PAKISTAN DEVELOPMENT UPDATE

Making growth matter

November 2016

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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 reform 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 poverty, nutrition, Karachi urban planning and infrastructure, and the FY17 federal budget.

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Acronyms and abbreviations

AJ&K	Azad Jammu and Kashmir	LHS	Left-hand side
CBN	Cost of basic needs	LNG	Liquified natural gas
CPEC	China-Pakistan Economic Corridor	LSM	Large-scale manufacturing
CPI	Consumer price index	MFN	Most-favored nation
CSF	Coalition Support Fund	NBFI	Non-bank financial institution
DB	Doing Business	NDA	Net domestic assets
DFAT	Australian Department of Foreign Affairs and Trade	NFIS	National Financial Inclusion Strategy
DFID	UK Department for International Development	NHA	National Highway Authority
EFF	Extended fund facility	NNS	National nutrition survey
EU	European Union	OMO	Open market operations
FAO	Food and Agriculture Organization of the United Nations	PBS	Pakistan Bureau of Statistics
FATA	Federally Administered Tribal Areas	POL	Petroleum, oil and lubricants
FBR	Federal Board of Revenue	PPHS	Pakistan Panel Household Survey
FDI	Foreign Direct Investment	PPIN	Pakistan Partnership for Improved Nutrition
FEI	Food energy intake	PSDP	Public Sector Development Program
FRDLA	Fiscal Responsibility and Debt Limitation Act	PSLM	Pakistan Social and Living Standards Measurement
FY16	Financial year 2015-16	REER	Real effective exchange rate
GCC	Gulf Cooperation Council	RHS	Right-hand side
GDP	Gross Domestic Product	ROA	Return on assets
GST	Goods and services tax	ROE	Return on equity
HIES	Household integrated economic survey	Rs.	Pakistani Rupees
IMF	International Monetary Fund	SBP	State Bank of Pakistan
IRC	Incremental risk capital	SME	Small and medium enterprises
KCD	Karachi city diagnostic	SUN	Scaling-up Nutrition
KIBOR	Karachi inter-bank offer rate	UK	United Kingdom
KP	Khyber Pakhtunkhwa	US	United States
KSE	Karachi Stock Exchange	WB	World Bank
LBW	Low birth weight	WTO	World Trade Organisation

Executive summary

To make growth matter, Pakistan needs to invest its economic gains in health, education and nutrition

Pakistan's growth accelerated in FY16, driven by consumption while investment remained low. Exports continued to fall when soft global demand exacerbated the effects of Pakistan's long-term decline in competitiveness. After achieving macroeconomic stability, the government continued to deliver on its structural reform agenda in FY16, but much remains to be done if growth is to be strengthened and sustained. The government's next challenge will be to invest in health, education and nutrition; Pakistan's staggering fall in poverty over the last 14 years has not been accompanied by a similar improvement in wellbeing. The country's long-term growth depends on this investment in its people—this is what will make growth matter for Pakistanis.

Pakistan's growth is beginning to catch up with its regional neighbors

Pakistan's growth started to catch up with its regional neighbors in FY16 with gross domestic product (GDP) expanding at 4.7 percent—the highest rate in eight years and a significant increase from the previous year's 4.0 percent. While India's growth (7.6 percent) continued to lead the pack in South Asia, Bangladesh and Pakistan began to strengthen relative to others. The South Asia region grew by 6.8 percent year-on-year in the second quarter of 2016, continuing to outpace East Asia and the Pacific (6.3 percent) while other regions experienced slow or negative growth.

Growth in FY16 was driven by strong domestic demand

Amidst an environment of soft global demand, Pakistan's growth in FY16 was driven by strong domestic demand. Consumption accounted for an overwhelming 92 percent of GDP in FY16, and contributed 7 percentage points towards GDP growth (moderated by a negative contribution of 2.2 percent from net exports), supported by sustained growth in remittances. Strong aggregate demand and improving business sentiments were evident in private sector credit growth of 12 percent, expanding by Rs. 461 billion in FY16 compared with Rs. 224 billion in FY15. Low inflation and low interest rates also contributed to higher credit growth.

An increase in foreign investment flows from China (to fund CPEC projects) made a small contribution to growth. The government's efforts to stabilize the macroeconomic environment provided a better footing for economic activity, while marginal improvements in energy supplies facilitated manufacturing growth in particular.

Low rates of investment continue to constrain growth

The low and stagnant investment rate, however, continues to pose significant challenges. After strong growth in FY15 of 13 percent, investment grew by only 5.7 percent in FY16. The ratio of investment to GDP is 15.6 percent—compared with an average rate in South Asia of 34 percent between 2010 and 2015. Pakistan's much lower rate of investment is driven by its volatile security situation, energy shortages and poor business regulatory environment (now ranked 144 of 190 countries). The World Bank's 2017 Doing Business report found that Pakistan improved four ranks in 2017—placing it among the top ten 'most improved' countries—although this was preceded by a fall of 72 ranks between 2008 and 2016. The implementation of the federal and provincial governments' joint action plan to improve the investment climate will be one important step towards reversing this long-term trend.

Exports continued to fall—highlighting Pakistan's worrying decline in export competitiveness

FY16 saw the continuation of a longstanding decline in Pakistan's share in global trade. This trend is a combined reflection of Pakistan's weakening export competitiveness and soft global demand in key sectors. Food and textiles, in particular, are key contributors to Pakistan's exports and continue to suffer from a decline in international prices and demand. For example, although Pakistan exported more rice in FY16 than in FY15, lower international prices translated to a lower total value of rice exports. More generally, Pakistan's decline in competitiveness has been driven by poor trade facilitation, infrastructure gaps, inefficient logistics and a poor investment climate.[1] Pakistan has also lagged behind its competitors in trade openness, reducing its prospects of regaining export momentum. The simple average tariff has fallen only slightly from 14.4 percent in FY13 to 13.4 percent in FY16.

The budget deficit has shrunk as revenue growth has outpaced expenditure growth

The government continues to make progress on fiscal consolidation, reducing the consolidated[2] fiscal deficit from 5.3 percent of GDP in FY15 to 4.6 percent in FY16. The FY17 budget implies a further fall in the fiscal deficit to 3.8 percent of GDP. Revenue growth is underpinning the falling deficit, driven in FY16 by a 20 percent increase in the Federal Board of Revenue's (FBR) collection. Some of this collection may, however, affect the progress of other reform efforts. For example, in contrast with efforts to reduce Pakistan's trade tariffs, FY16 saw a 32.7 percent increase in customs duties collection as a result of FBR's attempts to meet revenue targets. Similarly, the recently-introduced withholding tax on financial deposits may have driven customers to circumvent formal banking channels, as the currency-deposit ratio has increased from 0.29 to 0.35 in just one year. A series of new tax measures in the FY17 budget will broaden the tax base and are expected to contribute to another significant increase in FBR revenues. On the expenditure side, the development budget has grown faster than the recurrent budget. In the FY17 budget, an expected reduction in state-owned enterprise subsidies and interest payments has created space for an increase in infrastructure spending, including on CPEC projects. See **Section A2** for a FY16 fiscal analysis and **Section C4** for a FY17 budget analysis.

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[1] These issues were discussed at length in the export competitiveness special section in the April 2016 Pakistan Development Update.

[2] Refers to federal and provincial government budgets combined

The government has continued to deliver on its structural reform program, although challenges remain

The end of the IMF's Extended Fund Facility program in September 2016 marked significant progress in achieving macroeconomic stability over the last three years. Fiscal deficits are significantly reduced, foreign reserves have returned to comfortable levels and inflation is in-check. There remains, however, a significant agenda of economic reform to be implemented. The energy sector has reduced financial losses and load shedding—particularly for industry—but investments in transmission and distribution are desperately needed. The government has also made solid progress on financial sector reforms, but will need to continue to strengthen and diversify the sector and improve its governance and transparency. Continued improvements in tax collection will also be essential for the government's economic agenda, particularly those that widen the tax net and increase provincial revenue collection. See **Section B2**.

Pakistan's recent growth has been accompanied by a staggering fall in poverty

The government recently set a new national poverty line that identifies 29.5 percent of Pakistanis as poor (using the latest available data from FY14). By back casting this line, the poverty rate in FY02 would have been about 64.3 percent. This means that poverty has more than halved between FY02 and FY14, even according to this new and higher metric. The new poverty line was introduced in April 2016 precisely because of Pakistan's success in reducing poverty over the last decade and a half. Using the old national poverty line, set in 2001, the percentage of people living in poverty fell from 34.7 percent in FY02 to 9.3 percent in FY14—a fall of more than 75 percent. Other sources of data corroborate this decline—ownership of assets and dietary diversity also increased over this period. For example, in the bottom income quintile, motorcycle ownership increased from 2 to 18 percent between FY02 and FY14. See **Section C1**.

But growth and poverty reduction have not translated to sustained improvements in wellbeing

Progress on social sectors has, however, stagnated since FY10. Between FY02 and FY08, school enrolment rates increased significantly, coinciding with a rapid reduction in poverty. Gross enrolment rates for girls between age 5 and 9, for example, increased by 22 percentage points in this period. Since FY10, however, Pakistan has seen little progress across a number of key human development indicators. Literacy has remained between 58 and 60 percent since 2010. Enrolment rates for primary school, middle school and matric level have remained constant and only 52 percent of schools are equipped with basic facilities. Stunting remains very high, and the related problems of water quality and poor sanitation are either failing to improve or worsening. These disadvantages are far more concentrated in rural areas than in urban areas, and vary widely between provinces. See **Section B3**.

Malnutrition is a particular concern, with Pakistan experiencing the third highest rate stunting rate in the world

At 43.7 percent, Pakistan has the third-highest rate of stunting in the world.[3] In spite of economic growth, and unlike its regional peers, it has made no progress on nutrition indicators in recent decades. Poor nutrition exerts a heavy toll on health outcomes and economic activity—stunted children start school later, are less likely to graduate or undertake higher education and earn significantly less in adulthood. It also affects lifelong health, hindering brain development, intelligence, educability and productivity. Pakistan's public policy discourse is starting to give more attention to nutrition in recent years, and small but growing shares of provincial and federal budgets are being diverted to addressing it. However, a concerted effort at all levels of government is needed to exert a meaningful impact on national stunting rates. See **Section C2**.

[3] Defined as low height-for-age, also known as chronic malnutrition

Another challenge – shared by all three levels of government – is Karachi's urban planning and infrastructure

A recently completed diagnostic study of Karachi city catalogued its immense planning, infrastructure and service delivery challenges. Given Karachi's role in the national economy as a manufacturing and logistics hub, the city's shortcomings have implications well beyond those acutely felt by the city's residents. Karachi is now ranked as one of the least livable cities in the world. It is characterized by informal settlements (that house a majority of the city's residents), a proliferation of informal service providers and a highly centralized but fragmented governance structure. The diagnostic identifies a reform agenda that aims to build inclusive, coordinated and accountable institutions and address Karachi's critical shortfall in transport, water and sewage infrastructure and services. These efforts will need to seek private sector involvement and introduce greater sustainability and inclusion. See Section C3.

Pakistan's growth is expected to continue to accelerate in FY17 and FY18

In the medium-term, Pakistan's growth is expected to continue to accelerate, reaching 5 percent in FY17 and 5.4 percent in FY18. A moderate increase in investment (related to CPEC projects) is expected to supplement growth driven primarily by public and private consumption. Energy reforms are expected to support higher growth in the industry and services sectors. The agriculture sector is forecast to recover from its poor performance in FY16. Subdued growth in exports and accelerated growth in imports are expected to lead to a widening of the current account deficit from 1.1 percent in FY16 to 1.7 percent in FY17. Like in previous years, this will be offset by remittance inflows so foreign exchange reserves are expected to continue to accumulate. See **Section B1**.

But for sustained growth, Pakistan must implement structural reforms and improve wellbeing for all

But Pakistan's continued growth is not guaranteed. In the short- to medium-term, sustained progress on energy reforms, CPEC implementation and widening the tax net will be important. Without these structural reforms and other efforts to improve the investment climate, Pakistan's rate of investment will remain weak and its consumption-driven growth will eventually slow down. In addition, the 2018 election may have implications for the pace of reform implementation while 'Brexit' and the imminent US interest rate hike may affect the overall macroeconomic environment. In the longer-term, Pakistan's economic and human development relies heavily on better nutrition, health and education outcomes—which would in turn lift the productivity of the workforce. Using Pakistan's economic gains to invest in health, education and nutrition would also significantly lift wellbeing, making growth matter for all Pakistanis.

A. Economic Update

1. Real sector

South Asia continues to lead global growth

2016 has so far seen South Asia continue on a stable growth trajectory, in stark contrast to the economic performance of the rest of the world[4]. The region has remained sheltered from global headwinds such as China's economic sluggishness and monetary policy uncertainty in advanced economies and has benefited from the positive terms of trade shock from lower global oil prices. South Asia continues to be the fastest growing region in the world, as it has been for eight consecutive quarters. This is largely due to growth in public and private consumption, moderate optimism in industry, stable exchange rates, and inflation rates that—despite a modest pickup—remain historically low. This allowed the region to grow by 6.8 percent year-on-year in the second quarter of 2016,[5] led by strengthening economic activity in India, Bangladesh and Pakistan.

Nevertheless, several downside risks persist

Fiscal consolidation across South Asia continues to focus on expenditure cuts rather than revenue generation, in spite of low tax-to-GDP ratios. Debt-to-GDP ratios remain relatively high, political uncertainty persists and expenditure cuts in Gulf Cooperation Council (GCC) countries have led to a decline in remittances inflows in India and Nepal, while Pakistan's remittance growth has slowed.

Pakistan's growth is starting to catch up to its neighbors, driven by strong

Pakistan's economy may have begun the long process of catching up to its regional neighbors in FY16[6] with GDP growth reaching 4.7 percent—the highest rate in eight years and a significant increase from 4.0 percent growth in FY15. While this improvement is a positive sign, the economy could be growing faster; see Section

[4] While East Asia and the Pacific still managed strong growth of 6.3 percent, Latin America and Caribbean and Sub-Saharan Africa suffered from negative growth with Europe and Central Asia recovering to a 1 percent growth in second quarter of 2016, year-on-year

[5] South Asia Economic Focus, Fall 2016, The World Bank

[6] Financial year in Pakistan runs from July to June.

domestic demand and supported by a stable macroeconomic environment

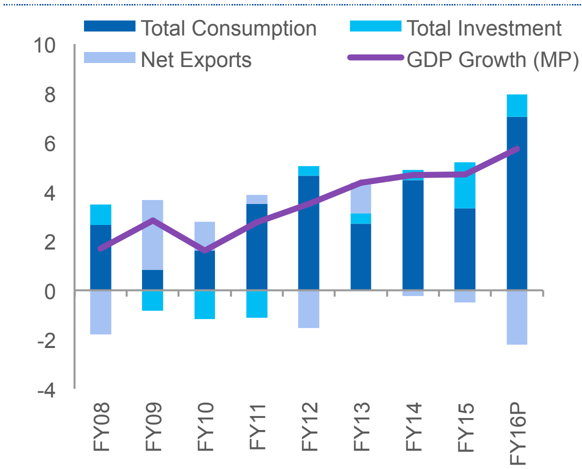
B2 for a discussion of the need for ongoing structural reforms that would help ease the key constraints in the economy. A strong pickup in government-supported construction and manufacturing activities fed into and supported strong domestic public and private consumption. Although large cotton crop losses led to a contraction in agriculture production, this was more than offset by a strong recovery in industry and robust growth in services. A relatively stable macroeconomic environment—due to better fiscal management, low inflation, a stable exchange rate and an accommodating monetary policy—supported this outcome. A marginal two percent increase in electricity supplies also contributed to industrial and services growth.[7] China-Pakistan Economic Corridor (CPEC) projects are generating much higher foreign direct investment (FDI) flows from China[8], but the substantive benefits of these investments will be felt over the medium-term.

On the demand side, consumption remains the largest contributor to growth

It is quite typical for consumption to be the largest component of aggregate demand. However, in the case of Pakistan, consumption constitutes an overwhelming 92 percent of GDP and contributes 7 percentage points towards GDP growth (see **Figure 1**). This has been driven mostly by private consumption, supported by sustained growth in remittances—leading to a record high US$ 19.9 billion of remittances in FY16 (discussed in **Section A3**). In the last fiscal year, the contribution of government consumption to growth has been strong at 1.7 percent. On the other hand, weak performance in net exports dragged down growth by about 2.2 percent.

Figure 1: Consumption remained the largest contributor to GDP Growth in FY16[9]

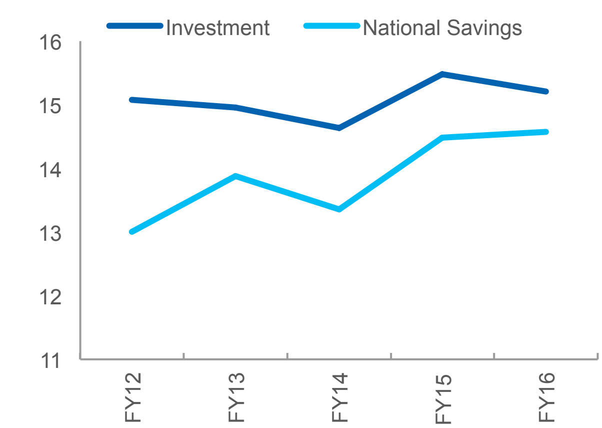
Percent



Source: Economic Survey of Pakistan 2015-16

Figure 2: Saving-investment gap (as percent of GDP)

Percent



Source: Economic Survey of Pakistan 2015-16

Investment continues to stagnate at rates much lower than peer countries

In real terms, investment growth in FY16 decelerated sharply to 5.7 percent from 13 percent in FY15. The ratio of investment to GDP remains relatively low at 15.6 percent. While the private sector's ratio of investment to GDP declined from 10.5 percent of GDP in FY15 to 10.3 percent in FY16, this was balanced by an increase

[7] During FY16 (July – March), total commercial energy supplies (electricity, oil, gas, petroleum products, and coal) were 2 percent higher than the same period in FY15

[8] FY16 total net flows from China were US$ 671 million compared with US$ 268 million in FY15, an increase of 136 percent. The first two months of FY17, however, have seen dwindling flows from China at US$ 26 million compared with US$ 136 million in the same period in FY16. See section A3.

[9] GDP growth at factor cost is 4.71 percent, while GDP growth at market price is 5.74 percent. Pakistan's official growth rate is measured in factor cost.

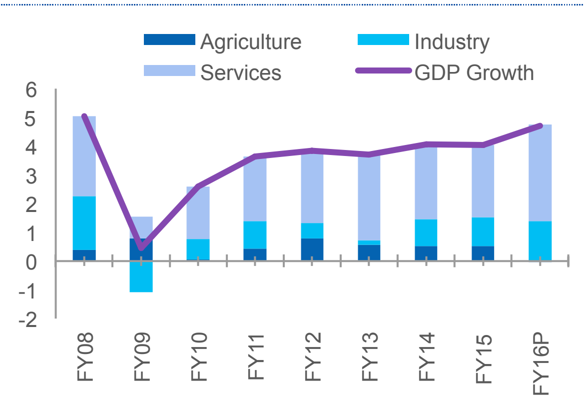
in general government investment. Pakistan's investment rates are low even compared with the South Asian average, which is well below other regions'.[10] Between 2010 and 2015, South Asia's average investment rate was around 34 percent while Pakistan's was less than half that, at 15 percent. A number of factors are responsible for this including: (a) a volatile security situation in Pakistan which has only recently started to improve; (b) the global slow-down, which is affecting foreign direct investment and limiting domestic demand; (c) energy shortages that prevent full capacity utilization and (d) a steady decline in the ease of doing business in recent years. Pakistan's low rate of investment is one of the most significant challenges facing the economy today.

Domestic savings are growing slowly and contributing to a saving-investment gap

Inextricably linked with investment, savings pose another long-term challenge for the economy. National savings reached 14.6 percent of GDP in FY16, only 0.1 percentage point higher than that in FY15 and only 1 percentage point higher than that in FY10 (see **Figure 2**). The slow growth of domestic savings is especially disappointing as they are generally a reliable and consistent source of funds for investment. Domestic savings were 9.8 percent of GDP in FY10 and have been falling steadily to a low of 8.3 percent in FY16. Real interest rates, which were very low until the recent fall in inflation, may partly explain the low rate of household savings.[11] The recent imposition of withholding taxes on financial transactions—although positive in terms of creating incentives for taxpayer registration—may also be slowing Pakistan's financial deepening.

Figure 3: Sectoral contribution to GDP growth - aggregate supply

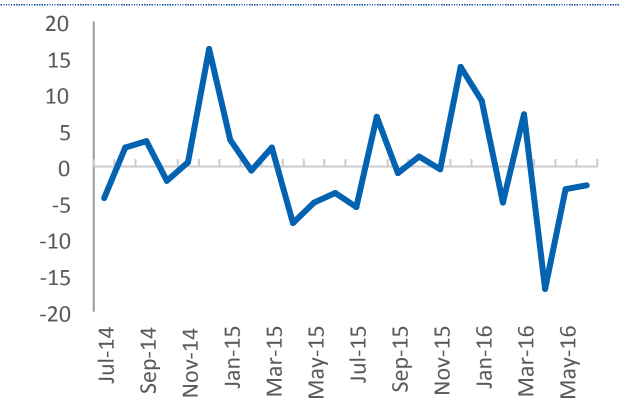
Percent



Source: Pakistan Bureau of Statistics

Figure 4: Quantum growth in large-scale manufacturing (m-o-m)

Percent



Source: Pakistan Bureau of Statistics

On the supply side, the performance of the industrial and services sectors has offset weak agriculture performance

On the supply side, the agricultural sector, representing 19.8 percent of GDP, contracted by 0.2 percent in FY16, compared to growth of 2.9 percent in FY15 (see **Figure 3**). The contraction was largely driven by poor performance of *Kharif*[12] crops, particularly cotton, whose production fell by almost 30 percent compared with FY15. As a result, overall crop sector performance declined by 6.3 percent[13]. Unusual rainfalls and a virulent pest attack (pink ballworm and whitefly) devastated cotton crops in the southern districts of Punjab. As prices are expected to remain

[10] World Bank, South Asia Economic Focus Fall 2016

[11] CPI inflation averaged 9 to 10 percent between FY10 and FY15, implying very low real interest rates. See Section A4.

