GROWTH AND INEQUALITY IN PAKISTAN

Agenda for Reforms

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FRIEDRICH EBERT STIFTUNG

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FOREWORD

The global financial, ecological and social crises of our times — wherever they currently manifest themselves — are of political nature. Many countries on the globe are now challenged by similar or related phenomena, albeit from very different starting points. A great number of analysts have exposed flaws in the conventional economic thinking behind discredited economic policies, which either cause or compound these crises, thereby fuelling political discontent across societies. The state of affairs has led to some intellectual reckoning and inspired national and global discourses about finding ways to produce socially just, sustainable and green dynamic growth.

This is the underlying theme of Economy of Tomorrow (EoT), a program which Friedrich-Ebert-Stiftung (FES) has established at global, regional and national levels. EoT is a narrative about the pursuit of a normative vision for a good society. Its work is aimed at inspiring public discourses to engage in critical reflection about existing growth models as well to as to develop policies of inclusive growth and development.

In Pakistan the work was initiated by forming an EoT Panel comprised of prominent experts and opinion leaders from diverse backgrounds facilitating a network of think tank institutions across Pakistan. The Panel has been led by our distinguished economist Dr Hafiz A Pasha, who also assumed the task of consolidating the work of the panel. The outcome is this seminal book on Growth and Inequality in Pakistan.

For developed and developing countries inequality of income or of structural nature has remained an intractable challenge and is pronounced everywhere as the scourge of our times. Pakistan has now been suffering from regressively slow growth for nearly a decade, which has amplified prevalent inequalities and exacerbated social and political instability. That low growth and inequality appear to be intertwined is the core message of this book. Based on extensive research and rigorous analyses of important policies, institutions and sectors of Pakistan’s economy, the book is cautioning that inequality has reached a critical level with grave implications for political, social and economic stability. The book presents a comprehensive reform agenda for working towards social, ecological sustainability as precondition for sustainable growth.

We express our profound appreciation to the untiring efforts of Dr Hafiz A Pasha in completing this work. We are also thankful to the esteemed members of the EoT Panel for their valuable participation and inputs, in particular of Dr Vaqar Ahmed of Sustainable Development Policy Institute Pakistan, whose collaboration has been instrumental for organising and disseminating this work in public and policy domains. We also acknowledge many participants for attending and contributing in the EoT academic, public and policy discussion events during last many year.

We at Friedrich-Ebert-Stiftung (FES) are confident that this pioneering work will enrich economic debate, draw the attention of decision makers and facilitate a new consensus towards achieving more socially just, sustainable and green growth policies for Pakistan.

Rolf Paasch and Abdul Qadir
FES Pakistan
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PREFACE

The theme of the book is Growth and Inequality. These are the two fundamental problems with the economy of the Pakistan. The rate of economic growth has barely touched 6 percent over the last decade. Simultaneously, the economic, social and political structure have perpetuated high income, wealth and regional disparities. Combined together, these two structural problems have led to high levels of unemployment and poverty. This has exposed the country to serious problems of law and order and religious extremism, accompanied by acts of terrorism, which have led to the killing of over 70,000 people in Pakistan and imposed heavy economic losses.

The material presented in the book is the consequence of many years of research, frequently undertaken with the help of M Phil / Ph D students at various universities in Lahore, especially the Beaconhouse National University and the Lahore School of Economics. Some of the research has been supported by international agencies like the FES, World Bank, DFID and UNDP. Also, local research institutions have provided research staff and funds to facilitate the research. This includes institutions like SPDC, IPP and IPR. In addition the leading newspaper *Business Recorder* has provided the publication platform for abbreviated versions of the findings from the research.

The FES has been the prime agency for supporting the preparation of this book. The origins of producing this book arose from the project on Economy of Tomorrow, which has been undertaken by local experts in partnership with the FES in many countries. This book is being launched by FES.

The book has sixteen sections relating to population growth, state of the economy, the IMF program, growth, investment, employment, balance of payments, taxation, public finances, fiscal federalism, social development, income and wealth inequality, regional inequality, poverty, governance and the overall reform agenda. Within these sections there are 48 chapters.

The major methodological innovations and principal findings are as follows:

(i) Section 1 has one chapter which undertakes a detailed analysis of the provisional results from the Population Census of 2017. In particular, the many surprises are highlighted.

(ii) Section 2 on the state of economy includes chapters 2 to 6 on the economy in 2017-18, Pakistan's international rankings, cost of the war on terror and the cost of power outages. In particular, the low and generally worsening position of Pakistan in key international rankings is highlighted.

New methodologies are developed for quantifying the cost to the economy of the war on terror and power outages. The first cost is estimated cumulatively since 2001-02 at over $250 billion and the second at almost 2 percent of the GDP in 2016-17.

(iii) Section 3 on the IMF program has chapters 7 and 8 describing the last program from 2013 to 2016 and the extent of success in its implementation. The major findings from the first Post-Program Monitoring exercise by the IMF are highlighted and there is a discussion on the issues relating to a return once again to the IMF.

(iv) Section 4 on growth contains chapters 9 to 13 on the record of economic growth, the 'real' GDP growth rate, agriculture, manufacturing and green growth. Reasons for low and variable growth since the 90s are focused on. A new approach is developed for determination of consistency of estimates of national income accounts and presented in Technical Appendix I. This leads to the finding that the GDP growth rate in the last three years has been significantly overstated. An overview of ecological problems is presented in Chapter 13 and on the design and implementation of environmental policies.

(v) Section 5 on investment includes chapters 14 to 17 on the path of investment, review of the Federal PSDP, China-Pakistan Economic Corridor and the privatization program. The Federal PSDP is assessed from the viewpoint of financing, allocation priorities and implementation capacity. CPEC is identified as a potential 'game changer' but some of the potential risks are also highlighted. A set of criteria is defined for identifying which public sector enterprises should be candidates for future privatization.

(vi) Section 6 is on employment with chapters 18 and 19 on the employment situation and on labor conventions and laws. The extent of 'decent work' in Pakistan is quantified and an assessment made of the prospects for providing ten million jobs in the next five years as per the election commitment by the ruling party, PTI. Labor laws on Pakistan are listed along with the gaps and the extent of implementation of existing laws.

(vii) Section 7 on balance of payments is of topical importance given the incipient financial crisis that Pakistan faces today. It contains chapters 20 to 23 on revival of exports, managing the trade deficit, balance of payments and external debt sustainability. A set of policies is presented for reviving exports, containing imports and improving the balance of payments position. Different measures are developed for assessing the extent of external debt sustainability.

(viii) Section 8 is on taxation. It contains chapters 24 to 26 including the description of the tax system of Pakistan, the size of the 'tax gap' and a comprehensive agenda of tax reforms both in Federal and Provincial taxes. The 'tax gap' is estimated at above 3 percent of the GDP. The tax reforms are designed to close this gap and make the tax system more broad-based and progressive.

(ix) Section 9 is on public finances with chapters 27 and 28. The trend in public finances and the recent deterioration are highlighted. The evolution of public debt is described and the contours outlined of a medium-term debt strategy.

(x) Section 10 is again a very topical section on Fiscal Federalism with chapter 29 on the 18th Amendment and chapter 30 on the NFC Award. The fundamental changes in the roles of the Federal and Provincial Governments as a result of the 18th Amendment are carefully highlighted along with pending issues of implementation. The 7th NFC Award is recognized as a major step forward both in terms of fiscal decentralization to the Provinces and fiscal equalization among the Provinces.

(xi) Section 11 is on social development with chapters 31 to 33. The first chapter provides a diagnosis of the very low HDI ranking of Pakistan at 150. Chapter 32 outlines the goals and targets of the SDGs up to 2030 of the UN. Given the local context, an attempt is made to prioritize the SDGs and quantify the required rate for achievement of particular targets in the Pakistani context. Chapter 33 quantifies the extent of inequality by income quintiles of households in access to basic services.

(xii) Section 12 is of major importance and has involved considerable primary research. It is on income and wealth inequality and includes chapter 34 and 35. The former describes within the existing framework of institutions, laws and regulations how the state is captured by different vested interest groups within the elite. Chapter 35 quantifies different measures of inequality leading to the conclusion that it is worse than has been highlighted before in the literature.

(xiii) Section 13 also presents the results of new research on regional inequality. Chapters 36 to 39 focus on growth of Provincial economies, Provincial labor markets, level of the HDI at the Provincial and district level and the size of the urban-rural divide respectively. Here again, there is evidence of large and growing regional disparities in Pakistan.

(xiv) Based on the analysis in the above sections on growth and inequality the stage is set in Section 14 to look at the prevalence of poverty in Pakistan. This is done in Chapter 40 on the incidence of poverty. There are diverse estimates from various sources. An attempt is made to resolve these differences, leading thereby to the estimate that 35 percent of the population was poor in 2015. Chapter 41 then sets up various criteria for evaluating the different programs of social protection in Pakistan.

(xv) Section 15 is on Governance and includes Chapters 42 to 45. Economic Governance is defined and pre-requisites for good economic governance are identified including the role of regulatory agencies and local governments. Prior to this a Governance Scorecard is given in Chapter 42 based on interviews of experts on the major areas of governance failure in Pakistan.

(xvi) Finally, Section 16 presents a comprehensive agenda of reforms based on the findings in the earlier sections of the book. Initially, Chapter 46 gives a synthesis of the relationships between growth, inequality and poverty. Chapter 47 then makes an assessment of the short-run and medium-run prospects for the economy of Pakistan. This is based on simulations of a Macroeconomic Model for Pakistan. The specification of the model is given in Technical Appendix II. Finally, Chapter 48 presents a very comprehensive reform agenda in ten areas ranging from reviving the economy to improving governance.

Special mention needs to be made of my Research Associates – Wasim Saleem, Mohammed Imran, Imtiaz Ahmed, Javeria Jannat, Mehwish Ehsan and Ayesha Javed. Thanks are also due to M. Rizwanullah Khan for the patient job of typing and composition of the book.

Any defects which remain are, of course, the sole responsibility of the author.

This book is dedicated to my parents.

Hafiz A. Pasha,
Professor Emeritus, BNU
and former Federal Minister
of Commerce, Planning and Finance

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LIST OF ACRONYMS

ABL	Allied Bank Limited
ADB	Asian Development Bank
ADP	Annual Development Program
ADT	Avoidance of Double Taxation
AEPAM	Academy of Educational Planning and Management
AERC	Applied Economics Research Centre
AIT	Agriculture Income Tax
AJ&K	Azad Jammu and Kashmir
AOPs	Associations of Persons
APTMA	All Pakistan Textile Mills Association
ASYB	Agricultural Statistics Year Book
BB	Benazir Bhutto
BISP	Benazir Income Support Program
BMR	Balancing, Modernization and Replacement
BOP	Balance of Payments
BOT	Build-Operate-Transfer
BPS	Basic Pay Scale
BSC	Behbood Savings Certification
CAA	Civil Aviation Authority
CBN	Cost of Basic Needs
CCB	Citizen Community Board
CCI	Council of Common Interests
CCOP	Cabinet Committee on Privatization
CCP	Competition Commission of Pakistan
CDWP	Central Development Working Party
CENTO	Central Treaty Organization
CEO	Chief Executive Officer
CGT	Capital Gains Tax
CIA	Central Intelligence Agency
CIT	Corporate Income Tax
CNG	Compressed Natural Gas
CNIC	Computerized National Identity Card
CPC	Code of Criminal Procedure
CPEC	China-Pakistan Economic Corridor
CPI	Consumer Price Index

LIST OF ACRONYMS

CPIA	Country Policy Institutional Assessment
CPIN	Corruption Perceptions Index
CPPA	Central Power Purchasing Agency
CSF	Coalition Support Fund
DAP	Diammonium Phosphate
DDMA	District Disaster Management Authority
DESA	Department of Economic and Social Affairs
DG	Director General
DI	Diversification Index
DISCO	Distribution Company
DQAF	Data Quality Assessment Framework
DRA	Drug Regulatory Authority
EAC	Economic Advisory Council
ECNEC	Executive Committee of National Economic Council
EDBI	Ease of Doing Business Index
EFF	Extended Fund Facility
EOBI	Employees Old Age Benefits Institution
EPA	Environmental Protection Agency
ERRA	Earthquake Reconstruction and Rehabilitation Authority
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
EYB	Energy Yearbook
FAC	Fuel Adjustment Charges
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FCF	Federal Consolidated Fund
FDI	Foreign Direct Investment
FESCO	Faisalabad Electric Supply Company
FLL	Federal Legislative List
FPCCI	Federation of Pakistan Chambers of Commerce and Industry
FPI	Foreign Portfolio Investment
FPSC	Federal Public Service Commission
FRDL	Fiscal Responsibility and Debt Limitation
FRDL	Fiscal Responsibility and Debt Limitation Act
FTA	Free Trade Agreement
GARV	Gross Annual Rental Value
GCI	Global Competitiveness Index
GDP	Gross Domestic Product

GDS	Gas Development Surcharge
GENCO	Generation Company
GEPCO	Gujranwala Electric Power Company
GHDR	Global Human Development Report
GHPL	Government Holdings (Private) Limited
GIC	Growth Incidence Curve
GIDC	Gas Infrastructure Development Cess
GIS	Geographic Information Systems
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
GNI	Gross National Income
GOP	Government of Pakistan
GPI	Gender Parity Index
GSP	Generalized System of Preferences
GST	General Sales Tax
Gwh	Gigawatt Hour
HBL	Habib Bank Ltd.
HDI	Human Development Index
HDIP	Hydrocarbon Development Institute of Pakistan
HEC	Heavy Electrical Complex
HEC	Higher Education Commission
HESCO	Hyderabad Electric Supply Company
HHI	Herfindahl Hirschman Index
HIES	Household Integrated Economic Survey
HSD	High Speed Diesel
HSPE	Handbook of Statistics on Pakistan Economy
IBRD	International Bank for Reconstruction and Development
ICBC	International Commercial Bank – China
ICT	Information and Communications Technology
IDA	International Development Association
IDB	Industrial Development Bank
IDI	Inclusive Development Index
IDP	Internally Displaced Person
IESCO	Islamabad Electric Supply Company
IMF	International Monetary Fund
INEQ	Inequality
IOSCO	International Organization of Securities Commission
IPO	Intellectual Property Organization
IPP	Independent Power Producers

LIST OF ACRONYMS

IPP	Institute of Public Policy
IRM&IG	Industrial Raw Material and Intermediate Goods
IRRI	International Rice Research Institute
IRS	Indus River System
IRS	Internal Revenue Service
IT	Information Technology
ITO	Income Tax Ordinance
JPCL	Jamshoro Power Company Limited
KAPCO	Kot Addu Power Company
K-ELECTRIC	Karachi Electric
KESC	Karachi Electric Supply Company
LDO	Light Diesel Oil
LESCO	Lahore Electric Supply Company
LFPR	Labor Force Participation Rate
LGO	Local Government Ordinance
LIBOR	London Interbank Offered Rate
LNG	Liquefied Natural Gas
LSSM	Living Standards and Social Management Survey
MAF	Million Acre Feet
MCB	Muslim Commercial Bank
MDGs	Millennium Development Goals
MEPCO	Multan Electric Supply Company
MFN	Most Favored Nation
MMBTU	Million British Thermal Units
MNA	Member National Assembly
MNCs	Multinational Companies
MOF	Ministry of Finance
MPA	Member Provincial Assembly
MPL	Mira Power Limited
MTBF	Medium-term Budgetary Framework
MTBs	Market Treasury Bills
MTDS	Medium Term Debt Strategy
MW	Mega Watt
NAB	National Accountability Bureau
NACTA	National Counter Terrorism Authority
NADRA	National Database and Registration Authority
NATO	North Atlantic Treaty Organization
NBFI	Non-Banking Financial Institution

NCCP	National Clearing Company of Pakistan
NCCW	National Council for Conservation of Wildlife
NCHD	National Commission for Human Development
NDA	Non-Disclosure Agreement
NDMA	National Disaster Management Authority
NEC	National Economic Council
NEPRA	National Electric Power Regulatory Authority
NFC	National Finance Commission
NFIS	National Financial Inclusion Strategy
NGOs	Non-Governmental Organizations
NHA	National Highway Authority
NICL	National Insurance Co. Ltd.
NIPS	National Institute of Population Studies
NIT	National Investment Trust
NPCC	National Power Construction Company
NPGCL	Northern Power Generation Company Limited
NRL	National Refinery Limited
NS	Nawaz Sharif
NSC	National Security Council
NSD	National Savings Directorate
NSS	National Savings Schemes
NTDC	National Transmission and Dispatch Company Limited
NTN	National Tax Number
O&M	Operation and Maintenance
OBOR	One Belt One Road
OCAC	Oil Companies Advisory Committee
ODA	Overseas Development Assistance
OECD	Organization for Economic Cooperation and Development
OGDCL	Oil and Gas Development Corporation Limited
OGRA	Oil and Gas Regulatory Authority
OLS	Ordinary Least Squares
OMOs	Open Market Operations
O-O	Owner Occupied
OPEN	Openness
OPHDI	Oxford Poverty and Human Development Initiative
P&D	Planning and Development
PAC	Public Accounts Committee
PASMIC	Pakistan Steel Mills Corporation

PASSCO	Pakistan Agricultural Supplies and Storage Corporation
PBC	Pakistan Business Council
PBS	Pakistan Bureau of Statistics
PC	Planning Commission
PDMA	Provincial Disaster Management Authority
PDS	Punjab Development Authority
PDWP	Provincial Development Working Party
PECO	Pakistan Electric Company
PEMRA	Pakistan Electronic Media Regulatory Authority
PEPCO	Pakistan Electric Power Company
PES	Pakistan Economic Survey
PESCO	Peshawar Electric Supply Company
PFC	Provincial Finance Commission
PFC	Provincial Finance Commission
PGDP	Provincial GDP
PGDPs	Provincial Gross Domestic Products
PGS	Provincial Growth Strategies
PIA	Pakistan International Airlines
PIBs	Pakistan Investment Bonds
PIT	Presumptive Income Tax
PM	Prime Minister
PML (N)	Pakistan Muslim League (Nawaz)
PNSC	Pakistan National Shipping Corporation
PO	Provisional Order
POL	Pakistan Oilfields Limited
POL	Petroleum, Oil and Lubricants
PPAF	Pakistan Poverty Alleviation Fund
PPL	Pakistan Petroleum Limited
PPP	Pakistan Peoples Party
PPRA	Pakistan Public Procurement Authority
PRA	Pakistan Revenue Authority
PRAL	Pakistan Revenue Automation (Pvt.) Ltd.
PRCL	Pakistan Reinsurance Company Limited
PRSP	Poverty Reduction Strategy Paper
PSD	Payment Systems Department
PSDP	Public Sector Development Program
PSE	Public Sector Enterprise
PSLSMS	Pakistan Social and Living Standards Measurement Survey

LIST OF ACRONYMS

PSO	Pakistan State Oil
PSQCA	Pakistan Standards and Quality Control Authority
PTA	Pakistan Telecommunication Authority
PTCL	Pakistan Telecommunication Company Limited
PTI	Pakistan Tehreek-e-Insaf
QESCO	Quetta Electric Supply Company
R&D	Research and Development
REER	Real Effective Exchange Rate
RIC	Regular Income Certificate
RLNG	Re-Gasified Liquefied Natural Gas
SAIFI	System Average Interruption Frequency Index
SBF	Standby Facility
SBP	State Bank of Pakistan
SCARP	Salinity Control and Reclamation Programme
SCB	Standard Chartered Bank
SDGs	Sustainable Development Goals
SDR	Special Drawing Rights
SEATO	Southeast Asia Treaty Organization
SECP	Securities and Exchange Commission of Pakistan
SEPCO	Sukkur Electric Power Company
SEZ	Special Economic Zone
SEZs	Special Economic Zone
SLIC	State Life Insurance Corporation of Pakistan
SMEDA	Small and Medium Enterprises Development Authority
SMEs	Small and Medium Enterprises
SNA	System of National Accounts
SNGPL	Sui Northern Gas Pipelines Limited
SPDC	Social Policy and Development Centre
SRO	Statutory Regulatory Order
SSGC	Sui Southern Gas Company Ltd.
SSM	Small-Scale Manufacturing
T&D	Transmission and Distribution
TDP	Temporarily Displaced Persons
TDS	Tariff Differential Subsidy
TEVTA	Technical and Vocational Training Authority
TGDP	Tax to Gross Domestic Product Ratio
UAE	United Arab Emirates
UBL	United Bank Ltd.

LIST OF ACRONYMS

UC	Union Council
UIPT	Urban Immovable Property Tax
UK	United Kingdom
UN	United Nations
UNDP	United Nations Development Program
UNEP	United Nations Environmental Program
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
UNFPA	United Nations Population Fund
UPS	Uninterrupted Power Supply
USA	United States of America
USAID	United States Agency for International Development
USC	Utility Stores Corporation
VAT	Value Added Tax
VIPs	Very Important Persons
WAPDA	Water and Power Development Authority
WDI	World Development Indicators
WEF	World Economic Forum
WPPF	Worker's Profit Participation Fund
WTO	World Trade Organization
WWF	Worker's Welfare Fund
ZTBL	Zarai Taraqiati Bank Limited

SECTION 1

POPULATION GROWTH

Chapter 1:

POPULATION GROWTH

The massive undertaking of the Population Census has finally been completed after a big gap of nineteen years. Thanks are due to the Pakistan Bureau of Statistics, to the hundreds of thousands of enumerators and army personnel who performed the task diligently and without any delays. In particular, the Census Commissioner must be recognized for having managed the process well.

Given the big gap between the two Censuses of 1998 and 2017 respectively there was inevitably some uncertainty about the size and distribution of Pakistan's population. There were bound to be some surprises. During the intervening years the country had witnessed relatively slow economic growth, interspersed with a few years of fast growth. Different regions of the country had shown substantial variation in performance. This was bound to be reflected in the pattern of increase and movement of the people within the country.

The summary provisional results have been released. There are, in fact, many surprises in the estimates, some of which are discussed below. It would, however, have been appropriate if detailed explanatory notes had been presented along with the results.

Section 1 of this chapter highlights the issues with regard to the approach adopted in the Census. Section 2 presents the earlier population estimates of Pakistan and compares Pakistan with selected countries. Section 3 highlights the regional distribution of population. Section 4 quantifies the extent and rate of urbanization while Section 5 looks at the city size distribution and growth. Finally, Section 6 quantifies the '*youth bulge*' in Pakistan.

1.1. ISSUES

The first basic question relates to the Census methodology. There are two approaches to Census enumeration. The first is the *de-jure* approach in which persons are counted at their usual place of residence. The second is the *de-facto* approach, in which persons are counted where they are found on the Census date.

The 1998 Census applied both the approaches simultaneously during enumeration. However, the data was tabulated and published on *de-jure* basis for comparability with the previous Censuses.

The Census Commissioner has indicated that the results of the 2017 Census are based on application of the *de-facto* approach. This could create a serious problem in analysis of trends since 1998. The provisional results may need to be modified by reverting to the *de-jure* approach to estimation, as was done in the 1998 Census.

The second question relates to the definition of 'urban area'. The approach adopted is based on the list of urban areas notified by the Provincial Governments. As such the areas covered by Metropolitan Corporations, Municipal Corporations, Municipal Committees, Town Committees and Cantonments are treated as urban. This is consistent with the definition of urban areas used in the 1998 population Census. However, it may have led to understatement of the size of urban population.

Beyond the above definitions and approaches, the explanatory notes to the 2017 Census estimates should clarify the definitions of '*household*' and, '*place of usual residence*'. Also given the large number of refugees, where they are located in the Census is of some importance. Apparently, Afghan refugees and other aliens have been counted in the Census process and allocated on the basis of their location at the time of enumeration. It is not clear, however, as to how Temporarily Displaced Persons (TDPs) have been treated. Perhaps in this case the *de-jure* approach ought to have been adopted. Also, there is a case for separately presenting the number of refugees and TDPs by Province.

The final issue relates to the role of different Governments in the undertaking of a Census. According to the Constitution of Pakistan, Census is part of the Federal Legislative List – Part-II. As such, decisions regarding the Census have to be taken by the Council of Common Interests (CCI), which has been the case. The question is the extent to which Provincial Governments should actually have been involved in the conduct of the Census. The explanatory note should also clarify in some detail the role that was actually played by these Governments. The CCI will also have to formulate a policy of resolving dissent on the estimates from any Province, FATA or the Islamabad Capital territory.

Following the identification of the key issues, the major findings from the 2017 Population Census are described below.

1.2. POPULATION

The provisional results indicate that the population of Pakistan has reached 207.8 million. Agencies like the UNFPA and World Bank had estimated the population at 193 million in 2016. The Annual Plan for 2017-18, prepared by the Planning Commission had projected the population at 198.4 million, almost 9.4 million less than the new Census estimate. Interestingly, the only agency which predicted a population above 200 million in 2016 was the CIA of USA. Estimates prior to the Census of the population of Pakistan are given Table 1.1.

Table 1.1: Prior Estimates of the Population of Pakistan by different Agencies

	Years	Population Million (%)	Growth Rate (%)	Urban Share (%)
UNFPA	2016	192.8	2.1	
GOP, PES	2017	199.1	2.1	40.5
CIA Fact Book	2016	202.0	2.3	38.8
World Bank	2016	193.0	2.1	39.4
Annual Plan, PC	2017	198.4	1.9	43.6
CENSUS	2017	207.8		36.4

UNFPA = United Nations Population Fund, GOP = Government of Pakistan, PES = Pakistan Economic Survey, CIA = Central Intelligence Agency of USA, PC = Planning Commission.
Source: Various Sources.

Pakistan has been ranked as the sixth largest country in terms of population. Brazil, with a population of 211.2 million, is just ahead of Pakistan. The gap is small at 3.4 million. With a higher growth rate, Pakistan could catch up in the next few years. We are doing well in at least one ranking.

The higher population implies that Pakistan is now an even more '*water stressed*' country. Also, there is a danger of the forest area of the country being depleted at an even faster rate. The expansion of urban areas could also reduce the availability of land for cultivation of crops at the periphery of cities, especially in Punjab. The higher population growth rate than previously estimated also implies that per capita income has risen more slowly.

The most common prior estimate of the population growth rate of Pakistan was 2.1 percent per annum. The latest Annual Plan assumed an even lower growth rate of 1.9 percent. The growth rate revealed by the Census for the period, 1998 to 2017, is significantly higher at 2.4 percent. This is perhaps one of the most worrisome outcomes. It has fallen only marginally by 0.2 percentage points in relation to the last inter-Censal growth rate from 1981 to 1998. Table 1.2 gives the annual growth rate of population revealed by the various Censuses since 1951.

Table 1.2: Annual Inter-Censal Growth Rate of the Population of Pakistan, 1951 to 2017

	Population (million)	Annual Compound Growth Rate (%)
1951	33.82	
1961	42.98	2.40
1972	65.31	3.80
1981	84.25	2.83
1998	132.35	2.66
2017	207.77	2.37
1951 to 2017		2.75

Source: Handbook of Statistics on Pakistan's Economy, State Bank of Pakistan (SBP).

The growth rate is also significantly higher than the underlying natural growth rate revealed by the various Demographic Surveys. Perhaps one of the reasons is that the number of refugees and aliens in Pakistan was understated earlier. If their number has increased by 3 million between 1998 and 2017, especially with the exodus from

Afghanistan after 2001, then this alone raises the growth rate by more than 0.1 percentage point. Also, there is the possibility of some overstatement by respondents who know that public resources, employment, political representation, etc., are distributed on the basis of population.

A comparison of the population growth rate with other South Asian and/or Muslim countries reveals the magnitude of the problem. Bangladesh, India and Nepal have a substantially lower growth rate at close to 1.4 percent, while Sri Lanka has an even smaller growth rate of only 0.7 percent, between 1998 to 2016. Large Muslim countries also have lower growth rates, ranging from 1.3 percent in the case of Indonesia to 1.9 percent of Egypt, as shown in Table 1.3.

Table 1.3: Comparison of the Population Indicators of Pakistan with selected Countries

	Population-2016 (Million)	Growth Rate (%)	Urban Share (%)	Urban Growth (%)[b]	Share of Female Population (%)
SOUTH ASIA					
Bangladesh	163	1.43	35.0	3.8 – 3.2	49.5
India	1320	1.43	33.1	2.6 – 2.4	48.2
Nepal	29	1.32	19.0	6.0 – 3.2	51.5
PAKISTAN[a]	**193**	**2.11**	**39.2**	**3.3 – 3.2**	**48.6**
(Census Results)	*208*	*2.38*	*36.4*	*3.0*	*48.8*
Sri Lanka	21	0.71	18,4	0.6 – 1.4	51.9
OTHER MUSLIM COUNTRIES					
Indonesia	261	1.31	54.5	4.5 – 2.5	49.7
Turkey	80	1.47	73.9	2.4 – 2.2	50.8
Egypt	96	1.95	43.2	1.8 – 2.2	49.5

[a]as reported by the World Bank | [b]Decline in the annual growth rate to the growth rate in 2016
Source: World Development Indicators (WDI), World Bank.

The central and most fundamental message is that Pakistan has failed to arrest the pace of population growth. We are not far from the '*Malthusian population trap*', according to which the rate of population growth eventually out paces the rate of increase in food production. Between 1981 and 1998 food production per capita grew by 1.5 percent per annum. In the latest inter-Censal period it has actually fallen by 0.3 percent per annum, as shown in Table 1.4.

Table 1.4: Index of Food Production and Per Capita Availability in Pakistan, 1981 to 2016

	Index of Food Production (2004-06 = 100)	Population (2005 = 100)	Per Capita Food Production (2005 = 100)	Annual Growth Rate (%)
1981	41.9	54.0	77.5	
1998	84.6	84.9	99.6	1.5
2016	126.2	132.6	95.2	-0.3

Source: WDI.

Another way of highlighting the problem of the population explosion in Pakistan is that if the present rate of growth continues, the population will more than double by 2050. Our children could grow up to find themselves in a world of shortages and large megacities characterized by excessive pollution and congestion. Needless to say, population control must now rank as one of the most important objectives of our policies and programs.

Population Planning was in the Concurrent List of the 1973 Constitution of Pakistan. Following the 18th Amendment, this function has been transferred to the Provinces. According to estimates by the PRSP Secretariat of the Ministry of Finance, the four Provinces combined devoted only 0.5 percent of their expenditure to population planning in 2015-16, as shown in Table 1.5. The highest share was observed in the case of Balochistan of 2 percent. The other three Provinces must aim to raise their shares to at least that of Balochistan.

Table 1.5: Public Expenditure on Population Planning - 2015-16

	Expenditure on Population Planning (Rs Million)	% of Total Expenditure	% of married women aged 15-45 using contraception, 2012-13
Punjab	3,862	0.39	40.7
Sindh	1,549	0.26	29.5
Khyber-Pakhtunkhwa	1,216	0.34	28.1
Balochistan	4,267	2.01	19.5
Total	**10,894**	**0.51**	**35.4**

Source: PRSP Progress Reports, Ministry of Finance (MoF), Government of Pakistan. | National Demographic and Health Surveys, National Institute of Pakistan Studies (NIPS).

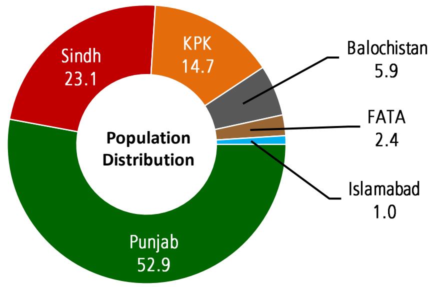
The prevalence of contraceptive practices among marred women aged 15 to 45 years is also given in Table 1.5, as reported by the latest National Demographic and Health Survey for 2012-13. The highest rate is observed in Punjab of 41 percent. For the country as a whole, the prevalence rate is 35 percent. It is not a surprise that the average family size in Pakistan remains high at over six persons. Pakistan must aim to learn from other Muslim countries on techniques used effectively for population control. In particular, the media must be harnessed for this purpose.

1.3. POPULATION DISTRIBUTION

According to the Census, the 207.8 million people of Pakistan are distributed as shown in Chart 1.1 as follows: 52.9 percent in Punjab; 23.1 percent in Sindh; 14.7 percent in Khyber Pakhtunkhwa; 5.9 percent in Balochistan; 2.4 percent in FATA and 1 percent in Islamabad, the Federal Capital. The changes in shares from 1981 to 2017 are given in Table 1.6.

There are many surprises in these estimates. The Federal Ministry of Planning and Development and the Pakistan Bureau of Statistics (PBS), which conducted the Census, had projected somewhat different shares in 2017. The share of Punjab in the national population was estimated with higher share of 54 percent, Sindh also with a larger share of 24 percent and Khyber Pakhtunkhwa and Balochistan both with significantly lower shares.

Chart 1.1: Distribution of Population of Pakistan, 2017 – (%)



Source: Population census 2017, Pakistan Bureau of Statistics (PBS).

The Provincial Bureaus of Statistics had also made projections in their respective publications of *Development Statistics*. In particular, the Punjab Bureau was conservative and estimated the inter-Censal growth rate at only 1.9 percent. The actual growth rate revealed by the Census is 2.1 percent. Similarly, the Balochistan Bureau projected lower growth at 2.9 percent. This would have implied one million less population in 2017 than with the Census estimate of growth rate of 3.3 percent. The Sindh Bureau expected that the population of the Province was growing at a significantly faster rate of 2.8 percent than the growth rate revealed by the Census of 2.4 percent. As such, the Bureau's projected population of Sindh in 2017 was 3.5 million higher than the Census estimate. It is not surprising that Sindh has shown strong dissent on the provisional results, especially since in the previous Census of 1998 it showed the highest growth rate. The only Bureau with a remarkable accurate projection was that of Khyber-Pakhtunkhwa, with a growth rate of 2.9 percent, the same as in the Census.

Table 1.6: Share of Population of Pakistan[a] in each Province, 1998 to 2017

	1981		1998		2017	
	Population (Million)	Share (%)	Population (Million)	Share (%)	Population (Million)	Share (%)
Punjab	47.29	57.88	73.62	57.35 (-0.05)[b]	110.01	54.80 (-0.25)
Sindh	19.03	23.28	30.44	23.71 (0.11)	47.89	23.85 (0.03)
KPK	11.06	13.54	17.74	13.82 (0.12)	30.52	15.20 (0.50)
Balochistan	4.33	5.30	6.57	5.12 (-0.20)	12.34	6.15 (0.96)
Total	**81.71**	**100.00**	**128.37**		**200.76**	

[a]excluding FATA and Islamabad | [b]Figures in parenthesis reflect Annual Rate of change in the share
Source: SBP, Handbook of Statistics on Pakistan's Economy | Population Census 2017, PBS

The question that arises is why there is variation in the population growth rate of the Provinces from a low 2.1 percent in Punjab to a high 3.3 percent in Balochistan? This implies that the cumulative growth of population from 1998 to 2017 was the lowest in Punjab at 48 percent as compared to a high of over 85 percent in Balochistan.

First, there is the possibility is that of under-enumeration in the previous Census of 1998. This is likely particularly in a Province like Balochistan, which is very sparsely populated. Consequently, with perhaps better coverage in 2017 the growth rate is artificially higher.

Second, natural growth rates of population differ among Provinces. There is evidence that the birth rate and the total fertility rate is smaller in Punjab, followed by Sindh, especially in the urban areas. Resort to family planning is also more prevalent in these Provinces as shown in Table 1.5. However, the rate of in-migration into these Provinces is higher, thereby compensating partially for the lower underlying population growth rate.

Interestingly, although Khyber-Pakhtunkhwa has traditionally experienced significant out-migration, especially to Karachi, it has begun to receive relatively large numbers of migrants from FATA. These findings have emerged from the Labor Force Surveys of PBS, which include a migration module.

Third, the *de-facto* approach used in the Census may have had an impact. In particular, the disproportionate location of refugees in Khyber-Pakhtunkhwa and Balochistan has probably affected the Provincial shares of population.

The population distribution among different Provinces has significant implications on the sharing of revenue transfers from the Federal Government as per the NFC awards, on seats in the National Assembly and on quotas of government employment. Therefore, there is a strong motivation for each Provincial Government to get higher population share from the Census.

The implications of the change in population shares of Provinces due to the 2017 Census are significant. First, due to the decline in share of Punjab it will receive almost 4 percent less according to the horizontal sharing formula used in the on-going 7th NFC Award. This is equivalent to a reduction in transfer of over Rs 40 billion on the base of divisible pool revenues in 2016-17. There is little change in the case of Sindh. However, Khyber-Pakhtunkhwa could get an extra transfer of Rs 22 billion and Balochistan, Rs 18 billion respectively. This will positively contribute to the process of fiscal equalization in the country with the rise in the revenue share of the two relatively less developed Provinces of Pakistan.

Second, Punjab could lose at least four seats in the National Assembly if the provisional Census estimates are used as the basis for allocation of seats. If current trends continue Punjab will cease to have the major share of the national population in the next fifteen years.

However, there is an upside for Punjab. With a lower rate of population growth, Punjab will tend to have faster per capita income growth. Research on the change in size of the Provincial economies reveals that Punjab had the fastest growth in per capita income from 1998 to 2017 of 2.5 percent per annum, as compared to just over 2 percent in the country as a whole. Cumulatively, the real per capita income has grown by 60 percent in Punjab since 1998, 14 percent higher than in Pakistan as a whole. Also, the Province will be in a better position to expand coverage to the incremental population, given the lower rate of population growth. This will mean a relatively better quality of life.

1.4. EXTENT AND RATE OF URBANIZATION

The main issue here is the approach adopted in the 2017 Census to define 'urban areas'. The pragmatic method used has been to follow the areas covered by Urban Local Governments as specified by Provincial Governments. However, this can lead to under-coverage in two ways. First, urban metropolitan boundaries may not have been expanded to adequately reflect residential development at the urban-rural periphery. This is probably the case especially with Karachi.

Second, rural settlements may have grown in population and acquired access to basic services, thereby qualifying for treatment as part of urban areas. Interestingly, the last Census in India of 2011 used the some definition as in Pakistan. This led to an estimate of the share of urban population at 31 percent. However, when towns with population size of 5000 or more were also included, the share of urban population increased substantially to 47 percent.

The estimates of the share of urban population in total population of a region in the provisional Census results are as follows: 36.7 percent in Punjab; 52 percent in Sindh; 18.7 percent in Khyber-Pakhtunkhwa; Balochistan, 27.6 percent and FATA, 2.8 percent. For the country as a whole the share of urban population in the total population is 36.4 percent. The change in the rate of urbanization by Province is given in Table 1.7.

There is a surprise here also. The Ministry of Planning and Development and PBS estimated the urban share at 40.5 percent in 2017. This is almost four percentage points higher than the Census. Similarly, the World Bank estimate was higher at 39.2 percent in 2016. Also, earlier estimates of the rate of urbanization were higher. The urban population growth rate ranged from 3.2 percent by the World Bank to 3.3 percent by PBS, as compared to 3 percent by the Census.

However, despite lower estimate of the extent of urbanization in Pakistan by the Census, it is perhaps a big surprise to know that Pakistan is the most urbanized country in South Asia. The share of urban population ranges from 18.4 percent in Sri Lanka, to 19 percent in Nepal, 33.1 percent in India and 35.1 percent in Bangladesh, as shown in Table 1.8, as of 2016. Can this be attributed at least partly to the GT road which has over 60 percent of the national population living in clusters in close proximity to the road?

Table 1.7: Rate of Urbanization by Province, 1981 to 2017

	Population – Million			Growth Rate – (%)		Share of Urban Population - 2017 (%)
	1981	1998	2017	1981 to 1998	1998 to 2017	
PAKISTAN[a]	**84.3**	**132.4**	**207.8**	**2.65**	**2.37**	**36.38**
Urban	28.8	43.0	75.6	3.48	2.96	
Rural	60.5	89.4	132.2	2.30	2.06	
Ratio of Growth Rate				*1.51*	*1.44*	
PUNJAB	**47.3**	**73.6**	**110.0**	**2.60**	**2.11**	**36.72**
Urban	13.1	23.0	40.4	3.31	2.96	
Rural	34.2	50.6	69.6	2.30	1.68	
Ratio of Growth Rate				*1.44*	*1.76*	
SINDH	**19.0**	**30.4**	**47.9**	**2.76**	**2.39**	**52.00**
Urban	8.2	14.8	24.9	3.47	2.74	
Rural	10.8	15.6	23.0	2.16	2.04	
Ratio of Growth Rate				*1.61*	*1.34*	
Khyber Pakhtunkhwa	**11.1**	**17.7**	**30.5**	**2.74**	**2.86**	**18.69**
Urban	1.7	3.0	5.7	3.34	3.37	
Rural	9.4	14.7	24.8	2.64	2.75	
Ratio of Growth Rate				*1.27*	*1.22*	
BALOCHISTAN	**4.3**	**6.6**	**12.3**	**2.52**	**3.27**	**27.64**
Urban	0.7	1.6	3.4	4.86	3.96	
Rural	3.6	5.0	8.9	1.93	3.03	
Ratio of Growth Rate				2.53	1.32	

[a]Including FATA and Islamabad

Source: Pakistan Economic Survey (PES), Population Census 2017

Table 1.8: Comparison of the Extent of Urbanization in Selected Countries[a]

	Share of Urban Population (%)	Primacy Index[b] (%)	% of Urban Population in Large Cities[c]
	SOUTH ASIA		
Bangladesh	35.0	31.9	41.8
India	33.1	6.0	44.9
Nepal	19.0	22.2	100.0
Sri Lanka	18.4	18.2	n.a
Pakistan[d]	**36.4**	**19.7**	**53.7**
	OTHER MUSLIM COUNTRIES		
Indonesia	54.5	7.4	19.5
Turkey	73.9	24.5	51.1
Egypt	43.2	46.2	58.0

[a]Estimates for 2016 | [b]Share of the Largest City in the Urban Population

[c]Large cities are cities with population above 1 million | [d]From Population Census

Source: WDI

The primacy index of Pakistan is low by international standards at 19.7 percent while the percentage of urban population living in cities with population above 1 million is relatively high at almost 54 percent. A comparison with selected countries is made in Table 1.8.

1.5. GROWTH OF CITIES

The size and growth of the major cities of Pakistan is given in Table 1.9. These cities all have a population of over 1 million in 2017. The largest city is Karachi and Lahore is the fastest growing city along with the Federal Capital, Islamabad.

Table 1.9: Population and Growth of Major Cities of Pakistan, 1981 to 2017

	Population – (Million)			Annual Growth Rate (%)	
	1981	1998	2017	1981 to 1998	1998 to 2017
Karachi	5.208	9.339	14.910	3.43	2.46
Lahore	2.953	5.143	11.126	3.26	4.06
Faisalabad	1.104	2.009	3.203	3.52	2.46
Rawalpindi	0.795	1.410	2.098	3.37	2.09
Gujranwala	0.601	1.133	2.027	3.72	3.06
Peshawar	0.566	0.983	1.970	3.25	3.66
Multan	0.732	1.197	1.872	2.89	2.35
Hyderabad	0.752	1.167	1.733	2.59	2.08
Islamabad	0.204	1.529	1.015	5.60	3.42
Quetta	0.286	0.565	1.001	4.00	3.01

Source: Statistical Year Book (PBS)
Population Census 2017

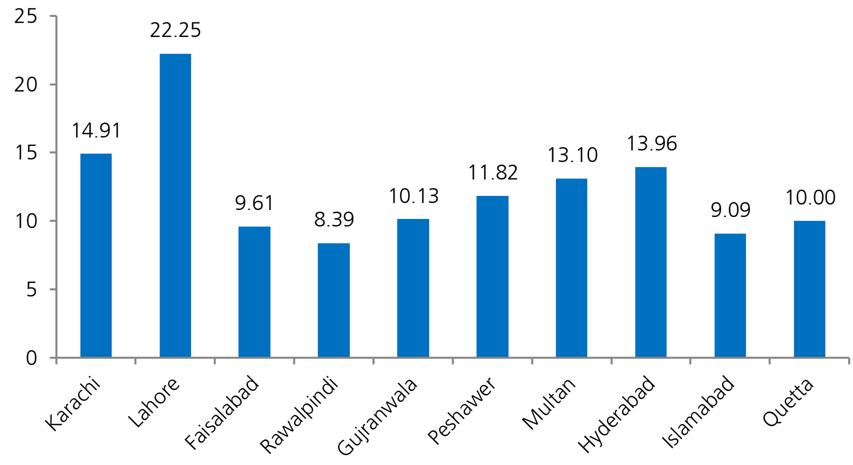
The basic question is how balanced is the urban settlement hierarchy of Pakistan, as revealed by 2017 Census. For this purpose the Rank Size rule is applied, which states the following:

Ranking of a city X Population of the City = A constant

Results are presented in Chart 1.2 for cities with population above 1 million in 2017. The dominance of the two large metropolitan cities, Karachi and Lahore, is clearly demonstrated. In particular, Lahore appears to have expanded very fast and more than doubled its population since 1998.

Medium-sized cities of Pakistan generally have lower population in relation to that indicated by the Rank Size rule. Within Provinces, the more imbalanced distribution is observed in Sindh. In relation to Lahore, the population of Karachi appears to be significantly understated.

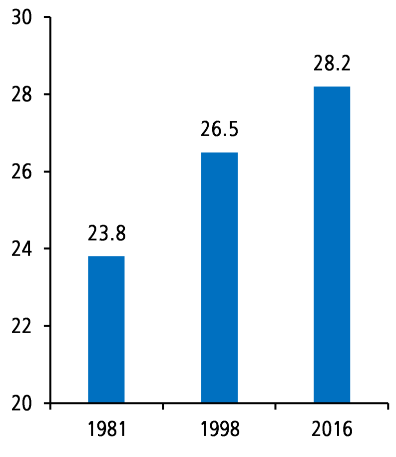
Chart 1.2: Application of the Rank Size Rule to Cities of Pakistan with Population above 1 million

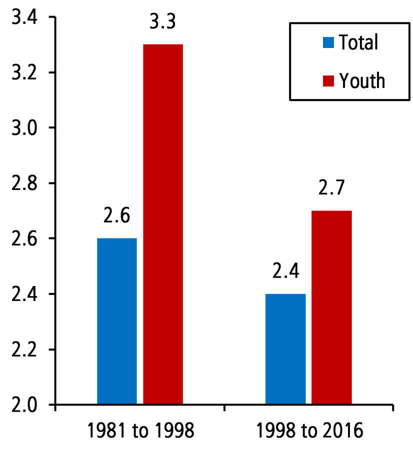


1.6. THE YOUTH BULGE

The high levels of fertility in the earlier years of Pakistan have led now to the '*youth bulge*'. The share of the population in the age group, 15 to 29 years has consistently been rising in the previous Censuses, as shown in the Chart 1.3. The share has increased from 23.8 percent in the 1981 Census to 28.2 percent in 2016. However, the age distribution of population according to the 2017 Census has not yet been released.

Chart 1.3: Share of Youth in the Population and Annual Growth Rate, 1981 to 2016





Source: PES

The number of youth in Pakistan is estimated at 60 million. It has trebled since 1981. The annual growth rate of youth population since 1981 has been 3 percent, while that of the total population has been significantly lower at 2.5 percent.

There are many implications of the youth bulge. First, it means a lower dependency ratio within the population. Second, it necessitates a need for faster expansion of the higher education system of colleges and universities. Third, the rate of entry into the labor fore is larger, implying also a greater need for jobs.

Overall, the findings regarding urbanization is that, first, Pakistan is relatively more urbanized, second, that urbanization is proceeding at a moderate rate and, third, that the size distribution of cities has become more imbalanced. The bottom line is that Pakistan will have to make strong efforts to reduce the growth rate of population in the metropolitan cities like Lahore.

SECTION 2

STATE OF THE ECONOMY

Chapter 2:

ECONOMIC TRENDS

This chapter gives a bird's eye view of the performance of the economy of Pakistan from 2012-13 to 2016-17. It covers key macroeconomic indicators including growth, investment, GDP by expenditure, public finances, balance of payments, inflation and employment.

2.1. GROWTH

The new millennium started with Pakistan in the midst of sanctions imposed by the international community following the nuclear tests which constrained growth to the low rate of 2 percent per annum. Soon after, with Pakistan becoming an ally of the USA in the global 'war-on-terror' the economic situation changed for the better with large aid inflows. The growth rate rose to reach a maximum of 9 percent in 2004-05. This was accomplished because of a boost in all sectors-industry, agriculture and services. Investment (both public and private), as a percentage of GDP, showed a big increase, being stagnant in the early years of the new millennium.

Table 2.1: Trends in Key Macro Economic Indicators, 2012-13 to 2017-18

		2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
A.	Growth Rate (%)						
	GDP	*3.7*	*4.1*	*4.1*	*4.5*	*5.3*	*5.8*
	Agriculture	2.7	2.5	2.1	0.3	3.5	3.8
	Manufacturing	4.9	5.7	3.9	3.7	5.3	6.2
	Services	5.1	4.5	4.4	5.6	6.0	6.4
B.	Investment *(% of GDP)*						
	Total[a]	*13.6*	*13.4*	*14.1*	*14.0*	*14.2*	*14.8*
	Public	3.9	3.5	3.7	3.8	4.3	5.0
	Private	9.7	9.9	10.4	10.2	9.9	9.8
C.	National Savings *(% of GDP)*	*13.9*	*13.4*	*14.7*	*14.3*	*13.1*	*11.4*

[a]Excluding change in stocks.

Source: PES

The high growth in Pakistan coincided with economic boom in most Asian economies, with one major difference. While the growth spurt in the emerging economies continued, more or less, unabated, growth in Pakistan could not be sustained. In fact, it was followed by a period of near stagflation. For the last five years GDP growth has averaged barely 4 percent per annum. However, in the last two years it has exceeded 5 percent. Deep rooted economic issues have constrained high and sustained growth in Pakistan including impact of the war on terror, high levels of power outages; low rate of savings and consequently inadequate investment not only by the private sector but also by the public sector in infrastructure and human capital; a weak industrial and export structure, dominated by textile based exports, due to trade policies that failed to promote diversification; an ambivalent attitude towards the private sector; ineffective governance structure with weak public institutions and rule of law; lack of accountability; high level of bureaucratic red-tape and rampant corruption.

Table 2.2: Gross Fixed Capital Formation (Publica + Private) by Sector, 2012-13 to 2017-18 – (% of GDP)

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Agriculture	3.1	2.9	3.0	2.9	2.9	2.9
Large-Scale Manufacturing	1.6	1.4	1.5	1.7	1.6	1.4
Electricity & Gas	0.7	0.4	0.8	0.6	0.5	0.7
Transport & Communications	1.6	1.7	2.0	1.7	1.7	1.6
Ownership of Dwellings	2.1	2.1	2.1	2.1	2.1	2.0
Others	2.0	2.2	2.0	2.1	2.3	2.3
TOTAL	**11.1**	**10.7**	**11.4**	**11.1**	**11.1**	**10.9**

[a]Excluding investment by General Government, for which sectoral data is not available.

Source: PES

2.2. INVESTMENT

Real gross fixed investment, excluding that by General Government, as a percentage of GDP has fallen steadily, showing a decline of over 30 percent from the peak in 2005-06. Over the period, 2012-13 to 2017-18, it has averaged 11.1 percent of GDP, one of the lowest on record. The decline in investment in industry, especially large-scale manufacturing is very worrying (see Table 2.2). Investment in the power sector has remained low, at below one percent of the GDP. This has been woefully inadequate to close the demand-supply gap in electricity and power outages reached a peak by 2012-13. Investment in agriculture remains one of the key areas, especially for the private sector.

2.3. GDP BY EXPENDITURE

Consumption expenditure has significantly contributed to economic activity; the official statistics indicate a share of over 90 percent over the period 2012-18 (See Table 2.3). The worrying trend is the decline in share of exports from has fallen from 12.7 to 9.5 percent of the GDP.

Table 2. 3: GDP by Expenditure, 2012-13 to 2017-18 – (% of GDP)

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Private Consumption Expenditure	81.0	80.5	76.7	77.8	79.9	81.1
Government Consumption Expenditure	10.8	12.0	11.0	11.2	11.8	12.1
Domestic Capital Formation	12.6	12.4	14.2	14.4	14.7	15.0
Change in Stocks	1.6	1.6	1.6	1.6	1.6	1.6
Exports of Goods & NFS[a]	12.7	12.3	10.3	9.6	9.1	9.5
Less Imports of Goods & NFS	-18.8	-18.8	-13.8	-14.6	-17.1	-19.3
GDP (market prices)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	

[a]Non-factor services.
Source: PES

2.4. PUBLIC FINANCES

Slow economic growth over the last decade has been accompanied by large and growing macroeconomic imbalances, and Pakistan has experienced stagflation with low growth combined with high inflation. This pattern was fortunately reversed after 2015-16. Public finances have deteriorated significantly and external transactions are being kept afloat as a result of large worker remittances and high levels of external borrowing.

Driven by a stagnant revenue-to-GDP ratio, mounting public enterprise losses and persistent subsidies for the power sector, the overall fiscal deficit has increased to an average of 5.6 percent of GDP over the last five years (See Table 2.4). The problem, however, is not only the large size of the deficit but what the deficit finances and how it is financed. Because of the low revenue-to-GDP ratio averaging around 14.9 percent, government revenues do not even cover current expenditures. The revenue deficit on general government current account has averaged 1.4 percent of GDP in the last five years and has been responsible for 25 percent of the overall fiscal deficit.

Table 2.4: Summary of Consolidated Public Finances of Pakistan, 2012-13 to 2017-18 – (% of GDP)

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Total Revenues	**13.0**	**14.3**	**14.4**	**15.0**	**15.5**	**15.2**
Tax Revenues	9.6	10.1	11.0	12.4	12.5	13.0
Non-Tax Revenues	3.4	4.2	3.3	2.7	3.0	2.2
Total Expenditure	**21.0**	**19.8**	**19.7**	**19.6**	**21.3**	**21.8**
Current Expenditure	16.0	15.8	16.2	15.9	16.3	17.0
Development Expenditure[a]	5.0	4.0	3.5	3.7	5.0	4.7
Overall Fiscal Deficit	**-8.0**	**-5.5**	**-5.3**	**-4.6**	**-5.8**	**-6.6**

[a]Including net lending and adjusted for statistical discrepancy.
Source: MOF, Fiscal Operations

The financing of the overall fiscal deficit historically has relied heavily on what are essentially inflationary means. The direct financing of the fiscal deficit by the Central Bank has been curtailed during the tenure of the IMF Program. Large commercial bank financing of the Government operations has been possible only through large liquidity infusion by OMOs to them by the State bank of Pakistan (SBP). This has resulted in significant monetary expansion, while 'crowding out' the private sector.

The overall public debt which was brought down to 57 percent of the GDP in 2007-08 has again shot up to over 72 percent by 2017-18 (see Table 2.5). Since 2012-13, the ceiling of 60 percent of the GDP imposed by the Fiscal Responsibility and Debt Limitation Act is being violated. Also, the share of external debt has increased.

Table 2.5: Level and Composition of Public Debt, 2012-13 to 2017-18 – (% of GDP)

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Total Public Debt	**62.7**	**64.3**	**63.3**	**67.6**	**67.2**	**72.5**
Domestic Debt	40.6	43.6	39.1	41.0	39.9	43.2
External Debt	22.1	20.7	24.2	26.6	27.3	29.3

Source: SBP

2.5. BALANCE OF PAYMENTS

While the large fiscal imbalances have persisted, the foreign exchange position is an even greater area of concern. The current account deficit in the balance of payments deficit shot up to $13.9 billion or 8 percent of GDP primarily because of the 'oil shock' in 2007-08. This necessitated a resort to the IMF Standby Facility (SBF) of $11 billion, which was only partly availed.

Table 2.6: Summary of the Balance of Payments, 2012-13 to 2017-18 – ($ billion)

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Current Account Balance	**-2.5**	**-3.1**	**-2.8**	**-4.9**	**-12.4**	**-19.0**
Exports	24.8	25.1	24.1	22.0	21.9	24.8
Imports	40.2	41.7	41.4	41.3	48.5	56.0
Trade Balance	**-15.4**	**-16.6**	**-17.3**	**-19.3**	**-26.6**	**-31.2**
Remittances	13.9	15.8	18.7	19.9	19.4	19.6
Capital & Financial Account Balance	**-0.5**	**6.9**	**5.4**	**7.6**	**10.5**	**12.9**
FDI	1.3	1.6	0.9	2.3	2.6	3.1
Net Foreign Assistance	0.2	1.6	1.4	3.4	4.9	4.9
Others[a]	-2.0	3.7	3.1	1.9	3.0	4.9
Balance of Payments	**-3.0**	**3.8**	**2.6**	**2.7**	**-1.9**	**-6.1**
Use of Fund Credit	**-2.5**	**-0.6**	**1.9**	**2.0**	**-0.1**	**-0.1**
Reserves (Net with SBP)	**6.0**	**9.1**	**13.5**	**18.1**	**16.1**	**9.8**

[a]including private borrowing and other flows.
Source: SBP

Table 2.7: Nominal and Real Effective Exchange Rate (REER), 2012-13 to 2017-18		
	Nominal Exchange Rate (Rs / $)	REER (Base is 2010)
2012-13	96.72	104.4
2013-14	102.86	110.1
2014-15	101.29	119.1
2015-16	104.24	120.6
2016-17	104.68	124.9
2017-18		111.2

Source: SBP

Stagnancy in exports and unsustainable imports, due to an increasingly overvalued exchange rate (as indicated by the REER in Table 2.7) put Pakistan's current account under stress, despite the continued growth in worker remittances and disbursements from the Coalition Support Fund (CSF). Another peak in the size of the current account deficit was reached in 2017-18 at $19 billion or more than 6 percent of the GDP. Liquid foreign exchange reserves held by the SBP declined $9.8 billion by end June 2017, not even enough to cover two months of imports.

2.6. INFLATION

Consumer price inflation averaged under 5 percent annually during the last five years, as shown in Table 2.8. Inflation moderated substantially from 2015-16 to 2017-18, in part due to a change in base year of CPI from 2000-01 to 2007-08 with under-reporting of the inflation in house rent, electricity and gas prices. However, food prices rose by only 2.1 percent in 2015-16, 3.8 percent in 2016-17 and only 1.8 percent in 2017-18. In 2017-18 inflation rate has dropped to below 4 percent primarily in response to falling international commodity prices, especially of oil.

Table 2.8: Rate of Inflation in Domestic and International Prices, 2012-13 to 2017-18 – (%)

	Consumer Price Index – (2007-08 = 100)			Unit Value Index of Imports (1990-91 = 100)
	Food	Non-Food	Overall	
2012-13	7.1	7.5	7.3	7.8
2013-14	9.0	8.3	8.6	4.3
2014-15	3.5	5.3	4.5	0.5
2015-16	2.1	3.4	2.9	-12.8
2016-17	3.8	4.4	4.2	-1.3
2017-18	1.8	5.4	3.9	5.1

Source: PES

2.7. EMPLOYMENT

The macroeconomic challenges will have to be surmounted if the GDP is to be put back on a high growth trajectory of at least 6 percent. This is essential if Pakistan is to absorb productively its labor force, which is rising at almost 2.5 percent per annum. Currently, almost 4 million workers are unemployed, as shown in Table 2.9. Given the demographic profile, Pakistan is witnessing a youth bulge. If this youth population is not gainfully employed, the 'demographic dividend' for Pakistan has the danger of becoming a 'demographic curse', given the rise of militancy extremism and crime.

Table 2.9: Labor Force, Employed and Unemployed, 2007-08 to 2017-18 – (Million)

	Labor Force	Employed	Unemployed	Unemployment Rate (%)
2007-08	53.7	50.9	2.8	5.2
2012-13	59.7	56.0	3.7	6.2
2013-14	60.1*	56.5	3.6	6.0
2014-15	61.0*	57.4	3.6	5.9
2017-18	65.5	61.7	3.8	5.8

*The numbers are underestimated
Source: PES

Overall, the economy showed little dynamism after 2007-08. There was some revival in the last two years. However, the emergence once again of large macroeconomic imbalances indicates that the focus will continue to be on stabilization of the economy rather than on growth.

Chapter 3:

THE ECONOMY IN 2017-18

The objective of this chapter is to review the developments in the economy in 2017-18. The first part of the review describes the movement of key indicators in 2017-18. The second part focuses on growth. The third section examines the level of investment in 2017-18. The fourth reviews the trend in employment and the fifth analyses the causes of the exceptionally low rate of inflation this year. The next two sections analyze the magnitude of the fiscal and current account deficits in 2017-18. Finally, in Section 3.7 the visible slow down of the economy in early 2018-19 is highlighted.

3.1. KEY INDICATORS

The economy has shown sharply divergent symptoms and indicators in 2017-18, as shown in Table 3.1. According to the estimates by the Pakistan Bureau of Statistics, the GDP growth rate has been rising consistently since 2012-13 reaching a peak of 5.8 percent by 2017-18. This is the highest growth rate since 2005-06 in an environment of low inflation. However, an attempt is made below to check the validity of the growth and inflation estimates.

As opposed to these claims, the underlying official economic data reflects contrasting signs. The 'twin' deficits have been steadily worsening since 2015-16. From a low of 5 percent of the GDP, after excluding one-off receipts, in 2015-16, the fiscal deficit has reached 6.6 percent of the GDP. Similarly, the current account deficit, which was only 1.7 percent of the GDP in 2015-16, has been soaring, and approached 6 percent of the GDP in 2017-18, leading to a substantial draw down of the foreign exchange reserves of the country.

What explains the simultaneous presence of both positive and negative trends in the economy? Part of explanation lies in the strong expansionary fiscal and monetary policies that fueled the growth process, feeding the sharp jump in import demand leading to a larger trade and current account deficit, without a concomitant increase in export earnings to finance the enhanced import bill. It is only recently that a much needed improvement is being witnessed in exports after a period of big decline since 2012-13.

3.2. GROWTH

The economy apparently has come very close to achieving the ambitious growth target in the Annual Plan of 2017-18 of 6 percent. The divergence is only 0.2 percentage points. All sectors seem to have exhibited relatively fast growth, as shown in Table 3.1. Agriculture achieved a growth rate of 3.8 percent, the highest since 2005-06. Industry experienced growth of 6.2 percent. This was the highest rate since 2007-08. The services sector also exhibited exceptional dynamism with a growth rate of 6.4 percent and contributed to over 67 percent of the increase in GDP in 2017-18.

Table 3.1: Key Economic Indicators for 2016-17 and 2017-18

	Unit	2016-17	2017-18
GDP Growth Rate	**%**	**5.4**	**5.8**
Agriculture		2.1	3.8
Industry		5.8	6.2
Services		6.5	6.4
Rate of Investment[a]	**% of GDP**	**14.5**	**14.8**
Public		4.5	5.0
Private		10.0	9.8
Rate of Inflation	**%**	**4.2**	**3.9**
Public Finances	**% of GDP**		
Total Revenues		15.5	15.2
Total Expenditure		21.3	21.8
Budget Deficit		5.8	6.6
Balance of Payments	**$ billion**		
Exports		22003	24824 (12.8)[b]
Imports		48683	56002 (15.0)
Trade Deficit		-26680	-31178 (16.9)
Current Account Deficit		-12621	-18989 (50.4)

[a]Fixed Capital Formation | [b]Figures in parenthesis are growth rate.
Source: PES, MOF, SBP

The major crop sector has apparently shown a high growth rate of 3.6 percent. This is not substantiated by the derivation of the weighted growth rate of individual crops, as shown in Table 3.2. Further, a high rate of growth is unlikely with a fall in fertilizer off-take in nutrient tons in 2017-18 of 4 percent and a big decline in water availability in the Rabi season. The actual growth rate is closer to 2.6 percent.

Table 3.2: Growth Rate of Major Crops, 2017-18 – (%)

	Unit	Weight	Growth Rate
Wheat	Tons	0.3994	-4.4
Rice	Tons	0.1823	8.6
Maize	Tons	0.0491	-7.0
Sugarcane	Tons	0.1019	0.0[a]
Cotton	Bales	0.2673	11.8
TOTAL		**1.000**	**2.6[b]**

[a]Growth in sugarcane output is unlikely given the nearly 7 percent decline in sugar production.

[b]The reported growth rate by PBS is 3.8 percent.

Source: PBS

Turning to the nearly 4 percent growth rate in the livestock sector it is in sharp contrast to the declining or unchanged trend in per capita consumption of major livestock products like milk, meat and beef. These products account for 60 percent of the value of output in the sector. Based on the consumption trends the growth rate is 2.8 percent.

The growth in large-scale manufacturing at over 6 percent has apparently been achieved in a situation where electricity consumption in the sector has actually fallen by 2 percent, according to the information in the Pakistan Economic Survey on energy. To say the least, this is extremely unlikely. This is based on data available for the first nine months of 2017-18. The last quarter saw a slowdown in the growth rate to 4.6 percent. Therefore, the growth rate of the sector for the full year is 5.6 percent.

A high growth rate is shown in the construction sector of over 9 percent. This is probably based on the double-digit growth rate in industries producing construction inputs like cement, iron and steel. However, construction activity linked to the execution of development projects has slowed down with a decline in the real PSDP expenditure of over 11 percent in 2017-18. Further, real investment in housing has increased by only 4 percent in 2017-18.

The high growth rate of 7.5 percent in the wholesale and retail trade sector will need to be adjusted downwards in line with the lower growth rates in the commodity-producing sectors. The finance and insurance sector is shown as recording a growth rate of over 6 percent in 2017-18. In the presence of very low interest rates, the SBP estimates that nominal profits of commercial banks collectively have witnessed a big downturn. This implies that the value added in the sector is unlikely to have been augmented significantly in 2017-18.

The last two other sectors where the growth appears to be exaggerated are Government services and private services. In the latter case, the data on fiscal operations enables a computation of the public expenditure growth rate, which is somewhat lower at 9 percent, than that reported by the PBS. Finally, private services are unlikely to be buoyant with a combined growth rate of over 6 percent in a situation where employment in the sector has been growing in recent years by less than 1 percent, as reported by the Labor Force Surveys.

Overall, adjusted estimates of the growth rates are 3 percent in agriculture, 5.2 percent in industry and 5.3 percent in services, as shown in Table 3.3. *This leads to an estimate of the overall GDP growth rate in 2017-18 of 4.8 percent, which is significantly lower than the PBS estimate of 5.8 percent*. A similar discrepancy was revealed in 2016-17. The estimate of the GDP growth rate by the PBS for the year was 5.3 percent, whereas the likely figure was 4.4 percent. The GDP growth rate appears to have been exaggerated by almost one percentage point in both years.

Table 3.3: GDP Growth Rate by Sector in 2017-18 – (Rs in billion at 2005-06 prices)

Sector	2016-17 Value Added	PBS Estimate 2017-18	Growth Rate (%)	Own Estimate 2017-18	Growth Rate (%)
AGRICULTURE	**2251.0**	**2336.8**	**3.8**	**2318.5**	**3.0**
Major Crops	432.5	551.5	3.6	546.3	2.6
Minor Crops	244.3	252.4	3.3	252.4	3.3
Cotton Ginned	53.4	58.0	8.7	58.0	8.7
Livestock	1326.9	1376.9	3.8	1364.1	2.8
Fishing	48.4	48.9	1.6	48.9	1.6
Forestry	45.5	48.8	7.2	48.8	7.2
INDUSTRY	**2449.4**	**2591.3**	**5.8**	**2577.3**	**5.2**
Mining and Quarrying	331.8	341.9	3.0	341.8	3.0
Large-Scale Manufacturing	1260.8	1338.0	6.1	1331.4	5.6
Small-Scale Manufacturing	214.8	232.4	8.2	226.0	5.2
Slaughtering	106.0	109.7	3.5	109.0	2.8
Electricity and Gas	215.5	219.4	1.8	219.4	1.8
Construction	320.5	349.7	9.1	349.7	9.1
COMMODITY PRODUCING SECTORS	**4700.4**	**4928.1**	**4.8**	**4895.8**	**4.1**
SERVICES	**7013.8**	**7464.5**	**6.4**	**7384.0**	**5.3**
Wholesale and Retail Trade	2187.4	2351.7	7.5	2338.3	6.9
Transport & Communication	1560.2	1616.0	3.6	1599.2	2.5
Finance and Insurance	395.5	419.7	6.1	403.8	2.1
Housing	777.1	808.2	4.0	808.2	4.0
Government Services	882.0	982.7	11.4	962.3	9.1
Private Services	1211.6	1286.1	5.8	1272.2	5.0
GDP	**11714.2**	**12392.6**		**12279.8**	**4.8**

Source: PES | Author's estimates.

The conclusion is that the growth rate has no doubt increased annually since 2012-13, but not as fast as indicated by the PBS. It has risen from under 4 percent in 2012-13 to almost 5 percent in 2017-18, not 6 percent, during the tenure of the PML (N) Government.

3.3. INVESTMENT

All indications were there that there would be an upsurge in investment, both private and public, in 2017-18. Interest rates have been exceptionally low along with the availability of ample credit. There has also been the apparent removal of the electricity supply constraint along with a greatly improved security environment and implementation of on-going projects of China-Pakistan Economic Corridor (CPEC).

Unfortunately, the overall level of investment has not been as high as anticipated. The Annual Plan had set a target for gross domestic capital formation at 15.6 percent of the GDP in 2017-18. According to the PBS, the actual level is 14.8 percent of the GDP. Private investment is estimated at 9.8 percent of the GDP as compared to 10 percent of the GDP in 2016-17. It has fallen annually from the level of 10.4 percent of the GDP attained in 2014-15.

The disappointing response of the private sector needs to be explained in the presence of favorable conditions. There has been little or no real growth in credit off-take by the private sector. One factor which has probably contributed is the deterioration in political conditions in the country after July 2017.

Analysis of the sectoral distribution of private sector investment reveals that four sectors, viz., agriculture, large-scale manufacturing, transport and communications and housing, account for bulk of the investment with share of 26, 13, 17 and 23 percent respectively.

Private investment in real terms in industry has actually fallen by 2 percent. This may be a reflection of the presence of excess capacity in industry, especially in textiles, following the earlier downturn in exports. It has also declined in transport and communications. The latter sub-sector experienced major expansion in earlier years but has reached a mature stage of development. However, it is heartening to note that investment in agriculture has grown in excess of 5 percent.

Turning to public investment, PBS estimates a big jump of 17 percent in 2017-18. Much of the upsurge is in government investment from budgetary sources of as much as 21 percent. Unfortunately, the latter part of the year witnessed a big cutback in spending on the Federal PSDP in an effort to reduce the fiscal deficit, especially by the caretaker Government. As such, the level of public investment is probably overstated by almost 1 percent of the GDP.

Overall, *it appears that the overall level of fixed investment is actually close to 13.8 percent of the GDP as compared to the PBS estimate of 14.8 percent for 2017-18*. This implies that there has been a fall in the rate of fixed capital formation also by 1 percent of the GDP from the level attained in 2016-17. Clearly, the process of faster growth has not been investment-led. This raises doubts about the ability of the economy to remain on a high growth path.

3.4. EMPLOYMENT

The labor force of Pakistan is expanding at a relatively fast rate of 2.5 percent in presence of the '*youth bulge*'. It is estimated at almost 67 million in 2017-18. However, this is reported at 65.5 million in the 2017-18 Labor Force Survey of PBS.

Consequently, the unemployment rate is also understated at 5.8 percent in 2017-18. It is closer to 8 percent. The level of unemployment is especially high in urban areas and among female or highly educated workers. For example, workers with a degree or postgraduate qualification currently face an unemployment rate of almost 20 percent.

3.5. INFLATION

One of the most positive elements of the economic picture is the low rate of inflation since 2014-15. The rate of increase in the Consumer Price Index was only 3.9 percent in 2017-18. It is even lower in the case of the food prices at 1.8 percent. This has cushioned low income families from falling below the poverty line. However, the '*core*' inflation rate was close to 5.5 percent.

There is a tendency here also for the PBS to somewhat bias the estimate of the rate of inflation downwards. In particular, the housing rent price index is reported to have increased by 6 percent while the HIES estimates it at 11 percent. *As such, the rate of inflation in the CP1 is close to 5 percent*.

Two factors have contributed to the relatively less pressure on prices. First, since June 2014 international commodity prices, especially of oil, have fallen cumulatively by 38 percent. This has been reflected in lower domestic prices. Second, the policy of deliberately maintaining the nominal value of the exchange rate has limited the rate of inflation. However, the recent depreciation of the rupee and the upsurge in oil prices do not auger well for inflation in coming months.

We turn now to the trend in the magnitude of the two deficits.

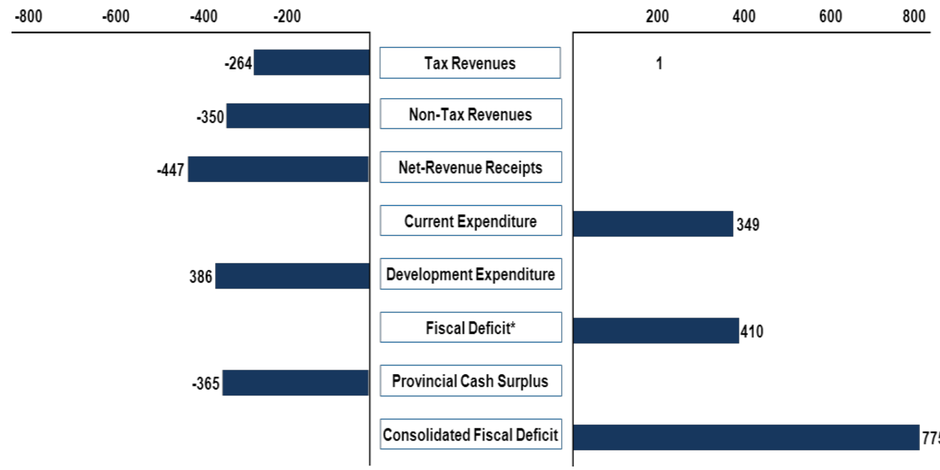
3.6. PUBLIC FINANCES

The Ministry of Finance (MoF) skillfully targeted for a big reduction in the fiscal deficit of 5.8 percent of the GDP in 2016-17 to 4.1 percent of the GDP in 2017-18. This was expected in the Budget estimates by making bloated revenue and understating the expenditure projections. Revenues were shown as growing by as much as 17 percent while the level of current expenditure was actually projected to show a decrease of 1 percent.

The information on fiscal operations reveals that the consolidated fiscal deficit has been significantly higher than originally projected, at 6.6 percent of the GDP in 2017-18. The deviation of 2.5 percent of the GDP from the target of 4.1 percent of the GDP is the largest in the five years of the PML (N) Government.

Reasons for the larger deficit of as much as Rs 775 billion are visually presented in Figure 3.1. There was a shortfall of Rs 264 billion in Federal tax revenues and of Rs 350 billion in non-tax revenues. Consequently, after transfers to the Provinces, Federal net revenues were lower by Rs 447 billion. However, total Federal expenditure, current and development combined, remained close to the target. The other source of the larger deficit was the failure of the Provincial Governments to generate a combined cash surplus of Rs 348 billion. In fact, they jointly had a cash deficit of Rs 17 billion.

Figure 3.1: Deviations of Key Public Finance*Magnitudes from Budget Estimates in 2017-18



*Federal Budget

3.7. BALANCE OF PAYMENTS

The outcome of the balance of payments in 2017-18 is of critical concern. Reserves have been depleted at a rapid rate and by end-June 2018 had come down to below $9.8 billion. In fact, if the 'swap' funds with the SBP are excluded the reserves fall to only $4 billion.

The Annual Plan had projected the current account deficit at $13.7 billion in 2017-18. The deficit actually reached $19 billion, as shown in Table 3.4. This represents a growth of 51 percent over the level in 2016-17 and the largest ever in absolute terms.

The difference is due primarily to underestimation of the projected level of imports in 2017-18. The Annual Plan projected that these will be close to $52 billion. By the end of

2017-18 imports touched $56 billion due primarily to big increases in machinery and oil imports. Exports did show some growth of almost 13 percent after falling for four years. However, the trade deficit increased by over 16 percent.

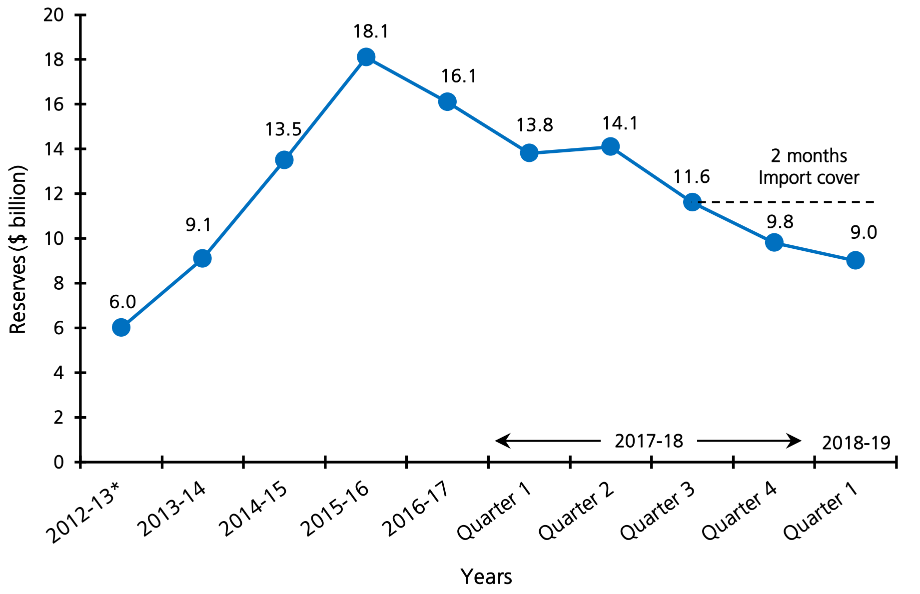
Table 3.4: Balance of Payments of Pakistan in 2016-17 and 2017-18 – ($ million)

	2016-17	2017-18	Growth Rate (%)
CURRENT ACCOUNT DEFICIT	**-12,621**	**-18,989**	**50.4**
Trade in Goods Balance	**-26,680**	**-31,178**	**16.9**
Exports	22,003	24,824	12.8
Imports	-48,683	-56,002	15.0
Trade in Services Balance	**-4,339**	**-5,719**	**31.8**
Exports	5,555	5,312	-4.4
Imports	-9,894	-11,031	11.5
Balance on Primary Income[a]	**-5,048**	**-5,487**	**8.7**
Balance on Secondary Income	**23,446**	**23,395**	**-0.2**
Home Remittances	19,351	19,623	1.4
Capital Account Balance	**375**	**391**	**4.2**
Financial Account Balance	**10,198**	**13,337**	**30.8**
Direct Investment	2,663	3,082	15.7
Portfolio Investment	-250	2,259	X
General Government Borrowing (Net)	5,040	4,885	-3.1
Other Inflows[b]	2,745	3,111	13.3
Errors and Omissions	**102**	**-587**	**X**
Overall Balance of Payments	**-1,946**	**-6,118**	**214.1**
Use of Fund Credit	**102**	**-86**	**X**
Change in FE Reserves	**-1,844**	**-6,204**	**236.4**

[a]repatriation of profit and interest payments | [b]mostly by banks and the private sector | X cannot be estimated
Source: SBP

Home remittances showed little growth of only l percent. The financial account did demonstrate some increase of just over $3 billion, due primarily to the flotation of bonds worth $2.5 billion. The overall balance of payments deficit rose by over $4 billion to $6.2 billion. This is reflected in the fall of foreign reserves to $9.8 billion by the end of 2017-18, not even adequate to provide two months import cover, as shown in Figure 3.2. Pakistan enters 2018-19 with an incipient financial crisis.

Figure 3.2: Level of Foreign Exchange Reserves of Pakistan, 2012-13 to 2018-19, First Quarter



3.8. SLOWDOWN OF ECONOMY

Towards the end of the third quarter of 2017-18 there was increasingly the realization that the growth path chosen was becoming unsustainable, especially in the light of the depleting foreign exchange reserves.

The first punitive actions were largely taken during the tenure of the caretaker Government. Releases for the PSDP projects were slashed. In fact, perhaps after a long time, development spending in the last quarter of 2017-18 was brought down by as much as 39 percent in relation to the expenditure in the corresponding quarter of 2016-17.

This can be considered as the beginning of the slowdown process. The large-scale manufacturing sector was quick to respond. The Quantum Index of Manufacturing was growing at the rate of over 6 percent in the better part of 2017-18. However, in June and July 2018 it grew by less than 1 percent and fell sharply in August 2018. The stimulus provided by development spending and its absence thereof after March 2018 is visible in the precipitous decline in production of cement and iron and steel. The former industry achieved a growth rate of 30 percent in July and August 2017. This has fallen to a negative 7 percent in July and August 2018. Similarly, production in the latter industry showed exceptional dynamism in July and August 2017 of over 40 percent. In contrast, output of iron and steel fell by 4 percent in July and August 2018. Other industries which are witnessing a big slowdown are vegetable ghee, cigarettes, pharmaceuticals, automobiles, fertilizer and petroleum products.

Another visible indicator is the over 70 percent reduction in the current account deficit in August 2018 compared to the level in July 2018. This is due largely to the tapering off of imports. In particular, there has been a sharp decline in imports of machinery by 25 percent in the first two months of 2018-19 as compared to the level in the corresponding period of last year.

There is evidence also that the implementation of CPEC is slowing down. Imports of machinery for electricity generation are down by 40 percent. Further, the flow of Chinese assistance for CPEC infrastructure projects has remained at a very low level. Hopefully, this is not a reflection of any strain in Pak-China ties.

If there are not enough indications of the slowdown, tax revenues of FBR have shown a visible decline in growth rate in the first quarter of 2018-19 to 9 percent from 14 percent in 2017-18. Clearly, the underlying tax bases are no longer so dynamic. To top it all, there is the unprecedented fall in foreign direct investment of 40 percent in July and August 2018-19. This may also be related to CPEC.

Recent actions will cause an even bigger slowdown. The Revised Budget presented in September 2018 by the new PTI Government has cut the Federal PSDP by 28 percent in relation to the original Budget for 2018-19. The SBP has jacked up the policy rate to 8.5 percent. It will be surprising if the GDP growth rate significantly exceeds 4.5 percent in 2018-19.

The unfortunate reality is that the slowdown of the economy is not necessarily seen as a bad outcome. If this leads to a continuing decline in the growth rate of imports it will lead to a quantitative reduction in the current account deficit and thereby reduce the external financing needs for supporting the balance of payments. But the new Government may have to pay a price with regard to unfulfilled expectations regarding more jobs and housing.

Chapter 4:

PAKISTAN'S INTERNATIONAL RANKINGS

An assessment of the level and change of Pakistan in key international indices and measures is important for two reasons. First, it provides a, more or less, objective evaluation of the performance of the economic, social and governance indicators of the country in relation to other countries, especially in South Asia, at a similar stage of development. This helps in identifying critical areas where there is need to improve performance and thereby in prioritizing the reform agenda both for the short and the long term. Second, the various indices influence international perceptions of Pakistan especially of foreign investors.

This chapter covers six key international indices. These are generally provided on an annual basis by international institutions like the UN agencies, World Bank, World Economic Forum and so on. The focus is also to study the change in Pakistan's ranking during the last few years, from 2010 or 2012 to the latest year for which information is available. A comparison is made of Pakistan with three South Asian economies, viz., India, Bangladesh and Sri Lanka. Other countries included in the analysis are Thailand, Indonesia, Turkey and Philippines.

4.1. HUMAN DEVELOPMENT INDEX

The most commonly referred to index is the Human Development Index (HDI) prepared by the United Nations Development Program (UNDP). Dr. Mahbub ul Haq played a major role in the development of this index. The HDI has three components, with equal weights, relating to health status of the population of a country, the level of education and the per capita income, adjusted for differences in purchasing power. The first ranking of the HDI was prepared in 1990. The ranking currently is for 185 countries.

Unfortunately, Pakistan does very poorly in terms of human development, as shown in Table 4.1. Out of the eight countries included in the analysis, Pakistan had the lowest ranking, at 147th in 2015. Turkey had the highest ranking at 71st, followed by Sri Lanka at 73rd. Pakistan is the second lowest ranked country among all countries in the world with a medium level of human development. Further, Pakistan's ranking has fallen further to 150th in 2017.

Table 4.1: Human Development Index Ranking – 2010 and 2015

Countries	2010	2015[b]
Bangladesh	137 (0.545)	139 (0.579)
India	127 (0.580)	131 (0.624)
Pakistan	145 (0.525)[a]	147[a] (0.550)
China	79 (0.700)	90 (0.738)
Thailand	83 (0.720)	87 (0.740)
Indonesia	110 (0.662)	113 (0.689)
Turkey	62 (0.737)	71 (0.767)
Philippines	123 (0.669)	116 (0.682)
Sri Lanka	75 (0.746)	73 (0.766)

Note: HDI Index value is given in parenthesis. | [a]Medium human development | [b]185 Countries

Source: Global Human Development Report, UNDP

The worrying aspect is the poor performance with respect to other South Asian countries. Even Bangladesh has a better ranking of 139th while India is ranked 131st. Between 2010 and 2017, Pakistan's ranking has deteriorated by five places. The absolute value of the HDI has shown only a small change. In fact, Pakistan ranks much higher in terms of per capita income than in the HDI.

The worst performance by Pakistan among the three components of HDI is in education, as shown in Table 4.2. For example, the mean years of schooling of the population was only 5.1 years in 2015, as compared to 8.3 years in India and as high as 10.9 years in Sri Lanka. Clearly, Pakistan needs to invest more on education.

Table 4.2: Magnitude of Key Indicators in the HDI, 2015

Countries	Life Expectancy	Expected Years of Schooling	Mean Years of Schooling	GNI Per Capita*	GNI per Capita Ranking minus HDI Rank
Bangladesh	72.0	10.2	5.2	3341	8
India	68.3	11.7	8.3	5663	-4
Pakistan	66.4	8.1	5.1	5031	-10
China	76.0	13.5	7.6	13345	-7
Thailand	74.6	13.6	7.9	14519	6
Indonesia	69.1	12.9	7.9	10053	-8
Turkey	75.5	14.6	7.9	18705	-7
Philippines	68.3	11.7	9.3	8395	-7
Sri Lanka	75.0	14.0	10.9	10789	21

*2011 PPP $

Source: Global Human Development Report, UNDP

4.2. GLOBAL COMPETITIVENESS INDEX

The next index of importance is the Global Competitiveness Index (GCI) of the World Economic Forum, which has twelve pillars of performance ranging from market size, infrastructure and institutions to technological readiness and innovation. The latest ranking is of 2017-2018 for 140 countries. Here again, Pakistan has the worst ranking at 107th, among the eight countries included in the analysis, as shown in Table 4.3. The highest ranking among these countries is of Thailand at 38th, followed by Indonesia at 45th.

Table 4.3: Global Competitiveness Index Ranking – 2012-13 and 2017-18

Countries	2012-13[a]	2018[b]
Bangladesh	118	103
India	59	58
Pakistan	124	107
China	29	28
Thailand	38	38
Indonesia	50	45
Turkey	43	61
Philippines	65	56
Sri Lanka	68	85

[a]144 Countries | [b]139 Countries
Source: World Economic Forum

Table 4.4: Pakistan's Position in Different Pillars and Sub-Pillars[a] in the Global Competitiveness Index

	Ranking		Ranking
Pillar 1: Institutions	**109**	**Pillar 7: Product Market**	**122**
• Organized Crime	121	• Competition in Services	128
• Terrorism Incidence	140	• Non-Tariff Barriers	110
• Freedom of Press	112	• Level of Trade Tariffs	138
• Quality of Land Admin	117	• Clearance Process	127
• Auditing and Reporting	113		
Pillar 2: Infrastructure	**93**	**Pillar 8: Labor Market**	**121**
• Electrification Rate	109	• Redundancy Costs	112
• Exposure to Safe Drinking Water	112	• Labor-Employer Relations	108
		• Flexibility of Wage Determination	123
		• Females in Labor Force	138
Pillar 3: ICT Adoption[b]	**127**	**Pillar 9: Financial System**	**89**
Pillar 4: Macroeconomic Stability[c]	**103**	• Credit to Private Sector	129
• Debt Dynamics	124	• Insurance Premium	109
Pillar 5: Health	**109**	**Pillar 10: Market Size**	**31**
• Healthy Life Expectancy	108	• Imports (% of GDP)	126
Pillar 6: Skills	**125**	**Pillar 11: Business Dynamism**	**67**
• Mean Years of Schooling	121	**Pillar 12: Innovation Capacity**	**75**
• Pupil-teacher Ratio, Primary	131		

[a]only those sub-pillars where the ranking is below the overall ranking of 107th.
[b]Below 107 in all indicators, except fiber internet subscriptions.
[c]Ranked 1st in Rate of Inflation.

Pakistan's ranking in the GCI has improved somewhat from 124th in 2012-13 to 107th in 2018. The areas of relative weakness of the country are in higher education and training, labor and goods market efficiency, skills and ICT adoption. Interestingly, Pakistan performs relatively better in terms of market size, innovation and business sophistication as shown in Table 4.4. The World Economic Forum in its assessment of the competitiveness of Pakistan has ranked in descending order the following negative factors: corruption, crime and theft, and tax rates.

4.3. CORRUPTION PERCEPTIONS INDEX

This takes us to the next very widely used index, that is, the Corruption Perceptions Index (CPIN) of the Transparency International. Contrary perhaps to perceptions, there has been an extraordinary improvement in Pakistan's ranking in recent years. It has gone up from 139th in 2012 to 117th in 2017, out of 176 countries (see Table 4.5).

Table 4.5: Ranking in Corruption Perceptions Index, 2012 and 2017

Countries	2012[a]	2017[b]
Bangladesh	144	143
India	94	81
Pakistan	139	117
China	80	77
Thailand	88	96
Indonesia	118	96
Turkey	54	81
Philippines	105	111
Sri Lanka	79	91

[a]Total of 174 Countries | [b]Total of 176 Countries
Source: Transparency International

However, other countries in the sample of eight countries generally do relatively better. India has a ranking of 81st, Turkey also of 81st and Indonesia of 96th. The only country in the sample which performs poorly in relation to Pakistan is Bangladesh, with a ranking of 143rd in 2017.

4.4. EASE OF DOING BUSINESS INDEX

Another index, which is potentially of interest particularly to potential investors, is the Ease of Doing Business Index (EDBI) of the World Bank. In this index there has been a substantial worsening in Pakistan's ranking from 105th in 2012 to 147th in 2018 as shown in Table 4.6. Consequently, it has now the second worst ranking among the eight countries, only better than Bangladesh. Thailand is ranked 26th. Turkey stands at 60th and India at 100th. The position of India has improved by thirty two places since 2012.

Table 4.6: Ease of Doing Business Index – 2012 and 2017

Countries	2012	2017*
Bangladesh	122	177
India	132	100
Pakistan	105	147
China	91	78
Thailand	17	26
Indonesia	129	72
Turkey	71	60
Philippines	136	113
Sri Lanka	89	111

*190 Countries
Source: World Bank

The critical areas identified by the EDBI which require improvement in the Pakistani context are of getting electricity, trading across borders, registering property, paying taxes and enforcing contracts as shown in Table 4.7. The country does very well in protecting minority investors, access to credit by an investor and in resolving insolvency in the event of failure.

Table 4.7: Ranking in different Activities related to Business of Pakistan – 2017

Better than Overall Rank	Close to Overall Rank [144]	Worse than the Overall Rank
< 140	140 – 148	> 148
Getting Credit [105]	Starting a Business [142]	Getting Electricity [167]
Protecting Minority Investors [20]	Dealing with Construction Permits [140]	Registering Property [170]
Resolving Insolvency [82]		Paying Taxes [172]
		Trading Across Borders [171]
		Enforcing Contracts [156]

Source: World Bank

4.5. GOVERNANCE

The World Bank gives annually the ranking of countries in different areas of governance, under the heading of 'Governance Matters'. Each country is placed in percentile terms within the overall distribution of scores in a particular indicator. The larger the percentile the worse is the position of the country.

Table 4.8: Ranking in Governance Matters – 2012 and 2017

Percentile* Ranking	PAKISTAN	
	2012	2017
Average Rank	82	77
Voice and Accountability	77	72
Political Stability and Absence of Violence	99	98
Governance Effectiveness	75	68
Regulatory Quality	74	71
Rule of Law	81	76
Control of Corruption	87	77

*The higher the percentile the worse the ranking.

Source: World Bank

Two sets of rankings are presented for Pakistan, for the years 2012 and 2017 respectively in Table 4.8. The former year was in the tenure of the last PPP Government, while the latter was during the Government of PML(N).

The results may perhaps come as a surprise. Pakistan's overall ranking has improved from the 82nd percentile in 2012 to the 77th percentile in 2015.

The area of greatest concern in the context of Pakistan is political stability and violence, where it has almost the lowest ranking among all the countries included. Pakistan also performs poorly in control of corruption. However, here also there has been some improvement. Relatively better rankings are observed in regulatory quality, government effectiveness, voice and accountability.

On the whole, Pakistan will have to do much better in facilitating business, especially the setting up of new projects by investors. Given the big deterioration in Pakistan's relative position internationally with regard to ease of doing business there is need for establishing an independent Commission, with the Federal Board of Investment as the Secretariat. This Commission should be charged with the task of identifying ways of eliminating 'red tape' and facilitating transactions, especially through use of information technology, with different Government and parastatal agencies.

4.6. INCLUSIVE GROWTH AND DEVELOPMENT

The World Economic Forum (WEF) has recently started preparing a ranking of countries in the extent of inclusiveness in the process of growth and development. The rankings for selected countries are presented in Tables 4.9. A total of 74 countries have been included in the ranking, with Pakistan placed 47th. Pakistan's ranking has fallen in one year by seven places.

Table 4.9: Ranking in Inclusive Growth and Development – 2018

Countries	IDI[a] Score	Ranking among Developing Countries[b]	Rate of Change (%)
Turkey	4.26	16	2.48
Thailand	4.24	17	1.93
Sri Lanka	3.79	40	-0.74
Philippines	3.83	38	2.40
Pakistan	3.55	47	7.54
Indonesia	3.95	36	2.57
India	3.09	62	2.29
China	4.09	26	2.94
Bangladesh	3.96	34	4.55

[a]Inclusive Development Index | [b]Total of 78 Countries

Source: WEF

The surprise here is that in the overall Inclusive Development Index (IDI) Pakistan actually does better than India. This is one of the few rankings in which Pakistan performs better than its large neighbor. However, the other sample countries are all placed better than

Pakistan. In particular, China and Turkey do well in this ranking. Pakistan has improved its ranking in this index by one place in 2018. Also, it is reassuring to note that Pakistan has the fastest rate of growth in the index as compared to the other selected countries.

The broad conclusion from the six international rankings is that Pakistan generally performs poorly. Also, the changes in rankings over time are mixed in character. If the country is to attract more foreign direct investment from diverse sources, a systematic effort will have to be launched by focusing on areas where the country is perceived as doing poorly.

Chapter 5:

COST OF THE WAR ON TERROR

The US started the war in Afghanistan after the 9/11 attack in New York. Pakistan joined the war as a coalition partner. The NATO forces in Afghanistan were provided special transit facilities, air bases and other support. There was a large-scale influx of 3 million refugees into Pakistan.

There has been retaliation by the Tehreek-e-Taliban, Pakistan. This has led to numerous terrorist suicide and other attacks on vital infrastructure, strategic locations and soft targets. Simultaneously, there have also been attacks by other religious extremist groups and by insurgent elements in Balochistan.

The consequence has been the loss of over 70,000 lives of civilians and security personnel, extensive physical damage and a heightened sense of risk and insecurity. This has inevitably affected very adversely the broader economic and business environment.

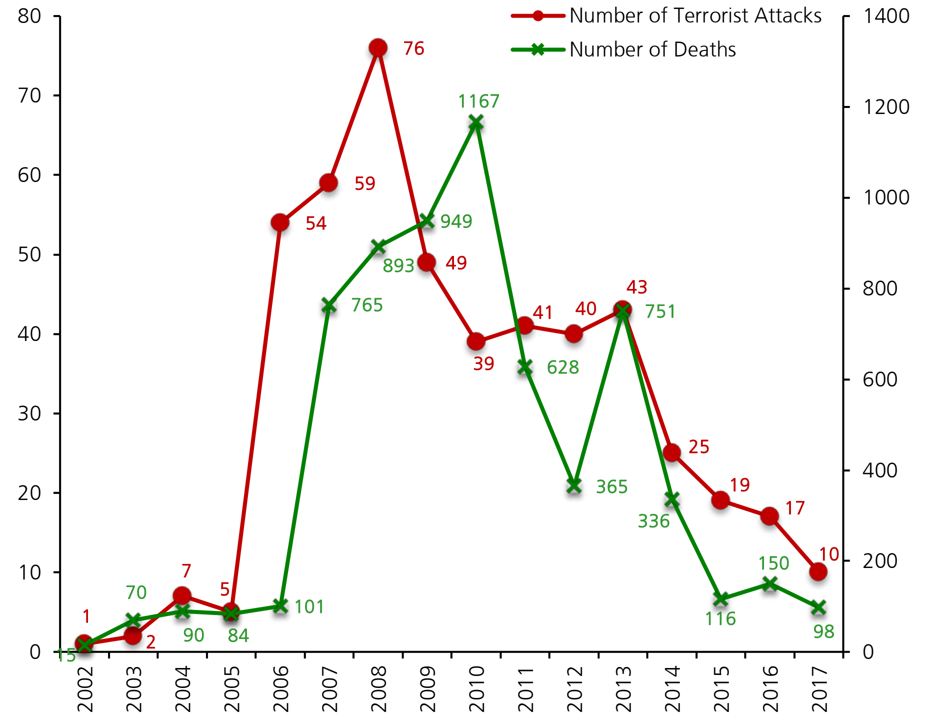
This chapter makes an attempt to quantify the costs of the war on terror to Pakistan. A comparison is then made with the international economic and security assistance received.

Section 1 of this chapter portrays the numbers and type of acts of terrorism from 2002 onwards. Section 2 describes the methodology used for quantifying the costs of terrorism. Section 3 and 4 present estimates of the direct and indirect costs respectively. The magnitude of these costs is compared with the quantum of assistance received, especially from the USA. Finally, in Section 5 an attempt is made to highlight some of the root causes of terrorism and describe the National Action Plan that was put in place by a consensus of the political parties and the military establishment against terrorism in 2015.

5.1. INCIDENCE OF TERRORISM

The annual number of terrorist attacks and the resulting casualties from 2002 to 2017 are presented in Figure 5.1. From 2002 onwards the frequency of suicide attacks and bombing increased rapidly, reaching a peak of 76 in 2008 and declined gradually thereafter to 43 in 2013.

Figure 5.1: Number of Terrorist Attacks and Deaths, 2002 to 2017



Source: Media

The attack on Army Public School in December 2014 led to widespread condemnation throughout the country. There was an emergency meeting of the political parties and the heads of the armed forces. This led to the approval of the National Action Plan and the launch of *Zarb-e-Azb* by the military. A massive cleanup operation was undertaken in the area of North Waziristan in early 2015. The result has been a visible decline in the number of acts of terrorism. By 2017 they had declined to 10.

Over 70,000 people have been killed. It is estimated that over 35 percent are civilians and 11 percent are security personnel. The remainder, 54 percent, are terrorists. The highest incidence of acts of terrorism has been in FATA, followed by Khyber-Pakhtunkhwa and Balochistan.

Chart 5.1 presents a list of some major terrorist attacks. The prime targets have included military and police installations, Shia mosques and Sufi Shrines and various public places. Two incidents which received a lot of international media coverage were the attacks on the Sri Lankan cricket team and the five-star Marriott Hotel in Islamabad.

Chart 5.1: Some Major Terrorist Attacks

Year	Date	Description
2017	16th February	Suicide attack on the shrine of Shahbaz Qalandar in Sehwan; 88 people killed
2016	27th March	Suicide bombing that hit the main entrance of Gulshan-e-Iqbal Park, Lahore; 74 people killed
2015	30th January	Bomb blast in a Shia Mosque in Southern Pakistan; 53 people killed
2014	2nd January	Wagah border suicide attack; 60 people killed
	16th December	Peshawar Army Public School massacre by Taliban Militants; 141 killed, including 132 children*
2013	3rd April	Bomb explosion in a Shia crowd in Karachi; 45 killed
2011	3rd April	Suicide bombing of a Sufi Shrine in D.G. Khan, Punjab; 50 killed
2010	12th March	Bomb targeting of military vehicles in Lahore; 45 killed
	28th May	Two Ahmadi Mosques attacked; 95 killed
2009	3rd March	Firing by gunmen on bus carrying Sri Lankan cricket team; 8 policemen killed
2008	20th September	Bombing of 5-Star Marriott Hotel, Islamabad; 54 deaths

*This led to an All-Parties meeting and preparation of the National Action Plan.
Source: Media

5.2. METHODOLOGY FOR QUANTIFICATION OF COSTS

There was a spate of articles in the USA after 9/11 highlighting the cost of the attack on the World Trade Center in New York. The Institute for the Analysis of Global Security (2011) has identified the big-ticket items in the cost. These include damage to major buildings including the World Trade Center, infrastructure damage, enhanced security costs to prevent other attacks, loss to the insurance industry and fall in air traffic and tourism. The total cost is estimated as $100 billion. The Institute makes the important point that if the loss in stock market wealth is included the price tag approaches a colossal $2000 billion, including less investment and fall in profits.

The Brookings Institution (2012) has identified the downstream, more long-term, costs. The 9/11 attack led directly to the war in Afghanistan and indirectly to the war in Iraq. The cost of these two wars has been almost $4000 billion. Consequently, the public debt of the US Government has increased correspondingly, implying higher interest costs on the federal budget.

Other studies on 9/11 costs include Chan (2002), J. Bauer (2002), Looney (2002) and Saxton Report to US Congress (2002). The costs can be categorized into direct and indirect costs. The former include the cost of damage to infrastructure and enhanced security costs for preventive purposes, compensation to victims, etc. The indirect costs are the broader consequences on the economy. These include the negative impact on investment and on industries and services like insurance, airlines and tourism. A potentially large cost is the impact, on the stock market in the form of a decline in the value of market capitalization.

The Pakistan Economic Survey of 2017-18, brought out by the Federal Ministry of Finance, contains an Annex on 'Impact of War in Afghanistan and Ensuing Terrorism on Pakistan's Economy'. The total cost cumulatively from 2001-02 to 2017-18 is estimated at $126.79 billion. The annual cost is estimated to have peaked in 2010-11 at $23.77 billion. Since then, it has apparently been falling and reaching a low of $2.07 billion in 2017-18.

However, the methodology used is defective. The largest cost item is the reduction in tax collection. Actually, the cost is the reduction in the overall tax base and not just in revenues. There is also some lack of clarity. One item of cost is the cost of uncertainty. It can only be quantified in terms of some retreat by investors and less buoyancy in the stock market. Some recognition of this effect is built in by quantifying the loss of foreign investment.

5.3. DIRECT COSTS

There are three major components of direct costs including higher expenditure on security, both public and private, damage to infrastructure and property and other costs.

5.3.1. Higher Expenditure on Security

Defence expenditure is the largest part of the costs of security. It includes military spending and costs of paramilitary forces like the Rangers, Frontier Constabulary, Civil Armed Forces, Airports Security Force and Pakistan Coast Guards.

Pakistan's participation in the war in Afghanistan required an increase in budget allocations for security by the Federal Government. Following the approval of the National Action Plan there was need to further augment the capacity of the military to undertake operations in North Waziristan.

Prior to 9/11, there had been modest growth annually in real defence expenditure of less than 1 percent. Thereafter, the growth rate rose to 1.3 percent initially, then to 3.1 percent and in recent years to as high as 6.1 percent.

Figure 5.2 identifies the increase in defence spending after 9/11. The dark triangle highlights the difference in expenditure following the war in Afghanistan and the projected level based on the trend observed prior to 9/11.

The cumulative increase from 2001-02 to 2017-18 is estimated at $38.5 billion, following conversion of increased spending from constant prices to current prices in rupees and then to dollars via the prevailing exchange rate.

A similar approach has been adopted in the case of expenditure on law and order, primarily on the police force both at the federal and provincial levels. The growth rate of this expenditure was 1.5 percent prior to 9/11. It jumped up substantially to 7.8 percent between 2001-02 and 2007-08. Thereafter, it has grown annually by 6 to 7 percent.

Figure 5.2: Level of Defence Expenditure – (*at constant prices of 1990-91*)

(Rs in Billion)

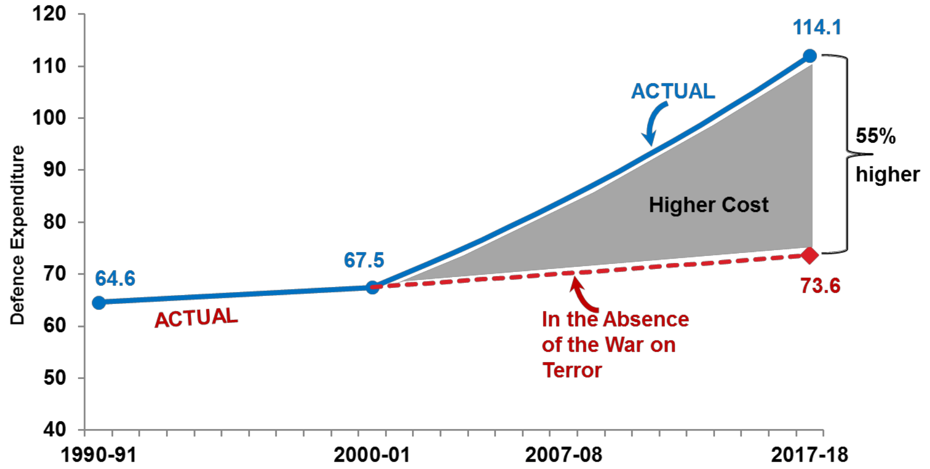
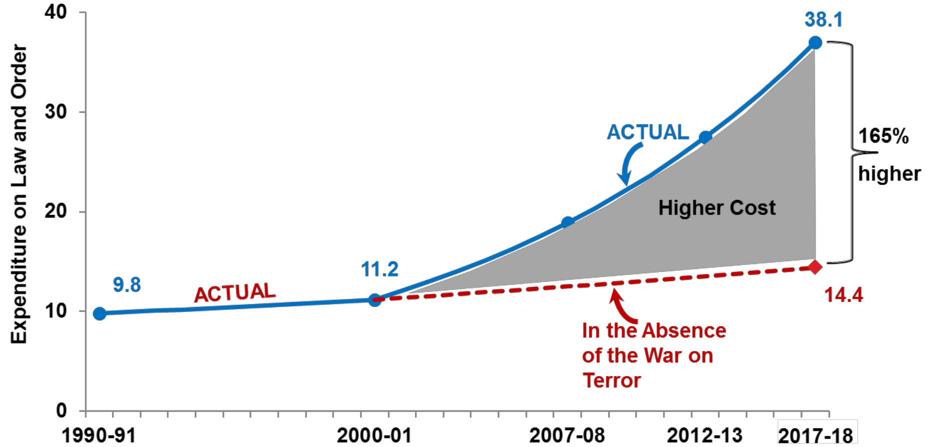


Figure 5.3 indicates the path of actual spending on law and order and the projected trend observed in the absence of the war on terror. By 2017-18, the spending had increased over the projected level by as much as 165 percent. The cumulative extra expenditure is estimated at $18 billion.

Figure 5.3: Law and Order Expenditure – (*at constant prices of 1990-91*)

(Rs in Billion)



The high incidence of terrorist attacks on hotels, banks, commercial establishments, etc., also forced the private sector to augment their own security arrangements in addition to that provided by the police force. There are reports that by 2017-18 the number of private security personnel in large cities like Karachi, Lahore, Peshawar and Quetta has become comparable to the size of the police force. Cumulatively, the increased expenditure on private security is $7.7 billion.

5.3.2. Damage to Infrastructure and Property

There is absence of precise information on damage to infrastructure and property due to the large number of terrorist attacks. Consequently, reliance has been placed mostly on Government estimates of damage. These aggregate to $6.8 billion up to 2017-18.

5.3.3. Other Direct Costs

Other costs include compensation by the Government to victims and the more recent expenditure on resettlement of Internally Displaced Persons following *Zarb-e-Azb*. The magnitude of these costs is $1.7 billion.

Overall, the total direct costs of the War on Terror are estimated at $72.7 billion. The dominant component is, of course, the higher expenditure on security.

5.4. INDIRECT COSTS

5.4.1. Lower Investment

The first indirect cost quantified is the loss in private investment, including foreign direct investment, due to perceptions of greater risk and uncertainty, especially after the peak in terrorist attacks in 2008 and 2009.

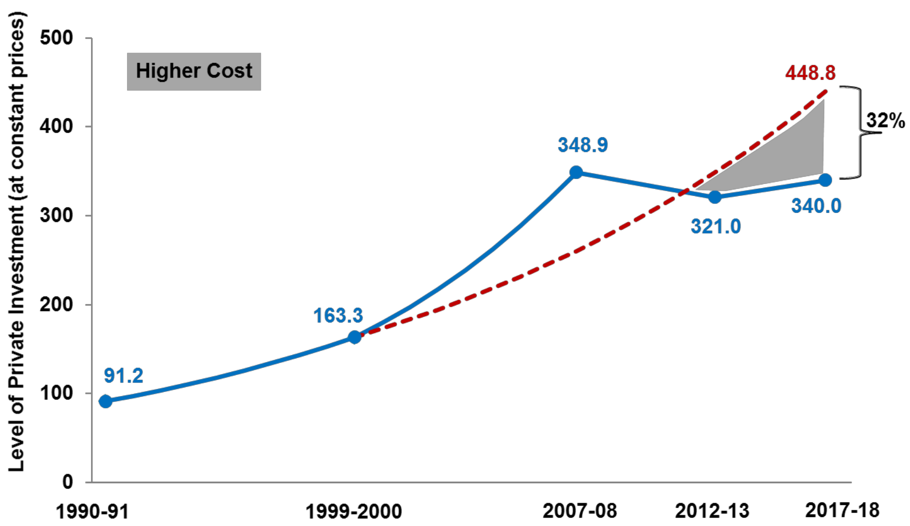
The long term growth rate of private investment in constant prices prior to 9/11 was 6 percent. It jumped up to 11 percent from 2000-01 to 2007-08. Thereafter, there was a fall of 2 percent per annum till 2012-13. Some minor revival is observed from 2012-13 onwards with a positive growth rate of 1 percent.

Figure 5.4 indicates the two paths, one of actual private investment and the other showing the projected level. The cumulative loss is shown by the shaded triangle. In 2017-18, the former was 32 percent less than the latter.

There is need to recognize that there have been other factors which have contributed to lower private investment after 2007-08. There was a big drawdown of foreign exchange reserves in 2008-09 following the large oil price shock. Pakistan had to go in for an IMF program which was accompanied by a big rise in interest rates in the process of stabilizing the economy. Also, high levels of power loadshedding became visible and this discouraged investors in the presence of a growing shortage of electricity.

Figure 5.4: The Extent of Fall in Private Investment

(Rs in Billion)



As such, the assumption has been made that only half of the lower level of investment in relation to the projected level is due to the negative impact on the business environment of high incidence of terrorist attacks.

The resulting estimate of the fall in investment due to terrorism is $62.5 billion. In addition, the lower GDP in other expenditures due to the fall in investment, inclusive of the 'multiplier' effect, is $77.4 billion.

5.4.2. Fall in Share Market Capitalization

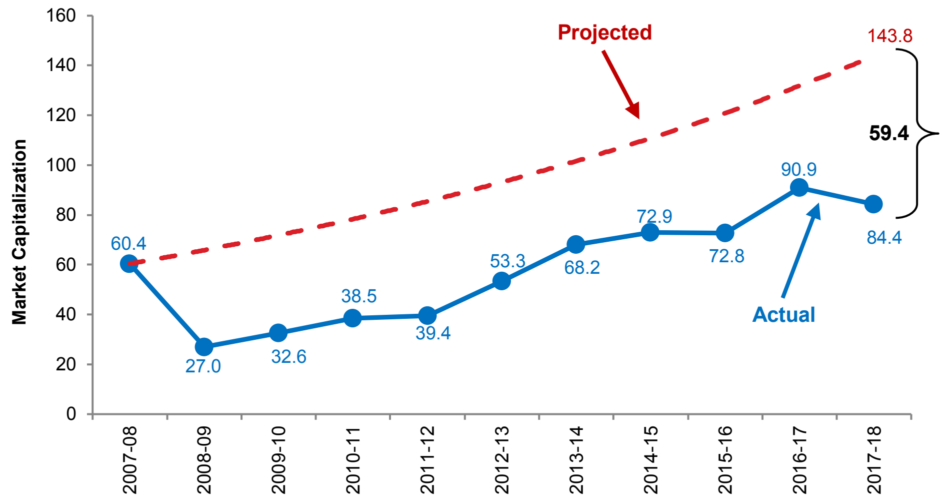
The long-term growth rate in market capitalization of shares in the Pakistan Stock Exchange from early 80's onwards was 9 percent in dollar terms. The market initially showed exceptional buoyancy from 2001-02 to 2007-08, due to the big jump in the GDP growth rate.

However, as shown in Figure 5.5, there was a near catastrophic fall in market capitalization of almost 56 percent in 2008-09. Thereafter, the market has fluctuated reaching a value of $84 billion in capitalization in 2017-18. Based on the trend growth rate of 9 percent, the projected value is over $143 billion. Therefore, the loss in value is $59 billion.

The same assumption is made as in the case of private investment that 50 percent of the loss in market valuation is due to the impact of terrorism. Therefore, the cost in this case is $28 billion.

Figure 5.5: Actual and Projected Market Capitalization

($ billion)



5.4.3. Other Indirect Costs

Other costs include the fall in tourism, higher insurance premia and higher inventory costs due to the need to maintain larger stocks in the face on supply interruptions due to terrorist attacks. Various data sources have been used to arrive at an estimate of these indirect costs combined at $11.2 billion.

Therefore, the aggregate of indirect costs is $179.1 billion as shown in Table 5.1. Inclusive of direct costs of $72.7 billion, *the estimated total cost of terrorism to the economy of Pakistan up to 2017-18 is $251.8 billion. This is effectively twice the cost estimate given in the PES.*

Table 5.1: Cost of the War on Terror

Direct Costs	($ billion)	Indirect Costs	($ billion)
Higher Defence Expenditure	38.5	Reduction in Private Investment	62.5
Higher Expenditure on Law and Order	18.0	Lower GDP due to decrease in Investment	77.4
Higher Expenditure due to Enhanced Private Security	7.7	Lower Tourism, Higher Insurance Premia, Higher Inventory Costs	11.2
Damage to Infrastructure and Property	6.8	Lower Growth in Market Capitalization of share in PSX	28.0
Cost of Resettlement of IDPs	1.2		
Other Costs	0.5		
TOTAL	72.7	TOTAL	179.1
Overall Total Cost of the War on Terror = $251.8 billion			

The total amount of external assistance received from the USA after Pakistan joined the war in Afghanistan is estimated at $33 billion. The bulk, over two-thirds, has been security assistance, mostly in the form of reimbursement from the Coalition Support Fund.

The bottom line is that Pakistan has paid a huge cost for the war on terror of over $250 billion. This is almost eight times the assistance received from the USA.

5.5. THE NATIONAL ACTION PLAN

5.5.1. The Plan

The National Action Plan against terrorism has the following 20 elements:

1) After the Peshawar incident, government decided to proceed with the execution of extremists convicted in terror related cases. The Government has already started implementation.
2) Special courts, headed by the officers of the armed forces, will be established for the speedy trial of terrorists. These courts will be established for a term of two years.
3) Formation of armed militia will not be allowed in the country.
4) National Counter Terrorism Authority will be revived and made effective.
5) There will be a crackdown on hate-speech, and action will be taken against newspapers, magazines contributing to the spread of such speech.
6) Financial sources of terrorists and terror organizations will be cut.
7) Banned outfits will not be allowed to operate under different names.
8) Special anti-terrorism force will be raised.
9) Measures will be taken to stop religious extremism and to protect minorities.
10) *Madrassas* will be regularized and reformed.
11) Print and electronic media will not be allowed to give any space to terrorists.
12) Keeping the rehabilitation of IDPs as the top-most priority, administrative and development reforms in FATA will be expedited.
13) Communication systems of terrorist organizations will be destroyed.
14) Social media and the internet will not be allowed to be used by terrorists to spread propaganda and the hate speech, through exact process for that will be finalized.
15) Like the rest of the country, no space will be given to extremism in any part of the Punjab.
16) Operation against terrorists in Karachi will be taken to its logical conclusion.
17) In the interest of political reconciliation, Balochistan government will be given complete authority by all stakeholders.

18) Elements spreading sectarian violence will be prosecuted.
19) Comprehensive policy will be formed for registration of Afghan refugees.
20) Give provincial intelligence agencies access to communication of terrorists and to strengthen anti-terror agencies through basic reforms in the criminal justice system. Constitutional amendments and legislation will be carried out for this purpose.

The Plan was reflected in the 21st Amendment to the Constitution, passed in January 2015. This enabled the establishment of military courts and the granting of capital punishment. The operation *Zarb-e-Azb* was launched soon after finalization of the Plan. This has resulted, as highlighted earlier, in a very big reduction in acts of terrorism in Pakistan.

The implementation of the Plan has not yet led to a fully effective National Counter Terrorism Authority (NACTA). Major action has also not yet been taken for regularization and reform of seminaries. There has been some progress in the process of registration of refugees.

A major step that has been taken is the merger of FATA into the Province of Khyber-Pakistan. A root cause of terrorism has been the extreme poverty and the dominance of *madrassas* in the education system of the area. A special grant of Rs 100 billion will be made to the FATA region to promote faster development of the area.

Chapter 6:

COST OF POWER OUTAGES

The high incidence of power outages in Pakistan since 2007-08 has been one of the key factors affecting the process of production throughout the national economy and adversely impacting on the quality of life of the people.

The explanations for emergence of high levels of power outages range from insufficient investment in the power sector, both in generation and distribution, to serious governance problems in management of the sector leading to high level of losses. More recently, the high level of circular debt in the sector has contributed to serious problems of liquidity and impacted on the performance of the sector.

The Chapter is organized as follows: Section 1 identifies the principal causes of loadshedding. Section 2 depicts the profile of outages. Section 3 highlights how production entities typically respond to outages. Section 4 presents the cost of outages by type of consumer. Finally, section 5 makes an assessment of the medium term outlook for the power sector and the prospects regarding the level of outages.

6.1. CAUSES OF OUTAGES

6.1.1. Generation Capacity

Historically, the fundamental reason for the emergence of power outages in the late 80s and early 90s and more recently after 2007-08 has been the absence of adequate generation capacity in the presence of growing demand for electricity.

There have been cycles in the creation of extra capacity with peak rates of expansion in the early 80s due to commissioning of the Tarbela Dam and the mid-to-late 90s by Independent Power Producers as part of the 1994 Policy, as shown in Table 6.1. This policy offered very attractive incentives including capacity charges irrespective of the volume of sales, guaranteed rates of return on equity and lifetime exemption of IPP projects from the corporate income tax.

The trough in the expansion cycle came in the tenure of the Musharraf Government. The rate of expansion in capacity in the first decade of the new Millennium came down to only 3 percent. The Military Government preferred to intensively use the capacity available with the IPPs rather than promote further expansion of capacity. The tragedy is that in presence of a strong Federal Government, under Military rule, the decision was not taken to expand renewable energy, especially with dams like the Kalabagh Dam. Consequently, by the end of the Musharraf rule in 2008 the country started experiencing frequent and widespread power outages once again.

The lack of investment in hydro-electricity, despite enormous potential in the Northern Areas of Pakistan, is vividly demonstrated in Table 6.1. The share of hydel power in generation capacity reached a peak of 45 percent after the commissioning of the Tarbela Dam in the early 80s. Since then it has declined to only one-fourth.

Table 6.1: Growth in Generation Capacity and Generation, Overall and by Hydel Power, 1980-81 to 2017-18

Years	Generation Capacity (MW)		Generation of Electricity (Gwh)		Source of Generation Hydel	
	Level	Growth Rate (%)	Level	Growth Rate (%)	Level (MW)	Share (%)
1980-81	4,105		16,062		1,847	45.0
1990-91	8,356	7.1	41,082	8.0	2,898	34.7
2000-01	17,498	7.4	48,585	9.4	4,867	27.8
2010-11	22,477	2.5	77,099	5.1	6,481	28.8
2017-18[a]	29,573	3.9	96,585	3.2	7,248	24.5

[a]as of March 2018

Source: PES and SBP

The decade of the 90s and thereafter have largely witnessed expansion in thermal power, with fuel sources of natural gas and furnace oil. The slow expansion of capacity during the tenure of the Military Government continued with the advent of the rule of the PPP Government. By 2012-13, power loadshedding was, more or less, at an all time peak.

The PML (N) party won the elections in 2013 with a manifesto which laid primary emphasis on elimination of power outages to improve the quality of life of the people and facilitate faster economic growth. This commitment has largely been honored. The commencement of CPEC has greatly accelerated the process of expansion of power generation capacity. Almost $46 billion have been allocated in the $60 billion CPEC Long Term Plan for this purpose. In addition, the Government of Punjab has financed two large thermal projects in the Province on the basis of self-financing.

By March 2018, the extra operational capacity that has been created is 7096 MW. It is expected that by the end of 2019 there will be more new capacity of 4000 MW, due to the completion of on-going projects.

The primary fuel sources in this cohort of new projects consist of coal and LNG. Gradually, furnace oil is being replaced by these sources. Unfortunately, renewable energy, either hydel, solar or wind has not been given the priority it deserves. The advantages of renewable energy are that they not only impose less on-going requirement of imports but also provide for a cleaner environment, unlike especially coal.

We discuss next the second generation of problems that have emerged in the power sector following the substantial expansion in generation capacity. These problems, unless tackled, will continue to imply power outages even in the presence of adequate generation capacity.

6.1.2. Sector Efficiency

The accelerated development of generation capacity has created a big imbalance in the power sector. National Electric Power Regulatory Authority (NEPRA) has highlighted that this has put added pressure for a stronger transmission and distribution infrastructure to make the delivery of more electricity to end-consumers possible. Over the years, the regulator has been stressing the need for strong and robust networks for a reliable power supply. However, it is the concerted and urgent efforts of National Transmission and Dispatch Company Limited (NTDC) and Distribution Companies (DISCOs) which can ensure sustainable reliable power supply to end-consumers.

Taking a holistic view of the transmission and distribution sectors, it is noted that (39 percent) transformers at 500/220 KV level were loaded above 80 percent of their rated capacity on June, 2017. At 220/132 KV level, (55 percent) transformers are overloaded. In the distribution sector, at the end of June 2017, about 37 percent of high capacity transformers (power transformers) were over-loaded (above 80 percent of their capacity). Similarly 29 percent of the 11 KV feeders, used for bulk transmission of electricity at distribution level, were found over-loaded, whereas more than 12 percent of the distribution transformers are loaded above 80 percent of their capacity.

The consequence also is that transmission and distribution losses are in excess of 17 percent. They have gone up from 16 percent in 2010-11. Therefore, the time has come for diverting more public resources for upgrading and expanding this part of the infrastructure. Continued reliance on self-financing by WAPDA / PEPCO will lead to delays in project implementation.

The other indicator of efficiency is the magnitude of losses in billing by DISCOs due to non-payment or buildup of arrears and theft of electricity. They stand at 10 percent of the total billing currently. They are significantly higher in K-Electric than in the PEPCO system.

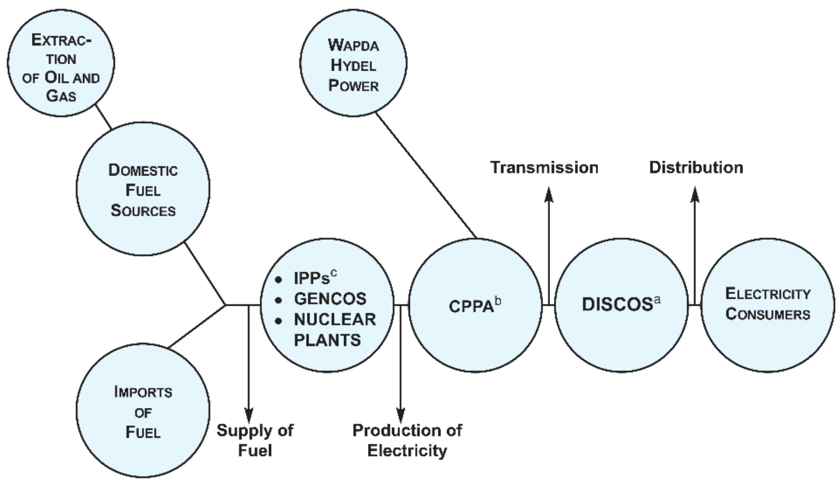
This takes us to the problem of the going magnitude of circular debt in the power sector.

6.1.3. Circular Debt

What is the circular debt in the power sector? The answer requires an understanding of the value chain in the sector. This flow is depicted in Figure 6.1. The starting point is effectively the supply of fuel to the generating units. The culmination of the process is the sale of electricity by DISCOs to end-consumers.

The circular debt effectively originates at the reverse end of the process. This happens when there are receivables from Federal Government on the subsidy offered to QESCO tubewells or to Azad Jammu and Kashmir. Alternatively, this may be due to delay in announcement of higher tariffs by NEPRA. Similarly, there may be lower revenues to DISCOs due to higher T and D losses than allowed for in the setting of tariffs. A major source of the circular debt is due to running defaulters or receivables from consumers due in installments.

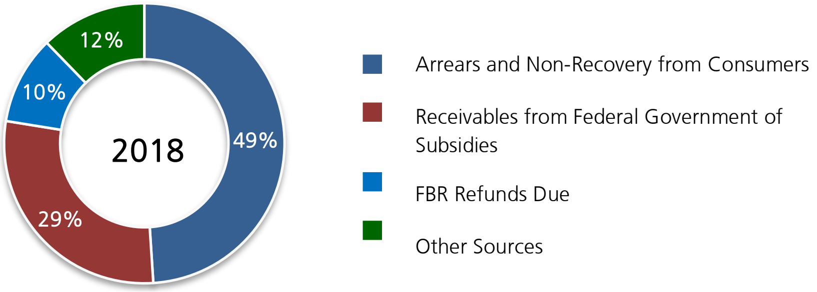
Figure 6.1: The Value Chain in the Power Sector



[a]Distribution companies | [b]Central Power Purchasing Agency | [c]Independent Power Producers

Currently, the quantum of circular debt stands at a colossal Rs 1196 billion. The distribution of the sources is given in Figure 6.2. The level of circular debt has reached a critically high level. It is beginning to fundamentally impact on liquidity position at different points in the sector. High and growing receivables are affecting the ability of IPPs to generate electricity. As receivables get transferred to companies supplying fuel, like the Pakistan State Oil, the ability to procure domestically or by import is seriously hampered. Clearly, the time has come to handle the problem of circular debt if electricity supplies are not to be seriously constrained. The solution lies in a combination of an increase in power tariffs and injection of liquidity into the sector by Government through large-scale lending operations as was done once before in 2012-13.

Figure 6.2: The Contribution of Different Sources to the Circular Debt in the Power Sector

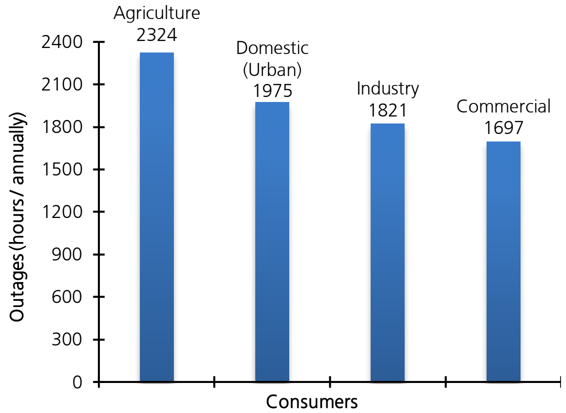


Source: Report by the Senate (2018)

6.2. INCIDENCE OF OUTAGES

The IPP [2013] undertook a major study on power loadshedding for the USAID. A large nationwide survey was conducted in 2012, when outages were at a high level, on different types of electricity consumers. The average number of hours of outages experienced annually are presented in Figure 6.3. These ranged from a maximum of 2324 hours in the case of rural consumers to 1697 hours faced by commercial consumers.

Figure 6.3: Average Number of Hours Annually of Power Loadshedding by Types of Consumers, 2012



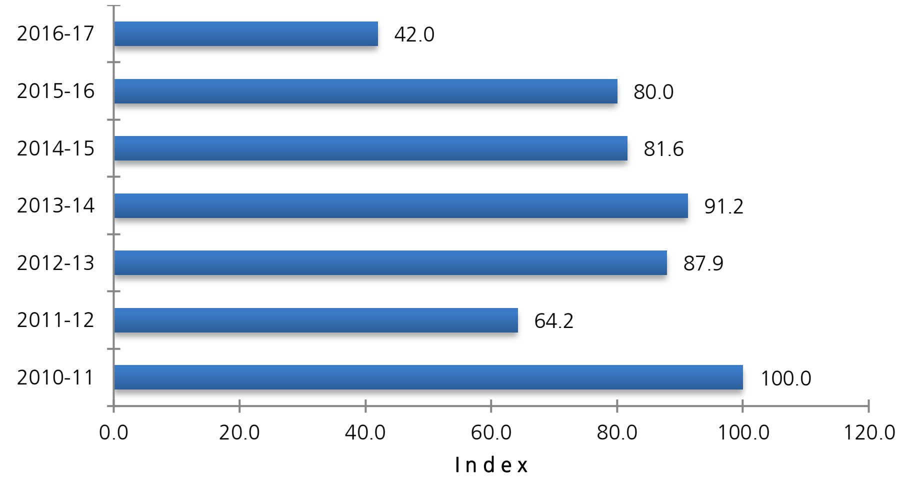
Source: IPP (2013)

The incidence nationally of outages is captured by the measure, System Average Interruption Frequency Index (SAIFI), developed by NEPRA. This is the aggregate of all consumer supply power supply interruptions (in hours) during a particular year. An index, I, has accordingly been developed as follows:

$$I = \frac{\text{SAIFI}}{\text{Number of Consumers}}$$

The base year for this index is 2010-11, when the value of SAIFI was at its all-time peak level. It may be observed that the incidence of outages has come down very sharply to only 42 percent of the peak level in 2016-17. This is attributable to the commissioning and coming into operation of new plants.

