 40 percent of irrigated land is affected by either salinity or waterlogging,⁷⁸ posing a serious long-term threat to agriculture.

Figure 38: Historical water availability (1960–2016), withdrawal (1975–2016), consumption (1975–2016) and projected availability and demand to 2047



Source: World Bank staff calculations based on Government of Pakistan (2017) data.

Figure 39: Share of agricultural water use and water-dependent agriculture to GDP in Pakistan, 2016



Source: World Bank staff calculations based on PBS data.

Growing water scarcity is compounded by poor water quality. Only four out of ten cities with more than 1 million inhabitants have wastewater treatment facilities. Karachi, with an estimated population of 15 million, has only three wastewater treatment plants, one of which is not functional. As a result, 89 percent of the 1.8 million m³ of sewerage generated daily are left untreated and discharged into the Arabian sea. The situation in Pakistan’s second-largest city is no better. Lahore, with a population of over 11 million, has no wastewater treatment plant and 2.4 million m³ of untreated sewage flow daily into the Ravi river. Inadequate treatment of industrial and municipal sewage and wastewater, combined with agricultural run-off have resulted in high levels of chemical and bacterial water contamination in both urban and rural areas.⁷⁹ Poor water quality is also a major determinant of Pakistan’s high level of stunting, which undermines human capital progress (Box 8). In addition, Pakistan has yet to develop a functional and integrated sustainable waste management system to manage about 20 million tons of solid waste generated yearly. As a result, only 70 percent of this waste ends up in the landfills or dump sites of its cities. In Karachi, on a daily basis, about 4,000 tons of garbage is left on the streets or dumped into open areas, of which about 65 tons is expected to enter water bodies and eventually flow into the sea.⁸⁰

⁷⁸ Salinity is most serious in Sindh, where about 50 percent of the area is saline. Waterlogging is also prevalent in Sindh, where 60 percent of the irrigated area is severely waterlogged, while about 25 percent of the irrigated area in Punjab is waterlogged (Young, et al., 2019).

⁷⁹ About 119 million people in Pakistan may live in areas with elevated levels (above the recommended WHO threshold of 10 µg/L) of arsenic in drinking water (World Bank, 2019).

⁸⁰ Poor waste management has made Pakistan one of top 20 most polluting nations ranked by volume of mismanaged plastic waste.

Box 8: Pakistan's water and sanitation challenge

Over the past decade and a half, Pakistan has made significant progress on reducing poverty and improving dietary diversity. However, this has failed to bring about any real improvement in critical markers of child health, namely rates of diarrhea and stunting.

While there has been a substantial reduction in open defecation (OD) and access to basic WASH infrastructure has improved throughout the country, significant gaps at the regional and sectoral levels persist. Poorer areas have much lower quality water and sanitation infrastructure, relying largely on unimproved toilets rather than toilets connected to sewerage systems or septic tanks. Rural areas are, in general, more poorly served by public water and sanitation services, with virtually no investments in publicly provided piped drinking water or sewerage connections. Self-provision is the norm, with virtually no regulatory enforcement to ensure adherence to basic safety or quality guidelines.

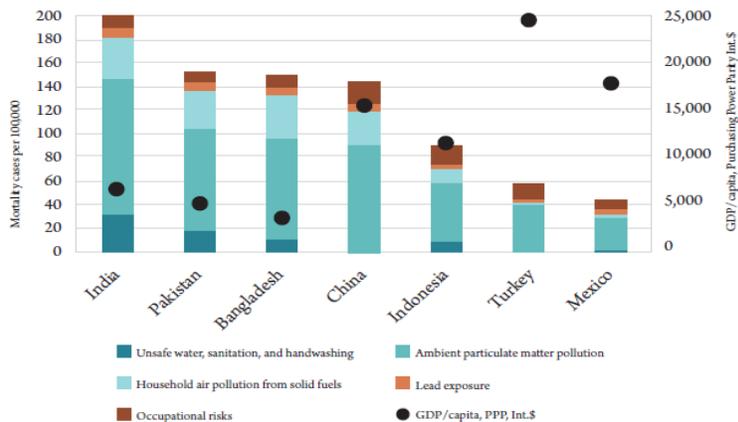
The policy focus on eliminating OD and increasing access to private toilets has completely overlooked the critical problem of fecal waste management. The expansion of unimproved toilets combined with poor fecal waste management systems and practices have worsened the total fecal burden within increasingly densely populated human settlements, leading to the contamination of soil, groundwater and surface water with fecal sludge and *Escherichia coli* bacteria.

E. coli-contaminated ground and surface water is used for drinking purposes, largely without any treatment. Untreated wastewater is also used for food production. This has led to the worsening of all five routes for the oral transmission of disease (food, flies, fingers, fields and fluids), with huge implications for both short- and long-term health outcomes, particularly for younger children.

Source: (Mansuri, et al., 2018)

Rapid and poorly planned urbanization has also contributed to the deterioration of air quality. Air quality measures, such as the concentration of fine particulate matter (PM 2.5), suggest that Lahore and Karachi both have worse air than Beijing, and that Pakistan's concentration of PM 2.5 is high compared with many countries at similar income levels. The Environmental Performance Index (EPI)⁸¹ ranks Pakistan 176th out of 180 countries in terms of air quality, and 140th in water sanitation with only 36 percent of the population having access to safely managed water. The overall health burden attributable to environmental/occupational risks in Pakistan is about 152 deaths per 100,000 population (Figure 40), and the total cost of air, water and industrial pollution and occupational safety is estimated at 9.0 percent of GDP in 2016 (World Bank, 2019).

Figure 40: Health burden attributable to environmental/occupational risks, selected countries



Source: World Bank staff estimation from Global Burden of Disease (2016) data.

⁸¹ (Yale Center for Environmental Law and Policy, 2018).

Depletion of natural resources and a lack of attention to manage natural resources sustainably amplify the vulnerability to natural disasters. Pakistan faces significant seismic, hydrological and meteorological risks, with recurrent major natural disasters are frequent, with significant impact on people lives and on the country's economy. A major earthquake in 2005 in northern Pakistan caused more than 73,000 deaths and US\$5 billion in losses. In the period 2010–14, five major floods hit Pakistan that cumulatively resulted in economic losses of US\$18 billion, caused more than 2500 deaths and affected the lives of 38 million people⁸². A major cyclone event in 2007 – cyclone Yemyin – caused more than 730 death and affected the lives of 2 million people. Droughts and extreme temperature event are similarly recurrent and catastrophic. Since 2014, droughts have affected more than 3 million people and severely impacted the livelihoods of poor resulting in forced displacements, while a heatwave that hit Karachi in 2015 left 1,200 people dead. Population growth, deforestation⁸³, soil degradation, depletion of water resources, an unplanned process of urbanization and the poor quality of buildings and infrastructures amplify the vulnerability of people to natural disasters.

Climate change will compound Pakistan's current environmental and development challenges. In the absence of adaptation measures and fundamental changes in Pakistan's growth model, climate change is expected to increase the occurrence and severity of extreme weather events, with high human and economic costs.⁸⁴ Climate change is expected to increase the variability of water inflow and to negatively affect agriculture, with yields of staple crops projected to decrease by up to 20 percent and livestock production predicted to decline by as much as 30 percent, as rangelands become increasingly stressed due to longer droughts. Climate change-induced rise in sea level is also projected to make Pakistan's coastal cities—Karachi, Thatta and Badin—vulnerable to flooding. Pakistan is ranked fifth on the Global Climate Risk Index⁸⁵ of countries most affected by climate change between 1999 and 2018. An estimated population of about 49 million resides in areas at risk of a 4 to 5 percent decline in the quality of life by 2030 due to climate change.

⁸² The worst and most destructive flood in 2010 swept away approximately 20 percent of Pakistan's land and affected over 20 million people.

⁸³ (Koirala, Ru, & Jabeen, 2018).

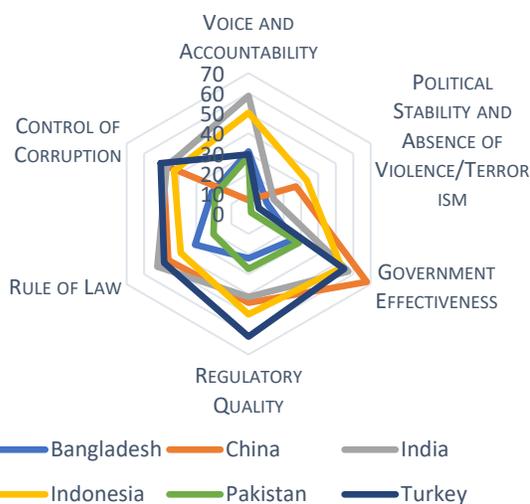
⁸⁴ (Stephen, Gueneau, Mekonnen, Ringler, & Robinson, 2016).

⁸⁵ (Eckstein, Hutfils, & Wings, 2019).

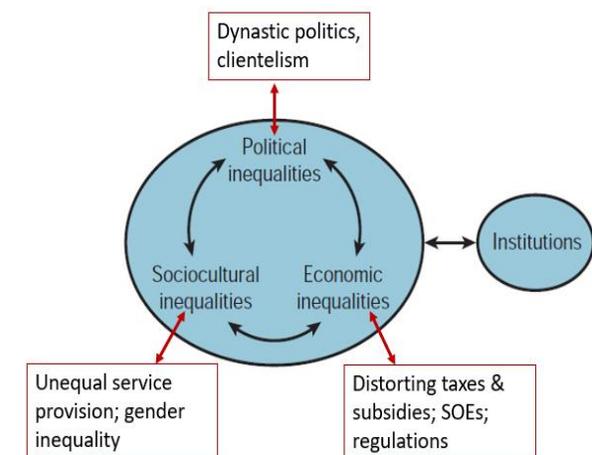
CONSTRAINTS TO GROWTH, POVERTY REDUCTION AND SHARED PROSPERITY: PAKISTAN’S “INSIDER – OUTSIDER” MODEL OF DEVELOPMENT

Pakistan’s poor growth performance, inclusion and shared prosperity challenges are rooted in weak governance. Pakistan performs below its regional peers on various governance and institutional indicators (Figure 41). It has the lowest percentile ranking among its peer countries on four out of the six indicators in the World Governance Indicators (WGI) database (Voice and Accountability, Political Stability, Rule of Law, and Control of Corruption) and is outranked by all countries apart from Bangladesh in the remaining two indicators (Governance Effectiveness and Regulatory Quality). Similarly, governance factors feature prominently among the obstacles to investment in Pakistan, as documented in the 2018 Global Competitiveness Report: businesses cite corruption, taxes, government instability, crime and theft, and inefficient bureaucracy as major constraints to investing in Pakistan.

Figure 41: Pakistan’s governance performance compared with peers, percentile rank 2018



Source: World Bank staff elaboration on WGI data.



Source: World Bank staff adaptation of (World Bank, 2006).

The fragility of Pakistan’s institutions—namely, the rules of the game governing interactions between citizens and the State—is the result of elite capture. As discussed in the *World Development Report 2006 “Equity and Development”*, institutions are not built in a vacuum. Rather, they reflect self-reinforcing power asymmetries present in the economic, political and socio-cultural spheres that result in a broken social contract that fails to account for the needs and voice of citizen (Figure 42). In Pakistan, the power of the elite(s) is rooted in the overlap of self-reinforcing asymmetries in the distribution of economic power (through the concentration of land and capital), social power (through the control of religious/sectarian or ethnic/kinship groups) and political power (through the control of state institutions

and resources).⁸⁶ The nexus of power between the elites that is rooted in the colonial legacy and evolution of the country has morphed into an “insider-outsider” model of development.^{87,88} In this model, weak and captured institutions serve the narrow interests of the few (insiders), while they fail to provide universal opportunities for socioeconomic development to the many (outsiders). In fact, the provision of opportunities (formal jobs in the public sector; access to services such as health, education and justice; goods and infrastructure, such as water, land, sanitation, roads and electricity) is mediated within a system of client-patron relations, which allows the political/economic elite(s) to maintain its hold—either directly or indirectly—on political power and economic resources, and perpetuate power asymmetries and extractive institutions in a vicious cycle over time. Over time, these dynamics have undermined the legitimacy and effectiveness of Pakistan’s formal institutions and weakened their ability to manage and mediate contestations and/or to adapt to societal change.

Pakistan is currently stuck in a development trap. As discussed in Section 1, Pakistan is on a stagnating growth and declining shared-prosperity path. *The thesis posited in this SCD is that the development of the key markets that regulate the allocation of productive factors (markets for land, capital and labor) has been stunted by elite capture.* More specifically, elites that—for reasons of historical legacy—controlled higher original endowments of land, and of physical and human capital (insiders), did not have the incentives to support policies that could have addressed land, labor and capital market imperfections because this could have diluted their hold on economic, social and political power, and their grip over (state) resources. On the other hand, citizens who would have benefited from such reforms (outsiders) lacked the power (resources and political representation) to bargain for change. As a result, by maintaining underdeveloped markets, the insiders have been able to extract resources from the State, and to further exacerbate inefficiencies and inequalities in the allocation and accumulation of productive factors. In this framework, the constraints that inhibit sustained growth and challenge prospects of poverty reduction and shared prosperity—namely, low investment, weak fiscal management, and slow and unequal progress on human capital accumulation and (growth enhancing) structural transformation—can be ascribed to the lack of support for reforms that could have addressed inefficiencies in the land, capital and labor markets.

⁸⁶ See (Lieven, 2011), (Hussain, 1999), (McCartney & Zaidi, 2019).

⁸⁷ (Hussain, 1999) identifies four influential groups in Pakistan that gained power through historical events and then leveraged their influence on the political system for personal gain. These are the: (i) civil servants; (ii) landowners; (iii) industrialists; and (iv) military. 20 years on, these groups continue to influence reform and policy implementation processes in Pakistan for their benefit (World Bank, 2019).

⁸⁸ In the words of (Alavi, 1972)—a prominent Pakistani sociologist and anthropologist—the power nexus between Pakistani elites resulted in a “over-developed post-colonial state dominating an un- or under-developed society” (McCartney & Zaidi, 2019).

Land Market

Inequality in the distribution of land has been at the root of Pakistan’s system of elite capture and of its reproduction over time. When societies have high levels of inequality, such inequalities are reflected in the unequal capacity of groups to influence the policy-making process, making inequality more persistent. Despite three major land reforms during Pakistan’s history, the level of inequality in land distribution observed today remains very similar to the one that prevailed during British colonial rule (Box 9). The prevailing inequality in land distribution and associated diffusion of landlord-tenancy institutions are at the heart of the development of Pakistan’s elite capture system. By providing patronage and public goods to their tenants, big landlords were able to secure political power and to preclude the development of effective policies for the “anonymous” provision of welfare by the State. Over time, through their influence on economic policies and collusion with other economic elites for the control of state resources, inequality in assets was perpetuated (if not expanded) and the clientelistic equilibrium reproduced.

Box 9: Land distribution and land tenure systems in Pakistan

Land distribution in Pakistan has been highly unequal since colonial times. During the period immediately before the consolidation of British rule in 1858, rural elites acquired large tracts of agricultural land in Punjab and the surrounding areas. After consolidation, British colonial officials recognized these elites’ proprietary land rights to gain political support and cooperation. In addition, the British granted large areas of land (*jagirs*) to individuals who helped conquer areas of what are today Punjab and Sindh. Thus, the existence of landlords with large tracts of land became widespread and set the pattern for Pakistan (Naqvi, Khan and Chaudhry, 1987).

A comparison between the agricultural censuses of 1960 and 2010 shows that, in 1960, 19 percent of farms had less than 5 acres of land. This percentage had increased to 65 percent in 2010 (and is likely even higher now), while the proportion of farms between 5 and 25 acres decreased from 68 to 32 percent. Currently, the 90 percent of farms with < 12.5 acres of land own less than half of all Pakistan’s agriculture land, while the 4 percent of farms larger than 25 acres account for 34 percent of all farm area.

Pakistan’s land tenure structure remains grounded in arrangements put in place during the colonial times. During British rule, two land tenure systems developed: a landlord-tenancy (*zamindari*) system and a peasant-proprietor system. Whereas the landlord-tenancy system was characterized by absentee landlords and verbal or customary tenancy arrangements, the peasant-proprietorship provided peasants with ownership rights and allowed farmers to cultivate land as they saw fit. The landlord-tenancy system was tied to colonial rule, and two subsystems developed: revenue-free land estates granted by the government to *jagirdars* (those who assisted the British in consolidating their administrative control) and estates in which landowners (*zamindars*) were required to pay a land tax to the government. Under the *jagirdari* system, tenant farmers were classified in two categories: occupancy tenants who had permanent, heritable, and transferable rights to cultivate *jagir* land, and tenants-at-will, or *haris*, who held no legal rights. Under the *zamindari* system, a majority of the land held by landowners was rented or parceled out and cultivated by sharecroppers and tenants, on whom the tax burden fell.

Source: (Malik, et al., 2016)

Inefficiencies in Pakistan’s land management system have further widened inequality between the elite (insiders) and the rest of the population (outsiders). Pakistan has a proud and fascinating history of land records and mapping that dates back centuries, and involves the mixing of customs, British colonial history, regional evolution, and the birth of Pakistan as a nation. However, the systems once developed for agricultural taxes, walled cities and cantonments have evolved into a situation in which land records and land recording institutions, despite multiplying, have been unable to keep pace with population growth and urbanization. Over time, fragmented and incomplete land records have created ample

opportunities for rent accumulation and clientelism by the elite, reducing incentives for efficiency and equity enhancing reforms (Box 10).

Box 10: Pakistan land tenure framework

Pakistan's current land revenue system is based on British colonial legislation on land transfers, tenancy, land revenues and land acquisition, and core institutions. Pakistan's land records, the Revenue Records—or, more accurately, the Record of Rights and the Village/Cadastral Maps—are maintained at the village level by the provincial Boards of Revenue (BoRs). The Record of Rights and the Register of Deeds are person-based records, but Cadastral Maps have a number as an identifier. The Revenue Records were originally rural, excluding cities. However, as urban areas expanded, so large urban areas around historical city areas have become covered by Revenue Records. In addition, the BoRs maintain a Register of Deeds that registers property transfers and mortgages. Stamp Duty is collected at the registration of deeds. In parallel with the revenue and legal land records, provincial Excise, Taxation and Narcotics Control Departments keep land and property records on urban properties (land and buildings) for recurrent property taxes (Urban Immovable Property Tax, UIPT).

In urban areas, the Deeds Registers and Revenue Records include the deeds and records of city center land parcels allocated to the Cantonments, Development Agencies, and Cooperatives, the properties within those urban allotments are not recorded in the Revenue Records. However, Cantonments, Development Agencies, and Cooperatives maintain their own land records on land plots, properties and rights in their areas, and also provide land registry services to owners, banks and others, including, for example the registration of mortgages. These semi-public land records are not reflected⁸⁹ or interlinked with the Revenue Records or the Excise and Taxation's UIPT records. Fragmentation in land records is an issue in all provinces. Punjab has over 200 standalone land records, Sindh has hundreds, and Baluchistan and KP dozens each. The BoRs' Revenue Records and Housing Agency records combined cover the entire geographical areas of Punjab and Sindh, but only half of KP's territory, and 5 percent of Baluchistan's area. The unrecorded areas are classified as tribal areas practicing customary tenure.

Lack of tenure security has also generated opportunities for insiders and barriers for outsiders, depressing overall investments. Pakistan ranks 161st globally in property registration,⁹⁰ with 144 days required to complete a commercial property transaction. Property transactions in Pakistan remain complex and risky. As records do not provide comprehensive coverage, land-rights related litigation is widespread.⁹¹ Moreover, as access to justice reflects economic and political inequalities,⁹² the lack of security in property rights has a differential impact on insiders and outsiders. For the former, it provides opportunities for rent extraction through deliberate fraud and the manipulation of land records;⁹³ for the latter, it adds to projects' riskiness and overall cost.

Moreover, elite capture, compounded by the weakness of Pakistan's land management system, has prevented an inclusive and efficient process of urbanization... Service provision in urban areas is closely linked to the capacity of municipalities to raise revenues, to plan for cities' development, and to secure

⁸⁹ The initial cantonment, allocation, etc., legal act that has vested state lands from the BoRs to Army, Housing Agencies, etc., has been registered in the BoRs' records. In result a busy top end urban neighborhood of Karachi held, developed and managed by a Development Authority appears in the BoR records as a large undeveloped piece of land.

⁹⁰ Registering Property Index in the Doing Business 2019.

⁹¹ In Punjab, the Lahore Development Authority is subject to some 8,000 court cases, and the Lahore Defense Housing Authority 10,000 court cases, over the ownership of land that they have acquired. It is estimated that 60 percent of court cases in Sindh province are related to land and property. and land and property cases dominate courts in all provinces.

⁹² (Lieven, 2011).

⁹³ In Karachi for example, cooperative housing societies are being accused to having been encroached public lands deliberately and selling of land plots that have been subdivided from mother parcel established under fake allotment papers.

budget allocations from provincial budgets. In all three aspects, insiders' interest in maintaining their privileges, compounded by the weakness of the land management system, has contributed to the poor livability of Pakistani cities. On the revenue front, the continuous use of outdated valuation tables for the purpose of immovable property taxation has stifled financial autonomy of municipalities. On the planning side, the fragmentation of land records and the lack of a complete inventory of public land have contributed to inefficient urban sprawl and created opportunities for illegal land appropriations and patronage through preferential land allocations to connected property developers. Lastly, municipalities' dependence on budget allocations from provincial assemblies—in which representatives elected in rural constituencies still control a majority of seats—may have curbed the gains that urbanization could have generated in terms of electoral competition (Box 11).

Box 11: Political economy of hidden urbanization in Pakistan

Due to political economy constraints, changes in the administrative classification of inhabited areas from rural to urban have not kept pace with underlying population dynamics (see Box 2). As a consequence, many areas that are not officially designated as city spaces but that otherwise have all the characteristics of urban life, do not have the institutional setup and the resources that are required for the public sector to cater to the needs of their urban populations. In fact, compared with their rural counterparts, local governments in areas that are administratively classified as urban have relatively higher margins of financial (and hence political) independence from provincial governments, as they can rely on receipts of immovable property tax in addition to the resources being allocated from the provincial budget.

A formal recognition of the true extent of Pakistan's urbanization would inevitably undermine the current system of elite capture. First, recognizing Pakistan as predominantly urban is likely to affect the balance of power within the elite class, possibly at the expenses of the landed agricultural elite, which might find it harder to advocate for extensive public transfers to the agriculture sector, as well as preferential tax treatment of agricultural land and incomes. Second, a greater incidence of urban over rural administrations would likely tilt the balance of power between institutions at the center (provinces) and periphery (municipalities), to the advantage of the latter. Greater financial independence of city governments is likely to positively affect accountability, increase political competition, and reduce the scope for patronage and clientelism.

