

PAKISTAN DEVELOPMENT UPDATE

Growth: A Shared Responsibility

May 2017



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Preface

The objective of this report is to update the Government of Pakistan, think-tanks and researchers, the general public and the World Bank's senior management on the state of the Pakistan economy, outlook, structural reforms and development challenges. The report begins with a chapter on economic developments, with sections on growth, fiscal policy, the external sector and monetary developments. The second chapter provides an outlook and describes upcoming challenges, including structural reform needs and progress in social indicators. The final chapter identifies several topical issues for detailed analysis, including sections on provincial revenue mobilization, need to impart skills to youth bulge, challenges in agriculture sector in the country and on reducing poverty and enhancing shared prosperity.

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Acronyms and abbreviations

AIT	Agriculture Income Tax	MVT	Motor Vehicle Tax
AJK	Azad Jammu and Kashmir	NDA	Net Domestic Assets
BPM6	Balance of Payments Manual 6	NEPRA	National Electric Power Regulatory Authority
CBN	Cost of Basic Needs	NFA	Net Foreign Assets
CCI	Council of Common Interests	NFIS	National Financial Inclusion Strategy
CD	Circular Debt	NFNE	Non Food Non Energy
CIC	Currency in Circulation	NHA	National Highway Authority
CMI	Census of Manufacturing Index	NPL	Non-Performing Loans
CPEC	China-Pakistan Economic Corridor	NPO	Not Profit Organizations
CPI	Consumer Price Index	OECD	Organization for Economic Co-Operation and Development
CSF	Coalition Support Fund	OMO	Open Market Operations
CVT	Capital Value Tax	OSR	Own Source Revenue
DISCOs	Distribution Companies	PBS	Pakistan Bureau of Statistics
EFF	Extended Fund Facility	PBTE	Punjab Board of Technical Education
EMDE	Emerging-Market and Development Economy	PDU	Pakistan Development Update
EU	European Union	PIB	Pakistan Investment Bond
FATA	Federally Administered Tribal Areas	POL	Petroleum, Oil and Lubricants
FBR	Federal Board of Revenue	PRA	Punjab Revenue Authority
FDI	Foreign Direct Investment	PSDF	Punjab Skills Development Fund
FED	Federal Excise Duty	PSDP	Public Sector Development Program
FPA	Fuel Price Adjustments	PSE	Public Sector Enterprise
FPI	Foreign Portfolio Investment	PSLM	Pakistan Social and Living Standards Measurement
FRDLA	Fiscal Responsibility and Debt Limitation Act	PSX	Pakistan Stock Exchange
FY	Fiscal Year	PTC	Pakistan Tobacco Company
GCC	Gulf Cooperation Council	PTEVTA	The Punjab Technical and Vocational Education Training Authority
GDP	Gross Domestic Product	PVTC	Punjab Vocational Training Council
GENCOs	Generation Companies	REER	Real Effective Exchange Rate
GST	General Sales Tax	RHS	Right-Hand Side
GSTS	General Sales Tax On Services	RM	Reserve Money
H1FY	First Half of the Fiscal Year	ROA	Return On Assets
HIES	Household Integrated Economic Survey	ROE	Return On Equity
IBRD	International Bank for Reconstruction and Development	SBP	State Bank of Pakistan
IDA	International Development Agency	SECP	Securities and Exchange Commission of Pakistan

IFI	International Financial Institution	SME	Small and Medium Enterprises
IMF	International Monetary Fund	SOE	State Owned Enterprise
IO	Input Output	SRO	Statutory Regulatory Order
IRC	Interest Rate Corridor	TCP	Trading Corporation of Pakistan
KIBOR	Karachi Interbank Offer Rate	TFC	Term Finance Certificate
KP	Khyber Pakhtunkhwa	TFP	Total Factor Productivity
KSE	Karachi Stock Exchange	TTB	Trade Testing Board
LFP	Labor Force Participation	TVET	Technical and Vocational Education and Training
LHS	Left-Hand Side	UIPT	Urban Immovable Property Tax
LIBOR	London Interbank Offered Rate	UK	United Kingdom
LNG	Liquefied Natural Gas	US	United States
LSM	Large-Scale Manufacturing	WALR	Weighted Average Lending Rate
M2	Broad Money	WAONR	Weighted Average Overnight Rate
MSCI	Morgan Stanley Capital International	WB	World Bank

Executive summary



Pakistan's economy is performing well, but weakening trade and fiscal balances underline the importance of ongoing reforms

Pakistan's economy continues to grow strongly, emerging as one of the top performers in South Asia. Beneath the surface, however, a number of warning signs are emerging. Revenue growth is slowing, with the fiscal deficit growing for the first time in three years. Exports continue to fall as imports grow, substantially increasing the current account deficit. Investment rates—already low—fell further in FY16 (the latest data available). Finally, the energy sector circular debt has resurfaced. These emerging concerns suggest that renewed policy emphasis is required on macroeconomic stability—to prevent the country from losing the impressive gains achieved over the past four years—and other structural reforms such as those required in the energy sector. While the federal government necessarily carries the majority of this burden, provincial governments also have a part to play. The special sections of this update analyze some of the specific challenges facing Pakistan's most populous province, Punjab, including increasing own-source revenue, equipping youth with employable skills and ensuring the poor share in the benefits of growth. Punjab, along with federal and other provincial governments, is also confronted with the urgent task of lifting agricultural productivity and addressing distortive subsidies, which are impeding growth.

Consumption is driving growth, aided by stronger confidence after the improved macroeconomic conditions

Amid an uncertain global climate, Pakistan's economic growth is expected to accelerate to 5.2 percent in FY17 from 4.7 percent in FY16. Pakistan's growth was again fueled by strong domestic consumption in the first half of FY17. Growing consumer and investor confidence was bolstered by the successful implementation of reforms which were supported by the IMF Extended Fund Facility (EFF) and Bank's development policy credits. On the supply side, a recovery in agriculture is countering a gentle slowdown in industrial activity from 6.8 percent growth in FY16 to an

expected 6.1 percent in FY17. Services, which comprise 59 percent of the economy, are expected to grow at a steady 5.6 percent in FY17. See **Section A1** for an extended discussion of the real sectors of the economy.

The fiscal deficit is growing for the first time in three years

Very soon after the country successfully completed the IMF EFF program, Pakistan has seen a weakening of several of the macroeconomic indicators that improved under the program. The country's fiscal balance is a key example. After falling significantly over the past three years, Pakistan's consolidated ¹ fiscal deficit increased to 2.4 percent of GDP in H1FY17, 0.6 of a percentage point higher than in the same period last year. This was largely due to weakening growth in federal tax revenues and a significant contraction in federal non-tax revenues. Consolidated expenditure increased by 11 percent, albeit largely in growth-enhancing development spending, while total revenue fell by 0.7 percent. This represents a significant reversal of the federal government's consistent fiscal consolidation effort. See **Section A2** for further discussion of fiscal accounts.

The trade deficit is increasing, partially offset by remittances, CPEC and other financial flows

The current account deficit widened in the first nine months of FY17 after exports declined by 1.2 percent and imports increased by 14.2 percent compared with the same period in FY16. The decline in exports, which continues a downward trend that began in FY15, was largely driven by textiles, which comprise 59 percent of total exports. Structural bottlenecks within Pakistan combined with low growth in destination markets resulted in weakened textile exports at both the high and low ends of the value chain. The significant trade deficit was partially offset by remittances. Remittances, which are historically a major source of import financing, are also starting to taper off, declining for the first time in over a decade. This was largely driven by deteriorating economic conditions in GCC countries, which account for almost two-thirds of Pakistan's remittances. Remittances from GCC countries fell by 4.5 percent in Jul-Mar FY17. The overall balance recorded a deficit of US\$1.1 billion during Jul-Mar FY17 compared to a surplus of US\$1.5 billion in the same period in FY16. Consequently, Pakistan's official reserves fell from a high of US\$18.1 billion in June 2016 to US\$16.5 billion by the end of March 2017, equating to only 3.6 months of goods and services. See **Section A3** for further discussion on the balance of payments.

Inflation increased marginally and the financial sector remains stable

Inflation has remained within a tolerable range and the State Bank of Pakistan has kept the policy rate unchanged at 5.75 percent for the first 10 months of FY17. More recently, however, inflation has been picking up momentum and reached 4.8 percent in April 2017 year-on-year. In the financial sector, private sector credit has grown by 8.6 percent during H1FY17, mostly driven by the textiles sector, although loans are evenly distributed across working capital, fixed investment and trade finance. Bank profitability is weakening in a low interest rate environment and as government debt declines, but remains healthy. See **Section A4** for further discussion of monetary policy and the financial sector.

Pakistan will continue to grow if it maintains momentum on structural reform and

The outlook for growth is positive, provided that Pakistan can evade some potential hazards. Growth is expected to continue to accelerate, reaching 5.8 percent in FY19. This acceleration would be driven by public and private consumption, aided by a moderate increase in investment. After a decrease from FY15 to FY16, Pakistan's investment-to-GDP ratio is expected to increase slightly in FY17 due to CPEC-

¹ Refers to federal and provincial governments combined

builds resilience towards external shocks

related infrastructure projects and other public investment. Pakistan's continued growth, however, will rely upon sustained progress on structural reforms— notwithstanding the speed bumps experienced in H1FY17—and further strengthening of the international economy. Despite declining remittances, Pakistan is, on balance, benefitting from low oil prices, thus a sharp increase in international prices would worsen the trade deficit and present fiscal risks in the form of an increase in energy subsidies. See **Sections B1 and B3** for discussion of the outlook and risks respectively.

After making meaningful gains in the past four years, momentum is slowing in the structural reform agenda

Since coming to power in 2013, Pakistan's government has implemented an ambitious economic reform program. As a result, external and internal macroeconomic balances improved markedly and the country made strides in important agendas, such as taxation, the energy sector and the business environment. As the government nears four years in office, there are concerns that progress is stalling. The first half of FY17 suggests deteriorating internal and external balances. Privatization efforts have stalled, which has also affected the broader reform efforts in the electricity sector, with the resurgence of circular debt. FBR performance in tax collection is below target, after several years of very strong performance. Reforms in areas that require collaboration between federal and provincial governments remain challenging. Reform momentum will need to continue to maintain macroeconomic stability and accelerate growth. See **Section B2** for a further discussion on the status of structural reforms.

The provinces also have a role to play in the growth agenda particularly with respect to revenues

The provinces also have a role to play in promoting ongoing economic growth. The four special sections in Chapter C discuss several of the challenges faced by the provinces, using Punjab as an example. Revenues, for example, are one area in which the provinces can make a much greater contribution to the country's reform effort. While Punjab's own-source tax revenues have grown significantly over recent years, they remain only 25 percent of their estimated potential. The World Bank estimates Punjab's revenue potential at Rs. 432 billion, compared with an actual collection in FY16 of Rs. 108 billion. This tax gap is driven by a mixture of tax policy and administration shortcomings. Particular challenges include: jurisdictional overlaps between different levels of government; large tax exemptions; low compliance; weaknesses in tax administration; and weak coordination among provincial administration bodies. The most significant tax gaps are associated with the General Sales Tax on Services and the Urban Immoveable Property Tax, which could vastly increase their collections by eliminating exemptions, increasing the range of services or properties subject to the taxes, and through more accurate data on the services sector and property valuations. See **Section C1** for further discussion of Punjab's tax gap.

Skills development could improve the employability of Pakistan's growing youth population

Skills development and training is another policy area in which provinces play an important role—made particularly urgent by Pakistan's emerging demographic youth bulge. Despite robust growth in Punjab over the past decade, the province's economy has struggled to create enough jobs for its growing youth population. Although the young in Punjab are better educated on average, they are more likely to be unemployed or informally employed than their older counterparts. A key constraint to productive employment is the lack of relevant skills. Conscious of this, the Punjab government is in the process of significantly expanding the Technical and Vocational Education and Training (TVET) ecosystem to deliver training on a large scale. After half a million individuals were trained in FY16, it is expected the government could well meet its target to train two million by 2018. There is limited evidence, however,

that this training is translating to labor market-relevant skills or better employment outcomes. Further policy efforts are therefore required to ensure that training meets minimum quality standards and is relevant to employers' needs. Additional actions may be required—public employment services or wage subsidies, for example—which could be trialed and evaluated to identify the most effective interventions. See **Section C2**.

Pakistan's agriculture sector presents enormous potential for growth through increased productivity

Increasing Pakistan's agricultural productivity is another policy reform area that will facilitate growth and structural transformation. While Vietnam, China and other South Asian countries have increased agricultural yields and shifted labor to more productive sectors over the past decade, Pakistan's agriculture sector has lagged behind. It continues to be a crucially important sector in the economy, accounting for 21 percent of GDP, 44 percent of the labor force and 78 percent of the country's export (directly and indirectly through food, textile, and leather) earnings in FY16. In recent years, however, the sector has underperformed, growing at less than 3 percent in each of the past five years. Limited water availability combined with low user charges and limited water storage creates significant water stress. Agricultural productivity is considerably low; as crop yields per hectare and per cubic meter of water are far lower than international benchmarks. These problems are not always eased by existing agricultural subsidies. Punjab's vast wheat procurement system generates significant distortions, stimulating extra production of a crop that is already overstocked and discouraging diversification. The cost of the program is significant, with direct costs estimated at Rs. 35 billion a year. See **Section C3**.

As well as persisting with structural reforms, it will be important to ensure that the benefits of growth translate into human development outcomes for the poor

While implementing structural reforms to promote growth, it is also important to ensure that the poor are sharing in both the monetary and human development benefits of growth. In Punjab, even after 20 million people escaped poverty between 2001 and 2014 (making Punjab the least poor province in Pakistan), two major concerns remain. First, economic growth in Punjab has not always been pro-poor, which has meant that the province is also Pakistan's most unequal. During the two periods of fastest growth in the past 13 years, the incomes of the poorest 40 percent of the population grew less than the richest 60 percent. Second, significant improvements in living standards have not been matched by comparable gains in human development outcomes. Although Punjab achieved some improvements in educational enrolment and maternal health outcomes, the gap in access between the rich and the poor has increased over time with much of the improvement concentrated among richer families. See **Section C4**.

A. Economic update



1. Real sector

South Asia is now the fastest growing emerging region

Amid a difficult year for the world economy marked by stagnant trade, weak investment and uncertain policy environment, South Asia performed well in 2016. Not only did the region continue to exhibit steady growth of 6.8 percent, but it is now also the fastest growing emerging-market and development economy (EMDE) region in the world.² With India accounting for most of this performance over the past three years, South Asia has been exceeding its long-term growth average of 6 percent (2000-14)³ and enjoying strong domestic demand. The region's limited global economic integration—while likely constraining its long-run growth—has also served to protect it from negative external spillovers in recent years. Regional growth has also been supported by: (i) consistently low commodity prices; (ii) infrastructure investment; (iii) accommodative monetary policy supported by low inflation; (iv) fiscal policies that aim to lower structural deficits; and (v) some progress on structural reforms.

However, vulnerabilities remain

Excluding India, however, the regional growth rate is 5.3 percent with considerable variations across countries.⁴ Despite lower energy import bills reducing pressure on external balances, deficits persist across the region (except for Bangladesh) due to reduced exports and remittances. Furthermore, fiscal consolidation continues to focus on lowering expenditures while revenue mobilization efforts yield minimal results

² Followed by East Asia and Pacific at 6.3 percent, Middle East and Africa at 2.7 percent, and Sub-Saharan Africa at 1.5 percent – World Bank, Global Economic Prospects, January 2017

³ World Bank, Global Economic Prospects, January 2017

⁴ After India, highest GDP growth (on fiscal year basis) was exhibited in 2016 by Bangladesh at 7.1 percent followed by Pakistan at 4.7 percent (factor cost) with Nepal having the lowest rate of 0.6 percent - World Bank, Global Economic Prospects, 2017

(India, Sri Lanka, Pakistan) and public debt levels rise (Maldives, Pakistan, Sri Lanka) in a bid to fund large-scale infrastructure projects.

Pakistan's economy continues to grow as warning signs emerge

Pakistan's economy is among the top performers of South Asia with GDP growth expected to reach 5.2 percent in FY17,⁵ a substantial increase from 4.7 percent in FY16. Despite this strong overall growth, external and fiscal balances have deteriorated in the past nine months. Pakistan has seen a weakening of several of the macroeconomic indicators during the first 9 months of FY17 that improved as a result of the reforms implemented at federal and provincial level during the last three fiscal years. During this period current account deficit has widened due to weak export performance and a marginal decline in remittances. These developments suggest that renewed attention and effort are warranted to protect Pakistan's hard-won macroeconomic stability.

Growth is driven by growing confidence and domestic consumption

Nevertheless, Pakistan's economic growth is expected to accelerate in FY17. In addition to the general conditions favoring economic growth across South Asia, Pakistan enjoyed increasing consumer and investor confidence, in part as a result of the successful conclusion of the IMF EFF program. In late 2016, the country also tapped into international markets by issuing a US\$1 billion 5-year Sukuk bond with a lower interest rate than a similar bond issued two years ago.⁶ The economy was further supported by strong domestic consumption, some recovery in agricultural production and a marginal recovery in foreign direct investment (FDI) flows.⁷ Recent debates in media have underscored flaws in Pakistan's measurement of GDP and needed improvements (see **Box 1**).

Box 1: Updating the Methodology and Source Data for Pakistan's GDP Measurement

There are several concerns with the GDP's measurement methodology and data sources:

- The input/output (I/O) tables used for GDP calculation were last updated about 26 years ago. In addition, the Census of Manufacturing Industries (CMI) is updated infrequently meaning that the Large-Scale Manufacturing (LSM) index is unable to capture the entry of new players in the market. Further, the index is based on poor data collection mechanisms and covers only 15 of 22 sectors, all of which likely results in an underestimation of industrial activity in the economy.
- The GDP in Pakistan is reported at factor cost while the international norm is to report it at market prices, making it hard to make cross-country comparisons. Furthermore, there is a significant disparity between Pakistan's two GDP datasets (factor cost vs. market price) with no uniform historical trends.
- International good practice suggests that national accounts need to be rebased every five to seven years to account for structural changes in the economy. Pakistan's last rebasing occurred in FY06, suggesting a far longer gap than international standards.
- In addition, quarterly or regional GDP is not published in Pakistan; both can be useful for policy making.
- It would be pertinent, therefore, to review comprehensively the institutional framework, the resources and source data used, and the compilation techniques at both current and constant prices. This could inform a strategy to update the measurement methodology, maintain a regular rebasing schedule and strengthen the capacities of national and provincial statistics bureaus.

Private consumption

Pakistan's growth, on the demand side, is historically led by consumption, which comprised an overwhelming 92 percent of GDP in FY16. Consumption in absolute

⁵ Financial year in Pakistan runs from July to June.

⁶ The interest rate on the 5-year Sukuk bond raised in October 2016 was set at 5.5 percent, 75 bps lower than the 6.75 percent paid on the same instrument in late 2014.

⁷ This was mostly due to a one-off flow of US\$469 million from Netherlands in end-2016.

continues to grow despite relatively weak remittance inflows during FY17 to date

terms also increased significantly over the years: there has been a 200 percent nominal increase in average monthly household expenditure in the past 10 years.⁸ In a sign of falling poverty, the composition of expenditure has also changed over this period with households across all quintiles spending 6 percentage points less on food each month and more on items such as transport and communication, rent and utilities, and recreation and entertainment.⁹ More recently, however, remittances—an integral component of Pakistan's household consumption—have fallen by 2.3 percent in the first nine months of FY17 compared with growth of 5.8 percent over the same period in FY16. Government consumption is the second-largest contributor towards demand-side growth, at 11.8 percent of GDP in FY16.¹⁰

Investment and savings rates continue to languish, constrained by long-term structural factors

On the other hand, the economy continues to suffer from low investment and savings rates. Total investment fell by 0.3 of a percentage point in FY16 to 15.2 percent, while national savings increased by only 0.1 of a percentage point over the same period to 14.6 percent of GDP. While these rates are low, even by regional standards,¹¹ multiple structural factors explain this performance. Drivers of Pakistan's low investment rate include an uncertain security situation and the global slowdown affecting FDI. Entry and administrative barriers in various sectors and an overall high cost of doing business have also constrained investment. A relatively detailed assessment of Pakistan's trade competitiveness was undertaken in the PDU in fall 2015 (<https://openknowledge.worldbank.org/bitstream/handle/10986/22926/Pakistan0development0update.pdf?sequence=1&isAllowed=y>). On the savings side, consistently low real interest rates and, more recently, withholding taxes on financial transactions partially explain low savings rates. However, historical reasons include: (i) a lack of financial deepening in the economy;¹² (ii) a high dependency ratio which translates to very high levels of consumption;¹³ and (iii) low labor force participation.¹⁴

Foreign savings are partially plugging the gap

In this scenario, it becomes inevitable for the economy to rely on foreign inflows to fill the investment-savings gap. In particular, inflows from the China-Pakistan Economic Corridor (CPEC) will be crucial to Pakistan. This US\$54 billion¹⁵ initiative

⁸ Average monthly consumption per household increased from Rs. 10,583 in FY06 to Rs. 32,578 in FY16 – Household Integrated Economic Survey.

⁹ Over past ten years, households have increased monthly expenditure on transport and communication by about 1 percentage points, 1 percentage points increase on recreation and entertainment, and while there was no increase for rent and utilities, a new category of expenditure is being captured in FY16 related to household furniture, and equipment receiving 3 percent share – Household Integrated Economic Survey

¹⁰ Net exports had a negative contribution to growth of about 2.2 percentage points in FY16 because of a higher trade deficit.

¹¹ Between 2010 and 2015, South Asian average investment rate was 34 percent (compared with Pakistan's 15 percent) while that of average gross savings was 33 percent (compared to Pakistan's 21.7 percent) – World Bank World Development Indicators

¹² Approximately 100 million adults or half of the population of Pakistan do not have access to formal and regulated financial services including savings, payments, deposits and credit. Only 13 percent of the adult population has a formal account with distance to a financial institution cited as a major deterrent – Global Findex 2014

¹³ In the recent past, Pakistanis have tended to spend a little over 90 percent of their monthly incomes on consumption expenditure with only 3-4 percent of incomes dedicated to deposits and savings – Household Integrated Economic Survey (various years)

¹⁴ The labor force participation rate has hovered at a little over 50 percent in the past decade or so – Pakistan Bureau of Statistics

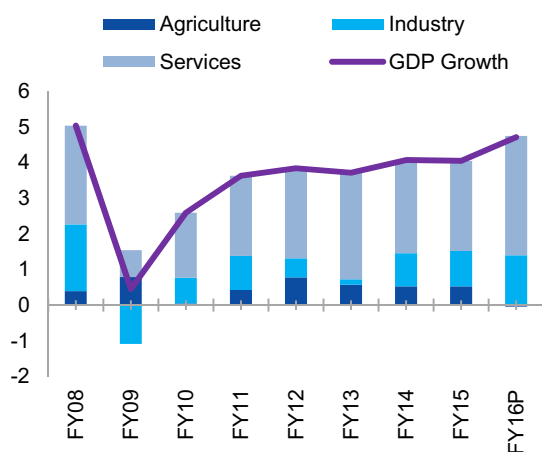
¹⁵ The total amount increased from US\$45 billion to US\$54 billion after the inclusion of some new projects including those pertaining to Pakistan Railways and Karachi Circular Railways Project.

is not only providing much-needed infrastructure funding (in the form of both FDI and loans), but also has the potential to unleash positive externalities over the short to medium term. Among these are: (i) stimulation of domestic industrial activity as construction-related sectors expand; (ii) attraction of foreign capital inflows as transport infrastructure and energy supplies improve; and (iii) better regional access to trade routes.