Figure 6.4: Index of Hours Lost Nationally due to Power Supply Interruptions – (2010-11 = 100)



Source: NEPRA, State of Industry Report

The regional distribution of outages in the DISCO areas covered is presented in descending order of incidence in Table 6.2.

Table 6.2: Descending Order of DISCOs in Incidence of Outages

Cities	Companies	Outages Decreasing / Increasing in 2016-17 in relation to the level in 2012-13
Sukkur	SEPCO	↗
Hyderabad	HESCO	↘
Peshawer	PESCO	↘
Quetta	QESCO	↘
Multan	MEPCO	↗
Faisalabad	FESCO	↗
Lahore	LESCO	↗
Karachi	K-ELECTRIC	↘
Gujranwala	GEPCO	↘
Islamabad	IESCO	↘

Source: NEPRA

The DISCO with the lowest incidence of outages is in the Federal Capital, Islamabad, followed by Gujranwala. The highest frequency is in the interior of Sindh in areas served by SEPCO and HESCO. Out of the ten distribution companies, the number of outages and time lost is declining in six and increasing in four. The latter are SEPCO, MEPCO, FESCO and LESCO. More recently, Karachi has been witnessing a big increase in widespread outages.

6.3. COST OF OUTAGES

Munasinghe (1981), Sanghvi (1983), Pasha and Ghaus (1989) and Beenstock (1991) have been the principal contributors to the development of the methodology for quantifying the cost of power outages. These costs tend to differ whether a particular outage is anticipated or not.

Consumers can make suitable adjustments if outage timings are known in advance as provided by the particular DISCO. These adjustments, however, imply some costs. For example, a firm subject to planned outages may change its shift time or workers may be asked to work overtime. Alternatively, a consumer may invest in a standby UPS or generator which becomes operative when the outage commences. Some industrial consumers may even invest in additional plant capacity so as to increase production in normal times.

The problem with unanticipated outages is that they tend to impose additional costs. These could include spoilage costs due to interruption of the production process and idle factor costs. Domestic consumers tend to have greater flexibility in changing timings of different activities and work their way around the outages.

The study by IPP for USAID elicited responses from the sample consumers on the types of adjustments made in response to outages in the year, 2012, when the survey was undertaken and there was a high frequency of load shedding.

The findings are presented in Table 6.3. A relatively high percentage, 60 percent of commercial consumers, who have less flexibility in changing timings, had installed a UPS or generator. This was the case with 32 percent of the sample industrial units and with 28 percent of urban domestic consumers.

Table 6.3: Types of Load shedding Costs by Consumer – (Share %)

	Industry	Commercial	Domestic	Agriculture & Domestic (Rural)
DIRECT COST	**74**	**70**		**67**
• Spoilage Cost	12	7		
• Idle Factor	62	63		
INDIRECT COST	**26**	**30**	**100**	**33**
• Generator Related Cost	24	30	10	
• UPS Cost			46	
• Monetization of Utility Loss			22	
• Home Based Activities Cost				23
• Other Costs	2		22	10
TOTAL OUTAGE COST	**100**	**100**	**100**	**100**

Source: IPP (2013)

The response of industrial consumers was also more varied in nature. 20 percent arranged for their workers to work overtime; 40 percent changed shift timings and 15 percent changed even their working days or increased intensity of operations during normal hours leading thereby to more wear and tear of machinery. There is need to recognize that many industrial units engaged in multiple responses.

The methodology used was designed to quantify the cost of each adjustment. These costs have been classified into two types – direct and indirect – as shown in Table 6.3. In the case of industrial consumers 74 percent of the costs were direct costs and 70 percent for commercial consumers, consisting of spoilage and idle factor costs.

Table 6.4: Types of Adjustment to Load shedding by Different Types of Consumers – (%)

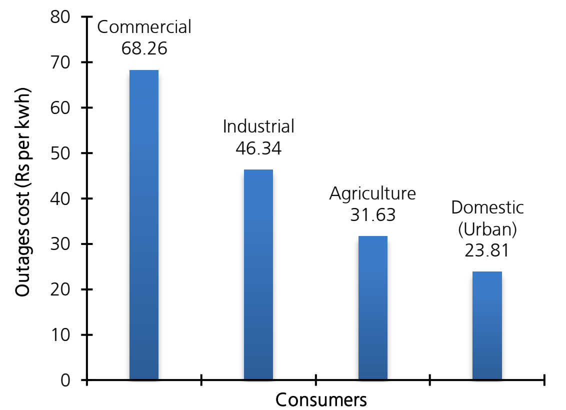
	Industrial	Commercial	Urban (Domestic)
Buying or Operating Generator/UPS	32.0	60.2	28.1
Working Overtime	20.4	5.1	-
Increasing Intensity of Operations	9.0	-	-
Changing Shift timings	40.3	2.8	-
Changing Working Days	5.8	-	-
Changing Timing of Key Activities	-	-	77.6

Source: IPP (2013)

Indirect costs were the highest in the case of domestic consumers and accounted for all the costs of the outages. 56 percent of the cost was incurred in acquiring a UPS or generator and in operating it. Domestic consumers were asked for their willingness to pay for uninterrupted supply of electricity. This represents the monetization of the utility loss associated with the inconvenience caused by the outages.

The resulting estimate of the cost per kwh incurred during the outage are presented in Figure 6.5. The cost is the highest in the case of commercial consumers at Rs 68.26 per kwh, followed by industrial consumers who incur a cost of Rs 46.34 per kwh on average during an outage.

Figure 6.5: Economic Cost per kwh of outage by type of consumer, (2012 estimates updated for 2016-17) – (Rs per kwh)



Source: Estimated.

The relatively large magnitude of these outage costs clearly demonstrates that the case for reduction in outages is very strong. If the marginal cost of supplying electricity is Rs 15 per kwh, the benefit-cost ratio of improving the supply is as high as 4.6:1 in the case of commercial consumers and 3.1:1 for industrial consumers. It significantly exceeds unity even in the case of domestic consumers.

Based on the estimates of the outage costs per kwh and on the quantum of electricity not supplied, estimate of the total cost of load shedding to the national economy is presented in Table 6.5 for 2016-17.

Table 6.5: Cost of Outages in 2016-17

Consumer	% of Time Annually of Outages	Electricity Not Supplied (Gwh)	Cost of Outage per kwh (Rs)	Outage Cost (Billion Rs)
DIRECT COST				
• Domestic	11.0	5939	25.81	153.3
• Commercial	9.7	835	68.26	57.0
• Industrial	15.0	2832	46.34	131.3
• Agricultural	13.3	1415	31.63	44.7
TOTAL		**12416**		**386.3**
Indirect Economic Cost				**112.4**
Total National Cost of Outages				**498.7 (5.2)***

*billion $
Source: Estimated

The indirect cost is the negative 'multiplier' effect of outages on the economy. The total outage cost approaches Rs 500 billion in 2016-17, equivalent to 1.6 percent of the GDP. It has come down substantially due to the big reduction in the frequency of load shedding in 2016-17.

The largest burden falls on domestic consumers, with a share of over 30 percent in the overall costs. Industrial consumers bear 26 percent of the cost. Indirect economic costs are over 22 percent of the total cost.

The estimated magnitude of the impact of outages on key macroeconomic variables is given in Table 6.6. Exports have been reduced by approximately $1.3 billion and 670,000 jobs have been lost due to outages in 2016-17.

Table 6.6: Impact of Outages on the Economy in 2016-17

On GDP:	1.9%
On Exports:	$1.3 billion
On Employment:	670,000
On Tax Revenues:	Rs 81 billion

Source: Estimated.

There is need to recognize the important role played by the previous PML (N) Government in reducing the incidence of outages in the country by almost 60 percent from peak levels.

However, the size of the circular debt has grown exponentially to reach Rs 1.2 trillion by the end of 2017-18.

The new Government is faced with a huge quandary. If tariffs are raised to recover some of the money due as arrears and to prevent further erosion of profitability by a significant escalation of power tariffs then this will impact adversely on export competitiveness and lead to more inflation. Alternatively, if it borrows more to inject liquidity into the sector than this will add significantly to the already large fiscal deficit. Perhaps an intermediate solution will be found.

SECTION 3

THE IMF PROGRAM

Chapter 7:

THE IMF PROGRAM

The IMF Extended Fund Facility (EFF) was negotiated, more or less, immediately after the assumption of power by the PML (N) after the elections in mid-2013. The EFF was for three years up to September 2016.

This Chapter describes first the key features of the EFF. In the process of finalizing the Program the Government also yielded on the need for some reforms which constitute an infringement of the laws of the country. These violations are described in the second section on IMF intrusions.

The next Chapter presents on in-depth evaluation of the IMF Program, following its completion. This is followed by presentation of the medium-term projections made by the IMF of key indicators after June 2017. The Chapter ends with a description of the outcome of the IMF Article IV Consultation with the Pakistani Authorities.

7.1. FEATURES OF THE PROGRAM

The last year, 2012-13, of the PPP Government witnessed a major deterioration in economic conditions of the country. The GDP growth rate was low at 3.7 percent. There was a large fiscal deficit of 8 percent of the GDP.

More importantly, the external balance of payments position had become very fragile. Foreign exchange reserves fell during the year by $4.8 billion. This was due a deficit in the balance of payments of $2.3 billion and a big repayment of the previous ESAF loan to the IMF of $2.5 billion. Consequently, by end-June 2013 reserves with the SBP had fallen to only $6 billion, providing import cover of only one and a half months.

On top of this, peak repayment of $3.2 billion was due to the IMF in 2013-14. With a 'business as usual' scenario, there was real danger of default by Pakistan in meeting its external obligations, unless drastic steps were taken. Inevitably, there was no option but to go to the IMF as the 'global lender of last resort'. The new Government had affectively decided to 'seek a new loan to repay the old loan'.

The key feature of the program negotiated with the IMF was a three year Extended Fund Facility (EFF), with focus on structural reforms. Access was given to 200 percent of

Pakistan's SDR quota with the IMF, equivalent to an amount of $6.2 billion. The initial release was $544 million, with twelve quarterly installments subsequently. This was subject to successful review each time by the IMF Staff Mission and approval by IMF's Executive Board.

The program design involved five prior actions. These included a devaluation of the rupee (8 percent reduction in the REER). In addition, there were five performance criteria and eleven structural benchmarks. The majority of reforms were to implemented by end-June 2014. As such, the Program was '*front loaded*'.

The performance criteria included targets / ceilings on the following for each quarter:

- Level of Net International Reserves
- Size of Budget Deficit
- Borrowings from SBP
- Net Domestic assets of SBP

The Structural Benchmarks included initially the following:

- Amend Law for SBP Autonomy (March 2014)
- Privatize 26 percent of PIA to Strategic Investor (December 2014)
- Issue Tax Notices to 75,000 Non-Filers (March 2014)
- Eliminate SROs (2014)

The bottom line in the Program design was for

'Stabilize First; Revive Later'

7.2. INTRUSIONS BY IMF

Traditionally, the IMF in its programs with Pakistan has restricted itself to the domain of economic reforms which are within the constitutional and legal framework of the country. The new Program, however, was different. Not only did it make comments on the adverse security situation in the country which has severely impacted on private investment and economic activity but it also tended to encroach on Constitutional boundaries and make comments which may be considered as perhaps objectionable in character.

Paragraph 71 of the First Staff Mission Report on the Risks in program implementation states:

'*The recent record of interventions by Supreme Court in economic and administrative issues may be another source of uncertainty*'.

This tends to have a negative connotation, as if the Supreme Court may affect adversely the implementation of reforms in the Program. On the contrary, there is a general recognition, both domestically and internationally, that the Supreme Court of Pakistan has made a stellar contribution to curbing corruption and nepotism and thereby limiting the failure of governance in the country. Surely, the IMF wants and realizes that improved governance is central to the successful implementation of reforms.

The same paragraph also makes a comment on the political dynamics in the country, as follows:

'*The governing party may lack political support in provinces outside of Punjab, complicating Provincial-Federal relations*'.

This is factually incorrect, as in the case of Balochistan, the PML(N) has the single largest number of seats in the Provincial Assembly. More importantly, it fails to recognize the gracious and sagacious behavior of the Prime Minister, Mr. Nawaz Sharif, who has preferred not to form his own Government in Balochistan and instead build a coalition with other parties. The spirit of accommodation and consultation is also visible in the agreement at the Council of Common Interests among the federating units on the new Energy Policy and the unanimous passage of the resolution on terrorism in the recent All Parties Conference.

There are other intrusions by IMF, perhaps motivated more by a desire to achieve results. One such example relates to the commitment apparently made by Pakistan to the IMF in paragraph 37 of Memorandum on Economic and Financial Policies on normalizing trade relations by eliminating the negative list on trade and extending MFN status to India. This was probably not the time to make such an explicit statement given the somewhat strained relations with India. Various senior government functionaries have said that there is no immediate plan to grant MFN status to India.

As such, any commitment in this regard ought to have been excluded from the Memorandum. Down the road, it weakens Pakistan's negotiating position in obtaining a relaxation of non-tariff barriers by India in return for MFN status.

Another unusual stipulation, which has been upgraded to the status of a structural benchmark, is the agreement to enact amendments to the Penal Code 1860 and the Code of Criminal Procedure (CPC) 1898. The objective is to strengthen the legal framework in cases of electricity theft by enhancing investigation, prosecution and penalties. The problem is that while this is desirable, the Federal Government is not in a position to make such a commitment. The CPC was originally in the Concurrent Legislative List of the Constitution. Following the abolition of this list in the 18th Amendment, the responsibility for any changes in the CPC has passed on to the Provincial Governments. It is not clear if they were consulted on the nature of changes in the laws prior to the making of this commitment.

The Staff Report also highlights on page 65 in Table 15 that a prior action implemented by the Authorities before IMF Board consideration of the Program was as follows:

'*Impose a balanced budget requirement on Provinces and agree with the Provinces to save additional revenues generated by the Program*'.

'*Presumably this was done through the Council of Common Interests.*'

The Provinces had budgeted for a combined deficit of Rs 52 billion in 2013-14. Following the agreement they not only had to eliminate this deficit but will also to generate a cash surplus of Rs 116 billion, equivalent to 57.5 percent of the revenues generated from taxation proposals by the Federal Government in the Budget of 2013-14. This required a cut of 5 percent in current expenditure and a 39 percent scaling down of the Provincial PSDPs in relation to the budgeted levels. In effect the already low expenditure on health and education had to be sacrificed.

The question is that whether there was, in fact, an explicit commitment by the four Provincial governments to implement these cuts in expenditure. The large reduction in the consolidated fiscal deficit from 8 percent of the GDP in 2012-13 to 5.8 percent of the GDP in 2013-14 agreed with the IMF was difficult to achieve otherwise.

The IMF also makes some not so veiled comments on problems with on-going 7th NFC Award in Box 2 on page 30 of the Staff Report. It suggests a revamp of the revenue-sharing formula in the next NFC Award whereby a better match is obtained between revenue and expenditure responsibilities which would not leave the federal government with chronic deficit, while the Provinces run surpluses.

The IMF needs to be informed about two relevant clauses in the post 18th Amendment Constitution. The first is Article 160 sub-section 3A, which states the following:

'*The share of the Provinces in each Award of National Finance Commission shall not be less than the share given to the Provinces in the previous Award*'.

The floor to the revenue share of the Provinces in the next Award is 57.5 percent. Therefore, the IMF is apparently intruding into Constitutional provisions in the context of federal-provincial fiscal relations, as manifest in the NFC awards.

Instead, the objective of more balanced relations can be achieved by ensuring that in the next Award, the Provincial Governments fully take on the expenditure responsibilities associated with the functions transferred to them by the 18th Amendment. Currently, the expenditures on higher education and vertical programs have been assumed by the Federal Government. Also, subject to agreement, a part of the revenue-sharing formula may be linked to the variation in the level of tax effort and fiscal discipline among Provinces, as has been case since the 11^{th} Finance Commission award of India.

In conclusion, as indicated above, the IMF has strayed into areas it has not tread before. The sensitivity of some of the observations made and suggested reforms ought to have been highlighted to the Fund by the Federal Ministry of Finance.

Chapter 8:

EVALUATION OF THE IMF PROGRAM[1]

The three year pro gram under the IMF's Extended Fund Facility (EFF) came to an end in September 2016. Pakistan has received $6.2 billion loan from the IMF under this program. During the tenure of the program, Pakistan was required to undertake wide - ranging structural reforms and implement the type of policies that would restore macroeconomic stability, gradually promote economic growth and build foreign exchange reserves to bolster external buffers.

After the completion of the twelfth and the final Review, the IMF Staff Mission Report declared 'victory' and stated that "the Fund Supported Program has helped the country restore macroeconomic stability, reduce vulnerabilities and make progress in tackling key structural challenges. Economic growth has gradually increased and inflation has declined. External buffers have been bolstered, financial sector resilience has been reinforced, and the fiscal deficit has been reduced while social safety nets have been strengthened".

On the reform side, the Report stated that "tax policy and administration reforms allowed for further revenue mobilization. Steps have been taken to strengthen the State Bank of Pakistan's autonomy. Energy sector reform allowed a reduction of power outages, energy subsidies, and accumulation of power sector arrears. A country - wide strategy to improve the business climate was adopted".

The objective of this evaluation is to present the other side of the picture. In particular, there is need to identify the extent of the success, how these "successes" have been achieved and the failure to implement reforms that are critical for achieving higher growth.

Section 1 looks at the extent to which the targets were achieved. Section 2 and 3 report respectively on the implementation of power sector and tax reforms. Section 4 assesses the impact of the Program on living standards. Section 5 highlights the anti-export bias in the Program. Section 6 derives the external financing requirements during the tenure of the Program. Section 7 highlights the macroeconomic projection in the post-Program

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[1]This was published as an 'Open Letter to IMF' in the *Business Recorder* of 24th October 2016. It was jointly prepared with Dr. Salman Shah and Dr. Ashfaque Hasan Khan.

period up to 2019-20. Section 8 summarises the findings from the Article IV consultation. Section 9 highlights the latest developments with Pakistan contemplating going back to the IMF.

8.1. TARGETS AND ACHIEVEMENTS

Firstly, building foreign exchange reserves to bolster the external buffer was the main pillar of the hurriedly put together IMF Program. The idea was to build reserves and pay back the IMF loan on time. That is why many independent economists, including the ones who remained associated with the IMF for a long time, termed the program as a 'Self-Serving Program'.

Such an objective of the Program forced the government to borrow extensively to build foreign exchange reserves and in the process accumulate net external debt of $13 billion during the Program period. Incidentally, Pakistan added, more or less, the same amount to its foreign exchange reserves as shown in Table 8.1. The above facts clearly suggest that the external buffer was improved entirely through adding external debt was this not simply postponing the current problem of insolvency to a future date?

Table 8.1: Build-Up of External Debt and Foreign Exchange Reserves – ($ Billion)

Period	External Debt		Foreign Exchange Reserves	
	Level	Cumulative Change*	Level	Cumulative Change*
2012-13	60.9	-	6.0	-
2013-14	65.3	4.4	9.1	3.1
2014-15	65.2	4.3	13.5	7.5
2015-16	73.9	13.0	18.1	12.1

Source: SBP

Secondly, in a three year Program, the IMF has extended fifteen waivers as shown in Table 8.2. Perhaps never in the history of the IMF did Pakistan receive such a large number of waivers. This diluted the purpose of the Program and also reflected on the lack of emphasis towards implementing and achieving the stated goals of the Program.

Table 8.2: Number and Type of Waivers by IMF during the Program

Waiver on Level of	Reviews	Number
• Net International Reserves	1, 5,	2
• Ceiling on Government Borrowing from the SBP	2, 4, 5, 8	4
• Ceiling on NDA of SBP	3, 4, 5, 8, 12	5
• Ceiling on Fiscal Deficit	8, 9, 12	3
		14
Others		1
TOTAL		**15**

Source: IMF Quarterly Reviews

Sadly, the IMF Staff Mission has selectively highlighted the improvement in some economic indicators from 2012-13 to 2015-16. This includes rising rate of economic growth, falling rate of inflation, rising tax-to-GDP ratio, higher spending under BISP, more private sector credit and falling subsidies as percentage of GDP.

The rate of economic growth achieved in the last three years remains contentious. The Pakistan Bureau of Statistics (PBS) has estimated the GDP growth rate as 4 percent or above each year, reaching 4.5 percent in 2015-16, as shown in Table 8.3. The authors have presented contrary evidence that the growth rate has been exaggerated each year, and it has ranged between 3.1 to 4.4 percent during the Program. The Data Quality Assessment Framework (DQAF) of the IMF should have been used to check the reliability of the national income estimates.

Table 8.3: Original Projections* and Actual Outcome during IMF Program

	2013-14	2014-15	2015-16
GDP Growth Rate (%)			
Projection	2.8	3.6	3.9
Actual	4.1	4.1	4.5
Rate of Inflation (%)			
Projection	7.9	9.0	7.0
Actual	8.6	4.5	2.9
Rate of Investment (% of GDP)			
Projection	14.8	16.1	16.5
Actual	14.6	15.7	15.6
Rate of Saving (% of GDP)			
Projection	14.2	15.6	15.8
Actual	13.4	14.7	14.3
Current Account Balance ($ billion)			
Projection	-2.3	-2.0	-2.6
Actual	-3.1	-2.7	-3.4
FE Reserves ($ billion)			
Projection	9.4	12.3	16.7
Actual	9.1	13.5	18.1
External Debt (% of GDP)			
Projection	27.7	26.6	25.5
Actual	26.7	23.8	26.3
Revenues (% of GDP)			
Projection	14.9	14.9	15.4
Actual	14.3	14.4	15.0
Fiscal Deficit (% of GDP)			
Projection	-5.5	-4.4	-3.5
Actual	-5.5	-5.3	-4.6
Public Debt (% of GDP)			
Projection	65.9	63.9	62.6
Actual	63.5	63.3	67.6

* as of January 13, 2014, following the first review.

Sources: IMF | SBP | MOF, PES

There was in important statement by the Managing Director of the IMF, as posted on September 1, 2016 by *IMF direct*. In her words "The longer demand weakness lasts, the more it threatens to harm long-term growth as firms reduce production capacity and unemployed workers are leaving the labor force and critical skills are eroding. Weak demand also depresses trade, which adds to disappointing productivity growth".

This statement clearly depicts the state of economic growth and unemployment in Pakistan in terms of the social costs of the excessive focus on stabilization policy. The persistence of lower economic growth has failed to create enough jobs. People in general and youth in particular, are facing difficulties to get jobs. People remaining unemployed for a longer duration are becoming unemployable, with all its social and economic consequences. Not only that the unemployment rate has surged to a 13 years high at over 8.0 percent (including the 'discouraged worker' effect), youth unemployment rate has also increased to over 11 percent in 2014-15. Furthermore, between 2012-13 and 2014-15, the annual number of entrants into the labour force has been approximately 650,000 as against 1.3 million during 2008-13.

A particularly worrying feature of the employment situation in 2015-16 was is the extremely high unemployment rate of 20 percent of workers with either graduate or post graduate degrees. There are 2.4 million educated workers with bad employment prospects. This is the unfortunate outcome of the IMF Program.

Table 8.4: Measures to bring down the Fiscal Deficit – (Rs in Billion)

	2013-14	2014-15	2015-16
Showing Grants 'above line'	12.3	-	-
Privatization Receipts shown 'above the line'	103.0	110.0	-
Retaining earmarked revenues[a]	31.8	57.0	79.8
Buildup of Refunds retained by FBR	50.0	60.0	70.0
Increase in Guaranteed Debt of PSEs	16.6	117.7	105.9
Increase in Statistical Discrepancy[b]	45.0	120.0	112.0
TOTAL	**258.7**	**464.7**	**367.7**
Reported Deficit	1388.7	1456.7	1349.3
% of GDP	5.5	5.3	4.6
Actual Deficit	***1647.4***	***1921.4***	***1717.0***
% of GDP	***6.5***	***7.0***	***5.8***

[a]Revenues from GIDC | [b]Above normal level.
Sources: MOF | Fiscal Operations | FBR

On the size of the fiscal deficit, the IMF Report claims that this has been reduced from 8 percent to 4.6 percent of the GDP. A number of steps have been taken to report smaller deficits as shown in Table 8.4. For example, holding back refunds and forcing commercial entities to pay taxes in advance to jack up revenue, privatization proceeds and foreign grants treated as non-tax revenue to inflate overall revenue rather than treating them as financing items, engaging in quasi-fiscal operations outside the budget, allowing for large statistical discrepancy each year (cumulatively Rs 600 billion in three years) to show lower expenditures, exaggerating the size of the Provincial cash surplus, retaining earmarked revenues in the Federal consolidated Fund and building up large contingent liabilities (power sector circular debt, commodity financing debt and pending tax refunds). The IMF staff has either been blissfully unaware of or has condoned this creative accounting. Adjusting for these practices implies a fiscal deficit each year in the range of 6 to 7 percent of the GDP.

Other areas, where serious distortions exist, are the estimates of the GDP deflator; investment and saving rates and rate of inflation, especially for poor households. A case ought to have been made for complete operational autonomy of the PBS.

Yet another "success" of the program as stated by the IMF Staff Mission is the sharp reduction in inflation rate. It declined from 7.4 percent in 2012-13 to 2.9 percent in 2015-16. Is this decline due to the '*prudent*' fiscal and monetary policies pursued during the program period? The answer appears to be in the negative. The international oil and commodity prices started collapsing after June 2014. Such a collapse in the oil and commodity prices led to a worldwide decline in inflation, including Pakistan. Furthermore, as stated above, the pursuance of stabilization policy for a prolonged period weakened domestic demand, resulting in a deceleration of the rate of increase in prices. Thus, the sharp decline in inflation during the program period is due partly to the weakening of domestic demand, as well as a collapse in the international prices of oil and commodities and not to the prudent use of monetary and fiscal policies. In fact, when inflation rate was rapidly on the decline, the SBP was pursing an easy monetary policy.

The quarterly reviews have ignored the deterioration in key economic indicators. They failed to discuss the big decline in exports-to-GDP ratio, stagnation in the overall and private investment-to-GDP ratio, fall in FDI, rise in external debt and public debt-to-GDP ratios, fall in total PRSP pro-poor expenditure to GDP and very importantly, a rise in the rate of unemployment especially among young, educated, and female workforce.

As stated above, Pakistan was asked to implement a wide-ranging reforms under the IMF Program. What has been the performance on the reform side?

8.2. POWER SECTOR REFORMS

The glaring failure of the Fund program was in the implementation of power sector reforms. The 12th Review Report declared victory primarily by demonstrating that the subsidy to the sector had fallen massively from 2 percent of the GDP in 2012-13 to only 0.6 percent of the GDP in 2015-16.

How has this been achieved? The answer is not by any major improvements in efficiency through big reduction in losses. Instead, the policy has been to raise the power tariffs to generate more revenues and thereby reduce the need for subsidies. From 2012-13 to 2015-16, the average electricity tariff (including surcharges) has been enhanced by

40 percent, leading to extra revenues of distribution companies of over Rs 250 billion. The tariffs were increased at the time when the fuel costs had fallen by over 49 percent.

On top of this, contingent liabilities have increased exponentially in the sector. In July 2016, the circular debt of the sector reached almost Rs 630 billion, over 2 percent of the GDP. Sooner or later, this debt will have to be retired, as happened in 2012-13, if a breakdown is to be avoided in supplies due to liquidity problems in the sector.

IMF also claims, on behalf of the Government, that power load-shedding has been substantially reduced, especially in industry. Evidence to the contrary is the large continuing demand-supply gap according to NEPRA, and the fact that electricity consumption per industrial consumer has fallen in nine out of ten distribution companies, in comparison to the level achieved in the pre-loadshedding years.

8.3. TAX REFORMS

The IMF Twelfth Review has highlighted, as one of the key successes of the Program, the over two percent point increase in the tax-to-GDP ratio. Much of the improvement has come in 2015-16. How has this been achieved? The main contribution is actually from enhancement in effective tax rates and not by broadening of the various tax bases. The tax structure has become more regressive and created more distortions in economic activity.

Table 8.5: Level and Composition of Tax Revenues – (Rs in Billion)

	2012-13	2015-16
FBR Taxes	**1936**	**3112**
% of GDP	*8.5*	*10.5*
Direct Tax	736	1192
% of GDP	*3.2*	*4.0*
Indirect Taxes	1200	1920
% of GDP	*5.3*	*6.5*
Other Federal Indirect Taxes	**178**	**265**
% of GDP	*0.8*	*0.9*
Provincial Taxes	**151**	**283**
% of GDP	*0.7*	*1.0*
Overall Taxes	***2265***	***3660***
% of GDP	*9.9*	*12.4*
Direct Taxes	**751**	**1220**
% of GDP	*3.3*	*4.1*
Indirect Taxes	**1514**	**2440**
% of GDP	*6.6*	*8.2*
Share of Direct Taxes (%)	**33.3**	**33.3**

Sources: MOF, Fiscal Operations

The biggest failure is in lack of development of the direct tax system. The elite continues to enjoy wide ranging tax exemptions and concessions like the virtually no or low taxation of global income of residents, profits of private companies, agricultural income and unearned capital incomes. The IMF clearly prefers not to antagonize the ruling elite through the reform agenda.

8.4. IMPROVEMENT IN LIVING STANDARDS

Contrary to the claims by the IMF, living standards have probably fallen in Pakistan during the tenure of the Program. A number of reforms undertaken have contributed to rising unemployment and poverty.

The anti-poor actions include, firstly, the rise in input costs of fertilizer and electricity in agriculture due to hike in power and gas tariffs and additional taxation in the form of the GIDC. The result is that food prices have risen faster than the overall CPI and wages of unskilled workers. Today, Pakistan has the extremely serious problem of malnutrition. In the 2016 ranking of the Global Hunger Index, Pakistan has the 11th lowest position, even below Bangladesh, out of 118 countries. The non-implementation of the PMs agricultural package of September 2015 under the IMF pressure has contributed to the recent debacle in the sector.

Secondly, the primary adjustment mechanism for achieving the fiscal deficit targets in the Program was large cut backs of up to 30 percent in budgeted development spending by the Federal and Provincial governments. In 2015-16 alone these cuts implied less employment generation of almost 300,000 jobs. Thirdly, hikes in indirect taxes have affected the cost of living adversely. This includes the levy of minimum import tariffs on basic food and other items and jump in GST rates on petroleum products, especially HSD oil. Fourthly, the decline in exports has contributed to loss of employment in labor-intensive sectors like SMEs and textiles. Consequently, as highlighted earlier, the underlying unemployment rate has gone beyond 8 percent. Fifthly, social indicators have shown only minor improvement in three years. This is due particularly to the pressure on Provincial Governments to spend less on social and other sectors so as to generate large cash surpluses.

8.5. ANTI-EXPORT BIAS

According to the original Program projections, exports were expected to show a steady annual growth rate of 8 percent and reach $31 billion by 2015-16. Instead, they fell since 2012-13 to below $22 billion in 2015-16, a decline of over 23 percent. This is perhaps one of the single most important failures of the Program. It has adversely impacted on growth and employment in the country and frustrated the achievement of greater self-reliance.

How did the Program reinforce the anti-export bias? The record level of external borrowings during the last three years led to a form of 'Dutch Disease'. Larger reserves, based, more or less, completely on external borrowing, created artificial stability in the value of the rupee, thereby reducing competitiveness. Enhancement of electricity tariffs by over 40 percent and gas price to industry by 64 percent, further affected competitiveness. In an effort to meet the Program revenue target, FBR held back over Rs 200 billion of refunds, leading to liquidity problems for exporters. Further, levy of a minimum import duty of 3 percent on raw materials and intermediate goods added to costs.

Today, the decline in ability to service external debt obligations, including those to the IMF, is clearly demonstrated by the phenomenal increase in the external debt to exports ratio. It was 193 percent in 2012-13 and has risen to 266 percent by the end of 2015-16. It is likely to continue rising and go beyond 300 percent by 2017-18. There is no other option now in the post-Program scenario but to present a strong export incentive package, including significant depreciation of the rupee.

8.6. EXTERNAL FINANCING REQUIREMENT

The original Program projections were that external financing requirements, consisting of external debt amortization and the current account deficit, would reach \$9.2 billion by 2016-17 and fall to \$8 billion in 2017-18. However, following the much larger build up of external debt, the latest estimates of the financing requirement in the 12th Review is \$10.9 billion in 2016-17, rising to \$13.2 billion in 2017-18.

However, these estimates are based on significant positive growth in remittances and exports and a big jump in FDI. This is highly unlikely given the current trends. A more realistic estimate of external financing requirement is \$15 billion in 2016-17 and over \$20 billion in 2017-18. This is more than 5 percent of the GDP, which is considered the danger point. Part of this requirement will have to be met by a sizeable depletion of foreign exchange reserves. There is a high likelihood that by June 2018, reserves may fall to about half of the present level.

Where is the sustainability of our external position? Has the IMF Program reduced our vulnerabilities? Are we doomed to go back once again to the IMF? Will conditionalities next time go beyond the usual prior actions? Already, two weeks after the end of the IMF Program, Pakistan has been forced to float relatively high cost bonds externally of \$1 billion. This indicates a lack of confidence in the sustainability of reserves in coming months and years.

Finally, in the immediate aftermath of the IMF Program, the economy has begun to unravel. Agricultural growth was negative last year and the prospects for the current cotton crop are not much better. Growth of the large-scale manufacturing sector has also turned negative in the last four months of 2015-16 for which data is available. Seven out of the twelve industrial groups are showing declining output. The fall in exports continues and the trade deficit has risen sharply. Remittances are also contracting, along with a sharp reduction in FDI. FBR tax revenue growth has plummeted and large borrowing has been resorted to by the Federal Government from SBP. Development releases of funds have been relatively small and the process of implementation of CPEC infrastructure projects is very slow. Contingent liabilities have reached alarming levels and the bleeding of public sector enterprises/utilities continues. Can we still say that the reforms implemented during the tenure of the Fund Program have left the economy in a 'sustainable position'? The answer, unfortunately, is an unambiguous no.

8.7. IMF PROJECTIONS

The last (twelfth) quarterly review of the IMF Extended Fund Facility to Pakistan was released on September 28, 2016. This review contains the final set of projections by the IMF of key macroeconomic variables from 2016-17 to 2019-20.

The projections are extremely positive about the medium-term to long-term prospects for the economy of Pakistan. They are based on the key assumption that the economy has sufficiently stabilized following the three-year Fund Program and is ready to embark in a major way on a higher growth trajectory. The Authorities must have welcomed these projections as they represent a fitness certificate by IMF. This ought to increase investment, both domestic and foreign, in Pakistan.

The key elements of the projections up to 2017-18 are as follows:

(i) The GDP growth rate will go beyond 5 percent.

(ii) The rate of inflation will remain subdued at close to 5 percent per annum.

(iii) Investment will show a strong recovery with a growth rate annually in real terms of over 8 percent.

(iv) Tax revenues will continue to rise rapidly from 12.4 percent to 13.6 percent of the GDP by 2017-18.

(v) The fiscal deficit will fall sharply from 4.6 percent of the GDP in 2015-16 to 2.9 percent of the GDP by 2017-18. Consequently, in two years, the public debt to GDP ratio will fall from 67 percent to less than 62 percent.

(vi) Foreign exchange reserves will rise from $18 billion, as of June 2016, to $22 billion by the end of 2017-18, despite a more than doubling in the current account deficit. This will be achieved due to more than doubling of foreign investment and big jump in external borrowing.

(vii) Exports will exhibit some dynamism and show cumulative growth of 10 percent from 2015-16 to 2017-18, despite persistent recessionary conditions in global trade. IMF expects this to be compensated for by depreciation of the Rupee to Rs 113 per US dollar by 2017-18. Remittances will also demonstrate some growth.

Why has IMF opted to make such positive projections of Pakistan's economy? The obvious explanation is that the IMF Staff Mission has a vested interest in demonstrating to the superiors in Washington that it has managed a very successful program.

Occasionally, one hears, however, exhortation from agencies, including IMF and the SBP, that momentum must be maintained in the reform process. Are the above-mentioned projections by IMF based on the full implementation of the required reforms? If so, it would have been useful to present a macroeconomic scenario with weaker implementation of reforms.

This exercise is particularly relevant now since the process of pork barreling and granting of concessions has started in the lead up to the elections in the first half of 2018. It is increasingly unlikely that deep structural reforms will be implemented in the intervening period.

What has been the fate of the IMF projections in the first half of 2016-17? It is indeed unfortunate that contrary to these optimistic projections the economy has started unraveling. The divergence between and actual outcomes has become too large, too soon.

They key areas of divergence of the actual outcomes from the projections made by IMF for the first half of 2016-17 are as follows:

(i) First indications are that the GDP growth will be significantly less than 5 percent in 2016-17. In the first half of the year, both manufacturing and agriculture are showing a growth rate between 2.5 and 3.5 percent, while electricity generation is up by about 4 percent. At this rate, it is unlikely that by the end of the year the GDP will show a growth rate of 5 percent or more.

(ii) Fortunately, inflation has remained low at below 4 percent. However, the 'low base' effect could start operating from February 2017 onwards and take the rate of inflation to beyond 5 percent.

(iii) There has been a 6 percent real growth in imports of machinery from July to December 2016, according to the SBP. Inclusive of CPEC, imports of power generating machinery have actually declined. Despite extraordinarily low interest rates, outstanding bank credit to the private sector for fixed investment has increased in real terms by only 6 percent in the first five months.

(iv) With the current growth rate of FBR revenues, the tax-to-GDP ratio will fall and not rise by the end of 2016-17.

(v) Already, in the first six months, the fiscal deficit is estimated at almost 2.6 percent of the GDP. The annual target of 3.6 percent of the GDP is likely to be substantially exceeded.

(vi) Exports and remittances are actually declining, rather than rising, as anticipated by the IMF. The current account deficit in the first six months is 46 percent above the Fund's projections.

(vii) Foreign exchange reserves have shown little growth from $18.1 billion in June 2016. They have actually started falling since October 2016. The IMF projection of reserves by end June, 2017 of $20.8 billion is looking increasingly elusive.

There are two other possible explanations for the biased and defective projections by the IMF. The first is that the IMF staff members, who have made the projections, may not possess the requisite professional competence. This reminds one of the observations by the Nobel Prize winning economist, Joe Stiglitz, that postgraduates from second or third tier universities of the USA join the IMF and other international agencies, while the output from top universities goes mostly into academia. In recent times, the problem has been compounded by the diversion of the best IMF personnel to managing large loan programs in European countries like Greece, Ukraine and Poland.

Finally, there could be on 'out of the box' explanation. The upbeat nature of the projections may be motivated by an attempt to lull the Authorities into a state of complacency. This will inevitably reduce the focus on reforms and thereby create conditions for a return of the IMF to Pakistan, within the next two years. However, this could be based on prior actions that are not necessarily only economic in nature.

Hopefully, the macroeconomic projections will be carefully scrutinized, in light of recent developments, during the forthcoming Article IV consultations with the IMF. Also, it would be extremely useful if a list of reforms is indicated for taking Pakistan to a higher growth trajectory. Similar to the 2015 consultations, the medium term macroeconomic scenarios, with reform and with no reform, should also be presented.

8.8. IMF ARTICLE IV REPORT

The IMF Executive Board concluded in July 2017, Article IV Consultation with Pakistan. This is with a gap of more than two months after the completion of the Article IV Staff Mission.

The text of the statement by the Executive Board represents a somewhat somber assessment of recent developments in Pakistan. An appropriate quotation from the statement is as follows:

'*The macroeconomic stability gains under the 2013-16 EEF (of IMF with Pakistan) have begun to erode and could pose risks to the economic outlook*.'

According to the IMF, fiscal consolidation has slowed down with the deficit target for 2016-17 likely to be significantly exceeded. Simultaneously, the current account deficit in the balance of payments has widened and is expected at 3 percent of the GDP. This is equivalent to a deficit of over $9 billion, two times the original projection, following the twelfth (last) review by IMF staff in October 2016.

The Executive Board has also highlighted the decline in foreign exchange reserves during 2016-17 over (of almost $3 billion) up to June 9, 2017. This again is in sharp contrast to the original projection of reserves by end-June of $20 billion, an increase of almost $2 billion. Therefore, the divergence already is of almost $5 billion.

The IMF observes that this decline has occurred in the context of a nominally stable exchange rate. It may be of interest that the projection following the IMF Twelfth review of the exchange rate by June 2017 was 113 Rs per US $. This was probably agreed to by the Pakistani Authorities but not yet implemented.

The IMF has also issued an early warning, as follows:

'*Over the medium run, failure to generate sufficient exports will make it difficult to meet external obligations arising from large-scale foreign-financed investments*'. Presumably, the Fund is highlighting the inability to service the debt and payment of profit obligations associated with the inflow of almost $60 billion under CPEC.

On the policy front, the IMF notes that the process of implementation of policies has weakened recently. In particular, the Board states that the 2017-18 Budget will require additional revenue measures in light of recent revenue performance.

However, the latest macro-economic projections for 2017-18, attached with the Executive Board's statement, are surprisingly positive and ambitious in character, despite the above-mentioned concerns. In particular, total revenues are expected to rise sharply from 15.8 percent of the GDP in 2016-17 to 17.6 percent of the GDP in 2017-18. Given the budget estimates of revenues of the Federal and Provincial Governments, this will require additional taxation measures of over Rs 300 billion to achieve the IMF projected level of revenue, beyond those already envisaged in the budget of 2017-18. This is highly unlikely during an election year.

The Directors of IMF have called on the Authorities to allow for greater exchange rate flexibility, rather than rely on administrative measures like cash margin requirement and regulatory duties on imports. Presumably, based on this expectation, exports are projected by the Fund to show substantial growth in 2017-18 of over 9 percent, with the growth of imports contained to below 7 percent, despite a peak potentially in machinery imports under CPEC.

Miraculously, foreign exchange reserves are expected to start rising once again and reach almost $19 billion by end- June 2018, according to the Fund projection. This, to say the least, is an extremely optimistic projection.

Implicit in the latest IMF projections is an external financing requirement for 2017-18 of almost $17 billion. This consists of a projected current account deficit of $11 billion and potential external debt repayment of almost $6 billion. It is highly unlikely that this financing requirement will be fully met. Even under optimistic assumptions about the level of FDI and gross external borrowing the gap is likely to be almost $6 billion.

The basic question is whether in an election year the recommendations of the IMF Executive Board will be implemented. These include significant depreciation of the exchange rate, reduction in electricity subsidies, phasing out of borrowing from SBP and heavy additional taxation. These could exacerbate inflationary tendencies and reduce the space for populist spending. As such, it remains to be seen how Authorities will react to the IMF exhortations following the Article IV consultation. If the recommended actions are not taken this could expedite the financial meltdown. History could repeat itself, as happened in the election years of 2007-08 and 2012-13.

There is need to understand why the Fund, despite its concerns, has made positive macro-economic projections for 2017-18. The objective is probably to provide a degree of comfort to potential lenders to Pakistan. There is need to ensure enough liquidity with the SBP in order to be able to honor the external debt repayment obligations. After all, repayment of the over $6 billion loan from the IMF also starts in 2017-18.

8.9. GOING BACK TO THE IMF

Pakistan is now definitely going to the IMF as of early October 2018. The meeting recently of the Finance Minister with the IMF Managing Director in Bali confirms that a formal request has been placed for an IMF program. A staff Mission of the Fund will be coming to Pakistan on the 7th of November. Sooner would have been better.

The frequency historically of Pakistan going to the IMF is relatively high. Since 2008 there has been first a Standby facility negotiated by the PPP Government which was not completed. This was followed in 2013 by the Extended Fund Facility finalized with the IMF by the PML (N) Government. This program is unique in that was successfully completed but did not lead to sustainable growth. Now we have the Tehrik-e-Insaf Government starting the process of arranging a program with the IMF. This ought to have started somewhat earlier. Given the size of the financing gap seeking support from friendly countries and going to the IMF are not mutually exclusive options. They supplement each other.

Therefore, in effect Pakistan will see the commencement and operation of three Fund Programs in the last decade. This predilection of Pakistan towards the IMF raises a number of important questions: Is this the reflection of deep-rooted structural problems which come to the surface every few years or is it due to exogenous external shocks? Is there a, more or less, acute need for an IMF program this time compared to the last two times? The answer in particular to the last question will help in assessing the quantum of support required and the likely toughness of the conditionalities including the prior actions.

The ten programs from 1988 to 2008 were largely the reflection of internal factors with the exception of the programs in 2000 and 2008. The former Program became essential as Pakistan tried to re-enter on a normal basis the world economy following the sanctions imposed after the bomb blasts. This return to the IMF was subsequently facilitated by Pakistan's support to the US in the Afghan war. The program in 2008 was clearly the consequence of an unprecedented price hike of oil to $152 per barrel.

The root causes of the incipient financial crisis today and the need ultimately to go to the IMF are a unique combination of both internal and external factors. Due to a wrong set of policies, especially with regard to the exchange rate, Pakistan has been afflicted by a very rare form of the 'Dutch Disease'. Large external borrowings have been used since 2014 to keep the exchange rate nominally stable while leading to a plummeting of exports and mushrooming of imports, thereby causing a big widening of the trade gap and resulting in a much larger current account deficit. The excessive external borrowing has also led simultaneously to a fast rise in debt repayment liabilities. Combined together the external financing needs reached a peak of $24 billion in 2017-18 which could only be financed by a big drawdown of reserves of $6.4 billion, beyond the normal sources of borrowing and FDI.

The second factor currently is a growing external shock. The oil price has started rising since mid-2016 after being exceptionally low for over two years. Now it has approached almost $82 per barrel as compared to the average of $62 per barrel last year. Every additional $10 per barrel now adds almost $1.5 billion to the import bill of Pakistan. Some forecasts are that oil could even touch $100 per barrel, following the US sanctions on Iran.

A revealing measure of the extent of pressure to seek balance of payments support from the IMF is the ratio of level of foreign exchange reserves of the SBP with the external finance requirements at the time of going to the Fund. The latter consists of the current account deficit plus the due external debt repayment.

In 2008, the external finance requirement was $17.5 billion, with reserves of $8.5 billion, implying thereby a ratio of just over two. The position was better in 2013 when the ratio was below 1.5. Now it is above three and approaching four. Clearly, the pressure for going to the IMF is much greater this time with the annual external financing requirement currently of over $30 billion and reserves of just over $8 billion.

What then is the type and size of the Program that the Authorities may seek from the IMF? The normal access is close to $6 billion, since Pakistan has already borrowed S6.4 billion in the last Program. Clearly, given the large net financing gap in 2018-19 of $12 to $14 billion, the Fund will have to agree to a Program size much above $6 billion. Also, Pakistan needs at least two years to undertake and implement wide-ranging reforms to stabilize the economy and lay the basis for higher and more sustainable growth. Therefore, if the Program is sufficiently large of up to $12 billion over a period of three years then the choice should be for an Extended Fund Facility. This is preferable to a Standby facility also because the repayment is stretched over a much longer period than in the latter case.

A program size of about $12 billion will mean that Pakistan will be accessing in total about 600 percent of its quota. This is not unusual. Countries like Greece and Argentina have been able to get programs from the IMF with funding almost ten times their quota. The program size of about $12 billion over three years will also give some 'breathing space' to design and implement the necessary structural reforms. Initially: however, the emphasis will inevitably have to be on adopting strong contractionary fiscal and monetary policies.

What will be the size of the adjustment required by Pakistan? The likelihood is that the target for the current account deficit in 2018-19 will be around $12 billion as compared to $18 billion last year. In effect, the net financing gap could be closed with one half by a strong adjustment and one half with injection of funds by the IMF as part of the Program.

There is no doubt that there will be high costs of the adjustment process. By the end of the current financial year inflation may reach a double digit rate of 10 percent to 12 percent. Along with the poor outcome expected currently from major crops, the GDP growth rate could fall to between 3.5 to 4 percent in 2018-19. Special efforts will have to be made to reduce the negative impact on employment and poverty.

Unfortunately, Pakistan today is in quagmire. This is the consequence of the legacy of a highly unsustainable economy left behind by the previous Government. Not going to the IMF would have enhanced greatly the probability of coming close to a default in international transactions leading to shortages in essential imports, substantially higher inflation and a much weaker currency.

We hope that the IMF will behave like the true lender of last resort globally and that the negotiations will not be complicated by extraneous factors. Before the Fund mission arrives, the Ministry and the SBP, along with other line Ministries, ought to complete the process of preparing home grown reforms for presentation during the negotiations. Hopefully, this will keep the initiative in Pakistan's hands.

SECTION 4

GROWTH

Chapter 9:

THE RECORD OF ECONOMIC GROWTH

The objective of this Chapter is to present a brief perspective on the economic history of Pakistan in terms of the growth performance. An attempt is made to explain the variation in the growth rate in different epochs. A more detailed analysis of the long-term economic development of Pakistan is available in Ishrat Husain (2004), Akmal Hussain (2012) and Omar Noman (1988).

Pakistan has, in fact, come a long way since its creation in 1947. The population at the time of partition was 30 million which is now almost seven times larger. Per capita income has risen from \$86 to \$1548 today. The structure of the economy has also changed fundamentally. The share of agriculture has fallen from one half to one fourth of the GDP, while that of industry has doubled to almost one fourth. Today, Pakistan is ranked sixth in the world in terms of population, 33rd in land area and 41st in size of the economy.

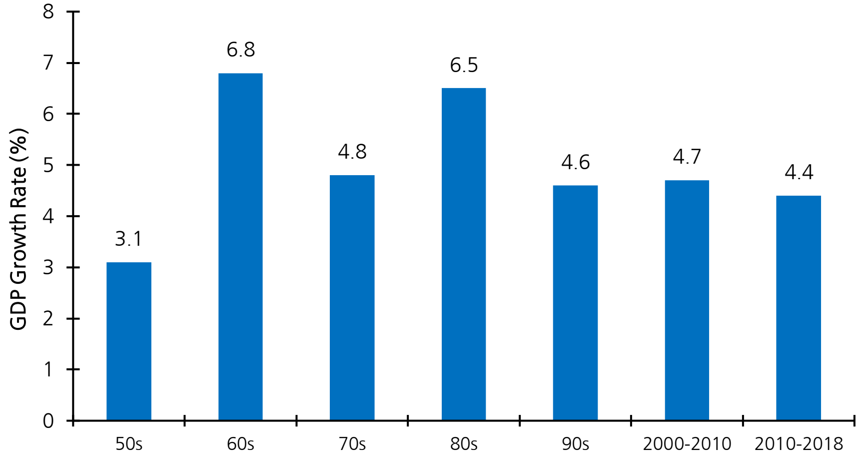
Section 1 of the Chapter presents the decade-wise average GDP growth rate. Section 2 highlights the more recent performance since the turn of the century. Section 3 describes the sectoral pattern of growth. Section 4 presents estimates of investment and savings while Section 5 gives magnitudes of the level of exports and imports and the resulting trend in the balance of trade. Finally, Section 6 makes a comparison of the performance of Pakistan's economy with that of selected South Asian countries.

9.1. GROWTH IN THE FIRST FIVE DECADES

The highest GDP growth rate approaching 7 percent was attained by the economy in the 60s. This decade saw the Green Revolution in agriculture and the first phase of industrialization of Pakistan. The 80s also witnessed an average growth rate of 6.5 percent. A big push was provided to agriculture in the initial years of this decade by the commissioning of the Tarbela dam. The move towards more technologically intensive industry by the Bhutto Government in the 70s yielded results in the 80s (See Figure 9.1).

The lowest growth rate of close to 3 percent was the outcome of the first decade after Partition. There was severe dislocation due to the arrival of millions of refugees from India. Also, there was a frequent change of Governments and considerable political instability. This process culminated in the declaration of Martial Law in 1958.

Figure 9.1: GDP Growth Rate by Decade – (%)



Source: SBP, HSPE

The decade of the 70s saw a growth rate of less than 5 percent. The economy was severely jolted by the separation of East Pakistan in 1971. The three decades from the 90s onwards have also witnessed a relatively low GDP growth rate between 4 and 5 percent. The 90s were marked also by rapid change of Governments.

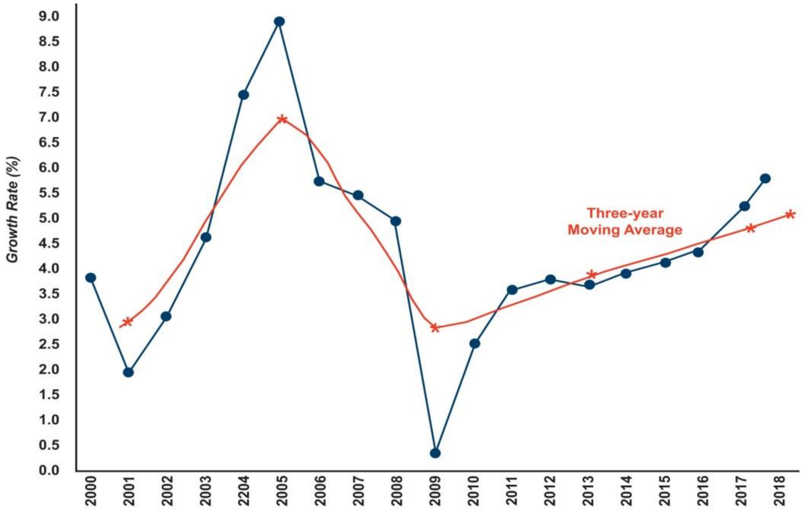
9.2. GROWTH SINCE 1999-2000

From 1999-2000 to 2007-08, during the tenure of the Musharraf Government, the GDP growth rate rose sharply to an average of 6.6 percent between 2002-03 and 2007-08. This was facilitated by the larger aid inflows after the support of Pakistan to the USA in the Afghan War. There was also surplus power available due to the investment by the IPPs in the mid-to late 90s. Export growth was in double digits and the overall level of investment, including FDI, reached a peak of 20 percent of the GDP.

From 2007-08 onwards, the economy has been plagued by a number of serious structural problems. First, the exponential jump in the incidents of terrorism raised drastically the perceptions of lack of security. This was a major contributing factor to the decline in the rate of investment. Estimates are that the greater risk and uncertainty have contributed to foregone private investment cumulatively over the last nine years of almost $60 billion. This is equivalent annually to almost 3 percent of the GDP.

Second, the problem of power loadshedding has become a major constraint to production and investment. By 2012-13, it is estimated that the national supply-demand gap of electricity had exceeded 30 percent or over 5000 MW. Simultaneously, electricity and gas tariffs have shown a rapidly rising trend as compared to previous decades. Estimates are that cumulatively the GDP has been reduced by 7 percent, exports by almost 15 percent and employment by 5 percent.

Figure 9.2: Annual GDP Growth Rate (%), 1999-2000 to 2017-18



Source: SBP, HSPE

The combined impact of a breakdown of security, law and order and large-scale outages explains the fall in the GDP growth to below 5 percent. There have also been other problems like the stagnation in the availability of water for agriculture, lack of increase in real investment in public infrastructure, and more oppressive tax burden on industry. Exports have declined from the peak level in 2013-14 and the balance of payments position has become more fragile.

Pakistan has been engaged for three years, from 2013-14 to the first quarter of 2016-17, in an IMF program described earlier in Chapter 7. As already highlighted, growth has had to be sacrificed in order to stabilize the economy.

However, the PML (N) Government has claimed a visible improvement in the average GDP growth rate to 4.8 percent in its five as compared to the average of less than 3 percent during the five years of the preceding PPP Government. In fact, the Pakistan Bureau of Statistics has shown that the economy has steadily been gathering momentum. The GDP growth has apparently increased from 3.6 percent in 2012-13, to 4 percent in 2013-14 and 2014-15, to 4.5 percent in 2015-16 to 5.3 percent in 2016-17 and to 5.8 percent in 2017-18. Unfortunately, there is strong evidence that the PBS has been manipulating the National Income Accounts to show a higher GDP growth rate than is indicated by the underlying trends. This evidence is presented in the next Chapter.

9.3. SECTORAL PATTERN OF GROWTH

9.3.1. Agriculture

The decade-wise sectoral pattern of growth is given in Table 9.1. There has been considerable fluctuation in the performance of the agricultural sector, ranging from a low of 1.7 percent growth n the 50s to 5.4 percent in the 80s. The decade of the 60s saw the introduction of Mexi Pak wheat and IRRI rice varieties. Consequently, yields went up sharply. Wheat output went up by over 6 percent annually and rice by 8 percent.

Table 9.1: Sectoral GDP Growth Rates by Decade – (%)

Growth Rate (%)	50s	60s	70s	80s	90s	2000-01 to 2009-10	2010-11 to 2017-18
GDP	3.1	6.8	4.8	6.5	4.6	4.7	4.4
Agriculture	1.7	5.1	2.4	5.4	4.4	3.2	2.4
Industry	8.2	9.9	5.5	8.2	4.8	7.1	4.4
Services	3.6	6.7	6.3	6.7	4.6	5.1	5.1

Source: SBP, HSPE

The high growth rate of agriculture in the 80s is due largely to a doubling of the output of cotton, which laid the basis for a more vibrant textile industry in Pakistan. The 90s continued to see a buoyant agriculture. This decade witnessed perhaps the most pro-agriculture set of policies. The terms of trade were shifted in favor of agriculture by setting up a regime of procurement or support prices and by providing a large subsidy to fertilizer by very low pricing of the natural gas input.

The first decade of the 2000s was marred initially by a severe draught. Thereafter, there was policy neglect of the sector. The Musharraf Government focused its growth strategy on industry, finance and telecom services. The year, 2010, witnessed severe floods with widespread devastation of crops and loss of livestock. The biggest debacle of the last eight years has been the plummeting of cotton output by over 20 percent, due largely to substitution by sugarcane. More recently, the water scarcity has become more visible.

9.3.2. Industry

The main driver of growth has been the industrial sector of Pakistan. The industrial base was extremely small at the time of Partition and most of the consumer goods were imported from India. The disruption of trade with India in 1954 forced the country to embark on the process of rapid industrialization.

The military regime of Field Marsha Ayub Khan set up a policy framework which was very pro-industry. The textile industry, especially cotton yarn, grew rapidly on the back of an overvalued exchange rate which facilitated the import of machinery and kept the price of cotton low. Exports were promoted through the bonus voucher regime.

The separation of East Pakistan in 1971 led to a disruption of inter-wing trade. Consequently, in an effort to divert exports to international markets there was a massive devaluation of the Rupee by the Bhutto Government in 1973. The process of rapid industrialization in the 60s had led to greater inequality symbolized by the emergence of the so-called 'twenty two families'. The Prime Minister, Zulfiqar Ali Bhutto, had been elected on a socialist agenda. He proceeded to nationalize a large number of industries and banks.

The Bhutto era also marks the onset of a large-scale process of import substitution by industry. The public sector undertook major investments in industries like fertilizer, cement, chemicals and steel. For example, a 1 million ton steel plant was set up in Karachi with Russian assistance.

The industrial sector continued to expand rapidly in the 80s led by industries like textiles, fertilizer and cement. The automobile industry also emerged during this decade with double-digit growth. Thereafter, barring a short span of dynamism in the latter part of the Musharraf era, industry has slowed down to a growth rate below 5 percent. This is one of the main reasons for the relative loss of overall growth momentum since 1990.

9.4. INVESTMENT AND SAVINGS

The level of investment and savings as a percentage of the GDP in different decades is given in Table 9.2. The trends revealed are perhaps unexpected. The highest level of investment was witnessed as far back as the 60s. Not only was the level of private investment at its highest, barring a spurt in the Musharraf era, but also public investment was also at a relatively high level.

Table 9.2: Level of Fixed Investment and Savings by Decade – (% of GDP)

	50s	60s	70s	80s	90s	2000-01 to 2009-10	2010-11 to 2017-18
Investment[a]	n.a	18.2	15.9	17.0	16.6	16.4	13.7
Private	n.a	9.9	5.6	7.8	9.1	11.8	9.8
Public	n.a	8.3	10.3	9.2	7.5	4.6	3.8
Savings	n.a	13.5	11.2	14.8	13.8	15.9	9.9

[a]Fixed

Source: PES

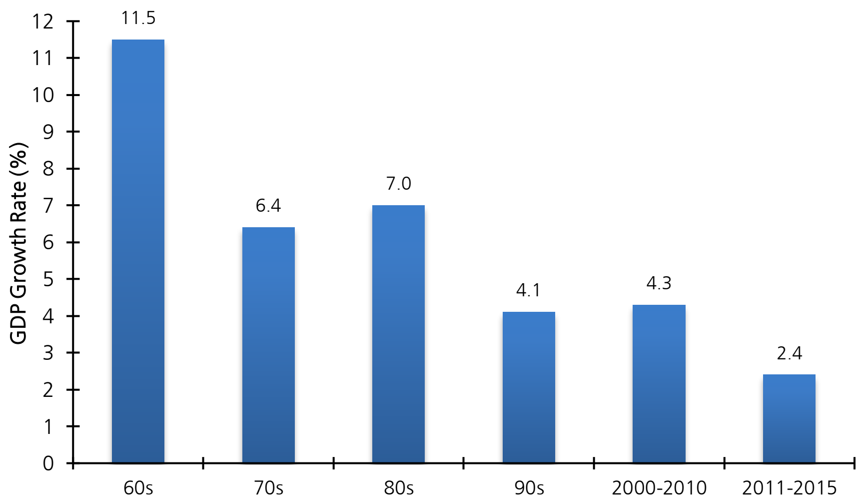
The first PPP Government during the decade of the 70s invested heavily in infrastructure. The level of public investment reached the peak of over 10 percent of the GDP. Major projects implemented included the second port at Port Qasim, Pipri Marshalling Yard, the Pakistan Steel Mill, electrification and doubling of railway track, construction of the Tarbela Dam, etc. These investments laid the basis for the fast GDP growth in the 80s.

However, the nationalization of industry and banking sector by the Bhutto Government scared away private investors in a big way. Consequently, private investment plummeted to an all time low of below 6 percent of the GDP. There has been a recovery since then and private investment reached a peak in the first decade of the new Millennium. A large quantum of investment, in particular, went into development of the telecom sector with the advent of the mobile phone.

Table 9.2 clearly reveals the declining trend of public investment as a percentage of the GDP over successive decades since the 80s. It currently stands at below 4 percent of the GDP. This underinvestment in infrastructure is due primarily to the 'crowding out', of development spending by the rising burden of debt servicing. The consequences of lack of adequate expansion in number of plants for electricity generation in the public sector has already imposed high costs on the economy. Similarly, the complete lack of investment in dams has already made Pakistan a 'water-stressed' country.

There is an apparent correlation between the rate of growth and the type of Government in Pakistan. GDP growth rates have been higher during the tenure of military regimes as compared to democratic Governments. One of the major reasons for this difference is that the former type of Governments have received more foreign assistance, as shown in Figure 9.3.

Figure 9.3: Foreign Assistance* by Decade as % of GDP



*including military assistance.
Source: SBP, HSPE

The peak level of foreign aid of over 11 percent of the GDP was observed in the Ayub era. Pakistan at that time was a close ally of the USA and a member of the SEATO and CENTO defense pacts. The level of support tapered off after the war with India in 1965.

The support by Pakistan in the guerilla war by the Mujahideen against the Russian occupation of Afghanistan during the regime of General Zia-ul-Haq also led to a large inflow of external funds. There was an upsurge of foreign assistance between 2002-03 and 2007-08 from the US following support by the Musharraf regime to the War in Afghanistan.

9.5. INTERNATIONAL TRADE

Pakistan initially followed the path of export-led growth in the 60s when emphasis was placed on development of the textile industry. The shift towards heavy industry in the Bhutto period marked the change in strategy towards import substitution, which has been the model of development followed since then.

Table 9.3 gives the decade-wise growth rate of exports and imports. The fastest growth rate of exports of over 20 percent was observed in the 60s.

Table 9.3: Growth Rate of Exports and Imports by Decade – (%)

	50s	60s	70s	80s	90s	2000-01 to 2009-10	2010-11 to 2017-18
Exports		20.8	13.5	8.5	5.6	9.9	3.4
Imports		10.2	16.6	4.5	3.2	13.7	8.1
Worker's Remittances		-	-	1.9	-5.3	26.8	11.3

Source: SBP, HSPE

The 70s also saw growth in exports due to impetus provided by the large devaluation and by the diversion of sales to East Pakistan to international markets. Since the 80s, the growth rate of exports has remained single-digit and slumped to an increase of only 3 percent per annum in the last eight years.

Imports showed high growth in the 60s with investment in plant and equipment. The biggest increase in the 70s is due to the big jump in oil prices by OPEC and machinery imports. Trade liberalization in the Musharraf era has contributed to a diversification and upsurge in imports, especially of automobiles, mobile phones and luxury goods. By 2017-18, imports have risen to the unsustainable level of 230 percent of exports. However, remittances continue to play a major role in reducing the gap.

9.6. COMPARISON WITH SOUTH ASIAN COUNTRIES

Another fact which is perhaps not so well known is that Pakistan has outperformed India in terms of economic growth after Partition. This was especially the case in first four decades. Since early 90s the Indian economy has shown greater buoyancy. A comparison with the economic status of Muslims of India is also very revealing. They mostly live in underperforming 'bimaru' states like Uttar Pardesh, West Bengal, Orissa and Bihar. Based on the statistics provided in the Sachar Commission Report of 2006 on Indian Muslims, it is estimated that the average per capita income of Muslims of India was 20 percent less than the average for India as a whole in 2015 and 13 percent less than that of the Muslims of Pakistan.

Bangladesh started in 1971 with a huge gap with respect to Pakistan in terms of living standards. The per capita income was two thirds that of the remaining part of Pakistan. Over the last three decades, Bangladesh has successfully followed a strategy of export-led growth, especially of value added textiles. Today, the exports of Bangladesh are 64 percent more than Pakistan's exports. The GDP growth rate has consistently exceeded 6 percent. By 2017, the gap with respect to Pakistan in per capita income has fallen to only 3 percent.

In conclusion, the long-run record of economic growth of Pakistan is one of success up to the 80s. From Partition to 1990, the average GDP growth rate was almost 5.5 percent. Since then it has fallen to only 4.5 percent. Unless Pakistan is able to raise its savings rate to 20 percent or more, like India and Bangladesh, and switch to an aggressive export promotion strategy it runs the risk of falling further behind.

Chapter 10:

THE 'REAL' GDP GROWTH RATE AND SIZE

The objective of this Chapter is to highlight the tendency of the Pakistan Bureau of Statistics (PBS) to overstate the GDP growth in recent years. Consequently, after a gap of eight years the GDP growth rate exceeded 5 percent in 2015-16. Apparently, it approached almost 6 percent in 2017-18.

Section 1 applies a number of consistency checks on the GDP growth rate in 2015-16 and 2016-17. This is followed in Section 2 by tests of the reliability of the high growth rate achieved, according to the PBS, in 2017-18. Section 3 focuses on the issue of the size of the GDP. The last rebasing of the National Income Accounts was for 2005-06. There is a view that the informal sector of the economy has grown faster and the GDP is, therefore, larger than currently reported by PBS.

10.1 'REAL' GROWTH RATE IN 2015-16 AND 2017-18

The Pakistan Bureau of Statistics (PBS) has estimated the growth rate of the GDP in 2016-17 at 5.3 percent. This is the first time since 2007-08 that the growth rate has exceeded 5 percent. Finally, it appears that Pakistan has come out of the 'low growth trap' and the economy should perform even better in coming years. Therefore, the efforts of our policy makers must be duly appreciated for providing the framework and environment for achieving higher growth.

However, the fundamental question that arises is whether this growth is real or illusory in character. In 2015-16, based on numbers for the first three quarters, PBS had reported a GDP growth rate of 4.7 percent. This growth rate was disputed by one of the leading think-tanks in the country, the Social Policy and Development Centre (2016), and by some independent economists.

Initially, PBS had reported in 2015-16 that there was negative growth rate in the agricultural sector, due particularly to the precipitous 28 percent decline in cotton output. During the last four decades of Pakistan's economic history, the experience is that in a year when agriculture performs poorly, with near zero or negative growth, the GDP growth rate does not exceed 4 percent. This is a reflection of the agricultural linkages with other sectors in Pakistan. A large part industry is agro-based and over 40 percent of transportation and domestic trade is in agricultural commodities.

SPDC estimated a substantially lower growth rate of GDP in 2015-16 of 3.1 percent, as opposed to that by PBS of 4.7 percent, as shown in Table 10.1. Apparently, the growth rate of ten sectors, out of the total of eighteen sectors, was overstated by PBS. Now that the full year data for 2015-16 has become available, PBS has revised the growth rate downward somewhat, from 4.7 percent to 4.6 percent.

Table 10.1: GDP Growth Rate, 2015-16, [PBS vs Estimated]

	Value Added 2014-15	PBS Growth Rate (%)	Estimated Growth Rate (%)	Estimated Value Added* 2015-16
AGRICULTURE	**2222**	**-0.19**	**-2.07**	**2175**
Major Crops	568	-7.18	-9.14	516
Minor Crops	247	-6.20	-6.20	232
Cotton Ginning	65	-21.0	-27.00	47
Livestock	1251	3.63	3.63	1296
Fisheries	44	3.30	3.30	45
Forestry	40	8.80	0.00	40
INDUSTRY	**2161**	**6.80**	**5.50**	**2280**
Mining & Quarrying	311	6.80	6.80	332
LSM	1130	4.60	3.46	1169
SSM	184	8.30	4.00	191
Slaughtering	99	3.32	3.32	102
Electricity & Gas	178	12.20	8.40	193
Construction	259	13.10	13.10	293
COMMODITY PRODUCING SECTORS	**4383**	**3.25**	**1.67**	**4456**
SERVICES SECTORS	**6261**	**5.70**	**4.10**	**6519**
Wholesale & Retail Trade	1943	4.60	2.60	1994
Transport & Comm.	1421	4.10	2.10	1451
Finance and Insurance	335	7.10	7.10	359
Housing Services	719	4.00	8.00	777
Government Services	792	11.10	5.70	837
Private Services	1051	6.60	4.78	1101
GDP (fc)	**10644**	**4.70**	**3.10**	**10975**

*Lower Growth Rate in 8 out of 18 sectors

Source: PES and Author's Estimates

The experience of last year and of estimates in earlier years has necessitated an in-depth examination of PBS numbers of the size of sectoral and overall GDP in 2016-17. The findings are given below. The research was undertaken by a group of M.Phil/Ph.D students and young economists under the overall guidance of the author. The methodology used for deriving the growth rate of each sector and of expenditure components of the GDP is given in the Technical Appendix-I.

10.1.1. Stylised Facts on High Economic Growth

Since 1979-80, the economy of Pakistan has shown a relatively high annual growth rate of 5 percent or above in fifteen out of the 36 years that have elapsed up to 2015-16. There appears to be a consistent pattern of growth in the high growth years, as follows:

(i) The large-scale manufacturing sector has been the leading sector driving the process of growth in thirteen out of the fifteen years. For example, in the five years of relatively high growth, 2003-04 to 2007-08, the GDP increased an average by 6.5 percent. During these years, the growth rate achieved in the large-scale manufacturing sector was consistently higher and averaged 9 percent.

(ii) In the two years, 1984-85 and 1995-96, when the economy grew at a rate higher than 5 percent, but with lower growth in large-scale manufacturing, the impetus was provided by agriculture, with bumper crops. The sector achieved double-digit growth rate in these two years.

(iii) In thirteen of the fifteen fast-growth years, there was also faster growth in exports than in the GDP. Part of the dynamism of the manufacturing sector was due to the buoyancy of exports, especially of textiles.

(iv) During the fast growth years, electricity generation also increased by 5 percent annually or more in fourteen out of the fifteen years.

10.1.2. Pattern of Growth in 2016-17

The basic question is whether the relatively high growth observed in 2016-17 is consistent with the above-mentioned historical pattern of growth in high growth years. The answer is a no for the following reasons:

(i) According to PBS, the rate of growth of the large-scale manufacturing sector is 4.9 percent. This is lower than the GDP growth rate of 5.3 percent.

(ii) Rather than show growth of above 5 percent, exports have actually declined by 2 percent in 2016-17.

(iii) According to the data of NEPRA, the growth rate of electricity generation is relatively low at 4.5 percent in 2016-17.

Therefore, either Pakistan has discovered a new way of achieving high growth or there are serious grounds for questioning the growth estimate by PBS for 2016-17.

10.1.3. Performance in Relation to Targets

Ambitious targets were set in the Annual Plan and in agreement with the IMF for 2016-17 in order to achieve the target GDP growth rate of 5.7 percent in 2016-17. The performance of the economy is close to the target, with the GDP growth rate of 5.3 percent. Have the targets for different indicators also been achieved or nearly achieved in order to ensure the attainment of the growth target? Here again, the answer is a no for the following reasons:

(i) A key target was to achieve a strong recovery of the cotton crop back to the peak attained in 2014-15 of over 14 million bales. This would have implied a growth rate in cotton output of over 40 percent. Instead, the estimated output is short by over 3 million bales. Results of research are that due its many linkages with the rest of the economy, a one million bale fall in the cotton crop leads to a decline in the GDP growth rate of 0.5 percentage points. This failure alone could have created a divergence from the target GDP growth rate of 1.5 percentage points. The substitution of cotton acreage by sugarcane only partially compensated for this loss.

(ii) Investment was expected to provide a growth stimulus with an increase of 10 percent in real terms in 2016-17. This was to be achieved especially by higher power sector investments and increased spending on physical infrastructure projects, partly under CPEC.

PBS estimates that investment has increased less in real terms at 8 percent. One of the reasons for this is the expected lower development spending under the national PSDP by almost 15 percent. Also, foreign direct investment is short by 38 percent in relation to the projected level.

(iii) As highlighted earlier, exports were expected to revive in 2016-17. Instead they have declined. Consequently, industrial growth is below target, with near zero growth in textiles.

Here again, based on the above, a large shortfall in relation to the key targets should have negatively impacted more on the GDP growth. As such, for these reasons also, the GDP growth rate in 2016-17 appears to be significantly overstated.

10.1.4. Inconsistencies in Estimation of Sectoral Growth

The sectors where the growth rate appears to have been overstated in 2016-17 on the basis of collateral evidence are discussed below. This evidence has been extracted from a large and diverse number of information sources. These include Federal / Provincial documents, the SBP, Associations/Councils of different industries, PSEs, International Agencies and recent financial statements of companies.

Minor Crops: This sector consists of pulses, oilseeds, vegetables, fruits, tobacco, fodder, etc. The prices of perishable food items have escalated rapidly in 2016-17 by over 13 percent. This is an indication of supply shortages. For example, the wholesale price of potatoes has gone up by 89 percent; of other vegetables by 12 percent, fresh fruits by 13 percent; oil seeds by 14 percent and tobacco by 21 percent. These increases in prices are substantially higher than the overall rate of inflation in the wholesale price index of 6 percent. Exports of fruits and vegetables have also fallen by 18 percent and 17 percent respectively.

Despite this indication of failure of a number of minor crops, PBS has shown a marginally positive growth rate of the sector in 2016-17. In fact, in the last nine years, the sector has shown a decline in value added in four years. It remains a much neglected and declining sector.

Livestock: This is a relatively large sector, with a share in the GDP of over 11 percent. In the absence of a recent Livestock Census it is difficult to get an accurate estimate of the growth in livestock population. However, one important piece of collateral evidence is the growth in consumption of livestock products from the Household Integrated Economic Surveys (HIES) carried out frequently by PBS. The last such survey is of 2015-16.

Milk is the single most product of the sector, with a share in value of output of over 45 percent. Beef and mutton are also major products with a combined share of 24 percent. According to the HIES, the per capita consumption of these items by quintile fell significantly in 2015-16, in relation to the level in 2013-14 by 4 to 13 percent. This pattern of decline has been observed for the last many years.

PBS reports a growth rate of 3.4 percent of the livestock sector in 2016-17. This implies that the per capita consumption of most livestock products is rising. This is contrary to the collateral evidence of declining trend in per capita consumption of major livestock products.

Manufacturing: The growth rate of this sector at 4.9 percent has probably been significantly overstated in 2016-17. In the first month of the year it started off with a growth rate of less than 2 percent, but by March 2017 it reached 5 percent. In March alone, apparently a growth rate of 10 percent was achieved. This buoyancy is in sharp contrast to appeals by Associations of Manufacturers of various industries in crisis, including the APTMA, for government assistance in leading newspapers.

There are two industry groups, viz, textiles and food, beverages and tobacco, where the growth rate appears to have been significantly overstated. These are the largest groups with weights of 30 percent and 18 percent respectively. In the case of textiles, the collateral evidence points to decline in the production of cotton cloth. First, domestic availability of cotton yarn for cloth production has decreased, with near zero growth in yarn output and rise in exports of 6 percent. Also, exports of cotton cloth have fallen by 15 percent.

In the case of food, beverages and tobacco, the major industries are sugar, cooking oil and cigarettes. There has been exceptional growth in sugar output of over 29 percent due to a big increase in sugarcane output. But there has been a huge decline in output of the cigarettes industry of over 42 percent. This largely neutralizes the growth in sugar output. Also, cooking oil production has risen by only 2 percent. Therefore, the overall growth rate of 6.9 percent of the food, beverages and tobacco industry group is very much on the high side. It is closer to 2.5 percent. As such, in the face of low growth in the two key industry groups, the growth rate of the large-scale manufacturing sector is closer to 3.3 percent.

Construction: This sector is reported to have achieved a growth rate of 9 percent in 2016-17, following an even higher growth rate of almost 15 percent in 2015-16. The performance of this sector is closely linked to the growth in capital formation in housing and infrastructure. Residential and other building construction accounts for over 40 percent of the value added in the sector. According to PBS, the annual increase of investment in housing is only 4 percent. The rise in capital formation in physical infrastructure, mostly in the public sector, is also below 9 percent. Therefore, the growth rate of the construction sector appears to have been overstated.

Wholesale and Retail Trade: With a growth rate of 6.8 percent, this sector has apparently achieved the highest growth rate since as far back as 2004-05. This seems highly unlikely. The performance of this sector is closely linked to growth of agriculture and manufacturing output. The combined growth of these sectors is reported at a significantly lower rate of 4 percent. Some impetus may have been provided to trading activity by the jump in imports in 2016-17. But the contribution of imports to the sectoral value added is relatively small, at less than 20 percent. As such, it is more probable that the growth rate of the wholesale and retail trade sector is closer to 5.5 percent.

Financing and Insurance: This sector has shown the highest growth rate of almost 11 percent among the eighteen sectors of the national economy in 2016-17. This is highly unlikely given the decline in profits of commercial banks, accounting for bulk of the sector, due to the sharp decline in interest rates and big decrease in investment in PIBs and MTBs.

Community, Social and Personal Services: Like wholesale and retail trade and road transport, this sector is largely a part of the informal economy. No recent surveys have been undertaken to assess the performance in recent years. However, PBS assumes a relatively high growth rate annually of this sector of between 6 and 7 percent.

The only collateral evidence available on developments in the sector is the change in level of employment, as determined from the Labor Force Surveys carried out by the PBS. The perhaps surprising finding is that the share of this sector in total national employment has consistently been falling. It was 19 percent in 2001-02 and significantly less at 14 percent in 2014-15. In fact, employment in this sector has actually fallen from 2012-13 to 2014-15. This is probably due especially to lack of growth in social services. Therefore, unless there has been a remarkable improvement in labor productivity, the sector is highly unlikely to have achieved the high growth rate of near 7 percent in 2016-17.

10.1.5. The GDP growth rate in 2016-17

Overall, based on the above analysis, PBS appears to have overstated the growth rate of eight sectors in 2016-17. Therefore, our conclusion is that the GDP growth rate in 2016-17 is not 5.3 percent but closer to 4.4 percent. The sectoral growth rates are 2.5 percent in the case of agriculture, 4 percent in industry and 5.2 percent in services.

Table 10.2: GDP Growth Rate by Sector in 2016-17, [PBS vs Estimated] – (Rs in Billion at constant prices of 2015-16)

	2015-16	2016-17			
	Value Added	PBS Estimate	Growth Rate (%)	Own Estimate	Growth Rate (%)
AGRICULTURE	**2208.1**	**2284.6**	**3.5**	**2263.5**	**2.5**
Major Crops	523.3	544.9	4.1	544.9	4.1
Minor Crops	251.5	252.0	0.2	238.9	-5.0*
Cotton Ginned	50.6	53.4	5.6	53.4	5.6
Livestock	1288.4	1332.6	3.4	1324.5	2.8*
Fishing	46.6	53.4	14.5	53.4	14.5
Forestry	47.8	48.4	1.2	48.4	1.2
INDUSTRY	**2325.4**	**2442.1**	**5.0**	**2419.8**	**4.0**
Mining and Quarrying	335.2	339.7	1.3	339.7	1.3
Large-Scale Manufacturing	1193.1	1251.9	4.9	1234.9	3.5*
Small-Scale Manufacturing	198.6	214.9	8.2	214.9	8.2
Slaughtering	102.4	106.1	3.6	105.3	2.8*
Construction	294.2	320.8	9.0	316.3	7.5*
Electricity and Gas Distribution	201.9	208.7	3.4	208.7	3.4
SERVICES	**6577.2**	**6970.2**	**6.0**	**6918.7**	**5.2**
Transport, Storage & Communication	1492.9	1551.7	3.9	1551.7	3.9
Wholesale and Retail Trade	2026.3	2164.4	6.8	2147.9	6.0*
Finance and Insurance	355.9	394.3	10.8	373.7	5.0*
Ownership of Dwellings	747.3	777.2	4.0	777.2	4.0
Public Administration and Defence	832.5	890.0	6.9	890.0	6.9
Social and Communication Services	112.1	1192.6	6.3	1178.2	5.0*
GDP (FC)	**11110.7**	**11696.9**	**5.3**	**11602.0**	**4.4**

*lower than the PBS estimate in eight sectors
Source: PBS and Author's Estimates

The difference in GDP growth rate may be attributable to differences in the underlying methodology and data bases. It may also be the consequence of some pressure from the concerned Ministry on PBS to present a better picture of macro-economic indicators. In particular, the Government may have been keen to show that the economy has finally crossed the threshold growth rate of 5 percent. It is important that PBS be made an autonomous organization.

There is need to recognize that the overstatement of the GDP growth rate is not as large as in 2015-16 of 1.4 percentage points. Achieving a growth rate above 5 percent will require faster growth of agriculture (especially of cotton output), industry, investment and exports.

10.2. 'REAL' GDP GROWTH RATE IN 2017-18

The economy apparently has come very close to achieving the ambitious growth target in the Annual Plan of 2017-18 of 6 percent. The divergence is only 0.2 percentage points. All sectors seem to have exhibited relatively fast growth. Agriculture achieved a growth rate of 3.8 percent, the highest since 2005-06. Industry experienced growth of 5.8 percent. This was the highest rate since 2007-08. The services sector also exhibited exceptional dynamism with a growth rate of 6.4 percent and contributed over 67 percent of the increase in GDP in 2017-18.

The major crop sector has apparently shown a high growth rate of 3.6 percent. This is not substantiated by the derivation of the weighted growth rate of individual crops. Further a high growth is unlikely with a fall in fertilizer off-take in nutrient tons in 2017-18 of 4 percent and a big decline in water availability in the Rabi season.

Turning to the nearly 4 percent growth rate in the livestock sector it is in sharp contrast to the declining or unchanged trend in per capita consumption of major livestock products like milk, meat and beef. These products account for 60 percent of the value of output in the sector.

The growth in large-scale manufacturing at over 6 percent has apparently been achieved in a situation where electricity consumption in the sector has actually fallen by 2 percent, according to the information in the Pakistan Economic Survey on energy. Further, the top 10 industries in terms of value added have a combined growth rate of 4 percent. These industries account for almost two-thirds of value added in the sector. It is beyond the realm of possibility that the relatively small industries could show a combined growth rate of over 10 percent.

There is also likelihood that the growth rate of large-scale manufacturing will be lower in the last quarter of 2017-18. This will be due to the on-going heavy load shedding in Karachi. Over 30 percent of industry is located in this city.

A high growth rate is shown in the construction sector of over 9 percent. This is probably based on the double-digit growth rate in industries producing construction inputs like cement. However, construction activity linked to the execution of development projects has slowed down with a decline in the real PSDP expenditure of over 5 percent in 2017-18, according to the budget documents. Further, real investment in housing has increased by only 4 percent in 2017-18.

The high growth rate of 7.5 percent in the wholesale and retail trade sector will need to be adjusted downwards in line with the lower growth rates in the commodity producing sectors. The finance and insurance sector is shown as recording a growth rate of over 6 percent in 2016-17. In the presence of very low interest rates, the SBP estimates that nominal profits of commercial banks collectively have witnessed a downturn. This implies that the value added in the sector is unlikely to have been augmented significantly.

The last two other sectors where the growth appears to be exaggerated are Government services and private services respectively. In the latter case, the budget documents enable a computation of the public expenditure growth rate, which is somewhat lower than that reported by the PBS. Finally, private services are unlikely to be buoyant with a combined growth rate of over 6 percent in a situation where employment in the sector has been growing in recent years by less than 1 percent, as reported by the Labor Force Surveys.

Overall, our estimates of the growth rates are 2.8 percent in agriculture, 4.9 percent in industry and 5.6 percent in services. This leads to an estimate of the overall GDP growth rate in 2017-18 of 4.9 percent, which is significantly lower than the PBS estimate of 5.8 percent. A similar discrepancy was revealed by us in 2016-17. The estimate of the GDP growth rate by the PBS for the year was 5.3 percent, whereas our estimate was 4.4 percent.

The conclusion is that the growth rate has not doubt increased annually since 2012-13, but not as fast as indicated by the PBS. Over the last two years the GDP growth rate has been overstated by up to one percentage point annually.

10.3. SIZE OF PAKISTAN'S GNP

The Ministry of Finance has apparently asked the World Bank to undertake a study to estimate the true Gross National Income (GNI) of Pakistan. The expectation is that this will lead to a significant increase in the size of the national economy, of even up to 25 percent.

If this happens, what are the implications? First, the public debt to GDP ratio will come down sharply, probably below the limit of 60 percent of the GDP imposed by the Fiscal Responsibility and Debt Limitation Act. This will indeed be a very ingenious way of managing the public debt.

Further, it could once again restore Pakistan's position with respect to India. Currently, India's per capita income is higher by 14 percent. This gap could be eliminated by the re-estimation of Pakistan's GNP in US $ and contribute greatly to boosting the national ego.

However, there is also a downside. It will imply a lower ratio of tax revenues, exports and investment to GDP. This will further expose the structural weaknesses of Pakistan's economy. For example, the estimated level of investment was 20.5 percent of the GDP in 2005-06. Following rebasing it turned out to be 17.7 percent of the revised GDP. Similarly, the tax to GDP ratio fell from 10.5 percent to 9.8 percent.

The World Bank actually does estimate already the Gross National Income (GNI) of all countries in US dollars. The approach is different from that adopted by national statistical agencies. It is based on the application of the ATLAS method, which at least partially adjusts for the over or undervaluation of the national currency with respect to the US dollars.

According to this method, the GNI of Pakistan is estimated at $272 billion in the calendar year of 2015. With this size, it is ranked as the 41st largest country immediately after Singapore, Malaysia and Egypt. The corresponding estimate of the GNI by the Pakistan Statistical Bureau (PBS) is $295 billion, higher by $23 billion or 8 percent. Therefore, handing over the re-estimation of GNP to the World Bank may even imply a fall rather than an increase in the size of Pakistan's economy. The basic reason for this is that Pakistan's currency has been significantly overvalued.

The re-estimation of the GDP is known as the 'rebasing' exercise of national income. The last such exercise was completed by the PBS in 2012-13. It led to change in the base year of GDP at constant prices from 1999-2000 to 2005-06. Technical assistance was provided by the German NGO, GIZ.

The rebasing did lead to an increase in the GNI by 7 percent. Much of the increase was in the agricultural and service sectors of the national economy like minor crops, livestock, wholesale and retail trade, housing services and transport, storage and communications. Value added in the industrial sector was actually brought down by 16 percent, with a fall of almost 64 percent in small-scale manufacturing.

Earlier a rebasing exercise was undertaken in 2003, during the tenure of the Musharraf Government, to change the base year from 1980-81 to 1999-2000. This led to a bigger rise in GNI of almost 20 percent. Here again, bulk of the increase was concentrated in sectors characterized by mostly informal activities, like wholesale and retail trade, transport and communications and social, community and personal services. In addition, the livestock and mining sectors jumped up substantially in size.

The consequence of this rebasing exercise was that it facilitated Pakistan's progressing from low income and joining the ranks of (lower) middle income countries by 2007-08.

This has been considered as a major achievement by the Musharraf Government. Whether the 20 percent jump in GNI from 1999-2000 onwards was illusory or real is difficult to judge fifteen years later.

What is likely to be the impact of a rebasing exercise in 2017-18? On the positive side, the GNI could be augmented by proper estimation of emerging and fast growing economic activities related to private security, information technology, Islamic banking, courier and internet services, public transport and mass transit, etc. Also, the informal economy may have expanded at a more rapid rate, especially the part linked to illicit transactions.

However, on the negative side, the input-output coefficients have probably increased significantly since 2005-06. This implies that the value added component in the value of production is lower. The prices of agricultural inputs like fertilizer and fuel for tube wells have gone up faster than commodity prices. Similarly, the prices/tariffs of electricity and gas inputs have gone up at a relatively fast rate. Also, imported intermediate goods prices have risen at a more rapid rate than output prices. The likelihood is that a rebasing exercise could lead to a contraction in the size of the agricultural and industrial sectors while the value added in the services sector could go up significantly. At this stage the net impact of rebasing on the size of the national economy is not clear.

The pre-condition for a proper rebasing exercise is the availability of data from Censuses or surveys of particular sectors. PBS has been updating surveys on labor force, household income and expenditure and access to basic services. But the last Census of Establishments was undertaken in 2005, Census of Manufacturing Industries in 2005-06, Livestock Census in 2006 and so on. These primary data collection exercises will have to be undertaken to provide appropriate benchmarks for rebasing. As such, the re-estimation of GNP could take up to two years, especially since the PBS was fully pre-occupied in 2017 with the Population Census and probably not in a position to undertake more surveys.

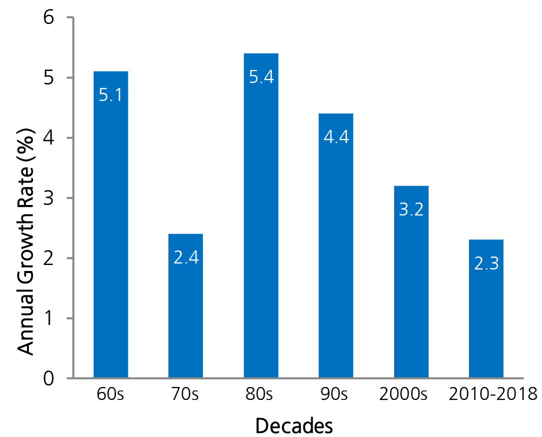
Also, the logical international agency for providing technical assistance is not the World Bank but the United Nations Statistics Division. The latter institution has developed the System of National Accounts (SNA), which is used globally and provides technical support to member countries.

The expectation is that an objective resizing of the economy from a new more up-to-date base year onwards will eventually not only provide a more accurate estimate of the size but also of the annual growth rate of GDP in recent years. This is essential because the present Government has tended to exaggerate significantly the economy's growth rate in recent years.

Chapter 11:

AGRICULTURE

Figure 11.1: Long-Term Decade wise Growth Rate of the Agriculture Sector – (%)



Source: SBP

Agriculture historically has been the mainstay of the economy of Pakistan. Prior to the Partition, Punjab was able to produce a large enough food surplus to feed North India. Since 1947, the performance of agriculture has been variable as shown in Figure 1.1. The decade of the 60s saw the Green Revolution and a major jump in crop yields. The growth rate achieved was over 5 percent. The 80s saw another period of buoyancy of agriculture partly on the back of improved water supplies following the commissioning of the Tarbela Dam. The growth process was largely sustained in the 90s by strong pro-agriculture policies.

There has been a secular decline in the growth rate of the agriculture sector after 1999-2000. During the first decade of the new Millennium, the growth rate came down to 3.2 percent. Thereafter, it has fallen further and in the eight years leading up to 2017-18 it has come down to the lowest growth since 1960 of only 2.3 percent. However, there was a significant recovery in 2017-18 when the growth rate went up to 3.8 percent.

The objective of this Chapter is, first, to identify in precise terms the contribution that the agricultural sector makes, both directly and indirectly, to the national economy. The objective is to demonstrate that agriculture must continue to have central place in national policies. Second, an attempt is made to diagnose the causes of the visible slump in agriculture during the last decade. This will lead to the identification of policies required to bring back more dynamism into the sector.

Section 1 of the chapter describes the role of agriculture and its contribution to the economy of Pakistan. Section 2 identifies in which agricultural activities there has been a visible decline in growth. Section 3 lists the factors which have contributed to this decline. Finally, in Section 4 a set of major policies is identified to revive the process of agricultural development in the country.

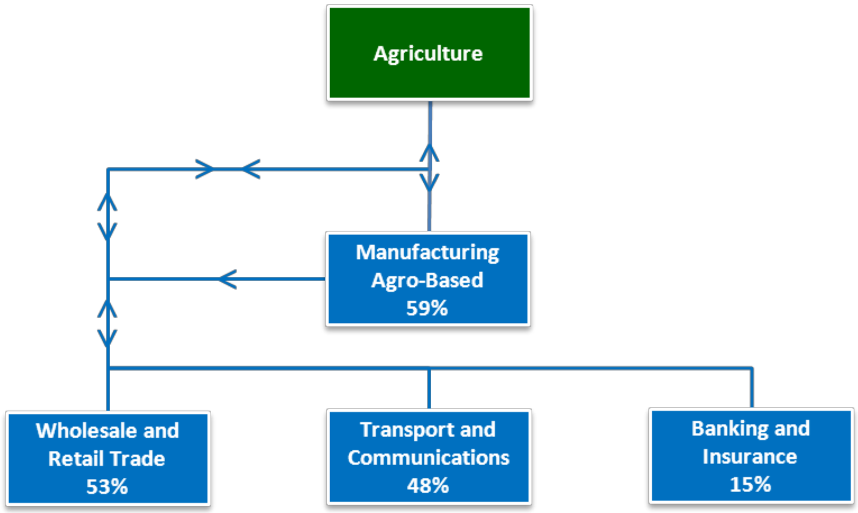
11.1. THE ROLE OF AGRICULTURE

Agriculture is the primary sector of the economy. As such, it has strong forward and backward linkages with the secondary (industrial) and tertiary (services) sectors. These linkages are shown in Chart 11.1.

The output from agriculture constitutes the basic input into production by agro-based industry. This includes major industries like textiles, sugar, cigarettes, beverages, leather products, etc. Almost 52 percent of the value added in the manufacturing sector is by agro-based industries.

There are various industries which also have a backward linkage with agriculture in the form of provision of inputs. This includes industries like, fertilizer, chemicals, tractors, etc. These industries constitute 7 percent of the manufacturing sector of Pakistan.

Chart 11.1: Sectoral Linkages of Agriculture



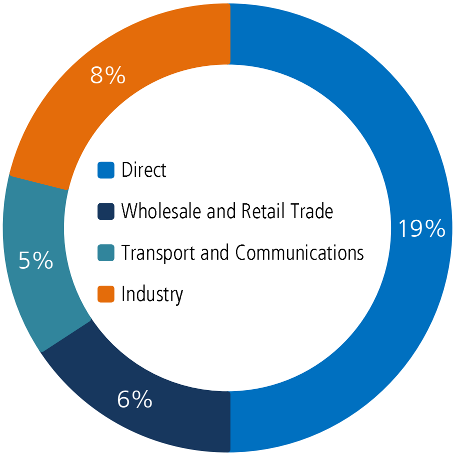
Source: PBS, National Income Accounts

Agriculture also has strong forward and backward linkages with the largest sector in the national economy, wholesale and retail trade. This is in the form of marketing of output and purchase of inputs by the farming population and intermediaries. As such 53 percent of the net overall trading margin is linked to the performance of agriculture.

Similarly, almost 48 percent of the volume of transport is of agricultural products and inputs, including diesel oil for tubewells. The provision of credit to farmers constitutes another linkage with agriculture of the banking system.

Overall, the figure 11.2 gives the share of the economy which is linked directly or indirectly to agriculture. The overall contribution is 38 percent of the GDP. The indirect contribution at 19 percent is the same as the direct contribution by the process of agricultural production. The linkage of 38 percent of the economy to agriculture, should silence critics who argue that agriculture cannot promote faster growth and that the planning process now needs to move beyond agriculture to the so-called 'modern' sectors. This view asserts that that through adoption of latest 'third generation' technologies in industry a quick economic breakthrough can be achieved. It also ignores the need for food security, job creation and alleviation of poverty.

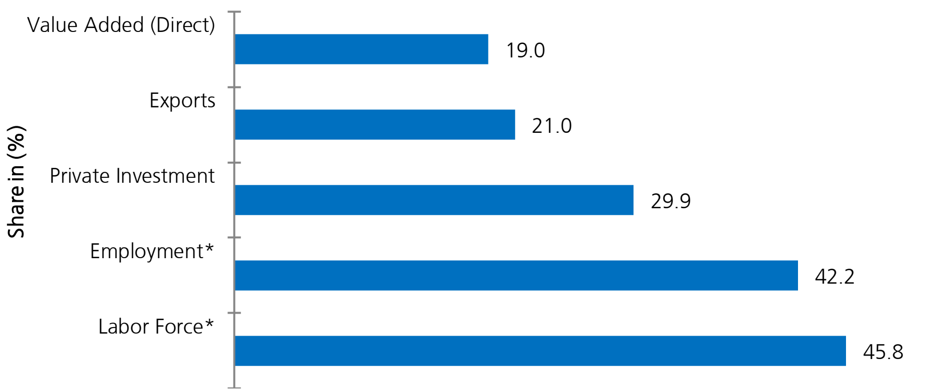
Figure 11.2: Direct and Indirect Contribution of Agriculture to National Economy – (% of GDP)



Source: PBS, National Income Accounts

Overall, the direct contribution of agriculture to various key macroeconomic magnitudes is given in Figure 11.3. The maximum share of agriculture is in employment at 42 percent. In other variables it ranges from 19 percent to 30 percent.

Figure 11.3: Agriculture Sector's Share in the National Economy, 2017-18 – (%)



Source: PBS, National Income Accounts

11.2. THE GROWTH OF AGRICULTURE

The analysis is undertaken below of the growth of the agricultural sector from 2000-01 onwards. The performance of the sector in three sub-periods is analyzed, corresponding to the regimes of the Musharraf Government, PPP and the PML (N) up to 2017-18.

The growth performance of different sub-sectors of agriculture is given in Table 11.1. A clear pattern of declining growth is visible. The growth rate had already declined sharply in relation to the 90s in the first sub-period, 2000-01 to 2007-08, to 2.8 percent. This fell further in the last sub-period, during the tenure of the PML (N) Government, to 2.1 percent. Fortunately, there was major recovery in 2017-18 when the growth rate went up to 3.8 percent. This is the highest growth rate achieved in the last twelve years.

Table 11.1: Growth Rate of the Sub-Sectors* of Agriculture – (%)

	Share of Sector 2017-18	2000-01 to 2007-08	2007-08 to 2012-13	2012-13 to 2017-18
Major Crops	24.2	1.9	3.2	1.1
Minor Crops	11.0	0.6	-1.1	-0.4
Livestock	60.4	4.7	3.4	3.3
Fishing	2.2	2.9	1.8	5.3
Forestry	2.2	-7.4	-1.3	1.7
AGRICULTURE	**100.0**	**2.8**	**2.5**	**2.1**

Source: PES

The largest two sub-sectors with the biggest decline in growth rate are, first, major crops combined to only 1 percent in the last five years. These crops include wheat, cotton, rice, sugarcane and maize with the strongest forward and backward linkages. Second, the minor crop sector is virtually in a state of crisis since 2007-08 with a negative annual average growth rate. These crops have unfortunately been declared as 'minor' and thereby largely neglected. They include items like pulses, vegetables, oil seeds, fruits etc., which form a significant part of the diet of relatively poor households.

The livestock sector has been able to sustain a growth rate of above 3 percent. Milk production has been relatively buoyant with a growth rate above 3 percent. The breakthrough has been in the poultry sub-sector. Consumption of chicken meat has risen at almost a double-digit growth rate since the turn of the century.

11.2.1. Major Crops

The next step in the analysis is identification of the performance of individual major crops. The annual growth rate of output and yield are presented in Table 11.2 for the three different sub-periods. Final estimates are not available for 2017-18.

Table 11.2: Growth Rate of Output and Yield of Major Crops – (%)

		1999-2000 to 2007-08	2007-08 to 2012-13	2012-13 to 2016-17*	1999-2000 to 2016-17
Wheat	Output	-0.1	2.9	1.5	1.2
	Yield	-0.5	3.0	0.0	0.7
Rice	Output	0.9	-0.4	5.3	1.6
	Yield	0.6	1.7	1.0	1.0
Cotton	Output	0.5	2.1	-4.9	-0.3
	Yield	0.2	3.4	-1.3	0.8
Sugar Cane	Output	4.0	0.0	3.6	2.7
	Yield	1.4	1.9	1.7	1.6
Maize	Output	10.1	3.1	9.3	7.9
	Yield	8.7	3.3	3.5	5.9

*Figures for 2017-18 are still preliminary estimates.
Source: PES

The fastest growing crop is the smallest major crop, maize, over the entire period of seventeen years. The annual growth rate has approached 8 percent. Three-fourths of the increase is due to improved yield and the remainder, one-fourth, by expansion in areas under cultivation.

All other major crops have shown a growth rate of less than 3 percent from 1999-2000 to 2016-17. The rise in sugarcane output is 2.7 percent annually on average, with almost 60 percent due to increase in yield.

Cotton is the only crop which has registered a negative growth rate, especially after 2012-13. There has been a drop in output of over 21 percent over the last four years. The area under this crop has fallen by 20 percent since 1999-2000. Cotton has the strongest forward linkages among major crops. The decline in output and acreage is the epicenter of the problems with agricultural growth in recent years. The loss in area under cultivation is primarily due to a substitution by sugarcane.

Turning to minor crops, information is available only for a few crops. The trend in output of these crops is presented in Table 11.3.

11.2.2. Minor Crops

The biggest falls in output are observed in the case of gram and rapeseed and mustard. Positive growth has taken place in the case of some fruits, especially mango and apple. Information on output of vegetables is available only till 2012-13. The only vegetable which has shown significant growth in output is potato.

Table 11.3: Growth in Output of Selected Minor Crops

	1999-2000 to 2007-08	2007-08 to 2012-13	2012-13 to 2016-17	1999-2000 to 2017-18
Coarse Food grains	1.9	-1.8	1.1	0.5
Gram	2.6	9.2	-20.6	-1.2
Rape seed and Mustard	-3.8	3.1	-3.1	-1.5
Tobacco	3.4	0.0	-1.9	1.0
Fruits				
Mango	8.2	-0.9	1.5	3.7
Citrus Fruit	2.7	-2.7	2.1	0.9
Apple	0.1	4.6	4.7	2.6
Dates	-1.7	-1.2	n.a	n.a
Vegetables				
Onion	5.4	-3.9	n.a	n.a
Potato	5.5	15.8	n.a	n.a
Other Vegetables	1.2	-1.4	n.a	n.a
Chilies	3.1	4.7	n.a	n.a
MINOR CROPS	**0.6**	**-1.1**	**-0.4**	**-0.3**

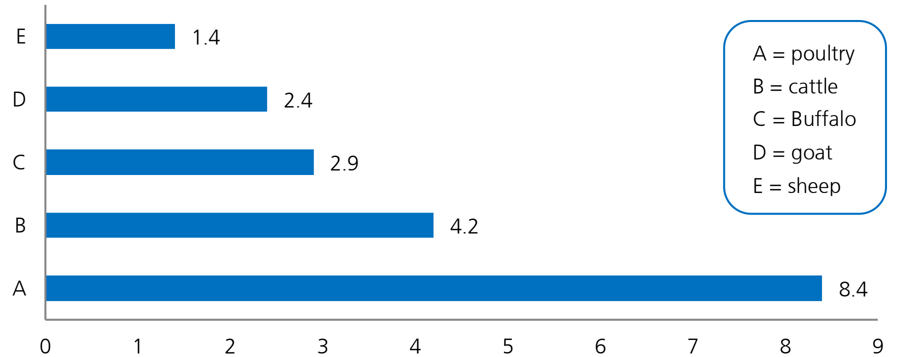
Source: PES

11.2.3. Livestock Sector

This is the largest sub-sector of agriculture, with a share of 60 percent in 2017-18. Livestock products showed high growth in output of almost 5 percent from 2000-01 to 2007-08. However, there are reasons to believe that the growth rate was overstated. The size of the sector was scaled up in 2004-05, which artificially led to a jump in the growth rate.

However, the sector has maintained a fairly high growth rate of over 3 percent since 2007-08. The natural rate of increase in animals producing livestock products is given in Figure 11.4. As highlighted earlier, poultry production has risen at the fastest rate of over 8 percent. The stock of other animals has risen from 1 percent to 4 percent annually.

Figure 11.4: Annual Growth Rate in Number of Livestock – (%)

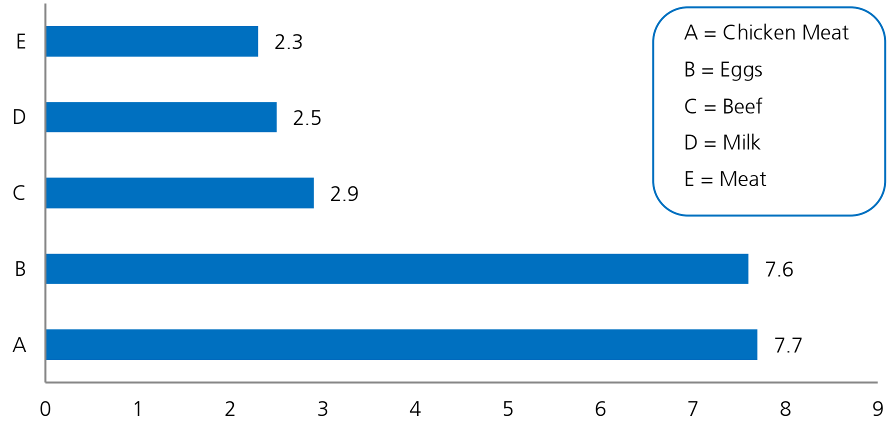


Source: PBS, Agricultural Statistics

According to the Federal Ministry of Food Security, the output of the largest product, milk, has increased annually on average by over 3 percent since 2000-01, and that of meat by almost 4.5 percent. One of the favorable characteristics of the livestock sector is limited fluctuation in growth of output, barring the losses in natural disasters like floods.

However, there are no annual surveys of number of livestock and their output, as is done in the case of crops. As such, a consistency exercise has been undertaken to compare the production with growth in consumption of livestock products from 2005-06 to 2015-16. The estimates are shown in Figure 11.5.

Figure 11.5: Growth Rate in Consumption of Livestock Products, 2005-06 to 2015-16 – (%)



Source: PBS, HIES

The fastest growth in consumption of almost 8 percent per annum is in poultry products. Milk consumption has gone up by 2.5 percent as compared to the rate of increase in production of over 3 percent. Overall, the weighted increase in the consumption of livestock products is 3.1 percent per annum. This is close to the overall production growth rates after 2007-08.

Overall, the agricultural sector has lost the dynamism that it had earlier in the decades of 80s and 90s. This has had an adverse impact on the overall GDP growth, given the many forward and backward linkages of agriculture. The annual growth rate of agriculture has been declining continuously since 1999-2000, reaching a low of only 2 percent from 2012-13 to 2017-18. Both major and minor crops have done poorly. There is effectively today a cotton crisis, with the output falling substantially below the peak attained of 14 million bales. Within minor crops, output has remained stagnant or fallen generally, with the solitary exception of some fruits and potato. Causes of the slowdown of agriculture are in investigated in the next section and proposals presented thereafter for restoring the buoyancy of agriculture.

11.3. CAUSES OF THE SLOWDOWN

Econometric analysis of the growth rate annually in value added (in real terms) of agriculture leads to the following results:

With respect to:	Elasticity* of Growth Rate of Agriculture
Water Availability	1.19
Agricultural Terms of Trade	0.83
Cropped Area	0.72
Agricultural Credit	0.68

*% input on agricultural growth of 1 percent increase in the variable.
Source: Estimated

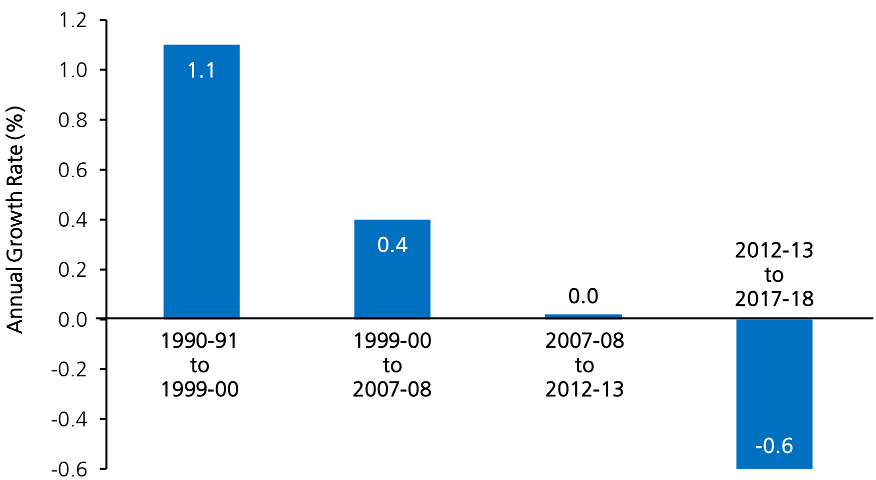
The largest elasticity is with respect to water availability.

The trends in the above factors which impact on agricultural output are presented along with recommendations for improvement.

11.3.1. Water Availability

The availability of water at the farm gate has shown varying rates of growth as highlighted below. There has been a progressive decline in the growth rate from 1.1 percent annually during the decade of the 90s to a negative 0.6 percent in the last five years as shown in Table 11.6. The difference is attributable to two factors. First, there has been little or no expansion in the canal irrigation system while water losses have increased due to lack of lining of canals. Second, the incremental water availability has come from ground water resources by installation of tubewells.

Figure 11.6: Annual Growth Rate in Water Availability – (%)



Source: PBS, Environmental Statistics

The decade of the 90s and up to 2007-08 witnessed the fastest rate of 'tubewellization', especially in Punjab. The annual rate of increase in the number of tubewells was as high as 7 percent. It has since fallen to below 3 percent. In fact, there is the risk today of over-exploitation and depletion of ground water resources. Currently, about 64 percent of water made available to farms is surface water from canals and the remaining 36 percent from tubewells. Also, 59 percent of the water is consumed in the Kharif season and 41 percent in the Rabi season. Pakistan has been identified as one of the countries which is likely to become 'water-stressed' by 2025. Also, the country has one of the very lowest rankings internationally in water use efficiency.

Clearly, the medium-run prospects for agriculture hinge crucially on water availability. A number of critical steps need to be taken on a priority basis to improve the efficiency of water use. First, the Provincial Governments, especially of Sindh and Punjab, need to expand greatly their program of lining of existing canals and building of small reservoirs and dams. Second, there is need for increasing the resort to drip irrigation through agricultural extension and subsidy on the required equipment.

Third, water is used inefficiently because of its extremely low price, in the form of *abiana*. This charge is only Rs 100 to Rs 200 per acre and the revenue generated currently is only 10 percent of the O&M costs of the irrigation system. The water charge needs to be substantially escalated and, if necessary, a metering system introduced eventually.

Fourth, there is need to use pricing policy and other measures more effectively to change the cropping pattern, especially in Kharif, towards less water-intensive crops. In particular, sugarcane consumes three times as much water per acre as other crops like cotton. Therefore, Pakistan has to take a major decision to move away as fast as possible from the cultivation of sugarcane.

Turning to the more long run strategy, ways will have to be found to augment significantly the overall water resources. In fact, Pakistan is losing almost 45 percent of its total water availability. Currently the storage capacity is 13.7 MAF, equivalent to only 10 percent of available water resources. The country can store water for only 35 days, which is much less than most countries. For example, India's storage can potentially last for almost 320 days.

There is a desperate need for construction of more dams in the Northern part of the country. The potential large dams include Dasu, Diamer-Basha and Mohmand. Fortunately, the need for dams, both for hydel power and water storage, has been strongly emphasized by the Chief Justice of the Supreme Court and more recently by the new Prime Minister. A special Fund has been established to receive funds for construction of Diamer-Basha and Mohmand Dams. However, substantial resources are required, ranging from close to $1 billion for the Mohmand Dam to almost $14 billion in the case of the Diamer-Basha Dam. The long-run future of Pakistan's agriculture will hinge crucially on more and better use of water resources.

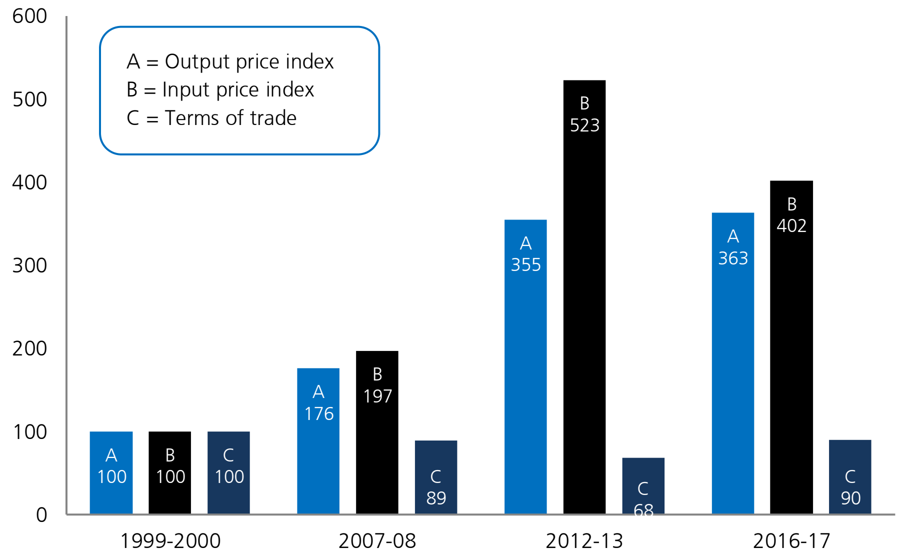
11.3.2. Terms of Trade

The terms of trade of agriculture is defined as the ratio of the price index of outputs with the price index of inputs. The former is computed as the GDP deflator for agriculture, corresponding to the ratio between value added at current prices versus that at constant prices. The terms of trade serve as an indicator of profitability in agriculture and the likely supply response.

The price index of inputs is the weighted index of prices of fertilizer (urea and DAP), LDO used in tubewells, pesticides and tractors. The weights are as of 1999-2000. Similarly, the base year for output and input price indices is also 1999-2000.

The values of these indices are shown for 1999-2000, 2007-08, 2012-13 and 2016-17 respectively in Figure 11.7. Input prices went up relatively faster than output prices from 1999-2000 to 2012-13. Consequently, the terms of trade of agriculture deteriorated from an index value of 100 in 1999-2000 to 68 in 2012-13. There is subsequently a visible improvement to 90 in 2016-17, due largely to reduction in prices of various fertilizers. This was the result of the larger subsidy offered to fertilizer as part of the Agricultural Relief Package of the Prime Minister in 2016. There appears to have been a strong supply response in 2017-18. The growth rate of agriculture went up to 3.8 percent.

Figure 11.7: Terms of Trade of Agriculture – (Base Year: 1999-2000 = 100)



Source: PES

The basic question is how are agricultural prices determined? There are two basic price determination mechanisms. The first is the regime of procurement / support prices for key crops. The second group of commodities have prices which are primarily determined by the operation of market forces. The issue is whether in the latter case especially there is a link between international prices and domestic prices. This is examined in Table 11.4. The general conclusion is that agricultural prices have risen faster in Pakistan than globally. However, in line with the fall in international prices, domestic prices have also generally declined.

Table 11.4: International and Domestic Price Index of Major Agricultural Commodities, 1999-2000 to 2016-17 – (1999-2000 = 100)

	Domestic Price Index (1)	International Price Index* (2)	Ratio of (1) to (2)
1999-2000	100	100	100
2007-08	197	168	117
2012-13	523	371	141
2016-17	402	331	122

*in Rupees

Source: PES, IMF

The faster increase in domestic prices is partly a reflection of the presence of the regime of procurement / support prices in Pakistan. For a long time, there was a wide coverage of these prices, including wheat, rice, sugarcane, cotton (phutti), potato and onion. However, many items have been taken away from this regime and farmers of these crops now have to bear the brunt of price fluctuations. Today, only wheat and sugarcane are covered by the procurement / support price system.

The change in the price system has had deleterious consequences. Given the powerful lobby of owners of sugar factories in Pakistan the sugarcane price has been kept very high in Pakistan. Simultaneously, a high regulatory customs duty has been introduced on the import of sugar. Therefore, sugar production can take place at a high domestic price conferring high returns to both factory owners and farmers growing sugarcane. The result is that sugarcane cultivation has begun to substitute in a big way the cotton crop. The area under sugarcane has increased by 16 percent since 2012-13 while that under cotton has fallen by 6 percent.

A comparison can be made with agricultural pricing policies in India. India has procurement / support prices for as many as 28 commodities. Further, agriculture is massively subsidized. According to estimates by the WTO in its most recent Trade Policy Review of India the total subsidy given to agriculture is as much as $27 billion. The fertilizer subsidy alone adds up to $13 billion. The corresponding estimate for Pakistan is about $600 million only. It is not surprising that the price of urea in India is 60 percent less in dollar terms in India than in Pakistan.

Based on the above analysis of the terms of trade the following recommendations are made regarding agricultural pricing policy in Pakistan:

(i) There is need to go back to the wider price support regime that Pakistan had earlier, especially in the 90s. in particular, rice, (basmati and Irri) and cotton (phutti) need to brought back into this regime along with wheat.

(ii) The support price on sugarcane should no longer be offered. Also, no protection should be given to sugar manufacturers. The objective is to substantially reduce the area under sugarcane and increase the area under cultivation of cotton. The latter has much stronger forward linkages and is a key input for larger exports. This will also simultaneously reduce the demand for water.

(iii) The prices of key vegetables like onion and tomato have a 'cob web' like pattern. If they are high one year then the big supply response next season leads to a big fall in prices and a reduction in output. The best way to remove the large fluctuations in prices is to introduce minimum support prices, as in India.

11.3.3. Other Supporting Measures

Agriculture has historically been relatively starved for credit in Pakistan. The total agricultural credit disbursed in 2016-17 was Rs 705 billion, equivalent to 12 percent of the total annual flow of credit from the banking system. The share of subsistence holdings, up to 12.5 acres, in credit was 53 percent. Relatively high interest rates are charged from farmers in view of higher transaction costs and greater lending risk. Almost 51 percent of the credit is by commercial banks, followed by 19 percent by the Zarai Taraqiati Bank Limited (ZTBL) and the remainder, 30 percent, by other specialized institutions, including NGOs.

The Agricultural Relief Package of 2016 set an ambitious target of almost doubling credit to the agriculture sector. This target was achieved. However, small farmers still continue to have more limited access to credit facilities. Recently some efforts have also been made to provide subsidized credit through NGOs, especially in Punjab.

The other issue relates to the fertilizer mix. Currently, urea consumption is almost four times the use of other fertilizers like DAP, when ideally the ratio should be below three to one, as in countries like India. This will require a reduction in the price differentials among different types of fertilizer.

Natural gas is the feedstock for fertilizer production. Historically, a subsidy has been offered indirectly by keeping the price of natural gas as feedstock low as compared to the tariff for domestic or commercial consumption. Recently, the new Government has raised the price of domestic natural gas for fertilizer plants by 26 percent and guaranteed only half the required supply, with the rest being met by higher price imported LNG. This has created a shortage of fertilizer and 100,000 tons are being imported with a subsidy of Rs 6 billion. The price of fertilizer has risen by almost 30 percent. This should have been avoided at all costs if Pakistan's agriculture is to remain competitive.

This takes us to the contribution of agricultural exports. Today, agricultural exports are of the order of $5 billion, equivalent to 20 percent of Pakistan's total exports. The major exports include rice, (Basmati and Irri.), fish, fruits, leguminous vegetables, meat and meat preparations. Almost $700 million of sugar was exported in 2017-18, but with the help of a significant subsidy. Raw cotton used to be a major export. However, now Pakistan has a cotton deficit and almost $1.2 billion is spent on imports, mostly from India, of almost 4 million bales.

There was a time in the late 70s when Pakistan had a trade surplus in agricultural products, with exports 50 percent more than imports. Now, imports, close to $7 billion, are 40 percent more than exports. They consist primarily of raw cotton, palm oil, tea, pulses, etc. Agricultural exports also suffered after 2013-14 when Pakistan maintained a grossly overvalued exchange rate. Now the export incentive scheme in operation since 2016 should be extended to also include agricultural products.

The next related issue is the extent to which the agricultural sector should be given protection from imports. According to the WTO Tariff Profiles, Pakistan has the lowest average MFN tariff on agricultural products in South Asia of 13 percent, as compared to 17 percent in Bangladesh, 33 percent in India and 24 percent in Sri Lanka. Today, the major part of non-edible oil agricultural imports of Pakistan are from India. As highlighted earlier, India heavily subsidizes agriculture. Therefore, Pakistan should impose a minimum tariff of 11 percent on agricultural imports as compared to 3 percent currently. The tariff on raw cotton import should also be raised to 11 percent so as to provide a measure of protection to domestic cotton producers. The duty drawbacks should be raised accordingly on exports of textiles.

Agricultural research and extension services have been given low priority in the country. Less than 1 percent of the agricultural value added is devoted to R&D, especially in development of new varieties of seeds for crops like cotton. The time has come not only for enhancing the capacity and budgets for research and extension but also of handing over the lead role in performing these functions to the Agricultural Universities.

There is need to reiterate the importance of agriculture in the conclusion of this Chapter. Not only is this sector important for greater food security and poverty alleviation but also in promoting overall economic growth. The role of the sector through the forward and backward linkages with other sectors must be recognized and promoted. This is essential for achieving inclusive and sustainable development in Pakistan.

Chapter 12:

MANUFACTURING

The manufacturing sector is often referred to as the modern or formal sector of the economy, as opposed to the agricultural sector which is seen as the traditional sector. The share of the manufacturing in the national economy is currently estimated at 14 percent. Almost 80 percent of the value added by the sector is by large-scale units, employing 10 or more workers.

The decade wise growth rates of the manufacturing sector are presented in Table 12.1. In the two decades, viz, the 60s and the 80s, the GDP growth rate exceeded 6 percent. During these decades, the manufacturing sector showed exceptional buoyancy with growth rate approaching 10 percent in the 60s and 8 percent in the 80s.

Table 12.1: Long-Term Growth and Share in GDP of the Manufacturing Sector[a] – (%)

Decades of	Growth Rate		Share of Manufacturing in GDP[b]
	Manufacturing	GDP	
60s	9.9	6.8	12.0
70s	5.5	4.8	16.9
80s	8.2	6.5	15.1[c]
90s	4.8	4.6	17.1
2010-11 to 2017-18	4.3	4.4	13.5[c]
2013-14	5.7	4.1	
2014-15	3.9	4.1	
2015-16	3.7	4.6	
2016-17	5.8	5.3	
2017-18	6.2	5.8	

[a]both large-scale, small-scale manufacturing and slaughtering | [b]at constant prices | [c] fall due to rebasing exercise

Source: PES

The lowest growth rate of the sector has been witnessed since 2009-10. It has grown at, more or less, the same rate as the GDP of significantly below 5 percent. The fundamental question is why the manufacturing sector has lost so much momentum in the last eight years. An explanation for this failure is the main purpose of this Chapter. Identification of the reasons will enable the development of a strategy for industrial revival.

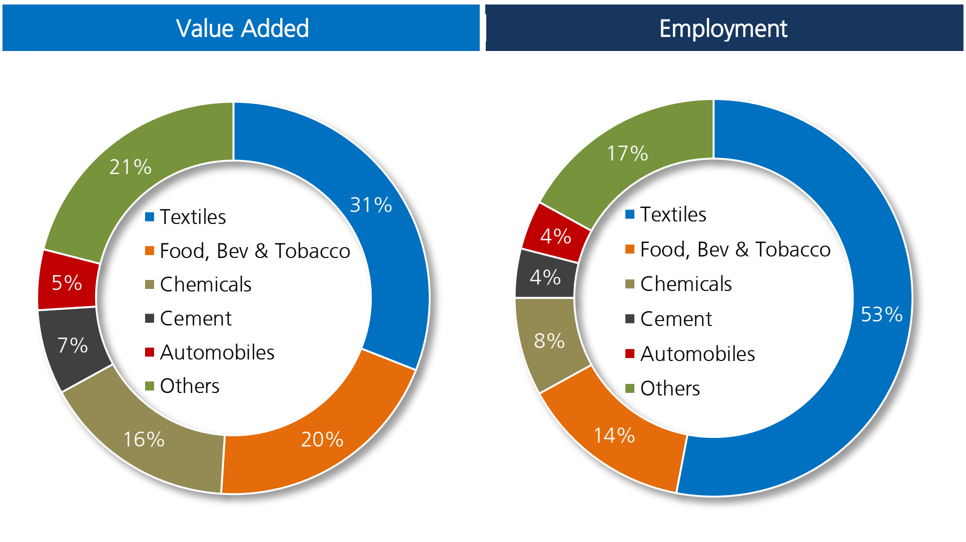
Section 1 describes the structure of manufacturing activity in the country. Section 2 focuses on the pattern of industrial growth. Section 3 identifies the reasons for the slow down. Section 4 presents the policies for industrial revival. Finally in section 5 the plight of small-scale manufacturing is highlighted.

12.1. LARGE-SCALE MANUFACTURING

The last Census of Large-Scale Manufacturing was undertaken in 2005-06. The industries contributing significantly to value added and employment, according to the Census, are shown in Figure 12.1.

The two major industries are textiles and food, beverages and tobacco respectively. Combined together they accounted for 51 percent of the value added and over 67 percent of the employment, also shown in Figure 12.1. Other major industries are chemicals, non-metallic mineral products, petroleum refining, automobiles and machinery.

Figure 12.1: Share of Major Industries in Value Added and Employment in the Large-Scale Manufacturing Sector

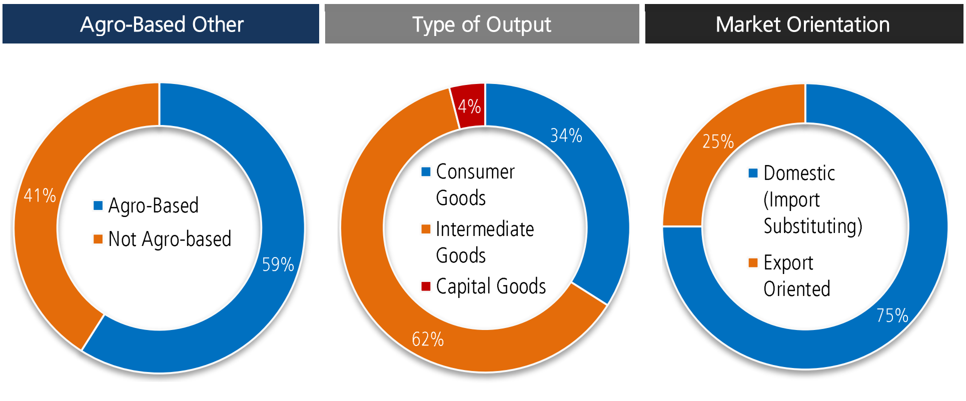


Source: PBS, CMI, 2005-06

Analysis has been undertaken of the characteristics of industries in terms of links with agriculture, type of output and market orientation. The summary findings are highlighted in Figure 12.2. Over 60 percent of the sector was agro-based, either in terms of backward or forward linkages. There is also some diversity in the output. 34 percent of production was of consumer goods, 62 percent of intermediate goods and only 4 percent of capital goods. A larger share of industry, 72 percent, was focused on import substitution while 28 percent has been export oriented.

The major agro-based industries are textiles, sugar, cigarettes, vegetable ghee and soft drinks. Most of these industries are producing consumer goods. The other major consumer goods industries are pharmaceuticals, automobiles and electronics. Intermediate goods are the output of industries like cotton yarn, petroleum products, chemicals, iron and steel and cement. There is very little presence of capital goods industry in Pakistan and bulk of the machinery is imported. The principal export oriented industries are textiles, leather products and cement.

Figure 12.2: Distribution of Industries by Type – (% of Value Added)



Source: MOF, Fiscal Operations

12.2. PATTERN OF INDUSTRIAL GROWTH

As highlighted above, the growth rate of the manufacturing sector, large-scale and small-scale combined, has fallen during the last eight years. This section examines the pattern of growth in large-scale manufacturing. Data at the individual industry level is not available in the case of small-scale manufacturing.