...which has ultimately stifled labor mobility and contributed to the spread of informality and Pakistan's limited productivity growth. Sustained population growth, compounded by inefficiencies in land management, has contributed to the increase in urban property prices, with a negative impact on labor mobility. It is estimated that the current housing shortage in Pakistan is about 10 million units, with about half in urban areas, where private sector developers, on average, supply only half of the formal housing units that would be required by population growth. This leaves the remaining half of housing demand to be produced through informal procedures without infrastructure, titling or planning. Over time, cities' development has witnessed a proliferation of high-end (gated) communities catering to the needs of insiders—*islands of efficiency* in which inhabitants pay private developers for service provision, rather than paying taxes to municipalities—along with a proliferation of under-served and environmentally hazardous informal settlements, in which outsiders pay private providers or middlemen to access services not provided by public providers (water tankers, illegal electricity connections, etc.). This expansion of informality in housing has also given rise to informality in businesses.

Capital Market

Capital accumulation in Pakistan has been shaped by the history of economic policies supported by the elite. In an ideal scenario of a perfectly competitive market, capital would flow to the most profitable investment projects, leading to productivity-led growth. When capital is scarce, and/or there are distortions in the allocation of credit (market imperfections), the initial distribution of assets (land and capital) matters for capital accumulation. Over Pakistan's history, capital market distortions that are typical of a developing country (low savings rate, shallow financial markets and unequal distribution of assets) have been exacerbated by the overlap between economic and political power. Through the control of economic policies that affect the relative profitability of sectors and activities—through trade policies (import tariff protection), tax policies (tax expenditures), subsidies (subsidized credit) and direct intervention in input and output markets (price controls, licensing schemes, SOEs)—the allocation of capital has been distorted in favor of activities/sectors dominated by the elite (insiders), with significant negative distributional and efficiency implications.

In the agriculture sector, the State's intervention has contributed to increasing the advantage of big landowners (insiders) at the expense of small farmers (outsiders), to environmentally unsustainable practices and, ultimately, to the sector's sluggish growth (productivity) performance. In Pakistan, the agriculture sector is both heavily subsidized and regulated. While the policy concerns that originally inspired public interventions in the sector are important,⁹⁴ the policy design and de facto implementation of those policies have benefited landed and business elites at the expense of small farmers and the overall sector's productivity (Box 12). State intervention has historically been focused on four major crops (wheat, rice, cotton, sugarcane), and still remains relevant for wheat and sugarcane. The government currently procures about 6 million tons of wheat annually (of which about 5 million tons are produced in Punjab), at a fixed procurement price (so-called "support price") that, until the recent rupee depreciation, significantly exceeded world market prices.⁹⁵ Besides coming at a high fiscal cost, analysis of the wheat procurement system shows that it fails to meet its goals of supporting poor farmers, or stabilizing prices and providing cheap flour to urban consumers.⁹⁶ Another interesting example is the policy support received by sugarcane cultivation—a water and labor-intensive crop predominantly grown on big estates. Among all crops, sugarcane cultivation is the largest water consumer in the Indus Basin⁹⁷ and, as such, a

⁹⁴ Key policy concerns behind state intervention in the sector include food security (wheat support prices to incentivize production, input subsidies such as water, fertilizers, energy), protection of farmers from exploitative practices of middle men and traders (produce markets regulation and establishment of market committees) and protection of urban consumers (subsidy to flour millers).

⁹⁵ The procured quantity is equivalent to about 25 percent of the national wheat harvest or about 60 percent of the marketable wheat surplus.

⁹⁶ The system is plagued with patronage and rent seeking, particularly in the distribution of gunny bags, during delivery of wheat to the purchase points, and in releases to flour mills. Small farmers rarely get bags and face difficulties in accessing delivery points, whereas releases of wheat to flour mills is often not transparent. As a result, most of the benefits of the wheat procurement and distribution scheme accrue to large farmers, wheat flour millers, banks (which finance the Government's procurement) and large traders (World Bank, 2015).

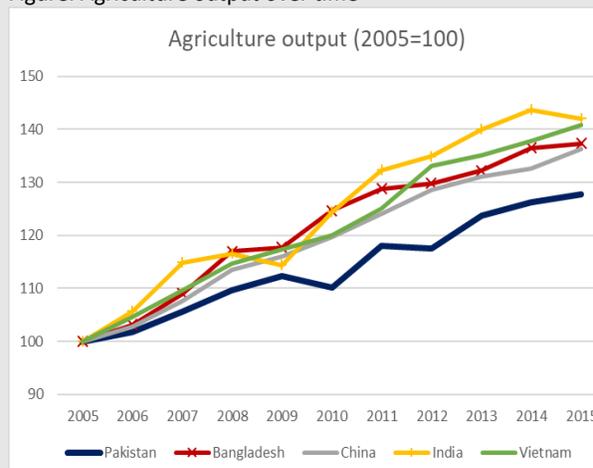
⁹⁷ Sugarcane is a deep-rooted crop, which remains in the soil for about 10 months before it reaches maturity. It is able to extract water to a depth well below one meter and can, therefore, even influence river flows as it intercepts run-off water heading toward the river. The crop needs about 1,500-2,500 mm of water throughout its growing period; therefore, three to four times more water is required to grow sugarcane than other major crops.

major contributor to environmental degradation.⁹⁸ Despite benefiting disproportionately (compared with other crops) from the underpricing of water⁹⁹ and other subsidy inputs (such as fertilizers, credit for equipment/machinery), sugarcane still requires minimum support prices to make its cultivation financially viable. As in the case of wheat, the certainty of a guaranteed price has increased production and created a surplus in the domestic market that then requires export subsidies to become competitive on international markets, further contributing to government expenditure. Over time, regressive input subsidies¹⁰⁰ and support price regimes have prevented diversification toward higher-value crops and distorted public resources away from investments in support of technological change (R&D, extension), which could have been used to boost productivity, particularly of small farmers, and to support diversification into higher-value crops.

Box 12: Productivity growth in agriculture

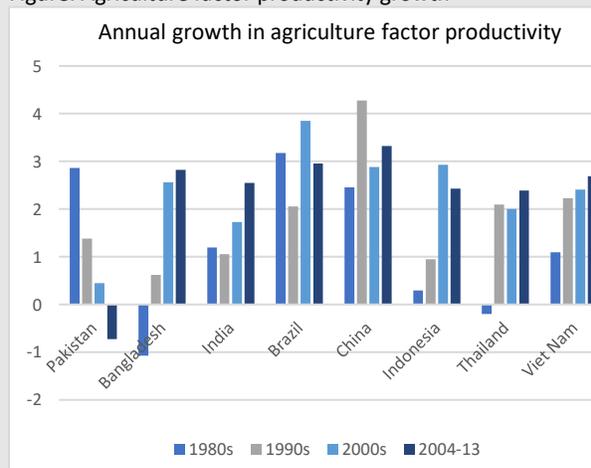
Growth in the agriculture sector has been slow compared with the country’s peers: Pakistan’s agriculture output index grew by 28 percent over the decade 2005–15, whereas that of Bangladesh, China, Vietnam, and India, for instance, grew by 36 to 42 percent over the same period (Figure below, left panel). Research suggests that yield increases are not only slower in Pakistan compared with neighboring countries, but that most of yield growth in Pakistan derives from higher levels of input use rather than growth in total factor productivity (TFP), with implications in terms of the sector’s environmental sustainability and deterioration in the quality of the natural resource base.^a In more recent years, Pakistan was the only country in Asia with declining TFP growth (Figure below, right panel).

Figure: Agriculture output over time



Source: World Bank staff elaboration on WDI data.

Figure: Agriculture factor productivity growth



Source: (Sharma, 2019)

Source: (a) Major portions of the country are constrained by decreasing soil fertility, soil salinization, waterlogging, erosion and a host of other challenges (IFPRI, 2014). See section on Environmental Sustainability.

In the industry sector, the State’s intervention through tax and trade policies has created barriers to entry for new/smaller businesses (outsiders), shielded larger companies (insiders) from competition, and negatively affected productivity growth. Pakistan’s industrial development has been supported by

⁹⁸ It is estimated that including environmental externalities to sugarcane production in Sindh would reduce farmers’ net profit by around 97 percent.

⁹⁹ See section on Environmental Sustainability.

¹⁰⁰ See (Dorosh, Alonso, Malik, & Salam, 2016).

tax and trade policies. Tax exemptions and discounted tax rates to select industries,¹⁰¹ economic actors, and economic activities have been granted in each year’s budget law to the detriment of fiscal sustainability.¹⁰² Over time, the growing complexity of the tax system has opened the door to discretionary policy implementation and expanded the scope for elite capture, thereby providing an “unfair” advantage of insiders over outsiders, disproportionately raising compliance costs for small businesses, and possibly contributing to the expansion of informality. Similarly, import substitution policies originally used to support industrial development have outlived their initial scope, preventing Pakistan from reaping the productivity benefits of international market integration. Over time, import duties have favored incumbents in traditional (established) sectors and created incentives for Pakistani firms to sell domestically, sheltered from the competition on international markets, with a negative impact on innovation, productivity growth and the efficient allocation of resources (Box 13). Restrictive tariff policies on intermediate goods, machinery and equipment, coupled with the complexity and implementation inefficiencies of duty and sales tax exemptions and refunds for exporters, have introduced a bias against small exporters.¹⁰³

Box 13: Trade and productivity

International evidence shows that policies to promote integration into the global marketplace can help boost productivity.

In the case of Pakistan, analysis based on data for non-banking listed firms indicates that internationally linked firms have higher productivity growth. Firms with foreign participation enjoy 70 percent higher productivity levels than domestic firms and the gap with domestic firms is widening over time (this gap is explained both by foreign investors acquiring more productive firms, and by foreign firms performing better over time than domestic firms). Exporters are on average 40 percent more productive than domestic-oriented firms. The exporters’ productivity premium holds across sectors and size classes. Innovators are also more productive. A 1-percentage-point increase in the innovation ratio is associated with a 0.68 percent increase in productivity.^a In addition to being more productive, exporters and firms with foreign participation also tend to innovate more.

The analysis also shows that policy distortions that affect upstream markets in Pakistan are hampering productivity growth in firms operating downstream. For example, higher tariffs on intermediates over the period 2012–17 have dragged down the productivity of domestic firms. Estimates suggest that a 1-percentage-point increase in upstream tariffs, which is equivalent to a 30-percent increase with respect to average upstream tariffs, is associated with a 4.2 percent decrease in productivity. The impact is driven by the negative impact on domestic firms (-7.1 percent). It is also mainly non-exporters (-11 percent) and smaller firms (-23 percent) that are affected by tariffs upstream. This is reasonable, given that large exporters are likely to secure exemptions on import tariffs for intermediates.^b

¹⁰¹ Pakistan’s tax expenditures (i.e., tax revenue foregone due to exemptions and concessional rates) are high at 2.5 percent of GDP in FY19, with the highest losses recorded in sales tax and customs duties.

¹⁰² For instance, till rescinded in the FY20 budget, distortions were present in the GST regime where industries (textiles, sports, surgical, carpets and leather) received tax concessions under the Statutory Regulator Order (SRO) 1125. The SRO provided a lower GST rate of 9 percent and 6 percent to these sectors, compared to the standard rate of 17 percent, along with zero-rating GST on exports including purchases related to exports.

¹⁰³ While exporters are in principle eligible to obtain refunds for the duties paid on intermediate inputs and machinery and equipment used to produce exportable products, the existing duty refund and duty exemption systems tend to favor larger companies. Processes to file for refunds are complex, requiring dedicated staff to file for them. This introduces a bias against relatively smaller exporters, for which the administrative cost of filing per unit of output is higher. This is why the productivity costs of high import duties on intermediates fall disproportionately on small rather than on large firms. In addition, the time it takes for refunds to be processed and paid to exporters is long (World Bank, 2020).

Figure: TFP gap between domestic-oriented and foreign-participated firms

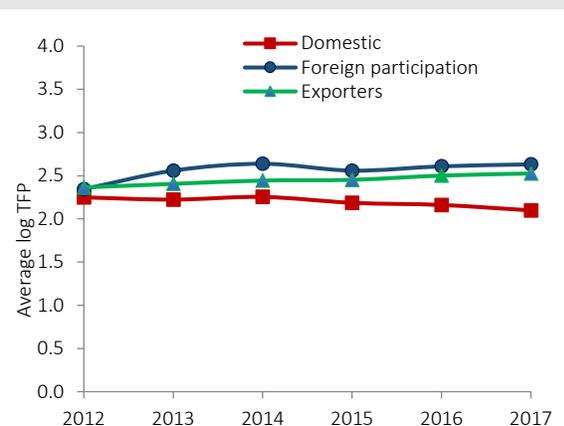
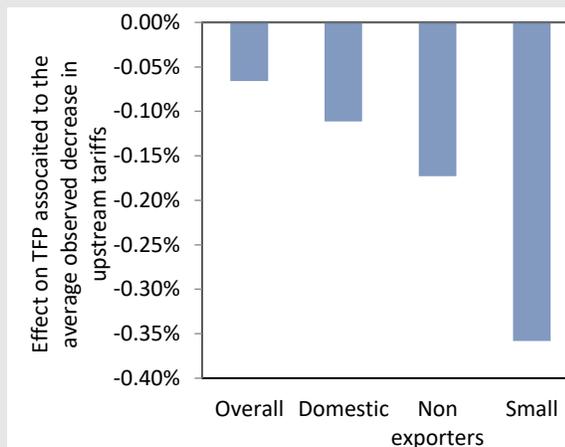


Figure: Impact of upstream tariffs on TFP^c



Source: (Lovo & Varela, 2020). (a) We measure innovation by considering the presence of intangible assets, which include patents, copyrights, trademarks, exploration accounts and knowledge accounts. The innovation ratio is given the ratio of intangible assets over total assets. (b) In principle, exemptions are available for exporters of any size, in practice, securing them is costly for firms due to administrative burdens, and since duty refunds take time to be processed, adding financial costs. Therefore, it is likely that small firms may opt out of using the exemption mechanism. (c) Figure reports regression coefficient multiplied by the average change in upstream tariffs over the period.

Similarly, direct state intervention in key sectors of the economy through SOEs and market regulation have distorted the allocation of resources to the advantage of insiders. SOEs are present across various sectors of the economy. The Federal Government owns 206 SOEs¹⁰⁴ with a combined output of 10.9 percent of GDP but that employ fewer than half a million people.¹⁰⁵ SOEs enjoy a dominant position in key sectors of the economy, such as energy (from upstream oil and gas exploration activities to downstream transmission and distribution of power), insurance (State Life Insurance Corporation), and road construction and transport (Pakistan International Airways [PIA] and Pakistan Railways [PR] enjoy near monopolies in their segments). Entry into such sectors, particularly for firms not enjoying political connections (outsiders), has been considerably impeded, as SOEs receive favorable treatment by regulators, preferential access to finance, and preferential access to government contracts (

Box 14). Similarly, the regulatory framework and institutional set-up regarding the establishment and operation of primary agricultural produce have contributed to strengthening the monopsonist¹⁰⁶ power of licensed traders/middlemen, and expanded the scope of patronage by political and landed elites to the

¹⁰⁴ SOEs have different legal structures, with public sector companies (PSCs) established under the Companies Ordinance being the largest with 186 enterprises. There are also 11 federal authorities and nine development finance institutions (DFIs). Only 12 federal PSCs are listed on the stock exchange.

¹⁰⁵ Of these SOEs owned by the Federal Government, 20 percent are in the energy sector, 17 percent are in transport, 16 percent in the financial sector,¹⁰⁵ 13 percent in services, 23 percent in promotional and advocacy, and 10 percent in industry and engineering. In terms of employment, 71 percent of the workforce is employed in the energy and transport sectors. Administratively, 68 percent of the SOEs portfolio comes under 4 ministries; Ministry of Finance, Ministry of Energy, Ministry of Ports and Shipping and Ministry of Industries and Production.

¹⁰⁶ A monopsony is a situation in a market in which there is only one buyer for goods and services offered by several sellers.

detriment of small farmers, and of a competitive and efficient development of marketing services and infrastructure (Box 15).

Box 14: State-owned enterprises in Pakistan

Here we outline three main channels through which SOEs distort competition in the transport, energy, and road construction sectors.

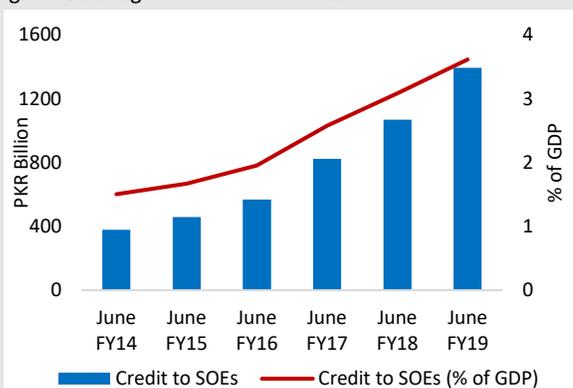
- 1. Favorable treatment by regulators:** Legal ownership of SOEs lies with the Government of Pakistan, but in practice line ministries exercise the ownership and oversight function over SOEs in their sectors. They often do so by appointing their own officials to SOEs' boards of directors, resulting in actual or potential conflicts of interest between the regulatory function of the line ministries on one hand and their interests as *de facto* owners of the SOEs in their respective sector on the other.^a The presence of independent directors, as mandated under the Securities and Exchange Commission of Pakistan's (SECP) Corporate Governance rules for SOEs,^b can help mitigate these conflicts of interest, but as of FY18, independent directors constituted only 28 percent of total SOEs board members.

In the rail transport sector, the Ministry of Railways exercises the policymaking and regulatory functions for the sector, as well as being the *de facto* owner of Pakistan Railways (PR), with the minister also holding the role of Chairman of PR. This concentration of functions in one entity and the conflicts of interest it breeds are inimical to good policymaking and sound commercial management of an SOE. Consequently, PR is one of the top ten loss-making SOEs in the country, with losses of PKR 41 billion in FY17 alone.^c

Likewise, in the air transport sector, the Aviation Division (AD, the policymaker for all matters related to civil aviation in the country) is the line ministry for the PIA (the SOE), as well as the Pakistan Civil Aviation Authority (PCAA, the regulator for all civil aviation activities, and the operator of civilian airports and air navigation activities in the country). Currently, the Federal Secretary of the AD is the Director General of the PCAA, as well as a member of PIA's board of directors. As noted in the Competition Commission of Pakistan's report on the air transport sector, this institutional set-up is prone to breach competitive neutrality principles. For example, PIA is *de facto* exempted from payment for airport services provided by the PCAA (whereas private competitors are not allowed to operate unless they clear their dues). Consequently, despite poor financial operational performance in recent years, PIA holds the largest capacity share in international flights (20 percent of all seats) and domestic flights (over 60 percent of all seats).^d

- 2. Preferential access to finance:** As discussed in the section on risks to macroeconomic sustainability, SOEs receive substantial financial support from the government in the form of subsidies, loans and grants. In addition, sovereign guarantees to SOEs, which cover a large proportion of SOEs debt, provide strong incentives for banks to issue loans to SOEs rather than private companies, depriving private firms of the financing needed to increase their investments. For instance, during FY16, PIA accumulated losses (financial costs included) of PKR 77 billion in FY16 and secured commercial debt of PKR 88 billion under short- and long-term government guarantees, including for aircraft leases.^e Overall, despite their declining profitability, there has been a sharp rise in banking sector credit to SOEs in recent years from PKR 380 billion (1.5 percent of GDP) in June 2014 to PKR 1,400 billion (3.6 percent of GDP) in FY19.^f In terms of total lending to the non-government sector, the share of credit to SOEs has risen by 8.2 percent between FY14 and FY19 (Figure below).

Figure: Banking sector credit to SOEs



Source: World Bank staff elaboration on SBP data.

- 3. Preferential access to government contracts:** This is most problematic in those sectors where the line ministry combines the roles of owner, regulator and customer of an SOE. Two examples of this, both in the road construction sector are: (i) the Ministry of Communications and the National Highway Authority (NHA); and (ii) the Ministry of Housing and Works, and National Construction Ltd. (NCL). In its assessment of the road construction sector, the Competition Commission of Pakistan finds that the Ministry of Housing and Works granted exemptions to NCL in government contracts and did not require NCL to furnish certain bank guarantees. Similar exemptions were also granted by the Ministry of Defence to the Frontier Works Organization and by the Planning and Development Division to the National Logistics Cell (NLC) for Public Sector Development Program (PSDP) contracts. Federal and provincial governments are the main clients for NCL, NLC and Frontier Works Organization (FWO), and due to these exemptions, private construction firms are effectively excluded from this market. Moreover, while the individual SOEs are exempted from furnishing bank guarantees, ultimately the guarantees are provided for by the Government of Pakistan.⁸

Source: (a) (Rontoyanni , 2019). (b) As per the rules issued in 2013, independent directors were required to be a majority on the Board, but an amendment to the rules in 2017 removed this condition due to non-compliance by most SOEs. (c) (Ministry of Finance, 2018) (d, e) (Competition Commission of Pakistan, 2019) (f) Monetary Survey, State Bank of Pakistan. (g) (Competition Commission of Pakistan, 2018).

Box 15: Wholesale agricultural produce markets

By law, the establishment and functioning of wholesale markets (mandi) in Sindh and Punjab are managed by the public sector through the establishment of Market Committees (MC), which regulate the sale and purchase of agriculture produce in their respective Notified Areas.

An MC, whose members are nominated by representative of local producers, comprises 10 or 17 members. In either case, half the members must be local growers, one member must be a government official and another member must be a local consumer. The other members are selected from tradesmen conducting their business under a license in the market. All these members are nominated by the District Council, i.e., the elected local body at the district level, or by the Government upon recommendation of the Deputy Commissioner. MCs are constituted for three-year terms and no member can be nominated for more than two terms.

The MC has sole responsibility for the licensing of marketing activities, both outside and inside the physical space of the market. Outside-market licenses include those to agribusiness enterprises (ginneries, textile mills, sugar mills, flour mills, cold storage facilities, etc.) and retailers, while inside-market licenses include those to middlemen (*arhti*), weighmen and other workers who are permanently stationed inside the market. Once an area falls under the jurisdiction of an MC, no person or agency is allowed to engage in wholesale marketing activities unless licensed by the MC.

Such public marketing system has created ample opportunities for elite capture, patronage and rent-seeking behaviors to the advantage of “insiders” (landed elite, middlemen, marketing officials) and at the expenses of “outsiders”, notably small farmers whose price bargaining power is squeezed by the lack of competition in their marketing channels. The prevailing

system limits to connected/licensed actors the space for private sector investment in marketing and value chains (including exports), and it further constrains the development of modern forms of farming relations (contract and corporate farming) and the establishment of rural cooperatives of producers.

Source: (Rana, 2014).