On the supply side, subdued industrial activity is compensated by recovery in agriculture, with the services sector remaining steady

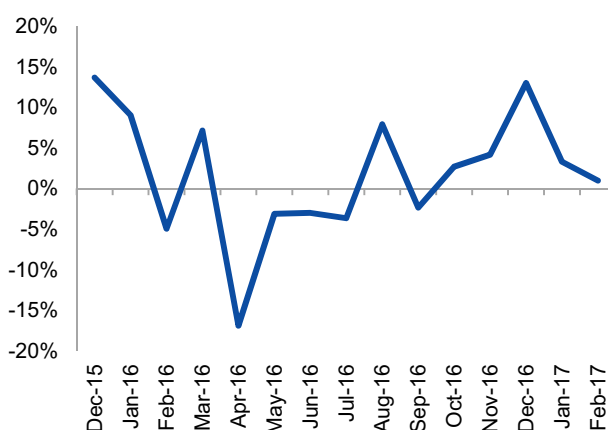
On the supply side, the agricultural sector, comprising one-fifth of GDP, is expected to recover to 3.4 percent growth in FY17 after contracting by 0.2 percent in FY16 (Figure 1). Cotton production suffered a blow in FY16, falling by 30 percent due to abnormal rainfalls, pest attacks in southern Punjab and low cotton prices. As a result, discouraged farmers invested less in cotton in FY17 leading to an immediate 15 percent fall in the sowing area. Instead, plantings switched to water-intensive sugarcane, whose production is expected to increase by 9 percent in FY17. Combined with 1.8 million tonnes of sugar reserves from the start of the year, high support prices and falling global sugar stocks, Pakistan's sugar export prospects look positive. Even so, cotton production is expected to recover by about 6 percent in FY17¹⁶ from the previous year. Wheat farmers are also expected to produce a bumper crop with increasing carryover stocks,¹⁷ and better availability of fertilizer¹⁸ and credit supporting agriculture's expected recovery in FY17.

Figure 1: Sectoral contribution to GDP growth - aggregate supply
Percent



Source: Pakistan Bureau of Statistics

Figure 2: Quantum growth in large-scale manufacturing (m-o-m)
Rs. Billion



Source: Pakistan Bureau of Statistics

¹⁶ Cotton production expected to reach to about 10.5 million tonnes – Pakistan Central Cotton Committee. Though this is way below historical production peaks.

¹⁷ Carryover stocks stand at 5.7 million tonnes in the first half of FY17 compared with 3.4 million tonnes in May 2015 however, persistently large carryover stocks pose policy challenges as a large gap between domestic and international prices (US\$ 130 per tonne in FY16) do not allow room for exports and the stocks themselves are exposed to spoilage, pilferage, and diseases and infestations.

¹⁸ The federal government announced a total fertilizer subsidy costing Rs. 27 billion, to be shared with the provincial government, and combined with reduction in GST on fertilizer, made this input more affordable.

While some segments are doing well, overall industry performance is slowing slightly

Making up a little over one-fifth of GDP, the industry sector is expected to grow less quickly in FY17 at 6.1 percent compared with 6.8 percent in FY16. Large-scale manufacturing (LSM) has grown at 4.1 percent, slightly lower than last year (Figure 2). Some sub-sectors exhibited a drag, including jute goods, cigarettes;¹⁹ jeeps and cars;²⁰ petroleum products, and leather products, which together comprise over 16 percent of LSM. On the other hand, LSM growth was supported by sugar production, pharmaceuticals, construction-related industries, automobiles and fertilizers, which together make up over 30 percent of LSM. These segments performed well on the back of improved energy supplies, demand from ongoing infrastructure projects, and a recent uptick in private sector credit. Cement and steel were particularly strong performers as private firms invested in capacity expansion²¹ to meet robust local demand both from public and private projects. Other positive signs in FY17 include: (i) the introduction of new car models by local and foreign manufacturers; (ii) major acquisitions in various sectors by foreign firms; and (iii) a favorable sugar position from higher production and international prices.

Services—the dominant sector in the economy—continues to grow steadily

The services sector is the largest and most reliant contributor towards supply-side growth with its share in GDP reaching about 59 percent in FY16.²² The sector itself is expected to grow by 5.6 percent in FY17, a similar rate to the 5.7 percent growth in FY16. Growth in the sector remains healthy due to the recovery in agriculture and steady growth in industrial activity, and is supported by the transport sector. Specifically, the largest sub-sector within services, *wholesale and retail trade*, will benefit from a significant increase in sugar production and slight cotton recovery combined with an expected boost in LSM in the second half of FY17. Transport is also expected to grow based on higher sales and imports of commercial vehicles and petroleum products²³ in addition to the additional demand created by CPEC. On the other hand, the communications sector is expected to remain subdued and uncertain banking sector profitability might keep overall growth of *finance and insurance* in check in FY17. Growth in *general government services* is also expected to continue owing to announced increases in government sector employees in the FY17 budget, allowing the overall services sector to maintain its steady growth momentum.

¹⁹ Cigarettes received a blow due to heavy taxes introduced on the segment in the budget of FY17, possibly also allowing further thriving of the informal sector which has reached to about 40 percent of total demand – Pakistan Tobacco Company

²⁰ Mostly due to *Apna Rozgar Scheme* which concluded in February 2016.

²¹ Major cement firms including DG Khan, Attock, Lucky, and Cherat while steel firms including Amreli, Mughal, and International have all announced plans to expand capacity.

²² Economic Survey of Pakistan 2015-16

²³ Imports of petroleum products (quantum) in the first seven months of FY17 increased by over 50 percent compared to same period in FY16 while imports of road motor vehicles (value) increased by over 40 percent over the same period – State Bank of Pakistan and Pakistan Bureau of Statistics.

2. Fiscal accounts

Pakistan's hard-won fiscal consolidation has come under pressure in FY17

Pakistan's fiscal position has improved significantly over the past three years as the consolidated²⁴ fiscal deficit (excluding grants) declined from 8.5 percent of GDP in FY13 to 4.6 percent in FY16. The data for the first half of FY17, however, suggest a slight reversal of this trend. The fiscal deficit for the first half of FY17 stood at 2.4 percent of GDP²⁵ (Table 1), 0.6 of a percentage point higher than the same period last year.

Table 1: Summary of Pakistan's fiscal operations

Rs. billion unless mentioned otherwise

	H1FY15	H1FY16	H1FY17	Percent growth	
				H1FY16	H1FY17
Total Revenue	1,749	2,005	1,991	14.6	-0.7
Tax Revenue	1,361	1,639	1,741	20.4	6.2
Federal	1,266	1,517	1,595	19.8	5.2
Provincial	95	122	146	28.8	19.1
Non-Tax	388	366	249	-5.7	-31.8
Federal	363	335	214	-7.9	-36.0
Provincial	25	31	35	26.8	13.2
Expenditures	2,401	2,520	2,790	5.0	10.7
Current of which:	1,989	2,104	2,242	5.8	6.5
Interest	573	632	647	10.4	2.4
Defense	330	303	336	-8.0	10.9
Development	321	426	497	32.6	16.7
Net Lending	10	-2	-6		
Statistical Discrepancy	81	-9	57		
Fiscal Balance	-652	-515	-799	-21.0	55.1
% of GDP	-2.4	-1.7	-2.4		
Memorandum items:					
GDP (nominal)	27,493	29,598	33,509		

Source: Ministry of Finance

The federal government's spending restraint could not overcome a significant decline in revenue

Total revenues during H1FY17 declined—for the first time in five years—by 0.7 percent on the back of timid growth in federal tax collection and a huge 36 percent contraction in federal non-tax revenues. On the other hand, total expenditure registered growth of 10.7 percent. Encouragingly, the federal government continued to hold recurrent spending under tight rein—federal recurrent spending grew by only 2.6 percent during H1FY17 compared with 3.7 percent in the same period last year. But this was not true for provincial governments—provincial recurrent spending increased by 15 percent compared with the previous year, likely due to an increase in public sector wages. Relatively weak revenue performance, together with healthy overall expenditure growth, resulted in a primary deficit (excluding interest payments) of 0.5 percent of GDP during H1FY17, as opposed to a surplus of 0.4 percent in the same period last year.

²⁴ This analysis refers to the consolidated fiscal accounts of federal and provincial governments.

²⁵ Coinciding with the level of deficit witnessed in H1FY15.

Table 2: FBR tax collection*Rs. billion unless mentioned otherwise*

	Percent growth				
	H1FY15	H1FY16	H1FY17	H1FY16	H1FY17
Direct	459	541	586	17.8	8.4
Indirect	713	844	881	18.4	4.4
Customs	135	179	218	32.6	21.5
Sales tax	514	591	577	15.0	-2.3
Federal excises	64	74	85	15.4	15.8
Total taxes	1,172	1,385	1,467	18.2	5.9

Source: Federal Board of Revenue

Slow growth in FBR revenue has driven poor overall revenue performance

In contrast with recent trends, total revenue of the consolidated government declined in the first half of FY17 due to a weak performance by the Federal Board of Revenue (FBR). FBR revenue grew by 6 percent during H1FY17, just one-third of the increase witnessed in the same period last year (Table 2). The collection amounted to Rs. 1,467 billion, equating to 41 percent of the FY17 revenue target. Recent history suggests that an achievement ratio²⁶ of this magnitude in the first half of the year is likely to result in a significant gap with the year's target. If this holds for FY17, a conservative estimate shows projected growth in FBR revenues for FY17 at around 4 percent.²⁷ FBR collection would need to grow by almost 25 percent in the remaining six months of FY17 to achieve the budgeted target—a daunting challenge for the federal tax machinery. On the other hand, taxes collected by the provincial governments grew by 20 percent during the period under analysis—a strong result, but still shy of the 29 percent growth in FY16.

FBR tax collection accrued primarily from customs duties and direct taxes

During the first six months of the fiscal year, collections from direct and indirect taxes grew by 8.4 percent and 4.4 percent, respectively. Growth in direct taxes during the first half of FY17 is an improvement on the contraction of 3.4 percent in Q1FY17. Nevertheless, this performance is not encouraging in comparison to the same period in FY16. Moreover, within indirect taxes, customs and federal excise duty grew by 22 percent and 16 percent, respectively. Robustness in customs duties can be attributed to an increase in imports (particularly transport, food and machinery),²⁸ and higher tariffs on some items.

The main driver of the FBR's revenue shortfall was a decline in sales tax collection

Sales tax performance showed the most deterioration—a decline by 2.3 percent over H1FY16—and was the main factor in slow growth of FBR tax collection.²⁹ This underperformance can be traced back to relief measures aimed at supporting export sectors and agriculture³⁰ announced in the federal budget FY17. Furthermore, sales tax revenues were affected by plummeting petroleum revenues due to lower prices

²⁶ This is computed through dividing actual collection under FBR revenues in a given period during a fiscal year by the budgeted target for that fiscal year.

²⁷ The targeted growth in FBR revenue stipulated in the Federal Budget 2016-17 is 16.7 percent.

²⁸ Merchandise imports grew by 6 percent in H1-FY17 as opposed to a contraction of 9 percent same period last year.

²⁹ The share of sales tax in FBR taxes stood at 39 percent, down from that of 44 percent in H1FY15.

³⁰ These include zero-rating of export-oriented sectors (textiles, leather, sports goods, surgical goods and carpets); exemption of 7 percent sales tax on pesticides; reduction of sales tax on urea from 17 percent to 5 percent; and doubling of the turnover threshold for cottage industry.

and changes to the tax regime.³¹ The decline in cigarette production following the increase in excise duty also reduced sales tax revenues.

Table 3: Non-tax revenues

Rs. billion unless mentioned otherwise

	Percent growth				
	H1FY15	H1FY16	H1FY17	H1FY16	H1FY17
Profits Post Office Dept./PTA	-	5.3	0.6	---	-89
Mark-up (PSEs and others)	4.1	2.2	8.9	-46	301
Dividends	39.5	31.4	12.2	-21	-61
SBP profits	137.5	122.6	87.8	-11	-28
Defense (incl. CSF)	80.2	78.2	4.6	-2	-94
Passport and other fees	7.2	6.2	7.1	-14	16
Discount ret. on local crude price	5.4	4.2	3.6	-22	-14
Royalties on oil/gas	40.9	31.5	24.4	-23	-23
Windfall levy on crude oil	8.7	1.4	0.5	-84	-64
Others	39.9	51.6	64.4	29	25
Provincial	24.6	31.3	35.4	27	13
Total	388.0	365.9	249.4	-6	-32

Source: Ministry of Finance

Non-tax revenues fell by 32 percent due to falling central bank profits, dividend incomes from SOEs and defense receipts

Non-tax revenues posted Rs. 249 billion, representing a contraction of 32 percent or Rs. 116 billion compared with H1FY16. Reduced SBP profits and Coalition Support Fund (CSF) inflows appeared to be the main reason behind this significant decline (Table 3). The former has been affected by the continued low interest rate environment, while in the case of the latter Pakistan did not receive any CSF disbursement until end-December 2016.³² Dividends from state-owned enterprises (SOEs) have also declined substantially due to reduced corporate profitability of state-owned enterprises, including that of oil and gas SOEs.³³ The revenue collected under the discount retained on crude oil and the windfall levy declined for the fourth consecutive year due to prevailing low domestic petroleum prices. Similarly, royalties on gas and oil declined due to a price effect. Provinces, on the other hand, generated growth of 13 percent in non-tax revenues in H1FY17, though this was lower than in the same period in FY16.

³¹ This performance is attributable to two factors: (i) SRO 490(I)/2016 notifying ad-valorem tax rates w.e.f. July 1, 2016 for this sector from previously a fixed rate regime; and (ii) fall in average domestic petroleum prices during H1FY17 (Rs. 64.6 per liter) compared to same period last year (Rs. 75.8 per liter).

³² However, during February-March 2017 Pakistan has received US\$550 million under CSF.

³³ Due to the government's decision to keep domestic petroleum prices unchanged for most of the first half of the year despite a surge in international crude oil prices.

Table 4: Analysis of consolidated spending*Rs. billion unless mentioned otherwise*

Percent growth					
	H1FY15	H1FY16	H1FY17	H1FY16	H1FY17
Total expenditures	2,401	2,520	2,790	5.0	10.7
Current	1,989	2,104	2,242	5.8	6.5
Federal	1,386	1,437	1,474	3.7	2.6
Interest payments	573	632	647	10.4	2.4
Domestic	524	578	588	10.2	1.7
External	48	55	60	13.3	9.3
Pensions	73	108	131	48.6	21
Grants	156	160	141	2.6	-11.6
Defense	330	303	336	-8.0	10.9
Public order and safety	44	47	51	7.3	9.5
Health & education	33	37	41	12.4	13.3
Others	178	149	124	-16.3	-16.6
Provincial	603	668	768	10.7	15.0
Development	321	426	497	32.6	16.7
PSDP	269	378	446	40.3	17.9
Federal	126	156	198	24.2	27.2
Provincial	144	222	247	54.4	11.4
Other dev. expenditures	52	48	52	-7.2	7.1
Net lending	10	-2	-6	-	-
Statistical discrepancy	81	-9	57	-	-

Source: Ministry of Finance

Consolidated government expenditure growth was contained by low growth in federal recurrent spending

Total expenditure of the consolidated government (excluding statistical discrepancy³⁴) during H1FY17 grew by 8.1 percent, lower than the 9.0 percent growth witnessed in the same period last year (**Table 4**).³⁵ The federal government increased its recurrent expenditure by less than 4 percent for the third consecutive year. Interest payments and pensions grew modestly during H1FY17 compared with the same period last year, whereas federal grants to SOEs declined by almost Rs. 20 billion.³⁶ On the other hand, defense spending and public order and safety expenditures increased significantly, as a result of augmented security-related spending.

Development spending continues to grow, particularly at the federal level

Both federal and provincial governments continue to increase development expenditure and, if this spending is executed well, it could provide much-needed stimulus to the economy. The federal government continued to direct significant resources towards Public Sector Development Program (PSDP)-related development spending. Federal PSDP grew by 27 percent during H1FY17, consistent with last year's trend. In contrast with the federal government, provincial governments increased PSDP spending by a moderate 11 percent. This behavior

³⁴ Statistical discrepancy for H1FY17 has been recorded at positive Rs. 57 billion (compared to a negative Rs. 9 billion in H1FY16) and has, therefore, increased the size of total expenditure.

³⁵ Nonetheless, total expenditure of the consolidated government including the statistical discrepancy during H1FY17 grew by 10.7 percent – more than double the 5.0 percent growth registered during the same period last year.

³⁶ As of April 19, power sector circular debt reached Rs. 329 billion or 1.0 percent of GDP. The government, in the short run, is contemplating imposing a special levy on electricity bills to adjust some of these receivables. However, in the event that most of this debt is ultimately absorbed into the budget, the expected fiscal deficit for FY17 may rise by 0.5 to 0.75 percent of GDP, also leading to a similar increase in the level of public debt.

may be the logical effect of almost flat growth in federal transfers to the provinces in H1FY17³⁷ compared with H1FY16. Among the provinces, Punjab's spending was similar to that of H1FY16, Sindh and KP spent almost 50 percent more while Balochistan underspent by almost half.

The provincial governments have generated a surplus of just 0.1 percent of GDP

The federal government's fiscal deficit of 2.5 percent of GDP was only marginally covered by the provincial governments, who registered a combined surplus of only 0.1 percent of GDP for the first half of the year. Given this trend, the budgeted assumption of a provincial surplus of Rs. 339 billion, or 1.0 percent of GDP at the end of FY17, is unrealistic, particularly given the tendency of provincial spending to increase during the third and fourth quarters of the fiscal year.

Public debt is declining in FY17

Public debt declined in the first half of FY17, and is expected to continue declining throughout the fiscal year and beyond if fiscal consolidation efforts continue. As of end-December 2016, total public debt stood at 62.8 percent of GDP,³⁸ 0.6 of a percentage point lower than the December 2015 stock of 63.4 percent (**Figure 3**). In line with historic trends, domestic debt dominated the stock. In a positive development, the government drew down the deposits held with the banking sector (including SBP)³⁹ to repay the maturities due during Q2FY17. On the other hand, foreign currency public debt to GDP ratio decreased by 0.4 of a percentage point during this period due to exchange rate stability, translational gains⁴⁰ and higher than expected nominal GDP compared with that in H1FY16. Nonetheless, government borrowed substantially from commercial banks⁴¹ during H1FY17. In October 2016, Pakistan successfully issued an international Sukuk bond of US\$1.0 billion⁴² with a maturity of five years. The profit rate was 5.5 percent—the lowest ever in Pakistan's history and 125 bps lower than that on the same-maturity Sukuk bond issued in November 2014.

³⁷ These transfers constitute 80-85 percent of total provincial revenues, thus any shortfall in federal tax collection directly impacts the spending levels by provinces.

³⁸ Total public debt remains above the 60 percent threshold stipulated in the Fiscal Responsibility & Debt Limitation Act 2005.

³⁹ Government deposits contracted by Rs. 374 billion during Q2FY17, as opposed to an accumulation of Rs. 407 billion during Q1FY17.

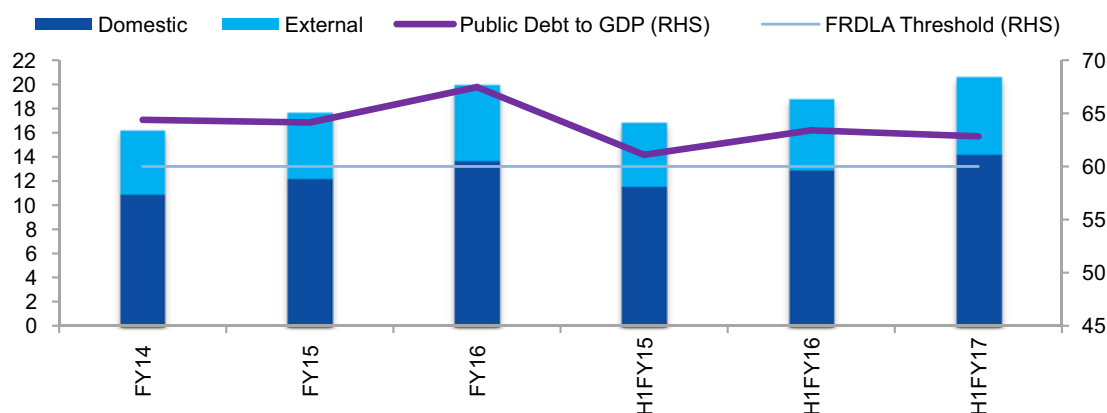
⁴⁰ Translational gain/loss implies the appreciation/depreciation of US dollar against major currencies. In Pakistan, external loans are contracted in various currencies but disbursements are effectively converted into PKR. As PKR is not an internationally traded currency, other currencies are bought and sold via selling and buying of USD. Hence, the currency exposure of foreign debt originates from two sources: USD/other foreign currencies and PKR/USD. The former exchange rate risk is called translational gain/loss.

⁴¹ Among these, the most notable is a US\$700 million one-time disbursed commercial loan by China Development Bank. This is a medium-term loan for BoP support under CPEC with a maturity of 3 years and an interest rate of 3 months LIBOR plus a fixed rate spread of 3.28 percent.

⁴² Against the initial expectations of raising US\$500 million.

Figure 3: Trends in public debt

External and domestic debt measured in Rs. trillion (LHS), while public debt to GDP is measured in percent (RHS)



Source: State Bank of Pakistan and WB staff calculations

3. Balance of payments

The overall external position deteriorated slightly in Jul-Mar FY17 despite significant widening of the current account deficit

The current account deficit widened significantly during Jul-Mar FY17 (**Table 5**). A continuing decline in exports, lower coalition support fund (CSF) receipts, rising imports and a contraction in workers' remittance inflows were the key drivers of this increase in the current account deficit. However, financial inflows from steady foreign direct investment (FDI) and loan receipts from commercial borrowing and international financial institutions (IFIs) partially eased this growing external pressure. This resulted in an overall deficit of US\$1.6 billion for Jul-Mar FY17 compared to a surplus of US\$1.1 billion in same period last year. Consequently, Pakistan's official reserves receded from a high of US\$18.1 billion at end June 2016 to US\$16.5 billion by end March 2017, which equate to 3.6 months of imports of goods and services. Pakistan's nominal exchange rate and credit ratings remained stable during Jul-Mar FY17.

Table 5: Balance of payments summary*US\$ billion unless mentioned otherwise*

	Jul-Mar FY16	Jul-Mar FY17
i. Current Account (A+B+C+D)	-2.4	-6.1
A. Trade balance	-13.4	-17.8
Export	16.3	16.1
Import	29.7	33.9
B. Services net	-2.0	-2.0
of which: CSF	0.7	0.6
C. Balance on Primary Income¹	-3.9	-3.2
D. Balance on Secondary Income²	16.9	16.8
of which Remittances	14.4	14.1
ii. Capital A/c	0.2	0.3
1. Balance from Current & Capital Accounts (i+ii)³	-2.1	-5.9
2. Financial A/c⁴	-3.4	-4.8
of which:		
Direct investment	-1.4	-1.5
Portfolio investment	0.4	-0.7
Net Acquisition of Financial Assets	-0.3	0.3
Net Incurrence of Financial Liabilities	2.1	2.9
3. Errors and omissions	-0.1	-0.6
Overall balance (-1+2-3)	-1.1	1.6
SBP reserves (excl. CRR, SCRR)	16.1	16.5
Memorandum Items		
Current A/c Balance (percent of GDP)	-0.8	-2.0
Trade Account (percent of GDP)	-4.7	-5.7
Export growth percent	-9.4	-1.4
Import growth percent	-4.9	14.2
Remittance growth percent	5.8	-2.3
Financial A/c (percent of GDP)	1.2	1.5

1: As per Balance of Payments Manual 6 (BPM6). 2: In BPM6 Income Account has been renamed as Primary Income and Current Transfers as Secondary Income. 3: Negative balance highlights that economy is net borrower from the rest of the World.

4: Negative balance highlights a net increase in incurrence of foreign liabilities.

Source: State Bank of Pakistan

The current account deficit widened largely due to a growing trade deficit

Pakistan's current and capital account recorded a combined deficit of US\$5.9 billion during Jul-Mar FY17—an increase of 161.0 percent y-o-y. The deterioration in the current account was primarily driven by the trade deficit, as exports continued to decline and imports picked up drastically during the first nine months of FY17. The current account also suffered from a decrease in CSF flows in Jul-Mar FY17, and a fall in remittances as low international oil prices continued to affect public spending in Gulf Cooperation Council (GCC) economies, which account for two-thirds of Pakistan's remittance inflows.