Table 12.2 presents the growth rates of individual industries from 1990-2000 to 2016-17. During the period, 1999-2000 to 2007-08 of the Musharraf Government, most industries showed a growth rate in output of above 6 percent. Even double-digit growth rates were registered by industries like cotton cloth, cement and beverages. The only decline was observed in the production of pig iron and billets due particularly to severe problems in the operations of the Pakistan Steel Mill.

The period, 2007-08 to 2012-13, witnessed a sharp decline in the growth rate of large-scale manufacturing to only 2 percent. Most industries showed growth of even less than 3 percent. In fact, negative growth was observed in industries like fertilizer (urea), chemicals and TV sets.

This slowdown has persisted in some industries after 2012-13. Industries which continue to exhibit low growth are cotton yarn, cotton cloth, vegetable ghee and chemicals. A significant recovery is observed only in the case of fertilizer, sugar and beverages.

Table 12.2: Growth of Major Large-Scale Industries

Industry	Unit	1999-2000	2007-08	2012-13	2016-17*
Cotton Yarn	(Million Kg)	1670	2809 (6.5)	3070 (1.8)	3428 (2.8)
Cotton Cloth	(Million Square Meter)	437	1016 (10.5)	1029 (0.2)	1043 (0.3)
Fertilizer (Urea)	(000 Tons)	3785	4925 (3.3)	4125 (-2.7)	5913 (8.5)
Vegetable Ghee	(000 Tons)	695	1311 (6.0)	1148 (0.3)	1305 (3.2)
Sugar	(000 Tons)	2429	4733 (8.3)	5073 (1.4)	7048 (8.2)
Cement	(000 Tons)	9314	26751 (13.2)	31098 (3.0)	37021 (4.4)
Beverages	(Million Dozen Bottles)	195	613 (14.3)	760 (4.3)	1010 (7.1)
Cigarettes	(Million)	46976	67250 (4.5)	67377 (0.0)	34342 (-16.8)
Chemicals	(000 Tons)	458	734 (5.9)	654 (-2.3)	776 (4.3)
TV Sets	(000 Tons)	121	716 (22.2)	460 (-8.8)	439 (-1.2)
Pig Iron	(000 Tons)	1107	993 (-1.3)	201 (-31.9)	0 (-0.0)
Billets	(000 Tons)	345	279 (-2.7)	1638 (35.4)	4099 (22.9)

*Full year estimates are not yet available for 2017-18.

Source: PES

12.3. CAUSES OF THE SLOWDOWN

A number of factors have contributed to the slowdown of industry after 2007-08. These range from decline in effective protection, loss of export competitiveness, high incidence of outages, excessive tax burden and lack of buoyancy in demand for consumer goods. These are discussed below.

Decline in Effective Protection: Pakistan has been undergoing a process of trade liberalization since the 90s. The move in this direction has been accelerated during the tenure of the last two IMF programs. Consequently, the large collection of import substituting industries has been subjected to more intensive competition from foreign sources of supply.

The scaling down of import tariffs has proceeded at a fairly rapid pace. The maximum customs duty in the mid-90s was 60 percent. By 2007-08 this had been reduced to 35 percent, as shown in Table 12.3. The tariff structure remained unchanged till 2010-11. The big and more rapid moves have taken place during the Extended Fund Facility (EFF) of the IMF from 2013 to 2016. The maximum tariff was brought down initially to 30 percent, then to 25 percent in 2014-15 and to 20 percent in 2015-16. Simultaneously, the number of slabs was reduced from seven to four. Also, the minimum tariff was raised from zero percent to three percent, primarily as a revenue generating measure.

Table 12.3: Scaling Down of Import Tariffs

	Number of Slabs	Minimum Tariff (%)	Maximum Tariff (%)	Average Effective Rate of Protection (%)
2007-08 to 2010-11	7	0	35	65
2012-13	7	0	30	52
2013-14	7	0	30	52
2014-15	6	1	25	48
2015-16	5	2	20	35
2016-17	4	3	20	33
2017-18	4	3	20	33

Source: FBR Customs Tariffs

The impact of the scaling down of tariffs has implied a major loss in the extent of effective protection. The average rate of effective protection was as high as 65 percent in 2010-11, which has been halved to 33 percent by 2016-17. Of course, it might be argued that this was potentially a good move. It exposed domestic industry to more foreign competition and thereby put pressure for more innovation and increased efficiency. Unfortunately, there have been simultaneously two other developments which have greatly handicapped Pakistani industry.

First, since 2013-14 up to 2016-17, the policy of the Government has been to maintain a, more or less, nominal fixed exchange rate. Consequently, the real effective exchange rate of the rupee appreciated by almost 24 percent. This rendered imported goods even cheaper and exacerbated the impact of the reduction in import tariffs.

Second, Pakistan signed a comprehensive Free Trade Agreement (FTA) in the last days of the Musharrat era with China. Presumably, the objective was to gain preferential access to Pakistani exports in the very large Chinese market. However, the opposite has happened. There has been a virtual invasion of cheap Chinese products into the Pakistani market.

The numbers in Table 12.4 highlight the extent of penetration by imports from China of manufactured goods. At the time of the signing of the FTA, Chinese exports to Pakistan were $2.7 billion. By 2016-17, they had risen almost four times to over $10 billion. Today, over 63 percent of the global trade deficit of Pakistan in manufactured goods, excluding petroleum products, is with one country, China. The gap would be even larger but for significant under-invoicing by Chinese exporters. This has crippled Pakistani manufacturers even more.

The story of the slowdown of large-scale manufacturing is one of a fundamentally wrong mix of policies. Trade liberalization should have been accompanied by a policy of market based exchange rate determination. Further, the pace of opening up of the Pakistani market should have been more gradual to give local manufacturers enough time to adjust. The signing of FTA with China should have had a negative list of products which continue to have MFN tariffs rather than concessionary import duties. Given the imbalanced outcome Pakistan must now renegotiate the FTA with China.

Table 12.4: Growth of Imports from and Exports to China* – ($ million)

	1999-2000	2005-06	2012-13	2016-17
IMPORTS				
China	472	2706	6642	10077
World	6392	10982	25791	32659
Share of China (%)	*7.4*	*14.2*	*25.8*	*30.9*
EXPORTS				
China	120	310	1740	1068
World	7676	14440	19698	18386
Share of China (%)	*1.6*	*2.1*	*8.8*	*5.8*
Trade Deficit with				
China	-352	-2396	-4902	-9009
World	1284	-4642	-6093	-14273
Share of China (%)	-	*51.6*	*80.5*	*63.1*

*excluding POL products
Source: SBP

Loss of Competitiveness: Pakistan's manufactured exports grew annually by 4 percent from 2007-08 to 2013-14. Thereafter, the have been declining. By 2016-17 they had fallen by 10 percent in relation to the peak level in 2013-14. Consequently, export-oriented industries, both large-scale and small-scale, have lost their buoyancy. In particular, the textile industry, which accounts for 57 percent of exports, has been badly hit.

The first reason for the loss of export competitiveness is the increasing overvaluation of the rupee after 2013-14 as highlighted earlier. This has reduced profitability in exporting and restricted the size of the exportable surplus. The second reason, frequently highlighted by Trade Associations, is the rising cost of energy inputs of electricity and gas into the production process. The trend in tariffs of these inputs is presented in Table 12.5.

Table 12.5: Electricity and Gas Tariffs on Industry

	Electricity Tariff[a] (Rs per kwh)	Gas Tariff (Rs per mcft)		International Oil Price (in Rs) (Index 2007-08 = 100)
		Industry	Power	
2007-08	6.00	251.55	238.88	100.0
	(9.6)[b]			
2012-13	10.51	488.23	488.23	196.1
	(10.9)			
	(2.5)[c]	(13.3)[c]	(14.3)	(13.5)
2018-19	17.64	780.00	780.00	144.5
	(14.50			
	(4.1)	(6.7)	(6.7)	(-4.3)

[a]The B-1 tariff up to 40 KW (400 Volts) | [b]Tariff in cents per kwh | [c]Annual Rate of Change of Tariff (in cents per kwh)
Source: MOF, PES

A big jump of almost 30 percent took place in the electricity tariff for industry in 2013-14. This was a prior condition to be implemented before the commencement of the IMF EFF program. The objective was to reduce the large tariff differential subsidy to the power sector. The high tariff has been maintained since then despite the fall in the international price of furnace oil by almost 45 percent by 2017-18. Monthly reductions have been made by NEPRA through the fuel adjustment charge (FAC). Here also, the size of the reduction has been limited by the imposition of a tariff rationalization surcharge on the industrial tariff of Rs 2 per kwh. Consequently, the industrial electricity tariff in June 2017 was equivalent to 13.2 cents per kwh. The corresponding tariff in Bangladesh and India ranges from 8 to 10 cents per kwh. This has placed Pakistan's exporters at a significant competitive disadvantage.

Similarly, gas tariffs have continued to rise. Many industrial units use natural gas as the input into captive power generation. A big jump took place when the Gas Infrastructure Development Cess (GIDC) was levied on natural gas in 2012-13. In addition, there have been shortages in the supply of gas, especially to industrial units in Punjab.

Excessive Tax Burden: The large-scale corporate structure and proper documentation of transactions have made industrial units a favorite choice for levy of taxes, both indirect and direct. During the last few years, the national tax-to-GDP ratio has gone up from less than 10 percent of the GDP to almost 12 percent of the GDP. Much of the increase in the nominal tax burden has fallen on industry, consisting of large-scale manufacturing, electricity, gas and construction companies.

The tax measures implemented include the enhancement in the standard tax rate of GST from 15 percent to 17 percent. In addition, in the case of a number of consumer goods industries the tax has been levied on the retail price and not on the ex-factory price. The GST rates on petroleum products have been scaled up to two the three times the standard rate.

In addition, the minimum income tax on companies has been raised from 0.5 percent of turnover to 1.5 percent. Contribution to the workers' welfare and profits participation funds has remained high. Higher presumptive/withholding taxes have been levied on industrial and commercial importers, on electricity bills, on dividends, on contracts and so on. The excise duty on cigarettes has also been substantially enhanced.

Overall, Pasha [2013] estimates that the overall nominal tax burden of Federal and Provincial taxes, direct and indirect, on industry in 2011-12 was much as 74 percent of the total tax revenues. The corresponding share for agriculture was only 2 percent and 24 percent on services respectively.

The contribution of industry has fallen somewhat in recent years due to the development of a broad-based sales tax and a higher presumptive income tax on services. The share currently of industry is estimated at 67 percent. Therefore, the tax burden on industry remains very high at almost five times on the economy as a whole.

Power Outages: Last but not the least, is the impact of power load-shedding on the industrial sector. The incidence of outages became visible from 2007-08 onwards as the demand – supply gap of electricity increased.

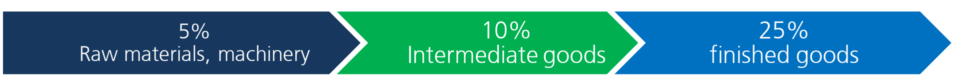
The study on costs of power load-shedding by Pasha [2013] highlights in quantitative terms the incidence and associated costs to industry. At its peak, outages hit industry by affecting production by over 5 hours daily on average. Consequently consumption per industrial unit fell sharply. Firms had to make all kinds of adjustments to cover at least part of the output lost during the outages.

Chapter 6 has earlier quantified the total cost of power outages in 2015-16 to industry at Rs 131 billion, equivalent to almost 3 percent of the actual value of output. Almost $2 billion of exports and employment of over 0.5 million workers have been affected in the industrial sector by outages.

12.4. POLICIES FOR INDUSTRIAL REVIVAL

There is need to attach high priority to achieving faster growth of the large-scale manufacturing sector if the overall GDP growth rate is to be significantly enhanced. The type of policies that need to be adopted are given below.

First, the level of effective protection to import-substituting industries needs to be enhanced, as highlighted above. As such, the import tariff structure may be changed as follows:



This will raise the effective protection level on average from 33 percent to 45 percent.

Second, there is need to focus on providing adequate export incentives. The overvaluation of the rupee has to be removed. Since December 2017 up to June 2018, there has been a spate of small devaluations of 3 to 5 percent each time. This has reduced the overvaluation in the exchange rate down to 11 percent. The Government has also put in place an export incentive package. Duty drawback rates have been enhanced to 7 percent for textile garments; 6 percent for textile made ups; 5 percent for yarn and fabric and 7 percent for sports goods, leather and footwear.

The incentive package also includes the removal of customs duty and sales tax on the import of cotton. Also, the customs duty on man-made fibers, other than polyester, and sales tax on the import of textile machinery have been withdrawn. Recently, the export package has been extended for three more years and the coverage widened to include electric fans, leather products, engineering goods, auto parts, furniture and food products.

There has been a favorable response to the export promotion measures. Exports have started growing once again in 2017-18 by 13 percent. However, this process could be facilitated even more if the duty drawbacks and the incentives are paid at the same time as the export receipts by commercial banks. These banks could then be reimbursed by the SBP.

Third, the competitive disadvantage arising from the relatively high tariffs of electricity and gas also needs to be focused on. The tax component in pricing of fuel for electricity needs to be reduced, especially in the case of furnace oil. Also, the tariff rationalization surcharge on industrial tariff needs to be removed and correspondingly raised for large domestic and commercial consumers.

Fourth, the time has also come for renegotiating the FTA with China which has hurt Pakistani industry. There is need for more quid pro quo from China. Also, in the case of items where there is evidence of under invoicing a regime of minimum import prices may be introduced.

Fifth, there is a strong case for shifting some of the tax burden away from industry to other sectors. The sales tax rate needs to be brought down from 17 percent once again to 15 percent. Recently, the Government has announced a phased reduction in the corporate income tax rate from 30 to 25 percent.

Finally, the process of investment in enhancement and modernization of capacity has to be promoted. The level investment in large-scale manufacturing has fallen from 3 percent of GDP in 2004-05 to below 1.5 percent of the GDP currently. Two incentives for investment need to be augmented. The accelerated depreciation allowance should be raised from 25 percent 50 percent and the tax credit doubled on expenditure on balancing, modernization and replacement.

We turn next to the plight of small-scale manufacturing in Pakistan.

12.5. SMALL-SCALE MANUFACTURING

The lobbying role of FPCCI, PBC, APTMA and other associations of large firms is currently at its peak. Proposals are being put forward to the new Prime Minister and heads of Economic Ministries for arresting the decline in exports, reducing the impact of cheap imports on domestic industries, facilitating the ease of doing business, reducing the tax burden on the manufacturing sector and so on.

Unfortunately, the vast multitude of small units from the manufacturing and other sectors have no access to the corridors of power to voice their problems, which have virtually reached crisis proportions. They are increasingly being marginalized from playing a role in the process of development of Pakistan.

Their greater engagement is vital for achieving more inclusive growth and for promoting the process of innovation and enhancement of productivity. There is the saying, '*Small is beautiful*'. In fact, in many of the East Asian tigers who achieved phenomenal export-led growth the cutting edge for increased competitiveness and diversification was small firms. For example, small firms account even now for 40 percent of South Korea's exports.

12.5.1. Size

Small-scale manufacturing units constitute 42 percent of the total population of small production units in the country. There is need to understand and quantify the contribution of these small industrial units. How are these units performing currently? What is the degree of government and institutional support to the small-scale sector? What measures need to be taken on a priority basis to raise the performance of small units and increase further their contribution to the national economy?

Contrary perhaps to perceptions, small-scale manufacturing is large and spread all over the country. The Factories Act defines small enterprises as those which employ less than ten workers. The SBP defines small units as those which employ up to 50 workers and have annual sales up to Rs 150 million. However, in India units are identified by the value of plant and machinery.

The first indicator is total employment. According to the Labor Force Survey of the PBS of 2014-15, the number of workers employed in industrial units with less than 10 workers is as much as 5.7 million (see Table 12.6). The corresponding number in large-scale manufacturing is 3.1 million. In effect, 65 percent of the employment in the manufacturing sector is in small units.

This large share is a revelation and underscores the need for an employment promotion policy to focus also on small units. It also provides an opportunity to recognize the extraordinary skills of Pakistani crafts persons, working mostly in small units. They have demonstrated the ability to produce and sell internationally the most sophisticated products like surgical instruments, sports goods, carpets, etc. But they have unfortunately remained the most neglected component of our labor force.

Table 12.6: Share of Small-Scale Manufacturing in Total Employment in Manufacturing

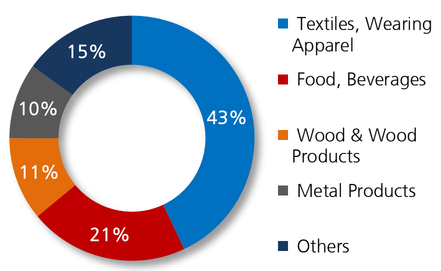
	Total Employment	Manufacturing – (000)			
		Percentage	Employment	Employment in Small-Scale Units	Percentage in Small-Scale Units
2001-02	39,600	13.8	5,465	3,006	55.0
2003-04	41,750	13.7	5,719	3,425	59.9
2005-06	46,940	13.8	6,477	4,125	63.7
2007-08	49,090	13.3	6,528	4,137	63.4
2009-10	51,870	13.2	6,846	4,474	65.4
2012-13	56,010	14.1	7,897	5,128	64.9
2014-15	57,420	15.3	8,785	5,684	64.7

Source: PBS, LFS

The distribution of small units is concentrated largely in five industries – textiles and wearing apparel, food and beverages, leather, wood products (furniture) and fabricated metal products. The first two industries have a combined share in number of units of 64 percent (see Figure 12.3).

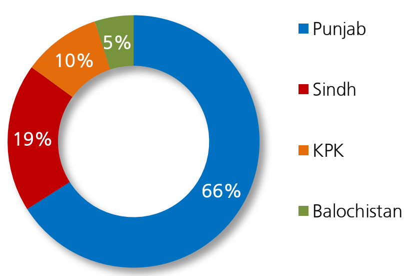
The regional distribution of employment in small units is tilted towards Punjab with a share approaching 66 percent (see Figure 12.4). In fact, cities like Faisalabad, Gujranwala, Sialkot, Gujrat, Kasur, etc., have acquired a reputation for specializing in particular product lines. Sindh has a share of 19 percent, followed by a combined share of Khyber-Pakhtunkhwa and Balochistan of 15 percent.

Figure 12.3: Share* of Industries in Small-Scale Manufacturing – 2012-13



*Based on number of units with employment less than 10 workers
Source: PBS, Economic Census, 2005.

Figure 12.4: Share* of Provinces in Employment in Small-Scale Manufacturing – 2014-15



*Based on number of units with employment less than 10 workers
Source: PBS, Economic Census, 2005.

A key indicator is the contribution of small units to exports. These include a wide range of products ranging from textiles to leather and leather products, carpets, sports goods, surgical goods, cutlery, furniture, pharmaceuticals, etc. The combined export of these goods in 2016-17 is $4.8 billion. The represents a share of 25 percent in total manufactured exports. Interestingly, small units are more export oriented than large industrial units. The share of exports in value of output is almost 40 percent in the case of the former as compared to 25 percent in the latter. This highlights the strategic importance of small units in the current context.

Table 12.7: Share of Small-Scale Manufacturing (SSM) in the GDP and the Manufacturing Sector

Years	Share of SSM in	
	GDP	Manufacturing
1959-60	5.0	38.8
1980-81	4.0	26.5
1990-91	3.7	25.2
2005-06	1.2	8.7
2017-18	1.9	14.8

Source: SBP, Handbook of Statistics on Pakistan's Economy and PES.

The PBS has done a great disservice to the population of small manufacturing units by grossly understating their size and overstating their growth rate in the GDP estimates. Apparently, as of 2017-18, the share in national value added of small-scale units, is less than 2 percent and the growth rate of the small-scale manufacturing sector is shown as over 8 percent and largely unchanged year-to-year. This is due primarily to lack of annual information. Both these magnitudes, low share and high growth, inevitably lead to a lack of focus on small manufacturing units.

There was time in the 80s and 90s when the reported contribution of small units to industrial value added was as high as 25 to 30 percent (see Table 12.7). The PBS now reports the share at 15 percent. With an employment share of as much as 65 percent, the implication is that the labor productivity is less than one tenth of large units. This is highly unlikely given their relative competitiveness and success in achieving a higher share of output devoted to exports. There is a need for PBS to raise substantially the contribution of small units to manufacturing value added.

12.5.2. Growth

The next issue is whether small units have actually been able to sustain a high growth rate of over 8 percent. The answer is an unambiguous no. Employment growth from 2005-06 to 2014-15 has been under 4 percent per annum as compared to over 4 percent in the case of large manufacturing units. It is highly unlikely that labor productivity has increased by over 4 percent annually in small units in the presence of various constraints.

Table 12.8: Growth of Exports of Manufactured Goods*

Export Item	Unit	2012-13	2013-14	2014-15	2015-16	2016-17
TEXTILES						
Cotton Cloth	Mill Sq M.	2160	2352 (8.9)	2074 (-11.8)	2106 (1.5)	1961 (-6.9)
Knitwear	Mill Doz.	98	116	104	120 (15.4)	113 (-5.9)
Bed Wear	000 MT	264	316	325	327 (0.6)	353 (8.0)
Towels	000 MT	170	171	172	178 (3.5)	182 (2.2)
Ready Made Garments	Mill Doz.	27	30	31	32 (3.2)	35 (9.4)
*which include exports by small-scale units						
OTHER MANUFACTURED GOODS						
Carpets	Th. Sq M	3,066	3,299 (7.6)	2,493 (-24.4)	1,922 (-23.0)	1,662 (-13.5)
Sports Goods-Footballs	Th. Doz.	2,924	4,389 (50.1)	3,176 (-27.6)	3,709 (16.8)	3,034 (-18.2)
Leather Tanned	Mill Sq M	27	27 (0.0)	22 (-18.6)	16 (27.3)	23 (43.8)
Leather Garments	Th. Doz.	944	1,266 (34.1)	965 (-23.8)	858 (-9.1)	746 (-13.1)
Leather Gloves	Th. Doz.	5,690	7,437 (30.7)	7,095 (-4.6)	5,119 (27.9)	4,879 (-4.7)
Surgical Goods	$ Mill	303	335 (10.6)	341 (1.8)	358 (5.0)	339 (-5.3)
Chemicals	$ Mill	324	646 (99.4)	504 (-22.0)	409 (-18.9)	438 (7.0)
Jewellery	$ Mil	1177	324 (-72.4)	6 (n)	8 (n)	5 (n)

n = negligible export

Source: PBS, External Trade Statistics.

The clear manifestation of an incipient crisis in the small-scale sector is the precipitous decline in exports since 2012-13 (see Table 12.8). Compared to the peak, either in 2012-13 or in 2013-14, the volume of exports of carpets has fallen by 50 percent, of sports goods by 31 percent, of leather products by 41 percent, of surgical goods by 5 percent and so on. Given the export orientation of small units, the level of production has consequently fallen sharply thereby drastically reducing profitability and leading in many cases to losses. The critical nature of the current situation is indicated by the sharp jump in non-performing loans to small units to over 20 percent of bank's outstanding financing to these units. The recovery in 2017-18 of exports has led to only a partial improvement in the production level of small units.

12.5.3. Constraints

Small manufacturing units have been hit disproportionately by power load-shedding. According to a survey of 412 units by the Institute of Public Policy, the number of outages faced annually by these units is over 1050. Consequently, the percentage of time lost is over 25 percent. Unfortunately, due to financial constraints, less than 35 percent of the units have been able to acquire generators. The usual response is working overtime or changing shifts, leading to higher labor costs. In effect, the percentage of output not recovered is 10 percent. On average, the total annual outage costs per unit is Rs 300,000. The outage cost per kwh approaches Rs 40. Overall, the cost nationally of loadshedding to small manufacturing units exceeds Rs 83 billion.

The second constraint is that historically the SME sector generally and the small units in manufacturing in particular have been discriminated in access to bank credit. The SBP estimates that the latter have had access to financing which is only 2 percent of total bank credit in the country. These units face pressures to pay bribes to functionaries of various departments. On the average, a typical unit also has to pay nine taxes. This imposes high compliance costs. Further, the general lack of competitiveness, due to an overvalued exchange rate and other factors, limits their efforts to raise exports as in the case of large units.

12.5.4. Recommended Support Policies

A comprehensive package of support needs to be put together for SMEs throughout Pakistan. This will include, first, a doubling of the share in bank credit, as proposed recently by the Governor of the SBP. The Central Bank should facilitate this increase by introducing a Credit Guarantee Scheme for small-scale industries. This will involve SBP taking on the role of a guarantee organization for the advances which are left unpaid, including interest overdue. A tax credit scheme may also be introduced for commercial banks linked to the increase annually to SMEs of credit.

Second, the Provincial Small Industries Corporations may setup a special Development Fund for small units, with a ‘single window’ operation. The Fund may focus on providing equity type support to entrepreneurs for setting up new projects.

Third, there is need for establishment of technical support services, especially in districts with a cluster of units in a particular product line. This task could be taken up by the Small and Medium Enterprises Development Authority (SMEDA), which has been somewhat moribund in recent years and needs to be activated. Also, the capacity of training facilities in skills required by small units needs to be enhanced.

Fourth, tax policy has to focus on small enterprise development. There is need for rationalization of the number of taxes to be paid. The maximum tax rate on Associations of Persons / Partnerships must be brought down from 35 to 25 percent. Simultaneously, the sales tax exemption limit ought to be doubled.

Fifth, and importantly, along with the overall steps being taken to boost exports, special incentives need to be given to small enterprises. This will include the exemption from the 1 percent export presumptive income tax, since in any cases the profit may be less than the recently enhanced exemption limit of Rs 1,200,000. In addition, the presence and role of '*deemed exporters*' should be recognized and the zero-rating of sales tax also extended to these entities.

There is no doubt that focusing on improving the performance of small manufacturing units will impact favorably on the lives of millions of workers, promote more widespread regional development and help in diversifying the exports base of the country.

Chapter 13:

GREEN GROWTH

Pakistan is a confronted with a number of serious environmental problems including an emerging water scarcity, rapid deforestation, rising air pollution and increasing vulnerability to natural disasters. In addition, there are concerns about the impact of climate change. These developments could have a major impact on the medium and long-term sustainability of economic growth in Pakistan. As such, this Chapter explores how the process of growth can be made 'green' and thereby ameliorate the negative impacts of ecological problems and climate change.

Table 13.1: Environmental Performance Indicators for a Sample of Countries – (Percentile)*

Indicators	Pakistan	India	Sri Lanka	Bangladesh	Malaysia	Indonesia
Environmental Burden of disease	33	29	31	30	64	34
Access to sanitation	31	9	55	17	66	28
Access to Water	44	42	31	26	71	27
Water quality index	57	70	91	85	50	55
Water stress index	10	10	30	44	67	69
Water scarcity index	5	60	24	94	49	59
Indoor air pollution	14	18	12	4	74	20
Outdoor air pollution	3	33	13	-	71	12
Sulphur dioxide emissions per populated land area	36	25	36	49	43	43
Nitrogen oxides emissions per populated land area	70	-	35	47	36	44
Non-methane volatile organic compound emissions per populated land area	58	32	26	26	18	16
Ecosystem zone	25	11	70	21	47	20
Greenhouse gas emissions per capita (including land use emissions)	86	91	83	99	20	35
Industrial greenhouse gas emissions intensity	23	13	79	48	49	55
CO_2 emissions per electricity generation	56	-	61	27	32	23
Biome protection	61	26	63	9	84	88
Marine protection	63	50	35	25	69	68
Trawling and dredging intensity	37	42	63	-	2	17
MTI slope	65	81	31	6	73	80
Annual change in forest cover	2	100	9	32	24	4
Growing stock rate	1	76	2	23	65	100
Agricultural water intensity	3	10	12	95	55	61
Pesticide regulation	15	17	47	6	62	64
Agriculture subsides	54	14	45	94	30	22

*The higher the percentile, the better the performance.

Source: Yale University 2011.

An Environmental Performance Index (EPI) has been developed by Yale University, USA. The standing of Pakistan in different indicators is compared with countries like India, Sri Lanka, Bangladesh, Malaysia and Indonesia (see Table 13.1; a lower percentile indicating a worse ranking among 132 countries). Pakistan does poorly in the water scarcity index (5th percentile), indoor air pollution (14th percentile), outdoor pollution (3rd percentile), annual change in forest cover (2nd percentile), growing stock rate (1st percentile) and pesticide regulation (15th percentile). Pakistan appears to have relatively more ecological problems.

This Chapter is organized as follows. Section 1 focuses on the water shortage, Section 2 on deforestation, Section 3 on air pollution and Section 4 on natural disasters. The environmental laws present in Pakistan are highlighted in Section 5 and Section 6 discusses issues related to environmental management. This is followed by a profile of the present debate on solving ecological problems in Section 7. Finally, the potential impact of climate change is highlighted in Section 8.

13.1. WATER SHORTAGE

The country's fresh water supply is primarily fed by river flows (140 MAF) which supply 70 percent of the water, with the rest by rainfall in monsoons. The river flows are largely fed by glacial and snow-melt from the Hindukush – Karakoram – Himalayan (HKH) mountains, which are sensitive to climate changes.

Since 1999-2000, there has been little change in overall water availability at the farm gate, ranging from 133 to 138 MAF. Surface water provided by the irrigation system is subject to significant losses due to poor maintenance of canals. Ground water is mostly extracted by private tube wells, the number of which has increased by 58 percent since 1999-2000 to almost one million currently. 81 percent of these tube wells are operated with diesel and the rest, 19 percent, by electricity. 84 percent of the tube wells are in Punjab, while a number of deep tube wells have been installed in Balochistan. The over investment in tube wells is a classic example of the 'tragedy of the commons', with the water extracted per tube well falling by 78 percent in the last decade. A market has also developed for tube well water, especially in Punjab. Recently, a National Water Policy has been developed by the Federal Government.

13.2. DEFORESTATION

Deforestation is taking place rapidly in Pakistan. Almost 22 percent of the forest area has been depleted since 2000, which now stands at just above 2 percent of the land area. Almost two thirds of the forest area is in the Northern part of the country. According to the World Bank the annual cost of deforestation is in excess of 2 percent of the GDP.

Deforestation in the North leads to more rapid silting of dams, reservoirs and canals. It increases vulnerability to floods. One of the primary causes of deforestation is the poverty of people who live close to the forests, who overexploit the resources for meeting their fuel and fodder requirements. Also, depletion of forests is the consequence of poor regulations and governance, with large-scale smuggling of timber for furniture and construction activities.

13.3. AIR POLLUTION

Urban air pollution is emerging as a serious hazard, leading to higher incidence of respiratory diseases. Emission from vehicles, burning of solid waste, brick kilns and natural dust are responsible for the increase in SPM. The highest incidence is in Lahore (117 ug/m3), followed by Peshawar (71 ug/m3) and Karachi (42 ug/m3). Indoor air pollution (due to burning of fuel wood) and water pollution (due to inadequate sanitation and presence of chemicals) are emerging problems.

Table 13.2: CO2 Emissions in a Sample of Countries

Country	Year	In Metric tons per capita	Kg per 2005 PPP $ per capita
China	2009	5.77	0.93
India	2009	1.66	0.58
Indonesia	2009	1.90	0.51
Malaysia	2009	7.14	0.55
Pakistan	2009	0.95	0.40
Sri Lanka	2009	0.62	0.14
Thailand	2009	4.10	0.55

Source: WDI

CO2 emissions are relatively low in Pakistan as compared to other countries, and have grown by 3 percent on a per capita basis, as shown in Table 13.2. The share of emissions due to gaseous fuel is about 42 percent, followed by liquid fuel with 37 percent and solid fuel with 11 percent. The contribution of gaseous fuel has been enhanced in Pakistan by the greater dependence on natural gas as a source of energy.

13.4. NATURAL DISASTERS

The Incidence of natural disasters has also increased. Since 2000, Pakistan has seen a severe drought in 2001, the earthquake in 2005 and the mega floods of 2010, which covered almost 20 percent of the land area. Almost 10 percent of the crop output was lost due to the drought. The earthquake in the North destroyed, completely or partially, almost 600,000 housing units. ERRA has since invested over Rs 110 billion in earthquake rehabilitation and reconstruction work. Recently, parts of Balochistan have been hit by a severe earthquake. The floods of 2010 affected over 20 million people, almost 5 million acres of cropped area, over 2000 deaths and loss of over 320,000 livestock. The damages have been estimated at almost $9 billion.

13.5. ENVIRONMENTAL LAWS AND POLICIES

In order to preserve the environment, Pakistan is one of the first countries to have issued laws and policies to protect the environment. However, the Federal and Provincial governments have not had a pro-active approach in implementing the national plans and policies that have already been prepared.

The Provincial governments claim that the delay in implementation of policies is due to inadequate transfer of powers. While the 18th Amendment called for devolution, the centre has not transferred the administrative powers to the Provinces. According to senior officials, it will take approximately one year for administrative powers to be transferred to the Provinces. Consequently, the Provincial Governments have not pursued some of the policies which have been discussed below. Additionally, there are coordination problems. Following devolution of the Ministry of Environment, an apex Federal body has not been established at the Federal level. Article 143 of the Constitution gives the Federal Government the authority to act as the focal point for fulfilling international obligations on global environmental protocols and agreements. In the absence of proper coordination and oversight, it is unlikely that these policies and acts will be successfully implemented.

Given below is an overview of the main environmental laws and policies in Pakistan.

13.5.1. Environmental Protection Act, 1997

The Environmental Protection Act, 1997 aims to provide for the protection, conservation, rehabilitation and improvement of the environment. It also aims to promote the prevention and control of pollution and encourage sustainable development. The salient features of this Act are as follows:

- Under this act, the Federal Government is mandated to call for the establishment of the Pakistan Environmental Protection Council. The Council is to hold meetings and frame its own rules of procedure. The Council will have several functions: coordination supervision of the enforcement of the provisions of this Act approve the national environmental quality standards; approve the comprehensive national environmental policies and ensure their implementation; and provide guidelines for the protection and conservation of species and habitats.
- The Federal Government will establish the Pakistan Environmental Protection Agency and this agency will exercise the powers and perform the functions assigned to it under this Act. The Federal agency will be in charge of implementing the national environmental policies that are approved by the Council, will publish and prepare a report on the National Environment and will also revise the National Environmental Quality Standards with the approval of the Council.
- The Federal agency will undertake enquiries and investigations into the environmental issues. Under this Act, it has the power to inspect under a search

warrant issued by the Environmental Court or Environmental Magistrate any building, premises or vehicle that is suspected of breaking environmental laws. An individual may be summoned for investigation pertaining to environmental issues.

- A National Environmental Coordination Committee will be set up by the Federal Government to carry out the functions of this Act.
- Every Provincial government will establish a Provincial Environmental Protection agency to perform the functions it is specified to perform. Additionally, Provincial Sustainable Development funds will be established from grants and loans advanced by the Federal Government or the Provincial governments, aid assistance, etc. These funds will be utilized in accordance with need.
- Environmental impact assessment will be carried out in areas such as trade, manufacturing, business activities, etc. with full participation from the public.
- Import of hazards waste, handling of hazardous substances will not be allowed. Regulation of motor vehicles will be carried out to ensure adherence to the highest standards.
- Whosoever fails to comply with the environmental standards that are in place, will be subjected to fine, which may extend to one million rupees. The environmental court or environmental magistrate can imprison a person or party up to two years if they fail to comply.
- The Federal Government can by notification establish an environmental Tribunal to deal with cases pertaining to the environment. The proceedings of this tribunal will be deemed to be judicial proceedings.
- The Federal Government can delegate any of the powers by notification in the official gazette to the Provincial government and the Provincial Government has the freedom to delegate them to local government.

13.5.2. National Drinking Water Policy

The National Drinking water policy aims to increase access to drinking water by establishing a new drinking, water supply and distribution system, and upgrading existing systems for both rural and urban areas (and especially for mega cities) on the basis of detailed assessment and analysis. The salient features of this policy are discussed below.

- Surface, ground water and coastal resources of the country will be protected in line with the National Environmental Policy and Pakistan Environmental Protection Act - 1997. Water will be treated to ensure that it complies with the National Drinking water quality standards.

- Water safety planning will be promoted, and a national action plan for the promotion of household water treatment options will be developed and implemented.
- Surveillance agencies will be established which will undertake independent assessment of the water quality, and compliance to the national drinking water quality standards will be reported to the water regulatory agencies.
- Community participation and empowerment, especially that of women and children will ensure community ownership. A national behavioral change and communication strategy will be formulated and implemented to create public awareness. Additionally, public-private partnerships for enhancing access to safe drinking water will be developed.
- A drinking water and management information system will be established at the Federal, Provincial and local levels. For inter and intra-sectoral coordination, a multi-stakeholder water and sanitation coordination committee will be established.
- The Pakistan safe drinking water act will be enacted to ensure compliance with national drinking water quality standards. The water conservation act and relevant standards and guidelines will be enacted. Standards for water saving plumbing equipment and appliances and legislation for regulation of groundwater exploitation will be enacted.

13.5.3. National Forest Policy

The national forest policy aims to improve conservation of forests and increase forest cover. The policies focus on reducing the adverse impact of socio-economic causes, and are as follows:

- A GIS/Remote system will be developed that establishes and monitors the boundaries of the forestlands and maintains proper records. Transfer of forestland for other activities such as non-forest uses will be done through the approval of the Federal Government. Tree planting will be an integral component of all construction projects.
- In order to reduce pressure on natural forests, the Government will exempt timber imports from all taxes. The creation of a forest development fund at the Federal level will ensure conservation and development of critical waterbeds. Local governments will be provided adequate financial and institutional support for promotion of forests and natural resources.
- Forests management will be promoted by allowing timber harvesting, so as to discourage the illegal cutting down of trees. Timber harvesting will be allowed in those areas, where the owners and right holders undertake fully to participate in the management and regeneration of their forests in association with the forest

department. Provincial governments will be encouraged to create and manage protected areas falling within their geographical boundaries. Appropriate measures will be undertaken for protecting the juniper, mangrove chalghoza and spruce forests. Biodiversity will be protected under the Biodiversity Action plan (BAP 2000), while the National Council for Conservation of Wildlife (NCCW) will provide effective advisory and coordination services.

- A national desertification control fund will be established as envisaged under National Action Program (NAP) and United Nations Convention to Combat Desertification (UNCCD) to ensure continued support for sustainable land management interventions at the grassroots level.

- Government of Pakistan will provide the necessary financial and technical assistance to provincial departments and R&D institutions for establishing regular monitoring system based on GIS and Remote Sensing. The Ministry of Environment will be responsible for establishing a cell for monitoring of the policy, while at the Provincial level the Provincial forest and wildlife departments will initiate actions to achieve the goal and objectives envisioned in the policy.

13.5.4. National Environmental Policy, 2005

The National Environmental Policy focuses on protecting, conserving and restoring the environment in order to improve the quality of life of the citizens through sustainable development. The main features of this policy have been discussed:

- Safe and sustainable water will be ensured through the enactment of the water conservation act and establishment of a water quality and monitoring and surveillance system.

- Air pollution and noise will be mitigated through the enactment of the National Clean Air act, effective enforcement of the National Environmental Quality Standards and self-monitoring rules.

- To address waste management issues, a national sanitation policy will be implemented, alongside developing a national oil spill contingency plan and establishment of marine pollution control commission. Pakistan oil pollution act will be framed.

- The national forest policy will be implemented, and the biodiversity plan will be revised and updated in line with developments taking place at the national and international levels. A comprehensive policy for the wetlands will be developed.

- Climate change will be combated through establishing a national clean development mechanism (CDM) The National Energy Conservation policy will be devised and implemented.

- Strategies and programs to tackle desertification will be developed in line with the national action plan to combat desertification and drought; a national desertification control fund will be established.
- The objectives of the policy will be achieved by integrating environment into development planning. This will involve implementing the provisions of the Pakistan Environment Act 1997. The legislative and regulatory framework will be enforced for implementation of the policy at the Federal, Provincial and District level. The capacity of the MOE, provincial environment departments and environment protection agencies will be enhanced through the provision of adequate staff, equipment, infrastructure and financial resources for effective implementation of the policy. Different levels of government will be encouraged to develop public private partnerships and the concept of 'participatory approaches and practices' will be included in the curriculum of environmental education and training programs.

13.5.5. National Water Policy

The National Water policy focuses on improving water usage in the country. The main features of this policy are as follows:

- In order to undertake basin wide planning and coordinated development of water resources in the country, there is a need to adopt the principles of integrated and unified river basin development to ensure all aspects of water are properly taken care of in decision making for water resource development.
- Land will be delineated into the following zones: water resources planning zones, fresh and saline ground water zones, drought prone planning zone and environmental management zones in areas of environmental hazard.
- The sustainability of the irrigation infrastructure will be ensured through awareness creation of farmers and by increasing the level of cost sharing. Management of irrigation schemes will be transferred to AWBs and FOs.
- Investments will be encouraged through public-private partnerships in urban water supply. Legislation that formally allows and defines the use of water abstraction licenses and water rates for industrial use will be enacted.
- The existing hydropower generating capacity will be optimized in such a way that it is sustainable and compatible with meeting national irrigation requirements. The development of renewable resources will be looked into in detail.
- It will be ensured that water rights in the Provinces in accordance with the 1991 Water Accord. Work on developing a drainage act similar to the water accord.
- Transition of SCARP tube wells from the public sector to the private sector will be expedited, and a groundwater atlas will be prepared for each canal command and

sub-basin. Work will be done for improving zoning and flood manuals, and the EPA standards for drinking water will be achieved.

Overall, it appears that while laws and policies have been put in place, the biggest problem appears to be their enforcement and implementation. This is a reflection of the poor quality of governance in the area of environmental protection.

13.6. ENVIRONMENTAL MANAGEMENT

As highlighted earlier, there is debate also on where the environment protection function should be placed. Following the abolition of the Concurrent List in the Constitution by the 18th Amendment, this function has essentially passed on to the Provincial Governments. However, these Governments have limited capacity to perform this function. A new Ministry for Climate Change has been created at the Federal level, with a still unclear mandate.

The management of water resources is a very contentious issue. Almost 40 MAF is lost from the water system due to lack of adequate reservoirs. For many years, construction of the Kalabagh Dam in the North West of Punjab has been under discussion. This Dam could provide an additional 6.5 MAF of water. While Punjab has been pushing for this dam, Sindh has been vehemently opposed on the grounds that it will reduce the availability of water downstream, while Khyber-Pakhtunkhwa is worried that some districts, like Nowshera, will be submerged. The debate on construction of large dams has now acquired greater importance because of the realization that more cheap hydel power is needed to solve the power crisis. The recently announced National Water Policy aims to resolve the problem of distribution of water.

There is consensus, however, on the Diamer-Basha Dam, with the ability to store 8.5 MAF and provide 4500 MW of electricity. It will also lessen the likelihood of floods. But the cost is very high at over $11 billion and the major sponsors, except USAID, appear to be reluctant to finance the project. More recently, the focus has shifted to construction of the Dasu Dam and the Mohmand Dam.

In the absence of increased water supplies for agriculture, there is growing appreciation of the need to conserve and use more efficiently the water available. More public resources are being allocated for lining of canals, especially in Punjab. The big emerging issue is water pricing to promote efficient use. The irrigation charges (Abiana) are currently very low and cover only about 10 percent of the O&M costs of the canal system. But this is being resisted by large landowners who have disproportionate political representation. Eventually, with rising water scarcity, Pakistan will have to adopt new irrigation practices, like drip irrigation, and change the cropping pattern away from water-intensive crops, like sugarcane and rice.

The use of tube wells has substantially exceeded the optimal level and led to overexploitation of ground water resources. But instead of discouraging further installation, the PPP government, in one of its last acts, reduced the power tariff for tube wells by 20 percent. This has since been withdrawn.

The water issue also has a regional dimension. The common perception is that India is building dams upstream, like the Kishanganga Dam, to reduce the water flow to rivers in Pakistan. This is potentially a serious issue and could damage the already strained relations between the two countries.

Turning to the problem of managing forests, the Provincial Government of Khyber-Pakhtunkhwa has to play the primary role. One possibility is the provision of alternate fuels at subsidized prices to people living in proximity to the forest areas. Alternatively, punitive taxation may be introduced on wood and wood products industries.

In an effort to reduce urban pollution and lower transport costs, the use of CNG in motor vehicles was introduced. Consequently, the use of CNG has increased rapidly. Now, the debate is that given the depletion of gas reserves in the country, the available gas should be diverted to higher value sectors, like power generation. Consequently, efforts are being made to ration the use of CNG and raise substantially the price, but this is meeting with stiff resistance.

However, some steps have been taken to reduce air pollution including a restriction on leaded gasoline and reduction in the Sulphur content of diesel oil. But there is need to introduce further regulation to ensure tougher emission standards on vehicles, encourage the use of pollution control technology by industry and relocate brick kilns far from urban centres. Also, given the highest level of air pollution in Lahore, the use of three-wheel rickshaws could initially be banned in this city, as has been done in New Delhi. But this has been argued against on the grounds that it will deprive a significant number of people of their livelihoods.

The PML (N) Government has announced that as part of the CPEC bulk of the new investment in power generation (about 7000 MW) will be with coal as the fuel source, instead of furnace oil. The implications of this on future levels of emission need to be worked out.

Finally, a National Disaster Management Authority (NDMA) was set up in 2006 following passage of the appropriate legislation. This is in addition to the multiplicity of agencies that already exist (see Chart 13.1). There is need to clarify the distribution of functions among these agencies and between different levels of Government.

Chart 13.1: Multiplicity of Disaster Management Institutions in Pakistan*

Phase	Institutions	
Prevention/ mitigation	• Federal Flood Commission • Provincial Irrigation Departments	• Water and Power Development Authority (WAPDA)/Dams Safety Council
Preparedness and response	• Armed forces • Civil Defence • Emergency Relief Cell • Fire Services • National Crisis Management Cell • Pakistan Metrological Department • Police • Provincial Communication and Works	• Provincial Food Departments • Provincial Health Departments • Provincial Relief Commissioners • Provincial Agriculture and Livestock Departments • Rescue 1122 • Space and Upper Atmospheric Research Commission (SUPARCO)
Recovery and reconstruction	• Earthquake Reconstruction and Rehabilitation Authority (ERRA) • Provincial Irrigation Departments	• Provincial Communications and works Departments • Other line departments

*Besides the NDMA, Provincial Disaster Management Authority (PDMAs) and District Disaster Management Authority (DDMAs)

Source: GoP 2007b.

13.7. PRESENT DEBATE TO SOLVE ECOLOGICAL PROBLEMS

Pakistan was one of the first developing countries to pass a landmark Environmental Protection Act in 1997. In addition, there exists a National Drinking Water Policy, a National Forest Policy, a new National Water Policy and the National Environment Policy of 2005 which have been described above. However, the fundamental problem is the, more or less, complete lack of implementation of these policies.

The absence of commitment to a ‘green’ economy is due to the perceptions, first, that this is an attempt on the part of advanced countries to impose emission standards on developing countries when they pollute much more and, second, that this is likely to lead to some loss of growth.

13.7.1. Green Economy and Growth

UNEP defines a green economy as one that results in “improved human well-being and social equity, while significantly reducing environmental risks and scarcities”. In its simplest expression, a green economy is low-carbon, resource efficient and socially inclusive. In a green economy, growth in income and employment is driven by public and private investments that reduce carbon emissions and pollution, enhance energy and resource efficiency and prevent the loss of biodiversity and ecosystem services. In fact, the greening of economies can be a new ‘engine of growth’.

These investments need to be catalyzed and supported by targeted public expenditure, policy reforms and regulation changes. The development path should maintain, enhance and, where necessary, rebuild natural capital as a critical economic asset and as a source of public benefits, which are important for the livelihood and security of poor people who depend more on nature.

'Green' economy can make a fundamental contribution to more inclusive growth by reducing poverty across a range of important sectors – agriculture, forestry, freshwater, fisheries and energy. Sustainable forestry and ecologically friendly farming methods help preserve soil fertility and water resources. This is especially important for subsistence farming. In this sense, the 'green' economy is particularly important in the Pakistani context with the on-going deforestation and emerging water scarcity.

13.7.2. 'Green' Initiatives in Khyber-Pakhtunkhwa

The Pakistan Tehrik-e-Insaf (PTI) Provincial Government in Khyber-Pakhtunkhwa recognized the special ecological problems in the Northern part of the country and launched the 'Green Growth Initiative'. It heralds the beginning of the most advanced environment-friendly initiatives for preserving the environment, addressing national energy shortages and promoting tourism. The key initiatives proposed under 'Green Growth' are as follows:

PLANT

Forest:

- Increase forest area up to 22% by 2018
- Convert 30,000 hectares of additional land into forest annually
- Launch of "Tree Tsunami" campaign
- Increase tree covered area up to 30% by 2018
- Commencement of "Youth Nurseries" Program
- Preserve Khyber-Pakhtunkhwa's forests as valued natural asset
- Complete ban on cutting down trees in reserved forests

PRESERVE

National Parks:

- Establishment of an autonomous National Parks authority
- Training of special Youth Park Management force
- Increase protected area up to 15% by 2018
- Build recreational Natural Wildlife Parks in every district

PROMOTE

Clean Energy:

- Zero carbon growth by 2018
- 80% power generation from hydro and solar sources by 2018
- 356 community driven small hydro power projects by 2014

Source: Advertisement in newspaper, Dawn.

13.8. IMPACT OF CLIMATE CHANGE

Climate change resulting from an increasing concentration of Greenhouse Gases (GHGs) in the atmosphere, due to the use of fossil fuels and other human activities, has become a major concern world over. It is particularly so for Pakistan, because climate change is posing a direct threat to its water, food and energy security.

Pakistan's total GHG emissions in 2008 amounted to 309 million tonnes (mt) of Carbon dioxide (CO2) equivalent, comprising about 54 percent CO2, 36 percent Methane, 9 percent Nitrous Oxide and 1percent other gases. The biggest contributor is the energy sector with 50 percent share, followed by the agriculture sector (39 percent share), industrial processes (6 percent share) and other activities (5 percent).

Pakistan is a small GHG emitter: It contributes only about 0.8 percent of the total global GHG emissions. On per capita basis, Pakistan with 1.9 tonnes per capita GHG emissions stands at a level which corresponds to about one-third of the world average, one-fifth of the average for Western Europe and one tenth of the per capita emissions in the U.S., putting it at 135th place in the world ranking of countries on the basis of their per capita GHG emissions.

During the last century, average annual temperature over Pakistan increased by 0.6 °C, in line with the global trend, with the temperature increase over Northern Pakistan being higher than over Southern Pakistan (0.8 °C versus 0.5 °C). Precipitation over Pakistan also increased on the average by about 25 percent. Studies based on the ensemble outputs of several Global Circulation Models (GCMs) project that the average temperature over Pakistan will increase in the range 1.3-1.5 °C by 2020s. Precipitation is projected to increase slightly in summer and decrease in winter with no significant change in annual precipitation. Furthermore, it is projected that climate change will increase the variability of monsoon rains and enhance the frequency and severity of extreme events such as floods and droughts.

The pattern of rainfall in the country is changing, and while climate change is regarded as an issue which is long-term in nature, the increased and abnormally high levels of precipitation suggest that for Pakistan climate change is already a reality. Pakistan will have to step up its efforts to deal with the effects of climate change.

The floods (2010) in Pakistan have provided a clear example of the potential for damage due to climate change in Pakistan. Triggered by two climate driven events, the rapid melting of Northern glaciers as well as erratic monsoon rains in the Northern Areas, dangerously coupled to produce the unprecedented floods in Pakistan which led to losses to human lives and infrastructure. Climate change is predicted to cause more such floods followed by periods of drought as the Northern glaciers rapidly melt and eventually vanish. The most important climate change potential threats to Pakistan are identified as:

- Increased variability of monsoons;
- Rapid recession of Hindu-Kush-Karakoram-Himalayan (HKH) glaciers threatening water inflows into the Indus River System (IRS); reduction in capacity of natural reservoirs due to glacier melt and rise in snow line;
- Increased risks of floods and droughts;
- Increased siltation of major dams resulting in greater loss of reservoir capacity;
- Severe water-stressed and heat-stressed conditions in arid and semi-arid regions, leading to reduced agriculture productivity;
- Increased upstream intrusion of saline water in the Indus delta, adversely affecting coastal agriculture, mangroves and breeding grounds of fish; and
- Threat to coastal areas including the city of Karachi due to sea level rise and increased cyclonic activity due to higher sea surface temperatures.

The above threats lead to major concerns for Pakistan in terms of its water, food and energy security, thereby impacting on growth and quality of life of the people. Some of the oft-mentioned climate change related concerns of Pakistan are identified as: Increase in deforestation; loss of biodiversity; increased health risks (heat strokes, pneumonia, malaria and other vector-borne diseases) and risks to other vulnerable ecosystems (e.g. rangelands, degraded lands, mountainous areas etc.). However, what often goes unnoticed is that in future it can also lead to an increase in cross border tensions. As countries will become water stressed, there will be greater likelihood of preserving the resources they believe they own. This, therefore, implies that climate change should be seen as an issue which can have potential implications on regional and international stability.

SECTION 5

INVESTMENT

Chapter 14:

THE PATH OF INVESTMENT

This Chapter trace the path of investment followed by the economy since the 70s. Clearly, the level of investment plays a critical role in expanding the productive capacity of the economy and determining the growth rate of the GDP.

Section 1 identifies the long-term trends in investment. Section 2 highlights the level and composition of capital formation since the turn of the century. Section 3 focuses on determinants of private investment. Section 4 is on foreign direct investment in Pakistan. Finally, in Section 5 a comparison is made of the level of investment in Pakistan with other Asian countries.

14.1. LONG-TERM TRENDS

The level of investment in Pakistan has been on declining path since the decade of the 80s. During this period it attained a peak of almost 19 percent of the GDP as shown in Table 14.1. Since 2010, it is operating at close to 15 percent of the GDP. This long-term decline in the rate of investment is the primary explanation for the significant fall in the growth rate of the economy from over 6 percent to between 4 and 5 percent.

Table 14.1: Average Level of Investment Annually in Different Decades – (% of GDP)

	Total Investment	Fixed Investment	Private Investment	Public Investment	Change in Shocks
Decade of 70s	17.1	15.9	9.6	10.3	1.2
Decade of 80s	18.7	17.0	7.8	9.2	1.7
Decade of 90s	18.3	16.6	9.1	7.5	1.7
2000-2010	17.9	16.4	11.8	4.6	1.5
2011-2017	15.1	13.5	9.9	3.6	1.6

Source: PES

There has also been a fundamental change in the role of the public and private sectors in the process of investment in the economy. During the decade of the 70s the pre-dominant share of investment was with the public sector. The regime of Zulfiqar Ali Bhutto first undertook large-scale nationalization of private industrial assets and banks. This was accompanied by a ‘big push’ in development of physical infrastructure, including Tarbela Dam, Port Qasim and Pipri Marshalling Yard. Simultaneously, high-tech investment took place in industries like steel, chemicals petroleum refining, etc.

However, the nationalization process scared away private investors in a big way. Consequently, private investment plunged to an all-time low. The takeover by the military in 1977 under General Zia ul Haq gradually restored the confidence of the private sector. The level of private investment went up from only 5.6 percent of the GDP to 7.8 percent of the GDP. The momentum of public investment was largely maintained. Combined together, the economy reached the peak level of investment in the 80s.

Beyond the 80s, the continuing decline in the overall level of investment is attributable primarily to a fall in the rate of public investment. It has fallen very sharply from the peak of 10.3 percent of the GDP in the 70s to less than 4 percent of the GDP during the last seven years. One of the primary reasons for this is the decline in the 'fiscal space' for development spending due to the rising debt burden. The annual cost of debt servicing in the Federal Budget has risen from 12 percent of the current expenditure in the late 70s to over 25 percent in 2016-17.

The decade of the 90s saw a visible upsurge in the rate of private investment. There was initially a big jump in investment in road transport. From the mid-90s onwards, the private Independent Power Producers invested heavily in the expansion of capacity for generation of electricity.

Developments since 2000 are discussed in the next section.

14.2. TRENDS SINCE 2000

The path of fixed investment since 2000-01 is presented in Table 14.2 and in Figure 14.1. There is a noticeable business cycle. Total fixed investment rose steadily during the tenure of the Musharraf Government, reaching a peak of over 20 percent of the GDP in 2005-06. Both private and public investment showed rising trends. Thereafter, the overall rate of fixed investment plunged to of low of 13 percent by 2013-14. Since then a minor recovery is visible with the rate rising to almost 15 percent.

Table 14.2: Level of Fixed Investment by the Public and Private Sectors – (as % of GDP)

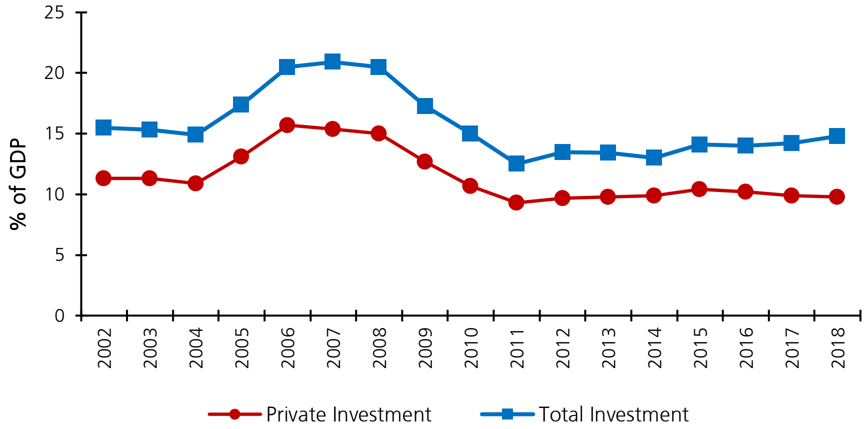
	Investment		
	Public	Private	Total
2001-02	4.2	11.3	15.5
2002-03	4.0	11.3	15.3
2003-04	4.0	10.9	14.9
2004-05	4.3	13.1	17.4
2005-06	4.8	15.7	20.5
2006-07	5.6	15.4	20.9
2007-08	5.4	15.0	20.5
2008-09	4.6	12.7	17.3
2009-10	4.3	10.7	15.0
2010-11	3.2	9.3	12.5
2011-12	3.7	9.7	13.5
2012-13	3.5	9.8	13.4
2013-14	3.2	9.9	13.0
2014-15	3.7	10.4	14.1
2015-16	3.8	10.2	14.0
2016-17	4.3	9.9	14.2
2017-18	5.0	9.8	14.8

Source: PES

What explains this business cycle with such a large amplitude? There are, in fact, a number of factors which have been operation. Following the support provided by Pakistan to the USA in the war in Afghanistan after

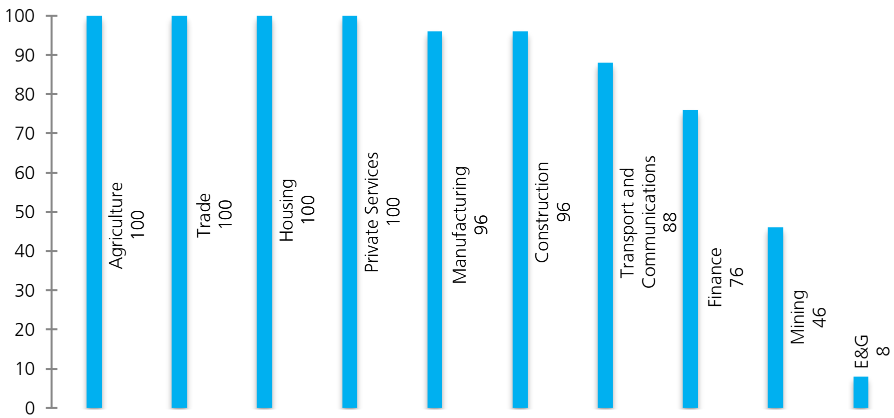
2001, there was an outpouring of financial support to the country. This enabled the financing of a larger public sector development program. Simultaneously, the level of foreign direct investment rose exponentially. However, this inflow has shown a declining trend since 2007-08.

Figure 14.1: Total and Private Investment, 2001-02 to 2017-18 – (as % of GDP)



Source: PES

Figure 14.2: Share of Private Investment in Total Investment in Different Sectors

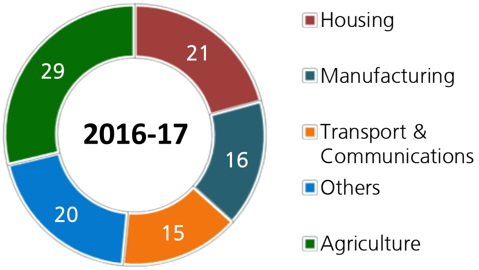


Source: PES

Private investment now accounts for over 70 percent of total investment. As such, the overall level of investment is influenced more by the behavior of private investors. As shown in Figure 14.2, almost the entire investment in six sectors, viz., agriculture, housing, wholesale and retail trade, private services, manufacturing and construction is by the private sector. Over 80 percent of the investment in the transport and communications sector is also by the private sector. Bulk of the public sector investment remains non-allocable to sectors within the GDP. There is need for methodology to be developed by PBS to achieve this allocation.

The resulting sectoral composition of private investment is given in Figure 14.3. Perhaps somewhat surprisingly, agriculture continues to be the largest sector with a share of 29 percent in 2016-17. Next in importance are housing, manufacturing and transport and communications with shares of 21 percent, 16 percent and 15 percent respectively.

Figure 14.3: Sectoral Composition of Private Investment



Source: PES

14.3. DETERMINANTS OF PRIVATE INVESTMENT

A number of factors have also played in role in determining the path of private investment. First, since 2007-08 there has been a more than fourfold increase in acts of terrorism by 2012-13. This has greatly increased the perception of risk and in security on the part of domestic entrepreneurs and, more particularly, foreign investors. FDI in 2016-17 was less than one third of the peak level attained a decade ago. The Zarb-e-Azb operations after 2014 have substantially curbed terrorism in the country. But a visible impact on the level of private investment remains to be seen.

Box 14.1 presents the quantitative impact of different variables. The results are based on econometric analysis. This has yielded the magnitude of the short-run elasticity of private investment in different sectors with respect to the determinants.

Private investment in agriculture is largely influenced by the access to credit largely for the purchase of tractors and installation of tubewells. Also, there is a 'crowding in' effect of public investment in roads, irrigation, power, etc. on private investment in Agriculture.

Box 14.1: Impact on Private Investment of different Factors

	Elasticity
Investment in Agriculture	
Total Public Investment	0.25
Real Agricultural Credit	0.21
Investment in Manufacturing	
Nominal Interest Rate	-2.70
Extent of Load Shedding	-0.25
GDP (lagged by one year)	0.63
Investment in Services	
Unit Value Index of Machinery Imports	-0.27
Nominal Interest Rate	-1.69
GDP (lagged by one year)	0.70

Source: Estimated

The level of private investment in manufacturing is sensitive to the level of nominal interest rate on bank advances. On average, a one percentage point increase leads to a fall in private investment by almost 3 percent. The level of power loadshedding has impacted on private investment in manufacturing. There is also clear evidence that a higher GDP growth rate in the previous year stimulates higher investment in the succeeding year. This highlights the presence of the 'accelerator effect'.

Private investment in services is also affected by the level of nominal interest rate. Investment in transport, communications and other services also appears to be sensitive to the unit value index (in Rupees) of machinery imports. Further, there is also the accelerator effect on investment in services.

The access to credit has diminished while the cost has increased. As shown in Table 14.3, the real markup rate on advances was close to 1 percent in 2005-06. It reached a peak of 4.5 percent in 2012-13 and still remains high at 3.7 percent. In 2005-06 the increase in commercial bank credit to the private sector was 3.6 percent of the GDP in 2005-06. It has fallen sharply since then. However, improved access is visible in 2016-17, although this is not reflected in the level of private investment. A major contributory factor to restricted access has been the 'crowding out' due to higher Government borrowings from the banking system.

Table 14.3: Trend in the Magnitude of Variables Impacting on Private Investment

	Unit	2005-06	2012-13	2016-17
Level of Private Investment	(% of GDP)	15.7	9.8	9.9
Real Markup Rate on Bank Advances *(on Machinery)*	(%)	1.3	4.5	3.7
Annual Increase in Credit to the Private Sector	(% of GDP)	3.6	0.4	2.3
Annual Increase in Credit to the Government by Commercial Banks	(% of GDP)	1.0	4.5	0.4
Public Investment	(% of GDP)	4.8	3.5	4.3
GDP Growth Rate *(lagged by one year)*	(%)	9.0	3.8	4.7
No of Incidents of Acts of Terrorism		352	1411	360

Source: SBP | SATP | PES

As opposed to this, there is empirical evidence of 'crowding in' of private investment by public investment in infrastructure, especially in the power sector. The rise in electricity outages since 2007-08, reaching a peak in 2012-13, has prevented the private sector from setting up new or expanding existing production facilities.

A snapshot of the profile of investment in the economy can be obtained by look at the trends in the level and composition of machinery imports in Table 14.4. Recent years have witnessed a peak in public sector and CPEC related imports of power generating machinery. Imports of textile machinery were relatively high in the earlier years, 2001-02 to 2005-06. They have since faltered as exports began to lose dynamism. Telecom equipment imports were also very high in these years with the extremely rapid expansion in the network and ownership of mobile phones. Currently, these imports are about 60 percent of the historic peak. Overall, there been a modest cumulative growth of 30 percent in the last twelve years in the import of machinery.

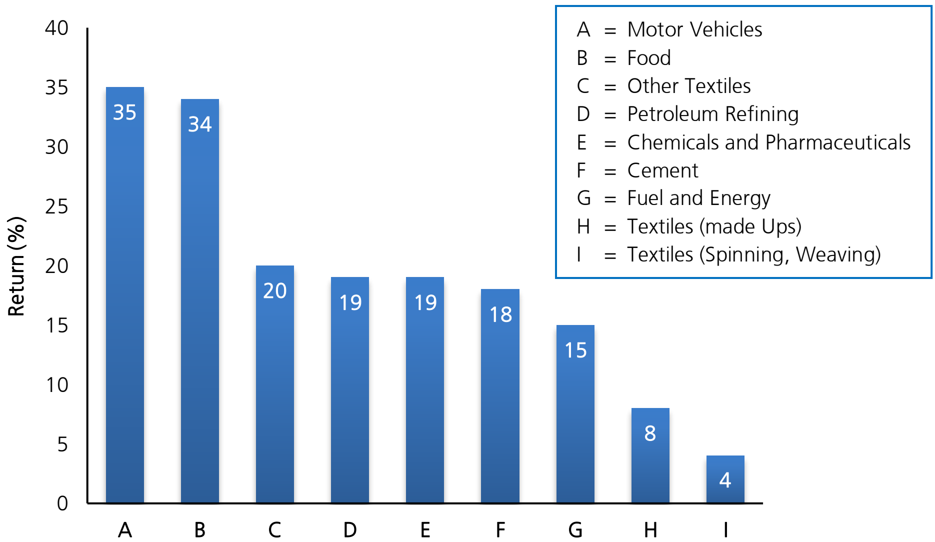
Table 14.4: Trend in Imports of Machinery – ($ million)

	2005-06	2012-13	2016-17
TOTAL IMPORTS	**6070**	**5705**	**7910**
Power Generating Machinery	512	959	1620
Textile Machinery	817	388	652
Electrical Machinery	509	843	1324
Telecommunication Equipment	1933	1494	1023
Agriculture Machinery	117	100	77
Office and DP Equipment	294	253	432
Construction and Mining Machinery	190	162	159
Other Machinery	1698	1506	2623

Source: SBP

The direction of investment within industry is likely to be strongly influenced by level of profit of existing enterprises. The companies listed in the Pakistan Stock Market have shown sharply varying levels of profitability in 2017, as shown in Figure 14.4.

Figure 14.4: Return of Equity in Different Industries



Source: SBP

One key message is conveyed by the varying levels of profitability among the major industries of Pakistan. Import substituting industries are generally substantially more profitable than their export-oriented counterparts. Currently, the most profitable industry is motor vehicles with a post-tax return on equity as high as 3.5 percent. This industry enjoys a very level of tariff protection. It is not surprising that many car assembly/ manufacturers have shown interest in investing in Pakistan.

Export oriented industries, especially textiles, appear to be in a near crisis situation. The return on equity in textile spinning and weaving and made ups is very low at 4 percent and 8 percent respectively. It is not surprising that import of textile machinery is only 40 percent of the level over a decade ago. Clearly, efforts have to be made to bolster profitability of exporting activities if private investment is to shift its focus from domestic to foreign markets.

14.4. FOREIGN DIRECT INVESTMENT

The path followed by foreign direct investment (FDI) is similar to total private investment. In 2000-01, when Pakistan was subject to sanctions, the level of FDI was very low at $322 million. Following the support to the USA in the Afghan War, it rose exponentially, reaching the highest level ever of $5.4 billion in 2007-08. This corresponded to almost 3 percent of the GDP, highest at that time among South Asian countries.

Thereafter, the frequent acts of terrorism and emergence of power outages deterred foreign investors. Consequently, FDI slumped to $923 million by 2014-15. Since then, the successful operation of Zarb-e-Azb has made the environment more secure. Also, the sharp drop in power loadshedding after 2015-16 has also facilitated FDI. By 2017-18, the level of FDI had increased to $3.1 billion, close to 1 percent of the GDP.

The period from 2002-03 to 2008-09 saw a large part of the FDI going to telecommunications, with the advent of the mobile phone. The origin of FDI was largely from USA, the Middle East and the UK. During this period there was also significant foreign investment in oil and gas exploration in Pakistan. The sectoral destination of FDI has changed from 2014-15 onwards. Bulk of the investment is being undertaken by China in CPEC, primarily in power projects. This is expected to continue over the next few years.

A number of incentives have been offered to foreign investors, as listed in Box 14.2. The incentives offered, both fiscal and financial, are very liberal in nature. In addition, there are many investment opportunities for foreign investors. These are also listed below:

Box 14.2: Incentives for Foreign Investors in Pakistan

- 100% foreign shareholding allowed for legal entities in Pakistan;
- No restriction on repatriation of dividends, royalties and capital;
- Business losses can be carried forward for six years for tax purposes;
- No minimum capital requirement, except in banking sector;
- Avoidance of Double Taxation agreements with 60 countries;
- IPR law enacted in 2012;
- Ease of hiring expatriates.

Fiscal Incentives for Foreign Investors

- Ten Year Tax Holiday for investment in Special Economic Zones (SEZ) plus exemption on customs duty on import of machinery;
- 25% accelerated depreciation allowance;
- Corporate tax rate on profits from FDI reduced to 20%, compared to the normal rate of 30%, for investment in a new industrial undertaking;
- 20% credit on tax payable for first two years for enlistment in the stock exchange.

Investment Opportunities in Pakistan

- Construction Machinery;
- Railway rolling stock + signaling system;
- Trucks, automobiles;
- Power Generating Machinery;
- Ships, Vessels.
- Renewable Energy;
- Pharmaceutical and Chemicals;
- Telecom Equipment (3G / 4G);
- Textiles and Leather Products for export to EU (*to avail GSP+ facility*);
- Banking and Insurance;
- Information Technology;
- Vocational and Technical Training.

Source: FBR, BOI

14.5. COMPARISON WITH SOUTH ASIAN COUNTRIES

Table 14.5 reveals that Pakistan has a substantially lower rate of gross capital formation compared to other South Asian countries. This was 15.4 percent of the GDP annually on average in the case of Pakistan from 2013 to 2017. The average for South Asian countries was 30.5 percent of the GDP, almost double that of Pakistan. This implies that Pakistan is likely to fall behind other countries in terms of the GDP growth rate unless the rate of investment is raised substantially.

However, there is an interesting paradox. Despite being a lower investor, Pakistan is able to get more growth from this level of capital formation. In effect, the country seems to be using capital more efficiently than other South Asian Countries.

The incremental capital-output ratio of Pakistan stands at close to 3. This is much smaller than the regional average of 4.5. Nepal and Sri Lanka ratios are even higher. This raises the possibility that either the magnitude of gross capital formation is underestimated in

Pakistan or that the GDP growth rate is overstated. The next National Income rebasing exercise by the PBS should focus on the issue of measurement of the quantum of investment in the economy, especially in agriculture and the more informal sectors of the economy.

Table 14.5: Comparison of the Level of Investment and the Incremental Capital-Output Ratio of South Asian Countries

	2013 to 2017, Average Annual		
	Gross Capital Formation (% of GDP)	GDP Growth Rate (%)	Incremental Capital-Output Ratio
Bangladesh	29.2	6.6	4.42
India	32.2	7.1	4.54
Nepal	38.8	4.3	9.02
Pakistan	15.4	5.0	3.08
Sri Lanka	33.6	4.2	8.00
South Asia	30.5	6.8	4.49

Source: WDI

14.6. OUTLOOK FOR INVESTMENT

Pakistan seems to be heading towards another downturn of the business cycle. This is likely to be caused by efforts at stabilization of the economy, given the extremely large current account and budget deficits.

A number of steps have already been taken to reduce the level of public investment. The original Budget for 2018-19 of the Federal Government envisaged a PSDP size of Rs 800 billion. The revised Budget for the year presented by the new Government has cut this substantially by 28 percent to Rs 575 billion. Similarly, the largest Provincial Government, Government of Punjab, has reduced its ADP by almost 40 percent, so as to generate a relatively large cash surplus and thereby contribute to a reduction in the consolidated fiscal deficit.

Private investment is also likely to be affected by steps undertaken to stabilize the economy. These include the hike in nominal interest rates. The policy rate of the SBP has been raised already from 6 percent to 10 percent. The rupee has been devalued by over 35 percent since December 2017. This has raised the landed cost of imported machinery. Further, there is likely to be more ‘crowding out’ of the private sector from bank credit as advances are diverted for the purchase of high return Government PIBs and MTBs. Given the magnitude of the elasticities presented in Box 14.3, private investment is likely to fall in real terms by 8 to 10 percent in 2018-19. A recovery can only be expected in 2020-21 onwards if in the interim period the economy has stabilized.

Chapter 15:

REVIEW OF THE FEDERAL DEVELOPMENT PROGRAM

Development spending undertaken by the Federal Government has the objective to upgrade and expand the existing physical infrastructure related especially to power, water resources and transport. In addition, it includes public investment in Federally administered areas and on social services like higher education. The Chapter has seven Sections relating to the size of the Public Sector Development Program (PSDP), financing of the PSDP, issues of implementation capacity, allocation priorities, CPEC projects and Special Programs. The last Section highlights the big cut back in development expenditure.

15.1. SIZE OF PSDP

The Federal Public Sector Development Program (PSDP) has been set at Rs 1001 billion for 2017-18. This represents a '*big push*', with 40 percent growth over the development spending in 2016-17 as shown in Table 15.1. In effect, the Federal PSDP will rise from 2.2 percent of the GDP to over 2.8 percent of the projected GDP in 2017-18. Inclusive of the four Provincial Development Programs, the national PSDP will reach a new peak of 6 percent of the GDP.

Table 15.1: Trend in the Budgeted and Actual Size of the Federal PSDP, 2012-13 to 2017-18 – *(Rs in Billion)*

	Budgeted PSDP	Actual Size	Percentage of Utilization
2012-13	360	323.5 (1.7)*	89.9
2013-14	540	432.9 (2.3)	80.5
2014-15	525	488.9 (2.1)	93.1
2015-16	700	593.3 (2.1)	84.8
2016-17	800	725 (2.3)	90.7
2017-18	1000	-	-
ACGR (%)	20.0	20.1	

ACGR = Annual Growth Rate | * % of the GDP
Source: Planning Commission, Federal PSDP | MOF, Fiscal Operations

What are the motivations for targeting such a big increase in the size of the Federal PSDP by almost Rs 300 billion? First, infrastructure investments, especially in expanding the capacity for transmission and distribution of electricity, have to be completed in time to enable the utilization of generation capacity of the new power plants. Second, CPEC infrastructure projects related to the two highway corridors and the Gwadar port are in the process of implementations and will require larger allocations for early completion. Third, 2017-18 is the election year and the objective of the incumbent Government may obviously be to create space for a larger quantum of populist spending and pork-barreling. Further, the multiplier effect of the larger PSDP will help in accelerating the growth process in the economy. There is evidence also that higher public investment crowds-in more private investment.

15.2. FINANCING THE PSDP

A number of questions arise with regard to the size and composition of the Federal PSDP for 2017-18. Will there be adequate funds available to finance the big jump in development spending? Does adequate implementation capacity exist to ensure completion of projects in time and without large cost overruns? Is the sectoral distribution of the PSDP adequately reflecting the stated priority of focusing on the power sector and on CPEC?

The experience during the four years of the present Government is that there have been significant shortfalls in financing the budgeted Federal PSDP, as indicated by the shortfall in releases in relation to the budgeted amount. On average, the targeted size has been missed by 13 percent, even though there was a relatively modest growth annually in the budgeted PSDP of 15 percent. This raises serious doubts about the ability to finance the big push in 2017-18. Further, after the big shortfall in FBR revenues in 2016-17, the required growth rate in these revenues is over 19 percent, when the nominal GDP is expected to grow at a significantly lower rate of about 11 percent. Also, the budgeted level of non-tax revenues looks unattainable, given the likelihood of no receipts from the Coalition Support Fund.

Fortunately, concessional project financing of CPEC should be available in larger amounts from China. Hopefully, this will be at similar terms as project loans from ADB and IBRD/IDA. It is surprising, however, that the Budget of 2017-18 expects an increase of only 14 percent in project loans, as shown in Table 15.2. In fact, a major portion, 52 percent, is expected to be for financing the Provincial PSDPs. As such, the Ministry of Finance may be left with no other option than to target for a larger fiscal deficit by over 2 percent of the GDP, primarily by printing of money through large-scale borrowing from the SBP.

Table 15.2: External Borrowing and Domestic Financing of the Federal PSDP, 2012-13 to 2017-18 – (Rs in Billion)

	Project Loans	Grants	Domestic Borrowing	Actual Size of Federal PSDP
2012-13	149.6 (43.0)[a]	29.1 (8.4)	169.6 (48.6)	348.3 (100.0)
2013-14	194.1 (44.0)	36.6 (8.3)	210.3 (47.7)	441.0 (100.0)
2014-15	143.0 (28.5)	22.4 (4.5)	336.8 (67.0)	502.2 (100.0)
2015-16	182.4 (30.7)	28.8 (4.8)	382.2 (64.5)	593.4 (100.0)
2016-17	335.6 (46.2)	25.3 (3.5)	364.7 (50.3)	725.6 (100.0)
2017-18 (B.E)[b]	340.6 (34.0)	27.1 (2.7)	633.3 (63.3)	1000.0 (100.0)

[a]Share in total financing | [b]Budget Estimate
Source: MOF, Fiscal Operations

During the election year, the experience in 2007-08 and 2012-13 is that the Federal fiscal deficit goes beyond 6 percent of the GDP. If this also happens in 2017-18, as in 2016-17, it will push up significantly the rate of inflation and also create demand pressures leading to a higher current account deficit in the balance of payments.

15.3. ISSUES OF IMPLEMENTATION CAPACITY

Turning to the issue of implementation capacity, the large portfolio of projects has led to a '*spreading thin*' of the PSDP. In 2017-18 there are 1148 projects under implementation, implying that the average allocation per project is even less than Rs 1 billion. The number of projects in key sectors is given in Table 14.3. Given the financing constraint and limits to implementation capacity the emphasis should be on completion of on-going projects rather than take on new projects, except those in CPEC and the power sectors.

Table 15.3: Number of On-Going and New Projects in the Federal PSDP, 2017-18

Division/Corporation	Number of On-Going Projects	Allocation (Rs in Billion)	Number of New Projects	Allocation (Rs in Billion)	Total Allocation (Rs in Billion)
Higher Education Commission	88	26.4 (74.2)*	63	9.2 (25.8)*	35.6
National Health Services	18	37.5 (68.8)	5	16.9 (31.2)	54.5
Railways	31	33.5 (78.1)	6	9.4 (21.9)	42.9
Water & Power (Water)	48	35.0 (95.1)	33	1.8 (4.9)	36.8
National Highway Authority	72	305.0 (95.4)	13	14.7 (4.6)	319.7
PEPCO	154	239.2 (96.3)	34	9.2 (3.7)	248.4
WAPDA (Hydel)	16	127.9 (99.0)	2	1.3	129.2

*Share of On-Going Projects and New Projects in total allocation
Source: Planning Commission, Annual Federal PSDP, 2017-18

Unfortunately, with political pressures to placate different constituencies there continues to be a proliferation of projects. For example, the Higher Education Commission, the Ministry of Health Services and the Railway have allocated 26 percent, 31 percent and 22 percent respectively of their earmarked funds to new projects.

This tendency to multiply the number of projects has delayed the completion of on-going projects. As of end-June 2017, the throw-forward of on-going projects is very large. For example, in the portfolio of projects with National Highway Authority the overall throw forward is as much 74 percent of the total cost. With full implementation of the allocated

PSDP in 2017-18 only 47 percent on average of the cost of on-going projects will have been incurred. A typical NHA on-going project will take almost four more years to complete. This not only delays the development impact of completed projects but also implies significant cost overruns during the execution.

The overall remaining cost of on-going projects in the Federal PSDP is Rs 6.6 trillion, while the cost of new projects is Rs 1.3 trillion. With the size of the PSDP at Rs 1 trillion, a typical project will take seven to eight years to complete. In the case of the vital project, the Diamer- Basha Dam, the cost is Rs 894 billion and the allocation is Rs 21 billion. At this rate, the Dam will take decades to complete.

The time has probably come for imposition of a moratorium on approval of new projects by the CDWP/ECNEC, except those related to water, power and CPEC and for substantial pruning of new projects in other sectors. Also, a serious malpractice has emerged. A large number of unapproved projects are being allocated funds in the PSDP. This must stop.

15.4. ALLOCATION PRIORITIES

Turning to the sectoral distribution of the PSDP, a very serious problem has been identified (see Table 15.4). During 2017-18, WAPDA and PEPCO are expected to spend Rs 377.6 billion on the portfolio of projects. However, only Rs 60.9 billion have been allocated in the PSDP for these projects. The implication is that there will have to be self-financing of as much as Rs 316.7 billion. This is highly unlikely. Ultimately, borrowed funds will have to be arranged probably through the support of government guarantees. In effect, the PSDP size will be significantly larger.

Table 15.4: Allocation Priorities in the Federal PSDP, 2016-17 and 2017-18 – (Rs in Billion)

Priority Area	2016-17		2017-18		Growth Rate (%)
	Allocation	Share (%)	Allocation	Share (%)	
Infrastructure	469	58.6	577	57.7	23.0
Social Services	89	11.1	150	15.0	68.5
Special Areas*	42	5.2	62	6.2	47.6
Special Programs	200	25.0	211	21.1	5.5
TOTAL	**800**	**100.0**	**1001**	**100.0**	**25.1**

*Azad Jammu and Kashmir, Gilgit-Baltistan and FATA

Source: Planning Commission, Annual Plan, 2017-18

Investments by PEPCO in transmission and distribution are crucial for ensuring that the new generation capacity in the pipeline becomes functional. The financing strategy being adopted is risky. Instead, a substantially larger share of the costs should be financed by the PSDP. This year's allocation to the power sector has, in fact, been reduced by more than half in relation to last year.

The question that arises is how the higher allocation to the priority sector can be achieved without increasing further the size of the bloated PSDP. As highlighted earlier, this means first the deferment of implementation of new projects. Second, the Ministries/Divisions share in allocations has been increased from 35.3 percent in 2016-17 to 37.7 percent in 2017-18 as shown in Table 15.5. Simultaneously, the share of Corporations (NHA and WAPDA) has been decreased from 39.8 percent to 38 percent. This is fundamentally a move in the wrong direction. There is need for review of the PSDP allocations to raise the share of the Corporations to over 50 percent, as they are implementing high priority CPEC and other power sector projects.

Table 15.5: Allocation to Ministries/Divisions, Corporations and Special Programs, 2016-17 and 2017-18 – (Rs in Billion)

Priority Area	2016-17		2017-18		Growth Rate (%)
	Allocation	Share (%)	Allocation	Share (%)	
Ministries / Divisions	282.0	35.3	377.8	37.7	34.0
Corporations	318.0	39.8	380.6	38.0	19.7
Special Programs	200.0	25.0	242.6	24.3	21.3
TOTAL	**800.0**	**100.0**	**1001.0**	**100.0**	**25.1**

* Azad Jammu and Kashmir, Gilgit-Baltistan and FATA
Source: Planning Commission, Annual Plan, 2017-18

15.5. CPEC PROJECTS

The importance of CPEC to Pakistan has been emphasized as a ‘game changer’. Bulk of the projects within the ambit of CPEC is being implemented within the PSDP by Ports and Shipping, Railway Division and the NHA. The largest part is currently with NHA.

A detailed examination of the portfolio of CPEC projects with NHA has been undertaken as shown in Table 15.6. Only 27 percent of the cost of these projects has been incurred up to the end of June 2017. With this year’s allocation it will take almost four more years to implement a typical project. Further, less than half the financing has been arranged from China up to now for the CPEC highway projects in the Eastern and Western Corridors. This phasing is far too staggered in terms of benefiting from the multifarious development consequences of CPEC. As such, efforts should be made to increase the component of Chinese financing to enable earlier execution. Further, the Planning Commission may wish to examine the proposal of establishing an independent CPEC Authority, similar to NHA and WAPDA, to implement projects other than those related to highways.

Table 15.6: Major Projects in CPEC included in the Federal PSDP, 2017-18 – (Rs in Billion)

Sector / Description	Cost	Throw-forward	%	Allocation	Foreign Financing	%
HIGHWAYS						
Construction of Hakla on M1	110.2	98.2	89.1	38.0	0.0	0.0
Thakot to Havelian – (118 kms)	136.7	101.8	74.4	21.3	20.8	97.7
Multan – Sukkur –(287 kms)	298.0	212.9	71.4	35.3	35.0	99.1
Lahore – Abdul Hakeem –(230 kms)	150.6	64.8	43.2	47.0	0.0	0.0
Sukkur – Hyderabad	175.0	101.8	58.2	21.3	20.8	97.7
PORTS						
Construction of East. Bay	14.1	14.1	100.0	1.4	1.0	1.0
SUPARCO						
Pakistan Remote-Sensing Satellite	19.7	15.9	80.7	3.3	1.0	30.3
TOTAL OF ABOVE PROJECTS	**904.3**	**609.5**	**67.4**	**167.6**	**78.6**	**46.9**

Source: Planning Commission, Federal PSDP, 2017-18

15.6. SPECIAL PROGRAMS

The last issue is the size of special programs in the Federal PSDP of 2017-18. Some of these programs are in continuation of the previous year's allocations, like the special Federal Development Program, SDGs program, PM's Youth Program, funds for TDPs and security enhancement and to ERRA. Further, some new programs have been added like the Energy for All, Clean Drinking Water for All and special provision for CPEC projects, as shown in Table 15.7. The total expenditure on these programs is 2016-17 was Rs 72 billion. This has been raised massively to Rs 255 billion in 2017-18. Many of these Programs essentially provide a camouflage to populist spending and pork-barreling. Proper mechanisms are necessary to rationalize the size of these programs, ensure spending in priority areas and avoid leakages of funds.

Table 15.7: Types of Special Programs in the Federal PSDP, 2012-13 to 2017-18 – (Rs in Billion)

	Actual Spending 2016-17	Allocation 2017-18
Prime Minister's Global SDGs Programs	42.5	30.0
Special Federal Development Program	-	40.0
Energy for All	-	12.5
Clean Drinking Water for All	-	12.5
ERRA	10.7	7.5
Special Provision for CPEC	-	5.0
Relief and Rehabilitation of IDPs	-	45.0
Security Enhancement	14.0	45.0
PM's Initiative	5.2	20.0
GIDC Fund	0.2	25.0
TOTAL	**72.6**	**242.5**

Source: MOF, Budget in Brief, 2017-18

Overall, the Federal PSDP of 2017-18 is confronted with a number of serious issues. These include the limits to financing and implementation capacity, wrong prioritization, relative priority to on-going versus new projects, feasibility of adequate self-financing by Corporations in key sectors and dangers of leakages and wastages in special programs, primarily in the nature of populist spending prior to elections. It is not surprising that the year concluded with actual development expenditure at 66 percent of the original size of the PSDP.

15.7. OUTCOME IN 2017-18

Earlier sections had referred to the emerging constraint for financing the big increase in the Federal PSDP of almost 38 percent in 2017-18. The rise in the fiscal deficit by the end of the third quarter of the financial year forced the Caretaker Government to cutback severely the release of funds for projects. Consequently, the year has ended with the actual development spending at the Federal level of Rs 661 billion, as much as 34 percent below the budgeted level of Rs 1000 billion.

We have the cuts been applied? The reduction in allocations is shown in Table 15.8. Fortunately, the priorities have largely been preserved in the cuts. Only marginal reduction in the allocation has taken place in the case of the National Highway Authority of 10 percent. In fact, the actual spending by the Power Division is higher than the initially budgeted allocation by 23 percent. Bulk of the cut by 90 percent has fallen on the Special Programs.

Table 15.8: Extent of Cut in Allocations in Relation to the Budgeted Level in 2017-18 – (Rs in Billion)

	Budgeted Allocation	Actual Spending[a]	Extent of Cut (%)
Federal Ministries/Divisions	**377.9**	**272.9**	**-27.8**
Higher Education	35.7	29.0	-18.8
Health Services	48.7	24.6	-49.5
Railway	42.9	19.4	-54.8
Special Areas[b]	70.5	69.2	-1.7
Water Resources	36.8	31.4	-14.7
Others	143.3	99.3	-30.7
Corporations	**380.6**	**361.3**	**-5.1**
Power Division / WAPDA	60.9	74.7	22.7
National Highway Authority	319.7	286.6	-10.3
Special Programs	**241.5**	**26.8**	**-88.9**
Total	**1000.0**	**661.0**	**-33.9**

[a]Assumed as 88% of the revised estimates from 2017-18 in Budget in Brief for 2018-19
[b]Gilgit-Baltistan, FATA, AJ&K

15.8. BIG CUT IN DEVELOPMENT SPENDING

The Revised Budget of the Federal Government for 2018-19 presented by the new Government of Pakistan Tehreek-e-Insaf (PTI) contains a big cut in the size of the Federal PSDP. The original Budget presented by the PML (N), just prior to its exit, had proposed a PSDP size of Rs 800 billion. This has now been cut by Rs 225 billion to Rs 575 billion, which represents a cut of over 28 percent. In relation to the actual development spending in 2017-18 of Rs 661 billion, there will be a decline of 13 percent.

Subsequently, the Government of Punjab, again with the PTI in power, has also announced a much smaller Annual Development Plan (ADP) of the Province. The PML (N) Government did not present the Budget for 2018-19 in this case. As such, a comparison is made with the actual spending of Rs 470 billion in 2017-18, as reported in the Fiscal Operations for the year. The ADP for 2018-19 has been set at Rs 238 billion. This represents an unprecedented decline of as much as 49 percent or Rs 232 billion, even more than the cutback by the Federal Government. Apparently, the motivation is to generate a big cash surplus approaching Rs 150 billion and thereby make a significant contribution to the containment of the fiscal deficit of the Federal and Provincial Governments combined.

The other Provincial Governments appear to have been reluctant to make a similar contribution. Their combined ADP size is likely to reach almost Rs 500 billion in 2018-19, as compared Rs 410 billion in 2017-18. There is, in fact, a big increase of over Rs 60 billion by the Government of Khyber Pakhtunkhwa. The Province also has the PTI in Power. However, it has preferred to show behavior contrary to its two counterparts in Islamabad and Lahore.

Overall, the national development spending in 2018-19 is estimated at Rs 1313 billion. This is Rs 228 billion or 17 percent less than the actual outlay on development projects all over the country in 2017-18. Adjusted for inflation, the cutback is likely to be as much as 25 percent. This is one of the largest cuts ever in the national development outlay in one year.

A number of fundamental question arise as follows: Where are the cuts being applied? What consequences will this have on the national economy?

The roll back in the Federal PSDP is examined first. The Planning Commission has, in fact, preferred to ignore the Revised Budget presented to the Parliament and opted for a larger PSDP size of 675 billion, 100 billion more than the size specified in the Revised Budget of 575 billion. While this may be good for faster implementation of more projects it represents a serious breach of the budgetary process and will imply that the fiscal deficit will be higher by almost 0.3 percent of the GDP. Also, the revised PSDP of the Federal Government for 2018-19 ought to have been presented to the National Economic Council (NEC).

The de facto cut in the Federal PSDP now is Rs 125 billion in relation to the original budget estimate for 2018-19, equivalent to 16 percent reduction. There are three types of allocations in the Federal PSDP. These are allocations to Federal Ministries/Divisions, Corporations and to Special Programs respectively. The proposed shares in the revised PSDP are 55 percent to Ministries/Divisions; 32 percent to the Corporations and the remaining 13 percent to Special Programs.

The biggest cut in relation to the original PSDP for 2018-19 has been applied on the total allocation to Special Programs of almost 26 percent, followed by a reduction of 16 percent and 11 percent in case of the Ministries and the Corporations respectively. Some Special Programs have been dropped like the PM's Youth Initiative. This is surprising given the strong electoral support from youth to the PTI and the very high levels of unemployment currently among youth graduates.

The decision to protect the allocations to the extent possible to NHA and NTDC/PEPCO is an appropriate one. NHA portfolio of projects includes a number of CPEC projects related to the physical corridor from Kashgar to Gwadar. However, the original allocation to NTDC/PEPCO of Rs 36 billion was perhaps too low. Given the need for balancing the power sector with improvement and expansion in the transmission and distribution network following the big increase in generation capacity, the allocation ought to have been much larger.

The share of the Water Resources Division also should have been bigger, given the need for faster completion of dams to alleviate the water shortage in coming years. In the Revised Budget, the combined share of highway, electricity transmission and distribution and hydel projects is 44 percent. Given the high priority of these projects the share should have been well in excess of 50 percent.

The cutback in the size of the PSDP should have led to a truncation in the number of projects being executed. New projects and projects with a large throw forward ought to have been dropped temporarily. The Planning Commission has, in fact, curtailed the portfolio of projects. The original PSDP for 2018-19 contained as many 1216 projects. This has been brought down to 848 projects. However, foreign aided projects also have been excluded from implementation. Consequently, there is a 16 percent fall in the foreign assistance available for financing the Federal PSDP.

Turning to the severe truncation of the Punjab ADP, this is clearly a case of 'overkill'. Even high priority sectors like education, health and water supply and sanitation see a reduction of 36 percent in relation to the estimated level of expenditure in 2017-18. Within infrastructure, the irrigation sector should have been given more resources for lining of canals to bring down water losses. This had not happened and allocation for irrigation projects has also been brought down by 30 percent.

It appears that the Punjab Government has been put under much more pressures by the Federal Government to generate a large cash surplus than other Provincial Governments. This has handicapped the Punjab Government in articulating the priorities highlighted in the election manifesto of the ruling party, Tehreek-e-Insaf, in its first year. A size of the ADP for this Province of Rs 350 billion would perhaps have been more reasonable. While still incorporating a cut of Rs 110 billion, it would have provided more 'fiscal space' for larger allocations to key sectors.

Based on the size of the PSDP/ADP of the five Governments it is estimated that the total national development spending will be 3.4 percent of the projected GDP in 2018-19. This will represent a fall of 1 percent of the GDP from the actual level last year. The first major negative impact is on the growth rate of the real GDP this year. It could fall due to this factor alone to 4 percent of the GDP from the growth rate achieved last year of 5.8 percent. Further, it will cut employment by over 500,000. The annual target set by the PTI of creating 2 million jobs annually will be missed in 2018-19 by a wide margin, especially in Punjab.

The big cut in development spending by the newly inducted PTI Government in its first year will effectively imply a 'slow start' on the economic front. More efforts ought to have been made to curtail current expenditure rather than the development outlay. However, efforts may now be made to fully implement their revised development programs by the respective Governments in 2018-19, with no shortfall. Also, the current slow pace of releases needs to be accelerated.

Overall, the slowdown in pubic development spending will bring down the overall GDP growth rate and worsen employment prospects. Importantly, it will reduce the future growth potential of the economy. This is the price the country will have to pay to stabilize the external balance of payments position.

Chapter 16:

CHINA-PAKISTAN ECONOMIC CORRIDOR

16.1. INTRODUCTION

China and Pakistan have had long standing friendly ties over the last many decades. Initially, the relationship was more political and focused on security. More recently, a strong economic relationship has emerged. A Free Trade Agreement (FTA) was signed in 2006. This has led to rapid growth in bilateral trade. Today, China is Pakistan's largest trading partner. In terms of FDI, the largest inflow currently is from China, especially focused on sectors like telecommunications and power. China has also provided some semi-concessional funding, cumulatively of $5.2 billion, for infrastructure projects, especially in the area of nuclear power generation.

Pakistan has supported China's initiatives, both international and regional. Pakistan is a member of the Shanghai Forum. More recently, Pakistan has acted as a founding Member of the Asian Infrastructure Investment Bank (AIIB), a regional development bank financially supported by China.

The China-Pakistan Economic Corridor (CPEC) represents the culmination of the broad and deep economic relationship between the two countries. It is one more manifestation of the transformation of China from a country receiving FDI to one which is aggressively pursuing investment opportunities in different regions / countries of the world.

CPEC is also part of the '*One Belt One Road*' (OBOR) global initiative of China. It will contribute to the development of the Western Region (especially the Province of Sinkiang) which is currently relatively backward. More importantly, it also has a key security dimension. It will provide an alternative route to the oil resources in the Middle East, in the event the Malacca Straits is blocked to Chinese ships.

Pakistan sees CPEC as a potential '*game changer*'. It will not only lead to improvement of the transport and port (Gwadar in Balochistan) infrastructure but it will also provide large-scale financing and involvement of the private sector of China in removing the constraint of power by substantial expansion in electric generation capacity by the end of the current decade. This will stimulate growth and promote investment, both domestic and foreign. A long-term plan from 2017 to 2030 of $60 billion investment by China has been signed between the two Governments.

The objective of this Chapter is to assess the role and impact of CPEC on Pakistan's economy. Section 2 of the Chapter describes the portfolio of projects included in CPEC. Section 3 assesses the potential impact on economic growth, regional trade, exports and on the balance of payments of Pakistan over the next four to five years. Section 4 highlights some of the risks associated with CPEC in terms of implementation and any possible negative implications.

16.2. CPEC PORTFOLIO OF PROJECTS

16.2.1. Size and Composition

The sectoral composition of CPEC agreed between the two Governments is given in Chart 16.1. The total size originally was $46 billion, which has been raised to $60 billion. The portfolio currently of projects is of $38.7 billion, as shown in Chart 16.1. The largest sectoral investment is in energy of $22.8 billion and includes 17 projects, leading to an expansion of capacity of over 11,000 MW. Next in importance is the highway sector, enabling a link for China to the Arabian Sea. Total investment proposed on highway development is $5.2 billion. In addition, the Railway project of $8.2 billion involves reconstruction of 1738 kms. The Lahore Mass Transit Project (the Orange Line) has also been included by China, with special arrangements for concessional financing.

Chart 16.1: Sectoral Composition of CPEC and List of Projects

Sector	Billion USD	Remarks
Energy	22.8	17 projects, 11,110 MW
Road	5.2	5 Projects
Rail	8.2	2 Projects, reconstruction of 1736 KMs
Lahore Mass Transit	1.6	1 project
Gwadar Port	0.8	8 Projects
Fiber-optics	0.1	1 project
TOTAL	**38.7**	

Source: Planning Commission, Ministry of Planning, Development and Reform, GoP.

The private and public sector component of the CPEC is given in Table 16.1. The dominant part of execution and management will be by the private sector, accounting for over 73 percent of CPEC funds. There is enormous scope between the private sectors of the two countries for developing partnerships.

Table 16.1: CPEC Component of Public and Private Sectors

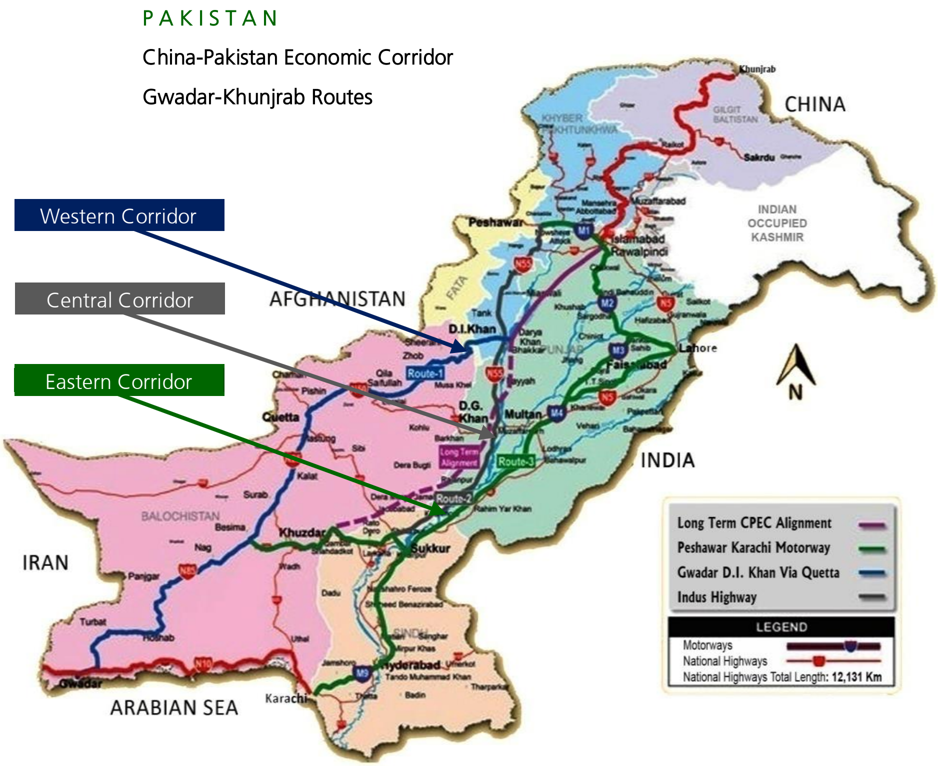
Executing Agency	Sector	Amount ($ billions)	Share (%)
Public Sector		15.9	41.0
Federal Government	Road, Rail, Gwadar Port Fiber-optics	14.3	
Provincial Government of Punjab	Mass Transit	1.6	
Private Sector	Energy	22.8	59.0
TOTAL CPEC		**38.7**	

Source: Planning Commission, Ministry of Planning, Development and Reform, GoP.

Highways

Three transport links are proposed with highways connecting Khunjerab with Gwadar, as shown in Chart 16.2. The first link is the Eastern Corridor, which essentially builds on the existing National Highway, from Peshawar to Karachi. A diversion is proposed at Sukkur via Khuzdar to Gwadar. The Western Corridor passes through a relatively underdeveloped part of the country, especially linking Peshawar with D.I. Khan in Khyber-Pakhtunkhwa, Quetta and Turbat in Balochistan on to Gwadar. The length of this proposed Corridor is significantly less than the Eastern Corridor. In the final phase, the Central Corridor will be constructed. It will pass mostly through Punjab and link up with Balochistan. It will essentially by pass Northern Sindh.

Chart 16.2: CPEC Transport Corridors



Source: NHA, Planning Wing also PC public announcement

Energy

The list of relatively energy projects already identified is given in Table 16.2. Four projects are in Punjab, nine in Sindh, two in Balochistan and two in Khyber-Pakhtunkhwa. The dominant energy source of six projects is coal, with four based on imported coal. Up to now, there is only one solar project and seven renewable energy projects. These projects combined will have a capacity close to 11000 MW. Most projects are likely to be completed by end 2018 or mid 2019. An additional capacity of 1500 MW is potentially in the pipeline. Currently, almost 4000 MW of capacity is fully operational.

Table 16.2: Portfolio of Chinese Energy Projects

	Location	Fuel source	Capacity (MW)	Cost ($ million)	Status
A. Energy Projects					
	Priority Projects				
1.	Port Qasim, Karachi	Coal	1320	1912	Operational
2.	Naran, KPK	Hydel	870	1707	Construction
3.	Sahiwal, Punjab	Coal	1320	1912	Operational
4.	Thar, sindh	Coal	1320	1991	Construction
5.	Thar, Sindh	Coal	n.a.	1470	Construction[1]
6.	Gharo, Sindh	Wind	50	113	Operational
7.	Gwadar, Balochistan	Coal	300	n.a.	New[2]
8.	Bahawalpur, Punjab	Solar	1000	1302	Partly Operational[3]
9.	Jhimpir, Thatta	Wind	100	250	Operational
10.	Jhimpir, Sindh	Wind	50	134	Operational
11.	Thar, Sindh	Coal	1320	3212	Construction
12.	Karot, KPK	Hydel	720	1700	Construction
13.	Three Gorges, Sindh	Wind	100	150	Operational
14.	Hub, Balochistan	Coal	1320	1912	Construction
15.	Matiari to Lahore	Transmission Line	n.a.	1658	New
16.	Matiari to Faisalabad	Transmission Line	n.a.	1500	New
17.	Thar, Sindh	Coal	1320	n.a.	New
	TOTAL		**11110**	**22914**	

[1]by December 2018 | [2]No Construction | [3]300MW

B. Infrastructure Projects

Sector	Description	Cost	Status
Road	KKH-II (Thokot-Havelian)	1315	Construction (2020)*
Road	Peshawar – Karachi (Multan-Sukkur)	2889	Construction (2019)
Road	Khuzdar – Basima	80	New
Road	D.I. Khan – Zohb	195	New
Road	KKH Thakot – Rialkot	720	New
Railway	Expansion and Reconstruction Line ML-1	8172	New (2022)
Railway	Havelian Dry Port	65	New
Mass Transit (MT) Peshawar (MT) Quetta (MT)	Tentative		
Orange Line, Lahore		1626	Construction (2019)

Source: Planning Commission

Infrastructure projects relate to transportation, primarily for the Corridors. There are five road projects, two railway projects and two mass transit projects, as shown in Table 16.2.

16.2.2. Project Constraints and Financing

The first case is of the Thar Coal-fired 660 MW project. This is a partnership of Pakistani and Chinese sponsors. The former consists of a joint venture of the Sindh Government with five local private firms led by Engro Corp. The Chinese sponsor is SINOSURE.

The total cost is $1.9 billion, which includes extraction of 3.8 million tons of coal from Thar and setting up the 660 MW plant. The financing is as follows:

	Amount – ($ million)
China Development Bank and Industrial and Commercial Bank of China	800
Pakistani Banks Syndicate- Habib, UBL and Alflah	500
Equity by Sindh Sponsor	500
Chinese Contractor	100
TOTAL	**1900**

The agreement for financing and execution of the project was to be signed on December 21, 2015. The pre-condition was the issue of a sovereign guarantee by the Government of Pakistan by December 2015. This has been considerably delayed. The proposed upfront tariff, set by NEPRA, is 9.5 cents per kwh. The financing terms are as follows:

Local Bank Financing:	KIBOR + 1.7%	≈ 9%
Chinese Financing:	LIBOR + 3.3%	≈ 4½%

NEPRA assumes that the tenure of the financing is ten years. This implies that the annual amortization of the Chinese loan will be about 12½ percent of the financing. This is very much in the domain of relatively high cost commercial financing.

The implementation process of two major highway infrastructure projects has also run into the difficulty in that cost escalations are required. These projects are identified below.

				($ billion)
	Projects	Original Cost	($ billion) Escalated Cost	% increase
1.	Multan – Sukkur | Section of Eastern Corridor	3.00	3.55	18
2.	Havelian – Thakot Road	0.93	1.40	51

Apparently, the upward revision of the cost is due to bids by Chinese contractors higher than the original cost estimate presented to ECNEC for approval. This is the result of the limitation imposed under the framework agreement signed with China, according to which the bidding process is limited only to Chinese firms. The consequence of the cost escalation is a significant reduction in the economic internal rate of return of the projects.

16.3. ECONOMIC IMPACT

We assess the potential macroeconomic impact of CPEC on various dimensions of the national economy.

Growth

CPEC has the potential to raise productivity and growth from 2018 onwards, provided the projects are implemented on time and are well-managed. However, any demand-driven expansion of the GDP as a result of project implementation is expected to be limited as increased investment may initially be offset by increased imports. Chinese contractors/companies are expected to import bulk of their required machinery and equipment mostly from China.

As opposed to this, there are likely to be major positive supply-side effects. The commissioning of power plants with combined capacity of up to 11,000 MW, starting from the end of 2017 onwards, will help greatly in removal of one of the big constraints to growth currently in the form of power outages. This cost will potentially be largely avoided. If an additional 36,000 Gwh is eventually generated by CPEC, then this will contribute to higher GDP of almost $11 billion dollars. This will cumulatively add over 3 percent to the size of the national economy. Initially, the spurt in the growth rate of the economy may be up to two percentage points.

Employment will be generated during the construction period, although a part of the staff at the management and technical levels will be taken up by Chinese personnel. As industrial production expands initially due to more intensive utilization of existing capacity, employment will also expand, especially in labor-intensive sectors like textiles.

The availability of power is also likely to stimulate private investment. The Government proposes to establish 29 Special Economic Zones (SEZs) in close proximity to the transport corridors, with dedicated supply of electricity. A number of fiscal incentives are being offered for investment in the SEZs. These include a ten year income tax holiday and exemption of import duties on plant and machinery. Foreign investment, with at least 50 percent foreign share in the equity, is being given the special incentive of a lower corporate income tax rate of 20 percent for the lifetime of a project.

16.4. POTENTIAL IMPACTS

Balance of Payments

Bulk of the CPEC power projects are based on imported coal. This will increase the import bill significantly. The magnitude of increase will depend on the international price of coal at the time when the projects are commissioned. Currently the price is very low. This represents a fall of over 50 percent from the level in 2013. However, in the medium term, energy prices could rise significantly.

Table 16.3 presents the impact of the power component of the CPEC on the balance of payments of the country. Inclusive of repatriation of profits, this could lead to a negative impact by 2018-19. However, this may be at least partially mitigated by a jump in exports.

Public Finances

From 2017-18 onwards, the federal PSDP will have to be expanded by at least 0.5 percent of the GDP) to create the 'fiscal space' for financing of CPEC infrastructure projects. This will lead to a corresponding increase in the size of the fiscal deficit. However, the financing of the larger deficit will come mostly from external (Chinese) sources. As such, the pressure on domestic borrowing should not increase.

Table 16.3: Impact of CPEC on Balance of Payments (BoP) – (approximate magnitude)

	($ billion)			
	2016-17	2017-18	2018-19	2019-20
INFLOW	**1.1**	**3.8**	**4.1**	**6.0**
Concessional	1.1	1.6	1.8	2.0
Commercial		2.2	2.3	4.0
OUTFLOW	**-1.5**	**-1.5**	**-3.9**	**-6.3**
Amortization Payments on Chinese Loans		-	-1.1	-2.6
Imports of Power Equipment	-1.3	-1.3	-1.6	-1.5
Imports of Construction and Other Equipment	-0.2	-0.2	-0.2	-0.2
Additional Fuel Import (Coal)	-	-	-1.0	-2.0
Repatriation of Profit	-	-	-0.4	-0.7
NET IMPLICATION ON THE BOP	**-0.2**	**2.3**	**-0.2**	**-0.3**

Source: Planning Commission, Ministry of Planning, Development and Reform, GoP.

From 2018-19 onwards, additional tax revenues will accrue, first, from the import of fuel and on the sale of the extra power generated. This could approach Rs 75 billion (close to 0.2 percent of the GDP). In addition, the higher GDP should also translate into additional revenues of about Rs 125 billion (over 0.3 percent of the GDP). Further, significant toll revenues will also be realized following the completion of the Eastern Corridor.

Regional Development

This will depend crucially on when the West Corridor is constructed. This corridor passes through the relatively underdeveloped parts of the country. Further, the Province of Balochistan will benefit directly by development of the Gwadar Port. In addition, the Northern Areas will also see additional investment on highways. Punjab is likely to benefit more with the development of the Eastern Corridor and with the location of the majority of power projects in the Province.

There are 9 Special Economic Zones (SEZs) to be located generally in proximity to the Corridor, with attractive fiscal incentives. They are to be situated in Mansehra, Dhabeji, Bostan, Faisalabad, Islamabad, Karachi, Mirpur, Mohamand and Gilgit Baltistan.

Regional Trade

CPEC greatly improves the access of Chinese exports to neighbouring countries like Afghanistan, Iran and India. Pakistan will also benefit from the higher revenues from transit traffic. As already indicated, CPEC will also provide a fillip to bilateral trade among the two countries.

Overall, there are substantial benefits of CPEC. This is why it has been referred to as a '*game changer*' for Pakistan and possibly for the region. However, there are a number of risks which are highlighted below.

16.5. RISKS

Stress on the Federation

The two smaller Provinces are clamoring for first priority to construction of the Western Corridor of CPEC. However, highway projects will first be implemented in the Eastern Corridor, mostly on the alignment of the existing National Highway. This will mean lower development costs. However, it will pass mostly through Punjab and northern Sindh.

The other objection which has been raised is the location of the majority of coal-fired, based on imported coal, power plants in Punjab. This increases the cost of transportation of the coal from Karachi port. However, Punjab has argued that the plants are located near the nodal centres of electricity consumption. Therefore, the location policy will reduce transmission and distribution losses.

Implementation Delays

High priority is being attached to completion of many of the infrastructure projects and power plants by 2018. However, there is the issue of adequate capacity to directly implement infrastructure projects and to support private sector investment in the power sector. This will imply the need for enhancement in capacity of institutions like the National Highway Authority. It will also be essential that there are no delays in the financial dose of power projects, so that construction work can start as planned.

Costs of Projects

Associated with the delays in implementation is the risk of escalation of capital costs of Projects. The Neelum-Jhelum and Nandipur projects are examples where cost escalations have been massive. Already, we have highlighted the rise in costs of highway projects of up to 50 percent. The monopoly power of Chinese companies, whereby bidding is restricted only to them in the case of Chinese financing, raises the likelihood of higher costs due to less competition.

Security

Another factor which could inhibit construction work is acts of terrorism in proximity to sites of projects. Fortunately, the Pakistan Army is playing an important role in the implementation of CPEC by setting up a dedicated force of military personnel to provide protection at the project locations and especially to Chinese workers.

Debt Sustainability

Prominent economists of Pakistan have raised the issue of external debt sustainability in the medium run. The total external debt could rise to $105 billion by end of 2018-19, especially with the large borrowing from Chinese financial institutions. External repayment liabilities will begin to peak after 2017-18 because of retirement of Euro Bonds and Ijara Sukuk bonds, repayment of the IMF loan of $6.6 billion and amortization of commercial loans from China. Special efforts will have to be made to raise exports by almost 50 percent by 2020-21 to create the requisite debt repayment capacity.

Pakistan is entering a critical stage of development. CPEC promises to remove the key bottlenecks to faster growth. But the process of implementation of CPEC will have to be carefully managed at the micro project level and at the macro level in terms of sustainability and inclusiveness of the process of growth.

Overall, there is need for strong support from the new Government to CPEC. Initially, some objections were raised and a case was being made for a review of CPEC projects. However, after a visit to China by the Prime Minister most problems have been resolved. A new wave of concern has come from the USA and the IMF. The latter is raising the issue of Pakistan's ability to meet the liabilities resulting from the projects down the road.

Chapter 17:

THE PRIVATIZATION PROGRAM

Privatization of state assets provokes strong emotions. The proponents see this as a way of reducing the burden on the exchequer by transfer of loss-making public state enterprises (PSEs) and achieving efficiency gains through a private sector management less vulnerable to graft and corruption. Opponents argue that privatization could lead to the creation of monopolies, with adverse implications on employment and consumer welfare. The consequence would be a further concentration of wealth and a return to the days of large 'robber barons'. The view that is recommended by the pragmatists on this issue is that privatization should be promoted only of state companies operating in a competitive environment in industry, finance and trade, but that this process should be strictly avoided in the case of natural monopolies and of strategic assets like natural resources.

Section 1 of the Chapter describes the framework for privatization that exists currently in Pakistan. It also highlights the policy on privatization enunciated earlier in the manifesto of the PML (N) and more recently by PTI. Section 2 reviews the history of privatization in the country and identifies the post-privatization performance in key sectors. This section also highlights the major lessons learnt.

Section 3 describes alternative models of privatization and the size and composition of the Privatization Program, as was agreed with the IMF in the Extended Funded Facility (EFF). Section 4 sets up the criteria for selection of units and modalities for privatization. These criteria are then applied to the units included in the Program. The projected impacts of the proposed privatization process on key variables like production, employment, public finances, balance of payments, inflation, etc., are identified in the Section 5. Finally, the key conclusions and recommendations are presented in Section 6.

17.1. THE FRAMEWORK

17.1.1. The Law

Pakistan does not have a comprehensive Privatization Law like Turkey, Philippines, Algeria, Morocco, Tunisia, Jordan, Bulgaria and others. Instead, privatization is undertaken under the *Privatization Commission Ordinance of 2000*. It describes the structure and functions of the Privatization Commission, the financial provisions, the process of privatization, jurisdiction of the Courts, regulatory and other provisions.

The Ordinance has a key provision regarding the utilization of privatization proceeds accruing to the Federal Government. According to Section 16(2), ten percent shall be used for poverty alleviation program and ninety percent for retirement of Federal public debt. Also, Section 5 states that the Privatization Commission must advise the Federal Government that monopolies are not created in the process of privatization. Policy decisions are taken by the Cabinet Committee on Privatization (CCOP).

The *Constitution of Pakistan* contains an important provision which has important implications on the process of privatization. Article 173(2) states the following:

> *'Subject to the existing commitments and obligations, mineral oil and natural gas within a Province .... shall vest jointly and equally in that Province and the Federal Government.*

This may be taken as implying that any state companies in oil and gas exploration, extraction and distribution should be privatized only after formal approval in the Council of Common Interests (CCI). Further, the proceeds should be shared on a 50:50 basis among the Federal Government and Provincial Governments (where the natural resources are located).

17.1.2. The PML (N) and PTI Manifesto

The policy on privatization of the Party is given in the section of the manifesto on '*State Owned Enterprises*', which is part of the first chapter on '*Economic Revival*'. The focus is on state-owned institutions like PIA, Railway, Pakistan Steel Mills, WAPDA and other institutions who are a major drag on Pakistan's economy, with losses currently of over Rs 300 billion per annum and cumulative losses of Rs 1.2 trillion. It is proposed to reform these institutions through a combination of privatization and restructuring.

As such, after induction into power, PML (N) proposed to initiate the following actions to turn around the loss making PSEs:

- Appoint independent and professional boards who in turn will appoint competent CEOs of state enterprises. Professional competence and merit will be the only criteria for appointment of boards and CEOs.
- The immediate task of the boards and CEOs will be to manage these corporations effectively and to plug the losses.
- Assign quantifiable targets and monitor on regular basis. Performance evaluation will be carried out on regular basis to ensure accountability.
- Stop every kind of political interference in the affairs of these enterprises.
- Undertake deep-seated and urgent reforms in the relevant sub-sectors.

- Identify enterprises which need to be privatized and assign targets to the Privatization Commission to ensure completion of the privatization process within the assigned time frame.
- Operational standards will be prescribed and complete autonomy will be given to achieve them.
- PIA shall be transformed into a profitable and reputed airline of the Region.

There will be special focus on Pakistan Railways to improve its operations. It has strategic importance as well as being the favored mode of transportation for the common man and cargo carriages. A fully autonomous board will be set up to oversee the working of Railways. However, the implementation of the above reforms has been very weak over the last five years.

The new PTI Government has a similar policy regarding privatization as the earlier PML (N) administration and manifesto. The difference is that it is proposed to set up a National Wealth Fund with management experts for restructuring the PSEs. Recently, an announcement has been made by the Privatization Commission that the Railway, PIA and the Pakistan Steel Mill (PASMIC) will not be privatized.

17.2. PAST PRIVATIZATION

17.2.1. Level and Composition

The major process of privatization started in 1991 during the tenure of the first Nawaz Sharif Government. The peak was attained in the Musharraf period, 1999 to 2008. Altogether, 169 units have been involved in this process. The largest privatization proceeds have been from the sale of telecommunications companies, especially PTCL, with a share of 39 percent in total proceeds (see Table 17.1). Next in size is the banking and finance sector, with privatization and market sale of shares worth Rs 174 billion, representing a share of 37 percent. Major banks transferred to private owners include ABL, MCB, UBL and HBL.

Table 17.1: Privatization Proceeds, 1991-2011* – (Rs in Billion)

Sectors	Number of Units	1991-1999	1999-2008	1991-2011	Percentage
Banking and Finance*	31	5.6	168.5	174.1	36.6
Energy Sector	14	10.3	41.5	51.8	10.9
Telecom Sector	4	30.5	156.8	187.3	39.3
Industry	105	11.9	49.0	60.9	12.8
Others	15	0.5	1.7	2.2	0.5
TOTAL	**169**	**58.8**	**417.5**	**476.3**	**100.0**

*including capital market transactions of Rs 133.1 billion
Source: Privatization Commission

Fourteen units in the energy sector have also been privatized, yielding Rs 52 billion (share of 11 percent). This list includes KESC, NRL and KAPCO. 105 industrial units have also been privatized. This includes units in automobiles, cement, chemicals, engineering, fertilizer, ghee, food and textiles. Some of the major industrial units privatized are DG Khan Cement, Wah Cement, Mustekham Cement, Javedan Cement, Pak-Saudi Fertilizers, Pak-Arab Fertilizers and Pak American Fertilizers. Rs 61 billion have been generated from the sale of industrial units, with a share of 13 percent.

24 capital market transactions have been undertaken. This includes POL (24 million shares), OGDCL (15 percent of shares)[2] PPL (15 percent of shares), UBL (19.6 percent of shares) and HBL (7.5 percent of shares). The total yield from these sales is Rs 133 billion, about 28 percent of the total proceeds.

Large revenues of Rs 418 billion were generated from privatization during the Musharraf period, equivalent to 88 percent of the cumulative proceeds since 1991, including almost $ 6 billion of foreign exchange receipts. This represents a share of 30 percent of the total FDI and FPI combined during this period and 70 percent of the foreign exchange reserves at the time of transition in 2008 to the PPP government. Clearly, the Musharraf government used privatization as a way of promoting FDI and building up foreign exchange reserves.

17.2.2. Post-Privatization Experience

ADB [2014] has assessed the performance of the units after privatization in Pakistan. Only 20 units appear to be performing better than before. In the case of manufacturing, 16 out of the 38 privatized units were performing worse than in the pre-privatization period. Transparency has been weak and regulatory mechanisms ineffective and extremely politicized.

A comparison of nationalized banks in the late 70s with privatized banks in recent years yields interesting conclusions. First, the latter are more risk-averse. Only 31 percent of the assets are in the form of credit and as much as 50 percent in government securities. As opposed to this, nationalized banks devoted 55 percent of their assets to credit and only 27 percent to investment in risk-free government treasury bills and bonds.

Second, the share of nationalized bank credit to agriculture was over 13 percent as compared to 5 percent only by the private banks currently. A credit plan at that time ensured that enough credit was allocated to priority sectors like agriculture, SMEs and exports. Third, the margin between the return on advances and on deposits was lower at about 5 percentage points in the late 70s as compared to over 7 percentage points currently. This highlights the likelihood of cartelization behavior by private banks.

[2] Including a GDR of 9.5 percent of shares.

KESC is the only power distribution company that has been privatized with a change in name to K-Electric. There are ten other distribution companies under PEPCO. K-Electric's performance compares unfavorably with PEPCO. Transmission and distribution losses are as high as 28 percent as compared to 18 percent in the latter. Billing losses are 15 percent, 5 percentage points higher than in PEPCO.

17.2.3. Lessons Learned

The above findings clearly indicate that privatization is no guarantee for improved efficiency. This depends not only on the management skills and experience of the new private strategic investor but also on the market environment and presence of effective regulatory mechanisms.

There is also a need for proper valuation and coverage of assets of the unit to be privatized. The Supreme Court stopped the privatization of PASMIC because of the lack of proper valuation of assets, especially land. In some cases, like KESC, despite a commitment, enough investment has not been made in the renovation and up- gradation of assets. The full proceeds from privatization of PTCL have not yet been realization due to a dispute on the value of assets.

One of the biggest lessons is that gains from privatization hinge crucially on the presence of autonomous, effective and alert regulatory agencies, free from any political influence and with quasi-judicial powers. This will prevent monopolistic behavior or emergence of cartels and protect consumer interests.

There is a view that post-privatization banks have effectively formed a cartel as indicated above and raised their margins between the rate of return on advances and deposits. Apparently, SBP has not done enough to get this margin reduced. The same suspicion about price-setting behavior applies to private cement companies.

17.3. THE PRIVATIZATION PORTFOLIO

17.3.1. Size, Modalities and Composition

The modalities that are proposed to be adopted in the privatization program are as follows:

(i) market sale of shares
(ii) privatization in 'as-is' condition
(iii) restructuring then privatization

The list of units in each category with the Privatization Commission is given in Table 17.2 by sector.

Table 17.2: Units up for Privatization

Sectors	Market Sale of Shares	Privatization	Restructuring then Privatization
Energy	• OGDC • PPL • MPL • GHPL • Pak-Arab Refinery • KAPCO	• IESCO • FESCO • HESCO • NPCC • JPCL • NPGCL	• PSO • SSGC • SNGPL
Banking	• HBL • UBL • ABL • NBP	• SME Bank	
Finance and Insurance	• SLIC	• NICL • NIT • PRCL	
Industry		• HEC • PECO • PASMIC	
Transport and Communications		• PIA • PIA Hotels • PNSC	
Others		• Convention Centre, Islamabad	
TOTAL	11	17	3

Source: Privatization Commission.

Market sales are proposed in the case of 11 entities. These are mostly blue chip companies like OGDC, PPL, HBL, UBL, NBP, etc. Seventeen units are targeted for privatization in 'as – is' condition and three for restructuring followed by privatization. During the tenure of the last PML(N) Government, substantial proceeds of Rs 1.1 trillion were realized by sale of shares of banks and companies like OGDC, by sales of licences by PTA and other assets of the Federal Government. However, these proceeds have been reported as non-tax revenues and not as a source of financing of the budget deficit as per the Privatization Ordinance.

The sectoral distribution is dominated by the energy sector, with 15 units in the privatization portfolio. The next sector in importance is banking and insurance with 9 units. Three industrial units, viz, HEC, PECO and PASMIC are targeted for privatization. Three units, namely, PIA (plus hotels) and NSC are from the transport and communications center.

The large size of the Privatization Program is indicated by the value of assets of the units in the portfolio. According to Table 17.3, the value aggregates to almost Rs 7 trillion ($69 billion). This is why it is sometimes referred to as the potential 'sale of the century'. Of course, not all assets will be sold in one go.

Table 17.3: Key Financial Statistics of Major PSEs* [as per recent information] – (Rs in million)

PSE	Total Assets	Net Profit (after Tax)	Return on Assets (%)
Energy Sector			
OGDC	414,011	90,777	21.9
PPL	347,578	42,155	12.1
Mari Gas	34,192	2,421	7.1
KAPCO	99,345	6,071	6.1
Banking Sector			
HBL	1715,271	23,027	1.3
UBL	1009,739	19,738	2.0
ABL	734,196	14,643	2.0
NBP	1371,718	5,306	0.4
Financial Sector			
SLIC	293,707	520	0.2
NICL	27,273	2,525	9.3
NIT	51,127	1,365	2.7
Transport			
PIA	192,355	-32,368	-16.8
PNSC	33042	660	2.0
Distribution			
PSO	281,308	12,557	4.5
SSGCL	173,285	2,447	1.4
SNGPL	173,325	3,044	1.8

*Data not available on PASMIC and PECO

Source: Annual Accounts / Reports

The total assets of the target PSEs is almost $6.7 billion and net profits are close to $1.8 billion. The market capitalization is $35 billion, as shown in Table 17.4.

The nature of the privatization portfolio clearly indicates that the Government has moved away from restructuring and then privatization of loss-making PSEs. Only few of the 31 enterprises, namely, PIA, PASMIC and some of the units in the energy sector are loss-making. Others include some highly profitable entities like OGDC, PPL, Mari Gas, KAPCO, NICL, etc.

Table 17.4: Market Capitalization of Shares by Sector – (Rs in Billion)						
Sectors	**June 2012**	**Share (%)**	**June 2013**	**Share (%)**	**June 2014**	**Share (%)**
TOTAL	**3518**	**100.0**	**5155 (46.5)[a]**	**100.0**	**7023**	**100.0**
Oil and Gas	1158	32.9	1639 (41.5)	31.8	1965 (19.9)	28.0
Electricity	119	3.4	186 (56.3)	3.6	19.6 (5.4)	2.8
Banks	753	21.4	952 (26.4)	18.5	1509 (58.5)	21.5
Insurance	62	1.8	86 (38.7)	1.7	144 (67.4)	2.1
Financial Services	41	1.2	57 (29.0)	1.1	68 (19.3)	1.0
Total of Above Sectors	**2133**	**60.6**	**2920 (36.9)**	**56.6**	**3882 (32.9)**	**55.3[b]**

[a]Figures in brackets are growth rates

[b]The Government owns about 50 percent of the shares.

Source: SBP

Clearly, under the pressure of IMF in the Extended Fund Facility (EFF) the emphasis was on quick generation of foreign exchange by market sales of profitable entities. As in the case of the policy adopted by the Musharraf government the objective was to build up foreign exchange reserves quickly and promote FPI into Pakistan. In some ways, the approach was one of 'selling family silver to repay debts'.