[12] Includes cotton, rice and sugarcane – season: July to October

[13] This decline in the crop sector was even higher than the 4.2 percent decline caused by the FY10 floods.

low in FY17, farmers may switch to more profitable and water-intensive crops such as sugarcane and corn[14]. In addition to cotton, rice production also suffered in FY16 due to depressed prices, heavy downpours in July 2015 and abundant rice stocks. Although sugarcane and wheat production increased, this was not sufficient to compensate for the crop sector shortfall.

Industry performed above expectations, making up for agriculture's underperformance

Industry, contributing 21 percent of overall GDP, grew by 6.8 percent compared to 4.8 percent in FY15—surpassing the growth target of 6.4 percent in the FY16 Annual Plan. The manufacturing sector grew by 5 percent, 1.1 percentage points higher than FY15. Within manufacturing, large-scale manufacturing (LSM), which accounts for a little over 50 percent of industry, grew by 4.6 percent in FY16 (see Figure 4). Continued soft prices of raw material, relatively improved energy supply, and high private sector credit flows[15] allowed some LSM sub-sectors to grow particularly rapidly, aided in some cases by government subsidies. These include automobiles (16.1 percent), fertilizers (13.8 percent) and cement (10.1 percent). The automobile sub-sector benefited from strong sale of cars, cheap auto financing[16], demand under the *Apna Rozgar* Scheme[17], and stronger trading activities. Cement production enjoyed growth on account of strong public[18] and private construction activities and lower production and distribution costs. Other sub-sectors of industry, such as construction and mining and quarrying, grew by 13.1 and 6.8 percent respectively, both surpassing their respective Annual Plan FY16 targets. The upward momentum of industry is expected to continue in FY17 on the back of consistent energy supplies and CPEC-related construction.

The services sector continues to perform consistently, contributing to the growth uptick

The services sector is generally the engine of Pakistan's growth on the supply side with its share in GDP reaching about 59 percent in FY16.[19] The services sector grew by an impressive 5.7 percent during FY16, the highest growth rate of the last decade. This growth was broad-based and supported by *wholesale and retail trade*, *finance and insurance*, and *general government services* sub-sectors. The performance of *wholesale and retail trade*, the largest sub-sector[20], was particularly notable as it recovered from 2.6 percent in FY15 to 4.6 percent. *Finance and insurance* grew by 7.8 percent in FY16 compared to 6.5 in FY15 as banks enjoyed higher pre-tax profits while growth in *general government services* recovered strongly from 4.8 percent in FY15 to 11.1 percent in FY16 owing to an increase in government salaries.[21] The second largest sub-sector within services, *transport, storage and communication*, however, suffered a setback when its growth fell by 0.7 percentage points to 4.8 percent on account of road transport, railways, pipeline transport, and water transport.[22] This occurred in spite of the communications industry enjoying growth of 10.9 percent in FY16 compared with 2.6 percent in the previous year. Going forward, growth in the services sector is expected to slow as base effects in *wholesale and retail trade* fade, although further government salary increases will likely moderate this somewhat.

[14] Cotton sowing for FY17 has already decreased by 15 percent compared to FY16 with the Cotton Crop Assessment Committee (CCAC) revising production estimates down to 11.3 million bales.

[15] Owing to a multi-decade low policy rate which was lowered by 75 bps over the year to stand at 5.75 percent at end-FY16.

[16] More than 60 percent of the ~Rs. 20 billion consumer financing during first 11 months of FY16 was intended for the purchase of cars – State Bank of Pakistan

[17] *Apna Rozgar* Scheme, a scheme to provide subsidized commercials vehicle for unemployed youth, sold more than 50,000 vehicles in the province of Punjab and concluded in February 2016.

[18] Development spending by the government increased by almost 17 percent to Rs. 1,301 billion in FY16 over FY15.

[19] Economic Survey of Pakistan 2015-16

[20] 18.3 percent share in overall GDP – Economic Survey of Pakistan 2015-16

[21] 2015-16 budget allowed a 7.5 percent ad-hoc increase in allowance with ad-hoc increases of 2011 and 2012 added into the pay scale as well – Federal Budget Speech 2015-16

[22] Growth in road transport decelerated from 4.6 percent to 2.8 percent in FY16 while that in railways, pipeline transport, and water transport declined by 19.2 percent, 16.8 percent and 3.4 percent respectively – Pakistan Bureau of Statistics

2. Fiscal accounts

Fiscal discipline has led to a lower budget deficit

Pakistan's fiscal position continues to improve. The consolidated[23] fiscal deficit (excluding grants) has declined from 5.3 percent of GDP in FY15 to 4.6 percent in FY16—the lowest in nine years. Fiscal consolidation is the lynchpin of the government's reform program, supported by the recently-finalized IMF program (Extended Fund Facility).

Table 1: Summary of Pakistan Fiscal Operations

	Budget FY16	Actual FY14	Actual FY15	Actual FY16	Actual FY15	Actual FY16
	Rs. Billion (unless mentioned otherwise)				Growth (percent)	
Total Revenue	**4,622**	**3,637**	**3,931**	**4,447**	**8.1**	**13.1**
Tax Revenue	3,702	2,565	3,018	3,660	17.7	21.3
Federal	3,418	2,375	2,812	3,377	18.4	20.1
Provincial	283	190	206	283	8.3	37.6
Non-Tax	921	1,073	913	787	(14.9)	(13.9)
Federal	883	1,023	838	693	(18.1)	(17.3)
Provincial	38	49	76	93	53.1	23.4
Expenditures	**5,950**	**5,026**	**5,387**	**5,796**	**7.2**	**7.6**
Current *of which*:	4,276	4,005	4,425	4,694	10.5	6.1
Interest	1,280	1,148	1,304	1,263	13.6	(3.1)
Defence	781	623	698	758	12.0	8.6
Development Expenditure	1,678	1,136	1,113	1,301	(2.0)	16.9
Net lending	(4)	101	27	13	(72.8)	(53.9)
Statistical Discrepancy	-	(215)	(178)	(212)		
Fiscal Balance	**(1,328)**	**(1,389)**	**(1,456)**	**(1,349)**	**4.9**	**(7.3)**
% of GDP	*(4.3)*	*(5.5)*	*(5.3)*	*(4.6)*		
Memorandum items:						
GDP (nominal)	30,672	25,169	27,493	29,598		

Source: Ministry of Finance

The consolidated deficit has fallen to 4.6 percent of GDP, in spite of higher provincial recurrent expenditure

The fiscal deficit of the consolidated government was 4.6 percent of GDP in FY16 (see **Table 1**), the smallest deficit of the last nine years. Total expenditure grew by 7.6 percent while total revenue increased by a robust 13.1 percent as a result of tax revenue growth. The federal government held recurrent spending under tight rein—recurrent spending grew by only 3.5 percent compared to 7.3 percent last year. On the other hand, provincial recurrent spending registered an increase of 11.7 percent. As a result, the government generated a primary deficit (excluding grants) of 0.3 percent of GDP during FY16 compared to 0.6 percent in FY15.[24]

[23] This analysis refers to the consolidated fiscal accounts of federal and provincial governments.

[24] However, an amount of Rs. 212 billion (0.7 percent of GDP) has been parked in the statistical discrepancy – if included, it raises the deficit of the consolidated government by 0.7 percentage of GDP to 5.3 percent of GDP. Statistical discrepancies have increased significantly in the past few years. It will be important to monitor this in the future as it may have implications for the overall fiscal stance of the government.

Table 2: FBR Tax Collection

	Budget FY16	FY14	FY15	FY16	FY15	FY16
	Rs. billions (unless mentioned otherwise)				Growth (percent)	
Direct	1,348	884	1,029	1,192	*16.4*	*15.8*
Indirect	1,756	1,388	1,565	1,920	*12.7*	*22.7*
Customs	299	241	306	406	*27.0*	*32.7*
Sales Tax	1,250	1,002	1,089	1,324	*8.7*	*21.6*
Federal Excises	206	145	170	191	*17.2*	*12.1*
Total Taxes	**3,104**	**2,272**	**2,594**	**3,112**	**14.2**	**20.0**

Source: Ministry of Finance

FY16 has seen a strong increase in FBR revenue due to reduced tax expenditures and higher customs duty collections

The total revenue of the consolidated government improved in FY16 due to a strong performance by the Federal Board of Revenue (FBR). FBR tax collection[25] grew by 20 percent, surpassing its target of Rs. 3,104 billion by Rs. 8 billion (see **Table 2**). Progress in reducing tax expenditures by removing concessions granted through statutory regulatory orders (SROs) have contributed to this strong performance.[26] Recent initiatives such as the withholding tax on immovable property transactions based on improved valuations will also contribute to increased revenues in the near future. However, it is important to flag that direct taxes continue to underperform and FBR has significantly increased its reliance on custom duties[27]. To compensate for below-target performance during the first quarter of FY16, the government resorted to increasing import taxes to cover the gap.[28] Pakistan's average tariff rates remain very high (see **Section A3**). These high tariffs are protecting inefficient domestic industries and amplifying the existing anti-export bias (in part because it increases the cost of imported inputs for firms hoping to join global value chains). The use of regulatory duties also makes the tariff structure more complex, reversing the progress of previous tariff simplification efforts.

Revenues are skewed towards indirect taxation and some measures may have unintended consequences on

Sales tax continued to dominate tax collections, contributing more than 40 percent of FBR's collections in FY16. Interestingly, more than one third of the sales tax collection from imports and domestic sales was from petroleum products.[29] Collection from direct taxes are low and much of it—about 70 percent—has been gathered through the withholding mechanism. While all countries rely on a withholding mechanism to some extent, the unprecedented reliance in Pakistan suggests weaknesses in the direct tax collection mechanism.[30]

[25] FBR tax collection comprises 85 percent of total tax revenues. Total tax revenues grew by 21.3 percent in FY16 compared with the previous year.

[26] About 1 percent of GDP has been recouped through removal of SRO concessions.

[27] The share of customs duties in FBR taxes has increased from 10.6 percent in FY14 to 13.1 percent in FY16. This increasing trend has been evident since FY11.

[28] These include: (i) imposition of regulatory duty in the range of 5 to 10 percent on 61 new imported items (projected to yield Rs. 4.5 billion); (ii) enhancing regulatory duty by 5 percent on 289 imported items (Rs. 4.5 billion); (iii) increasing Federal Excise Duty on cigarettes (Rs. 6.5 billion), (iv) additional one percent customs duty across the board except the exempted items (Rs. 21 billion); and (iv) additional regulatory duty on imported used and old cars (Rs. 2.5 billion).

[29] Part of this performance can be attributed to increasing sales tax rate on petroleum products over the course of the year.

[30] The level of direct taxes in Pakistan (33 percent of tax revenue) remains unfavorable compared to other developing countries, where direct taxes amount to 55 percent of total tax revenue – *Unlocking Pakistan's Revenue Potential*, IMF Working Paper 16/182

financial deepening and trade competiveness

The introduction of withholding taxes on financial transactions, though positive in terms of providing incentives for taxpayer registration, might have had a detrimental impact on financial deepening. The currency-deposit ratio has increased from a very stable 0.29 in FY15 to 0.35 in FY16 (see **Section A4**).

Table 3: Non-Tax Revenues

	FY14	FY15	FY16	FY15	FY16
	Rs. billions (unless mentioned otherwise)			Growth (percent)	
Profits Post Office Deptt/PTA	95	4	34	*(96.1)*	*831.9*
Interest (PSEs & Others)	67	14	58	*(78.8)*	*306.9*
Dividends	66	74	89	*12.4*	*19.5*
SBP Profits	326	399	228	*22.3*	*(42.9)*
Defence	117	157	107	*34.0*	*(31.9)*
Passport Fee	19	19	21	*(1.2)*	*11.2*
Development Surcharge on Gas	39	-	-	…	…
Discount Retained on Crude Price	41	10	9	*(76.2)*	*(5.9)*
Royalties on Oil/Gas	76	74	58	*(3.1)*	*(22.1)*
Gas Infrastructure Development Cess	32	-	-	…	…
Windfall Levy against Crude Oil	15	12	2	*(16.6)*	*(86.6)*
Others	131	75	89	*(42.8)*	*18.1*
Provincial	49	76	93	*53.1*	*23.0*
Total	**1,073**	**913**	**787**	***(14.9)***	***(13.9)***

Source: Ministry of Finance

Non-tax revenues fell further in FY16, compounding a fall in FY15

Non-tax revenues posted Rs. 787 billion, a decline of 14 percent compared to FY15 (see **Table 3**). State Bank of Pakistan (SBP) profits declined by 43 percent due to the prevailing low interest rate environment. Moreover, the royalties on gas and oil also declined due to low international petroleum prices. Additionally, defense receipts (on account of the coalition support fund) fell by Rs. 50 billion compared to last year. These shortfalls created a gap that was not adequately met by an increase in provincial non-tax revenue collection (by 23.4 percent) and higher profits, interest and dividends received from PSEs and others (increasing by almost Rs. 90 billion collectively).

Restraint in federal recurrent spending has kept expenditure growth relatively low, but the federal deficit nonetheless exceeded its target

Total expenditure of the consolidated government increased by 7.6 percent in FY16, in line with the previous year's growth (see **Table 4**). Federal recurrent spending grew by only 3.5 percent due to a lower interest payment on domestic debt (as a result of the benign interest rate environment). This, combined with a marginal increase in defense spending and grants to provinces,[31] compensated for higher growth in pension payments and grants to SoEs. On the other hand, the federal government directed significant resources towards Public Sector Development Program (PSDP) spending. Federal PSDP grew by almost 20 percent in FY16 while non-PSDP development spending (comprising largely of the Benazir income support program, which accounts for 80 percent) contracted by 7.8 percent. Similarly, net lending fell from Rs. 27 billion in FY15 to Rs. 13 billion in FY16. However, despite this effort, the federal fiscal deficit for FY16 stood at 5.75 percent of GDP – exceeding the target and representing a marginal improvement of 0.2 percent of GDP over last year.

[31] Together these three items constitute almost 60 percent of Federal recurrent expenditure.

Table 4: Consolidated Expenditure

	FY14	FY15	FY16	FY15	FY16
	Rs billions (unless mentioned otherwise)			Growth (percent)	
Total expenditures	**5,027**	**5,387**	**5,797**	***7.2***	***7.6***
Current	4,005	4,425	4,694	*10.5*	*6.1*
Federal	*2,831*	*3,038*	*3,144*	*7.3*	*3.5*
Interest payments	1,148	1,304	1,263	*13.6*	*(3.1)*
Domestic	1,073	1,208	1,151	*12.6*	*(4.7)*
External	75	96	113	*27.6*	*17.7*
Pensions	180	185	223	*2.8*	*20.2*
Grants	283	288	362	*1.7*	*25.6*
Defense	623	698	758	*12.0*	*8.6*
Public Order and Safety	86	83	96	*(3.4)*	*15.6*
Health & Education	76	84	95	*11.4*	*12.7*
Others	435	395	348	*(9.2)*	*(12.0)*
Provincial	*1,173*	*1,387*	*1,550*	*18.2*	*11.7*
Development	1,136	1,113	1,301	*(2.0)*	*16.9*
PSDP	865	988	1,186	*14.1*	*20.1*
Federal	435	489	593	*12.4*	*21.4*
Provincial	431	499	592	*15.9*	*18.8*
Other Dev. Expenditures	270	125	116	*(53.6)*	*(7.8)*
Net Lending	101	27	13	*(73.3)*	*(51.9)*
Statistical Discrepancy	(215)	(178)	(212)	*(17.2)*	*19.1*

Source: Ministry of Finance

Provinces fell short of their budgeted surpluses because of high recurrent spending

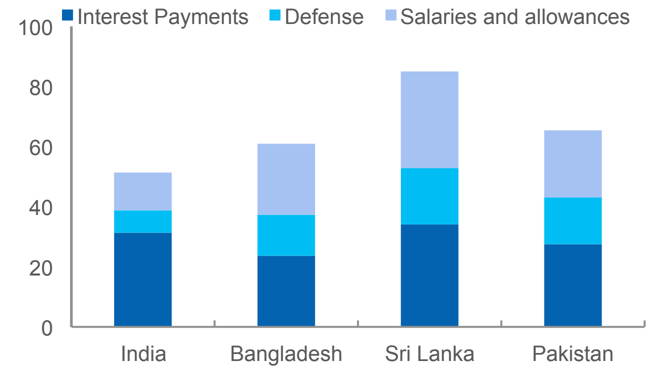
The government's fiscal consolidation program initially assumed that provincial governments would contribute a combined surplus of 0.9 percent of GDP (or Rs. 297 billion) in FY16. In reality, however, the provinces' combined surplus stood at just 0.5 percent of GDP (or Rs. 142 billion). This was largely due to provinces overspending on recurrent expenditures, which exceeded their budgets by 29 percent. Consistent with a recent trend, much of the growth in expenditure is directed towards higher salaries and pensions, while almost all provinces were unable to execute their development budgets in full. Provincial development expenditure was 27 percent below budget, although it represented a 19 percent increase on FY15. This gap can be attributed to Punjab (50 percent), KPK (29 percent) and Sindh (20 percent) while Balochistan was the only province to spend more than it budgeted on the development side.

Pakistan's recurrent spending is highly rigid

Pakistan's federal and provincial budgets feature high rigidity in recurrent spending compared with the rest of South Asia. Around two-thirds of consolidated recurrent expenditure is required for debt servicing, wage payments and defense spending. After Sri Lanka, Pakistan has the most rigid recurrent budget over the last five years (see **Figure 5**). It is partly because of this rigid portion of expenditure that Pakistan has struggled to create the requisite fiscal space to meet its public investment needs.

Figure 5: Fiscal Rigidity in South Asia

Percent of Recurrent Expenditures



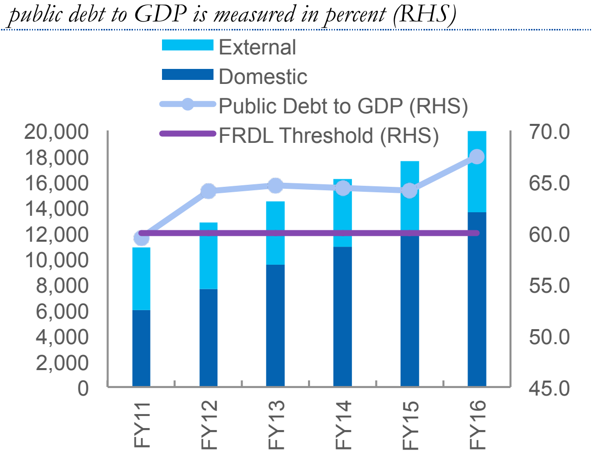
Source: State Bank of Pakistan and Staff calculation

Total public debt increased in FY16

Over the last five years, public debt has remained above the 60 percent limit stipulated in the Fiscal Responsibility and Debt Limitation Act (FRDLA) of 2005. As of end-June 2016, total public debt stood at 67.4 percent of GDP, an increase of 3.3 percentage points from June 2015 (see **Figure 6**). Domestic debt continued to dominate the total stock in FY16.[32] However, foreign currency public debt also increased significantly by 1.6 percentage points. This was likely due to the slight depreciation of the Pakistani Rupee against US Dollar[33], sizeable revaluation losses as a result of the depreciating US Dollar against Japanese Yen[34], disbursements under multilateral loans, the ongoing IMF program, and substantial commercial borrowings.

Figure 6: Trends in public debt

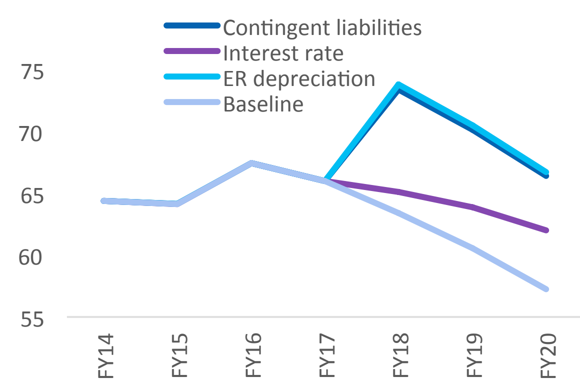
External and domestic debt measured in Rs. Billion (LHS) while public debt to GDP is measured in percent (RHS)



Source: State Bank of Pakistan and staff calculations

Figure 7: Public debt sustainability analysis

(Percent of GDP)



Source: World Bank calculations

32 Government deposits underwent an exponential increase during FY16, closing the year at Rs. 459 billion (compared to Rs. 25 billion in FY15).

33 During FY16 the Rs. depreciated by almost 3 percent against US$ (point-to-point).

34 During FY16 the US$ depreciated by almost 19 percent against JPY (point-to-point) and contributed to translational loss given the currency concentration of JPY stands at around 20 percent in Pakistan's external debt.

The debt-to-GDP ratio is expected to fall in the medium-term

However, public debt as a percentage of GDP is expected to decline over the medium-term. Underpinned by moderately higher GDP growth expectations and continued fiscal consolidation, the public debt-to-GDP ratio is projected to decline below the legislative threshold of 60 percent by FY20. A public debt sustainability analysis[35] shows that the debt path is sensitive to exchange rate depreciation shocks and, to a lesser extent, the materialization of contingent liabilities, either from power sector arrears or SOE losses (see **Figure 7**).