Exports continued to decline, led by falls in the textile sector

After contracting for 10 consecutive quarters between Q4-FY14 and Q1-FY17, exports experienced moderate q-o-q growth of 0.9 percent and 0.8 percent in the second and third quarters of FY17. But this growth was not enough to overcome the fall in the first quarter; overall, exports suffered a contraction of 1.4 percent (y-o-y) in Jul-Mar FY17. This decline is broad-based, particularly focused in the textile and food sectors. Textile exports, with a 59 percent share in total exports in Jul-Mar FY17, fell by 2.7 percent. This decline was observed in both the high and low ends of textile value chain except for bed wear, tents

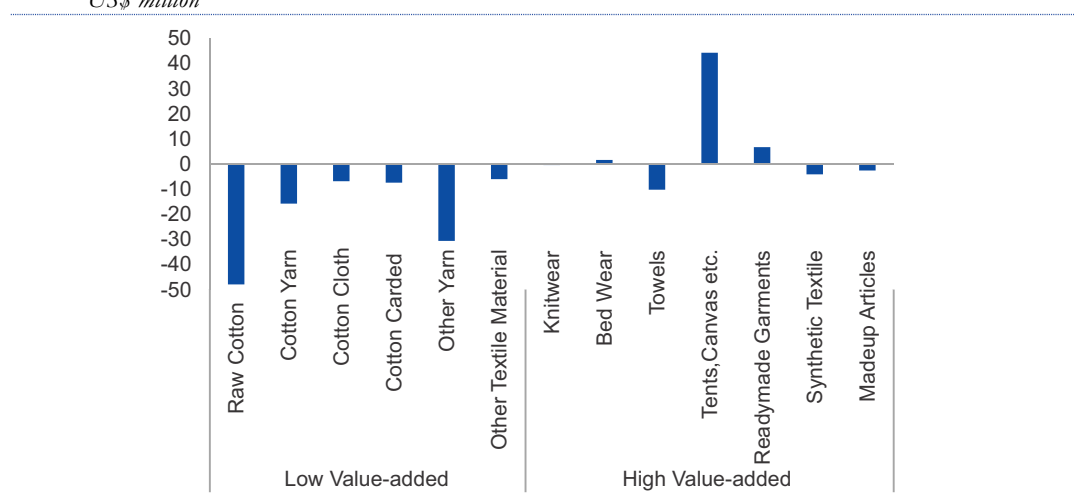
& canvas, and readymade garments, which benefited from both higher international prices and a higher quantum exported during Jul-Mar FY17 (**Figure 4**). However, the overall decline in textile exports reflects the weak economic situation in destination markets, as well as persistent structural bottlenecks in the domestic economy.

Imports increased as Pakistan imported larger quantities of oil and capital goods

After experiencing a contraction in FY16, imports recorded growth of 14.2 percent in Jul-Mar FY17. The major import groups, including food, transport, and petroleum, experienced positive growth with petroleum products and imports of power generation machinery growing at 22.0 percent and 11.7 percent, respectively. Growth in machinery group imports reflected the impact of CPEC-related machinery imports. A gradual buildup of domestic economic activity has also kept petroleum imports high despite a significant fall in the unit price of imported petroleum products.

Figure 4: Textile export performance Jul – Mar FY17 H1FY17

US\$ million

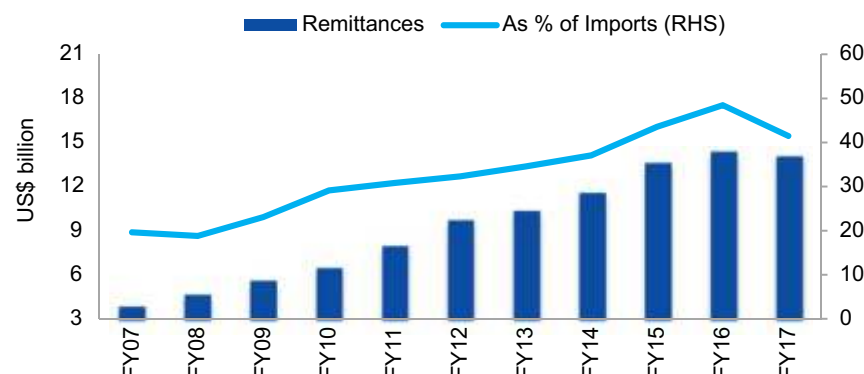


Source: State Bank of Pakistan

Remittances, which represent a major source of import financing, have started to taper off

The balance on the secondary income account decreased slightly to US\$16.8 billion during Jul-Mar FY17, from US\$16.9 billion in Jul-Mar FY17. The slight decline in the secondary income balance was brought about by a fall in remittances, which contracted by 2.3 percent in Jul-Mar FY17. It was the first occasion since FY04 that remittances have contracted (y-o-y) for three consecutive quarters. Despite this decline, these flows continue to play a major role in curtailing the current account deficit by financing about 41.5 percent of the import bill in Jul-Mar FY17 (**Figure 5**). Remittances from the GCC countries, which accounted for 63 percent of remittances during Jul-Mar FY17, have started to contract due to the decline in public investments in these economies as oil prices remain depressed. Remittance flows from the GCC countries decreased by 4.5 percent in Jul-Mar FY17 compared with an increase of 8.0 percent in Jul-Mar FY16. Remittance flows from the UK and the US—which are also significant—also experienced a slowdown during Jul-Mar FY17, falling by 8.5 percent and 7.0 percent, respectively.

Figure 5: Worker's remittances during Jul-Mar
US\$ billion

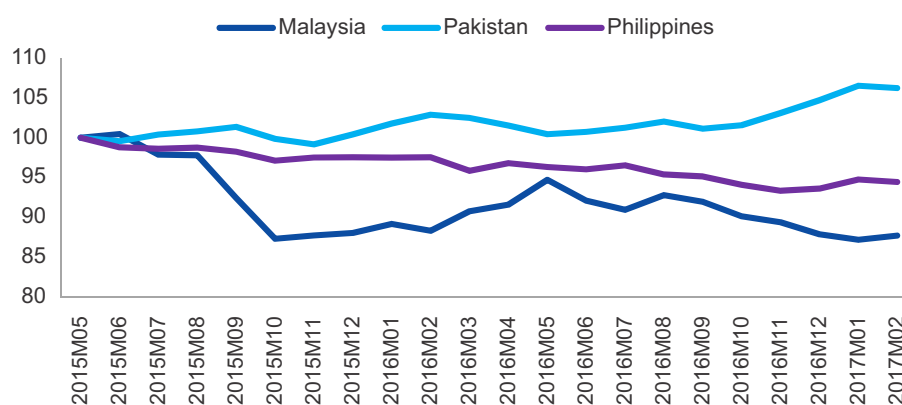


Source: State Bank of Pakistan

The financial account posted a surplus but foreign investment remains subdued

The financial account posted a surplus of US\$4.8 billion in Jul-Mar FY17. FDI, which has been slowly recovering from very low levels over the past few years, was recorded at US\$1.5 billion—US\$0.1 billion higher than the same period last year. However, almost 35 percent of the FDI flows in Jul-Mar FY17 were the result of a one-time privatization proceed of Engro Foods Pakistan. Portfolio investment during Jul-Mar FY17 was recorded at US\$0.7 billion compared with an outflow of US\$0.4 billion in the same period last year. This was, however, largely attributable to a US\$1.0 billion Sukuk launch in October 2016. General government flows were recorded at US\$1.0 billion during Jul-Mar FY17, a decline of US\$0.9 billion compared with the same period last year, as disbursements from IFIs slowed down and amortization of these loans picked up slightly. However, the pickup in disbursements of commercial official and private sector loans helped ease the position of the financial account.

Figure 6: Real effective exchange rate



Source: International Financial Statistics

Despite a decline in international reserves, foreign exchange market remained stable.

After reaching US\$16.1 billion at end-March 2016, official reserves climbed to a peak of US\$18.6 billion at end September 2016 before receding to US\$16.5 billion by end-March 2017, a decrease of US\$1.9 billion. Despite this decline in reserves, the Pakistani rupee remained largely stable against the US dollar. Successful completion of the IMF's EFF program has improved sentiment in the foreign exchange market. With a relatively stable nominal exchange rate with respect to a strong US dollar and inflation that is stable in comparison to peer countries, Pakistan's real effective exchange rate (REER) has appreciated by 6.2 percent (**Figure 6**) in recent times and may have contributed to declining competitiveness for exporters.

4. Monetary policy, financial sector and inflation update

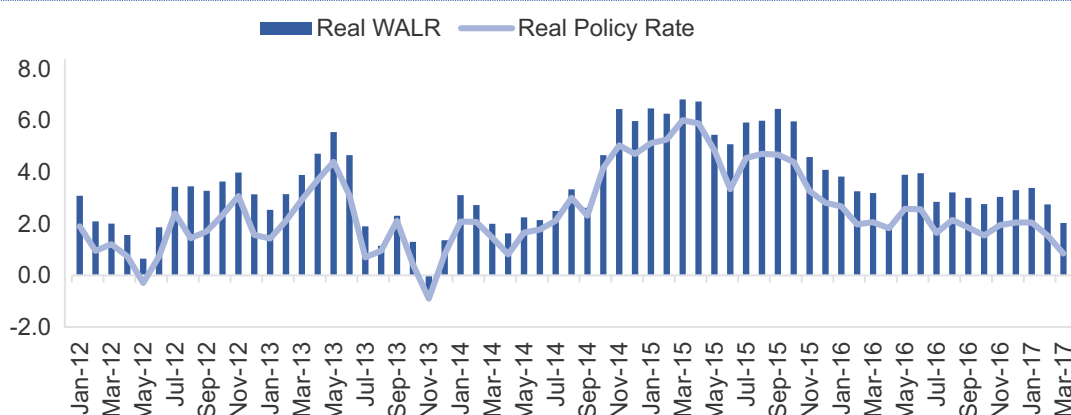
a. Monetary policy

SBP adopted a neutral policy stance during Jul-Mar FY17

Following a 75 bps cut in the policy rate in FY16, SBP kept the rate unchanged at 5.75 throughout the first three quarters of FY17. This approach was adopted in response to some increase in inflation and pressure in the current account. As a result, the real weighted average lending rate also began to decline in recent months (**Figure 7**).

Figure 7: Real policy and weighted average lending rates

Percent



Note: Real rates calculated using YoY inflation
Source: State Bank of Pakistan

Money supply (M2) growth picked up slight during Jul-Mar FY17

Broad money (M2) expanded (Y-o-Y) by 13.6 percent by end-March 2017, compared to 13.5 percent in the same period last year (**Table 6**). This marginal improvement in M2 came along due to increase (Y-o-Y) in Net Domestic Assets (NDA) of the banking system despite a significant decline of Net Foreign Assets (NFA) in this period. Higher government borrowing from State Bank of Pakistan (SBP) and better private sector credit in Jul-Mar FY17 contributed to this rise in NDA during this period. The currency deposit ratio deteriorated for a second consecutive year during Jul-Mar FY17 albeit at a much lower pace.

Table 6: Monetary aggregates

Rs. billion unless mention otherwise

	Stock		Flow (July to end March)	
	End-Mar-16	End-Mar-17	FY16	FY17
Net Foreign Assets	897	723	84	(285)
of which: SBP	864	878	141	(155)
Net Domestic Assets	11,063	12,858	594	1,041
Government borrowing:	7,394	8,388	436	569
Budgetary borrowing	6,940	7,899	537	704
from SBP	1,394	2,244	(535)	802
from scheduled banks	5,546	5,655	1,071	(98)
Commodity operations	464	499	(100)	(138)
Non-govt. sector borrowing:	4,792	5,652	336	639
Private sector	4,327	4,888	323	439
Public sector enterprises	446	741	12	197
Other items	(1,123)	(1,182)	(178)	(167)
Broad Money (M2)	11,960	13,581	678	756
Reserve Money (RM)	3,576	4,288	434	314
Memorandum item				
Currency in circulation	3,013	3,485	458	151
Demand and time deposits	8,931	10,077	218	605
CIC/Deposit ratio	0.34	0.35	-	-
Growth (YoY)				
M2	13.5	13.6	-	-
RM	19.2	19.9	-	-
Currency in circulation	24.9	15.7	-	-
Demand and time deposits	10.1	12.8	-	-

Note: Rounded off to the nearest value

Source: State Bank of Pakistan

Net domestic assets grew by 16.2 percent in Jul-Mar FY17 compared with 12.8 percent in Jul-Mar FY17

The higher government borrowing during Jul-Mar FY17 from SBP along with higher growth in private sector credit was primarily responsible for this expansion in NDA. During Jul-Mar FY17, the government borrowed Rs. 802 billion from SBP compared with a retirement of Rs. 535 billion in Jul-Mar FY16. Higher government borrowing from SBP was marginally offset by Rs. 98 billion net retirement from scheduled bank borrowing during this period. The main reason behind government resorting to borrowing from SBP was to meet its additional budgetary requirements and repay a large volume of maturing Pakistan Investment Bonds (PIBs) in the first quarter of FY17.

Private sector demand for credit is picking up on the back of a growing economy and the low cost of borrowing

As a result of net retirement of government borrowing to scheduled banks and low real interest rates, the private-sector credit in the first 9 months of FY17 has grown at a faster pace than a year ago. It expanded by Rs. 562.0 billion, mostly comprised of loans to the private sector (Rs. 429.2 billion). The improvement in credit off-take was fairly broad-based, as it was spread over a number of sectors including manufacturing, ship breaking, trade and commerce, real state, and other businesses (Table 7).

Table 7: Credit to the private sector

Rs. billion unless mention otherwise

	Flows (July-March)		
	Stock	Flow	
	-End-June FY16	End- March FY16	End-March FY17
Total credit to the private sector (A+B+C)	4450.0	331.0	562.0
A. Investment in securities and shares	248.6	6.1	19.2
B. Loans to the private sector (1+2+3)	3793.2	257.6	429.2
1. Personal: of which	415.3	18.2	63.4
Consumer financing	300.9	19.6	63.9
2. Trust Funds & NPOs and others	22.4	-9.7	-2.6
3. Loans to private sector businesses (a.+h)	3355.5	249.0	368.4
By sectors:			
a. Agriculture	293.1	-1.4	0.1
b. Manufacturing	1915.3	206.4	259.7
Textile	612.3	82.5	87.0
Wearing apparel, readymade garments	59.3	3.9	14.0
Food products and beverages	476.4	68.7	112.4
Chemicals	270.4	33.1	3.2
Non-metallic mineral products	69.2	-2.3	10.3
Leather	23.7	-2.3	-1.1
Others	403.9	23.0	33.9
c. Electricity, gas and water	312.8	39.8	38.3
d. Ship breaking	25.9	-5.0	0.8
e. Construction	97.5	26.7	22.4
f. Commerce and trade	266.3	11.3	19.3
g. Transport, storage and communication	182.2	20.9	-0.6
h. Real estate	114.1	7.1	7.6
i. Other businesses	148.3	-56.8	20.8
C. Others¹	408.1	67.3	113.6
Of which NBFC	128.9	-0.3	6.2

¹ This also includes credit to public sector enterprises and others

Note: Rounded off to the nearest value

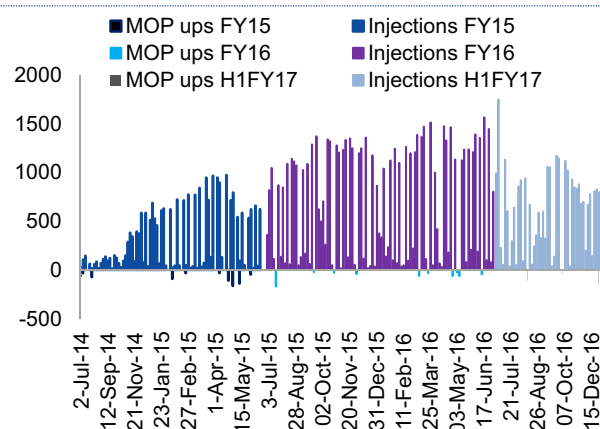
Source: State Bank of Pakistan

SBP was active in open market operations to manage liquidity

Liquidity management via open market operations (OMOs) kept the market sufficiently liquid and supported the banks to fulfill increased private sector credit demand. In response to liquidity swings—stemming from maturing PIBs, Eid-related cash withdrawals and increased liquidity demand from the private sector—SBP continued to actively manage liquidity conditions in the interbank market through OMOs (**Figure 8**). This is visible in the overnight repo rate, which remained largely within the interest rate corridor and close to the policy rate (**Figure 9**).

Figure 8: Liquidity injections through OMOs

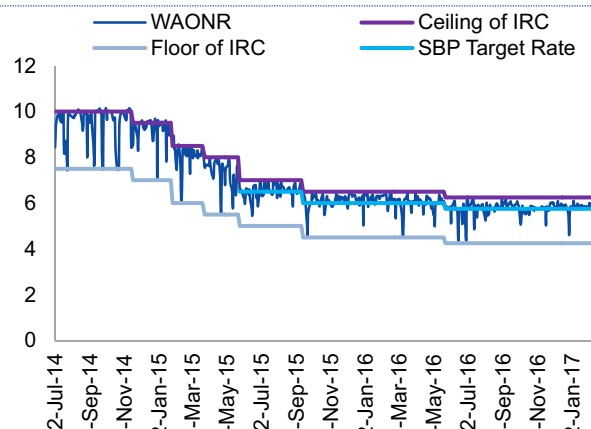
Rs. billion



Source: State Bank of Pakistan

Figure 9: IRC and WA overnight repo rate

Percent



Source: State Bank of Pakistan

b. Inflation

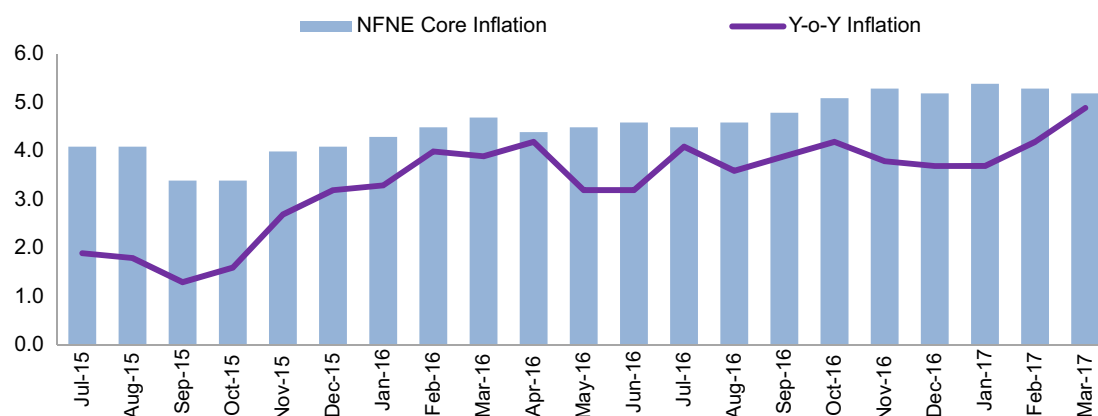
Inflation increased throughout the first half of FY17, but remains within a tolerable range

Year-on-year inflation rose at the start of FY17 to reach 4.9 percent in March 2017 after reaching its lowest level in 13 years in FY16. Average headline inflation increased from 2.6 percent in Jul-Mar FY16 to 4.0 percent in Jul-Mar FY17, driven by both supply- and demand-side factors (**Figure 10**). A pick-up in aggregate demand was accompanied by supply-side factors such as: higher international prices of key commodities (including crude oil and industrial inputs); a recovery in the prices of major food items (palm oil and rice); an increase in regulatory duties; and other fiscal measures to increase tax mobilization.⁴³ Nevertheless, the current trend suggests that inflation will remain at about 5 percent due to the consistent supply of perishable items, stable exchange rate, and the government's absorption of higher international oil prices. However, risks include upward adjustments of the gas tariff and uncertain global oil prices.

⁴³ The government changed the duty structure by: (a) replacing 5 percent FED with fixed rate of Rs. 1 per kg of cement; (b) increasing FED on cigarettes; (c) enhancing FED on beverages from 10.5 to 11.5 percent; (d) imposing regulatory duty on powdered milk; and (e) increasing the rate of sales tax on certain ingredients of poultry feed from 5 to 10 percent. Following these changes, the prices of cigarettes and cement rose by 17.5 and 5.8 percent in Q1FY17, compared with 16.3 and -0.9 percent, respectively in Q1FY16.

Figure 10 : Y-o-Y inflation trends

Percent

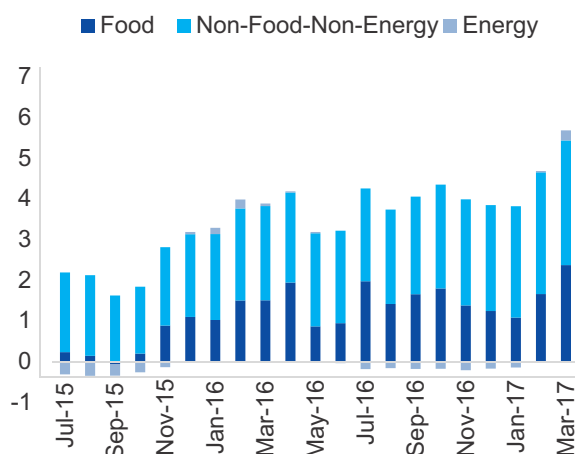


Source: State Bank of Pakistan

Both food and non-food prices increased moderately

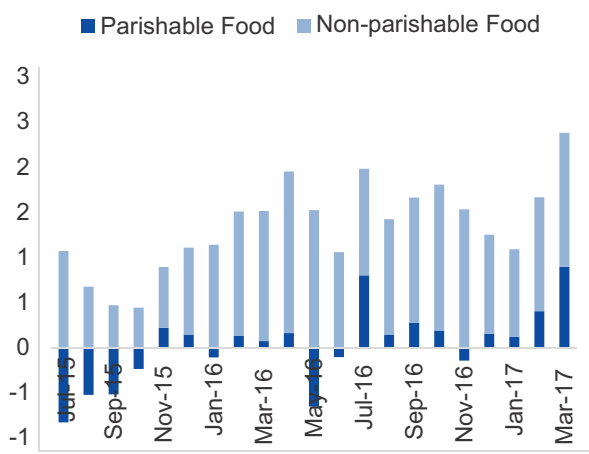
The increase in inflation was driven by a moderate increase in both food and non-food prices to 5.0 percent and 4.9 percent respectively y-o-y to March 2017 (**Figure 11**). Within the food category, some food items experienced substantial price increases. For instance, the prices of tomatoes, potatoes, and gram wholei increased by over 20 percent y-o-y to March 2017 due to reduced domestic production driven by weather patterns⁴⁴. In addition, seasonal (Eid-related) demand contributed to higher food prices while supply constraints arose from stricter payment controls for cross-border trade, which particularly affected Pakistan's trade of fresh fruits, vegetables and other perishable items with Iran and Afghanistan. Consequently, fresh vegetables exhibited the most prominent inflationary pressure in the CPI food basket (**Figure 12**). The key factors driving non-food inflation included: alcohol and beverages, housing costs, water, electricity, gas and fuels, education and health.

Figure 11: Weighted contribution in y-o-y inflation



Source: State Bank of Pakistan

Figure 12: Weighted contribution in y-o-y food inflation



Source: State Bank of Pakistan

⁴⁴ Heavy rains during July and August reportedly damaged the crop harvest in India, which reduced both the formal as well as informal import of fresh vegetables in Pakistan.

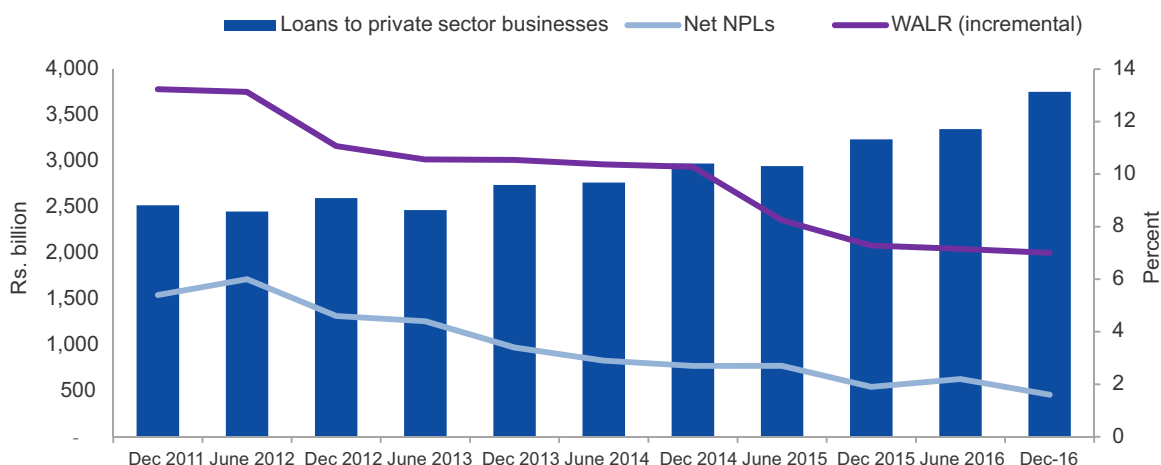
c. Financial sector

The low interest rate environment and stronger macroeconomic fundamentals continue to drive higher private sector credit

Stronger macroeconomic fundamentals, structural reforms, and low inflation have allowed for considerable easing of the interest rate environment. The weighted average lending rate on incremental borrowing is at 6.2 percent in December 2016 compared with 6.5 percent a year ago. At the same time, the deposit rate on new deposits is 3.6 percent in December 2016 compared with 4.6 percent a year earlier, translating to a lower cost of funds for banks. The trend in deposit rates has been declining since the FY14 change in methodology from a fixed minimum rate of 5 percent to a floating minimum rate of 50 bps below the SBP repo rate. In addition, the government's incremental borrowing requirement from commercial banks has fallen, allowing more liquidity to be available for the private sector. Finally, NPLs are at their lowest level in the past eight years (**Figure 13**).