The structural benchmarks in the program with IMF with regard to privatization are given in Chart 17.1. The biggest action related to the sale of 26 percent of PIA shares by end-December 2014. However, the EFF with the IMF came to an end in September 2016. The sale of shares took place but the privatization of PIA was avoided.

Chart 17.1: Structural Benchmarks in IMF Program on Privatization

- Hire three Financial Advisors for three PSEs in the capital market transactions list and three PSEs in the strategic privatization list

  Status *Partially Met*

- Privatize 26 percent of PIA's shares to strategic investor

  Status *Net Met*

- Offer the minority shares of UBL, PPL, OGDC, ABL to domestic and foreign investors

  Status *Met*

17.4. CRITERIA FOR PRIVATIZATION

17.4.1. Market Sale of Shares

The basic decision is if a share should be sold or not by the Government from its holding of equity in a company. The decision depends upon the factors described below. We designate the following:

g = projected capita gain/loss in the market value of a share

d = rate of annual dividend on a share

τ = projected mark-up annually on long term PIBs

Then, market sale of shares owned by the Government in a company is justified if;

$$g + d < \tau$$

and not justified if

$$g + d > \tau$$

Therefore, the decision as to whether to go in for more market sales hinges crucially on expectations of the future growth of share prices at three levels - market, sector, individual scrip. Further, in the case of shares of companies with ownership of natural resources, oil and gas, the Article 172(3), referred to earlier, becomes applicable. Therefore, the Provincial Governments will need to be involved in the decision to sell. In the event sale takes place, then 50 percent of the proceeds will have to be reverted to them.

17.4.2. Privatization to Strategic Investor

Based on the past experience and the need to avoid the creation of monopolies, the following criteria have been identified to determine if a unit should be privatized and handed over for management to a strategic investor:

Criteria for Evaluating Case for Privatization			
S. #	Score	S. #	Score
1. Profit-Making`		5. Outstanding Liabilities	
▪ If losses	1	▪ If no or small liabilities	1
▪ If small profits	½	▪ If large liabilities	0
▪ If large profits	0	6. Performance of Social Functions	
2. Monopoly		▪ If Social functions not performed	1
▪ If a competitive market	1	▪ If performed	0
▪ If a monopoly	0	7. Over employment	
3. Regulatory Authority		▪ If large over employment	1
If presence of:		▪ If no or small over employment	0
▪ Strong Regulatory Authority	1	8. If Political Opposition / Resistance from Trade Unions / Transparency Issues	
▪ Weak Regulatory Authority	0		
4. Valuation of assets		▪ If no	1
▪ If proper and full valuation of assets	1	▪ If yes	0
▪ If not	0		

According to the above criteria, the case for privatization of a unit is strong / weak if it is making losses/high profits; if it will be in a competitive market / become a monopoly; if the relevant regulatory authority is effective / ineffective; if it is possible / not possible to fully evaluate the assets; if there are small / large outstanding liabilities; if the unit is not performing / performing basic social functions; if there is over employment / proper level of employment; and if there political opposition or resistance from trade unions.

The combined (un-weighted) score is as follows:

Maximum Score 8

Minimum Score 0

A unit has to have a score of at least 5.5 (just over 2/3rds of the maximum score) to be considered for privatization.

These criteria are applied to the 20 units earmarked for privatization in the Statistical Appendix to the Chapter. The results are summarized in Chart 17.2.

Chart 17.2: Case for Privatization

Yes	No
PASMIC	PIA
NSC	PIA Hotels*
NIT	PSO*
SME Bank	SSGC
HEC	SNGPL
Convention Centre	IESCO
NPCC	FESCO
JPCL	HESCO
PRCL	NICL
NPGCL	PRCL
10	**10**

*Marginal case

Therefore, according to the above criteria, there is a case for privatization of ten out of twenty units in the proposed privatization portfolio. This include entities like PASMIC, NSC, NIT, SME Bank and so on.

17.5. IMPACT OF PRIVATIZATION

The direction of impact of different forms of privatization is given in Chart 17.3. It is clear that the impact varies with the modality of privatization.

Chart 17.3: Impact of Different Forms of Privatization

	Market Sale of Minority Shares	Restructuring + Privatization or Privatization
Production	0	+
Employment	0	-
Fiscal	+ / -[a]	- / +[b]
Balance of Payments	+ / -	+ / -
Consumer Welfare	0	?

[a] Better now; worse later
[b] Worse now; better later
? Not Clear

17.5.1. Market Sale of Shares

This does not lead to any change in management. As such, there is no impact on production or employment. The major short-run impact of a favorable nature is on the balance of payments and public finances. If sales lead to larger foreign investment, then there is some improvement in the reserve position, as has happened recently with the sale of ABL, UBL, HBL and PPL shares. Similarly, the proceeds from sale of shares help in the retirement of federal debt and reduce the cost of debt servicing.

However, the subsequent effects are negative. The repatriation of dividends or encashment of shares affects the balance of payments position. Also, by sale of shares the Government foregoes the future stream of dividend income. This is especially the case with sale of shares of profitable companies like OGDC and PPL.

17.5.2. Privatization to a Strategic Investor

In this case if the new private management is more efficient then there could be gains in production. Also, the surplus employment could be retrenched. There could be some net losses initially if the outstanding liabilities have to be retired. For example, the loans of and guarantees issued to PIA aggregate to over Rs 300 billion. The price that these units fetch may be lower than the outstanding liabilities. However, following the privatization the Government will save the annual cost of subsidies.

The balance of payments impact depends on whether the strategic investor is a foreign entity. If this is the case, then there is more foreign investment. The impact thereafter is negative due to repatriation of profits.

Consumer welfare gains are ambiguous. If higher efficiency translates into lower prices than consumers will benefit. As opposed to this, there is the danger of exercise of monopoly power or formation of a cartel. The cement units privatization in the last decade may have led to cartelization, which the CCP has not been able to break. Similarly, the SBP has been unable to prevent the increase in the margin between the returns on advances and on deposits, following the large-scale privatization of the banking sector.

17.6. CONCLUSIONS AND RECOMMENDATIONS

On the basis of application of rational criteria, the recommendations is for a truncated process of privatization. Market sales of shares of profitable companies with valuable assets, must generally be avoided. The shares of such companies are likely to continue appreciating in future and yield large capital gains.

Privatization to a strategic investor may be resorted to in ten out the twenty units included in the list for privatization. The focus should instead be on restructuring of loss-making PSEs. In particular, bulk over 80 percent, the emphasis should be reduction of the losses is in the power sector. The Government has done little to improve efficiency in the sector by replacement and modernization of old plants and the transmission system, cutting down of billing losses, buildup of arrears, etc. Given the state of the power sector, especially of low liquidity due to accumulation of circular debt, it is unlikely that any private investor would like to rapidly take over a GENCO or a DISCO.

There is need to ensure that interests of employees are protected. A proper severance package must be offered. In addition, a portion of the shares being sold must be allocated to employees, either individually or collectively, subject, of course, to payment of the reservation price.

There will be need to strengthen regulatory agencies like CCP, SECP and others to ensure that no monopoly or cartel emerges post-privatization. Also, to the extent that units to be privatized are performing social functions, then these should continue after privatization, possibly with a subsidy from the Government.

The nature of the new PTI Government, which is seen as business-friendly, requires even more that transparency of transactions be fully preserved. The development of a business – political nexus must be avoided. Members of the Privatization Commission have to be careful about any conflict of interest.

The Privatization Program must be handled carefully and with concern for different stakeholders. It should not degenerate into a desperate rush for selling ‘family silver’ to acquire foreign exchange, as happened in the earlier years of the Musharraf era. Instead, if proper restructuring of major national enterprises takes place then the benefits to the economy and to the people in general will be substantially enhanced.

Table S-1: Application of Criteria for Evaluation of Case for Privatization

Criteria	PIA	PIA Hotel	PASMIC	NSC	PSO	SSGC/ SNGPL	NIT
Profit Making	1	0	1	″	0	″	″
Monopoly	1	1	1	1	1	0	1
Regulatory Authority	″	1	1	1	0	0	1
Valuation of Assets	0	0	0	1	1	1	1
Liabilities	0	1	0	1	1	1	1
Social Functions	0	1	1	1	0	0	1
Over employment	1	1	1	1	1	1	1
Political Opposition/ Resistance by Unions/ Transparency Issues	0	0	″	1	1	1	1
TOTAL	**3″**	**5**	**5″**	**7″**	**5**	**4″**	**7″**
%	44	63	69	94	63	56	94
Privatization (Yes/No)	*No*	*No / Yes**	*Yes*	*Yes*	*No / Yes**	*No*	*Yes*

*marginal cases

Table S-2: Application of Criteria for Evaluation of Case for Privatization

Criteria	IESCO/ FESCO	HESCO	NPGCL	NPCC	JPCL	PRCL	SME Bank	NICL	HEC	PECO	Convention Centre
Profit Making	1	1	1	1	1	0	1	0	1	″	1
Monopoly	0	0	1	1	1	0	1	0	1	1	1
Regulatory Authority	1	1	″	0	″	0	1	0	1	1	0
Valuation of Assets	0	0	1	1	1	1	1	″	1	1	1
Liabilities	0	0	0	0	0	1	0	1	0	0	0
Social Functions	0	0	1	1	1	″	0	1	1	1	1
Over employment	1	1	1	1	1	1	1	1	0	0	1
Political Opposition/ Resistance by Unions/ Transparency Issues	0	1	1	1	1	1	1	1	1	1	1
TOTAL	**3**	**4**	**6.5**	**6.0**	**6.5**	**4.5**	**6**	**4.5**	**6**	**5.5**	**6**
Percentage	38	50	81	75	81	56	75	56	75	69	75
Privatization (Yes/No)	*No*	*No*	*Yes*	*Yes*	*Yes*	*No*	*Yes*	*No*	*Yes*	*Yes*	*Yes*

SECTION 6

EMPLOYMENT

Chapter 18:

THE EMPLOYMENT SITUATION

The layout of the chapter is as follows: Section 1 describes the state of the labor market in Pakistan. Section 2 then identifies the problem areas. Section 3 quantifies the extent of 'decent work' in the country as defined by ILO. Section 4 makes an assessment of the feasibility of two million jobs as committed by the ruling party, PTI. Finally, given the 'youth bulge', the design of some youth employment programs is presented in Section 5.

18.1. STATE OF THE LABOR MARKET

The Pakistan Bureau of Statistics has released the summary of the findings of the Labor Force Survey of 2014-15. The Bureau must be complimented for undertaking this Survey, more or less, annually and publishing the findings quickly. This enables timely monitoring of the employment situation in the country. However, the findings of surveys after 2014-15 have not yet been made available.

Thirty three such surveys have been carried out by PBS. The coverage is nationwide. The sample size was 42,108 households in the 2014-15 survey. Information is provided on the level and characteristics of the labor force and employment, the level of unemployment, the number of hours daily, the occupational distribution and wages. Based on this survey findings an assessment is made below of the employment situation in Pakistan.

Between 2012-13 and 2014-15 the number of jobs created was 1.4 million. Accordingly, the decrease in the number of unemployed workers was 100,000. As such, by the end of 2014-15, the number of unemployed workers was 3.6 million. However, if the number of discouraged workers is included and the normal increase in labor force allowed for, the total number of unemployment rises to 5.3 million. It appears that PBS has understated significantly the level of unemployment.

The reported unemployment rate is just under 6 percent. Apparently, it has fallen slightly from the level in 2012-13. However, if appropriate adjustment is made the unemployment rate rises to 8.5 percent in 2014-15. This is the highest rate of unemployment in the last thirteen years.

A worrying feature of the current unemployment situation is that the employment rate among literate workers is more than twice that among illiterate workers. In fact, the highest rate of unemployment rate, three times above the national average, is observed in the case of highly educated workers with either degree of post-graduate qualifications.

Similarly, the unemployment rate among female and young workers is also relatively high. There is little difference in the unemployment rate between urban and rural areas of the country. After 2012-13, the unemployment rate has improved the most in Khyber-Pakhtunkhwa. However, employment growth has been the fastest in Punjab.

Significant changes have occurred in the sectoral distribution of employment. Employment has fallen somewhat in agriculture. The positive finding is that almost two-thirds of the new jobs created during the last two years have been in the manufacturing sector. Only one-third of the additional jobs are in the services sectors, which largely fall in the informal economy. The prospect of finding 'decent work' is much higher in the formal sector. Currently, about 27 percent of the workers are engaged in the formal sector.

An important development is the trend towards increased labor force participation rate of women in Pakistan, which is currently one of the lowest in the world. It has risen significantly after 2008-09 by almost three percentage points, to reach 22 percent. Meanwhile, the labor force participation rate for males has actually fallen by 1.5 percentage points.

What is the trend in real wages? Between 2008-09 and 2014-15, real wages have increased for technicians and professionals, while that for unskilled workers have fallen. The skill premium is rising in the economy. Beyond a point, this could become a source of greater inequality. There has also unfortunately been some increase in the gender wage differential for similar skills in the last six years.

In the context of the employment situation, one very disturbing feature is the number of 'idle' young males, which is very large and exceeds 6 million currently. They are perhaps more vulnerable to crime and / or militancy. It is unfortunate that the Youth Employment Programs launched by the Government have not been so successful in enabling productive engagement in the labor force.

The overall message is that both positive and negative developments are observed in the labor market of Pakistan. For a sustainable unemployment-reducing situation to develop, the growth rate of the GDP will have to rise to over 6 percent. Simultaneously, the state and the private sector will both have to invest more in improving the skill endowment of the labor force.

18.2. PROBLEM AREAS

18.2.1. Bonded Labor

Bonded labor in Pakistan arises primarily due to non-repayment of debt. A laborer becomes bonded when his or her labor is demanded in repayment for a loan. This is known as *peshgi* in Pakistan. The worker is then forced to work for little or no wage, often for seven days a week.

The bonded worker essentially forfeits his/her right to choice of employment, right to move freely and the right to sell his/her labor at market value. Additionally, bonded laborers are routinely threatened and subjected to all kinds of physical abuse by employers.

Bonded labor is present in some sectors of the economy of Pakistan, most notably in agriculture, brick kilns, carpet weaving, fisheries, and mining. No reliable statistics exist of the number of bonded workers. However, ILO estimates that the number of bonded workers in Pakistan is in excess of 2 million.

18.2.2. Child Labor

Convention on Minimum Age, 1973 deals with child workers, aged up to15 years. .In 2012-13 the number of child workers in the labor force was almost 2.7 million, over 11 percent of the children in the age group of 10-14 years. Fortunately, the number has declined by 48 percent to 1.4 million by 2014-15. 87 percent of the child workers are resident in the rural areas and the remainder, 13 percent in the urban areas. 56 percent are male and 44 percent female.

The key indicators of problems in the labor market are highlighted in Chart 18.1. These include the incidence of child and bonded labor; gender inequality in the labor market; workers earning less than the minimum wage; extent of prevalence of ' decent work'; lack of spread of collective bargaining and low level of labor productivity.

Table 18.1: Incidence of Child Workers – ('000')

	2003-04	2008-09	2012-13
Population	148,159	169,996	184,349
% of Population aged 10-14 years	12.82	13.28	12.79
Number of Children aged 10-14 years	18,993	22,575	23,578
Labor Force Participation Rate (%)	12.80	13.08	11.40
Number of Child Workers	**2,431**	**2,953**	**2,688**

Source: LFS, PBS

Chart 18.1: Key Indicators of Problems in the Labor Market

Bonded Labor

- Prevalence of Bonded Labor

Child Labor

- Prevalence of Child Labor

Access / Gender

- Incidence of Women in Marginal Occupations
- Employment Distribution by Level of Education
- Incidence of Women who are Unpaid Family Workers

Wages

- Incidence of Workers with wages below the Minimum Wage
- Wage Differential by Sex
- Trend in Real Wages
- Wage Differentials by Occupation

'Decent' Work

- Share of Workers in the Informal Sector
- Share of 'Overworked' Workers (> 50 hours a week)
- Share of Part Time Workers (< 35 hours a week)
- Distribution of Workers by Employment Status

Labor Productivity

- Trend in Labor Productivity by Sector

Collective Bargaining

- Extent of Trade Unionization of Workers
- Incidence of Industrial Disputes

Safety

- Incidence of Work Related diseases/injury

Unemployment

- Unemployment Rates by Sex by Age Group
- Unemployment Rates by Level of Education

18.2.3. Female Workers

As indicated earlier, the labor force participation rate (LFPR) of females is relatively low in Pakistan, compared to other South Asian Countries. In 2012-13, the LFPR of females aged 10 years and above is just over 24 percent, less than one third of the male LFPR. The positive development is that the female LFPR is rising.

Table 18.2: Distribution of Employment by Sex within Sectors, 2012-13 – ('000')	Male	%	Female	%	Total
Number Employed	**52,188**	**85**	**9,098**	**15**	**61,277**
Agriculture	19,949	77	5,873	23	25,822
Manufacturing	7,104	84	1,378	16	8,482
Construction	3,699	100	-	-	3,699
Wholesale and Retail Trade	8,914	98	167	2	9,081
Transport and Communication	3,570	99	37	1	3,607
Finance and Insurance	538	99	6	1	544
Community, Social and Personal Services	7,911	83	1,589	17	9,500
Others	503	93	39	7	542

Source: LFS, PBS

The distribution of employment by gender is given in Table 18.2. Overall, females account for 15 percent of the total employment. The presence of females in different sectors is generally determined by prevailing social norms and the physical nature of work. Sectors with relatively greater presence of females include agriculture, manufacturing and community, social and personal services, especially education and health. Their presence is very limited in sectors like construction, trade and transport.

The Labor Force Survey also quantifies the number of women in marginal occupations like subsistence agriculture, own construction of one's dwelling, etc. The number is estimated at 10 million in 2012-13, with a decline of 3 percent since 2008-09. Inclusion of marginal occupations leads to a significant increase in the female LFPR.

Table 18.3 presents the distribution by gender of employment in different occupations. Women have an extremely limited presence of only 2 percent in high level occupations like senior officials, managers and legislators. This highlights problems of access, despite the presence of quotas in the civil service.

Table 18.3: Distribution of Employment by Sex within Occupations, 2012-13 – ('000')	Male	%	Female	%	Total
Number Employed	**52,188**	**85**	**9,098**	**15**	**61,277**
Legislators, Senior Officials and Managers	6,896	98	168	2	7,064
Professionals	1,045	82	224	18	1,269
Technical and Associate Professionals	2,048	70	863	30	2,911
Clerks	1,015	97	31	3	1,046
Service Workers and Sales Workers	3,357	97	111	3	3,468
Skilled Agricultural Workers	17,241	81	4,029	19	21,270
Craft and Related Trades Workers	8,572	86	1,360	14	9,932
Plant & Machine Operators & Assemblers	2,378	100	19	-	100
Elementary (Unskilled) Occupations	9,635	81	2,285	19	11,920

Source: LFS, PBS

Women have higher presence of 18 to 30 percent in three occupations, namely, professionals, technicians and associate professionals and skilled agricultural workers. Given the rising number of highly education women in the country, the challenge is to promote upward mobility of such women. Today, almost 40 percent of the persons in Pakistan with a degree, post-graduate or Ph.D qualification are women. At the lower end of the labor market, a very high proportion of unpaid family workers are women. Almost 80 percent these women are engaged in agricultural activities. Since this labor input is not remunerated, despite its contribution to output, the GDP of Pakistan is understated.

We turn next to an important indicator, the differential in wages by gender. For an unbiased comparison, there is need to control for differences in sectoral and occupational distribution. Focusing on individual sectors, women have approached men in the level of remuneration in sectors like finance and insurance, public administration and education services, as shown in Table 18.4. These sectors are mostly part of the formal economy and there is apparently no wage/salary discrimination in a particular job.

Table 18.4: Ratio of Female to Male Wages by Sectors, 2008-09 and 2012-13 – Average Wage per Month (Rs)

	Female		Male		Ratio of Wage (%)	
	Share (%)	Wage	Share (%)	Wage	2012-13	2008-09
Agriculture	38.1	3,863	8.8	7,873	49.1	59.4
Manufacturing	17.5	5,169	24.1	11,733	44.0	39.4
Electricity, Gas	0.1	19,128	1.6	24,904	76.8	81.0
Construction	0.8	10,454	20.4	9,609	108.8	96.1
Wholesale & Retail Trade	0.5	7,245	9.7	8,668	83.6	74.1
Finance & Insurance	0.6	28,624	1.3	22,293	128.4	44.2
Public Admin & Defence	0.9	21,031	7.7	21,559	97.5	66.5
Education	23.8	14,282	6.6	21,278	67.1	114.3
Health	5.8	15,894	2.0	18,131	87.7	109.3
Other Services	1.4	4,421	2.4	8,559	51.7	49.8
Domestic Services	9.2	4,329	1.3	9,079	47.7	44.2
TOTAL	**100.0**	**7,869**	**100.0**	**12,804**	**61.4**	**64.9**

Source: LFS, PBS

Turning to wage differentials by occupation, it is surprising to find that the average remuneration of female professionals and technicians is less than 70 percent of their male counterparts (see Table 18.5). This category includes almost 30 percent of female workers. There is need for an in-depth analysis of the gender wage differential in various occupations.

Table 18.5: Ratio of Female to Male Wages by Occupation, 2012-13

Occupation	Average Wage per Month (Rs)				Ratio of Wage (%)
	Female		Male		
	Share (%)	Wage	Share (%)	Wage	
Managers	0.9	34,618	2.4	38,113	90.8
Professionals	23.8	15,051	7.1	24,326	61.9
Technicians and Associate Professionals	6.1	13,429	5.9	19,801	67.8
Clerical Support Workers	0.8	13,720	3.9	19,029	72.1
Skilled Agricultural Workers	1.0	3,246	1.1	9,703	33.4
Service and Sales Works	1.2	9,516	14.2	11,052	86.1
Craft and Related Trade Workers	15.4	4,563	23.2	11,031	41.4
Plant and Machine Operators & Assemblers	0.4	6,862	9.3	11,729	58.5
Elementary Occupations	50.3	4,309	32.7	8,826	48.8
TOTAL	**100.0**	**7,869**	**100.0**	**12,804**	**61.4**

Source: LFS, PBS

18.2.4. Real Wages

There is conflicting evidence on the trend in real wages during the last few years. Table 18.6 presents the annual increase in real wages for skilled and unskilled workers by location in two periods, 2001 to 2008 and 2008 to 2013 respectively. A clear pattern is visible. *Real wages increased rapidly in the first period, 2001 to 2008, but have fallen significantly since 2008.* This is consistent with changing conditions in the labor market and *the slow growth generally in labor productivity*, as given in Table 18.8.

However, the LFS data presents a different picture. According to Table 18.7, real wages have continued to rise in most sectors of the economy. A fall is observed in only two sectors, viz., agriculture and services. The biggest increase in real wages is in public administration. This reflects the liberal policy on salary increases to government employees.

Table 18.6: Trend in Real Wages, 2001 to 2013

	Annual Increase in Wages (%)			
	2001 to 2008	Growth Rate of Real Wages	2008 to 2013	Growth Rate of Real Wages
Skilled Worker 1[a]				
Islamabad	15.0	6.5	8.4	-2.6
Karachi	9.8	1.3	4.0	-7.0
Lahore	10.5	2.0	5.3	-5.7
Peshawar	11.7	3.2	6.4	-4.6
Quetta	13.3	4.8	8.4	-2.6
Skilled Worker 2[b]				
Islamabad	15.0	6.5	8.4	-2.6
Karachi	11.2	2.7	5.1	-5.9
Lahore	11.3	2.8	4.4	-6.6
Peshawar	12.1	3.6	7.9	-3.1
Quetta	13.3	4.8	12.9	1.9
Unskilled Worker				
Islamabad	14.0	5.5	11.8	0.8
Karachi	9.8	1.3	7.4	-3.6
Lahore	10.9	2.4	9.6	-1.4
Peshawar	14.6	6.1	14.9	3.9
Quetta	17.0	8.5	12.9	1.9

[a]Carpenter | [b]Mason

Source: Pakistan Economic Survey (PES).

Table 18.7: Growth in Wages of Employees by Sector, 2008-09 to 2012-13

	(Rs per Month)		Growth Rate of (%)	
	2008-09	2012-13	Nominal Wage	Real Wage
Agriculture	4349	6221	9.4	-1.6
Manufacturing	6768	11022	13.0	2.0
Wholesale & Retail Trade	5619	8656	11.4	0.4
Transport & Communications	8069	12470	11.5	0.5
Public Administration & Defence	11207	21549	17.8	6.8
Education	10424	18703	15.7	4.7
Health	9889	17412	15.2	4.2
Domestic Services	3680	6517	15.3	4.3
Other Services	6254	8197	7.0	-4.0

Source: LFS

Table 18.8: Trend in Labor Productivity, 2005-06 to 2012-13 – (Rs in Billion at 2005-06 prices)

	2005-06	2012-13	Growth Rate (%)
AGRICULTURE			
Value Added	1775.6	2152.3	
Employment (million)	20.54	22.73	
Labor Productivity	**86,446**	**87,032**	**0.1**
INDUSTRY			
Value Added	1616.1	2129.1	
Employment (million)	9.82	12.54	
Labor Productivity	**164,572**	**169,786**	**0.4**
SERVICES			
Value Added	4324.3	5945.3	
Employment (million)	17.01	19.31	
Labor Productivity	**254,221**	**308,353**	**2.8**
GDP			
Value Added	7716.0	10226.7	
Employment (million)	47.37	56.58	
Labor Productivity	**162,888**	**180,748**	**1.5**

Source: PES

18.3. 'DECENT' WORK

Decent work, according to ILO, represents opportunities for work that is productive, delivers a fair income, provides security at the workplace and social protection for families. It provides better prospects for personal development and social integration, freedom for people to express their concerns, organize and participate in the decisions that affect their lives and equality of opportunity and treatment for all women and men.

18.3.1. The Informal Work Force

A large part of the labor force works in the informal sector in Pakistan. Conditions for 'decent work' are seldom satisfied in the informal sector. Wages are low and variable, the working day is characterized by long hours of work, job security is minimal and the working environment has health and other hazards. There is also little or no scope for collective bargaining.

The LFS gives the distribution of the labor force into three segments – in agriculture, formal non - agriculture and informal non – agriculture. Trends in the number of workers in the last component are presented in Table 18.9. Currently, the number of workers employed in the informal sector is 23.5 million, representing over 41 percent of the total number employed.

Table 18.9: Number of Employed Workers in the Informal Sector, 2003-04 to 2012-13 – ('000')

	2003-04	2008-09	2012-13
Population	148,159	169,996	1,843,349
% 10 years and above	69.53	71.85	71.94
Population above 10 years of age	103,015	122,142	132,621
LFRP (%)	43.74	56.66	45.70
Labor Force	45,059	55,770 (4.36)*	60,608 (2.10)
Unemployment Rate (%)	7.69	5.46	6.24
Employed Number	41,594	52,724 (4.85)	56,826 (1.89)
% Employed in Agriculture	43.05	44.91	43.71
Employment of Non-Agricultural Workers	23,688	29,045 (4.16)	31,987 (2.44)
% in informal sector	70.0	73.30	73.60
Number of Workers employed in the Informal Sector	16,582	21,290 (5.12)	23,542 (2.54)

*annual growth rate
Source: PES

The worrying trend is the fast growth in informal sector workers between 2003-04 and 2008-09 of over 5 percent annually. This was a period when the informal sector in the economy grew very fast. The failure in labor absorption implies a degree of 'jobless growth' in the formal sector. Since 2008-09, the employment growth rate in the informal sector has fallen to 2.5 percent annually.

18.3.2. Incidence of Work Related Injuries / Diseases

The LFS gives the incidence of work related injuries / diseases, during the last twelve months prior to the Survey. The incidence of injuries/diseases is relatively high and growing (see Table 18.10). Over 4 percent of the workers have been affected in 2012-13. The incidence is almost twice in the case of male workers. The highest number of injuries / diseases is in agricultural work and among self-employed workers.

18.3.3. 'Over Worked' Workers

The share of workers working more than 48 hours a week is given in Table 18.11. *The percentage of 'overworked' workers is high, although it has been declining since 2001-02.* In 2012-13, almost 39 percent of the workers put in 49 or more hours a week. The incidence of 'overworked' workers is higher in the urban areas, among males and employers / self-employed.

Table 18.10: Incidence* of Injuries / Diseases Work Related, 2008-09 and 2012-13 – (%)

	2008-09	2012-13
PAKISTAN	**2.71**	**4.02**
Male	3.15	4.52
Female	1.09	2.28
DISTRIBUTION BY SECTOR		
Agriculture	50.43	49.15
Manufacturing	13.96	13.32
Construction	14.54	15.24
Trade	7.54	9.20
Transport	8.14	7.03
Others	5.39	6.06
DISTRIBUTION BY OCCUPATION		
Craft and Related Workers	22.11	18.78
Agriculture	44.86	43.51
Elementary Occupations	19.83	20.92
Others	13.20	16.79
DISTRIBUTION BY EMPLOYMENT STATUS		
Self-Employed	38.87	38.80
Employee	38.36	38.12
Contributing Family Worker	22.68	22.42
Other	0.09	0.66

*in the 12 months prior to the survey
Source: LFS, PBS

Table 18.11: Share of 'Overworked' Workers, (Working 48 or more hours a week), 2001-02 to 2012-13 – (%)

	2001-02	2008-09	2012-13
Total	**43.2**	**38.2**	**37.7**
Rural	41.5	34.4	33.1
Urban	45.7	50.0	48.4
Male	47.4	43.9	45.9
Female	16.4	17.0	9.1
By Occupation			
Employer	54.9	70.3	62.4
Self Employed	53.9	54.3	51.8
Unpaid Family Worker	31.1	21.6	18.3
Employees	38.0	38.4	38.0

Source: LFS, PBS

18.3.4. Minimum Wages

The minimum wage in 2012-13 was Rs 8000 per month. According to Table 18.12, over 44 percent of the workers received less than the minimum wage. This percentage was higher in the case of females at 72 percent; among rural workers at 51 percent and in sectors like agriculture (74 percent), other services (61 percent) and domestic services (71 percent).

Table 18.12: Percentage of Employees receiving less than the Minimum Wage by Sector, 2012-13

	2012-13
PAKISTAN	**44.5**
Male	40.7
Female	72.0
Urban	37.7
Rural	50.9
SECTOR	
Agriculture	74.6
Manufacturing	47.7
Construction	47.8
Transport	34.8
Finance and Insurance	11.3
Public Admin and Defence	8.3
Education	25.4
Health	29.4
Other Services	61.3
Domestic Services	71.3

Source: LFS

18.3.5. Collective Bargaining

The trade union movement is relatively underdeveloped in Pakistan as shown in Table 18.13. Also, more recent data is not available. In 2007, there were 455 registered trade unions, according to ILO. The total membership was 441,000, with a trade union density of 1.2 percent. This compares with 32.9 percent in India, 17.9 percent in Sri Lanka and 59 percent in Turkey. The fundamental question is why the process of formation of trade unions has been so slow and retarded in Pakistan.

Table 18.13: Trade Union Membership in Selected Developing Countries – ('000')

Country	Year	Number of Trade Unions	Number of Members (000)	Members per Union	Trade Union Density (%)
India	2008	9702	9573	979	32.9
Malaysia	2012	694	890	1282	9.3
Pakistan	2007	455	441	969	1.2
Philippines	2012	18428	1833	99	8.7
Sri Lanka	2011	2057	1042	506	17.9
Turkey	2008	102	3205	31420	59.0

Source: ILO

18.4. TWO MILLION JOBS ANNUALLY

The lynchpin of the manifesto of the new ruling party, PTI, is the commitment to create 10 million jobs in its tenure of five years. Next in order of value perhaps to the people is the target of construction of 5 million houses also in these five years. The focus here is on the magnitude of job creation promised.

The expectation of an average of 2 million new jobs annually has come at a time when the unemployment rate is almost 6 percent as reported in the Labour Force Surveys of the PBS. These statistics have been manipulated by showing a lower rate of increase in the labour force. As highlighted earlier, the underlying unemployment rate is probably significantly higher and approaching 8.5 percent. Therefore, the commitment by PTI is seen very positively by the over 5 million unemployed workers currently and the nearly 2 million entrants annually into the labour force.

Estimates are that 4.5 million jobs were created during the last five years from 2012-13 to 2017-18. During the first two years, the economy grew relatively slowly at 4 percent and only 840,000 jobs were created annually. The acceleration in the GDP growth rate in 2016-17 and in 2017-18 has led to a faster creation of jobs at the rate of over 1.2 million per annum in the last three years. The target of 10 million jobs in five years after 2017-18 can, therefore, be seen as ambitious. It will require a more than doubling in the rate of expansion of employment annually as compared to the previous five years.

The need for doubling of the rate of job creation raises a number of questions: What is the feasibility of realization of this commitment made by the ruling party? No doubt, this enabled Tehreek-e-Insaf to garner many more votes. But what is the likely nature of reaction if the target is not met? Economists who helped in the drafting of the party manifesto ought to have realized that the country is on the brink of a major financial crisis. This is hardly the time when the labor market is likely to be buoyant.

The fundamental problem is that contractionary fiscal, monetary and trade policies will have to be adopted to bring down sharply the 'two' deficits, one in the current account of the external balance of payments and the other the fiscal deficit in public finances. Consequently, there is bound to be a plummeting in the rate of creation of jobs. For example, a cut of Rs 225 billion has been made in the Federal PSDP of 2018-19. This alone will mean over 180,000 less jobs, either directly or indirectly.

The process of structural adjustment will require a minimum period of two years, as highlighted recently by the new Prime Minister. As such, the GDP growth rate is likely at best to remain in the range of 3.5 to 4.5 percent. Consequently, the cumulative number of new jobs likely to be created during 2018-19 and 2019-20 is no more than 2 million.

There is a need to realize that under this scenario the rate of unemployment will actually rise and not fall up to 2019-20. The annual increase in the labour force is now almost 2 million. Therefore, there is the unfortunate prospect of an increase in the number of unemployed workers by 2 million in two years. This will take up the unemployment rate to almost 10 percent by the end of 2019-20.

The cutting edge of the unemployment problem is the absorption of the 'youth bulge' entering the labour market. As far back as 2014-15, the unemployment rate of youth, aged 15 to 24 years, was 10 percent in the case of male youth and close to 14 percent for female youth. There is a real risk that these unemployment rates could increase further to 12 percent and 16 percent respectively by 2019-20.

An even worse predicament is faced by graduate youth. Their unemployment rate was as high as 18 percent in 2014-15. With conditions worsening it could rise to almost 20 percent by the end of 2019-20. On top of this, there are over 6 million male youth who are effectively 'idle.' They are neither in the education system nor in the labour force. Many of them have probably exited from the labour force due to failure in finding a job after an extended search.

There is need to understand the potential disappointment of youth and other unemployed workers if 2 million jobs are not created annually in 2018-19 and 2019-20. They were in the vanguard of the support mobilized by the PTI, especially through its charismatic leader. There is the danger that this could lead to a measure of protest and agitation. The tone of the leadership of the party may need to change now to one of more realism and moderation if expectations of the millions of voters of 2018 are to be managed.

The final question is that what is likely to be the state of the labour market after the difficult initial two years of the PTI government? There will then be the prospect of moving on to a trajectory of higher growth if by 2019-20 the current account deficit has been brought down to about 2.5 percent of the GDP and the fiscal deficit limited to below 5 percent of the GDP.

Starting in 2020-21 there will be backlog of 8 million in the five year target of 10 million jobs. In effect, over 2.6 million employment opportunities will have to be created annually from 2020-21 to 2022-23. This is achievable if the GDP growth rate rises to at least 7 percent per annum. Following the removal of the constraints to growth, efforts will need to be made to raise the overall rate of investment close to 20 percent, the tax-to-GDP ratio to above 15 percent and for exports to grow by at least 15 percent per annum. An improved economic environment with less graft and corruption and improved functioning of institutions leading to greater ease of doing business will facilitate the process of growth.

Managing expectations will need to remain a key motive behind the narrative of the party spokespersons and elected representatives. If the economy is successfully transformed by 2019-20 then the aspirations of the people will begin to be fulfilled. Otherwise, Pakistan remains vulnerable to an 'Arab Spring'.

18.5. YOUTH PROGRAMS

UNESCO defines youth as persons aged between 15 and 24 years. There are accordingly 39 million youth in Pakistan today, with a population share of 21 percent. Due to the demographic bulge, their number is growing relatively fast at almost 2.6 percent, with the increase of one million annually. The share of urban based youth is 38 percent, while the remainder, 62 percent live in the rural areas. The overall labor force participation rate of youth in the country is 44 percent, 24 percent for females and 65 percent for males. Altogether, it is estimated that almost 17.5 million youth are in the labor force, representing 29 percent of the total labor force.

There have been two striking developments during the last five years. First, in the tight conditions prevailing in the labor market, there is a 'discouraged worker' effect on male youth, whose participation in the labor force has declined significantly. In fact, there are almost four million male youth who are neither working nor studying. These 'idle' youth constitute a potential threat to society due to their possible greater propensity towards crime and militancy.

Second, there has been, on the contrary, a sharp increase in labor force participation of female youth. A positive interpretation of this is that greater access to education and changing social values are enabling more young women to work. However, this may also be consequence of the big jump in the cost of living which is compelling families to find more than one earner.

Turning to the employment absorption of youth, this is deteriorating over the last few years as the growth rate of the economy has remained low. Today, the unemployment rate among youth is above 11 percent. A large proportion of workers have part time work or are engaged in the informal sector with low wages. This compares with the national unemployment rate of 6 percent. The number of unemployed youth exceeds two million, with 59 percent in the urban areas and 80 percent being males. The situation is worsening; with an additional 180,000 youth getting unemployed every year and new entrants have only a 60 percent chance of finding a job in the first two years.

These developments clearly justify a special program for greater integration of youth into mainstream of the economy. In addition, they have become politically more active as evinced in the last elections. They are demanding that their rights be honored. It is important that this be done if, an, 'Arab Spring' situation is to be avoided. The former Prime Minister from the PML (N) had taken due notice of the concerns of youth. He announced a number of programs to facilitate education and productive labor absorption of youth. These programs ought to be welcomed by all sections of society, given the dangers of alienation of youth.

The Prime Minister announced a total package for youth of Rs 20 billion. The first is a program of micro interest free loans of Rs 12,000 each to 250,000 youth costing Rs 3 billion. The second is a scheme of discounted interest rate loans at 8 percent ranging from 0.5 million to 2.0 million loans each, with an annual running liability of Rs 5.0 billion. The third is a youth training scheme involving a monthly stipend of Rs 10,000 each during internship, costing annually Rs 4 billion. The fourth is a skill development scheme for jobless youth of Rs 5,000 monthly with the annual cost of Rs 0.8 billion.

The next program is for students from underprivileged areas for Masters of higher level training in the form of scholarships of Rs 40,000 per year with the cost of Rs 1.2 billion. Finally, there is the Prime Minister's Laptop Scheme for 100,000 students, costing Rs 4 billion. Therefore, the schemes are wide ranging in character and will potentially benefit almost half a million youth. Given that there are currently two million unemployed and four million 'idle' male youth in the country, these schemes could have significant benefits and visible impact over the next few years.

The issue is one of delivery capacity for six diverse programs/schemes. The Federal Government will have to work closely with the Provincial Governments, especially in the schemes relating to youth training and skill development. NGOs are the natural partners for the scheme of micro-interest free loans, especially in the rural areas.

The Higher Education Commission could be asked to operate the post-graduate scholarships program. The Government of Punjab had earlier run a laptop scheme and the Federal counterpart announced that it could also be managed with the partnership of other Provincial Governments. The largest scheme of small business loans at a discounted interest rate is to be operated by the National Bank of Pakistan and the First Women's Bank. With relatively large loans per youth of up to Rs 2 million, this is the scheme which is potentially most vulnerable to wrong targeting and leakages. With almost 200,000 unemployed graduate or post-graduate youth in the country, there could be a veritable stampede for these loans.

Therefore, it will be important to clearly define objective eligibility criteria and to ensure that the process of selection of beneficiaries is fair and transparent. Also, it is important that the projects financed are economically viable and repayment of these loans takes place. Otherwise, the level of bad debts of the two public financial institutions could rise significantly.

It is suggested that SMEDA, an organization set up in the earlier tenure of Mr. Nawaz Sharif and some business schools be invited to prepare a menu of feasibility studies of small projects, which pass the market test of profitability and are replicable in large numbers. Borrowers can then select mostly from this menu of projects. In addition, strong monitoring arrangements will have to be put in place to ensure proper utilization of funds made available.

Given the level of frustration among the youth of Pakistan today, it is important that all six schemes operate transparently without any intervention by influential parties in the choice of beneficiaries. Otherwise, the Prime Minister's noble intentions of reaching out to the youth may magnify the problem, not reduce it. Also, ultimately the full productive absorption of youth will hinge on the economy growing fast once again.

18.6. THE LATEST SITUATION

The latest Labor Force Survey findings for 2017-18 have been released by the PBS. There do not appear to be major changes in the labor situation as compared to 2014-15. Between 2014-15 and 2017-18 the labor force has increased by 4.5 million and the number of employed by 4.4 million. Consequently, there has been a marginal decline in the unemployment rate from 5.9 percent to 5.7 percent.

The pattern of unemployment is essentially the same as follows:

(i) The unemployment rate for highly educated workers continues to be much higher at 16.3 percent as compared to only 3.4 percent for illiterate workers.

(ii) Unemployment rate in urban areas remains higher at 7.2 percent while it is 5 percent in rural areas.

(iii) Female unemployment rate is 8.2 percent versus 5.1 percent in the case of male workers.

(iv) The highest unemployment rate in 2014-15 was in Khyber-Pakhtunkhwa. This continues to be case in 2017-18.

(v) The unemployment rate for youth also remains high at 9.4%.

The surprise is perhaps that there has been no qualitative change in the conditions in the labor market despite the fact that while the GDP growth rate was 4.1 percent in 2013-14 it went up apparently to 5.8 percent in 2017-18. This is yet another evidence that the latter growth rate has been overstated.

Chapter 19:

LABOR CONVENTIONS AND LAWS

The need to focus on labor conventions and laws in Pakistan has become essential following the granting of Generalized System of Preferences (GSP) plus status to Pakistan by the European Union (EU). The continuation of this special status will hinge on the adherence to a number of international conventions including those relating to labor.

Section 1 describes the GSP+ while Section 2 of the chapter highlights the conditions for eligibility and continuation. Section 3 identifies the labor conventions. The last section reviews the labor laws in Pakistan and determines the extent of adherence to the international conventions. An assessment is also made of the existing institutional framework for implementing the existing labor laws.

19.1. THE GSP+ AND ADHERENCE TO CONVENTIONS

From January 1, 2014, onwards Pakistan became eligible for an EU trade program known as GSP+. This allows virtually all exports of Pakistan to enter the EU free of duty. Pakistan can now export some 6,000 tariff lines, including textiles and clothing, free of duty to the European Union's 27 member countries. Historically, Pakistan has had difficulty competing in the EU market because competitors such as Bangladesh. Sri Lanka, Turkey, Morocco, Tunisia and Mexico already enjoyed duty free access. GSP+ will provides Pakistan's industries with an edge compared to countries such as China, which does not have duty free access to the EU, and India, which has only limited concessions for apparels under the standard GSP.

The coverage of GSP+ is restricted to those countries which are considered to be vulnerable due to a lack of diversification and insufficient integration into the international trading system. These countries have to meet the following two criteria:

(i) GSP-covered imports should represent less than 2 percent of the EU's imports from all GSP beneficiaries (Pakistan's share of total GSP imports is 1.6 percent).

(ii) The seven largest GSP-covered products / sections must cover at least 75 percent of the country's total GSP-covered exports to the EU (Pakistan's seven largest GSP sections account for 94.6 percent of its total GSP-covered exports).

Even if a developing country meets the above criteria, however, its entry into GSP+ is not automatic. The country must also demonstrate that it has ratified and implemented 27 core international conventions on human and labor rights, sustainable development, and good governance.

If the GSP-covered imports exceed 2 percent of the EU's imports from all GSP beneficiaries (Pakistan's share of total GSP imports is 1.6 percent), it could lose GSP+ status when the scheme is reviewed after three years. Furthermore, the EU regulations on safeguards in the textile, agriculture and fisheries sector provide that on First of January of each year the European Commission can remove the tariff preferences for products whose imports increase by more than 13.5 percent in quantity (by volume) as compared with the previous calendar year. However, these provisions only apply for those products whose share exceeds 6 percent of total EU imports in value.

19.2. CONDITIONS FOR ELIGIBILITY AND CONTINUATION

In addition to the vulnerability criteria discussed above, Pakistan has had to ratify 27 core international conventions and subscribe to binding commitments to implement them effectively. These are mainly UN and International Labor Organization (ILO) conventions and conventions on the environment and good governance. Examples of such conventions are the Convention on the Elimination of all Forms of Racial Discrimination, the International Convention on the Rights of the Child, the Freedom of Association and Protection of the Right to Organize Convention, and the Convention on International Trade in Endangered Species. Given below is the complete list of the required conventions.

The Government of Pakistan (GoP) has signed a 'binding undertaking' committing itself to maintaining the ratification of the 27 relevant international conventions and ensuring their effective implementation. It has also accepted, without reservation, reporting requirements and monitoring mechanisms imposed by those conventions. Finally, the GoP is committed to accepting and cooperating with the EU monitoring procedure. The EU is in the process of giving Pakistan a scorecard, which will form the basis of dialogue on GSP+ compliance.

The UN/ILO reporting systems are operational, but the EU will not limit itself to these sources. It may use information from civil society organizations and social partners that are considered to be accurate and reliable reporting sources. Detailed procedural rules have been drawn up regarding the specific roles for all contributing parties, European Commission, EU Member States, beneficiary country concerned, third parties, etc.

The EU will report on compliance every two years first report was issued on 1st January, 2016 in the case of Pakistan. The report covers the status of ratification of the relevant conventions, the compliance with any reporting obligations under those conventions, and the status of the effective implementation thereof.

GSP+ was taken away from Sri Lanka in 2010 due to non-effective implementation of certain human rights conventions. GSP concessions were also withdrawn from Belarus and Myanmar on the grounds of serious and systematic violation of labor rights. The GSP+ preferences can be withdrawn partially or fully if Pakistan fails to meet its commitments on enforcing the required conventions. The burden of proof for compliance rests on the Federal Government.

The following 27 conventions have been ratified by Pakistan as pre-condition for getting the GSP+ status from EU:

1) Convention on the Prevention and Punishment of the Crime of Genocide (1948)
2) International Convention on the Elimination of All Forms of Racial Discrimination (1965)
3) International Convention on Civil and Political Rights (1966)
4) International Convention on Economic Social and Cultural Rights (1966)
5) Convention on the Elimination of All Forms of Discrimination Against Women (1979)
6) Convention Against Torture and other Cruel, Inhuman or Degrading Treatment or Punishment (1984)
7) Convention on the Rights of the Child (1989)
8) Convention concerning Forced or Compulsory Labour, No.29 (1930)*
9) Convention concerning Freedom of Association and Protection of the Right to Organize, No.87 (1948)*
10) Convention concerning the Application of the Principles of the Right to Organize and to Bargain Collectively, No.98 (1949)*
11) Convention concerning Equal Remuneration of Men and Women Workers for Work for Equal Value, No.100 (1951)*
12) Convention concerning the Abolition of Forced Labor, No.105 (1957)*
13) Convention concerning Discrimination in Respect of Employment and Occupation, No.111 (1958)*
14) Convention concerning Minimum Age for Admission to Employment, No.138 (1973)*
15) Convention concerning the Prohibition and Immediate Action for the Elimination of the Worst Forms of Child Labor, No.182 (1999)*

16) Convention on International Trade in Endangered Species of Wild Fauna and Flora (1973)
17) Montreal Protocol on Substances that Deplete the Ozone Layer (1987)
18) Basel Convention on the Control of Trans-boundary Movements of Hazardous Wastes and their disposal (1989)
19) Convention on Biological Diversity (1992)
20) The United Nations Framework Convention on Climate Change (1992)
21) Cartagena Protocol on Bio-safety (2000)
22) Stockholm Convention on persistent Organic Pollutants (2001)
23) Kyoto Protocol to be United Nations Framework Convention on Climate Change (1998)
24) United Nations Single Convention on Narcotic Drugs (1961)
25) United Nations Convention on Psychotropic Substances (1971)
26) United Nations Convention against illicit Traffic in Narcotic Drugs and Psychotropic Substances (1988)
27) United Nations Convention against Corruption (2004)

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*Labor-related conventions.

19.3. LABOR CONVENTIONS

The key contents of the eight Labor Conventions and the labor standards that are embodied in these conventions are described below.

19.3.1. Forced Labor Convention, 1930

The objective of this convention is to suppress the use of forced or compulsory labor in all its forms. Forced or compulsory labor is all work or service which is exacted from a person under the menace of a penalty and for which the person has not offered himself voluntarily.

Exceptions include the following:

(a) Compulsory military service;
(b) Work or service as part of normal civic obligations;
(c) Work or service during an emergency;
(d) Community service.

The competent authority in a country will not allow forced labor for private gain. Also, the authority shall issue complete and precise regulations governing the use of forced labor.

The Annual Report that a member makes, who has ratified the Convention, shall contain information on the extent of recourse to forced labor and the purposes for which it has been used.

19.3.2. Abolition of Forced Labor Convention, 1957

This follows the 1930 Convention, described above. It contains proposals consistent with the UN Universal Declaration of Human Rights. It seeks to suppress the following forms of forced labor:

(a) as a means of political coercion or education;

(b) mobilizing labor for economic development;

(c) as a means of labor discipline;

(d) as punishment for having participated in strikes;

(e) as a means of racial, social, national or religious discrimination.

19.3.3. Freedom of Association and Right to Organize Convention, 1948

The convention adopts proposals concerning freedom of association and right to organize as a means of improving conditions of labor and as essential to sustained progress. It states in Article 2 that workers and employers have the right to establish and join organizations of their choosing without previous authorization. Such organizations cannot be dissolved or suspended by administrative authority. However, these organizations will respect the law of the land.

The extent to which this Convention applies to the armed forces and the police shall be determined by national laws or regulations.

19.3.4. Right to Organize and Collective Bargaining Convention, 1949

This convention shall apply particularly to the following:

(a) make the employment of a worker subject to the condition that he will not join a union or shall relinquish trade union membership;

(b) cause the dismissal of a worker by reason of union membership.

19.3.5. Equal Remuneration Convention, 1951

This convention adopts proposals with regard to the principle of equal remuneration for men and women workers for work of equal value.

The term *remuneration* includes the basic or minimum wage or salary and any other emoluments in cash or in kind.

This principle of equal remuneration shall be applied by means of the following:

(a) national laws or regulations;

(b) legally established or recognized machinery for wage determination;

(c) collective agreements between employers and workers;

(d) a combination of these various means.

19.3.6. Discrimination (Employment and Occupation) Convention, 1958

This convention focuses on the elimination of discrimination in the field of employment and occupation. For purposes of this Convention, the term *discrimination* includes:

(a) any distinction, exclusion or preference made on the basis of race, color, sex, religion, political opinion, national extraction or social origin, which has the effect of nullifying or impairing equality of opportunity or treatment in employment or occupation;

(b) such other distinction, exclusion or preference which has the effect of nullifying or impairing equality of opportunity or treatment in employment or occupation as may be determined by the Member concerned after consultation with representative employers' and worker's organizations, where such exist, and with other appropriate bodies.

Any distinction, exclusion or preference in respect of a particular job based on the inherent requirements thereof shall not be deemed to be discrimination.

For the propose of this convention the terms *employment* and *occupation* include access to vocational training, access to employment and to particular occupations, and terms and conditions of employment.

Each Member for which this convention is in force undertakes by methods appropriate to national conditions and practice:

(a) to seek the cooperation of employer's and worker's organizations and other appropriate bodies in promoting the acceptance and observance of the policy;

(b) to enact such legislation and to promote such educational programs as may be calculated to secure the acceptance and observance of the policy;

(c) to repeal any statutory provisions and modify any administrative instructions or practices which are inconsistent with the policy;

(d) to pursue the policy in respect of employment under the direct control of a national authority;

(e) to ensure observance of the policy in the activities of vocational guidance, vocational training and placement services under the direction of a national authority;

(f) to indicate in its annual reports on the application of the convention the action taken in pursuance of the policy and the results secured by such action.

Any measures affecting an individual who is justifiably suspected of, or engaged in, activities prejudicial to the security of the State shall not be deemed to be discrimination, provided that the individual concerned shall have the right of appeal to a competent body established in accordance with national practice.

19.3.7. Minimum Age Convention, 1973

This convention aims at total abolition of child labor. Each member commits to a national policy designed to progressively raise the minimum age for admission to employment to a level consistent with the fullest physical and mental development of young persons. The minimum age for wage in the convention is at least 15 years. A Member whose economy and administrative facilities are insufficiently developed may, after consultation with the organizations of employers and workers concerned, where such exist, initially limit the scope of application of this convention.

Each Member which avails itself of the above provisions shall specify, in a declaration appended to its ratification, the branches of economic activity or types of undertakings to which it will apply the provisions of the convention.

The provisions of the convention shall be applicable as a minimum to the following: mining and quarrying; manufacturing; construction; electricity, gas and water supply; sanitary services; transport, storage and communication; and plantations and other agricultural undertakings mainly producing for commercial purposes, but excluding family and small-scale holdings producing for local consumption and not regularly employing hired workers.

This convention does not apply to work done by children and young persons in schools for general, vocational or technical education or in other training institutions, or to work done by persons at least 14 years of age in undertakings, where such work is carried out in accordance with conditions prescribed by the competent authority, after consultation with the organizations of employers and workers concerned, where such exist, and is an integral part of:

(a) a course of education or training for which a school or training institution is primarily responsible;

(b) a program of training mainly or entirely in an undertaking, which program has been approved by the competent authority; or

(c) a program of guidance or orientation designed to facilitate the choice of an occupation or of a line of training.

National laws or regulations may permit the employment or work of persons 13 to 15 years of age on light work which is:

(a) not likely to be harmful to their health or development; and

(b) not such as to prejudice their attendance at school, their participation in vocational orientation or training programs approved by the competent authority or their capacity to benefit from the instruction received.

19.3.8. Worst Forms of Child Labor Convention, 1999

For the purposes of this convention, the term the *worst forms of child labor* comprises:

(a) all forms of slavery or practices similar to slavery, such as the sale and trafficking of children, debt bondage and serfdom and forced or compulsory labor, including forced or compulsory recruitment of children for use in armed conflict;

(b) the use, procuring or offering of a child for prostitution, for the production of pornography or for pornographic performances;

(c) the use, procuring or offering of a child for illicit activities, in particular for the production and trafficking of drugs as defined in the relevant international treaties;

(d) work which, by its nature or the circumstances in which it is carried out, is likely to harm the health, safety or morals of children.

Each member shall, after consultation with employers' and worker's organizations, establish or designate appropriate mechanisms to monitor the implementation of this convention.

19.4. LABOR LAWS IN PAKISTAN

There are a number of labor laws in Pakistan, which have been enacted either at the Federal or the Provincial level. Many of these laws pertain to the implementation of the eight international labor conventions that Pakistan has ratified. The list of labor laws is given in Chart 19.1.

The relevant laws the provisions that have been built in for enforcement mechanisms, penalties, are described below etc.

19.4.1. Enforcement Mechanisms

Abolition of Bonded Labor: The law is titled *Bonded Labor (Abolition) Act, 1992.* The Government may confer such powers as required on the *District Coordination Officer (DCO)* to ensure that the provisions of the Act are carried out. It shall be the duty of the DCO to determine if bonded labor is being enforced in his jurisdiction.

Any person who forces bonded labor is punishable with imprisonment for a period not less than two years or more than five years, or with a fine which shall not be less than fifty thousand rupees, or with both. If a fine is recovered, payment shall be made to the bonded worker at the rate of not less than fifty rupees for each day for which bonded work as extracted for him.

Chart 19.1: Labor and Human Resource Laws
BONDED LABOUR SYSTEM (ABOLITION) ACT, 1992
COMPANIES PROFITS (WORKERS' PARTICIPATION) ACT, 1968
DISABLED PERSONS, (EMPLOYMENT AND REHABILITATION) ORDINANCE, 1981
EMPLOYEES' COST OF LIVING (RELIEF) ACT, 1973
EMPLOYMENT (RECORD OF SERVICES) ACT, 1951
EMPLOYMENT OF CHILDREN ACT, 1991
ESSENTIAL PERSONNEL (REGISTRATION) ORDINANCE, 1948
FACTORIES ACT, 1934
INDUSTRIAL STATISTICS ACT, 1942
MINIMUM WAGES ORDINANCE, 1961
PAYMENT OF WAGES ACT, 1936
PROVINCIAL EMPLOYEES’ SOCIAL SECURITY ORDINANCE, 1965
EMPLOYEES SPECIAL ALLOWANCE (PAYMENT) ACT, 1988
FAIR PRICE SHOPS (FACTORIES) ORDINANCE, 1971
INDUSTRIAL RELATIONS ACT 2010
WEIGHTS AND MEASURES (INTERNATIONAL SYSTEM) ENFORCEMENT ACT, 1975
ROAD TRANSPORT WORKERS ORDINANCE, 1961
WEST PAKISTAN INDUSTRIAL AND COMMERCIAL EMPLOYMENT (STANDING ORDERS) ORDINANCE, 1968
WEST PAKISTAN MATERNITY BENEFIT ORDINANCE, 1958
WEST PAKISTAN MINIMUM WAGES FOR UNSKILLED WORKERS ORDINANCE, 1969
WEST PAKISTAN SHOPS AND ESTABLISHMENTS ORDINANCE, 1969
WORKERS CHILDREN (EDUCATION) ORDINANCE, 1972
WORKERS WELFARE FUND ORDINANCE, 1971
WORKMEN’S COMPENSATION ACT, 1923

A *Vigilance Committee* shall be set up at the District level, consisting of elected representatives, labor department, media, etc. The tasks of the Committee include implementation of the law and help in rehabilitation of freed bonded labor.

A Magistrate of the first class empowered in this behalf by the Provincial Government may try any offence under this Act. Any offence under this Act shall be tried summarily. The offence is cognizable and bailable.

Child Labor: The law is titled *Employment of Children Act, 1991.* A ‘child’ is defined as a person who has not completed his fourteenth year of age. The law prohibits employment of children in certain occupations and processes.

A Cadre of Inspectors is to be appointed to check if any establishment is violating the law. The punishment for violation of the law is imprisonment for a period not less than six months and up to two years. No court inferior to that of a Magistrate of the first class shall try any offence under this Act.

Minimum Wages: The law is titled *Minimum Wages Ordinance 1961.* The law proposes the establishment of Minimum Wages Board by a Provincial Government, with representation both from employers and workers. The Board will recommend to the Provincial Government, the minimum rates of wages for adult unskilled workers and juvenile workers employed in industrial undertakings in the Province.

Any employer who contravenes the provisions of this Act shall be punishable with imprisonment for a term which may extend to six months. Cases of violation will be tried by a Magistrate.

Collective Bargaining: The law is titled *Industrial Relations Act, 2010*. Section 3 of the Act provides for freedom to a worker to join a trade union and for unions to be established, except in some activities specified in Section1. Unions can apply for registration under this Act. The Government can appoint Registrars of trade unions. In the presence of competing unions, the Registrar will decide which union is the legitimate collective bargaining agent. He will also regulate unfair practices.

The law also provides for registration of Federation of Trade Unions. A number of returns have to be filed to the Registrar by a Trade Union. Shop stewards are to be appointed as a link between labor and management. There is also a provision for establishment of Workers Management Council in establishments employing fifty persons or more.

The Government may also establish Labor Courts, with the function of adjudicating on industrial disputes. Such courts will be deemed to be a Civil Courts. Further, the Government may also constitute Labor Appellate Tribunals.

A person who commits any breach of any term of any settlement shall be punished with a penalty. For the first offence, the penalty may be up to twenty thousand rupees and for any subsequent offence, up to fifty thousand rupees.

19.4.2. Assessment of the Laws

The laws described above are comprehensive in character and cover key areas related to the conventions like abolition of bonded labor, prohibition of child labor, minimum wages, establishment of trade unions and collective bargaining. An important 'missing' law is one that would ban discrimination in payment of wages especially to women for equal work and in access to different occupations.

Special institutional arrangements have been proposed for ensuring implementation:

(i) Setting up of Vigilance Committees in the Bonded Labor (Abolition Act).

(ii) Setting up of a Cadre of Inspectors for enforcement of the Employment of Children Act.

(iii) Establishment of Minimum Wages Board in the Minimum Wages Ordinance.

(iv) Appointment of Registrars of Trade Unions and establishment of Labor Courts under the Industrial Relations Act.

There is need for a periodic third party *field survey* at the Provincial / District levels to determine if the above provisions of the laws have been honored. The assessment of the contribution made towards the attainment of objectives embodied under the Laws by the special institutional arrangements may be assessed and appropriate actions taken.

SECTION 7

BALANCE OF PAYMENTS

Chapter 20:

REVIVAL OF EXPORTS

The developments during the last two years in the external balance of payments position have sharply highlighted the importance of achieving faster growth in exports. Since 2013-14 exports have shown a declining trend, with a modest recovery in 2017-18, but not enough to compensate for the fall over the previous four years. Meanwhile, imports have grown rapidly, especially in the last two years. Consequently, imports are now almost two and a half times the level of exports. The trade deficit has reached the unsustainable level of 10 percent of the GDP in 2017-18.

The fundamental question is why have exports been faltering in recent years.? Is it due to any anti-export bias in national planning with a long-term predilection towards industrialization based on a policy of import substitution? Is it the consequence of retarding supply factors like power outages, high energy cost, lack of growth in supply of raw materials for export-oriented industries? Or is it the consequence of the wrong mix of policies, especially with regard to the exchange rate and lack of focus on factors impacting on export competitiveness?

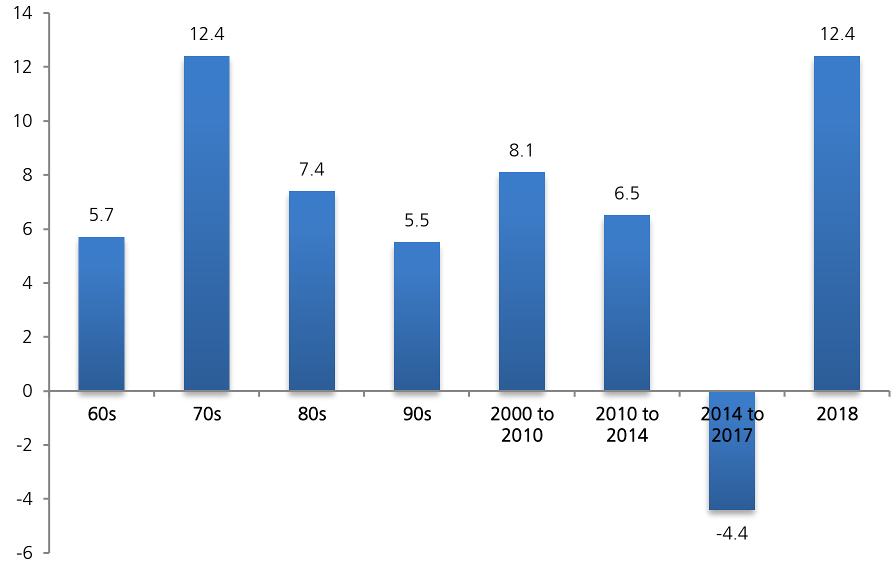
The objective of this Chapter is to attempt to answer the above questions. Section 1 reviews the long-term growth of exports of Pakistan. Section 2 looks at the composition of exports both in terms of products and market destinations. Section 3 looks at the relationship of exports with developments in world trade, while Section 4 tests for the sensitivity of exports to movements in the exchange rate. Section 5 looks at the overall role of different factors in influencing exports and Section 6 on the potential role of export incentives. Finally, in Section 7 the key elements of the export development strategy are identified.

20.1. GROWTH OF EXPORTS

Exports reached a historic peak of $25 billion in 2013-14. They then fell to $22 billion BY 2016-17. There has been some recovery and they stand at $24 billion in 2017-18. The long-term growth in the value (in $) of exports is given in Figure 20.1. Over the last 58 years, since 1959-60, the growth rate annually has averaged a moderately respectable rate of close to 7 percent. The best performance was in the decade of the 70s when the growth rate achieved was above 12 percent. Two reasons can be identified for this upsurge in exports. First, after the loss of East Pakistan there was a need to divert the exportable surplus of West

Pakistan from inter-wing to international trade. This was facilitated by the massive devaluation of the rupee in May 1972 from Rs 4.77 to Rs 11 per dollar. Second, international prices of commodities rose rapidly in the 70s.

Figure 20.1: Annual Growth Rate in Value of Exports



Source: SBP

There was a visible slowing down in the growth rate over the next two decades. An upsurge was witnessed once again in the period, 1999-2000 to 2009-10. This was a period when there was a boom in world trade. Thereafter, the performance began to flounder. Exports fell cumulatively by over 12 percent from 2013-14 to 2016-18. Fortunately, there has been some recovery in 2017-18 although the level is still somewhat lower than that attained in 2013-14.

The unfortunate fact is that if exports had maintained their annual long-term growth rate of 7 percent between 2013-14 and 2017-18, the level attained in the latter year would have been $32.9 billion. This would have reduced the record current account deficit in 2017-18 of $18 billion to a more manageable level of close to $10 billion.

The growth of Pakistan's major exports in value from 2002-03 to 2016-17 is presented in Table 20.1. From 2002-03 to 2007-08, during the tenure of the Musharraf Government, the annual growth rate reached 11 percent. The fastest growth rate was observed in items like cement, leather products, surgical instruments, fish and apparel.

Table 20.1: Growth of Pakistan's Major Exports, 2003 to 2018 – ($ millions)

		Description	2003	2008	g (%)	2013	g (%)	2017	g (%)	2018	g (%)
Chapters	63	Made Up Textiles	2358	3145	5.8	3685	3.2	3955	1.8	4060	2.6
	52	Cotton	2532	3595	7.0	5333	7.9	3497	-10.6	3583	2.5
	61	Apparel K/C	1300	1888	7.5	2105	2.2	25.0	4.5	2710	8.0
	62	Apparel, not K/C	1051	1362	5.2	1854	6.2	2275	-	2465	8.4
	10	Cereals	667	2508	26.5	2181	-2.8	1751	-5.5	2456	23.1
	42	Articles of Leather	459	767	10.3	744	-0.6	632	-4.1	734	16.1
	17	Sugar	86	239	20.4	633	19.5	511	-5.3	817	59.9
	90	Surgical Instruments	133	279	12.0	348	4.4	411	4.2	437	6.3
	03	Fish	138	217	9.0	333	8.6	407	5.0	485	19.2
	25	Cement	29	601	A	723	3.7	386	-15.7	471	22.0
		Total of Above	8773	14601	10.2	17939	4.1	16335	-2.3	17918	9.7
		Others	3157	5678	11.7	7181	4.7	5542	-6.4	6301	13.7
		Total	**11930**	**20279**	**10.6**	**25120**	**4.3**	**21877**	**-3.5**	**24219**	**10.7**

Source: SBP

The period of the PPP Government from 2007-08 to 2012-13 witnessed a perceptible decline in the growth rate of exports to only 4 percent. The growth of cotton and textile products remained low at between 2 and 8 percent. Thereafter, during the period of decline from 2012-13 to 2016-17, in the presence of the PML(N) Government, of almost 4 percent annually, the majority of the big export items registered declines. The export revival in 2017-18 with 11 percent growth was led by agricultural products and value added textiles. There was also some diversification of the export base.

There is need to distinguish how much of the change in the value of exports is due to change in quantity / volume and in the price of exports, as measured by the unit value index of exports in US $. This disaggregation is shown in Table 20.2.

Table 20.2: Growth Rate of Volume, Price and Value of Exports, 2002-03 to 2016-17* – (%)

	Annual Growth Rate in		
	Volume	Price	Value
2002-03 to 2007-08	5.4	5.2	10.6
2007-08 to 2012-13	-1.3	5.6	4.3
2012-13 to 2016-17	-1.2	-2.3	-3.5

*Information not available for the full year of 2017-18.

Source: Derived

The process of decline in the volume of exports appears to have started from 2007-08 onwards. This is the especially worrying aspect of the export performance. The unit value of exports continued to rise up to 2012-13 but this has also started falling since then.

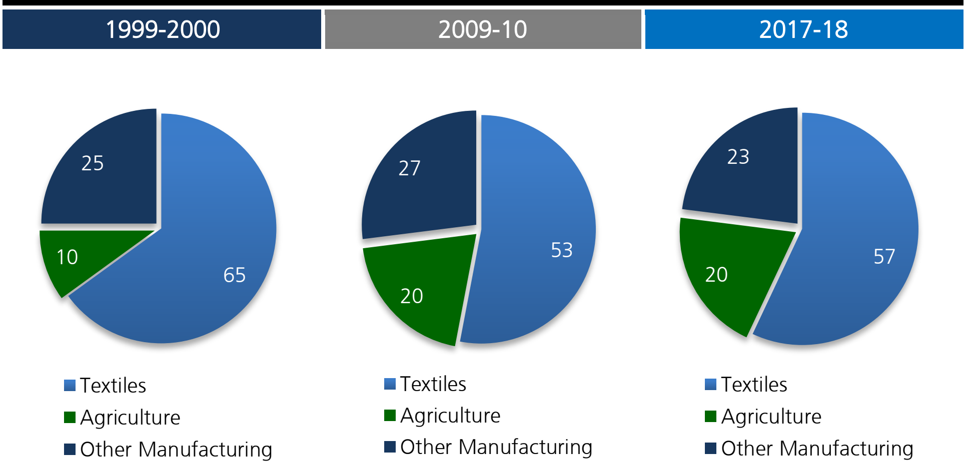
20.2. COMPOSITION OF EXPORTS

20.2.1. Major Export Products

The composition of exports in terms of the shares respectively of agricultural commodities, textiles (including cotton) and other manufacturing is given in Figure 20.2. The major agricultural commodities exported since 1999-2000 are rice, fish, fruits, vegetables, meat and meat preparations. Textiles include cotton, cotton yarn, cotton cloth and value-added textiles. Other manufactures include carpets, sports goods, leather tanned and manufactures, surgical and medical instruments, chemical and pharmaceutical products, cement, etc.

During the last seventeen years there have been no major changes in the composition of exports. The share of agricultural items has remained close to 25 percent and of manufactured goods at 75 percent. Within the latter category, textiles dominate with an overall share of 65 percent in 1999-2000, falling to 53 percent in 2009-10 and rising back to 57 percent in 2017-18. A more detailed analysis of exports is undertaken in a subsequent section.

Figure 20.2: Composition of Exports, 1999-2000 to 2017-18



Source: SBP

The quantity of major exports over the last five years is highlighted in Table 20.3. There was a, more or less, decline across-the-board from 2012-13 to 2016-17. The only exceptions were rice, fish and bed wear. However, the quantity of exports of most items is significantly higher in 2017-18 in relation to the level in 2012-13. The two products which have not yet recovered fully are cotton yarn and cement. There is need to focus especially on these two exports. In particular, cotton yarn exports of Pakistan to China have fallen sharply despite the FTA.

Table 20.3: Level of Quantities of Major Exports, 2012-13 to 2017-18					
	Unit	**2012-13**	**2016-17**	**2017-18**	**g (%)**
Rice	000 Tons	3439	3523	4106	3.5
Fish	000 Tons	144	155	198	6.4
Fruits	000 Tons	710	646	710	0.0
Vegetables	000 Tons	724	632	875	6.5
Sugar	000 Tons	1064	307	1469	6.5
Cotton Yarn	000 Tons	735	456	522	-6.8
Cotton Cloth	000 Sq M	2078	2049	2250	1.6
Knitwear	000 Doz.	105	104	108	0.6
Bed wear	M.T	264	358	373	6.9
Ready Made Garments	Million Doz.	27.7	35.2	40.1	7.8
Footballs	Th. Doz.	3055	3008	3538	2.9
Leather Garments	Th. Doz.	923	754	833	-2.0
Cement	000 MT	9073	4519	4559	-13.8

Source: PBS

20.2.2. Major Markets

Pakistan's exports are focused more on markets in developed countries. These countries account for 53 percent of Pakistan's total exports. The distribution by country is presented in Table 20.4.

Table 20.4: Major Export Markets of Pakistan, 2012-13 to 2017-18 – ($ millions)					
Country[1]	**2012-13**	**Share (%)**	**2017-18**	**Share (%)**	**Growth Rate (%)**
Afghanistan	2066	8.4	1476	6.2	-6.7
Bangladesh	709	2.9	724	3.0	0.4
Belgium	496	2.0	639	2.7	5.1
China	2609	10.7	1744	7.3	-8.0
Germany	967	4.0	1363	5.7	6.9
Holland	495	2.0	778	3.2	9.0
Italy	538	2.2	766	3.2	7.1
Spain	527	2.1	939	3.9	11.6
UAE	2139	8.7	1378	5.7	-8.8
UK	1253	5.1	1768	7.4	6.9
USA	3532	14.4	3862	16.1	1.8
Others	9129	37.3	8460	35.3	-1.5
TOTAL	**24460**	**100.0**	**23987**	**100.0**	**-0.4**

[1]Countries are listed alphabetically. They have been included if exports to a country exceeded $ 500 million in 2017-18.

Source: SBP

The three largest markets for Pakistan are the USA, UK and the UAE. There have been major changes in the regional distribution of Pakistan's exports between 2012-13 and 2017-18. Exports to the EU countries have shown faster growth following the granting of GSP+ status.

The big decline of 8 percent annually is in exports to China, despite the signing of an FTA in 2006. Exports to Afghanistan have also fallen sharply following diversification of its source of supply. Exports to the rest of the world have also shown some decline of about 2 percent. There is clearly a need to focus on emerging markets for increasing Pakistan's exports.

20.2.3. Measures of Concentration and Diversification

The extent of product concentration in measured by the Herfindahl – Hirschmann Index (HHI). An index value closer to 1 indicates that exports are concentrated in a few products.

The value of HHI for Pakistan is given in Table 20.5, along with this magnitude for other South Asian countries. There has been little change in HHI for Pakistan since 2000. Also, there is evidence that the extent of product concentration is relatively low. However, the HHI for India and Sri Lanka is even lower.

The other export related measure is the Diversification Index (DI). The diversification index also takes value from 0 to 1. A value closer to 1 indicates greater divergence from the world pattern. DI values are also presented in Table 20.5. The magnitude is between 0.7 and 0.8, implying high divergence of Pakistan's exports from the pattern of world trade. This is a reflection of the relatively large share of textiles in Pakistan's exports. Here again, the value of DI is higher than that for India and Sri Lanka.

Table 20.5: Index of Concentration and Diversification of Pakistan's Exports

Years	Concentration[a] Index	Diversification[b] Index
2000	0.215	0797
2008	0.207	0.716
2013	0.189	0.720
2016	0.214	0.775

Index of Concentration and Diversification of Exports of South Asian Countries

Countries	Concentration Index	Diversification Index
Bangladesh	0.406	0.889
India	0.120	0.441
Pakistan	0.214	0.775
Sri Lanka	0.201	0.727

[a]The closer the value is to 1 the more concentrated are exports

[b]A value closer to 1 indicates greater divergence from the world pattern

Source: World Bank

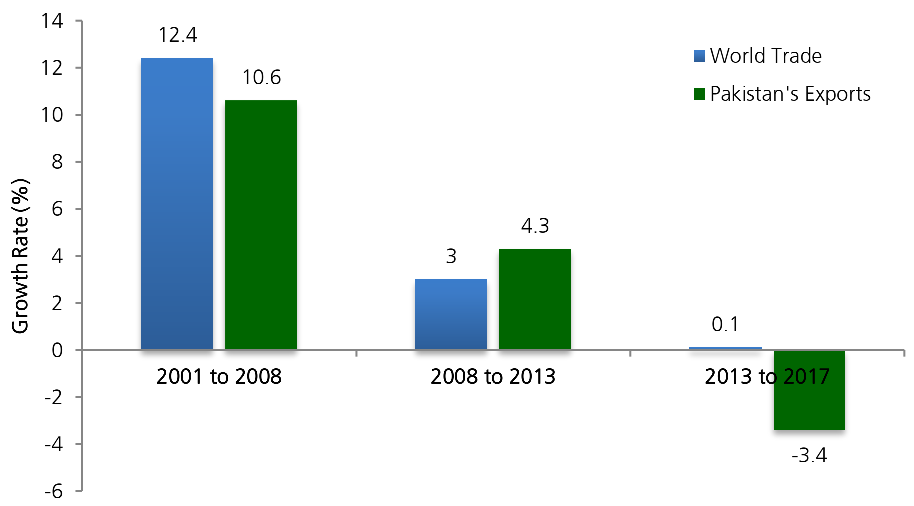
20.3. DETERMINANTS OF EXPORTS

The focus of this section is on the possible role of different factors in influencing the growth of Pakistan's exports. These include the growth of world trade, impact of supply factors, role of the exchange rate and the impact of export incentives.

20.3.1. Growth of World Trade

Figure 20.3 shows the relationship between the growth rate of world trade and Pakistan's exports in different sub-periods. There is a strong correlation. For example, when world trade was buoyant between 2001 and 2008, Pakistan's exports also showed double-digit growth. When there was little increase in world trade between 2013 and 2017, Pakistan's exports actually fell.

Figure 20.3: Growth Rate of World Trade and Pakistan's Exports



Source: WTO

Clearly, there is a need for monitoring the trends in world trade. This should be a key factor in determining the extent of aggressiveness of export promotion policies.

20.3.2. Role of Supply Factors

Table 20.2 had earlier identified that volume of Pakistan's exports started declining after 2007-08. This coincides with the periods when the shortage of electricity emerged in Pakistan and there was a rising incidence of power outages. Consequently, export industries were also hit and there were significant production losses. Pasha et al [2013] have estimated that almost $3 billion of exports were lost due to the high frequency of power load-shedding.

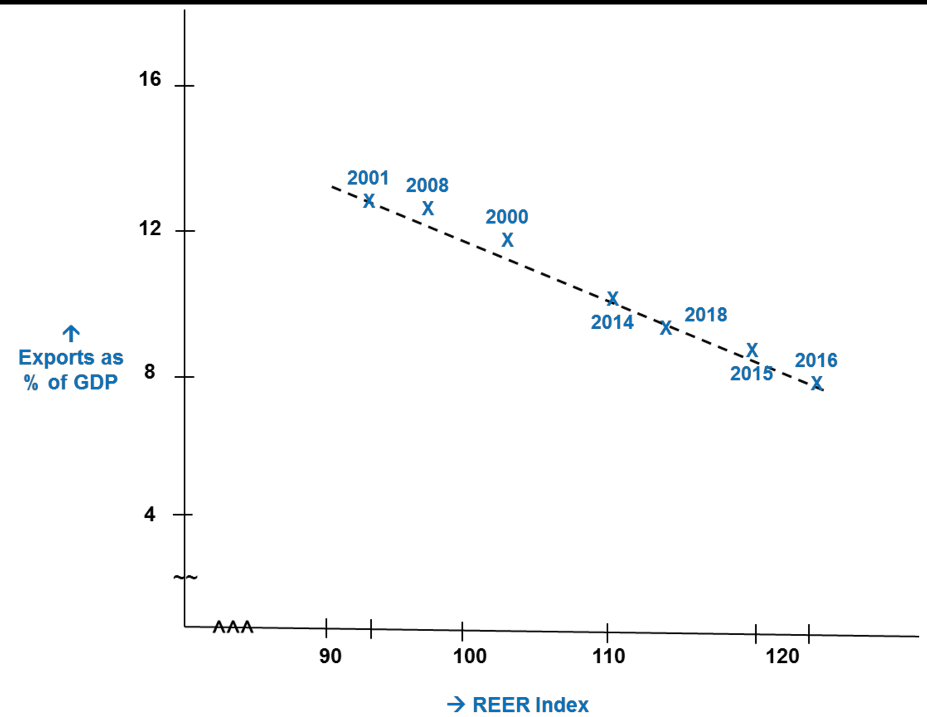
The second factor relates to the price of electricity and gas supplies to industry. Here again, there is evidence that energy tariffs are relatively high in Pakistan and have increased at a faster rate. This evidence has already been presented in Chapter 6.

Given the large share of textiles in exports the issue is what has been happening to the domestic production / supply of the key raw material, cotton. Here again, there is an unambiguous relationship. From 2000-01 to 2012-13, the underlying trend was an increase in cotton output of about 2 percent on average. Thereafter, the production of cotton has declined sharply by 17 percent between 2012-13 and 2016-17. Clearly, much higher priority has to be attached to the cultivation of cotton to ensure ample supply for the textile industry export.

20.3.3. Exports and the Exchange Rate

The next critical issue is the impact of the exchange rate of the Pakistani rupee, with respect to the US $, on exports of the country. Figure 20.4 shows the relationship between the Real Effective Exchange Rate (REER) and exports as a percentage of GDP. The relationship is very strongly negative, highlighting the adverse impact of an overvalued exchange rate on the level of exports.

Figure 20.4: Level of Exports and the Real Effective Exchange Rate (REER) – (as % of GDP)



Source: SBP

Two particular years illustrate this relationship well. The year 2001 saw a somewhat undervalued exchange rate of the rupee with REER at 93.5 (value of 100 in 2010). Exports were at the highest level of over 12 percent of the GDP. The policy of maintaining a, more or less, stable nominal exchange rate started in 2014. Consequently, the REER kept rising, reaching a peak of 127 in April 2017. By this time, exports had fallen to 8 percent of the GDP.

The fundamental implication is that for sustained export growth the rupee cannot be allowed to become overvalued. The year, 2017-18 saw significant depreciation of 16 percent in the value of the rupee, thereby bringing down the REER from 125 to 111. It is not surprising that exports showed significant positive growth for the first time in four years.

20.3.4. Impact of Export Incentives

Countries frequently employ export incentives and/or set up special institutional arrangements for promotion of exports. Imtiaz Ahmed [2013] has identified these special measures for a number of Asian countries, which are presented below in Table 20.6, as of the year, 2011.

Table 20.6: Export Incentives and Institutions in Different Countries

Country	1	2	3	4	5	6	7	8	9	Total
India	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	9
Pakistan	Yes	Yes	Yes	No	Yes	No	No	Yes	Yes	6
Bangladesh	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	8
Malaysia	Yes	Yes	Yes	No	Yes	No	No	No	Yes	5
Philippines	Yes	Yes	Yes	Yes	Yes	No	Yes	No	Yes	7
Thailand	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	9
Korea, Rep.	Yes	Yes	Yes	No	Yes	No	No	No	Yes	5
Singapore	Yes	Yes	Yes	No	Yes	No	No	No	Yes	5
Indonesia	Yes	Yes	Yes	Yes	Yes	No	No	No	Yes	6
China	Yes	Yes	Yes	Yes	No	No	No	No	Yes	5
TOTAL	10	10	10	5	8	3	3	4	10	

1 = Duty Drawback/Tax Exemptions on Imported Inputs
2 = Exports Finance Concessionary
3 = Exports Insurance and Guarantees
4 = Export Quality Management
5 = Export Processing Zones
6 = Exports Performance Requirement
7 = Exports Cash Subsidies
8 = Lower Income Tax
9 = Export Promotion Organization

There are nine special arrangements identified. The most commonly used measures are duty drawbacks, concessionary export finance and the setting up of an export promotion organization.

Imtiaz Ahmed has undertaken an analysis of the value of export incentives given to textile products by three south Asian countries – India, Pakistan and Bangladesh. The value is measured as the change in the exchange rate that would have yielded the same profit to an exporter as the incentive.

Table 20.7 gives the value of export incentives in the three countries. Clearly, Bangladesh has been more aggressive in offering incentives to exporters than India and Pakistan. In particular, the Box 20.1 describes the current generous cash incentive scheme put in place by Bangladesh.

Table 20.7: Total Value* of Export Incentives in Bangladesh, India and Pakistan, (for 2011) – (%)

	Spinning and Weaving	Other Textiles	Made-up Textiles
Actual Export Incentives in Pakistan	12.7	23.7	21.5
If Export Incentives of India were applied to Exports of Pakistan	17.8	31.0	24.8
If Export Incentives of Bangladesh were applied to Exports of Pakistan	27.0	45.9	37.5

*equivalent to change in exchange rate

Source: Ahmed [2013]

Box 20.1: Cash Incentives Scheme of Bangladesh

- 27 categories of goods covered by scheme
- Cash incentive ranges from 2 percent to 20 percent
- Fish with lowest rate of 2 percent; halal meat and pharmaceuticals highest rate of 20 percent
- Leather products at 15 percent
- Apparel sector to get 4 percent instead of duty drawback; Additional 3 percent in US, Canada and EU

Source: Bangladesh Bank

The export performance of Bangladesh, in terms of the annual growth rate achieved, was the best among the three countries from 2013 to 2017. The difference may partly be due to the cash incentives offered.

20.4. EXPORT REVIVAL STRATEGY

The Strategic Trade Policy, 2013-18, of Pakistan had set a target of exports in 2017-18 of $35 billion. There has, in fact, been a massive shortfall of over $10 billion. The new Policy under preparation for the next five years needs to consider the incorporation of the following measures:

(i) Electricity generation capacity has already expanded by 7000 MW in the last five years, due to special efforts by the PML (N) Government. Clearly, highest priority should be given to ensure near zero power load-shedding in supply to export-oriented industries.

(ii) The backbone of the textile sector is ample supply of domestically produced cotton of good quality at competitive prices. Pakistan had attained the peak production of cotton of 14 million bales in 2014-15. Since then there has been a fall in output over 16 percent. The target must be to get back to the output of at least 14 million bales as soon as possible. This will require a basic change in cropping patterns in the Kharif season away from sugarcane to cotton cultivation. This could be achieved by reintroducing a support price for cotton (phutti), as was the case in the 90s. Simultaneously the support price on sugar cane may no longer be given. Also, there is a strong case for providing a bigger subsidy to fertilizer and pesticides.

(iii) A serious mistake was made from 2014 to 2017 in allowing the real effective exchange rate index of the rupee with respect to the US $ to rise to the peak level of 127. Following depreciation of the currency during the last one year it has come down to 108 by October 2018. This has contributed to some recovery in exports. As a policy, at no stage should the REER be allowed to rise above 100, implying that the rupee is beginning to get overvalued.

(iv) Pakistan has introduced a cash export incentive scheme. This scheme needs to be developed in a number of ways. First, it should be paid by the Commercial Banks at the time of export receipts, with no-pre-conditions of minimum growth in exports, etc. The Commercial Banks can then claim reimbursement from the SBP. Second, the higher cost of electricity and gas in Pakistan should be reflected in the duty drawback rates. This could add two to three percentage points to these rates. The issue of pending refunds to exports should also be resolved.

(v) Like Bangladesh, the export incentive scheme should cover more items. Three categories of items may be identified – traditional, emerging and nascent – with the highest rate of incentive for the last category. This will help in diversification of the export base. The three categories of exports are listed in Table 20.8. The total number of items to be covered is 45, at the four digit level of the Harmonized Code.

Exports today constitute the 'lifeline' of Pakistan. Their rapid growth is essential to sustain the balance of payments position of the country. A double-digit growth rate of 12 percent must be targeted for to take exports of Pakistan up to $42 billion by 2022-23.

Table 20.8: Classification of Exports for the Export* Incentive Package

Traditional (> $ 500m)	Emerging ($150m – $500m)	Nascent ($50 - $ 150m)
Rice	Fish	Meat
Leather Apparel	Dates	Crustaceans
Cotton Yarn	Wheat Flour	Citrus Fruit
Cotton Fabrics	Sugar	Ginger, Saffron
Gents Shirts	Ethyl Alcohol	Confectionary
Men / Boys Suits	Cement	Chromium Ore
Bed & Table Linen	Petroleum	Graphite
	Leather	Polyesters
	Synthetic Fabrics	Tableware
	Gents Suits	Travel Goods
	T-shirts	Paper & Board
	Sweaters	Carpets
	Hosiery	Terry Fabrics
	Women's Suits	Overcoats
	Made-ups	Ladies Suits
	Medical, Surgical Instruments	Gloves
	Sports	Curtains
		Tarpaulins
		Footwear
		Copper Waste
		Bedding

*According to the level of exports.
Source: SBP

Chapter 21:

MANAGING THE TRADE DEFICIT

The previous chapter has highlighted the fall in exports since 2013-14 with only a partial recovery in 2017-18. Factors contributing to the loss of momentum have been identified. A number of proposals have been made to restore the dynamism of exports.

There is need also to recognize that along with the fall in exports, there has been a big increase in imports in 2016-17 and 2017-18. Consequently, the combined effect of low exports and high and growing imports has contributed to a quantum jump in the size of the trade deficit. This is reflected in the exceptionally large current account deficit, the financing of which has led to a big erosion of foreign exchange reserves.

The critical issue now is management of the trade deficit. This is exercising a strong constraint on the process of growth in the economy and placing Pakistan in an extremely vulnerable position in the conduct of its external transactions.

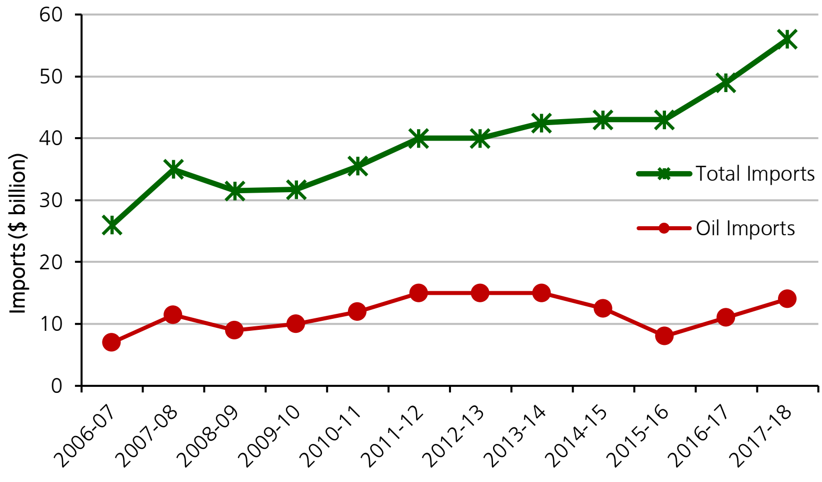
Section 1 of the chapter describes the size, composition and growth of imports. Section 2 highlights the trend in the size of the trade deficit and the contribution that remittances have made to financing this deficit. Section 3 analyses the role that the exchange rate can play in influencing the size of the trade deficit. Section 4 focuses on the impact of an increase in aggregate demand on the level of imports. Section 5 identifies the various policy instruments that are available to controlling imports besides the exchange rate.

21.1. TREND IN IMPORTS

The trend in total imports and in oil imports respectively is presented in Figure 21.1. Oil imports constitute about one fourth of imports. There was little growth in imports from 2011-12 to 2015-16. In fact, the oil import bill fell sharply during these years. The upsurge in imports started in 2016-17 and has continued since then.

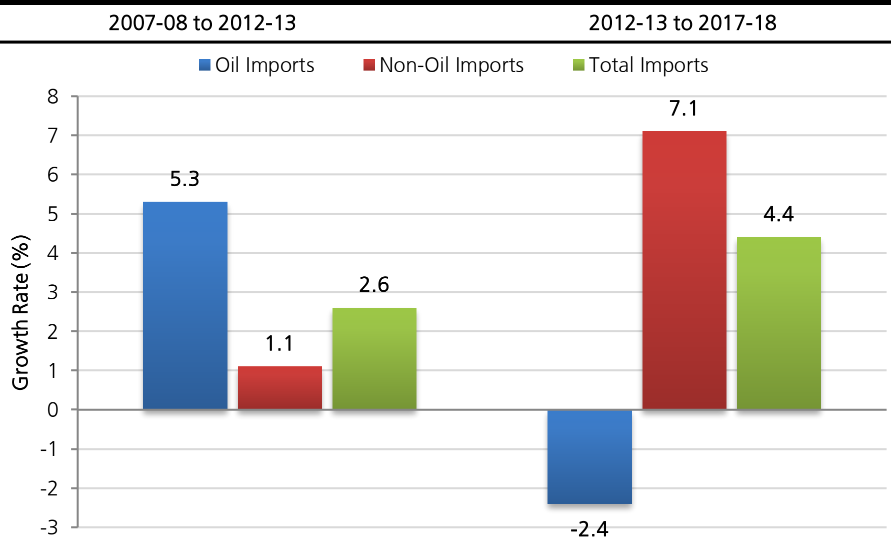
The annual growth rate of imports is presented in Figure 21.2. The overall rate of increase in imports was restricted by the slow growth in non-oil imports between 2007-08 and 2012-13. The relatively high growth rate since 2012-13 of almost 5 percent is due to buoyancy in non-oil imports. Oil imports actual fell during these years due to lower oil price.

Figure 21.1: Total and Oil Imports – 2006-07 to 2017-18



Source: SBP

Figure 21.2: Growth Rate of Oil, Non-Oil and Total Imports – (%)



Source: SBP

21.2. TREND IN THE TRADE DEFICIT

The size of the trade deficit as a percentage of the GDP in presented in Table 21.1 and visually in Figure 21.3. The striking fact is how exports have declined as a percentage of GDP. The peak was 13.5 percent of the GDP in 2002-03. By 2017-18 the ratio had fallen to only 7.7 percent of the GDP.

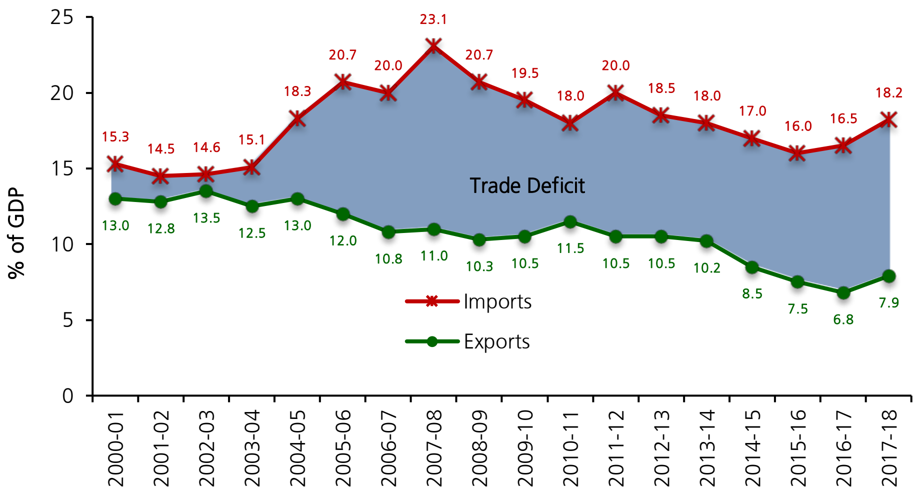
The trade deficit was very low in earlier years. It rose sharply to reach a peak of over 12 percent of the GDP in 2007-08. Since then it has declined somewhat. However, it jumped to over 10 percent of the GDP in the last two years.

Table 21.1: Exports, Imports, Trade Deficit and Remittances, 2001-02 to 2017-18 – (% of the GDP)

Year	Exports	Imports	Trade Deficit	Worker's Remittances	Remittances as % of the Trade Deficit
2000-01	12.9	15.1	2.1	1.5	71.4
2001-02	12.8	14.4	1.8	3.3	183.3
2002-03	13.5	14.8	1.3	5.1	392.3
2003-04	12.5	15.9	3.3	3.9	181.8
2004-05	13.0	18.5	5.5	3.7	67.3
2005-06	12.0	20.9	8.9	3.4	38.2
2006-07	11.1	20.0	8.9	3.6	41.9
2007-08	11.2	23.5	12.3	3.8	30.9
2008-09	10.5	20.7	10.2	4.6	45.1
2009-10	10.9	19.6	8.7	5.0	57.4
2010-11	11.6	18.9	7.3	5.2	71.2
2011-12	10.5	20.0	9.5	5.9	62.1
2012-13	10.6	19.4	8.9	6.0	67.4
2013-14	10.3	18.5	8.2	6.5	79.3
2014-15	8.7	16.9	8.2	6.9	84.1
2015-16	7.4	16.0	8.6	7.1	82.6
2016-17	6.7	17.3	10.6	6.3	59.4
2017-18	7.9	18.2	10.3	6.1	59.2

Source: PES | SBP

Figure 21.3: Imports and Exports as % of the GDP – 2000-01 to 2017-18



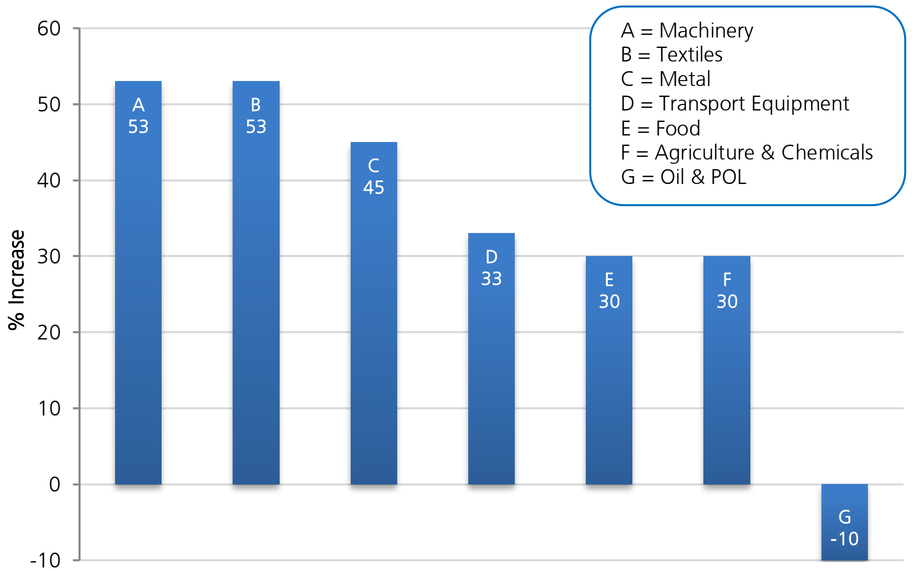
Source: SBP

Pakistan has seen a rising flow of remittances. They rose from 1.5 percent of the GDP in 2001-01 to as high as 7.1 percent of the GDP by 2015-16. The fall in oil prices in recent years has affected the inflow of remittances, especially from the Middle East. Overall, remittances have made a major contribution to financing the trade deficit. There have been years when more than 100 percent contribution was made. However, in the last two years it has fallen to about 60 percent. This explains the big rise in the current account deficit.

The question is why despite the fall in imports of oil and POL products between 2012-13 and 2017-18 there was still a cumulative 24 percent increase in total imports during these five years. The cumulative rise during this period in various groups of imports is given in Figure 21.4.

Virtually all groups of imports have risen rapidly after 2012-13 with the exception of crude oil and petroleum products. The decline in oil imports is primarily due to a fall in international price. The PML (N) Government got this large bonus during its tenure, but was unable to use it fully for the benefit of greater economic stabilization and growth.

Figure 21.4: Cumulative Growth in Groups of Imports from 2012-13 to 2017-18



Source: SBP

The large increase of 53 percent in machinery imports is largely attributable to investment from 2015-16 onwards in CPEC power projects. Textile imports, especially of synthetic inputs, are due to the availability of these inputs cheaply, especially from China. There has also been a boom in the consumer markets in Pakistan for imported cars, motorbikes and food items.

A common perception is that Pakistan is over-dependent on imports and this is the basic cause of the large imbalance in trade. Table 21.2 gives the imports, exports and trade balance as percentage of the GDP for the four major South Asian countries in 2017.

Pakistan has the largest trade deficit as percentage of the GDP, followed by Sri Lanka. The surprise is that Pakistan has the lowest import-to-GDP ratio among these countries. The real difference is in the very low export-to-GDP ratio of less than 8 percent as compared to almost 12 percent in India, 13 percent in Sri Lanka and 14 percent in Bangladesh. Clearly, policy makers will have to focus much more on raising as fast as possible the level of exports so as to narrow the trade gap.

Table 21.2: Exports and Imports as % of GDP in Selected South Asian Countries, 2017

	Exports as % of GDP	Imports as % of GDP	Trade Deficit as % of GDP
South Asia:			
Bangladesh	14.1	19.0	-4.9
India	11.7	17.6	-5.9
Pakistan	7.6	17.4	-9.8
Sri Lanka	13.1	21.6	-8.5

Source: World Bank | WDI

21.3. BALANCE OF TRADE AND THE EXCHANGE RATE

The standard prescription, promoted especially by the IMF, is the devaluation of the national currency to reduce the trade gap and thereby improve the balance of payments position of a country. The success of such a policy hinges on the extent there is a rise in exports and a fall in imports. Of course, the cost of such a policy is a higher rate of inflation.

The responsiveness of exports and imports hinges on the respective elasticities with respect to the exchange rate. There are presented in Table 21.3. There are two types of elasticities – short run and long run. The former is, more or less, the impact during the year when the exchange rate is changed. The latter is the effect over a longer period.

Table 21.3: Elasticities of Exports and Imports with respect to the Exchange Rate

	Short-Run	Long-Run
Imports	-0.145	-0.260
Exports	0.502	1.673

Source: Estimated

The response of imports to the change in the exchange rate is limited. For example, a 10 percent devaluation will decrease imports by about 1.5 percent in the short run. As opposed to this, exports are significantly more responsive. The same extent of depreciation in the value of the rupee leads to an over 5 percent increase in exports.

21.4. BALANCE OF TRADE AND INCOME GROWTH

Imports, in particular, are sensitive to income growth in the economy. The demand for imported consumer goods could rise rapidly if there is a big increase in the real income, especially of middle and upper income households.

The estimated short-run income elasticity of demand for imports is 0.464, while the long-run equivalent is 0.833. Therefore, if the real GDP goes up in a particular year by 5 percent, this will have the impact of raising the volume of imports by 2.3 percent. Overtime, the rise will be as much as 4.1 percent.

This relationship also makes it possible to derive the consequences of a larger fiscal deficit of say, Rs 500 billion, due to higher public expenditure, on the level of imports. This is approximately the magnitude by which there has been higher expenditure by the Federal and Provincial Governments in 2017-18 over and above the original budget estimates.

Other things being equal, the '*multiplier*' effect is an increase in national income of Rs 1000 billion, as the estimated multiplier in Pakistan is close to two. The marginal propensity to import in the country is estimated at 0.3. Therefore, there is likely to be an increase in imports of Rs 300 billion ($2.4 billion). Therefore, almost 30 percent of the increase in imports in 2017-18 was due to the higher than budgeted fiscal deficit.

21.5. MEASURES TO CONTAIN IMPORTS

The impact of depreciation of the exchange rate has been demonstrated as having a limited impact on imports. Therefore, for the reduction of the trade deficit of over $31 billion in 2017-18 there is need to use other measures to restrict the level of imports in 2018-19. There is the likelihood that imports would rise beyond the level of $56 billion attained in 2018-19 due to the growth in aggregate demand and the possibility of a further increase in the international price of oil.

A number of other instruments are, in fact, available for controlling imports. These include higher import tariffs, regulatory duties, cash margins on imports, minimum import prices and import or tariff quotas. Table 21.4 presents the rating of these measures from the viewpoint of scope for differentiation among imports; impact on tax revenues; ease of administration; effectiveness in restricting imports and likely inflationary impact.

Table 21.4: Assessment* of Different Measures for Reducing Imports	Scope for Differentiation across Products	Additional Revenue	Ease of Administration	Effectiveness in Restricting Imports	Inflationary Impact
Rupee Devaluation	L	H	H	L	H
Higher Import Tariffs	M	M	H	L	M
Regulatory Duties	H	M	M	L	L
Cash Margins on Imports	M	L	M	H	L
Minimum Import Prices	H	M	L	M	M
Tariff Quotas	H	L	L	H	M

* = H = High | M = Medium | L = Low

Source: Author

The Government has already used some instruments including the devaluation of the rupee in a number of discrete moves cumulatively by 32 percent since December 2017. The first step was the imposition of regulatory duties on about 700 items with rates ranging from 2 percent to 80 percent. A 100 percent cash margin has been introduced on a group of luxury goods. However, the combined impact of these measures is small because of their limited coverage of imports.

There is need for wider coverage of commodities by the different steps to restrict imports. Prior to this, the rupee still remains overvalued by about 6 percent. An important step would be to eliminate this overvaluation. Also, Pakistan appears to have gone prematurely for trade liberalization after 2012-13 under pressure from the IMF during the EFF program. There is a strong case for restoring the maximum tariff to 25 percent from the present level of 20 percent and ensuring a minimum tariff.

Further, cash margins of up to 30 percent may be introduced, more or less, across the board on imports, with the possible exception of POL products, fertilizer and medicines. This was the policy adopted by Pakistan in 1999 following the imposition of sanctions by the US in the aftermath of the atomic explosions. Also, minimum import prices may have to be imposed on items prone to under-invoicing, especially on imports from China. Finally, there may eventually be no option other than to introduce a regime of import quotas, with a large negative impact on the growth process in the economy and shortages in the domestic market leading to a big upsurge in prices.

Chapter 22:

BALANCE OF PAYMENTS

The external balance of payments position of Pakistan is currently very imbalanced. There has been a precipitous rise in the current account deficit since 2015-16 by over 250 percent. Consequently, it has become increasingly difficult to finance this large deficit. Between June 2016 and June 2018 foreign exchange reserves of the SBP have fallen by almost 46 percent. They stand at $9.8 billion in June 2018, not adequate to provide import cover for even two months.

This Chapter describes the fluctuations in the balance of payments since 2007-08, the last year prior to the transition to democratically elected Governments in the country. Positive and negative developments are identified, including the impact of two Programs that provided financing to Pakistan from the IMF. The coming together of a number of negative factors after 2015-16 is specifically highlighted.

Section 1 presents a summary of the overall trends in the balance of payments over the last decade from 2007-08 to 2017-18. Section 2 describes the development in the current account and Section 3 in the capital and financial accounts. Section 4 highlights the trend in foreign exchange reserves. Section 5 presents the projection of the balance of payments for 2018-19 under different scenarios. The case for going in the short term for another loan facility with the IMF is examined. Implications of pursuing the path of self-reliance are also highlighted.

22.1. THE BALANCE OF PAYMENTS

The balance of payments of a country has three components as follows:

Current Account: Transactions on both the credit and debit side of a current and recurring nature are included in this account. Exports of goods and services and home remittances are the big inflows on the credit side. Imports of goods and services, foreign companies in Pakistan repatriation of profits and payment of interest on outstanding external debt are on the debit side.

Capital Account: This is a relatively small account and consists of grants received mostly from bilateral sources.

Financial Account: The positive side includes the inflow of foreign, direct and portfolio investment, and loans to the Government and the private sector from various sources. The negative side consists of any outflow of funds from stock markets of Pakistan and repayment of external debt.

The expectation is that in the case of many developing countries like Pakistan, the current account will be in deficit. The financial account is generally in surplus, due particularly to some FDI and borrowing from external sources. If the surplus exceeds the deficit then there is a buildup of reserves. Alternatively, if the deficit is too large, as is the case with Pakistan currently, then there is a depletion of the reserves.

Table 22.1 presents in summary form the size of the accounts of the balance of payments from 2007-08 to 2017-18. The year 2007-08 witnessed a huge 'oil price shock'. This raised the current account deficit to almost $14 billion. This is the highest deficit experienced over the last ten years in relation to the GDP. Despite a relatively large surplus in the financial account, there was a big fall in foreign exchange reserves of over $5.5 billion.

The PPP Government was formed in the middle of 2008 and proceeded immediately to negotiate a Stand-by Facility with the IMF. During 2008-09 and 2009-10, Pakistan received installments from the IMF of $3.7 and $2.8 billion respectively. Over the two year period there was a buildup in reserves of $4.6 billion. The IMF program prematurely ended in 2010-11. This was the year when Pakistan actually enjoyed a surplus in the current account, caused primarily by a sharp fall in oil prices. Reserves went up further by $2.2 billion.

Table 22.1: Summary Balance of Payments, 2007-08 to 2017-18 – ($ million)

	Current Account Deficit	Financial* + Capital Account Surplus	Balance of Payments	Transactions with IMF	Change in Reserves	Level of Reserves
2007-08	-13874	8509	-5365	-173	-5538	9145
2008-09	-9261	6205	-3056	3691	635	9686
2009-10	-3946	5212	1266	2797	4063	12540
2010-11	214	2278	2492	-267	2225	14784
2011-12	-4658	1383	-3275	-1155	-4430	10803
2012-13	-2456	504	-1952	-2538	-4490	6008
2013-14	-3130	6988[a]	3858	-573	3285	9098
2014-15	-2795	5441	2646	1949	4595	13526
2015-16	-4867	7519	2652	2009	4661	18142
2016-17	-12621	10675	-1946	102	-1844	16145
2017-18	-18989	12871	-6118	-86	-6204	9789

*includes errors and omissions
[a] including the Saudi Grant of $1.5 billion
Source: SBP

The next two years saw a significant deterioration in the balance of payments position. The current account deficit was back with a larger magnitude while inflows into the financial account became smaller. Reserves fell by almost $9 billion combined in 2011-12 and 2012-13. Further, $3.7 billion had to be repaid to the IMF for funds received earlier.

The new PML (N) Government was sworn in June 2013. Reserves had plummeted down to $6 billion, not even enough to provide import cover for two months. Yet again at the start of its tenure a Government had to seek IMF support. A three year Extended Fund Facility of $6.2 billion was negotiated.

Initially, the IMF funding was used in 2013-14 to pay the installments due. Net inflows from the Fund became large and positive in 2014-15 and 2015-16. Simultaneously, the current account deficit fell to moderately low levels due primarily to a big fall in oil prices. There was substantial accumulation of reserves throughout the tenure of the Fund Program. Reserves reached the peak level of $18.1 billion, sufficient to provide import cover for almost four months. The Extended Fund Facility (EFF) with the IMF was declared unambiguously a great success. The economy appeared to have stabilized and was ready to get on to a trajectory of higher growth.

What happened in the very next year which dramatically altered the picture? Why did the current account deficit rise so drastically by 159 percent in 2016-17 and a further 39 percent in 2017-18? This takes us to an examination of the different components of the current account of the balance of payments.

22.2. THE CURRENT ACCOUNT

There is a fundamental difference between the balance of payments crisis in 2007-08 and 2012-13 and the on-going difficulties in external transactions. The earlier crisis was due largely to a big jump in oil prices. However, oil prices have been low since 2014-15 and have risen only moderately since December 2016. This time the incipient financial crisis is due to structural factors.

First, exports have been falling since 2013-14, as shown in Table 22.2. The decline by 2017-18 was almost 2 percent. The buildup of reserves due to the Fund program and large external borrowing, including the flotation of over $5 billion of Euro/Sukuk bonds, created a 'Dutch Disease' type of problem. The real effective exchange rate rose sharply in the presence of a nominally stable value of the rupee with respect to the dollar. By the end of 2017 the rupee was overvalued by almost 27 percent.

Second, the appreciation in the value of the rupee led to a significant cheapening of imported goods in relation to domestically produced goods. Pakistan had adopted the path of trade liberalization on the advice of the IMF. The maximum import tariff was brought down from 35 percent to 20 percent. Imports of machinery also jumped in 2017-18 by 19 percent with the commencement of larger investments in CPEC projects.

Overall, there was a quantum jump in imports of 18 percent in 2016-17, followed by another rise of 15 percent in 2017-18. Due both to the fall in exports and the big rise in imports, the trade deficit widened by 38 percent in 2016-17 and another 17 percent in 2017-18.

Table 22.2: Summary of the Current Account of BOP, 2007-08 to 2017-18 – ($ million)

	Exports of Goods	Imports of Goods	Trade Deficit	Deficit in Services	Balance on Primary Income[a]	Balance on Secondary Income[b]	Current Account Surplus/Deficit
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
2007-08	20448	35282	-14834	-6593	-3921	11476	-13874
2008-09	19126	31665	-12540	-3468	-4407	11154	-9261
2009-10	19680	31332	-11452	-1774	-3282	12562	-3946
2010-11	25369	35796	-10427	-2029	-3017	15687	214
2011-12	24718	40370	-15652	-3305	-3245	17544	-4658
2012-13	24802	40157	-15355	-1564	-3669	18092	-2456
2013-14	25078	41668	-16590	-2650	-3955	20065	-3130
2014-15	24090	41357	-17267	-2970	-4599	22041	-2795
2015-16	21972	41255	-19283	-3406	-5347	23169	-4867
2016-17	22003	48683	-26680	-4339	-5048	23446	-12621
2017-18	24824	56002	-31178	-5719	-5487	23395	-18989

(7) = (3) + (4) + (5) + (6)

[a]Primarily repatriation of profits and interest payments on external debt

[b]Primarily home remittances

Source: SBP

Third, there had been significant inflows into the trade in services account in the form of reimbursements from the Coalition Support Fund (CSF). Annually, these were of the order of $1.5 billion. However, by 2016-17 they had fallen to below $650 million by 2016-17. They, more or less, ceased in 2017-18.

Fourth, there was some indirect effect of oil prices. The fall in these prices in 2014-15 and 2015-16 impacted negatively on the flow of remittances from the Middle East. Earlier they had been buoyant with growth rate in 2013-14 of as high as 18 percent. They actually fell in 2016-17 by 3 percent and remained, more or less, static in 2017-18. Altogether the coming together of a number of negative factors after 2015-16 has led to a plight in the balance of payments so soon after the apparently 'successful' IMF Program.

22.3. THE FINANCIAL AND CAPITAL ACCOUNTS

The magnitude of different flows in the financial and capital accounts is identified in Table 22.3. The flows of grants into the capital account are usually small. The exception is the big grant of $1.5 billion by Saudi Arabia in 2013-14.

The overall inflows combined into the two accounts over the decade have a U-shaped curve. They were high in the initial two years due to a relatively large level of foreign direct investment. They fall sharply from 2010-11 to 2012-13. Following the pre-mature termination of the IMF program, inflows of assistance to the Government dried up.

Table 22.3: Capital and Financial Accounts of BOP, 2007-08 to 2017-18 – ($ millions)

	Capital Account Balance	Foreign Direct Investment	Portfolio Investment	General Government			Other	Financial Account	Errors & Omissions	Total
				Disbur-sements	Amorti-zation	Net Inflow				
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
2007-08	121	5335	-	3054	1293	1761	-	8131	257	8509
2008-09	455	3695	-1073	3690	2246	1444	1566	5632	118	6205
2009-10	175	2075	-65	4134	2250	1884	1203	5097	-60	5212
2010-11	161	1591	338	2377	1957	420	-248	2101	16	2278
2011-12	186	744	-144	2633	1577	1056	-379	1277	-80	1383
2012-13	264	1258	26	2530	2282	248	-983	549	-309	504
2013-14	1857	1572	2762	4349	2734	1615	-396	5553	-422	6988
2014-15	375	915	1886	4243	2841	1402	871	5074	-8	5441
2015-16	273	2286	-429	6159	2714	3445	1488	6790	456	7519
2016-17	375	2663	-250	9414	4374	5040	2745	10198	102	10675
2017-18	391	3082	2258	8992	4107	4885	2721	13337	-857	12871

TOTAL: (10) = (1) + (8) + (9)
Financial Account: (8) = (2) + (3) + (6) + (7)
Source: SBP

The rising part of the U-shaped curve starts in 2013-14. The return to IMF bolstered market confidence and there was relatively large inflow of portfolio investment in 2013-14 and 2014-15, including the sale of Euro/Sukuk bonds. Also, assistance from multilateral agencies was resumed and there was a jump of 72 percent in disbursements in 2013-14.

The rising path of flows into the financial account has continued till 2017-18. However, the nature of the flows has been very different. The big jump is in gross external borrowing by Government and other agencies. The commencement of CPEC has contributed to larger inflows from China for infrastructure projects. Similarly, bulk of the increase in foreign direct investment is by Chinese companies in power projects. The government has also found a new source of borrowing in the form of relatively high cost and shorter mature period commercial loans. This is the receipt of funds from international commercial banks, especially of China.

22.4. FOREIGN EXCHANGE RESERVES

As highlighted above, reserves with the SBP have been fluctuating sharply during the decade. They have declined in five out of the eleven years and increased in the remaining six years, as shown in Table 22.4. The biggest increases are observed in the aftermath of the IMF EFF program in 2014-15 and 2015-16. Earlier the biggest declines occurred in 2007-08 and 2012-13, which had compelled Pakistan to seek support from the IMF in the form of the Stand.

Table 22.4: Level of Foreign Exchange Reserves, [end of year], 2007-08 to 2017-18 – ($ millions)

	Foreign Exchange Reserves[a]	Months of Import[b] Cover	
2007-08	9145	2.4	↓IMF[c]
2008-09	9686	3.0	
2009-10	12540	4.1	
2010-11	14784	4.1	
2011-12	10803	2.7	
2012-13	6008	1.5	↓IMF
2013-14	9098	2.2	
2014-15	13526	3.2	
2015-16	18142	4.3	
2016-17	16145	3.3	
2017-18	9789	1.8	

[a]with SBP | [b]imports of goods and services
[c]entry into an IMF Program
Source: SBP

The peak level was observed in 2015-16 of $18.1 billion, equivalent to 4.3 months of imports of goods and services. Earlier, the year 2012-13 saw reserves fall to a level not even enough to provide import cover for two months. This was the trigger for seeking IMF assistance. Pakistan is in a similar situation at the end of 2017-18. Will Pakistan go back again to the IMF?

22.5. BOP PROJECTIONS FOR 2018-19

Three scenarios are presented of the balance of payments in 2018-19 as follows:

Scenario 1: This is the 'business as usual' scenario, with no major moves on the policy front to contain the trade deficit. Consequently, the current account deficit could remain high at close to $19 billion.

Further, the financial account is likely to weaken significantly. The fall in reserves to below two months by the end of 2017-18, will compel the multilateral agencies to reduce, more or less, completely their assistance to Pakistan. Also, flotation of bonds will become very difficult following the decline in credit rating by Moody's and Fitch. However, Chinese commercial banks may continue to make loans to Pakistan. Overall, the net inflow into the financial account may fall by $3.5 billion in 2018-19, as shown in Table 22.5.

Table 22.5: Different Scenarios of the Balance of Payments in 2018-19 – ($ millions)

	Current Account Deficit	Financial + Capital Account Surplus	Balance of Payments	Transactions with IMF	Change in Reserves	Level of Reserves
2017-18[a]	-18989	12871	-6118	-86	-6204	9789
2018-19						
Scenario – I[b]	19000	7840	-11160	-498	-11658	Negative [c]
Scenario – II[d]	12600[e]	10600[f]	-2000	3502[g]	1502	11291[h]
Scenario – III[i]	9600	7840	-1760	-498	-2258	7531

[a] Outcome in 2017-18

[b] 'Business as Usual Scenario' in 2018-19: *No Bond; Less Lending by Multilaterals; More from Chinese Commercial Banks; Maturing $1 billion bond*

[c] Not Feasible

[d] With IMF Program

[e] Cut in Imports; Faster Increase in Exports due to policy measures

[f] Continued Multilateral funding; flotation of bonds of $2.5 billion; higher commercial borrowing

[g] IMF Standby Facility with first year funding of $4 billion

[h] Over two months import cover

[i] Self-Reliance; No IMF Program due to unacceptable conditions

Source: SBP and Author's Estimates

The other significant development in 2018-19 will be the commencement of repayment of the loan taken earlier from the EFF of the IMF. This starts at $0.5 billion and approaches $1 billion in subsequent years.

Overall, in Scenario 1 the deficit in the balance of payments may exceed $11 billion in 2018-19. Before the end of the year, reserves which stand at $9.7 billion at the beginning of the year will be completely depleted. Clearly, this scenario is not feasible.

Scenario 2: This is the scenario for 2018-19 with Pakistan going to the IMF by the end of the second quarter with the newly elected Government in place. The 400 percent SDR quota of Pakistan has been partly exhausted by the EFF loan and about $6 billion is still available from the IMF.

The advantage of going to the IMF is the resumption of the flow of concessional assistance from the ADB, World Bank and IDB. Also, the feasibility of the flotation of

Sukuk/Eurobonds will be enhanced. Further, international commercial banks may be willing to lend more to Pakistan.

However, this will require Pakistan to reduce the current account deficit to $12.6 billion or so, on the basis of the strong policy actions agreed with the IMF, mostly in the nature of prior actions. This could include a relatively big devaluation, enhancement in tax rates and in power tariffs. Achieving a current account deficit reduction of 28 percent will require a cut back in imports by 9 percent in relation to imports projected in the 'business as usual' scenario of close to $60 billion in 2018-19.

The overall impact in the presence of the IMF program could be a decline in the balance of payments deficit by over $4 billion in relation to the level of 2017-18. Coupled with a gross inflow of $4 billion in the first year of the SBF, reserves could increase by $1.5 billion. This will ensure that Pakistan's foreign exchange reserves will provide for a minimum import cover of two months. As the Program proceeds, a more safe level of reserve cover of imports could be achieved.

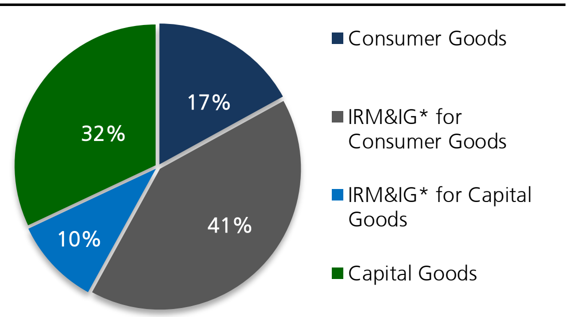
Scenario 3: This is the scenario when either Pakistan decides not to seek a Program with the IMF or the actions asked by the IMF are beyond the ability of incumbent Government to deliver. These could include non-economic steps demanded by the largest member of the Executive Board of the IMF, the USA. Pakistan is then forced to adopt the path of self-reliance, with increase in support from friendly countries, like China, Saudi Arabia and the UAE.

There will be need for even greater import compression of as much as 14 percent or $8 billion. Exports cannot be substantially raised in the short run due to capacity and other constraints. With lower inflows in the Financial Account, as show in Table 22.5, there is the real risk that foreign exchange reserves could fall further to $7.5 billion by June 2019.

How can the import compression be achieved? The composition of imports by type of good is shown in Figure 22.1. The primary emphasis should be on reduction of non-basic food imports and intermediate goods for domestic production of consumer goods. If necessary, then the import of intermediate goods for capital goods may also have to be curtailed. The year 2018-19 may witness in

Figure 22.1: Composition of Imports, 2017-18 – (%)

2017-18



* Industrial Raw Material and Intermediate Goods (IRM&IG)
Source: SBP

this scenario large cuts in imports of automobiles, mobile phones, electronic goods, exotic food, other consumer goods for high income groups and so on. This will minimize the impact on growth…

As highlighted in the previous Chapter, there are a number of instruments available for reduction in imports.

The Government will have to assess judiciously which combination of instruments to use to achieve the required degree of import compression. Overall, Pakistan will be faced with very difficult choices in 2018-19. The new Government will have to take major steps to reduce the large gaps in the balance of payments to take the country back to a sustainable financial position.

Chapter 23:

EXTERNAL DEBT SUSTAINABILITY

The previous chapter has highlighted that the current account deficit in the balance of payments has generally been larger than the quantum of non-debt creating inflows, like foreign direct and portfolio investment and grants. Consequently, the gap has had to be filled by recourse to external borrowing and the resultant build up of the size of the external debt.

The fundamental issue is whether the growth in external debt is sustainable or not. Perhaps the most obvious indicator of sustainability is whether the outstanding debt can be serviced or not. Otherwise, there is the danger of a sovereign default with all its negative consequences.

The Chapter starts with Section 1 showing the evolution of external debt of Pakistan since 2007-08. Section 2 then identifies the changes in the composition of external debt and their implications on debt servicing liabilities. These liabilities are quantified in Section 3. Section 4 focuses on the key ratios which act as indicators for assessment of debt sustainability. Section 5 looks at developments in recent years and the prospects for 2018-19.

23.1. SIZE OF EXTERNAL DEBT

The size of external debt in absolute terms and as a percentage of the GDP is presented n Table 23.1. During the tenure of the PPP Government, external debt increased by $14.7 billion. During the year, 2008-09 to 2009-10, it increased rapidly due to the inflow of borrowing from the IMF as part of the Standby Facility. Subsequently, it fell with repayment back to the Fund.

Table 23.1: Total External Debt* of Pakistan, 2007-08 to 2017-18 – ($ billion)

	Total External Debt	External Debt as % of GDP
2007-08	46.2	27.2
2008-09	52.3	31.0
2009-10	61.6	34.7
2010-11	66.4	31.1
2011-12	65.5	29.1
2012-13	60.9	25.7
2013-14	65.3	26.7
2014-15	65.2	24.1
2015-16	73.9	26.5
2016-17	83.4	27.3
2017-18	95.3	31.0

*including external liabilities
Source: SBP

External debt has shown a rising trend in the nearly five years of the PML(N) Government. The cumulative increase is $34.4 billion, over two times the increase during the tenure of the previous Government. Consequently, the external debt to GDP ratio has gone up from less than 26 percent in 2012-13 to 31 percent in 2017-18.

23.2. COMPOSITION OF EXTERNAL DEBT

The distribution of external debt between public entities like the Government and PSEs and private borrowers like banks and the corporate sector is given in Figure 23.1. Contrary perhaps to perceptions, the share of private debt has increased from only 4 percent in 2017-18 to 14 percent in 2017-18. Consequently, while the public external debt has the dominant share, it has declined from 96 percent to 86 percent.

Figure 23.1: Share of Public and Private External Debt, 2007-08 and 2017-18

Source: SBP

Table 23.2: Composition of Public External Debt* - 2007-08 to 2017-18 – ($ millions)

	2007-08	%	2012-13	%	2017-18	%
Long Term (> 1 year)	*39732*	*89.7*	*43488*	*81.9*	*62525*	*81.5*
Paris Club	13928	31.4	13548	25.5	11643	15.2
Multilateral	21449	48.3	24198	45.6	28102	36.6
Other Bilateral	1129	2.5	2939	5.5	8674	11.3
Euro/Sukuk Bonds	2650	6.0	1550	2.9	7300	9.5
Commercial Loans	120	0.3	-	-	6806	8.9
Short Term (< 1 year)	*713*	*1.6*	*264*	*0.5*	*1617*	*2.1*
Multilateral	713	1.6	256	0.5	961	1.2
Commercial Loans	-	-	8	-	655	0.9
From IMF	*1337*	*3.0*	*4387*	*8.3*	*6095*	*7.9*
Foreign Exchange Liabilities	*1296*	*2.9*	*3107*	*5.9*	*5121*	*6.7*
Public Sector Enterprises	*1203*	*2.7*	*1848*	*3.5*	*1384*	*1.9*
TOTAL	44281	100.0	53104	100.0	76742	100.0

*including liabilities and borrowing by PSEs which is mostly guaranteed by Government
Source: SBP

The composition of public external debt is given in Table 23.2. There are some significant developments since 2007-08 as follows:

(i) The outstanding debt with the Paris Club countries has actually declined. This is a reflection of the ebb in new inflows from these countries and increasing repayment.

(ii) Multilateral debt is the debt owed to international development institutions like the World Bank, Asian Development Bank and the Islamic Development Bank. The outstanding debt has continued to grow at about 3 percent per annum, reaching $28.1 billion by March 2018.

(iii) The other bilateral source, outside the Paris Club, is mostly China. This is largely the flow of relatively long term concessional funding for CPEC infrastructure projects. The level of borrowing has grown rapidly since 2015-16.

(iv) The Government of Pakistan has periodically been floating Sukuk/ Eurobonds of five or ten years maturity. The last flotation was in December 2017 of $2.5 billion, with the interest rate of 5.625 percent on five year Sukuk bonds and 6.875 percent on ten year Eurobonds. The total outstanding amount has reached $7.3 billion, equivalent to almost 10 percent of public external debt. A Sukuk bond of $1 billion will mature in April 2019.

(v) A recent source of borrowing that has emerged is from international commercial banks. These include banks from China, like the ICBC and China Development Bank, and other banks like Credit Suisse and Standard Chartered Bank. These loans are relatively expensive and for periods of only two to three years. This process of borrowing from commercial banks essentially started in 2016. By March 2018, the cumulative amount due has reached $6.8 billion. It is expected to continue rising rapidly.

(vi) The outstanding loan with the IMF stands at $6.1 billion. This is the amount disbursed over a period of three years, ending in September 2016, under the Extended Fund Facility (EFF). Repayment starts at $500 million approximately in 2018-19 and will reach $1.1 billion in 2020-21.

The above developments since 2007-08 lead to some basic conclusions. First, the share of relatively concessional loans is declining while that of more market-based borrowing is increasing. The share of the latter source has increased to 25 percent by March 2018. The tenure of these loans is also shorter, implying higher rates of amortization annually.

23.3. AMORTIZATION OF EXTERNAL DEBT

The amortization, debt repayment plus interest cost, is given in Table 23.3 of total external debt, both public and private, since 2012-13. The worrying development is that the size of debt repayment has increased sharply with increased resort in incremental borrowing of either short-term or medium-term duration. A similar trend is observed in the case of interest costs. This is, of course, the consequence of declining share of concessional loans.

Table 23.3: Annual Amortization of External Debt[b], 2012-13 to 2017-18 – ($ billions)

	Debt[a] [1]	Debt Repayment [2]	Interest Cost [3]	Amortization	[2] as % of [1]	[3] as % of [1]
2012-13	65.5	2.7	0.8	3.5	4.4	1.3
2013-14	60.9	2.9	0.9	3.8	8.1	1.6
2014-15	65.3	3.0	1.1	4.1	4.9	1.8
2015-16	65.2	3.9	1.3	5.2	6.6	2.2
2016-17	73.9	6.5	1.6	8.1	9.6	2.4
2017-18	83.4	5.1	2.3	7.4	6.1	2.8
Annual Growth Rate (%)[c]		**12.7**	**21.1**	**15.0**		

[a] lagged by one year | [b] Excluding the IMF Loan | [c] from 2012-13 to 2017-18
Source: SBP

The rising debt amortization is illustrated by a look at the terms of loans from different sources in Table 23.4.