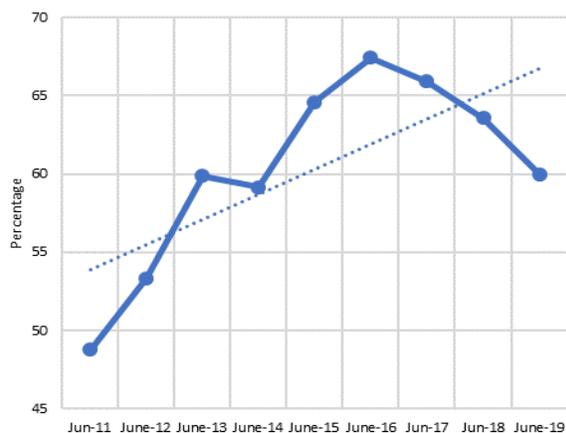
The distortive impact of economic policies and the consequent economic advantage of insiders over outsiders have been reinforced by capital allocation through financial institutions. The Government's growing financing needs and policy-induced differential returns (and riskiness) of investments between economic activities have contributed to distorting the allocation of commercial banks' credit in favor of insiders. Credit to the government sector in Pakistan, including non-bank public sector enterprises, has increased dramatically in recent years, both as a percentage of total credit extended by the banking sector and in absolute terms (Figure 43).¹⁰⁷ In addition, limited private sector credit is primarily being intermediated to the corporate sector, leaving other critical segments, such as SMEs, consumers, agriculture, etc., underserved. The corporate segment accounts for close to 71 percent of private sector credit extended by the banking sector and this share has been trending upward in recent years (Figure 44). Not only is the banking sector over-exposed to the corporate segment, but lending is significantly concentrated in just a handful of large business conglomerates: 20 business groups in the country account for 30 percent of the banking sectors private sector lending portfolio and a mere 0.4 percent of bank borrowers account for 65 percent of all bank loans.^{108,109} A similar concentration of credit favoring insiders was evident when looking at public export finance schemes operated by the State Bank of Pakistan (the Export Finance Scheme, EFS; the Long-Term Financing Facility, LTFF). Until recently, these schemes had been highly concentrated in just a few firms in the textile sector and show substantial inertia in the allocation of funds. For example, data for disbursements in 2017 showed that the largest 100 exporters accounted for 39 percent of Pakistan's exports, but for 62 percent of the EFS and for 67.5 percent of the LTFF. Moreover, 63.5 percent of EFS loans and 86 percent of LTFF loans were accounted for by textile exporters. Inertia in the allocation had also been marked: the top 10 firms in terms of loan size secure the systematic rollover of the financing facility period after period, while the average of the bottom 10 firms only secured the rollover of the facility in one out of 10 periods. The recent decision of making these schemes available for a wider set of sectors in the economy is a positive development and will likely contribute to reducing the concentration of export finance allocation.

¹⁰⁷ Credit extended by the banking sector to the Government has increased from PKR 2,891 billion to PKR 9,357 billion over the period FY11–FY19, signifying an increase of 223 percent and starting from the same base as the private sector. Over the same period, credit to private sector increased by 108 percent.

¹⁰⁸ See (State Bank of Pakistan, 2017), (State Bank of Pakistan, 2015).

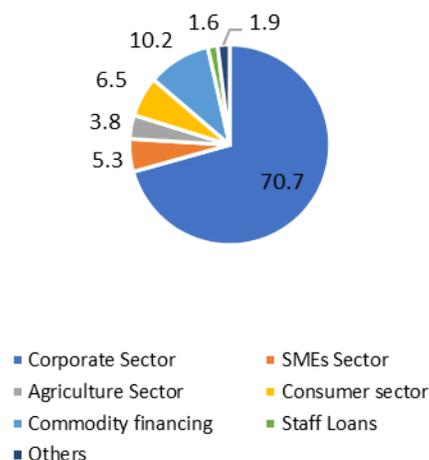
¹⁰⁹ According to a study, between 1996 and 2002, politically connected firms in Pakistan received 45 percent more government credit than other firms, even though they were less productive and had default rates that were 50 percent higher. Based on the productivity gap between firms, the annual cost of this credit misallocation could have been as high as 1.6 percent of GDP (Khwaja & Mian, 2005).

Figure 43: Credit to government sector and SOEs as a percentage of GDP



Source: World Bank staff elaboration using SBP data.

Figure 44: Distribution of total advances to private sector



Source: World Bank staff elaboration using SBP data

Labor Market

Pakistan’s elites had little interest in supporting human capital accumulation, and investments in public education and health service provision have traditionally not been high on the policy agenda. In the absence of well-functioning credit markets, public sector provision of health and education is necessary for human capital accumulation, and so is public support for collecting and redistributing resources toward these sectors. In Pakistan, support for public investments in health and education was limited by the fact that elites have traditionally opted out of public service providers. In addition, both economic and political-economy factors may have limited the incentives to broaden the tax base and direct resources toward the strengthening of public service provision. On the economic front, the pattern of specialization of Pakistan’s economy has reflected the abundance of (unskilled) labor relative to physical capital.¹¹⁰ On the political-economy front, due to political instability and the alternance of elected and non-elected governments and consequent lack of commitment, electoral campaigns have seldom focused on long-term objectives such as the ones implied by the development of efficient service provision. Rather, as is typically found in clientelistic settings, political support was exchanged for short-term and targeted benefits¹¹¹ (jobs, roads, electricity, resources, etc.) (Box 16).

Box 16: Unequal land distribution and access to services

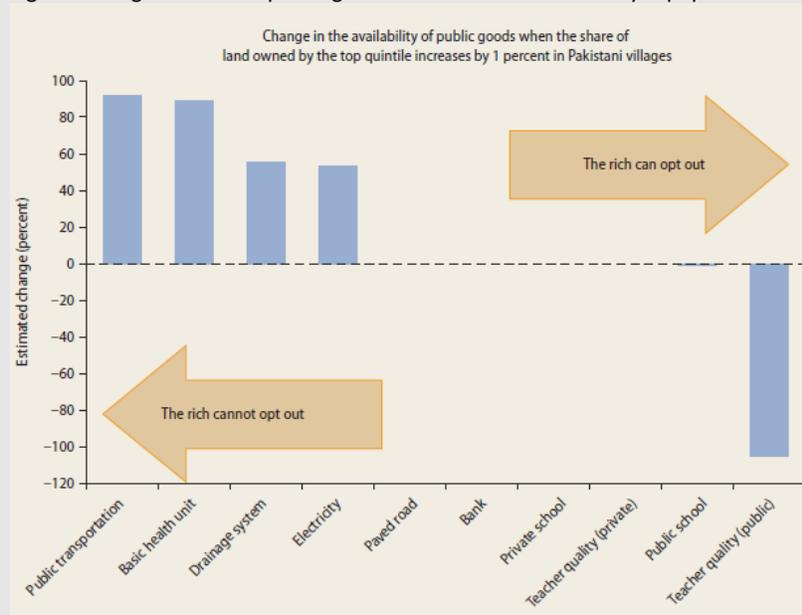
A growing body of evidence indicates that inequality negatively affects the ability of people to act collectively, the institutions they set up, and the ways in which resources are allocated for the benefit of the group. A salient case is the provision of public goods, where inequality can have effects of opposite signs. On the one hand, in a very unequal society, the better-off typically have more power and are more effective at pulling in resources for the public goods they value. On the other hand, a high degree of inequality makes it more tempting for the better-off to opt out of public services altogether. In the end, which of the two effects prevails is likely to depend on whether opting out is an option.

¹¹⁰ This is reflected in the choice of labor-intensive crops (cotton, sugarcane, rice) in agriculture and in the specialization in labor-intensive textile in manufacturing.

¹¹¹ This tendency is captured in the popular electioneering slogan from the 1970s: *roti, kapran, makan* (bread, clothing, house).

Recent analytical evidence for Pakistan indicates that land inequality is unambiguously associated with greater access to services in the cases of electricity, drainage, and access to public transport (Figure below). In contrast, the teaching quality in public primary schools is far poorer in the most unequal villages. Notably, this negative impact of land concentration on teaching quality does not extend to private schools. These results imply that service quality and access tend to decline at very high levels of inequality but mainly for services for which the wealthy can move to private providers, such as schools.

Figure: Change in share of public goods if share of land owned by top quintiles increases by 1 percent



Source : (Rama, Bêteille, Li, Mitra, & Newman, 2015).

Moreover, the quality of public provision of health and education services has been hampered by political patronage. Historically, subdued demand for skilled labor in the private sector has strengthened the monopsonistic power of the State with respect to the employment of educated professionals, increasing the scope for patronage. Political interference in the appointment of bureaucrats, teachers, and doctors has a detrimental impact on performance. On the one hand, politicians—who control the appointment, suspension, transfer, and other sanctions for the underperformance of civil servants—can use teachers and doctors to support their political agendas¹¹² and, in exchange, service providers can extract rents, notably in the form of absenteeism or low-quality service provision, to the disadvantage of students and patients.¹¹³ Politicians can also appoint teachers and doctors directly from their social networks. In both cases, clientelism and patronage reduce politicians' authority to monitor and sanction service providers at the expense of their performance. Poor performance and absenteeism of teachers

¹¹² Teachers and doctors are commonly recruited to assist the election commission with drawing up voter lists and overseeing polling on election day (Naviwala, 2016).

¹¹³ Evidence in this sense is provided in a study by a recent study conducted in Punjab (Gulzar, 2014). Using a quasi-experimental identification strategy, the analysis indicates that doctors in ruling party areas are more likely to know politicians personally, to be absent from work more often and to enjoy higher tenures. In addition, results indicate that connected doctors are absent more often and are inspected less often by monitors. Qualitative evidence further shows that ruling politicians provide patronage in exchange for doctors working as political mediators.

and medical practitioners (doctor, nurses, etc.) have traditionally been very high in Pakistan, reflecting the underlying incentives of service providers and the lack of electoral competition, particularly in rural areas.¹¹⁴

Besides accumulation of human capital, a clientelist relationship between voters (outsiders) and politicians (insiders) has also prevented the full realization of efficiency gains from labor mobility. Besides the constraints originating in land markets, labor mobility—particularly of less educated and poorer workers—has also been negatively affected by patronage in access to jobs and social protection (insurance and safety nets). First, the limited development of pension and other forms of social insurance outside the public sector has increased the value of public versus private sector jobs¹¹⁵ and expanded the scope of clientelism. Second, until the recent modernization of safety nets with the introduction of BISP (Box 17), the political discretionality in the allocation of (scarce) safety net resources, as well as the importance of social groupings (caste, kinship and *biradris*) in the allocation of labor market opportunities,¹¹⁶ has limited the scope for domestic migration, possibly explaining the low rate of inter-provincial labor mobility.

Box 17: Safety nets in Pakistan

Until recently, the principal formal social protection program in Pakistan was the publicly administered *Zakat* cash transfer system. However, the impact of *zakat* funds on poverty and vulnerability has been limited, mainly because of the small amount of aggregate transfers. The publicly administered *Zakat* system is funded by a wealth tax and disbursed to institutions operating at the national level, with the remainder divided among local committees for disbursement to individuals. Those eligible to receive *zakat* include the poor, especially widows and orphans, and the handicapped.

The impact of *Zakat* transfers on poverty and vulnerability alike also depends to a large extent on targeting efficiency. Evidence on this has been mixed at best. According to some studies, only about half of all direct payments went to households in the lowest expenditure quintile. One of the reasons for this inefficiency is the problem in identifying eligible beneficiaries, which appears to be exacerbated by patronage politics at the level of the local *Zakat* committees. In addition, the status of beneficiaries is not kept up to date. Accordingly, beneficiaries may continue to receive support for years after their initial entry into the program, regardless of their current status.

Pakistan Bait-ul-Maal (PBM) is another notable safety net program, mainly providing assistance to those in need, such as minorities who are not covered by *Zakat*. Administered by an autonomous board of management, PBM provides two main benefits: the Individual Financial Assistance scheme, and the Atta Subsidy Scheme. However, limited coverage severely limits the impact of PBM, as does the tedious procedure involved in applying for assistance from this program. And unlike *Zakat*, Bait-ul-Maal does not have any identifiable source of income, so that its exclusive reliance on budgetary support leaves it vulnerable to changing fiscal conditions. From recent reports, it also appears that transparency is a serious problem, on account of the discretion that high-level functionaries have in allocating funds from this program.

Public works programs have also been used in Pakistan to smooth consumption in periods of high unemployment. Examples of such programs are the Rural Works Program (1962–72) and the People’s Works Programs (1972–83) and the former Khushal Pakistan Program (KPP) for Physical infrastructure (started in 2003–07). Under these programs, funds have typically been allocated to the districts through provincial governments, and the selection of projects and their implementation have involved local communities. A typical characteristic of these programs is the lack of clear targeting instruction on the selection of districts (either based on infrastructure needs or poverty), adding to the risk of capture by local politicians. Evidence on the targeting performance and impact of these schemes is scarce.

¹¹⁴ Results from a recent experimental evaluation of a health sector reform in Punjab (Callen et al., 2018) indicates that interventions aimed at reducing absenteeism through better monitoring technology (in this case providing government inspectors with a smartphone monitoring system to report doctors’ absenteeism) can fail to provide intended effects unless “complemented” by electoral competition.

¹¹⁵ (Cho & Majoka, 2020).

¹¹⁶ See (World Bank, 2002)

To protect the poor and the vulnerable against a series of economic shocks since 2007, the Government decided to create a new cash transfer program, the Benazir Income Support Program (BISP)—a national program—during the second half of 2008. In order to quickly launch the program, parliamentarians (members of the National Assembly and senators) were asked to identify 8,000 beneficiary households using a prescribed form that collected information on names, national ID card, and household income. After verification of lists by the National Database and Registration Authority (NADRA), payments to beneficiaries were implemented via post offices and delivered to the doorstep through money orders to adult females in each household. By April 2009, the program was paying about 1.6 million families based on more than 2.4 million applications received. The problem with this hurried approach was that, first, public officials used discretion to direct spending toward groups or individuals they preferred for political objectives (clientelism) or personal ones (capture), i.e., favoritism. Second, this favoritism undermined public support for the program.

Recognizing these constraints, the Government introduced a targeting reform, moving from one based on discretion, to a formula-based (anonymous) proxy-means test (PMT) targeting mechanism. Research showed that, before the reform, households from the villages of winning politicians were 200 to 400 percent more likely to receive the transfer than those in rival politicians' villages. After the reform, transfers to wealthier households were reduced significantly and improvements in targeting increased the welfare gains from the cash transfer program by 15 percent, even after accounting for the mechanism's administrative costs. The reform also increased public approval of social protection programs by 10 percentage points, a 40-percent increase over the pre-implementation level.

Today, BISP is Pakistan's main social safety net program, covering about 17 percent of the population at a cost of about 0.5 percent of GDP. Impact evaluations of the program indicate that it has resulted in significant welfare gains and improved coping mechanisms among beneficiary households. Finally, evaluations suggest that BISP is contributing to a change in household attitudes toward women, and supporting the empowerment and mobility women who are BISP beneficiaries.^a

BISP was instrumental to the establishment of the National Socio-Economic Registry (NSER), which overtime has become an independent social registry and is currently being used to target for more than 70 programs, including the new social health insurance program (*Sehat Sahulat*). BISP continues to make significant investments to ensure corruption-free targeting and payments. BISP is currently updating the National Socio-Economic Registry, with the objective of recertifying beneficiaries by exiting ineligible households and bringing in new eligible households. Similarly, to prevent leakages in payments, BISP has overhauled the payment system and transitioned to a fully biometrically verified system.

Source: (Haseeb & Vyborny, 2016), (World Bank, 2002) (a) (Cheema, Hunt, Javeed, Lone, & O'Leary, 2016), (Ambler & Alan, 2017)

PATHWAYS AND OPPORTUNITIES TO SUSTAIN GROWTH, POVERTY REDUCTION AND SHARED PROSPERITY

Pakistan’s insider-outsider model lacks the potential to bring the country out of its low middle-income development trap. Consumption-led growth, with limited capital accumulation, declining productivity growth, an increasing debt burden, a heavy public footprint in the economy and limited labor reallocation toward more productive sectors, will be insufficient to move Pakistan out of its structural boom-bust cycles. Moreover, without addressing existing inequality of opportunities, systematic socioeconomic discrimination affecting Pakistan’s women, as well as underlying grievances that threaten stability, the prospects for sustaining poverty reduction moving forward are limited, as are the prospects for reversing the trend of declining shared prosperity. These challenges are further exacerbated as the country grapples with the socio-economic consequences of the COVID-19 pandemic.

Moreover, as risks to macroeconomic stability, social cohesion and environmental degradation accumulate, continuing on the same path is becoming increasingly unsustainable. Not only is change necessary to move Pakistan out of a low middle-income trap, it is also necessary to create opportunities for the renewal of the social contract allowing for greater inclusion, increased accountability, amplified voice and heightened citizen engagement. The insider-outsider model is running out of steam and cannot continue indefinitely going forward. Increasing levels of debt and liabilities, coupled with slowing GDP growth and persistent external imbalances, pose a constraint on the amount of rents that can be captured and patronage that can be redistributed, thereby challenging the sustainability of Pakistan’s clientelistic system. If neither growth, nor the State, nor the patrons can deliver on jobs and services, or more generally on the betterment of socioeconomic conditions, the sustainability of the social contract is itself at risk, with potential consequences in terms of instability. In addition, a development model that privileges the exploitation of scarce environmental resources and intensive input use over investments is bound to hit the wall of natural resource degradation. While the growing sustainability constraints can create the right enabling environment, changing the underlying incentives that have shaped Pakistan’s policies and institutions will not be easy, as shown by several failed attempts to reform in the past.

Fortunately, forces of change are already at play, both internally... First, a technological revolution is underway. Not only has technology brought new players into the business arena operating in non-traditional/non-captured spaces, it has also created new opportunities for productive self-employment (Box 18). If properly leveraged, technology can provide solutions for improving the performance of public and private institutions, as well as improving accountability and transparency. Second, Pakistan is urbanizing. Whether or not reflected fully in official statistics, population growth and domestic migration are bringing more people to live and work closer to each other. This has two consequences. On the one hand, it is increasing demand for formal (functioning) institutions, as opposed to informal relations-based institutions (moving from deals to rules).¹¹⁷ On the other hand, as the population of constituencies increases, electoral competition (and the contestability of the policy arena) also increases, as the cost of patronage becomes too high to sustain.¹¹⁸ Taken together, growing demand for functioning institutions and electoral competition are changing—for the better—the incentives of the elite. Lastly, recent changes in Pakistan’s Constitution—notably the 18th Amendment that institutionalizes provincial autonomy and

¹¹⁷ (World Bank, 2017).

¹¹⁸ (Sayeed, 2018).

the 25th Amendment that merges the former Federally Administered Tribal Areas into KP—if properly supported through stronger institutions—can create the necessary foundations for greater political stability, coordination and, ultimately, for greater commitment to deliver in the interests of all Pakistani citizens.

...and externally. Equally important are the incentives for change coming from transnational rules. In June 2018, Pakistan was included in the Financial Action Task Force’s (FATF) grey list. Acknowledging the negative consequences that the lack of action could bring in terms of access to international financial markets, the Government is implementing a 27-point action plan to improve the legal and regulatory framework to fight money laundering and terrorist financing. Of particular relevance in this respect is the push to enforce the 2017 Benami Law, which criminalized the establishment of Benami accounts¹¹⁹ and anonymous asset transactions, which have enabled illicit transactions, corruption and patronage, particularly affecting land market development, as well as financial market deepening. Similarly, the country is facing a different authorizing environment on the international arena, which translates into a more coherent push toward the necessary structural reforms. Taken together, internal and external drivers of change create an enabling environment for elite bargains and help to expand the set of implementable policies.

Box 18: Pakistan’s emerging technology sector, and the gig and sharing economy.

The technology sector: This includes those businesses that produce and distribute ICT-based goods and services as outputs. Such activities include software development, computer products, and services relating to telecommunications and information technology (IT). Since its birth in the late 1980s, Pakistan’s technology sector has grown significantly, generating about US\$3.5 billion in annual revenues as of 2017, equivalent to just under 1 percent of nominal GDP. There are now over 1,500 registered IT firms and over 15 IT parks (with IT-enabled infrastructure) in Pakistan. Growth is partly driven by IT exports, with estimated export revenue of US\$5 billion by 2020.^a Estimating the number of workers in the sector is hard but, according to a Pakistan Software Houses Association survey in 2015, 120,000 jobs have been created.

The freelancing (online gig) economy and sharing economy: Technology has given workers more access to consumers and investors locally as well as globally and has exponentially expanded freelancing opportunities. Well-known freelancing platforms include Freelancer.com, Upwork.com, Guru.com, and Fiverr.com.^b Individuals or agencies can use these platforms to bid for contracts posted by employers from around the world, and then complete the work online. The tasks can be done virtually, for example, graphic design, software programming, and legal and accounting services. More than 200,000 Pakistanis are thought to be working on online work platforms as independent contractors. Meanwhile, platforms for the sharing economy provide earning opportunities to a large number of affiliated workers. In Pakistan, the global platform Uber (ride-sharing app) and regional leader Careem, established in Dubai, have been active in large cities such as Karachi and Lahore since 2016.

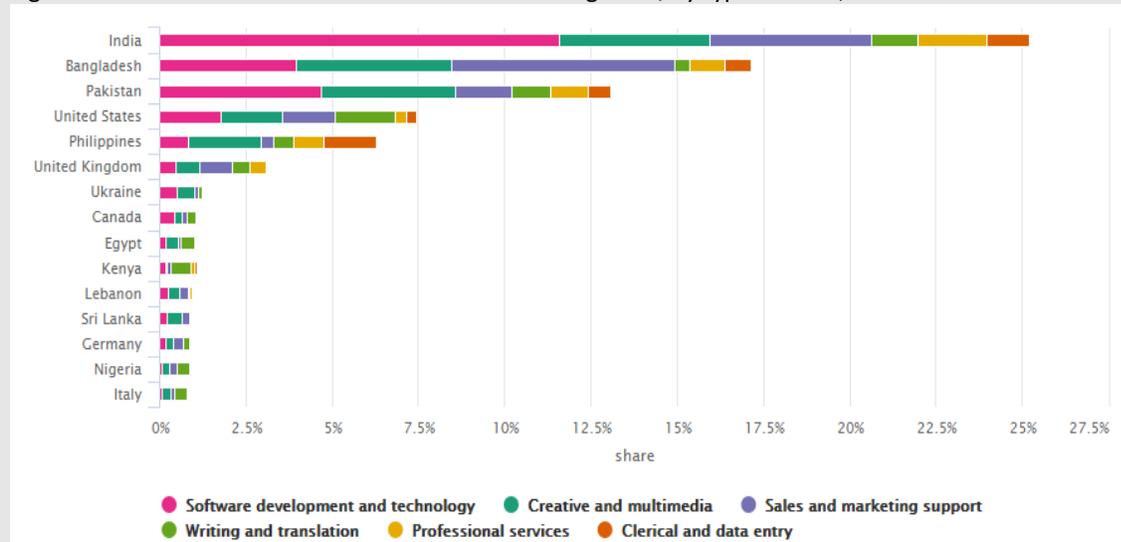
The advantages of the freelancing and sharing economy: Compared with traditional digital jobs in the technology sector, freelancing and the sharing economy offer several advantages in creating better and more inclusive jobs. Since the online gig economy allows flexible work hours and the tasks to be done remotely, it can provide job opportunities to those who have mobility and time constraints, such as women, students, and people with disabilities. Also, online freelancing links the local supply of talent to the global pool of demand with a large set of potential markets.