Figure 13: Loans to the private sector vis-à-vis lending rates and NPLs (2011-16)

Rs. billion and percent (RHS)



Source: State Bank of Pakistan

However, maturity profiles remain persistently skewed to the short-term

The growth in private sector credit has been evenly distributed across working capital, fixed investment and trade finance segments. Overall, however, the cautious view on longer-term economic performance is persisting among financial sector sources, users and intermediation. About 36 percent of overall loans to private sector firms are categorized as long-term or fixed investment, but this ratio is lower for the manufacturing sector, at 31 percent. The manufacturing sector represents 59 percent of total loans.

The banking system remains robust based on standard solvency indicators, but the stock of government debt is declining

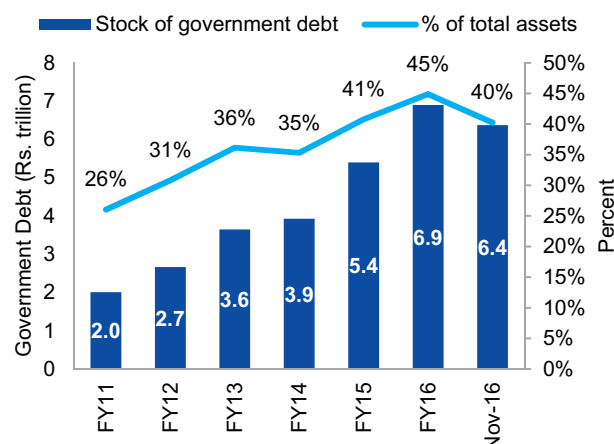
The key driver of robustness in the banking sector in recent years has been a shift in the risk behavior of banks from private sector loans to risk-free government securities. The banking sector has achieved sizable growth, driven primarily by increased government borrowing, but this trend is reversing. Commercial banks hold about Rs. 6.4 trillion of government domestic debt as of December 2016, which is about 40 percent of their total assets (**Figure 14**). Even with the recovery in private sector off-take, the outstanding stock of government debt continues to significantly reduce the risk-weighted assets of the banking system. As a result, the sector's capital adequacy ratio remains strong at 16.2 percent as of December 2016.

Bank profitability is deteriorating in a low interest rate environment, but is cushioned by reduced deposit rates

The significant pressures expected on bank profitability in the current low interest rate environment have been eased to an extent by a decline in deposit rates. As a result, the return on assets and return on equity of the banking sector are still at a healthy 2.1 percent and 23.9 percent, respectively, for the quarter ending December 2016 (**Table 8**). However, net interest income to gross income is lower at 47.8 percent for the quarter ending December 2016, compared with 55.6 percent a year ago, on the back of lower interest rates on private sector credit and lower yields on government securities.

Figure 14: Commercial banks' exposure to government debt is decreasing

Rs. trillion and percent (RHS)



Source: State Bank of Pakistan

Table 8: Selected key indicators of the banking sector

	Rs. billion	
	Dec-15	Dec-16
Profit Before Tax ytd	329	314
Credit to Private Sector	3,880	4,833
(In percent)		
ROA Before Tax	2.5	2.1
ROE Before Tax	25.8	23.9
Advances to Deposits Ratio	46.4	46.6
Liquid Assets/Deposits	73.3	72.1
Capital Adequacy Ratio	17.3	16.2
Gross NPLs to Loans	11.4	10.1
Net NPLs to Loans	1.9	1.6
6 month KIBOR	6.5	6.2

Source: State Bank of Pakistan

Small and Medium Enterprises (SME) credit growth is recovering and asset quality is improving

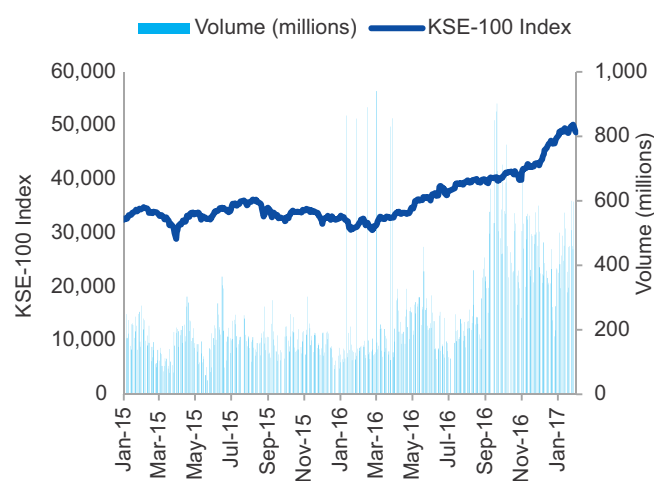
Credit to SMEs has increased for three consecutive quarters (March-December 2016), which is the highest sustained growth in the past five years. Non-performing loans (NPLs) have declined to 10.1 percent of the overall loan portfolio. Because of adequate provisioning, net NPLs also continued to decline, and are at 1.6 percent in December 2016 (**Table 8**).

The equity market has regained its upward momentum following successful structural reforms

Pakistan's equity market exhibited stellar growth during 2016, with the benchmark KSE-100 Index growing 45.7 percent in 2016, after a volatile 2015 during which it grew only 1 percent (**Figure 15**). Equity market reforms have contributed to this growth, including the integration of the country's three stock exchanges, improved governance and risk management, and transitioning of the National Clearing Company to function as a central counterparty.⁴⁵ As a result, the Morgan Stanley Capital International (MSCI) Pakistan Index was reclassified from Frontier Markets to Emerging Markets. Market capitalization of the KSE-100 benchmark index has grown to over US\$75 billion, of which foreign investors represent over 10 percent.

⁴⁵ Under a central counterparty function, settlement transactions are novated to the National Clearing Company, thus minimizing counterparty risk arising from default of brokers.

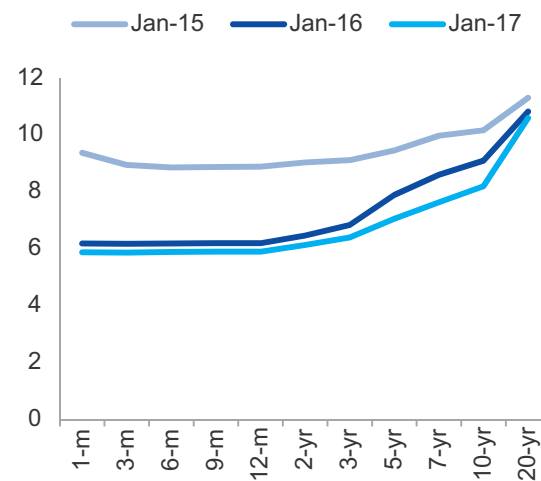
Figure 15: KSE-100 Index and volumes



Source: Pakistan Stock Exchange

Figure 16: Yield curve

Percent



Source: State Bank of Pakistan

The corporate bond market is underdeveloped, although a solid framework is in place

Improved macroeconomic stability has resulted in improved expectations for medium term. The yield curve has flattened for tenors up to 10 years, which is a positive sign (Figure 16). The secondary corporate bond market has witnessed limited activity with the last debt listing occurring in 2016 (Habib Bank Limited's 10 year TFC of Rs. 10 billion), following two new listings in 2015 worth Rs. 25 billion. The primary debt market is dominated by government securities and, though sizeable, it lacks efficiency, depth and liquidity. While the regulatory framework and market infrastructure is in place, one of the biggest constraints remains a very limited non-bank investor base consisting of only a few institutional investors. The Islamic bond market remains underdeveloped as well. In 2015 and again in 2016, the government raised US\$1 billion from international Islamic capital markets through Sukuk bonds. Following that, Karachi-based utility K-Electric issued US\$216 million worth of 7-year international Sukuks in 2015, and Fatima Fertilizer issued Rs. 10.5 billion worth of 5-year domestic Sukuks in 2017.

The outlook for financial sector performance is cautious

The prospects for private sector financing are strong, given historically low interest rates and the growth momentum of non-seasonal fixed investment advances. However, this growth is likely to be balanced by a lower incremental borrowing requirement from the government. Net interest income, which has remained high in recent years without affecting capital adequacy, will be under pressure, but the effects on profitability may be limited by the lower cost of funds and improving asset quality. Subsequent growth in the sector is unlikely to be driven by government securities, but will reflect the slow recovery in the real economy. Reforms within equity markets have yielded strong returns in 2016 and the successful divestment of 40 percent of the PSX to a strategic investor in 2017 is a strong market signal. The debt market continues to offer growth potential since interest rates are low but there has been limited appetite for debt raisings in recent months.

B. Outlook and upcoming challenges



1. Outlook

GDP is projected to grow at 5.2 percent in FY17, reaching 5.8 percent in FY19

Pakistan's economy is projected to grow by 5.2 percent in FY17 (**Figure 17**). On the demand side, the outlook for near-term growth will primarily be supported by public and private consumption, aided somewhat by a moderate increase in investment. Pakistan's low investment-to-GDP ratio is expected to improve marginally in FY17 due to CPEC-related infrastructure projects and other public investment (**Figure 18**). These projects are also expected to contribute to the domestic construction industry and expand electricity generation. Improved electricity availability may, in turn, support growth in the industry and services sectors. For details, see **Table 9**.

Figure 17: Real GDP growth (constant factor prices)
Percent

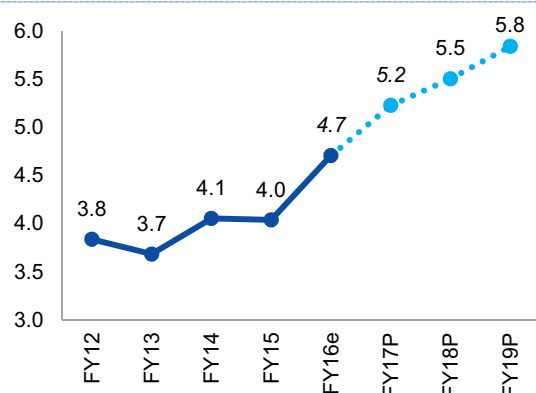
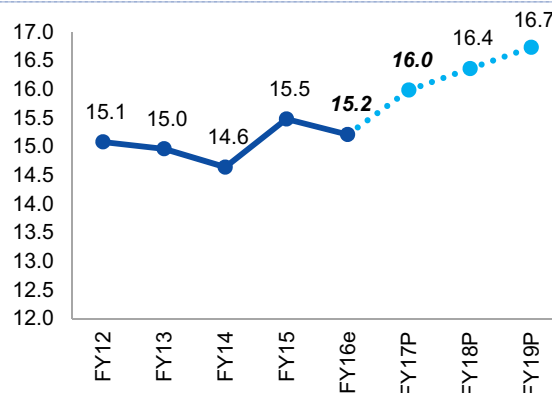


Figure 18: Total investment
Percent of GDP



Source: Data from Pakistan Economic Survey and World Bank staff estimates

Table 9: Pakistan key macroeconomic indicators

Percent

	Percent growth					
	FY14	FY15	FY16	FY17	FY18	FY19
Real GDP growth, at constant factor prices	4.1	4.0	4.7	5.2	5.5	5.8
Agriculture	2.5	2.5	-0.2	3.4	2.9	3.3
Industry	4.5	4.8	6.8	6.1	7.0	7.7
Services	4.5	4.3	5.7	5.6	5.8	8.2
Real GDP growth, at constant market prices	4.7	4.7	5.7	5.2	5.5	5.8
Private Consumption	5.6	3.2	7.0	4.4	4.3	4.7
Government Consumption	1.5	8.1	15.1	11.5	11.3	11.2
Gross Fixed Capital Investment	2.5	14.1	5.7	8.2	8.3	6.0
	Percent of GDP unless mentioned otherwise					
Inflation (Consumer Price Index)	8.6	4.5	2.9	5.0	6.0	7.0
Current Account Balance	-1.3	-1.0	-1.2	-2.7	-2.6	-2.5
Exports of Goods (% growth)	1.1	-3.9	-8.8	-0.2	8.5	10.0
Imports of Goods (% growth)	3.8	-0.9	-2.0	12.0	4.7	5.9
Remittances (% growth)	13.8	18.2	6.4	-0.4	1.4	1.4
Financial and Capital Account	3.0	2.0	2.1	2.7	2.6	2.5
Net Foreign Direct Investment	0.6	0.3	0.7	0.5	1.1	1.1
Fiscal Balance Excluding Grants	-5.5	-5.3	-4.6	-4.7	-5.1	-4.8
Primary Balance Excluding Grants	-1.0	-0.6	-0.3	-0.5	-0.9	-0.7
Debt	64.4	64.1	67.5	65.7	64.3	62.0

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice

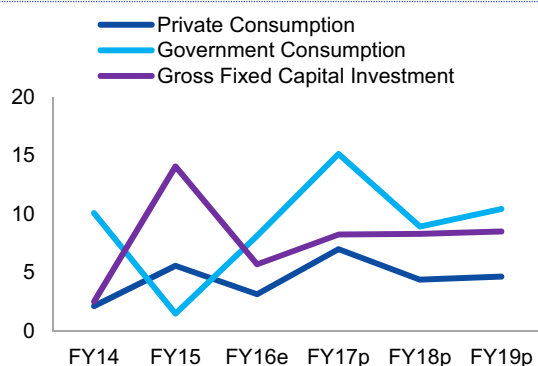
Notes: e = estimate, f = forecast.

On the supply side growth is expected to be driven by the services and industrial sectors

On the supply side, impetus to grow this projected to come from services and industrial sectors. The services sector is expected to grow by 5.6 percent whereas the industrial sector is expected to grow by 6.1 percent in FY17. After a weak performance in FY16, the agriculture sector is expected to grow at 3.4 percent in FY17 (Figure 20).

Figure 19: Growth in consumption and investment

Percent

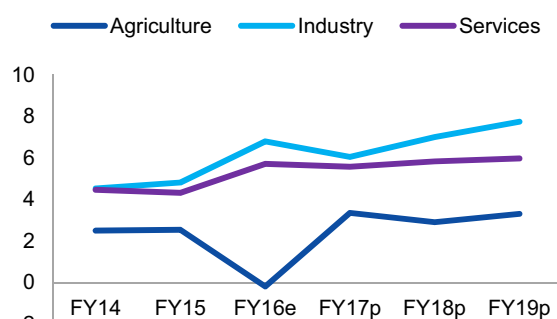


Note: e = estimated, p = projected

Source: Data from Pakistan Economic Survey and World Bank staff estimates

Figure 20: Growth in economic sectors

Percent



The current account deficit is projected to widen in FY17 and foreign reserves are expected to fall to 3.4

The current account deficit is expected to widen from 1.2 percent of GDP in FY16 to 2.7 percent in FY17. The key contributor to this will be a widening of the trade deficit due to slow growth in exports (as a result of weakening export competitiveness and subdued global demand) and higher growth in imports arising from increased economic activity and CPEC investments. FDI flows will strengthen due to the accelerated implementation of CPEC projects. The decline in exports growth,

months of imports by FY19	however, is expected to bottom out by the end of FY17 as the domestic supply side factors including electricity availability improves. Despite this expected recovery in exports, official foreign exchange reserves are projected to fall to 3.4 months of imports by FY19 due to the substantial current account deficit and higher debt repayments in FY18 and FY19.
Fiscal consolidation is expected to continue after the elections	The fiscal deficit is projected to be 4.7 percent in FY17, 0.1 of a percentage point higher than the FY16 deficit. This slight widening is primarily driven by a slower increase in government tax revenues (both federal and provincial) coupled with a rise in expenditures due to the upcoming election cycle. This trend is projected to persist in FY18, an election year. However, fiscal adjustment efforts are anticipated to continue after the election, which will decrease the fiscal deficit from 5.1 percent in FY18 to 4.8 percent in FY19.
Inflation is expected to rise moderately	Inflation has already bottomed out. Projected increases in economic activity and an expected marginal rise in global oil prices will push up domestic prices. Inflation is projected to grow from 2.9 percent in FY16 to 5.0 percent in FY17 and 7.0 percent in FY18.

2. Risks

The potential loss in reform momentum is a key risk domestically	There are significant downside risks to the projected outlook. Pakistan remains vulnerable to domestic and external shocks. Domestically, the country is exposed to natural disasters, political events and terrorism. The recent issue of Panama papers has enhanced political risks and created some policy uncertainty. The upcoming national election in 2018 may affect reform momentum and macroeconomic policy orientation. Slower progress in much-needed structural reforms would weaken growth prospects and discourage private investment. A stable Rs./US\$ nominal exchange rate has resulted in appreciation of the real effective exchange rate (REER). This can erode Pakistan's export competitiveness. Furthermore, protracted global economic weakness, especially in the Euro area due to Brexit could negatively affect exports.
Global uncertainty and falling remittance flows may be a threat to continued growth	Lingering uncertainty about the course of US economic policy could have a significantly negative effect on global growth prospects. Pakistan is also vulnerable to any significant decline in remittance flows, particularly from oil-rich countries (around two thirds of all remittances), if oil prices remain depressed. But low oil prices will also improve the current account deficit and create an environment conducive for a reduction in energy subsidies. On balance, low oil prices have been positive for Pakistan, being a net oil importer. Conversely, a sharp increase in oil prices will worsen the trade deficit and could increase energy subsidies.

3. Progress and next steps on structural reform

Pakistan needs to continue with the reform momentum, to maintain macroeconomic stability and accelerate growth.

Since coming to power in 2013, Pakistan's government has implemented an ambitious economic reform program. As a result, external and internal macroeconomic balances improved markedly and the country made strides in important agendas, such as taxation, energy sector and the business environment. As the government nears four years in power, there are concerns that progress is stalling. The first half of FY17 suggests deteriorating internal and external balances. Privatization efforts have stalled, which has also affected the broader reform efforts in the electricity sector, with the resurgence of the circular debt. FBR performance in tax collection is below target, after several years of very strong performance. Reforms in areas that need improved collaboration between federal and provincial governments remain challenging. Reform momentum will need to continue to maintain macroeconomic stability and accelerate growth.

Despite progress in electricity sector reforms, circular debt is on the increase again and load-shedding seems to be back.

The government approved an energy sector policy in July of 2013. Reforming the electricity sector to deal with accumulating arrears and frequent load shedding was a crucial part of the government's reform efforts, including raising electricity tariffs while reducing subsidies and implementing reforms to improve technical and commercial efficiency. After some initial progress, reforms have now stalled. Load shedding is on the increase, and the sector's arrears (circular debt) are close to where they were in 2013 (**Box 2**). Significant investments will provide much-needed generation capacity, but they need to be accompanied by investments in transmission and reforms to improve the performance of the distribution sector. An improved regulatory environment in the electricity sector is a precondition to attract private investment – reversals to the reforms implemented over the past few years would create uncertainty in the sector and affect private sector investment. Planned reforms in the gas sector—that will allow for increased supply from imports and improve sectoral performance—will need to be pressed home vigorously.

Financial sector reforms are far reaching and will result in a stronger, more inclusive and stable financial sector

Over the past three years, Pakistan has renewed efforts to develop its financial sector and increase access to finance. The government's National Financial Inclusion Strategy (NFIS) provides a comprehensive reform framework to coordinate public-private efforts to rapidly increase financial inclusion by 2020. The legislative basis for financial sector development is being overhauled, including the Financial Institutions (Secured Transactions) Act, the Credit Information Bureaus Act, amendments to the SECP Act, the Financial Institutions (Recovery of Finances) Act, the Deposit Protection Corporation Act 2016 and the Benami Transaction Prohibition Act. Reforms have also focused on broadening the financial sector with the establishment of new institutions, including the Pakistan Microfinance Investment Company, Pakistan Development Fund, Pakistan Mortgage Refinance Company, and the unification of the stock exchanges into a single one with strategic international ownership.

There is a need to improve coordination between provincial and federal governments in the

The 18th Constitutional Amendment significantly expanded the responsibilities of the provinces, with a corresponding reduction in the responsibilities of the federal government. A large number of areas are now of joint responsibility, including electricity, higher education and fiscal management. Improvements to the business environment, labor productivity and governance will all be crucial to accelerate growth. The country's ability to maximize the benefits of CPEC will require ancillary

implementation of structural reforms

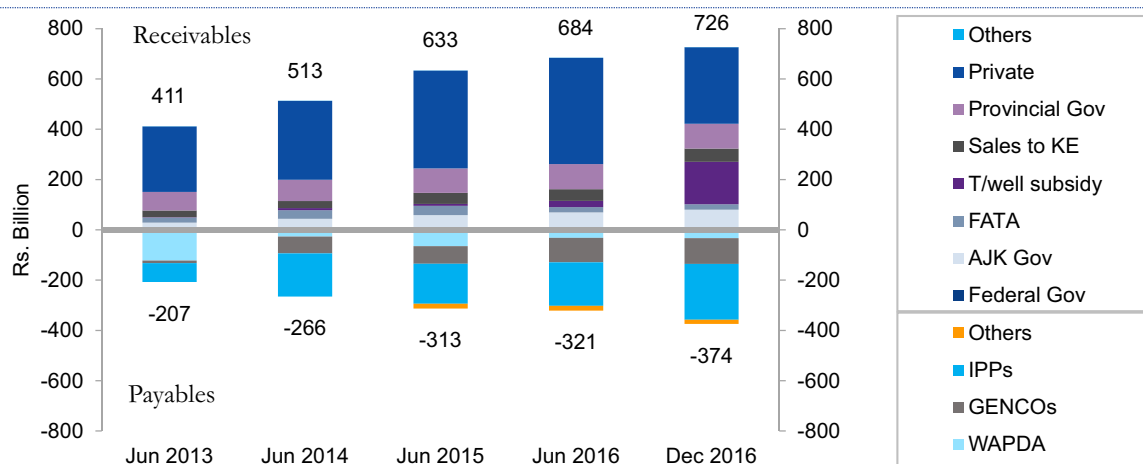
investments and reforms by the provinces to ensure that the private sector can respond to the opportunities presented. The main body to steer coordination in areas of joint responsibility is the Council of Common Interests (CCI). Coordination needs are also significant in other areas where the provinces have sole responsibility. As a result, there is a need for increased coordination between the federal government and the provinces in policymaking and the implementation of reforms.

Box 2: Circular debt in the electricity sector

Circular Debt (CD) or payables to generators is a symptom; unless its underlying causes are addressed, it will continue to reappear. In June and July 2013, the government cleared the entire CD stock of Rs. 480 billion but, by the end of FY13, it had reemerged to the tune of Rs 266 billion. In September 2015, the government introduced a comprehensive CD management plan to gradually reduce flows and eliminate the stock. The privatization of distribution companies (DISCOs) was a key action proposed to tackle the flow and the stock simultaneously. The CD plan, however, has struck some challenges in implementation. The DISCO privatization process has stalled, subsidy and tariff issues have not been addressed in AJK, FATA and Baluchistan tube-wells, NEPRA determinations have been suspended and DISCO performance has been below expectations. Consequently, as shown in the chart below, account receivables and payables continued to accumulate. As of December 2016, CD (defined as payables to generators) reached Rs. 374 billion, equivalent to five months of power purchase price (**Figure B2**).

Figure B2: Receivables and payables

Rs. billion



Source: Government of Pakistan

Lower fuel costs provided some relief as negative monthly Fuel Price Adjustments (FPAs) are not being passed on to subsidized consumers. This has helped the government in meeting flow targets and maintain the CD level within manageable limits during FY15 and FY16. Suspension of FY16 tariffs, on the other hand, meant that capacity charges and transmission and distribution margins have not been adjusted to reflect changes such as capacity additions, rupee depreciation and inflation. The payables data for the first half of FY17 show that circular debt is increasing at an accelerating rate as international crude oil prices are increasing. Consequently, the benefit of lower crude oil prices is beginning to diminish and circular debt is expected to increase further in the coming months.