Table 23.4: Rates of Amortization on Different Types of Borrowing

	Terms[a] For loan of $100 million	Annual Amortization[c] ($ million) on loan of $1 billion
China Infrastructure Loan	r = 5.3%, T = 20 years	84
IDA Concessional Loan	r = --%, T = 25 years	48
ADB Loan	r = 3.1%, T = 23 years	60
IBRD Loan	r = 3.25%, T = 21 years	62
Bank of China	r = 5.29%, T = 3 years	360
China Development Bank	r = 5.52%, T = 3 years	367
ICBC – China	r = 5.09%, T = 2 years	528
Sukuk Bond 2022	r = 5.625%, T = 5 years	56[b]
Eurobond 2027	r = 6.875%, T = 10 years	69[b]

[a] r = interest rate | [b] only interest cost | [c] following expiry of any grace period | T = tenure
Source: PES

The traditional IDA, ADB and IBRD loans are '*soft*' and concessional in character. The interest rate is low at close to 3 percent and the tenure is long, ranging from 21 to 25 years. As such, there is implicitly a significant grant component. The Chinese infrastructure loans are also concessional, although somewhat less than the international development agencies. The interest is just above 5 percent and the repayment period is 20 years.

The recent influx of commercial loans has increased substantially the overall rate of amortization of external debt. For example, loans from ICBC, China, carry an interest rate of over 5 percent and a repayment period of only two years. Consequently, the annual amortization of a loan of $1 billion is as high as $528 million.

An exercise is undertaken to determine for 2018-19 the overall level of amortization on the outstanding external debt of different types as of 30th of June 2018 in Table 23.5. The estimated magnitude is $7.7 billion for public external debt. Inclusion of repayment of short-term, PSEs, private debt and liabilities raises the level to $11.7 billion.

Table 23.5: Projection of Amortization of External Debt – 2018-19 – ($ millions)

	Outstanding Debt	Amortization Payment
Paris Club	11643	558
Multilateral	28102	1609
Other Bilateral	8674	728
Euro/Sukuk Bonds	7300	1456
Commercial Loans	6806	2847
IMF	6095	500
TOTAL PUBLIC DEBT[a]	**68620**	**7698**
Short Term	1617	1713
Private & PSEs Debt and Liabilities	25105	2291[b]
TOTAL DEBT	**95342**	**11702**

[a]Government Debt | [b]20% Growth

Source: SBP

23.4. MEASURES OF EXTERNAL DEBT SUSTAINABILITY

Given the rapid growth in external debt in recent years, there is need to determine the extent of deterioration in different measures of external debt sustainability. Table 23.1 has already shown that the external debt to GDP ratio has gone up from 27 percent to 31 percent in the last five years.

Table 23.6 gives the ratio of the stock of outstanding external debt with exports. This has increased substantially from 193 percent of the GDP percent in 2012-13 to 394 percent in 2017-18. The increase has been accentuated by the lack of growth in exports.

Table 23.6: Measure of External Debt Sustainability, 2012-13 to 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
External Debt as % of Exports	193.2	215.2	217.4	266.6	302.5	393.8

Source: SBP | PES

Table 23.7 presents the ratios of external debt amortization with key macroeconomic variables like GDP, exports and foreign exchange reserves. The critical measure is with respect to foreign exchange reserves. This was 110 percent in 2012-13, when Pakistan had to seek support from the IMF. It fell sharply to a low of 36 percent by 2015-16. Since then it has been rising once again reaching 76 percent by 2017-18. This is yet another signal that Pakistan may have to go back once again to the IMF. Overall, Pakistan is in a state of incipient financial crisis.

Table 23.7: 'Flow' Measures of External Debt Sustainability, 2012-13 to 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
External Debt Amortization as % of:						
GDP	2.9	3.1	2.4	2.3	3.0	2.5
Exports	26.9	29.9	26.6	29.5	41.4	30.5
Foreign Exchange Reserves	110.0	82.4	47.4	35.9	56.5	75.5

Source: SBP | PES

SECTION 8

TAXATION

Chapter 24:

THE TAXATION SYSTEM OF PAKISTAN

Revenues from taxes are the principal source of financing the operations and development spending by different levels of Government. The Constitution of Pakistan specifies in the Federal Legislative List, Part-I, the taxes that can be levied by the Federal Government. Residual fiscal powers rest with the Provincial Governments.

The objective of this Chapter is to highlight the salient features of the taxation system of Pakistan. Section 1 identifies the taxes levied by different levels of Government and their relative contribution to total tax revenues. Section 2 presents some key facts about the income tax. Section 3 focuses on indirect taxes. Section 4 describes the level and type of energy taxation in Pakistan. These taxes make a big contribution to overall tax collections. Finally, an attempt is made to derive the implications of the tax system on the burden imposed by sector and by income group.

24.1. TYPES OF TAXES

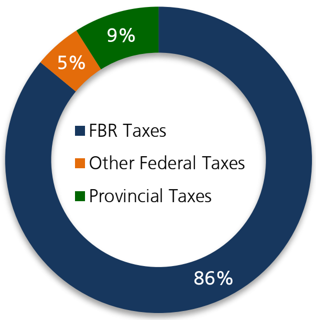
The Federal Board of Revenue (FBR) is the principal tax agency of the Federal Government. The taxes collected by FBR include the income tax, general sales tax, customs duty and excise duty. Other Federal taxes include the petroleum levy, gas infrastructure development cess and the gas development surcharge.

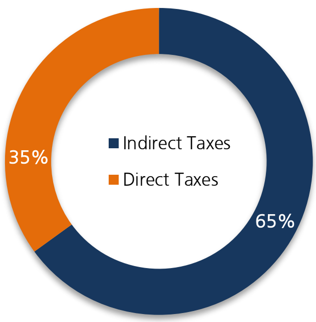
Provincial Governments collect revenues from a wide range of taxes, each yielding relatively small level of revenue. Direct taxes include the agricultural income tax and the urban immoveable property tax. The significant indirect taxes are the stamp duty, land revenue and motor vehicle tax. The sales tax on services was transferred to the Provincial Governments following the 18th Amendment to the Constitution in 2010. It has since emerged as the largest source of revenue at the sub-national level.

The key facts on the taxation system of Pakistan are presented in Figure 24.1 below. The dominant share in 2017-18 is of tax revenues generated by FBR of 86 percent. Other Federal taxes contribute 5 percent and Provincial taxes, 9 percent. The major share in overall revenues is of indirect taxes at 65 percent. The remainder, 35 percent, is from direct taxes. This is the first indicator of the relative lack of progressivity of the tax system of Pakistan.

Figure 24.1: Key Facts on the Taxation System – 2017-18

Share in Tax Revenues	Share by Type of Taxes



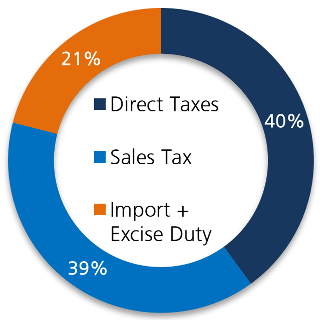


Source: MOF, Fiscal Operations

The relative contribution of the four FBR taxes to total tax collection by FBR is given in Figure 24.2. The two big taxes are income tax and sales tax, making a contribution of 40 percent and 39 percent respectively to FBR revenues. The two relatively minor taxes are customs duty and excise duty, with shares of 15 percent and 6 percent only. Up to the end of the decade of the 90s, customs duty used to be the principal source of revenue.

Figure 24.2: Share of Different Taxes in FBR Revenues, 2017-18

2017-18



Source: MOF, Fiscal Operations

The trends in the national tax-to-GDP ratio are given in Table 24.1. The national tax-to-GDP ratio remained low at close to 10 percent of the GDP during tenure of the PPP Government from 2008-09 to 2012-13. Since then there has been considerable progress with a rise in the ratio by over 3 percent of the GDP. Three-fourths of this increase has come from FBR taxes and one-fourth from other Federal and Provincial taxes.

Table 24.1: Tax-to-GDP Ratio of Pakistan, 2007-08 to 2017-18 – (%)

	2007-08[a]	2012-13[b]	2017-18[c]
National[d]	**10.0**	**9.6**	**13.0**
FBR	9.6	8.5	11.1
Other Federal	-	0.5	0.7
Provincial	0.4	0.6	1.2

[a] No petroleum levy or GIDC | [b] Petroleum levy | [c] Petroleum Levy, GIDC+ GDS | [d] GIDC and GDS were converted from non-taxes to taxes

Source: MOF, Fiscal Operations

24.2. KEY FACTS ON INCOME TAX

The Federal income tax is collected in various ways. First, revenues accrue from voluntary payments through filing of returns. As shown in Table 24.2, this source contributed over 31 percent in 2012-13 which has fallen to 27 percent in 2015-16, the last year for which information is available. Second, random assessment of a proportion of returns files leads to some collection out of demand. Over 11 percent of revenues were generated this way in 2012-13. This has fallen to 7 percent by 2015-16 and reflects somewhat poorly on the performance of the Internal Revenue Service (IRS) of FBR.

Table 24.2: Types of Collection of Income Tax, 2012-13 and 2015-16 – (Rs in Billion)

	2012-13	% Share	2015-16	% Share	Annual Growth Rate (%)
Collection out of Demand	89.5	11.5	87.9	7.1	-0.6
Filing of Returns/Voluntary Payments	244.9	31.6	340.8	27.4	11.0
From Withholding/Advance Taxes	436.1	56.2	803.1	64.6	20.4
Miscellaneous	5.6	0.7	10.4	0.9	20.6
TOTAL REVENUE	**776.1**	**100.0**	**1242.2**	**100.0**	**15.7**
Refunds	53.4		47.5		
TOTAL REVENUE	**722.7**		**1194.7**		**16.8**
(Net)					

Source: FBR Year Book. Latest available is for 2015-16.

Third, the largest and the fastest growing source is advance/withholding taxes. The share has risen from 56 percent to almost 65 percent, with a high annual growth rate above 20 percent between 2012-13 and 2015-16. The policy of FBR has been not only to introduce more deductions at source but also to enhance the rates of deduction. Many of the withholding taxes are actually presumptive taxes, representing full and final discharge of tax liabilities.

Pakistan has a very elaborate withholding tax regime. There are 64 such levies on different transactions. However, almost three-fourths of the revenues are from six sources which include imports, salaries, dividends, interest income, sale of goods, services and contracts.

Pakistan has a relatively low income tax-to-GDP ratio at 4 percent in 2015-16, as compared to 6 percent in India, 8 percent in Malaysia, 5 percent in Nepal, 7 percent in Thailand and 8 percent in Vietnam. Only one in 160 persons files an income tax return in Pakistan as compared to one in 40 in India. Also, only one third of the companies registered with the SECP file income tax returns in Pakistan. The accrued capital gains in the stock market of Pakistan in 2016-17 were over Rs 2000 billion. The gains realized are almost Rs 540 billion. But the tax paid is only Rs 15 billion. There are 304,000 farmers in Pakistan with farms of 25 acres or more. Their total income is estimated at Rs 1085 billion, but the agriculture income tax paid by them in 2016-17 is less than Rs 2 billion. Similarly, the domestic wholesale and retail trade sector is one of the largest sectors in the country, with income generated of Rs 3980 billion in 2015-16. However, the revenue collected from the sector is only Rs 60 billion. Therefore, the effective burden is not even 2 percent.

Independent Power Producers (IPPs) enjoy lifetime exemption from corporate income tax, as per the 1994 Energy Policy. Cumulatively this has led to a loss of over Rs 400 billion in revenues since 1995. They also enjoy high rate of return annually on equity of over 26 percent.

Pakistan has no transfer pricing regulation, unlike the tax laws in other countries, including India. Consequently, a higher share of profits accrues to head offices of multinational companies, thereby reducing the tax liabilities in Pakistan. This practice is common in sectors like pharmaceuticals and automobiles.

The Income Tax Ordinance of 2001 taxes global income of residents under Section 103. In 2014 Pakistanis invested $4.8 billion in Dubai alone. The income from the assets of non-Resident Pakistanis in Dubai is fully taxable in Pakistan because there is no income tax in Dubai. This provision is included in the Avoidance from Double Taxation Agreement of Pakistan with the United Arab Emirates. Similar problems exist with income of resident Pakistanis from the other countries.

The tax rate on corporate income from foreign direct investment is 20 percent, as compared to the standard corporate income tax rate of 30 percent for the tax year 2017-18. This difference is in the nature of a fiscal incentive to attract more FDI. However, it increases the likelihood of '*round-tripping*' of capital. In the Budget of 2018-19, the tax rate is proposed to be brought down to 25 percent in the next five years.

According to the latest Tax Directory for 2014 published by FBR, only 40,764 Associations of Persons (AOPs) / Partnerships filed returns. The total tax paid was Rs 35 billion, equivalent to only 4 percent of the total revenues from the income tax. This highlights the high level of tax evasion by AOPs.

The income tax collection is highly skewed. Among the total numbers of personal income tax payers of 791,456 in 2014-15, only 20,802 paid an amount of tax in excess of Rs 1 million. However, while these taxpayers represented only 2.6 percent of the total number, they contributed as much 69 percent to the total revenue from the personal income tax. At the other end of the distribution, as many as 297,002 taxpayers or 38 percent paid zero income tax.

Similarly, the distribution of tax payments by companies is also very imbalanced. Only 98 companies, out of the total of 24,186 companies in 2014-15, contributed over 67 percent to the revenues from the corporate income tax. 7,756 companies showed a tax liability of less than even Rs 1 million.

The personal income tax structure in Pakistan is much less progressive than in other countries. Following the Budget of 2018-19, the highest marginal tax rate is attained at ten times the per capita income, as compared to nine times in India and eight times in Bangladesh. Also, there are now only three personal income tax slabs in Pakistan. The highest rate has been brought down to 25 percent from 30 percent.

Withholding income taxes on imports, electricity, CNG, telecommunications and sales of agricultural products have made the income tax more regressive. These sources account for almost 30 percent of the total revenues from withholding taxes. Almost 90 million persons pay income tax on their phone bills/cards, howsoever small their income. 18 million are charged on their electricity bills, 41 million on interest income from bank deposits and so on. As opposed to this, the number actually filing returns in 2017 is just above 1.2 million.

The Tax Directory for 2016 of Parliamentarians has just been released. It contains some very interesting revelations. Analysis of returns by representatives of the National Assembly indicates that 12 percent did not even file a return. Only 8 percent paid income tax in excess of Rs 1 million. 19 percent paid tax of Rs 100,000 to Rs 1 million and 61 percent paid less than Rs 100,000. The implication is either that there is some under declaration of income even among MNAs, who formulate and approve our tax laws, or that, contrary to popular perceptions, majority of them are from the middle class or poorer sections of the community in the various constituencies.

Overall, the conclusions from the above key facts on income tax in Pakistan are that there is absence of a developed tax culture, presence of substantial tax concessions/ exemptions and widespread tax evasion. These messages highlight the main areas of reform in the income tax law and of improvements in the quality of tax administration by the IRS of FBR.

24.3. INDIRECT TAXES

24.3.1. Sales Tax

The general sales tax is the largest indirect tax. The sales tax on goods is collected by the Federal Government while the sales tax on services is the responsibility of the Provincial Governments. It has the characteristics of a value added tax under the Sales Tax Act of 1990.

Registered persons are required to pay the tax. Exports are zero-rated and the sales tax on inputs is to be refunded to the exporter. However, under the pressure to achieve revenue targets, FBR has held back refunds, which are now in excess of Rs 250 billion. This has adversely affected the liquidity position of exporters and impacted adversely on exports.

Registered persons include manufacturers who are not running a cottage industry. Domestic wholesalers and retailers, with turnover in excess of Rs 5 million, are also expected to register for payment of the tax. In the case of supplies made to a non-registered person, a further tax has to be paid at the rate of 3 percent, over and above the standard rate.

The standard rate of the sales tax on goods is 17 percent. However, there are variations in this rate. According to the Third Schedule, 20 items are expected to pay the tax on the retail price and not on the ex-factory price. The Fifth and Sixth Schedule contain a comprehensive list of exemptions. 134 items are exempted in the case both of imports or local supplies. This includes food items, medicines, stationery, equipment for renewable energy, computers and pesticides. More recently, supplies to Gwadar Free Zone and equipment for CPEC projects have also been exempted from the sales tax.

The Eight Schedule includes items which pay the tax only on the final value of sales with no input tax invoicing. The rate is either 5 percent or 10 percent. A number of food items with brand names, machinery, second hand and worn clothing are included in this schedule. Imported fertilizer is subject to specific rates.

Sales tax revenues from imports and domestic supplies respectively are, more or less, equal in magnitude. The major import items which contribute to revenues from this source are POL products (32 percent), machinery (14 percent), iron and steel (8 percent), vehicles (7 percent) and chemicals (7 percent). POL products are also the biggest source of revenue from domestic supplies, with a share of 42 percent. Other significant sources are electricity (6 percent), cement (4 percent), cigarettes (4 percent), natural gas (3 percent) and sugar (3 percent).

The sales tax on services was effectively introduced by the Provinces from 2012 onwards. Specialized tax agencies, the Sindh Revenue Board and the Punjab Revenue Authority, were established for this purpose. The list of taxable services is notified by each agency. The rates vary, with 13 percent in Sindh and 16 percent in Punjab. There are provisions for tax invoicing of service inputs into goods and vice versa. However, there continues to be a problem of refunds.

The sales tax on services has rapidly emerged as the largest Provincial tax. Total revenue from this tax by the four Provinces combined was Rs 224 billion in 2017-18, equivalent to 0.6 percent of the GDP and 56 percent of total Provincial tax revenues. It has been a buoyant source of revenue with the growth rate in 2017-18 of over 30 percent.

24.3.2. Customs Duty

Customs duty was the largest source of Federal tax revenues uptil 1998. Historically, Pakistan had pursued a policy of high import tariffs to provide protection to domestic industry. However, since then a policy of trade liberalization has been adopted gradually, especially during the tenure of IMF programs. Today, the importance of customs duty is greatly diminished with a revenue contribution of less than 1.6 percent of the GDP.

The scaling down of import tariffs during the last ten years is described in Table 24.3. In 2007-08, there were seven slabs with a maximum duty of 35 percent. By 2017-18, the number of slabs was brought down to four and the maximum rate set at 20 percent. However, a minimum duty of 3 percent has been introduced on hitherto exempt items.

Table 24.3: Structure of Import Duties, 2007-08 to 2017-18

Year	Number of Slabs	Rates (%)
2007-08	7	0, 5, 10, 15, 20, 25, 35
2012-13	7	0, 5, 10, 15, 20, 25, 30
2017-18	4	3, 11, 16, 20

Source: FBR, Customs Tariffs.

The main contributors to revenues from import duties are vehicles (15 percent), iron and steel (10 percent), machinery (10 percent), POL products (9 percent) and edible oil (6 percent). During 2016-17 regulatory duties were introduced on over 700 items to curb the rapid growth in imports. In addition, a cash margin requirement of 100 percent has been introduced on the import of luxury goods.

24.3.3. Excise Duty

The importance of excise duty has also waned over time. It is now by far the smallest tax of FBR, with a revenue contribution of 0.6 percent of the GDP in 2016-17. Almost 66 percent of the revenue is from cigarettes, followed by air travel, beverages and cement.

24.4. ENERGY TAXATION

Energy taxes on petroleum products, natural gas and electricity have acquired greater importance in the tax system of Pakistan over time. The reasons for this development are, first, large size of the tax base, which valued at international prices is almost 8 percent of the GDP. Second, taxing energy is efficient because of inelastic demand. Third, energy taxes effectively act as carbon taxes and reduce the negative impact of emissions on the environment. Fourth, there is need to restrict the oil import bill by higher domestic prices including taxes.

Pakistan has a number of indirect taxes on energy. First, the general sales tax covers all energy sources. Second, a petroleum levy was introduced in 2008-09, to explicitly act as the equivalent of a carbon tax on fossil fuel. The effective rate is close 13 percent in the case of motor spirit. Third, natural gas is also subject to an excise duty and development surcharge. A gas infrastructure development cess was introduced in 2011. Fourth, again a recent development, import duties have been levied on crude oil and petroleum products. The highest rate is on furnace oil, inclusive of a regulatory duty, of 13 percent. The rate of import duty on HSD is 11 percent while on other products and crude oil it is 3 percent.

What is the contribution of this diverse collection of energy taxes to indirect tax revenues? In 2015-16, revenues of over Rs 857 billion were collected from energy taxes as shown in Table 24.4. This represents over 44 percent of the total revenue from indirect taxes and at the Federal level 24 percent of total tax revenue. The biggest contribution is from the general sales tax with a share of 63 percent.

Table 24.4: Energy Tax Revenues, 2014-15 and 2015-16 – (Rs in Billion)

	2014-15	2015-16*
Sales Tax (Domestic)	**281.0**	**325.4**
POL Products	242.2	269.8
Natural Gas	14.4	18.2
Electricity	24.4	37.4
Import Duty POL	**24.4**	**38.0**
Sales Tax (Imports)	**166.0**	**219.1**
POL Products	166.0	219.1
Excise Duty	**12.8**	**13.6**
Natural Gas	12.8	13.6
GDS	**25.9**	**32.6**
GIDC	**57.0**	**79.8**
Petroleum Levy	**131.4**	**149.3**
TOTAL	**698.5**	**857.8**
Total of Indirect Taxes	1782.5	1946.4
% of Total	39.2	44.1
Energy Taxes as % of GDP	**2.5**	**2.9**

*Latest year for which data is available
Source: FBR Quarterly Reviews

The energy sector also makes a major contribution to the corporate income tax. Some of the largest taxpayers are from this sector including OGDC, PPL, PSO and Pak-Arab Refinery. Out of the tax payments with returns, the share of the energy sector is close to 40 percent.

What has happened to revenues from the energy sector following the sharp fall in oil prices since September 2014? Given the primary source as GST, there was the danger of a big decline in the tax contribution of the sector. However, there has been a simultaneous enhancement in the rates of GST on petroleum products above the standard rate of 17 percent. As of the 1st of January 2018, the sales tax rates respectively are 25.5 percent on High Speed Diesel oil, 6 percent on light diesel oil, 17 percent on motor spirit, kerosene oil at 6 percent and 20 percent on furnace oil. The overall incidence of energy taxes approaches on average almost one third of the retail prices.

Are the current differential rates of GST justified? Actually, the price of HSD oil is almost 14 percent higher than the price of motor spirit in Pakistan. This pricing policy is very unusual. In all other countries of South Asia, the opposite is the case. For example, the price of motor spirit is higher than that of high speed diesel oil by 16 percent in India, 50 percent in Bangladesh, 34 percent in Sri Lanka and 28 percent in Nepal. The logic is that HSD oil is used mostly in public transportation, especially in the movement of essential goods, like food items. As opposed to this, motor spirit is largely consumed by the upper income groups for private transportation. Therefore, the tax incidence on motor spirit should be more than that on HSD oil.

A major review of the pricing policy on petroleum products needs to be undertaken since the almost 40 percent hike in international oil prices after June 2017. Given this price upsurge, it is possible now to rationalize the tax rates without any significant loss of revenues.

The Government has, in fact, brought down the GST rate of HSD from 31 percent to 25.5 percent. However, in an inexplicable move, a 6 percent GST has been introduced on Kerosene oil and Light Diesel Oil, which had been exempted earlier. The former product is consumed mostly by low income households and the latter in the running of tube wells. The exemptions need to be restored.

There are also serious problems with the levy of the gas infrastructure development cess. According to the GIDC Act of 2015, this is earmarked source of revenue. The revenues generated are to be used for construction of pipelines like the TAPI and Pak-Iran pipelines. However, revenues are currently being taken into the Federal Consolidated Fund, instead of a special purpose fund. Also, an annual report is to be presented to the Parliament. Apparently, this has not been the case up to now.

The following proposals are made for changes in the energy taxation structure:

(i) Given the increase in petroleum prices internationally, the policy should be to revert to the standard GST rate of 17 percent in the case of motor spirit and HSD. Both kerosene oil and light diesel oil should be exempted. Any adjustment for revenue purposes should be made in the rate of petroleum levy, especially on motor spirit.

(ii) The same duty of 11 percent should be applied on the import of HSD and motor spirit. This will represent an increase in the duty on the latter product from 3 percent to 11 percent. However, it will reduce the differential between the retail prices of the two products.

(iii) The highest rate of the gas infrastructure development cess is on gas used as a feedstock in the production of fertilizer. It should be brought down from 300 Rs to Rs 100 per MMBTU. Simultaneously, the rate may be enhanced on large domestic consumers to prevent any revenue loss. The consequential reduction in the price of urea will facilitate crop output in the country. A GIDC of Rs 100 per

MMBTU may also be levied on LNG, given the need of pipelines for domestic distribution.

(iv) To the extent that furnace oil continues to be used for electricity generation, the regulatory duty on import should be removed and the GST rate brought down to the standard rate.

The above proposals need to be implemented to improve the competitiveness of Pakistani industry. They will also imply a less regressive burden of energy taxes and a favorable impact on the price level.

24.5. INCIDENCE OF TAXES

There are two dimensions of incidence of taxes which are important from the policy point of view. The first is the distribution of the tax burden among sectors of the national economy. The second is the incidence of taxes by income level of households. The latter is particularly important from the viewpoint of determining the degree of progressivity of the tax system in the country.

24.5.1. Sectoral Incidence

The sectoral distribution of taxes is presented in Box 24.1. Nine taxes levied on industry include corporate income tax, customs withholding taxes, sales tax, excise duties, petroleum levy, motor vehicle tax and gas development surcharge. The largest number of taxes are collected from industry. At the other extreme is the agricultural sector which pays the withholding tax on crops, customs duties on agricultural items, presumptive income tax on agricultural exports, agricultural income tax, land revenue and a share of stamp duties.

Box 24.1: Sectoral Incidence of Taxes

AGRICULTURE

- Withholding Tax on Agricultural Crops
- Customs Duties on Agricultural Item
- Presumptive Income Tax on Agricultural Exports
- Agricultural Income Tax, Land Revenue and Stamp Duties

INDUSTRY

- Corporate Income Tax on Industry
- Customs Duties on Manufacturers
- Withholding Taxes on Industry
- Sales Taxes on Goods
- Excise Duties on Manufacturing
- Petroleum Duty
- Motor Vehicle Tax
- Gas Development Tax
- Urban Immovable Property Tax

SERVICES SECTOR

- Sales Tax of Services
- Federal Sales Tax
- Excise Duty on Services
- Corporate Income Tax on Services
- Withholding Tax on Services
- Share in other Withholding Taxes
- Customs Duty on Freight and Insurance on Import Goods
- Urban Immovable Property Tax

Source: Pasha (2013)

Services sector which accounts for over half of the economy and is the most rapidly increasing sector bears the burden of seven taxes: provincial sales tax of services; federal sales tax (on certain services like restaurants and franchises), excise duties;

corporate income tax; withholding tax; customs duty on freight and insurance, and; infrastructure development fee on freight levied by Sindh government. The important question which arises is what is the revenue contribution of each sector to the public exchequer?

Quantification of the nominal incidence indicates that the spread of tax burden on the three sectors is very skewed, as shown in Table 24.5. Over 72 percent of tax revenues are collected from the industrial sector. This is a very high share when compared to the other sectors. Services sector contributes 25 percent to revenue collection and agriculture less than 3 percent. The tax burden on industry is oppressive at almost 50 percent of value added. Clearly taxation policy in Pakistan needs to more balanced sectorally and effort needs to be made to tap more the services and agricultural sectors.

Table 24.5: National Sectoral Tax Incidence, 2015-16 – (%)

	Share in Tax Revenues	Share in Value Added (at current prices)	Effective Tax Burden (Tax Revenues as % of Value Added)
Agriculture	2.6	23.8	1.4
Industry	72.4	18.1	49.5
Services	25.0	58.1	5.9
TOTAL	**100.0**	**100.0**	**12.4**

Source: FBR Year Book, PES

24.5.2. Incidence by Income Group

Equity considerations relating to horizontal and vertical equity require that the tax system is designed such that there should be “equal treatment of equals” and those who have the ability to pay more should pay more taxes than those who do not. This is one of the cardinal principles of progressive fiscal policy. As such, there is need to derive explicitly the implications of the tax system on who bears the burden of taxes in Pakistan?

Kemal [2008] demonstrated that the overall incidence of taxes was regressive in 1999-2000. Wahid and Wallace [2010] under took a study on incidence commissioned by FBR. Their finding was that the pattern of incidence appeared to be mildly progressive in 2007-08.

However, there are strong reasons to believe that the tax incidence has become even less progressive since 2007-08. First, the regressive component in the withholding income tax regime with collection on imports, contracts, services, sale of goods, POL products, electricity bill and telephones has made the income tax system less progressive. If this component is effectively included in indirect taxes, then their share rises to as much as 80 percent. Clearly, the tax system is lopsided with a ratio of 4:1 between indirect and direct taxes.

Second, the contribution of products which impact more, directly or indirectly, on the lower income groups has risen. In particular the share of POL products, especially HSD oil, has increased in indirect tax revenues.

Third, the Budget of 2018-19 has witnessed an inexplicable attack on the progressivity of the tax system. The exemption limit on the personal income tax been trebled while the maximum tax rate has been halved. In addition, taxes on capital income have been significantly reduced. There is little doubt that the tax system of Pakistan today is only mildly progressive. Major reforms will be required to restore equity in the incidence of the tax burden.

Chapter 25:

THE TAX GAP

A fundamental question that arises is the extent to which the tax-to-GDP ratio of Pakistan can be raised without negatively impacting on the process of growth. Higher tax revenues will not only help in containing the fiscal deficit and slowing down the buildup of public debt but also enable higher development spending.

This Chapter is aimed at quantifying the tax gap in the country. This is the difference between the tax potential and the actual level of tax revenues. Based on the estimated potential an attempt can further be made to identify the extent to which exemptions and concessions in the tax system have affected the level of revenue. The cost of these deviations from standard tax rates are referred to as 'tax expenditures'.

The Chapter is organized as follows. Section 1 estimates the tax potential of Pakistan. Section 2 then quantifies the tax expenditure. Section 3 identifies the factors which have contributed to the increase in the FBR tax-to-GDP ratio from 2012-13 to 2016-17.

25.1. TAX POTENTIAL

A representative tax system approach is generally adopted to estimation of the tax potential of a country. This links the size of potential tax revenues as a percentage of the GDP to the relevant economic characteristics of the country.

UNESCAP [2014] has undertaken this exercise for 28 countries. The existing tax-to-GDP ratio, TGDP, is correlated with the following variables: PCGDP: the per capita income in US$. A higher per capita income is likely to imply a larger tax potential. Consumer spending will tend to have a lower percentage devoted to food and basic services. As such, the taxable component for levy of indirect taxes will be larger. Similarly, the share of personal incomes above an exemption limit will be larger.

AGRI: This is the share of income generated in the agricultural sector as a percentage of the GDP. In most countries, rural incomes are relatively low and large part of agricultural output is of food items. Consequently, a relatively large agricultural sector is likely to restrict the revenue potential:

OPEN: This corresponds to the degree of openness of the economy. It is measured as the sum of exports and imports as a percentage of the GDP. This variable can have an ambiguous impact on the tax potential. If the economy is more open due to higher imports then the scope for taxation via indirect taxes is larger. However, if the economy is more export-oriented then the need for zero-rating of exports reduces the tax potential.

INEQ: This is the measure of inequality of income, generally measured by the Gini coefficient. More inequality implies higher revenues from a progressive income tax system. However, it may reduce aggregate level of consumer spending as a percentage of the GDP and thereby limit the level of revenues from indirect taxes.

The above five variables are correlated by the use of OLS with the tax-to-GDP ratio. The results obtained from data of 2012-13 by UNESCAP are as follows:

$$TGDP = 18.52 + 0.01\ (OPEN) - -0.24\ (AGRI) + 0.34\ (PCGDP\ 1000) \ldots \ldots \ldots [1]$$

The variable INEQ did not emerge as significant. It may be noted that the TGDP of a country relates to taxes on income, sales, production and imports. This implies that unconventional levies like the petroleum levy, GIDC and the Gas Development Surcharge are excluded from the measurement of TGDP for Pakistan. These levies could even be classified as non-tax sources of revenue. Equation [1] can be used to derive the potential tax-to-GDP ratio of Pakistan.

The analysis is undertaken for 2017-18, when

$$PCGDP = 1640,\ AGRI = 22.57,\ OPEN = 26.92$$

The resulting estimate of the potential tax-to-GDP ratio of Pakistan is 13.9 percent of the GDP. The actual FBR tax-to-GDP ratio in 2017-18 was 11.2 percent. Therefore, the tax gap is significant at almost 2.8 percent of the GDP. In effect, Pakistan should strive for attaining an tax revenue target of the FBR and Provincial taxes of 14 percent of the GDP in the next three years.

25.2. TAX EXPENDITURES

One way of filling the tax gap is, first, to estimate the tax expenditures in the tax system of Pakistan and, second, to determine which exemptions or concessions can be reduced.

Various attempts have been made to estimate the quantum of tax expenditures for Pakistan. World Bank [2015] has estimated the total expenditure as Rs 720 billion in 2014-15, equivalent to 2.6 percent of the GDP. 71 percent of the tax expenditure is in Federal taxes and the remainder, 29 percent, in Provincial taxes. Also, 46 percent of the tax expenditure is in direct taxes.

The Pakistan Economic Survey (PES) includes an Annex every year on Tax Expenditure. The latest issue gives the overall magnitude in 2017-18 as Rs 541 billion, equivalent to 1.6 percent of the GDP. These estimates are made by FBR. The estimated magnitude in 2016-

17 was Rs 416 billion, implying a big increase of 30 percent in 2017-18. Apparently, the tax system has become more vulnerable to special interests.

There are two problems with the FBR estimates. First, they appear to be on the low side. At 1.6 percent of the GDP in 2017-18 they are substantially lower than the World Bank estimate of 2.6 percent of the GDP in 2014-15. Second, FBR is of the view that the size of the tax expenditure in the income tax is very small. For 2017-18 it is estimated at only Rs 62 billion, equivalent to only 11 percent of the total tax expenditure. The corresponding estimate of the World Bank was Rs 331 billion or 46 percent in 2014-15.

The wide variation in the expenditure estimates has necessitated an up-dating exercise for 2017-18. The approach adopted is to determine carefully from the latest version of the Income Tax Ordinance of 2001 what the significant concessions and exemptions are and the resulting revenue foregone. In the case of indirect taxes reliance is largely placed on FBR estimates.

Results of the estimation exercise are presented in Table 25.1. The tax expenditure in income tax is very large. At Rs 411 billion, it is over six, times the estimate by FBR.

Table 25.1: Magnitude of Tax Expenditures – 2017-18

	Tax Expenditure *(Rs in Billion)*
FEDERAL	
Income Tax	
• Tax Holiday (lifetime) to IPPs	64
• Tripling the income tax exemption limit and halving of maximum rate	90*
• Accelerated (Initial) Depreciation Allowance	48
• Concessionary Tax Rate on Exports	20
• Tax Deduction on Bad Loan Provisioning by Banks	36
• Tax Credit for BMR	35
• Under-recovery on Capital Gains in Securities	32
• Exemption of Business Income of Trusts/Foundations	15
• Investment Allowance to Tax Payers	13
• Tax Deduction on WWF & WPPF Payments	12
• Other Tax Deductions	10
• Other Concessionary Tax Rates	51
• Other regional/sector exemptions	20
TOTAL	**446**
Sales Tax	
• Zero Rating of Exportable Items	61
• Exemptions to Local Supply (under 5th Schedule)	28
• Exemptions to Imports (under 6th Schedule)	76
• Exemptions to Local Supply (under 8th Schedule)	19
TOTAL	**280**
Import Duty	
• Cost of Duty Reductions in FTA with China	31
• Cost of Other FTAs	11
• Import Duty concessions to Automobile Sector, E&P Companies, CPEC, etc.	63
• Concessions under 5th Schedule	92
TOTAL	**197**
PROVINCIAL TAXES	
• Low Assessment of Agricultural Income Tax	40
• Low Assessment of Urban Immoveable Property Tax	30
• Exemptions from Sales Tax on Services	25
TOTAL	**95**
SUMMARY	
FEDERAL	
• Income Tax	446
• Sales Tax	280
• Customs Duty	197
PROVINCIAL	95
TOTAL (% of GDP)	**1018**

*for 2018-19

Source: Estimated by Author

The tax expenditures in income tax which have not been identified by FBR include the revenue foregone due to the initial depreciation allowance, lifetime tax holiday to IPPs, tax credit on BMR, investment allowance for individual tax payers, various other tax deductions and soon. Many of these exemptions/concessions are justified on the grounds that they are required to promote some key macroeconomic variable like investment, savings, exports, etc., or to promote the development or relatively backward areas.

Overall, the tax expenditures identified in Table 25.1 aggregate to just over 1018 billion Rs, equivalent to 3 percent of the GDP. They are almost double the estimates of FBR and include Rs 95 billion of tax expenditure in Provincial taxes like the Agricultural Income Tax and the Urban Immoveable Property Tax.

The next chapter on Tax Reforms will analyze the case for the retention of exemptions and concessions included in the analysis.

25.3. RISE IN TAX-TO-GDP RATIO

The tax-to-GDP ratio combined of taxes collected by the Federal Board of Revenue (FBR) has gone up appreciably over the last four years. It was 8.4 percent of the GDP in 2012-13. By 2017-18 it had increased by 2.8 percentage points to reach 11.2 percent of the GDP. In other words while the GDP increased during this period by 50 percent, FBR revenues showed cumulatively an increase of 98 percent.

The basic question is what explains the higher growth in tax revenues? Is it due to the relative buoyancy of the different tax bases on which the four FBR taxes are levied? Alternatively, is it the consequence more of escalation in statutory and/or effective tax rates in the four budgets or mini budgets announced during these years? Answers in the case of income tax, sales tax, customs duty and excise duty are given below.

The change in the tax-to-GDP ratio can be decomposed into two parts. The first is the 'base' effect which reflects the impact of a divergence between the growth in the tax base of a tax and in the GDP. The second is the 'rate' effect which captures the impact of a change in the overall incidence of revenues from the tax on its tax base.

The tax base for income tax can broadly be defined as the non-agricultural GDP. Agricultural incomes are outside the purview of FBR and within the taxation powers of the Provincial Governments. Non-agricultural incomes grew by 52 percent between 2012-13 and 2017-18, almost the same as the rise in the overall GDP. Income tax revenues grew substantially faster by 109 percent. This can be effectively attributed to an enhancement in the statutory and/or effective rates of taxation. The latter captures the effect of reduction in tax expenditures or some success in reducing tax evasion.

The income tax-to-GDP ratio has increased by 1.3 percentage points in the five years. Virtually all the rise is attributable to the 'tax rate' effect. What has been the change in statutory tax rates? There have on the contrary been same reductions. The corporate income tax rate was reduced from 35 percent to 30 percent and the highest personal income tax rate brought down to 30 percent.

As opposed to this, the presumptive and withholding tax rates have generally been enhanced in the case of imports, services, contracts and telecom services, capital gains from shares, etc. On top of this, substantially higher rates have been introduced in the case of non-filers. Further, the minimum tax on turnover was enhanced to 1 percent. More recently, a super tax has been introduced. Tax evasion has been reduced by expansion in the number of withholding levies, as for example, in the case of banking transactions in cash above a minimum level.

Sales tax is the second largest source of FBR revenues, after the income tax. It is essentially in the nature of a value added tax and collected at the stage of imports and manufacturing of goods from units above a certain minimum size. As such, the relevant tax base for the sales tax is the duty-paid value of imports plus the value added by the large-scale manufacturing sector.

The sales tax base has grown cumulatively by 50 percent between 2012-13 and 2017-18. However, sales tax revenues have demonstrated some buoyancy and risen cumulatively by 57 percent. Consequently, the sales tax-to-GDP ratio has gone up from 3.7 percent to 4.3 percent. The 'base' effect as highlighted above is negative at 0.4 percent of the GDP and the 'rate' effect is a positive 1.0 percent of the GDP.

Initially, the standard sales tax rate was raised from 16 percent to 17 percent. The major escalation in sales tax rates since has been in the case of POL products. It was possible to raise these rates in the face of sharply falling import prices. For example, at its peak the tax rate on HSD oil was as high as 51 percent, three times the standard rate. Similarly, the rate on motor spirit reached 25 percent in mid-2015. There has also been a 'cascading effect' on sales tax revenues. As import duties went up, the effective sales tax rates have gone up correspondingly. Another step taken by FBR was the levy of the sales tax on the retail price on a number of consumer goods. This amounted to a higher effective rate on the ex-factory price. It is worth noting that if these steps had not been taken the revenues from the sales tax would have been lower by Rs 230 billion, equivalent to 15 percent of the revenues actually collected in 2017-18.

Import duties have traditionally been a declining source of revenue. Up to the late-90’s they were the largest source of revenue but they now occupy the third place in FBR sources of revenue. However, during the last four years the tax-to-GDP ratio of this tax has actually gone up by 0.8 percentage points. While the tax base consisting of the total value of imports went up by 54 percent, revenue from import duties, increased by an impressive 153 percent. Consequently, while the 'base effect' was a negative 0.2 percent of the GDP, the 'rate' effect was a positive 1.0 percent of the GDP.

What explains the relatively large 'rate effect' in the case of a relatively small tax like import duties? This question needs to be answered especially in light of import tariff reforms, whereby the maximum rate was reduced to 20 percent from 30 percent alongwith corresponding reductions in the lower slabs.

The answer is to be found in three steps taken by FBR. First, a large number of items with zero duty were subjected to a minimum duty of 3 percent. Second, the rates of import duties on POL products were also enhanced. For example, in 2012-13 the tariff on furnace oil was zero percent which was raised to 11 percent. Third, more recently, regulatory duties have been introduced on over seven hundred items. In the absence of these changes, the revenue from import duties in 2017-18 would have been lower by Rs 238 billion, equivalent to almost 39 percent of the revenues actually collected.

Excise duty is the smallest tax of FBR and levied on a few select industries. Its tax-to-GDP ratio has gone up marginally by 0.1 percentage points, due primarily to a change in the tax structure on cigarettes.

Overall, for FBR revenues as a whole, tax base effect has been negative at 0.6 percent of the GDP and the rate effect is positive and large at 3.4 percent of the GDP. This has yielded an overall increase in the FBR tax-to-GDP ratio of 2.8 percentage points.

This important finding highlights, first, that in the absence of tax rate escalations and improved tax administration the tax-to-GDP ratio would have actually fallen. In 2017-18, total revenues would have been almost Rs 929 billion less, equivalent to 24 percent of the revenues actually collected.

However, the strategy of raising tax rates to initially protect and then raise the tax-to-GDP ratio has had some important implications. First, it has limited the growth of the various tax bases, especially the large-scale manufacturing sector. Second, many of the tax moves have been regressive in nature. These include enhancement in withholding tax rates on non-filers. Some of them may be tax evaders but the majority is persons with low incomes who are genuinely exempt from payment of the income tax. This has led to a perverse outcome whereby smaller taxpayers face higher tax rates.

Regressive moves in indirect taxes include, first, the levy of a 3 percent duty on historically exempt imports, including many food items. Second, the heavy taxation of HSD oil has implied higher transport costs while the enhanced import duty and sales tax on furnace oil have raised the price of electricity. Third, the increase in withholding/tax rates on imports, contracts, telecom etc., have had widespread impacts.

Looking ahead, FBR will have to find ways of raising the tax-to-GDP ratio by tapping relatively fast growing income in sectors like services demanded by the upper income groups, more comprehensive coverage of companies and increase in the number of filers. A conscious effort must be made to avoid tax measures which enhance the regressivity of the tax system and over burden the poor.

Chapter 26:

AGENDA OF TAX REFORMS

The previous Chapters have highlighted, first, the salient features of the tax system of Pakistan. Second, the tax gap has been quantified at close to 3 percent of the GDP in the case of FBR taxes and major Provincial taxes. Third, it has been demonstrated that the rise in the tax-to-GDP ratio from 2012-13 to 2016-17 of over 3 percent of the GDP is due almost entirely to higher statutory or effective rates of taxation.

Based on these Chapters, the agenda of tax reform is presented in this Chapter. Section 1 highlights some key parameters for reforms. Section 2 presents the objectives of the reforms. Section 3 proposes ways in which the impact of the unprecedented tax breaks in the pre-election budget for 2018-19 by the PML(N) Government can be partly ameliorated. Section 4 highlights the proposed reforms in direct taxes, followed by a listing of reforms in indirect taxes in Section 5. Finally, in Section 6 an attempt is made to quantify the potential revenue gains from the reforms.

26.1. SOME REFORM PARAMETERS

The previous Chapter has highlighted that in the case of FBR taxes there has generally been a rise in the ratio of tax revenues to the tax bases, implying higher effective tax rates. However, this has been accompanied by a fall in the ratio of the tax bases to the GDP. This raises the fundamental issue that in the process of generating higher revenues by increasing tax rates the process of growth of the economy may have been adversely affected.

Some examples can be adduced to establish this finding, as follows:

(i) The telecom sector has been subjected to heavy taxation. There is the sales tax at 17 percent. In addition, a withholding tax has been imposed on telephone bills and mobile phone cards. The rate of this tax has been enhanced to 12.5 percent. As such, the combined incidence is high at almost 32 percent. Following the higher taxation, the growth rate of the number of mobile phones has fallen to only 2 percent from over 8 percent in earlier years. Recently, the Supreme Court has given a verdict against the heavy taxation of mobile phone cards.

(ii) In an effort to bolster revenues the rates of import duty and sales tax have been raised on furnace oil, a key fuel input into generation of electricity. The import duty was enhanced from zero percent to 11 percent and the sales tax increased from the standard rate of 17 percent to 20 percent. This has implied a higher price of electricity. Very importantly, it has reduced competitiveness of Pakistani products in export markets. As such, this is one of the factors contributing to the fall of exports after 2013-14.

(iii) In 2015 there was an ill-advised move of introducing a withholding tax on cash transactions by commercial banks. This led to a sharp decline in the growth of bank deposits and a corresponding rise in the quantum of currency in circulation.

There are, no doubt, other examples in the last few years of hikes in tax rates leading to contraction of the tax bases and distortions in the economy. As such, one of the key parameters for the future reform process is that further increases in tax rates must be avoided and wherever possible an effort must be made to gradually bring them down.

Another piece of strong evidence on relatively high tax rates in Pakistan is the comparison with those in other Asian countries, shown in Table 26.1. Out of the nine countries highlighted the only country with a corporate income tax rate higher than Pakistan is India. Similarly, the sales tax rate is the highest in Pakistan, with the solitary exception of Turkey. However, the halving of the maximum personal income tax rate in the Budget of 2018-19 to 15 percent, presented initially by the PML (N) Pakistan will imply the least progressive personal income tax system.

Table 26.1: Corporate, Personal and Sales Tax Rates in selected Asian Countries, 2013-2015 – (%)

	Corporate Tax Rate	Maximum Personal Tax Rate	Standard Sales Tax Rate
Bangladesh	27.5	25	15.0
India	34.0	30	12.5
Indonesia	25.0	30	10.0
Malaysia	25.0	26	10.0
Pakistan*	**30.0**	**30**	**17.0**
Philippines	30.0	32	12.0
Sri Lanka	28.0	24	12.0
Thailand	20.0	30	7.0
Turkey	20.0	35	18.0

*In the latest budget of 2018-19, the corporate tax rate has been brought down to 29 percent, with the expectation that it will be reduced to 25 percent in five years. The maximum personal income tax rate also reduced to 15 percent.

Source: UNESCAP [2014]

Next we turn to a negative but wrong perception about the tax system. This relates to the low number of income tax return filers at 1.3 million in Pakistan. This has inevitably led to the conclusion that there is massive tax evasion in the country and only a very small proportion of households pay the income tax. However, development of the withholding tax system and deductions at source were designed primarily to check tax evasion. Consequently, the number of de-facto tax payers is substantially larger. For example, there are 151 million mobile phones in Pakistan. Ownership of these phones has permeated down to every low income levels. Consequently, a very large number of people are paying the withholding income tax on telecom services. Similarly, the number of persons with a bank deposit has exceeded 11 million. All pay a presumptive tax on their interest income, irrespective of the amount.

The conclusion is that the coverage of the income tax is much larger than is thought to be the case. In fact, the withholding tax rates are higher for non-filers. This has led to a basic lack of equity in the tax system as a non-filer is not necessarily a tax evader but may actually have an income below the exemption limit.

The implication is that an effort must be made to narrow down the withholding tax rates between filers and non-filers. The proportionate difference should not exceed, say, 20 percent. Also, the rates are recommended to be scaled down where the burden falls effectively on a large number of households.

Another important issue is the impact of fiscal incentives on the particular macro-economic variable they are expected to influence. The experience is mixed in this regard. For example, the reduction in the rate of income tax on companies, lower tax on bonus shares and on undistributed profits in the latest Budget should have led to a strong positive response by the Stock Market. Instead, it fell sharply in the first week after the announcement of the Budget for 2018-19.

Another example of lack of response to a fiscal incentive is the case of foreign direct investment. In the Budget of 2015-16, the corporate tax rate on new multinational companies was fixed at 20 percent, much below the rate for domestic companies of 30 percent. However, there has been only a marginal increase in FDI since the announcement.

Overall, the basic lesson of experience with tax reform in Pakistan and elsewhere is that the tax system should not be characterized by too high tax rates and too much variation from the standard rate. This will not only make the tax system more simple and transparent it will also ensure that while revenue growth takes place it is not achieved by negatively impacting on the tax base.

We turn now to the proposed agenda of reforms starting with a statement of the objectives of the process.

26.2. OBJECTIVES OF TAX REFORM

The objectives of the tax reforms must be to achieve the following:

- Higher revenue-yielding and more buoyant tax system
- More equitable tax burden across income groups
- More balanced sectoral tax incidence
- Promote investment, savings, exports, employment and more balance regional development
- Minimize escalation in tax rates and focus on gradual rationalization of rates with broad-basing of revenue sources
- Build in mechanisms, laws and institutional processes to check tax evasion and corruption
- Promote integration and co-operation between the Federal and the Provincial tax systems
- Lead to a simpler, transparent and more friendly tax system
- Create a more modern, autonomous and functional tax administration
- Formulate tax policy that is more evidence-based and consistent.

The next section focuses on reforms in direct taxes.

26.3. INCOME TAX

A number of reforms are required in the direct tax systems of the Federal and Provincial Governments, as follows:

26.3.1. Repairing the Damage

The latest Federal Budget of 2018-19 was presented by the PML(N) Government with an eye on the forthcoming elections. Major tax concessions have been given to individuals and companies. The biggest and most unprecedented break is in the personal income tax. The exemption limit has been trebled from Rs 400,000 per annum to Rs 1,200,000. Simultaneously, the maximum rate has been halved from 30 percent to 15 percent. This has not only greatly reduced the progressivity of the tax system but also led to a substantial revenue loss approaching Rs 90 billion, almost 6 percent of the revenues from the income tax.

The difference between the pre– and Post– Budget tax liability at different levels of pre-tax income is presented in Table 26.2. The tragedy is that the move is contrary to the basic norms of taxation. In proportionate terms the relief is higher for a tax payer with a larger income. The tax benefit for a person earning Rs 500,000 annually is only 0.4 percent of the income, whereas for an individual with an income of Rs 10,000,000 the tax saving is as much as 11.8 percent of the income.

Table 26.2: Pre– and Post– Budget Income Tax liability by Level of Income, 2018-19 – (Rs)

Taxable Income	Old	New	Tax Savings as % of Income
400,000	0%	0	0.0
500,000	2000	0	0.4
750,000	14500	0	1.9
1,400,000	79500	10000	5.0
1,500,000	92000	15000	5.1
1,800,000	137000	30000	5.9
2,500,000	259500	130000	5.2
3,000,000	359500	180000	6.0
3,500,000	472000	230000	6.9
4,000,000	597000	280,000	7.9
7,000,000	1,422,000	690000	10.5
10,000,000	2,322,000	1140000	11.8

Source: Estimated

How can the distortion be minimized? The answer lies in amending the Income Tax Ordinance of 2001 in the following ways:

(i) All perquisites to be monetized and added to the nominal income with no exceptions.

(ii) The tax deductibility provisions in Sections of the ITO for investment, provident fund payment, etc. may be withdrawn. Instead, a tax credit at the rate of 7½ percent, irrespective of the income, be instituted. This will eliminate the differential advantage to high income tax payers.

(iii) There is a final tax on various forms of capital income like dividends and interest. This should be converted into a proper advance tax.

26.3.2. Rationalizing the Withholding Tax regime

Pakistan has one of the more elaborate withholding/presumptive income tax regimes. The number of deductions have increased over time and currently there are 64 levies of this type. However, only 17 of them account for 92 percent of the revenues. These include levies on contracts, imports, salary, telecom services, other services, exports, interest income from financial assets, electricity, dividends and cash withdrawals from banks. Table 26.3 gives the structure of these deductions.

Table 26.3: Characteristics of Major Withholding Taxes – (%)

Section	Levied on	Advance/ Final	Rate* on (%)	
			Filers	Non-Filers
148	Imports	Final	6	9
149	Salaries	Advance	As per schedule	
150	Dividend Income	Final	15	20
151	Returns on NSS	Final	10	17.5
151	Return on Bank Deposits	Final	10	17.5
153	Sale of Goods	Final	1.5	1.5
153	Execution of Contracts	Final	7	12
153	Services		6-8	10-12
154	Exports	Final	1	1
231	Cash Withdrawal from Banks	Advance	0.3	0.6
231	Registration of Vehicles	Advance	As per schedule	
235	Electricity Bills	Advance	As per schedule	
236	Telephone	Advance	10-12.5	-
236	Air Ticket (Domestic)	Advance	5	-
236	Wholesalers or Dealers	Advance	0.1	0.2
236	Retailers	Advance	0.5	1.0
236	Purchase of Property	Advance	2	4

Source: FBR

Given the skewed distribution of revenues there is a case for withdrawing many of the withholding/advance taxes, especially those which impose high transaction costs. A set of criteria have been developed to determine which levies can be withdrawn. These are given in Box 26.1.

Box 26.1: Criteria for Assessing whether a particular Withholding Tax should be retained or not

Rating Criteria of Withholding Taxes

1.	Advance Tax/Presumptive Tax	If Advance Tax = 1, Presumptive = 0
2.	Types of Tax Base	If Income = 1, if sales/purchase = 0.5; If consumption expenditure = 0
3.	Scope for Forward Shifting	If Yes = 0; if No = 1
4.	Progressive / Regressive	If Progressive = 1; If Regressive = 0
5.	Same Tax Base as Provincial Governments	If Yes = 0; If No = 1
6.	Number of Withholding Agents	If Large = 0; If Small = 1
7.	Size of Revenues	If Large = 1; If Small = 0

The lowest scores are obtained by the following levies:

▪ On non-Residents	Under Section 7
▪ Sales of Agricultural items	Under Section 153
▪ Registration of Cars	Under Section 231
▪ Commissions	Under Section 233
▪ Road Transport	Under Section 234
▪ CNG stations	Under Section 234

Therefore, there is a strong case for withdrawing these withholding taxes or reducing them substantially.

Further, there is a need for bring down the rate of withholding on telecom services from 12½ percent to 5 percent and reducing the advance tax collection in the case of electricity bills from industrial consumers. As highlighted earlier, the proportionate difference in rates on filers and non-filers should not exceed 20 percent.

26.3.3. Taxation of Capital Gains

According to Section 37 of the ITO 2001, a capital gain arising from disposal of an asset by a person in a tax year will be treated as income and chargeable to tax in that year.

The capital gain is computed as the difference between the consideration received by the person on the disposal of the asset and the original cost of the asset.

There is need for the following reforms in the taxation of capital gains:

(i) The tax should be levied on real and not nominal capital gains. The ITO should use the inflation index with respect to the holding period. This index should be applied to the original cost and the difference with respect to the disposal value be taken as the capital gain.

(ii) There should be no upper limit for the holding period in terms of application of the tax on capital gains

(iii) For holding period of up to two years the tax rate should be 20 percent and thereafter, 15 percent.

(iv) The rate of advance tax on sale and purchase of shares respectively should be raised from 0.02 percent to 0.1 percent.

26.3.4. Reduction in Tax Expenditures

An exhaustive list of tax expenditures in income tax and the cost in terms of revenue foregone is given in the previous Chapter. There is a strong case for withdrawing the exemption or concession in the following cases:

(i) Tax deduction on bad loan provisioning by banks should be restricted only to SMEs, as defined by the SBP.

(ii) Business income of trusts/foundations may be subjected to a fixed tax of 5 percent.

(iii) Any donation paid to recognized institutions to be given tax credit at the fixed rate of 10 percent.

(iv) Withdrawal of 40 percent reduction of tax payable to teachers and tax rebate to other professions.

26.3.5. Filing of Returns

Under Section 114 of the ITO various types of persons are required to furnish a return of income in a tax year. In the Budget of 2018-19 a person can engage in a property transaction of Rs 4 million or more only if he is a return filer. The same condition is in the case of purchase of a car. A similar pre-condition of being a filer of return may also be imposed in the following cases:

(i) Continuation of an industrial or commercial connection of electricity where the annual bill exceeds Rs 500,000.

(ii) Continued registration of motor vehicle having capacity above 1000 cc.

(iii) Membership of any Chamber of Commerce, Trade Association or any professional body.

(iv) Membership of any club where the monthly subscription exceeds Rs 1000.

(v) Having a bank credit card.

This step will help significantly in increase the number of income tax return filers.

26.3.6. Innovative Reforms

A member of innovative reforms have been implemented in different countries in the direct tax system. Some of these reforms are identified below:

INDIA	▪ Levy of an Education Cess at 3 percent of the tax liability in all taxes. Earmarking into a Special Fund ▪ Introduction of a Securities Transaction Tax
TURKEY	▪ Gift and Inheritance Tax
INDIA	▪ Wealth Tax
BANGLADESH	▪ Excess Profits Tax if the profit exceeds 20 percent of capital and reserves. Such a tax could be made generally applicable
SRI LANKA	▪ Dividend tax at 15 percent for non-declaration of at least 60 percent of profits
OTHERS	▪ Lower rate of corporate taxation on commercial banks, subject to a minimum level of credit (SMEs, Agriculture, Exports or Backward Areas) ▪ Levy of a Withholding Tax on Credit Card Charges ▪ Tax rebates for investment in renewable energy and energy conservation ▪ Linking deductibility of financial charges to a maximum debt-equity ratio

26.3.7. Taxation of Global Income

Under Section 103: where a resident taxpayer derives foreign source income chargeable to tax under this Ordinance in respect of which the taxpayer has paid foreign income tax, the taxpayer shall be allowed a tax credit of an amount equal to the lesser of

(a) The foreign income tax paid or

(b) The Pakistani tax payable in respect of income.

There is a need to use the Avoidance of Double Taxation and Fiscal Evasion agreements to exchange information. Pakistan has this agreement with 47 countries, including countries such as the UK and UAE, where Pakistani residents have invested in a big way.

26.3.8. Transfer Pricing

The issue of transfer pricing is important as it reduces the corporate income tax base due to shifting of profits via higher prices of imports by multinational companies. Industries that are more vulnerable to this practice include automobiles, pharmaceuticals, aerated waters/beverages and chemicals.

A section on transfer pricing needs to be included in the ITO of 2001. Section 92 of the Income Tax Act 1961 of India contains one of the methods for detecting transfer pricing via computation of the ‘arms length price’. The same methodology should be adopted in Pakistan. The DG of Transfer Pricing should be supported by a legal provision in the ITO.

26.3.9. Development of Information System

PRAL was established in the 1990s with the objective of developing a database, largely electronic, to aid the assessment process. Unfortunately, this objective has not been achieved. There are at least three reasons for the failure. First, there was a need to develop a unique numbering system to identify the different transactions by a particular taxpayer. The NTN never took off as the identifier. The recent move to rely on the CNIC number is the correct decision. Second, PRAL has largely maintained an autonomous identity with respect to FBR. A day-to-day operational integration has not taken place. Third, the officials of FBR have generally not been trained in the use of IT systems. Therefore, use of an electronic database remains very limited. As mentioned earlier, this type of training must now be made a prerequisite before an officer can be given assessment functions.

A few years ago, the idea of establishing an Electronic Data Warehouse was mooted. The design of this system is to bring all external and internal information on one taxpayer (either corporate or personal) into one large portal, to facilitate the assessment process through the availability of collateral evidence.

Fortunately, in the presence of an elaborate withholding tax regime in Pakistan, the potential for obtaining diverse information on a taxpayer is enormous. This should be the first step in the development of the Data Warehouse. Box 26.2 indicates the potential information from withholding tax payments. Initially, information should be obtained in sources that are collected by a small number of withholding tax agents. This includes banks, National Savings Directorate, DISCOs in the power sector, airlines, etc. A payment equivalent to 0.1 percent of the withholding tax revenue generated on information supplied should be made by FBR to the collection agent. This will enable the agents to invest and maintain an appropriate electronic information system.

Box 26.2: Information on Individual Taxpayers from Withholding Tax Regime

Source	Information on	Number of withholding Tax Agents
Salaries	Earned Income	Large
Dividends	Unearned Income/Assets	Medium
Bank Profit on Deposits	Unearned Income/Assets	Small
NSS Profit	Unearned Income/Assets	Small
Services	Professional/Earned Income	Large
Income from Property	Unearned Income/Assets	Large
Registration of New Car	Assets	Small
Purchase of Shares	Assets	Small
Electricity Bills	Expenditure	Small
Telephone Bills	Expenditure	Large
Air Ticket Purchase	Expenditure	Small

Source: Derived

26.3.10. Audit Policy

There are serious defects in the audit system of FBR. The introduction of the Universal Self-Assessment Scheme during the Musharraf era was a very positive step. However, there was little or no audit of returns filed under this scheme. Consequently, there was no deterrence against non-compliance. Currently, about five percent of the returns are being audited.

The following proposals are made for improvement in the audit system:

(i) Within three years, increase the percentage of returns audited to 10 percent.

(ii) Develop a risk-based audit policy. The parameters should be identified on the basis of demands raised following audit of different types of taxpayers.

(iii) A new taxpayer may be exempted from audit for the first three years, in order to promote compliance. This should apply only in the case of individual taxpayers and not companies or AOPs.

The time has also come for moving to composite audit of income and sales tax returns, under the IRS.

26.4. SALES TAX

There is primarily a need to ensure that the sales tax retains the characteristics of a value added tax to the extent possible. As such, it is important that, first, the rate of input taxation be the same as the rate of output taxation. Second, that wherever refunds are due they should be paid appropriately in time. This is especially the case with zero rating of exports. Unfortunately, FBR has been very slack in the payment of refunds and there are currently outstanding claims of over Rs 200 billion. This is affecting the liquidity of exporters and thereby their competitiveness.

The major deviation in the case of rates other than the standard rate is in petroleum products. Currently, the sales tax on motor spirit is 8 percent, 13 percent on HSD oil and 20 percent on furnace oil. The IPPs using furnace oil have in some cases negative sales tax liabilities because the sales tax rate on electricity is 17 percent.

The preferred policy should be to levy the sales tax on POL products at the standard rate of 17 percent. If there is scope for additional taxation, especially in a period of falling international oil prices, then additional revenue should be mopped up through the petroleum levy. The original Budget of 2018-19 built in a provision for such a change in policy.

The earlier chapter on the Tax System has identified different schedules under which the sales tax system operates. One schedule in particular lists the consumer items which are taxed on the retail price and not on the ex-factory price. There is a strong case for expansion of this list so that the wholesale and retail trade sector is more effectively covered by the sales tax. Strong candidate items for inclusion in this list are vegetable ghee, garments, footwear and consumer durables like motor cars, TV sets, air conditioners, etc. Similarly, the sales tax on imported consumer goods should be levied on the duty-paid price with a markup of 20 percent as the domestic trade margin.

Special provisions have been built into the various schedules for Chinese companies involved in CPEC projects. As a policy, discriminatory treatment should be avoided. The same facility must be made available to Pakistani companies.

There is a need to find ways to eliminate the problem of ‘flying invoices’ whereby manufacturers are artificially able to increase the quantum of input tax invoicing. As per Section 8B (part 4) of the Sales Tax Act the Board is empowered, by notification in the Official Gazette, to prescribe any limit of input tax adjustment for any person or class of persons. Currently, the general limit imposed is 90 percent. There is a case for introducing a limit of say, 70 percent, on the extent of input tax adjustment during a particular year. However, there should be a provision for carry forward of the excess input invoicing. In addition, the existing law allows for full input tax adjustment to be made on machinery acquired without any limit to the overall extent of input tax invoicing. The value added tax is based on the use of the capital input. As such, rather than the overall capital cost being adjusted in one year an appropriate accelerated depreciation schedule may be specified for a period of three years after the acquisition of the machinery.

26.5. IMPORT DUTIES

Currently, the import tariff system of Pakistan has four slabs with rate of 3, 11, 16 and 20 percent. Simultaneously, there are a large number of SROs granting exemptions in special cases. Also, tariffs in the Free Trade Agreements are lower than the MFN tariffs. In view of the rapid increase in imports and the resulting pressure on the balance of payments, there is a need to move to somewhat higher tariff structure of 5, 15 and 25 percent as follows:

5% on machinery, raw materials and food items

15% on intermediate goods

25% on all other items

Simultaneously, the import tariff system should be made more simple and transparent by eliminating SROs to the extent possible.

There is also a growing perception that the FTA with China has largely worked to Pakistan's disadvantage. Therefore, there is a strong case for renegotiating this agreement for ensuring more quid pro quo. In 2016-17, China exported over $15 billion worth of goods and imported only $2 billion.

There is also a perception that there is significant under-invoicing of imports from China, as revealed by Table 26.4 Inclusive of cost of freight and insurance, the average extent of under-invoicing is almost 25 percent. This has rendered many Pakistani industries uncompetitive with respect to artificially cheap imports from China. Consequently, the time has come to introduce a regime of minimum import prices on major goods imported from China.

Table 26.4: Difference in the Value of Exports by China to Pakistan and the Value of Imports of Pakistan from China, 2013 to 2016

	Exports (f.o.b) of China to Pakistan	Imports (c.i.f) of Pakistan from China	Extent of Under-invoicing* (%)
2013	11020	9588	13.0
2014	13245	11019	16.8
2015	16442	13680	16.8
2016	17233	15383	10.7

*percentage difference between imports and exports

Source: UNCOMTRADE

26.6. EXCISE DUTIES

Expansion of Tax Base of Excise Duty on Goods

There is a case for levy of excise duty, in addition to the GST, on the following:

(i) Industries that confer negative externalities and damage the environment. Excise duty can be used as a means of restricting the damage inflicted by such activities. There is already municipal legislation on dangerous and offensive production processes. These industries should be targeted for expansion of the tax base of excise duties. The rate may be set at non-invoiceable 10 to 15 percent. The proposed list of industries to be taxed under this criterion is given in Box 26.3.

(ii) Goods that are in the nature of luxury items or consumption may also be brought into the excise duty net. In the particular case of electrical goods, such as air conditioners and deep freezers, this step will also help in restraining demand for electricity, which is in short supply. The list of goods in this category is also given in Box 26.3. The tax rate may be set at non-invoiceable 8 to 12 percent.

Box 26.3: Expansion of the Tax Base for Excise Duties on Dangerous and Offensive Production Activities

Manufacture of:				
Soap	Brick Kilns	Leather Goods	Caustic soda, acid	Paints
Naphtha	Turpentine	Spirits	Wine	Metal products
Environmental				
Wood and Furniture				
Luxury Goods [*Both on Imports and Domestic Production*]				
Electrical Goods – Air Conditioners, Deep Freezers (A*lso for conservation*)	Ceramic Sanitary Ware and Tiles		Foam and Foam Products	Glass and Glassware

26.7. PROVINCIAL TAXES

The sales tax on services has been developed rapidly by the Provincial Governments, especially of Sindh and Punjab. It now generates revenues equal to 0.7 percent of GDP. However, its counterpart in India, the Union Service Tax, yields 1.5 percent of India's GDP, even though its standard rate is lower at 12.5 percent, compared to 13 percent to 16 percent in Pakistan.

There is a case for broadening the tax base by bringing more services into the tax net. Chapter 98 of the Harmonized Code contains a very detailed list of services at the eight digit level. Following an Establishment Census by PBS, promising services in terms of revenue yield can be identified from this Census.

A major area for taxation is the import of services. The method of taxation could be based on the 'reverse charge' principle, whereby the responsibility for paying the tax rests with the domestic importer. This principle has been applied successfully in India and Philippines.

Turning to other provincial taxes, there is need to focus on the development of sub-national direct taxes. These are the urban immoveable property tax and the agricultural income tax. The former has suffered because of very outdated assessed rental values. The system could be simplified by taking the rent to be, say, 8 percent of the capital values assessed for neighborhoods in different cities by FBR. These are of more recent origin than the DC values.

The agricultural income tax has languished because of lack of focus on its development and collection. It is important that it be linked to actual income. This is essential if over-declaration of agricultural income by Federal income tax payers is to be avoided.

26.8. POTENTIAL REVENUE GAINS

Implementation of the above agenda of reforms over a three-year period has the potential of contributing significantly to national tax revenues. Table 26.5 shows that the potential revenue is Rs 845 billion, equivalent to 2.4 percent of the GDP. 57 percent could be generated from direct taxes, thereby making the national tax system more equitable.

There is need for implementing the above reforms on a top priority basis. This will reduce the distortionary effects of taxes, broad-base the tax system and make it more progressive, while yielding substantial additional revenues.

Table 26.5: Potential Increase in Tax Revenues by Implementation of Reforms*

(Rs in Billion)

1. FEDERAL	715
INCOME TAX	425
• Change in Tax Treatment of Perquisites	35
• Taxation of Foreign Income	100
• Withdrawal of Tax Expenditures	50
• Taxation of Capital Gains	50
• Compulsory Filing of Returns	60
• Introduction of a Tax on the Capital Value of Assets	60
• Other Reforms	70
SALES TAX	115
• Imposition of Limit to Tax Invoicing	60
• Taxation of Consumer Goods on Retail Price	40
• Other Reforms	15
CUSTOMS DUTY/EXCISE DUTY	175
• Higher Import Tariffs and rationalization of SROs	85
• Excise Duty on harmful Industries	25
• Excise Duty on electricity-intensive and luxury goods	20
2. PROVINCIAL	130
• Sales Tax on Services	70
• Agricultural Income Tax	35
• Urban Immoveable Property Tax	25
TOTAL	845
% of GDP	2.4

*with tax base of 2017-18
Source: Estimated

SECTION 9

PUBLIC FINANCES

Chapter 27:

TREND IN PUBLIC FINANCES

Public finances relate to financial transactions by Government entities, especially the Federal and the Provincial Governments of Pakistan. Operations in the public finance domain reflect the fiscal policy of different levels of Government.

The chapter has a number of sections. Section 1 describes the budgeting system in Pakistan. Section 2 highlights the trends in public finances since 2007-08. Section 3 focuses on Federal finances and Section 4 on Provincial Finances. The different types of deficit are identified in Section 5 while Section 6 describes the various sources available for financing the consolidated budget deficit of the Federal and Provincial Governments combined. Section 6 focuses on the outlook for public finances. This involves an appraisal of the first Federal Budget 2018-19 presented by the new PTI Government. Finally, Section 7 describes the new emphasis on primary deficit versus overall budget deficit reduction.

27.1. THE BUDGETING SYSTEM

The principal features of the budgeting system are presented in Figure 27.1. As is the case with any set of accounts, there are two sides of the Federal Budget, namely, revenues and expenditure. These are described below:

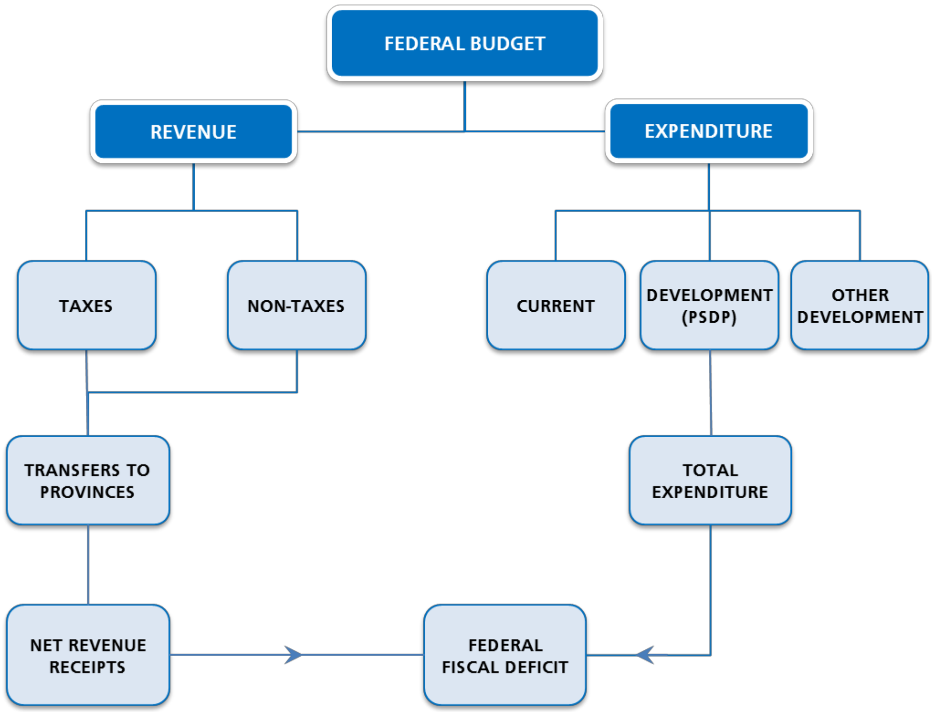
Revenues: Federal revenues consist of tax revenues and non-tax revenues. The former consist of tax revenues collected by the FBR and other taxes like the petroleum levy. Non-tax revenues include dividends from public state enterprises, profits of the SBP, royalty from oil and gas and income from services provided.

The gross revenue receipts are reduced by the transfer of revenues to the Provincial Governments as mandated by the NFC and the Constitution of Pakistan. The net revenue receipts represent the resources available with the Federal Government to meet its expenditure obligations.

Expenditure: There are two types of expenditure, current and development. The former includes major heads of expenditure like debt servicing, defence, other services, grants and subsidies, salaries and pensions. Development expenditure includes the outlays on the

Federal Public Sector Development Program (PSDP) and on other development expenditure, especially the Benazir Income Support Program (BISP).

Figure 27.1: The Budgeting System



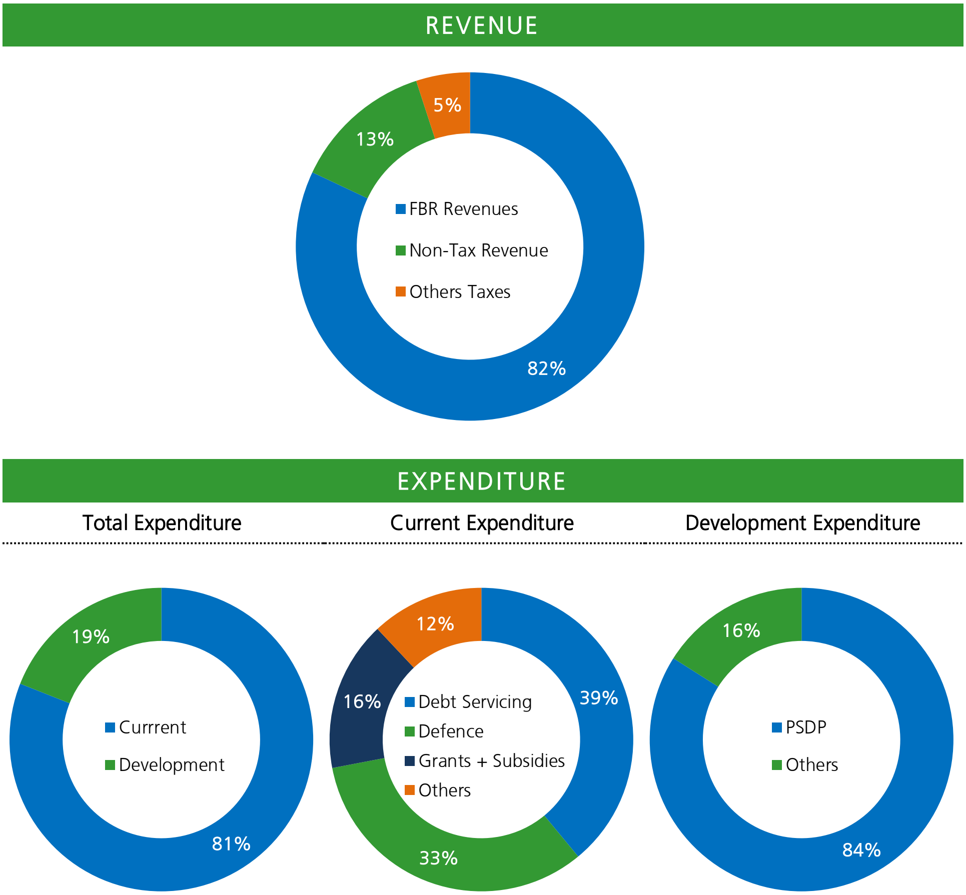
Source: Budget in Brief, MOF

The difference between net revenue receipts and total expenditure is the fiscal deficit of the Federal Government. The Provincial Governments have access to the Federal transfers and their own tax and non-tax revenues. They generate a cash surplus or deficit depending on whether their revenues exceed or are less than their total expenditure, both current and development. The consolidated budget deficit is the sum of the Federal deficit and the combined Provincial cash surplus/deficit.

27.2. OVERALL TRENDS IN PUBLIC FINANCES

Figure 27.2 presents the share of key components in Federal revenues and expenditure, as of 2017-18. FBR revenues constitute the pre-dominant source, with a share of 82 percent. Next in importance are non-tax revenues with a contribution of 13 percent. The remainder, 5 percent, is by other taxes.

Figure 27.2: Share of Different Types of Revenue and Expenditure in the Budget of Federal Government – 2017-18



Source: MOF, Fiscal Operations

The bulk, 81 percent, of Federal expenditure is of a current nature. Development expenditure had a share of 19 percent in total expenditure in 2017-18. Within current expenditure, the three major components are debt servicing, defense and grants/subsidies, with shares of 39 percent, 33 percent and 16 percent respectively. The dominant share of 84 percent of development expenditure is on the PSDP.

The major public finance magnitudes, combined for the Federal and Provincial Governments are presented in Table 27.1, as percentage of the GDP. Tax revenues remained low at close to 10 percent of the GDP from 2007-08 to 2013-14. As described in Chapter 26, these revenues have shown buoyancy in recent years. By 2017-18, the tax-to-GDP ratio has risen significantly to 13 percent.

Table 27.1: Overall Trends in Public Finances, 2007-08 to 2017-18 – (% of GDP)							
	Tax Revenue	Non-Tax Revenue	Total Revenue	Current Expenditure	Development Expenditure	Total Expenditure	Budget Deficit
2007-08	10.0	4.3	14.3	15.5*	4.0	19.5	-5.2
2008-09	9.2	4.9	14.1	15.6	3.5	19.3	-5.2
2009-10	10.0	4.1	14.2	16.3	4.5	20.8	-6.6
2010-11	9.4	3.1	12.5	16.1	3.0	19.1	-6.6
2011-12	9.9	2.5	12.4	15.1	4.0	19.1	-6.7
2012-13	9.6	3.4	13.0	16.0	3.4*	19.4	-6.4
2013-14	10.1	4.2	14.3	15.8	4.9	20.7	-6.4
2014-15	11.0	3.3	14.4	16.2	3.5	19.7	-5.3
2015-16	12.4	2.6	15.0	15.9	3.7	19.6	-4.6
2016-17	12.5	3.0	15.5	16.3	5.0	21.3	-5.8
2017-18	13.0	2.2	15.2	17.0	4.7	21.8	-6.6

*excluding one-off expenditures on retirement of circular debt, etc.
Source: MOF, Fiscal Operations

Non-tax revenues have been subject to fluctuations depending on the presence of one-time receipts like large grants, proceeds from privatization, etc. A major source of financing was the reimbursement by the USA from the Coalition Support Fund (CSF) for operations by Pakistan in the war against terror. The flow of funds from this source has diminished greatly since 2015-16. Overall, total revenues have shown a steadily rising trend from 13 percent of the GDP in 2012-13 to 15.2 percent of the GDP by 2017-18, primarily on the back of rising tax-to-GDP Ratio.

The trend in current expenditure is upwards, rising by over 2.5 percent of the GDP by 2017-18. Development expenditure has also demonstrated a variable trend. In particular, during the tenure of the IMF Program from 2013-14 to 2015-16 it came down from almost 5 percent of the GDP to 3.7 percent of the GDP. It has since risen once again to 4.7 percent of the GDP in 2017-18.

Total expenditure has remained in the range of 19 percent to 22 percent of the GDP during the ten-year period. The peak of 21.8 percent of the GDP was observed 2009-10 and in 2017-18.

The consolidated budget deficit has also shown significant variation. It was at its lowest in 2015-16 at 4.6 percent of the GDP. This was the third and final year of the Fund program and there appeared to be a significant degree of fiscal stabilization. However, the deficit jumped up significantly in 2016-17 to 5.8 percent of the GDP and then to 6.6 percent of the GDP in 2017-18, indicating that the success achieved was largely temporary.

Table 27.2 presents the trend in major components of current expenditure of the Federal Provincial Governments respectively. Debt servicing has shown no visible upward trend as percent of the GDP. This is reassuring since the public debt to GDP has risen during this period. Clearly, interest rates have a shown a downward trend in recent years with the fall in the rate of inflation.

Table 27.2: Trend in Components of Current Expenditure, 2007-08 to 2017-18 – (% of GDP)

	Federal				Provincial	Total
	Debt Servicing	Defence Service*	Other	Total		
2007-08	4.7	2.7	4.0	11.4	4.1	15.5
2008-09	4.9	2.5	4.0	11.4	4.2	15.6
2009-10	4.3	2.6	5.1	12.0	4.3	16.3
2010-11	3.9	2.5	5.2	11.6	4.5	16.1
2011-12	4.3	2.5	3.6	10.4	4.7	15.1
2012-13	4.3	2.4	4.5	11.2	4.8	16.0
2013-14	4.5	2.5	4.1	11.1	4.7	15.8
2014-15	4.7	2.5	3.9	11.1	5.1	16.2
2015-16	4.3	2.6	3.7	10.6	5.3	15.9
2016-17	4.2	2.8	3.9	10.9	5.4	16.3
2017-18	4.4	3.0	3.6	11.0	6.0	17.0

*including military pensions

Source: MOF, Fiscal Operations.

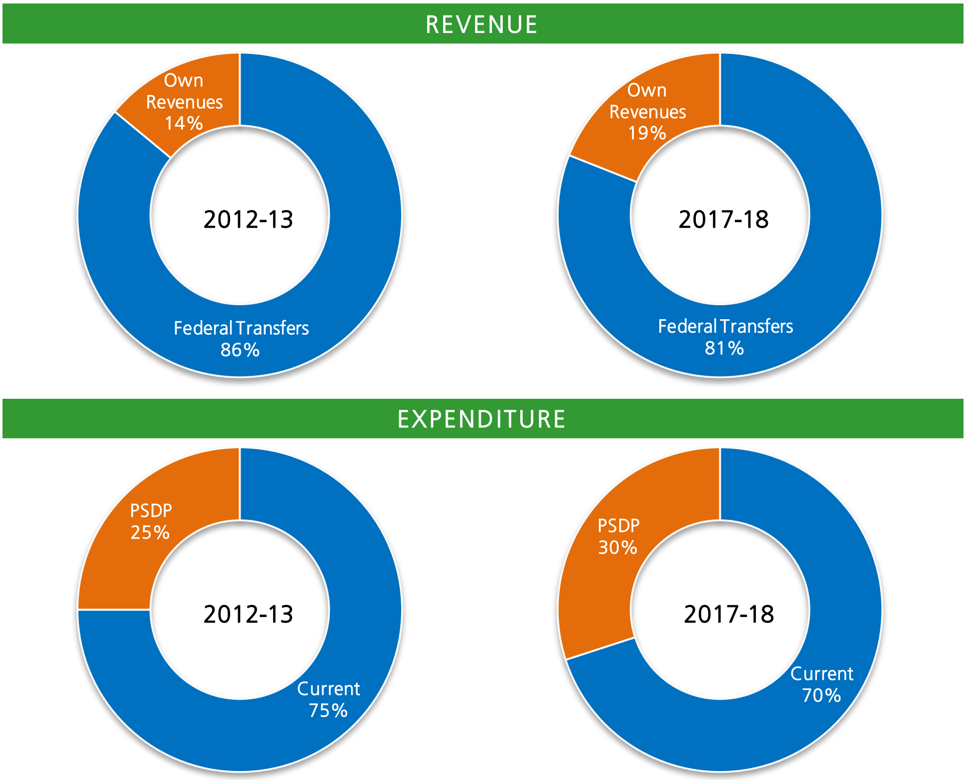
Defence expenditure, excluding military pensions, has increased gradually to 3 percent of the GDP. The big variation is in other expenditure at the Federal level. The positive development is that is has shown a declining trend as a percentage of the GDP. This is attributable to a major cutback is subsidies and grants and in expenditure on services provided in Federally Administered territories. The consequence is that total federal current expenditure as percentage of the GDP has also shown a somewhat flat trend.

Provincial expenditure has been rising steadily since 2007-08. This has been facilitated by the generous NFC Award in 2009-10. The Provinces are primarily responsible for the delivery of basic social services. This implies that public expenditure on education and health has been increasing since 2007-08.

A description of the salient features of Provincial finances is given in Figure 27.3, as of 2012-13 and 2017-18. The Provincial Governments rely heavily on federal transfers to finance their operations. The share of these transfers in Provincial revenues was as high as 86 percent in 2012-13. It has since fallen somewhat to 81 percent.

Within total expenditure, the share of development spending from the Provincial PSDPs has increased from 25 percent in 2012-13 to 35 percent in 2017-18. This share is significantly higher than that devoted to development spending by the Federal Government. Since the 7th NFC Award, total PSDP expenditure by the four Provincial Governments has been larger in absolute terms than at the Federal level. This is an indicator of the process of fiscal decentralization that has taken place in Pakistan.

Figure 27.3: Share of Different Types of Revenue and Expenditure in the Budget of Provincial Governments, 2012-13 and 2017-18



Source: MOF, Fiscal Operations

Table 27.3 highlights the absolute contribution of the Federal and Provincial Governments to the overall consolidated budget deficit. Under the Constitutional provisions, borrowing by the latter Governments has been substantially restricted. Permission for any borrowing has to be sought from the National Economic Council (NEC), chaired by the Prime Minister.

Consequently, Provincial Governments in Pakistan generally follow a policy of balanced budgets, unlike the practice among the States of India which incur large deficit. Consequently, the cash surplus or deficit is small. The consolidated deficit is virtually incurred in its entirety at the Federal level.

Table 27.3: Federal and Provincial Shares in the Consolidated Deficit, 2007-08 to 2017-18 – (Rs in Billion)

	Federal Deficit*	Provincial Cash Surplus/Deficit	Consolidated Budget Deficit	Deficit as % of GDP
2007-08	-554	8	-546	-5.2
2008-09	-680	-36	-644	-5.2
2009-10	-941	12	-929	-6.6
2010-11	-1328	134	-1194	-6.6
2011-12	-1331	-39	-1370	-6.7
2012-13	-1520	53	-1467	-6.4
2013-14	-1586	197	-1389	-6.4
2014-15	-1544	87	-1457	-5.3
2015-16	-1557	208	-1349	-4.6
2016-17	-1847	-16	-1863	-5.8
2017-18	-2242	-18	-2260	-6.6

*excluding one-off expenditures
Source: MOF, Fiscal Operations

Table 27.3 does highlight that the four Provinces combined generated a significant cash surplus from 2013-14 to 2015-16 of Rs 492 billion. These were the years when the IMF Program was operative. There is need to appreciate the efforts by these Governments towards restricting the overall deficit and in helping the Federal Government in coming close to the deficit target agreed with the Fund as one of the performance criteria.

27.3. THE DIFFERENT DEFICITS

There are different deficits in public finances, each with its own significance as described below:

Revenue Surplus / Deficit: This is a measure of the level of public saving or dissaving. It measures the difference between total revenues and current expenditure as percentage of the GDP.

Primary Surplus / Deficit: This is the difference between total revenues and total expenditure, excluding debt servicing. If positive then the prospect is that the total public debt as percentage of GDP could fall. If negative, there is the risk that the public debt ratio to GDP will rise. This is an indicator that the economy is falling into the 'debt trap'.

Budget Deficit: The larger the budget deficit as a percentage of the GDP the more expansionary is the nature of fiscal policy.

The trend in the magnitude of different deficits is given in Table 27.4. Unfortunately, public savings have been negative throughout the ten years, implying dissaving. The extent of dissaving visibly declined in the two years, 2015-16 and 2016-17 but has increased in 2017-18.

The primary deficit is also negative throughout the period under consideration. Other things being equal, this would tend to indicate that there has been pressure on the public debt to rise as a percentage of the GDP. It did increase from 58.9 percent in 2008-09 to 72.5 percent by 2017-18. The latest magnitude violates in a big way the limit of 60 percent of the GDP set by the Fiscal Responsibility and Debt Limitation Act of 2005. The first violation occurred in 2009-10. The rate of increase in the public debt to GDP ratio has been more rapid in recent years. The year, 2017-18, saw a big increase of 5.5 percentage points, partly due to the rise in the rupee value of external debt following the devaluation of the rupee.

The overall budget deficit was relatively high in the five years of the PPP Government from 2008-09 to 2012-13. It reached a peak of 8 percent of the GDP in 2012-13 when a once-and-for-all retirement of circular debt of the power sector of almost 1.6 percent of the GDP took place. As highlighted earlier, it was successfully contained during the tenure of the IMF program. However, it approached 6 percent of the GDP in 2016-17 and reached 6.6 percent of the GDP in 2017-18. Effectively, expansionary policies have been followed by Governments in Pakistan, following the end of the IMF Program in September 2016.

Table 27.4: Trend in the Different Deficits, 2007-08 to 2017-18 – (% of GDP)

	Revenue Surplus (+)/ Deficit (-)	Primary Surplus (+)/ Deficit (-)	Budget Deficit (-)
2007-08	-1.2	-0.5	-5.2
2008-09	-1.5	-0.3	-5.2
2009-10	-2.1	-2.3	-6.6
2010-11	-3.6	-2.7	-6.6
2011-12	-2.7	-2.4	-6.7
2012-13	-3.0	-2.1	-6.4
2013-14	-1.5	-1.9	-6.4
2014-15	-1.8	-0.6	-5.3
2015-16	-0.9	-0.3	-4.6
2016-17	-0.8	-1.6	-5.8
2017-18	-1.8	-2.2	-6.6

Source: MOF, Fiscal Operations

27.4. FINANCING OF BUDGET DEFICIT

There are four ways of borrowing to finance the consolidated budget deficit, as follows:

External borrowing: Government can get financial assistance from multilateral institutions like the ADB, IBRD, IDA, etc. The financing is net of debt repayment. Historically, external financing has been relatively low cost, with long grace periods and low interest rates. However, Pakistan has been forced more recently to also seek high cost loans from international commercial banks and float Sukuk/Eurobonds. However, this has been motivated more by the need to protect the external balance of payments of Pakistan rather than for financing the budget deficit.

Domestic Bank borrowing from the SBP: This essentially represents the printing of money by the issuance of treasury bills by the Government against cash advances by the Central Bank. Governments frequently prefer this kind of borrowing because the interest cost reverts back in the form of SBP profits. However, this mechanism of financing is highly inflationary in character.

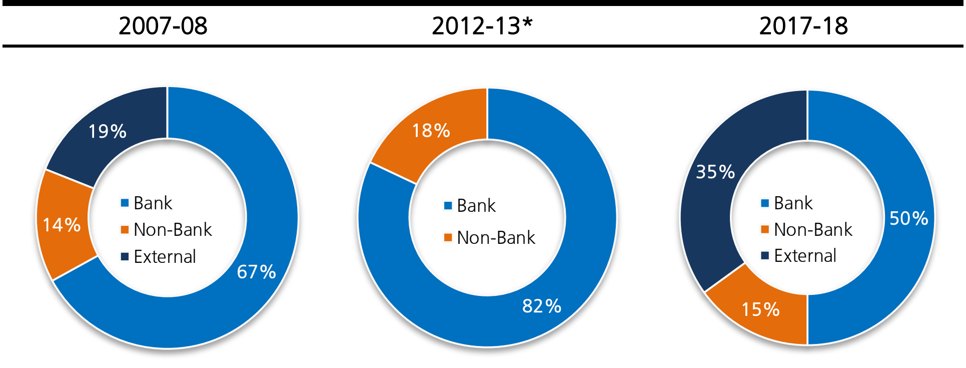
Domestic Bank borrowing from Commercial Banks: In the presence especially of high interest rates, commercial banks may be motivated to buy Government bonds and treasury bills, especially since there is zero risk, unlike in advances to borrowers. However, large borrowing by the Government from commercial banks leads to a 'crowding out' of the private sector from credit. This can adversely impact on overall investment and growth.

Non-Bank Borrowing: This is the flotation of savings schemes like regular income certificates, defense savings certificates, behbood certificates, etc., by the National Savings Directorate of the GOP. These are accessible to individuals and thereby to the household sector of the national economy. Therefore, these savings instruments can help to raise domestic savings while providing funds to the Government. In addition, non-banking institutions, like insurance companies, have a portfolio of Government bonds.

A profile of the borrowing by the Federal Government is given for different years in figure 27.4. Domestic bank borrowing has traditionally constituted the main source of financing. It reached a peak with a contribution of 82 percent to meeting the deficit in 2012-13.

The resort to net external borrowing has increased in recent years. The share of this source increased from being virtually negligible in 2012-13 to 29 percent in 2016-17. Non-Bank borrowing contributes less than 20 percent to the budget deficit financing. There is definitely a need for developing more this source also as a way to stimulate savings in the country.

Figure 27.4: Distribution of Borrowing from Different Sources, 2007-08 to 2017-18 – (%)



Source: MOF, Fiscal Operations

27.5. REDUCING THE PRIMARY DEFICIT

Negotiations between the Ministry of Finance (MOF) in late 2018 and the IMF reveal that among the many steps and reforms being discussed a heavy emphasis is being placed by the IMF on improvement in the state of public finances of the country. Consequently, reduction in the size of the fiscal deficit has emerged as one of the primary goals of the reform agenda. The motivation is clearly to enable containment of the level of aggregate demand in the economy so as to depress the level of imports and thereby bring down the current account deficit in the balance of payments.

However, the approach being adopted is somewhat different this time. Apparently, the Fund is focusing more in the negotiations on elimination of the primary deficit rather than reduction in the size of the overall fiscal deficit. The primary emphasis is clearly the take Pakistan out of the 'debt trap', as highlighted earlier.

The revenue side of the primary deficit consists of tax and non-tax revenues of the Federal and Provincial Governments combined. Tax revenues are the dominant source with a share of 86 percent in total revenues. On the expenditure side, the major components are, first, the expenditure excluding debt servicing of the Federal Government and total combined current and development expenditure of the four Provincial Governments.

The relative importance of the different components can be determined from the latest data on Fiscal Operations for 2017-18. The largest component is the current expenditure on administration and on economic and social services by the Federal and Provincial Governments. The share of this component was 34 percent in 2017-18 in total public expenditure excluding interest payments. The second largest component is security related spending. It had a share of 29 percent and consists of the expenditure on defense services (including military pensions) and on public order and safety at the Federal level plus the outlay on maintenance of law and order by the Provincial Governments.

The third major component is development spending, including the capital expenditure on projects, in the Federal and Provincial PSDPs. The Share of this component was 27 percent in 2017-18. Therefore, the three major components collectively have a share of 90 percent in total non-interest expenditure. The remainder, 10 percent, is mostly accounted for by Federal grants and subsidies.

As shown in Table 27.4, in 2015-16, the third and last year of the previous IMF program the primary deficit was near zero and total revenues virtually matched the public expenditure, excluding interest payments. It has grown rapidly in the last two years to 1.6 percent of the GDP in 2016-17 and to 2.2 percent of the GDP in 2017-18. Combined with debt servicing outlay of 4.4 percent of the GDP the overall budget deficit reached a peak level of 6.6 percent of the GDP last year.

Clearly, the primary deficit has to be contained otherwise not only will the fiscal deficit be large but the public debt to GDP ratio will also rise rapidly, well beyond the limit specified by the Fiscal Responsibility and Limitation Act of 2005. As part of the adjustment program, with or without the IMF, the primary deficit needs to be eliminated within a maximum of three years and ideally in two years.

Before the strategy for primary deficit elimination is developed, there is need to identify the reasons for the big jump in the deficit from 2015-16 to 2017-18. Revenues performed relatively well with an increase of 0.2 percent of the GDP. The tax to GDP ratio has risen to 13 percent. The problem is one the expenditure side. The biggest increase of over 1.1 percent of the GDP has been in Federal (excluding interest payments) and Provincial current expenditure on civil administration and services. The next big increase of 0.6 percent of the GDP is in total security spending, followed by an additional almost 0.5 percent of the GDP in development spending by the Provincial Government. An additional cost of 0.2 percent of the GDP was observed in other expenditures.

The Federal and Provincial Budgets for 2018-19 envisage a reduction in the overall budget deficit from 6.6 percent of the GDP in 2017-18 to 5.1 percent of the GDP. This is based on a big decline in the primary deficit to only 0.3 percent of the GDP as interest payments will go up in the presence of substantially higher interest rates.

Unfortunately, these projections are based on very optimistic assumptions. The performance in the first quarter of 2018-19 reveals that revenues are not showing the expected buoyancy and both non-interest current expenditure on services and defence expenditure have shown rapid growth of 21 percent and 23 percent respectively. The only area where there will be a big cut is on development spending of almost 0.8 percent of the GDP in 2018-19.

Therefore, on current trends, the primary deficit in 2018-19 is unlikely to change significantly from the level of 2.2 percent of the GDP observed in 2017-18. The saving in development spending is likely to be neutralized by the fall in the overall revenues-to-GDP ratio, especially due to slow growth in FBR revenues.

There is need to develop a strategy for halving the primary deficit this year to 1.1 percent of the GDP by various measures, including probably a mini-budget early in 2019 with a number of taxation proposals. This should include measures for raising the tax-to-GDP ratio by 0.36 percent of the GDP and to implement measures for achieving containment in current expenditure of 0.74 percent of the GDP. This means that one third of the adjustment will be on the revenue side and two thirds in expenditure. The downward adjustment in development spending has already been made. Therefore, the revenue target for FBR has to be raised from Rs 4398 billion to Rs 4523 billion by implementing taxation proposals yielding Rs 125 billion in approximately six months.

The required cutback in current expenditure is Rs 250 billion. This needs to be distributed proportionately between the Federal and Provincial Governments, more or less, equally. For example, this implies a cut of 6 percent in each component of expenditure. Surely, this is attainable given the strong commitment to economy in expenditure of the PTI Government. The defence establishment also could voluntarily make the cut of 6 percent.

Overall, elimination of the primary deficit in two years appears to be a feasible goal. The IMF must be made to realize that an even faster rate of adjustment will unleash severe 'stagflation' in Pakistan and could lead to public disorder as has happened recently in Argentina and earlier in Greece and Tunisia in the process of implementing their respective Fund programs. Not only will there be more unemployment but the number of poor will rise sharply. Fortunately, the Fund has already expressed the need for more social protection coverage of the poor.

27.6. MEDIUM-TERM BUDGETARY FRAMEWORK

The presentation of the Federal Budget for any particular year always contains a final chapter in the *Budget in Brief* document on the Medium-term Budgetary Framework (MTBF). This indicates the strategy of the Government in terms of ensuring sustainability of the public finances of the country by setting targets usually over the next three years in the change in the level of the revenue and expenditure of the Federal and Provincial Governments combined. This yields the target fiscal deficit and the implied Public Debt to GDP Ratio. However, the new Government failed to present its MTBF along with of the Revised Budget for 2018-19.

The budgetary framework on the revenue front usually gives the break up into FBR revenues, other tax revenues and non-tax revenues. The expenditure is shown separately for current expenditure and development expenditure. The former is disaggregated into interest payments and other expenditure in order to enable the derivation of the 'primary deficit'.

A major exercise of developing the MTBF for the three-year tenure of the last IMF Program was undertaken in the second half of 2013 and the resulting framework was presented in the Budget in Brief of 2013-14. The medium term was defined as extending from 2013-14 to 2015-16, with 2012-13 as the base year.

The framework was ambitious in line with the Fund's expectations. The fiscal deficit in the base year, 2012-13, was 6.4 percent of the GDP, excluding the retirement of circular debt in the power sector of 1.6 percent of the GDP. The target set was to bring down the budget deficit to 4 percent of the GDP by 2015-16. Clearly, this represented a major process of adjustment with on average an annual rate of reduction in the deficit of 0.8 percent of the GDP.

The strategy to achieve the deficit reduction of 2.4 percent of the GDP was based on half the adjustment by raising the total revenues to GDP from 13 percent to 14.2 percent of the GDP. The other half was proposed on the expenditure side involving a reduction in total expenditure as a percentage of the GDP from 19.4 to 18.2 percent. In this sense the strategy was balanced involving equal effort both on the revenue and expenditure sides of the budget.

Within revenues, the entire focus was on raising tax revenues. There was the prospect that non-tax revenues were likely to fall as the process of privatization was completed and the inflow of funds from the Coalition Support Fund was likely to decline sharply. Consequently, non-tax revenues were projected to fall sharply from 3.4 percent to 2.2 percent of the GDP by 2015-16. Consequently, the required increase in the tax to GDP ratio was large at 2.4 percent of the GDP. On average, the fiscal effort involved an increase annually in the tax to GDP ratio of 0.8 percent.

The targets on the expenditure front involved substantial cuts on the current expenditure side and big jump in development expenditure, so as to sustain the growth process in the economy. Current expenditure was to be reduced from 16.0 to 12.9 percent of the GDP. Development expenditure was to be raised from 3.4 to 5.3 percent of the GDP. Consequently, the target of the level of total expenditure was 18.2 percent of the GDP. This implied that the fall was 1.2 percent of the GDP, equal to half the required adjustment.

What have been the results of implementation of the budgetary framework from 2013-14 to 2015-16? The performance on the revenue front was truly extraordinary. The tax to GDP ratio increased more than targeted by 2.8 percent of the GDP. Further, there was also some success in exceeding the non-tax revenue target by 0.5 percent of the GDP. Overall, the performance on the revenue front was unprecedented with a rise of 2.1 percent of the GDP. In particular, the much maligned FBR must be recognized positively for a very successful mobilization of tax revenues.

As opposed to success on the revenue front, there was a big failure in containing current expenditure which exceeded the target level in the terminal year of the framework by as much as 3 percent of the GDP. Inevitably, development spending had to be substantially cut in relation to the target for 2015-16 by 1.6 percent of the GDP. Overall, there was failure in reducing total public expenditure and it increased by 0.2 percent of the GDP by 2015-16.

The end result was nevertheless a big reduction in the fiscal deficit from 6.4 percent off the GDP in 2012-13 to 4.6 percent of the GDP by 2015-16. Overall, the medium-term framework prepared under the aegis of the IMF Program can be considered as having been successfully implemented. The fiscal deficit in 2015-16 was the lowest in ten years.

The performance criteria in the IMF program ensured a degree of fiscal discipline and a commitment to adhere to the budgetary framework to the extent possible.

Following the end of the Fund program, another MTBF was prepared with 2015-16 as the base year up to 2018-19 and presented in the Budget in Brief of 2016-17. Unfortunately, this framework was very badly implemented and the fiscal deficit in 2017-18 was as much as 3.1 percent of the GDP above the target of 3.5 percent of the GDP. The failure again was most pronounced in the containment of expenditure.

The absence of a MTBF in the presentation of the Revised Budget for 2018-19 by the new PTI Government is a big gap and needs to be filled on a top priority basis. This will be necessary if anew IMF program is to be negotiated.it will also reduce uncertainty by highlighting the fiscal policy in the mid-term, say up to 2021-22, with 2017-18 as the base year. The IMF program, if it is successfully negotiated, will be operative from 2019-20 to 2021-22.

What should be the contours of the new MTBF? The process of adjustment will have to be exceptionally large given the peak deficit of 6.6 percent of the GDP in 2017-18. The recommended deficit target for 2021-22 is 4.5 percent of the GDP. The reduction of 2.1 percent of the GDP is considered tough but feasible. This will imply on average annual reduction in deficit by 0.7 percent of the GDP, with some front loading of the decrease.

A set of targets has been developed for incorporation into the new framework. Enough fiscal effort should be made to raise the tax to GDP ratio from 13 percent to 14.5 percent. Non-tax revenues are unlikely to show significant buoyancy and rise only marginally to 2.5 percent of the GDP. Overall, the budgetary framework should envisage the overall increase in revenues from 15.2 percent to 17 percent of the GDP. Three fourths of the increase, that is, 1.4 percent of the GDP, will be from Federal revenue sources and one fourth or 0.4 percent of the GDP from Provincial taxes.

The level of total public expenditure will be equivalent to the target revenues plus the fiscal deficit, that is 21.5 percent of the GDP in 2021-22. The level of development spending will need to be raised to provide ‘fiscal space’ for key CPEC, water and power projects, including especially the Diamer-Basha and Mohmand dams. This is essential to ward off the prospect of severe water shortage by 2025. As such, it will have to be pitched at least at 5 percent of the GDP.

Consequently, the overall level of current expenditure will have to be brought down from 17 percent to 16.5 percent of the GDP. Interest payments are expected to rise from 4.4 percent to 5 percent of the GDP by 2021-22. As such, other current expenditure will have to be brought down from 12.6 percent to 11.5 percent of the GDP. This expenditure is on defense, other current expenditure of the Federal Government and current expenditure of Provincial Governments. Reducing non-interest current expenditure will perhaps be the biggest challenge.

Overall the proposed MTBF, shown in the Table 27.5, can achieve the following. First, it will represent a vigorous resource mobilization effort. Second, it enforces fiscal discipline leading thereby to significant containment of current expenditure. Third, it creates enough space for expansion in development spending, especially on large dams. Fourth, it leads to generation of a primary surplus of 0.5 percent of the GDP from a primary deficit of 2.2 percent of the GDP in 2017-18. All this will enable a sizeable adjustment in public finances. The overall fiscal deficit will come down by over 2 percent of the GDP to 4.5 percent of the GDP by 2021-2022.

Table 27.5: A Suggested Medium-Term Budgetary Framework, 2017-18 to 2021-22 – (% of GDP)

	2017-18 (Actual)	2021-22 (Target)
Total Revenues	**15.2**	**17.0**
Tax Revenues	13.0	14.5
Non-Tax Revenues	2.2	2.5
Total Expenditure	**21.8**	**21.5**
Current	17.0	16.5
(interest payments	(4.4)	(5.0)
Development	4.7	5.0
Deficit		
Primary	-2.2	0.5
Overall	-6.6	-4.5

Source: Estimated

Chapter 28:

EVOLUTION OF PUBLIC DEBT

The National Assembly of Pakistan passed an important piece of legislation in 2005 called the Fiscal Responsibility and Debt Limitation (FRDL) Act. The objective was to ensure effective management of the public debt. A ceiling was placed on the size of the public debt at 60 percent of the GDP and in order to ensure this the budget deficit was expected annually to be contained to below 4 percent of the GDP. Therefore, the Parliament effectively acquired the role of monitoring the evolution of public debt in the country. This has placed the public debt to GDP ratio as one of the key indicators of the economic performance of a Government.

The objective of this Chapter is to quantify the trend in the level of public debt and to identify the main issues associated with the evolution of this debt. Section 1 presents estimates of the level of public debt, as defined in the FRDL. In addition, other estimates of public debt are also presented. Section 2 gives the composition of public debt. Section 3 highlights the changing profile of external public debt and the changes that are taking place in the inflow of foreign assistance.

28.1. EVOLUTION OF PUBLIC DEBT

The size of public debt is presented in Table 28.1. Between 1990-91 and 1999-2000 there was a decline in the public debt to GDP ratio from 54 percent to 51 percent. During the tenure of the Musharraf Government it rose to 55 percent by 2007-08.

However, since 2007-08, there has been a big increase in the public debt to GDP ratio. By June 2018 it had reached 72.5percent of the GDP, substantially in violation of the FRDL.

Table 28.1: Evolution of Public Debt, 1999-91 to 2017-18 – (Rs in Billion)

	Total Public Debt (Billion Rs)	Annual Growth Rate (%)	Public Debt as % of GDP*	Public Debt per Capita (Rs)
1990-91	776		53.8	6820
1999-2000	2790	14.2	51.5	20100
2007-08	5847	9.2	55.0	34834
2012-13	14292	17.9	62.4	79080
2016-17	21408	10.1	67.2	103022
2017-18	24952	16.5	72.5	117261

*The GDP in the 90s has been adjusted upwards following the rebasing exercise.

Source: SBP, H of S | MOF

The public debt per capita has risen exponentially. It was approximately Rs 6800 only in 1990-91, which has increased to almost Rs 117,261 by June 2018. The inter-generational implications of this high level of public debt need to be fully understood.

A broader definition of public debt includes the debt of PSEs, circular debt of power sector and the debt accumulated in commodity operations. This adds Rs 2490 billion to public debt and raises the public debt to GDP ratio to almost 80 percent.

28.2. COMPOSITION OF PUBLIC DEBT

The relative magnitudes of external and domestic public debt are presented in Table 28.2. The share of domestic debt has increased from 50 percent in 2008-09 to 67 percent in 2012-13 and to 69 percent in 2016-17. However, the share has declined in 2017-18 to 66 percent. The share of external debt has risen in 2017-18 due to depreciation of the rupee.

Table 28.2: The Evolution of Public, Domestic and External Debt, 2008-09 to 2017-18 – (Rs in Billion)

	Domestic Debt	% of GDP	External Debt	% of GDP	Total Public Debt	% of GDP	Share of Domestic Debt
2008-09	3860	29.5	3871	29.5	7731	59.0	50.0
2009-10	4653	31.7	4357	29.7	9010	61.4	51.6
2010-11	6014	33.3	4757	26.3	10771	59.6	55.9
2011-12	7638	37.0	5058	24.5	12696	61.5	60.2
2012-13	9520	41.6	5228	20.8	14292	62.4	66.7
2013-14	10906	42.9	5085	20.1	15991	63.0	68.1
2014-15	12192	44.5	5188	19.0	17380	63.5	70.1
2015-16	13625	46.0	6051	20.5	19676	66.5	69.2
2016-17	14809	46.5	6599	20.7	21408	67.2	69.2
2017-18	16416	47.7	7796	22.8	24952	75.2	65.8

Source: SBP

28.2.1. Domestic Debt

There are three types of domestic debt. Permanent debt is the long-term component, mostly in the form of Pakistan Investment Bonds (PIBs). The floating debt is short-term debt through flotation of market treasury bills. Unfunded debt is the stock of savings instruments of the NSD held by people at large.

The changing composition of domestic public debt is presented in Table 28.3. It is noticeable that the share of permanent debt has increased from 18 percent in 2008-09 to almost 44 percent by 2015-16. Since then it has fallen to 28 percent. Simultaneously, the share of unfunded debt has fallen from 33 percent to 18 percent. The share of floating debt has been the largest. In the latest estimates of domestic debt, the share of short-term debt is over 54 percent.

Table 28.3: Composition of Domestic Public Debt, 2008-09 to 2017-18 – (Rs in Billion)

	2008-09	2012-13	2015-16	2016-17	2017-18
Permanent Debt	678	2175	5936	5528	4659
	(17.6)*	(22.9)	(43.6)	(37.2)	(28.4)
Floating Debt	1904	5195	5002	6551	8889
	(49.4)	(54.6)	(36.7)	(44.1)	(54.1)
Unfunded Debt	1271	2146	2684	2765	2868
	(33.0)	(22.5)	(19.7)	(18.7)	(17.5)
TOTAL	**3853**	**9516**	**13622**	**14844**	**16416**

*Figures in brackets are percentage shares
Source: SBP

During the tenure of the last IMF Program a restriction was placed on the increase in floating debt so as to reduce the refinancing risk. Heavy reliance was placed on the frequent offering of PIBs. Consequently, the share of permanent debt went up sharply from 23 percent to 44 percent. However, this happened at a time when interest rates were relatively high as shown in Table 28.4. The 'lock in' effect has added Rs 120 billion annually to the cost of debt servicing.

Commencing in 2016-17, following the end of the Fund Program, there has been massive resort to short-term treasury bills, especially with the SBP. Interest rates had fallen sharply with the decline in the rate of inflation. The preferred strategy should have been to opt for more financing through PIBs at relatively low nominal interest rates. The position now is that the refinancing risk has gone up once again, especially in 2018-19 when interest rates are increasing rapidly. This could add Rs 160 billion or more to the cost of debt-servicing in 2018-19.

Table 28.4: Rates of Return on Government Instruments, 2008-09 to 2017-18 – (%)

	2008-09	2012-13	2017-18
Pakistan Investment Bonds (PIB)			
5 Years	11.50	11.50	7.75
10 Years	12.00	12.00	8.75
20 Years	13.75	13.00	10.75
National Savings Certificates			
Regular Income Certificate	12.00	11.88	6.54
Behbood Savings Certificates	14.16	14.04	9.36
Market Treasury Bills* (MTBs)			
3 months	13.84	9.28	5.96
6 months	14.00	9.28	5.98
1 year	14.25	9.36	-
Rate of Inflation (%)	**17.0**	**7.4**	**4.2**

*Sales held in December of a particular financial year.
Source: SBP

28.2.2. External Debt

The composition of external public debt is given in Table 28.5. Long term debt is the largest component with a share of 83 percent in 2017-18. However, there have been major changes among long term-debt instruments. In the earlier years, there was hardly any resort to flotation of Euro/Sukuk Bonds and to loans from international commercial banks. The debt in these forms has increased to $7.3 billion and $6.8 billion respectively by June 2018. Consequently, their combined share has risen to 19 percent and the rate of amortization of external debt has increased.

Table 28.5: Composition of External Public Debt, 2009-10 to 2017-18

	2009-10	Share (%)	2012-13	Share (%)	2016-17	Share (%)	2017-18	Share (%)
Long Term	**42057**	**78.5**	**43488**		**55547**	**84.0**	**62525**	**83.0**
Paris Club	13958		13548		12678		11643	
Multilateral	23694		24198		26376		28102	
Other Bilateral	1782		2939		4445		8674	
Euro / Sukuk Bonds	1550		1550		4550		7300	
Commercial Loans	-		-		882		6806	
Others	1073							
Short Term	**851**	**1.6**	**264**		**882**	**1.3**	**1617**	**2.1**
From IMF	**8077**	**15.0**	**4387**		**6109**	**9.2**	**6095**	**8.1**
Foreign Exchange Liabilities	**2585**	**4.8**	**3106**		**3564**	**5.4**	**5121**	**6.8**
TOTAL	**53570**	**100.0**	**51245**		**66103**	**100.0**	**75358**	**100.0**

Source: SBP

Turning the composition of the gross inflow of external assistance, the first major finding is that the composition of gross government external borrowing from July 2016 to June 2018 is very different from the profile of outstanding government external debt. The share of multilateral agencies has fallen from 43 percent to 32 percent, as shown in Table 28.6. Similarly, the share of bilateral funding has plummeted to only 2 percent from 43 percent. As such, the overall share of relatively concessional financing has visibly declined.

Table 28.6: Composition of the Gross Inflow of Foreign Assistance, 2012-13 to 2017-18 – (Million $)

	Multilaterals[a]	Bilaterals[b]	Euro/ Sukuk Bonds	Commercial Banks	Short Term	Others	Total
2012-13	1085 (42.8)[c]	1089 (43.0)	-	-	256 (10.1)	103 (4.1)	2533 (100.0)
2015-16	2782 (37.9)	1706 (23.2)	500 (6.8)	1381 (18.8)	861 (11.7)	118 (1.6)	7348 (100.0)
2016-17	2600 (24.6)	2042 (19.4)	1000 (9.5)	4367 (41.3)	405 (3.8)	136 (1.2)	10550 (100.0)
2017-18	3800 (32.4)	254 (2.2)	2500 (21.4)	4147 (35.4)	950 (8.1)	50 (0.4)	11701 (100.0)

[a]ADB, IBRD, IDA,IDB | [b]74% from China in 2017-18 and 78% in 2016-17 | [c]% Share

The increases that have taken place are in borrowing from non-Paris Club countries, especially from China, commercial borrowing and flotation of Euro/Sukuk bonds. There was no commercial borrowing in 2012-13. It has now become a major source with share of 35 percent. Such borrowing has come from Chinese banks like ICBC and China Development Bank, and other banks like SCB, London and Credit Suisse. The flotation of Euro/Sukuk bonds reached a peak of $2.5 billion in 2017-18.

The basic implication is that external debt servicing costs will rise faster in years to come, if there is continued dependence on Chinese project financing and loans from Chinese banks. Meanwhile, there is a visible tendency on the part of traditional lenders, especially the World Bank, to reduce annual assistance to Pakistan in the form of either project or program loans.

28.3. MEDIUM-TERM DEBT STRATEGY

Turning to the strategy for public debt management in coming years, the Ministry of Finance has formulated a Medium Term Debt Strategy (MTDS). The salient features of the strategy are raising the maturity profile of domestic debt; widening the investor base of T-bills, PIBs and Ijara Sukuk bonds; focusing on concessionary borrowing from multilateral/bilateral donors; annually floating Eurobonds and achieving centralization and transparency in debt management operations.

Successful execution of the MTDS will require generation of primary surpluses of at least one to two percent of the GDP. This implies a vigorous mobilization effort and strict economy in expenditure. Raising the maturity profile reduces the risk of rollover of short term debt but it adds to the cost of debt servicing. The composition of domestic borrowing should reflect expectations about future interest rates. If these are expected to fall, then more short-term debt may be the preferred option.

Overall, the public debt of the Federal Government is rising exponentially and reaching a high level as percentage of the GDP. As per the FRDL, there is a need to present a serious and detailed plan to the Parliament to bring down the public debt to GDP ratio close to 60 percent within the next five years.

SECTION 10

FISCAL FEDERALISM

Chapter 29:

THE 18TH AMENDMENT

The 18th Amendment to the Constitution of Pakistan was passed unanimously by the National Assembly on 19th April 2010. Along with the liberal 7th NFC Award, it has led to fundamental changes in the structure of governance in the country. Both additional functions and resources have been transferred to the Provinces. This has led to a big leap forward in the process of decentralization and the Provincial Governments are more empowered today.

The salient features of the 18th Amendment are, first, abolition of the Concurrent List and transfer of most of the functions in this list to the Provinces. Second, a new list, the Federal Legislative List Part II, has been created of functions which are the joint responsibility of both Federal and Provincial Governments. Third, some additional fiscal powers have also been given to the Provincial Governments. Federal Legislative List Part I continues to have functions to be performed exclusively by the Federal Government.

The objectives of this chapter are, first, to identify in precise terms the extent of decentralization of functions and resources following the 18th Amendment. Second, key issues and challenges are focused on which need to be resolved for full implementation of the 18th Amendment. Reforms are highlighted for carrying further the process of decentralization in the country.

29.1. EXTENT OF DECENTRALIZATION

The functions with the Federation after the 18th Amendment are shown in Figure 29.1. These include defense, external affairs, currency, international commerce, SBP, etc. The functions which are the joint responsibility of both the Federation and the Provinces are included in Federal List, Part II, also shown in figure 29.1. These include functions related to the railway, electricity, major ports, regulatory authorities, etc. Issues related to these functions are to be resolved in the Council of Common Interests.

Figure 29.1: The New Federal List of Functions

Federal List-I	Federal List-II
• Defence	• Railways
• External Affairs	• Major Ports
• Citizenship	• Development of Industries
• Migration	• Electricity
• Posts and Telegraphs	• Regulatory Authorities
• Telecommunication	• National Planning
• Currency	• Public Debt
• Foreign Exchange	• Census
• Public Debt of Federation	• Legal, Medical & other Professions
• FPSC	• Standards in Higher Education
• Federal Pensions	• Inter- Provincial Matters and Coordination
• Ombudsman	• CCI
• Courts and Tribunals	• All Matters related to the Above
• Libraries, Museums	
• Foreign Students	
• Nuclear Energy	
• Research Institute	
• Maritime Shipping	
• Air Navigation	
• Copyrights, Inventions	
• International Import & Export	
• SBP	
• Insurance	
• Stock Exchanges	
• International Treaties	
• National Highways & Strategic Roads	
• Federal Surveys	
• International Fishing	
• Standards	
• Elections	
• Salaries of VIPs	
• All Matters related to the above	

Source: Constitution of Pakistan

29.1.1. Allocation of Functions

Prior to the passage of 18th Amendment, there were 51 Divisions at the Federal Level. Following the Amendment, 19 Divisions have either ceased to exist or changed in character. An attempt has been made to retain some of the functions by establishment of the following new Divisions.

Figure 29.2: List of New Divisions in the Federal Government

- Aviation
- Capital Administration and Development
- National Security
- Climate Change
- Heritage
- Narcotics Control
- Human Rights
- National Food Security and Research
- National Health Services
- Overseas Pakistanis and Human Resource Development
- Inter-Faith Harmony

Consequently, there are 42 divisions currently in the Federal Government. Even prior to the 18th Amendment, the Ishrat Hussain Report (2008) on Reforming the Government in Pakistan had recommended that the number of Divisions be brought down to 37 and the number of Ministries to 23.

Following the 18th Amendment there is an even stronger case for reducing the size of the Federal Government and also thereby avoiding duplication of functions. The rationalization of the Federal structure could be in the following directions:

(i) Based on the principle of 'Subsidiarity', Agriculture, Education, Health, etc., are pre-dominantly provincial subjects and there is no strong case for having these Divisions at the Federal Level. Any common issues in these sectors can be handled by the CCI, through the Ministry of Inter-Provincial Coordination.

(ii) The number of Ministries could be reduced by merging, for example, Railway with Communications, Textiles with Industry, Overseas Pakistanis with Foreign Affairs and so on.

However, strong resistance has come from the Federal Bureaucracy because fewer Ministries/Divisions will mean fewer senior positions at the BPS 21-22 level.

29.1.2. Allocation of Fiscal Powers

The fiscal powers retained by the Federation after the 18th Amendment are shown in Figure 29.3. There are only two changes. The tax base of sales tax has been bifurcated. Goods remain with the Federal Government, while services have been given for taxation purposes to the Provincial Governments. This is a potentially big move. Also, taxes on immoveable property, excluding the income tax on rent, have been transferred to Provincial Governments.

Figure 29.3: Fiscal Powers of the Federation

- Duties of customs, including export duties.
- Duties of excise
- Taxes on Income other than agricultural income
- Taxes on Corporations
- Taxes on sales and purchases of goods imported, exported, produced, manufactured or consumed except sales tax on services
- Taxes on the Capital value of assets, not including taxes on immoveable property
- Taxes on mineral oils, natural gas and minerals for use in generation of energy
- Taxes and duties on the production capacity of any plant, machinery, establishment or installation
- Terminal taxes on goods or passengers carried by railway, sea or air, taxes on their fares and freights

*excluding estate duties on succession of property

Source: Constitution of Pakistan

The abolished Concurrent List is given in Figure 29.4. There are some important functions which stand transferred to the Provincial Governments with the end of this List. These include Criminal and Civil Law and Procedure, Drugs and Medicines, Environmental Pollution and Ecology, Population Planning, Labor-related functions, Professions, Zakat, etc.

The reduction in the number of Divisions should have led to a savings in costs of administration at the Federal level by about 11 percent. However, this has not been fully realized because all the staff in the closed Divisions have yet to be sent to the Provincial Governments. The Provincial Governments have incurred additional costs in the range of 5 percent, especially due to transfer of development schemes. These estimates are based on analysis of expenditures as reported in the budget documents.

Figure 29.4: The Abolished Concurrent List of Functions

Concurrent List	Concurrent List
• Criminal Law & Procedure	• Labor Exchanges
• Civil Procedure	• Boilers
• Marriage, Divorce, Adoption Wills	• Safety in Mines, etc.
• Bankruptcy, Insolvency	• Unemployment
• Arbitration	• Insurance
• Contracts	• Inland Waterways
• Trusts	• Mechanical Vehicles
• Transfer of Property e	• Newspapers, Books
• Arms and Ammunition	• Evacuee Property
• Explosives	• Historical Sites, Monuments
• Opium	• Curriculum, Syllabus, Centers of Excellence and Standards
• Drugs & Medicines	• Islamic Education
• Mental Illness	• Zakat
• Environmental Pollution and Ecology	• Censorship, Exhibition of Films
• Population Planning and Welfare	• Tourism
• Welfare of Labor	• Legal, Medical & Other Professions
• Trade Unions; Industrial Disputes	• Auqaf
	• All Matters related to the above

Source: Constitution of Pakistan

The key issues and challenges with regard to the implementation of the 18th Amendment are identified below, with regard to the allocation and performance of different functions.

29.2. THE ROLE OF CCI AND NEC

CCI should meet quarterly. This did not happen in the tenure of the PML (N) Government. Eight meetings should have been arranged in the last two years. Instead, only three meetings took place.

The Agriculture Relief Package announced in 2016 by the Prime Minister should have been launched after full consultation with the Provincial Governments, preferably in the CCI. Agriculture has always been a Provincial subject and consensus should have been reached on the 50:50 sharing formula, announced by the PM, on parts of the package.

The National Economic Council (NEC) should meet biannually. During the tenure of the PPP Government and currently with the PML(N) Government meetings have been held only once a year, primarily for finalization of the Annual Plan for the next year. The Draft Five Year Plan (2013-18) was presented to the NEC in the 2015 meeting, without due consultation with the Provincial Governments.

In fact, the planning process ought to change fundamentally after the 18th Amendment. It should become a 'bottom-up' process, instead of the old 'top-down' process. Each Province should prepare its Regional Development Plan. This should be aggregated by the Planning Commission and a consistent Macroeconomic Framework developed.

29.3. BORROWING POWERS OF PROVINCIAL GOVERNMENTS

Article 167, clauses 3 and 4, give the Provincial Governments powers to borrow, after the 18th Amendment. This is subject to the following:

(i) Consent by the Federal Government (only if a Province has outstanding loans with the Federal Government)

(ii) Within such limits and subject to such conditions as may be specified by the NEC.

However, there is a fundamental contradiction. While the Provinces were allowed to borrow, simultaneously the Federal Ministry of Finance made a commitment to the IMF as part of the Extended Fund Facility (EFF) that the four Provinces combined will generate large cash surpluses during the tenure of the Program. How can the Provincial Governments generate a surplus if they are engaging in borrowing? Any commitment to make the Provinces generate large surpluses should have been made after consensus was reached in the CCI (as happened in 2013-14).

29.4. SHARE FROM DIVISIBLE POOL

The 18th Amendment has set a floor in Article 160, 3(A), on the share of the Divisible Pool of the four Provinces combined. This floor corresponds to the share decided in the previous NFC Award. Under the 7th NFC Award, the combined share of the Provinces was set at 57.5 percent. This is the floor for the next Award.

The Federal Government is trying to circumvent this condition in the following ways:

(i) The TOR of the new Award for the 9th NFC has tried to define the provincial share as inclusive of the allocations to the Governments of Azad Jammu and Kashmir, Gilgit-Baltistan and FATA. This will, of course, be resisted strongly by the four Provincial Governments.

(ii) The Federal Government has found it appropriate to develop new sources of revenue outside the Divisible Pool, so that sharing with the Provinces can be avoided. Examples of such sources are the Petroleum Levy and the Gas Infrastructure Development Cess. The former tax could have been collected in the form of excise duty and shared.

29.5. ALLOCATION OF FUNCTIONS

29.5.1. Development Functions

As per a CCI decision of 2010-11, vertical programs in Population Welfare and Health continue to be financed from the Federal PSDP, up to the next NFC Award. Despite the vital nature of these programs, they have since received step fatherly treatment from the Federal Government. Annually, actual allocations have been only 70 percent to 80 percent of the proposed amount at the start of the year. The program of Lady Health Workers has been a successful program. But there are months now when the salary of these workers is not paid. It is not surprising that many of the health indicators have either shown little improvement or actually deteriorated in recent years.

29.5.2. Higher Education

Following the 18th Amendment, the Federal Legislative List contains the below mentioned functions which potentially relate to higher education:

FLL Part I	• Federal agencies and institutes for the following purposes, that is to say, for research, for professional or technical training, or for the promotion of special studies • Education as respects of Pakistani students in foreign universities and foreign students in Pakistan.
FLL Part II	• Standards in institutions for higher education and research, scientific and technical education.

Therefore, on a permanent basis, there is need for a Federal institution to perform the above-mentioned functions.

During the transitional period, the Supreme Court has ruled that the HEC will continue to exist and perform functions as per status quo, as long as the HEC Ordinance 2002 remains operative. This judgment is in line with Article 268(1) of the Constitution which states that

"Except as provided by this Article, all existing laws shall, subject to the Constitution, continue in force, so far as applicable and with the necessary adaptations, until altered, repealed or amended by the appropriate legislature."

One of the major functions performed by the HEC is the recurrent and development funding of all 91 public universities/DAIs in Pakistan. This represents a significant allocation from the Federal Budget as shown in Table 29.1.