The size of the workforce: Estimating the size of the workforce in the freelancing and sharing economy, and its value added through activities, is challenging due to the lack of consistent definition and measurement methods. Given the flexibility and diversity of platform activities, individuals can have multiple jobs without any employment-employee relations—a setup that may not be captured by traditional household surveys. The Online Labour Index^c ranks Pakistan third after India and Bangladesh, with about 13 percent of world’s total supply of workers in online freelancing.^d This is not directly translated into market shares of the revenue generated from freelancing work. In Pakistan, freelancers work on average about 34 hours per

¹¹⁹ “Benami accounts” are bank accounts that are held in names other than the beneficiaries.

week and types of jobs include IT and programming, design and multimedia, writing and translation, and sales and marketing. The hourly rates for these jobs are between US\$17 and US\$23. Interestingly, female freelancers in Pakistan charge more than their male counterparts.^e

Figure: Selected countries' market share of freelancing work, by type of work, 2017



Source: Online Labour Index 2017.

Source: (Cho & Majoka, 2020). (a) Pakistan Software Export Board (PSEB); (b) (Iftikhar, 2017); (c) Oxford Internet Institute; (d) (Kässi and Lehdonvirta, 2016); and (e) (Shorish, 2016).

This SCD identifies two priorities for Pakistan if it is to escape from its development trap: increasing competitiveness, and promoting equity and inclusion. Policies aimed at *leveling the playing field*, i.e., policies that change (directly or indirectly) the distribution of power in the policy arena, are needed to address the distortions associated with insider-outsider dynamics. Actions aimed at leveling the playing field can be articulated under two complementary pillars: one tackling issues around competitiveness, and the other addressing constraints around equity and inclusion. The theme of institutional strengthening will be cross-cutting across each of the two pillars; proposed pathways will reflect on existing institutional weaknesses, while options to address them will be further discussed in the Prioritization chapter.

The COVID-19 pandemic has further highlighted the importance of these priorities. The socio-economic impact of the COVID-19 crisis has accentuated the need to address existing vulnerabilities in Pakistan's economic development model. As such, the two priority areas identified in the SCD will remain key to Pakistan's recovery as the country works towards addressing challenges brought about by the COVID-19 pandemic.

1. Increase Competitiveness

Increasing the competitiveness of Pakistan's economic system is a key priority to unleashing the growth potential of the private sector – specially as the country recovers from the COVID-19 pandemic. Moreover, by tackling competitiveness constraints, the proposed interventions are also expected to address underlying distortions at the basis of Pakistan's insider-outsider model. Increasing competitiveness will require: (i) supporting macroeconomic stability; (ii) improving the business environment; and (iii) supporting competition.

Support Macroeconomic Sustainability

Frequent cycles of macroeconomic instability have dampened private investment in Pakistan (risk channel) and impeded the development of a well-functioning financial market (through the crowding-out of private investments). Going forward, sound macroeconomic management is needed to achieve the full potential of other reform initiatives aimed at achieving productivity-led growth in Pakistan. This is even more critical given the additional risks to macroeconomic stability posed by the COVID-19 pandemic.

Improve fiscal management

A weak fiscal architecture and poor budgetary planning add to Pakistan's fiscal weaknesses (i.e., low revenue mobilization and large/rigid current expenditures). Strengthening the institutional framework underlying fiscal management is a first pre-requisite to supporting macroeconomic stability. While measures have been taken to improve budget management through the Public Finance Act of 2019, further interventions are needed to support fiscal *coordination* between federal and provincial governments and increase the *commitment* toward fiscal discipline through better public financial management. These interventions are expected to limit the discretionary power of political actors and to strengthen efforts already underway.

Strengthening institutions and mechanisms for a coordinated approach to fiscal management, with each tier of government working toward achieving common national objectives. While responsibilities are well demarcated, there is little to no coordination on revenue collection, planning and budgeting between federal and provincial governments. On the revenue side, as per the provisions of the 7th NFC Award, the Federal Government must remit about two-thirds of the total revenue collection to provinces, irrespective of their revenue collection efforts.¹²⁰ Lacking incentives to raise revenues directly, the share of tax revenue collected by the provinces remains very small (1.0 percent of GDP in FY19). The National Finance Commission Monitoring Committee (NFC-MC), comprising federal and provincial finance ministers, was tasked with the purpose of setting, reviewing and monitoring federal and provincial fiscal policies, including expenditures, revenues, debt and cash management. However, the NFC-MC does not meet regularly, and it does not have adequate secretarial support to provide evidence-based advice for policy decisions. Lacking coordination, in times of fiscal crisis the Federal Government imposes fiscal surplus requirements on the provinces, and/or delays revenue transfers to the provinces which, de facto,

¹²⁰ The Constitution assigns income taxes (except for income derived from agriculture), the GST on goods, customs duties, federal excises, and the capital gains tax (CGT) to the federal level and GST on services (GSTS), tax on professions, agricultural income tax, motor vehicle tax, urban immovable property tax (UIPT), and other taxes related to real estate (e.g., stamp duty, capital value tax) to provinces.

undermines provincial autonomy¹²¹ and distorts provincial fiscal policy implementation. Strengthening institutions for a national approach to fiscal management responds to incentives of all players in the policy arena (central and provincial governments). The COVID-19 pandemic has put additional strains on Pakistan's already weak fiscal position and elevated the need for having well-functioning coordinating bodies that provide a platform for building consensus and implementing a national-level strategy to deal with similar crises. Thus, the current macroeconomic environment provides an opportunity to establish institutions that will ensure greater coordination in the future.

The legal framework for Pakistan's public financial management (PFM) could be strengthened, and the passing of the PFM Act by Parliament in June 2019 is a positive step. Historically, the PFM system has been regulated by various sets of rules that contain numerous contradictions and gaps, leading to inefficiencies. For example, prior to the enactment of the PFM Act of 2019, there was no clear requirement for budget funds to be held in the Treasury Single Account (TSA) which, over time, resulted in the accumulation of government entities' deposits in commercial banks.¹²² This practice has two distortive implications. On the one hand, the availability of large government deposits does not create incentives for commercial banks to increase their market penetration through improved client services or products. On the other hand, it has artificially over-stated government expenditure, thereby inflating the fiscal deficit and leading the Federal Government to overestimate short-term borrowing needs. In turn, increased short-term borrowing exacerbates the burden of debt servicing on the budget.¹²³ In addition, the weakness of the PFM system has undermined the development of sound budget management practices. In fact, frequent in-year budget revisions have replaced accurate planning and oversight, at the cost of budget transparency. The latest PFM Act is intended to address some of these longstanding issues and includes provisions for increasing budget credibility and transparency, strengthening budget execution, and improving cash management through a TSA.¹²⁴ While the PFM Act sets out key principles that need to be followed to improve the existing system, these should be dealt with in more detail in budget manuals and other relevant documents. Improving PFM practices, particularly budget execution and cash management is critical for the government in the post-COVID-19 pandemic context where it faces a tight fiscal position (due to limited revenues) but needs to increase spending in the health, education and socio-economic sectors.

Improve debt management

High and growing debt levels add to macroeconomic instability, raise future debt-servicing costs and increase Pakistan's vulnerability to external shocks. Strengthening debt management institutions, notably

¹²¹ For example, under the current IMF EFF, provincial governments have signed MoUs with the Federal Government to record surpluses.

¹²² At end-June FY19, government entities had accounts in commercial banks with a total cash balance of PKR 2.0 trillion (5.4 percent of GDP). These accounts (over 450,000 in number) appear in the SBP's reports on the banking sector but, as they are not linked to the TSA, they are not shown in government fiscal reports.

¹²³ In FY19, interest payments on domestic debt absorbed 37 percent of total government revenues and amounted to 4.7 percent of GDP, while government deposits in commercial banks at the end of the fiscal year amounted to 5.4 percent of GDP.

¹²⁴ In September 2019, the Government also issued a new Cash Management and Treasury Single Account Policy 2019–29 which calls for the establishment of a Treasury Office in the Ministry of Finance.

improving commitment toward debt management strategy implementation and strengthening transparency in debt reporting, is a prerequisite in mitigating the long-term impact of these risks on the economy. The COVID-19 pandemic has raised Pakistan’s fiscal and debt concerns, with debt levels expected to remain high over the medium-term, there is an urgent need for sound debt management to respond to these risks.

Despite Pakistan’s increasing public debt levels and greater exposure to debt-related shocks, debt management in Pakistan is weak and inadequate. Debt management in Pakistan faces three main challenges. First, there is significant fragmentation in debt-management functions between different offices in the Ministry of Finance and other agencies,¹²⁵ which operate independently with no single entity empowered to, and/or tasked with, implementing a coherent debt-management strategy in Pakistan. The Debt Policy Coordination Office (DPCO)—established through FRDLA 2005—only plays a coordination and advisory function.¹²⁶ Second, there is lack of a coherent medium-term debt-management strategy. In fact, while the DPCO prepares a medium-term debt strategy (MTDS), it does not have the authority to enforce its implementation. As a result, the debt-management authorities have relied excessively on short-term domestic borrowing to finance the fiscal deficits. This has increased the Government’s exposure to debt rollovers¹²⁷ and the consequent liquidity risks of debt, while also contributing toward crowding out the private sector from the credit market. Third, availability of debt data in Pakistan is fragmented and not reconciled between different data sources. Currently, there is limited consolidation of debt data that investors and creditors can easily have access to, and that policymakers can base policy decisions on. Information on public debt is fragmented across several documents, often with overlapping or incomplete information.¹²⁸ Moreover, detailed information on fiscal risks and contingent liabilities (e.g., guarantees to SOEs’, commodity operations liabilities) and provincial debt stocks is either highly aggregated or not disclosed at all (e.g., circular debt in the energy sector).

Maintain a market-determined exchange rate regime

A flexible, market-determined exchange rate helps boost an economy’s export competitiveness (as it reduces the production costs of domestic relative to foreign producers) and supports the functioning of financial markets, while contributing to a better allocation of resources in the economy. Pakistan has recently transitioned toward a market-determined exchange rate regime. Strengthening institutional commitment to maintain such a regime, even under adverse macroeconomic conditions such as those

¹²⁵ These include the Budget Wing in the Ministry of Finance, the Central Directorate for National Savings (CDNS), the Economic Affairs Division (EAD), and the External Finance (EF) Wing.

¹²⁶ DPCO focuses on advising on a debt reduction path; providing policy advice; monitoring the costs of borrowing; and preparing the debt policy statement. It does prepare a medium-term debt strategy (MDTS) but due to fragmentation issues and lack of implementation authority, the strategy is not properly followed. Recently additional functions have been assigned to the DPCO. These should be effectively implemented and codified through amendments to the FRDLA 2005.

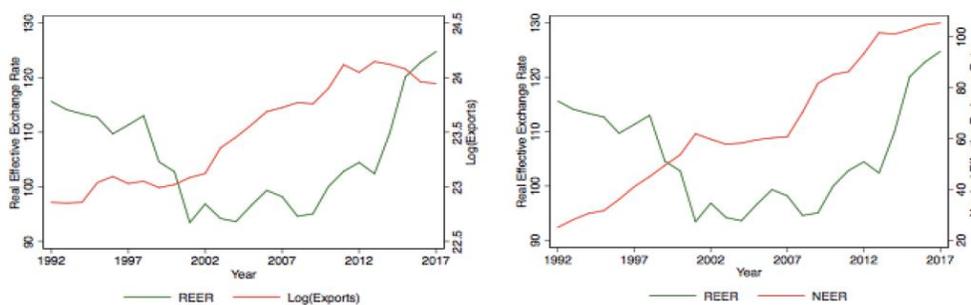
¹²⁷ As part of the current IMF program, the authorities reprofiled the stock of short-term debt held by the SBP into medium- to long-term debt at the end of FY19.

¹²⁸ These reports are published by different entities such as, the Ministry of Economic Affairs, the Debt Policy Coordination Office (DPCO), SBP, and the Ministry of Finance. There are several reports available such as Statistical Bulletins by SBP; Risk Reports, Debt Policy Statements, Medium Term Debt Strategies, and Fiscal Policy Statements by DPCO, as well as some provincial debt bulletins.

created by the COVID-19 pandemic, will be important in supporting the coordination of economic actors to undertake investments necessary to compete in international markets.

In the past, an overvalued exchange rate has adversely impacted Pakistan’s economy and led to a decline in its export competitiveness, contributing to Pakistan’s external imbalances. International experience shows that real currency depreciations boost export competitiveness.¹²⁹ However, the defense of an overvalued nominal exchange rate in Pakistan led to an appreciation of the real effective exchange rate (REER) by 32.2 percent between 2008 and 2017, and 6.2 percent per year during the period 2013–16 (Figure 45).¹³⁰ This real appreciation of the currency has reduced export competitiveness,¹³¹ particularly for export industries with higher shares of domestic value-added. Evidence suggests that the negative impact of exchange rate overvaluation on export competitiveness has limited GDP growth (Hamid & Sarosh Mir, 2017). Recently, the Government allowed the exchange rate to depreciate by 25.5 percent in FY19 and moved toward a market-determined exchange rate regime in May 2019. Under this flexible regime, the State Bank of Pakistan might intervene to prevent possible overshooting of the exchange rate, or disorderly market conditions, but will do so without suppressing the underlying trends of the exchange rate or by drawing down on reserves (International Monetary Fund, 2019). This is a positive step and, together with other structural reforms to improve exports, will help boost export competitiveness.

Figure 45: Real and nominal effective exchange rates in Pakistan



Source: Bruegel and World Development Indicators.
Note: Increases are appreciations (real and nominal).

Source: (Rocha & Varela, 2018).

Improve the Business Environment

A conducive business environment that levels the playing field for all market participants can help unshackle the private sector, incentivize investment and contribute to quickly accelerating productivity growth.

¹²⁹ This is particularly true for developing countries that are less integrated in global value chains (Rocha & Varela, 2018).

¹³⁰ Ibid.

¹³¹ Specifically, a 10-percent real appreciation of the currency resulted in export contractions of 5.7 percent between 1998 and 2016.

Simplify and improve the business regulatory environment

Market distortions arising from a complex and opaque regulatory regime distort the efficient allocation of resources, create room for discretionary application, clientelism and capture, and ultimately reduce investment. Empirical research shows that economies that process business registrations efficiently also tend to have a higher entry rate of new firms, i.e., greater private investment and higher business density.¹³² Higher entry costs, both implicit (opaque and cumbersome processes) and explicit (high costs associated with business registration, licensing and permitting), in contrast, are associated with a larger informal sector and a smaller number of legally registered firms.¹³³ During consultations with the private sector, an opaque business regulatory environment was highlighted as a key impediment for SMEs, as these firms are typically less connected to the elites and have to bear the brunt of rent-seeking by regulators. Larger firms have both the ability to hire staff to deal with government agencies and to obtain exemptions/facilitations through their connections. They can therefore navigate through the regulatory morass.

Significant progress has been made by Pakistan in improving the investment climate to facilitate private sector development and investment, including foreign direct investment, but more needs to be done.

Over the past two years, the Government's commitment toward reforming and streamlining the investment climate and regulatory environment has led to an improvement in Pakistan's ranking on the WBG's Doing Business Report 2020, from 147 out of 190 countries to 108—a net improvement of 28 ranks over two years.¹³⁴ But despite this recent progress, Pakistan's investment climate still fares poorly compared with regional and global comparators. In the Doing Business 2020 Report, Pakistan ranks fifth out of eight countries in South Asia, ranking higher than only Afghanistan, Bangladesh and the Maldives. It takes 16.5 days to start a business (registration and operationalization through securing relevant licenses and permits) in Pakistan, as opposed to an average 14.5 days in South Asia and 9.2 days in high-income countries. Starting a business in Pakistan requires multiple interactions with both federal and provincial authorities, in addition to private institutions, raising the specter of rent-seeking and corruption.¹³⁵ The COVID-19 pandemic has created new challenges for firms and to help them bounce back faster as the pandemic subsides, the government will have to continue the work on creating a more conducive investment climate.

Regulatory delivery and governance have become more fragmented following the 18th Amendment and devolution. Instead of abiding by, and responding to a single, harmonized and transparent regulatory regime, investors with operations across the country frequently need to comply with five distinct

¹³² (Leora, Lewin, & Delgado, 2009)

¹³³ (Levon & DiCecio, 2009)

¹³⁴ The improvement in Pakistan's ranking is linked to a series of reforms undertaken in November 2018 and May 2019. Reforms recognized in the 2018 rankings covered the areas of starting a business, registering a property and resolving insolvency. In 2019, another six reforms were recognized in the areas of starting a business, dealing with construction permits, getting electricity, registering property, paying taxes and trading across borders.

¹³⁵ Aspiring private investors interested in setting up a limited liability company (LLC), among other steps, need to reserve the company name, register the business with the SECP, obtain a National Tax Number (NTN), register with the federal Employees Old-Age Benefits Institution (EOBI), etc. A different set of rules, regulations and processes and procedures governs the registration and operationalization of other business types. Sole proprietorships, for instance, are registered at the Federal Board of Revenue (FBR) under Income Tax Ordinance 2001, while registration and operations of partnerships are governed by the Partnership Act 1932 and firms are registered at the registrar of firms under the district government.

regulatory regimes that are administered with little coordination and often with overlapping jurisdictions. There are at least 12 different categories of general regulatory layers that are applicable to all firms, with four additional administrative processes for foreign companies. Administration and implementation of business regulations are also based on cumbersome processes with patchy enforcement. For example, a total of 50 laws and a multitude of secondary regulations are enforced by over 40 national and subnational agencies and departments through a litany of NOCs, permits and licenses in regulating the manufacturing sector. The multiplicity of regulations, their fragmentation across different levels of government, together with their ad hoc and mostly manual administration, exposes the system to rent-seeking behavior, which has served as a major deterrent to private investment in the country. In recent years, the government has taken steps to simplify, automate and integrate regulatory processes across the federal and provincial authorities.¹³⁶ Going forward, the government can build on the progress achieved and complete the implementation of these reforms across the country.

Harmonize tax policy and improve tax administration

A complex and opaque tax policy regime increases disproportionately the cost of compliance for smaller businesses, discouraging the entry of new firms. Pakistan's tax system is governed by multiple legislation and complex administration, and characterized by ad-hoc policy changes, multiplicity of taxes, distortionary tax exemptions and jurisdictional overlaps.¹³⁷ Strengthening institutions for interprovincial coordination on tax policy, as well as eliminating exemptions and discretionary decision-making in tax administration, will not only improve the business climate, but also contribute to expanding Pakistan's revenue base- both of which are particularly important as the country recovers from the COVID-19 pandemic.

The GST regime has fragmented Pakistan into five competing tax jurisdictions, creating high compliance costs for businesses. The complexity and inefficiency of Pakistan's tax policy and administration are well represented by the case of the general sales tax (GST).¹³⁸ Businesses operating across the country need to submit 60 tax returns annually and sales tax refunds take an average time of 18 months. The tax base is split into goods and services, with the power to tax them separately vested with the federal and provincial governments, respectively. The base is further broken down spatially, as each province has the power to tax services supplied within its jurisdiction and levy its own tax rates on these services. This fragmented nature of the base has led to inter-provincial and federal-provincial jurisdictional conflicts, resulting in double taxation, exporting of taxes to other provinces, tax evasion, and consequently extremely high costs of compliance for businesses, especially SMEs with a small capital base.

¹³⁶ The Government has recently adopted the 'Better Business Regulation Initiative' (BBRI) to introduce a new wave of investment climate reforms, in addition to those captured by the EoDB. BBRI entails the mapping of all the rules, regulations, licenses and permits which govern the operations of the private sector in Pakistan, followed by the simplification and streamlining of these rules and regulations, and finally automation and integration.

¹³⁷ (World Bank, 2018).

¹³⁸ The 1973 Constitution assigned the sales tax on services to the provinces. A GST regime was legislated by the Government in 1990 and the Central Board of Revenue (former name of the Federal Board of Revenue) collected the sales tax on services on behalf of the provinces and transferred the proceeds to them after deducting an administrative fee. After the implementation of the 18th Amendment, provinces established their own revenue authorities and started directly collecting the sales tax on services.

Weak tax policy formulation has led to large and distortionary exemptions, reducing the Government's tax collections while creating adverse incentives. Differential taxation and exemption regimes in various sectors of the economy further distort the incentives of economic players. Some sectors (most notably textile, pharmaceuticals, chemicals, and food) and, at times, firms within such sectors (exporters, firms in Special Economic Zones) receive preferential treatment through a plethora of tax exemptions, often benefiting incumbents over new entrants, and contributing to the overall complexity of the system and discretion in its administration. Some sectors, notably the agriculture sector, benefit from a preferential tax regime,¹³⁹ which is often abused to avoid paying personal income tax (PIT). In urban areas, owners of residential, commercial, and industrial property are expected to pay an annual urban immovable property tax (UIPT). However, the tax base is eroded due to the use of outdated valuation tables. This wedge between official and market values has not only deprived the Government of much needed revenue, but this policy-induced distortion has also led to the diversion of savings to the real estate sector over time.

Support infrastructure development

Investments in critical infrastructure increase the marginal productivity of private inputs, thus increasing the rate of return on private capital and attracting investments.¹⁴⁰ In the case of Pakistan, improving energy sector performance, as well as providing transport and logistic infrastructure while addressing concerns of long-term environmental sustainability, is key to supporting private sector growth and investments. Institutional strengthening is required to improve planning and inter-agency coordination, and a more balanced and efficient risk-sharing between private and public entities.

The quality of infrastructure in Pakistan remains relatively poor and needs significant investment.