4. Progress on social indicators

Progress on social indicators over the past decade has been mixed

Pakistan's progress on social indicators over the past decade has been mixed. While monetary poverty has fallen significantly, improvements in stunting, education and health indicators are not similarly noteworthy. The following discussion draws on the indicators listed in **Annex A**.

Pakistan has had great success in reducing poverty

Pakistan has made significant progress in reducing poverty over the past decade. Based on the poverty line set in 2001, the percentage of people living below the poverty line decreased from 34.6 percent in FY02 to less than 10 percent in FY14. Moreover, these gains in income were shared with everyone; even the poorest 5 percent of the population saw real improvements. Data from the household income and expenditure survey (HIES) show that in the year 2001, some 14 percent of the population had a real per capita expenditure level of Rs. 550 per person per month. By 2014, this was down to just 2 percent. In April 2016, the government announced a new national poverty line, which sets a higher standard for wellbeing at the poverty line, identifying 29.5 percent of the population as poor.

Maternal and infant mortality rates are also slowly improving

Pakistan is moving in the right direction—albeit slowly—on reducing maternal and infant mortality rates and delivery through skilled birth attendants. The infant mortality rate fell from 80 to 66 deaths per 1,000 births between 2005 and 2015, while maternal mortality fell from 249 to 178 per 100,000 live births. Life expectancy at birth has also improved for both males and females. Overall, the proportion of births attended by skilled birth attendants has increased to 58 percent in 2014-15 from an earlier 37 percent in 2006-07, and the overall proportion of women who had given birth during that last 3 years and had made at least one antenatal care consultation also increased from 56 percent in 2007-08 to 73 percent in 2014-15.

Nutrition and water & sanitation outcomes have shown little improvement over the last decade

Rates of stunting (a nutritional deficiency also called chronic malnutrition), however, have remained extremely high, and have not changed much over recent decades—Pakistan now has the third-highest number of stunted children in the world at 43.7 percent, and the highest stunting rate in South Asia. As stunting is strongly correlated with access to safe drinking water and availability of adequate sanitation facilities, Pakistan needs to prioritize improvements in these services. The current situation of water and sanitation facilities is clearly insufficient to reduce stunting. Although the number of households with access to an improved water source has remained more or less stagnant over the past 15 years, the percentage of households with access to piped water or tap water has reduced over time. The proportion of households with access to piped water fell from 29 percent in 2005 to 27 percent in 2010, while the percentage of households with access to tap water fell from 34 percent in 2005 to 32 percent in 2010, and to a further 27 percent by 2015. Sanitation facilities also show a similar picture, where the percentage of households with a flush toilet has increased from 52 percent to 73 percent between 2005 and 2015, but the proportion of households that have a flushing toilet connected to a piped sewerage system is still less than one quarter.

Significant gains were achieved in education in the early 2000s but progress has stalled

While education indicators improved in the early 2000s, they have largely stagnated since 2010. For instance, literacy rates increased from 53 percent to 58 percent between 2005 and 2010 but have remained within the 58 to 60 percent range since 2010. Similarly, gross and net enrolment rates for both primary and middle school saw an increase between 2005 and 2010, but have stayed more or less constant thereafter. More importantly, gross enrolment rates for middle and secondary school still remain low at 62 percent and 58 percent, respectively, in 2015.

The quality of education has failed to improve

Available data suggest that the quality of education has not improved in recent years. Learning outcomes, as measured by the proportion of year five students who can read a story in Urdu, Sindhi or Pashto, have seen little change since 2010, hovering around 50 percent. Moreover, a large number of schools in Pakistan still lack basic facilities such as drinking water, electricity and toilets. At the national level, 52 percent of the schools are equipped with electricity, running water, toilets and a boundary wall.

Provinces have had varying success at improving social indicators over the last decade

Pakistan's provinces have experienced very different levels of progress in human development over the last decade. KP seems to have made the most progress in a number of areas. The gross primary enrolment rate in the province increased 3 percentage points between 2010 and 2015, in a period when other provinces were deteriorating. The child immunization rate in KP increased from 40 percent in 2005 to 53 percent in 2013 and 58 percent in 2015, the largest increase of all provinces over that time period. Sindh, on the other hand, appears to be flat-lining across the same indicators. Child immunization was lower in 2015 than it was in 2005 (45 and 46 percent, respectively) and the gross primary enrolment rate also fell from 82 percent in 2010 to 79 percent in 2015. The proportion of fully immunized children from 12-23 months has also steadily increased from 2006-07 from 76 percent to 82 percent in 2014-15, while the proportion of children suffering from diarrhea has also decreased from 11 percent in 2006-07 to 9 percent in 2014-15. Stunting in Sindh also remains very high, at 48 percent in 2014. Sindh also continues to face large differences in urban and rural outcomes, which are most stark in water and sanitation where only 31 percent of rural households have a flushing toilet compared with 97 percent of urban households. Only 23 percent of Sindh schools are equipped with basic facilities compared with 93 percent in Punjab, 44 percent in KP and 26 percent in Baluchistan.

Punjab has had mixed success while Baluchistan has struggled

The data suggests that Punjab is also stagnant in some of the social outcomes over recent years. Its improvement falls between Sindh and KP, having made steady progress on child malnutrition (particularly stunting, which fell to 33.5 percent in 2014 from an earlier percentage of 43.7 in 2011), as well as child immunization and rural sanitation, while making little or no progress on enrolment rates and the quality of learning outcomes. Baluchistan has struggled to increase its particularly poor outcomes, seeing a deterioration in learning outcomes (only 33 percent of year 5 children could read a story in 2014) and child immunization.

Gender equality is improving somewhat—from a low base—in education and the workforce

Progress on women's empowerment is also mixed. While gender inequalities persist, women are slowly participating more in education and work. Female labor force participation is slowly increasing, albeit from a low base (from 19.3 percent in 2005 to 24.8 percent in 2014) and more girls are completing lower secondary. The ratio of female to male literacy is steadily improving, with seven literate women for every ten literate men in 2015. This ratio differs wildly across provinces, however, with Baluchistan exhibiting only four literate women for every ten literate men.

Population growth is a key challenge for service delivery

Looking forward, population growth presents a key challenge for all areas of human development. Systems are not expanding quickly enough to increase access and coverage to Pakistan's fast-growing population. Service delivery strategies will need to take a long-term view if services are to cover a greater share of a growing population while also improving quality.

C. Special sections



1. Mobilizing revenues for the development of Punjab

Even after a concerted effort to increase revenues over the last five years, Pakistan nonetheless faces a significant challenge in financing its development needs with a low tax to GDP ratio. The federal government has set a revenue target of 14 percent of GDP by FY20, the achievement of which will require continued effort from both federal and provincial governments. Punjab's revenue collection from its major taxes is currently around 25 percent of their potential of Rs. 432 billion, suggesting an estimated tax gap of Rs. 324 billion.⁴⁶ This gap is driven by a mixture of tax policy and administration shortcomings, including: jurisdictional overlaps between different levels of government; large tax exemptions; low compliance; weaknesses in tax administration; and weak coordination among provincial administration bodies. The most significant tax gaps are associated with the General Sales Tax on Services, the Urban Immoveable Property Tax, and transaction taxes (stamp duty and capital value tax), which could vastly increase their collections by eliminating exemptions, expanding the tax net, improving the quality of data and ICT reforms.

While Pakistan's revenues are growing, further efforts are needed—including by Punjab

Pakistan's overall tax-to-GDP ratio improved from 9.5 percent in FY11 to 12.4 percent in FY16. During this period, provincial tax to GDP increased from 0.4 to 1.0 percent (**Figure 21**), aided by the transfer of collection authority of some taxes to the provinces, and by some policy and administration reforms. However, additional efforts are required to finance Pakistan's development needs. In particular, the country's most populated and rapidly-urbanizing province of Punjab faces significant capacity gaps in revenue mobilization, which may hinder its development agenda.⁴⁷ The province's tax and non-tax revenues currently account for around 18

⁴⁶ The World Bank's preliminary estimates (2017)

⁴⁷ Punjab's population represents 54 percent of country's total population. With agriculture comprising around 28 percent of estimated provincial GDP, Punjab is considered the bread basket of the country,

percent of total expenditure (**Figure 22**). The majority of this own-source revenue comes from taxes (69 percent), predominantly the services sales tax, stamp duty, property-related taxes (urban immoveable property tax and capital value tax), and the motor vehicle tax (**Figure 23, 24**). Most of these taxes have recently been devolved to the provinces and are generally recognized as buoyant tax bases.

Punjab's taxes could generate far more revenue

According to recent estimates, actual collection from Punjab's six largest taxes is only 25 percent of its potential, suggesting there is a huge opportunity for increasing own-source revenues. The government could more than double its revenues by eliminating the tax gap on its major taxes: the General Sales Tax on Services, the Urban Immoveable Property Tax, and transaction taxes (**Table 10**). The province can further mobilize revenues by tapping key non-tax bases, and rationalizing or eliminating nuisance taxes.

The tax base is narrow due to a mix of tax policy and administration challenges

The key challenges related to Punjab's revenue mobilization are: (i) policy or jurisdictional overlaps between federal, provincial and local governments, (ii) large tax exemptions, (iii) low compliance,⁴⁸ and (iv) weaknesses in tax administration and coordination across the province's revenue bodies. Relevant departments, including finance and the revenue authorities, lack the requisite skills to carry out tax policy research or analysis. Furthermore, tax evasion is made easy by the absence of efficient coordination mechanisms to share data between departments (although there have been isolated efforts towards automation), as well as the lack of economic, sectoral, and taxpayer data at the provincial level. As a result, the government has an incomplete picture of the tax system and its potential. It is not surprising, therefore, that Punjab's revenue collection has generally fallen short of targets. A brief analysis of the potential in key taxes is presented below⁴⁹.

Table 10: Potential in key taxes of Punjab⁵⁰

	Actual (FY16)	Potential	Gap	
	Rs. billion		Rs. billion	% of potential
GST on Services	59	198	139	70
Urban Immoveable Property Tax	9	108	99	92
Stamp Duty	27	73	45	63
Capital Value Tax	12	27	15	56
Agriculture Income Tax	1.4	14	13	90
Taxes on Profession	0.6	13	12	95
Total	108	432	324	75

Source: Punjab civil accounts (actual numbers); and World Bank staff estimates (potential and gap – preliminary estimates).

although the province's economy is gradually shifting towards the services sector. The province faces increasing unemployment (from 5.7 percent in FY10 to 6.3 percent in FY15), particularly among urban, young and female populations.

⁴⁸ On the one hand, there exists a large undocumented economy that remains outside the tax net (Pakistan's estimated shadow economy is 34 percent of the GDP—larger than average of 31 percent for the 162 countries (Schneider, F 2012, "The Shadow Economy and Work in the Shadow: What Do We (Not) Know?" IZA Discussion Paper No. 6423, March 2012). On the other hand, those who are in the tax net find it difficult to pay taxes (as evidenced by the country's deteriorating rating on the paying taxes indicator of the [Doing Business report](#)).

⁴⁹ This is based on preliminary estimates. Detailed analysis (reports) will be disseminated after necessary peer review process.

⁵⁰ Motor vehicle tax is another major source of revenues, which is close to achieving its previously identified tax potential (collections in FY2016 were Rs. 8.9 billion, close to the potential of Rs. 9.6 billion in FY2013, estimated by Pasha (2014)). Relevant potential analysis using updated data is under process.

Key revenue indicators

Figure 21: Provincial tax effort has seen an increase in recent years

Percent of GDP

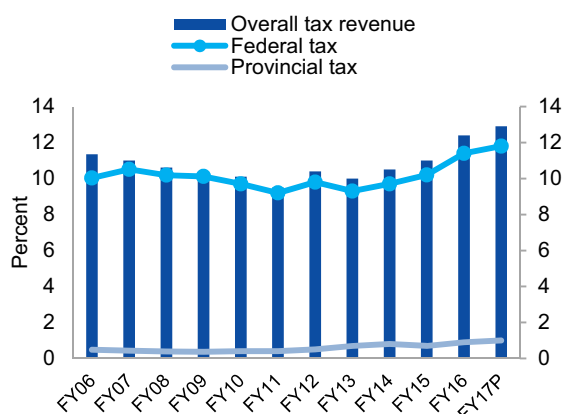


Figure 22: But financing of expenditure relies more on federal transfers

Rs. billion

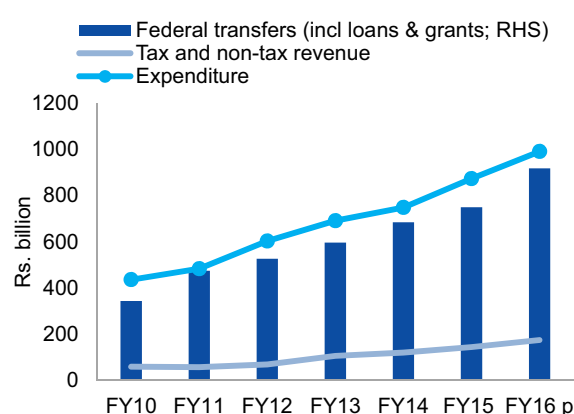


Figure 23: Punjab's tax revenues have recorded sporadic growth

Rs. billion and percent

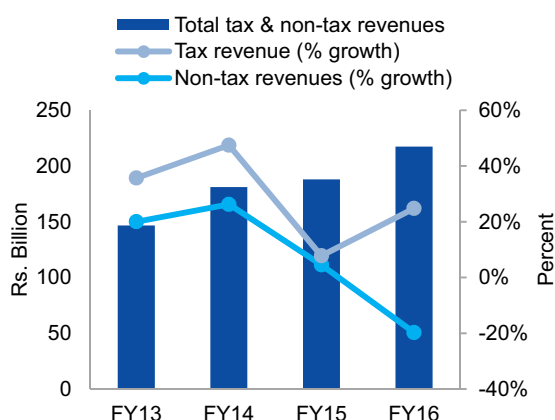
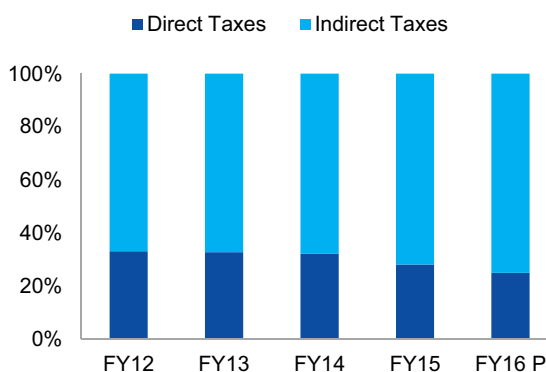


Figure 24: The share of indirect taxes in Punjab's own-source revenue is growing

Percent



Note: P: provisional.

Sources: Ministry of Finance Fiscal Operations; Punjab's budget documents and Civil Accounts data; IMF data; and World Bank staff calculations

a. General Sales Tax on Services (GSTS)

The GSTS has more than doubled in four years

The GSTS makes the largest contribution to Punjab's own-source revenue collection. After collecting Rs. 59.0 billion in FY16, it now comprises 39 percent of total tax revenue in Punjab. Since the establishment of the Punjab Revenue Authority (PRA) in 2012, GSTS collections have increased from Rs. 26.8 billion in FY12 to Rs. 59.0 billion in FY16—an increase of over 100 percent in four years. The telecommunications and financial sectors together contribute about 50 percent of GSTS revenue.

The increase is due to strong performance of the service sector and policy and administration reforms

The services sector is rapidly growing and is the largest contributor (over 60 percent) to Punjab's estimated GDP.⁵¹ Following the devolution of authority to collect GSTS to the provincial government, Punjab increased the tax base by expanding GSTS coverage to more than 100 services (as of FY16) compared with 43 in FY12. The government to slightly reduce the overall tax rate from 17 to 16 percent (with the exception of the telecommunications sector, which is taxed at 19.5 percent)⁵². The PRA is in the process of improving its tax administration capacity, especially through automation, taxpayer education and awareness, enforcement, and improved human capacity.

But actual GSTS collections are only around 30 percent of their potential

The current tax collection (Rs. 59 billion) is estimated to be well below its potential of Rs. 198 billion,⁵³ largely on account of compliance and administrative shortcomings. The non-telecom sectors (banking and insurance, business services, and construction sectors) represent a significant potential source of additional tax revenue (**Figure 25**). Methodologically, these estimates are based on an analysis of tax liability under the current Punjab GSTS law (FY16; including exemption, deduction, credits etc.)⁵⁴ and GSTS statutory rates. It assumes an 80 percent compliance rate, which is on par with OECD and EU countries.⁵⁵ Some of the sectors where there is potential are highlighted in **Figure 26**.

Exemptions are creating significant losses

The losses associated with exemptions suggest significant erosion of the tax base. The construction and telecommunication sectors, for example, have explicit exemptions that cost an estimated Rs. 25 billion and Rs. 2 billion, respectively (**Table 11**).

Figure 25: Punjab GSTS potential - overall
Rs. billion

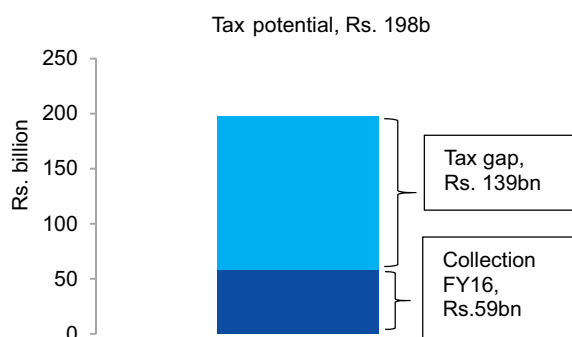
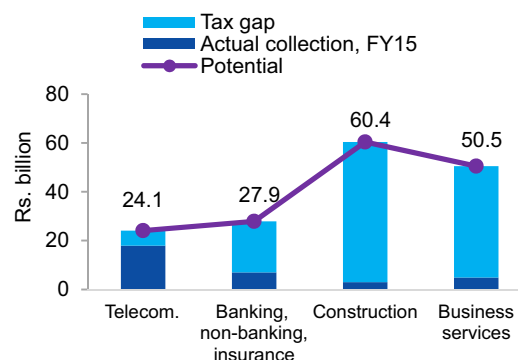


Figure 26: Punjab GSTS potential – major sectors
Rs. billion



Source: World Bank staff estimates.

⁵¹ World Bank staff estimates, 2017

⁵² The property developers and credit rating agencies are charged flat rates.

⁵³ This includes an estimated Rs. 47 billion that Punjab allows as a credit for federal GST paid on goods that are used as inputs to services in Punjab. This credit (based on current interpretation) is a liability for Punjab that is not yet repaid by the federal government.

⁵⁴ The tax liability was determined by using an adjusted input-output table, updated sectoral flows of 51 sectors (100 percent of services in these sectors are assumed as taxable), and provincial economic activity by sector (World Bank estimates). Data for other variables of the model was sourced from the Pakistan economic survey, State Bank of Pakistan, and estimates of income by province.

⁵⁵ Other assumptions are related to the taxable share of the construction sector, share of the telecommunications industry in the category of transportation, storage, and communications, crediting of federal tax paid, and the GSTS tax rate.

Table 11: GSTS exemptions and revenue cost*Rs. millions*

Exemptions	Estimated revenue loss
1. Construction ¹	25,000
2. Insurance services: health, life, crop and marine insurance ²	19,000
3. Exemption for cost of land for developers, builders, and promoters ³	17
4. Services for contractual execution work ⁴	237
5. Personal care services ⁵ 7.5	
6. Broadband internet (telecommunications) ⁶	2,300

1/ projects less than 10,000 square feet (house), 20,000 apartments, and where tax is paid as developers, builders, or promoters.

2/ Based on the life insurance premiums of Rs. 122 billion in 2014-15 (reported by Insurance Association of Pakistan), and tax rate of 16 percent.

3/ Conservatively assumes that land value is 50 percent of cost of services.

4/ Conservatively assumes that 10 percent of activity is exempt.

5/ Assumes that the exemption reduces the base by 25 percent.

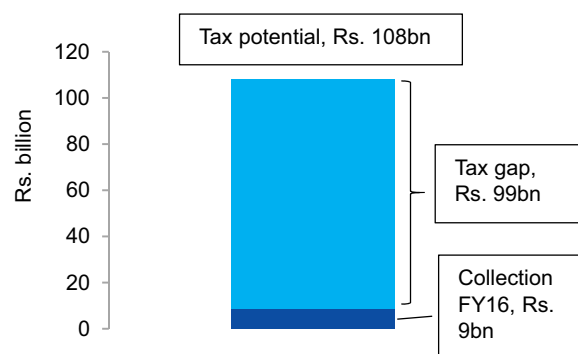
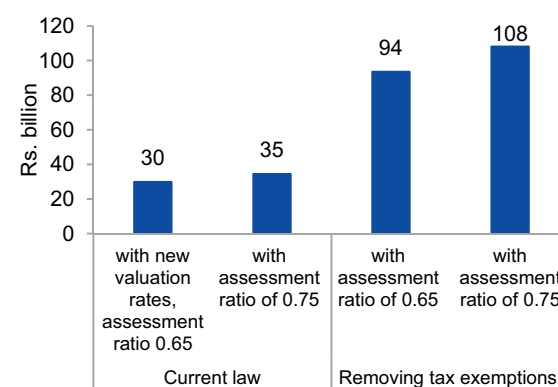
6/ Sourced from Telecom Exempt Sale Summary shared by PRA.

Source: World Bank staff estimates /calculations.

b. Urban Immoveable Property Tax (UIPT)

The UIPT is a particularly under-utilized revenue source for Punjab

Administered by the Punjab Excise and Taxation Department, the UIPT collected Rs. 8.6 billion in FY16, equating to 3 percent of own-source revenue (OSR), or 0.061 percent of Punjab's GDP. Punjab's UIPT collects far less than those in comparable countries and regions, in terms of proportion of total revenues as well as share of GDP (e.g., Turkey has property tax to GDP ratio of 1.46 percent, Malaysia 1.1 percent, South Africa 0.37 percent, and India 0.48 percent⁵⁶). This is mainly due to a large difference between market rates and official valuations, large exemptions, and incomplete computerization of tax rolls (only six districts' records have been digitized).

Figure 27: Punjab UIPT potential - maximum*Rs. billion***Figure 28: Punjab UIPT potential – by measures***Rs. billion*

Source: World Bank staff estimates.

⁵⁶ Estimates of different years.

The gap between the UIPT's actual collection and maximum potential is Rs. 99 billion

The scope for improvement in UIPT may be assessed from its estimated potential of Rs. 108 billion, which leaves a tax gap of about 92 percent, as shown in **Figure 27**. Using market-based values of the properties surveyed in five districts of Punjab,⁵⁷ the estimated potential under the *current law* (retaining all exemptions), but with new valuation rates, is Rs. 29.9 billion, around three times the tax's FY16 collection. It increases to Rs. 34.5 billion with an assessment ratio of 0.75. However, with the removal of exemptions and improved assessment methodology, the revenue potential could reach Rs. 108.09 billion (**Figure 28**).

c. Transaction Taxes (Stamp Duty and Capital Value Tax)

Stamp duty and capital value tax also suffer from administrative weaknesses

With a collection of Rs. 39 billion (Rs. 27 billion from stamp duty and Rs. 12 billion from CVT) in FY16, these taxes account for more than 20 percent of tax revenue of Punjab. However, a significant tax gap persists due to administrative weaknesses including: low valuation rates,⁵⁸ lack of information-sharing between the Board of Revenue and Excise & Taxation department; and multiple taxes on property transfers (including stamp duty, CVT, registration fee, tax on transfer, and capital gain tax—in addition to UIPT), increasing compliance and administration cost.

Collections could be improved by more than 55 percent

Based on a survey-based valuation of sample properties from selected districts of Punjab and available records of property transfers (e-stamping),⁵⁹ administrators are significantly undervaluing properties compared with their market value. If the assessment ratio increases to 20 percent, the estimated revenue potential of stamp duty is Rs. 44 billion, and Rs. 16 billion for CVT. The potential collection increases to Rs. 66 billion in stamp duty and Rs. 24 billion in CVT with an assessment ratio of 30 percent. These collections can be further increased by 10 percent to Rs. 99 billion (**Figure 30**) by pairing reduced rates with improved collection efficiency measures (e.g., digitizing and bunching together tax payments).