Table 29.1: Annual Allocation of Funds of HEC, 2016-17 and 2017-18 – (Rs in Billion)

	Recurring	Development	Total
2016-17	58.0	21.5	79.5
2017-18	62.2	35.7	97.9

Source: MOF, Islamabad, Budget Documents.

Therefore, since provisions were not made in the 7th NFC Award for transferring resources to the Provincial Governments to take on funding responsibilities of public universities, HEC has continued to perform this function, pending any future award.

A recent development has complicated the institutional arrangements for regulation and financing of higher education in Pakistan. This relates to the establishment of Provincial HECs under Provincial Acts by two Provincial Governments, viz., Punjab and Sindh. There is now a danger of duplication of functions with the Federal HEC.

However, the Provincial laws make it clear that the standards set will be consistent with the HEC in Islamabad, as per Part II of the FLL. But, under Section 10(h) and 10(j) of the Sindh and Punjab acts respectively, there is provision for the Provincial HECs to perform the funding function.

Therefore, a sustainable long-run arrangement could have the following features:

- HEC continues to perform primarily a regulatory function of setting standards and monitoring their adherence. In addition, Federal universities/DAIs will continue to be funded by the HEC.
- The 9th NFC Award makes provisions for transfer of additional resources to the Provinces for funding of public universities within their respective domains. Provincial HECs can then begin to perform the financing function.

The advantage of this arrangement is that it will separate the regulatory function from financing.

29.5.3. Labor-related Functions

The abolition of the Concurrent List in the 18th Amendment has implied that all labor-related functions stand transferred to the Provincial Governments, including the following:

(i) Welfare of labor, conditions of labor, provident funds, employer's liability and workmen's compensation, health insurance including invalidity pensions, old age pensions.

(ii) Trade unions, industrial and labor disputes.

(iii) The setting up and carrying on of labor exchanges, employment information bureaus and training establishments.

(iv) Regulation of labor and safety in mines, factories and oil fields.

(v) Unemployment Insurance.

The Provincial Governments will need to expand their capacity substantially to be able to perform the above functions. This has become even more important after the granting of GSP+ status by the European Union (EU) to Pakistan. Continuation of this facility is contingent on effective adherence to 27 Conventions, eight of which relate to labor.

As such, the following steps will be needed to be undertaken to ensure that the above functions are performed adequately by the Provincial Governments:

(i) The Federal Government currently collects the contributions by corporate entities to the Worker's Welfare Fund (WWF) and the Worker's Profit Participation Fund (WPPF) along with the income tax. The estimated contribution to the two funds combined is almost Rs 35 billion. This amount will henceforth have to be reverted to the Provinces on the basis of an agreed formula.

(ii) The Employees Old Age Benefits Institution (EOBI) has uptil now been a Federal entity. For consistency with the 18^{th} Amendment, this institution ought to be provincialized and its assets also distributed according to a formula. However, this institution can continue in its present form if the majority of Provincial Governments pass on appropriate resolution in the CC1.

(iii) Setting of minimum wages should be seen as a Provincial, not Federal, function.

29.5.4. Social Welfare Function

The social welfare function has also been included in the Concurrent List. The implication is that this function also stands devolved to the Provinces. Consequently, the Social Welfare and Special Education Division at the federal level was closed after the 18^{th} Amendment. For example, the Government of Punjab has established a Social Protection Authority, chaired by the Chief Minister.

However, the largest social welfare program of Pakistan, the BISP, continues to be financed and operated through an autonomous entity at the Federal level. The apparent justification is that this Program started in 2008-09, before the 18th Amendment was promulgated.

The problem today is the proliferation of social welfare initiatives, both at the Federal and Provincial levels. These programs have acquired a populist character. A number of schemes had been launched by the Federal Government during the tenure of the PML (N) Government as 'Prime Minister's Scheme', including the following:

i) PM' Interest Free Loan Scheme

ii) PM's Business Loan Scheme

iii) PM's Fee Reimbursement Scheme for less Developed Areas

iv) PM's Youth Training Scheme

v) PM's Youth Skill Development Scheme

vi) PM's Scheme for Provision of Laptops

vii) PM's Housing Scheme

It may be interpreted that these schemes have a 'development' character and should not be treated as such as social welfare. However, there remains some ambiguity. Also, Provincial governments have been offering similar schemes and there is considerable duplication.

Recently, a National Health Insurance Scheme has been announced by the new Federal Government of the PTI. This intrudes into the provincial domain in two major ways. First, it is in the area of the health, which is clearly a Provincial subject. Second, it is in the nature of a social welfare scheme, again in the Provincial domain after the 18^{th} Amendment.

However, in practice it is difficult to avoid supporting the scheme, which will help the poor. Also, a national scheme will ensure uniformity of benefits across locations. Perhaps, a partnership could be developed whereby the Federal Government provides half the funds and the Provincial Governments the other half. The latter should also manage and operate the scheme.

29.5.5. LOCAL GOVERNMENTS

Perhaps the biggest failure in implementing the 18^{th} Amendment is the long delay in establishing elected Local Governments. The vision behind the Amendment was to promote the process of decentralization not only from the Federal to the Provincial level but also from the Provincial Level to the local level.

For the first time, there was recognition of a third tier of Government, the Local Governments. This is articulated in Article 140A, which states:

(i) *Each Province shall by law, establish a local government system and devolve political, administrative and financial responsibility and authority to the elected representatives of the local government.*

(ii) *Elections to the local governments shall be held by the Election Commission of Pakistan.*

The first delay occurred in the formulation and passage of a law by each Provincial Assembly for the setting up of Local Governments. In Punjab and Sindh the Local Government Act was enacted in 2013, followed by some amendments in 2015. It was passed earlier in 2012 in Khyber-Pakhtunkhwa and in 2013 in Balochistan.

There is strong evidence that the impact on social indicators was better in the tenure of district governments during the Musharraf era. The tragedy, however, is that the new Local Government Acts mostly represent a truncation in functions to a varying degree. Also, in violation of Article 140A the devolution of political, administrative and financial responsibility is limited in the law in most Provinces, with the possible exception of Khyber-Pakhtunkhwa.

29.6. PROJECT APPROVAL

As highlighted earlier, following the empowerment of the Provinces by the 18th Amendment, the planning process must change to reflect the greater autonomy of the Provincial Governments. In particular, the project approval process must be devolved more. This will require a number of changes.

First, the Provincial Governments must play a more active role in the National Economic Council. They may be asked to present their respective Annual Plans and state their development priorities as reflected in their PSDPs. The Federal Planning Commission can then present the aggregated National Annual Plan, inclusive of the plans of the Federal and Provincial Governments.

Second, the approval of the Annual Plans by the NEC should imply greater autonomy in the project approval process for Provincial Governments. Currently, the approval process is as follows:

PDWP	Approval of Projects of size up to Rs 1000 million. Chaired by the Additional Chief Secretary, P&D
CDWP	Approval of Projects of size up to Rs 5000 million. Chaired by the Deputy Chairman, Planning Commission.
ECNEC	Approval of Projects larger than Rs5000 million. Chaired by the Federal Finance Minister.

The proposal is that provincial projects need not go for approval in Islamabad, irrespective of their size. Only those projects should go to CDWP/ECNEC which are either part of the Federal PSDP or are Provincial and involve either some Federal or foreign funding.

29.7. ISSUES IN THE ENERGY SECTOR

There are a number of potentially contentious issues in the power sector which could put stress on the Federation. The first set of issues relates to the interpretation of Article 157, which allows a Province to do the following:

a) *to the extent that electricity is supplied to that Province from the national grid, require supply to be made in bulk for transmission and distribution within the Province.*

b) *levy tax on consumption of electricity within a Province.*

c) *construct power houses and grid stations and lay transmission lines within a Province.*

d) *determine the tariff for distribution within the Province.*

The Provincial Governments, especially of Sindh and Punjab, are currently engaged in investing in power projects. Article 157 (c), in effect, allows the future supply of electricity from these projects to be retained within the Province. How will this impact on the role of NTDC?

Further, there is provision in clause (d) for differential tariffs, as opposed to the current policy of uniform tariffs throughout the country. This will mean a transition to a policy similar to that followed by the States of India, with big differences regionally in tariffs. Also, will provincial equivalents to NEPRA have to be established?

Another emerging issue, which has already been voiced recently by the Finance Minister of Sindh. relates to Article 158, which states

'The Province in which a well-head of natural gas is situated shall have precedence over other parts of Pakistan in meeting the requirements from the well-head, subject to the commitments and obligations as on the commencing day '.

Sindh is the Province currently with the largest surplus of natural gas. What will be the implications of diverting more gas from the rest of the country to Sindh? Sindh has already placed a demand for this. This is clearly an issue which will have to be resolved in the CC1.

29.8. FISCAL ISSUES

The 18th Amendment has unambiguously allocated the sales tax on services to the Provinces. However, the grey area relates to the tax base of Federal excise duty. Consequently, FBR has levied an excise duty on some services like banking and insurance, air travel, etc. The consequence is double taxation of a tax base. The Federal Government ought to abolish excise duties on services or drastically reduce the tax rates.

The other contentious area is the capital gains tax on property. The 18th Amendment has excluded the capital value tax on property presumably and the intent is also to exclude the capital gains tax on property from the domain of Federal fiscal powers. But FBR has proceeded to levy the CGT on property on the grounds that this is a form of income tax.

In recent years, the federal Government has increasingly encroached on Provincial tax bases through the levy of higher withholding taxes. This has happened in the case of a number of provincial taxes including stamp duty, sales tax on services, urban immoveable property tax, motor vehicle tax and entertainment tax.

The best example of the negative impact of this encroachment is in the telecommunication sector. In the Federal Budget of 2013-14, the withholding tax on phone bills/cards was raised from 5 percent to 15 percent. The prevailing tax rate of the sales tax on this service is 19.5 percent. Therefore, the combined tax rate rose to over 37 percent, thereby impacting negatively on the growth of the tax base. Recently, the Supreme Court has passed a judgement whereby the withholding tax has been withdrawn.

There is need for adopting an 'integrated- view of the tax system. The combined rate of taxation has to be kept relatively low to avoid large deadweight losses and contraction of the tax bases, especially to the detriment of the Provinces.

29.9. RECOMMENDATIONS

A number of recommendations have been made above in different sections of the paper. These are summarized below:

(i) The Federal Government remains too big, even after the transfer of many functions following the 18th Amendment. There are as many as 42 Divisions currently. A number of Divisions like Food Security, Education and Health are essentially duplicating Provincial functions. The number of Ministries could also be reduced by merger of various Divisions.

(ii) The rate of improvement in social indicators has not been commensurate with the substantial transfer of additional resources following the 7th NFC Award. The literacy rate has actually fallen up to 2014-15, while other indicators have remained stagnant. There are three possible reasons for this disappointing outcome relating to failure of governance, low growth, rising poverty and the move back from Local Governments to Provincial Governments for delivery of social services. There is need for setting up a Commission to investigate why social indicators have performed poorly after 2008.

(iii) As per article 154(3) the Council of Common Interests must meet quarterly. During the last two years, only three meetings have been held in eight quarters.

(iv) Borrowing powers have been given to the Provinces after the 18th Amendment, subject to the fulfillment of some conditions. As a special case, the National Economic Council may permit borrowing up to specified limits for power projects.

(v) Vertical programs in Population Welfare and Health continue to be financed form the Federal PSDP, up to the next NFC Award. Given the importance of these Programs it is essential that adequate allocations be made and releases of funds correspond to the allocations.

(vi) Following the setting up of Provincial HECs in Sindh and Punjab, there is potentially some duplication with the Federal HEC. It is essential that prior to the 9th NFC Award a decision is taken in the CCI on the allocation of responsibilities, including financing, in the area of higher education between the Federation and the Provinces. Appropriate changes will then be needed in the federal HEC Act.

(vii) Following the transfer of all labor-related functions to Provincial Governments, the amounts collected under the Workers Welfare Fund (WWF) and the Workers Profit Participation Fund (WPPF) may be reverted to the Provinces, as per a mutually agreed formula. The CCI will also have to take a decision on the future of EOBI.

(viii) Perhaps the biggest failure in implementation of the 18th Amendment was the delay in the establishment of elected Local Governments, with requisite autonomy as per Article 140A. It is essential that proper arrangements be made for financing of Local Governments. This could involve reversion to the provision in the 2006 Distribution of Revenue and Grant-in-Aid Order, which provided for transfer of one-sixth of sales tax revenues to Local Governments.

(ix) The Provinces may be granted more autonomy in the planning process. Only those Provincial projects should come up to Islamabad for approval by the CDWP/ECNEC which either have foreign assistance or cost-sharing by the Federal Government.

(x) There is a proliferation of ‘populist’ social welfare programs at both the Federal and Provincial levels. There is need for avoiding duplication and promoting cost sharing and implementation primarily at the Provincial level.

(xi) A number of contentious issues are emerging in the energy sector. It is imperative that these are resolved in the CCI if undue stress on the Federation is to be avoided.

(xii) Following the transfer of the sales tax on services to the Provincial Governments, federal excise duties on services must be withdrawn or drastically reduced to avoid double taxation.

(xiii) In recent years, the Federal Government has been encroaching on various provincial tax bases, leading to over taxation and erosion of these tax bases. There is need for focusing on development of a national integrated tax system.

Hopefully, the spirit of the 18th Amendment will remain alive and the Federation of Pakistan will find strength from '*Unity in Diversity*'.

Chapter 30:

THE NFC AWARDS

The National Finance Commission (NFC) has been established as a Constitutional entity under Article 160 of the Constitution of Pakistan. The members of the NFC, the nature of recommendations in an award to the President of Pakistan, the federal taxes included in the divisible pool for sharing between the Federal Government and the Provincial Governments and the (five year) tenure of an Award are highlighted in Box 30.1.

This chapter is organized as follows: Section 1 traces the history of NFC Awards since the 1st Award of 1974 to the 7th NFC Award of 2009. The five-year tenure of the latter award came to an end in 2014-15. In the absence of a new Award, it has been continued on an ad-hoc basis. The 9th NFC has been constituted recently but has made little progress.

Section 2 describes the key features of the 7th NFC Award and the implications of the vertical and horizontal sharing formula embodied in the Award on the distribution of revenue transfers among the Provinces. Section 3

Box 30.1: Section of the Constitution of Pakistan on the NFC

160 National Finance Commission

(1) Within six months of the commencing day and thereafter at intervals not exceeding five years, the President shall constitute a National Finance Commission consisting of the Minister of Finance of the Federal Government, the Ministers of Finance of the Provincial Governments and such other persons as may be appointed by the President after consultation with the Governors of the Provinces.

(2) It shall be the duty of the National Finance Commission to make recommendations to the President as to-

a) the distribution between the Federation and the Provinces of the net proceeds of the taxes mentioned in clause (3);
b) the making of grants-in-aid by the Federal Government to the Provincial Governments;
c) the exercise by the Federal Government and the Provincial Governments of the borrowing powers conferred by the Constitution: and
d) any other matter relating to finance referred to the Commission by the President.

(3) The taxes referred to in paragraph (a) of clause (2) are the following taxes raised under the authority of Majlis-e-Shoora (Parliament) namely:-

(i) taxes on income, including corporation tax. but not including taxes on income consisting of remuneration paid out of the Federal Consolidated Fund;
(ii) taxes on the sales and purchases of goods imported, exported, produced, manufactured or consumed;
(iii) export duties on cotton, and such other export duties as may be specified by the President;
(iv) such duties of excise as may be specified by the President: and
(v) such other taxes as may be specified by the President.

(3A) The share of the Provinces in each Award of National Finance Commission shall not be less than the share given to the Provinces in the previous Award.

reviews the process of implementation during the first five years of the Award and identifies some key issues. Section 4 makes an attempt at countering the recent attacks on the NFC Award. Finally, Section 5 presents the terms of reference of the new NFC and highlights some issues which could come up in future negotiations.

30.1. HISTORY OF NFC AWARDS

The 7th NFC Award took major steps towards greater fiscal decentralization to Provincial Governments and for more fiscal equalization among the Provinces. The former has been achieved by increasing the combined share of the Provinces in the divisible pool of taxes. The process of fiscal equalization has been promoted by moving from a population-based horizontal sharing formula to multiple criteria.

Table 30.1 presents the evolution of the share of the divisible pool of taxes in various Awards. The share of the Provinces in the divisible pool has been rising in every successive Award. It currently stands at 57.5 percent.

Table 30.1: Provincial Share in Divisible Pool Taxes, 1974 to 2009 – (%)

Divisible Pool Taxes	1st NFC 1974	4th NFC 1991	5th NFC 1997	PO 2006	7th NFC 2009
Income Tax and Corporation Tax[a]	**80**	**80**	**37.5**	**41.50 -46.25**	**56.0 - 57.5**
• Other Direct Taxes	-	-	37.5	41.50 - 46.25	56.0 - 57.5
Sales Tax	**80**	**80**	**37.5**	**41.50 -46.25**	**56.0 - 57.5**
Central Excise Duty[b]	**-**	**-**	37.5	41.50 - 46.25	56.0 - 57.5
• Tobacco	-	80			
• Sugar	-	80			
Import Duties	**-**	**-**	**37.5**	**41.50 -46.25**	**56.0 - 57.5**
Export Duties					
• Cotton	80	80	-	-	

[a]Excluding taxes on income consisting of remuneration paid out of federal consolidated fund.

[b]Excluding Central Excise Duty on Natural Gas.

Source: SPDC (2014)

Table 30.2 gives the criteria for horizontal sharing among the Provinces. Historically, the only criterion used was population. In the 7th NFC Award, the distribution was based on four criteria. These are population (82 percent); poverty/backwardness (10.3 percent); revenue collection/generation (5 percent) and inverse population density (2.7 percent).

Table 30.2: Criteria used in Horizontal Distribution of Divisible Pool Taxes, 1974 to 2010 – (%)

Factors	1st NFC 1974	4th NFC 1991	5th NFC 1997	PO 2006*	NFC 2010
Population	100.0	100.0	100.0	100.0	82.3
Poverty / Backwardness	-	-	-	-	10.0
Revenue Collection / Generation	-	-	-	-	5.0
Inverse Population density	-	-	-	-	2.7

*Other than 1/6th of sales tax on goods collected and distributed in lieu of Octroi / Zila Tax.
Source: NFC Secretariat [2010].

30.2. THE SEVENTH NFC AWARD

Pasha and Pasha [2010] have demonstrated that the 7th NFC Award has achieved among the various awards the greatest degree of fiscal equalization, followed by the 1997 Award. Consequently, in relation to population share, the share in revenues has increased most for the two relatively backward provinces, Balochistan and Khyber-Pakhtunkhwa. This has occurred at the expense of the largest province, Punjab (see Table 30.3).

Table 30.3: Ratio between Share in Transfers and Share of Population, 1990-91 to 2010-11

Province	1990-91	1991-92	1996-97	1997-98	2005-06	2007-08	2009-10	2010-11
Punjab	0.953	0.778	0.884	0.810	0.821	0.824	0.822	0.815
Sindh	1.030	1.026	1.069	1.021	1.270	1.257	1.235	1.127
K-PK	0.948	1.418	1.186	1.328	1.043	1.072	1.099	1.234
Balochistan	1.453	2.264	1.491	2.151	1.647	1.569	1.565	1.857
Pakistan	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000

*Ratio of share in transfers to share in population.
Source: Pasha and Pasha [2010]

Other special features of the 7th NFC Award which was for the period, 2010-11 to 2014-15, are as follows:

(i) Provinces have been given the choice to collect GST on services themselves or ask FBR to collect it on their behalf. The expectation is that there will be no Federal excise duties on services.

(ii) The magnitude of straight transfers has been raised. These transfers include the Gas Development Surcharge (GDS), excise duty on gas and royalty on gas and oil. The distribution is on the basis of collection.

(iii) Special grants have been given, first, to Sindh in lieu of the octroi/zila tax, second, arrears to Khyber-Pakhtunkhwa of hydro-electricity profits and, third, arrears of the GDS to Balochistan.

(iv) The costs of collection of divisible pool taxes have been reduced from 5 percent to 1 percent.

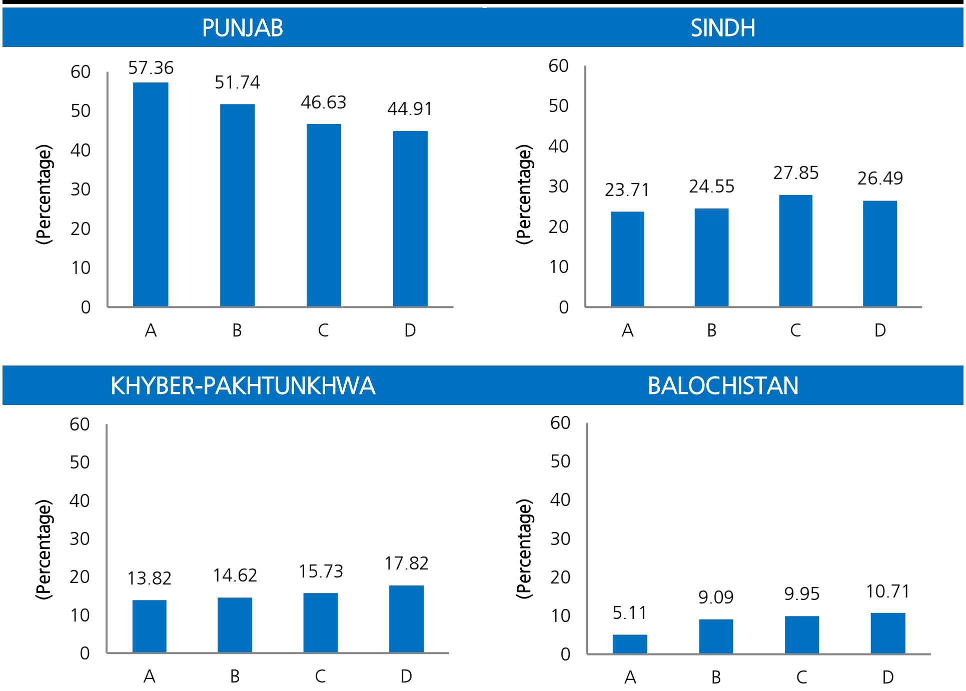
(v) A special transfer of 1 percent of the divisible pool (net) has been given to Khyber-Pakhtunkhwa to provide resources for the War on Terror.

(vi) In recognition of the special needs of Balochistan, Rs 83 billion was to be given to the Province in the first year, 2010-11, of the Award. Any shortfall was to be met by the Federal Government.

The Social Policy and Development Centre (2014) has done careful analysis of the change in transfers due to the 7th NFC award, in relation to the Provisional Order (PO) of 2006 as shown in Figure 30.1. The findings are as follows:

(i) The total transfers to Provinces in relation to PO 2006 increased by Rs 217 billion in 2010-11, rising to Rs 270 billion by 2014-15. This is equivalent to almost 1 percent of the GDP. However, the percentage increase in relation to the PO 2006 has declined from 26 percent in 2010-11 to 10 percent in 2014-15.

Figure 30.1: Share in Transfers by Province, 2014-15*



Share in: A = Population | B = Divisible Pool | C = Divisible Pool + Straight Transfers | D = Divisible Pool + Straight Transfers + Grants

NOTE: Total across Provinces may not add up to exactly 100 due to rounding off. | *last year of the 7th NFC Award

Source: PES, MOF, Budget-In-Brief

(ii) As expected, increase in the share of transfers in the case of Balochistan is of over 109 percent in 2014-15 as compared to its population share. Figure 30.1 shows that there has been a big drop in transfers of Punjab from 57.36 percent to 44.91 percent. There has been a modest increase in Sindh's share. The big beneficiaries are Balochistan and Khyber-Pakhtunkhwa.

30.3. REVIEW OF 7TH NFC AWARD

In the context of the review the first question relates to the impact of higher transfers on the fiscal behavior of Provinces. Did they slacken their own fiscal effort in the face of larger transfers? There is strong evidence that the two relatively developed Provinces, Sindh and Punjab, actually engaged in more aggressive resource mobilization following the enhancement of fiscal powers, with the transfer of the sales tax on services to the Provinces in the 7th NFC Award.

Sindh set up the Sindh Review Board and Punjab, the Punjab Review Authority, as specialized tax agencies to collect the sales tax on services. More recently, Khyber-Pakhtunkhwa has also taken this step. By 2017-18, the total revenue nationally of the tax has reached Rs 224 billion, equivalent to 0.6 percent of the GDP. This has raised the Provincial tax-to-GDP ratio from 0.4 percent of the GDP in 2009-10 to almost 1.2 percent of the GDP in 2017-18.

The consequence is that generally the increase in transfers has translated into a corresponding rise in expenditure. The combined expenditure of the four Provinces has gone up from 6.2 percent of the GDP in 2009-10 to over 7.2 percent of the GDP in 2015-16. However, almost 74 percent of this jump is in current expenditure. Salaries and allowances, in particular, of government employees have risen by almost 40 percent in real terms during the tenure of the 7th NFC Award.

There is need to recognize the fact that following the commencement of the IMF Program in September 2013, the Provincial Governments have been compelled to generate large cash surpluses to facilitate achievement of the consolidated deficit target set in the Program. The cumulative cash surplus over the period, 2013-14 to 2015-16, is as much as Rs 492 billion. Consequently, the budgeted level of PSDP of the four Provinces combined has been cut back by as much as by 27 percent.

The next question is whether the Provinces have increased their share in total national public expenditure following the NFC Award, despite the pressure to generate cash surpluses in recent years. The combined share of the four Provinces has gone up to 39 percent in 2017-18, as compared to 28 percent in 2009-10. Therefore, a significant degree of fiscal decentralization has been achieved, despite the Fund Program. However, this is significantly less than the target share of 45 percent set by the 7th NFC for 2014-15.

One of the principal objectives behind the relatively liberal dispensation in favor of the Provinces by the 7th NFC was to promote human development, especially since most of the social services are in the domain of Provincial Governments. Therefore, a relevant question is whether the share of education, health, water supply, etc. has increased in the total expenditure by Provincial Governments. In the case of all four Provinces, the overall share in public expenditure of social services has in fact, increased. The biggest increase is in Balochistan from 26 percent in 2009-10 to 37 percent in 2017-18. In the latter year, the largest share of expenditure on social sectors was in Khyber-Pakhtunkhwa at 47 percent.

The fundamental question is whether the 7th NFC Award led to a faster rate of expansion in the coverage of social services, given the increase in expenditure? Unfortunately, the outcome here has been disappointing. A five-indicator index has been constructed to measure the combined coverage of different social services. There are two major findings as follows:

(i) The rate of increase terms nationally of the index is larger between 2004-05 to 2008-09, the pre-7th NFC period, than from 2008-09 to 2014-15.

(ii) The highest index value of coverage of social services in 2014-15 is in Punjab. However, the biggest increase in the index value has been registered in Khyber-Pakhtunkhwa and smallest increase in Sindh.

The fundamental question is why despite larger outlays, the progress in social indicators has not been commensurately greater. There are three possibilities. First, within social sectors the priorities may have been altered. For example, there is evidence of far greater emphasis on curative health rather than preventive measures, including provision of safe drinking water. Second, Local Governments were far more active in pre-7th NFC period. They probably did a better job in reflecting peoples' preferences and in more effective delivery of services. Third, it is likely that the cuts in development spending, due to the constraints imposed by the IMF program, limited significantly the expansion in coverage of services.

30.4. ATTACK ON THE 7TH NFC AWARD

The 7th NFC Award has been subjected to criticism recently. The Award has been characterized as 'imperfect' by the Federal Advisor to the Prime Minister on Finance, of the last PML (N) Government. He has declared it as one of the three big structural problems that the country faces. The other two are flawed agricultural policy and loss-making public enterprises.

He has lamented that after handing over 57.5 percent of Federal Governments' revenues to the Provincial Governments, the remaining revenues are only sufficient for debt servicing. To meet the needs of defence, development, pensions and running its affairs, the Federal Government has no other option but to engage in large-scale borrowing. As such, the 'natural' fiscal deficit at the Federal level is close to 6 percent of the GDP.

The statement by the Advisor is not borne out by the on-going fiscal operations in the country. Total revenues of the Federal Government consist not only of tax revenues net of transfers, but also of non-tax revenues. The latter are retained, more or less, completely by the Federal Government, excluding some small straight transfers.

Consequently, total revenues of the Federal Government are adequate not only to finance the cost of debt servicing but also defence expenditure and a part of other costs of running the affairs at the Federal level. For example, in 2016-17 the net revenue receipts of the Federal Government were Rs 2583 billion. The combined outlay on debt servicing and defence was Rs 2237 billion. This left a surplus of Rs 347 billion to meet other expenditures.

There is also the wrong perception that the 7th NFC Award raised the Provincial share in the net divisible pool too much. It is 57.5 percent currently since 2014-15, which should have been the last year of the Award. The previous ad-hoc dispensation, as per the 2006 Presidential order, had built in a share of 46.25 percent. However, the commitment for making grants to Provincial Governments was significantly higher than subsequently in the 7th NFC Award. The target was to raise the share to 50 percent through grants.

What has, in fact, been the overall trend in transfers combined from the divisible pool, straight transfers and grants, as a percentage of total Federal revenues, tax and non-tax? In the benchmark year, 2009-10, prior to the operation of the 7th NFC Award, the share was 38 percent. Following the Award, the share jumped up to almost 50 percent in 2010-11. However, by 2016-17, it has fallen to 44 percent.

Why has the share declined so much during the tenure of the 7th NFC Award? First, the share of grants to Provincial Governments has fallen from 3.3 percent of Federal revenues in 2010-11 to only 0.7 percent in 2016-17. Second, the Federal Government has developed revenue sources outside the Divisible Pool. The Petroleum Levy is in the nature of a 'carbon tax'. It could have been introduced as an excise duty and shared with the Provinces. This was not the case. Similarly, revenues from the Gas Infrastructure Development Cess accrue completely to the Federal Government. Therefore, the Federal Government has found some ways of reducing the extent of pre-emption of its tax revenues by the Provincial Governments.

There is need also to focus on the size of the Federal budget deficit. Last year, as observed by the Advisor, it was close to 6 percent of the GDP. The reason for such a large deficit is attributable more to the failure of the Federal Government to mobilize more resources and reduce expenditure by handing functions which had been transferred to the Provincial Governments following the 18th Amendment.

Paragraph 9(3) of the Presidential Order on the 7th NFC Award states that the Federal Government and Provincial Governments should streamline their tax collection systems to reduce leakages and increase their efforts to achieve tax-to-GDP ratio of 15 percent by the terminal year, 2014-15. The actual ratio was significantly lower at 11 percent of the GDP in 2014-15, implying a big short fall of 4 percent of the GDP. From 2009-10 to 2014-15, Federal tax revenues increased annually by 14 percent whereas Provincial tax revenues showed significantly faster increase of 27 percent annually, especially after the levy of the sales tax on services. As such, the Federal fiscal effort has been disappointing, contributing thereby to a larger deficit. In fact, the NFC Secretariat in the Federal Ministry of Finance projected earlier that the Federal fiscal deficit should have come down to 4 percent of the GDP by 2014-15.

Further, the Federal encroachment of Provincial functions has increased the size of its budget. As highlighted in the previous Chapter, there are as many as 42 Divisions in the Federal Government, many of which are contrary to the spirit of the 18th Amendment. Further, development programs in the domain of health, population planning, higher education, etc., should ideally have been handed over to the Provinces after the Constitutional amendment. On top of this many of the so-called 'Special Programs', like on the SDGs, should be the joint responsibility of both levels of Government.

Finally, there is need to compare the two Federations of India and Pakistan, which have a common history going back to the Government of India Act of 1935. Sub-national Governments are much larger in relation to the Union/Federal Government in India. The former undertake 58 percent of the public expenditure and pre-empt, more or less, the same percentage of national tax collections. Revenues from the sales tax on goods accrue completely to State Governments in India. The corresponding share in expenditure of Provincial Governments in Pakistan is 39 percent, while the share in tax revenues is much smaller at only 9 percent. Also, the State Governments in India engage in large borrowing. In Pakistan, budgets of the Provincial Governments are generally balanced. During the tenure of the last IMF program they actually generated large cash surpluses. This helped in limiting the size of the consolidated fiscal deficit.

The difference between the two Federations has had basic implications on the spending on human development. Expenditures on health and education are primarily incurred at the State/Provincial level. In India, the combined spending on these two services is over 5 percent of the GDP, whereas in Pakistan it is significantly lower at 3 percent of the GDP. This clearly establishes the case for larger transfers to Provincial Governments in Pakistan.

In conclusion, there is a need to avoid undue criticism of the 7th NFC Award. In fact, a successor Award has been pending for four years now. A new Award needs to be negotiated. According to Article 160(3A) of the Constitution the share of the Provinces cannot be reduced in the divisible pool of taxes. However, there is a strong case for agreement on transfer of functions and financial responsibility to the Provincial Governments in line with the 18th Amendment. This will not only imply a larger role and more autonomy to Provincial Governments but also lead to some downsizing of the Federal Government.

30.5. THE 9TH NFC

The Terms of Reference for the 9th NFC are as under:-

a) Distribution between the Federation and the Provinces of the net proceeds of the following taxes:

   1) Taxes on income, including corporation tax, but: not including taxes on income consisting of remuneration paid out of the Federal Consolidated Fund;

   2) Taxes on the sales and purchases of goods imported, exported, produced, manufactured or consumed;

   3) Export duties on cotton, and such other export duties as may be specified by the President;

   4) Such duties of excise as may be specified by the President; and

   5) Such other taxes as may be specified by the President.

b) Making of grants-in-aid by the Federal Government to the Provincial Governments;

c) Exercise by the Federal Government and the Provincial Governments of the borrowing powers conferred b y the Constitution; and

d) Assessment and Allocation of resources to meet expenditures related to Azad Government on the States of Jammu and Kashmir, Gilgit-Baltistan, FATA, Natural Disasters and terrorism etc.

e) Any other matter relating to finance referred to the Commission by the President.

One of the reasons for delay was the absence of a recent Population Census. Fortunately, a Census was undertaken in 2017 and provisional results have become available.

The other problem is the absence of reliable and up-to-date data on the horizontal criteria at the Provincial level. Clearly, the NFC Secretariat should have realized that more recent data is required for determining fairly the Provincial shares in different criteria. During the intervening period of five years up to the setting of the 9th NFC, more surveys ought to have been commissioned, possibly with the help of international partners. The poverty numbers are still subject to controversy and have been updated only up to 2014-15. Application of the horizontal criteria by the 9th NFC will be a major contentious issue in the absence of more recent and reliable data.

Clause (d) of the terms of reference is also potentially contentious in nature. Federally administered and autonomous areas are the financial responsibility of the Federal Government. The Provinces may not be willing to share in the discharge of this function. Fortunately, FATA has recently been merged into the Province of Khyber-Pakhtunkhwa and will be henceforth covered in NFC awards.

In the previous Award, the Federal Government and Province of Punjab demonstrated some flexibility and accepted a big loss in their respective shares. This time, hopefully, the other Provinces will also show some spirit of accommodation. This is essential if Pakistan is to move further in the process of fiscal decentralization and thereby strengthen the Federation. Following the induction of new Government after the elections in July 2018, the 9th NFC will need to be convened to start the process of deliberation on a new Award.

SECTION 11

SOCIAL DEVELOPMENT

Chapter 31:

PROGRESS IN HUMAN DEVELOPMENT

The previous Chapters have highlighted the path breaking steps for stronger fiscal federalism taken by enactment of the 18th Amendment to the Constitution and the 7th NFC Award. The 18th Amendment passed on more functions and the 7th NFC award ensured a larger transfer of resources to the Provincial Governments from the Federal Government.

These major developments held out the prospect for faster progress in the provision of social services, as services like education, health, water supply and sanitation are the prime responsibility of Provincial Governments. Consequently, it was anticipated that human development of the people of Pakistan would also proceed at a faster place.

The objective of this Chapter is to explore if the optimism emanating from the reforms mentioned above has been justified or not. In particular, the rate of change pre-and post-reforms is quantified for the key human development / social indicators.

Section 1 of the Chapter presents the trend in the indicators. Section 2 quantifies the increase in the allocation of public resources to social services. Section 3 then investigates the respective roles of the public and private sectors. Sector 4 examines the provision of key inputs into these services. Finally, Section 5 makes an overall assessment of the impact of different factors on the rate of progress achieved.

31.1. RATE OF PROGRESS IN KEY INDICATORS

The most commonly used and summary index is the Human Development Index produced annually by the UNDP. This index has three components – education, health and per capita income. The growth rate in these components is given in Table 31.1 for different sub-periods.

Table 31.1: Trend in the Growth Rate of HDI and of Per Capita Income, 1990 to 2015 – (%)

	HDI	Education and Health	Per Capita Income
1990-1995	0.9	0.0	2.6
1995-2000	1.3	0.9	1.6
2000-2005	1.7	1.0	2.6
2005-2010	1.4	1.0	1.8
2010-2015	0.9	0.5	1.3

Source: UNDP, GHDR

There is, in fact, likely to be a two-way relationship between the education and health status of the population and the income level. The former makes for a more productive labor force. Higher income leading to more tax revenues in turn enables higher expansion in the coverage of social services.

The existence of such a relationship is demonstrated in the period, 2000-2005, when both the annual growth rates of the combined education and health index and per capita income showed the fastest growth. As opposed to this the slowest rate of progress is observed in the latest period, 2010-2015. This is the fundamental finding that the pace of improvement in human development has not improved after 2010.

The trend in the level and absolute rate of change in individual key social indicators is presented in Table 31.2. Two periods have been identified. The first is from 2003 to 2010, prior to the 18th Amendment and the 7th NFC Award. The second period is from 2010 to 2016 following these developments. More recent data is generally not available.

Table 31.2: Trend in Key Social Indicators, 2003 to 2016

	2003	2010	Annual Change 2003-2010	2016	Annual Change 2010-2016
EDUCATION					
Literacy Rate, Adult (15 + years) (%)	49.9[a]	55.4	2.1	57.0[b]	0.7
Net Enrollment Rate, Primary Level (%)	60.9	74.4	2.9	77.8	0.7
Net Enrollment Rate, Secondary Level (%)	31.8[c]	36.2	3.2	45.5[d]	3.8
HEALTH					
Life Expectancy (years)	63.4	65.1	0.4	66.5	0.4
Infant Mortality per 10,000, up to 5 years	105.7	92.1	1.9	78.8	-2.6

[a]2005 | [b]2014 | [c]2006 | [d]2016

Source: World Bank, World Development Indicators

The findings are mixed in nature. The rate of increase in the literacy rate and in the net primary enrollment rate was visibly higher in the earlier period, 2003 to 2010. As opposed to this, the increase in the net secondary enrollment rate and the reduction in the infant mortality rate is more pronounced in recent years from 2010 to 2016. The rate of improvement in life expectancy has remained, more or less, unchanged over the entire period. The next section examines the overall allocation and to different social services since 2003.

31.2. PUBLIC SPENDING ON SOCIAL SERVICES

The trend in total public expenditure on social services is given in Table 31.3. There are clear indications that the outlays by the Federal and Provincial Governments have gone up since 2009-10, following the 7th NFC Award. In 2009-10, the total expenditure was 2.54 percent of the GDP. This had increased to 3.43 percent of the GDP by 2016-17.

Table 31.3: Total Public Expenditure on Education, Health, Water Supply and Sanitation, 2007-08 to 2016-17 – (Rs in Billion)

Years	[Federal and Provincial Governments Combined]					
	Education	Percentage of GDP	Health	Percentage of GDP	Water Supply and Sanitation	Percentage of GDP
2007-08	187.6	1.76	62.4	0.59	19.5	0.18
2009-10	259.5	1.74	94.3	0.63	25.5	0.17
2016-17	699.2	2.18	329.0	1.02	72.0	0.23

Source: MOF, PRSP Progress Reports

However, it is important to realize that the level of spending on social services is relatively low in Pakistan, as compared to other South Asian and developing countries in East Asia. Table 31.4 gives the health expenditure, both public and private, as a percentage of the GDP in selected Asian countries while only public expenditure is reported in the case of education. The Human Development Index of each country is also given in the Table 31.4.

Pakistan has the lowest level of spending in health and the second lowest (higher than Bangladesh) in education among the selected countries. Consequently, it is not surprising that Pakistan has the lowest HDI among these countries. Clearly, the country will have to accord much higher priority to public spending to social services.

Table 31.4: Social Sector Spending in Selected Countries, 2016 – (% of GDP)

	Expenditure on Education	Expenditure on Health	Human Development Index
SOUTH ASIA			
Bangladesh	2.5	2.6	0.608
India	3.8	3.9	0.640
Nepal	3.7	6.1	0.574
Sri Lanka	3.5	3.0	0.770
Pakistan	**2.8**	**2.7**	**0.562**
OTHERS			
Indonesia	3.6	3.3	0.694
Malaysia	4.8	4.0	0.803
Thailand	4.1	3.8	0.755
Philippines	n.a	4.4	0.699

Source: UNDP

The combined expenditure on all social services, including education, health and water supply and sanitation, by the four Provincial Governments is given in Table 31.5. Federal spending is primarily in Islamabad Capital Territory and FATA. Also, public universities are managed and financed by the Federal Government.

Social Sector expenditure has taken a larger share of Provincial budgets, with the share rising from 29 percent in 2002-03 to over 36 percent by 2016-17.

Contrary to perceptions, the growth rate of real expenditure on social services was actually faster at 11 percent prior to the NFC Award, then after 2009-10, of 9 percent. This is attributable to the faster growth of total real expenditure in the earlier period, due to faster growth in transfers to Provincial Governments resulting from more buoyancy in Federal divisible pool of taxes caused by the greater dynamism in the national economy.

Table 31.5: Total Expenditure, Nominal and Real*, on Social Services [by the Four Provincial Governments Combined], 2002-03 to 2016-17 – (Rs in Billion)

	2002-03	2009-10	2016-17
Total Expenditure (Nominal)	259	905	2591
Expenditure on Social Services (Nominal)	76	309	943
Share of Social Services (%)	29.3	34.1	36.4
Expenditure on Social Services (Real)	76	161	299
Growth Rate (%)	-	10.7	8.8

Source: MOF, PRSP Progress Reports

Table 31.6 presents the share of the total social sector expenditure devoted to different services and the respective growth rates in real expenditures. The share of total expenditure devoted to education has actually declined sharply from 75 percent in 2002-03 to less than 63 percent by 2016-17. Consequently, the growth rate has fallen from 9.5 percent to 7.5 percent in the latter period.

Table 31.6: Share of each Service in Total Expenditure on Social Services and Growth in Real Expenditure, 2002-03 to 2016-17 – (Rs in Billion)

	2002-03	2009-10	2016-17
EDUCATION			
Share (%)	75.0	68.9	62.7
Expenditure (Real)	57	107	187
Growth Rate (%)	-	9.5	7.5
HEALTH			
Share (%)	21.1	23.0	29.9
Expenditure (Real)	16	37	89
Growth Rate (%)	-	12.0	12.5
WATER SUPPLY AND SANITATION			
Share (%)	3.9	8.1	7.4
Expenditure (Real)	3	13	22
Growth Rate (%)	-	22.6	7.5

Source: MOF, PRSP Annual Reports

The biggest gain in share is of health expenditure from 21 percent in 2002-03 to 30 percent in 2016-17 and the growth rate in spending has also increased. Similarly, the share of water supply and sanitation increased up to 2009-10 but has since fallen. Education expenditure has been declining in importance. The share has fallen from 75 percent to 63 percent and the growth rate has been lower in the post-7th NFC period.

The trends in expenditure are consistent with the rates of progress in social indicators. The fall in priority in education on the part of Provincial Governments is one of the major explanations for the loss of momentum in the enhancement of literacy in the country. This is explored further by allocations of funds to different levels of education, shown in Table 31.7. There are clear indications that the priority for primary and early secondary education has been prematurely reduced in Pakistan. The share of expenditure on the primary level of education has fallen sharply from 51 percent to 39 percent. This has happened at a time when as many as 22.8 million children are out of school due largely to a low net enrollment rate of 78 percent at the primary level.

Table 31.7: Share of Different Levels of Education in the total Education Expenditure, 2002-03 to 2016-17 – (%)

	2002-03	2009-10	2016-17
PRIMARY			
Share (%)	50.9	39.0	38.0
Annual Growth Rate[a]	-	5.7	7.5
SECONDARY			
Share (%)	28.1	28.2	33.7
Annual Growth Rate[a]	-	9.5	10.1
HIGHER[b]			
Share (%)	21.0	32.8	27.4
Annual Growth Rate[a]	-	25.2	12.0

[a]in real terms | [b]College and University

Source: MOF, PRSP Annual Reports

Turning to public expenditure on health the changing priorities between curative and preventive health are highlighted in Table 31.8. The dominant part of health expenditure is taken up by curative health services in the form of public hospitals and clinics. The worrying finding is the extremely low share of preventive health programs like mother and child care services (pre- and post-natal), immunization, etc. Given the externalities from such services, the maximum social benefits are likely to accrue from outlays on preventive health services.

Table 31.8: Share of Different Types of Health Expenditure in Total Health Expenditure, 2002-03 to 2016-17 – (%)

	2002-03	2009-10	2016-17
CURATIVE			
Share (%)	71.7	73.5	74.0
Annual Growth Rate[a]	-	10.6	9.7
PREVENTIVE			
Share (%)	15.1	15.7	8.2
Annual Growth Rate	-	10.8	0.2
OTHER[b]			
Share (%)	13.2	10.9	17.8
Annual Growth Rate[a]	-	7.4	16.7

[a]in real terms | [b]medical education, health insurance, etc.

Source: MOF, PRSP Annual Reports

This low priority is reflected in the fact that as much as 22 percent of the children are not fully immunized and 71 percent of the mothers do not get the benefits of post-natal consultation.

Further, the low allocations of public funds for water supply and sanitation have created shortages of clean water especially in the urban areas and even more so in the large metropolitan cities. In Karachi, for example, there is a flourishing black market for water and severe shortage of drinking water in poor neighborhoods.

The low priority attached to primary education, preventive health and drinking water is a reflection of the political economy of public expenditure allocations within social services. The urban middle class is the most organized and vocal group. Their preferences are for larger and better coverage of secondary and higher education and for access to public hospitals with adequate medical services.

31.3. PUBLIC VERSUS PRIVATE PROVISION

The private sector has taken on an increasing role in the provision of social services. This is partly in response to the poor coverage of public services, especially in the rural areas, and partly because of rising levels of affordability for higher quality services.

The shares of the public and private sectors respectively in school enrollments are presented in Table 31.9. The share of the private sector in enrollment has expanded rapidly, particularly in middle schools and high schools, with shares of 42 percent and 37 percent respectively by 2016-17.

Table 31.9: Share of Public and Private Schools in Enrollment, 2002-03 to 2016-17 – (%)

	2002-03	2009-10	2016-17
PRIMARY			
Public	68.2	81.1	87.5
Private	31.8	18.9	22.5
MIDDLE			
Public	74.4	67.8	58.0
Private	25.6	32.2	42.0
HIGH			
Public	78.2	69.6	63.0
Private	21.8	30.4	37.0

Source: AEPAM, Pakistan Education Statistics

There are a number of issues with regard to the emergence of the private schooling system. First, this has increasingly led to a 'dualistic' education system, with a wide gap in the quality of education provided by public versus private schools. This, is in effect perpetuating social and economic inequalities.

Second, at the lower end of private schools there is still a problem of adequate quality. This is the case especially in rural areas. Also, many of the private schools catering for a relatively rich clientele have engaged in semi-monopolistic behavior by charging high fees and escalating them rapidly. There is, therefore, a need for an effective agency in each Province for performing the function of regulating private schools. One of the pre-requisites should be the establishment of a system of scholarships for relatively poor but meritorious children. The Supreme Court has passed a judgement recently whereby elite private schools charging fees of over Rs 5000 per month must reduce them by 20 percent.

Turning to the curative health system in Pakistan and the role of the private sector, useful information is available in the National Health Accounts prepared periodically by the PBS. The relevant information is summarized in Table 31.10.

Table 31.10: National Health Accounts of Pakistan, 2007-08 to 2015-16 – (Rs in Billion)

	Public	Private	Other	Total
2015-16				
General Hospitals	251.9	42.8	17.0	311.7
Ambulatory Health Care	-	174.5	-	174.5
Health Administration	26.1	-	-	26.1
TOTAL	**278.0** **(54.3)***	**217.3** **(42.4)**	**17.0** **(3.3)**	**512.3** **(100.0)**
(growth %)	*14.3*	*9.3*	*9.1*	*11.8*
2007-08				
General Hospitals	73.3	20.4	8.2	101.9
Ambulatory Health Care	-	82.9	-	82.9
Health Administration	15.1	-	-	15.1
TOTAL	**88.4** **(44.2)**	**103.3** **(51.7)**	**8.2** **(4.1)**	**199.9** **(100.0)**

*share
Source: PBS

The health system, pre-dominantly on the curative side, had the size of Rs 512 billion in 2015-16, equivalent to 1.8 percent of the GDP. The share of the public sector is 54 percent and that of the private sector is 42 percent. The remainder, close to 4 percent, is the service provided largely by NGOs.

As expected, the public service provision is largely through hospitals, with a dominant share of over 80 percent. The private sector specializes in ambulatory healthcare. This is primarily outpatient services, including diagnosis, observation, consultation and testing services.

A perhaps unexpected finding is the fast growth in health services provided by the public sector between 2007-08 and 2015-16 of 14 percent versus the growth in the private sector annually of 9 percent. Nevertheless, there are a large number of complaints about long queues and lack of beds and medicines in Government hospitals. The electronic media has vividly highlighted these problems.

31.4. EFFICIENCY IN PUBLIC EXPENDITURE

The chronic problem of low quality of public schools in terms of provision of basic facilities like furniture, labs, library, latrines, drinking water and playgrounds has frequently been highlighted. In addition there is a strong perception of poor quality of teachers, rampant absenteeism and even 'ghost teachers'.

An effort has been made here to develop an indicator of efficiency of the public schooling system. This is measured as:

$$g_e = g_r / (\alpha_1 g_t + \alpha_2 g_s) \ldots \ldots \ldots \ldots [1]$$

where g_e is the indicator of the change in the level of and efficiency. In particular, if g_e is less than 1, then this indicates that the growth in inputs (teachers, g_t, and schools, g_s) is not matched by a corresponding increase in enrollments, g_r. Earlier research AERC [1977] on education production functions reveals that α_1 and α_2 are approximately equal to 0.6 and 0.4 respectively. This research has been undertaken for the period, 2009-10 to 2016-17.

The magnitude of the output and input growth rates and their ratios are presented in Table 31.11 for both the public and private schools. There are two important findings from Table 31.11. Perhaps surprisingly, the efficiency ratio of public schools was generally higher than private schools in the earlier period but lower in the latter period, 2009-10 to 2016-17. Second, there has been a sharp decline in the efficiency ratio of public schools after 2009-10, particularly in the case of middle and high schools.

Table 31.11: Measure of Efficiency of the Schooling Systems, 2002-03 to 2016-17 – (%)

	Public Schools			Private Schools		
	g_r	g_i^*	g_e	g_r	g_i^*	g_e
PRIMARY						
2002-03 to 2009-10	-0.4	0.1	-4.0	-0.1	0.7	-7.0
2009-10 to 2016-17	-0.5	-0.5	1.0	5.2	2.4	2.2
MIDDLE						
2002-03 to 2009-10	3.5	1.5	2.3	7.8	7.8	1.0
2009-10 to 2016-17	1.2	1.2	1.0	5.3	5.0	1.1
HIGH						
2002-03 to 2009-10	5.3	1.4	3.8	10.5	9.8	1.1
2009-10 to 2016-17	3.2	3.8	0.8	5.6	5.0	1.1

*$g_i = (\alpha_1 g_t + \alpha_2 g_t)$

SPDC [2010] and Ismail [2007] have found the explanation for the declining efficiency of public schools in the system of governance. From 2002 to 2008, public schools were run by elected District Governments set up during the tenure of the Musharraf Government. After 2008, management of schools has reverted back to the Provincial Line Departments, with the solitary exception of Khyber-Pakhtunkhwa. The District Governments were given adequate financial resources under the PFC Awards. They also had autonomy and a modicum of institutional capacity. Consequently, school managements and teachers were subject to a greater deal of accountability at the local level. In fact, in many districts school management committees were established with representation from parents. Now, the system has reverted back to much less regulation and oversight. 'Ghost teachers' and teacher absenteeism have become more prevalent.

In conclusion, the story of Pakistan is one of failure in human development. Today, the country ranks behind other South Asian countries in the HDI. This has been the consequence of relatively low allocations of public resources to social sectors, wrong expenditure priorities within each service and the falling efficiency in service provision due largely to a deterioration in the quality of governance.

Chapter 32:

MEETING THE SDGs

The period for meeting the Millennium Development Goals (MDGs) set by the United Nations came to an end in 2015. They were in operation for fifteen years from 2000 onwards. There were eight goals in the MDGs, ranging from the halving of poverty to halting the spread of HIV/AIDs and providing universal primary education.

The MDGs were unanimously supported by all countries and by all the international development institutions. Goal 8 involved a global partnership for development. Developed countries made a commitment to give overseas development assistance (ODA) to developing countries, especially the least developed, of 0.7 percent of their Gross National Incomes. Unfortunately, one of the big failures of the MDGs was that this target was not met.

The MDGs were quickly succeeded through another UN resolution in 2016 by the Sustainable Development Goals (SDGs). The benchmark year for the SDGs is 2015. The new set of targets are to be achieved by 2030. The SDGs are substantially more ambitious and more diverse than the MDGs. The number of goals has been expanded from eight to seventeen. They include focus on environmental sustainability, industry and employment, reduction in income inequality, strengthening of institutions, etc. There are now as many as 169 targets.

The Chapter first reviews Pakistan's performance on the MDGs. Section 2 describes the SDGs and prioritizes them in the Pakistani context. Section 3 then assesses the extent to which Pakistan will have to improve on its historical performance to come close to achieving the key targets by 2030. Section 4 describes the kind of strategy, policies and institutional arrangements which will need to be put in place, with the support of development partners, to facilitate the achievement of the targets.

32.1. PERFORMANCE ON THE MDGs

Pakistan performed relatively poorly on most MDGs. According to the UNDP [2016] the country achieved less than most other South Asian countries. Table 32.1 presents estimates of the extent to which Pakistan achieved the MDG targets, especially in education and health.

Table 32.1: Pakistan's Performance on the MDGs, 1990 to 2015

Indicators	Benchmark (Year 1990 Value)	Actual 2015	Target	% of the Required Increase Achieved
EDUCATION				
Net Primary Enrollment Ratio (%)	46	57	100	20.4
Literacy Rate (%)	35	60	88	47.2
Gender Parity Index (GPI):				
Primary Education	0.73	0.88	1	55.5
Secondary Education	0.76	0.87	0.94	61.1
Youth Literacy GPI	0.51	0.82	1	63.3
HEALTH				
% of Children fully Immunized	75	82	> 90	46.7
% of Children Immunized against Measles	80	83	> 90	30.0
% of births with Skilled Attendants	18	58	> 90	55.5
WATER SUPPLY AND SANITATION				
% of population with access to Improved Water Source	53	86	93	82.5
% of population with access to Sanitation	30	73	90	71.7

Source: PBS, PS & LSMS

Pakistan did not achieve any of the targets given in Table 32.1 in education, health and water supply and sanitation. However, the performance was relatively better in increasing access to an improved water source and sanitation and the weakest in the area of education.

There is an interesting contradiction. While Pakistan did poorly on the MDGs relating to access to basic social services, it apparently performed exceptionally well in reducing poverty. The target was to reduce the incidence of poverty by half from 1990 to 2015. Based on the World Bank poverty line of $1.90 PPP per day, Pakistan was apparently able to bring the percentage of poor population from 58 percent in 1990 to as low as 6 percent in 2015.

32.2. THE SDGs

The seventeen SDGs are listed along with the earlier eight MDGs in Table 32.2. Some of the goals are, more or less, the same. However, there is focus also on energy, decent work, economic growth, industry, infrastructure, innovation, environmental sustainability, climate action and on peace, justice and institutions.

Each of the seventeen goals has a set of targets. This ranges from as many as 13 targets in Goal 3 relating to Good Health and Well-being to five targets each in the case of Goals 7 and 13 on Affordable and Clean Energy and Climate Action respectively. Altogether, there are 169 targets.

Table 32.2: The MDGs and SDGs Goals

MDGs	
Goal 1:	Eradicate Extreme Poverty and Hunger
Goal 2:	Achieve Universal Primary Education
Goal 3:	Promote Gender Inequality and Empower Women
Goal 4:	Reduce Child Mortality
Goal 5:	Improve Maternal Health
Goal 6:	Combating HIV / AIDs, Malaria and other Diseases
Goal 7:	Ensure Environmental Sustainability
Goal 8:	Develop a Global Partnership for Development
SDGs	
Goal 1:	No Poverty
Goal 2:	Zero Hunger
Goal 3:	Good Health and Well-Being
Goal 4:	Quality Education
Goal 5:	Gender Equality
Goal 6:	Clean Water and Sanitation
Goal 7:	Affordable and Clean Energy
Goal 8:	Decent Work and Economic Growth
Goal 9:	Industry, Innovation and Infrastructure
Goal 10:	Reduced Inequalities
Goal 11:	Sustainable Cities and Communities
Goal 12:	Disposable Consumption and Production
Goal 13:	Climate Action
Goal 14:	Life below Water
Goal 15:	Life on Land
Goal 16:	Peace, Justice and Strong Institutions
Goal 17:	Partnerships for the Goals

Source: UNDP

32.3. THE KEY SDGs

Seventeen Goals and 169 Targets are definitely too ambitious and well beyond the financial and institutional capacity of most developing countries to achieve. Therefore, there is need to identify fewer targets which can be attached greater priority within the SDGs.

A number of criteria have been used to identify the key targets in the Pakistani context. These criteria are listed below. A selected target should fulfill one or more of these criteria:

(i) Essential for implementing a strategy of inclusive and sustainable growth.

(ii) Included in the earlier MDGs to provide a continuity in the commitment to achievement of targets.

(iii) Already embedded as a target in national planning.

(iv) History of cooperation in the area with international development institutions like the UN Agencies, World Bank, Asian Development Bank and bilateral aid-giving institutions in achieving the target.

(v) Where data is available frequently to monitor progress in the achievement of the target.

(vi) Has the appeal and attraction for wider participation of people, non-governmental organizations and media in achievement of the target.

Based on the above criteria, 24 targets have been selected from the seventeen Goals. These are listed below along with the benchmark and terminal year magnitudes in 2015 and 2030 and the source of information for monitoring the progress.

Goal 1: The chosen target is to reduce the incidence of poverty by half. This is estimated at 39 percent in 2015 according to the Planning Commission. As such, this should be reduced to less than 20 percent by 2030. Annual estimates are usually given in the Chapter on Poverty in the Pakistan Economic Survey.

Goal 2: The target is to achieve by 2030 the internationally agreed levels of stunting and wasting of children. This information is available in the National Nutrition Surveys carried out by the Institute of Population Studies.

Goal 3: There are two targets. The first is to reduce under-5-mortality at 79 per 1000 in 2015 to 25 per 1000 by 2030. Information is available in the World Development Indicators of the World Bank. The second relates to ending the incidence of HIV/AIDS, Malaria and Tuberculosis. Special surveys will have to be designed to determine the extent of success.

Goal 4: A key target is achievement of universal primary and secondary education for both boys and girls. This has also been emphasized in the Constitution of Pakistan. Information on enrollment rates is available in the annual publication, Pakistan Education Statistics, brought out by the Academy of Educational Planning and Management (AEPAM). Also, Surveys on Living Standards and Social Measurement (LSSM) are carried out periodically by PBS.

Goal 5: The target is to eliminate discrimination, gender based violence and promote gender equality. Information is available in the LSSM Survey and Labor Force Survey of PBS. The target is achieve a Gender Parity Index (GPI) of 1 in school enrollment and labor force participation rates. Data on gender based violence is collected by NGOs.

Goal 6: The targets here are of vital importance to the people of Pakistan given the projection that the country will be characterized as 'water scarce' if priority is not given to achieving the targets in this Goal.

The first target is to achieve by 2030 universal and equitable access to safe and affordable water for all. Information on access to improved water source is available in the LSSM Survey. The second target is to substantially increase water use efficiency through proper water resource management. The target must be to double the availability of water for agriculture and simultaneously double the value added per Acre Foot of Water. The relevant information is available in the publication on Environment Statistics of PBS.

Goal 7: By 2030, ensure universal access to affordable and reliable energy services. The NEPRA State of industry Report and the LSSM have the relevant information. By 2030, another target is to increase substantially the share of renewable energy. This is also available in the NEPRA Reports.

Goal 8: Achieve 7 percent GDP Growth. The PES has the estimates. By 2020, reduce the number of 'idle' youth. This number can be derived from the Labor Force Surveys of PBS.

Goal 9: Double the share of national employment in industry. This information is also contained in the Labor Force Surveys.

Goal 10: Progressively achieve and sustain the income growth of the bottom 40 percent of the population at a rate higher than the national average. The relevant information is available in the Household Integrated Economic Survey of PBS.

Goal 11: By 2030, ensure access to safe and affordable housing and basic services and upgrade slums. The required information is contained in the LSSM.

Goal 12: No targets.

Goal 13: Strengthen capacity to manage climate-related hazards and natural disasters. Integrate climate change measures into national policies, strategies and planning

Goal 14: By 2020 sustainably manage and protect marine and coastal ecosystems.

Goal 15: By 2020 protect inland fresh water ecosystems and forests

Goal 16: Ensure equal justice for all. Develop accountable and transparent institutions. Substantially reduce corruption and bribery.

Goal 17: (i) Strengthen domestic resource mobilization, especially taxation. This information is contained in the database on Fiscal Operations with MOF. (ii) Doubling the share of developing countries in Global trade by 2020. The relevant trends are available in the WTO, International Trade Statistics. (iii) Developed countries to achieve target of 0.7 percent of ODA/GNI. OECD monitors these trends.

32.4. REQUIRED RATE OF PEFORMANCE

The process of estimation of the required rate of performance has been carried out on a selective basis of ten targets. This will also help in accessing the feasibility of the targets. Evaluation of the required rate of performance in relation to the historical progress annually is presented in Table 32.3. This leads to the following conclusions:

(i) In three targets, the historical rate is, in fact, higher than the required rate. These are incidence of poverty, gender parity index in primary education and access to safe drinking water. As such, these targets can be considered as highly achievable.

(ii) Some targets have required rates that are substantially higher than the historical rates of performance and are, therefore, considered as difficult to achieve. These include under-5 mortality at 176 percent, achievement of 7 percent growth at 146 percent and tax-to-GDP ratio at 167 percent.

(iii) Some targets appear to be infeasible in the Pakistan setting. These include net primary enrollment ratio, share of renewable energy and share of employment in industry and safe shelter. As such more modest targets may be set in these cases.

32.5. STRATEGIES, POLICIES AND INSTITUTIONS

Amidst the incipient financial crisis that Pakistan finds itself today contemporary issues are for more short-run improvements than focusing of targets to be attained many years down the road. There is, in fact, the risk that attainment of sustainable and inclusive growth will be sacrificed at the altar of economic stabilization. The process of adjustment may have a disproportionately negative impact on the incidence poverty.

Table 32.3: Required Rate versus Historical Rate of Performance on Targets

Targets	Actual		Historical Rate of Change (Action) [1]	Target 2030	Required Rate of Change (Annual) [2]	Ratio [2] / [1] (%)
	2000	2015				
Incidence of Poverty (%)	55.2[a]	38.8	1.6	19.4	1.3	81
Under-5 Mortality (per 1000)	112.8	81.0	2.1	25	3.7	176
Net Enrolment Rate[b]: Primary	54.2	57.0	0.2	100	2.9	α[c]
Gender Parity Index in Primary Education	0.72	0.87	0.010	1	0.009	90
Access to Safe Drinking Water (%)	69	86	1.1	100	0.9	82
Share of Renewable Energy (%)	0	2	0.13	10	0.53	408
Achieve 7 percent Growth (%)	-	-	4.8	7.0	-	146
Share of Employment in Industry (%)	18.0	23.6	0.37	47.2	1.57	424
% of Pucca[d] Housing Units	87.8	79.1	Negative	100.0	-	n.a.
Tax to GDP Ratio	9.0	12.0	0.20	17.0	0.33	157

[a] As of 2005 | [b] for boys and girls combined | [c] very high, not feasible | [d] housing with cement or brick walls

Source: PBS, PS& LSMS | World Bank, World Development indicators | NEPRA, State of Industry Report
PBS, Labor Force Survey | MOF, Fiscal Operations

However, some critical minimum steps may still be undertaken. First, a national SDGs unit should be established with UN support in the Planning Commission. This unit will monitor the movement of the key SDG indicators. It will also coordinate the flow of assistance from international multilateral and bilateral agencies for attaining the SDGs.

Many of the services related to the SDGs are provided by the Provincial Governments in Pakistan, especially after the 18^{th} Amendment. As such, SDG Units need to be established in the Planning and Development Departments of each Province, to perform similar functions similar to the national SDG unit. There should be vertical integration between these units.

One target which can make a significant contribution both to the short-run stabilization process as well as the long-run attainment of the SDGs is the enhancement of the tax-to-GDP ratio. Based on the 7^{th} NFC transfer formula this will transfer additional resource and enable them to achieve more in the domain of SDG-related services like education, health, housing, water supply and sanitation.

Chapter 33:

INEQUALITY IN ACCESS TO SERVICES

The focus up to now in the literature has been on the inequality in income and wealth among households. There is need to be complement this analysis with the differentials among households in access to education, health and residential services. An example of why this is necessary is that of a child in a poor family who is unable to go to school. This means that on growing up the only possible employment is low paid unskilled work. The consequence is the intergenerational transfer of poverty. Similarly, an undernourished and disease prone child will probably remain stunted and relatively weak even after growing up and unable to do hard physical work, thereby reducing the ability to earn higher income.

This chapter quantifies the differentials in access to basic services among households in different income quintiles of the population. Section 1 highlights the source of data. Section 2 develops a summary measure for quantifying the extent of inequality in access to a particular service. Section 3 presents the inequality in education; Section 4 in health and Section 5 in residential services.

The second part of the Chapter presents a summary index of access to social and economic services. This is quantified for the population of each Province, separately for urban and rural areas. This enables an assessment as to whether the process of fiscal equalization carried forward substantially by the 7th NFC Award is also leading to more equalization in the coverage of services among the Provinces.

33.1. SOURCE OF DATA

The Pakistan Social and Living Standards Measurement Survey (PSLSMS) of 2011-12 carried out by the Pakistan Bureau of Statistics (PBS) is unique in that perhaps for the first time information on access to different services by income quintile of households was given. The sample size of the survey was 17056 households, who were identified on the basis of a regionally stratified random sampling approach. The number of urban households in the sample was 7248 and the number from rural areas was 9809. There is need to recognize the efforts of PBS for providing this valuable and unique information.

33.2. MEASURE OF INEQUALITY

This measure is developed as follows:

n_i = percentage in the ith quintile having access to a service

then $100 - n_i$ = percentage without access

Then the overall lack of access, LA, of the population is given by

$$LA = \frac{1}{5}\sum_{i=1}^{i=5}(100 - n_i) \qquad \ldots \ldots \ldots [1]$$

The share of the ith quintile in overall percentage of population without access is

$$S_i = \frac{(100 - n_i)}{\sum_{i=1}^{5}(100 - n_i)} \qquad \ldots \ldots \ldots [2]$$

The measure of Inequality, I, is then given by

$$I = \frac{S_5}{S_1} \qquad \ldots \ldots \ldots [3]$$

Where S_5 is the share from (2) of the bottom quintile and S_1 of the top quintile.

I ranges from 1 to infinity. the higher the value of I the greater the inequality.

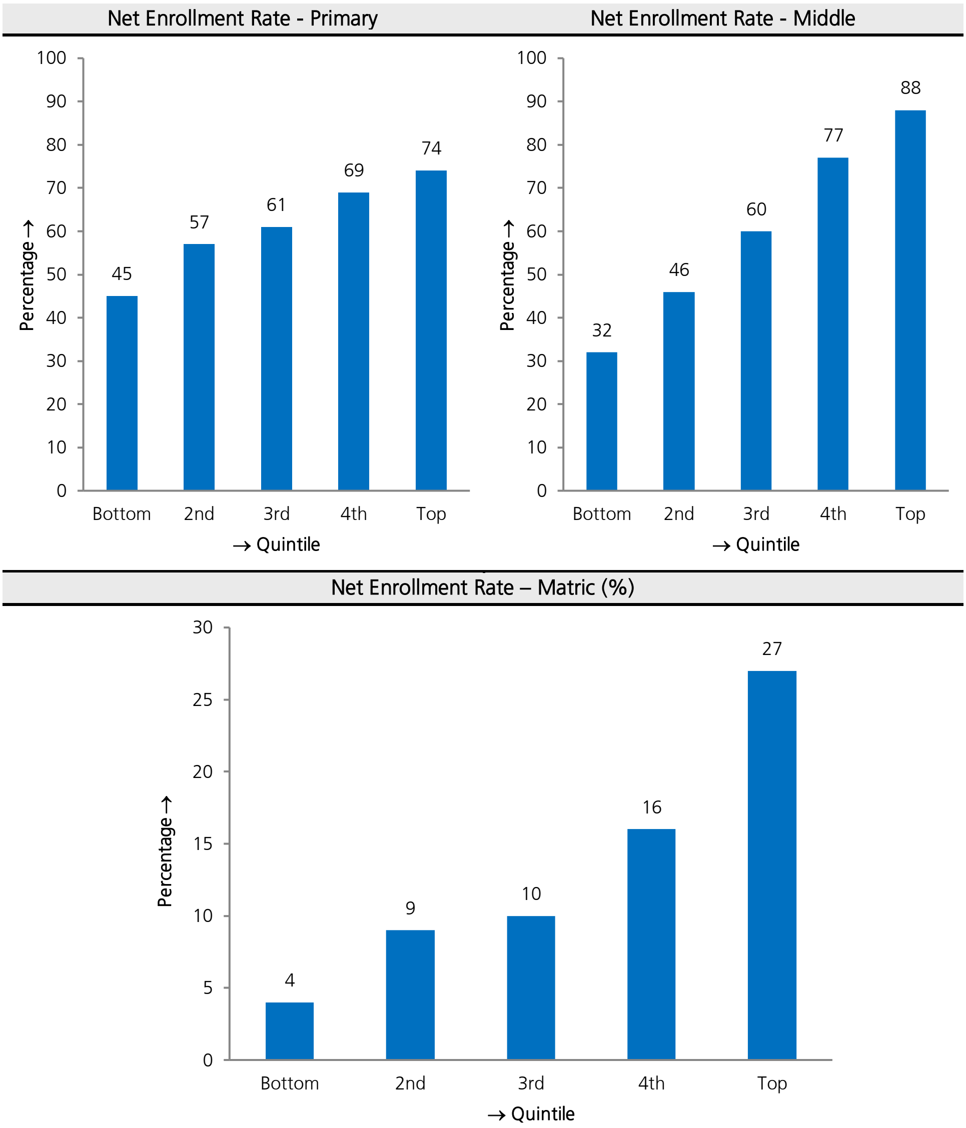
33.3. ACCESS TO EDUCATION

The net enrollment rates by quintile are presented for the level of primary, middle and matric in figure 33.1.

The computed inequality measure is as follows:

	I
Primary Level	2.12
Middle Level	5.67
Matric	1.31

Figure 33.1: Net Enrollment Rates by Quintile



Source: PBS, PSLSMS

It is interesting to note that inequality is most pronounced at the middle level. Only 32 percent of the children of relevant age are to in a middle school from the bottom quintile. As opposed to this, the corresponding percentage in the highest quintile is 88 percent. In effect almost 36 percent of the children not in middle school belong to the bottom quintile. Inequality is lower at the matric level because of generally lower enrollment rates in all quintiles.

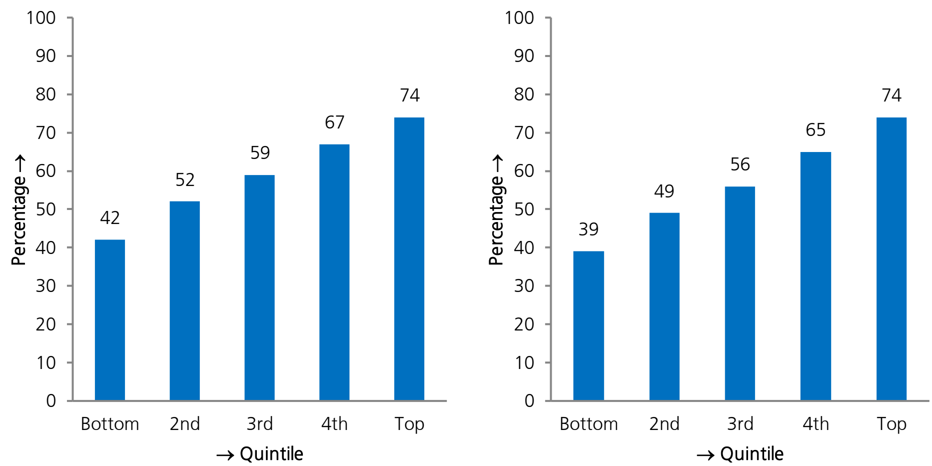
Figure 33.2 presents the percentage of population aged 10 years and above who have ever attended school and the literacy rate by quintile. The inequality measure is as follows:

	I
% who have ever attended school	2.42
% Literacy Rate	2.35

The inequality measures have an intermediate magnitude. As expected, the two measures are very close to other, given the need generally of attending school for becoming literate. It may be noted that over 51 percent of the illiterate population is in the lowest two quintiles. Some evidence of upward social mobility is provided by the fact that almost 12 percent of the illiterate population is in top income quintile.

Figure 33.2: Percentage who have ever attended school and Literacy Rate by Quintile of population (aged 10 years or above)

% who have ever attended School* | Literacy Rate* (%)



*age 10 years and above | *aged 10 years and above

Source: PBS, PSLSMS

33.4. ACCESS TO HEALTH

The PSLSMS provides information by quintile of access to immunization of children and to family planning by married women aged from 15-49 years. The distributions are presented in Figure 33.3.

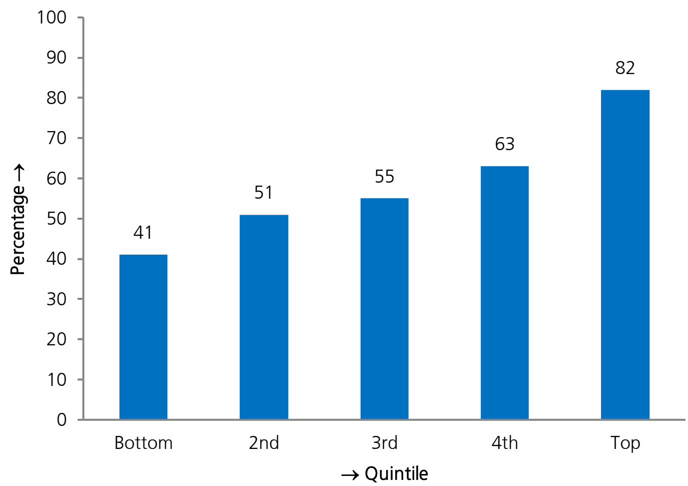
The inequality measure is as follows:

% of children immunized		3.27
% of women using family planning:	ever used:	1.05
	currently using:	1.04

There appears to be a big different in access to immunization. This service is provided at the household level by health workers. The difference may be due to under-coverage of slums and poor neighborhoods. Also, some religious objections have emerged about immunization. This has probably impacted more on poorer households with less education. At the aggregate level the coverage of immunization is surprisingly low at 58 percent.

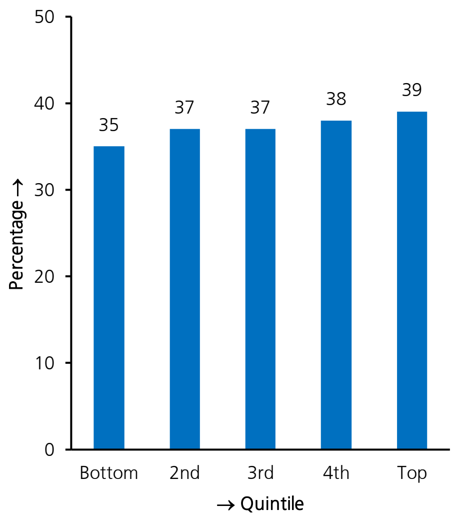
Figure 33.3: Access to Immunization and Family Planning by Quintile

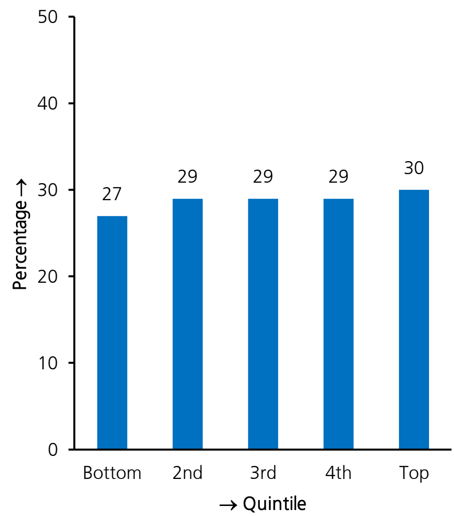
Fully Immunized (%)



% of Currently Married Women, 15-49 years - Use of Family Planning

Ever Used (%)	Currently Using (%)





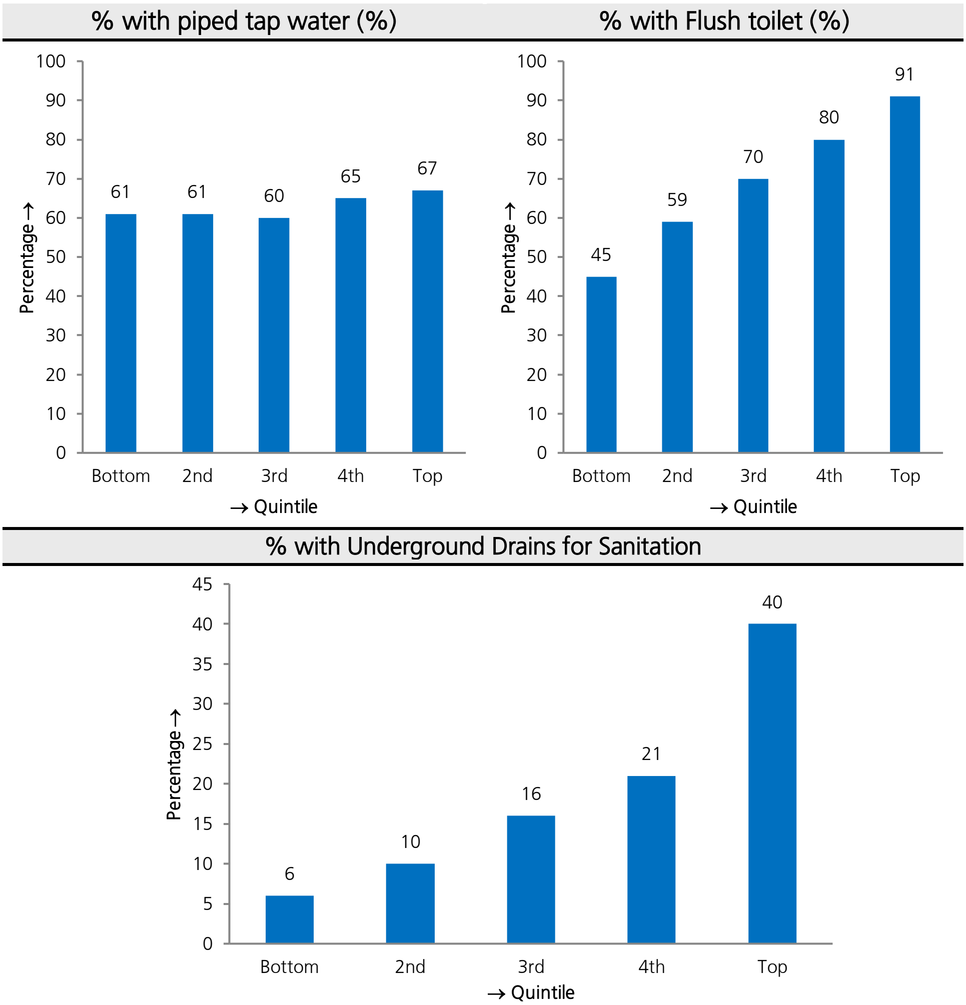
Source: PBS, PSLSMS

Access to family planning, though low, is, more or less, the same across quintiles. The inequality measure is very close to unity. This result is perhaps somewhat surprising. The general perception is that the number of children tends to be higher in poorer households, implying thereby less resort to family planning.

33.5. ACCESS TO RESIDENTIAL SERVICES

Information is provided on three residential services, viz., piped tap water, flush toilet and underground drains for sanitation. The access by quintile to each service is given in figure 33.4.

Figure 33.4: Access to Residential Services by Quintile



Source: PBS, PSLSMS

The inequality measure is as follows:

Piped water:	1.18
Flush toilet	6.11
Sanitation	1.57

Inequality is apparently very low in access to piped tap water. However, this masks the variation in frequency and quantities of water of supplied. A flourishing black market has developed in metropolitan cities, like Karachi. Poor neighborhoods are deprived of water and supply is made to rich households by tankers.

The greatest inequality is observed in access to flush toilet and is more pronounced in urban areas. This is essentially a privately provided service. As such, affordability influences the degree of access. However, underground sanitation is a public service and available more uniformly across households. However, the overall level of access is low at 19 percent.

The overall conclusions from the above inequality analysis are as follows:

(i) The incidence of poor children reaching the middle level is very low in relation to those from richer families. This implies high incidence of inter-generational poverty. Clearly, there is need to launch programs to reduce the rate of dropout from primary to middle level.

(ii) The substantial inequality in access to immunization must also be removed. There is need for monitoring to ensure equal provision to all neighborhoods. Also, the media will need to be used more aggressively to remove the wrong perception of an 'alien' substance entering the body of infants.

(iii) Given the growing shortage of clean drinking water in urban areas especially, there is need for more uniform rationing of water across neighborhoods and households. Strict vigilance must be exercised to curb the black market for water.

33.6. EXTENT OF EQUALIZATION IN SERVICE COVERAGE AMONG PROVINCES

Five indicators have been used to quantify the coverage of services in each Province:

I_1 = Literacy Rate (%)

I_2 = Net Primary Enrollment (%)

I_3 = % of Children fully immunized

I_4 = % of Households with Tap Water

I_5 = % of Households with Electricity

The composite indicator, I, of service coverage is given by

$$I = \frac{1}{500}\left[1_1 + \ 1_2 + 1_3 + 1_4 + 1_5\right]$$

The index has been derived for each Province–total, urban and rural–for the years 2004-05, 2008-09 to 2014-15. The Pre-7th NFC position is given from 2004-06 to 2008-09, and the post-7th NFC change from 2008-09 to 2014-15.

The basic source of data the same as above, that is, the PSLSMS of the PBS. This survey was first carried out in 2004-05 and the latest in 2014-15.

The estimated magnitude of the coverage index, I, are given in Table 33.1 for each Province. Some interesting and important conclusions emerge as follows:

(i) The value of I in 2014-15 for Pakistan as a whole is 0.61. This implies that on the average, the population not covered as high is high at 39 percent. Further, the rate of improvement, perhaps surprisingly, was higher in the pre-NFC period and not in the post-NFC period.

(ii) There is a big gap between urban and rural areas of Pakistan in service coverage. In 2014-15, the difference between the index values is 0.20. However, it is reassuring to note that the gap has narrowed from 0.25 in 2004-05.

(iii) The highest level of coverage nationally in 2014-15 is observed in Punjab, followed by Khyber-Pakhtunkhwa, Sindh and Balochistan. A positive development is that the difference between Punjab and Balochistan has narrowed somewhat between 2004-05 and 2015-16. Also, a perhaps unexpected finding is that service coverage is higher in Khyber-Pakhtunkhwa than in Sindh. In fact, among the four Provinces rural areas are the best served in Khyber-Pakhtunkhwa. However, the urban population enjoys the highest level of coverage in Sindh. The biggest urban-rural gap in service coverage is observed in Sindh.

It is reassuring to note that throughout the period, 2004-05 to 2014-15, there has been some 'catching up' by the two relatively backward provinces, especially in the case of Khyber-Pakhtunkhwa. However, as highlighted earlier, the growth rates are generally lower in the post-7th NFC period.

Table 33.1: Magnitude of Index, I, of Service Coverage in each Province, Urban, Rural and Total, 2004-05 to 2014-15

	2004-05	2008-09	2014-15
RURAL			
Punjab	0.49	0.53	0.57
Sindh	0.38	0.40	0.42
K-PK	0.50	0.56	0.58
Balochistan	0.32	0.37	0.43
Pakistan	**0.45**	**0.50**	**0.54**
URBAN			
Punjab	0.71	0.72	0.73
Sindh	0.72	0.73	0.76
K-PK	0.63	0.68	0.73
Balochistan	0.67	0.69	0.68
Pakistan	**0.70**	**0.72**	**0.74**
TOTAL			
Punjab	0.57	0.59	0.63
Sindh	0.54	0.56	0.59
K-PK	0.52	0.58	0.61
Balochistan	0.39	0.44	0.47
Pakistan	**0.54**	**0.58**	**0.61**

Source: PBS, PSLSMS.

SECTION 12

INCOME AND WEALTH INEQUALITY

Chapter 34:

STATE CAPTURE BY THE ELITE

The ‘elite’ has often been referred to as the conglomeration of rich and powerful groups in society. The acquisition of wealth or power may be the consequence of inter-generational bequests or accumulated in the current generation. The objective here is to highlight how the elite is able to operate successfully within the existing framework of laws and institutions. The focus is not on illegal means of becoming richer or more powerful.

The process by which there is ‘state capture’ is by the drafting and implementation of rules, procedures and laws which give special privileges to different vested interests. Further, there may be preferential access to land, bank credit, etc., which facilitate faster accumulation of assets. In recent years, allocation of land for residential and commercial development in large cities has become a primary source of large capital gains. Historically, favoured tax treatment through concessions and exemptions has been the primary source of benefits to particular economic and political interests. These have already been discussed and also quantified in Chapter 25.

The first elite group discussed below is of large rural land owners, who enjoy substantial political and economic power. This is followed by a description of state capture by other privileged groups like the defence establishment, multinational companies, urban property developers and owners and so on.

34.1. LARGE LAND OWNERS

According to the Agricultural Census of 2010 there are 13438 large land owners, representing only 0.2 percent of the total population of farmers in the country, who own over 11 percent of the farm area. The average land holding is 435 acres.

Since the time of creation of Pakistan, these large rural land owners have enjoyed various tax privileges. This includes the lack of imposition of an income tax on agricultural incomes, unlike on other form of incomes in the country. This was made possible by the disproportionate representation of these individuals in the Federal and Provincial legislatures. As an exception, it was also made a tax within the fiscal powers of Provincial Governments.

A tentative attempt was made in Punjab and Sindh to introduce the agricultural income tax in 1997, with pressure from international agencies, especially the IMF. Initially, it was levied as a presumptive tax, linked to farm size. There was an exemption to small farms up to 12.5 acres in size. The maximum rate of Rs 250 per acre was set for farms exceeding 25 acres. The tax was equivalent to only about 5 percent of the average net income per acre.

Subsequently, the tax was linked to net income, with exemption limit of Rs 100,000 in 2001. The maximum rate was set at 15 percent on income exceeding Rs 300,000. The total national yield from this tax in 2017-18 was only Rs 2 billion, equivalent to only 0.07 percent of the net income from crops in the country.

Clearly, not only have the tax rates been set very low but also there is substantial evasion and underassessment by the Boards of Revenue. A number of studies have demonstrated that if agricultural income is treated like any other income for tax purposes the revenue yield could be much higher. IPP [2012] estimates the revenue potential for the four Provinces combined as close to 0.3 percent of the GDP in 2011-12. Based on the GDP in 2017-18 the potential revenue is Rs 103 billion. As such, large and owners pay only 2 percent of their true income tax liability. Further, given the low tax rates, there is over-declaration of agricultural income and consequently non-agricultural income is understated and thereby under-taxed. In effect, agricultural income has become a 'tax haven'.

The other big advantage that large landowners enjoy is access to irrigation water at extremely low rates. The *abiana*, the water charge, is very low and has remained unchanged for a long time. Believe it or not, it is not even Rs 100 per acre. The O&M cost of the irrigation system is ten times as much as the revenue from the water charge. The under recovery in the Province of Punjab of the cost by *abiana* is over Rs 15 billion. This has also encouraged wasteful use of water at a time of emerging scarcity.

More recently, domestic prices of wheat and sugarcane have been set at substantially more than the equivalent international prices through the procurement/ support price mechanism. For example, the procurement price of wheat has been fixed at Rs 1300 per 40 kgs. This is almost 25 percent more than the landed price of imported wheat. A large part of the marketed surplus of wheat is by large landowners. Small farmers mostly self-consume their output. As such, the former are the prime beneficiaries of the higher prices. The estimated additional income of these landowners due to the price support by the Provincial Governments is as much as Rs 90 billion. Overall, the three concessions of low income tax, low water charge and high procurement prices add over Rs 200 billion to the incomes of large farmers.

34.2. THE DEFENCE ESTABLISHMENT

The military has been considered as a kind of '*sacred cow*' in Pakistan. This perception has been augmented by the role played either directly or indirectly by the defence establishment in the running of the affairs of the country. There have been three military dictators who have ruled in an autocratic fashion in 31 out of the 71 years of Pakistan after its creation.

The most vivid demonstration of the special status of the military is that the defence budget is not subject to any Parliamentary scrutiny as part of the Federal budget approval process given in the Constitution of Pakistan. Inclusive of pensions and the cost of paramilitary forces the lump sum budgetary allocation for defence in 2018-19 is Rs 1492 billion. This is equivalent to over 30 percent of the total projected federal current expenditure budget for the year.

The level of defence expenditure has gone up from 3.4 percent of the GDP in 2007-08 to 4 percent of the GDP in 2017-18, due primarily to the cost of fight against terrorism in the country. The implementation of the *Zarb-e-Azb* initiative after the launching of the National Action Plan in 2014 has contributed in a big way to reduction of terrorism in the country. The courage and sacrifices made by our valiant soldiers must be recognized.

The special status accorded to the Army Chief and the Core Commanders is demonstrated by their inclusion in the list of VIPs who enjoy special tax treatment. This provision is contained in Section 51 and 52 of the Second Schedule of the Income Tax Ordinance along with the President of Pakistan.

The military-industrial complex of Pakistan is the largest conglomerate of companies in the country. This is similar to the industrial links of Pentagon in the USA. However, it goes beyond defence production. The Fauji Foundation has 25 companies in diverse sectors like fertilizer, cement, power, banking, food production, etc. The total assets are worth Rs 342 billion ($2.5 billion) and net profit is almost Rs 30 billion ($215 million). The expectation is that the profits will be used for the welfare of soldiers in the form of hospitals, education and other facilities. Also, the various companies provide a multitude of employment opportunities for retired army personnel.

The Army is also the largest upper and middle income real estate developer in the country. Defence Housing Societies exist in the large cities of Pakistan in Karachi, Peshawar, Lahore, Islamabad and Rawalpindi. The old Cantonment Areas within these cities have provided the requisite land for this type of development. The Karachi Defence Authority has 8797 acres of land with over 50,000 plots. Land is allotted prices much lower than market values to members, who are mostly officers of the Pakistan Army. The Chief Justice of the Supreme Court has recently expressed reservations about the Army playing the role of real estate developer. He is of the view that the role should be restricted to provision of housing to soldiers, especially to the families of martyrs (*Shaheeds*).

There is also the Army welfare Trust. This entity has 16 companies in sectors like insurance, security services, mutual funds, sugar, etc. These companies have a net worth of Rs 30 billion and employment of 25,000 people. The Army Welfare Trust has asked for 100 percent income tax exemption on its profits in view of its welfare activities.

Clearly, the Army has institutionalized the provision of welfare and facilities to its existing and retired personnel. These services are substantially better than the quality of services available to the civilian population.

34.3. MULTINATIONAL COMPANIES

Multinational companies (MNC) located in Pakistan also enjoy strong preferential treatment. Their number is 195 from 35 countries. The investment is in 14 sectors, mostly of an import-substituting nature. The total value of assets of these companies is $74 billion. They provide employment, either directly or indirectly, to almost one million workers.

The primary facility provided to MNCs is a high protective wall of import tariffs as they are mostly catering to the domestic market for consumer goods and durables. These import duties range from 20 percent in the case of milk food and beverages to 100 percent in the case of automobiles.

Consequently, the rates of return on equity are exceptionally high. For example, the return to the joint venture companies of Toyota and Honda in the automobile sector is generally in excess of 30 percent on equity every year. Companies like Nestle and Unilever, engaged in the sale of consumer goods, have returns on equity over 60 percent. There is another invisible source of profits to these companies. The resort to high transfer pricing by the headquarters in other countries adds to global profits of a MNC. Pakistan has no effective legal provisions to regulate transfer pricing like India.

Recently, the Government has announced a corporate income tax rate of 20 percent for new MNCs as compared to the standard rate of 30 percent. Further, income tax paid by well-remunerated foreign employees has been reduced substantially, with the increase in exemption limit from Rs 400,000 to Rs 1,200,000.

34.4. COMMERCIAL BANKS

The commercial banks of Pakistan are now mostly in the private sector, following successful rounds of privatization since the early 90s. The only major exception is the National Bank of Pakistan.

The nationalization of most of the banks in the mid-70s by the Zulfiqar Ali Bhutto regime was primarily motivated by the consideration that the private owners of these banks were able to direct credit to their own industrial and commercial entities and thereby establish large business empires. This had led to the expression '*22 families*' who had become extremely rich in the days of the Field Marshal Ayub Khan's tenure of eleven years.

Today, the proclivity to captive lending is back. A good example is the Muslim Commercial Bank which supports the industrial empire of the owners' family. In addition, banks have found large outlets for almost risk-free lending. These include the investment in Government treasury bills and Pakistan Investment Bonds with infusion of additional funds from the SBP over and above deposits. Today, almost 47 percent off the assets of banks is in these investments. The share of advances has declined from over 60 percent to 53 percent.

The tenure of the General Musharraf government saw a boom in the banking sector. Earlier in the 90s the corporate income tax rate on profits of banks was 58 percent. This was brought down to the standard rate for companies of 35 percent. The higher rate had been justified on the grounds that in a credit-starved economy banks had a quasi-monopoly status, which continues to this day.

The other development since 2000 is the fragmentation of the credit market due to the entry of a number of smaller banks, including Islamic Banks. The large banks like HBL and UBL mostly have large corporate clients while the smaller banks have been compelled to go in for riskier lending to SMEs, agriculture and housing. This has had two consequences. First, the share of agriculture and SMEs has remained low at 8 percent and 3 percent respectively. The development role of banking has, therefore, become very limited.

Second, there is a big difference in profitability by size of banks. The big give banks had a return on equity in 2016 ranging from 23 to 26 percent, while the smaller banks achieved much lower returns of 1 to 13 percent. There is clearly a need for a progressive system of income taxation of banks. The PPP Government in 2010 made another concession in favor of commercial banks. A Seventh Schedule was introduced in the ITO whereby a tax deductibility provision was included of up to 1 percent of total advances for write off of bad debt.

Overall, Commercial banks have failed to perform an adequate developmental role. They have enjoyed tax concessions and privileged access to high yielding government paper. The estimated value of benefits is in excess of Rs 120 billion.

34.5. URBAN REAL ESTATE DEVELOPERS AND OWNERS

The development of real estate property, both residential and commercial, has become a booming activity in the larger cities of Pakistan like Karachi and Lahore. The real estate developers and owners have been facilitated by substantial under-taxation and tax evasion. A classic example is that of property taxation. The tax liability is linked to assessed gross annual rental values (GARVs). These assessments are mostly outdated and consequently very low in relation to prevailing rents. Owner-occupied properties enjoy 80 percent exemption.

IPP [2012] has made a conservative estimate for 2011-12 that the under-taxation in the case of the Urban Immoveable Property Tax for the four Provinces combined is of Rs 48 billion. This estimate rises to Rs 90 billion for 2017-18. Also, the federal income tax treats rental income effectively as a separate block of income. The exemption limit is up to Rs 200,000 of annual rental income. There are effectively four slabs and the marginal tax rate rises from 5 to 20 percent. The impact is a reduction in the progressivity of the income tax system.

Property transactions also enjoy favored treatment. The assessed capital values, referred to as the '*DC values*' are out of date. Consequently, the stamp duty and the capital gains tax revenues are very low. Estimates are that the loss of revenue approaches Rs 80 billion on the tax base of 2016-17.

Influential property developers have also been able to extract more concessions from Municipal Corporations / Development Authorities. The prime example of such collusion is the lack of extension of metropolitan boundaries. Consequently, new property schemes at the rural-urban periphery are able to avoid payment of property taxes and other charges. Further, state land is frequently allocated to developers at low prices.

34.6. MNA / MPAs

The members of the National and Provincial Assemblies are responsible for passage of the Finance Bills, relating especially to taxation proposals. They are by definition influential citizens. These MNAs and MPAs have also been to legislate benefits for themselves. Generous increases in salaries and allowances have been passed in the august chambers of the Parliament. The budgets, for example of the National Assembly and the Senate are in the nature of 'charged expenditure' and, therefore, cannot be voted on. Therefore, it is not surprising that the annual expenditure of these two bodies has almost trebled from 2007-08 to 2017-18.

Another very unusual practice in Pakistan is the allocation of development funds to MNAs/MPAs for projects in their respective constituencies. Therefore, these projects do not go through the normal approval process and implementation. Consequently, there is scope for leakages and misuse of funds.

The year, 2017-18, was the pre-election year. Under the banner of 'SDGs Community Development Programme' almost Rs 30 billion has been distributed among MNAs. This amounts to a large allocation per MNA of Rs 110 million, with possibly larger amounts for the ruling party members. This is a blatant misuse of public funds.

34.7. OTHERS

There are other privileged groups with favored tax treatment and access to public resources. Chart 34.1 presents a summary of the benefits enjoyed by different groups.

This includes, other than those described above, groups like the trading community, exporters, stock market members and owners of shares, public sector enterprises and senior bureaucrats.

The state capture by the elite is persistent and pervasive in character. The tax concessions alone add up to over Rs 1000 billion, equivalent to almost 25 percent of the actual revenue collection. In addition, there are large-scale distortions and wastage in the utilization of public resources. Undeniably, one of the ultimate root causes of inequality in Pakistan is state capture by the elite.

Chart 34.1: Types of Benefits Pre-empted by Various Groups in Pakistan

A.	FUEDAL CLASS
(1)	Extremely Low-income taxation
(2)	Lack of Indexation of Land Revenue
(3)	Very Low rates of *Abiana* and disproportionate allocation of water
(4)	Subsidy on Imported Fertilizer
(5)	High Procurement Support Price of Wheat (in relation to import parity price) and sugarcane
(6)	Lower Tax Rate on Tractors
(7)	Effectively Low Stamp Duty on Land Transactions
(8)	'Tax Loophole' of Agricultural Income
(9)	Low Electricity Charges on Tubewells
(10)	No Petroleum Levy on LDO
B.	MILITARY
(1)	Little or no Parliamentary scrutiny of defense budget
(2)	Tax Privileges of Senior Officers
(3)	No GST on Defense Stores
(4)	Large Business Income of Foundation / Trust
(5)	Lower or no Property Tax collected from Cantonment Boards
(6)	Access to Land and Residential Projects
C.	TRADING COMMUNITY
(1)	Low PIT, high evasion and low collection
(2)	Exemption from GST (minor move now)
D.	EXPORTERS (ESPECIALLY APTMA)
(1)	Low PIT on Export Receipts
(2)	Exemption of Domestic Sales from GST or very low rates
(3)	Zero duty on imported cotton (5% earlier)
(4)	SROs for low duties on imported inputs
E.	MNCs
(1)	Relatively high tariff walls for import substitution e.g. Automotive Sector
(2)	Now lower CIT on FDI (20 percent vs 29 percent)
(3)	SROs for cheaper inputs, especially, pharmaceuticals and chemicals
(4)	No Law on Transfer Pricing

Contd...

Chart 34.1: Types of Benefits Pre-empted by Various Groups in Pakistan *(...Contd.)*

F.	**POWER SECTOR**
(1)	Lifetime exemption from Corporate Income Tax of IPPs
(2)	Big Tariff Differential Subsidy
G.	**BANKS**
(1)	Tax rate down from 58 percent to 35 percent, despite large spreads
(2)	Tax Deductibility for Provisioning against Bad Debt
(3)	Under Capitalization
(4)	Access to risk-free Government Bonds
H.	**URBAN PROPERTY OWNERS AND DEVELOPERS**
(1)	Very low rates of UIPT due to under assessment of GARVs
(2)	Low Income Tax on Rental Income
(3)	No Taxation of Long-Term Capital Gains
(4)	Low Rates of Stamp Duty / CVT due to outdated Valuation Lists
(5)	Non-extension of Rating Ares to benefit Developers
I.	**VIPs***
(1)	Tax exemption of Perquisites
(2)	Access to Subsidized Land in Posh Societies
(3)	Duty Free Imports
Parliamentarians	
(1)	Low Rate of Filing or Returns
(2)	Development Fund Allocations for Constituencies (suspended currently)
Foreign Income of rich Residents	
(1)	Effectively not taxed even if generated in countries with which Pakistan had ADT agreements
J.	**CAPITAL MARKET / STOCK EXCHANGE**
(1)	No or very low Taxation of Capital Gains
(2)	No questions asked on source of investment
(3)	Carryforward of Capital Losses in Income Tax
(4)	Evidence of insider trading
K.	**PUBLIC SECTOR ENTERPRISES**
(1)	High tariff Protection (e.g. Iron and Steel)
(2)	Underwriting of Losses
(3)	Conversion of Debt into Equity (WAPDA)
(4)	Access to Government Guarantees on Borrowing (PSO)
L.	**SENIOR BUREAUCRATS**
(1)	Low Rate of taxation on Monetization of Transport
(2)	Large and Rapid Salary Increases and Pensions
(3)	Tax Exemption of Large Pensions and Provident Funds
(4)	Tax Exemption on income from *Behbood* Certificates after age of 65
(5)	Access to Subsidized Plots in Islamabad

*includes President, Prime Minister, Ministers, Supreme Court Judges, Chiefs of the Army, Navy and Air Force Core Commanders and senior Bureaucrats.

Chapter 35:

INCOME AND WEALTH INEQUALITY

There are diverse sources of wealth and income inequality. The previous chapter has highlighted how the strong vested interests have captured the state through targeted tax breaks, special access to land, bank credit, etc.

The perhaps more legitimate sources of inequality are inter-generational transfers of wealth, differences in endowment of education, skill and capability. As such, inequalities can be due to variation both in earned income and in unearned income due to a larger stock of assets.

The objective of this chapter is to quantify the level and change in income and wealth inequality among households of Pakistan. Section 1 highlights different measures of inequality. Section 2 presents the latest estimates of income inequality in the country from the data on share in income of different population quintiles in Household Integrated Economic Survey (HIES), carried out periodically by the PBS. Section 3 quantifies the trend in income inequality since 2001-02. Finally, Section 4 gives estimates of the extent and the change over time in the extent of wealth inequality.

35.1. MEASURES OF INEQUALITY

There are various measures and indicators of inequality. The first is a relatively simple measure, the ratio of income/wealth share of the top quintile of population with the share of the bottom quintile. This measure highlights the distance between the households with the highest incomes and those with the lowest incomes.

The second measure is the Robin Hood ratio. The name appropriately identifies the extent to which income has to be transferred from the top one or two quintiles to lead to a perfectly equal income of each member of the population.

The third and a commonly used indicator of inequality is the Gini coefficient. This measures the extent of divergence of each quintile from the perfectly equal distribution on a cumulative basis.

Each measure has its merits. The ratio between income share of the top 20 percent and bottom 20 percent is a simple indicator with a ready interpretation of the extent of inequality. It is also a fairly sensitive measure. The Robin Hood Ratio is useful from a policy point of view. It highlights the scope for redistributive policies. Finally, the Gini coefficient focuses on all the five quintiles of the income distribution. It is, however, a relatively less sensitive measure of changes in inequality. The first measure has no maximum value. The Robin Hood ratio and the Gini coefficient have maximum values of 80 percent and 100 percent respectively.

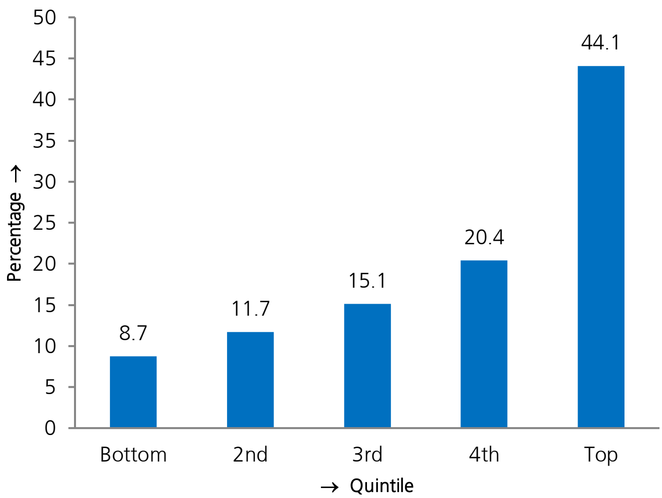
35.2. LEVEL OF INCOME INEQUALITY

The latest year for which the HIES is available is 2015-16. The findings on inequality in income from this survey are presented below.

35.2.1. Overall Measure

The share of income by quintile is presented in Figure 35.1 for 2015-16.

Figure 35.1: Share of Total Income with each Quintile, 2015-16 – (%)



Source: HIES

The top quintile of population has a share of over 44 percent while the bottom quintile has a share of even less than 9 percent. The resulting estimates of inequality are as follows:

Ratio of top quintile to bottom quintile	= 5.1
Robin Hood Ratio	= 24.5%
Gini Coefficient	= 32.1%

Almost 56 percent of the income of the top quintile would have to be transferred in varying degrees to the three bottom quintiles to produce a perfectly equalitarian distribution of income. The trend in the extent of income inequality is highlighted in a subsequent section.

35.2.2. Inequality by Sources of Income

The HIES gives the composition of income from different sources of each quintile. The shares in each source of income are presented below in Figure 35.2.

Figure 35.2: Share of Top and Bottom Quintiles in different Types of Income in 2015-16

Share of Income (%)	Bottom Quintile	Income Source	Top Quintile	Ratio
3	1%	From Property*	78%	78
3	1.5%	Pensions	68%	45
6	2.6%	Home remittances	57%	22
10	5.2%	O-O Property**	56%	11
51	10%	Wages & Salaries	44%	4
4	9%	Domestic Remittances	35%	4
10	12%	Crop Production	34%	3
13	13%	Livestock	23%	2
100				

*rental income | Imputed Income from owner-occupied property

Source: PBS, HIES

The most unevenly distributed source of income is the flow of rents from property owned and rented. The bottom quintile hardly owns any property that it can rent out. Bulk, 78 percent, of this income accrues to the top quintile. Similarly, the coverage of pensions is largely limited to upper income workers.

The distribution of the largest source, wages and salaries, is more balanced. 44 percent is received by the top quintile and 10 percent by the bottom quintile. Similarly, income from crop production and livestock is more evenly distributed.

The results demonstrate that home remittances from abroad are a significant disequalizing source. Households which are recipients are more likely to be in the upper quintiles. Domestic remittances trend to be more evenly distributed across all quintiles.

35.2.3. Understatement of Inequality

The HIES picks up a relatively small part of the national income when the sample is blown up to the population. For example, given the household incomes reported in 2015-16 it appears that the national household income is only 45 percent of the GDP.

One of the principal reasons for this that households in the upper income groups are likely to under report their incomes because of the fear of detection for payment of taxes. The missing 55 percent of the national income is also attributable to the retention of part of corporate profits in the form of reserves.

36.2.4. Upper Tail of Income Distribution

There are also other indicators of the relatively unequal distribution of income than that derived from the HIES. A key set of income data is contained in the Income Tax payers' Directory published by the Federal Board of Revenue.

The exemption limit of income tax was Rs 400,000 per annum in 2015-16. According to the Tax Directory for the year, the upper tail of the income distribution in Pakistan is extremely skewed. The top 1 percent of personal income tax payers contributed as much as 29 percent of the total tax paid. Similarly, the top 20 percent contributed over 90 percent. These results highlight the relatively high income inequality in Pakistan.

35.2.5. Regional Variation in Income Inequality

The extent of income inequality in 2015-16, as revealed by the HIES, is given in Figure 35.3 and 35.4 respectively for the four Provinces and for the urban and rural areas of the country.

Figure 35.3: Ratio of the Income Share

Top 20% to Bottom 20% of Population in each Province, 2015-16

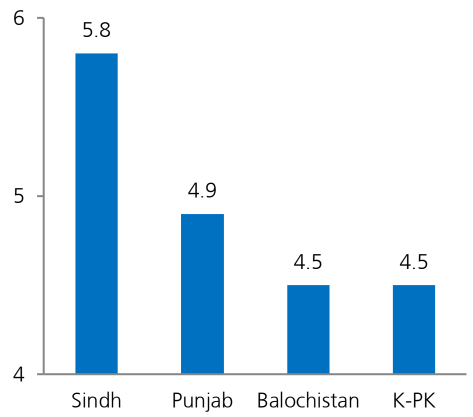
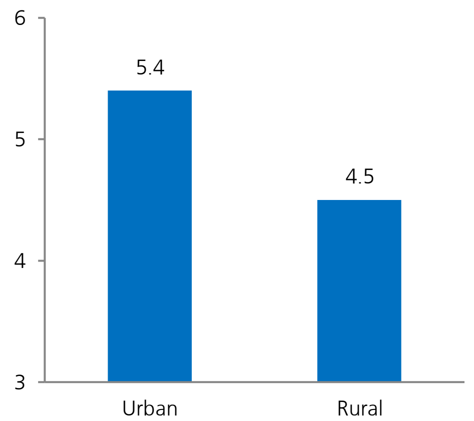


Figure 35.4: Ratio of the Income Share

Top 20% to Bottom 20% of the Population in the Urban and Rural Areas of Pakistan, 2015-16



Source: PBS, HIES

The highest income inequality is observed in Sindh. This is partly attributable to the highest share of urban population in this Province. As shown in Figure 35.4, inequality tends to be higher in urban areas. This is due to the greater presence of highly paid professionals and entrepreneurs receiving income from corporate entities and large trading operations. Sindh also has a pre-dominantly feudal structure in the rural areas. After Sindh, inequality is higher in Punjab, followed by Balochistan and Khyber-Pakhtunkhwa. The last Province has a more pronounced relatively equalitarian tribal structure and relies relatively more on the receipt of domestic remittances.

35.3. TREND IN INCOME INEQUALITY

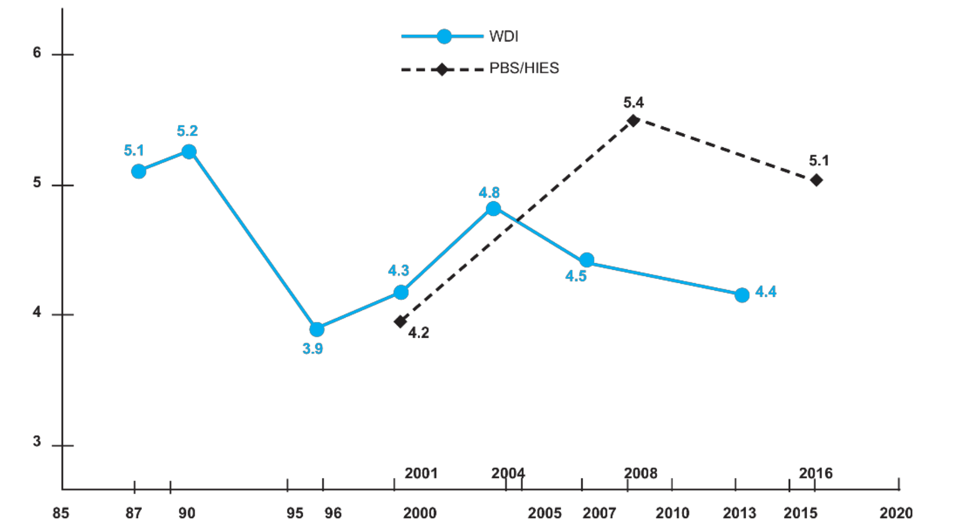
The trend in the extent of income inequality can be derived from two sources.

The first source is, of course, the various HIES undertaken by the PBS, which are available on its website. The period is from 2001-02 to 2015-16. The second source is the World Development Indicators data base of the World Bank. This provides for a longer time series from the late 80s up to 2013.

35.3.1. The Trend in Inequality

From both sources, the ratio of the income share of the top and bottom quintiles have been obtained. These ratios are presented in Figure 35.5. The path of income inequality has been variable in nature. According to the World Bank, the ratio was relatively high in the late 80s. Thereafter, it fell during the decade of the 90s, reaching its lowest level in 1995. During the next decade it rose sharply to a peak in 2008. Thereafter, it has fallen up to 2013.

Figure 35.5: Income Share Ratio between Top and Bottom Quintiles in Pakistan, 1987 to 2016



The HIES findings are similar in character, although for a shorter period. Apparently, the level of income inequality went up from 2001 to 2008, reaching the highest ratio in the latter year. There appears to be some decline in inequality up to the last observed year, 2015-16. Therefore, both sources are highlighting similar trends.

What explains the variation over time in the level of inequality? The first empirical regularity is that inequality tends to be high and rising during the tenure of military Governments. This happened in the 80s during the tenure of General Zia-ul-Haq and from

2001 to 2008 in the General Musharraf era. Presumably, the power structure under these Governments is more amenable to catering to special interests so as to build support and legitimacy. Democratic Governments tend to follow more inclusive growth policies focusing on agricultural development, social sectors and poverty alleviation.

The trend in the level of income inequality, as measured by the Gini coefficient, is given in Table 35.1. Two estimates have been made. The first is the Gini coefficient estimated from the income shares of different quintiles as reported in the HIES. The second measure adjusts for capital income, which is grossly underreported in the HIES and accrues mostly to the top quintile of households. The capital income is estimated from the fixed presumptive income tax collections by FBR from income in the form of dividends, interest on securities, capital gains from trading of shares, etc.

The Gini coefficients, both unadjusted and adjusted, follow a similar path to that described above in the case of the ratio of income shares of the top 20 percent versus the bottom 20 percent. The greatest inequality is revealed in the year, 2007-08, in the case of the adjusted Gini, with a value of almost 46 percent. This falls to below 38 percent by 2015-16.

Table 35.1 also presents the estimates of the Gini coefficient of consumption expenditure shares of different quintiles. The consumption expenditure can be taken as a proxy for 'permanent income'. Apparently, inequality is significantly less pronounced in consumption expenditure as compared to income.

Table 35.1: Trend in the Level of Income Inequality, 2001-02 to 2015-16

	Income Gini Coefficient		Consumption Expenditure Gini Coefficient
	Unadjusted	Adjusted	
2001-02	28.33	32.58	28.08
2004-05	30.97	40.26	29.42
2005-06	32.01	43.21	30.08
2007-08	32.65	45.71	30.28
2010-11	32.91	41.13	31.59
2011-12	33.37	40.04	28.84
2013-14	32.72	39.26	28.72
2015-16	31.86	37.59	30.14

Source: HIES and FBR Year Book

35.3.2. The Growth Incidence Curve

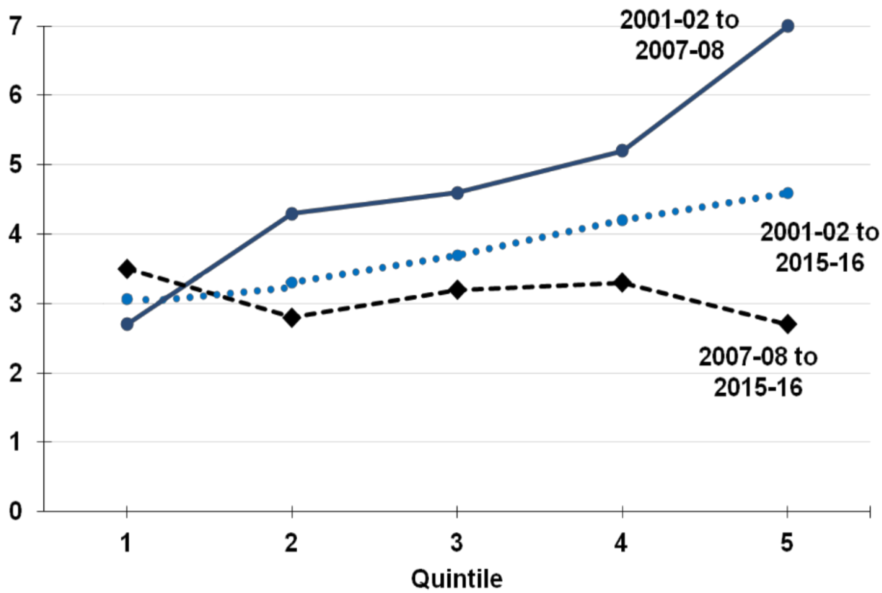
Another visually powerful technique to determine what is happening to income inequality is to construct the Growth Incidence Curve (GIC) between any two years. This curve highlights the growth rate in real income per capita of each quintile of population during the period. If the curve has an upward / downward slope it will indicate that inequality has increased/ decreased. The larger the slope the faster is the change in inequality.

The GICs for the period, 2001-02 to 2007-08, of the Musharraf period and from 2007-08 to 2015-16, during the tenure of the two elected Governments of PPP and PML (N), are presented in Figure 35.6. The GIC is positively sloped in the first period and has a variable slope in the second period.

There appear to be big differences among quintiles in the growth rate of real per capita income from 2001-02 to 2007-08. The bottom quintile had a modest growth rate of less than 3 percent while the top quintile and the fourth quintile achieved substantially higher growth rates of above 7 percent and 5 percent respectively. This explains the worsening of income inequality during this period.

The opposite has happened between 2007-08 and 2015-16. The fastest growth rate is observed in the lowest quintile of 3.5 percent. It is below 3 percent in the case of the top quintile. Consequently, while this period saw significantly less overall GDP growth, the lowest income group was able to do relatively well. However, over the entire period the top quintile has performed relatively well.

Figure 35.6: Annual Growth Rate in Real Per Capita Income by Quintile, 2001-02 to 2015-16



Source: HIES

What explains the divergent patterns of income growth and change in income inequality? Earlier the contrast has already been made of the pattern of governance between military and democratic Governments.

The other potential explanation lies in the rate and pattern of growth. The earlier period saw not only faster growth but the process of growth was relatively concentrated in modern sectors like large-scale manufacturing, banking and insurance, telecom and private services catering for upper income groups. This raised the demand for educated and highly skilled manpower. Meanwhile, the agricultural sector languished.

The period after 2007-08 has witnessed a severe loss of momentum by the manufacturing sector, while the agricultural sector has performed somewhat better. Also, there has been more dynamism in the informal sectors of the economy employing less educated and not so skilled labor.

This explanation is confirmed by the change in unemployment rate of workers with different levels of education between the two periods, shown in Table 35.2. There has been a visible decline in the employment prospects for highly educated workers, with graduate or post-graduate degrees. Their unemployment rate had fallen to below 5 percent by 2007-08. It has since more than trebled to almost 17 percent in 2015-16. As opposed to this, illiterate and workers with only pre-matric education have seen a near halving in their rate of unemployment.

Table 35.2: Unemployment Rates by Education Level, 2001-02 to 2014-15 – (%)

	2001-02	2007-08	2014-15
ILLITERATE	**7.6**	**4.9**	**3.2**
LITERATE	**8.9**	**5.4**	**8.0**
Pre-Matric	8.5	4.9	5.1
Matric	9.7	6.5	6.8
Intermediate	10.0	7.0	11.3
Degree, Post-Graduate	8.7	4.9	17.6
Overall	8.3	5.2	5.9

Source: PBS, LFS

35.4. LEVEL OF WEALTH INEQUALITY

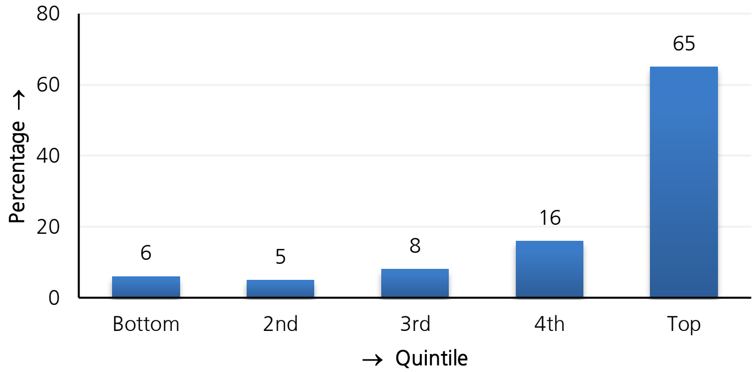
We turn now to quantification of the level of wealth inequality in Pakistan. There is the likelihood that the skewness in the distribution of wealth is more pronounced than in income. First, inter-generational transfers perpetuate the inequality in wealth, especially since there no inheritance taxes in Pakistan. Second, the savings rate is likely to be much higher for upper income households. This leads to a process of accumulation of income generating assets. Poor households are barely able to make ends meet.

Given below is the evidence on wealth inequality in Pakistan based on information contained in the HIES and other sources. The former tends to underreport income from ownership of assets, besides property. As such, the extent of inequality is underreported. Therefore, other information is also presented to highlight the distribution of various physical and financial assets.

35.4.1. Savings Inequality

The rate of household savings varies widely from a low of 4 percent in the second quintile to 13 percent in the top quintile. The corresponding shares of each quintile in national household savings are given in Figure 35.7 for 2015-16.

Figure 35.7: Share in Savings of different Quintiles, 2015-16 – (%)



Source: HIES

Almost two-thirds of the total saving is pre-empted by households in the top quintile. The measure of inequality corresponding to the ratio between the share of the top and the bottom quintiles is almost 11. This is more than twice that observed in the case of income inequality.

The evidence on inequality in ownership of assets is given below.

35.4.2. Ownership of Farm Land

Table 35.3: Distribution of Ownership of Farm Land, 2010 – (% of Farm Area)

	Farmers Number (000)	Farm Area (million acres)	% of Farm Area Owned	Farm Area per Farm
Top 1%	82.6	10.760	20.3	130
Top 20%	1652.9	36.508	69.0	22
Bottom 20%	1652.9	1.164	2.2	0.7

Source: Agricultural Census, 2010.

Given the presence of a quasi-feudal structure in the agricultural economy, it is not surprising that the ownership of farm land is highly skewed. The figures on land distribution are presented in Table 35.3. Only 82,600 farmers out of the total of over 8.26 million farmers, that is, 1 percent, own over 20 percent of the total farm land. The average farm size of these large farmers is 130 acres. They not only own substantially more land than the average farmer they also have greater access to irrigation, mechanization and electricity. The ratio between the top 20 percent and the bottom 20 percent of farmers is extraordinarily high at 31.4. This is over six times that observed in the case of income inequality.

35.4.3. Ownership of Property

One of the principal forms of wealth is ownership of property. The inequality in the distribution of property has already been highlighted. The results from the HIES of 2015-16 indicate that 61 percent of the value of property is with the top 20 percent of population. The value is measured as the imputed rental value of owner-occupied property plus the actual rental value of property owned which is rented out. Only 4 percent of the value of property is with the lowest quintile. This implies a ratio of almost 15.

Similar analysis conducted from the HIES of 2001-02 yields an inequality ratio of under 11. Therefore, inequality in ownership of property has been rising steadily. This is not surprising given the privileged access to urban land for residential development of the rich and powerful highlighted in the previous chapter.

35.4.4. Ownership of Company Shares

Ownership of shares of companies quoted in the Pakistan Stock Exchange is also a significant part of wealth of the top 1 percent of the population of Pakistan. The market capitalization of shares is given in Table 35.4.

Table 35.4: Market Capitalization of Shares Traded in the Pakistan Stock Exchange, 2001 to 2017 – (Rs in Billion)

	Market Capitalization of Shares	% of GDP
2001	339.2	8.1
2008	3744.1 (34.3)*	35.2
2017	9522.4 (10.4)	29.8

*annual growth rate

Source: State Bank of Pakistan

There has been extremely fast growth in the market capitalization of shares. Between 2001 and 2008, it has spiraled up more than ten times. This growth was unprecedented in the history of Pakistan. From 2008 to 2017 there has been a further jump of over 150 percent. The market capitalization in 2017 is equal to almost 30 percent of the GDP as compared to 8 percent in 2001. However, there has been a decline in market capitalization of almost 25 percent since June 2017.

Realization of the huge capitalization gains has converted large stock brokers into a new class of capitalists. They now own cement and fertilizer companies and even banks. This is a classical example of how a favorable business environment can confer exceptional gains to those enjoying greater access and favored treatment.

Overall, there is very strong evidence of extremely skewed distribution of wealth in Pakistan. The HIES estimates of the income distribution clearly grossly understate the extent of income inequality in Pakistan. The time has come for structural reforms to address the fundamental issue of inequality. Unfortunately, the political economy within the existing power structure will tend to perpetuate the status quo.

35.5. THE MIDDLE CLASS

The focus in the previous sections has been on the two extremes of the income distribution, the bottom 20 percent and the top 20 percent of the population. There is a need also to look at the intermediate 60 percent of the population, a large part of which constitutes the middle class of Pakistan.

The middle class has generally been defined as the class of people who are between the ‘upper’ class and the ‘working’ class on the basis generally of income or expenditure. These people are sometimes referred to also as the ‘bourgeoisie’. They possess either or both of two characteristics. First, they are generally persons with higher education often employed as professionals or managers. Second, they may be endowed with entrepreneurial qualities and own small trading or production establishments. A large and expanding middle class is the sign of a rapidly growing economy.

The middle class can also play an effective role in promoting social and political change, as has been the case in many countries. They are frequently instrumental in ensuring accountability for efficient and honest delivery of services and act as a counter to elite capture of state resources. They are also more inclined to promote the formulation and implementation of progressive policies.

The simplest approach to identifying the middle class is to look at the characteristics of the people in the third and fourth quintile of population on the basis of income or expenditure from data in the HIES. Based on adjustment described earlier for some understatement of income especially at the upper end of the income distribution, the spread of per capita income among the three classes has been determined for the latest survey year, 2015-16. Accordingly, the per capita income of the middle class is 225 percent of the per capita income of the lower class (bottom two quintiles) and 27 percent of the income of the upper class (top quintile). This demonstrates again the fairly highly level of income inequality in Pakistan.

Three periods can be identified with regard to the progress of the middle class since 2001-02. During the Musharraf era up to 2007-08, incomes grew relatively fast but income inequality increased sharply. Consequently the per capita income of the middle class rose in real terms annually by a relatively high 5 percent. The tenure of the PPP government for the next five years saw both slow growth in the economy and, more or less, unchanged inequality. The per capita income of the middle class grew by just over 3 percent annually.

During the tenure of the PML (N) government, income growth has continued to be slow but with some falling inequality, due particularly to developments in the labor market described later. The middle class saw per capita income growth of even less than 2 percent in the first three years of PML (N) government.

Turning to the question as to whether to the size of the middle class is expanding or contracting with respect to the total population, a different approach has to be adopted. The middle class is now defined to include households with per capita consumption expenditure in the range of 25 percent below and 25 percent above the median expenditure. The results are very revealing. In 2001-02, 43 percent of the population was in the middle class. By 2015-16, the share had fallen to 38 percent. Therefore, the presence of the middle class is shrinking as part of the population of the country.

The next question of interest is how large the middle class is in relation to an international standard for a family to qualify as part of the middle class. The standard used is that the per capita expenditure per day should range from $5 to $25 in purchasing power parity (PPP) terms. For the latest year, according to this criterion almost 30 percent of the population falls in the middle class, with the PPP $ being almost four times the nominal US$ in the case of Pakistan. Therefore, almost 10.5 million families of the country form part of the global middle class. As such, Pakistan's middle class is 6 percent of the middle class of Asia and the Pacific. The combined purchasing power annually is estimated at $360 billion. This implies a relatively large market for housing, consumer durables, etc.

There is need also to identify the distribution of the middle class within the country. Estimates are that 56 percent of the middle class is in the cities and towns of Pakistan and 44 percent in the rural areas. 59 percent of the middle class lives in Punjab; 22 percent in Sindh; 15 percent in Khyber-Pakhtunkhwa and 4 percent in Balochistan. The share in home remittances of the middle class is 34 percent. Over 57 percent of the remittances accrue to the upper class. With a share of 38 percent in income, the middle class owns 28 percent of the property in the country. This share has also been declining. Bulk of the property, almost two thirds, is with the upper class.

Based on the above findings, there is need to explain why the middle class of Pakistan is shrinking and why their incomes are growing relatively slowly. The first reason is the adverse development in the labor market during the last few years, with regard to employment opportunities for educated workers, a large segment of which is in the middle class. There has been an exponential increase in the unemployment rate of such workers. As highlighted earlier, it was 5 percent in 2007-08 and has risen to 18 percent by 2014-15. Consequently, almost one in five workers in the labor force, with a graduate or post-graduate degree, is without a job. This is a tragic waste of the human capital in the country.