[35] Source: World Bank analysis, using the Joint Bank-Fund Debt Sustainability Framework for Middle-Income Countries, October 2016

3. External sector

a. Balance of Payments

Pakistan's external position improved despite a slight increase in the current account deficit

The current account deficit widened slightly in FY16 which was compensated by healthier financial flows compared to FY15. This resulted in an overall surplus of US$ 2.7 billion for FY16, slightly higher than the FY15 surplus of US$ 2.6 billion. This allowed foreign exchange reserves to grow for a third consecutive year (see **Table 5**). The key drivers of continued progress are (i) growing workers' remittances which continue to offset the trade deficit and (ii) robust financial inflows due to growing FDI and loan receipts from IFIs. Pakistan's official reserves reached US$ 18.2 billion by end June 2016, which are sufficient to cover almost 4 months of imports of goods and services. The nominal exchange rate experienced a slight depreciation of 2.7 percent. Pakistan's international credit rating also improved.

Table 5: Balance of Payments Summary[1]

US$ billion

	FY15	FY16
i. Current Account (A+B+C+D)	**-2.7**	**-3.3**
A. Trade balance	**-17.2**	**-18.4**
Export	24.1	22.0
Import	41.3	40.3
B. Services net	**-3.0**	**-2.9**
of which: Coalition Support Fund	1.5	0.9
C. Balance on Primary Income[2]	**-4.6**	**-5.3**
D. Balance on Secondary Income[2]	**22.0**	**23.3**
of which Remittances	18.7	19.9
ii. Capital A/c	**0.4**	**0.3**
1. Balance from Current & Capital Accounts (i+ii)[3]	**-2.3**	**-2.9**
2. Financial A/c[4]	**-5.0**	**-5.5**
of which:		
Direct investment	-0.9	-1.9
Portfolio investment	-1.9	0.4
Net Acquisition of Financial Assets	-0.1	0.1
Net Incurrence of Financial Liabilities	2.2	4.2
3. Errors and omissions	**0.0**	**0.0**
Overall balance (-1+2-3)	-2.6	-2.7
SBP reserves (excl. CRR, SCRR)	13.5	18.2
Memorandum Items		
Current A/c Balance (percent of GDP)	*-1.0*	*-1.1*
Trade Account (percent of GDP)	*-6.3*	*-6.5*
Export growth (percent)	*-3.9*	*-8.8*
Import growth (percent)	*-0.9*	*-2.3*
Remittance growth (percent)	*18.2*	*6.4*
Financial A/c (percent of GDP)	*1.8*	*2.0*

Source: State Bank of Pakistan
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.

b. Current and Capital Account

Pakistan continues to be a net borrower

Pakistan's current and capital accounts yielded a combined deficit of US$ 2.9 billion in FY16, increasing from US$ 2.3 billion in FY15. This occurred primarily due to a larger trade deficit and lower receipts in the capital account compared to the previous fiscal year. As a result, Pakistan continues to be a net borrower from the rest of the world.

The trade deficit widened and contributed to a higher current account deficit

Exports continued to shrink during FY16, recording a decline of 8.8 percent compared to a 3.9 percent fall in FY15. FY16 imports also contracted by 2.3 percent primarily due to lower international oil and commodity prices (see **Table 5**). This resulted in a slight widening of the trade deficit as a percentage of GDP from 6.3 percent in FY15 to 6.5 percent in FY16. Remittances, in line with the trend of the last six years, grew solidly and reached an all-time high of US $19.9 billion—more than offsetting the trade deficit. However, higher repatriation of profits led to an increase in the primary income deficit. This resulted in an overall current account deficit of US$ 3.3 billion—about US $0.6 billion higher than FY15.

Non-oil imports continued to rise in FY16, offsetting the decline in the value of petroleum imports

Imports declined by 2.3 percent during FY16, compared with 0.9 percent in the previous year. Continuing the trend seen in FY15, this contraction can be attributed to a decrease in the value of petroleum group imports—which declined by 35.5 percent (US$ 4.2 billion) in FY16.[36] This was largely due to a 32.7 percent fall in petroleum group prices.[37] Non-oil imports other than agriculture saw an increase in volume, which significantly diluted the impact of the declining value of oil imports. In particular, imports of raw cotton and power-generating machinery increased significantly as a result of a poor local cotton crop and ongoing investments in energy throughout Pakistan.

Weak global demand and persistent competitiveness issues resulted in a sharp decline of Pakistan's exports

Pakistan's exports declined again in FY16 as weak global demand exacerbated the effects of Pakistan's long-term decline in export competitiveness. Food and textiles are key contributors to Pakistan's exports and continue to suffer from a decline in international prices and demand. For example, although Pakistan exported more rice in FY16 than in FY15, the value of rice exports fell due to a decline in international prices. The textiles sector, which accounted for 60 percent of total exports during FY16, saw a contraction of 5.6 percent compared to FY15. This decline was broad-based and affected both high- and low-value textile exports. The only exceptions were knitwear and cotton carded, both of which grew due to higher global prices in these sub-categories (see **Figure 8**).[38] Although 'Brexit' has not yet affected exports, the EU accounts for 23.4 percent of Pakistan's exports and the UK 7.4 percent, suggesting that potential future impacts could be significant.

Pakistan is losing its share in international trade

FY16 saw the continuation of a long-term decline in Pakistan's share of global trade (see **Figure 9**). This has been driven by poor trade facilitation, infrastructure gaps, inefficient logistics and a poor investment climate.[39] Pakistan has also lagged behind its competitors in trade openness, which reduces its prospects of regaining momentum in export growth (See **Figure 10**).

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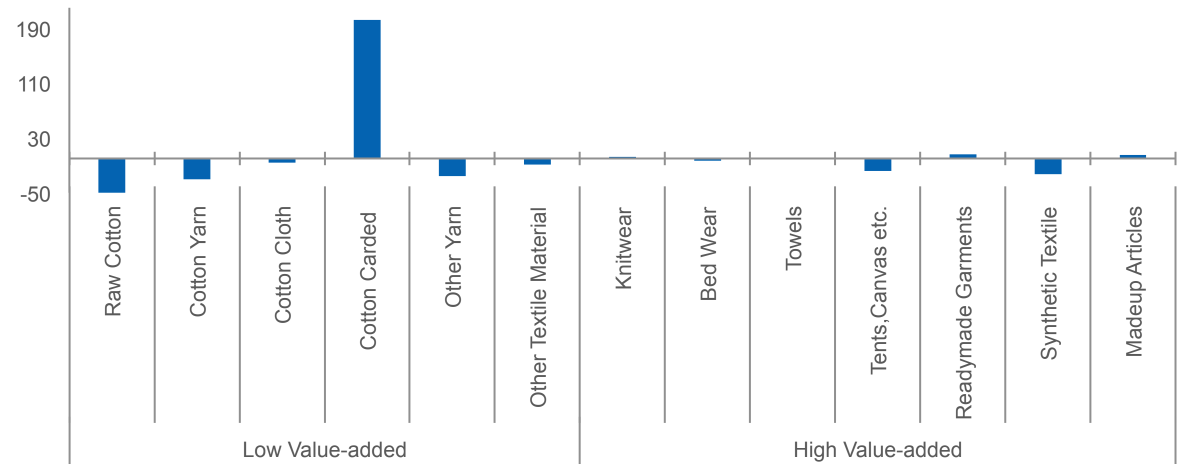
[36] Quantity imported also declined by 4.1 percent according to Pakistan Bureau of Statistics
[37] External Trade Statistics, Pakistan Bureau of Statistics (PBS).
[38] Exports by all commodities, State Bank of Pakistan (SBP).
[39] These issues were discussed at length in the export competitiveness special section in the April 2016 Pakistan Development Update.

Figure 8: Growth in value of textile exports in FY16
Percent

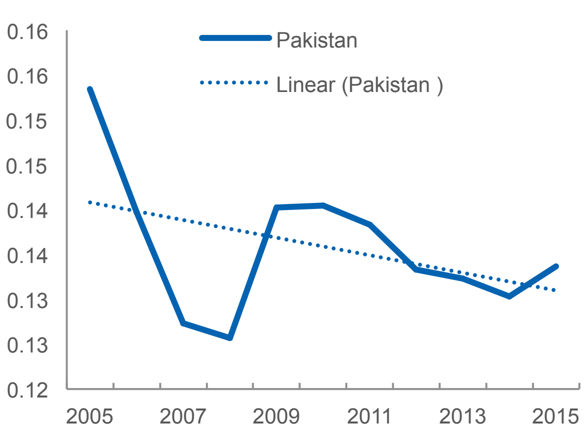


Source: Data from State Bank of Pakistan and staff calculation

Rising remittances continue to support the current account

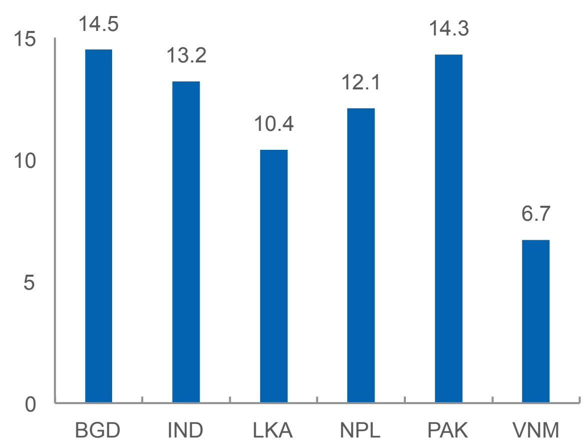
The secondary income surplus increased to US$ 23.3 billion during FY16 from US$ 22.0 billion in FY15. This increase is mainly supported by continuous growth in workers' remittances which grew by 6.4 percent during FY16 (see **Figure 11**). These flows continue to play a major role curtailing the current account deficit by financing about 49.2 percent of the import bill in FY16. However, growth in remittances from GCC countries, which accounted for almost 65 percent of remittances during FY16, has started to decelerate due to a slowdown in public investment in these economies as oil prices remained depressed. Consequently, remittance flows from GCCs grew by 6.0 percent in FY16 compared with a 24.1 percent increase in FY15. Remittances from the United Kingdom and the United States, also major sources of remittance flows, displayed signs of slowing by recording 8.5 percent and -6.7 percent growth respectively during FY16. The slowdown in remittance flows has continued in Q1FY17, with remittances declining by 5.4 percent compared to 4.0 percent growth in Q1FY16.

Figure 9: Pakistan share of world exports
Percent



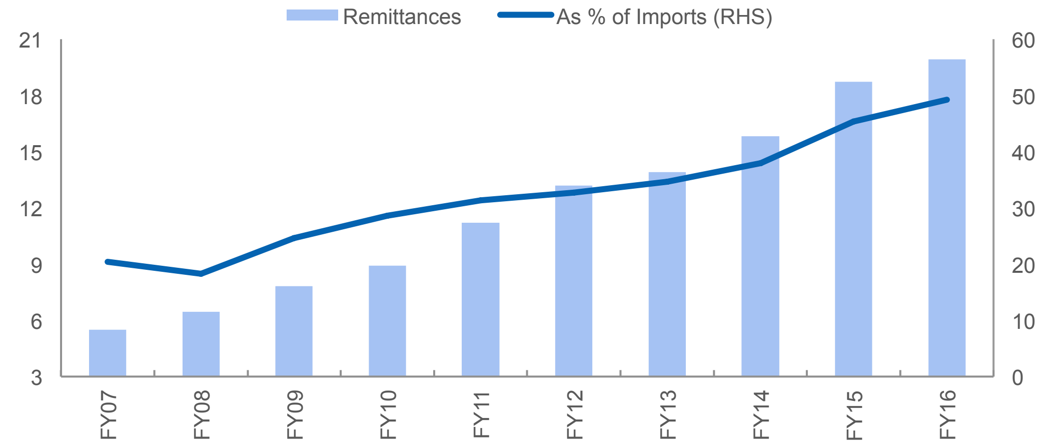
Source: United Nations Conference on Trade and Development UNCTAD

Figure 10: Simple Mean MFN Tariffs (2013)
Percent



Source: World Bank Staff Calculation Based on World Trade Organization (WTO) Data

Figure 11: Worker's remittances remain a mainstay for the current account
US$ billion for LHS, Percentage of imports for RHS



Source: State Bank of Pakistan

c. Financial Account

The financial account enjoyed healthy inflows during FY16

The financial account recorded an inflow of US$ 5.5 billion (2.0 percent of GDP) in FY16, reflecting an increase compared to last year's US$ 5.0 billion (1.8 percent of GDP). This increase can be attributed to (i) foreign direct investment of US$ 1.9 billion in FY16, US $1.0 billion higher than the previous year; and (ii) disbursements by multilateral development banks worth US $3.6 billion. FDI flows increased to 1.3 percent of GDP in FY16, the highest rate since FY10 (see **Figure 12**). The dramatic increase in FDI cannot be taken at face value, however, as the data collection methodology was improved in FY16 compared with FY15.[40] Notwithstanding this, there was a more-than-doubling of foreign investment from China in FY16, which is attributable to CPEC rather than the data update.[41] These financial inflows more than offset the deficit in the current and capital accounts. As a result, official reserves reached US$ 18.2 billion by end-June 2016 from US$ 13.5 billion at end-June 2015 (see **Figure 13**).

The Pakistani Rupee was stable in FY16

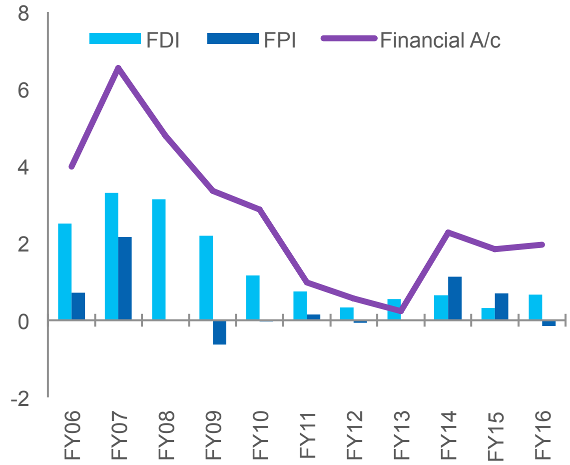
Supported by strong foreign reserves accumulation, the Pakistani Rupee experienced another year of stability with a small depreciation of about 2.7 percent against the US dollar. A stable nominal exchange rate and relatively low inflation resulted in the Real Effective Exchange Rate (REER) appreciating by 0.84 percent in the period under review (see **Figure 14**).

[40] The government undertook a foreign investment survey during FY16 which identified previously unrecorded FDI arising from reinvested profits by foreign investors. The survey identified US$ 746 million in reinvested profits (out of total FDI of US$ 1.9 billion). These reinvestments were mainly from financial, power and telecom sectors. See the footnote in SBP's summary balance of payments: http://sbp.org.pk/ecodata/Balancepayment_BPM6.pdf.

[41] Net investment from China increased from US$ 257 million in FY15 to US$ 626 million in FY16. Because there are few established Chinese multinational firms operating in Pakistan, we can assume this increase is attributable to new investment and not the improved measurement outlined in the footnote above.

Figure 12: Financial Account

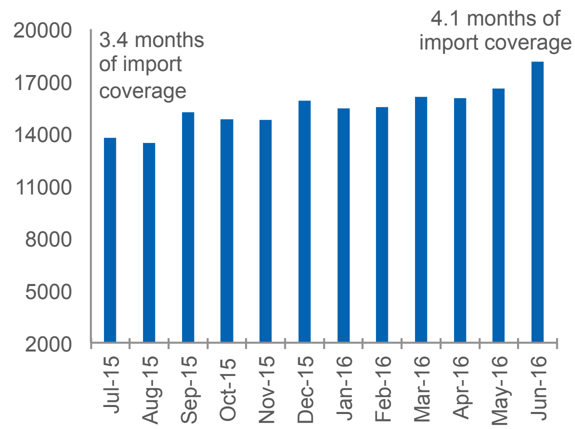
Percent of GDP



Source: State Bank of Pakistan

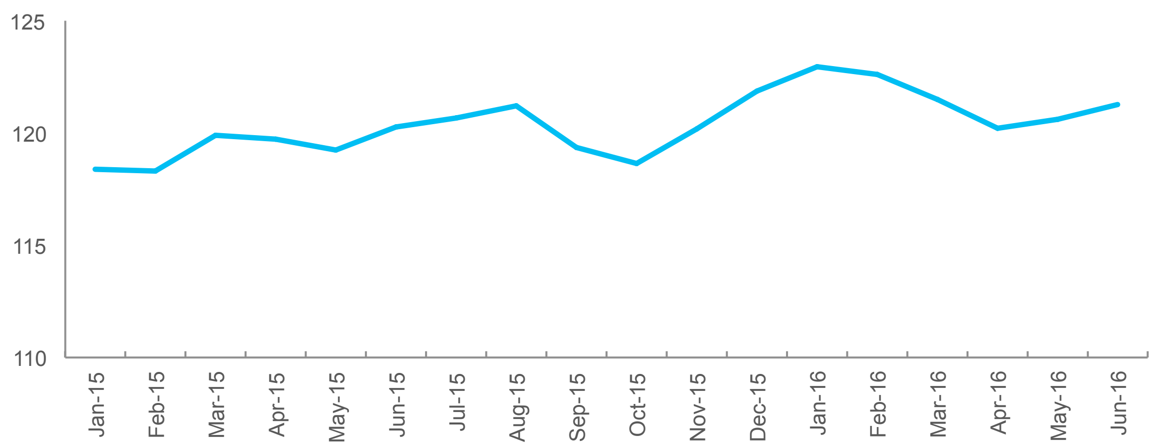
Figure 13: SBP's Foreign Exchange Reserves - Month End Position

Billion US$



Source: State Bank of Pakistan

Figure 14: Exchange rate movements (index of real effective exchange rates),



Source: International Finance Statistics, IMF

4. Monetary policy, financial sector and inflation update

a. Monetary policy

Stronger macroeconomic indicators allowed SBP to further ease its monetary policy stance during FY16

Strong workers' remittances, Coalition Support Fund (CSF) flows, declining international oil prices and substantial financial inflows helped build up SBP's reserves. This reserve buildup, in turn, brought stability to the foreign exchange market. The stability in the Pakistani Rupee and the swift pass-through to domestic consumers of falling international oil and commodity prices eased inflation considerably. All of this allowed SBP to further ease monetary policy through cuts of its policy rate by 75 bps during FY16 to 5.75 percent—the lowest rate in 44 years.[42]

Table 6: Monetary Aggregates (Flow since end-June)

	Stock		Flow	
	30-Jun-15	30-Jun-16	FY15	FY16
Net Foreign Assets	***813***	***1006***	***220***	***193***
of which: SBP	722	1032	241	309
Net Domestic Assets	***10469***	***11819***	***1096***	***1349***
Government borrowing:	**6958**	**7805**	**933**	**847**
Budgetary borrowing	6404	7195	861	791
from SBP	*1929*	*1442*	*-474*	*-487*
from Scheduled banks	*4475*	*5753*	*1335*	*1278*
Commodity operations	564	622	72	58
Non-govt sector borrowing:	**4456**	**5027**	**303**	**571**
Private sector	4003	4464	224	461
Public Sector Enterprises	435	544	80	109
Other Items	-812	-1013	-8	-201
Broad Money (M2)	**11282**	**12825**	**1316**	**1543**
Reserve Money (RM)	**3142**	**3974**	**282**	**832**
Memorandum item				
Currency in circulation	2555	3334	377	779
Demand and Time Deposits	8714	9472		
CIC/Deposit ratio	0.29	0.35		
Growth (YoY)				(Percent)
M2	*13.2*	*13.7*		
RM	*9.8*	*26.5*		
Currency in circulation	*17.3*	*30.5*		
Demand and Time Deposits	*12.0*	*8.7*		

Source: State Bank of Pakistan

Movements in monetary aggregates were largely dictated by targets set in the IMF's EFF program and strong private sector credit pick up

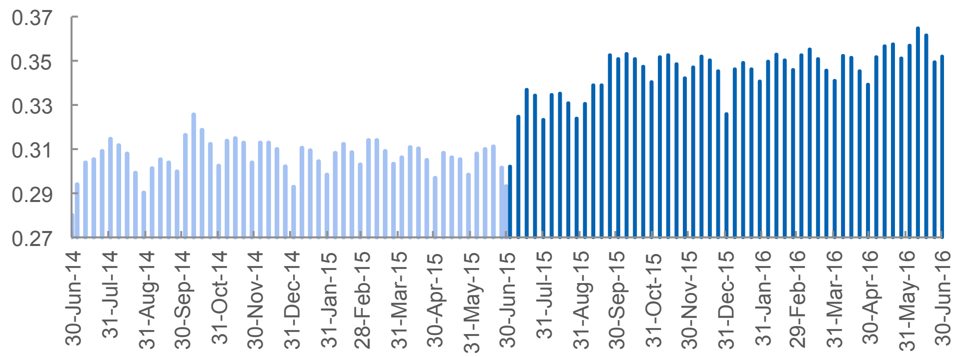
Broad money grew by 13.7 percent in FY16, compared with 13.2 percent in FY15, while reserve money grew by 26.5 percent against 9.9 percent in FY15. The growth in broad money was largely driven by the expansion in net domestic assets (NDA), which grew by 12.9 percent against 11.7 percent in FY15. The government borrowed about Rs. 1,278 billion from scheduled banks during FY16, around Rs. 57 billion less than the previous year. Simultaneously, as part of the IMF's EFF program, the government continued to retire its outstanding central bank debt. On a net basis, the government borrowed about Rs. 791 billion from the banking system—Rs. 70 billion less than in FY15 (see **Table 6**). The slower growth in government credit allowed for strong growth of 12 percent in private sector credit. Private sector growth was aided by low interest rates and improved economic activity. Continuous reserve accumulation by the central bank resulted in an expansion of net foreign assets (NFA), although the growth was slower than in the previous year.