⁵⁷ During November 2016 to February 2017, a survey was conducted in 6 districts (Lahore, Faisalabad, Gujranwala, Rawalpindi, Multan and Sialkot) to ascertain *market values and rent* of a stratified random sample of 1,505 properties, selected from property records. The survey values and property records data were used to calculate *valuation rates* on the pattern of valuation tables. These valuation rates are then used to calculate Annual Rental Value and tax liability for a sample of 168,131 properties. Then, revenue forgone on account of exemptions is calculated for 2.2 million properties for which computerized records are maintained by the authorities. In the next step, the tax liability for the province is calculated using the ratio of the total tax demand of 6 districts and the provincial tax demand. Keeping in view that higher valuation would be phased in over time, the tax potential estimates are computed using assessment ratios of 0.65 and 0.75.

⁵⁸ Bahl, Roy, Sally Wallace, and Musharraf Cyan (2008) "Pakistan: Provincial Government Taxation," ISP Working Paper 08-07.

⁵⁹ The approach to gap estimation assumes: (a) assessment is undervalued due to adherence to notified valuation threshold; (b) collection efficiency is stable over time at 92 percent; and (c) tax administration imposes high compliance costs on taxpayers. The property valuation assessment (values / sales prices) was conducted through a survey of 501 stratified random sample properties (e-Stamp database) from five districts (Lahore, Faisalabad, Layyah, Sargodha, and Bahawalpur).

Figure 29: Potential in other transaction taxes – maximum

Rs. billion

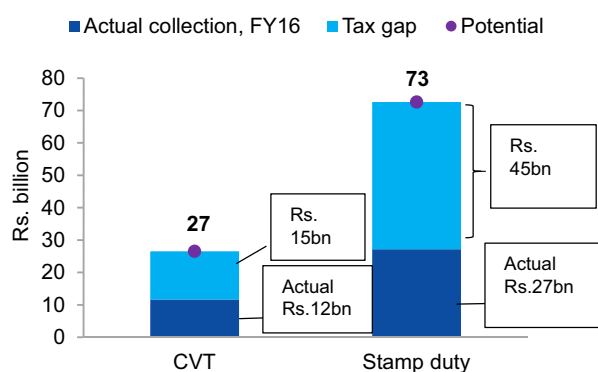
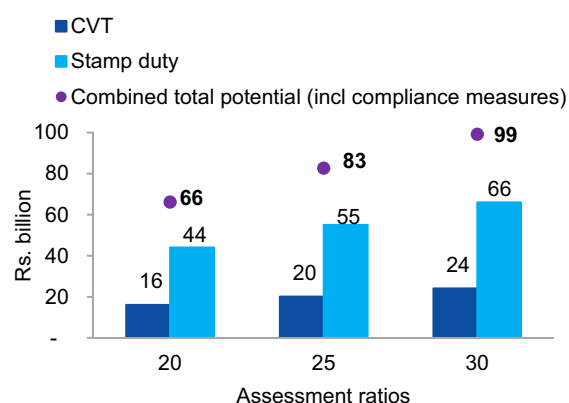


Figure 30: Potential in other property related taxes – by efficiency measures

Rs. billion



Note: Assessment ratio is declared value divided by market value.

Source: World Bank staff estimates.

d. Agriculture Income Tax (AIT)

Collections from AIT remain 90 percent below its estimated potential

Regardless of positive growth in collections over the past five years (from Rs. 717 million in FY11 to Rs. 1.39 billion in FY16—**Figure 31**), the agriculture sector pays only about 0.04 percent of its income in tax (estimated at Rs. 3,664 billion in FY15, current). The potential revenue from AIT is estimated at Rs. 14.5 billion, assuming full compliance and that farmers receive about 70 percent of the market price for most non-perishable crops. By incorporating non-compliance and the limitations in tax administration, the authorities can reasonably collect Rs. 7.2 billion under 50 percent compliance, and Rs. 4.3 billion under 30 percent compliance. These estimates are based on an analysis of agriculture income of the representative farm, per acre, and AIT as per the first schedule (area-based) and the second schedule (income-based). The greater of the two (area-based or income-based) is then used to arrive at the applicable AIT of the farm, and potential AIT. The data related to production and acreage of over 60 different crops grown in 36 districts of Punjab (covering grain, fruits, vegetables, oil seeds, pulses, etc.) was used. It was collected from the Government of Punjab and other analytical studies (farm gate prices and cost of production).

Figure 31: Potential in Punjab's AIT - maximum
Rs. billion

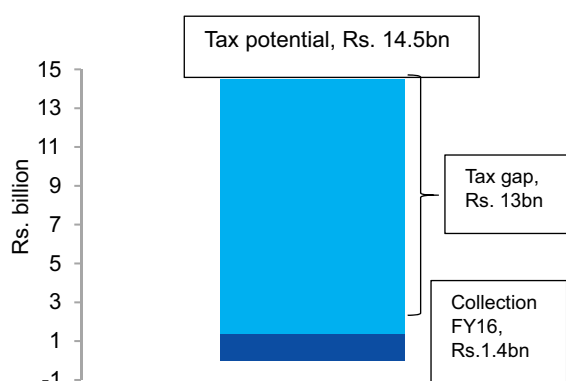
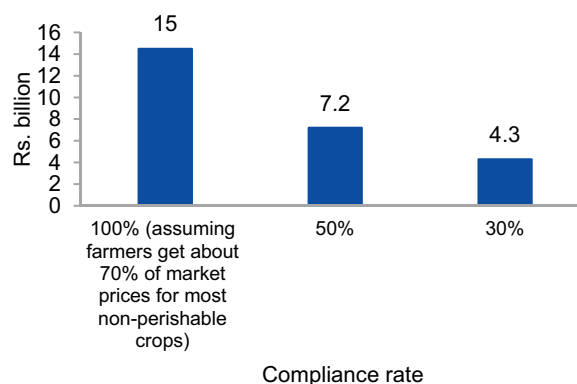


Figure 32: Potential in Punjab's AIT – compliance level
Rs. billion



Source: World Bank staff estimates.

e. Tax on Professions

The professions tax could be increased significantly by collecting from another 1 million professionals who are liable for the tax

In FY16, Rs. 603 million (including arrears) was collected from 1.45 million individual province-wide—about Rs. 417 per person, on average (**Figure 33**). In contrast, the information from a recent survey (based on the regular annual survey and site visits of ETD staff) shows that the department is losing about Rs. 479 million from an additional 0.96 million individuals who are liable for tax but are not yet included in the tax net. The collections could be further increased by including new liable persons in the tax net and through an increase in tax rates (a 50 percent increase in tax rate for each category would generate about Rs. 2 billion).

Figure 33: Potential in professions tax – maximum
Rs. billion

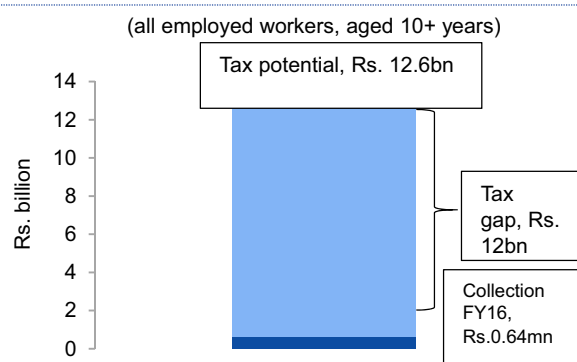
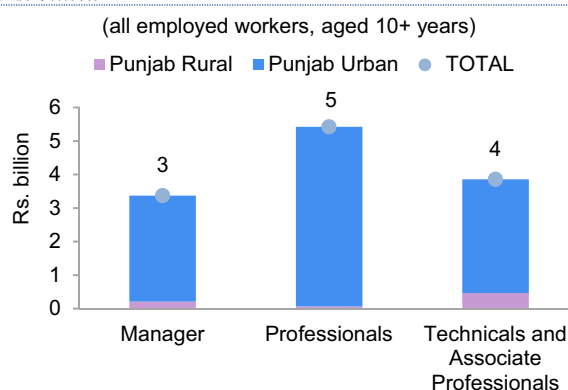


Figure 34: Potential in professions tax – professions and locations
Rs. billion



Source: World Bank staff estimates.

The tax gap is estimated at more than 90 percent

Due to the non-availability of province-wide (or national) survey of professionals, the true tax potential is difficult to ascertain. However, using the latest available data from the Labor Force Survey (FY15) and Securities and Exchange Commission of Pakistan (SECP), we have estimated the potential for all workers, non-agricultural workers

(aged 10+ years), and the corporate sector (**Figure 34**). With an average tax rate of Rs. 510 per person in selected occupational categories, the tax potential for all workers totals around Rs. 12.6 billion, whereas for non-agriculture workers it is estimated at Rs. 4.4 billion. The potential from the corporate sector is between Rs. 276 million and Rs. 350 million under different assumptions.⁶⁰

f. The way forward

A medium- to long-term approach is required

Reform efforts to date have achieved important outcomes, leading to improved fiscal outcomes. However, for sustainable impact, there is a need to build momentum and introduce properly sequenced tax policy and administration reforms to best exploit the province's tax potential.

There is a need to reform tax policy and administration

Several of the taxes discussed in this section share common reform needs. With respect to tax policy, collections would benefit from eliminating exemptions, improving definitions and expanding the sectors or groups covered by each tax. Increasing the consistency and coverage of taxes in these ways (coupled with effective implementation) could provide the government scope to reduce tax rates, while increasing revenues. To improve tax administration, the government could invest in gathering and then regularly updating its datasets, including accurate property valuations. Tax payments could be better facilitated, including through electronic means, databases could be integrated across relevant provincial government agencies and a multi-year capacity development plan could be developed for the three revenue bodies of the province – PRA, ETD, and BOR..

The Government of Punjab has developed a draft revenue mobilization strategy

By focusing on both tax and non-tax revenues, the government's strategy takes a holistic approach to revenue mobilization for enhanced fiscal space. The envisaged outcomes of the strategy are: (i) broaden the revenue base including both tax and non-tax revenue; (ii) increased integration/use of IT software and different facilities; (iii) enhance efficiency and effectiveness of the tax system; and (iv) encourage taxpayer's voluntary compliance and increase their satisfaction. In these areas, the World Bank is also providing support to the Government of Punjab.⁶¹

⁶⁰ Per SECP data, in FY15, Punjab accounted for 49 percent of new incorporations. It is assumed this as true across all of the classifications of paid-up capital, and conservatively applied a rate of Rs. 5,000 to all companies in that category (Assumption 1). Second assumption is that 2/3 of the companies in that category are with less than 5,000,000 paid-up capital, and 1/3 are larger. Thus we consider 2/3 to 1/3 split.

⁶¹ This includes technical assistance (Trust Fund for Accelerating Growth and Reforms, focusing on Finance Department, Punjab Revenue Authority, Excise and Taxation Department, and Board of Revenue) and other projects (Punjab Public Management Reforms Project, and Land Record Management Information System Project)

2. The 2 million challenge in Punjab: skilling the youth bulge

Punjab, the largest and most populous province in Pakistan, is experiencing a youth bulge with the share of young people (between the age of 15 and 24 years) increasing at a faster rate than that of other age groups. Young people currently make up about 36 percent of the working age population (between the age of 15 and 64 years) and an additional two million young individuals reach working age every year. In order to harness this youth potential for a demographic dividend, it is crucial for the economy to be able to absorb these workers into the labor market and involve them in productive activities. This requires both accelerated economic growth enabling sufficient job creation and the enhancement of human capital in the work force to be more productive in the labor market. In recognition of this, the Government of Punjab in its “Punjab Growth Strategy” and “Punjab’s Skill Development Sector Plan 2018” has set an ambitious target of achieving 8 percent annual GDP growth and training 2 million young individuals by 2018, and has demonstrated its commitment to provide access to better quality employment. This note aims to highlight the discussion on skills and employability of young people in Punjab, review current efforts by the Government of Punjab and its progress, and discuss areas of continued and further investment in growth-conducive and employment-generating policies.

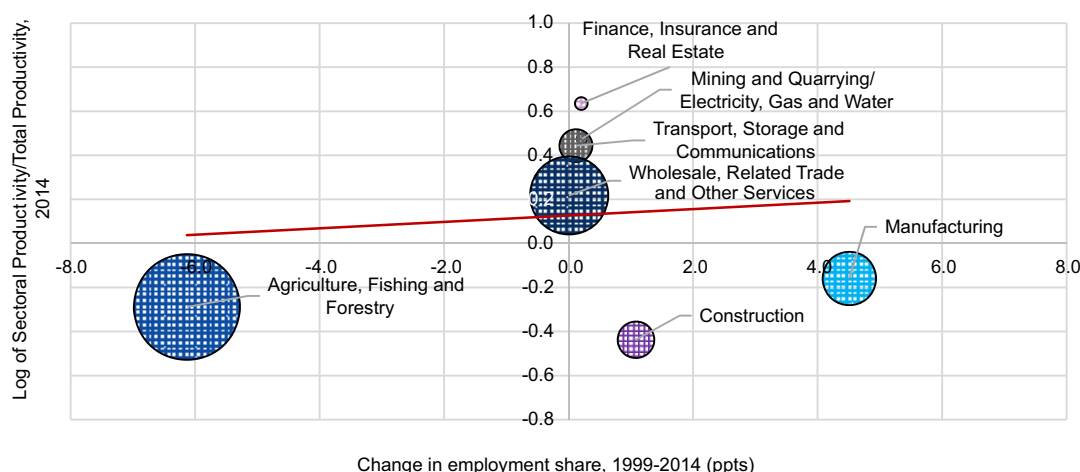
a. The employment challenge

Punjab has experienced robust growth but job creation is not keeping pace with labor force growth

Over the past 15 years, between 1999 and 2014, Punjab’s economy grew on average by about 4.5 percent annually, higher than the average growth rate of 4.2 percent nationally. However, compared with its pace of growth, the ability of Punjab’s economy to create jobs (annual employment growth of 2.7 percent) has barely kept up with labor force growth (2.8 percent annually). While employment has shifted towards higher productivity sectors, most notably from agriculture to manufacturing, overall productivity gains have been weak (**Figure 35**). At the same time, higher productivity services (e.g., transport, communications, finance and other services) have failed to add a significant number of jobs over the same period, indicating challenges in improving job quality. The overall labor force participation rate and the employment ratio have increased by 5.2 and 4.2 percentage points, respectively, but overall levels remain low largely due to low female labor force participation.

Figure 35: Female labor force participation rates

Percent



Source: Labor Force Survey and Bank’s estimates of provincial GDP

The quality of jobs is also a concern, with high rates of informality

Only 18 percent of Punjab's working age population is employed in regular wage jobs. Close to 45 percent of the working age population is inactive. Workers engaged in agriculture are largely unpaid family contributors, or self-employed in subsistence farming. Informality (defined as working in non-wage employment, or those wage employees without contracts) is common and more prevalent among women and youth. In addition to higher job insecurity, informal sector workers earn less. Informal wage workers' average monthly earnings are below Punjab's minimum wage (Rs. 14,000 per month) and as much as 45 percent lower than those of comparable formal sector workers with similar educational attainment in the same industry.

Table 12: Trends in labor market outcomes in Punjab

Year	LFP rate (all)	LFP rate (female)	Employment ratio	Non-agricultural workers / total employment	Wage employment / total employment	Informal workers (without contract) / wage employees
FY00	50.8	18.2	50.2	51.0	35.3	N/A
FY06	54.6	26.6	54.4	57.8	32.5	N/A
FY08	53.2	24.9	52.7	58.5	N/A	N/A
FY09	53.8	26.0	53.2	57.4	32.8	73.8
FY11	54.6	28.7	54.4	56.4	31.2	65.7
FY13	54.9	28.8	53.6	57.3	33.4	72.5
FY14	55.5	30.7	54.6	56.5	32.2	74.0
FY15	56.0	31.2	54.3	57.1	32.6	70.7

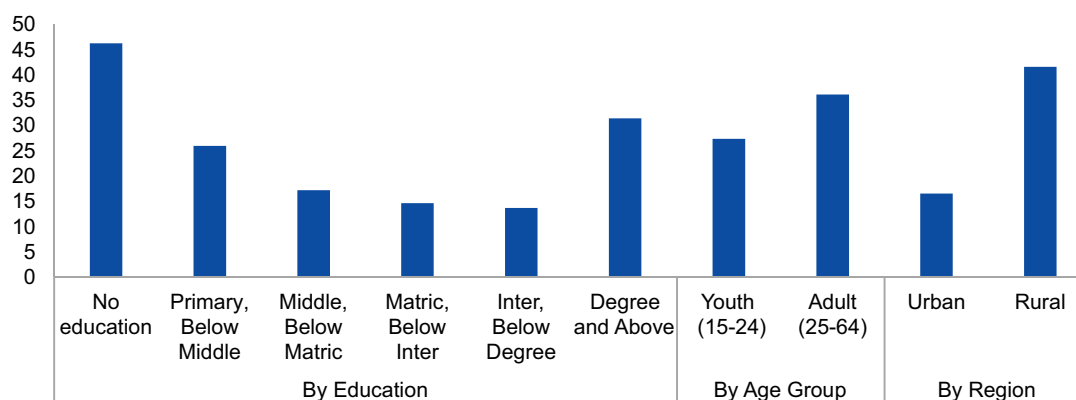
Source: Labor Force Survey various years

Female labor force participation remains particularly low in Punjab

Female LFP has been increasing in rural areas over the past 15 years, but has stagnated in urban areas; according to the latest labor force survey in 2014, the FLFP rate was 16.5 and 41.6 percent in urban and rural areas, respectively. While agriculture provides opportunities for unpaid family work and self-employment for women in rural areas, employment opportunities for urban females, who are on average more educated, are scarce. Indeed, the FLFP rate decreases with educational attainment, except for those at the very highest education level (**Figure 36**), likely because those with mid-level education do not receive sufficient returns (wages) or have the economic necessity to justify labor market participation that may involve substantial social, as well as economic, costs. Bleak earnings prospects can also discourage women from participating in the labor market: over 50 percent of employed women are unpaid compared with 14 percent of men; women are largely engaged in agriculture and manufacturing, which are low-paying sectors, and there exists a large gender wage gap. Furthermore, most agricultural workers and close to half of those engaged in the non-agricultural sector work among females work from home. This seems to corroborate the argument that female labor market activities may be underreported in surveys and that household responsibilities, combined with social norms and mobility constraints, are major barriers to labor market activities.

Figure 36: Female labor force participation rates

Percent



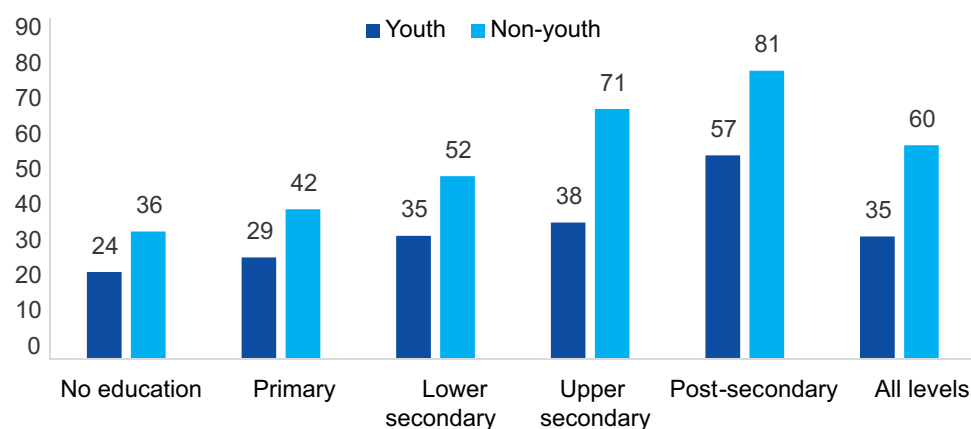
Source: Labor Force Survey 2014-15.

Despite higher rates of education, youth face greater labor market challenges

The share of those with no education is far lower for the young (23 percent) than older adults (46 percent). Nonetheless, compared with older adults, young individuals in Punjab are less likely to be active in the labor market and employed. Among those who do participate in the labor market, young people are more likely to be informally employed without a contract (**Figure 37**), or to be in unpaid work. Stark gender differences also still exist among young people, with these outcomes being far worse among females. The difficulties in school-to-work transitions and labor market challenges can be in part explained by inadequate job preparedness because of the poor quality and lack of labor market relevance of education. This is exacerbated by lower demand for young workers due to their lack of experience and the presence of social networks through which the majority of recruitment in Punjab takes place.⁶² The fact that the majority of employers search for workers through social networks and referrals tends to amplify labor market inefficiencies.

Figure 37: Share of wage employees employed with a written contract: by education

Percent



Source: Labor Force Survey 2014-15

⁶² The Punjab Economic Opportunity Program's Employer Survey suggests that social networks are the most common method of recruitment.

Policies to improve skills and ensure equitable access to labor market opportunities are critical

Lack of skills is one of the major constraints to productive employment in Punjab, where education levels and quality are generally poor and skills development opportunities limited. The labor force tends to lack the relevant labor market skills, including cognitive, technical and socioemotional skills. In addition, inequitable access to labor market opportunities due to information asymmetries and network-based recruiting practices, together with social and cultural norms that especially impact women, have led to poor employment outcomes.

b. Building skills and employability in Punjab

Skills are important in determining labor market outcomes

A large and growing body of evidence highlights the importance of better skills to improve labor market outcomes of workers. In today's global economy, the demand for skills is fast-changing, not only for cognitive and technical skills, but also for socioemotional skills, including motivation, aspiration and determination to succeed. A wide range of studies have shown a strong and positive association between cognitive (e.g., reading, writing) and non-cognitive skills (e.g., motivation, preferences and traits), and labor market outcomes (e.g., formal sector employment and earnings) in both developed and developing countries: better education and technical skills tend to lead to higher earnings through formal employment.⁶³ Increasingly, the importance of non-cognitive skills and early intervention in improving labor market productivity and resilience has been emphasized.⁶⁴

Vocational training in Punjab is an important part of skills development

Given weaknesses in early childhood development and formal education systems in Punjab, technical and vocational education and training (TVET) is important in fostering skills relevant to the labor market. Efforts to strengthen the TVET sector, as well as skills training for low-income populations (e.g., Wasela-e-Rozgar⁶⁵ and the Punjab Employment Opportunity Program⁶⁶) have been actively promoted. However, the incidence of TVET in Punjab remains relatively low at about 14 percent.⁶⁷ Men are more likely to complete vocational education than women. The incidence of vocational education is slightly lower among youth than among adults, probably because many young individuals are still in school and access to vocational training may not have increased over time. In recognition of the limited access to training opportunities, policy efforts for skills training have accelerated.

Punjab's TVET ecosystem has evolved rapidly to

In addition to the three largest providers⁶⁸, various government departments provide their own training from agriculture extension to health and tourism. Between the three large providers and the government departments, about half a

⁶³ See Heckman J. and T. Kautz (2013) "Fostering and Measuring Skills: Interventions that Improve Character and Cognition" NBER Working Paper #19656 for a review on the detailed discussions.

⁶⁴ Heckman J. and T. Kautz (2012). Hard evidence on soft skills. *Labour Economics* 19 (4), 451–464.

⁶⁵ Skills training for beneficiaries of Benazir Income Support Program carried out in 2012.

⁶⁶ Skills training that took place in Southern Punjab focusing on low income areas.

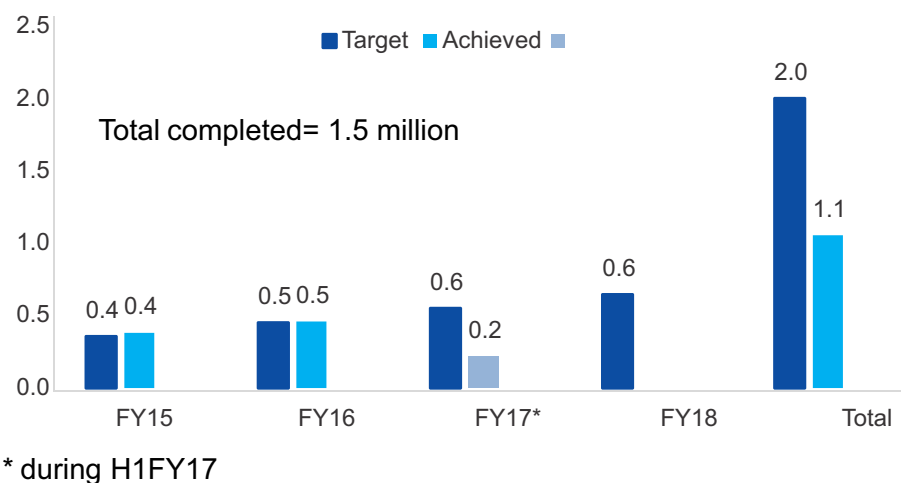
⁶⁷ LFS 2014-15. Please note that this number refers to technical or vocational training completed off-the-job. Another 3.9 percent completed on-the-job training.