Second, the middle class is being squeezed by rising costs of living, especially of housing and utilities. The expansion in the number of housing units with two to four rooms between 2010-11 and 2014-15 has been only 10 percent. This compares with an increase of 17 percent for the upper class of housing units with five or more rooms. Also, rents, especially in metropolitan cities, have risen 20 percentage points more than the cumulative rise in the overall consumer price index since 2007-08. Simultaneously, the electricity tariff for monthly domestic consumption of 300 to 1000 kwh per month has gone up almost four times. It is not surprising that the average savings rate for the middle class is down to below 5 percent.

There is nevertheless some good news. Middle income workers, with annual income from Rs 400,000 to Rs 1,000,000 per annum remain the backbone of our personal income tax system. The majority are salaried tax payers. They account for over 90 percent of tax return filers and contribute over 46 percent to the tax revenue.

There has also been a rapid growth in the demand for consumer durables like motor cycles, refrigerators, TV sets, etc., of 6 to 8 percent per annum in the last eight years. This has been facilitated by the arrival of relatively cheap Chinese makes in the market and somewhat improved consumer financing. Mobile phones have, of course, filtered down even to the lower class. Meanwhile, the fast growth in sale of motor cars of over 10 percent annually continues unabated. This testifies to the affluence of the upper class.

The overall conclusion is that the middle class of Pakistan finds itself faced today with limited opportunities in the labor market and a squeeze in its living standards. The elections of 2017 provided an opportunity to the middle class to continue agitating for improved governance, greater accountability against corrupt practices, for progressive policies against high inequality and for improvements in the provision of services. This middle class vote bank was a major factor in the victory of the PTI. Hopefully, promises made by the Party will be fulfilled.

SECTION 13

REGIONAL INEQUALITY

Chapter 36:

GROWTH OF PROVINCIAL ECONOMIES

Not much is known currently about the size, composition and growth of the Provincial economies, of Pakistan. This is unlike India, which has a tradition of constructing and maintaining Regional Income Accounts so as to estimate and derive the trends in the Provincial Gross Domestic Products (PGDPs). This has rendered it extremely difficult to engage in meaningful planning at the Provincial level.

However, the time for formulation of Provincial Growth Strategies (PGS) has come especially after the 18th Amendment. These strategies should form the basis for the allocation among sectors of the funds in the respective Annual Development Programs (ADPs). This role of the Provinces in promoting the growth of their respective economies has been greatly facilitated by the passage of the 18th Amendment. This Amendment has led to the abolition of the Concurrent List in the Constitution and the resultant transfer of the large number of functions in this List to the Provinces.

The Pakistan Bureau of Statistics (PBS), in coordination with the Provincial Bureaus of Statistics, should have undertaken the task of distributing the national GDP into the PGDPs on the basis of allocators for each sector. This has not happened because planning has been very much in the Federal domain under the Planning Commission, Government of Pakistan. As highlighted earlier, the approach now required is a 'bottom-up' process whereby Provincial development plans are first prepared and then aggregated into the National Plan. The task for the Federal Planning Commission is to ensure that there is a consistent sectoral and macroeconomic framework to support the Provincial and Federal Plans.

The objective of this report is to present estimates by sector of the PGDPs for the period, 1999-2000 to 2016-17. In the process, there is substantial deepening of the knowledge on the economy of Pakistan, especially in terms of the location of different activities. Further, one of the principal objectives of this chapter is to highlight the extent of regional inequality in Pakistan.

The report is organized as follows: Section 2 describes the methodology used for constructing the regional income accounts to yield estimate of the PGDPs. Sections 3 and 4 present the results of the application of the methodology and conclusions derived regarding the relative size, composition, growth of the four Provincial economies and the extent of inequality. Section 5 quotes or constructs other indicators of regional growth to judge the consistency of the PGDP estimates. Section 6 asks the question as to whether regional inequality has been increasing or decreasing in Pakistan over the last seventeen years? Section 7 identifies the sub-sectors which can act as potential drivers of growth in each Province. Finally, in Section 8 are presented a summary of the major findings and recommendations.

36.1. METHODOLOGY FOR ESTIMATION OF THE PGDPs

The first attempt at estimating by sector the PGDP of the four Provinces is by Bengali and Sadaqat [2001] under the technical guidance of the author. The estimates are for the period, 1972-73 to 1999-2000. This report represents extension of the methodology developed in this paper.

This finalization of the methodology is also based on a comprehensive review of literature of papers by Nair [1987] and Tiwari [1971] on India, Walters [1987] on Australia, Adler [1970] on Canada, Arndt [1973] on Indonesia, Brown and Woodward [1969] on the U.K, Sourroile [1976] on Indonesia and Graham and Romans [1971] on the USA.

The methodology essentially involves the identification of appropriate regional allocators of the value added in different sectors/sub-sectors. The choice depends also on the availability of data. There are three possible approaches, including estimation of factor incomes, output or expenditure. The approach here is a hybrid one depending on the sector.

Table 36.1 gives the allocator used for each sub-sector. The total number of sub-sectors is 18. The factor income approach has been adopted for four sectors, the output method for seven sectors and the expenditure approach for the remaining six sub-sectors. Diverse sources of data have been used.

Before presenting the PGDP estimates for the more recent period, the earlier differential growth patterns by Province are presented in Table 36.2, as revealed for different epochs by the estimates from Bengali and Sadaqat [2001]. A remarkable empirical regularity is observed. On a long-term basis, over a period of 27 years from 1972-73 to 1999-2000, three Provincial economics of Punjab, Sindh and Khyber-Pakhtunkhwa have grown at virtually the same rate of close to 5 percent. The only Province which has shown a significantly lower growth rate is Balochistan.

There is also another pattern in terms of the impact of business cycles. When the economy is growing fast, as in the Zia-ul-Haq period, Sindh performs relatively well. In low growth periods, as from 1973 to 77, Punjab manages a somewhat higher growth rate. The question is whether these patterns are also observed in the more recent period?

Table 36.1: Regional Allocators* for Different Sectors/Sub-Sectors

Sector/Sub-Sector	Allocator	Data Sources**
AGRICULTURE		
Major Crops	Share in Output of major crops	PDS, ASYB
Minor Crops	Share in Output of minor crops	PDS, ASYB
Cotton Ginning	Share in Cotton Output	ASYB
Livestock	Share in Consumption Expenditure of Livestock products	HIES
Forestry	Share in Expenditure on Forest Products	HIES
Fishing	Share in Output	PDS, AYSB
INDUSTRY		
Mining and Quarrying	Share in Output of Crude Oil, Natural Gas & Coal	PDS, EYB
Large-Scale Manufacturing	Share in Output of 100 industries	PDS, PES[a]
Small-Scale Manufacturing	Share in Informal Sector Employment in Manufacturing	LFS
Slaughter	Share in Consumption Expenditure on Livestock Products (excluding milk)	HIES
Electricity, Gas and Water	Shares in electricity generation, electricity consumption, gas consumption and canal water withdrawal	PDS, EYB, ASYB
Construction	Income-Adjusted Share in Employment	HIES, LFS
SERVICES		
Transport, Storage and Communications	Shares in Consumption of POL and number of cellular phone subscribers	OCAC, PTA
Wholesale, and Retail Trade, Hotels and Restaurants	Share in trade margins in marketing of goods and in employment in hotels and restaurants	HIES, LFS
Finance and Insurance	Share in bank advances	SBP
Ownership of Dwellings	Share in actual and imputed rents	HIES
Public Administration & Defense	Income-Adjusted share in employment	HIES, LFS
Community, Social & Personal Services	Income-Adjusted share in employment	HIES, LFS

[a]data was only available for selected industries, for other industries data was obtained directly from the Punjab Bureau of Statistics and Pakistan Bureau of Statistics

*Data was not available on a number of allocators for 2017-18

**PDS = Punjab Development Statistics, ASYB = Agricultural Statistics Year Book, HIES = Household Integrated Economic Survey, LFS = Labor Force Survey, OCAC = Oil Companies Advisory Committee, PTA = Pakistan Telecommunication Authority, SBP = State Bank of Pakistan, EYB = Energy Yearbook

Table 36.2: Annual Growth Rate of the Provincial Economies in Different Epochs – (%)

	1973-77 (Bhutto)	1977-88 (Zia ul Haq)	1988-1999 (BB + NS)*	1973-1999
Punjab	3.2	6.0	4.4	4.9
Sindh	1.9	7.0	4.1	5.0
Khyber-Pakhtunkhwa	1.1	7.0	4.3	5.0
Balochistan	2.5	4.9	4.6	4.4
Pakistan	**2.5**	**6.4**	**4.5**	**4.9**

*BB = Benazir Bhutto, NS = Nawaz Sharif

Source: Bengali and Sadaqat [2001]

36.2. SIZE AND GROWTH OF PROVINCES

The respective size of the Provinces in the initial year, 1999-2000, and in the latest year, 2016-17, is given in Table 36.3. As expected, Punjab is the largest provincial economy with a share of just over 54 percent in 2014-15. However, the share of this Province has fallen somewhat since 1999-2000. The next economy is that of Sindh with a share of 30 percent in 2016-17. There has been a modest increase in the share of this Province since 1999-2000. The economy of Khyber- Pakhtunkhwa has a share in the national economy of 13 percent. It has increased its share significantly since 1999-2000. Balochistan is by far the smallest province, with a declining share.

Table 36.3: Size of the Provincial Economies – (at constant prices of 2005-06, Billion Rs)

	1999-2000	Share (%)	2016-17	Share (%)
Punjab	3147.7	55.3	6320.4	54.0
Sindh	1686.7	29.6	3522.1	30.1
Khyber-Pakhtunkhwa	644.2	11.3	1523.4	13.0
Balochistan	214.5	3.8	343.0	2.9
Pakistan	**5693.1**	**100.0**	**11708.9**	**100.0**

Source: Estimated

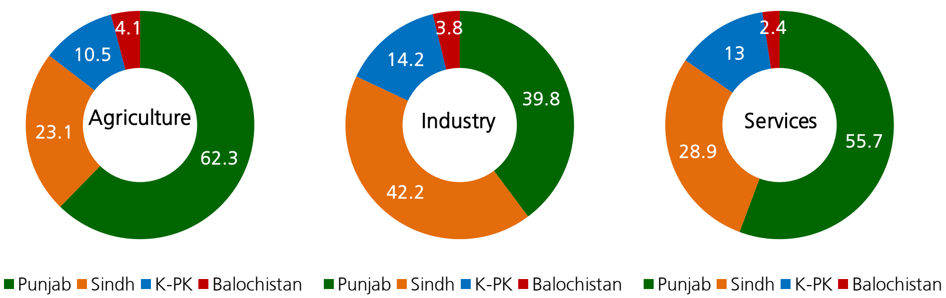
Table 36.4 presents the sectoral distribution of value added among the Provinces. Punjab dominates in agriculture, with a share of over 62 percent. It is significant that the industrial sector of Sindh, with a share of 42 percent, is even larger than that of Punjab. In services, the ranking of size is the same as in agriculture. The shares have been depicted in Chart 36.1.

Table 36.4: Share of the Provinces in the National Economy by Sector, 2016-17 – (%)

	Agriculture	Industry	Services
Punjab	62.3	39.8	55.7
Sindh	23.1	42.2	28.9
Khyber-Pakhtunkhwa	10.5	14.2	13.0
Balochistan	4.1	3.8	2.4
Pakistan	**100.0**	**100.0**	**100.0**

Source: Estimated

Chart 36.1: Share of the Provinces in the National Economy by Sector, 2016-17 – (%)



Source: Estimated

Turning to the growth rates of the Provincial economies, these have been derived for three periods, as follows:

Musharraf Period:	1999-2000 to 2007-08
PPP Period:	2008-09 to 2012-13
PML(N) Period:	2013-14 to 2016-17

Table 36.5 presents the Provincial growth rates in the above periods. The performance of the four regional economies is also visually presented in Chart 36.2.

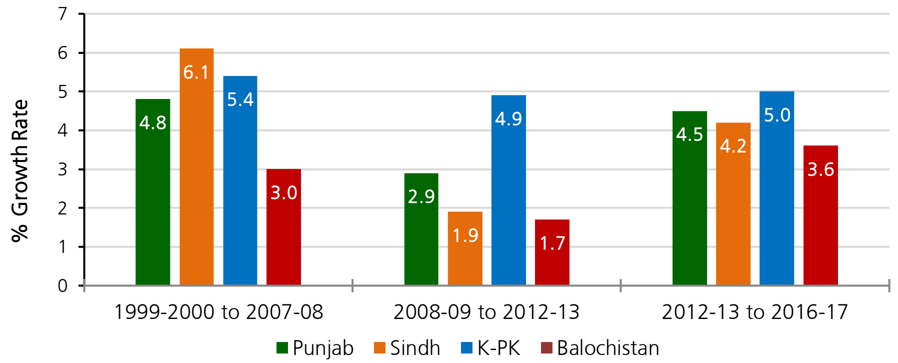
Table 36.5: Annual Growth Rates of the Provincial Economies in Different Periods, 1999-2000 to 2016-17 – (%)

	1999-2000 to 2007-08	2008-09 to 2012-13	2012-13 to 2016-17	1999-2000 to 2016-17
Punjab	4.8	2.9	4.5	4.2
Sindh	6.1	1.9	4.2	4.4
Khyber-Pakhtunkhwa	5.4	4.9	5.0	5.2
Balochistan	3.0	1.7	3.6	2.8
Pakistan	**5.6**	**2.8**	**4.5**	**4.5**

Source: Estimated

During the Musharraf period, the economy achieved relatively fast rates of growth. Sindh was the best performing economy with a growth rate in excess of 6 percent. In the slow growth period of the PPP Government, the growth rate of Sindh's economy has plummeted to below 2 percent, with some recovery in the last two years. This is consistent with the earlier finding that the performance of Sindh fluctuates more with the business cycle. The economy of Punjab has maintained an intermediate growth rate. In the Musharraf period, its growth rate was below that for the national economy. It has since shown somewhat higher growth rate than the rest of the country.

Chart 36.2: Annual Growth Rates of the Provincial Economies in Different Periods, 1999-2000 to 2016-17 – (%)



Source: Estimated

The real surprise is the dynamism of the economy of Khyber-Pakhtunkhwa. It has maintained a growth rate close to 5 percent throughout the seventeen years and achieved the highest growth rate since 2007-08. Explanations for this performance are offered in the subsequent section. Hitherto, there has been the common perception that the economy of Khyber-Pakhtunkhwa is the most adversely affected region by the war on terror.

Balochistan has been a straggler, with a growth rate, which has not exceeded 3 percent at any time during the last seventeen years. This is one of the really worrying features of the growth process since 1999-2000. The people of Balochistan are probably suffering today from a greater sense of deprivation and exclusion.

A detailed description of the growth performance of each economy is given in the following section.

36.3. GROWTH PERFORMANCE OF INDIVIDUAL PROVINCES

36.3.1. Punjab

The sectoral value added estimates are presented for Punjab in Table 36.6. The dominance of agriculture is the most pronounced in Punjab. The latest estimate of the share of this sector in the Provincial economy is almost 23 percent, as compared to 20 percent for the rest of Pakistan. Clearly, in the presence of strong forward and back word linkages, the performance of the agricultural sector has a vital role to play in the growth process of the Province.

Unfortunately, the emerging structural problem for Punjab is the loss of dynamism of agriculture. This sector grew at the rate of almost 4.5 percent in the decade of the 90s, but since then it has managed a growth rate of only about 2 percent. The fundamental problem is the lack of buoyancy in the production of major crops, as highlighted in Box 36.1. This is a reflection especially of the growing water constraint, diminishing returns to fertilizer use (especially urea) and increasing land degradation due to water logging and salinity. The cotton crop, in particular, is more vulnerable to pest attacks. Further, floods, especially in 2010-11, have also damaged crops.

The industrial sector of Punjab performed well in the Musharraf period, especially in textiles and other agro-based industry. The rise in the incidence of power outages after 2008 has impacted severely on industrial production. The small-scale sector has been hit badly and exports affected. The services sector also maintained a high growth rate between 1999-2000 and 2007-08. But the fall in buoyancy of the commodity-producing sectors has inevitably impacted on the dynamism of this sector.

Table 36.6: Estimated PGDP of Punjab by Sector, 1999-2000 to 2016-17 – (Rs in Billion at Constant Prices of 2005-06)

SECTOR	1999-2000	Share (%)	2007-08	Share (%)	2012-13	Share (%)	2016-17	Share (%)
Agriculture	994.9	31.61	1162.3 (1.96)*	25.37	1296.9 (2.22)	24.58	1438.6 (2.59)	22.81
Industry	418.9	13.30	708.4 (6.79)	15.46	816.6 (2.88)	15.48	981.8 (4.61)	15.50
Services	1733.9	55.09	2710.7 (5.74)	59.17	3162.8 (3.13)	59.95	3900.0 (5.23)	61.69
PGDP	**3147.7**	**100.00**	**4581.4 (4.80)**	**100.00**	**5276.1 (2.86)**	**100.00**	**6320.4 (4.51)**	**100.00**

*Annual Compound Growth Rate
Source: Estimated

Box 36.1: The Slowdown in Growth of Major Crops in Punjab

- Punjab accounts for 75 percent of the national value added in the major crops sector of agriculture.
- The agricultural economy of the Province performed well in the decade of the 90s. It has faltered since then as shown below:

(Annual Growth Rate %)

	Share of National Output (%)	Nineties	1999-2000 to 2007-08	2007-08 to 2016-17
Wheat	77	6.6	-0.7	3.5
Rice	63	7.7	3.6	1.1
Sugarcane	67	1.7	5.1	1.3
Cotton	73	5.1	0.4	1.0

Source: PBS, Government of Punjab, PDS

36.3.2. Sindh

The economy of Sindh showed exceptional dynamism in the Musharraf period. The leading sector was industry with double-digit growth rate of 10 percent as shown in Table 36.7. Currently, the economy of Sindh has the highest share of industry in its PGDP of 29 percent.

Conditions in Sindh changed fundamentally after 2008. The breakdown of law and order in the Metropolitan city of Karachi has led to a severe loss of economic momentum, from over 6 percent in the earlier years to below 2 percent after 2008. This implies a loss to the regional economy of almost Rs. 400 billion per annum. There has been some recovery from 2015 onwards, following the operations in Karachi by the Rangers.

Industry has actually contracted since 2008. Box 36.2 highlights the major industries, which have exhibited negative growth rates. Agriculture of Sindh has also performed poorly over the last fifteen years, with an average growth rate of less than 2 percent. The services sector, especially trade, has also been impacted by periodic closures and lack of security. The growth rate has fallen to just over 3 percent.

Table 36.7: Estimated PGDP of Sindh by Sector, 1999-2000 to 2016-17 – (Rs in Billion at Constant Prices of 2005-06)

SECTOR	1999-2000	Share (%)	2007-08	Share (%)	2012-13	Share (%)	2016-17	Share (%)
Agriculture	379.2	22.48	440.3 (1.88)*	16.23	480.0 (1.74)	16.09	532.2 (2.58)	15.11
Industry	412.9	24.48	884.6 (10.00)	32.61	864.8 (-0.45)	28.99	1040.0 (4.61)	29.53
Services	894.6	53.04	1387.5 (5.64)	51.15	1637.8 (3.37)	54.91	1949.9 (4.36)	55.36
PGDP	**1686.7**	**100.00**	**2712.4**	**100.00**	**2982.6 (1.92)**	**100.00**	**3522.1 (4.15)**	**100.00**

*Annual Compound Growth Rate
Source: Estimated

Box 36.2: Growth of Manufacturing in Sindh

- Index of Industrial Production grew at the rate of 10 percent between 1999-2000 to 2007-08.
- Some Industries showed phenomenal growth rates like sugar (24 percent); cement (17 percent); cotton fabrics (14 percent); beverages (9 percent) and vegetable ghee (8 percent).
- There was a slump in the manufacturing sector after 2007-08 up to 2014-15. Many Industries showed negative growth rates up to 2012-13, including fertilizer (-14 percent); cars (-8 percent); POL refining (-7 percent); sugar (-5 percent); cotton yarn (-5 percent) and cotton fabrics (-1 percent).

Source: GOS, Sindh Development Statistics.

36.3.3. Khyber-Pakhtunkhwa

Contrary to expectations, Khyber-Pakhtunkhwa has performed well despite being a front-line state in the war on terror as shown in Table 36.8. The basic contributing factor is the large inflow in per capita terms of remittances, both foreign and domestic. Almost 20 percent of household income in the Province comes from remittances, as compared to less than 10 percent in Punjab and below 3 percent in Sindh and Balochistan. Consequently, it is estimated that almost 27 percent of the national home remittances flow into Khyber-Pakhtunkhwa. These remittances have shown rapid growth of over 15 percent in recent years.

Table 36.8: Estimated PGDP of Khyber-Pakhtunkhwa by Sector, 1999-2000 to 2016-17 – (Rs in Billion at Constant Prices of 2005-06)

SECTOR	1999-2000	Share (%)	2007-08	Share (%)	2012-13	Share (%)	2016-17	Share (%)
Agriculture	163.1	25.32	182.5 (1.41)*	18.57	218.1 (3.63)	17.45	241.8 (2.57)	15.87
Industry	113	17.54	224.8 (8.97)	22.87	292.2 (5.38)	23.37	351.2 (4.60)	23.05
Services	368.1	57.14	575.7 (5.74)	58.57	739.8 (5.14)	59.18	930.4 (5.73)	61.08
PGDP	**644.2**	**100.00**	**938.0 (5.42)**	**100.00**	**1250.1 (4.92)**	**100.00**	**1522.4 (5.00)**	**100.00**

*Annual Compound Growth Rate
Source: Estimated

Box 36.3: Growth of Services in Khyber-Pakhtunkhwa

- The services sectors of Khyber-Pakhtunkhwa have shown exceptional dynamism, as revealed by the following table:

Growth Rate of Services: 1999-2000 to 2016-17 (%)		
Sub-Sectors	Khyber-Pakhtunkhwa	Pakistan
Transport, Storage & Communications	5.8	4.6
Wholesale and Retail Trade	4.7	4.4
Finance and Insurance	2.9	5.3
Ownership of Dwelling	6.5	4.0
Public Administration and Defence	5.8	5.8
Social and Community Services	7.0	5.9
Services Total	**5.6**	**4.8**

- Afghan transit trade and NATO supply movement have contributed to the higher growth in the transport sector. The ownership of dwellings sector has achieved a high growth rate of 6.5 percent due to the investment in housing from home remittances. These inflows have also created high demand for economic and social services.

Today, Khyber-Pakhtunkhwa has acquired the characteristics of a remittance-led service economy, with a limited indigenous production base. Box 36.3 gives the growth in individual services as compared to the whole country. Reasons for the high growth are also given in the Box. In 2016-17, the services sector accounted for 61 percent of the provincial economy. This is the highest share among the Provinces.

36.3.4. Balochistan

The Province of Balochistan has remained the slowest growing Province since 1999-2000. The insurgency in the Province and actions taken in response by the military has reduced investment and economic activity, and in some years the real per capita income may have actually fallen, as shown in Table 36.9.

Table 36.9: Estimated PGDP of Balochistan by Sector, 1999-2000 to 2016-17 – (Rs in Billion at Constant Prices of 2005-06)

SECTOR	1999-2000	Share (%)	2007-08	Share (%)	2012-13	Share (%)	2016-17	Share (%)
Agriculture	59.7	27.83	70.3 (2.06)	25.78	85.2 (3.92)	28.68	94.4 (2.56)	27.52
Industry	56.4	26.29	73.4 (3.35)	26.92	77.1 (0.98)	25.95	92.8 (4.63)	27.05
Services	98.4	45.88	128.9 (3.43)	47.28	134.7 (0.88)	45.35	155.8 (3.64)	45.43
PGDP	**214.5**	**100.00**	**272.6 (3.04)**	**100.00**	**297.0 (1.72)**	**100.00**	**343.0 (3.59)**	**100.00**

*Annual Compound Growth Rate
Source: Estimated

Box 36.4: Growth of Minor Crops in Balochistan

- The growth rate in the minor crops has been impressive since 1999-2000, at over 5 percent per annum. In 2016-17, minor crops accounted for 45 percent of total agricultural value added in Balochistan as compared to 12 percent for the country as whole.
- The share of Balochistan in national production of some minor crops and the growth rate are given below:

(Annual Growth Rate %)

Sub-Sectors	Share of National Output (%)	Balochistan	Rest of Pakistan
Tomato	40	18	3
Other Vegetables	16	11	0
Apples	81	5	-1
Apricot	93	6	-4
Grapes	98	5	0

Source: ASYB

However, there is one side of the story of Balochistan, which has not been highlighted. The Province has had spectacular success in the production of fruits and vegetables, which have made it the fastest growing Province in agriculture. Box 36.4 shows that in some products, Balochistan contributes a large share of the national output.

The favorable 7^{th} NFC Award to Balochistan is beginning to have some positive impact on the economic growth rate. From below 2 percent between 2007-08 to 2012-13, it has risen to above 3.5 percent in the last four years.

36.4. PROXY INDICATORS

36.4.1. Per Capita Household Income

This section tests for the reliability of the trends revealed by the PGDP estimated above. In specific terms, is there other evidence to support the findings that Khyber-Pakhtunkhwa has shown exceptional dynamism, that Balochistan has been a straggler, that Sindh grew fast initially and has since visibly slowed down and that Punjab has performed moderately well?

The first set of data is that of per capita income from the Household Integrated Economic Survey (HIES) carried out by the PBS periodically. Table 36.10 shows the Provincial rankings in terms of per capita household income in different HIES.

Table 36.10: Rankings of the Provinces in per Capita Income*, 2001-02 to 2015-16

Province	2001-02	2007-08	2015-16
Punjab	2	1	1
Sindh	1	2	2
Khyber Pakhtunkhwa	4	3	3
Balochistan	3	4	4

Source: HIES

The findings are largely consistent with the results on rates of economic growth. K-PK has steadily moved up in the rankings, from the bottom position in 2001-02, to 3^{rd} in 2007-08 and thereafter Punjab has ascended from second to first place. Sindh has slipped from first to second place, while Balochistan has fallen from 3rd to 4th place. Overall, there have been dramatic changes in the ranking of the four Provinces over the last seventeen years.

In the first period, 1999-2000 to 2007-08, the fastest growth rate of employment of almost 4.5 percent per annum is in Sindh. This is consistent with the dynamism of the Sindh economy during these years. The surprise is the relatively slow growth of jobs in Punjab in this period.

The rise of employment in the non-agricultural sector has a very different pattern in the latter period, 2007-08 to 2012-13. The fastest growth of over 4 percent is observed in Khyber-Pakhtunkhwa, especially in the informal sector of the Province, mostly in services. There has been a visible pickup in the employment growth of Punjab. Here again, the good performance of the economy of Khyber-Pakhtunkhwa in recent years is highlighted.

36.4.2. Other Indicators

One sensitive indicator of the underlying growth of incomes in an economy is the rate of annual increase in income tax revenues. This data has become available from the Year Books of FBR. Between 2008-09 and 2012-13, the fastest annual growth in revenues is observed in Khyber-Pakhtunkhwa of almost 18 percent. Next is Sindh with growth rate of 15 percent, followed by Punjab, Balochistan and Islamabad of between 12 percent to 13 percent. Yet again, the exceptional buoyancy of Khyber-Pakhtunkhwa is demonstrated.

Finally, information on the growth in value of owner-occupied housing is extracted from the HIES. Here again, the biggest rate of increase is observed in Khyber-Pakhtunkhwa of almost 20 percent per annum, between 2007-08 and 2013-14, as compared to 13 percent for the country as a whole. Clearly, this reflects the impact of the large and rapidly growing remittances to the Province of Khyber-Pakhtunkhwa.

Overall, the findings from estimates of PGDP are mostly confirmed. The evidence largely points to the dynamism of the economy of Khyber-Pakhtunkhwa, especially after 2007-08. This is perhaps the most unexpected finding from this research.

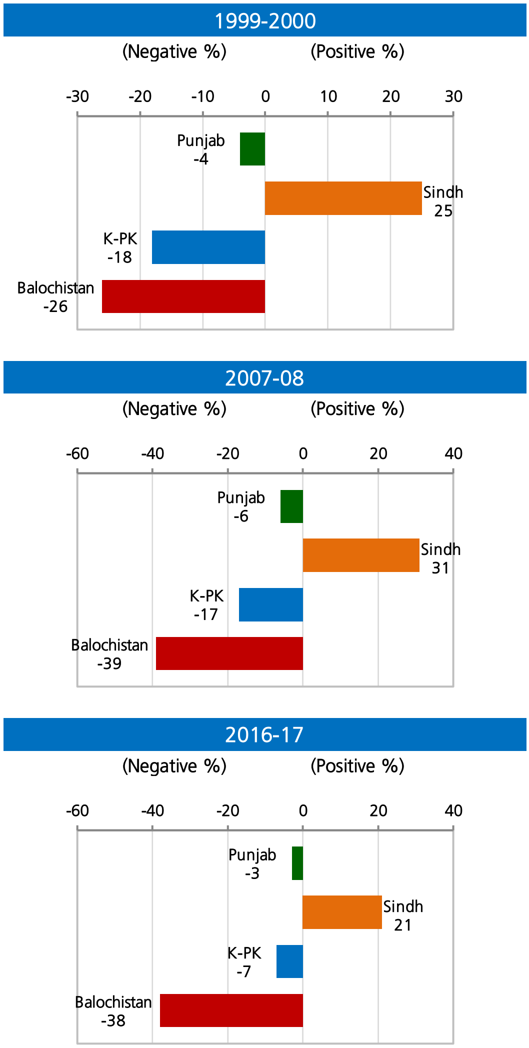
36.5. TRENDS IN REGIONAL INEQUALITY

The basic question is as follows: Has inter-provincial inequality increased or decreased in the last seventeen years? During the Musharraf era the fastest growth of Sindh province, with the highest per capita PGDP, is likely to have accentuated the extent of inequality. In the more recent period, the emergence of Khyber Pakhtunkhwa could imply a reduction in inequality. However, the slow growth since 1999-2000 in Balochistan, the Province with the lowest per capita GDP, has been a constant factor in perpetuating inequality.

The per capita GDP of Punjab was 4 percent below the national average in 1999-2000. This gap increased to 6 percent by 2007-08. It has since come down once again to 4 percent. Sindh has a per capita PGDP substantially above the national average. It was 25 percent higher in 1999-2000, rising to 31 percent by 2007-08. Since then, it has come down to 22 percent.

Khyber-Pakhtunkhwa has caught up significantly. It had a per capita PGDP 18 percent below the national average in 1999-2000. The gap has been reduced to only 6 percent. Balochistan has fallen further behind, from a 26 percent gap in 1999-2000 to almost 45 percent by 2014-15.

Chart 36.3: Deviation of Per Capita PGDP from National Average by Province, 1999-2000 to 2016-17



Source: Derived

Given the contrasting trends, a summary measure needs to be developed to quantify the extent of inter-provincial inequality. The indicator used is the population-weighted coefficient of variation, as follows:

$$CV_t = \sum_{i=1}^{4} = w_{it}\, d_{it}^2 \quad \ldots\ldots\ldots [1]$$

Where $\mathbf{CV_t}$ = coefficient of variation in year **t**; w_{it} = population share of the ith province in year **t** and $\mathbf{d_{it}}$ = percentage deviation of the ith province in year **t** from the national average.

The estimated values are as follows:

Year	Coefficient of Variation
1999-2000	234.1
2007-08	353.2
2016-17	199.1

The results indicate that inter-provincial inequality increased sharply during the Musharraf period. Following the return to democracy, it has come down. Over the seventeen year period, it has declined somewhat.

36.6. GROWTH DRIVERS BY PROVINCE

This section focuses on the sub sectors in which a particular province has a comparative advantage. If the growth strategy of a province focuses on these sub-sectors of comparative advantage, then it is likely to be more consistent with the factor endowments of the province, including the natural resources.

The comparative advantage is based on the magnitude of the location quotient. This is derived as follows:

$$LQ_{ij} = \frac{S_{ij}}{S_j} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ \ \ldots\ldots\ldots\ldots\ldots\ldots [2]$$

Where;

LQ_{ij} = location quotient of the ith sector in the jth province;

S_{ij} = shares of the ith sector of the jth province in value added nationally in the ith sector

S_j = share of the jth province in the GDP of Pakistan.

Table 36.12 presents the sectors of comparative advantage in each Province, where LQ is greater than one. In summary, these are given below for each Province.

Table 36.11: Comparative Advantage of the Provinces by Sub-Sector, 2016-17 (L_{ij} is greater than 1)

	Punjab	Sindh	Khyber-Pakhtunkhwa	Balochistan
AGRICULTURE				
Important Crops	✓	-	-	-
Minor Crops	-	-	-	✓
Cotton Ginning	✓	✓	-	-
Livestock	✓	✓	✓	-
Fishing	-	✓	-	✓
Forestry	-	-	✓	✓
INDUSTRY				
Mining and Quarrying	-	✓	-	✓
Large-Scale Manufacturing	✓	✓	-	-
Small-Scale Manufacturing	✓	-	-	-
Slaughtering	✓	-	✓	-
Construction	✓	-	✓	-
Electricity & Gas	-	-	✓	✓
SERVICES				
Transport & Communications	✓	-	✓	-
Wholesale & Retail Trade	-	✓	-	✓
Finance & Insurance	✓	✓	-	-
Ownership of Dwellings	-	✓	✓	-
Public Admin & Defense	✓	-	-	✓
Social and Community Services	✓	-	✓	-
Number of Sub Sectors	**11**	**8**	**8**	**7**

Source: Derived

Punjab: important (major crops); cotton ginning; livestock (especially milk production); large-scale and small-scale manufacturing slaughtering; construction; transport and communications; finance and insurance; public administration and defense and economic, social and community services.

Sindh: cotton ginning; livestock; fisheries; mining and quarrying; large-scale manufacturing; wholesale and retail trade; finance and insurance and ownership of dwellings.

Khyber-Pakhtunkhwa: livestock; forestry; slaughtering, construction; electricity and gas; transport and communications; economic, social and community services; ownership of dwellings.

Balochistan: minor crops; fishing; forestry; mining and quarrying; electricity and gas; wholesale and retail trade; public administration and defense.

36.7. FINDINGS AND RECOMMENDATIONS

Not much has been known hitherto about the size, composition and growth of the Provincial economies of Pakistan from 1999-2000 to 2016-17. The objective of this chapter has been to fill this major gap.

The findings of research are as follows:

(i) Prior to 1999-2000, earlier research has revealed the long-term convergence of the three Provincial economies Sindh, Punjab and Khyber-Pakhtunkhwa to, more or less, the same growth rate of their PGDPs of 5 percent. However, Balochistan performed poorly in relation to the other Provinces.

(ii) A pattern of growth is also visible. During periods of high growth, like in the 80s, the Province of Sindh performs relatively well. In low growth periods, like in the 70s, Punjab manages a somewhat higher growth rate.

(iii) Punjab has a share of 54 percent in the national GDP in 2014-15. The next economy in size is Sindh, with a share of 30 percent. Khyber-Pakhtunkhwa and Balochistan have shares of 13 percent and 3 percent respectively.

(iv) Punjab dominates in agriculture, with a share of over 62 percent. It is significant, however, that the industrial sector of Sindh, with a share of 42 percent, is even larger than that of Punjab. In services, Punjab has the largest share of almost 56 percent.

(v) During the Musharraf period, from 1999-2000 to 2007-08, the fastest growing Provincial economy was Sindh, with a growth rate in excess of 6 percent. Balochistan had the lowest growth rate of only 3 percent.

(vi) During the period of the PPP Government, from 2008-09 to 2012-13, the growth rate of the Sindh economy has plummeted to 2 percent only. The fastest growing economy during this period is Khyber-Pakhtunkhwa, at almost 5 percent. The same pattern is seen, more or less, in the first four years of the PML(N) Government. Balochistan has remained a straggler, with a low growth rate of about 3 percent.

(vii) The emerging structural problem for Punjab is the loss of the dynamism of agriculture. From a growth rate of almost 5 percent in the 90s, it has fallen to only 2 percent. This is a reflection especially of the emerging water constraint. Since 2008, power outages have impacted severely on industrial production in the Province.

(viii) The breakdown of law and order in Karachi has led to a visible loss of momentum in the economy of Sindh. It is estimated that the annual cost of the troubled situation in Karachi is almost Rs 400 billion.

(ix) Contrary to expectations, Khyber-Pakhtunkhwa has performed well despite being a frontline state in the war on terror. A major contributing factor is the large inflow of home remittances, which on average account for 20% of the income of households in the Province. Consequently, it has acquired the characteristics of a remittance-led service economy. However, the indigenous production base remains limited.

(x) The insurgency in Balochistan and the resultant military action have affected economic activity and investment in the Province. In some years, the real per capita income may even have fallen. There is need, however, to highlight the spectacular success of Balochistan in the production of fruits and vegetables, which has made it the fastest growing province in agriculture.

(xi) Other proxy indicators of growth have been used to test for the reliability of the PGDP estimates. These include the trend in household incomes as revealed by the HIES, growth of employment, rise in collection of income tax and growth in value of owner-occupied property. These indicators also confirm the dynamism of Khyber-Pakhtunkhwa, the loss of buoyancy by the economy of Sind, the moderate growth performance of Punjab and the persistent low growth of Balochistan.

(xii) The trend in inter-provincial inequality increased sharply during the Musharraf era due, in particular, to the fast growth of Sindh, with the highest per capita PGDP. Since then inequality has come down, with the fall in the growth rate of Sindh and the exceptional performance of the economy of Khyber-Pakhtunkhwa, a Province with relatively low PGDP. Overall, over the seventeen year period, there has not been much change in the magnitude of inter-provincial inequality.

(xiii) The sub-sectoral estimates for each Province of value added enable the determination of areas of comparative advantage of each Province. Out of the 18 sub-sectors in the national economy, Punjab has a locational advantage in 11, Sindh in 8, Khyber-Pakhtunkhwa in 7 and Balochistan also in 7 sub-sectors. Each Province ought to concentrate on sub-sectors where it has the comparative advantage if the growth potential is to be maximized.

Chapter 37:

PROVINCIAL LABOR MARKETS

The responsibilities of the Federal and the Provincial Governments in managing unemployment are linked to the allocation of functions following the 18th Amendment, which led to the abolition of the Concurrent List. Accordingly, the following functions stand transferred to the Provincial Governments:

(i) Welfare of labor; conditions of labor, provident funds; employer's liability and workmen's compensation, health insurance including invalidity pensions, old age pensions;

(ii) Trade Unions; industrial and labor disputes;

(iii) The setting up and carrying on of labor exchanges, employment information bureaus and training establishments;

(iv) Unemployment insurance.

Therefore, the Federal Government's role in management of unemployment is more macro and indirect, by following a development strategy which promotes employment and reduces unemployment. The Provincial Governments not only have a similar role but also more directly in performing functions indicated in (iii) and (iv) above.

Section 1 focuses on the role of Federal Government followed by Sections on the Provincial labor markets. The analysis is conducted from 2001-02 to 2014-15 based on data from the Labor Force Surveys carried out by PBS.

37.1. FEDERAL GOVERNMENT

37.1.1. The Unemployment

Table 37.1: National Rate of Unemployment, 2001-02 to 2014-15 – (%)

	2001-02	2007-08	2012-13	2014-15
Pakistan	**8.27**	**5.20**	**6.24**	**5.94**
Urban	9.80	6.34	8.83	7.98
Rural	7.55	4.71	5.08	5.01

Source: PBS, LFS

Before the role of the Federal Government is discussed, the trends in the unemployment rate at the national level are given in Table 37.1.1. The unemployment rate fell significantly between 2001-02 and 2007-08. Since then it has been rising, given the low rate of growth in GDP. It is estimated at close to 6 percent in 2014-15. The unemployment rate in urban areas has approached 8 percent. This is one explanation for the growing discontent in the cities.

37.1.2. Size of PSDP

The size of the PSDP, executed at the Federal level, is given in Table 37.2. Development expenditure not only expands the productive capacity of the economy and greater labor absorption but also provides employment during the period of construction.

Table 37.2: Size of Federal PSDP, 2013-14 to 2017-18 – (actual expenditure)

	Size (Rs in Billion)	% of GDP
2013-14	441	1.7
2014-15	502	1.8
2015-16	602	2.0
2016-17	726	2.3
2017-18	660	1.9

Source: MOF

The size of the Federal PSDP executed in 2013-14 was 1.7 percent of the GDP. This is slightly larger than the level in 2012-13. In 2016-17, the budgetary allocation for the PSDP was raised to Rs 726 billion, equivalent to 2.3 percent of the projected GDP. However, it was cutback to 1.9 percent of the GDP in 2017-18. This has led to a loss of almost 300,000 jobs.

37.1.3. Sectoral Priorities

Major supply-side constraints have emerged in the economy. These have negatively impacted on employment. The biggest problem has been the shortage of energy. Also, in years to come, water will become a major factor impeding growth of agriculture. However, the electricity generation capacity has expanded significantly in 2017-18. Larger allocations from the Federal PSDP must go to the water and power distribution sectors.

37.1.4. Social Protection

One of the major factors contributing to poverty is unemployment or low wage employment. The Federal Government has been operating since 2009-10 the Benazir Income Support Program (BISP). This program gives monthly income support to households below the poverty line. Originally, the stipend of Rs 1000 per month was given. In the Budget of 2014-15, this has been raised to Rs 1500 with a targeted coverage of almost 6 million households. Credit is due to the PML(N) government for not only continuing a program started by the PPP, but also for raising the funds allocated to the program.

37.2. PUNJAB

37.2.1. The Labor Market

Punjab had the highest labor force participation rate (LFPR) among the Provinces of Pakistan in 2014-15. It was 69 percent in the case of males and 28 percent among females, implying an overall LFPR of 48 percent for population aged 10 years and above. The LFPR is 52 percent in rural areas and 40 percent in urban areas.

The labor force is estimated at close to 35 million in 2014-15, of which 72 percent is male. The annual growth rate of the labor force is 2.0 percent. The overall unemployment rate is projected at just over 6 percent in 2014-15, as shown in Table 37.3. It has risen from 5.5 percent in 2007-08.

Table 37.3: Unemployment Rate in Punjab, 2001-02 to 2014-15 – (%)

	2001-02	2007-08	2012-13	2014-15
Punjab	**8.51**	**5.54**	**6.38**	**6.29**
Urban	10.78	7.14	8.70	8.33
Rural	7.56	4.91	5.44	5.46

Source: PBS, LFS

37.2.2. Profile of Unemployment

In 2014-15, the unemployment rate was significantly higher in the urban areas at 8.3 percent as compared to 5.5 percent in the rural areas. There is also a large difference in the unemployment by gender. It is 5.6 percent in the case of males and 7.8 percent among female workers.

A worrying feature of the labor market is the high unemployment rate of highly educated workers (with degree or above) of close to 11 percent. Also, youth (15-29 years) are finding it difficult to get jobs. Their unemployment rate currently is almost 13 percent.

The Government of Punjab has given high priority to training. The Technical and Vocational Training Authority (TEVTA) of Punjab is operating under the TEVTA Act of 2010. The basic objective is to promote and provide demand driven technical education and vocational training service.

TEVTA offers short courses as well as degrees like B. Tech and DAE. The total enrolment is about 86,000 in a network of over 500 institutes at the district level. It is proposed to expand the number in the next three years to over 400,000.

Overall, the rate of unemployment remains high. The Government of Punjab is not devoting enough resources on educating the population. However, it is focusing strongly on technical and vocational training for raising employability, especially of young workers. The level of development activity is also relatively low, which limits the prospects for faster growth in output and employment.

37.3. KHYBER-PAKHTUNKHWA

37.3.1. The Labor Market

Khyber-Pakhtunkhwa has a relatively low LFPR among the Provinces of Pakistan in 2014-15. It is 59 percent in the case of males and 14 percent among females, implying an overall LFPR of 36 percent for population aged 10 years and above. The LFPR is 37 percent in rural areas and 34 percent in urban areas.

The labor force is estimated at close to 7 million in 2012-13, of which 80 percent is male. The annual growth rate of the labor force is only 1.1 percent, due largely to out-migration of workers. The number employed is 6.4 million, of which 83 percent are in the rural areas. The overall unemployment rate is relatively high at almost 8 percent in 2014-15, as shown in Table 37.4. This partly explains the out-migration of workers from the Province to the rest of Pakistan and abroad.

Table 37.4: Unemployment Rate in Khyber-Pakhtunkhwa, 2001-02 to 2014-15 – (%)

	2001-02	2007-08	2012-13	2014-15
Khyber-Pakhtunkhwa	**13.09**	**8.62**	**8.57**	**7.71**
Urban	12.16	9.77	11.82	9.74
Rural	12.79	8.40	7.88	7.26

Source: PBS, LFS

37.3.2. Profile of Unemployment

In 2012-13, the unemployment rate was significantly higher in the urban areas at close to 10 percent as compared to 7 percent in the rural areas. There is also a large difference in the unemployment by gender. It is 6 percent in the case of males and as high as 16 percent among female workers.

A worrying feature of the labor market in this Province also is the high unemployment rate of highly educated workers (with degree or above) of about 18 percent. Also, youth (15-29 years) are finding it difficult to get jobs. Their unemployment rate currently is over 12 percent.

Overall, the unemployment situation in Khyber-Pakhtunkhwa is worse than in the other Provinces. The formal sector of the Province is small and much of the employment is in the informal sector. Growth of the regional economy has been impacted by the high incidence of acts of terrorism.

37.4. SINDH

37.4.1. The Labor Market

Sindh had a labor force participation rate of 43 percent in 2014-15. It is 69 percent in the case of males and 13 percent among females. The overall LFPR is 43 percent, with 49 percent in rural areas and only 37 percent in urban areas.

The labor force is estimated at 15.2 million in 2014-15, of which 83.6 percent is male. The annual growth rate of the labor force is 2.35 percent. The number employed is 14 million, of which 57.7 percent are in the rural areas. The overall unemployment rate is one of the lowest in Pakistan and is estimated at less than 5 percent in 2014-15, as shown in Table 37.5. It has risen from 3.1 percent in 2007-08, with a big jump in urban employment. This explains the high level of crime and violence in the Metropolitan city of Karachi.

A worrying feature also of the labor market of Sindh is the high unemployment rate of highly educated workers (with degree or above) of 12 percent. Also, youth (15-24 years) are finding it difficult to get jobs. Their unemployment rate currently is 7 percent.

Table 37.5: Unemployment Rate in Sindh, 2001-02 to 2014-15 – (%)

	2001-02	2007-08	2012-13	2014-15
Sindh	**5.15**	**3.10**	**5.24**	**4.66**
Urban	7.09	3.63	8.72	2.46
Rural	2.19	2.04	2.52	7.31

Source: PBS, LFS

Sindh enjoys the lowest unemployment rate among the four Provinces. In recent years, as the growth rate of the regional economy came down, the rate of urban unemployment, in particular, has risen sharply. This is a reflection of the inability of the Provincial Government to improve the bad law and order situation in Karachi. The Provincial Government also appears to be attaching relatively low priority to education and to implementing programs for directly creating employment opportunities.

37.5. BALOCHISTAN

37.5.1. The Labor Market

Balochistan had a relatively low labor force participation rate of among the Provinces of Pakistan in 2014-5. It was 65 percent in the case of males and 18 percent among females, implying an overall LFPR of 44 percent for population aged 10 years and above. The LFPR was 47 percent in rural areas and 36 percent in urban areas.

Table 37.6: Unemployment Rate in Balochistan, 2001-02 to 2014-15 – (%)

	2001-02	2007-08	2012-13	2014-15
Balochistan	**7.76**	**2.78**	**3.93**	**3.92**
Urban	12.70	3.80	6.25	5.82
Rural	6.69	2.21	3.28	3.35

Source: PBS, LFS

The labor force is estimated at almost 3 million in 2014-15, of which 88 percent was male. The annual growth rate of the labor force is high at over 5 percent. The number employed is 2.9 million, of which 79 percent are in the rural areas. The overall unemployment rate is the lowest in Pakistan at below 4 percent in 2014-15, as shown in Table 37.6. It has risen from 2.8 percent in 2007-08. There was a big decline in the unemployment rate between 2001-02 and 2007-08. The low unemployment rate is due to the labor shortage in the presence of a small population base.

37.5.2. Profile of Unemployment

In 2014-15, the unemployment rate was significantly higher in the urban areas at close to 6 percent as compared to 3.3 percent in the rural areas. There is also a large difference in the unemployment by gender. It was below 3 percent in the case of males and almost 9 percent among female workers.

Despite being a backward Province, Balochistan has a low level of unemployment. Following the favorable 7th NFC Award, the Provincial Government has raised substantially the level of education spending. However, it needs to raise the size of the ADP and focus on expanding the productive capacity of the regional economy as well as the institutional base. A planning and growth strategy has to be developed to manage the high costs of delivery of services in the presence of the extremely low population density.

Overall, analysis of the Provincial labor markets reveals substantial variation among the Provinces. The highest unemployment rate is observed in Khyber-Pakhtunkhwa. Also, the unemployment rate is generally high among female, young and highly educated workers.

Chapter 38:

LEVEL OF HDI IN THE PROVINCES AND DISTRICTS OF PAKISTAN

The Human Development Index (HDI) is considered as a better measure of development than just per capita GDP. The HDI has three components, namely, measures of health, education and per capita income (in purchasing power parity terms) respectively. The HDI is computed annually for 188 countries by the United Nations Development Program (UNDP). Pakistan currently stands at 150th, with a medium level of human development.

There have been occasional attempts at deriving the HDI at the Provincial level in Pakistan. This was first done for the Pakistan Human Development Report of UNDP for 2003. In 2008, the Pakistan Bureau of Statistics (PBS) estimated the HDI for each Province. However, there has been no attempt the update index values for recent years. Also, the findings were defective as they substantially understated the per capita income of Sindh relative to the other Provinces. This is also the first attempt at estimating the HDI at the district level.

The need for this research has arisen following the setting up of the 9th National Finance Commission (NFC). In the last NFC award, multiple criteria were used for the first time for distribution of transfers from the divisible pool to the Provinces. One criterion was the level of backwardness. The HDI was used as one measure of backwardness of a Province, along with the incidence of poverty.

The following measures have been used to construct the HDI: life expectancy in years for health; mean years of schooling of population aged ten years and above for education and income per capita. The methodology for deriving the value of HDI is the same as that used by UNDP. Diverse sources of data have been used. Estimates of the HDI are for the period, 2013-14 to 2015-16. The HDI ranges from 0 to 1. The larger the value the higher the level of human development.

38.1. HDI RANKING OF PROVINCES

The Provincial rankings are as follows: Sindh is ranked first with HDI of 0.565, followed by Punjab at 0.542, Khyber Pakhtunkhwa at 0.512 and Balochistan at 0.462. Sindh gets the highest ranking primarily because of a per capita income 22 percent higher than the national average, thanks to Karachi. Three provinces, Sindh, Punjab and Khyber-

Pakhtunkhwa are at the medium level of human development, Balochistan is at the low level of human development.

HDI values have also been derived at the Provincial level for 2008, to determine the annual rate of improvement in the index. For the country as a whole the HDI has risen at the rate of one percent only over the last six to seven years. The fastest rate of growth is observed in Khyber-Pakhtunkhwa, followed by Punjab, Balochistan and Sindh.

The two basic questions at this stage are as follows: Why has Khyber-Pakhtunkhwa put in the best performance since 2008? Why has the HDI of Sindh been relatively slow-moving in the last seven to eight years?

The primary reason for the divergence is the difference in growth rate of per capita incomes. Contrary perhaps to expectations, Khyber-Pakhtunkhwa has been the most dynamic regional economy, as highlighted earlier despite being affected more by terrorism. The primary explanation for this is that as much as 30 percent of the domestic and international remittances have been destined for Khyber-Pakhtunkhwa, while the corresponding share of population is much smaller at 14 percent. These remittances have shown extremely rapid growth since 2008. Beyond this, the many families in the Province who are receiving remittances have shown a strong demand for health and education services.

The relatively small increment of HDI in Sindh is due to the poor performance of the economy, especially of Karachi, after 2008. The breakdown of law and order in the city has contributed to the slow growth in income. However, there is some evidence of revival after 2015.

The consequence of the faster improvement in the HDI of Khyber-Pakhtunkhwa versus Sindh and Punjab is that regional disparities in the HDI among different regions of Pakistan have narrowed somewhat in recent years. However, there is need to push more strongly for a higher HDI of Balochistan. Punjab, being the largest Province, continues to show a performance close to the national average.

38.2. HDI OF DISTRICTS

We turn now to the HDI at the district level. The findings are extremely rich and useful in character and provide valuable insights for regional planning. Estimation of the per capita income at the district level is based on quantifying the value added in the agriculture and manufacturing. The services sector is assumed to be linked in size and growth to the commodity-producing sectors. The distribution of districts in a Province by level of HDI is given in Table 38.1.

The focus first is on the higher end of the regional distribution of HDI. Which are the districts of Pakistan that have achieved a high level of human development? This requires a particular district to have HDI value of above 0.7, as specified by the UNDP.

Table 38.1: Distribution of Districts of Provinces by Level of HDI, 2013-14 to 2015-16* – (Number)

	Low HDI	Medium HDI	High HDI	Total
Punjab	22	12	2	36
Sindh	21	3	1	25
Khyber Pakhtunkhwa	20	6	-	26
Balochistan	32	-	-	32
TOTAL	**95**	**21**	**3**	**119**
Islamabad	*0*	*0*	*1*	*1*
Pakistan	**95**	**21**	**4**	**120**

*depending upon data availability
Source: Estimated

There are four locations in the country characterized by a high level of human development. These include the Federal capital, Islamabad, Karachi, Lahore and Rawalpindi districts. It is interesting that this list does not include the other two provincial capitals, Quetta and Peshawar and the third largest city of Pakistan, Faisalabad.

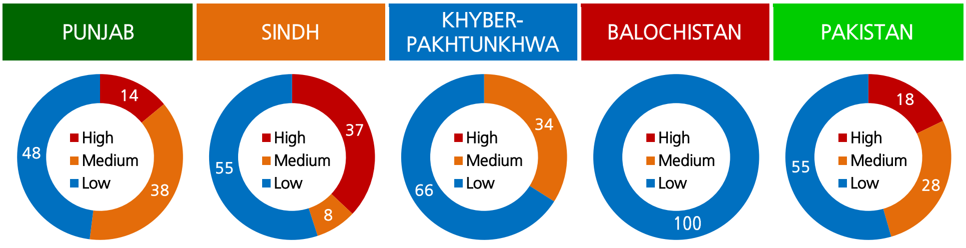
The districts with a medium level of human development are those with a HDI value 0.55 to 0.70. 21 districts of Pakistan fall in this category. 12 districts are from Punjab and include Chakwal, Sialkot, Jhelum, Gujranwala, Gujrat, Faisalabad, Attock, Multan, Sargodha, Mianwali, Sheikhupura, Mandi Bahauddin and Toba Tek Singh. The six districts from Khyber-Pakhtunkhwa with medium HDI are Peshawar, Abbottabad, Haripur, Nowshera, Malakand and Mansehra. Two districts of Sindh, Hyderabad and Sukkur, are at the medium level of human development, Quetta district in Balochistan is still at the low level of HDI, despite being a Provincial capital.

Overall, for Pakistan as a whole, 18 percent of the population lives in locations with high level of development and 28 percent in districts with medium level of development. Almost 54 percent of the population resides in districts characterized by low level of human development (HDI less than 0.50). The number of such districts is 96 out of the total of 119 districts in Pakistan.

The three districts in each Province with the lowest HDI can also be identified. In Punjab, these districts are Layyah, Muzaffergarh and Rajanpur, all in South Punjab. In Sindh, it is two districts also in the South, namely Tharparkar and Badin, with one district in the North, Jacobabad. The three most backward districts in Khyber-Pakhtunkhwa are Batagram, Kohistan and Upper Dir. In Balochistan, the districts at the bottom are Qila Saifullah, Barkhan and Musakhel.

The distribution of the population of each Province by level of HDI is given in the Chart 38.1. The extent of inequality in HDI is most pronounced among the districts of Sindh. This Province is effectively a '*dual economy*', with a highly developed primate city, Karachi, and a relatively underdeveloped hinterland. Inequality is, more or less, the same in Khyber-Pakhtunkhwa and Punjab. Balochistan has the least inequality as all districts are at the low level of development.

Chart 38.1: Distribution of Population of Provinces by Level of HDI



Source: to be added?

The results of the research on HDI of Provinces and Districts of Pakistan should prove useful. They will help in identifying the right regional development strategy in each Province. Also, they can be used as one of the criteria for horizontal sharing by the 9th National Finance commission and the Provincial Finance Commissions.

Chapter 39:

THE URBAN-RURAL DIVIDE

The recent Population Census has revealed that the share of urban population in the country is 36.4 percent. The remainder, 63.6 percent, of the population lives in rural areas of the country. The basic question is how large is the urban – rural divide in terms of the per capita income or value added differential. This will highlight not only the inequality between the incomes or value added but also provide a measure of the likely pressure for migration from rural to urban areas of Pakistan.

The Chapter is organized as follows: Section 1 presents estimates of rural and urban per capita incomes as derived from the Household Integrated Economic Surveys (HIES), carried out periodically by the Pakistan Bureau of Statistics (PBS). Section 2 describes the approach adopted to disaggregate the value added in each sector of the economy into the rural and urban components. This leads to an overall measure of the rural and urban GDPs respectively.

Section 3 of the chapter highlights the differences in the structure and growth of the two economies. Section 4 quantifies the absolute and relative per capita value added from 2007-08 to 2015-16. This enables an answer to the question whether the divide is rising or diminishing over time. Section 5 disaggregates the national urban and rural economies by Province. Finally, in Section 6, the urban and rural divide is quantified by Province.

39.1. ESTIMATES FROM HOUSEHOLD SURVEYS

The per capita income estimates in the rural and urban areas of Pakistan are given in Table 39.1. These are derived from the HIES conducted in 2007-08, 2010-11 and 2015-16. It needs to be emphasized that these estimates include the receipt of foreign and domestic remittances. As such, they do not represent estimates of per capita value added.

According to Table 39.1, the urban per capita income in Pakistan in 2007-08 was almost 52 percent above the rural per capita income. Apparently, it has been rising since then and the gap has widened to 61 percent by 2015-16. Throughout this period the growth in real per capita income has been faster in the urban areas.

Table 39.1: Urban and Rural Per Capita Income*, 2007-08 to 2015-16 – Rs at constant prices of 2007-08**)

	Urban Per Capita Income	Annual Growth Rate (%)	Rural Per Capita Income	Annual Growth Rate (%)	Ratio of Urban to Rural Income
2007-08	2848		1879		1,516
2010-11	3052	1.7	1979	1.3	1.542
2015-16	3684	3.8	2284	2.9	1.613

* from Household Integrated Economic Surveys of PBS
** The consumer price index is assumed to be the same for urban and rural areas.
Source: PBS, PES

Table 39.2 gives the income differential between urban and rural areas in each Province. It is highest in Sindh, followed by Balochistan, Punjab and Khyber-Pakhtunkhwa.

Table 39.2: Average Per Capita Income in Rural and Urban Areas by Province, 2015-16 – *(Rs at Current Prices per month)*

	Household Income	Household Size	Per Capita Income
PUNJAB	26230	6.04	5998
Urban	46616	5.92	7874
Rural	30973	6.09	5086
Ratio			1.548
SINDH	33948	6.22	5458
Urban	42846	5.87	7299
Rural	23825	6.62	3598
Ratio			2.029
KHYBER-PAKHTUNKHWA	38349	7.34	5225
Urban	49910	7.10	7029
Rural	35691	7.39	4830
Ratio			1.455
BALOCHISTAN	30041	7.84	3831
Urban	41991	7.88	5328
Rural	25569	7.82	3270
Ratio			1.629
PAKISTAN	35662	6.31	5652
Urban	45283	6.03	7510
Rural	30110	6.47	4654
Ratio			1.614

Source: HIES

Urban per capita income is more than twice the rural per capita income in Sindh. This is primarily attributable to the presence of the primate city, Karachi, in the Province. The city alone accounts for 59 percent of the Provincial urban population and has a heavy concentration of economic activity within the Metropolitan boundaries.

The Province of Balochistan also has a relatively high income differential of 63 percent. The interior of Balochistan is very underdeveloped and a sizeable part of the income is generated in the capital city, Quetta.

The urban–rural divide of Punjab is less at 55 percent. Here the rural areas are characterized by relatively high yielding agriculture. On the urban front, with the exclusion of Lahore and Faisalabad, most of the cities and towns have labor-intensive small-scale manufacturing.

The real surprise is the presence of the lowest income differential in Khyber-Pakhtunkhwa of 45 percent. The largest city, Peshawar, is characterized by considerable informal economic activity while the agricultural sector in the rural areas is relatively underdeveloped. The narrowing of the gap is primarily due to the large inflow of foreign and domestic remittances into the rural areas of the Province. Almost 24 percent of the income of rural households is from to the receipt of remittances.

There is need to recognize that per capita income estimates may not be accurate estimates of the value added generated from economic activities within a region. First, as highlighted above, the net inflow of remittances could lead to a significant divergence. Second, urban households, especially in the two top quintile, may be prone to substantially understate their income in surveys in the presence of large quantum of tax evasion. Therefore, reliance on the findings from the HIES may tend to significantly underestimate the urban–rural divide.

39.2. ESTIMATES OF URBAN AND RURAL GDP

The methodology used first estimates the Provincial GDPs. The resulting estimates have already been given in Chapter 36. In the second stage, allocators are used to disaggregate the Provincial GDP into its urban and rural components by sector. The sectoral allocators are given in the Chart 39.1. Application of the methodology leads to the first set of results on the shares of urban and rural areas respectively in the value added in each major sector and sub-sector. The shares are highlighted in Chart 39.2 and in Table 39.3.

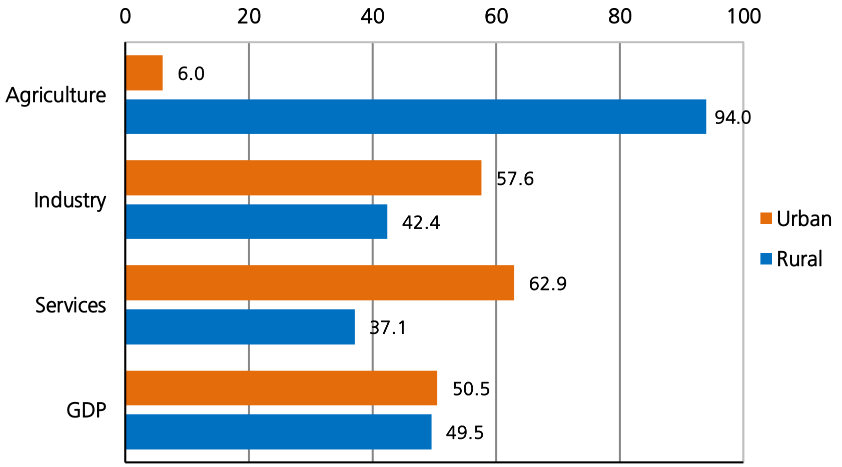
As expected, the rural share in Pakistan is highest in agriculture at 94 percent. The urban share is highest in banking and insurance at 85 percent, followed by the share in large-scale manufacturing at 71 percent. Rural areas have relatively large share in mining and quarrying at 65 percent; slaughtering at 53 percent; construction at 65 percent and public administration and defence at close to 50 percent.

Chart 39.1: Allocators of Sectoral Value Added between Urban and Rural Areas for Different Sectors/Sub-Sectors

Sector/Sub-Sector	Allocator	Data Sources*
AGRICULTURE INDUSTRY		
Agriculture	Income-Adjusted Share in Employment	HIES, LFS
Mining and Quarrying	Income-Adjusted Share in Employment	HIES, LFS
Large-Scale Manufacturing	Income-Adjusted Share in Employment	HIES, LFS
Small-Scale Manufacturing	Share in Informal Sector Employment in Manufacturing	LFS
Slaughter	Share in Consumption Expenditure on Livestock Products (excluding milk)	HIES
Electricity, Gas and Water	Income-Adjusted Share in Employment	HIES, LFS
Construction	Income-Adjusted Share in Employment	HIES, LFS
SERVICES		
Transport, Storage & Communications	Income-Adjusted Share in Employment	HIES, LFS
Wholesale & Retail Trade, Hotels & Restaurants	Income-Adjusted Share in Employment	HIES, LFS
Finance and Insurance	Income-Adjusted Share in Employment	HIES, LFS
Ownership of Dwellings	Share in actual and imputed rents	HIES
Public Administration and Defense	Income-Adjusted share in employment	HIES, LFS
Community, Social & Personal Services	Income-Adjusted share in employment	HIES, LFS

Source: HIES = Household Integrated Economic Survey, LFS = Labor Force Survey

Chart 39.2: Share of Urban and Rural Areas in Value Added by Different Sectors, 2015-16



Source: Estimated.

Table 39.3: Sectoral and Sub-Sectoral Share of Urban and Rural Areas, 2015-16

	Rural	Urban	Total
AGRICULTURE	**94.0**	**6.0**	**100.0**
INDUSTRY	**42.4**	**57.6**	**100.0**
Mining and Quarrying	64.5	35.5	100.0
Large-Scale Manufacturing	29.0	71.0	100.0
Small-Scale Manufacturing	47.8	52.2	100.0
Slaughtering	52.9	47.1	100.0
Construction	65.3	34.7	100.0
Electricity and Gas	41.3	58.7	100.0
SERVICES	**37.1**	**62.9**	**100.0**
Transport and Communications	42.6	57.4	100.0
Wholesale and Retail Trade	32.4	67.6	100.0
Finance and Insurance	15.2	84.8	100.0
Ownership of Dwellings	34.9	65.1	100.0
Public Administration and Defence	47.8	52.2	100.0
Social, Commercial & Private Services	42.0	58.0	100.0
GDP	**49.5**	**50.5**	**100.0**

Source: Estimated

Overall, the important finding is that the economy is partitioned into two, more or less, equal parts. Half of the GDP is generated in the rural areas and the remaining half in the urban areas. Given that the population distribution is 64:36, it is clear that per capita value added in the rural areas is significantly lower than in the urban areas.

39.3. STRUCTURE AND GROWTH

The evolution of sectoral value added in aggregative terms from 2007-08 to 2015-16 is given for the rural economy in Table 39.4 and for the urban economy in Table 39.5. The differences in the structure of the two economies are highlighted in Chart 39.3.

Table 39.4: The Size and Sectoral Distribution of the Rural GDP, 2007-08 to 2015-16 – (Rs in Billion at constant prices of 2005-06)

	2007-08	2010-11	Growth Rate[a] (%)	2015-16	Growth Rate[b] (%)	Growth Rate[c] (%)
Agriculture	1758.5	1822.2	1.2	2074.4	2.6	2.1
Industry	777.3	814.1	1.5	998.3	4.1	3.1
Services	1982.1	2014.0	0.5	2436.2	3.8	2.6
GDP (fc)	***4517.9***	***4650.3***	***1.0***	***5508.9***	***3.4***	***2.5***
% of National GDP	***52.8***	***51.0***		***49.5***		
Population (million)	108.4	115.8	2.2	129.3	2.2	2.2
Per Capita GDP (Rs)	***41678***	***40158***	***-1.2***	***42605***	***1.2***	***0.3***

[a] Annual growth rate from 2007-08 to 2010-11 | [b] Annual growth rate from 2010-11 to 2015-16 | c Annual growth rate from 2007-08 to 2015-16

Source: Estimated.

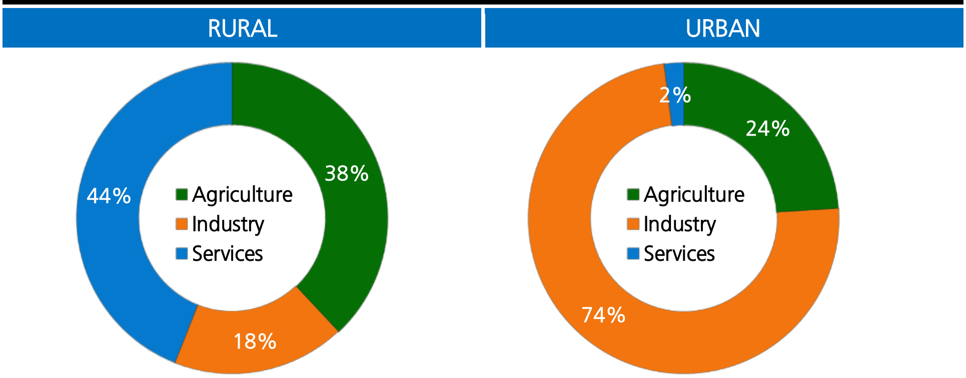
Table 39.5: The Size and Sectoral Distribution of the Urban GDP, 2007-08 to 2015-16 – (Rs in Billion at constant prices of 2005-06)

	2007-08	2010-11	Growth Rate[a] (%)	2015-16	Growth Rate[b] (%)	Growth Rate[c] (%)
Agriculture	110.3	155.0	10.9	132.4	-3.2	2.3
Industry	1110.7	1124.3	1.2	1343.9	3.6	2.4
Services	2809.1	3193.1	4.3	4148.2	5.2	4.9
GDP (fc)	*4030.1*	*4472.4*	*3.5*	*5624.5*	*4.6*	*4.2*
% of National GDP	*47.1*	*49.0*		*50.5*		
Population (million)	59.4	64.4	2.7	73.6	2.7	2.7
Per Capita GDP (Rs)	*67846*	*69447*	*0.8*	*76420*	*1.9*	*1.5*

[a] Annual growth rate from 2007-08 to 2010-11 | [b] Annual growth rate from 2010-11 to 2015-16 | c Annual growth rate from 2007-08 to 2015-16

Source: Estimated.

Chart 39.3: Sectoral Shares in the Rural and Urban Economies, 2015-16 – (%)



Source: Estimated

The estimates provide some interesting insights. First, the off-farm economy in the rural areas is large and accounts for 62 percent of the rural GDP. Of course, most of these activities have either backward or forward linkages with agriculture.

Second, the urban economy consists primarily of service activities, which constitute almost 74 percent of the urban GDP. These activities include trade, transport, communications, banking, public and private social and personal services.

The annual growth rates of the rural and urban GDP are also presented in Table 39.4 and 39.5 respectively. There were floods in 2010-11. Consequently, the rural economy had a growth rate of only one percent between 2007-08 and 2010-11. There has been a substantial recovery in the next five years and the growth rate has jumped to 3.4 percent. For the eight year period as a whole, the rural economy has shown a growth rate of only 2.5 percent. This has barely kept pace with the growth of rural population.

The urban economy has demonstrated a better performance as shown in Table 39.5. It achieved a growth rate of 3.5 percent from 2007-08 to 2010-11 and 4.6 percent from 2010-11 to 2015-16. Consequently, economic growth has outpaced population growth and per capita income has increased significantly.

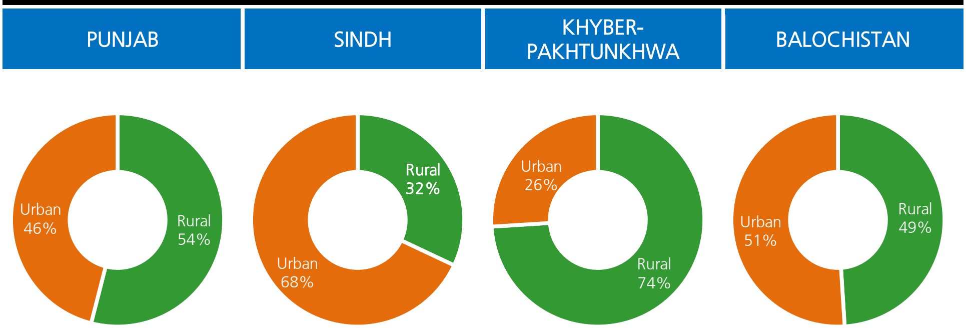
The divergence in growth of the urban and rural GDPs has implied that the urban-rural divide in per capita value added has widened. It was 63 percent in 2007-08, rising to 73 percent by 2010-11 and reaching 79 percent by 2015-16.

These estimates of the urban-rural differential are higher than these revealed by the various HIES. According to the value added estimates the gap was 79 percent in 2015-16, whereas according to the HIES it is 61 percent. Part of this difference is attributable to the equalizing effect of remittances from urban to rural areas.

39.4. PROVINCIAL ESTIMATES

The methodology described above in Section 2 has been applied to the sectoral value added in the GDP of each Province. The results are presented in Chart 39.4.

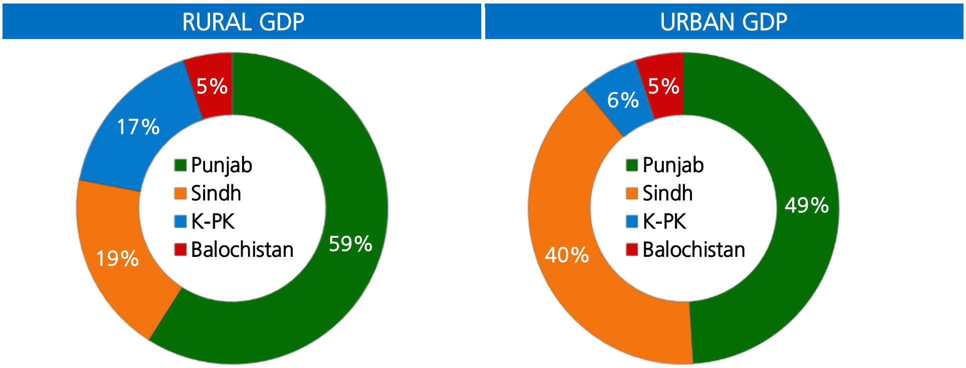
Chart 39.4: Distribution of Provincial GDP between Urban and Rural Areas, 2015-16 – (%)



Sindh is the only Province where the urban GDP has the dominant share of 68 percent. As opposed to this, the rural share is very large in Khyber-Pakhtunkhwa at 74 percent. Overall, as highlighted earlier, the national GDP is, more or less, evenly split between the urban and rural economies.

The Provincial distribution of the rural and urban GDP is presented in Chart 39.5. The major part, 59 percent, of the rural economy is located in Punjab and 19 percent in Sindh. The two smaller Provinces combined have a share of 22 percent. The urban economy is largely concentrated in Punjab and Sindh with shares of 49 percent and 40 percent respectively. The two smaller Provinces contribute only 11 percent to the national urban GDP.

Chart 39.5: Provincial Distribution of the Rural and Urban GDP, 2015-16 – (%)



Source: Estimated

39.5. PROVINCIAL URBAN-RURAL DIVIDE

The urban-rural value added per capita differential is quantified for 2015-16 in Table 39.6. The largest gap is observed in Balochistan of 169 percent, followed by Sindh with urban-rural differential of almost 100 percent. The Province of Punjab and K-PK have substantially less inequality at 46 percent and 54 percent respectively.

Table 39.6: Average Per Capita Value Added in Rural and Urban Areas by Province, 2015-16 – (Rs per Month at Current Prices)

	Per Capita Value Added		
	Rural	Urban	Total
PUNJAB	9843	14382	11522
Ratio		*46.1**	
SINDH	9539	19057	14484
Ratio		*99.8*	
KHYBER-PAKHTUNKHWA	8143	12513	8954
Ratio		*53.7*	
BALOCHISTAN	6025	16184	8785
Ratio		*168.6*	

* % difference between value added per capita in urban and rural areas.
Source: Estimated | PES

The gap in terms of value added versus income per capita appears to be larger in the Provinces of K-PK and Balochistan, while it is lower in Punjab and the biggest in Sindh. Two Provinces, in particular, which will have to focus on reducing the urban-rural divide are Balochistan and Sindh.

The estimates of relative value added per capita provide the basis for the ranking of the four Provinces. In the rural measure, Punjab ranks the highest and Balochistan the lowest. The ranking is very different in urban areas. As expected, in the presence of Karachi, Sindh has the highest per capita value added.

Table 39.7: Ranking of Provinces in terms of Per Capita Value Added

	Per Capita Value Added	
	Rural	Urban
Punjab	1	3
Sindh	2	1
Khyber-Pakhtunkhwa	3	4
Balochistan	4	2

Source: Estimated

Somewhat surprisingly, Balochistan is ranked second, possibly because of a small population base.

The overall conclusion is that the urban-rural differential is large and growing. This will put greater pressure on migration to large cities, as has been observed in the case of Lahore in the latest Census and earlier in the case of Karachi. Consequently, these cities are seeing a breakdown in the provision of basic municipal services and rising levels of congestion and pollution.

The answer lies in laying substantially greater emphasis on rural development. The agricultural sector has shown very limited growth annually of only 2.5 percent from 2007-08 to 2015-16. This has to be raised to close to 4 percent. Revival of agriculture will also provide a strong stimulus to the off-farm economy in rural areas of Pakistan.

SECTION 14

POVERTY

Chapter 40:

INCIDENCE OF POVERTY

The ultimate indicator of the degree of success in management of the economy of a Government it can be said is the extent of poverty eradication. Two fundamentally different approaches can be adopted. The first is to implement policies which promote growth, not focus on inequality but hope that the 'trickle down' effect is large enough to alleviate poverty. The second strategy is to target explicitly for inclusive growth. Reduction in inequality and direct support to the poor then become the cornerstones of the development path adopted. Here the hope is that the process of growth continues largely unabated.

Pakistan has seen different eras with varying combinations of rates of growth and changes in inequality. The decade of the 60s, 80s and the earlier part of the first decade of the new Millennium were characterized by high growth and rising inequality. As opposed to this, the decade of the 70s, 90s and the last ten years have witnessed relatively low growth and some decline in inequality. The consequential impact on poverty in each era has been of a varied nature.

The objective of this Chapter is to identify what has been happening to the incidence of poverty since 2000. It is organized into three sections. Section 1 focuses on poverty trends as measured by the multidimensional approach. The implications of using the more conventional Cost of Basic Needs (CBN) for quantifying the extent of poverty are presented in Section 2. Section 3 then tries to reconcile the findings to determine if poverty has been falling or rising in different sub-periods after 2001.

40.1. MULTIDIMENSIONAL POVERTY

The first attempt at measuring multidimensional poverty in Pakistan has been by the Oxford Poverty and Human Development Initiative (OPHI) and the Planning Commission with support by the UNDP. The report was published in 2015. The multidimensional approach adopted for the measurement of poverty has been to use indicators of access to health and education and of the standard of living of a household.

Pasha [2017] has undertaken a critical analysis of the approach adopted. A number of shortcomings have been identified. The first relates to the choice of indicators. The health indicators do not include the incidence of malnutrition, especially among children in a family. Second, the employment status of the head of household has not been incorporated in the standard of living indicators. Third, the extent and quality of access to basic services like drinking water have not been allowed for. Consequently, the access to services is overstated in the context of urban areas.

The incidence of multidimensional poverty from 2004-05 to 2014-15 is presented in Table 40.1 for Pakistan and for rural and urban areas separately. According to the multidimensional approach, poverty has declined from over 55 percent in 2004-05 to less than 39 percent by 2014-16. The incidence of poverty is substantially lower in urban areas compared to rural areas. This is a reflection perhaps of over-reliance on access to services as a measure of poverty.

Table 40.1: Trend in Multi-Dimensional Poverty, 2004-05 to 2014-15 – (%)

	2004-05	2006-07	2008-09	2010-11	2012-13	2014-15
PAKISTAN	**55.2**	**52.5**	**49.3**	**44.7**	**40.8**	**38.8**
Urban Areas	24.0	19.0	17.3	12.7	10.0	9.4
Rural Areas	70.3	69.5	65.2	60.2	56.0	54.6
Poverty-Growth Elasticity	←	-1.27	→	←	-.3.33	→

Source: OFPI

Table 40.1 also presents the magnitude of the poverty – growth elasticity for two sub-periods. This elasticity is the ratio of the change in the incidence of poverty to the growth in per capita annually. The higher the absolute magnitude of the elasticity the more pre-poor is the growth process. The poverty – growth elasticity in different countries over different periods has been quantified by Bourguignon [2013]. He estimated the average elasticity as close to – 2 over a large number of observations. The absolute elasticity of multi-dimensional poverty with respect to income is substantially higher from 2008-09 to 2014-15 at 3.3. Clearly, this period appears to have witnessed much more pro-poor growth.

40.2. COST OF BASIC NEEDS POVERTY

The estimates of CBN poverty from 2001-02 to 2015-16 are by the Planning Commission. These are shown in Table 40.2 are presented in the latest Pakistan Economic Survey. Table 40.2 reveals a very fast rate of poverty reduction from 2005-06 to 2015-16. Overall, incidence of poverty at the national level has fallen by 52 percent in ten years. The difference between the extent of urban and rural poverty is smaller than from the estimates of multi-dimensional poverty.

The absolute magnitude of the poverty-growth elasticity is greater at over 6. This raises serious doubts about the unbiased nature of these estimates. The Planning Commission may have been under pressure to show a faster rate of decline in poverty than indicated by the underlying trends.

Table 40.2: Trend in the Incidence of CBN Poverty, 2005-06 to 2015-16 – (%)	2005-06	2007-08	2010-11	2013-14	2015-16
PAKISTAN	50.4	44.1	36.8	29.5	24.3
Urban Areas	36.6	32.7	26.2	18.2	12.5
Rural Areas	57.4	49.7	42.1	35.6	30.7
Poverty-Growth Elasticity	←		-6.08		→
Source: PES					

The second set of estimates of CBN poverty incidence are by the Social Policy and Development Centre [2017]. These are presented in Table 40.3. The SPDC estimates of CBN poverty are fundamentally different from those of the Planning Commission. They actually reveal a rising trend in the incidence of poverty, especially from 2004-05 to 2010-11. Thereafter, it has remained unchanged up to 2015-16. These estimates also show a very small gap in the incidence of poverty in the urban and rural areas. Clearly, there is need to make an assessment as to which trend is more representative of the ground realities.

Table 40.3: Incidence of CBN Poverty According to SPDC, 2001-02 to 2015-16 – (%)	2001-02	2004-05	2010-11	2015-16
PAKISTAN	**33**	**30**	**38**	**38**
Urban Areas	30	28	34	32
Rural Areas	35	31	39	41
Source: SPDC				

40.3. POVERTY: RISING OR FALLING?

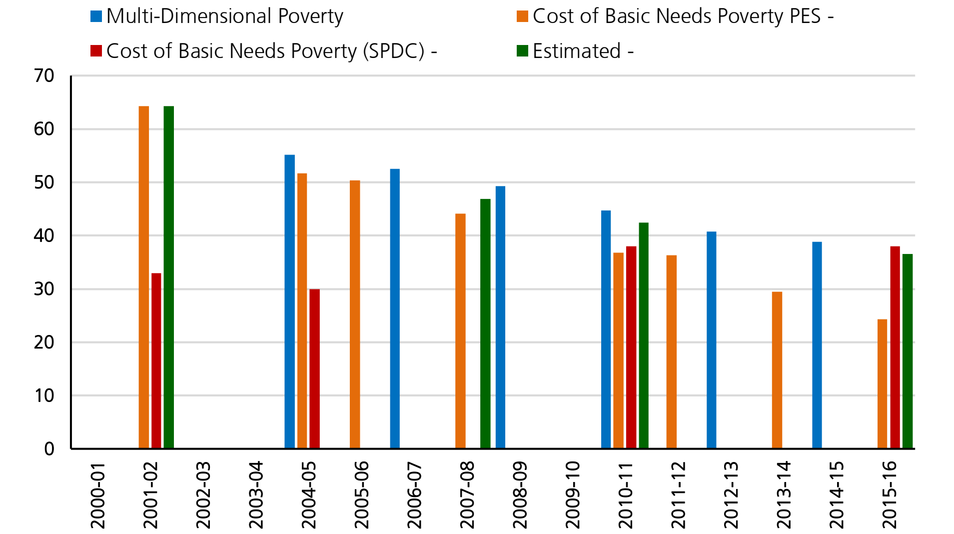
Figure 40.1 presents the trends revealed by the different estimates. The first part of the investigation is to determine what has been happening to inequality in different periods. Chapter 35 has highlighted the inequality trends in Pakistan. Inequality increased sharply from 2001-02 to 2007-08 and declined from 2007-08 to 2015-16. Consequently, even through the growth rate of per capita income was much faster in the first period, the growth rate in income of the lowest quintile was higher in the second period.

Apparently, the distribution of the increase in real national income among households was very different in the two periods: The ratio of the shares of the increase in income from 2001-02 to 2007-08 of the top quintile to the bottom quintile was over 10 to 1. It declined sharply to 4 to 1 from 2007-08 to 2015-16.

Overall, given the fall in inequality in the second period, it is likely that the poverty-growth elasticity is higher in absolute terms in this period. The SPDC estimates do not allow for the improvement in employment opportunities and bigger rise in real wages. As such, the rise in poverty from 2004-05 to 2010-11 is considered unlikely.

Figure 40.1: Trends in the Incidence of Poverty, 2001-02 to 2015-16 – (%)

Cost of Basic Needs Poverty



Sources: Planning Commission | Ministry of Finance | SPDC

Probably, the national incidence of poverty has been falling from 2001-02 to 2015-16. A first estimate of the likely trend is that it has declined from 47 percent in 2007-08 to 37 percent in 2015-16, implying a poverty-growth elasticity of approximately -2. The estimate by the Planning Commission of poverty incidence at 24 percent in 2015-16 is very much on the low side.

Chapter 41:

SOCIAL PROTECTION

Achieving the goal of inclusive growth requires recognition of the fact that there are marginalized sections of the population who are unable to participate in the growth process or not benefit enough to have a living wage. Social protection is a must for a humane security to provide state support to such people.

The Asian Development Bank [2009] divides social protection into three major categories, as follows:

Social insurance: contributory schemes to help people respond to common risks, such as illness, old age and unemployment. The major components are health insurance, pensions and unemployment insurance.

Social assistance: providing unrequited transfers to groups, such as the poor, who cannot qualify for insurance or unlikely to receive inadequate benefits from such a source. The major components of social assistance are cash or in-kind transfers, child welfare, assistance to the elderly, health assistance, disability benefits and disaster relief.

Active labor market programs: the objective is help people secure employment. Major components are skill development and training programs and special work programs, such as cash- or food-for-work programs.

The objective of this Chapter is to describe and then to evaluate social protection programs in Pakistan. Section 1 highlights the major social safety nets in the country, mostly at the Federal level and some at the Provincial level. Section 2 presents the criteria to be used for evaluation of any social protection program. Section 3 gives the results of evaluation of existing programs. Finally, recommendations are made for improving the strategy, design, coverage and implementation of social protection in the country.

41.1. SOCIAL PROTECTION IN PAKISTAN

The Benazir Income Support Program (BISP). The genesis of BISP was the sharp rise in food prices, especially of *atta*, in 2008-09. Initially, an allocation of Rs 34 billion was made to provide a cash supplement of Rs 1000 per month to poor families throughout Pakistan. The recipient is the adult female of a family. Identification of beneficiaries is based on the 'Poverty Scorecard', a proxy means testing technique. Wherever possible the smart card system is being used to distribute the assistance on a quarterly basis.

A number of special initiatives have been introduced in the BISP. These include schemes for small loans, skill development, support for catastrophic illness and for education of children of beneficiary families. Approximately 98 percent of the funds are in the nature of unconditional transfers and 2 percent as conditional transfers.

The BISP is funded entirely from the Federal Budget. The amount disbursed in 2017-18 was 113 billion, which has been raised to Rs 125 billion for 2018-19. In line with inflation, the cash assistance per family has been raised from Rs 1200 to Rs 1500 per month. Over 5.6 million families are being covered by BISP. Almost half the poor in Pakistan are benefiting from the Program. It is estimated that about 40 percent of the 'poverty gap' in the country is being covered by the BISP.

The Government proposed an earmarked tax, the Income Support Levy, to provide funds especially for BISP in the Budget of 2013-14. The levy was 0.5 percent of net immoveable assets of a person. But the levy was challenged in the Courts and was withdrawn in the Budget of 2014-15.

Zakat and Baitul Maal: The other cash assistance programs are Zakat and Baitul maal. Zakat, in particular, has its genesis in the religion of Islam. The funds are collected through a special levy on savings and fixed deposits of individuals in banks. However, the revenue is limited because of large-scale exemptions. Zakat is administered through Zakat Committees.

The next type of program is in the nature of price subsidies.

Price Subsidy: One of the biggest mechanisms of social protection in Pakistan today is the large subsidy to life-line consumers of electricity. This is costing as much as Rs 140 billion today. It is a big part of the tariff differential subsidy given to the power sector. There is a strong case for targeting this subsidy, as currently an inflated number of 17 million electric consumers are claiming this benefit.

The other major subsidy is the wheat price subsidy, given mostly by the Provincial governments. It is a generalized subsidy and should be made a more targeted subsidy. The Utility Stores Corporation (USC) has a chain of outlets in urban areas which sell food items like atta, sugar, ghee, etc., at prices lower than those prevailing in the market. But USC has only limited coverage, quality is low and prone to leakages.

Social Insurance: The most important social insurance program is the pension scheme for government employees. The annual payment to retired civil and military personnel is from the Federal Budget. The amount paid in 2017-18 is Rs 337 billion. However, there are no contributions during the period of service. The entitlement is based on meeting some conditions like 25 years of service in the case of civilian personnel. Almost half the amount is paid to low level retired employees.

The other important scheme, which does have a contributory character, is the *Employees Old Age Benefits Institution (EOBI).* The EOBI Act 1975 was designed to introduce pensions as per the Constitution. The Act covers all workers in establishments with ten or more workers. Currently, over 67,500 establishments are actively registered with EOBI and the number of workers ensured is 5.7 million, while 485,000 are currently receiving pensions.

The EOBI is based on contributions from employers and receives no subsidy from the Government. The employers' contribution is 5 percent of the minimum wage per worker while the employees' contribution is 1 percent. Currently, there are four types of pensions: old age pension, invalidity pension, old age grant and survivor's pension. The minimum pension is Rs 5250 per month which has been raised recently to Rs 10000. The maximum pension is based on a formula. Total disbursement in 2017-18 is estimated at Rs 25 billion. According to the latest cash flow statement, EOBI received Rs 15.2 billion as contributions and Rs 16.1 billion as investment income. The overhead cost of EOBI was Rs 2.3 billion. The value of assets with EOBI is close to Rs 200 billion.

Labor programs: The principal labor market program relates to micro credit for creation of employment. The flagship institution in this case is the *Pakistan Poverty Alleviation Fund (PPAF)*. Since its inception in 1998 it has disbursed Rs 188 billion to its partner organizations in each district of the country. 8.4 million loans have been disbursed with 60 percent to women and 80 percent in the rural areas. Over 40,000 small health, education and water supply projects have been completed.

There also exists a *Micro Finance Network* in Pakistan. This network includes micro-finance institutions, 11 Micro finance Banks and four Rural Support Programs. The total number of active borrowers is 5.3 billion and the outstanding loan portfolio is Rs 193 billion.

The other programs are *Employment and Training* programs. Given the serious nature of the youth employment issue, the Federal Government has started under the PM's name a number of schemes described earlier. Provincial Governments are also getting increasingly active in this area. The Punjab Government has started a large program of Technical and Vocational Training.

41.2. TOTAL OUTLAY ON SOCIAL PROTECTION

The outlay on different types of Social Protection Programs is given in Table 41.1. The total spending and credit annually is estimated at Rs 624 billion in 2017-18, equivalent to 1.8 percent of the GDP. It has gone up from 1.3 percent of the GDP in 2011-12.

The largest type of program is Social Security, with a share of 31 percent. Next in size are Price Subsidy and Cash Assistance with shares of 27 percent and 20 percent respectively. The three largest individual programs are Government pensions, electricity subsidy and BISP.

Table 41.1: Outlays on Different Social Protection Programs in Pakistan, 2017-18 – (Rs in Billion)

Scheme	Benefits	Financing	Outlay (2013-14)
1. SOCIAL SECURITY			
• Civil / Military Pension Fund	• Pensions	• Federal and Provincial Budgets	167*
• Employees Old-Age Benefits Institution (EOBI)	• Old age Pension • Invalid Pension • Survivor's Pension for Workers	• Employer's Contribution Employees Contribution	16
• Workers Welfare Fund	• Schools • Hospitals • Housing for Workers	• Employers' Contribution	10
		TOTAL	193
2. CASH ASSISTANCE			
• Benazir Income Support Program	• Cash Assistance	• Federal Budget	113
• Zakat	• Cash Assistance	• Deduction from Bank Deposits	8
• Baitul Maal	• Cash Assistance	• Federal Budget	2
		TOTAL	123
3. PRICE SUBSIDY			
• Subsidy to Life-Line Consumers of Electricity (up to 100 kwh)	• Lower Price of Electricity	• Federal Budget	140
• Subsidy on Procurement	• Lower Wheat Price	• Federal Budget (PASSCO) + Provincial Government	27
• Utility Stores Corporation USC)	• Lower Price of Food Items	• Federal Budget	4
		TOTAL	171
4. EMPLOYMENT PROGRAMS			
• Pakistan Poverty Alleviation Fund (PPAF) + Other Micro Credit Agencies	• Microcredit	• Federal Budget + Other Sources	66
• PM's Schemes	• Interest Free Loans • Business Loans	• Federal Budget	30
		TOTAL	96
5. EDUCATION AND TRAINING PROGRAMS			
• PMs and Schemes: o Fee Reimbursement Scheme o Youth Training o Youth Skill Development o Laptop Scheme	• Subsidized Education and Training	• Federal Government Budget	21
• Punjab Government	• Subsidized Technical and Vocational Training	• Provincial Budget	20
		TOTAL	41

SUMMARY	Rs in Billion	(%)
• Social Security	193	30.9
• Cash Assistance	123	19.7
• Price Subsidy	171	27.4
• Employment Programs	96	15.4
• Education and Training Programs	41	6.6
OVERALL TOTAL	624	100.0
% OF GDP	1.8	

*half for low level employees
Source: EOBI, MOF, NEPRA, PPAF

41.3. EVALUATION CRITERIA

Progressive fiscal policy requires that individual social protection programs be evaluated on the basis of the following criteria first identified by Pasha [2000]:

(i) *Targeting efficiency:* measured by the extent to which a program's expenditure actual reaches poor people rather than the relatively well-off segments of the population. Programs which promote self-targeting by the poor are also ranked high on this criterion. For example, if the wage rate in public works program is kept low enough to attract unemployed workers only and not divert workers from other jobs. Alternatively, provision of subsidy for a coarse or low quality food grain is likely to be availed only by relatively low income households.

(ii) *Extent of program coverage:* the proportion of poor households which receive benefits from the program;

(iii) *Degree of ease of access:* the level of transactions costs imposed on eligible households in accessing the program, as indicated by the simplicity and transparency of procedures, documentation requirements and level of discretion with program officials in the disbursement of benefits. Programs with relative ease of access can be ranked 'high' on this criterion;

(iv) *Percentage of program expenditure dedicated to benefits:* measured by how much of the program budget is spent on benefits rather than on administrative costs;

(v) *Adequacy of support:* the extent to which the benefit reduces the poverty of a recipient;

(vi) *Income equivalence of transfer:* the extent to which the transfer is equivalent to a cash transfer and does not distort consumption choices of beneficiaries. For example, an open-ended subsidy on a good or service may lead to over-consumption and waste;

(vii) *Absence of negative incentive effects:* anti-poverty interventions can change behavior. For example, an unemployment benefit may reduce the motivation for job search. On the other hand, school food programs can raise school participation and reduce dropout rates;

(viii) *Extent of self-finance / progressive finance:* programs which raise funding through well-defined and earmarked sources are likely to be more sustainable fiscally. A program is more secure if it is supported by higher income households rather than through general budgetary sources which are vulnerable to inflation and cut-backs when the fiscal position worsens as has happened in Pakistan during the last few years;

(ix) *Degree of independence from private transfers:* a transfer should ideally not displace corresponding transfers by households or private sector entities. An example of substitution is the *Zakat* whereby compulsory deductions may lead to a, more or less, matching reduction in private charitable contributions;

(x) *Degree of impact on development:* programs can contribute either directly or indirectly to development. A public works program, for example, could lead to the creation of improved irrigation or farm-to-market roads and thereby contribute to high agricultural productivity.

The evaluation / rating formula is as follows:		
a) All criteria have been equal weight.		
	If rated	**Score**
b) for an evaluation criterion	High (H)	4
	Medium (M)	2
	Low (L)	0
c) The maximum score is 40 and the minimum is zero		

The results of evaluation of program are given in Chart 41.1.

The three Programs with the highest scores are as follows:

- Pakistan Poverty Alleviation Fund (PPAF)
- Benazir Income Support Program (BISP)
- Government Pension Scheme for Low-Grade Employees

Chart 41.1: Evaluation of Programs

Criteria	1	2	3	4	5	6	7	8	9	10
Targeting Efficiency	H	M	H	H	M	L	L	H	L	4
Extent of Program Coverage	H	L	L	L	H	M	L	L	L	1
Degree of Ease of Access	L	H	L	L	M	H	M	L	M	2
Share of Benefit in Program Expenditure	M	M	H	M	M	L	L	M	L	1
Income Equivalence of Program Benefits	H	H	H	H	M	M	M	H	H	6
Absence of Negative Incentive Effects	M	M	H	M	L	M	H	H	H	4
Adequacy of Support	M	L	M	L	H	M	L	H	M	2
Extent of Self/Progressive Finance	M	H	M	H	L	M	M	M	M	2
Degree of Independence from Private Transfers	H	L	H	H	H	H	H	H	H	8
Degree of impact on Development	L	L	L	L	L	H	L	H	M	2
SCORES	**24**	**18**	**24**	**20**	**20**	**22**	**14**	**28**	**20**	
High (H)	4	3	5	4	3	3	1	6	3	
Medium (M)	4	3	2	2	4	5	3	2	4	
Low (L)	2	4	3	4	3	2	5	2	3	

1 = BISP | 2 = Zakat / Baitul Maal | 3 = Government Pensions (low grades) | 4 = EOBI
5 = Electricity Subsidy | 6 = Wheat Subsidy | 7 = Utility Stores Corporation | 8 = PPAF
9 = PM's Schemes and training programs | 10 = Number of Schemes with H

41.4. RECOMMENDATIONS

- The *BISP* must be expanded to provide coverage to at least 8 million families out of the total of almost 12 million poor families.
- There is need for diversification of BISP to include a larger component of conditional cash transfers for sending girl child to school, immunization of the child and adoption of family planning.
- Mechanisms should be developed for facilitating the 'exit' of households from income / cash supplements.
- Proposals with regard to the *EOBI* are as follows:
  - (i) The Government has raised the minimum pension recently to Rs 12,000 per month. The EOBI has the financial resources to also raise its minimum pension to this level.
  - (ii) EOBI has been racked by scandals with regard to its investment portfolio. The Board has to exercise more oversight.
  - (iii) The contributions should be linked not to the minimum wage but to the actual wages.
  - (iv) The EOBI schemes only cover workers in the formal sector. The self-employed could also be covered through an individual pass book system, with self-contribution.
- *The price subsidy on electricity* should be restricted to families who are part of BISP and to those who offer themselves for Poverty Score Card assessment with an electricity connection. This will also help in expanding the BISP coverage and targeting it better.
- Persons who qualify with a diploma from accredited Technical and Vocational Training Programs should be given automatic access to microcredit of up to Rs 0.5 million. Part of the training should include preparation of a feasibility report on a potential small project.
- Even though microcredit has expanded significantly, only 10 percent of the potential borrowers are covered. A tax credit scheme may be introduced for commercial banks and other financial institutions equivalent to 5 percent of the increase in credit to wholesalers of microcredit like PPAF and Micro Finance Banks.
- 'Social Welfare' has been transferred to the Provincial Governments after the 18th Amendment. Therefore, there is need for joint sponsoring, design, execution and funding by both the Federal and Provincial Governments.

The basic message is that social protection is the foundation of a just, humane and benevolent society.

SECTION 15

GOVERNANCE

Chapter 42:

GOVERNANCE SCORECARD

Serious issues of misgovernance have been highlighted in the context of Pakistan in recent years. In particular, there are widespread allegations of large-scale corruption, state capture by the elite and so on.

There is need first to define formally what constitutes governance. This is done in Section 1 of the Chapter. Pakistan's performance is evaluated in Section 2 over the last decade in various areas of governance on the basis of the country's ranking in the World Bank's indicators of governance, measured for a large number of countries.

Section 3 presents the answers to questions related to different dimensions of governance by a sample of experts in Pakistan. Finally, Section 4 highlights the findings from a citizen score card on the quality of public and residential services. In addition, the findings from the Pakistan Social and Living Standards Measurement Survey of the PBS on respondents' assessment of changes in their quality of life over the years are highlighted.

42.1. WHAT IS GOVERNANCE?

The World Bank almost two decades ago defined governance as "the manner in which power is exercised in the management of a country's economic and social resources for development". More recently governance has been defined as the traditions, rules and institutions by which authority in a country is exercised. This includes the process by which governments are selected and replaced, the capacity of the government to formulate and implement sound policies and the effective functioning of institutions that govern economic and social interactions among citizens and the state.

However, governance is characterized by activities backed by shared goals among various stakeholders within an economy. In this period of global change, national governments are finding it hard to contend with the process of globalization and decentralizing dynamics. Hence, there is a need for various institutions, both public and private to work towards shared goals to make governance more efficient and demand driven. The overall system of governance embraces government institutions but also incorporates non-governmental agencies.

The role of 'good' governance lies in the allocation and management of resources for the maximum public benefit. In the process of supply of public goods, governance needs to be guided by principles such as equal access, democratic values, transparency, participation and decentralized power sharing, rule of law and accountability (IPP, 2010).

'Good' governance promotes the reduction of poverty, deprivation and violence. This includes the strengthening of democratic institutions by free, fair and frequent elections, a representative legislature, media and judicial independence, transparent and accountable institutions and a civil society which projects and defends the need of the most vulnerable people.

DESA (2007) identifies three main types of governance, as follows:

Political or public governance: wherein authority lies in the state, government or public sector. It relates to the process by which a state organizes its affairs and manages itself.

Economic governance: where authority is primarily with the private sector. Economic governance relates to the policies, the processes or organizational mechanisms that are necessary to produce and distribute goods and services.

Social governance: where authority is with civil society, including citizens and non-profit organizations. Relates to a system of values and beliefs that are necessary for proper social behavior and for public decisions to be taken.

As emphasized by Nzongola-Jtalaja (2003), governance should not be reduced only to the role of the government, as the above three aspects of governance are interdependent in a society. Indeed, social governance provides the moral foundation, economic governance gives the material foundation and political governance guarantees order and cohesion within a society.

Mimicopoulos (2006) has emphasized that in the political or public domain five dimensions of governance are crucial, namely, efficiency, equity, transparency, accountability and participation, as follows:

Efficiency: is the government's ability to establish predictability in the institutional and policy environment through an economically efficient system of production and distribution. Efficiency is also the correct prioritization of government services with respect to citizens needs and preferences.

Equity: is the existence of a fair and just legal system which provides access to all. It also includes the equitable distribution of public services, especially to underprivileged groups.

Transparency: is the availability and clarity of information provided to the general public about government activity. A lack of transparency creates opportunities for corruption and reduces public sector efficiency.

Accountability: rests on the establishment of criteria for evaluating the performance of public sector institutions, including financial accountability. The focus is on internal and external audit of operations.

Participation: is the essential element for an engaged civil society, through the workings of an active and free media, presence of an electoral management body, full right and access to information on government procurement and contracting and public discussion on policy and budget making.

42.2. PAKISTAN'S RANKING IN GOVERNANCE

The most widely quoted indicators of governance are those prepared and disseminated by the World Bank. There are two sets of these indicators. The first are those prepared by Kaufman and Krauss [2001] as part of their research to demonstrate that governance matters. The second set of indicators are prepared by the World Bank in the form of Country Policy Institutional Assessment (CPIA) and helps the Bank in deciding on the allocation of concessional assistance among countries.

The place of Pakistan in indicators on governance matters is presented in Table 42.1. The rankings are presented in the form of percentiles. The higher the percentile value of Pakistan in an indicator the better its relative position in a group of 180 countries. The table presents the position in three years, viz, 2006, 2011 and 2016. The year 2006 is towards the end of the tenure of the quasi-democratic government of General Musharraf. The PPP was in power in 2011 and the PML (N) in 2016.

Table 42.1: Pakistan's Place (in percentile) in World Bank's Indicators of Governance Matters, 2006 to 2016 – (percentile)*

	2006	2011	2016	Trend
Voice and Accountability	25	26	29	↗
Political Stability and Absence of Violence / Terrorism	3	0	1	↘
Government Effectiveness	41	22	29	⤴
Regulatory Quality	34	29	27	↘
Rule of Law	23	20	20	↘
Control of Corruption	20	22	19	⤵

*100 percentile is the highest rank and 0 percentile is the lowest rank.

Source: World Bank

There has been a fall in Pakistan's relative position, in terms of percentile values, in three out of the six indicators. These are related to absence of violence / terrorism, regulatory quality and rule of law. There is an improvement in voice and accountability following the transition to a fully democratic system.

There is need to focus, in particular, on Pakistan's position with regard to control of corruption. Over the decade Pakistan is mostly placed in the lowest quintile of countries. However, contrary perhaps to popular perceptions, Pakistan's position improved somewhat from 2006 to 2011 and has since fallen marginally.

The opposite trend is witnessed in the case of government effectiveness, relating to efficient and effective delivery of services. This indicator fell sharply in the case of Pakistan from 2006 to 2011. There has been some improvement thereafter.

Table 42.2 presents the CPIA ratings by the World Bank of Pakistan for the years, 2007, 2012 and 2016 respectively. Twenty dimensions of governance are included in these ratings. By and large, Pakistan has intermediate scores from 2 to 4, with the ratings ranging from a low of 1 to a high of 6.

Table 42.2: World Bank (CPIA Ratings) for Pakistan – [1 = low to 6 = high]

	2007	2012	2016	Trend
Policies for Social Inclusion / equity	3.1	3.1	3.2	↗
Building Human Resources	3.5	3.5	3.5	→
Debt Policy	4.5	3.5	4.0	⤻
Economic Management	4.0	2.8	3.5	⤻
Efficiency of Resource Mobilization	3.5	3.0	3.5	⤻
Equity of Public Resource Use	3.5	3.5	3.5	→
Financial Sector	4.5	3.5	3.5	↘
Fiscal Policy	3.5	2.5	3.0	⤻
Gender Equality	2.0	2.5	2.5	↗
Macroeconomic Management	4.0	2.5	3.5	⤻
Business Regulatory Environment	4.0	3.0	3.5	⤻
Policy and Institutions for Environmental Sustainability	3.5	2.5	3.0	⤻
Property Rights and Rule-based Governance Rating	3.0	2.5	2.5	↘
Public Sector Management and Institutions	3.2	3.0	3.1	⤻
Quality of Budgetary and Financial Management	3.5	3.5	3.5	→
Quality of Public Administration	3.5	3.5	3.0	↘
Social Protection	3.0	3.5	3.5	↗
Structural Policies	4.2	3.3	3.5	⤻
Trade	4.0	3.5	3.5	↘
Transparency and Accountability and Corruption in the Public Sector	2.5	2.5	3.0	↗

Source: World Bank

Pakistan's relative performance has improved steadily from 2007 to 2016 in four areas of governance. These are policies for social inclusion, gender equality, social protection and corruption in the public sector. The last result is in contrast to the finding regarding corruption in the first set of World Bank indicators.

There has been a progressive deterioration in four indicators. These relate to the performance of the financial sector, rule-based governance, quality of public administration and trade policy. The last indicator clearly reflects the decline in Pakistan's exports after 2013, following the arrival of the PML (N) government.

The most commonly observed trend in as many as nine indicators is one of a decline from 2007 to 2012, followed by an improvement up to 2016. The largest absolute improvement in the score is observed from 2012 to 2016 in the quality of macroeconomic management. In fact, Pakistan was in an IMF program from 2013 to 2016 and the primary focus was on stabilization of the economy. It is only in three areas where there is no change from 2007 to 2016.

42.3. ASSESSMENT BY EXPERTS

Pasha and Pasha [2014] prepared a report on Teaching of and Research on Governance for the Higher Education Commission. This report included an assessment by experts of the status of governance in different areas, both political and economic. The findings are presented below.

A respondent was asked to rate the performance in a particular area of governance as very low, low, moderate, high, very high. Numerical values were assigned to the response of 1 to 5, in a rising scale. Experts chosen were senior retired civil servants, politicians, professors in related fields and corporate leaders.

The results are presented in Table 42.3 and Table 42.4. The scores are generally low, ranging from as low as 1.4 to a maximum of 3.9. This reflects the more or less, common perception of the poor state of governance in Pakistan.

The areas of poor governance (score of less than 2.5) in the context of interest integration in the political process are as follows:

(i) Absence of a democratic internal structure in political parties.
(ii) Extent to which the political process reflects public concerns.
(iii) Accountability of the legislature to the public.

Within the area of government stewardship and conduct, the failure is especially in the following:

(i) Extent of focus of government on reducing unemployment and poverty.
(ii) High presence of kickbacks and corruption in influencing government decisions.
(iii) The civil-military relationship.

Table 42.3: Rating of Different Areas of Governance by Experts			
Interest Integration in the Political Process	**Score***	**Government Stewardship And conduct**	**Score**
To what extent is the legislature representative of Society	2.5	To what extent is the Government committed to ensuring the security of citizens?	3.2
To what degree is there real competition for political power?	3.9	To what extent is the Government focused on reducing unemployment and poverty?	**1.8**
To what extent are the political parties broad based?	3.0	To what extent are Government decisions not influenced by kickbacks	**1.4**
To what extent is the internal structure of parties democratic?	**1.5**	To what extent is the military sub-ordinate to the civil government?	**2.0**
To what extent does the political process reflect public concerns?	**2.2**	To what extent is the judiciary independent of the executive?	4.2
To what extent is the legislature accountable to the public?	**2.2**	To what extent is the government committed to resolution of internal conflicts?	3.2

*1 = lowest, 5 = highest

Source: Assessment by Experts

The scores in Table 42.4 are also low ranging from a minimum of 1.4 to 3.2. The weak areas in the context of the relationship between the state and the market are as follows:

(i) Weak regulatory framework.

(ii) Too much corruption in business transactions.

(iii) Lack of consultation of government with stakeholders.

Table 42.4: Rating of Different Areas of Governance by Experts			
Relationship between the State and Market	**Score**	**Dispute resolution, role of judiciary**	**Score**
To what extent has a regulatory framework been established to ensure competitive markets?	**2.4**	To what extent is there equal access to justice for citizens?	**2.3**
To what extent are economic regulations applied equally to firms in the economy?	2.7	To what extent are there clear decision making processes in the judicial system?	3.0
To what extent is there a clear demarcation of the respective roles of the public and private sectors?	2.9	To what extent are judgments influenced by bribes?	3.2
To what extent are business transactions not associated with corruption?	1.4	To what extent are members of the judiciary accountable for their actions?	**2.4**
To what extent is there consultation on policy between the government and the private sector?	**2.4**	To what extent are international legal norms incorporated in national laws?	3.0
To what extent does Government consider new international rules, norms and conventions in formulating policy?	2.8	To what extent are non-judicial processes available for fair resolution of conflicts?	**2.3**

Source: Assessment by Experts

The experts have also highlighted that the process of dispute resolution, especially by the judiciary, is weak in the following areas:

(i) Limited access of the relatively poor and underprivileged to justice,
(ii) Lack of accountability of the judiciary,
(iii) Absence of alternate dispute resolution mechanisms.

From the above findings it is clear that the process of interaction with experts has led to the precise identification of critical areas of governance failure.

42.4. CITIZEN SCORE CARD

The project on governance supported by the HEC also involved the preparation of an instrument, in the form of a questionnaire, to determine the perception of citizens about the quality of services provided by the State. This questionnaire was administered on a regionally stratified national sample of 500 households, both in urban and rural areas of Pakistan.

Table 42.5 highlights the level of satisfaction with different government agencies. This is the percentage of respondents reporting the service provided as 'good' or 'excellent'. A service is considered as inadequately provided if the percentage is below 50 percent.

Table 42.5: Extent of Use and Levels of Satisfaction* of Sample Households with Public Services

Service	Use (%)		Level of Satisfaction (%)	
	Rural Households	Urban Households	Rural Households	Urban Households
Police Thana	21	18	**40**	**25**
Family Planning	22	-	90	-
Land Revenue Department**	9	2	90	**49**
Sessions Courts	7	5	80	56
NADRA Office	43	28	57	57
Irrigation Department	16	-	**48**	-
Public Schools	63	32	56	62

*% of respondents rating the service as 'good' or 'excellent'.
**In the case of urban areas, it is the Provincial Excise and Taxation Department
Source: Survey of Households

The most visible finding is the relatively low level of satisfaction throughout the country with the role played by the local police thana. The dissatisfaction was more pronounced in urban areas. In rural areas, there is a surprisingly high level of satisfaction with the role played by the Land Revenue department and Lady Health Workers supporting family planning.

Table 42.6 presents the level of satisfaction with residential services of urban households. Given the high levels of power outages, it is not surprising that only 20 percent are satisfied with the quality of service provided by the electricity distribution company. The second service with which a majority of respondents is dissatisfied is the supply of gas.

Table 42.6: Extent of Use and Levels of Satisfaction of Sample Households with Residential Services

Service	Use (%) Urban Households	Level of Satisfaction (%) Urban Households
Gas	96	46
Electricity	100	20
Tap Water	90	79
Sanitation	90	74
Garbage Disposal	48	72

Source: Survey of Households

A special effort was made in the score card to determine perceptions about problems in the operation of public schools and public hospitals. With regard to public schools, the pre-dominant majority, over 90 percent, has identified poor quality of teaching and lack of facilities (water, latrine) as the major problems. Teacher absenteeism has been pointed out by almost two-thirds of the respondents.

Turning to public hospitals, the dissatisfaction of urban households is primarily with non-availability of medicines (91 percent), absence of proper testing facility (94 percent) and too many patients (95 percent). Overall, the respondents are very concerned about the very poor quality of service provided in public hospitals.

The overall conclusion is that there is substantial scope for improvement in governance in Pakistan, both economic and political. The emphasis has to be on achieving greater accountability of institutions with the people. The instruments of citizen score card and assessment by exports need to be used periodically to highlight areas of misgovernance. In addition, international country rankings must be viewed carefully to identify areas of weakness. Improvement in these rankings will enhance the prospects especially of more foreign direct investment and support by donor agencies.

Chapter 43:

ELEMENTS OF 'GOOD' ECONOMIC GOVERNANCE

The previous Chapter has highlighted that institutions, policies, rules and processes play an important role in determining the performance of countries. As such, this Chapter assesses the quality of economic governance in Pakistan. There are at least ten key elements of good economic governance.

Section 1 assesses the capacity for policy formulation and implementation in Pakistan. Section 2 determines the extent of fiscal discipline in the management of the budget. Section 3 highlights the policy mistakes that have been made in recent years and the reasons for this failure. Section 4 focuses on the issue of credibility and Section 5 on consistency in the context of economic governance. Section 6 takes up the issue of the political economy in the reform process and the extent to which the larger public interest is protected. Section 7 then assesses the ability to manage crisis. Section 8 makes an assessment of the degree of effectiveness in the delivery of services. The issue of integrity is taken up in Section 9. Finally, in Section 10 the extent of sovereignty in the formulation of policies is examined.

43.1. INSTITUTIONAL CAPACITY

The basic issue here is the extent to which the process of economic policy making has been institutionalized or not. Is there effective inter-ministerial coordination among economic ministries and with line ministries? How are emerging problems identified and is there adequate analysis of the costs and benefits of different policy options to resolve these problems? Is there sufficient and open dialogue with the different stakeholders in a particular problem area? What kind of fora exist for decisions on the actual choice of policy? Are there sufficient checks and balances to ensure that policy excesses are avoided?

43.1.1. Institutional Arrangements

In Pakistan, there do exist a number of institutional arrangements for economic policy making. At the apex is the National Economic Council (NEC), a Constitutionally mandated body, which is chaired by the Prime Minister and includes a number of Federal Ministers. In addition, provincial Chief Ministers and Finance Ministers sit in the NEC along with top level Federal and Provincial bureaucrats. Despite the wide ranging powers and terms of reference of the NEC, during the last few years it has met usually only once a year before the Budget to finalize the Annual Plan and the size of composition of the Public Sector Development Program (PSDP), prepared and presented by the Planning commission. Below the NEC is the Executive committee of the National Economic council (ECNEC) which is chaired by the Finance Minister and is primarily responsible for approval of public sector projects for inclusion in the PSDP. It meets five to six times a year.

There are other cabinet committees for investment, privatization, etc. However, most of the statutory committees essentially deal with micro issues at either the individual project or sectoral level. There exists no body where serious discussion takes place on macro policy issues. The annual budget which is considered to be the prime policy instrument for fiscal matters (of taxation and expenditure) is submitted in the form of a Money Bill (containing the taxation proposals) to the Parliament for approval. Members of the Parliament seldom focus on macroeconomic policy issues and are more concerned with 'constituency politics,' that is, whether the budget allocates enough funds or not for their respective constituencies.

How then in this vacuum are major economic policy decisions taken? The Ministry of Finance has emerged as the principal arbiter of the economic future of Pakistan and other economic ministries of planning, commerce, etc. have been relegated to a secondary role. While this has ensured that there is greater adherence to the discipline imposed by the annual budget, it has led to a much more short-term orientation in the process of policy making. The long term implications of policy decisions are seldom focused upon. The centralization of economic decision making has also had other unfavorable consequences. The process of transparency and dialogue with stakeholders has been largely lost and there is little public involvement.

A number of proposals could be put forward for improving the process of economic policy making. The apex body of the National Economic Council needs to be activated to meet at least once a quarter to focus on important and fundamental areas of policy and reform like export growth, resource mobilization, etc. Prior to this, specific proposals should be technically examined and discussed by a Economic Advisory Council (EAC), chaired by the Prime Minister, including representation of outside economic experts, (including expatriate Pakistani professionals), bankers, corporate leaders, etc. The EAC of the PML (N) Government remained moribund for most of the time. Earlier, the PPP Government had an EAC which played a more active role. The new Government of PTI has also constituted an EAC.

The next area of concern is whether there are enough institutional checks and balances to ensure that policy excesses are avoided. Traditionally, there has always been the danger that the government would pursue an expansionary fiscal policy by increasing the size of the budget deficit in order to achieve its growth objectives or of transferring benefits to favored target groups like large farmers, industrialists, traders, etc. This prospect has been heightened in the presence of a subordinate Central Bank which would feel obliged to adopt a correspondingly expansionary monetary policy in order to accommodate the larger borrowing needs of Government while simultaneously keeping credit flowing into the private sector. The consequence would be loss of macroeconomic stability, currency depreciation and higher inflation.

43.1.2. Faulty Policies

The next issue is the ability of the government machinery to undertake systematic analysis of the costs and benefits of different policy options. This capacity appears to have been seriously eroded in recent years. First, the primacy of the Ministry of Finance, which is frequently pre-occupied with some form of crisis management, has meant that there is little time generally for a serious and objective analysis of various options. The logical choice is the Planning Commission which needs to be converted from being largely a project approving agency to an in-house policy think tank for the Government.

Overall the consequence of over-centralization in the person of the Finance Minister and a lack of openness in policy making, has led to a number of fundamental 'mistakes' being made in the design, sequence or implementation of economic policies. These mistakes have had a major negative impact on the future prospects for economic growth and macroeconomic stability. Some of these mistakes have also occurred because of adherence to some faulty paradigm or on the behest of international agencies. These almost ‘fatal errors’ of policy include the following:

- Fixed nominal exchange rate policy leading to substantial overvaluation of rupee discouraging exports and increasing imports. Simultaneously trade liberalization, with maximum import tariff down to 20 percent, leading to an upsurge in imports.
- Too much external borrowing to build up foreign exchange reserves, leading to a rare form of the ‘Dutch disease’ with artificial stability of the rupee.
- Too expansionary fiscal and monetary policy at a time of a large and growing current account deficit.
- Too heavy taxation of energy inputs into power sector leading to high electricity prices and affecting export competitiveness.
- Big swings in policy on domestic debt management, initially shift to PIBs at a time of high interest rates and then to MTBs in the presence of low interest rates, leading to higher costs of debt servicing in the medium to long run.
- Policy of raising tax rates too much rather than focusing on expanding the tax bases with lower tax rates, negatively impacting on growth of the tax bases.
- Spreading too thin the PSDP with too many projects leading to delays in completion of projects and cost overruns.

- Too much emphasis on expanding electricity generation capacity rather than upgrading the transmission and distribution system; too much reliance on imported fuel rather than on domestic renewable sources.
- Too much reliance on domestic bank borrowing from commercial banks, during the tenure of the IMF Program, to finance the budget deficit, not taking advantage of the scope for 'seignorage' and encouraging the flow into National Savings Schemes. The result has been 'crowding out' the private sector.

43.1.3. Institutional Capacity for Reforms

The next area of concern is the institutional capacity for undertaking structural reforms. This is one of the most critical constraints to implementation of reforms. For change to occur, there must be an understanding not only of what type of change is required, but also the process of change has to be carefully managed so as to pre-empt action by vested interests to preserve the status quo. For this purpose effective 'change agents' have to be found with the necessary leadership qualities to motivate the process and create a sense of 'ownership' of the reform

For example, the vital reform of federal tax administration (the FBR) has got nowhere since 2001. The proposal to form an autonomous Pakistan Revenue Authority (PRA) and to create a separate service cadre for tax officials, with higher remuneration but less security of service, has been effectively blocked by a coalition of interests. The rest of the bureaucracy has been jealous of the possibility of special treatment to tax officials and has resisted changes in the service structure and rules. Within the FBR many of the senior officials have been opposed to the reform because it could make them more accountable and increase the probability of removal from service for inefficiency or corruption following the general loss of tenure. Business and political interests have been wary of the change because a more effective and autonomous tax administration which is less prone to patronage may be more even-handed in its treatment of tax payers and tackle tax evasion more effectively.

The lack of institutional capacity for reform is also vividly demonstrated in the failure to reduce losses of public sector enterprises. Cumulatively, the losses have accumulated to over Rs 1200 billion by the end of 2017-18. The power sector has been receiving a large tariff differential subsidy partly due to the high transmission and distribution losses and inability to fully recover the billing. Similarly, the Pakistan Steel mill has been idle for the last six years. It should either have been privatized or restructured. Instead, the wage bill of employees continues to be the liability of the Government.

The important lesson to learn for economic governance is that the process of structural reform, especially involving institutional change, is complex and difficult to manage. It has to be properly planned, executed and monitored. There should be little expectation of early success. Given the limited commitment and institutional capacity for reform within

Government, both at the political and bureaucratic levels, it is necessary to avoid spreading the reform effort too thin and concentrating only on areas where the prospects for success are greater and/or the returns are higher. It is in this context that the typical structural adjustment program with the IMF is too ambitious and does not recognize adequately the limited capacity for implementing reforms in a developing country. It becomes crucial, as such, to prioritize the reform program.

43.2. FINANCIAL DISCIPLINE

Perhaps the most commonly used and traditional test of the quality of economic management of a government is it ability to manage its resources prudently and efficiently without recourse to too large borrowings. This limit on borrowings should be such that debt servicing obligations do not rise disproportionately in relation to the capacity to meet these liabilities. This is especially important in the context of external borrowing.

Table 43.1 highlights the trend in the cost of overall debt servicing in relation to revenues and of external debt repayment plus interest cost as a percentage of exports. The servicing of external debt has reached crisis proportions.

Table 43.1: The Size of the Debt Servicing Burden

	Overall Debt Servicing as % of Total Revenues	External Debt Repayment plus interest as % of Exports
2007-08	32.6	15.6
2012-13	33.2	25.2
2017-18	28.7	30.1

Source: PES

Further, the Fiscal Responsibility and Debt Limitation (FRDL) Act of 2005 has imposed the following limits:

- Public debt to GDP ratio should not exceed 60 percent.
- Fiscal deficit annually should be below 4 percent of the GDP.

The position as of the end of 2017-18 is that public debt has approached 67 percent of the GDP and the fiscal deficit stands at 6.6 percent of the GDP.

Adherence to the norms of good budgeting practices has been violated in a number of ways, as follows:

(i) Off-budget transactions are undertaken so as to put less pressure on budgetary resources and contain the size of the fiscal deficit. This includes debt guaranteed by the Government of public sector enterprises taken directly by them from commercial banks. Also, the circular debt of the power sector is not included in the public debt even though it is now in excess of Rs 1.2 trillion.

(ii) One-off items which are in the nature of financing are instead shown 'above the line' as revenues. In 2013-14, the large Saudi Grant of $1.5 billion was shown in non-tax revenues. Privatization proceeds are also included in non-tax revenues although the Privatization Ordinance of 2000 clearly states that these should be shown to the extent of 90 percent as financing 'below the line'.

(iii) There is the tendency for retaining earmarked revenues in the Federal Consolidated Fund. This includes revenues from the Gas Infrastructure Development Cess (GIDC) which according to the law the levy should be only used for financing the construction of gas pipelines. The same problem arises in the case of the Export Development Cess and with contributions for workers' welfare collected along with the income tax.

(iv) Supplementary grants are usually approved on bloc at the time of presentation of the subsequent budget. The standard practice should be that if the expenditure on a particular head exceeds by more than, say, 25 percent the budgeted allocation should be submitted for approval by the National Assembly. This practice is not followed in Pakistan.

(v) Tax exemptions or concessions constitute tax expenditure. In India, for example, these tax expenditures are reported along with the budget documents as a Statement of Revenue Foregone, to preserve the transparency of special tax treatment. This practice is not followed in Pakistan. Also, SROs are not submitted for Parliamentary approval.

(vi) There is a tendency to approve too many new projects in order to cater to the interests of particular groups, regions or constituencies. Currently, the cost of the portfolio of projects in the federal PSDP is over Rs 8 trillion, whereas the size of the annual PSDP was Rs 661 billion in 2017-18. This implies that on average a project will take over ten years to complete. As such, there should be a moratorium on new projects, except where foreign financing is available like CPEC. Instead the last meeting of the ECNEC, before the end of the tenure of the PML (N) Government, approved new projects costing more than Rs 1 trillion.

(vii) The audited Fiscal Operations reported by the Federal Ministry of Finance frequently contain a 'statistical discrepancy'. This happens when the estimate of the fiscal deficit 'below the line' and 'above the line' do not tally. In some years this discrepancy is over Rs 200 billion as, for example, in 2015-16. This reflects very poorly on the overall system of budgetary management and control.

(viii) The Public Accounts Committee (PAC) of the National Assembly is supposed to play a strong 'watchdog' role. In particular, it needs to ensure that audit objections are adequately taken care of by the concerned Agency/Ministry. Unfortunately, during the last few years the PAC has not done its job properly and there is a large backlog.

43.3. CONSISTENCY

A seldom emphasized but potentially important element of economic governance is the credibility and consistency of policy. In their absence, policy announcements are likely to be seen as, more or less, temporary in character and thereby fail to induce the desired change in behavior of economic agents. A continuous reversal of policy decisions under pressure of special interest groups eventually erodes the administrative fiat of government and leads to the effective abdication of the task of economic management. It is, therefore, that much more necessary for major policy changes to be carefully thought through and only announced after a broad-based coalition of support has been built.

Consistency of economic policy is especially important from the viewpoint of promoting medium-and long-term decisions by economic agents on the nature of their participation in the economy. Continuity, in particular, is essential in taxation and trade policies, related to the degree of protection. This enables potential investors to project likely levels of profitability of projects under consideration. It is not surprising that business surveys generally find that foreign investors have a stronger preference for countries which demonstrate a consistency in their economic policies over time. This is frequently considered more important than the regime of fiscal incentives in place to attract FDI.

Discontinuity in economic policies is likely to be the most pronounced at the time of transition from one Government to another. This is motivated by a number of factors. First, the new Government sees the change as a way of discrediting the previous Government for following the wrong set of policies. Second, the base of support for the in-coming government may be different and changes in policy are deemed essential to reward particular target groups. However, this has the consequence of creating a great deal of medium-term uncertainty about the conduct and nature of economic policy.

The lack of consistency is also manifest in the short run. This relates, for example, to the practice of announcing mini-budgets. Clearly, changes in fiscal policy are justified during a particular financial year in the event of unanticipated, exogenous shocks like a major crop failure, natural disaster, rise in international prices, etc. But mini-budgets become a serious problem in normal times when a government follows a strategy of announcing a soft tax-free budget initially and then, more or less, surreptitiously announces taxation proposals over the year.

Rapid changes in taxation or protection policies create a perpetual state of uncertainty in markets. They promote rent seeking and speculative behavior and ultimately damage the prospects for investment and growth. It is essential that in the larger national interest there is a political consensus on a minimum economic agenda to ensure continuity of policies in key areas. Also, as a way of discouraging mid-year changes in taxation policy it is essential that each individual proposal should not be promulgated through SROs

(Statutory Regulatory Orders) but through proper legal amendments after due process including approval by the Parliament.

43.4. CREDIBILITY

The PML (N) had acquired a reputation for large-scale manipulation of statistics, perhaps to a degree not witnessed before. The principal source of economic and social statistics is the Pakistan Bureau of Statistics, which has been subordinate to the Ministry of Finance with the prime responsibility for managing the economy. As such, it has had a vested interest in presenting a substantially better picture of the economy than the ground reality.

Consequently, the GDP growth rate, the level of investment, tax revenues and private consumption expenditure have been over stated. Simultaneously, there has been under statement of the rate of unemployment, rate of inflation, size of the fiscal deficit and so on.

In fact, a stage had been reached when the private sector, media and civil society stopped taking government statistics seriously. Perhaps even the Ministries have been duped by the numbers and either did not undertake or postponed the necessary structural reforms. Clearly, the time has come to make PBS a fully autonomous agency.