According to the WEF Global Competitiveness Index (GCI), Pakistan ranks 105th out of 140 countries in terms of the quality of its overall infrastructure, which includes transport and utility infrastructure, such as road connectivity, electricity access, electricity supply, quality and reliability of water supply, i.e., infrastructure whose provision lies primarily within the government domain.¹⁴¹ Pakistan also lags in digital infrastructure, ranking 104th out of 121 countries in the 2019 Network Readiness Index (NRI)¹⁴². While infrastructure investments being undertaken by the Government under the umbrella of the China-Pakistan Economic Corridor (CPEC) are an important step in bridging infrastructure gaps, especially in power generation and logistics, gaps remain and may widen given population growth and the vast infrastructure financing requirements of the country. It is estimated that Pakistan needs to ramp up its investment in infrastructure to over US\$30 billion (10 percent of GDP) annually if it is to sustain growth.¹⁴³ To this end, given existing fiscal constraints, the Government needs to leverage resources from the private sector through public-private partnerships (Box 19). In addition, the Government needs to leverage long-term sources of funding. At present, the debt capital market is dominated by government securities. The

¹³⁹ Agriculture in Pakistan is subject to agriculture income tax, land-based tax, land revenue and irrigation water charges. However, agriculture-related tax revenues amount to only US\$120 million per year, compared with agricultural subsidies of US\$1.4 billion per year and an agricultural GDP of US\$50 billion per year. This situation reflects a weak land registration system, low land valuations, low agricultural income tax rates and poor collection rates.

¹⁴⁰ (Agenot & Moreno-Doson, 2006)

¹⁴¹ In comparison, India ranks 70, Indonesia 72 and Sri Lanka 71.

¹⁴² The NRI 2019 is a publication of the Portulans Institute, in partnership with the World Information Technology and Services Alliance (WITSA). The index ranks the network readiness performance of countries across four different pillars: technology, people, governance, and impact.

¹⁴³ See Financial Sector Assessment Program – Development Module. Technical Note on Infrastructure Finance.

institutional investor base and existing bilateral development finance institutions (DFIs) invest primarily in sovereign debt and land.

Box 19: Public-private partnerships in Pakistan: Managing the risks and opportunities

The private sector could play a much more prominent role in the financing and provision of physical and social infrastructure. The Government needs to raise investment by an estimated US\$165 billion in order to reach the universal access goals of the SDGs over the next two decades. Limitations in the fiscal space of the Government call for private participation to accelerate the development and maintenance of infrastructure. Private participation could help improve service quality and instill budget discipline. But Pakistan's track record of structuring public-private partnerships (PPPs) has been mixed and there are concerns about contingent liabilities. Noteworthy deals in a relatively modest portfolio of 68 PPP transactions include the power and port sectors. But guarantees in support of underused infrastructure built through PPPs have given rise to fiscal liabilities of as yet unknown magnitude. The practice of providing state guarantees and viability gap funding needs to follow a transparent process based on value-for-money considerations. The lack of capacity to assess, manage and report fiscal implications is relatively low, according to the World Bank's latest PPP benchmarking.

The Government needs to strengthen PPP frameworks and methodically build capacity. It needs to identify true PPP champions at the federal and provincial levels, and also offer full commitment and high-level leadership to address challenges of coordination. Pipeline development needs to be part of an enhanced public investment management system to ensure that only economically sound investments that fit with the overall infrastructure plan are prioritized. This would require better methodologies and specific guidelines for value-for-money assessments and a clearer process to handle unsolicited bids. Furthermore, contract awards and renegotiations need to be transparent to promote fair competition and avoid the favoring of politically connected entities. Building a strong transaction advisory capacity and setting up ring-fenced funding so that projects can engage qualified advisors will also be important going forward.

At the transactional level, focusing the PPP agenda on "low-hanging fruit" is likely the best way forward. PPP engagements would be desirable in renewable energy, ports, bus-based mass transit/BRTs, highways, rail freight/bulk terminals, water, transmission, and telecoms. Given the challenges of low administrative capacity, a difficult political economy, and internal coordination, the Government would be well advised to take a pragmatic approach and focus on model transactions that can showcase the feasibility of the PPP concept. Cabinet-level ownership for such an agenda is crucial, and a list of potential transactions needs to be endorsed and monitored with clear accountability and responsibility assigned. PPP transactions with explicit and material user charges that produce forex-denominated cash flows are arguably most realistic. Such a list could include seaports, airports and rail freight/bulk terminals, which tend to generate revenue for the Government, and mass transit/BRTs or highways.

Pakistan's PPP agenda will eventually develop once the issues of long-term finance and demand from domestic sponsors are addressed. The country lacks long-term debt-financing and hedging products (currency and interest-rate swaps) to bridge the mismatch between long-term forex financing and local currency revenues, and the conversion of variable rates to fixed rates. This explains the country's reliance on forex finance which, given that many PPPs receive cash flows in local currency, leads to contingent liabilities and hence further fiscal risks. An ambitious PPP agenda would therefore need to be complemented by efforts to strengthen debt and capital markets that can support long-term local currency finance. Islamic finance and its various instruments have been used for infrastructure/PPPs in Pakistan in the past and represent a large untapped potential in the provision of long-term finance.

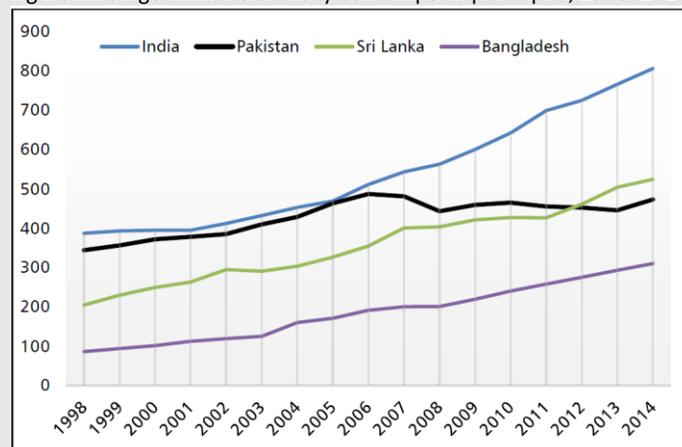
Addressing energy sector constraints and reducing the cost of electricity production are critical to stimulating investment and raising productivity. The inability of the energy sector to meet growing demand has been a major constraint to productivity growth and private sector development in the country (Box 20). While recent investments in generation capacity have reduced demand-supply shortages, they have not contributed to reducing the cost of electricity, which is only partly offset by subsidies. Governance constraints, the lack of long-term planning, an inefficient fuel mix and the Government's need to negotiate capacity expansion under duress, have all contributed to Pakistan's high electricity generation cost, which in FY19 was about US\$ cents 9.2, as opposed to an average of US\$ cents 4-8/kWh in neighboring countries. The high cost of energy generation is further compounded by

inefficiencies in transmission and distribution (T&D) infrastructure, with losses accounting for about 18 percent of generated power.¹⁴⁴ Improving institutional efficiency, strengthening the regulator (National Electric Power Regulatory Authority, NEPRA) and supporting inter-agency coordination for better long-term planning will be crucial in addressing constraints imposed by high energy costs, as well as those of growing circular debt in the sector. The COVID-19 pandemic is estimated to have added an additional US\$1.6 billion to the circular debt, reinforcing the need for immediate cost-reducing reforms in the energy sector. In addition, the recent commitment of the Government to increase the share of domestic low carbon energy (hydro, solar and wind) in the total energy mix to almost 70 percent should reduce both the cost as well as the environmental and health burdens associated with fossil fuel power generation.

Box 20: Energy sector constraints

Pakistan’s energy sector has traditionally been affected by underinvestment, insufficient planning and poor governance. Supply shortages against a consistent increase in consumers (in both domestic, industrial and commercial subsectors) were managed through frequent and prolonged load-shedding spells, which curtailed growth of electricity consumption. Compared with other countries in the region, the average electricity consumption in Pakistan has stagnated from mid-2000s onward (Figure below). The productivity of economic sectors is dependent on power, as well as smaller businesses that are unable to access credit/afford back-up generators, which have been particularly affected by electricity shortages.^a According to the Business Enterprise Survey, 68 percent of firms in 2007 and 44 percent of firms in 2013 reported energy as a major business constraint.

Figure: Average annual electricity consumption per capita, 1998–2014

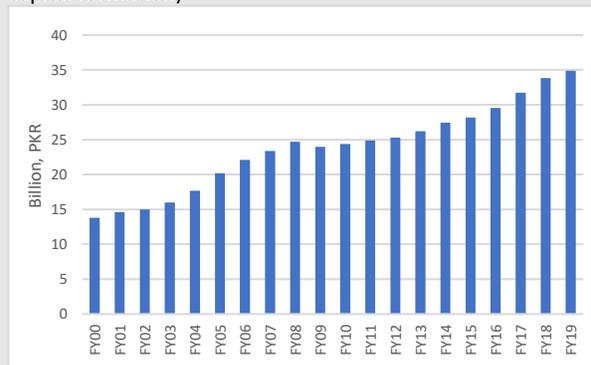


Sources: World Bank Databank and NEPRA Status of the Industry 2017 report.

Investments in generation capacity over the past five years have substantially reduced demand-supply shortages. The commitment of the PML-N Government^b to curtail load shedding, reflected in the ambitious 2013 National Power Policy, has resulted in a substantial increase in investments in the sector (Figure below, left panel) and the addition of 12 GW of generation capacity to the system, which have substantially reduced peak demand shortages (Figure below, right panel). However, the recent increase in generation capacity has not been cost effective and did not contribute significantly to reducing energy generation costs. More than 70 percent of the additional capacity added over the past five years has been obtained through thermal plants relying on imported fuels, including coal and Liquefied Natural Gas (LNG), while the use of cost-effective renewable indigenous sources such as hydro, wind and solar has remained limited.^c The expansion in generation capacity was mainly obtained through power purchase agreements (PPAs) with independent private producer (IPPs) whose investments were supported by high guarantee returns and take-or-pay clauses guaranteeing capacity payments even if no electricity is generated.

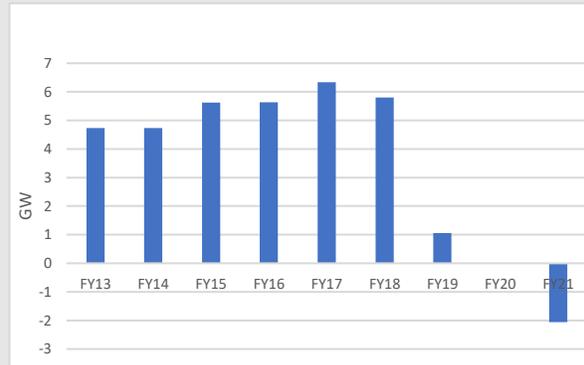
¹⁴⁴ Full recovery of generation, transmission and distribution costs would imply an average tariff of US\$ cents 12.3 /kWh, while the average tariff passed on to consumers, after subsidies, is about US\$ cents 10.3/kWh.

Figure: Investments trends in energy sector (gross fixed capital formation)



Note: Gross fixed capital formation, constant prices 2005.
Source: World Bank staff elaboration on PBS data.

Figure: Peak demand shortages



Source: State of industry report, various years.

Notes: (a) Manufacturers of metal products are estimated to have been the most affected, suffering a loss of productivity of 50 percent for every 10 percent increase in power shortages (Asian Development Bank , 2019); (b) Pakistan Muslim League – Nawaz (PML-N) governed from 2013 to the summer of 2018; and (c) The energy mix for power generation in Pakistan is dependent primarily on hydropower, oil-fired and gas-fired power plants, with each accounting for about 30 percent, whereas the costs are heavily skewed toward oil-fired power plants, which account for 46 percent of total costs, contributing significantly to the high average cost of supply (Asian Development Bank , 2019).

Similarly, strengthening inter-city infrastructure and intra-city public transport is critical to capitalize on agglomeration and urbanization gains. While several centers of dynamic manufacturing-driven growth have emerged in Pakistan that feature linkages among geographically close cities, many small and medium-size cities remain excluded from such clusters. Expanding the network of secondary roads between major highways, and small and medium-sized urban centers, is therefore important to improve the market potential of these cities. In addition, investment in transport logistics, such as promoting containerization of freight transport, will enhance the commercial and export potential of markets. These logistics improvements will also strengthen urban-rural linkages and reduce the loss of agriculture products from farm to market during the logistics chain. Similarly, congestion problems in larger cities should be addressed through continued improvement in public transport¹⁴⁵ and more efficient land use to help limit urban sprawl and air pollution. To support such investments, institutions in charge of urban planning should be strengthened, as well as the coordination between different layers of government (federal, provincial and local) to support regional and integrated infrastructure planning.

Infrastructure development needs to respond to growing environmental sustainability challenges. In the absence of adaptation measures, depletion of natural resources will negatively affect twin goals' achievement. As outlined in Pakistan's Intended Nationally Determined Contributions (INDC),¹⁴⁶ national

¹⁴⁵ Bus rapid transit systems are being pursued in Lahore, Islamabad and Karachi.

¹⁴⁶ The INDCs are a key part of the Paris Agreement of 2015 and reflect a country's contribution to the global effort to reduce emissions of greenhouse gases (GHG) and limit global warming in the post-2020 period. Pakistan has committed to reduce up to 20 percent of its projected green-house gas (GHG) emissions below business-as-usual levels by 2030, subject to availability of international grants to meet the total abatement cost of \$40 billion at 2016 prices. Adaptation needs have been identified to range between \$7-14 billion per annum during this period, with

adaptation priorities include the building of climate-resilient infrastructure with a focus on water-related and transport infrastructure. Strengthening investments in water and sanitation is key to respond to growing water scarcity and contamination challenges and, indirectly, to address one of the underlying causes of stunting. Collectively, water sector financing is well below recommended levels. The most important infrastructure gaps are associated with water supply and sanitation services, and irrigation and drainage services.¹⁴⁷ Major infrastructure investments need to be accompanied by institutional strengthening, especially regarding irrigation and urban water. The governance challenges relate to inadequate legal frameworks for water at federal and provincial levels, the incompleteness of policy frameworks and the inadequacy of policy implementation. The policy deficiencies stem from institutional problems, including unclear, incomplete, or overlapping institutional mandates, and a lack of capacity in water institutions at all levels.

Though internet infrastructure and access has improved in the country, barriers remain. The number of internet subscriptions, particularly mobile, have surged from approximately 6 million in April 2014 to nearly 80 million in December 2019.¹⁴⁸ However, high taxation and regulatory restrictions around internet services have kept prices relatively high – a 100 Mbps connection can cost upwards of 40 percent of the GNI per capita – and restricted the diversity of service providers and services offered. The predominantly state-owned Pakistan Telecommunication Company Limited (PTCL) controls the country’s largest internet exchange point (IXP) and exerts considerable influence on charges over the internet backbone whereas the Pakistan Telecommunication Authority (PTA) exercises significant control over internet/mobile providers through licensing fees, renewals and other bureaucratic processes. Overlapping jurisdictions related to Right of Way (RoW) permissions, and the lack of clear policies at the local government levels have also constrained the deployment of fiber optic cables; even in dense urban localities. As access and use of digital services becomes increasingly important for economic recovery post the COVID-19 pandemic, the government needs to reduce existing barriers to internet access, affordability and usage across the country.

Improve land management system

Supporting the development of an efficient and transparent market for land is critical for improving Pakistan’s investment climate, unleashing efficiency/productivity gains from urbanization and improving productivity in agriculture.

Province-wide digitization efforts are underway. In Punjab, the Record of Rights has been fully digitized (establishing the Land Records Management Information System, LRMIS), while progress is ongoing in Sindh (establishing a Land Administration and Revenue Management Information System, LAR-MIS). Similarly, KP and Baluchistan have digitized the Record of Rights in primary areas. However, all provinces continue manual updating of the Record of Rights in the village and district offices¹⁴⁹ of BoRs. Cadastral Maps are scanned in many parts of Pakistan (all of Punjab, two-thirds of Sindh), but converted to digital maps in only small areas of Punjab and Sindh. Records for UIPT collection are mostly in digital form but

the NDC committing to the development of a National Adaptation Plan (NAP). Identified adaptation priorities for the short-term focus around integrated water resources management, mainstreaming climate change, supporting disaster risk management and strengthening institutions and knowledge.

¹⁴⁷ (Young, et al., 2019).

¹⁴⁸ Pakistan Telecommunications Authority indicators.

¹⁴⁹ The manual process is implemented in two copies by village based Assistant Collectors called Patwaris and a district level Deputy Commissioners.

suffer from coverage issues. After a sizeable investment,¹⁵⁰ Punjab’s digital UIPT records and map cover 4.4 million properties, and both KP and Sindh are investing in similar digital UIPT records. Cantonments, Housing Authorities, and Cooperatives are converting to digital records, each developing their own data models, solutions and applications.

In moving forward, Pakistan should adopt a policy and program for the completion of comprehensive land records in all provinces by 2030. Federal Pakistan should take a lead in establishing the program as a Federal Policy of Land Records Modernization defining the objectives, components and activities for federal and provincial implementation in back-to-back five-year periods. Key elements of such a program would include, among others: (i) digitalization and automation of land (revenue) records and maps interlinked with the registers of deeds; (ii) standardization, interlinking and eventual integration of all rural and urban land records to a single access point, and information system (including property valuation); and (iii) a mass (survey/registration) campaign to complete comprehensive land records, cadaster maps and valuations province-by-province in Pakistan.

Support Competition

Competition—by enabling an efficiency enhancing process of creative destruction, innovation and factor reallocation—is the key engine of productivity-led growth. In Pakistan, barriers to trade preventing integration with international markets, and direct state intervention in the economy through SOEs, have contributed to reducing competition and constraining productivity growth, while creating rents for incumbents/insiders.

Reduce anti-export bias in trade policy and promote green competitiveness

The link between productivity and exposure to trade works in both directions. First, little exposure to foreign markets reduces exposure to competition, and to more sophisticated technologies and know-how.¹⁵¹ Second, lagging productivity reduces the chances of Pakistani firms successfully integrating into highly competitive international markets. The recent transition to a market-determined exchange rate regime creates an important opportunity that should be capitalized upon by strengthening institutions supporting trade policy and promotion. In addition, with growing concerns of environmental sustainability, promoting climate-efficient solutions and clean technology development will be critical to increase the competitiveness of Pakistan’s industries and supply chains.

Pakistan’s inward-oriented rules and regulations—with tariffs on average 50 percent higher than those in South Asia—have had the effect of stalling integration into regional and global value chains (GVCs).

To facilitate integration into GVCs, countries have made efforts to reduce trade costs. Pakistan has not. Rather, trade policies have reverted to protectionism. In recent years, to reduce the trade deficit, import duties, including import tariffs and other taxes on imports, regulatory and additional customs duties (RD, ACD) have been increased. As a result, trade taxes account for one-fifth of Pakistan’s tax revenues, high by most international standards. These practices have sheltered incumbent firms from international competition and encouraged them to sell domestically.¹⁵²

¹⁵⁰ Under the World Bank’s Punjab Cities Governance Improvement Project.

¹⁵¹ Amiti and Konings (2007), Goldberg et al (2012), Javorcik (2017).

¹⁵² The FY20 Budget Bill introduced further increases in import duties that increase the anti-export bias of trade rules and regulations.

In moving forward, Pakistan should work on strengthening the institutional framework supporting trade policy and trade promotion. The Government has already started undertaking corrective measures to reduce the anti-export bias of the national tariff policy. In the first instance, the Cabinet has adopted the National Tariff Policy, transferring responsibility for trade tariff setting from the Federal Board of Revenue (FBR) to the Ministry of Commerce, and simplifying and rationalizing the tariff structure. This is a very significant step toward making tariff policy a trade promotion instrument rather than a revenue generating measure. Due to the COVID-19 pandemic, Pakistan’s exporters will face a hostile environment in the near-term. To help these firms remain afloat and bounce back as conditions improve – the government will need to remain committed to reforms for trade promotion and export competitiveness.

Export-oriented firms can improve their economic performance by adopting resource efficient and cleaner production practices. The environmental footprint of Pakistan’s key exporting industries – textiles, leather, agricultural products – is an impediment to their future development. For example, the textile sector contributes to 9 percent of Pakistan’s GDP but consumes almost 70 percent of the country’s industrial water.¹⁵³ Similarly, other export sectors (and more generally all industrial sectors) of Pakistan can improve their economic performance and green competitiveness by adopting resource efficient and cleaner production (RECP) technologies and practices. To improve global performance of its key exporting sectors, the Government should develop a green growth strategy to highlight the importance of green competitiveness. As shown in many other countries, the Government needs to increase public investments in green competitiveness and to implement public policy schemes to encourage private investments in environmentally responsible RECP technologies and practices.

Improve SOE performance

Improving SOEs’ performance is key to supporting the privatization agenda and to improving competition in sectors where the State has a footprint. State support through preferential access to finance (and non-binding budget constraints) and specialized regulations has led to the misallocation of resources away from productive private enterprises and toward public enterprises. Market liberalization reforms in the 2000s and early 2010s reduced the State’s footprint in the financial and telecom sectors, boosting competition, investment, innovation and growth in these sectors. While progress on the privatization agenda has stalled in recent years due to political constraints,¹⁵⁴ competition gains could still be achieved by strengthening the performance of SOEs through better governance. Loss making SOEs are a drain on government’s fiscal resources. Currently, despite being fiscally constrained, the government is under pressure to increase spending on the health, education and social protection sectors due to the COVID-19 pandemic. In this situation, it is even more important for SOEs to improve their performance and reduce their losses.

¹⁵³ A recent study found that Pakistan’s textiles sector can save nearly 22 percent of its energy consumption and boost productivity by implementing cleaner production practices (National Productivity Organization and Cleaner Production Institute, 2016)

¹⁵⁴ An ambitious privatization program, launched in 2013 and targeting more than 60 SOEs, resulted in just five transactions in the period 2013–15, and none thereafter. This was because the program was undermined by political, legal, and labor-related issues, as well as limited interest from prospective investors, the lack of clear communication strategy, and capacity constraints in the Privatization Commission.

Ensure full compliance with corporate governance rules to raise the performance of SOEs. The regulatory framework for SOEs has improved since 2013 with the adoption of the Rules on the Corporate Governance (CG) for Public Sector Companies. The CG Rules regulate appointments to management positions and Boards of Directors, the role of the Boards, and mandatory financial reporting, as well as internal and external audit requirements. SOEs are required to report annually to the SECP on their compliance with the CG Rules. However, implementation of the rules is lagging. It is estimated that only about half of federal SOEs submit annual declarations of compliance to the SECP and actual compliance is likely to be even lower. The appointment of civil servants to SOEs' Boards and senior management positions remains common across SOEs but is not conducive to performance improvements.

Strengthen the State's ownership and oversight function of SOEs, currently exercised under a decentralized institutional arrangement without coherent portfolio management. The Ministry of Finance (MoF) has made progress in compiling extensive data on federal SOEs, which is essential for evidence-based decisions. However, these reports covering financial indicators, Board composition, and human resource information of SOEs, have been completed with a time lag of one to two years, which is too late to inform the annual budget process. Moreover, the main reason for the lack of follow-up to the MoF reports is that the Government does not have an SOE ownership policy. This has perpetuated an ad-hoc approach to the ownership and oversight functions. An ownership policy (which can be embedded in a legal act, as in Indonesia) would lay down the principles and objectives of state ownership, its role in the corporate governance of SOEs, and the institutional arrangements for implementing the policy.