⁶⁸ The Punjab Technical and Vocational Education Training Authority (PTEVTA), the Punjab Vocational Training Council (PVTC) and service providers financed by the Punjab Skills Development Fund (PSDF)

deliver training on a large scale

million trained workers emerged from the system in FY16 (**Figure 38**). At this pace, the government's target to train two million individuals by FY18 should be achievable. In terms of certification and the recognition of skills, the main certification bodies⁶⁹ are currently working closely with training institutions for improved and more streamlined certification mechanisms.

Figure 38: TVET sector target and achievements (million people)



Source: Punjab Skills Development Fund/ Government of Punjab.

However, there is no evidence that the expanded system is delivering labor-market relevant training

Early tracer studies and anecdotal evidence on the expanded TVET system suggest that the linkages between training and industry were weak and that employment outcomes were unremarkable. A survey⁷⁰ of graduates who were employed after 13-16 months following graduation showed that it took up to one year to find a job for over half of them. With the rapid scaling-up of training, efforts to measure employment outcomes or assess the process of job searches have been limited. Currently, the TVET system has limited support for supplementary intervention, such as job search assistance or counseling for graduates. It is a common finding in the literature that training alone will not be sufficient to lead to improved employment outcomes.⁷¹

Beyond TVET, there are few active labor market programs to address constraints

In contrast with the daunting and wide range of challenges discussed earlier, policy responses have largely focused on TVET. Instruments that are widely used elsewhere to target unemployed youth are not available on a large scale in Punjab. These measures include wage subsidies (to increase labor demand for youth), apprenticeship and internship (to foster labor market experience), counseling or mentoring (to foster socioemotional skills), and job search assistance and employment services (to provide intermediation and matching services). Interventions to promote entrepreneurship and self-employment, which may be more applicable in an environment where labor demand is limited, are being

⁶⁹ Includes the Punjab Board of Technical Education (PBTE) for technical education and the Trade Testing Board (TTB) for vocational skills.

⁷⁰ A Skills for Job Tracer study conducted by the PSDF.

⁷¹ See McKenzie (2017). "How Effective Are Active Labor Market Policies in Developing Countries? A Critical Review of Recent Evidence." World Bank Policy Research Paper 8011.

implemented with a limited scope.⁷² A pilot intervention to facilitate linkages between employers and job seekers through employment services and supplementary interventions is now underway, focusing on interventions for poor and vulnerable urban youth.⁷³

c. Going forward

The focus of TVET policies needs to be expanded to employment outcomes.

With respect to TVET, further policy efforts are required to ensure that the focus shifts beyond the number of trainees to the relevance of training such that it meets minimum quality standards and supports employment outcomes. The relevance of training can be in part achieved by rolling out competency-based training in priority trades. This would lead to greater standardization of quality training, comparability of Punjab training with international accreditations and, eventually, better-trained workers for domestic and international labor markets. Encouraging efforts are underway to strengthen governance of the TVET system and need to continue.

Additional interventions are necessary to better connect job seekers and employers

Being equipped with those skills demanded by employers, while necessary, does not guarantee access to better jobs. For instance, considering the lack of information on available jobs, required qualifications, or expected earnings faced by jobseekers, and the widespread use of network-based recruitment, labor market intermediation through publicly-funded employment services is generally considered to be a cost-effective measure. Such intervention could also be complemented with job search assistance and counseling to encourage young jobseekers. With respect to self-employment, business skills and access to finance or productive assets could be promoted. While there is no panacea intervention, innovative programs could be introduced, examined and evaluated to find scalable solutions in the context of Punjab.

Tailored approaches are required to ensure women are able to access training and employment opportunities

In order to address the constraints faced by vulnerable groups, such as youth, women and those from low-income backgrounds, specific efforts will be required. The poor and unskilled, who often lack the minimum education required for entry into training programs, will need alternative pedagogical methods and curricula. Possible interventions to facilitate the graduation of the poor and vulnerable include linking training to access to finance and productive assets for business development. The very low female labor force participation and their lagging employment outcomes also suggest an urgent need to address the constraints facing women as they relate to social norms, mobility constraints, work hours, household responsibilities and separate sections for only women at the workplace. In facilitating inclusive employment, opportunities for overseas employment can also be explored as a strategy to access better jobs and increase earnings.

⁷² Interest free loans exist in Punjab to foster entrepreneurship and businesses. However, little is known about the availability of such schemes for youth and the effectiveness, and this needs to be further examined.

⁷³ A pilot initiative being planned under the Punjab Social Protection Authority.

3. Modernizing agriculture in Pakistan

Agriculture continues to be an important sector in Pakistan, both politically and socioeconomically, accounting for almost 21 percent of total GDP, employing 44 percent of the labor force and providing 78 percent of the country's export (textile, food, and leather in FY16) earnings, either directly or indirectly. In recent years, however, the agriculture sector's performance has declined relative to its potential: below 3 percent over the past five years, and turning a negative 0.19 percent in FY16.⁷⁴ Agriculture is beset by numerous challenges, including a lack of availability of modern cultivars, the slow rate of technological innovation, increasing land fragmentation, limited diversification, and insufficient investment in and maintenance of infrastructure. Related to these challenges are institutional and policy issues pertaining to Punjab's enormous public wheat procurement program, which has created market inefficiencies, excess supply and a high fiscal burdens for the provincial government.

Agriculture is an important sector for the economy, but is experiencing declining growth

Within agriculture, arable crops represent 37 percent of agricultural GDP, livestock 59 percent, and fishing and forestry 4 percent. In Pakistan, there are some 8.3 million farms, of which 82 percent are owned and the remaining 18 percent are owned-cum-tenant and tenant farms. While 89 percent of these farms have fewer than 5 hectares (ha), nearly 82 percent of the cropped area is irrigated and agriculture is by far the largest user of water. Despite its importance, agricultural performance in recent years has been disappointing, with only 3.3 percent annual growth over the past decade compared with over 5 percent in the 1980s and over 4 percent in 1990s.

And the sector faces numerous challenges

The major factors underlying this poor performance include sluggish growth in productivity in recent years, the slow rate of technological innovation and limited adoption of progressive farming technologies, the non-availability of essential inputs such as certified quality seeds, fertilizer and water (especially to the tail-enders), declining public investment in research and technology development and its extension, limited investment in construction and maintenance of infrastructure, marketing and trade restrictions, and a high incidence of pest and livestock diseases. In addition, the majority of the farms are small in size, yield gaps are large relative to potential (as demonstrated by progressive farmers in Pakistan and farmers elsewhere such as India, Thailand, China, etc.), both input and output markets are inefficient, the focus of agriculture is only on four major crops, and yields vary largely across different agro-climatic zones. These challenges are aggravated by poor rural infrastructure, inefficient extension services, and poor access to capital and financial resources by small and medium farmers. The absence of effective regulatory regimes constrains private investment in the supply chain and seeds, leading to market inefficiency.

Regional peers are increasing crop yields at a faster pace

Looking at the regional context, the share of the agriculture sector in national GDP of countries in Southeast and East Asia, such as Vietnam and China, has declined over time—and at a much faster rate than in Pakistan. At the same time, these countries have made major strides to increase yields of their important crops, while Pakistan has lagged in its attempts to do likewise. Similarly, government expenditure on the agriculture sector, both as percentage of total outlays and as a percentage of

⁷⁴ Cotton production remained 27 percent below the previous year's production and 35 percent below the target of 15.5 million bales. This was driven by a combination of factors, including a prolonged cold spell and severe pest attacks that, as a result of non-availability of resistant seeds, led to crop losses mainly in Southern Punjab and Sindh. In addition, the depressed price of cotton may have reduced farmers' incentive to invest in good quality pesticides and inputs.

agricultural GDP, is far lower in Pakistan than other countries in South and Southeast Asia, including Bangladesh, India and Sri Lanka, Vietnam and China (Table 13, 14).

Table 13: Public expenditure on agriculture

Country	Agriculture as share of GDP (%)	%age of ODA spent on agriculture	Government expenditures on agriculture sector	% of total Outlays	% of Agri-GDP
Pakistan	20.1	3.2	1.2	1.0	
Bangladesh	17.5	5.0	8.9	6.4	
India	17.4	2.8	6.8	6.4	
Sri Lanka	12.1	1.2	5.3	9.6	
China	10.0	3.1	1.7	2.3	
Vietnam	21.3	6.3	2.5	4.1	

Table 14: Comparative yields (kg/ha) of key crops

Country	Yield (kg/ha)					
	Cereal ⁷⁵	Wheat	Rice	Sugar-cane	Cotton	Pulses
World		3,268	4,486	7,094	2,271	
Asia		3,141	4,566	6,771	2,349	
South Asia		2,848	3,717	6,497	2,848	
Pakistan	2,950	2,830	3,580	5,648	2,225	
Bangladesh	4,190	2,600	4,220		1,120	930
India	2,860	2,990	3,590		610	620
Sri Lanka	3,500	--	3,550		--	1,160
China	5,710	4,840	5,540		1,340	1,660
Vietnam	5,380	--	6,690		3,990	850

Source: Food and Agriculture Organization Statistical Year Book 2014, Annual Plan FY16.

a. Challenges from water stress, low yields, and limited diversification

Water availability is under stress, with demand expected to soon outstrip supply

Not only is Pakistan classified as one of the world's most water-stressed countries, it is also dependent on a single river system. The surface irrigation system in the Indus delta suffers from rapid infrastructure degradation caused by insufficient maintenance and repair expenditure, in addition to pollution of surface and groundwater from the excessive use of pesticides and fertilizers. The surface water infrastructure has extremely low user charges and lacks an effective asset management plan. Moreover, the Indus basin is vulnerable to climate change⁷⁶ compounded by water storage problems. Total dam storage in Pakistan represents only 30 days of average demand, compared with 220 days in India and 1,000 days in Egypt. The demand for water is likely to reach 261 million acre-feet (maf) by 2025, whereas supply is likely to stagnate at around 150 maf (barring the impact of climate change), resulting in a shortfall of about 111 maf.⁷⁷ In this situation, the conservation of water by containing losses and improving productivity becomes the only viable option besides the construction of water storage facilities and increasing water pricing.

And productivity remains below par

Apart from water stress, productivity is also considerably lower in Pakistan than in other countries. Crop yields, both per hectare and per cubic meter of water, are much lower than international benchmarks (Table 15). This is due to excessive reliance on traditional irrigation methods (flood irrigation) combined with the basic absence of pricing of surface water, which together cause huge water losses due to overuse, excessive run-off, deep percolation and evaporation. It not only damages the land quality (water-logging) but also reduces crop yields, as excessive water leaches

⁷⁵ Cereals include wheat, rice paddy, barley, maize, corn, rye, oats, millets, sorghum, buckwheat, quinoa, fonio, triticale, canary seed, mixed grain and cereals.

⁷⁶ Winston Yu, Yi-Chen Yang, Andre Savitsky, Donald Alford, Casey Brown, James Wescoat, Dario Debowicz, and Sherman Robinson, "The Indus Basin of Pakistan – The Impacts of Climate Risks on Water and Agriculture", Washington DC, World Bank.

⁷⁷ Kahlown, M. Akram, and A. Majeed. (2002). 'Water resource situation in Pakistan: Challenges and future strategies'. Science Vision Quarterly, Vol. 7, No. 3&4, Jan-Jun 2002.

nutrients out of the root zone.^{78,79} In addition, total factor productivity (TFP) has also been rapidly declining, accounting for 44 percent of output growth in the 1960s, 67 percent in the 1980s, and 37 percent in the 1990s, while it now accounts for less than one-fifth of growth. From a top performer of TFP growth in the 1980s, Pakistan has turned into a laggard in this regard (Figure 39).

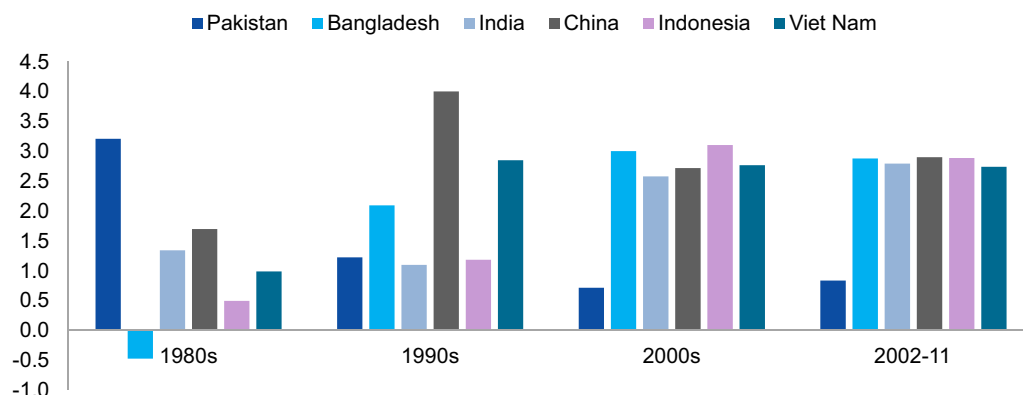
Table 15: Comparison of water productivity

Productivity per unit of land		GDP per cubic meter of water	Productivity per unit of water
Country	Tons/ha	Constant 2005 US\$	Kg/m ³
Egypt	7.3	1.9	
France	7.1	74.5	
Japan	6.1	53.1	
China	5.9	8.9	0.8
Vietnam	5.4	1.2	
Indonesia	5.2	3.9	
Brazil	4.8	16.1	
Bangladesh	4.4	3.1	
India	2.9	2.0	0.4
Kyrgyz Republic	2.9	0.4	
Pakistan	2.7	0.8	0.1
Ghana	1.7	20.0	

World Bank Indicators Database, 2015.

Figure 39: Percentage annual growth in total factor productivity (TFP) in agriculture

Percent



Source: World Bank staff estimates

Crop yields are growing too slowly

Yield growth of the four major crops⁸⁰ has slowed since the 1990s. For example, rice yields grew at an average annual rate of 5.6 percent in the 1960s, falling to 2.9 percent in the 1990s and just 1.7 percent in the period 2000-10. A similar pattern can be observed in wheat, with average annual yield growth of 3.6 percent in the 1960s, 3.1 percent in the 1990s, 0.9 percent in the period 2000-10, and negative 0.4 percent in the period 2011-15.

⁷⁸ But on the other hand, it also contributes to recharge of the groundwater aquifers. However, the lack of sufficient water storage capacity leads to vast amounts of water being lost to the sea.

⁷⁹ Kahlowan, M. Akram, M. Ashraf and M. Yasin. (2003), Water Management for Efficient Use of Irrigation Water and Optimum Crop Production, Pakistan Council of Research in Water Resources, Islamabad.

⁸⁰ Wheat, cotton, rice and sugarcane.

For sugarcane, the decline was from 3.6 percent in the 1960s, 1.2 percent in the 1990s, 1.4 percent in the period 2000-10, and negative 0.3 percent in the period 2011-15. The story of cotton is no different, with average annual yield growth of 2.7 percent in the 1960s, 2.8 percent in the 1990s and 1.3 percent in the 2000s. Moreover, average yields tend to be below the achievable upper bound of progressive farmers⁸¹ yields. The national average yields of major crops such as rice and wheat are about 45 percent of progressive farmers' yields. The yield gaps are even greater for some cash crops, such as sugarcane in Sindh (73 percent) and Punjab (62 percent). Likewise, the yield gap for cotton and maize is 31 percent and 58 percent, respectively.⁸²

Crop diversification is limited, particularly on smaller farms

There is limited diversification in crop agriculture across all farm sizes (Figure 40 and 41). The major focus is on wheat, rice cotton and sugarcane rather than on value-added products such as orchards, pulses, vegetables or expanding cropped area under cotton. About 70 percent of farms with fewer than 5 ha grow grains, compared with 55 percent of farms of 20 ha and above. Likewise, 45 percent of small farms grow wheat, compared with closer to 40 percent of medium to large farms. About 10 percent of small farms grow cotton, compared with 14 percent of medium to large farms. Diversification on farms of 20 ha and above seems to be slightly higher than on farms with fewer than 5 ha.⁸³ Over-reliance on the traditional four crops reflects government support (including subsidies, procurement policies, research and extension, etc.) that is heavily focused on the major crops, inefficient markets for non-major crops and livestock products, insufficient technical knowledge regarding on-farm production and post-harvest handling of high-value commodities, and difficult and costly access to finance.

Figure 40: Diversification in crop agriculture – farms less than 5 hectares

Percent

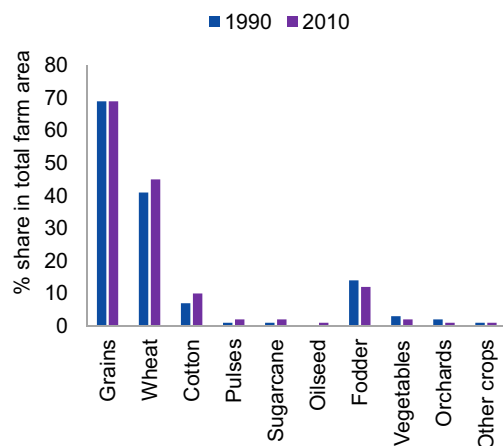
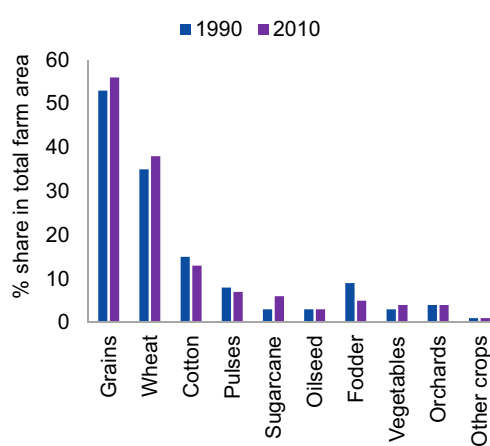


Figure 41: Diversification in crop agriculture – farms 20 hectares and above

Percent



Source: Pakistan Agricultural Census 2010

⁸¹ "Progressive farmers" refers to farmers in Pakistan who have achieved high crop yields applying the available technology and management practices. They thus provide good benchmarks of what is currently achievable.

⁸² Planning Commission. 2009. Task Force on Food Security: Final Report. Islamabad. Government of Pakistan.

⁸³ Small farm < 5 ha, medium farm > 5 ha but < 20 ha, large farm 20 ha and above.

Agricultural reform at a fundamental level is now crucial

There is substantial scope for accelerating broad-based agricultural growth by stimulating productivity, technology and innovation; better water management; an improved regulatory regime and agricultural trade policies; and a smarter subsidy regime. Fundamental reforms in agricultural research and extension systems, marketing of crops and livestock products (market reforms) as well as water management policies and institutions, could provide greater efficiency to the sector.

b. The burden of the wheat procurement program in Punjab**The Government of Punjab operates a large wheat procurement system**

The Government of Punjab operates the largest wheat procurement system in Pakistan, whereby the Food Department procures wheat at the announced support price and releases it to registered flour mills. This system is financed via budgetary allocations including bank borrowing,⁸⁴ with the support price consistently on the rise. Over the past decade, the price at which the government procures wheat has risen by 225 percent, and in 2016 it stood at Rs. 1,300/40kgs (US\$310/metric ton), well above the international price of wheat (fob of US\$180/ton and estimated cif Lahore of US\$238/ton). This policy distorts farmers' incentives, by encouraging them to produce more of a crop that has become increasingly inferior over time (as incomes have grown), and for which there are already excess stocks. The policy also increases the prices paid by local consumers across the country for flour and generates high carryover stocks that are vulnerable to spoilage and pilferage. An export subsidy policy of US\$120 per ton was announced in June 2016 with traders seeking an additional US\$60 per ton. However, even these generous export subsidies have not been effective in encouraging significant levels of wheat exports.

The system comes at huge costs, both direct and indirect (Table 16)

Often deemed to be ineffective in stabilizing prices and making wheat more affordable, the wheat procurement system is plagued with patronage and rent-seeking, with smaller farmers particularly disadvantaged. The entire cost of the program is enormous, with the direct costs of buying, storing and releasing wheat at a fixed price over the year estimated at Rs. 35 billion annually.⁸⁵ Indirect costs are also substantial and include physical losses due to poor storage and high spoilage; pilferage; over-production of wheat and a consequent under-production of other higher value commodities; diversion of credit from the banking system; and a disincentive for the private sector to build storage facilities that would also be available for other crops besides wheat.

Table 16: Wheat subsidy per kg in Punjab

Rupees

Year	Procurement price	Incidentals cost	Cost price	Release price	Subsidy	Subsidy per MT
FY06	10.4	1.7	12.1	10.8	1.4	1,360
FY07	10.6	1.9	12.6	11.6	0.9	950
FY08	15.6	2.0	17.6	15.6	2.0	2,000
FY09	23.7	4.0	27.8	18.8	9.0	9,000
FY10	23.7	4.2	28.0	25.0	3.0	3,000
FY11	23.7	7.3	31.1	25.0	6.1	6,060
FY12	26.2	8.1	34.3	28.1	6.2	6,190
FY13	30.0	7.9	37.9	33.2	4.7	4,730
FY14	30.0	8.8	38.8	33.2	5.5	5,530

Source: Own calculations based on data from Punjab Food Department

⁸⁴ Ranging from between Rs. 120 to Rs. 150 billion annually.

⁸⁵ Of which more than 90 percent consists of interest payments both on current borrowing and accumulated debt.

A more efficient alternative does exist, however

There is an alternative to this system, however, which could replace the existing system with one that combines: (i) a targeted income transfer program; (ii) reducing procurement quantity and stock limits to a level required for an emergency reserve; (iii) the private sector assuming a leading role in the wheat market; (iv) a liberalized trade regime; and (v) an incentive program for farmers to diversify that would be financed from the freed up fiscal resources. This alternative would lower prices of wheat and wheat flour, incentivize farmers to diversify into higher-value commodities that would result in higher incomes, and result in net consumers and producers both being better off.

A proposed reform plan would entail more intensive private sector engagement

Such an alternative in the case of the Government of Punjab would involve the public sector withdrawal from the wheat market, with the private sector filling the capacity and trade gaps. The proposed reform could also have the following features:

- Farmers negatively impacted by the drop in the wheat price would be compensated by a direct income transfer based on the difference between the prevailing market price at harvest and the Government of Punjab's previously announced procurement price. This transfer would be capped (both in terms of quantity and time duration) and would be made eligible to a broad range of farmers.
- Creation of a strategic wheat reserve adequate to meet needs during emergencies and disasters. This strategic reserve could eventually be held by the private sector on behalf of the government, but in the short-term the government would need to build good quality silo storage.
- Disposal of the existing wheat stock to the domestic market to avoid further losses—either through open auction setting a floor price or using a cascading price. Following the move towards silo-based, and eventually private sector-managed, near-farm storage of about 1 million tons, the existing warehouses owned by the Food Department would no longer be needed and would be sold or leased out.
- The deregulation of private sector wheat imports would allow traders to import wheat in times of domestic shortages. The government would not intervene in the domestic wheat market unless prices were to rise above the current level of Rs. 1,300/40kgs. If this were to occur, then the Trading Corporation of Pakistan (TCP) would import and release subsidized wheat onto the domestic market. The current regulatory duty on wheat imports (60 percent since September 2016) would be gradually phased out over a three-year period, which would coincide with the phasing out of the proposed compensation to farmers.

These reforms would generate immediate benefits

Abolition of the current wheat procurement system would immediately result in net annual savings of Rs. 26 billion per year. In addition, the sale of excess wheat stocks would generate another Rs. 150 billion, which could potentially be used to reduce the fiscal burdens being carried by the provincial government.⁸⁶ Multiple social benefits of the program would also materialize, including a lower domestic price of wheat and crop diversification into high value-added crops.

⁸⁶ Either to pay off their debt of Rs. 250 billion to the State Bank of Pakistan or to finance the income transfer program.