[42] Since the start of FY15, SBP has reduced its policy rate cumulatively by 425bps.

Worryingly, currency in circulation increased by 31 percent, lifting the currency deposit ratio from 0.29 to 0.35 in just one year

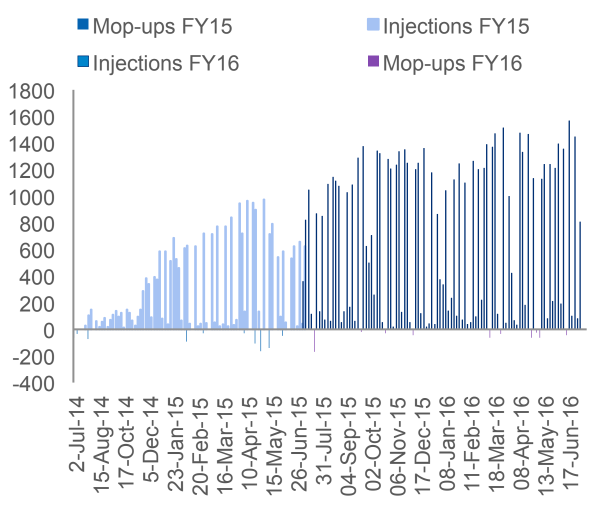
Figure 15 depicts the 'new normal' of a higher currency-deposit ratio following the imposition of two taxes on banking transactions: a turnover tax and a withholding tax[43]. Whilst these taxes are at relatively low rates, they represent significant total collections given the high volume of transactions. They may also facilitate a widening of the tax net. But these taxes can negatively impact financial deepening as they may encourage customers to circumvent formal banking channels. In a country that already has a significant informal sector, these taxes may create an additional disincentive to 'formalize'.

Figure 15: Currency to Deposit Ratio



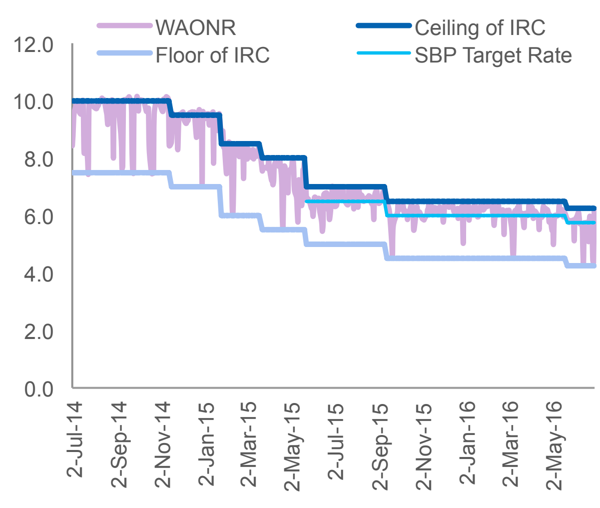
Source: State Bank of Pakistan

Figure 16: Liquidity Injections through OMOs
Billion Rs.



Source: State Bank of Pakistan

Figure 17: Interest Rate Corridor and Weighted Average Overnight Repo Rate
Percent



Source: State Bank of Pakistan

[43] The turnover tax of 0.3% is levied on all non-filers for cumulative transfers of more than Rs. 50 thousand on any given day. The withholding tax is levied on all cash withdrawals that accumulatively amount to more than Rs. 50,000 on any given day (this tax is levied at 0.6% for non-filers—though FBR is charging less as part of a concession package—and 0.25% for filers).

SBP's explicit targeting of policy rates led to substantial liquidity injections through open market operations

Liquidity conditions in the banking system tightened in FY16, driven by increased private sector credit demand, substantial borrowing by the government from scheduled banks to compensate for retirement to the central bank, and a higher currency-deposit ratio. This is visible in the overnight repo rate, which on average remained between the interest rate corridor ceiling and the policy rate. To keep the overnight rates closer to the explicit policy rate, SBP stepped up its liquidity injections through open market operations (OMOs). **Figure 16** shows that SBP has increased these injections since the beginning of FY16, when the new interest rate corridor was implemented. The outstanding level of net OMO injections increased to an average of Rs. 662.7 billion during FY16 compared to Rs. 343 billion in FY15. SBP's higher injections led to a reduction of the spread between the overnight repo rate and the policy rate (see **Figure 17**).

Table 7: Credit to Private Sector (Flow in Rs. Billion)

	FY14	FY15	FY16
Total credit to Private sector (A+B+C)	**371.0**	**224.0**	**461.0**
A. Investment in securities and shares	15.3	35.9	25.2
B. Loan to Private Sector (1+2+3)	362.5	238.3	365.5
1. Personal: of which	31.8	45.0	39.9
Consumer financing	31.5	32.0	33.2
2. Trust Funds & NPOs and others	-7.7	5.6	-6.7
3. Loans to private sector businesses (a.+.h)	338.3	187.7	332.4
By sectors:			
a. Agriculture	30.7	32.7	7.7
b. Manufacturing	187.2	68.4	210.9
Textile	43.2	-8.4	62.7
Wearing apparel, ready made garments	-0.6	-0.3	5.7
Food products and beverages	97.5	15.3	46.7
Chemicals	20.2	17.9	60.7
Non-metalic mineral products	-13.2	19.7	-4.2
Leather	-0.8	6.9	-3.8
Others	40.9	17.2	43.2
c. Electricity, gas and water	49.8	-11.4	45.6
d. Ship Breaking	0.1	11.0	0.0
e. Construction	-1.1	13.6	31.6
f. Commerce and trade	16.4	13.7	29.3
g. Transport, storage and communication	27.3	29.5	35.6
h. Real estate	-10.4	8.2	16.4
i. Others businesses	38.4	22.0	-44.7
C. Others[1]	-6.8	-50.2	70.2
of which NBFC	-4.2	-35.3	12.0

Source: State Bank of Pakistan

[1] This also includes credit to Public Sector Enterprises and others.

Private sector demand for credit increased in FY16, driven by low energy prices, strong aggregate demand, CPEC investments and low interest rates

This liquidity management via OMOs kept the market sufficiently liquid and nudged banks to lend to the private sector. On the demand side, low interest rates, improved business sentiments and energy availability provided much needed impetus to credit demand. Credit to the private sector expanded by Rs. 461 billion during FY16, the majority of which (Rs. 323.4 billion) was loaned to private sector businesses, representing a significant increase from FY15's Rs. 187.7 billion. The improvement in credit off-take was fairly broad-based, spread over a number of sectors including manufacturing; electricity, gas and water; construction; and transport, storage and communication (see **Table 7**).

b. Inflation

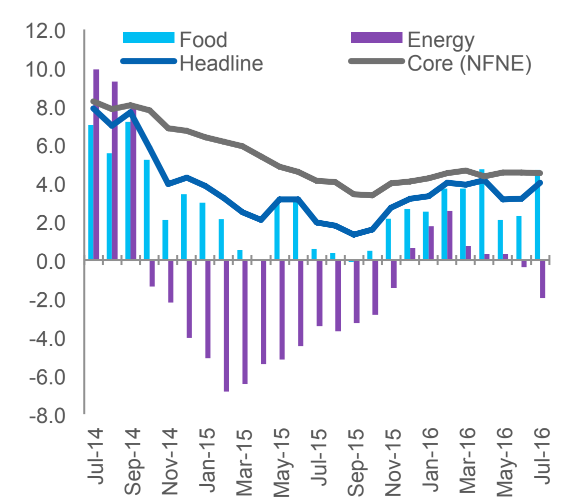
Inflation hit a 13-year low in FY16, aided by falling international oil prices

In spite of high aggregate demand and low interest rates, inflation was contained in FY16 due to a stable currency and falling international oil prices. Average inflation for FY16 reached a 13-year low of 2.9 percent. Food price falls in the second and third quarters, and low domestic petroleum, oil, lubricants prices—driven by international oil prices—kept average inflation low for the year (see **Figure 18**). Some food items, however, experienced dramatic price increases due to local factors. The prices of gram whole, pulse mash and pulse gram rose 50 percent, 47 percent and 46 percent respectively year-on-year to July 2016 due to reduced domestic production driven by local weather patterns.

While inflation has risen in the most recent quarter, it remains well below historical rates

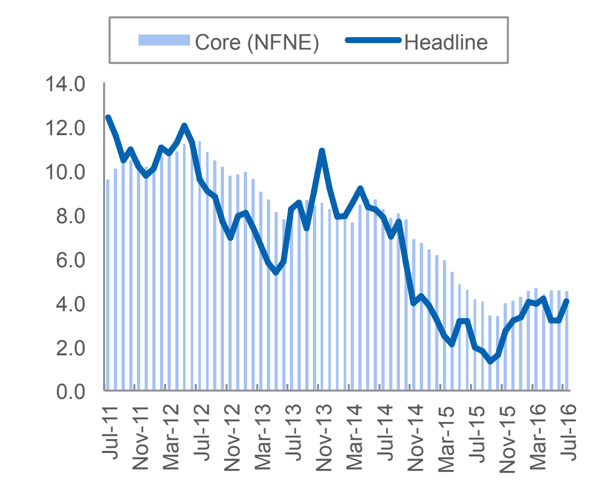
Since the end of FY16, headline inflation has increased slightly as a result of a recovery in international oil prices. The year-on-year inflation rate reached 3.9 percent in September 2016 after registering 3.6 percent in the year to August 2016. Health and education costs have also notably risen in the last 12 months, increasing 7 percent and 10 percent respectively year-on-year to September 2016. In spite of a recent uptick, however, Pakistan's headline inflation remains well below historical levels—enabled by low underlying (core) inflation (see **Figure 19**).

Figure 18: Headline y-o-y inflation was aided by falling energy prices and steady food prices
Percent



Source: State Bank of Pakistan

Figure 19: 12-month moving average of core and headline inflation
Percent



Source: State Bank of Pakistan

c. Financial sector

The banking system remains robust, largely because of government borrowing

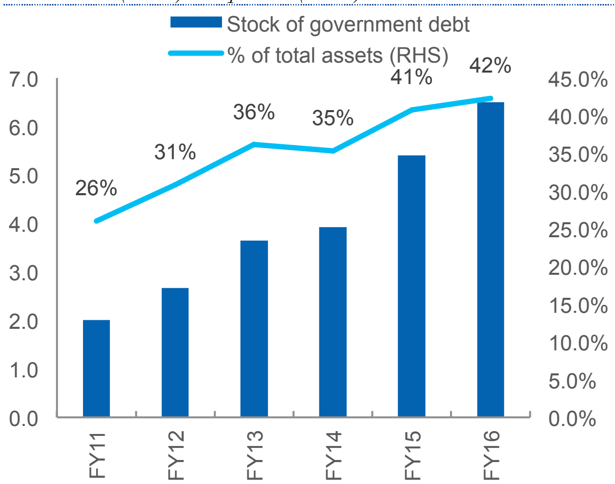
The key driver of recent robustness in the banking sector has been a shift in banks' risk behavior from private sector loans to risk-free government securities. As a result, the banking sector has achieved sizable growth, driven primarily by increased government borrowing. Commercial banks hold about Rs. 6.5 trillion of government domestic debt as of June 2016, which is about 42 percent of their total assets (see **Figure 20**). Furthermore, investments in government securities constitute approximately 92 percent of total banking system investments. Even with the mild 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 16.1 percent as of June 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 somewhat eased by a decline in deposit rates. As a result, the spread between weighted average lending and deposit rates on incremental loans and deposits has actually increased from as low as 270 basis points in December 2015 to 330 basis points in July 2016. Given these spreads, the return on assets and return on equity of the banking sector is still at a healthy 2.2 percent and 24.9 percent respectively for the quarter ending June 2016 (see **Table 8**). The trend is still expected to weaken on the back of lower yields on government securities (see **Figure 22** for yield curve).

Figure 20: Commercial banks' exposure to government debt has increased

Rs. Trillion (LHS) and percent (RHS)



Source: State Bank of Pakistan

Table 8: Selected Key Indicators of the Banking Sector

Rs. Trillion

	Jun-14	Jun-15
Profit Before Tax ytd (Rs. bn)	171	162
Credit to Private Sector	4,003	4,464
ROA Before Tax	3%	2%
ROE Before Tax	28%	25%
Advances to Deposits Ratio	46%	47%
Liquid Assets/Deposits	70%	77%
Capital Adequacy Ratio	17%	16%
Gross NPLs to Loans	12%	11%
Net NPLs to Loans	3%	2%
6 month KIBOR	7%	6%

Source: State Bank of Pakistan

SME credit growth and banks' asset quality are both improving

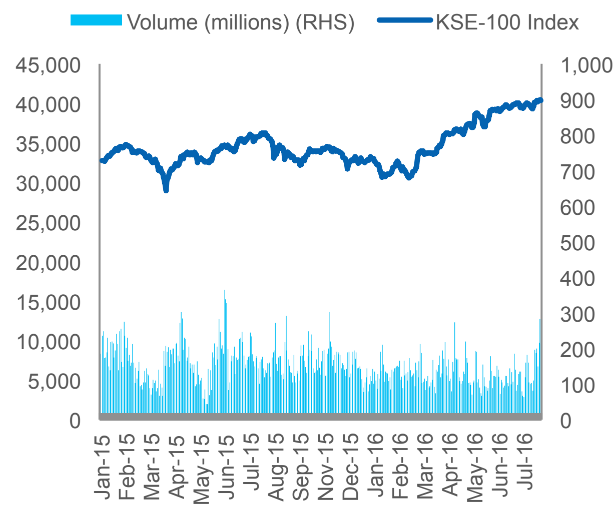
The growth in private sector credit has also been reflected in small and medium enterprises (SME) credit, which has been increasing since 2014[44] after a downward trend over the preceding five years. Non-performing loans (NPLs) have declined to 11.1 percent of the overall loan portfolio. Because of adequate provisioning, net NPLs also continued to decline, and were at 2.2 percent in June 2016. Year on year, NPLs in SMEs decreased from 31.6 percent to 26.5 percent of loans and NPLs in the corporate sector decreased from 13.4 percent to 11.8 percent between June 2015 and June 2016 (see **Table 8**).

[44] Advances to SMEs have grown at a compounded annual growth rate (CAGR) of 5.4 percent in the past 3 years (FY13-16), reaching Rs. 273 billion as of June 2016.

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 23 percent between January and September 2016, after a volatile 2015 which saw it grow only 1 percent (see **Figure 21**). Market confidence was aided by equity market reforms which have integrated the country's three stock exchanges and resulted in the National Clearing Company becoming a central counterparty,[45] improving governance and risk management. In recognition of improved macroeconomic fundamentals, Morgan Stanley Capital International (MSCI) will reclassify the Pakistan Index from a *Frontier Market* to an *Emerging Market*, effective from June 2017. Market capitalization has grown to over US$ 75 billion, of which foreign investors represent over 10 percent.

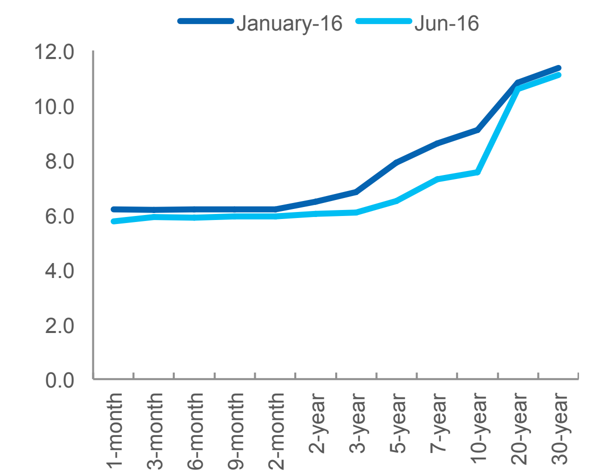
Figure 21: KSE-100 Index and volumes



Source: Pakistan Stock Exchange

Figure 22: Government security yield curve

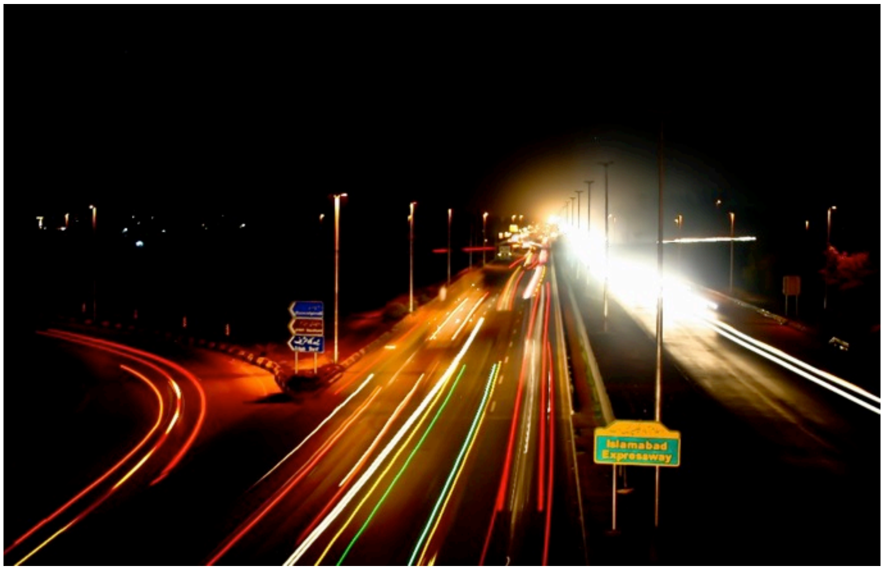
Percent



Source: State Bank of Pakistan

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

B. Outlook and upcoming challenges

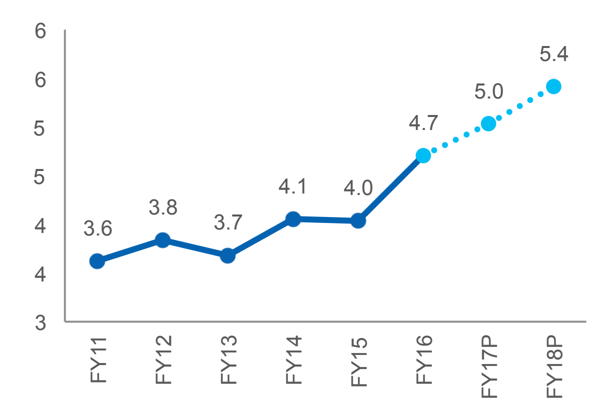


1. Outlook

GDP is projected to grow at 5.0 percent in FY17, reaching 5.4 percent in FY18

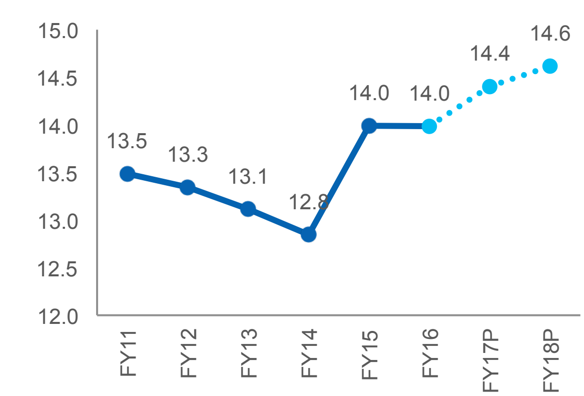
Pakistan's growth is expected to continue to accelerate, reaching 5 percent in FY17 and 5.4 percent in FY18 (see **Figure 23** and **Table 9**). On the demand side, growth is expected to be primarily driven by public and private consumption, supported somewhat by a moderate increase in investment (see **Figures 24, 25**). Pakistan's low investment to GDP ratio is expected to increase due to infrastructure projects under CPEC and other public investment. These projects, if delivered on schedule, are expected to accelerate growth in the domestic construction industry and expand electricity generation. Improved electricity availability would, in turn, support growth in the industry and services sectors.

Figure 23: Real GDP growth
Percent



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

Figure 24: Total investment
Percent of GDP



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

Table 9: Pakistan Key Macroeconomic Indicators

	2013	2014	2015	2016	2017	2018
Real GDP growth, at constant market prices (%)	4.4	4.7	4.7	5.7	5.0	5.4
Private Consumption	2.1	5.6	3.2	7.0	4.4	4.7
Government Consumption	10.1	1.5	8.1	15.1	8.9	10.4
Gross Fixed Capital Investment	2.6	2.5	14.1	5.7	8.2	6.9
Exports, Goods and Services	13.6	-1.5	-6.3	-4.8	0.7	3.6
Imports, Goods and Services	1.8	0.3	-1.6	12.4	4.5	5.5
Real GDP growth, at constant factor prices (%)	3.7	4.1	4.0	4.7	5.0	5.4
Agriculture	2.7	2.5	2.5	-0.2	2.7	2.6
Industry	0.8	4.5	4.8	6.8	5.7	6.0
Services	5.1	4.5	4.3	5.7	5.6	6.1
Inflation (Consumer Price Index)	7.4	8.6	4.5	2.9	4.6	5.0
Current Account Balance (% of GDP)	-1.1	-1.3	-1.0	-0.9	-1.7	-2.4
Financial and Capital Account (% of GDP)	0.4	3.0	2.0	1.8	1.7	2.4
Net Foreign Direct Investment (% of GDP)	0.5	0.6	0.3	0.4	0.8	0.9
Fiscal Balance (% of GDP)	-8.4	-4.9	-5.2	-4.4	-4.2	-4.0
Debt (% of GDP)	64.7	64.4	64.1	66.1	63.2	60.2
Primary Balance (% of GDP)	-3.9	-0.3	-0.5	-0.1	0.5	0.0

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice

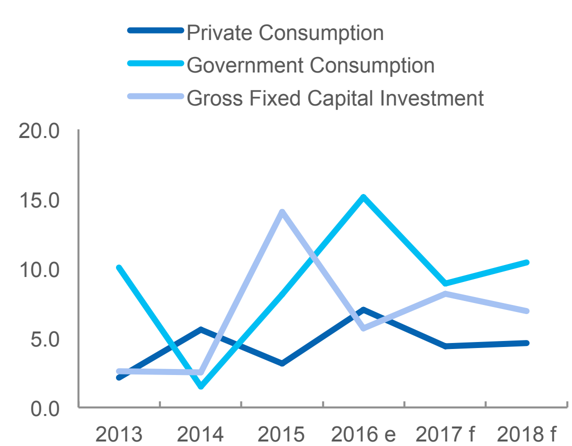
Notes: e = estimate, f = forecast.

