1. Country Background

Pakistan’s economic and social performance is improving. Macroeconomic balances have improved, economic growth has picked up, social indicators are starting to improve, and structural reforms are continuing to advance. However, poverty is widespread and sustaining growth in the context of macroeconomic stability has proved challenging in the past.

2. Operation Objectives and Description

The proposed operation is the second Poverty Reduction Support Credit (PRSC II) to support the implementation of Pakistan’s poverty reduction strategy. This strategy is summarized in the Government of Pakistan’s 2003 Poverty Reduction Strategy Paper (PRSP), entitled “Accelerating Economic Growth and Reducing Poverty: The Road Ahead.” It emphasizes sustained, rapid growth as the main vehicle for poverty reduction and is grounded on four pillars: (i) achieving sustained high and broad-based economic growth, while maintaining macroeconomic stability; (ii) improving governance and consolidating devolution, both as a means of delivering better development results and ensuring social and economic justice; (iii) investing in human capital, with a renewed emphasis on effective delivery of basic social services; and (iv) targeting the poor and vulnerable, to bring the marginalized sections of the population and backward regions into the mainstream of development, and to make marked progress in reducing existing inequalities. The government is currently in the process of preparing a second PRSP. This strategy is expected to draw upon outcomes and data that have become available since the 2003 PRSP was prepared, and also take into account developments on the economic front that require an adjustment in the macroeconomic framework. A strategy for recovery of earthquake-affected areas is expected to be part of PRSP II.
Pakistan’s PRSCs are one-tranche programmatic operations to support the next phase of the Government of Pakistan’s medium-term reform program, laid out in the PRSP. The PRSC program would monitor the key areas of the PRSP, and each credit under the PRSC program would be disbursed against a selected set of prior actions. The PRSC II supports selective reforms by the government that will contribute to sustain rapid growth by: (i) maintaining macroeconomic stability; (ii) improving the management and effectiveness of public expenditures; (iii) implementing the government’s Power Sector Action Plan; (iv) supporting the privatization program and improving the regulatory framework for competition; (v) enhancing female labor force participation and labor market flexibility; and (vi) improving the management of water resources. The PRSC II will also support improved governance through reforms to improve financial reporting and budget execution. Service delivery of public health and education is largely a provincial and local government mandate. However, the proposed credit will support accelerated progress in human development by (i) creating additional public resources for education and health, (ii) strengthening the health and education national sector policies; and (iii) piloting innovative education and health programs, focusing on the poor, to enhance demand for these services. The PRSC II also supports improved support to the poorest and most vulnerable segments of the population, through targeted programs aimed at addressing poverty and vulnerability directly.

The PRSC Reform Program

The Bank supported the first phase of implementation of the PRSP with a first PRSC, which was approved by the Bank’s Board and disbursed in September, 2004. The first year of the PRSC program overlapped with and complemented the last year of implementation of the macro stabilization program supported by the IMF with a PRGF, which ended in December of 2004. PRSC I was closely aligned with the PRSP’s four pillars. Because Pakistan’s poor growth performance was at the root of worsening poverty in the 1990s, the PRSC program emphasizes policy reforms to help accelerate and sustain rapid growth.

While economic growth is expected to be the main driver of poverty reduction, the PRSP for Pakistan also recognizes the need to strengthen Pakistan’s safety nets targeting the poorest and the vulnerable. An analysis of the country’s safety nets and steps towards strengthening the country’s main safety net programs are being supported under the PRSC program. The PRSP also emphasizes policies to accelerate progress in education and health indicators, in which Pakistan lags behind nearly all South Asian countries. While in Pakistan the responsibility for improving service delivery in education, health, and water and sanitation rest primarily with provincial and local governments, the PRSC program focuses on those critical policy and institutional reforms that are in the domain of the federal government only. Sub-national operations, such as the Punjab Education DPCs and the NWFP and Sindh DPCs support improvements in the delivery of these services by provincial governments. The PRSC program does support a public expenditure framework that prioritizes not only increased expenditures on key infrastructure for growth, but also a significant increase in education and health expenditures. The PRSC program also supports key steps in improving governance. The Government of Pakistan is making progress in strengthening its financial management and procurement systems, and significant steps in this process are being supported by the PRSC program.
3. **Rationale of Bank’s Involvement**

The Bank’s assistance strategy to Pakistan is guided by the Bank Group’s Country Assistance Strategy (CAS), discussed by the Board on June 11, 2002. The Bank is currently preparing a new CAS to cover FY06-09, which is expected to be presented to the Bank’s Board in June 2006. The elements of the draft CAS focus on three pillars, aligned with the strategic priorities of the government’s PRSP: (i) sustaining growth and improving competitiveness; (ii) improving government effectiveness and service delivery; and (iii) improving lives and protecting the vulnerable.

4. **Financing**

The IDA credit, in an amount equivalent to US$300 million, will be disbursed in one tranche upon effectiveness.

5. **Institutional, Implementation, and Monitoring Arrangements**

The implementation of the PRSC’s ambitious, multi-sectoral reform program requires effective coordination between Government Ministries and agencies. The PRSP Secretariat in the Ministry of Finance will remain the focal point for the PRSC and will oversee the implementation of reforms. Progress toward PRSP objectives is being supported by improvements in government systems to collect, analyze and disseminate data. The Secretariat also collates information from various sources, identifies information and data gaps, and produces progress reports, based on a set of indicators agreed upon by federal and provincial governments as well as the international donor and domestic community. Since PRSP’s completion in December 2003, the government has regularly prepared Annual and Quarterly PRSP Progress reports, which are available on the web. Progress reports track and analyze pro-poor public expenditures and their sectoral composition and provincial patterns within the context of the macroeconomic situation in the country. In addition, the reports also monitor PRSP intermediate indicators, PRSP and social sector performance, employment, non-budgetary expenditures, and special programs for poverty reduction.

6. **Benefits, Risks, and Mitigating Measures**

*Benefits*

The PRSC’s support for the reform program is expected to contribute to sustaining rapid per capita growth for an extended period of time. This, along with policy reforms and public investments to increase the poor’s participation in economic growth, is expected to contribute to the reduction in poverty incidence.

*Risks and Mitigation*

(i) Risks to the fiscal outlook due to expenditure pressures resulting from the October 8, 2005 earthquake and to external balances due to a rising trade imbalance.
(ii) Implementation risks stemming from technical and institutional capacity constraints. Weaknesses in implementation capacity and institutional coordination are expected to decline as institutions are strengthened and local capacity is built.

(iii) Risks of exogenous shocks and natural disasters. The Bank is working with the government to strengthen hazard risk management and capacity to minimize exposure to exogenous shocks and natural disasters.

(iv) Political and security risks.

The Bank is mitigating some of these risks by sustaining and deepening its policy dialogue, supporting reforms and capacity building of key government institutions. While implementation delays could arise, the Bank’s program mitigates against this risk by disbursing against an agreed set of prior actions.

While overall risks to the operation remain relevant, they have diminished as a result of a demonstrated ownership of the PRSP’s reform program by the elected government and the continuity of economic and social policies over the past five years.

7. Environment Aspects

The specific country policies proposed in the proposed PRSC II are unlikely to cause significant environmental impact. It is possible, however, that the indirect effects of these policies will generate environmental benefits by promoting economic diversification and a less resource-intensive economic structure.

8. Contact Points

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