2. Promote Equity and Inclusion

Promoting equity and inclusion is a key priority to sustain poverty reduction moving forward, particularly as the country faces the consequences of the COVID-19 pandemic. Moreover, addressing barriers to inclusion and socioeconomic mobility, the proposed interventions can also contribute toward easing power imbalances at the basis of Pakistan's insider-outsider model and, in the long run, improve contestability of the policy arena. Promoting equity and inclusion will require: (i) improving productivity in the agriculture sector; (ii) strengthening financial inclusion; (iii) making cities work for the poor; (iv) supporting women's socioeconomic empowerment; and (v) improving the efficiency and equity of spending on poverty reduction.

Improve Productivity and Environmental Sustainability of the Agriculture Sector

In the agriculture sector, intervention by the State has contributed to increasing the advantage of big landowners (insiders) at the expense of small farmers (outsiders), to encouraging environmentally unsustainable practices and, ultimately, to the sector's sluggish growth (productivity) performance.

Improving the agriculture sector's productivity is key to sustaining growth, promoting environmental sustainability and poverty reduction going forward. Agriculture plays a major role in Pakistan's economy. Estimates indicate that, if Pakistan could bring its yields up to the world average, the country's agriculture sector could earn US\$10 billion in additional gross revenues¹⁵⁵ and significantly boost Pakistan's export

¹⁵⁵ (Ali, 2017).

potential. In addition, the progressive feminization of the sector and the increasing reliance of agricultural incomes of the poor¹⁵⁶ indicate that interventions aimed at boosting the agriculture sector's productivity will have an important role in sustaining women's economic empowerment, as well as poverty reduction. Lastly, adoption of climate smart technologies is key to improving efficiency in water usage and addressing growing water scarcity constraints and climate change risks in the sector.¹⁵⁷

Unlocking growth in agriculture and its potential for boosting inclusion requires catering to the needs of small farmers and women. Agricultural production in Pakistan is increasingly dominated by farmers operating on less than 5 acres of land,¹⁵⁸ with poor farmers operating on an average 5.5 acres of land.¹⁵⁹ Over the past 15 years, the agriculture sector has been absorbing most of the increase in female labor force participation, with the female share of employment in agriculture reaching remarkable levels in Punjab (almost half of the total) and KP (more than one-third of the total) (Figure 46). While location and household characteristics contribute to making small farmers a highly heterogeneous group, some key constraints are common to all small farmers, notably: limited crop diversification (predominance of subsistence crops/wheat); limited market access (small quantities for sale and high cost per unit, limited price information); low security of tenure (limiting access to credit and incentives to invest); poor access to credit (reliance on informal credit by *arthis* [middlemen], interlinkages between inputs, outputs and credit); poor soil fertility (limited access to water); limited ability to adapt to climate change and water scarcity; and poor literacy and numeracy. Such constraints are particularly binding for women small farmers, whose participation in non-subsistence/market activities faces cultural barriers that expose them to the risk of exploitation and further reduce the profitability of their businesses.

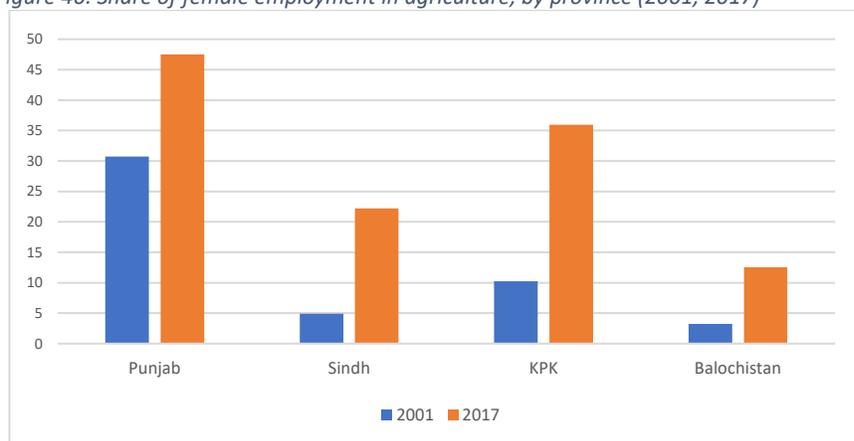
¹⁵⁶ As discussed in the section on Growth and Productivity Dynamics.

¹⁵⁷ Improving efficiency of water usage in agriculture is also part of Pakistan's Intended Nationally Determined Contributions (INDC) which highlights current water stress and identifies agriculture as a one priority adaptation area. Medium-to-long term adaptation measures (up to 2030) to address vulnerability of water and agriculture to climate change in the INDCs include: (i) lining of canals and irrigation channels; (ii) implementation of a Climate Smart agriculture program; and (iii) enhanced water resource management.

¹⁵⁸ According to Agriculture Census data, the total number of farms under 5 acres has more than tripled, going from 4.9 million, or 19 percent of the total in 1960 to 8.3 million, or 65 percent of the total in 2010. The polarization in land distribution has increased over time. Currently, 90 percent of small and medium farms (with less than 12.5 acres of land) account for less than half of agricultural land, while the 4 percent of farms larger than 25 acres account for one-third of all farm area.

¹⁵⁹ According to latest household survey data (HIICS, 2015–16), poor farmers operate on average 5.5 acres of land, but size of own plot is about 2 acres.

Figure 46: Share of female employment in agriculture, by province (2001, 2017)



Source: World Bank staff calculations on LFS data.

Strengthen Financial Inclusion

Deepening financial inclusion is key to supporting productivity growth of agricultural and non-agricultural businesses operated by the poorest and most vulnerable segments of Pakistan’s population, and a building block for both poverty reduction and inclusive growth. As demonstrated during the implementation of emergency cash assistance in response to the COVID-19 pandemic, strengthening financial inclusion and supporting digital payment system will be crucial to support greater resilience to shocks moving forward.

In Pakistan, financial intermediation is bank-centric, focused on select market segments,¹⁶⁰ and limited to traditional financial products and channels. Low saving rates and limited diffusion of bank accounts go hand-in-hand with the predominance of informal savings and credit. By some estimates, less than 30 percent of domestic savings find their way to the financial sector, with the rest being used in real estate or being intermediated through informal channels.¹⁶¹ Similarly, only 39 percent of credit in the rural and agricultural economy comes from formal channels, with the rest supplied through money lenders, commission agents and advance purchases often at exploitative prices.¹⁶² Among SMEs, over 90 percent of businesses rely on internal funds or informal channels for financing.¹⁶³ Finally, only 11 percent of women had access to formal financial services by 2015, itself a jump from 8 percent in 2008.¹⁶⁴ While Pakistan has taken some important steps in implementing reforms and policies to promote financial inclusion in the country—including the passage of a National Financial Inclusion Strategy (2015), regulations for Electronic Money Institutions (2019), a Payment Systems and Electronic Funds Transfer Act (2007) and branchless banking regulations (2008)—these measures and reforms have not yet translated into a significant improvement in the country’s performance on key metrics of financial

¹⁶⁰ The government and top-tier corporates account for large shares of credit, while women, SMEs and rural markets remain underserved.

¹⁶¹ (Ali, 2016)

¹⁶² (Pakistan Microfinance Network, 2013).

¹⁶³ World Bank Enterprise Surveys 2014.

¹⁶⁴ (World Bank, 2018).

inclusion. Moreover, a lack of gender-disaggregated data from the financial sector makes it difficult to assess women's financial inclusion.

Most importantly, Pakistan has yet to leverage the potential of digital finance. Digital finance has the potential to enhance financial inclusion significantly through lowering costs, using data to ascertain creditworthiness of borrowers, and intermediating retail-level savings to small borrowers. Digital finance also has a huge potential to increase women's financial inclusion.¹⁶⁵ Currently, low levels of digital financial inclusion are an outcome of: (i) a bank-centric financial system that enjoys comfortable profits lending to the Government and established corporate enterprises; (ii) lack of regulations allowing fintechs to drive innovation in savings, credit, investment and digital channels; (iii) the digital ID system maintained by the National Database and Registration Authority (NADRA) has not leveraged data for development of use cases such as credit scoring, digital lending, etc.; (iv) a payment system that does not allow for frictionless and cost-effective retail-level transactions; and (v) a cumbersome formal legal execution mechanism in the case of loan defaults. Because of these issues, Pakistan has not managed to develop a vibrant digital finance ecosystem in which fintechs are able to deploy Big Data platforms or dynamic risk management techniques to provide cost-effective digital financial services to wider population and enterprise segments.

Make Cities Work for the Poor

Rural to urban migration and the expansion of off-farm opportunities in the informal sector have been key drivers of poverty reduction over the past 15 years. Nonetheless, poor service provision, risky housing conditions, and weakened informal (kinship-based) safety nets expose migrants to vulnerabilities that require mitigation in order to support productivity growth and inclusion.

The poor livability of Pakistan's urban centers affects the poorest segments of the population the most.

As previously discussed, inefficient institutions, weak financial capacity, and a lack of planning all adversely affect the quality of public service provision in urban areas. As the poorest segments of the population lack the financial means to adequately satisfy their needs through private providers, inefficiencies in public-service provision disproportionately weigh on the poor. Moreover, increasing congestion costs due to urban sprawl and poor public transport infrastructure limit labor mobility options within urban centers, possibly contributing to the expansion of informality¹⁶⁶ and negatively affecting female labor force participation. The challenges faced by urban poor have become even more evident as a result of the COVID-19 pandemic. Congested housing conditions and poor access to water and sanitation have contributed to the highest incidence of contagion in urban centers. In Pakistan (similar to most other peer countries), housing is not considered to be critical infrastructure in urban planning and public policy.¹⁶⁷ As such, across most urban centers in Pakistan, the housing sector is left to develop independently, which is increasingly complex given the inefficiencies in the land market, particularly for the poorest segments of

¹⁶⁵ For example, an increase in the use of mobile money services and digitization of BISP payments has been a driving force for the increase in women's access to the formal financial system in recent years (World Bank, 2018).

¹⁶⁶ Recent evidence based on the expansion of metro line in Mexico City suggests that better connectivity through efficient public transport provision can induce labor reallocation from informal to formal sector (Zarate, 2019)

¹⁶⁷ In Karachi, for example, where there has been a renewed focus on the city's livability, resources are being directed toward traditional infrastructure such as water, transport and electrical networks with no allocation to the housing sector. This is despite the fact that almost half of Karachi's population lives in informal settlements.

the population that end up living in informal settlements, with limited access to basic services¹⁶⁸ (Box 21). In general, the lack of (affordable and adequate) formal housing options (rentals or for sale) is a key constraint to labor mobility, and a source of vulnerability for poor and lower-income households.

Box 21: Regularization and upgrading of informal settlements

Pakistan has mixed success history of intervention in regularization and upgrading of informal settlements in urban areas. In 1978, the Government started the Katchi Abadi Improvement and Regularization Program (KAIRP). It envisaged infrastructure development and the granting of tenure for the residents of *katchi abadis*, against repayment of land and development charges. However, it has failed to achieve its targets for a number of reasons; these include the high costs of upgrading squatter settlements, lack of access to credit for the poor and low-income groups, lack of community participation, and lack of capacity and capability in the implementing agencies.

In contrast, other programs—notably the Orangi Pilot Project (OPP) in Karachi—that have sought to organize communities to help solve problems in securing infrastructure facilities such as sanitation, have met with more success.

Source: World Bank (2002).

Tailoring social protection interventions to the needs of the working poor in urban centers should become a priority to support labor mobility and to mitigate the welfare impact of shocks. Safety nets and social protection interventions should be aligned with the specific opportunities and challenges associated with informality (lack of job security) and urban poverty. As demonstrated during the COVID-19 lockdown, workers in the informal sector have been the most affected by the lack of job security and of any form of social insurance. In order to address these challenges, efforts should be devoted to introducing innovative hybrid social assistance-social insurance programs to help reduce informal workers vulnerability to systemic and idiosyncratic shocks. In addition, safety nets could be better tailored to the development needs of urban areas. For instance, public works could focus more on local community projects that improve urban public services (e.g., water and sanitation, waste management) and labor programs could support public transport and green enterprises (e.g., recycling, eco-construction and green energy).

Support Women's Socioeconomic Empowerment

Most of the positive attributes associated with development require increasing the participation of excluded groups. In the case of Pakistan, the largest excluded group is represented by women, whose participation in the labor force and, more generally in the public sphere of life, remains substantially constrained.

¹⁶⁸ Estimates suggest that 40 to 60 percent of the urban population lives in *katchi abadis* or nonregularized subdivisions on agricultural land (World Bank, 2002). Pakistan has mixed success history of intervention in regularization and upgrading of informal settlements in urban areas. In 1978, the government started the Katchi Abadi Improvement and Regularization Program (KAIRP). It envisaged infrastructure development and the granting of tenure for the residents of *katchi abadis*, against repayment of land and development charges. However, it has failed to achieve its targets for a number of reasons; these include the high costs of upgrading squatter settlements, lack of access to credit for the poor and low-income groups, lack of community participation, and lack of capacity and capability in the implementing agencies. In contrast, other programs—notably the Orangi Pilot Project (OPP) in Karachi—that have sought to organize communities to help solve problems in securing infrastructure facilities such as sanitation, have met with more success.

Prevailing social norms do not support women’s involvement in economic activity outside their homes, with negative implications on earning potential and intergenerational investments in girls’ education.

Socially accepted definitions of masculinity and femininity, and the consequent centrality of women’s “honor”, are key dynamics that seriously inhibit women from working for pay. A “good” man is one who is the breadwinner for his family, and who maintains control and leadership of his household. A “good” woman is one who fully exercises her primary societal function of caregiving—for children, husband, home, and the extended family. A key aspect of a “good” woman is also her “honor” or virginity—actual and as perceived by the community—before marriage. This “honor” of a woman is intricately linked, as in much of South Asia, to the honor of men and the household.¹⁶⁹ Women’s freedom to step outside the house—for example, for a job—is seen as a threat to men’s and the family’s honor because it creates a potential threat to women’s sexual safety. These norms generate several behaviors and practices that have negative ramifications for women’s ability to work for pay, especially outside the home. The current distribution of women’s employment still reflects such normative constraints. Looking at new jobs occupied by women over the period 2001–17, employment in agriculture and low-paying, home-based manufacturing activities¹⁷⁰ still accounts for the majority. Low earning potential of traditional jobs reinforces, in a vicious cycle, low demand for girls’ education, particularly in rural areas.¹⁷¹ The lack of girl-friendly schools further entrenches households’ unwillingness to send girls to school, especially beyond elementary grades. The Government has been responding to education challenges mainly through demand-side interventions (Box 22), while less attention has been devoted to ensuring (at scale) access and quality of the supply of schools. In particular, in order to increase girls’ education and to ensure that girls can stay in school, supply-side interventions should focus on upgrading/maintaining the quality of existing school facilities (functioning/separate toilets for girls, access to safe drinking water, the presence of boundary walls)¹⁷² and on ensuring the availability of female teachers.

Box 22: BISP’s Waseela-e-Taleem (WeT) program

The Waseela-e-Taleem (WeT) program is BISP’s co-responsibility cash transfers (CCT), which provides additional financial support to BISP beneficiary families for their children’s primary education. Conditions include enrolment and over 70 percent of attendance. The program was launched in five pilot districts in 2012, expanded to 27 districts in 2015, and is currently being implemented in 32 districts across all provinces, with plans to expand into 18 additional districts. To date, 1.9 million children in BISP beneficiary families, aged 4 to 12 years old, have been enrolled into the WeT program.

WeT’s service delivery process builds on six components, including: supply capacity assessment; social mobilization; registration; admissions and attendance verification; case management; and cash transfers. Given that demand-side interventions such as CCTs will not help if supply-side services are not in place, the BISP conducted a supply-side capacity assessment to ensure the provision of primary schooling services prior to the launch and expansion of the WeT. The program also carefully defines conditionality and compliance conditions so that enrolment and attendance are regularly assessed for benefits payments.

¹⁶⁹ (Solotaroff & Pande, 2014)

¹⁷⁰ According to Labour Force Survey data, between 2001 and 2017, 89 percent of the 1.2 million new jobs occupied by women in the industry sector were informal, with predominance of home-based work arrangement paid on a piece-rate basis.

¹⁷¹ As discussed in the section on Inequality of Opportunities and Limited Socioeconomic Mobility.

¹⁷² Government statistics for 2015–16 suggest that primary schools’ infrastructure lags that of higher-level schools. Only slightly more than half of Pakistan’s primary schools had electricity, about 67 percent have drinking water and toilets for students, and 71 percent have a boundary wall. Only in Punjab do almost all schools have drinking water, toilets, and boundary walls; primary schools in Balochistan fare the worst, followed by those in Sindh (NEMIS 2017).

An evaluation of WeT suggests that the program has increased school enrolment equally for both girls and boys but has not narrowed the gender gap in enrolment. Social norms about girl's education also persist: parental disapproval of girls' education persists, with parents favoring boys over girls, and also spending more to educate boys compared with girls. Supply-side components are important too: schools being too far away is more likely to be given as a reason to not send girls to school compared with boys.¹⁷³

Source: (Ahmed, Cho, & Fasih, 2019)

Expansion of employment opportunities in the services sector creates new opportunities to promote women's socioeconomic inclusion, but investments are needed to properly leverage these opportunities. Between 2001 and 2017, expansion of the private sector provision of health and education services—traditionally considered as socially acceptable jobs for women—provided new job opportunities for educated women, particularly in urban areas. Growing labor demand in new sectors such as ICT and financial services can further expand the range of socially acceptable options, as no gender-specific stigma is associated with women's employment in these sectors.¹⁷⁴ Harnessing the potential of the services sector's expansion in urban areas to increase female labor force participation requires, first and foremost, addressing women's physical mobility and personal safety constraints.

Improve the Efficiency and Equity of Spending on Poverty Reduction

Given the existing fiscal constraints, improving efficiency and equity in spending is of paramount importance, particularly when talking about the spending classified as “pro-poor” according to the Government's latest Poverty Reduction Strategy Paper (PRSP-II, 2009).¹⁷⁵ The COVID-19 pandemic has furthered the need improve equity and efficiency of spending. As resources become increasingly scarce due to the economic contraction and needs grows in the population affected by the crisis, spending better at the advantage of the neediest will be a key priority moving forward.

Inefficiencies in the devolution process have muted the pro-poor potential that could have been achieved with better targeting of PRSP spending. With the 18th Amendment, responsibility for hitherto federal functions, including responsibility for education, health, the environment and agriculture, was transferred to the provinces and, together with that, much of the responsibility for the allocation of the PRSP budget. However, the allocation of budget from provinces to districts, and from the center to the provinces, has not be as conducive to better poverty and inclusion outcomes as it could have been, had targeting mechanisms been better designed. More money has not led to significantly improved outcomes. In fact, on the one hand, the reallocation of functions to the provinces was not accompanied by further

¹⁷³ (Oxford Policy Management, 2016).

¹⁷⁴ Contrary to other sectors, ICT sector is not affected by a gender gap in earnings. In fact, evidence seems to indicate that female freelancers in Pakistan earn more than their male counterparts.

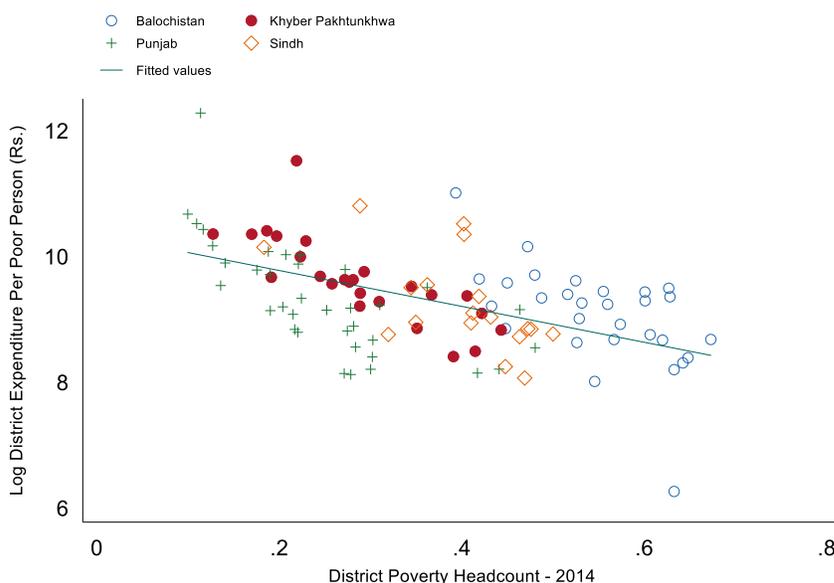
¹⁷⁵ These cover: Market access and community services: (i) roads, highways and buildings; (ii) water supply and sanitation; Human development: (iii) education; (iv) health; (v) population planning; Rural development: (vi) agriculture; (vii) land reclamation; (viii) rural development; (ix) rural electrification (People's Works Programme-II); Safety nets: (x) subsidies; (xi) social security and welfare including BISP; (xii) Food Support Programme including that of Pakistan *Bait-ul-Mal* and Punjab Food Support Scheme; (xiii) Peoples' Works Programme-I; (xiv) natural calamities; (xv) low cost housing; Governance: (xvi) justice administration; and (xvii) law and order.

devolution to strength the planning, financial and managerial responsibilities of local governments,¹⁷⁶ thereby limiting the accountability-enhancing potential of devolution. Moreover, as the allocation of budget resources between districts is decided at the provincial level without any explicit targeting rule, the transfer of responsibility between the federal and provincial levels has not substantially altered underlying clientelistic distortions. As shown in Figure 47, the allocation of development spending does not cater to the needs of poor people living in lagging areas, neither when looking at development spending as whole, nor when considering health, education or WASH spending separately. On the other hand, the allocation of resources from the center to the provinces does not provide incentives to improve social outcomes, or to coordinate interventions at scale toward a common goal. According to the 7th NFC Award (Government of Pakistan, 2009), the allocation of the divisible pool of resources between provinces is mostly based on population distribution (82 percent of the total), followed by poverty (10.3 percent of the total), provincial tax efforts (5 percent of the total), and the remaining based on the inverse of population density (2.7 percent).¹⁷⁷ While the 7th NFC Award represents an improvement over previous allocations, as it increased the resources allocates to smaller (KP) and poorer (Balochistan) provinces, thereby going in the direction of addressing some of the underlying causes of fragility, it still does not provide incentives to close development gaps between provinces, or to achieve specific development targets.