On the supply side growth is expected to be driven by the services sector

On the supply side, the services sector, which comprises more than half of the economy, is expected to be the primary source of growth. The sector is expected to grow by 5.6 percent in FY17 (see **Figure 26**). After a lean performance in FY16, the agriculture sector is expected to recover sufficiently to grow at 2.7 percent in FY17, while the industrial sector is forecast to grow at 5.7 percent.

Figure 25: Growth in consumption and investment

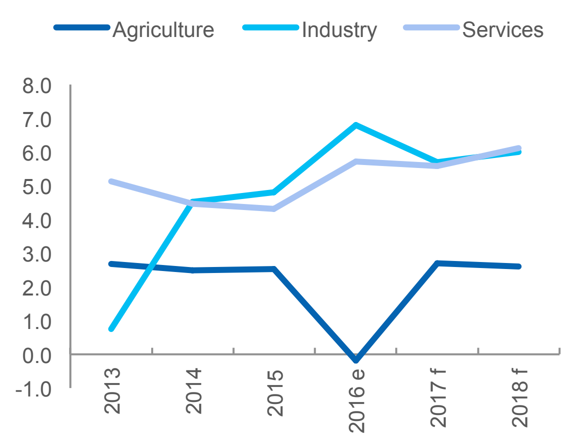
Percent



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

Figure 26: Growth in economic sectors

Percent



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

Current account deficit is projected to widen in FY17 but strong financial flows will support reserve build up

The current account deficit is expected to widen from 1.1 percent of GDP in FY16 to 1.7 percent in FY17. The key contributor to this will be a widening of the trade deficit due to moderate growth in exports (because of weak global demand and appreciation of the real exchange rate) and likely higher growth in imports (due to increased economic activity and a marginal rise in international oil prices). However, ongoing remittance inflows will support the current account. It is also expected that FDI flows will strengthen due to the accelerated implementation of CPEC projects. Therefore, like previous years, foreign exchange reserves are projected to increase.

Fiscal consolidation is expected to continue

The fiscal deficit is projected to be 4.2 percent in FY17, 0.4 percentage point lower than the revised estimates of FY16, which already represented the lowest deficit in nine years. This decline in consolidated fiscal deficit is primarily driven by an increase in government tax revenues (both federal and provincial) and a further rationalization of government current expenditures including subsidies. The provinces are also expected to supply a small surplus to support this effort. Federal and provincial governments are, however, expected to continue increasing their development expenditures. See **Section C4** for a further discussion of the FY17 federal budget.

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 4.6 percent in FY17 and 5.0 percent in FY18.

2. Progress and next steps on structural reform

Three years into its tenure, the government continues to implement an ambitious economic reform program

Over the past three years, Pakistan has successfully implemented an economic reform agenda with a strong focus on achieving macroeconomic stability, achieving both external and internal balance. As a result, Pakistan was able to complete a stabilization program with the International Monetary Fund after several failed attempts. The three-year Extended Fund Facility, which closed in September 2016, contributed to significant improvements in reducing fiscal deficits and the accumulation of reserves. Structural reforms supported in this program focused on energy sector reforms, privatization and improvements to the business environment. Acknowledging the significant progress made over the past three years, there remains a significant agenda of economic reform to be implemented—and the government continues to be committed to its implementation.

Energy reforms have reduced load-shedding, losses and subsidies but delays in the privatization of distribution companies may affect the sustainability of these results

Energy subsidies and the accumulation of arrears in the energy sector pose fiscal costs and risks, while insufficient amounts of energy limit the ability of the economy to prosper. The government's plans to reform the energy sector were laid out in its July 2013 policy, including raising electricity tariffs while reducing subsidies and reforms to improve technical and commercial efficiency. There has been progress: at the end of FY16 government reported losses at 17.9 percent, down from 18.6 percent in FY13, while bill collections rose from 88.7 percent to 94.6 percent over the same period. Load shedding now averages about 6 hours a day and has been largely eliminated for industry. The government has also managed to attract significant private investment into electricity generation, especially through the China Pakistan Economic Corridor program. Investments in transmission, on the other hand, will mostly be public and are urgently needed to cope with the pipeline of new generation projects. Delays in the sale of three of the best-performing distribution companies in Faisalabad, Lahore and Islamabad, and the government's preference to sell shares through Initial Public Offerings (IPOs), means that a different approach will have to be adopted. Investment in distribution to reduce technical losses and improve metering, billing and collection is badly needed and is now likely to fall on the public purse.

Pakistan is also implementing a far-reaching reform of its 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), developed in FY15, has provided a comprehensive framework for reform efforts on financial inclusion and aims to increase access to finance for underserved market segments such as women, SMEs, and rural geographies. Several weaknesses in basic financial sector infrastructure and in the legal and judicial framework have constrained lending to the private sector, including: the absence of an appropriate insolvency framework; deficiencies in credit information; the lack of a secured transactions framework and electronic collateral registry for moveable collateral; and difficulties in enforcing collateral outside of the judicial system. Recent measures taken to redress long-standing legislative issues include amendments to the Financial Institutions (Recovery of Finance) Ordinance 2001 to improve the recovery of NPLs without court intervention; enactment of a new legal framework for secured transactions; passage of a new and strengthened Securities and Exchange Commission of Pakistan Act; enhancements to the Credit Bureau Act; and passage of the Deposit Protection Corporation Bill to implement a deposit insurance scheme. Reforms have also focused on broadening the financial sector. Pakistan Microfinance Investment Company has been set up as the wholesale microfinance lender, non-bank financial institutions (NBFI) regulations have been modernized, and the stock exchanges have been demutualized and unified under a stronger governance and risk management framework.

Institutional and legislative reforms will need to continue in the financial sector

There is a need to continue efforts to strengthen and diversify the financial sector and improve its governance and transparency. The legislative agenda includes the Corporate Rehabilitation Bill, which deals with bankruptcy, and the Deposit Protection Corporation Bill, a deposit insurance scheme. Institutional reforms include the setup of the Pakistan Development Fund (to finance infrastructure) and the unified Shariah Board for the financial sector. Together, these reforms will contribute to a stronger and more inclusive financial sector.

Fiscal reforms have successfully increased revenues; the government will continue with a gradual fiscal consolidation effort

Tax revenues have increased from 10 percent of GDP in FY13 to 12.4 percent in FY16. This progress was achieved through a combination of eliminating tax exemptions and strengthening tax administration. The successes in broadening the tax net have been more mixed—only a very small number of Pakistani businesses and people pay taxes, and this number has increased only slightly in recent years. Going forward, efforts may need to focus on strengthening the authorities' capacity to monitor and enforce compliance through market analysis, access to data and information as well as increased recourse to tax compliance audits. A careful examination of the balance of revenue sources may also be helpful, including the mix of direct and indirect taxes and the impact on other policy objectives of measures such as the withholding tax, turnover tax and the increase of regulatory duties. The provinces' contribution to tax revenues remains limited, with several taxes under the responsibility of the provinces (agricultural income tax, urban property taxes) significantly underperforming. Improved coordination between the federal government and the provinces (and among provinces) will be necessary to deal with double taxation and increasing tax compliance costs. On the expenditure side, recent amendments to the Fiscal Responsibility and Debt Limitation Act will contribute to medium term debt sustainability but it will be necessary to continue strengthening debt management given persistently high debt levels and high financing costs.

Reforms to improve the competitiveness of the private sector have had mixed results

Despite strong growth, private investment in the South Asia region remains relatively low, as discussed in the most recent South Asia Economic Focus[46]. Pakistan's export performance has also been poor over the past few years, caused by both a weak external environment and significant supply-side constraints that affect the country's competitiveness. The 2013 Enterprise Survey conducted by the World Bank identified infrastructure and electricity, corruption and governance, and taxes as major constraints to private sector investment. The economic reform program being implemented by the government addresses a number of these constraints. Similarly, recent reforms in the financial sector (see above) will also have a positive impact on the business environment. The federal and provincial governments have developed a joint time-bound action plan to improve the investment climate and start addressing some of the key constraints for doing business (accessing credit, starting a business, registering property). The government has also simplified the tariff structure, bringing the tariff slabs from six to four. Results of tariff simplification efforts have been more mixed, though, with the simple average tariff reducing only slightly from 14.4 percent in FY13 to 13.4 percent in FY16. While tariffs declined marginally, the use of regulatory duties expanded significantly (in order to achieve revenue targets), with almost 10 percent of imports paying regulatory duties in FY15, up from below 1 percent in FY13. The tension between revenue objectives and trade competitiveness may warrant

[46] World Bank, 2016, "Investment Reality Check", South Asia Economic Focus (Fall 2016), World Bank, Washington DC

further examination by the government. This increase in duties, together with the persistent supply-side constraints and the weak external environment, explain the negative exports performance over the past few years.

Pakistan's performance in the 2017 Doing Business rankings suggests some progress, but sustained efforts are required

Pakistan's performance in the Doing Business (DB) 2017 is encouraging—having arrested a long-term decline and improved its position from 148[47] to 144 out of 190 countries in 2017. This improvement of four ranks follows a fall of 72 ranks between 2008 and 2016. Reforms relating to automation of land records in Punjab, getting credit and customs clearance improved the ranking to 144. Pakistan was recognized in the report as one of the ten economies with the biggest improvements in their business regulation. However, Pakistan's DB performance greatly varies across indicators—from 27 on protecting minority investors to 172 on trading across borders—which underscores the need for consistent implementation of a three-year strategic roadmap for DB reforms.

[47] Due to major data revisions and methodology changes, Pakistan's DB2016 ranking has been revised from 138 to 148. The main reasons behind this include: data revisions in a number of indicators namely starting a business, dealing with construction permits, registering property, getting electricity, paying taxes, enforcing contracts and resolving insolvency as well as additional methodology changes.

3. Progress on social indicators

Progress is mixed on social indicators over the last decade

Pakistan's progress on social indicators over the last decade has been mixed. While monetary poverty has fallen substantially, improvements in stunting, education and health indicators remain sluggish. The following discussion draws on the indicators listed in **Annex A**.

Pakistan has had great success in lowering poverty

Pakistan has made significant progress in reducing poverty over the last 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) shows 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 (see **Section C1**).

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. The infant mortality rate fell from 80 to 66 deaths per 1000 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.

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 (see **Section C2**). 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 to its desired levels. 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 enrollment 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 enrollment rates for middle and secondary school still remain low at 62 percent and 58 percent respectively in 2015.

The quality of education has also failed to improve

Available data suggests that the quality of education has also 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—has seen little change since 2010, hovering around 50 percent. Moreover, a large number of schools in Pakistan still lack basic facilities like 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. Khyber Pakhtunkhwa (KP) seems to have made the most progress in a number of areas. The gross primary enrolment rate in the province increased three 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. Stunting in Sindh also remains very high. Sindh 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 Balochistan.

Punjab has had mixed success while Balochistan 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), as well as child immunization and rural sanitation while making little or no progress on enrolment rates and the quality of learning outcomes. Balochistan 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 Balochistan 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 capture a greater share of a growing population while also improving quality.

4. Risks

CPEC delays and inadequate revenue mobilization are two risks to near-term growth

The gradual growth trend is underpinned by increased public investment through CPEC. If CPEC is not implemented as expected in FY17, this will reduce the growth outlook. Failure to follow through with the fiscal consolidation agenda would also affect growth in a number of ways. Reduced fiscal space may reduce public investment and the resultant increase in government borrowing may crowd out private investment, as witnessed in the recent past. More generally, slippages in fiscal consolidation would undermine confidence in reform momentum and Pakistan's ability to absorb future shocks.

External and internal balances could be affected by large increases in oil prices

Pakistan's external and fiscal balances continue to benefit from low global oil prices, but a sudden increase in oil prices could disrupt this stability. On the other hand, low oil prices will curtail public spending in GCC economies, which are a key source of remittances for Pakistani foreign workers. This would reduce remittances growth and widen the current account deficit.

The fallout from Brexit could still harm Pakistan's exports

The European Union (EU) is a major—and growing—market for Pakistan's exports, accounting for 30.8 percent, of which the UK's share is 7.4 percent in FY16.[48] An economic slowdown in the EU and the U.K. as a result of 'Brexit' would likely slow the demand for Pakistani exports, particularly textile exports. Also, a potential appreciation of the Pakistani Rupee against the British Pound and Euro would increase the price of Pakistan's exports, thereby reducing their competitiveness.

[48] EU's share in Pakistani exports (including U.K) is 30 percent. U.K's standalone share in Pakistani exports is 7.0 percent.

C. Special sections

1. Poverty in Pakistan: settling an old debate and establishing a more inclusive poverty line

Until April 2016, the most recent official poverty data available in Pakistan were from FY06. The Government of Pakistan, supported by the World Bank, recently undertook a validation exercise to substantiate the poverty data from the intervening years, identify key shortcomings in the methodology and to lay out the next steps for creating a credible and autonomous system for monitoring poverty and inclusion. This exercise found that Pakistan has indeed achieved remarkable success in reducing poverty from 34.7 percent to 9.3 percent between 2001 and 2014 (using the poverty line determined in 2001). This success, and changing community perceptions of wellbeing, led the government to update its poverty measurement methodology and define a new, more inclusive poverty line in April 2016. The new poverty line identifies 29.5 percent of the population and 6.8 to 7.6 million households as poor, setting a higher, more inclusive standard for pro-poor policies. This note discusses the evidence corroborating the fall in poverty, explores two important critiques of the declining poverty trend and finishes with a description of the new methodology and the resulting poverty trend.[49]

Pakistan has seen a steep decline in poverty since 2001[50]

Using the poverty line set by the government in 2001, the percentage of people under the poverty line has fallen from 34.7 percent in FY02 to well under 10 percent in FY14[51]—a 75 percent reduction in poverty over 14 years (see **Table 10** and **Figure 27**).

[49] This note was prepared by Dr. Ghazala Mansuri (Lead Economist, Poverty and Equity), with assistance from Dr. Freeha Fatima (Economist, Poverty and Equity).

[50] The estimation and release of the poverty numbers is the responsibility of the Planning Commission, which uses Household Income and Expenditure Survey (HIES) data produced by the Pakistan Bureau of Statistics (PBS) to produce national, regional and provincial poverty rates. The data is produced roughly every two years.

[51] The last year for which poverty data is currently available.

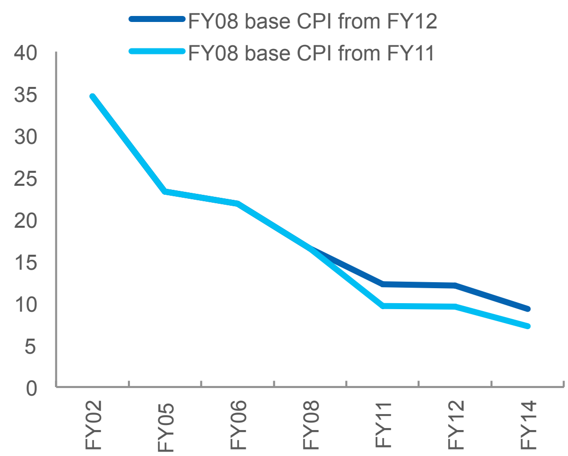
Table 10: The trend in poverty between 2001 and 2014

Year	Poverty Line (in rupees)		Poverty Rate (percent)	
	FY08 base CPI from FY11	FY08 base CPI from FY12	FY08 base CPI from FY11	FY08 base CPI from FY12
FY02		723		34.7
FY05		871		23.3
FY06		939		21.9
FY08		1133		16.5
FY11	1657	1741	9.6	12.2
FY12	1847	1939	9.6	12.1
FY14	2153	2259	7.2	9.3

Source: HIES and World Bank Staff calculations

Figure 27: The trend in poverty between 2001 and 2014

Percent



Source: HIES and World Bank Staff calculations

Despite this success, there are political and administrative challenges to disseminating poverty data

Unfortunately, however, throughout much of this period there was no official release of poverty numbers, with the most recent official poverty rates from FY06. While there were a number of reasons for this, including the changing political climate, the most critical was the absence of a credible, independent and empowered commission with the authority and capability to validate data and routinely release poverty numbers as new data came in.

This vacuum was filled by a host of unofficial poverty numbers, adding to conflicting narratives

Due to the vacuum created by the lack of official poverty numbers, unofficial estimates of poverty were released by several researchers and think tanks. Unsurprisingly, these produced a range of poverty numbers—some of which showed increasing or stagnant poverty rates over this time period, mainly due to incorrect use of the 2001 poverty line. Some of these alternative narratives about poverty found considerable currency in policy circles and in the media—bolstered by a sense that GDP growth had been too low and volatile to sustain such a consistent and sharp decline in poverty and that other social sector indicators, particularly child stunting rates and school enrollment, had not improved sufficiently. This depleted confidence among citizens and policymakers in the veracity of national data, thwarting effective policy dialogue on the government's role in reducing poverty and vulnerability. It also created challenges in using poverty data as a basis for targeting or allocating resources.

Renewed government efforts over the past two years helped validate the narrative of a poverty decline

For the past two years, the Government of Pakistan has renewed efforts to review the quality of the data and propose a way forward for the credible and timely release of poverty numbers. These efforts were supported by the World Bank through technical assistance. The following sections describe the findings of the validation process, which substantiate the decline in poverty using a variety of data sources, identify key shortcomings in the national data, and lay out measures to create a credible and autonomous system for monitoring poverty and inclusion.

Collaboration between the government and the World Bank resulted in key improvements

The Planning Commission, the Pakistan Bureau of Statistics (PBS) and the Ministry of Finance, supported by the World Bank, recently engaged in a validation process. It concluded with three recommendations to improve poverty measurement in Pakistan. The first two identified critical improvements in the data used to measure inflation and poverty. These are reviewed briefly below. The third recommended

in the way poverty is measured

that Pakistan set a new poverty threshold. As countries develop they need to periodically re-evaluate and raise the consumption floor for the least advantaged. In October 2015, following the review process, the government validated the declining trend in poverty and decided it was time to set a new poverty line.

As a result, a new poverty line was agreed and announced

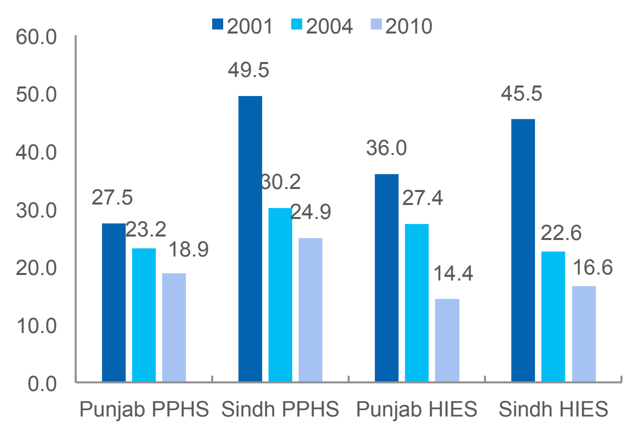
The government announced the new poverty line in April 2016. At this time the trend in poverty since 2001 was also officially released. By resetting the poverty threshold, the government reaffirmed its commitment to a sustainable and inclusive development path in line with its policy priorities. These include its commitments in relation to the Sustainable Development Goals (SDGs), a robust social protection program and the creation of more and better jobs for the poor. The final section of this note briefly reviews the method used to update the poverty line and the trend in poverty based on the new line.

a. Corroborating the Poverty Decline

Independent data corroborates the decline in poverty

Pakistan is fortunate that, in addition to the HIES series, there is an independent panel survey—the Pakistan Panel Household Survey (PPHS)—which covers the key period of poverty decline (2001-2010) and can be used to check official data. The PPHS tracked the same households through three survey rounds in rural Punjab and Sindh and confirms the decline in poverty observed in the HIES. The headcount rate in rural Punjab (Sindh) fell from 27.5 percent (49.5 percent) in 2001 to 18.9 percent (25.9 percent) in 2010, and as in the HIES, the sharpest decline in poverty was observed in the period 2001 to 2004 (see **Figure 28**).