The credibility of government has also been eroded by its inability to honor commitments made, like the following:

- Tax refunds have been piling up, especially those due to exporters. By now they have accumulated to over Rs 300 billion. Periodically, the Government assures the private sector that a sizeable payment will be made in the short-term of the refunds. But this does not happen because of the pressure on FBR to meet the revenue targets.
- The Provinces have frequently been told that pending issues like the determination and payment of hydro-electricity profits, avoidance of double taxation, fixation of and guarantees to provincial borrowing will all be resolved soon. But this does not happen even after the convening of the Council of Common interests (CCI). This has increased the stress on the Federation of Pakistan.
- The Government of Pakistan had agreed to some key structural benchmarks with the IMF as part of the Extended Fund Facility. For example, it was agreed that PIA and some DISCOs will be privatized. But this did not happen over the three years of the Program. Consequently, the credibility with international agencies has been affected. If Pakistan goes back to the IMF for a new Program then the Fund may now ask for more prior actions.

43.5. PROTECTION OF THE PUBLIC INTEREST

This relates to the political economy of the reform process. A key test of the quality of economy governance is whether policies are oriented towards powerful special interest groups or are motivated by the objective of protecting what can be called broadly 'the public interest'. The political economy of reforms relates to the identification of gainers and losers. If it becomes clear that most of the time the Government is catering to particular interest groups then the quality of economic governance becomes suspect. For sound and neutral policies, it is enough that the welfare loss to losers should be less than the welfare gain to gainers, irrespective of who the gainers and losers are. But a bias in policy making becomes visible where a Government appears to be concerned only about the gains to a particular segment of society and ignores the costs that it may confer on people at large.

State capture by special interest groups is most acutely manifest in the level and nature of tax expenditures (representing the revenue foregone in granting of tax exemptions or concessions) and subsidies from the exchequer, both implicit and explicit. Tax expenditures in Pakistan are estimated conservatively at over Rs 1,000 billion as shown earlier.

Another example of special favors is the targeting of subsidies. Perhaps the best example of subsidies are those targeted primarily to the feudal elite. Not only is their income tax liability marginal, but they also have access to a wide range of subsidies on inputs including water, electricity for tube wells, tractors, etc. The total subsidy bill on these inputs aggregates to about Rs 200 billion. In addition, subsidies on secondary and higher education, consumption of gas, etc., which primarily benefit the better off segments of society are in place.

Recent examples of steps which benefit more the rich and powerful or particular groups include the following:

- As a parting gift in the Budget of 2018-19, the Federal government drastically reduced the income tax burden on individual tax payers. As highlighted earlier, the exemption limit of income tax was raised from Rs 0.4 to Rs 1.2 million and the maximum tax rate halved to 15 percent. This benefited the 1.3 million tax payers. However, the gain is proportionately higher for larger pre-tax incomes, contrary to the norms of progressivity. Also, the revenue loss is a massive Rs 90 billion. This will have to be recovered subsequently probably by the levy of higher indirect taxes which will hit the entire population of Pakistan.
- The Government periodically offers amnesty schemes which potentially benefit only the large tax evaders. Recently, a scheme was announced for the return of money laundered and taken out of Pakistan or for tax evaded money in the country with payment of a penalty of only 2 to 5 percent. This initiative is

unacceptably in favor of the rich and provides an incentive for continuing tax evasion in the future.

- Over the last decade it has become an annual practice in the Federal and Provincial budgets of annual increases in salary, allowances and pensions. The rate of increase usually significantly exceeds the rate of inflation. For example, in 2008-09 an increase of as much as 50 percent was granted. This had led to rapid rise in the costs of civil administration and defense and 'crowded out' expenditure on basic social and economic services. Government employees have become a kind of privileged class. Meanwhile, people working in the private sector are languishing because of rising unemployment and falling real wages.

- There has been a strong proclivity towards 'mega' projects during the tenure of the PML (N). These are more visible and are probably more amenable to larger kickbacks. A prime example is the Orange Line (mass transit) Project in Lahore costing over Rs 250 billion for the benefit of about two million commuters daily in the metropolitan city. Instead, with this amount state-of-the art facilities could have been provided to Government hospitals in each district of Punjab, thereby benefiting many more people.

- The wholesale and retail trade sector is the largest component of the informal economy and compares favourably in size with the large-scale manufacturing sector. It has largely remained outside the tax net. Any meaningful extension of the sales and income taxes would have to cover this sector. The trading community, with a strong political voice within the Pakistan Muslim League had been able to frustrate moves by the Nawaz Sharif government to extend the GST to the sector. The new Government has also succumbed to pressure of the traders and postponed the extension of GST on the basis of proper documentation.

The problem is that whenever any particular interest group is able to extract a concession from the government the burden automatically falls on the exchequer. This necessitates either higher taxation elsewhere, usually regressive in incidence, or cut back in expenditures in areas which are generally pro-poor. In this respect the larger public interest is sacrificed. This is why there is a need for such a high premium on this element of economic governance.

43.6. ABILITY TO MANAGE CRISES

A major test of good economic governance is how crises when they come are handled. This requires the presence of early warning systems, quick policy response times and a willingness at both the political and bureaucratic levels to take strong actions to mitigate against or reduce the impact of crisis. It also requires the adoption of a long term development strategy which insulates the economy to the extent possible from external shocks caused by fluctuations in the global economy.

Pakistan has typically found itself in a financial downturn every three to four years. Since 1988 it has been necessary to seek the support of the IMF multiple times to manage a balance of payments crisis. Seldom, however, has a program with the Fund been successfully completed. In fact, the country had acquired the reputation of being a ‘one tranche’ country.

The causes of financial crises are manifold. Sometimes the trade deficit widens in an unsustainable manner due to a big jump in commodity prices, especially of oil. For example, in 2007-08, the international price of oil virtually doubled and the import bill of crude oil and petroleum products went up by more than $4 billion. By September 2008 reserves had fallen by 57 percent in comparison to the level at the start of the year. A similar story was repeated in 2012-13. Both times Pakistan had to move fast to negotiate an IMF program, immediately after the assumption of power by a newly elected Government.

Other times the causes of an impending financial crisis have been different and more domestic in character. The widening of the trade gap and the resulting fall in reserves in 1993 was caused mostly by the big jump in imports of automobiles for the ‘yellow cab’ scheme of the first Nawaz Sharif government. In 1997, there was a big hemorrhaging of the balance of payments because of the import since 1994 of power generating equipment, as part of the IPP policy adopted by the second Benazir Bhutto Government.

During the last two years Pakistan finds itself once again moving towards a major financial crisis. Here again the causes are mostly of domestic origin, as follows:

(i) Presence of a nominally stable exchange rate in nominal terms as part of a conscious policy had led to a sizeable appreciation in the real effective exchange rate by over 24 percent from 2014 to 2017. Consequently, there was a major loss of competitiveness and exports fell by almost 20 percent during these years.

(ii) The exchange rate policy adopted led to the cheapening of imports in relation to domestically produced goods. This was exacerbated by the process of trade liberalization as part of the Fund program. The maximum import tariff was brought down from 35 percent to 20 percent.

(iii) Large-scale import of machinery for power generation and construction commenced from 2016 for CPEC projects.

Consequently, the stabilization of the economy achieved from 2013 to 2016 under the IMF program proved to be very temporary in character. The current account deficit which was $5 billion in 2015-16 shot up to $12 billion in 2016-17 and reached $19 billion in 2017-18.

Foreign exchange reserves have fallen from the peak of almost $19 billion to $8 billion by end-September 2018, despite resort to large-scale high cost external borrowing. The new Government will have to probably seek the support once again of IMF.

Given this frequent repetition of financial downturns there is need, once and for all, to understand the root causes of Pakistan's vulnerability. The fundamental lesson is that the country has to focus much more on export promotion rather than rely mostly on import substitution. Managing risk on a sustained manner will require building up reserves to provide import cover of at least three to four months.

Was the PML (N) Government's response to the incipient financial crisis timely, strong and appropriate? The answer unfortunately is a not, for the following reasons:

(i) Hesitantly there were three small depreciations of the Rupee since December 2017. Cumulatively, the devaluation was of 14 percent. However, the incremental policy has fuelled speculation about future moves and led to an upsurge in imports by almost 17 percent in 2017-18.

(ii) Efforts have been made to restrict imports by imposition of regulatory duties and cash margins on luxury imports. But these apply to only about 10 percent of imports.

(iii) Blissfully the Government has maintained expansionary and fiscal policies as 2017-18 was also the pre-election year. The budget deficit went out of control at close to 6.6 percent of the GDP and interest rates remained exceptionally low.

The unfortunate conclusion is that dragging of feet in terms of strong policy actions on a timely basis only deepens and protracts the financial down turn. There is no other option but for the MOF and the SBP to be always vigilant and pro-active in terms of wide ranging adoption of strong policies to avert or manage crises.

43.7. INTEGRITY

An important element of economic governance relates to the level of corruption in the discharge of Government functions. When corruption becomes deeply entrenched it can devastate the entire economic, political and social fabric of a country. There is, in fact, a mutually reinforcing vicious cycle between corruption and human development. Corruption hinders human development directly by limiting access to basic social services and indirectly by reducing economic growth due to loss of investment. Low levels of human development contribute to an environment which breeds corruption and reduces governance still further.

Corruption in developing countries including Pakistan has a number of distinctive features. First, it occurs upstream at the highest levels of government thereby distorting fundamental decisions about development priorities, policies and projects. Second, corruption moneys are usually smuggled out to safe havens abroad and in this sense there is no local multiplier effect. Third, there are no effective accountability mechanisms against corruption.

There are essentially three types of corruption. The first is petty corruption mostly by low level personnel in the performance of some regulatory function (e.g., traffic police) or provision of some service (e.g., black marketing of drinking water through tankers). Middle level corruption normally takes place at the enterprise level by bureaucrats in areas like industrial licencing, award of contracts, allocation of quotas and tax evasion. Grand corruption occurs at the highest levels of the state and frequently involves foreign money.

Corruption can be equated with monopoly power plus discretion minus accountability. Exclusive provision of a service and greater discretion in the discharge of the function leads to more corruption. Trade restrictions, government subsidies, price controls, etc. are well-known sources of corruption. Accountability has traditionally been low in Pakistan at all levels – state, judicial and civil society.

The extent of corruption is particularly difficult to quantify because by definition it is unobserved. The big areas of corruption in Pakistan include tax evasion in connivance with the tax collector; illicit trade across borders with the tacit approval of security forces; theft and underpayment of public utility bills in collaboration with meter readers; bribes in the award of engineering contracts for development or maintenance works in the public sector; corruption in the granting of bank loans; judicial and police corruption.

There are indications, however, the level of corruption has been changing in Pakistan. The Corruption Perceptions Index of Transparency International has recently ranked Pakistan higher. However, Index is based primarily on the views of foreign and local businessmen on the amount of corruption involved in conducting their activities in a particular country. As such, this index is probably geared more towards measuring the level of middle level and grand corruption rather than petty corruption.

The National Accountability Bureau (NAB) has become more active in recent times. This process has been initiated following the greater involvement of the Supreme Court, especially after the Panama Papers, and the appointment of a new Chairman of the Agency. It was set up under the National Accountability Ordinance of 1999 (as modified on 26-2-2010). The motivation was the need for effective measures for detection, investigation, prosecution and speedy disposal of causes involving corruption, misuse of power, misappropriation of property and taking of kickbacks or commissions. The focus is also on default in bank loans. Currently, NAB is engaged in the following cases:

- 29 Financial Scams,
- 20 Land Scams,
- 24 Cases of Abuse of Official Position by Public Office Holders,
- 101 Court Cases.

It is important that there should be no bias in the selection of cases by NAB. Also, due process needs to be followed as per the law and full transparency must be preserved. Ideally, cases should not linger for long periods. There is need to also ensure no bias in the selection of cases by NAB.

Altogether, integrity in the formulation and conduct of economic policy and in the discharging of government functions of regulation and provision of services remains a vital element of economic governance. A wide ranging program for elimination of corruption has become absolutely essential. Given the systemic nature that corruption has acquired, it is necessary that strong symbolic actions must 'pave the path' for sending a shock to jolt it out of the corruption trap. The government must identify and give exemplary punishments to major tax evaders, a few dishonest judges and corrupt officials of public utilities. This is clearly the people's expectation from the new Government.

43.8. EFFECTIVE DELIVERY OF SERVICES

The chapter has already identified as one of the problems of economic governance the choice of wrong priorities in the allocation of public expenditure whereby expenditures, in particular, on development, social services and safety nets have suffered. Superimposed on this is the fact that whatever expenditures are incurred in these areas are not spent in an efficient and cost effective manner. In addition, in the case of services provided publicly which are of a private nature there is little emphasis on adequate direct cost recovery. This has further restricted operating and maintenance outlays and led to a progressive decline in the quality of services provided.

Public utilities can be viewed as microcosms of the wider financial management problem. State enterprises have been primary targets for political patronage resulting in massive over employment and unsustainably large subsidies to favored target groups. Rampant corruption, inefficient management and large revenue leakages have eroded financial viability even further.

In Pakistan, the typical public utility now employs three to four times the number it should. WAPDA is beset with serious financial and management problems which threaten to even have macroeconomic consequences. Costs of power generation have risen rapidly due to increasing reliance on thermal power, commissioning of IPPs and rise in the price of fuel inputs. Serious management and technical inefficiencies exist in transmission and distribution and overall system (including billing) losses have approached one-third. On top of this are serious problems in the setting of tariffs and in collection of receivables. Large numbers of consumers remain heavily subsidized. It is estimated that subsidies to domestic, agricultural, public sector consumers and to consumers in some designated areas imply a subsidy (difference between the tariff and marginal cost) of as much as Rs 250 billion, as compared to actual revenues of about Rs 900 billion. Not only are tariffs low in many cases but there are serious problems of theft, undercharging and recovery of bills. Receivables stand at over Rs 800 billion. This has contributed to the problem of circular debt.

The Pakistan Railway was over forty years ago a viable and profitable institution providing high quality service to even low income consumers. Today, it is a rundown institution with depreciated assets of both the rolling stock and the track. However, over employment continues to be an unsustainable burden. The number of passengers and freight carried fell sharply by 48 percent and 86 percent respectively between 2007-08 and 2012-13. There has been some recovery since in the traffic volumes and gross earnings have more than doubled after 2012-13. However, the Railway continues to impose a burden on the Federal budget. In 2016-17 it was given a subsidy of Rs 39 billion.

The gas sector is beginning to suffer similar problems as the power sector. Transmission losses are as high as 9 to 11 percent. The circular debt problem has also arisen now in this sector and will necessitate a big increase in gas tariffs.

The same story is repeated in the case of PIA as the Pakistan Railway. Overall, the borrowings by PSEs from commercial banks, largely to finance their running deficit, over and above any subsidy provided by the Government, stands currently at Rs 823 billion. They are increasingly annually by over Rs 250 billion.

43.9. SOVEREIGNTY

Last but not the least, is the issue of sovereignty of Governments in the process of policy and decision making. Given its persistent balance of payments problem Pakistan has been forced periodically since 1988 to seek program assistance from the IMF and other international agencies. Funding has been made conditional frequently on a number of reforms. Most governments have abdicated from the task of identifying home grown reforms and have passively accepted the set recipe of measures from the Fund and the World Bank.

Therefore, there has been little 'ownership' of the reforms by Government. Virtually all IMF programs in Pakistan have floundered on the grounds of partial, delayed and defective implementation. There has been some flurry of action around the time of mission reviews and release of tranches followed by inactivity subsequently.

The best way to assert sovereignty is to get agreement on program targets with the IMF and then develop a truly home grown reform package to achieve the agreed targets after careful technical analysis and evolution of a national consensus on the package. Of course, implicit in this approach is the assumption that if the Fund does not think that the reforms are adequate then it can withhold program financing. However, this approach will lead to the reassertation of self-confidence and a commitment to the process of reforms by Government. Once agreed, the program will have a greater chance of successful implementation.

A new issue of sovereignty that has come up is the relationship with China following the signing of the agreement on CPEC. China has committed to investing $60 billion over the next decade in Pakistan. Therefore, if properly designed and executed, CPEC can be a 'game changer' for Pakistan. However, it is important to realize that the corridor through Pakistan gives China vastly better and much shorter access to the Arabian Sea, the Middle East market and beyond.

As such, an asymmetry in the negotiations process must be avoided whereby Pakistan makes most of the concessions to China without much reciprocity. Already, under various SROs, Chinese companies, engaged in infrastructure projects as part of CPEC, have been given import duty, sales tax and withholding tax exemptions. Special sections have been added to the Second Schedule of the Income Tax Ordinance whereby a 23 year income tax holiday has been given to companies operating in Gwadar Port. Also, a ten year tax exemption will be given to companies setting up operation in the SEZs.

Reciprocal steps from China should include concessional terms on credit from China for infrastructure similar to that given by IDA. Also, the FTA with China has worked hugely to the advantage of China as highlighted earlier. The time has come for a *quid pro quo* to enhance substantially Pakistan's exports to the large Chinese market.

The chapter has identified nine elements of good economic governance as fiscal discipline, institutional capacity, credibility, consistency, protection of the public interest, ability to manage crisis, effective delivery of services, integrity and sovereignty. Based on these dimensions, the track record of economic governance in Pakistan appears to be a mixed one. Clearly, if Pakistan's economy is to emerge once again as a relatively high growth performer the quality of economic governance will have to be of the highest level. This is perhaps one of the greatest challenges that Pakistan's leadership faces today.

Chapter 44:

REGULATORY AGENCIES

The primary role of regulatory agencies is to protect the larger public interest. This can be achieved by ensuring competition and absence of restrictive practices in markets, setting proper standards and licensing systems, adequate information and monitoring mechanisms, etc.

There are presently a multitude of regulatory agencies in Pakistan. The first type are authorities which perform functions related to all segments of the economy like the Competition Commission of Pakistan (CCP) and the Intellectual Property Organization (IPO). Then there are more specialized agencies like the State Bank of Pakistan (SBP), which manages the monetary policy and regulates scheduled banks; the Securities and Exchange Commission (SECP) which focuses on the corporate sector, the stock market and non-banking financial institutions and the National Electric Power Regulatory Authority (NEPRA) and the Oil and Gas Regulatory Authority (OGRA) which regulate the power sector and the supply of fuel and energy respectively.

Section 1 of the Chapter focuses on the nature of Constitutional recognition of regulatory authorities. This section also the law under which they have been established. Section 2 presents the objectives of the setting up of particular regulatory bodies. Section 3 describes the governance structure of different agencies. Section 4 undertakes case studies of three key regulatory agencies – SBP, SECP and NEPRA – in terms of their recent performance, successes and failures. Section 5 highlights the ranking of Pakistan in one area of governance, relating to the discharge of regulatory functions. Finally in Section 6 some recommendations are made for improving the functioning of regulatory agencies in Pakistan.

44.1. LEGAL FOUNDATIONS OF REGULATORY AGENCIES

The Constitutional role of regulatory entities has been formally recognized. Under the Fourth Schedule of the Pakistan Constitution, post-18th Amendment, the Federal Legislative List (FLL) Part 2, item 5, includes the following:

'All regulatory authorities established under a Federal Law'

The functions included in this list are the joint responsibility of the Federation and the Provincial Governments.

The Council of Common Interests (CCI) has been constituted under Article 153 of the Constitution. The Council consists of the following:

(a) The Prime Minister who shall be Chairman of the Council

(b) The chief Ministers of the Provinces

(c) Three members from the Federal Government to be nominated by the Prime Minister.

According to Article 154, the Council shall formulate and regulate policies in relation to matters in Part II of the FLL and shall exercise supervision and control over related institutions. Therefore, the supervision of Regulatory Authorities (established under a Federal Law) is under the ambit of the CCI. Implicit in this provision is that the Board of each Regulatory Agency should have representation from each Province. Unfortunately, this is generally not the case. Also, CCI must meet quarterly, which has generally not been the case. Administrative control of some regulatory agencies like NEPRA is under the Cabinet Division, Government of Pakistan.

The law under which the eleven key regulatory agencies have been established is given in Chart 44.1. It is interesting that many of these agencies were established under Acts/Ordinance of the National Assembly after 2000. The OGRA ordinance was passed in 2002, PEMRA Act amended in 2007, CCP in 2010 and DRA in 2012.

Chart 44.1: Major Regulatory Agencies in Pakistan

Agency	Act
• State Bank of Pakistan (SBP)	SBP Act, 1956
• Competition Commission of Pakistan	Competition Act, 2010
• Securities and Exchange Commission of Pakistan (SECP)	SECP Act, 1997
• Oil and Gas Regulatory Authority (OGRA)	OGRA Ordinance, 2002
• National Electric Power Regulatory Authority (NEPRA)	Regulation of Generation, Transmission and Distribution of Electric Power Act, 1997
• Pakistan Standards and Quality Control Authority (PSQCA)	PSQCA Act, 1996
• Pakistan Electronic Media Regulatory Authority (PEMRA)	PEMRA (Amendment) Act, 2007
• Drug Regulatory Authority of Pakistan (DRA)	DRA Act, 2012
• Civil Aviation Authority (CAA)	Carriage by Air Act, 2012

Administrative control of NEPRA, OGRA, and CAA is with the Cabinet Division. Others are under the relevant Ministries.

Source: List of Laws in Pakistan

There is need to emphasize that regulatory functions are also performed by the Provincial Governments, especially after the 18th Amendment. A case study of Punjab reveals considerable legislation for the performance of regulatory functions, for example:

- The Punjab Food Authority Act, 2011
- The Punjab Procurement Regulatory Authority Act, 2009
- The Punjab Environmental Protection Act, 1997
- The Lahore Development Authority Act, 1975
- The Punjab Essential Articles (Control Act), 1973
- The Minimum Wages Ordinance, 1970
- The Societies Registration Act, 2006

44.2. OBJECTIVES OF REGULATION

The objectives of regulation as derived from the preamble of the relevant laws are presented in Chart 44.2 for five major regulatory agencies. The performance of these institutions should be measured by the extent to which they are fulfilling their respective objectives.

Chart 44.2: Objectives of Regulation

	Statement of Objectives in Law
State Bank of Pakistan (SBP)	**“**. . To provide for the Constitution of a State Bank to regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest to secure monetary stability and fuller utilization of the country’s productive resources**”**
Competition Commission of Pakistan (CCP)	**“**. . To provide for free competition in all spheres of commercial and economic activity to enhance economic efficiency and to protect consumers from anti-competitive behavior **”**
Securities and Exchange Commission of Pakistan (SECP)	**“**. . To provide for the establishment (of SECP) for the beneficial regulation of the capital markets, superintendence and control over corporate entities**”**
Oil and Gas Regulatory Authority (OGRA)	**“**. . To foster competition, increase private investment and ownership in the midstream and downstream petroleum industry and protect the public interest**”**
National Electric Power Regulatory Authority (NEPRA)	**“**. . To provide for the regulation of generation, transmission and distribution of electric power**”**

Source: Respective Laws

44.3. GOVERNANCE STRUCTURE

Chart 44.3 shows the governance structure of the major regulatory authorities in terms of the composition of the Board of Directors. SBP and NEPRA have provincial representation on the Board, along with eminent professionals. In some cases, like the CCP and SECP, members of the Board are full-time.

Chart 44.3: Composition of Board of Directors

	Statement of Objectives in Law
State Bank of Pakistan	*Central Board of Directors:* consisting of: (i) the Governor (ii) Secretary, Finance Division, GoP (iii) Eight directors, with at least one from each Province, who are eminent professionals. *Monetary and Fiscal Policies Coordination Board:* consisting of: (i) Finance Minister, Chairman (ii) Commerce Minister (iii) Deputy Chairman, Planning Commission (iv) The Governor, SBP (v) Two eminent economists.
Competition Commission of Pakistan	Not less than five and not more than seven Members, who will be full-time. The federal Government shall appoint the Chairman from among the members.
Securities and Exchange Commission of Pakistan	Same as CCP. The Members will be referred to as Commissioners.
Oil and Gas Regulatory Authority	The Authority shall consist of a Chairman and three Members for Gas, Oil and Finance respectively.
National Electric Power Regulatory Authority	The Authority shall consist of a Chairman, to be appointed by the Federal Government, and four members, one from each Province.

Source: Respective Laws

44.4. CASE STUDIES OF REGULATION

Three regulatory institutions, namely SBP, SECP and NEPRA, have been studied in terms of their latest performance as per their latest Annual Reports. The results are as follows:

44.4.1. State Bank of Pakistan

Salient features of the performance Report

The positive areas highlighted in the SBP Annual Report of 2016-17 are as follows:

- The policy rate remained exceptionally low at 5.75 percent in line with the very low rate of inflation. This led to a big 67 percent growth in credit to the private sector.
- Interest rates on PIBs and MTBs also remained very low.
- The Monetary Policy targets in the last year of the IMF Program were successfully met in 2015-16.
- National Financial Inclusion Strategy (NFIS) prepared, including development of branchless banking.
- Big jump in agricultural credit of 18 percent.

However, there were a number of negative developments

- Foreign exchange reserves fell by $2 billion in 2016-17 to the level of $16.1 billion.

- Borrowing by the Government from SBP had been strongly controlled during the tenure of the IMF Program up to September 2016. Thereafter, the borrowing reached the record level of Rs 908 billion by June 2017, implying more inflationary pressures with a lag.
- Lending to sectors like SMEs and housing remained very low. Microfinance has very limited coverage with only 2.2 million borrowers and total loan portfolio of Rs 110 billion, equivalent to only 1.5 percent of total bank advances.

44.4.2. Securities and Exchange Commission of Pakistan

SECP performance report for 2014-15

- Three stock exchanges in Karachi, Lahore and Islamabad integrated into one Pakistan Stock Exchange.
- Improved compliance with the International Organization of Securities Commission (IOSCO). Improvement in Compliance Rate from 37 percent in 2004 to 62 percent in 2015.
- Promulgation of a New Securities Act.
- Growth in market capitalization by 16 percent.
- 936 cases of investor grievances handled / resolved.
- Increase in number of companies registered of 10 percent.
- Examination of Accounts of 928 companies.

Positive Aspects of Performance

- Buoyancy of Stock Market.
- Corporate Profitability at a High Level.
- Development of NBFIs.

Negative Aspects of Performance in Regulation

- Only 8 IPOs during 2014-15 of Rs 11.3 billion.
- Decline in average number of shares traded daily.
- No market developed for corporate bonds.
- No handle on Insider Trading.

44.4.3. National Electric Power Regulatory Authority

Performance report for 2015-16

- Focus on Renewable Energy (solar plants and small hydel projects and wind energy).
- Clear identification of the serious structural problems with the Power Sector, including the buildup of circular debt.
- Determination of Upfront Tariff for Coal and RLNG fired projects.
- Incentivizing Private Investment in the field of Power Transmission.
- Formulation of Guidelines for Wheeling of Electricity.
- Development of a Performance Ranking System of DISCOs.

Positive Aspects of Performance

- Transmission of benefit of lower fuel costs via negative monthly Fuel Charges Adjustment.
- Setting of Tariffs for Renewable Energy Projects.

Negative Aspects of Performance

- No incentive system developed for reduction in T&D and billing losses.
- Levy of an Electricity Surcharge at the time of large fall in fuel costs, especially of furnace oil.
- Lack of proper examination of Annual Accounts of IPPs and DISCOs.

44.5. PAKISTAN'S RANKING IN REGULATORY QUALITY

The World Bank ranks countries on the basis of their performance in different areas of governance. One particular area of governance that is focused on is Regulatory Quality. Table 44.1 gives the trend of ranking of Pakistan in this area from 1996 onwards. The trend generally has been downwards.

Table 44.1: Pakistan's Position in Regulatory Quality According to the World Bank

Years	Estimate	Standard Error	Number of Sources	Rank (Quintile)	Lower	Upper
1996	-0.45	0.32	4	30.88	18.54	55.61
2000	-0.73	0.27	6	21.08	12.68	37.56
2004	-0.88	0.18	9	18.14	11.71	29.27
2007	-0.50	0.18	10	32.04	22.22	48.31
2009	-0.55	0.16	10	33.01	23.81	43.81
2012	-0.73	0.17	11	24.88	17.62	35.24
2014	-0.69	0.18	11	27.88	16.27	38.28

Source: World Bank, Governance Matters

The rankings of a number of countries are given in Table 44.2. Two conclusions emerge from the tables. First, Pakistan is in the lowest one third of countries in terms of the overall performance of regulatory agencies. Sri Lanka and Turkey have a much better ranking. Second, a relatively better score was obtained in 1996, followed by a big decline up to 2004. There is some improvement thereafter up to 2009, followed again by some worsening.

Table 44.2: Comparative Position of Pakistan in Regulatory Quality – 2014

Countries	Estimate	Standard Error	Number of Sources	Rank	Lower	Upper
Bangladesh	-0.94	0.18	11	18.27	9.57	28.71
China	-0.27	0.18	11	45.19	30.62	54.07
India	-0.45	0.18	11	34.62	25.36	48.33
Nepal	-0.85	0.18	10	20.67	11.00	31.58
Sri Lanka	-0.08	0.33	2	57.21	38.28	74.16
Turkey	0.41	0.17	13	66.35	55.98	73.21
Pakistan	**-0.69**	**0.18**	**11**	**27.88**	**16.27**	**38.28**

Source: World Bank, Governance Matters

A subjective ranking, based on application of Delphi technique, of individual regulatory institutions of Pakistan is given in Table 44.3. Out of the 10 agencies considered, SBP and NEPRA get the best rating. The lowest rating has been given to CCP, PSQCA and DRA.

Table 44.3: Subjective Rating of Performance of Regulatory Agencies

Regulatory Agency	Rating: (0 = lowest, 10 = highest)
SBP	6
CCP	2
SECP	3
OGRA	3
NEPRA	5
PSQCA	2
PEMRA	3
DRA	2
CAA	4
PRA	3

Source: Application of the Delphi Technique

CCP has not done an effective job in preventing the emergence of monopolies and cartels in various activities. In some industries, reported rates of return on equity are even higher than 35 percent. PSQCA has very limited capacity and has been unable to improve quality especially of exports which are subject to psycho sanitary measures. DRA has failed in controlling the spread of spurious drugs and exercise price control on multinational pharmaceutical firms, who have raised prices of life-saving drugs recently by up to 70 percent.

44.6. RECOMMENDATIONS

The not-so-good performance of regulatory agencies of Pakistan implies the need for the following:

(i) Regulatory Institutions should be truly autonomous. For example, independence of SBP from the Federal Ministry of Finance has happened only recently. There is need to insulate the agencies from political influence or to be captured by special interests.

(ii) Appointments of members of the Boards should not be by Ministries but by a confirmation process in a Select Committee of the Senate of Pakistan.

(iii) There is some ambiguity in the role of the Ombudsman's Office and Regulatory agencies. This should be clarified and roles clearly defined.

(iv) Annual Reports of all Federal Regulatory agencies must be presented in the CCI, which in turn presents a report to the Parliament. CCI meetings must be regularly held on a quarterly basis.

(v) All Boards of Federal Regulatory Agencies must have representation from each Province.

(vi) There is need for technical capacity building, especially of the specialized agencies.

(vii) The performance of Provincial regulatory functions needs to be substantially improved, especially in the area of environment protection.

Finally, it must be remembered that from the viewpoint of inclusive and sustainable growth, regulatory authorities have a critical role to play.

Chapter 45:

THE ROLE OF LOCAL GOVERNMENTS

The purpose of this Chapter is first is to describe the key features of the Local Government in Pakistan and undertake a comparison of the institutional structure, functions and fiscal powers in the four Sections of the Chapter. Section 1 describes the history of local government in Pakistan. Section 2 outlines the features the contemporary four local governments and Section 3 the functions of these governments. An assessment of the degree of autonomy of the new Local Governments is undertaken in Section 4.

45.1. HISTORY OF LOCAL GOVERNMENT

The Local Government Ordinance (LGO) of 1979 entrusted both compulsory and optional functions to local governments. These functions were, more or less, common to all four provinces and were divided into two broad categories. Some functions were regulatory in nature while the others related to the provision and delivery of services. There was also a distinction between functions of rural and urban councils. The former performed civil, welfare and development functions while the latter performed compulsory functions such as provision and maintenance of roads, bridges, public buildings, water supply, maintenance and management of hospitals, maintenance and construction of school buildings among others. The local bodies that performed service functions were town committees, municipal committees, municipal corporations and metropolitan corporations in urban areas and district councils and union councils (UCs) in rural areas of Pakistan.

The Devolution Plan of 2001 overwhelmingly altered the local government in Pakistan. Functions were decentralized to the local level on the basis of 'subsidiarity'. The principle of subsidiarity states that "a central authority should recognize subsidiary functions and perform only those tasks which cannot be delivered effectively at a more immediate or local level". In other words, any activity that can be performed by a more decentralized entity should be given to that entity if there is a cost saving and efficiency improvement. In this way, the local authorities will have the authority (administrative, political and fiscal) and responsibility to address all problems that are, in their jurisdiction. However, efficiency improvement does not merely require delegation of authority but also increased capacity of lower level institutions to effectively exercise this authority.

The structure of local government in Devolution Plan had three tiers – district government tehsil municipal administration and union council. The functions handed over to each tier are shown in Chart 45.1.

Chart 45.1: Selected Responsibilities of Districts, Tehsils and Union Councils

District	Tehsil	Union Councils
Primary and Secondary Education, Literacy	X	X
Dispensaries and Local Hospitals, Preventive Care, Enforcement of the Drugs and Food and Sanitation Acts	X	X
District Roads	Local Roads and Streets	Local Streets
X	Water Supply System, Water Treatment	Wells and Ponds
X	Sewers and Sanitation	X
X	Fire Services	X

Source: USAID (2006)

The Devolution Plan also provided for representation of relatively disenfranchised segments of the population. Quotas were specified for women, minorities, peasants and workers. Further, the Plan promoted the formation of Citizen Community Board (CCBs) to not only enhance participation at the local level but also to strengthen capacity of people to identify and implement their own development priorities. Grants were given to the CCBs by the District Governments.

Provincial Finance Commissions (PFC) were constituted to determine, first, the vertical share of local governments in provincial resources; second, the horizontal sharing formula among local governments. By 2006-07, almost 38 percent of provincial resources were transferred. The share ranged from 30 percent in Balochistan to 40 percent in Punjab.

The Devolution Plan and its implementation from 2001 to 2007 can be considered as the 'golden age' of local governments in Pakistan. Not only was the process of fiscal decentralization deep and meaningful, but also the outcomes were truly exceptional. The education and health outcomes showed extraordinary improvement, which has not been possible after 2007-08.

Based on the success achieved in the Devolution Plan, the 18th Amendment for the first time recognized local government as a legitimate tier of government. Article 140A was inserted, which states:

> *'Each Province shall, by law, establish a local government system and devolve political, administrative and financial responsibility and authority to the elected representatives of the local governments'.*

Article 140A should have motivated the Provincial Governments to proceed quickly with enactment of appropriate laws, followed by local elections and establishment of these governments. However, during the tenure of democracy, the opposite tends to happen. Provincial Governments are more empowered and there is a reluctance to decentralize further down to the local level. Consequently, despite Article 140A, the Provincial Governments delayed the formation of local governments. The Supreme Court had to intervene and ensure that local government acts were passed in the Provincial Assemblies, followed by elections in the period, 2012 to 2015.

45.2. THE STRUCTURE OF LOCAL GOVERNMENTS

The relevant laws passed by the four Provincial Governments are as follows:

Provinces	Law
Punjab	1) Punjab Local Government Act, 2013 2) Punjab Local Government (Amendment) Ordinance, 2015
Sindh	1) Sindh Local Government Ordinance, 2013 2) Sindh Local Government (Third Amendment) Act, 2015
Khyber-Pakhtunkhwa	(i) Khyber-Pakhtunkhwa Local Government Act, 2012 (ii) Khyber Pakhtunkhwa Local Government Act, 2013
Balochistan	1) Balochistan Local Government Act, 2010

The first Provincial Government to pass the new Local Government Act was Balochistan in 2010. This was followed by the Khyber-Pakhtunkhwa Government in 2012. However, after the induction into power of the PTI Government in 2013, a new version of the Act was passed. Punjab and Sindh Promulgated the Local Government law in 2013. Amendments were legislated in 2015.

Study of the four laws reveals major differences in the institutional structure of local government among the Provinces as follows:

(i) Three Provinces, viz, Sindh, Balochistan and Punjab, have essentially reverted to the local government structure in the LGO of 1979. This provides for separate local governments in the urban and rural areas of a district. In the former there are metropolitan/municipal corporations/municipal or town committees, depending upon the population size of an urban jurisdiction. Rural areas have District Councils. The lowest tier is of Union Councils.

(ii) Punjab has a unique structure which provides for the role of specialized agencies. Each district is the have a District Education Authority and a District Health Authority, which are essentially under jurisdiction of the relevant Provincial Government Line Department. A *Saaf Pani* Company has also been established to set up and manage water supply systems in different parts of the Province.

(iii) Khyber-Pakhtunkhwa is the only Province which has essentially replicated the 2001 Devolution Plan. District governments operate in this Province.

45.3. FUNCTIONS OF LOCAL GOVERNMENTS

The Local Government Acts also reveal a significant variation among the Provinces in functions to be performed at the local level, as shown in Chart 45.2. Basic municipal functions have been made the responsibility of local governments throughout the country. These include water supply, public health, sanitation and maintenance of streets.

The variation is primarily in the allocation of health and education services. Local governments in Punjab have no role to play in these functions, which will be performed by specialized District Authorities. At the other extreme, local governments in Balochistan and district governments in Khyber-Pakhtunkhwa have also been allocated these functions. Overall, local governments will perform fewer functions then those discharged under the Devolution Plan of 2001.

Chart 45.2: Functions of Local Governments

	Urban			Rural			District K-PK
	S	P	B	S	P	B	
Streets	✓	✓	✓	✓	✓	✓	✓
Public Safety	✓	✓	✓	X	X	✓	X
Public Health	✓	✓	✓	✓	✓	✓	✓
Sanitation	✓	✓		✓	✓	✓	✓
Water Supply & Drainage	✓	✓	✓	✓	✓	✓	✓
Primary Education	✓	X	✓	X	X	✓	✓
Secondary Education	X	X	✓	X	X	✓	✓
Hospitals and Clinics	✓	X	X	✓	X	X	✓
Town Planning & Building Control	X	✓	✓	✓	X	✓	✓
Public Transport	X	X	X	X	X	X	✓

Note: [S] Sindh; [P] Punjab [B] Balochistan [KPK] Khyber-Pakhtunkhwa
Source: Local Government Acts.

45.4. FISCAL POWERS

The range of fiscal powers of urban and rural local governments is given in Chart 46.3, for the different Provinces. More powers have been given generally to urban local councils and to district governments in Khyber-Pakhtunkhwa. Fiscal powers are, more or less, the same as provided for in the Devolution Plan of 2001.

Chart 45.3: Fiscal Powers of Local Governments

Revenue Source	Urban			Rural			District
	S	P	B	S	P	B	K-PK
Urban Immoveable Property Tax	✓	✓	✓	X	X	X	✓
Tax on Transfers of Property	✓	✓	✓	✓	✓	✓	✓
Water, Drainage & Conservancy Rates	X	✓	✓	✓	✓	✓	✓
Tax on Professions and Callings	✓	✓	✓	X	X	X	X
Fee on Slaughter/Sale of Animals	✓	✓	✓	X	X	X	✓
Market Fees	✓	✓	✓	X	X	X	✓
Parking Fees	✓	✓	✓	X	X	X	✓
Tax on Cinemas and Shows	X	X	✓	X	✓	✓	✓
Fee for Registration of Deaths, Births, Marriages	✓	✓	✓	✓	✓	✓	✓
Local Rate on Agricultural Land	X	X	X	X	✓	X	✓
Tax Fee for Education and Health	X	X	X	X	X	X	✓

Note: [S] Sindh; [P] Punjab [B] Balochistan [KPK] Khyber-Pakhtunkhwa
Source: Local Government Acts.

Audit of local governments is to be carried out through the Local Government Commission. Also, the role of the Provincial Finance Commissions is to give awards periodically on transfers to local governments. Ideally, there should be no element of discretion and the sharing should be formula-based, both vertically and horizontally.

There is a problem with the composition of the PFC especially in Punjab. The overwhelming majority consists of Provincial Assembly members. As such, local interests may not be adequately represented. There is a need for greater local representation in the PFCs.

Overall, it is unfortunate that despite the formal recognition by the Constitution in the 18th Amendment of local governments as a legitimate third tier of Government, the Provincial Governments, with the exception of Khyber-Pakhtunkhwa, have shown a reluctance to grant adequate autonomy, functions, financial transfers and fiscal powers to local governments in their respective Acts. Consequently, the local government system that has emerged is a truncated version of the Devolution Plan of 2001 and more a replication of local governments in the 1979 law. The Supreme Court may wish to review the implementation of Article 140A.

The recent assumption of power by the Pakistan Tehreek-e-Insaf at the Federal level and in Khyber Pakhtunkhwa and Punjab has brightened the prospects for the formation of a local government system in Punjab which faithfully implements Article 140A of the Constitution. At this stage the policy that will be followed by the new Provincial Governments of Sindh and Balochistan is unclear.

SECTION 16

THE REFORM AGENDA

Chapter 46:

THE GROWTH–INEQUALITY–POVERTY NEXUS

The objective of this chapter is to bring together into a framework the findings in the previous chapters on the relationships between growth, inequality and poverty. This will motivate the agenda of reforms presented in the next chapter.

Section 1 presents the conclusions of earlier research by a number of authors on, first, the relationship between growth and inequality and, second, between inequality and poverty. Section 2 examines the experience of a sample of countries in achieving reduction in the incidence of poverty.

Section 3 proceeds to study the relationships from 2001 to 2015 in the Pakistani context from the information contained in the Household Integrated Economic Surveys (HIES) carried out periodically by the PBS. Section 4 then identifies the key underlying variables which explain the differences in the relationship among growth, inequality and poverty in different time periods in the Pakistani setting.

46.1. REVIEW OF LITERATURE

The relationship between growth and inequality has been extensively studied in the economic literature. The first major conclusion was in the form of the Cambridge Savings Equation. Kaldor (1957) and Kuznets (1955) stated that inequality leads to higher growth because the rich save proportionately than the poor and their marginal rates of saving from incremental income are higher.

However, Benhabib and Rustichini (1996) and Acemoglu and Robinson (2000) have argued that inequality hurts growth because it leads to redistributive pressures, either through the median voter who enacts redistributive taxes or through generating social conflict, expropriation and rent seeking behavior.

The recent experience of Pakistan supports this view. The profits and capital gains accruing on assets of the rich have partly been repatriated abroad through money laundering and illicit transactions. This has reduced the level of private investment in Pakistan and thereby affected growth.

Golar and Zeira (1993) and Banerjee and Newman (1993) have put forward another reason why greater inequality could lead to less growth. State capture of bank credit, public services and land preclude the talented poor from undertaking investments in physical and human capital, thereby limiting the full potential for growth of the economy. This privileged access of the rich and powerful versus the relatively poor is highlighted in the Pakistani context in Chapter 34.

The other issue is that of the tradeoff between absolute measures of poverty and relative inequality. Ravallion (2005) has asserted that falling inequality comes with falling poverty. However, there does exist the possibility that any decline in the share in national income of the top quintile may accrue primarily to the 'middle class' in the second and third quintiles and there is little transfer of income to the bottom two quintiles.

Overall, the different types of relationship between growth, inequality and poverty are depicted in Chart 46.1. They are potentially eight types of outcomes. Six outcomes are feasible and two appear to be infeasible. These are, first, high growth with decreasing inequality should not be associated with an increase in poverty. Second, low growth and increasing inequality cannot be accompanied by falling poverty.

Chart 46.1: The Different Types of Relationships between Growth, Inequality and Poverty

Type	Growth	Inequality	Poverty
I	High	Increase	Decrease [F][a]
II	High	Increase	Increase [F][a]
III	High	Decrease	Decrease [F][a]
IV	High	Decrease	Increase [NF][b]
V	Low	Increase	Decrease [NF][b]
VI	Low	Increase	Increase [F][a]
VII	Low	Decrease	Decrease [F][a]
VIII	Low	Decrease	Increase [F][a]

[a]F = Feasible | [b]NF = Not Feasible

The classic 'trickle down' case is Type I. Here there is fast growth and rising inequality. However, some benefit accrues to the lower income groups leading to a modicum of poverty allocation. It is, of course, true that if there is no filtering down then Type II applies in this case.

The 'inclusive' growth nexus is observed in Types III and VII. Here, irrespective of the rate of growth, the fall in inequality enables a decline in the incidence of poverty. Clearly, the 'ideal' scenario is Type III where a high rate of growth and appreciable fall in inequality enable a big reduction in poverty.

46.2. COUNTRY EXPERIENCE

The typology of a number of countries in terms of the growth – inequality – poverty nexus since 2000 is presented in Chart 46.2. There are a number of interesting cases as described below:

Chart 46.2: Typology of Countries

Countries	Trend in: Growth Rate of Per Capita Income[a]	Trend in: Level of Inequality	Trend in: Incidence of Poverty[b]	Poverty – Growth Elasticity
Bangladesh	Moderate	Slow Decrease	Slow Decrease	-0.454
China	Fast	Fast Increase	Fast Decrease	-1.831
India	Fast	Slow Increase	Slow Decrease	-0.487
Indonesia	Moderate	Decrease	Fast Decrease	-1.654
Nepal	Slow	Fast Decrease	Fast Decrease	-1.837
Pakistan	Slow	Slow Increase then Decrease	Fast Decrease	-2.476
South Africa	Slow	Fast Increase	Slow Decrease	-1.174
Sri Lanka	Fast	Slow Decrease then Increase	Fast Decrease	-1.781
Vietnam	Fast	Fast Decrease	Fast Decrease	-3.024

[a]fast : > 5%; Moderate: 3½ - 5%; Low < 3½ | [b]fast decrease; more than 5%; slow decrease; less than 5%

Source: World Bank, WDI

(i) China is the classic case of a strong 'trickle down' effect. The economy achieved very high growth rate in per capita income of almost 9 percent per annum for a long period. Inequality increased sharply and there are estimates that the Gini coefficient currently stands at over 0.5. Nevertheless, the incidence of poverty has fallen sharply and is now down to only 7 percent. However, the Chinese experience is not easily replicable because of the extraordinarily high growth rate achieved. The only country in the sample with a similar record is Vietnam.

(ii) In contrast with China, India despite also being a high growth performer and with a slow increase in inequality, has a very low poverty-growth elasticity of 0.49 in absolute terms. It is likely in the Indian case that the middle class has pre-empted a larger share of the increased income.

(iii) Two countries which have shown relatively high poverty-growth elasticities in absolute terms are Nepal and Pakistan. The former country saw relatively slow growth but inequality declined sharply especially after the Maoist takeover. Pakistan has a high poverty-growth elasticity with an absolute magnitude of 2.5. Despite relatively slow growth, the rate of decline in poverty has been over 5 percent per annum. This raises issues about possible biases in the measurement of poverty in Pakistan, as highlighted earlier in Chapter 40.

46.3. THE PAKISTAN CASE

The trend in inequality and poverty in Pakistan has been extracted from the various HIES since 2001-02. The analysis has been conducted for two periods. The first is from 2001-02 to 2007-08 when the Military Government of General Musharraf was in place. The second period is from 2007-08 to 2015-16 during the tenure of two democratically elected Governments of the PPP and PML (N) respectively.

The shares in income by quintile are presented in Table 46.1. The evolution of the ratio of the income share of the top 20 percent versus the bottom 40 percent has been computed to determine the trend in inequality. Bulk of the population in the bottom two quintiles is poor.

Table 46.1: Share of Income by Class in Pakistan

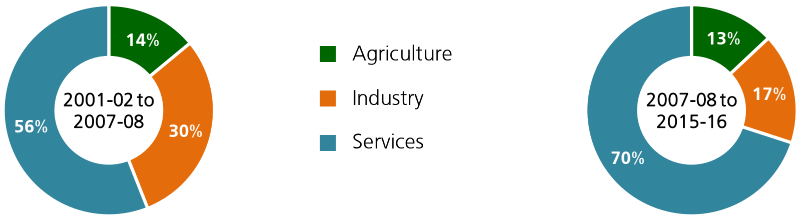
	Bottom - 40% (the Poor)	Middle - 40% (the Middle Class)	Top - 20% (the Rich)	Measure of Inequality[a] (%)	Total (%)
2001-02	22.32	35.96	41.72	1.87	100.00
2007-08	19.12	34.12	46.77	2.45	100.00
2015-16	20.35	35.46	44.19	2.17	100.00

[a]Ratio between income share of 20% and bottom 40% of population.
Source: PBS | HIES

The Table clearly reveals that inequality increased sharply in the first period and then has fallen. As highlighted in Chapter 40, poverty declined in both periods.

The basic question is what explains the rise and fall in inequality in Pakistan? A number of factors are behind the changing trend in inequality. First, the sectoral pattern of the increase in GDP has been different as shown in Figure 46.1. The share of industry has declined from 30 percent to 17 percent. This is a major factor because large-scale manufacturing consists mostly of units in the formal sector. The profits from this sector largely accrue to the top 20 percent. Also, this sector is more skill-intensive and employs relatively educated workers.

Figure 46.1: Share of Sectors in the Increase in the Real GDP



Source: PES

The growth of profits in the corporate sector was, as expected very rapid in the first period at almost 29 percent per annum. It fell sharply to 11 percent in the second period. The market capitalization of shares in the Karachi Stock Market increased annually at an extraordinarily high rate of 41 percent in the Musharraf era, compared to only 8 percent thereafter. Clearly, growth in capital incomes has an important bearing on inequality.

There were also sharply contrasting trends in the labor market. The overall employment elasticity with respect to growth of GDP was very low at 0.35 in the first period. It rose sharply in the second period to 0.77. Consequently, even with a substantially lower GDP growth rate the second period saw faster growth in employment.

The demand for different types of workers with varying levels of education also changed in a big way. This is demonstrated by the change in unemployment rates of workers with different levels of education, as shown in Table 46.2.

Table 46.2: Unemployment Rate by Level of Education – (%)

	2001-02	2007-08	2014-15
Illiterate	7.63	4.93	3.19
Pre-Matric	8.51	4.86	5.14
Intermediate	10.05	6.98	11.27
Degree, Post Graduate	8.67	4.85	17.62

Source: PBS | HIES

During the first period, there was a decline in the unemployment rate for all workers. However, in the second period there has been a big jump from less than 5 percent to almost 18 percent in the case of highly educated workers with degree or post-graduate qualification. As opposed to this, there was some decline in the unemployment rate of illiterate workers, who constitute almost one third of the labor force.

Another important factor contributing to poverty reduction in the period, 2007-08 to 2015-16, despite low growth, was the greatly expanded program of social protection. This demonstrates the fact that the voice of the poor is heard more in periods of democracy of because they still have a voice.

The largest social safety net of Pakistan, the BISP, was the started by the PPP in 2009-10. It now covers 5.8 million families, almost half the number of poor households in Pakistan. There are now many other programs, described in detail in Chapter 41. During the tenure of the Military Government the total outlay on social protection was 0.8 percent of the GDP. It has since more than doubled to almost 1.8 percent of the GDP.

The conclusions from the above findings provide insights into the reform agenda for achieving inclusive growth in Pakistan. The path chosen has to combine at least moderate growth (up to 5 percent per annum) with reduction in inequality and a, more or less, rapid rate of reduction in the incidence of poverty. The areas to focus include the development of labor-intensive sectors, progressive taxation especially of capital incomes to finance faster human development and an expanded program of social protection.

46.4. DETERMINANTS OF INEQUALITY

The final stage of the research on income equality is econometric analysis of changes in the level of income equality in the Pakistan context on the basis of data from 1990-91 to 2013-14. The ratio of income share of the top quintile to the share of the bottom quintile is used as the measure of inequality. The Gini coefficient is not used as it is a slow measure of changes in inequality.

The explanatory variables used are the real GDP growth rate, growth rate of employment in the informal sector of the economy, growth rate of real corporate profits and growth rate of real tax revenues. The informal sector includes construction, wholesale and retail trade, transport, economic and social services. The indicator of corporate profits is the total profit of private companies quoted in the Pakistan Stock Exchange.

The estimated elasticity of the measure of inequality with respect to the above determinants is given in Chart 46.3.

Chart 46.3: Elasticity of the Measure of Inequality with respect to the Determinants

	Elasticity*	t-ratio
Growth Rate of Real Corporate Profits	0.223	2.19
Growth Rate of Real GDP	1.485	2.50
Growth Rate of Employment in the Informal Sector	-1.667	-2.16
Growth Rate of Real Income Tax Revenues	-0.452	-1.70
$\bar{R}^2 = 0.928$		

*short-run elasticity

The results are very revealing. The highest elasticity in absolute terms is with respect to growth of employment in the informal sector. This is not surprising that as compared to the formal sector the employment in the informal sector has a higher share of unskilled and semi-skilled workers. The relationship between inequality and growth of the economy is positive in the Pakistani context. As expected, faster growth of corporate profits leads to more inequality while more rapid growth of real income tax revenues reduces inequality.

The above results are used to forecast the change of inequality between 2013-14 to 2017-18. The magnitude of the explanatory variables is as follows:

Cumulative growth from 2013-14 to 2017-18 – (%)	
GDP	21.3
Tax Revenues	49.9
Employment in Informal Sector	16.3
Corporate Profits	28.6

Based on the elasticities, the cumulative change in the index of inequality is minus 11.7 percent. This implies that the ratio of share of income of the top 20 percent to the share of the bottom 20 percent has fallen from 5.39 in 2013-14 to 4.81 in 2017-18. As such, there appears to have been a significant reduction in inequality in the last four years.

Chapter 47:

PROSPECTS FOR THE ECONOMY

There is a dire need to visualize the state of the economy in the next few years in view of the high risks associated with the difficulties that Pakistan may face in honoring its external payment obligations and financing its imports in the not so distant future.

The Chapter is organized as follows: Section 1 presents the short- to medium-run scenario. Section 2 presents a somewhat more long-run perspective on Pakistan.

47.1. THE SHORT-TO MEDIUM-RUN SCENARIO

The initial conditions for 2018-19 can be captured by a ‘business as usual’ scenario, in which no major new policy measures are implemented. In this case, the current account deficit approaches $19 billion while the external debt repayment is above $11 billion for the year. Therefore, the external financing requirement is $30 billion, approaching the extremely high level of 9 percent of the GDP. The probability is extremely high that such a large inflow of FDI and external loans will not take place in 2018-19.

The more realistic scenario is one in which Pakistan opts for an IMF Program supplemented by support from friendly countries. Therefore, for achieving sustainability, the reduction in current account deficit that will be required in 2018-19 is about one third of the level in 2017-18 of $19 billion. This implies that the deficit has to be close to $13 billion. Wide-ranging policy measures will need to be adopted to achieve a reduction of $6 billion in relation to the ‘business as usual’ scenario in 2018-19. The financing package required to meet the external financing requirement in 2018-19 will then be $23 billion.

The extension is to project the medium-run scenario up to 2020-21. The strength of the policy package in each year is identified and simulations undertaken with the Macro Econometric Model described in Technical Appendix 2 to determine the external financing requirements in 2019-20 and 2020-21 and whether these can be financed.

Table 47.1 gives the magnitude of the key policy variables in the medium-run scenario. In the case of public investment, the policy instrument is fixing the size of the national Public Sector Development Program (PSDP). The level of public consumption can be managed through the current budgets of the Federal and Provincial Governments by determining the annual rate of increase in salaries, allowances and pensions, fixing the level of Federal grants, subsidies and expenditure on defence services.

Table 47.1: Magnitude of Policy Variables*, 2018-19 to 2020-21

	2018-19	2019-20	2020-21
ANNUAL RATES OF CHANGE *(at Constant Prices) (%)*			
Public Investment (PSDP)	-25	0	10
Public Consumption (Current Expenditure)	-3	-2	0
LEVEL			
Interest Rate (%)	12	12	12
Additional Taxation (*Rs in Billion at Constant Prices of 2017-18)*	300	200	150
RATE OF CHANGE (%)			
Nominal Exchange Rate	-40	-20	-10
Money Supply	9	10	12

* The external environment variables are projected with the following growth rates annually over the period, 2018-19 to 2020-21:

World Trade: 3%	Unit Value Index of Exports / Imports in $: 0%	Home Remittances: 8%

The quantum of additional revenues can be generated through taxation reforms, many of which have been identified in the earlier Chapter 26 on Tax Reforms. The interest rate corresponds to the policy rate which is set by the Monetary Policy Committee of the SBP. Similarly, changes in the exchange rate are managed by the SBP. Also, the rate of change in money supply can be influenced by the SBP by the extent to which the Government can borrow from it in the presence of some decline in Net Foreign Assets.

The results of simulation of the Model, over the three years 2018-19 to 2020-21 are given in Table 47.2.

Table 47.2: Projected Macro Economic Variables, 2018-19 to 2020-21

	2018-19	2019-20	2020-21
GROWTH RATE (%)			
GDP	3.8	4.2	5.0
Private Investment	-5.5	2.0	5.8
Private Consumption	3.5	4.1	4.6
Exports	10.0	8.0	9.0
Imports	-5.0	0.0	2.0
Consumer Price Index (end of period)	12.1	9.1	6.4
Consumer Price Index (average)	8.0	6.0	5.0
LEVEL			
Current Account Deficit (*$ billions*)	12.0	9.0	7.2
Fiscal Deficit (*% of GDP)*	5.8	5.5	5.0
ABSOLUTE CHANGE			
Increase in Employment (*million)*	0.9	1.2	1.6
Increase in Incidence of Poverty (*% points*)	3.1	1.8	-1.2

The trade and current account deficits are projected in Table 47.3. The current account is reduced by one third in 2018-19 as targeted. It falls to $9 billion in 2019-20 and is projected to fall further to $6 billion in 2020-21.

Table 47.3: Projected Trade and Current Account Deficit, 2018-19 to 2020-21 – ($ billions)

	2017-18	2018-19	2019-20	2020-21
Exports	24.8	27.2	29.4	32.0
Imports	56.8	54.0	54.0	55.0
Trade Deficit	-32.0	-26.8	-24.6	-23.0
Current Account Deficit	-19.0	-12.0	-9.0	-6.0

The GDP growth rate is expected to fall sharply from 5.8 percent in 2017-18 to 3.8 percent in 2018-19 due to the very contractionary stance of policies. There is some recovery in 2019-20 to 4.2 percent. Finally, in 2020-21 the economy is expected to get back to the trajectory of a relatively high growth rate of 5 percent and above in subsequent years. As expected, private investment in real terms is expected to fall by almost 6 percent in 2018-19, given the spike in interest rates and heightened risk perceptions. There is some recovery in later years as the economy stabilizes.

The inflation rate is expected to rise substantially in 2018-19 to a double-digit rate of 12 percent from the very low rate 4 percent in 2017-18. This is primarily due to the large devaluation in 2018-19. Gradually, the inflation rate is projected to come down to 6.4 percent by 2019-20.

The significant outback in the size of the national PSDP of 25 percent coupled with economy in current expenditure and incremental fiscal effort are expected to stabilize the public finances. Consequently, the projected fiscal deficit is down to 5.8 percent of the GDP in 2018-19 as compared to 6.6 percent of the GDP in 2017-18. Thereafter, it continues to decline at a modest rate to 5 percent of the GDP by 2020-21.

The areas of major concern are what is likely to happen to the unemployment rate and to the incidence of poverty in the effort to stabilize the economy and to take it back to a path of sustainable growth. The projected unemployment rate is derived in Table 47.4. There is an increase likely in the number of workers unemployed of as much as 0.9 million in 2018-19 and another 1.2 million after 2018-19 up to 2020-21. Consequently, the unemployment rate may jump up from 6.3 percent in 2017-18 to 7.2 percent in 2018-19 and to 8.3 percent by 2020-21.

A similar depressing projection is likely in the case of the incidence of poverty. The incidence of poverty is expected to rise by 3.2 percentage points in 2018-19. In other words, the number of people below the poverty line could increase by over 6 million. Thereafter, it rises by 0.6 percentage points by 2020-21.

Table 47.4: Projected Unemployment Rate, 2018-19 to 2020-21 – (million)				
	2017-18	2018-19	2019-20	2020-21
Labor Force	66.2	68.0	69.9	71.9
Employment	62.2	63.1	64.3	65.9
Unemployed	4.0	4.9	5.6	6.0
Unemployment Rate (%)	6.3	7.2	8.0	8.3

The external financing requirements over the three year period add up to $66 billion. The primary source of financing continues to be borrowing, both public and private. This will necessitate a relatively large size of the IMF program and higher level of support from countries like China, U.A.E and Saudi Arabia. The level of external debt is expected to rise from $96 billion in 2017-18 to $120 billion by 2020-21.

There is need to emphasize that the above scenario is fraught with a number of risks. In fact, uncertainty is expected to be at a peak in 2018-19. First, a new Government has been inducted into power in August 2018. Inevitably, it will take some time to assess the situation before it begins to implement its plan. Therefore, the process of adjustment will start only from the second quarter onwards. The initial position taken by the ruling party during the election campaign was that of self-reliance and ‘breaking of the begging bowl’, which is clearly beyond the realm of possibilities initially.

Second, with reserves at below the level of two months import cover, external lenders may be reluctant to extend borrowing facilities to Pakistan unless an IMF program is operative. The multilateral development agencies like the World Bank and the Asian Development Bank have temporarily reduced the flow of funds. The big question mark relates to the willingness of international commercial banks to lend relatively large amounts of money to Pakistan. At the minimum, a risk premium is likely to be added to the interest rate on commercial loans. Also, there is uncertainty about the level of support forthcoming from friendly countries on a continuing basis. Further, there are political risks attached with the strong measures needed to take the economy back to the path of sustainability.

47.2. THE LONG-TERM SCENARIO

Pakistan today is the grips of an incipient financial crisis. The inherent contradiction is that the new Government of PTI has come on a wave of populism and given hope about their future particularly to the otherwise frustrated youth of the country. Among other promises, the new ruling party has promised 10 million jobs and construction of 5 million houses during its tenure of five years.

However, the economic conditions are hardly conducive for fulfillment of these promises. For example, the economic scenario up to 2020-21 presented earlier indicates that at the maximum 3.7 million jobs can be created over the next three years. The year, 2018-19, will witness a jump in the unemployment rate, with only 0.9 million jobs being created with over 1.7 million new workers, especially male youth, entering the labor force.

The large gap between expectations, especially of youth, and the prevailing ground realities could create an '*Arab Spring*' like situation in Pakistan. People, particularly youth, could start street agitation against the worsening economic situation in the country and lack of fulfillment of promises made to them during the election campaign by the charismatic leader of the PTI, Imran Khan.

Therefore, there is a real danger of economic and social breakdown. But if it is avoided then the future could be brighter. The present Government is giving the highest priority to austerity, accountability and overall improved governance. If significant progress is achieved in these areas and critical constraints, like water and power, are removed along with investments in human development then the long-run prospects could be much better. An overall assessment of the probability of different critical elements of the economy being achieved in the foreseeable future in presented in Chart 47.1.

Chart 47.1: Analysis of Probability of Critical Elements of the Economy

	Probability
NON-ECONOMIC FACTORS	
• Continuation of the substantial end to Acts of Terrorism	High
• Continuation of the Improvement in the Law and Order Situation in Karachi	Medium / High
• Process of Resolution of the Insurgency Problem in Balochistan	Low/Medium
• End of Sectarian Violence and Ethnic Polarization	Low/Medium
• Move towards Restoration of Peace in Afghanistan	Medium
MACRO ECONOMIC STABILIZATION	
• Move to a new Program with IMF for Balance of Payments Support in 2018 or early 2019	High/Medium
• Overvaluation of exchange rate removed and higher interest rates	High
• Reduction in the Current Account Deficit as % of GDP from 5.8% to 2.5% of the GDP by 2020-21	Medium
• Rise in the tax-to-GDP ratio to 15% of the GDP by 2020-21	Medium
• Reduction in Current Expenditure by 1% of the GDP by 2020-21	Low/Medium
• Reduction in the Fiscal Deficit from 6.6% of the GDP in 2017-18 to 5% of the GDP by 2019-20	Low/Medium
• Reserves reach level necessary to provide import cover of three months by end 2020-21	Medium/High
• Reduction in circular debt of the power sector and losses of PSEs	Low
GROWTH	
• Investment level rises to 18% of the GDP due to CPEC, Water and Power Sector Investments by 2020-21	Medium/Low
• The Industrial Sector revives due to virtual elimination of loadshedding, more export incentives and protection to domestic industry	Medium
• Agricultural sector shows higher growth due to more efficient utilization of water, lower input prices and expanded access to credit	Medium/Low
• Water resources position improves substantially by 2025 due to improvement of the irrigation system, better management of ground water sources, investment in reservoirs and dams	Low/Medium
ECOLOGY	
• Major initiatives on Climate Change and Implementation of Environmental Policies	Medium
SOCIAL DEVELOPMENT	
• Have the number of out-of-school children by 2020-21	Medium/Low
• Achieve gender equality in school enrolments	Medium/High
• Reduction in child under nutrition by one third in 2020-21	Low/Medium

Chapter 48:

THE REFORM AGENDA

The results of the analysis and principal findings in the chapters of the book have led to the identification of a comprehensive reform agenda, both short-term and medium-term. The focus is first on reviving the real sectors of the economy. This is followed by a set of policies and actions required to stabilize the balance of payments and the public finances of the country. The reform agenda then identifies the root causes of inequality and suggests ways by which these can be tackled. The final part of the agenda highlights fundamental improvements in governance required to support the process of high and inclusive growth in the country on a sustained basis.

The policies required for revival of the economy are identified below:

48.1. REVIVING THE ECONOMY

48.1.1. Agriculture

The top most priority has to be to ensure enough water for agriculture. The emphasis has to be simultaneously on improving water utilization efficiency and on greater exploitation of water resources. The former will require a big enhancement of the water rate ('abiana') to ensure full recovery of the O&M cost of the irrigation system and to facilitate an eventual move towards metering. In addition, the Provincial Governments will need to implement a greatly expanded program of lining of canals to reduce water losses. Currently, the Government of Punjab, for example, devotes only 8 percent of its ADP to irrigation. This will have to be raised to at least 20 percent.

Appropriate pricing policies will have to be adopted to change cropping patterns away from water-intensive crops like sugarcane towards crops like cotton. Priority will have to be given to promoting use of drip irrigation, with appropriate fiscal incentives and agricultural extension services.

The Prime Minister and the Chief Justice of the Supreme Court of Pakistan have strongly emphasized on the need for construction of dams like Diamer-Basha and Mohmand. There is also the need to resolve the issues related to the construction of the very cost effective Kalabagh Dam.

The terms of trade (ratio of output to input prices) of agriculture must not be allowed to deteriorate. This will require the restoration of minimum support prices, in particular, of cotton and the withdrawal of this support from sugarcane. Also, the price of fertilizer must be kept unchanged of its level in 2017 even if this necessitates a higher subsidy.

The credit availability for agricultural purposes must be enhanced, especially for small farmers. Currently, the share in total advances is 7 percent. It needs to be enhanced to at least 10 percent. A tax credit may be offered to banks for the annual increase in advances to the agricultural sector.

48.1.2. Manufacturing

During the last five years, the average rate of effective protection to domestic import substituting industries has been halved due to the cascading down of import tariffs, with the maximum tariff down from 35 percent to 20 percent. There is strong case for raising the maximum tariff to 25 percent. In addition, the Regional Free Trade Agreement (FTA) with China has displaced many industries, especially in the engineering goods sector. This is due not only to virtual elimination of import tariffs as part of the FTA, but also by the under invoicing of imports by China. There is a case for setting minimum import prices on some major imports from China and re-negotiating the FTA with more quid pro quo for Pakistan's exports to China.

The loss of export competitiveness of manufacturing sector of Pakistan has to be restored by maintaining the exchange rate at its true value and not allowing it to appreciate. In addition, since domestic electricity and gas tariffs are above world prices the difference may be reflected in the duty drawback regime.

The industrial sector of Pakistan faces a disproportionate tax burden in relation to other sectors. 74 percent of the tax burden falls on the sector with a share of only 20 percent in national value added. As first steps, a tax deductibility provision must be introduced in the corporate income tax for payments of WWF/WPPF. Second, the minimum income tax on turnover should be withdrawn. As the tax-to-GDP ratio rises, the standard sales tax rate should be brought back to 15 percent from 17 percent.

There is need to provide strong fiscal incentives for revival of investment in industry. As such, the accelerated depreciation allowance on machinery should be raised to 50 percent from 25 percent currently. Also, the tax credit on balancing, modernization or replacement (BMR) should be doubled.

48.2. PROMOTING INVESTMENT

48.2.1. Private Investment

The setting up a new entity requires ease of establishing and doing a business. Pakistan fares very poorly in the international ranking of Ease of Doing Business. It stands at 136 out of 190 countries with a significant improvement of 11 places in 2018.

Bank credit has been relatively scarce for small farmers, SMEs and for persons seeking housing mortgages. There is a perception of higher risk of lending in these areas. As such, the provision in the Seventh Schedule of the Income Tax Ordinance for write off by banks against bad debt should be amended. It should now be available only to the above three types of loans and increased to 5 percent.

There is need to reiterate once again the fiscal incentives that are needed for promoting investment. As highlighted above, the initial depreciation allowance and the tax credit for BMR should both be doubled. Third, as a step towards simplification and uniform treatment, a standard import tariff of 5 percent only may be charged on plant and machinery and most of the existing SROs on machinery withdrawn.

Special tax holidays need to be put in place for investment in SEZs that are part of CPEC. If a SEZ is located in a designated backward area than the tax holiday may be extended for a period of ten years. Alternatively, SEZs in close proximity to major urban areas may be given this facility for five years.

48.2.2. Public Development Spending

The lack of adequate implementation capacity is a serious issue. This is due primarily to too large a portfolio of projects in both the Federal and Provincial PSDPs. The emphasis must be on timely implementation of on-going projects for realizing on time the development impact and for avoiding cost overruns. New Federal projects should only be undertaken if they are in priority sectors like Water, Power and CPEC.

Top priority has to be given to early completion of transmission and distribution projects to enable fully the utilization of new power generation projects. However, almost 84 percent of the on-going projects are currently to be self-financed by PEPCO and WAPDA and only 16 percent with funds from the federal PSDP. This has led to big implementation delays. Bulk of the transmission and distribution projects must be brought into the Federal PSDP. This can be achieved by reducing the largest allocation currently to the National Highway Authority, except for CPEC projects. Also, the focus of the Federal PSDP should be on trunk infrastructure and small intra-provincial projects should be avoided. Further, there should be equal sharing by Provincial Governments in allocations for sectors of joint responsibility like higher education and population planning and health.

An examination of CPEC projects in the Federal PSDP reveals that in a number of cases no Chinese financing has been arranged yet or that the Chinese share in project cost is small. Efforts must be made to secure virtually full Chinese concessional financing for all CPEC infrastructure projects. Special Federal Programs which either represent forms of pork-barreling or the provision of services essentially in the Provincial domain must be avoided. Stronger monitoring and accountability arrangements must be put in place to avoid leakages and wastage. There is a strong case for moving to e-procurement to the extent possible. Efforts must be made to expand the portfolio of projects through innovative arrangements like Build, Operate and Transfer (BOT) and Public-Private Partnerships (PPP).

48.2.3. Privatization Program

The biggest gains from privatization hinge crucially on the presence of autonomous, effective and alert regulatory agencies, free from any political influence and with quasi-judicial powers. In the absence of such regulation, the larger public interest may not be protected. For example, post-privatization commercial banks have raised the margin between the rate of return on advances and deposits. Agriculture, housing and SMEs have been neglected due to higher transactions cost and somewhat higher risk. The performance has instead been on investing in risk-free, high return government paper. The SBP has largely failed in regulating the banks.

A number of criteria should be used to evaluate a candidate unit for privatization to a strategic investor. These criteria include whether the unit is profit or loss-making; whether there is an effective regulator in the sector to which the unit belongs; whether there are large or small liabilities; whether the unit is performing some social function; whether there is large over employment and whether there is strong political opposition and / or resistance from trade unions.

Application of the criteria indicates that the case for privatization is strong in the case of PASMIC, NSC, NIT, SME Bank, HEC and NPCC. As opposed to this, the case is weak in the case of PIA, SSGC, SNGPL, the DISCOs and NICL.

Privatization receipts should not be seen as non-tax receipts 'above the line' in the budget. Instead they should be reported as financing of the budget deficit 'below the line'. It is important that interests of employees are protected in the process of privatization. A proper severance package must be offered and in the case of sale of Government shares a portion may be allocated to employees, subject, of course, to payment of the reservation price.

48.3. GENERATING EMPLOYMENT

48.3.1. Employment Strategy

The development strategy should focus on sectors which have relatively labor-intensive and have high employment elasticity with respect to the growth of output. These sectors are construction, small-scale manufacturing, domestic trade and exports, transport and emerging private services.

The plight of highly educated workers in the labor market is visible, with unemployment at almost three times the national unemployment rate. This represents a tragic waste of human capital. A tax credit scheme may be established whereby companies can charge 10 percent of their wage bill on newly employed graduates for two years against their corporate income tax liability. A similar scheme may be offered for the hiring of female workers.

Also, there is need to restrict the expansion in the number of public colleges and universities in the country. The degree programs should focus more on areas where there is greater market demand. The emphasis must shift to secondary education and technical/vocational training.

The growing number of Idle youth to almost 6 million in the country has the makings of a problem of greater social disruption and rising crime. Various youth programs will need to be offered including training opportunities and access to microcredit. In the rural areas, employment guarantee programs of the type in India and a food for work program may also need to be established.

The Government's collects contributions from companies for the earmarked source of the Workers Welfare Fund. However, the receipts on this account have been taken into the Federal Consolidated Fund. This practice must stop. Henceforth, the receipts should be used for payment of higher pensions and for unemployment insurance to workers to the extent possible.

One of the consequences of the large 28 percent devaluation of the Rupee that has already taken place since December 2017 is that wages of Pakistani workers have fallen significantly in dollar terms. This is the appropriate time for Pakistani entrepreneurs to search for a place in the labor-intensive part of global value chains, especially in textiles. A special opportunity is for units in the SEZs, as part of the CPEC, to be oriented towards the Chinese market.

48.3.2. Labor Laws and Conventions

Pakistan has most of labor and human resource laws including those relating to abolition of bonded labor, child employment prevention, minimum wages, worker's welfare fund and prevention of sexual harassment in the work place. The basic problem is effective implementation of the existing laws. Abolition of bonded labor requires the setting of Vigilance Committees at the district level. A Magistrate is empowered to try summarily any offence related to bonded labor. But such arrangements seldom exist.

A cadre of Inspectors is to be appointed to check if any establishment has employed child workers. The Government must establish Labor Courts, with the function of adjudicating on industrial disputes. The Government must also create Labor Appellate Tribunals. However, few such Courts and Tribunals have been put in place. Further, the law also provides for establishment of a Minimum Wages Board at the Provincial level. There is need for periodic third-party field survey at the Provincial / district level if the various provisions of different labor laws have been honored.

A major step forward would be the enactment of law relating to gender equality in the workplace, especially for the elimination of discrimination in access to jobs and in payment of wages for the same job.

48.4. STABILIZING THE BALANCE OF PAYMENTS

48.4.1. Promoting Exports

One of the major constraints to export growth has been largely eliminated. Electricity generation capacity has already expanded by 7000 MW in the last five years, due to special efforts by the PML (N) Government. Clearly, highest priority should be given to ensure near zero power load-shedding in supply to export-oriented industries and to avoid any increase in the power or gas tariff paid by these industries.

The backbone of the textile sector is ample supply of domestically produced cotton of good quality at competitive prices. Pakistan had attained the peak production of cotton of 14 million bales in 2014-15. Since then there has been a fall in output of over 16 percent. The target must be get back to the output of at least 14 million bales as soon as possible. This will require a basic change in cropping patterns in the Kharif season away from sugarcane to cotton cultivation. This could be achieved by reintroducing a support price for cotton (*phutti*), as was the case in the 90s. Simultaneously, the support price on sugarcane may no longer be given. Also, there is a strong case for providing a subsidy to pesticides.

A serious mistake was made from 2014 to 2017 in allowing the real effective exchange rate of the rupee with respect to the US $ to rise to 124. Following depreciation of the currency during the last one year it has come down to 106. This has contributed to some recovery in exports. As a policy, at no stage should the REER be allowed to rise above 100, implying that the rupee is beginning to get overvalued.

Pakistan has introduced a cash export incentive scheme. This scheme needs to be developed in a number of ways. First, it should be paid by the commercial banks at the time of export receipts, with no pre-conditions of minimum growth in exports, etc. The commercial banks can then claim reimbursement from the SBP. Second, the higher cost of electricity and gas in Pakistan should be reflected in the duty drawback rates. This could add 2 to 3 percentage points to these rates.

Like Bangladesh, the export incentive scheme should also cover more items. Three categories of items may be identified - traditional, emerging and nascent - with the highest rate of incentive for the last category. This will help in diversification of the export base. The total number of items to be covered is 45, at the four-digit level of the HC.

The following sections focus on reduction in the current account and fiscal deficit:

48.4.2. Containing Imports

The trade deficit in goods and services has reached alarming proportions. In 2017-18 it was $36.4 billion, equivalent to almost 12 percent of the GDP. The steps that need to be taken to boost exports of goods have already been described above. The focus here is on containing the level of import of goods and on enhancing exports of services.

Empirical research has highlighted the low price elasticity of imports of Pakistan. This is a reflection of the nature of imports which include essential items like edible oil, tea, pulses, machinery, transport, iron and steel and POL products. Therefore, this feature of imports has to be kept in mind for designing the appropriate mechanisms for reduction.

In practice, the instruments available are rupee devaluation, higher import tariffs, regulatory duties and cash margins on imports. If Pakistan goes for an IMF Program then the primary mechanism will be a big depreciation in the value of the Rupee. For example, a 10 percent reduction in the level of imports will require devaluation of almost 40 percent and with the full impact accruing with a time lag.

Regulatory duties have already demonstrated their relative inability to control imports in a targeted manner due to under-invoicing and smuggling. There is need to try other instruments like cash margins of up to 30 percent on all imports with the exception of essential items like POL products, fertilizer and medicines.

Other somewhat unconventional instruments also need to be considered. The first is the setting of tariff quotas as an effective way of controlling the level of import. The MFN tariff will apply to a pre-specified fixed quantity of import, beyond which the import tariff could be doubled or trebled. This could apply to Pakistan's imports of edible oil, exotic foods, transport equipment, automobiles, mobile phones, electronic goods, iron and steel, etc. Many of these items are currently imported from China.

There is significant potential for development of export of services, especially IT services and tourism. As a special incentive the 1 percent presumptive income tax should not be levied on the export of services. Also, IT exports should also be included in the export incentive scheme and appropriate support services provided.

48.4.3. Fulfilling the External Financing Requirement

The balance of payments position has deteriorated to the point where default on external debt repayments is not an unlikely possibility. Already a number of international agencies like Bloomberg have included Pakistan in the list of 10 Countries most prone of default.

The external financing requirement in 2018-19 is projected at over $30 billion in the 'business as usual' scenario. This includes $19 billion of current account deficit and over $11 billion of external debt repayment. Normal flows in the financial account, including those from the multilaterals, bilateral, commercial borrowings, bond flotation and FDI, aggregated to $17 billion in 2017-18. Therefore, the net financing gap is $13 billion, which could be met by a drawdown of reserves. But net reserves with the SBP were down to $9.8 billion at the end of 2017-18. Therefore, in this scenario, major steps need to be taken. The PTI Government has mobilized strong support from friendly countries. However, this is in the nature of a short-term solution. Major steps will need to be taken to bring down the current account deficit by one-third in 2018-19 to note more than $13 billion.

The Government has opted for seeking balance of payments support from the IMF, the global lender of last resort, irrespective of the level of support from friendly countries. The Fund is likely to ask for a downward adjustment in the size of the current account deficit to $12 or $13 billion. This is likely to be largely predicated on a big devaluation of the Rupee of over 10 percent in relation to the rate of Rs 139 per $. This implies that the Rupee may have to be brought down to Rs 153 per $.

Following negotiations a number of major changes will also have to be in fiscal policy to bring down the budget deficit to about 5.5 percent of the GDP in 2018-19. In addition, monetary policy will have to be more contractionary in character with a hike in interest rates and restrictions on Government borrowing from the SBP. Also, strong actions will be required to reduce losses in PSEs and notify big increases in power and gas tariffs. The latter step has already been partly taken.

48.5. MANAGING PUBLIC FINANCES

48.5.1. Tax Reforms

The current tax-to-GDP ratio of Pakistan is 13 percent of the GDP. Research on the size of the 'tax gap' reveals that this is close to 3 percent of the GDP. Therefore, the target must be to raise the tax-to-GDP ratio to 16 percent of the GDP as soon as possible. Direct taxes constitute only 34 percent of total tax revenues and stand at 4.5 percent of the GDP. Therefore, the fiscal effort will need to concentrate on raising revenues from direct taxes by about 1.5 percent of the GDP, equivalent to half the total increase targeted. This will raise the direct tax revenues to 6 percent of the GDP and increase their share in total tax revenues to 37.5 percent.

One important way of raising tax revenues is to withdraw the 'tax expenditures'. These tax exemptions and concessions currently aggregate to over Rs 1 trillion or 3 percent of the GDP. The potential measures include, first, reducing the personal income tax limit from Rs 1.2 million to Rs 800,000 and raising the maximum rate back to 35 percent. Second, there is need to broad-base further the income tax and substantially increase the number of tax return filers. The 2018-19 Budget has precluded non-filers from purchase of a car or a property valued at more than Rs 5 million. This restriction should be extended to the holding of bank credit cards and to consuming of electricity more than Rs 20,000 per month by domestic consumers. Similarly, companies not filing returns should have their licenses revoked by SECP.

Third, the capital gains tax base on securities and property needs to be extended by lengthening the holding period subject to taxation. Fourth, there is need for development of computerized information base to give collateral evidence on big tax evaders. Fourth, the audit policy should be risk-based and cover at least 10 percent of the returns.

Turning to the sales tax there is need for development of a comprehensive and integrated national VAT. This will require harmonization of the federal tax rate on goods and the provincial tax on services. Further, broadening of the VAT will require taxation of manufacturers on the fixed retail price and not on the ex-factory price, in the case of more consumer goods and consumer durables. The sales tax on services will have to be extended to import of services on the basis of the 'reverse charge' principle.

Regarding import tariffs, the need for more effective protection to domestic manufacturers and to help generate more revenue, the tariff wall may have to be raised somewhat at least temporarily. The suggested move is to raise the maximum tariff to 25 percent from 20 percent currently. There will then be four slabs of 5 percent, 10 percent, 15 percent and 25 percent. The rates of export incentive / duty drawback will have to be adjusted accordingly.

Excise duties tax base can be broadened by taxing industries which are in the nature of 'dangerous and offensive' trades as identified in Municipal laws. A key element of tax policy is the tax rates on motor spirit and HSD oil in the event that oil prices continue to rise internationally. Combined together, the rate of GST should be fixed at 17 percent and the Petrol Levy enhanced. This will imply relatively taxation of motor spirit. This is the practice in all other South Asian countries.

48.5.2. Controlling the Budget Deficit

A new area of concern in public finances is the sharp fall in the non-tax-to-GDP ratio. From a peak of 4.9 percent of the GDP it has fallen to only 2.2 percent of the GDP in 2017-18. This is the principal reason why the net revenue receipts of the Federal Government actually fell in absolute terms in 2017-18. The Federal and Provincial Governments will have to raise charges and fees for water, highways, passports, identity cards, postal and telecom services, etc. The rise in oil prices also provides an opportunity for collecting more from royalties on oil and gas. However, there will be greater pressure for raising the tax-to-GDP ratio to compensate for the lower non-tax-to-GDP ratio.

Current expenditure has shown a rising trend and reached a peak of 17 percent of the GDP in 2017-18. The big increase is in Provincial current expenditure which has gone up from 4.8 percent of the GDP in 2012-13 to 6 percent of the GDP in 2017-18. Given the labor-intensity of provincially provided social services, big real increases in salaries, allowances and pensions have had a disproportionate impact on Provincial budgets. There is a case for imposing a moratorium on increase in emoluments for the next two years, except for low grade employees up to BPS Grade 16.

Defense expenditure has gone up by 0.6 percent of the GDP since 2012-13. This was initiated by the war on terror operations in the form of *Zarb e Azb*. Now that terrorism is on the wane, the Defense establishment may consider a voluntary cut in the budget for the Armed forces.

The overhead costs of the Federal Government may be contained significantly by economy in non-salary operating costs of over 2.5 percent of the GDP. In fact, after the 18th Amendment, there is a strong case for 'downsizing' the Federal Government by reducing the number of Divisions / Ministries and undertaking a 'zero base' budgeting exercise of the over 200 Attached Departments and Autonomous Bodies. Grants which are not mandatory to Provincial Governments should also be reduced.

Turning to the financing side of the fiscal deficit there has been far too much resort to borrowing from the SBP in the last two years, with downstream inflationary implications. This borrowing should be limited to the extent of 'seignorage' in the national economy of about 1.5 percent of the GDP.

Another major constraint has emerged in public finances of the country. The need to limit the size of the fiscal deficit has led to major cuts in the size of the national PSDP. For example, this was targeted at Rs 2001 billion in 2017-18. The actual expenditure has been Rs 1456 billion, implying a cut of almost 27 percent. Now in the Revised Budget for 2018-19, the Federal PSDP has been reduced once again by 28 percent. This is happening at a time when the requirements of funds for infrastructure are peaking with lumpy investments in dams, upgrading of the electricity transmission and distribution system and CPEC projects. This should increase the pressure to cut back current expenditure to divert more resources for development.

48.5.3. Public Debt Management

Total public debt has been rising exponentially since 2007-08 with an annual growth rate of almost 15 percent. Consequently, the public debt-to-GDP ratio has reached 72.5 percent of the GDP, as of end-September 2018. This is way above the limit imposed by the Fiscal Responsibility and Debt Limitation Act of 60 percent of the GDP.

There have been serious flaws in the management of public debt. During the tenure of the IMF Program, the share of permanent (long-term) domestic debt was pushed up from 23 percent to 37 percent at a time when interest rates were at a peak. Since 2015-16, the trend has been opposite with a shift to floating (short-term) debt. Now, with this overhang of maturing debt at a time when interest rates are rising sharply, the cost of debt servicing is bound to rise sharply.

There is a dire need for strengthening public debt management capacity in the Ministry of Finance. Also, the focus on unfunded debt must increase. National savings schemes should be made more attractive, with wider access, in order to promote household savings in the country. Earlier, the returns on such schemes were brought down for too much. Consequently, the share of unfunded debt has fallen sharply from 33 percent, a decade ago, to less than 18 percent currently.

The next two sections of focus on improving the Federal structure of Pakistan.

48.6. STRENGTHENING THE FEDERATION

48.6.1. Implementing the 18th Amendment

The salient features of the 18th Amendment are, first, abolition of the Concurrent List and transfer of most of the functions in this list to the Provinces. Second, a new list, the Federal Legislative List Part II, has been created of functions which are the joint responsibility of both Federal and Provincial Governments. Third, some additional fiscal powers have also been given to the Provincial Governments. Federal Legislative List Part I has functions to be performed exclusively by the Federal Government.

The planning process ought to change fundamentally after the 18th Amendment. It should become a 'bottom-up' process, instead of the old 'top-down' process. Each Province should prepare its own Regional Development Plan. This should be aggregated by the Planning Commission along with the Federal Development Plan and a consistent Macroeconomic Framework developed.

Following the 18th Amendment a sustainable long-run arrangement in the area of higher education should be as follows: HEC continues to perform primarily a regulatory function of setting standards and monitoring their adherence. In addition, Federal universities / DGIs will continue to be funded by the HEC. The 9th NFC Award may make some provision for transfer of additional resources to the Provinces for funding of public universities within their respective domains. Provincial HECs can then begin to perform the financing function. The advantage of this arrangement is that it will separate the regulatory function from financing.

For the first time, there has been recognition of a third tier of Government, the Local Governments. This is articulated in the Article 140A, which states:

(i) Each Province shall by law, establish a local government system and devolve political, administrative and financial responsibility and authority to the elected representatives of the local government.

(ii) Elections to the local governments shall be held by the Election Commission of Pakistan.

Unfortunately, the local government laws passed by the Provinces have not adhered to 140A, with the exception of Khyber-Pakhtunkhwa. The Supreme Court may wish to ensure that this is done.

The Provinces may be granted more autonomy in the planning process. Only those Provincial projects should come up to Islamabad for approval by the CDWP/ECNEC which either have foreign assistance or cost-sharing by the Federal Government. There is a proliferation and duplication of 'populist' social welfare programs at both the Federal and Provincial levels. There is need for avoiding this duplication and promoting implementation primarily at the Provincial level. A number of contentious issues are emerging in the energy sector. It is imperative that these are resolved in the CCI if undue stress on the Federation is to be avoided.

Following the transfer of the sales tax on services to the Provincial Governments, federal excise duties on services must be withdrawn or drastically reduced to avoid double taxation. In fact, in recent years, the Federal Government has been encroaching on various Provincial tax bases, leading to over taxation and erosion of these tax bases. There is need for focusing on development of a national integrated tax system.

Hopefully, the spirit of the 18th Amendment will remain alive and the Federation of Pakistan will find strength from ‘Unity in Diversity’.

48.6.2. The 9th NFC Award

The tenure of the 7th NFC Award came to an end in 2014-15. No new Award has been announced since then despite the setting of the 8th NFC earlier. One of the reasons for the delay may have been the absence of a recent Population Census. Such a Census was completed in 2017 and results have been announced.

Clause (d) of the TOR of the 9th NFC is contentious, relating to the allocation of resources to meet expenditures of AJ&K and Gilgit-Baltistan. These are Federal Territories and should be financed from the Federal share. As such, they do not come under the purview of the NFC. Following the merger of FATA with Khyber-Pakhtunkhwa the expenditure requirement of FATA will be met through the share of the Province. There is need for the NFC Secretariat in the Federal Ministry of Finance to update the data on the horizontal criteria, besides population, at the Provincial level. This is essential if any controversy is to be avoided during discussions of the 9th NFC.

The 9th NFC must recognize that following transfers from the Federal Government, the Provincial Governments are fully autonomous in the utilization of their funds. No conditions must be place on the generation of cash surpluses of a particular magnitude unless the Provinces themselves voluntarily do so.

The 9th NFC must complete the process of implementation of the 18th Agreement. There should be agreement on the remaining functions to be transferred to the Provinces and the Award should cater for the cost of these functions to be borne henceforth by the Provincial Governments.

We move on now to proposals for accelerating the pace of human development in Pakistan.

48.7. ACCELERATING THE PACE OF HUMAN DEVELOPMENT

48.7.1. Progress in Human Development

Pakistan does very poorly in the Human Development Index (HDI) of the UNDP. It is ranked 150th out of 189 countries in 2017 and is the second lowest country in the group of countries with medium level of human development. Also, it has the lowest ranking among the countries of South Asia.

There is a visible slowing down in the growth of social indicators after 2010, despite larger transfers to Provinces, with prime responsibility for health and education, after the 7th NFC Award. The total public outlay on education has increased from 1.7 percent to 2.2 percent of the GDP and on health from 0.6 percent to 1.0 percent of the GDP.

The slow pace of improvement in the HDI despite higher level of public expenditure is the consequence of wrong priorities in budgetary allocation within a social service. In the education sector a pre-mature transition has been made to higher education with a larger share in allocations. There is need to restore the priority of primary and secondary education with the objective of reaching full net enrolment and thereby largely eliminating the number of out of school children. Priorities in the health sector are also distorted. A very large share goes to curative health service and only a small residual share for preventive programs like immunization, pre-and post-natal care, etc. This has also to be altered substantially.

Efficiency generally in the delivery of social services has been adversely affected due to bad governance, corruption and leakages. There is need for more accountability of persons and agencies delivering the services. This makes out a strong case for local governments to be involved in the management and financing of basic social services.

48.7.2. Meeting the SDGS

The SDGs are substantially more ambitious and more diverse than the MDGs. The number of goals has been expanded from 8 to 17 goals. They include focus on new goals like environmental sustainability, industry and employment, reduction in income inequality, strengthening of institutions, etc. There are now as many as 169 targets.

Given the vast number of goals and targets, there is need to prioritize the SDGs in the Pakistani context. It is recommended that 26 targets out of the total of 169 targets be focused on. The criteria used for selection of the sub-set of targets is, first, the target is essential for achieving sustainable and inclusive growth; second, is already embedded as a target in national planning; third, there is greater scope for achievement of the target with co-operation from multilateral agencies; fourth, where regular data on trends is available and where achievement of the target has popular appeal.

As such, the chosen targets relate to poverty reduction, reduction in the stunting and wasting of children; decrease in infant mortality, elimination of HIV/AIDS, Malaria and Tuberculosis; achievement of universal primary and secondary education; elimination of gender inequality in basic education; access to safe and affordable drinking water for all, reduction in income inequality.

SDG units need to be established in the Federal Planning Commission and in the Provincial P&D Departments. Efforts must be made with support from the UNDP for estimation of the cost of achieving the targets. This will provide an assessment of feasibility and the level of international assistance required.

The root causes and the extent of inequality are discussed next along with proposals for a more inclusive society.

48.8. REDUCING INEQUALITIES

48.8.1. State Capture by the Elite

The 'elite' is the conglomeration of rich and powerful groups in society. The process by which 'state capture' takes place is by the promulgation of rules, procedures and laws which confer special privileges and access to these groups or 'vested interests'. These privileged groups include the feudal class, the defence establishment, multinational companies, bureaucracy, urban property owners and developers, trading community, MNA/MPAs and so on.

The feudal class enjoys numerous privileges including a very low agricultural income tax, extremely small water charges, input subsidies, high procurement and support prices and low electricity charges on tube wells. The solutions are obvious, including the levy of the AIT at the same rate as on non-agricultural income and pricing of output at world prices and inputs at their cost or a subsidy in the case of fertilizer. This faces formidable opposition because of the strong representation of the feudal class in the Assemblies.

The military in Pakistan has diversified its role to areas which do not have a link with the defense of the country. Today, the Army is the owner of the biggest conglomerate of housing societies for the upper income groups and of companies producing a variety of goods and services. The Fauji Foundation and the Army Welfare Trust have assets of Rs 382 billion and net profit of over Rs 30 billion. The Chief Justice of the Supreme Court has said recently that the Army ought to be only involved in low cost housing for the common soldier. Also, there are various tax privileges, like the exemption from sales tax in Cantonment Areas.

Multinational companies in Pakistan generally operate behind high tariff walls, set up to attract them. The best example is that of foreign companies assembling and selling automobiles. In addition, there is no vigilance over transfer pricing, especially by pharmaceutical companies. The Chinese companies that have entered Pakistan recently enjoy virtually tax free treatment from all taxes, including income tax exemption of as many as 23 years. The basic principle that ought to be followed is that the difference in treatment of foreign and local companies should be largely the same.

Urban real estate developers and owners also enjoy the benefits of very low taxation including hugely under assessed values of rents and capital value for determination of tax liabilities. Influential property developers have either had vast tracts of land allotted illegally or new development of housing schemes at the urban periphery has been kept outside the tax net because of the lack of extension of metropolitan boundaries.

MNAs/MPAs have been able to legislate generous increases in emoluments and benefits for themselves. For example, the annual cost of the National Assembly has more than doubled since 2012-13. A very unusual and unacceptable practice is the allocation of development funds to MNAs/MPAs, which provides scope for big leakage of funds.

Senior bureaucrats skillfully perpetuate and enhance their salaries, pensions and other privileges virtually on an annual basis. Benefits which have been monetized are subject to very low tax rates or exempt. Recently, a huge tax break has been given to salaried tax payers. Senior officers are also given plots in Islamabad at nominal prices.

The list goes on and on of privileges enjoyed by the elite due to state capture. A conservative estimate of the additional income or increase in wealth that accrues annually to these groups is almost Rs 2 trillion. This implies that the tax and other revenue foregone is over Rs 400 billion. The people have to wait for the time, when this type of mostly legalized plunder of the State will come to an end. This will require a basic change in the power structure and strengthening of democracy with more voice of the people.

48.8.2. Inequality in Income and Wealth

Among different sources of income, the most uneven distribution in favor of the top quintile is in property related income, pensions and home remittances. This makes out a very strong case for progressive taxation of rental income and capital value of property. As such, there is need to develop taxes like the property tax, income tax on property income, stamp duty and capital gains tax on sale of property.

There is evidence of substantial underreporting of income by households in the top quintiles in Household Integrated Economic Surveys (HIES). This is indicative of the high levels of income tax evasion in the country. The revenues from the personal income tax could be over twice the existing level if somehow FBR could sharpen its tools for detection of tax evasion.

The most unequal distribution of personal income is in the Province of Sindh and the least unequal in Khyber Pakhtunkhwa. Therefore, the yield of the personal income tax as a percentage of the provincial GDP should be the highest in Sindh.

An important finding is that income inequality tends to increase in the regime of military Governments and becomes more equal in the presence of a democratic system. The likelihood is that the former tend to form an alliance with powerful segments of society to gain legitimacy and extend their rule. Also, higher growth has been observed during the tenure of military Governments with faster development of the modern and formal sectors of the economy. This increases the share of capital income which accrues mostly to the rich. The economic history of Pakistan highlights an important tradeoff between faster growth and more inclusive growth. Perhaps the objective should be to target for more moderate growth which is based on a strategy and policies for greater inclusion and sustainability.

Recent years have witnessed a big increase in unemployment rate in the case of highly educated workers and some decline in the case of illiterate workers and workers with education up to the secondary level. This is one of the prime explanations for falling inequality.

The distribution of farm land remains extremely skewed in Pakistan. Only 1 percent of the farmers own over 20 percent of the farm area. A redistribution of land would substantially reduce rural poverty. But land reform is no longer part of the policy agenda. A less radical solution would be the development of a very progressive agricultural income tax.

A new class of capitalists has emerged in Pakistan. These are individuals who realized massive capital gains from ownership and trading of shares, especially during the Musharraf era. This is also a reflection of the failure of the income tax system to adequately tax the trading and capital gains accruing in the Stock Exchanges of Pakistan and for SECP to ensure that there is no insider trading.

The emergence of inequality is also manifest in the differential access to publicly provided services. In the context of access to education almost 58 percent of the children in the lowest quintile of families have never attended school. This is one of the basic reasons why inequality is perpetuated on an intergenerational basis. Similarly, immunization service providers consciously avoid low income neighborhoods and *Katchi Abadis*. The spread of major diseases is consequently much higher among children from poor families and the resulting costs incurred are higher. Drinking water through taps is seldom available to low income households in metropolitan cities like Karachi.

The middle class of Pakistan is shrinking, as per an appropriate definition, from 43 percent of the population in 2001-02 to 38 percent in 2015-16. The explanations for this adverse trend lie in the high and increasing unemployment of educated workers and the squeeze on living standards due to rapidly increasing rents and cost of utilities. The Pakistan Tehreek-e-Insaf has been elected on the back of support from the urban middle class. Hopefully, their interests will be catered for more in coming years.

48.8.3. Inter- Provincial Income Inequality

There is a fairly substantial difference in per capita income among the four Provinces of Pakistan as revealed by the estimates of Provincial GDPs and population. Sindh is the only Province with per capita income above the national average, by 22 percent in 2014-15. Punjab, Khyber-Pakhtunkhwa and Balochistan have per capita incomes 4 percent, 6 percent and 45 percent below the national average.

Overall, the evidence is that inter-provincial inequality in income increased sharply in the Musharraf era when Sindh was the fastest growing regional economy with an exceptionally dynamic large-scale manufacturing sector. Inequality has since declined with the emergence of Khyber-Pakhtunkhwa and a relatively better performance of Punjab.

The truly backward Province of Pakistan is Balochistan. It has continued to fall behind. The per capita income of the Province was 26 percent below the national average in 1999-2000. The gap has increased to 45 percent by 2014-15. This probably explains the presence of disgruntled and insurgent elements in the Province. There is need for launching a Special Development Program and for enhancing institutional capacity for better governance.

There is need for understanding the roots of inequality in Pakistan. The 7th NFC Award saw a radical change in the horizontal formula for distribution of the overall share in revenues from the divisible pool of taxes. The shares of Balochistan and Khyber Pakhtunkhwa went up markedly while the big decline was in the share of Punjab.

Why did Balochistan not do better? Perhaps this was due to the burden placed on the regional economy due to Afghan refugees and dislocation of economic activity by more frequent acts of terrorism. In addition, there are issues of lack of institutional capacity for undertaking development activities and also the likelihood of greater corruption. The bottom line, therefore, is improvement in the quality of governance in the Province.

Estimation of the sectoral composition of the Provincial GDPs enables the determination of the sectors in which a particular Province has the comparative advantage. Within the agricultural sector, Punjab has a comparative advantage in major crops and livestock; Sindh in livestock and fishing; Khyber Pakhtunkhwa in livestock and forestry and Balochistan in minor crops, fishing and forestry.

Within the industrial sector, Punjab has comparative advantage in large-scale and small-scale manufacturing and in construction; Sindh in mining and quarrying and large-scale manufacturing; Khyber Pakhtunkhwa in construction and electricity and Balochistan in mining and quarrying and gas.

Among, more or less, autonomous service sectors, Punjab does well in public administration and defense, Sindh in finance, insurance and housing, Khyber

Pakhtunkhwa in housing and social and community services and Balochistan in public administration and defense.

The Provincial Growth Strategies should focus particularly on development of the sectors in which the Province has the comparative advantage. This will maximize the rate of exploitation of the development potential of the country.

The 9th NFC may need to take cognizance of some important developments. In particular, the absorption of FATA into Khyber-Pakhtunkhwa has some implications. FATA is perhaps the most underdeveloped part of the country, with a literacy rate of 24 percent, well below the national average, and poverty incidence as high as 73.7 percent of the population, according to UNDP [2015]. Therefore, the weight in the horizontal distribution formula of backwardness /poverty may need to be raised from 10 percent in the 7th NFC Award and the overall share of Khyber Pakhtunkhwa increased.

48.8.4. Spatial Variation in the HDI

Based on the methodology developed by the UNDP, the Human Development Index (HDI) of the Provinces and districts of Pakistan has been computed. Sindh Province has the highest HDI of 0.565, followed by Punjab at 0.542, Khyber-Pakhtunkhwa at 0.512 and Balochistan at 0.462. The fastest growth in the HDI is observed in Khyber Pakhtunkhwa and the slowest in Sindh. Therefore, inter-provincial disparities have narrowed in the HDI. However, Balochistan remains at a low level of human development and special efforts will have to be made to raise its HDI to above 0.5.

There are large disparities in the HDI at the district level. Only 3 districts (Karachi, Lahore and Rawalpindi) have achieved a high level (HDI > 0.7) of human development. 21 districts are at the medium level of HDI, with the majority of twelve in Punjab. The remaining 95 districts are characterized by a low level of human development (HDI < 0.5). 22 of these districts are in Punjab, mostly in the Southern part of the Province. 21 out of the 25 districts of Sindh are relatively backward. This highlights the sharp duality between the urban centers and the rural areas of the Province. As such, the greatest disparity in HDI is observed in Sindh.

Khyber Pakhtunkhwa has even more districts at the medium level of development than Sind. There are 20 out of the 26 districts of the Province at the low level of human development. These districts are spread throughout the Province, with relative concentration in the North. The unfortunate reality in Balochistan is that all 32 districts of Balochistan, including Quetta, are relatively backward.

Provincial Governments will need to have special programs for development of backward districts in their domain. In addition, Federal Agencies like the BISP, PPAF, NCHD and national NGOs must increase their involvement and support to the people in these backward districts.

48.8.5. The Urban-Rural Divide

A methodology has been developed for decomposing the GDP of a Province into its rural and urban components. The urban-rural divide is then the difference in per capita income between the two parts of the Province.

At the national level, contrary perhaps to expectations, almost 40 percent of the value added in industry and 44 percent of services activity is actually in the rural economy. Consequently, the economic base of rural areas is fairly diversified, with the share of non-farm activities at 62 percent. This, of course, also highlights the forward and backward linkages of agriculture with other sectors. Overall, Pakistan is divided into two, more or less, equal parts with 50 percent of the GDP being generated in rural and urban areas respectively.

The presence of diversified economic activities in the rural areas highlights the need for investment in physical infrastructure and spreading the network of services in these areas. Emphasis will, therefore, have to be given to farm-to-market rural roads, village electrification and gas connections besides rural water supply and sanitation, basic education and health services.

There has been some divergence during the period, 2007-08 to 2015-16, between the growth rate of 4.2 percent of the urban GDP and 2.5 percent of the rural GDP. The difference is smaller in terms of growth rates of per capita income of 0.9 percent. This indicates that the pressure for rural-urban migration may not have been as pronounced as in earlier years.

The urban-rural divide is most pronounced in Balochistan with urban per capita income 169 percent above the rural equivalent. This clearly demonstrates the extreme challenge of developing the rural areas of the Province due to low population density, limited availability of water for agriculture and limited human capital. A perhaps unconventional recommendation is to promote the development of a dispersed network of towns and encourage migration to these centres so that some economies of scale could be realized.

A similarly dichotomy is observed in Sindh Province, though of a less intensive nature. Urban per capita value added is twice that in the rural areas. The urban-rural divide is less visible in Punjab and Khyber-Pakhtunkhwa with the gap of 46 percent and 54 percent respectively. As such, these Provinces are less vulnerable to large rural-urban migration. The disparity in both Provinces, especially in Khyber Pakhtunkhwa, has been significantly reduced by the inflow of remittances into rural areas.

48.9. TACKLING POVERTY

48.9.1. Incidence of Poverty

There is considerable controversy about the trend in the incidence of poverty in Pakistan from 2001-02 to 2015-16. More recent data is not yet available. The cost of basic needs

(CBN) approach to draw the poverty line has been adopted by the Planning Commission, according to which the percentage of population below the poverty line fell rapidly from 50.4 percent in 2005-06 to 24.3 percent in 2015-16. Apparently this has happened when the growth rate of per capita income was only 1.2 percent. This implies a high poverty-growth elasticity of minus -5. This is highly unlikely

The SPDC adopts the same CBN approach on the same HIES data sets but comes up with very different results. Poverty incidence is reported to have fallen only from 2001-02 to 2004-05 and then increased significantly from 30 percent in 2004-05 to 38 percent in 2010-11. Thereafter, it has remained constant up to 2015-16.

The big surprise is that with the same approach the trends identified in the incidence of poverty are so different. Perhaps the Planning Commission is under some pressure for political reasons to show sharply declining poverty.

The OPHDI (2015) has made an attempt to resolve the controversy by adopting a different multi-dimensional approach to measure the incidence of poverty. The results also show a downward trend from 2004-05 to 2014-15 like the Planning Commission, but with a significantly lower rate of decline of 1.6 percentage points annually as compared to 2.6 percentage points annually by the Planning Commission.

An attempt at reconciliation based on the use of other indicators leads to the conclusion that there has been some fall in poverty from 47 percent in 2007-08 in 2005-06 to 37 percent in 2015-16. This implies an annual rate of reduction of 1.2 percentage points and a poverty-growth elasticity of-2. However, the absolute level of poverty remains high at 37 percent and a lot more has to be done to alleviate poverty in Pakistan, especially in rural areas where it stands at over 40 percent. Based on the poverty-growth elasticity of -2, the incidence of poverty is estimated as 32.6 percent in 2017-18. Almost 70 million are still below the poverty line in Pakistan.

48.9.2. Expanding Social Protection

Social protection represents ways of providing support to the poor. There are three types of social protection – social insurance; social assistance and active labor market programs.

The major social assistance programs in Pakistan include the BISP, Zakat and Baitul Maal; price subsidies on basic food items and social protection in the form of pensions to workers provided by the Government or EOBI. The principal labor market program is the provision of microcredit by PPAF and a number of microfinance banks and NGOs. There are also some programs for technical and vocational training.

The total outlay on social protection programs was Rs 624 billion in 2017-18, equivalent to 1.8 percent of the GDP. It has gone up from 1.3 percent of the GDP in 2012-13. The largest spending is on pensions followed by BISP and price subsidies. The share of social insurance is 31 percent, while that of social assistance is 41 percent and 28 percent of employment related programs.

The large number of social protection programs have been evaluated on the basis of a number of criteria including the targeting efficiency, extent of program coverage, ease of access, share of expenditure dedicated to benefits, adequacy of support, income equivalence of transfer, absence of negative incentive effects, extent of self- and progressive finance, degree of independence from private transfers and extent of impact on development. The three Programs with highest scores are the PPAF, BISP and the Government pension scheme for low grade employees.

The proposed reform agenda includes, first, expansion of coverage of BISP to 8 million families out of the total of almost 11 million poor families. In addition, the monthly supplement needs to be raised by 20 percent to account for inflation. This will raise the budgetary outlay for BISP to Rs 163 billion. In addition, BISP may act as the social platform for conditional cash transfers like sending the girl child to school and child immunization.

Second, the EOBI may consider enhancement of the minimum pension amount and inviting self-employed workers to participate on a contributory basis. Also, a special pension scheme can be developed for Pakistani expatriate workers through the SLIC like India.

Third, persons who qualify with a diploma from accredited technical or vocational training program may be given automatic access to micro-credit. The training should include a module on entrepreneurship and preparation of a feasibility report on a small project.

Fourth, only 10 percent of potential microcredit borrowers are currently covered. A tax credit scheme may be introduced for commercial banks and other financial institutions equivalent to 5 percent of the increase in credit to wholesalers of microcredit like PPAF and Micro Finance Banks.

Fifth, the unemployment rate among graduate or post-graduate youth is high and estimated at over 20 percent. There is a dire need for special programs for such youth. These could include internships for these youth with high performance rating in their education. Also, a tax credit of up to 10 percent of the salary and allowances of recently hired graduate youth may be given to employers for the first two years of employment.

The function of 'social welfare' has been transferred to Provincial Governments after the 18th Amendment. Therefore, both Provincial and Federal Governments must cooperate in the design, execution and finance of social protection programs. Programs should ideally be national in character to ensure the same benefit throughout the country. The recent introduction of the Health Insurance scheme in Islamabad Capital Territory and FATA by the new Government needs to be evaluated carefully if it can be replicated at the national scale.

This final section identifies the required improvements in the quality of governance.

48.10. IMPROVING GOVERNANCE

48.10.1. Governance Scorecard

The World Bank rates countries on the basis of various governance indicators. Pakistan is ranked in the lowest 30 percent of countries in the most indicators including voice and accountability, government effectiveness, regulatory quality and rule of law. It is in the lowest 20 percent of countries in control of corruption. Within the CPIA ratings of the World Bank in the area of economic governance, the poorest rating is in the areas of rule-based governance and focus on removing gender inequality.

A survey of experts, as part of the Governance Report for HEC prepared by IPP (2012), has identified key areas of reforms. First, on the political process and stewardship, there is need for making the structure of political parties more democratic, ensuring that the legislature is more accountable to the public, minimizing decisions by Government on the basis of kickbacks and ensuring that the military is sub-ordinate to the civil Government.

With regard to the relationship between the State and the market the focus mostly is on freeing business transactions from corruption and strengthening the regulatory framework of SBP, SECP and CCP to ensure competitive operation of markets. In the area of dispute resolution two major problems areas identified are ensuring equal access to citizens to justice and establishment of alternative mechanisms for dispute resolution.

A questionnaire was also implemented on a random sample of citizens as a score card on the delivery of services. Within the rural services, the lowest level of satisfaction was reported with services provided by the Police *thana* and the Irrigation department. Similarly, in the urban areas also the Police *thana* was rated very poorly. In terms of quality of residential services, the lowest rating by far was given to gas and electricity supply. Interestingly, the provision of tap water was rated more highly throughout the country.

Negative perceptions are common with regard to the operation of public schools and public hospitals. In the case of the former the problems identified are poor quality of teaching and absence of facilities like drinking water and latrine. With regard to public hospitals, the maximum number of complaints was recorded with regard to lack of medicines and testing facility and too many patients leading to very long queues and not enough beds.

48.10.2. Achieving Good Economic Governance

The process of economic policy making needs to be improved. The apex body of the National Economic Council (NEC) must meet every quarter to focus on important issues of policy and reform like export growth, resource mobilization, etc. Prior to this, specific proposals may be examined by an Economic Advisory Council, chaired by the Prime Minister, including representation of economic experts from outside. The Planning Commission needs to be converted into an in-house policy think tank of the Government rather than just be a project approval institution.

The process of structural reform, especially involving institutional change, is extremely complex and difficult to manage. It has to be properly planned and executed. Given the limited capacity of the implementing bureaucracy, it is necessary to avoid spreading the reform effort too thin and focusing only on areas where the prospects for success are better or the returns are higher.

There is need to adhere to the norms of good budgeting practices. This includes avoidance of off-budget transactions, showing financing items as revenues, retaining earmarked revenues in the FCF, making large supplementary grants without prior Parliamentary approval, retaining refunds to show higher tax revenues, passing SROs on tax exemptions or concessions without adequate scrutiny, carrying too large a portfolio of projects in the PSDP and so on. Also, the role of the PAC in the National Assembly has to be made more effective as a 'watchdog' of financial operations.

An important but seldom emphasized element of good economic governance is consistency in policy making. Reversal of policies under pressure of special interest groups affects the fiat of government. Continuity in policy is essential especially to remove uncertainty in the minds of investors.

Credibility is essential to facilitate the process of economic management. In particular, large-scale manipulation of economic statistics to present a better picture of the economy than is really the case must be avoided. There is a strong case for making the PBS an autonomous institution.

The larger public interest must always be protected. Given the state capture by powerful vested interests any concession leads inevitably to a drain on the exchequer. This necessitates either higher taxation elsewhere or a cutback in expenditure in areas which are generally pro-poor. Alternatively, the Government may resort to excessive borrowing from the SBP, which amounts to printing of more money and higher inflation. This impacts more on the relatively poor. As such, proposals for reform must be subject to proper Parliamentary scrutiny.

A major test of good economic governance is the ability to anticipate and manage crises. This requires the presence of early warning systems, quick policy response times and a willingness to take strong actions to mitigate or reduce the impact of crisis. A recent example is the delay by the new Government in taking a decision to go to the IMF in the presence of a balance of payments crisis. Meanwhile, the stock market crashed. The need for the hour is the development of more sophisticated Management Information Systems, especially in the Ministry of Finance and their use by the ECC.

The next requirement is integrity of the political leadership and different echelons of the bureaucracy. Recently the country has been rocked by scandals of large-scale corruption and money laundering by the NAB at the highest level of the Government. There is need to put in strong laws, institutions and mechanisms for greater transparency and accountability. Among the various measures, there is a dire need to promulgate a strong Right to Information Act, of the type which already exists in India and other countries. Also, the NAB Ordinance has to be amended for identification of proper processes.

Effective delivery of services is an important pre-requisite for successful governance. This may not be achieved frequently due to choice of wrong priorities in public expenditure allocations or the adoption of a flawed strategy for delivery of a service. For example, the increased transfer of revenues to Provincial Governments under the 7th NFC Award did not lead to faster improvement in key social indicators. Also, the large losses of PSEs in different sectors are a prime example of failure in effective delivery of services like electricity, gas, railway and air transport.

Finally, an important ingredient of economic governance is the presence of sovereignty in policy decisions. Historically, Government has passively accepted the prescriptions and conditionalities in IMF Programs. Consequently, there has been little 'ownership' of the reform process. The new Government will be starting discussions with the IMF on a new program. It should prepare a well-thought set of 'homegrown' reforms and negotiate for their inclusion in the Program. This will preserve the initiative with Government in the reform process and increase the motivation for implementation.

48.10.3. Vigilant Regulatory Agencies

The role of a number of regulatory agencies which perform functions in the economic domain has been analyzed. This includes the SBP, CCP, IPO, SECP, NEPRA and OGRA. All Regulatory Agencies have been established under Federal Law. But the regulatory function has been placed in FLL-2, according to which this function is the joint responsibility of the Federation and the Provincial Governments.

There are also a number of regulatory authorities under the Provincial Governments, performing functions relating to food, procurement, environment, etc. the Development Authorities at the local level are responsible for land zoning and other related functions in cities.

SBP has engaged in record level of lending of over Rs 1.2 trillion to the Federal Government in 2017-18. This has felled inflationary pressures. Aggressive intervention recently in the inter-bank market has led to a faster depletion of foreign exchange reserves. SBP has failed also in ensuring more lending by commercial banks to SMEs, agriculture and housing.

Also, the emergence of large accounts with ordinary people for money laundering purposes is a very big failure of regulation.

CCP has largely remained a passive regulator. It has been unable to stop the formation of cartels and restrictive practices in many activities and markets. SECP has had little success in developing a corporate bond market and preventing insider trading in the stock market.

The list of regulatory failures goes on and on of different agencies. It is not surprising that the World Bank ranks Pakistan in the lowest 30 percent of country globally and lower than counties like India, Sri Lanka and Turkey. In comparative terms, a panel of experts gives the highest ranking to SBP, followed by NEPRA. The lowest ranking is of CCP.

The following reforms are required for improving the performance of regulatory agencies:

(i) Regulatory Institutions should be truly autonomous. For example, independence of SBP from the Federal Ministry of Finance is only partial, despite the SBP Act. There is need to insulate the agencies from political influence or to capture by special interests.

(ii) Appointments of members of the Boards should not be by Ministries but by a confirmation process through a Select Committee of the Senate of Pakistan.

(iii) There is some ambiguity in the role of the Ombudsman's Office and Regulatory agencies. The boundaries should be clarified and roles clearly defined.

(iv) Annual Reports of all Federal Regulatory agencies must be presented in the CCI, which in turn presents a report to the Parliament. CCI meetings must be regularly held on a quarterly basis.

(v) All Boards of Federal Regulatory Agencies must have representation from each Province.

(vi) There is need for technical capacity building, especially of the specialized agencies.

(vii) The performance of Provincial regulatory functions needs to be substantially improved, especially in the area of Environment Protection.

Finally, it must be remembered that from the viewpoint of inclusive and sustainable growth, regulatory authorities have a critical role to play.

48.10.4. Establishing Strong Local Governments

The 18th Amendment has formally recognized Local Governments as a legitimate third tier of Government by insertion of Article 140A in the Constitution which states:

> *'Each Province shall, by law, establish a local government system and devolve political, administrative and financial responsibility and authority to the elected representatives of the local governments'*

This was followed by the enactment of Local Government Ordinances by each Provincial Government and elections have also been held. Unfortunately, with the exception of Khyber-Pakhtunkhwa, Article 140A, has not been faithfully implemented.

Three Provinces –Punjab, Sindh and Balochistan - have essentially reverted to the structure of LGO, 1979, with separate Local Governments in rural and urban areas. Punjab has created an Education Authority and a Health Authority in each District with links to the Provincial line departments. In some services, like drinking water (saaf pani), companies at the provincial level have been established. The role of Local Governments is crucial from the viewpoint of ensuring grassroots participation of the people and creating accountability in the delivery of basic services.

The following reforms are recommended:

(i) The Supreme Court may be requested to pass a judgment on whether the Local Government laws of the different Provinces adhere to the provisions of Article 140 A. Accordingly, new laws may be drafted.

(ii) Like the Khyber-Pakhtunkhwa Local Government system, the functions of primary and secondary education, hospitals, clinics and public transport should come under the ambit of Local Government, along with the basic municipal services.

(iii) The Amendment Order of 2006 on Distribution of Revenues and Grant-in-Aid introduced a special provision whereby Provinces were instructed to transfer the net proceeds of 1/6th of sales tax to Local Governments. This amount was to be distributed on the basis of 50.00 percent to Punjab 34.85 percent to Sindh, 9.93 percent to Khyber Pakhtunkhwa (then NWFP) and 5.22 percent to Balochistan. This provision may be considered for incorporation by the 9th NFC in finalizing its Award. This will ensure a flow of at least Rs 300 billion to the Local Governments in the country.

(iv) The Provincial Finance Commissions, which are chaired by the Provincial Finance Minister, must have balanced representation of Provincial and Local functionaries. Inclusive of straight transfers, the target should be a transfer at least 30 percent of Provincial revenues to Local Governments.

The new Government of Pakistan Tehreek-e-Insaf is making an effort to introduce a strong Local Government in Punjab, similar to the system already prevalent in Khyber Pakhtunkhwa. This will represent a big change from the present setup which is characterized by little devolution to the local level.

In conclusion, the reform agenda proposed above is comprehensive and ambitious. Implementation of this agenda will ensure fast, inclusive and sustainable growth in Pakistan.

The book comes to an end here. We conclude with a prayer for a better future for Pakistan and its people.

TECHNICAL APPENDIX

Technical Appendix 1: CONSISTENCY CHECKING OF NATIONAL INCOME ACCOUNTS

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	Sector/Sub-Sector	Indicators for Consistency Check
(20.88)	**AGRICULTURE**	
(5.34)*	Important Crops	• Production Data and Value Added (at constant prices) per unit. [PES]
(2.32)	Other Crops	• Relationship between Growth of Output and Prices (for vegetables and fruits) CPI, ASP] • Relationship with growth in quantity of imports of pulses [PBS] • Growth in exports of fruits and vegetables
(0.61)	Cotton Ginning	• Relationship between growth of cotton output [PES]
(11.76)	Livestock	• Relationship between growth of output of livestock products [PES] • Relationship with growth in consumption of livestock products [HIES, PBS]
(0.---)	Forestry	• Growth in Total Forest Production [PES] • Growth in Output of Wood Products Industry [PBS, QIM] • Growth in consumption of firewood [HIES]
	Fishing	• Growth in Fish Production [PES] • Growth in Fish Consumption [HIES]
* Share of GDP		
(20.30)	**INDUSTRY**	
(2.92)	Mining and Quarrying	• Growth of Output of Gas, Oil Limestone, etc. [PES, EYB]
(10.62)	Large-Scale Manufacturing	• Consistency of weights and growth of individual industries with overall growth of QIM [PBS, SBP] • Relationship with Growth in Consumption of major manufactured consumer products (less net trade) [HIES] • Relationship with Growth in Electricity Consumption by Industrial Consumers
(1.73)	Small-Scale Manufacturing	• Relationship with growth in exports of major small-scale manufacturing industries [PBS] • Growth in the informal sector of manufacturing [LFS]

TECHNICAL APPENDIX 1: CONSISTENCY CHECKING OF NATIONAL INCOME ACCOUNTS (… Contd.)

	Sector/Sub-Sector	Indicators for Consistency Check
(0.93)	Slaughtering	• Growth in Production of Beef and Meat [PES] • Growth in Consumption of Beef and Meat [HIES]
(1.67)	Electricity Generation & Distribution & Gas	• Growth in Electricity Generation [PES] • Growth in Electricity Consumption [PES] • Growth in Gas Generation [PES]
(2.44)	Construction	• Growth in Availability of Cement [QIM, PBS] • Real Growth in Federal + Provincial PSDP [BD] • Growth in Employment in Construction Sector [LFS]
(58.82)		
(18.26)	Wholesale & Retail Trade	• Growth in Output of the Commodity-Producing Sector [PES] • Growth in Volume of Imports [PES] • Growth in Employment in Sector [LFS]
(13.36)	Transport, Storage & Communication	• Growth in Availability of HSD and Motor Sprit [OCAC, PBS] • Growth in Tonnage Handled by the Ports [PES] • Growth in Other Traffic • Growth in Number of Trucks on Road
(3.14)	Finance & Insurance	• Change in Net Rates of Return (the Spread) [SBP] • Growth in Investment in Government Securities [SBP] • Growth in Bank Deposits [SBP] • Growth in Number of Bank Branches [SBP]
(6.75)	Housing Services	• Growth in Number of Housing Units [HIES] • Growth in Rental Expenditure by Households [HIES] • Growth in Availability of Cement
	General Government Services	• Growth in Consumption Expenditure by Federal and Provincial Governments Combined [BD] • Growth in Real Wages [BD] • Growth in Employment [LFS]
	Other Private Services	• Growth in Employment [LFS] • Growth in Revenues from WHT [FBR]

TECHNICAL APPENDIX 1: CONSISTENCY CHECKING OF NATIONAL INCOME ACCOUNTS (… Contd.)

	Sector/Sub-Sector	Indicators for Consistency Check
		GDP BY EXPENDITURE
	Expenditure Components	**Indicators for Consistency Check**
(76.4)*	Private Consumption Expenditure	• Growth in Household Consumption Expenditure at constant prices (HIES)
(11.7)	Government Consumption Expenditure	• Growth in Real Current Expenditure of Federal and Provincial Governments [BD]
(--.8)	Gross Fixed Capital Formation-Private Sector	• Growth in Credit to the Private Sector by the Banking System [MOF] • Growth of Imports of Machinery [PBS] • Growth in Number of Industrial and Commercial Consumers of Electricity [NEPRA] • Growth in Value of Fixed Assets of Companies [SBP] • Growth in WHT on Contractors [FBR]
(3.57)	Gross Fixed Capital Formation Public + Government	• Growth in Federal and Provincial PSDPs [PC]
(1.6)	Change in Inventories	• Growth in Stocks of Agricultural Products
(10.6)	Exports	• Growth in Real Exports of Goods & Services
(13.7)	Imports	• Growth of Real Imports of Goods & Services

Technical Appendix 2: SPECIFICATION OF THE MACROECONOMIC MODEL

A-2.1. THE VARIABLES

The listing of the variables in the model is as follows:

Endogenous Variables*	Exogenous Variables	Policy Variables
• Private Consumption Expenditure (PCE) • Private Investment (PIV) • Exports of Goods and Services (XGS) • Imports of Goods and Services (MGS) • GDP Deflator (PID) • Domestic Price Level (PD) • Tax Revenues (TRV) • Budgetary Expenditure (BGE) • Employment (EMP) • Poverty Incidence (POV) • GDP (YM) • Trade Deficit as % of GDP (TD) • Budget Deficit as % of GDP (BD)	• Home Remittances (HRM) • Unit Value Index of Imports (UVM) • United Value Index of Machinery Imports (UVK) • Unit Value Index of Exports (UVX) • Volume of World Trade (WT) • Population (POP)	• Nominal Interest Rate (NIR) • Public Investment (PUIV) • Public Consumption Expenditure (PUCE) • Exchange Rate Index (ε) (1990-91 = 100) • Discretionary Revenues from Proposals (DRV) • Level of Wages (NWG) • Money Supply (MS) • Level of Non-Tax Revenues (NTR)

*measured at constant prices

Equations are estimated with logarithmic transformation of the variables.

A-2.2. EQUATIONS OF THE MODEL

1. Private Consumption Expenditure

$$\mathrm{PCE} = \mathrm{PCE}\ (\mathrm{YM} + \mathrm{HRM}, \mathrm{NIR}, \mathrm{PCE}_{-1})$$

2. Private Investment

$$\mathrm{IP} = \mathrm{IP}\ \left(\mathrm{YM} = \mathrm{HRM}, \mathrm{NIR}, \frac{\mathrm{UVK}.\,\varepsilon}{\mathrm{PD}}, \mathrm{PUIV}, \mathrm{IP}_{-1}\right)$$

3. Exports of Goods and Services

$$\mathrm{XGS} = \mathrm{XGS}\ \left(\mathrm{WT}, \frac{\mathrm{UVX}.\,\varepsilon}{\mathrm{PD}}, \mathrm{XGS}_{-1}\right)$$

4. Imports of Goods and Services

$$\mathrm{MGS} = \mathrm{MGS}\ \left(\mathrm{YM}, \frac{\mathrm{UVM}.\,\varepsilon}{\mathrm{PD}}, \mathrm{IP}, \mathrm{MGS}_{-1}\right)$$

5. Domestic Price Level

$$\mathrm{PD} = \mathrm{PD}\ (\mathrm{MS}_{-1}\mathrm{YM}, \mathrm{IVWG}, \mathrm{UVIM}.\,\varepsilon, \mathrm{PD}_{-1})$$

6. Tax Revenues

$$\mathrm{TRV} = \mathrm{TRV}\ (\mathrm{YM}, \mathrm{MGS}, \mathrm{DRV}, \mathrm{TRV}_{-1})$$

7. Budgetary Expenditure

$$\mathrm{BGE} = \mathrm{BGE}\ (\mathrm{PUIV}, \mathrm{PUCE}, \mathrm{BGE}_{-1})$$

8. GDP

$$\mathrm{YM} = \mathrm{PCE} + \mathrm{IP} + \mathrm{PUIV} + \mathrm{PUCE} + \mathrm{XGS} - \mathrm{MGS}$$

9. Budget Deficit (as % of GDP)

$$\mathrm{BD} = \frac{(\mathrm{TRV} + \mathrm{NTR} - \mathrm{BGE})\mathrm{PD}}{\mathrm{YM}.\,\mathrm{PID}} \times 100$$

10. Trade Deficit as % of GDP

$$\mathrm{TD} = \frac{(\mathrm{MGS}.\,\mathrm{UVM}.\,\epsilon - \mathrm{XGS}.\,\mathrm{UVX})}{\mathrm{YM}.\,\mathrm{PID}}$$

11. GDP Price Deflator

$$\mathrm{PID} = \mathrm{PID}\ (\mathrm{DP}, \mathrm{UVM}.\,\varepsilon, \mathrm{PID}_{-1})$$

12. Employment

$$\mathrm{EMP} = \mathrm{EMP}\ \left(\mathrm{YM}, \mathrm{XGS}, \frac{\mathrm{NWG}}{\mathrm{PD}}, \mathrm{EMP}_{-1}\right)$$

13. Poverty

$$\mathrm{POV} = \mathrm{POV}\left(\frac{\mathrm{YM}}{\mathrm{POP}}, \mathrm{PI}, \frac{\mathrm{NWG}}{\mathrm{PD}}, \mathrm{POV}_{-1}\right)$$

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