¹⁷⁶ All four provinces have adopted the LGAs with little consultation among provinces or direction from the Federal Government. These Acts tend to subordinate the LGs to the provincial governments, despite Article 140-A, which requires the provinces to establish LG systems and devolve administrative, fiscal, and political authority. The Chief Minister of the various provinces can dismiss the LG or the head of the local council. The Chief Minister also has appointing powers, thus restricting the autonomy of LGs. All in all, provincial governments still retain powers of appointment of LG officials, of controlling the election of local-level officials along party lines, and the powers to determine district boundaries.

¹⁷⁷ This formula implies a share of 51.74 percent to Punjab, 24.55 percent to Sindh, 14.62 percent to KP, and 9.09 percent to Balochistan from the divisible pool.

Figure 47: District-level (log) development expenditure per poor person, by province (PRSP Budget 2016–17)



Source: World Bank staff calculations on PIFRA data and Data4Pakistan

Similarly, a greater efficiency and equity impact could have also been achieved by improving the functional allocation of spending and by better allocating responsibilities between the center and the provinces... Analysis of spending patterns for health and education reveals additional areas in which efficiency gains could be achieved. In education, for example, irrespective of the province, about 90 percent of spending is devoted to recurrent expenditure, with the budget for teachers' salaries eating into the budget for operating, maintaining and rehabilitating school facilities. While in some provinces efforts have been made to improve the attendance and performance of teachers through the use of technology and stronger involvement of parents and communities in monitoring, addressing incentives and the performance of teachers, as well as the quality of teaching practices, remains of paramount importance to improving efficiency in spending on education,¹⁷⁸ even more so than increasing the budget allocation to the sector. Similarly, in the health sector, considerable efficiency gains could be achieved through prioritizing spending on preventive medicine (primary health units) rather than building hospitals (which remain most of the time poorly staffed and equipped), and through better management of drug procurement, which represents about one-third of overall expenditure in the sector. In fact, not only does Pakistan have the one of the largest Essential Drug Lists (EDL) in the region,¹⁷⁹ but inefficiencies also originate from fragmentation in drug procurement (at the district level) and the frequent purchase of originator drugs instead of much cheaper generics.

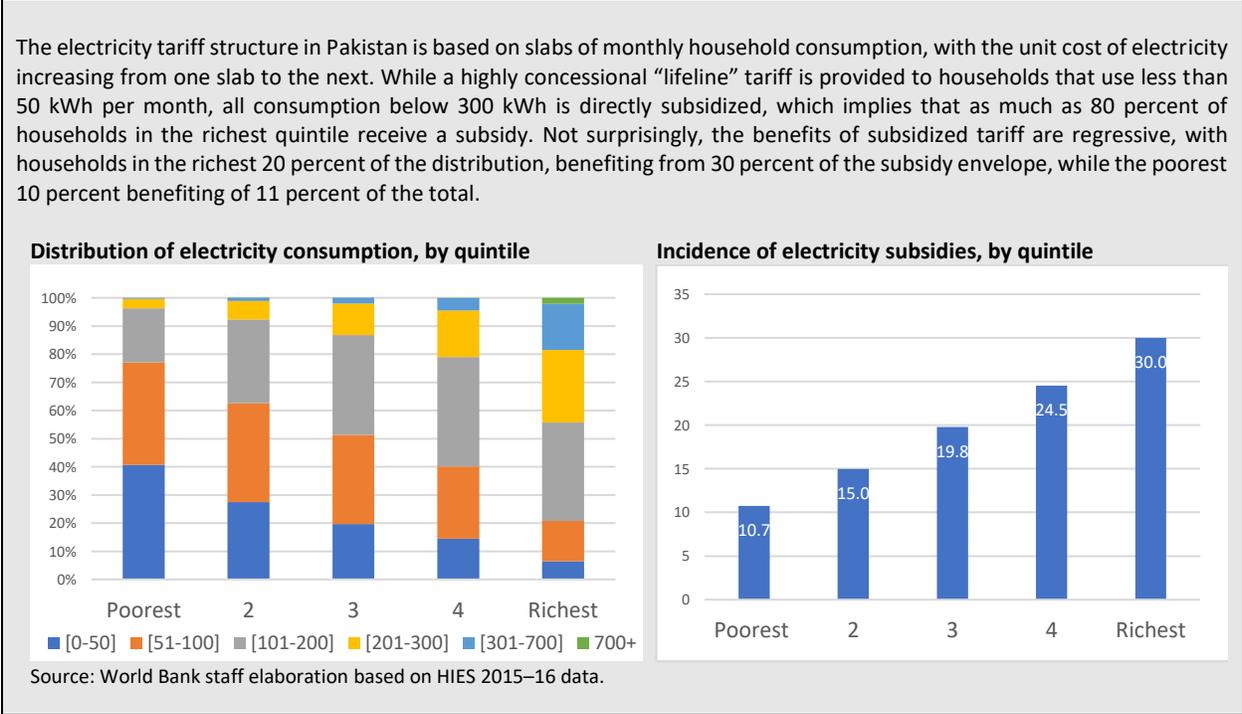
¹⁷⁸ On average public sector teachers are paid 5 times as much as private sector's teachers.

¹⁷⁹ Despite this, Pakistan EDL is poorly enforced and outdated vis-à-vis current morbidity patterns (for example, it does not require non-communicable diseases and mental health medications at primary and secondary level facilities).

...and by improving targeting and transparency of spending on subsidies. Spending on sectoral subsidies (e.g., agriculture inputs, energy, food/commodity operations) is another area of intervention that is ripe for improving the efficiency and equity of spending. In fact, not only is spending on such subsidies typically regressive, but ambiguity in the underlying policies, poor implementation, and a lack of transparency in reporting on actual spending on subsidies in the budget, let alone analysis on benefit incidence, all prevent coalition-building in support of reform, to the advantage of insiders who benefit from the status quo. As demonstrated by the Government interventions in response to the COVID-19 crisis, having a reliable and up to date system to target beneficiaries is key when trying to distribute limited resources. To this end, undergoing efforts to update the National Socio-Economic Registry (NSER)¹⁸⁰ and to expand the use of efficient targeting mechanisms beyond existing safety net programs are a step in the right direction.

Lastly, improving efficiency and equity in spending would require strengthening Pakistan’s data systems. Access to accurate, reliable and timely statistics is vital to support evidence-based policymaking and to strengthen accountability. However, lack of investments, coupled with continuous political interference in the dissemination of key data, has weakened the reputation of the Pakistan Bureau of Statistics (PBS) and prevented the development of a strong culture of evidence-based policymaking. A case in point is the fact that key statistics underlying the update of NFC Award allocations are not made officially available to the public: the 2017 Census has not yet been released amid controversies over provinces’ population changes, nor have provincial poverty estimates.¹⁸¹ Similarly, lack of uniformity in budget classification and fragmentation of sectoral MIS systems across Pakistan’s provinces, together with poor integration of input, output and outcome information, does not support informed political and administrative management of the sectors and allows the perpetuation of the status quo.

Box 23: Benefit incidence of electricity subsidies



¹⁸⁰ See Box 17.

¹⁸¹ The apical position of Chief Statistician at PBS has been vacant since completion of Census operations.

PRIORITIZATION

Based on the evidence presented thus far, this chapter identifies a set of priorities to sustain poverty reduction and boost shared prosperity. The analysis suggests that Pakistan's reform agenda should focus on leveling the playing field by increasing competitiveness and promoting equity and inclusion. In doing so, a cross-cutting theme will be that of strengthening institutions responsible for delivering on such an agenda. The objective of this chapter is to provide a framework to prioritize and sequence the reforms that will be required to move Pakistan onto a more sustainable and inclusive development path.

Top Priorities for Reform

The SCD identifies four priority areas of reform: macroeconomic stabilization, energy sector reform, public governance and water management. Reforms in these four areas are prerequisites for successful implementation of structural reforms and policies in other areas. A stable macroeconomic environment is a prerequisite to support effectiveness of policies aimed at promoting investments and productivity growth. Similarly, energy sector inefficiencies need to be addressed to enable private sector competitiveness, as well as to curb their growing fiscal burden. Weak public governance, compounded by a deficit of accountability and transparency, has contributed to maintaining the status quo. Unless constraints to the public governance environment are addressed, reform efforts might not be effective. Lastly, environmental issues encompassing water management pose grave problems for the sustainability of Pakistan development model going forward. Such reform priorities directly address key structural constraints identified in the SCD and are expected to remain valid and possibly become even more urgent as the country navigates through the consequences of the COVID-19 crisis.

Restoring Macroeconomic Stability

Structural reforms to improve macroeconomic stability should focus on improving fiscal and debt management and empowering the central bank to act independently. In all these areas, key actions should focus on the strengthening of institutions that can then plan and execute policies more effectively. Stronger institutions with clear mandates will reduce the room for use of discretionary powers by any individual/stakeholder and increase co-ordination and commitment from different tiers of government.

Suggested areas of reform include:

- Restructure the Ministry of Finance to establish a Macro-Fiscal Policy Unit to provide sound, evidence-based policy advice and analytics, and to constrain the annual budget with a sustainable medium-term fiscal and budget framework.
- Task the NFC-MC to form a national consensus on fiscal policy decisions that are binding on the federating units. The NFC-MC can also be used to transmit the good PFM practices of the Federal Government (as required by the PFM Act) to the provinces to improve PFM practices, and have public finances and accounts be better aligned.
- Amend the State Bank of Pakistan Act to ensure the full operational independence of the State Bank of Pakistan to conduct monetary policy, with price stability as its primary objective and maintain exchange rate flexibility.

- Implement the PFM Act 2019 by issuing secondary regulations, and the compilation of subsidiary rules, budget manuals, treasury rules, and accounting policies and procedures manuals. These documents should be developed with the aim of making government officials accountable for results and addressing gaps in the existing processes.
- Consolidate all mandates for public debt management into an integrated Debt Management Office (DMO) that is responsible for managing all aspects of domestic and external debt and issuance of guarantees, implementing a medium-term debt-management strategy and publishing semi-annual comprehensive debt reports with detailed data on key debt indicators, subnational debt, guaranteed debt, and collateralized debt (e.g., debt undertaken by provincial governments for commodity operations), as well as fiscal risks.
- Make better use of information system technology including digital payments, e-procurement and enhanced use of National Integrated Financial Management Information System (NIFMIS).
- Strengthen cash management institutions and strengthen cash forecasting. It should also improve coordination between cash- and debt-management arrangements in the Ministry of Finance.

Improving Energy Sector Performance

Reforms in Pakistan’s energy sector should focus on updating and implementing the Ministry of Energy’s (MOE) circular debt reduction plan, reducing the cost of generation and improving transmission and distribution. The circular debt in the energy sector (recorded at 4.2 percent of GDP at end-June 2019) poses a significant fiscal risk to the government. Under the current IMF Program, the government has formulated and will implement a Circular Debt Management Plan (CDMP). These efforts should be supported by other reforms aimed at reducing the high cost of electricity generation, reducing losses in electricity transmission and eliminating unbudgeted subsidies to the sector. The government should also rebalance through private sector investments the future energy mix, so it is less reliant on expensive fossil fuels and more reliant on indigenous, clean and green resources.¹⁸² Recently, the government has committed to reverse the energy mix from the current 70-30 ratio between fossil fuels and domestic low carbon energy (hydro, solar, and wind) to 34-66 by 2030. The proposed actions are also in line with the mitigation options for the energy sector identified in Pakistan’s INDC (which includes an increase in grid efficiency, improvement in coal efficiency and large-scale and distributed grid-connected renewable electricity as high priority actions).

Suggested areas of reform include:

- Reduce the cost of power generation.
 - The Ministry of Energy should conclude negotiations with all the IPPs and Government power producers in a timely and transparent manner following which NEPRA should notify updated tariffs for these plants.
 - Implementation of recently approved RE Policy 2020 to initiate competitive bidding of RE projects.
 - Introduce competition through tariff-based bidding for all future power projects except Government large hydropower on the Indus River.

¹⁸² In Pakistan, fossil fuels used for power production are coal (22 percent), natural gas (27 percent), and oil (8 percent). Numbers in brackets are estimated shares of overall power production in FY20.

- Retire inefficient GENCOs (public generation companies)
- Take steps to transition into an open wholesale market for power generation
- Improve efficiency in distribution.
 - Continue the reduction of theft; increase recovery and collection of historical receivables.
 - The MoE should develop a comprehensive plan for privatization of distribution companies
- Strengthen the regulator.
 - Amend the NEPRA Act to empower the agency for automatic notification of quarterly adjustments.
 - NEPRA should build up capacity to step up its monitoring of IPPs to ensure that PPAs are followed (e.g., that dependable capacity, fuel and O&M costs are correct) and that any capital padding, heat rate and fuel consumption manipulations, are dealt with appropriately.
- Improve coordination and planning functions.
 - Revise the CDMP to reflect the cost changes post COVID-19 and implement measures as identified in the plan to reduce the circular debt flow and stock.
 - Improve targeting of energy subsidies and eliminate unbudgeted subsidies.
 - Approval of the updated Policy Framework that includes an updated Electricity Policy, Hydropower Policy, and Thermal Power Policy.
 - Approval of: (i) least-cost generation; and (ii) transmission plans for 2020–40.
 - Approval of Pakistan Grid Code by NEPRA, including the integration of solar and wind, and modern best practices in economic dispatch.

Strengthen Public Governance

Improving public sector governance in Pakistan entails reforms aimed at strengthening the 18th Amendment institutional framework, improving administrative efficiency, and strengthening transparency and accountability. The 18th Amendment has been an important first step toward addressing underlying fragility in Pakistan’s state architecture. Having agreed on the vision for decentralization, the next step should be to outline clear and mutually agreed upon principles for the division of responsibilities and coordination between federating units. Such a process would also delineate how the allocation of resources aligns with the achievement of common developmental goals. This will require revision of the current NFC Award system and a road map for assigning functional responsibilities for the implementation of decentralization. Moreover, deepening devolution and strengthening local government systems with fiscal decentralization are the best guarantee for ensuring the effective decentralization of decision-making and accountability and, ultimately, for improving service delivery. Strengthening public administration is another important area of reform. Efforts to modernize systems and processes to reduce human interface and improve efficiency are already underway, and they should be complemented by efforts to improve human resource management and planning systems, with a particular focus on performance management.¹⁸³ Lastly, strengthening social accountability would be key to support the transition toward a more inclusive social contract. Information-sharing, transparency and grievance redressal are key aspects of social accountability. With better information, the community and citizens can demand better performance. Transparency in government processes, budget allocation, and actual expenditure allows citizens and the State to make more informed decisions. Along with improved

¹⁸³ (Muhula, 2019).

information-sharing and transparency, the mechanism for grievance redressal must be strengthened, together with legal, economic, and political space for people to raise their demands and grievances.¹⁸⁴

Suggested areas of reform include:

- Strengthen the key devolution organs, for example, the National Finance Commission (NFC) Secretariat, the Council of Common Interests (CCI), and the Council of Ministers, to effectively support devolution.
- Complete Pakistan's decentralization process by establishing elected local government authorities and devolving administrative autonomy, finances and expenditure responsibilities to them to enhance accountability.
- Revise the current NFC formula to better align resource allocation with the achievement of development goals.
- Develop service delivery standards for the federation and provinces, and monitoring adherence.
- Transform Pakistan's human resource management apparatus, including recruitment, in-service training, career progression, remuneration systems, performance management, and accountability.
- Develop Right to Information legislation at the federal level, to complement provincial legislation.

Improve Management of Water Resources

Improving water resources management to maximize economic, social, and environmental outcomes from water use is critical to sustainable development in Pakistan. Currently, Pakistan is failing to make the best use of its water endowment. Pervasive and unproductive water use in agriculture, coupled with poor water supply and sanitation are primary water-related development challenges that are increasingly exacerbated by population growth and climate change. Water resources management in Pakistan is compromised by poor monitoring and planning capacity. Inadequate monitoring and data management prevent robust water resource assessments and accounting to guide water planning and management. Water resources planning has historically focused on supply augmentation and has not addressed sustainable resource use and water quality issues or been linked adequately to broader economic planning. Although provincial water shares have been formally defined, these allocations are rigid and not based on robust decision-making. Fundamental concerns remain regarding the economic efficiency of these allocations and the insufficient clarity on risk-sharing during times of scarcity. These deficiencies are expected to become more acute given the significant growth in demand for a supply that is fixed or even diminishing as a result of pollution and climate change impacts. In order to move the economy to more efficient management of water resources, an integrated approach encompassing multiple sectors, institutions and levels of government, and mediating between competing interests and demands is required. To achieve this transition, it is essential for Pakistan to strengthen water governance across the economy to deliver significantly improved water-based development outcomes, notably in the provision of safe drinking water and reliable and efficient irrigation services.

Suggested areas of reform include:

¹⁸⁴ Ibid.

- Support the evolution of policy, legal, and institutional frameworks for water resources management at the federal and provincial levels in line with the objectives and vision of the National Water Policy
 - Accelerate the work of the National Water Council in providing strategic leadership for cross-jurisdictional basin planning.
 - Clarify and strengthen the linkages between federal and provincial water resources management responsibilities, particularly with respect to the integrated management of the Indus River Basin.
 - Reform the institutional and legal framework for irrigation service delivery and for water resources management at the provincial level to increase accountability to water users and to the public.
 - Improve water data, information, mapping, modeling, and forecasting and all levels; and
 - Ensure broad stakeholder engagement and protect the interests of vulnerable communities and the environment.
- Improve the capacity of federal agencies to implement their mandates and support the provinces
 - Strengthen the capacity of the Water and Power Development Authority (WAPDA) and the Indus River System Authority (IRSA).
 - Strengthen the Federal Flood Commission (FCC), particularly with respect to flood risk mapping, flood forecasting, and emergency preparedness planning;
 - Improve the delivery of hydro-met and climate services.
 - Build capacity of the Pakistan Council of Research in Water Resources (PCRWR) for basin-scale modeling and analysis of surface water–groundwater interactions.
- Ensure sound mechanisms for provincial water planning and intersectoral water allocation
 - Develop policies for water allocation, ensure performance requirements for service delivery, and create incentives for efficient water use.
 - Establish transparent water use permitting systems, including public registers.
 - Ensure adequate budget for the development and maintenance of water infrastructure.
- Promote conjunctive planning and management of surface water and groundwater
 - Establish provincial-level regulatory frameworks for groundwater access and management.
 - Strengthen the capacity of provincial water resources management departments, water user associations, and area water boards (where appropriate) for groundwater management.
 - Develop conjunctive water management plans at the district or canal command area level that focus on building drought and flood resilience.
- Reform, professionalize, and build capacity of water and sewerage service delivery institutions in rural and urban areas
 - Strengthen local governments to deliver integrated water and sanitation services and rationalize overlapping legislations and policies to facilitate coordination within provincial governments and relevant tiers of local governments.
 - Develop and implement a comprehensive water quality monitoring system that ensures compliance with national and provincial drinking water quality standards.
 - Reform district and tehsil level budget allocation processes by introducing index-based targeting to prioritize areas with low access to improved or safely managed water and sanitation, poor health indicators, and a high incidence of poverty.

- Shift towards digital Management Information Systems (MIS) for monitoring of WSS service delivery performance, including tracking of consumer complaints and grievances.

Additional Priorities for Reform

In addition to the four top priorities discussed above, additional areas for reform under each of the two pillars of increasing competitiveness, and promoting equity and inclusion, have been selected based on the following prioritization criteria:

- a. *Disrupt insider/outsider dynamics*: This criterion is directly linked to the overarching constraint of elite capture and power asymmetries.
- b. *Impact on the twin goals*: This criterion will assess each intervention’s potential impact on reducing poverty and increasing shared prosperity.
- c. *Preconditions*: This criterion would assess interventions against their capacity to unlock wider positive change.
- d. *Time horizon for impact*: This criterion would look at the timeframe under which the impact can be realized.
- e. *Complementarity*: This criterion would assess the degree to which proposed interventions would have influence across different domains (growth, inequality and sustainability) and/or would magnify the positive impact of other interventions.

Additional details of reform priorities are provided in Annex 1.

Pillar 1: Increase Competitiveness

| Pillar 1 - Increase Competitiveness | Disrupt insider/outsider dynamics | Impact on twin goals | Preconditions | Time horizon for impact | Complementarity |
|--|-----------------------------------|----------------------|---------------|-------------------------|-----------------|
| <i>Simplify and improve the business regulatory environment</i> | Yes | Indirect | Yes | Medium | No |
| <i>Harmonize tax policy and improve tax administration</i> | Yes | Indirect | Yes | Medium | Yes |
| <i>Support infrastructure development</i> | No | Indirect | Yes | Long | Yes |
| <i>Improve the land management system</i> | Yes | Direct | Yes | Long | Yes |
| <i>Reduce anti-export bias in trade policy and promote green competitiveness</i> | Yes | Indirect | Yes | Medium | No |
| <i>Improve SOE performance</i> | Yes | Indirect | Yes | Medium | No |

Reforms in land management and tax policy and administration are critical to disrupting Pakistan’s insider/outsider dynamics and creating a more enabling environment for businesses. Incomplete and fragmented land records create an impediment for investments and, over time, have created an enabling environment for capture. Improvements in the existing land management system through comprehensive recording and digitization of land records will be vital to both increasing competitiveness and leveling the playing field. Reforms necessary to improving the land management system, while being a precondition to achieve effectiveness in growth- and inclusion-related intervention, will take time to complete and are likely to be met with strong resistance. This was recently demonstrated by the tentative plan to reinstate the *patwari* system in Punjab, where digitization of rural land record had started in the recent past.¹⁸⁵ In

¹⁸⁵ (DAWN, 2020)

order to create an enabling environment for this fundamental reform, greater efforts should be devoted to raising awareness and mobilizing a wider set of stakeholders (civil society, media, etc.) to support and sustain change. Similarly, inefficiencies and distortions in the tax system have led to an inefficient allocation of resources across sectors (e.g., higher investment in real estate vs more productive sectors) and negatively affected tax revenue collection. Having a harmonized GST and income (agriculture and non-agriculture) tax regime, and regularly updated valuation tables, will lower administrative costs, raise revenue (e.g., UIPT for provinces) and increase efficiency. Reforms in this area are also likely to be met by resistance, as they will entail political trade-offs in the short term, while delivering on their competitiveness-enhancing impact in the medium to long term. Such commitment problems could be eased through greater fiscal transparency and support by international actors.