Figure 28: Poverty headcount in rural Punjab and Sindh
Percent

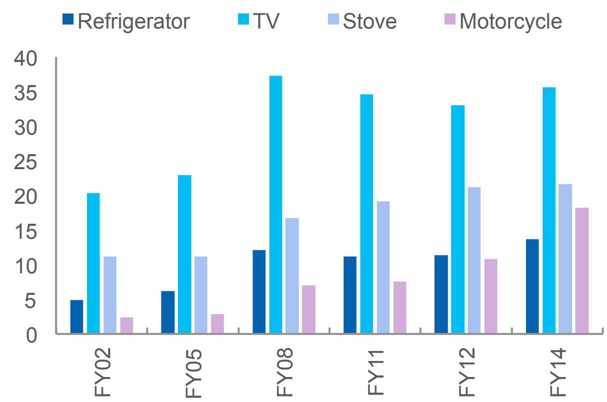


Source: HIES and World Bank Staff calculations

The decline in poverty resulted in substantial gains in wellbeing

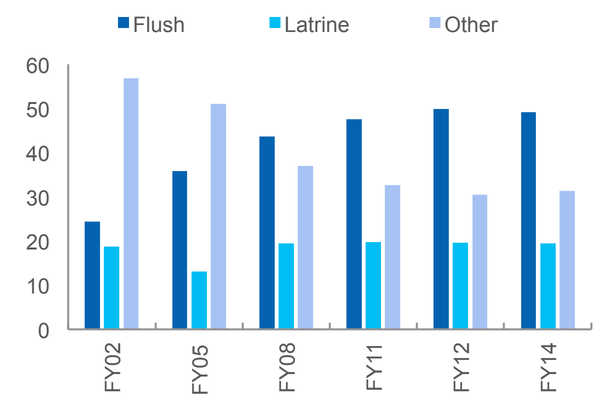
When poverty declines, it usually coincides with other gains in household welfare. Throughout the period under review, Pakistan saw substantial gains in welfare, including the ownership of assets, the quality of housing and an increase in school enrollment, particularly for girls. First, the ownership of relatively more expensive assets increased even among the poorest. In the bottom quintile, the ownership of motorcycles increased from 2 to 18 percent, televisions from 20 to 36 percent and refrigerators from 5 to 14 percent (see **Figure 29**). In contrast, there was a decline in the ownership of cheaper assets like bicycles and radios. Housing quality in the bottom quintile also showed an improvement. The number of homes constructed with bricks or blocks increased while mud (katcha) homes decreased. Homes with a flushing toilet almost doubled in the bottom quintile, from about 24 percent in FY02 to 49 percent in FY14 (see **Figure 30**).

Figure 29: Asset ownership in the bottom quintile
Percent



Source: HIES and World Bank Staff calculations

Figure 30: Household toilet type in the bottom quintile
Percent



Source: HIES and World Bank Staff calculations

The sharpest increase in school enrollment rates coincides with the steepest fall in poverty

While net enrollment rates, particularly for girls, still remain far too low, both net and gross enrollment rates increased sharply in the period between FY02 and FY08 which is also the period when the sharpest decline in poverty occurred. The increase in elementary school enrollment for girls is particularly noticeable in this period (see **Table 11**). Gross (net) enrollment rates for girls between age 5 and 9 increased by 22 (14) percentage points. This increase is also corroborated in the PPHS data.

Table 11: School Enrolment Rates
(Percent)

	FY02	FY05	FY08	FY11	FY12	FY14
Elementary school (age 5-9)						
Gross enrollment ratio						
Boys	83	94	97	100	97	98
Girls	61	77	83	83	83	81
Total	72	86	91	92	91	90
Net enrollment ratio						
Boys	46	56	59	60	60	60
Girls	38	48	52	53	54	53
Total	42	52	55	56	57	57

Source: Pakistan Bureau of Statistics PSLM reports

The share of non-food items in consumption also increased significantly

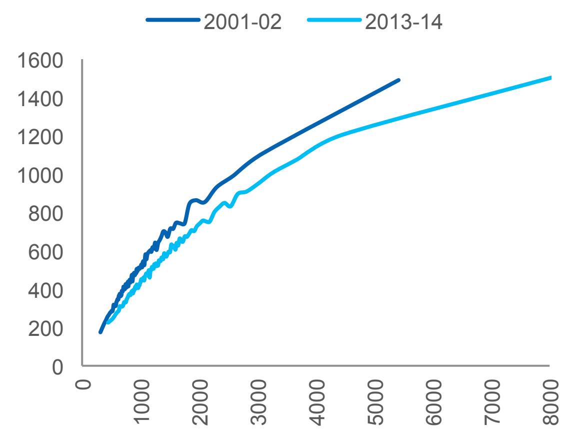
Changes in consumption patterns over time were also consistent with the poverty decline. It is well-known that increases in income are strongly associated with households spending less of their budget on food, and more on non-food items (Engel's law). In Pakistan, the 25 percentage point decline in poverty between FY02 and FY14 was associated with a 10 percentage point reduction in the share of expenditure devoted to food (see **Figure 31**).

Households moved towards a more balanced and diverse diet

In Pakistan, the reduction in poverty led to an increase in dietary diversity for all income groups. For the poorest, the share of expenditure devoted to milk and milk products, chicken, eggs and fish rose, as did the share devoted to vegetables and fruits. In contrast, the share of cereals and pulses, which provide the cheapest calories, declined steadily between FY02 and FY14. Because foods like chicken, eggs, vegetables, fruits, and milk and milk products are more expensive than cereals and pulses, and have lower caloric content, this shift in consumption also increased the amount that people spent per calorie over time (see **Table 12**). For the poorest quintile, expenditure per calorie increased by over 18 percent between FY02 and FY14.

Figure 31: Relationship between total expenditure (x-axis) and real food expenditure (y-axis), Engel Curve

FY02 prices



Source: HIES and World Bank Staff calculations

Table 12: Average budget shares for major food groups (bottom quintile)

Percent

Food Category	FY02	FY14
Milk and Milk Products	16.8	19.3
Chicken and Other Poultry	1.1	3.5
Eggs	0.6	1.0
Fresh and Canned Vegetables	9.7	12.1
Cereals	33.2	29.3
Pulses	2.7	2.3

Source: HIES and World Bank Staff calculations

The fall in poverty is credible

Overall, this analysis confirms that the decline in poverty exhibited by the 2001 poverty line is quite credible, and that Pakistan has done remarkably well overall in reducing monetary poverty based on the metric it set some 15 years ago.

b. Critiques of the Poverty Decline

Two important concerns have been raised regarding the declining poverty trend

Pakistan's public discourse has raised two important critiques of the poverty trend. The first is the suggestion that the decline in the share of food in the poor households' budgets has occurred due to a 'food squeeze' rather than an increase in wellbeing. The second is that the CPI data used to inflate the poverty line underestimates inflation, particularly for poorer households. The following addresses each in turn.

Is there evidence of a 'food squeeze'?

The 'food squeeze' argument stems from the lack of improvement in nutritional outcomes in Pakistan. If poverty has declined, why has there been such little improvement in child stunting and wasting indicators? This line of argument assumes that nutritional deficits are due to a lack of access to adequate food, both in terms of quantity and quality. However, there is now a considerable body of research suggesting that the link between food availability and nutritional status is weak, and is mediated by the ambient disease environment and the quality of water and sanitation.

Contaminated water and poor sanitation, rather than food availability, may

While nationally representative data on water quality is not yet available, data from select rural districts in Punjab, Sindh and KPK shows that between one third and two thirds of the drinking water in the rural areas of Pakistan is contaminated with E-coli and is unfit for drinking. Sanitation and associated health behaviors also

explain high rates of malnutrition

remain quite poor, and are much worse in poorer communities. Without a substantial improvement in these critical public services and greater awareness about detrimental heath behaviors in households and communities, it is unclear that a rise in the income of the poorest will substantially improve nutritional outcomes.

An FY02 basket of food became substantially cheaper between FY02 and FY14

Further, the cost of the basket of food consumed by the average household in FY02 has become more affordable over the time period under review. The share of real expenditure required to purchase the FY02 food basket consumed by the average household declined by almost 10 percentage points over 12 years from FY02 to FY14. This was witnessed in both the top and bottom quintile of the distribution of expenditure (see **Table 13**).

Table 13: Percentage of total expenditure required to purchase FY02 food basket

Percent

	FY02	FY08	FY14
National			
Bottom Quintile	55.3	48.9	45.4
Top Quintile	42.0	33.8	31.1
Urban			
Bottom Quintile	50.6	42.0	38.8
Top Quintile	32.6	26.1	24.4
Rural			
Bottom Quintile	57.0	49.8	47.0
Top Quintile	48.5	42.6	39.5

Source: HIES and World Bank staff calculations.

Calorie-consumption decreased, but this was due to a shift from cereals to more nutritious foods

The final question in exploring a possible food squeeze is whether the poor consumed fewer calories over the reference period. While measured calories in the HIES did indeed decrease over time—only in rural areas across all income quintiles—the wealthiest rural quintile reduced their calories the most. Further, the only items for which calories declined were cereals, which are also the cheapest foods. Rural households apparently chose to move away from cheap calorie-dense foods towards more nutritious and lower-calorie foods—and their consumption patterns also became more closely aligned to those of urban households.

There is no evidence of a food squeeze—surveys need to better capture food consumed away from home

Ultimately, a 'food squeeze' story does not appear to be credible for Pakistan. A more likely explanation of the reduced calories is that food consumed away from home—a category of expenditure that is currently poorly captured in the HIES—has increased substantially as poverty has fallen and labor has moved into non-farm work. Non-agricultural wage workers tend to purchase their lunchtime meals, and *roti* and *daal* is the most common lunchtime meal among workers!

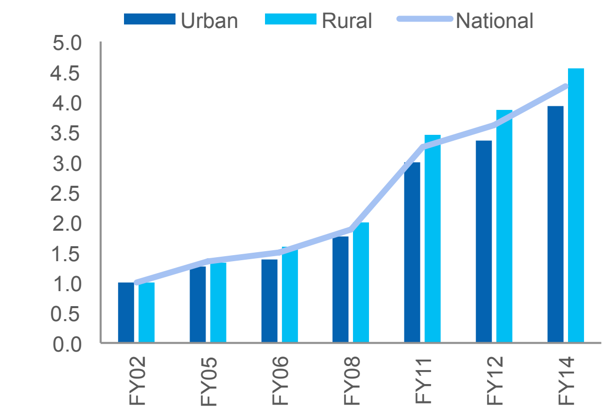
Does the CPI underestimate inflation?

The CPI is used to inflate Pakistan's 2001 poverty line to current-year values. Some commentators have raised concerns that underestimates of inflation have effectively lowered the poverty line, thus reducing the number of people in poverty.

If inflation rates are updated to better reflect rural inflation, the poverty decline is dampened but remains significant

The CPI in Pakistan has traditionally been measured using prices from urban markets and item weights from an urban survey. Recent analysis showed that rural inflation substantially exceeded urban inflation, particularly after 2007, leading to a significant underestimation of inflation (see **Figure 32**). Accounting for this shrinks the poverty decline by six to eight percentage points. While this is significant, it does not overturn the trend in poverty; even after this adjustment, Pakistan more than halved its poverty rate between 2001 and 2014.

Figure 32: Survey Based Price Index
FY02 base



Source: HIES and World Bank Staff calculations

The PBS is improving inflation measurement and the HIES

To address this inaccuracy, the PBS has started the process of measuring inflation using a national survey and including both rural and urban prices. Work is also underway, supported by the World Bank, to improve the measurement of food consumed away from home and more broadly improve the part of the questionnaire used to measure consumption in the HIES.

c. Setting a New Poverty Line

Poverty lines require revision as countries grow and perceptions change

Most countries revisit their poverty threshold when poverty rates get as low as those seen in Pakistan today. Many developing countries have done this, and there are sound theoretical justifications. A periodic resetting of the absolute poverty line aligns it with perceptions of what is required for a basic level of wellbeing in a country that is undergoing rapid changes. It is precisely Pakistan's success in reducing poverty on the 2001 metric that made this the right time for raising the bar on whom is considered disadvantaged, thereby committing to a more robust response to poverty and exclusion. Setting a new poverty threshold also allowed for a re-evaluation of the estimation methodology to bring it in line with international best practice.

The FY02 poverty line used the Food Energy Intake method

Pakistan's poverty line was last determined in FY02 using the Food Energy Intake (FEI) method, with a reference group that included the bottom three quintiles of the distribution of consumption expenditure. It was anchored to a minimum caloric threshold of 2,350 calories per adult equivalent per day. The FEI method assumed that the expenditure level at which 2,350 calories can be consumed by the reference group covers necessary food and non-food expenditures adequately. This approach produced a poverty line of Rs. 723.40 per adult equivalent per month in 2001, which produced a headcount rate of 34.6 percent at the time.

The new poverty line adopts a best

To determine the new poverty line, the government adopted the methodology considered best practice today—the Cost of Basic Needs (CBN) method. CBN is

practice method that is more transparent and better captures non-food needs

more transparent and captures non-food needs better than the FEI method.[52] The new line adopted the 10th to the 40th income percentiles as a reference group, thereby excluding both the poorest and the wealthiest households as recommended by best practice. It retained the normative metric of 2,350 calories per person per day to maintain consistency. For a country like Pakistan, the Food and Agricultural Organization (FAO) recommends a daily caloric threshold of 2,150 calories per person per day, so the standard set in Pakistan substantially exceeds FAO's recommendation.[53]

The new poverty line identifies 6.8 to 7.6 million households as poor in FY14

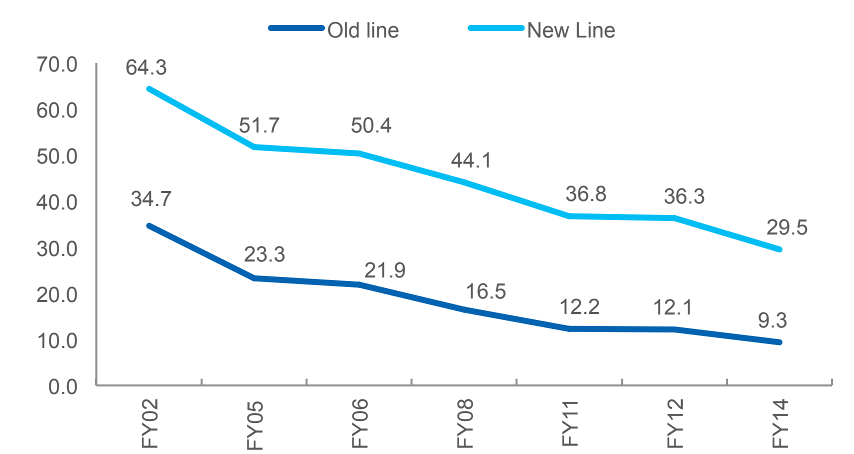
Based on these decisions and the FY14 HIES, the new poverty line for Pakistan was estimated at Rs. 3,030.32 per adult equivalent per month, which produces a national headcount rate of 29.5 percent in 2014. In absolute numbers, and based on population estimates of 180 to 200 million in FY14, some 6.8 to 7.6 million households (53 to 59 million people) are now classified as poor.

d. The Trend in Poverty using the New Poverty Line

The new poverty line represents a higher bar for pro-poor policy

Using national CPI data, the new poverty line can be back-casted to the year FY02. Both the new and old poverty methodologies confirm the same declining trend in poverty between 2001 and 2014 (see **Figure 33**). However, the two lines represent two very different standards of wellbeing, with the new poverty line setting a higher, and more inclusive standard for pro-poor policies.

Figure 33: Poverty headcount using FY02 and FY14 poverty lines
Percent



Source: HIES and World Bank Staff calculations

[52] For more details on the method see the 'Pakistan Poverty Line Update Factsheet', 2016. Planning Commission.
[53] This translates into 1,941 calories per adult equivalent per day. In the re-estimation of the poverty line, the government decided to maintain consistency with the previously adopted standard of 2,350 calories per adult equivalent per day.

2. Overcoming Pakistan's nutrition challenge: An essential step for a healthy economic future

Pakistan has the third-highest rate of stunting in the world and, unlike its regional peers, has not made progress on nutrition indicators in recent decades. Poor nutrition exerts a heavy toll on health outcomes and economic activity, and Pakistan's stunting rates are likely driving significant economic losses. Pakistan's public policy discourse has begun to give more attention to nutrition in recent years, and small but growing shares of provincial and federal budgets are being diverted to nutrition-specific interventions. However, a concerted effort at all levels of government is necessary to exert a meaningful impact on national stunting rates. This brief provides an overview of Pakistan's undernutrition challenge, discusses the economic implications of widespread malnutrition and concludes with current policy initiatives and priorities going forward.[54]

Pakistan's stunting rate is among the highest in the world

Around the world, undernutrition represents the single largest killer of under-five children, and is responsible for the death of 3.1 million children each year, or nearly half the total.[55,56] Globally approximately 162 million children under the age of 5 years are stunted. Pakistan accounts for up to 12 million of this total, and its stunting prevalence of 43.7 percent[57] represents the highest in South Asia and third highest in the world (see **Figure 34**). A growing body of evidence suggests that addressing the nutrition challenge will be essential to ensure a healthy economic future for Pakistan.

Poor nutrition in the first two years of life have lifelong consequences and create a cycle of poverty

Today, millions of young children are not reaching their full potential because of inadequate nutrition, lack of early stimulation and learning, and exposure to stress. The effects of malnutrition are long-term and undermine children's ability to thrive physically, cognitively and emotionally, reducing the chances that they can escape poverty and build successful lives as adults. The most damaging effects of undernutrition occur during pregnancy and in the first two years of life, the first 1,000 days, also called the 'window of opportunity'. Chronic malnutrition affects an individual's health and increases morbidity and mortality, brain development, intelligence, educability, and productivity. Beyond the age of two years stunting is irreversible. In brief, malnutrition has severe consequences on an individual's wellbeing and on a nation's socio-economic development as a whole.

Investments in early life yield significant rewards

Investments in the physical, mental and emotional development of children—from before birth until they enter primary school—is one of the smartest investments a country can make to break the cycle of poverty, address inequality, and boost productivity later in life. Investments in the early years are essential to ensure that children reach their full physical and cognitive capacity to lead a healthy and productive life.

[54] This note was prepared by Silvia Kaufmann (Senior Nutrition Specialist), with assistance from Zahra Saleem Ladhani (Consultant).

[55] UNICEF, World Health Organization, and World Bank (2014). Joint Child Malnutrition Estimates: Levels and Trends in Child Malnutrition. New York, Geneva, Washington, DC.

[56] The Lancet's Series on Maternal and Child Under nutrition, Executive Summary, available at: http://www.thelancet.com/series/maternal-and-child-nutrition

[57] National Nutrition Survey 2011 (NNS 2011). Ministry of Planning and Development and Ministry of Health Services, Regulations and Coordination, Government of Pakistan

a. The challenge of under-nutrition in Pakistan

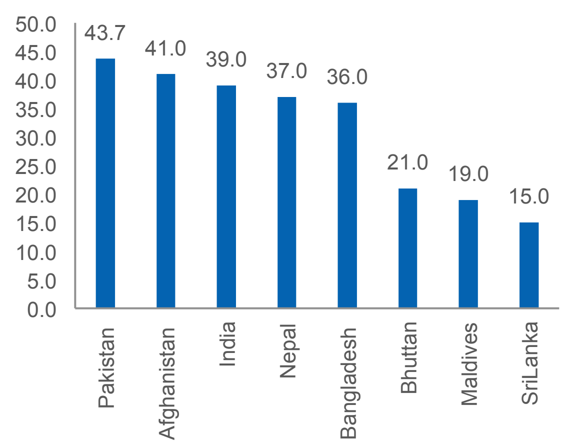
Stunting is defined as low height-for-age while wasting is low weight-for-height

Chronic and acute malnutrition (stunting and wasting) reflect different facets of under nutrition and are measured in children under five years. Stunting or shortness is defined as low height-for-age—too short at a given age due to inadequate nutrition over a long period of time leading to failure of linear growth. Acute malnutrition or wasting describes an individual who has a low weight-for-height ratio. Wasting or thinness indicates in most cases a recent and severe process of weight loss, which is often associated with acute starvation and/or severe disease.

While global rates of stunting are falling, Pakistan is making no progress in addressing malnutrition

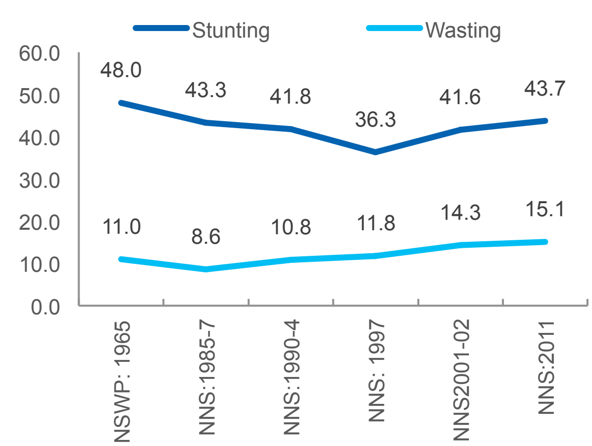
Moreover, Pakistan is falling behind in the fight against malnutrition. The global prevalence of stunting is improving at an average annual rate of 2.1 percent per year[58]. However, Pakistan's stunting rates have barely changed over the last three decades, instead worsening in recent years (see **Figure 35**). Peer countries with a comparable stunting burden a decade ago have improved significantly. Bangladesh, for example, reduced its stunting rates from 42 percent in 2004 to 36 percent in 2014[59] and Afghanistan reduced stunting from 52 percent in 2004 to 41 percent in 2013[60].