While some would be disadvantaged by the reforms, the beneficiaries would be broad-based

Nevertheless, larger farmers would still be disadvantaged by the proposed reform plan, as they would no longer benefit from higher wheat prices. In addition, banks and manufacturers of gunny bags would also lose business. On the other hand, consumers of wheat across the country would enjoy lower prices, producers would be incentivized to invest in high value-added crops, and the Government of Punjab would benefit from immediate cost savings and overall lower costs in the future.

4. Reducing poverty and boosting shared prosperity in Punjab: the equity challenge⁸⁷

Punjab is Pakistan's most populous and

Over the past decade and half, it has made enormous progress against extreme poverty, more than halving its headcount poverty rate, from 61 percent in FY02 to 25 percent in FY14.

Despite the robust decline in poverty, Punjab continues to face important challenges. The pace of urbanization was slow

With only a third of Punjab's population living in an urban area by FY14, implying an increase of only 4.5 percentage points in the urban population share between FY02 and FY14. In contrast, the urban population share in Sindh is at 50 percent, with a commensurate increase in the urban population share of 10.9 percentage points over the same period. The rate of progress for the poorest and richest segments of the population was uneven. Overall, inequality increased between FY02 and FY14, and rural areas lagged substantially behind urban areas, with the rural poverty rate almost twice as high as the urban rate.

Structural change has been slow

The share of employment in non-agriculture has grown sluggishly overall. Agriculture accounted for 39 percent of all employment in FY14, and 64 percent of female employment. There was an encouraging increase in paid work among female workers but the overall labor force participation among women remains extremely low.

Finally, the improvement in living standards has not been matched by comparable gains in human development

Enrollment in primary school has more or less flat lined over the past decade. There has been even less improvement at the higher educational level. Overall, access to education and health services is highly unequal between the rich and the poor as well as between urban and rural areas.

⁸⁷ The information for this note is derived from the Household Integrated Economic Survey (HIES), unless otherwise specified.

a. Trends of Poverty, vulnerability and shared prosperity

Punjab saw a sharp and consistent decline in poverty between 2001 and 2014

Based on the poverty line established in 2014,⁸⁸ Punjab reduced monetary poverty by 35.9 percentage points in 13 years; from 61.2 percent in FY02 to 25.3 percent in FY14 (Figure 42). This pace of reduction was the second-fastest in the country, slower than the 46.2 percentage points in KP but faster than the 30.8 percentage points in Sindh and the 14.4 percentage points in Baluchistan. Punjab had the lowest poverty rate throughout this time period. Similar to the rest of Pakistan, the largest poverty reduction in Punjab (4 percentage points per year) occurred between FY02 and FY06, which is the period when GDP per capita growth rose rapidly and peaked at 5.5 percent in 2005. Since then, as growth has slowed, poverty has continued to decrease but at a slower pace. Among the poor, welfare has also improved, bringing the poor closer to poverty line, hence reducing the amount of resources needed to eliminate poverty (Figure 43).

Figure 42: Poverty trends in Punjab, 2001-14

Percent

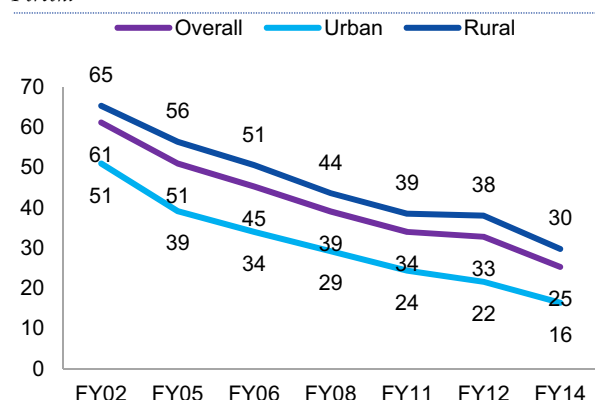
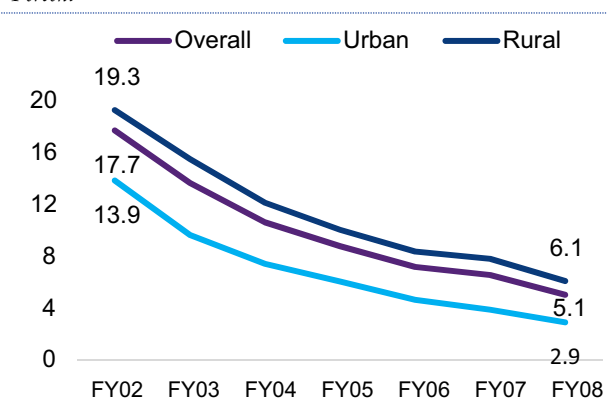


Figure 43: Vulnerable population in Punjab

Percent



Source: World Bank staff calculations based on HIES

The poor are concentrated in rural areas

In FY14, the poverty rate in rural Punjab was twice as high as in urban areas, and four out of five of Punjab's poor lived in rural areas. While remarkably high, the difference between urban and rural poverty rates in Punjab (13.4 percentage points) was the lowest compared with other provinces, and rural Punjab still experienced a similar pace of poverty reduction as urban Punjab. Most of Punjab's districts have done better than those in other provinces. By FY15, Punjab had 12 out of the 20 richest districts in Pakistan and none of the 20 poorest districts.⁸⁹

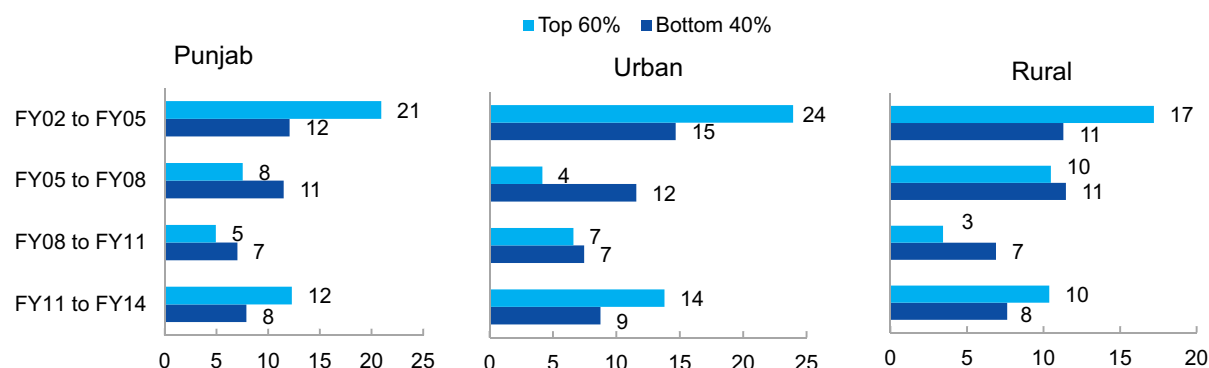
Economic growth in Punjab has not always been pro-poor, and inequality has increased

Over the entire period between FY02 and FY14, the consumption of the poorest 40 percent grew less than that of the top 60 percent, and the gap was bigger in urban areas (Figure 44). This is particularly true during the two periods of higher consumption growth (FY02-05 and FY11-14). This has resulted in widening inequality, with the Gini coefficient increasing from 27.5 in FY02 to 29.7 in FY14, making Punjab the most unequal province in Pakistan. This inequality was highest and increased most in urban areas.

⁸⁸ Responding to the decline in poverty, the government of Pakistan updated the national poverty line in April 2016 using the most recent household survey (HIES 2013-14). The 2014 poverty line was based on the Cost of Basic Needs method and was set at an expenditure level of Rs. 3,030 per adult equivalent per month in 2014 rupees. For all years before 2013-14, the poverty line was back-casted using the survey-weighted CPI.

⁸⁹ Estimation based on imputation between PSLM Survey 2014-15 and HIES 2013-14.

Figure 44: Shared prosperity in Punjab: Growth rate of real consumption expenditure per adult equivalent



Source: World Bank staff calculations based on HIES (base year for real consumption is 2001-02)

b. Beyond poverty: Trends in human development outcomes

Punjab's labor market was able to accommodate its fast growing labor force

Over the period between FY02 and FY14, the working-age population⁹⁰ of Punjab increased on average by 3 percent a year. Despite the strong demographic pressure, enough jobs were created to maintain the unemployment rate at a very low level (around 3-4 percent) and the share of employed in the working age population constant at around 50 percent.

Still, low levels of labor force participation remain a concern

In FY14, labor force participation in Punjab was only 53 percent, mostly due to the low level of female labor market activity. Women's economic empowerment remains an important challenge in Punjab, with only one in four women economically active in 2013-14, despite gains in literacy and education levels.

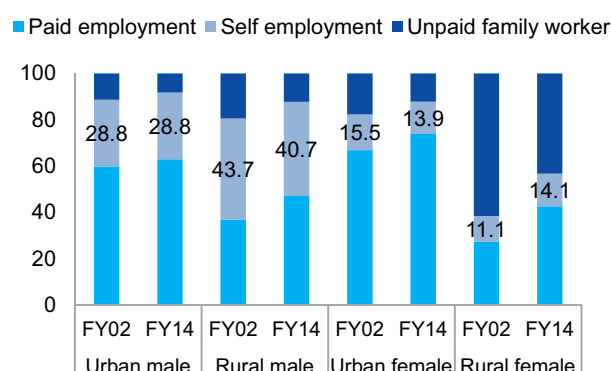
Economic progress was accompanied by an increase in paid employment

The shift out of unpaid work was particularly noticeable in rural areas, where the share of paid employment increased by 10.2 percentage points among male workers and by 15.3 percentage points among female workers (Figure 45). Among men, this shift was accompanied by a move from agriculture into industry: by FY14, 26.5 percent of rural men worked in manufacturing, up from 19 percent in FY02, whereas rural women tended to stay within agriculture, but towards paid work (Figure 46). In urban areas, the shift towards paid employment was less significant, but there was a shift from low-skilled services into manufacturing, among both men and women.

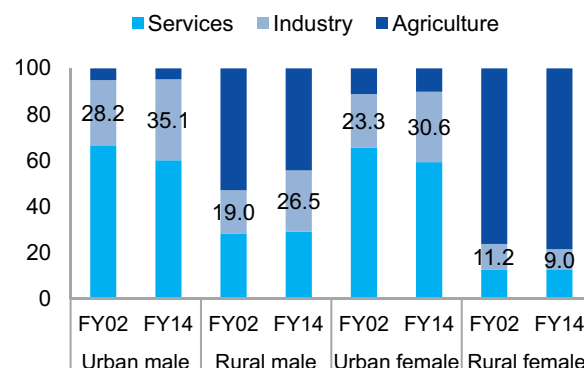
⁹⁰ Working age population includes individuals aged 15 to 64.

Figure 45: Employment type among the employed working age (15–64) in Punjab

Percent

**Figure 46: Employment sector among the employed working age (15–64) in Punjab**

Percent



Source: World Bank staff calculations based on HIES.

Education is an important channel for economic mobility and improvement in employment quality

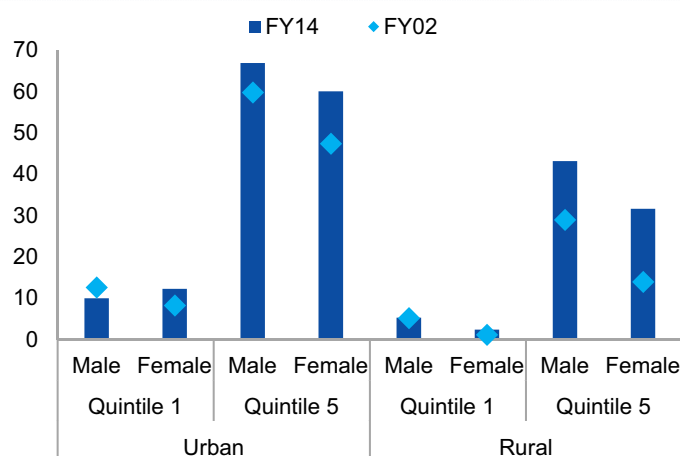
However, inequality in education opportunities remains evident

Punjab saw a 9.6 percentage point increase in the share of adults completing lower secondary school between FY02 and FY14. This may account for some of the improvement in job quality, particularly among women. Households with at least one adult with lower secondary school education or higher were less likely to be poor.⁹¹ Looking within Punjab, districts that achieved higher rates of poverty reduction also did well on lower secondary school completion rates overall, and among women.

There is a stark and persistent gap, between the bottom and top quintiles, in the share of adults having completed lower secondary school in both urban and rural areas (Figure 47). Enrollment levels have shown virtually no improvement over the past decade, in both primary and middle school, with children from the poorest families continuing to fare the worst, particularly in rural areas (Figures 48 and 49). By FY14, for example, 74.7 percent of girls aged 5-9 in the top quintile in rural areas were enrolled in primary school, compared with only 42.7 percent in the bottom quintile. Similarly, 34.4 percent of girls aged 10-12 in the top quintile in rural areas were enrolled in middle school. Their peers in the bottom quintile, in contrast, had a net enrolment rate of only 6.8 percent.

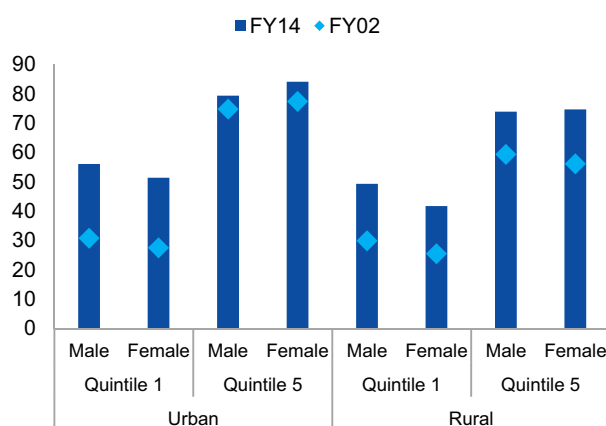
⁹¹ Controlling for urban/rural, household size and composition and the employment structure of the household.

Figure 47: Completion of low secondary school (grade 10) among adults (aged 18+) in Punjab
Percent



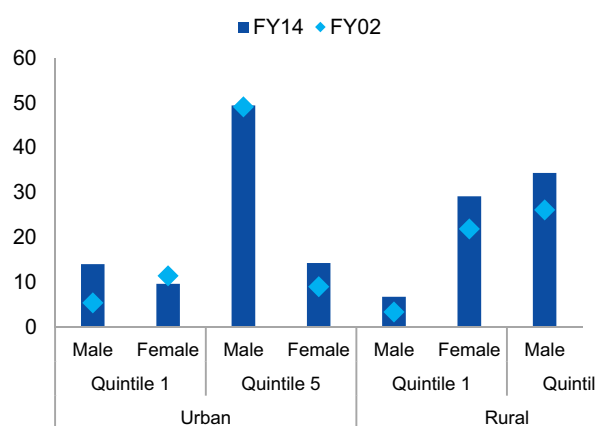
Source: World Bank staff calculations based on HIES and PSLM.

Figure 48: Net enrolment in primary school (aged 5-9) in Punjab
Percent



Source: World Bank staff calculations based on HIES

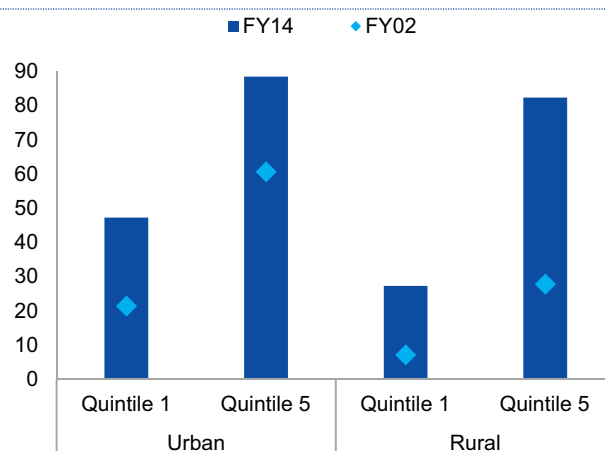
Figure 49: Net enrolment in middle school (aged 10-12) in Punjab
Percent



Turning to other human development outcomes, there has been a significant improvement in access to maternal health services though inequality increased

Over the period from FY02 to FY14, the share of women receiving pre- and post-natal care and giving birth in a health facility more than doubled. However, the gap between rural and urban areas remained unchanged. More importantly, the gap between rich and poor in rural areas has increased over time (Figure 50). Among the bottom quintile, an alarmingly large share of births was still taking place at home (52.7 percent in urban areas and 72.7 percent in rural areas).

Figure 50: Share of birth given in hospital, by area of residence and consumption quintile in Punjab
Percent



Source: World Bank staff calculations based on HIES

ANNEX: PAKISTAN'S SOCIAL INDICATORS

Indicator	2005	2010	2013	2014	2015	2016
Education						
Gross enrolment rate for primary (6-10 years)	85%	91%	92%	91%	91%	-
Punjab	93%	98%	98%	100%	98%	-
Sindh	74%	82%	81%	78%	79%	-
Khyber Pakhtunkhwa	80%	89%	92%	92%	92%	-
Balochistan	65%	75%	73%	66%	73%	-
Net primary enrolment ratio (5-9 years)	52%	56%	57%	57%	57%	-
Punjab	58%	-	62%	64%	61%	-
Sindh	48%	-	52%	48%	51%	-
Khyber Pakhtunkhwa	47%	-	54%	54%	56%	-
Balochistan	47%	-	45	39%	46%	-
Gross enrolment rate for middle school (11-13 years)	53%	62%	63%	59%	62%	-
Gross enrolment rate for matric level (14-15 years)	43%	55%	57%	57%	58%	-
Percentage of schools with basic facilities (electricity, water, toilets, boundary wall)	-	-	-	-	-	52%
Punjab	-	-	-	-	-	93%
Sindh	-	-	-	-	-	23%
Khyber Pakhtunkhwa	-	-	-	-	-	44%
Balochistan	-	-	-	-	-	26%
Proportion of students in year 5 who can read a story in Urdu, Sindhi or Pashto	-	52%	50%	46%	55%	-
Punjab	-	-	66%	63%	-	-
Sindh	-	-	41%	41%	-	-
Khyber Pakhtunkhwa	-	-	39%	38%	-	-
Balochistan	-	-	49%	33%	-	-
Literacy rate (10 years and older)	53%	58%	60%	58%	60%	-
Punjab	55%	60%	62%	61%	63%	-
Sindh	56%	59%	60%	56%	60%	-
Khyber Pakhtunkhwa	45%	50%	52%	53%	53%	-
Balochistan	37%	41%	44%	43%	44%	-
Expenditure on education (% of GDP)	1.8	1.7	2.1	2.1	-	-
Health						
Child immunization rate (full immunization based on records)	49%	-	57%	58%	60%	-
National - urban	61%	-	66%	70%	70%	-
National - rural	41%	-	54%	53%	56%	-
Punjab	58%	-	65%	69%	70%	-
Sindh	46%	-	42%	40%	45%	-
Khyber Pakhtunkhwa	40%	-	53%	62%	58%	-
Balochistan	31%	-	29%	27%	27%	-
Infant mortality rate (per 1000 births)	80	73.5	69.1	67.4	65.8	-
Maternal mortality rate (per 100,000 live births)	249	211	190	184	178	-
Life expectancy at birth	63.9	65.2	66.0	66.2	-	-
Male	63.0	64.3	65.1	65.3	-	-
Female	64.8	66.1	66.9	67.2	-	-
Physicians per 1000 population	0.74	0.80	0.87	0.89	0.91 (P)	-
Expenditure on health (% of GDP)	0.6	0.5	0.6	0.7	-	-

Indicator	2005	2010	2013	2014	2015	2016
Poverty						
Poverty headcount based on 2001 poverty line (percent)	21.9	12.2	9.3	-	-	-
Punjab	18.2	12.1	8.3	-	-	-
Sindh	21.6	11.9	10.6	-	-	-
Khyber Pakhtunkhwa	26.8	12.7	6.1	-	-	-
Balochistan	50.7	14.6	22.4	-	-	-
Poverty headcount based on FY14 poverty line (poverty, earlier years back casted)	50.4	36.8	29.5	-	-	-
Punjab	45.3	34.0	25.3	-	-	-
Sindh	50.9	37.7	34.2	-	-	-
Khyber Pakhtunkhwa	60.2	42.3	27.6	-	-	-
Balochistan	76.5	48.9	56.8	-	-	-
Shared Prosperity (percent growth in real consumption of the bottom 40%)	3.0	7.6	6.5	-	-	-
Punjab	5.1	7.0	6.1	-	-	-
Sindh	1.7	6.5	6.4	-	-	-
Khyber Pakhtunkhwa	3.4	5.0	11.1	-	-	-
Balochistan	-9.0	21.7	2.5	-	-	-
Water & sanitation						
Percent of households whose main source of drinking water is improved water ⁹³	-	88	-	89	-	-
Punjab	-	94	-	96	-	-
Sindh	-	89	-	87	-	-
Khyber Pakhtunkhwa	-	72	-	75	-	-
Balochistan	-	50	-	62	-	-
Percent of households whose main source of drinking water is tap water	-	32	-	27	-	-
Punjab	-	24	-	18	-	-
Sindh	-	43	-	41	-	-
Khyber Pakhtunkhwa	-	45	-	35	-	-
Balochistan	-	35	-	33	-	-
Percent of households with a flushing toilet	-	66	-	73	-	-
Punjab - urban	-	97	-	98	-	-
Punjab - rural	-	61	-	70	-	-
Sindh - urban	-	95	-	97	-	-
Sindh - rural	-	26	-	31	-	-
Khyber Pakhtunkhwa - urban	-	91	-	97	-	-
Khyber Pakhtunkhwa - rural	-	56	-	71	-	-
Balochistan - urban	-	84	-	78	-	-
Balochistan - rural	-	16	-	14	-	-
Percent of households with no toilet facility at home	-	18	-	13	-	-
Punjab - urban	-	2	-	1	-	-
Punjab - rural	-	33	-	24	-	-
Sindh - urban	-	1	-	1	-	-
Sindh - rural	-	14	-	16	-	-
Khyber Pakhtunkhwa - urban	-	3	-	1	-	-
Khyber Pakhtunkhwa - rural	-	21	-	14	-	-
Balochistan - urban	-	2	-	0	-	-
Balochistan - rural	-	16	-	18	-	-

⁹³ * Improved water include: piped water, motorized pump, hand pump, tube well, covered well, protected spring, filtration plant, rainwater

Indicator	2005	2010	2013	2014	2015	2016
Nutrition						
Percentage of population that is moderately or severely stunted	-	43.7	-	-	-	-
Punjab	-	39.2	-	-	-	-
Sindh	-	49.8	-	-	-	-
KP	-	47.8	-	-	-	-
Balochistan	-	52.2	-	-	-	-
FATA	-	57.6	-	-	-	-
AJ&K	-	31.7	-	-	-	-
Gilgit	-	50.6	-	-	-	-
Percentage of children who started breastfeeding within 1 day of birth	-	-	57.9	-	-	-
Percentage of children who were born with a birth weight under 2500g	-	-	25	-	-	-
Percentage of children under 6 months old who were exclusively breastfed	-	-	38	-	-	-
Gender						
Gender development index (ranking of 161 countries)	-	-	-	121	--	-
Adolescent birth rate (births per 1000 women aged 15-19)	-	30.9	27.3	-	27.3	-
Share of seats in Parliament held by women	21.3	22.2	20.7	20.7	20.6	-
Female labor force participation rate (% of female population ages 15+)	19.3	23.9	24.6	24.8	-	-
Ratio of female to male lower secondary completion rate	73	78	81	83	-	-
Gender parity index for primary education	-	0.88	0.89	0.88	0.88	-
Gender parity index for secondary education	-	0.85	0.89	0.84	0.87	-
Ratio of female to male literacy rate (10 years and older)	0.62	0.67	0.68	0.67	0.70	-
Punjab	0.68	0.73	0.76	0.73	0.77	-
Sindh	0.60	0.65	0.65	0.64	0.70	-
Khyber Pakhtunkhwa	0.41	0.49	0.50	0.50	0.49	-
Balochistan	0.37	0.32	0.37	0.42	0.41	-

Sources: PSLM (various years), Alif Ailaan Pakistan District Education Rankings, Annual Status of Education (various years), Economic survey of Pakistan (various years), World Bank World Development Indicators, World Bank gender data portal, National Nutrition Survey 2011, Pakistan Demographic Health Survey 2012-13, Gender Development Index (UNDP)



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