Simplification of the business regulatory environment, reduction of the anti-export bias in trade policy and promotion of greener technologies will facilitate growth in job creation, investment and productivity. The Government has locked in its reform program for the next three years with support from the IMF EFF. The structural-policy part of this program includes reducing the regulatory burden faced by businesses through the streamlining of business procedures, the use of online portals for tax payments and requisitioning of new commercial electricity connections, etc. Recent improvements in Pakistan’s Doing Business rankings also provide a window of opportunity for the Government to build upon the momentum of the reform agenda. In particular, the Government could establish a National Regulatory Agency (NRA) under the CCI to harmonize regulations and procedures across the country so that Pakistan functions as a single regulatory market. Similarly, the adoption of the new national tariff policy by the Cabinet and the State Bank of Pakistan’s transition to a market-determined exchange rate regime will provide opportunities for the Government to implement other policies to strengthen Pakistan’s export sector. These include simplification of refund processes for importers, reform of the export finance scheme to accommodate a diversified set of firms from all sectors, and finalization of free trade agreements with Turkey and Thailand. Reforms in these two areas are low-hanging fruit for the Government and are likely to be met with less political opposition (as opposed to reforms in land and tax management). Moreover, their benefits will begin to materialize more quickly.

Pillar 2: Promote Equity and Inclusion

| Pillar 2 - Promote Equity and Inclusion | Disrupt insider/outsider dynamics | Impact on twin goals | Preconditions | Time horizon for impact | Complementarity |
|--|--|-----------------------------|----------------------|--------------------------------|------------------------|
| <i>Improve productivity and environmental sustainability of the agriculture sector</i> | Yes | Direct | Yes | Medium | Yes |
| <i>Strengthen financial inclusion</i> | Yes | Direct | Yes | Medium | Yes |
| <i>Make cities work for the poor</i> | No | Direct | No | Medium | Yes |
| <i>Support women’s socioeconomic empowerment</i> | Yes | Direct | Yes | Long | Yes |
| <i>Improve efficiency and equity of spending on poverty reduction</i> | Yes | Direct | Yes | Medium | Yes |

Improving the productivity and environmental sustainability of the agriculture sector is essential to achieving sustainable growth and poverty reduction. Analysis in preceding sections has highlighted the centrality of the agriculture sector to Pakistan’s economy through its direct contribution to overall GDP

and employment, and the dependence of the poor on agricultural incomes. Thus, there is an urgent need to reverse the declining productivity trends in the sector. Interventions aimed at liberalizing commodity markets and the withdrawal of distortive interventions by the Government on domestic and international markets will be key in supporting greater diversification toward higher-value crops, a more sustainable use of resources, particularly water, and to free up public resources for investments in public goods (e.g., agriculture innovation systems). Such reforms remain difficult from a political-economy perspective. However, favoring greater transparency on subsidies cost and allocation could support a wider mobilization of stakeholders in support of change.¹⁸⁶

Improving the efficiency and equity of spending on poverty reduction will ensure continued progress on poverty reduction and reverse the declining trend of shared prosperity. Inequality of opportunities and constraints to socioeconomic mobility are not only a source of poverty traps, but they also represent a key driver of fragility. In Pakistan, the pro-poor potential of development spending has been hampered by poor targeting and inefficiency in spending. Addressing such constraints will be a key pre-condition to enabling the returns from any future increase in spending toward social sectors. Once again, better management and information systems and data will be vital to enable reforms in this area and ease associated political economy constraints.

Supporting women’s socioeconomic inclusion will support both sustained growth and greater progress toward the twin goals. Women’s socioeconomic inclusion is possibly the most encompassing challenge in breaking Pakistan’s low development trap. In practice, policies that facilitate women’s socioeconomic inclusion should be mainstreamed across all reform areas identified in the SCD. As shown by international experience, the evolution of cultural norms takes shape along long-time horizons. However, interventions aimed at easing more narrowly defined constraints (physical mobility and safety, financial inclusion, access to education and health services) and at supporting greater productivity of sectors in which women’s participation is already strong or growing (agriculture, ITC, finance, social services) will go a long way in supporting positive change.

¹⁸⁶ Most recently, the PM constituted two inquiry committees to probe into circumstances leading to the wheat/flour shortages and sugar price hike in the country toward the end of 2019. On the directives of the PM, the reports prepared by the two committees were published on the Directorate of Electronic Media and Publications (DEMP, an attached Department of the Ministry of Information and Broadcasting) website for the general public on April 4, 2020. Availability of these reports to the public is a step toward greater transparency and accountability as it can build widespread support for reforms to address issues of governance and policymaking that led to these crises.

DATA AND KNOWLEDGE GAPS

The SCD has drawn from existing studies, as well as undertaken some new analysis, specifically on: (i) drivers of poverty reduction; (ii) productivity and employment dynamics in the informal sector; (iii) productivity dynamics of listed firms; (iv) land management constraints; and (v) constraints to private investments. The SCD has also identified areas that are important for achieving progress towards the twin goals, but where data and knowledge gaps currently limit the ability to provide well-substantiated policy directions. In moving forward, as the World Bank engages on the new Country Partnership Framework, the following knowledge gaps will need to be filled:

1. Socio-economic impact of the COVID-19 pandemic.

The analysis underpinning this SCD pre-dates the COVID-19 pandemic. As briefly discussed throughout the document, the crisis is expected to have significant impact on macro-economic stability, poverty, human capital and inequality, without necessarily changing the diagnostics and the priority policy distortions and reform needs. Given the current high level of uncertainty regarding the scope and duration of such effects, efforts should be devoted to monitor the evolution of the crisis and of its impacts through primary data collection and secondary data sources. Among primary data collection, important insights will become available from ongoing efforts to monitor the welfare impact of the crisis in Pakistan's provincial capitals and from a pulse survey on businesses. Crucial secondary data sources will include the 2020-21 Labor Force Survey (LFS) and a special survey for evaluating the welfare impact of COVID-19 conducted by the Pakistan Bureau of Statistics. In addition, the analysis of recently released 2018-19 round of the Household Income and Expenditure Survey (HIES) will provide an up-to-date baseline to assess the impact of the crisis on key indicators, including poverty.

2. Labor demand and the informal economy:

Information on businesses and, specifically, on the informal economy (comprising of self-employed and businesses with fewer than 10 employees) is constrained by data availability and data quality issues. The last Economic Census was conducted in 2003; the Census of Manufacturing Industries (which only covers business with more than 10 employees) was last conducted in 2015–16, but data have not yet been made available;¹⁸⁷ the last World Bank Enterprise Survey in Pakistan (which covers non-agricultural businesses with more than five employees) was conducted in 2013, but the quality of data is hampered by low response rates, which undermine the credibility of the results.

Given these constraints, the analysis presented in the SCD relied on alternative data sources. On the informal sector, Labor Force and Household Survey data (notably the non-agriculture establishment module) were used to assess the evolution of informal employment and the analysis of trends in productivity of the informal sector between 2001 and 2015. On the formal sector, data on listed firms were used to analyze productivity trends and impact of trade. However, due to data constraints, the analysis could not cover issues related to productivity of small and medium enterprises, nor compare productivity levels and dynamics between different types of firms.

¹⁸⁷ Latest available CMI data date back to 2005.

Limited data on the informal economy adversely affect the quality of GDP estimates. There are currently no comprehensive National Account Statistics (NAS) estimates related to the size of the informal economy. It must be noted that in the manufacturing industries sector, for which specific estimates for small-scale industries are available, the informal sector represented 9.0 percent of the total value-added in 2005/06. However, for the same year, the informal sector represented 63.6 percent of employment in this sector. Even considering large differences in productivity, these numbers suggest the informal sector in the manufacturing industries could be underestimated.

3. Subsidies:

Consolidated information on subsidies is not available and it was therefore impossible, within the SCD timeline, to precisely assess their overall cost to the exchequer.

In particular, there is no consolidated information on all direct and indirect subsidies, tax exemptions and guarantees provided the different tiers of government to SOEs, statutory bodies and standalone programs. Similarly, there is limited information on the impact of such interventions vis-à-vis their stated objectives. Impact and cost benefit analysis has been done on few subsidies/programs (e.g., electricity subsidies, wheat procurement in Punjab, etc.), while no comprehensive assessment has been conducted to assess the efficiency and impact of spending on such subsidies/programs.

4. Service delivery:

Service delivery is another area in which knowledge gaps have emerged during the SCD. In particular, no comprehensive assessment has been conducted on how to best prioritize investments in health and education. In fact, while there is ample evidence on the existence of constraints, ranging from governance, quality and motivation of providers, quality of infrastructures, etc., a more in-depth assessment would have been needed to better understand the relative importance of supply vs demand constraints. To this end, a careful review of the quality of existing EMIS systems would be required. Such analysis will also support better policy advice on how to strengthen data for policymaking.

Quality and availability of private sector providers in health and education is another area in which more and better data would be required for policymaking, particularly to understand how to best support public-private partnerships in service provision and access to more vulnerable segments of the population.

5. Profile urban poverty:

The analysis of urban poverty is affected by a lack of household survey data representative at below-district level and by the outdated administrative classification of urban areas' boundaries.

The lack of representative household survey data on urban areas in each of Pakistan's provinces limits the ability to assess the welfare profile of the urban poor, as well as the existence of pockets of poverty that could very well exist, particularly in informal settlements. Data limitations are particularly striking for large

metro-centers, such as Karachi and Lahore, for which no representative data are available for disaggregated analysis.

Similarly, the analysis of poverty dynamics by urban and rural areas is based on administrative classification of urban/rural boundaries. As such, this analysis may not fully reflect the effective urban status of areas under consideration and may bias estimates of the pace of poverty reduction in urban vs rural areas.

6. Long-term finance:

The development of long-term finance is important for the country to finance its infrastructure needs. However, there is no consolidated information on existing sources of finance that could be leveraged to this end. In particular, no mapping of institutional money is currently available either in the public or in the private sector.

Similarly, no assessment has been conducted regarding the potential role that the National Saving Scheme (NSS) could play to support long-term investments. The NSS is a savings instrument that taps the long-term retail savings market. However, this scheme is at present solely used to finance short-term government spending. An assessment should therefore be conducted to understand how to integrate the NSS into a medium- to long-term debt management strategy, such that these funds are leveraged more efficiently.

ANNEX 1: MATRIX OF SUGGESTED REFORMS

| Pillar 1: Increase Competitiveness | |
|---|---|
| Priority Areas | Detailed Actions |
| Simplify and improve regulatory environment | <ul style="list-style-type: none"> • Establish a National Regulatory Agency (NRA) comprising of the Federal Government and provinces under the Council of Common Interests (CCI) as a permanent body to harmonize laws, regulations, and procedures across the country so that Pakistan functions a single regulatory market. • Establish a National Public-Private Dialogue (PPD) Platform. • Conduct a comprehensive inventory of all federal and provincial business regulations and eliminate redundant regulations and harmonize and simplify remaining regulations. • Establish a single online business registration portal for all federal and provincial requirements under the NRA. |
| Harmonize tax policy and improve tax administration | <ul style="list-style-type: none"> • Establish a permanent National Tax Council (NTC) comprising the Federal Government and provinces. The NTC would be tasked with resolving all inter-governmental taxation issues. The NTC would advise the National Finance Commission Monitoring Committee (NFC-MC) on measures to harmonize, streamline, and resolve all taxation issues. Decisions of the NFC-MC should be binding. • Harmonize the GST by agreeing to common taxation principles, supply and use rules, common definitions and a single positive rate. • Eliminate low yielding minor taxes that impose a significant compliance costs for taxpayers. • Update annually property valuation tables to reflect market values. • Implement a single electronic tax payment system with end-to-end processing without a need for a direct interaction between the taxpayer and collector. Expand e-registration, e-filing and e-payment mechanisms. • Harmonize agricultural income tax rates and thresholds to levels equivalent to non-agriculture income. This potentially could lead to a seven- or tenfold increase in revenues from agricultural income tax and increase tax revenues from non-agricultural income, since there will no longer be any incentive to shift non-agricultural income to agricultural income. • Extend the land-based tax to uncultivated rural land. |
| Improve quality of infrastructure | <ul style="list-style-type: none"> • Improve the public investment management system by improving project appraisal and monitoring systems to ensure the limited fiscal space is spent on the most productive investments. • Increase the private provision in infrastructure through divestment of public infrastructure that can be managed and maintained effectively by the private sector. • Identify risks and develop effective PPP modalities to share risk with the private sector. • Strengthen coordination across different tiers of government on infrastructure planning to support effective management of spatial agglomerations. • Develop city platforms to strengthen coordination across different tiers of government on urban planning, capital investments and service delivery. |

| Pillar 1: Increase Competitiveness | |
|---|--|
| Priority Areas | Detailed Actions |
| | <ul style="list-style-type: none"> • Support logistics investments in distribution centers near cities boundaries that can accommodate multiple modes of transport. • Allow mixed-used land and development of high-rise buildings around main bus stops to promote clustering of economic activity and increase density/reduce urban sprawl. • Develop bankable framework (including concession agreements, risk allocation, standardized legal agreements, etc.) which will allow private sector investments in water, waste management, urban transport. • Review and repurpose investment policies of public institutional investors and bilateral DFIs to meet long term funding needs for infrastructure. • Develop and disseminate standards for urban water service delivery (link service tariff increases to service quality,) establish legal mandate for oversight of urban water service provider(s) performance (and establish an independent regulator for this purpose), increase capacity and performance of wastewater treatment, improve O&M of existing major distribution infrastructure. • Establish provincial standards and targets for rural sanitation services (monitor and report progress toward set targets), investment in public infrastructure for rural wastewater collection and basic treatment and disposal at village level. |
| Develop and efficient market for land | <ul style="list-style-type: none"> • Provinces should finalize digitalization of their land records and integrate their rural records of the BoRs with the urban records maintained by the cantonment boards, housing agencies, housing societies and others into a joint information system, platform and services. • Federal and provincial governments can use the improved access to information on public land and properties, and their custodians, for identifying suitable and available land for development, including for affordable housing schemes. • The Government should incentivize asset-heavy public sector agencies and companies to monetize or render their property assets, where appropriate, for development. • Provinces should complete and update land records in peri-urban and urban areas where they are most out of date and accelerate the regularization of informal settlements. The updating of land records should be accompanied by new (GIS based) cadastral maps covering all land parcels. • Incremental integration of rural and urban records should continue toward the eventual aim of having a single land register and cadastral map of all lands and built properties of Pakistan. |
| Reduce anti-export bias in trade policy and promote green competitiveness | <ul style="list-style-type: none"> • Simplify processes for exporters to receive sales and import-duty refunds. • Reform export finance schemes to allow firms in all sectors to participate, prioritizing diversification (new firms, firms exporting new products, or to new destinations), and gradually align interest rates with market rates. • Implement the National Tariff Policy, with a focus on reductions in tariffs on intermediates and machinery, and a gradual reduction of tariffs on final goods to reduce effective protection. • Strengthen export promotion infrastructure, both in terms of support to firms' capabilities upgrading, and in terms of provision of export intelligence. • Finalize the negotiations of free trade agreements (FTAs) with Turkey and |

| Pillar 1: Increase Competitiveness | |
|---|---|
| Priority Areas | Detailed Actions |
| | <p>Thailand, and seek opportunities to negotiate other agreements to increase market access.</p> <ul style="list-style-type: none"> • Develop a green growth strategy to support private investments in environmentally responsible RECP technologies and practices. |
| Improve SOE performance | <ul style="list-style-type: none"> • Prepare an SOE ownership policy. Consider adopting an SOE law to streamline the regulations governing different sets of SOEs and safeguard the principles for government ownership of SOEs. • Designate a central ownership entity with strong mandate to oversee financial performance of the SOE portfolio (dual model), or the broader performance, including operational aspects (centralized model). • Amend the Corporate Governance Rules to exclude public officials from SOE Boards and senior management positions and make the publication of annual financial statements and external audit reports mandatory for all SOEs. • Issuance of guarantees to SOEs should be contingent upon publication of the previous year’s audited financial accounts and detailed plans to achieve financial stability. • Replace budget financing of SOEs’ operational losses by subsidies tied to the unit costs of public service obligations, which should be specified in annual performance agreements with measurable indicators. Alternatively, allow SOEs to charge user fees that enable cost recovery and compensate low income consumers with social assistance to consumers. • Divest government stakes in selected SOEs. Classify SOEs by relevance of their activities to the SOE ownership policy’s criteria for government ownership and by financial performance. Use the classification to identify which SOEs to keep in the public sector, or privatize, or close. • Prepare partial divestment or privatization transactions for SOEs in commercial sectors, especially where SOEs have dominant positions in the market. |

| Pillar 2: Promote Equity and Inclusion | |
|---|--|
| Priority Areas | Detailed Actions |
| Improve productivity and environmental sustainability of the agriculture sector | <ul style="list-style-type: none"> • Support diversification into higher value crops by: <ul style="list-style-type: none"> - Gradually withdrawing government intervention in domestic market (wheat and sugarcane) while simultaneously liberalizing international trade of agriculture commodities; and - Liberalizing agriculture commodity markets to support value-chain development and the expansion of alternative marketing channels (farmers’ markets, consumer markets, direct marketing and e-marketing). • Leverage digital technologies to support microfinance expansion and to reduce operational expenses and informational asymmetries (support lower interest rates). • Leverage digital technologies to revive agricultural extension and advisory services, with a specific focus on catering to the needs of women in agriculture (crop production, livestock, fisheries) and support climate-resilient agricultural development. • Strengthen water-user and farmer organizations (for improved system operation and <i>abiana</i> collection), while reforming provincial irrigation departments to adopt integrated water-resources management. • Modernize irrigation and drainage infrastructure, with a focus on hydraulic control structures that facilitate responsive water management with real-time data. • Reform irrigation tariffs to reflect realistic O&M costs. • Support development of agriculture insurance. • Expand skills/training cum literacy interventions targeting women in agriculture. |
| Strengthen financial inclusion | <ul style="list-style-type: none"> • Deploy the micro-payment gateway with good governance, modern technical architecture, and fair business rules to accelerate the adoption of digital payments across all retail transactions in the economy – (State Bank of Pakistan). • Allow citizen ID infrastructure to be leveraged by the fintech sector by rationalizing the cost structure and making eligibility criteria fully transparent for current and potential financial market players – NADRA. • Adopt a risk-based regulatory, supervisory and oversight framework for the fintech sector to minimize the regulatory burden and harness innovation across digital financial services – SBP and Securities and Exchange Commission of Pakistan (SECP). • To increase women’s financial inclusion, support the development of female financial agents in banks and elsewhere with whom women customers can comfortably interact. • Improve collection and availability of gender disaggregated statistics. • Promote digital and financial literacy, with a specific focus on youth, women and rural population. |
| Make cities work for the poor | <ul style="list-style-type: none"> • Update administrative boundaries of urban areas across all provinces. • Assess social protection needs of informal sector workers and develop options to expand social insurance. • Promote availability of formal and affordable housing options, including for rental. • Support upgrading and regularization of informal settlements with basic infrastructures (water, sanitation, electricity). |

| Pillar 2: Promote Equity and Inclusion | |
|--|--|
| Priority Areas | Detailed Actions |
| Support women's socioeconomic empowerment | <ul style="list-style-type: none"> • Conduct a comprehensive assessment of supply-side constraints for primary and secondary public-school facilities, with a focus on addressing supply-side constraints for girls' schooling. • Support expansion of government girls' secondary schools in rural areas to facilitate the local supply of female teachers and nurses. • Pilot/evaluate and bring to scale interventions aimed at promoting women's labor force participation, including by promoting changes in social norms (e.g., life-skills, safe spaces, self-help groups, peer networks, mentoring/coaching, access to assets/finance, care services) as well as demand-side issues to ensure employers increasingly recruit women. • Improve comfort, safety, reliability and affordability of public transport and infrastructure for non-motorized trips (e.g., sidewalks and cycle-paths). • Provide public spaces for the development of dedicated co-working spaces for women in ICT (internet connections and mentoring services). |
| Improve efficiency and equity of spending on poverty reduction | <ul style="list-style-type: none"> • Reduce discretion in allocation of budget between districts and introduce allocation formulas based on needs and performance. • Strengthen de facto independence of PBS and invest in modernization of statistical system. • Centralize MIS system development. • Improve PFM systems. • Financial and nonfinancial data reporting should be improved and made accessible to citizens in a user-friendly manner. • Consolidate bulk procurement of drugs. • Strengthening merit-based recruitment and career paths to improve teachers' performance. • Consolidate reporting of subsidies (direct and indirect) at different government levels. • Phase out subsidies for wheat and sugarcane and improve targeting of subsidies to agriculture inputs. • Establish NSER as an independent national social registry, separated from current safety net programs of BISP. • Transitioning NSER into a dynamic social registry. |

ANNEX 2: CONSULTATIONS

The SCD has benefited from countrywide consultations with a broad set of stakeholders. A series of more than five consultations were conducted from July 2018 to January 2020 with entrepreneurs, academics, think-tanks, NGOs, and government. Consultations were undertaken as part of the Pakistan country program to ensure opinions of stakeholders are not just informing the SCD but are also incorporated in the on-going country program including, Pakistan@100: Shaping the Future, the human capital project, Girls Learn and Women Earn, Financial inclusion and digital finance. Below are the key points raised in each context.

CONSULTATIONS WITH ENTREPRENEURS:

There was wide agreement on the diagnostics that were presented on Pakistan's development challenges. Discussion points hovered around the ways to improve the climate for private investment and job creation. Salient points raised were:

- Periodic macroeconomic crises and the resulting stabilization measures dampen private investment and increase risks. It was recommended that the country credibly maintains a market-based exchange rate and ensure the fiscal deficit remains sustainable.
- Importance of the country functioning as a single regulatory and tax market. The current arrangements where the Federal Government and provinces are responsible for business regulations and sales tax are leading to unbearable compliance costs, especially for MSMEs.
- There was also lively discussion around how to enforce the law to reduce perceptions of unfairness among the private sector. In this regard, the majority of private sector participants stressed the need for dedicated commercial and banking courts.
- Concrete steps to make regulations work and enable competitiveness were emphasized.

The Government's heavy borrowing from banks at high interest rates was disincentivizing the banks from lending to the private sector.

CONSULTATIONS WITH ACADEMICS/THINK-TANKS/NGOS:

Some salient points:

- Elite capture underpins many of Pakistan's the development challenges. Participants concluded that it would be better framed in terms of a vicious cycle between weak incentives (coupled with lack of accountability) and low capacity of public sector.
- The short tenure of officials affects morale and the ability of institutions to retain focus on implementation of policies.
- Subsidies in agriculture and the lack of effective water usage were major drags on productivity.
- SOEs were a source of significant bureaucratic capture and net fiscal drain on the economy. It was noted that the country spends more on SOEs' subsidies than it does on health.

CONSULTATION WITH GOVERNMENT:

Some salient points:

- There was agreement with the diagnostic and a stronger elaboration was requested of ways to improve targeting of subsidies. The Government has requested a public subsidy review.

- There was broad agreement that Pakistan needs to double private investment, and that reducing the compliance costs for business regulations and easing the of payment of taxes would both be key.
- The 18th Amendment to the Constitution provides adequate room for the country to function as a single regulatory and tax market. The Council of Common Interests is the appropriate body to resolve any issues. There is need to establish institutions with the technical capacity to support the CCI with analysis for appropriate decision-making.
- Government rules and regulations needed to be updated and digitized.

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