Figure 34: Prevalence of Stunting in South Asia
Percent



Source: Afghanistan NNS 2013, Bangladesh DHS 2014, Bhutan NNS 2015, India RSOC 2014, Maldives DHS 2009, Nepal MICS 2014, Pakistan NNS2011, Sri Lanka DHS 2007

Figure 35: Malnutrition trends in Pakistan
Percent



Source: National Nutrition Survey 2011. Planning Commission. Planning and Development Division. Government of Pakistan

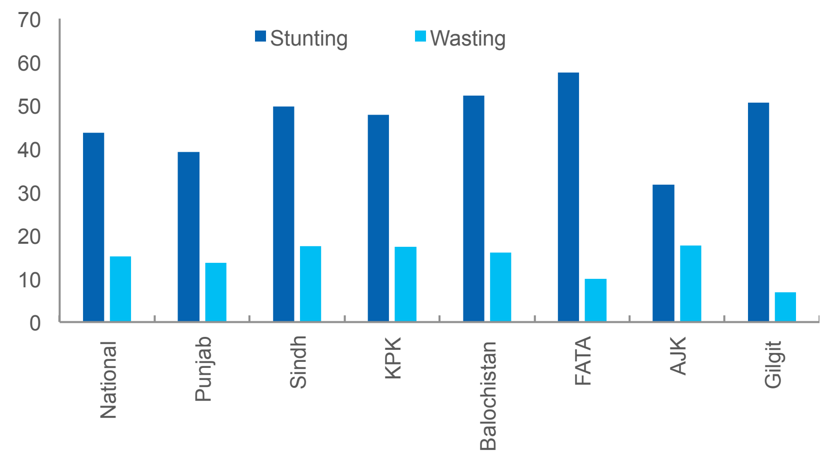
Stunting is most prevalent in Sindh and Balochistan

Stunting and malnutrition vary across provinces in Pakistan, with Sindh and Balochistan showing the highest prevalence (see **Figure 36**) and Punjab exhibiting the lowest rates. Children in urban areas are slightly better off than their peers in rural areas (36.9 percent urban and 46.6 percent rural). There are no significant differences in the nutritional status of boys and girls[61].

58 Improving Child nutrition: The achievable imperative for global progress. UNICEF 2013
59 World Bank fact sheet: Nutrition at Glance: Bangladesh. Available at: http://siteresources.worldbank.org/NUTRITION/Resources/281846-1271963823772/Bangladesh.pdf
60 World Bank fact sheet: Nutrition at Glance: Afghanistan. Available at: http://siteresources.worldbank.org/NUTRITION/Resources/281846-1271963823772/Afghanistan.pdf
61 National Nutrition Survey 2011 (NNS 2011). Ministry of Planning and Development and Ministry of Health Services, Regulations and Coordination, Government of Pakistan.

Figure 36: Prevalence of stunting and wasting by province

Percent



Source: National Nutrition Survey 2011. Planning Commission

Malnutrition is caused by disease and inadequate food intake, which are affected by water quality, feeding practices, sanitation practices and poor maternal health

The causes of malnutrition in Pakistan are complex. Immediate determinants are related to disease and inadequate food intake, which are in turn caused by inadequate care and feeding practices, poor hygiene and sanitary practices, access to health services, and unhealthy household environments. Some of these factors may be exacerbated by the low rates of female literacy. Over 20 percent of the rural population and 82 percent of the lowest income quintile in Pakistan defecate in the open.[62] Stunting rates are exacerbated by unfavorable infant and young child feeding practices (only 12.8 percent of children are exclusively breastfed[63]) and poor maternal factors such as early and frequent pregnancies, inadequate diet, and a lack of access to proper health care. These factors are further complicated by low birth weight (LBW, newborns weighing less than 2,500 grams at birth), high rates of open defecation and high rates of maternal underweight. The prevalence of stunting is markedly higher in children with LBW than those with normal birth weights; in Pakistan, LBW is both alarmingly high[64] and deteriorating (increasing from 25 percent of newborns in 1996 to 32 percent in 2008)[65].

b. The health and economic impacts of under-nutrition

Stunting exerts a significant economic cost

Healthy nutrition is essential for proper organ formation and function, a strong immune system, and neurological and cognitive as well as physical development. Research shows that stunted children start schooling later and are less likely to go on to higher education or graduate.[66] Studies have also shown that non-stunted children earn up to 40 percent more in adulthood and are 33 percent more likely to escape poverty, compared with stunted children.[67,68] As a result, populations with higher rates of stunting face significant annual GDP losses.

[62] UNICEF/WHO joint monitoring programme, 2015.
[63] National Nutrition Survey 2011 (NNS 2011), Ministry of Planning, Development and Reforms and Ministry of Health Services, Regulations and Coordination, Government of Pakistan
[64] Pakistan: Profile of preterm and low birth weight prevention and care. Report by USAID
[65] World Bank Nutrition Indicators 1990 - 2014
[66] "The double burden of malnutrition in Indonesia", available at: http://www.worldbank.org/en/news/feature/2015/04/23/the-double-burden-of-malnutrition-in-indonesia
[67] Martorell et al. 2010. Weight gain in the first two years of life is an Important of schooling outcomes in pooled analysis from 5 birth cohorts from low- and middle-income countries. Journal of Nutrition. 140:348-54

Malnutrition reduces labor productivity directly and indirectly, and drives higher health care costs

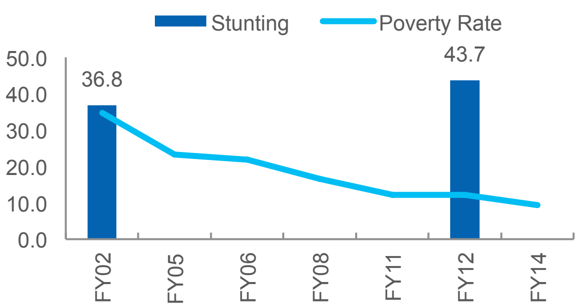
Malnutrition slows economic growth and perpetuates poverty through three routes; i) direct losses in individuals' productivity from a poor physical state; ii) indirect losses from poor cognitive developments and deficits prior to and during schooling including the consequent lower skill level of the future workforce; and iii) losses due to increased health care costs as a result of the higher morbidity and mortality associated with undernutrition in early childhood, including from non-communicable diseases later in life such as diabetes and heart disease.

High rates of stunting have persisted in spite of falling poverty rates—reducing poverty is not enough

Poverty reduction alone is not enough to overcome malnutrition. Pakistan has performed exceptionally well in reducing monetary poverty over the past decade and a half[69]. Using the government's 2001 poverty line, the poverty rate has fallen from 34.7 percent in FY02 to 9.3 percent in FY14. However, while poverty is clearly falling, nutritional indicators have not improved (see **Figure 37**).[70,71] Furthermore, stunting rates remain high in middle and upper income groups (although rates are highest in the lowest income quintile, see **Figure 38**).[72] This suggests that efforts to increase incomes alone will not eradicate stunting; the solution is more nuanced.

Figure 37: Trends in Poverty and Stunting Prevalence Pakistan

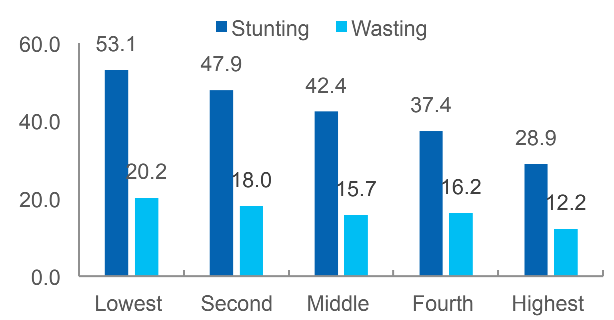
Percent[73]



Source: HIES, CPI & World Bank calculations

Figure 38: Levels of Stunting and Wasting across wealth quintile

Percent



Source: National Nutrition Survey 2011. Planning Commission. Planning and Development Division. Government of Pakistan.

c. The nutrition agenda in Pakistan is turning a corner

Human development in Pakistan is a major economic challenge

Accelerating progress in human development, including nutrition, remains the key challenge for sustained economic gains in Pakistan. Pakistan's public spending on education and health is one of the lowest in South Asia (less than 3 percent of GDP combined), and allocations to nutrition are modest. Historically, nutrition—as well as early childhood education and development—have received little attention in Pakistan. The attention nutrition has received has been delivered through a project-based approach, lacking cohesive planning and mainly funded by international donors and implemented by NGOs.

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68 Hoddinott, J., J. Maluccio, J. R. Behrman, R. Martorell, P. Melgar, A. R. Quisumbing, M. Ramirez-Zea, A. D. Stein, and K. M. Yount. 2011. "The Consequences of Early Childhood Growth Failure over the Life Course." Discussion paper 1073. International Food Policy Research Institute, Washington, DC.

69 Poverty in Pakistan – Raising the bar: Fact sheet 2015

70 World Bank's HIES Poverty analysis 2001 to 2014

71 World Bank Pakistan, estimates from Pakistan Social and Living Standards Measurement Surveys; 2001 and 2011 NNS.

72 National Nutrition Survey 2011 (NNS 2011). Ministry of Planning and Development and Ministry of Health Services, Regulations and Coordination, Government of Pakistan.

But impetus is building for action on nutrition

Political awareness of nutrition has, however, grown in recent years as leaders have recognised the potential of nutrition to reduce poverty through improved human and social capital. The release of the National Nutrition Survey 2011 by the Ministry of Planning, Development and Reforms (MoPDR) and the decision to join the global movement of Scaling-Up-Nutrition (SUN) in 2013 underscored the government's commitment to addressing this issue. Nutrition became an important subject of Pakistan's Vision 2025, and the MoPDR established a secretariat to coordinate and support its scaling-up. Development partners have jointly carried out a dialogue on undernutrition and prepared policy papers to support each province to develop inter-sectoral nutrition strategies. In FY16, Pakistan allocated 1.06 percent of consolidated federal and provincial budget expenditure to nutrition-specific interventions,[74] an encouraging improvement from the previous year's allocation of 0.34 percent[75]. As a comparison, most developing countries are spending less than 1 percent of their budgets on nutrition and, similarly, nutrition accounts for less than 1 percent of official development assistance[76].

Federal and provincial governments, supported by donors, are starting to take action

Following the 2010 devolution of responsibilities from federal to provincial governments, Pakistan's provinces have put in place institutional arrangements and resources to plan and implement nutrition interventions. Health-related nutrition services have been introduced in Sindh, Balochistan and Punjab. Donors have also increased their allocations to nutrition for Pakistan. For example, the Multi-Donor Trust Fund Pakistan Partnership for Improved Nutrition (PPIN), managed by the WB with contributions from Australian Department of Foreign Affairs & Trade (DFAT) and UK's Department of International Development (DFID) provides grants to fund selected key interventions. The World Bank is also making significant funding available to support nutrition-specific and multi-sectoral actions in Sindh and Punjab and has recently provided technical support to the governments of Sindh and Punjab to develop a more ambitious multi-sectoral response, increasing investment in early years. In addition, the EU is providing financial support for nutrition in four districts of Sindh and USAID is supporting Sindh in another four districts.

d. Priorities going forward

Investments in nutrition in Pakistan could generate a return of 1:30

The return on investments in nutrition are among some of the highest in global development, and there is a growing consensus that improving young child nutrition is one of the best investments a country can make in future prosperity. According to recent estimates, investing $1 in key interventions to reduce stunting in Pakistan would generate an economic return of $30[77].

Pakistan should make large-scale investments in early

Pakistan needs to address malnutrition through large-scale investments in early years and bolder programs in nutrition, health, early childhood care and education. By giving priority to nutrition programs and exerting appropriate political and technical

[74] Nutrition Specific Interventions: improving maternal nutrition; improving infant and young child feed practices, which include exclusive breastfeeding for the first 6 months of life; and improving child nutrition through micronutrient supplementation and the provision of nutritious complementary foods

[75] Global Nutrition Report 2015 and 2016, International Food Policy and Research Institute, Washington D.C. US.

[76] National budgets; SPRING4; Save the Children; CRS database (2013) basic nutrition disbursements were projected to 2015 based on OECD reported growth projections

[77] Hoddinott, Alderman, Behrman, Haddad, & Horton (2013). The economic rationale for investing in nutrition. Maternal and Child Nutrition 9(Suppl. 2): 69-82.

years and adopt bold programs, focusing on needy districts and effective institutional coordination

leadership, malnutrition can be reduced significantly within a generation. Steps include:

- Ensure that provincial governments commit the required resources, build institutional structures and capacities to plan and implement quality services at scale.
- Establish high-level political coordination committees at federal and provincial levels that include a diverse group of stakeholders. Strengthened institutional structures are urgently required to implement, coordinate, supervise and monitor the varied multi-sectoral activities to improve nutrition. A successful coordination mechanism would need sufficient influence to be able to create accountability within line ministries and the capacity to enable coordination between development partners.
- Expand and scale up well-proven direct nutrition interventions targeted to vulnerable populations and the 'golden 1,000 days', and implement—through a phased approach—additional nutrition-sensitive interventions focusing on the 50 most under-developed districts of south Punjab, north/south Sindh, Balochistan and south KP in the next two to three years with full expansion in five years.
- Employ bolder and innovative interventions on a large scale including greater use of private sector skills, conditional cash transfer programs targeted to the poor, and multi-sectoral interventions with priority to health, water and sanitation, nutrition-sensitive agriculture, education and early childhood development, and social protection.
- Significantly enhance Pakistan's own investment in nutrition programs as well as seeking support from development partners.

Pakistan needs to build on the impetus to take comprehensive action on malnutrition

Without a significantly enhanced and urgent response to address stunting, Pakistan risks developing a largely unskilled, economically-unproductive population. Nutrition and early childhood development have received little attention in Pakistan with an absence of policies and programs *at scale* to address the severity of the challenge. Following the 2010 devolution of responsibilities to provincial governments, momentum around nutrition has built steadily: nutrition is part of the Pakistan Vision 2025 and provincial strategies are in place. Pakistan's FY16 allocation to nutrition-specific interventions was an encouraging improvement from the previous year and programs are now being rolled out in a number of districts. This impetus needs to continue, with additional attention on the critical interventions outlined above. Nutrition interventions also need to be complemented by other investments in the early years, including in early childhood education. An increased funding commitment from the government will be of utmost importance.

3. Karachi City Diagnostic: livability, sustainability and growth in the city of Karachi

Karachi's population and economy have grown rapidly since Pakistan's independence in 1947. It is the country's economic hub, and a strong industrial base. Yet the city's infrastructure and institutions have failed to keep pace with its physical growth. Karachi is ranked as one of the least livable cities in the world. It is characterized by informal settlements in central areas and on the fringes, a proliferation of informal service providers, a highly centralized but fragmented governance structure, and declining manufacturing and trade sectors. The city's security and livability are also under threat from regional conflicts in northwest Pakistan and Afghanistan, organized crime linked to drugs- and arms-trade, and social and ethnic tensions stemming from multiple waves of immigration. The Karachi City Diagnostic (KCD), prepared jointly by the World Bank and the Government of Sindh, is a comprehensive effort to highlight the metropolitan region's key challenges and opportunities, through comprehensive data collection on physical infrastructure, business environment, social inclusion and livability. The KCD presents a number of recommendations to elevate Karachi to "world-class city" status, based on three pathways for transformation: growth and prosperity; livability, and sustainability and inclusiveness[78].

a. Economic growth and competitiveness

Manufacturing and trade dominate Karachi's economy

Karachi's size, as the largest city in Pakistan, allows it to exploit powerful agglomeration economies. It is a national powerhouse with respect to manufacturing, and forms a key economic corridor with Hyderabad, Thatta and Lasbela (with Hub). Manufacturing and trade together make up 63 percent of all employment in Karachi. Finance and real estate also play an important role in the economy.

But congestion and real estate speculation is suppressing growth in the urban center

However, there is little evidence that agglomeration is leading to productivity gains. This could be related to congestion in central commercial areas, plus a boom in real estate speculation driving high demand for low-skilled labor. The intensity of nighttime lights can be used as a proxy for economic activity. From 2000 to 2010, Karachi saw a decline in light intensity in the center, but an increase in peripheral areas (see **Figure 39**). This stagnation of economic activity in the central areas is highly worrisome for long term economic and social potential.

Challenges in the business environment are damaging Karachi's competitiveness

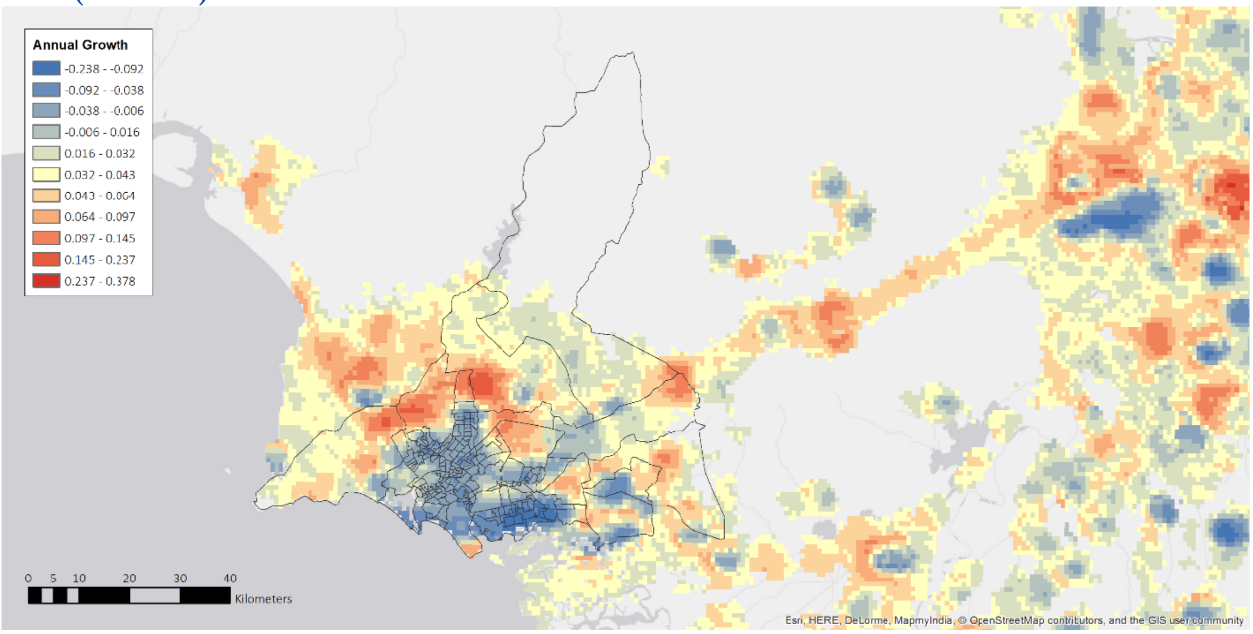
Karachi's competitiveness has declined relative to other cities within Pakistan and across the region. The business environment is hampered by large infrastructure gaps, frequent power outages, congestion, political instability, corruption and extortion. The formal manufacturing sector in the city is also affected by more competitive imports. Informality is on the rise across most sectors, and pervades the land market. Within the labor market there is also a striking imbalance between genders. This is not unique to Karachi, but nonetheless represents a large missed opportunity.

Connectivity between Karachi and the rest of Sindh is essential for the province's growth

Karachi's economy is acutely linked to that of the larger Sindh province. Fostering strong links will be critical for growth and job creation. In fact, key reforms for improved competitiveness will need to be initiated and implemented at the provincial level. This in turn requires a deeper assessment on how those reforms might impact rural areas beyond Karachi. At the same time, there is a need to streamline essential government processes and minimize their negative effects.

[78] This note was adapted from a longer report prepared by Jaafar Sadok Friaa (Program Leader), Peter Ellis (Lead Urban Economist) and Jon Kher Kaw (Senior Urban Development Specialist).

Figure 39: Karachi's pattern of dimming nightlights at the core, with rapid growth in peripheral areas (1999-2010)



Source: Karachi City Diagnostic, World Bank 2016

b. Livability

Karachi is one of the least livable cities in the world due to poor services and urban planning

Karachi is ranked among the bottom 10 cities in the 2015 Global Livability Index. Urban planning, management and service delivery have not kept pace with population growth. The city may be headed towards a spatially unsustainable, inefficient, and unlivable form. More than half the residents live in informal settlements, or *katchi abadis*, which grow at double the rate of the city at large. Public open spaces and cultural heritage sites are under threat from modern, high density luxury developments. Other new formal developments have begun to leapfrog past city limits, eschewing underutilized sites near the center and on the waterfront (see **Figure 40**). A critical spatial mismatch is emerging between this new peripheral development and the high-skilled jobs concentrated in the central business districts.

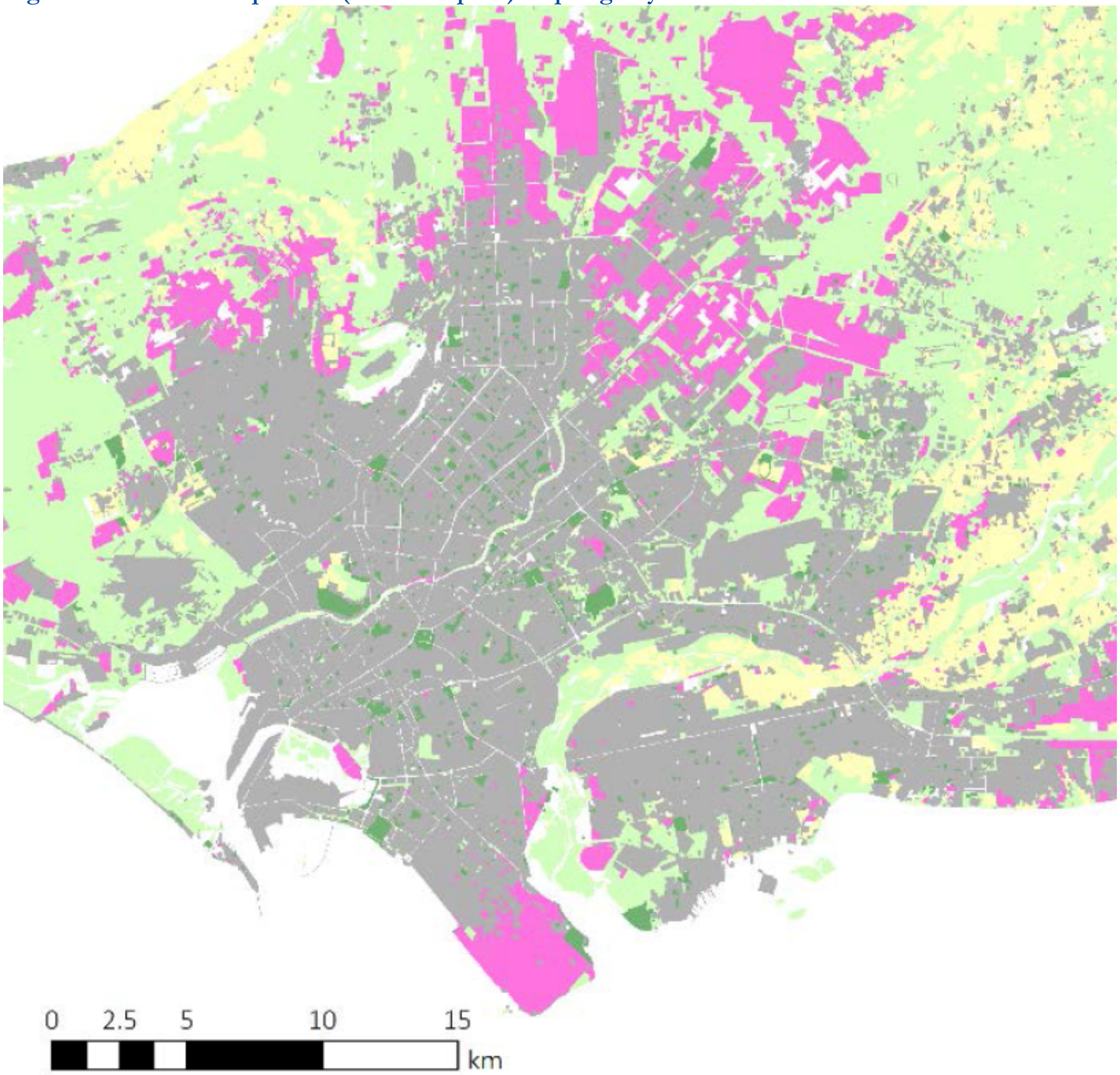
Institutional fragmentation and low capacity mean that gaps cannot be filled

Local institutions lack the authority, resources and coordination to address major gaps in planning and service delivery. Elections for mayor, a post that was filled in August 2016 after being vacant since 2010, were delayed twice. Strategic city planning functions have been centralized under provincial authorities. Municipal functions are highly fragmented across roughly 20 agencies with independent development plans. Public investment in infrastructure is often reactive and uncoordinated, with a persistent focus on extension over preventive maintenance or rehabilitation. These agencies also control nearly 90 percent of land in Karachi, but are reluctant to make it available for development.

Coordination and data collection will be crucial

Institutional coordination is necessary and critical to help guide future growth. Collecting and consolidating accurate city data will be a first step towards effective long-term integrated planning. Local governments' ability to deliver public services will also depend on strengthening their capacities. There are no quick-fix solutions, but a phased approach can be adopted for gradual improvements.

Figure 40: New developments (shown in pink) leapfrog beyond the urban core.



Source: Karachi City Diagnostic, World Bank 2016

A comprehensive transport policy should be developed to address Karachi's significant congestion and public transport shortfalls

No cohesive transportation policy exists for Karachi, even as a thousand new vehicles are added to the roads each day. Traffic congestion and road safety are both serious concerns. In most commercial areas, parking space is heavily encroached upon by vendor carts and stalls. There is also no official public transit system. Other forms of mass transportation (minibuses, rickshaws, etc.) account for 42 percent of travelers but just 5 percent of vehicles, and shrinking. Walking remains the dominant travel mode. Limited access to transit options impacts women in particular. However, Karachi's transport problems cannot be resolved by simply investing in more infrastructure and facilities; the solution lies in a comprehensive strategy and efficient institutions.

Similarly, a formal policy for water supply and sewerage is needed

Karachi is experiencing a water and sewerage crisis that stems largely from governance shortfalls. Neither Karachi nor Sindh province has a formal policy for water supply and sanitation. Financing is typically ad hoc and aimed at addressing immediate needs, rather than achieving long-term goals. Only 55 percent of water requirements are met daily. Rationing is widespread, and leakages and large scale theft is common. Non-revenue water from physical losses reached 192 million gallons per day (43 percent of revenues), not counting commercial losses from unmetered water provision. Private tankers are a major source of water supply, especially in informal settlements. Karachiites also face limited access to sewerage and solid waste management. Up to 475 million gallons of raw sewage are discharged into the sea each day, including hazardous materials and untreated industrial effluent. Less than half of estimated solid waste is collected and transported to open dumpsites. Reaching full coverage would require a three-fold increase in expenditures. However, reform efforts have been initiated—a new Sindh Solid Waste Management Board was established recently with comprehensive authority over the sector.

c. Sustainability

Karachi's high disaster risk warrants greater disaster response capacity and planning

Karachi is prone to natural disasters: floods, earthquakes, tsunamis, cyclones, water scarcity, heat waves, and fires. It is one of the most vulnerable divisions in Pakistan. Various authorities responsible for disaster response suffer from weak integration, gaps in information, low technical and operational capacity, and limited planning. Emergency response is hindered by inadequate land use planning and building control, such as requirements for fire alarm systems. In the event of a high intensity earthquake, a large share of buildings would incur moderate to complete damage.

Pollution is inflicting significant health and economic costs on the population

Karachi residents are also prone to diseases linked to environmental pollution. Air pollution is one of the most severe environmental problems, along with burning industrial waste and discharging untreated liquid waste. Drinking water is a major source of lead exposure, linked to learning disabilities in children and reduced incomes. The economic cost of these environmental health impacts is significant[79].

The city is not effectively managing the large flow of migrants, leading to violence and exclusion

Karachi is a city of migrants, but with insufficient city planning to absorb the flow of people in adequate housing. Its broad ethnic diversity is organized in pockets of homogeneous zones, and certain groups are perceived to have been favored over others. Informal land developers, known as land mafias, wield outsize power in the development process through corrupt and violent means. Areas accessible to low-income households are far from jobs, exacerbating spatial inequality and exclusion. These informal settlements are closely linked to informal and illicit trades. Violence is a feature of daily life for most, particularly the poor and women.

Improved city management must consider resilience and sustainability

Resilience and sustainability should be at the heart of coordinated city management. Interventions to address environmental pollution must be linked to other sectors such as transport and waste management. Environmental regulations should be strengthened, with an emphasis on safeguarding vulnerable groups.

[79] Sánchez-Triana et al. (2015) Sustainability and Poverty Alleviation Confronting Environmental Threats in Sindh, Pakistan

d. The Way Forward

Karachi needs a programmatic, phased approach to address its deeply structural challenges

Karachi must act quickly and resolutely to preserve its central position as Pakistan's main growth pole and window to the world. The City Diagnostic underlines the structural nature of the city's challenges. Karachi faces a complex political environment, ad-hoc planning, poor governance, and weak financial and institutional capacities. Failing to address issues in a timely manner would exacerbate the infrastructure and service deficit. Yet there is high potential for Karachi's transformation into a world class metropolitan region through economic growth and prosperity, livability, sustainability and inclusiveness. What is needed is a programmatic, phased approach aligned with the Karachi City Development Plan 2020.

This phased approach should include four strategic pillars

Strategic pillars to transform Karachi into a world-class metropolitan region

1. **Inclusive, coordinated, and accountable institutions.** Create strong coordination mechanisms among public land owners and service delivery agencies. Support activities to help agencies' ability to plan, finance and manage programs. Empower local agencies to take the lead in city management.
2. **Greening for sustainability and resilience.** Close infrastructure gaps and safeguard funds for maintenance. Put in place buffers to protect vulnerable groups from the negative impacts of growth and climate change. Build a resilient and sustainable environment with an emphasis on livability, regeneration and transformation.
3. **Leveraging economic, social and environmental assets.** Involve the private sector in infrastructure provision. Develop stronger incentives for more efficient performance, innovative financing, and new technology adoption. Improve the ease of doing business and encourage PPPs. Reduce delays and discretionary power for key business transactions under city and provincial authority. Improve cost recovery and revenue collection for basic services while safeguarding vulnerable groups. Leverage land assets to finance key infrastructure for growth.
4. **Creating a smart Karachi.** Innovate with smart policies to manage services, enhance competitiveness, facilitate engagement, and improve investment projects. Use assets creatively, efficiently, and sustainably.

4. The FY17 Federal Budget

The FY17 federal budget continues the government's fiscal consolidation efforts in the federal recurrent budget and an emphasis on revenue mobilization. The targeted fiscal balance will, however, depend on provincial government surpluses and continuation of the federal government's energy sector reforms. On the expenditure side, an expected fall in interest payments and non-provincial grants has created space for an increase in infrastructure spending.[80]

a. FY17 fiscal balance

The consolidated fiscal deficit is expected to fall by 0.8 percent of GDP

The FY17 budget aims to reduce the overall fiscal deficit to 3.8 percent of GDP, 0.8 percentage points lower than revised estimates of FY16 (see **Table 14**). The budget suggests this outcome would be achieved through a 1 percent of GDP increase in total revenues and a 0.2 percent of GDP increase in expenditure. The revenue increase will be driven by higher tax revenues at both the federal and provincial level, which counteract a decline in non-tax revenues of 0.5 percent of GDP.

But this outcome is dependent on significant reduction in support to SOEs and provincial government surpluses

The fiscal outcome will, however, be dependent on provincial surpluses and the federal government's efforts to reduce subsidies to SOEs. The federal government aims to achieve a 4.8 percent of GDP federal budget deficit by cutting recurrent spending by 0.7 percent of GDP. The cuts in recurrent spending fall largely in three areas: lower interest payments (0.2 percent of GDP), significantly lower subsidies (0.5 percent of GDP), and lower grants to SOEs. The reduced spending on subsidies and grants to SOEs will depend on the government's efforts to reduce electricity subsidies. The consolidated surplus will similarly rely upon a provincial government surplus of 1 percent of GDP. The federal government's recent 10 percent ad hoc relief allowance on civil servants' pay is likely to be emulated by provinces, perhaps putting at risk the expected surplus.

A new legislative ceiling on the federal fiscal deficit will be very challenging to implement

The federal government plans to establish a permanent ceiling on the federal fiscal deficit through a proposed amendment of the Fiscal Responsibility and Debt Limitation Act (FRDLA); the significant challenge of implementing this ceiling has been left to the next elected government. The proposed amendment would limit the federal fiscal deficit – excluding foreign grants – to 4 percent of GDP during the three years from FY18, and to 3.5 percent of GDP thereafter. This will represent a significant reduction; deficits over the last five years have averaged 6.7 percent of GDP. Several gaps in the legislation will also make it harder to implement: the amendments did not reduce institutional fragmentation in debt management, codify borrowing purposes, strengthen the escape clause or include sanctions for missing stipulated targets. Moreover, recurrent spending at the federal level appears to be very rigid. Over the past five years, almost 60 percent of the federal government's recurrent spending has been comprised of defense and interest payments.

[80] This note is an edited extract of a longer note prepared by Saadia Refaqat (Senior Economist, GMFDR) with assistance from Mehwish Ashraf (Economist, GMFDR).

Table 14: Summary of consolidated fiscal accounts, FY16-FY17

Percentage of GDP

	FY15		FY16	FY17
	P. Actual	Budget	P. Actual	Budget
Total Revenue	**14.4**	**15.1**	**15.0**	**16.0**
Federal Revenue	*13.3*	*14.0*	*13.8*	*14.6*
Tax Revenue	10.3	11.1	11.4	11.8
of which FBR	9.5	10.1	10.5	10.8
Non-Tax Revenue	3.1	2.9	2.3	2.8
Provincial Revenues	*1.0*	*1.1*	*1.3*	*1.4*
Tax Revenue	0.8	0.9	1.0	1.1
Non-Tax Revenue	0.3	0.3	0.3	0.3
Total Expenditure	**19.7**	**19.4**	**19.6**	**19.8**
Current Expenditure	16.2	13.9	15.9	14.4
Federal Expenditures	*11.1*	*10.0*	*10.6*	*9.9*
Interest Payments	4.8	4.2	4.3	4.1
Domestic	4.4	3.8	3.9	3.7
Foreign	0.3	0.4	0.4	0.3
Defense	2.5	2.5	2.6	2.6
Transfers	1.1	1.1	1.2	1.0
Others	2.7	2.3	2.6	2.2
Provincial Expenditures	*5.1*	*3.9*	*5.2*	*4.5*
Development Expenditure	**4.2**	**5.5**	**4.4**	**5.4**
PSDP	*3.6*	*4.9*	*4.0*	*5.0*
Federal	1.8	2.3	2.0	2.4
Provincial	1.8	2.7	2.0	2.6
Operational Shortfall	0.0	0.0	0.0	0.0
Non-PSDP Development	*0.5*	*0.5*	*0.4*	*0.5*
Net Lending	**0.1**	**0.0**	**0.0**	**0.0**
Statistical Discrepancy	**-0.6**	**0.0**	**-0.7**	**0.0**
Fiscal Balance	**-5.3**	**-4.3**	**-4.6**	**-3.8**
Financing	**5.3**	**4.3**	**4.6**	**3.8**
External (Net)	0.7	1.1	1.3	0.7
Domestic	4.6	3.0	3.3	2.9
Bank	3.3	0.0	2.7	0.3
Non-Bank and Others	1.3	3.0	0.6	2.6
Privatization Proceeds	0.1	0.2	0.0	0.1

Source: Federal Budget 2016/17 and World Bank staff calculations

b. Revenue mobilization

Elimination of SROs and other new tax policy measures are expected to increase FBR revenues by 17 percent

If a series of new tax policy measures are successfully implemented, tax revenues are expected to increase by 0.5 percent of GDP to 12.9 percent of GDP (see **Table 15**). The budget anticipates that total revenues in FY17 will be 16.0 percent of GDP, 1 percentage point higher than FY16 provisional outcomes. A series of measures to expand the tax base and increase direct taxes are expected to contribute to a 17 percent increase in FBR revenues in FY17 (0.3 percent of GDP). Almost one third of the expected increase of Rs. 517 billion is projected to come through the withdrawal of concessions and new tax measures introduced in the budget. Based on last year's performance, the proposed revenue effort may be achievable. However, much of it will be delivered through an increasing reliance on direct taxation, which accounts for 83 percent of the revenue expected from the new measures. Measures related to federal GST will generate 32 percent of additional revenue while customs duties are projected to contribute 9 percent. Much of this increase will be delivered by eliminating a portion of SROs exempting various entities from income tax, sales tax and customs duties. This will significantly broaden the tax base. On the other hand, non-tax revenues are expected to decline by 0.5 percent of GDP compared with FY16 revised estimates. This is largely due to a fall in SBP profits, defense receipts and a significant fall in royalties from crude oil and natural gas.

Table 15: Proposed Tax Measures for FY17

	Revenue Impact	
	Rs. Million	% of GDP
Total	**163,435**	**0.49**
SROs	**77,350**	**0.23**
Income	45,250	0.14
Sales	31,500	0.09
Customs	600	0
Other measures	**86,085**	**0.26**
Income	62,160	0.19
Sales & Excise	14,727	0.04
Customs	9,199	0.03
Memorandum		
Base-broadening measures	76,650	0.23

Source: Federal Board of Revenue and World Bank staff calculations
1/ Preliminary estimates subject to change after the enactment of Finance Act.

Agriculture and export industries will receive tax breaks

FY17 budget tax measures will also provide support to export industries and agriculture. The agriculture sector will benefit from a series of subsidies and tax breaks, including the reduction of sales tax on urea from 17 to 5 percent, lower electricity tariffs for tube wells and the elimination of the 7 percent GST on pesticides. For the exporting sector, key measures include a reduction of export refinancing rates from 3.5 percent to 3 percent and a zero rating[81] of textiles, leather, sports goods, surgical goods and carpets.

Some tax measures are unpopular with provincial governments

Several of the Finance Bill's tax measures have been criticized by provinces as unconstitutional. The first will require provincial governments to withhold federal taxes from those who are registered for provincial sales tax but do not file federal tax returns. This could create a disincentive for people to pay provincial taxes, and would have benefitted from further consultations at the appropriate forum. The second controversial measure will deny GST input credits in relation to services, thereby increasing the cost of doing business and the price of finished goods. This step will also dilute the benefits of a value-added tax and create tax cascading,[82] a regression for Pakistan's emergent tax system. Finally, the federal government has

[81] The term zero-rating refers to items that are taxable, but the rate of tax is nil on their input supplies.
[82] Tax cascading is a turnover tax that is applied to every step of the supply chain without credit for taxes paid at earlier stages. It introduces distortions into the economy and encourages vertical integration.

not withdrawn the Federal Excise Duty on particular services that are subject to provincial Sales Tax, a long-standing request by the provinces – including facilities for travel by air, inland carriage of goods by air and services provided by port and terminal operators (excluding stevedoring services). Sindh province, in particular, has objected to this double taxation, given it draws one quarter of its revenues from port and terminal services.

c. FY17 expenditure

Government spending is expected to fall due to lower interest payments and grants

Consolidated government spending is expected to increase only slightly by 0.2 percent of GDP. This outcome hinges on reductions in federal recurrent spending, which is expected to fall by 0.5 percent of GDP as a result of a significant fall in interest payments and non-provincial grants. In contrast, development spending and net lending of the consolidated government is expected to increase by 1 percentage point to 5.4 percent of GDP.

Federal PSDP will increase 21 percent, mostly directed towards infrastructure projects

The recurrent spending cuts allow space for an increase in Federal PSDP[83] of 21 percent to Rs. 800 billion in FY17 (see **Table 16**). Like the previous year, infrastructure-related projects received a 55 percent share of PSDP allocations, with a budget of Rs. 437 billion. Three energy-related projects receive particularly large allocations, with the Diamer Bhasha Dam being allocated Rs. 32 billion and the 1200MW LNG-based Baloki power plant and Haveli Bahadurshah each receiving Rs. 30 billion allocations. The budget provides a particularly large increase in the allocation to the National Highway Authority (NHA), growing from Rs. 29 billion to Rs. 188 billion, dominated by four projects: construction of Burhan-Hakla on M-1 to D.I.Khan motorway (CPEC) (Rs. 22 billion), Thakot to Havelian (CPEC) (Rs.16.5 billion), the Lahore Abdul Hakeem section (Rs. 34 billion), and the Multan-Sukkur Motorway (Rs. 19 billion). A new program entry, Gas Infrastructure Development, is budgeted to receive Rs. 25 billion.

Social services PSDP spending will not increase in FY17

Allocations to social sector PDSP projects will remain stagnant at 6.5 percent of GDP. Allocations for two programs that started in FY16 are to be marginally reduced: Special Development Programme for Temporary Displaced Persons (from 14.3 percent of federal PSDP in FY16 to 12.5 percent in FY17) and the Prime Minister's Youth Programme (from 2.9 percent of federal PSDP in FY65 to 2.5 percent in FY17). The allocation to the Ministry for Planning and Development has increased to Rs. 11 billion, despite spending only Rs. 1.8 billion from a Rs. 14 billion allocation last year.

CPEC projects will account for 9 percent of federal PSDP

China-Pakistan Economic Corridor (CPEC) investment projects are expected to account for 9 percent of federal PSDP in FY17. CPEC projects have been budgeted at Rs. 73 billion, the lion's share of which is earmarked for infrastructure-related projects (highways, ports and shipping, and energy). Almost 50 percent of CPEC funding is for the National Highway Authority. Ten new projects have entered the CPEC portfolio with a total allocation of Rs. 26 billion.

[83] The PSDP figures rely on FY16 revised estimates, as FY16 provisional actual estimates were not available

Table 16: Public Sector Development Program FY16-FY17

Rs Million

	FY16		FY17	FY17		Shares	
	Budget	Revised	Budget	Percent Change		FY16	FY17
	Total	Total	Total	Budget	Revised	Budget	Budget
Infrastructure	386,452	408,216	437,244	13.1	7.1	25.5	26.1
Social Services	43,672	52,981	52,247	19.6	-1.4	2.9	3.1
Economic Services	3,770	2,531	4,025	6.8	59.0	0.2	0.2
Others	47,670	34,476	58,434	22.6	69.5	3.1	3.5
Special Areas Program	42,937	58,815	48,050	11.9	-18.3	2.8	2.9
Pak MDGs & Community Dev. Program	20,000	20,900	20,000	0.0	-4.3	1.3	1.2
Fed. Dev. Prog./Projects for Provinces & Special Areas	28,500	-	28,000	-1.8	--	1.9	1.7
Earthquake Related Program	7,000	7,000	7,000	0.0	0.0	0.5	0.4
Special Development Programme for TDPs and Security Enhancement	100,000	55,313	100,000	0.0	80.8	6.6	6.0
Prime Minister's Youth Programme	20,000	21,065	20,000	0.0	-5.1	1.3	1.2
Gas Infrastructure Development			25,000				1.5
Estimated Operational Shortfall	-	-	-	--	--	0.0	0.0
Total Federal PSPD	**700,001**	**661,297**	**800,000**	**14.3**	**21.0**	**46.2**	**47.8**
Provincial Program	**813,717**	**732,280**	**875,000**	**7.5**	**19.5**	**53.8**	**52.2**
Total PSDP	**1,513,718**	**1,393,577**	**1,675,000**	**10.7**	**20.2**	**100.0**	**100.0**
as a percent of GDP	*4.9%*	*4.7%*	*5.0%*				

Source: Federal Budget 2016/17 and World Bank staff calculations

Non-PSDP spending is falling

Non-PSDP spending has declined, primarily as a result of falling fertilizer subsidies. The strategic trade policy framework and textile policy (2009-14) have each received an allocation of Rs. 6 billion despite zero utilization last year. Unfortunately, an allocation has once again been made to the *lump sum provision of misc. items,* which has received Rs. 14.5 billion, compared with Rs. 16.5 billion in FY16.

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 backcasted)	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[84]	-	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	-	-

[84] * 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)